



PSERS PRIVATE INVESTMENT PROGRAM

**Recommendation for Investment in
Psilos Group Partners III, L.P.**

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Psilos Group Partners III, L.P.

INTRODUCTION

Psilos Group Partners III, L.P. is a \$250 million offering to pursue early, mid-stage and later-stage opportunities across the entire healthcare spectrum. Psilos takes a “systems” view of the healthcare industry since sustainable business solutions in the healthcare sector require a coordinated understanding of all operating and financial aspects of the dislocations in the healthcare industry. Thus, Psilos invests in all relevant healthcare sectors, including services, information technology, medical devices, drug development and drug delivery, and instrumentation. Psilos III held an initial closing on September 30, 2005 primarily with existing investors and has made three investments.

Psilos Group was founded in 1998 by Dr. Albert Waxman, a long-time healthcare entrepreneur and founder/CEO of several successful companies including Diasonics and American Biodyne/Merit Behavioral Care (“MBC”), and Stephen Krupa, formerly a healthcare investment banker at Wasserstein Perella & Co. The two had previously worked together in the management and financing of several healthcare companies, culminating in the sale of MBC to Magellan Health Services for \$800 million in 1998. Together with Jeffrey Krauss, previously a general partner at healthcare venture fund Nazem & Company, and a team of five additional healthcare operating and finance executives—Lisa Suennen, David Eichler, Joseph Riley, Darlene Collins and Warren Van der Waag—the Psilos team deploys a highly disciplined, operationally-oriented approach. The Psilos team came together during the period 1998-2000 and has worked together as a cohesive unit since 2000 with several professional relationships dating back 10-16 years. All Psilos team members have ownership in Psilos I, II and III.

Psilos III will follow the same proven investment strategy employed in Psilos’ prior investment activities. Investment themes developed by the team stem from a deep understanding of particular healthcare dynamics and broad trends that present exceptional market opportunities for investment. Specifically, the conditions that are impacting the cost increases in healthcare require integrated entrepreneurial solutions to improve both the quality and efficiency in the healthcare system.

BUSINESS STRATEGY

Key elements of the Fund’s strategy include the following:

1. **Strong, Cohesive, Experienced Team** – Led by Dr. Albert Waxman, who originally conceived Psilos’ investing strategy, Psilos III will be managed by a team of eight professionals of which seven have worked together as a cohesive unit at Psilos for six years and together in the healthcare industry for up to 16 years. Psilos’ team members bring extensive experience in healthcare operations, finance, sales, and business development and have worked closely together through the deployment of two successful venture funds.
2. **Focus on Healthcare as a “System”** – The need to vastly improve the U.S. healthcare system has been well documented but poorly addressed, largely as a result of a non-integrated approach to problem solving. Positive change requires a recognition of the inter-relationships of all aspects of the healthcare delivery system, and particularly the alignment of incentives within the system. Psilos has developed a unique investment thesis to deploy capital around businesses that fundamentally accelerate and benefit from the alignment of payer, patient and

provider incentives. To support this objective, Psilos seeks opportunities that demonstrate many or all of the following characteristics: (1) empower and involve consumers of care; (2) address diseases of aging as a long-term endeavor; (3) remove barriers to data and information; (4) provide physicians with clinical information to drive care management; (5) recognize the role of cost as part of outcome; and (6) build upon next generation technology (whether in medical devices, information technology or medical technology) to achieve these objectives.

3. **Business Perspective on Healthcare Investing** - The Psilos team analyzes investment opportunities from an overall business perspective rather than one that is dependent on the specific allure of new medical or scientific advances. Psilos looks beyond scientific advances to ensure that the investment opportunity has the potential to evolve beyond an idea and into an operating business that will create substantial capital appreciation for the Fund.
4. **Market Innovation and Deal Origination Capability** - Psilos has been at the forefront of the development of several key market trends in the healthcare services field. It has identified business opportunities and originated transactions that have set the stage for sweeping innovations. Psilos was a founding investor in the new market areas of evidence-based medicine (Active Health) and consumer-driven health insurance (Definity Health) at a time when other healthcare operators and investors did not recognize the potential for cost savings and commensurate improvement in care. Strong industry contacts and extensive direct operating experience should continue to lead to the identification of excellent investments, and to the development of the next generation of market leading companies in the healthcare sector
5. **Proactive, Hands-On Investment Management Model** - Psilos professionals have extensive entrepreneurial, operating and financial expertise. This enables the team to support the management teams of portfolio companies as strategic advisors, consultants and partners. Working hand-in-hand with management, serving as partners with tightly aligned objectives, and actively participating throughout each portfolio company's life creates value and builds excellent, sustainable, high-growth businesses.

Investment Process – Psilos has developed an investment process that leverages the experience and skill sets of the Managers. This process focuses on:

Sourcing of Investments — The investment professionals' broad industry contacts and backgrounds in the healthcare communities on both coasts facilitate the origination of a steady stream of high quality, highly targeted investment opportunities. As Psilos has established itself as a specialty healthcare and medical technology venture capital firm, it has seen an increase in the volume and quality of transaction flow from interactions with industry leaders, entrepreneurs, board members, portfolio company managers, consultants, strategic partners and investment bankers. Psilos has made a point of building strong financing syndicate partnerships and close ties to early stage venture funds to amplify deal flow in target investment areas. Psilos also maintains close ties to industry and medical leaders to ensure that deal flow relates specifically to those areas that interest potential strategic investors and acquirers. Because of its history in the healthcare field, as a firm and as individuals, Psilos often gets an early look at the most sought-after deals, and now reviews hundreds of business plans per year.

Due Diligence — To ensure that each target investment meets its requirements and has the best opportunity to prosper, Psilos actively investigates management experience and commitment; sustainability of technology advantages and breadth of intellectual property; reimbursement and regulatory risks and opportunities; existing and potential customer, distributor, subcontractor and supplier relationships; operational models, capacity and scalability; and soundness of economic models and financial plans. The team takes a highly disciplined approach to this analysis to validate company claims and market realities against its own investment criteria in order to minimize the risks inherent in each potential investment. Ultimately, Psilos is looking for companies who have the uniqueness of idea, size of addressable market, sustainable competitive advantage, quality of management team and ability to execute upon the proposed strategic, operational and financial plan and, therefore, can establish the framework to generate substantial returns.

Structuring Investments and Ongoing Governance — Investments are structured with the goal of providing the portfolio company with adequate capital to grow and realize substantial value-creation prior to a subsequent round of financing or exit. Psilos seeks to acquire significant or controlling holdings in order to be in a position to influence the operational, strategic and financial objectives of portfolio companies, and anticipates supporting these companies throughout their entire private company life cycle. As large shareholders, Psilos generally requires a seat on the company's board of directors, and typically retains the right to approve major material transactions and strategic initiatives. To maximize value and minimize risk, Psilos also generally seeks certain favorable investment terms such as liquidation preferences, redemption rights, registration rights and rights to participate in follow-on financings, as applicable.

Ongoing Portfolio Monitoring — Psilos has implemented a methodology by which all portfolio companies are monitored with a view towards actively creating value in anticipation of ultimate exit. These procedures include: (i) frequent monitoring of the performance of each portfolio company by the same investment professional who initiated the original investment; (ii) following the industry sectors and tracking other participants in these sectors; (iii) creating strategic relationships among portfolio companies for sharing of information, technology and ideas; (iv) active Board participation; and (v) reviewing each portfolio company's progress with all Psilos professionals at weekly staff meetings.

Creating Strategic Value Post Investment — Psilos' investment professionals have established an outstanding reputation for mentoring portfolio companies, making Psilos a preferred investor. A key advantage of Psilos is the extensive operating experience of Psilos' investment professionals in numerous healthcare companies. These operational, financial and managerial skills have made Psilos a better partner that has the ability to provide true value when companies inevitably face challenges in their development. Once an investment is made, Psilos views itself as a partner with management in developing the strategic direction and execution of the business plan. The team assists by helping to recruit top quality management, directors and advisors; providing access to relationships with key product suppliers, customers and strategic partners; providing hands-on assistance with acquisitions, joint ventures and marketing alliances; and offering guidance and leadership with respect to ongoing capital formation strategies and exit planning.

Exit Strategy — Psilos will seek to realize on Fund investments primarily through sales to strategic and financial buyers and through initial public offerings. Psilos strives to

minimize the risk profile of its investments while also ensuring that considerable value creation is achieved.

KEY PERSONNEL

One of Psilos' key strengths is the quality, cohesiveness and the healthcare operating and financial experience of its team.

Albert S. Waxman, Ph.D., 65, Senior Managing Member

Dr. Waxman was a co-founder of Psilos and has been recognized as one of the leading innovators in the healthcare field for three decades. Previously, he founded and was Chairman and CEO of two companies which became market leaders, completed successful IPOs and were ultimately acquired by large public corporations: Diasonics, Inc., one of the first medical companies to provide ultrasound and magnetic resonance imaging; and Merit Behavioral Care (previously known as American Biodyne), a managed mental healthcare company which now has over 30 million beneficiaries.

Dr. Waxman is Chairman and/or a director of several Psilos companies including: Comprehensive NeuroScience, HealthEdge Software, Health Hero Network, and Coordinated Care Solutions. He was the Chairman of both Definity Health and Active Health Management, both now exited. He focuses much of his time on building relationships among Psilos companies and leading Psilos' overall investment strategy.

Dr. Waxman earned a BS in Electrical Engineering from the City College of New York and both a MS and PhD in Electrical Engineering from Princeton University.

Stephen M. Krupa, 41, Managing Member

Mr. Krupa founded Psilos Group along with Dr. Waxman in 1998. Mr. Krupa advised Dr. Waxman on mergers and acquisitions while Dr. Waxman was Chairman and CEO of Merit Behavioral Care and Mr. Krupa was at Wasserstein Perella & Co. ("Wasserstein").

Mr. Krupa is currently a board member of: Comprehensive NeuroScience, HealthEdge Software, LesConcierges and Caregiver Services (for which he serves as Chairman). He was a director of HealthScribe and Active Health Management, both now exited. He serves as a general financial advisor to each of the Psilos portfolio companies and actively manages the execution of portfolio merger and acquisition activity. Prior to joining Wasserstein, Mr. Krupa was an associate at Kidder Peabody & Co. From 1987 through 1992, he worked for Johnson Controls Inc., first as a mechanical engineer and custom software applications developer, then as a manager of new business development.

Mr. Krupa earned a BS in Mechanical Engineering from the University of South Florida, where he was elected to Tau Beta Pi, and an MBA with Distinction from The Wharton School of the University of Pennsylvania, where he graduated a Palmer Scholar.

Jeffrey M. Krauss, 48, Managing Member

Mr. Krauss joined Psilos in early 2000. He currently serves on the Boards of VersaMed, Valera Pharmaceuticals, Cohesive Technologies, HealthEdge Software and OneShield.

Prior to Psilos, Mr. Krauss spent ten years at the healthcare venture capital firm of Nazem & Company ("Nazem") as a General Partner of three venture capital funds with \$250 million of capital commitments. While at Nazem, he specialized in healthcare services and healthcare information technology investments.

Prior to joining Nazem, Mr. Krauss was an attorney with the law firm of Simpson Thacher & Bartlett, where he specialized in venture capital transactions and worked extensively on transactions originated by KKR.

Mr. Krauss earned a BS in Accounting from the State University of New York at Albany, magna cum laude, and a JD from Harvard Law School, cum laude. He is also a Certified Public Accountant.

Lisa M. Suennen, 39, Managing Director

Ms. Suennen joined Psilos at its founding in 1998 to establish a West Coast presence. She has been actively involved in the development of two of Psilos' largest investments, Active Health and Definity Health. Ms. Suennen serves as a board member and/or board observer for AngioScore, InSound Medical, Estech, Definity Health (exited) and Health Hero Network.

Ms. Suennen joined Psilos after nine years as a senior executive at Merit Behavioral Care (formerly American Biodyne), an \$800 million national behavioral healthcare company where she worked with Dr. Waxman. Prior to Merit, she served as worldwide PC product manager for INGRES, Inc., a relational database company; as Director of U.S. Market Development and Government Relations for X/Open, an international computer industry standards setting and lobbying consortium; and as Senior Account Manager at Regis McKenna, Inc., an international high technology marketing and public relations firm.

Ms. Suennen holds an MA in Political Science and a BA in Political Science and Mass Communications, all from the University of California, Berkeley. Ms. Suennen is a daughter of Dr. Waxman.

David A. Eichler, 35, Managing Director

David Eichler joined Psilos in 1999, having worked previously with Mr. Krupa at Wasserstein. Mr. Eichler works directly with many Psilos investments as an advisor on finance, strategy and business development. Mr. Eichler currently serves on the Board of Directors of Acuity Pharmaceuticals, Caregiver Services, and LesConcierges, and actively participates as an observer on the Boards of Cohesive Technologies and QualityMetric.

Prior to Wasserstein, Mr. Eichler worked as a defense policy analyst for DynCorp, focusing on issues relating to nuclear nonproliferation and export control.

Mr. Eichler holds a BA in Government and International Relations from Cornell University, where he graduated magna cum laude, an MA in National Security Studies from Georgetown University, and an MBA from the Darden Graduate School of Business Administration at the University of Virginia, where he received the Faculty Award for Academic Excellence (top 10% of class).

Joseph R. Riley, 35, Managing Director and Chief Administrative Officer

Mr. Riley joined Psilos in 1998 and serves as its Chief Administrative Officer. His responsibilities include investor relations, financial reporting and cash and capital management. He also plays an instrumental role at Psilos in the evaluation of healthcare services and healthcare information technology investment opportunities.

Mr. Riley joined Psilos after spending six years at Price Waterhouse, LLP ("PW"), most recently as a manager in the Corporate Finance Group, where he advised clients on

mergers and acquisitions in the healthcare, manufacturing and food services industries. Previously, Mr. Riley spent three years as a senior accountant in the PW Audit and Business Advisory Services Group.

Mr. Riley earned an MBA from the Wharton School of the University of Pennsylvania and a BS in Accounting from Georgetown University, where he graduated magna cum laude. He is a Certified Public Accountant and a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants.

CONCLUSION/RECOMMENDATION

Based upon the successful track record and experience of the principals and the recommendation of PSERS' consultant, Portfolio Advisors, staff recommends that the Board invest an amount equal to 25 percent of the committed capital, but not to exceed \$62.5 million plus reasonable normal investment expenses, in Psilos Group Partners III, L.P. The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.