

## State Governments Start Investing Capital for Entrepreneurs to Grow the Local Economy and Keep Jobs

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**E**quity capital for entrepreneurs is a scarce commodity in most of states in the United States. This is particularly true for states that are predominantly rural. The extraordinary concentration, both geographically and by stage of development, of venture capital investing over the past two decades has dramatically altered the economic landscape for entrepreneurial start-ups in the United States.

While the venture capital industry often portrays itself as the fount of economic growth, basking in the glow of such wealth- and job-creating giants as Fed-Ex, Microsoft, and Dell, statistics show clearly that as the industry has aged, so has its appetite for larger funds, from which it invests larger amounts of money into later-stage companies.

Upon careful reflection, that change presents no great surprise. As the venture capital industry's success stories gathered media attention, it was able to raise larger funds, requiring fewer, larger investments for more lucrative and manageable portfolios. And the industry tended to concentrate its work closer to the centers for research and entrepreneurship: the San Francisco Bay Area, Boston's Route 128, North Carolina's Research Triangle, and Seattle.

Institutional venture capital, as measured by the "Money Tree," the most commonly used reference, has now nearly abandoned the start-up-seed-capital stage of investing, placing only 2 percent or 3 percent of its capital in such firms. In fact, roughly 80 percent of all venture capital is invested in expansion and later-stage companies.<sup>1</sup>

The average-size venture capital fund has nearly tripled to more than \$200 million of capital under management (that's other people's capital), exacting more efficiency in its investing practices, translating into later-stage, larger deals that are geographically concentrated.

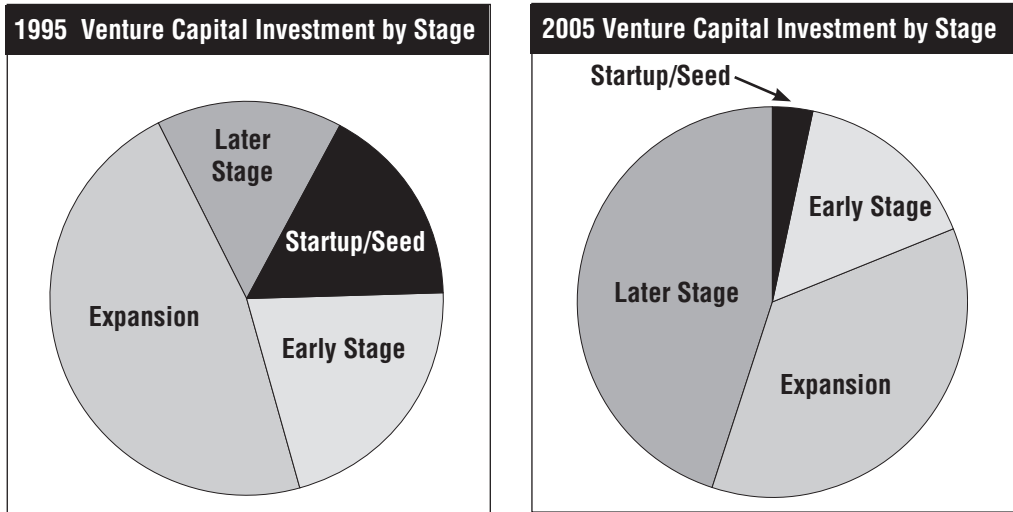
So, while the venture capital industry's trend lines are perfectly logical, the consequence for that portion of the nation that has come to be known as "fly-over" states is a brain drain, a loss of prospective high-growth entrepreneurial companies, and an array of economic challenges.

Just as U.S. Supreme Court Justice Louis Brandeis nearly a century ago envisioned state legislatures as "laboratories of democracy," willing to tackle new and innovative approaches in meeting the needs of the citizenry, once again the states are obliged to step to the plate, launching a variety of ideas for making equity capital available for their entrepreneurs.

Economic development, job creation, and retention of talent are most frequently cited as reasons for the state to get involved. And after more than a decade of experience with

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<sup>1</sup> Annual reports of 1995 and 2005 of the PricewaterhouseCoopers, National Venture Capital Association, Thomson Financial survey of institutional venture capital investments.



such programs, many states have come to recognize that it is appropriate, even desirable, to include a profit motive, that is, to treat the state's investment, whether it be direct or by tax credit, in a manner similar to how venture capitalists treat their limited partners.

Connecticut often is credited with launching the first initiative, then called the Connecticut Product Development Corporation, a program by which entrepreneurs with compelling ideas could obtain state equity capital investments to create a company. It proved to be a success, and eventually was copied and massaged by other states that found themselves challenged to retain their more capable entrepreneurs.

During the past few months, the National Association of Seed and Venture Funds (NASVF) conducted a study to get a picture of what state governments are doing today to promote or create equity capital. Our researchers uncovered more than 150 programs in 45 states with a combined \$5.8 billion in committed capital. Such programs are scattered through the bureaucracies of state governments—governors' offices, treasury departments, departments of economic development, state pension systems, and special objectives funds, such as clean energy. Most target early-stage investments in companies aligned with the state's priorities (job creation, for example).

Only about 40 percent of the programs, however, provide the state with an equity position for its investments. Many funds are restrained by constitutional prohibitions. Additionally, state universities, particularly those with research programs, have increasingly recognized an economic-development responsibility to their states and have created programs to assist both the transfer of technologies and the creation of businesses.

State involvement in creating equity capital to finance entrepreneurial businesses continues on an evolutionary path as state legislators look for more effective ways to retain their entrepreneurial talent. As such, the process commands continued scrutiny to identify and share best practices.

Among the more promising approaches is a program originally launched in Oklahoma in the mid-1990s. The program, frequently called a fund of funds, uses contingent tax credits to raise funds that are, in turn, invested in established venture capital firms willing to evaluate and invest in potential Oklahoma growth companies. Variations of the model have also been established in Arkansas, Iowa, Oregon, Ohio, South Carolina, and Michigan.

NASVF's study also illuminated what we do not know about state involvement in equity capital formation. States often showcase anecdotal data about successful and failed programs. And just as radio stations are wont to claim, "We're number one," so also do states like to pronounce their claims of success. Responses to the NASVF survey suggest that a more detailed examination of programs would be valuable in determining what really works well in creating economic benefits from state-sponsored equity-investment programs. In fact, a more critical analysis could provide vital information for state policymakers, particularly in the "fly-over" states, as to what works and what does not. Taxpayers as well as entrepreneurs would welcome more clarity.

One of the more revealing responses to the NASVF survey is that many of the states operating equity capital programs do not consider return-on-investment a priority for the state. Most look to job creation or other economic-development measures as their metric.

## Lessons Learned

States tried many experiments to increase capital access in recent years and have learned much from both the failures and the successes. What has become clear is that initiatives of government support and policy direction combined with private-sector market discipline appear to offer an effective formula for creating equity capital for local entrepreneurs. Government as the direct investor engendered a poor track record. State officials are rarely in a position to make disciplined business investment decisions. The reward system in a bureaucracy punishes risk-taking, a critical factor in early-stage investing. State direct-investment programs are also challenged to fit an investment manager into their pay-classification programs. However, relying exclusively on the private sector to meet the changing needs of today's entrepreneur leaves many states watching and waiting while other regions jump ahead.

Based on our research of all the state-sponsored venture capital funds, we have identified nine key themes that are necessary for success. Consider the following:

### *Demonstrate Leadership*

In the best programs, state leaders take the initiative in getting a program launched, and they help set a long-term direction. In Iowa, for instance, a coalition of the Iowa Bankers Association, the Greater Des Moines Partnership, the Iowa Taxpayers Association, and others organized a statewide campaign to establish a fund of funds venture capital program. It is supported by contingent state tax credits and successfully attracts out-of-state institutional venture capital to the Hawkeye State. The contingent tax-credit approach to creating state-sponsored venture capital, first developed in Oklahoma, is also being tried in Arkansas, South

Carolina, Oregon, and several other rural states. It relies on experienced, private managers to make day-to-day investment decisions. States must be actively involved in selecting managers, using rigorous standards common in the venture capital industry, and then regularly monitoring the progress and performance of the managers over time.

### ***Promoting Knowledge Is as Important as Providing Capital***

The best programs recognize that the challenge of capital formation is not so much about money as it is about knowledge—how the business community understands seed and venture capital, the steps involved, the do’s and don’ts, and what it looks like and feels like to build a world-class company. Creating visible access to an abundant source of capital is just one key to supporting the growth of this culture and helping young people develop the courage to venture. In every state, someone is doing good work in this arena. State leaders should take care to build on this existing momentum.

### ***Insist on a Long-Term Perspective***

Making good investments takes a lot of time, and building an industry that is prepared to make and manage these investments takes even longer. The state should expect no measurable impact for at least five years and should do nothing that would compromise the integrity of the investment process. Many states have taken shortcuts, only to be embarrassed. A fund must take all the time needed to find the right people, and all the time needed to make the right investments. The good deals are there.

### ***Be Financially Fair***

The best programs treat the state as a valued financial partner. When states commit capital, or support programs with tax incentives, or bear risk in any way, they should be compensated for this financial commitment with an opportunity for financial returns commensurate with the risk they take. This may seem counterintuitive, but in this form of economic development, when capital or tax credits are simply given away, the integrity of the program gets compromised and the results become disappointing.

### ***Do Not Be Afraid to Make Money***

The best programs focus on access to capital, not cost of capital, and adopt the philosophy that the most effective economic development is produced by those firms that are growing rapidly and are profitable. These are good investments, the type that disciplined investors want to find.

### ***Do Not Oversell the Program, and Be Mindful of Competing Interests***

Policymakers must recognize that the varied expectations of stakeholders and customers may be at odds. The business customers may expect that state-sponsored funds will be a source of low-cost money; the investment community may see them as a competitor; and economic development organizations will expect them to create jobs quickly. There is no way that any program can satisfy all those expectations at once.

### ***Be Big to Be Effective***

The best programs are large enough to make a difference. Big funds and little funds all require the same processes and, ultimately, the same amount of work (little funds often take more work). Creating a substantial, visible source of seed and venture capital will help generate a willingness on the part of would-be entrepreneurs to take the plunge. This is not to say that a large program must deploy its capital within a fixed time frame.

### ***Build In a System of Evaluation***

The best programs build in achievable outcome measures from the beginning. Keep track of program results and evolve as conditions change.

### ***Be Flexible***

Finally, the best programs are governed not by encoded rules but by the exercise of discretion by trained professionals and experienced laymen. Statutory programs often get packed with details and constraints, to the point that the best investment managers will want nothing to do with them. Quality programs are built on carefully selected, quality people. Do everything possible to get capable professionals on board from the very start.

## **On the Wings of Angels**

Too important to ignore is another relatively recent development regarding state government involvement in creating equity capital for entrepreneurs—the rapid growth in the creation of angel investing groups. Angel investors have gone from being isolated individuals to well-organized teams of investors. Many states are using tax credits to encourage the formation of angel investment groups, which now number more than 200. For more detail on this phenomenon, see the article by Steve Mercil in this issue of the *Review*.

Angel groups are important for two reasons. By their very existence, more equity capital becomes available to more worthy entrepreneurs. And greater public awareness sends a message to worthy entrepreneurs that the opportunity to fund their enterprises exists locally.

While angel group activity is highly encouraging, it is too recent a phenomenon to provide measured results. But clearly there is economic benefit for angels, working in teams, to offer more in-depth analysis regarding the potential of a business plan, as well as to mentor the entrepreneur in executing it. The shared responsibility for due diligence and mentoring reduces the burden and increases the prospects for creating successful new companies.

Angel investing is extremely important in aggregating capital for entrepreneurs. The Center for Venture Research at the University of New Hampshire estimates that angels provide more equity capital for entrepreneurs than institutional venture capital. State tax credit involvement offers a relatively small risk for taxpayers in exchange for more visibility for both entrepreneurs and investors.<sup>2</sup>

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<sup>2</sup> Jeffrey Sohl, “The Angel Investor Market in 2005,” Center for Venture Research, University of New Hampshire, March 2006.

Creating or encouraging the creation of equity capital for entrepreneurs is a challenge for state governments, especially for rural states that have experienced an out-migration of people, jobs, and capital. The blend of state sponsorship, market discipline, and a growing—albeit inchoate—culture of entrepreneurship appears to be a winning combination to develop businesses in rural communities.

*George Lipper is editor of NASVF Net News, the popular weekly newsletter of the National Association of Seed and Venture Funds. Net News is a free weekly electronic newsletter aggregating current stories dealing with capital formation, seed and early stage venture and angel investing, technology transfer and other subjects related to technology-based entrepreneurial activity. He is a former broadcast journalist. Lipper worked at radio and television stations in Texas, Michigan, Iowa and Illinois. He has been involved in both civic and political activities and currently resides in Las Vegas.*