Staff Report | Expanding VC Access Fund Program

1. Introduction

The California Infrastructure and Economic Development Bank ("IBank") staff recommends the IBank Board of Directors (the "Board") adopt Resolution No. 22-11 approving the adoption of the Criteria, Priorities, and Guidelines for the IBank's Expanding VC Access Fund ("Venture Fund"). This new program will utilize federal funds to improve access to venture capital for underrepresented fund managers, entrepreneurs, and regions of California, as well as advancing climate equity.

2. Background and Venture Capital in General

Venture capital is the practice of investing in early stage, high growth companies, also known as startups. Startups generally have greater risk than more established companies, as they may not yet have steady revenues. They seek to grow revenues by developing their product and exploring the optimal customers and business models for their product or service. Startup investors often expect a 20-30% gross internal rate of return to compensate for this risk.

Venture capital funds seek to manage and balance this risk in two principal ways. First by balancing risk across a portfolio of investments invested carefully and often across different industries, geographical areas or investment stage. Venture capital funds usually invest in a minimum of 10 startups with the expectation that many of the investments will fail, but a few will generate outsized returns to compensate. Second, fund managers use detailed analysis based on their investment skill and market expertise to identify the startups most likely to succeed and provide strong investment returns.

California is known as the home of venture capital, it represented half of all venture capital dollars in the last five years[1]. But this abundance has not extended to underrepresented managers, and those located outside of the dominant Bay Area venture capital scene. 78% of investment partners are white[2], and 85% are male[3]. Typically, these groups find it harder to raise funds, and their funds are smaller. Emerging managers - those raising their first institutional fund – also have a tougher time than established managers. Further, we are entering a period of slower venture capital investment: total funding fell 23% YOY in the second quarter[4]. Programs such as the Venture Fund can play a role in supporting underrepresented and emerging fund managers during difficult times.

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[1] Pitchbook / NVCVA figure
[2] Pitchbook figure, November 2021
[3] Deloitte & NVCA, "VC Human Capital Survey" 2020
[4] CBInsights figure

3. State Small Business Credit Initiative 1.0 and Other State Venture Capital Programs

The inaugural source of funding for the Venture Fund is the State Small Business Credit Initiative (SSBCI) authorized by the American Rescue Plan Act of 2021 and administered by the US Treasury (UST). SSBCI was originally created through federal legislation, the Small Business Jobs Act of 2010. In 2010, SSBCI 1.0 was funded with $1.5 billion to strengthen state programs that support financing of small businesses. California received $168 million of the $1.5 billion and the Infrastructure and Economic Development Bank (IBank) and the California Pollution Control Financing Authority (CPCFA) – an agency housed within the State Treasurer's Office (STO) - split the funding equally between the two agencies. The allocation was utilized to assist small businesses to gain access to capital and create jobs in California. More than 10,000 eligible small businesses in California received SSBCI fund support, which created or saved more than 90,000 jobs.

States have long operated venture capital fundsand UST noted that there were state run venture capital programs in 37 states[5]. 33 states ran such programs under SSBCI 1.0[6]. For SSBCI 2.0, 47 states applied for a venture capital program[5]. While they have various structures, several are broadly similar to those proposed by California in its SSBCI 2.0 application to UST. Venture capital continues to be a popular use of SSBCI funds as it provides a high leverage ratio (it leverages greater private capital than alternate programs) and benefits the highest growth small businesses, those that are best equipped to create jobs.

4. SSBCI 2.0

The American Rescue Plan Act of 2021 included $10 billion for the reauthorization of the State Small Business Credit Initiative. With the authorization of SSBCI 2.0, IBank will use approximately $200 million of California's allocation to establish the Venture Fund. The relationship between IBank and UST will be governed by an allocation agreement, and the program is once more shared with CPCFA as was the case for SSBCI 1.0. One aspect of UST's oversight of the program is a rigorous set of quarterly, annual and per-investment reporting requirements.

Funds received from UST under this program will be invested with our trustee, Fiduciary Trust International. Monies are conservatively invested in securities authorized under Government Code, Section 16430, such as money market mutual funds, until such time they are invested in venture capital funds or co-investments, referred to as cash calls.

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[5] U.S. Department of the Treasury figure
[6] SSBCI figure

5. IBank's Expanding VC Access Fund Program

Effective June 30, 2022, a new Article 12 (consisting solely of Government Code Section 63089.99) was added to the IBank Act establishing a venture capital program at IBank. The program shall be referred to as the Expanding Venture Capital Access Fund Program. This authority was set forth in Chapter 68, Statutes of 2022 (SB 193).

This new Article 12 mandates that the Venture Capital program will be operated pursuant to guidelines and requirements as developed and approved by IBank's Board. The Venture Fund will also operate pursuant to regulations set forth by UST for operation of state venture capital programs and pursuant to obligations set forth in the UST's allocation agreement. Article 12 further directs that the program will be operated by a deputy director appointed by the Governor and who serves under the guidance and authority of the IBank's Executive Director. The program is currently awaiting approval by UST.

The Venture Fund is designed as a sustainable revolving finance program within the IBank with the investment proceeds continually recycling to fill market gaps and catalyze economic development across California. It will be guided by three strategies:

a. *Inclusive California Initiative*. This initiative provides funding to venture capital managers raising at least their second fund. The goal is to support a more inclusive venture capital community in California, with a particular focus on underrepresented managers, and funds with a track record of investing in SEDI-owned businesses (those that support underrepresented communities identified by UST). Commitments are expected to average $10 million per fund for approximately 10 fund investments.

b. *Emerging California Initiative*. This initiative provides funding to managers raising their first fund with institutional capital. It focuses on underrepresented managers and fund managers seeking to focus on SEDI. Commitments are expected to average $5 million per fund for approximately 10 fund investments.

c. *California Co-investment Initiative*. This co-investment initiative combines: providing (1) follow-on capital into portfolio companies of the Venture Fund raising a subsequent investment or (2) funding that meets pre-defined criteria including both strategic elements (e.g., projects borne out of regional economic development plans, climate equity, underserved regions, underrepresented ownership) and financial characteristics. Commitments will range from $500,000 to $5 million per investment, with an estimated total of 30 investments across the first few years of the program's life.

6. Administrative Process for Selection of Investments

The Venture Fund will be administered by the IBank Venture Manager acting under the direction of IBank's Executive Director, and aided by external service providers who are expert in venture capital. The program will invest in both venture capital funds and startups, and will invest via a hybrid debt instrument in order to comply with California's constitutional prohibition on equity investment. The selection of investments will be key for program performance and so the selection of external service providers is important.

Broadly, external service providers utilize one of two models: the External Program Administrator and External Consultant models:

- An External Program Administrator will make investments directly in venture capital funds and / or co-investments based on established criteria, categories and priorities approved by the Board. Investment transactions will be undertaken and executed by the External Program Administrator at their discretion, including negotiation and execution of investment agreements, and completion of any required UST program documentation. The External Program Administrator will report to the Venture Fund at least quarterly on the progress of its investments as well as providing a detailed valuation report at least annually. The advantage of this approach is that it consumes less staff and Board time and enables investment decisions to be further removed from conflicts of interest.The disadvantage is that it reduces oversight as IBank may not be aware of investments or performance challenges until it receives a periodic update from the External Program Administrator.
- An External Consultant will source, diligence and recommend investments in venture capital funds and / or co-investments, which will be provided to the Board for approval. The Board, or its designee, will approve each investment. The Board may elect to designate approval authority to a newly created investment committee. The External Consultant will provide due diligence packs and other information that the Board or its designee require to make a decision on each potential investment. The IBank Venture Manager will be responsible for collection of reporting information and may use a third party to collect this information. The advantage of this approach is that it gives IBank greater oversight over the allocation of funds. The disadvantage is that it requires more specialized expertise and work on behalf of the staff and Board.

The Venture Fund will manage a request for qualifications process to identify suitable External Program Administrators and / or External Consultants, and will then provide a recommendation to the Board.

7. Conclusion and Recommendation

IBank staff believes that the document entitled "Criteria, Priorities, and Guidelines for the Selection of Projects For IBank Financing under the Expanding VC Access Fund Program" presents a sound framework for the execution of IBank's legislative mandate to support underrepresented fund managers, entrepreneurs, and regions of California, as well as advancing climate equity in California. Therefore, IBank staff recommends the Board approve Resolution No. 22-11.