

**State of Oklahoma
Incentive Evaluation Commission
Oklahoma Capital Investment Board
Draft Report**



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Prepared by



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At a Glance: Oklahoma Capital Investment Board

Statute: 74 O.S. Section 5085.1

Program Goals

- Mobilize equity and near-equity capital
- Invest in such a manner as to result in significant potential to create jobs and diversity and stabilize the State economy

Fiscal Impact

	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
Tax Credits Sold	\$3,400,000	\$0	\$0	\$0	\$0



Economic Impact

- Cannot be calculated with the available data
- Prior economic impact analysis is not sufficiently connected to the size of investments and other factors

Adequate Protections for Future Fiscal Impact?

- Yes, the statute limits the program to total tax credits of \$100 million and use of no more than \$20 million per year – to date, \$31 million expended
- The Legislature has also limited further OCIB investments and program activities in a way that limits future fiscal impact

Effective Administration?

- Yes, the program uses professional management and a 'fund of funds' approach that diversifies investments and risks
- OCIB policies and procedures include industry standard approaches to conflict of interest, reporting and audits of investments and returns

Achieving its Goals?

- As with many public sector venture capital programs, return on investment analysis is more complicated than for private sector investors, and weighing the benefits and opportunity costs does not yield a clear answer
- Past concerns about risk have led the Legislature to constrain OCIB program activities

Retain, Reconfigure, Repeal?

- Retain within its current parameters to allow OCIB to complete its scheduled activities prior to its legislated sunset
- There is no compelling conclusion related to reversing the sunset imposed by the Legislature, particularly given short-term budget issues facing the State

Changes to Improve Future Evaluation?

- Should the program be retained, additional reporting on results related to Oklahoma firms (pre and post-investment payroll, jobs, capital investment) and investments by sectors

Executive Summary

Introduction

Access to capital is a critical need for the development and expansion of businesses, particularly small businesses. Venture capital, which is targeted at start-up firms and small businesses that have long term growth potential, is often cited as a critical need that is in short supply in most areas of the country.

Recognizing that need, in 1991 the Oklahoma Capital Formation Act created the Oklahoma Capital Investment Board (OCIB). Its statutory mission is “to mobilize equity and near-equity capital for investment in such a manner that will result in significant potential to create jobs and diversify and stabilize the economy of the State of Oklahoma.”

As part of the enabling legislation, the State provided OCIB the authority to sell \$100 million in transferrable tax credits to be used to support its programs. To date, OCIB has sold (for transfer on a dollar-for-dollar basis) approximately \$31.9 million of these tax credits.

OCIB provides two programs for providing equity and near-equity capital for investment. Its efforts are focused on the areas of venture capital investment and access to capital. OCIB has been significantly constrained by the Legislature in recent years. In 2012, SB1159 directed the OCIB to not enter into any new or additional contracts, investments or loan guarantees. While OCIB is able to participate in existing investment pools and contracts, no otherwise new activity is taking place. OCIB is scheduled to sunset on June 30, 2018.

Economic Impact

OCIB has produced many reports and studies on the positive economic impacts of its two primary programs. For example, OCIB retained an economics consulting firm to produce a report titled *Economic Impacts of the Oklahoma Capital Investment Board’s Venture Investment Program and Oklahoma Capital Access Program* in 2015. The project team reviewed these reports as part of the incentive program analysis.

In general, the project team determined that there is insufficient data to accurately estimate or verify the total economic or tax revenue impacts of either of OCIB’s two programs. Any attempt to estimate the economic impact would require significant assumptions regarding “but for” these programs, funds would not have been made available to applicant companies in any form. The project team’s perspective is that some companies would have been able to obtain capital (albeit perhaps at a higher rate), while others might have raised funds in multiple rounds.

Many of the assertions regarding the economic impact of the Venture Investment Program, for example, factor in the “leverage” produced by other investments not made by the State of Oklahoma. Given that OCIB is but one of many investors in these funds (and certainly not the primary investor), an alternate approach that might more fully reflect the return on investment to the State of Oklahoma might be to apportion the impact based on the OCIB investment. For example, if OCIB’s Venture Investment Program contributed \$30 million out of a total of \$500 million of new financing, then OCIB should be credited with 6 percent of the total impact (\$30 million / \$500 million) not 100 percent. Similar logic would apply to the Capital Access Program.

Access to capital, whether venture capital or small business loans, is critical to all Oklahoma businesses. However, it is not clear that absent OCIB activity, there would be a material negative economic impact on the overall State economy. This finding is not intended to diminish the role OCIB plays in funding Oklahoma businesses, but rather reflects the complexity in measuring the impact of venture capital funding.

A review of the administrative and other processes in place suggest that the program is managed to the standards required of the enabling legislation as well as industry standards. Based on 'best practices' approaches to public sector venture capital operations, OCIB aligns with most recommendations. There are, however, opportunities to improve on the information reported, and how it is reported. This may allow a more nuanced analysis of the economic impact of the programs.

In the end, public sector venture capital programs are often confronted with short-term fiscal realities that call into question longer-term possible returns. These decisions are made even more difficult by the long timeframes for positive pay-outs and the risks associated with the inevitable investments that do not yield a positive return. Given the short-term financial issues facing the State, the project team believes the Legislature's decision to constrain the program (and ultimately sunset it) is reasonable.

Introduction

Overview

The Oklahoma Incentive Evaluation Commission (the Commission) was established in HB2182, which was enacted and became law in 2015. It requires the Commission to conduct evaluations of all qualified state incentives over a four-year timeframe. The law also provides that criteria specific to each incentive be used for the evaluation. The Oklahoma Capital Investment Board is one of the incentive programs reviewed in 2016 by the Commission with recommendations to the Governor and the Legislature.

Introduction

Access to capital is often a critical need for the development and expansion of businesses – particularly small businesses. Venture capital generally describes money invested in start-up firms and small businesses that have long term growth potential but do not have sufficient access to capital. Because these are early stage investments, they are often considered to be risky but have the potential for above average returns, at least in the long-run. An accepted venture capital model is to generate a sufficient portfolio of strong performing companies to balance the inevitable businesses that fail to provide a positive return on investment. Often, a key consideration for venture capital investors is whether they have sufficient resources to remain a going concern while waiting (sometimes for decades) to receive a return on investments.

While there are many private venture capital investors and firms in the US, they tend to be concentrated in a handful of locations – most recently California and Massachusetts. One study found that in the period from 2008 to 2013, companies headquartered in these two states received more than 60 percent of venture capital investments in the U.S., while these states represent 14 percent of the U.S. population. Firms in these two states also managed 63 percent of the US venture capital under management.¹

This, of course, is a concern for those regions of the country that do not have as easy access to venture capital. Access to capital can be critical to the growth and development of local businesses, and it can also impact on location decisions – firms that are interested in attracting (or would be likely to attract) venture capital investors may well locate or relocate in places where there is a greater opportunity to attract venture capital.

It is for these reasons that a variety of states have undertaken efforts to stimulate or enhance venture capital within their states. These efforts have focused on multiple approaches, and Oklahoma has used more than one method to assist companies at various stages of development.

In 1991, the Oklahoma Capital Formation Act created the Oklahoma Capital Investment Board (OCIB). Its statutory mission is “to mobilize equity and near-equity capital for investment in such a manner that will result in significant potential to create jobs and diversify and stabilize the economy of the State of Oklahoma.”² OCIB is a public trust and is led by five directors appointed by the Governor and confirmed by the State Senate.

¹ “Information and Observations on State Venture Capital Programs, Report for the U.S. Department of the Treasury and Interested Parties in the State Small Business Credit Initiative,” February 2013.

² Oklahoma Statutes, Title 74, Section 5085.3

As part of the enabling legislation, the State provided OCIB the authority to sell \$100 million transferrable tax credits that may be used to support its programs.³ To date, OCIB has sold (on a dollar for dollar basis) approximately \$31.9 million of these tax credits.⁴

OCIB provides two programs for providing equity and near-equity capital for investment. OCIB focuses its efforts in the areas of venture investment and capital access programs.

The Venture Investment Program (VIP) makes targeted investments in venture capital funds in sectors of interest or expected areas of growth within the State. Key areas of focus for VIP have included bio-tech, healthcare, aerospace and manufacturing. Its first investment occurred in March 1993.

The Oklahoma Capital Access Program (OCAP) uses a pooled reserve concept to enable small businesses that may otherwise not be able to do so to access commercial credit. Oklahoma depository institutions may participate in the program by entering into an agreement with OCIB and paying a fee or premium to enroll loans in the program. OCIB then establishes a reserve account equal to the amount of the fee plus an obligation by OCIB for a predetermined portion of the loan. Cash, up to the amount of the reserve account, may then be paid to the participating lender if they incur a loss on the loan.⁵

OCIB has been significantly constrained by the Legislature in recent years. In 2012, SB1159 directed the OCIB to not enter into any new or additional contracts, investments or loan guarantees. While OCIB is able to participate in existing investment pools and contracts, no otherwise new activity is taking place. OCIB is also scheduled to sunset on June 30, 2018.

Criteria for Evaluation

A key factor in evaluating the effectiveness of incentive programs is to determine whether they are meeting the stated goals as established in state statute or legislation. In the case of OCIB, the mission is “to mobilize equity and near-equity capital for investment in such a manner that will result in significant potential to create jobs and diversify and stabilize the economy of the State of Oklahoma.”⁶ As with several State incentives, this is focused on investments with ‘significant potential to create jobs’ as well as to ‘diversify and stabilize the economy.’

In determining whether OCIB is furthering its mission, the Incentive Evaluation Commission has adopted the following criteria:

- Net change in jobs and payroll created in Oklahoma via the Board’s investments
- Loan repayments as a percentage of total loans made
- Loan repayment rates compared to industry/other state metrics

³ These tax credits may not be exercised after July 1, 2020, unless they were purchased or contractually agreed to be purchased prior to December 31, 1995. Title 74, Section 5085.7

⁴ OCIB will only transfer tax credits in the case of a call on an OCIB guarantee.

⁵ “Report for the Year Ending June 30, 2014,” Oklahoma Capital Investment Board, April 15, 2015, p. I-3.

⁶ State Statute, Title 74, Section 5085.3

- Dollars invested in Oklahoma Businesses as a percent of principal guaranteed by the Board
- Return on investment, measuring economic impact versus cost of the program

The criteria focus on what are generally considered goals of incentives programs (such as creating jobs in the State) as well as more specific objectives related to this program (serving as a source of funding for loan guarantees with the goal of increasing access to capital). Ultimately, incentive programs have to weigh both the benefits (outcomes related to achieving policy goals and objectives) and the costs, and that is also a criteria for evaluation (State return on investment).

Program Background and Benchmarking

Background

As previously noted, the OCIB board is able to fund the investments needed to carry out its mission by selling tax credits granted by the State at the time of the board's inception. The board uses funds raised through the sale of tax credits to invest in venture capital funds. OCIB has the freedom to establish its own criteria in the selection of investments in the funds. However, statute requires that the board ensures two dollars is invested in Oklahoma businesses for every one dollar of principal guaranteed.

A total of \$100 million in tax credits were provided. These tax credits may be used to offset income tax or insurance premium tax liability. The credits will expire on July 1, 2020. State statute restricts the amount of credits that may be sold in one year to \$20 million.⁷ To date, OCIB has used over \$30 million of the \$100 million of tax credits originally allotted them.⁸

Benchmarking

Since the 1990s, states have become increasingly more involved in stimulating venture capital investment. States do this in a variety of ways. The most common form of this is state tax credits to encourage private investment.⁹ Many states have also chosen to leverage state funds through the use of either certified capital companies (CAPCOs), or the creation of a fund of funds program. CAPCOs use insurance companies as investors by offering premium tax credits to encourage investment in venture capital companies. CAPCOs have proven controversial in a number of states.¹⁰

Oklahoma does not use the CAPCO model and instead uses the fund of funds program approach, which focuses on investment in venture capital funds that then make investments in individual companies. Other states using this model include Iowa, Ohio, Michigan, and Arkansas. Each of these states have programs that are similar to Oklahoma's. The programs share a goal of increasing venture capital investment in the state in which they operate. Also, each program is funded by the sale of state tax credits. However, the programs are differentiated in three main areas: total credit amount, investment requirements, and per-year tax credit sale limit:

Total Tax Credit Funding: Across the comparison group, total tax credit allotment ranges from \$60 million to \$450 million. Arkansas and Iowa, which recently reduced total tax credits available to its program from \$100 to \$60 million, have the lowest amount. Ohio and Michigan each have much higher allotment amounts compared to Oklahoma, \$380 million and \$450 million, respectively.

Investment Requirements: States have various restrictions related to selection of investments. In each state, guidelines have been included in statute to focus investment within state borders. For example,

⁷ 74 OS Section 5085

⁸ OCIB 2015 Annual Audit

⁹ <http://www.ncsl.org/documents/fiscal/entrepreneurshipFINAL05.pdf>

¹⁰ See for example, "State Financing Incentives for Economic Development," Norton Francis, The Tax Policy Center, Urban Institute, February 2016, p. 5, accessed electronically at <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000635-state-financing-incentives-for-economic-development.pdf>

Oklahoma requires two dollars be invested in Oklahoma businesses for every one dollar of principal guaranteed. Michigan has the same requirement in place. Ohio requires a certain percentage of program money be invested in Ohio-based funds.

	Total Credit Allotment	Investment Requirement	Per Year Tax Credit Limit
Arkansas	\$60 million	No specific requirement, just the goal of promoting economic development in the state	\$10 million
Iowa	\$60 million	Funds must make a commitment to invest in Iowa businesses. Five percent of tax credits to be used for rural and small business investment	\$20 million
Michigan	\$450 million	Two dollars invested in seed or early stage businesses in the state for every dollar of principal guaranteed	Not specified
Ohio	\$380 million	At least 75 percent of program fund money must be invested in Ohio-based venture capital funds	\$20 million
Oklahoma	\$100 million	Two dollars invested in Oklahoma businesses for every dollar of principal guaranteed	\$20 million

Benchmarking Program Evaluations

The two OCIB programs are distinctly different and should be viewed from that perspective. Of the two programs, OCAP is more of a traditional loan assistance program that seeks to increase (on the margins) access to loans from traditional lenders by augmenting an insurance-like reserve to be tapped for non-performing loans. This sort of program is in operation in states around the country. The US Treasury Department has written multiple reports on the topic, as under their State Small Business Credit Initiative, 24 states allocate a portion of their federal funding to capital access programs (CAPs). One of the notable features of this program is the fact that states initially allocated \$291 million of these funds to CAPs, but the CAPs were unable to attract the level of interest from financial institutions to justify that level of involvement. As a result, as of June 2015, states had shifted 84 percent of that initial funding allocation to other small business programs, leaving \$46 million allocated to CAPs.¹¹

¹¹ "Best Practices from Participating States: Capital Access Programs," Department of the Treasury, September 2015, accessed electronically at https://www.treasury.gov/resource-center/sb-programs/Documents/CAP%20Best%20Practices_Sept%202015_v%20FINAL.pdf.

An earlier analysis of state-level CAP programs found that they ‘encourage small business lending in a cost-efficient and simple way.’ This review also found that CAPs are less staff intensive than other credit enhancement programs, require little administrative cost for banks, borrowers or the government.¹² This survey of existing programs (19 states and 2 cities) reported loan losses of 3.2 percent of all loan volume extended.

This study also reported some data on job creation. Based on data from six states, the report suggested caution around figures for jobs created or retained through CAP lending as well as the amount of CAP loan dollars per job created or retained. The figures showed considerable variation, from \$28,000 per job at the high end and \$9,000 per job at the low end. The report also suggested this was accomplished with little cost to the state: the average state subsidy for the six reporting states was \$777 per job created/retained.¹³

The State of South Carolina has published several reviews of its CAP program. Its 2010 review reported that there were 44 loans made in 2009 and 31 in 2010 (and noted that economic conditions in these years were challenging for banks). These loans resulted in 40 jobs created and 110 retained, or \$1,478 in reserves per job. For the year, it averaged 4.84 jobs per loan.¹⁴ The State found that its program leveraged \$21.83 in private lending for every \$1.00 provided by the program and created or retained 290 jobs (47 new), an average of 5.9 jobs per loan.¹⁵

As previously noted, there is significant interest and involvement among the states in venture capital efforts. The US Treasury has also been active in providing support for venture capital funds targeted at small businesses. A report commissioned by the Treasury Department in 2013 provided the following recommendations for state programs:

- **Understand the supply of and demand for venture capital.** Program managers with detailed knowledge of the capacity for VC investments in their state (i.e., data on number of resident VC funds, amounts of capital managed, transactions closed, amounts invested, industry focus and preferred development stages, etc.) are more likely to develop programs with targeted investment strategies that “prime the pump” for accelerated private sector investing.
- **Focus on capacity building with an ecosystem approach.** Program managers committed to building long-term entrepreneurial capacity and a sustained venture capital presence, rather

¹² “Capital Access Programs: A Summary of Nationwide Performance,” Department of the Treasury, October 1999, p. 1

¹³ Ibid., p. 8-9.

¹⁴ “South Carolina Capital Access Program, Review of Program’s 2010 Activity,” South Carolina Department of Commerce. Accessed electronically at

http://sccommerce.com/sites/default/files/document_directory/Capital_Access_-_South_Carolina_Capital_Access_Program_Review_of_Year_2010_Activity.pdf

¹⁵ “South Carolina Capital Access Program, Review of Program’s 2007 Activity,” South Carolina Department of Commerce, March 8, 2008, p. 4. Accessed electronically at

http://dc.statelibrary.sc.gov/bitstream/handle/10827/15141/DOC_Capital_Access_Program_Review_2009.pdf?sequence=1&isAllowed=y

than one-off investments, are more likely to design strategies aligned with market-based principles. Several state program managers communicated how they are using SSBCI capital to boost existing development strategies designed to build innovation capacity.

- **Create pathways to the next investment round.** The most successful VC investors are continually planning for the next financing event, actively communicating about investment opportunities and expanding professional networks to the benefit of portfolio of companies. If pathways to the next financing event are not created, small businesses receiving early-stage investments from state VC programs might not survive.
- **Plan for the long-term and manage expectations.** Experienced managers set expectations for achieving “comprehensive returns” across a diverse portfolio of long- term investments that include reasonable projections for both financial returns and indirect economic benefits.
- **Proactively address the potential for conflicts of interest and political influence.** Well- designed initiatives use clearly stated policies and processes to govern activities and investment decisions.
- **Attract the most capable leaders to manage resources.** Successful programs recruit capable fund managers with specialized skills and credibility with elite entrepreneurs and investors.
- **Measure results accurately with defensible logic.** In an industry without recognized standards for measuring results, experienced program managers define credible measurement standards at the outset and then measure results consistently and with third party validations.
- **Align state economic development interests with the financial interests of fund managers and limited partner VC fund investors.** States should participate in the financial returns from successful investments in order to provide future capital resources for new investments.¹⁶

The evaluation will return to these recommendations in the following discussion.

A recent analysis of another state fund-of-fund approach was recently conducted by David Zin, Chief Economist, State of Michigan Senate Fiscal Agency. The analysis acknowledged that the State’s support of venture capital had an impact on overall availability of venture capital in the state, quoting figures that the number of venture capital firms headquartered in Michigan has increased from ‘just a few’ in 2003 to 16 in 2009 and 23 in 2013.¹⁷ However, the balance of the analysis focused on how the State might deal with the significant fiscal impact associated with the venture capital funds. In this respect, the State of

¹⁶ “Information and Observations on State Venture Capital Programs, Report for the U.S. Department of the Treasury and Interested Parties in the State Small Business Credit Initiative,” February 2013.

¹⁷ “Michigan Early Stage Venture Capital Tax Vouchers,” State Notes Topics of Legislative Interest, Winter 2015, p. 7, accessed electronically at <https://venturemichiganfund.com/the-program/fund-metrics/>

Michigan was also in something of the ‘time bind’ that exists between making the financial commitment to venture capital in the early stages when pay-offs are not yet on the horizon.

While there are a variety of reports and surveys that identify state venture capital programs and tax credits that support them, there has been little systematic analysis of program impacts or program evaluations. Part of this may relate the lengthy timeframe necessary to judge the results of early stage venture capital investments and programs. It may also reflect the general lack of knowledge and information related to the programs themselves – or the relatively insulated nature of investments in funds of funds. One assessment of a state program noted that state-sponsored venture capital programs have had mixed results. As this study notes, “measures of the ‘contribution’ of a ‘successful’ public venture capital fund generally did not go beyond counting businesses and jobs and estimating taxes paid. Program assessments rarely considered the opportunity cost of the public funding used or the counterfactual of what likely would have happened to the portfolio of companies in the absence of public venture capital investments.”¹⁸ This point is well taken, and it is discussed in the section on economic impact.

¹⁸ “The Role of a Public Venture Capital Program in State Economic Development: The Case of Kansas Venture Capital, Inc.,” David L. Barkley, Ferdinand DiFurio and John Leatherman, *The Journal of Regional Analysis and Policy*, 2004, p. 84.

Fiscal Impact

As previously noted, OCIB programs have been capitalized by making available \$100 million in transferrable tax credits. To date, OCIB has used approximately \$30.9 million of those credits. The \$100 million represents the entirety of the financial commitment and impact on the State of Oklahoma. This impact reduces revenue collections in the years where the sold credits are used to offset what would otherwise be State tax liability.

The following table provides a year-by-year history of tax credits sold by OCIB:

Tax Credits Sold by OCIB	
Year	Amount
2007	\$8,000,000
2008	\$4,700,000
2009	\$6,815,000
2010	\$8,000,000
2011	\$3,400,000
2012	\$0
2013	\$0
2014	\$0
2015	\$0
Total	\$30,915,000

As also previously noted, in 2012, the Legislature restricted the future activities of OCIB. As a result, no new investments are being made, and the ultimate fiscal impact (absent change in that legislation) will depend on the results of existing investments.

The long-term goal for the State is to leverage the State's contribution in various funds into investments in Oklahoma companies that ultimately become successful and generate payroll and investment in the State that also generate tax revenue. As previously noted, many of the investments are long-term where many businesses have not reached that stage of development.

One of the requirements of HB2182 is that each evaluation should determine "whether adequate protections are in place to ensure the fiscal impact of the incentive does not increase substantially beyond the state's expectations in future years." There appear to be adequate protections in place for this program. They consist of:

- The incentive is limited in its ability to sell and transfer tax credits to fund its operations – the amount, \$100 million, is specified in statute.
- The program is also limited to a yearly cap, \$20 million, on the amount that may be issued.
- The Legislature has also stipulated that additional loans (and the risks associated with it) will not be made under the CAP program.

Economic Impact

As noted in the Program Background, OCIB manages two programs that provide access to capital for Oklahoma businesses:

- **Venture Investment Program** - invests in professional, privately managed partnerships whose managers are willing and have a clear plan for identifying Oklahoma investment opportunities in sectors that are meaningful to the State
- **Capital Access Program** - incentivizes bankers to lend needed capital to Oklahoma's small business borrowers, a majority of which are located in rural areas.

OCIB has produced many reports and studies on the positive economic impacts of these two programs. For example, OCIB retained Applied Economics LLC of Phoenix, Arizona to produce a report titled *Economic Impacts of the Oklahoma Capital Investment Board's Venture Investment Program and Oklahoma Capital Access Program* in 2015. The project team reviewed these reports as part of the incentive program analysis.

In general, there is insufficient data to allow the project team to accurately estimate or verify the total economic or tax revenue impacts of either of OCIB's two programs. Any attempt to estimate the economic impact would require significant assumptions regarding "but for" these programs funds would not have been made available to applicant companies in any form. Some companies would have been able to obtain capital (albeit perhaps at a more expensive rate), while others might have raised funds in multiple rounds.

Many of the assertions regarding the economic impact of the Venture Investment Program, for example, factor in the "leverage" produced by other investments not made by the State of Oklahoma. As described in the *OCIB Fiscal Year 2017 Business Plan*, dated June 20, 2016:

"The Board's programs have exceeded their original goal of mobilizing \$500 million of new financing for Oklahoma businesses. The Board's programs have resulted in approximately \$550 million of risk capital for Oklahoma projects. As of June 2015, the Board had attracted more than \$163 million in venture capital, \$48.7 million in development loans and participated in a \$10 million revenue guarantee resulting in \$221 million of reported capital for Oklahoma companies. It is also estimated that more than \$326 million of leveraged debt was available to the venture backed companies due to the \$163 million in equity capital invested in them. OCIB's total direct impact is currently estimated to be \$547 million of risk capital provided for Oklahoma projects. Achieving this level of impact means OCIB's programs have exceeded their original impact expectations and can clearly do more."

According to the same report:

"Since 1992 the Oklahoma Capital Investment Board has a proven 61 to 1 impact from its investment; meaning for the \$31 million invested by the state, the state's economy has received more than \$1.9 billion in return according to a 2015 independent study by Applied Economics."

An alternate approach that might more fully reflect the return on investment to the State of Oklahoma might be to apportion the impact based on the OCIB investment. For example, if OCIB's Venture Investment Program contributed \$30 million out of a total of \$500 million of new financing, then OCIB should be credited with 6 percent of the total impact ($\$30 \text{ million} / \500 million) not 100 percent. Similar logic would apply to the Capital Access Program.

Access to capital, whether venture capital or small business loans, is critical to all Oklahoma businesses. It is not clear that absent OCIB activity, there would be a material negative economic impact on the overall State economy. This finding is not intended to diminish the role OCIB plays in funding Oklahoma businesses, but rather reflects the complexity in measuring the impact of venture capital funding. The Capital Access Program should be measured by jobs created and retained as well as the percent of loans repaid.

Technical and Administrative Issues

Overview

OCIB operates differently from many of the incentive programs in that its administrative functions aren't focused on determining eligibility for the credits either through an application or tax return. The fund-of-funds approach to investments for the Venture Investment Program is more focused on making good choices of funds that will leverage the involvement in the fund into investments in worthy Oklahoma-based companies.

The best practices identified in the Benchmarking section are a good place to start related to discussions of some of the administrative functions and requirements. Among them are:

- **Proactively address the potential for conflicts of interest and political influence.** Well-designed initiatives use clearly stated policies and processes to govern activities and investment decisions.
- **Attract the most capable leaders to manage resources.** Successful programs recruit capable fund managers with specialized skills and credibility with elite entrepreneurs and investors.

At the start, the legislation creating OCIB has prominent features that seek to ensure that it is managed well and avoid conflicts of interest. The OCIB board includes members with significant experience and expertise in business and investing in businesses. There are strong conflict of interest policies in place. In these areas, there do not appear to be additional administrative needs for OCIB.

Another set of best practices relates to the actual workings of decision making regarding fund investments and considerations of strategic direction:

- **Understand the supply of and demand for venture capital.** Program managers with detailed knowledge of the capacity for VC investments in their state (i.e., data on number of resident VC funds, amounts of capital managed, transactions closed, amounts invested, industry focus and preferred development stages, etc.) are more likely to develop programs with targeted investment strategies that “prime the pump” for accelerated private sector investing.
- **Focus on capacity building with an ecosystem approach.** Program managers committed to building long-term entrepreneurial capacity and a sustained venture capital presence, rather than one-off investments, are more likely to design strategies aligned with market-based principles. Several state program managers communicated how they are using SSBCI capital to boost existing development strategies designed to build innovation capacity.
- **Create pathways to the next investment round.** The most successful VC investors are continually planning for the next financing event, actively communicating about investment opportunities and expanding professional networks to the benefit of portfolio of companies. If pathways to the next financing event are not created, small businesses receiving early-stage investments from state VC programs might not survive.

- **Plan for the long-term and manage expectations.** Experienced managers set expectations for achieving “comprehensive returns” across a diverse portfolio of long- term investments that include reasonable projections for both financial returns and indirect economic benefits.
- **Align state economic development interests with the financial interests of fund managers and limited partner VC fund investors.** States should participate in the financial returns from successful investments in order to provide future capital resources for new investments.¹⁹

In these areas, it is difficult, with the information available, for the project team to make a definitive judgement. Some of the metrics identified are not readily available, but the published annual reports and business plans do identify, for example, sectors of interest for OCIB, and these tend to align with State sector efforts in other programs as well. In other areas, some of these best practices are not measurable but nonetheless important for the strong operation of the program.

The final best practice deals with what are commonly considered performance reporting aspects of a program:

- **Measure results accurately with defensible logic.** In an industry without recognized standards for measuring results, experienced program managers define credible measurement standards at the outset and then measure results consistently and with third party validations.

In this area, there does not appear to be as much focus on measurement reporting as in at least some other state programs. For example, the State of Michigan, on its website for a similar state venture capital program, provides the following information:²⁰

The Michigan early stage venture investment corporation shall publish and make available on the Internet an annual report not more than 3 months after the close of the Michigan early stage venture investment corporation’s fiscal year that includes all of the following:

1. An enumeration of all investment and related activities for the fiscal year.

In fiscal year 2015, ending on December 31, 2015, the Venture Michigan Fund, incorporating both the Venture Michigan Fund I and the Venture Michigan Fund II:

- *There were no new commitment to underlying fund managers. The Venture Michigan Fund is fully committed.*
- *\$22.1 million was drawn by underlying fund managers in the Venture Michigan Fund.*
- *\$8.0 million was distributed by underlying fund managers in the Venture Michigan Fund.*

2. Documentation and analysis of the implementation and status of the Michigan early stage venture investment corporation’s investment plan and the economic impact of the plan on this state, including, but not limited to, the following:

¹⁹ “Information and Observations on State Venture Capital Programs, Report for the U.S. Department of the Treasury and Interested Parties in the State Small Business Credit Initiative,” February 2013.

- **Number of Michigan-based investments made**
- **Total dollars invested in these companies to date**
- **Total amount invested by all other investors in these Michigan companies since the date of the fund manager’s first investment in said companies**
- **Investment reserves, if any, associated with these Michigan company transactions**
- **Number of full time equivalent Michigan employees in these companies at the time of investment – as well as number currently employed (or employed at the time of exit)**
- **Number of professionals (investment or otherwise) employed by the underlying fund managers in Michigan**
- **For the Michigan investments and relating to expenses in the State: salary, payroll and other taxes, operating expense, capital expenditures, and legal/audit expenses**

In March 2016, the Venture Michigan Fund undertook a survey from the underlying fund managers in both Venture Michigan I and Venture Michigan II to ascertain impacts to Michigan associated with their investments. This survey specifically asked each fund manager in the Venture Michigan Fund. The following responses are the aggregate summing of the responses provided directly by the fund managers in the programs.

- i. *The number of jobs represented by the investments made in qualified businesses in this state.*
 - *As of March 1, 2016, 1,453 people are employed in Michigan associated with investments made by the Venture Michigan Fund underlying fund managers.*
- ii. *Return on investment generated by investment, the types of activities in which investment was made, and the impact of that investment on the economic base of this state.*
 - *Fund Managers in Venture Michigan Fund I (“VMF I”) and Venture Michigan Fund II (“VMF II”) have invested \$187.3 million to 46 unique portfolio companies. Note there are several Michigan companies that have received investments from fund managers in VMF I as well as VMF II. Any potential overlap in metrics has been accounted for in the following data.*
 - *The total amount invested in these portfolio companies from VMF managers and other investors in the syndicate was \$1.2 billion, representing a 6.28x leveraging effect to Venture Michigan Fund Investments.*
 - *Total jobs positively impacted across the 46 companies has been 1,453, up from 692 at entry, an increase of 109.8%*
 - *The VMF fund managers directly employ 35.25 FTE employees in Michigan*
 - *Approximately \$185 million in cost of goods sold were appropriated in the State of Michigan*
 - *The approximate payroll expense for the VMF I and VMF II underlying fund managers and the subsequent portfolio company employees was approximately \$147.0 million for the prior 12 month period ending March 31, 2016.*
 - *In total, the positive financial impact on the State of Michigan is approximately \$332 million on an annual basis.*

Venture Michigan Fund I

- Overall, \$1.0 billion of equity has been invested into 31 portfolio Michigan-based companies. This represents a 7.58x leveraging of the VMF I's underlying fund manager investment of \$133.4 million.
- These portfolio companies have exposure across the following sectors: life sciences, manufacturing, healthcare, IT, application software and cleantech.
- Life sciences accounts for 55.5% of the investments on a dollar basis as of April 2016. Healthcare IT is second in size at 28.2%, and Application Software is third at 5.5%.

Venture Michigan II

- Overall, \$414.4 million of equity has been invested into 22 Michigan-based portfolio companies. This represents a 3.72x leveraging of VMF II's underlying fund manager investment of \$111.3 million.
- These portfolio companies have exposure across the following sectors: life sciences, healthcare IT, application software, cleantech, advanced manufacturing and media.
- Healthcare IT being the largest sector on a dollar invested basis as of April 2016 at 38.6%. Application Software is second at 22.7%, and Life Sciences is third at 18.3%.

3. Return through the fiscal year from investments made by each Michigan early stage venture investment fund in venture capital companies.²

As of December 31, 2015, the underlying investment net multiple and internal rate of return of the Venture Michigan I investments were 1.04x and 0.93% on invested capital, respectively.

As of December 31, 2015, the underlying investment net multiple and internal rate of return of the Venture Michigan II investments were 2.05x and 37.45% on invested capital, respectively.

4. The number of seed or early stage businesses that have been funded by venture capital companies.

Venture Michigan Fund I ("VMF I") and Venture Michigan Fund II ("VMF II") have invested \$187.3 million to 46 unique portfolio companies.

5. The aggregate net distributions made to each fund by the venture capital companies that have entered into agreements with each Michigan early stage venture investment fund through the end of the fiscal year and since the inception of each Michigan early stage venture investment fund.

*VMF I distributions during calendar year 2015: \$7.3 million
VMF I distributions since inception: \$21.8 million*

*VMF II distributions during calendar year 2015: \$0.8 million
VMF II distributions since inception: \$6.6 million*

6. The total amount invested by each Michigan early stage venture investment fund in venture capital companies.³

VMF I: \$133.4 million equity has been invested into 31 portfolio Michigan-based companies.

VMF II: \$111.3 million of equity has been invested into 22 Michigan-based portfolio companies.

7. Any upcoming use of tax vouchers that is certain and the timing of that use.

Venture Michigan Fund I: It is currently anticipated that during the State's 2017 fiscal year there will be a need for \$40 million of mandatory tax vouchers to be used, pursuant to the amended loan agreements.

8. An estimate of the potential use of tax vouchers over the 5-year period following the end of the fiscal year.

Venture Michigan Fund I: In addition to \$40 million of tax vouchers to be used in the State's 2017 fiscal year previously referenced, there is a possibility that there will be up to \$20 million of tax vouchers used during fiscal year 2018 and up to \$23.4 million during the State's 2019 fiscal year depending on the timing of proceeds of VMF I.

Venture Michigan Fund II: Based on the latest forecasts, it is currently projected that the first year of tax voucher usage for VMF II will be the State's 2020 fiscal year. Over the next five years (calendar year 2016 through calendar year 2020), total estimated tax voucher usage would be approximately \$71 million (if sold at a 10% discount and total return on the portfolio was 1.0x), with \$8.4 million in the fourth quarter of calendar year 2019 and \$62.5 million in the first through third quarters of calendar year 2020.

From the project team's perspective, a similarly public posting of data specific to the OCIB venture investment program would be useful.

Outcomes

From the prior discussion, the following have been identified as key issues for evaluation:

1. What has been the impact of OCIB on identified goals?
2. How does Oklahoma's experience compare to the nation as a whole and other states?
3. How should the identified costs be weighed against the benefits (both quantitative and qualitative)?

An important factor in considering the efficacy of incentives is consideration of whether the incentive is necessary to spur investment. In the theory of incentives, the 'but for' test refers to the argument that a project or a capital investment would not be made without the incentive ('but for the incentive' the film production would not occur in Oklahoma). In the case of many projects, the existence of incentives in other states can be cited as a need for the Oklahoma incentive – 'but for' the Oklahoma incentive, the project will occur in other states. However, as described in the economic impacts section, that may be difficult to prove or disprove in this instance.

First, it should be understood that the State (through OCIB) is not making direct investments in businesses; rather, it is one of a number of investors that are pooling their resources and, based on the decision of professional fund managers, jointly investing in companies that are judged to have the best opportunity to have a return on the investment within the normal timeframe for venture capital funds. As a result, some of the general 'but for' analysis is likely too far removed from business decisions to be effective.

Second, unlike incentive programs that operate entirely within the State of Oklahoma, the funds that are supported by OCIB (for the Venture Investment Program) may make investments in businesses located throughout the United States. This means that any economic impact analysis must consider the fact that Oklahoma resources are also supporting non-Oklahoma business investments.

OCIB seeks to counter this concern by arguing that its investments create a positive return as it relates to cash in and outflows – that the participating funds as a percentage of total investments put more dollars in Oklahoma companies than OCIB provides as a percentage of its total funds. This is a difficult question related to balance of interests: would OCIB return more on the State's investment in it if it focused entirely on funds investing in Oklahoma (to the extent they exist), even if some long-term performance were sacrificed?

These are issues that do not lend themselves to easy answers, and the longer time horizons for determining whether venture capital investments will pay off create additional uncertainty. In the short term, the fact that the State is participating in venture capital funds – as a way of demonstrating its commitment to Oklahoma start-ups and small businesses, is often what is relied upon in discussions of outcomes.

The following table provides an explanation of historic OCIB investments and data relating to involvement in Oklahoma firms or firms identified as fitting an 'Oklahoma strategy':²¹

OCIB Investments (Venture Investment Program) By Year

Fund	2007	2008	2009	2010	2011	2012	2013	2014	2015 Commitment
Acorn Growth Capital Fund III, LLC			\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Blue Sage Capital, LP	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000
Chisholm Private Capital Partners, LP	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700	\$3,385,700
Davis, Tuttle Venture Partners, LP	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000
Dolphin Communications Fund II, LP	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000	\$6,000,000
Emergent Technologies Oklahoma, LP	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435	\$1,380,435
Intersouth Partners III, LP	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000
Mesa Oklahoma Growth Fund I, LP	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000
Oklahoma Equity Partners, LLC	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000
Oklahoma Life Sciences Fund II, LLC	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000	\$1,750,000
Oklahoma Seed Capital Fund, LLC	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Pacesetter Growth Fund LP	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000	\$3,500,000
Prolog Capital II, LP	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000
Richland Ventures LP	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000
Richland Ventures II, PL	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Rocky Mountain Mezzanine Fund II, LP	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000	\$3,000,000
SSM Venture Partners III, LP	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000
Tullis-Dickerson Capital Focus III, LP	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000	\$7,500,000
Ventures Medical II, LP	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000
Total Commitments	\$68,516,135	\$68,516,135	\$69,516,135						
% in OK-Based Funds	32%	32%	33%	33%	33%	33%	33%	33%	33%
% in Funds with OK Strategy	23%	23%	23%	23%	23%	23%	23%	23%	23%
% of in OK-Based Funds or funds with OK Strategy	54.8%	54.8%	55.4%	55.4%	55.4%	55.4%	55.4%	55.4%	55.4%
Gain/Loss	\$2,461,860	-\$559,675	-\$5,259,027	-\$2,182,924	-\$1,352,141	\$1,180,078	\$2,271,042	\$1,341,683	-\$191,508
Distributions Received	\$5,141,671	\$2,585,347	\$1,110,764	\$37,094	\$3,852,596	\$5,200,906	\$3,305,118	\$4,629,014	\$1,132,108
Advances	\$6,521,746	\$7,121,630	\$3,838,625	\$1,585,553	\$1,013,974	\$1,193,668	\$611,382	\$757,418	\$367,705
Net Gain/Loss	-\$1,380,075	-\$4,536,283	-\$2,727,861	-\$1,548,459	\$2,838,622	\$4,007,238	\$2,693,736	\$3,871,596	\$764,403

As can be determined, OCIB has maintained a policy of investing one-third of its available resources in Oklahoma-based funds, as well as 23 percent in funds that are identified as having an Oklahoma strategy. These are funds that invest in industries that are considered expected areas of growth in the State. According to OCIB yearly reports, these have included bio-tech, healthcare, aerospace and manufacturing.

The following table aggregates these investments by fund and also includes the business headquarters of the funds:

Fund	Commitment	Based
Acorn Growth Capital Fund III, LLC	\$1,000,000	Oklahoma
Blue Sage Capital, LP	\$2,000,000	Texas
Chisholm Private Capital Partners, LP	\$3,385,700	Oklahoma
Davis, Tuttle Venture Partners, LP	\$5,000,000	Oklahoma
Dolphin Communications Fund II, LP	\$6,000,000	New York
Emergent Technologies Oklahoma, LP	\$1,380,435	Texas, but focused on technologies licensed from OU Health Sciences Center
Intersouth Partners III, LP	\$4,000,000	North Carolina
Mesa Oklahoma Growth Fund I, LP	\$3,000,000	Oklahoma
Oklahoma Equity Partners, LLC	\$7,500,000	Oklahoma
Oklahoma Life Sciences Fund II, LLC	\$1,750,000	Oklahoma
Oklahoma Seed Capital Fund, LLC	\$1,000,000	Oklahoma
Pacesetter Growth Fund LP	\$3,500,000	Texas
Prolog Capital II, LP	\$5,000,000	Missouri
Richland Ventures LP	\$4,000,000	Tennessee
Richland Ventures II, PL	\$1,000,000	Tennessee
Rocky Mountain Mezzanine Fund II, LP	\$3,000,000	Colorado
SSM Venture Partners III, LP	\$7,500,000	Tennessee
Tullis-Dickerson Capital Focus III, LP	\$7,500,000	Connecticut
Ventures Medical II, LP	\$2,000,000	Not Found
Total	\$69,516,135	
% in OK-Based Funds	32.6%	
% in Funds with OK Strategy	22.8%	
% of in OK-Based Funds or funds with OK Strategy	55.4%	

One of the requirements of the OCIB statute is that Oklahoma investments constitute \$2.00 for every \$1.00 of investment. The following table, from the OCIB annual report, supports the claim that OCIB has met this statutory obligation – and thus generated that positive outcome for the State:

Fiscal Year	Dollars Invested in OK Businesses
2015	\$14,900,000
2014	\$5,000,000
2013	\$1,500,000
2012	\$8,000,000
2011	\$2,100,000
2010	\$1,600,000
2009	\$11,000,000
2008	\$13,500,000
2007	\$5,200,000
Total	\$62,800,000

Total Invested in OK Companies since inception	\$163,000,000
Total Guaranteed Principal	\$69,516,135
Dollars Invested in Oklahoma Businesses per Principal Guaranteed	\$2.34

The primary difficulty with OCIB – and related venture capital fund of funds approaches – is balancing the short term costs and risks, which can be considerable, with the promise of long-term gains. While the State has invested approximately \$31 million and can point to investment ‘leverage’ in the State, it is an open question as to whether similar investments in other programs targeted at, for example, small business assistance to more financially viable businesses located entirely in the State of Oklahoma might yield a larger (or at least more immediate) return on investment – perhaps with less downside risk.

Recommendations

OCIB is one of multiple State of Oklahoma efforts to increase access to capital for start-up firms. A majority of the states have also provided some form of assistance targeted at increasing venture capital in their state. Most of the evaluations of these efforts to date are inconclusive as to the ultimate impact of these programs.

To its credit, OCIB has sought to identify the overall economic impact from its venture capital efforts. It appears, from the information available to the project team, that there have been positive outcomes from some of their programmatic efforts. Of course, given that OCIB has expended approximately \$30 million of the \$100 million in tax credits provided to them, there have been costs associated with these efforts, and not all of the investments have had a positive ROI. This is the nature of venture capital programs, and other states have experienced similar outcomes.

The analysis of OCIB economic impact indicates that the claimed economic benefits appear overstated. It is understood that OCIB does not take a majority position in any particular fund in which it invests (which is no doubt a prudent move on their part), but the economic gains claimed from OCIB's minority stake in these funds is often the entirety of the additional jobs or capital created within the State. It is also notable that economic impact does not translate into dollar-for-dollar tax revenue for the State – which, of course, would only occur if tax rates approached 100 percent of profits or consumption. As a result, the filtering of economic activity that translates into tax revenue must be taken into consideration – including the length of time it takes to recoup any investment, which, for venture capital, is lengthy.

Given these factors, the project team makes no recommendation as to legislative changes to the existing modifications to the program, including its sunset provisions. The very real additional investment (in the range of \$70 million) versus the possible gains, which are likely many years down the road, do not, with the data available, lend themselves to a straightforward cost benefit calculation.

However, to the extent the program will continue for several years, the project team recommends that reporting requirements related to the program, along the lines of those provided for the State of Michigan's venture capital funds, be enhanced. These would include:

- Number of full-time Oklahoma employees and payroll in companies at the time of investment as well as number currently employed and payroll
- Breakdown of Oklahoma investments by sector by year
- Performance of Oklahoma investments by sector by year
- Return on investments in Oklahoma companies
- Any upcoming use of tax credits that is certain, and the timing of that use
- An estimate of the potential use of tax credits over a 5-year period following the end of the fiscal year