Understanding CAPCOs

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National Association of Seed and Venture Funds

serving those who invest in America's entrepreneurs

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Venture Capital and Economic Development

The National Venture Capital Association published a report in 1998 to document the impact of venture capital on economic development.[1] The report was prepared by Venture One and Coopers & Lybrand.

For those who concern themselves with local economic development, it is not surprising to hear the results of the NVCA report. A typical 5-year old venture backed company has:

- Generated 99 jobs, almost twice as many as its non-venture-backed peers
- Produced new jobs at the rate of 40% per year
- Created high-quality skilled positions at four times the rate of the general economy
- Grown sales by 66.5% per year
- Generated nearly one-half of its revenues from foreign exports

Venture-backed companies are 70% more likely to go public than their non-venture-backed peers. And, the vast majority are operating within the high tech sectors that are becoming the industries of the future.

[1] Eighth Annual Economic Impact of Venture Capital Study, NVCA, 1998

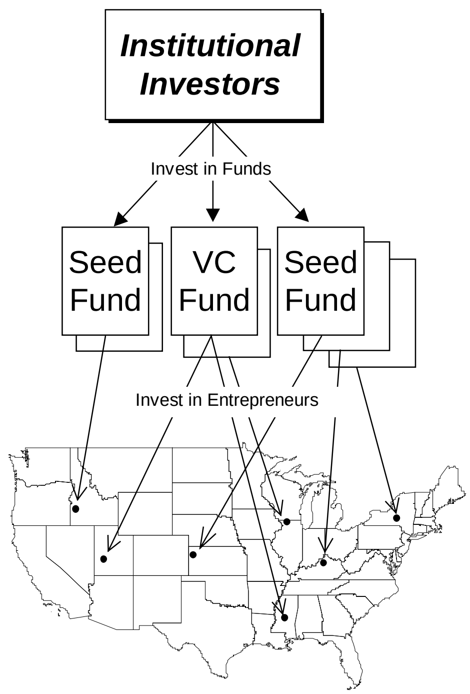
How the VC industry works

The venture capital industry has three basic components:

1. World Class Entrepreneurs
2. Professionally Managed Venture Funds
3. Institutional Investors

To attract venture capital, a region must have entrepreneurs that present exciting investment opportunities. Venture investors look for businesses that solve big problems, serve large and growing markets, possess world class technology, and are led by proven managers.

By some counts there are well over 1,000 venture capital funds in the U.S. Venture funds are typically organized as limited partnerships. The people we point to as venture capitalists are the general partners. They spend their time marketing their capital resources, seeking investments, analyzing proposals, making investments, adding value to their portfolio companies, and arranging for the sale of their investments.



Venture capital funds are capitalized by limited partners, mostly wealthy individuals and institutional investors. Public and private pension funds, endowments, insurance companies, corporations and banks have led the field of institutional investors.

Regions that possess all three components of the venture capital industry have a solid foundation upon which to build a vigorous entrepreneurial economy.

State Experiences with Venture Capital

States have been working to increase local venture investing for many years. To serve local entrepreneurs—and in this way create new wealth and quality jobs for their citizens—most states have adopted programs to deliver, encourage, or facilitate the formation of seed and venture capital resources. According to the National Governors' Association Center for Best Practices, states have pursued four basic strategies:

- expand the knowledge of seed and venture investing;
- promote the visibility of entrepreneurs to investors and of investors to entrepreneurs;
- create investment capital to fill a gap or grow a sector; and
- create investment capital to build a seed and venture capital industry.

In its 2000 report, *Growing New Businesses with Seed and Venture Capital: State Experiences and Options,*[2] the NGA details a wide range of investment programs. We recommend it as a good starting point for gaining a broad perspective on how states have approached the challenge.

In the report, Certified Capital Companies or CAPCOs, are identified as by far the most expensive model to facilitate the formation of venture capital. Vigorously promoted in a number of states, CAPCOs have been implemented in five states and are scheduled for implementation in two more. Given the size of these programs, and the experience of states with legislating, implementing and monitoring these programs, it is important for policy makers to have a comprehensive understanding of how CAPCOs work, what they cost a state, and how they compare to the traditional venture capital industry.

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[2] NGA Center for Best Practices, 2000

Structure of CAPCO Programs

Source of Capital for CAPCOs

- Insurance companies provide funding for capitalization of CAPCOs (referred to as “certified capital”).

- As an incentive to invest in CAPCOs, a state provides tax credits to insurance companies against their premium taxes. Tax credits equal 100% of certified capital to be taken at 10% per year for ten years. In some states, tax credits may be transferable or sold.

- The insurance companies are guaranteed the return of their principal and an annual coupon.

Maintain Certification and Qualification for Tax Credits

- A specified share of certified capital must be invested in businesses with specific characteristics (referred to as “qualified businesses”). Qualified businesses generally are small (per the SBA definition), in certain industrial sectors, and located in the state.

- CAPCOs must meet investment milestones as specified in the enabling legislation (e.g., 30% of certified capital invested in 3 years).

Returns from CAPCO Investments

- CAPCOs generally cannot make liquidating distributions to CAPCO owners until they have invested an amount equal to the amount of original certified capital.

- The state generally receives little or none of the liquidating distributions in exchange for revenues lost due to the provision of tax credits.

Cost of CAPCO Programs

The states of Louisiana, Missouri, Florida, New York and Wisconsin have implemented CAPCO programs, together committing $1.25 billion in tax credits. By any measure, this is an enormous allocation of state resources compared to other commitments of public resources by states to high tech business development, rural business development, and minority business development.

According to the investment banking firm Stifel Nicolas,[3] the CAPCO industry expects to receive at least $400 million in 2002 from the states of New York, Colorado, Texas, and the District of Columbia. Thereafter, they predict commitments of $300 million per year, most likely from the states of California, Arizona, Michigan, Mississippi, North Carolina and Illinois, as well as follow-on commitments from current CAPCO states.

Committed to date:	
Louisiana	$ 630,000,000
Missouri	$ 140,000,000
Wisconsin	$ 50,000,000
Florida	$ 150,000,000
New York	$ 280,000,000
Scheduled for 2002:	
Colorado	$ 200,000,000
Texas	$ 200,000,000
Grand Total	$ 1,650,000,000

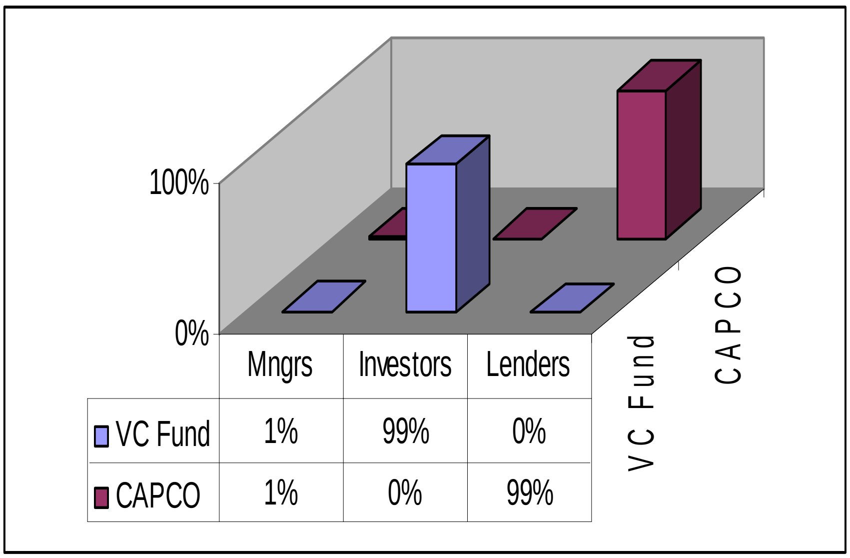
[3] Stifel Nicolas & Co., Equity Research Reports, 8/8/01

How is a CAPCO Funded?

A traditional seed or venture capital partnership is capitalized with investments from large institutions and wealthy individuals. These investments are fully at risk. There is no guarantee that investors will receive a return on their capital, or even a return of their capital.

In contrast, CAPCOs are funded almost entirely with debt. Insurance companies lend 99% to 100% of the total capitalization of most CAPCOs. These loans are usually fully guaranteed. The guarantees extend to 100% of principal and 100% of the interest for the life of the loan. The loans are for a term of 10 to 12 years, and are very low risk, of the type appropriate for the fixed income portfolio of many insurance companies. CAPCOs also pay an unusually high interest rate on these loans, making them very attractive to insurance companies.

Sources of Capitalization

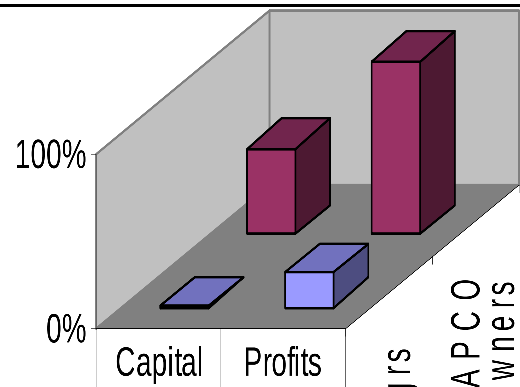


How are Capital and Profits Distributed?

A traditional venture capital partnership is owned by the limited partners (institutions and wealthy individuals) and the general partners (the venture capitalists). The general partners always invest at least 1% of the total capital of the partnership. All investors share pro-rata in the return of capital from fund investments. Once original capital is fully returned to all investors, the general partner is typically paid 20% of the profits that may accrue thereafter.

In contrast, CAPCOs may be owned entirely by the CAPCO promoters. The insurance companies are usually lenders, not risk-bearing investors. CAPCO owners typically contribute not more that 1% of the total capital of the CAPCO, while receiving about 50% of the return of original capital and 100% of the profits.

Comparison of Distributions



	Capital	Profits
VC Mgrs	1%	20%
CAPCO Owners	50%	100%

How are Most VCs Compensated?

Annual Management Fee

A typical venture fund general partner receives an annual management fee equal to 2.5% of the total capital available for investment. If the fund has capital of $50 million, the VC would earn $1.25 million per year for the life of the fund (usually 10 years).

To have $50 million of investable capital a CAPCO manager raises about $100 million. Most statutes provide for an annual management fee of 2.5% of the total certified capital (the full $100 million), or $2.5 million.

Incentive Fee

A typical venture fund general partner receives incentive compensation based on success in producing investment profits. For most funds this is equal to 20% of the profits. So, if the general partner is moderately successful and doubles the size of the capital under his management to $100 million, he would first return $50 million to his investors, then receive 20% of the $50 million profits, or $10 million.

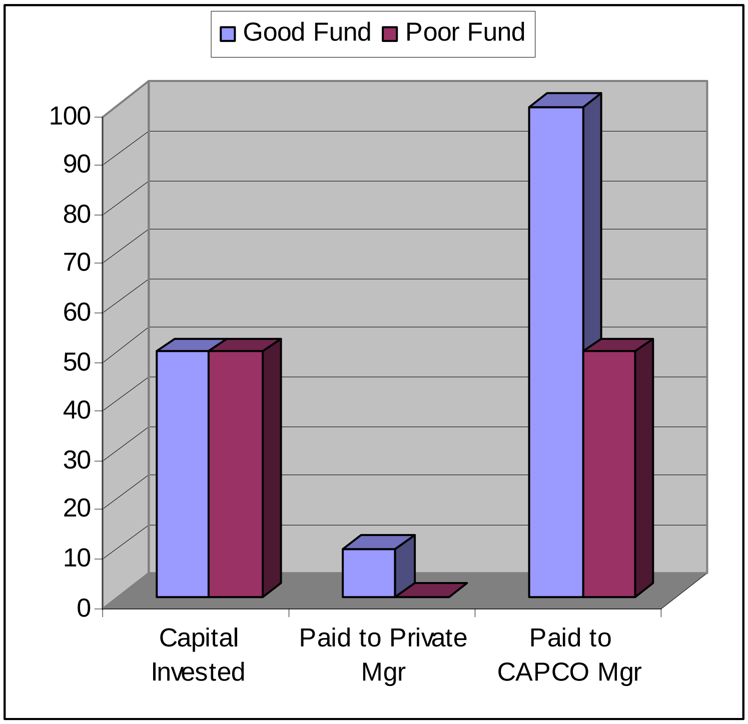
If a CAPCO manager is equally successful and doubles the size of the capital available for investment to $100 million, he would be paid not only 100% of the $50 million in profits, but also 100% of the $50 million in base capital, for a total of $100 million.

So, if a CAPCO manager does reasonably well, he earns ten times the amount earned by a private venture fund manager.

What happens if they both do poorly and only recover the original $50 million, with no profits? The private VC would earn no incentive fee. The CAPCO manager would still earn $50 million.

By all counts, traditional venture fund general partners are very well paid. Yet, their chance at wealth depends on whether they produce for their investors. In contrast, CAPCO managers may become immensely wealthy regardless of investment success.

Incentive Compensation



Who Bears the Risk of CAPCO Investments?

In a traditional seed or venture capital partnership all the investors bear risk. A primary goal of sophisticated investors is to make sure the interests of the general partners and fund managers are aligned with the interests of the limited partners. Care is taken to ensure that the limited partners and the general partners always win together, or lose together.

In contrast, in a typical CAPCO, the insurance companies bear no equity risk and only low credit risk. The CAPCO owners and managers also bear little risk, given the compensation paid to them in relation to the small amount they may invest Consequently, the insurance companies do not underwrite the investment skill of the CAPCO managers in the way a private investor would, but base their decisions to lend on the quality of the collateral and guarantee.

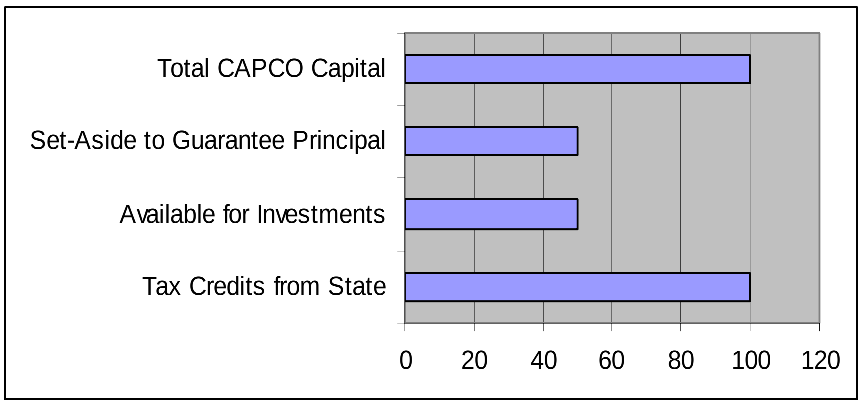
The equity risk in the CAPCO structure is borne almost entirely by the state. The state provides the tax credits, and, as a result, sacrifices future tax revenues. The tax credits make the guarantee possible, without which the insurance companies would not lend. Under any comparable scenario, an investor of this type would deserve equity compensation similar to or exceeding that received by the limited partners in a traditional venture fund.

How does the Guarantee Work?

The state provides one dollar of tax credit for every one dollar of CAPCO capital, while permitting about half of the CAPCO capital to be set aside to guarantee the principal amount of the loan from the insurance companies. The set-aside is invested in a zero coupon bond or similar instrument. Over a ten to twelve year period the instrument approximately doubles in size. At maturity, this is used to repay the principal on the insurance company loan. Depending on prevailing rates at the time a CAPCO is formed, the amount necessary to place in the set-aside will vary.

The tax credit (usually equal to 100% of the CAPCO capital) may be claimed at the rate of 10% per year over a ten year period. This effectively serves as the interest payment on the loan.

Once the insurance companies have received the return of their principal and the tax credits, they in most cases have been paid in full and receive no further compensation. As a lender, they do not participate in the net gains realized from CAPCO investments, nor in the return of capital from CAPCO investments.



How are CAPCOs Selected?

When making an investment in a traditional venture capital fund, experienced investors look carefully at the investment track record, investment strategy and business ethics of the prospective general partners and fund managers. The goal is to place capital with a team that can demonstrate they have what it takes to produce exceptional results, while managing risk and other difficult situations that may arise. It is common to look at dozens of prospects before making an investment, and to spend considerable time conducting due diligence.

In contrast, CAPCOs are selected by states in a very short, legislatively mandated race. Selection is based almost solely on the proficiency of applicants to raise guaranteed loan commitments from insurance companies. Applicants must have managers with several years of venture investing experience. But, there is no requirement that this be successful experience, nor senior level experience. And, there is generally no provision for the analysis of investment track records, nor weight given to whether track records were successful. The process for selecting CAPCOs fails to meet any of the common standards employed by most state investment or development agencies when selecting investment advisors, financial advisors, investment managers, or other capital program professionals.

How do CAPCOs Differ from State to State?

All CAPCOs are substantively identical.

The heart of the CAPCO model is the commitment by the state of dollar for dollar tax credits, the provisions that permit the set-aside of capital to guarantee lenders from loss of principal, and the willingness of the state to accept little or no financial compensation for its contribution. All CAPCOs have these core provisions. The net effect of these provisions enables CAPCO owners to profitably operate a CAPCO with nearly any set of other conditions they may negotiate with a state.

The following are a few of the special features:

- Wisconsin permits the sale of tax credits.
- Colorado has special tax incentives for making investments in rural areas.
- Florida requires a small, upside return be shared with the state.
- Texas requires CAPCO managers to reside in the state.
- Several states require investments in smaller companies. Missouri set the company-size limit at $3 million in revenues.
- Wisconsin limits investments to businesses with no more than 100 employees, where at least 75% are in the state.
- Wisconsin requires recipient businesses to agree not to relocate.

What Types of Investments Can a CAPCO Make?

In the new Texas rule, a CAPCO is required to make investments in businesses *"for the purchase of any debt, debt participation, equity, or hybrid security of any nature or description, including a debt instrument or security that has the characteristics of debt but that provides for conversion into equity or equity participation instruments such as options or warrants."*

Therefore, a Texas CAPCO can make investments in the form commonly made by traditional venture investors, as well as loans made by mezzanine lenders, as well as fully secured loans of the type made every day by commercial banks, and purchase loan participations of the type sought aggressively by many lending institutions.

The Florida statute has similar provisions.

The Wisconsin program authorizes both equity and debt investments. The debt securities must be unsecured or convertible into equity or equity-like instruments, and must have a maturity of at least five years.

In Lousiana, CAPCOs licensed as Business and Industrial Development Companies (BIDCOs) can make SBA guaranteed loans with their state-subsidized dollars.

According to the Newtek Annual Report, as of December 31, 2000, the company had a $22.1 million portfolio of qualified investments. Of this amount, $17.3 million was in loans, of which $4.1 million were SBA guaranteed loans. Only $4.7 million were equity investments. The non-SBA loans generally have short maturities, ranging up to 24 months. Several are demand notes.

Who are the Leading Proponents of CAPCO Legislation?

Three organizations have received the lion's share of all CAPCO tax credits awarded by states to date. These are:

- Advantage Capital, of New Orleans and St. Louis
- Bank One, with CAPCO assets now managed by Stonehenge Capital of Baton Rouge and Columbus, Ohio
- Newtek, a publicly traded New York firm, also known as The Wilshire Group

These firms make extensive use of lobbyists in each state they target. According to the Stifel Nicolas report, "Newtek is actively lobbying in the states of California, Arizona, Michigan, Mississippi, North Carolina and Illinois," and expects "follow-on CAPCOs from current CAPCO states."

Which States have Declined CAPCO Proposals?

A number of states have considered the CAPCO model and chosen not to adopt it. To date these include at least:

Alabama	Arizona
Arkansas	Connecticut
Hawaii	Kansas
Kentucky	Illinois
Iowa	Indiana
Michigan	Mississippi
North Carolina	Ohio
Oklahoma	Virginia
Utah	Vermont

Are There Ways to Improve the CAPCO Model?

The authors believe all public finance programs should be exposed to extensive competition, managed with transparency, and subjected to frequent reviews.

There are two halves to the CAPCO program – capital raising and capital investing. If states wish to employ the CAPCO model, these tasks should be de-coupled.

Capital Raising:

States should supervise the raising of capital to ensure that capital is raised at the lowest possible cost. Expect private placement fees to run from 1% to 2% of the proceeds. Interest rates paid to insurance companies should not exceed 200 basis points over comparable term Treasuries.

Capital Investing:

States should supervise the selection of CAPCO Fund Managers, searching broadly to find those with the skills and investment focus best suited to serve the needs of local entrepreneurs. States would be wise to employ a professional investment advisor or management firm experienced in investing in venture capital funds to aid in this process. The advisor should market the resources of the CAPCO, advise on the selection of Fund Managers, negotiate investments, then monitor investments to term. Full service professionals tend to charge from 0.5% to 1% of assets under management, plus 0% to 10% of net realized gains.

The Fund Managers should be selected based on experience and track record, investment strategy, appropriateness for the state, standards of ethics, etc. The process of selecting Fund Managers should be deliberate. The typical fee for a Fund Manager is 2.5% per year of committed capital, plus 20% of net realized gains.

After repaying the lenders, and paying the competitive fees of the above listed advisors and managers, the state should receive all remaining distributions. Some states would choose to pay this to the Treasury, others to a revolving fund for future investments.

Summary

The challenge of nurturing young entrepreneurs – who may build tomorrow's high-paying industries – is critical for every state. State resources are scarce, and it is imperative that all programs be as efficient and as effective as possible.

Facilitating access to seed and venture capital can be done in many ways, some at no cost to state budgets. It behooves all public policy makers to review the options thoroughly before committing significant dollars or tax credits to any program.

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Suggested Readings

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