MINUTES OF THE
NEW MEXICO STATE INVESTMENT COUNCIL
Santa Fe, New Mexico
March 31, 2005

ROLL CALL

A regular meeting of the New Mexico State Investment Council was called to order on this date at approximately 2:25 p.m. in the Governor’s Cabinet of the State Capitol Building, Santa Fe, New Mexico.

A quorum was present:

Members Present:
Mr. Gary B. Bland, State Investment Officer
Mr. James C. Jimenez, Secretary, DFA, Acting Chair
Mr. Patrick Lyons, Commissioner of Public Lands
Mr. Andrew Davis, Public Member
Mr. David Harris, Public Member [by telephone]
Mr. Ike Kalangis, Public Member

[Representing Treasurer Robert Vigil: Deputy George Everage]

Members Excused:
Hon. Bill Richardson, Governor of New Mexico
Mr. Robert Vigil, State Treasurer
Mr. Michael Stanford, Public Member

Legal Counsel Present:
None.

Staff Present:
Ms. Lorri Espinosa
Mr. Bob Jacksha
Mr. Greg Kulka
Mr. Adam Levine
Mr. Charles Wollmann

Guests Present:
[See Guest List.]
INTRODUCTION OF GUESTS

Guests and staff members were introduced.

APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: February 22, 2005

Upon motion by Commissioner Lyons, seconded by Mr. Davis, the Minutes of the February 22 meeting were approved, as submitted, 6-0 by voice vote.

DISCUSSION AND VOTE ON NGN BIOMED OPPORTUNITY I, L.P.

Aldus Equity Partners representative Marcellus Taylor said Aldus strongly recommends a $20 million commitment in NGN, a late stage healthcare and biotech venture capital firm founded in 2003 that is targeting total commitments of $250 million in its first institutional fund.

Mr. Taylor stated that, although NGN is focused on healthcare and biotech, they maintain a far lower risk profile than is typical in a biotech fund by investing in companies and products in the late stage of development, companies that develop medical devices, and companies that perform healthcare services with very high margins. He said the Fund has already completed six investments, “so New Mexico will have the benefit of getting a look back at the performance of those six investments, all of which are checking along very well.”

Mr. Taylor also pointed out that the team includes “a strong mix of high quality finance experience combined with high quality industry experience both in the biotech sector and in the healthcare sector,” which Aldus believes to be a critical mix in this arena.

Mr. Taylor also stated that, in terms of competitive advantage, NGN has a very strong deal-sourcing network; and although this is their first institutional fund, the partners have over 100 years of direct investment experience in this sector. He commented, “This gives us a lot of comfort and a lot of confidence that they’re well positioned to execute on their investment goals.”
NGN representative William Gedale introduced himself to the SIC, stating that he is one of NGN Capital's five managing General Partners. He said NGN focuses on pharmaceuticals, medical devices and medical services, and also plans to do Private Investments in Public Equities (PIPS) on occasion — although they have not done any yet, they have the experience and background for it. He said, “The reason we use some of these other vehicles is to get the money back to you as rapidly as we can. The key thing in our investment philosophy is we’re late stage, meaning we are looking prospectively at five-year exits for all of our investments. Even if we were to look at some earlier and mid-stage companies — which we will do on occasion — they have to meet those same five-year criteria. Just by the nature of life and things, very, very few mid-stage and early stage companies can ever achieve a rational or credible exit in five years.”

Mr. Gedale said NGN invests principally in the United States and Europe, and has an office in New York City and another in Heidelberg, Germany, where they have a strong investor base that includes the principals of Boehringer Ingelheim, the largest private drug company in the world.

Mr. Gedale said, “We’re incentivized to perform on our desire to get you your money back before we share in any profits with anybody. Before we get any of the capital gains of the portfolio when they exist, we have to get you all your money back and all your fees back and a preferred return of 7.5% per annum, and only then do we begin to participate on an 80-20 basis. Our fund term reflects the fact that we think being later stage, we can get the money back to you faster. We have an eight-year term with two one-year possible extensions. The comparative statistics in these funds are ten years plus two plus two; so at the extremes, we’ll probably have a 40% lesser term to our fund.”

Mr. Davis asked Mr. Gedale to discuss the opportunities and the risks associated with recent events in the big pharma industry, such as the Merck scandal, and how NGN might be positively or negatively affected.

Mr. Gedale commented that the turmoil in the pharmaceutical industry has created intense pressure on drug companies “to pare back their pipelines to skinny the companies in general. What that means is that...they may have a whole string of $200 million, $300 million, $400 million potential products that they will not exploit and they will not develop. That’s just cannon fodder for us, and we have the skill sets resident within our company to see that. When we say late stage in pharma, we’re talking about that area between discovery and putting a drug in a bottle. That’s the important late stage discipline that we have."

Mr. Gedale commented that there are big risks in the drug industry, as evidenced most recently with the Vioxx scandal, “but the opportunities to cure people, as we know more about biology, will enhance the value of a lot of drugs.”
Responding to questioning from Mr. Davis, Mr. Taylor said that, while the SIC portfolio is overweight in venture capital, “our strategy is to selectively invest in venture capital firms that have strategies that really seek to mitigate risk. As we look across the spectrum, we really wanted to identify teams that had a lot of domain industry experience in the market that they were pursuing; so from a portfolio management perspective, we think this sort of hits on all cylinders.”

Mr. Taylor said the next group on today’s agenda is a mezzanine fund, “so if you weigh those off in terms of the risk-reward profile, this is a little higher on the risk spectrum, and it’s geared toward getting some higher return, but we like the fact that the strategy, relatively speaking, is a lower risk one compared to other biotech venture firms.”

Mr. Davis said the Private Equity Investment Advisory Committee unanimously endorsed Aldus’s recommendation to invest $20 million. He commented, “I think we were obviously in favor of the biotech aspect. We didn’t see any of that in anything recently, so that was useful. But I also think the Committee liked the way they laid out the returns…. We don’t see an awful lot of that, I would argue, so that was very compelling in our minds.”

Mr. Kalangis asked Mr. Taylor at what point Aldus decides that the risk factor is too great in terms of an investment in this genre.

Mr. Taylor responded, “There are some funds out there that, just based on past experience, we would view as way too speculative and way too risky. For example, we think venture capital firms pursuing dot.com Internet-related strategies are too high on the risk profile for something we would pursue. And unproven teams — if we had a team that came in here that didn’t have requisite experience in terms of investing in the sector that they’re currently pursuing. Factors like that are what we really look for in order to weed out firms that we think would put too much risk into the portfolio.”

Mr. Taylor also pointed out that this is not a standalone investment, but is in the confines of a portfolio, which means the risk is offset by other much more conservative investments.

Responding to questioning from Commissioner Lyons with respect to why the portfolio is currently overweighted in VC, Mr. Kulka explained that the SIC was not permitted to invest in anything but venture capital from the inception of the program in 1988 until ten years later, so the SIC has only been diversifying out from venture capital since 1998. He said that VC in the portfolio currently is 47% of cost and about 35% of market.
Mr. Taylor said Aldus normally recommends no more than 20% on the high end for a total weighting of venture capital.

Mr. Davis pointed out, though, that the risk of not being in the market at all each year would “set you up for a diversification risk on the timeline, so you want to try to fit, and I think this is what we charged Aldus with — trying to find the best of the venture capital firms, and that’s why we’re not going to see many of them in the next year.”

Mr. Taylor explained that, for the year, Aldus is targeting 15% of the total allocation in venture capital, so this investment (the first this year) would represent about half of the total weighting, or 7.5%.

Commissioner Lyons remarked, “This looks like a pretty good investment to me.”

Mr. Davis moved approval of a recommendation to commit $20 million from the National Private Equity Program to NGN Biomed Opportunity I, L.P., subject to negotiation of final terms and conditions and completion of appropriate paperwork.

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

**DISCUSSION AND VOTE ON CAPITAL POINT PARTNERS, L.P.**

Aldus Equity Partners representative Marcellus Taylor stated that Capital Point Partners is a mezzanine investment firm, meaning that most of their investments are structured in the form of debt securities, with participating equity usually in the form of warrants.

Mr. Taylor said Capital Point has been investing in mezzanine since 1987, and are considered one of the pioneers of mezzanine investing. He said their focus is on sub-debt investments in middle market companies, and Aldus likes the fact that they maintain a very conservative investment approach that focuses on credit and risk reduction.

Mr. Taylor stated that Aldus sees Capital Point’s investment performance as top quality: “These guys have invested over $670 million in some 59 different mezzanine transactions, and they’ve generated an IRR over a 20-year period of time of 19.1%.”

Mr. Taylor said the team has an exceptional amount of team cohesion in that the partners have been working together for a total of almost 20 years, an element that Aldus considers important in private equity because it offers a lot of
stability. He said Aldus deems Capital Point’s team to be a “leader in terms of stability.”

Mr. Taylor also pointed out that Capital Point “is one of the most prominent middle market mezzanine funds in the Southwest U.S., have a very strong reputation, have been investing in a space for a long period of time, so they see the bulk of the quality transactions that come to market in their region. More importantly, they are able to source a lot of transactions without pursuing market-based auctions. One of the distinctions with this market is they often invest along with other private equity firms, so they source transactions both directly and through the private equity community. During the course of our reference checks, our due diligence checks, all of them came back very favorably in terms of their reputation and their ability to source strong deal flow.”

Partners Jeff Sangalis and Darl Petty appeared before the SIC and presented an overview of their performance and key strengths, including their backgrounds and experience.

Mr. Davis asked Mr. Sangalis to discuss the last fund and the reasons for its underperformance in comparison to the rest of its investments.

Mr. Sangalis responded that the Fund under discussion today is solely a mezzanine fund, while the last fund had the capability of doing a substantial amount of equity, whether it be control or significant minority equity, “and that equity has not performed. Mezzanine has performed very, very satisfactorily, and frankly it has been 85+% of the business that we’ve done throughout the years. So we preclude ourselves from doing any standalone control equity or minority equity, so we can focus on what we do best.”

Mr. Davis commented that this was important to the PEIAC members when they went through the returns, “because precluding them from being in that particular area seemed to be the logical decision. They did it on their own; and as a result, looking specifically at what we figured their expertise was, their returns turned from mediocre to extraordinarily good. So we became comfortable with that, although initially we weren’t.”

Mr. Davis asked Mr. Sangalis to flesh out Capital Point’s reasons for focusing on the middle market.

Mr. Sangalis commented that “middle market” is an overused term, but Capital Point’s “middle market” is to invest $10-$35 million in companies with revenues of $50-$250 million. He added, “If you start going too high up the scale in terms of dollars in the larger companies, our view is it’s a very price competitive higher risk/lower return type of business, and we do not want to get in major auctions. That’s why we pride ourselves in the deal flow, working in the
middle market where we can provide some value and get some nice pricing along the way and not be in competitive auction situations.”

Mr. Davis said the PEIAC unanimously recommended approval of Aldus’s $30 million investment recommendation: “This seems like a good deal for us.”

Mr. Taylor added, “The beauty of this type of investment structure is that it’s an investment that has a current coupon, so it’s actually structured as a debt instrument. So in the private equity spectrum it’s on the lowest risk profile because they’re getting current income back each year and they’re also receiving warrants in the form of equity to participate in the upside. So when you think about the entire SIC portfolio, this investment will help recoup capital at a much quicker pace and will help shorten out the J-curve and mitigate the exact problem that we faced when we came on board in terms of the overweighting of venture capital that has a much longer J-curve and much slower return. This helps return capital quicker, has much less risk and volatility, and we think is a much safer type of investment.”

Mr. Davis moved approval of a recommendation to commit $30 million from the National Private Equity Program to Capital Point Partners, L.P. subject to negotiation of final terms and conditions and completion of appropriate paperwork.

Commissioner Lyons seconded the motion, which passed 6-0 by voice vote.

STATE INVESTMENT OFFICER’S REPORT

Mr. Bland stated that the findings of the recent audit have been forwarded to SIC members. He noted that the major issue was the valuation of the private equity portfolios.

As background, Mr. Bland stated that Pacific Corporate Group (advisors to the SIC until they were fired about 20 months ago) developed a valuation program for the SIO to verify the value of 115 outside portfolios; and after the State Investment Office subsequently developed its own internal program using its own software, and then went through a lengthy process of entering the data, it was discovered that PCG had not done a respectable job of verifying the numbers, and there were significant variances and differences dating back to 2001.

Mr. Bland said the auditors eventually deemed the SIO’s numbers to be acceptable but remained uncomfortable with not having an independent fourth party to check audited statements of outside partnerships. He stated that, after a
meeting with the auditors on how to remedy that, the auditors have concurred with the SIO’s decision to enter into a contract with Aldus to address that problem.

Mr. Taylor elaborated that Aldus has taken on the responsibility (through partner Matthew O’Reilly) of doing the input and monitoring of the data and will also provide ongoing reports. He said any problems can thus be caught early in the system as opposed to later in the pipeline “and will ensure that the data being provided the SIC is very accurate, up to date, and has buy-in by Aldus and the SIC itself.”

Mr. Bland reported that the State Auditor now has the audits.

Mr. Bland additionally provided preliminary figures on the SIC’s total funds for the fiscal year to date; as of today, the balance is about $12.2 billion.

Mr. Bland further reported on legislation passed and now on the Governor’s desk.

Mr. Bland announced that the RFP process for general consultant has been completed and interviews with the three respondents will begin tomorrow. He invited SIC members to sit in on these interviews.

Mr. Bland also discussed new legislation that will simplify and shorten the RFP hedge fund manager process. He noted that the RFP process in hiring a fund manager has been so cumbersome that it is still underway nearly a year after hedge fund legislation was passed. He assured SIC members that transparency and the public interest would not be compromised in the more streamlined process.

OLD BUSINESS

Responding to questioning from Commissioner Lyons, Mr. Kulka stated that there has been no reported progress on the “Walkout” film project since SIC approval several months ago. Mr. Bland added that apparently the film company is seeking additional funds.

Mr. Kulka said staff has discussed the possibility of requiring projects that haven’t moved forward for a certain period, e.g., six months, to return to the PEIAC/SIC for re-approval.

Mr. Kulka noted that the “Blind Horizon” film project has repaid (in February) the principal on the loan made to them.
Mr. Kulka stated that legislation just signed by the Governor has increased the amount available from 2.5% of the Severance Tax Permanent Fund to 5%, which will allow the SIC to approve up to $15 million on a project rather than $7.5 million.

Mr. Kulka provided an update on other projects. He stated that, in addition to “Walkout,” two other projects have not materialized: “Believe in Me” declined the SIC money, deciding that they didn’t need the financing; and “Night in Old Mexico” has been postponed because of outside funding delays. He said the producer hopes to return to the SIC in late spring to restart the project.

Mr. Davis asked staff to provide film project updates every four to six months.

**NEW BUSINESS**

Mr. Bland distributed information disseminated by the Investment Management Network, a group that holds educational investment management seminars in business, and which will be holding a “Guns & Hoses” conference at the Tamaya resort in June. [Date uncertain.] He said that, at the SIO’s request, the third day will be dedicated to all of the various New Mexico programs. He asked all SIC members to be prepared to make presentations, participate in the receptions in order to meet their associates on other State fund boards, and perhaps participate on one or two panels.

Responding to questioning from Commissioner Lyons, Mr. Kulka stated that legal counsel Zach Shandler was in Arizona today on business and asked staff to contact him prior to today’s meeting if any legal advice was needed.
ADJOURNMENT

Its business completed, the State Investment Council adjourned the meeting at approximately 3:30 p.m.

Approved by:

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Hon. Bill Richardson, Governor

Respectfully submitted:

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Judith S. Beatty, Council Reporter