## General

***Code:*** S1Investment-AC21

***Name:*** Washington State Investment Board

***Group:*** Financial Audit

***Type:*** S1-Agency, Commission, or Board

***Location:*** State

***Scope:*** Not Applicable

## Team

***Lead:*** Rajpreet maynock

***Manager:*** Carol Gross

# Procedures

**C.2.PRG - Significant IC Systems**

***Procedure Step:*** Private Equity External Manager Due Diligence and Monitoring

***Prepared By:*** RKM, 1/18/2022

***Reviewed By:*** CJG, 1/20/2022

Purpose/Conclusion***:***

**Purpose:**

To determine whether the private equity program controls are adequate to safeguard public resources.

**Sources:**

Fabrizio Natale, Senior Investment Officer

Aaron Daley, Assistant Senior Investment Officer

**Conclusion:**

We determined the private equity program controls are adequate to safeguard public resources. ***No issues noted.***

Testing Strategy***:***

Guidance/Criteria***:***

Record of Work Done***:***

**Risk Identified in Planning:**

* There is a risk that monitoring activities are not performed to ensure the investment philosophy outlined in the original investment approved by WSIB is in place and being followed.

**Gain an Understanding**:

The objective of the private equity program is to generate a significant premium above the returns of the public equity markets over the long term, by investing in a well-diversified portfolio of funds managed by high-quality general partners. The portfolio is being managed to a model portfolio to ensure adequate diversification by general partner, strategy type, and geography. The Legislature has established a standard of care for investment of these funds in [RCW 43.33A.140](https://app.leg.wa.gov/rcw/default.aspx?cite=43.33A.140).

The WSIB may invest in any appropriate private equity investment opportunity that has the potential for returns superior to traditional investment opportunities and is not prohibited by the WSIB's policies or by law. These investment types are generally divided into venture capital, corporate finance, growth equity, special situations, distressed debt, mezzanine, and other investments. Private equity investments are made through either limited partnerships or direct investment vehicles and in a manner consistent with [RCW 43.33A.110](https://app.leg.wa.gov/rcw/default.aspx?cite=43.33a.110), which mandates that “the Board shall establish investment policies and procedures designed exclusively to maximize return at a prudent level of risk". To meet the return and plan objectives, the private equity portfolio has diversified investments in companies in a variety of growth stages. The portfolio also includes a broad cross-section of opportunities in different industries and geographic regions.

The objectives and goals of the private equity investment program are to:

1. Prudently employ the assets that the Washington State Investment Board (WSIB) has allocated to private equity investments to produce a well-diversified profitable portfolio that will enhance the total return of the WSIB portfolio and ultimately pay benefits to participants and beneficiaries and meet actuarial requirements.

2. Diversify away from traditional capital market risks.

3. Employ consistent strategies that contain sufficient flexibility to take advantage of opportunities available to the WSIB due to changes in the private equity or debt marketplaces.

4. Endeavor to provide ancillary benefits to the WSIB including, but not limited to:

* Negotiation of special terms based on the WSIB's size, its attractiveness to any one general partner, and its ability to attract other investors.
* Establishment of strong general partner relationships that may enhance later direct investment deal flow.
* Promotion of staff-consultant interaction to leverage the consultant's private equity investment experience.

5. Invest as a limited partner in a variety of carefully chosen limited partnerships, each with a successful track record, consistent investment strategy, and stable management.

6. Develop secondary market capabilities to enhance the WSIB's ability to minimize losses and maximize returns by 1) enabling it to sell its interest in a private equity asset prior to maturity or liquidation, if prudent to do so, or 2) alternatively, to invest in established partnerships in the secondary market.

7. Emphasize professional and timely handling of private equity investment proposals in order to present the WSIB as a sophisticated, cutting-edge investor in the private equity investment field.

8. Implement a standardized and thorough method of proactively monitoring portfolio investments to maximize profit realization.

9. Develop in-house expertise and resources for the prudent employment of funds in private equity investments and refine the use of consultants/outside experts to augment staff's capabilities.

10. Assess the private equity investment program's performance, strategies, and objectives on a continuing basis to permit flexible responses to changing circumstances.

11. Maintain the stability of the private equity investment program by following established guidelines and procedures, only altering policies and strategies after careful consideration.

12. Comply with all applicable laws and regulations concerning the investment of the WSIB’s pension assets.

During FY21 the portfolio was valued at $41.5 billion. During FY20 the portfolio was valued at $26.2 billion. The portfolio's increase in value is due to appreciation in the value of portfolio investments, as capital contributions into the portfolio were exceeded by distributions received from portfolio liquidity events. The WSIB closed on $7.3 billion new commitments during FY21 and $4.1 billion during FY20.

See Private Equity Investment Program policies at: [C.2.20].

On December 22, 2021, we met with Fabrizio Natale, Senior Investment Officer, and Aaron Daley, Assistant Senior Investment Officer, to discuss internal controls in regards to private equity external manager due diligence and monitoring.

Fabrizio started the meeting by explaining the private equity program. The programs receives assets on the behalf of their beneficiaries and are managed by outside managers. WSIB is a limited partner, this means that WSIB gives the funds to general partners for them to manage. Limited partners pay general partners a management fee (approximately 2%) and sometimes a profit sharing incentive (approximately 20%) depending on the partnership. For these funds the Board sets targets for each asset class and a range of +/- 5%. These asset classes are valued on a quarterly basis and valued based on public markets.

Their team has approximately 9 employees right now to manage 89 general partners. These are self-liquidating partnerships and each partner has a different strategy (i.e. buy out, North America, Europe, etc.). These partnerships typically have multiple funds and can take 10 to 12 years to fully realize.

The private equity process first starts with researching and monitoring a new general partner that WSIB might want to engage with as a manager. Their research and monitoring spans over multiple years, throughout these years they are becoming comfortable in making a commitment. If they do decide to commit they will do a deep dive of the strategy and the general partner. Also, they will visit one office location of a general partner and spend time with the investment and non-investment team. During this deep dive they prepare an investment memo to present to the investment committee (CIO, CEO, and other officers) and/or the Board **(Key Control 1)**. If a new strategy with an existing or new partner is being presented it must first be approved by the investment committee and then approved by the Board otherwise it must be approved by the CEO.

The investment memo has ten sections and a few paragraphs which include the following information related to due diligence activities (outlined in the policy above):

* Investment Recommendation Summary
* Investment Thesis
* Investment Performance
* Management
  + Assessing the ability and stability of the investment management team and the investment organization.
* Investment Strategy
  + Evaluating the proposed investment strategy.
  + Reviewing the use of financial leverage.
* Portfolio Fit
  + Evaluating the fit of the proposed investment within the WSIB private equity portfolio.
* Key Terms and Conditions
  + Reviewing the proposed terms, conditions, and fees of the partnership.
* Investment Summary (Details in Section 9)
* Metrics Evaluation
  + Analyzing the investment track record of the principals.
  + Reviewing the proposed business plan and exit strategies
* Key Concerns
  + Identifying and resolving key issues.
* Due Diligence
  + Reviewing market conditions.
  + Identifying potential competitors and evaluating sources of deal flow.
  + Conducting reference checks
  + Conducting face-to-face meetings with the principals to discuss important aspects of the offering.
  + Reviewing the offering memorandum and related documents, including the most recent partnership financial statements and the most recent audited financial statements.
* Action Requested

After staff provide their recommendation for the investment, an outside consultant must also provide an investment memo (second opinion) that concurs their recommendation **(Key Control 2)**. Their outside consultant in 2020 was Hamilton Lane and in 2021 it was Albourne. If the investment gets approved, the staff member/CIO then negotiate legal terms with the attorneys general office and an outside consultant. If they come to an agreement then the investment can be closed and they can move forward.

Once the investment is made a representative from the WSIB attend an annual manager meeting and advisory board meetings throughout the year **(Key Control 3)**. The WSIB has one representative on each general partner's advisory board. These boards have a high degree of influence related to what the general partners decide to do. Their recommendations are followed through a majority of the time. During these meetings they are monitoring whether the investment strategy is being followed. Also, they check-in in regards to conflicts of interest.

Additionally, each investment has a staff member with a high degrees of education on the general partner. They have formal and informal update meetings to monitor the general partner's activity. They also get financial information for the general partners and update their internal database. The WSIB also has a valuation committee to monitor how the assets are doing and that they are being priced accurately.

**Summary of Key Controls:**

**Key Control 1:** A staff members prepares an investment memo to present to the investment committee (CIO, CEO, and other officers) and/or the Board. If a new strategy with an existing or new partner is being presented it must first be approved by the investment committee and then approved by the Board otherwise it must be approved by the CEO. The contents of the investment memo comply with required due diligence procedures as outlined in WSIB policy 2.10.700.

**Key Control 2:** An outside consultant must provide an investment memo (second opinion) that concurs their recommendation.

**Key Control 3:** Once the investment is made a representative from the WSIB attend an annual manager meeting and advisory board meetings throughout the year.

**Confirmation of Key Controls:**

**Key Control 1:** We obtained the KKR European Fund V, L.P. investment memo that was presented by WSIB staff to the Board on September 20, 2018. We noted that there were ten sections that comply with the required due diligence procedures found in WSIB policy 2.10.700, including Investment Recommendation Summary, Investment Thesis, Investment Performance, Management, Investment Strategy, Portfolio Fit, Key Terms and Conditions, Investment Summary, Metrics Evaluation, and Key Concerns. At the bottom of the memo there was a paragraph about due diligence and action requested as well.

We obtained the September 20, 2018 board minutes and noted that this investment was unanimously approved. ***No issues noted.***

We obtained the KKR European Fund V, L.P. AG approval. An email dated November 1, 2018 from Tori Jernudd, Assistant Attorney General,stated, "Based on my review of the documents and the representation of Proskauer, I conclude the form of the documents is appropriate for this investment and that the investment is consistent with the WSIB's investment authority (as set forth in the Washington State Constitution, RCW 43.33A, and elsewhere). An investment of $300 million plus fees and expenses in KKR Europe Fund V L.P. was approved unanimously at WSIB's September 20, 2018 board meeting. "Accordingly, I give legal approval for the Executive Director or her delegate to execute the attached documents in the even that the WSIB make the business decision to do so. ***No issues noted.***

**Note:** This investment was not made until January 15, 2020.

**Key Control 2:** We obtained the KKR European Fund V, L.P. investment memorandum that was prepared by Hamilton Lane Advisors, L.L.C on September 24, 2018. They recommended that the WSIB execute the fund documents (investment). ***No issues noted.***

**Note:** This investment was not made until January 15, 2020.

**Key Control 3:** We obtained the KKR Flagship Funds meeting notes for the November 9, 2020 advisory board and annual meeting. In the meeting notes there was information provided by the general partners related to the market environment, organization, and funds. There were also notes about the staff member's observations. ***No issues noted.***

# Issues

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| **ISS.1 - V: Small and Attractive Assets Tagging** | | |
| ***Prepared By:*** HB, 2/7/2022  ***Reviewed By:*** SLB, 3/30/2022  ***Type:*** Verbal Recommendation  ***Category:*** Safeguarding of Assets/Property   |  |  | | --- | --- | | ***Reporting Level(s):*** |  |   ***Impact***  ***Cost Savings:***  ***Questioned Costs:*** $0.00 | ***Issue***  We found two small and attractive assets at the Olympia location and one asset at the Seattle location that did not include a tag number as required by SAAM 30.40 and WSIB inventory procedures.    We recommend WSIB ensure all small and attractive assets are properly labeled with tag numbers or the tag is placed on a copy of the item packing slip or purchase order in order to stay in compliance with SAAM 30.40 and internal inventory procedures. | |
| **NOTES** | | |
| LOR: [AS2.a].    Recommended level of reporting: Verbal recommendation    Rationale for level of reporting: There were three assets in our selection that did not include tag numbers. We are able to identify that these were the assets listed in Asset Panda and CAMS due to the correct location and matching serial numbers.    Communication: We communicated this issue to Jason Gordon, Financial Service Manager, on 1/27/2022. We communicated this issue to Marie Steffen, Audit Director, on 2/1/2022. | |