FISCAL IMPACT REPORT

ORIGINAL DATE 2/13/19
SPONSOR Cisneros **LAST UPDATED** **HB**

SHORT TITLE Severance Tax Fund Small Business Investment **SB** 10

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	FY20	FY21	FY22	FY23		
$0.0	($50,000.0)	(Indeterminate)			Recurring	Severance Tax Permanent Fund
$0.0	$50,000.0	Indeterminate			Recurring	Small Business Investment Corporation

Parenthesis ( ) indicate revenue decreases

Relates to SB30 and HB289

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

Senate Bill 10 seeks to increase the amount of Severance Tax Permanent Fund (STPF) capital dedicated for investment through the Small Business Investment Corporation from 1 percent of the STPF to 2 percent, with the goal of increasing state participation in loans to small business owners in New Mexico. There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

The bill does not include an effective date, but given the total dollars involved are based on a fiscal-year-end value for the STPF, the practical impact of the bill's additional funding would be based on 6/30/19 valuations and occur during FY20.

Since inception in 2001 to the end of FY18, the SBIC reports it has facilitated more than 4,500 loans that have supported more than 12,000 jobs across 223 communities across the state.

The SBIC annual report cites an economic impact study by UNM's Bureau of Business and Economic Development (BBER) that projects for every $1 million in loans granted by the SBIC, 12 new jobs were created while 21 other jobs were saved.

SBIC also reported positive investment returns for the fiscal year ending 6/30/18, with a positive change in net assets of $2.1 million. State Investment Council (SIC) staff report that of that growth, $459 thousand came from investment returns, while the other $1.6 million was delivered through the annual "right-sizing" of the current 1 percent allocation from the STPF, which occurs on an annual basis in any year the permanent fund sees year-over-year growth of its corpus. The investment gains – as cited in the SBIC audit – were a positive 1.19 percent for FY18.

Historical investment returns SBIC were not as strong. SIC staff state the SBIC has been and continues to be negatively impacted by its equity investments in New Mexico-focused venture capital funds, which have resulted in approximately $9.9 million in losses since inception. SIC staff indicate most of the losses were due to commitments made over a decade ago, which were authorized by a different governing board and executive director. SIC staff indicate today's SBIC largely abandoned the practice of making risky venture capital investments and instead focuses on its core mission of delivering small business loans to New Mexicans via lending partners. For the most part, that aspect of SBIC efforts have been successful and have created and supported employment at a significantly lower cost than the much smaller number of venture capital investment related jobs. As captured in the BBER analysis, SBIC opportunity cost for jobs created through loans was on average $4,717 per position, while equity-investment driven jobs on average cost more than $29k/job.

According to SIC staff, SBIC equity investments in New Mexico are being carried at a value of approximately $9.8 million as of the end of FY18, or about half of the net dollars invested. While those returns could improve as stakes in existing companies are exited, there is also a high potential for additional losses to be realized.

The bill does not specifically give direction on how SBIC should deploy the additional 1 percent of capital. SBIC has informally indicated to SIC staff that it has the ability to scale up operations on its lending program, though they reportedly have not shared any plans on how that might be accomplished. SIC staff also state that SBIC has not indicated any plans to deploy any new capital via equity investments in New Mexico companies, which staff point out would potentially be a red flag, given past history.

SIGNIFICANT ISSUES

SIC staff provide the following additional discussion:

> "The SBIC currently has multiple millions of capital that it has not yet deployed either through its loan or equity investment programs. This money may be committed through those programs as committed follow-on investments, but it has not yet been drawn down. As of 12/31/18, the SBIC has invested $8.45 million of non-deployed capital into a separate "client" account with the SIC. These dollars – which originated from the 1 percent STPF

allocation – are currently invested in a low-risk core-plus bonds pool, alongside other permanent fund and client dollars. SBIC may have additional short-term investments in certificates of deposit with New Mexico banks. The status of the SBIC's short-term, non-business investments is not clear, and whether those dollars should be counted toward existing SBIC loan/investment capacity is something that policy makers may want to fully understand prior to doubling down on the SBIC allocation from the STPF."

PERFORMANCE IMPLICATIONS

SIC staff indicate that, historically, the SBIC has not produced any substantive positive financial returns to the STPF, and currently carries its investment value at a multi-million dollar loss. This lack of financial returns is allowable under the SBIC statute in the Severance Tax Bonding Act (NMSA 7-27-15.5), which specifically recognizes the value of jobs and industry-creation that help offset less-than market rates of investment return.

While the SIC believes additional dollars deployed to the SBIC under its current strategy would not be likely to result in significant loss of principal, there is also a limited expectation that SBIC investments will ever produce a "market rate" of return that would help the STPF accomplish its long-term investment return target of 6.75%. While statute is very clear that certain STPF investments have a statutory mandate to achieve both financial returns as well as job-creation goals, the SIC may need to seek additional high-risk/high-return investments help offset an additional 1 percent lag on overall fund financial performance. As the total amount of differential-rate investments increases in the STPF portfolio, this could potentially increase the level of risk to the long-term health of the STPF and the hundreds of millions ($225 million in FY20) it delivers to the state's general fund every year.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Senate Bill 30 seeks a new STPF authorization of one-fourth of 1 percent (0.25 percent) to be invested in early stage technologies emerging from state universities and the national labs.

House Bill 289 seeks to require an additional 1 percent investment of the STPF in broadly-defined renewable energy opportunities in New Mexico.

TECHNICAL ISSUES

Historically, the SBIC's 1 percent allocation has been treated as a stand-alone carve-out in statute, completely separate from the current 9 percent allowance of STPF investment in New Mexico businesses and private equity funds under the NM private equity investment program (NMPEIP). However, questions have arisen recently whether the SBIC's 1 percent should be included as part of the NMPEIP 9 percent. Upon review of the pertinent statute and its definitions, SIC does not believe this is the case. The reasons include the long-standing interpretation of law that the two allocations being separate, but also more specifically the following:

The SBIC is neither a business nor private equity fund as identified in Section 7-27-5.15 NMSA 1978 regarding the 9 percent authorization. Section D provides:
(1) "New Mexico business" means, in the case of a corporation or limited liability company, a business with its principal office and a majority of its full-time employees located in New

Mexico or, in the case of a limited partnership, a business with its principal place of business and eighty percent of its assets located in New Mexico; and

(2) "New Mexico private equity fund" means an entity that makes, manages or sources potential investments in New Mexico businesses and that:

(a) has as its primary business activity the investment of funds in return for equity in or debt of businesses for the purpose of providing capital for start-up, expansion, product or market development, recapitalization or similar business purposes;

(b) holds out the prospects for capital appreciation from such investments;

(c) has at least one full-time manager with at least three years of professional experience in assessing the growth prospects of businesses or evaluating business plans;

(d) is committed to investing or helps secure investing by others, in an amount at least equal to the total investment made by the state investment officer in that fund pursuant to this section, in businesses with a principal place of business in New Mexico and that hold promise for attracting additional capital from individual or institutional investors nationwide for businesses in New Mexico; and

(e) accepts investments only from accredited investors as that term is defined in Section 2 of the federal Securities Act of 1933, as amended (15 USCA Section 77(b)), and rules and regulations promulgated pursuant to that section, or federally recognized Indian tribes, nations and pueblos with at least five million dollars ($5,000,000) in overall investment assets.

According to SIC staff, SBIC arguably does not fit the definition of either a New Mexico business, or a New Mexico private equity fund, though additional clarity might be considered should this bill need to be amended.

OTHER SUBSTANTIVE ISSUES

Under current law, only the SBIC allocation of 1 percent is required to occur, while all other economically targeted investment (ETI) allocations come at the fiduciary discretion of the State Investment Council.

In aggregate, there are multiple aspects of the Severance Tax Bonding Act that authorize various ETI strategies. These ETI "carve outs", if fully implemented, would result in more than three-quarters of the STPF being placed in "below market" investment strategies:

- Up to 9 percent of the STPF in NM private equity
- Up to 6 percent of the STPF in NM Film Loans (policy now dictates a market rate of interest)
- Up to 20 percent of the STPF in bank CDs with NM financial institutions
- Up to 20 percent of the STPF in NM Farmers Home Administration Loans
- Up to 10 percent of the STPF in Educational Institution Revenue Bonds
- About $130 million in dollar-specific STPF-authorized investments

Generally, the legislature has not overridden fiduciary duties of the Council to prescribe potential ETI strategies, rather leaving them at the discretion of the SIC. SBIC is the only mandatory ETI currently in law, and this bill would continue to require SBIC investment, but at a 2 percent cap rather than 1 percent.

ALTERNATIVES

SIC staff provide the following alternative:

> "Rather than providing the full 2 percent in an annual payment to correct the total dollar allocation as of each June 30 every year, the SBIC's allocation could be drawn down as needed periodically – say every quarter - leaving the funds invested via the STPF until called for investment by SBIC. This structure, which would require an amendment of [this bill], could produce additional long-term financial returns in the permanent fund's well-diversified portfolio, rather than being placed into short-term fixed income investments as the SBIC currently does, as they appropriately seek to preserve, rather than grow their capital."

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