

# TEXAS

## BUSINESS REVIEW

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## Texas Venture Capital Programs: Recommendations for Taxpayer Profits and Improved Accountability

By

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Since 2005, state taxpayers have provided nearly \$600 million for two venture capital programs: the Texas Emerging Technology Fund (TETF) and the Texas Certified Capital Company Program (CAPCO). Heading into the 2011 biennial Legislative Session, these two radically different approaches to creating 21st century jobs have proponents and critics alike armed with data and preparing for tough questions from skeptical lawmakers charged with eliminating a projected \$20 billion budget deficit. Can Texas afford these programs? Can Texas move its economy forward without them?

Given the crosscutting nature of the state's economic hardships, the 2011 Session presents an opportune time for lawmakers to consider new ideas for consolidating initiatives and sustaining only the best features of both. A state-sponsored venture capital program is necessary when existing sources of investment capital are insufficient to sustain and retain a vibrant ecosystem of inventors, entrepreneurs, and investors who create wealth and high-paying jobs. Though it is a fundamental principle of capitalism that government should only intervene in capital markets when absolutely necessary, there is appreciation among even the most fiscally conservative venture capitalists for government-sponsored technology commercialization incentives. Now more than ever, with the unwinding of venture capital funds launched during the glory

days of the dotcom and telecom bubbles, industry leaders are concerned about the availability and accessibility of seed- and early-stage equity investments for the next generation of transformational entrepreneurs.

State-sponsored venture capital programs have four key attributes to analyze and compare: 1) the source of funding; 2) the scope of allowable investments; 3) the direct economic returns to the state; and 4) the agents tasked with making investment decisions. Ultimately, state-sponsored venture capital programs, such as TETF and CAPCO, are both "jobs bills." All states need high-wage jobs, especially in this economy. Both programs make investments in small companies that use the capital, in part, to make payroll and, hopefully, smart, strategic investments that will lead to economic growth, wealth creation, and more jobs. TETF and CAPCO both have worthy features to contribute to a new, consolidated, best-practice venture capital program for Texas, one that could continue making capital more accessible to early-stage, high-growth technology companies while shedding criticisms from the legacy programs.

### Sources of Capital for Small Business Investments

Most venture capital programs compete with other economic stimulus initiatives at a substantial disadvantage, as costs incurred today are intended to yield returns several years in the future.

The problem with CAPCO programs, however, is that they are far more costly and no more strategic than generic programs to incentivize small business loans. TETF investments, by comparison, address the greater economic development need: equity investments in pre-seed, seed and early stage companies in targeted industries.

|                                      | <b>TETF Commercialization Awards</b>   | <b>CAPCO Investments</b>   |
|--------------------------------------|--|--|
| <b>Source of Capital</b>             | Direct appropriation   | Deferred insurance premium tax credits   |
| <b>Capital Committed (2005-2010)</b> | \$188 million <sup>1</sup>   | \$400 million  |
| <b>Program Agents</b>                | Seven regional centers of innovation and commercialization, statewide advisory committee and state leadership (Governor, Lt. Governor, and House Speaker)                              | Eleven private sector, for-profit CAPCO funds, with oversight from State Comptroller   |
| <b>Key Metrics</b>                   | Investments made by region and industry, matching funds, returns on investments  | Investments made, jobs created and retained  |
| <b>Targeted Industries</b>           | Biotechnology and life sciences, advanced technology and manufacturing, IT/computer technology, energy, aerospace and defense  | None — Most CAPCO funds are “industry agnostic”  |
| <b>Stage of Investment</b>           | Primarily equity or convertible debt investments in pre-seed and early-stage technology businesses   | Primarily debt with stock warrants investments in mature, profitable businesses  |
| <b>Where the Money Goes</b>          | State receives ownership stake in companies through commercialization investments; successful investments will return principal and proportionate share of capital gains to state fund | State funds are fully consumed by program; principal and profits are divided between CAPCO funds and insurance companies fronting capital in exchange for deferred tax credits |

Providing for a continuation of TETF, which is funded by direct state appropriations, will dig a deeper financial hole for lawmakers working to eliminate the state budget deficit. CAPCO programs address this mismatching of costs and benefits by using future tax credits as the funding source. The problem with CAPCO programs, however, is that they are far more costly and no more strategic than generic programs to incentivize small business loans. TETF investments, by comparison, address the greater economic development need: equity investments in pre-seed, seed-, and early-stage companies in targeted industries.

### How CAPCO Works

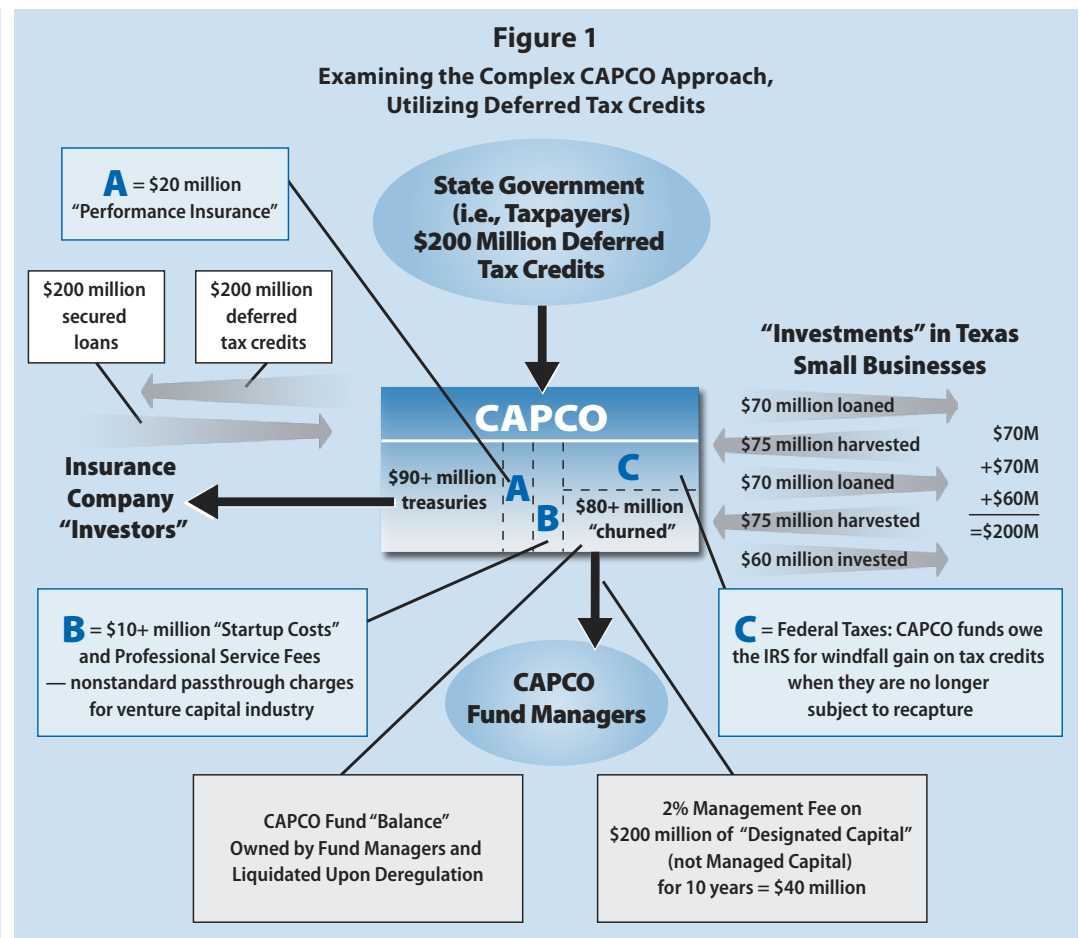
CAPCO funds create a complex structured finance product that converts future tax credits into funds that can be invested in small businesses today. An insurance company that “invests” in the CAPCO security will receive deferred tax credits equal to the

amount of the investment. The tax credits can be used in future years to offset a kind of state sales tax insurance companies doing business in Texas must pay on premiums collected from Texas policyholders. Additionally, the insurance company investors will receive the principal and interest from U.S. Treasury securities purchased with nearly half of their invested funds and held in escrow until the securities mature. The combination of the future tax credits and the escrow fund proceeds provide the insurance companies with a fixed income return that is guaranteed by a kind of default insurance referred to as the “wrap,” which is also purchased by the CAPCO funds from the investor proceeds.

### CAPCO Issues to Address

The problems with the CAPCO model as a funding source are numerous and well-documented from the experiences of other states.<sup>2</sup> First, the model is extremely expensive to implement. There are avoidable costs

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associated with developing the financial security, purchasing the default insurance, having the security rated by an investment rating agency, and marketing it to insurance companies. Second, the peculiarities of the structured finance security serve as a barrier to entry for venture funds accustomed to recruiting limited partner investors on the merits of their investing prowess rather than their ability to engineer a fixed-income product. Third, so much of the capital is committed to the escrow fund, the default insurance and the “startup costs” of the CAPCO fund that the amount of capital actually available to invest in companies is typically less than half of the amount of tax credits committed to the program. As explained in the next section, this fact affects the investment behavior of the funds in a manner that discourages the kind of investments most needed in Texas.

**Recommendation:** *Texas should use deferred insurance premium tax credits as*

*the source of funds, but sell the tax credits directly to insurance companies as funds are needed for investments. Using models we have developed that improve greatly upon the methods deployed to finance the TNInvestco program in Tennessee, Texas could nearly double the yield of investment capital from the tax credits as compared to the typical yield from the Texas CAPCO model.*

### Investment Focus Areas

TETF was designed to spur technology-based economic development by co-financing high-growth businesses through the technology commercialization “valley of death” — the period after new technologies have exhausted federal R&D grants for basic research and before they are considered investment-grade by most venture capital funds. Even fiscal conservatives generally accept the premise that state-subsidized capital investments in pre-revenue technology companies are a legitimate use

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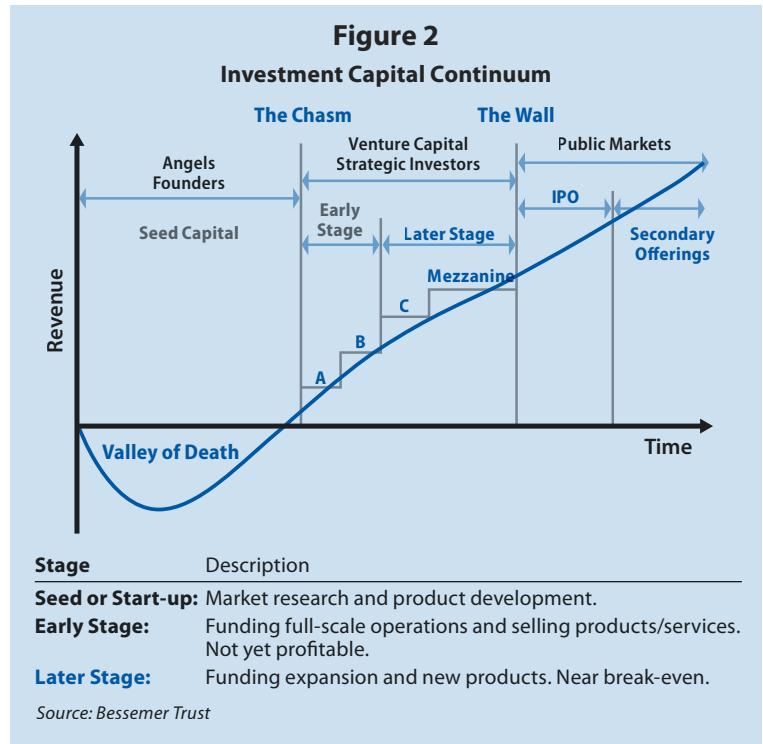
of taxpayer funds in order to compete with other regions for the downstream, high-wage jobs created by technology companies that successfully navigate through the valley of death. CAPCO has no such design.

Some CAPCO funds have invested in early-stage technology companies, but those investments appear to be the exception rather than the rule. Most CAPCO funds focus on later-stage investments in revenue-generating, profitable companies, where the investments are typically structured as loans with fixed and determinable repayment terms. The economics of managing a CAPCO fund practically require a focus on debt investments in order to meet the “pacing requirements” outlined in the CAPCO legislation.

For example, a CAPCO fund receiving an allocation of \$20 million of tax credits will have around \$9-10 million of capital to invest, after accounting for the escrow fund requirements, default insurance payments, and other startup costs unique to CAPCO funds. The CAPCO fund is required to make \$20 million of investments within the statutory investment period (the amount equal to 100% of the allocated tax credits). How does one make \$20 million of investments from \$10 million of capital? One makes loans in mature companies with repayment terms of fewer than three years, such that the principal and interest returns from these investments can be recycled into new investments.

The problem with this model is two-fold: 1) CAPCO funds are effectively state-subsidized competitors with banks and later-stage private equity funds for lower-risk investments in profitable companies,

and 2) the state’s genuine economic development need for capital investments in the “valley of death” is under served by CAPCO funds.



**Recommendation:** Taxpayer-subsidized venture capital funds should be restricted to making seed- and early- stage equity investments in companies with extraordinary growth potential. Investments with fixed or determinable repayment plans at the time of the investment should be prohibited, and there should be an independent review process to ensure that deals involving taxpayer-subsidized funds could not be funded completely with unsubsidized capital sources.

### Economic Returns to Taxpayers

The most troubling and misunderstood aspect of the CAPCO program is that the state only receives indirect economic benefits from the investment activities of the funds. None of the profits from the investments made by the CAPCO funds are returned to Texas taxpayers. Only the jobs “retained” by companies receiving CAPCO funds, and those “created” by the firm after CAPCO funds are received, are reported

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as indirect benefits to the state's economy, a very suspect performance measure.

What most lawmakers do not understand is that the CAPCO program consumes the entire amount of the state taxpayer investment — \$200 million of foregone tax revenues for each of the two CAPCO programs. The state commits the capital, insurance company investors get a fixed-income return, and small businesses get capital investments for which they must pay back the principal plus interest and/or give up equity in their companies. Once the CAPCO funds have met their statutory requirements, the fund is “decertified” and the fund owners keep everything left over. For Texas taxpayers, it is a “lose-lose” scenario: if a CAPCO fund invests poorly and there is nothing left over, the taxpayers get nothing. If the CAPCO fund invests well and realizes substantial profits, the taxpayers still receive no financial returns that could be used to finance future economic development needs.

In contrast, TETF investments have the potential to produce substantial direct financial returns for the state. Although by the nature of pre-revenue technology investments there will be many TETF investees that fail to generate any returns on the state's investment, the portfolio as a whole has a reasonable chance to return substantial profits. Financial returns can be used to fund future economic development initiatives or simply to lessen the taxpayer burden of funding unrelated state government operations.

**Recommendation:** *State-subsidized venture capital programs should provide taxpayers with the same rights as investors in venture capital funds: the state should receive a return of 100 percent of its principal invested prior to any profit distributions to fund managers, and the state should receive 60-80 percent of any profits when the fund is liquidated.*

## Program Agents — Who Makes the Investment Decisions?

TETF recently has been criticized for involving government officials in the investment decision-making process. Whether or not it could ever be proven that political influence affected investment decisions is irrelevant to this analysis.

Arguably, the state would be better served by vesting the decision making processes in private sector, profit-motivated venture capital funds for two reasons. First, venture capital funds are measured almost exclusively by the financial returns they generate for investors, an effective control against committing limited funds to substandard, politically active companies. Second, an important goal of any state-subsidized venture capital program should be to give new funds an opportunity to generate measurable results that can be used as proof of performance to attract future funding commitments from unsubsidized sources.

Even Austin Ventures, one of the state's largest private equity firms, started as a small fund, but given the opportunity, it developed a 25-year track record such that it now manages \$3.9 billion across ten funds — little if any of which is subsidized by taxpayers. Were small funds with experienced fund managers engaged to manage TETF investments along regional or industry lines, a potential outcome could be a new generation of self-sustaining venture capital funds. The challenge of this approach involves finding the right balance of incentives and controls to insure that the participating venture funds remain focused — if not legally committed — to investing in seed- and early-stage technology companies based in Texas and committed to growing in Texas.

CAPCO uses independent funds to make investments, but the fund economics are so dissimilar from the standard venture capital model that the financial performance of CAPCO funds does not provide a track record that can be leveraged in the competition for unsubsidized limited

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partner investments. The insurance companies that invest in CAPCO funds are not comparable to typical limited partner investors in venture capital funds, as the returns they receive from the CAPCO structured finance investments have very little risk and are far below the returns limited partners typically seek from their alternative investments portfolio. The state of Texas cannot be considered a limited partner investor because the financial return to its taxpayers is fixed at minus 100 percent.

***Recommendation:*** *Develop an independent, expert-advised process for investing state funds in small venture capital funds selected through an open, competitive process to manage \$20-40 million allocations exclusively in seed- and early-stage technology companies in Texas.*

## Conclusion

Texas' executive and legislative leaders have the experience and the motivation to consolidate and reinvent the state's investment in venture capital programs. Whether or not Texas businesses are directly engaged in the high-growth small business ecosystem that depends on a reasonable and accessible supply of venture capital for development and growth needs, Texas firms and their owners are taxpayers, too, and share concerns about the future economic prosperity of the state and the efficiency with which government leaders manage essential economic development programs. This challenging economy, and this challenging budget cycle, demand a fresh look at these programs in order to achieve more from less.

## Endnotes

1. TETF has three focus areas: commercialization investments in private-sector companies; research infrastructure grants primarily to universities and non-profit research institutions; and research matching grants for individual high-potential R&D projects. Nearly half of the \$365 million contracted and encumbered through July 2010 were for projects in the latter two focus areas. Only the TETF commercialization awards are comparable to CAPCO investments and, therefore, provide the focus for this comparative discussion.
2. Government audit reports from Colorado (2003) and Missouri (2004), plus disclosures in SEC filings by Newtek, Inc., d/b/a Wilshire in Texas CAPCO programs, stand out as useful documents in understanding CAPCO model mechanics.

