

**STRATEGIES TO INCREASE
THE SUPPLY OF RISK CAPITAL
FOR
NEW ECONOMY GROWTH
IN WISCONSIN**

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Risk Capital and its Role in the New Economy

Risk capital includes a wide variety of financing that provides equity capital to new and operating businesses. Risk capital addresses the funding needs of entrepreneurial companies that do not generally have the size, assets, and operating histories necessary to obtain capital from traditional sources, such as public markets and banks. Risk capital does include financings made by the following sources:

- Personal resources
- Angel investors
- SBIR/STTR Resources
- Community development venture funds
- Mainstream venture capital funds
- Strategic partners/corporate venture capital programs
- Private equity/mezzanine funds

Brief definitions of these types of investing include the following: 1) *personal resources* involve investment capital supplied by family, founders and friends; 2) *angel financing* is risk capital invested by wealthy individuals or angel networks into early growth companies; 3) *SBIR/STTR resources* are Phase I feasibility and Phase II prototype and testing grants offered to small businesses by 10 major federal agencies; 4) *community development venture capital* is financing made by community-based venture capital institutions into early and later business expansion opportunities, seeking to improve economic and social conditions within distressed communities; 5) *mainstream venture capital* is financing made by professional venture firms into a wide spectrum of seed, early and expansion stage companies; 6) *strategic partners/corporate venture capital* comprise direct investments that are aligned with the primary business or mission of a participating non-financial corporation; and 7) *private equity/mezzanine financing* provides capital from institutional investors for later stage companies to expand or acquire businesses.

Risk capital investments are made into a broad range of American businesses – manufacturing, services, transportation, tech companies, retail, etc. Yet, regardless of venture capital industry's many diverse roles, investments have been most heavily placed in recent years into high technology businesses. These high tech enterprises have had a disproportional role in the recent flourishing of American entrepreneurial enterprises – in what is called the NEW ECONOMY.

Main Drivers of the New Economy

The New Economy is powered by five main driving forces. These forces combine to produce rapid, high value added economic growth. The five drivers are:

- BRAIN POWER
- CHANGING TECHNOLOGY
- EXPANDING GLOBAL MARKETS
- NEW BUSINESS MODELS
- VENTURE CAPITAL

Wisconsin has many of the key drivers needed to build a New Wisconsin Economy. But building the NEW ECONOMY in Wisconsin will require significantly increased amounts of venture capital invested into early technology companies. This can only be accomplished through boosting in-state venture capital activities.

In the 19th Century, productive income and wealth were mostly derived from agriculture production; for most of the 20th Century, the main economic drivers were manufacturing production. Today, the main catalysts for economic growth (i.e., productive increases in income and wealth) are being derived from NEW IDEAS. Wealth produced through the value of new ideas comes largely from startup companies that are financed by risk capital.

The modern American entrepreneurial economy is being driven by successful marketplace applications of emerging technologies being developed by American inventors and laboratories. There appears to be a nearly endless supply of modern technological advances that can be commercialized in the U.S. and around the world. A local community – or region – that can more rapidly and extensively commercialize new technology advancements will likely realize greater economic growth and future prosperity.

The seminal research in this arena remains a study done by Dr. David Birch, MIT's noted business demographer.¹ He concluded that all areas of the United States lose jobs at approximately similar rates. Regions of economic prosperity, however, differed from non-growth or low-growth regions in their ability to create new jobs, which are in turn functions of achieving higher rates of technology innovation. Dr. Birch's data covered 5.6 million firms, representing 82% of all private-sector employment. In those firms, he noted that more jobs tended to be created by small and new businesses: between 1969 and 1976, Birch found 80% of all new jobs were created by firms with 100 or fewer employees, and 80% of those new jobs were created by firms that were four years old or **younger**.

Throughout the United States, new jobs tend to come from innovation-related growth spurts in existing enterprises and from the development of new enterprises.² Technological innovation spurs productivity gains within individual enterprises and industries, tending to create higher-income jobs in both new and existing businesses.

Risk capital, including venture capital, money from friends and family, angel investments, etc., has been vital to the establishment and growth of many budding companies. Venture investing has definitely been a crucial factor in the technological and economic development of the regions in which high-tech companies are located. Studies of the interrelationships of innovation, technology transfer, and entrepreneurship conclude that invention alone is not sufficient to fuel the process of economic growth. Innovation and a combination of technology transfer and

¹ David L. Birch, "Choosing a Place to Grow: Decision's in the 1970's" (Cambridge, MA: MIT Program on Neighborhood and Regional Change, 1981)

² Michael Dukakis and Rosabeth Kanter, *Creating the Future* (New York: Summit Books, 1988) 19.

entrepreneurship comprise the critical next step. Specialized venture-capital institutions often play an essential role in that growth process.

The Role of Venture Capital Firms

The role in particular of venture capital firms is important to fostering high economic growth. Venture capitalists foster growth in companies through their hands-on involvement in the management, strategic marketing, and planning of their portfolio companies. Venture capitalists invest alongside management and other stakeholders through an assortment of equity and equity-like financing approaches. These classical venture capitalists are entrepreneurs first and financiers second.

As equity owners and board members, venture capitalists succeed when the portfolio company succeeds. Many venture capitalists will readily point out that many of their most successful companies ended up with a business or product model that was quite different from the original business plan. This morphing of a business from a fledgling startup to a successful company with marketable products and services is aided by advise and financing from venture capitalists.

Venture capital (VC) firms generally are private partnerships or closely held companies funded by private and public pension funds, endowment funds, major corporations and commercial banks, foundations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capital funded companies contributed nearly \$1.1 trillion to the American gross domestic product in 2000 – or around 11% of the nation's GDP.³

A National Science Foundation (NSF) study found that a small segment of the venture capital industry has been responsible for launching a surprisingly large share of all venture-capital-backed "high tech" companies. Although a large proportion of venture capital firms participate in such financings through syndications of follow-on investment rounds, a smaller subset of VC firms – known as *seed capital funds* – actively generate those investment opportunities **and** play a critical role in their development – by further making substantial **value-added** business contributions to their portfolio companies.

A core of experienced venture capital firms account for a disproportionate share of early-stage high tech venture investing. These firms' special entrepreneurial know-how often include a broad web of contacts within technology communities, a greater degree of syndication, and more intense involvement with their fledgling companies.

These venture firms' heavier involvement with young technology companies usually occurs through the originating **lead investor group** (i.e., the seed-stage venture firm), who closely monitor an investee company and usually serve on the portfolio company's board of directors. Venture capitalists' investments in innovative technology ventures are often made into earlier stage businesses – nearly two-thirds of first-round

³ DRI-WEFA, *The Economic Impact of the Venture Capital Industry on the U.S. Economy* (study sponsored by the National Venture Capital Association: 2002) 3.

investments into high-tech companies occur in the seed and startup stages. Actual startup investments by VC firms into high-tech ventures are approximately 70% of the universe of startup investments that additionally include low-tech ventures.

The founders of the most successful venture-backed, higher technology companies have tended to engage venture capitalists with noteworthy reputations for making non-monetary, high value-added contributions into fledgling businesses. Generally, venture capitalists who emphasize high-tech investing tend to perform a catalytic role in finding and blending the necessary combination of people, technology, and opportunities to bring unproven ideas to commercial reality. These special venture firms often bring together the talents of the business, academic, and scientific cultures that spawn innovative technologies.

Alternative Risk Capital Strategies for Wisconsin

To revitalize the state's economy, the public and private business leadership in Wisconsin needs to fully explore alternative program initiatives that might meaningfully boost in-state technology business investment and risk capital availability. NorthStar Economics, Inc. believes that any such **New Economy** initiatives should be guided by *competitive marketplace principles*:

- Key economic and risk investment decision-making should be exclusively delegated to private, exceptionally-qualified venture financing professionals, who must be permitted to operate without direct or indirect governmental political intrusions or interference.
- Any public funds (i.e., matching investment capital) should receive financial rewards on the same terms and be invested under the same risks as other participating private investors.
- Available public investment dollars should offer, as much as possible, incentives that maximize private investor venture capital participation within any new Wisconsin investment programs.

The venture capital programmatic models outlined are promising ways to enhance early-stage technology business financing in Wisconsin. Each investment capital financing option (model) addresses the above listed *marketplace principles* and several have been successfully implemented elsewhere with the aim of boosting entrepreneurial finance availability in other states.

NorthStar Economics recommends the following investment capital programs as ways to boost the availability of risk capital in Wisconsin:

- 1) The State of Wisconsin could offer **State Income Tax Credits** that encourage early seed capital investments by private investors who participate in community-based seed capital funds, sometimes known as *regional angel investor networks* (demo states: Iowa and Oklahoma).

- 2) The state could encourage formation of a **Tech Commercialization Fund** that can assist businesses to get ready for initial rounds of venture financing. These supplementary capital increments are often the key missing ingredients for initiating commercially successful enterprises. The Tech Fund would make potentially recoverable grants to young entrepreneurial businesses (ranging from \$5,000 to \$75,000) for technology/management/legal demonstration purposes in exchange for future company equity ownership options. Therefore, when assisted individual businesses do eventually become successful, periodic paybacks accrue to the Tech Fund from the company's *up-side investment results*. This Tech Fund might be jointly organized by state government, major commercial banks, and Wisconsin-based venture capital firms for making such "pre-seed" capital injections into growth business opportunities. Involving experienced venture managers in making these choices (besides their capital being at risk) will increase the likelihood of quality investment selections.
- 3) Form a **State Venture Finance Authority** that invests matching financial capital in corporate shares, LLC memberships, or limited partnership interests offered by Wisconsin for-profit venture capital funds. This new State Authority would primarily stimulate mainstream venture capital expansion in Wisconsin, while further targeting focused venture investing needs (e.g., *seed capital* for earliest startups, minority and inner-city business investments, multi-county rural business development initiatives, etc.). *Sources of funds:* the State of Wisconsin makes available direct general state expenditures and/or the use of offsetting state contingent tax credits (these public funds could be combined for independent side-by-side investing into select venture firms chosen with the State of Wisconsin Investment Board, the Patient's Compensation Fund, and other major in-state corporate, Native American, educational and philanthropic organizations).
- 4) Establish a **Wisconsin Fund-of-Funds** that arranges for a designated rate of return on investments made by participating private investors into the "fund-of-funds" through offsetting contingent tax credits. This state enacted program would invest into existing in-state venture firms and would work to attract out-of-state venture capital partnerships to Wisconsin with proven track records. Redemption of any legislated tax credits would be limited to an amount sufficient only to offset any shortfalls occurring in the scheduled returns to designated investors (demo states: Iowa, Oklahoma, Arkansas, Utah and Ohio).