

VENTURE AND RISK CAPITAL STUDY - BACKGROUND MEMORANDUM

INTRODUCTION

Section 18 of Senate Bill No. 2032 (2005) provides for a study of issues relating to venture and risk capital and whether and how some of these issues may be negatively impacting business development in the state. The study must address how to define venture and risk capital for purposes of the study; real and perceived issues regarding gaps in the availability of venture and risk capital in the state; whether state programs adequately address the venture and risk capital needs of businesses in the state and whether these programs should be changed to increase availability to venture and risk capital, including whether the partnership in assisting community expansion (PACE) program might be used as a model to address possible venture and risk capital availability issues and whether the state could effectively play a role as facilitator in improving access to venture and risk capital; how the state could assist in creating an environment more conducive to attracting private venture and risk capital in the state; and how other states have attempted to address venture and risk capital concerns of businesses.

The Legislative Council has charged the interim Economic Development Committee with performing this venture and risk capital study. Additionally, under Section 17 of Senate Bill No. 2032, the Legislative Council has assigned to the committee the charge of studying the state's business climate through a business climate initiative. Although both of these studies are directly related to the work of the 2003-04 interim Economic Development Committee's business climate study, the details of the business climate study are addressed in a separate background memorandum.

RELATED ACTIVITIES DURING 2005-06 INTERIM

In addition to the economic development-related studies under Sections 17 and 18 of Senate Bill No. 2032, the committee is to receive:

- Annual reports from the Department of Commerce Division of Community Services on renaissance zone progress under North Dakota Century Code (NDCC) Section 40-63-03.
- A report from the Commissioner of Commerce on the outcome of the Department of Commerce study of the state's economic development incentives under Section 52 of Senate Bill No. 2018.
- A report from the president of the Bank of North Dakota on the status of the Bank's investment in alternative and venture capital investment

and early-stage capital funds under Section 19 of Senate Bill No. 2032.

The economic development-related investment charges of the Budget Section include receiving annual reports from the Department of Commerce Division of Community Services on conclusions of annual audits of renaissance fund organizations under NDCC Section 40-63-07. Under Section 1 of House Bill No. 1524, the Tribal and State Relations Committee is charged with studying tribal-state issues, including government-to-government relations, the delivery of services, case management services, child support enforcement, and issues related to the promotion of economic development.

LEGISLATIVE BACKGROUND 2005 Legislation

House Bill No. 1133

House Bill No. 1133 modifies the definition of "business" for purposes of eligibility under the PACE program, expanding the definition from allowing for targeted service industries as defined by the Bank of North Dakota to allowing for targeting industries as defined by the Bank.

House Bill No. 1526

House Bill No. 1526 requires the Industrial Commission to establish at the Bank of North Dakota a guaranty program for a business located in the state which contracts with a business located in the state which is either owned by one of the five North Dakota Indian tribes or which is an American Indian-owned small business located in the state. The Industrial Commission is required to limit participation in the guaranty program so that the cumulative value of the guaranteed portion of the receivables under the program does not exceed \$5 at any one time. The bill is effective through June 30, 2007.

Senate Bill No. 2032

Senate Bill No. 2032 is the business incentive bill recommended by the 2003-04 interim Economic Development Committee as part of the committee's business climate. Several portions of the bill address economic development-related investments.

- Sections 1 and 3 expand the Bank of North Dakota and North Dakota Development Fund, Inc., alternative and venture capital and early-stage capital investment program and Section 19 provides for the president of the Bank of North Dakota to report to the Legislative Council on the status of the investment program.

- Sections 15 and 25 provide that NDCC Chapters 10-30.1 and 10-30.2, relating to venture capital corporations and the Myron G. Nelson Fund, Inc., are repealed effective August 1, 2007.
- Sections 9 through 14 amend Chapter 57-38.5, the seed capital investment tax credit law. The bill makes the seed capital investment tax credit available to corporations and pass-through entities; limits qualified investments in a qualified business to a maximum of \$500,000 for which the credit may be claimed; and allows investments made before 2005 which did not qualify for the tax credit because of the limitation in effect at that time to claim a credit of 45 percent of the amount invested in a qualified business, with a minimum qualifying investment of \$5,000 and a maximum investment to obtain a credit of \$250,000.

Senate Bill No. 2147

Senate Bill No. 2147 authorizes the Agriculture Commissioner to develop a source-verified and process-verified beef marketing program and authorizes the Agricultural Products Utilization Commission (APUC) to administer grants related to nature-based tourism and to provide a technical assistance grant program for value-added businesses. This bill also directs the Bank of North Dakota to establish and administer a livestock loan guarantee program, which will expire June 30, 2009.

Senate Bill No. 2217

Senate Bill No. 2217 creates the biodiesel partnership in assisting community expansion (Biodiesel PACE) fund to buy down the interest rate on loans to qualified biodiesel production facilities. The Bank of North Dakota is directed to administer the fund.

Senate Bill No. 2281

Senate Bill No. 2281 makes the agricultural business investment tax credit available to corporations, limits the credit to investments in the first 10 businesses that qualify, increases from \$20,000 to \$50,000 the annual credit a taxpayer may obtain for agricultural business investments and imposes a lifetime limit of \$250,000 in credits, reduces from 15 to 5 years the time which an investment tax credit may be carried forward, and allows a credit for a taxpayer whose investment in an agricultural commodity processing facility was made before 2005 and did not qualify for the tax credit because of the limitation on the seed capital investment tax credit. This credit is 30 percent of the amount invested by the taxpayer, but the taxpayer may claim no more than one-fourth of the credit in any taxable year.

Prior Studies

2003-04

Under House Bill No. 1504 (2003), the Economic Development Committee studied the state's business climate, including the creation of an index of key objective measurements that address the state's competitiveness with other states; the consideration of methods of creating business partnerships with North Dakota Indian tribes in order to increase primary sector business growth in the state, with a focus on business opportunities that may be available to North Dakota Indian tribes through the United States Small Business Administration 8(a) business development program; and active participation in the activities of the Primary Sector Business Congress. The committee recommendations for the 2005 legislative session included Senate Bill No. 2032, which among other things, provides for this venture and risk capital study. Provisions of the bill which directly address venture capital are addressed above in the **2005 Legislation** portion of this memorandum.

2001-02

Under Section 16 of Senate Bill No. 2019 (2001), the Commerce Committee studied the availability of venture capital, tax credits, and other financing and research and development programs for new or expanding businesses, including an inventory of the programs available, a review of the difference between public and private venture capital programs, an assessment of the needs of business and industry and the research and development efforts of the North Dakota University System, and a review of the investments of the State Investment Board and the feasibility and desirability of investing a portion of these funds in North Dakota. The committee did not make any recommendations with respect to this study.

1999-2000

Under Section 16 of House Bill No. 1019 (1999), the Commerce and Labor Committee studied the economic development efforts in the state, including the provision of economic development services statewide and the related effectiveness, the potential for the privatization of the Department of Economic Development and Finance, and the appropriate location of the North Dakota Development Fund, including the potential transfer of the fund to the Bank of North Dakota. While conducting this study, the committee received extensive testimony from a broad range of state, local, regional, and private sector parties interested in economic development, including the Bank of North Dakota, Department of Economic Development and Finance, Division of Community Services, Indian Affairs Commission, Job Service North Dakota, University System, Workforce Development Council, local development associations, Economic Development Association of North Dakota, Greater North Dakota Association, job development authorities, regional planning councils, and the Small Business

Center. The committee considered the issues of venture capital, privatization and consolidation of state economic development efforts, population retention and demographics, and workforce development. In performing this study, the committee surveyed state agencies to determine the amounts of money being spent for economic development efforts. The committee recommendations for the 2001 legislative session included:

1. House Bill No. 1039 - State venture capital fund. This bill would have provided for a North Dakota venture capital fund program under which a seven-member North Dakota venture capital authority would have designated a for-profit investment fund for lending to and investing private money in seed and venture capital partnerships and would have provided for a one-time issuance of \$5 million of state tax credits to the authority to offset losses under the program. The bill failed to pass the House.
2. House Bill No. 1040 - Entrepreneur seed fund. This bill would have established a North Dakota entrepreneur seed fund program under which a nine-member North Dakota entrepreneur seed fund board would administer the fund, which was designed to be available to local entrepreneur seed fund applicants on a 500 percent local fund match basis to invest in North Dakota early-stage companies and small companies through equity or equity-type investments. The bill would have provided for a \$3 million appropriation from the general fund to fund the program for the 2001-03 biennium. The bill failed to pass the House.
3. House Bill No. 1041 - Seed capital investment tax credit requirements. This bill would have allowed the seed capital tax credit to be claimed on the state income tax short form, lessened the requirements to be classified as a qualified business under the seed capital investment tax credit law, allowed taxpayers to claim the seed capital investment tax credit for any amount up to \$50,000, allowed a seed capital investment tax credit to exceed 50 percent of the taxpayers' tax liability, provided seed capital investment tax credits for investments in one qualified business may not exceed \$250,000, decreased certain limitations on how a qualified business may use a seed capital investment, and increased the annual aggregate amount of seed capital investment tax credits from \$250,000 to \$500,000. Although the bill failed to pass the House, House Bill No. 1413, which was very similar to House Bill No. 1041, did pass.
4. House Bill No. 1042 - Venture capital corporation incorporation requirements. This bill decreased the financial requirements for venture capital corporations to incorporate in the state.
5. Senate Bill No. 2032 - Commerce Department. This bill consolidated the Division of Community Services, Department of Economic Development and Finance, and Tourism Department into the Department of Commerce administered by the Commissioner of Commerce; created the North Dakota Commerce Cabinet; and allowed for creation of a privately funded North Dakota Economic Development Foundation.
6. Senate Bill No. 2033 - Renaissance zones. This bill revised the renaissance zone law. Among the changes, the bill authorized a statewide renaissance fund corporation, provided that an income tax exemption is effective beginning the year of the purchase or lease, removed the requirement that a petition for investment in a renaissance zone must include a plan for sale or refinancing that results in proceeds equal to or in excess of the proportional investment made by the renaissance fund corporation, provided that a taxpayer must be current on all taxes in order to be eligible for a tax exemption or credit under the renaissance zone law, and allowed a city with a zone of less than 20 blocks to expand up to 20 blocks and allow these expanded blocks to have renaissance zone status for up to 15 years.

1997-98

Under Section 12 of Senate Bill No. 2019 (1997), the interim Commerce and Agriculture Committee studied the economic development functions in this state, including the Bank of North Dakota programs, Technology Transfer, Inc., North Dakota Development Fund, Inc., the Department of Economic Development and Finance, and other related state agencies. The committee did not make any recommendations with respect to this study.

BACKGROUND

Definitions

The venture and risk capital study charge provides the committee shall address how to define "venture capital" and "risk capital" for purposes of the study. The North Dakota Century Code provides limited guidance in defining these terms. The North Dakota Century Code does not appear to provide a universal definition of the terms venture and risk capital.

Under NDCC Section 10-30.1-04(2) relating to venture capital corporations law, the purpose of a venture capital corporation "must be solely to raise funds to be used to make investments in, and provide financing to, qualified entities in a manner that will encourage capital investment in the state, encourage

the establishment or expansion of business and industry, provide additional jobs within the state, and encourage research and development activities in the state." This section of law will be repealed effective August 1, 2007.

Under NDCC Chapter 54-34 relating to the Department of Commerce Division of Economic Development and Finance authority to establish a venture capital network, Section 54-34-12 provides the purpose of the network is to serve "as a clearing-house for information on informal risk capital investment opportunities in the state."

Looking to more common and general definitions of the terms venture capital and risk capital provides a broad range of definitions. The *American Heritage College Dictionary* entry for "risk capital" refers the reader to the term "venture capital." The entry for "venture capital" is "Money for investment in innovative enterprises or research in which both the risk of loss and the potential for profit may be considerable."

The *Black's Law Dictionary* entry for "risk capital" provides: "1. Money or property invested in a business venture, esp. one in which the investor has no managerial control. 2. See venture capital." The entry for "venture capital" provides: "Funds invested in a new enterprise that has high risk and the potential for high return -- Also termed risk capital."

The web site www.investorwords.com entry for "risk capital" provides: "Funds made available for startup firms and small businesses with exceptional growth potential. Managerial and technical expertise are often also provided. also called risk capital. also called venture capital (VC)." The entry for "venture capital" provides: "Funds made available for startup firms and small businesses with exceptional growth potential. Managerial and technical expertise are often also provided. also called risk capital."

Because of the variance in definitions of the terms venture and risk capital, it may help to consider how venture capital funds are used in the state. At the August 5, 2004, meeting of the interim Economic Development Committee, representatives of the Department of Commerce presented information regarding the spectrum of economic development funding programs and risk capital programs available in this state. As part of this presentation, the department provided the following definitions regarding the development stages at which businesses access funding. Although these definitions do not specifically define the terms venture and risk capital, the definitions may be helpful in putting into context the framework in which funding in this state is provided.

Early-Stage Financing

Within the classification of early-stage financing are:

- Seed financing, which is a relatively small amount of capital provided to an inventor or entrepreneur to provide a concept and to

qualify for startup capital. This may involve product development and market research as well as building a management team and developing a business plan, if the initial steps are successful.

- Startup financing, which provides financing to companies completing development and initial marketing. Companies may be in the process of organizing or they may already be in business for one year or less, but have not sold their products commercially. Usually such firms will have made market studies, assembled the key management, developed a business plan, and are ready to do business.
- First-stage financing, which provides financing to companies that have expended their initial capital, often in developing and market testing a prototype, and require funds to initiate full-scale manufacturing and sales.

Expansion Financing

Within the classification of expansion financing are:

- Second-stage financing, which is working capital for the initial expansion of a company that is producing and shipping and has growing accounts receivables and inventories. Although the company has made progress, it may not yet be showing a profit.
- Third-stage financing provides major expansion of a company whose sales volume is increasing and that is breaking even or profitable. These funds are used for further plant expansion, marketing, working capital, or development of an improved product.

Later-Stage Financing

Within the classification of later-stage financing are:

- Bridge financing, which is needed at times when a company plans to go public within six months to a year. Often bridge financing is structured so that it can be repaid from the proceeds of a public underwriting. It can also involve restructuring of major stockholder positions through secondary transactions. Restructuring is undertaken if there are early investors who want to reduce or liquidate their positions or if management has changed and the stockholdings of the former management, their relatives, and associates are being brought out to relieve a potential oversupply when public.
- Open market, which involves acquiring securities of companies whose common shares trade publicly.

Acquisition/Buyout

Within the classification of acquisition/buyout financing are:

- Acquisition financing, which provides funds to finance the acquiring of another company.
- Management/leveraged buyout, which enables an operating management group to acquire a product line or business, at any stage of development from either a public or private company. Often these companies are closely held or family-owned. Management/leveraged buyouts usually involve revitalizing an operation, with entrepreneurial management acquiring a significant equity interest.

State Programs

The study charge provides the committee shall address whether state programs adequately address the venture and risk capital needs of businesses in the state and whether these programs should be changed to increase availability to venture and risk capital, including whether the PACE program might be used as a model to address venture and risk capital availability issues and whether the state could effectively play a role as facilitator in improving access to venture and risk capital.

At the August 5, 2004, presentation to the Economic Development Committee, representatives of the Department of Commerce provided the following information regarding funding available to businesses in the state:

EARLY-STAGE FINANCING		
Seed Financing	Startup Financing	First-Stage Financing
Angel investors	Certified development company (CDC) 504 program - Small Business Administration (SBA)	Angel investors
Agricultural Products Utilization Commission (APUC)	Micro loan program - SBA	North Dakota Development Fund (debt and equity)
Agricultural entrepreneur program	Intermediary relending program (IRP) loan program - United States Department of Agriculture (USDA)	Regional councils
Center of North America Coalition for Rural Development (CONAC) reap zone fund	Local development corporation grant/loan/equity	Renaissance fund
Seed capital investment tax credit	Startup beginning entrepreneur program - Bank of North Dakota	Business development loan program - Bank of North Dakota
New venture capital fund - Bank of North Dakota	North Dakota Development Fund (debt and equity) - Department of Commerce	Local development corporations
	Regional councils	New venture capital fund
	New venture capital fund	Micro loan program
	Angel investors	CDC 504 program

Renaissance fund	USDA IRP program
Rural growth incentive program - Department of Commerce	Rural growth incentive program
Beginning farmers loan program	CONAC fund
Seed capital investment tax credit	
CONAC fund	
EXPANSION FINANCING	
Second-Stage Financing	Third-Stage Financing
North Dakota Development Fund (debt and equity)	Small Business Investment Corporation (SBIC)
Regional councils	Financial institutions - PACE program
Renaissance fund	North Dakota Development Fund (debt and equity)
CDC 504 program	Regional councils
USDA IRP program	Investment bankers
Micro loan program	Local development corporations
Local development corporations	CDC 504 program
New venture capital fund	New venture capital fund
Rural growth incentive program	USDA IRP program
Seed capital investment tax credit	Renaissance fund
Financial institutions - PACE program	Micro loan program
CONAC fund	Rural growth incentive program
	Seed capital investment tax credit
	CONAC fund

Later-Stage Financing		Acquisition/Buyout	
Bridge Financing	Open Market Financing	Acquisition Financing	Management/Leveraged Buyout
SBIC	Public funding	Venture capital firms	Venture capital firms
Renaissance fund	Seed capital investment tax credit	Buyout firms	Buyout firms
North Dakota Development Fund (debt and equity)		North Dakota Development Fund (debt and equity)	SBIC
Regional councils		SBIC	
New venture capital fund		Regional councils	
CONAC fund		Renaissance fund	
		Financial institutions - PACE program	
		New venture capital fund	
		Seed capital investment tax credit	

As part of the study, the committee is charged with considering whether the PACE program might be an appropriate model upon which the committee could base a venture and risk capital program. Enacted in 1991, at NDCC Chapter 6-09.14, the PACE program

is administered by the Bank of North Dakota. The Bank has summarized the program as follows:

This program has two major elements: (1) the participation by BND with a local lender in a community based loan, and (2) the participation by the PACE Fund with the local community in reducing the borrower's overall interest rate.

The PACE program is available to finance the purchase of equipment or real estate, as well as term working capital. In conjunction with community support, the program provides an interest buy down that can reduce the borrower's rate of interest by as much as 5%. This buy down can mean an interest savings of approximately \$385,000 over the term of the loan. In return, the borrower must create 1 new job in North Dakota for each \$75,000 of total loan proceeds.

Examples of the use of this format in other programs include the agriculture PACE program, at NDCC Chapter 6-09.13, which was also enacted in 1991, and the Biodiesel PACE program, at Chapter 6-09.17, which was enacted in 2005.

Private Venture and Risk Capital

The study charge provides the committee shall address how the state could assist in creating an environment more conducive to attracting private venture and risk capital. The effectiveness of state initiatives to attract private venture and risk capital ranges from the growing use of the seed capital investment tax credit under NDCC Chapter 57-38.5 and of the Bank of North Dakota's venture capital fund to the lack of use of the laws and incentives relating to North Dakota incorporation of venture capital corporations under Chapter 10-30.1. Consideration of what elements have been successful in helping to incentivize private venture and risk capital may help further this portion of the study. Related to this portion of the study may be the issue of which aspects of venture and risk capital are appropriate for state action and which are not.

Gaps in Availability - Other States

The study charge provides the committee shall address real and perceived issues regarding gaps in the availability of venture and risk capital in the state and how other states have attempted to address venture and risk capital concerns of business.

Because of a high rate of interest in the issues related to venture and risk capital, there are numerous sources of information regarding the venture and risk capital activities of other states. For example, the Rural Policy Research Institute has created the *Directory of State-Assisted Venture Capital Programs, 2000* and the National Governors

Association Center for Best Practices has prepared the document *Growing New Businesses With Seed and Venture Capital: State Experiences and Options*.

Information regarding state initiatives may be classified or researched in a variety of ways, including by state, by rural versus urban regions, or by a specified business sector being addressed. Regardless of the particular focus of the research, there are great numbers of entities carefully following the venture capital initiatives of other states. For example, according to an August 2005 report by Wisconsin Technology Network, recent state initiatives relating to venture capital include:

- Wisconsin launched a new tax credit for angel and venture capital investors registered in Wisconsin and investing in Wisconsin-based companies. Qualified new ventures in Wisconsin which have registered with the Department of Commerce and qualify will allow their new investors to receive a 12.5 percent tax credit for the money invested in each of two years for a total of 25 percent tax credit off state taxes. Missouri has something like this already in place.
- Illinois launched a new state venture fund to consist of \$50 million, of which approximately \$10 million was disbursed into three venture capital companies during the first part of 2005.
- Michigan announced the launch of a \$150 million venture fund for investing in Michigan companies.
- Indiana announced the formation of Indiana Future Fund I, which is a \$73 million fund for Indiana companies.

Other states have conducted legislative studies similar to this North Dakota venture and risk capital study. For example, during Montana's 2003-04 interim, the Montana interim Economic Affairs Committee had a working group that studied angel networks, near equity/mezzanine financing, community development lending options, and venture capital options. This working group considered what other states are doing in each of these areas. The legislative initiative that came from this study was Senate Joint Resolution No. 3 (2005), which appears to have died in standing committee. This joint resolution urged the Governor's Office of Economic Development to:

- Set as a high program priority the pursuit of funding for the ongoing oversight of a pilot project that develops nonprofit groups and networks of individual, accredited, or "angel" investors willing and financially able to provide seed capital for startup businesses in Montana; and
- Place a high priority on coordinating throughout the state and with the board of regents the training and educational programs provided by

all levels of government, education, and the private sector to businesses in Montana.

STUDY APPROACH

The information needed to perform this study comes from a wide variety of sources. The committee may seek to receive information from the private sector, in the form of testimony from business people, private venture capital companies, and financial institutions; state agencies, including the Bank of North Dakota, Department of Commerce, and Securities Department; and local economic developers.

The definition of the terms venture and risk capital for purposes of the study will likely best be established by the committee in cooperation with representatives of the business communities, banking community, economic development community, and investment community. Benefits of clarifying the definitions and uses of the terms may include:

- The act of the committee reviewing and considering how each of the several business funding sources available in the state fits within the definitions, will likely result in committee members increasing their knowledge regarding the available funding sources;
- The committee may consider whether the general use of the terms venture and risk capital as they relate to issues of business funding may be broader than necessary, and the committee might determine it is possible to

narrow the scope of discussions to more specific types of business funding needs; and

- Standardizing the use of the terms for purposes of the committee's work will help in clarifying information provided to the committee in the course of the study.

As part of the study, the committee is charged with addressing whether state programs adequately address the venture and risk capital needs of businesses in the state and whether these programs should be changed to increase availability to venture and risk capital. Due to the Economic Development Committee's participation in the business climate initiative, under the business climate study, the committee is in the unique position of being able to gather this information from members of the business community and from members of the local economic developers community through the business climate initiative focus group discussions. On the same note, the committee charge to consider how to improve the state's business climate in order to attract more venture and risk capital and the committee charge to address real and perceived funding gap issues could be addressed at least in part at the focus group level.

In addition to using the focus groups to gather information, in performing this study the committee may wish to consider the results of the Department of Commerce study regarding the spectrum of economic development programs offered by the state. This information may assist the committee in considering gaps or perceived gaps in business funding availability.