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## FISCAL IMPACT REPORT

ORIGINAL DATE 02/19/13

SPONSOR Muñoz LAST UPDATED \_\_\_\_\_ HB \_\_\_\_\_

SHORT TITLE Small Business Investment Corporation SB 357

ANALYST Walker-Moran

### APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY13	FY14		
	\$13,300.0	Recurring	SBIC

(Parenthesis ( ) Indicate Expenditure Decreases)

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY13	FY14	FY15	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
<b>Total</b>		(\$13,300.0)	(\$998.0)	(\$14,398.0)	Recurring	STPF

(Parenthesis ( ) Indicate Expenditure Decreases)

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Taxation and Revenue Department (TRD)  
 Department of Finance and Administration (DFA)  
 Economic Development Department (EDD)  
 New Mexico Finance Authority (NMFA)  
 State Treasurer's Office (STO)

### SUMMARY

#### Synopsis of Bill

Senate bill 357 amends section 7-27-5.15 NMSA 1978, New Mexico Private Equity Fund and Business Investments, to increase the SIC investment to the small business investment corporation (SBIC) pursuant to the Small Business Investment Act from one percent to 1.5 percent of the market value of the severance tax permanent fund (STPF) to create new job opportunities by providing capital for land, buildings or infrastructure for facilities to support new or expanding businesses and to otherwise make investments to create new job opportunities to support new or expanding businesses in a manner consistent with the constitution of New Mexico.

This section of NM statute allows for such economically targeted investments to be made at below-market rates, should accompanying economic development drivers be deemed attractive enough (by SBIC) to warrant the overall commitment.

The effective date of this bill is July 1, 2013.

### **FISCAL IMPLICATIONS**

This bill increases the investment from the severance tax permanent fund (STPF) to the NM Small Business Investment Corporation (SBIC). This will reduce the amount in the STPF by about \$13 million.

In 2007, the SIC by statute was required to allocate 1 percent of the STPF to the SBIC. Of the \$47 million invested by SBIC, today approximately \$14 million of value has been lost through equity investments made by the SBIC in NM businesses and venture funds. Additionally, \$10 million is currently sitting idle, and un-invested.

According to the SIC, statute regarding SBIC's allocation was last changed in July 2007, increasing the distribution amount from the STPF from 0.75 percent to 1.0 percent. At the time, the STPF was near all-time highs at \$4.701 billion, and the distribution to SBIC was more than \$47 million. Market losses and the subsequent economic crisis in 2008/2009 led to diminished valuation of the STPF, which as of 12/31/12 stood at \$4.018 billion, or almost 15 percent off all-time market highs.

It is worth noting that while the stock markets are again approaching all time highs, and the Land Grant Permanent Fund (LGPF) exceeded its historic values in 2012, the STPF has been unable to recover significantly. The primary driver behind this lag in STPF values is that over the past decade, the STPF has on average distributed \$140 million more per year to the General Fund than has been contributed to the STPF from severance taxes. In comparison, the LGPF historical distributions have been closer to \$1 for every \$.75 of contributions from the Land Office.

Assuming passage of SB 357 and valuation of the STPF at December 31, 2012 market values, the SBIC STPF allocation would increase to \$60.3M, or add approximately \$13.3 million to SBIC funds for FY14. Future year deployments are indeterminate, based on the valuation of the STPF every subsequent July 1.

The STPF would be impacted not only by the proposed FY14 draw down, but also by diminished earning power. Assuming 7.5 percent targeted annualized returns for the STPF, versus no returns achieved by the SBIC on an additional \$13.3 million, first year impact is estimated at a loss of \$997.5 thousand. Compounding over time is likely to increase the overall opportunity cost of this investment to greater than \$1 million per year on the STPF.

### **SIGNIFICANT ISSUES**

According to the SIC, while the SBIC can certainly point to a notable and generally positive track record when it comes to making successful small business loans in New Mexico, up until recently, the SBIC board focused primarily on making – or at least deploying a majority of its capital in - equity investments in NM businesses through venture capital funds. These equity investments have had, at best, a rocky track record, and have suffered overall losses of more than \$14.5 million on \$27.1 million invested. The SBIC has committed another \$5 million to follow-

on future venture investment rounds in 9 early/seed stage venture funds.

It should be noted that 5 of 6 Governor's appointees on the board were changed in 2011, and the board has hired a new Executive Director. Both he and the new board chair have indicated publicly that the focus of the SBIC should be on increasing its credit/debt side of its operations, and making loans to New Mexico businesses through its lending partners. Historically, through FY13, the SBIC has funded 2,419 loans with 5,811 associated jobs. As of June 30, 2012, SBIC has \$12.4 million invested or committed to New Mexico small businesses through its loan program, and \$5.3 million in reserve for investment.

According to DFA, although the fund has likely had some positive impact on jobs and the funding of start-up businesses over the years, the most recent yearly statutory reports indicate a negative 7.36 percent return for FY10, a reduction of 4.5 percent in net asset value in FY11, and a 3.97 percent reduction in net assets in FY12. Furthermore, due to a \$9.5 million loss over the 2007-2010 time period, the FY12 SBIC Annual Report indicates the board is "having on-going discussions about [their] role in partnering with equity/venture partners, in order to avoid the losses experienced in the past."

SBIC is party to two loan participation cooperative agreements with New Mexico non-profit corporations. The loans are considered risky and may have a higher rate of default than traditional loans. For each loan made, these corporations provide 25 percent of the funding and SBIC provides the remaining 75 percent, and SBIC shares in the 75 percent of loan losses and recoveries. These corporations make non-traditional loans; collateral for the loans may also be non-traditional, or in some cases non-existent.

Additionally, there is currently little oversight to the actions of the SBIC. There are several bills proposed now that would increase the reporting requirements of the SBIC to the Council, but for now this board and its small staff are managing a significant amount of money mostly without oversight.

## **PERFORMANCE IMPLICATIONS**

The LFC tax policy of accountability is met with the bill's requirement to report annually to the legislature, the legislative finance committee, the revenue stabilization and tax policy committee and any other appropriate interim committee. The report shall provide the amount invested in each New Mexico private equity fund, as well as information about the objectives of the funds, the companies in which each fund is invested and how each investment enhances the economic development objectives of the state.

According to EDD, the goal of the NMPEIP is to invest in NM based companies that lead to job creation and new capital investment. The program has not made any new fund investments since 2008 due to the 2008 market crash. Presently, the SIC has given the go ahead to review fund options for consideration. In November 2012, SIC presented information that early years of the program generated poor returns at negative 18 percent. After a reassessment of how to improve financial performance and the uptick in strong distributions of the investments, the program was better poised to begin review of future fund investments. To date, NMPEIP continues to deploy funds to NM companies from earlier commitments and is currently operated by Sun Mountain Capital, reporting that current returns have improved slightly at negative 3 percent overall.

Currently the SIC has several legislatively-authorized STPF “carve outs” for New Mexico focused / economically-targeted investments (ETIs), including:

- Up to 9 percent of the STPF for the New Mexico Private Equity Investment Program
- Up to 6 percent of the STPF for the New Mexico Film Investment Program
- One-percent of the STPF automatically allocated the New Mexico Small Business Investment Corporation (SBIC)
- Up to 20 percent of the STPF for bank certificate of deposit investments with NM Financial Institutions (NMSA 1978, Section 7-27-5.19).

Other statutorily available ETI programs also include:

- Up to 20 percent of the STPF for NM Farmers’ Home Administration Loans (NMSA 1978, Section 7-27-5.4)
- Up to 10 percent of the STPF for Educational Institution Revenue Bonds (NMSA 1978, Section 7-27-5.13)
- \$130MM (about 3 percent) of dollar specific STPF-authorized investments

In summary, the STPF currently has 69 percent of its funds earmarked for possible ETI investment. Since being reconstituted in 2010, the Council has made a repeated point that it has an extremely limited appetite for differential or “below-market” rate investments, and has brought additional accountability and standards into its investment and due diligence processes.

There are several factors behind the Council taking a cautious approach regarding these types of investments. The core reason is the poor performance associated with ETIs, and the historically negative impact on the bottom line of STPF performance and returns. The Council, LFC and others have criticized below-benchmark STPF returns resulting from ETI impact on the portfolio. For example:

- From 1993-2004, the NM Private Equity Program was focused on job and industry creation rather than return on investment. Annualized investment returns from 1993-2004 were at negative 18 percent, which notably occurred during some of the historically prime years for venture capital investing. Since 2004, when the focus shifted to investment return, program returns have been positive.
- From 2001-2008, the SIC invested in 25 NM film and television projects, offering zero-interest loans in lieu of profit sharing. While all principal was returned, and certainly the projects brought jobs and spent money in the state, only two films produced profit, and opportunity cost to the STPF was more than \$30 million (compared to investments conservatively made in US Treasury Bills).
- In 2007, the SIC by statute was required to allocate 1 percent of the STPF to the NM Small Business Investment Corporation (SBIC). Of the \$47 million invested by SBIC, today approximately \$14.5 million of value has been lost through equity investments made by the SBIC in New Mexico businesses and venture funds.

It is noteworthy that of the 69 percent of the differential rate investment allowances created by the legislature, it is the SBIC allocation and the SBIC allocation alone which is specifically required to be deployed by statute (“...shall invest...”). All other STPF below-market allocations are left to the prudent investment judgment of the State Investment Council (“...may invest...”).

## CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB9, which focuses on SIC membership and other clean-up statutory language, would allow the SBIC to invest as 17 other state and government entities do, rather than in low return Certificates of Deposit or other treasury-type short term investment accounts. The intent is to allow a more balanced and prudent approach in seeking long-term returns on undeployed capital, rather than limiting it to near zero-rate returns prior to loaning or investing the commitment.

There are some other bills seeking to adjust the guidelines or amounts of investments the Council can consider under NMSA 7-27-5.15

HB240 seeks to create a \$100M non-profit small business development fund using STPF dollars. SB223 seeks to remove the Private Equity Investment Advisory Committee as a statutory entity. HB405 seeks to allow investment from the STPF in bonds funding public/private projects. HB 401 seeks to allow investments from the STPF in New Mexico a business that performs technology transfer, research and development, research commercialization, manufacturing, training, marketing or public relation in any field of science or technology.

## TECHNICAL ISSUES

As pointed out by EDD, the NM Private Equity Investment Program is with the NM State Investment Council; however the bill mentions Small Business Investment Corporation. The NM Small Business Investment Corporation is funded by an allocation from the Severance Tax Permanent Fund. Clarification is needed on the intended fund or agency.

Definition of “NM based business” should correlate in with all legislation – too many varying definitions have been proposed.

## POSSIBLE QUESTIONS

Does the bill meet the Legislative Finance Committee tax policy principles?

- 1. Adequacy:** Revenue should be adequate to fund needed government services.
- 2. Efficiency:** Tax base should be as broad as possible and avoid excess reliance on one tax.
- 3. Equity:** Different taxpayers should be treated fairly.
- 4. Simplicity:** Collection should be simple and easily understood.
- 5. Accountability:** Preferences should be easy to monitor and evaluate