

**CALIFORNIA INFRASTRUCTURE AND ECONOMIC DEVELOPMENT BANK
(IBank)**

STATE SUPPLEMENT FOR IBANK VENTURE CAPITAL

STAFF REPORT

Issue:

IBank staff recommend the IBank Board of Directors (the “Board”) adopt Resolution No. 23-14, which approves the use of supplemental state funding (“State Supplement”) for the Expanding Venture Capital Access program (“Venture Program”).

Background:

IBank was established in 1994 pursuant to the Bergeson-Peace Infrastructure and Economic Development Bank Act (the “IBank Act” or the “Act”, Government Code Sections 63000 et seq.). IBank’s mission is to provide financial assistance to eligible projects. The Venture Program, established by Article 12 of the IBank Act (Government Code Sections 63089.99) is one of the financing mechanisms employed by IBank to carry out its mission.

The Venture Program is funded by \$200 million from the State Small Business Credit Initiative (“SSBCI”), authorized by the American Rescue Plan Act of 2021 and administered by the U.S. Department of the Treasury (the “US Treasury”). The Criteria, Priorities, and Guidelines (“Venture Program Criteria”) for the Venture Program were adopted by the Board on February 22, 2023. Further, the Board approved Resolution No 22-14 on October 19, 2022 authorizing the retention of Cambridge Associates as an External Consultant for the Venture Program.

The purpose of the Venture Program is to improve access to venture capital for underrepresented fund managers and entrepreneurs, and underserved regions of California, as well as invest in climate equity solutions. The Venture Program closed its first transaction in May 2023.

Based on direct feedback from US Treasury, peer programs in other states, and industry stakeholders, staff believe the addition of state funds would enable the Venture Program to operate more effectively and better achieve its mission of creating a more inclusive venture capital ecosystem.

Discussion:

Staff are seeking to allocate up to \$50 million from the Small Business Expansion Fund (“Expansion Fund”) over ten years to create a State Supplement to improve the effectiveness and performance of the Venture Program. While the program has been allocated \$200 million in federal SSBCI funds to carry out its purpose, SSBCI restrictions

are imposing detriments on fund managers and preventing the program from participating in promising investment opportunities that would advance the mission of the program.

To date, our external consultant Cambridge Associates has forwarded to IBank six highly qualified venture capital funds that support the program's mission. The Venture Program's Investment Committee approved or indicated interest in all six opportunities and successfully closed one, in Unshackled Ventures; two more are currently in negotiations. The remaining three funds showed initial interest in the Venture Program but ultimately decided to decline IBank's funding, each citing concerns related to SSBCI restrictions.

Specifically, SSBCI restrictions for venture fund activities include:

- *A cap on venture fund fees set at a level well below market rates.* In SSBCI 1.0, US Treasury made no provision for fees. In SSBCI 2.0, US Treasury allowed payment of fees and set the SSBCI cap at 1.71% average per annum over the life of the fund up to 10 years, while recognizing that funds charged 2.138% on average based on a study conducted in 2013. In fact, today, most target funds in this space charge an initial management fee of at least 2.5% annually. The restriction on fees inhibits the funds' ability to operate compared to their peers, especially for small emerging fund managers who are more financially constrained. It also creates a disadvantage for other investors in the fund who would pay full fees, which could discourage them from investing. To address this market gap, other states such as Colorado, Hawaii, Connecticut, and New York have used state funds to supplement the SSBCI fee cap.
- *Investment exclusions with admittedly outdated provisions that no longer reflect the market.* Most notably, there is a maximum company fundraising round size of \$20 million that was set in the federal SSBCI statute over a decade ago, which has not been updated and has been acknowledged by US Treasury as outdated. This restriction alone constrains fund managers' participation in follow-on investments in the most promising companies within a venture fund portfolio as the exclusion of SSBCI funds reduces the venture fund's available capital for these investments, making them less competitive and attractive to promising small businesses. These follow-on investments are often primary drivers of value of the fund managers' overall portfolio. Further, investment exclusions impose administrative burden and complications for the fund managers and results in variations in the portfolios of other investors in the fund, creating potential conflict related to variations in fund performance.

Implementing a State Supplement would allow the Venture Program to overcome these restrictions, mitigate the disadvantages imposed on fund managers, and improve the performance of the program in the following ways:

- Offering the same terms as our peers in the market will help us and the fund managers successfully invest in the highest-potential opportunities and avoid

adverse selection, while reducing administrative and financial burdens on these fund managers and allowing them to better serve small business entrepreneurs.

- Our ability to participate in more opportunities within a portfolio – especially in small companies that gain traction quickly – allows us and the fund managers to capture a major return driver in venture capital and optimize the performance of the Venture Program overall to keep the program sustainable.
- Based on lessons learned from other states and previous programs, several successful state venture programs end up creating a state supplement or similar mechanism to align as closely to market as possible and better support the funds in which they invest.

We project that the \$50 million in state supplement funds will be deployed to venture capital funds over a ten-year period. The Expansion Fund previously received state funds that were targeted at COVID relief for small businesses, including the California Rebuilding Fund (\$37.5 million) and the COVID-19 Micro Loan Guarantee Program (\$50 million). Both programs have effectively ended, and this is an opportunity to deploy available Expansion Fund capital over time as they become available, unencumbered, or recycled.

The Expansion Fund is continuously appropriated. Monies in the Fund can be used for the purposes specified in Government Code 63089.5(b) including to fund direct loans or other debt instruments authorized under Chapter 6 of the IBank Act, which includes Article 12 that establishes the Venture Program. It is under this authority that we can use the available monies to establish a State Supplement for the Venture Program.

While the Executive Director has authority to make non-substantive amendments to the Venture Program Criteria, any material amendments and revisions must be approved by the IBank Board. A clean version of the proposed new Venture Program Criteria document appears in **Attachment A**.

Below are the changes to the Venture Program Criteria which staff believe are most material and worthy of the Board's attention. All proposed changes either conform to or do not conflict with the IBank Act and any relevant state and federal regulations, and can be viewed in the redline in **Attachment B**.

- *Establishing a State Supplement as a potential source of funding alongside SSBCI for opportunities that support the mission of the Venture Program.* The updated Venture Program Criteria describe the existence of a State Supplement; the ability to use the State Supplement to pay fees and expenses; the ability to use the State Supplement to finance certain entities that are ineligible for SSBCI funding, subject to negotiation and approval by the Investment Committee; and the role of the Investment Committee in determining the appropriate use of State Supplement funds, if any, in each investment decision that is approved.

- *Clarifying the role of the external consultant as a non-discretionary advisor.* The existing Venture Program Criteria clearly define the external consultant as a service provider that makes recommendations but does not make investment decisions. To ensure full compliance to US Treasury requirements, the language related to the external consultant and their interaction with the Investment Committee has been updated to clearly distinguish the role of the Investment Committee and that of the external consultant in making recommendations.

RECOMMENDATION

IBank staff recommend approval of Resolution 23-14, which approves the creation of a state supplement and adopts the amended and restated Criteria, Priorities, and Guidelines for Financing under the Expanding Venture Capital Access Program.

October 11, 2023

Attachments

Attachment A

Criteria, Priorities, and Guidelines for Financing under the Expanding Venture Capital Access Program (Revised VC Criteria), dated October 11, 2023

Attachment B

Redline of proposed amendments compared to the Venture Program Criteria approved on February 22, 2023.