California Public Employees' Retirement System
Investment Office

Memorandum

February 3, 2016

To: INVESTMENT COMMITTEE

From: THEODORE ELIOPOULOS
Chief Investment Officer

Subject: USE OF CREDIT FACILITIES BY PRIVATE EQUITY FUNDS

This is a follow-up to the Investment Committee's (IC) request for additional information about the use of credit facilities by private equity funds.

Most private equity funds, including separate account entities, have the ability to utilize a fund level credit facility. These facilities are secured by the uncalled capital commitments and/or the assets of the fund. The facilities are typically used to manage capital calls in an efficient way for the purposes of paying fund management fees or the purchase of new investments. In some instances, the facility can be used to make a distribution to the Limited Partners (LPs) prior to receiving the proceeds from the sale of an asset. The facilities are paid down either by calling capital from the LPs or using the proceeds from the sale of an asset.

The terms and limitations under which a General Partner (GP) can enter into a facility arrangement are part of the Limited Partnership Agreement (LPA). The terms are reviewed and negotiated by CalPERS PE staff as part of the due diligence process.

The key questions staff analyzes from a risk perspective when reviewing the terms of the LPA are:

- Collateral: Is a credit facility secured by the uncalled capital of the fund, the assets held by the fund, or a combination of the two? It is important to note that in no circumstance will the LPs be liable for an amount greater than remaining uncalled capital.
- Duration: How long can the facility be outstanding (90, 180 or 365 days)?
- Size: Is the facility limited to the lesser of a percentage of the fund or the remaining uncalled capital?

The benefits of credit facilities to the LP's are to decrease the frequency of capital calls (making the timing and amount of capital calls more predictable) and to improve the net Internal Rate of Return (Net IRR) for the fund (delaying the payment of a management fee or distributing proceeds earlier increases the Net IRR).

The benefit of the credit facilities to the GP is the improvement in the Net IRR can help the fund achieve the hurdle rate more quickly thereby entitling the GP to profit sharing. Additionally, credit facilities allow the GP to better control the timing of portfolio investments, as they can provide a timely source of capital while individual capital calls are collected from the LPs.

The credit facilities currently have interest rates in the 2% to 3% range. While the Net IRR is improved by the use of the facility, the cost of the facility will slightly reduce the investment multiple of the portfolio.

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