

New York State Common Retirement Fund In-State Private Equity Investment Program

Status Report and Review of Investment Activity



**New York State
Office of the State Comptroller**

Alan G. Hevesi

Division of Pension Investment and Public Finance

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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

June 2004

To the Governor and Legislature:

One of my first priorities upon taking office eighteen months ago was ensuring that the Common Retirement Fund's (CRF) in-state private equity investment program was doing all it could to provide needed capital to New York businesses. This report provides a review of the Program's investments since inception in 1999 and highlights the steps I have taken to increase the pace of investment activity. The report also suggests legislative changes that would enhance the effectiveness of the Program.

Highlights of the report include:

- This is first and foremost an investment program using assets of the Common Retirement Fund. The primary objective is to obtain an appropriate risk-adjusted return comparable to what would be available for other investments with similar characteristics. The fiduciary responsibility of the Comptroller's Office is always paramount.
- Private equity is at upper end of the spectrum in investment risk. This asset class can provide superior returns, but with greater volatility. This volatility is manifested in a range of possible investment outcomes – from failure to success. While all of the companies that have received capital under the Program are currently doing well, it is inevitable that some will fail. Problems will also come faster than success because of the time required to execute a business plan.
- Job retention and creation will be the byproduct of a successful investment program. The availability of capital and the management expertise provided by our fund managers will help companies grow. Business growth will bring employment growth.
- I am optimistic about all of New York State as an investment opportunity – upstate and downstate. There is a demonstrated need for private equity capital throughout New York State. The State lags the nation in attracting funding for private businesses, with investments below the level that would be expected given the State's share of economic output and population. Upstate New York businesses have historically captured less than one percent of the nation's private equity capital market.
- Private equity is a labor intensive business that requires building long-term relationships. One of the major objectives of the Common Retirement Fund's activities is to identify private equity investors who will partner with CRF and together become permanent sources of investment capital in New York State. Our investment activity involves two

steps: sealing commitments with our equity partners who then manage individual private equity funds and using the funds to provide capital to New York State companies.

- CRF's capital provided resources essential for several of the fund managers in the program to start operations in New York State; absent CRF's investment, several would not have had the scale to manage an investment fund.
- Since taking office we have substantially increased the number of fund managers. There are now CRF fund managers who are knowledgeable about the specific economic trends and capital needs of every region in the state. These managers are in the business of finding and participating in opportunities to invest in New York State companies.

Progress Report

- During the first three years of the program, five fund managers received commitments totaling \$97.5 million of New York investments. Since taking office, I have made seven additional commitments totaling \$200 million. When the Governor and Legislature worked with CRF in 1999 to establish this program, a goal of \$250 million was set. This goal has been exceeded, and its impact will nearly double to provide over \$500 million to New York State businesses when other investors' capital is included. CRF continues to seek out suitable investment opportunities that will assist small businesses in New York.
- Each commitment to a fund manager is approximately \$25 million and is generally matched by at least that amount by other investors. Through other investors, our commitment is expected to bring in an additional \$25 million to the State. Each manager is granted up to five or six years to identify enough companies to fully deploy these commitments. Companies that receive investments will also require four to six years to develop. Private equity investing takes place in two steps: a multi-year commitment of funds is made by an investor to a general partner; the general partner then invests that capital.
- The investment pace of actual dollars into New York State companies in the CRF portfolio is improving. In 2001, only two companies received a total of \$5.9 million in investment of CRF assets; the figure increased to only four companies in 2002, with a total of \$5.6 million invested. During my first year in office, nine companies received \$25.1 million in investments. So far in 2004, four companies have received \$7.2 million. All together, nineteen companies have received a total of \$43.7 million from CRF, which triggered additional capital of \$156 million from other sources.
- Of the \$43.7 million in total investment activity in New York State nearly two-thirds has taken place in upstate New York or Long Island. Nationally, upstate New York accounts for less than one percent of the private equity market.
- I will ensure that investments made in businesses located outside of New York will not be part of the program. I have adjusted the accounting for commitments made prior to

2003 to ensure that out-of-state investments do not count against the Program's \$250 million allocation.

Finally, my office has now had just over one year to work with the program and assess its strengths and weaknesses. As a result of this experience I am asking that the Legislature change the underlying statute in three important areas:

- Expand the universe of eligible businesses that can be considered for investment. The current statute emphasizes early stage venture capital investments. The CRF and New York businesses would do better if the program could consider businesses when they start out **and as they grow**. Suitable investment at all stages of a company's development should be considered as eligible.
- Remove the \$250 million cap on commitments. CRF should be allowed to invest in New York State to the extent that good deals are available.
- Remove the cap on the number of employees in an eligible company. Private equity partners who participate with CRF, and CRF as a fiduciary fund, are motivated by economic returns not economic development goals. There are no public subsidies involved in these investments. Maximum flexibility should guide these investment decisions.

I urge the Legislature to consider these reforms that will improve the flexibility of the program, allowing it to respond to changing capital needs and to also take advantage of new investment opportunities.

Sincerely,

Alan G. Hevesi
State Comptroller

I. OVERVIEW

The New York State Common Retirement Fund (CRF) created a private equity investment program (Program) targeted at investing in New York State in November 1999. The program was in response to legislation (Jobs 2000, or J2K) adopted in August 1999 and signed into law in November 1999. The legislation represented an important achievement by the Legislature under the leadership of Senator Bruno and Speaker Silver.

This report details the steps taken to implement the program, describes the commitments made to date, and also suggests legislation that will make the program more flexible and effective.

To date, the program has resulted in a number of attractive investments in small businesses across the State. A summary of several investments is included in Section VI of this report. Among the highlights are:

- **VersaMed.** A \$3 million investment induced this manufacturer of portable ventilators to relocate from New Jersey to Rockland County.
- **Pacific Pools.** The availability of capital from the Common Retirement Fund helped management finance an acquisition from an international corporate parent retaining jobs in the Capital District and providing the company with resources to continue to grow.
- **Reichert.** The former German owner of this Buffalo manufacturer of ophthalmic equipment disposed of the business because it was no longer core to its long-term business plan. Our investment manager was able to help finance the purchase of the company by its management; the alternative would likely have been the sale to an out-of-state competitor who would likely have closed the New York facility and moved its jobs out of state.

II. BACKGROUND

The Jobs 2000 Act was implemented in a national economic environment that saw unprecedented investment in new technologies, largely in response to recognition of a paradigm shift in business communications, most visibly manifested by growth in commercial applications of the Internet. The growth in the Internet is widely accepted to be of the same order of magnitude in importance as commercial flight, the telephone, canals and the interstate highway system.

The investment environment in the mid to late 1990s was supporting creation of new companies that took advantage of the growing availability of telecommunications infrastructure. Fiber optic cable networks made global communications affordable to business and, through the Internet, gave individuals and businesses of all sizes a standardized tool to communicate with each other. Companies developing software to enable communication or to sell products in the new “connected” environment boomed.

In addition to communications and software, life sciences, particularly biotechnology was beginning to develop. New drug discovery tools and innovations that took advantage of breakthroughs in information technology also promised investors strong returns and appealed to policy makers as an engine for economic growth.

Investing in new technologies and encouraging the location of high tech businesses within the State were seen by policy makers as a tool to address economic development needs and create an environment conducive to long-term economic growth.

In hindsight, the surge in public and private company valuations that accompanied the investment boom was overdone. Much that was invested in venture capital during the period was subsequently written down, and public equity markets suffered one of their worst sustained downturns in recent history.

Regional Patterns in Venture Capital Investing

Venture capital investing was one of the most visible factors fueling the economic growth of the late 1990s, and except for pockets in New York's Silicon Alley, New York State was not the beneficiary of investment flows. Not only were New York companies not receiving capital, they were believed to be encouraged to move out of New York State to Silicon Valley, Boston and other centers for technology investment.

Table 1 illustrates the concentration of venture investing in Silicon Valley and New England. These two regions accounted for nearly half of venture capital investment activity in 2003. The boom-bust cycle in venture funding is also clearly visible; venture capital investing totaled \$7.6 billion in 1995; it nearly doubled by 1997 when it reached \$14.8 billion. The level of investing peaked in 2000 when it totaled \$105.9 billion and then sharply fell to \$18.2 billion in 2003.

Table 2 provides data for New York State as well as New York City and Upstate New York. (Note that the data in Table 1 includes the tri-state area for NY Metro.) New York State accounted for 3.6 percent of national venture capital investing in 2003, compared to an 8.2 percent share of national economic activity.¹ Venture activity was also below the share that would be expected based on population; New York accounted for 6.7 percent of the United States population in 2001.²

As noted in Table 2, the New York City metropolitan area (New York City, Rockland, Westchester, Nassau and Suffolk counties) received the vast majority of venture investing. Appendix 1 contains data describing the regional distribution of venture investing within New York State. The data are based on a survey methodology that has since been revised by PriceWaterhouseCoopers, and as a result, does not match aggregate figures contained in Tables 1 and 2. However, the regional patterns should continue to be valid.

¹ Based on 2001 data, the most recent available; New York's share of gross state product did not vary materially between 1995 and 2001. Source: United States Bureau of Economic Analysis, Regional Economic Accounts. <http://www.bea.doc.gov/bea/regional/gsp/>.

² United State Bureau of the Census, State and County Quick Facts. <http://quickfacts.census.gov>.

Data in the Appendix illustrate the small number of venture investments completed between 1998 and 2000. With the exception of the Finger Lakes Region, centered in Rochester, most areas outside of the New York Metropolitan Area saw only a scattering of venture capital investment activity.

Table 1
Historical Trend Data on Venture Capital Commitments by Region
In \$ millions
1995-2003

Region	1995	1996	1997	1998	1999	2000	2001	2002	2003
AK/HI/PR	7.8	24.2	14.0	5.5	17.2	230.6	169.0	3.4	15.7
Colorado	316.2	309.0	382.1	836.1	1,915.7	4,307.1	1,309.9	555.5	620.9
DC/Metroplex	398.9	590.3	571.0	1,119.0	2,489.6	5,568.8	2,125.0	1,095.7	791.9
LA/Orange County	528.6	569.7	775.9	1,388.4	3,628.2	6,321.7	1,937.2	1,203.9	983.7
Midwest	446.6	723.3	825.5	1,652.5	2,511.5	5,845.1	2,004.4	986.9	873.6
New England	800.6	1,278.1	1,588.9	2,352.2	5,406.8	11,747.8	5,277.2	2,725.9	2,764.4
North Central	210.7	223.3	349.9	482.1	750.2	1,335.0	690.2	462.6	270.8
Northwest	382.8	510.6	559.3	834.5	2,520.6	3,541.4	1,272.3	763.4	558.1
NY Metro	501.1	697.4	1,170.4	1,646.9	4,892.1	11,062.1	3,502.4	1,394.7	1,388.1
Philadelphia Metro	229.7	357.6	535.9	622.7	1,515.3	2,868.1	1,100.2	505.4	555.0
Sacramento/N.Cal	38.6	28.4	18.9	85.8	108.8	356.1	240.7	111.1	93.8
San Diego	295.3	493.6	544.6	586.2	1,368.6	2,316.7	1,544.9	960.1	707.0
Silicon Valley	1,869.3	3,762.7	4,694.1	6,222.5	18,707.8	34,300.3	12,695.2	7,018.1	5,868.2
South Central	48.2	74.7	92.7	188.1	407.2	439.3	151.6	69.6	83.0
Southeast	950.7	1,173.9	1,462.4	1,583.3	4,628.5	7,474.9	2,615.1	1,764.7	1,100.0
SouthWest	108.7	170.3	296.9	359.8	771.7	1,394.6	503.4	374.7	217.7
Texas	455.6	505.4	826.2	1,068.8	2,669.4	6,133.3	3,206.4	1,285.2	1,165.9
Upstate NY	37.4	27.4	86.5	192.5	213.8	444.9	174.5	128.5	119.6
Other US	0.3	2.1	4.3	32.1	2.4	171.3	62.4	-	9.4
Grand Total	7,627.2	11,522.0	14,799.5	21,258.8	54,525.3	105,859.1	40,582.0	21,409.4	18,186.9

Source: PriceWaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey, Investments by Regions Q1 1995 – Q4 2003. Available at www.pwcmoneytree.com.

Note: NY Metro includes the tri-state metropolitan area surrounding New York City.

Table 2
Historical Trend Data on Venture Capital Commitments
New York State, New York City and Upstate New York Compared to Nation
In \$ millions
1995-2003

Region	1995	1996	1997	1998	1999	2000	2001	2002	2003
National	7,627.2	11,522.0	14,799.5	21,258.8	54,525.3	105,859.1	40,582.0	21,409.4	18,186.9
Upstate NY	37.4	27.4	86.5	192.5	213.8	444.9	174.5	128.5	119.6
% National	0.5%	0.2%	0.6%	0.9%	0.4%	0.4%	0.4%	0.6%	0.7%
% NYS	13.0%	9.0%	13.0%	15.8%	5.7%	6.1%	8.3%	16.1%	18.4%
New York City	250.9	275.8	580.4	1,025.8	3,519.2	6,840.3	1,920.8	671.5	531.3
% National	3.3%	2.4%	3.9%	4.8%	6.5%	6.5%	4.7%	3.1%	2.9%
% NYS	87.0%	91.0%	87.0%	84.2%	94.3%	93.9%	91.7%	83.9%	81.6%
New York State	288.3	303.2	667.0	1,218.2	3,733.0	7,285.2	2,095.3	800.0	650.9
% National	3.8%	2.6%	4.5%	5.7%	6.8%	6.9%	5.2%	3.7%	3.6%

Source: PriceWaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey, Investments by Regions Q1 1995 – Q4 2003. Available at www.pwcmoneytree.com.

Note: New York City data were modified to exclude transactions outside of New York State.

III. PRIVATE EQUITY INVESTMENTS

Background

Private equity investing is unlike most other forms of capital deployment. Unlike lending or making investments in the public stock of companies, private equity combines both the provision of capital and expertise. Private equity investors, particularly those that focus on early stage venture investing or growth capital for small businesses, provide management expertise, strategic direction, and other value added services along with capital. When making an investment, private equity managers become part owners of the investee company and generally join the company's board of directors. Creating an environment where private equity capital is available helps spur economic development and supports the formation of strong, well-managed companies.

Modern private equity investing first developed in the United States through the personal investments of major industrial families, such as the Rockefellers, Phipps and Whitneys. Technology focused investing began following World War II and the formation of private limited partnerships that invested in companies whose shares were not traded on public markets.

Numerous, but small, organized pools of capital dedicated to technology investing were formed in the late 1950s, following creation of the Small Business Investment Act at the federal

level. It was not until the 1980s, however, when institutional capital began to be attracted to private equity. In 1979, changes to the federal Employment Retirement Investment Security Act (ERISA) were instrumental in allowing pension plans to invest in private equity.³

Private equity is now a recognized asset class for institutional investors. In 2003, nearly seventy percent of North American tax exempt investors (largely pension funds and endowments) had allocations to private equity; these investors had a median allocation of 8.2 percent to private equity.⁴

Structure of Private Equity Investments

Private equity is an illiquid, long-term investment. It is typically structured in the form of a limited partnership where the general partner acts as fund manager and sponsor of the investment vehicle. The bulk of a private equity fund's capital is usually raised from outside investors, which can range from wealthy individuals to family offices to endowments and pension plans.

The partnership agreement:

- details the responsibilities of the general partner to the fund (This generally includes an acknowledgement that the general partner is a fiduciary, provides limitations on outside activities of the general partner, and includes a contractual agreement that key individuals see the fund through completion.);
- outlines permitted investments, providing limits on the size of individual investments, restrictions on specific industries and geographies;
- sets a period of time during which investments may be completed (the “commitment period”), and then a deadline for liquidating the fund's investments (the fund's “term”);
- provides rights to the limited partners to remove the general partner or stop the fund's investments if a set proportion of limited partners agree and the general partner has breached his or her agreed-to responsibilities.

Upon execution of a partnership agreement, a limited partner is contractually bound to follow the terms of the agreement, the most important of which is to agree to provide capital upon request to the general partner as investments are completed. The amount of capital that a limited partner is obligated to provide is capped at the partnership's inception, as is the length of time during which capital may be called (see “commitment period” above).

Private equity is unlike other forms of investments. Traditional investments are generally initiated with a set amount of capital provided to a manager. For private equity funds, a typical investment period is five or six years (an additional five to six years is provided to exit from

³ DRI-WEFA, “Measuring the Importance of Venture Capital and Its Benefits to the United States Economy,” June 19, 2002. The discussion of the origins of private equity investing is based on pages 7-11 of the DRI-WEFA report.

⁴ Goldman Sachs & Russell Investment Group, “Report on Alternative Investing by Tax-Exempt Organizations 2003,” undated.

investments). During this period, the general partner seeks out investment opportunities and negotiates the terms of investments with portfolio company owners. When an investment is completed, the general partner requests the capital from the limited partner.

When a fund has exhausted its capital, the general partner will typically raise a new vehicle to continue its investment program.

Compensation to the general partner takes two forms:

- A management fee, which is a set percentage of either commitments or invested capital that provides the general partner with income to manage the fund, pay investment professionals, and seek out and monitor investments.
- A share of profits, typically 20 percent of gains generated from fund investments. This is referred to as carried interest, promote or override.

Private equity investors structure a general partnership's economic terms in a way that maximizes the general partner's incentives to generate profits. This is done by limiting management fee income to an amount necessary to fund the manager's operations, but not provide a profit and by requiring that the general partner invest his or her own funds in the partnership.

Due to restrictions in the legal provisions that govern limited partnerships, the investor limited partner may not have a role in the operations of a private equity fund. Other than to review potential conflicts of interest that may face the general partner, or other specified functions, the general partner is completely responsible for all investments and limited partners may not influence how a fund operates.

Private equity investments are not, however, entirely passive. Limited partners do play a role in monitoring the general partner's investment progress and performing ongoing evaluations of the quality of the fund's portfolio. Because general partners will raise new funds as capital is deployed, limited partners use ongoing monitoring as an important tool in the investment process for making investments in successor funds.

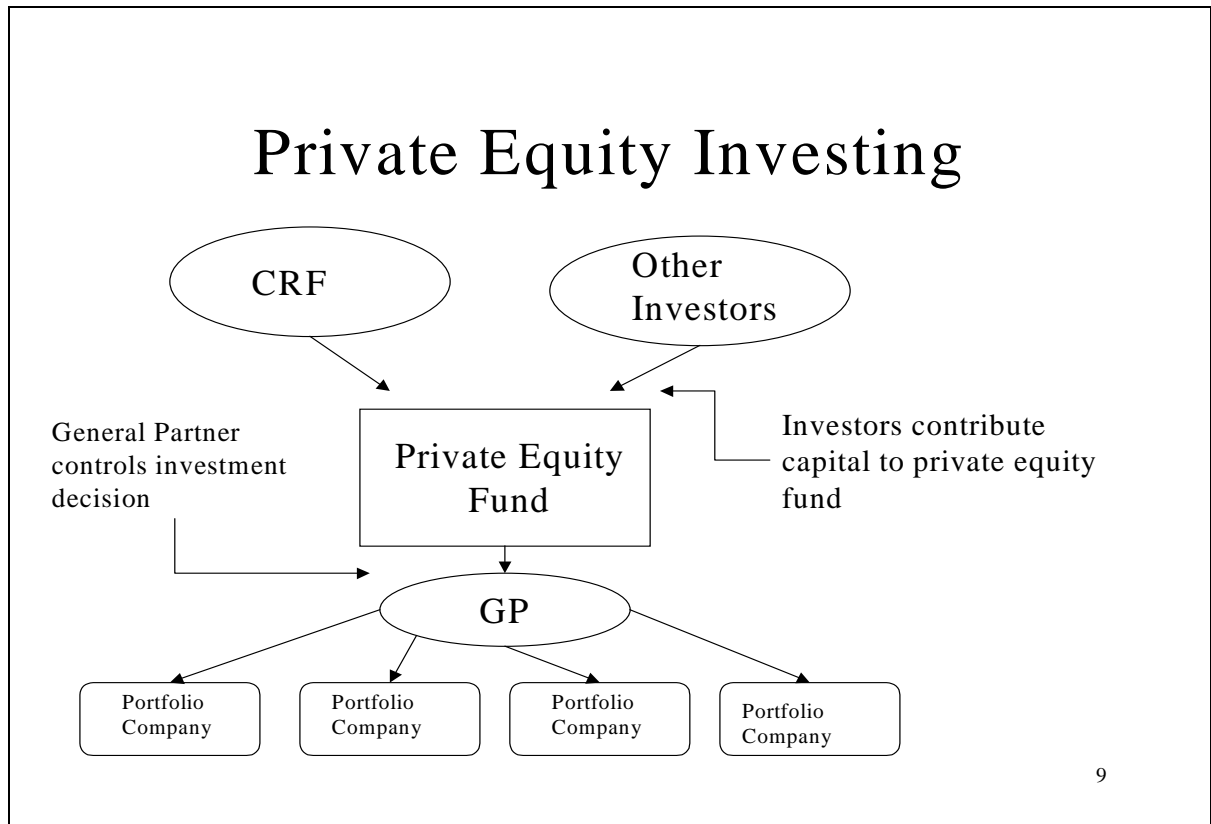
In summary, investments in private equity funds are blind pools where the investor, once making a commitment and absent a breach by the general partner, is bound to see the investment through its ten to twelve year term.

The figure below summarizes the structure of the relationship between investors and a general partner in a private equity fund. Key features to highlight include:

- Private equity funds have a ten to twelve year life. The commitment of funds by a limited partner is the first step in the investment process. Funds are actually invested over a five or six year "investment period;" during the remaining five to six years of the fund's term, the general partner focuses on selling the investments.

- The private equity fund is distinct from actual private equity investments in portfolio companies.
- The limited partners do not have a role in the operations of the fund and cannot be involved in the investment decision-making process.

FIGURE 1
Structure of Private Equity Investing



Investment Styles

The investment focus of a private equity fund is generally on a specific style of investing, largely determined by either the portfolio company's stage of development or industry focus. A key feature is that the investments involve equity ownership in a business, in contrast to loans. Equity investors generally receive a seat on a company's board of directors and are involved in management and strategic decision-making. Private equity investment funds can be classified into the following styles:

Venture Capital

Venture capital invests in companies early in development, ranging from seed investments designed to develop a concept, to funding to complete development of a product, to late stage investing where expanding a firm's customer base is the investment goal. Venture capital is frequently deployed in technology-oriented companies. It is the highest risk form of investing, since the success of a portfolio company is affected by numerous risk factors, including financial, market, operational, and technology.

Venture capital investing can also provide spectacular returns. One of the notable examples from CRF's core portfolio is a \$53.7 million investment made by Warburg Pincus in BEA Systems; since 1995, BEA Systems has generated \$6.8 billion in returns, a multiple of 126 times cost. (CRF's share is 6.2 percent.)

Buyout/Corporate Finance

Investments in existing operating businesses make up a large portion of the private equity investment universe. These investments may include helping new owners finance the acquisition of a business (generally as a result of a sale by a corporate parent or a generational change in the ownership of a family business); finance expansion for an existing business, allowing it, for example, to acquire smaller competitors; or to recapitalize a business to provide it greater flexibility to operate.

Mezzanine

Mezzanine investments are a form of corporate finance where the investment has characteristics of both a loan and an equity investment. These investments are at the point in a company's capital structure between debt and equity (hence the term "mezzanine").

The fundamental difference between private equity investing and investments in public securities is the manager's participation in the growth and development of the portfolio company. The investment manager's ability to devise strategy, hire key staff, implement an optimal capital structure, seek new customers, and identify possible acquisitions set private equity apart from passive investments in public securities.

IV. INVESTMENT CRITERIA AND SELECTION PROCESS FOR THE NEW YORK PROGRAM

CRF began implementation of the Program by issuing a Request for Information (RFI) in November 1999. The RFI was designed to provide potential investment managers and other interested groups with broad outlines of the program and to seek advice on how it could best be structured. It also served as an invitation to fund managers to prepare proposals for CRF's consideration.

CRF received several suggestions in response to the RFI that shaped the design of the in-state investment program. Among these were:

Flexibility. Potential fund managers stressed the need to manage private equity funds in a commercial manner, and not as a government sponsored economic development program. Programmatic constraints on the characteristics of an investment, particularly a structure that would require CRF approval of individual investments, would be counter productive. General partner managers should be provided with the flexibility to pursue a broad investments strategy in pursuit of returns. It should be CRF's role to select those strategies that would also provide economic development benefits.

Breadth of investment mandate. An overall lack of private equity capital was identified as a serious impediment to business formation and growth. New York State, particularly upstate, is home to a large number of middle-market privately owned businesses. These businesses generally have few options when seeking equity capital. Because many operate proven, successful business models with existing employees, providing equity financing to allow expansion or ownership transitions is attractive: there is less risk backing a proven business and the ability to preserve and expand an existing employer provides immediate economic development benefits.

Supporting Permanent Sources of Capital. Private equity investing is hands-on, and business owners must be comfortable when exchanging ownership of their company for capital. In addition to the immediate benefit from investing in growing businesses, the in-state private equity program is designed to provide support to investors who will become permanent institutions in the State, and who will be an attractive source of equity capital in the future.

Fundamental Requirements

To ensure that investments meet the prudent person fiduciary standard and the requirement that they be made solely for the benefit of CRF's participants, the following minimum standards for vetting potential general partners were required:

- A successful track record of making private equity investments, including an ability to demonstrate that value was added in the investment.
- An investment strategy designed to provide returns consistent with similar, non-New York focused investments.
- A coherent investment strategy consistent with the business environment.
- A fund manager dedicated to potential investments without any potential conflicts of interest.
- An ability to raise capital from other sources. This serves to both multiply the impact of CRF's capital and to also validate its investment decision.
- The infrastructure needed to monitor and report on the portfolio.
- An established network of contacts within the State to serve as a source of new investment opportunities.
- A business presence within the State.

Investment Process

CRF's investment process for its core private equity portfolio requires both CRF staff and its private equity consultant to review investment opportunities. Both the staff and consultant must agree that an investment has merits before it is presented to the Comptroller for approval. This parallel recommendation system is an integral part of CRF's policies and procedures and provides an internal control in the investment process. This is particularly important given that the State Comptroller is the sole trustee of CRF.

All potential investment opportunities receive a preliminary review. Proposals that do not meet CRF's fundamental requirements are initially deferred, but the investment manager is provided with detailed advice on what steps are necessary to make a suitable proposal. In several instances, CRF staff worked with managers who were eventually added to the program for extended time periods before making commitments. During this period, staff monitored organizational restructuring or progress in developing an investment track record until the manager had met CRF's requirements.

For example, when DeltaPoint capital initially sought CRF funding, it was engaged in merger and acquisition advisory work that could pose a conflict of interest. CRF staff provided continuous feedback to DeltaPoint's principals as they restructured their business and expanded their investment track record.

CRF actively sought out potential managers and encouraged them to structure a private equity fund that could be considered for investment. Particular attention was paid to identifying managers in all areas of the State.

V. IN-STATE PRIVATE EQUITY PORTFOLIO

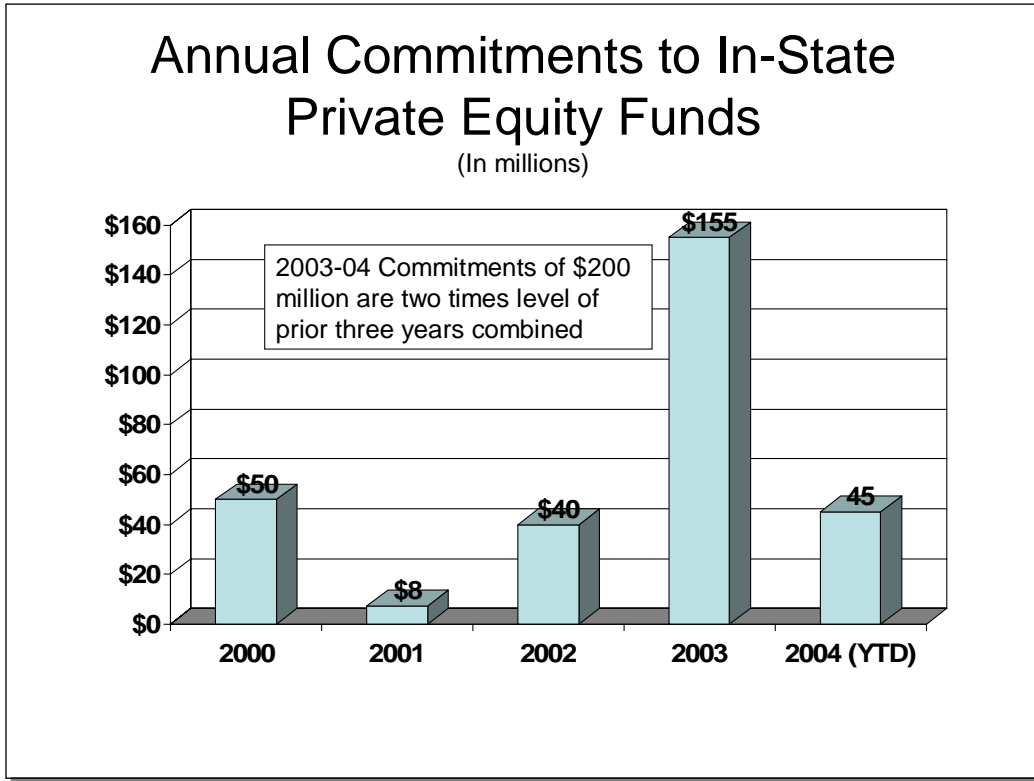
As of March 31, 2004, CRF has made thirteen commitments to twelve private equity fund general partners. Comptroller Hevesi has made completion of the investment program a high priority and stepped up investment activities upon taking office.

Year-by-year commitment activity by CRF has been:

- 2000: Two commitments for New York investments totaling \$50 million;
- 2001: Two commitments to one general partner with \$7.5 million targeted to New York;
- 2002: Two commitments totaling \$40 million;
- 2003: Five commitments totaling \$155 million; and
- 2004: Two commitments totaling \$45 million.

Because CRF requires that funds included in the in-state program also seek capital from other sources, the impact of CRF's investments are leveraged. CRF's commitments of \$298 million are supplemented by nearly \$240 million in additional capital raised by these funds from other investors, bring total investments available for New York transactions to over \$500 million. Even more capital is involved if the impact of syndication of transactions (several private equity

funds will generally participate in a single investments) and lending and other forms of financing is considered.



The in-state program is in addition to an existing lending partnership CRF has with the New York Business Development Corporation (NYBDC). Since the program began in 1987, NYBDC has made 563 loans totaling \$162.2 million to New York small businesses. During the 2003-04 fiscal year, 33 loans totaling \$13.1 million were completed.

Cumulative Commitments to In-State Private Equity Funds

(In millions)

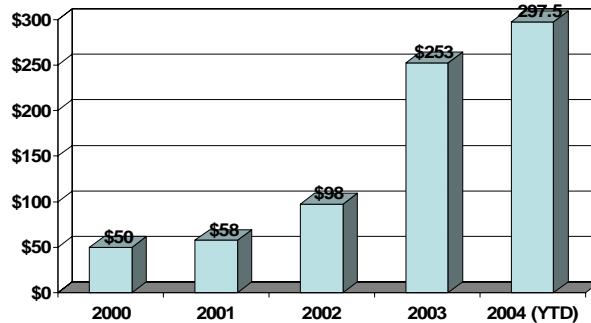


Table Three
In-State Investment Program Fund Portfolio
As of March 31, 2004

Fund	Stage	Commitment Date	Amount
FA Tech Ventures ¹	Venture	Oct-00	\$25
Summer Street	Buyout	Aug-00	25
Ascend ²	Venture	Mar-01	2.5
Ascend NY	Venture	Apr-01	5
Wheatley	Venture	Jul-02	25
Delta Point ³	Buyout	Aug-02	15
Subtotal: Pre 2003			\$98
Hamilton Lane Coinvestment	Buyout/Venture	Sep-03	50
Wheatley Additional Commitment	Venture	Dec-03	25
High Peaks	Venture	Dec-03	30
Founders	Growth/Buyout	Dec-03	20
Easton Hunt	Venture/Growth	Dec-03	30
Paladin Homeland Security	Growth/Buyout	May-04	20
Trillium Lakefront Partners	Venture	May-04	25
Subtotal: Since 2003			200
Subtotal: All to date			\$298

¹ FA Tech Ventures received a total commitment of \$50 million; \$25 million is the targeted New York State portion

² Ascend Ventures received a total commitment of \$10 million; \$2.5 million is the targeted New York State portion.

³ DeltaPoint received a commitment of up to \$25 million, based on a

Description of CRF's Portfolio



TECHNOLOGY VENTURES

FA Technology Ventures is an Albany-based venture capital fund affiliated with First Albany Corporation, a regional investment bank. CRF's commitment includes \$25 million dedicated to New York investments. The fund seeks to capitalize on large trends that create attractive investment opportunities in two areas:

- The continuing IT (Information Technology) revolution, including software-based services, networked communications, Internet-enabled business models, and novel technologies,
- The emerging ET (Energy Technology) developments in the production of new-age power generation, storage, conditioning, and delivery systems.

FA Technology Ventures makes new investments of \$3 to \$8 million in early and expansion stage IT and ET companies. The fund's total available capital is approximately \$100 million.

Contact: John Cococcia, (518) 447-8200

Web site: www.fatechventures.com



Summer Street Capital Partners is headquartered in Buffalo. The fund has approximately \$100 million in committed capital provided by an investor group that includes national banking institutions, regional banks, the Small Business Administration, and high net worth individuals. CRF's commitment is \$25 million.

Summer Street focuses on investments with the following characteristics:

- Profitable companies with growth potential,
- Companies with market values of approximately \$10 to \$100 million,
- Strong management partners either already in place, or recruited from our network of potential partners,
- Proven products and technology,

Summer Street invests in acquisitions, phased buyouts of closely-held companies, recapitalizations, and expansion capital. The fund generally invests \$2-\$10 million per transaction.

Contact: Gary Hull, (716) 566-2900

Web site: www.summerstreetcapital.com



Ascend Venture Group is located in New York City and invests in early-stage businesses that leverage emerging technologies, including computer hardware, software, online services and other Internet-related businesses. CRF's commitment includes \$7.5 million for New York investments. In the near term, Ascend is focusing on the following areas:

- Outsourced business services and software providers, especially those targeting small and medium-sized enterprises,
- Application of technology in the education, energy, financial services and retail sectors,
- Application of technology to improve direct marketing effectiveness, and
- Anywhere, anytime access to information.

Ascend actively uses minority and women-based networks to identify attractive investment opportunities.

Contact: David Bowen (212) 324-2222

Website: www.ascendvetures.com



DeltaPoint Capital Management is a Rochester based fund with approximately \$40 million in total commitments; CRF's share of DeltaPoint's committed capital is \$20 million. The fund invests in management-led buyouts, corporate divestitures, going private transactions, and ownership transitions of family businesses. Businesses should be established with proven cash flow and revenues of at least \$5 million. Focus industries include manufacturing, distribution and specialized services. As a member of the board of directors of its portfolio companies, DeltaPoint is involved in the development and implementation of financial and operational strategies.

Contact: David Waterman (585) 454-6990

Website: www.deltapointcapital.com



Wheatley Partners is a New York-based private equity firm focused primarily on technology-related companies. CRF provided Wheatley with \$50 million in commitments. Wheatley work closely with entrepreneurs to build successful businesses and supports its portfolio companies at all stages of development. Wheatley's target sectors include Software, Business Services, Information Technology Services, Life Sciences, Medical Devices, Communications, Networking and Education.

Since its inception in 1992, Wheatley Partners has invested in over 150 private companies, most through multiple rounds of financing. Wheatley's principals have been investing in both public and private companies for over thirty years.

Contact: Larry Wagenberg (212) 918-0563

Website: www.wheatleypartners.com

Founders

Founders Equity is a New York City based fund focusing on providing growth capital to existing businesses. CRF committed \$20 million to this fund. Founders is actively seeking out opportunities in the following areas:

- Information, Healthcare Delivery, Business and Environmental Services
- Outsourcing and Distribution
- Food/Food Services
- Industrial Manufacturing
- E-Commerce and Enhanced Technological Solutions Applied to "Old Economy" Businesses.

Founders primarily invests in stages ranging from accelerating growth to small-cap buyouts. Target companies will have the following characteristics:

- Size of Investments: Between \$5 and \$15 million for consolidation investments, and between \$3 and \$7 million for growth equity investments
- Size of Companies: Companies with valuations between \$10 and \$150 million.

Contact: John Teeger (212) 829-0900, x 203

Web site: www.fequity.com



High Peaks Venture Partners is based in the Capital District with offices in Saratoga Springs and at Rensselaer Polytechnic Institute's (RPI) incubator, located on RPI's Troy campus. CRF committed \$30 million to High Peaks.

High Peaks will focus on making early-stage venture capital investments. Equity investments will range from \$500,000 to \$4 million in technology oriented businesses; investments in individual portfolio companies will be deployed in tranches of between \$500,000 to \$1.5 million. The geographic focus of the fund is upstate New York, in the region between "Tech Valley" in the Capital District area to Buffalo.

High Peaks is the upstate New York affiliate of Village Ventures, a consortium of thirteen venture capital funds located in areas not traditionally serviced by private equity investors. The network includes funds located in Middlebury, VT; Indiana; Portland, ME; Providence, RI; Williamstown, MA; and Boise, ID. The affiliation with Village Ventures will provide High Peaks with three major resources: networking and business contacts, capital and back office support.

Contact: Bela Musits or Brad Svrluga (518) 306-3058

Web site: www.highpeaksventures.com



HAMILTON LANE

capital.

New York Coinvestment Program is managed by Hamilton Lane advisors. It provides additional capital to private equity fund investors who are deploying capital in New York State. Hamilton Lane Advisors will seek out private equity funds that are considering an investment in New York based. The Coinvestment Program will provide an additional source of

Contact: Paul Yett (610) 617-6073

Web site: www.hamiltonlane.com

EASTON HUNT

Easton Hunt Capital Partners, is a Buffalo and New York City based venture capital/private equity fund. The firm takes a multidisciplinary approach to investing by considering both venture capital investment in developing companies and growth equity investments in established businesses.

Targeted investments include:

- Healthcare has represented, and will continue to represent, the largest single segment of Easton's investment portfolio. Easton invests in all segments of the healthcare industry, including biopharmaceuticals, drug delivery, medical devices and healthcare services.
- Other growth capital opportunities which address continuing persistent societal needs:
 - Companies in overlooked or out-of-favor basic industries.
 - Companies with innovative products and services that have achieved or are likely to quickly achieve a critical level of commercial acceptance.

Easton invests between \$2 million and \$7.5 million in a company and prefers to invest alongside other strong financial players to provide maximum value to the company and to ensure the availability of adequate growth capital. Easton has generally not been a seed stage investor.

Contact: Mark Chen, (212) 702-0950

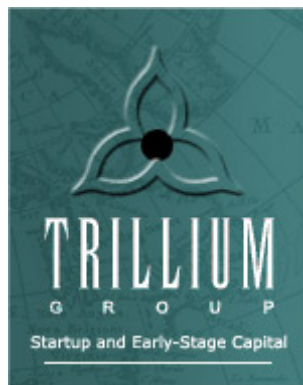
Web site: www.eastoncapital.com



Paladin Homeland Security Fund is a Washington DC based private equity fund that agreed to open a New York office to pursue New York-based investment opportunities. The fund invests in enterprises whose principal business centers on products and services that address homeland security issues and needs. The Fund's first priority will be to invest in existing companies with immediate solutions designed to prevent harmful attacks, defend against attacks, cope with the aftermath of attack or disaster and recover from terrorist attacks and other threats to homeland security. CRF's investments will only be used to fund New York based businesses.

Contact: Mark Maloney (202) 293-5590

Web site: www.paladincapgroup.com



Trillium Lakefront Partners is a Rochester based venture capital fund. Trillium invests in early stage businesses in growth technology areas, particularly those involved in photonics, imaging, medical technology and software, enterprise software and wireless or optical communications. Photonics and medical technology, areas where the principals have strong expertise, will be a priority for the fund.

Trillium plans to be the first venture capital round in portfolio companies, which will likely have received funding previously from seed or start-up angel sources.

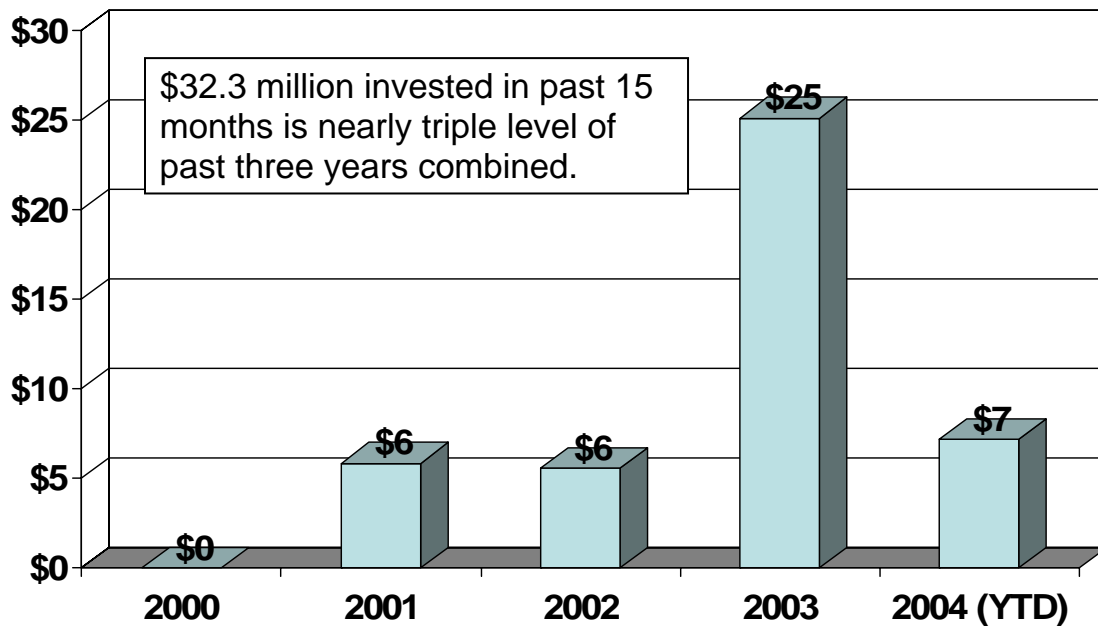
Contact: Denny DeLeo (585) 383-5680

Web site: www.trillium-group.com

VI. CAPITAL DEPLOYED BY PRIVATE EQUITY FUND MANAGERS

The table below provides a listing of the portfolio companies that have received investments through the in-state program. To date, nineteen companies have received capital totaling close to \$200 million from all sources. CRF's share of this total is \$43.7 million. The funds in which CRF invested provided \$73 million, inclusive of CRF's capital.

In-State Investments Completed (In millions)



**Table Four
Portfolio Company Investments
As of April 1, 2004**

Ascend Ventures	Date	All Capital	Fund Capital	CRF Share	
SchoolNet, Inc.	Mar-02	8,100,000	3,200,000	632,960	New York City
The NewsMarket	Sep-03	5,200,000	2,136,000	422,501	New York City
Platform Learning	Dec-03	6,100,000	2,802,762	554,386	New York City
Subtotal: Ascend Ventures		19,400,000	8,138,762	1,609,847	
Ascend NY					
SchoolNet, Inc.	Mar-02	800,000	800,000	792,000	New York City
The NewsMarket	Sep-03	534,000	534,000	528,660	New York City
Platform Learning	Dec-03	700,690	700,690	693,683	New York City
Subtotal: Ascend NY		2,034,690	2,034,690	2,014,343	
FA Technology Ventures					
Adapt Media	Mar-03	8,650,000	3,500,000	1,803,653	New York City
Concentrix	Jun-03	2,920,000	1,500,000	772,994	Pittsford, NY
CreditSights	Apr-04	7,000,000	3,000,000	1,545,988	New York City
Subtotal: FA		18,570,000	8,000,000	4,122,635	
Summer Street					
Latham International, L.P.	Dec-01	70,653,000	7,660,000	3,791,700	Latham
U.S. Datanet Corp.	Jul-01	4,000,000	4,000,000	2,073,703	Syracuse
Reichert	Dec-02	9,750,000	4,250,000	2,103,750	Buffalo
Upstate Systems Tec	Feb-03	6,350,000	5,200,000	2,574,000	Victor
Innovative Concepts in Entertainr	Jun-03	30,610,000	2,853,000	1,412,235	Buffalo
Interstate Waste Services, Inc	Feb-04	21,000,000	3,780,000	1,871,100	Sloatsburg
Subtotal: Summer Street		142,363,000	27,743,000	13,826,488	

Table Four- Continued
Portfolio Company Investments
As of April 1, 2004

Wheatley New York Partners	Date	All Capital	Fund Capital	CRF Share	
Q-RNA	Dec-02	1,200,000	1,200,000	594,000	New York City
Unger Software Company	Nov-02	3,000,000	1,500,000	1,485,000	New York City
VersaMed	Jun-03	9,300,000	3,000,000	1,485,000	Rockland County
Subtotal: Wheatley		13,500,000	5,700,000	3,564,000	
Hamilton Lane Coinvestment Program					
Applied Graphics Technology	Dec-03	NA	5,000,000	4,950,000	New York City
Unifrax	Sep-03	NA	10,000,000	9,900,000	Niagara Falls
Subtotal: Hamilton Lane			15,000,000	14,850,000	
Easton Hunt					
Innovative Stone International	Jan-04	NA	6,000,000	3,000,000	Hauppauge
Acorda Therapeutics	Feb-04	NA	750,000	750,000	Hawthorne
Subtotal: Easton Hunt			6,750,000	3,750,000	
TOTAL		195,867,690	73,366,452	43,737,313	

Case Studies

VersaMed. VersaMed designs, manufactures and markets a compact, software-based, “smart” medical ventilator that is capable of supporting patients requiring mechanical ventilation. Wheatley Partners invested \$3 million in VersaMed in June 2003 (including \$1.5 million contributed from CRF). The company was located in New Jersey when it began seeking financing; as a condition of the investment from Wheatley using CRF assets, the company moved to Rockland County.



OPHTHALMIC INSTRUMENTS

Summer Street Capital invested \$4.25 million in Reichert in December 2002. The transaction allowed management of this Buffalo-based subsidiary of Leica Microsystems AG to purchase the ophthalmic instruments manufacturing subsidiary. A sale to the division’s existing plant management was crucial to keep jobs in New York; other potential buyers were in similar businesses and would likely have closed the New York business and consolidated operations out

of state. Employment at Reichert has expanded from 120 when the investment was made to 138 at the end of 2003. Summer Street assisted in Reichert's recent acquisition of Leica's Microscope Division, which saved and additional 23 jobs in Buffalo.



the news market

The NewsMarket is a New York City based startup that provides the only video archive and distribution service that enables journalists from around the world to find, preview and download free broadcast-standard video over the Internet.



Summer Street Capital invested \$7.7 million in the buyout of Latham (the owner of Pacific Pools) from Cookson PLC, its United Kingdom based parent company. Cookson was seeking to divest a portion of its United States assets and Summer Street partnered with the former owner to restore local ownership and preserve New York jobs. Pacific Pools manufactures vinyl pool liners and pool accessories in two plants in the capital district. Since the buyout, the company has more than doubles revenues. New York employment has grown from 198 employees in 2001 to 230 at the end of 2003. Continued additional growth is expected.



FA Tech Ventures invested \$1.5 million in Pittsford-based Concentrix. Concentrix is a leader in providing outsourced customer relationship management (CRM) services, which involves helping companies manage existing customers and acquire new customers. Concentrix offers companies a full range of strategic services to expand their customer base, and provides the resources necessary to implement those campaigns such as call centers, databases, and printing and mailings. The company's breadth of expertise allows it to tailor services to each customer's needs, and it will use the investment to expand its operations in Pittsford. The investment will allow Cencentrix to expand its customer base.

VII. LEGISLATIVE ENHANCEMENTS

The operation of CRF is guided first by the Comptroller's fiduciary responsibility to invest according to the prudent person principal and to ensure that investments are done for the sole benefit of the beneficiaries of CRF.

The legislation that initiated the Program recognized that fiduciary responsibility was paramount. CRF implemented the Program using the flexibility the legislation offered, consistent with the fiduciary obligations noted above. Discussions with private equity fund managers and other investors highlighted the need for a program that did not unnecessarily limit the types of investments that could be pursued. Fund managers also identified a significant unmet need for equity capital for existing small businesses. Although they do not meet the definition of eligible businesses referred to in the J2K legislation, these investments offer an attractive risk/reward profile; from an economic development perspective, they also offer immediate benefits as a result of job retention and the prospect of expanded employment.

The following key changes are suggested to enhance the flexibility of the program:

- Clarify that private investments at all stages of a company's development should be considered as eligible. A balanced portfolio that includes investment funds that invest in all stages of a company's development will provide diversification to CRF and also ensure that private capital is available for businesses as they grow.
- Remove the cap on number of employees in an eligible company. An effective private equity investment program requires the participation of other capital. Because financial investors are motivated by returns, maximum flexibility should be allowed.
- Remove the cap on amount that may be allocated to the program. Under Comptroller Hevesi, total commitments to the program have now passed the Legislature's target of \$250 million. The comptroller should be allowed to invest to the extent that suitable transactions are available.

Statement of Legislation Intent (Extract):

The legislature hereby recognizes the need to foster economic growth, particularly in emerging technology industries, by increasing the availability of [public venture] private equity capital funding to New York state businesses and entrepreneurs. In addition, the legislature recognizes the need to attract private venture capital to New York. The legislature hereby determines that a New York state venture capital program should be established.

Amendment to the Retirement and Social Security Law (Section 423-b was added):

§ 423-b. New York state [venture capital] private equity investment program. The comptroller is hereby authorized to establish within the common retirement fund a New York state [venture capital] private equity investment program for the purpose of investing in [qualified businesses as defined in paragraph six of subdivision (a) of section eleven of the tax law] private businesses.

The comptroller is authorized to invest such amounts that may be prudently deployed [up to two hundred fifty million dollars of assets of the common retirement fund to carry out the purposes of this section]. The comptroller may make investments pursuant to this section in partnerships, corporations, trusts or limited liability companies organized on a for-profit basis that enter into agreements to invest the moneys of the New York state [venture capital] private equity investment program in [qualified] New York State businesses. The comptroller shall make such investments consistent with the provisions of [paragraph (b) of] subdivision nine of section one hundred seventy-seven of this chapter. The comptroller may establish procedures necessary to insure that investments of moneys of the New York state [venture capital] private equity investment program are, for each investment in a qualified business, equitably matched by investments made by other sources. The comptroller shall, to the maximum extent practicable, insure that the geographic distribution of investments [in] by the program is in proportion to the state population.

Appendix
Venture Capital Transactions in New York State by Region
1998, 1999 and 2000

Region	1998			1999			2000		
	Number of Transactions	Amount Invested (Millions)	Region's Share of Total Investments	Number of Transactions	Amount Invested (Millions)	Region's Share of Total Investments	Number of Transactions	Amount Invested (Millions)	Region's Share of Total Investments
Capital District	2	\$3.1	0.6 %	3	\$17.0	1.0 %	2	\$6.1	0.2%
Central New York	1	\$1.0	0.2 %	4	\$21.6	1.1 %	6	\$56.1	2.1%
Finger Lakes	12	\$56.2	10.1 %	14	\$122.6	6.6 %	11	\$56.9	2.1%
Long Island	6	\$7.5	1.3 %	6	\$46.5	2.5 %	7	\$95.1	3.6%
New York City	70	\$420.2	75.4 %	156	\$1,480.0	80.0 %	206	\$2,273.1	85.4%
Southern Tier	2	\$5.6	1.0 %	2	\$3.3	0.2 %	2	\$9.8	0.4%
Westchester and Rockland	8	\$40.8	7.3 %	20	\$121.0	6.5 %	13	\$141.3	5.3%
Western New York	11	\$22.9	4.1 %	5	\$37.1	2.0 %	5	\$22.7	0.9%
New York State Total	112	\$557.0		210	\$1,849.0		252	\$2,661.0	
United States Total		\$14,233.0			\$35,592.0			\$68,756.0	

Note: This table is discussed in Section II of this report and is based on a data series that is no longer available.