Class 14: Venture Capital

Overview of Venture Capital

Three Phases of Venture Capital Investing

1. Raising Investment Capital

2. Investing Funds and Operating Issues

3. Exiting Investments

SBICs and SSBICs

State Government Initiatives

Community Development Venture Capital

Key Challenges and Best Practices
- Investment strategy
- Operations
- Capitalization

Applicability of Canadian Labor-sponsored funds

CDFC Case Study

Overview of Venture Capital

- New capital source developed after WWII
- Historically focused on supplying scarce equity capital for high-growth early stage and technology-based businesses that need large up-front investment before becoming profitable
- Organized largely as private partnerships to invest & manage funds for pension funds, corporations, wealthy individuals, endowments & financial institutions. Some financial institutions & corporations set-up their own funds.
- Over 500 venture funds managed almost $50 billion & invested $13 billion in 1998. With the Internet boom, VC exploded to 635 funds that raised and invested over **$90 billion** in 2000! In the first half of 2002, investments dropped to $12 billion.
- Potential for large economic development impact due to its role in financing new technologies and industries, and growth firms.
- Federal government supports private venture capital formation via SBIC/SSBIC programs and new market tax credits.
- 45 states created initiatives to expand venture capital via publicly managed funds, investment in private funds, or tax incentives to private investors.
- Some regions and cities have created venture capital funds
- Recent emergence of community development venture capital
- Three phase investment process: raising capital, investing, exiting

Raising Investment Capital

- Need long-term patient capital. Typical private fund is a 10-year limited partnership.
- VC funds need more capital than RLFs to support higher management costs, cover lack of cash flow in early years, diversify their portfolios and make follow-on investments.
- Pension funds are the largest investor; provided 38 to 59% of new annual funding from 1993 to 1998.
- Investors use incentives that tie compensation to returns and covenants in partnership agreements to influence managers.
- Economic development-oriented venture capital funds use a variety of capital sources:
  - General obligation bonds (CDFC)
  - Appropriations (Mass Technology Development Corp)
  - Dedicated revenues (Alaska Renewable Resource Corp)
  - Federal loans and grants (SBICs, Murex)
  - Public pension funds: (Michigan, Silicon Valley VF)
  - Local corporations: (Mass Ventures)
  - Banks and financial institutions (Boston CVF)
  - Tax incentives for private investors (Kansas, CAPCOs)
- Organizational form and capital sources are inter-related:
  - Limited partnership is best to attract private and pension investors but precludes the reinvestment of gains
  - Quasi-public corporation allows reinvestment of gains and greater accountability for government funding.

Venture Capital Investing

- VC investing involves extensive pre-investment due diligence, staging of investments, active monitoring of firms (frequent visits, board membership), and syndicating investments among several funds

- Funds screen a large number of firms to make a small number or investments. Only 1 or 2 out of every hundred are funded.

- Active monitoring favors investing near the VC fund office while syndications allow funds to invest outside their region. **Implies the need for both local capacity and strong ties to national VC network.**

- Large influx of capital and growth in the size of private funds has moved them away from their traditional role financing early stage companies and toward large transactions and later stage companies. Average investment VC investment grew in real terms from $3.2 million in early 1980s to over $7 million in 2000.

- Investments are highly concentrated geographically (over half in CA, MA, and Texas) and by industry (80% in 4 industries)

- "Herding" by VC firms where they over invest in a few hot industries and ignore others with strong growth prospects

Exiting Investments

- Exits convert an illiquid investment to cash and realize returns
- Four means to exit equity investments:
    1. Initial public stock offering (the most profitable)
    2. Acquisition of firm by another company
    3. Buyback of stock by firm
    4. Royalty or other debt-like payments
- A small number of investments generate super returns and account for the bulk of VC fund returns. A large share (25% to 35%) fail and most investments provide very modest returns.
- Exiting strategies and returns are linked to performance of IPO market. VC investment focus follows industries with strong potential for completing IPOs. This herd mentality creates a role for public purpose VC funds in supporting growth sectors & technologies overlooked by public stock markets and VC industry.
- Difficulty of exiting from pure equity investments leads some VC funds to use debt instruments with equity kickers and equity-like features such as deferrals of interest and principal payments. Deferred debt repayment provides an alternative exit strategy.
- MTDC's Investment Results (over its first 14 years):
  $8.2 million in original capital ($3 million EDA, $5.2 million state appropriations)
  $20 million invested in 63 companies with 4800 employees
  $18 million in gross gains; $13.3 million in net gains
  $270 million in private investment in portfolio firms

SBIC and SSBIC Programs

- SBIC program established in 1950s to promote private venture capital investing. SBA licensed SBICs and provided low-interest debt capital
- Program flawed by use of debt to fund equity investment funds and plagued by many poorly managed SBICs. Only 25% of almost 800 licensed SBICs are still active.
- SSBIC (originally MESBICs) created in 1972 as inner city economic development strategy based on "Black Capitalism".
- SSBICs faced same problems as SBICs plus the additional problem of being very small (many had $2 mm of less in capital). 30% of SBICs still active as of 1997. Average returns of 1% from 1976 to 1996, and 5% from 1986 to 1996.
- Two types of financially successful SBICs: (1) asset-based lenders financing taxi medallions, restaurants, grocery stores, etc.; (2) equity funds financing larger growth oriented minority and women-owned firms.
- Lessons from SBIC/SSBIC Experience
  - Don't use debt to finance equity investment funds
  - Funds need a large capital base to be viable
  - Private sector management does not guarantee success

State Government Venture Capital Initiatives

- Over 45 states established policies to promote venture capital
- Three types of initiatives:
  - Public venture capital funds
  - Investing state dollars in privately managed funds
  - Tax incentives to stimulate private investment in privately managed funds
  - Most states direct capital to privately managed funds
- Many initiatives linked to a brokering role (venture capital fairs) and other development policies, such as technology commercialization and small business development.
- Programs build local venture capital capacity and demonstrate that a market exists to attract larger flows of VC dollars.
- Best practices from studies of state experience:
  - State officials should set goals and monitor performance but not make and manage investments
  - VC funds, whether public or private, need skilled professional manager, compensation to attract them, and sound investing processes. Public funds need to operate outside state civil service system
  - Strong focus on financial returns is key to political & financial viability, and to attract private co-investment.
  - Marketing and development services are needed to generate sufficient deal flow
- Contrast to Canadian provinces' labor-sponsored funds
  - How do they work? Any potential applications in US?

Community Development Venture Capital

- Emerging *private* venture capital that focuses on economic & social goals, e.g., firm growth and job creation in low-income areas, quality jobs, minority and women ownership
- Kentucky Highlands Investment Corp. created to simulate economic development in rural Kentucky, is the earliest CDVC funds. About half of current CDVCs serve rural regions.
- 60 CDVC funds existed in 2002 with $400 million in capital. Most are small, averaging under $7 million in total assets. Just under half are equity funds with the balance providing debt.
- Funds seek lower returns that private VC funds (10 to 15%)
- Investments have been modest ($200,000 to $300,000), emphasized early stage firms and served more diverse industries that conventional VC.
- Recent trends: growing bank funding, more focus on financial returns, and shift toward bigger funds and larger companies.
- Social investment standards and practices are informal and need further development for some funds
- Capacity and strategies to exit investments unproven

Management Challenges and Best Practices

- Investment strategy must be linked to capacity to generate high-growth firms
  - Service area with scores, if not hundreds, of potential investments
  - "Demand-side" initiatives to cultivate business opportunities and support entrepreneurs
    - Attract entrepreneurs from outside the area
    - Find and support entrepreneurs & firms with high growth potential
    - Promote commercial development of new technologies at universities and research labs
    - Link venture capital to technology development and commercialization programs
  - Build support infrastructure and networks for young firms (attorneys, consultants, angel investors, enterprise forums)

- Building skilled local VC managers
  - Managers need understanding and commitment of ED mission
  - Offer compensation that approach private levels
  - Contracting with private firms an option—but local one
  - Strong public/community oversight of managers
  - Cultivating credibility and relationships with national VC industry

- Raise Appropriate Recurring Capital Sources
  - Minimum fund of $5 to $10 million financed with equity
  - Pensions & financial institutions are key sustained sources
  - Will New Market Tax Credits to expand investor base ?