Special Report
Arkansas Legislative Audit

Review of Investment Activity Related to the Venture Capital Investment Act of 2001
Arkansas Development Finance Authority

For the Period April 19, 2001 through December 31, 2015

INTRODUCTION

The Venture Capital Investment Act of 2001 (the Act) authorized the Arkansas Development Finance Authority (ADFA) to increase the availability of funding for high-risk, emerging businesses that may not be able to obtain conventional financing for the purpose of strengthening the State's economic base. The Act required ADFA to select a private investor group to raise and invest capital within the terms of the Act. ADFA pursued this activity through the creation of the Arkansas Venture Capital Investment Trust (Trust) and the Trust's subsequent creation of the Arkansas Institutional Fund (AIF). The Trust's investment activities related to the Act were administered through AIF by a contracted investment manager and financed by a line of credit from a financial institution. This line of credit was secured, first, by $10 million from the ADFA Bond Guarantee Reserve Fund and, second, by $60 million in transferable state income tax credits. This report is issued at the request of the Legislative Joint Auditing Committee to review the Trust's investment activities related to the Act. At December 31, 2015, the net position of the related investment activities was negative $7.6 million. Again, this report only discusses the Trust's investment activities related to AIF and does not include the other financial activities of the Trust.

OBJECTIVES

The objectives of this report were to:

- Provide detail regarding fees and bonuses paid to the Trust's AIF contracted investment manager.
- Review activity related to the Trust's current line of credit with a financial institution used to fund investments encouraged by the Act.
- Review the investment activities of the Trust as related to the Act.
- Provide the status of the $60 million in transferable state income tax credits issued to guarantee activities of the Trust authorized by the Act.
- Describe the current status and recently reorganized management structure of the Trust's investments as related to the Act.

SCOPE AND METHODOLOGY

The review was conducted from the passage of the Venture Capital Investment Act of 2001 through December 31, 2015. Arkansas Legislative Audit (ALA) staff analyzed related Arkansas Code, ADFA records, and financial audit reports and conducted interviews with ADFA personnel.

ARKANSAS LEGISLATIVE AUDIT
500 Woodlane Street, Suite 172, Little Rock, AR 72201
Phone: 501-683-8600 • Fax: 501-683-8605
www.arklegaudit.gov

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The methodology used in preparing this report was developed uniquely to address the stated objectives; therefore, this report is more limited in scope than an audit or attestation engagement performed in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

BACKGROUND

The Arkansas Development Finance Authority (ADFA) was created by Act 1062 of 1985, which dissolved the former Arkansas Housing Development Agency and transferred all its powers and duties to ADFA. ADFA's primary role is to provide affordable public financing through the issuance of tax-exempt bonds and other debt instruments for needed projects, primarily in the areas of economic development, homeownership, and affordable rental housing.

The Arkansas Venture Capital Investment Act of 2001 (the Act) was enacted with the stated purpose of increasing the availability of "capital for emerging, expanding, relocating, and restructuring enterprises in the state...to help strengthen the state's economic base and create jobs." To meet the objectives of the Act, a public trust was created. The Arkansas Venture Capital Investment Trust (the Trust) was created for the purpose of holding the ownership of investments related to the Act. According to ADFA, this step was necessary to comply with the Arkansas Constitution, which prohibits the State from owning equity in a corporation (Ark. Const. art. 12, § 7). Ark. Code Ann. §§ 28-72-201 – 28-72-207 provides the authority for the creation of public trusts. ADFA is designated as the beneficiary and serves as the administrator of the Trust. Trustees consist of the following:

- ADFA President.
- Department of Finance and Administration (DFA) Director.
- Arkansas Economic Development Commission Executive Director.

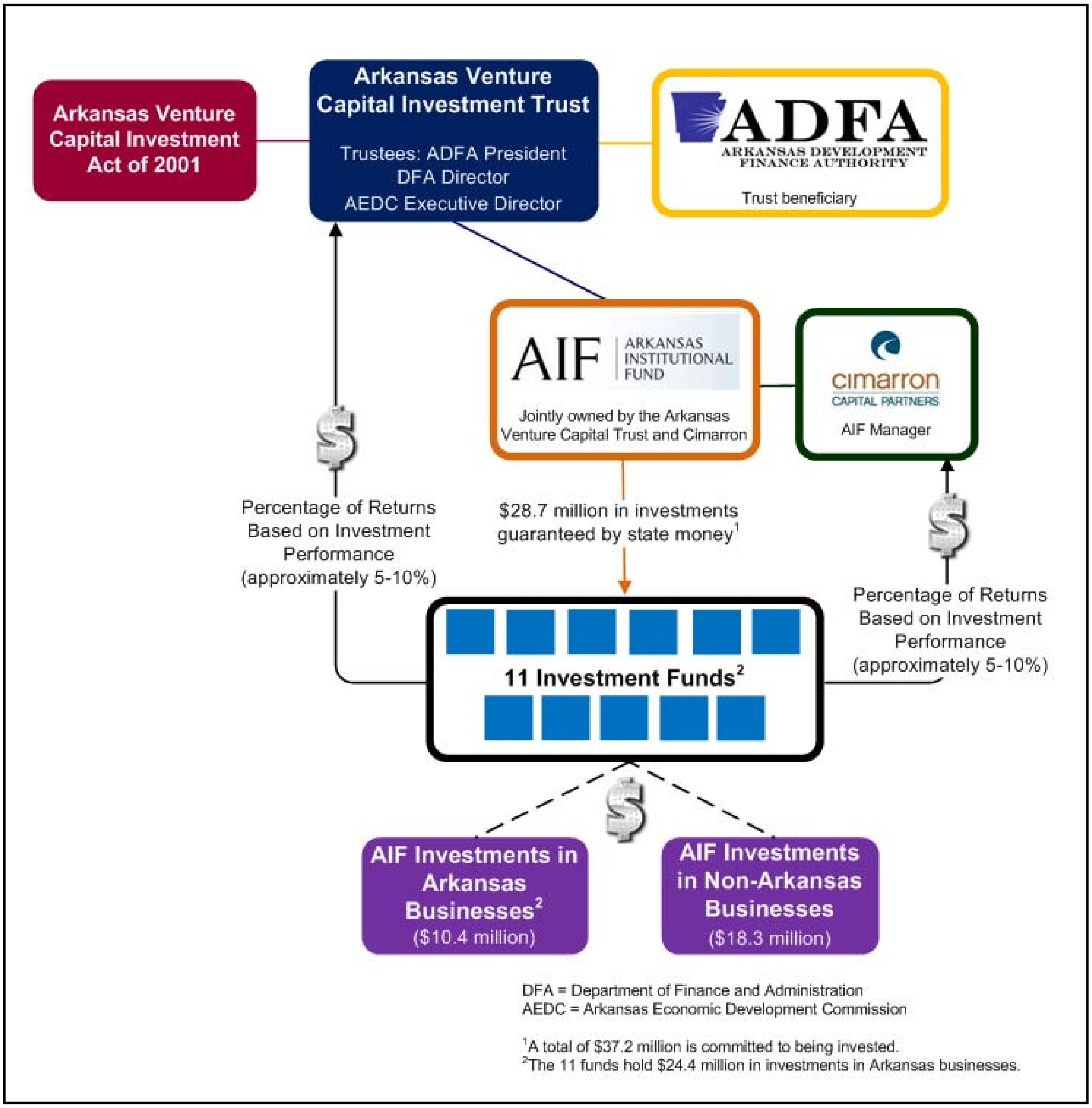
In 2002, ADFA selected an investment management firm, Cimarron Capital Partners, LLC (Cimarron), through the State's Request for Proposal (RFP) process, to identify investment opportunities for the Trust related to the Act. Subsequently, the Trust formed Arkansas Institutional Fund, LLC (AIF), a joint limited liability corporation, with Cimarron. Returns on investment in AIF are shared between the Trust and Cimarron based on mutually agreed-upon percentages of tiered returns. Cimarron's share of returns ranges from approximately 5% to 10% based on investment performance. This relationship is illustrated in **Exhibit I on page 2**.

A line of credit (current maximum borrowing capacity of $43.5 million) was established with a financial institution to provide cash for AIF's investment activities, with the expectation that returns on the investments would eventually (a) diminish the necessity of the line of credit, (b) eliminate the potential need for the sale of the tax credits, and (c) produce growth in Arkansas enterprises at no direct cost to taxpayers. The state assets pledged to obtain the line of credit total $70 million. The $70 million in collateral consists of $10 million from the ADFA Bond Guaranty Reserve Account and $60 million in transferable state income tax credits authorized by the Act. The line of credit balance as of December 31, 2015, was $24.2 million and has a $43.5 million maximum borrowing capacity. To date, no collateral has been expended.

As of December 31, 2015, ADFA terminated Cimarron as fund manager of AIF. The Trust was named the replacement fund manager of AIF and began the process of forming a new LLC for

Exhibit I

Activity Related to the Venture Capital Investment Act of 2001
April 19, 2001 through December 31, 2015



Source: *Arkansas Development Finance Authority (unaudited by Arkansas Legislative Audit)*

future investment activities of the Trust related to the Act. The Trust does not have staff. Thus, the Trust is in the process of finalizing an administrative services agreement with ADFA that will outline specific tasks ADFA will perform on behalf of the Trust. Ownership of investments made by AIF prior to 2016 continue to be shared with Cimarron as outlined in the AIF agreement between ADFA and Cimarron in the event the fund manager was ever terminated.

INVESTMENT MANAGER FEES AND BONUSES

In 2002 and again in 2009, ADFA selected Cimarron as the investment manager of its venture capital activities through the State's RFP process. Compensation to Cimarron, outlined in the contract, consisted of a $350,000 annual management fee payable in quarterly installments as well as the following performance-related bonuses:

- **In-State Investment bonus:** $5,000 payable for every $500,000 (or 1%) of venture capital invested directly or indirectly in or from an Arkansas business. This bonus is capped at a maximum of $65,000 per year, with any additional bonuses earned carried forward to the next year. No additional bonuses related to in-state investment are expected to be paid to Cimarron.

- **Business Plan Development bonus:** A one-time bonus of $200,000, paid in 2004, upon delivery of a completed startup business plan specifying AIF's mission and goals, investment and strategic objectives, target asset allocation, marketing plan, proposed funding mechanism, and budget.

- **Funding Mechanism bonus:** A one-time bonus of $50,000 (of a maximum $200,000), paid in 2005, upon delivery of closing documents on initial funding from a line of credit and the commitment of a financial institution to purchase the state tax credits.

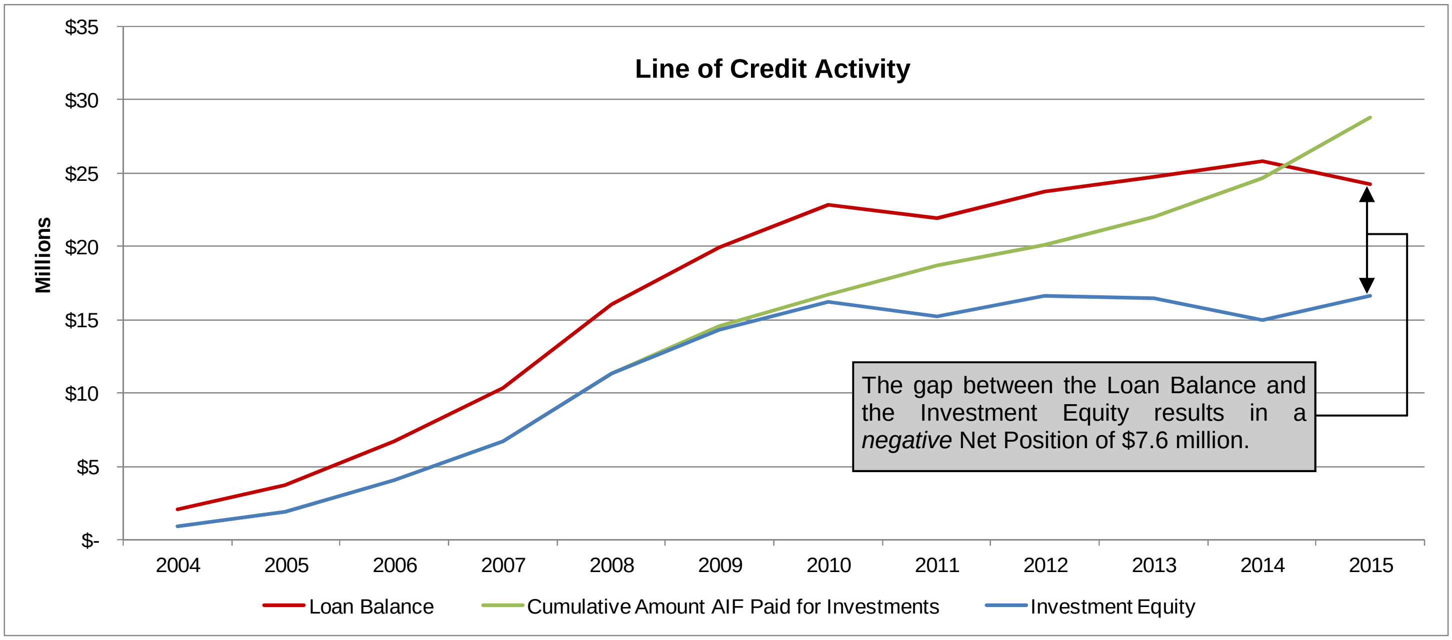
In addition, Cimarron retains part ownership in the investments made with AIF funds and receives approximately 5% to 10% of AIF's net earnings through shared ownership with the Trust based on a tiered plan. Conversely, Cimarron is contractually limited to maximum investment losses of $100,000. As shown in **Schedule 1 on pages 8 and 9**, annual management fees and performance bonuses paid to Cimarron from AIF's start up in 2003 through December 31, 2015, totaled $5.1 million (approximately $4.2 million for management fees, $824,990 for bonuses, and $103,000 in shared net earnings). Additional management fees may have been paid during AIF's start-up phase; however, these fees could not be determined, according to current ADFA management, due to the routine destruction of financial records over time.

LINE OF CREDIT ACTIVITY

At December 31, 2015, the AIF line of credit with a financial institution had a maximum borrowing limit of $43.5 million and a drawn balance of $24.2 million. The line of credit is collateralized by two sources: $10 million from ADFA's Bond Guaranty Reserve Account and $60 million in transferable state income tax credits authorized by the Act. Funds from the line of credit were used to make investments related to the Act, pay investment manager fees related to AIF, and make accrued interest payments on withdrawals against the line of credit. As detailed in **Exhibit II on page 5**, at year end, $24.2 million had been drawn against the $43.5 million line of credit. As designed, when AIF investments return capital and distribute earnings, that money is used to pay down the balance drawn on the line of credit.

Exhibit II

Arkansas Institutional Fund (AIF)
Line of Credit Activity and Net Position
At Calendar Year-End 2004 through 2015



Calculation of Net Position

Investments made by AIF through December 31, 2015	$28,743,922
Less Return of Capital	(7,999,555)
Less Investments Impaired	(4,128,539)
Investment Equity	16,615,828
Less Loan Balance at December 31, 2015	(24,228,567)
Net Position of Investments	($7,612,739)

Source: *Arkansas Development Finance Authority (unaudited by Arkansas Legislative Audit)*

At December 31, 2015, the interest rate on the line of credit was 2.95%. The current interest rate is based on the London Interbank Offered Rate (LIBOR), a widely-used benchmark for short-term interest rates, plus 2.25%, with a minimum of 2.95% regardless of LIBOR. The highest rate incurred was 6.75% in 2006. From 2003 through 2015, interest expense totaled $6.5 million.

FUND INVESTMENT ACTIVITY

AIF invests in venture capital investment funds using a “Fund of Funds” model to reduce investment risk. This model works much like a mutual fund: Money from multiple investors is pooled into funds that, in turn, invest in stocks or similar assets. AIF has invested or committed to invest in 11 such funds that then invest in the stock of private operating companies, as illustrated in **Exhibit I on page 3**, and these investment funds have pledged to seek to invest in Arkansas businesses as opportunities arise but without specific requirements for investments in the State.

At December 31, 2015, AIF had invested $28.7 million and committed to invest a total of $37.2 million in these 11 venture capital investment funds, identified in **Schedule 2 on page 10**. As of December 2015, 7 of these 11 investment funds had directly invested $24.4 million in Arkansas businesses. Investments from these 7 funds create the potential for additional investments and loans for Arkansas businesses that might not have been available otherwise. Through fiscal year 2014, Cimarron estimated that $32.9 million in additional investments and $19.5 million loans were made available to Arkansas companies as a result of AIF investments. **Schedule 3 on page 11** provides a listing of Arkansas companies receiving AIF investments at December 31, 2014.

TRANSFERRABLE STATE INCOME TAX CREDITS

As previously discussed, to provide initial cash resources for investments, AIF obtained a line of credit from a financial institution, with $10 million collateralized by ADFA’s Bond Guaranty Reserve Account (Bond Account) and $60 million guaranteed by transferable state income tax credits. The use of future tax credits as collateral was intended to eliminate the immediate negative impact of income tax credit claims against state revenues.

The Bond Account was created by Act 505 of 1985 to enhance the creditworthiness of debt instruments guaranteed by ADFA. The program’s revenue is derived from (a) guaranty fees collected, (b) interest earned on investments, and (c) proceeds from the sale of development revenue bonds. AIF pays the ADFA Bond Guaranty Fund $50,000 per year as compensation for the use of the Bond Account as collateral.

If AIF incurs losses and is unable to increase the line of credit to cover losses, the Bond Account is responsible for covering the first $10 million in losses. The transferable state income tax credits may then be sold to cover any additional losses. The Act limits the amount of related credits that can be sold to $10 million per state fiscal year. ADFA has established purchase contracts with several Arkansas income tax payers to purchase the credits at par value and also has the ability to competitively market the credits, if necessary.

If the venture capital investments were required to be liquidated, their market value would be difficult to ascertain due to their volatility and the relative illiquid nature of the investments. However, the worst case scenario would result in 100% loss of investment value. Based on 2015 amounts, the State would realize a maximum loss over time to General Revenue of $14.2 million (AIF liabilities of $24.2 million less $10 million secured by the Bond Account), not to exceed $10 million per fiscal year.

CURRENT STRUCTURE OF THE FUND

As previously stated, ADFA terminated Cimarron as fund manager of AIF on December 31, 2015. The Trust was named the replacement fund manager of AIF and began the process of forming a new LLC for future investment activities related to the Act. The Trust is in the process of finalizing an administrative services agreement with ADFA that will outline specific tasks ADFA will perform on behalf of the Trust. Ownership of investments made by AIF prior to 2016 continue to be shared with Cimarron as outlined in the AIF agreement between ADFA and Cimarron in the event the fund manager was ever terminated.

CONCLUSION

The Act was successful in bringing new venture capital funds to Arkansas. To date, the use of the Bond Account and transferable state income tax credits as collateral to establish a line of credit to provide initial cash for investments has been successful in minimizing the cost of the investments to the State. In addition, no collateral has yet been expended. However, four areas of concern are identified below.

1. If the performance of AIF investments does not continue to improve, the solvency of the Trust will become at-risk. The current maximum borrowing capacity of the line of credit ($43.5 million) has not been reached, thus allowing the Trust or its agent to seek additional Arkansas investments and continue to pay investment manager fees and interest expenses with proceeds from the line of credit. However, if investment returns do not improve over the long-term, the line of credit will be exhausted, resulting in the call on the line of credit's collateral, the sale of the corresponding tax credits, and fewer General Revenue dollars for the State's operations.

2. The contract with Cimarron has proven not to be as advantageous for the State as it has for Cimarron. In exchange for Cimarron's services (i.e., establishing a line of credit with a financial institution and directing investment dollars to 11 venture funds), AIF paid Cimarron $5.1 million in manager fees and bonuses from January 1, 2003 through December 31, 2015. In addition, Cimarron has retained part ownership in the investments made by AIF, with the percentage of returns based on investment performance (ranging from 5% to 10%), and contractually limited Cimarron's share of investment losses to $100,000. The result of Cimarron's efforts left AIF with a $24.2 million bank loan at December 31, 2015, and investment equity of $16.6 million, for a net position of *negative* $7.6 million.

3. ADFA was created and is funded by the General Assembly. The Trust was created by ADFA, and the trustees of the Trust are appointed based upon the positions they hold as state employees. The Trust created AIF. Therefore, ADFA's investment relationship with AIF through the creation of the Trust and ADFA's subsequent assumption of administrative and investment management services of AIF under the direction of the Trust may conflict with Ark. Const. art. 12, § 7, which prohibits the State from owning equity in a corporation. ALA staff recommend ADFA seek an Attorney General's opinion regarding the propriety of this relationship.

4. A potential $60 million contingency exists to the State resulting from transferable tax credits created by the Act. These transferable tax credits will only be executed in the event that AIF incurs losses that are not covered by its line of credit or by $10 million from ADFA's Bond Guaranty Reserve Account. The Act also limits the amount of related credits to $10 million per year. DFA has already disclosed this potential contingency in the notes to the financial statements of the DFA departmental audit and also plans to disclose it in the State's Comprehensive Annual Financial Report.

Schedule 1

Arkansas Institutional Fund (AIF)
Investment Returns and Related Expenses
January 1, 2003 through December 31, 2015

Calendar Year	Amount AIF Paid for Investments	Return of Capital	Investment Impairment	Cumulative Net Investment Equity at Dec 31	Investment Income *(Note 2)*	Investment Manager Annual Fees
	a	b	c	d = a - b - c	e	f
2003						(Note 1)
2004	$ 880,000			$ 880,000		$ 350,000
2005	997,000			1,877,000		350,000
2006	2,143,500			4,020,500		350,000
2007	2,719,245			6,739,745		350,000
2008	4,586,875			11,326,620		350,000
2009	3,219,313	$ 199,997		14,345,936		350,000
2010	2,131,250	249,247		16,227,939		350,000
2011	1,988,538	2,973,811		15,242,666	$ 1,005,346	350,000
2012	1,441,000	19,104		16,664,562	872,352	350,000
2013	1,883,044	915,649	$ 1,172,058	16,459,899	1,267,352	350,000
2014	2,696,908	1,566,790	2,644,537	14,945,480	1,421,132	350,000
2015	4,057,249	2,074,957	311,944	16,615,828	4,786,576	350,000
Totals	**$ 28,743,922**	**$7,999,555**	**$4,128,539**	**$16,615,828**	**$9,352,758**	**$4,200,000**

Continued on page 9

Schedule 1
(continued)

Arkansas Institutional Fund (AIF)
Investment Returns and Related Expenses
January 1, 2003 through December 31, 2015

Investment Manager Bonuses Earned *(Note 3)*	Interest Expense	Total Investment Related Expenses	Investment Income Less Related Expenses	Loan Balance at Dec 31	Interest Rate
g	h	i = f + g + h	j = e - i	k	l
$ 200,000		$ 200,000	($ 200,000)		
8,000	$ 52,763	410,763	(410,763)	$ 2,093,048	3.54%
59,502	270,169	679,671	(679,671)	3,716,608	5.54
18,500	496,806	865,306	(865,306)	6,708,950	6.75
13,000	658,422	1,021,422	(1,021,422)	10,329,431	5.93
8,500	515,053	873,553	(873,553)	16,037,798	2.14
87,768	236,993	674,761	(674,761)	19,893,371	2.50
58,977	571,060	980,037	(980,037)	22,820,262	3.00
37,500	757,120	1,144,620	(139,274)	21,947,283	2.95
190,535	640,806	1,181,341	(308,989)	23,772,976	2.95
34,437	759,419	1,143,856	123,496	24,766,830	2.95
36,721	754,546	1,141,267	297,865	25,782,207	2.95
71,550	756,960	1,178,510	3,608,066	24,228,567	2.95
$824,990	**$6,470,117**	**$11,495,107**	**($2,142,349)**	**$ 24,228,567**	

Note 1: Additional management fees may have been paid prior to 2004; however, according to current management, these fees could not be determined due to the routine destruction of records over time.

Note 2: The fiscal year 2015 amount includes $103,000 in Cimarron investment income.

Note 3: The bonus is capped at a maximum of $65,000 per year, with any additional bonuses earned carried forward to the next year.

Note 4: Indirect revenues and expenses (e.g., bond guarantee and professional fees) are not included because they are immaterial.

Note 5: Investment income loss of $2.1 million plus investment impairments of $4.1 million plus approximately $600,000 in annual bond guarantee fees paid by AIF to ADFA ($50,000 x 12 years) plus approximately $800,000 in other expenses (e.g., legal and audit fees) equals the *negative* $7.6 million net position reported in **Exhibit II on page 5**.

Source: *Arkansas Development Finance Authority (unaudited by Arkansas Legislative Audit)*

Schedule 2

Arkansas Institutional Fund (AIF)
Amounts Invested and Committed to Invest in Venture Capital Funds
At December 31, 2015

Venture Capital Fund Name	Total AIF Investment in Venture Capital Fund	Total AIF Committed to Invest in Venture Capital Fund	Total Venture Capital Funds Invested in Arkansas Businesses	Maximum Amount AIF invested in Arkansas Businesses
Fulcrum Growth Fund QP II, LLC	$ 3,187,051	$ 4,000,000		
Fund for Arkansas Future, LLC	100,000	100,000	$ 5,546,958	$ 100,000
Fund for Arkansas Future II, LLC	80,000	100,000	3,378,099	80,000
MB Venture Partners, LLC	4,000,000	4,000,000		
Meritus Ventures, LP	2,000,000	2,000,000	1,393,090	1,393,090
Noro-Moseley Partners VI, LP	5,000,000	5,000,000	4,156,667	4,156,667
Noro-Moseley Partners VII, LP	1,875,000	5,000,000		
Petra Growth Fund II	2,250,000	4,500,000	5,168,154	2,250,000
Prolog Capital Partners II, LP	4,463,520	4,500,000		
SSM Venture Partners III	3,720,000	4,000,000	800,000	800,000
Technology Operators Fund II	2,068,351	4,000,000	4,000,000	2,068,351
Totals	**$28,743,922**	**$37,200,000**	**$24,442,968**	**$10,848,108**

Source: *Arkansas Development Finance Authority (unaudited by Arkansas Legislative Audit)*

Arkansas Institutional Fund (AIF)
Investments in Arkansas Businesses at December 31, 2014

Company Name	City	Description
BRI/Mach	Bentonville	open price point goods supplier
Red Clay	Bentonville	crowd sourced product design
Arkansas Automatic Sprinklers	Cabot	fire protection sprinklers
Acumen Brands	Fayetteville	retail ecommerce websites
BioDetection - Vir, Inc.	Fayetteville	pathogen detection device
BlueInGreen	Fayetteville	water purification systems
Btiques	Fayetteville	web hub for boutique shops
DataRank (TTAG)	Fayetteville	social analytics for products
Duralor **(Note 1)**	Fayetteville	nano particle coatings
Movista (Merchant View)	Fayetteville	IT systems for retailers
NanoMech - Vir, Inc.	Fayetteville	nano manufacturer
Qbox (StackSearch)	Fayetteville	web data search and analytics
SFC Fluidics - Vir, Inc.	Fayetteville	microfluidic instrumentation
The Ark	Fayetteville	business incubator/accelerator
The Ark II	Fayetteville	business incubator/accelerator
Vegrandis - Vir, Inc. **(Note 2)**	Fayetteville	medical diagnostic device
Balm Innovations	Little Rock	skin care products
Bourbon and Boots	Little Rock	internet etailer
Ceton	Little Rock	cable TV hardware and software
Collision Hub	Little Rock	auto collision industry web
EZRA Innovations	Little Rock	drug development technology
Infusion Marketing	Little Rock	bank cross marketing
Labscoop	Little Rock	sales of lab equipment
Rx Results	Little Rock	prescription management
Treatsie	Maumelle	internet curated food collections
National Medical Solutions	Pine Bluff	wound care clinic
Vivione Biosciences	Pine Bluff	bioscience
WellNow Urgent Care	Searcy	health care clinics
Patriot BioFuels	Stuttgart	bio fuel producer

Note 1: Merged into NanoMech in 2010.
Note 2: Merged into SFC Fluidics in 2012.

Source: *Arkansas Institutional Fund (AIF) Annual Report - January 1, 2014 through December 31, 2014 (unaudited by Arkansas Legislative Audit)*