

ACTION SUMMARY

NM SMALL BUSINESS INVESTMENT CORP

July 18, 2011

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NEW MEXICO SMALL BUSINESS INVESTMENT CORP.

REGULAR MEETING

July 18, 2011

A regular meeting of the New Mexico Small Business Investment Corporation was called to order on this date at 9:00 a.m. in the conference room of the New Mexico Mortgage Finance Authority, 344 S. 4th Street, S.W., Albuquerque, NM.

A quorum was present:

Members Present:

Mr. Sam Cobb, Interim Chair
Mr. Joseph Badal
Mr. Alan Fowler
Mr. Lupe Garcia
Ms. Mary A. Garza, Interim Secretary
Ms. Roxanna Meyers

Members Excused:

Mr. Clarence L. Smith [designee of the Hon. James Lewis, State Treasurer]

Legal Counsel to Board:

Mr. Randall J. McDonald

Financial Advisor to Board:

Mr. Paul Goblet

Recording Secretary:

Ms. Judith Beatty

Guests Present:

Mr. Jake Dopson, Pulakos
Mr. Brad Steward, Pulakos

COMMENTS FROM STATE TREASURER JAMES LEWIS

Treasurer Lewis commented that, as former City Manager for the City of Rio Rancho and later for the City of Albuquerque, he is well aware of economic development efforts to work with small businesses and the tough challenge that continues to present. He said New Mexico is competing with other states to attract businesses here, including small businesses, which are especially important, and encouraged NMSBIC members to do what they can to offer their support. He said the NMSBIC has been doing an outstanding job.

APPROVAL OF AGENDA

Mr. Fowler moved approval of the Agenda, as published. Ms. Garza seconded the motion, which passed by voice vote.

INTRODUCTION OF BOARD MEMBERS

Board members individually introduced themselves and discussed their professional and personal backgrounds.

NMSBIC BACKGROUND

History of the NMSBIC

Mr. Goblet said he was a member of the State Investment Council's private equity committee from 1999 to 2002, during which time Governor Gary Johnson asked him to be a catalyst on this committee to help accelerate efforts to attract more funds to New Mexico; prior to that time, only \$28 million had been committed to seven funds.

Mr. Goblet said Sen. Don Kidd introduced legislation in 2000 that created the NMSBIC, and in 2001 the newly-appointed Board approached him (Mr. Goblet) to help them figure out how to structure the organization and implement the directives of the legislation.

Mr. Goblet said the original legislation required the NMSBIC to underwrite deals. They invested \$100,000 in one deal under this requirement, Santa Fe Windows & Doors. The transaction took four months to complete and \$30,000 worth of legal bills. As a result, the statute was amended to allow the NMSBIC to invest equity or debt in cooperation with financial professionals, and the NMSBIC is now a conduit of capital rather than a loan underwriter or equity investor.

Legal Structure

Mr. McDonald stated that a high level review of the organization's legal structure would take more than one meeting, and today he would present an overview.

-- The NMSBIC was created under the New Mexico Small Business Investment Act in 2001 and incorporated under the New Mexico Non Profit Act.

-- The NMSBIC then applied for and received tax-exempt status from the Internal Revenue Service as a 501(c)(4) organization, which is a "social welfare" category. Economic development organizations are considered social welfare organizations under the IRS Code.

-- The NMSBIC receives direct funding from the Severance Tax Permanent Fund (STPF). Each year, the State Investment Council, custodian of the STPF, values the STPF and determines whether or not the NMSBIC has received the entire 1% allocation due to it or whether additional funding is necessary.

-- The statute has been amended three times, incrementally increasing the percentage from the original 1/4% to the current 1%. The current statute reads 3/4%. When the Legislature increased it to 1%, two bills amended the statute; and because the Governor signed them in a certain order, the Compilation Commission took the second one and applied it to the statute. The second bill amended a different part of the statute and did not pick up the change to 1%. In short, the law states that it is 1%, and the Attorney General and State Investment Council have confirmed that this was the legislative intent.

-- Because of the performance of the STPF over the past several years – its high water mark was \$4.7 billion in 2007– the NMSBIC has received \$47.2 million to date. Since then, the balances in the STPF have declined and the NMSBIC has received no further distribution. For the NMSBIC to receive any additional funding, the STPF would have to exceed \$4.7 billion.

Mr. Cobb added that the intent of the Board since inception has been to depoliticize the function of the Board and professionalize its relationships with the people it does business with. He said he hopes this shows through in the NMSBIC's investment policies and procedures.

-- The Small Business Investment Act calls for creating new job opportunities by providing capital for land, buildings or infrastructure for facilities to support new or expanding businesses, and to make debt and equity investments to create new job opportunities to support new or expanded businesses. The basis on which the NMSBIC operates is to make debt and equity investments.

-- Legislation in early 2011 amended the statute to remove the State Investment Officer or designee from the NMSBIC Board.

Mr. Goblet said the SIC proposed this legislation, which removed the State Investment Officer from four boards it was required to serve on.

Mr. Goblet stated that the SIC's chief focus is to make the highest possible return on investments, and it considers the NMSBIC to be an Economically Targeted Investment vehicle, which when included in the overall SIC portfolio affects returns.

Mr. Cobb commented that this raises the question of what the support of or creation of nearly 5,000 jobs and millions in tax revenues means in terms of public benefit – and this is the philosophical difference between the NMSBIC's role and what the SIC's perception of that role is.

[Discussion on this item was set aside to accommodate a report from the Auditors.]

PRESENTATION BY PULAKOS, CPAS

a) Discussion and Possible Vote on Renewal of Audit Contract

Pulakos CPA's Audit Partner Brad Steward and Audit Manager Jake Dopson presented an overview of Pulakos' responsibilities to the Board under its contract with the NMSBIC, along with a 2011 anticipated audit timeline.

-- July 2011: Audit planning; preliminary communications with NMSBIC Board.

- August 2011: Preliminary work.
- Mid-September 2011: Majority of audit fieldwork, with assistance of Paul Goblet and Dee Brescia.
- October 2011: Presentation of audit to Board of Directors; issuance if audited financial statements.

Mr. Dopson noted that this year's proposed audit fee of \$22,900 is in line with fees paid to Pulakos in 2008-2010.

Responding to Ms. Meyers, Mr. Dopson said Pulakos looks at the audited financial statements for all of the funds, which have a 12/31 year-end as opposed to the NMSBIC's 6/30 year-end. He said they do look at the interim information.

Mr. Dopson said they always use a reasonableness standard in their analyses.

Mr. Steward said their audit opinion includes an extra paragraph about underlying investments that says they are receiving information from third parties and are relying on that, because there is no actively traded market for this. He said the intent here is to provide funding for people who can't get it through actively traded portfolios. Mr. Steward said this extra paragraph is not uncommon and is in accordance with the audit requirements.

Mr. Steward said he wanted to emphasize that Pulakos is looking at how money is being transferred to people, expense work, etc. – they are auditing everything but the value, which of course is subjective.

Vice Chair Cobb said the NMSBIC also assumes the auditors for the underlying funds would not sign off on an audit if they disagreed with a fund's mark to market value of a company.

Mr. Steward responded that Pulakos makes that assumption as well, although obviously there is some subjectivity – if the company were publicly traded, they might come to a different conclusion.

Mr. Goblet noted that FASB 157 forced every fund to start to value their portfolio on a quarterly basis based upon certain parameters. Since these are small, privately held companies, it makes it very difficult.

Ms. Meyers asked if management fees are reviewed within the funds, and Mr. Steward responded that they look at the reasonableness of those fees, and if a fee were unusual, they would inquire; however, they do not try to second-guess fees because they are part of approved contractual agreements.

Mr. Goblet noted that the SIC has invested in Flywheel and Verge with exactly the same contractual terms and fee structure. He said fees for these smaller funds are typically 2.5%, but these are \$10 million funds as opposed to \$100 million funds that have fees closer to 2%.

Responding to Mr. Badal, Mr. Dopson said Pulakos does not audit the audits of the underlying funds, but they are constantly receiving information from all of the funds about investment activity, capital calls, gains and losses, and so forth. He said investments are valued on the good faith of the GP, and that is what Pulakos relies on.

Mr. Dopson said there are two sets of internal controls – transactional controls, which involve looking at day-to-day cash activity, and monitoring controls, which involves oversight of what is happening with investments within the funds and to ensure they are in accordance with agreements.

Mr. Steward said that, while Pulakos does not audit the audits, they do look at the opinions to see if there is anything that stands out.

Mr. Badal asked if the internal controls include a review of the process of how the NMSBIC selects a fund to invest in or decides to invest more money in an existing fund. Mr. Steward responded no, since the financial statements are not impacted as a result of the Board's discussion. Once the Board approves an investment, Pulakos looks to see whether the Board approved the investment and was the money appropriately disbursed.

Mr. Badal commented that the NMSBIC is acting as an underwriter of partners, and he cannot think of anything the NMSBIC does from an administrative standpoint that is more important than the process of managing the underwriting of its investment partners. He said it would seem an appropriate internal control for Pulakos.

Mr. Goblet noted that the NMSBIC has entered into one relationship in the three years that Pulakos has been auditor.

Mr. Goblet said the Board holds him responsible for the vetting of relationships with new financial partners in terms of alignment with statute, etc.

Mr. Steward commented that, at some point in stepping into that management role, Pulakos would lose its ability to be independent of the process and thus not be able to do the audit. He said there is a fine line.

Ms. Meyers said it would be helpful for the new members to receive copies of Board minutes and relevant materials when decisions were made, so they can understand the process.

Mr. Cobb noted that, historically, the vetting process for equity partners as well as loan partners sometimes has taken as long as six months, with the Board meeting that many times to ask questions and hear presentations.

Mr. McDonald noted that no third party placement fees have ever been paid in a transaction involving the NMSBIC.

Mr. McDonald said it would be useful to develop a checklist for Pulakos to look at whenever a transaction is approved.

Responding to Mr. Badal, Mr. Steward said the NMSBIC does not have an audit charter, although it is beneficial to have one. He said perhaps 10% of their clients have a document that

actually lays out a process for evaluating an auditor and the audit process, so Pulakos gives its presentations as though such a document were in place.

[Break.]

NMSBIC BACKGROUND

Legal Structure (Cont'd)

Mr. McDonald continued with his review.

-- There is a statutory requirement to require an annual audit to the Governor and LFC. If the NMSBIC has "net excess funds" at the end of a fiscal year, it is to return them to the Severance Tax Permanent Fund.

Mr. Goblet commented that it will be a while before the NMSBIC will be able to upstream capital back to the state.

Mr. Cobb said the NMSBIC would never be able to gain ground if it had to go back to the Legislature every year to re-sell its program and request additional funding – it would never be able to create a long-term capital distribution system in the state or create conduits of capital as it has. He disagreed that the permanent fund is the SIC's money – it is the people's money, and should be invested to grow the economy of the State of New Mexico and not necessarily be invested in a mutual fund outside of the state.

Mr. Cobb also commented that it takes innovation and a great passion to go out and find good business deals in places like Hobbs, Deming, Espanola and Clovis. He said the NMSBIC has vetted a number of deals that politicians have said it should be doing but were not good business deals.

Directors and Officers Insurance

Mr. McDonald noted that the Small Business Investment Act exempts Board members from liability in any act they perform in good faith without intent to defraud, and there are similar statutes that provide the same kinds of protections under the Non Profit Corporation Act. He noted that the NMSBIC also carries D&O insurance in the amount of \$1 million and is also covered under the State Tort Claims Act, and the NMSBIC bylaws also indemnify the Board members.

NMSBIC BACKGROUND (Cont'd)

Mr. Goblet made a power point presentation on the NMSBIC, with the following highlights on the lending partnerships and equity partnerships:

- Lending partnerships:
 - ACCION NM: \$4,950,000 – 85% of their loans are with NMSBIC capital.

- The Loan Fund: \$7,500,000 – 70% of loans via NMSBIC capital.
 - WESST Corp: \$375,000.
- Lending commitments have led to \$33 million in loans to over 2,200 small businesses since 2004. Loan losses of slightly over \$1 million since 2004, or 3%.
 - No equity funds domiciled in NM prior to NMSBIC's effort.
 - Very early stage equity funds complement SIC New Mexico program.
 - Typically very small funding from \$50,000 to \$750,000.
 - 45 New Mexico companies have received equity investments.
 - Initial equity losses are significant due to write-downs, write-offs at NM GF 1 and management fees. Investment values could be recouped over next 2-3 years.

Mr. Goblet reviewed challenges facing the new Board:

- Understand the purpose in creating the NMSBIC and its role in creating capital delivery systems.
- Understand the rationale behind the NMSBIC's current commitments.
- Review the financial status of the NMSBIC.
- Define objectives moving forward.
- Determine uses for uncommitted capital.
- Determine the status of the NMSBIC's service providers.
- Agree on communication direction to key legislators and agencies, e.g., Economic Development Department, SIC.

REVIEW AND APPROVAL OF PRIOR BOARD MINUTES

April 26, 2011

May 16, 2011

Mr. Goblet noted that these minutes state, on page 3: "Mr. Goblet reminded the Board that it had previously approved an increase in the lending ceiling to The Loan Fund from \$7.5 million to \$8.5 million. In the course of finalizing the documentation, The Loan Fund had requested that the revisions to the documents also include an extension of the final due date for the loan. Currently the loan is due in full in July 2017. Although over the past several years the credit facility had been

increased several times, from \$3.5 million to \$8.5 million, the final maturity date had never been changed.”

Mr. Goblet stated that the Board approved the amendment to the loan documents such that the final maturity date for each increase in the principal commitment would be set at 10 years after the date of the increased commitment. He said this would extend the final maturity date for this last increase of \$1 million to 2021.

Mr. Goblet said the contract has not been signed because the Board was changed during the process. He suggested that the Board revisit the agreement at the August meeting. He said this delay would not impair The Loan Fund’s ability to draw capital, as they still have access to some capital.

Mr. McDonald clarified that the Board can choose to approve or disapprove this transaction after reviewing it at the August meeting.

Ms. Garza moved approval of the April 26 and May 16 Minutes, as submitted. Mr. Cobb seconded the motion, which passed by voice vote, with Ms. Garza and Mr. Cobb voting in favor, and Mr. Badal, Mr. Fowler. Mr. Garcia and Ms. Meyers in abstention.

Upon motion by Mr. Badal, seconded by Mr. Fowler, and unanimously approved, it was:

RESOLVED, that the Board table the signature of The Loan Fund document until further review of the transaction by the Board of Directors.

REVIEW AND ACCEPTANCE OF FINANCIAL REPORTS

a) May 2011, June 2011

Mr. Goblet stated that the June financials were in draft form because the second quarter reports from the equity funds were not yet in.

In reviewing equity investments, Mr. Goblet noted that \$9 million out of the \$11 million in total equity investment losses were embedded in New Mexico Growth Funds I and II.

Responding to Ms. Meyers, Mr. Goblet stated that the Holly Company has a contract with the NMSBIC to provide an information delivery system about business financial literacy called Finance New Mexico. An article is published weekly in about 25 newspapers; the article is then blogged to about 1,200 business entities and groups, including chambers of commerce, that then post the information on their websites and/or send on to members. He said the NMSBIC pays the Holly Company \$35,000 annually for its efforts in producing and managing Finance New Mexico. Additionally, co-sponsors like NM Connect pay for the remaining half of those annual expenses.

Responding to Mr. Badal, Mr. McDonald said that he did not foresee any legal expenses in connection with the lawsuit involving NM Growth Fund.

Mr. Goblet reviewed the May financials.

Ms. Garza moved to approve the May financial report. Mr. Badal seconded the motion, which passed by voice vote.

FINANCIAL ADVISOR'S REPORT

Mr. Goblet stated that the equity funds are all fairly new, most having 10-year lives, so returns have been disappointing and far more negatively impacted by the recession. As with the NMSIC, which has invested \$350 million in 28 funds through its New Mexico program, equity fund returns over the last 10 years have been negative; and given the very early stage nature of the New Mexico based funds and the very early stage nature of the investment portfolio, NMSBIC returns have been even poorer than those of the NMSIC's program.

Mr. Goblet said both the NMSBIC and NMSIC New Mexico program are invested in Flywheel Ventures and Verge Fund.

Mr. Goblet reviewed a capital summary of the NMSBIC's equity funds with assumptions on ending equity value, based on which he was projecting total assets of approximately \$45 million in 2014.

Mr. Garcia said he would be interested in discussing ways for the Board members to communicate the positive effects of the NMSBIC to legislators and others.

Mr. Cobb responded that educating legislators and coming up with an overall strategy will be important going forward. He noted comments by Mr. Badal that the Bureau of Business and Economic Research at UNM has determined the economic impact to New Mexico of a new job, and it would be useful for the NMSBIC gets that information.

Mr. Fowler and Mr. Badal suggested that the Board review the rationale behind various investment decisions made in the past – what can it learn based on past experience? Referring to the Advisor's Report, Mr. Badal asked Mr. Goblet to address a series of questions at a future Board meeting to help educate the new members:

-- Flywheel Ventures. TruTouch has been written off and 2 investments have been written down. It is hoped that Flywheel could return at least 50% of the NMSBIC's investment over the next 2 years. Despite that, the NMSBIC helped create the NM Gap Fund managed by the GPs of Flywheel. Why did the Board make that decision, knowing that performance has not been that good?

-- The NMSBIC invested in NM Growth Fund companies, then invested in the same companies through Flywheel. If the NMSBIC already knew NMGF was having problems, why would it invest in the same companies through another entity?

-- What were the conditions of the NMSBIC's investments in New Mexico Growth Fund when it raised its commitments to them?

-- What was the status of NMGF I when the NMSBIC helped create Fund II?

Given that regulators are restricting banks from adding to their commercial real estate portfolios, Mr. Badal asked if the NMSBIC could step in and provide a guarantee on a commercial real estate loan for a fee. The NMSBIC would be subordinate lender but the bank would then manage the loan, which would mean the NMSBIC would have excellent expertise. He wondered if this would not be included in the calculations the regulators make to determine whether or not that is part of the bank's real estate portfolio. He said this would provide the NMSBIC with another conduit of capital for lending purposes.

Mr. Goblet referred to a 28-page spreadsheet of loans made by ACCION NM since 2004, representing 1,814 loans.

Mr. Badal commented that, if the Board were to look at the NMSBIC's mission from the standpoint of job creation and IRR, it would appear that the lending function has been far more positive than the equity side; and at a time when the banks have pulled back dramatically, that is another reason why it would appear that the biggest bang for the buck would be the lending side rather than the equity side.

Mr. Goblet agreed. He said the NMSBIC has been able to strengthen ACCION and The Loan Fund, and the lending activity has had by far the broadest impact.

Ms. Meyers commented that the main goal in these lending relationships is to create jobs, but the loans are being made to people/entities that can't get loans from banks. To Mr. Badal's point, she said it would seem much more comfortable lending to solid businesses where lenders would normally make a loan but currently are prevented from doing that. Speaking to the equity side, she said someone really has to be prepared to invest in something that may or may not have a return for at least ten years.

Mr. Cobb said the NMSBIC should have some money set aside for people wanting to start a small business in New Mexico; and properly done, and with the right strategy, there will be some successes.

Ms. Meyers pointed out that the equity deals are so small in comparison to the fee structure. She said perhaps the NMSBIC doesn't have the "stomach" for making equity investments anymore.

Mr. Goblet said it will be up to the Board to decide on its direction. He added that the SIC does not want Economically Targeted Investments in its \$15+ billion portfolio.

ELECTION OF OFFICERS

- a) **Chair/President** **Vacant**
- b) **Vice Chair** **Sam Cobb**
- c) **Secretary** **Mary Garza**
- d) **Treasurer** **Vacant**

Board members agreed that Mr. Cobb would serve as Acting Chairman and Ms. Garza as Acting Secretary until Election of Officers at the next meeting.

Mr. Cobb asked Board members to consider commissioning an economic impact analysis.

DISCUSSION REGARDING CONTRACT SERVICE PROVIDERS

- a) **Paul Goblet, Financial Advisor**
- b) **Randall McDonald, Legal Counsel**
- c) **Dee Brescia, Accounting Services**
- d) **Judith Beatty, Recording Services/Board Minutes**
- e) **The Holly Company, Finance NM and NMSBIC Website**

Mr. Goblet stated that all contracts expired on 6/30, and all have agreed to continue providing these services until the Board takes action.

Mr. Badal moved to extend these contracts, with the exception of the audit contract, another quarter. Mr. Fowler seconded the motion, which passed by voice vote.

- f) **Renewal of Audit Contract**

Mr. Fowler moved to approve Pulakos for the 2011 audit. Ms. Meyers seconded the motion, which passed by voice vote.

PROPOSED MEETING SCHEDULE

Board members agreed to continue the schedule of meeting on the third Monday of the month.

NEXT MEETING: Monday, August 15, 2011 NMMFA

ADJOURNMENT

Its business completed, the NMSBIC Board adjourned the meeting at approximately 1:55 p.m.



Mr. Sam Cobb, Acting Chairman/President

8/15/11

Date