MEMORANDUM

Date: July 14, 2003

To: Wisconsin Technology Council

From: Alexander T. Pendleton, Chair, Investment Capital Committee
Wisconsin Technology Council

Subject: INVESTMENT CAPITAL POLICY AGENDA

- Statement of the Investment Capital Issue
- A Proposed Investment Capital Policy Agenda
- Alternatives

Statement of the Investment Capital Issue

The goal of the Wisconsin Technology Council's Investment Capital Committee is to increase the amount of venture capital, angel capital, federal funds and other investment capital available to Wisconsin tech businesses. To that end, the Committee has met and considered numerous proposals to achieve this goal. The Committee has agreed unanimously on recommending that the Governor and the Legislature give their support to the following three proposals:

1. Expand the CAPCO program by $200 million and extend tax benefits to permit additional in-state insurance firms to invest in CAPCOs.

2. Create tax incentives for seed capital investments in Wisconsin tech start-ups, specifically:

   - Create a tax credit for investors who invest seed capital in Wisconsin tech start-ups.

   - Create a tax deferral of the gain that would otherwise be recognized upon the sale of an investment in a tech start-up, if that investment is rolled over into an investment into a seed-level investment.

3. Create incentives to bring the Biotechnology Industry Organization (BIO) '05 Midwest conference to Wisconsin.

Support for the first two proposals follows, as does a discussion of alternatives. The Committee is currently developing information related to the third proposal. It is worth noting, however, that the Wisconsin Technology Council and the Wisconsin Biotechnology Association have already discussed the possibility of bringing the BIO '05 Midwest conference to Wisconsin. In 2006, the national BIO conference will take place in Chicago, so a regional effort in Wisconsin a year earlier would be an appropriate precursor.

CERTIFIED CAPITAL COMPANY PROGRAM

Stimulating Wisconsin's High Tech Sector
(Revised from a document first prepared on March 31, 2003)

1. The Importance of Venture Capital

Wisconsin possesses many of the characteristics that are viewed as essential ingredients to the establishment of a vibrant high tech economy. We are the home of a major research university that stimulates innovation. We have a highly educated and skilled workforce. However, we lack sufficient venture capital to start and grow many of the businesses with the greatest potential. Why is it strategically important for Wisconsin to have adequate pools of venture capital? Consider the characteristics of venture capital backed companies and the staggering impact of venture capital on the U.S. economy. For every $1,000 in assets, companies that were originally venture backed outperformed other public companies on a relative basis across a number of economic measures between 1980 and 2000[1]:

- Venture-backed companies had nearly double the revenue at $634 versus $391.
- Venture-backed companies paid almost three times as much in federal taxes at $14 compared to $5.
- Venture-backed companies exported nearly double the product at $138 versus $72.
- Venture-backed companies spent approximately three times as much on research and development with $44 versus $15.
- About 11 percent of the U.S. GDP and one out of every nine jobs in 2000 was generated by an originally venture-backed enterprise. If supporting businesses that deliver goods and services to these venture-backed companies were also included in the total, the jobs number increases by a factor of 2.2, translating to 27 million jobs.

The state of Wisconsin generates direct financial returns from the CAPCO program and the venture capital industry investment through the income tax of the employees and businesses, a capital gains tax from the gains of founders and investors, as well as sales and property taxes resulting from the activities of these new businesses and the individuals associated with them.

2. Wisconsin's need for venture capital

Despite being the home to the second largest research institution in the nation, and having above average per capita spending on Research and development at our universities, we lag in our capacity to commercialize our discoveries.

According to the National Venture Capital Association, the venture capital industry has $253 billion under management[2], while Wisconsin has $96 million under management, or *only 0.04% of the national total*. The average venture capital firm in the U.S. in

Wisconsin compared to the Nation	Wisconsin's Percent	Wisconsin's Rank
Population	1.95%	18th
R&D spending at Universities	2.24%	13th
Venture capital under management	0.04%	32th
Wealth	1.30%	41st
Sources: US Census Bureau, National Science Foundation, National Venture Capital Association, Wisconsin Tax Payers Alliance.		

[1] DRI-WEFA studies on Venture Capital, 2001 and 2002.

[2] National Venture Capital Association 2003 Yearbook

2002 has $283.9 million under management, nearly three times the amount that all Wisconsin based venture capitalists have raised in the last eight years combined. Venture capitalists that invest in companies that are in the later stages of development will invest nationally, so Wisconsin companies can potentially access the capital that is managed outside of the state. However, venture capitalists need to be more actively involved with an early stage company, which typically requires the presence of a local lead investor. Without the adequate availability of venture capital at the earliest stages, few companies will develop to the stage where they can compete for capital nationally. As a result, Wisconsin based venture capital is an essential ingredient to building companies and attracting investment capital from outside of Wisconsin.

Venture capital is viewed as critical to the development of a robust high technology sector. To be competitive on an international basis, these companies must make enormous investments in research and development and specialized facilities. In the biotech and medical device sectors, where Wisconsin's universities are research leaders, these companies face the added burden of regulatory approval. As a result, Wisconsin not only needs venture capitalists so more companies can obtain financing; it needs venture capitalists whose investment capacity fits the financing requirements of the most qualified opportunities. Nationally, a firm receiving its first round of venture capital had an average round of funding of $6.99[3] million in 2002, and most companies need multiple rounds of funding over time. Wisconsin's three CAPCOs each have $16.7 million under management and have a statutory limitation of investments of $2.5 million per firm. However, most venture funds do not want to put more than 10 percent of their capital in any one deal. Furthermore, venture capital funds want to maintain reserve investment capacity for subsequent funding rounds, so rarely will one of the CAPCOs be able to prudently consider an investment of more than $1 million at the time of the initial investment. This modest capacity makes it extraordinarily difficult to take a lead role and attract sufficient co-investors for a first round of funding that would be typical at the national level.

a. The CAPCO Program causes venture capital fund formation in Wisconsin

The establishment of a venture capital industry in a state is a classic chicken and egg problem. Pools of capital are difficult to raise unless there are a demonstrated concentration of entrepreneurial success stories and an experienced group of venture capital fund managers. However, without the availability of capital, it is difficult to create the concentration of entrepreneurial success stories and fund managers cannot build their track record. We need to grow our own venture capital industry. Success in the venture capital business is tied to the ability to build a network of local and regional contacts and resources to advise and counsel a company. A successful venture capitalist is unlikely to abandon the resources they develop in one state and then start from scratch in a new location. Unfortunately, it is a difficult time to grow the state's venture capital industry. Traditional investors in venture capital are not currently getting liquidity from past investments in the weak climate for initial public offerings, slowing the ability to make new commitments to new funds in the U.S. from a high of over $100 billion in 2000 to less than $1 billion in the first quarter of 2003.

[3] National Venture Capital Association 2003 Yearbook

The CAPCO program uses tax credit incentives to tilt the playing field, reducing risk or enhancing returns to make an investment in a Wisconsin-based fund relatively more attractive. Certified Capital Company legislation has been adopted by eight states: Louisiana, Missouri, Florida, New York, Colorado, Texas, Alabama and Wisconsin. The evidence from these eight states is that the demand for this type of investment opportunity exceeds supply. As a result, the availability of additional tax credits for the CAPCO Program will almost certainly result in the availability of more venture capital in Wisconsin, even in the current difficult climate. Wisconsin's CAPCO Program is currently the smallest of the eight established programs.

STATE	Total Requested Since Inception of CAPCO Program (Industry-wide)	Total Allocated Since Inception of CAPCO Program (Maximum available)
Florida	$ 274,850,000	$ 150,000,000
Louisiana *	$ 1,121,000,000	$ 721,000,000
Missouri	$ 317,800,000	$ 140,000,000
New York	$ 758,200,000	$ 280,000,000
Wisconsin	$ 150,000,000	$ 50,000,000
Colorado	$ 454,000,000	$ 100,000,000
Alabama	Not yet allocated	Not yet allocated
Total	**$ 3,075,850,000**	**$ 1,441,000,000**

*Estimated: amount available was unlimited prior to 1998.
Source: Advantage Capital

Multiplier effect for CAPCO Program (dollars in millions)	Advantage Capital	Stoneheng e Capital	Wilshire Capital	Total[1]
Amount invested by Wisconsin CAPCOs	$7.9	$5.5	$7.4	$20.7
Co-investment by other WI investors	$30.8	$14.2	$1.3	$35.5
Co-Investment by out-of-state investors	$86.3	$15.3	$0.1	$89.0
Total invested in Wisconsin companies	$125.0	$34.9	$8.7	$145.1
Multiplier of invested capital	**15.9** x	**6.4** x	**1.2** x	**7.0** x
Amount managed by CAPCO	$16.7	$16.7	$16.7	$50.0
Side-by-side VC capital fund raised	$37.1	0.0	$0.0	$37.1
Total raised	$53.8	$16.7	$16.7	$87.1
Multiplier of venture capital managed	**3.2** x	**1.0** x	**1.0** x	**1.7** x

1. Source: Venture Investors, Advantage Capital, Stonehenge Capital, Wilshire Capital
[1] Numbers do not total across because of common investments of CAPCOs

3. The CAPCO Program has a multiplier effect

4. The CAPCO Program has a multiplier effect on the availability of venture capital in Wisconsin in two ways. First, the CAPCO fund managers serve as lead investors and actively solicit participating investment from other venture capitalists locally and nationally. Second, management of the CAPCO fund can enhance the ability of the manager to raise additional capital outside of the CAPCO Program.

5. The venture capital industry tends to be more cooperative than competitive. The typical transaction includes three or four venture capitalists that band together and provide financing on a single set of terms. This is usually necessary because the financing requirements of a single firm are commonly greater than the capacity of any single investor. This also provides greater capacity around the table for future rounds of financing, and greater diversity of expertise to assist the company. The investor that locates the deal, drafts the terms for investment, and coordinates or actively recruits the participation of the

other investors is informally considered the lead investor. Advantage Capital Wisconsin Partners I L.P. has served as lead investor or co-lead investor in each of the six transactions in which it invested, while Stonehenge and Wilshire have led the majority of their deals. We have demonstrated that this is an effective means of attracting investment capital into Wisconsin.

Venture Investors LLC, Advantage Capital's manager for their Wisconsin CAPCO, committed a portion of their investment returns from the CAPCO to the limited partners of Venture Investors Early Stage Fund III L.P. This proved to be an important component in obtaining investor commitments of $37.1 million for this new fund in 2000.

CAPCO backed companies create good jobs

The typical venture capital backed company operates in a rapidly growing sector of the economy and relies on highly skilled labor. The Wisconsin CAPCO experience has been consistent with the venture capital industry data that venture backed companies experience rapid employment growth. Thus far, Wisconsin's CAPCOs have invested $20.7 million in 15 companies. These companies have had extraordinary growth in their number of employees, with continued growth expected. The growth is particularly strong when you consider that all the investments are three years old or less.

Employment growth at CAPCO backed companies	Advantage Capital	Stonehenge Capital	Wilshire Capital	Total
Wisconsin based employees at time of investment	141	163	29	273
Wisconsin based employees as of 3-31-2003	247	208	44	430
Average annual salary	$71,521	$51,723	$149,941	$69,885
Total Payroll	$17,666k	$10,758k	$6,597k	$30,051k
Est. annualized Wis income tax revenue	$1,218,934	$742,334	$455,221	$2,416,491
(1) Sources: Venture Investors, Wisconsin Taxpayers Alliance Estimated annualized tax revenue assumes a 6.9% tax rate.				

The jobs created by the venture capital industry are good jobs. Managers, scientists and engineers account for 60.3 percent of the labor force in venture capital backed companies, versus 13.7 percent in the U.S. labor force. Wisconsin CAPCO backed companies have an average annual salary of $69,885, as compared to a personal income per capita of $29,270 in Wisconsin.

CAPCO-backed companies generate wealth in Wisconsin

Wisconsin has $13,862 in wealth for every man, woman and child, which places it 41st nationally. The U.S. per capita average is $20,864, or 51 percent higher. It is far easier for wealth to be generated through the appreciation in value of a business than by personal savings from a paycheck.

In some communities in the country, the enormous success of a single company has generated the kind of wealth that transforms a local economy by spawning the next generation of companies from the seed capital of success. Dell Computer created thousands of millionaires and 20,000 jobs in Austin, Texas, setting the stage for a robust high tech economy. DePuy is an orthopedic business in little Warsaw, Ind., and now together with spin-outs Zimmer and Biomet, Warsaw has three of the five largest orthopedic implant businesses in the world representing a combined 30 percent world market share.

A study by DRI-WEFA[4] shows that venture capital has played a significant role in creating industry clusters. What if Whitefish Bay native and University of Wisconsin-Madison graduate John Morgridge had decided to start Cisco Systems in Madison or Milwaukee? Even after the tech stock slide of the last few years, Cisco Systems is worth $118 billion today. Each CAPCO has focused on different market niches, often investing in more than one company in a particular industry cluster.

The DRI-WEFA study shows that venture backed companies outperform their peers, which translate into more rapid growth in the value of the company's ownership. When these investments reach maturity and investors receive liquidity from the initial public offering or sale of the business, unrealized gains will become realized and create wealth. Successful entrepreneurs become angels that back the next generation of companies.

The CAPCO program is part of the solution to our state's budget shortfall

The CAPCO program provides stimulus to Wisconsin's economic future. The CAPCO funds have backed high-growth companies in sectors that include biotechnology, medical devices, semiconductors and communications. These companies are formed around patented innovations that provide a sustainable competitive position for continued future growth. They hire highly skilled professionals that graduate from Wisconsin's universities, plugging the brain drain while providing desirable high paying jobs that will help Wisconsin increase its personal income per capita closer to the national average. Many of these companies have invested or made long-term lease commitments for highly specialized facilities that are necessary for their research, development and manufacturing needs. The combination of highly trained personnel and highly specialized facilities means that these companies are planting deep roots in Wisconsin that create substantial economic barriers to their possible relocation outside the state.

The existing $50 million CAPCO program may already be budget neutral, generating net tax revenue that exceeds the annual $5 million in tax credits. It adds to Wisconsin's tax base in a variety of ways:

- Income taxes: CAPCO-backed companies retain or create jobs in Wisconsin, with a combined payroll of more than $30 million and an estimated $2.4 million in income taxes. This does not include any multiplier effect of the jobs created by the other spending of the company or by the spending of those individual employees.
- Sales taxes: The CAPCOs have routinely been the lead investor in venture capital financings, and the $20.7 million invested by the CAPCOs has attracted total investment of $145.1 million. In addition to payroll and facilities costs, this money is largely spent on goods and services in Wisconsin. Furthermore, the individuals whose jobs are created by the CAPCO program are spending on goods and services, which results in sales tax revenue for the state.
- Property taxes: Many of the CAPCO-backed companies have entered into long-term leases that resulted in the construction of specialized facilities with a net cost of at least $21 million to meet their unique needs. This adds to the property tax base in the state. This is in addition to any new home construction by the 430 individuals

[4] Formed by the merger of Data Resources, Inc. and Wharton Econometric Forecasting Associates, DRI-WEFA is one of the leading economic and financial forecasting companies in the world.

employed by a CAPCO-backed company or whose job has been indirectly created or supported by the activities of a CAPCO-backed company.

- Capital gains tax: The CAPCO program is still too young to have created significant realized capital gains thus far. However, most CAPCO-backed companies have aspirations to become a public company, which typically requires a growth in total market value to an amount of at least $150 million. Such an event results in significant capital gains and generates tax revenue.

Recognizing the initial budget impact of the CAPCO program, Wisconsin's existing CAPCOs have recommended that the new CAPCO legislation delay the availability of the first tax credit until the next biennium. This would enable the CAPCOs to raise capital from insurance company investors today, with all tax revenue in the current biennium reducing the budget shortfall. By the time of the initial tax credits, the investment activity will have stimulated economic activity to reduce any temporary negative impact, and will shorten the path to the long-term positive budget impact.

Why is additional funding needed now?

There are two factors that are driving the need for additional funding for the CAPCO Program. First, the CAPCO program is working in Wisconsin, but its small size limits its effectiveness. Second, if the program is not funded now, the continuity of the program will be lost.

The average venture capital fund formed in 2002 raised $141 million[5]. Each of Wisconsin's three CAPCOs have $16.7 million under management. As noted previously, the average first round of company financing by venture capitalists is $6.99 million nationally. The appetite for capital of Wisconsin-based companies that are trying to compete internationally is no different. Wisconsin's three CAPCOs are limited to $2.5 million per company. Since these companies commonly require multiple rounds of financing, most venture capitalists limit their first round of funding to a company to half their capacity. As a result, the Wisconsin CAPCOs are practically limited to initial investments of $500,000 to $1 million in most cases. Venture capitalists from the East Coast and California will consider investments in the Midwest, but rarely in the first round of funding. They will consider investment once operations are well established and a complete management team is in place. As a result, the first round of venture capital funding has to originate from the region. The current CAPCO program is not large enough to address the needs of the market.

[5] National Venture Capital Association 2003 Yearbook

Like any venture capital firm, CAPCOs must charge fees to a fund to cover operating costs and salaries for a professional team. Thus, a portion of the requirement to invest 100 percent of the committed amount can not be fulfilled until first investments have been successfully exited. Furthermore, venture capitalists must reserve money for follow-on investment. Two of Wisconsin's CAPCOs are nearing the investment of 50 percent of the current allocation, which will limit the ability to back additional companies until an exit event occurs. Without additional funding, these firms will effectively be out of the market. This type of disruption in the CAPCOs ability to serve the market would undermine the groundwork that has been laid thus far. In addition, it effects the ability of the CAPCOs to recruit and retain a team of skilled professionals.

NO SEED CAPITAL; NO TECH START-UPS. NO TECH START-UPS; NO VIBRANT TECH-BASED ECONOMY

There is a critical need in Wisconsin for seed capital. Seed capital is the early-stage capital that enables an entrepreneur or scientist with an idea for a new product or business, to take those first steps necessary to get the business started. Getting a new business started is risky and expensive. There are numerous decisions and actions that the entrepreneur needs to make regarding what type of business entity should be established, how ownership of the entity should be structured, the terms by which key employees should be retained and motivated to commit fully to the new business, how key inventions and other intellectual property should be protected, how to obtain space for the business to operate in, how to obtain equipment the business needs to operate and how potential investors should be approached. There are often significant expenses associated with each of these steps.

Federal research grants (such as Small Business Innovation Research, or SBIR, grants) can often help with the expenses associated with early stage research, but usually do not cover the expenses associated with getting a business started, building a prototype, and/or taking those steps necessary to get to where a product is ready to be marketed. The personal funds of entrepreneurs, and entrepreneurs' friends and family, are often used to cover early expenses, but their resources are usually limited and insufficient. Venture capital firms are usually not interested in investing in a new company until it has reached a minimal level of organization, intellectual property protection and operations. Traditional banks and investment bankers are usually not interested in extending capital to tech start-ups until after venture capital firms have invested in them. There is almost always a gap between where personal funds are exhausted, and where venture capital funds are available. On an individual level, if an entrepreneur can not find funds to bridge this gap, the entrepreneur's idea for a new business, technology, product or treatment goes no where. On a statewide level, if this "seed capital" gap is not filled, the state will have very few tech-based start ups, and will be unlikely to ever develop a vibrant tech-based economy.

Seed capital is usually provided by individuals who themselves have previously had success at starting a business. These individuals, often called "angel investors," often bring more to entrepreneurs than just money. They often bring a wealth of advice and connections to new companies. Despite the value they bring to a new company, angel investing is extremely risky investing. Most new companies fail. Tech companies especially face numerous obstacles to making a profit. As some of the earliest investors in a company, even if a company is successful, angel investors have to wait longer than other investors to see a return on their investment, and they face the risk that the portion of the company they own will be dramatically reduced, as the start-up burns through its initial capital, and needs to attract additional investors/capital.

It is the experience of those involved in the Wisconsin Technology Council that there is a shortage of seed capital in Wisconsin. Wisconsin has made some gains in this area over the last few years, as there has been an increase in the number of individuals interested in becoming angel investors, and an increase in the number of Wisconsin-based local "angel networks." Wisconsin is disadvantaged relative to other states, however, in that we do not have the relatively higher number of successful former tech entrepreneurs turned angel investors that are in such states as California, Texas, Massachusetts, Virginia, Washington and Minnesota. Much of Wisconsin-based investment capital is invested in companies outside of Wisconsin. To encourage more of that Wisconsin-based investment capital to be invested in Wisconsin start-ups, the Tech Council recommends that Wisconsin create tax incentives for seed capital investments in Wisconsin tech start-ups, by modifying state tax policy in two ways:

- Create a tax credit for investors who invest seed capital in Wisconsin tech start-ups.

- Create a tax deferral of the gain that would otherwise be recognized upon the sale of an investment in a tech start-up, if that investment is rolled over into an investment into a seed-level company.

As to the first proposal, the proposal does for angel investors, something similar to what the CAPCO program does for insurance companies, but with a focus on seed level investment. It enables an investor who would otherwise have to pay a portion of the investor's income to the state, to instead invest that income in a start-up, thus creating tech-based jobs and laying the foundation stones for future successful tech-based companies.

As to the second proposal, the proposal is a way to "keep the ball rolling" by creating incentives for an investor who makes a profit in a tech start-up, to reinvest those funds in a new, seed-level company. This in turn helps to create new tech-based jobs, and new tech start-ups.

The benefits of Wisconsin having a tech-based economy are clear. We believe it is equally clear that there is inadequate seed-level investment capital in Wisconsin. Unless such is created, the state is never going to be able to get where it wants to be regarding having a tech-based economy. Creating tax incentives for more investors to become and/or continue to be angel investors, is the best way to obtain the benefits of a tech-based economy all of us want to see, for ourselves and for those who come after us.

ALTERNATIVES

Here are some other policy changes that could encourage the creation of investment capital in Wisconsin. The Committee recognizes, however, that the state's immediate budget needs may preclude the immediate adoption of the alternatives below that require state funding.

1. Ensure there is state staffing support within the Department of Commerce for the SBIR-STTR program. In the reporting period most recently concluded, Wisconsin had more SBIR-STTR grants (39) than in any previous period. The state continues, however, to lag behind most states in obtaining these research-oriented grants from federal agencies such as the National Institutes of Health, the National Science Foundation, the Department of Energy, the Department of Defense and others. The state also should consider the creation of a state SBIR-STTR fund of $50 million, financed from sales tax or gaming proceeds. Such a fund could help to finance up to 1,000 start-up, tech-based companies.

2. Encourage the State of Wisconsin Investment Board to give public employees the option of investing some limited portion of their retirement accounts in a

retirement fund which is primarily focused on investing in Wisconsin oriented technology companies.

3. Repeal Subsection (2)(b) of Section 180.0622 of the Wisconsin Statutes. Subsection (2)(b) is a unique Wisconsin provision of law that both discourages investment in Wisconsin start-up companies and encourages Wisconsin entrepreneurs to incorporate their businesses elsewhere. The vague language of Subsection (2)(b) has unfortunately been interpreted by our courts as providing that those who invest in a Wisconsin corporation can be personally liable (*i.e.*, can be liable for amounts beyond the amounts they have already invested in the Wisconsin company), for up to six months of unpaid employee wages, even if the shareholder has no participation in the operation of the company. No other state has a provision like this in its corporate statutes, and potential investors are often shocked when they find out about it (especially potential out-of-state investors, who invariably have never heard of anything like it before). Subsection (2)(b) renders utterly ineffective the standard limitation of shareholder liability contained in Subsections (1) and (2)(a) of Section 180.0622. An out-of-state angel investor or venture capitalist does not want to hear that if he or she invests $10 million in a Wisconsin corporation (as opposed to investing somewhere else), he or she may be subject to paying out another $10 million dollars, if the Wisconsin company is unsuccessful. It is not overstating the matter to say that limited liability, as opposed to unlimited liability, is one of the key foundation stones upon which western economic vitality has been built. (For support of this idea, see John Micklethwait and Adrian Wooldridge's recent book *The Company, a Short History of a Revolutionary Idea.*) There are other means by which the laudable intent of subsection (2)(b) (*i.e.*, ensuring some way that employees get paid for their services) can be achieved (such as an amendment to the state's unemployment compensation law). The Plant Closing Notification Law (Wis. Stat. Sec. 109.07), already provides protection to workers at larger companies (those that employ more than 50 persons). Repealing subsection (2)(b) is one of the most important things Wisconsin can do to improve its image among potential investors in small Wisconsin start-up companies.

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