

Q&A re: Government sponsored venture capital funds, a practitioner's guide

Q: What is a Government sponsored venture capital fund? Why is it an interesting vehicle especially in these times of global financial distress?

A: A Government sponsored venture capital fund is a privately managed venture capital fund whose anchor investor is a government that initiated the formation of the fund. Such fund's other investors are typically investors from the private sector (the "private investors"). This is the reason this fund is a type of a private-public partnership. The fund serves a dual purpose of fulfilling an economic goal desired by the government (such as stimulating high-tech start-ups) while generating a satisfactory rate of return to its private investors.

The fund enables the Government to deploy a larger pool of capital (compared to its own direct commitment in the fund) toward the desired economic activity. Not only is the government commitment to the fund augmented by the commitments of the private investors, but also, the fund itself may generate co-investments by such private investors or third parties that may considerably increase the "firepower" of the fund. In this way, the Government gets "more bang for its buck" and reduces the line item cost of a public project. Another advantage to the Government is the potential to recuperate its investments in the fund through the fund's distributions to the Government, such that the sponsorship of the fund by the Government may end up not burdening the Government's budget in the long term obviously, the Government may even receive a return on its investment in the fund but that is typically a minor consideration from the Government's point of view).

During the current times of financial distress these funds are especially interesting for Governments to consider because these funds enable Governments to stimulate a range of desired economic activity while minimizing the burden of such stimulus on the public budget.

Q: What are the advantages of a Government sponsored fund to the private investors and the management team?

A: As discussed below, the terms of such a fund will typically include some form of subordination of the economic rights of the Government to the economic rights of the private investors (referred to as the "Government benefit"). The main reason for the grant of the Government benefit is that in practice the Government will sponsor a venture capital fund in circumstances in which a market failure occurs and the private investors will demand the Government benefit as a pre-condition to their investment to compensate them for the risk they are taking in investing under such circumstances. Depending on the manner this benefit is structured, it either increases the likelihood of the fund achieving satisfactory returns to the private investors, or decreases the risk of loss on their part (or leads to a combination of the former and the latter); in any event, the Government benefit enhances the appeal of the fund to the private investors.

From the management team perspective, the obvious advantage is the presence of an anchor investor (the Government) that is highly motivated to assist in the formation and eventual success of the fund.

Q: What are some examples of Government sponsored funds?

A: Government authorities in the UK, Australia and New Zealand all sponsored venture capital funds – for more information see Maula, Murray & Jääskeläinen (2007), Public Financing of Young Innovative Companies in Finland, Ministry of Trade and Industry, Finland. The following are several examples from Israel:

- (i) YOZMA (1993-1997)– an Israeli Government initiative that formed a number of venture capital funds that in essence were the driving force behind the creation of the Israeli high tech industry (which won for Israel the nickname "Start-Up Nation").
- (ii) The "Manof Funds" (2009) - a number of large mezzanine funds designed to stimulate the Israeli credit markets in the wake of the 2008 global financial crisis (note that this is an example of a Government sponsored

fund that is not a venture capital fund, however most of the observations made in this note are relevant to such a fund).

(iii) The “Minority Fund” (2010) - a private equity/venture capital fund designed to invest in minority owned businesses in Israel.

(iv) Bio-Technology Fund (2011) – a venture capital fund designed to facilitate the growth of the Israeli bio-technology industry.

Q: What are some typical terms of Government sponsored venture capital funds?

A: The underlying theme in structuring the fund is to ensure that the fund resembles a standard private venture capital fund to the utmost extent possible (subject to the aforementioned grant of the Government economic subordination in favor of the private investors, commonly referred to as the “Government benefit”). The more “standard” the terms are the easier the capital raising process will be because such “standard” terms will promote the investor community’s comfort level with the fund.

Another overarching principle is to attempt to strike a balance between: (a) pro-manager terms in order to attract top managers to consider managing the fund, and (b) pro-investor terms in order to assist in capital raising.

In fact, to the extent the Government team determines the terms of the fund, such team is placed in a unique situation of playing out hypothetical negotiation discussions that result in the team’s determination of “middle of the road” terms. Another possibility is for the Government team to take a “hands-off approach” and let the selected management team determine the terms based on a standard negotiating process with the investors (as is the case with standard privately sponsored venture capital funds). The pros and cons of each possibility are numerous and vary depending on the specific facts and circumstance of any given fund, however we can point out that the former approach (i.e, terms determined by the Government team) facilitates a competitive process among the potential management teams vying for the management of the fund, while the latter approach (i.e., the “hands off approach”) hinders such competitive process.

Composition of Management Team:

The key to success of the fund is the selection of a top notch management team to manage the fund. Therefore the fund formation process should include a selection process geared to select the best possible management team from the venture capital community. Based on our experience we would recommend selecting an experienced management team that has managed funds as a team in the past and was not assembled ad-hoc for the purpose of managing the specific new fund. Similarly, the management selection process should restrict to the bare minimum requirements as to the composition of the management team so as to keep the “organic” management team as intact as possible; on the other hand, certain composition requirements may be needed due to the special nature of the specific new fund (such as the geographic location of key members of the management team).

Governance:

The fund should be based on the classic venture capital fund governance structure: an active management team that manages the fund and passive investors (including the Government).

The fund should be set up in a way that makes it clear that the Government sponsor will “step aside” as soon as the fund is formed and will enable the management team to fully take over the management of the fund. Similarly, the management team should be made fully responsible for the results of the fund. Practical ways of ensuring this sense of responsibility include making the name of the fund match the names of prior funds managed by the management team, and having the management team commit to include the track record of the specific fund in future capital raising offering documents of the management team’s future funds.

Revenue Distribution:

Again, the fund's distribution provisions should be based on the standard venture capital fund distribution waterfall, i.e., 1st tier capital return, 2nd tier preferred return (or "hurdle"), 3rd tier GP catch-up, and 4th tier 20%/80% distribution (i.e., 80% of the remaining distributions to the limited partners and 20% to the general partner). To the extent permitted under relevant law, we would recommend modifying the aforementioned distribution waterfall by granting the private investors a Government benefit for the reasons mentioned above.

This Government benefit can take a variety of forms, including:

(1) "Downside Protection" to the private investors which is followed by a "catch-up" mechanism in favor of the Government. Under this form of Government benefit, only the private investors (and not the Government) participate in the 1st tier (capital return) of the fund's distribution waterfall and the Government receives its capital return after the private investors receive their invested capital in full. A variant of this mechanism is to extend the Government benefit so that the Government begins to receive its share of the fund's distributions only after the private investors receive their invested capital as well as their preferred return in full. Another variant is to have the Government participate in the fund's distributions together with the private investors from the first dollar of distributions but at a lower ratio of participation than its pro-rata share. In any event, once the private investors have fully received their pro-rata portions of the 1st tier (capital return) and 2nd tier (preferred return) of the distribution waterfall, the Government can receive the amount of distributions necessary to make it whole so that it would receive its full pro-rata share of the 1st tier and 2nd tier of the distribution waterfall. In some cases, the Government would be willing to completely forgo a portion of its pro-rata share of such distributions in order to incentivize the management team; and

(2) "Upside Sharing" by the Government with the private investors of the Government's pro-rata portion of the 4th tier of the distribution waterfall (the 80%/20% tier) so that the private investors receive a larger portion of the 4th tier distribution than their pro-rata share. Again, there are several variants of this "Upside Sharing" that can be considered: what portion of its pro-rate distributions is the Government willing to forgo? Is the size of such portion dependent on the rate of return achieved by the Government? One can even consider having the management team, and not only the private investors, benefit from the "Upside Sharing".

An interesting consideration here is whether or not to prevent the dilution of the Government Benefit as the fund size increases and the Government pro-rata portion of the commitments to the fund decreases. One way of achieving this result is by increasing the portion of the distributions relinquished by the Government as the proportion of the private investors' commitments to the fund increases (and the proportion of the Government commitments to the fund decreases).

Investment Guidelines:

The investment guidelines of the fund are a key component of the fund terms as such guidelines must balance between (a) the Government's desired economic goals that led the Government to sponsor the fund in the first place, and (b) the central goal of the management team and private investor to maximize returns.

The Government can require certain pre-determined investments guidelines, such as: (1) the geographical location of the portfolio companies, (2) the type of technology developed by the portfolio companies, and (3) the stage of maturity of the portfolio companies.

Alternatively, the Government may decide to leave the managers some or full latitude as to one or more of these guidelines. However, even the most flexible approach must ensure that the fund's investment policy is in line with the Government's desired economic goals.

Q: In what manner can the Government select the management team and form the fund?

A: Again, the key to success of a Government sponsored fund is the quality of the management team. The private investor's perception of such quality will be critical in the fund raising stage of the fund. For example, a highly regarded management team with a stellar track record will probably be able to "round up" a considerable amount of capital for its investor base (i.e., investors in past or current venture capital funds managed by this team). There are two possible approaches to selecting the management team and determining the terms of the fund:

The first approach is the "informal" approach in which the Government team can hire a boutique investment bank or broker in the relevant venture capital community to reach out informally to potential management teams and begin a dialogue with the Government. This dialogue can result in an agreement of the basic terms of the fund (some of which are summarized above) to be followed by a fund raising effort by the relevant management team. The advantage of this method is that the Government team can benefit from a free flow of information and feedback from the potential management teams that can help in optimizing the terms of the fund and the selection process of the management team. However, this approach is vulnerable to abuse (such as corruption) and in certain jurisdictions and circumstances may not be available under applicable public procurement (sometimes called "tender laws") laws.

The second approach is the "formal" approach, which is often mandated by public procurement laws. Under this approach, the government team launches a formal selection process of the management team that will manage the fund. This process is conducted by way of a public tender and is strictly regulated by law. Usually, the basic terms of the fund are published as part of the tender documents without the ability of the tender bidders to discuss or negotiate these terms with the Government. For that reason, the Government team should conduct in-depth research as to the optimal tender process terms and fund terms prior to the publication of the tender documents. While this approach has the advantage of being less prone to abuse, it is burdened by formal requirements and restrictions that are more appropriate to a public procurement scenario than to the more fluid context of the formation of a privately managed venture capital fund.

Q. Can you please sum this all up?

A: In sum, the Government sponsored venture capital fund model is a compelling model in these times of financial distress, limited government budgets, and the general impression that Governments should intervene to correct market failures in order to improve the economic outlook. However, structuring these funds and selecting the best possible management teams from the private sector are complicated tasks that should be handled with due consideration.