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

SPONSOR	Dixon/Serrato/ Martinez/Maestas/ Hickey	**ORIGINAL DATE** **LAST UPDATED**	1/14/22 2/09/22	**HB**	104/aHAFC
SHORT TITLE	Venture Capital Program Act			**SB**	
				ANALYST	Taylor/Torres

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY22	FY23	FY24	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
$250.0	$1,500.0	See fiscal implications		Recurring	Venture Capital Investment Fund

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Economic Development Department (EDD)
New Mexico Finance Authority (NMFA)
New Mexico Attorney General (NMAG)
State Investment Council (SIC)

SUMMARY

Synopsis of HAFC Amendment

The House Appropriations and Finance Committee amendment to house bill 104 removes the requirement that investments be made to businesses in industries as determined by the statewide economic development strategic plan. The amendment now allows investment in any industry, so far as it "enhances the economic development objectives of the state."

Synopsis of Original Bill

The bill creates the Venture Capital Investment Act and the venture capital investment fund under the New Mexico Finance Authority (NMFA). The purpose of the fund is to make investments in new, emerging or expanding business in New Mexico that create new job opportunities. These investments are required to be made with venture private equity funds or with New Mexico businesses in early stages of development, where the investments enhance the economic development objectives of the state.

The effective date of this bill is July 1, 2022.

FISCAL IMPLICATIONS

Though the bill creates the venture capital program, the bill does not include an appropriation to the fund for this purpose. HB104 allows for continuing appropriations to NMFA from the fund for the purpose of the venture capital program. The HAFC substitute for House Bill 2 includes $50 million appropriated for this purpose contingent on enactment of this or similar legislation. The newly created fund consists of appropriations, gifts, grants, investments made, and other transfers into the fund. The balance of the fund does not revert to the general fund.

New Mexico Finance Authority is authorized to draw on the fund to cover operational costs associated with the program. A similar program operated by the State Investment Council requires at least 2 FTE at a cost of about $250 thousand, before investment fees. It is likely this program will cost at least $250 thousand to create a similar program, before investment related fees. These costs would be covered by the fund and would not require appropriation.

Private sector managers of venture capital programs typically charge management fees per annum of two to five percent of total assets under management. Private sector managers also typically charge a performance fee of ten to twenty percent of total assets deducted from realized investment returns. A more refined estimate would depend on program strategy and instrument mix that is not defined at this stage. NMFA will evaluate the appropriate structure of and fees for the program as it develops rules and policies for the Fund. NMFA will incur costs specific to the Venture Capital Program, such as specialized legal and consultancy services. These program specific costs and other costs of administration will be paid from the fund.

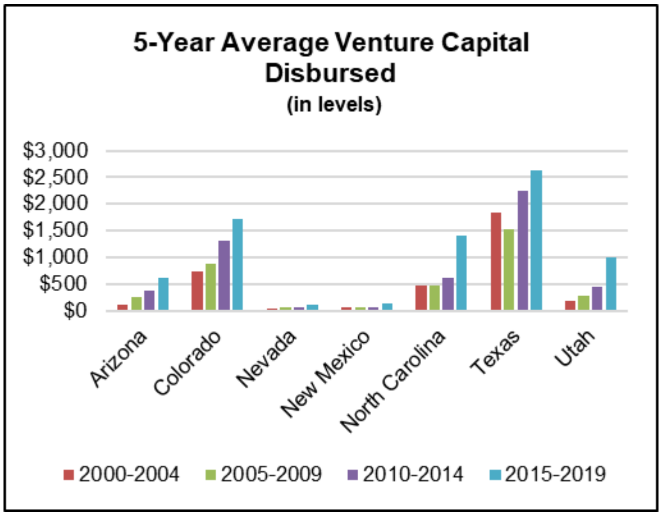
NMFA is required to have an individual bond or a blanket bond for an amount and coverage deemed best to protect the state's interest from claims against the program. The bond premiums shall be paid by the fund.

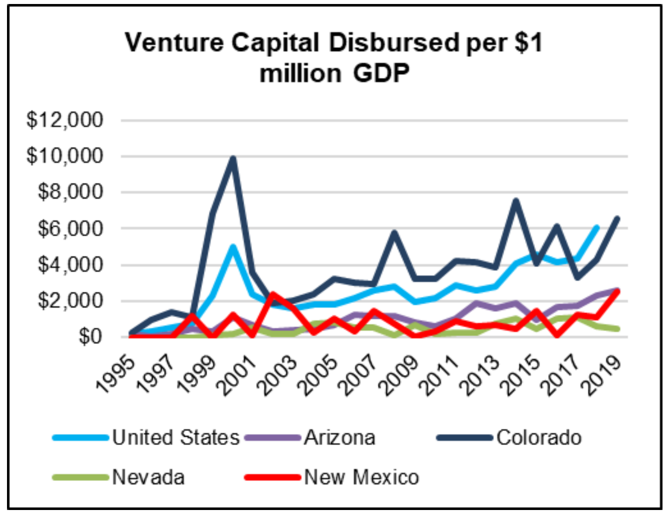
SIGNIFICANT ISSUES

NMFA is charged with administering the fund and is required to adopt rules governing the terms and conditions of investments from the fund. Investments are to be made using cooperative investment agreements with parties that have demonstrated abilities in making investments in new, emerging or expanded businesses. No investment may exceed 10 percent of the total balance of the fund or represent more than 51 percent of total investment capital in a business. Investments require approval from the NMFA board of directors.

The bill seeks to address a lack of available venture capital funding in New Mexico that allows the state to retain and attract businesses in early stages of development. Data from the National Science Foundation[1] and the National Venture Capital Association indicate New Mexico has a significant gap in venture capital available to local businesses on a per GDP dollar basis, when compared nationally or to peer states.

[1] https://ncses.nsf.gov/indicators/states/indicator/venture-capital-per-1-million-state-gdp





The Economic Development Department reports:

> This program could fill gaps within the current landscape and look to assist underserved New Mexico business owners and address shortfalls in available capital in early seed stage and Series A funding. It could help address the significant shortcomings in the state's ability to assist startup companies form and grow as noted in the state's recent 20-year economic development strategic plan. The result could be an improved entrepreneurial ecosystem, more jobs, more investment, and more opportunities for New Mexicans to create new careers.
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> When the program is developed, key factors to consider are making the program responsive and flexible to meet the needs of the market. Insight gathered from investment firms and other stakeholders point to the following as impediments for some New Mexico companies to access funding:
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> - Too early stage
> - The industry does not fit the investment firm's desired portfolio or meet return requirements
> - Business leaders lack technical or managerial skills
> - There is a gap between seed stage and series A funding
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> New Mexico is receiving approximately $76 million through the federal State Small Business Credit Initiative over the next 10 years, which will help fund multiple venture capital funds. This fund will be administered by EDD. The fact that EDD has a seat on the NMFA Board would allow for collaboration between the two programs and avoid overlap or conflict as well as align this program with the state's 20-year strategic plan.
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> Many socially and economically disadvantaged New Mexico business owners struggle to access funding; there is an opportunity to expand the focus and reach of this program and increase capital access to underserved populations. Additionally, many New Mexico businesses need technical assistance related to technology transfer, accounting, and legal issues. It would be beneficial for the bill to allow for expenses related to technical assistance and business development support.

The New Mexico Finance Authority adds:

> HB104 provides a secondary source of state-supported seed capital for emerging New Mexico businesses. Similar programs administered by the SIC have been successful in helping spur economic development while generating returns for their portfolios, which is a primary goal of the SIC. While structured very similar to the SIC-administered NM PEIP, the Venture Capital Program Fund's intent appears to be more focused on impact rather than income generation. Placing this secondary program at NMFA allows for businesses not currently served by the NM PEIP to access early seed equity capital.
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> If the intent is to provide a different model for early seed venture capital and thereby broaden the number of businesses that could be served by state-support capital, NMFA suggests revising Section 3 and where relevant throughout to include language specifying that the Fund makes "differential rate investments for economic development purposes". This will address questions surrounding the prudent investor rule and is consistent with the investment policy of the NM PEIP. NMFA also suggests the legislature consider eliminating the requirement of cooperative investment agreements as it may impede investments in early-stage businesses and venture private equity funds because many investors prioritize revenue generation over impact generation thereby limiting the number of investments that could be made. Similarly, the 10 percent threshold in Section 4.B.2 may be difficult to achieve, particularly during portfolio ramp-up and it may be prudent to achieve a higher sector concentration for economic development purposes.

The New Mexico Attorney general notes it is unclear whether HB104 comports with the anti-donation clause of the New Mexico constitution if companies default. LFC notes the program is structured analogous to the State Investment Council private equity statute.

The State Investment Council notes the following:

> Despite the SIC program having both grown and evolved in its strategies over the almost 30 years it has existed – with the strategic focus shifting from investment with regional funds to local VC managers, to direct investments for a short time, to co-investment funds, and more recently, the inclusion of an emerging NM manager program. Current efforts also emphasize working with regional/national funds that have greater domain and technical expertise that can help New Mexico companies scale nationally, with the goal towards acquisition or Initial Public Offering.
>
> Historically the track record of the program has been mixed.

NM SIC Regional Private Equity Performance (by Portfolio)

As of June 30, 2021 ($ in millions)

Portfolio	# of Funds	Commit.	Contributed	Distributed	NAV	Total Value	Net Multiple [1] 6/30/2021	Net Multiple [1] 6/30/2020	Net IRR [1] 6/30/2021	Net IRR [1] 6/30/2020
Active Commitments										
Catalyst Fund	1	$ 10.0	$ 4.6	$ 0.0	$ 4.7	$ 4.7	1.03x	1.03x	1.2%	1.7%
Co-Investment Funds	5	197.6	205.4	12.6	271.6	284.3	1.38x	1.40x	4.5%	5.3%
Fund Investments	25	255.8	197.9	113.5	148.3	261.9	1.32x	1.10x	4.0%	1.4%
Recovery Fund	1	100.0	92.7	4.8	87.4	92.2	0.99x	0.99x	(0.9%)	(2.1%)
Sub-total	32	$ 563.4	$ 500.6	$ 131.0	$ 512.1	$ 643.0	1.28x	1.23x	4.1%	3.3%
Liquidated Funds	15	150.7	151.2	91.6	-	91.6	0.61x	0.49x	(6.2%)	(10.3%)
Grand Total	**47**	**$ 714.1**	**$ 651.7**	**$ 222.6**	**$ 512.1**	**$ 734.6**	**1.13x**	**1.06x**	**1.7%**	**0.9%**

Source: Invient
[1] Performance since inception

> …However, the NM Program underperforms financial metrics relative to SIC's national

private equity investments, and the benchmarks for national venture capital and private equity.

Returns as of Sept. 30, 2021	Q	1 year	3 years	5 years	7 years	10 years
NM Program Returns	2.61	10.43	-1.83	4.69	4.84	6.02
National PE Returns	13.09	50.05	20.61	18.4	14.46	13.36
Cambridge US PE Index	12.95	53.9	20.68	19.57	15.57	15.36
Cambridge US VC Index	12.09	87.84	37.04	26.77	22.22	19.83

The chart above from SIC advisor RVK shows the most recently available performance report from September 2021. It shows NM Program investments have substantially underperformed venture capital investment metrics nationally and have also lagged similar private equity investments SIC made in nationally and internationally-focused private equity funds.

Another concern is that the existing return metrics for the NM Program are based on investments that are largely unrealized. Until the fund manager sells the assets/businesses they have invested in, there is always a question regarding the ultimate outcome and whether valuations will decline prior to an exit. Venture capital investments traditionally see a success rate of only about 2 of 10 companies succeeding, with the majority being written off completely. Successful VC funds rely on the "home runs" in the portfolio to make up for the far greater number of companies that will fail. While there have been successful exits, and there remain promising companies in the NM Program, to date there has not been a "home run" investment realized…

While the VCPA would seem to be independent of the existing investment program managed by the SIC, duplication of efforts and the small eco-system in which both entities will operate, reasonably ensure there will potentially be competition for capital which could result negatively for one or both programs.

This occurred historically to a degree in the early 2000s when the Small Business Investment Corporation elected to use a portion of its allocation from the STPF to invest in NM-venture funds. This resulted in some cases with the SBIC investing in funds in which SIC had already committed capital, and in other cases SBIC investing in funds the SIC had previously rejected. In its 2021 annual report, SBIC indicated that historically it had made $19.4 million in net NM venture investments, with $12.6 million in losses, for an estimated cost per job of $36,132. SBIC has since almost entirely abandoned new efforts to invest in venture capital, citing high fees, limited funding dispersion outside the Rio Grande corridor, and concerns that equity investments "…do not generate significant job creation during their initial phases of development."

…There are other risks and considerations that should be weighed prior to investing in venture capital:

- Venture capital as an asset class is not only one of the most complex investment strategies but also one of the riskiest. Dispersion of ultimate outcomes between top and bottom quartile performers is usually the largest in venture capital.

- The nature of venture capital is 1) by necessity - very selective investing because most of these investments will lose some or all of your principal and 2) the process is ongoing since these small companies realistically will not make money for a long time and will require multiple rounds of follow-on capital.
- Direct investments, made outside of an independent external manager, have a higher potential for politicization. When SIC made three direct investments in local companies in the early 2000s, allegations of political influence were made. The three investments later failed, and the SIC no longer makes direct investments.
- In HB104, there is an allocation limitation of 10% on investments in any one industry. While diversification should be sought, this limitation is arbitrary and unlikely a term any legitimate VC would accept. Around 25% of VC investments nationally in 2018 were in the software sector.
- The indemnification bond sought under HB104 will be expensive and may not be needed.
- The NM Program at SIC is governed under the Uniform Prudent Investment Act, as well as the statutory authority to make differential rate investments (NMSA 7-27-5.15). It is not clear from the bill what investment standards under which NMFA will operate.

PERFORMANCE IMPLICATIONS

NMFA is required to submit a report by July 1 of every year to the Legislative Finance Committee, the Revenue Stabilization and Tax Policy Committee and any other appropriate interim legislative committee. The report will provide information for the prior calendar year on the amounts invested with each venture private equity fund, the companies in which the venture private equity fund is invested and how each venture private equity investment enhances the state's economic development objectives.

TECHNICAL ISSUES

The bonding requirement of Section 5, in subsection A, does not specifically refer to the act or the fund. To address the lack of clarity regarding bonding requirements, the bill could include "for the venture capital program" in Section 5A following "upon the employee's duties" on page 5 line 16.

Replace "only on warrants" with "as" in Section 3 A, page 3, line 16. The mechanics governing Fund disbursals as warrants are not operationally relevant for NMFA.

AMENDMENTS

NMFA proposes the following changes:

> The following language should be added to HB104 in order to protect confidential information collected by the NMFA during venture capital investment underwriting from disclosure. "Information obtained by or on behalf of the authority that is confidential or proprietary technical or business information of a New Mexico business or venture private equity fund shall be confidential and not subject to inspection pursuant to the Inspection of Public Records Act [14-2-4 NMSA 1978]."
>
> NMFA recommends revising Section 3 and where relevant throughout to include language specifying that the Fund makes "differential rate investments for economic

development purposes”. This may assist in clarifying the Legislature’s intent that investments are made to enhance economic development objectives.

Remove the Section 4.B.1 requirement of cooperative investment agreements; this provision could impede investments in early-stage businesses and venture private equity funds.

In Section 4.B.2 change the limit in any one business or industry to 30 percent of the fund balance and move this limit to the jurisdiction of the program policies subject to approval by the NMFA Board of Directors; 10 percent would be difficult to achieve particularly during portfolio ramp-up and it may be prudent to achieve a higher sector concentration for economic development purposes.

IT/acv/al