March 13, 2008

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Proposed Private Equity Investments in CSFB/NJDI Investment Fund, L.P. (2008-1 Series), CS/NJDI Emerging Opportunities Fund II, L.P., NJHL European Buyout Investment Fund III, L.P. and AnaCap Financial Partners Fund II, L.P.**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9 (a) to report on four proposed private equity investments: a $400 million commitment to CSFB/NJDI Investment Fund, L.P. (2008-Series), $100 million to CS/NJDI Emerging Opportunities Fund II, L.P., $200 million to NJHL European Buyout Investment Fund III, L.P. and € 106.25 million to AnaCap Financial Partners (GP and Fund II, LLP).

Please note that these investments will be authorized pursuant to Articles 69 and 90 of the Council's regulations. These investments are all considered "Buyout Fund" investments as defined under N.J.A.C. 17:16-90.1.

The Alternative Investments Procedures adopted by the Council on February 21, 2008 require any potential alternative investment opportunities to be identified and initially evaluated by the applicable staff of the Division of Investment ("DOI") and the applicable asset class consultant (Strategic Investment Solutions for Private Equity or "SIS") in coordination with the DOI Investment Committee (Director, Deputy Directors and the Senior Staff member for the applicable alternative asset class).

As a result of internal and external sourcing, the DOI Investment Committee identified these proposed investments. SIS and Division staff proceeded to undertake extensive due diligence on the proposed investments. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council. Based on this due diligence, the Division has determined that these proposed investments meet the criteria for investments set forth in the Alternative Investments Policy.

Credit Suisse Customized Fund Investment Group ("CFIG") is part of Credit Suisse's Private Equity Group responsible for all private equity fund-related investment activities within the Firm. CFIG currently manages over $11 billion of commitments in over 600 private equity funds and 150 co-investments. CFIG specializes in developing customized private equity investment programs that address the specific needs of investors.

In August 2005 New Jersey approved a separate account mandate with CFIG to source and commit $200 million to buyout funds located in North America raising $1 billion or less. This separate account was and is our only means for investing in such funds. In July 2006 we provided them with an additional $250 million to execute the same strategy. Credit Suisse has implemented those mandates, providing New Jersey with commitments to approximately 23 funds spanning 4 vintage years. DOI staff has been very satisfied with the work Credit Suisse has done to implement this mandate and is recommending an additional commitment to the CFIG so that they may continue their work finding the "best" domestic managers in the $1 billion and under size range.

The Division is recommending an additional allocation of $400 million. Within that amount, $350 million is dedicated to a continuation of the program's small to middle market buyout strategy and that the additional $50 million remain available for Credit Suisse to invest on New Jersey's behalf opportunistically within strategies outside the mandate and which Credit Suisse believes will offer superior risk-adjusted returns. Some examples of other strategies may include venture capital, growth equity, infrastructure and biotech. Given the number of funds that Credit Suisse reviews each year, we believe that providing Credit Suisse with this added flexibility (subject to oversight and approval by the Division) will help to improve the portfolio's returns by providing access to smaller private equity funds in a broader variety of strategies other than leveraged buyouts.

CS/NJDI Emerging Opportunities Fund II, L.P. is a separate account that will make commitments in small and/or "emerging" buyout and venture capital funds. The Division approved the original investment in January 2007, mandating $100 million over a 1 year investment period. Credit Suisse has successfully implemented its mandate into 10 funds spanning 2 vintage years. Division staff spent a significant amount of time researching this segment in 2006 in order to gain a better understanding of the market for small and emerging private equity funds. It is important to reiterate some of our observations:

- Smaller capitalized funds have outperformed larger funds, on an IRR basis, over the past 10, 15 and 20-year time periods.
- Such performance is likely to continue due to attractive market fundamentals at the smaller end of the private equity market, which is more fragmented, offers more favorable entry multiples, greater opportunity for multiple expansion and consolidation as well as greater exit opportunities.
- A portfolio with an allocation to small/emerging managers allows an institutional investor to benefit from commitments to small/emerging funds, allowing for portfolio diversification through exposure to deal flow not generally targeted by larger private equity funds.

The Division is recommending an additional allocation of $100 million to CS/NJDI Emerging Opportunities Fund II to continue implementing their mandate with small and emerging managers.

NJHL European Buyout Investment Fund III, L.P. – this separate account was established with Hamilton Lane to explicitly invest in large International Corporate Finance/ Buyout funds with significant investment exposure to European based companies. In August 2005 New Jersey approved the first mandate focusing primarily on the larger buyout market defined as funds over $1 billion in size. In November 2006 New Jersey allocated an additional tranche of $200 million to continue executing on the same strategy. Overall the Division staff continues to be extremely pleased with the level of diligence and client service provided by Hamilton Lane. Furthermore, we believe continued exposure to European private equity funds is critical for diversification purposes as well as obtaining an appropriate risk adjusted return on the Division's investment portfolio. Hamilton Lane has implemented those mandates, providing New Jersey with commitments to approximately 9 funds spanning 3 vintage years.

The Division is recommending an additional allocation of $200 million to NJHL European Buyout Investment Fund III.

AnaCap Financial Partners Fund II - AnaCap is a United Kingdom based middle market buyout fund. The fund's investment strategy is to acquire or create and actively work with management teams of small to medium sized European financial services platforms, utilizing the team's experience in financial and risk management techniques together with AnaCap's well established operational processes. Many of the businesses targeted by AnaCap are characterized by underlying assets with predictable and/or annuity-like cash flows. AnaCap will be New Jersey's first direct investment in a private equity fund based in the UK. NJDOI has invested in AnaCap I via the European small-mid market buyout separate account managed by Goldman Sachs. One rationale behind our separate account mandates was for New Jersey to eventually invest directly with select GPs once a level of knowledge, resources and comfort are gained with underlying managers in the program. Our recommended investment in AnaCap also includes a 5% ownership stake in the management company.

For all of our recommended private equity investments, management fees are reasonable, and all the legal and economic terms associated with the partnerships are fair and consistent with market standards.

A formal written due diligence report for these proposed investments were sent to each member of the Investment Policy Committee of the Council on March 7, 2008, and a meeting of the Committee was held on March 12, 2008. In addition to the formal written due diligence reports, all other information obtained by the Division on these investments was made available to the Investment Policy Committee.

After review of the extensive due diligence, the Investment Policy Committee of the Council decided to report on the proposed investments to the full Council pursuant to Step 3 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern each investment. In addition, each proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with one or more of those general partners.

We look forward to discussing the proposed private equity investments at the Council's March 20, 2008 meeting.

WGC: cpp
Attachment