SSBCI | State Small Business Credit Initiative



Best Practices from Participating States: Venture Capital Programs

April 2014

Acknowledgements

This SSBCI Best Practices document resulted from many constructive discussions and editing sessions with volunteers directly involved in the implementation of SSBCI State Venture Capital Programs. SSBCI thanks the following members of the Venture Capital Working Group for their time and thought leadership in support of this project:

- Bill Anderson, Executive Director, Missouri Technology Corporation (Missouri)
- Steve Cohen, Deputy Commissioner, New York Empire State Development (New York)
- Kathleen Coviello, Director, Technology & Life Sciences Division, New Jersey Economic Development Authority (New Jersey)
- Tom Dann, Managing Director, Maryland Venture Fund (Maryland)
- Joe Edgar, Venture Capital Coordinator, J4T Venture Fund (Texas)
- Karl Fooks, President, Hawaii Strategic Development Corporation
- Chris Igielski, Chief Operating Officer, The W Fund (Washington]
- Scott Meacham, President & CEO, i2E (Oklahoma)
- Joe Morrison, Angel Fund Program Manager, Municipality of Anchorage, Alaska (Alaska)
- John Sider, Managing Director, Statewide Initiatives, Ben Franklin Technology Partners (Pennsylvania)

SSBCI also thanks the initiative's venture capital consultants, Eric Cromwell and Dan Schmisseur, for facilitating meetings and collecting perspectives. Finally, we express our gratitude to colleagues at the Department of the Treasury, Jeff Stout, Zakaria Shaikh, and Terry Valladares, for their assistance in producing this document.

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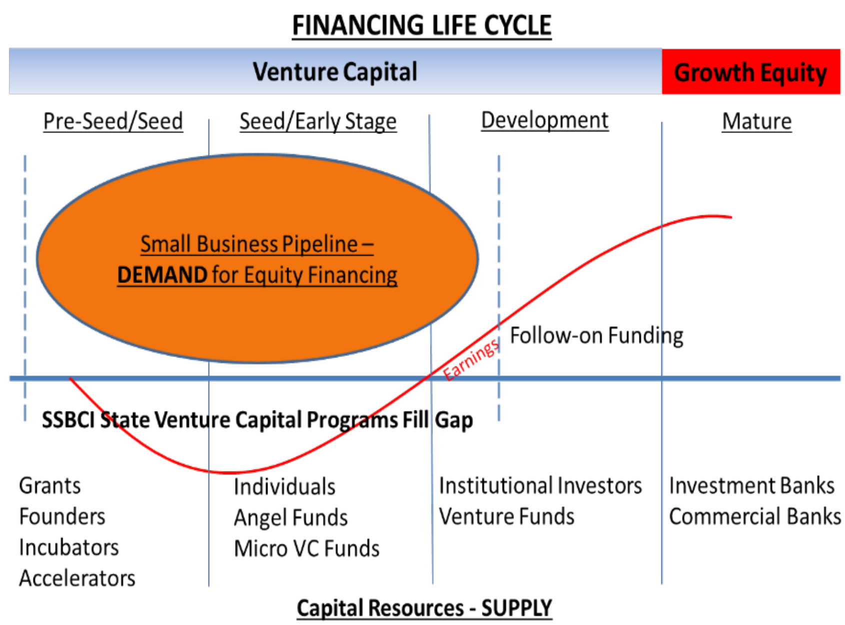
State Small Business Credit Initiative
Venture Capital Program Best Practices

Under the State Small Business Credit Initiative (SSBCI), thirty-three states received funding for a state venture capital (VC)[1] program. As summarized in the *Information and Observations Report* on state VC programs that Treasury published in the spring of 2013, these programs are an important part of a comprehensive economic development strategy to create jobs and long-term economic growth. Although some states previously operated VC programs with state appropriations, managers had little opportunity to learn from each other's experience. The allocation of SSBCI funds to state VC programs provides an opportunity to collect perspectives from a diverse group of professionals involved in this federal-state-private collaboration.

This paper compiles practical advice offered *by* program managers and *for* program managers. The paper aims to communicate best practices in an easy-to-read format for consideration and adaptation to local conditions.

A common motivation for states enacting VC programs is to address market inefficiencies in a region's "financing life cycle" or "capital continuum" for high-growth businesses. These terms refer to the financing needs of a small business through phases of company development, from pre-revenue to profit generation. In these phases, demand by small businesses for risk capital is likely to exceed the available supply.



State VC programs that follow best practices are designed to stimulate and support private investment over time, rather than fill a capital markets gap with public funding alone. Furthermore, programs that follow best practice are designed to address identified market imperfections, not to interfere in efficient markets where private capital resources are sufficient to meet demand.

[1] By "venture capital," we mean the sub-category of the private equity asset class that refers to equity or hybrid-equity financings primarily in young, high-growth potential, high-risk companies. This and other terms are defined in the Appendix.

CORE PRINCIPLES FOR STATE VC PROGRAMS

The Venture Capital Working Group members endorsed the "Principles of Well-Designed State VC Programs" in the *Information and Observations Report*. The working group emphasized five principles that apply to all state VC programs including those outside the SSBCI program:

1. **Venture capital programs to promote small business investing are most effective when integrated into the larger realm of economic development activity that enables and promotes the growth of small businesses, often called the "entrepreneurial ecosystem." This ecosystem includes factors such as sources of innovation, entrepreneurial talent, legal and financial expertise, as well as a risk capital industry.**

2. **Venture capital program managers must have a realistic understanding of the supply of and demand for equity-based financings.**

3. **The design of a venture capital program and its investment processes should align with industry norms for equity-based investing. To the extent possible, programs should avoid creating barriers that deter participation by credible private sector investors.**

4. **Venture capital programs require specialized expertise and adequate administrative resources -- talent and capital -- for successful implementation.**

5. **Equity-based small business financing programs require a long-term view of supporting small business investment and growth, a time horizon of several years.**

For this paper, best practice recommendations are organized in categories of *Program Design* and *Program Implementation*.

Program Design

Generally, state VC programs fit in one of three *capital deployment models*, categorized by the entity that makes the investment decisions: a state agency, a quasi-public authority, or one or more third-party investment managers. If a state selects more than one private investment manager to manage the investments, the program is called a "fund of funds." In designing a VC program, state leaders seek a model that works within local market conditions. State leaders must balance market needs (the demand for and supply of equity-based investment), the internal and external capacity and capability to manage a VC program, and the attributes of various capital deployment models.

Research and Assess Market Opportunities

- **Locate and assess third-party data on small business investment and entrepreneurial activity within the state and nationally.** Institutional research data should be analyzed and compared with studies, reports, and perspectives from in-state resources. Examples of institutional research include the Milken Institute Risk Capital / Entrepreneurial Infrastructure Composite, the PWC / NVCA MoneyTree® Report, and the HALO Report on angel investment activity.

- **Use a holistic approach to assessing small business financing gaps.** Gather input and feedback from the various players in the state's entrepreneurial ecosystem to understand the gaps from the perspectives of entrepreneurs, private investors, and Venture Development Organizations. The nexus of the collected perspectives will reveal areas where a state VC program can achieve the greatest impact.

- **Target the most underserved gap in the financing lifecycle that has the necessary volume of transactions to attract private investors over a period of time.** Targeting the early stage/start-up financing gap typically provides the greatest benefit to entrepreneurial ecosystems because it creates a pipeline of growth-oriented companies. If the program is based on solid underwriting and a portfolio approach to diversify program investments, focusing on this stage can also offer risk-adjusted financial returns to stakeholders.

Engage with Market Players

- **Reach out to program leaders in other states for information and advice.** This is especially beneficial when participating in a new federal program or when state leaders are considering a capital deployment model that is new to their state.

- **Collect market feedback by contacting industry / investment experts within the state.** Engaging in conversations with private investors and small business leaders to share information is more likely to result in a VC program that addresses market inefficiencies. Considering the design and implementation of different, but complementary, capital deployment models can be an effective approach for states to consider.

- **Engage with local stakeholders before determining your program's general structure.** Even a small number of information-gathering sessions with local partners and Technology-Based Economic Development leaders on program design can set a state on a better path to stimulating investment, facilitating program roll out, and enlisting broad support.

Determine the Appropriate Market Niche

- **<u>Size the amount of capital in the VC program appropriately.</u>** When a funding gap is identified, there can be a risk of providing too much capital too quickly. When launching a VC program, there are often several good investment opportunities that have managed to develop quality businesses despite the obstacles. However, once these companies are funded, the ecosystem may not produce other opportunities immediately. Rather than force too much investment into the target sector, VC program managers should reserve some funds to stimulate quality deal flow and participate in follow-on financings with private investors.

- **<u>Avoid investing in companies with significant revenues or in VC funds that specialize in such companies.</u>** It is difficult to make the case that these businesses or VC funds suffer from a market inefficiency requiring government intervention. (Unfortunately, there is no absolute revenue level for defining when a market inefficiency may exist.)

- **<u>A critical mass of credible investors should be identified that are prepared to finance the companies growing to the next stage.</u>** Understanding regional investors – who they are and their goals – is a critical factor in stimulating private financings and building private investment capacity.

- **<u>Focus on developing a portfolio of investments.</u>** If the VC program is a fund of funds program, a balanced portfolio of funds across industries and/or stages should be the target. If the program is a direct investment program, a balanced portfolio of companies should be the target. A key part of portfolio design is to understand that funds should be invested diligently over time and without pressure to invest funds too quickly or in too concentrated a fashion.

Assemble the Necessary Resources

- **<u>The decision to pursue a VC program, especially a direct investment program, should be based on whether qualified personnel can be hired and compensated for managing a portfolio over many years.</u>** Experience suggests that a VC program will succeed or fail based on the quality/capabilities of the investment manager(s).

- **<u>A state must be prepared to commit sufficient resources to make a VC program credible to the private investors it seeks to attract for co-investment and follow-on financings.</u>** The precise level will depend on the size of the program and local market conditions.

- **<u>Seek the guidance of qualified legal counsel for guidance on legal agreements and supporting documentation.</u>** Legal counsel should have specific experience and expertise in limited partner-backed venture fund structures.

Actively Manage Program Operations and Expectations for Program Outcomes

- **Keep it simple and don't build unnecessary complexity into an already complicated policy and program arena.** Venture investing has enough challenges to achieving comprehensive returns – defined as positive economic development and financial returns to government stakeholders. VC program managers should take care not to over-engineer the processes that may deter participation from credible investors or eligible small businesses.

- **Make generating an acceptable financial return the first priority of a state's investment portfolio.** To achieve the economic development objectives of the state, a VC program should address a perceived gap in the ecosystem and generate financial returns to investors. The most effective way to address a gap in the financing ecosystem is not to attempt to provide all the necessary funds through a state program, but rather to engage private investors and bridge the gap. Therefore, links to opportunities in the target sector should be created, along with links to the resources (both human and financial capital) that will support companies' continued growth.

- **Identify the amount of financial risk the state is willing to manage and understand the inherent uncertainty of private equity investing.** Venture investing involves a professional judgment of quantitative and qualitative factors about the how the early-stage company will respond to unforeseeable changes in the business environment. Not all deals in a due diligence pipeline can or should close. It is the nature of venture investing that that many companies that receive an investment based on careful evaluation will not deliver a financial return to the state despite best efforts.

- **Thoroughly review and understand compliance and reporting requirements for government-supported VC programs prior to making decisions on program design.** This is especially important when contracting with independent, private investment entities for fund management services. Both state representatives and third-party managers must understand the program compliance rules and who is responsible for documenting compliance.

- **Carefully consider whether commitments made by out-of-state VC funds to invest in-state can be achieved.** When launching a new program, a state VC program may be tempted to hire out-of-state fund managers or to invest in VC funds located out-of-state. In-state fund managers with the requisite expertise are typically better aligned with a state's economic development goals. Building capacity with a "homegrown" investor base that produces investments with a satisfactory financial return will do more to attract out-of-state investors than will the strategy of investing in out-of-state VC funds that promise to invest in-state.

Program Implementation

After the market needs have been identified and the capital deployment model selected, a program manager's focus shifts to effectively and efficiently overseeing the investment of capital.

Establish Professional Management and Professional Networks

- **Choose a program manager with the requisite background to build and manage the target portfolio.** This is an early, important task because adherence to a disciplined portfolio design will allow the program manager to manage risks. Venture investing is unlike commercial loan underwriting because the program manager has fewer objective characteristics for identifying good investments. **Venture investing is not about avoiding risks, but understanding and managing risks with the right people**.

- **Engage with the investor community early in the implementation phase so that angel investors and institutional investors are aware the investment program, its strategy, and its resources.** Similarly, it is important to engage with the entrepreneur and founder community to stimulate a pipeline of potential investments for evaluation.

- **Secure meaningful buy-in from regional ecosystem partners.** This can include universities, technology transfer entities, and other regional economic development organizations that can refer companies or co-investors to participate in the VC program.

- **Move beyond superficial relationships with ecosystem partners; assess and determine market gaps by actively maintaining and empowering the partners to drive successful implementation.** These partners can provide statewide support and help drive demand for the program while providing valuable feedback to fine tune areas that need improvement. Meaningful, lasting partnerships should be the goal, in which all partners contribute resources, receive benefits, and are mutually accountable.

Be Deliberate and Disciplined with a Business Strategy

- **Maintain consistent standards during the investment review and decision process with periodic evaluation of process efficiency and effectiveness.** This will help potential investees move through investment due diligence efficiently and hold state program staff accountable for managing the investment process.

- **Focus on investment opportunities that will be visible to the broader community and will provide opportunities to celebrate progress.** Venture investing is strongly influenced by a perception of momentum. It is important to find ways to communicate progress through early success stories.

- **<u>Understand that VC funds cannot always accept more capital at the moment the state VC program is ready to proceed.</u>** Utilizing a rolling application/review process to access the best available fund managers is important to building sustainable investment capacity.

- **<u>A state should conduct its own in-house due diligence on investment partners / managers.</u>** Outsourced due diligence is a supplement to, and not a replacement for, in-house review.

Focus on Achieving Both Business and Program Results

- **<u>Avoid creating process hurdles for low-value services.</u>** Some VC programs require a prospective investee to satisfactorily clear an organizational hurdle before moving on to underwriting, term sheet negotiation, investment approval, and closing. This administrative hand-off can create redundancies as potential investment prospects move from one point-of-contact to the next.

- **<u>Avoid the mentality that your agency / department / organization knows best.</u>** Learning how to work with the established private sector leaders will make a program successful. Inventing new, untested programs on speculation requires a great deal of resources to succeed.

- **<u>Communicate with staff of the state or its administering authority to address any potential implementation issues.</u>** Communications with administrative staff about program operations and compliance, especially in a question-and-answer format that creates a record of correspondence (e.g., email communications), can improve performance and mitigate risks.

- **<u>Manage expectations of financial results and program outcomes for the various stakeholder groups.</u>** Stakeholders include investees, investment partners, government leaders, and economic development entities in the state. The interests of each group may diverge at times, making communication and transparency about program outcomes important.

Definitions:

Capital Continuum or Financing Lifecycle – The financing lifecycle refers to the development phases that an early-stage company moves through from ideation to execution to growth and mature stages. The capital continuum refers to the associated sources of risk capital needed to finance development,

Hybrid-equity or Quasi-equity Financing – The most common form of a hybrid-equity investment is a short-term debt note that functions initially as a loan but then automatically converts into shares of stock upon a future event like an equity financing.

Private Equity Financing – The process of raising funds through the offering and sale of ownership interest (shares) in a business enterprise that is not listed on a public stock exchange.

Technology-Based Economic Development – An approach to economic development that focuses on improving the conditions for an innovation-based economy to grow and thrive. The drivers of a technology or innovation-based economy are considered to be a strong research and development base, a skilled workforce, an entrepreneurial culture and access to risk capital.

Venture Capital – A sub-category of the private equity asset class that refers to equity or hybrid-equity financings primarily in young, high-growth potential, high-risk companies.

Venture Capital Program/Capital Deployment Models implemented within SSBCI:

- **Direct Investment Funds** – state serves as fund manager to actively network with entrepreneurs, source deal flow, performing due diligence, assist in the recruitment of co-investors and possibly set terms
- **Co-investment Funds** – state invests with private sector investors in deals meeting certain requirements (the state's role is focused on compliance rather than actively performing subjective evaluations)
- **Fund-of-Funds** – state invests capital in more than one VC fund as a limited partner; each fund manages the full processes of investing in high-potential small businesses
- **Third Party Managed Funds** – state contracts with a single external firm to manage the full investment process, with a single fund structure that may or may not commingle private funds

Venture Development Organizations – A public or nonprofit organization that contributes to economic development by providing a portfolio of services, including: assisting in the creation of high-growth companies; providing expert business assistance to those companies; facilitating or making direct financial investments in companies; and speeding the commercialization of technology.[2]

[2] Regional Innovation Acceleration Network (RIAN)