



ICIC

Iowa Capital Investment Corporation

IOWA CAPITAL INVESTMENT CORPORATION

REPORT

TO

GOVERNOR THOMAS VILSACK

February 7, 2006

Copies to: Mary Lawyer, Iowa Department of Economic Development
Rick Newman, Iowa Capital Investment Board
David Casey, Iowa Department of Revenue
Legislative Leadership
Secretary of the Senate
Clerk of the House

PURPOSE

Iowa Capital Investment Corporation's goal is to accomplish the purposes expressed in its enabling legislation in Iowa Code §§ 15E.61:

- *To mobilize private investment in a broad variety of venture capital partnerships in diversified industries and locales.*
- *To retain the private-sector culture of focusing on rate of return in the investing process.*
- *To secure the services of the best managers in the venture capital industry, regardless of location.*
- *To facilitate the organization of the Iowa fund of funds in which to seek such private investment and to create interest in such investments by offering state incentives for private persons to make investments in the Iowa fund of funds.*
- *To enhance the venture capital culture and infrastructure in the state of Iowa so as to increase venture capital investment within the state and to promote venture capital investing within Iowa.*
- *To accomplish these purposes in such a manner as to minimize any appropriations by the state of Iowa.*

The Iowa fund of funds program, envisioned by the Legislature in 2002 and finalized in 2005, is now in operation. ICIC has committed capital to three venture funds in life sciences, medical services, information technology, and later stage manufacturing, distribution and services. We have a pipeline of high quality funds interested in working within Iowa and helping our local entrepreneurs. Cimarron Capital Partners, L.L.C. ("Cimarron"), our fund allocation manager brings the skills developed in years of managing the Oklahoma and Arkansas fund of funds programs and developing the entrepreneurial ecosystems of a number of states. We have new and exciting proposals in direct early stage investing and New Markets Tax Credit-supported funds for disadvantaged areas in Iowa. We have carefully coordinated our work to enhance the parallel efforts of the Iowa Department of Economic Development, the Regents universities, the local investing community, Iowa's technology associations, and local entrepreneurs. **We have done all this without one dollar of State appropriations or reductions of revenue.** Our vision, described in more detail at the end of this report, is to build a thriving Iowa entrepreneurial ecosystem in which an evergreen, self-sustaining Iowa fund of funds and its partner venture funds play an important empowering role. This will be the work of years. We are enthusiastic about our mission.

BACKGROUND

Through action during its 2002 and 2005 sessions, the Iowa Legislature has enacted an economic stimulus measure designed to encourage private venture capital investment in emerging, expanding, and restructuring business enterprises in communities throughout Iowa. The legislation has been codified at Iowa Code §§ 15E.61 et. seq. ("Capital Investment Act" or "Act"). In order to facilitate the goals set forth in the Act, the Legislature authorized the formation of the Iowa Capital Investment Board ("ICIB") and the Iowa Capital Investment Corporation ("ICIC"). ICIB is a state agency organized for the purpose of mobilizing private

venture capital for investment in targeted enterprises and communities. ICIC is a private, 501(c)(3), not-for-profit corporation organized under Iowa Code Chapter 504A on May 7, 2002. The initial members of the ICIC Board of Directors were Bruce Tamisiea, Dennis Murdock, John Rigler, Mary Quass and Tim Urban. Melinda Ellsworth, appointed to replace Mary Quass who resigned effective November 15, 2002, in turn resigned on October 7, 2005. ICIC is not a public corporation or instrumentality of the state, but is audited annually by the State Auditor (or a private auditing firm selected by the State Auditor) and must, upon termination, turn all assets over to the State. In 2005, technical amendments to the original legislation removed unanticipated impediments to securing low-cost investment capital. As a result, the Fund of Funds, A was formed and capitalized on June 28, 2005.

SUMMARY OF ACTIVITIES IN 2005

2005 Amendments to the Enabling Legislation

The original Fund of Funds legislation had been written with a number of limitations on the issue of contingent tax credit certificates which had the unintended effect of dramatically raising the cost of capital to the Fund of Funds to a point at which it became impossible to raise reasonably-priced investment capital. This is one reason the Fund of Funds was stalled until mid-2005. ICIC and its investment manager identified these limitations and requested technical amendments from the Legislature in 2005. These were embodied in SF 114, were passed, and signed into law by the Governor on March 14, 2005. Rules to implement these changes were adopted by the Iowa Capital Investment Board on March 24, 2005 and became effective on that date. These changes made possible the first funding of the Iowa fund of funds on June 28, 2005.

Formation and Funding of the Fund of Funds

ICIC is the General Partner of the Iowa Fund of Funds, Fund A, L.P. (the "Fund of Funds"), an Iowa private, for-profit limited partnership, which was organized on October 30, 2003. In accordance with the statute, the investments of the Iowa Fund of Funds have focused on partnership interests in private venture capital funds rather than direct investments in individual enterprises. ICIC acts as the general partner to coordinate private investment in the Fund of Funds. The Fund of Funds is required by statute to invest five percent of its assets in a program to provide loan guarantees and other related credit enhancements on loans to rural and small business borrowers within the state of Iowa. The Iowa Fund of Funds, L.C. (the "Revolving Fund"), an Iowa limited liability company was organized by ICIC under the laws of the State of Iowa on November 6, 2003. ICIC is also the general partner of the Revolving Fund. The Revolving Fund acts as a Special Limited Partner in the Fund of Funds for the purpose of receiving a carried interest in the Fund of Funds and continuing the purposes of the Act.

The first funding for the Fund of Funds was provided under a revolving line of credit with West Bank in West Des Moines. This line is collateralized by contingent tax credit certificates issued by the ICIB. The tax credits have value only to the extent the overall program experiences a loss and their redemption is contingent on certain ICIB-developed criteria, limited to \$100 million in the aggregate and \$20 million in any fiscal year.

ICIC has crossed many hurdles to make the Fund of Funds the operating, active entity that it is today. We engaged Cimarron as fund allocation manager on August 31, 2004. Cimarron is headquartered in Oklahoma City, OK, and has offices in Little Rock, Phoenix, Chicago, and Ames, IA. The principals of Cimarron designed, implemented and are managing funds of funds programs for the Oklahoma Capital Investment Board (\$100 million) and Arkansas Development Finance Agency (\$70 million). A Cimarron affiliate also manages the annual World's Best Technologies conference, the leading forum linking companies emanating from federal laboratories to venture capital investors.

ICIC entered into an interim agreement with Cimarron on August 31, 2004 and a Fund Manager Agreement with Cimarron on June 3, 2005. Working together with Cimarron, ICIC has

- Closed the first tranche of financing for the Fund of Funds through West Bank in the amount of \$10 million on June 28, 2005
- Closed separate financing through Wells Fargo, N.A. in the amount of \$5 million on June 28, 2005 to secure "accredited investor" status for all fund investments.
- Committed to invest Prolog Capital II, Richland Ventures IV and Bayview Capital Partners II, venture capital firms each of whom has agreed to work in the state of Iowa, as described more fully below.
- Developed a formal investment policy statement.
- Developed a formal fund allocation program.
- Developed a pipeline of national venture funds interested in participating in the Iowa Fund of Funds program and making investments in qualified Iowa companies.
- Carefully screened over twenty funds in 2005, selecting those with exemplary management teams, good investment track records, interests appropriate for the Iowa economy, and willingness to establish physical presence in Iowa and work with Iowa entrepreneurs.
- Reviewed the due diligence completed by Cimarron regarding the first three venture commitments for the Fund of Funds:
 - **Prolog Capital II** (\$5 million commitment)

Prolog is a \$66 million early-stage venture capital firm specializing in life sciences and related information technologies. The firm has invested in a variety of life sciences firms in the Midwest, always focusing on technological innovation and scientific excellence. Prolog has engaged a local representative in Iowa and an Iowa advisory board consisting of life sciences experts at Iowa's Regents universities.

- **Richland Ventures IV** (\$5 to \$7.5 million commitment)

Richland IV is the fourth fund being organized by Richland Ventures. Richland IV provides expansion capital for companies with an emphasis on healthcare services, medical devices and technology, and diversified services. The firm has a long history of successful investing in a variety of medical and services firms in the South and Midwest. Richland has agreed to engage an Iowa representative and appoint an Iowa advisory board with skills in medicine and related information technologies.

- **Bayview Capital II** (\$5 million commitment)

Bayview Capital II, a \$125 million fund, is the second fund managed by Bayview Capital Partners. Bayview II continues their focus on late-stage, small capitalization manufacturing, services, and distribution companies in the Midwest. It is a licensed small business investment company. Bayview has agreed to extensive marketing, development, and educational efforts within Iowa in partnership with Iowa banks, attorneys, and CPAs.

All three of these venture funds have agreed to participate in various Iowa venture activities, including the annual Entrepreneur and Venture Capital Conference in Des Moines, sponsored by the Iowa Department of Economic Development.

The Iowa Fund of Funds capital commitments totaling \$15 to \$17.5 million are therefore leveraged by up to nineteen times through investing in larger venture funds able to bring substantial amounts of external capital for potential investment in appropriate and carefully screened Iowa companies. These funds meet the test of the private market: they compete worldwide for capital and are able to raise the major share of their capital from private sources in a competitive market.

- Developed additional funding products to add investment capacity and flexibility to the Iowa Fund of Funds at reduced cost.
- Developed mechanisms to monetize tax credit certificates if needed and improve the collateral value of the certificates to lenders.
- Engaged an expert in rural development, formerly with the Federal Reserve Bank of Kansas City, to advise the ICIC Board on the direction of its rural and small business investment programs.
- Co-sponsored the October, 2005 Entrepreneur and Venture Capital Conference in Des Moines and presented a seminar on angel investing.
- Marketed the annual World's Best Technologies conference, held each year in April in Fort Worth, TX to startup companies spun out of Iowa's federal laboratories; and engaged Iowa reviewers to assist in screening firms prior to presentation to venture investors. This conference is managed by a Cimarron affiliate.

- Participated on the Iowa Business Council Capital Formation Hot Team and developed the first version of www.IowaEntrepreneur.Com, an educational site for Iowa entrepreneurs and investors.
- Participated as a member in a number of Iowa business and trade associations and actively represent the interests of Iowa's angel and private equity investors and entrepreneurs.
- Joined the Iowa Venture Capital Association and developed contacts within the angel capital, private equity and investment community in the State. Encouraged and facilitated communications among angel investors and joint investing statewide to increase local capacity to invest in attractive deals.
- Developed relationships with all three Regent universities, Pappajohn Centers, and small business accelerators to spread knowledge of private equity capital and investing throughout the state.

Actions Related to the New Market Tax Credit Program

The New Market Tax Credit Program (NMTC) permits taxpayers to claim a credit against Federal income taxes for qualified equity investments made to acquire stock or a capital interest in designated community development entities (CDEs). CDEs must use substantially all of the proceeds from such investments to make investments in low income communities (LICs). Allowable investments range from real estate to venture capital. The tax credit provided to the investor (either the original holder or a subsequent purchaser) will total 39% and can be claimed over a seven-year credit period. In each of the first three years, the investor receives a tax credit equal to five percent of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the tax credit is six percent annually. The Community Development Financial Institutions Fund certifies CDEs on an ongoing basis, and allocates New Markets Tax Credit allocations annually to select CDEs through a competitive application process. In 2006, up to \$3.5 billion of New Markets Tax Credits will be allocated. Last year Iowa was one of the few states not to receive allocations of tax credits from this program.

ICIC, with the support and assistance of the Iowa Department of Economic Development, created the Iowa Development Corporation, an Iowa non-profit corporation. The Iowa Development Corporation has in turn formed Iowa Community Development, L.C., an Iowa limited liability company, that has been designated by the US Department of the Treasurer on as a CDE.

ICIC has caused Iowa Community Development, L.C., in conjunction with the Iowa Business Growth Company, to apply for an allocation of NMTC in the amount of \$70 million.

Actions Related to the Rural Business Investment Program

ICIC has discussed a variety of concepts for the small \$5 million rural and small business credit support program authorized under the enabling statute. These discussions continue and the Board, assisted by Cimarron, expects to develop proposals during 2006 to implement the legislative intent of the program.

GOALS FOR 2006

- Continue marketing the Iowa Fund of Funds to national venture firms;
- Continue selection of high quality venture firms for commitment by ICIC;
- Commit to appropriate venture funds and build a carefully structured, diversified portfolio of venture funds characterized by quality management, good track records, and commitment to Iowa;
- Build tax credit liquidity mechanisms to enhance the value of the contingent tax credit pool to lenders;
- Develop alternative funding instruments to improve funding flexibility;
- Commence Iowa Community Development programs (if a NMTC allocation is received);
- Deploy the rural and small business credit support program;
- Safeguard the contingent tax credits so that the program will not impact state revenues.

Legislative Matters

In response to a request from the House Economic Growth Committee chair, we have proposed a direct seed investing program, adding §16E.66A, employing transferable contingent tax credits in an amount limited to \$50 million in total and \$10 million per year. This program will, when funded, provide ICIC with an investment fund to support the needs of very early stage businesses still in the commercialization and proof of concept phase of development. It will support and be closely coordinated with grant and investment programs authorized by the Legislature and managed by each of the Regents universities under Value Fund initiatives enacted in 2005.

VISION

Our vision foresees a thriving private equity culture in Iowa, one that is an essential part of a broader entrepreneurial ecosystem quickening the economic pace of the entire state. If we and our partners in state government and the private sector are successful, then Iowa will experience a cultural change of profound implications. This new culture of innovation and entrepreneurship will empower individual creativity, add vigor and initiative to our urban centers, universities, and small towns, and foreshadow the growth of a new, knowledge and capital-intensive industrial base able to lead Iowa to global economic achievement. A necessary part of that new base is a thriving private equity sector to provide capital and expertise. Iowa

needs the best investors in the world to work with and invest in our entrepreneurs. Money alone is not the answer: instead, money combined with investing wisdom, knowledge, and patience; deep experience; extensive networks; dexterity in innovation; and long track records of success - all of which constitute the core of "entrepreneurial private equity capital" - are needed. And this entrepreneurial capital is best deployed by the private sector where the skills and right motivations lie. Government can play a valuable role, but only the private sector can create an innovative, dynamic entrepreneurial ecosystem. To that end, ICIC and its Iowa Fund of Funds seek to mobilize the best venture capital managers in the country to come and participate in the Iowa entrepreneurial economy. In participating, they will empower our entrepreneurs and drive the cultural change needed to reshape our economy into a global competitive force. They will also earn a positive financial return which will in turn build an evergreen revolving fund of funds, one that will grow away from reliance on contingent tax credits for funding support. We are under no illusions that this will be a quick task: we fully expect that it will require decades of patient, consistent, well-coordinated efforts. We appreciate the help of our Legislature and Governor, who responded positively to our request for modification to the Iowa Capital Investment Act. With these statutory changes, we were able to commence our efforts in earnest during 2005.

We are available to meet at your convenience.

Respectfully submitted,

Dennis Murdock