

**A FAILURE BY ANY MEASURE:
The State Investment Council's New Mexico Private Equity Program**

An Investigative Report for The Rio Grande Foundation
by Jim Scarantino

Is the State Investment Council's New Mexico private equity program a success or failure? With fifteen years experience and \$378 million invested, it's time we knew the answer. Unfortunately for taxpayers, the truth isn't pretty.

The program is losing money. The number of jobs claimed to have been created is overstated. Only about 1,000 jobs in New Mexico today can be credited to the program. Those jobs were created at a staggering price tag of over \$378,000 each.

A Private Equity Primer

In managing the billions of dollars under its care, the State Investment Council (SIC) also dabbles in private equity in New Mexico. Private equity, also known as venture capital, is investing by purchasing an ownership position or debt that can be converted to equity in start-up companies. These are high risk investments. Most are expected to and do fail, but a few home runs will hopefully make the program pay off.

The SIC has invested about \$378 million in New Mexico venture capital. In 2003, the Legislature, at Governor Richardson's urging, changed the law to permit the SIC to invest directly into New Mexico companies. The SIC may also place a venture capital bet through a fund manager, which is the most frequent way the SIC has made private equity investments.

Good Reasons to Ask Hard Questions

In a previous report¹, we focused on a company that had pledged to create 200 jobs in Santa Teresa and then received a \$9 million convertible loan from the State Investment Council. That company, Earthstone International, never built the plant but got the money anyway, five years ago. No one bothered to look into their failure to create those jobs until we at the Rio Grande Foundation started asking around. In the course of that investigation we concluded that whereas Earthstone once claimed to have thirty-three employees in Santa Fe, it now has fewer than a dozen full-time employees in New Mexico. When we brought this to the SIC's attention, we were assured by Earthstone that was not the case. However, during a tour of the Earthstone facility, we asked its founder how many employees it really had, and he confirmed it had less than a dozen.

¹ "The \$9 Million Loan to Earthstone International, or, A Funny Thing Happened On The Way To Santa Teresa, March 26, 2009.

Furthermore, in another report², we showed how a company described in the 2007 SIC annual report as a New Mexico company receiving state investment was actually owned by an Arabian bank.

These two errors in the SIC's own information about its investments led us to be skeptical of everything else the public has been told about the SIC's track record, so we started digging.

Since When Is Losing Money Proof Of Success?

"We're very happy with how the program is progressing and what it's accomplishing," the SIC's public information officer, Charles Wollman, told *The New Mexico Business Journal* in the summer of 2008. The SIC's private equity program was "doing exactly what the governor and the Legislature set out to do."

But the report by Sun Mountain Capital, which manages the SIC's private equity investment program, shows that the SIC has been running an 8.3% *loss* over the past fifteen years. That loss was calculated as of September 30, 2008, before Eclipse Aviation entered bankruptcy and dismissed its 1,100 employees and before market declines wreaked even more havoc with the portfolio. The second largest position and third largest employer in the SIC's New Mexico private equity portfolio, Advent Solar, laid off nearly half of its workforce later in 2008.³

Of the 28 venture capital funds into which the SIC has invested since 1993, only 5 have shown any positive returns. Sixteen of the funds report negative results as high as 22.5%. Seven funds have yet to report any results.

The portfolio's largest return of 44.8% came fifteen years ago on its smallest investment of only \$1.2 million. In contrast, its largest pool of investments, a commitment of \$62 million, shows a 21.3% loss.

Venture capital investments take time to prove themselves. Bad bets frequently prove their worthlessness before winners take shape. The sweeter fruit, as venture capitalists say, takes longer to ripen. Sun Mountain's report explains that for the first half of the average 10-year life of a private equity fund, capital is drawn down, producing negative returns. The next five years of the fund's life are when capital should be returned to investors. This phenomenon is plotted as "J" curve, showing declines followed by steeply positive returns.

Even measured against that theory, the SIC's private equity portfolio shows mostly prolonged failures. Twenty-one of the investments are old enough that they should either have been closed out or have swung into their upward phase of positive returns. But only five of the older funds show positive returns, and minor returns, at that. With the exception of a significant return of 44.8% on a \$1.2 million investment in 1993, as mentioned above, the other returns are modest to poor, ranging

² "Nothing To Smile About: New Mexico's Curious Investment In Small Smiles Dental Clinics," January 12, 2009.

³ And trouble looms for the second largest employer in the Sun Mountain's list of companies, MicroOpticalDevices. This company received a small SIC investment fifteen years ago and is now a division of Emcore, a fiber-optics and photovoltaic manufacturer. In its 2008 year-end disclosure to the NASDAQ stock exchange, Emcore expressed "substantial doubt about the company's ability to continue as a going concern." Since commencing operations in 1984, Emcore has accumulated deficits of nearly \$425 million.

from the highest at 9.9% to a low of a mere 2.7%. To put this into perspective, similar and better returns could have been achieved with much less risk by investing in many mutual stock and bond funds available to small investors.

The SIC frequently justifies losing money in bad investments as necessary to create jobs. So we next ask: (1) how many jobs has the SIC's New Mexico venture capital program really created, and (2) what has been the cost to taxpayers of creating those jobs?

Jobs MIA

Sun Mountain Capital report to the SIC claims that, as of September 30, 2008, 2,994 jobs existed in New Mexico due to the SIC's private equity investments. In answer to an e-mail inquiry, Brian Birk, Sun Mountain's managing partner, explained that this figure was calculated by surveying the firms that had received SIC venture capital. The survey was limited to firms that were still in business and had not moved operations out of New Mexico. Several companies have received millions of dollars, only to shortly afterwards leave New Mexico⁴.

We asked Sun Mountain to release its company-by-company tally of the jobs created in each of the 54 companies in its report. It declined, saying only that it was "confident" of the accuracy of its numbers.

Instead of taking Sun Mountain Capital's word on the number of jobs created by the SIC's New Mexico \$370 million private equity program, the Rio Grande Foundation conducted its own tally of every company listed in the Sun Mountain Report by consulting industry sources, newspaper reports and other on-line resources. When we could find no information on a company's payroll, we made a site visit. That was only necessary for a few of the very smallest companies still housed at one address at a venture capital incubator building on the edge of downtown Albuquerque. When we encountered two or more reports giving conflicting accounts of a firm's employment, we credited that company with the higher number. In some instances, we were able to verify our calculations with an investor in several of the companies. We excluded from the count all firms that had moved out of state, were owned by out-of-state investors, or had headquarters outside New Mexico since they could not longer be legitimately considered a "New Mexico company."

Our research found that less than 2,200 jobs in the New Mexico companies listed on the Sun Mountain report as of September 30, 2008, could be independently verified. That's almost 800 fewer than claimed in the report prepared for the SIC.

We may have missed a few employees here and there. But are there 800 jobs out there that we, the media and industry sources cannot locate? Not likely. Half of the total jobs were in one company, and no other company came close in payroll. The largest employer on the list at the time was

⁴Mr. Birk did not identify any of these firms in his e-mail, but they can be identified from news reports and industry sources. For instance, Seclarity, received a \$6.7 million commitment from the SIC and then moved to California. Another example is Protalex, which moved to Pennsylvania shortly after receiving an investment under the SIC's New Mexico private equity program. A national low-income dental chain named Small Smiles received an investment under the SIC's New Mexico private equity program but was removed from the list as the result of a report by The Rio Grande Foundation showing it to be not a New Mexico company, but a company owned by a bank in the nation of Bahrain. That \$550,000 investment has simply been scratched from the New Mexico private equity investment program, but should be added to the losses computed by Sun Mountain since it is unlikely to ever pay off.

Eclipse Aviation. It had publicly reported 1,100 employees during the summer of 2008. Most of the companies had fewer than 50 employees. A significant number had fewer than ten employees, and several had none.

More Reasons to Question the Numbers

While Sun Mountain declined to release its company-by-company tally, we have obtained a breakdown conducted by Fort Washington Advisors, its predecessor in managing the New Mexico private equity portfolio. This tally was completed in October 2005. It calculated a total of only 1,138 jobs generated from the SIC New Mexico private equity program. For Sun Mountain's numbers to be accurate, the private equity portfolio companies would have to have created 1,856 more jobs in under two years to reach Sun Mountain's number of 2,994. This is highly unlikely, even considering that more companies received venture capital during that time. Those companies, by definition, were start-ups with very small or no payrolls. None of them had the large payroll that would be needed to create more than twice the number of jobs that the SIC's private equity program had created in the preceding decade. Also, during that time, some of the SIC's private equity companies folded, left the state, or contracted.

An internal SIC e-mail obtained in a public documents inspection on another investigation by the Rio Grande Foundation attributes even fewer jobs to the New Mexico private equity investment program. That e-mail, dated January 23, 2007, attributes only 685 jobs to the program. It qualifies the count by stating it does not "track" the "ramping up" of employment at Eclipse and Advent Solar. Those two companies, once "ramped up" added 1,100 and 146 jobs respectively. That would bring the total to just 1,931 jobs or 1,063 fewer than Sun Mountain reported.

A May 12, 2009 Performance Briefing prepared by Susan Fleischmann, policy analyst for the Legislative Finance Committee, reported even fewer jobs than counted in this report. That document states that only 1,370 jobs were created by the SIC's direct equity program from 2007 to 2009.

The SIC's Very Expensive Job Creation Program

How much have New Mexico taxpayers paid to create jobs through the SIC's New Mexico private equity program? First, let's look at Sun Mountain's jobs figure.⁵

According to Sun Mountain, the amount committed to SIC's private equity program is \$378.65 million. If we divide that by the number of jobs claimed, 2,994, we get \$126,470 per job.

This calculation includes 1,100 Eclipse jobs that have since disappeared. Eclipse was a highly speculative investment from day one. Many aviation experts predicted its failure years ago. In other words, those jobs were never here to stay.

Let's remove Eclipse from the equation. We can also deduct the lost Eclipse jobs from the 2,200 jobs we were able to verify, instead of the unverified number in the Sun Mountain report. We will also deduct the layoffs at Advent Solar. There have been reductions in payroll at more of the

⁵If the program had been showing a positive return, the cost of creating each job could be offset by the profits from the investment. There are, however, no profits, but a negative 8.3% performance over the past fifteen years.

companies into which the SIC has invested, but we won't factor them in. These adjustments to reflect current employment levels produce an astounding result: Only about 1,000 jobs can today be credited to the SIC's New Mexico venture capital program. The cost of creating each of those jobs comes to approximately \$378,000!⁶

One last number is worth noting. Sun Mountain says the average salary of each job was \$59,160. Using Sun Mountain's numbers or the research conducted by the Rio Grande Foundation, the cost to the taxpayers of creating each job far exceeded the average wage of those jobs.

Back to the question with which we began this report: Is New Mexico's private equity program a success or a failure? The numbers speak for themselves: negative returns, fewer jobs than expected, and an exorbitant cost for each permanent job created. This program has been a major league loser for taxpayers.

The Legislature should conduct its own study by demanding that the actual payrolls records of the benefited companies be examined. Instead of taking the word of the companies who have gotten public dollars—as reported to us by the fund manager who also benefits by a continuation of this program—taxpayers should know exactly what economic benefit has been created for the state in return for the \$378 million they have sunk into this program.

⁶This is calculated using the amount of money the SIC has committed divided by the number of verifiable jobs existing today that can be attributed to that program.