WASHINGTON STATE INVESTMENT BOARD
Private Markets Committee Meeting Minutes
February 2, 2006

The Private Markets Committee met in open public session at 9:05 a.m. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present:	George Masten, Chair Debbie Brookman Senator Lisa Brown John Magnuson Sandy Matheson Treasurer Mike Murphy David Nierenberg Jeff Seely
Other Board Members Present:	Glenn Gorton Charles Kaminski Patrick McElligott David Scott
Others Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Tom Ruggels, Senior Investment Officer – Private Equity Janet Kruzel, Investment Officer – Private Equity Linda Buchanan, Administrative Secretary Paul Silver, Assistant Attorney General Thomas Kubr, Capital Dynamics David Woolford, Capital Dynamics Gerry Langeler, OVP Venture Partners Chad Waite, OVP Venture Partners Lucinda Stewart, OVP Venture Partners George Roberts, Kohlberg Kravis Roberts and Company Michael Michelson, Kohlberg Kravis Roberts and Company

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

The meeting convened at 9:05 a.m. with Chair Masten identifying members present.

ADOPTION OF MINUTES – JANUARY 5, 2006

> **Treasurer Murphy moved to adopt the minutes of January 5, 2006. Ms. Matheson seconded, and the minutes were adopted unanimously.**

PRIVATE EQUITY INVESTMENT RECOMMENDATION – OVP VENTURE PARTNERS VII, L.P.

Ms. Kruzel introduced herself and David Woolford, Capital Dynamics, and recommended an investment of up to $40 million in OVP Venture Partners VII, L.P., a $200 million (target) venture capital fund that will invest in seed and early stage companies primarily in the Pacific Northwest Region. Capital Dynamics also recommended an investment of $40 million. The WSIB has invested in three prior OVP funds, two through INVESCO and one directly. Ms. Kruzel discussed the firm's strategy, regional focus, fit in the WSIB portfolio with minimal overlap of other partners, partners' backgrounds, fund performance, volatility of early-stage venture investing, tightened strategy and procedures, and expectations for Fund VI.

[Mr. Kaminski was in attendance at 9:09 a.m.]

Mr. Woolford discussed OVP's history, strategy, leadership, market environment, access to networks and other venture partners, ability to compete with other venture capital firms, demonstrated ability to recognize and act on marketable product ideas, experience and quality of the team, interplay of operations and marketing skills, and the lessons learned from Fund V. He stated that Capital Dynamics recommends an investment of up to $40 million.

The Committee discussed the numbers reported for Safe Harbor, expected returns of Fund V, Airgo, successful investments, timing of exits, motivation, lessons learned, and the low number of write offs in Fund VI.

Treasurer Murphy asked for clarification regarding numbers reported for Safe Harbor and for an explanation of "due diligence is careful and thorough but not excessively elongated." Mr. Woolford explained that, in early stage venture capital investing, the competition for good transactions includes the ability to identify the strengths and weaknesses of the entrepreneur and the product rapidly. Treasurer Murphy questioned staff's reported IRR numbers for Fund V and the amount written off and Ms. Kruzel responded that the fund is expected to return half the invested capital.

Mr. Nierenberg discussed the firm's successful investments in other funds, and the impact of the timing of exits in Fund V.

Ms. Matheson asked what lessons were learned in the results of Fund V. Ms. Kruzel responded that lessons learned included timing of exits and the importance of having other venture capitalists in the deal to form a good, strong syndicate. Mr. Woolford addressed the fact that the firm had attempted to change strategy in Fund V, and has since developed better processes.

Mr. Seely inquired as to the quartile rating of Fund V compared to other funds during the time period and Mr. Woolford responded that it was bottom quartile.

Mr. Nierenberg discussed the low "infant mortality" rate.

Treasurer Murphy requested clarification of the amount written off by Fund VI and Mr. Woolford explained that the written off company was one inside the accelerator.

Mr. Langeler, Mr. Waite, and Ms. Stewart, OVP, introduced themselves and discussed the advantages of investing in the Pacific Northwest, technology trends, the firm's experience, strategic relationships, strategy, size, team, performance, and lessons learned.

[Mr. McElligott and Mr. Scott were in attendance at 9:40 a.m.]

The Committee discussed the fact that the firm voluntarily gave up fees on Fund V, impact of OVP investments in Washington, leadership credentials, allocation of board seats among partners, capacity and specialization of the partners, the numbers listed for Safe Harbor, Fund V performance, outlook, and expected returns for Fund VI, distribution of carry among partners, ranking of Fund VI, and the amount of capital invested by the WSIB in prior OVP funds.

Treasurer Murphy asked whether Fund V would return capital to investors and Mr. Langeler replied that some had been returned and more would be.

[Ms. Brookman was in attendance at 10:02 a.m.]

Mr. Seely inquired about ranking methods for Fund VI when there have been no liquidity events and whether Airgo is carried at a marked up value. Mr. Langeler responded that Airgo is carried at a marked up value because it is carried at the last independent outside round of financing, which was done last year, and that the ranking is a comparison to other funds of the same vintage.

> **Ms. Matheson moved that the Private Markets Committee recommend to the Board an investment of up to $40 million, plus fees and expenses, in OVP Venture Partners VII, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Brookman seconded.**

The Committee discussed the OVP team, the voluntary surrender of management fees in Fund V, flat sharing of carry among partners, double teaming on board seats, potential impact of OVP investments on economic growth in Washington, and the reputation of the principals.

[Senator Brown was in attendance at 10:18 a.m.]

> **The motion carried with Treasurer Murphy voting no.**

[The Committee recessed at 10:27 a.m. and reconvened at 10:39 a.m.]

PRIVATE EQUITY INVESTMENT RECOMMENDATION – KKR 2006 FUND, L.P.

Mr. Ruggels introduced himself and recommended an investment of up to $1.5 billion in KKR 2006 Fund, L.P., a $10 billion (target) leveraged buyout fund that will invest in large buyout transactions primarily in North America and Europe. The WSIB has invested in many prior KKR funds. Mr. Ruggels described the firm's strong brand name and franchise, history, dominant position in the U.S. and Europe, expansion into Asia, strong network of relationships, access to deal flow and financing, access to the best and brightest people, deep and experienced management team, strong and consistent track record, strategy focused on value creation, portfolio concentration, and management succession issues. This is a very successful, long-term relationship for the WSIB and the recommendation recognizes the success of prior funds and represents a strong endorsement of the firm.

Treasurer Murphy requested an explanation of bridge loans, how interest rates are determined for bridge loans, and whether there were any fees paid. Mr. Ruggels explained that bridge loans and other forms of recycling are common in the buyout arena and provide short-term financing when needed due to timing issues. The general partner issues a drawdown notice, which identifies the monies as a bridge loan. If the general partner pays the money back within a specified timeframe with interest, the capital does not count against the commitment and can then be redrawn at a later date. Mr. Bruebaker added that the rate is based on Treasury bill rates, plus 400 basis points.

The Committee discussed terms and management fees of the fund. Mr. Bruebaker confirmed that Mr. Michelson told him that the management fee for larger investors would be 1.3 percent.

Mr. Woolford stated that Capital Dynamics recommends an investment of $1.5 billion and described the firm's brand name, disciplined culture, innovation, reputation, consistently positive track record, experience, deep industry expertise, changes in partnership, industry risk, price discipline, market trends, and management succession.

Treasurer Murphy asked Mr. Woolford to expand on the statement in Capital Dynamic's report that KKR's geographic expansion could dilute focus on North America, Western Europe, and potentially lower returns to core activities. Mr. Woolford explained that the potential need to move people into the new geographic regions and the distance involved could detract time and effort away from core activities.

The Committee discussed the effect of the larger size and scale of portfolio companies on exit options, liquidity concerns given the potential that portfolio companies could be held up to 18 years, cash flows, and concentration issues.

Ms. Matheson inquired whether the claim that KKR receives first calls from prospective investments could be proven and the reason KKR's interest rate advantage is no longer as valid. Mr. Woolford responded that Capital Dynamics spoke with companies where KKR did not invest and found that, in every case, KKR had been given the opportunity to invest. He explained that the change in the preferred interest rate was most likely due to new entrants in the arena and the securitization market.

Mr. Kaminski asked about the compensation of Capstone consultants, whether this was standard industry practice, what additional fee load there might be on the portfolio companies, and the reasons KKR would need outside consultants. Mr. Woolford responded that although he could not address the fee load issue, the Capstone setup was more cost effective than hiring an outside consultant and that the need for consultants was due to the large number of deals that KKR invests in each year and that such practice is consistent with industry practices.

Mr. Nierenberg commented on the transition from an entrepreneurial to a more institutional style of fund management, enhancement of operational performance, and value added post investment approach to deals. He stated that some other firms were quicker to institute such ideas.

Mr. Roberts and Mr. Michelson, KKR, introduced themselves and discussed the firm's relationship with the WSIB, competitive position, experience, team, internal processes, industry expertise and focus, returns, operational value creation, global reach, brand, relationships, reputation, access to investment opportunities, market leadership with respect to large and complex investments, annual report to Board, annual investors' conference, semi-annual full-day reviews, and open access to KKR executives.

Treasurer Murphy asked how $1 billion was actually invested by the WSIB in the 1996 KKR Fund when the WSIB committed was $850 million. Mr. Michelson explained that under the bridge loan provisions of the contract, monies designated as bridge loans can be drawn. If those monies are paid back within 18 months with interest, the capital does not count against the commitment and can be drawn again later. If the totals are cumulated on a gross basis, the gross amount can be in excess of the commitment, but the net drawn cannot be in excess of the commitment.

The Committee discussed the differences in KKR's and staff's reports, cash flow projections, fees and conditions of the investment, co-investment opportunity, KKR's preference for fewer limited partners, market trends, size of investments, the effect of the larger proposed fund size on liquidity, projected returns for the Millennium Fund, the effect of hedge funds, and how KKR arrived at their request for the WSIB to invest $3 billion.

[Senator Brown was no longer in attendance 12:19 p.m.]

[The Committee recessed at 12:46 p.m. and reconvened at 12:55 p.m.]

> **Treasurer Murphy moved that the Private Markets Committee recommend to the Board an investment of up to $1.5 billion, plus fees and expenses, in KKR 2006 Fund, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded.**

Ms. Matheson asked how much impact a larger investment would have on concentration.
Mr. Kubr discussed, using the S&P 500 as an index, the possibility the WSIB would have had higher profits if the portfolio had been more diversified, the history of the WSIB with KKR, the

issues of fee and most favored nation status, and the offset of a larger investment with lower fees.

[Senator Brown was in attendance via teleconference at 1:26 p.m.]

Mr. Kubr discussed the impact of a hypothetical catastrophic event and the impact such an event could have on a concentrated portfolio. Mr. Kubr stated that an investment over $1.5 billion would be too large, and that the WSIB would have had higher returns if it had diversified its investments into three or four firms rather than concentrating with KKR.

Ms. Brookman stated that she was in favor of the $1.5 billion recommendation and asked about the co-investment aspect of the investment. Mr. Ruggels explained that, when he wrote the recommendation, it was his assumption that the WSIB would be given the same terms that Oregon is receiving at the $1.5 billion level of investment. However, staff learned later that this is likely not the case. Mr. Bruebaker added that the co-investment vehicle had good terms but is also a higher risk as it will be invested at the GP's discretion only in the larger deals.

Mr. Masten asked whether staff would support a larger investment and Mr. Bruebaker responded that staff would.

Ms. Matheson asked for clarification on whether the discount on fees would offset the risk of a larger investment. Mr. Kubr replied that the fees would not offset the entire risk, but would offset the cost of concentration, that Capital Dynamics would not support a larger commitment, and that a larger commitment would limit other opportunities.

Chair Masten moved that the investment amount be changed to $2.25 billion. The motion died for lack of a second.

Mr. Kaminski discussed portfolio construction and asset allocation issues with deals expected to come before the Committee.

Ms. Matheson asked the nonvoting members what they believed the commitment should be. Mr. Seely and Mr. Magnuson indicated they felt the WSIB should commit between $2 billion and $2.25 billion, while Mr. Nierenberg and Mr. Kaminski indicated they felt the WSIB should commit $1.5 billion.

The original motion carried with Chair Masten voting no.

PRIVATE MARKETS CLOSING LOG

The Private Markets Closing Log was presented for informational purposes.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 1:48 p.m.