

APPROVED

STATE OF WASHINGTON
STATE INVESTMENT BOARD

Private Markets Committee Meeting
Minutes

February 5, 2004

The Private Markets Committee met in open public session at 9:12 A.M. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present: Debbie Brookman, Chair
 John Charles
 Jeff Hanna (via teleconference)
 John Magnuson
 Patrick McElligott
 Mike Murphy
 Jeff Seely

Members Absent: Senator Zarelli

Other Board Members
Present: Charles Kaminski

Others Present: Joe Dear, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Tom Ruggels, Senior Investment Officer – Private Equity
 Steve Draper, Senior Investment Officer – Real Estate
 Diana Will, Investment Officer – Asset Allocation
 Linda Buchanan, Administrative Secretary

 Paul Silver, Senior Assistant Attorney General
 Eric Becker, Pacific Corporate Group
 Tara Blackburn, Pacific Corporate Group
 Marty Sutter, Essex Woodlands
 Mark Pacala, Essex Woodlands
 Doug Eplett, M.D., Essex Woodlands
 Michael Humphrey, Courtland Partners

[Names of other individuals attending the meeting are not included in the minutes but are listed in the permanent record.]

The meeting convened at 9:12 A.M. with Chair Brookman identifying members present.

REVIEW AND APPROVAL OF MINUTES – NOVEMBER 6, 2003

Mr. Charles moved to adopt the November 3, 2003, minutes. Ms. Brookman seconded, and the motion carried unanimously.

PRIVATE EQUITY – ESSEX WOODLANDS HEALTH VENTURES VI, L.P. – INVESTMENT RECOMMENDATION

Mr. Ruggels introduced himself and Mr. Becker, Pacific Corporate Group (PCG). Mr. Ruggels stated that staff recommends an investment of up to \$40 million in Essex Woodlands Health Ventures VI, L.P. (Essex VI). He explained that Essex is an existing partner and that, in addition to the \$40 million recommended here, the WSIB has committed \$15 million to Essex VI through Pathway Capital Management. Although staff is recommending an investment of up to \$40 million, the fund is oversubscribed and the actual investment, if approved, will likely be \$25 million. Mr. Ruggels described the fund's strong management team, experience, track record, investment strategy, diversification, and risk control. He stated that the fund is an excellent fit in the WSIB portfolio, staff knows the group well, and the relationship is successful. Mr. Ruggels discussed the termination of one partner and the poor performance of Fund III. He pointed out that the WSIB is not an investor in Fund III. Mr. Ruggels said he believes the issues leading to the poor performance have been corrected. He stated that Funds I and II are strong, and that Funds IV and V appear to be performing well. Mr. Ruggels discussed the key-man provision. He stated that staff believes this to be a strong fund offering and strongly recommends an investment of up to \$40 million.

Discussion ensued regarding the performance of Fund IV portfolio companies, private investment in public companies (PIPEs), and Internal Rate of Return (IRR) calculations.

Mr. Becker described methodology used by PCG in determining value.

Discussion ensued regarding advantages of investing in PIPEs, turnover issues, gestation period of investments, investment strategies, diversification, j-curve, and follow-on investments.

Ms. Blackburn, PCG, described deal flow and the time involved in realization of investments.

[Mr. McElligott was in attendance at 9:48 A.M.]

Further discussion ensued regarding advisory board seats, influence of general partner on portfolio companies, the reasons for the poor performance of Fund III, management fees, clawback provisions, tax distributions, and capital reinvestment.

Mr. Charles requested information regarding whether the WSIB will also be investing in Essex VI through HarbourVest. Staff will provide the information.

Mr. Sutter, Mr. Eplett, and Mr. Pacala, Essex Woodlands, introduced themselves. Mr. Sutter described the firm's team, strategy, experience, performance, institutional investors, partnership structure, diversification, and fund size.

Discussion ensued regarding sector focus, investments in PIPEs, changes in investment strategy, investment performance, diversity in investment stage, j-curve, partners, and the short turnaround in one portfolio company.

[A recess was called at 10:48 A.M. and the regular session reconvened at 11:04 A.M.]

Discussion ensued regarding size of investment, key-man issues, change of investment style, oversubscription of fund, expectations for Funds IV and V, market cycles, and value of market niche.

Mr. McElligott moved that the Private Markets Committee recommend to the Board an investment of up to \$40 million, plus fees and expenses, in Essex Woodlands Health Ventures Fund VI, L.P., subject to final negotiation of terms and conditions. Mr. Murphy seconded.

Discussion ensued regarding staffing requirements.

Mr. Murphy called for the question, and the motion carried with Mr. Charles abstaining.

PRIVATE EQUITY BENCHMARK UPDATE

Ms. Will introduced herself and described the issues involved in choosing a benchmark, desirable attributes of a benchmark, available benchmarks, the advantages and disadvantages of each, and the process used to develop staff's recommendation. Staff recommends utilizing the S&P 500 plus 400 basis points for the Private Equity benchmark.

Mr. Kaminski requested data on the R-squared between venture capital and non-venture capital. Tara Blackburn of PCG stated that they will provide the breakdown.

Discussion ensued regarding different uses of benchmarks and the possibility of utilizing two benchmarks.

Mr. Bruebaker stated that staff and PCG are continuing to work with other investors to develop a better benchmark that will meet WSIB needs and be superior to any other benchmark available.

Discussion ensued regarding the desirability of setting high standards for general partners, fair compensation for risk level, liquidity issues, advantages of a set figure over a range, inconsistencies between real estate and private equity benchmarks, time weighted and total return as opposed to dollar weighted methodology, reasons for utilizing basis points over a percentage, range peers are utilizing for benchmark, capital market assumptions, pension contribution rates, future market expectations, and past performance in meeting benchmarks.

Mr. Murphy moved that the Private Markets Committee recommend that the Board approve changing the benchmark to the S&P 500 time weighted total return plus 500 basis points and allow staff to update the affected policy to reflect the change. Mr. McElligott seconded, and the motion carried unanimously.

[A recess was called at 12:19 P.M. and the regular session reconvened at 12:33 P.M.]

PRIVATE MARKETS CLOSING LOG

Mr. Bruebaker distributed information regarding a secondary investment in Mobius Technology Ventures Side Fund VI, L.P.

The Private Markets Closing Log was presented for informational purposes. Mr. Bruebaker explained that staff negotiated better transaction fees on Silver Lake, and that credit goes to Mr. Ruggels and the private equity team for the improvement.

PRIVATE EQUITY ANNUAL PLAN

Mr. Bruebaker described the process in establishing the private equity annual plan and stated that the plan establishes discipline and framework for investment decisions. He stated that PCG would provide an overview of 2004, a recap of 2003, and a performance review. Mr. Bruebaker explained that Mr. Ruggels would discuss the private equity management guidelines, tier relationships, and details on existing relationships in the deal flow for 2004.

Ms. Blackburn described the objectives, priorities, and diversification by vintage year, subsector, and manager. She explained the forced growth in private equity, tumultuous market, and long-term perspective.

Discussion ensued regarding contribution levels, commitment levels, and potential contribution changes.

Ms. Blackburn discussed investment history, pacing, growth assumptions, and market predictions.

Mr. Becker described proposed changes to subsector targets, strategy groupings, and reclassifications. He discussed the methods and rationale used to determine the recommendation.

Discussion ensued regarding small, medium, and large corporate finance, the advantages and disadvantages in grouping all three in one subsector, flexibility within guidelines, effect of current events on model, classification of funds, overlap of fund between subsectors, the importance of diversification, number of relationships, and mezzanine funds.

Mr. Ruggels discussed the goals and guidelines used to develop specific recommendations.

Chair Brookman announced that the Committee would go into executive session under the provisions of RCW 42.30.110(1)(k) to consider certain financial and commercial information relating to the investment of retirement funds, public knowledge of which would result in loss to the funds, or in private loss to the providers of this information. Chair Brookman stated that the executive session would last at least one hour, and the Committee would then resume its open meeting to discuss the annual plan for real estate.

[The executive session convened at 12:55 P.M. and the regular session reconvened at 1:55 P.M.]

[Mr. Seely was no longer in attendance 1:45 P.M.]

REAL ESTATE ANNUAL PLAN

Mr. Bruebaker stated that Mr. Humphrey would discuss general market conditions and that Mr. Draper would discuss a brief history of the real estate program, provide information about the program, describe existing holdings, and discuss future investment activities. Mr. Bruebaker stated that the entire presentation would be in open session unless the committee had questions that would require staff to disclose material non-public information.

Mr. Humphrey discussed current market conditions, vacancy rates, average rental rates, pricing, appreciation returns, capital flow, correlation between capital flow and appreciation returns, property types, market history, market cycles, market volatility, pricing, market projections, and opportunities. He stated that caution is required in determining valuations and how real estate is acquired in the current market. Mr. Humphrey explained that the current market conditions may bring buying opportunities and discussed the need to position capital allocation with partners so they can be in a position to take advantage of that opportunity.

[Mr. Charles was no longer in attendance at 2:25 P.M.]

Discussion ensued about expectation on how long the current conditions will exist.

Mr. Draper discussed the history of the real estate department, investment structures, the breakdown of the real estate portfolio, advantages and disadvantages of the different structures, and presented an overview of the WSIB's real estate partnerships.

Discussion ensued regarding drawn capital, use of leverage, incentive fee structure, and the timber market.

[Mr. McElligott was no longer in attendance at 2:46 P.M.]

Mr. Draper discussed future strategic direction to include an emphasis on real estate operating companies (REOC) investments, focus on domestic growth markets, non-domestic exposure, reduction of exposure to chronically underperforming partners, and identification of strategies or niches for new investments. He stated that the portfolio continues to perform well and that the REOC strategy is producing above-average returns thus far.

Mr. Magnuson stated that Mr. Draper has done a good job in his first year as Senior Investment Officer.

Discussion ensued regarding the hiring process and need for additional real estate staff.

Mr. Dear stated that Mr. Magnuson has been of tremendous value to staff.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 2:53 P.M.