F I S C A L   I M P A C T   R E P O R T

SPONSOR Padilla **ORIGINAL DATE** 01/23/15 **LAST UPDATED** 01/28/15 **HB**

SHORT TITLE Investment in NM Tech Collaborative Companies **SB** 26

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
($900.0)	($900.0)	($900.0)	($900.0)	($900.0)	Recurring	Sev. Tax Perm. Fund
		($8.0)	($16.0)	($32.0)	Recurring	General Fund
See “Fiscal Implications” below						

(Parenthesis ( ) indicate revenue decreases

Duplicates HB66

SOURCES OF INFORMATION
LFC Files

Responses Received From
Economic Development Department (EDD)
Higher Education Department (HED)
New Mexico Institute of Mining and Technology (NMIMT)
State Investment Council (SIC)

SUMMARY

Synopsis of Bill

Senate Bill 26 amends the Severance Tax Bonding Act to require the State Investment Council (SIC) to invest at least .25 percent of the market value of the Severance Tax Permanent Fund (STPF) in private equity funds New Mexico businesses approved by the Technology Research Collaborative (TRC). The bill also reduces from 51 percent to 49 percent the cap on the percentage of the total capital investment that the SIC’s investment may represent.

The bill also repeals 21-11-8.6 NMSA 1978, the statutory foundation for the TRC under present law, and replaces it with a new statutory section. The new section transfers the fiscal administration of TRC from the NMIMT to the Economic Development Department (EDD).

The new section also changes the composition of the eleven-member TRC board and requires monthly, rather than quarterly meetings. The new composition replaces the governor or governor's designee with the secretary of economic development, who may only vote to break a tie. The at-large appointees are now also required to include persons with expertise in the law, investment banking venture capital, entrepreneurship, or technology businesses. The new section also exempts the meetings of the TRC board from the requirements of the Inspection of Public Records Act.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

The fiscal impact on the STPF is likely to be negative, or at minimum, expensive in terms of expected risk-adjusted returns relative to opportunity cost. SIC notes the bill requires about $12 million to be invested in technology businesses in New Mexico, but the return on this investment cannot be reasonably estimated because the businesses that will be invested in have not been identified.

However, using SIC's past experience with various Economically Targeted Investments (ETIs) as a guide, investment returns will be significantly lower than would otherwise be expected for investments with a similar level of risk (early stage venture investments are among the riskiest available in terms of financial returns). Currently, the 10 percent of the STPF that is invested in ETIs is estimated to cost the STPF $40 million annually in forgone returns compared to market rate investments.

SIC notes that, assuming a 0 percent investment returns on nearly $12 million, once fully deployed, the yearly opportunity cost would be approximately $900 thousand had that money been otherwise invested to achieve overall long-term investment returns of 7.5 percent.

Under this scenario, the annual impact on reduced distributions to the general fund from the STPF would grow to approximately $40 thousand once fully incorporated into the 5-year rolling average of the year-end fund market value.

SIGNIFICANT ISSUES

Under current law, SIC is authorized to invest up to 9 percent of the STPF in New Mexican technology businesses based upon review and recommendation by the SIC's private equity investment advisory committee (PEIAC). The amendment maintains the 9 percent cap and the role of PEIAC.

The bill requires that .25 percent of the STPF (roughly $12 million) be invested in New Mexican businesses approved by TRC, but does not address what should happen if no suitable investments can be found, to the satisfaction of both the TRC board and SIC.

The SIC notes SB26 would require that the TRC review and approve or disapprove all equity investments in NM businesses to be made by the State Investment Council under NMSA § 7-27-5.15. While it would be understandable that TRC would approve its own investments, SB26 takes the concept a step farther, effectively giving "veto power" to the TRC over the State Investment Council and its fiduciary authority regarding the full 9 percent of the STPF currently

authorized for NM private equity.
SIC adds that SB26 does not place a time requirement on when the SIC/TRC "shall" invest the $11.7 million into TRC-authorized investments. However, it does require that the investments be made, which puts into question whether investments might be made regardless of whether they meet the quality standards of the Uniform Prudent Investment Act, which governs all investments made by the SIC under law, and is in place to help ensure its investments are made in the best fiduciary interests of the STPF.

EDD notes in its analysis of the bill that many other states, including those bordering or in close proximity to New Mexico, have implemented funded initiatives based on commercialization of new technologies, creating the basis for a strong technology-based, higher wage economy. According to EDD these commercialization initiatives are focused on building a pipeline of opportunities for new, scalable products and service companies, many which could in rural areas and are clean manufacturers. EDD adds, funding is key to building that pipeline by maturing technologies by building prototypes for testing and to gain early customers. New Mexico is rich in technology assets, but without funding, the technologies remain in the lab or university once the research funding is depleted and the economic rewards are not realized.

NMIMT adds that the three research educational institutions in New Mexico contributed almost $325 million in externally funded grants and contracts last year to the state's economy. Some of this research technology is being spun out of the universities into commercial ventures but without additional financial assistance from the state most of the intellectual property becomes dormant within the institutions. With some assistance from the TRC fund, NMIMT points out, the opportunity to develop the intellectual property created by our New Mexico's institutions, partnered with private industry and strategically focused on technology initiatives identified by the TRC may have a positive impact on the state's economy.

PERFORMANCE IMPLICATIONS

The SIC notes that although an $11.7 million investment is relatively small on the scale of a $4.6 billion dollar fund, the potential drag on portfolio performance of compounding 0 percent return investments is well documented. The LFC has previously noted that historic performance of the STPF has lagged the LGPF by as much as 1 percent primarily due to investment underperformance of ETIs including NM venture capital; 0 percent interest film investments, and loss of SBIC equity investments. One-percent of underperformance on a $4.6 billion fund is $46 million annually.

ADMINISTRATIVE IMPLICATIONS

Currently, SIC and its Private Equity Advisory Investment Committee (PEAIC) employ private equity fund managers by making commitments to their fund through the NM Private Equity Investment Program (NMPEIP). The Council and its staff, while responsible for closely monitoring investment decisions made by these NM-based private equity managers, remain passive investors in the process, who rely significantly on the professional managers they have hired to make quality investments. The manager is, in-turn, financially incentivized to make the best investments possible, as if ultimately successful, the manager will share in the profits, or carried interest ("carry"), of a company's exit via sale, merger or initial public offering (IPO).

If the SIC would still be allowed to employ its private equity advisor in this capacity, in tandem with TRC, suitable compensation and/or profit sharing would have to be arranged by the Council or EDD. Such payments and costs are not contemplated by the bill.

OTHER SIGNIFICANT ISSUES

The SIC identifies several other concerns:

- The new TRC board would have an unspecified degree of investment and entrepreneurial expertise, depending on who the members are. SIC adds it is unclear whether members of the board be fiduciaries with fiduciary responsibilities and the (potential) personal financial liabilities that can accompany an investment that later proves imprudent.
- While TRC board members are required to attest annually to any personal, financial or other conflict of interest in carrying out their monthly duties, there is no stated penalty should a conflict become apparent. Without investment professionals driving the investment process, there may be an increased potential for undue political or other inappropriate influence to enter the investment award process.
- EDD would be the new fiscal agent and administrator for the TRC. The SIC notes a similar program has been created in the past to funnel business investments sourced by the EDD into the NM private equity program. The SIC notes the council, after three unsuccessful investments, restructured how these types of investments were made, hiring an outside manager to act as fiduciary and to coordinate future NM private equity commitments.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

The SIC reports it is seeking to remove the PEIAC as a statutory entity, and combine the duties of this committee with that of the Council's Investment Committee. The intent is to allow the Council's strategic investment priorities to be better coordinated by a single committee. The bill, which is not yet pre-filed but has been approved by its sponsor, also seeks additional updates and improvements to the SIC's enabling act. The SIC-backed bill will conflict with SB26.

SB26 duplicates HB66.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Under current law, SIC has the authority to indirectly co-invest in promising New Mexican technology businesses. Accordingly, not enacting the law will not prevent SIC from continuing its efforts to invest STPF assets in such business.

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

PvM/aml/je