Venture Capital

- Overview of Venture Capital
- Three Phases of Venture Capital Investing
- SBICs and SSBICs
- State Government Initiatives
- Community Development Venture Capital
- Key Challenges and Best Practices

Overview of Venture Capital

- New capital source developed after WWII to supply equity to high-growth early stage and technology-based businesses that needed large investments before becoming profitable
- Potential for large economic development impact due to its role in financing new technologies and industries, and growth firms
- Private partnerships invest funds from financial institutions. pensions, corporations, wealthy individuals, & endowments Some financial institutions and corporations set-up their own funds.
- 1998: 500+ VC funds had $50 billion & invested $13 billion.
  - With Internet boom, VC exploded to 635 funds that raised and invested over **$90 billion** in 2000!
  - By 2005, investments dropped to $21.7 billion-67% above 1998
- Multiple public and civic efforts to expand and target VC
  - Federal SBIC/SSBIC programs and new market tax credits.
  - 45 state initiatives via publicly managed funds, investment in private funds, or tax incentives to private investors.
  - Some regions and cities have created venture capital funds
  - Recent emergence of community development venture capital

Raising Investment Capital

- Need Long-term patient capital and far more capital than RLFs:
  - VC funds typical have 10-12 year life
  - Capital covers high management costs, lack of cash flow in early years, and follow-on investments.
- Pension funds are key investor: 40%+ of new annual capital
  - Fueled 240% increase in size of median VC partnership during 1990s
- Investors use incentives that tie compensation to returns and covenants in partnership agreements to influence managers
- ED-oriented venture capital funds use multiple capital sources:
  - General obligation bonds (CDFC)
  - Appropriations (Mass Technology Development Corp)
  - Dedicated revenues (Alaska Renewable Resource Corp)
  - Federal loans and grants (SBICs, Murex)
  - Public pension funds: (Michigan, Silicon Valley VF)
  - Local corporations and financial institutions :
  - Tax incentives for private investors (Kansas, CAPCOs)
- Organizational form and capital sources are inter-related:
  - Limited partnership is best to attract private and pension investors but precludes the reinvestment of gains
  - Quasi-public corporation allows reinvestment of gains and greater accountability for government funding

Venture Capital Investing

- VC investing involves extensive pre-investment due diligence, staging of investments, active monitoring of firms (frequent visits, board membership), and syndicating investments among funds
- Funds screen a large number of firms to make a small number or investments. Only 1 or 2 out of every hundred are funded.
- Active monitoring favors investing near the VC fund office while syndications allow funds to invest outside their region.
  - **Implies the need for both local capacity and strong ties to national VC network.**
- Growth in fund size has shifted private VCs from their historic role financing early stage companies to large transactions and later stage companies.
  - Average VC investment grew in real dollars from $3.2 million in early 1980s to over $11 million in late 1990s.
  - 2005: 6% of companies and 3% of invested dollars were in seed or start-up stage enterprises
- Investments are highly concentrated geographically (over half in CA, MA, and Texas) and by industry (80% in 4 industries)
- “Herding” by VC firms in which they over invest in a few hot industries and ignore others with strong growth prospects

Exiting Investments

- Exits convert illiquid investments to cash and realize returns
- Four ways to exit equity investments:
  - Initial public stock offering (IPO)--the most profitable exit
  - Acquisition of firm by another company
  - Buyback of stock by firm
  - Royalty or other debt-like payments
- A small number of investments generate super returns and account for the bulk of VC fund profits.
  - A large share (25% to 35%) fail and most investments provide very modest returns
- Exiting strategies & returns closely linked to IPO market
  - VC investment focus follows industries with strong potential for completing an IPO
  - Role for public purpose VC funds in supporting growth sectors & technologies overlooked by public stock markets and VC industry
- Difficulty of exiting pure equity investments leads some VCs to use debt instruments with equity kickers
  - Mezzanine investment-debt with warrants or royalties
  - Deferred debt repayment with high interest rates and/or “success fees”

SBA Small Business Investment Company (SBIC) Programs

- SBIC program created in 1950s to promote private venture capital by licensing SBICs and providing them low-interest debt
- Program flawed by use of debt to fund equity investment funds and many poorly run SBICs:
  - Only 25% of almost 800 licensed SBICs are still active
- SSBIC program created in 1972 as tool for inner city economic development based on “Black Capitalism”
- SSBICs faced same problems as SBICs and had very small capitalization (many had $2 mm of less)
  - 30% of SSBICs were still active in 1997
  - Average returns of 1% from 1976 to 1996; 5% from 1986 to 1996
- Two types of financially successful SSBICs:
  - Asset-based lenders for taxi medallions, restaurants, grocery stores
  - Equity investors in larger growth-oriented minority and women-owned firms
- Lessons from SBIC/SSBIC Experience
  - Don’t use debt to finance equity investment funds
  - Funds need a large capital base to be viable
  - Private sector management does not guarantee success

State Government Venture Capital Initiatives

- 45+ states have promoted venture capital via three approaches:
  - Public venture capital funds
  - Investing state dollars in privately managed funds
  - Tax incentives for private investment in privately managed funds
- Most states direct capital to privately managed funds
- Many initiatives are linked to demand side policies for technology commercialization and small business development.
- Programs build local venture capital capacity and demonstrate a market to attract larger flows of VC dollars
- Best practices from studies of state experience:
  - State officials should set goals and monitor performance but not make and manage investments
  - VC funds, public or private, need skilled professional managers, compensation to attract them, and sound investing processes. Public funds need to operate outside state civil service system
  - Strong focus on financial returns is key to political & financial viability, and attracting private co-investment
  - Marketing and development services are needed to generate sufficient deal flow
- How does the Canadian provinces' labor-sponsored funds compare to US state approach? Are there lessons for the US?

Community Development Venture Capital

- Emerging *private* venture capital investing for economic & social goals, e.g., job creation in low-income areas, quality jobs, minority and women ownership: “Double bottom line”
- Kentucky Highlands Investment Corp. created to simulate economic development in rural Kentucky, is the earliest CDVC fund. About half of current CDVCs serve rural regions.
- 68 funds with $870 million in capital in 2004
- 2002 study found average fund < $7 million with just under half equity funds and the balance providing debt
- Seek lower returns that private VC funds (10 to 15%)
- Investments have been modest ($200,000 to $300,000), emphasized early stage firms and serve more diverse industries that conventional VC
- Banks have been the primary type of investor
- Growing focus on financial returns and trend toward bigger funds and investments in larger companies
- Social investment standards and practices are informal and need further development
- Capacity and strategies to exit investments are unproven

VC Management Challenges and Best Practices

- Investment strategy must be linked to capacity to generate high-growth firms
  - Service area and industry targets with scores, if not hundreds, of potential investments
  - Link to "demand-side" initiatives to cultivate business opportunities and support entrepreneurs
    - Attract entrepreneurs from outside the area
    - Find and support entrepreneurs & firms with high growth potential
    - Commercial use of technology from universities and research labs
  - Support "infrastructure" of advisors, angels and skilled workforce
- Building skilled local VC management capacity
  - Understanding of and commitment to ED mission
  - Compensation to attract skilled managers
  - Contracting with **local** private firms is an option
  - Strong public/community oversight of managers
  - Cultivating credibility and relationships with national VC industry
- Raise Appropriate Recurring Capital Sources
  - Minimum fund of $5 to $10 million financed with equity
  - Pension funds & financial institutions are key sustained sources
  - Can New Market Tax Credits to expand the investor base?