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ECONOMIC DEVELOPMENT

Risky Ventures

Private investors are pushing a complex venture-capital scheme that involves big risks and uncertain rewards for states.

By CHRISTOPHER SWOPE

There is a phrase that venture capitalists, the investors who bet on small start-up companies, use to describe business locations that aren't worth their time: "flyover states." For any place in America that is watching jobs move to China or India, to be labeled a flyover state is an ominous sign. Information technology, biotechnology and nanotechnology are the future, and growing these industries without venture capital is like growing a rose without water.

The distressing truth, however, is that venture investors and the money they manage are concentrated in frustratingly few places. Silicon Valley accounts for one-third of all venture capital in the country, followed by a handful of smaller hubs such as Boston, Austin, San Diego, New York and Seattle. The lack of venture capital almost everywhere else makes it likely that any inventor with an idea, any professor with a patent or any entrepreneur with a business plan who aspires to launch a start-up company will move to where the money is. States are understandably desperate to hold on to their entrepreneurs. So it is easy to see why governors and legislators are increasingly willing to use public funds to jump-start a local venture-capital industry.

What is harder to understand is why so many of them have latched onto one controversial strategy, lobbied for by a small cadre of private investors, that critics call a rip-off for taxpayers and a sweetheart deal for both its promoters and insurance companies. Nine states have earmarked nearly $2 billion to "certified capital companies" or CAPCOs. Yet many state economic development officials contend that CAPCOs don't much resemble typical venture-capital deals in which investors pouring large sums of money into risky start-up companies expect to be highly rewarded. With CAPCOs, the state is taking on nearly all of the risk in exchange for little, if any, of the financial rewards. In fact, states are not really "investing"

their money at all. They are essentially handing it over to the CAPCOs, which, after fulfilling their obligations, are free to keep the remainder.

Ever since a Louisiana law gave birth to the CAPCO program in the 1980s, three CAPCOs in particular have been quietly but aggressively pushing this venture-capital model around the country. They make big campaign contributions and use well-paid lobbyists to win over lawmakers. And in states where they have secured funding once, they have nearly always come back and pressed for more.

The CAPCO trend hasn't attracted much public interest, however, because the funding structure is so complex. Last year in Alabama, while voters were souring on new taxes for education, state officials were quietly implementing a 2002 law that gave CAPCOs $100 million in tax credits. In November, Washington, D.C.'s city council passed a $50 million CAPCO bill without triggering a single mention in the Washington Post. Texas and Georgia are preparing to fund CAPCO programs worth $200 million and $75 million, respectively. "These CAPCO guys are good at lobbying," says George Lipper, who tracks CAPCOs for the National Association of Seed and Venture Funds, a group that monitors economic development efforts in the states. "They show up at the table with a solution to the state's lack of venture capital. Most state legislators don't have any knowledge of venture capital at all, and what they have in front of them is a promise to answer that problem. So they're very vulnerable to it."

The beginnings of a backlash are visible, however. The Wisconsin Assembly last month beat back the CAPCOs' push for a second round of funding. Florida is refusing to fund a 2002 law giving the CAPCOs a second $150 million. The situation is even more heated in Colorado. When the legislature passed a CAPCO law in 2001, funding was split into two $100 million installments, the first of which was disbursed two years ago. Policymakers in Colorado are so angry with how the first $100 million is being used that they raced to divert the second $100 million before the CAPCOs got it this April. Even the former House speaker who originally sponsored the CAPCO measure is having second thoughts. "As a legislator, I passed 80 good bills," says Doug Dean, who is now Colorado's insurance commissioner. "And one bad one."

BUY NOW, PAY LATER

To understand the CAPCO controversy, it is helpful to look at how venture capital traditionally works. After pooling together money from pension funds, foundations and wealthy individuals who become limited partners in a fund, venture capitalists invest in start-up companies in exchange for an equity stake in the business. This kind of early-stage investing carries big risks — more than half of those start-ups typically won't survive. But occasionally one hits it big, earning limited partners large returns on their investments. If all goes well, an investor who gives $100 million to a venture capitalist would expect to get his $100 million back, and in addition a share of 80 percent of the fund's profits. The venture capitalist takes 20 percent of the profits, plus an annual management fee of about 2.5 percent, or roughly $2.5 million a year.

CAPCOs work quite differently. In order to raise a $100 million venture pool, states turn to insurance companies. Insurers give $100 million upfront to the CAPCOs, in exchange for the same amount in tax credits to be taken over 10 years. The CAPCOs then begin investing the money in local start-up companies. It is a buy-now, pay-later formula that elected officials find hard to resist. The state, however, is the only party in the deal who bears much risk. The CAPCOs have none of the fiduciary responsibilities to the state that a venture capitalist owes to his limited partners. In fact, much of the "investment" here — the state's $100 million in forgone tax revenues — actually lands on the CAPCOs' books as income.

Almost any group of investors may form a CAPCO, as long as they have a couple of years of venture-capital experience, $500,000 in the bank and agree to set up an in-state office. But the states' boilerplate laws, crafted by CAPCO lobbyists, subtly favor a few established national players who have been around since the early days in Louisiana. Not coincidentally, they are the same players who are lobbying legislatures the hardest. Of the $1.5 billion that seven states have so far funneled to CAPCOs via the insurance tax-credit mechanism, only $1 billion is traceable through public records. Those records clearly show who the Big Three nationally are:

• Advantage Capital Partners in St. Louis has received at least $261 million.

• The Wilshire Group, a subsidiary of Newtek Business Services in New York City, has received at least $140 million.

• Stonehenge Capital Corp., based in Columbus, Ohio, and affiliated with Bank One, has received at least $226 million.

The insurance companies, in addition to receiving the tax credits, negotiate with the CAPCOs for a guaranteed rate of return. Exactly how much insurance companies make off the deal is not public record, although Colorado regulators believe the insurers' overall return is as high as 10 percent a year. According to state records in Florida, New York and Colorado, insurers Metropolitan Life, Travelers, John Hancock and Northwestern Mutual, among others, have taken CAPCO tax credits in each of those states.

To be sure, states do attach a few strings to CAPCO money. The CAPCOs must invest in start-ups located in the state. Start-ups typically must begin with a small number of employees, and firms practicing law, accounting, medicine or real estate often don't qualify. Otherwise, state laws are generally silent about how to measure outcomes. It is hoped that the CAPCOs will create jobs and taxable income, but they are not required to show any economic benefits. Instead, the laws gauge success by how quickly the CAPCOs pump out dollars. They typically must have 30 percent of their funds invested within three years and 50 percent invested within five years.

EVEN NOT TRUE WITH SB133

These laws leave much open to the CAPCOs' interpretation. The Wilshire Group, for example, uses the states' CAPCO programs primarily as an income stream for Newtek, its parent company. Newtek is a publicly traded company that performs credit card

processing and financial services for small businesses. Its corporate strategy, laid out in filings with the Securities and Exchange Commission, is to channel the states' money into Newtek's own subsidiaries. In 2002, state CAPCO programs accounted for 88 percent of Newtek's gross revenue.

Newtek calls its tactic a "hands-on approach" to investing and says in its latest annual report that "the states' objectives of job creation and economic development are unquestionably met." Indeed, all of Newtek's "partner companies" are based in CAPCO states. But Alice Kotrlik, who oversees the CAPCOs for Colorado's economic development office, says, "Legislators never intended this to be free capital for a company to expand its own product line. That's not anybody's perception of venture capital."

SAFE BETS

When the CAPCOs came calling in Colorado three years ago, the state was already in an enviable position — ranking among the top 10 for venture-capital investment. Nevertheless, high-tech industries were complaining that early-stage seed funding was still hard to come by, particularly in biotechnology. The CAPCOs finally won over lawmakers by agreeing to spread the venture-capital wealth beyond Denver and Boulder and make one-quarter of their investments in rural counties.

It didn't take long for policy makers to realize that the CAPCO approach wasn't quite what they expected. Their first shock was learning that $100 million worth of tax credits yielded a pool of only about $40 million for the CAPCOs to invest. That's because the CAPCOs placed nearly half of the $100 million in safe havens such as treasury bonds in order to pay the insurance companies back. This would not have come as a surprise to anyone who had looked at other states' CAPCO programs. Still, even legislators who originally supported the CAPCOs didn't understand how this so-called "defeasance" worked. Nor did they seem to grasp the fees CAPCOs were allowed to charge: $11 million to set up their offices, plus an additional $4 million in management fees the first year.

This is not to say that the CAPCOs won't make $100 million worth of investments. In fact, the law encourages them to do so — and quickly. The CAPCOs are deregulated once they have put 100 percent of the insurance companies' money to work. What that means though, is that in order to turn a $40 million pool into $100 million worth of investments, the CAPCOs must roll over some of the money a few times. That prompts them to make safe bets, which is at odds with the very goals of a venture-capital program. Indeed, more than half of the CAPCOs' investments to date have been in the form of loans, some of them short-term.

The last straw for Colorado officials, however, was the revelations in a state auditor's report last October: Not only had the CAPCOs spent $472,000 on lobbying in four years, but $85,000 of that was financed with state-backed money from the venture-capital program. And the CAPCOs were meeting only the letter, not the spirit, of the rural investment requirement. Three portfolio companies landed in an office park in "rural" Clear Creek County, 600 yards from the border of Denver's western suburbs.

AN INNOVATIVE MODEL?

Although CAPCO critics harp on these anecdotes, if you look at the 23 Colorado companies in the CAPCOs' portfolios many are high-tech start-ups of the nature that lawmakers had in mind. Ischemia Technologies, for instance, is a biotech company based in the Denver suburbs. Ischemia sells a blood test that helps doctors determine quickly whether a patient reporting chest pains is having a heart attack or just heartburn. The market for Ischemia's product is huge: 6 million Americans show up at hospitals with chest pains annually.

A year and a half ago, Ischemia was burning through cash while waiting for the U.S. Food and Drug Administration to approve its product. To get through the crunch, it sought its fourth round of venture capital, but the dot-com meltdown had made such funding hard to find. Two CAPCOs, Advantage and a smaller one called Murphree Colorado Capital, came through with $700,000. Ischemia also raised $7.6 million from other venture investors, but Chief Financial Officer Steven Joanis says, "The CAPCOs were instrumental to closing the round. In an era when not many others are doing deals, the CAPCOs are."

The FDA approved Ischemia's device in February 2003. Now that the company is selling a product, cash flow is improving and the focus of its 25 employees is shifting from research toward marketing and manufacturing. According to Peter Crosby, Ischemia's president and CEO, the company likely would have downsized some had the CACPO funds not come through when they did. "Our payroll is $3.5 million. We pay lots of state taxes. Who can tell me this isn't making money for the state?"

The CAPCOs point to other small-business success stories. Federation Inc., another company in Advantage's portfolio, is a software integrator in the defense aerospace market that moved to Colorado from Israel. The company's staff has grown from two to nine since it landed $7 million in venture capital a little over a year ago (Advantage's stake was $300,000). Another start-up, called StorePerform Technologies, sells software to retailers. It has grown from 18 employees to 30 since one of the CAPCOs, Enhanced Colorado Issuer, invested $750,000 in it. The new positions came about during Colorado's toughest job market in years.

As the CAPCOs see it, they've created an innovative model for financing venture capital — persuading insurance companies, who are safe investors by nature, to put money into high-risk investing. This approach is particularly effective in flyover states, they say, where CAPCOs pull in co-investors from other states. That is beginning to break down venture capital's geographic barriers, according to John Neis, a Wisconsin-based venture capitalist who manages Advantage Capital's CAPCO there. "You need a local lead investor who has a meaningful amount of capital to be credible to attract folks from the coasts," he says.

But since this isn't traditional venture capital, the CAPCOs say, the costs and benefits should be evaluated differently. The CAPCOs are fusing together two worlds — profit-driven venture capital with jobs-

driven economic development — and those goals sometimes contradict each other. Normally, venture capitalists seek the best deals, period. But CAPCOs are restricted to in-state deals and limited by other political considerations, such as Colorado's rural requirement. Which is why, they argue, states should reward them more handsomely than a typical limited partner would reward a venture capitalist. "There's a lot of great deals I have to pass on in the CAPCO model," Neis says. "The objective is economic development more so than return on investment. We're trying to get a return, but the expectations are vastly lower for the CAPCO model."

According to the CAPCOs, success can be measured only in the long run. And the main test is whether the benefits outweigh the admittedly expensive costs. A January study of Missouri's seven-year-old CAPCO program, funded by the CAPCOs' own trade association, found that $52 million worth of CAPCO funding had leveraged $1.3 billion in co-investment (this assumes that CAPCO money always pulls in other investors, not the other way around). Using liberal assumptions on job creation, the study concluded that state and local governments were receiving $3.30 in tax revenues for every $1 the state had invested in the program. "Without our actions through the CAPCOs, these ventures would not happen," says Joe Maxwell, Missouri's lieutenant governor. "Missouri wins when we create new jobs that would not otherwise have been created."

BANG FOR THE BUCK

The question, however, is not whether the CAPCOs might produce some positive results. Nobody doubts that aiding high-tech, high-paying companies such as Ischemia Technologies are good for Colorado. The issue is cost-efficiency. Are there ways to accomplish the same goals that give states more bang for the buck?

A report by the National Governors Association in 2000 outlined at least a half-dozen approaches to state venture-capital programs. A few states, such as Connecticut, Maryland and Massachusetts, directly invest public funds in local companies. Others, such as Pennsylvania and more recently Oregon, have asked public pension funds to place a small percentage of their investments with local venture-capital firms. States such as Maine, Ohio and Virginia offer tax credits to wealthy individuals, known as "angel investors," for investing seed money in local start-ups. Another model from Oklahoma, copied by Arkansas and Iowa, uses tax credits a bit like the CAPCO programs, except that the credits act only as a backstop. After 11 years in Oklahoma, investors have poured $30 million into local start-ups and the state has yet to give up any tax credits. "The best programs treat the state as a valued financial partner, not as a chump," says the NGA report, which was co-authored by Robert Heard, who runs the Oklahoma program.

SPLITTING THE DIFFERENCE

The CAPCOs counter that the alternatives have flaws as well. The closer the state is to investment decisions, they say, the more likely it is that those choices will become politicized. A worst-case example of that is Mississippi, whose Magnolia Venture fund folded in 1998 and wound up with its director in prison on fraud charges. Pension

fund managers, for their part, hate it when lawmakers tell them how and where to invest retirees' money. And the CAPCOs are right when they say that no other venture-capital program pumps as much money into a state's economy as quickly as they do. Clearly, to many election-minded state legislators and governors, that is all that matters.

Colorado officials weighed all of this in February when they debated what to do with the second $100 million worth of CAPCO tax credits. They were convinced that CAPCO could not be reformed, that its underlying structure was defective. But a state law prevented them from simply wiping those tax credits away. Bob Lee, then the state's economic development director and now chief of staff to Governor Bill Owens, wanted to try a new venture-capital model. Mike Coffman, the state treasurer and the CAPCOs' leading critic, wanted Colorado out of the venture-capital business altogether. "It's an inappropriate role for state government to be picking winners and losers," Coffman says.

In the end, the legislature split the difference. It diverted $50 million of the tax credits to a state health insurance fund. The other $50 million will go toward a new venture-capital program. Insurance companies will still fund it, in exchange for the tax credits. But a quasi-public authority will manage it, rather than the CAPCOs. The authority won't pick the investments itself. It will invest the money with private venture funds (the CAPCOs may participate if they wish). And if there are profits, the authority expects to be rewarded the way normal investors are in the real venture-capital world.

According to Chris Christoffersen, a Boulder venture capitalist who helped craft Colorado's new program, the real highlight is that it's an "evergreen" fund. Where the CAPCOs' record is to seek successive infusions of tax credits, Colorado's program, if it works, will build on itself and grow in perpetuity. "CAPCO was almost the antithesis of a real venture-capital program," Christoffersen says. "To call it venture capital was a misnomer."

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