

MINUTES OF THE HOUSE COMMITTEE ON NEW ECONOMY.

The meeting was called to order by Chairperson William Mason at 3:30 p.m. on February 20, 2001 in Room 522-S of the Capitol.

All members were present except: All present

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

Conferees appearing before the committee:

Charles Ranson, President, Kansas, Inc.
Rich Bendis, President, KTEC
Gary Sherrer, Secretary, KDOC&H
John Fowler, President & CEO, KCCI

Written Testimony Only:

Harold Bradley, Senior Vice President, American Century Ventures
Tom Blackburn, Executive Vice President, Kansas Venture Capital, Inc.

Others attending: See Attached List

HB 2505 - Relating to income taxation; concerning venture capital

Charles Ranson, briefed the committee on the Venture Capital bill. Copies of "*Best Practices of State Sponsored Seed and Venture Capital Programs and Alternatives to Direct State Funding*" and "*A Kansas Vision for the 21st Century*", were distributed to the committee, copies on file at Kansas, Inc. He gave data on existing Venture Capital money in Kansas resulting in loss of businesses. He stated that the three economic development entities had agreed to the language and amounts of \$25 million with a \$12.5 tax credit, although the current bill reflects \$50 million with a \$25 million tax credit. He stated that was the only issue currently separating them.

Rich Bendis quoted statistics from the "*National Venture Capital Association*". The total last year invested by Venture Capitalists was in excess of \$103 billion dollars. The amount invested in Kansas companies was \$223 million dollars (2/10 of 1% of all the venture capital invested in the US). The average investment in seed capital was \$5 million dollars, the average investment made in a company was \$15 million dollars. The total amount of venture capital available through KTEC's related programs annually, is \$1.5 million dollars. He explained the process of availability of the tax credits in the current bill and asked the committee to consider whether the money represented a cost or an investment.

Representative Mason explained that the current bill, reflecting \$50 million dollars with 50% tax credits, was changed per his direction. The Legislature has been working on this bill for several years and he believes these amounts are reasonable representing the minimum amount they should invest.

Secretary Sherrer stated he was against the bill last year for the following reasons; questionable time frame for investments, tax credits too high, lack of restrictions on types of investments and liability for the state. His concerns this year are budgetary in nature and he believes they should start the program modestly and increase on a need basis.

John Fowler, President & CEO, KCCI expressed his support for **HB 2205 (Attachment 1)**. The use of income tax credits to stimulate private investment in new and promising ventures represents a sound approach to resolving the competitive issue of Kansas' risk capital deficit.

Written testimony was distributed from Tom Blackburn, Exec.Vice President, Kansas Venture Capital,

Inc. (Attachment 2) and Harold S. Bradley, President, American Century Ventures, (Attachment 3).

The hearing on **HB 2205** was closed.

HB 2497 - Concerning the renaming of Economic Development to the Committee on New Economy

It was moved by Representative Kuether and seconded by Representative Cox that **HB 2497** be passed out favorably. The motion carried on a voice vote.

HB 2205 - Relating to housing; concerning administration of state housing program; establishing a state housing corporation

Representative Aday moved that **HB 2205** be passed out favorably. The motion was seconded by Representative Beggs. After a voice vote, the Chair being undecided, asked for a show of hands. There were 10 counts in favor. The motion carried. Bob Nugent asked permission to update two dates in the bill from 2000 to 2001. There was no objection.

Representative Cox moved for the approval of the Committee minutes for February 13. Representative Compton seconded the motion which passed by a voice vote.

Next meeting March 6.

The Chairman adjourned the meeting at 5:00 p.m.

HOUSE ECONOMIC DEVELOPMENT COMMITTEE COMMITTEE GUEST LIST

DATE: Feb 20, 2001

NAME	REPRESENTING
Robert Frouse	KCC
Charles Ranson	KS, Inc.
RICH BENDIS	KTEC
Debby Fitzhugh	KS Inc
John Fowler	KCCI
Tom Burch	KTEC
Corrie Kangas	Sen. Brownlee
Stephanie Buchanan	DOB
Jackie Clark	Hallmark Cards
Sherry Brown	KDOC/H
Fred J. Schwan	KDOC/H
Kip Peterson	Lt. Governor
Gary Sherrer	Lt. Governor
Beth Brough	KTEC

LEGISLATIVE TESTIMONY



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HB 2505

February 20, 2001

KANSAS CHAMBER OF COMMERCE AND INDUSTRY

Testimony Before the

House New Economy Committee

by

John Fowler
President & CEO

Mr. Chairman and members of the Committee:

I am John Fowler, President of the Kansas Chamber of Commerce and Industry. Thank you for allowing me the opportunity to speak to you in support of HB 2505.

The Kansas Chamber of Commerce and Industry (KCCI) is a statewide organization dedicated to the promotion of economic growth and job creation within Kansas, and to the protection and support of the private competitive enterprise system.

KCCI is comprised of more than 2,000 businesses which includes 200 local and regional chambers of commerce and trade organizations which represent over 161,000 business men and women. The organization represents both large and small employers in Kansas, with 48% of KCCI's members having less than 25 employees, and 78% having less than 100 employees. KCCI receives no government funding.

The KCCI Board of Directors establishes policies through the work of hundreds of the organization's members who make up its various committees. These policies are the guiding principles of the organization and translate into views such as those expressed here.

KCCI has long advocated for policies that will stimulate economic expansion through new jobs and new investment. Over the years the Kansas Legislature has enacted economic development legislation which has been widely emulated, and which has clearly resulted in new jobs and opportunities for Kansas citizens.

One area where our state has consistently lagged is in its ability to attract venture capital. Kansas has consistently ranked among the lowest states in venture capital funding, at about one third the national average. Start up and early stage venture capital, in fact, in certain years has been virtually nonexistent. This suggests a gap in support for firms with high growth potential, clearly a competitive disadvantage.

While KCCI does not advocate direct taxpayer investment in private ventures, we believe the state can play an important role in encouraging private investment in promising entrepreneurial companies. The tax credits provided in HB 2505 do not make these investments risk-free. However, they may serve to retain private investment within the state, and employ that capital to create new jobs, and thus future revenues for state and local governments.

The use of income tax credits to stimulate private investment in new and promising ventures represents a sound approach to resolving the competitive issue of Kansas' risk capital deficit. With the adoption of this bill, the Kansas Legislature can take an important step to encourage private investment, enable more entrepreneurs to turn their ideas into vital, growing business enterprises, and create economic opportunity for Kansas residents.

I appreciate this opportunity to express our support, and would be happy to respond to any questions.

Testimony of Tom Blackburn

**Executive Vice President,
Kansas Venture Capital, Inc.**

**Presented to
Senate Commerce Committee
February 2, 2001**

Thank You Madam Chair and members of the Senate Commerce Committee. My name is Tom Blackburn. I am Executive Vice President and a Board Member of Kansas Venture Capital, Inc. ("KVCI") located in Overland Park. I appreciate the opportunity to be here today to provide testimony on venture capital in Kansas and HB2688 as I understand its current version. I stand before you today as a senior officer and Director of KVCI - the most active venture capital firm in Kansas over the past decade; as a venture capital practitioner having been directly involved in the venture capital investment process in Kansas for the past decade; and as a past member of the Kansas, Inc. Technical Advisory Committee on Seed & Venture Capital ("TAC"). My intent is to specifically address a few issues in my testimony. The first issue - Is there lack of seed or venture capital available to Kansas businesses? The second - Can (or should) State government play a role in addressing these needs by facilitating risk capital formation? And third, What are some of the key issues, potential risks and potential rewards to the State for enacting legislation in addressing the State's seed and venture capital needs?

First, a little background on KVCI for those of you who do not know us or our history. KVCI was incorporated in 1976 as a private for-profit licensed Small Business Investment Company as a subsidiary of the Kansas Development Credit Corporation. In 1987, KVCI was restructured subsequent to the economic development initiatives passed during the 1986 Kansas legislative session on the heels of the Redwood-Krider Report. Specifically, two pieces of legislation provided the impetus for the restructuring. The first, the Kansas Venture Capital Company Act provided new investors in KVCI a 25% tax credit against various Kansas taxes. To qualify, "certified" venture capital companies were required to, among other things, invest 60% of their funds in "qualified" Kansas businesses. The second legislative initiative - the Kansas Statewide Risk Capital Act required the State's Pooled Money Investment Board ("PMIB") to match private sector investments in KVCI up to \$10 million in the form of a direct preferred stock investment in KVCI with the caveat that all venture capital investments had to be in Kansas. The resulting capital structure was \$6.6 million in private capital, predominantly from Kansas banks and a \$5 million investment from the State's PMIB.

In 1998, Governor Graves signed into law SB487 which established a mechanism for the repayment of the State's direct PMIB investment in KVCI and the privatization of KVCI. The genesis of the legislation was in response to concerns over direct public investment in venture capital companies. KVCI completed the preferred stock redemption in September 1999, fully repaying the \$5 million PMIB investment well ahead of the scheduled repayment commitment. KVCI subsequently completed a \$6 million stock offering to replace the \$5 million in financial footings depleted as a result of the PMIB stock redemption pursuant to the Kansas Venture Capital Act and as such all investors who subscribed received the 25% Kansas state tax credit.

Today, KVCII has in excess of \$50 million in capitalization consisting of approximately \$15 million equity capital and an additional \$35 million in SBIC leverage availability. We are actively making investments in Kansas companies, creating and retaining jobs that would, in many instances otherwise be non-existent or at risk. An important note is that KVCII was, and still is, a successful public/private business model, fashioned by the Federal Government through the SBIC program, the Kansas Legislature through the legislation I referenced earlier and Kansas banks - large and small who stepped up and provided the original risk capital that seeded our company. KVCII has a significant track record in creating jobs, taxes and wealth for Kansans throughout the State, as I will better detail in a minute.

Is there lack of seed and venture capital available to Kansas businesses? Yes, I believe there is. I will not reference the statistical data that has been previously disseminated by Kansas Inc., or KTEC, but rather speak from what I see going on in our marketplace. My view is that Kansas, and the Heartland in general, is still under-served. In particular, capital for seed, start-up and early stage investments as well as risk capital for established and later stage smaller companies, particularly those located in non-metropolitan areas, is still in short supply. The risk capital markets continue to be generally focused elsewhere - on the Coasts and in the major metropolitan areas. There are not a lot of funds spending time canvassing for deals in Kansas with the exception of the Kansas City metro area, and to a lesser degree in Wichita. Even then, they tend to be focused on the bigger deals. The average size of the institutional equity funds has gotten so large that, by necessity, they need to invest big chunks of money - \$10 million, \$20 million or more at a time. Many companies in Kansas in need of equity oriented financing are simply not going to be on the radar screen of these large institutional players because of geographic location and/or company size. That's a reality. KVCII and other SBIC's are able to serve many of these smaller businesses, however I believe there are others that do not receive funding as venture firms focused on these smaller company investments are few in number and relatively small in size such as KVCII.

With respect to the early stage deals, the big institutional players also tend to lean toward putting out bigger dollars. They also prefer deals closer to home, with seasoned management and blue chip sponsorship. This is more true today after the "tech wreck" on Wall Street in 2000. I just don't see many firms in our market making very many new early stage investments at this time. Taking the Kansas City market as an example, investment activity in early stage companies significantly accelerated in 1999 and the first half of 2000. Most of the funding since then has been follow-on investments to fund big burn rates (negative cash flow) - not investments in new companies. Valuations for technology companies have crashed and the follow-on financing is not available to the extent it was last year at this time. This will likely continue to be the case for some time. Additionally, the appetite of angel investors seems to be softening. This too is to be expected, given the tech wreck and dot-com disasters. Also, the long term viability of many of early stage growth companies' business models are receiving greater scrutiny. This too is, as it should be. Clearly, more deals have gotten done in our market over the past few years, but many did not get sufficient capital or may not have investors with the financial wherewithal or network to take the companies to a point of critical mass necessary to be self-supportive or to access the institutional or public equity markets. In light of these factors I believe the availability of seed and early stage investment capital, which has been on a positive trend line over the past few years, will reverse and the scarcity of capital for such investments will continue. Therefore, I do believe there is merit to legislative consideration of the state government playing a role in increasing the supply of risk capital for seed and early stage growth companies.

Can (or should) State government play a role in addressing these needs by facilitating risk capital formation? Absolutely. Let me address this by referencing the success of the KVC I model. Since 1988, KVC I has invested over \$30 million in 36 Kansas-based companies located in 17 Kansas counties. Many of these companies would not have received the capital to grow or get through some tough times had it not been for KVC I. I have attached an Exhibit to the back of this testimony to highlight the investment provided to KVC I and the subsequent returns, financial and other, resulting from the State's investment. I won't go into detail as it is pretty much speaks for itself, but will point out that the economic development story is significant. The state and local taxes paid by KVC I portfolio companies alone has paid for the State's investment several times over. This is exclusive of taxes paid as a result of significant capital gains taxes paid by equity holders in many of our successful investments - the so-called "wealth effect." Additionally, the returns continue to accrue as KVC I makes new investments and our past investments continue to employ more Kansans, make additional capital investments and pay significant state and local taxes. These returns continue to accrue without additional State support. Clearly the Kansas Legislature, along with Kansas banks, led by the Kansas Bankers Association, played a critical role in the KVC I success story. I believe the attached Exhibit validates this success. State government can and, I believe should play an important role in risk capital formation as needed and appropriate.

What are the key issues, potential risks and potential rewards to the State for being involved in seed and venture capital initiatives? Assuming the premise that the need has been established and the Legislature elects to play a role in fulfilling the need, the key issues in my mind are as follows:

- 1) Drafting a bill with specific language to ensure legislative intent - the language must be specific enough to ensure that the target companies receive the benefits.
- 2) Establishing appropriate oversight to ensure compliance and legislative intent - accountability and integrity is critical.
- 3) Confidentiality of all portfolio company information and financial records - without it the companies, the CFC's and the program will not succeed will be in jeopardy.
- 4) Attraction of experienced fund managers to manage CFC's - crucial for program success.
- 5) Clearly establishing the State's role as a facilitator and the CFC as the investment manager - state government should not be in the business of picking winners and losers, but rather facilitating those with the expertise to do so.
- 6) Shaping realistic expectations - because these are high risk investments the track record may be poor. That is why the availability of capital is scarce.

The macro risks of State sponsored risk capital initiatives are well documented, debated and have even been litigated over the past several years in Kansas. The micro risks are relevant and primarily go to appropriate drafting and merit. Similar programs in other states have often found that legislative intent was not accomplished due to poor drafting. Additionally, merit is often challenged based on program structure and reach. The costs, benefits and reach must be carefully analyzed. The rewards of State sponsored risk capital initiatives can be significant. Rewards to the state can and must be measured beyond financial return on investment. The KVC I model validates this premise.

Finally, with respect to the proposed CFC legislation, I stand in support of the initiative as currently being contemplated. Reducing the tax credit to 50%, while being more cost effective to the taxpayer, will also ensure that capital is at risk and necessitate that appropriate risk/reward scrutiny is applied to potential investments in order to generate returns for CFC shareholders. This is healthy and I believe this is a significant improvement to the previous bill. Establishing an oversight mechanism through KDOC to ensure that the spirit of the legislation is carried out is also important. If the target

is seed and early stage investments, there needs to be a mechanism to monitor compliance. I believe there is merit to legislative initiatives to encourage investing in Kansas companies not effectively served by existing private seed and venture capital investors. The CFC initiative as contemplated should provide ample incentives to the private sector to step forward and play an important role in filling the financing gap that currently exists for Kansas-based start-up, seed and early stage businesses. Additionally, I believe the revised legislation also incorporates the necessary provisions to ensure appropriate accountability and integrity.

Thank You for the opportunity to be here and I would be happy to answer questions.

STATE INVESTMENTS AND RELATED RETURN ON INVESTMENT

State investments into KVCII

- \$5 million PMIB direct investment in KVCII preferred stock
- \$3.2 million in Kansas state tax credits to KVCII investors

Returns on the State's investment in KVCII (unaudited - thru 12/31/00)

- KVCII repaid the entire \$5 million PMIB investment in full
- KVCII paid the PMIB \$75,000 in dividends
- KVCII has invested approximately \$30 million in 36 companies located in 17 counties in Kansas
- Approximately 25% of investment activity has been focused in smaller Kansas communities
- 5,500+ jobs created or retained by KVCII portfolio companies since initial investment
- \$600+ million in cumulative payrolls paid to employees of KVCII portfolio companies
- \$100+ million in federal, state and local taxes paid by KVCII portfolio companies
- \$20+ million in state and local taxes paid by KVCII portfolio companies
- \$80+ million in capital expenditures made by KVCII portfolio companies
- 90% of KVCII portfolio companies increased sales subsequent to initial KVCII investment
- 90% of KVCII portfolio companies increased employment subsequent to initial KVCII investment
- 100% of KVCII portfolio companies invested in capital equipment and facilities subsequent to initial KVCII investment
- 100% of KVCII portfolio companies leveraged KVCII funding with other private sector financing (banks, other venture capital or private investors)
- 80% of KVCII portfolio companies continue today as going concerns
- Six portfolio companies have transitioned to the public markets via IPO or an M&A transaction
- Current payroll of KVCII's 24 existing portfolio companies exceeds \$100 million
- Since privatization, KVCII has continued to invest primarily in Kansas-based companies with over \$8 million of the \$10.7 million in investments in 1999 and 2000 going to Kansas businesses including seven new investments.

Development of risk capital markets in Kansas

- \$30+ million invested by KVCII in Kansas-based businesses
- \$100+ million invested by other (non-Kansas) venture capital firms in KVCII portfolio companies
- \$11+ million of public market equity raised by KVCII portfolio companies
- \$160+ million of private sector bank debt
- KVCII has been the sole, lead or co-lead investor in 70% of all portfolio investments
- KVCII has been the primary conduit for importing institutional venture capital to Kansas-based small businesses
- Financial leverage on the State's \$5 million investment exceeds 60 to 1

February 2, 2001

Testimony of Harold S. Bradley
President, American Century Ventures
Kansas City, MO

Thank you Chairman Brownlee and members of the Senate Commerce Committee for inviting me to participate in a discussion about venture capital and its impact on economic development in Kansas and the region.

I am Harold Bradley, a Kansas resident, and the leader of the strategic investing activities for American Century in Kansas City. American Century ranks among the largest mutual fund and investment management organizations in the United States with more than \$100 billion in assets under management. We serve more than two million investors nationwide and 82,000 in Kansas. We are also proud to manage "Learning Quest," the post-secondary education savings program sponsored by the Kansas State Treasurer's office. More than 1,000 American Century workers reside in Kansas. We care deeply about building a region with a robust and expanding economy.

My experience in the capital markets is broad and deep. At the Kansas City Board of Trade in the late 1970s, I learned how futures and options markets help reduce the business risk of producers and processors – and lead ultimately to more stable markets. At American Century, I gained similar insights into the risk transference mechanisms of the public equity markets. I have supervised equity trading activities for our mutual funds and also managed more than \$1.6 billion in two public equity funds.

In 1999, American Century asked me to evaluate and invest in newly emerging companies that might enhance our abilities to better serve investors. We are now committing \$25 million a year through 2003 to private equity investments. Of the roughly \$56 million we have invested to date, only \$2.5 million has found its way to local private companies.

I have attached a chart that shows the geographic distribution of our invested dollars. The pie looks very similar to often-circulated pie graphs depicting national patterns of venture capital investments. Our money flows to Silicon Valley and to the

high-technology corridors around Boston and Washington, D.C. Several themes seem to be common to these areas:

- Rich academic environments that create a perpetual pipeline of intellectual capital –
 - Boston – Harvard and MIT
 - Silicon Valley – Stanford, Berkeley and UC San Francisco
 - Austin – University of Texas
 - San Diego – U.C. San Diego
- Strong reliance on capital markets to underwrite risk, from start-up to Initial Public Offering;
- Established networks of professional services experts and advisors;
- Risk capital providers in a concentrated and highly competitive environment
 - ⇒ The concentration of risk capital allows for co-investment by a number of firms in a single company;
 - ⇒ Competition implies that entrepreneurs who seek to “lead” an investment round have incentive to negotiate terms favorable to the person with the idea;
- A pattern of successful and established venture-backed companies that provide potential “spin-out” deal flow, “serial” entrepreneurs and experienced management teams.

In 2001, this region has not yet established leadership in any of the aforementioned activities. The recent initiatives announced in Kansas City around the life sciences initiative takes a step in this direction but we do not yet have systems in place to make the promise of future rewards aligned with the perceived risk taken today by investors in new Kansas companies.

My friend, Mike Brown, the chairman of Euronet Worldwide in Leawood, KS tells me that his experience with the three public companies he has led -- Innovative Software, Informix and Euronet -- produced jobs in the local economy “from out of the dust.” More than 90% of his sales came from outside the region – and often from around the world.

Mike tells me that capital is just not available locally for companies after the start-up stage when \$10 million or so is required to build a truly sustainable business. Banks were not designed for such high-risk activities. Managers for these companies spend time and money away from building the business and travel to the coasts in an often fruitless search for money.

Why is the search fruitless? Two years ago I invested as an "angel" in an Overland Park-based company called Tidestone. The company has executives with an established track record. Tidestone has established products, blue chip customers and actual earnings. I recently introduced Tidestone managers to venture backers I know in New York and California. They still can't find the money...

Outside investors do not put money in Kansas companies because:

- They have plenty of good ideas stacked on their desks just "down the road;"
- Most early stage investors desire an active role in board meetings, in strategy planning and in assessing management capabilities – why fly 1,500 miles when you can drive 15 minutes;
- Private equity investing relies on strong relationships among professional investors and we have not built bridges to the coasts;
- They want an "exit" that involves a planned public offering or possible acquisition;
- The absence of venture-backed success stories causes investors to shy away from the region.

I believe seed capital from "angels" is available in our region but that companies often cannot find "second round" capital of \$1 million or more to develop the business. The state must develop systems that create significant incentives for out-of-state investors to underwrite companies as they grow if we are to build companies and keep them here. The state should also seek to build and sustain research initiatives, including the purchase of capital equipment and facilities. That's how intellectual capital will be attracted. That's how jobs are created.

We can create structures to support venture activities, business development and real economic growth here in Kansas. Recently, I spent hours with entrepreneurs formerly with Sprint who were seeking significant capital to fund business development. They are also still looking. The words of Clayton Christensen, author of *The Innovator's Dilemma*, provide some context for this discussion:

“While established firms’ technological prowess (allowed them) to lead sustaining innovations from the simplest to the most radical, the firms that led the industry in every instance in developing and adopting disruptive technologies were entrants to the industry, not its incumbent leaders...(n)ew companies usually include frustrated engineers from established firms.”

I wonder how many frustrated engineers we have walking around Kansas right now because they can't find money for their ideas.

Thank you for this opportunity to present my views.