

Economic Development and the Search for Equity Capital

A Final Report of the Economic Affairs Interim Committee
for the 2003-04 Interim

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**Economic Affairs Interim Committee
2003-04 Interim**

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Abstract

The Economic Affairs Interim Committee tackled economic development issues in the 2003-04 interim by reviewing what Montana has been doing in economic development and assessing options that could help companies in need of venture or equity* capital. Assisted by an ad hoc working group, the Committee proposed a resolution urging the Governor's Office of Economic Development to support educational and networking resources for "angel" or early-stage investor networks and a bill providing tax credit incentives for investors in equity funds. The Committee also adopted recommendations from economic developers for legislation intended to help businesses locate or expand in Montana.

* As used in this report, venture or equity capital describes cash invested in startup companies or early-stage companies. Venture funds are a high risk type of investment made with expectations of high rates of return. Although venture and equity are not entirely synonymous in describing investments or capital, the terms will be used together when appropriate. A "venture" is a high-risk startup. A venture fund refers to a high-risk fund.

Executive Summary

The Economic Affairs Interim Committee tackled the broad, hot topic of economic development in the 2003-04 interim by building into its work plan a review of what the state has been doing in economic development and analyzing options that could help startup companies in need of venture or equity capital.

After examining the need for and the scope of existing programs and the availability of other funding sources, the Committee heard a broad spectrum of opinions--ranging from people who thought that the best tactic for the state is to keep hands off the process to those who saw the state as a key player in public-private partnership programs that assist private entrepreneurs.

The Committee asked a working group, which had convened primarily to look at equity capital issues, to come up with a low-cost proposal, in the form of a draft bill, that would help capital formation in Montana. Despite floods and power outages that seemed to have an affinity for striking when either the Committee or the working group met,** the Committee and the working group developed draft legislation intended to help companies with high growth potential and high risk quotients at a projected low cost to the state.

The Committee also adopted recommendations from economic developers in Montana for draft legislation intended to help businesses locate in Montana or grow and expand here. Whether the myriad recommendations will help Montana compete successfully in the global market for capital remains to be seen.

**The Committee's October 24 meeting continued despite trickles of water streaming from the ceiling. (One floor above, a burst water pipe had drenched occupants, while below those offices, legislative services staff were scrambling to avoid steady streams of water that disrupted their work.) At the first meeting in January of an advisory group working on venture capital, ice and a second flood at the opposite end of the building triggered a fire alarm that resulted in the meeting being moved across the street. A citywide power outage resulted in no power at a bill drafting August meeting of the working group, but the group labored on in natural light.

Chapter 1: Incorporating Economic Development Issues into the Work Plan

The Economic Affairs Interim Committee (Committee) for the 2003-04 interim started life much like other committees. Its first meeting on June 11, 2003, featured the following typical activities:

- review of its duties (see pp. 1 and 2 of the Work Plan, Appendix A);
- review of a study assigned to the Committee by the Legislative Council. That study, SJR 17, is the subject of its own report entitled: "Tweaking Workers' Compensation Statutes: Seeking Simplicity and Compliance With Court Decisions".
- discussion of a staff-prepared list of potential meeting topics (see Appendix B), after which the Committee decided to combine topics for upcoming meetings; and
- finally, discussion of a work plan, which included review of agencies assigned to the Committee,¹ topics of interest to legislators, rule review, and a proposed schedule of meetings. (See a copy of the Work Plan in Appendix A.)

Here in brief is a review of the Committee's meetings as they related to economic development:

June 11, 2003 -- Economic development predominated as a theme among the topics chosen for discussion at upcoming meetings. The Committee specifically called for 1 day of a 2-day meeting in October to address economic development issues. At the June 2003 meeting, convened by the senior senator on the Committee, Senator Mike Taylor, the Committee elected Representative Joe McKenney as presiding officer and Senator Glenn Roush as vice presiding officer.

October 23-24, 2003 -- After a day spent reviewing activities of agencies under the Committee's purview but not covered during the June 11 meeting, the Committee focused October 24 on learning various perspectives about Montana's economic development climate from economists, economic developers, and others. The meeting concluded with a discussion of a plan put forward by the Board of Regents, "Shared

¹These include: the Departments of Agriculture, Commerce, Labor and Industry, and Livestock, along with the Governor's Office of Economic Development and the State Auditor's Office. Under an agreement with the State Administration and Veterans' Affairs Interim Committee, the Economic Affairs Interim Committee also monitors the Montana State Fund because the Committee covers workers' compensation issues and including the State Fund with other workers' compensation activities is considered a more efficient use of time.

Leadership to Strengthen Montana's Economy". The Committee voted to write a letter to the Board of Regents in support of the Regents' spearheading of statewide efforts to promote economic development issues. The Committee also recommended spending more of its time on economic development issues and, in particular, on examining the state's role in encouraging venture capital formation and investment in Montana.

January 23, 2004 -- January's meeting featured a presentation by State Auditor John Morrison and his staff, an overview of venture or equity capital, workers' compensation updates, and a joint morning session with the State Administration and Veterans' Affairs Interim Committee. The morning session involved state, federal, and private sector officials discussing proposed changes in federal banking regulation and how that might affect the financial services industry in Montana. In the afternoon, the Committee requested background information on past economic development funding efforts in the state, including information on missteps.

March 11, 2004 -- Further information about economic development needs and perspectives came during the March meeting when the Committee formally included economic development as an amendment to the work plan. Highlights of this meeting included:

- perceptions from businesses in Montana that a gap remained for funding needs beyond what bank loans, friends, families, and other lenders might provide, even though existing programs, such as the federally funded, state-administered Community Development Block Grants program and the new workers' training program,² were of great benefit;
- an emphasis by economic developers on the need for economic development tools that could help them in attracting businesses to Montana by improving their options to compete successfully against out-of-state economic development groups;
- caution urged by venture capital experts about the risks involved in venture capital. The experts also provided insights into conditions necessary for a vibrant venture or equity capital market, which include proximity to other venture capitalists.
- the importance to early stage companies of "angel" investors--wealthy individuals who commit both time and equity investment to help a business grow; and
- recognition that growth in the state's economy helps all concerned, including

²Initiated under HB 564, Chapter 567, Laws of 2003.

banks.

The Committee also heard about the problems experienced and resolved under an early venture capital tax credit plan--the Montana Capital Company Act--and the successes of one form of economic development facilitation being practiced in the Golden Triangle area north of Cascade County. The Golden Triangle Enterprise Facilitation Project has raised funds for a trained facilitator who works with potential businesses in the area to steer them toward appropriate contacts.

May 5, 2004 -- The May meeting featured various ways for a state to be involved in venture capital formation. A. Bart Holaday of Adams Street Partners, one of the Board of Investments investors involved in venture funds, described the volatility of these high-risk funds: two venture funds started in 1988 and 1993 had returns of 21.38% and 40.14%, respectively, but a third fund in 1999 had negative returns to date of 17.35%. Two members of Credit Suisse First Boston (CSFB) provided an overview of their investment program. The CSFB formula typically invests state money, CSFB's own money, and money solicited from other investors in venture funds. The managers of some of these funds then look at (and possibly invest) in ventures located in the state. The CSFB representatives stressed that return on investment is the most important element. Phillip Thomas, a representative of Advantage Capital, provided information about the capital company or CAPCO approach in which a private equity firm invests in ventures within a state in exchange for incentives, such as tax credits. The last speakers were investors who are implementing "fund of funds" legislation in Oklahoma and Iowa. They provided perspectives on how a fund of funds relies on contingent, deferred tax credits to back investment returns. The Committee requested a bill draft incorporating fund of funds approaches. (See Appendix C for a copy of the bill draft.)

June 30 and July 1, 2004 -- The June 30 and July 1 meetings combined the Committee's review of legislation proposed by agencies for which the Committee has monitoring duties with updates on the workers' compensation study and work on a venture capital bill. The State Auditor's Office included a fund of funds bill in its bill drafting requests, and the Committee urged cooperation with the drafting of that bill as a potential Committee bill. After a brief discussion, the Committee decided to encourage a network of angel investors by drafting a resolution asking the Governor's Office of Economic Development to set as a priority the development of such an "angel" network. (See Appendix C for a copy of the draft resolution.)

