

KENTUCKY SMALL BUSINESS INVESTMENT PROGRAM

Program Description

The **Kentucky Small Business Investment Program (KSBIP)** is a 10-year, \$4.2 billion, state-financed, investment program that is designed to create enough jobs in Kentucky to increase household incomes throughout the state and reduce much of the poverty that exists in Kentucky today. The money will be raised in rounds, distributed through privately-owned and managed venture capital funds, and targeted to capitalize small businesses and start-up ventures located in Kentucky. As currently planned, the first round will be for \$100 million and the second round for \$300 million. Each round of financing must be approved by the Cabinet for Economic Development and the Capital Projects and Bond Oversight Committee of the Legislature. The investment risk to Kentucky taxpayers is about \$15 per person per

month over the 10-year period, less than the amount many spend on lottery tickets now.

Table 1. Number of Jobs Needed in Kentucky by 2016

2000 Census Total Population	4,041,769
Projected 2016 Population (1)	4,643,000
Projected 2016 Civilian Labor Force (2)	2,465,000
Current Employment (3)	1,899,000
Number of Jobs Needed	566,000

- (1) Assumes that population grows at the annual rate of growth from 1990 to 2000.
- (2) Assumes that 78.2% of population is 16 or older as in 2000 and that the labor participation rate is 67.9%. The labor participation rate of 67.9% is an extrapolation of the 2008 U.S. participation rate projected by the U.S. Census Bureau in the 2001 Statistical Abstracts of the United States.
- (3) Employment figure for October 2005.

The goal of the **KSBIP** is to reduce unemployment in every county in Kentucky to 3%±. This goal helps ensure that the jobs are distributed throughout the state. Table 1 shows that this will require creating over 560,000 jobs over the next 10 years. The operational philosophy to achieve this goal is "unemployment can always be reduced by starting one more business."

The **KSBIP** is a transformational program that will improve life for

hundreds of thousands of Kentuckians who currently live in poverty or are otherwise struggling to make ends meet. It will create jobs for graduates of Kentucky schools, so that they will not have to move to other states to get a job, and jobs for veterans and those with special needs. It will contribute to creating a budget surplus, enabling taxes to be reduced for senior citizens who need help buying food and medicine and/or enabling increased spending on roads, education, law enforcement, and homeland security. It will produce additional revenue from occupational and property taxes for cities, counties, and school districts. It will reduce family financial pressures that lead to divorce and help combat drug abuse and drug-related crime. It is an educational program itself that will train and develop venture capitalists, entrepreneurs, workers, and risk managers. It is a powerful alternative to legalizing gambling in the Commonwealth.

Kentucky taxpayers invest billions of dollars in education; but lose the return on that investment when graduates move to other states to work, and pay taxes, because enough jobs are not available in Kentucky. The KSBIP plugs a gaping hole.

Sources of Funds

The **KSBIP** requires that the venture funds match the Commonwealth's portion \$1 for \$1 overall. Some venture funds will be financed primarily with private capital and SBIC money while others may be financed primarily with state-backed money. The funds with private capital will have a cost of capital of about 6-7% (blended rate). The state-backed funds' cost of capital will be about 2% or less. In comparison, current venture capital funds have a 15-25% cost of capital. A lower cost of capital will enable the venture capital funds to invest in riskier business ventures and still be profitable.

As currently planned, the Commonwealth's portion will be funded initially with \$950 million in zero-coupon discount bonds and \$3,250 million in budget appropriations later, taken out of future surpluses

Table 2. Sources of Funds for Venture Capital Funds, Program Level
(\$ in millions)

KSBIP	\$ 4,200
Private investors	1,147
SBIC program	<u>3,053</u>
Total	\$ 8,400

Note: The SBIC program will buy securities from the venture funds or guarantee securities issued by them up to 200% of their qualified capital (13CFR107.1150).

generated by the program. The debt jump-starts the program until the surpluses are of sufficient magnitude to finance the rest of the program. *No budget appropriation is needed now, and no annual debt service payments will have to be made* because both principal and interest are due at maturity with zero-coupon discount bonds. The bonds will be retired with funds received from the liquidation of the venture capital funds. The surplus also will be sufficient to establish a sinking fund to retire the bonds if desired.

Table 3. U.S. Venture Capital Commitments
(\$ in billions)

<u>Year</u>	<u>Amount</u>
1990	\$ 3.4
1995	10.2
2000	106.1
2002	9.0
2003	11.5
2004	18.2

Source: Table 753, Statistical Abstracts of the United States: 2006

The sources of matching funds are private investors and the Small Business

Investment Company (SBIC) program of the Small Business Administration (SBA). Private investors include individual investors, other venture capital funds, institutional investors such as pension funds and insurance companies, and corporations and other businesses. The venture funds must raise \$1.15 billion from private investors and will then be able to get \$3.05 billion from the SBIC program as indicated in Table 2. On an annualized basis, the \$1.15 billion is about 1% or less of the amount of venture capital that is formed each year as indicated in Table 3. In fact, the entire \$1.15 billion is less than 1% of the amount of venture capital that was formed in the year 2000 alone. The **KSBIP** venture funds will compete for this private money.

Leveraging Coal Severance Dollars: Community Venture Capital Funds

Each \$1.00 of coal severance money could become \$9.00 for investment in creating jobs if counties were to put their coal severance money into SBIC-licensed venture capital funds. For example, if a county invests \$2 million in an SBIC with \$4 million of capital from private sources, then that fund can raise an additional \$12 million from the Small Business Administration. If the 31 coal counties were to do this, then they would have \$558 million to invest in creating new jobs. These funds could provide matching funds in the **KSBIP**.

The initial \$4 million investment could be raised in small amounts from the residents of the county. In a county with 25,000 people, \$4 million could be raised if everyone invested only \$160, about \$14 per month for 1 year. This is the fundraising concept of a *Community Venture Capital Fund*.

We have grossly underutilized the capacity of the SBIC program to create jobs in Kentucky.

Budget Surplus

The **KSBIP** will generate a budget surplus relative to the current budget. Tax revenue to the Commonwealth will increase as the new jobs are created, and spending on welfare programs will decline as people move off welfare after getting jobs. If each new job created produces \$1,500 in additional revenue and reduces welfare spending by \$1,300, then the budget surpluses in future years will be on the order of \$500-1,000 million *after funding the KSBIP*, with an accumulated surplus over 10 years on the order of \$3.0-3.5 billion.

Increased tax revenues. The economic activity stimulated by this investment program will result in greater tax revenues from both businesses and individuals. Businesses will pay more in profit taxes, because more businesses will exist and profits will be up for others, and more in property taxes because new property will be placed in service from business start-ups and the growth of existing businesses. Also, some businesses may relocate to Kentucky simply because of the good economic climate.

At the individual level, income tax revenue will increase because of the new jobs and from existing jobs that earn more because of the better economy (overtime, pay raises, etc.) In addition, the increased incomes will result in increased spending which will increase revenue from the sales tax; excise taxes such as gasoline, cigarette, and alcohol taxes; and taxes on cable and satellite TV, insurance, electric, telephone, and other communications bills. More people will be able to afford cable or satellite TV and to access the internet. More people will be driving back and forth to work. People will buy new housing or upgrade existing housing, leading to increased property tax revenue. People will travel more in general; and if some of the investment is made in the tourism industry, then tourists will provide another source of increased revenue from sales, gasoline, and room taxes.

Considering this, increased revenue of \$1,500 per job seems conservatively low. This is about 9% of a full-time, \$8/hr job. Tax revenue from the individual income and sales taxes alone averaged about \$2,900 per person employed in FY2004. In addition, cities, counties, and school districts will receive more revenue from property taxes and occupational taxes.

Decreased spending on social programs. Many people who become employed as a result of this investment program will move off welfare. State spending on welfare programs is on the order of \$2,500-3,000 per recipient. A spending reduction of \$1,300 per job created is less than 50% of this, so it seems conservatively low. The number of people on welfare should decline tremendously, perhaps by 80% or more.

Impact on the Commonwealth's Debt Rating

Any program that substitutes jobs for handouts should improve a state's debt rating. The debt rating assigned to a state's debt is simply a measure designed to gauge the state's ability to make debt payments on time. Factors that contribute to a higher debt rating include reduced levels of government spending, a broad tax base, operating at a budget surplus, and accumulating surpluses into a "rainy-day" fund or

other such fund. Factors that contribute to a lower debt rating include high levels of government spending; relatively high levels of debt; a weak tax base signified by relatively high unemployment, poverty, low household incomes, etc.; deficit spending; and having a relatively low balance in an accumulated surplus fund.

The **KSBIP** will expand the tax base, increase tax revenues, and reduce spending on welfare programs, enabling the Commonwealth to operate with a surplus and increase the "rainy-day" fund. The bonds issued for the **KSBIP** will not affect our ability to repay other debt because they will not require making any debt service payments – both principal and interest are due at maturity (15 years or so). Also, these bonds will be backed by the investments made in the program, further enhancing our ability to repay the debt. The Commonwealth's debt rating should improve.

Risk and Risk Management

The risk of the **KSBIP** is diversified across all Kentucky taxpayers. The risk to taxpayers is about \$1,750 per person over the 10-year period. This is \$175 per year or \$15 per month. Many people spend more than this buying lottery tickets. The benefits are great, however. There will be more jobs for Kentucky's graduates, veterans, those with special needs, and others. Household incomes will be higher, greatly reducing poverty; cities, counties, and school districts will have more revenue; many families will be under less financial pressure; senior citizens will have more money to spend on food and medicine because of lower taxes; drug abuse and drug-related crime should be lessened because of the improved economic opportunity; and there will be more money to spend on roads, education, law enforcement, and homeland security.

The **KSBIP** will displace welfare spending. Nothing is more risky than a handout. A handout is analogous to an investment that has a 100% chance of losing 100% of the investment. The worse case scenario for the **KSBIP** is that all of the invested dollars are lost. This is highly unlikely; but if it were to occur, the benefits of the program would still be achieved, including the budget surplus. The projected accumulated surplus, after funding the program, is on the order of \$3.0-3.5 billion but only \$2.0 billion will be needed to retire the bonds. The bonds could be retired using funds from the surplus generated by the program. The program will pay for itself even under the worst case scenario.

At the venture fund level, the cost of capital has a tremendous impact on the ability to take risk. Venture capital funds have three basic costs that have to be covered – administrative costs, cost of capital, and risk premium to cover losses. They cover these costs through return on investment from the investments that are successful. The higher the fund's administrative costs and cost of capital, the less risk the fund managers can afford to take. The return on individual investments can range from losing it all to a hundred-fold or more increase in value. Stock can be purchased in start-ups for pennies per share and ultimately sold for tens of dollars per share.

Generally, venture capital funds have a 15-25% cost of capital because their investors (insurance companies, pension funds, etc.) require about a 5% risk premium over the return they could get in the stock market. The venture funds established in the **KSBIP** will have a cost of capital of about 2%, so they will be able to take greater risks and still cover their costs. For example, a venture fund with a 20% cost of capital and a 35% loss rate will have to make an average annual return of about 25% on its remaining investments in order to cover its cost of capital. A venture fund with a 2% cost of capital and

a 70% loss rate (twice as high) will have to make an average annual return of only about 15% (40% lower) on its remaining investments to cover its cost of capital. (The loss rate is the proportion of the fund's investment base that is ultimately lost. It includes the administrative costs since they are paid out of the capital base.)

The **KSBIP's** low cost of capital provides an ability to absorb substantial losses and still return the initial investment to the taxpayers with a return sufficient to pay the interest on the bonds. The low cost of capital, coupled with skillful risk management, will help ensure that the **KSBIP** will meet its employment goal without losing taxpayer investment dollars.

Risk Management

While the risk of each individual investment may be high, measures can be taken at all levels – individual businesses, the venture funds, and the state – to manage the risk. The risk management goal of the **KSBIP** is to achieve a rate of return greater than or equal to break-even. As currently planned, the taxpayers' break-even annual rate of return is about 2%. To achieve this goal, the **KSBIP** must be a cooperative effort among Kentucky's elected officials, the venture fund managers, business owners, and workers. All must work together to reduce risk and help ensure the success of the investments.

At the individual business level, risk will be reduced by the availability of the capital itself, since undercapitalization is the number one cause of small business failures. Many businesses do well during good economic times and fail during a slow period, such as a recession, because they cannot raise the funds to finance the losses incurred during the slow period. The jobs provided by these businesses could be saved by a short-term, unsecured investment to help the business until the economy picks up again.

Risk can be further reduced by the venture funds providing an array of professional services that small businesses may not be able to afford now – accounting, financial management, legal, marketing, and general business consulting such as strategic planning. Many business failures have their roots in the failure of the business to keep good accounting records.

At the venture fund level, risk can be reduced by monitoring businesses to ensure that good accounting records are kept, the business managers manage its cash flow, and the business gets the professional resources it needs. The venture fund managers can spread their risks across industries, business size, and stage of development. While the venture funds will be focused on start-ups and small businesses, they can balance their investments between start-ups and growth-stage businesses and have a few larger, more secure investments in their portfolio. Diversification reduces risk.

Selling early, when the business first reaches profitability, will reduce risk. The objective of the **KSBIP** venture funds is to develop entrepreneurs and businesses to the point where they are attractive to other investors. A typical success story would be for a **KSBIP** venture fund to liquidate its investment in a business by helping that business attract financing from the larger venture capital funds. Early returns can be quite attractive. Stock in start-up ventures is bought for pennies per share and sold for dollars per share. Business environments are dynamic, and a business that has been successful for 3 or 4 years may ultimately fail 3 or 4 years later because of unforeseen events that occur in the business' environment. Selling early avoids the risk of "hanging on too long."

Mergers and acquisitions can prevent failures. Many businesses fail to make a profit because their overhead costs are too high, they are too small to get volume price discounts, or they lack access to other needed resources, such as marketing support. Merging with or being acquired by a larger business can enable some small businesses to become profitable by enabling them to achieve the economies of scale that larger businesses enjoy. The **KSBIP** venture funds can help prevent failures, and protect their investment, by helping small businesses find merger partners or purchasers among their portfolio of companies or elsewhere.

The **KSBIP** venture funds also can establish holding companies out of businesses within their portfolios. Holding companies diversify risk and provide administrative and other services, including raising capital, to their component businesses more efficiently than the businesses can do on their own. The value of a holding company can be greater than the value of the sum of its businesses individually because of the greater efficiency and lower risk of the combination. The whole can be worth more than the sum of its parts. The lower risk will make the holding company more attractive to private investors, so the **KSBIP** venture funds can liquidate their investment by creating holding companies and selling them to other investors.

Finding a buyer or merger partner, forming a holding company and selling to private investors, and selling to larger venture capital funds are exit strategies available to the **KSBIP** venture funds. They also could help take a business public and liquidate their investment as part of the public offering.

At the state level, risk can be reduced by taking measures to reduce the cost of doing business and the cost of living in Kentucky. Reducing the cost of doing business will lower the break-even point for small businesses and more will succeed. The cost of doing business can be reduced by reducing taxes paid by small businesses, reducing the cost of complying with regulations, reducing the cost of lawsuits, reducing the cost of health insurance, and reducing the cost of workers compensation. Reducing cost reduces risk.

The cost of living can be reduced by reducing government spending and taxes and reducing the cost of doing business. Reducing the cost of living will put more money into the pockets of Kentuckians to spend on the products and services offered by the new businesses created. If the risk can be reduced enough, then private capital will replace the taxpayers' investment. The benefits will continue, but taxpayers will not have to take the risk.

Deal Flow

In a broad sense, the potential for new business opportunities is limited only by the imagination and creativity of the people of Kentucky, and the nation. The **KSBIP** finances the unbridled spirit of Kentucky.

In a more concrete sense, many funding requests of businesses are turned down. This will be a major source of the potential business opportunities for the **KSBIP** venture funds. The larger venture capital funds currently reject about 97% of the business plans they review. They reject businesses because of risk, too low return, or simply because the business may be too small. Banks reject business loan requests regularly because of risk. Other sources of business financing include corporate financing

companies, mezzanine financiers, asset-based lenders, and factors. All are potential sources of referrals for business opportunities.

The **KSBIP** venture funds can provide financing for products that are developed in university research labs and for products spun out of larger corporations. For example, Procter & Gamble sells the rights to produce and sell some of its smaller brands to entrepreneurs. In addition, many existing small businesses may relocate to Kentucky to get financing.

Welfare Reform

Current welfare programs must be reformed to smooth the transition from welfare to work in order for the **KSBIP** to be successful. One way this could be done is to change welfare to a loan-based system. Recipients would receive loans rather than handouts with the expectation that they work to the extent they are able to repay the loans. Special measures can be taken for those who cannot work. Loans provide a helping hand, are more dignified for the recipients than handouts, and eliminate the incentive to not work that is built into our current welfare system.

The **KSBIP**, coupled with a loan-based welfare program, will have the effect of converting welfare expenditures in the Commonwealth's budget into assets, a positive change for taxpayers. Taxpayers will have to pay only for bad debts rather than the entire cost of the program. Recipients will be held responsible to repay their assistance, so the waste, fraud, and abuse that currently plagues our welfare system will be greatly reduced.

Summary

The **Kentucky Small Business Investment Program** is perhaps one of the best uses of taxpayer dollars. The risk to each Kentucky taxpayer is about \$15 per month for 10 years, less than the amount many spend on lottery tickets now. The benefits, however, are immense.

The **KSBIP** will improve life for hundreds of thousands of Kentuckians who currently live in poverty or are otherwise struggling to make ends meet. It will create jobs for graduates of Kentucky schools, so that they will not have to move to other states to get a job, and jobs for veterans and those with special needs. It will contribute to creating a budget surplus, enabling taxes to be reduced for senior citizens who need help buying food and medicine and/or enabling increased spending on roads, education, law enforcement, and homeland security. It will produce additional revenue for cities, counties, and school districts from occupational and property taxes. It will reduce family financial pressures that lead to divorce and help combat drug abuse and drug-related crime. It is an educational program itself that will train and develop venture capitalists, entrepreneurs, workers, and risk managers. It is a powerful alternative to legalizing gambling in the Commonwealth, and the taxpayers may actually receive a positive return from the program itself.

While investing in small businesses and start-ups is risky, the overall risk is relatively low because of risk management and diversification. The **KSBIP** itself will reduce the risk of investing in small businesses because it addresses the number one cause of business failures – undercapitalization. The **KSBIP** venture funds can provide needed accounting and other business consulting services to the small

businesses, further reducing the risk. Business failures also can be avoided by merger and acquisition and forming holding companies to help small businesses achieve economies of scale.

The **KSBIP** should improve the Commonwealth's debt rating because it will result in a broader tax base, higher household incomes, increased tax revenue, and lower government spending. No debt service payments will be required because principle and interest are due at maturity with zero-coupon discount bonds. As currently planned, the **KSBIP** is financed with 23% debt. The bonds can be retired from the liquidation of the venture capital investments or out of the surplus generated by the program.

The risk is relatively low because of diversification and risk management, the state's debt rating should improve, no annual debt service payments will have to be made, the debt is covered in two ways without relying on raising taxes, and the rewards are great. How can we justify not implementing the **KSBIP**?

The KSBIP is an educational program itself that will train and develop venture capitalists, entrepreneurs, workers, and risk managers, making the Commonwealth stronger.

KENTUCKY SMALL BUSINESS INVESTMENT PROGRAM

APPENDIX

This appendix presents a response to the Memorandum Report to Rep. Dennis Keene, dated January 12, 2006, from Mr. Mike Clark, Ph.D., Chief Economist of the Legislative Research Commission (LRC).

General

"Past performance is not an indicator of future performance" is a principle that wise stock investors keep uppermost in their minds. This is because the success of any given company can change rapidly for better or worse. This principle also applies to the **Kentucky Small Business Investment Program (KSBIP)**. The past is not a good indicator of the future because we can change the way we operate.

The very objective of the **KSBIP** is to greatly improve the economic situation of hundreds of thousands of Kentuckians, to greatly improve upon the past. The numbers are large (\$4.2 billion investment, 560,000 jobs) because the problem is acute. Using historical data that reflects undesirable performance as an indicator of future possibilities inherently assumes that we cannot do much better than the past. This is pessimistic thinking. The situation in Kentucky calls for optimism, bold action, and challenging goals.

Optimism moves mountains, pessimism maintains an undesirable status quo.

Clarifications

- The "Job Creation and Small Business Development Summary" is now referred to as the **Kentucky Small Business Investment Program (KSBIP)**.
- The **KSBIP** is not solely funded by debt. Debt is used initially to jump-start the program until the surpluses generated by the program are sufficient to finance the rest of the program.
- The current debt ceiling in the program is \$2.0 billion. This ceiling refers to the face amount of the zero-coupon debt, which includes both principal and interest. The actual amount of money to be borrowed will be \$950 million.
- The current job target is 560,000 jobs.
- Simply creating 560,000 jobs will not drive unemployment to 3% in every county. Achieving a 3% unemployment rate in every county within 10 years is a management goal of the **KSBIP**. The purpose of this goal is to ensure that the 560,000 jobs are distributed throughout the Commonwealth. Venture capital investment will be targeted to areas in which the unemployment rate is higher than 3% until the rate reaches the goal.
- The **KSBIP** calls for an average annual investment of \$840 million, not \$500 million, over a 10-year span, approximately half of which would come from investors other than the Commonwealth.
- The documentation showed that a first-year investment of \$20 million would produce 1,333 jobs, not 2,000 as stated in the report.

"The Amount of Venture Capital ... is Substantially Higher than ... Observed in Kentucky"

The LRC report claims that "*the amount of venture capital proposed is substantially higher than that typically observed in Kentucky.*" This is true, but the level of poverty in Kentucky also is substantially higher than we want it to be. The point made by the **KSBIP** is that we are missing a great opportunity to create more jobs by not having more venture capital invested in Kentucky and that if we were to substantially increase the amount of venture capital invested in Kentucky, then we would increase household incomes and substantially reduce poverty.

Raising \$840 million of venture capital annually is a management objective of the **KSBIP**, not an assumption. Also, looking at venture capital committed only in Kentucky is not appropriate. The venture capital funds created by the **KSBIP** will draw capital from the entire country, even the world if possible. A more appropriate measure is venture capital formation in the United States, which varies from \$10-20 billion at the low end as shown in Table 3. Also, Table 2 shows that only \$115 million annually, 1% or less of the U.S. total, is required from private investors. The rest can come from SBIC leveraging.

Narrowly defining the potential for venture capital investment by past investment history in Kentucky is not appropriate. The **KSBIP** will compete nationally and use its start-up financing to attract entrepreneurs and other small businesses from other states. Also, the historical data is dominated by venture capital funds that have a high cost of capital (15-25%). Smaller funds with lower overhead costs and a lower cost of capital will invest in businesses that the larger funds rejected because they were too small or not profitable enough.

A better gauge of the potential for venture capital investment in Kentucky is to look at the number of business plans that are rejected by existing venture capital funds, the number of bank loan requests that are rejected in the United States, and the number of start-ups that did not occur because start-up capital was not available. The latter includes research projects sitting in university labs waiting to be commercialized. Referrals also will come from corporate-backed finance companies, mezzanine financiers, asset-based lenders, and factors. In a broader sense, the potential for venture capital investments is limited only by the imagination and creativity of the people of Kentucky and others across the nation. The **KSBIP** finances the unbridled spirit of Kentucky, and the nation.

"The Gains in Employment ... Are High Relative to Historical Growth and ... Other Estimates"

The LRC report claims that "*the gains in employment that are predicted as a result of this investment are high compared to historical growth and to other estimates of the employment associated with the capital investment.*" The report refers to historical data that shows that over a 10-year period of robust economic growth, Kentucky's economy created an average of 21,000 jobs per year. This data does not include the effect of investing substantial amounts of additional venture capital as in the **KSBIP**. The venture capital investment level in the **KSBIP** averages \$840 million per year. This investment will directly create an additional 28,000 jobs per year without considering a multiplier. A multiplier of only 0.25 will bring the total up to 55,000. The multiplier used in the **KSBIP** analysis is 1.0.

The LRC report refers to the natural rate of unemployment to support the claim that unemployment can never be totally eliminated. The **KSBIP** does not claim to totally eliminate unemployment. The management goal of the **KSBIP** is to achieve a 3% unemployment rate in every county.

Venture capital is high-powered money. It attracts additional investment from other sources because it shoulders much of the risk. For example, a 150-200 seat restaurant can be started with an investment of about \$1.5 million. This amount includes purchasing the land, kitchen equipment, and dining room furniture; constructing the building; and working capital until the operation reaches the cash flow break-even point. Approximately 60% of the investment may be borrowed using assets as collateral, but the remaining 40% must be raised or pledged by the entrepreneur. If the entrepreneur cannot raise the required \$600,000, then the restaurant project will not be implemented.

Venture capital funds created by the **KSBIP** could invest the \$600,000 to make the restaurant a reality. The \$600,000 would attract the additional \$900,000 from traditional lenders. A 150-200 seat restaurant will employ 40-80 people. At the low end, 1 job would have been created for every \$15,000 of venture capital. At the high end, 1 job would have been created for every \$7,500 of venture capital, very powerful indeed. Generally in the venture capital industry, 1 job is directly created for about every \$30,000 of venture capital invested. This is the figure used in the **KSBIP** analysis.

The LRC report mentioned the use of an econometric model that predicted that only 250 jobs would be created by an investment of \$20 million, under the most generous assumptions and including a multiplier effect. This is \$80,000 per job. This is so much higher than venture capital industry experience that one is led to believe that the model did not control for the high-powered nature of venture capital and that "investment" in the model was really total investment. For a \$20 million project, or several projects totaling \$20 million, venture capital would not finance the entire amount, only the unsecured risk portion. If venture capital financed 40% of the investment, then the result would be that 1 job was created for every \$32,000 of venture capital invested, which is close to that which was assumed in the **KSBIP** analysis.

"The Statement 'Unemployment Can ... Be Reduced By Starting One More Business' Is Incorrect"

The LRC report further claims that the statement "*unemployment can always be reduced by starting one more business*" is incorrect because the state would be providing capital for investments that the private markets deemed too risky and the unemployment rate would not be reduced because the businesses may ultimately fail. ***The businesses will reduce unemployment while they are operating.*** Their employees will get paychecks to feed their families, the state will get tax revenue from their earnings and spending, and the state will not have to provide welfare benefits to them. If a business ultimately fails, then another one can be started. The point is not to start businesses that will not fail, but to start businesses to employ people so that they will not have to rely on welfare to feed themselves or their families. They will be able to live better lives and also will be paying taxes.

Human needs and wants are limitless, so there will be demand for new products and services. The limiting factor is the consumer's ability to pay. Investment spending puts money into peoples' pockets through paychecks. The increased tax revenue and reduced government spending that will accompany the **KSBIP** will finance tax cuts to put even more money into their pockets.

The LRC report states that the likelihood of not being able to retire the debt from liquidating the investments is significant and the state would have to cover the cost of the debt. While this could happen, there are many steps that can be taken to ensure that it doesn't. As currently planned, the

KSBIP is financed with 23% debt and the program can sustain a 52% loss and still return enough to pay off the bonds.

To ensure that this loss does not occur, the **KSBIP** venture funds will manage and reduce the risk by providing capital and consulting assistance to the small businesses and by arranging mergers and acquisitions and forming holding companies to avoid business failures. In addition, the state legislature can help reduce the risk by passing measures that will reduce the cost of doing business and the cost of living in Kentucky – measures that will reduce the cost of taxation, regulation, lawsuits, health insurance, and workers compensation.

The worst case scenario is that the venture funds will return nothing to the state. This is highly unlikely; but if it were to occur, the benefits would still be achieved, including the surplus. The bonds could be retired out of the surplus generated by the program. The **KSBIP** will pay for itself even under the worst case scenario.

"The business plans ... targeted ... are those that ... are deemed too risky"

Finally, the LRC report claims that *"the business plans that appear to be targeted by this proposal are those that private investors deemed too risky."* This statement does not take into account the impact that the **KSBIP** will have on business failures. Also, the assumption that the venture capital funds reject business plans because of risk is not entirely accurate. They also may reject plans because they will not yield enough to cover the fund's high cost of capital or simply because a business is just too small.

The **KSBIP** itself will have an impact on the failure rate of small businesses by providing capital to them. Undercapitalization is the number one cause of small business failures. Many small businesses also fail because they do not keep accurate accounting records or because they do not have access to specialized consulting assistance they may need. The venture funds will help ensure that the small business gets the human capital resources it needs, further reducing the probability of failure.

Many of the business plans rejected by the larger venture capital funds may be good investments for a smaller fund with a lower overhead cost and a lower cost of capital. Many venture capital funds have a high cost of capital (15-25%), so potential investments that may be profitable are rejected because they may not be profitable enough. The cost of capital to the funds in the **KSBIP** will be 6-7% for some and 2% or less for others.

Generally, venture capital funds do not want to invest in a business unless they think they will have to invest \$2-3 million ultimately. They spend almost as much time and money monitoring a small investment as they would a large one, so they invest in the businesses that will make their resources the most productive. A venture fund with lower overhead costs will be able to deal with smaller businesses.

Summary

The LRC report claims that the assumptions concerning potential venture capital investment and job creation in Kentucky are unreasonable or optimistic. These are not assumptions, they are management goals of the program. They are large because the unemployment and household income problem that is being addressed is acute in Kentucky. The key assumptions made in the program's analysis are that 1

job will be created for every \$30,000 of direct venture capital investment, 1 additional job will be created for every job created by direct venture capital investment (multiplier effect), each new job created will produce an additional \$1,500 in revenue to the state, and each new job created will reduce welfare spending by \$1,300. These assumptions were not addressed in the LRC report nor were the benefits of the program, not even for a scaled-down version.

The LRC report looks at historical venture capital commitments only in Kentucky and claims that this provides a "sound estimate for the size and scope of potential investment in Kentucky," implying that we cannot do much better than we have already done. This claim is flawed in two major respects. First, looking at the venture capital market only in Kentucky is inappropriate. The start-up financing provided by the **KSBIP** will draw entrepreneurs from other states, possibly from other countries. The venture funds established by the **KSBIP** will compete nationwide, possibly worldwide, so the appropriate markets are the United States' and the global markets. Kentucky's economy is not a closed economy.

Second, the claim is based in part upon the erroneous assumption that venture capital funds reject business plans solely because of risk. Venture capital funds also reject business plans because they may not be profitable enough to return the funds' high cost of capital and because the businesses simply may be too small. These rejected potential investments can be profitable for smaller funds with lower overhead costs and a lower cost of capital.

Also, most venture capital funds rarely invest in start-up companies. There are many university research projects that have commercial potential if they could receive the start-up funding to move from the lab to the marketplace. Also, in general, the potential for start-up companies is limited only by the imagination and creativity of individuals – the unbridled spirit of Kentucky, and the nation/world.

Potential investments rejected by larger venture funds, university research projects, start-up companies, and, in general, the imagination and creativity of individuals nationwide, or worldwide, reflect the potential for venture capital investment. The challenge to the venture funds created by the **KSBIP** is to develop this potential in Kentucky.

In summary, the assumptions that the LRC report claims are unreasonable or optimistic are not assumptions at all. They are managerial goals of the **KSBIP** and are large because the problem that the program is addressing is acute in Kentucky. Kentucky needs an optimistic program at this time with challenging goals if we want to increase household incomes throughout the state and reduce the level of poverty. State participation in venture capital is a growing trend and will become the economic management tool of the future. At least 13 states have moved in this direction. Kentucky has an opportunity to lead the nation into a better world for those who now are struggling to make ends meet.