



ICIC

Iowa Capital Investment Corporation

IOWA CAPITAL INVESTMENT CORPORATION

2006 ANNUAL REPORT OF THE

IOWA FUND OF FUNDS

TO

GOVERNOR CHET CULVER

December 17, 2007

Copies to: Michael Tramontina, Iowa Department of Economic Development
G. Richard Neumann, Iowa Capital Investment Board
David Casey, Iowa Department of Revenue
Legislative Leadership
Secretary of the Senate
Clerk of the House

PURPOSE

Iowa Capital Investment Corporation's goal is to accomplish the purposes expressed in its enabling legislation in Iowa Code §§ 15E.61:

- *To mobilize private investment in a broad variety of venture capital partnerships in diversified industries and locales.*
- *To retain the private-sector culture of focusing on rate of return in the investing process.*
- *To secure the services of the best managers in the venture capital industry, regardless of location.*
- *To facilitate the organization of the Iowa fund of funds in which to seek such private investment and to create interest in such investments by offering state incentives for private persons to make investments in the Iowa fund of funds.*
- *To enhance the venture capital culture and infrastructure in the state of Iowa so as to increase venture capital investment within the state and to promote venture capital investing within Iowa.*
- *To accomplish these purposes in such a manner as to minimize any appropriations by the state of Iowa.*

SUMMARY

The Iowa Fund of Funds program ("IFOF"), envisioned by the Legislature in 2002 and begun in 2005, continues to grow and is beginning to have an effect on the Iowa economy. At December 31, 2006 the Fund of Funds had closed on commitments of capital to two venture funds – the first in early stage life sciences and medical services, and the second in later stage manufacturing, distribution and services. A commitment has closed on a third fund and preliminary commitments have been made to four additional funds and as of the date of this report. The first investment in an Iowa company was made this year by an IFOF-supported venture fund. The program has a pipeline of high quality experienced funds interested in working within Iowa and helping our local entrepreneurs.

The Fund of Funds was formed by the Iowa Capital Investment Corporation ("ICIC"). In 2005 ICIC engaged Cimarron Capital Partners, L.L.C. ("Cimarron") as its fund manager. Cimarron brings extensive experience managing fund of funds programs and developing entrepreneurial ecosystems for states and regions.

In partnership with Iowa's banking industry, ICIC has separately helped launch a \$45 million fund supported by New Markets Tax Credits.

These programs have been implemented without State appropriations or reductions of revenue. ICIC carefully coordinates its work to enhance the parallel efforts of the Iowa Department of Economic Development, the Regents universities, the local investing community, Iowa's technology and industry associations, and local entrepreneurs.

Over time, ICIC will help build a thriving Iowa entrepreneurial ecosystem in which an self-sustaining Iowa Fund of Funds and its partner venture funds play an empowering role.

BACKGROUND

Creating a Venture Capital Network in Iowa. The economic well-being of Iowa depends on the creation and growth of competitive, knowledge-intensive companies capable of success in high-growth domestic and international markets. These companies depend on Iowa's access to sophisticated risk capital and investment skills, employee talent, and a network of connections to entrepreneurial resources. These are all essential ingredients for a vigorous entrepreneurial Iowa. The Governor and Legislature recognize that it is imperative these resources are made more broadly accessible to our local entrepreneurs. One important source of such money, talent and connections is found in the people making up America's 1000+ professional venture capital firms. Most of these firms have traditionally focused their efforts on the east and west coasts, leaving the rest of the country, including Iowa, with little access to the necessary resources of the national venture capital network. In recent years, leading states (including Iowa) have forged creative ways to connect themselves to this network, seeking to ensure that their most promising entrepreneurs have a chance to compete on a level playing field with their peers in the venture capital-rich areas of the country and, now, the world.

It is very important to build proper expectations about the number of Iowa companies that will find backing from professional venture capitalists. Only a few companies will be among the most promising and receive an investment from the national venture capital network. But even those not selected will benefit -- They will be challenged to rise to national standards of quality and will be more likely to find local funds of a different character to support their growth. The ultimate success of Fund of Funds investments will help build overall economic momentum and catalyze cultural change and a more robust entrepreneurial ecosystem in Iowa in the years and decades to come.

Strategic Goals. The key strategic goal of Iowa policy leaders is to create a dynamic entrepreneurial ecosystem in Iowa, to cause a change in our culture that will both encourage more entrepreneurs and help them succeed. ICIC and the Iowa Fund of Funds will play our part to help achieve this goal. This is a goal that will take decades of hard work to achieve.

Iowa Fund of Funds. Through legislative action in 2002, the Iowa Legislature created the Iowa Fund of Funds Program. The program is designed to help level the national venture capital playing field and bring venture funds, expertise, and networked resources to assist Iowa entrepreneurs. The Legislature also directed that resources to be allocated to support loan guarantees and other related credit enhancements for rural and small business borrowers within the state. Codified in Iowa Code §§ 15E.61 et. seq. ("Capital Investment Act" or "Act"), the Legislation pledges up to \$100 million of transferable Iowa tax credits to be used to support the capitalization of the Fund of Funds and its investments in venture capital funds. The tax credits, which are applicable against State income, franchise, and premium taxes, are contingent on the success of the investments and have value only to the extent of any future loss in the program.

ICIB and ICIC. In order to facilitate the goals set forth in the Act, the Legislature authorized the formation of the Iowa Capital Investment Board ("ICIB") and the Iowa Capital Investment Corporation ("ICIC"). ICIB is a state agency organized for the purpose of mobilizing private venture capital for investment in targeted enterprises and communities. ICIB

authorizes the commitment of tax credits, while ICIC directs the program. ICIC is a private, 501(c)(3), not-for-profit corporation organized under Iowa Code Chapter 504A on May 7, 2002. The members of the ICIC Board of Directors are Dennis Murdock (President), John Rigler (Vice President), Bruce Tamisiea (Treasurer), Tim Urban, and Julie Bintner. Serving as general counsel is the firm of Davis, Brown, Koehn, Shors & Roberts, P.C. ICIC is audited annually by a private auditing firm selected and supervised by the State Auditor. Upon its termination, ICIC is scheduled to turn its assets and accumulated profits over to the State.

Formation. In 2005, technical amendments to the original legislation removed impediments to securing low-cost investment capital. As a result, the Iowa Fund of Funds, Fund A, LLLP (the “Fund of Funds”), an Iowa private, for-profit limited partnership, was capitalized on June 28, 2005. ICIC is the General Partner of the Fund of Funds. In accordance with the statute, the investments of the Iowa Fund of Funds have focused on partnership interests in private venture capital funds rather than direct investments in individual enterprises.

Management. The statute requires ICIC to employ a professional fund allocation manager. In 2005 Cimarron Capital Partners LLC (“Cimarron”) was engaged in this capacity. Cimarron, a national leader in regional private equity, has operations in Ames, Des Moines, Little Rock, Phoenix, Chicago, and Oklahoma City.

Investment Allocation and Strategic Objectives of the Fund of Funds. Working with Cimarron, ICIC has developed a formal policy to guide the allocation of venture fund investments and achieve the strategic objectives of the Fund of Funds. The Iowa Fund of Funds is investing in a diverse set of private venture capital funds so as to connect Iowa’s most promising entrepreneurs with the full resources of the national venture capital network.

To minimize the use of Iowa contingent tax credits, the Iowa Fund of Funds invests only in carefully selected and diversified private equity and venture capital funds with capable management teams showing promise of earning market rates of return. In the aggregate, the portfolio will be broadly diversified across industries, time and geography, and across stage of investment within the following guidelines:

- Early Stage (includes seed and start-up) 20% - 35%
- Traditional Venture Capital 30% - 45%
- Later Stage (includes expansion & mezzanine) 20% - 30%
- Special Situations (turnarounds, restructuring, etc.) 5% - 10%

To meet the needs of the Iowa economy, fund commitments will be focused in several strategically important industries:

- Life Sciences (including agricultural technology and animal sciences)
- Information Technologies
- Financial Services
- Advanced Manufacturing

Each fund management team agrees to establish an appropriate presence within the state and work aggressively with entrepreneurs, angel investors, other venture funds, university tech

transfer and development staff, economic developers, and corporate business development groups to identify promising Iowa opportunities.

SUMMARY OF ACTIVITIES IN 2006

Since 2002, ICIC has worked patiently to create the Fund of Funds and build it into the active investing program it is today. With the Legislature's timely assistance in 2005, ICIC made significant progress in 2006.

Commitments to Venture Funds

The Iowa Fund of Funds has selected seven venture capital funds for investment. As of this date three have closed and four are pending. The closed commitments were to:

- **Prolog Ventures Fund II**, a \$5 million commitment to this \$66 million early stage life sciences fund focused on deals in the central Midwest. Based in St. Louis, the managers of Prolog Ventures engaged a local representative in Iowa and formed an investment advisory board consisting of key members of the life sciences and entrepreneurial communities from Iowa State and the University of Iowa.
- **Bayview Capital Partners Fund II**, a \$2.7 million commitment to this \$125 million fund focused on late-stage manufacturing, services, and distribution companies in the Midwest. Based in Minneapolis, the fund is a licensed Small Business Investment Company. The managers of Bayview Capital Partners are engaged in extensive marketing, development, and educational efforts within Iowa in partnership with Iowa banks, attorneys, and CPAs.
- **Village Ventures Fund II**, a \$5 million commitment to this \$104 million fund launched in February of 2007. Village Ventures, based in Boston, is seed and early stage venture capital firm focusing on consumer media and retail, health care and financial services in emerging US technology centers which possess world class innovation but generally lack local sources of institutional early stage capital. The managers of Village Ventures have engaged a local representative in Iowa and have vigorous program to identify prospective companies.

The four pending commitments include:

- \$5 million to a \$30 million fund that plans to invest growth and expansion capital in smaller middle-market growth-stage companies in the business services, consumer and health sectors, with a special emphasis on businesses that are owned or led by female entrepreneurs or that serve markets of interest to women.
- \$7 million to a \$125 million fund that will focus on early-stage firms offering technology-enabled or business information services with an emphasis on information

technologies, life science (medical devices, healthcare IT, and animal/plant sciences), and wireless technologies.

- \$5 million commitment to a \$50 million seed and early stage venture fund that will focus on core technologies, financial services, for-profit education and technology-enabled services.
- \$5.5 million commitment to a \$150 million private equity fund focused on debt and equity investments in high growth small businesses.

Expanding Our Funds' In-State Iowa Presence and Capital Leverage

- *In-State Development Efforts.* The managers of all of the selected venture funds have agreed to participate in a wide variety of Iowa venture activities, including the annual Entrepreneur and Venture Capital Conference in Des Moines sponsored by the Iowa Department of Economic Development, as well as to conduct aggressive deal prospecting throughout the state.
- *Celebration of the first investment* by an Iowa Fund of Funds portfolio firm in an Iowa company. Bayview II invested a seven-figure amount in Accu-Mold, Inc. of Ankeny, a precision maker of small, high technology molded plastic parts with exciting prospects in medical devices and advanced manufacturing markets. With this single investment, the Iowa Fund of Funds has returned more money to the Iowa economy than has been drawn in capital commitments and startup costs for the entire program. This illustrates the economic leverage potential of the Fund of Funds program.
- *Capital Leverage.* Part of this leverage represents the ability of the Fund of Funds to make large capital resources available to Iowa enterprises through carefully selected, smaller capital commitments to venture funds. The closed capital commitments of the Iowa Fund of Funds, now totaling \$12.7 million, are leveraged by over twenty times through investing in three venture funds that directly manage more than \$295 million. These funds meet the test of the private market: they compete worldwide for capital and are able to raise the major share of their capital from private sources in a competitive market.
- *Co-Investment Networks.* The managers of IFOF portfolio venture funds also bring extensive networks of venture and private equity co-investors able to multiply their own direct investments. On average, every dollar invested by an IFOF portfolio fund is expected to attract two to three matching dollars from co-investors.
- *Investing Culture and Expertise.* Finally, the managers of IFOF portfolio venture funds bring investing expertise into the state. Iowa has historically lagged other states in the breadth and vigor of its entrepreneurial economy in high-knowledge, high-growth, and high-capital-intensive industries. By importing expertise and culture, we transmit the “intellectual DNA” of entrepreneurship and venture investing into our

Iowa ecosystem and help jump-start a more dynamic economy better able to compete in global technology markets.

Developing Additional Funding Sources to Lower Capital Costs

The Fund of Funds is capitalized by private investments with the support of contingent tax credit certificates issued by the Iowa Capital Investment Board. The first funding was provided in 2005 with the help of West Bank in West Des Moines. The tax credits have value only to the extent the overall program experiences a loss and their redemption is contingent on certain State-approved criteria. The credits are limited to \$100 million in the aggregate and \$20 million in any fiscal year.

During 2006, we:

- *Continued our financing relationships* with West Bank and Wells Fargo to support the Fund of Funds.
- *Developed additional funding products* to add investment capacity and flexibility to the Iowa Fund of Funds at reduced cost.
- *Developed mechanisms to monetize tax credit certificates* if needed and improve the value of the certificates and further reduce costs.

Demonstrating Good Financial Stewardship

During 2006, we undertook our first financial audit with the active assistance and supervision of the Auditor of State, Mr. David Vaudt, and his staff. This audit was conducted by Deloitte and Touche. The audit report and financial statements are attached.

Developing Iowa Business Development and Venture Industry Relationships

During 2006, our fund manager was active in expanding our relationships and resources both within Iowa's entrepreneurial community and into the national venture capital community:

- *Co-sponsored* the October, 2006 Entrepreneur and Venture Capital Conference in Des Moines and presented a seminar on angel investing.
- *Marketed IFOF at the annual World's Best Technologies Showcase*, held each year in Fort Worth, TX. Hosted startup companies spun out of Iowa's federal laboratories and engaged Iowa reviewers to assist in screening firms prior to presentation to venture investors.
- *Participated* on the Iowa Business Council Capital Formation Hot Team and helped develop the latest version of www.IowaEntrepreneur.com, an educational site for Iowa entrepreneurs and investors.

- *Participated* as a member in a number of Iowa business and trade associations and actively represented the interests of Iowa's angel and private equity investors and entrepreneurs.
- *Continued membership in the Iowa Venture Capital Association* and developed contacts within the angel capital, private equity and investment community in the State. Encouraged and facilitated communications among angel investors and venture investors to increase local capacity to invest in attractive deals.
- *Enhanced our relationships with all three Regent universities*, Pappajohn Centers, and small business accelerators to spread knowledge of private equity capital and investing throughout the state.
- *Becoming the first associate member in the Midwest Research Universities Network* in order to assist Iowa's Regent university technology transfer offices to better network with the entrepreneurial finance economy.

Securing \$45 Million for Iowa from the Federal New Market Tax Credit Program

The New Market Tax Credit Program (NMTC) permits taxpayers to claim a credit against Federal income taxes for qualified equity investments made to acquire stock or a capital interest in designated community development entities (CDEs). CDEs must use substantially all of the proceeds from such investments to make investments in low-income communities, identified by census tract. Allowable investments range from real estate to venture capital. The tax credit provided to the investor will total 39% and can be claimed over a seven-year credit period.

To help secure some of these resources for Iowa businesses, ICIC helped launch the Iowa Development Corporation, an Iowa non-profit corporation, with the support and assistance of the Iowa Department of Economic Development and the Iowa Bankers Association. This entity in turn formed Iowa Community Development, L.C., an Iowa limited liability company, that has been designated by the US Department of the Treasurer as an approved CDE and which will conduct investment activities in Iowa.

We are pleased to report that Iowa Community Development received an allocation of \$45 million of these NMTC credits in June 2006 to begin operations. The program is now seeking appropriate investments in targeted census tracts in Iowa.

Providing Advice to the Legislature and Executive Branch

ICIC serves as a resource of expertise to provide information to legislative committees and the Executive Branch on the advantages and disadvantages of a variety of investment programs in early to late stage capital. We stand ready to assist the Legislature and Governor in developing sound economic development programs for Iowa.

We appreciate the help of our Legislature and Governor, whose continuing support of our program and patient understanding of our goals and timelines are so important to our success.

We are available to meet at your convenience.

Respectfully submitted,

Dennis Murdock
President