



Grove Street Advisors

Catherine Crockett leaned back in her chair, noticed the cracked tile in the conference room ceiling, and smiled at the other three partners of Grove Street Advisors, LLC (GSA), Clint Harris, Dave Mazza and Ann St. Germain. In the three years since they had founded the firm, GSA had grown to nearly \$3 billion under management. GSA was an investment advisory firm that specialized in the management of large, individually-tailored private equity investment programs for major institutional investors.

The major driver of GSA's growth had been its relationship with the California Public Employees Retirement System (CalPERS). With \$170 billion of assets, CalPERS is the largest state pension fund in the United States. Starting in 1996, CalPERS resolved to increase its allocation to private equity from approximately 2% to a long-term target of 8%. While CalPERS had historically been a major investor in large buyout funds, it had very few venture capital relationships and had hired GSA to help build a venture fund portfolio. CalPERS had effectively put GSA into business in 1999 with a \$350 million dedicated fund-of-funds which GSA was to invest on a discretionary basis. The bulk would go to established and emerging venture firms across a range of sectors, stages and geographies, with a portion earmarked for co-investments directly in portfolio companies. This initial program was followed by a \$400 million fund-of-funds in 2000 and a \$500 million fund-of-funds in 2001. In addition to these discretionary funds, CalPERS had invested another \$1.5 billion alongside GSA in venture funds and as the founding limited partner in five new "turn-key" funds where GSA had played an active role in assembling the team.

Recently, the CalPERS model had been expanded to a second client, the Oregon Investment Council (OIC). Having invested in KKR's original fund in 1981, OIC was one of the more sophisticated private equity limited partners in the world. However, with \$100 billion under management OIC found it difficult to directly invest amounts less than \$50 million and did not have the resources to effectively identify and evaluate emerging investment teams. In early 2001, Oregon had agreed to place a \$250 million discretionary account with GSA targeting small venture and buyout funds.

The past two and a half years had been a virtual whirlwind. GSA's four partners had evaluated over 1,000 venture funds and had made investments in 75 of these. In addition, five "turn key" funds had been created (see **Exhibit 1**). With two major clients and a broad range of top-tier and emerging fund relationships, GSA was now a solid feature on the private equity landscape. Crockett, Harris, Mazza and St. Germain felt the time was right to evaluate a range of options for growing the firm.

There were a number of directions GSA could take. The most straightforward to was add more clients under the existing model and discussions were underway with pension managers from a number of US states and foreign countries. GSA had to consider how many dedicated accounts it could effectively service as well as the minimum size account that made sense. In addition, the firm also had to consider the realistic total allocations it would be able to obtain in top funds, as well as potential conflicts in how to divide this allocation between its various clients.

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From a “product” standpoint, another growth option might be to extend the model to additional asset classes in private equity. The most recent CalPERS fund, as well as the Oregon program, allowed GSA to invest a portion of the capital in small to mid-sized buyout firms. A further logical extension might be to build an investment program targeting smaller hedge funds. In addition, GSA’s skills in evaluating illiquid fund portfolios in order to assess a fund’s track record could potentially be extended to the secondary market, which consisted of buying out the position of limited partners that wished to exit a fund before the natural end of the fund’s term. GSA was also considering development of a traditional fund-of-funds that would be managed as one discretionary pool with a range of investors, in contrast to its dedicated programs for large clients with specific strategic objectives.

Lastly, the range of relationships GSA had established with private equity groups created the potential opportunity to access the deal flow of these firms via a fund for direct investment in operating companies. In theory, GSA’s advisory relationships with very large investors, such as CalPERS, would make it a desirable co-investor. However, GSA had decided in early 2000 to slow down the co-investment component of the first CalPERS fund for a range of reasons. If GSA decided to restart a direct investment program, how should the original approach and structure be modified? What potential conflicts with its core activity of investing in funds did a direct co-investment program create?

With so many options, the group wondered how GSA should determine its strategic priorities. How should GSA balance the demands of executing for its current clients with the opportunities to win new clients and broaden its lines of business?

Intermediaries in Private Equity Fundraising¹

A number of parties provide services which seek to facilitate the process by which private equity firms raise their funds from limited partners.

Placement agents assist in preparation of private placement memorandums describing the fund and also arrange meetings with institutional investors. Groups in this segment include divisions of the major investment banks, such as DLJ and Merrill Lynch, as well as specialized groups such as The Monument Group. Placement agents are typically compensated on a transaction basis and receive a percentage of the funds raised, ranging from 0.5% for established funds to as high as 3% for first-time funds.

Another set of intermediaries include consulting firms such as Venture Economics and Cambridge Associates that catalogue the performance of the industry and assist limited partners in evaluating fund investments. Such firms work on a fee-for-service or subscription basis.

Investment Advisors, or “gatekeepers,” also assist institutional investors in allocating funds to venture partnerships. In some cases, these firms play a role similar to the consulting firms, advising clients on investments, performing due diligence on fund’s track record and providing fairness

¹ This section is based largely on Robert Pease, *Private Equity Funs-of-Funds: State of the Market*, Wellesley, MA, Asset Alternatives 2000; Lerner, Josh. Harvard Business School, “Note on the Private Equity Fundraising Process”, N9-201-042; and Lerner, Josh. Harvard Business School case #N9-201-043, “University Technology Ventures.”

opinions on investments by public pension funds. In these cases, advisor compensation is based on fee-for-service. In other cases, advisors have discretion over their client's money, either as dedicated accounts or commingled in "funds-of-funds" (see **Exhibit 2**). In the case of discretionary programs, advisors typically receive an annual management fee in the range of 1% of the total capital in the program. While such funds-of-funds had their origins as pools of capital raised from institutional investors, recent years have seen an increase in the number of funds-of-funds offered by banks to their high-net-worth clients.² In addition, there has been a trend towards inclusion of a share of profits, or "carry", as a part of compensation for funds-of-funds managers. Such carry is typically in the range of 5% of profits.

The fund-of-funds category has seen significant growth in recent years, accounting for as much as 20% of total capital raised in 1999. Such dramatic growth can be explained by the five types of benefits provided by funds-of-funds. First, *access* to funds with top quartile historical track records can be difficult. Established funds-of-funds have historical relationships with these top partnerships and new investors in the asset class often see funds-of-funds as a way to gain access to top general partnerships. Second, because they typically invest in 10 to 30 different partnerships, funds-of-funds can provide a simple means of achieving *diversification* in the asset class. Third, investing in private equity requires significant effort in due diligence, tax and legal issues and fund oversight. Funds-of-funds are positioned to more effectively handle these *administrative tasks*, reducing the burden on both the limited and general partners. Fourth, funds-of-funds with a *specialization*, for example by geography, industry sector or stage of investment, can allow large institutional investors to fill gaps in their portfolios. Lastly, with respect to differences in *scale*, most general partners will only take limited partners that can meet their required minimum investment, often in excess of \$5 to \$10 million. Many smaller institutional investors, and certainly most individual investors, are therefore not in the position to invest large enough amounts in the asset class to participate in more than a few funds. On a related note, some of the very large institutional investors may lack the resources to make fund investments below a minimum size. In this way, funds-of-funds can mediate such size difference by allowing investors to either "scale up" or "scale down" (see **Exhibit 3**).

Planting the Seeds of Grove Street Advisors

Clint Harris

After 5 years as a US Navy submarine officer, Clint Harris attended Harvard Business School and graduated in 1977 as a Baker Scholar. After graduation, Harris joined a new strategy consulting firm, Bain & Company, where he spent 7 years participating in the firm's growth from 20 employees to over a thousand. In 1984 Harris joined Peter Brooke of venture firm TA Associates as a co-founder of a private equity firm, Advent International. In addition to serving on the Investment Committee that reviewed and approved several hundred portfolio company investments, Harris focused on fundraising and brought in more than \$800 million from both corporate and institutional investors over his 13 years with the firm. At the end of 1997 Harris decided to leave Advent to start a new type of intermediary in the private equity fundraising industry. He recalled:

The original vision for Grove Street came from observing how gatekeepers treated Advent International. Advent was a firm founded on Peter Brooke's reputation from TA Associates and the concept of building an international network of private equity firms. Yale and Harvard both committed to our first fund. It was a classic first time fund with proven people but, irregardless

² Toll, David M. "Funds of Funds Begin to Specialize as Field Grows More Crowded." *The Private Equity Analyst*. August 1998.

of Peter's prior track record, as a first time fund we had no shot at raising money via gatekeepers. Advent grew significantly and, by early 1997, was able to raise a \$1.3 billion fund in about 6 months. In those months we spent a huge share of our fundraising manpower responding to information requests and attending meetings with the 6 traditional gatekeepers we were talking to. At the end of the fundraising process, the fund was over-subscribed, none of the gatekeepers had given us an answer and we had no clue where we stood with any of them. When we called them to say we were closing the fund, in two cases it was clear that they could not have cared less. In another two cases they said they could not invest in an international fund, which made us wonder why they were talking to a firm named Advent International in the first place! The last two said they were very interested but needed two more months to complete their analysis. We all looked at each other and said, "never again." When it came down to it, the gatekeepers, relative to the size of the checks they could write, were the least impressive people in the private equity chain. The way they ran their businesses from their own internal perspective made no sense to me and I could not understand why large institutional investors would choose to be represented by them. But these firms effectively controlled a large share of the funds available to private equity.

This experience caused me to think about how I might design a firm in that space. I wouldn't really call this a moment of recognition of a market need, because if you went around asking the market if they felt the industry needed another gatekeeper the answer would have been a resounding, "no." In fact, when I asked my colleagues in private equity for their views of my concept for Grove Street, they said, "why would you want to get in that business? Its a horrible business."

However, there appeared to be a much better business model than anyone was using and, if you could pull it off, there were some very attractive things about the market. First, it wouldn't go away since the public pension fund managers are required to use an outside advisor of some sort. Second, if your process and your people were respected by the private equity fund managers, they would ultimately become your sales force because they are always asking each other who are good limited partners to work with. Lastly, if you properly structured your relationship with your clients, your performance would be completely measurable. If you could produce above average returns and link these returns to your process and people, you have a long-run position that is very defensible.

Catherine Crockett

While Harris and Advent were pioneering private equity in countries like Israel, Catherine Crockett was working in a parallel universe as an advisor to public and private institutions on the use of private equity to stimulate local economic development and enhance investment returns for public pension funds. After graduating from Harvard's Kennedy School of Government in 1987, Crockett joined Economic Innovation International, Inc., a consulting firm which helped institutions develop economic development strategies that could leverage technology entrepreneurship and investment. After rising to Partner and COO, Crockett left in 1996 to form her own firm, The Gazelle Group. Crockett recalled:

Our assignments ranged from helping the state of Michigan induce a top private equity group to move from Chicago to Detroit, to creating a program for Puerto Rico's government development bank to invest in private equity via a fund-of-funds and use the profits for local development. Over the years, Peter Brooke of Advent was a very helpful mentor to me and introduced me to Clint Harris. We worked together on the Puerto Rico project in 1997 and got to talking about the opportunity Clint saw to create a new type of advisory firm. My experience working with public sector clients and helping to put together private equity partnerships fit very well with Clint's

background. At the end of 1997, we shook hands on working together on the concept and formally hung out our shingle on May 1, 1998.

We were convinced that, as a new organization with no track record, the best we could hope for would be to find a client who really understood private equity and would give us a small amount of money on a trial basis. We thought if we could win two or three small projects and prove our model over a few years, we might be in a position to take on a big client. However, within a month we were introduced to Barry Gonder at CalPERS and the exact opposite happened.

CalPERS

As of March 31, 1998, CalPERS administered a pension fund with total assets of \$140 billion. These assets were allocated as follows: \$65.6 billion in domestic equities; \$38 billion in domestic fixed income; \$27.3 billion in global equities; \$5 billion in global fixed income; \$5.8 billion in equity real estate; \$1.2 billion in cash; and \$3.4 billion in alternative investments, including private equity.³

Barry Gonder joined CalPERS in 1996 as Senior Investment Officer. Prior to CalPERS, Gonder had spent 10 years building a private equity program for Travelers Insurance, primarily investing directly in deals but also as a limited partner in some funds. Gonder recalls:

When I first joined CalPERS in 1996 I was a little stunned. The private equity portfolio was 89% in buyouts with virtually nothing in venture capital, mezzanine growth capital or international private equity. My mandate from the CalPERS Board was to build a world class private equity program and to get to a point where we could invest 5-10% of assets in the sector. Including the amounts we would receive as distributions from our existing private equity investments, that translated to moving some \$20 billion into the market over a few years.

Within 3 months of joining, Gonder became a champion of CalPERS' Alternative Investment Management (AIM) Program, an initiative to expand and diversify the alternative investment portfolio. By 1998, CalPERS had forward commitments of \$7 billion to 98 partnerships under the AIM program. However, less than \$200 million of these commitments were in venture capital.⁴ While this allocation to venture partnerships may appear relatively low, it was not an atypical allocation for a state pension fund.

The primary factor driving the historically low public pension fund allocations to venture capital is the sheer size of their assets relative to their manpower. For example, with \$140 billion in assets, it was very difficult for CalPERS to make individual investments of less than \$50 million. For top-tier funds an allocation of this size were difficult for a new investor to obtain, whereas for smaller funds such an investment would represent a majority of the fund.⁵

Furthermore, through the 1980's and early 1990's, returns from venture capital had been similar, if not inferior, to returns from the buyout business. The ability to invest large amounts per fund in the buyout area, combined with the perceived lower risk and greater understandability of the companies in buyout portfolios versus venture portfolios, resulted in large allocations to the buyout funds as compared to venture funds.

³ CalPERS memorandum. Venture Capital Vehicle Solicitation. July 6, 1998.

⁴ Carey, David. "The True Believer at CalPERS." *The Daily Deal*. October 24, 2000.

⁵ Tenorio, Vyvyan. "Unlocking the Gates." *The Daily Deal*. June 21, 2000.

Lastly, one cannot underestimate the role of investment advisors as a barrier to public pension fund investment in venture capital. Even though these firms often did not have discretion in a literal sense, state pension managers were forced to have an advisor to render a fairness opinion on any investment, and most had only one approved advisor. By default these firms were therefore true gatekeepers and the only way to change advisors was to hold a drawn out public process to approve a new advisor.

With respect to CalPERS' buyout fund portfolio, one could argue the gatekeeper process had been effective, with the buyout portfolio delivering a long-term annual return in the range of 30%. However, from the perspective of the private equity firms, the gatekeepers were viewed, at best, as a "necessary evil." Because the large buyout firms had to raise multi-billion dollar funds in chunks of several hundred million per investor, they were willing to put up with a state pension fund's process and associated gatekeeper if a \$200 million check was waiting at the end of the process. According to Gonder, "the Blackstones, KKR's and Welsh Carsons of the world have an insatiable demand for capital and will put up with a hell of a lot from the limited partners who can write the big checks. In contrast, in the top venture funds and in the small end of buyouts, the General Partner picks their investors, not vice versa. You have to build good relationships and be well thought of. You can't just buy a stock like we do in the public markets."

In addition to structural factors, however, CalPERS also suffered from reputational barriers that had reduced its appeal as an investor for the venture community.⁶ Firstly, CalPERS had a relatively onerous process that required a lot of paperwork and a lot of time. Harris recalled from fundraising days at Advent:

CalPERS were one of the biggest checks you could get but also one of the hardest to deal with. This makes some sense in that, when you're the biggest you have the opportunity, and perhaps the fiduciary responsibility, to throw your weight around to get better terms. Unfortunately, that doesn't work well in private equity, particularly in the small end of the market or in the top-tier part of the market. In addition, CalPERS has always had a reputation for being an activist in corporate governance and shareholder litigation. That had never really been brought to bear in private equity but there was the association of this with the CalPERS name. Then, in the mid-1990's, their Chief Investment Officer tried to lead a revolt on KKR's fee policy. KKR refused to allow them into the fund and successfully raised it on their original terms. CalPERS got a lot of negative publicity on this in the private equity community.

Gonder acknowledged CalPERS' reputational problems, as well as the barriers that its current process created. He also recognized what a lack of access to quality venture capital funds meant to the overall portfolio returns, in both the short and long-term, compared to institutional investors of similar size (see **Exhibit 4**). With internet boom of the late 90's taking off, the CalPERS Board wanted to invest in the Silicon Valley venture capital industry but were disappointed to find they could not gain access. Gonder commented:

It is only a 110 mile drive from CalPERS' offices in Sacramento to Sand Hill Road in Menlo Park, where a large portion of the world's venture money sits. You would think that as one of the largest institutional investors in the world and as a pension manager for millions of Californians, we would be major supporters of the California VC industry, but we were not. On top of that venture capital had been giving great returns and CalPERS was missing out.

⁶ Kumar, Vishesh. "No More Mr. Mean Guy." *Industry Standard*. April 27, 2001.

When I tried to investigate why that was, I found a couple of things. First, the traditional gatekeepers that worked for CalPERS really didn't understand VC at all and had alienated the venture community with 100 page questionnaires. You can't go to Kleiner Perkins and ask them to fill out a 100 page form. You go to KP and get on your knees and beg. Second, CalPERS itself was viewed as a political animal with a corporate governance program that, in many cases, took a hard line with corporate America and a tough stance on incentive fees. Layer on this the fact that to do a typical venture fund investment of \$20 million takes the same work as putting \$200 in a buyout fund. Lastly, CalPERS was late to VC and most of the great funds were closed to new investors.

Gonder felt he knew how CalPERS needed to change to get access and developed the Venture Capital Vehicle (VCV). The objective of the program was to find a partner who could build a venture capital program for CalPERS. Gonder recalled:

I realized the problems we had and I knew we had to do business a different way. Part of venture investing is analytics and part is relationships. For example, when I got to CalPERS I called Brook Byers, a founder of Kleiner Perkins, whom I had known from Travelers as a limited partner in the KP funds. I said, "Brook, I'd like to invest with you," and he said, "Sure Barry, let's talk about it. Who are you with now?" I said, "CalPERS." There was a bit of silence and then he said, "Well, good luck to you."

In order to overcome this reputational problem I knew we had to create a buffer to give the GPs a security blanket. In addition, we needed to put a really good face on CalPERS by choosing representative who were well-connected and could open doors. We needed people who could do the analytics but who were also viewed as members of the community. I wanted a group would both give us access to the great existing firms and could also do the work to identify the up-and-coming groups that were likely to be the next generation of great funds and get in these early so that, when they became closed to new investors, we would already have a seat at the table. I called everyone I knew in venture capital and asked who would be good at doing this. I was eventually introduced to Clint Harris. In my first meeting with Clint, within about 3 minutes I knew that he "got it." He was a member of the community, had been a direct investor and he had dealt with gatekeepers. One of my problems with traditional gatekeepers is that most have never been in a direct investment firm. How can you analyze a fund and judge a team's ability to do investing if you've never been on their side of the table?

Harris recalls,

We met Barry in the Spring in 1998. We had a vision of what we wanted GSA to be and Barry had a vision of what he was looking for. It turned out to be a perfect match, except for three small issues: we had no track record, our team was incomplete and we weren't based in California. However, in terms of the qualifications of the core partners and the vision of what he was looking for, it was a great fit.

As for the team's completeness, Gonder did have some concerns. Without an established business and deal stream, it was not clear that GSA had the relationships with private equity fund managers to gain quick access to quality funds. This prompted GSA to formalize a relationship with one of their current informal advisors.

David Mazza

After graduating from Harvard Business School with Harris in 1977, Dave Mazza entered the executive search industry with leading firm Russell Reynolds Associates. He then went on to co-found his own search group focused on recruiting general partners and senior executives for venture capital and buyout firms and their portfolio companies. Mazza sold his firm to Korn-Ferry in 1996. These years as a “collector of people” in the private equity industry left Mazza with a phenomenal rolodex and “IOUs” from the General Partners he had placed at 40 of the industry’s top firms. Mazza recalled:

Clint and I were sectionmates at HBS and had known each other over our careers. I did a number search assignments for Advent and also introduced Clint to GE Capital which, with an initial commitment of \$225 million, became the biggest deal Advent ever did with an institutional investor. While Clint was thinking about forming GSA, we spent a lot of time talking to about his ideas. I was initially dismissive of the idea of being a gatekeeper but, as Clint’s discussions with CalPERS evolved, it became clear to me that we had an opportunity to develop a different type of advisor. I knew my industry contacts were the element Clint and Catherine were missing and also believed there was a great opportunity to leverage some of these relationships to create new “turn-key” teams. With Barry Gonder’s encouragement, I agreed to join contingent on GSA getting the CalPERS contract.

The Proposal to Create California Emerging Ventures

After a series of discussions Gonder strongly recommended that GSA submit a proposal for the VCV. The Partners of GSA took a month off from all other activities to write the proposal for creation of a vehicle named California Emerging Ventures I (CEV I).

The primary component of the program would be a dedicated fund-of-funds of \$350 million which GSA would invest at its discretion. Not more than \$25 million would be placed in any one fund and not more than 10% of the pool would go to international funds. GSA decided on a pricing structure that would include a combination of fees and carried interest. The group’s objective was to fully align its interests with those of CalPERS. The fees for a typical institutional fund-of-fund manager were 1% of committed capital for the life of the fund with no carried interest. GSA set its fees at 0.75% of the total committed capital of a program for the first 3 years, 0.375% for years 4 to 6 and 0.1875% for years 7 to 12. GSA’s proposal was to make up for the lower fees by sharing in the net profits of its programs via a carried interest. The carry was set so that the program had to meet a benchmark rate of return of 10% per year before any fees were payable. Above this hurdle, GSA would receive an increasing share of the profits as the level of return increased. In this way, if GSA failed to achieve benchmark rates of returns the cost of the GSA program would be substantially less than the fees only structure of a large institutional fund-of-funds provider. At an acceptable level of returns GSA’s compensation would be equivalent. If GSA substantially exceeded the benchmarks, it would clearly earn more than with a fees-only structure, but the returns would have been earned through the superior performance of the program for CalPERS.

Of the \$350 million, between \$250 and \$300 million would go to investments in fund partnerships with \$50 to \$100 million set aside for direct investments in portfolio companies. Gonder commented:

Originally, there were three reasons I wanted the CEV I program to have a direct investment component. First, I felt GSA could be value-added to the partnerships we backed by providing capital for co-investment. Second, I thought being in some deals would keep GSA connected to

the underlying market in a tighter way. Third, we get a lot of direct investment deal flow at CalPERS and we just did not have the time to look at the small investments. We needed a place to put it so we could evaluate it and respond appropriately.

The proposal also allowed for the creation of a supplemental pool for CalPERS to make investments in funds alongside CEV I in cases where GSA was able to obtain a larger allocation and CalPERS was interested in holding more than \$25 million of the fund. On these extra co investments GSA would not receive any fees and would have half the level of carry of the primary program.

In addition to the core fund-of-funds and the supplemental pool, GSA also included ideas on how it could add further value for CalPERS. Harris recalls, "When Dave came into the mix he brought this tremendous added-value opportunity to integrate his relationships with people in the industry to create new "turn-key" funds." For example, Mazza had been in confidential discussions with two senior partners at Bain Capital who wished to start their own fund. GSA thought they could serve as the catalyst to turn groups such as these into great platform investment opportunities for CalPERS. Gonder was very receptive to this idea:

I had noticed a phenomena where many very strong partners at the mid-points of their careers with a lot of deals under their belt with great firms were getting itchy, either because they wanted their own name on the door or because they felt uncomfortable with the succession plan, or lack thereof. As firms grow and are successful you run into a lot of incentive issues: do the partners stay together, are they so wealthy they lose interest, are they grooming young people for the succession of the firm? It was clear there was a great opportunity for CalPERS to use its checkbook to capitalize on this feature of the industry and to grab these people and help build great firms around them. GSA was wonderfully positioned to help us do this.

The GSA team added the turn-key strategy to their proposal and proposed to receive half the level of carry and half the fees of the core program for all funds invested in turn-key projects. In addition, in cases where GSA was able to negotiate a discount on the fund terms in exchange for its role in forming the team and securing the founding investment commitment, GSA and CalPERS would share these discounts equally. Such discounts might take the form of a few % points of ownership in the General Partner's carry.

In April 1999, GSA and 15 other groups submitted their proposals to CalPERS and waited over the summer for a response.⁷ Harris recalled:

In September we found out we were one of four finalists. Barry and his colleagues came to visit us for a few days and, in October, we went to Sacramento to make a presentation to the CalPERS Board. We had a timed 10 minute slot to present. I had practiced the presentation a thousand times and had it cold at 9 minutes and 30 seconds. This turned into a bit of a funny scene as we had to make a "politically correct" decision as to who would turn the slides. We did not want it to be Catherine, as that might send the wrong signal, so we chose Dave. Now Dave was an All-American athlete at Brown but had apparently never turned plastic overheads in his life. He had all kinds of trouble and dropped slides and when the 10 minute bell went off I hadn't been able to conclude my presentation. However, we knew it had gone well when the first question asked was "would you please conclude your presentation." We flew back to Boston with high hopes and the next day they called to tell us we won it. There is still a cracked ceiling tile in conference room where Catherine literally hit the roof in her exuberant jumping up and down.

⁷ Toll, David M. "CalPERS Entrusts Venture Program to Fledgling Firm." *The Private Equity Analyst*. November 1998.

Over the next few months GSA and Gonder negotiated a detailed term sheet and eventually finalized documents with the CalPERS attorneys in early 1999. However, as soon as the proposal was approved GSA began talking to the funds who were raising capital. Crockett recalls, “in late 1998 we committed to Technology Crossover Ventures (TCV) and Idealab Capital Partners and they both held spots for us until we had our money. Those turned out to be two great funds. In fact, these funds produced some immediate big hits resulting in a net IRR of 322% in our first quarterly report to CalPERS. It was truly a unique time in the history of venture capital and the cover letter to CalPERS stated that we were 100% confident in our ability to never again achieve a return of this level!”

With the contract in place, Mazza went to work on the first turn-key with Geoff Rehnert, a co-founder of Bain Capital, and Marc Wolpov, previously at Bain Capital and later the founder of Sankaty Advisors, Inc., an affiliate of Bain Capital that invests in bank debt, high yield bonds, mezzanine loans and special situations. The pair planned to create a new firm, Audax Group, and wished to develop a structure that would allow them to very quickly play in all the important segments of private equity. Mazza commented:

We came up with a structure where CalPERS would invest in a holding company, Audax LP, in exchange for an ownership stake in this holding company. Audax would be structured with a series of funds, including buyouts, mezzanine debt and venture capital. Each of these funds would have its own 20% carry, with a portion of this going to the people dedicated to managing that fund and a portion going to the holding company. CalPERS would have the right to invest up to 20% of each fund. This approach gave Rehnert and Wolpov the capital to build a top team and jump start their efforts to create deal flow without having to wait until a critical mass of money was raised for each individual fund.

In June 1999 the CalPERS Board approved an investment in Audax of \$187.5 million, which was increased by an additional \$50 million a year later.

GSA’s next turn key was Solera Capital, a firm founded by three women, Molly Ashby, Lori Koffman and Karen Gordon Mills, who each had very successful track records as partners at top private equity firms. Mazza recalled:

We thought Solera was a great opportunity to build an unfair competitive advantage in the industry. Private equity has historically been an “old boy’s network,” but some significant minority of entrepreneurial ventures have women as founders or CEOs who would love to work with a high quality team of women investors. We thought building a first-tier team with a set of top advisors was a great opportunity to be the one fund, in a universe of thousands of funds, with a disproportionate access to these deals. We committed the first \$75 million to the fund alongside Chase Capital’s \$25 million. The response since then has been great with a total of \$225 million raised to date.

CEV II and CEV III

When CalPERS and GSA originally planned the investment strategy for CEV I, GSA had identified the funds where it felt it could gain access. Both parties had expected GSA to commit the \$350 million over a single “fundraising cycle” of two to three years. However, 1999 was such a banner year in venture fundraising that all the targeted groups came to market that year and GSA found itself putting the money out much faster than anticipated. Harris recalled, “we were at a real decision point since we felt we either had to invest all the money in one year and convince CalPERS to give us another fund so we could be in the market the next year, or we would have to pass on a number of very good funds.” GSA chose the first option and CalPERS agreed to commit another

\$400 million, CEV II, in June 2000 and the rapid pace continued through most of that year. CEV III at \$500 million was committed in March 2001, but with the pace of fundraising clearly slowing, both GSA and CalPERS expected it to take at least two years to commit CEV III to quality funds.

By mid 2001, GSA managed a total of \$2.75 billion for CalPERS, including \$1.25 billion in three dedicated funds-of-funds and approximately \$1.5 billion in supplemental investments and turn-key programs (see **Exhibit 5**).

Building GSA's Operating Strategy

Once the CalPERS contract was awarded in 1999, GSA got to work creating a set of operating systems and philosophies to help move the \$350 million into funds (see **Exhibit 6**). Harris talked about the way GSA approached the evaluation of fund investments and gaining access to quality funds:

The way you get into good funds is to run your process so that you can make a good investment decision but also in a way that allows you to pick and choose the funds you invest in, not vice versa. This process is being quick and being clear, being somebody they respect, not wasting their time, doing diligence on things that matter and saying "no" relatively quickly if the answer is going to be "no." When we started GSA, I could not see any reason why our investment process shouldn't be run in the same way a VC runs its process. The major asset in any investment firm is the time of its people and a good VC firm minimizes the time it spends on deals it doesn't do, focuses its energy on the deals it does do and is respectful of the time of the entrepreneurs it backs. What we are doing is not rocket science. The way we design a portfolio and think about manager selection is what Yale and Harvard have been doing for 20 years. The way we run our evaluation process is what every good venture firm does with the deals it considers.

In the long term you need to be a stable organization and develop a reputation for fairness and efficient thoughtfulness. When a major investor chooses to pass on a fund or to not reinvest in a fund, this can do major damage to the fund. Our decision not to invest in a fund is about as important as our decision to invest. To say "no" without thinking about it is to do harm without thinking about it.

In addition to the process for evaluating funds and making investment decisions, a major part of the GSA operating system would be the accounting and reporting infrastructure of the firm.

Ann St. Germain

GSA's fourth partner, Ann St. Germain, joined the group as CFO upon signing of the final documents for CEV I. St. Germain had spent 12 years in public accounting as a Partner at Ernst & Young where she focused on assisting venture capital firms with financial due diligence on portfolio company investments. Advent was one of her clients, both for due diligence and also for the firm's reporting to its limited partners. It was in the latter capacity that she got to know Clint Harris and came to later join GSA. St. Germain commented on the creation of GSA's reporting systems for CalPERS:

They wanted a tremendous level of detail and the ability to slice the data in a number of dimensions. We were also eager to start with a system that captured a lot of information, knowing that we could always provide less to a client if that's what they wanted, but would still have the data to answer any questions that came up. Today we receive quarterly information

from 90 funds, including updates on every portfolio company, which we process into an universal data base and provide in different forms to CalPERS. Luckily, an increasing portion of our funds are now reporting to us electronically or providing us with direct access to their fund accounting data via a private network.

Adding Value

The partners of GSA believed that the key to sustainable growth was to ensure they were continuing to deliver value to their clients. For CalPERS, this was primarily achieved by using their contacts and experience to get into the best funds, but also to intelligently choose those emerging funds expected to be the top funds in the future.

In addition, CalPERS' stated objective in the CEV program was to establish itself as an "investor of choice" in private equity. CalPERS viewed GSA as means to achieve this objective rather than as a permanent intermediary in its long-term relationships with select funds. On this basis, GSA had structured its program with CalPERS to transfer fund relationships to CalPERS over time. For instance, in 1999 GSA was able to gain access to New Enterprise Associates (NEA) one of the industry's oldest fund managers and a long-term top performer. GSA made a \$5 million investment in NEA 9 out of the CEV I pool. In 2000, NEA came to the market again with NEA 10 and GSA invested \$10 million from CEV II but also facilitated a direct investment of \$65 million by CalPERS from the supplemental pool. The expectation of all parties for NEA 11 was that GSA would make no investment and CalPERS would have the opportunity to invest in the range of \$100 - \$150 million. Other GSA fund investments expected to be transferred to CalPERS include Austin Ventures, Draper Fisher Jurvetson, Highland Capital Partners, Lightspeed Venture Partners (formerly Weiss, Peck & Greer), MPM Asset Management, Oak Investment Partners, Quadrangle Capital Partners, Spectrum Equity Investors, Summit Partners, TA Associates, Technology Crossover Ventures and VantagePoint Venture Partners.

Harris commented:

There is no other investment advisor in the market that includes self-cannibalization as a conscious part of their business model. This is partly the service philosophy I learned at Bain & Company. Any service firm, especially a premium price firm, always has to be on the steep part of a value-added curve in order to win new business from the client in the future. Looking at our business model, one can see a risk that, as clients reach their target allocation and we have handed off the top-tier relationships, that there is no future role for us with that client. The art form is to continue to do a good job of doing the part of the business they can't do in-house and, in effect, cannibalizing ourselves long before the client gets frustrated with a lack of added value. A less preferable alternative might be to keep managing the same programs for the client but reduce our fees over time. In either case, the key is to keep our fees in line with our perceived added value.

One of the strategic questions we face is that CalPERS likes us right now and we could probably go to them with an additional product, such as a hedge fund program, and they would give it to us. But we don't want to do that until we are confident we can run a top quality program.

In addition to adding value for its clients, GSA believed that adding value to the funds in which it invested was an essential aspect of its strategy. GSA's objective was to be the first added-value institutional investor in private equity. To date, corporations and select high-net-worth entrepreneurs have been desirable limited partners based on the contacts and resources they bring. However, because their investments tend to be small, these groups are more expensive to raise money from on a per-dollar-raised basis. Because their strategic objectives change over time, they also tend to be less

stable investors from fund to fund. In contrast, institutions are able to make larger investments, increasing fundraising efficiency, and also tend to be reinvest over the long term. However, with the exception of select endowments, such as Harvard and Yale, that bring credibility to a fund, institutional investors typically do not add any value to the fund. In fact, as previously stated, many of the largest pension fund investors can be difficult to deal with.

Part of GSA's strategy was to make it painless for venture fund managers to work with the largest institutional investors, allowing them to diversify their investor base. In addition, GSA believed it could position itself as a preferred limited partner by bringing value to the funds in the form of deal flow and assistance with staffing.

Relationship with TMP Highland

Part of GSA's added value was its relationship with the executive search firm TMP Highland. The principals of The Highland Search Group had worked together as the financial services headhunting team at Russell Reynolds in New York and had left in 1995 to form their own firm. The group had come to be the leading executive recruiter in financial services, including buyout and hedge funds, before it was acquired by TMP in 2000. GSA had developed a relationship with TMP Highland where, in exchange for a share of the economics of GSA's investment programs, GSA had access to Highland's industry contacts. GSA considered this a competitive advantage on three fronts. Mazza commented:

Just like my rolodex from my executive search days, our relationship with Highland give us tremendous access to people in the industry to assess the dynamics of the funds we are evaluating. We are able to very quickly find out, before we invest, which junior partners are unhappy and looking to leave a fund, as well as how much time the senior partners are spending on the golf course. By definition, the returns one looks at when one is evaluating a fund are 5 years old. During that period the dynamics and incentives within a fund change a lot and it is critical to find out who is really driving the current value creation, or lack thereof, to determine if a historic top-tier fund is likely to remain a top performer over its lifecycle (see **Exhibit 7**).

Secondly, our relationship with Highland allows us, in many cases, to know which funds need people and to assist in the building fund teams. This has the highest added value in the case of the emerging teams.

Highland also provides a competitive advantage in creating turn-key opportunities. They have brought us a number of opportunities to back high-quality people from established funds to create new investment platforms. One example is Steven Klinsky, formerly at buyout firm Forstmann Little, who we worked with to create New Mountain Capital with a \$100 million founding commitment in 1999. New Mountain's fund is expected to close out at \$800 million. Once the core of these new funds is created, Highland helps to build out the rest of the team at no additional charge to GSA, CalPERS or the fund.

Revaluating the Direct Investing Program

Shortly after signing the CEV I documents, GSA added a fifth partner, Steve Horen, to handle the direct investing part of the program. Horen was based in California in order to focus on California direct investment opportunities. At the outset, the firm believed there were three strategies it could adopt as a co-investor. The first would be to represent to the funds in which it invested that part of its model was to be a co-investor in these fund's Series A deals; effectively, providing GSA with access to some of the fund's deals as a co-investor would be an unwritten *quid pro quo* for GSA investing in the fund. Secondly, GSA could establish its own deal flow and bring these opportunities to the

appropriate fund in its portfolio. The fund would lead the deal and GSA could co-invest, resulting in added-value for all parties. Third, GSA could build an organization that would scour the portfolio's of its various fund managers to identify deals that it liked and would seek to build a position as a late-stage investor in these companies.

As the direct program progressed, a total of \$28 million was invested in 15 companies. However, a number of issues surfaced. First, the CalPERS program was scaling much faster than anticipated and the partners found that, on a per-dollar-invested basis, direct investments required significantly more time than fund investments. Crockett recalled:

CalPERS was paying us fees with the primary objective of developing fund relationships and we were spending a disproportionate amount of time on the direct part of the program. In addition, there were some debates as to which of the three co-investment strategies GSA should adopt and what that meant for our organization and our relationships with our fund managers. I was not in favor of using our fund relationships to claw our way into our GP's best deals. As a limited partner, we should want our GPs to get the best possible co-investors in their deals to add value and it was hard to argue we were that best Series A co-investor in many cases. Furthermore, there were issues as to how we should behave in this role. If a good fund gives you a co-invest opportunity you need to say "thanks." While you should kick the tires, unless you see a major issue, it is usually not appropriate to try to reinvent to deal from ground zero and there is a temptation to do that. You have to assume that, if you've chosen good investors and they are putting their money in the deal alongside you, the deal has been thoroughly scrubbed. In summary, there was a real question as to whether the better deals we got into were given to us at the expense of some goodwill at a time when our core objective was to break into the top funds in a market that was flush with capital.

St. Germain added, "There were also some situations in which a fund might offer us two co-invest deals, call them deal "A" and deal "B." When we looked at A it seemed a great opportunity, but B was kind of a funny deal that they appeared to be having trouble financing. In some cases the implication was, if you want A, you have to do B too."

The group consulted with Gonder and his staff and made the collective decision in 2000 to suspend the first strategy in order to avoid the conflicts with the core fund-of-funds mission. In order to be effective at the third strategy, GSA felt it would have to increase the scale and incentive terms of its direct activity but the Partners did not feel the time was right to focus their energy on this. As for the second strategy, GSA had a reasonable flow of direct deals, both from CalPERS and from their personal networks and, in a few cases, had referred deals to GSA's portfolio funds that had worked out well for all parties. The group decided to slow down the pace and effort put into the direct program and to limit its co-investments to added-value referrals of any deals it received. Gonder commented on his view of the decision:

As previously mentioned, I supported the direct investment program based on the premise of added-value and market intelligence. However, once we got it going, the timing was such that the industry was awash in capital so GSA's value-added to GPs as a co-investor was limited. We decided to slow it down for the time being and put the money out opportunistically over 4 to 5 years instead of over 2 years as originally expected.

From Start-up to Sustainability

Harris reflected on the thoughts he had at the outset of the GSA adventure and where he felt the firm was today:

When we started, there were two big risks in my mind. First, could we get off the ground and get a client? Our initial idea was to work our way up to “mega-clients” but somehow, we got lucky and won the biggest client in the industry right off the bat. Today, the first question must be, “can we duplicate CalPERS?” I think with the Oregon program and the other things we have in the pipeline, the answer to this is coming in. It seems very achievable to build a group of perhaps five large, long-term clients putting a total of few billion dollars per year to work. However, there are perhaps good reasons not to grow beyond this in our core business. We are only going to get a certain allocation in the good funds and, once we reach this level, we will have to go elsewhere to put additional money to work. If we take on too much money we risk becoming an index, which will destroy our positioning as an added-value intermediary.

The second risk in my mind was whether there was truly an opportunity to build a premier organization in a space in which, up to now, no elite organization existed. In other words, could we build the first Bain & Company of the gatekeeper space? To date the traditional gatekeeper has not been a premium firm. In contrast to the firms that are hiring the top talent at all levels of their organization, like Bain or Goldman Sachs or the private equity firms, the traditional gatekeeper is not interested in that type of person because their business model would not support the income and earnings needed to attract and retain them. Except for the top few people in the company who may do well, the rest of the organization will not. The question in my mind was, would the industry allow you to premium price your services in order to support such a firm? In the short term, the answer seems obvious as we are now very profitable and the economies of scale in our business are significant. In the long run, it should be an industry where this is sustainable because you can show a crystal clear track record and the economics of the asset class make it worth it to the client to pay for better performance.

We are where we are today mainly because CalPERS scaled so fast. But where do we go from here? Most people would probably advise us to focus on adding a few more clients to establish a broader foundation, building the team to give us more bandwidth and taking the initial steps into buyouts under the most recent CalPERS and Oregon mandates. But we wonder if this might cause us to miss out on other growth opportunities?

Future Directions

The group sitting around the conference table shared a laugh over that broken ceiling tile and thought back to the progress of GSA since that thrilling day in October of 1998 when GSA had won the initial CalPERS contract. GSA’s partners had been talking a lot recently about how they should chart the strategic path of the firm in the next few years and beyond.

In terms of core clients, should they focus on winning more “elephants” like CalPERS or was there an added-value opportunity to further differentiate themselves as specialized advisors? One of the primary voids the group saw in the market was a lack of fund-of-fund advisors that would truly customize an investment program for a client. As GSA evolved, each of the partners began to gravitate towards specialization by industry with Crockett spending much of her time focused on healthcare and life sciences funds. Recently, she had been in discussions with a large potential client that was considering GSA for a \$50 million program to build a healthcare private equity portfolio.

Should GSA consider taking on a smaller industry-focused program for a client? In general, how small a client could GSA afford to take on for a custom program? In addition, as new clients were added, how should GSA think about managing potential conflicts in how its limited allocations in the top funds were split between old and new clients?

GSA was also considering international expansion. In Europe the buyout industry was reasonably well-developed but venture capital was still at an early stage relative to the United States. Asia and Latin America were even further behind. To date, cash-to-cash returns from foreign private equity did not equal returns in the United States. Was there a true diversification benefit for GSA clients in international investing? How should GSA think about timing for international expansion? Would others fill the space if GSA waited?

A simple additional product might be a traditional fund-of-funds open to high-net-worth individuals and institutions. Such a discretionary fund could generate attractive additional fees and carry without the need to consider the fit of the fund portfolio with a client's individual needs. However, this space was crowded with groups such as Harbourvest well-established in the institutional fund-of-funds space and many investment banks, such as Goldman Sachs, offering their wealthy clients fund-of-funds products. GSA wondered if it should seriously consider entering this space and if so, how it might differentiate itself.

In terms of leveraging GSA's existing skill sets and relationships, the secondary business seemed an obvious extension. Following the crash of the IPO market and NASDAQ, many limited partners were interested in selling their fund positions. However, this opportunity had not gone unnoticed and several groups, including the large investment banks, had raised pools of capital to purchase secondary positions. How might this increase in ready-capital effect pricing of these deals? The recent deal with IMG / Sports Capital Partners had originated as secondary which then led to a turn-key expansion of the group. Should GSA raise a pool of money to target secondary opportunities or continue with an opportunistic approach of bringing interesting secondary deals to CalPERS, Oregon or its future clients on a case-by-case basis?

Hedge funds also seemed a logical extension. The manager selection process was similar to venture capital, the smaller and newer funds often had the best performance and the added value of picking the right funds could be significant. With its investment in Technology Crossover Ventures, as well as the MPM BioEquities turn-key, GSA had already begun to tread into the hedge fund space. However, GSA wondered what additional skills sets it would need to be truly effective in this market.

Lastly, there was a strong argument for revisiting the possibility of a direct fund to co-invest in companies with the funds where GSA was a limited partner. If GSA elected this route, what size of fund should it consider? Should its objectives be to position itself as an intelligent late-stage co-investor, or should it seek to develop its own proprietary deal flow? How should a direct fund be integrated or separated from the core fund-of-funds business? Did the strategy selected have implications for potential conflicts of interest with its clients, its fund investments or even between the partners of GSA?

Exhibit 1 – GSA Turn Key Programs

Audax Group – As described in the text, Audax Group was founded by senior partners from Bain Capital and manages buyout and mezzanine funds.

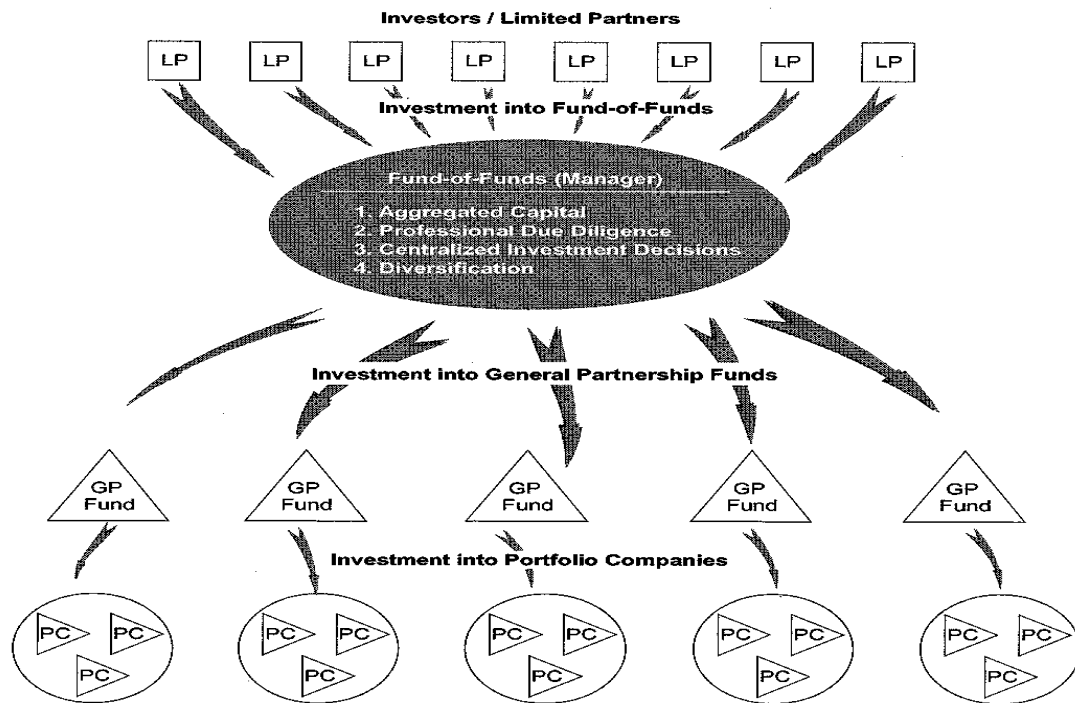
New Mountain Capital - Founded in 1999 by Steven B. Klinsky, previously a co-founder of Goldman Sachs Leveraged Buyout Group and a senior level partner of Forstmann Little, the fund invests in leveraged acquisitions, build-ups, recapitalizations, control restructurings, management buyouts, pre-public offering opportunities and growth equity transactions, with a focus on middle-market companies with enterprise values of \$100 - \$500 million.

Solera Capital – As described in the text, Solera was founded by Molly Ashby from JP Morgan Capital, Lori Koffman of CIBC Capital Partners and Karen Gordon Mills of MMP Group.

MPM BioEquities – MPM Capital is the world's largest private equity investor focused on biotechnology. In early 2001, Kurt von Emster joined MPM from Franklin Templeton where he had runs a top-performing biotechnology mutual fund. GSA coordinated a \$100 million founding investment in a hedge fund run by von Emster that would establish MPM as the first true crossover investor in biotechnology. In March 2001, the fund went live with initial capital of \$400 million.

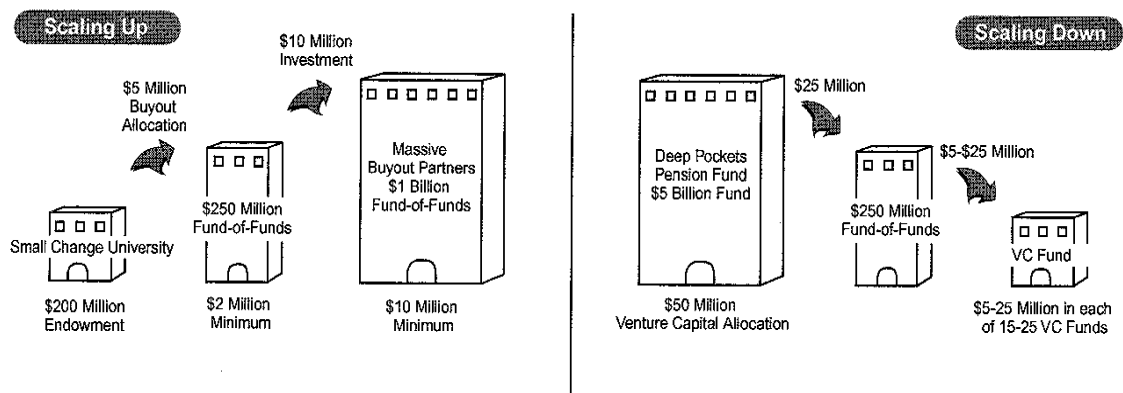
IMG / Sports Capital Partners – Originally founded as a joint venture between the sports industry giant, International Marketing Group (IMG), and the private equity firm, Chase Capital, Sports Capital Partners is the premiere fund targeting investments in sports and entertainment opportunities. GSA purchased Chase's position in a secondary transaction and then arranged an investment in the fund by CalPERS of \$100 million.

Exhibit 2 – Relationship Between Investors, Funds-of-Funds and Private Equity General Partnerships



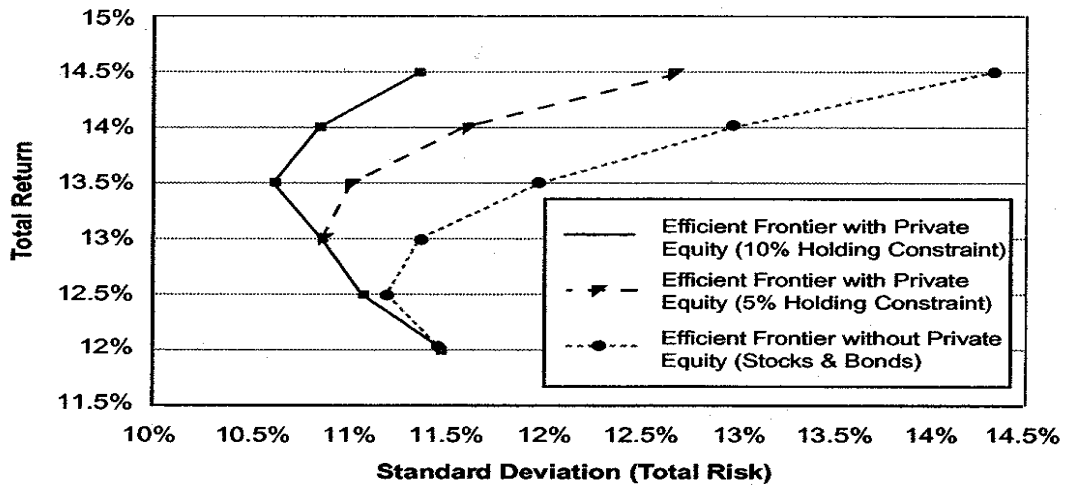
Source: Robert Pease, *Private Equity Funs-of-Funds: State of the Market*, Wellesley, MA, Asset Alternatives 2000

Exhibit 3 – Role of Funds-of-Funds in Bridging Differences in Scale Between Investors and Private Equity General Partnerships



Source: Robert Pease, *Private Equity Funs-of-Funds: State of the Market*, Wellesley, MA, Asset Alternatives 2000

Exhibit 4 – The Effect of Private Equity on the Efficient Portfolio Frontier



Source: Merrill Lynch Quantitative Analysis and Equity Derivatives Research

Exhibit 5 - Summary of GSA / CalPERS Program as of March 2001

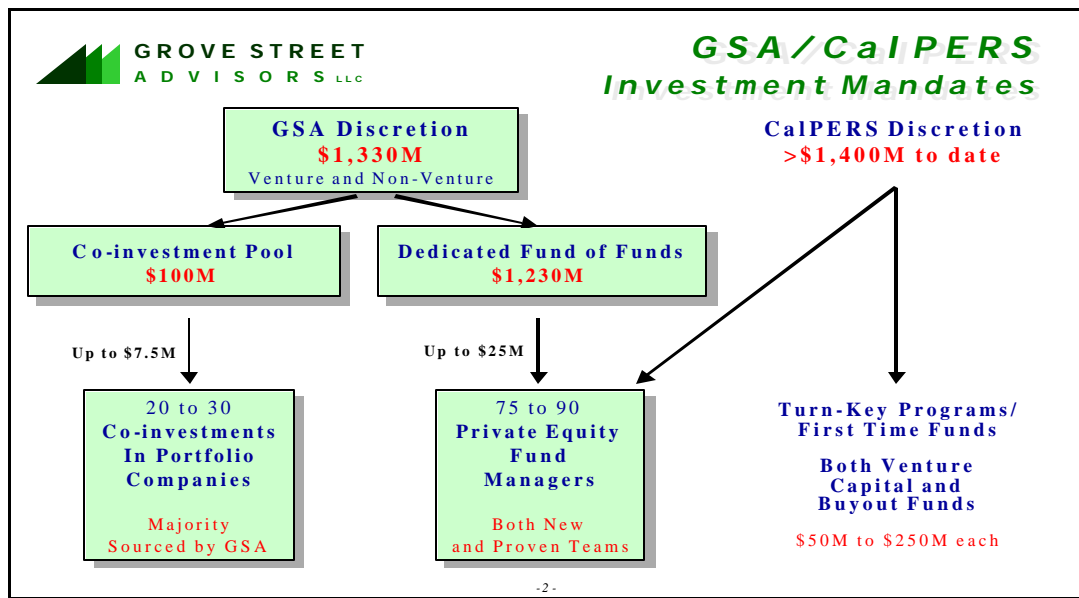


Exhibit 6 – GSA Fund Evaluation Process

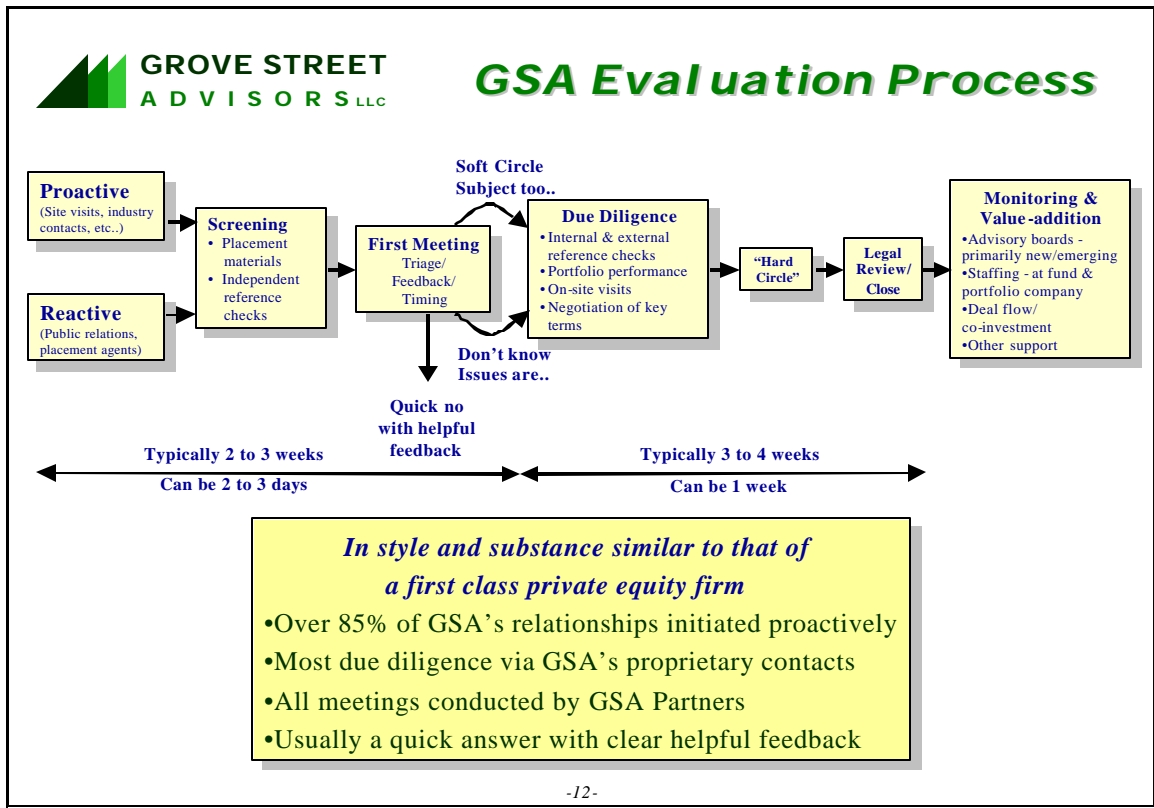


Exhibit 7 - Life Cycles of Private Equity Fund Managers

