Annual Board Review: Private Equity

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TMRS
Texas Municipal Retirement System
What is the Private Equity Asset Class?

It’s lots of things, not just “private equity”.

Private Equity – What people typically think of when they hear the term “private equity” is actually the main sub category of private equity called Buyout/Control. It is then used generically to represent the entire asset class. It is where a group of investors (like pension funds), buy most or all of an existing public or private business in order to fix it, or combine it with other businesses, and resell it at a profit.

It is also...

Venture Capital/Growth Equity – A minority ownership stake in a private company, which can vary, but typically represents less than 45% of a company’s value. This capital is used to help grow a company quickly by bringing a new idea or product to market, or can be used to help a company expand its sales or market share.

Special Situations/ Opportunistic (Debt) – Unique situations where can earn equity like returns, typically using control-oriented debt investments, to help a company work through temporary or meaningful financial issues that a company cannot resolve on its own.

<table>
<thead>
<tr>
<th>TMRS Investment Policy Statement Strategy Limits</th>
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<tbody>
<tr>
<td>Buy-out/Control</td>
</tr>
<tr>
<td>Venture/Growth</td>
</tr>
<tr>
<td>Special Situations/Opportunistic (Debt)</td>
</tr>
<tr>
<td>40.0% to 75.0%</td>
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<tr>
<td>10.0% to 40.0%</td>
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<tr>
<td>5.0% to 35.0%</td>
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Why Does TMRS Invest in Private Equity?

*Because most U.S. companies are privately owned.*

- The number of US publicly listed companies available to invest in has decreased by 45% over the last 25 years from approximately 7,200 companies to 3,900. (source: Journal of Financial Economics)

- Less than 1% of firms with employees in the US have publicly traded shares. (source: Forbes)

- Among firms with 500 or more employees, 86% are privately owned. (source: Forbes)
Because of capital markets expectations.

Private Equity is the only asset class expected to exceed TMRS’ 6.75% discount rate on a stand-alone basis.

As you can see in the charts to the left, falling interest rates have caused pensions and endowments to seek out higher returning alternative asset classes.
The length of time a company stays private, before going public, has increased from 3 years, in the mid 1990’s, to 10 years or more today.

Therefore, Private Equity has increasingly been where the actual value creation takes place...

...and the public market IPO is where that value is realized.

It’s where value is created in today’s capital markets.
Current TMRS Private Equity Portfolio
Allocation & Exposures

Total Commitments: $3.34 billion
Net Asset Value: $1.01 billion
Portfolio Weight: 3.36%
Target Portfolio Wgt.: 10.0%
Investment Vehicles: 52
Investment Managers: 33
Companies in the TMRS Private Equity Portfolio
Private Equity: The “J” curve

Early on, private equity fund returns are usually negative due to the payment of management fees and asset purchases. (Red outflows)

During the later years, company sales provide profits to private equity investors. (Green inflows)

The typical net cash flow totals over time (blue line) tend to look like a tilted letter “j” thus the name “j-curve”.

![J-Curve Effect](image-url)
TMRS Private Equity Performance: No “J” curve

The blue line shows a typical j-curve for a single private equity fund.

The red line shows the average private equity portfolio return and its composite j-curve effect.

The TMRS Portfolio Performance is shown with green triangles.

Not only is the portfolio tracking ahead of expectations, but we avoided the typical early negative returns.

Source: State Street Bank, 12/31/19
The private equity portfolio has been TMRS’ star performer recently. Within private equity, Growth Capital is exceeding expectations, while the other allocations are in line with expectations at this stage of portfolio development.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Internal Rate of Return (IRR)</th>
<th>Total Value Multiple (TVM)</th>
<th>Public Market Equivalent (PME)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Capital</td>
<td>29.1%</td>
<td>1.5x</td>
<td>12.1%</td>
</tr>
<tr>
<td>Buyout</td>
<td>15.1%</td>
<td>1.2x</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Venture</td>
<td>8.3%</td>
<td>1.1x</td>
<td>-9.9%</td>
</tr>
<tr>
<td>Special Situations</td>
<td>8.1%</td>
<td>1.1x</td>
<td>-6.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>17.1%</strong></td>
<td><strong>1.3x</strong></td>
<td><strong>1.3%</strong></td>
</tr>
<tr>
<td>Total Equity Focused</td>
<td><strong>20.4%</strong></td>
<td><strong>1.3x</strong></td>
<td><strong>4.2%</strong></td>
</tr>
</tbody>
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Source: Stepstone as of 12/31/19
Accomplishments & Planning

2020 Checklist

- Commit $750mm - $1B of capital.
  
  $863mm committed YTD with more planned activity prior to year end.

- Meet/Exceed Performance expectations.
  
  Portfolio continues to track at, or ahead of, expectations. Longer term effects of COVID remain to be seen.

- Subscribe to Co-Investment Mandate.
  
  Diligence and recommendation completed and approved. Legal negotiations expected to conclude in Q4.

2021 Goals

- Commit $900mm – $1.2B of capital.
  
  Moderately increased allocation goals for 2021. Most allocation likely to be taken up by TMRS' existing managers.

- Implement Co-Investment Mandate.
  
  Phase in operational implementation and successfully deploy capital. Target deployment is ~$100mm per year.

- Improve capital deployment traction.
  
  TMRS can't directly affect manager deployment, but portfolio management approaches can affect over time.
DISCLOSURES

TMRS periodically discloses public information that is not excepted from disclosure under Section 552.0225(b) of the Texas Public Information Act. Information provided by a manager, a Managing General Partner (GP), any of its Associates or other data provider to TMRS or a TMRS service provider, and contained in these materials (i) may have been independently produced or modified by TMRS or the TMRS service provider; (ii) has not been reviewed or approved by the manager, Managing GP or any of its Associates; and (iii) may not reflect the historical performance or asset value reflected in the manager’s, Managing GP’s or any of its Associates’ records and, therefore, should not be used for comparative purposes.