

PERFORMANCE AUDIT REPORT

Reviewing the State's Investment in
Venture Capital

Executive Summary *with Conclusions and Recommendations*

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
January 1998



LEGISLATURE OF KANSAS
LEGISLATIVE DIVISION OF POST AUDIT

MERCANTILE BANK TOWER
800 SOUTHWEST JACKSON STREET, SUITE 1200
TOPEKA, KANSAS 66612-2212
TELEPHONE (913) 296-3792
FAX (913) 296-4482
E-MAIL: LPA@postaudit.ksleg.state.ks.us

January 6, 1998

To: Members of the Kansas Legislature

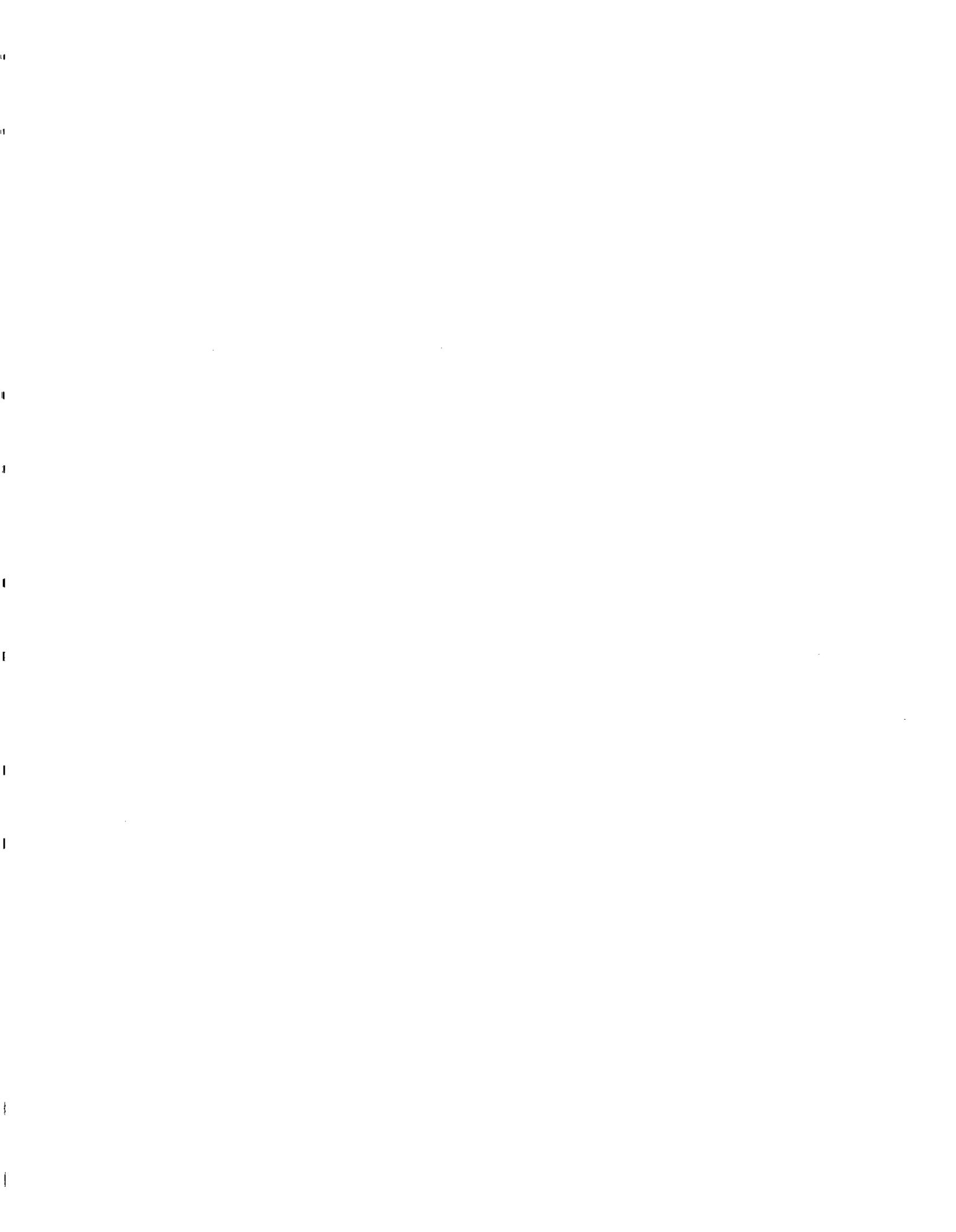
This executive summary contains the findings and conclusions, together with a summary of our recommendations and the agency responses, from our completed performance audit, *Reviewing the State's Investment in Venture Capital*

This report includes two recommendations for the Kansas Technical Enterprise Corporation to ensure its compliance with reporting requirements, and to determine how presidents of commercialization corporations in other states are compensated. The report also contains several appendices showing details about such things as the companies in the Ad Astra and commercialization corporations' portfolios, KTEC's ownership percentage in the portfolio companies, individual stockholders in the companies, and other states' venture capital programs.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials. These findings are supported by a wealth of data, not all of which could be included in this report because of space considerations. These data may allow us to answer additional questions about the audit findings or to further clarify the issues raised in the report.

If you would like a copy of the full audit report, please call our office and we will send you one right away. We would be happy to discuss these recommendations or any other items in the report with you at your convenience.


Barbara J. Hinton
Legislative Post Auditor



Reviewing the State's Investment in Venture Capital

EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

In the late 1980s and early 1990s, the Kansas Technology Enterprise Corporation (KTEC) and private investors created two limited partnerships to make venture capital investments—Ad Astra I and Ad Astra II. These partnerships were created after a 1986 study of economic development in Kansas identified a lack of venture capital. KTEC provided \$1.8 million for Ad Astra I in 1989 and 1990, and private investors provided an additional \$800,000. Ad Astra II was formed in 1994 with about \$2.9 million from KTEC and \$950,000 from private investors. The Ad Astra investments are managed by the partnerships' general partner—Sam Campbell—through Campbell-Becker, Inc. page 4

KTEC also has created innovation and commercialization corporations that invest moneys directly in start-up companies. The innovation and commercialization corporations are private/public partnerships between KTEC, the universities, and the local private sector. This audit focused primarily on the Ad Astra partnerships, but also provided similar information about the commercialization corporations when it was readily available.

Question 1: How Much Has the State Invested Through Venture Capital Investments, and How Were Those Investments Selected?

Since 1988, KTEC has provided \$6.7 million to the Ad Astra partnerships and the commercialization corporations to invest in high-technology start-up companies. *Of that total, about \$4.8 million was invested in Ad Astra I and II. The remaining \$1.9 million was provided to three commercialization corporations and their affiliates, which are partially funded by KTEC. Ad Astra has made equity or loan investments in 28 companies. It owns an average of about 17% of the companies it invests in.* page 8

Companies were selected for investment based on assessments of whether those companies were high tech, had unique products, and had capable management. *Both Campbell-Becker and the commercialization corporations used processes for screening potential investments that were similar to the other venture capital companies we talked to. However, in conducting their background investigations, Campbell-Becker and the commercialization corporation officials tended to use techniques such as credit checks less often than other managers. Campbell-Becker officials told us they uncovered similar information through other means.* page 11

For the investments we reviewed, it appeared Campbell-Becker followed the requirements of its contract; we didn't find any indications of favoritism in the way investments were selected. *Our review of files for a sample of investments showed that Campbell-Becker officials performed all the investigations called for in their contract. When companies were turned down for funding it generally was because they didn't fit Ad Astra's investment criteria. Two companies Campbell-Becker invested in were out-of-State, but both had planned to open operations in Kansas. In the investments we reviewed, we saw no evidence of conflict of interest or favoritism.* page 12

Our review of recent statements of substantial interest for KTEC board members and staff didn't reveal any financial relationships that haven't been previously disclosed. One KTEC Board member and the KTEC president own small amounts of stock in companies invested in by Ad Astra. Both had been disclosed earlier. page 16

In addition to its direct investments in venture capital, the State indirectly has provided \$6.4 million in funding through Venture Capital Tax Credits. State law allows people investing in any of the 14 certified Kansas venture capital companies in Kansas to receive a 25% tax credit on the amount of their investment. In 1995, about \$942,000 in such tax credits were used. page 17

Question 2: Have All the Statutory Requirements Been Met For Selecting and Reporting on Venture Capital Investments?

The basic statutory requirements for selecting venture capital investments have been met. Because KTEC chose to make venture capital investments through a private limited partnership, it didn't have to meet some requirements that would have applied if it had made direct investments in individual companies. For example, Campbell-Becker doesn't require companies it invests in to file a statement of economic impact, and it is allowed by contract to invest up to 40% of the Ad Astra funds in out-of-State companies. If KTEC had made the investments itself, it would have had to restrict its investments to Kansas companies. An informal Attorney General opinion we requested concluded that the Ad Astra partnerships weren't bound by the statutory requirements placed on KTEC. page 18

Most requirements for reporting on venture capital investments have been met in recent years. State law contains a number of requirements for Kansas Inc., the Department of Commerce and Housing, and KTEC to report on economic development and venture capital. Only a few of these requirements weren't met. For example, except for 1996, KTEC hasn't reported on other states' spending on venture capital. page 19

Question 3: What Return Has the State Gotten on Its Investments In the Companies in the Ad Astra Portfolios in Terms of Jobs Created, Investment Income, and Appreciation in the Value of the Investments?

So far, the State's venture capital investments have increased in value by an estimated \$5.7 million, have generated about \$363,000 in investment income, and have helped create about 317 additional jobs in Kansas. However, figures on increases in value of venture capital investments should be used with caution. Valuations of investments in companies that aren't publicly traded are very speculative and are impossible to estimate with any degree of accuracy. The method Campbell-Becker uses to value the Ad Astra investments is the standard method used in the venture capital industry. page 22

The investment income KTEC has received came from returns from three companies in the Ad Astra portfolios. More than two-thirds of the jobs created were from one company—Oread Laboratories. The information the managers report on the number of jobs provided by Ad Astra and the commercialization corporations appears to be fairly accurate.

**Question 4: How Much Have the Managers of the Ad Astra Portfolios
Received in Fees, Expenses, and Equity Benefits
From the Ad Astra Investments?**

Since 1988, Campbell-Becker has been paid \$1.5 million from the Ad Astra funds in management fees, and \$220,000 from KTEC to help it cover early financial losses in support of the funds. Campbell-Becker receives a fixed fee of \$120,000 annually to manage Ad Astra I, and 5% of the amount invested to manage Ad Astra II. The fee for Ad Astra II was about 194,000 in 1996. The management fees come out of the Ad Astra funds. page 26

In addition, KTEC provided \$220,000 in extra fees to Campbell-Becker from 1992-1994 because Campbell-Becker wasn't able to operate its office on the fees from Ad Astra I. In return, Campbell-Becker officials agreed to not exercise their option of starting other venture capital funds. KTEC stopped the extra fees as soon as Ad Astra II was formed. KTEC paid about \$430,000 in start-up costs for Ad Astra I and II, which the general partner agreed to repay out of its final profits from the funds.

Campbell-Becker will receive 16% of any profits after all the limited partners have received their original investments back, which is less than a general partner normally receives. In addition to annual management fees, the general partner traditionally receives 20% of the final profits of the partnership. In return for KTEC paying the start-up costs of the Ad Astra partnership funds, Campbell-Becker agreed to give 4% of its distributions to KTEC. page 29

On a percentage basis, Campbell-Becker's management fees are higher than national averages, but are in-line with other small funds. National averages show that the average management fee for managing a fund of less than \$20 million is about 3% of the fund. We looked at several funds and found that as the size of the fund decreased, the percentage fee increased. Both Michigan and Kansas had funds about the same size and both paid fees in the 4.5-5% range. page 30

From 1994 through 1997, KTEC has paid more than \$2.2 million for operating expenses of the commercialization corporations. KTEC pays a portion of the operating costs of the corporations, along with their other partners (generally universities and local governments). The presidents of the corporations receive a salary set by the boards of the corporations. In addition, the presidents receive 5% of final profits of the funds, which they can keep or split with their staff. Because of time constraints, we couldn't determine whether sharing the profits was common in other states. page 31

**Question 5: What Efforts Have Been Made To Raise
Private Investment For Sunflower Technology Ventures,
How Much Money Has Been Raised, and
What Problems Have Been Encountered?**

The 1995 Legislature appropriated \$3.3 million to KTEC to start a new private venture capital fund which KTEC called Sunflower Technology Ventures. KTEC officials planned to combine the State money with at least \$6.7 million from private investors so that the fund could access up to \$20 million in additional moneys from the Small Business Administration. page 33

KTEC officials didn't raise any private investment moneys to add to the new venture capital fund because of what they considered to be a negative climate for finding investors. *These included the controversy over who would manage the fund, and KBI investigations of two companies in the Ad Astra portfolios. In November 1997, the KTEC board voted to voluntarily return the money from Sunflower to the State Treasurer. The money was returned on December 15.* page 34

To-date, KTEC has spent about \$63,000 for legal work, accounting, printing, and other costs related to organizing Sunflower Technology Ventures. *About three-fourths of that amount was spent for attorney fees.* page 36

Question 6: Are Other States Making Public Funds Available For Venture Capital, and Are Their Policies and Results Similar to Those in Kansas?

Many states have made public moneys available for venture capital investments. *We were able to identify at least nine other states that have publicly supported venture capital programs. With \$5 million in public funding, Kansas ranked fourth of the 10 states shown in the amount of public money committed to venture capital investments. Funding in those states ranged from less than \$1 million to \$75 million.* page 37

Kansas' policies and practices regarding venture capital investments are similar to other states in a lot of areas, but in some areas they varied significantly. For example, most states didn't mix public and private moneys, and many states had in-house staff that screened investments for a board of directors who made all investment decisions.

The level of oversight of venture capital investments in Kansas doesn't appear to be substantially different from the oversight exercised in other states. *Oversight in most states tends to consist of annual financial audits and annual reports to the Governor and the Legislature. States that contract out investment decisions also require managers to make quarterly or annual reports to officials of the agencies that hired them.* page 39

KTEC and Campbell-Becker appear to have at least as much oversight as venture capital operations in other states. Campbell-Becker officials make a quarterly presentation to the Investment Committee of the KTEC Board of Directors. The contract with Campbell-Becker also established an Ad Astra Advisory Committee—which is a committee of some of the limited partners and other qualified individuals—to review the investments and valuations of the investments. A KTEC staff member represents KTEC on this committee. In addition, an annual financial audit of the Ad Astra funds is done by an independent certified public accountant hired by the fund managers.

Ad Astra's track record compares favorably with other funds established about the same time, except that it hasn't yet had any companies go public or be sold at a profit. *We compared the Ad Astra partnerships to venture capital funds in three other states that started their funds during the mid-to-late 1980s. The Ad Astra funds compare reasonably well in such areas as the estimated value of the current portfolio, the percent of companies invested in that are still in business, and the percent of investments written off. The Ad Astra portfolios tended to fall behind in the percent of companies that have gone public or been sold at a profit.* page 41

Question 7: What Other Sources of Venture Capital Are Available to Kansas Entrepreneurs?

Moneys available through large nationwide venture capital funds are growing, but very little of that money has been invested in Kansas. *Nationally, about \$10 billion was invested in 1996. Kansas received only 1% of that funding. In many years it receives much less. Venture capital professionals told us it's very difficult to get representatives from the large out-of-State venture capital companies to come to Kansas to look at a company. Venture capital involves a lot of direct participation in a company's management, so a deal must be very large and very attractive to get an out-of-state venture capital company to commit to a long-distance relationship.* page 43

Although Kansas has a number of venture capital companies, few invest in early-stage, high-technology companies. *There isn't a comprehensive list of venture capital companies in Kansas. We identified about 20, including 15 "certified" venture capital companies and two local "seed capital" pools, all of which have met the requirements to use the State's venture capital and seed capital tax credits. Officials from a number of these companies said their firms didn't invest in early-stage or high-technology companies. We identified two main sources of venture capital for such companies—the Ad Astra partnerships, which are generally fully invested, and Kansas City Equity Partners, a \$30 million private venture capital company in Missouri. High technology isn't Kansas City Equity Partners' major focus, but it does invest in that type of business. Generally all the people we talked with who were familiar with venture capital in Kansas agreed that additional venture capital was needed, especially for early-stage companies.* page 44

Several other states are using plans that involve tax credits to encourage venture capital investment without directly investing state moneys. *The Oklahoma Capital Investment Board uses tax credits to back loans for moneys to invest in venture capital companies. With this backing, the State has borrowed money from Oklahoma banks and invested that money with venture capital companies. Moneys Oklahoma receives from its investments in the venture capital companies are used to pay off the bank loans. The only time Oklahoma actually would sell its tax credits would be if a loan became due and there wasn't enough money from the profits from the venture capital investments to pay it back.* page 47

Missouri, Louisiana, and New York have certified capital companies that allow insurance companies that form venture capital funds to take tax credits. Under these plans, one or more insurance companies can form a venture capital company that invests at least 60% of its funds in in-state companies. Generally insurance companies get a 100% tax credit for the moneys they invest, but can use a maximum of only 10% a year.

Finally, Kansas Inc.'s Board of Directors voted at its October 22, 1997, meeting to conduct a study about venture capital moneys in the State.

Conclusion: *During the last year, a number of issues have arisen regarding the State's venture capital investments. Some of the issues such as legislators' involvement with some of the companies that received State funding, and possible problems with the companies themselves are being dealt with by the Attorney General's Office and the Kansas Bureau of Investigation and aren't addressed by this audit.* page 49

The audit showed that, through the Ad Astra partnerships and the commercialization corporations, KTEC has invested about \$6.7 million in high technology start-up companies. Indirectly the State has provided another \$6.4 million through tax credits allowed for venture capital investments. In return, KTEC has received \$363,000 in cash payments and has seen the value of the investments grow by an estimated \$5.7 million. The State has seen 317 new jobs created.

The basic statutory and contractual requirements for selecting investments were met, and we didn't find any indication of favoritism in the way investments were selected. We also didn't find other investors selling their investments in the companies while the Ad Astra partnerships were putting more money in, nor did we find a lot of common owners in the companies that received money from the Ad Astra funds.

The firm of Campbell-Becker Inc. has received more than \$1.7 million in total fees since the Ad Astra funds were started, and will receive 16% of any profits after all investors get back their original investments, and after \$430,000 in start-up costs plus interest have been paid back to KTEC. Although somewhat higher than national averages, Campbell-Becker's fees didn't appear out of line compared to managers of similar-sized funds. No private money was ever raised for Sunflower Technology Ventures, and the KTEC Board has returned the \$3.3 million appropriated for that Fund to the State Treasury.

At least nine other states have made public money available for venture capital, but most haven't mixed public and private moneys, and most don't allow investments in out-of-state companies. Although there are a number of venture capital companies in Kansas, the Ad Astra funds (which have no more money to invest), the commercialization corporations, and Kansas City Equity Partners appear to be the main sources of capital for high technology start-up firms.

In sum, given the questions we were asked to answer, this audit didn't find any significant problems with the State's venture capital investments. That doesn't mean that some investment failures shouldn't be expected over time. These investments bear a high degree of risk, and historically a high percentage of them fail. As the Legislature considers the future of venture capital in Kansas, hopefully this report will provide some of the basic information necessary to make those policy decisions.

Recommendations: *A brief summary of the report's recommendations, together with a summary of applicable comments from KTEC and Campbell-Becker, is presented below.* page 50

We recommended that KTEC officials review the revisions of K.S.A. 74-8111 and file an annual report that meets all the specified requirements. In addition, because we were unable to fully research how common it was for presidents of commercialization corporations to receive an ownership share of the investments they manage, we recommended that KTEC staff should work with us to collect information on how other states compensate presidents of commercialization corporations.

KTEC and Campbell-Becker generally were in agreement with the findings of the report. KTEC officials pointed out that KTEC and the commercialization corporations have another level of accountability not mentioned in the report—a board of directors comprised of legislators and representatives of the universities and private industry. KTEC officials also said that it's a common practice for commercialization corporations that make equity investments to share the equity with their presidents, and that they could quickly collect information on that topic to share with the Legislative Post Audit Committee and the KTEC Board.

APPENDIX A: <i>KTEC's Venture Capital Investments</i>	.....	page 51
APPENDIX B: <i>KTEC's Ownership Percentages In the Ad Astra and Commercialization Corporation Portfolio Companies</i>	.....	page 53
APPENDIX C: <i>Listing of Major Stockholders of Companies that Have Received Venture Capital Investments from the Ad Astra Partnerships</i>	.....	page 54
APPENDIX D: <i>Numbers of Jobs Created by the Ad Astra Funds and the Commercialization Corporations</i>	.....	page 58
APPENDIX E: <i>Other State Survey Information</i>	.....	page 61
APPENDIX F: <i>Summary of Venture Capital Investment Activity For the Past 10 Quarters</i>	.....	page 66
APPENDIX G: <i>Venture Capital Companies in Kansas</i>	.....	page 68
APPENDIX H: <i>Agency Responses</i>	.....	page 69

This audit was conducted by Allan Foster, Cindy Crawley and Tracey Elmore. Leo Hafner was the audit manager. If you need any additional information about the audit's findings, please contact Mr. Foster at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call (785) 296-3792, or contact us via the Internet at: LPA@mail.ksleg.state.ks.us.

