

---

# Washington State Investment Board Economically Targeted Investment Policy



**2004 Annual Report  
January 20, 2005**

## Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages almost \$60 billion in assets for 34 separate state retirement and public funds. The Board conducts its investment activities in accordance with investment policies and procedures designed to maximize return at a prudent level of risk. Asset allocation is the driver of investment performance. Accordingly, the WSIB invests in basic asset classes including Public Equity (both U.S. and Non-U.S.), Fixed Income, Real Estate, and Private Equity to help control risk and ensure stronger performance overall.

This is the second annual progress report on the WSIB Economically Targeted Investment (ETI) policy originally approved in March 2003. In this year's annual poll of WSIB's private equity General Partners' (GPs') deal flow activity for fiscal year 2004 (July 1, 2003, through June 30, 2004), the key findings exhibited consistent strength with some improvement over last year and included the following:

- ❖ 43 GPs looked at 597 Washington-based opportunities.
- ❖ 80 deals were still in the pipeline at fiscal year end.
- ❖ 30 deals were completed.
- ❖ Venture capital and private equity firms are still coming to the region to look at deals.
- ❖ Not all deals get funded.

Washington is rich with investment opportunity and has earned the interest of and access to top quality GPs. The WSIB's GPs continue to actively seek quality opportunities based in Washington, and deals are getting done in Washington.

The WSIB believes the state of Washington is an excellent place in which to invest a portion of the trust funds under management by the Board. Over \$1.3 billion in value is currently held in the WSIB investment portfolio in Washington-based investments through its public equity, fixed income, real estate, and private equity investment programs. These investments were made consistent with the WSIB's statutory mandate. More than \$4.6 billion in private equity commitments have yet to be called, representing significant capital ready to put to work as qualified investment opportunities arise. The Washington-based investments made by WSIB's GPs further leverage additional capital from other sources to put to work in the state.

The WSIB has made a strong commitment to facilitate access to and awareness of quality in-state investment opportunities. Further, it has devoted resources to implement that policy and to track future in-state investment activity. The WSIB continues to work with the Washington Technology Center (WTC) to access valuable Washington economic development networks, assist Washington companies achieve exposure to potential sources of capital, and provide feedback regarding educational and investor networking events.

## Overview of Policy

In March 2003, the Board adopted a policy with respect to ETIs to communicate the role and responsibilities of the WSIB relative to such initiatives. ETIs are defined in this instance as investments having the primary objective of investment return to pension trust fund assets and the collateral objective of assisting the regional economy and the economic well-being of the state of Washington, its localities, and its residents.

In the ETI policy, the Board reiterated its "fiduciary duty to invest and to manage the entrusted funds in a manner consistent with statutes, regulations, Board policies, and the highest standard of professional conduct for the exclusive benefit of fund beneficiaries." The Board has established written policies and procedures for all its investments. The Board will continue to seek quality investment opportunities within the state in accordance with its established policies, statutory mandates, and fiduciary duty.

The ETI policy holds the Board responsible for requesting its private equity GPs to report annually on Washington-based investments evaluated during the prior year. Private equity investments include securities that are not listed on a public exchange and are not easily accessible to most individuals. These

investments range from initial capital in start-up enterprises to leveraged buyouts of mature corporations. Private equity investments are typically long-term commitments that may last up to 12 years or more. Although they are less liquid and perhaps more risky than publicly traded investments, when employed as part of a larger balanced portfolio, they can offer higher returns than traditional public equity.

The WSIB's private equity portfolio originated in 1981 and is invested primarily in limited partnerships. The partnerships, which are managed by a GP, acquire or create ongoing businesses or operating companies at the discretion of the GP. Ultimately, the companies are sold in the public market or to strategic or financial buyers, and only then can the true return on investment be accurately measured. To meet return and plan objectives, the WSIB's private equity portfolio has diversified investments in a broad cross-section of sub-sectors, industries, and geographic regions including Washington and other Northwest states.

The Board established a staff function to facilitate the exchange of information between its private equity GPs and appropriate parties with knowledge of quality in-state investment opportunities and, in accordance with the policy, to prepare the annual report of its ETI activities to provide to the Board, beneficiaries, the Legislature, and the Governor. This report presents the progress to-date of the WSIB policy on ETIs.

## Investment Environment

Although the WSIB portfolio contains asset classes other than private markets, much of the following report focuses on private equity and, more specifically, on venture capital. This is due to the fact that the policy reporting is focused on private equity, and much of the in-state investment activity of interest is focused on the venture capital arena. In addition, the venture segment traditionally has provided more detailed and summary data over longer periods of time and for more investment characteristics than other segments of the private equity industry, allowing more meaningful analysis and comparisons.

According to Thompson Venture Economics, U.S. venture capital investing for the first nine months of 2004 totaled \$15.3 billion, up 15 percent over the same period in 2003. The Life Sciences (Biotechnology and Medical Devices industries together) continued to dominate as it has for the past 9 consecutive quarters, capturing 29 percent of all venture capital in the third quarter of 2004. The Software Industry remained on top as the largest single industry category and garnered 22 percent of the third quarter venture dollars. As it has for the past two years, Telecommunications continued to languish at 10 percent of all third quarter 2004 venture capital, and most of the companies funded were receiving follow-on financings.

As for stage of development in third quarter 2004, 30 percent of all deals and 19 percent of all dollars (\$840 million) were in early stage companies; expansion stage companies accounted for 44 percent of all deals and attracted 49 percent of all dollars. True to historical norms, later stage funding captured 30 percent of the period investing.

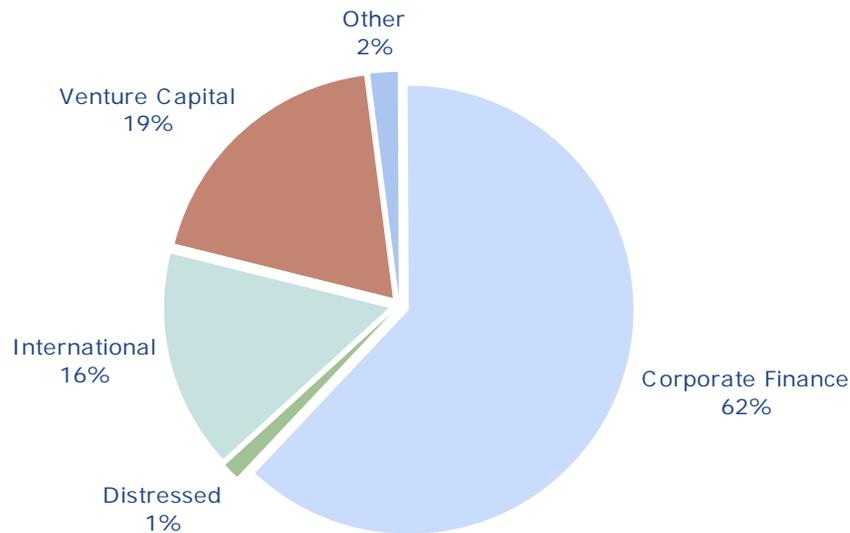
For the fiscal year 2004, total venture capital investments in the U.S. totaled \$20.9 billion in 2,932 deals. Of that total, \$878 million was invested in 131 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 97 of the Northwest deals and \$716 million of the newly invested dollars. During this same time frame, the WSIB GPs invested over \$631.7 million in private equity including \$13.3 million in Washington-based companies. The \$13.3 million is 2.1 percent of WSIB's fiscal year 2004 total private equity investment and close to 2 percent of the Thompson Venture Economics reported invested dollars in Washington. Based on the Thompson Venture Economics data, venture deals are getting done in Washington.

**Overhang:** A continuing issue in private equity is whether the industry has too much "overhang." Overhang is the amount of available or uninvested capital that has been raised by private equity funds. Excess capital may encourage unwarranted competition for new deals and lead to overvalued deals. Overhang may further result in over-investment in sectors that cannot support adequate rates of return, raising concerns about how GPs will be able to effectively put the money to work and how future returns may be impacted as a result.

The overhang in venture capital at the end of 2004 was estimated by Thompson Venture Economics to be approximately \$50 billion, down from over \$100 billion at the end of 2002. Buyout funds may hold as much as another \$100 billion overhang. GPs began reducing fund sizes in early 2002; and, in recent fund-raising activities, have generally been targeting smaller funds, some less than half the size of their predecessors. However, limited partners may be contributing a new type of overhang, through both increased allocations and new entrants to the market that reflects their increased appetites for venture capital and private equity exposure.

A review of the \$4.6 billion WSIB overhang at June 30, 2004, by strategy indicates that well over half the unfunded commitments are in the areas of corporate finance and that 19 percent is in the venture capital arena.

#### Portfolio Allocation by Strategy Based on Unfunded Commitments at June 30, 2004



A shortage of investment capital is not an inhibitor to the growth of high-technology companies in Washington State or the U.S.

### Investments in Washington

The WSIB seeks the best investment opportunities no matter where they might be headquartered. The state of Washington is home to many successful companies and Washington-based investments can be found in all of the WSIB's investment portfolios. The following table reflects a summary of Washington investments in the WSIB portfolio at fiscal years ended June 30, 2003 and 2004.

Washington Investments in the WSIB Portfolio (\$ millions)		
Investment Class	Value	Value
	Fiscal Year ended 6/30/03	Fiscal Year ended 6/30/04
Public Equity	\$594.2	\$677.3
Fixed Income	\$317.8	\$196.9
Real Estate	\$343.0	\$428.7
Private Equity	\$59.4	\$61.3
<b>TOTAL</b>	<b>\$1,314.4</b>	<b>\$1,364.2</b>

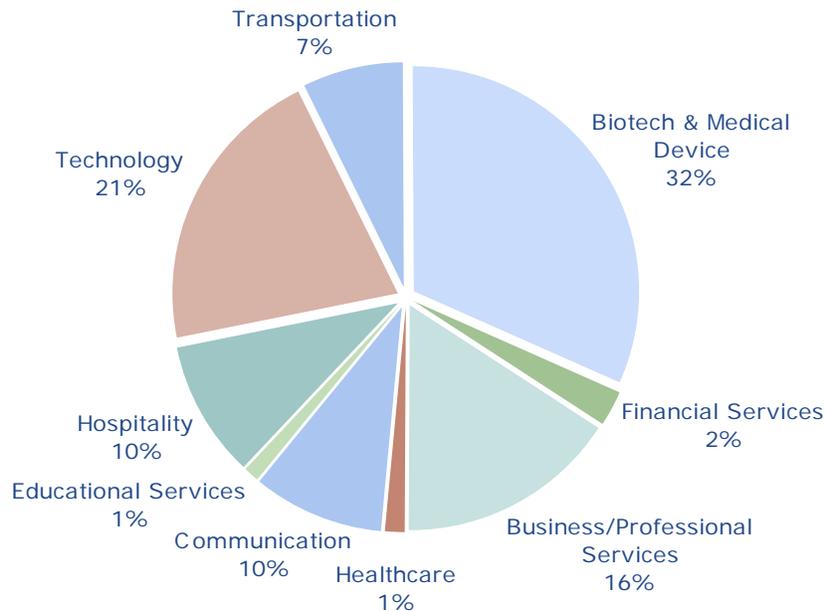
The WSIB portfolio contains numerous public equity and fixed income investments in Washington-based companies. In the year-over-year comparison, the value of public equities increased nearly 14 percent predominantly due to a similar improvement in public market index values. The 38 percent decline in fixed income value was the result of the portfolio's reduced allocation to corporate bonds.

Several of the WSIB's real estate partners have property investments located in Washington. Over half of the large increase in investment value for real estate in Washington was due to new properties purchased during the fiscal year. Additionally, the total value for fiscal year 2004 was impacted positively by appreciation in value of existing properties and the more accurate classification of property locations. WSIB real estate investments have helped develop the Biotechnology industry in Washington. A real estate partner of the WSIB developed a property in South Lake Union in Seattle for Biotechnology companies. It was sold at a profit to a real estate investment trust that specializes in properties suitable for Biotechnology firms.

The small increase in value year-over-year for private equity was due in part to the appreciation in the fair market value for many private companies in the past fiscal year combined with numerous exits, which returned value to the WSIB. As of June 30, 2004, the WSIB had over \$61.3 million invested in Washington-based companies in its private equity portfolio, representing approximately 1 percent of the total private equity portfolio value. The Washington-based investments are held in 51 different funds by 27 individual GPs, 3 of which are Washington-based.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing that roughly 70 percent are concentrated in Biotech and Medical Devices, Technology, and Business/Professional Services industries. Six other industries have smaller representation.

**Percent Invested in Washington-based Companies at June 30, 2004**



The WSIB currently has \$10.7 billion committed to private equity among 87 GPs in over 170 partnership funds. More than \$6.1 billion is already invested in private equity investments. However, nearly half of the committed total, \$4.6 billion, has yet to be called by the GPs. The unfunded commitment represents a significant amount of capital overhang to be invested in the future by current WSIB GPs, many of whom actively review and evaluate investments in Washington State.

## Highlights of 2004 ETI Activity

Following the adoption of the ETI policy in March 2003, a private equity investment officer, Janet Kruzel, was hired on August 1, 2003, to focus on in-state activities. The 2003 annual ETI report detailed the initial implementation efforts and the plans for the year 2004. Ms. Kruzel has initiated multiple efforts to provide exposure and understanding of the Board's policy in the state and to establish contact with the local and regional organizations and networks to accomplish implementation of the ETI policy.

**Regional Funds:** The WSIB is currently invested in three regional firms: Frazier Healthcare Ventures, OVP Venture Partners, and Endeavour Capital. During 2004, staff intensified its assessment of area funds and conducted numerous meetings with 34 regional funds, not limited to those in fund raising mode. The meetings focused on developing strong, in-depth relationships with fund managers and initiating a long, deep due diligence process on the funds and their portfolio companies.

Although many of the fund sizes are currently below what WSIB usually invests in directly, staff channeled at least 12 of the regional funds to WSIB's discretionary venture capital managers, INVESCO and Pathway, for investment consideration. INVESCO and Pathway each manage a pool of money to be invested at their discretion in venture capital firms on behalf of the WSIB to provide exposure to the smaller venture capital funds. An additional result of the meetings was that staff was willing and interested, based on the extended knowledge of the firms, in providing access (through introductions and referrals) for a number of quality area firms to WSIB's peer institutional limited partners and select third parties actively seeking emerging managers. An unplanned benefit of the new relationships was that local area GPs were receptive to accept staff referrals of ten companies and entrepreneurs that contacted WSIB seeking direct funding.

**Annual GP Deal Flow:** In November 2004, for a second year, a letter was sent to 56 of WSIB's private equity GPs requesting information about their deal flow review in Washington for the year September 1, 2003, through August 31, 2004, including the number of deals done, number passed, and any still in process. (The poll was not sent to funds that had completed their investment period or funds that only invest outside the U.S.) A satisfying 100 percent of the funds responded. In spite of the fact that this year's poll was sent to 16 percent fewer GPs than last year (primarily due to the end of fund investment periods), results continue to show strong, consistent, active Washington deal interest.

The highlights of the report are:

- ❖ 43 GPs reported looking at 597 Washington-based opportunities (versus 36 GPs looking at 561 deals in 2003).
- ❖ 19 GPs completed 30 deals (versus 9 GPs doing 28 deals in 2003).
- ❖ 16 GPs were still considering 80 deals remaining in the pipeline (versus 6 GPs still considering 30 deals in 2003).
- ❖ 487 deals were reviewed but passed on or not considered active (versus 508 in 2003).

These responses suggest that Washington continues to earn the interest and access of top-quality GPs, and that interest has remained stable over the past two years. Washington is rich with investment opportunity and does not appear to have a problem attracting venture capital and private equity firms to come to the region to look at deals and check out companies. It also reveals the fact that not all deals get done.

**Regional Networks:** Staff made over 35 trips to the Seattle area, several trips to Spokane and the Tri Cities, and visits to Pullman, Wenatchee, and Raymond. The WSIB received numerous comments of appreciation for its interest in and willingness to initiate contact across the entire state, especially outside the Seattle area. Staff contributed to several regional networks, including serving on:

- ❖ The WTC Angel Network Advisory Board.
- ❖ The WSA Investment Forum Steering Committee.
- ❖ The Bio21 Funding Subcommittee.



- ❖ Washington Economic Development Commission focus group (on seed funding issues).

WSIB was also represented at the following regional meetings and events:

- ❖ Alliance of Angels (monthly).
- ❖ WSA Investment Forum.
- ❖ Eye of the Investor (Tri Cities).
- ❖ Connect Northwest (Spokane).
- ❖ Oregon Investment Fund Launch (Portland).
- ❖ 2004 Northwest Innovation Summit.
- ❖ Technology Alliance Annual Awards luncheon.
- ❖ Amgen Helix campus preview.

Each of these presented an opportunity to provide genuine support and expertise to the regional investment environment, to broaden the WSIB regional contact base, and to enhance and demystify the WSIB image across the entire state. These networks afforded direct contact with academic and research entities, angel groups, and economic development organizations, which in turn resulted in several contacts on potential deal flow. Staff will continue to build and strengthen these relationships over the long term to the benefit of all parties.

**WTC:** The WSIB and WTC continue to work together through their 2003 Memorandum of Understanding to foster in-state deal flow in several ways. Early in 2004, the WTC web portal was opened for companies and entrepreneurs to gain access to the WSIB. Although there were only a few respondents, one company was reviewed by WSIB GPs, and WTC assisted several of the responding companies that were too early stage for venture funding. WTC provided WSIB valuable introductions to state-wide economic development organizations at regional meetings. In addition, the WSIB arranged for GPs to speak at two WTC sponsored "Eye of the Investor" meetings.

**ETI Metrics:** Staff has been monitoring the ETI activities of numerous states for more than a year. Following up on the issue of ETI metrics, staff reviewed the current use of performance measurement for ETIs through websites, written reports, and phone interviews. The review highlighted that few comprehensive studies have been done on this topic for nearly a decade, that it is difficult to narrowly define ETI, and that no standard methodology has emerged to measure the results of ETI programs. The majority of ETI efforts (excluding programs targeting only social benefits) focus appropriately on investment rate of return as their major or even sole metric. Few investors track other results, and several reported that they specifically do not utilize other metrics to prevent those ancillary measures from complicating or clouding the investment decision process.

Metrics that may provide useful information about the WSIB policy (as opposed to a program) focus on the health and development of the investment environment. These measures spotlight attention on the strengths and weaknesses of the region, and help target specific areas for more effective intervention or make decisions related to continuation or adjustment of the policy. Several new measures of the state/regional investment environment are attached in charts and graphs at the end of this report.

## Looking Forward

During the year 2005, the initial implementation efforts will continue to develop and expand. The flexibility of the current policy allows staff to respond to needs effectively as they arise. Meetings will remain an important means to maintain and solidify valuable relationships with networks and interested parties in the state, and staff interaction with GPs will encourage continued access and interest in Washington deal flow. The WSIB will continue to work with the Washington networks and individuals in place to:

- ❖ Assist Washington companies to achieve exposure to potential sources of capital through the WSIB's relationship with both local and national GPs.
- ❖ Expand ways that the WSIB contributes and provides valuable resources (other than simply funds) to the regional environment.

- ❖ Enhance the due diligence and relationship building with regional GPs.
- ❖ Improve the WSIB GPs awareness of and accessibility to potential Washington opportunities.
- ❖ Encourage the WSIB GPs to act as speakers or presenters in various educational and investors networking events across the state.
- ❖ Provide feedback from GPs regarding methods and mechanisms that may help Washington companies become better positioned to seek investment capital.
- ❖ Develop small, interactive forums for local GPs and WSIB GPs to discuss and exchange ideas.
- ❖ Contact WSIB GPs for their feedback and advice on how the WSIB can more effectively exchange information with them on quality investment opportunities in Washington and improve access to funding for Washington-based companies.
- ❖ Analyze funding data for trends and information on partner coalitions.
- ❖ Continue to monitor ETI policies in a number of other states and refine applicable metrics.

Staff will build on the policy implementation efforts to date to generate long-term results and continue to reflect the WSIB as a strong interested ally and resource for the Washington investment environment.

## Appendix

### Dollars Invested and Number of Deals July 1, 2003 through June 30, 2004 (\$ million)

#### Washington

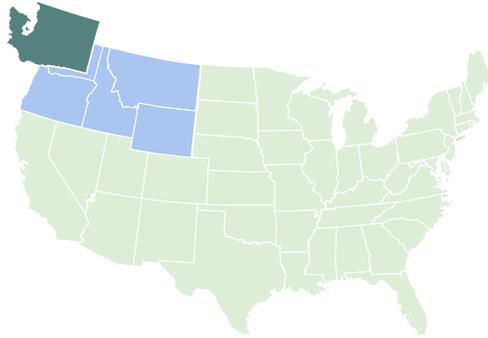
Number of Deals: 97  
Amount: \$716

#### Northwest

Number of Deals: 131  
Amount: \$878

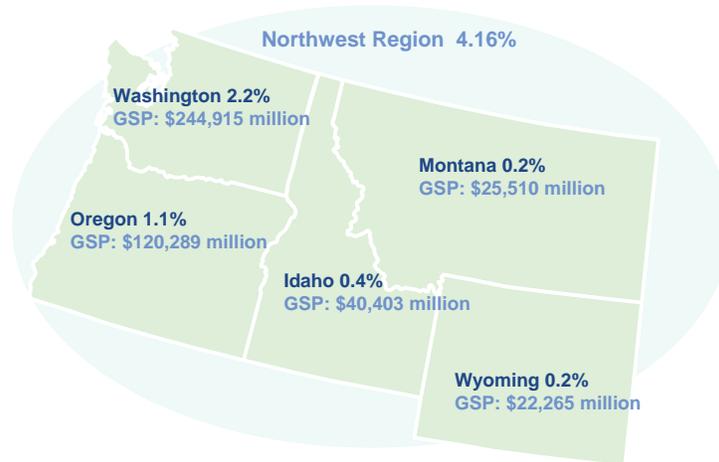
#### U.S.

Number of Deals: 2932  
Amount: \$20,876



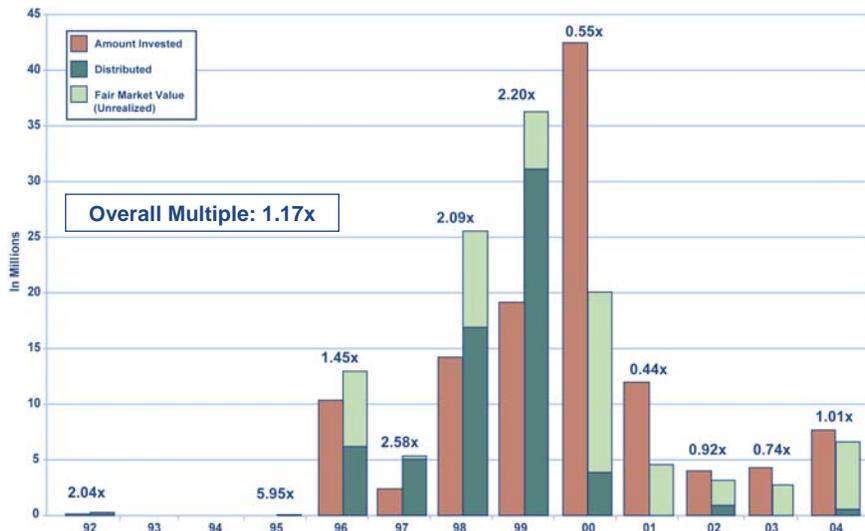
Source: PriceWaterhouseCooper/Venture Economics/NVCA MoneyTree Survey

### Gross State Product (GSP) as a Percent of U.S. National Gross State Product of \$10.9 trillion



Source: Bureau of Economic Analysis, U.S. Department of Commerce

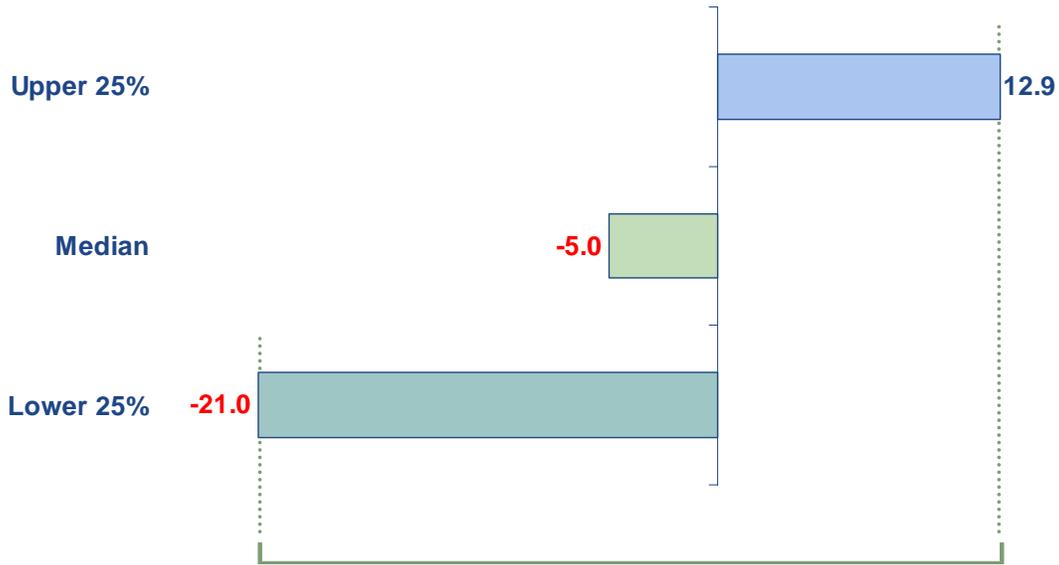
### Status of Dollars Invested in Washington 1992 through June 30, 2004



Source: Pacific Corporate Group, LLC

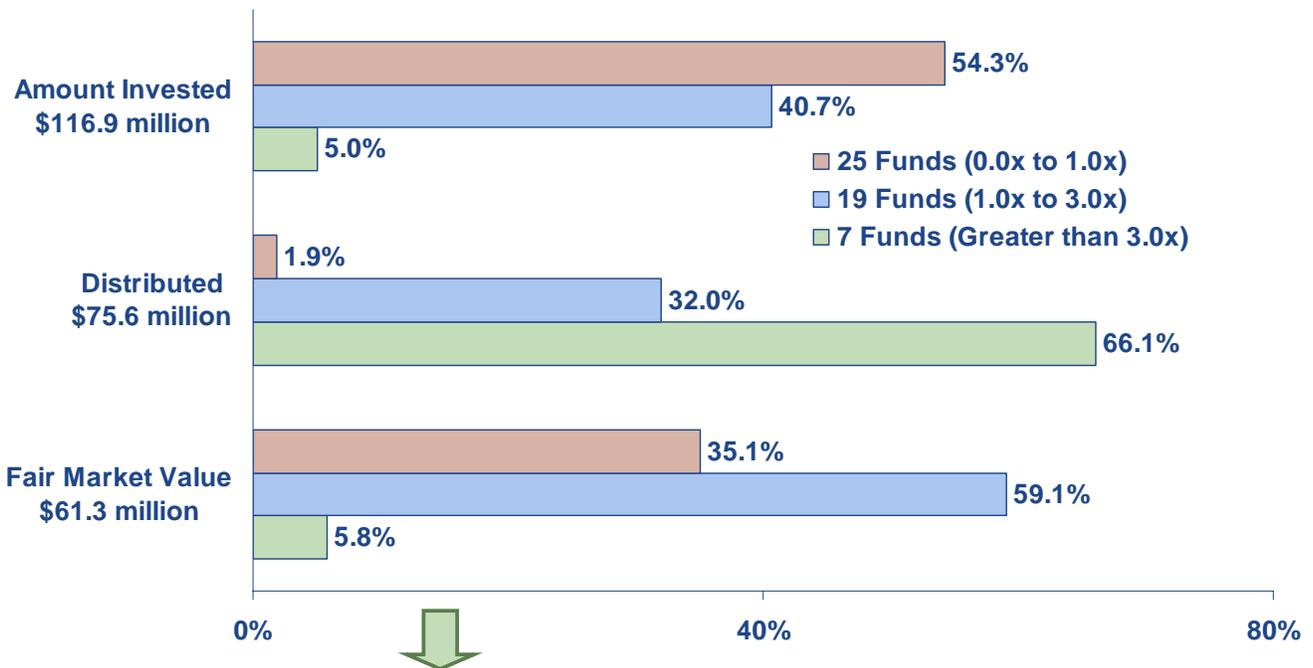
### Manager Selection is Critical From 1995 to 2003

In Venture Capital there is a wide spread between top and median performers.



Source: Venture Economics

### WSIB Investments Made by Our General Partners in Washington From 1992 through June 30, 2004



**Out of 51 funds (primarily venture capital), 7 produced 2/3rds of the total distributions**