Fiscal impact reports (FIRs) are prepared by the Legislative Finance Committee (LFC) for standing finance committees of the Legislature. LFC does not assume responsibility for the accuracy of these reports if they are used for other purposes.

FISCAL IMPACT REPORT

		LAST UPDATED	3/15/23
SPONSOR	Hickey	**ORIGINAL DATE**	3/7/23
SHORT TITLE	NMFA Venture Capital Program	**BILL NUMBER**	Senate Bill 402/aSFC
		ANALYST	Torres/Graeser

APPROPRIATION
(dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY23	FY24		
	0	Nonrecurring & Nonreverting	General Fund

Parentheses ( ) indicate expenditure decreases.

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
	No Direct Impact; eventually, this investment may lead to increased GRT & Income taxes				Recurring	General Fund
	No Direct Impact; eventually, this investment may lead to increased GRT				Recurring	Local Governments

Parenthesis ( ) indicate revenue decreases.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	$1,050.0	$1,050.0	$2,100.0	Recurring	NMFA Operating (3% of Venture Capital Fund)

Parenthesis ( ) indicate expenditure decreases.

Section 5 of CS/HB2 allocates $15,000.0 for NMFA Venture Capital.

Sources of Information
LFC Files

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

SUMMARY

Synopsis of SFC Amendment to Senate Bill 402

Senate Finance Committee amendment to Senate Bill 402 struck the $35 million appropriation. HAFC Committee Substitute for HB2, as amended by the Senate Finance Committee allocates $15 million for the NMFA Venture Capital program.

Synopsis of Original Senate Bill 402

Senate Bill 402 amends the 2022 Venture Capital Program Act, which created the venture capital program fund within the New Mexico Finance Authority (NMFA) and authorizes NMFA to make investments from the fund in New Mexico businesses and venture private equity funds that make, manage, or source investments in New Mexico businesses that enhance economic development objectives of the state.

The bill removes the requirement that venture private equity funds raise matching investment funds, removes the requirement that investments in New Mexico businesses be made in conjunction with cooperative investment agreements, increases the maximum investment in any one industry to 30 percent (from 10 percent), allows NMFA to make differential rate investments for the purposes of economic development, removes the requirement that NMFA obtain a bond or blanket bond for employees performing duties related to the administration of the act, and adds protection from the Inspection of Public Records Act for confidential, proprietary technical, trade secret, or business information obtained by NMFA for purposes of administering the act.

The bill makes an appropriation of $35 million from the general fund to the venture capital program fund in FY24 for investments pursuant to the Venture Capital Program Act. Any unexpended or unencumbered balance remaining at the end of a fiscal year shall not revert to the general fund.

This bill does not contain an effective date, and as a result, would go into effect June 16, 2023, (90 days after the Legislature adjourns) if signed.

FISCAL IMPLICATIONS

NMFA notes a moderate administrative (operating budget) impact:

> NMFA currently administers $35 million in the Fund that was created and capitalized by the Legislature in 2022. The Fund is administered by NMFA staff and external consultants and/or managers of venture private equity funds with specialized expertise investing in early-stage businesses.
>
> NMFA costs related to administration of the Fund include direct staff costs and professional services fees paid to specialized consultants, fund managers and related legal and accounting service providers. NMFA estimates total administrative costs of three percent (3 percent) of the Fund, which is commensurate with the cost of fund management, legal and accounting fees charged by private sector managers of venture and private equity funds.

EDD notes the following:

> The proposed appropriation would fund a venture capital (VC) program that is intended to complement the Economic Development Department's (EDD's) VC program and fill gaps that exist in equity capital available to New Mexico companies. EDD received an allocation of up to $65 million that is targeted for VC investment in New Mexico companies from the State Small Business Credit Initiative (SSBCI) which was federally

funded by the American Rescue Plan Act (ARPA). Unlike the proposed NMFA program, the SSBCI program has a private investment requirement of at least 1:1 with a target of 10:1.
EDD's statewide economic development strategic plan states that the key to an innovation ecosystem is the availability of equity capital to support the research, development, commercialization, and scaling of innovative technologies and ideas. Equity capital can take many forms, including venture capital, private equity investors, angel investors, and investments from accelerator or incubator programs.

Data from the National Center for Science and Engineering Statistics found in 2019 that about 1.5 venture capital deals were made for every 100,000 of the population in New Mexico, ranking the state 35th in the United States.

A consistent challenge cited by stakeholders in New Mexico was the accessibility of different financing mechanisms within the state, particularly for entrepreneurs seeking pre-seed and early-stage funding. This challenge has been experienced in many U.S. states, given that three states capture 75–80 percent of venture funding in the United States. Most states have responded to this challenge by implementing creative tax incentives, such as those supporting research intensive startups, or by establishing a state-funded venture capital fund or "fund of funds." New Mexico utilizes a number of tax incentives to support venture funding, including an angel investment tax credit, and maintains a few different funds that target investments in New Mexico-based startups.

The full and summary reports can be found on EDDs website at:
https://www.eddstateplan.com/

SIC has similar comments:

It is the understanding of the State Investment Council (SIC) that NMFA is currently at work developing policies and practices to initiate the original $35mm Venture Capital Program passed into law in 2022. The SIC and others are serving in an advisory role in this process, as well as in a similar process with the NM Economic Development Department, as it looks to create a similar venture investment program using ~$74mm it was awarded by the State Small Business Credit Initiative (SSBCI), a federal stimulus program targeting economic and business development in the United States.

The SIC has had a NM-focused venture capital investment program since the early 1990s, with statutory goals similar to that of the NMFA Venture Capital Program. Both programs authorize "differential rate", or below-market rates of financial return in lieu of job and industry creation via investment. The SIC's program (7-27-5.15 NMSA 1978) allows up to 11 percent of the $7.64 billion Severance Tax Permanent Fund to be invested in NM VC/businesses, though the Council targets up to 9 percent ($688 million) through policy bands.

While each of these programs has differences from the others, there is potentially considerable overlap amongst the efforts, as they share the core mission of investing with venture capital funds that will in turn create, support and grow New Mexico companies.

Whether SB402 passes or not, in the short term at least, the state's support of NM start-up business and entrepreneurs will have never been better funded or with as many public resources for those seeking venture capital investment.

SIC's total private equity program (national, international & NM) is overseen by the 11-member Council, and staffed with a program director and analyst, with additional external due diligence performed by an independent advisor, Mercer. Private equity also requires substantial legal expertise given the highly complex nature of the partnership agreements involved. The New Mexico portion of the SIC's private equity investment program would account for roughly ¼ of the annual costs, though often the time required for NM-focused investments is substantially more than that. A fair estimate of the SIC's annual costs around the NM-program would be $350k.

SIGNIFICANT ISSUES

NMFA identifies obstacles to success:

[LFC note: … if the modifications proposed in this bill are not enacted …] restrictive statutory requirements in the Act specific to investment policy parameters may constrain capital deployment and impede the ability of NMFA to raise additional capital in the Fund to support early-stage New Mexico businesses.

In more detail, SIC identifies the changes sought in the Venture Capital Investment Act:

- Removal of a requirement that the venture fund manager hired by NMFA bring co-investment dollars of equal or greater value to the investment deal;
- That the investments be made with a manager that has demonstrated abilities and expertise in this investment strategy;
- A new requirement that an investment in any one industry cannot exceed 30 percent of the balance of the venture capital program fund;
- An allowance that the NMFA may make differential rate investments for economic development purposes;
- Removal of a "blanket bond" indemnifying NMFA personnel from any future litigation around any investment; and
- An exclusion to the New Mexico Public Records Act, protecting any proprietary, trade secret or other business information from disclosure to the public.

Many of these changes have been suggested as NMFA has worked to develop the practical requirements around such an investment program. The SIC, in its program, has similar requirements and boundaries set through either statute, policy, and/or practice.

EDD also points out significant features proposed by the provisions of this bill:

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The full and summary reports can be found on EDDs website at:
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PERFORMANCE IMPLICATIONS

NMFA bears the administrative burden of ensuring that this investment is appropriately used:
The requirements that venture private equity funds raise matching investment funds pose impediments to capital deployment. The Fund seeks to provide promising New Mexico businesses with capital in the early stages such that the businesses may subsequently attract additional private sector investors. The Fund may invest in venture private equity funds that lead investment rounds for early-stage businesses where there may not yet be demand from private sector investors. The matching fund requirement has proven challenging for many local fund managers that have raised investment capital from state investment programs with economic development objectives and similar requirements.

The maximum investment in one industry of ten percent (10 percent) of the balance of the Fund may impede deployment due to a lack of suitable investments in some sectors, and otherwise may limit the Fund from supporting early-stage businesses in emerging sectors demonstrating strong growth and promising momentum. A reasonable constraint on total investments in one industry is prudent for risk management purposes and to support the mission of increasing access to early-stage capital for businesses across sectors of the New Mexico economy. The proposed 30 percent maximum in any one industry mitigates concentration risk and supports sector diversification while also allowing the Fund to capitalize on attractive opportunities in specific sectors.

The Fund provides a state-funded source of early-stage capital for emerging New Mexico businesses and seeks to invest in businesses across diverse sectors and communities throughout New Mexico. Some sectors and business models may not present opportunities to earn financial returns required by traditional venture capital investors. Allowing NMFA to make differential rate investments for economic development purposes will allow the Fund to accept lower financial returns relative to traditional venture capital on investments that serve economic development objectives.

EDD notes the intrinsic risks in early stage venture capital investing:

> Venture Capital investing is an inherently high-risk form of investing so there is significant risk that not only could there be no investment return but there could be loss of principal. The plan with government programs is to absorb some of the risk to catalyze local economic development which is prioritized over investment returns.

SIC provides a context and background related to venture capital investing – particularly pre-seed and early phase:

> There are few investment strategies with higher levels of risk than venture capital, and accordingly venture investments pay out at remarkable multiples when they succeed. On a national basis, venture capital investments will see far more of their company investments go to $0 in value than investments that will return 5x or 10x their value. The basic VC rule of thumb would be that around 75 percent of VC-funded businesses will fail, with about 4 of 10 losing everything, around 4 of 10 returning the original investment, and possibly 1 or 2 of 10 proving successful. When the strategy is geographically constrained as a NM-focused program will be, that loss-ratio increases.
>
> NMFA, which is still developing the final rules around its investment process, has indicated it will focus on creating impact and benefit for New Mexicans as much, if not more than financial returns. The SIC's program has evolved several ways over the past 30 years of investing in NM start-ups via venture capital funds, and today focuses first on the potential for financial returns, then on the jobs being created. Even with more stringent requirements around the SIC program, there have been only a handful of success stories, with many of the program's gains remaining yet unrealized. The following shows the most recent investment performance returns across multiple SIC NM VC strategies:

IRR Horizon Performance

As of June 30, 2022 ($ in millions)

	Quarter	1-year	3-year	5-year	10-year	Inception	
Portfolio	IRR	IRR	IRR	IRR	IRR	IRR	Net Gain/Loss
Catalyst Fund	0.0%	1.5%	1.8%	4.4%	N/A	1.7%	$ 0.3
Co-Investment Funds	(6.8%)	(11.6%)	(10.2%)	(2.4%)	3.0%	(0.1%)	(1.3)
Recovery Fund	1.0%	4.2%	N/A	N/A	N/A	1.9%	2.5
Fund Investments	(8.3%)	(2.9%)	15.6%	9.5%	5.1%	2.0%	48.5
2008 and Before	3.5%	(6.8%)	3.1%	(0.6%)	0.8%	(0.2%)	(3.5)
2016 and After	(10.5%)	(2.0%)	22.5%	20.3%	N/A	19.9%	52.0
Grand Total	(6.3%)	(6.6%)	(2.9%)	1.2%	3.8%	1.0%	$ 49.9

Source: Invient
Note that fund investments are divided by vintage year representing a removal in the requirement for a fund manager to open an office in New Mexico which increased the number of fund investments beginning in 2016.

> The program most like the emerging NMFA program and the follow-on proposed by SB402 is the SIC Co-Investment Funds strategy, which has returned 3 percent on average over the last decade, and lost a small portion of capital since inception in ~1992. More recently the program's investments have lost >10 percent in value per year over the last three years.
>
> New Mexico-focused venture investments have not kept pace with national venture capital returns (or related public market metrics), which should be expected as with any strategy that is constrained by geography and lesser diversification by design. The following returns show the benchmark (CA US Venture Capital) for the end of FY22. Source: Cambridge Associates

FIGURE 1 US PRIVATE EQUITY AND VENTURE CAPITAL INDEX RETURNS
Periods Ended June 30, 2022 • Percent (%)

Index	6 Mo	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr	25 Yr
CA US Private Equity*	**-5.3**	**6.7**	**23.0**	**20.6**	**17.8**	**12.6**	**14.8**	**13.8**
Russell 2000® mPME	-23.5	-25.6	3.9	5.0	10.2	7.1	8.6	7.9
S&P 500 mPME	-20.0	-10.9	10.5	11.2	13.5	8.9	9.4	8.3
CA US Venture Capital	**-13.0**	**2.7**	**30.5**	**25.7**	**19.3**	**13.6**	**11.8**	**28.1**
Nasdaq Composite** mPME	-29.3	-23.5	13.1	14.1	16.2	11.6	12.0	10.4
Russell 2000® mPME	-23.5	-25.5	3.9	5.0	10.0	6.7	8.7	8.0
S&P 500 mPME	-20.0	-10.9	10.5	11.3	13.3	8.8	9.4	8.4
Nasdaq Composite*** AACR	-29.2	-23.4	12.2	13.5	15.4	11.2	11.6	9.3
Russell 2000® AACR	-23.4	-25.2	4.2	5.2	9.4	6.3	8.2	7.4
S&P 500 AACR	-20.0	-10.6	10.6	11.3	13.0	8.5	9.1	8.0

* Includes US buyout and growth equity funds only. ** Constructed Index: Data from 1/1/1986 to 10/31/2003 represented by Nasdaq Price Index. Data from 11/1/2003 to present represented by Nasdaq Composite. *** Capital change only.
Sources: Cambridge Associates LLC, Frank Russell Company, FTSE International Limited, Nasdaq, Standard & Poor's, and Thomson Reuters Datastream.

While as with any investment, the devil will be in the details around the opportunity as well as the broader market forces, venture capital is both an extremely competitive and difficult investment strategy in which to succeed, and there is a very wide divergence between top and bottom performing funds. Venture capital is one space where it is not unusual for an investment – possibly most of an entire portfolio – to result in a complete write-off.

ADMINISTRATIVE IMPLICATIONS

NMFA notes no additional administrative impact:

NMFA has administered programs serving New Mexico private sector entities for more than 20 years and has directly deployed more than $560 million through loan programs supporting private sector economic development. NMFA collaborates with other public agencies including the New Mexico Economic Development Department, State Investment Council, Department of Health, Behavioral Health Services Division, and others on private sector programs.

Venture capital investments are long-term investments and NMFA does not anticipate realizing returns and generating revenue in the Fund until FY29 (seven years after anticipated first investment in FY23).

With the current program strategy, NMFA does not expect administrative costs to increase with growth of the Fund.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SIC notes the following:

As mentioned, the SIC's investment program is very active, supporting both local "emerging managers" in venture capital and regional firms that operate and source deals within New Mexico. NMFA's program is in early stages but expected to begin capital deployment later this year. The EDD SSBCI-funded venture program will use an RFP process and deploy an expected $63 million into "impact" VC investments over the coming decade.

TECHNICAL ISSUES

NMFA points out the following:

NMFA does not anticipate entering cooperative investment agreements nor does NMFA require the need to purchase bonds related to Fund administration to protect state interests as NMFA is covered by the NMSA 1978, Section 41-1-1 et. seq, New Mexico Tort Claims Act.

There is currently no protection from the Inspection of Public Records Act of confidential, proprietary technical, trade secret or business information that may be provided to NMFA for the purposes of administering the Act. This may deter venture private equity funds and New Mexico businesses from seeking investment from the Fund.

OTHER SUBSTANTIVE ISSUES

EDD summarizes the stakes:

A significant commitment is being made in the venture capital investment space by government-sponsored plans. The State Investment Council (SIC), EDD, and NMFA will all be supplying capital to this market. It remains to be seen if there is sufficient demand to deploy these volumes of equity capital together with attracting and deploying the matching private capital that may be required in the near future.

SIC notes three other substantive issues:

- The SIC is not the only entity that has found investing in New Mexico challenging in recent decades. In the 2000s, the Small Business Investment Corporation used almost half of its allotted capital at the time to invest in venture capital firms and start-up companies in efforts to "catalyze" New Mexico's entrepreneurial ecosystem. In its 2021 annual report, SBIC reported $12.6 million in losses on $19.4 million invested. SBIC has since abandoned its VC investing strategies to focus on its core mission of making small business loans.
- Efforts and expertise required to make successful investments in venture capital are, not surprisingly, not cheap. While costs can be negotiated by NMFA to a degree, typical "market" costs around venture capital funds are a standard "two and 20", meaning a 2 percent annual management fee and a 20 percent cut of the investment's profits.
- Direct investments – which are contemplated in the current law – can be unduly influenced or politicized if unscrupulous actors are involved in the investment, approval, or oversight process. The SIC experienced this in its national private equity program in the mid-2000s, though the New Mexico-focused program was not specifically involved. Costs to the state are difficult to quantify, but legal recovery efforts required years of litigation which ultimately recovered more than $50 million.

IT/LG/ne/al