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MINUTES OF THE
NEW MEXICO STATE INVESTMENT COUNCIL

Santa Fe, New Mexico

May 23, 2006

ROLL CALL

A regular meeting of the New Mexico State Investment Council was called to order on this date at approximately 9:05 a.m. in the Governor's Cabinet Room of the State Capitol Building, Santa Fe, New Mexico. A quorum was present, as follows:

Members Present:

Mr. Patrick Lyons, Commissioner of Public Lands
Ms. Katherine B. Miller, Secretary, DFA, Acting Chair
Mr. Gary B. Bland, State Investment Officer
Mr. Andrew Davis, Public Member
Mr. David Harris, Public Member
Mr. Ike Kalangis, Public Member

Members Excused:

Hon. Bill Richardson, Governor of New Mexico
Mr. Douglas Minge Brown, State Treasurer
Vacancy [Public Member]

Legal Counsel Present:

Mr. Zack Shandler

Staff Present:

Mr. Bob Jacksha
Mr. Greg Kulka
Mr. Adam Levine
Mr. Rick Scroggins
Mr. Charles Wollmann

Guests Present:

[See Guest List.]

INTRODUCTION OF GUESTS

Guests and staff members were introduced.

APPROVAL OF AGENDA

Mr. Kalangis moved approval of the Agenda, as published. Mr. Davis seconded the motion, which passed 6-0 by voice vote.

APPROVAL OF MINUTES: April 25, 2006

Mr. Harris moved approval of the Minutes of the April 25 meeting, as submitted. Mr. Bland seconded the motion and it passed 6-0 by voice vote.

STATE INVESTMENT OFFICER'S REPORT

Mr. Bland stated that the next item on the Agenda would include this information.

**FIRST QUARTER PERFORMANCE REVIEW: ALLAN MARTIN,
NEW ENGLAND PENSION CONSULTANTS.**

Mr. Martin reported that, as of this month, NEPC has updated the hedge funds to be current, and henceforth NEPC will be working with staff so that the accounting issues Mr. Bland has previously expressed concern over no longer impede the ability to report the latest performance figures.

Mr. Martin distributed and reviewed a newly revised (as of yesterday) First Quarter report.

Reviewing a Market Environment Overview (page 13), Mr. Martin noted continuing improvements in the economic picture not only in the GDP and industrial production, but in consumer spending (up 8%) and decreased unemployment. He said inflation has now started to appear, however, and the Fed has raised rates to 5% and higher, crude oil prices have surged and the dollar has weakened. He said these "clouds" suggest that, while the U.S. is in an ongoing economic recovery, it is aging and each quarter added is not likely to be as good as the quarter before.

Mr. Martin reported that, for the 12 months ending March 31, the SIC gained \$2 billion in net investments, easily outpacing the \$669 million in distributions. He said the combined Funds recorded a net investment gain, for the quarter, of \$653 million; and as of March 31, total Fund values were at \$13.7 billion.

Mr. Martin noted that, over the ten-year period, the LGPF returned 8.8% per year, exceeding its policy index by 0.5%, and over the same period, the STPF matched its policy index with a return of 8.6%.

Mr. Martin reported that, for the year, LGPF returned 13.6%, exceeding its policy index by 0.1%, while the STPF lagged by 1.3% with a return of 13.4%. He explained that the STPF has a higher allocation to private equity and real estate, which causes it to have a higher allocation to fixed income, which had a less attractive impact on returns.

Mr. Martin said total equity exposure for LGPF continued to hover around 67%, while the STPF's equity exposure approached 70%. He said that has been traded down over the last month or so, so the Funds are generally in line with long-term targets.

In the course of Mr. Martin's review of manager performance in the Mid Equity Pool in domestic equity, Mr. Davis cautioned that every great ten-year record has a three-year period with bad performance.

Mr. Martin added that managers tend to be fired when they are at the bottom of their performance, after which they proceed to do well; and there is a tendency to hire managers who have great recent records, only to have them disappoint at some time after that.

Mr. Davis concurred. He said a study by the University of Cambridge found that the next three years of a fired manager are better than the next three years of the hired manager.

DISCUSSION AND VOTE ON GF CAPITAL PRIVATE EQUITY FUND, L.P.

Aldus Equity associate Richard Ellman was present with Erik Baker, principal in the firm of GF Capital.

Mr. Ellman stated that GF Capital is seeking \$250 million in its first institutional fund. He said GF Capital has been investing money for many years primarily through its parent company, GF Capital Merchant Bank, which became a high profile institutional asset manager with clients such as the Lauder Family and Edgar Bronfman. He said Mr. Bronfman sits on GF's investment committee in the same offices as the Fund and has availed the team of his outstanding network, and this has resulted in extraordinarily deal flow.

Mr. Ellman said GF focuses on media and entertainment and branded consumer products, and strategy includes control and non-control buyouts, recaps and growth equity. He stated that, since 1995, GF has put to work about \$540 million in 13 companies and has more than doubled that, returning over \$1.2 billion. He said Aldus broke GF's track record down into two separate funds, and overall, they are well within the top quartile of their vintage. He said their 1995 fund generated 55.4% IRR and the 2000 fund an amazing 87.9% IRR.

Mr. Ellman said the core members of the team have been together for more than ten years and bring together an aggregate of 75 years of experience.

Mr. Baker thanked the SIC members for this opportunity and stood for questions.

Mr. Davis said he did not chair the PEIAC meeting where this investment was considered, but he read the documents. He commented that the proceeds, realized and unrealized, in GF Capital's funds are extraordinary. He said the size of this Fund is not dramatically bigger than the last fund, which he thought important, and commented that it would have been relatively easy for them to go for a much larger fund, based on past returns, but they chose not to.

Mr. Bland moved that the SIC invest in a commitment of \$30 million, not to exceed 20% of the committed capital of the fund, from the National Private Equity Program in GF Capital Private Equity Fund, L.P. subject to and contingent upon New Mexico State law, New Mexico State Investment Council policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Davis seconded the motion, which passed 6-0 by voice vote.

DISCUSSION AND VOTE ON INTERMEDIA PARTNERS, VII, L.P.

Aldus Equity associate Richard Ellman introduced Peter Kern, a principal in InterMedia.

Mr. Ellman said Aldus feels this is one of the best opportunities in the market right now. He said this \$1 billion fund — InterMedia's seventh — is focused on the media space, a highly attractive segment of the market. He said media is a \$700 billion market with tremendous growth characteristics.

Mr. Ellman said the team is exceptionally well positioned to capitalize on the market; Mr. Kern and the rest of the team come from highly operational backgrounds with over 100 years of aggregate experience in the media industry. He said partner Leo Hindery is considered an icon in the industry as former president and CEO of ATT Broadband and TCI.

Mr. Ellman said InterMedia's track record speaks for itself — they have invested \$850 million in this space and have returned over \$2 billion, or 2.3X invested capital since 1988. He stated that InterMedia has never lost money on a fund nor had a write-off, a remarkable record given the different market cycles they have seen over the years.

Mr. Ellman said InterMedia's differentiating strategy is unique in that they build media platforms by clustering add-on acquisitions and targeting specific audiences, and they have done this successfully time and time again.

Mr. Kern thanked the SIC for considering this investment, and stood for questions.

Mr. Bland stated that Mr. Brown, who could not be present at this meeting, asked that Aldus discuss the issue of concentration in the media area.

Mr. Ellman responded that Aldus has clearly been active in the media space, but not overly, given the size of the portfolio. He pointed out that InterMedia's strategy is dramatically different from other funds focused on the media, and InterMedia is not typically competing against them.

Mr. Kern elaborated that InterMedia's strategy, using their experience base of staying away from the mainstream and prototypical LBOs, sets them apart from the bulk of their competitors. He said Quadrangle and VSS, obviously very high quality teams, apply a very different strategy within media with many more minority investments and many more standard issue LBOs. He said InterMedia has much more of a buy-and-build strategy of consolidating and then growing assets, and this is a different pool of assets in the media space.

Mr. Davis asked Mr. Kern to discuss the significantly larger size of Fund VII as compared to Fund VI.

Mr. Kern responded that InterMedia did a series of about five funds totaling about \$840 million in the aggregate, but then there was a hiatus of about five years. He stated that InterMedia has done many multibillion dollar transactions, however, and has run large media companies. He said the size of a fund is really driven by the strategy, and what their strategy dictates is they need to put about \$100 million to \$200 million of equity into each category to aggregate enough businesses to build the kind of business they are looking for.

Mr. Bland said the PEIAC liked this investment. He said staff recommended that Aldus look into this investment because it is one of the safest growth areas going into the future.

Mr. Bland moved that the SIC invest in a commitment of \$30 million, not to exceed 20% of the committed capital of the fund, from the National Private Equity Program to InterMedia Partners Fund VII, L.P. subject to and contingent upon New Mexico State law, New Mexico State Investment Council policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Kalangis seconded the motion, which passed 6-0 by voice vote.

**UPDATE ON NEW MEXICO PRIVATE EQUITY PROGRAM: BRIAN BIRK,
FORT WASHINGTON CAPITAL PARTNERS**

New Mexico Private Equity Investment Program

Advisor Brian Birk reported that the program is currently in compliance, with 12-18 months of dry powder remaining. He said capital committed is 67.8% of the commitment target and the program has turned positive somewhat ahead of what was anticipated, thanks to the significant step-up in the evaluation of Eclipse and the performance of a couple of portfolio companies in NMCIP I.

Mr. Birk cautioned that, even though there is a positive multiplier and IRR and returns are expected to grow stronger over time, this will not be a linear trajectory — there will be a number of ups and downs as the portfolio matures. He pointed out that 63% of the capital has been committed in the last three years, and it takes a fair amount of time for capital to be deployed and for the J-curve effect to work its way through.

Mr. Birk noted that the program has had a significant effect on the New Mexico economy. He said 32 companies have been financed through the NMPEIP, which has resulted in the creation of 1,211 jobs with an average salary of about \$68,000 — substantially higher than a New Mexico average salary of \$36,000.

Mr. Birk also pointed out that the State's investment in aggregate is about \$92 million, and the annual economic impact (salary plus purchases) is \$115 million. He said these are actual dollars.

New Mexico Co-investment Partners

Mr. Birk stated that the NMCIP was established on March 30, 2004, and initially funded with \$30 million with the goal of making direct investments in promising New Mexico-based companies while leveraging external due diligence and post-investment follow-up capabilities. He said the SIC transferred its investments in Earthstone International and TCI Medical, with associated reserves, into the NMCIP in November 2004, raising the size of the fund to \$46 million. He said this is where the fund stands today.

Mr. Birk reported that there are currently 11 companies in the NMCIP portfolio, and as of December 2005, NMCIP had reviewed 120+ companies for potential direct investment and invested in six.

Mr. Birk stated that NMCIP is 89.8% committed with 63.5% drawn, and there is room for one to two more investments. He said deal flow remains robust, and they are seeing new deals every week.

- Responding to questioning from Mr. Kalangis, Mr. Birk said he sits on the boards of all of the companies in the portfolio and has all of the observer roles.

Mr. Kalangis said it appeared that the reporting on several companies was late, and asked why.

Mr. Birk responded that IRS-mandated changes through Rule 409A have caused a great deal of difficulty in the venture industry because of the requirement for external validation on valuations of stock options within companies. He said this has resulted in a lot of pushback from the companies, and the venture funds themselves have been scrambling to figure out how to line up volume discounts for their portfolio. He said NMCIP has been negotiating with a couple of different providers, and that has taken some time to pull together. He stated that all of this has extended the typical 60-90 day turnaround time of the accounting firms and traditional providers of year-end services to 120 days.

Mr. Birk reviewed updates on companies in the portfolio.

In discussing the latest developments with TCI Medical, Mr. Birk stated that NMCIP is actively negotiating with several potential acquirers, one of which has backed off, citing the low market prices of the new competitive reality of selling thallium. He said NMCIP is still in discussions with another entity, which has offered to purchase the remaining equipment and existing facilities. He stated that, on the positive side, two entities have expressed interest in TCI's Centillion breast cancer detection device, and other acquirers may be interested in an earlier transaction that TCI negotiated with Russia.

Mr. Birk noted that this was a frustrating experience for NMCIP, because TCI Medical met all the milestones in the various investment tranches set out by the SIC, had received FDA approval on their facility, and were within two months of having approval on their ability to sell thallium on the market. He said GE unexpectedly launched a competitive challenge with low pricing and excellent terms, and this created a significant setback.

Mr. Birk stated that TCI Medical's carrying value is currently at \$2-\$3 million; so with the other positive events reports in the fourth quarter, the return should be about even or slightly higher. He said TCI has struggled for quite some time, and NMCIP has been prudent in seeing that it has been reflected on the books at fair market value.

OLD BUSINESS

None.

NEW BUSINESS

CFO Rick Scroggins reported that he and two members of the accounting team (Cyndy Lynch and Angela Romero) traveled to Chicago in early May, toured Northern Trust's offices, and had a number of meetings with some of their various teams to deal with reporting and the timing issues. He said they also discussed the approach being taken on the valuation of the pools, timing, and reporting.

Mr. Scroggins stated that staff continues with the shift of private equity over to Northern and has taken additional steps to provide another level of independence in some of the numbers reported to NEPC. He commented that staff feels that some progress is being made in the relationship with Northern, although some issues remain.

Mr. Scroggins said Northern plans to send representatives to the SIO offices four or five days per month.

Mr. Scroggins reported that staff is in the final throes of the audit, and should file with the SAO office within two weeks.

Mr. Scroggins stated that the SIO went out to RFP for audit services for FY 2006 but had received no responses by last week's deadline. He said the SIO was hoping to get some interest from a national firm, and one of the criteria (apparently too restrictive) required that the firm examine at least one other investment-related firm in excess of \$5 billion. Mr. Scroggins said he also personally called several firms.

Mr. Scroggins said he plans to meet with State Auditor Domingo Martinez to discuss the next step — either he will be instructed to reissue an RFP or else Mr. Martinez will assign an auditor.

Mr. Davis questioned why there was no response to the RFP.

Mr. Bland responded that this is a very tough audit because some of New Mexico's standards are outdated. Secondly, he said, there are a number of other financial institutions with detailed audits currently underway, and these are lucrative contracts for auditors. Thirdly, he said, the indictment of former State Treasurer Robert Vigil has caused many people to back away from doing business with New Mexico out of concern that their reputations could be compromised.

Mr. Davis asked Mr. Bland if the fees being offered up for this project are reasonable, and Mr. Bland responded that the fees are well below what auditing firms can get elsewhere.

On the issue of the Region III Housing Authority, Mr. Bland said the SIC has a piece of debt on that and is actively addressing the issue through an audit as well as through legal participation, as required.

**NEXT MEETING DATE: TUESDAY, JUNE 27, 2006, 9:00 A.M.
IN SANTA FE.**

ADJOURNMENT

Its business completed, the State Investment Council adjourned the meeting at approximately 10:45 a.m.

Approved by:

Hon. Bill Richardson, Governor

Respectfully submitted:

Judith S. Beatty, Council Reporter