Iowa Agricultural Finance Corporation

Vision.

Iowa Agricultural Finance Corporation will provide the financial and business leadership, expertise, and financial leverage to help Iowa agricultural producers, Iowa agricultural industry ventures, and Iowa biotechnology enterprises lead the world in responsibly produced, high-quality value-added agricultural products and services, profits, and growth in the twenty-first century.

Mission. Iowa Agricultural Finance Corporation will:

- Make prudent investments in the business ventures and emerging technologies necessary for Iowa's leadership in responsibly produced value-added agricultural, food and biotechnology products and services.
- Help qualified Iowa agricultural producers obtain equity interests in Iowa value-added agricultural industry ventures.
- Help qualified Iowa value-added agricultural industry ventures obtain financing for growth.
- Help qualified biotechnology enterprises grow and foster Iowa's biotechnology industry in general.
- Deliver a competitive return to investors.

A Short History of State Assistance for Equity Capital Formation in Iowa

Iowa lacks the access to equity capital and entrepreneurial experience enjoyed by high growth states like California, Texas or Massachusetts. These states benefit from past successes in high technology and experienced managers and venture capitalists looking to repeat lessons already learned. Iowa's distance from venture capital money pools makes it difficult to attract equity or near equity investments for companies with the high growth potential to generate jobs and market leaders in emerging industries. Iowa's political leaders are aware of this and have tried several times to jump start venture or equity capital activity with State assistance.

The Iowa Agricultural Finance Corporation (IAFC) is a new attempt to do an important task for Iowa that the State has struggled with in past attempts. The equity capital-oriented assistance programs listed below had success in some individual portfolio investments, including Engineering Animation Inc. (EAI) and McLeod Communications. They were operated with fiscal diligence, some made money, and many new companies were created. However, judged by total portfolio return, scale and longevity they failed to consistently achieve market rates of return, the scale of economic development impact desired or the life span to be a consistent player in Iowa's economic growth. They did not produce a long-term cure for the venture capital blues.

This is hard stuff. If it was easy, it would have been done before. We know it's hard, but that it is also important to Iowa. Therefore we are doing are best to learn from the past successes and failures to assure undiluted success this time around. IAFC's design and management are applying the lessons learned to assure success for IAFC and Iowa.

1. **Iowa Seed Capital Corporation (ISCC)** Born 1983 -- Died 1998

   a. **Model** – a quasi-public venture capital investor intended to invest like a private business in companies with significant growth prospects. Operated by State employees, subject to annual appropriation for continued funding. (Began life as Iowa Product Development Commission.)

   b. **Problems Encountered:**

      (1) **Too Small.** Investment fund too small to achieve critical mass. Average annual appropriation of less than $1.5 million for first nine years. Available funds limited size of potential investments to relatively small firms (high speculative) or small investments as a co-investor in larger companies (not significant enough to influence control).

      (2) **Too Expensive to Operate** (relative to size). Administrative or operating costs overwhelmed investment pool. E.g., $300,000 annual budget for a $1.5 million appropriation, meant operating expenses equal to 20% of the fund when private investors with larger pools operate closer to 2.5% for fixed annual administrative expenses. Unfortunately, the expense to analyze a $250,000 investment is not that much different than a $2.5 million or $10 million investment.

      (3) **Failures obvious before Successes.** Successes were slow to be realized and failures obvious all too soon. Sponsors looked for immediate results.

      (4) **Public Agency Perceptions and Restrictions.** Too often perceived by applicants as grants not investments. Investments were often repaid with royalties rather than equity to avoid conflict with State Constitutional amendment barring State from becoming a shareholder in a corporation.

      (5) **Short-term pressure for results.** As a state agency or quasi-public agency dependent upon continuing appropriations, ISCC was under pressure to place money quickly and show immediate success. Political eye was on the jobs to be created not whether the jobs would be sustained and expanded by profits.

   c. **Results.** ISCC under went more than one retooling, for instance making it more private in an attempt to allow equity investments. Still, lack of results of the scope desired led to cessation of funding in 1996 and eventual liquidation in 1998.

2. **Iowa Fund Limited Partnership** Born 1986 – Inactive, few investments still in wrap-up

   a. **Model.** Private investment fund with capital required to be contributed by Iowa Public Employees Retirement System (IPERS). Hired private manager in typical venture fund structure.

   b. **Problems Encountered.**

      (1) **IPERS unwilling participant.** IPERS was forced into the investment and was therefore an unwilling partner, uncommitted to success. Eventually willing to pay substantial sums (approximately $1.5 million) to get out.

(2) **Narrow funnel.** Limitation to Iowa deals only proved too narrow. Belief that there were great deals in Iowa going unfunded *only* because of lack of equity capital challenged by results.

(3) **Fast deals vs. good deals.** Pressure to place money quickly may have overwhelmed need to place money effectively. Fund ended up taking deals that were available, rather than pressing to find better deals.

(4) **Passive marketing.** Finding good deals requires both patience and diligence.

3. **Business Development Finance Corporation (BDFC)** Born 1989 -- Died 1999.

a. **Model.** Shared public and private leadership with leverage resulting from investments into BDFC by private shareholders. Seven public members of the board and five private board members. Public employees as management with contract private investment advisors. Up-front State investment proposed at $50 million but actually funded at only $4.65 million. With private investments, total fund reached $11 million. Majority of 160 some private investors were banks. Legislative authority and corporate existence expired (sunsetted) after ten (10) years.

b. **Problems Encountered.** Despite a mixed public-private model, BDFC both repeated some problems incurred by ISCC and added some new lessons.

(1) **Conflicted Leadership.** The public-private mixture, both on the board and management, led to mixed signals and conflicts in objectives. Investors looking for market returns (not just acting out of public duty) not attracted by public sector dominance. Private investors were deterred from broader participation even though, private investors guaranteed money back plus 25% before State gets anything.

(2) **Political Judgment vs. Business Judgment.** The public majority perceived to exercise political judgment in investment choice rather than business judgment regarding long-term success and investment returns.

(3) **Too Small.** An $11 million fund is still too small for critical mass. Prudent business judgment limited the amount invested in any one venture and therefore limited the size of potential investments to relatively small businesses.

(4) **Initial investments too risky.** Initial investments went bad and set the tone. Later re-tuning enough to rescue some investments but not all.

(5) **Failure to manage investments.** Original structure left BDFC as a passive investor, uninvolved in on-going management of portfolio companies. By contrast private venture capitalists are often key players to assure the success of the investment. Private investment advisor eventually replaced and successor's proactive management interventions helped turn-around some (but not all) previously under performing investments.

(6) **Lack of Dry Powder** (money for follow-on investments). Private venture capitalists typically reserve a portion of their money to reinforce success with more follow-on money. BDFC did not have dry powder.

(7) **No reinvestment of returns to repeat success.** Proceeds upon sale of investment are to be wholly distributed to private investors, leaving the Fund no money for new investments; so deal flow (new investment opportunities) disappears.

(8) **Sunset date.** Makes exit strategy planning difficult. Private venture capital funds typically have the power to extend a fund to avoid fire sale exits.

(9) **Not a Long-term Player.** Sunset provision meant BDFC was in and out rather than able to become a permanent player, even if investments had been more successful. Another reason why deal-flow dried up.

c. **Results.** Private sector will get money back and promised return, but banks unlikely to repeat as equity investors. State unlikely to get much if any of its money back from investments. Overall losses in the millions. (Not counting tax revenues generated by new economic activity – there has been some public benefit.)

4. **Iowa Capital Corporation (ICC)** born 1991 – died 1999

a. **Model.** Essentially similar to BDFC with targeted co-investors being electric utilities rather than banks. Only two cooperatives participated. Total of $5.5 million available, but only $3.5 million placed in twelve (12) different portfolio companies.

b. **Problems Encountered.** In addition to the problems experienced by BDFC, ICC added the following:

(1) **Too Few Private Investors.** Dramatically fewer private participants than BDFC.

(2) **Narrow Funnel** (scope or investment opportunities). The narrow scope of ICC meant the fund could not successfully place all of the money available or committed for investment.

(3) **Sunset date.** Expectations set in advance limited exit strategies.

c. **Results.** Better than BDFC. One homerun with McLeod Communications enough to make the difference. (Private venture fund's success often turns on the success of only one or two deals.) Total profits in the millions. Private partner bought State out to resolve conflict in management and retain possibility of using structure for private deal-flow beyond originally planned sunset.

5. **Heartland Seed Capital Fund** Born 1992 – Died 1994

a. **Model.** Private seed capital fund with IPERS as exclusive investor. Contract money manager. Total fund size $15 million.

b. **Reasons for Problems.**

(1) **Passive marketing.** Ended up considering mostly opportunities already shopped to other investors and rejected by others. Failed to generate own, proprietary deal flow.

(2) **Small size.** Size of the fund influences size of the deals fund can consider.

(3) **Narrow funnel.** Iowa only deals didn't look like what California money manager was used to seeing.

c. **Results.** Management contract terminated after three (3) years. Failed to place money. Manager content with annual management fee. IPERS not content to pay annual management fee without effective placement of funds.

6. **Lessons incorporated in design of Iowa Agricultural Finance Corporation.**

a. **Model.** Publicly chartered, but turned over to pure private management like FannieMae or FarmerMac at the federal level. Funding is a one time, interest-free long-term loan for $25 million to be leveraged with additional private investors. Charged with making a profit and pursing a public purpose, promoting the strategic growth of value-added agriculture and biotechnology in Iowa. Part of "Iowa as the Food Capital of the World" vision. IAFC will seek investment opportunities that fit with Iowa's historic agricultural strength but that are focused beyond the farm gate. IAFC especially seeks investment opportunities that benefit Iowa agricultural producers through ownership, long-term supply relationships or that use Iowa agricultural commodities for inputs.

b. **Lessons applied.**

(1) **Consistent leadership.** IAFC features a purely private Board of Directors and Management insulated from short-term focus by being freed from dependence upon continuing State appropriations. However, efforts structured as private funds have produced less than spectacular results as well. This may be a necessary feature, but it is not in and of itself sufficient.

(2) **Larger size.** The $25 million long-term loan enables leverage of $20-25 million of private equity. Other potential initiatives could increase this to $75-100 million. These levels can sustain IAFC as a permanent player.

(3) **Wide Funnel (scope).** The scope of potential investments within IAFC's authority and focus is broad, but to assure the funnel of potential deals is as wide as possible, IAFC will help promising prospects structure themselves to fit the funnel. The question is not whether a company currently qualifies, but can we help them become part of the Iowa economy to the benefit of Iowa producers as a result of our investment? IAFC is not limiting itself to deals that *begin* in Iowa or that limit their benefits or operations to Iowa *exclusively*. We will look nationally for opportunities that help Iowa.

(4) **Perpetual existence.** IAFC is organized to continue on with or without any additional State funding. It has the capacity to succeed and reinvest in new ventures. It is a private Iowa for-profit corporation with perpetual existence.

(5) **Lower fixed operating expenses.** The fund's management is paid just as in any other private venture capital fund. There is an annual management fee, but the real gold is the pot at the end of the rainbow. The fund manager receives a share of the "carried interest" or profits. The more the fund makes, the more dollars the manager earns. If the manager makes the investors successful with

good returns. Every dollar saved up-front contributes to higher internal rate of return (IRR) on the back-end.

(6) **Business Judgment.** The Board is required, both by statute and by fiduciary duties to private limited partners, to apply reasonable business judgment and pursue profits. The Board understands that success will attract more private money in the future to fuel Iowa's growth in food processing and biotechnology. It is essential to get it right and start well. Profitable companies will deliver the desired jobs, economic growth and tax revenues.

(7) **Focus on doing it right from the start.** If we want strategic growth, focusing on profit potential is more successful than focusing on jobs created in the first year. The IAFC Board understands that it does Iowa agricultural producers no good to involve them in failing propositions. Success breeds success. If initial investments are well placed and deliver competitive returns, IAFC will have more money to fuel Iowa's growth in pursuit of leadership in biotech and food. IAFC has the patience to wait for good investments and the persistence to find or make good deals.

(8) **Structured to appeal to private investors.** IAFC is modeling its efforts so far as possible on what the market knows and understands; private equity funds structured as limited partnerships. The first fund will be called Tecterra Food Capital Fund I. We intend to appeal not only to friends of Iowa institutional investors, like Farm Bureau, but also to market-driven institutional investors with an eye on total-return.

(9) **Attention to Deal Flow.** IAFC is proactively pursuing deals not just with companies already in Iowa but with those outside of Iowa that can be brought to the State. The source of financing often influences where the money is spent. IAFC will not simply wait for business plans to be shopped to it but intends to seek out promising companies and help them formulate winning strategies that IAFC can finance. Partners chosen based upon ability to contribute to proprietary deal flow both from within and outside of Iowa.

(10) **Proactive Management of Investments.** IAFC will not be a passive investor. It will be actively involved in management and oversight, just as any significant equity investor must.

(11) **Dry Powder.** IAFC is reserving a portion of its investment portfolio for follow-on investments necessary to assure success or reinforce winners.

(12) **Ability to go and do it again.** If the first round of investments succeeds, IAFC will be able to reinvest its share of the profits in new investments. Private investors will also bring more money to the table with demonstrated ability to deliver results.

c. **IAFC's Progress.** Serious and capable players involved on the team.

(1) **Cybus Capital Advisors - Fund Manager.** A national niche investment banker specialized in agriculture and food technology, with headquarters in Iowa. Selected for ability to add generate significant proprietary deal flow.

(2) **Piper Jaffray Inc. - Investment Banker.** Midwest's leading investment banker. Selected for experience with producer ventures and deal flow pipeline.

(3) **Leverage.** Private Placement Memorandum planned in near future to limited audience of sophisticated institutional investors. (Limited offering avoids cost and expense of public offering and assures investors are experienced in similar deals.)

(4) **Promising Deal Flow.** Already reviewing several promising investment opportunities. Like any investor, we will have to sort through many rocks to find the gems, but we're already seeing enough sparkle to be convinced there are good deals to be done.

10 Key Points.

1. **Private, For-Profit.** IAFC is a private, for-profit investment fund, not a public agency.
2. **Target Market.** IAFC's target market is value-added ag processing and biotechnology. IAFC seeks to improve the market for Iowa ag commodities and encourage producer involvement in ownership in processing ventures beyond the farm gate.
3. **Not Production Agriculture.** IAFC is not focused on production agriculture. Legislature requires IAFC to help process what Iowa producers already grow, not add more to the surpluses currently depressing prices for almost every farm commodity.
4. **Leverage.** IAFC is seeking to leverage the State loan with private equity into a larger, self-sustaining investment fund.
5. **Compete for Capital.** IAFC will compete for capital by producing competitive returns for investors. Success breeds success and fuels more growth. Ultimately must satisfy total return investors, not just Friends of Iowa.
6. **Investments not Grants.** IAFC is not a source of grants. We have to make money to pay-off loan.
7. **Equity or Near Equity Financing.** IAFC is not offering cheap money. We are offering money in a form not generally available in Iowa, equity or subordinated debt (near equity).
8. **Not Asset-backed Lending.** IAFC is not a substitute for banks. Plenty of asset-backed lending available in the State. We don't want to compete with banks or Farm Credit System, both of which have far better retail distribution networks.
9. **Exit Strategy.** Because IAFC is making equity investments, it must be able to exit any individual investment within a reasonable period of time to realize gains and reinvest in other opportunities.
10. **Lean, Cost-conscious.** No intention to create large staff. Not duplicating resources already available in Iowa. Partnering with those that have necessary skills by hiring experienced consultants. Strict cost control pays long-run dividends in higher rates of return.