
Washington State Investment Board Economically Targeted Investment Policy



**2006 Annual Report
December 21, 2006**

Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages \$74 billion in assets for 36 separate state retirement and other trust funds as of October 31, 2006. 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 explains over 90 percent of the variability of return. 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 overall performance.

This is the fourth annual report on the WSIB Economically Targeted Investment (ETI) policy. This year's annual poll of the WSIB's private equity General Partners' (GPs') deal flow activity for the year ended September 30, 2006, shows consistent strength and improvement over the prior three years. Key findings include the following:

- ❖ 50 GPs looked at 1367 Washington-based opportunities.
- ❖ 493 deals were still in the pipeline at September 30, 2006.
- ❖ 51 deals were completed.
- ❖ Venture capital and private equity firms continue to look at deals in the region.

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. Nearly \$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. This \$1.3 billion investment in Washington-based companies represents 2.4 percent of the state's commingled trust fund, while the state's Gross Domestic Product (GDP) is only 0.6 percent of the GDP for the investible universe within which we invest. More than \$6.6 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 the WSIB's GPs significantly 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 in-state investment activity. The WSIB continues to work with regional partners 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

The WSIB's private equity portfolio originated in 1981 and is invested primarily in limited partnerships. Each partnership, which is managed by a GP, acquires or creates 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.

In March 2003, the Board adopted an ETI policy 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 Board requests 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 less liquid and perhaps more risky than publicly traded investments, private equity investments can offer higher returns than traditional public equity when employed as part of a larger balanced portfolio.

The Board established a staff role 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 ETI policy, provide this annual report of relative activities to the Board, beneficiaries, Legislature, and Governor.

Investment Environment

Although the WSIB portfolio contains asset classes other than private equity, 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.

According to Thompson Venture Economics, U.S. venture capital investing for the first 9 months of 2006 totaled \$19.2 billion, up from \$17.0 billion for the same period in 2005. Remarkably, each of the three consecutive quarters of 2006 was in excess of the \$6 billion mark. Although quarter to quarter investment activity has fluctuated, overall it has been fairly stable since the third quarter of 2003.

Consistent with historical percentages, the Life Sciences (Biotechnology and Medical Devices industries together) continued to experience strong interest, capturing \$1.8 billion or 29 percent of all venture investing in the third quarter of 2006. Biotech took over the highest dollars received by a single industry category from Software for the first time, and Medical device investing increased 12 percent over second quarter. Software experienced a 19 percent decline in dollars and 24 percent decline in deals from the prior quarter, its lowest number since 1996, although Software still accounts for 18 percent of total dollars and 23 percent of all deals. The Industrial/Energy sector continued a steady incline, reaching a 6-year high; much of the increase is attributed to a single alternative energy company which received 76 percent of the quarter's investment. Although Telecommunications investments have continued to languish in recent years, Telecommunication had its strongest quarter since 2002, driven by deals in the Internet and Wireless Communications sub-sectors.

For the third quarter of 2006, venture capital investment in the seed/early stage companies increased 10 percent in dollars and accounted for 35 percent of the deals; first-time financings continued at strong levels with half the dollars to seed/early stage deals, apparently reflecting optimism within the industry. The increases were driven by both more seed stage deals and higher dollars in total, suggesting greater confidence in the potential opportunities represented in young companies. Expansion stage funding declined 10 percent in dollars and 14 percent in deals; likewise, later stage declined 13 percent in dollars and 20 percent in number of deals.

Private equity fundraising activity remained robust with 179 venture capital funds raising over \$25.4 billion and 121 buyout and mezzanine funds raising nearly \$84 billion during the first three quarters of 2006. These amounts already surpass the 2005 totals for the respective time period. Although fundraising receded somewhat in the third quarter, the industry is nearing the end of the 3 year fundraising cycle which is expected to raise approximately \$75 billion for venture capital firms. According to the National Venture Capital Association, early stage venture capital funds were the most active in the third quarter with 27 funds raising \$3.5 billion or 71 percent of the third quarter amount. Follow-on venture capital funds continued to be the dominant fundraisers with 43 funds raising 83 percent of the amount raised in the quarter. New funds consistently represented 17 percent of the number of funds for

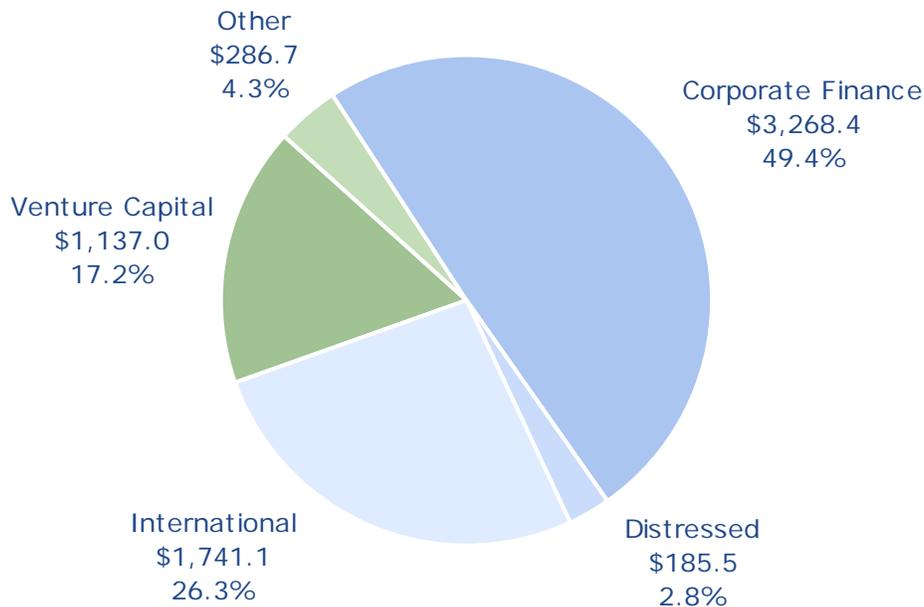
both the third quarter and the first three quarters. The ratio of follow-on funds raised compared to first time funds was nearly 5-to-1.

A continuing issue in private equity is whether the industry has too much "overhang," which is the amount of available or uninvested capital that has been raised by private equity funds. Excess capital may encourage too much competition for new deals and lead to overvalued transactions. 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.

Venture capital GPs began reducing fund sizes in early 2002, and have generally been targeting smaller funds in recent fund-raising activities, some nearly half the size of their predecessors. However, limited partners may be contributing to a new type of overhang, through both increased allocations and new entrants to the market that reflect their increased appetites for venture capital and private equity exposure. Hedge funds have continued to edge into traditional private equity space further adding to the issue of excess capital.

A review of the \$6.6 billion WSIB private equity overhang by strategy at June 30, 2006, indicates that nearly half the unfunded commitments are in the area of corporate finance and that over 17 percent is in the venture capital arena.

Portfolio Allocation by Strategy Based on Unfunded Commitments at June 30, 2006 (\$ millions)



Thompson Venture Economics reports that for the 12 months ended June 30, 2006, venture capital investments in the U.S. totaled \$23.9 billion in 3,231 deals. Of that total, \$1,223 million was invested in 166 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 133 of the Northwest deals and \$1,042 million of the newly invested dollars. During this same time frame, the WSIB GPs invested over \$2.6 billion in private equity including \$15.7 million in Washington-based companies. Over 40 percent of the investment in Washington-based companies represented new investments. The \$15.7 million is over 1.5 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.

In the third quarter of 2006, 23 Washington companies raised \$147 million, which is the lowest quarter of the last 12 and well below the investment levels of 2000 when the average quarterly total was

\$678 million. Notably, the 13 indigenous venture capital funds have raised over \$4.6 billion since 1999. The total increases to \$8.3 billion for that time period if national firms that have significant local presence are added. This total does not include local buyout or several small venture funds.

Much of the discussion on Washington-based investments focuses on the dollars WSIB has invested in Washington through its GPs. While this is an important amount, it may also be useful to expand the perspective on the funding of a Washington investment to include the total amount the WSIB GPs invested in a Washington deal and, further, to examine the total funding round for a Washington deal that includes the non-WSIB GPs. The power of this multiple can be observed through a real example of the investment round for a Washington-based company that received money from three GPs, one of which is a WSIB GP. The total investment round for the company is \$20.1 million; the WSIB GP invested \$3.6 million or 18 percent of that round; and the WSIB portion is reported as \$800,000, or approximately 4 percent of the total funding.

Focus on only the \$800,000 attributed directly to WSIB in the example overlooks the significance of more than \$20 million invested in a Washington-based company by sources from both in and outside the state. The amount reported for private equity invested in Washington has grown by nearly 43 percent from \$66.7 million at June 30, 2005 to \$95.2 million at June 30, 2006. The true impact of that amount on the Washington economy is substantially enhanced by the multiple effect of including the total amount of the WSIB GPs' investments and the addition of non-WSIB GPs' investments.

A shortage of investment capital is not an inhibitor to the growth of high-technology companies in Washington State or the U.S. Good deals will attract dollars whether from local players or more remote sources.

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, 2004, 2005, and 2006.

| Washington Investments in the WSIB Portfolio (\$ millions) | | | |
|---|--|--|--|
| Investment Class | Value Fiscal Year Ended 6/30/04 | Value Fiscal Year Ended 6/30/05 | Value Fiscal Year Ended 6/30/06 |
| Public Equity | \$677.3 | \$602.0 | \$474.2 |
| Fixed Income | \$196.9 | \$148.4 | \$85.8 |
| Real Estate | \$428.7 | \$448.6 | \$615.7 |
| Private Equity | \$61.3 | \$66.7 | \$95.2 |
| TOTAL | \$1,364.2 | \$1,265.7 | \$1,270.9 |

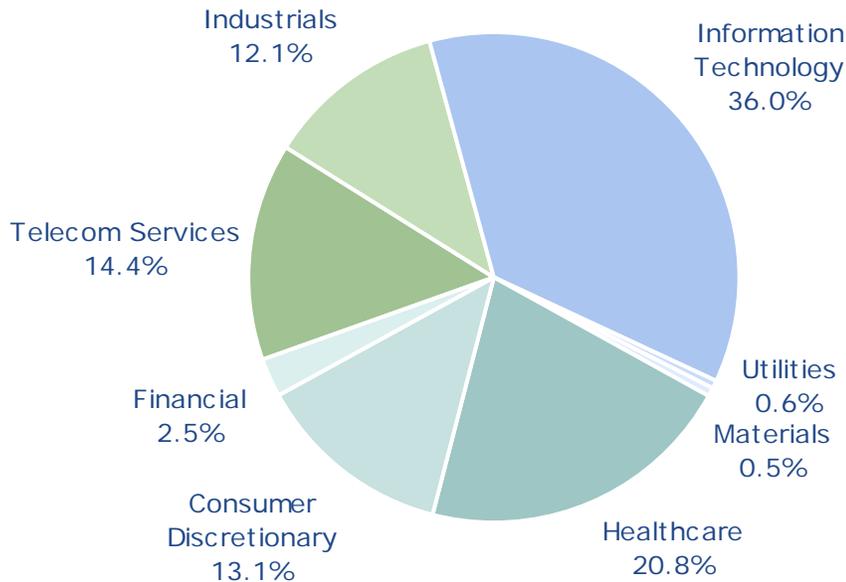
The WSIB portfolio contains numerous public equity and fixed income investments in Washington-based companies. In the year-over-year comparison, the value of public equities decreased 21 percent predominantly due to the Board's decision to increase exposure to international equities, which reduced the overall U.S. asset value. On a comparative basis, the percentage of Washington investments to the net asset value in public equities for 2006 decreased by only 0.23 percent, maintaining nearly the same exposure to total U.S. equity asset value as 2005 despite the overall reduction. The 42 percent decline in fixed income value was the net result of the portfolio's value of maturing or sold Washington bonds over new bonds added. The 37.2 percent increase in investment value for real estate in Washington was attributable to appreciation and new acquisitions.

The 42.7 percent increase in value year-over-year for private equity was due to the net appreciation in the fair market value for many private companies in the past fiscal year combined with new in-state investments, less over \$7 million returned in distributions. As of June 30, 2006, the WSIB had over \$95 million invested in Washington-based companies in its private equity portfolio, representing

approximately 1.6 percent of the total domestic private equity portfolio value. The Washington-based investments are held in 62 different funds by 34 individual GPs, 4 of which are regionally-based.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing that over 90 percent are diversified across five indigenous industries: Information Technology, Telecom Services, Consumer Discretionary, Healthcare and Industrials. Three other industries have smaller representation.

Percent Invested in Washington-Based Companies at June 30, 2006



The WSIB currently has a private equity portfolio valued at more than \$9.0 billion invested with 105 GPs in 233 partnership funds. An additional \$6.6 billion has yet to be called by the GPs. The unfunded commitment represents a significant amount of capital to be invested in the future by current WSIB GPs, many of whom actively review and evaluate investments in Washington State.

Highlights of 2006 ETI Activity

WSIB staff have initiated multiple efforts to provide exposure and understanding of the Board's policy in the state and establish contact with the local and regional organizations and networks in order to accomplish successful implementation of the ETI policy. The current outreach included meetings with the Washington Department of Community, Trade and Economic Development and with the U.S. Small Business Administration to seek ways to collaborate efforts to assist entrepreneurs and small businesses.

Regional Funds

The WSIB is currently invested in four regional firms: Endeavour Capital, Frazier Healthcare Ventures, OVP Venture Partners, and Polaris Venture Partners. During 2006, staff intensified its assessment of area funds and conducted numerous meetings with regional funds, concentrated but not limited to those in fund raising mode. The meetings with over 50 firms in the past 3 years have 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 some of the fund sizes are smaller than what WSIB usually invests in directly, staff has channeled a number of regional funds to Pathway, WSIB's discretionary venture capital manager, for investment consideration. Pathway is a fiduciary to the Board and manages 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 have been receptive to accept staff referrals of several companies and entrepreneurs that contacted WSIB seeking direct funding.

Annual GP Deal Flow

The WSIB conducted its fourth annual survey of the WSIB private equity GPs by sending letters to 66 GPs requesting information about their deal flow review in Washington for the year ended September 30, 2006, 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. Over 98 percent of the GPs responded. The results continue to show strong, consistent, and active Washington deal interest. The table below highlights the results.

| | 2003 Annual Report | 2004 Annual Report | 2005 Annual Report | 2006 Annual Report |
|-------------------------------|--------------------|--------------------|--------------------|--------------------|
| Number of GPs involved | 33 of 51 | 43 of 56 | 46 of 62 | 50 of 66 |
| Total deals reviewed | 567 | 597 | 1,223 | 1367 |
| Deals not pursued | 508 | 487 | 637 | 823 |
| Number of GPs involved | 6 | 16 | 24 | 34 |
| Deals in pipeline | 30 | 80 | 553 | 493 |
| Number of GPs involved | 9 | 19 | 15 | 20 |
| Deals done | 29 | 30 | 33 | 51 |

These responses suggest that Washington continues to earn the interest and access of top-quality GPs, and that interest has remained stable with measured growth over the past 4 years. The data also suggests that WSIB's GPs review and do deals in Washington in the normal course of their business, aside from the advent of reporting that activity. 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 check out companies, look at deals, and fund their choice of opportunities. The data is also a reminder that not all deals get done.

Regional Networks

Staff made over 22 trips to the Seattle area, contributed to several regional networks, and served on the Capital Formation Task Force and WSA Investment Forum Steering Committee.

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

- ❖ Early Stage Investor Forum
- ❖ WBBA Invest Northwest
- ❖ Alliance of Angels
- ❖ Keiretsu Forum

Each of these presented an opportunity to provide genuine support and expertise to the regional investment environment, broaden the WSIB regional contact base, and 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.

ETI Metrics

For more than 3 years, staff has monitored the ETI activities of numerous states and sought metrics that might be applied to the WSIB portfolio review. Staff continued to seek the use of performance measurement for ETIs through websites, written reports, and phone interviews. It is difficult to narrowly define ETI and no standard methodology has emerged to measure the results of ETI programs. The majority of ETI efforts (excluding programs targeting only social benefits) continue to 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 focus on the health and development of the investment environment provide useful information regarding the WSIB policy. Such metrics spotlight attention on the strengths and weaknesses of the region and may help target specific areas for more effective intervention or make decisions related to continuation or adjustment of the policy. Several measures of the state/regional investment environment have been adapted for use in this report.

In 2006, staff assumed a leadership role in the Institutional Limited Partners Association's (ILPA) targeted programs project, which will focus on researching and developing industry best practices among institutional private equity investors.

Looking Forward

The implementation efforts will continue to develop during the coming year. The flexibility of the current policy allows staff to respond to needs effectively as they arise. Personal contacts 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 sustained 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 appropriate potential sources of capital through the WSIB's relationship with both local and national GPs and other funding sources.
- ❖ Expand ways that the WSIB contributes and adds value (other than simply funds) to the regional environment.
- ❖ Enhance the due diligence and relationship building with regional GPs.
- ❖ Continue to improve the WSIB GPs' awareness of and accessibility to potential Washington opportunities.
- ❖ Provide feedback from GPs regarding methods and mechanisms that may help Washington companies become better positioned to seek investment capital.
- ❖ Continue the dialog with WSIB GPs for their feedback and advice on how the WSIB can more effectively exchange information with them on quality investment opportunities in Washington.
- ❖ 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, 2005 through June 30, 2006 (\$ million)

Washington

Number of Deals: 133

Amount: \$1,042

Northwest

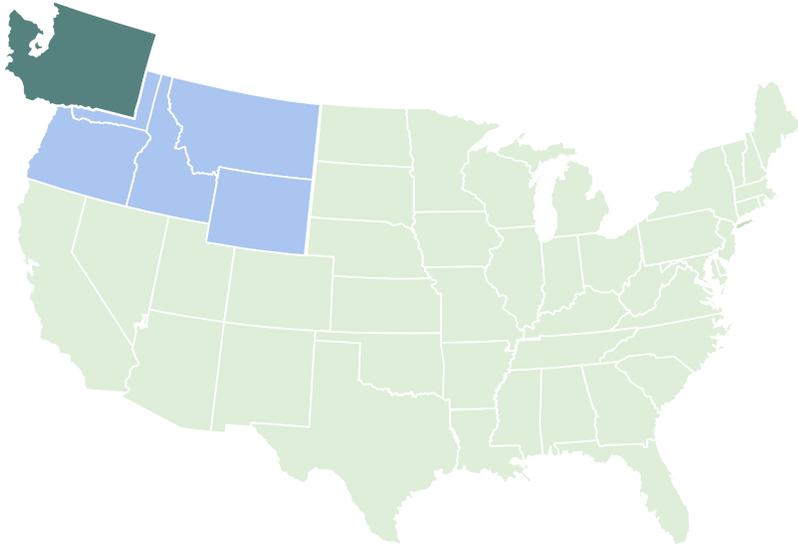
Number of Deals: 166

Amount: \$1,223

U.S.

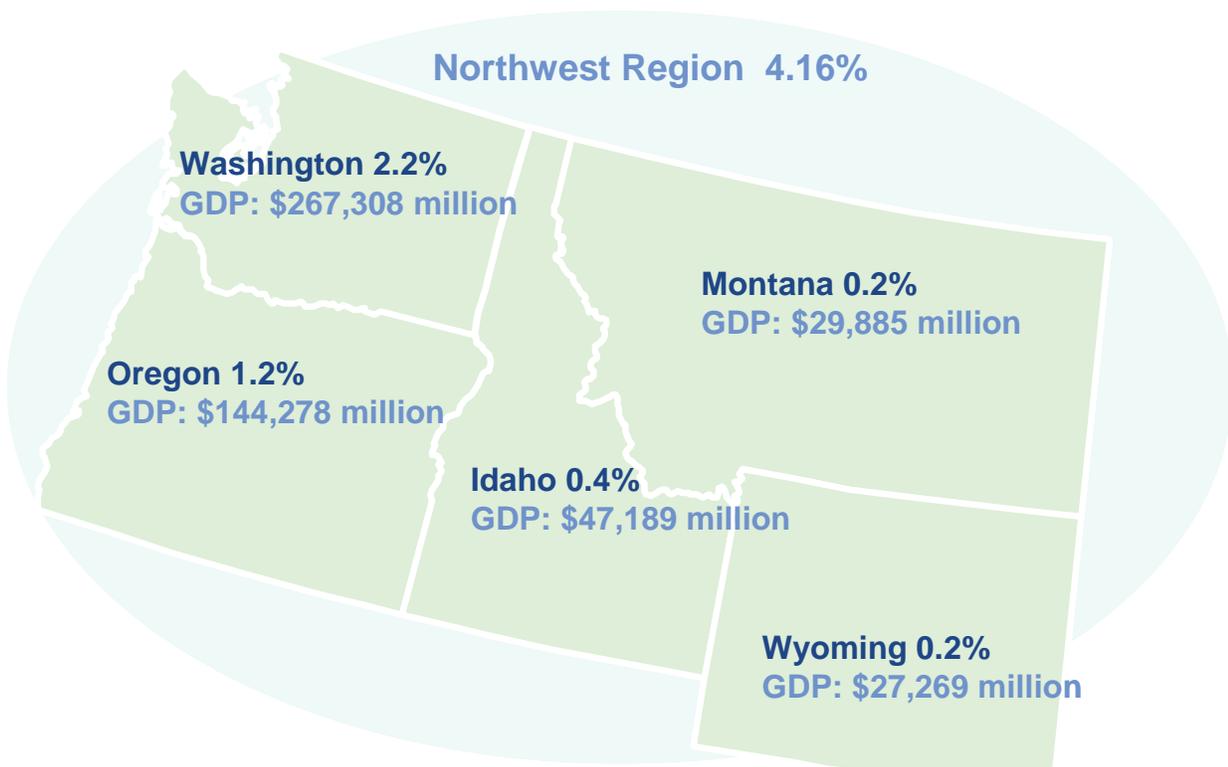
Number of Deals: 3,231

Amount: \$23,859



Source: PriceWaterhouseCooper/Venture Economics/NVCA MoneyTree Survey

2005 Gross Domestic Product (GDP) as a Percent of U.S. National GDP of \$12.4 trillion



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

Meetings with Washington Funds – August 2003 through November 2006

| | FIRM | WSIB MEETING(S) | FUND SIZE (\$MM) |
|----|--|-----------------|------------------|
| 1 | Altitude Life Science Ventures | 1 | 100 |
| 2 | Amerivon Equity Partners a | 1 | 200 |
| 3 | Arcadia Ventures | 1 | 250 |
| 4 | ARCH Venture Partners | 4 | 400 |
| 5 | Battelle Ventures | 1 | 100 |
| 6 | Blue Point Capital Partners | 1 | 500 |
| 7 | Blueprint Ventures (Portland partner) | 2 | 150 |
| 8 | Buerk Dale Victor | 14 | 125 |
| 9 | Cascadia Capital | 2 | N/A |
| 10 | <i>Cascadia Partners</i> | 1 | |
| 11 | Chrysalix (BC) | 1 | |
| 12 | Column Group, The | 2 | 500 |
| 13 | <i>Compass Capital</i> | 1 | |
| 14 | Copan Fund II a | 1 | 150 |
| 15 | Divergent Venture Partners | 3 | 100 |
| 16 | Eastven a | 1 | 200 |
| 17 | Encompass Ventures (including WSA Ventures) | 2 | 100 |
| 18 | * <i>Endeavour Capital</i> | 7 | 385 |
| 19 | Evergreen Pacific Partners | 6 | 300 |
| 20 | Fluke Venture Partners | 2 | 57 |
| 21 | Fontis Partners (Ethnic Media) b | 1 | 150 |
| 22 | * <i>Frazier Healthcare</i> | 6 | 450 |
| 23 | Frazier Technology Ventures II | 6 | 150 |
| 24 | Fulton Ventures (Dr. Samir Master) | 1 | |
| 25 | Guide Ventures | 3 | 75 |
| 26 | Highway 12 (Boise, ID) | 2 | 75 |
| 27 | IDG | 2 | 100 |
| 28 | Ignition Partners | 3 | 300 |
| 29 | <i>Integra Ventures</i> | 3 | 150 |
| 30 | Intel Capital | 2 | N/A |
| 31 | Intellectual Ventures | 1 | 1,000 |
| 32 | Keiretsu Forum (Todd Dean) | 2 | N/A |
| 33 | Madrona Venture Fund III | 10 | 150 |
| 34 | Maveron | 1 | 300 |
| 35 | Northwest Venture Associates | 15 | 100 |
| 36 | Northwest Entrepreneur Network | 4 | N/A |
| 37 | N W Location Professionals | 1 | |
| 38 | Obsidian Investment Advisors c | 1 | 50 |
| 39 | Orca Bay Partners | 1 | |
| 40 | Oregon Entrepreneur Forum | 1 | N/A |
| 41 | * OVP Venture Partners | 8 | 200 |
| 42 | Pacific Horizon Venture Partners IV | 4 | 75 |
| 43 | Paladin Partners | 1 | N/A |
| 44 | * Polaris | 1 | 900 |
| 45 | Quellos Capital | 3 | |
| 46 | Raven Capital | 1 | |
| 47 | Rustic Canyon - 21st Century Energy Fund b | 1 | 100 |
| 48 | SeaPoint Ventures | 3 | |
| 49 | Sisu Ventures d | 2 | 50 |
| 50 | Staenberg Venture Partners | 2 | |
| 51 | Stratos Biofund | 4 | 40 |
| 52 | Trilogy | 1 | |
| 53 | Village Ventures | 2 | 125 |
| 54 | Voyager Capital | 7 | 215 |
| 55 | Vulcan Capital | 2 | |
| 56 | WIN Partners | 2 | |
| 57 | WRF | 1 | |
| 58 | WSA Venture Partners (reverted to Encompass) e | 5 | 100 |
| 59 | Zefram LLC | 1 | |

- * Funds in which WSIB is invested
- a Focus on Pacific Northwest
- b Associated with Staenberg
- c Wellspring (Glenn Gregory)
- d Formerly part of Perennial Ventures
- e Reverted to Encompass in 2004

BOLD = fund raising now
Italics = pre-fund raising