



# Private Equity Audit

## #2019-07

August 19, 2020

From the Director

Internal Audit has completed its Private Equity audit at the Employees Retirement System of Texas.

Based on the audit scope areas reviewed, internal controls are effective and provide reasonable assurance that most key goals and objectives will be achieved despite improvement opportunities identified. The improvement opportunities identified are likely to impact the achievement of ERS' strategic direction.

- 1) Additional information communicated in the Annual Asset Class Review would improve clarity (Significant)
- 2) Private Equity investment classification process should be improved (Moderate)
- 3) ICP Private Equity goals and procedures are not fully developed (Moderate)

Detailed results and observations are included in subsequent pages. Other matters deemed less significant were communicated with management directly. We thank management and staff of the divisions for their courtesy and cooperation extended to us during the review.

Sincerely,

**Anthony Chavez, CIA, CGAP, CRMA**

*Director, Internal Audit Division*

## ERS Internal Audit Division

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## Objective

The overall objective of the audit was to determine if investments in private equity are in accordance with ERS Investment Policy.

### Portfolio Management

1. Has the portfolio been adopted to meet investment objectives?
2. Are processes in place to manage and mitigate portfolio risk?

### Investments

1. Do investment recommendations communicate relevant information?
2. Is information validated?
3. Are investments properly authorized?

### Governance

1. Is information presented reliable to facilitate proper oversight?
2. Is portfolio performance and management explained to promote transparency?
3. Does performance incentive align with portfolio objectives?

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## Conclusion and Summary Results

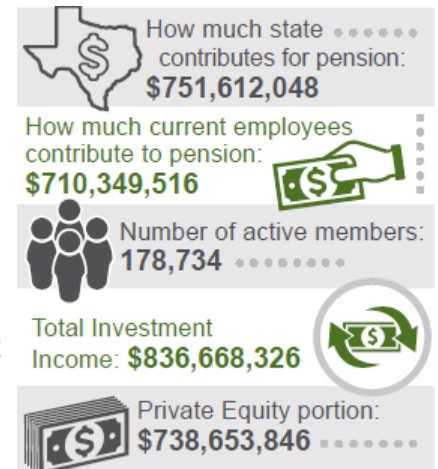
OVERALL ASSESSMENT		SATISFACTORY
SCOPE AREA	RESULT	RATING
<b>Portfolio Management</b>	Observation #2: Private Equity investment classification process should be improved (Moderate)	Satisfactory
<b>Investments</b>	The investment selection process is comprehensive and provides accurate information for the Investment Committee's review and approval of new investments.	Satisfactory
<b>Governance</b>	Observation #1: Additional information communicated in the Annual Asset Class Review would improve clarity (Significant) Observation #3: ICP Private Equity goals and procedures are not fully developed (Moderate)	Needs Improvement

Achieve target returns within risk tolerance—Private Equity Program Objective

## Background

ERS' Private Equity portfolio began in 1998 and as of August 2019, has closed 109 private equity funds and 48 co-investments with commitments totaling \$7.7 billion. Distributions to the portfolio have totaled \$4.9billion, with \$738M being received in FY19.

ERS' private equity investments are made in a manner consistent with the entire portfolio and the exclusive benefit requirements of the Texas Constitution. The selection and management of private equity assets are required to maintain diversification of assets, and to preserve investment capital. The diversification objective is required to manage overall market risk and the specific risks inherent in any single investment or management selection.



## What is Private Equity

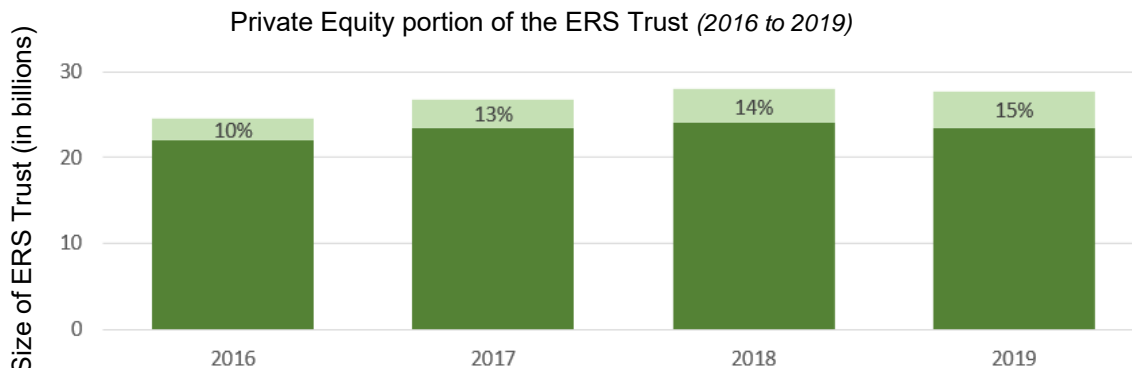
Private equity investments involve the purchase of unlisted, illiquid common and preferred stock, and to a lesser degree, subordinated and senior debt of companies that are privately held.

Private equity assets are investments in funds where the pension plan is a Limited Partner (LP) with limited liability and limited decision making ability. Decisions are made by the General Partner (GP). The GP invests in companies on behalf of the partnership. These investments are long term, typically ten years or more. New investments into an investment portfolio company are generally made in the first five or six years, and the typical amount of time the GP holds each company is four to six years. The GP has complete discretion to make investments and liquidate them, within the bounds of the limited partnership agreement.

An investment in private equity means a commitment of pension funds. No money changes hands initially; the commitment is a promise to fund future investments and certain expenses. When the GP needs money, they send a capital call requesting funding. The limited partners (ERS) transfer cash to the GP, referred to as a capital draw. The GP then invests in portfolio companies and works to increase the value of the company through financial engineering, growth and operational improvements. When the GP sells the company, proceeds are distributed back to investors which are called distributions. Final returns can take up to ten to 12 years.

# Key Facts and Figures

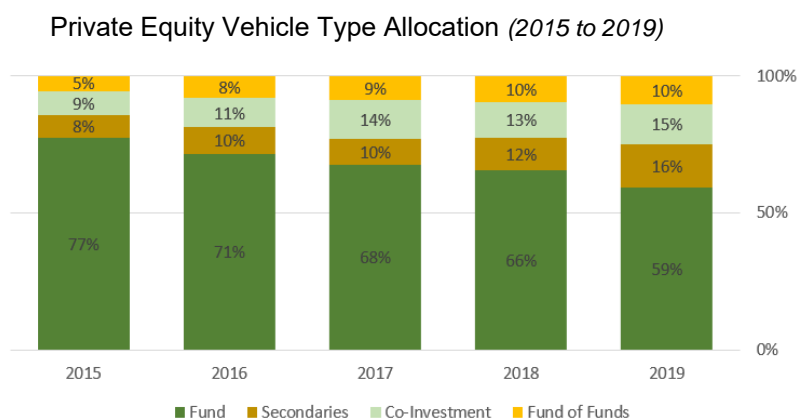
## Size of Private Equity to the total Trust



Over the last four years, the Portfolio has increased in value with the Private Equity portfolio incrementally increasing its portion of the total trust

## Tactical Planning

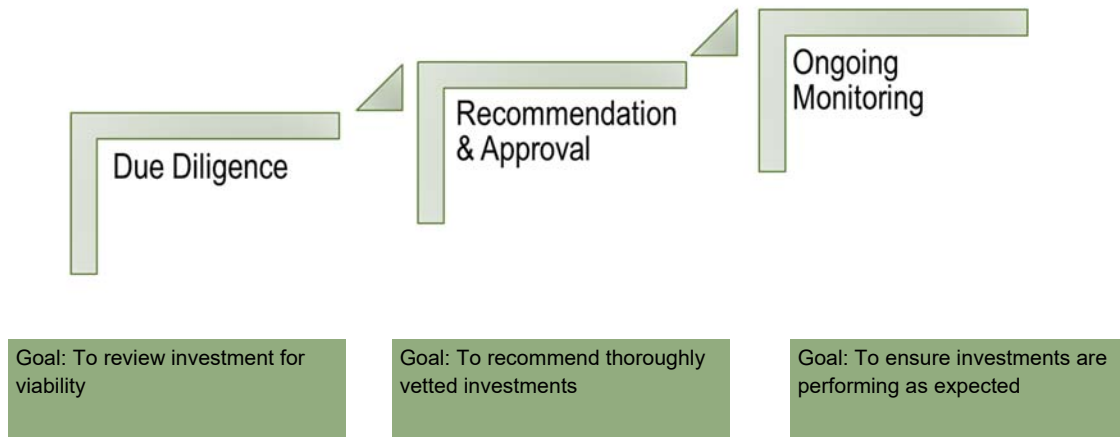
The private equity program is guided by the Private Equity Guidelines and Procedures. In accordance with the guidelines, staff prepare and present to the Board for its review and approval an Annual Tactical Plan. The plan reviews the current status of the portfolio, recent historical and prospective market conditions and proposes the steps to be taken over the next 12 months to implement the private equity program. The plan include the types and number of investments to be sought as well as any other actions or considerations germane to the success of the program.



The above graph illustrates the most recent five years allocation of the portfolio by investment vehicle type

## Investment Selection Process

The first part of the investment process is the due diligence performed over a potential investment. This is a very detailed process that includes reviewing information over commercial, financial and legal components of the general partner. ERS performs a review confirming information received is accurate and then creates a packet of information for the Asset Class Investment Committee (ACIC) review and approval of the investment. The investment information is routed to Burgiss, ERS' Investments portfolio software, for inclusion into the portfolio. Then continuous monitoring ensuring investments are performing as expected.



## Private Equity Control Activities

### Private Equity staff perform key controls including:

Find and retain access with the best general partners to retain relationships that fit into the overall ERS investment strategy—Phone conversations with GPs and their staff—Attendance at annual meetings—Attendance at advisory board meetings—visits to GP's offices and meeting their extended staff—Meet management teams from the portfolio companies and occasionally visit the companies to review operations—Review and approve/reject proposed amendments, consents and elections of the LP agreements—Routinely monitor and review events that affect the GPs and the partnership performance—Search for new deals—Due diligence—Staff due diligence is a continual process that goes on with all relationships—Formulation of overall program strategy and portfolio construction

# Observations and Recommendations

## 1. Additional information communicated in Annual Asset Class Review would improve clarity. (Significant)

To assist with Board oversight, an annual asset class review is presented by the Private Equity team. Information presented includes, but is not limited to, investment returns (performance), investment risks, portfolio costs and portfolio implementation decisions.

**Transparency** comes from accurate, timely, and clear reporting to the Board of the Trust's assets, investment returns and risks, portfolio costs, and portfolio implementation decisions made by Staff —*ERS Investment Guidelines*

Evaluation of the annual private equity review identified the following:

**Investment Returns (Performance)** The unique characteristics of private equity investments—the reporting lag, the long lock-up of capital and the impact of the J curve, make performance measurement and benchmarking difficult. Investment performance can be assessed at the aggregate portfolio (summary) level and at the sub-component (investment) level. Summary performance was determined to use best practice benchmarks including peer group comparison and public market equivalent (PME). Best practices have identified PME as key benchmark as it addresses the question, **“Was the decision to allocate capital to private investments a good one?”** The PME benchmark incorporates an appropriate public equity index. The Institutional Limited Partners Association recommends including a premium above the returns of public equity to reflect the additional compensation that an institution both requires and expects to be able to achieve when taking on illiquidity and other risks of private equity. ERS Investment Policy also notes the role of private equity illiquidity premium. Historically the premium used by ERS was 300 basis points. The May 2019 adopted Investment Policy removed this premium and currently no premium is included in PME.

- Private Equity Governance Activities**
- Annual Asset Class Reviews
  - Quarterly Summary Board Reports
  - Primer for new Board members

Performance Benchmark	Performance Metric	Benchmark
Peer Comparison (Peer)*	Relative performance to other public pension private equity portfolios	Wilshire Trust Universe public pension private equity portfolios > \$5 billion NAV
Public Market Equivalent (PME)**	Relative performance to a public market index	ACWI IMI
* Policy Benchmark		
** Reference Index used for comparison purposes to assess performance against other benchmarks that are not the policy benchmark.		

Additional observations identified to improve clarity and understanding of portfolio investment performance drivers:

Sub-component Level - While PME and Peer Comparison measure overall portfolio performance, performance measurement at the sub-component level evaluate the sources of performance within the portfolio and address the follow questions:

- Did we make good decisions within the portfolio across strategies, sectors, geographies and vintages?
- Did we select good fund managers (General Partners)?

Best practices suggest a pooled performance attribution process which segments the portfolio by different attributes such as vintage year and investment type. This pooled performance attribution methodology is utilized by the Private Equity team when performing due diligence of general partner performance at a more granular level. In the 2019 annual review private equity portfolio returns for 5-year and 10 year performance were 12.0% and 12.4% respectively. However no additional information was communicated as to which investment strategies have been the best performers within the portfolio and how this will impact investment decisions going forward. Quarterly reports will provide quartile performance by individual investment (Fund).

**Portfolio Management** Private Equity is a complex asset class with a large mix of available investment types. Investment guidelines have been established to assist with portfolio management including eligible investment types and diversification requirements:

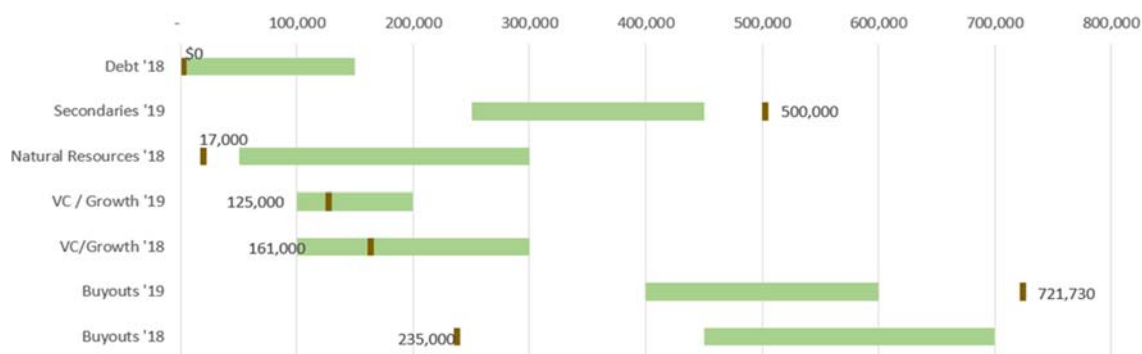
- Strategy—Venture capital & growth equity, buyout, debt, energy & natural resources, secondaries, special situations
- Geography—Domestic and internationally
- Industry Sector—Varying sectors like biotechnology, computers, financial services, healthcare, medical, media/communications, electronics, software, consumer/retail, etc.
- Life cycle— Commitments staged over time
- General Partner—Varying investment sponsor organizations

Investment Philosophy	Implementation
Disciplined	<ul style="list-style-type: none"> <li>• Capital deployed on a set schedule</li> <li>• Focus on meeting private equity sub-asset class targets</li> </ul>
Opportunistic	<ul style="list-style-type: none"> <li>• Focus on selecting best fund managers (general partners) independent of sub-asset class</li> </ul>
Hybrid (ERS Approach)	<ul style="list-style-type: none"> <li>• Multi-year portfolio plan with inherent flexibility</li> <li>• If access available to a quality fund manager, flexibility allowed to deviate from the plan to take advantage of the opportunity</li> </ul>
ERS Private Equity Board Primer	

The following observations were identified to improve clarity of portfolio implementation decisions made during the review period:

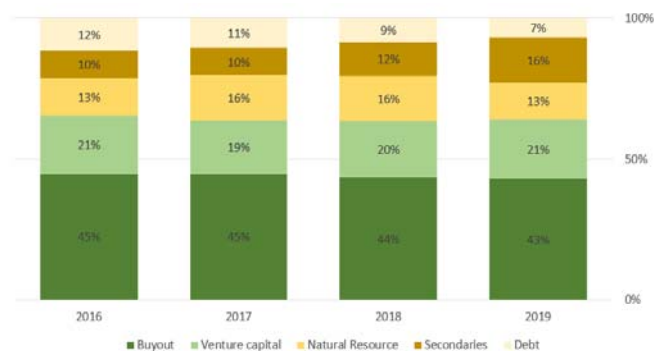
Tactical Plan Implementation Decisions The Tactical Plan is the estimated mix of investment types and amounts to reach/maintain long-term target allocations (13% of Trust) for the current year. It is not a set investment schedule and the private equity portfolio team is granted flexibility by the Board to take advantage of opportunities as they arise. Currently, the annual overview nor tactical plan discuss implementation decisions made in the prior year including comparison between committed and actual investments, explanation of variances, and impact on future flexibility. For example in the 2019 Tactical Plan, the private equity team exercised flexibility and made much larger investments in Buyouts and Secondaries than what was scheduled. Communication of implementation decisions and rationale will help improve the transparency and oversight of the program.

Tactical Plan Ranges-to-Actual FY18 and 19 (in millions)



**Diversification Levels** The Board has established diversification ranges and limits as a risk management control. The private equity team reports on compliance with diversification limits including the percentage for each investment type. The private equity portfolio has maintained compliance with all diversification requirements. However the annual asset class overview does not report diversification relative to target allocations nor diversification level trends. Discussion of relative diversification would promote transparency by identifying the investment vehicle types the private equity team has determined to emphasize/deemphasize (overweight/underweight). Review of current diversification levels identified the portfolio is relatively neutral and has maintained these levels over the last several reporting periods. The portfolio team has recently targeted Secondaries with reduced holdings in Debt the last several reporting periods. (See Observation #2 for further information on investment type classifications.)

Private Equity Strategy Allocation (2016 to 2019)



- Target allocation percentages for Investment Strategy diversification levels do not equal 100%. Total target allocation equals 105% (excluding Specials Situations). Per Private Equity Guidelines portfolio managers will seek to manage the allocations to the mid-point of the ranges.

Strategy	Target Allocation	Diversification Range	2019 Diversification
VC - Growth Equity	20%	10-30%	21%
Buyouts	47.5%	35-60%	43%
Debt	7.5%	0-15%	7%
Secondaries	17.5%	5-30%	16%
Energy & Natural Resources	12.5%	5-20%	13%
Special Situations	2.5%	0-5%	0%

**Portfolio Costs** The ERS Investment Policy states costs matter and need to be effectively managed. Decisions to invest cannot be made without considering costs, and costs must be actively and prudently managed whenever possible to maximize investment returns. Historically the annual overview has included private equity management fees and carried interests by commitment year and realized and forecasted cost savings based on investment efficiencies, but has not included the following:

- Actual costs (management fees and other expenses) including overall assessment on cost amounts and trends

Fiscal Year	Management Fees	Other Expenses	Total Expenses
FY 2015	\$ 35,233,736	\$ 7,741,670	\$ 42,975,406
FY 2016	\$ 44,028,952	\$ 26,741,212	\$ 70,770,164
FY 2017	\$ 27,333,872	\$ 18,964,075	\$ 46,297,948
FY 2018	\$ 28,631,519	\$ 8,480,903	\$ 37,112,421
FY 2019	\$ 32,483,346	\$ 13,117,048	\$ 45,600,394



- Actual profit share earned by ERS' private equity investment partners. To improve governance, beginning in Fiscal Year 2018, the Texas Government Code required ERS to build a system to calculate, track and report profit share distributed by asset class. In response ERS Investments Operations and Investment Accounting teams verify and track profit share. ERS asset class portfolio managers are responsible for evaluating the reasonableness of profit share earned particularly when variances identified between investment partners reported provide profit share and ERS' recalculations.

<b>Fiscal Year</b>	<b>Profit Share</b>
FY 2017	\$ 12,608,854
FY 2018	\$ 18,417,554
FY 2019	\$ 31,682,773

## Recommendation

The private equity annual overview should be evaluated to ensure the clarity of portfolio activities. The overview should incorporate the following:

- Sub-component performance results to communicate performance attribution of overall portfolio performance results
- Portfolio implementation decisions at an aggregate level including
  - Actual investments for the prior year relative to the approved tactical plan
  - Investment strategies the portfolio team is prioritizing including diversification levels relative to target allocations
  - Multi-year trending of strategy, lifecycle, industry sector, general partner and geography
- Communication and discussion of portfolio costs

## Management Action Plan

**Responsible Position:** Ricardo Lyra, Private Equity Director

**Implementation Date:** August 31, 2021

The Private Equity (“PE”) Program provides detailed reports to ERS’ Board on a Quarterly and Annual basis. Such reports include, and are not limited to, yearly commitments by strategy and economic cost (fee and carried interest) breakdowns. The PE Program’s annual presentation includes, and shall continue to include, return comparisons to its approved benchmark (TUCS - peer database), to the PE market (Burgiss database) and to the public equities market (ACWI IMI). For the Annual Asset Class Review, the PE Program prioritizes and summarizes the last fiscal year’s most relevant and appropriate data for the Board’s understanding of ERS’ PE Program on a short, medium and long-term basis.

The PE Program, along with the program’s new PE advisor, will review all reports, process and procedures in FY2021 to create a manual of PE operations. Additionally, the PE Annual Asset Class Review will continue to be reviewed and discussed with the PE advisor to make sure it is the best depiction of short, medium and long term accounts of the PE Program.

# Observations and Recommendations

## 2. Private Equity investment classification process should be improved. (Moderate)

Investment classification is the process of sorting investments according to shared qualities or characteristics. Proper classification of private equity securities into various sub-groups (categories) is a key process in portfolio risk management and investment performance assessments. For the private equity portfolio, five primary categories have been established and defined. In addition diversification metrics have been established for each category to measure and manage portfolio risk.



Annually diversification metrics are reported to the Board to ensure prudent diversification of investments in accordance with ERS Investment Policy. However, observations were noted in the Strategy sub-group and the process to classify investments per definitions. Specifically the following observations were identified:

**Group (category) Definitions** For the private equity portfolio five primary sub-groups (categories) have been established and defined for tracking, monitoring and reporting. Review of each private equity Strategy group identified the following:

### ERS Private Equity Diversification Categories

- Strategy
- Sector
- Geography
- General Partner
- Vintage Year

**Private equity classification process not formalized** Private equity investments are complex. It is important to have a classification process that is systemic and is clearly communicated to ensure consistent and accurate classification. The current private equity classification process is based on private equity team member’s evaluation of the fund’s documents and strategy followed by identification of which approved group it should be allocated to. Industry practices suggest a rules based approach that follows a specific sequence of criteria to determine final classification to promote a repeatable, consistent and more objective investment classification.

When compared to Burgiss, ERS’ third-party private equity service provider, investment classifications for 86 of 114 private equity investment sub-asset class/strategy classifications aligned. Note: Investments classified as Secondaries by ERS and investments not tracked by Burgiss were not included in analysis. Of the 28 investments that did not align by sub-asset class/strategy the two primary characteristics were:

- 1) Funds with a mixture of multiple investments in asset classes/strategies primarily such as Buyouts and Venture Capital & Growth Equity.
- 2) Buyout and/or Venture Capital & Growth Equity funds that invested in real assets (oil and gas industry; hotels/resorts)

ERS Classification	Burgiss Classification	Number of Instances
Growth Equity	Buyout	12
Natural Resources	Buyout	4
Natural Resources	Mezzanine	3
Debt	Special Situation	2
Buyout	Venture Capital	2
Buyout	Real-Estate	2
Buyout	Special Situation	2
Buyout	Distressed Securities	1

**What is Burgiss?** Burgiss is a research-quality database for private capital funds. The data assists investors managing, measuring and reporting on private investments. Burgiss provides benchmarks and risk models from and has performance data on 10,000 institutional funds covering \$7.3T in committed capital.

To help address these investment scenarios, Burgiss established the following guidance:

Investment Classification Scenario	Taxonomy Guidance
Funds invest in a mixture of sub-asset class such as Buyouts and Venture Capital/Growth Equity?	The category with the majority of capital invested (70%) minimum is selected.
Control buyout and growth capital funds investing in the oil and gas industry? Control buyout/growth capital funds investing in travel and leisure businesses (hotels/resorts, clubs)?	Are the underlying investments companies? Do the companies derive value primarily through their underlying tangible assets?

Guidance noted above is providing an example of an industry practice for classifying investments. It is not required nor recommended that the ERS private equity classification process incorporate Burgiss parameters. The example above provides a control framework to assist in developing a classification process that aligns with ERS investment goals and objectives.

*Inclusion of Secondaries in the Strategy Group should be further clarified.* In December 2017 Secondaries was formally added to the Private Equity Strategy group and a target allocation assigned. Rationale for adding Secondaries as a line item within the Strategy group was that these investments were becoming a larger segment of the portfolio. While investment in Secondaries is an investment strategy, it does not share the same characteristics and attributes of other elements in the Strategy grouping. Items within a group should be **distinct** and **independent** from each other to ensure proper diversification. ERS Investment Guidelines defines Secondaries as:

**ERS Private Equity Strategy Group**

- Buyout
- Growth Equity & Venture Capital
- Energy & Natural Resources
- Secondaries
- Debt
- Special Situations

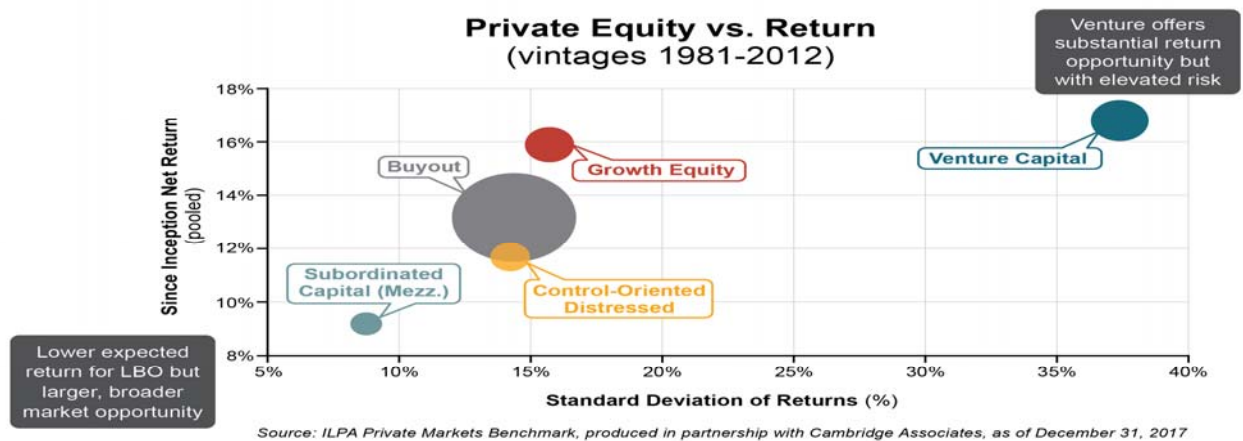
*“Partnerships that have been acquired from other limited partners and typically have had their capital called to greater than 50% of commitments. **These partnerships can include any of the Private Equity strategies.**”*

Review of ERS Private Equity benchmark provider Burgiss identify items listed in the Strategy group as sub-asset classes within the private equity asset class. Secondaries were not included in this grouping.

Sub-Asset Class vs. Investment Vehicle Type			
Sub-Asset Class	Characteristics/Attributes	Investment Vehicle Type	Characteristics/Attributes
<ul style="list-style-type: none"> <li>• Buyouts/Acquisition</li> <li>• Venture Capital &amp; Growth Equity</li> <li>• Energy &amp; Natural Resources</li> <li>• Debt</li> </ul>	<ul style="list-style-type: none"> <li>• Equity or debt</li> <li>• Company or asset focused</li> <li>• Company maturity (developing or developed)</li> <li>• Rating of debt</li> <li>• Seniority of debt</li> </ul>	<ul style="list-style-type: none"> <li>• Primary Funds</li> <li>• Co-investments</li> <li>• Fund-of-one</li> <li>• Fund-of-Funds</li> <li>• <b>Secondaries</b></li> </ul>	<ul style="list-style-type: none"> <li>• Partnership structure</li> <li>• Maturity of the fund (vs asset held)</li> <li>• Marketplace purchased</li> </ul>

Further research of industry guidance identified Secondaries as "the market for the sale of partnership interests in private equity funds". This aligns with ERS definition as "Partnerships that have been *acquired from other limited partners* and typically have had their capital called to greater than 50% of commitments." As such the main attribute of Secondaries is the maturity of investments held in the Fund and the associated J-curve path location.

One challenge with Secondaries is they tend to invest in multiple sub-asset classes (no strategy class accounting for more than 50%). Of the current ERS Secondary Funds, Burgiss identified 9 of 16 as "Generalist" and did not meet the threshold to be classified in any particular sub-asset class.



## Recommendation

A formal classification methodology should be developed and adopted including:

- Rules based guidance when investments may have a mix of multiple strategies, such as buyouts and growth equity
- Rules based guidance when investments may be in buyout funds that invest in real asset industries, such as energy and natural resources or real estate
- Evaluate the inclusion of Secondaries in the strategy grouping, and how this aligns with intended investment diversification objectives
- If Secondaries are to remain in the strategy group, adopt a rules-based guidance when Secondaries invest in the other strategies

## Management Action Plan

**Responsible Position:** Ricardo Lyra, Private Equity Director

**Implementation Date:** August 31, 2021

Proper allocation of capital within the PE portfolio is a critical factor in portfolio development and management. Strategies are defined by their investment processes, return profile, cash flows, fit in capital stack, level of risk, etc. Deep and broad analysis is conducted for each individual commitments and investment prior to it being assigned a strategy. The PE Program's understanding of individual strategy assignments is based on, and not limited to, the due-diligence process as well as analysis of historical and expected future deal flow.

The Burgiss platform, the PE Portfolio's main database and data management system, will continue to help in the management and allocation of the PE Portfolio data. Yet, it is likely that the PE Program's strategy assignment will, in a small number of instances, diverge from Burgiss' strategy assignment due to particularities of the PE Portfolio, such as the PE Programs developed Secondary strategy.

The PE Program, along with the program's PE advisor, will review all reports, process and procedures in FY2021 to create a manual of PE operations. This project will include explanations of defining factors for each strategy to clarify doubts and avoid external misinterpretation of capital allocation.

## Observations and Recommendations

### 3. ICP Private Equity goals and procedures not fully developed.

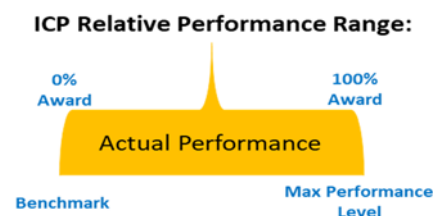
Private Equity Incentive Compensation Plan (ICP) goals are based on industry best practices for private equity performance benchmarks and incorporate Board approved private equity portfolio benchmarks. Private Equity ICP performance goals account for 50% of total ICP potential awards for the ERS Private Equity team and include the following two goals:

The ICP provides meaningful incentive to participants who excel in implementing ERS' investment activities.

Private Equity ICP Goal	ICP Portfolio Weight	Performance Metric	Benchmark
Peer Comparison (Peer)	40%	Relative performance to other public pension private equity portfolios	Wilshire Trust Universe public pension private equity portfolios > \$5 billion NAV
Public Market Equivalent (PME)	10%	Relative performance to a public market index	ACWI IMI

Rationale and support for specific ICP related provisions should be formalized including:

**ICP award ranges** ICP award ranges establish when performance compensation will begin (0% realization) and max out (100% realization). For ICP purposes, awards are realized when performance begins to exceed established benchmark and capped based on active risk budget per the ERS Investment Policy. A max performance level is established to protect against unnecessary risk taking. The private equity primary risk control of diversification levels are not conducive to establish a max performance level for ICP purposes. As such max performance levels have been specifically developed for ICP purposes. Observations for ICP award ranges include:



- **Peer Comparison**—Establishment of the maximum performance level of 37.5<sup>th</sup> percentile should be further explained and supported in ICP Performance Memo to evaluate appropriateness. When evaluating general partners and individual funds, top quartile are those performing in the 25<sup>th</sup> percentile range and above.

Private Equity Peer Comparison

	Maximum	Realized	% Realized
<b>FY 2016</b>	\$ 102,083	\$ 82,994	81%
<b>FY 2017</b>	\$ 120,761	\$ 96,194	80%
<b>FY 2018</b>	\$ 148,296	\$ 148,296	100%
<b>FY 2019</b>	\$ 120,297	\$ 68,292	57%

Note 1: Realization is percent of maximum award earned.

Note 2: ICP Awards reported are for Private Equity Team only.

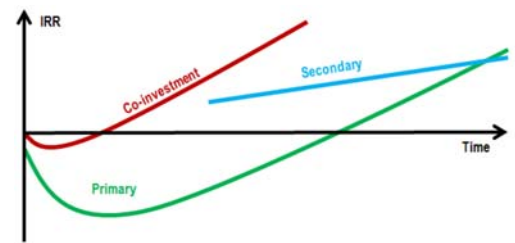


- Public Market Equivalent

**PME Benchmark Premium** - Establishment of the maximum performance level should be further explained and supported in the ICP Performance Memo. The Institutional Limited Partners Association (ILPA) recommends for a PME benchmark limited partners like ERS incorporate a premium above the returns of public stocks to reflect the additional compensation expected to be achieved when taking on illiquidity and other risks of private equity. The Board previously approved a PME benchmark of ACWI IMI (index) + 300 bps (premium) based on a time-weighted return (TWR) calculation. The ICP calculation is based on an Internal Rate of Return (IRR) and includes no premium. Review of industry practices could not identify the exclusion of a PME premium when utilizing an IRR calculation.

**PME Goal Performance Period and Associated Adjustments** - The PME performance goal incorporates a “since-inception” ICP performance period rather than 1, 3, and 5 year performance as described by ICP policy. A since inception performance period is an industry best practices because of the longer-term horizon for private equity investments to mature. The since-inception time period vs. 1, 3, 5 year should be noted in performance goal methodology memo approved by Executive Office.

The current PME performance goal methodology also includes a provision to exclude primary funds with vintage dates less than five years maturity to account for the J-curve effect not seen in public markets. Private Equity team estimates that 25% of the portfolio will be in the J-curve. Review of industry practices could not identify primary funds still in the J-curve to be excluded when evaluating PME performance.



Source: Private Equity Board Primer

**PME Goal Calculation Support Documents** - To improve segregation of duties ERS private equity consultant has been tasked with calculating ICP performance goals. Both performance goals were determined to be calculated based on described methodology however for the PME performance goal the following observation noted:

- Three primary funds five years or older and six non-primary funds (Secondaries, co-investments) were improperly excluded from the calculation. Based on the current ICP award range this improper exclusion of investments would not have impacted award. To improve transparency and calculation accuracy the consultant should specifically identify and report in the calculation workbook the primary funds 5 years or younger that were *excluded* from calculation.

**Private Equity Public Market Equivalent**

	Maximum	Realized	% Realized
<b>FY 2016</b>	\$ 43,692	\$ 43,692	100%
<b>FY 2017</b>	\$ 51,686	\$ 51,686	100%
<b>FY 2018</b>	\$ 66,399	\$ 66,399	100%
<b>FY 2019</b>	\$ 30,074	\$ 30,074	100%



## Recommendation

Formalize the rationale for ICP performance goal components including:

- Determination of the 37.5<sup>th</sup> percentile as the peer comparison maximum performance level
- Determination of PME ICP performance range, including the exclusion of a premium in the approved benchmark
- Communication and discussion with the Investment Advisory Committee for feedback and input to assist the Executive Director in reviewing for approval of the final ICP performance goals
- Formalize the since-inception performance period utilized for the PME ICP goal, including variances from the ICP and reason for any variance
- Formalize explanation for excluding primary funds with vintage years younger than five years from the PME ICP calculation
- Improve transparency by requiring the private equity consultant to identify any investments that are excluded from calculation within the calculation workbook

## Management Action Plan

**Responsible Position:** Ricardo Lyra, Private Equity Director

**Implementation Date:** August 31, 2021

The Private Equity ICP goals incentivize the PE Program staff to deliver best in class results in the short, medium and long term. During FY 2021, the PE Program will provide the ICP Program back-up data and analysis to facilitate understanding of PE goals. Such analysis will include, and not be limited to, TWR vs IRR comparisons and trends and duration of the J-curve by strategy.

## Appendix: History of ERS Private Equity Investments

	# Deals closed	# of Co-investments closed	Total \$ Commitment	NAV
2014 & previous	45	16	\$4.3B	-
2015	10	5	\$1.02B	\$2.76B
2016	12	4	\$749M	\$2.57B
2017	13	9	\$866M	\$3.4B
2018	11	3	\$677M	\$3.9B
2019	18	11	\$1.33B	\$4.1B
<b>Total</b>	<b>109</b>	<b>48</b>	<b>\$9B</b>	-

*The Private Equity portfolio began in 1998 and has consistently closed investments every year since inception. The System has obtained Limited Partner Advisor Committee seats on 63 active funds and four fund Limited Partner Advisory Observer seats. Distributions to the portfolio have totaled \$4.9billion, with \$740M being received in FY19.*

## Scope and Methodology

We performed this audit in accordance with the fiscal year (FY) 2019 annual audit plan. Internal control activities reviewed include those in place during FY 2020 and at the time of audit fieldwork testing which ended on June 30, 2020.

We conducted this audit in accordance with Generally Accepted Government Auditing Standards and in conformance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

A defined set of control objectives was utilized to focus on operational goals for the identified scope. The Committee of Sponsoring Organizations of the Treadway Commission Internal Control Integrated Framework was the basis for internal control assessment. Our Internal Audit opinion is an assessment of the condition of the overall control environment based on the effectiveness of internal control activities through the audit period and the degree to which defined control objectives are being met. Our Internal Audit opinion is not a guarantee of operational effectiveness or regulatory compliance, particularly in areas not included in the scope of this audit.

This audit included a review of internal controls considered relevant to audit objectives including review of statutes, policies and procedures, interviews with management and staff, data analysis and testing procedures.

Audit procedures performed should not be considered part of the control process and management is responsible for accuracy of awards.

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## Related Audits

1. Real Assets—Infrastructure (2018-07)
2. Profit Sharing (2019-08)
3. Investment Management Fees (2018-09)