

## **AGENDA ITEM DETAILS**

**Subject:** \*Private Equity Market Update and Program Overview

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### **Background:**

The Employees Retirement System of Texas (ERS) has determined that, over the long term, the inclusion of private equity and debt investments (herein after referred to collectively as private equity or PE) enhances ERS' expected portfolio investment characteristics. Private equity investments have the potential to produce rates of return greater than publicly traded securities, which can increase the Trust's overall long-term expected real return and reduce year-to-year portfolio volatility due to the illiquid nature of the commitments.

During the Joint Meeting of the Board of Trustees (Board) and Investment Advisory Committee (IAC) on August 19, 2008, the Board approved a private equity target allocation of 8%. Subsequently, during the February 26, 2013 Joint Meeting of the Board and IAC, the Board approved an increase to the private equity allocation from 8% to 10% of the Trust's assets. On August 23, 2017, during the Joint Meeting of the Board and IAC, the Board approved an additional increase to the private equity allocation from 10% to 13% of the Trust's assets. The division reviews ERS' Private Equity program at least annually with the Board. As of June 30, 2020, the trust's private equity exposure was 15%.

### **PRIVATE EQUITY PROGRAM REVIEW**

During the August 2019 Joint Meeting of the Board and IAC, the Board approved ERS' Fiscal Year 2020 private equity commitment target of \$800 million with a commitment range of +/- 25% (\$600 million – \$1.0 billion).

As of June 30, 2020, the ERS Private Equity Team has closed on nine fund investments and one co-investment totaling \$534 million. Staff expects to commit an additional \$100 million before the end of this fiscal year, bringing total private equity committed capital for FY20 to \$634 million. From inception through June 30, 2020, ERS has closed on 113 private equity funds and 55 co-investments with commitments totaling \$10.1 billion. Of these commitments, 102 funds and 49 co-investments are currently active representing \$9 billion committed with \$3.2 billion unfunded. From inception through June 30, 2020, distributions totaled \$5.4 billion, of which \$336 million was received in the current fiscal year. ERS has limited partner (LP) Advisory Committee seats in 68 active funds and LP Observer rights in 5 funds.

For Fiscal Year 2021, ERS is targeting commitments totaling \$800 million with a range of +/- 25% (\$600 million – \$1.0 billion). Please refer to the summary tables in Exhibit A regarding private equity fund commitments and portfolio metrics.

ERS Private Equity had a net asset value (NAV) of \$4.1 billion as of June 30, 2020. This represents an increase of \$36 million in NAV over August 31, 2019, increasing private equity exposure to 15.0% of the Trust's assets versus 14.3% as of August 31, 2019.

### **PORTFOLIO DIVERSIFICATION**

The private equity portfolio remains highly diversified. Buyout remains the dominant strategy in the portfolio at 43.4% of NAV, followed by Growth Equity and Venture Capital at 22.0%. As seen in the summary tables in Exhibit A, the Private Equity Portfolio is diversified across geographies with larger exposures to the more established markets of the US (52.4%) and Western Europe (25.6%) followed by Asia Pacific (17.1%) and Latin America (3.0%). Versus prior year, the portfolio saw a geographical

representation shift from the US market, which saw a reduction of 350 basis-points (bps) in its representation to the Western European market (+130bps) and Asian markets (+240bps). As presented to the Board in previous years, ERS' Private Equity Team worked over the past three years to prudently deploy capital in both Europe and Asia. The re-allocation is fruit of the PE's team efforts.

During Fiscal Year 2020, ERS' Private Equity division worked with the procurement team to competitively solicit a private equity consultant that would work with ERS for the next few years. Aksia Torrey Cove (Aksia) was selected by the Board during the Joint Meeting of the Board of Trustees and Investment Advisory Committee on March 11, 2020. The PE division has been working closely with Aksia to onboard the consultant's team to ERS processes and portfolio details and to identify new opportunities for ERS investments, including buyout, growth equity, mezzanine, secondary, distressed debt, venture capital, and turnaround/restructuring funds. The division has been satisfied with Aksia's services.

Throughout FY20, the ERS PE division has worked diligently to identify new managers, as well as commit to new funds and co-investments of existing managers. The team also supported the Internal Audit program's efforts to review the private equity's due diligence activities, monitoring processes, and reporting effectiveness.

As of 2020 FYTD June 30, PE commitments included four new commitments to existing managers (re-ups), five new relationships, and one co-investment. PE division expects to close on another re-up, and two co-investments before the end of the FY20.

### **CO-INVESTMENTS AND SAVINGS**

The PE Team is intently focused on improving the economics of its investments through co-investments and deal structuring (segregated accounts and negotiations). This has led to a significant improvement in third party economics and much greater efficiency in the portfolio. The Private Equity Program averaged 1.7% in management fees and 18.1% carried interest from Fiscal Year 2007 through Fiscal Year 2011, while Buyouts alone averaged 1.8% in management fees and 19.3% carried interest for the same period. Since use of co-investments began in Fiscal Year 2012, the PE program has averaged 1.1% in management fees and 13.3% carried interest for the portfolio. The buyout program specifically has averaged 1.4% in management fees and 16.2% in carried interest during the same period.

From inception, the PE division has executed 43 direct private equity co-investments, one of which closed in FY20, and 12 dedicated co-investment vehicles. Both co-investment structures account for \$1.6 billion in committed capital and \$324 million in realized and estimated fee and carry savings. To date, of the 43 direct co-investments, eight have been mostly or fully exited, returning \$208 million on \$83 million invested, a 2.5x multiple on invested capital. No fees or carried interest have been paid on these eight investments, which is typical of co-investments, resulting in \$30 million in savings. All direct co-investments are expected to deliver close to \$59 million in management fee savings and \$124 million of carried interests (profit sharing) savings over the life of the investments. Dedicated co-investment vehicles represent commitments totaling \$928 million; \$442 million of these commitments have been deployed while \$159 million have been returned. The weighted average age of the co-investment portfolio is 3.9 years. Management fee savings realized to date total \$20 million. The total estimated savings will depend on the outcome of the investments' performance and resulting carried interest savings.

Negotiating fund economic terms has also been a productive source of savings. ERS bilaterally negotiated reduced management fees and/or carried interest for \$1.5 billion of committed capital. Fee offsets and waterfall parameters are also an economically important part of negotiations but ERS is not currently able to track the impact. These negotiations are expected to lead to an estimated \$150 million in total savings, of which \$46.6 million has already been realized. As with co-investments, total savings will depend on the final outcome of the funds' performance and the resulting carried interest savings.

**PORTFOLIO STATUS AND PERFORMANCE** - From inception through June 30, 2020, PE produced a Total Value to Paid in Capital (TVPI) of 1.27x, Distributed to Paid in Capital (DPI) of 0.73x, and an Internal Rate of Return (IRR) of 9.5%. NAV is \$4.1 billion, which represents a \$35 million increase versus the 2019fiscal year valuation mark. The PE portfolio was impacted by the COVID-19 pandemic and the energy crisis, which significantly drove down valuations in the first quarter of the 2020 calendar year. Up

until the end of the CY19, the PE portfolio had seen value growth of almost 4% (excluding capital calls). All private equity strategies had seen growth, with the exception of Energy and Natural Resources, which had already seen a value drop of 9.8%. From December 31, 2019 to June 30, 2020, the PE portfolio saw a reduction of TVPI of 8bps, from 1.36x to 1.27x. Value reduction represented 82% (or 6.6bps) of the drop in portfolio returns while the remainder was driven by the impact of capital calls. Energy and Natural Resources underwent the largest relative percentage drop, as value fell by 26.1%, or \$138 million. Buyout, the largest strategy in the portfolio (43% with a NAV of \$1.8 billion), saw the largest value reduction of \$244 million, which represented a 15.7% drop in value.

Over the first 10 months of FY20, private equity's portfolio underwent a value drop of 7.9%, or \$325 million. Energy and Natural Resource led the relative percentage reduction with a drop of 33.7% (\$194 million) versus its prior fiscal year valuation. Buyout saw the largest value reduction of \$204 million, which represented a 13.8% drop in value versus the PE's portfolio Buyout valuation at the end of the FY19.

The table below depicts the NAV changes from the FY19 valuation to the current FYTD June valuation providing details by strategy and investment type.

#### Private Equity NAV Breakdown FY19 to 2020 FYTD June

Description	Valuation (\$)	Detail Change (%)
<b>2019 FY NAV</b>	<b>4,098</b>	
Capital Calls	652	
Distributions	(336)	
Total Value Delta	(325)	-7.9%
- Secondaries	56	10.7%
- VC & Growth Equity	12	1.7%
- Co-Investments	6	0.6%
- Debt	(2)	-0.6%
- Energy and Natural Resources	(194)	-33.7%
- Buyout	(204)	-13.6%
<b>2020 FYTD June NAV</b>	<b>4,089</b>	

The Private Equity Team continues to evaluate methodologies to compare private equity asset class performance against public markets. Using a Private Market Equivalent (PME) comparison method, ERS' Private Equity Portfolio (as of March 31, 2020) has outperformed the MSCI ACWI IMI +300 basis points in all measurement periods seen below.

#### Private Equity PME Performance Comparison Summary As of March 31, 2020

Period in Years	ERS PE Portfolio IRR	MSCI ACWI IMI PME +300 bps	ERS vs. Benchmark
1	-3.5	-12.3	+861 bps
3	7.1	1.5	+564 bps
5	8.6	2.9	+570 bps
10	10.2	5.9	+432 bps

As of March 31, 2020, private equity has produced a TVPI of 1.28x, DPI of 0.73x, and an IRR of 9.8% since inception.

The Private Equity Team also conducts a Time Weighted Return (TWR) peer comparison of the PE portfolio's performance. The Whilshire Trust Universe Comparison (TUCS) report shows the TWR

performance of a subset of public pension plans with PE programs above \$5 billion. TUCS is used to establish a benchmark for the ERS PE program. As seen in the table below, with the exception of the one year comparison, ERS private equity has ranked in the top quartile in all measured periods evaluated below.

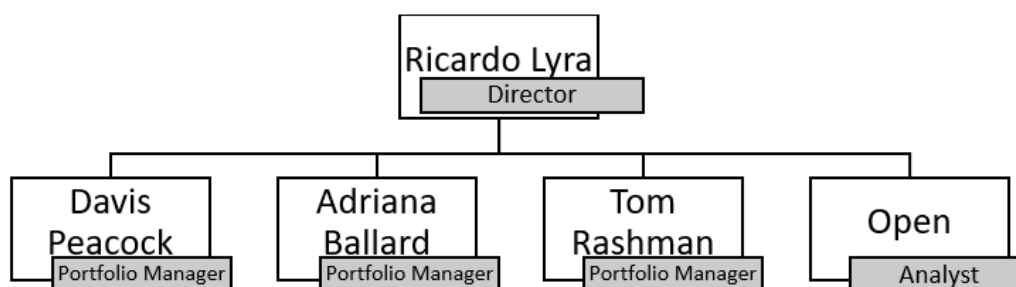
**Private Equity Peer Performance Comparison Summary  
March 31, 2020 TUCS Report**

Period in Years	ERS PE Portfolio TWR	\$5B Public Plans 1 <sup>st</sup> Quartile	ERS vs. Peer 1 <sup>st</sup> Quartile
1	5.4	9.7	-431 bps
3	12.0	11.8	+17bps
5	11.2	10.3	+87 bps
10	12.5	11.6	+87 bps

As of March 31, 2020 ERS' Private Equity Portfolio holdings consisted of 2,818 portfolio assets (1,673 are portfolio companies not in fund-of-fund like vehicles) with an aggregate unrealized value of 1.2x cost. From 2007 through March 31, 2020, ERS has returned 2.0x cost on its 610 realized portfolio transactions. The long term assumption for ERS private equity's Buyout transactions is 1.8x cost.

**PRIVATE EQUITY TEAM**

Wesley Gipson, the previous Senior Managing Director of Private Equity, left ERS on August 31, 2019. Ricardo Lyra served as Interim Director through December 1, 2019. He has since been promoted to Director. Tom Rashman joined the Private Equity Team as a Portfolio Manager in early January 2020. The team expects to hire an additional analyst during Fiscal Year 2021.



This agenda item is presented for information and discussion purposes only. Aksia has provided a market overview as Exhibit B. No action is required.

*\*ERS is accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees for continuing education.*

**ATTACHMENTS – 2**

1. Exhibit A – Private Equity Portfolio Commitments and Summary Tables
2. Exhibit B – Aksia Private Equity Market Review
3. Appendix\_Co-Investment Portfolio Statistics