Approved: March 25, 1999
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT

The meeting was called to order by Chairperson Bill Mason at 3:30 p.m. on March 23, 1999 in Room 522-S of the Capitol.

All members were present except: Representative Kuether - Excused
Representative Henderson - Excused
Representative Weiland - Excused

Committee staff present: April Holman, Legislative Research Department
Lynne Holt, Legislative Research Department
Renae Jefferies, Office of Revisor of Statutes
Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee:
Charles Ranson, Kansas, Inc.
Rich Bendis, KTEC
Deryl Schuster, Business Loan Center

Others attending: See Attached

SB 315: **An act concerning venture capital**

The bill is currently in the Senate, and *if it is passed out*, it may be assigned to the committee later next week The briefing provided information to the committee members on the issues of the bill. Chairman Mason gave the background of venture capital issues, and stated that in the past the legislature has taken a dim view of the state being involved in venture capital issues themselves. He voiced concern over the lack of venture capital available from private sources, and the resulting impact on economic development in the state. The discussions were to be general in nature, due to the lack of an actual bill at this time.

Charles Ranson, President, Kansas, Inc. (No written testimony). He referred to his presentation on January 21 on "*Best Practices Study of State-Sponsored Seed and Venture Capital (*Research Report, dated December 1998, on file at the Kansas, Inc. Agency). That study documented the critical need for seed capital in Kansas. He cited several promising businesses where struggling entrepreneurs needed seed capital to sustain and grow. They may be forced to go to other states in order to obtain that capital. **SB 315** focuses on start up venture capital for high risk businesses, through tax credits, that in turn will spark private sector's investments. This is a way to stop the current mass exodus of our brightest young people graduating from our universities.

Deryl K. Schuster, President, Business Loan Center, Inc., Mid-America Division stated that the lack of equity capital was the biggest problem lenders encounter when trying to find a way to say "yes" on long term loan requests to new and early stage businesses (Attachment 1). He said the need was real and that **SB 315** would help fill this void.

Rich Bendis, KTEC, reviewed the history and reason for the bill and summarized the eighteen key points of **SB 315**, as outlined in his testimony (Attachment 2). He provided answers to three questions that had been asked in the Senate Commerce Committee and referred to three business journal included in his testimony.

Discussion followed regarding the definition, prerequisites and tax credit rules for a CapCo organization, 100% tax credit incentives, pros and cons of giving tax credits for Kansas and lessons learned from past mistakes.

Representative Gerringer moved that the minutes of the March 4, 9, 11 and 16 meetings, with an attendance correction on the March 4th meeting, be approved. Representative Stone seconded and the motion carried.

The next meeting is on March 25, noon, or upon adjournment of the House in Room 423-S. The Chairman adjourned the meeting at 4:15 p.m.

HOUSE ECONOMIC DEVELOPMENT COMMITTEE
COMMITTEE GUEST LIST

DATE: March 23, 1999

NAME	REPRESENTING
Jim Janousek	KDOC+H
Rich Bendis	KTEC
Charles Ranson	KS Inc.
Deryl Schuster	KS, Inc.
Keith Meltzer	Entrepreneurial Consulting Corp.
Doug Farmer	DOB

Statement by Deryl K. Schuster, President
Business Loan Center, Inc., Mid-America Division and
Member of Kansas, Inc. Board of Directors and
Chairman, National Association of Government Guaranteed Lenders

To: Kansas House of Representatives Economic Development Committee

Re: House Bill Number 315

Mr. Chairman and distinguished representatives all. I thank you all for the leadership that you provide in working to strengthen the economic vitality of our great state. Wearing my hat as Chairman of the National Association of Government Guaranteed Lenders, an organization whose 700 plus lender members made over 80% of all SBA guaranteed loans last year, I had the pleasure a week ago today of testifying before the United States Senate Committee on Small Business. The similarities of today and the opportunity of last Tuesday are most interesting. The purpose of the United States Senate hearing was to discuss the President's fiscal 2000 budget. The President's budget includes a request for direct appropriation to assist businesses that the administration classifies as "new markets." Those businesses finding it traditionally difficult to obtain loans and equity. As defined by the President, new market businesses include start-ups, early stage firms, businesses in rural areas, inner-city areas, as well as minority, female and handicapped applicants. I must tell you that from a national perspective, the difficult in attracting investment capital, and even loans by early stage or start-up businesses, as well as all new market type businesses, was well established in the Washington D.C. hearing last Tuesday. I heard Senator John Kerry from Massachusetts, the ranking minority on the Senate Small Business Committee, say that in his state, venture capital was one of the biggest impediments or deficiencies new market type businesses face. In addition, I

Economic Development
March 23, 1999
Attachment 1

heard the President of the National Association of Certified Development Companies say that the lack of equity or investment capital was the most serious problem faced by new and early stage businesses. Representing the National Association of Government Guaranteed Lenders as well as my company, Business Loan Center, I joined in confirming that the lack of equity capital was the biggest problem lenders encounter when trying to find a way to say "yes" on long term loan requests to new and early stage businesses. Mr. Chairman, it is logical to observe that if this is a problem in Boston, how much greater the problem must be in Wichita, El Dorado, Pittsburgh, Colby or Lyons. Ladies and gentlemen, no regulated lender can make 100% loans particularly to start-up or early stage businesses without exposing their institution to regulatory criticism. In fact, my company, Business Loan Center, which was the 11th largest SBA lender in the nation last year and, by law, we or other SBA lenders cannot make a 100% loan to a start-up business. Yes, even government-backed loans require equity. To emphasize, if at least 10% to 20% equity is not present, by law, we must say no to the loan proposal. The legislation discussed today would create a vehicle of opportunity for many Kansas entrepreneurs! The need is real and it is a national problem. The difference between the bill we address today and the President's budget is that the administration is asking for direct appropriation to help address the problem. We in Kansas are asking for tax credits. A much more saleable and responsible approach, in my opinion.

Please let me relate a real live situation that occurred while I was in Washington this past week. I called my office in Wichita for messages. One call was from a Mr. Greg Shuey, President, TensorTech, a technology development company from Lenexa in Johnson

County that my company had made a loan to several years ago to help finance this start-up high tech firm. At that time Mr. Shuey had adequate personal investment capital to leverage into a $212,000 SBA loan. Mr. Shuey's background is incredible. He was the project manager for a $700 million dollar satellite program for the U.S. Force, and he was also Air Force Director of Engineering at the Johnson Space Center. He owned and started the first American technology transfer company in Korea, representing the State of Florida, Kansas City Aviation Department, Burns and McDonald, etc. As mentioned, we were able to make the initial loan because he had accumulated adequate personal investment capital to support the loan. Also, at that time SBA's guarantee was 85% instead of the current 75%, which made it easier to say "yes." Mr. Shuey's s loan has paid as agreed, so I had not heard from him for several years. When I returned his call from Washington D.C. he told me his business had done extremely well but that he had developed new technology that could revolutionize compression technology in the video communication industry. Technology in which several national and international firms have expressed interest. His immediate need is to find $500,000 of investment capital to complete the development, to be followed by a $4.5 million stock offering when the technology is totally marketable. I told him that our company only made loans and by name I suggested he contact the established venture capital firms operating in our area. Unfortunately, he was way ahead of me in that each venture capital firm I mentioned he gave me the reason why they had declined to come to the table. His need was too small, too early stage, not enough collateral, or whatever. Mr. Shuey had decided he needed to find "angel type investors." Ladies and gentlemen, the best I could do was to suggest that Mr. Shuey contact Charles Ranson, President of Kansas, Inc., who had been working on a venture capital initiative for our state to see if he had heard of any additional venture capital or angel type investment sources during his involvement with this issue. Please know I received approval from Mr. Shuey to communicate this actual, real life situation. I am sure Mr. Shuey would be pleased to explain his dilemma in greater detail, if requested. Unfortunately, lenders in Kansas, yes in America, are confronted with this situation on a regular basis. Investment capital to new and early stage firms is a serious void in economic development that some states have tried to fill and with which even Congress is struggling. This legislation would help fill this void. I appeal to you to let Kansas join those states where people like Greg Shuey might find hope and help and where our state might enjoy the fruits of their labors in creating jobs, tax revenue, and innovation. I ask for you to take the leadership to make House Bill 315 happen this year! The need is real and it is now! To defer action is to invite the Greg Shueys of our State to take their businesses elsewhere as too many already have. We should not let this happen! Thank you and I would be pleased to respond to any questions.

SB 315 - Key Points

- **Seed capital is virtually non-existent in Kansas today.**

- Bill is catalyst for formation of private seed capital industry in Kansas.

- Not a technology company bill. Only real estate, retail, and financial and personal services are excluded.

- Businesses in all 105 counties are eligible for investments.

- 100 percent tax credit to accredited investor in CapCo, *with suggested minimum investment of $25,000.*

- CapCo's would invest only in Kansas companies with *less than $1 million in revenue and less than five years old.*

- Companies receiving investment agree to stay in Kansas for at least ten years.

- $50 million maximum credits with no more than $5 million to be claimed per year.

- Job, wealth, and tax base expansion benefits to state up-front while tax credits (state payment) over 10 years.

- Total tax credits will not exceed $10 million to investors in any single CapCo.

- A minimum of $5 million investment in each CapCo is required.

- Bill is designed to attract out-of-state capital to Kansas through transferrable tax credits.

- CapCo managers screened for competency to ensure success of CapCo and positive economic benefits to state in return for tax credits.

- Purpose of securities regulations is to protect investors.

  With publicly traded companies (stock market and mutual funds), investor protection is through public reporting requirements imposed on companies.

  With privately traded companies (seed capital funds), investor protection is through "accredited investor only" restriction.

- Securities Commission has audit authority and other oversight powers.

- *Department of Revenue would administer tax credits.*

- State shares in financial success of CapCo's: 25 percent of distributions after guaranteed 15 percent IRR.

- Bill reflects lessons learned from other states' CapCo's and Kansas' 1986 tax credits.

* *Suggested amendments are in italics.*

Economic Development
MARCH 23, 1999
Attachment 2

SB 315

What's to prevent a CapCo from claiming tax credits for its investors but never making investments?

The bill has several provisions to prevent any such abuse of the tax credit provisions. To maintain certification - and hence, the tax credits - a CapCo must invest 25 percent of its capital within three years, 40 percent within five years, and 70 percent within seven years (page 7, line 23). Furthermore, 100 percent of a CapCo's capital must be invested before a liquidating distribution of the CapCo can occur (page 8, line 35). The bill also prohibits a CapCo from investing in an affiliate of the CapCo or an affiliate of an investor (page 7, line 37). This provision precludes the possibility of a "shell game" with only the appearance of qualified investments and ensures that the intent of the bill is carried out.

How will the state know if jobs have actually been created as a result of the tax credits?

The Securities Commissioner is required to conduct an annual review of each CapCo to determine whether the CapCo is still in compliance with the certification requirements (page 9, line 41). The Securities Commissioner is also required to submit an annual report to the Governor and the Legislature. The bill stipulates that the annual report contain, among other criteria, the number of permanent jobs created or retained by each company in the CapCo portfolio (page 11, line 2). Any material violation of the act is grounds for decertification of the CapCo (page 10, line 6) and the forfeiture and recapture of all tax credits issued to that CapCo's investors (page 10, line 19).

What if a CapCo portfolio company moves out of the state?

As a condition for investment from a CapCo, the company must certify to the CapCo that the company shall remain domiciled in Kansas for ten years (page 3, line 39). Should a company move from Kansas before ten years pass, this would not be grounds for decertification. Since the CapCo will seldom if ever have a controlling interest in the company, it would be unfair to penalize the CapCo and its investors for actions of the company which are beyond their control. The CapCo could, however, build domicile provisions into its investment documents with a company. To monitor its investments and avoid friction with the state, it is reasonable to assume that a CapCo would make every effort to keep its portfolio companies in Kansas.

Exhibit A

Indicator 15
Venture Capital

Venture capital funding in Kansas is one-third the national per capita average

Indicator Significance

Venture capital is essential for new business start-ups. A state with access to venture capital is more successful in fostering the creation and growth of start-up firms in technology-based areas. A lack of venture capital indicates a weakness in a state's prospects for future growth in emerging technologies. Also, entrepreneurs also may choose to locate in an area with greater prospects for obtaining access to venture capital.

While every new start-up will not require all forms of venture capital, entrepreneurs may need:

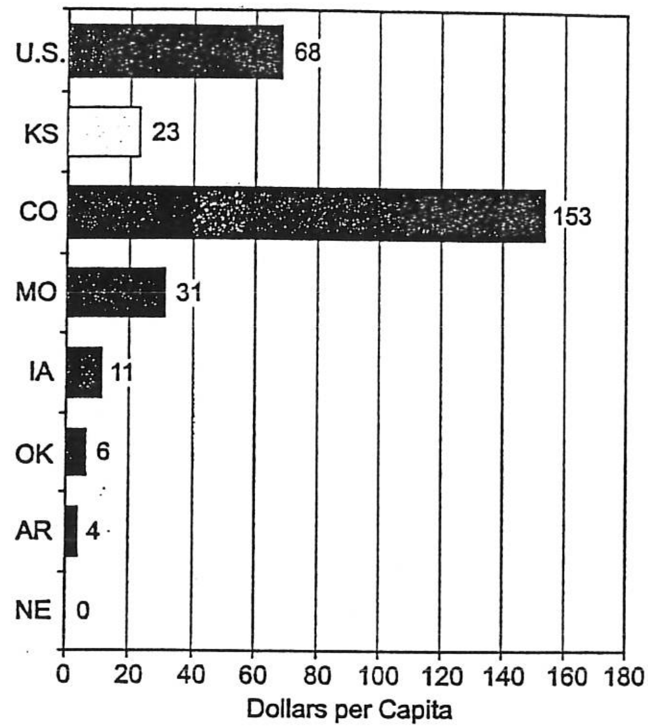
- *seed/start-up capital* - the firm is proving the concept (seed), completing initial product R&D, building a prototype, completing market research, and hiring initial management and employees;
- *early stage capital* - the period when the new firm has high growth potential but minimal product revenue and often an incomplete management team;
- *second stage capital* - the firm has started producing, has growing sales, and needs funding for expansion;
- *late stage capital* - the firm is continuing to grow, may be showing a profit, and needs additional funds for improvement and expansion.

Sources of venture capital include individual investors, institutional investors, and venture capital firms. This indicator measures the amount of venture capital invested in a state from venture capital firms.

Kansas Performance

For 1997 and the first two quarters of 1998, Kansas had $23 per capita in venture capital funding. This was one-third of the national average of $68. During this period, there were 10 venture capital investments in Kansas for a total of $59,701,000. Kansas ranked third in the region behind Colorado and Missouri.

15a. Venture Capital Funding, Q1 1997 - Q2 1998 (per Capita)



Source: PriceWaterhouseCoopers Money Tree ™ Survey.

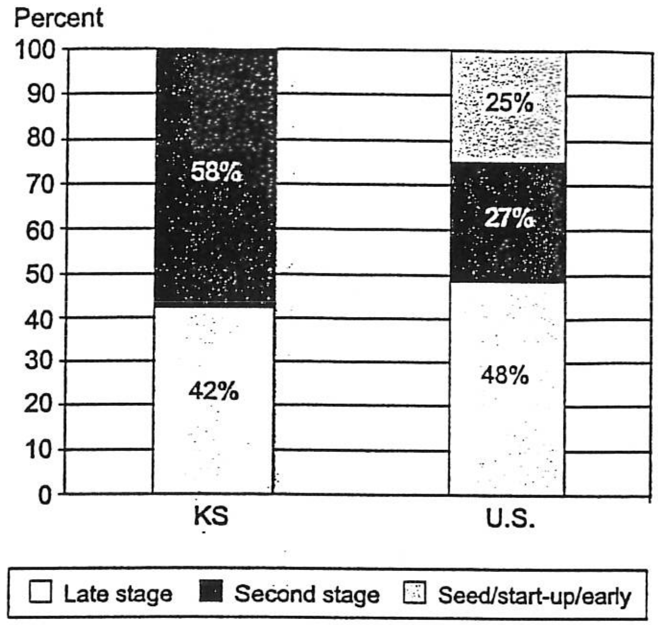
"... Kansas had $23 per capita in venture capital funding ... only one-third the national average of $68."

2-3

Notably, Kansas did not have any seed/start-up/ early stage venture capital for 1997-98. These earliest stages of venture capital are important for moving ideas from a research lab to commercialization. If the absence of venture capital funding of start-up firms continues, it would indicate a serious gap in Kansas support for new firms with high growth potential.

This indicator suggests that Kansas is not starting and growing a sufficient number of new businesses using venture capital. Either too few entrepreneurs are starting new firms requiring venture capital or inadequate access to venture capital resources exists.

15b. Venture Capital Funding by Stage of Financing, Q1 1997 - Q2 1998



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THE TOP 25 LISTS OF ... & II - Pages 33, 35

Kansas City
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VOLUME 17, NUMBER 27 THE METRO AREA'S MOST COMPREHENSIVE BUSINESS COVERAGE MARCH 12-18, 1999

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Bill would give tax credits to seed investors

BY SUZANNE KING
STAFF WRITER

Since his software development firm got its start in Lenexa last year, Digital Archaeology Corp. CEO David Frankland has been impressed by the Midwestern work ethic. He can go on and on about employee loyalty. But, like most other technology executives trying to build companies in Kansas, Frankland can't believe how difficult it is to find funding here.

"That's the only thing that keeps me awake at night," he said.

Digital Archaeology has raised $8.5 million through Kansas City Equity Partners, St. Louis venture capital fund Gateway Partners and other angel investors. But as the firm goes looking for an additional $10 million to $15 million, Frankland said there is very little chance it will find the money locally.

"We're looking for a lead investor outside the area," he said.

A bill making its way through the Kansas Senate aims to fix this kind of problem. The bill would provide income tax credits for private investors who put their money in start-up companies that are located or will be located in the state.

SB 315, developed by Kansas Inc., would create Certified Capital Companies, which would attempt to bolster seed and venture capital in the state. The proposed legislation would offer 100

See BILL, Page 51

BILL

Continued from Page 1

percent tax credits to certified capital companies, formed in Kansas and approved by the state, that put money in start-up companies with no more than 50 employees.

Charles Ranson, president of Kansas Inc., said an amendment on the table would replace the 50-employee limit with a requirement that qualifying companies have no more than five years in business and annual revenue of no more than $1 million or $3 million.

"My sense is we would probably support the $1 million or less simply because we want to focus the need on the early-stage business," Ranson said. "We don't want to see a program come into existence that allows companies to cherry pick more mature firms."

Ranson said he is hopeful the commerce committee will pass the legislation to the full Senate.

"I feel the objections that had surrounded venture capital in Kansas over the last several years have been addressed," he said.

Richard Bendis, president of the Kansas Technology Enterprise Corporation, which has been aggressive about investing state dollars in early-stage companies, said he supports encouraging private investment in early-stage companies.

"We think there's a role for government to be a catalyst, but at a certain point in time, it's time to turn to private investors," Bendis said.

According to a recent study commissioned by KTEC, Kansas companies did not receive any seed, start-up or early stage venture capital from private investors in 1997 or the first half of 1998.

Frankland said he would testify before the Senate Commerce Committee this week that the state's lack of early-stage venture dollars has made finding funding — even out-of-state funding — much more difficult than if his company were on one of the coasts.

"The challenges we've faced by not having the kind of capital infrastructure other cities have ... is really a limiting factor in terms of how you get your plan funded," Frankland said.

Ed Meltzer, president of Intelligent Wireless Systems Inc. in Johnson County, called early-stage dollars "a critical need" in the state and said his company could have benefited from investors driven by tax incentives.

"A lot of states focus on, 'What do we need to do to keep businesses here?'" Meltzer said. "So they channel their tax credits to maintain their current economic development. This, on the other hand, shines the light on opportunities to increase what's here."

Don Peterson, founder of Lenexa computer manufacturer DeskStation Technology Inc., said Kansas will never have a significant high-tech base if it doesn't generate more seed capital.

"Most of the resources that become available to support (high-tech startups) come from people who have been successful in their own high-tech ventures," he said.

A tax incentive might help the state fill the pipeline leading to successful companies, which would then reinvest in startups down the road.

"Kansas has to make the investment in filling the pipeline," Peterson said.

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Hanson sells realty company to Builders Inc.
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VOLUME 14, NUMBER 12 E-mail: wichita@amcity.com Internet: http://www.amcity.com/wichita MARCH 19, 1999

Kansas Senate bill would give credit to seed investors

By SUZANNE KING

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> *"There's a role for government to be a catalyst, but at a certain point in time, it's time to turn to private investors."*
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SB 315, developed by Kansas Inc., would create Certified Capital Companies, which would attempt to bolster seed and venture capital in the state. The proposed legislation would offer 100 percent tax credits to certified capital companies, formed in Kansas and approved by the state, that put money in start-up companies with no more than 50 employees.

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Suzanne King is a reporter for the Kansas City Business Journal, a sister publication.

SPECIAL SECTION: Business to Business Expo TOP 10 LIST: Engineering Firms

ON THE WEB: A SERVER THAT ISN'T

JOHNSON COUNTY Business Times

The Last Word

2-7

March 17-23, 1999

PLANTING THE SEED

A couple of years ago, Rich Bendis, president of the Kansas Technology Enterprise Corporation, got his hands on the "Index of the Massachusetts Innovation Economy," a report put out by the Massachusetts Technology Collaborative. His goal of generating similar data for the state of Kansas was realized recently with the publication of the "Kansas Innovation Index."

Bendis stopped by last week to share the results of the study. He brought along Dr. Charles Krider, director of the Institute for Public Policy and Business Research at the University of Kansas, who served as the project's director.

Christine Perez
Editor

KTEC was founded in 1987 to stimulate economic development and move the state away from its dependency on the agricultural, aviation and oil industries. The Innovation Index measures how the state is coming along with its goal of fostering innovation and the development of technology.

The bottom line, according to the report, is Kansas has a realistic opportunity to achieve solid economic growth by focusing on high-growth and high-wage industries. The state has a good foundation of technology-based industries and a highly educated workforce.

But there are some critically weak areas, too. Chief among them are a dearth of spending on research by Kansas companies and universities and a lack of access to venture capital.

Kansas ranks 1st among all states when it comes to research and development expenditures; in part because it must compensate for the low spending by universities and companies. Using 1995 numbers, Kansas ranked 32nd in the country for R&D spending by industry, averaging $221 per capita, less than half of the national average of $503 per capita.

> "There are plenty of companies in Kansas that should be receiving venture capital but aren't."
> — Rich Bendis, president, KTEC

Venture capital numbers are even bleaker. For 1997 and the first half of 1998, Kansas had $23 per capita in venture capital funding — one third the national average of $68.

As Krider noted in his report, "If the absence of venture capital funding of startup firms continues, it would indicate a serious gap in Kansas support for new firms with high growth potential."

During the 18-month period measured, there were 10 venture capital investments in Kansas that totaled nearly $60 million. None of these were made in the seed or startup state; all came in during the second or late stages of development.

"Companies that shouldn't get funded are getting funded on both coasts," says Bendis. "And there are plenty of companies in Kansas that should be receiving venture capital but aren't."

A bill currently being debated by state senators would make it easier for Kansas companies to invest in home-state businesses. Senate Bill 315 would create the Kansas Certified Capital Company Act, which would give 100-percent tax credits to qualified companies or individuals that provide seed money to Kansas startups.

According to the original proposal, startups must be independently owned and operated and must be based in Kansas or move here within six months of the initial date of investment. It also must have at least 50 employees, half of which live in Kansas.

Investors could use up to 10 percent of their tax credit each year. The total amount of tax credit allowed under the act would be $50 million, of which $5 million could be claimed each year.

Bendis says investors can get a good deal by investing in Kansas companies, because they often offer a better value than startups on the coasts.

If SB 315 passes, private companies should become more willing to take advantage of those values, and help plant the seeds necessary to help the state's economy continue to grow.

Send letters to 7373 W. 107th St., Overland Park, Kan., 66212. Fax us at (913) 381-9889, or send E-mail to JCBT@sunpublications.com.