# *MEMORANDUM*

**Montana Board of Investments**
**Department of Commerce**
**2401 Colonial Drive, 3rd Floor**
**Helena, MT 59601**
**(406) 444-0001**

**To:** Board Members

**From:** Carroll South, Executive Director

**Date:** March 6, 2006

**Subject:** Regional Venture Capital Fund of Funds

**HISTORY** – On October 21, 2004 the Board approved a $25.0 million commitment to a regional venture capital "fund of funds" with Credit Suisse First Boston (CSFB) as the General Partner. The commitment was contingent upon CSFB raising an additional $15.0 million from other investors in the region.

The staff recommendation on which the Board acted is enclosed as Exhibit A. The portion of the Board minutes at which the Fund was approved is enclosed as Exhibit B. In May 2005 the documents creating the Fund were signed and fund raising efforts began.

**FUND DISSOLUTION** – Despite the best efforts of CSFB, fund raising efforts have not been successful. As articulated in the letter attached as Exhibit C, the General Partner recommends that fund raising efforts cease and that the Fund be dissolved effective May 2006. With the dissolution of the Fund, the Board's $25.0 million commitment is withdrawn.

If you have questions or would like additional information, please contact me.

## APPENDIX A

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**2401 Colonial Drive, 3rd Floor**
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**To:** Board Members

**From:** Carroll South, Executive Director

**Date:** October 21, 2004

**Subject:** Regional Private Equity Fund

Montana law encourages the Board to invest up to 3% of retirement funds in venture capital companies and whenever possible give preference to investments in companies interested in making investments in Montana. To that end, the Board at its September 16, 2004 meeting heard a presentation from Credit Suisse First Boston (CSFB) regarding the viability of and opportunities for the creation of a regional "fund-of-funds" investment vehicle. CSFB has created a Customized Fund Investment Group that has created regional or in-state programs for other states.

The Board requested that staff conduct further research on the regional concept and provide the Board with specific details and a recommendation at the October 21, 2004 meeting. Board staff worked with CSFB representatives to develop terms and conditions for a regional fund. The primary concept of the fund is to "lower the radar" and thereby raise the visibility of Montana businesses in need of capital to venture capital firms that may otherwise overlook them.

In many respects a regional "fund-of-funds" (Fund) with CSFB as a General Partner and the Board as a Limited Partner would operate similar to the fund-of-funds relationship the Board currently has with Adams Street Partners. The General Partner would contribute some of its capital, raise funds from other Limited Partners, charge a fee to the Limited Partners, choose the venture capital firms in which to invest, and distribute capital and profit.

In other respects the regional concept would be different. First, the Board as the entity responsible for initiating the Fund would have to ensure that the fees paid the General Partner were sufficient to carry out the fund raising process from Fund creation to closing. As other Limited Partners become investors in the Fund, the Board's fee would be reduced as a proportion of the total amount committed by the General Partner and other Limited Partners.

Second, an office would be established in Montana to ensure that all fund-raising activities and Montana business/venture capital relationships were coordinated. The Board would be required to fund the office apart from the fees paid by itself and other Limited Partners who may not have a vested interest in establishing a Montana office.

Third, the General Partner would have to ensure that the venture capital firms in which it invests have an obligation to at least look at investment opportunities in the region encompassed by the Fund. Because the Fund's primary focus is on "return" rather than "economic development", the General Partner would not influence in any way the investments made by these firms.

## TERMS OF A PROPOSED FUND

**Region Composition** – At a maximum the region could be comprised of Montana, Idaho, Utah, South Dakota, North Dakota, eastern Oregon, eastern Washington, Nevada, and Wyoming. The region's actual size would be determined by the listed states' decision to become a Limited Partner in the fund by contributing capital.

**Montana's Capital Commitment** – The Board would commit $25.0 million to the Fund.

**General Partner Commitment** – The General Partner would contribute 2.0 percent of the total committed amount

**Fund Raising Parameters** – The Fund would be capped at $75.0 million and have a minimum size of $40.0 million. The Board's commitment would be contingent upon the General Partner raising an additional $15.0 million (including its contribution). The General Partner would have 12 months to raise the additional funds and if the additional $15.0 million could not be raised, the Fund would not be created and the Board would withdraw its commitment.

**Return Expectations** – The Fund's return target net of fees would be an annual internal rate of return of at least 15.0 percent.

**Fees** – The General Partner would charge the greater of 1.0 percent annually on the total committed amount or $500,000. To ensure creation of the Fund and the General Partner's ability to solicit commitments from other Limited Partners, the Board would pay an annual 2.0 percent fee on its commitment of $25.0 million ($500,000). As other Limited Partners commit to the Fund the Board's fee would be reduced.

For example, at the Fund's minimum size of $40.0 million, the Board's would pay an annual fee of 1.25 percent, while the other Limited Partners would pay an annual 1.0 percent fee. If Fund size reached $50.0 million, the Board's annual fee would be reduced to 1.0 percent. Although the Board would ultimately pay a higher fee than other Limited Partners unless the Fund size reaches $50.0 million, the Board's fees would be reimbursed under the "Distribution/Profit Sharing process described below.

**Other Montana Commitments** – In addition to the fee paid by the Board as a Limited Partner, the Board would reimburse the General Partner for establishing a one-person office in Montana to ensure proper coordination between Montana businesses and venture capital firms in which the General Partner invests. The Board would also reimburse the General Partner for the costs of maintaining a Montana web site for the Fund. The reimbursement would be based on actual costs after receipt of invoice.

Other states in the region that may become Limited Partners in the Fund would be responsible for the costs of establishing an offices and web sites in their jurisdiction if they chose to do so.

**Distributions/Profit Sharing** – Distributions from investments would first be used to return capital and all partnership expenses to the Limited Partners, plus an 8.0 percent return on the investment of the Limited Partners. After these obligations are met, the General Partner would then receive 5.0 percent of the profit. After these distributions are completed all profit would be distributed 95.0 percent to Limited Partners and 5.0 percent to the General Partner.

## STAFF RECOMMENDATIONS

Staff recommend that the Board commit $25.0 million to the Fund subject to staff negotiation of a satisfactory agreement with CSFB. That agreement must include precise language regarding how CSFB would ensure a "regional" focus for the Fund. Given that its role would be a "fund of funds" manager rather than making direct investments in Montana and regional businesses, we are unclear at this time how this "focus" would be guaranteed. Staff must be convinced that there is a practical way to address this issue and that appropriate language is included in any agreement.

Further, there would be no guarantee that a significant portion of the Board's commitment would be invested in Montana businesses. The entire premise for the creation of a regional fund is to "lower the radar", making Montana businesses more visible to venture capital funds. While these funds may spend considerable time in Montana scrutinizing businesses that may need equity financing, neither Board staff nor CSFB as the General Partner will attempt to influence their decision to invest.

For this Fund to be considered prudent as required by state law, investment decisions must be based on return to the pension funds, rather than economic development. To the extent that Montana businesses receive funding as a result of the creation of the Fund, the state's economy will benefit, while the state's retirement funds receive a return on their investment commensurate with the risk inherent in venture capital investing.

# APPENDIX B

**Regional Private Equity Fund**

Mr. South updated the Board on the Regional Private Equity fund. At the September 16, 2004 meeting, the Board heard a presentation from Credit Suisse First Boston (CSFB) regarding the viability of and opportunities for the creation of a regional "fund-of-funds" investment vehicle. The Board requested that staff conduct further research on the concept and provide the Board with specific details and a recommendation at the October Board Meeting.

Staff has worked with CSFB representatives to develop terms and conditions for a regional fund. The concept is to "lower the radar" and thereby raise the visibility of Montana businesses in need of capital to venture capital firms that may otherwise overlook them.

Mr. South presented staff recommendation that the Board commit $25.0 million to the Fund subject to staff negotiation of a satisfactory agreement with CSFB. That agreement must include precise language regarding how CSFB would ensure a "regional" focus for the Fund. Given that its role would be a "fund of funds" manager rather than making direct investments in Montana and regional businesses, we are unclear at this time how this "focus" would be guaranteed. Staff must be convinced that there is a practical way to address this issue and that appropriate language is included in any agreement.

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Member Ryan motioned for approval of staff recommendation; Member Fleming seconded the motion and the motion was passed 9-0.

## APPENDIX C

CREDIT SUISSE

**CREDIT SUISSE ALTERNATIVE CAPITAL, INC.**
Eleven Madison Avenue
New York, NY 10010-3629
Phone 21
www.credit-su

February 15, 2006

Mr. Carroll South
Montana Board of Investments
Dept of Commerce
2401 Colonial Drive, 3rd Floor
PO Box 200126
Helena, MT 59620-0126

We would like to thank you and Cliff Sheets for taking the time to visit with Credit Suisse representatives David Almodovar, Ryan Smith and me to discuss the fundraising process for the InterMountain Private Equity Fund, L.P. (the "Fund").

As discussed, fundraising has been particularly challenging. After contacting 64 potential investors and advisors on behalf of the Fund, including each of the pension plans in the region and surrounding states, endowments, consultants, large corporations, banks and high net worth investors, Credit Suisse has received no indications of interest to date. The primary reasons for not investing in the Fund given by the potential investors include the following: (i) the potential investor either has no allocation to private equity or is just beginning to invest in private equity, (ii) the potential investor is already investing directly into companies in the region or through funds and does not believe a fund of funds approach would be particularly helpful to the investment efforts, and/or (iii) the potential investor is skeptical about the opportunity in the region. Credit Suisse has been using its best efforts to actively pursue this opportunity since May 2005 and is disappointed with the progress to date. As we discussed and mutually agreed during our meeting on February 14, 2006, we do not believe it is in the best interest of the Montana Board of Investments to continue the fundraising efforts for the Fund. Accordingly, pursuant to Section 10.1(c) of the Limited Partnership Agreement of the Fund, Credit Suisse hereby elects to dissolve the Fund as of May 16, 2006, with this letter fulfilling the notice requirement set forth therein. Further, as of the date of this letter, Credit Suisse will discontinue the management fee charges to the Fund.

Credit Suisse continues to believe there is considerable opportunity for potentially attractive returns by investing in Montana and the InterMountain region. Further, we have identified a number of core clusters for potential investment, as well as several private equity managers that are intrigued by the opportunities in the region. Per our agreement, Credit Suisse will continue to pursue the current list of potential investors on behalf of the Fund, at no additional fee, until the expiration date of our original agreement, May 16, 2006. Credit Suisse stands ready and willing to implement the investment strategy of the Fund on a stand-alone basis with the Montana State Board of Investments sole participation. In spite of the disappointing results for the fundraising for the Fund we look forward to continuing our relationship with the Montana Board of Investments.

Please contact me with any questions or comments.

Sincerely,

Michael Arpey

Michael W. Arpey
Managing Director
Co-Head of the Customized Fund Investment Group