

5 CLR

29

SENATE COMMITTEE REPORT

FURTHER

DATE TURNED INTO OFFICE

4/19/90

4/11/89
Mr. President:

FINANCE

Committee considered

SCR 29

investment of the state's public trust funds

and recommended

- replace with _____ CS _____) same title
- or adopt _____ CS _____) new title
- attached amendment(s) and technical title change (HB only)
- _____ letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to _____

FISCAL NOTE(S) zero fiscal impact appropriation no FN
 new updated previous
 same as previous fiscal note(s) published 4/10/90

MEMBERS SIGNING DO PASS

OTHER RECOMMENDATIONS

[Signature]
[Signature]
[Signature]

[Signature] (Co-CHAIR)

Chairman signature and recommendation

Committee Backup attached

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Investment of the State's
Public Trust Funds
Sponsor: Senate Special Committee on
Banking and Development
Requestor: Senate Labor and Commerce

Agency Affected: Department of Revenue
BRU: Treasury
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
OPERATING						
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LANDS & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL	0	0	0	0	0	0
REVENUE	0	0	0	0	0	0

FUNDING: (Thousands of Dollars)

GENERAL FUND	0	0	0	0	0	0
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: attach a separate page for analysis.

Prepared By: Milt Barker *MB* Phone: 465-2350
Division: Treasury Date: _____

Approved by Commissioner: Hugh Malone *For* Date: 4/10/89
Agency: Department of Revenue

Distribution (by preparer):

Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

No fiscal impact is
projected through 1996.

1/19/90 *www* page ___ of ___

1 IN THE SENATE
2
3 SENATE CONCURRENT RESOLUTION NO. 29
4 IN THE LEGISLATURE OF THE STATE OF ALASKA
5 SIXTEENTH LEGISLATURE - FIRST SESSION
6
7 Relating to the investment of the
8 state's public trust funds.
9
10 BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:
11
12 WHEREAS the supply of investment capital in the state has been severe-
13 ly restricted by the decline of real estate values and business activity
14 during the past three years; and
15
16 WHEREAS this lack of available investment capital is hampering eco-
17 nomic recovery in the state by slowing the formation of new businesses for
18 the state's emerging new business opportunities; and
19
20 WHEREAS it will be necessary to attract investment capital from out-
21 side of the state in the near future in order to provide adequate invest-
22 ment capital for entrepreneurs in the state; and
23
24 WHEREAS it is often difficult to attract capital from outside of the
25 state, especially for relatively small ventures, due to the perceived
26 remoteness of the state, its relatively small economy, and its unique
27 characteristics; and
28
29 WHEREAS it is a well-established practice in the United States to
invest a small portion of public trust funds in high-grade, diversified
venture capital funds; and
WHEREAS the prudent investment of public trust funds in venture capi-
tal funds generally enhances the yield of trust fund portfolios; and
WHEREAS investing in appropriate venture capital funds can also
enhance the supply of investment capital in a state that practices this
technique if the investments are accompanied by formal or informal terms
and conditions that encourage the venture capital fund managers to

1 participate in the state's economy when prudent and practical; and

2 WHEREAS, due to the large size of its public trust funds, Alaska would
3 benefit greatly if this proven technique were used;

4 BE IT RESOLVED that the Alaska State Legislature encourages the manag-
5 ers of the state's public trust funds to consider placing a portion of
6 their investment portfolios in sound, diversified venture capital funds;
7 and be it

8 FURTHER RESOLVED that the Alaska State Legislature recommends that all
9 investments placed in venture capital funds be accompanied by appropriate
10 terms and conditions that encourage the venture capital fund managers to
11 actively pursue investment opportunities in the state.

SCR 29

MINUTES
VENTURE CAPITAL WORKING GROUP

March 30, 1989

Present: Jack Jessee, ComRim Systems, Chair, Alaska Industrial Development and Export Authority (AIDEA); Larry Mercurieff, Commissioner, Department of Commerce and Economic Development (DCED); Jim Rhode, Special Assistant, Department of Revenue; Dave Rose, Executive Director, Alaska Permanent Fund Corporation; Dave Van Amberg, Apple Computer; and Bert Wagon, Executive Director, AIDEA. Staff: Kelley Hegarty, Assistant Commissioner, DCED; Elaine Wurster, DCED, AIDEA. Guest: Jim Baldwin, Assistant Attorney General.

The meeting was called to order by Larry Mercurieff. Mercurieff explained that the meeting would be divided into two parts, with the group going into executive session to discuss the respondents to the Request for Proposals (RFP). Jim Baldwin concurred, noting the sensitivity of discussions involving personalities and reputations.

Mercurieff noted the need for the group to address some very fundamental questions, as outlined in the agenda, not necessarily for the purpose of drawing immediate conclusions, but for the purpose of setting some general parameters for subsequent refinement by the selected consultant.

Mercurieff first posed the basic question of whether AIDEA monies could actually be utilized in this type of investment. Bert Wagon replied that, given the conservatism of AIDEA's investment strategy, it was unclear to him. Wagon noted that 80% of the portfolio was placed in Governments or Government equivalents going out no more than 24 months. With the change in Title 37 and the consequent elimination of an approved list of investments, the emphasis now is on prudence and operating in the best interest of the fund.

Jim Baldwin noted that in interpreting the new law, it was decided early on to look at ERISA, which has strict requirements for diversification, for a model. The Attorney General's office will be rendering an opinion soon, and it is expected that their interpretation will permit AIDEA to make venture capital investments, but the opinion will be rendered in such a way that other funds are not affected. Because AIDEA is charged with industrial and commercial development, the requirement for diversification is discretionary. Unlike the retirement funds or the Permanent Fund, economic development is more consistent with the overall goals of the agency. Baldwin added that their research indicates that at least twelve states are doing social investing with their retirement funds and other surplus funds, usually keeping such investments within 2-3% of available funds.

Jim Rhode cautioned that the pension funds at one point were 40% invested in Alaska real estate, a single kind of real estate in a single economy, which generated massive portfolio losses, and that the Permanent Fund is still viewed by some as a development bank. Mercurieff pointed out that we are not looking at other funds, only AIDEA.

A discussion ensued as to whether we are talking about strictly Alaskan investments and to what extent the monies would be invested in Alaskan projects. Dave Van Amberg emphasized that our objective is to make venture capital available here, not to mandate that it be invested here. Social issues would be a by-product, Van Amberg added, noting that we are not looking to set policy.

Dave Rose noted that trust considerations should not enter the picture; AIDEA has no beneficiaries, and its monies should not be managed as a trust. The prudent man rule, Rose asserted, speaks to trust law, not to a fund whose primary mission is economic development. Rose advocated that AIDEA not attempt to run a venture capital fund, but rather to deal with seasoned national and international professionals. Rose cautioned that socially engineering the fund through the RFP will tie the hands of venture capitalists and result in limited response from seasoned professionals.

Rhode noted that HB123 would recast AIDEA'S role by allowing it to take equity positions. Wagon noted that, while joint ventures and equity positions would be permitted, AIDEA was not looking at involvement in every type of project, but more specifically basic industry. HB123 seeks to place emphasis on what the name indicates, instead of strictly acting as an in-state correspondent, Wagon added.

Jack Jessee pointed out that, in retrospect, ARRC doesn't look so bad if one compares its performance with the high default rates of other state loan programs. Rose concurred, emphasizing that AIDEA's purpose is economic development, not return on investment.

Wagon cited the Authority's role as a passive investor. With a social goal of in-state investment, Mercurieff added. Mercurieff further observed that, politically and socially, AIDEA's is the only money that can fund venture capital.

Van Amberg averred that the objective of the fund should have capitalistic motivations; while encouraging development, the fund manager should not be measured on the number of jobs created. Jessee disagreed, citing the comparison between returns on the Permanent Fund and AIDEA portfolios. Wagon suggested that we move on to the proposals, setting the issue aside for the consultants.

Mercurieff reported that an outside venture capital firm is looking seriously at establishing a \$30-50 million Alaska fund, with a specific interest in primary industry. Apart from this group's efforts, we may end up with an Alaska-based fund. And we may not.

Jessee again raised the basic policy issue, noting that it had to be resolved by this group. Jessee made a strong pitch for economic development objectives, resulting in further discussion around the venture capitalists' response to such constraints. Rose asked rhetorically why we were hiring someone who would simply ask the same questions we had not yet answered. Mercurieff wondered whether it was possible to achieve consensus within the group.

In response to Rose's concurrence with Jessee's economic development objectives, Wagnon noted that farming was economic development, but farming provided no return on investment. Rose stated that it would be necessary to establish sensible parameters. Wagnon advised that, without definite parameters, the result would be another ARRC. Wagnon suggested that in addition to farming, perhaps service sector investments could be eliminated from consideration. Jessee noted that, without a reasonable rate of return, the fund would die. Van Amberg cited the need to provide a structure that would ensure a return to the fund manager.

Rose questioned whether it was within the purview of this group to make these decisions: if we give guidance to the consultant, then why not do it in-house? Van Amberg noted that the attraction of other funds was critical to success, and the consultant would be able to provide advice that would not tie the venture capitalist's hands. Jessee concurred, citing the role of the consultant as buffer and a test with reality. Rose added that this would provide assurance that we don't have too much social engineering. Wagnon cautioned that fund investments in New Mexico would generate public flak. Van Amberg suggested that we not stipulate what percentage of the monies be invested in Alaska, maybe skewing it with a back-end bonus for successful Alaska investments, in essence paying for performance. This would assure that we achieve our bottom line objective of making money available in Alaska.

Mercurieff suggested a break, after which the group reconvened in executive session to discuss the proposals. After executive session, the group voted to retain Callan Associates for the purpose of providing venture capital advisory services, including drawing up a Request for Proposals and recruiting and screening respondents to same. The group also voted to retain Donald Vogt for the purpose of providing advisory services regarding goals and objectives for the proposed venture capital investment.

The meeting was adjourned.

0565F

MINUTES
VENTURE CAPITAL WORKING GROUP
January 25, 1989

Present: Jack Jessee, ComRim Systems, Chair, Alaska Industrial Development and Export Authority (AIDEA); Larry Mercurieff, Commissioner, Department of Commerce and Economic Development (DCED); Jim Rhode, Special Assistant, Department of Revenue; Dave Van Amberg, Apple Computer; and Bert Wagon, Executive Director, AIDEA. Absent: Dave Rose, Executive Director, Alaska Permanent Fund Corporation. Staff: Kelley Hegarty, DCED; Tom Lawson, DCED, Division of Business Development (DBD); Elaine Wurster, DCED, DBD/AIDEA. Guest: Belden Daniels, Counsel for Community Development.

The meeting was called to order by Larry Mercurieff. A recap of efforts to date was provided by Elaine Wurster, who summarized efforts to create a network, linking venture capitalists with Alaskan entrepreneurs, and the futility of that effort due to time and cost factors related to our geographical distance. These earlier efforts evolved into the concept of putting together a privately managed fund, wherein the state's role would be limited to that of catalyst and facilitator and, possibly, passive investor. Mercurieff summarized a meeting with Governor Cowper on December 21 wherein the Governor was presented with an outline of the state's capital shortage and the department's networking efforts. As a result of this meeting, the Governor directed Mercurieff to head a working group to put together a fund.

Bert Wagon provided a synopsis of the scope of AIDEA's investment parameters, stating that, under the "new" Title 37, investment decisions revolve around the prudent man rule. Consequently, venture capital, given the precedents set by other similar public entities in other states, is a legally permissible investment vehicle for the Authority. Wagon did caution that venture capital investments should be de minimus, representing no more than 1-3% of the portfolio value.

Jim Rhode raised the question as to whether all of AIDEA's venture capital investments could be in one place. If so, it was clear that, given AIDEA's charge, it differed from the retirement funds. Rhode also noted that the Permanent Fund differed, too, in that it still operates with a legal list.

Belden Daniels outlined four areas of concern:

(1) demand. The Alaska Renewable Resources Corporation (ARRC) raises questions as to demand. North Carolina and Utah, in their efforts, studied the demand issue extensively. Alaska is 50th in manufacturing, 1st in government employment, 44th in employment base derived from exports, low in number of scientists, Ph.D.s. There is no way to quantify deal flow in advance. There is basically only one way to find out: that is, to take a risk. Encourage private sector flows. Based on experience in other resource dependent states, if there is a deal flow here, it is more likely development capital, mezzanine capital. The question relates to,

(2) the kind of money. A fund here would have a mix: a small percent seed, small percent venture, more likely the bulk in mezzanine.

Jack Jessee pointed out that, given the current banking situation and recession, there is nothing left to mortgage, thereby resulting in illiquidity.

Bert Wagnon cited the current loan craze, recession, and the perception of Alaska as a socialistic state. Wagnon posed the question, isn't the economy doing what a free enterprise economy is supposed to do.

Daniels reiterated that the demand issue is a tricky one. Which brings us to,

(3) structure of the deal. The deal should be structured so that there is private pain if the deal falls through. This is a true market test. Daniels supported Mercurieff's contention that the state's role should be limited to catalyst and facilitator; the fund should clearly be private-sector driven. Make sure the general partners do not get rich on fees. The industry standard maximum is 2-2.5%. Nebraska and Kansas negotiated fees less than 1%. In looking for a serious manager, structure the deal so it rises based on thresholds of return to fund, i.e., based on a certain percentage of capital gains. Where typically the split is 80:20, he suggests a more rigorous standard.

(4) minimum size. Daniels agreed that our \$30MM figure was in the ballpark: location of an office here is essential, and the scale of effort should be such that it warrants expenses.

Daniels also noted that general partners should be putting their own money into the deal. The private sector industry standard is low (about 1%).

While exceptions do exist, a prudent investor should be contributing no more than 10% of a fund. Daniels cited North Carolina's Treasury investment of \$20MM in a \$100MM fund as one such exception.

Daniels noted, too, that economic development benefits are additional on top of return. Subsidies don't work since they don't lower risk. Conversely, we should aim to price return up to meet the risk. A fund maturing in five to seven years should show a compound 20% rate of return.

Daniels cited some of the rules established by the Utah retirement system, which he noted were quite stringent:

Spread the risk every way possible:

- *No more than 3% of the total assets of the fund.

- *No direct investments.

- *Find prudent fund managers--i.e., make sure they have cashed out at least one complete partnership. Consequently, the five years experience cited in the draft RFP were not sufficient.

- *Look for another sophisticated co-investor, preferably institutional. Daniels noted that other states have provided incentives, notably tax credits, with great success to private sector investors. Kansas and Oklahoma, which he singled out as two of the best, provided transferability of these credits.

In Utah, 3% of the total fund was allocated to venture capital. This \$100MM would be used over time to invest in fifty partnerships, which would be diversified by geographical location and economic sector, thereby spreading risk in every way possible.

Daniels noted that the overall goal is to attract venture capital in, and the only way to achieve that goal is to partner out.

Wagnon questioned whether we should mandate that only a portion of the fund be invested in-state. Daniels responded, 50%. Dave van Amberg questioned the size of AIDEA's total portfolio, and Wagnon responded that it was roughly \$250MM, with approximately \$220-230MM discretionary or partially discretionary. Van Amberg noted that \$6MM would fall within the 3% rule.

Daniels discussed due diligence and how you actually do the deal:

- (1) negotiate terms of the deal itself;
- (2) extremely broad casting of the net--firms should be encouraged to respond. In Nebraska, 100 firms responded. Jim Rhode pointed out that we are legally required to do that, given that the expertise in the area does not reside in Alaska. Daniels emphasized that we must reach out, not simply advertise.

Van Amberg asked how we would go about encouraging other (not simply mezzanine) levels of financing. Unless we meet at least two of the three risk levels of investment, we have failed to meet the goals of the exercise. Daniels cited the Nebraska Investment Council, which spelled it out: "we're looking for a portfolio with 5% seed, 10% venture capital, . . ." and then went through a negotiation process with the manager.

Jack Jessee pointed out the importance of expertise more than money at the seed and venture capital stages. Van Amberg echoed the perception that Alaska has a very thin depth of management.

Rhode analogized the infancy of the Alaska venture capital situation to that of a baby needing protection. With regard to pricing, the more risk, he asserted, the lower the rate of return, and isn't there a dry period in venture capital? Daniels replied that there is, indeed, a dry period, and that typically the first five years generate a negative return: the lemons come to light early on, the plums take time.

Van Amberg reiterated that our needs are at more than one level and that we need to address our reasons for doing this: are our objectives development oriented, or are we presenting AIDEA with an investment opportunity? Rhode cited a third objective, namely providing expertise. Van Amberg concurred, noting that his personal agenda was to address the dearth of capital and the fact that capital is worthless without expertise. Van Amberg reasserted the need to define where to apply it. Do we invest in a tire and rubber plant or a blast furnace repair facility? We need clear agreement of our objectives. Daniels cited the Nebraska experience, where the first process was a sketching out of all possibilities, which alone was a full-day process. Van Amberg stressed that we need no more commercial malls. Daniels noted that it is very facile to simply rule out some sectors of the economy and spell out our objectives so that we attract the kind of people we want, but at the same time retaining flexibility to adapt. Rhode noted the irony in the fact that venture capital is now safer than buying malls. Wagon echoed the thought by citing AIDEA's fisheries portfolios, which have gone from worst-to best-performing.

Wurster recapped the areas of interest shown by the venture capital firms who have visited the state, noting that, of the two firms which have shown serious interest, one is interested in putting together a \$30MM fund to invest in primary industry only, while another firm, also looking at a \$30MM fund, is interested in tourism and natural resource opportunities as well as local entrepreneurial efforts.

Jessee pointed out that those fisheries-related companies doing the best are those with the most up-to-date equipment, and those firms are all outside-bank financed. Given that those loans are not paid off, those outside banks who are participating in Alaska are not interested in financing their competition.

Van Amberg emphasized that, given the limited amount of resources here to invest, we should make certain that they are spent developing those industries which import dollars into the economy. In an earlier effort, a group he'd been working with had identified software development, fishing, minerals, and timber as four broad categories which met those criteria.

A philosophical discussion ensued, brought on by a question from Rhode as to what caused investment to happen and what prevented it from happening without state interference. Jessee and Van Amberg both cited personal experiences in attempting to find debt or equity capital for their respective firms and the difficulty of raising capital in Alaska.

Daniels responded that we can put out an RFP and, if there is no response, then it becomes clear that we do not meet the market test. Rhode noted that, if we do meet the market test, then his objection must fall. Daniels noted that, if there is no private participation, then there is no deal, and the Governor recognizes this.

Wagon cautioned the group that, in prior efforts, there was a great deal of rush involved and the state created an imperfect child. He also noted that he does not like hiring a consultant, but in this case we do not have the in-house expertise. We should, he urged, consider reorienting our direction and should solicit hiring a consultant to put together an RFP, objectives, and a contract for monitoring. Continuation will be dependent on performance, which needs to be measured. The consultant should be doing networking: we cannot destine the project to failure through stringent standards.

Daniels advised that, in this scenario, there must be a legitimate, authorized group within the state that is the decision-maker. This group should define the scope of services and the objectives, and those objectives should not change with the market and should not be too stringent.

Merculieff polled the group and found consensus among the members for hiring a consultant. It was suggested that Wurster contact other states which have hired consultants. Rhode offered to provide names referred to him by Stanford. Van Amberg cautioned that this was not the time to go for the lowest bidder. Wagon noted that this was a logical group to continue on the project, given the expertise and diverse opinions represented.

Wagon questioned how much this procedure would cost and where the money would come from. Mercurieff proposed that the group present a proposal to the AIDEA board.

Wagon outlined a scenario for how the project might proceed from here: Wurster would continue as the primary staff person, gather solicitations from other states, produce an RFP, circulate it to the working group for approval, broadly disseminate the RFP, and present the group with a short list of three candidates to be interviewed.

In response to a question from Van Amberg, Wagon asserted that it would not be productive to run the plan by the Governor, since his interest is in seeing the venture capital program implemented and working.

Jack Jessee agreed to present the plan at the February 26 AIDEA board meeting in an attempt to secure funding to support the program and hire a consultant. Mercurieff, upon finding consensus within the group, directed Wurster to follow Wagon's suggestions and adjourned the meeting.

4/17/90
H(LIC)
FIX

STATE OF ALASKA
1990 LEGISLATIVE SESSION

Bill Version: SCR 29
Publish Date: _____

FISCAL NOTE

REQUEST:

Revision Date: _____	Agency Affected: <u>Department of Revenue</u>
Title: <u>Investment of State Public</u>	BRU: <u>Treasury</u>
Trust Funds _____	
Sponsor: <u>Senate Banking & Economic Dev.</u>	Components: _____
Requestor: <u>House Labor & Commerce</u>	

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96
OPERATING						
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LANDS & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL	0	0	0	0	0	0
REVENUE	0	0	0	0	0	0

FUNDING: (Thousands of Dollars)

GENERAL FUND	0	0	0	0	0	0
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: attach a separate page for analysis. Fiscal year 1990 effect is zero.

Prepared By: Milt Barker MB
Division: Treasury

Phone: 465-2350
Date: April 9, 1990

Approved by Commissioner: _____
Agency: Department of Revenue

Date: 4/9/90

Distribution (by preparer):
Legislative Finance
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