EQUITY CAPITAL NEEDS

OF

NEW MEXICO TECH START-UPS

Presentation
to the
Jobs Council
of the
New Mexico Legislature

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"One way that high-tech start-up companies distinguish themselves from other start-up companies is the relatively high compensation that they provide. Whether it is because of the skills and education required or a premium for the risk of joining an unproven company, the average compensation of the surveyed start-ups was $71,065, well above the New Mexico average compensation ($52,765)."

From "STC.UNM: The Impact of Start-Up Companies on the New Mexico Economy" by UNM Bureau of Business and Economic Research, June 2014

7-27-5. Investment of severance tax permanent fund.

The severance tax permanent fund shall be invested in separate differential rate and market rate investment classes. **"Differential rate investments" are permitted in Sections 7-27-5.3 through 7-27-5.5, 7-27-5.13 through 7-27-5.17, 7-27-5.22 and 7-27-5.24 through 7-27-5.26 NMSA 1978 and are intended to stimulate the economy of New Mexico and to provide income to the severance tax permanent fund**. "Market rate investments" are investments that are not differential rate investments and are intended to provide income to the severance tax permanent fund. All market rate investments and differential rate investments shall be invested in accordance with the Uniform Prudent Investor Act [45-7-601 through 45-7-612 NMSA 1978] and shall be accounted for in accordance with generally accepted accounting principles.

7-27-5.15. New Mexico private equity funds and business investments.

A. No more than nine percent of the market value of the severance tax permanent fund may be invested in New Mexico private equity funds or New Mexico businesses under this section.

B. In making investments pursuant to Subsection A of this section, the council shall make investments in **New Mexico private equity funds or New Mexico businesses whose investments or enterprises enhance the economic development objectives of the state**.

45-7-602. Prudent investor rule.

A. Except as otherwise provided in Subsection B of this section, a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in the Uniform Prudent Investor Act [45-7-601 through 45-7-612 NMSA 1978].

B. **The prudent investor rule, a default rule, may be expanded, restricted, eliminated or otherwise altered by the provisions of a trust**. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Introduction

The New Mexico State Investment Council ("SIC") has the authority to allocate a portion of the assets of the Severance Tax Permanent Fund ("STPF") to investments in private equity funds that invest in New Mexico based companies ("Funds") and/or co-investments directly in New Mexico companies ("Co-Investments"). The maximum target allocation to New Mexico private equity is 9% of the STPF by statute (Section 7-27-5.15 NMSA 1978). The New Mexico Private Equity Program (the "New Mexico Program") Policies and Procedures describe the private equity allocation, the administrative structure and the procedures and guidelines for managing the New Mexico Program of the SIC.

Administrative Structure

The Private Equity Investment Advisory Committee ("PEIAC" or the "Committee") was established by statute to review all private equity investments and make recommendations to the SIC regarding private equity investments and any matters or policies related to such investments (Section 6-8-20 NMSA 1978). The State Investment Office's staff ("Office" or "Staff") will also oversee all private equity programs. The statute allows for an investment advisor ("Advisor") to be hired and compensated to assist with accomplishing the New Mexico Program's objectives (Section 6-8-20.H NMSA 1978). The duties of each party are defined in more detail in the subsequent sections of this document.

The PEIAC will review these policies and procedures at least annually and recommend any changes to the SIC for approval.

Objectives

The New Mexico Program was intended by the Legislature to encourage development of a private equity industry within the State. The three objectives of the New Mexico Program are to 1) produce significant capital gains to grow the corpus of the STPF; 2) provide additional diversification for the STPF's assets; 3) the creation, retention or expansion of employment opportunities and economic growth in the State. These objectives are accomplished through the SIC's investments in private equity funds and dedicated co-investment funds. The Program is governed by the Prudent Investor Rule.

Investment Structure

Fund commitments in the New Mexico Program will only be made from the STPF. Agreements will be executed between the STPF and the General Partner of the private equity fund.

Investment Guidelines

The New Mexico Program will be expected to diversify investments by vintage year over time, although the level of annual commitment may fluctuate as the size of the STPF fluctuates and as New Mexico opportunities arise. Due to the relatively small size of the New Mexico economy, industry concentrations within the State and the fact that the majority of the opportunities in private companies within the State will tend to be in start-up or early stage ventures, diversification by strategy, geography and industry may not be achieved to the same degree as in the National Program.

The Investment Guidelines for the New Mexico Program are defined in the statutes (Section 7-27-5.15, NMSA 1978). Fund managers are required to:

- Have as their primary business activity the investment of funds in return for equity in or debt of a business, for the purpose of providing capital for start-up, expansion, product or market development, recapitalization or similar business purposes.
- Hold out the prospects for capital appreciation from such investments.
- Have at least one full-time manager with at least three years of professional experience in assessing the growth prospects of businesses or evaluating business plans and who has established permanent residency in the State.
- Be committed to investing or help secure investing by others, in an amount at least equal to the total investment made by the SIC in that fund, in businesses with a principal place of business in the State and that hold promise for attracting additional capital from individual or institutional investors nationwide.
- Accept investments only from accredited investors as defined in Section 2 of the federal Securities Act of 1933.

Other investment guidelines for the New Mexico Program include:

- Minimum commitment size of four (4) million dollars to a specific fund.
- The fund's total commitment size must exceed twelve (12) million dollars including any commitment by the SIC.
- No commitment may exceed thirty-three (33) percent of the total capital of any fund.
- Shall not make any investments that include equity or debt participation by the New Mexico Small Business Investment Corporation.

Strategy

The New Mexico Program's strategy should encompass the performance and risk objectives of the SIC and the Investment Guidelines set forth in this document. The Advisor and Staff will be responsible for formulating the New Mexico Program strategy. The PEIAC will review the strategy and make recommendations to the SIC. On at least an annual basis, the Advisor, with Staff input, will prepare a strategy update and tactical plan and present the plan to the PEIAC, which will recommend any plan changes to the SIC.

New Commitments

New commitments in the New Mexico Program can include existing or new private equity managers. The same level of due diligence and evaluation should be applied to reviewing potential fund investments regardless of whether the manager is an existing or new relationship.

The Advisor and Staff will lead the process for sourcing, screening and completing the due diligence of new investments that meet the Investment Guidelines and Strategy approved by the SIC. The diligence process will include:

- Comparison of the proposed investment opportunity against the SIC's approved private equity strategy, investment opportunity, concept, structure and terms .
- Review and analysis of documents provided by the fund manager, including the Limited Partnership Agreement, private placement memorandum and supporting information.
- Review due diligence questions specific to the investment opportunity.
- Assess the quality and continuity of the fund management and investment professionals.
- On-site due diligence meeting at one of the investment firm's offices.
- Reference checks on portfolio company executives and industry professionals.

- Confirmation of performance representations of the track record provided by the firm by independently calculating the overall internal rate of return represented by the cash flows provided by the firm.
- Comparison of prior performance against relevant private equity performance benchmarks.
- Analysis of the performance and carrying value of the unrealized portfolio and discuss exit scenarios on key investments with the firm's investment professionals.
- Consideration of actual or perceived potential conflicts of interest, if any, posed by the proposed investment, prior investments and other activities of the firm.
- Other procedures as deemed necessary.

The Advisor, with Staff input, will prepare an investment memorandum that summarizes the investment opportunity and the Advisor's due diligence findings and includes a recommendation to the PEIAC and the SIC. The investment memorandum will be reviewed by the PEIAC.

Upon approval, Staff will work to close the SIC's investment commitment. If within six (6) months from the date any fund or investment receives approval from the SIC, that fund or investment has not closed, then that approval shall be deemed expired. For the purposes of this provision, an investment is closed once the fund documents have been executed by both the SIC and the General Partner of the fund.

In addition to the above procedures, it should be emphasized that the primary goal of the evaluation process for partnerships in the New Mexico Program will be to identify and recommend those partnerships that have the necessary experience and/or capabilities to succeed in the New Mexico private equity environment.

The PEIAC shall review all recommendations of the Advisor and Staff and make recommendations to the SIC. All investments require the approval of the SIC (Section 7-27-5.15(C), NMSA 1978).

Monitoring Commitments

The Staff and Advisor will review the existing New Mexico Program portfolio on a continuing basis and advise the PEIAC and SIC on matters and policies related to such investments. The Staff and Advisor will perform the following activities regarding investment monitoring:

- Receive and review all correspondence from the General Partners of the fund.
- Monitor the fund's activities, and report at least annually to the PEIAC and SIC, compliance with the fund's documents and agreements regarding State of New Mexico activity.
- Conduct periodic meetings with the General Partners on an individual basis as appropriate.
- Attend annual meetings as appropriate.
- Serve on advisory boards as appropriate.
- Review all amendments to the partnership agreements. The Advisor will forward such amendments to Staff with recommendations for approval or disapproval.

Portfolio status and performance reports will be provided by the Advisor on a quarterly basis, using data compiled by the SIC's third-party data provider and information provided by the fund managers. The performance reports should include:

- Fund investment performance calculated on a dollar-weighted basis (i.e., internal rate of return).
- Portfolio performance calculated on a dollar-weighted basis, including the effects of both cash flows and current market valuations.

performance was impacted by poor manager selection because these vintage years are tracking below median benchmark returns.

Mr. Pugmire said increasing performance of these commitments to average returns of the Cambridge Associates All U.S. Private Equity benchmark would increase since-inception IRR by approximately 170 basis points and increase the since-inception net multiple from 1.45 x to 1.53x.

Mr. Pugmire commented that the key takeaways from this modeling confirm the strategy that has been in place for this program since 2011: 1) having a consistent commitment pace regardless of the market environment; and 2) finding the best managers available and having manager selection drive the investment process.

Mr. Smith said he has asked LP Capital to look at the three assumptions in the private equity program to see if they are still valid: 1) that the top performing managers continue to be top performers; 2) consistently investing across all vintage years; and 3) market capitalization with regard to strategy is still efficient.

Chair Eitzen noted that the venture capital category is the poorest performer in the private equity categories, and the last investment was in 2007.

Mr. Pugmire responded that, in 2007, the NMSIC sold a lot of its high quality venture capital funds, and the funds the NMSIC couldn't sell remain in the portfolio. He said LP Capital continues to look at the venture capital category; however, because most VC funds tend to be under $1 billion and can even be under $500 million, making a sizable commitment is very challenging. He said LP Capital is seeing more VC funds being added to the pipeline, though, because the fund-of-funds are pulling back and the VC funds are looking for more stable sources of capital. He said LP Capital is starting to talk to a lot of high quality venture funds, but the challenge remains not only size, but also comfort with the NMSIC's disclosure requirements.

c. <u>4Q 2013 NMSIC Co-Investment Fund Review</u>

[Informational.]

d. <u>National Private Equity Reporting Items</u>

[Informational.]

e. <u>EPIC Ventures V, L.P.</u>

Sun Mountain advisor Brian Birk presented an overview of EPIC Ventures and why Sun Mountain feels this investment is a good fit for the NMPEIP.

-- The NMSIC initially committed to Wasatch III, a 2001 vintage fund, and made a second commitment in 2004 to Wasatch New Mexico, which was dedicated to investing in New Mexico-based companies.

-- In 2008, the NMSIC committed to EPIC Fund IV. Along with the name change from Wasatch, the firm made a change to its senior team with the departure of the founding Managing Director, Todd Stevens, and the addition of Chris Stone. The firm also refocused its investment strategy to software, mobile and other IT-related sectors. This new strategy is carried over to EPIC Fund V.

-- EPIC has invested in nine New Mexico-based companies, and has a New Mexico-based investment professional, Katie Rice.

– Fund IV is performing near the top of the second quartile for 2008 vintage venture capital funds per Thomson Reuters and Cambridge Associates benchmarks, with a net to LP IRR of 13.23 percent and a 1.48x multiple as of December 31, 2013. Fund IV's portfolio includes three companies with significant upside potential from their current carrying values.

Mr. Birk noted that, with Sun Mountain's recommendation of $10 million, the NMSIC's total exposure would be slightly under $40 million for all three funds. Sun Mountain is comfortable with this because: 1) this amount is spread over almost 15 years and in four different vintage years; 2) the portfolio has a number of exits on the horizon in the next three years; and 3) the statutory cap for the New Mexico program is over $400 million, so an exposure of about $40 million is not unreasonable given the number of funds and different vintage years.

Managing Directors Chris Stone and Nick Efstratis introduced themselves to the committee and made a presentation.

Mr. Stone stated that EPIC is working on 20 to 22 deals in the New Mexico pipeline at any given time. New Mexico is experiencing less deal flow than Utah, which is a booming tech state; however, in software, deal flow is equal to or better than deal flow EPIC sees in other tech states like Idaho and Colorado.

Responding to Mr. Moise, Mr. Efstratis stated that Utah outpaced every other Rocky Mountain state in Q1 2013 in venture capital raised in the region, and that trend continues. He said this is largely because of the infrastructure that was laid 15-20 years ago with Novell, WordPerfect, Iomega and other firms that became tech giants and spawned upstarts, and this has continued to repeat itself.

Mr. Efstratis said EPIC sees the same opportunities in New Mexico because of the universities, research labs, and interest in entrepreneurship.

Mr. Moise asked what New Mexico could have done 15-20 years ago that it didn't do, but perhaps could do now.

Mr. Stone responded that a more robust computer science program at the universities would be one step that New Mexico could take. Also Mr. Stone discussed TechStars, a mentorship-driven startup accelerator that is now in Boston, Chicago, Los Angeles, and other cities. He said a smaller version of TechStars could be established in Albuquerque or Santa Fe.

Chair Eitzen noted that EPIC has investments in Aspen Avionics, Exagen Diagnostics and Lumidigm, which are also in the NMSIC's co-investment funds. She commented that there are limited numbers of quality companies in New Mexico, and expressed concern about exposure issues.

Mr. Stone responded that those investments were made several years ago, and the New Mexico pipeline has grown substantially since then. He said the 20-22 companies that EPIC is now working on are unique to EPIC, and there will not be the same level of crossover going forward.

Dr. Burke said he did not see any assurances that the $10 million investment would be spent in New Mexico and would have the appropriate matches as required by NMSIC policy.

Mr. Birk responded that the side letter requirements articulate what Dr. Burke is discussing, and those would be included in the legal documentation.

Mr. Land added that the NMSIC has statutory compliance and other requirements for all asset classes, and that is included in the contracting processes that are addressed by legal staff after the vetting process is completed by the CIC and/or PEIAC.

Dr. Burke said Sun Mountain has a unique set of criteria that address the New Mexico program, and he feels those criteria should be mentioned at the presentation before the NMSIC, so the NMSIC can be assured that they will be monitored.

Chair Eitzen suggested that Mr. Birk's presentations to the NMSIC include mention of the side letter restrictions in his introductory remarks, and that the fund sponsor acknowledge that it is a goal of the fund to invest in New Mexico companies.

Referring to EPIC Fund IV, Chair Eitzen asked what percentage of value is in New Mexico companies. Mr. Stone responded a total of $2 million has been invested in New Mexico companies.

Mr. Birk commented that Sun Mountain explored that aspect with respect to the side letter requirements. He noted that the amount is not only in aggregate, but is also fund by fund. In Fund IV, two of their existing portfolio companies have substantial reserves set aside that are still relatively early stage; in addition, over and above their direct investment, their cause to invest has been substantial in those companies.

Chair Eitzen said one concern is that the performance of the Severance Tax Permanent Fund has been less than that of the Land Grant Permanent Fund, and there are only two differences in the investments, and one is a small percentage of the STPF to the NM Small Business Investment Corp, and the other is the NMSIC's venture capital commitment, which is virtually all in the New Mexico program. She expressed concern about committing more money to a venture capital program that seems to be harming overall performance, especially when investments are only regional rather than national. She noted from Sun Mountain's documentation that, since 2004, 40 percent of the vintage funds are above median, so more than half are under the benchmark.

Mr. Birk stated that the benchmarks are a blended composite of different venture capital investing, and New Mexico investments tend to be early stage, creating a pronounced J-curve effect. Because of the base and timing of investments, Sun Mountain expects further increases in performance from the New Mexico portfolio vis-à-vis the national portfolio. Investments in the national portfolio are later stage, so there is less time to exit and less time in the J-curve.

Chair Eitzen wondered about the inclusion of a larger percentage of venture capital in the New Mexico program; and if it is to be included, should it be New Mexico based in both co-investment funds as well as in the private equity program, which seeks funds investing in New Mexico.

Mr. Smith commented that, while Sun Mountain is doing a very good job in this asset class, the 50/50 mix in the STPF's private equity portfolio is the primary difference between the STPF and LGPF.

Mr. Smith said he would address this in depth as part of the asset allocation study. He noted that the NMSIC made a specific allocation out of the STPF (5 percent) to the NMPEIP, which will have to be built into the asset allocation mix.

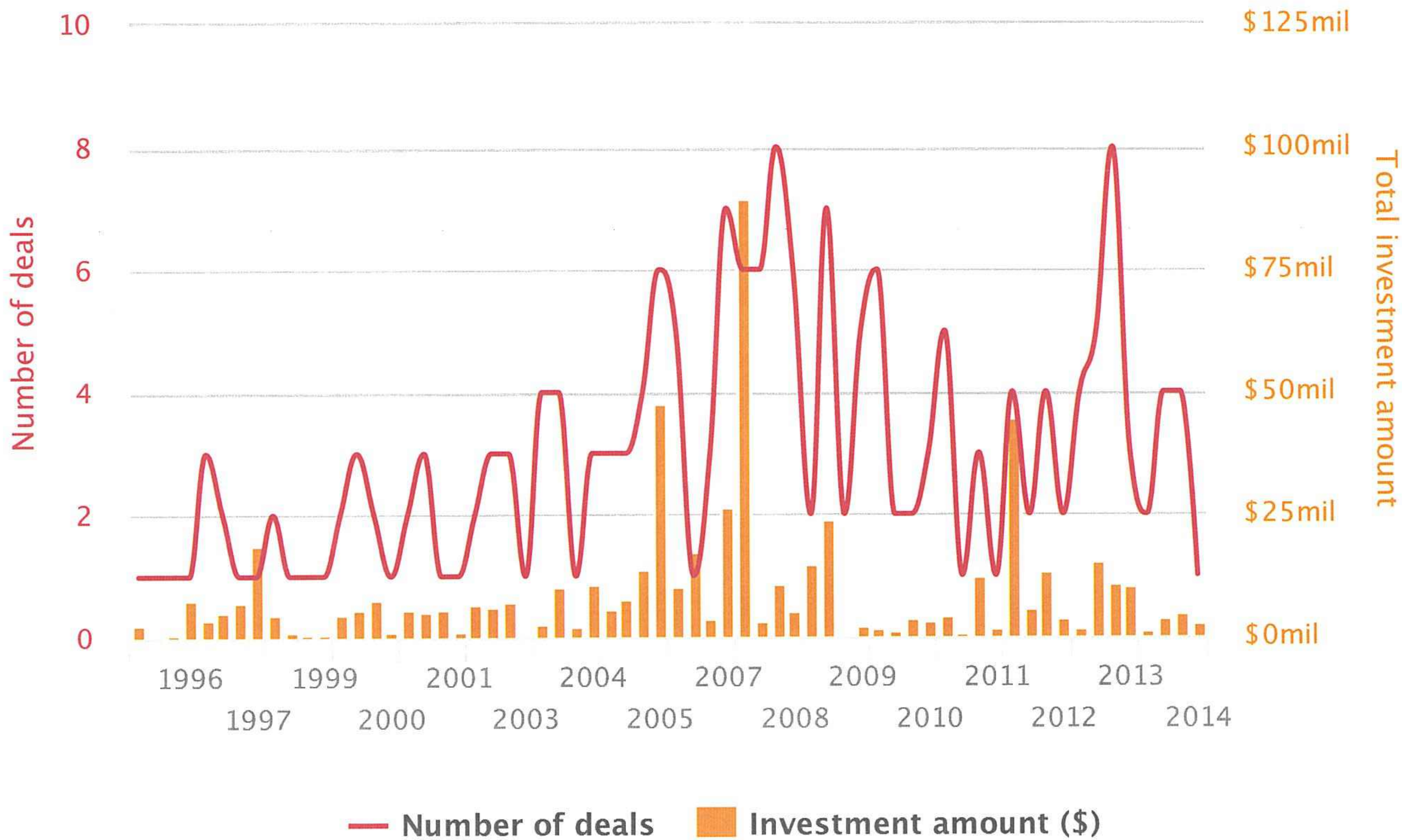
Mr. Birk reviewed terms and fees under discussion with EPIC.

Based upon the recommendation of Sun Mountain Capital and staff, Dr. Burke moved that the PEIAC recommend to the SIC a commitment of 10 percent of the fund, not to exceed $10 million, from the New Mexico Private Equity Program to EPIC Ventures V, L.P. (the "Fund"), and subject to and contingent upon New Mexico state law, New Mexico State Investment Council policies, negotiation of final terms and conditions and completion of appropriate paperwork. Mr. Feinberg seconded the motion, which passed unanimously by voice vote.

[Mr. Feinberg signed off.]

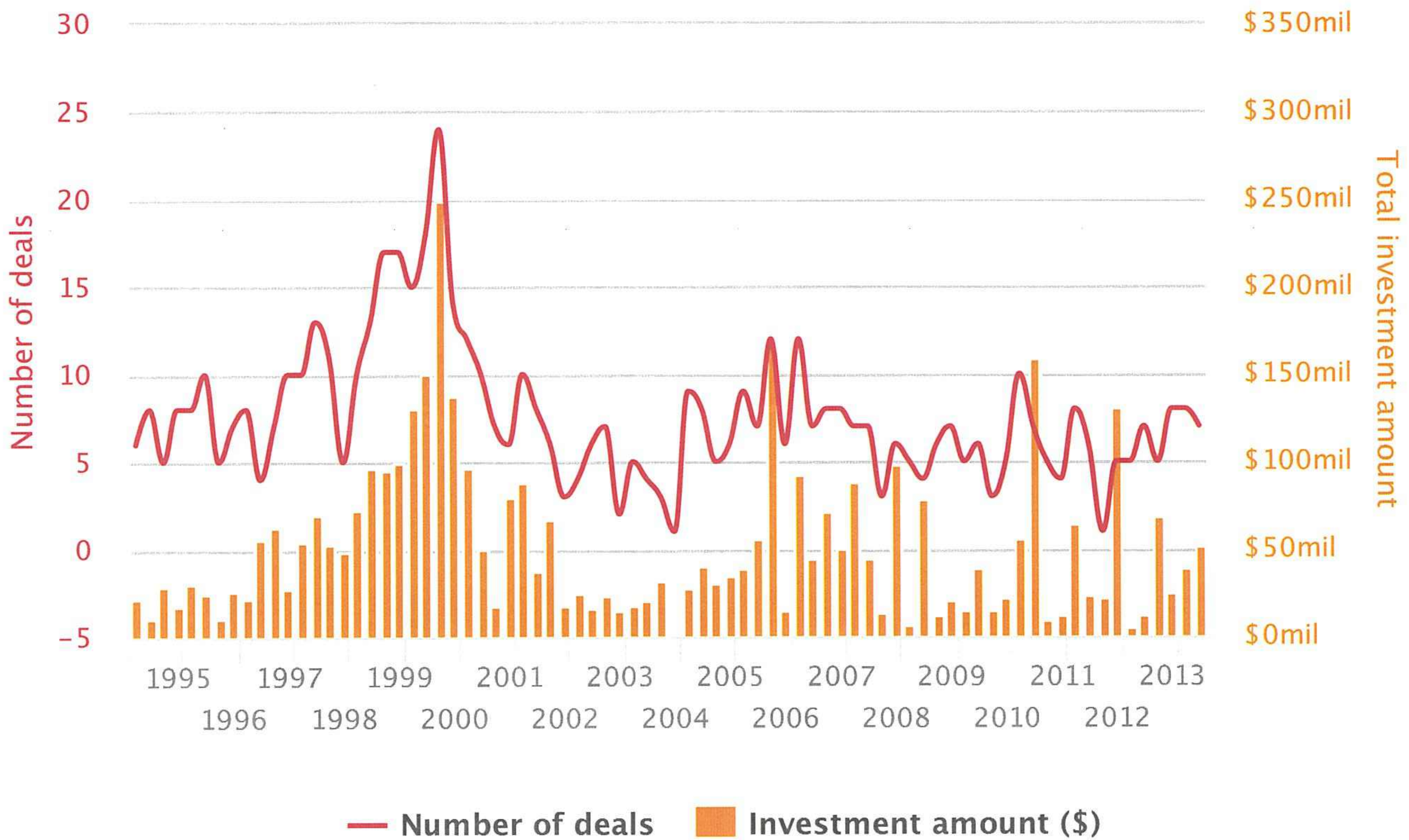
Historical trend data

Historical Data
Filtered by State: New Mexico
Source: PwC/NVCA MoneyTree™ Report, Data: Thomson Reuters



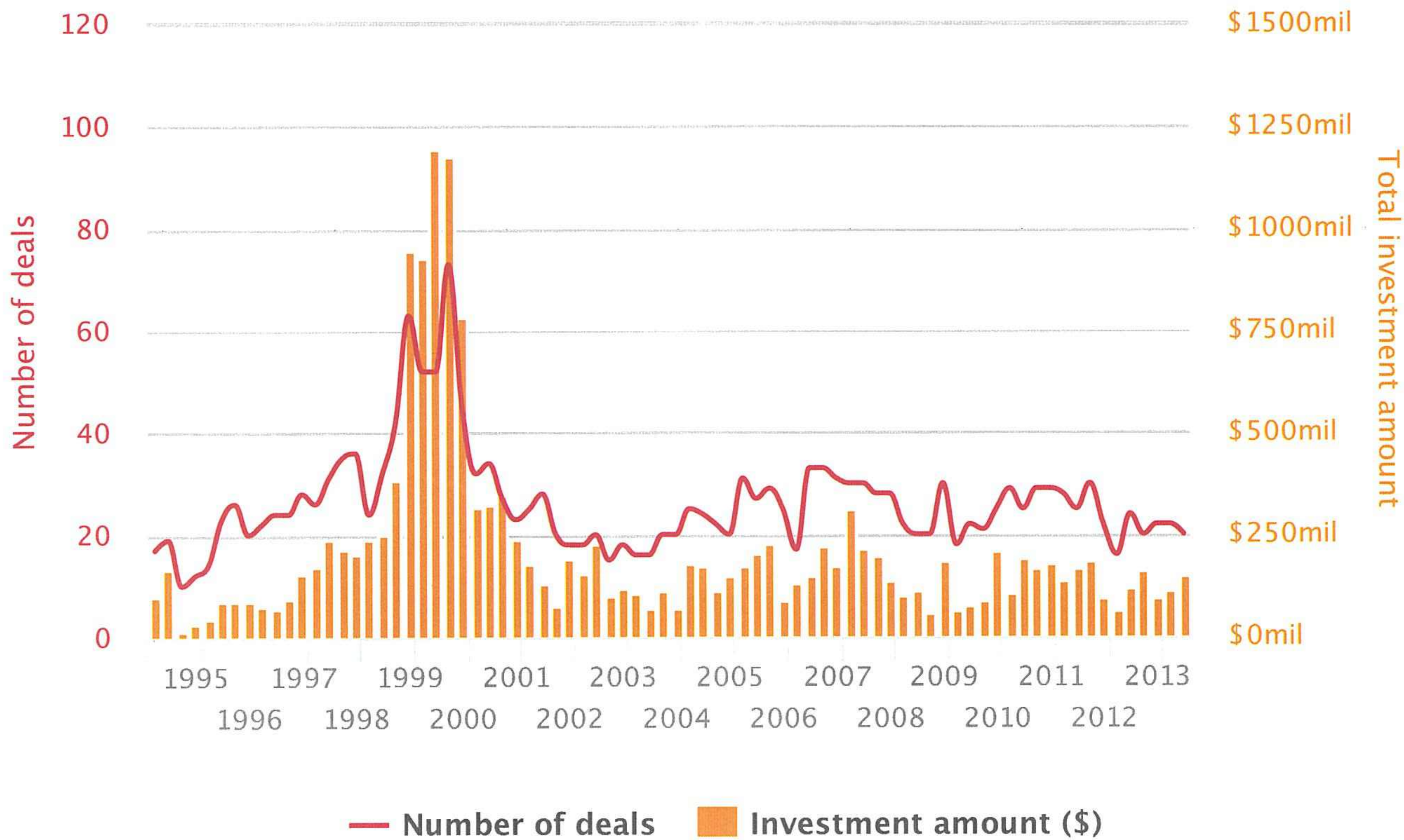
Historical trend data

Historical Data
Filtered by State: Arizona
Source: PwC/NVCA MoneyTree™ Report, Data: Thomson Reuters



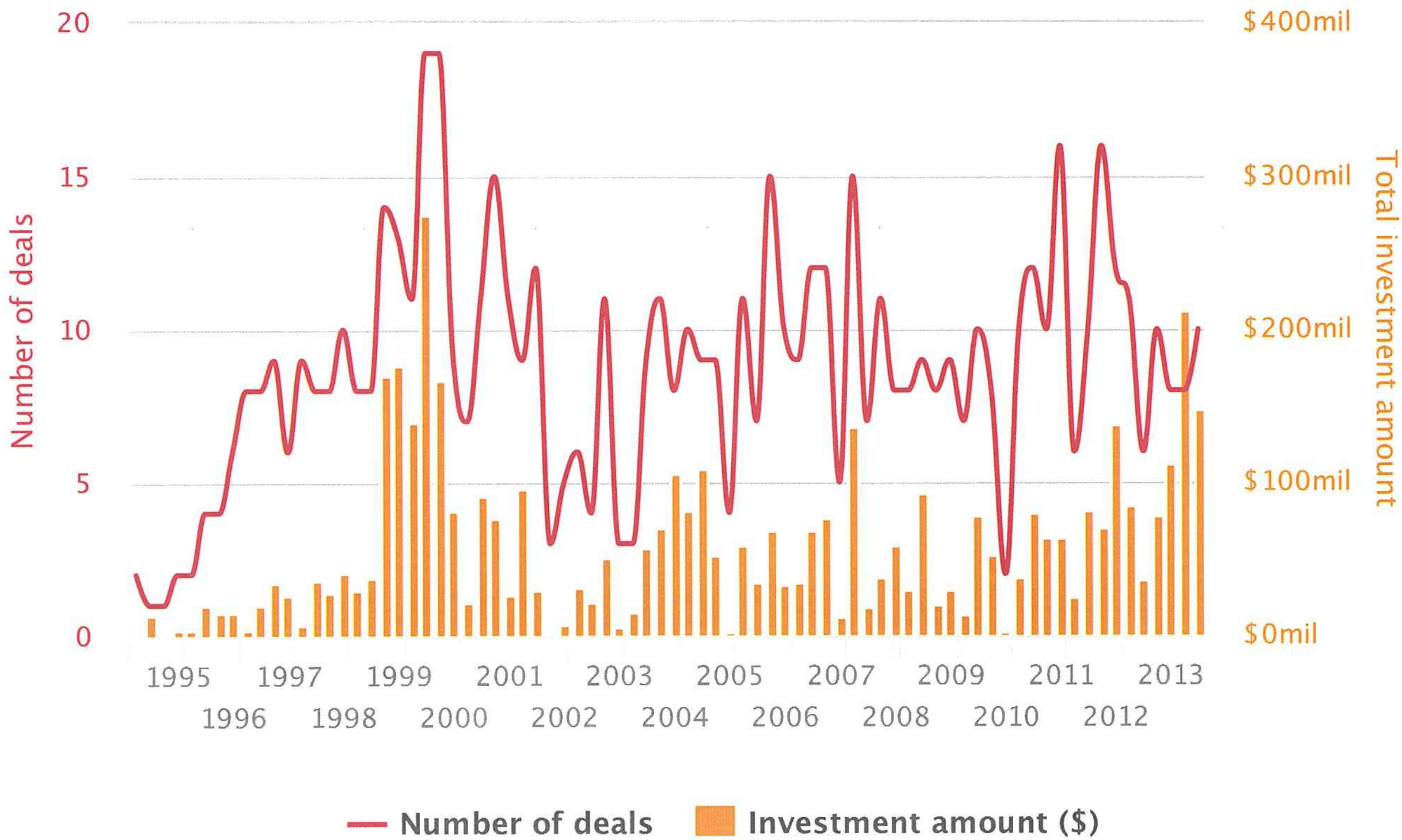
Historical trend data

Historical Data
Filtered by State: Colorado
Source: PwC/NVCA MoneyTree™ Report, Data: Thomson Reuters



Historical trend data

Historical Data
Filtered by State: Utah
Source: PwC/NVCA MoneyTree™ Report, Data: Thomson Reuters



Historical trend data

Historical Data
Filtered by State: Texas
Source: PwC/NVCA MoneyTree™ Report, Data: Thomson Reuters