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

SPONSOR Trujillo, CA
ORIGINAL DATE 1/26/17
LAST UPDATED
HB 128

SHORT TITLE Investment in Certain NM Businesses
SB

ANALYST Martinez

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY17	FY18	FY19		
($11,700.0)	($11,700.0)	($11,700.0)	Recurring	Severance Tax Permanent Fund
$11,700.0	$11,700.0	$11,700.0	Recurring	TBD Fund
	($5.0)	($15.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From

State Investment Council
Economic Development Department

SUMMARY

Synopsis of Bill

House bill 128 would amend NMSA § 7-27-5.15 to require the State Investment Council to invest 0.25% of the market value of the Severance Tax Permanent Fund (STPF) in NM businesses approved by the Technology Research Collaborative (TRC).

HB128 repeals NMSA § 21-11-8.6, the statutory foundation for the TRC under present law, and replaces it with a new statutory section under NMSA § 7-27-5.15. The new section transfers the fiscal administration of the TRC from the New Mexico Institute of Mining and Technology to the Economic Development Department. The new section also changes the composition of the TRC board and requires monthly, rather than quarterly meetings. The new composition would keep five governor's designees, to be approved by the NM Senate for two-year terms. The at-large appointees would also be required to include persons with expertise in the law, investment banking and venture capital. Other TRC members would include the UNM, NMSU, & NM Tech Presidents, the Directors of Sandia and Los Alamos National Laboratories, or alternately, designees thereof for each. The 11th member would be the EDD Secretary, who would not have voting powers except in the case of a tie. Public members of the board shall receive per diem allowance/reimbursements.

The new section exempts the "meetings" of the TRC board from the requirements of the Inspection of Public Records Act (IPRA). HB128 expands the SIC's semiannual reporting requirements under NMSA § 7-27-5.15, which now requires only a report of the amount of investments in NM businesses, to also include the returns on those investments. HB128 reduces the percentage of a NM business that can be owned by the SIC from 51% to 49%.

FISCAL IMPLICATIONS

House Bill 128 would amend NMSA § 7-27-5.15 to require the State Investment Council (SIC) to invest 0.25% of the market value of the Severance Tax Permanent Fund (STPF) in NM businesses approved by the Technology Research Collaborative (TRC). The SIC states as of December 31, 2016, that the estimated market value of the STPF is $4.67 billion. Therefore, 0.25% would be approximately $11.7 million.

The Severance Tax Permanent Fund (STPF) was created by the New Mexico Legislature in 1973, as a way to save and invest the severance taxes not being used that year to bond capital projects. The taxes originate from oil, gas and other natural resources as they were taken (severed) from the state. Voters later approved constitutional protections for the STPF against legislative appropriation from the corpus of the fund, which coupled with investment returns, allowed the fund to grow. The STPF annually distributes 4.7% of its 5-year average, or about $200 million per year to the state's general fund.

The State Investment Council (SIC) states that the fiscal impact of HB 128 on the Severance Tax Permanent Fund will be indeterminate, but over time is likely negative, or at minimum, expensive in terms of expected risk-adjusted returns relative to opportunity cost. There would be a lot of risk for little chance of reward. HB128 requires that about $11.7 million be invested in New Mexico based technology businesses, but the return on this investment cannot be reasonably estimated because the businesses or proof of concept technology vehicles originating in the national labs or state research universities in which the funds will be invested, have not yet been identified.

Given the SIC's past experience with various Economically Targeted Investments (ETIs) as a guide, financial investment return will be significantly lower than would otherwise be expected for investments with a similar level of risk, as early stage venture investments are among the riskiest available in terms of financial returns. Furthermore, investments at the seed or start-up level often require substantial follow-up investment participation over multiple rounds and years to successfully recoup initial capital and profit. Early investors who fail to, or are unable to participate in subsequent investment rounds often find their original investment capital de-valued, "crammed down" or washed out completely by new investor capital.

According to the State Investment Council, predicting the revenue impact of HB128 is difficult because the SIC's investment results from New Mexico investments have varied significantly depending on the goals of the investments. For example, the performance of the NM Private

Equity Investment Program (NMPEIP), which is operated under NMSA § 7-27-5.15, changed dramatically when the focus of the program shifted from economic development to seeking market rate returns. Since 2004, when the Council hired Sun Mountain Capital to run the NMPEIP with the goal of seeking market rate investment returns, the NMPEIP has produced respectable investment returns of 4.6% annualized. However, in the decade prior (1993-2003), where the focus of the NMPEIP was economic development, investment returns were negative -18.2% annualized.

Given the wide dispersion of possible investment results, the numbers listed on the Revenue Impact table at the top of this analysis is only an educated guess as to the impact of HB128. The numbers are based upon the difference between the STPF net composite return over the last ten years (4.32% annualized) and return on ETIs over same period (-.15% annualized). However, the impact on both the STPF and the General Fund would become significantly greater in later years because of the compounding effect of investment growth and the five year averaging of STPF distributions.[1] For example, if the Revenue table were extended to fiscal year 2021, it would show STPF impact of negative $615 thousand and a General Fund revenue loss of $51 thousand, more than triple the General Fund impact listed for fiscal year 2019.

The State Investment Council notes that this is a rather optimistic revenue estimate used in the chart above. If instead of assuming the TRC would generate returns similar to other ETIs, it is assumed the TRC would generate returns like the NMPEIP did during the decade when it focused on economic development, and then the cost would be much greater. Specifically, under this scenario, by fiscal year 2021, HB128 would cost the STPF over $10 million in lost principle and income, and have an annual negative impact on the General Fund of more than $310 thousand.

The only certain fiscal effect of HB128 is that it will provide the TRC with roughly $11.7 million in seed money. The cost of that seed money in terms of lost STPF investments and distributions to the General Fund, though likely significant, is inherently uncertain.

Further, the SIC has no experience or means to calculate collateral impacts such as potential economic windfalls, jobs or industry creation that may be produced through HB128 investments. Past experience does suggest, however, that it is unlikely that seed stage investments would at some point much later on, be transformed back into positive investment returns to the STPF.

SIGNIFICANT ISSUES

HB128 would require that the TRC review and approve or disapprove all equity investments in New Mexico businesses to be made by the State Investment Council under NMSA § 7-27-5.15. HB128 would allow final say by the TRC over the State Investment Council and its fiduciary authority regarding the full 9% of the STPF currently authorized for New Mexico private equity.

According to HB128, the Governor will appoint 6 of the 11 members to the TRC board. The Governor is also the chair of the SIC, this aspect of HB128, may complicate the process of making investments in New Mexico companies. HB 128 does give significant authority to the TRC regarding the current 9% potential New Mexico venture capital investment of the STPF.

[1] The New Mexico Constitution, Article VIII, Section 10(C), provides that "the STPF annual distributions shall be four and seven-tenths percent of the average of the year-end market values of the fund for the immediately preceding five calendar years." As a result of this 5 year averaging, the full impact of HB128 on the General Fund will not be felt for five years.

The SIC states that many New Mexico venture funds in which the SIC currently invests in are New Mexico based businesses and, under HB128, they could now fall under the purview of the TRC. HB128 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.
Additional significant issues according to the State Investment Council are as follows:

- The new TRC board would have an unspecified degree of investment and entrepreneurial expertise, depending on who the University presidents, Lab directors or their designees are at any given time. The five Governor's appointees "…include persons that have expertise in the law, investment banking and venture capital" is vague, and does not quantify the level or years of experience expected. 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. Potential conflicts may or may not be covered by applicable penalties under the state Governmental Conduct Act, the Gift Act or similar provisions in law.

- 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.

- HB128 exempts TRC meetings from the Inspection of Public Records Act. This leaves an apparent gap where IPRA may require TRC staff to produce documents of a confidential nature. Further, the TRC meetings would still be subject to the Open Meetings Act, which might lead to inadvertent disclosure of confidential information. Consideration should be given to adding express language allowing the TRC to protect documents and discussions that might have economic consequences if revealed to the public. Finally, a need of reporting on the profitability of individual investments requires company-specific detail that would undoubtedly reveal proprietary trade information, and competitive valuation data, which could result in potentially fatal damage to any early stage company, as well as actionable damages incurred by co-investors and other shareholders due to loss of trade secrets.

- The state investment officer (SIO) is tasked with providing an annual report detailing how each investment "enhances the economic development objectives of the state." As TRC would be under the supervision of EDD, it may be that EDD, rather than the SIO, would likely be in a better position to articulate these results, apply economic impact multipliers and the like, which currently fall outside SIC's core mission and expertise.

PERFORMANCE IMPLICATIONS

According to the New Mexico Economic Development Department (EDD), the purpose of the TRC (as defined in HB 128) is to establish advanced technology centers based on the wealth of scientific and technical talent that exists in the participating institutions; to foster the development and creation of new intellectual property for the state; to encourage new opportunities for business and increase jobs; to commercialize the intellectual property created; and to help create a workforce to support enterprises based on the intellectual property that is created. The ability to achieve these goals is predicated on the amount of funding available to the TRC and technology companies. Without funding at early stages, New Mexico's growing technology companies may be at a disadvantage.

The Economic Development Department also states that funding is prudent to building prototypes, testing, and gaining early customers. New Mexico has large research and development assets (3 national labs and 3 research universities), but without early stage funding, the technologies created remain in the lab, never reaching the market and their economic rewards and impact often go unrealized and remain untapped. EDD also states that many other states have implemented funding initiatives to commercialize new technology from their research and development assets. As a result, these initiatives have yielded strong diversified technology based economies and generated high wage jobs. Without a similar initiative, EDD believes that New Mexico will remain at a competitive disadvantage as it strives to grow and diversify its economy.

ADMINISTRATIVE IMPLICATIONS

HB128 states that the TRC Board shall appoint a director and other staff as necessary. Funding for staff will, presumably, be obtained through its "fiscal agent" the Economic Development Department. Staff shall be exempt from the state personnel code. TRC personnel will also prepare annual reports for the legislature. The Economic Development Department has current vacancies that can be repurposed if need be. HB128 could create additional costs related to staffing, document production, auditing, investment monitoring, governmental oversight or any other administrative functions associated with TRC authorized investments.

The State Investment Council employs private equity fund managers by making commitments to their fund through the NM Private Equity Investment Program (NMPEIP). The State Investment 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 financially incentivized to make the best investments possible, as if ultimately successful, the manager will share in the profits, or carried interest of a company's exit via sale, merger or initial public offering (IPO). As referenced earlier, the Council no longer makes direct investments in New Mexico companies, but instead invests only with private equity managers, relying on their abilities and expertise. HB128 would seem to remove the SIC's experts from the equation, however, replacing them with the TRC. 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 proposed by the bill.

TECHNICAL ISSUES

The SIC states that the new language on page 2 line 16 would seem to indicate that the SIC can only make commitments to NM private equity and to TRC approved entities if they are in a "fund structure." The SIC also states that as drafted, the language may prevent direct investment in technologies that seek to be commercialized from the national labs and New Mexico's research universities.

OTHER SUBSTANTIVE ISSUES

While there is a reporting requirement placed/maintained at the SIC level, there does not appear to be substantive methodology in how the TRC is to record, document or report company-level or investment valuation data.

ALTERNATIVES

As the legislature did when it created the Small Business Investment Corporation (SBIC), the legislature has the authority to carve out the 0.25% STPF allocation without including the SIC as fiduciaries in this process, leaving the investments solely in the hands of the TRC, as it did with the SBIC board.

The SBIC's legislation is the only ETI language that, like HB 128, explicitly requires investment through the use of the words "shall invest," versus all other ETI legislation which is permissive, allowing the SIC to make prudent investments only at its discretion. Changing "shall be invested" to "may be invested" on page 2 line 6 of the bill would allow the Council greater fiduciary discretion regarding TRC investments.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Under current law, the SIC has the authority to indirectly co-invest in promising New Mexican technology businesses and does so frequently. Failing to enact HB128 will not prevent SIC from continuing its efforts to invest STPF assets in such technology business.

JM/al/jle