LEGISLATIVE SERVICES AGENCY
Serving the Iowa Legislature

ISSUE REVIEW

Fiscal Services Division

January 5, 2017

Iowa Fund of Funds

ISSUE

This ***Issue Review*** provides a program history of the Iowa Fund of Funds (IFOF, or “the Fund”), as well as a review of the IFOF financial status and the State General Fund implications of the associated income tax credit created as the investment guarantee for the IFOF investments.

AFFECTED AGENCIES

Iowa Capital Investment Board

State General Fund Tax Revenue

CODE AUTHORITY

Iowa Code chapter 15E, division VII

BACKGROUND – IOWA FUND OF FUNDS ENTITIES

The IFOF was designed as a method to attract venture capital firms to Iowa with the hope that those firms would invest in Iowa companies. The IFOF concept involves the entities described below:

The **Iowa Capital Investment Board** is a state governmental body. Although the Board has had other duties in past years, the Board’s sole remaining purpose is the administration of tax credits available through the IFOF Program. The Board has five voting members, and four legislators serve as nonvoting members. The Board is required to file an annual report with the Governor and Legislature.

The **Iowa Capital Investment Corporation** (ICIC) is a private, nonprofit entity created in Iowa Code section 15E.64. The statutory purpose of the ICIC is to create and manage the IFOF investment concept described in the following IFOF background portion of this document. Upon dissolution of the Fund, the ICIC is to be dissolved and any assets owned by the ICIC liquidated, and the resulting money deposited in the State General Fund.

The **Iowa Fund of Funds** is a private, for-profit company created in 2002 in Iowa Code section 15E.65. The statutory purpose of the Fund is to invest in private seed and venture capital entities. As originally enacted, the IFOF was to operate for 50 years. The IFOF is now required to liquidate no later than December 31, 2027.

The **Iowa Fund of Funds Revolving Fund** is a private entity established to receive distributions from the Portfolio Funds in excess of the money needed to pay administration and financing costs. Money in the IFOF Revolving Fund would then be used to make additional investments in Portfolio Funds.

Iowa Designated Investor (IDI), Inc. is a private company formed for the purpose of making equity investments in the Fund. The company has a capital commitment obligation of up to $40.0 million to the Fund. To fund this capital commitment, the IDI obtained bank financing in an amount up to $40.0 million. In exchange for the capital committed, the IDI has an economic interest in the IFOF and the limited partner share of the Fund is an asset of IDI.

The **Portfolio Funds** are seven private venture capital funds that have received a portion of their funding through the Fund (see **Table 1**). In return, the IFOF received an economic interest in the seven Portfolio Funds.

Cimarron Capital Associates, LLC is an Oklahoma-based venture capital and private equity firm specializing in fund of funds investments. Cimarron is employed by the ICIC to manage the IFOF. The agreement provides that in addition to receiving annual management fees paid from the Fund, Cimarron will receive profits from the Fund up to an agreed-upon percentage after the Fund receives its required profit distribution. The company also manages fund of funds concepts in Oklahoma and Arkansas.

BACKGROUND – IOWA FUND OF FUNDS

The Iowa Legislature created the IFOF in 2002 as an effort to increase the availability of early-stage venture capital funding. As the IFOF was initially envisioned, equity funding would be raised from private investors, and the investment return for those investors would be backed and guaranteed by state income tax credits should their equity investments in the IFOF not provide sufficient financial return on their own. As the Fund was implemented, the capital to create the IFOF was acquired through bank loans, with IFOF tax credits utilized as loan collateral. The bank loans were of short duration and periodically needed renewal.

In 2012, bank loans or equity investors could not be secured to replace existing loans that had reached maturity. An agreement was reached among the various parties that provided, among other things, for the issuance of more than $25.0 million in verified tax credits and an additional $31.0 million in contingent tax credits in exchange for replacement debt financing in order to continue the IFOF concept.[1]

With enactment of Iowa Code section 15E.72 in 2013, the Legislature codified the agreement and provided for a method to repay the bank debt, issue tax credits, wind down the investment portfolio, and end the Fund.

The IFOF was formed for the purpose of making investments in private venture capital funds. The investments by the Fund are partnership interests in private venture capital funds and not direct investments in individual businesses. These Portfolio Funds are allowed to invest in companies located inside and outside of Iowa. Each fund in which the Fund invests must:

- Make a commitment to consider equity investments in businesses located within the State of Iowa.
- Maintain a physical presence within Iowa. This physical presence requirement can be met in a number of ways and is subject to a written agreement.

[1] Under the IFOF program, a “contingent” tax credit is a credit that may be redeemed at a later date if the IFOF investor’s actual return on investment is less than a scheduled rate of return set by the ICIC Board. If such a return deficiency occurs, the contingent tax credit may be exchanged for a “verified” tax credit equal to the difference between the scheduled investment return and the actual investment return, and that verified tax credit amount may be claimed against Iowa tax.

The IFOF began operations on October 30, 2003, and was designed to continue until October 30, 2053, as stated in the agreement of the limited partnership dated June 9, 2005, unless sooner dissolved by operation of law or with the unanimous consent of the partners. No significant financial IFOF transactions occurred prior to June 28, 2005.

The IFOF has four partners:

- The General Partner is the Iowa Capital Investment Corporation (ICIC), a private, not-for-profit Iowa corporation.
- Iowa Designated Investor, Inc. (IDI), Preferred Limited Partner.
- Iowa Fund of Funds L.C. (a Revolving Fund) admitted as the Special Limited Partner.
- Cimarron Capital Associates I, LLC (Cimarron) has been admitted as a limited partner. Cimarron is employed by ICIC as the Fund manager.

The Fund has made capital commitments totaling $35.0 million to the Portfolio Funds listed in **Table 1**. The entire commitment had not been invested in the various funds as of the end of 2015. In addition, some invested capital has been returned to the Fund. On a cost basis, the outstanding IFOF investment totaled $20.6 million at the conclusion of 2015.[2]

Table 1

Iowa Fund of Funds (IFOF) Investment in Venture Capital Funds

Portfolio Funds	Company Headquarters	IFOF Investment Commitment	IFOF Investment as of 12/31/2015 (Cost Basis)
Prolog Capital II, LP	Missouri	$ 5,000,000	$ 1,186,813
Bayview Capital Partners II, LP	Minnesota	2,750,000	1,199,150
Village Ventures Fund II A, LP	Massachusetts	6,206,417	5,546,074
LFE Growth Fund II, LP	Minnesota	5,000,000	3,720,423
OCA Venture Partners II, LP	Illinois	5,000,000	4,384,146
Petra Growth Fund II, LP	Tennessee	5,000,000	1,831,881
Stone Arch Capital II, LP	Minnesota	6,000,000	2,770,308
		$34,956,417	$ 20,638,795

LP = Limited Partnership

On August 8, 2012, the partnership agreement of the IFOF was amended to state that the Fund shall not make capital investments in any additional portfolio funds and shall not make new commitments to any of the venture capital funds in the IFOF portfolio, but it shall honor mandatory capital calls based on commitments to existing portfolio entities made prior to December 31, 2011. The amendments to the agreement provide that the IFOF is to dissolve no later than December 31, 2027. In addition, no new partners are to be admitted to the agreement, and any remaining capital contributions required of the Preferred Limited Partner (Iowa Designated Investor, Inc.) as a result of previous commitments to the Portfolio Funds shall occur without approval of any other partner.

[2] Of the $35.0 million capital commitment to the seven Portfolio Funds, the Fund has contributed $30.2 million through the end of 2015. See **Table 5** for the status of the capital actually committed.

Revisions to Iowa Code chapter 15E, including new Iowa Code section 15E.72, were adopted by the 2013 Legislature. The 2013 legislation codifies the August 8, 2012, amendments to the Partnership Agreement. The 2013 legislation also limits the authority of ICIC to only those actions needed to comply with existing agreements and to wind down the IFOF. The legislation further provides that all returns payable to the IFOF Revolving Fund under the Partnership Agreement must instead be paid to the State General Fund.

According to the ICIC website and various annual reports of the ICIC, funds in which the Fund has invested have in turn provided capital in the amount of $21.7 million to eight companies with Iowa locations. Those companies include:

- Dwolla (Des Moines)
- Accumold (Ankeny)
- Global ID (Fairfield)
- Trego-Dugan Aviation (Sioux City)
- Asoyia (Iowa City)
- AppleWhite Dental Partners (Dubuque)
- JobDig (Des Moines)
- Mail Communications Group, Mail Services, LLC (Urbandale)

The Iowa Department of Revenue tracks tax credit liabilities and redemptions through its periodic Contingent Liabilities Report (CLR). The March 2016 CLR shows that a total of $25.6 million in IFOF tax credits has either been redeemed through 2015 ($23.5 million) or was projected to be redeemed ($2.1 million) during FY 2016 and FY 2017 (see **Table 2**). Redemption of the tax credits reduces State General Fund revenue in the years indicated.

Table 2
Iowa Fund of Funds Tax Credit Claims
Reductions in Net General Fund Revenue

	Tax Credit Claims
FY 2012 Actual	$ 185
FY 2013 Actual	11,295,681
FY 2014 Actual	12,182,951
FY 2015 Actual	0
FY 2016 Projected	1,353,376
FY 2017 Projected	763,375
FY 2018 Projected	0
Total	$ 25,595,568

Source: March 2016 Department of Revenue Contingent Liabilities Report

AUDITS – IOWA FUND OF FUNDS AND IOWA DESIGNATED INVESTOR

Audits of the IFOF from program inception through the end of calendar year 2015 are available through the State Auditor's Office. Audits for IDI are also available beginning with 2007.[3] The following information is based on information contained in the available IFOF and IDI audits.[4]

Administrative Expenses

Legal, managerial, and other administrative expenses occur within both IFOF and IDI, and the totals and subtotals are displayed in **Table 3**. From 2005 through 2015, $11.4 million in administrative expenses has been paid through the IFOF and its investor company, IDI. As program manager, Cimarron Capital has received the majority ($6.4 million) of the administrative expenses. Over the 11-year history of the program, the Fund has invested $30.2 million in venture capital funds (see **Table 5**). The $11.4 million in administrative costs is an amount equal to 37.7% of the invested amount.

Table 3
Administrative Expenses
Iowa Fund of Funds and Iowa Designated Investor *

Expenditure Item	Iowa Fund of Funds (IFOF)	Iowa Designated Investor (IDI)	Total
Iowa Capital Investment Corporation	$ 1,187,550	$ 0	$ 1,187,550
Iowa Capital Investment Board	55,000	0	55,000
Cimarron Capital Partners	6,360,889	0	6,360,889
Other Administration	730,372	1,682,847	2,413,219
Income Tax Expense	0	1,385,626	1,385,626
Administrative Expenses, Total	$ 8,333,811	$ 3,068,473	$ 11,402,284

* Iowa Designated Investor administrative expenses prior to 1/1/2007 are not available and not included.

Iowa Fund of Funds and Iowa Designated Investor Net Revenue

Over the course of 11 years, the IFOF and IDI have received $15.2 million in interest and portfolio revenues and incurred $10.2 million in interest expenses, leaving a net interest and portfolio revenue amount of positive $5.0 million. This net revenue return is an amount equal to 16.6% of the $30.2 million invested amount. With repayment of the bank loan nearly complete, interest expenses should be much lower going forward.

[3] Iowa Designated Investor, Inc. began operations June 24, 2005, and audits are available beginning with 2007. This leaves an 18-month window without an available audit of IDI.

[4] Financial information for **Table 3** (Administrative Expenses), **Table 4** (Interest and Portfolio Revenue), and **Table 5** (IFOF Portfolio Investment) is summed from the various annual audits' Statements of Operations and the accompanying audit notes. Financial information for **Table 5** and **Table 6** (Combined Balance Sheet) is from the Balance Sheet portion of the 2015 annual audits of the IFOF and the IDI.

Table 4
Interest and Portfolio Revenue
Iowa Fund of Funds and Iowa Designated Investor *

Net Revenue Item	Iowa Fund of Funds (IFOF)	Iowa Designated Investor (IDI)	Total
Interest and Portfolio Income	$15,097,684	$115,581	$15,213,265
Interest Paid	-892,001	-9,314,977	-10,206,978
Interest and Portfolio Income, Net	$14,205,683	-$9,199,396	$5,006,287

* Iowa Designated Investor interest earned and paid prior to 1/1/2007 is not available and is not included.

Iowa Fund of Funds Capital Invested in Portfolio Funds

From 2005 through 2015, the Fund invested $30.2 million in seven Portfolio Funds. This leaves approximately $4.8 million in potential capital contributions remaining, should the Portfolio Funds request the total $35.0 million commitment from the IFOF. Over time, the Portfolio Funds have returned $6.4 million of the invested capital, and $3.2 million in capital has been written off as permanently impaired. This results in a capital value of the various investments, at cost, of $20.6 million.[5]

Table 5
Iowa Fund of Funds Portfolio Investment

	Amount as of 12/31/2015
Capital Invested in Portfolio	$30,234,953
Capital Returned From Portfolio	-6,439,497
Capital Losses	-3,156,661
Portfolio Value, at Cost	$20,638,795

Combined Balance Sheet, Iowa Fund of Funds and Iowa Designated Investor

As IDI is the sole limited partner of the IFOF, the asset value of the limited partners in the Fund flows directly to the asset value of IDI. At the end of 2015, the balance sheet asset value of IDI was $-6,056,091. Besides the equity value in the Fund, the IDI asset value accounts for the remaining bank loan balance ($448,722) and the debt to the State of Iowa General Fund for verified tax credits issued, interest, and related state expenses, totaling $25,986,190.[6]

[5] The 2015 audit shows the estimated fair market value of the Fund investment in the Portfolio Funds is $27.5 million on December 31, 2015, suggesting a point-in-time unrealized gain of $6.9 million. This unrealized capital gain is not part of the IFOF asset value calculation.

[6] The IDI debt to the State General Fund of $25,986,190 is directly from the 2015 audit. The breakdown between verified income tax credits issued and additional debt owed to the state is calculated from annual reports of the Iowa Capital Investment Board stating that the verified tax credits issued total $25,595,568. The actual breakdown of the $25,595,568 may be somewhat different.

Table 6
Combined Balance Sheet as of 12/31/2015
Iowa Fund of Funds and Iowa Designated Investor

Balance Sheet Item	Iowa Fund of Funds (IFOF)	Iowa Designated Investor (IDI)	Total
Cash, Accounts Payable, and Other Items	$82	$-1,107,095	$-1,107,013
Iowa Designated Investor Loan Balance	0	-448,722	-448,722
Certified Income Tax Credits Issued	0	-25,595,568	-25,595,568
Additional Debt Owed to State of Iowa	0	-390,622	-390,622
Portfolio Investment, at Cost	20,638,795	0	20,638,795
General Partner's Equity	847,039	0	847,039
Transfers IFOF Equity to IDI	-21,485,916	21,485,916	0
	$0	$-6,056,091	$-6,056,091

BUDGET IMPACT

During FY 2013 and FY 2014, Iowa net General Fund revenue decreased by a total of $23.5 million due to the redemption of verified tax credits issued to banks to repay money borrowed to capitalize the IFOF. During FY 2016 and FY 2017, an additional $2.1 million is projected to be redeemed, bringing the total negative impact of the IFOF tax credits on the General Fund to $25.6 million.

Current Iowa law provides for repayment of the tax credits issued, plus interest and administrative costs, from the available assets of the IFOF Program. At the end of calendar year 2015, the combination of IFOF and IDI had a balance sheet value of $-6.1 million (see **Table 6**), a number that includes the negative balance sheet impact of the debt owed to the State General Fund. Once the remaining bank debt ($0.4 million) is repaid and any additional capital commitments to the Portfolio Funds (potentially $4.8 million) are honored, the IFOF Program may begin to repay its debt to the State General Fund. At the conclusion of 2015, that debt was $26.0 million.

The debt to the State General Fund will continue to grow through an interest calculation until repaid. If and when the debt to the State General Fund is repaid in full, Cimarron Capital will receive any further profit distributions, up to percentages listed within the revised IFOF agreement.[7]

STAFF CONTACT: Jeff Robinson (515)281-4614 Jeff.Robinson@legis.iowa.gov

[7] According to the 2015 IDI audit, the potential profit distribution to Cimarron is equal to 7.5% “carried interest” on the Fund's net profits from interests in the Portfolio Funds and an additional amount based on the amount and time period of the deferral calculated at an annual rate of 12.0%. The audit does not report the potential value of this calculation to Cimarron and does not carry this potential payment as a liability.

APPENDIX

LEGISLATIVE HISTORY

2002 – HF 2078 (Iowa Fund of Funds Act). Created the Iowa Capital Investment Corporation, the Iowa Fund of Funds, and the contingent tax credit used to provide a guaranteed return to Iowa Fund of Fund investors.

2005 – SF 114 (Iowa Capital Investment Board Tax Certificate Act).

- Removed a restriction that prohibited equity redemptions sooner than five years after an equity investment was made by an investor and a restriction that prohibited tax credit redemptions sooner than five years after tax credit issuance.
- Permitted tax credits to be transferred and redeemed by the transferee.

2006 – HF 2754 (Regulation of Renewable Fuels and Energy Act). Added the need for increased Iowa venture capital in the areas of alternative and renewable fuels to the original Act's purpose.

2009 – SF 478 (Standing Appropriations Act). Required the ICIC, the IFOF, and designated investors to file annual financial statements with the State Auditor.

2010 – SF 2380 (Tax Expenditure Reduction and Study Committee Act). Reduced the $100.0 million aggregate amount of contingent tax credits that could be issued for IFOF investments to $60.0 million.

2012 – HF 2465 (Standing Appropriations Act). Directed the Executive Council, in consultation with the Attorney General, to take any action necessary to protect the interest of the state with respect to any tax credits issued or any entities created as part of the IFOF Program.

2013 – SF 452 (Standing Appropriations Act). Removed the existing 50-year lifetime of the IFOF and directed the Iowa Capital Investment Board to wind down and liquidate the Fund as directed in new Iowa Code section 15E.72.