

# Memorandum

**To:** Board of Trustees, Fresno County Employees' Retirement Association  
**From:** Michael Kamell, CFA, CAIA, Consultant  
**Date:** March 1, 2017  
**RE:** Hamilton Lane Secondary Fund IV Commitment

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In conjunction with the restructuring of the private equity program previously discussed, Verus recommends a \$75 million commitment to Hamilton Lane Secondary Fund IV. The purpose of this memorandum is to provide supporting rationale for the recommendation.

**Background:**

As of December 31, 2016, the FCERA's private equity portfolio market value was \$112.1 million, 2.7% of Plan Assets. The target allocation to private equity is 6%. In order to align the private equity portfolio with the target allocation, it is necessary to over-commit, as due to the timing of calls and distributions, an individual fund investment rarely reaches the commitment amount. Based off of prior commitment analyses conducted by Verus, FCERA will need to commit \$100 million a year to private equity funds in order to reach the target allocation around 2020. Hamilton Lane forecasted a total commitment amount of \$450 million over the next three years. The difference in assumptions is largely predicated on growth of the overall portfolio.

Secondary investments in private equity are unique from more traditional primary commitments. While a primary fund commitment is made during the fundraising cycle before capital has been invested, secondary fund investments are existing private equity funds whereby the investor is selling their interest to a new investor. Verus believes that secondary funds are particularly attractive for FCERA at this time because we can ramp up exposure to private equity quicker but without risking too much vintage year concentration (as the underlying funds are at varying stages in their lifecycle). They also represent a sound late-cycle investment because if the market becomes distressed, discounts for secondary fund investments may increase, allowing FCERA to realize more attractive entry points. Furthermore, because of the nature of the underlying investments there is little to no J-curve. Secondary Fund-of-Funds enable an efficient method of gaining access to this market; the FoF General Partner aggregates individual investors' commitments and uses that capital to buy a series of secondary investments. The investors benefit from the General Partner's network and sourcing capabilities, as well as the due diligence necessary to identify and screen for more attractive secondary investments.

FCERA has a long track record with Hamilton Lane. FCERA invested in HL VI, a primary fund-of-funds with a 2007 vintage. That fund's net IRR was 9.3% as of September 30. The Fund called \$62.6 million, returned \$62.4 million, and has a remaining market value of \$34.9 million. FCERA

has also invested in Hamilton Lane IX, a 2016 vintage fund with the same strategy. While still early in the life of that Fund, the IRR is 12.7%. \$23.6 million has been called.

#### **Performance of Prior Secondary Funds:**

In total, Hamilton Lane's weighted average IRR for secondary fund investments is 18%, 920 basis points of outperformance relative to the S&P 500 public market equivalent.

- HL's "Pre-Fund" with a vintage year of 2000, generated a net IRR of 13.2% with a net multiple of 1.5x.
- HL Secondary Fund I (\$360 million), a 2005 vintage, generated a net IRR of 4.3% and a net multiple of 1.2x.
- HLSF II (\$590 million), a 2008 vintage, generated a net IRR of 15.1% and a net multiple of 1.5x.
- HLSF III (909 million), a 2012 vintage, generated a net IRR of 18.6% and a multiple of 1.3x.

#### **Background on the Firm:**

Hamilton Lane has 12 global offices and 290 employees, 106 of which are shareholders. They manage and supervise over \$332 billion in assets. The Firm's investment committee consists of ten individuals with an average of 22 years of investment experience, and an average of 15 years working together at Hamilton Lane. There are an additional 16 individuals serving on a dedicated secondary team. Verus has gained additional comfort around the resources of the firm through the RFP process that was previously conducted.

#### **Background on the Strategy:**

HL's strategy for secondary investing is to create competitive advantages by leveraging the HL platform, purchase high quality assets managed by leading GPs, and to acquire those assets at attractive prices. They target single fund investments or small portfolios, seeking mature assets with strong liquidity profiles. HL will also leverage their network in order to conduct deals "off-market." They monitor over \$3.0 trillion in assets across a 3,200 fund database, hold more than 300 advisory Board seats, and meet with hundreds of general partners annually.

Because they have a large primary fund business, they believe they are a preferred partner of GPs hoping to attract capital for future funds; they committed \$24.7 billion to primary funds in 2016 alone. Historically, HL has achieved an average discount to net asset value of 22%.

For Hamilton Lane Secondary Fund III (prior fund, same strategy), they screened \$104 billion of deals, conducted full due diligence on 31% of those, submitted a bid on 8%, and closed on less than 1%. HL cites off-market transactions as a competitive advantage, as the majority of the deals they closed on were not invested through competitive bidding processes (which tends to drive secondary pricing up very close to net asset value).

The Fund has a 3-year commitment period, a term of 10 years; Hamilton Lane, as manager of the fund, will commitment of 1% of total commitments to invest alongside LPs. The management fee is 85 basis points for commitments between \$50-\$99 million and 75 basis points for commitments

of at least \$100 million. After the commitment period, management fees decline by 10% per year. Carried interest is 12.5% with a preferred return of 8%.

**Current update for HL Secondary Fund IV:**

Hamilton Lane has secured \$1.7 billion of commitments, indicating a high level of demand for the Fund. The Fund has already invested \$357 million in either closed or pending commitments across 11 transactions. While very early in the Fund's life, the underlying deals are 75% funded, and have generated a net IRR for the Fund of >100% as a result of early distributions. Hamilton Lane purports to have another \$2 billion of deals in active pipeline.

**Recommendation:**

As part of the diversified build-out of the private equity program, Verus recommends that FCERA begin legal negotiations with Hamilton Lane for a \$75 million commitment to Hamilton Lane Secondary Fund IV. The anticipated final close is at the end of the first quarter of 2017.