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Capital Formation Strategies with Funds Provided by the State Small Business Credit Initiative

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September 2021

The American Rescue Plan Act of 2021 includes a \$10 billion reauthorization of the State Small Business Credit Initiative (SSBCI), a Treasury-administered federally funded economic development program intended to increase state capacity to support small business “access to capital” programs. “SSBCI 2.0” will provide the Kentucky Cabinet for Economic Development with at least \$82 million of federal funds to administer, a substantial increase over the \$15.5 million from the initial SSBCI program that operated from 2010-17.

With the original \$1.5 billion SSBCI program, more than 30 states allocated nearly 1/3 of total SSBCI funds to venture capital programs (VCPs). Kentucky briefly allocated \$3.5 million to a VCP that never deployed capital. All SSBCI capital deployed to small businesses in Kentucky by the Cabinet was invested via a collateral support lending program. With substantially more capital allocated to Kentucky under SSBCI 2.0, and the potential for more to come as Treasury adopts the rules and regulations for \$3 billion of supplemental funding, KSTC is hopeful that the Cabinet will consider substantial allocations to VCPs to support capital formation strategies for startup ecosystems.

The Kentucky Science & Technology Corporation (KSTC) is a state-sponsored non-profit venture development organization and the leading advocate for technology-based economic development in the Commonwealth. KSTC retained Cromwell Schmisser, a consulting firm that served as technical advisors to the Treasury for VCPs funded by SSBCI 1.0, to support KSTC in serving as an authoritative resource for SSBCI 2.0 and to develop strategies for deploying SSBCI capital to high-growth startups in Kentucky via VCPs. This report intends to explain the SSBCI opportunity in the context of the Commonwealth’s relative strengths and needs in the collaborative pursuit to increase the supply and accessibility of risk capital for Kentucky startups.

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With approximately \$500 billion of assets under management, venture capital is a small niche of the \$4.4 trillion private equity industry in the United States.¹ Management of venture capital assets is *highly* concentrated geographically, with 85% managed from California, Massachusetts, and New York. More than other forms of private equity, geographic proximity is advantageous for venture capital due to mentoring and networking effects that VC investors provide startups before they are independently viable. Many states, including Kentucky, need to invest resources to support startup ecosystems that can connect high-growth startups to later-stage investors because the private sector VC industry is not performing this important role independently.

The Commonwealth has the infrastructure to deploy at least \$65 million of SSBCI capital through a portfolio of VCPs that directly support startup and investor ecosystems. These programs would stimulate more than \$10 of private capital investment for every \$1 of SSBCI capital by the conclusion of the SSBCI 2.0 program in 2028, and they would support startups at every stage of development, from the pre-seed “idea” stage through the “growth” stages of investing in revenue-generating facilities and teams.

The investments of SSBCI capital into Kentucky startups would generate positive financial returns in aggregate, providing “evergreen” funds for future startup investments or new programs addressing emerging economic development needs. A significant commitment of SSBCI funds would also send an important signal to private capital investors that Kentucky is committed to making the Commonwealth a competitive and desirable place to start and grow transformational businesses.

II. Market Need for Additional Venture Capital Programs in Kentucky

Most small businesses in Kentucky are well-served by the banking industry. The Commonwealth exceeds the per capita national average for banks, bank branches, Community Development Financial Institution (CDFI) loans, and New Markets Tax Credit investments.

	Lending Programs			
	Kentucky	U.S.	KY as % of U.S.	% of per capita avg
Population	4,505,836	331,449,281	1.36%	100.0%
State GDP	\$ 214,671	\$ 21,307,047	1.01%	74.1%
Banks	169	5,275	3.20%	235.7%
Bank Branches	1,554	82,124	1.89%	139.2%
NMTC Investment	\$ 876	\$ 48,238	1.82%	133.6%
CDFI Loans	\$ 745	\$ 49,116	1.52%	111.6%

By comparison, the niche segment of “high growth” small businesses – those financed primarily by venture capital – are not well served by private sector investors in Kentucky. According to data from Pitchbook, the total amount of venture capital assets under management in the Commonwealth is just 1% of the per capita national average. This gap constitutes an imperative “market need” if Kentucky is to compete in the retention and attraction of startups creating wealth and high-paying jobs.

	Venture Capital Programs			
	Kentucky	U.S.	KY as % of U.S.	% of per capita avg
Population	4,505,836	331,449,281	1.36%	100.0%
Fortune 1000	9	1,000	0.90%	66.2%
University R&D	\$ 611	\$ 83,496	0.73%	53.8%
Patents	710	148,876	0.48%	35.1%
S&E Workforce	61,030	7,317,290	0.83%	61.4%
Billionaires	3	642	0.47%	34.4%
Billionaires' \$\$\$	\$ 9,304	\$ 5,086,027	0.18%	13.5%
VC AUM	\$ 74	\$ 548,140	0.01%	1.0%
VC Investment	\$ 225	\$ 122,834	0.18%	13.5%

Compared to other states, Kentucky received a substantially larger SSBCI resource allocation than the initial program that sunset in 2017. If Kentucky provided the same resources to lending programs as it did with the initial program – \$15.5 million – then \$66.5 million would be available for programs that stimulate private capital investments in high-growth startups.

With the Kentucky Enterprise Fund (KEF) and the Commonwealth Seed Capital Fund (CSC), Kentucky has the necessary infrastructure to manage venture capital programs funded in part with SSBCI capital. Both KEF and CSC enable direct and indirect seed and follow-on investments with established processes and networks capable of serving startups in Kentucky. A portfolio approach managed on behalf of the Commonwealth could stimulate private capital investment in startups at pre-seed, seed, early, and growth stages.

III. Objectives and Strategies for SSBCI Venture Capital Programs

Other states have used SSBCI capital for a wide range of programs, ranging from pre-seed accelerators to late-stage mezzanine loan funds. SSBCI program managers need to focus on the types of programs that best match the capacity and needs of regional startup ecosystems. The following table shows the types of programs that could best match a state’s economic development objectives.

Objectives	Program Models	Performance Metrics	Market Impacts
Develop entrepreneurship (startup) ecosystems	- Accelerators (Gener8tor) - Angel networks - Univ. entrepreneurship	- Entrepreneurs advised - Startups launched - Capital raised	- Hard knocks education - Networking and mentoring - Culture development
Fund high-potential startups	- State-sponsored non-profit seed/early investment fund - JumpStart (OH), i2E (OK), Elevate (IN), CIT Gap (VA), CT Innovations	- Private capital leverage “Comprehensive Returns” = financial + development outcomes	- Startup validation - First institutional capital - Lowens risk for follow-on investors (angel, Corp, VC)
Increase VC AUM	- Emerging Managers FoF “Eminent Investors” recruitment (Drive Capital)	- Co-invested capital - Financial returns - Follow-on funds	- Supporting opportunity for emerging managers to develop track record - Support established investors to develop new brands in WI
Increase VC investments	“RenVC” FoF model “BioEnterprise” model (niche technology focused venture facilitation)	- Financial returns - Imported capital	- Networking with coastal VC - Develop performance track record for local startups - Corporate VC engagement
Diversify VC industry	Placement services for aspiring VC managers from diverse backgrounds	Women and minority representation in VC investment teams	Reduce systemic barriers to industry participation

1. **Entrepreneurship ecosystems** – While Kentucky is reasonably well-served by regional accelerators, university technology transfer services, and angel investor groups, an investment of \$15 million of SSBCI capital could leverage existing resources to boost startup activity in regional markets. For example, the funds could back accelerator-associated investment vehicles or make direct investments of \$100k in startups that graduate from Kentucky-based accelerators and raise private capital matching funds. Also, capital could be used to fund “themed-accelerators” in technology sectors such as healthcare, logistics and supply-chain, agriculture technology, or blockchain services.
2. **High-potential startups** – \$20 million of SSBCI capital could be invested through existing services into Kentucky-based startups raising \$250k to \$5 million in seed, Series A, or Series B venture capital investments. Funds might require a minimum 1:1 match and invest up to \$1 million in a single startup. In other states, direct investment funds managed by non-profits provided some of the most successful impacts from SSBCI capital investments.
3. **Venture capital fund investments** – Kentucky could utilize \$30 million of SSBCI capital to support capital raises in MicroVC funds in the Commonwealth and perhaps include program models that import venture capital from other states into Kentucky startups. Venture facilitation models like BioEnterprise could successfully showcase high-potential Kentucky startups to venture investors in the Midwest and Southeast. A corporate-philanthropy fund-

III. Objectives and Strategies for SSBCI Venture Capital Programs

of-funds model like RenVC could also successfully raise the profile of Kentucky startups with regional investors.

IV. Best Practices from SSBCI Venture Capital Programs

In this section, the “best practices” from SSBCI as published by Treasury in an April 2014 report are annotated with recommendations specific to Kentucky:

1. **Understand the supply of and demand for venture capital.** To design a state venture capital program that alleviates market inefficiencies and increases access to risk capital, it is necessary to have a realistic understanding of capital supply and demand unique to a specific geographic region. Venture investing can vary significantly from state to state and region to region. Program managers who communicate knowledge of the current financing lifecycle in their state – # of resident VC funds, # of transactions, \$ amounts invested, funding sources, funding stages – are more likely to develop programs with targeted investment strategies implemented at an appropriate scale to support small businesses and create value.

Kentucky does not have a sufficient base of venture capital firms to rely on the private sector to carry the regional startup ecosystem building burden. Instead, funds like KEF and CSC are critical to creating access for Kentucky startups to venture investors outside the Commonwealth and creating enough of a support structure to retain the startups in Kentucky even when outside investors finance them. The market research described in this report is the kind of research “best practice” state programs conducted before investing SSBCI capital into specific VCPs. Some state program managers were far less sophisticated in their planning, and the outcomes reflected their poor planning.

2. **Focus on capacity building with an ecosystem approach.** The potential comprehensive benefits of a state venture capital program will be limited if the program operates as a stand-alone initiative rather than integrating into more extensive small business support systems. Program managers committed to building entrepreneurial capacity and a sustained venture capital presence are more likely to design strategies aligned with market-based principles. Several state program managers communicated how SSBCI would interact with and support complementary development strategies while building innovation capacity within their state’s economy.

We strongly recommend that states leverage existing capacity and teams – such as those resources available through KEF & CSC – rather than haphazardly stand up a “one-off” program to expend SSBCI capital and then close it down when the program sunsets. Far too many states lacked coherent, coordinated strategies with the first SSBCI program.

3. **Create pathways to the next investment round.** Nearly all state program managers communicated their expectation that the SSBCI funds allocated to venture capital would be readily absorbed by market demand. However, with most VC programs focused on the seed/early stage of investment along the capital continuum, the more significant challenge that faces program managers may well be in securing follow-on investment rounds in markets underserved by institutional venture investors. The most successful private VC investors continually plan for the next financing event, actively communicating about investment opportunities and expanding professional networks to benefit portfolio companies. If pathways to the next financing event are not created, small businesses receiving seed investments might not survive.

Accelerators prepare startups for angel investors, who then prepare startups for venture capital,

IV. Best Practices from SSBCI Venture Capital Programs

who then prepare startups for strategic corporate investment or acquisition. In regions without a significant base of venture capital investors, venture facilitation models can be critical to retaining high potential startups that need venture capital investment to grow. SSBCI capital could add this capacity to for the benefit of startup ecosystems throughout the Commonwealth.

4. **Plan for the long-term and manage expectations.** State venture capital programs are long-term development initiatives, and the term “patient capital” is used to describe this type of investing for a reason. Venture investing, and particularly early-stage venture investing, is dynamic and unpredictable, so experienced program managers understand the need to plan for a six to ten-year or more maturation cycle. Furthermore, it is essential to manage expectations for achieving a “comprehensive return” that includes both financial ROI and economic development calculations when communicating about VC programs. There will be successful and unsuccessful investments (and some total write-offs), so program leaders should be proactive in educating partners and stakeholders on a program’s processes and expectations.

*Comprehensive return means state government fully participating in the financial upside of successful investments and incorporating intangible values into the returns equation, such as the investments in innovation ecosystems that do not translate directly into financial returns. Most importantly, comprehensive return implies direct and open communications with state legislators about realistic expectations and maturation periods for venture capital programs. Too many states, including Kentucky, “give away” taxpayer funds through a variety of vehicles. It is far better for taxpayers if states leverage infrastructure programs like KEF and CSC to *invest* taxpayer funds for economic development, ecosystem building, and financial returns.*

5. **Address specifically the potential for conflicts of interest and political influence.** Several state VC program managers acknowledged the potential for conflicts of interest and/or political influence in a state-managed capital formation initiative. It is not unheard of for a manager of a VC program to receive correspondence from a state official (elected or appointed) about an investable deal that has their interest. Similarly, state capital programs commonly engage volunteer civic leaders to serve on advisory committees with responsibilities for vetting opportunities and making investment recommendations. Well-designed initiatives specifically address the potential for conflicts and influence by having clearly stated policies and processes in place to govern activities and investment decisions.

Best practice SSBCI programs had both internal processes and political advocates to shield them from undue influence.

6. **Attract the most capable leaders to manage resources.** A critical success factor for state capital programs is attracting competent investment managers to manage public resources. Some state programs have successfully engaged high-performance leaders as part of the internal team or through a state-sponsored organization. Other state programs seek capable managers by contracting with for-profit investment managers rather than building duplicate internal capabilities. Both strategies can deliver expected outcomes; however, successful programs are built on the understanding that success is primarily determined by who is involved with managing funds.

IV. Best Practices from SSBCI Venture Capital Programs

Kentucky should view state-sponsored investment funds like KEF and CSC as proving grounds for future venture capital investors. They should invest in the staff's continuing education through access to NVCA or Kauffman Fellows programs and provide staff with the resources to provide valuable information and interactions with local and regional venture capital fund managers.

7. **Measure results accurately with defensible logic.** Some state program managers have significant experience with evaluating key metrics for VC program performance and reporting results. Although there are currently no recognized national standards for assessing state VC programs' direct and indirect impact, potential best practices are emerging. SSBCI could help bring clarity to the national debate by offering sound, logical methodologies for calculating value. Program managers have communicated perspectives on this crucial topic and expressed interest in sharing information on how to move towards a best practice approach. Key measurement issues with VC programs relate to calculations of investment leverage, job retention/creation, causal impact on investment transactions, etc.

The purest measurement criteria for state venture capital programs is the amount of venture capital invested in the state, as reported by NVCA. Kentucky should set an objective to reach 35% of the per capita national average by the end of SSBCI 2.0, up from 13% average over the five years from 2016-20.

8. **Align state economic development interests with the financial interests of fund managers and limited partner VC fund investors.** "Double bottom-line" rhetoric has persuaded some state policy leaders to trust that private sector interests will focus equally on creating jobs as well as maximizing their financial interests. In the Consultants' view, the two goals do not always coincide. State policy leaders should recognize that indirect economic development benefits such as creating high-wage jobs, the expansion of innovation within targeted sectors, and the development of new industries are achieved *indirectly* from profit-motivated investing, not by placing new priorities on professional investors that perform best when singularly focused. In the Consultants' view, states can best target economic objectives by influencing the parameters of allowable investments and then fully participating in sharing financial returns. Successful state investments will create new sources of capital for future investments.

*SSBCI, fortunately, has a single financial metric that aligns with the market – private capital leverage. More than lending programs, VCPs can realize substantial private capital leverage through follow-on investment rounds. We have found that private capital investors respond more favorably to state-sponsored partners investing on the same terms – *pari-passu* – than those giving away the state's capital through other schemes.*

V. Recommendations for Kentucky's SSBCI Program Capital Allocations

Market data and the current demand for lending programs left over from the initial SSBCI program raise substantial concerns about whether well-served small businesses in Kentucky have an unmet need for SSBCI lending programs. At most, we recommend a \$15 million extension of existing lending programs, but perhaps with “loan participation” options rather than just the established collateral support program.

We strongly encourage Kentucky to view SSBCI 2.0 – and its increased allocation share of \$82 million – as a unique opportunity to bolster the Commonwealth's presence in the venture capital industry. Three program models could be successful in Kentucky with achieving the private capital leverage requirements and providing long-term value to regional startup ecosystems:

1. **\$15 million for industry-focused accelerators.** Through KEF and CSC, Kentucky would invest \$3-5 million in partnership with 3-5 accelerators focused on technologies where the Commonwealth has demonstrated a propensity for startup activity, corporate investment, or university research. The funds would reserve SSBCI capital for seed or follow-on investments in companies that complete the accelerator program and raising matching funds from the private sector.
2. **\$20 million for seed fund investments.** KEF and CSC could deliver exceptional value to the Commonwealth with the opportunity to expand its existing seed fund and follow-on investment capabilities. States like Oklahoma, Connecticut, and Florida were successful investing SSBCI capital directly in startups. Without a substantial presence from the private venture capital industry, state-sponsored seed funds need to play an outsized role in facilitating seed, early and growth-stage investments matched by angel investors, emerging managers, and out-of-state venture funds.
3. **\$30 million for venture facilitation or MicroVC investments.** With just \$74 million of VC AUM in Kentucky, the Commonwealth needs to either facilitate new fund creation and support emerging managers through limited partner investments in new funds or facilitate out-of-state investment with direct co-investments from regional venture funds. We recommend a flexible program with both approaches in its strategy.

ⁱ <https://www.preqin.com/insights/research/blogs/private-equity-aum-will-top-9tn-in-2025>