

New Mexico Small Business Investment Corporation
P.O. Box 22547
Santa Fe, N.M. 87502
505-690-4503 • 505-466-2022 (fax)
website: www.nmsbic.org
email: joseph@josephbadal.com

December 1, 2011

The Honorable Susana Martinez
Office of the Governor
490 Old Santa Fe Trail
Suite 400
Santa Fe, New Mexico
87501

Dear Governor Martinez:

On behalf of the members of the Board of Directors of the New Mexico Small Business Investment Corporation ("NMSBIC"), I want to thank you for appointing us to this important organization and giving us the opportunity to serve our State.

The NMSBIC was formed in 2001 by the Small Business Investment Act, NMSA 58-29-1 et. seq., to create new job opportunities in communities statewide and is funded by an allocation from the Severance Tax Permanent Fund pursuant to NMSA 7-27-5.15. Upon receipt of the independent audited financial statements, the NMSBIC Board of Directors is charged with reporting the organization's financial results to you in accordance with the provisions of the Act. This letter is intended to serve that purpose. A copy of the report of the independent auditors for the corporation's fiscal year ended June 30, 2011 is enclosed. As the new Board Chairman and President, elected to those positions on November 21, 2011, I am charged with reporting to you the following results for the fiscal year ending June 30, 2011.

FINANCIAL OVERVIEW

Set out below is the overview of the financial condition of the organization as of June 30, 2011 as compared to June 30, 2010 and as reflected in the enclosed independent audit report:

	2011	2010
• Interest and Dividend Income	\$ 331,558	\$ 570,851
• Equity Fund Management Fees	\$ 629,655	\$ 702,731
• NMSBIC Direct Operating Expenses	\$ 252,432	\$ 264,758
• Realized Loss on Investment	\$ (1,684,400)	\$ (2,033,282)
• Unrealized Gains	\$ 689,158	\$ (500,282)
• Total Income or (Loss)	\$ (1,732,606)	\$ (3,053,226)
• Net Assets at Year-end	\$36,718,662	\$38,451,268

As seen from the above comparative results, the NMSBIC had lower fund management fees and direct operating expenses in 2011, but also had lower interest income due to the historically low rates paid on deposits for the fiscal year. In addition, the NMSBIC

posted a significantly lower total loss in 2011 as equity fund investments began to show improved valuations as the economy has begun to firm up, albeit minimally. The NMSBIC posted a reduction in net asset value for the fiscal year ending June 30, 2011. Net asset value used for evaluation purposes (\$36,718,662) includes lending portfolio assets, current valuation of all equity partnerships, and all short-term deposits or cash equivalents. This valuation represents a reduction of 4.5% from the NMSBIC's net asset value of \$38,451,268 at fiscal year-end 2010.

The NMSBIC has established contractual relationships with financial professionals that have experience making loans to or equity investments in New Mexico companies. Relationships with alternative or micro-lenders have led to nearly 2,200 loans statewide since 2004, while New Mexico-domiciled equity funds have been created to provide a capital delivery system. Prior to 2004 there were no equity funds headquartered in New Mexico. Today, five funds provide a full continuum of equity to the very earliest stage companies, as well as more mature businesses, and have invested capital in 48 New Mexico businesses.

LENDING ACTIVITY

In the midst of a very challenging banking regulatory environment where access to capital has been dramatically restricted, alternative lenders have helped fill the void. Small businesses, whether start-ups or those in rural areas, were already very unlikely to qualify for traditional loans prior to the recession. Yet it is these very businesses, those employing 1-10 people, which are the economic backbone of small communities around the State. ACCION New Mexico, the New Mexico Community Development Loan Fund (also known as "The Loan Fund") and WESST Corp. typically provide capital as small as \$2,500 and as large as \$250,000 to businesses to help support current employment and encourage additional hiring. Loans for buildings, equipment, inventory and other needs are essential, while loans to start-ups are equally important. The NMSBIC and its lending partners have been increasingly critical to the support of business owners, entrepreneurs and the local communities in every quadrant of the State.

Since inception in 2004 through June 30, 2011, lending activity has been as follows:

Organization	Total # of Loans	Dollars Lent	Employees Supported
The Loan Fund	346	\$17,259,418	2,023
ACCION NM	1,814	\$14,894,881	3,263
WESST Corp.	30	\$ 309,062	143
Totals	2,190	\$32,463,361	5,429

As of June 30, 2011, the NMSBIC, through its lending partners, had the following outstanding loan balances:

Organization	Total # of Loans	Commitment	Outstanding
The Loan Fund	115	\$ 7,500,000*	\$6,656,796
ACCION NM	398	\$ 4,929,864	\$2,683,138
WESST Corp.	18	\$ 375,000	\$ 96,963
Totals	531	\$12,804,864	\$9,960,408

*In October 2011, the NMSBIC increased its commitment to The Loan Fund to \$8,500,000

Based on the above statistics, you can see that nearly three times the committed capital has been lent and recycled via repayments of interest and principal providing tremendous leverage of the NMSBIC's capital. Nearly 5,500 jobs have been sustained or created, and while some companies have failed or reduced the number of employees, a number of others have added employees as they have prospered and grown. Collectively these 2,100 businesses generate over \$250 million in annual revenues, which in turn creates a significant amount of gross receipts tax, sales tax, payroll tax and ultimately stronger family units and healthier communities.

Loan losses during the fiscal year increased slightly from \$123,074 to \$176,177, which represented a loss ratio of 1.76%. Given the fact that many of these borrowers would not qualify for traditional lending, the extremely low loss ratio is most impressive. Virtually all of the loan losses occurred at ACCION New Mexico, which originates and services many small start-up loans. It is important to note that loan losses have been mitigated due to requirements imposed by the NMSBIC's Board relative to loan operations at our partners, including requirements for improved collateral on loans and the requirement, in the case of The Loan Fund, to remove 180-day delinquent loans from our pool of loans.

EQUITY PARTNERS

Equity markets globally have been volatile over the past 12 to 36 months, and private equity has performed poorly over the last three to five years. With limited public market liquidity, decreasing credit availability and reduced portfolio company revenues and profitability due to the recession, private equity investments have under-performed. Equity investments in New Mexico were virtually unheard of prior to 2000, but slowly the efforts of the State Investment Council and the NMSBIC have attracted funds, and, equally importantly, investment professionals to New Mexico. Prior to 2004 there were no equity funds headquartered in New Mexico and no funds focused their capital and expertise exclusively on New Mexico companies. It was the NMSBIC's capital and early commitments that led to the formation of five General Partnerships and 9 venture capital funds based in New Mexico.

Most large equity funds look to deploy \$5 to \$10MM in any one investment, while New Mexico had very small, early stage companies that warranted investments of only \$250,000 to \$1MM. Few if any local companies would have been able to attract national attention, and, without equity, could not have secured any credit relationships. Beginning in 2004 the NMSBIC committed capital to Flywheel Ventures, Verge Fund and New Mexico Growth Fund to address the need for capital access for local start-ups, technology transfer licensees and other small businesses looking to expand.

As of June 30, 2011 the NMSBIC had the following equity commitments:

Organization	Commitment	Called Capital	Current Value
Flywheel Ventures	\$1,500,000	\$1,500,000	\$ 584,144
NM Growth Fund	\$7,500,000	\$7,497,288	\$ 43,411
Verge Fund 1	\$1,800,000	\$1,638,000	\$1,659,144
NM Comm. Capital	\$7,000,000	\$5,341,650	\$3,422,107
Verge Fund 1.5	\$3,000,000	\$2,685,000	\$2,510,966
NM Growth Fund II	\$3,500,000	\$2,946,813	\$ 968,606
NM Mezzanine Fund	\$3,000,000	\$ 405,000	\$ 241,882
NM Gap Fund	\$2,000,000	\$2,000,000	\$1,435,114
Verge Fund II	\$3,000,000	\$1,144,680	\$ 703,225
Totals	\$32,300,000	\$25,158,431	\$11,568,599

While most private equity funds, both locally and nationally, have reported lower valuations over the last five years, the NMSBIC has been especially adversely impacted by losses at the two New Mexico Growth Funds. Approximately \$9.5MM, or 90% of the capital provided to the New Mexico Growth Funds by the NMSBIC, has been lost in these two funds. Both funds were designed to make investments in lower risk non-tech companies that had existing clients, revenues and profits. There was no equity capital in New Mexico that targeted these more traditional manufacturing and distribution sectors and this fund was designed to meet those needs.

In general, private equity fund performance has been poor over the last several years, particularly for new funds that carry the burden of management fees and expenses, as well as the inability to generate gains immediately from the sale of portfolio companies. Even more challenging have been investments in very early stage or start-up technology companies that must go through the significant time and cost associated with research and development prior to having products, services, clients or revenues. As a means of reducing portfolio risk and diversifying the NMSBIC's portfolio, the NMSBIC helped create the two New Mexico Growth Funds that invested growth capital in more traditional manufacturing or services businesses that had existing clients and what was determined to be a reliable stream of revenue. In addition, these companies had physical assets, typically equipment, which would allow the companies access to additional debt capital.

The portfolio of the New Mexico Growth Funds was diversified geographically and by industry sector consisting of more basic businesses as follows:

- An organic pet food manufacturer in Belen,
- A gas field equipment servicer in Aztec,
- A specialty packaging company in Belen,
- A financial services company in Santa Fe, and
- A Voice-Over IP phone company headquartered in Albuquerque that had 25,000 landline phone customers in southern New Mexico.

There was little technology risk with any of these investments. They had basic execution and normal business risks, yet each company failed to meet projections, saw revenues decrease, and, as the economy entered the recession in 2007, their problems multiplied.

As the economic downturn accelerated and credit availability diminished, every company in these funds began to lose access to capital. One company, One Connect IP, went from \$9,000,000 in revenues to a forced merger and, ultimately bankruptcy. Within a three-year period, from 2007 to 2010, the two New Mexico Growth Funds lost 90% of their committed capital, which translated to \$9,500,000 of the NMSBIC's capital.

Virtually every private equity fund goes through a period called the J-Curve, which typically lasts the first three to five years of a fund's life. That period includes management fees and expenses, plus early losses. The NMSBIC is just coming through that period with its fund commitments, and valuations are beginning to firm up. Verge Fund 1 now has a positive valuation, and, together with Verge 1.5, are the most well diversified of all the funds. With improvement in national and local economic conditions, the hope is that each of the Verge funds will continue to show higher valuations over the next 12 to 24 months. As New Mexico Community Capital becomes a more mature fund, it also should show value improvement.

FINANCIAL EDUCATION

In 2007, the NMSBIC helped create and continues to support a statewide business financial literacy effort called Finance New Mexico, see www.financenewmexico.org. Each week, business-related articles are published in over 20 local newspapers and then circulated electronically to over 1,750 local businesses and economic development organizations. Selected in 2009 as the Albuquerque Chamber of Commerce Small Business Advocate of the Year, Finance New Mexico has developed one of the best business resource web sites in the country and now contains an archive of more than 200 business related articles. This organization plays an important role in getting out the word about the NMSBIC's programs in all corners of the State

STATUTORY REQUIREMENTS

As required by NMSA 58-29-6(B), I also provide you with the following information:

Realized losses in its equity investments of \$1,684,400, coupled with equity fund management fees of \$629,655 and other operating expenses, were partially offset by unrealized gains of \$689,158 leading to the NMSBIC reporting a net loss of \$1,732,606. This represents a reduction of 4.5% in net asset value. The NMSBIC is charged with making a distribution of its net excess income to the Severance Tax Permanent Fund; however, based on the reported performance, there will be no distribution of funds to the Severance Tax Permanent Fund for the fiscal year ended June 30, 2011.

The NMSBIC Board strives to remain the most cost effective conduit of capital in the State with direct operating expenses of just \$252,432 for the fiscal year. The NMSBIC has consistently offset those operating expenses since its inception via the generation of earned interest income, and did so again in the June 30, 2011 fiscal year.

With the appointment of five new Board Members in mid-2011, the NMSBIC Board is reviewing its current investment and lending commitments and recently has increased its commitment to the New Mexico Community Development Loan Fund to \$8,500,000. The Board will seek to protect the citizen's money by minimizing investment risk and controlling operating expenses, while continuing to help improve the economic climate of the State through the fulfillment of its mission.

CONCLUSION

The NMSBIC is extremely grateful for the support of the Governor, State Legislators, the State Investment Council and its financial partners. Through the creation and expansion of the NMSBIC, New Mexico has created a unique, cost effective delivery system of investment capital that has helped expand the capacity of its lending partners. This capital has resulted in over \$32 million in loans to businesses that would likely not have had access to capital. These loans, most of which are fairly small in size, have led to the support of over 2,100 businesses in communities statewide and the related jobs that would have been damaged or eliminated without access to that capital.

Equity investment losses have slowed over the prior year and yet have contributed to a 4.5% reduction in net asset value of the NMSBIC in the 2011 fiscal year. It is believed that an improvement in the economy will lead to valuation improvements in the coming years.

With the dramatic reduction in traditional lending activity and heightened regulatory constraint being imposed on banks, access to loans is even more challenging for New Mexico small businesses. The NMSBIC, through its lending and equity partners, plays a significant role in helping to fill that void by focusing its capital on Main Street, not Wall Street. This program, created by the legislature, is about New Mexicans investing taxpayer's dollars in New Mexico businesses.

GOING FORWARD

The NMSBIC Board of Directors met on November 21, 2011 in a strategic planning session to develop a strategic vision for the organization. The context for our discussion was that the NMSBIC needed to be structured in a manner that would survive the test of time while fulfilling its mission. The agenda for the meeting included:

1. The NMSBIC's investment focus in the future,
2. The nature and availability of loan and equity partners,
3. Staffing/consulting requirements, and
4. Discussions about the State Investment Council's recommendations.

I will report to you under separate cover about the results and recommendations that came out of this strategic planning meeting.

Finally, I respectfully request that Sam Cobb of Hobbs, New Mexico be reappointed to the NMSBIC Board of Directors. It is not an exaggeration that we new Board members would have been at a definitive disadvantage and would have been hampered in fulfilling our duties had Mr. Cobb not been retained during this initial transition phase. He is the only independent Board member with any NMSBIC institutional knowledge, and has proved to be highly supportive of the changes your appointees discussed making during our strategic planning session. The other members of the Board are unanimously in agreement with this request to reappoint Mr. Cobb.

Respectfully,

Joseph H. Badal
Board Chairman & President

The Honorable Susana Martinez
December 1, 2011
Page 7

c (w/enc):

The Honorable John Arthur Smith, Chair, New Mexico Legislative Finance Committee
The Honorable John A. Sanchez, New Mexico Lieutenant Governor
Steve Moise, New Mexico State Investment Officer