

# Private Equity Search Process and Recommendations

Chris Schelling, Director of Private Equity  
Chris Tindell, Private Equity Analyst  
StepStone Group  
February 23, 2017



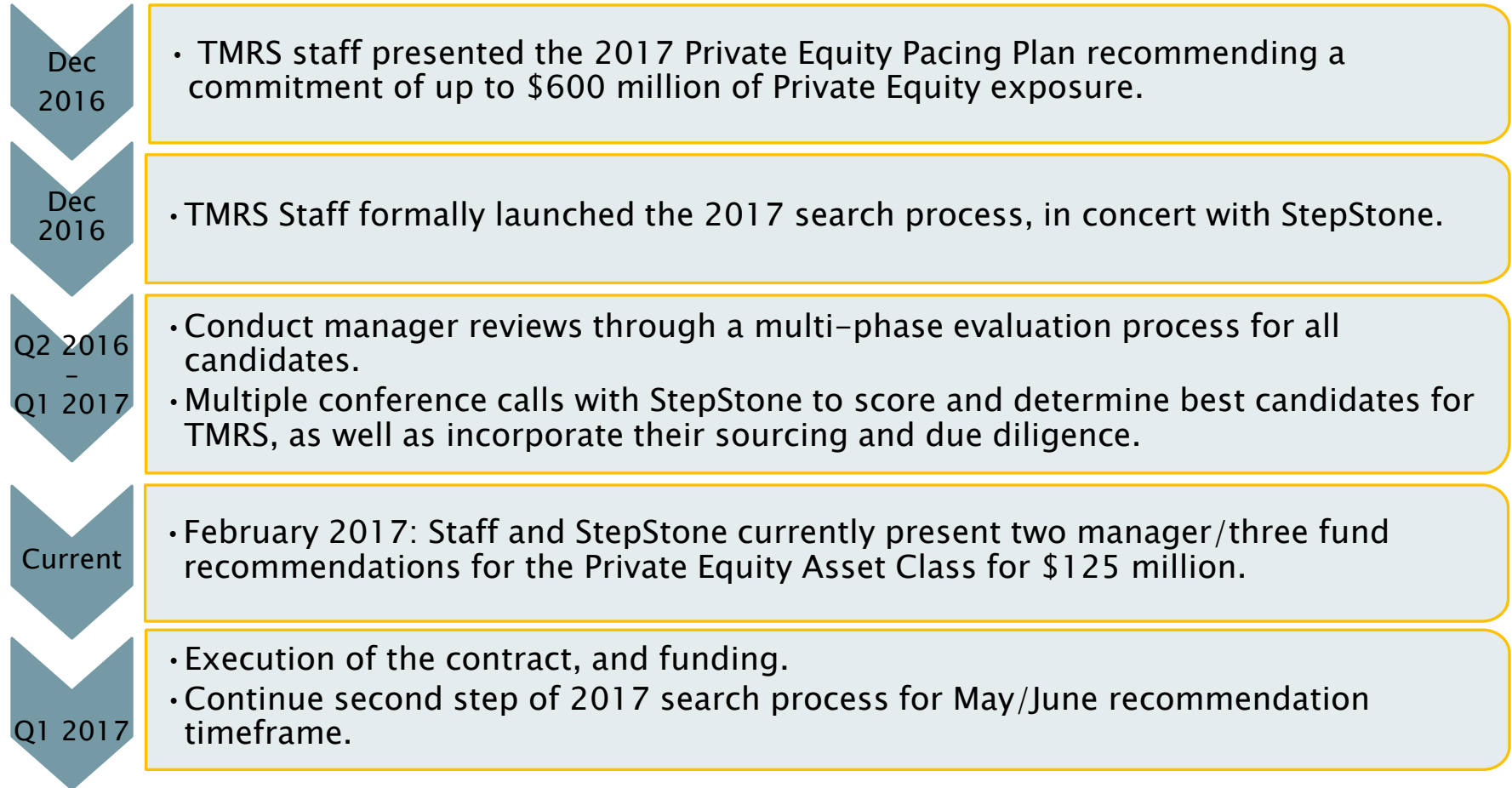
# Agenda

- I. Private Equity Search Process Timeline & Allocation Objectives
- II. Manager Search Process
- III. Portfolio Construction
- IV. Manager Selection & Recommendations
- V. Requested Board Action

Section I

# PRIVATE EQUITY SEARCH PROCESS TIMELINE & ALLOCATION OBJECTIVES

# Private Equity Search Process Timeline



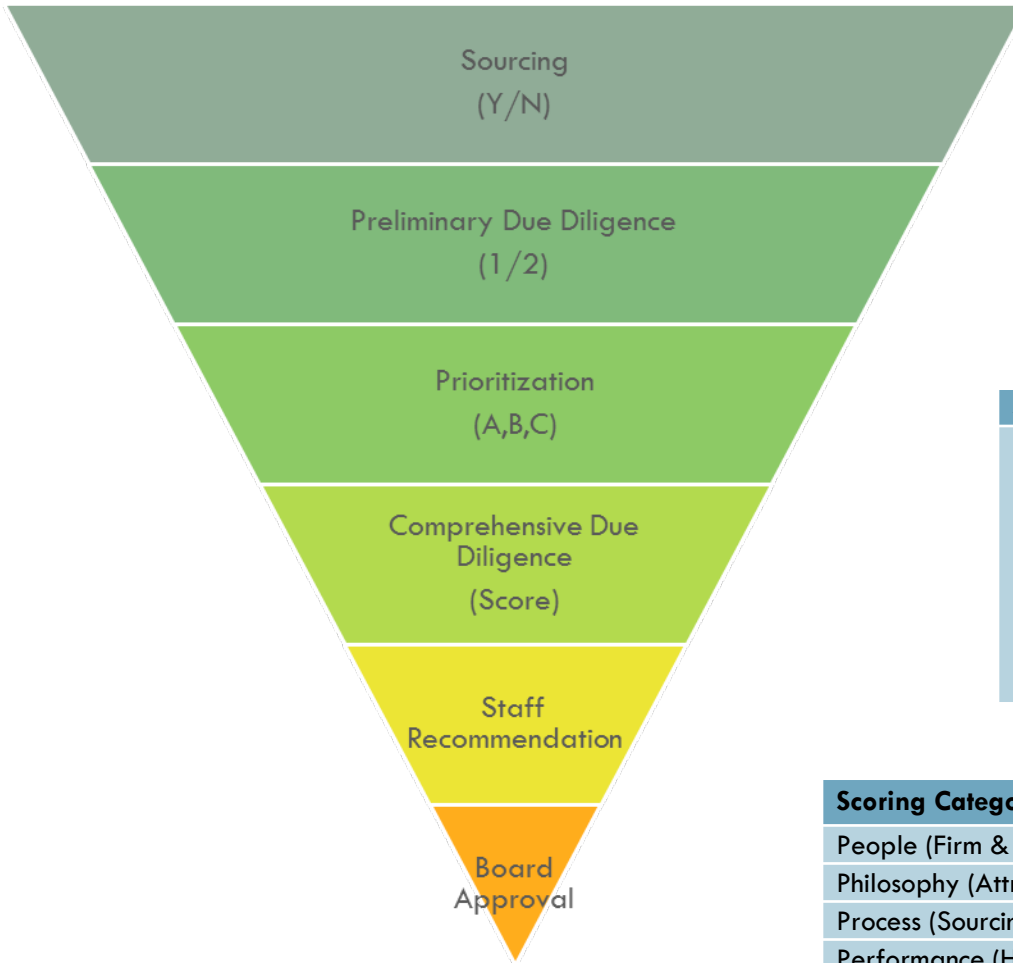
# Private Equity Search Process Objectives

- ▶ **Excess Return Potential**
  - Expected excess return consistent with TMRS' overall objective for Private Equity asset class: Russell 3000 + 3.00%.
  - Identify best in class managers currently in fundraising.
- ▶ **Portfolio Diversification**
  - Balance concentration and diversification across managers.
  - Ensure sufficient strategy diversification, consistent with policy guidelines, and whenever possible incorporate tactical and opportunistic considerations into manager selection.
- ▶ **Targeted Commitment Level**
  - Per the December 2016 Board approval, the targeted Private Equity Pacing Plan for 2017 is up to \$600 million.

Section II

# MANAGER SEARCH PROCESS

# Manager Search Process



## Manager Screen & Universe Analysis Scoring

Scoring Category	Score / Outcome
<b>Manager Screen</b> - Is vehicle consistent w/ TMRS' objectives?	Yes - Take Meeting; No - Don't Take Meeting
<b>Manager Analysis</b> - Does vehicle have adequate capacity and timeline? - PPPPT* Preliminary Review	1 - Advance; 2 - Stop Research

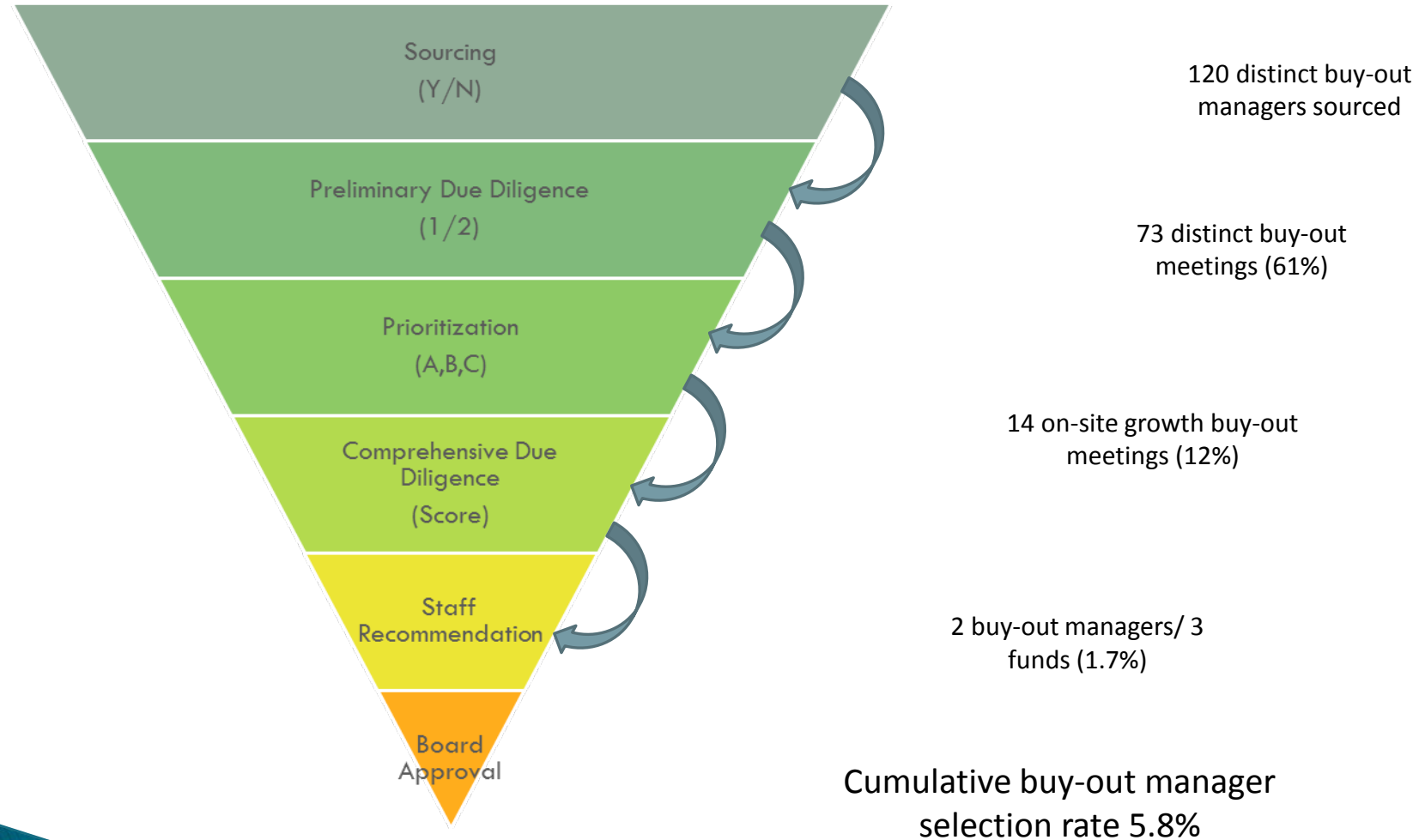
## Semi-Finalist Scoring Matrix

Scoring Category	Score
<b>Finalist Manager Review</b> - Questionnaire Review - Detailed PPPPT* Review - In-depth Manager Qualifications Review - Compliance with TMRS IPS - Verification of Research, References, Further Market Research	A - Prioritize for Final Due Diligence B - Perform More Research C - Stop Research / Manager not Selected

## Final Due Diligence Scoring Matrix

Scoring Category	Possible Points
People (Firm & Team)	0 - 40 points
Philosophy (Attractiveness of Opportunity / Portfolio Fit)	0 - 20 points
Process (Sourcing, Underwriting and Managing)	0 - 40 points
Performance (Historical / Expected)	0 - 40 points
Terms (Fees, Liquidity, etc.)	0 - 20 points
<b>Total</b>	<b>100†</b>

# Manager Search Process





# Final Selected Managers Scoring Matrix

## Final Due Diligence Scoring Matrix - Aggregated Results\*

Recommended Manager/Fund	Manager Score†	Comparable Mgr. 1 Score	Comparable Mgr. 2 Score
Marlin Equity V, L.P. (Marlin Equity)	100.0	93.0	90.0
Marlin Heritage II, L.P. (Marlin Heritage)	100.0	90.0	89.0
One Rock Capital Partners II, L.P. (One Rock)	100.0	90.5	82.0

\*Scoring matrices utilize difference calibrations depending on the strategy being utilized.

†Selected managers standardized to a score of 100 to allow comparability among selected managers

Section III

# PORTFOLIO CONSTRUCTION

# Manager Selection Portfolio Considerations

## *Strategy Diversification*

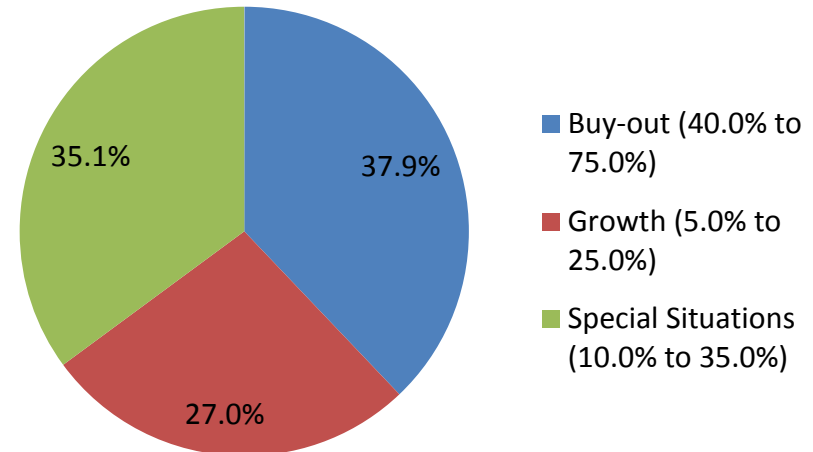
### *Strategy considerations:*

*2015: Overweight special situations early for J-Curve mitigation, efficiency of capital deployment, and tactical opportunities.*

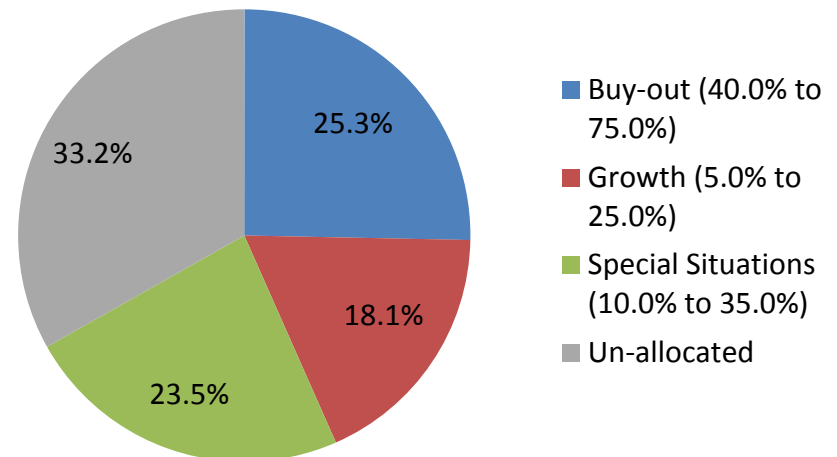
*2016: Focus on growth opportunity set and continue to add buy-out exposure.*

*2017: Round out buy-out portfolio, and opportunistically add to growth and credit.*

**Figure 1 : Private Equity Strategy Diversification by Commitment**



**Figure 2 : Private Equity Target Diversification**



# Manager Selection Portfolio Considerations

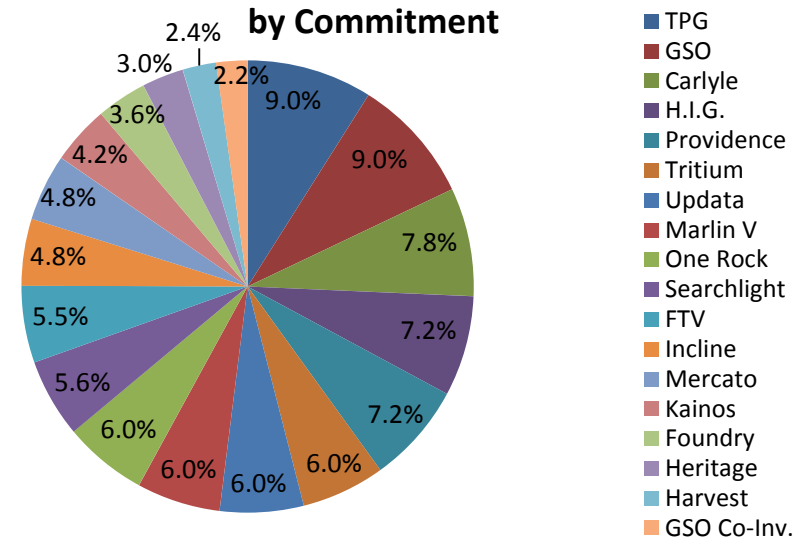
## Manager Implementation

*The overall goal remains identifying top quartile performers to partner with.*

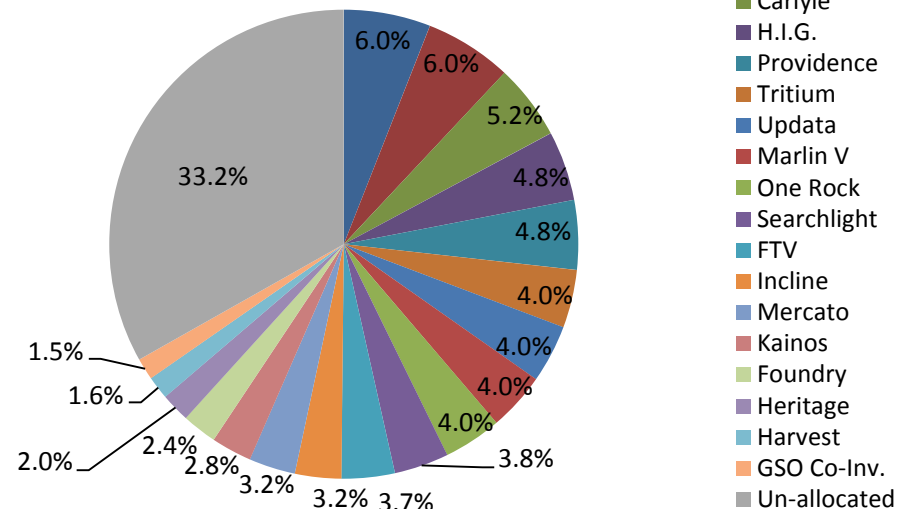
*Position sizing considerations:*

- Continue to reduce the unallocated portion of the private equity portfolio while sensibly balancing the trade-off between diversification and concentration.*
- Areas of focus are enhancing manager diversification, and building strategic relationships where possible/appropriate.*

**Figure 3: Private Equity Manager Diversification**



**Figure 4: Private Equity Target Manager Diversification**

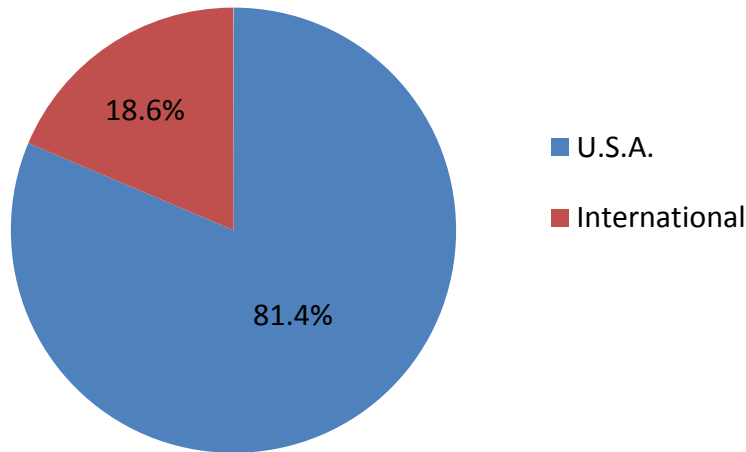


# Manager Selection Portfolio Considerations

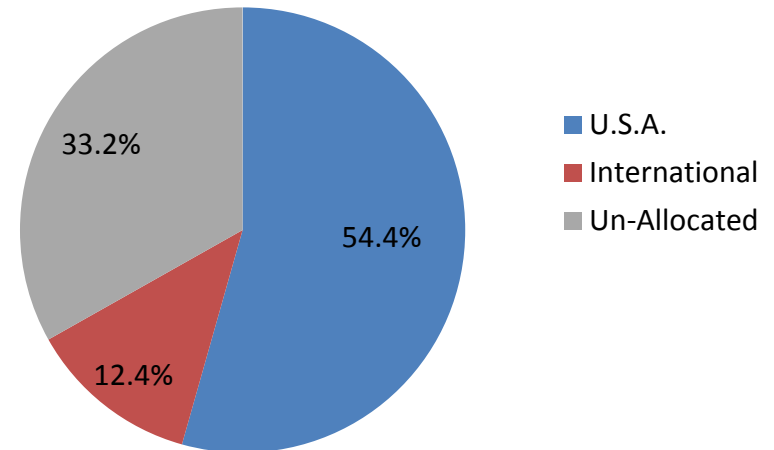
## *Geographic Diversification*

*TMRS is focused on taking a measured approach to global geographic diversification.*

**Figure 5 : Private Equity Geographic Diversification by Commitment**



**Figure 6 : Private Equity Target Geographic Diversification**



**The Target Portfolio keeps a conservative stance on international exposure.**

Section IV

# MANAGER SELECTION & RECOMMENDATIONS

# Executive Summary of Manager Recommendation

Summary of Recommendations			
Recommended Manager/Fund	Strategy Classification	Target Return	Recommended Amount
Marlin Equity	Buy-out Strategy	20% / 2.0X	\$60 million
Marlin Heritage	Buy-out Strategy	25% / 2.5X	\$15 million
One Rock	Buy-out Strategy	20% / 2.0X	\$50 million
Total Net Recommendations:			\$125 million

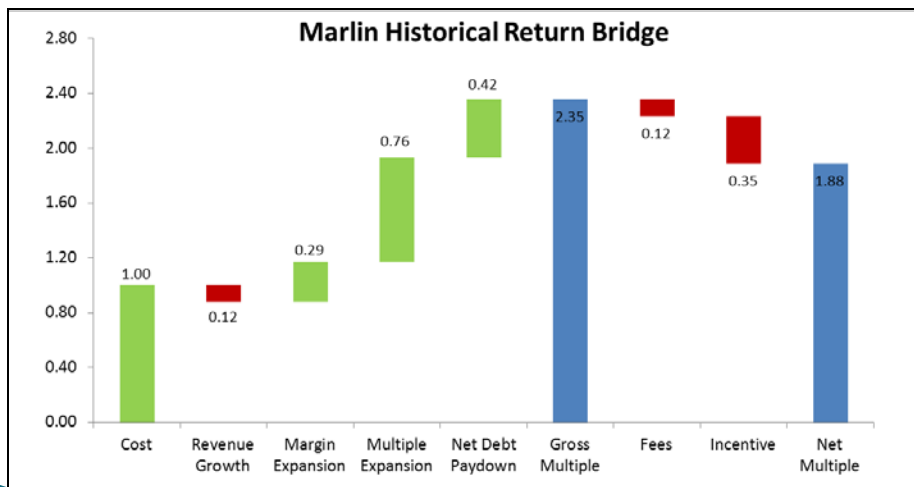
*Private Equity Pacing model as approved by the TMRS Board of Trustees in December 2016 established up to \$600 million as the targeted level of commitments for 2017.*

# Top Candidate Characteristics – Marlin Equity

## *\$60 million Recommendation*

*Marlin invests in the software/technology sector, with additional secondary sectors that the Firm may opportunistically pursue. The fund will follow the same strategy employed by prior Marlin funds, targeting businesses with shared attributes such as sustainable operations, predictable revenue streams, scalable cost structures, and underutilized assets. Marlin has a heavy operational focus, working with portfolio companies to turn underperforming businesses around. Marlin Equity will target investing in 15 to 20 platform companies, committing US \$75 – 300 million per investment, invest primarily in North America and Western Europe, with investments outside North America subject to a cap of 25% of commitments. It will be a \$2.5 billion fund.*

Category	Marlin Equity	Turnaround Comp 1	Turnaround Comp 2
People	23.5	23.5	21.5
Philosophy	25	23.5	19.5
Process	18.5	18.5	17.5
Performance	17.5	17.5	17.5
Terms	15.5	10	14
<b>Total</b>	<b>100</b>	<b>93</b>	<b>90</b>



### Reasons to Invest

- Cohesive senior team with limited turnover – Managing partners have worked together for 9 years at Marlin and many more together while at Gores Group.
- Top quartile performance – Funds I-III each rank in the top quartile on a net TVM, net IRR and DPI basis relative to their peers.
- Operations-focused strategy - This differentiated investment approach is expected to provide a significant competitive advantage.

### Risks & Mitigants

- Fund size increase – Represents significant increase, but team has success with larger deals.
- Departure of George Kase – Staff has become familiar with the reasoning behind his departure and does not consider Mr. Kase’s departure as a risk.
- Fund IV largely unrealized – The fund is still very young and every position is still in the early stage of the turnaround process.

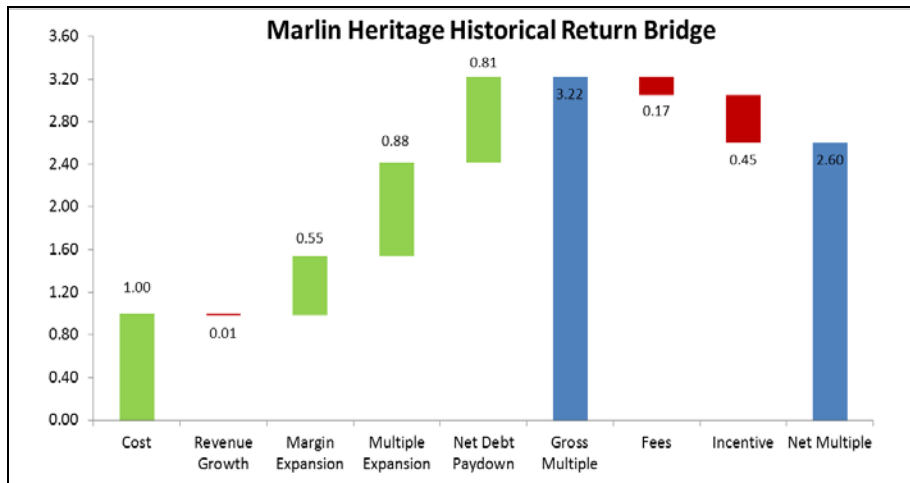


# Top Candidate Characteristics – Marlin Heritage

## *\$15 million Recommendation*

*Marlin Heritage follows the same investment philosophy and operationally-focused strategy employed by the larger Marlin funds, but is focused on the Lower Middle Market and limited to North America. Marlin invests primarily in companies within the software/technology sector, as well as a number of secondary sectors that the firm will opportunistically pursue. Marlin Heritage will target businesses with shared attributes such as sustainable operations, predictable revenue streams, scalable cost structures, and underutilized assets. The Firm generally expects Marlin Heritage to make 15 to 20 platform investments in small and lower middle-market companies requiring an initial investment of between \$10 million and \$60 million. The fund is raising \$500 million.*

Category	Marlin Heritage	Small Turnaround 1	Small Turnaround 2
People	23	22	19
Philosophy	21	19	20
Process	18	17	16
Performance	24	18	21
Terms	14	14	13
<b>Total</b>	<b>100</b>	<b>90</b>	<b>89</b>



### Reasons to Invest

- Cohesive senior team with limited turnover – Managing partners have worked together for 9 year at Marlin and many more together while at Gores Group.
- Dedicated Investment Team – Marlin’s Heritage team is comprised of 13 dedicated professionals.
- Impressive, low loss ratio – loss ratio of just 3% across all funds

### Risks & Mitigants

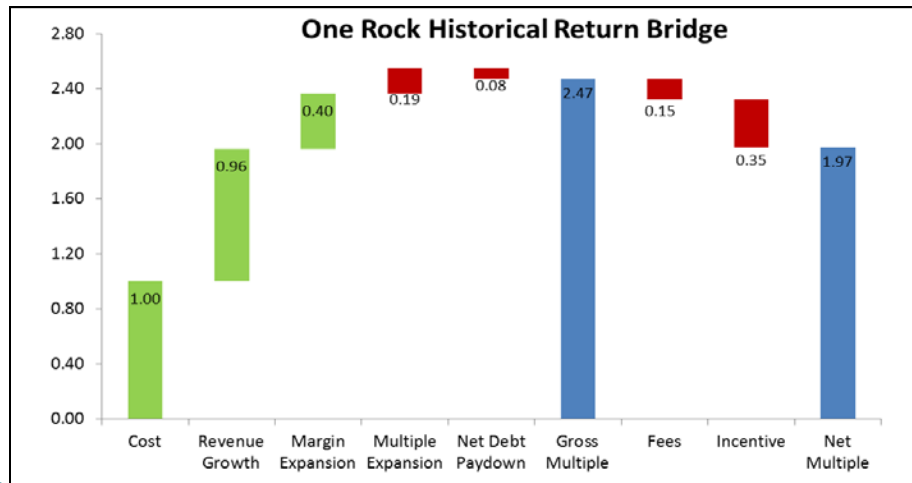
- Departure of George Kase –Staff has become familiar with the reasoning behind his departure and do not consider Mr. Kase’s departure as a risk.
- Competition – The lower-end of the technology space has become increasingly competitive over the past several years, but Heritage benefits from Marlin’s scale
- Fund I Immaturity – The fund is still very young and every position is still in the early stage of the turnaround process.

# Top Candidate Characteristics – One Rock

## *\$50 million Recommendation*

*One Rock Capital Partners was founded in 2010 by former professionals of Ripplewood. One Rock will focus on Lower Middle Market companies that primarily operate in the specialty manufacturing, healthcare products, chemicals & process, business services, environmental services and auto retail sectors. One Rock is a value-oriented, operationally-focused manager, targeting control investments in complex transactions. The fund is targeting \$700 million and expects to make 8 to 12 investments of \$35 to \$100 million each, with no less than 80% deployed in North American companies.*

Category	One Rock	Small Buyout 1	Small Buyout 2
People	23.0	18.5	20.0
Philosophy	21.0	18.5	18.0
Process	18.5	19.5	16.0
Performance	22.0	24.0	15.0
Terms	15.5	10.0	13.0
<b>Total</b>	<b>100.0</b>	<b>90.5</b>	<b>82.0</b>



### Reasons to Invest

- Senior team experience and cohesion – Managing partners have been in private equity since the late 1990s. One Rock has not had any turnover since inception.
- Strong Fund I and absolute performance – Top quartile track record, with only one deal returning less than a 1.6x multiple.
- Impressive, low loss ratio – loss ratio of just 8% across all funds

### Risks & Mitigants

- Fund size increase – One Rock's target fund size represents a 62% increase from Fund I. However, Fund I deals have required over \$200 million of co-investment capital, suggesting that the firm's growth in fund size will likely not result in strategy drift.
- Mitsubishi ownership – Mitsubishi's ownership will decline materially in Fund II and the firm provides significant operational resources.
- Fund I largely unrealized – The fund is very young, and assets are performing as expected.

Section V

# **REQUESTED BOARD ACTION**

# Recommendations

- TMRS Staff and StepStone Group recommend that the Board of Trustees approve the selection of the following funds as referenced in the Board Communication Memo for investment:
  - Marlin Equity V, L.P.: \$60 mm to Buy-out Strategy
  - Marlin Heritage II, L.P.: \$15 mm to Buy-out Strategy
  - One Rock Capital Partners II, L.P.: \$50 mm to Buy-out Strategy

## *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 general partner or other data provider to TMRS or a TMRS service provider, and contained in these materials, may have been independently produced or modified by TMRS or the TMRS service provider.*