Governor Dayton's Small Business Capital Access Task Force

Final Report to the Governor

October 2011

Governor Dayton's Small Business Capital Access Task Force

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Governor Dayton's Small Business Capital Access Task Force

Executive Summary

Introduction

Two issues led to the formation of Governor Dayton's Small Business Capital Access Task Force. The first is the governor's goal of putting Minnesotans back to work. The second is a concern raised repeatedly by small business—that investment capital and credit are more difficult to obtain and their unavailability is a significant constraint to business expansion and job growth.

To address these issues, the task force was charged with making practical, prudent recommendations to the governor to improve the flow of investment capital and credit to small businesses and to recommend other financial strategies for facilitating job retention in Minnesota.

In assembling the task force, members were invited to participate from each of the areas that fund, lend to, or otherwise impact small business: namely, venture, community banking, small business lending, private equity, government, nonprofits, community development lending and taxation.

In fashioning its recommendations the task force was directed to take into account:

1. Limitations on state resources, necessitating leveraging any government dollars with significant private and nonprofit investment
2. The need to collaborate with and not duplicate ongoing efforts at job creation in the private sector.

By and large, the task force's final recommendations honored these constraints:

1. One recommendation provides immediate deposits for lending by community banks to small business (**MINNESOTA SMALL BUSINESS/BANKING PARTNERSHIP**--$200 million).
2. Other recommendations could provide investment capital (**EB-5 PROGRAM**), new markets (**EXPORT-IMPORT FINANCING OFFICE**), or growth opportunities (**BUY MINNESOTA**) for small businesses in the near term without legislative action and minimal investment.
3. Most of the remaining recommendations address specific investment or lending needs of small businesses modeled on successful programs at the city state or federal level that leverage significant federal, private sector or nonprofit dollars (**LOAN GUARANTEE TRUST FUND; STATE SBIC PROGRAM; NEW MARKETS TAX CREDIT; AND SMALL BUSINESS REVOLVING LOAN PROGRAM**)

Report Structure

Executive Summary: Introduces the work of the task force and provides an overview of the recommendations of the five subcommittees

Subcommittee Reports: Provides the recommendations of the five subcommittees with background information and greater detail.

- Banking Subcommittee
- Government/Nonprofit Subcommittee
- Private Equity/Growth Companies Subcommittee
- Venture Capital Subcommittee
- Tax Subcommittee.

Subcommittee Recommendations

Banking Subcommittee

Recommendation 1: Minnesota Small Business/Banking Partnership

Provide up to **$200 MILLION IN DEPOSITS** to state community banks for lending to small business for working capital needs. This recommendation is estimated to have **NO COST AND REQUIRES NO LEGISLATIVE ACTION**.

Recommendation 2: Business Finance and Technical Assistance Portal

Expand the existing DEED website to include all existing state and local lending and technical assistance programs and ensure timely updates are implemented on a regular basis. There was no cost estimate for this proposal, which **WOULD NOT REQUIRE LEGISLATIVE ACTION**.

Recommendation 3: Minnesota Small Business Revolving Loan Program

Create a statewide below market interest rate lending program addressing small business needs for longer term fixed asset financing. Funding is proposed at $50 million over three years, which would require legislative approval.

Recommendation 4: Minnesota New Markets Tax Credit Program

Create a state tax credit that parallels and leverages the federal NMTC program that would fund larger projects in low-income communities. This recommendation, which would require legislative action, proposes an allocation of $50 million in tax credits to be claimed over seven years.

Government/Non-Profit Subcommittee:

Recommendation 1: Loan Guarantee Trust Fund

Fund and launch the Minnesota Loan Guarantee Program, created by the 2011 legislature, with initial funding from Minnesota's allocation from the federal State Small Business Credit Initiative (SSBCI). This recommendation **ALREADY HAS LEGISLATIVE APPROVAL** and **WILL NOT REQUIRE ADDITIONAL FUNDING** unless demand outpaces SSBCI funding available for the program.

Recommendation 2: Twin Cities and Greater Minnesota Revolving Loan Fund

Expand funding to regional and nonprofit organizations with experienced track records in providing gap financing to small businesses in need of capital. This recommendation proposes $12 million in total funding, which would require legislative approval.

Recommendation 3: Marketing Campaign to Increase Awareness of EX-IM Export Financing

The Minnesota Trade Office will lead a marketing plan to build awareness of the EX-IM Bank's financing resources. This recommendation does not have a cost estimate, but **WOULD NOT REQUIRE LEGISLATIVE ACTION**.

Recommendation 4: Establish an EB-5 Regional Investment Program for Minnesota

Sponsor a public-private partnership to pursue the establishment of a statewide EB-5 regional center to encourage investments in Minnesota companies in return for immigrant visas. The application process is **ESTIMATED TO COST $200,000, AND IT WOULD NOT REQUIRE LEGISLATIVE ACTION**.

Recommendation 5: Buy Minnesota Strategy

Establish a public-private partnership to encourage businesses to purchase goods or services within the state that were previously purchased outside Minnesota. Consider an executive order that instructs state agencies to purchase from Minnesota vendors when bids are equivalent in cost and value. This recommendation does not have a cost estimate, but **WOULD NOT REQUIRE LEGISLATIVE ACTION**.

Recommendation 6: Business Assistance Portal—Starting with Business Finance Programs

Create a state of the art gateway to doing business in Minnesota in the form of a central internet portal for entrepreneurs, businesses, bankers and non-profits to start or grow a business. There was no cost estimate for this proposal, which **WOULD NOT REQUIRE LEGISLATIVE ACTION**.

Private Equity/Growth Companies Subcommittee

Recommendation 1: State Level Small Business Investment Company Program

Create a program modeled after the U.S. Small Business Administration's SBIC program by providing capital to licensed private equity, venture and mezzanine investment funds (SBICs) using funds loaned at favorable rates and guaranteed by the state of Minnesota. **THE PROGRAM WOULD LEVERAGE SIGNIFICANT PRIVATE DOLLARS AND REQUIRE NO STATE FUNDS**, but it would require legislative action.

Recommendation 2: Friendly Capital for Minnesota Growth Companies

Create a fund, using large Minnesota corporations as founding investors, that invests in Minnesota growth companies in the form of a long maturity preferred security with a current dividend and attached warrants that could be sold back to the company to provide additional returns based on valuation increases. **SINCE LARGE CORPORATIONS PROVIDE THE CAPITAL, THERE IS NO COST TO THE STATE; NO LEGISLATIVE ACTION IS NECESSARY**.

Venture Capital Subcommittee:

Recommendation 1: The Minnesota Growth Fund

Create a venture capital fund to encourage global and in-state fund managers to consider Minnesota investments. The portfolio would include guidelines for investments in three segments: venture capital fund of funds, seed and early stage investing, and direct investment alongside investments made by the venture capital funds of funds segment. The fund is proposed to be capitalized at $300 million with capital coming from either private institutional capital or a contingent tax credit. **IN EITHER CASE, THE SUBCOMMITTEE SUGGESTS THAT THERE IS NO SHORT-TERM COST**; this proposal would require legislative action.

Recommendation 2: Employment Based Immigration Investment Program (EB-5)

Establish and EB-5 center to allow immigrant investors to obtain permanent visas based on qualified investments. The application process is estimated to cost $200,000, and it would not require legislative action.

Recommendation 3: New York City Investment Fund (NYCIF)

Consider the NYCIF model of civic investment. No cost estimate was provided; no legislative action required.

Recommendation 4: Technology Business Tax Certificate Transfer Program

Consider allowing technology businesses to sell their unused net operating losses and unused research and development credits to other profitable corporate taxpayers. No cost estimate was provided; legislative action would be required.

Recommendation 5: Small Business Matching Grants

Consider a program of matching federal grants with state grants that could multiply the impact of this important source of funds for business innovation and research. No cost estimate was provided; legislative action would be required.

Recommendation 6: University of Minnesota Best Practices Review

Encourage the university to review best practices at other universities for moving innovations from the laboratory into the venture capital community. No cost estimate was provided; no legislative action would be needed for this recommendation.

Tax Subcommittee

Recommendation 1: Establish a Small Business Office or Liaison Within DOR

Establish a dedicated function within DOR designed to simplify and expedite tax compliance for small businesses. No cost was estimated; **NO LEGISLATIVE ACTION REQUIRED**.

Recommendation 2: Enhanced State Agency Coordination

Instruct state agencies to develop a one-stop point of contact for small business owners. No cost was estimated; **NO LEGISLATIVE ACTION REQUIRED**.

Recommendation 3: Commissioner Listening Sessions

Pursue a systematic assessment of tax policy and tax compliance issues with small business owners and communities statewide. No cost was estimated; **NO LEGISLATIVE ACTION REQUIRED**.

Recommendation 4: Job Creation Tax Credit

Request the legislature to approve a temporary, targeted job creation tax credit that provides a limited incentive to qualifying small businesses that increase their total employment beyond a base year. No cost was estimated; legislative action would be required.

Recommendation 5: Enhanced Research and Development Credit

Refine and renew the request to enhance Minnesota's research and development tax credit by increasing the credit from 10 percent to 15 percent of the first tier of qualified research expenses over the base amount. No cost was estimated; legislative action would be required.

Recommendation 6: Adopt Affiliate Nexus

Request the legislature reform state law to reflect modern technologies and business practices that have resulted in an uncompetitive business climate for Minnesota-based companies selling the exact same products as remote sellers. No cost was estimated; legislative action would be required.

Recommendation 7: Clarify Unitary Business Sales Definition

Request the legislature reform state law to stay current with business practices that have resulted in an increasing number of non-Minnesota companies paying lower Minnesota corporate franchise tax than do Minnesota companies despite potentially competing against Minnesota companies. No cost was estimated; legislative action would be required.

Recommendation 8: Federal Conformity to Section 179 Expensing

Request the legislature adopt full conformity to federal section 179 expensing provisions for tax year 2012. Under current law, the state partially conforms but does not extend the full, accelerated benefit to Minnesota businesses. No cost was estimated; legislative action would be required.

Final Recommendation

Recommendation 1: Implementation Task Force

ONCE THE GOVERNOR HAS HAD AN OPPORTUNITY TO REVIEW AND EVALUATE THE RECOMMENDATIONS OF THE TASK FORCE, THE GOVERNOR SHOULD APPOINT AN IMPLEMENTATION TASK FORCE TO ADVISE HIM ON HOW TO IMPLEMENT THESE RECOMMENDATIONS. THE CHAIR OF THE SMALL BUSINESS CAPITAL ACCESS TASK FORCE WILL RECOMMEND FIVE PEOPLE TO SERVE ON THE IMPLEMENTATION TASK FORCE WITH FINANCIAL, LEGISLATIVE AND REGULATORY EXPERTISE. THE IMPLEMENTATION TASK FORCE WILL REPORT BACK TO THE GOVERNOR WITHIN THIRTY DAYS OF THEIR APPOINTMENT.

Governor Dayton's Small Business Capital Access Task Force

Recommendations from the Banking Subcommittee

Acknowledgements

The following individuals participated on the banking subcommittee:
David Reiling, co-chair, Sunrise Community Banks
Dave Rader, co-chair, Wells Fargo
Dave Beito, Northern State Bank
Elliott Jaffee, U.S. Bank
Kathy Polasky, city of Minneapolis

Introduction

The banking subcommittee has researched the best practices of current Minnesota city and state lending programs as well as numerous best practice lending programs from other states. Our focus was to identify new lending programs outside of traditional banking channels and existing governmental programs to spur lending activity within the state and ultimately help small business customers grow revenues, add jobs and increase the Minnesota tax base. Our research has concluded that new best practices lending programs have one or more components:

- Programs that provide reduced borrowing costs through below market interest rates
- Programs that provide collateral enhancement to mitigate concerns on asset valuations or shortfalls in overall collateral
- Programs that provide loan guarantees as secondary or tertiary repayment support.

Any new program initiative must meet key litmus tests:

- Not duplicate an existing lending program if credit is available elsewhere
- Provide a reasonable risk reward and return on investment for the State
- Provide marketability and scalability for the state and all lending institutions involved.

Today's Lending Gap/Opportunity

There are many macro and micro economic reasons for the slowdown in the economy which has placed additional burdens on small business access to capital to grow and expand. Evidence suggests that small business optimism has declined (causing decreased loan demand) as borrowers have deleveraged to the new economic realities of reduced revenues and tighter business and personal cash flows. Small business owners have experienced depressed valuations on their key assets such as business real estate, equipment and personal home equity leaving gaps in collateral coverage. National data also suggests that lending institutions (national, regional and local) have tightened credit underwriting standards, increased customer cost of borrowing due to increased loan losses, stricter regulatory pressures and weakened bank capital positions. These influences have made access to capital more difficult for all small business owners, especially for the near-bankable small business owners as it relates to key borrowing gaps:

1. Short-term working capital needs: Used to run daily operations, purchase inventory, fund payroll and add additional employees. Working capital lending gaps exist today due to reduced business revenue levels and corresponding levels of accounts receivable and inventory and stricter underwriting/monitoring levels. New lending programs must help small business close these gaps by offering reduced rates, collateral enhancements and provide banks with additional short-term funding sources.
2. Long-term fixed asset financing: Used to purchase and invest in new equipment, real estate, tenant improvements or business acquisition. Long-term fixed asset financing gaps exist today due to reductions in appraisal valuations, stricter underwriting levels and pressure on bank capital ratios. New lending programs must help small business close these gaps by providing longer-term fixed rate financing, below market financing, collateral enhancement or enhanced loan guarantees.
3. Information needs: Business owners are busy running their businesses and do not have firsthand knowledge of available lending programs and technical assistance resources at their disposal. Community and business bankers have the same need for a centralized resource. A gap exists in Minnesota today to effectively catalog in a central website all of the lending program and technical assistance resources for small business owners.

RECOMMENDATIONS

Recommendation 1: Minnesota Small Business/Banking Partnership

Provide up to $200 million in deposits to state community banks for lending to small business. Nature of deposits will be the best match to fund lending for working capital needs.

The Minnesota State Board of Investment (SBI) has a program that makes available to “qualifying Minnesota banks” up to $750,000 per bank in three and six month certificates of deposit. Under the current program, approximately $50 million to $100 million is deposited in Minnesota’s community banks for lending to their customers–principally small businesses throughout the state. We recommend that the program be doubled in size–up to $1,500,000 per bank and total deposits of $100 million to $200 million.

To qualify for the program, banks must have a rating of at least “satisfactory” from the Minnesota Department of Commerce and must be “well capitalized”. Rates will be established on a quarterly basis by the SBI. Deposits must be fully insured by the Federal Deposit Insurance Corporation (FDIC). The proposed modifications in the program will provide financial institutions throughout Minnesota with up to $200 million to lend to small businesses.

Recommendation 2: Business Finance and Technical Assistance Portal

Expand the existing Department of Employment and Economic Development (DEED) website to include all existing state and local lending and technical assistance programs and ensure timely updates are implemented on a regular basis. We believe a one-stop business resource website would benefit small business owners and lenders by providing them tools to meet borrowing needs that can support job creation and job retention. The funding for this enhanced website to come from existing DEED resources or potential access/user fees.

Recommendation 3: Minnesota Small Business Revolving Loan Program

Create a statewide below market interest rate (4% fixed rate) lending program for working capital and longer term fixed asset financing. This will be a self-sustaining loan program; all repaid loan funds will be recycled back into the lending pool for future new small business loan originations. The program will be modeled after the successful city of Minneapolis loan program called the "Minneapolis Small Business Revolving Loan Program".

Background

A number of cities throughout Minnesota have established revolving loan funds in partnership with local lenders to provide financing to small businesses to purchase equipment and/or to make building improvements. These revolving loan programs provide financial assistance to community retail, service and manufacturing businesses through paired public and private lending. To expand access to credit to more Minnesota small businesses, the state should create a statewide Small Business Revolving Loan Program (program).

We recommend that the program be capitalized over three years as a $50 million revolving loan program. Potential funding sources could include annual appropriations, dedication of fees from the issuance of revenue bonds and capital bonding.

Program Scope

The Program will establish a state-wide low interest, longer term loan program to provide:

- Capability and incentive for business owners to upgrade the appearance, structural condition and operating efficiency of their place of business
- Improvement of the market and service of their business to the local community
- Retention and expansion of job opportunities.

The Program will provide small businesses with access to $50 million in low interest capital, leveraging another $50-100 million in private lending from participating banks.

Criteria for Participation

- The business must be located in Minnesota
- Applicants may include individual owners, partnerships, corporations, tenant operators or contract for deed partners
- Businesses must benefit low-to-moderate income persons by creating jobs or improving community services
- Businesses must operate out of a commercial space (not home-based).

Program Overview

The program will operate as a public/private partnership of the state of Minnesota and local banks and/or other lending partners. The program is a shared financing among a bank, other lending partners and the state of Minnesota. The program will provide up to one-half of each small business loan up to a maximum of $100,000 at an interest rate of 4 percent.

Matching funds at least equal to the amount provided by the program will be provided at current interest rates by community banks and/or other lending partners. The term of the loan shall be up to 10 years and will be matched by the term of the lender's loan. The lender shall have the sole responsibility of determining the applicant's credit risk and shall determine with the state the type and amount of collateral the borrower will provide. In most cases the lender shall have a senior lien on the collateral.

Prior Experience in Minnesota

A number of cities including Woodbury, Brooklyn Park and Minneapolis operate revolving loan funds in partnership with local private lenders. Businesses and bankers value the programs for their simplicity, knowledgeable and friendly city staff, use of the bank's underwriting, reduced risk to the banks, lower interest rate on the city's portion of the loan, and ability to meet a broad range of small business needs. The loan loss experience in Minneapolis has been under three percent.

Required Disclosures and Reports

To verify compliance with the objective of increased small business lending, participating banks will be required to:

- Disclose the number and dollar volume of their small business loans as well as data on the loan repayments
- Report to the state on a semi-annual basis the qualifying loans made during that quarterly time period to small businesses
- Compile on a semi-annual basis an analysis of the jobs retained and created as a result of their qualifying loans.

Recommendation 4: Minnesota State New Markets Tax Credit Program

Background of Federal Program

The New Markets Tax Credit Program (NMTC program) was established by Congress in 2000 to increase investments into operating businesses and real estate projects located in low-income communities. The NMTC program attracts private investment capital to low- income communities by permitting individual and corporate investors to receive a tax credit against their federal income tax return in exchange for making an equity investment in a specialized financial institution called a community development entity (CDE). The credit totals 39 percent of the original investment amount and is claimed over a period of seven years. The investment in the CDE cannot be redeemed before the end of the seven-year period.[1]

Since the NMTC program's inception, the CDFI Fund has made 594 awards allocating a total of $29.5 billion in tax credit authority to CDE's through a competitive application process. This $29.5 billion includes $3 billion in American Recovery and Reinvestment Act awards and $1 billion of special allocation authority to be used for the recovery and redevelopment of the Gulf Opportunity Zone.[1]

In 2010 Minnesota had four NMTC allocatees serving the state in both rural and urban communities. These five have a combined allocation of $190 million: Capital City Properties ($14 million), Midwest Minnesota Community Development Corporation ($74 million), National New Markets Tax Credit Fund, Inc. ($77 million) and University Financial Corporation d/b/a Sunrise Community Banks ($25 million).

Minnesota New Markets Tax Credit Program

Program Scope:

The federal NMTC program is designed to attract investment into low income communities and get projects in production that would otherwise remain idle "but for the tax credit". The Minnesota NMTC program would also be designed to attract investment and incent project implementation but

[1] Information obtained from www.cdfifund.gov

specifically in Minnesota. Although federal NMTC funds have been awarded to Minnesota allocatees, not all of the funds are targeted for Minnesota projects. Many NMTC investors will only invest in projects where there is both a state and federal NMTC program due to the added financial benefit. Currently, eight states administer their own NMTC program. Minnesota would be positioned to attract more NMTC project investment and therefore create and retain more jobs.

Program Overview:

A state NMTC program would require the Minnesota legislature to authorize a state tax credit and provide nominal start-up costs to administer the program. The state will award an allocation of $50 million in tax credits to CDE's in Minnesota that have a CDFI Fund NMTC allocation agreement. These allocatees will then partner with investors and leveraged lenders (banks, etc.) to make loans to a Qualified Active Low Income Community Business (QALICB) in urban or rural communities. The QALICB then uses the loan funds for fixed asset acquisition and/or real estate acquisition and/or improvement. The NMTC program is accessible to all sizes QALICBs but is generally more economically suited for larger transactions and hence larger QALICBs.

Criteria for Participation:

The participation criteria would mirror the federal program with the additional requirement of serving low-income communities or low-income persons in the State of Minnesota.

Basic requirements for CDEs:

- Be a domestic corporation or partnership at the time of the certification application
- Demonstrate a primary a mission of serving, or providing investment capital for, low-income communities or low-income persons in Minnesota
- Maintain accountability to residents of low-income communities through representation on a governing board of or advisory board to the entity.

Program Benefits:

The program benefits all parties involved. The QALICB receives a below market interest rate, favorable terms (interest only 7 yrs.), and equity equivalent financing. The leverage lender gets the opportunity to make a good loan, develop a new customer and facilitate a high impact project in a low income community. The investor receives a 39% federal tax credit over 7 years.

The federal tax credit is structured as: 5% for years 1-3 and 6% for years 4-7. Plus, the investor would receive a Minnesota state tax credit structured as: 0% for years 1-2, 7% for year 3, and 8% for years 4-7. The combined tax credit would be 78% over 7 years. The origination and deployment of the tax credit project has proven to create and retain approximately 1 job for every $35,000[2] invested in a QALICB. Hence the targeted job creation or retention for the Minnesota NMTC program is approximately 4,000 jobs when combined with a matching federal tax credit.

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[2] Information obtained from www.hud.gov (Economic Development Toolkit – page 126). This figure combines both NMTC and non-commercial real estate loans.

Governor Dayton's Small Business Capital Access Task Force

Recommendations from the Government/Nonprofit Subcommittee

Acknowledgements

The following individuals participated on the government/nonprofit subcommittee:
Mark Phillips, chair, Minnesota Department of Employment and Economic Development
Frank Altman, Community Reinvestment Fund
Bill Blazar, Minnesota Chamber of Commerce
John Elden, Northland Foundation
David Gaffaney, U.S. Department of Agriculture
David Hengel, Headwaters Regional Development Commission
Yvonne Cheung Ho, Metropolitan Economic Development Association
Bob Isaacson, Minnesota Department of Employment and Economic Development
Kim Isenberg, Minnesota Department of Employment and Economic Development
Nancy Libersky, U.S. Small Business Administration
Mark Lofthus, Minnesota Department of Employment and Economic Development
Scott Martin, Northland Institute
Paul Moe, Department of Employment and Economic Development
Mike Mulrooney, Central Minnesota Development Company
Jeff Nelson, Department of Employment and Economic Development
Mark Ruff, Ehlers and Associates
Lee Sheehy, McKnight Foundation
Matt Sjoberg, Iron Range Resources Agency
Robin Sternberg, Minnesota Department of Employment and Economic Development
Mike Temali, Neighborhood Development Center

Introduction

Minnesota's government and nonprofit sectors play a key role in helping small businesses meet their capital access needs. First, government serves as a facilitator and information provider. Businesses are frequently not aware of the services or tools offered by government to finance or facilitate small business needs. Second, government and nonprofits frequently finance the areas of the credit markets not served by the traditional banking and finance sectors. Earlier stage businesses and small business by asset size frequently need lending enhancements the private sector cannot provide. Third, government can lead, advise, finance and facilitate expansion of new or foreign markets.

Recommendations

Recommendation 1: Loan Guarantee Trust Fund

Overview:

Growing small businesses have a need for credit, but many have difficulty obtaining it because they often have little or no credit history. Loan guarantees are an accepted approach to improve the functioning of capital markets.

Within the 2011 budget bill a new Minnesota Loan Guarantee Program was established. The subcommittee recommendation is to fund and launch the Trust Fund program with initial funding from the State Small Business Credit Initiative (SSBCI). This SSBCI federal initiative will provide $15.4 million overall to Minnesota to improve credit availability for small businesses. From that larger amount, at least $2.2 million will be dedicated to the Minnesota's Loan Guarantee Trust Fund.

This program is all about leveraging. The $2.2 million reserve fund is authorized to guarantee up to five times its value, or $11 million, representing a 70% guarantee on a total loan value of $15.7 million. Businesses are required to have 50 percent of the total cost covered by other financing, such as bank loan. This contributes another $15.7 million for a total of $31.4 million in financing – a leverage ratio of more than 14:1 on the $2.2 million investment. Moreover, if loan is sold to secondary markets, the lender has the available capital for additional loans. Initial estimates project that this $2.2 million loan guarantee program would fuel 600 permanent full-time jobs at a cost of less than $3,700 per job.

Program Description:

Loan guarantees are a promise by the guarantor (DEED) to assume a debt obligation if a borrower defaults. A reserve fund seeded by SSBCI funds will provide the dollars to pay any guarantee obligations. Although the U.S. Department of Agriculture (USDA) and U.S. Small Business Administration (SBA) offer loan guarantees, the DEED programs will be different by offering guarantees to lenders that may not be approved by federal agencies, lower fees and a less burdensome process.

Legislative/Cost Considerations:

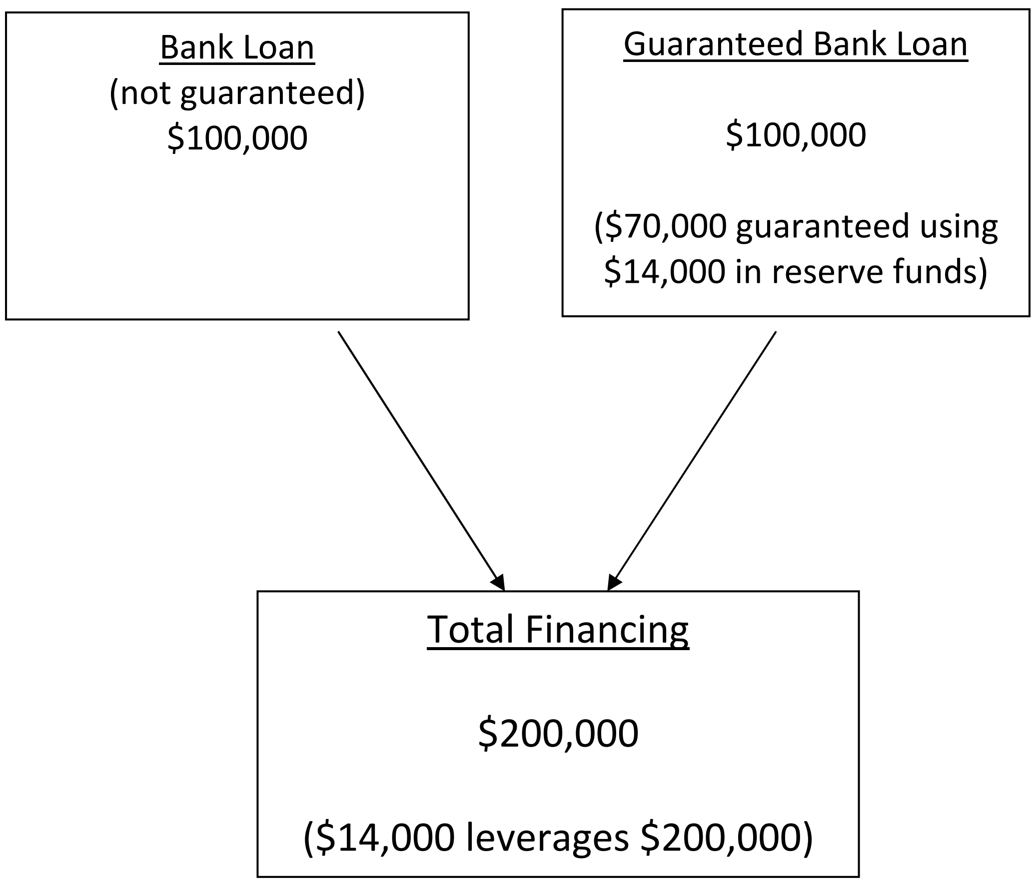
Over time, the muscle of the program will be proven and the goal is to build the trust to a much larger amount through funding partnerships from the state, private and philanthropic sources. Or, if the program is oversubscribed, funds can be transferred from other SSBCI initiatives to this program with the U.S. Department of Treasury approval.

This proposal does not call for additional funding at this time. However, once demand has been established and the SSBCI-funded loan guarantee program has operated for at least 12 months, the reserve fund used to guarantee loans may need to be increased through state appropriation, private and/or philanthropic funds.

How It Will Work:

Non-bank/commercial lenders approved by DEED to participate in the program would request enrollment of individual loans in the program. If approved, DEED would guarantee up to 70% of up to 50% of the total financing packaging. A commercial lender or bank would provide the second half of the financing and the loan guaranteed by DEED would subordinate to a second lien position. The maximum guarantee amount would be $1.5 million, and only businesses with fewer than 500 employees would be eligible.

Guarantee Loan Fund Example



Recommendation 2: Twin Cities and Greater Minnesota Revolving Loan Fund

Overview:

The committee recommends an appropriation of $12 million in general fund dollars to support loans to regional and nonprofit organizations with experienced track records in providing gap financing to small businesses in need of capital. The recommendation includes a stipulation that these funds be matched by non-state sources, so that the total funding available would be $24 million.

In tough economic times such as these, it becomes even more crucial that businesses have adequate access to capital, but this is exactly the time it can be the most difficult for them to secure financing in a skittish credit market. Even some of the strongest businesses in the portfolios of nonprofit lenders are struggling to remain viable and requesting relief, such as interest-only payments, until the economy improves. This puts additional pressure on the lenders' already stretched capital resources.

Funding would be awarded to established nonprofit lenders – such as the six Minnesota Initiative Foundations and the nonprofit organizations authorized as partners under the state's Urban Initiative Program – to make loans that fill gaps in conventional credit markets that inhibit growth and job creation by the small business clientele. The business lending experience of the partners would be complemented by their proximity to the businesses they intend to serve, and the resulting understanding of the best approaches to meet their financial needs.

Program Description:

DEED would award $6 million in total to nonprofit lenders in Greater Minnesota and $6 million in total to existing Urban Initiative partners. Funding from these awards would be used to offer gap financing in partnership with local banks, direct lending, loan guarantees, and other tools, to complement traditional lending mechanisms in flexible ways that greatly increase businesses' potential for success.

How It will work:

The Initiative Foundations and the Urban Initiative partners have participated in state partnerships in the past, under state law and appropriations. No new programmatic legislation will be required. While the Initiative Foundations and Urban Initiative partners were the primary lenders envisioned for this proposal, other nonprofit lenders could be considered, such as the state's nine regional development commissions.

Participating organizations will be allowed to structure loans as they deem appropriate, and retain the interest from the loans. As loans are repaid, funds will be revolved for their future use.

A Record of Success:

The Minnesota Initiative Foundations and Urban Initiative partners have a dynamic track record showing they have the competence, capacity, and accountability to make this a very sound public investment. It will spur economic activity and community vitality, produce quality, family-sustaining jobs, and leverage significant private sector investment and corresponding tax revenues.

The Minnesota Initiative Foundations have made 3,302 loans totaling $197.6 million, creating and retaining 40,660 jobs. This includes funds from all sources (including but not limited to the $12 million allocated by the state of Minnesota in 1987 and 1993). These loans leveraged $1.116 billion in total business lending. The partners in the smaller Urban Initiative Program (from an original $6 million appropriation in 1993) have made 692 loans with a total of $14.4 million in state funds (therefore revolving more than once since the start of the program). Collectively, Urban Initiative partners have leveraged $56.3 million in total business lending.

Legislative/Cost Considerations:

$12 million of general fund dollars, structured as a matching appropriation, leading to a total of $24 million in total business lending across the state.

Recommendation 3: Marketing Campaign to Increase Awareness of EX-IM Export Financing

Overview:

When Minnesota companies export, they are looking for ways to increase their export sales by limiting their international risk, offering credit to their international buyers and accessing working capital funds. Fortunately, through the Export-Import (EX-IM) Bank of the United States, a federal government agency chartered by Congress, companies are able to receive export credit insurance, term financing and working capital guarantees. However, few companies know of this great resource that now has $2.2 billion available for companies and agriculture producers.

Program Description:

The closest EX-IM Bank representative responsible for the Minnesota market is located in Chicago, Illinois. While the Minnesota Trade Office (MTO) regularly refers companies to the EX-IM bank and our representative in Chicago, we do not believe many Minnesota companies are aware of this access to capital resource. We would like to develop an awareness campaign to help Minnesota exporters and potential exporters understand what financial resources are available to support their export business through federal funding and how that financing support eliminates most of the real and perceived risk associated with exporting.

How It Will Work:

Under the governor's trade initiative, MTO will lead an access to capital marketing plan with a goal to build awareness of the EX-IM Bank financing resources. The marketing plan will leverage federal expertise and dollars and will include outreach, media outreach and advertising targeted to Minnesota exporters and potential exporters. The marketing plan will be delivered through partnerships with industry channels and business associations to best reach Minnesota businesses most likely to have export potential and who could most benefit from these resources. MTO will support the marketing strategy through a series of training events that will bring our EX-IM Bank representative to Minnesota multiple times throughout the year.

The EX-IM Bank access to capital training will be a part of a larger training series called "Export Essentials". Export Essentials is a series of training courses for either new to export companies or companies who are currently exporting and looking to expand into a new international market. By including this training program in the Export Essentials series, we will also reach new to export companies to ensure they receive this financing information at the beginning of their exporting venture.

MTO will build a stronger partnership with the EX-IM Bank and leverage that relationship to facilitate greater awareness of the program directly to Minnesota industries and companies.

MTO also applied for the State Trade and Export Promotion (STEP) grant through the SBA. If awarded this grant, (should hear back last week in September), we will have further financial resources available for small business to access export credit insurance.

Legislative/Cost Considerations:

No legislation is required. There will be a cost for the marketing strategy including staff, printing, training materials and advertisements. Potential travel cost for EX-IM Bank representative travel to Minnesota.

Recommendation 4: Establish an EB-5 Regional Investment Program for Minnesota

Overview:

To encourage an infusion of foreign investment in the U.S. economy through the EB-5 category, Congress created an EB-5 regional center pilot program (program) in 1992. By so doing, Congress permitted the U.S. immigration agency to designate qualified applicants as "regional centers." A regional center is a private enterprise or corporation or a regional governmental agency with a targeted investment program within a defined geographic region. The regional center program in many ways mirrors long active and successful investment-employment based programs in the United Kingdom, Canada, Australia, and other foreign nations.

Congress created the fifth employment-based preference (EB-5) immigrant visa category in 1990 for qualified foreigners seeking to invest in a business that will benefit the U.S. economy and create or save at least 10 full-time jobs for U.S. workers. It is Section 203(b)(5) of the Immigration and Nationality Act. The basic amount required to invest is $1 million, although that amount is reduced to $500,000 if the investment is made in a rural or high unemployment area. Of the 10,000 EB-5 green cards available each year, 3,000 are reserved for foreign nationals who invest through a regional center. U.S. Citizenship and Immigration Services (USCIS) estimates that approximately 90 percent of EB-5 visas are based on regional center investments.

How an EB-5 Program Works:

The development of an EB-5 regional center is a financial strategy for capitalizing one or more businesses in a targeted economic area by leveraging foreign investment capital.

A regional center obtains its designation by submitting a detailed application to USCIS. The application must state:

1. The kinds of businesses that will receive capital from investors
2. The jobs that will be created directly or indirectly as a result of the investment of capital
3. The other positive economic impacts that will result from the investment of capital.

Once USCIS has approved a regional center application, an investor seeking an EB-5 green card through the program must make the qualifying investment (i.e., $1 million or $500,000) within an approved regional center. However, the requirement of creating at least 10 new jobs is met by a showing that as a result of the new enterprise, such jobs will be created directly or indirectly.

Before an investor can participate in a regional center's EB-5 investment program, each investor must independently petition USCIS for an EB-5 visa. USCIS solely determines whether the investor qualifies for the EB-5 visa. USCIS' diligence includes a detailed review of the sources of the investor's funds, family history, and other representations of the head of household and his immediate family members under the age of 21.

There are currently 162 EB-5 regional centers in the United States. Minnesota is one of only four states in the country that do not currently have a regional center. Many regional centers have been established around a specific project, while other centers serve larger geographic areas or have a specific industry focus. An EB-5 regional center recently opened in Grand Forks, North Dakota which covers the entire state of North Dakota plus 20 counties in western Minnesota. This North Dakota center aims to secure $1 billion to $3 billion per year in foreign capital investment from China, South Korea, Brazil, India and Canada. The focus industries for this regional center are renewable energy, agribusiness, bioscience, manufacturing, IT/Communications, aviation/aerospace and real estate development.

Minnesota's EB-5 Initiative:

An EB-5 regional center has the potential to provide significant foreign capital investment and job creation opportunities for Minnesota.

The governor's office will embrace a state-sponsored private-public effort to pursue the establishment of a statewide EB-5 regional center for Minnesota. A position will be created within the MTO to support the initiative. A cooperative, strategic partnership with an economic development entity will be sought by DEED and together they will develop a business and funding plan in preparation for the application process. The intent is that the regional center operates as a business with sound fiscal, operational and marketing systems and with expectations for a return on investment. A framework for partnerships, vendors, operating commitments, recruitment, costs and an effective marketing campaign will be essential to ensure success and to sustain operations.

DEED will support the application process and provide matching funding for the application fee. DEED will work with the nonprofit partner and others to complete the necessary application elements including:

- Economic analysis with complete explanation of job creation
- Amount and source of funds committed to the regional center
- Develop an EB-5 business plan for the regional center and proposed new commercial enterprises
- Regional center operational plan
- Description of plan to administer, oversee and manage the regional center.

Once a regional center is established, DEED will work in close affiliation to promote investment in Minnesota, help support the deal-making process and help promote foreign investment relationships through trade missions and other channels. When appropriate, DEED will make available its other economic development tools to enhance EB-5 project deals (e.g., angel tax credits).

Legislative/Cost Considerations:

No legislation needed. Application process estimated to cost $200,000. The EB-5 application process can take two to three years before approval is made.

Additional Information about Immigrant EB-5 Visas:

As with the regular EB-5 program, qualified investors investing through a regional center first receive a conditional green card valid for two years. At the end of that time the investor files another application with USCIS showing that their money was "at risk" during the two-year period and that the jobs have been created. Once those applications have been approved, the investor and his immediate family become permanent green card holders and can later apply to become U.S. citizens. The whole EB-5 process takes approximately three to five years or longer depending upon the timeliness, quality and validity of the investor's submissions.

The regional center investment program allocates 3,000 green cards each year for people who invest in designated regional centers. The 3,000 is not a limit, just the amount reserved specifically for regional center based investments. The program has been renewed several times, and is currently due to expire on September 30, 2012. There are efforts to make the Program permanent.

Recommendation 5: Buy Minnesota Strategy

Overview:

Local purchasing is a preference to buy locally produced goods and services over those produced more distantly. Community and economic development organizations often support “buy local” campaigns and programs to increase local spending and create local jobs. There a number of buy local campaigns:

- Buying local foods (consumers, businesses, and institutional)
- Encouraging consumers to buy from local businesses

- Encouraging businesses to buy from local businesses
- Encouraging government to buy from local businesses.

The Minnesota Department of Agriculture has a Minnesota Grown program. A number of web portals encourage consumers to shop locally. Governments at all levels have considered ways to implement "buy local" in their purchasing. This proposal recommends that the governor consider issuing an executive order instructing state agencies to purchase from Minnesota vendors when bids are equivalent in cost and value. A carefully crafted proposal should have positive benefits with minimal unintended consequences.

This proposal also recommends encouraging businesses to buy from in-state businesses. An example of such a program is the Greater Des Moines Partnership's "Buy Into the Circle" program.[3] The Itasca Project has created the Minnesota Supplier Showcase to connect small and growing Minnesota businesses to larger customers. Businesses are encouraged to purchase goods or services locally that were previously purchased outside the state. The goal is typically five percent of non-local spending. In Des Moines, they ask businesses to fill out surveys on the type and amount of expenditures brought to the local area. Overall, this type of program benefits from being entirely voluntary and requiring no legislation to implement.

Program Description:

The "Buy Minnesota" initiative would be involve two components:

1. A state government portion, based on an executive order from the governor.
2. A new program based on Buy Into the Circle. It could be a joint effort of DEED, the Minnesota Chamber, the Itasca Group and a number of other economic development organizations.

How It Will Work:

The state government portion will be based on an executive order from the governor that would encourage state agencies to award "tie bids" to in-state suppliers, when price and value are equivalent.

The business purchasing program is entirely voluntary. No legislation is required. Businesses are encouraged to bring five percent of their out-of state spending back to Minnesota. Businesses are requested to pledge the amount and type of spending that will be brought in-state.

Legislative/Cost Considerations:

No legislation is required. There will be a cost for marketing and promotion, as well as potential matchmaking opportunities for vendors and purchasers for the business purchasing program.

Additional Information:

Since the type of expenditure and the amount are gathered with a business's pledge, economic impact for the program can be calculated.

Since 2004, it is estimated that $90 million in purchases has been redirected to businesses in the Des Moines metropolitan area as a result of the Buy Into the Circle program.

[3] http://www.buyintothecircle.com/

Recommendation 6: Business Assistance Portal—Starting with Business Finance Programs

Overview:

A state-of-the-art gateway to doing business in Minnesota requires an Internet portal, central hub, for entrepreneurs, business, bankers and non-profits to start or grow a business. Several attempts have been made in other states to develop a one-stop for new and existing businesses. There is currently no comprehensive site to use as a model, especially if the expectation is to provide information **and** complete a task, e.g. apply for and issue a business-related permit. There are successful sites that focus on a particular problem or community.

DEED and the Minnesota Chamber of Commerce's Grow Minnesota! program have tested a comprehensive Q&A site for the last three years. The BusinessConnection (www.mnbizconnect.com) offers users information via keyword search as well as the opportunity to submit a specific question via e-mail. The site will be redesigned later this year based on its operating experience. The keyword search format will likely be replaced with a "decision tree" format that gets the user to a website where a question is answered or, more likely, to a business assistant professional who will answer the questions. The start up and test has been funded by grants from the McKnight Foundation.

Program Description:

We recommend the following phases to create a Minnesota business resource portal:

1. DEED should join with Grow Minnesota! to redesign and rebrand the BusinessConnection so that it can become the foundation for a comprehensive Internet portal to Minnesota's business assistance services, including business financing. The most important issue to resolve is the extent to which information should be provided by links to a business assistance professional versus the website itself. Since BusinessConnection is managed by Grow Minnesota!, it gives us the opportunity to have a one-stop that's linked to the private sector and has long-term resources and stability.
2. Make business finance programs the first content that's available on the redesigned, rebranded website.
3. Determine the BusinessConnection's relationship to other state websites, especially the existing Minnesota state government website (Northstar). The Northstar site is currently lacking any effective resources for individuals or businesses seeking information for starting or growing a business in Minnesota. Google looks to .gov extension websites as the most relevant sites in its search algorithm. Without any accurate information on the state portal, we fail to take advantage of Google's high ranking of that site. Once BusinessConnection's redesign is complete, linking it with Northstar could be completed quickly, at no cost other than staff time, making an immediate impact on users.
4. Over time, develop a comprehensive statewide plan to create, administer, maintain and monitor a business portal that allows users to input information about their business or business plan, providing them with access to specific, user-defined resources. These resources will allow users to complete various state business licenses and permit applications online, without submitting multiple applications.

How It Will Work:

Developing an effective business portal will take considerable time. It will require support from the private sector (i.e. Grow Minnesota!) and as functionality increases, a growing group of state agencies. A cross-functional government team will need to be created. The team's responsibilities will depend on the design decisions for the website, e.g. to what degree it will focus on connecting users with business assistance professionals as opposed to linking them to databases and websites.

Legislative/Cost Considerations:

At this point, it's hard to estimate a cost for a project where the scope has not been clearly defined.

Additional Information:

We can take advantage of the research and operating experience of the BusinessConnection to make significant improvements in the availability of information about doing business in Minnesota. This can be done immediately and at least initially, at relatively little cost. This work should produce a long-term plan and budget for a complete business portal.

Additionally, DEED staff will populate the current Northstar website with links to key business development resources that exist within state government.

Governor Dayton's Small Business Capital Access Task Force

Recommendations from the Private Equity/Growth Company Subcommittee

Acknowledgements

The following individuals participated on the private equity/growth company subcommittee:
Tim Johnson, chair, Goldner Hawn Johnson & Morrison
Howard Bicker, Minnesota State Board of Investment
Tony Christianson, Cherry Tree Companies
John Griebenow, Minnesota State Board of Investment
Lisa Rotenberg, Goldman Sachs Asset Management
Alan Wilensky, self employed attorney

Introduction

By design, the focus of the private equity/growth company subcommittee was to cover areas that the other subcommittees might miss. Private equity tends to deal with more mature, income producing small businesses whose growth potential may require more complicated financing solutions than a bank or venture investor may propose. These businesses can grow rapidly and make decisions concerning expansion that create or outsource large numbers of jobs. One focus of the subcommittee was to develop creative financing strategies for inducing businesses in this somewhat larger, but high growth category to retain jobs in Minnesota.

For reasons that are not clear, Minnesota has relatively few private equity and mezzanine funds in relation to the size of the state's economy. As a result, the subcommittee felt there is less capital available to Minnesota-based small businesses and/or growth companies. The recommendations of the subcommittee are aimed at generating more in-state investment funds , anticipating that they will invest in job retention in the state.

Recommendations

Recommendation 1: State level SBIC Program

Program Goals

The program would model the U.S. Small Business Administration SBIC Program described below. A private market sponsored program designed to provide capital to private equity, mezzanine and venture investment funds in the form of debentures guaranteed by the state. These funds would be invested alongside additional private capital sourced by the investment funds. Targeted investments would be mature, income producing small businesses based in Minnesota or, if the program were to be expanded, in the upper midwest region.

The program would improve access to capital for Minnesota-based businesses seeking junior capital to support growth. This new capital source would enhance the creditworthiness of these companies and thereby further improve access to bank funding. Investment in these established and growing businesses would have the beneficial impact of retaining business in the state and creating meaningful and sustainable long-term employment growth.

Features of the Program

A legislatively approved agency would make State guaranteed debentures available to private Minnesota based investment funds which are licensed in good standing by the SBA. Currently there are a total of six private equity and mezzanine SBIC funds operating in Minnesota.

The board would appoint a third party administrator with lending and/or proven investment credentials to screen and qualify fund managers for the state program and allocate the program dollars to the investment funds. The investment fund managers would have fiduciary responsibility for the fund investments.

The administration of the program should not require significant infrastructure investment to the extent the appointed board and the program administrator are prepared to "rely upon" the federal level SBA licensing process to qualify eligible fund sponsors.

The program would be revenue neutral and would not require the appropriation of new funding by the state. The debentures would be sold through an underwriting process to private investors.

Based on a preliminary discussion with Jim Schowalter, the commissioner of Minnesota Management and Budget, the credit enhancement features of a state guarantee program would be "outside" of the state's debt management guidelines. A state agency would have to be sanctioned by the state legislature to issue participation certificates and to provide guarantees to support a debenture program.

The size of the program could initially be established at a level of $300 million under which up to six investment funds would receive fund allocations of up to $50 million each. Future allocations to the program would be based on the performance of the program.

Timeframe

It would likely take 12 to 18 months for implementation of required legislative approvals and to structure the debenture issuance program. Objectives for job retention and employment growth would be achieved over the five to seven year average investment cycle of the funds.

Background Overview of the U.S. Small Business Administration SBIC Program

The federal government has provided capital to licensed private equity, venture and mezzanine investment funds (SBICs) using funds loaned at favorable rates and guaranteed by the U.S. government, through the Small Business Investment Company Program run by the SBA. The following is a brief summary of the SBIC Debenture Securities program.

Started in 1958, the SBA provides private licenses to investment funds with loans as leverage to supplement their private capital. The debentures are guaranteed by the U.S. government and sold to private investors. The debentures have current, payable interest, so the debenture SBICs typically invest in income-producing, mature small businesses. The SBA continues to issue new leverage commitments under this program, and the debenture program was amended and enhanced by the 2009 American Recovery and Reinvestment Act.

In 1994, the SBA also provided capital to SBICs in a "participating securities" program. This program was targeted to early stage venture. Due to significant losses suffered by the SBA in this program, it was terminated in September, 2004.

SBIC Program Basics

An SBIC can receive up to $150 million in federal money for a single fund or $225 million for multiple funds operated by one manager. SBIC debentures have a term of 10 years with semiannual interest payments and a lump-sum payment of the principal at maturity. An SBIC may leverage up to three times the amount of its private capital, although most funds are generally approved to leverage no more than two times the level of their private capital. Once committed to an SBIC, the leverage may be drawn down over the entire four- to five-year commitment period.

Over the history of the program debenture securities have been primarily utilized by mezzanine or venture debt funds. Recently the SBA opened up the program to equity investing funds and the venture space has been de-emphasized.

Restrictions on Investments by an SBIC Fund

The SBIC license limits the type of investments qualifying funds may make with the loaned capital in the following ways:

- SBICs are required to invest in small businesses in either debt or equity (or a combination of the two). "Small businesses" are generally defined as companies (including any subsidiaries, parent companies, and affiliates) with a tangible net worth of $18 million or less and an average after-tax net income of $6 million or less for the last two years.
- Further, 25% of investments must be directed to "smaller enterprises," defined as entities whose net worth is less than $6 million and whose average after-tax income for the two prior years is less than $2 million.
- A maximum of 10% of an SBIC's total capital may be invested in a single small company unless the SBA approves a larger investment.
- SBICs are permitted to control small businesses for a maximum of seven years, absent SBA approval to manage them for a longer term.
- SBICs may not invest in other SBICs, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than 51% of their assets and employees in the United States, passive or casual businesses, companies using the proceeds to acquire farmland, and companies whose primary business activity is contrary to the public interest.

Recommendation 2: Friendly Capital for Minnesota Growth Companies

Many students of economic growth point to core manufacturing, service and corporate infrastructure jobs as the main employment driver which, in turn, creates demand for a large cascade of jobs in the derivative service areas; retailing, health, education, small businesses providing support, and government jobs themselves. A few of these core employment generators are at any given time growing rapidly, thus driving the marginal growth of core employment. One thought about how to accelerate job growth in Minnesota economy is to find a way for successfully growing companies to accelerate their growth in hiring in Minnesota.

Many Minnesota growth companies may already be encouraged to grow because they are publicly traded companies. But there are many well-run, conservatively capitalized, growing private companies which do not want to add more debt and would be reticent to add a minority owner. Our objective is to use the backing of the Minnesota state government to encourage the formation or support of investment vehicles that can provide “friendly capital” to those high quality private businesses, or public ones, for that matter, which could and would accelerate their Minnesota hiring if they could add some incremental, patient capital. And, we think that such investments may appeal to some of these businesses and, at the same time, provide attractive risk-adjusted returns to investors.

Our initial style of investment for the purpose of providing “friendly capital” to Minnesota growth companies comes in the form of a long maturity preferred security with, perhaps, a 7% current dividend and attached warrants that could be sold back to the company to provide additional returns based on valuation increases. The objective would be to establish a long-term market rate of return. Since, by definition these target investments are in significant businesses of $50 to $500 million or more, with conservative capital structures, it seems that a portfolio of 20 or more could be fairly diversified. The investments would likely be $5 - 10 million or more each, so a $100 - 200 million portfolio could be a starting vision of such an investment strategy. We would need to establish criteria for selecting qualifying companies, such as Minnesota jobs created relative to the capital committed, and a process and mechanism for the operation of the fund. We would propose that large Minnesota corporations be the founding investors in the fund.

Governor Dayton's Small Business Capital Access Task Force

Recommendations from the Venture Capital Committee

Acknowledgements

The following individuals participated on the venture capital committee:
Ed Spencer, chair, Affinity Capital Management
Santiago Bazdresch, University of Minnesota
Joe Biller, Sightline Partners
Lisa Rotenberg, Goldman Sachs
Andrew Schneider
Kathy Tune, Thomas, McNerney & Partners
Richard Venegar, Milestone Growth Fund
Neal Young, Minnesota Department of Employment and Economic Development

Introduction

The committee believes the state of Minnesota has a solid base of existing venture capital activity that we can use to create a more vibrant investment community. According to a 2008 Global Insight study, 2008 revenue from Minnesota venture capital-backed companies was $159 billion with employment of 365,584. Both measures ranked in the top eight nationally. The decline in venture capital investing in Minnesota from 2009 to 2010 can primarily be attributed to the challenges the medical technology industry is facing with the FDA approval process, not a lack of capital availability. The Venture Collaborative noted that in 2008 and 2009, Minnesota was the leader in venture capital investment among the 12 surrounding states.

Since 2001, the amount of capital committed to venture backed companies in Minnesota has ranged from .63 percent to 1.8 percent of the national total with a 1.37 percent average. This equates to an annual average of approximately $342 million. By comparison, Minnesota makes up about 1.7 percent of U.S. population and nearly 1.9 percent of U.S. GDP. Increasing venture capital investment to be proportional to these indicators will create a more vibrant investment community and create jobs. It is the focus of our primary recommendation.

On a broad scale, the opportunity for Minnesota's economy is only limited by our vision. Minnesota is atypical in its dependence upon medical technology and like all industries, medical technology is subject to the demands unique to its industry. We should continue supporting this critical state resource while supporting and investing in additional industries. Other states and other countries have successfully implemented initiatives by providing tax relief, supporting development of a pipeline of up-and-coming entrepreneurs, and stimulating growth in venture capital investment.

The committee looked at a broad range of programs implemented in other states and talked to several fund managers who administer state initiated programs. Some broad themes on best practices emerged from this research.

<u>The guiding principle of the venture capital committee is to build sustainable businesses that provide market-based returns to investors. Job creation will be a result.</u>

Our belief is that if this guiding principle is followed, significant jobs will be created and significant additional capital will flow into Minnesota. Our primary recommendation flows from this guiding principle. The committee suggests that the governor also consider several other worthy programs, even if they may be more focused on short-term targeted job creation than on return on investment.

Venture Capital Principals and Best Practices:

A 2006 report by the National Association of Seed and Venture Funds reported several key indicators for measuring the success of state government efforts in designing and implementing seed and venture capital programs. The committee agrees that these are key indicators to measure the success of state backed or institutional programs. Key indicators include:

Focused Purpose: The goal of a venture capital program is to invest in funds that will make profitable investments for the state. Other goals must be considered lower priority or met by other types of programs.

Profit Motivated: The primary performance metric for successful programs is getting good financial return for the state's investment. Investments in profitable, growing businesses result in long-term, sustainable job creation.

Effective Scale: The program needs to be of sufficient size to be noticeable in the market. Without sufficient size, it is also difficult to attract the attention of experienced fund managers.

Strong Leadership: State leadership is critical in creating programs and setting <u>long-term</u> direction, but then it is equally as critical to turn over everyday management to experienced, private sector fund managers.

Long-Term Focus: Venture capital is the first step in meaningful job creation. Good investments over time are both profitable for investors and result in job creation in the long run. Short cuts tend to be counter-productive.

Discretionary: Experienced managers are evaluated based on the return of investment secured for the state. They need to be allowed to be selective and empowered to say "no" to deals they don't like.

Focus on Knowledge: Investments also need to focus on existing expertise <u>and</u> increasing the expertise in the state.

System of Evaluation: Programs decide what to measure up front and report results. Metrics also need to be able to be adjusted to meet information needs.

The committee after extensive research developed several additional best practices, the result of studying programs implemented in other states and countries. These additional best practices are:

Attract Top Investors: Structuring the program to be as attractive and flexible as possible will help bring new expertise to the state as new venture capital funds seek new opportunities in the state. Once fund managers become more familiar with the state, they are more likely to continue investing here. We want to attract the best and brightest venture capital fund managers.

Flexibility: Successful programs only require that funds commit to making their "best effort" to invest in the state. Strict in-state requirements are often counter-productive because they don't draw new, world-class funds to the state. Our recommendation provides some key criteria important in the selection of funds that we hope will lead to commitments for investing in the state. In addition, we recommend a significant amount of capital be reserved for direct investment in companies in Minnesota alongside the fund investments. Providing flexibility to the manager(s) is critical to long-term success.

Ensure Adequate Deal Flow: Increasing venture capital alone, which traditionally does not invest in angel and seed rounds, is not sufficient to create sustainable growth. It is also critical to support entrepreneurship and seed and early-stage investment programs. Our recommendation provides capital for seed and early-stage funds to grow the in-state venture capital industry. It is important to support the continuum of the investment cycle.

Support New Industry Development and Emerging Fund Managers: It is important that the state provide opportunities for new fund managers to get their footing in the venture capital industry. Otherwise, long term, the supply of qualified fund managers may become a critical constraint. While our recommendation is driven by return on investment, we will encourage the fund manager to provide opportunities for emerging funds and emerging fund managers to compete for allocations from the fund.

Recommendation 1: The Minnesota Growth Fund

Fund size: $300 million to be funded either by institutional investors or a contingent tax credit program.

Fund Managers: The Minnesota Growth Fund will be managed by a fund of funds manager with a track record of success. If a national fund of funds manager is selected to manage the program, he or she will be required to have direct knowledge and expertise in Minnesota and either (i) maintain a Minnesota office; or (ii) work in conjunction with a local Minnesota partner also chosen by the committee.

Selection of Managers: The governor will appoint a committee of experienced, Minnesota- based venture capital and institutional investors to select the fund of funds manager who will implement the program.

Oversight: Depending on whether the decision is to focus on an institutional investor base or a funding source supported by contingent tax credits, there may be an oversight committee to monitor the performance of the selected fund of funds manager(s). If an institutional fund, then the oversight committee will be made up of three to four of the institutional investors. If a fund backed by contingent tax credits, then the oversight committee will be made up of four members, one appointed by the speaker of the house, one by the president of the senate and two by the governor. The appointees must be experienced venture capital or institutional investors. The oversight committees will have advisory and oversight functions only and cannot dictate investment decisions by the fund of funds manager.

Fund Allocation: The intent is to provide the fund of funds manager with a maximum amount of flexibility within the following framework, which is intended to support the continuum of investment opportunities from seed capital to private equity. The committee strongly believes in the need to support the continuum to maximize the ability to build strong companies and drive job creation.

1. Approximately 50 percent will be invested in venture capital funds that meet some or all of the following criteria:
   - Have a strong presence and record of investing in Minnesota
   - Have shown a serious interest in developing a presence in Minnesota
   - Show a willingness to spend time looking for investment opportunities in Minnesota
   - Have employees in Minnesota.
   - Have track records of success in venture investing
   - Have other sophisticated institutional investors as limited partners
   - Have track records of success in industry segments that will help Minnesota diversify its industry base, including cleantech, agriculture, software and biotechnology.

2. Approximately 20 percent will be available to support seed and early stage investing, emerging managers in Minnesota, and incubators in Minnesota. The allocation can also support programs at Minnesota based universities and educational institutions designed to support new technology development. This early stage allocation is critical to ensure adequate long term deal flow is available for portfolio fund managers.

The venture and seed funds will be allocated to venture and seed fund managers during a three to five year period to mitigate the risk of missing a quality firm's funding cycle and to diversify over a number of vintage years. The manager will also attempt to support funds from the seed stage to the private equity stage of investment.

3. Approximately 30 percent will be available for direct investment alongside investments made by funds supported in the fund of funds segment. The direct investment allocation will focus 100 percent of the dollars on companies in Minnesota that have already been subject to significant diligence by portfolio fund managers.

Performance metrics: The primary performance measurement will be long-term return on investment. Since a program such as the one recommended by the committee has a relatively long investment cycle, and returns are typically not a solid indicator of performance for five-plus years, a number of other metrics will be measured on an ongoing basis. They include:

- Job creation
- Additional capital attracted to Minnesota.

Each category of investment (private equity, seed and early stage, venture capital) will be measured against industry benchmarks.

Sources of Capital: The committee recommends that the governor consider two alternative sources of capital for the program.

1. **Private institutional capital:** Private institutional capital can include corporations, pension funds, foundations, endowments, and high net worth individuals. If this strategy is chosen, it will be

important to identify several possible lead investors. The advantage of this approach is that it does not require legislative action. The major disadvantage is that it will take time to raise the capital.

2. **Contingent tax credit:** Several states have implemented programs with contingent tax credits using a variety of methods. Typically, private, taxable investors invest in the fund. The tax credit is only issued to the extent the actual rate of return on investment does not meet the rate of return guaranteed to investors. The tax credits issued are for the difference between the guaranteed return and the actual return if lower. If the guaranteed return is met, there is no cost to state taxpayers. If the governor elects to pursue this alternative, we suggest he authorize the oversight committee to investigate other state contingent tax credit programs.

Additional Programs to Consider

During the course of our evaluation of capital creation programs, the committee identified several additional programs that while not a part of our primary recommendation, should be brought to the attention of the governor and the Minnesota Legislature as potential job creation opportunities:

Recommendation 2: Employment Based Immigration Investment Program (EB-5)

The United States Citizens and Immigration Services (USCIS) administers the EB-5 program that was approved by Congress and enacted in 1992 to allow immigrant investors to obtain a permanent visa if they invest $1 million ($500,000 in economically depressed areas) in U.S. businesses. Thirty-nine states have established EB-5 centers.

Recommendation 3: New York City Investment Fund (NYCIF)

Established in 1996 by its founding chairman, Henry R. Kravis, to mobilize the city's business leaders to help build a stronger and more diversified local economy. It was initially capitalized by contributions of $1 million each from 67 individual and corporate investors. Current capital exceeds $110 million.

Recommendation 4: Technology Business Tax Certificate Transfer Program

The state of New Jersey allows businesses developing technology and biotechnology products to sell their unused net operating losses and unused research and development tax credits to other profitable corporate taxpayers in the state. The companies must have less than 225 employees with a minimum number of these employees based in the state to be eligible to claim up to $15 million over the lifetime of the company.

Recommendation 5: Small Business Matching Grants

The Small Business Innovation Research Program (SBIR) and the Small Business Technology Transfer Program (STTP), both federal, are important sources of funds for business innovation and research in the U.S. A program of matching federal grants with state grants could multiply the impact of state funds.

Recommendation 6: University of Minnesota Best Practices Review

The University of Minnesota is an important source of innovation. We encourage the governor to work with the university to streamline and consolidate its approach to moving innovations from the laboratory into the venture capital community. The committee suggests a review of best practices at other universities, since it may be helpful for streamlining the process.

Governor Dayton's Small Business Capital Access Task Force

Recommendations from the Tax Subcommittee

Acknowledgements

The following individuals participated on the tax subcommittee:
David Beito, Northern State Bank
Myron Frans, chair, Minnesota Department of Revenue
Margaret Anderson Kelliher, Minnesota High Tech Association
Matt Massman, Minnesota Department of Revenue
Tom Stinson, Minnesota Management and Budget
Michael Vekich, Vekich Associates

Introduction

The preliminary recommendations of tax subcommittee of the Governor's Task Force on Capital Access reflect one aspect of a multi-faceted effort to strengthen the economy by promoting job creation and business investment in the near term.

In general, the tax subcommittee observes that the jobs crisis is primarily a function of the economy and not state tax policy and thus formulating a targeted state tax policy change that provides and effective incentive for creating new jobs is challenging. The economic challenge around jobs and small business hiring seems to be that businesses need the assurance of an expanding customer base before they have a strong reason for hiring back workers. Further, businesses seek certainty in their cost structures, including cost for labor and taxes, as a condition for making permanent investments in an expanded work force and output capacity.

Relative to the short-term and long-term nature of the economic challenge and the importance of both expanded demand and reduced business costs, the tax subcommittee wants to underscore the importance of two key state government responsibilities in need of attention but which are beyond the near term scope of the task force:

1. A structurally balanced, sustainable state budget climate free of accounting shifts and one-time budget balance strategies, along with strengthened state budget reserve policies, are an important step toward establishing an environment in which tax policy certainty can be achieved
2. A more comprehensive review of tax policy should be considered to ensure that general taxation levels are adequate given the collective budget priorities of state policy-makers.

Minnesota's economic strength and recovery is most certainly tied to the national and global economic recovery. While state tax policies must ultimately focus on the long term to provide certainty of costs for

Minnesota businesses, near term efforts to adjust tax policy to provide incentives to create needed, permanent, high-quality jobs should recognize both the more powerful effect federal policies have on the economy and capitalize on Minnesota's strengths within the broader economy.

More specifically, consistent with its charge of designing practical, prudent recommendations that recognize current state budget constraints and promote collaboration among similar private, non-profit, and governmental efforts, the Tax Subcommittee's recommendations are guided by the following:

- Recommendations should promote Minnesota's reputation as a great place to grow a business and raise a family
- Incentives targeted toward near-term economic challenges should also advance sound, long-term tax policy objectives
- Tax laws should not disproportionately advantage non-Minnesota business entities relative to their Minnesota based competitors
- Tax laws should be more simple and transparent, making it easier for small businesses to comply with the tax code. This includes ensuring that small businesses have the information they need to efficiently comply with the tax code
- Thoughtful alignment with federal tax laws, where those laws are consistent with Minnesota policy objectives, is preferable because the federal tax conformity extends tax benefits and promotes a level playing field.

The recommendations draw on the careful work of previous tax study groups along with input from various business leaders.

RECOMMENDATIONS

The preliminary recommendations of the Tax Subcommittee are presented in two categories: recommendations that can be implemented administratively without the need for law changes; and recommendations that would require a law change to implement.

ADMINISTRATIVE OPTIONS

Recommendation 1: Establish a Small Business Office or Liaison within the Minnesota Department of Revenue (DOR)

Utilizing direct feedback from the commissioner's statewide listening sessions (included below) and a review of department practices, the commissioner would establish a dedicated function within the department designed to simplify and expedite tax compliance for small businesses.

Recommendation 2: Enhanced State Agency Coordination

Under direction from the governor's office, the commissioner would work with other state agencies to develop a one-stop point of contact for small business owners to:

- Learn about business incentives, grant programs and helpful resources
- Receive assistance in meeting regulatory requirements
- Receive assistance in tax code compliance.

Recommendation 3: Commissioner Listening Sessions

As an important follow-up to the governor's current jobs tour, the commissioner would pursue a systematic assessment of tax policy and tax compliance issues with small business owners and communities statewide. Particular attention should be given to listening for opportunities for administrative improvements and efficiencies in how the DOR fulfills statutory requirements.

TAX LAW CHANGE OPTIONS

Recommendation 4: Job Creation Tax Credit

Request the legislature to approve a temporary, targeted job creation tax credit that provides a limited incentive to qualifying "small" businesses that increase their total full-time equivalents beyond a base year. The targeted job creation tax credit is recommended to:

1. Be consistent with President Obama's job credit proposal to support hiring of workers who have been unemployed and are veterans
2. Represent new hires for small businesses.

The new hires job credit would provide a refundable tax credit for those new hires beginning January 1, 2012, through December 31, 2013, for small business with at least five but fewer than 100 full-time employees in 2011. The job credit would start at an annual $3,000 credit for each new job at wages beginning at $25,000, and increasing to $4,000 for wages beginning at $75,000.

Recommendation 5: Enhanced Research & Development Credit

Refine and renew the governor's request to enhance Minnesota's Research and Development tax credit by increasing the credit from 10 percent to 15 percent of the first $2 million (first tier) of qualified research expenses over the base amount. The additional incentive would be for small business investment in new technologies.

Recommendation 6: Adopt Affiliate Nexus

Request the legislature reform state law to reflect modern technologies and business practices that have resulted in an uncompetitive business climate for Minnesota-based companies selling the exact same products as remote sellers.

Recommendation 7: Clarify Unitary Business Sales Definition

Request the legislature reform state law to stay current with changing business practices that have resulted in an increasing number of non-Minnesota companies paying lower Minnesota corporate franchise tax than do Minnesota companies despite potentially competing against Minnesota companies.

Recommendation 8: Federal Conformity for Section 179 Expensing

Request the legislature adopt full conformity to federal section 179 expensing provisions for tax year 2012. Under current law, the state partially conforms but does not extend the full, accelerated benefit to Minnesota businesses.

Appendix: Task Force Members

Thomas H. Borman, task force chair

Of Counsel, Maslon Edelman Borman & Brand, LLP

Borman has practiced at the Maslon Law Firm since 1977, specializing in banking and insurance law. He also represented the Minnesota Twins for more than a decade. Borman is an owner and founder of Tradition Capital Bank and formerly a director of GeorgeTown Re, Ltd., a reinsurance subsidiary of the St. Paul Companies. He currently serves as a senior advisor to Governor Dayton on economic development and job creation. From 1990 to 1991 he served as the commissioner of commerce for the state of Minnesota.

Santiago Bazdresch

Associate Professor of Finance; Carlson School of Management, University of Minnesota

David Beito

President and Owner of Northern State Bank

Beito is president and chairman of Northern State Bank of Thief River Falls and four other smaller community banks in northwest Minnesota. He serves as treasurer of the board of Sanford Health Systems and serves on both the Thief River Falls Chamber of Commerce and the Minnesota Bankers Association. He is a former secretary and treasurer of the Minnesota Chamber of Commerce. In 2008 he served on Governor Tim Pawlenty's 21st Century Tax Commission.

Howard Bicker

Executive Director, Minnesota State Board of Investment

Bicker spent his entire career with the state's investment board, including more than a quarter-century in the top post. The board manages a $60 billion pension portfolio for state employees, as well as the state's cash accounts and its deferred-compensation plan.

Yvonne Cheung Ho

President and CEO, Metropolitan Economic Development Association (MEDA)

MEDA is a nonprofit organization offering services to Minnesota businesses owned and operated by minority businesspeople. Its services include help with loans and financing, training, and consulting. As the head of MEDA, Cheung Ho has been an outstanding advocate for Minnesota's minority business owners and entrepreneurs. She also currently serves on the boards of the Minneapolis Foundation and Great Neighborhoods! Development Corporation.

Tony Christianson

Chairman, Cherry Tree Companies

Throughout 30 years working as a director or investor in more than 120 companies, Christianson has been involved in more than 200 private equity financings, 100 merger and acquisition transactions, and 24 initial public offerings. He was formerly the vice president of Norwest Venture Capital as well as a consultant at Arthur Andersen.

Myron Frans

Commissioner, Minnesota Department of Revenue

Commissioner Myron Frans has nearly three decades of tax law expertise as well as strong business and managerial experience. Prior to his appointment, Frans served as president of Leed's Precision Instruments, a manufacturing and distributing company in Golden Valley, Minnesota. Frans has been a tax attorney in private practice for 27 years, most recently as a senior tax partner at the law firm of Faegre & Benson in Minneapolis. Prior to that he was a tax partner at Gray Plant Mooty Mooty & Bennett, also in Minneapolis.

Elliot Jaffee

Executive Vice President and Twins Cities Market President, U.S. Bank

Elliot Jaffee serves as Twin Cities market president at U.S. Bank, and he manages the company's commercial banking business in the Twin Cities, Washington, Oregon, Nevada Arizona and Utah. He also oversees U.S. Bank's business activities in the Twin Cities market, supervises the company's regional board in the Twin Cities and leads the Twin Cities-based market committee, a group of local senior leaders representing the company's key lines of business and staff functions.

Timothy D. Johnson

Partner and Managing Director at Goldner Hawn Johnson & Morrison

Since joining Mike Goldner and Van Hawn in 1989 at the firm's founding, Johnson has been closely involved in all areas of the business, including leading or co-leading investments in Marathon Funds I through V. He began his career with JP Morgan in New York, and throughout his 11-year tenure held a number of banking and corporate finance positions. He currently sits on the board of directors for GHJ&M portfolio companies Houlihan's Restaurants, Mid Valley Industries and Westlake Hardware.

Mark Phillips

Commissioner, Minnesota Department of Employment and Economic Development

Phillips was formerly director of business development for Kraus Anderson both in the Twin Cities and in northern Minnesota. Prior to that he served as director of economic development at Iron Range Resources and Rehabilitation Board (IRRRB). A native of the Iron Range, he brings extensive experience with both venture capital and community development lending.

David J. Rader

Executive Vice President, Wells Fargo SBA Lending

David J. Rader is the business head of the Wells Fargo SBA Lending line of business. He is responsible for overall revenue and P & L growth, credit quality and portfolio risk management, loan closing functions and financial activities of the business. He oversees 330 SBA lending professionals responsible for the generation of more than $1 billion in new SBA loan originations and a portfolio of $6.9 billion under management.

David Reiling

Chief Executive Officer, Sunrise Community Banks

Reiling leads one of region's most aggressive and successful community development lenders. Sunrise Banks is comprised of University Bank and Park Midway Bank in St. Paul and Franklin Bank headquartered in Minneapolis.

Lisa Rotenberg

Senior Relationship Manager, Goldman Sachs Asset Management, New York, NY

Rotenberg's senior relationship role includes work with corporate pensions, public pensions, endowments and foundations, insurance companies, and the consultants who cover them. She has worked with these strategic investors from 2000 to the present. From 1994-1999, Rotenberg was Goldman Sachs Asset Management's global head of consultant relations. Rotenberg was named a Goldman Sachs managing director in 2003 after joining the firm as a vice president in 1994. Prior to Goldman, Rotenberg served as Minnesota's deputy state auditor representing the state auditor in all plan sponsor decisions relating to the Minnesota State Board of Investment. Rotenberg also served as Minnesota's chief deputy commerce commissioner with oversight responsibility for the securities, banking, insurance, and real estate industries.

Lee Sheehy

Program Director, Region and Communities, McKnight Foundation

Sheehy was chief of staff for Senator Amy Klobuchar and earlier, served as the director of community planning and economic development for the city of Minneapolis. Sheehy also served as regional administrator and chief operating officer of the Metropolitan Council, and was chief deputy attorney general under Attorney General Skip Humphrey.

Edson W. Spencer, Jr.

Founder, Affinity Capital, a prominent medical device venture capital fund

President, Minnesota Venture Capital Association

Spencer was principal and co-founder of Peterson-Spencer-Fansler Company, the predecessor of Affinity Capital. He also spent eight years as a senior officer of Dyco Petroleum, Inc., a large independent oil and gas corporation.

John Taft

CEO, RBC U.S. Wealth Management

President, Securities Industry and Financial Markets Association

Taft served as head of asset management and products for RBC's U.S. and international division and as CEO of Voyageur Asset Management. Taft also served as head of North American Wealth Management services, part of Royal Bank of Canada's Global Asset Management Division.

Richard Venegar

President and CEO, Milestone Growth Fund, Inc.

Venegar has more than 27 years of private equity experience, with a strong focus on the underserved emerging domestic market. Prior to joining Milestone in 2007, Venegar was a senior vice president of Pacesetter Capital Group of Dallas, Texas. While at Pacesetter, he concentrated on managing some of the firm's most difficult portfolio companies, focusing on restructurings, workouts and turnarounds. Venegar is vice-chair of the National Association of Investment Companies (NAIC), and serves of the boards of the Metropolitan Economic Development Association (MEDA) and the University of Minnesota's Carlson Funds Enterprises.

Ray Waldron

Former President, Minnesota AFL-CIO

Former President, Minneapolis Building and Construction Trades Union

Waldron served the AFL-CIO representing more than 300,000 workers and 1,000 affiliate unions since 1999, serving first as its secretary-treasurer and then as president. Having been elected to serve as organizer for his union in 1974, he has been working for various labor councils and federations ever since.

Task Force Advisory Members

John Griebenow, Minnesota State Board of Investment

Matt Massman, Minnesota Department of Revenue

Cathy Polasky, director of economic policy and development, city of Minneapolis Community Planning & Economic Development

Robin Sternberg, director of job creation initiative, Minnesota Department of Employment and Economic Development

Kathy Tunheim, principal and CEO, Tunheim Partners; senior advisor to the governor for job creation

Sam Tunheim, intern

Alan Wilensky, formerly a deputy for taxation at the Department of the Treasury under the Bush administration, and a partner at Dorsey and Whitney

Neal Young, director, economic analysis unit, Minnesota Department of Employment and Economic Development