

Approved: January 28, 1999  
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Chairperson William G. Mason at 3:30 p.m. on January 21, 1999 in Room 522-S of the Capitol.

All members were present except: Vice Chair Vickrey  
Representative Larry Campbell - E  
Representative Broderick Henderson - E  
Representative Bonnie Sharp - E

Committee staff present: April Holman, Legislative Research Department  
Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee: Charles Ranson, President, Kansas, Inc.

Others attending: See Attached List

April Holman, Legislative Research provided information on a question raised at the January 19<sup>th</sup> meeting. The transient guest tax charged by motels is currently capped at 2 percent. Many cities charge up to 5 percent transient guest tax because they opted out of the statute by home rule.

The Chairman asked for bill introductions from the committee and the audience. Hearing none, he introduced Mr. Ranson for a committee briefing.

Mr. Charles Ranson, President, Kansas, Inc. spoke to the committee on the *Best Practices Study of State-Sponsored Seed and Venture Capital* (Research Report, dated December 1998, on file at the Kansas, Inc. Agency). It is anticipated that the report will form the basis for an informed, reasonable, rational discussion of the needs of entrepreneurial businesses in the state. He acknowledged Tom Blackburn, a member of the technical advisory committee.

Mr. Ranson gave testimony regarding the background, recommendations for development of: **a. seed stage** venture capital **b. early stage** venture capital **c. business modernization and expansion capital** to support non-technology enterprises. He addressed reconciling public accountability, avoidance of conflict of interest while protecting confidentiality for investors and portfolio companies before presenting the conclusion of the study (Attachment 1).

Chairman Mason expressed his appreciation for the timely report and provided the historical background that led up to the study.

Discussion followed regarding these issues: mezzanine capital, the effects on rural communities regarding participation requirements, federal tax incentives and clarification of specific funds and sectors listed in the report.

Chairman Mason talked about the ongoing strategy to bring to Kansas the higher paying technology positions that affords reasonable income for families. The seed and venture capital is one part of that entire strategy. They must think globally to determine the best direction for the state. He asked Mr. Ranson to summarize what the report says and where they should be headed.

Mr. Ranson stated that there is a critical need for seed funding. The study demonstrates that the funding will not be available through purely private sources. The state economy is traditionally based on agriculture, manufacturing and oil and gas and currently those sectors, in varying degrees, are in distress. It may take a five year time frame before those industries recover fully. While they have had a very strong economy, they need to diversify to minimize the risk of economic downturn. Kansas does an excellent job in education and is second in the country in educating PhD's in Engineering and Sciences, however they are 38<sup>th</sup> in the nation in absorbing those graduates into the Kansas economy. They are exporting their strongest natural resources, their youth. They must create opportunities, to build companies to employ the young, aggressive and ambitious people therefore strengthening the overall economy of Kansas. The seed

funding is only one part of the big picture but a well thought out, well run, accountable, transparent seed venture capital program is an essential element to the future of this state.

Discussions followed regarding the differences in the ongoing and past programs, specific instance in seed venture funding in Manhattan, agency responsible for attracting new companies to Kansas communities, the history, role, Board of Directors of Kansas, Inc., and the credentials of Mr. Ranson.

Chairman Mason suggested that members read the report and be prepared to discuss the subject at future meetings.

Representative Geringer moved, seconded by Representative Kuether that the minutes from the January 19 minutes be approved. The motion carried.

The next meeting is Tuesday, January 26.

Chairman Mason adjourned the meeting at 4:45 p.m.



## Kansas, Inc. Testimony

### Best Practices Study of State-Sponsored Seed and Venture Capital

Presented to the  
House Economic Development Committee  
21 January, 1999

#### Background

Over the past decade, the Kansas Legislature has appropriated a total of \$9.8 million for the development of seed and venture capital funds in Kansas. These appropriations leveraged approximately \$8.35 million in additional private investment, all of which monies were invested in three newly organized, privately managed investment funds, Ad Astra I, Ad Astra II, and Kansas, Venture Capital, Inc. (KVCI). Investors in these funds also received a 25% state income tax credit on their investment. In addition to the three privately managed risk capital funds in which state funds were invested, slightly more than a dozen privately held seed and venture funds were established with the encouragement of a similar tax credit. In all, a total of nearly \$37 million in private funds has been raised; and over \$9.0 million in state income tax credits have been granted to investors since 1986.

As a result of media stories, public attention became focused on investment decisions and operational management of two of the three privately managed funds in which state monies were invested. A thorough investigation dispelled all notions of any mismanagement. However, with the issue of public ownership in private enterprises having been raised, concerns persist among policymakers relating to an entrepreneur's need for confidentiality and the state's need for accountability for state funds. This conflict has given rise to two very basic public policy questions - should state funds be used directly to fund seed and venture capital funds? And, what viable alternatives to direct public funding exist?

In the Summer of 1997, the Kansas, Inc. Board of Directors directed Kansas, Inc. staff to conduct a best practices study to identify effective alternatives to direct public funding of seed and venture capital in Kansas. The Board further directed that the study evaluate and consider alternative policies and/or incentives used by other states to encourage development of sufficient private seed and venture capital in Kansas.

To help facilitate the study, Kansas, Inc. established a technical advisory committee of 20 members to provide guidance and oversight of the study. Members of the committee include representatives of the seed and venture capital community, entrepreneurs having successfully secured seed and venture capital, and representatives of the public sector. (A list of those members is attached.) It is important to acknowledge the partnering support of the Kansas Department of Commerce & Housing and KTEC in the realization of this study. We publicly express our thanks to Secretary Sherrer and to Rich Bendis and the KTEC Board for their cooperation and assistance with this undertaking.

The technical advisory committee met first in May 1998 to approve an RFP which was distributed to researchers across the country. The committee met a second time in June to review the proposals received and chose the researcher that would conduct the study. The researcher chosen to conduct the study was Economic Innovation International (EII) of Boston. Under the direction of its founder and president, Beldon Daniels, EII has helped to develop a

broad range of development funds in the U.S. and abroad, including funds specializing in technology development and commercialization, seed capital, early stage venture capital, later stage venture capital, mezzanine capital, and subordinated intermediate term debt. Beldon Daniels has worked with the Kansas Legislature on economic development issues in the past - most notably, helping to implement the Redwood-Krider report in the late 80's.

The technical advisory committee met again in September to review the draft results of the study. The researcher also presented the results of the draft report to the Kansas, Inc. Board of Directors on September 3, 1998. The Board of Directors voted to accept the preliminary reports of Economic Innovations International. The Board further voted to, in principal, support the concept of the utilization of tax credits to help generate seed capital in the state. At its December 7 Board meeting the Board of Kansas, Inc. accepted the final report and recommendations, which it now offers as a starting point for legislative deliberation directed to meeting the needs of high potential, high risk business start-ups in Kansas.

Economic Innovation International conducted case studies of a number of successful development funds. (Full results of these case studies may be found in section 5.0 of the full report and the matrix found at the end of section 1.0.)

Alliance Technology Ventures of Georgia  
Connecticut Innovations, Inc.  
Grupo Guayanacan of Puerto Rico  
Heartland Capital Fund of Nebraska  
Massachusetts Capital Resource Company  
Massachusetts Technology Development Corporation  
Mid-Atlantic Venture Funds of Pennsylvania  
Oklahoma Capital Investment Board  
Oregon Resource & Technology Development Fund  
Source Capital of Louisiana

From review of these funds, Ell found that there are eight factors common among successful funds. These common elements are

- ◆ A market large enough to generate sufficient deal flow.
- ◆ Goals focus first on returns; economic benefit follows.
- ◆ Management matters most and is compensated appropriately.
- ◆ Financial Structure focuses on net internal rate of return.
- ◆ Fund size is optimum for early stage focus and follow on investments.
- ◆ Legal structure preferred by investors is a 10 year limited partnership.
- ◆ Marketing helps generate deal flow.
- ◆ Public Accountability and oversight focuses only on overall economic portfolio returns, while protecting confidentiality and guarding against conflict of interest.

A summary of key findings from the final report, in addition to key observations connected with the underlying economic development infrastructure present in Kansas, provides recommendations in four main areas:

- 1) Development of Seed Stage Venture Capital in Kansas
- 2) Development of Early Stage Venture Capital in Kansas
- 3) Recommendations for Business Modernization and Expansion Capital to support Non-technology enterprises
- 4) Recommendations for Reconciling Public Accountability and Avoidance of Conflict of Interest while Protecting Confidentiality for Investors and Portfolio Companies



## General Recommendations/Observations

### **The importance of creating a system to support state technology commercialization and business modernization.**

- ◆ State investment in seed and venture capital will produce little without prior state investment in building a platform of technology infrastructure.
- ◆ State investment in seed capital will produce little if there is not an investment in building a set of funds which span a range of technologies, geographics, and management teams.
- ◆ State investment in seed capital will produce little if steps are not taken to create larger private investment in later stage funds headquartered in the state.
- ◆ State investment in seed capital will do little for smaller, slower growing, more traditional manufacturing and agribusiness located in outlying regions if it is not accompanied by a parallel investment in expanded business modernization, mezzanine capital and subordinated debt funds.

This concept of designing (or strengthening) a state technology commercialization and business modernization system is evident in case studies of Connecticut, Georgia, Massachusetts, Nebraska, Oklahoma, and Pennsylvania. In each case, the state system helps generate deal flow and serves a broader range of firms in more locations.

### **The State of Kansas should continue to play a major role in technology development and commercialization for two reasons.**

- global competitiveness in the Information Age depends upon technology driven innovation; and
- a platform of technology infrastructure must be built upon which the private sector can launch innovation.

### **Alternatives for funding:**

- ◆ The most common alternative to public investment in technology development is the investment of retained earnings by large multinational corporations resident in the state.
- ◆ For a variety of reasons, relying on multinational corporations is not a viable alternative for Kansas.
- ◆ Thus, the State of Kansas needs to continue being the engine of growth if healthy growth is to take hold in Kansas.
- ◆ Kansas has been making a significant long-term investment to build a technology infrastructure over the last decade, resulting in nationally-emulated models in KTEC, MAMTC and the ICCs.
- ◆ Nonetheless, Kansas' technology infrastructure is still in its early stages and needs continued support to realize its demonstrated potential.

- ◆ Local technology bridges are necessary to bring universities, the private sector, and state and local government into market-driven technology commercialization partnerships.



## Findings & Recommendations for Development of Seed Stage Venture Capital in Kansas

- ◆ Kansas could experience continued growth through one, or a series, of \$10 million seed capital fund(s) based by Kansas Tax Credits accessed through a competitive process.
- ◆ Tax credits are necessary, as the researchers know of no other case outside Silicon Valley or Route 128 where seed capital has been created without direct public investment or tax credits. Even there, underlying infrastructure -- national laboratories, defense research facilities and universities with an abiding commitment to basic research, were beneficiaries of enormous investment of federal dollars. This is why, in our present context, the success of Senator Pat Roberts' Science, Technology and the Future Committee is such an important corollary of the issue which we address today.
- ◆ The researcher recommends a system which separates the sources of credits from the uses of the credit by developing a process in which qualified venture capital partnerships, from in-state and out-of-state, access funds generated by Kansas tax credits through a competitive process.
  - The Oklahoma model demonstrates this separation by using tax credits to borrow capital from commercial lenders in the state rather than providing tax credits directly to investors for their own use.
  - The Oklahoma model forces organizations to compete for access to capital (rather than tax credits) derived from the stand-by tax credits by matching borrowed funds with equal or greater private funding. (Oklahoma has experienced a 10 to one leverage due to the intense competition for funds.)
  - Organizations vying for these funds might include the ICCs or private venture capital partnerships from in-state and out-of-state.
  - Costs to the State of Oklahoma have been limited to the operating costs of the associated investment board and those interest costs associated with the borrowed capital. Oklahoma expects the funds to begin producing a return around year four of operations.
- ◆ The Oklahoma model demonstrates the value of creating a set of funds, as opposed to a single fund. It is important to note, however, that no seed fund should be smaller than \$10 million dollars.
  - National experience demonstrates that you cannot profit from your "winners" without sufficient resources for follow-on investments. Funds of less than \$10 million historically appear to be too small to meet follow-on demand for capital.
- ◆ The Kansas, Inc. report also recommends for consideration that we could adopt the CAPCO legislation, or a variation, to import the capital of institutional investors from out of state.
  - Originally developed in Louisiana, the concept behind CAPCO is to offer tax credits to out-of-state corporations such as insurance companies in exchange for an investment into a certified capital company.

- ◆ Kansas also should consider merging the best of the CAPCO insurance company premium tax credit experience of Louisiana, New York, and Missouri with the previously mentioned Oklahoma stand-by tax credit.

## Findings & Recommendations for development of Early Stage Venture Capital in Kansas

- ◆ Kansas must develop an early stage venture capital system to pick up and grow seed capital successes.
- ◆ Providing one stage of capital is not enough.
- ◆ Whereas seed capital funds can generally not be built without some public investment, best state practice suggests that early and later stage venture capital funds can be.
- ◆ Leading private sector corporations, utilities, banks and insurance companies within Kansas can be encouraged to invest in a first time early stage venture capital fund without direct public funding if it has:
  - a. the appropriate corporate sponsorship
  - b. a nationally recognized venture fund manager
  - c. a sufficient initial capital base of at least \$30 million
  - d. a sufficient regional geographic base to support deal flow
- ◆ It is important that the fund(s) be located within the jurisdiction, though investments may be anywhere within the region.
- ◆ Large institutional investors such as corporate pension funds headquartered in Kansas would invest in later stage venture capital funds without the direct public funding if:
  - a. a key corporate leader takes the initiative in raising such a fund, often with a Governor's informal backing;
  - b. a nationally recognized venture capital manager agrees to help close and then manage the fund;
  - c. the fund focus is broader than seed and early stage capital, and geographically broader than just the state of origin;
  - d. major private corporate pension funds are asked to allocate a minimum of \$2.5-\$5 million of their 1-2% venture capital allocation to this fund closing;
  - e. public institutional investors are invited to participate on the same terms as private institutional investors, but are not essential to the closing;
  - f. closing is minimum of about \$50 million.

## Findings & Recommendations for Development of Business Modernization and Expansion Capital to support Non-technology Enterprises

- ◆ Successful state economic development requires a continued public investment in the application of technology and business modernization to non-technology enterprises in order to help them develop the capacity to compete in today's global markets.
- ◆ Business modernization is especially important to state economic development initiatives in more remote regions.
- ◆ MAMTC, which has expanded from Kansas, to Colorado, Missouri, and Wyoming, reaches 400+ companies a year. These companies are mostly small manufacturers in non-technology sectors removed from major metropolitan areas.
  - Further expansion of this resource in more rural regions of the state would be extremely cost effective in growing existing manufacturing and agribusinesses to help create high value-added jobs throughout Kansas.
- ◆ Expansion capital for non-technology companies is one of the most cost-effective ways to create more high value added jobs, especially in the more rural areas of Kansas.
  - Increased productivity from the application of technology to business modernization requires an investment in expansion capital. Small firms need external financing to implement new productivity measures. Their slower growth and business sector, however, make them unlikely candidates for traditional venture capital.
- ◆ Larger, more successful firms, may well be candidates for mezzanine capital. Mezzanine capital has many attractive qualities, allowing the business to benefit from external equity without fear of losing control of the business to a venture capitalist
  - Massachusetts has one of the oldest, largest and most successful of the state sponsored, (but privately capitalized) small firm expansion capital funds. This fund has helped hundreds of small (often 100 year old) Massachusetts shoe, leather, fish processing, paper, and jewelry companies to invest in modernization which has made it possible for them to increase their productivity and competitiveness in global markets, and remain located in small towns throughout Massachusetts.
- ◆ Targeted CAPCO insurance or other tax credits could be used to expand Kansas Venture Capital Inc.'s operations into other geographic regions of Kansas.
  - Kansas Venture Capital Inc.(KVCI) has emerged as one of the very good expansion capital funds based on this earlier model. In turn, it has become the model for similar funds built in Indiana, Nevada, Michigan, Virginia, and elsewhere.
- ◆ MAMTC's Capital for Manufacturers (CFM) is another important and existing component of the expansion capital system. CFM is an *investment bank-like* intermediary established to put together highly specialized mezzanine capital, equity and other forms of debt on a "fee for service" basis for growing and restructuring small firms in the MAMTC service area. This service is particularly important for smaller, more mature firms in outlying areas.

- Kansas could choose to increase the availability of capital in non-technology manufacturing and agribusinesses in outlying regions by contracting with CFM to share in some of the initial development costs of projects, with the understanding that these costs will be recovered out of final project closing.
- ◆ The Kansas Department of Commerce & Housing (KDOC&H) is another important component to Kansas' expansion capital system in which the Certified Development Companies (CDCs) and Small Business Development Centers (SBDCs) can make subordinated debt more accessible through the SBA 504 program. (The SBA 504 program is a mechanism by which CDCs issue debentures to finance business development.)
  - The most cost effective way to provide expansion capital to small non-technology companies in more remote areas (especially in western Kansas) is to make a further investment through KDOC&H to increase the capital strength of the CDC and SBDC system.

## Findings & Recommendations for Reconciling Public Accountability and Avoidance of Conflict of Interest while Protecting Confidentiality for Investors and Portfolio Companies

### ◆ Approaches to ensure public accountability:

- All ten cases rigorously protect the confidentiality of business and trade secrets for all portfolio companies or potential portfolio companies at all times from any external inquiry from competitors, media, and the public sector.
- In the four specific cases of Connecticut, Massachusetts, Oklahoma, and Oregon in which there is either direct state funding or a public instrumentality of the state, there are specific statutory exemptions to the open meeting law of the state in order to protect all possible instances of confidential business or trade secrets of portfolio companies or potential portfolio companies.
- Explicit exemptions to state sunshine law provisions, in order to protect client company trade secrets, are simply state statutory codifications of what has been federal practice for many years. The federal Small Business Investment Company (SBIC) Act of 1958 has provided for specific exemptions (#s 4 and 6) to the federal Freedom of Information Act to protect SBIC's applicant companies from the risk of divulging commercial and financial information to the advantage of competitors. In adopting this proven model from federal practice, Kansas would simply be following a federal precedent of many years standing already applicable and accepted in all 50 states.
- In the other six cases studied, the funds are either limited partnerships or limited liability corporations in which the absolutely confidential practices of the private equity industry are maintained.
- The four specific cases in which there is direct state funding are generally willing to share their portfolio returns in appropriate circumstances, although none choose to publish these portfolio returns regularly in their annual reports. We were able to include portfolio returns in this report because of our research consultant's long and close relationship with these funds.
- The six limited partnerships never make their portfolio returns public, although all ten funds do make their returns available through their prospecti which are made available to prospective identified and numbered investors. Our research consultant's long standing relationship with these funds again has enabled us to include in this report the range of return for these funds.
- Most of the cases were sponsored by their state for a public purpose beyond their net internal rate of return. Thus, in virtually every instance there is a sense of public responsibility which leads to an annual report's public accounting of the external returns created by the fund. For example, these external returns are reported in terms of job and company creation, or direct and indirect taxes generated. Massachusetts Capital Resource Company therefore, reports over its 20-year life as of June 30, 1997, that it had invested \$392 million in 394 investments in 220 companies in 98 cities and towns, yielding job creation in excess of 14,000 jobs.

- Finally, our study concludes that economic development impact is always a legitimate matter for public accountability if the institution has been publicly sponsored, or if there is either a direct or indirect investment through appropriations or tax expenditures. In fact, Kansas institutions are recognized by peer institutions throughout the United States as leaders in developing and annually reporting for the last decade rigorous economic performance measures in their annual reports. Measures pioneered in Kansas are now being widely adopted in other states as the important tool of public accountability. Reporting systems in California, Florida, Maine, Massachusetts, Nevada, Oklahoma and Tennessee specifically draw on Kansas models.

◆ **Methods for avoiding conflict of interest:**

- All ten cases provide for the avoidance of conflict of interest.
- In the four specific cases of Connecticut, Massachusetts, Oklahoma, and Oregon in which there is either direct state funding or a public instrumentality, there are specific statutory exemptions to the state ethics law in order to provide an alternative means of protecting against conflict of interest.

These special provisions are required because it is essential that the board of directors include exactly those highly experienced investors, lawyers, accountants, and business people who might have a potential conflict of interest. The solution is a simple one. The best possible professionals are attracted to the board. These professionals are required to disclose any potential conflict of interest in advance. Should an investment proposition be presented to the board, which could invoke such a conflict, the board member is required to recuse him/herself from participating in any board actions. As a practical matter, and because personal and institutional credibility is key to business success, all of these funds discourage any board member from having even an appearance of conflict of interest.

As a further practical matter, if any investment involving a potential conflict subsequently becomes a delinquent investment, the board member would be asked to leave the board so that the recovery actions taken by the fund would be uncompromised.

In any event, the management team is not permitted to have any direct investment in the portfolio.

- In the other six cases, the funds are either limited partnerships or limited liability corporations in which the rules in place with regard to conflict of interest are the rules of the private equity industry. These rules are very different than those in which there is direct state funding.

First, the managements are expected to profit from the investments which they make, and are explicitly given a 20% carried interest in the value which they add to investments after principal (and sometimes an enhanced "hurdle return") have been returned to the limited partners.



Second, there is no board of directors to have a conflict of interest. There is an advisory board made up of investors for each individual fund. The only legitimate concern of these investors is that if there is a follow-on investment in a second fund which originated in a first fund, the funds are rewarded in a way that does not unfairly benefit one or the other. Generally, the best solution is not to have follow-on investments in a second fund unless the investors in the second fund are the same as those in the first.

## Conclusion

This concludes my presentation of the report and recommendations received of EII by Kansas, Inc. I would be remiss if I did not also make specific reference to the recommendations of our Technical Advisory Committee. More in the form of implementing recommendations, this group of Kansas stakeholders expressed consensus support of the broad findings of EII.

In addition, this group of practitioners proposed that investors in certified seed capital funds receive a 100% non-refundable tax credit against corporate, individual, premium and privilege tax, with these credits both transferable and subject to indefinite carry forward. In recognition of the diverse needs of Kansas business, it is further recommended by the TAC that a funding component modeled after the Community Services Program be created to enable investments through rural development organizations to support modernization and expansion of rural manufacturers.

Aware that transparency and accountability are central to a successful program, the TAC has proposed that funds established be certified by the Kansas Securities Commission. Suggested benchmarks include:

- ◆ Investments must be in start-up companies with less than \$1 million in annual sales.
- ◆ At least 60% of fund must be invested in Kansas domiciled companies (100% for rural funds.)
- ◆ Confidentiality and accountability standards based on established industry practice must be maintained.
- ◆ Clearly prescribed conflict of interest standards must be maintained.

Certifications would remain subject to annual review by the Securities Commission to ensure continued observance of all certification standards.

Given the very tight time frame in which this project was accomplished, I believe we have addressed all pertinent issues and that we now have before the Legislature, a sound vehicle upon which to conduct a reasoned and reasonable discussion of what next steps should be taken to assure a vibrant and dynamic environment for entrepreneurship in Kansas.