

**Confidential**



**Venture Capital Evaluation**  
**Sterling Venture Partners II, L.P.**

**TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS  
VENTURE CAPITAL PARTNERSHIP EVALUATION**

**STERLING VENTURE PARTNERS II, L.P.**

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**TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS  
VENTURE CAPITAL PARTNERSHIP EVALUATION  
STERLING VENTURE PARTNERS II, L.P.**

**Introduction**

The Teachers' Retirement System of the State of Illinois ("TRS") Annual Tactical Plan identified venture capital as an area of interest for the 2005 fiscal year. TRS Staff has been monitoring venture capital fund formation and believes that Sterling Venture Partners II, L.P. ("Fund II") is an attractive investment opportunity.

**Evaluation Process**

TRS Staff met with Sterling Venture Partners ("Sterling") in Springfield on April 13, 2004. The Private Placement Memorandum and Private Equity Manager Questionnaire materials were reviewed in detail. A supplemental question list was sent to Sterling, and the supplemental questions were addressed during a meeting conducted in Sterling's Chicago office on Tuesday, May 18, 2004.

**Findings**

TRS Staff believes that Sterling Venture Partners II, L.P. is an attractive investment opportunity given that:

- A commitment to Fund II will help fill the late-stage venture capital allocation and will help the System move closer to reaching the 35% allocation for venture capital. Approximately 80% of the commitments to late-stage venture capital have been invested and new commitments will need to be made to reach the 10% target for late-stage venture capital.
- The Principals are an experienced group of individuals who collectively have more than 50 years of operating, managerial, and investment experience in healthcare, business services, education, and industrial technology investments.

Taking into consideration the TRS strategic and tactical plans, as well the evaluation of Sterling as a venture capital manager, TRS Staff recommends that the System make a commitment to Sterling Venture Partners II, L.P. of \$25 million. The recommendation is subject to review and approval of the partnership documents by TRS legal counsel.

**Investment Strategy**

Sterling will make investments in expansion stage and growth capital investments. The investment philosophy behind the strategy is founded on deep industry knowledge and specialization, and a disciplined process that has effectively been used to source and create investment opportunities, conduct thorough due diligence, develop strong relationships with management teams, and generate profitable realizations. There are four key principles that Sterling strictly adheres to when seeking out new investment opportunities:

- **Sterling only invests in what they know.** The three Principals collectively have over 50 years of operating, managerial, and investment experience in the core industries that Fund II will target for investments (Healthcare Services and IT, Business Services, Education, Testing, and Training, and Industrial Technology/Clean Technology).
- **Sterling applies rigorous criteria to each of its investment opportunities.** Sterling places emphasis on strong management teams with a proven track record, companies with a defensible competitive advantage, a recurring revenue stream, and leverageable operating model, diversified customer base, attractive underlying fundamentals, and fragmented markets.
- **Sterling is actively involved with the portfolio companies.** Central to Sterling's successful investment oversight and management is the Business Value Accelerator ("BVA") methodology. Developed and practiced over Sterling's twenty-year investment history, BVA is a methodology by which the firm becomes actively involved in its investments, adding value at multiple stages of a company's development.
- **Sterling critically evaluates the performance of the portfolio companies and makes adjustments as necessary.** Sterling has developed a proprietary management assessment and executive development tool that gives it better insight into the capabilities, fit, and potential of prospective managers. Sterling has a dedicated Human Resources executive who oversees the development of these tools and identifies executive talent.

#### *Industry, Geography and Other Diversification*

- Expansion and growth capital investments will comprise 100% of Fund II.
- Fund II will be diversified by industry sector.
- All of Fund II's investments will be located in the U.S.

#### **Transaction Sourcing**

Sterling has significant expertise in healthcare, business services, educations, and industrial technology. This expertise and knowledge allows Sterling to identify emerging trends, target investment opportunities that are poised to benefit from industry changes, and position portfolio companies to take advantage of these evolving market dynamics. In Fund I, approximately 40% of the investments were derived from long-standing relationships from the Principals' operating backgrounds.

## **Investment and Portfolio Management Process**

### *Decision Process*

The investment decision is subject to the unanimous approval of all three Principals of Sterling. Investment can be declined at any time due to any issues raised during the investment decision-making process.

### *Due Diligence*

Prior to an investment being made, Sterling completes a rigorous investigation of the target company. The process includes a thorough examination of the prospective portfolio company, including its management (including third party assessment, background checks, and reference calls), internal systems, financial statements and forecasts, customer and supplier relationships, and sales and marketing strategies. Sterling also considers a number of external factors, typically including the industry and competitive dynamics, existing and prospective strategic relationships, technological developments, regulatory considerations, the total addressable market size, and exit opportunities.

### *Active Management*

All of the portfolio companies benefit from active management. The BVA process is customized for each company's competitive position, operating structure, and industry segment, and guides a series of activities that are developed within a predefined framework. During the due diligence process, a company's strengths and weaknesses are investigated and assessed so that an action plan for optimizing results may be developed prior to the transaction closing. Sterling shares the due diligence results with the management team post-closing, and collaborates with them to implement the action plan.

### *Monitoring*

In Fund I, Sterling is on the Board of Directors of 17 of the 19 portfolio companies. Sterling anticipates having a Board seat on all of Fund II's investments.

### *Exit*

Prior to making an investment, Sterling identifies multiple exit scenarios for the company. Sterling then assists in crafting the company's strategy with the probable outcomes in mind. When the company's performance and market conditions indicate the time is appropriate, Sterling works with management to best utilize its extensive network of likely buyers, investment bankers, and other agents to identify the most probable exit. After an exit vehicle is selected, Sterling remains actively involved in all aspects of the process to drive the most successful outcome. Sterling has experience developing high-value exit strategies for companies through both sales and public offerings.

## Organization and Management Team

Sterling was formed by the Principals of Sterling Capital, Ltd., a private equity firm founded in 1983. Through 1999, Sterling Capital, Ltd. raised capital for its investments on a deal-by-deal basis. The following year, the firm began its transition to an institutionally-focused, fund-based investment model with the sponsorship of Sterling Venture Partners I, a \$135 million venture capital fund raised in 2000, which was followed by Sterling Capital Partners, a \$316 million middle-market buyout fund raised in 2002.

### *Sterling Investment Professionals*

Sterling has a total staff of 11 full-time people, as seen in the following chart. Please refer to *Appendix A* for biographies of key professionals.

Position	Total
Managing Directors	3
Investment Professionals	4
Administrative	4
Total	11

## Historical Performance

Fund I is a vintage year 2000 fund with \$135 million in commitments. There have been seven partial or full liquidations and there were two successful exits in 2003. Of the remaining ten portfolio companies, nine will be cash flow positive in 2004.

## Terms and Conditions Summary

Fund Size	Targeting \$200,000,000 of commitments
Management Fee	2.25% on commitments
Profits Allocation	80% Limited Partners, 20% General Partner
Hurdle Rate	N/A
Clawback Provision	Yes
Term of Partnership	10 years, with three one-year extensions
Investment Period	Six years, subject to expenses, management fees, and a reserve for follow-on investments
Minimum Investment	\$5 million, subject to GP's discretion
Draw-down Notice	Minimum ten days prior notice
Organizational Expenses	\$750,000
LP Advisory Board	Yes
Third Party Fees Paid	There are no third party fees being paid with respect to an investment by TRS
GP Investment	2% of the total commitments

The GP is planning on having a first closing in September 2004 on commitments of \$85 million.

## **Key Concerns**

### *Sterling Venture Partners II, L.P. Concerns*

- Performance of Fund I: Fund I has a gross IRR of -15%. Fund I is a vintage year 2000 venture capital fund. The performance of vintage year 2000 venture capital funds has struggled. Fund I would be near or in the top quartile of all venture capital funds raised in 2000. The Principals believe Fund I will end up with a mid-teens IRR and a multiple on invested capital of 2.0x. TRS Staff believes the investment team has the right strategy to produce top quartile returns for Fund II.

## **Legal Review**

Staff asked Gardner Carton to review the proposed documentation associated with the Sterling investment opportunity. Gardner Carton is working with Sterling's legal counsel in finalizing the language for the legal documents.

## **Summary**

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## Sterling Professional Staffing and Biographies

### Managing Directors

#### **Eric D. Becker**

Mr. Becker is a co-founder of Sterling Venture Partners and is a member of the General Partner of Fund I and Fund II. Mr. Becker has 20 years of experience building and operating, as well as investing in, more than 30 companies. He has served as a investor, founder, CEO, and director. Mr. Becker has coached CEOs, structured transactions, and advised on strategic planning and board development.

He attended the University of Chicago.

#### **Michael G. Bronfien**

Mr. Bronfien is a co-founder of Sterling Venture Partners and is a member of the General Partner of Fund I and Fund II. Prior to joining Sterling, Mr. Bronfien served as Chairman, President, CEO, and co-founder of NeighborCare (NASDAQ: NCRX). Started as a single drugstore, under Michael's leadership, NeighborCare grew to become a leading national specialty distributor and provider of pharmaceutical services to the long-term care and managed care industries.

He received a B.S. in Accounting from the University of Baltimore and is a CPA.

#### **Daniel W. Rosenberg**

Mr. Rosenberg is a co-founder of Sterling Venture Partners. Prior to joining Sterling, Mr. Rosenberg was an investment banker at Vector Securities International, where he focused primarily on transactions in healthcare services and medical device companies. Prior to Vector, Mr. Rosenberg was a Vice President of acquisitions at Heitman Financial where he was responsible for the acquisition and asset management of more than \$250 million of commercial real estate.

He received his B.A. from Duke University and a M.B.A. from Northwestern University's Kellogg School of Management.