

## ILLINOIS VENTURE CAPITAL: HOW IT STACKS UP\*

*Why Early Stage Venture Capital is so important to new company growth*

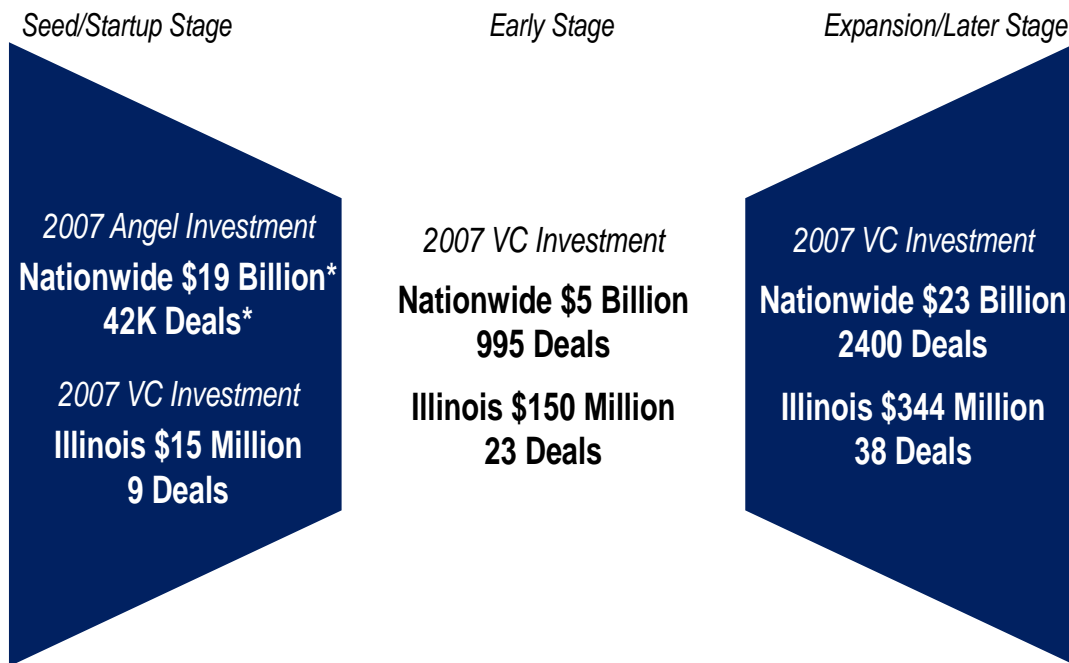
- Typically, new businesses are initially funded by entrepreneur savings, credit cards and "friends & family".
- Additional sources of "seed" capital include investments from high net worth individuals, i.e., angel investors, and/or grant programs.
- However, these sources of seed capital generally cap at \$1 million – usually much less than is needed for a technology start-up to gain traction. This "gap" between seed funding and later stage venture capital is filled by early stage venture capital.
- There is an important distinction between venture capital (both early stage and later stage) and private equity, which focuses on mature businesses with reliable cash flows and is employed in leveraged buyouts and recapitalizations.
- Once a business achieves traction (e.g., full product development, initial revenue, marquee customers, clinical trials), capital becomes more readily available. These businesses can attract expansion or later stage venture capital from institutional investors. However, prior to achieving traction, it is more difficult to access early stage institutional funding/venture capital, especially in the Midwest. Thus, companies that cannot attract early-stage capital either fail, seek capital elsewhere (e.g., on the coasts) or grow more slowly until expansion stage capital is available.
- Early-stage funding is geographically highly parochial. Because of the volatility of start-ups, most experienced early-stage investors prefer to fund deals that are no more than a couple hours travel away. Close proximity allows investors to be actively involved with the start-up in the early phases of the company's development.
- ***Many start-ups in the Midwest either fail for the lack of early-stage venture capital or are forced to relocate elsewhere, mainly the coasts for close oversight and involvement by the out-of-state venture capital funds that fund them.***
- Thus, the success of new company growth in a region can be directly correlated to the quantity and available assets of local venture capital firms.
- With few exceptions, successful programs in other regions that have resulted in sizable new company growth rates (San Diego, Austin and Silicon Valley) have been the result of civic/business coalitions.
- Virtually every Midwest state has recognized the importance of venture capital, particularly early stage capital, and have created programs to increase the availability of venture funding.
- **Programs in Indiana, Iowa, Michigan, Ohio and Wisconsin direct substantially more capital to address the lack of local venture capital than Illinois (see page 4).**
- Only Illinois, Indiana and Wisconsin have created programs that do not rely on tax credit financing. However, the size of the Illinois program is dwarfed by programs in other states.
- **The proposed TDA II legislation will bring the Illinois program closer to these states' level of support and make Illinois more competitive in helping to develop and retain start-up companies in the state.**

## The Gap in Early Stage Venture Capital in Illinois

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Over the past 20 years, the vast majority of private equity capital in Illinois has been used to finance the acquisition of mature companies, either in leveraged buyout transactions or recapitalizations. While this capital can save failing companies or expand and grow existing companies, it is not used to fund new businesses, which are the primary drivers of economic growth. Venture capital is critical to supporting entrepreneurial activities. In particular, early stage financing – capital used to establish a company before it starts to generate sales and profit -- is critical to new company development and growth. Companies that are unable to obtain early stage financing from a local venture capitalist either fail or accept financing from investors that are located elsewhere, most notably on one of the coasts. This out-of-state financing often carries the requirement that the company receiving the funding move outside of Illinois to where the investor is located for ease of closer oversight and involvement in the management of the company.

As the chart below illustrates, both nationally and locally, there is a large gap between seed/angel stage investing and expansion/later stage investing.<sup>1</sup> This early stage funding gap is magnified in the Midwest, where there are fewer numbers of venture firms and fewer dollars to invest. In Illinois, later stage venture capital investment is also low as compared to the coasts. So the need for increased venture capital investment here runs across the spectrum from early stage to later stage.



<sup>1</sup> \*Estimated from UNH Center for Venture Research 2006 Angel Investor Market Report  
Sources: UNH Center for Venture Research, PWC MoneyTree 2007

### *Downward Trend for Local Venture Capital Funding*

The need for increased venture capital in Illinois has never been more pressing, especially for local venture capital firms that provide early stage funding for local companies. This shortage of local venture capital funding can be attributed to several factors:

- Local private equity firms are moving away from venture capital funding into buyout only (Illinois hosts several large private equity buyout firms);
- Local funds-of-funds have significantly grown such that for efficiency reasons, they are almost forced to make more investments on the coasts, which can better accommodate larger investments;
- Local institutional investors and high net worth individuals are allocating their alternative investments to funds-of-funds, (which as mentioned above are not geographically focused) rather than directly into local venture capital funds;
- Some state and local pension funds do not invest in venture capital at all. Those that do have significant amounts of capital to invest. Thus, they either invest in fund-of-funds or, if they invest directly, the capital is invested in large coastal funds.

The lack of venture capital in Illinois has caused many businesses to fail and sent many others to the coasts for funding. Netscape and Amgen are two of the many companies that were forced to move out of the state for early stage capital.

## State Venture Programs in the Midwest

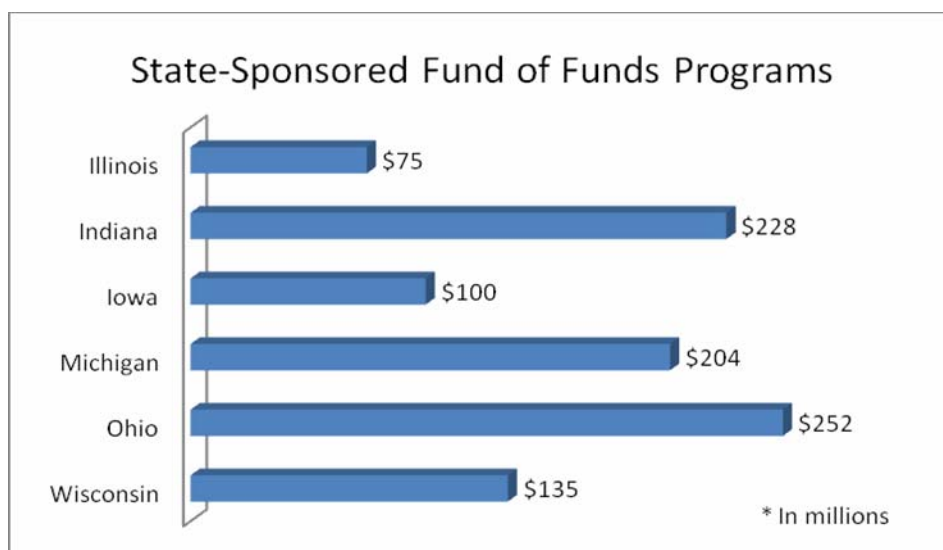
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For close to two decades, states have understood the importance of developing a vibrant venture community to promote new company formation, increased employment and economic growth. As a result, many states have initiated efforts to promote their local venture capital markets. These programs have used various structures, such as dedicating state revenues to a specific program or issuing various types of tax credits.

The National Association of Seed and Venture Funds (“NASVF”), which is headquartered in Illinois, recently surveyed every state in the nation in an attempt to identify all state venture programs. In total, 44 states participated in the survey, and according to the information provided, the NASVF estimates there are over 150 programs, totaling close to \$6.0 billion of capital. Over 75% of the programs provide capital in the form of cash. Approximately 20% of the programs use private capital.

As state venture programs have become more popular, many Midwestern states have started their own such programs. It is not a coincidence that these states, like Illinois, have historically lagged in terms of the amount of venture capital invested in local companies. To help ensure that these programs have a meaningful impact on their economy, these Midwestern states, including Michigan, Ohio, Wisconsin, Indiana and Iowa, have been fairly aggressive with their state venture programs (i.e., the funds equivalent to the TDA), especially when compared to their relative economic size.

The chart below shows the amount of capital allocated to each state program in the Midwest (\$ in millions).



STATE PROGRAMS IN THE MIDWEST FOCUSED ON VENTURE CAPITAL

Fund	Size	Type of Investors	Status	Comments
Indiana Future Fund	\$73 million	Public pensions, private corporations and universities	Fund is fully invested in six funds. In discussions for second fund.	Heavily focused on life sciences.
Indiana Investment Fund	\$155 million	Public employees retirement fund (PERF)	Fund has made several investments, with \$30M+ remaining to invest.	Both fund and direct investments; non-life sciences funds only.
Iowa Capital Investment Corporation	\$100 million	Supported by tax credits.	Fund is currently making investments and to date has 3 commitments.	
Venture Michigan Fund	\$95 million	Supported by tax voucher certificates.	Fund has made three investments; looking to make a total of ten to 12 commitments.	Invests in both funds and corporations that are mainly in Michigan and the Midwest. Can represent up to 25% of any one fund.
21 <sup>st</sup> Century Investment Fund (Michigan)	\$109 million	Tobacco settlement monies, as invested in the 21 <sup>st</sup> Century Jobs Fund initiative.	Fund has invested \$58.8M in seven funds.	Requires significant presence, i.e., office, in Michigan.

Ohio Capital Fund	\$150 million	Fifth Third and Deutsche Bank led financing and syndicated it to insurance companies, corporations and other investors. The financing is backed by tax credits.	Fund has invested \$100M in nine funds; six in the state, three outside.	At least 75% of fund must be invested in Ohio-based venture funds, and up to 25% may be invested in venture funds which are not in Ohio. Maximum investment in a fund is \$10 million.
Ohio Midwest Fund	\$102 million (was \$51 million; recently doubled)	Almost entirely financed through Ohio Public Employee Retirement System.	Fund has made eight investments.	Invests in both funds and corporations that are mainly in Ohio and the Midwest. Several of the funds are middle buyout funds.
State of Wisconsin Investment Board (SWIB)	n/a	SWIB is the 10 <sup>th</sup> largest U.S. pension fund for public employees and invests its own capital.	Fund has invested \$135M in five WI-based funds. Recently agreed to re-up in funds.	Initiative by SWIB Board of Trustees to invest in WI funds as part of overall PE portfolio.
Illinois Technology Development Account	\$75 million	Illinois Treasurer's Account	Fund has committed to 14 funds. It expects to make its final commitments in 2008.	Invests only in funds that have an office in the State.

Some key points about these state programs:

- Of all of these states, Illinois has the largest gross domestic product (by at least \$100 million). Yet, all of these other programs are larger than the TDA. Ohio, which is the next largest Midwestern state in terms of GDP, has over \$250 million devoted to programs similar to the TDA (in comparison TDA I tops out at about \$75M). Most importantly, when compared to the current size of the venture markets in each of these states, the state programs are significantly larger than what Illinois has allocated.

<u>Rank</u>	<u>State</u>	<u>2006 Real GDP (a)</u>	<u>2006 Venture Investments (b)</u>	<u>State Program (c)</u>	<u>State Program versus Venture Investments</u>
1	Illinois	\$507,037	\$410	\$75	18.3%
2	Ohio	\$397,243	\$75	\$252	336.0%
3	Michigan	\$339,507	\$106	\$204	192.5%
4	Indiana	\$215,025	\$79	\$228	288.6%
5	Wisconsin	\$196,642	\$72	\$135	187.5%
6	Iowa	\$106,346	\$12	\$100	833.3%

(a) Source: Bureau of Economic Analysis, 2006 Advanced Results

(b) Source: Venturexpert data as of July 13, 2007

(c) Various public sources

- Many of the programs have accessed both private and public funds.<sup>2</sup> This underscores both the willingness of private investors to participate in such programs and how having such partners can help increase the amount of capital available.
- For the most part, the legislation or rules governing these funds are more flexible than what is currently permitted under TDA I. For example, the Venture Michigan fund can represent up to 25% of any one fund. In Ohio, up to 25% can be invested in funds outside of the state. From a practical standpoint, the result of this provision is that the Ohio Capital Fund has invested in funds that have a track record of making investments in the state but just do not have an office physically located in Ohio. TDA II would address several of these issues.
- Generally the commitments to the funds have been larger than the average TDA I commitment. In Indiana, the \$73 million fund is fully invested in six funds, with an average investment of about \$10 million. Similarly, the Ohio Investment Fund, with \$102 million of capital and eight investments, has an average investment of over \$11 million. In comparison, the average TDA I commitment is approximately \$4 million.

<sup>2</sup> In some cases the public funding is in the form of future tax incentives.

## Illinois' Technology Development Account (TDA)

The Treasurer's Technology Development Account II (TDA II) builds upon the success of TDA I, which was authorized by legislation in 2003. Like TDA I, TDA II will provide much-needed venture capital to the high technology sector in Illinois by:

- Allowing up to 2% of the Treasurer's investment portfolio to be invested in venture capital funds (up from 1% in TDA I); and
- Establishing a new public/private partnership, with capital from private institutional investors being invested side-by-side with the Treasurer's capital. The public fund (TDA II a) would be housed in the Treasurer's Office, holding money from the State's investment portfolio; the private tandem fund (TDA II b) would be held outside the Office. Both funds would be managed by professional investment advisors.

Legislation authorizing TDA II was introduced on April 2 in the Senate (Senate floor amendment No. 1 to SB 786) and passed by a vote 58 to 0 on April 16<sup>th</sup>. The bill now awaits House action.

Given the budgetary issues in Illinois, it is not feasible to create a tax credit program to promote increased venture capital investment in the state. Moreover, with many of the existing state tax credit programs across the country coming under scrutiny for their cost/benefit effectiveness, the structure of TDA I serves as a model for states to follow in helping to develop a local vibrant venture capital community. It also allows for portfolio diversification of the state's investments, allocating a certain percentage of those investments to venture capital funds.

Managed professionally and with the appropriate focus on investment returns, TDA I has increased the amount of early-stage venture capital available for investing in Illinois and elsewhere. ***By expanding and refining the program, the state can play a larger and more effective role in providing capital for new company formation in the state, leading to job and economic growth.***

- Start-up companies are engines of economic growth.
  - Generate 80% of all new jobs in the U.S. economy
  - Expected to grow 3 times faster than the economy as a whole
- Chicago created 3.6 new businesses per 1000 capita in 2000.<sup>3</sup>
  - 9.5 in Los Angeles
  - 6.7 in New York
  - 4.9 National Average

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<sup>3</sup> A.T. Kearney

- Venture-backed companies outperform their non-ventured counterparts.<sup>4</sup>
  - Job creation: 4.1% vs. 1.3%
  - Sales growth: 11.3% vs. 8.5%
- Although venture capital investments equate to only 0.2% of the nation's GDP, venture capital is responsible for 9.0% of private sector employment and revenues equating to 16.6% of the GDP.<sup>5</sup>
- Venture capital-backed companies spend more than twice as much on R&D, translating into more innovation.

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<sup>4</sup> Global Insight, "Venture Impact 2007"

<sup>5</sup> Global Insight, "Venture Impact 2007"

**Appendix: Venture Capital in Illinois**

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Illinois has historically been ranked between the 10<sup>th</sup> and the 14<sup>th</sup> largest venture market when compared to the other 49 states. As shown below, for calendar 2006, Illinois ranked 11<sup>th</sup>, behind North Carolina and just barely ahead of Georgia and Virginia.

**TOP 10 STATES, RANKED BY VENTURE CAPITAL INVESTMENTS (a)**  
 Period: 2006 (\$ in millions)

<u>Rank</u>	<u>State</u>	<u>Investment</u>		<u>Number of Deals</u>	
1	California	\$12,828	48%	1,527	39%
2	Massachusetts	\$2,848	11%	383	10%
3	Texas	\$1,437	5%	187	5%
4	New York	\$1,283	5%	203	5%
5	Washington	\$1,075	4%	141	4%
6	Pennsylvania	\$860	3%	106	3%
7	New Jersey	\$766	3%	89	2%
8	Colorado	\$670	3%	102	3%
9	Maryland	\$655	2%	109	3%
10	New Carolina	\$514	2%	71	2%
11	Illinois	\$410	2%	56	1%
	Other	<u>\$3,386</u>	<u>13%</u>	<u>964</u>	<u>24%</u>
	Total	<u>\$26,732</u>	<u>100%</u>	<u>3,938</u>	<u>100%</u>

(a) Source: Venturexpert data as of July 23, 2007

While Illinois' rank has improved somewhat over the last several years, (from #15 in 2004 to #11 in fiscal 2006), when looking at the cumulative amount of investments over the four year period beginning in 2003, Illinois is in 14<sup>th</sup> place. Perhaps more telling is a comparison of the average annual growth rate over the last several years. Between 2003 and 2006, venture investments in Illinois grew approximately 7.7% per year versus 10.6% for the United States.

When viewed from a relative perspective, such as compared to a state's gross domestic product, Illinois lags even further behind. As shown in the table below, venture investments made in Illinois as a percentage of the State's Gross Domestic Product is well below many other states. For example, Pennsylvania, with a gross domestic product slightly smaller than Illinois', has a ratio of venture investments to GDP of 0.17%, more than twice the comparable figure for Illinois of 0.07%. If the comparison is limited to states with total annual venture investments about equal to Illinois (between \$350 and \$500 million), Illinois also

falls short. For example, the ratio of venture investments to GDP for Georgia (with total venture investments in 2006 of \$400 million) equals 0.11% versus Illinois of 0.07%. Similarly, North Carolina (\$514 million of venture investments) has a venture to GDP ratio of almost twice that of Illinois (0.14%). Virginia, with \$392 million of venture investments, has a ratio of venture to GDP of 0.11%.

### VENTURE INVESTMENTS VERSUS STATE GROSS DOMESTIC PRODUCT

Period: 2006 (\$ in millions)

Rank	State	Gross Domestic Product (a)	Venture Investments in 2006 (b)	GDP to Venture Investments
1	California	\$1,727,355	\$12,828	0.74%
2	Texas	\$1,065,891	\$1,437	0.13%
3	New York	\$1,021,944	\$1,283	0.13%
4	Florida	\$713,505	\$365	0.05%
5	Illinois	\$589,598	\$410	0.07%
6	Pennsylvania	\$510,293	\$860	0.17%
7	Ohio	\$461,302	\$75	0.02%
8	New Jersey	\$453,177	\$766	0.17%
9	Michigan	\$381,003	\$106	0.03%
10	Georgia	\$379,550	\$401	0.11%
11	North Carolina	\$374,525	\$514	0.14%
12	Virginia	\$369,260	\$392	0.11%
13	Massachusetts	\$337,570	\$2,848	0.84%
14	Washington	\$293,531	\$1,075	0.37%
15	Maryland	\$257,815	\$655	0.25%

(a) Source: Bureau of Economic Analysis, 2006 Advanced Results

(b) Source: Venturexpert data as of July 23, 2007