

The National Association of Seed and Venture Funds

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**State and Ventures Capital –
*State Experiences and Options***

Executive Summary

Entrepreneurs always have led in building the United States economy. But never has the pace of new business development been so fast or the competition so intense. To win in the race for wealth and jobs, the 50 states have been called upon to serve entrepreneurs and help create an environment where new business ventures can thrive. Part of this challenge is ensuring that entrepreneurs have access to the seed and venture capital they need to launch and grow their companies. This report is a survey of the status of seed and venture capital in the states. We discuss the objectives of state programs and current sources of capital, with a focus on state-sponsored and state-facilitated funds. The report encompasses the reported experiences of the NASVF members with state government operated or state sponsored funds and includes examples of both successes and failures. In addition to surveying our members' programs, we have reached out to all program managers in each of the 50 states who run programs that provide innovation capital, and the preliminary results of the state-by-state survey of programs is provided along with this report. We also provide examples of the kinds of initiatives that state governments can undertake to facilitate access to equity capital for small- and medium-sized businesses.

Finally, we address the lessons learned over more than twenty years of experience with state-sponsored or state-facilitated capital programs. This experience has led to some clear indicators of success for state government in the design and implementation of seed and venture capital programs. These are:

- **Strong Leadership** – In the best programs, state leaders take the initiative in getting a program launched, and ensure a long-term direction.
- **Private Sector Management** – The best programs rely on carefully selected private managers to make the day-to-day investment decisions.
- **Focus on Knowledge** – Money is not enough to create strong companies. Investment happens in communities where both entrepreneurs and investors know how to

structure world class companies, how to invest, and how to attract others to invest. Where this know-how is lacking, good investment seldom occurs.

State and Venture Capital – *State Experiences and Options*

- **Long-Term Focus** – The best programs are long term in perspective. They expect no measurable impact, in terms of investment returns or significant job creation, for a bare minimum of five years, and do nothing that would short cut the integrity of the investment process. Venture capital must be patient capital to yield good results. In the private sector of venture capital, investment exits sometimes take as long as 12 years, particularly in dealing with early-stage companies.
- **Financially Fair** – The best programs treat the state as a valued financial partner, not as a source of “easy money.” States that seek financial returns commensurate with their support, beyond economic development returns, help reinforce the intent of the program to produce high quality business development.
- **Profit Motivated** – The best programs seek to make money. They adopt the philosophy that the best economic development is produced by those firms that are growing most rapidly and are likely to be the most profitable.
- **Focused Purpose** – The best programs are careful not to oversell. They recognize that the expectations of the various stakeholders may be at odds, and that not all can be satisfied.
- **Effective Scale** – The best programs are large enough to make a difference.
- **System of Evaluation** – The best programs establish outcome measures from the beginning, keep track of program results, and evolve according to changes in conditions.
- **Discretionary** – Finally, the best programs are governed not only by encoded rules, but by the exercise of discretion by trained professionals and experienced laypeople.

Since our First Report

The NGA (National Governor’s Association) invited the NASVF to prepare its first report on the experiences of states with seed and venture capital in 1999, and released it in 2000. Since that time the world has changed more than a bit. The Internet bubble helped attract over \$100 billion in venture capital in 2000 alone. Investors who got out early made phenomenal profits, while the crash that followed yielded the worst returns in the venture capital industry’s history. For a brief period, never had more private capital

been available for start-ups, at least in the information technology sector. But money for seed and start-up stage companies has shrunk dramatically.

In 1995 over 17% of all institutional venture capital went to investments at the seed and start-up stages. This share of the venture pie has steadily fallen, and since 2000 has hovered around 2-3%.¹

Enthusiasm in the stock market during the “bubble” period helped catalyze a new breed of angel investor.² In some regions angels became more prevalent than traditional venture investors. After the crash, angel investment also slowed to a trickle, or so it seemed. In a welcome turnabout, and with strong leadership from Kauffman Foundation, angel investing has reemerged in a new, more vigorous form. The Angel Capital Association (ACA) counts more than 200 angel groups across the U.S. and Canada³ and over 100 are members of the ACA (Angel Capital Association).

Recognizing the lack of early stage capital, many new venture capital programs have been launched with the support of states. A fund of funds strategy has been adopted by more than 18 states. Pre-seed, or validation, funds are becoming more common, particularly at universities. And tax incentives, some incredibly generous, have taken root in about 20 states.⁴ Perhaps most promising, states have gained an appreciation for the role of culture in entrepreneurial business development. Cost effective programs are being implemented to advance the knowledge of world class business venturing and the entrepreneurial ecosystem.

Why is Seed and Venture Capital Important?

Upstart entrepreneurs increasingly dominate the nation’s economy. The life cycle of many new products has become so short that a business can only succeed by moving rapidly from a good idea to a great product to global distribution. In slower times, a business could grow incrementally from region to region, usually from internally generated capital. Now, the demands for rapid growth require outside capital. Banks don't provide this type of money. And the public stock market is only an option for established firms, with initial public offerings (IPOs) an option for very few new companies.⁵ Private seed and venture capital fills the gap, so much so that private equity

¹ PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTreeTM

² Angel Investor – an individual who invests for his or her own account in young, private companies.

³ Sohl, Jeffrey, “Business Angel Investing Groups Growing in North America”

⁴ The status of these programs is fluid – as of this writing, several state legislatures are actively considering legislation to initiate or modify tax credit programs.

⁵ It is worth noting that, partly as a result of the Sarbanes-Oxley legislation, IPOs for small U.S. start-ups are increasingly being launched outside of the U.S., often on the UK AIM or the Toronto Stock Exchange. These IPOs are still small in number.

has become an integral part of the capital structure of most high growth firms. However, professional seed and venture investing is still a relatively young phenomenon.

... In much of the country, seed and venture capital is largely invisible, and, when located in a far-off city, hard to reach or trust. Entrepreneurs are much more likely to find capital and accept capital if the resource is available locally, delivered by people they know. Likewise, venture capital investors tend to be local in outlook, particularly at the earliest stages of investment. Investing happens through relationships. The greater the opportunity to build these relationships, the greater the chance that understanding and trust can develop, and that money can flow to worthwhile ventures.

Basic Forms of Risk Capital: R&D, Pre-Seed, Seed, Venture, and Mezzanine

In order to consider how states might act to make equity capital more available to local entrepreneurs, it is important to understand the various forms of capital used to build companies. Each form has different outcome measures and stakeholders. Table 1 below represents the basic forms of risk capital, the entities that deliver them, and how the forms often overlap.

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are needed to see this picture.

The innovation process appears linear, but it is not. The forms of capital are complementary and often blend together, and may even be used simultaneously to meet the capital needs of a company. The following are common definitions for equity capital categories:

Research Capital – funds invested in support of basic research.

Pre-Seed Capital – funds invested in support of applied research with the aim of developing new products.

Seed Capital – funds invested in young companies that have not yet fully established commercial operations, often to launch new products, and may involve continued research and product development.

Venture Capital – long-term equity capital invested in rapidly expanding enterprises with an expectation of significant capital gains, often for product rollout. Typical investee companies have demonstrated sales, but are not yet profitable.

Mezzanine Capital – capital invested with a structure involving subordinated debt, generally in profitable, established companies.

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Current Status of Capital Access in the United States

The amount of venture capital available in the U.S. now is well below the heady levels of 1998- 2000, but most would agree that a correction in the market was necessary. In 2004 and the first part of 2005, the amount of venture capital invested has showed modest recovery and is currently at a level that most in the industry consider “about right” to allow sufficient competition, yet reasonable valuations and profits. These positive trends for the industry, however, mask a troubling problem for young companies. Institutional venture investment in start-up company’s remains at low ebb, both in absolute amount and as a share of all venture investments.

A number of firms produce annual or quarterly reports on venture capital investments in the U.S. While useful, these look at a very select segment of capital in the country—private institutional venture capital firms. However, these data do give an indication of where equity capital is concentrated, how shifts in regional investment are occurring, and what kinds of industries are attracting investment... (Appendix A in the full report includes a spreadsheet showing investment amounts for 1995-2005 state-by-state).

In 2005 institutional venture capitalists (VCs) invested a total of \$21.7 billion with an average deal size of \$7.4 million. Notably, over 58% of the investments were made in just two states, California and Massachusetts. California alone received 47.4% in 2005, as its share continues to creep upward toward the 50% mark. Texas, New York, New Jersey, Washington, Colorado, and North Carolina rounded out the top eight, and together received 22% of the venture capital in 2005. The other 42 states collectively garnered less than 20% of venture investments – some so little their share showed up as zero. It is little wonder that many states see the need to “jump start” their entrepreneurs’ access to capital via state programs.

In addition to favoring certain states, venture capital gravitates toward later-stage companies. Formative stage companies, those in the start-up and seed stages of development, garnered funding of \$736 million, or only 3.4% of total dollars...

Venture capital’s migration to larger investments has widened the capital gap for smaller, younger firms. Seed and early stage capital needs for many are in the range of \$500,000 to \$2 million, which is well below the typical VC horizon of \$5 to \$7 million per investment. While venture capital firms are an important element in the financing of entrepreneurial companies, they fill only a part of the need for capital. In addition, the

concentration of VC activity in a few limited regions leaves large areas of the country under-served.

In contrast to traditional VC investments of \$21 billion in 2005, the volume of angel investment in 2005 was \$23 billion. The majority of angel investments remain in the start-up/seed stage – 55% according to the Center for Venture Research. By these estimates, angels provide 17 times the volume of start-up/seed capital, compared to VCs. While largely concentrated in regions of existing entrepreneurial strength, would-be angel investors can be found in every major community in every state. Certain states are tapping this resource through networking and training events, and by supporting the formation of angel investor groups.

Other states are making forms of seed and venture capital accessible and visible through a variety of state-sponsored programs.

State Strategies for Mobilizing Investment Capital

To serve local entrepreneurs, and thereby create new wealth and quality jobs for their citizens, most states have adopted programs to deliver, encourage, or facilitate the formation of local seed and venture capital resources. There are four basic strategies that states have pursued:

- **Spread knowledge** – Expand the knowledge of seed and venture investing among policy makers, individual investors, and entrepreneurs.
- **Create visibility** – Create visibility of entrepreneurs to investors, and investors to entrepreneurs.
- **Fill a gap** – Create investment capital to fill a gap or grow a sector.
- **Build an industry** – Create investment capital to build a seed and venture capital industry.

Of these, the first two are critical to building a culture of entrepreneurship and risk capital investing. Knowledge of how seed and venture investing works, how investors think and make their decisions, gives a would-be entrepreneur a much better chance to assemble a plan that will attract money. And, making the two camps visible to each other—through venture forums and networking events—makes it possible for relationships to form and trust to develop, which are key to facilitating investment.

The third strategy has been the most common, and is often based on the desire of state policy makers to encourage high-tech ventures, or a particular industry sector of strategic importance to the state. Typical mission statements include language like “for the purpose of providing funding for the start up of new technology, modernization of existing businesses through dual-use technology, and enhancement of service delivery systems to promote economic development and security.” These economic development, national competitiveness, and social missions may be an outcome of venture capital investment, but they are not a goal of most VCs. First and foremost, venture investors seek to optimize financial return on investment by maximizing profit, while minimizing risk and reducing time to exit. In contrast, a government sponsored strategy may aim resources at early-stage companies, or industry sectors, that are not generally attractive to

the venture capitalists, or the strategy may focus on later stage, low- cost financing of companies which cannot get conventional financial assistance – such as in traditional industry sectors that need revitalization.

The fourth strategy is based on the belief that the best way to serve aspiring, young companies is to help ensure that these companies have local access to a robust professional seed and venture capital industry, one with deep local roots and a variety of local investing talent. In this approach, the targeting of sectors is accomplished by selecting private seed and venture funds that specialize in the targeted sectors and invest in these funds. The state adopts the philosophy that an investment discipline that seeks to optimize return on investment is the most efficient way to achieve the greatest economic development. The goals of the state are therefore aligned with the goals of the venture investor, enabling the state to invest in the best available seed and venture funds. In turn, these funds search for the best entrepreneurs and support these in building fast-growth companies, the kind that hold the potential to create jobs, wealth, and high quality development.

Types of State-Sponsored Seed and Venture Capital Programs (see full report for details)

Our research indicates there are currently eight types of programs. The models fall into these basic categories:

1. Direct investments by state agencies
2. State Investment in privately managed, geographically restricted funds
3. Investment in a portfolio of private seed and venture capital partnerships
4. Tax credit incentives for private direct investment
5. Tax credit incentives for private indirect fund investment
6. Mobilizing Angel Networks
7. Matchmaking Services
8. Culture Bending Initiatives

While this report focused on capital programs, the real key to transforming an old economy into a new economy has more to do with culture, ideas, and know-how than money. The most effective strategies for encouraging entrepreneurs and building access to capital are those that transform the know-how and vision of people in a community. Aspiring entrepreneurs, and those who wish to serve them, must possess a profound awareness of how market leaders across the world are implementing new business models in order to compete effectively.