



Illustrated By David Habben

BUILDING UTAH'S FORTUNE

The Utah Fund of Fund Targets Venture Capital for Economic Growth

By Jamie Huish Stum

In 1980, young software manager David Bailey came up with an idea for a data storage product while working at IBM in Arizona. He and two partners decided to establish the business in Utah, close to their roots. Calling the company Iomega, they wrote a business plan and looked for venture capital funding. After realizing there was no venture capital to be had in Utah, Bailey headed for California to make his pitch before established firms. When a firm in La Jolla, Calif. committed

to providing startup funds, there was only one caveat. Bailey could start the company anywhere but Utah.

"No one believed that Utah had the potential it has," Bailey says. "They said, 'Are there any deals in Utah worth investing in?'"

A Need for a New Way

Bailey's story was familiar to Utah's entrepreneurs in the 1980s and 1990s. Always a place generating creativity, Utah

didn't have the venture capital network to finance most new ideas, forcing valuable talent to look elsewhere to develop a business. These innovators were often told the same thing from outside venture firms: Sell the business or move out of Utah.

As the dot-com bust in 2001 and the financial downturn following 9/11 created an increasing strain on the economy, leaders in Utah decided it was time to take action. They realized Utah's entrepreneurs would only

flourish if more venture capital was flowing into the state, says Peggy Wallace, a former state representative from West Jordan. The state needed a source of capital for venture funds.

"We had to have good jobs for these people," she says. "You can't keep recycling the money you have in your piggybank in the state of Utah; you have to have new funding coming in."

During the summer of 2002, Wallace was part of an unfunded work group that examined how Utah could bring in outside venture funding.

"It was basically a sign-up with a commitment on the part of everyone and they just did it," Wallace says. "That's one of the unique things about government in Utah."

The group researched ways other states enticed venture capital investments and brought in legislators from those states with successful programs. After a whirlwind summer and fall, the group drafted House Bill 240, modeled after legislation operating in states such as New Mexico and Oklahoma. Wallace volunteered to sponsor the bill in the House of Representatives, to be picked up in the Senate by Scott Jenkins, R-Weber County.

To show the legislature what the bill would mean to Utahns, Wallace and the group encouraged lobbying from entrepreneurial, business and technology groups in and outside the state. The show of support was unprecedented, Wallace says.

"We had entrepreneurial groups who said, 'Hey, look, if this had been in place six or 10 years ago, I would still be here,' and that's powerful testimony," Wallace says. "It was the real people that would be impacted directly by this."

Support from both parties, the Utah Information Technology Association (now the Utah Technology Council) and the community led to the bill's passage with 95 percent yeas in both the Senate and the

House. In 2003, House Bill 240, called the Venture Capital Enhancement Act, officially established the Utah Fund of Funds.

Nuts and Bolts

The Fund of Funds is designed to increase the amount and quality of capital funding accessible to startups and growing companies in Utah. The fund does not directly finance the startups; instead, it provides capital to carefully selected venture firms, both in and outside the state. These firms then invest in young companies and commit to spending time in Utah. The result is increased deal flow, a stimulated economy, job creation and maturation of Utah companies.

Though no money has been put up by the government, the state potentially sees huge returns in tax revenues, fund officials say. The legislature initially approved \$100 million contingent tax credit for Fund I to be dispersed in qualified investments. This was used as collateral to obtain financing from a third party, Deutsche Bank, headquartered in Frankfurt, Germany. According to the financing, the fund has 15 years to pay the obligation to Deutsche; if the fund has insufficient returns on its investments after the allotted time, Deutsche can file a Utah tax return, apply for the tax credit and receive cash from the Utah State Tax Commission.

The program is designed to make the likelihood of failure incredibly small, officials say. If the fund invests in 20 venture firms, which each invest in 15 companies, the state will have a vested interest in 300 businesses, says Jeremy Neilson, managing director for the Utah Fund of Funds. All the companies don't have to succeed for the fund to pay back its dues.

"If Google was in that 300, I could lose 299 and return my investment," Neilson explains.

According to the Cambridge

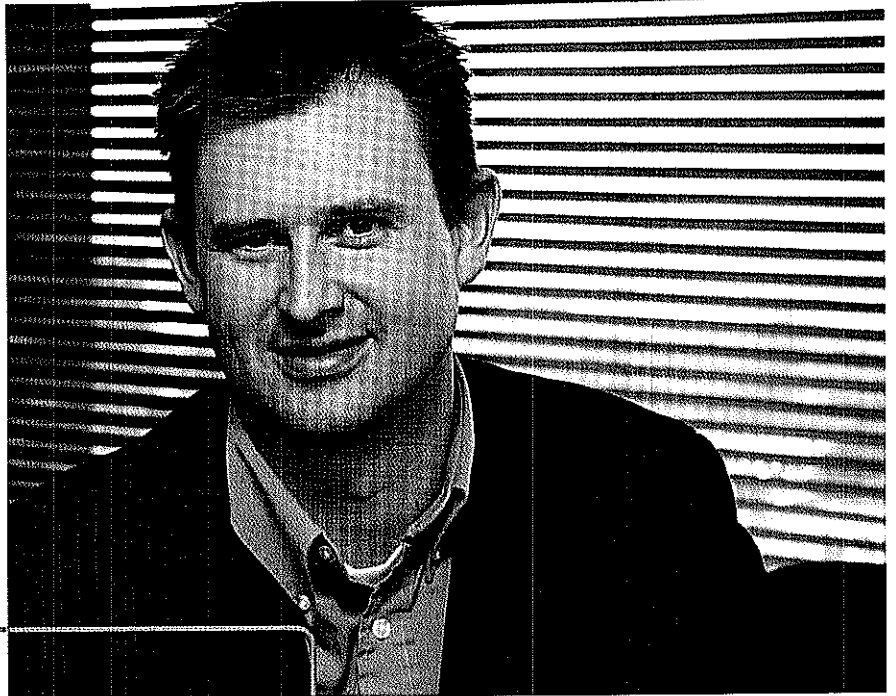
Associates Benchmark Statistics report on Fund of Funds performance, which compiles data on for-profit Fund of Funds return data, the median return to investors has never gone negative since tracking began in 1986. "The risk is there, but it's small," Neilson says. "In all likelihood, if you do lose, it's not a large number."

Two governing boards oversee the fund. The Utah Capital Investment Board (UCIB) is the government arm of the fund. It holds the weighty responsibilities of securing tax credits for the program and reporting the status of the fund to the Utah Legislature, although it does not determine any investment placements. Members include government positions and appointments by the governor.

The Utah Capital Investment Corporation (UCIC) is the public side of the fund's governance. A non-profit corporation with a public charter, UCIC boasts a board comprised of solely volunteers with a strong background in finance, entrepreneurialism and venture capital. UCIC oversees and approves all Fund of Fund investments.

Fort Washington Capital Partners, headquartered in Cincinnati, serves as a professional outside investment advisor to the Fund of Funds. In this role, Fort Washington finds and evaluates potential fund investments, performs deep due diligence and makes investment recommendations to the UCIC board.

The fund purposefully is structured to provide capital to venture firms instead of directly funding promising technologies for long-term impact, beyond what investments in a few companies could provide. By supplying a source of funding to venture firms, in-state venture firms grow and out-of-state firms consider doing deals in Utah, fund officials say. By being just one investor in a venture capital firm, the level of equity investment in Utah companies



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Jeremy Neilson, Utah Fund of Funds

may reach two or three times the amount of the original fund. As those companies generate returns, national interest in Utah's companies increases, perpetuating increased equity investment available for future entrepreneurs.

Once the Fund of Funds makes a financial commitment to a venture firm, that firm is not required to invest in Utah companies. Research shows that forced investment requirements usually result in lower returns and tempered relationships between funds and firms.

"If you dictate to them what they have to invest in, they won't take your money," Neilson says. "If we put those types of restrictions, we can't get into quality funds and then it puts a stress on the tax credit."

This approach has paved the way for successful relationships with many new venture firms. More than 160 firms in and out of Utah have applied to receive funding from

the Fund of Funds, which is 60 percent of all fund-raising venture firms in the national marketplace. Other states with similar funds, such as New Mexico, received applications from about 25 percent of the market, Neilson says.

Under House Bill 240, any out-of-state firm that receives capital from the Fund is required to spend time in the state getting to know the companies and entrepreneurs. The 11 out-of-state firms have committed to spend more than 1,000 days in Utah over the next three to five years.

"They come often," he says. "Whenever we send them a company, they're very responsive in following up with them. Some are within minutes of a referral."

San Francisco-based Allegis Capital, which received Fund of Funds money earlier this year, found the fund to be a natural fit as an institutional partner. The firm, which invests in early-stage information technology, was attracted by the fund's use of borrowed

money instead of tax dollars, says Spencer Tall, managing director for Allegis. Tall says he is seeing a turning point in Utah's entrepreneurial situation with the fund, making the state a much more attractive place to invest.

"Utah has both an IT side and a medical side to venture business...which makes it a little different than others," he says. "We continue to have nice exits come out of Utah."

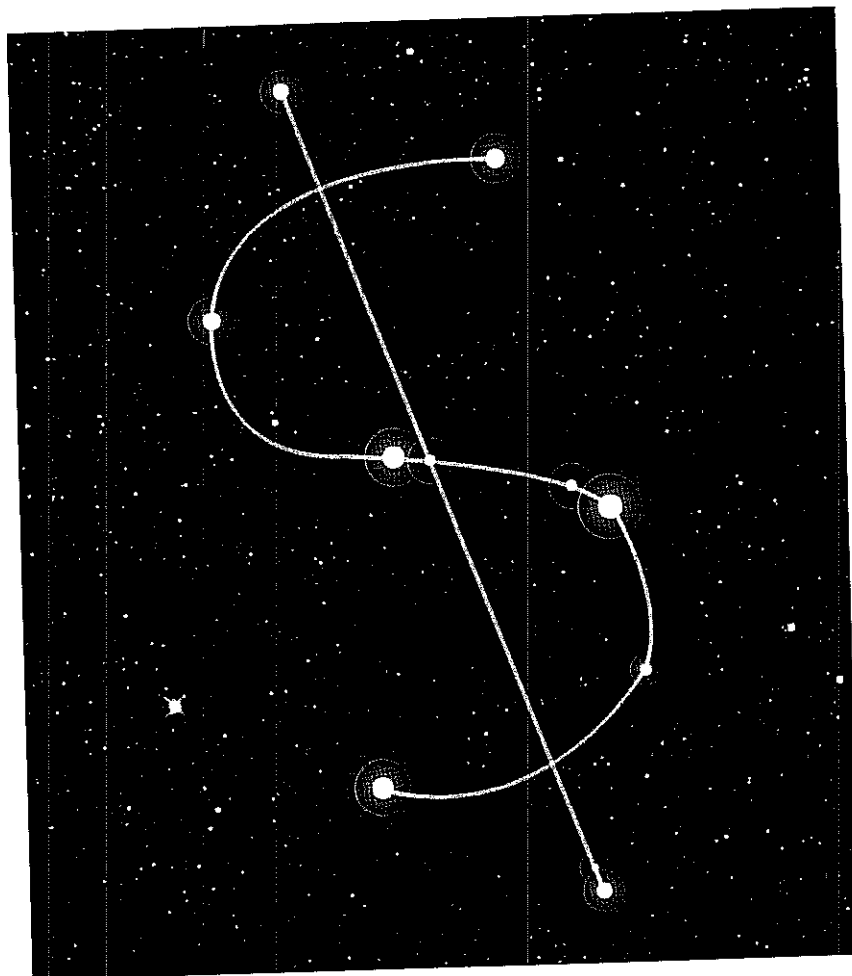
Allegis, which currently has financial interests in two Utah companies, continues to seek investment opportunities in Utah through Fund of Fund referrals and outside research. Tall and other Allegis general partners spend about four days in Utah every month, he says.

"We hope to have a close relationship with the Fund of Funds for as long as I'm in this business," Tall says. "I anticipate it being around many years from now."

The fund also increases partnership opportunities with local venture firms. UV

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David Bailey, Iomega



Partners, a Salt Lake City-based venture firm that invests in information technology and life sciences, became part of the fund's portfolio in June. Having the fund as an institutional player in Utah has made the market much stronger, says Blake Modersitzki, managing director of UV Partners.

"At the end of the day, we are all tasked with generating positive returns for our investors," he says. "The fund will help the economy not just simply by making good investments, but by creating more jobs, putting more tax dollars at work and creating more disposable income."

The fund also promotes a higher quality investment standard, Modersitzki says. "It's fostering an environment where [entrepreneurs] have to pitch to a dozen or more firms. The Fund of Funds does a nice job of making sure those companies have their best foot forward to present to receive funding."

Taking Flight

For Fund I, the program has invested in 17 firms, with plans to invest in 19 or 20,

ranging across industry and development stages. The diverse portfolio includes companies such as Highway 12 Ventures, an Idaho-based firm focused on seed and early expansion investments, and Hummer Winblad, a Fund VI focusing on software technology.

Though the fund's investments do not flow directly to the entrepreneur, the money is already reaching Utah companies. Currently, 26 Utah companies have been funded from the Fund of Funds portfolio, creating 1,066 jobs, says Neilson. Those businesses have raised a total of \$375 million and of that, \$127 million has come from the Fund of Funds portfolio, according to fund officials.

"Over the next 10 to 15 years, those 1,066 jobs will equate to more than \$100 million in tax income to the state of Utah," Neilson says. "So the state puts no money out and gets \$75 million back."

Program officials are asking the Legislature for a \$200 million increase for Fund II, bringing the total to \$300 million. Based on legislators' initial responses, the

group is hoping for another easy ride. "No brainer" is the number one comment I hear," Neilson says.

Most significantly, the fund is providing a way for Utah's entrepreneurs to get companies funded, but keep them in Utah. Bailey, who had to convince a California venture firm to fund his Utah-based company, Iomega, in 1980, can now get backing in Utah for his newest business enterprise, IntelliSum, Inc., which invented one of the market's first 3D cameras. He has secured funding from local venture firm vSpring and from out-of-state firm Flywheel, which has not received funding from the Fund of Funds but invested after the Fund of Funds made an introductions

Bailey says he has witnessed firsthand the alterations in perception the fund has fostered in Utah investments.

"The atmosphere and the attitude toward Utah have changed so dramatically since the early '80s," Bailey says. "We could very well be the next West Coast center of technology right here. And that is exciting."