

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Chairman Bill Mason at 3:30 p.m. on March 11, 1998 in Room 423-S of the Capitol.

All members were present except: Barbara Allen (A)  
Broderick Henderson (E)  
Lisa Benlon

Committee staff present: Lynne Holt, Legislative Research Department  
Renaë Jefferies, Revisor of Statutes

Conferees appearing before the committee: Tom Blackburn, Kansas Venture Capital, Inc.  
Chuck Stone, Kansas Bankers Association  
Elmer Ronnebaum, Kansas Rural Water Ass'n  
Jamie Clover Adams, Legislative Liaison  
Rich Bendis - KTEC

Others attending: See attached list

Lynne Holt briefed the committee on the Joint Committee on Economic Development endorsements of two motions adopted by the Kansas, Inc. Board at its October meeting. The motions are to: Support the need for venture and seed capital resources in Kansas; recommend development of a plan to move the state away from direct public funding of venture and seed capital programs; and direct Kansas, Inc. staff to conduct a study to identify the most effective means possible, through appropriate incentives and policies, to build effective venture and seed capital resources in the state (Attachment 1). The bills are the results of the motions that are before the committee. Lynne Holt proceeded to explain the difference in **SB 487** and **SB 554** and clarified the background of Seed and Venture Capital, KVC, division and proposed disposition of funds.

Chairman Mason opened the hearing on **SB 487**

Tom Blackburn, Kansas Venture Capital, Inc. (proponent) He briefed the committee on **SB 487** on KVC aspects of the bill. This bill establishes the payment mechanism to pay the state the entire 5 million investment. It also provides sunset for the additional 5 million investment commitment for contingent liability the state has to KVC for future investments (Attachment 2). He said that he was appearing as a result of the actions from the Joint Committee hearings, the negative publicity, and the commentary from Kansas Inc. They understand the public policy concerns about mixing public and private moneys in venture capital investments, and as a result they developed the privatization plan to meet the needs of everyone concerned.

General discussion followed.

Chuck Stones, Kansas Bankers Association (proponent) He appeared before the committee in support of **SB 487**. The Kansas Bankers Association believes that allowing KVC to privatize will allow it to continue to grow and remove some of the burden placed on it by the involvement of State money (Attachment 3).

Elmer Ronnebaum, Kansas Rural Water Association (proponent) He spoke to the committee regarding the need of loan funds to meet eligible activities of the 1996 amendments to the Safe Drinking Water Act, which include: Projects to consolidate water supplies or restructure systems, planning or design costs, projects to replace aging infrastructure, including source improvement projects; and installation or upgrades of treatment facilities, storage facilities or distribution systems (Attachment 4).

Jamie Clover Adams, Legislative Liaison, (proponent), spoke to the committee about Section one of the **SB 487** dealing with the Kansas Public Water Supply Loan Fund (Attachment 5).

Chairman Mason closed the hearing on **SB 487**.

Chairman Mason opened the hearing on **SB 554**.

Rich Bendis - KTEC. He reviewed SB 554, with the committee. The Kansas Venture Capital Company Act will allow for the purchase of KTEC interest from the Ad Astra funds that would be eligible for existing tax credits against Kansas income which sold to qualified buyers. Secondly it would clean up the languages to include limited liability companies which didn't exist when the original legislation was created back in 1986. Rather than have a sunset on the tax credits, the tax credits would be claimed until exhausted (Attachment 6).

General discussion followed regarding: the current KTEC Board members, dollar amounts available, various values & investments, annual reports, relationship between SB 487 and SB 554, the process of tax credits if sales are not made, benefits to KTEC from the investment of tax credits, process of securing quality purchasers, and a better way to use the tax credits to attract addition investments into seed venture capital.

A suggested modification (Attachment 6 -page 2) was explained.

Chairman Mason closed the hearing on SB 554.

The next meeting is scheduled for Wednesday, March 18.

Chairman Mason advised the committee that there was a possibility that the Russian delegation would like to meet with the committee and he has been advised to keep Tuesday open for that opportunity.

The meeting was adjourned at 5:00 p.m.



# JOINT COMMITTEE ON ECONOMIC DEVELOPMENT

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## ***Kansas Seed and Venture Capital Companies\****

**SUMMARY:** The Joint Committee on Economic Development recommends the introduction of two bills. One bill would repeal legislation enacted in 1995, which authorized establishment of the state sponsored technology-based venture capital fund, Sunflower Technology Ventures. The Kansas Technology Enterprise Corporation (KTEC) would be required to remit to the State Treasurer any moneys, including accrued interest but less any outstanding obligations, credited to the fund. This bill would take effect upon publication in the *Kansas Register*. The other bill would prohibit any seed or venture capital fund from investing any funds in a firm which has its principal place of business outside Kansas. This prohibition would apply only to funds in which KTEC invests directly or through a surrogate instrumentality, such as KTEC Holdings, Inc. The Committee also:

- endorses two motions by the Kansas, Inc. Board which: support the need for venture and seed capital resources in Kansas; recommend development of a plan to move the state away from direct public funding of venture and seed capital programs; and direct Kansas, Inc. staff to conduct a study to identify the most effective means possible, through appropriate incentives and policies, to build effective venture and seed capital resources in the state;
- recommends that a valuation of the portfolio assets of the two Ad Astra funds be undertaken; and
- recommends that there be no additional capitalization of five existing pre-seed funds under KTEC's auspices (Manhattan, Lawrence, Wichita, Johnson County, and Hutchinson); and that no new pre-seed funds be created until the 1998 Legislature has had

an opportunity to examine their operations and effectiveness more closely.

## **BACKGROUND**

**Definition of Seed and Venture Capital.** A company often receives several rounds of financing prior to going public, merging with, or becoming acquired by, another company. The earliest financing stage is pre-seed funding which is used to prove a concept or to develop a prototype. This stage is followed by seed capital funding, generally applied to assisting emerging companies with initiating marketing, manufacturing, and sales. Venture capital funding is applied to rolling out the product of the new company and even to later-stage investments, such as financing mergers, acquisitions, and leveraged buy-out. These funding categories frequently overlap in the type of activities they finance.

**Need for Seed and Venture Capital in Kansas.** The need for increased availability of seed and venture capital in Kansas was identified in the 1986 *Kansas Economic Development Study* by Professors Tony Redwood and Charles Krider. This need was reinforced in two *Kansas Vision* reports issued by Kansas, Inc. in 1993 and 1997, respectively. The *Kansas Vision* reports updated various aspects of Kansas' 1986 economic development strategy.

**Commercialization Organization Pre-Seed Funds.** The Kansas Technology Enterprise Corporation (KTEC) network includes three commercialization organizations in Manhattan, Lawrence, and Wichita, which have similar missions of assisting technology-based businesses and commercialization of university technologies in their respective regions of the state.

- Each of these organizations reflects a partnership of a state university, community or chamber of commerce, and KTEC.

\* H.B. 2588 and H.B. 2589 accompany this report.

Economic Development Comm  
3/11/98  
Attachment 1

- Each of these organizations is for legal purposes comprised of:
  - a 501(c)(3) not-for-profit entity, which enables foundations and others to provide grants and in-kind support;
  - a for-profit limited liability company which provides perpetual pre-seed investment funding for technology-oriented start-up companies in the region; and
  - a for-profit "C" company which contractually provides the support required for the 501(c)(3) entity and the for-profit limited liability company.

Two other pre-seed funds operate in Johnson County and Hutchinson and receive management assistance from the for-profit "C" companies in Lawrence and Wichita, respectively.

- Each of the five pre-seed funds (Manhattan, Lawrence, Wichita, Johnson County, and Hutchinson) has received some level of state support. For each of the pre-seed funds, investment decisions are recommended by the fund managers of the for-profit limited liability company but must be unanimously approved by the investment review committee overseeing that fund.

(An outline of various aspects of management of the five regionally-based pre-seed funds and other Kansas venture and seed capital funds is available in matrix form from the Kansas Legislative Research Department, revised, September 15, 1997. In addition, a flowchart depicting the structure of these funds was distributed on September 15, 1997 by KTEC to the Joint Committee.)

**Ad Astra Funds.** KTEC is statutorily authorized to engage in seed capital financing for the development and implementation of innovation and new technologies for existing resource, technology-based, and emerging Kansas businesses (K.S.A. 74-8102 (b)(3); also K.S.A. 74-8109). The Kansas Legislature authorized initial funding in FY 1989 from the Economic Development Initiatives Fund for the first seed capital fund (Ad Astra I) established by KTEC and, in FY 1994, for the second seed capital fund (Ad Astra II).

Campbell-Becker (Lawrence) is the full-time manager of both Ad Astra funds. Sam Campbell is the General Partner and KTEC Holdings, Inc. (a for-profit company owned exclusively by KTEC) is one of several limited partners of the two funds. Campbell-Becker makes investment decisions and is authorized to use investment instruments of equity, debt, equity-related debt, and venture capital agreements. To date, the size of Ad Astra I is over \$2.6 million, including \$800,000 from private sources. The size of Ad Astra II is almost \$3.9 million, including \$950,000 from private sources.

(An outline of various aspects of management of the Ad Astra funds and other Kansas venture and seed capital funds is available in matrix form from the Kansas Legislative Research Department, revised, September 15, 1997. In addition, a flowchart depicting the structure of these funds was distributed on September 15, 1997 by KTEC to the Joint Committee.)

**Kansas Venture Capital, Inc. (KVCI).** KVCI is a private, for-profit licensed Small Business Investment Corporation. Initially, KVCI existed as a subsidiary company of the Kansas Development Credit Corporation but reorganized subsequent to legislation enacted in 1986. That legislation, titled the Kansas Statewide Risk Capital System (K.S.A. 74-8201 *et seq.*), committed \$10 million of idle funds from the state's Pooled Money Investment Board to be capitalized in the form of preferred stock to match \$10 million raised from private sources, to be capitalized in the form of common stock. However, only \$6.6 million of the \$10 million threshold was ultimately raised from the private sector. KVCI received a preferred stock investment totaling \$5 million from the Pooled Money Investment Board.

In contrast to the funds in the KTEC network, KVCI generally focuses on later stage investments which are not restricted to technology-based enterprises. KVCI's investments include: ventures, turn-arounds, expansions, leveraged buyouts, and acquisitions. All portfolio company investments are structured with some form of equity potential. Investment decisions are made by an executive management team, subject to approval by the Investment Committee of the KVCI Board of Directors.

(An outline of various aspects of management of KVCI and other Kansas venture and seed capital funds is available in matrix form from the Kansas Legislative Research Department, revised, September 15, 1997.)

**Legislative Direction to the Joint Committee on Economic Development.** In April and May 1997, there was considerable press coverage about the controversial activities of two companies, BioCore and Rubber Recovery. Both companies received funding from Ad Astra. Legislative concern about these investments resulted in a provision in KTEC's FY 1998 appropriations bill requiring KTEC to report to the Joint Committee prior to the 1998 Session the investments and compliance procedures of the seed and venture capital funds subject to its oversight. In addition, Senator Alicia Salisbury, in a letter to Representative Bill Mason, requested that KTEC respond to several questions related to the seed and venture capital funds in its network.

## COMMITTEE ACTIVITIES

**Committee's Policy Concerns.** The Committee devoted two days in August and a portion of its meeting in September to its review of Kansas seed and venture capital investments. Major policy questions raised were:

- Is there a market failure with respect to the availability of seed and venture capital for Kansas technology-oriented businesses?
- If there is a market failure, should the state be involved in providing assistance and, if the state should be involved, in what manner?
- To what extent are and should financial information about the portfolio companies of the funds in the KTEC network and the intellectual property of these portfolio companies be confidential?
- What measures have been and should be taken by the managers of these funds to increase public accountability and mitigate against perceived conflicts of interest?
- What guidance should be given to KTEC concerning Sunflower Technology Ventures (which is intended to provide later stage

funding through the Ad Astra funds, was appropriated \$3 million, and is not yet operational)?

**Background Information.** The Committee spent most of its meeting in August receiving information about various seed and venture capital fund management practices in Kansas and other states. In addition, the Committee heard several presentations on the history, structure, and operations of the Kansas funds. The Committee heard two presentations by Rich Bendis, President of KTEC, who reviewed the background and present structure of seed and venture capital funds in the state. Wayne Embree, a Partner in Cascadia Pacific Management, LLC, Oregon, presented general information on trends in seed and venture capital activity in the United States and information specific to the Oregon Research and Technology Development Fund managed by his company. He underscored several points at the conclusion of his presentation:

- investors in venture funds do not like early stage investments;
- venture firms are moving away from such investments;
- there is an increasing demand for universities to generate technology;
- nonventure states lack market infrastructure; and
- the best opportunities are from emerging growth companies.

Other conferees included: Senator Dave Kerr; Sam Campbell, Campbell-Becker; Bob Rosander, President, Wichita Technology Corporation and fund manager of the associated pre-seed fund in Wichita; Gary Sherrer, Secretary, Kansas Department of Commerce and Housing; Tom Blackburn, Vice-President, KVCI; Dr. Steven Robbins, President and CEO, Cryptic Afflictions; and Dr. Charles Warren, President, Kansas, Inc.

**Post Audit Report.** The Committee learned that the Legislative Post Audit Committee had directed the Legislative Division of Post Audit to conduct a performance audit, to be completed in January 1998, to respond to eight questions related to the state's investment in venture

capital funds. These questions relate to: the investment activity of the Ad Astra funds; the estimated values of Ad Astra portfolio companies; the return to the state of such investments; the statutory requirements governing the venture capital funds; the management fees, compensation for expenses, and equity benefits paid to the Ad Astra Fund managers; the fund raising activity related to Sunflower Technology Ventures; the policies of other states that have committed public funds to venture capital investments; and other sources of venture capital available to Kansas entrepreneurs.

**Ad Astra Review Committee.** The Committee heard a presentation by Kurt Saylor, Chairperson of the Ad Astra Review Committee. That Committee was formed to review the operations and policies governing KTEC's investments in the Ad Astra funds. Mr. Saylor explained the Committee's recommendations, which were subsequently submitted to and approved by the KTEC Board of Directors:

- The KTEC Investment Committee should continue to meet with Campbell-Becker quarterly to address inquiries from the Investment Committee regarding compliance with agreements and policies.
- A KTEC employee should continue to serve on the Ad Astra funds' advisory committee in order to monitor relevant issues and report back to the KTEC Board Executive Committee.
- KTEC should accept Campbell-Becker's proposal to place a one-year moratorium on out-of-state investments by the Ad Astra funds.
- On an annual basis, a member of the KTEC Board Investment Committee and a KTEC staff member should perform a review of selected portfolio investments of the Ad Astra Funds for adherence to criteria governing investment decisions in the Funds.
- An independent study should be performed to determine the need for seed and venture capital in Kansas. The study should be performed by an independent, third-party contractor agreed upon by the Joint Committee on Economic Development.

**Attorney General Opinion.** The Attorney

General issued an opinion on October 9, 1995 which responded to the questions of whether the Ad Astra funds are "public agencies," as defined by the Kansas Open Records Act, and whether they are subject to the provisions of the Kansas Open Meetings Act. The opinion concluded that while KTEC is subject to the Kansas Open Records Act, its interests in the Ad Astra funds are confined to its role as a limited partner. The funds are not subordinate to KTEC. Although the funds did receive moneys from KTEC as an investment, they failed to receive funding in a manner sufficient to trigger the Kansas Open Records Act. The opinion further concluded that the funds are not subject to the Kansas Open Meetings Act. The basis for that conclusion is that the funds are neither a legislative nor an administrative body or agency of either the state or any political or taxing subdivision. Nor are they subordinate to the KTEC Board of Directors.

**Kansas, Inc. Board Motions.** At its October meeting, the Kansas, Inc. Board unanimously approved two motions related to venture and seed capital activities, which are cited below. (The first motion amended minutes of the Board's August meeting and essentially restated a motion adopted at that time with one change.)

**First Motion:** Kansas should devise a plan to move away from direct public funding of venture and seed capital programs, while acknowledging the past role of Kansas, Inc. in supporting the current system of venture capital in the state, and to encourage the private availability of venture and seed capital through other incentives and policies.

**Second Motion:** The Board reaffirms its belief in the need for venture and seed capital resources in Kansas and directs staff to conduct a study to identify the most effective means possible, through appropriate incentives and policies, to build effective venture and seed capital resources in the state.

## CONCLUSIONS AND RECOMMENDATIONS

The Committee notes that several policy questions have been raised during the course of its deliberations which warrant response:

- Is there a continued need for venture and seed capital resources in Kansas?
- If there is a need, should the state continue to provide direct funding of venture and seed capital programs?
- Alternatively, if there is a need, should tax credits or other types of incentives be made available?

In responding to these questions, the Committee supports two motions adopted by the Kansas, Inc. Board, summarized above. These motions underscore the continued need for venture and seed capital resources in Kansas. However, they also reflect a policy shift—the decision to move away from a policy adopted by the Legislature during the past ten years to provide direct funding of such programs. This shift in funding paradigm is reflected in the Committee's recommendation to introduce a bill to repeal legislation enacted in 1995, which authorized establishment of the state sponsored technology-based venture capital fund. The bill also would require KTEC to remit to the State Treasurer any moneys, including accrued interest but less any outstanding obligations, credited to the fund. This bill would take effect upon publication in the *Kansas Register*. The proposed legislation applies specifically to Sunflower Technology Ventures, which is currently not operational.

The Committee notes that in 1995, \$3.3 million was authorized from the Economic Development Initiatives Fund for Sunflower Technology Ventures. KTEC subsequently invested the money in an interest bearing account with the Municipal Investment Pool. At present, slightly more than \$3.45 million remains available although financial obligations may be incurred in conjunction with the disso-

lution of the fund. The Committee recommends the bill be assigned to the appropriate standing committee for its consideration.

Movement away from direct funding could result in privatization of the Ad Astra Funds. At the Kansas, Inc. Board meeting in October, the President of KTEC indicated that he would try to make a proposal to the Legislature to privatize the Ad Astra Funds. To facilitate consideration of such an option, the Committee recommends that a valuation of the portfolio assets of the two funds be undertaken.

Another recurrent theme in Committee deliberations was the need for greater accountability with respect to fund investments. The Committee recommends two actions to address that need.

First, the Committee recommends a bill be introduced to prohibit any seed or venture capital fund from investing any funds in a firm which has its principal place of business outside Kansas. This prohibition would apply only to funds in which KTEC invests directly or through a surrogate instrumentality, such as KTEC Holdings, Inc. The Committee learned that, in response to concerns about an investment in a Texas company, Campbell-Becker proposed a one-year moratorium on out-of-state investments by the Ad Astra Funds unless there was significant evidence that an investment in an out-of-state portfolio company will provide significant economic benefit to the state of Kansas. The KTEC Board approved Campbell-Becker's proposal. The proposed legislation expresses the Committee's intent that out-of-state investments be prohibited for Ad Astra and all other seed and venture capital funds in which KTEC invests.

Second, the Committee recommends that there be no additional capitalization of the five existing pre-seed funds under KTEC's auspices (Manhattan, Lawrence, Wichita, Johnson County, and Hutchinson). In addition, no new pre-seed funds should be created until the 1998 Legislature has had an opportunity to examine their operations and effectiveness more closely.



REMAINING INVESTMENT CAPACITY IN STATEWIDE RISK CAPITAL SYSTEM

	<u>CAPACITY</u>	<u>CREDIT</u>
KVCI	\$3,417,109	\$ 854,277.25
SUNFLOWER	\$8,607,582	\$2,151,895.50
PRIVATE	\$ 552,110	\$ 138,027.50
TOTAL	\$12,576,801	\$3,144,200.25
PUBLIC TOTAL	\$12,024,691	\$3,006,172.75
KVCI/KTEC SPLIT	\$6,012,345.50	\$1,503,086.38
KVCI SHARE OF KTEC CREDITS	\$2,595,236	\$648,809

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**Private Investment in  
Certified Venture Capital  
Companies & Local Seed Pools**

*Venture Capital Companies*

<b>Company</b>	<b>Investment</b>
Research Capital Management Group I, Ltd.	\$1,575,600
Kansas Venture Capital, Inc.	\$6,582,791
Research Capital Management Group II, Ltd.	\$2,222,000
Devlin Venture Partners, L.P.	\$2,025,000
Jabara Ventures Group	\$1,500,000
Kansas Business Investment Company	\$8,505,288
Carmen Venture Partners, L.P.	\$1,770,000
DV Venture Investments, L.P.	\$1,500,000
Ruhfus Venture Capital Corporation	\$1,500,000
Coleman Venture Capital, Inc.	\$1,500,000
VanKan, Inc.	\$3,200,002
Ad Astra Fund I, L.P.	\$742,418
Ad Astra Fund II, L.P.	\$650,000
Harris Capital Fund	\$1,500,000
Sunflower Technology Ventures, L.P.	<u>\$0,000,000</u>
<b>TOTAL</b>	<b>\$34,773,099</b>

*Local Seed Capital Pools*

<b>Company</b>	<b>Investment</b>
Kansas Seed Capital Fund	\$ 200,000
Harris Seed Capital Fund	<u>\$ 700,000</u>
<b>TOTAL</b>	<b>\$ 900,000</b>

*Year of Fund Certification*

- 1986  
Research Capital Management Group I
- 1987  
Kansas Venture Capital, Inc.
- 1988  
Devlin Venture Partners, L.P. Jabara Ventures Group  
Kansas Business Investment Company Carmen Venture  
Partners, L.P. DV Venture Investments, L.P. Ruhfus  
Venture Capital Corporation Coleman Venture Capital,  
Inc. Kansas Seed Capital Fund, Inc.

1989  
VanKan, Inc. Harris Seed Capital Fund

1990  
Ad Astra Fund I, L.P.

1994  
Ad Astra Fund II, L.P.

1995  
Harris Capital Fund Sunflower Technology Ventures,  
L.P.

*Certified Kansas Venture Capital Companies*

Ad Astra Fund, L.P. 1321 Wakarusa Drive #2102  
Lawrence, Kansas 66046 (785) 841-7120 Contact:  
Charlie Becker

Ad Astra Fund II, L.P. 1321 Wakarusa Drive #2102  
Lawrence, Kansas 66049 (785) 841-7120 Contact:  
Charlie Becker

Research Capital Management Group I, Ltd., L.P. 1321  
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Kansas Venture Capital, Inc. (Main Office) Overland  
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Park, Kansas 66204 (785) 262-7117 Contact: Rex  
Wiggins

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Kansas Business Investment Company 3706 S.W.  
Topeka, Suite 400 Topeka, Kansas 66609 (785) 266-  
8333 Contact: Charles Tantillo

Ruhfus Venture Capital Corporation 8100 E. 22nd Street  
North, Building 500 Wichita, Kansas 67226 (316) 681-  
5100 Contact: Roy R. Baker

Coleman Venture Capital, Inc. P.O. Box 1762 Wichita,  
Kansas 67201 (316) 261-3402 Contact: Jim Beebe

Harris Capital Fund 5051 East Lincoln, Apt 9B Wichita, Kansas 67218 (785) 687-6430

Sunflower Technology Ventures, L.P. 214 S.W. 6th, 1st Floor Topeka, Kansas 66603 (785) 296-5272 Contact: Mr. Richard A. Bendis

*Certified Kansas Local Seed Capital Pools*

Kansas Seed Capital Fund, Inc. 155 N. Market, Suite 710 Wichita, Kansas 67202 (316) 262-8339 Contact: Tom Hyde

Harris Seed Capital Fund 5051 East Lincoln, 9B Wichita, Kansas 67218 (316) 687-6430 Contact: Jack Harris

**Additional Division Accomplishments in FY97**

In addition to program results already presented, there were considerable accomplishments in other areas of the Division. Some had significant employment impact and enhanced economic opportunities for Kansas companies and communities. Others provided technical assistance or much-deserved recognition to Kansas companies and their associates.

Our efforts to grow the Kansas economy requires staff and resource involvement at a number of different levels. In addition to our in-house development representatives and out-of-state contract offices, members of our staff are involved in the analysis of project information to determine the impact and cost of a particular project. The appropriate use of State programs to achieve economic opportunity for Kansans is critical. Also critical is the level of customer service provided to our clients. Our Workforce Training and Business Finance staffs are consistently involved in development and analysis of project proposals that can make or break a project.

Financing resources, such as the State's Private Activity Bond (PAB) cap for tax-exempt bonds, can be significant. PABs are a federal bonding authority administered by the KDOC&H Business Development Division. In Calendar Year 1996 PABs were allocated as follows:

<i>Manufacturing projects</i>	\$67,670,000
<i>First-time homebuyers</i>	\$55,428,221
<i>Residential rental projects</i>	\$24,950,000
<i>Beginning Farmer Bonds</i>	<u>\$ 1,861,143</u>
<b>TOTAL</b>	<b>\$149,910,143</b>

The High Performance Incentive Program in FY97 had a role in proposed capital investment projects totaling over \$69 million. This program provides tax credits to promote investment by firms which pay high wages and are committed to workforce training.

We often partner with other economic development entities to leverage our ability to serve Kansans. Certified Development Companies, which receive State support, were involved in the packaging of financial resources which impacted employment opportunities for nearly 2,000 Kansans. Small Business Development Centers, which also receive State funding, provided no-cost business counseling for more than 8,000 clients last fiscal year. The Kansas Cavalry, which is composed of business leaders and economic development professionals from around the state, has been a partner in our efforts to attract and expand business in Kansas and has co-sponsored our business recognition program.

Meeting the technical and business assistance needs of our customers is an important component in the work of the Division. The KDOC&H regional field representatives provide us with the ability to respond quickly and effectively to meet client needs. In FY97, they called on over 1,100 businesses around the state to identify company needs and to assist them in strengthening their businesses. Direct assistance to the client, and referrals to other assistance sources result from many of these business calls. The First Stop Clearinghouse responds to the needs of entrepreneurs and small businesses seeking information and assistance on topics involving business registration, licensing, and related business questions. In FY97, more than 2,600 clients were assisted by the Division staff person that operates this program. Enhancing opportunities for minority-owned and women-owned businesses are



# Kansas Venture Capital, Inc.

## TESTIMONY

Senate Bill No. 487

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House  
Economic Development Committee

March 11, 1998

By: Tom Blackburn  
*Executive Vice President*

Economic Development Comm  
3-11-98  
ATTACHMENT 2

# **KVCI Testimony Outline**

## **Senate Bill No. 487**

### **KVCI Privatization Objectives**

- The KVCI Board developed a privatization plan primarily in response to the following:
  - 1) Public policy concerns raised by legislative and administration officials over the compatibility of public funding of venture capital companies.
  - 2) Market concerns as a result of negative publicity.
- A financial feasibility model was developed to determine a financial scenario that could accommodate the following:
  - 1) Preservation of KVCI's ongoing operations and new investment activity.
  - 2) Retirement of the state's entire \$5.0 million preferred stock investment.
- The KVCI Board approved plan projects a redemption of \$1.0 million per year over five years, while preserving ongoing operations and new investment activity.

### **Public Policy Objectives**

- The provisions of SB487 are consistent with the public policy position of eliminating direct public funding of venture capital companies - a position supported by many legislators, the administration, public policy advisors and many in the private sector.
- The provisions of SB487 are consistent with the public policy position of maintaining current initiatives (such as KVCI) and providing incentives for private sector venture capital investments in Kansas companies - positions supported by many who favor eliminating direct public funding and other public and private sector participants who support the current initiatives (such as KVCI).

### **Benefits to the state**

The primary benefits to the state of the proposed legislation are as follows:

- 1) The state would be repaid the \$5.0 million invested in KVCI, in addition to the economic development returns and dividends received to date. This represents a 100% return of the state's original preferred stock investment in KVCI - a financial result unmatched by most, if not all, other state economic development programs.
- 2) The state's additional \$5.0 million investment commitment to KVCI would sunset. This would keep the state from getting more involved in the direct funding of venture capital - a public policy that has lost favor with many in both the public and private sector.
- 3) The reinstatement of unused venture capital tax credits may assist in attracting new private capital to KVCI. Additional private capital could provide the cash resources necessary to allow an accelerated state preferred stock payoff. Additional capital would also allow KVCI to increase investment activity and the related benefits.

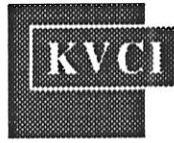
- 4) Once KVCII is privatized, the challenging issues related to the appropriate balance between adequate disclosure, accountability, oversight and portfolio company confidentiality would be removed.
- 5) The state would receive additional economic development returns from future investment activity of KVCII in Kansas-based companies in addition to the economic development returns from the ongoing operations of past and present Kansas-based companies assisted by KVCII financing and management assistance.
- 6) The state would receive future economic development returns from infrastructure investments from the public water supply loan fund as a result of KVCII repayments and leveraged Federal funds.
- 7) The state would retain a "homegrown" venture capital firm with a continued commitment to Kansas businesses. As a private company, Kansas-based investment activity will likely increase because of an ability to focus full time on investing, an increased risk appetite, a broader investment authority and an enhanced market perception.
- 8) The state would have an economic development success story to celebrate with a negative cost (positive return) to Kansas taxpayers. KVCII's track record detailed in the Company Overview handout.

### **Financial Feasibility**

- KVCII anticipates funding the state redemption through a combination future return of capital and realized gains on KVCII portfolio investments. The timing and amount of future realized capital gains ultimately determine the financial feasibility and timing of the state preferred stock redemptions.
- Prospects are favorable for significant portfolio repayments and realized capital gains over the next two years. Based on current market conditions, portfolio fundamentals and projected exits, 1998 will likely be a record year for KVCII. We believe we earn \$2.0 to \$3.0 million after tax this year, possibly more.
- Based on the current financial feasibility model, a repayment schedule of \$1.0 million per year for five years is achievable. Portfolio performance significantly less than projected may not prudently support a \$1.0 million per year redemption. Conversely, performance superior to projection may permit an acceleration of the projected redemption.
- While there is no assurance of future portfolio company performance, KVCII management believes that performance will exceed projections and financial resources will be sufficient to complete the projected redemption on schedule.
- Selected historical and projected financial data is presented in more detail in Exhibits A and B of the Company Overview handout.

### **Summary**

- Providing incentives for private sector venture capital investment in Kansas is important.
- Initiatives to preserve and privatize the current state-sponsored venture capital funds such as Kansas Venture Capital, Inc. are good public policy.
- KVCII has been an economic development success story and remains the primary conduit for importing institutional venture capital to Kansas-based small businesses.
- SB487 provides KVCII with the necessary flexibility and affordable repayment terms to preserve continued operations and new investment activity.
- The Board of Directors of KVCII supports SB487 without reservation.



# **Kansas Venture Capital, Inc.**

## **COMPANY OVERVIEW**

**February 1998**



## Kansas Venture Capital, Inc.

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### MISSION

#### Operating Mission

*“To provide equity capital, loans and management assistance to Kansas-based small businesses having potential for significant growth and long-term equity appreciation.”*

#### Operating Goals

- Build long-term shareholder value
- Enhance the Kansas economy
- Establish a self-sustaining entity
- Largest and most active Kansas-based venture fund





## Kansas Venture Capital, Inc.

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### HISTORY

- 1976** - KVCII incorporated as a private, for-profit licensed Small Business Investment Company (SBIC). Initially, KVCII existed as a subsidiary company of the Kansas Development Credit Corporation (KDCC).
- 1987** - KVCII restructured subsequent to 1986 risk capital formation initiatives passed by the Kansas Legislature.
- 1988** - KVCII raised private capital of \$4.3 million through the efforts of the Kansas Bankers Association (KBA).
- 1988** - KVCII received initial State of Kansas preferred stock investment of \$4.3 million from the Pooled Money Investment Board (PMIB) pursuant to the Kansas Statewide Risk Capital Act (KSRCA).
- 1990** - KVCII raised additional private capital of \$2.3 million and received additional preferred stock investment from the PMIB of \$700,000 pursuant to KSRCA statutes.
- 1992** - KVCII surpassed the 75% investment activity requirement established by the Kansas Venture Capital Company Act (KVCCA), well ahead of statutory guidelines.
- 1994** - KVCII recognized by the Inspector General of the SBA as one of nine SBICs nationally in a "Best Business Practices" report.



## Kansas Venture Capital, Inc.

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### MANAGEMENT TEAM

#### Executive Management

John S. Dalton, President

Thomas C. Blackburn, Executive Vice President

Marshall D. Parker, Executive Vice President

#### **Collective Credentials:**

- Over 45 years of investment industry experience
- Over 30 years of venture capital and investment banking experience
- Kansas natives with a wealth of Kansas business community and civic relationships
- Served on or continue to serve on the Board of Directors of over 20 private and two public companies in varied industries
- Directly involved in the closing of over 50 venture capital or corporate finance transactions

#### Staff

Carole J. Ladish, Corporate Secretary and Office Manager

Ellyn M. Tyrell, Treasurer and Assistant Secretary



## Kansas Venture Capital, Inc.

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### BOARD OF DIRECTORS

**H. James Bartels**, Chairman,  
Commerce Bank  
Hays, Kansas

**Terry C. Matlack**  
Green Street Capital, Inc.  
Prairie Village, Kansas

**John S. Dalton**, President  
Kansas Venture Capital, Inc.  
Overland Park, Kansas

**Michael J. Meyer**, Managing Dir.  
Holden Capital Advisors, LLC  
Prairie Village, Kansas

**R.A. Edwards**, President  
First National Bank  
Hutchinson, Kansas

**Derek L. Park**, President  
P.M.S. Foods  
Hutchinson, Kansas

**Gordon W. Elliott**  
Private Investments  
Pittsburg, Kansas

**Reed A. Peters**, Chairman  
The First State Bank and Trust  
Larned, Kansas

**John R. Elmore**, President  
Mercantile Bank of Lawrence  
Lawrence, Kansas

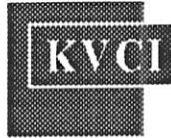
**Paul D. Stephenson**, Exec. V-P  
NationsBank, N.A.  
Wichita, Kansas

**Donald R. Landoll**, Chairman  
Landoll Corporation  
Marysville, Kansas

**John C. Taylor**, President  
Deines Manufacturing Corp.  
Ransom, Kansas

**John J. Luerding**, Sr. V-P  
Intrust Bank, N.A.  
Wichita, Kansas

**Wendell L. Wilkinson**, Chairman  
City National Bank  
Pittsburg, Kansas



## **Kansas Venture Capital, Inc.**

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### **OPERATING STRATEGY**

#### **Financing Provided To Kansas-Based Businesses**

- Flexible, equity oriented investment structures
- Intermediate investment time horizon
- Unsecured loans and equity securities
- Risk adjusted pricing

#### **Diversified Investment Profile**

- Company type
  - Predominantly manufacturing
  - Selected construction, service, retail and distribution
- Company revenue size at initial investment
  - Start-up to \$30 plus million
  - Predominately \$2.0 million to \$10 million
- Company stages
  - Higher risk profile: early stage, turnarounds
  - Lower risk profile: expansions, acquisitions
- Co-investment with other regional or national venture capital firms on large or specialized transactions
  - Risk diversification
  - Specialized expertise
  - Financial leverage

#### **Balanced Investment Philosophy**

#### **Value Added Management Assistance**



## Kansas Venture Capital, Inc.

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### CAPITALIZATION

#### December 31, 1997 Capitalization

Common stock	\$ 6,582,791
Preferred stock	5,000,000
Retained earnings	141,070
Net unrealized appreciation	<u>2,187,656</u>
<b>Total Equity</b>	<b>13,911,517</b>

#### Stockholder Profile

- Common stockholder profile:  
Approximately 350 strong as of December 31, 1996. Originally, 100% of the common stock owned by Kansas-based financial institutions, corporations or individuals. Currently, over 40% of the common stock owned by non Kansas-based financial institutions.
- Preferred stockholder:  
The State of Kansas through the PMIB investments.

#### Book Value Per Share - \$12.01

**Note:** The State of Kansas' \$5.0 million of Preferred Stock was protected by \$13.9 million in equity reserves.

*(Based on the December 31, 1997 balance sheet - subject to year-end audit verification)*



## **Kansas Venture Capital, Inc.**

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### **OVERSIGHT AND REPORTING**

#### **General Corporate Governance**

- Kansas General Corporate Code
- Kansas Statewide Risk Capital Act (KSRCA)
- Kansas Venture Capital Company Act (KVCCA)
- Federal Small Business Investment Company Act (SBIC)

#### **Specific Corporate Reporting and Oversight**

- Monthly reporting to Board of Directors
- Quarterly Board of Directors' Meetings
- Annual financial audit by independent accounting firm
- Annual financial report to the Investment Division of the SBA
- Bi-annual audit by the Investment Division of the SBA
- Annual and periodic reporting requirements to the Governor, the Kansas Department of Housing and Commerce, the Joint and Standing Economic Development Committees, the State Treasurer, and Kansas, Inc.
- Annual and Quarterly Shareholders' Report to all common and preferred shareholders



## Kansas Venture Capital, Inc.

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### INVESTMENT ACTIVITY

- \$19.5 million invested (170% of initial capitalization)
- 24 companies in 13 counties throughout the State of Kansas
- 9 companies located in smaller Kansas communities under 15,000 population (35% of dollars invested)
- 5 of 6 regions throughout the State of Kansas

*(Based on investment activity through December 31, 1997 - subject to year-end audit verification)*



## Kansas Venture Capital, Inc.

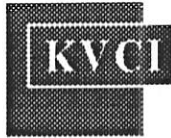
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### INVESTMENT PROFILE

<u>PROFILE</u>	<u>BY COMPANY (#)</u>	<u>BY DOLLARS (%)</u>
<i>Sector</i>		
Manufacturing	16	73%
Service	5	11%
Construction	1	6%
Retail/Distribution	2	10%
<i>Company Size</i>		
Start-up to \$2.0 Million	8	28%
\$2.0 to 5.0 Million	6	17%
\$5.0 to 10.0 Million	7	38%
\$10.0 Million or more	3	17%
<i>Company Stage</i>		
Start-up/Early Stage	5	14%
Recapitalization/Turnaround	6	37%
Expansion/Acquisition	13	49%
<i>Community Size</i>		
Population under 15,000	8	31%
Population over 15,000	16	69%

*(Based on investment activity through December 31, 1997 - subject to year-end audit verification)*





## Kansas Venture Capital, Inc.

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### STATE INVESTMENT IN KVCI

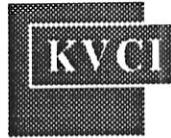
Cost of tax credits (25% of \$6,600,000)	-	\$1,700,000
Opportunity cost for PMIB investment ( <i>est.</i> )	-	<u>3,700,000</u>
Total gross cost to state	-	5,400,000
Less:		
State and local taxes paid by portfolio companies	-	<u>(9,000,000)</u>
<b>Net negative cost (positive return) to state<sup>(2)</sup></b>		<b>\$3,600,000</b>

- (1) assumes \$5.0 million invested at PMIB average annual rate of return through December 31, 1997 less dividends received.
- (2) assumes \$5.0 million preferred stock investment as an asset

#### Ancillary Returns

- Portfolio company trade with other Kansas-based manufacturers and service providers
- Preservation of Kansas-based ownership
- Attraction of additional venture capital from outside Kansas
- Other traditional multiplier effects

*(Based on activity through December 31, 1997 - subject to year-end audit verification)*



## Kansas Venture Capital, Inc.

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### FINANCIAL LEVERAGING

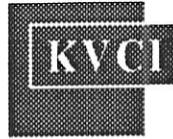
#### Financial leverage on the State of Kansas' Preferred Stock investment

- \$6.6 million of private-sector common stock
- \$29.4 million of private-sector bank debt
- \$26.6 million of private-sector venture capital
- \$11.0 million of public market equity
- \$1.4 million of CDBG funding

Financial leverage . . . . . \$75.0 million  
State Preferred Stock investment . . . . . \$ 5.0 million

**Total financial leverage  
on State Preferred Stock investment . . . . . 15 to 1**

*(Based on activity through December 31, 1997 - subject to year-end audit verification)*



## Kansas Venture Capital, Inc.

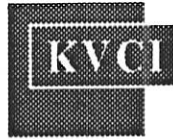
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### ECONOMIC DEVELOPMENT HIGHLIGHTS

Since KVCI's initial investment . . . .

- 2,800 jobs created or retained by KVCI portfolio companies (30% with companies located in smaller Kansas communities under 15,000 population)
- \$55.0 million of capital expenditures made by KVCI portfolio companies
- \$300.0 million of cumulative payrolls paid by KVCI portfolio companies
- \$50.0 million of taxes paid by KVCI portfolio companies
- \$9.0 million of state and local taxes paid by KVCI portfolio companies
- \$45.0 million annual payroll run rate of the 14 existing portfolio companies

*(Based on activity through December 31, 1997 - subject to year-end audit verification)*



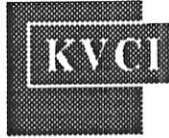
## Kansas Venture Capital, Inc.

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### INVESTMENT IMPACT

- 88% of KVCI portfolio companies increased sales subsequent to initial investment
- 88% of KVCI portfolio companies increased employment subsequent to initial investment
- 100% of KVCI portfolio companies invested in additional capital equipment or facilities subsequent to initial investment
- 83% of KVCI portfolio companies continue as going concerns
- 100% of KVCI portfolio companies leveraged KVCI investments with other private sector financing sources
- Four KVCI portfolio companies have transitioned to the public markets. (2 initial private offerings (IPO), 2 mergers)
- KVCI was the sole or lead investor in 73% of all portfolio company investments

*(Based on investment activity through December 31, 1997 - subject to year-end audit verification)*



## Kansas Venture Capital, Inc.

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### RESEARCH SURVEY RESULTS

- 100% response rate from 15 companies surveyed in 1995 by Kansas, Inc. pursuant to its "Analysis of Kansas Business Assistance" study
- 80% reported KVCI financing made an "essential or critical contribution" to their business
- 80% reported that their projects would have "stopped or not proceeded" without KVCI assistance
- 73% reported employment growth of 10 or more
- 33% reported employment growth of 50 or more
- 93% reported sales increased of \$100,000 or more
- 67% reported sales increased of \$1.0 million or more
- 33% reported sales increased of \$5.0 million or more
- KVCI had the highest customer satisfaction rating of all programs surveyed (4.67/5.0 - 93%)
- 93% reported they would recommend KVCI to other businesses

*(Based on information provided by Kansas, Inc. from independent research conducted by Central Research & Consulting)*



## Kansas Venture Capital, Inc.
























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### SUMMARY

- KVCI has and will continue to fulfill its mission of building long-term value for our shareholders and enhancing the economy of Kansas
- KVCI's financial condition is sound and our strong management team and Board will ensure that we will remain a self-sustaining entity well into the future
- KVCI's reporting and corporate governance structures provide significant checks and balances at the Federal, State and Board levels to ensure appropriate accountability and oversight
- The cost of the State's investment in KVCI has been negative and portfolio company investments will continue to provide financial returns through increased tax collections well into the future
- The financial leverage exceeding 15 to 1 on the State Preferred Stock investment is significant
- The economic development record is strong and will continue to build as KVCI's capital is redeployed into other Kansas businesses
- The impact on the portfolio companies has been direct and real
- KVCI continues to be focused on growth and is committed to funding future operations with a capital structure that best serves the interests of all stockholders - common and preferred

*A Venture Capital firm dedicated to Kansas-based businesses*

**Acquisition Financing ♦ Stockholder Liquidity ♦ Expansion Funding  
Ownership Transitions ♦ ESOPs  
Early-Stage Capital Formation ♦ Turnarounds ♦ Recapitalizations**

<b>Recreation Vehicle Products, Inc.</b> Wichita, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Organized Living, Inc.</b> Lenexa, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Visual Components, Inc.</b> Lenexa, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Guidon, Inc.</b> Paola, Kansas  <i>The undersigned structured a financing package and made a direct investment in the company</i>  Kansas Venture Capital, Inc.
<b>Hancock Electric Motor, Inc.</b> Lyons, Kansas  <i>The undersigned structured a financing package and made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Plains Plastics, Inc.</b> McPherson, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Taylor Products Co., Inc.</b> Parsons, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	
<b>Tru-Circle Corporation</b> Wichita, Kansas  <i>The undersigned structured a financing package and made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Central Fiber Corporation</b> Wellsville, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>CSU Holdings, Inc.</b> Overland Park, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Cutler Repaving, Inc.</b> Lawrence, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.
	<b>WEBCO Mfg., Inc.</b> Olathe, Kansas   Kansas Venture Capital, Inc.		
<b>Jones &amp; Mitchell Sportswear, Inc.</b> Overland Park, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>A.R.E. Industries, Inc.</b> Wichita, Kansas  <i>The undersigned structured a financing package and made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>TABS, Inc.</b> Topeka, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Electronic Processing, Inc.</b> Kansas City, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.
	<b>MacDiesel Power of Kansas, Inc.</b> McPherson, Kansas   Kansas Venture Capital, Inc.	<b>Crossroads U.S.A., Inc.</b> Hoisington, Kansas   Kansas Venture Capital, Inc.	<b>Biomune, Inc.</b> Lenexa, Kansas   Kansas Venture Capital, Inc.
<b>Airport Systems International, Inc.</b> Overland Park, Kansas  <i>The undersigned assisted in forming and funding the acquisition company</i>  Kansas Venture Capital, Inc.	<b>Kan-Build, Inc.</b> Osage City, Kansas  <i>The undersigned structured a financing package and made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Calido Chile Traders Systems, Inc.</b> Merriam, Kansas  <i>The undersigned made a direct investment in the company</i>  Kansas Venture Capital, Inc.	<b>Peerless Products, Inc.</b> Ft. Scott, Kansas  <i>The undersigned initiated, structured and negotiated this transaction, arranged mezzanine financing and made a direct investment in the company</i>  Kansas Venture Capital, Inc.

**Thomas C. Blackburn**  
*Executive Vice President*

**John S. Dalton**  
*President*

**Marshall D. Parker**  
*Executive Vice President*

**EXHIBIT A**

**Financial Data and Disclosures**



# Kansas Venture Capital, Inc.

## Selected Historical and Projected Financial Data

2-22

	----- Audited -----									----- Projected <sup>(1)</sup> -----						
	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>Preliminary</u>	<u>Mgmt. Case</u>	<u>Best Case</u>	<u>Management Case</u>			
										<u>1997</u>	<u>1998</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b>Net Income</b>	\$81,928	\$172,270	\$(859,880)	\$421,845	\$50,164	\$1,474,945	\$(588,131)	\$215,518	\$219,235	\$(434,965)	\$1,984,108	\$2,921,608	\$529,242	\$(7,924)	\$375,660	\$(335,255)
<b>Net Income/Share</b>	\$0.12	\$0.20	\$(0.74)	\$0.36	\$0.04	\$1.27	\$(0.51)	\$0.19	\$0.19	\$(0.38)	\$1.71	\$2.52	\$0.46	\$(0.01)	\$0.32	\$(0.29)
<b>Book Value <sup>(2)</sup></b>	\$8,781,579	\$9,970,148	\$11,590,950	\$11,438,519	\$11,671,972	\$13,222,866	\$13,431,120	\$13,458,553	\$14,140,515	\$13,911,517	\$15,875,969	\$16,813,469	\$16,880,211	\$17,422,287	\$18,122,947	\$18,256,691
<b>Book Value/Share</b>	\$10.02	\$10.44	\$10.01	\$9.88	\$10.08	\$11.42	\$11.60	\$11.62	\$12.20	\$12.01	\$13.71	\$14.52	\$14.57	\$15.04	\$15.65	\$15.76
<b>Dividends Paid <sup>(3)</sup></b>																
<b>Preferred Stock</b>			\$21,675				\$ 50,000						(3)	(3)		(3)
<b>Common Stock</b>			<u>26,063</u>				<u>65,828</u>									
<b>Total</b>			\$47,738				\$115,828									
<b>Per Share</b>			\$ 0.05				\$0.10									

**Notes and Disclosures:**

<sup>(1)</sup> The 1998-2002 projections were prepared by KVC I management for the purpose of determining the financial feasibility of a proposed redemption of the state's preferred stock. The company's business is highly volatile and these forecasts are necessarily subject to a high degree of uncertainty. KVC I makes no express or implied representation or warranty as to the accuracy, completeness or attainability of the projections or the assumptions from which they were derived.

**1998 Projection:** Both projected scenarios for 1998 anticipate the realization of significant capital gains and some realized loss during the year on portfolio company investments. Both cases would result in net realized capital gains in excess of capital gains realized in any prior year.

**Management Case:** Based on financial model utilized by management and KVC I Board of Directors in determining the financial feasibility of the preferred stock redemption proposal.

**Best Case:** Best Case scenario anticipates net realized gains to KVC I at the upper end of projected ranges in the financial feasibility model on portfolio company investments for the year.

<sup>(2)</sup> Book value includes common stock, preferred stock, retained earnings and net unrealized appreciation of investments.

<sup>(3)</sup> Based on past history, if such results were achieved, the KVC I Board of Directors might declare a modest dividend in the following year.

Per share amounts calculated based on common shares outstanding and preferred stock "as if" converted to common stock.

2

# FINANCIAL DISCLOSURES

## Historical Financial Information

- Based on KVCI December 31, 1997 unaudited financial statements, the book value of the state's KVCI preferred stock was \$12.01 per share (\$6.0 million). The original cost of the state preferred stock was \$10.00 per share (\$5.0 million). This represents book value growth of \$2.01 per share (\$1.0 million).
- Since 1988, the state has received a total of \$71,675 in dividends on its preferred stock investment.
- The total return on the state's preferred stock (compound annual growth rate of book value plus dividends) for the 10 year period ending December 31, 1997 has been slightly less than 2.0% per year.
- The PMIB has foregone an estimated \$3.7 million in interest on funds used to purchase the state's preferred stock investment. (based on historical average annual PMIB returns through December 31, 1997)
- Historical financial statements are audited for each year through December 31, 1996 and unaudited for the year ended December 31, 1997.

## Projected Financial Information (assumes no state redemption)

- Assuming a historical (2%) total return, the book value of the state preferred stock would be \$13.00 per share (\$6.5 million) at December 31, 2002.
- Based on KVCI's financial feasibility model, the book value of the state preferred stock is projected to be \$15.76 per share (\$7.9 million) at December 31, 2002.
- Based on KVCI's financial feasibility model, the book value of the state's preferred stock is projected to be \$13.71 per share (\$6.9 million) at December 31, 1998. This projection is based primarily on assumed net income of \$2.0 million or \$1.71 per share for 1998.

## FINANCIAL DISCLOSURES (continued)

### Projected Financial Information (continued)

- Recent developments concerning its portfolio investments indicate that KVCI's financial feasibility model may be conservative. KVCI management believes that net income may be as high as \$3.0 million, possibly higher, based on realized capital gains in excess of that projected in the financial feasibility model. Under such a scenario, the book value of the state's preferred stock could be as high as \$14.52 per share (\$7.3 million), possibly higher, at December 31, 1998, and could approach \$16.85 per share (\$8.4 million), possibly higher, at December 31, 2002.
- While there is no requirement to pay dividends to stockholders, past history would suggest a modest dividend might be declared by the KVCI Board in 1999 in the event of performance that equals or exceeds the financial feasibility model.
- The 1998-2002 projections were prepared by KVCI management for the purpose of determining the financial feasibility of a redemption of the state's preferred stock. The company's business is highly volatile and these forecasts are necessarily subject to a high degree of uncertainty. KVCI makes no express or implied representation or warranty as to the accuracy, completeness or attainability of the projections or the assumptions from which they were derived.

### Other Considerations

- There is currently no public market available to provide liquidity for KVCI common or preferred stockholders. KVCI has been made aware of past private market transactions, as recent as fourth quarter 1997, involving KVCI common stock well below book value.
- Dividend and capital distributions to KVCI common and preferred stockholders are restricted pursuant to Federal SBIC regulations.
- Due to the highly speculative nature of projecting KVCI's future performance, no prediction can be made as to the timing or amount of dividends paid with respect to the preferred stock or the amount of realizable distributions with respect to the preferred stock if KVCI were ever liquidated.

## PRIVATIZATION FINANCIAL CONSIDERATIONS

The KVCII Board has evaluated the feasibility of privatization in response public policy concerns raised by legislative officials, the administration and others over the compatibility of the public funding of venture capital companies and market concerns related to negative publicity of such public policy. Based on the analysis, a plan to privatize KVCII over time and maintain ongoing operations and new investment activity has been developed.

- The key assumptions in the financial feasibility model are as follows:
  - 1) KVCII would continue to operate at investment activity levels slightly above historical levels and generate portfolio returns consistent with historical levels with the exception of an expectation of 1998 performance superior to historical levels.
  - 2) KVCII may not be successful in attracting additional new capital.
- Based on the above assumptions and KVCII's current and projected financial conditions, the plan projects that at a price of \$5.0 million, payable at \$1.0 million per year for five years, privatization is financially feasible. This represents a 100% return of the original cost of the state preferred stock.
- KVCII will rely exclusively on future repayments and realized capital gains from portfolio company investments to fund ongoing operations and redeem the state preferred stock investment over the five year period. Additional private capital, if raised, could make an accelerated state redemption possible.
- If the State elects to have its preferred stock redeemed, its equity interest in KVCII represented by such redeemed shares of preferred stock will terminate. No prediction can be made as to the timing or amount of dividends paid with respect to the preferred stock or the amount of realizable distributions with respect to the preferred stock if KVCII were ever liquidated. Accordingly, no forecast can be made as to the return the state would receive if it continued to hold its interest in KVCII.

**EXHIBIT B**

**Quarterly Shareholder's Report**

# Kansas Venture Capital, Inc.

January 23, 1998

**To: SHAREHOLDERS  
of Kansas Venture Capital, Inc.**

## **Fourth Quarter Shareholders' Report - December 31, 1997**

### **Financial Condition**

Kansas Venture Capital, Inc. reported an unaudited \$683,327 net loss for the year ended December 31, 1997 compared to \$219,235 net income for 1996. The Company's unaudited stockholders' equity at December 31, 1997 stood at \$13.9 million or \$12.01 per share versus \$12.20 per share at December 31, 1996. KVCI's book value at December 31, 1997 remains above the original \$10.00 per share cost basis of our shareholders, particularly shareholders that used the 25% state tax credits.

Contributing to the loss for the year was a \$1,657,000 write off of one troubled investment. This loss, however, was partially offset by \$871,000 of capital gain income realized during the year from the sale of equity securities of two successful portfolio investments.

We consider the write off of any investment disappointing and unacceptable, but recognize and anticipate that KVCI, like other small business investment companies, will incur losses on investments from time to time. Our strong capital base, however, gives us the ability to withstand occasional losses while continuing to make investments that we believe will generate capital gains similar to those we have experienced in the past. In addition, we have made several improvements in our investment process and monitoring activities that we believe will improve our future performance.

Overall, we believe that KVCI's portfolio of thirteen Kansas-based businesses is in healthy condition and expect to realize net capital gains from the portfolio in 1998. Three companies currently performing below expectation are being monitored closely and have been valued accordingly. Most of our investments, however, are meeting or exceeding our expectations. We will continue to concentrate on balancing our dual objectives of economic development and return on investment while increasing our portfolio of Kansas-based businesses.

Our annual report, to be distributed in March, will detail 1997 results and highlight KVCI's positive impact on the Kansas economy.

### Investment Activity

KVCI invested \$1.4 million in Kansas-based companies during 1997. We expect 1998 to be a more active investment year and, in fact, our first investment for 1998 was completed on January 6th. KVCI was one of three institutional investors participating in the acquisition and expansion of a flexible packaging manufacturer in Kansas City, Kansas.

Since 1987, KVCI has invested more than \$19 million throughout Kansas. We look forward to the redeployment of our capital into other Kansas-based businesses in our continuing effort to accomplish our objectives.

### Portfolio Company Highlight

**Transline Communications, Inc.**  
*Prairie Village, Kansas*

On November 14, 1997, KVCI completed an investment in Transline Communications, Inc. ("TCI"). TCI provides specialized, international long distance services to financial companies. From its primary office in Prairie Village, Kansas, TCI sells voice and data circuits and private networks to brokerage and trading companies with multinational operations. Proceeds of KVCI's investment are being used to add personnel, purchase equipment and additional transatlantic bandwidth and for working capital to expand the company's network capabilities and customer base.

We are excited to add an investment in our portfolio in the rapidly growing telecommunications field and look forward to the continued success of TCI in its specialized niche of this global industry.

### Economic Development

We continue to play a meaningful role in the economic development efforts of Kansas. Since 1987, KVCI has invested in 24 companies located in 13 counties throughout the state of Kansas. These companies have created and preserved more than 2,800 jobs, over 35% of which are a result of investments in businesses located in Kansas communities less than 15,000 in population. Cumulative payrolls in excess of \$310 million and state and local taxes exceeding \$9 million have been paid by these companies since our involvement.

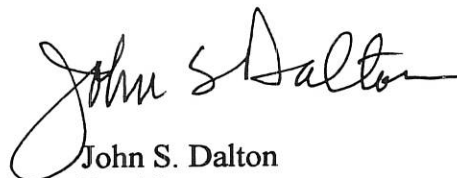
**Proposed Redemption  
of the State of Kansas' Preferred Stock Investment in KVC**

The controversy over the role of state government in seed and venture capital escalated throughout the 1997 legislative interim hearings. The Joint Committee on Economic Development recently conducted public hearings concerning the compatibility of public funds and venture capital. We have been closely monitoring the legislative proceedings and have had many discussions since mid 1997 with members of the state legislature and administration, KVC stockholders and the Kansas Bankers Association regarding the impact on KVC of the current public policy concerns.

In response to these recent events and the current negative environment concerning the direct investment of state funds in seed and venture capital companies, KVC management and Board of Directors are pursuing a course of action to redeem the state's preferred stock and privatize the operations of KVC. Many members of the Kansas legislature and the administration support the privatization proposal and the Kansas Bankers Association has adopted a resolution supporting KVC's privatization effort. The Board of Directors of KVC also adopted a resolution to facilitate the privatization proposal with the state. We believe that such a move will best serve the interests of all stockholders, common and preferred. We expect legislation will be passed during the 1998 session that will define the terms and conditions of the redemption. We will keep our stockholders informed of significant events relating to this transition.

**Referrals**

We appreciate the referrals that our shareholders have provided us and hope you will continue to contact us with potential investment opportunities or concerning equity financing activities in general. As you know, we rely heavily on a broad referral network and we encourage your assistance in that regard. Thank you for your continued support of KVC. Please feel free to contact me or any of our officers or directors with any questions you may have concerning your company.

  
John S. Dalton  
President



# Kansas Bankers Association

800 SW Jackson, Suite 1500

Topeka, KS 66612

785-232-3444 Fax - 785-232-3484 e-mail - kbacs@ink.org

TO: House Economic Development Committee  
FROM: Chuck Stones, Director of Research  
RE: SB 487

Mr. Chairman and Members of the Committee:

The Kansas Bankers Association is supportive of SB 487. During the 1986 Legislative Session the KBA became very involved in a series of economic development initiatives. We became particularly involved in the formation of a venture capital company that would fill a financial niche that was not currently being served. Banks from all over the state, large and small, invested in Kansas Venture Capital, Inc.. They invested their money mostly out of loyalty to the State of Kansas and to the KBA since there was no precedent and certainly no assurance that such an entity could survive in those difficult times. Another crucial part of the plan was the participation of the State. The investment by the State provided stability, credibility and liquidity. It was crucial at the time.

The KBA does not want to get involved in the actual payback method, nor does it want to imply it represents the common stockholders. The KVICI Board of Directors represents the stockholders and is a very capable group of individuals. Under their direction KVICI has become an economic development success story. You have heard from the company about the economic benefit their investments have provided to the State's economy. The State can be proud of the foresight it showed with its support of KVICI.

However, the KBA, as the group instrumental in the founding of KVICI, wants the Committee to know that we believe that KVICI is now at a point where they can operate more effectively without direct State money. If SB 487 passes, the State can either put its money to better use or return it to the taxpayers. We are assured that KVICI will continue its commitment to businesses in Kansas. We feel SB 487 is the next step. Allowing KVICI to privatize will allow it to continue to grow and will remove some of the burden placed on it by the involvement of State money. We believe this is the best path to follow for all involved. We would urge you to allow KVICI to keep doing what they have been doing, but with a capital structure that does not have direct state involvement.

We urge your favorable consideration.

Charles A. Stones  
Director of Research

Economic Development Comm  
3-11-98  
Attachment 3



P.O. Box 226 • Seneca, KS 66538 • 785/336-3760  
FAX 785/336-2751 • <http://www.krwa.net>

COMMENTS ON SENATE BILL No. 487  
BEFORE THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT  
March 11, 1998

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present comments on Senate Bill No. 487. I am Elmer Ronnebaum, General Manager of the Kansas Rural Water Association. Kansas Rural Water is a non-profit industry association which provides a variety of training opportunities for operators, board and council members and on-site assistance to public water and wastewater utilities. The Association's membership includes 290 rural water districts and 340 cities and over 250 supplier/vendor associate members. Our service to systems is not contingent on membership in the Association.

The 1996 Amendments to the Safe Drinking Water Act provided federal grants to states to establish revolving loan funds for public water systems. Kansas passed enabling legislation already in the 94 Legislature. The actual loan program was developed over a period of 17 months of discussions and development led by KDHE and KDFA and various interest groups including the League of Municipalities and Kansas Rural Water. Kansas will receive some \$14.6 million in funds from EPA and after certain set-asides are taken out, the state has leveraged the remaining \$11.350 million by 4:1 ratio. In December, KDFA issued \$45 million in bonds for this program. The first loan agreements were recently signed between the state and City of Salina, City of Garden City and the City of McLouth.

Eligible activities of the new loan program are include:

- \* Projects to consolidate water supplies or restructure systems
- \* Planning or design costs
- \* Projects to replace aging infrastructure, including source improvement projects; and installation or upgrades of treatment facilities, storage facilities or distribution systems

There is a demand for the loan funds. Early in 1997, KDHE sent a letter to all the state's 845 publicly owned water suppliers asking about their planned capital expenditures for 1997-2001. KDHE received 464 responses indicating a need for \$52,505,491 for 1997; through 2001, the total was \$479,220,000. Kansas Rural Water suggests that the actual need is even higher. Some systems did not respond to the survey because they were not fully aware of the purpose of the survey or just missed the communication.

The new revolving loan program provides below-market interest rates. Both rated cities and non-rated rural water districts have access to the program. The application process is streamlined. We know that many of the projects which are proposed for funding are making the improvements because of the attractiveness of the loan program. Having a good water supply and sound water delivery system in place are essential for public health, safety and welfare. The City of McLouth as an example of one of the first loans is financing a connection to a rural water district; McLouth is excited to finally have a water supply with a reasonable iron quantity and additional quantity. The economic impact on communities is immeasurable.

Cities and rural water districts which will be approved for loans through this fund are realizing savings. We hope you will favorably consider ways to enable that program to reach as many more towns and rural water districts as possible.

Respectfully submitted,

  
Elmer Ronnebaum  
General Manager

Economic Development Comm.  
3/11/98  
Attachment 4

# New SDWA \$\$\$ help small systems

**I**t's finally here! The much-heralded 1996 Safe Drinking Water Act's state revolving loan fund has come to Kansas.

Two giant steps took place in September, 1997:

## #1. First priority list.

KDHE submitted a draft project priority list of 48 projects -- cities, rural water districts and public wholesale water supply districts to the U.S. Environmental Protection Agency for funding. The list is part of a federally-required state intended use plan that must be approved by EPA before FY97 federal dollars are available.

## #2. Bond ratings.

Meetings were held in New York with Moody's and other national



bond rating agencies on a \$45 million bond issue. The bonds would supply state funds needed to match the federal grant from EPA. Led by the Kansas Development Finance Authority (KDFA), KDHE and others provided details on the proposed 48 projects and payback plans. The higher the bond rating given, the lower the interest rate to the state fund.

Kansas anticipates an "A1" rating from Moody's. What does that mean? Less interest will be paid by the state. In turn, more dollars will be available for loans.

Rome wasn't built in a day. And behind those two huge steps in September were years of fighting in Congress, careful preparation in Topeka anticipating the SDWA's passage and building a unique partnership among KDHE, KDFA and the Kansas Rural Water Finance Authority (KRWFA). "I feel that we have this loan fund structured in a way to keep it investment grade and yet make the bonds saleable," said William Caton, President of KDFA.

## SRF ABCs

The 1996 amendments to the Safe Drinking Water Act included new money to help public water systems -- a state revolving loan fund (SRF). The SRF's purposes are compliance with the SDWA and protection of the public's health. Each participating state establishes a revolving loan fund comprised of its EPA grant plus state matching funds. As the loans are paid off, money is "revolved" out to other approved systems for loans.

### Major aspects of the SDWA SRF:

- Nearly \$1.3 billion is available nationally in the first year, FY97
- A state must contribute at least 20 percent in matching funds
- 15 percent of the loan funds must go to systems serving

fewer than 10,000 people "to the maximum extent possible"; Kansas law requires 20% funds to systems serving fewer than 5,000

- Up to 30 percent of the EPA grant can be used for "disadvantaged" communities

- Set asides for administration (4 percent maximum), technical assistance to small communities (2 percent maximum), etc. are allowed

- A state must get EPA approval for its plans, priorities and process before its EPA grant is awarded

**Eligibility.** While the SDWA permits both publicly and privately owned community water systems -- and nonprofit noncommunity water systems -- to be eligible, some states have laws or a regulation that exclude privately-owned systems. A majority of the SRF working group under EPA's National Drinking Water Advisory Committee voted in September that states should not be allowed to categorically exclude systems from applying based on ownership, unless state law prohibits.

Eligible activities per federal guidelines:

- ✓ Projects to consolidate water supplies or restructure systems
- ✓ Planning or design costs
- ✓ Projects to replace aging infrastructure, including source improvement projects; and installation or upgrades of treatment facilities, storage facilities or distribution systems

Projects ranging from dams to O&M expenses aren't eligible

## Draft Project Priority List submitted to EPA

(see sidebar for details).

However, some otherwise ineligible projects may be included if they ensure compliance with the water quality regulations and/or technical, managerial and financial capability. "Ensure" in this case requires the system to get state approval for its improvement plan.

**State steps.** To receive an EPA grant under the 1996 SDWA, states must:

1. Pass legislation authorizing the state to operate a drinking water SRF (Kansas status: Completed)

2. Prepare an intended use plan how funds will be used, including a priority list of projects to be funded (Kansas status: Submitted to EPA in September, 1997)

3. Provide assurances, including a minimum 20 percent state match (Kansas status: Exceeds requirement by matching every federal dollar with four state-procured dollars, making much more money available for loans)

4. After EPA's approval, the state sells bonds (Kansas status: Approval is anticipated during the Fall, 1997)

5. Funds go to projects (Kansas status: First loans anticipated by end of 1997)

### Kansas moves quickly

Early in 1997, KDHE sent a letter to all the state's 845 publicly owned water suppliers asking about their planned capital expenditures for 1997-2001. The 464 responses showed a need for \$52,505,491 for 1997; through 2001, the total was \$479,220,000.

Municipality name	Loan requested	Project description
Finney 1*	\$2,400,000	RWD serving MHP around Garden City
Spivey*	\$ 75,000	Interconnect to Harper CO RWD 5
Abilene	\$1,000,000	New water treatment plant
Newton	\$2,000,000	Water treatment plant rehab, corrosion control, etc.
Dickinson CO RWD 2*	\$ 465,000	Share of WTP upgrade, booster pump rehab, etc.
Garden City	\$2,950,000	1.0 MG ground storage reservoir & by-pass piping
Kirwin*	\$ 595,412	New public water supply source
Raymond*	\$ 60,000	Two new wells
Colwich*	\$3,000,000	New water system to serve city
Garden City	\$2,350,000	2.0 MG ground storage reservoir and standby gen.
Goodland*	\$2,600,000	Waterline replacement, storage tank, new wells
McLouth*	\$1,105,412	Interconnect
PWWSD 17	\$4,051,875	PWWSD 17
Protection*	\$ 350,000	New water supply wells
Saline CO RWD 4*	\$ 148,610	New well, chlorination system, transmission line
Shawnee CO RWD 3*	\$1,250,000	Storage tank and transmission line
Shawnee CO RWD 5*	\$ 320,000	Storage tank
Johnson CO RWD 7*	\$ 300,000	Two miles of water line
Johnson CO RWD 7*	\$ 700,000	Joint project with Miami CO 2 for plant upgrade
Stockton*	\$2,500,000	Replace water treatment plant
Johnson CO RWD 6C*	\$ 515,000	Loop lines
Leavenworth CO RWD 1C*	\$ 500,000	Transmission mains
Parsons	\$9,500,000	New water treatment plant
Shawnee CO RWD 2C*	\$1,200,000	Water line; 200,000 gal. elevated storage tank
Valley Center*	\$3,100,000	Interconnect
Baxter Springs*	\$2,300,000	WTP rehab, upgrade; distrib. rehab; etc.
Hugoton*	\$ 400,000	Loop lines; new well to replace abandoned one
Miami CO RWD #2	\$4,804,000	Plant rehab and transmission lines
PWWSD 4	\$1,200,000	New filters and sludge lagoons
Pittsburg	\$3,185,000	New water tower, rehab. of existing storage, etc.
Severy*	\$ 290,000	Water source improvements, low water dam, etc.
Alma*	\$1,100,000	Water storage tank, line looping, rehab filters
Burden*	\$ 480,000	New water wells to replace old ones
Clifton*	\$ 500,000	New wells and standpipe
Emporia	\$4,918,995	Phase 2 plant upgrade
Franklin CO RWD 5*	\$ 120,000	Replace well, chlor. facility; new replacement well
Geary CO RWD 4*	\$1,000,000	Filter system, interconnect
Independence	\$1,200,000	Improve supply in town; replace old serv. pumps
Marion CO RWD 4*	\$1,977,000	Transmission and storage
Mitchell CO RWD 2*	\$1,020,000	Rehab and expand WTP
Nickerson*	\$ 275,000	New well, pump station, transmission line
Osage CO RWD 3*	\$ 280,000	Distribution line, loop
Osage CO RWD 7*	\$ 135,000	Construct four miles of line
PWWSD 15	\$2,575,000	Construct 20" line Pfeifer-Schoenchen
Rice CO RWD 1*	\$ 135,000	Transmission lines
Salina	\$3,600,000	Air strippers
Sylvan Grove*	\$ 308,000	Replace 12000 lf PVC
Syracuse*	\$ 220,000	Paint and clean tower, replace river crossing

\* = Systems serving population less than 5,000

## What's out

**H**ere's the list of ineligible projects per EPA (2/97):

- Dams or rehabilitation of dams
- Water rights except if the water rights are owned by a system that is being purchased through consolidation as part of a capacity development strategy
- Reservoirs, except for finished water reservoirs and those reservoirs that are part of the treatment process and are located on the property where the treatment facility is located
- Laboratory fees for monitoring
- Operation and maintenance expenses
- Projects needed mainly for fire protection
- Projects for systems that lack adequate technical, managerial and financial capability, unless assistance will ensure compliance
- Projects for systems in significant non-compliance, unless funding will ensure compliance;
- Projects primarily intended to serve future growth

The EPA grant for Kansas is \$14,095,000 for FY97. After setasides for allowable items like small systems technical assistance and administration, Kansas allocated \$11,354,800 for its new state revolving fund (SRF). But how to get the total up to match needs from the 464 responses?

**Leveraging federal dollars.** State matching dollars brought the FY97 total up to the needed \$45,419,000 -- an aggressive 4:1 ratio. The grant from EPA is not loaned to systems. Some states are aiming at a smaller 2:1 ratio which would only double their EPA grant. And some will contribute only the mandatory 20¢ for each federal dollar. In contrast, Kansas quadrupled its EPA grant, a 4:1 ratio. This means much more money available for loans

**Criteria.** Proposed projects received through August, 1997 were reviewed by KDHE. Top criteria include issues such as compliance with the SDWA, regionalization of systems and reliability. Another important criteria is readiness to proceed. A public meeting to discuss the priority ranking system was held in late May.

### **FY97 priority list.**

Forty-eight projects were on the draft project priority list appended to the intended use plan submitted in September, 1997 to EPA. The projects had to comply with (a) SDWA requirements and (b) other federal and state laws and with executive orders dealing with environmental and socio-economic requirements. A public hearing on the intended use plan was held early in September.

**Loan rate.** Only after EPA approves the intended use plan can loans be made. "We'll make loans at 80 percent of market rate, with all recipients paying the same rate," said David F. Waldo, Chief, Public Water Supply Section in KDHE's Bureau of Water. The 80 percent is based on the average three months' 20 Bond Index as published in *The Bond Buyer*. Interest earnings from the federal grant are used to subsidize the interest rate charged to borrowers.

### **Approved set asides**

The 1996 SDWA permitted states to set aside part of their grants for four major activities:

- Administration of the fund -- 4 percent
- Technical assistance to systems serving 10,000 or fewer persons -- 2 percent
- For any of (a) supplement the public water supply

supervision grant; (b) source water protection programs; (c) capacity development strategies; and (d) operator certification programs -- 10 percent

- For any of (a) loans for land or a conservation easement to protect the system's source water from contamination; (b) loans to implement local, voluntary source water protection measures; (c) loans for source water petition programs; (d) technical or financial assistance to a system under the state's capacity development strategy; (e) from funds appropriated through FY97 only, to delineate and assess source water projection areas -- 15 percent

In Kansas, the setasides for FY97 total \$2,740,200. Per the intended use plan submitted to EPA, they are for:

- ✓ Program administration: \$563,800 or 4 percent. This includes financial reviews, project review and approval, project ranking, priority list management, tracking of loan repayments, construction inspection and updating the needs survey.

- ✓ Small system technical assistance (TA): \$281,900 or 2 percent. TA will be provided to systems serving less than 10,000 population by the Kansas Rural Water Association under third-party contract. It includes systems using surface water sources to prepare for the enhanced surface water treatment rule.

- ✓ Capacity development strategy: \$485,000 or 3 percent. Capacity development (see article in the March, 1997 *The Kansas Lifeline*) refers to the ability of a drinking water system to have enough money, technical know-how and

## David K. Shupe employed by KRWFA



David K. Shupe has been employed as a full-time financial advisor to the Kansas Rural Water Finance Authority (KRWFA).

Shupe has worked as financial advisor to the Authority since 1991, where he personally coordinated the issuance of 37 bond issues. KRWFA has issued \$44 million in bonds since its inception in 1988.

As financial advisor to KRWFA, he will assume the role of Senior Financial Analyst for the Kansas Public Water Supply Loan Fund. He will conduct on-going review for financial compliance with loan agreements.

The Kansas Rural Water Finance Authority is under contract to the Kansas Development Finance Authority for that work (see related articles).

In his tenure with KRWFA, Shupe has assisted hundreds of communities and rural water districts across Kansas on financing options. He has participated in dozens of seminars discussing the benefits of bidding interest rates and underwriting discounts vs. negotiating bond issues.

"The KRWFA has provided invaluable services to rural water districts and small towns in Kansas. David has been instrumental in saving money on financing for many entities," said Maurice Meirowsky, President of KRWFA's board of representatives. "KRWFA looks forward to working in partnership with state agencies on the new Public Water Supply Loan Fund."

Shupe holds a master's degree in public administration from Wichita State University and a Bachelor's degree from Kansas State University. He can be reached at PO Box 3608, Wichita, KS 67201-3608. The Wichita phone is 316-265-4855; fax is 316-265-5403. KRWFA's general offices are maintained in conjunction with KRWA's office at Seneca, KS. Write to KRWFA at PO Box 111 or call 785-336-3760.

managerial skill to comply with the SDWA's requirements.

✓ Source water assessment and delineation: \$1,409,500 or 10 percent (available only for the FY97 federal grant, it can be spent over the next four years). This program is required if Kansas is to qualify for approval of its own contaminant monitoring program, which will substitute for EPA monitoring requirements.

### Three-way partnership unique

A three-way partnership makes the Kansas SDWA SRF unique. Three organizations are working together to make the Kansas Public Water Supply Loan Fund work for large and small systems.

• **KDHE** is the primacy agency for the entire Safe Drinking Water Act, responsible to EPA for carrying out the Act and its state revolving loan fund.

• **KDFA**, the Kansas Development Finance Authority, is responsible to the state for creating and managing the loan fund in a cost-effective manner that protects both taxpayers and investors.

• **KRWFA**, the Kansas Rural Water Finance Authority, is under contract to KDFA to (1) conduct financial analyses for all SRF loan applicants and (2) manage the Financial Integrity Assurance Contracts of non-rated rural water districts and towns identified as needing management and reporting assistance. These steps will help assure that the water utility is well managed and the public health protected – and that the loan is repaid.

In Kansas, it made sense for the three organizations to mesh their expertise. "The three-way

partnership is unique," said KDFA's President Bill Caton. "Kansas does not need to hire expertise at the state level when we have an organization [KRWFA] that has the mission, organization and track record. It's a good way not to create more government."

"I feel we have this loan fund structured in such a way to keep it investment grade and yet make the bonds salable," said Caton.

### Return on investment

*The bottom line:* The Kansas Public Water Supply Loan Fund is win-win for everyone.

✓ The state's major water industry entities are cooperating to get funding to qualified systems -- larger cities, small towns and rural water districts.

✓ Kansas has selected an aggressive 4:1 ratio that matches

state to federal dollars, creating a much larger fund to loan out

✓ The bond pool concept includes rated and non-rated water systems in a structure that makes bonds an attractive investment

✓ Participating systems have demonstrated their technical, managerial and financial capacity to operate a strong utility today and in the future

✓ Set asides permit special attention to important issues like source water protection

✓ By using the proven expertise of existing organizations like KRWFA, state government stays lean

*Prediction:* For water utilities, the new Kansas Public Water Supply Revolving Loan Fund may well become as important as Farmers Home funding was 30+ years ago.

# Getting SRF dollars in Kansas

**W**hat's the gateway to SDWA SRF dollars? The state's priority project list; the first one was submitted by KDHE to U.S. EPA for FY97 funds. Forty-eight water projects were named.

The September 1997 list covered 28 municipalities, 17 rural water districts and three public wholesale water supply districts. Out of the 48 projects, 35 (73 percent) serve less than 5,000 population.

## Steps to take

If your system didn't make KDHE's FY97 draft project priority list submitted to EPA, now's the time to start on the FY98 cycle. Here's how.

**Step 1.** A municipality or rural water district submits to KDHE a project description (but not an engineering report) including problems addressed and preliminary costing.

**Step 2.** Projects with the highest rank listed on the Intended Use Plan are ranked by KDHE. Top criteria include water quality issues such as compliance with the SDWA, regionalization of systems and reliability. Readiness to act is also a top criteria.

**Step 3.** KDHE sends the higher ranked systems an official application package.

**Step 4.** The system completes its official application (including environmental impact reports and a financial analysis made by the Kansas Rural Water Finance Authority), requesting review and clearance from federal and state agencies.

**Step 5.** If appropriate, based on agencies' review and if the utility meets financial requirements, KDHE issues a Finding of No Significant Impact (FONSI) on the environment, permitting the loan to be made.

**Step 6.** Presuming the applicant holds a public hearing, etc., SRF funding is available in a few months.

The key to SDWA SRF dollars? Getting on KDHE's annual project priority list.

## Wanted: A water conservation plan

Each SRF applicant needs an approved water conservation plan, pointed out KDHE's David F. Waldo, Chief of KDHE's Public Water Supply Section. "That's one thing that's somewhat unique in Kansas," Waldo stated. "If they anticipate submitting an SRF application, they need to apply to the Kansas Water Office."

Per materials handed out by Darrel L. Eklund, Kansas Water Office, at training in July 1997, to be eligible to participate in the new SRF, a water utility must:

**"1.** Have a current municipal water conservation plan that has been approved by the Division of Water Resources or the Kansas Water Office and has been adopted and implemented by the water utility, or

**"2.** Prepare a new municipal water conservation plan which must be approved by the Division of Water Resources

or the Kansas Water Office and the plan must be adopted and implemented by the water utility."

## Keeping up to date

Four main methods are being used to get the word out about the Kansas SRF.

**Training.** Over 350 people from cities and rwd's attended four SRF training seminars in July, 1997. Speakers from KDHE, KRWFA, the Kansas Water Office, Acord Cox & Company and KRWA presented basic information and fielded questions. KRWFA is responsible for providing these training seminars, which will also be held for the FY98 cycle.

**Mailings.** A mailing about the SRF will be sent to 845 Kansas public water supplies by the end of December 1997. Last summer, over 5,000 notices were sent out by KRWFA notifying systems of the four SRF seminars.

**KRWA website.** If you're not on the Internet yet, go to your local library and check [www.krwa.net](http://www.krwa.net). You'll find out the latest on the revolving loan fund plus much, much more (see related article in this issue).

**Telephone.** For further information, contact Dave Waldo at 785-296-5503 or the Kansas Rural Water Finance Authority at 785-336-3760. KRWFA's new full-time senior financial analyst, David Shupe, can be reached at 316-265-4855. His fax is 316-265-5403; the mailing address is PO Box 3608, Wichita 67201-3608.

## SRF application form

Since the Kansas SRF is a new program, it's understandable that the official application form (see step 4 above) isn't cast in concrete. "The form is final



## Something old, something new

enough for this first year," said Dave Waldo, "and we can modify and improve it due to experience."

*Information to be provided includes:*

- ✓ Project type, such as emergency, plant rehabilitation, line construction or water storage
- ✓ Brief narrative of the proposed project
- ✓ Estimated costs for construction, inspection, engineering, audit/legal, other
- ✓ Amount requested from the Kansas SRF fund; amount from other sources
- ✓ Proposed project schedule
- ✓ Major expansions and/or improvements in the past 10 years
- ✓ Number/type of customers for the past five years
- ✓ Present sources and/or contractual agreements (attach copies)
- ✓ List of customers providing 5 percent or more of revenue from water sales
- ✓ Status of approved Water Conservation Plan
- ✓ Water production history for the past five years
- ✓ Financial information such as most recently adopted and proposed water rates; financial statements from the last three years; taxing powers; outstanding debt; leases; assessed valuation

A copy of the governing body's resolution approving submittal of the application must accompany the form, along with copies of the last three years' financial statements and other attachments.

You thought you had finally mastered all the jargon? Think again, because some things have changed.

**EPA** -- *U.S. Environmental Protection Agency.* The regulatory agency in charge of assuring compliance with the 1996 Amendments to the Safe Drinking Water Act.

**FIAC** -- *Financial Integrity Assurance Contract.* Kansas water systems that have neither taxing powers nor the ability to get bond insurance must sign a FIAC if they are selected for SRF funding. That contract, part of the SRF loan agreement, means the water system opens its books to KDFA. In return, KDFA takes care of all SRF reports for the system. A one-time, one percent fee on the outstanding balance is charged for a FIAC. It is included in the total amount loaned.

**KDFA** -- *Kansas Development Finance Authority.* The state agency responsible for forming and administering the Kansas Public Water Supply Loan Fund. That fund consists of (1) the EPA grant and (b) matching state-procured dollars. It also takes the lead in procuring the highest possible national bond rating for each bond issue. The higher the rating, the lower the interest rate Kansas' borrowers will pay.

**KDHE** -- *Kansas Department of Health and Environment.* The primacy agency responsible to EPA for carrying out the SDWA and EPA regulations and guidelines.

**KRWFA** -- *Kansas Rural Water Finance Authority.* Established in 1988 as a non-profit corporation, it is under contract to KDFA to (1) conduct financial analyses for all prospective borrowers and (2) manage the FIAC contracts of the non-rated rural water districts and towns identified as needing management and reporting assistance.

**Kansas Public Water Supply Loan Fund.** -- The official name of the reserve account made up of the EPA capitalization grant plus matching state dollars. For FY97, the EPA grant totals \$11.3 million after allowable set asides. Kansas is matching that amount with another \$45 million via revenue bonds. The result is an aggressive 4:1 ratio that provides a much larger fund to be loaned to approved state water systems.

### Adequate rates are "must do"

Be sure you do a thorough rate analysis. "You have to make sure that your rates will cover debt service and operations and maintenance," stated David Shupe of KRWFA. "Systems need a 1.25 coverage ratio. That means that for every dollar of expenses, you need to have \$1.25 in operating revenue. That's the minimum coverage ratio required for a system to qualify for a loan." In addition, there is a 10 percent loan reserve (funds sitting in escrow which earn interest).

The situation may be different for municipalities if

they elect to use general obligation bonds.

How do you find out your ratio? Look at your recent audits. Also check out Section 8, "Financial analysis and ratios," in *Financial Accounting Guide for Small Water Utilities*, volume four in the *Water Board Bible* series published by KRWA.

But beware, because not all auditors want to tell you bad news. Recently a rural water district contacted KRWA because it was having a hard time paying bills. It turned out that over the past five years, the rwd didn't even have a 1.10 coverage ratio (for every \$1.00 owed it must have a \$1.10 in



## Getting on the FY97 SRF list: *The view from McLouth*

The City of McLouth had its first experience with a state revolving fund (SRF) when it sought funding from the 1987 Clean Water Act's SRF for sewers. At that time, seeking Community Development Block Grant (CDBG) funding for a water project was on the back burner.

**Changing priorities.** A crisis reversed the priorities: Three new dry holes in June, 1996 followed the 18 dry ones that had been drilled in 1989.

"We had to do something," said Operator Carl Chalfant. The priority shifted from sewer to water. Kansas Rural Water Association told McLouth that there might be funding available from the then-pending Safe Drinking Water Act's state revolving loan fund.

As more information emerged, it looked like the SDWA SRF might provide the financing that would be the most affordable. While it was too early for specifics, conversations with KDHE staff fueled McLouth's interest in the forthcoming SRF.

**Necessary paperwork.** In January, 1997 KDHE sent out questionnaires statewide about possible capital expenditures for the years 1997-2001. Having already prepared the CDBG proposal saved time. McLouth drew heavily on that earlier document, preparing a project description that was appended to the KDHE questionnaire.

When the Kansas Rural Water Finance Authority, KDHE, the Kansas Water Office, Acord Cox & Company and KRWA presented seminars in

July, 1997, McLouth was ready to complete its preliminary application for SRF funding.

The Bank of McLouth offered a donation of \$100,000 when the city first applied for the CDBG. When the CDBG grant was delayed, Stan Braksick, owner, offered to transfer the gift to the new drinking water project so less money needed to be borrowed. "The Bank of McLouth sees this as an investment in the community. No community can survive, much less thrive, without water" he said.

**Outcome.** The City of McLouth was included in KDHE's intended use plan submitted to EPA in September, 1997. An interconnect, pipeline and storage tanks are listed for \$1,105,412.

Want to know more about applying for SDWA SRF funds? Chalfant advises systems to:

- ✓ Show your need; be able to explain the project and its scope.
- ✓ Make sure you have financial records from the last five years handy and up to date. It takes time to get all the records -- for example, financial and production -- together.
- ✓ "Be patient. Even though some things seem frustrating and redundant, there's a reason for it."
- ✓ Get all the help you can. "KRWA's Elmer Ronnebaum and KRWFA's Dave Shupe pitched in. The City of McLouth really appreciates their help throughout the process."

revenue). Their margin (.74) was far less.

Because this auditor didn't reveal to the board what he should have, he had some liability. Rather than pay legal fees to take the auditor to court or pay for restructuring the debt, this system opted to raise rates in

order to get into compliance with bond issue covenants.

*The outcome?* A whopping 51 percent rise in water rates. Not surprisingly, the public meeting on this increase included very spirited comments.

### "But what if we're not rated?"

Kansas has gone out of its way to help smaller municipalities and rural water districts that have no bond rating or that can't afford bond insurance. Rwd's don't have taxing authority.

**Question:** How to help small systems while attracting investors who don't like risk?

**Answer:** A bond pool that includes both rated and non-rated entities.

"We have taken great pains to make sure that small water utilities are included in our program," said William Caton, President, Kansas Development Finance Authority. The Kansas bond pool requires non-rated borrowers and those that can't afford bond insurance to get a Financial Integrity Assurance Contract (FIAC). A FIAC is a one-time, one percent fee on the outstanding loan balance and is built into the total loan. The goal of the FIAC is to provide necessary information and reporting to the state. Systems should find the ongoing review by an outside entity, KRWFA, to be a helpful management tool.

KRWFA manages the FIAC contracts. During the application process, this includes reviewing the financial statements and operational/historical information from each utility. There will also be an annual review to ensure compliance with loan covenants. The outcome? Heightened overall financial integrity of the entire loan fund.

## The SRF in other states

**W**hat's going on nationally? In March, 1997, Georgia was the first to receive its EPA capitalization grant of \$25.7 million for FY97; the state added another \$5 million.

In September, Moody's gave the first-ever rating under the SDWA SRF to Colorado. Its Aa2 rating (which is a high one with associated lower interest rates for the borrowers) will help fund loans to the cities of Englewood and Fort Collins plus Arapahoe Estates Water District.

The crucial step is getting federal funding. "As of October 1, 18 states had received their capitalization grant according to EPA officials," stated Vanessa Leiby, Executive Director of the Association of State Drinking Water Administrators.

The 10-year experience of states with the earlier Clean Water Act State Revolving Fund has both helped and hindered. Under that earlier SRF, virtually only municipalities received loans -- and often just the larger ones that already had high bond ratings and/or could afford bond insurance. That made their bond issues much safer for the investor.

In contrast, the SDWA SRF mandates participation of small systems and disadvantaged areas. Many of them are non-rated and don't have taxing authority and can't afford bond insurance . . . and thus are riskier for investors.

"Many states are just beginning to identify how they will operate and give grants," said James Smith, Executive Director of the Washington-based Council of Infrastructure Financing Authorities. "The common wisdom is that states will have to lend to rural systems and communities not as financially healthy as with the Clean Water Act SRF. There were probably about 5000 loans made under that SRF and there's not been a single default yet. Drinking water may not be as strong, but that will cause states to carefully structure their assistance to these small communities."

### This fund's for you

Kansas has gone out of its way to assure that smaller municipalities and rural water districts can participate in the new SDWA state revolving loan fund. Yes, it takes preparation. But here's new money that combines federal and state dollars.

The goal was to have a loan program which would be accessible to small and non-rated systems. As a result, Kansas has one of the most innovative and aggressive programs nationally.

The SDWA SRF is not the only solution. There's not enough funding to meet all the state's water capital improvement needs. But the program helps. Take advantage of this opportunity for reasonable-cost financing to help your customers and your community.



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## OFFICE OF THE GOVERNOR

### MEMORANDUM

**TO:** House Economic Development Committee

**FROM:** Jamie Clover Adams, Legislative Liaison

**DATE:** 11 March 1998 *Jamie*

**SUBJECT:** Support for Senate Bill 487

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Mr. Chairman and members of the Committee, thank you for the opportunity to appear this afternoon in support of Senate Bill 487. I will limit my comments to Section one of the bill dealing with the Kansas Public Water Supply Loan Fund.

S.B. 487 makes available an additional \$5 million to leverage \$20 million in loans for providing more communities with critical water system upgrades. Governor Graves voiced his support for this additional funding during his State of the State message for two important reasons. First, effective public water supply systems are critical to protect public health. The Safe Drinking Water Act requires water suppliers to deliver water at the tap that meets national safety guidelines. Loans from the fund will assist water suppliers in meeting these requirements. Secondly, a safe and quality water supply is important for economic development and community growth. Growing communities need increased water supply infrastructure to meet the needs of new industry and their citizens.

The Kansas Public Water Supply Loan Fund was established by the Legislature in 1994 so the state could receive capitalization grants from the federal government under a national revolving loan program for public water supply infrastructure. The national program was funded with the passage of the 1996 amendments to the Safe Drinking Water Act. Kansas received its initial capitalization grant of a little more than \$14 million from the Environmental Protection Agency (EPA) in December, 1997. Another \$10 million is expected in federal fiscal year 1998. Federal capitalization grants are authorized by the Safe Drinking Water Act through federal fiscal year 2003. The initial \$14 million has been used to leverage more than \$45 million to finance 26 public water supply infrastructure projects.

*Economic Development Comm*  
*3-11-98*  
*Attachment 5*

Capitalization grants received from EPA are credited to a reserve account within the loan fund. The assets of the reserve account are then pledged as security for repayment of state issued revenue bonds. The investment earnings on the reserve account are used to buy-down the effective interest rate charged to the loan recipients. The interest rate last month was 4.25 percent.

Both KDHE and EPA have identified needs that outstrip the money leveraged from federal capitalization funds. According to a 1997 KDHE survey of needs, Kansas municipalities indicated they will need nearly \$190 million to finance 181 projects over the next five years. An EPA survey shows that Kansas municipalities will need nearly \$2 billion over the next 20 years to meet system needs. The additional funding provided in S.B. 487 moves the State forward toward meeting these needs.

On behalf of the Governor, I urge favorable consideration of S.B. 487. Thank you for the opportunity to appear before you today. I would be happy to answer any questions you may have on the program.

## What SB 554 Would Do

### Kansas Venture Capital Company Act

- ◆ Purchase of KTEC's interests in Ad Astra funds would be eligible for existing tax credits against Kansas income if sold to qualified buyer(s).
- ◆ Clean-up language would be added to include "limited liability company" (a business structure which did not exist when original legislation written) along with current references to "partnership" and "corporation".
- ◆ Tax credits could be claimed until exhausted.

### Local Seed Capital Pools Statute

- ◆ \$6.0 million of cash investment into STV currently eligible for 25 percent tax credits (\$1.5 million) would be transferred to qualified buyer(s) of KTEC's interests in Ad Astra fund, if sold.

## What KTEC Would Do

- ◆ Retain investment banker to represent KTEC and act as financial intermediary to evaluate and conduct sale of KTEC's interests in Ad Astra funds.
- ◆ Conduct sale through private auction or other bid process to obtain highest competitive price.
- ◆ Final sale would be subject to approval by KTEC Board of Directors.

## What State Needs To Do

- ◆ With State withdrawing from direct venture capital investments and an acknowledged shortage of seed and venture capital in Kansas, a Best Practices Study should be conducted to identify successful venture capital formation policies in other states.
- ◆ Kansas, Inc. - in cooperation with KTEC and KDOCH - would conduct the study and advise the Legislature and Administration on best practices and recommendations for Kansas.

Economic Development Comm.  
3/11/98  
Attachment 6

### Recommended Modification To SB 554

- ◆ Strike (3) on page 4, line 7 of Senate Bill 554.

#### Why Is Modification Needed

- ◆ Current draft limits tax credit use to only the purchase of State's current interest in Ad Astra by qualified private sector investors.
- ◆ Modification would enable tax credits remaining after the purchase (if all were not used to purchase State's interest) to be used for additional investment in Ad Astra.

#### Why Is This Important To Kansas

- ◆ This would hopefully encourage additional new risk capital to be invested in Ad Astra portfolio companies.
- ◆ Ad Astra has no available capital for follow on or new investment.
- ◆ Sunflower Technology Ventures which was to be created to provide follow on capital has been killed.