

## HOUSE OF REPRESENTATIVES STAFF ANALYSIS

**BILL #:** CS/HB 83 Capital Formation  
**SPONSOR(S):** Economic Expansion & Infrastructure Council; Grant  
**TIED BILLS:** HB 131 **IDEN./SIM. BILLS:**

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REFERENCE	ACTION	ANALYST	STAFF DIRECTOR
1) <u>Committee on Economic Development</u>	<u>9 Y, 0 N</u>	<u>Brown</u>	<u>Croom</u>
2) <u>Economic Expansion &amp; Infrastructure Council</u>	<u>14 Y, 0 N, As CS</u>	<u>West</u>	<u>Tinker</u>
3) <u>Policy &amp; Budget Council</u>	<u></u>	<u>Voyles</u>	<u>Hansen</u>
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### SUMMARY ANALYSIS

This bill creates the Florida Capital Formation Act (Act), which is designed to increase the amount of venture capital investment in Florida.

The bill creates the Florida Opportunity Fund (fund), to invest in seed capital and early stage venture capital funds. The investments may not be direct investments with individual businesses, but must consist of partnerships with private venture capital funds (the "funds of funds" approach). Enterprise Florida, Inc., shall facilitate the creation of the fund. The fund shall be organized as a private, not-for-profit corporation under chapter 617. Enterprise Florida shall select a five-person appointment committee. That committee will select a board of directors (the board) for the Florida Opportunity Fund. The board shall select a Florida Opportunity Fund investment manager.

The bill calls for investments in venture capital funds focusing on opportunities in Florida such as investments in Florida-based businesses in life sciences, information technology, advanced manufacturing processes, aviation and aerospace, and homeland security and defense.

The bill appropriates \$30 million for fiscal year 2007-2008 from the General Revenue Fund to Enterprise Florida, Inc., of which \$29.5 million will be used for investments and \$500,000 shall be used for startup activities.

This bill provides an effective date of July 1, 2007.

## FULL ANALYSIS

### I. SUBSTANTIVE ANALYSIS

#### A. HOUSE PRINCIPLES ANALYSIS:

**Provide Limited Government** - The bill creates the Florida Opportunity Fund, a private, not-for-profit corporation.

The bill appropriates \$500,000 for the fiscal year 2007-2008, from the General Revenue Fund to Enterprise Florida, Inc., to be used for start-up activities necessary to implement the provisions of this act.

#### B. EFFECT OF PROPOSED CHANGES:

##### PRESENT SITUATION

##### Venture Capital Industry Overview

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for startup companies.<sup>1</sup>

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards; and
- Have a long-term orientation.

Venture capitalists actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges. Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund.

A venture capitalist may invest before there is a real product or company organized (so-called "seed investing"), or may provide capital to a company in its first or second stages of development known as "early stage investing."

Some organizations may include government affiliated investment programs that help startup companies either through state, local or federal programs. One common vehicle is the Small Business Investment Company or SBIC program administered by the Small Business Administration, in which a venture capital firm may augment its own funds with federal funds and leverage its investment in qualified companies.

##### Term of Investment

Depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the portfolio company within three to five years of the initial investment. While the initial public offering is considered the most heralded type of exit for the venture capitalist and owners of the company, most

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<sup>1</sup> Material in this section is taken from the National Venture Capital Association website, available at <http://www.nvca.org/def.html>. (Visited January 31, 2007.)

successful exits of venture investments occur through a merger or acquisition of the company by either the original founders or another company.

### Management Fees

As an investment manager, the general partner will typically charge a management fee to cover the costs of managing the committed capital.

### **Venture Capital in Florida:**

Enterprise Florida, Inc. (EFI) reports total venture capital spending in Florida was more than \$555 million for 114 deals in 2003 and 2004. According to the EFI website, there are 30 venture capital firms headquartered in Florida.<sup>2</sup> However, no large early-stage venture capital firms are located in Florida.<sup>3</sup>

EFI also reports that since the late 1990s, venture capital investment in Florida has fallen sharply both in absolute dollar terms and as a share of the U.S. total. Despite being the 4<sup>th</sup> most populous state, Florida ranks 13<sup>th</sup> in the U.S. in terms of venture capital investment in 2004. In 2004, Florida accounted for only \$300 million, or 1.42% of the total venture capital funding in the U.S. A 2007 Development Report Card for the States published by CFED, a national nonprofit focused around expanding economic opportunity, reports that Florida saw a 110 percent loss in venture capital investment dollars between 2000 and 2005; ranking the state 27<sup>th</sup> in the nation for venture capital investment when measuring percent change over the five year period.<sup>4</sup>

Currently, the State of Florida offers venture capital through two programs: the Cypress Equity Fund and the Certified Capital Company Act (CAPCO).

### The Cypress Equity Fund

In 1995, the Enterprise Florida Capital Partnership, Inc.,<sup>5</sup> created the Cypress Equity Fund as part of a strategy to help improve Florida businesses' access to venture capital.<sup>6</sup> The Cypress Equity Fund's purpose is to facilitate initial venture capital investments by Florida private financial institutions and institutional investors, and provide a means to encourage national venture capital managers to consider investment opportunities in Florida.<sup>7</sup> This program invests both public and private funds into privately managed venture capital funds.

The Cypress Equity Fund was designed as a "fund of funds" to invest in national private venture capital funds that, in turn, would invest in companies with high growth potential. However, investments may be made in venture capital funds located anywhere in the country and therefore are not required to target in-state companies.<sup>8</sup>

The Cypress Equity Fund obtained \$35.5 million in commitments from five private financial institutions (\$20.5 million) and one public institutional investor, the Florida State Board of Administration (SBA) (\$15 million). The Cypress Equity Fund Management Corporation, an entity established by the Capital Development Board, is responsible for overall management of the fund. The corporation, in turn, contracts with a private equity manager to invest fund assets with national venture capital firms.

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<sup>2</sup> Information from Enterprise Florida's website listing of Florida-based venture capital firms located at: <http://www.eflorida.com/businessadvantages/1/venturecapital.asp?level1=24&level2=152>. (Last visited January 31, 2007.)

<sup>3</sup> See generally *In Full Bloom*, Entrepreneur, July 2006, available online at <http://www.entrepreneur.com/magazine/entrepreneur/2006/july/159800.html>. The article provides Entrepreneur magazine's list of the top 100 early-stage venture capital firms in the nation.

<sup>4</sup> See 2007 Overview Development Report Card for the States, available online at <http://www.cfed.org/go/drc>.

<sup>5</sup> In 1996, the Legislature replaced Enterprise Florida Capital Partnership, Inc., with the Capital Development Board.

<sup>6</sup> Office of Program Policy Analysis and Government Accountability (OPPAGA) *Review of the Enterprise Florida, Inc. Capital Development Board's Cypress Equity Fund*, Report No. 98-33.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 2.

In its report on the Cypress Equity Fund, OPPAGA concluded that the fund has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital because its investments were not targeted at in-state companies.<sup>9</sup> The Cypress Equity Fund was scheduled to end in 2006; however, dissolving the fund while it still had money was not feasible. The fund will be dissolved when the remaining funds are disbursed.

EFI staff report that the Cypress Equity Fund's net compound annual internal rate of return, since inception, is 22.9 percent.

### Certified Capital Companies

The 1998 Florida Legislature enacted the Certified Capital Company Act.<sup>10</sup> This program encourages private investment in venture capital by providing direct tax credits for investment in qualified businesses. The stated purpose of this act is to stimulate a substantial increase in venture capital investments in Florida by providing an incentive for insurance companies to invest in state-certified capital companies (CAPCOs) which, in turn, will invest in new or expanding businesses.<sup>11</sup> Eligible insurance companies are granted insurance premium tax credits in amounts equal to investments in CAPCOs. The increase in investment capital is intended to contribute to employment growth, create high-paying jobs, and expand or diversify Florida's economy.

To date, the insurance industry has invested \$150 million in three state-certified CAPCOs. The insurance companies may claim insurance premium tax credits totaling \$15 million each year for ten years.

According to information in the most recent annual OPPAGA report on the CAPCO program, there were 47 qualified businesses in which the CAPCOs had invested as of December 31, 2004.<sup>12</sup> Examples of industries represented by the qualified businesses are electronic imaging, medical technology, boat manufacturing, credit card payment processing, vehicle fleet management systems, an internet portal for fishermen, and a cookie manufacturer. The most recent investments include businesses predominantly in the child daycare, landscaping, and restaurant industries. The total number of full-time jobs in qualified businesses at the time of the initial investments in the 47 companies was 1,218. The total number of full-time jobs in all qualified businesses as of December 31, 2004 was 1,009.

While as many as nine states have created CAPCOs, this type of program is increasingly viewed by researchers as the more "problematic" of the Venture Capital Funds (VCF) programs, in terms of

"...its high cost, poor design and target-inefficiency. Unlike any other VCF program, the CAPCO program provides a 100% premium tax credit to insurance company investors. In effect, the government underwrites the entire investment risk."<sup>13</sup>

### Biotechnology Investment

Although not through traditional venture capital promotion, the State of Florida offered \$300 million to attract the Scripps Research Institute as a means to catalyze a biotech cluster in South Florida and to

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<sup>9</sup> Id.

<sup>10</sup> Section 288.99, F.S.

<sup>11</sup> Section 288.99(2), F.S.

<sup>12</sup> Section 288.99(12), F.S., requires OTTED to report annually on the performance of the CAPCO program. The following information was compiled from the latest annual report issued in 2004. Executive Office of the Governor, Office of Tourism, Trade & Economic Development, *Certified Capital Company Act Annual Report on Performance*, June 2005.

<sup>13</sup> Statement of Professor Daniel Sandler, University of Western Ontario, London; senior research fellow of the Taxation Law and Policy Research Institute, Melbourne; associated with Minden Gross Grafstein & Greenstein LLP, Toronto. See Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States* (Toronto: Canadian Tax Foundation, 2004).

eventually attract a venture capital presence in Florida.<sup>14</sup> The National Association of Seed and Venture Funds noted this unique program under the category of venture capital “culture bending initiatives.” Although it is too early to determine the long-term venture capital impacts of the Scripps project, Florida has successfully recruited at least three other biotechnology businesses in the last year (Torrey Pines, SRI, and the Burnham Institute).

### Other States and Lessons Learned

There are approximately eight different state-sponsored venture capital models across the country.<sup>15</sup> Michigan, New Mexico, Oklahoma, Arkansas, Maine, Iowa, Hawaii, Indiana, Illinois, Wyoming, South Carolina, Oregon, and many other states currently operate a “fund-of-fund” model for venture capital investment.<sup>16</sup> Other popular models include direct investments in business, or providing direct tax credits for investment in either private business or venture funds. The National Association of Seed and Venture Funds suggests the following guidelines for a successful program.<sup>17</sup> The program should:

- Be private-sector driven with private-sector management. Programs with government as a direct business investor have a poor track record.
- Have a long-term perspective. States should not expect measurable results for a minimum of five years.
- Be created with the state as a valuable financial partner, with an opportunity for a financial return that is proportionate with the risk taken.
- Build on existing momentum.
- Expect the investment manager to make money.
- Have achievable outcomes with measures set from the beginning to keep track of program results.
- Be governed by simple and not overly-complex legislation.

### **EFFECT OF PROPOSED CHANGES:**

The bill creates the Florida Capital Formation Act (Act), and provides legislative findings and definitions related to this Act.

### **The Florida Opportunity Fund**

HB 83 creates the Florida Opportunity Fund to invest on a “fund-of-funds” model emphasizing investment in seed capital and early stage venture capital funds focusing on opportunities in Florida. The Opportunity Fund is “not precluded from investing in funds with a wider geographic spread of portfolio investment,” but it must require an investment fund to have a record of successful investment in Florida, be based in Florida, or have an office in Florida. The Opportunity Fund has additional criteria:

- Investments may not be direct investments with individual businesses, but must consist of partnerships with private venture capital funds (the “fund of funds” approach);
- Investments must have received capital from other sources “in an amount greater than the investment of the Florida Opportunity Fund, such that the amount invested in an entity in this state by the receiving venture capital fund is at least twice the amount invested by the fund.”; and
- Investments must be made in Florida-based businesses.

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<sup>14</sup> For a background on the state’s offer to the Scripps Research Institute, see Cynthia Barnett, *Biotechnology: Rolling the Dice*, Florida Trend, January 2004.

<sup>15</sup> Strommer, Susan P. and George Lipper, “State and Venture Capital – State Experiences and Options”, National Association of Seed and Venture Funds, May 2006, available online at <http://www.nasvf.org>.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

The fund may negotiate all terms for investments. When a return on investment is realized, those earnings will be reinvested into the program to further the economic development of the state.

### **Annual Report**

The board of directors for the Florida Opportunity Fund is required to provide an annual report on its activities to the Governor, the President of the Senate, and the Speaker of the House of Representatives. The report, at a minimum, must include the following:

- An accounting of the amount of investments disbursed by the fund and the progress of the fund;
- The benefits of the state resulting from the program, including the number of businesses created, associated industries started, the number of jobs created, and the growth of related research projects; and
- A copy of the independent audit of the fund that shall include receipts and expenditures for personnel, administration, and operational costs.

The effective date of the bill is July 1, 2007.

#### **C. SECTION DIRECTORY:**

**Section 1.** – Creates ss. 288.9621-288.9624, F.S., relating to the Capital Formation Act.

**Section 2.** – Provides an appropriation.

**Section 3.** – Provides an effective date.

## **II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT**

#### **A. FISCAL IMPACT ON STATE GOVERNMENT:**

##### **1. Revenues:**

If the amount of venture capital in the state is increased, it could stimulate increased state tax revenues..

##### **2. Expenditures:**

The bill appropriates \$30 million for fiscal year 2007-2008 from the General Revenue Fund to Enterprise Florida, Inc., of which \$29.5 million is to be used by the Florida Opportunity Fund for investments, and \$500,000 is to be used for start-up activities as necessary to implement the provisions of this act.

#### **B. FISCAL IMPACT ON LOCAL GOVERNMENTS:**

##### **1. Revenues:**

None.

##### **2. Expenditures:**

None.

#### **C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:**

The bill should have a net positive impact on the amount of venture capital investment in Florida businesses.

D. FISCAL COMMENTS:

None.

**III. COMMENTS**

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

This bill does not require counties or municipalities to spend funds or take action requiring the expenditure of funds. This bill does not reduce the percentage of state tax shared with counties or municipalities. This bill does not reduce the authority that municipalities have to raise revenue.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

None.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

D. STATEMENT OF THE SPONSOR

This bill increases the amount of money available to finance new businesses in the state. Scripps and other biotech firms will generate start-ups and spin-offs. In order to keep them and their high-value jobs in state, we will need more venture capital than currently exists here. Venture capitalists generally choose to invest within 75 miles of their home base, and new businesses follow the financing. By establishing incentives for venture capitalists, we can keep the new high-tech, high-wage jobs in Florida.

**IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES**

On Thursday February 8, 2007, the Committee on Economic Development reported the bill favorably with three amendments. These amendments:

- Clarify the amount of "matching" funds required from venture capital funds receiving investments from the Florida Opportunity Fund and clarifying that investments must be made with Florida-based companies, including but not limited to the life-science, information technology, aviation, and defense industries;
- Add a requirement that OPPAGA prepare interim and final reports regarding the Florida Opportunity Fund's performance;
- Clarify that tax credits created under this act are not transferable before July 1, 2012 or after June 30, 2037.

On Tuesday April 17, 2007, the Economic Expansion and Infrastructure Council reported the bill favorably with a strike-all amendment. The amendment:

- Eliminated the tax credit program and provided a direct appropriation from the General Revenue Fund to Enterprise Florida, Inc. to be used by the fund for venture investments.
- Eliminated the Florida Capital Investment Trust and the Florida Opportunity Fund Management Corporation and gave the applicable duties of those entities to Enterprise Florida, Inc.