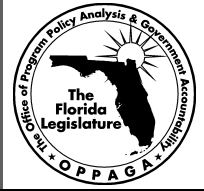




Office of Program Policy Analysis And Government Accountability



John W. Turcotte, Director

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Review of The Enterprise Florida, Inc. Capital Development Board's Cypress Equity Fund

Abstract

- The Cypress Equity Fund achieved its limited goal of initiating venture capital investments by state institutional investors and banks. However, due to the fund's design, it has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital.
- Although the Cypress Equity Fund has not improved Florida businesses' access to venture capital, discontinuing the fund would not benefit the state.

Purpose

Florida law requires the Office of Program Policy Analysis and Government Accountability to review Enterprise Florida, Inc., and its boards. In this report, we review the Capital Development Board's Cypress Equity Fund to assess:

- the appropriateness of the strategy underlying the fund; and
- the fund's progress towards achieving its goals.

This is one of seven reports related to our review of Enterprise Florida, Inc. We will issue three other reports on the Capital Development Board, Technology Development Board, International Trade and

Economic Development Board, and Workforce Development Board. In a sixth report, we will report on our review of Enterprise Florida, Inc.'s, private matching contributions. We will issue a seventh report on our overall assessment of Enterprise Florida, Inc.

Background

Access to venture capital is considered an essential element in stimulating the growth of businesses offering high wage jobs in Florida.¹ In 1995, the Enterprise Florida Capital Partnership, Inc., created the Cypress Equity Fund as part of a strategy to help improve Florida businesses' access to venture capital funding.² The Cypress Equity Fund's purpose was to facilitate initial venture capital investments by Florida private financial institutions and institutional investors, and provide a means to encourage national venture capital managers to consider investment opportunities in Florida. These actions, in turn, were expected to help improve Florida businesses' access to venture capital.

The Cypress Equity Fund was designed as a "fund of funds" that would invest in national private venture capital funds that, in turn, would invest in companies with high potential growth. However, investments

¹ Venture capital refers to the early-stage financing of new companies with high growth potential. Venture capital investments typically have several characteristics, including an investment in a start-up or expansion-oriented company that has a higher level of risk than is typically associated with traditional bank lending activities; equity participation in the business by the venture capitalist; long-term investments with a 5- to 10-year time horizon; and an established mechanism for the payout of the venture capitalist at the end of that time period.

² In 1996, the Legislature replaced Enterprise Florida Capital Partnership, Inc., with the Capital Development Board.

could be made in companies located anywhere in the country and were not targeted to in-state companies. Enterprise Florida, Inc.'s Capital Development Board initially intended to create a second venture capital initiative that would target its investments to Florida companies, but has not developed this fund.

The Cypress Equity Fund obtained \$35.5 million in commitments from five private financial institutions (\$20.5 million) and one public institutional investor, the Florida State Board of Administration (\$15 million).³ As of October 31, 1998, the fund had invested \$10.9 million in 17 national venture capital firms and committed to invest another \$22.2 million. The Cypress Equity Fund Management Corporation, an entity established by the Capital Development Board, is responsible for overall management of the fund. The corporation, in turn, contracts with Abbott Capital Management, a private equity manager, to invest fund assets with national venture capital firms.

Fund operations are financed by an annual management fee of 1% assessed by the corporation against the fund's total commitments of \$35.5 million, or \$355,000 per year. Of this amount, the corporation pays Abbott Capital Management \$250,000 to provide investment management services. The remaining \$105,000 is used to support Capital Development Board activities related to the fund.

Findings

The Cypress Equity Fund achieved its limited goal of initiating venture capital investments by Florida private financial institutions and public institutional investors. However, due to the fund's design, it has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital.

The Cypress Equity Fund was successful in achieving its limited goal of initiating venture capital investments by a major public institutional investor, the Florida State Board of Administration (SBA), and state financial institutions. As noted above, the fund obtained \$35.5 million in commitments from five private financial institutions (\$20.5 million) and the SBA (\$15 million).

³ One of the State Board of Administration's primary responsibilities is investing Florida Retirement System assets. The market value of Florida Retirement System assets was \$83.5 billion as of June 30, 1998.

However, we concluded that the fund has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital. In our prior 1995 and 1997 reports, we expressed concern that the fund's design would result in it being of little benefit to Florida businesses since its investments were not targeted to in-state companies.⁴ In order to obtain the SBA's participation, the fund had to be designed to meet certain conditions, such as having no geographic restrictions on its investments. Our review of other states' business venture capital programs determined that they generally limited investments to in-state, start-up, technology-based companies.

We also concluded that the Cypress Equity Fund was not a factor in the decisions by national venture capital firms receiving fund moneys to invest in specific Florida companies. For example, the Capital Development Board reported that through June 1998, national venture capital companies invested in by the fund had invested in six Florida companies, with cumulative investments totaling \$96 million.

However, these results are not due to the Cypress Equity Fund's existence. We interviewed executives from three of the six national venture capital firms that received Cypress Equity Fund moneys and were reported as investing in Florida companies. None of the executives reported any relationship between Cypress Equity Fund's investments in their firms and their subsequent decisions to invest in Florida companies. We therefore concluded the fund was not a factor in the firms' investment decisions.

Although the Cypress Equity Fund has not improved Florida businesses' access to venture capital, discontinuing the fund would not benefit the state.

Although the Cypress Equity Fund has not improved Florida businesses' access to venture capital, we concluded it would not benefit the state to discontinue the fund:

- The fund's contracts with the SBA and Florida private financial institutions preclude its funds being transferred to other investment media that would more directly invest in Florida businesses.

⁴ *Review of the Enterprise Florida Capital Partnership*, Report No. 95-09, October 1995; *Follow-up Report on the Enterprise Florida Capital Partnership*, Report No. 97-29, January 1998.

- Although the fund incurred start-up costs of \$1.1 million in state funds in Fiscal Years 1995-96, it is currently supported entirely by fees and receives no state funding.
- Executives of fund investors reported to us they believe the fund produces a satisfactory return for a fund of its type and maturity.⁵

If the Legislature adopts the recommendation made in our review of the Capital Development Board to eliminate the board, the Legislature would not need to take any action with respect to the Cypress Equity Fund Management Corporation or Cypress Equity Fund, Ltd., to ensure that the Cypress Equity Fund satisfies its contractual obligations. A three-member board of directors manages the Cypress Equity Fund Management Corporation. The corporation's by-laws permit the existing board to appoint successor directors. Moreover, the corporation receives sufficient fees to support its operations.

Conclusions and Recommendations

The Cypress Equity Fund achieved its limited goal of initiating venture capital investments by state institutional investors and banks. However, the fund was not designed to target in-state investments. As a result, it has not contributed to the achievement of its more important goal of improving Florida businesses' access to venture capital.

However, it would not benefit the state to discontinue the fund. Given the fund's contracts, commitments and investments made to the fund by the SBA and Florida private institutional investors could not be readily transferred to other investment media that would target investments to Florida companies. The fund is also supported entirely by fees and currently receives no state funding.

We recommend that the Legislature take no action with respect to the Cypress Equity Fund. However, if the Legislature implements our recommendation made in our review of the Capital Development Board to discontinue the board, the board, prior to its expiration, should amend the Cypress Equity Fund Management Corporation's charter and by-laws to permit transfer to

Enterprise Florida, Inc. or another entity responsibility for appointing the corporation's board of directors.

Agency Response

The Director of Operations offered the following response.

We agree with your recommendation that the Cypress Equity Fund should continue to operate as it is currently organized. As you have stated, the Cypress Equity Fund achieved its goal of initiating venture capital investments by state institutional investors and banks.

An outgrowth of this initiative was the introduction of the State Board of Administration (SBA) to this asset class. Subsequently, the SBA has significantly increased its venture capital investments.

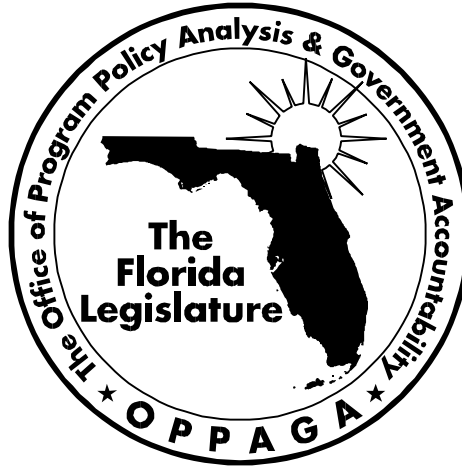
Although the intent of the Cypress Equity Fund was not to directly improve Florida businesses' access to venture capital, we are hopeful that some Florida companies will continue to benefit from direct investments as a result of its existence.

Sincerely,

William C. Jones
Director of Operations
Enterprise Florida Capital Development

⁵ Venture capital investments are usually made on a long-term basis (up to 10 years) and the venture capital investor's final return on investment is usually not determined until the end of that period. During the period from Fiscal Year 1995-96 through Fiscal Year 1997-98, the State Board of Administration contributed a total of \$4,443,302 to the Cypress Equity Fund. The market value of these investments was \$4,379,656 as of June 30, 1998.

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