

Innovation and new jobs for Connecticut

Incentives for Private Funding of Entrepreneurs

Leveraging private dollars to create jobs and keep
Connecticut competitive with other states in attracting new
high growth firms

Recently in the news

COMMERCE COMMITTEE FORUM ON ENCOURAGING ENTREPRENEURIAL GROWTH IN CONNECTICUT

http://www.ctn.state.ct.us/show_info.asp?EventID=8555 Date: 1/24/2008

Article in Hartford Business Journal: **Kick-Starting Startups** 02/04/08

For the second consecutive legislative session, the Connecticut Technology Council and Connecticut Innovations will be asking lawmakers to adopt a bill that would give tax credits to angel investors, members of the private sector that fund entrepreneurial dreams.

In fact, most states — 37 — have angel investment legislation. “It’s hardly a new occurrence,” said Matthew Nemerson, president and CEO of CTC. But so far, Connecticut hasn’t signed up. Last year, a bill that would give angel investors a tax credit made it through the General Assembly’s commerce committee. But that is as far as the bill got.

“I think instituting a new credit into the political debate is not a one-session issue,” Nemerson said. “We were delighted with how much traction it gained last year.”

CTC’s proposal is to give angel investors a 35 percent tax credit for their investment, which they can take over five years. The tax credits would be awarded only if there are actual investments. The proposal is based on the notion that successful new companies will provide a greater tax benefit to the state in the future.

The CTC believes that \$15 million of tax credits could leverage \$43 million in new angel investments in Connecticut startups.

Nemerson said the initial cost to implement the program would be about \$50 million. However, he is well aware that the state government’s two-year budget setup is a hurdle that needs to be overcome.

“We know it’s the second year of a two-year budget and there isn’t really an appetite for things that have a fiscal impact, even if it could have a positive economic impact,” he said. “I’m confident that people will continue to talk about this and how it can be a tool to increase jobs and stimulate the economy.”

CI On Board

The fact that Connecticut is late on this trend may provide a boost to CTC’s cause because they have the reports from other states who have implemented tax credits. “We’ve just gotten a report from Wisconsin and we’re going to get them from other states that show they are happy with their returns,” Nemerson said.

Wisconsin, for example, has increased the cap to their tax credit from an initial \$13 million to \$23 million as a result of early success.

CI is also on board with CTC’s angel investment proposal. The quasi-public agency testified in favor of such a proposal last March. However, CI also is looking to secure more state funding of their own to become a pseudo-angel investor.

Emily Smith, CI’s managing director for external relations and government relations, said CI is proposing to receive a steady stream of state funding yearly so it can invest in seed programs and young startups.

From 1989 to 1995, CI received \$65 million in bonding. However, it has not received new funding since, Smith said. In regard to CI’s seed programs, the agency plans to ask state lawmakers to allocate between \$3 million and \$5 million annually.

Currently, CI’s seed program is funded from the return earned on previous investments.

Smith described CI as a “step above” angel investors, as CI usually gets involved after an entrepreneur has put up his or her own money, asked family and friends for financial support, and has turned to wealthy private individuals.

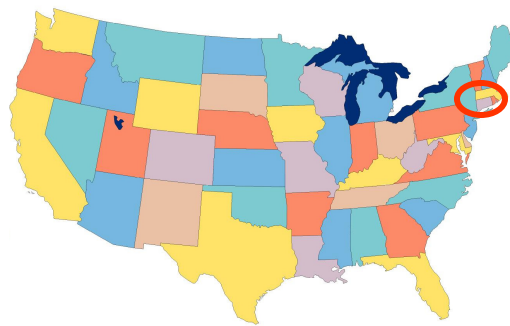
Sean O’Leary is a Hartford Business Journal staff writer.



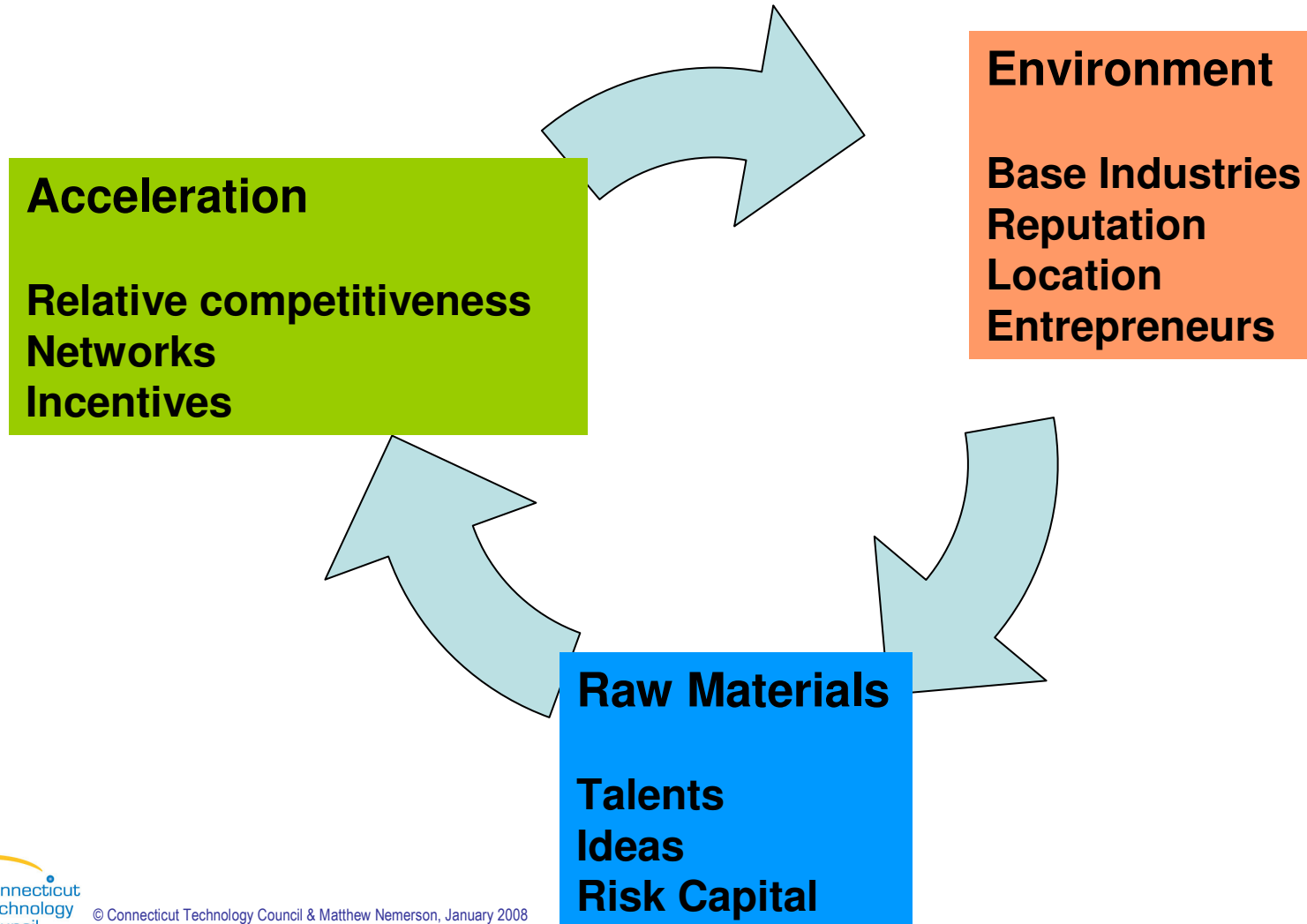
The Global setting

- From 1980 to 2001 ALL job growth came from companies that started as small firms.
 - All other companies lost jobs.
- Thomas Friedman in “The World is Flat”: growth is the result of new ideas
 - innovation from new firms or spun out of existing firms.
- Connecticut: focus on number of start-ups
 - increase the amount of funding to support these new firms.

Many Perspectives on growth

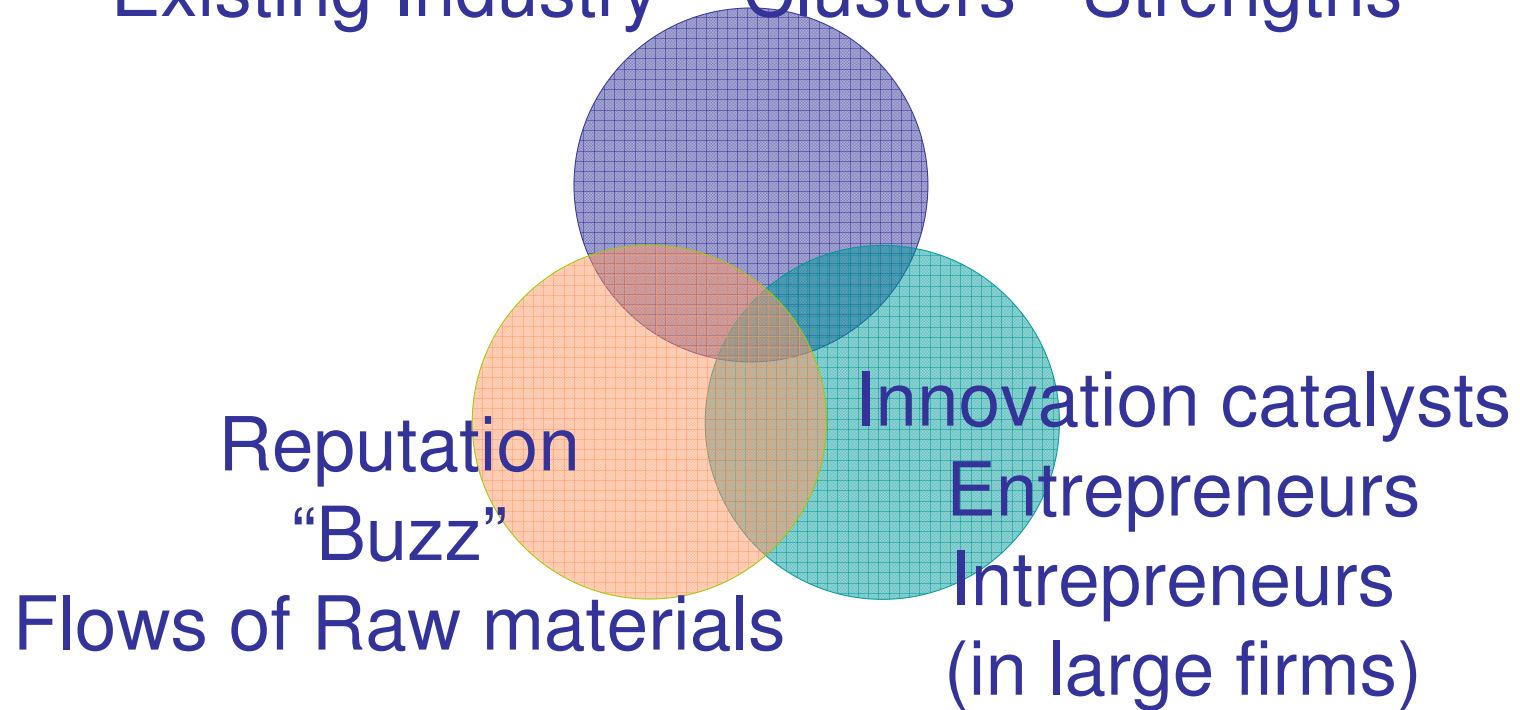


The Innovation Eco-System

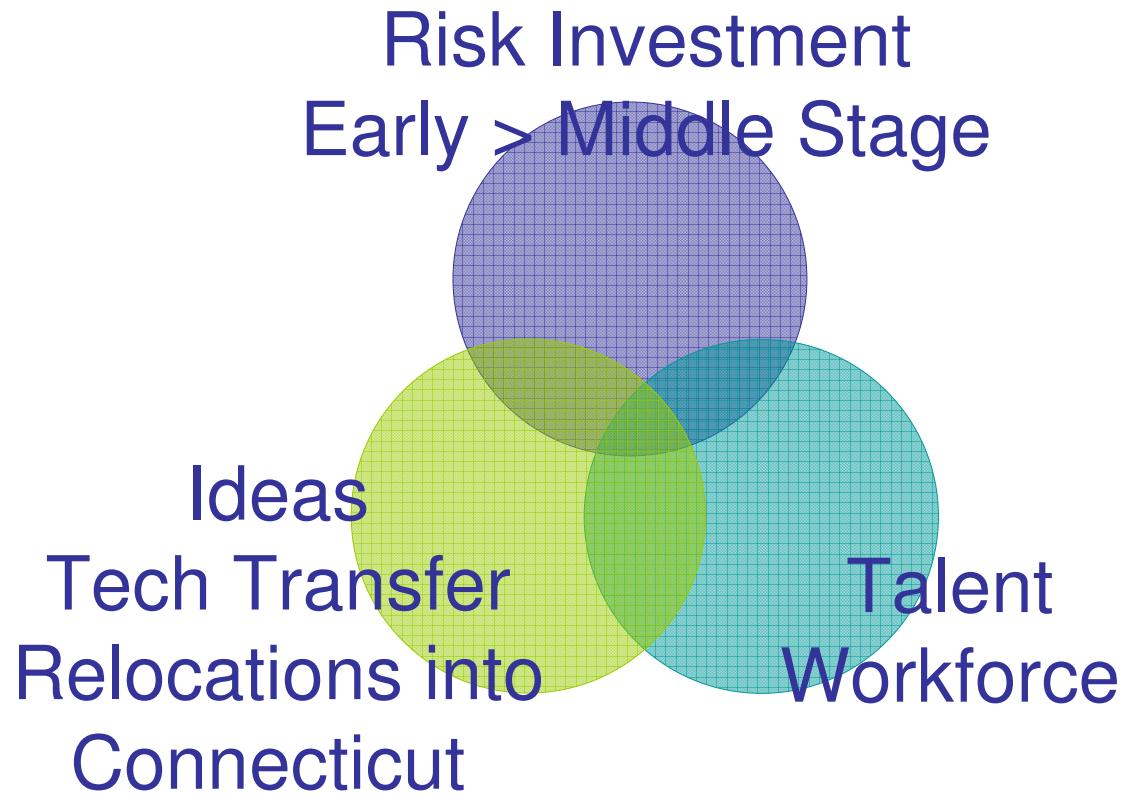


The Environment

Existing Industry – Clusters - Strengths

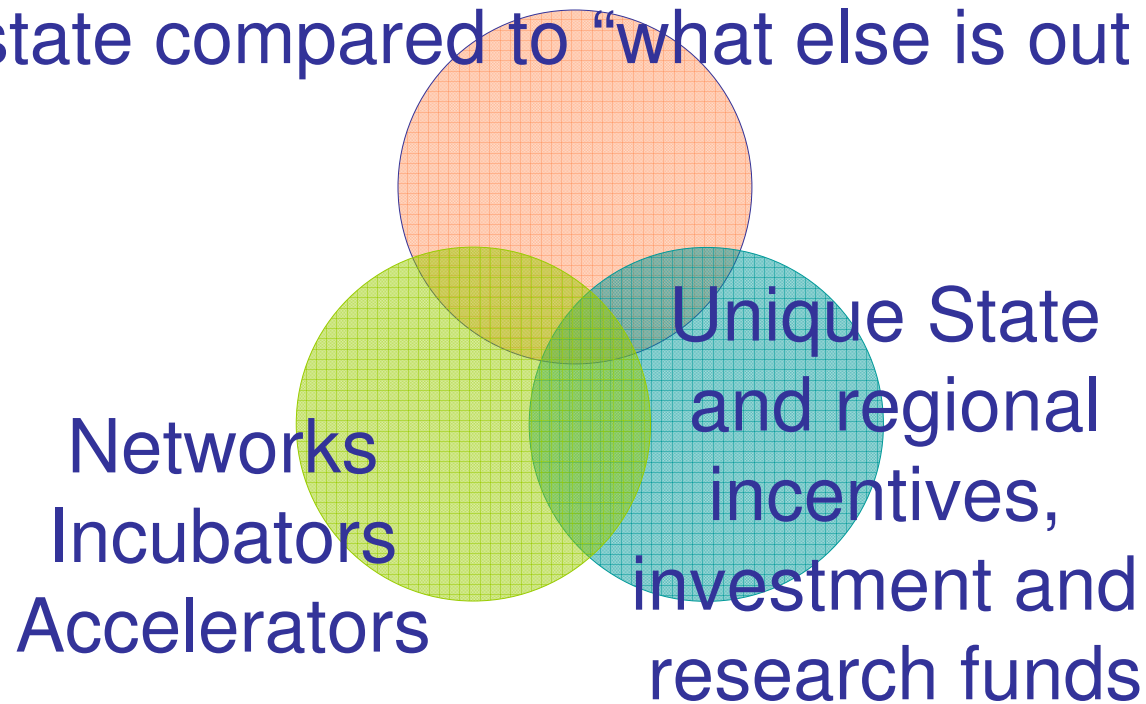


Raw Ingredients of growth



Acceleration

Competitiveness – Living in the “Flat World”
(this state compared to “what else is out there”)



Connecticut: Making what we have work

- High costs
 - Labor > Great Education and skills
 - Utilities > Incubators and green buildings
 - Housing > Great communities
 - Taxes > Great services and amenities
- Missing
 - Educated youth > more fun jobs and cities
 - Entrepreneurs > Great innovation environment
 - Early stage \$ > more is better, leverage state dollars

A Great Entrepreneurial Environment

- Other Entrepreneurs
- Networks and easy connections
- Risk taking attitude
- Early stage money
- Healthy larger companies
- Marketable unique ideas
- Government willing to bet on itself
- Optimism about the future

The Connecticut setting

- Innovation based jobs –
 - significant job creation given higher costs of doing business here.
- Emphasizing more start-ups
 - a key to holding on to 24 to 32 year olds.
- Incentives will be known in New England and metro New York
 - They'll look at putting Connecticut opportunities
- The credit will “put Connecticut on the map”
 - entrepreneurs look at where to locate in northeast corridor.

Before getting to today's topic...here are our Top 10 economic development things for DECD's strategic plan

- 10 – **Increase foreign marketing and trade show presence** – we have always been important international players and should not lose out to the southeast and larger states.
- 9 – **Improve Mass Transit** – Economic development starts with great transportation and links to NYC and the rest of the world. Consider commuter rail expansion and even a return to trolleys.
- 8 – **Reorganize the state departments and establish one plan** – get people at the same table – DECD, CI, CDA, OWC, Labor, Transportation, UConn, CSUS, CC. Establish the same strategy and systems approach. One plan with many partners and one set of deliverables.
- 7 – **Encourage Affordable Housing & Urban Development** – as ways to make Connecticut more attractive to 25 to 35 year-olds and young families. Don't forget the old mill towns of the route 8 corridor, they can be good tie-ins to expanding Hudson Valley
- 6 – **Promote STEM Education** – through regional magnet schools that compete with the best private schools, this will attract families and make taxes seem low. Offer scholarships through UConn for STEM high performers
- 5 – **Offer attractive incentives to entrepreneurs** –tax credits that attract early stage investments are crucial. Structured well, this state-wide commitment to entrepreneurs will grab global attention added to modifications of the R&D Credits, we should target mobilizing capital for innovation.
- 4 – **Push for Tech Transfer out of Universities** – as well as more research money going in. Stem cell money is a good start, but other states are investing \$100ms.
- 3 – **Support large businesses** – we need a platform of major employers, branch out from financial services, high tech manufacturing and R&D should be on the map. Support for key industries such as clean energy and advanced digital imaging would get noticed.
- 2 – **Work Regionally** – Don't get bogged down in "townism" – work at the state level and seek to assign organizations roles that we should playing and then hold us to deliverables.
- 1 – **BE BOLD** – Come to us with a bold plan and ask for support for a multi billion initiative including annual TBED funding and capital improvements.

New business growth is key

Small firm births have largest impact Gross State Product, state personal income, and total state employment.

In fact, the authors find that small firm establishment birth rates and death rates have equal and opposite effects on state economic growth. This is a key finding.

–February 2007 No. 292 Small Business and State Growth: An Econometric Investigation
•by Donald Bruce, John A. Deskins, Brian C. Hill, and Jonathan C. Rork Maryville, TN 37803.

Growing new firms

- New companies
 - existing firms,
 - from entrepreneurs
 - scientists in an academic or R&D setting.
- Exhaust their money or time
 - need “seed” or “early stage risk capital”
 - After friends and before “institution” money, they need to find funding from “angels.”
- If location lacks angels
 - entrepreneurs and ideas will go elsewhere
- Connecticut should have more angel funding
 - high potential ideas and firms will move here.

Big picture

How can we increase the number of small tech-oriented business?

- \$25 billion was invested in “angel” investments in the U.S.A. last year
- In Connecticut we estimate less than \$5 million of angel investments were made.
- Based on informal surveys we estimate that the demand for angel investments in Connecticut is probably \$50 million a year or more!
- How can we fix this and provide more funds for Connecticut firms?

How can tax credits create more entrepreneurs?

- Assume a 33% credit for early stage risk investments
 - \$30 million of new private investment dollars for \$10m state cost
 - Put leverage, due diligence and risk in hands of private investors
 - Use CI money, incubator funds and other state money to match and support angel picks
- Assuming about \$300,000 of angel funding per company
 - Could impact 100 companies
 - Last year we invested in fewer than 10 firms

2008 Proposal for Incentives for Private Funding of Entrepreneurs

- Credit applies to **Angel Investors** not institutional capital
- All **equity securities** including subordinated debt.
- Personal income tax credit of 35% of cash invested (or Corporate income tax credit of 45%) for
 - Each company on first \$3,000,000 raised in equity instruments from unrelated investors
 - Each individual limited to \$250,000 of new credit per year
 - can be realized over a 5 year period
- Qualified Businesses are:
 - Based in state with over half of employees here.
 - Under \$5 million in sales
 - Fewer than 25 employees
- Approval will be automatic and as of right, DRS or designee will manage the credits and track company results
- No Annual cap recommend (if one is instituted then available credits will need to be tracked on a forward looking basis at the beginning of each month).

“Mentor Capitalism” with Angels

1. People with ideas need capital
2. Start-up capital is raised first from personal and family assets.
3. Who is ready to take the high risk of putting personal money in unproven products or services?
4. Someone who believes and wants to get involved
5. This “angel army” is the key to state growth!


Incentives are necessary

1. Self-made, wealthy individuals with personal experience in the technology world look for the best place and best companies to invest in.
2. Connecticut has rich people but a very low level of in state Angel investing, why?
3. We have the most to gain of ANY state by providing a better context for investment

Getting over the usual objections

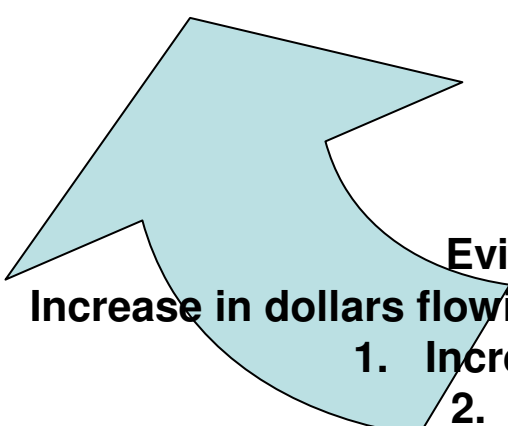
- Why give a tax benefit to wealthy individuals?
 - They have the money to invest and lose.
- Shouldn't the personal income tax be sacrosanct in Connecticut?
 - If we stay within limits that have net positive fiscal impacts the source of the tax expenditure is immaterial.
- Why just use state agencies?
 - Having private investors vet companies will always be more reliable
- Why should we copy all the other states?
 - If money and companies can just move to Westchester, Springfield or Warwick for a 25% instant return, won't they?

A cycle for Angel Investments and growth



The secret of the success of Silicon Valley
And Boston is **CRITICAL MASS**
Surge of early stage investment will lead to more
entrepreneurs and skilled workers
Locating to Connecticut

Wealthy Investors look for places to located their capital –
-Private equity
-Hedge funds
-Mutual funds
-Angel investments



Evidence in other states show a marked
Increase in dollars flowing to early stage deals: (Maine, Wisconsin, Ohio, Kansas)

1. Increase money available for early stage firms
2. Increase Angel networks in the state
3. Encourage firms to move to Connecticut to qualify for investments

Statistics

- Angels continue to be the largest source of seed and start-up capital, with 46% of 2006 angel investments in the seed and start-up stage, followed closely by post-seed/start-up investments of 40%
- A total of 51,000 entrepreneurial ventures received angel funding in 2006, a 3 percent increase from 2005.
- Average deal size increased by 7.5% compared to 2005

Statistics

- 13.8% of Angels are women
- 12.9% of women entrepreneurs attempted to raise Angel capital
- 21.5% of these women raised Angel capital
- 3.4% of Angels are minority
- 6.9% of minority entrepreneurs attempted to raise Angel capital

Keeping up with the neighbors

*Some of the 35 states with
existing early stage tax
credit programs*

Massachusetts (now)	3%
Indiana	20%
Iowa	20%
New York	20%
Massachusetts (2009)	25%
Minnesota	25%
New Mexico	25%
Ohio	25%
Vermont	25%
Wisconsin	25%
Arizona	35%
Connecticut ?	35%
Colorado	50%
Kansas	50%
Louisiana	50%
Maryland	50%
Rhode Island	50%
Maine	60%
Hawaii	100%

Other states are using tax credits

- Some states are already increasing the “caps” on their tax credits because of the successes
 - Wisconsin is doubling tax credit limits
 - Kansas is \$4 million, up from \$2 million
- There is a growing national consensus that this is a concept that works to direct money to a place where it highly benefits the states’ economies.
 - Attached studies from the Kauffman Foundation and Northstar Economics confirm successes.

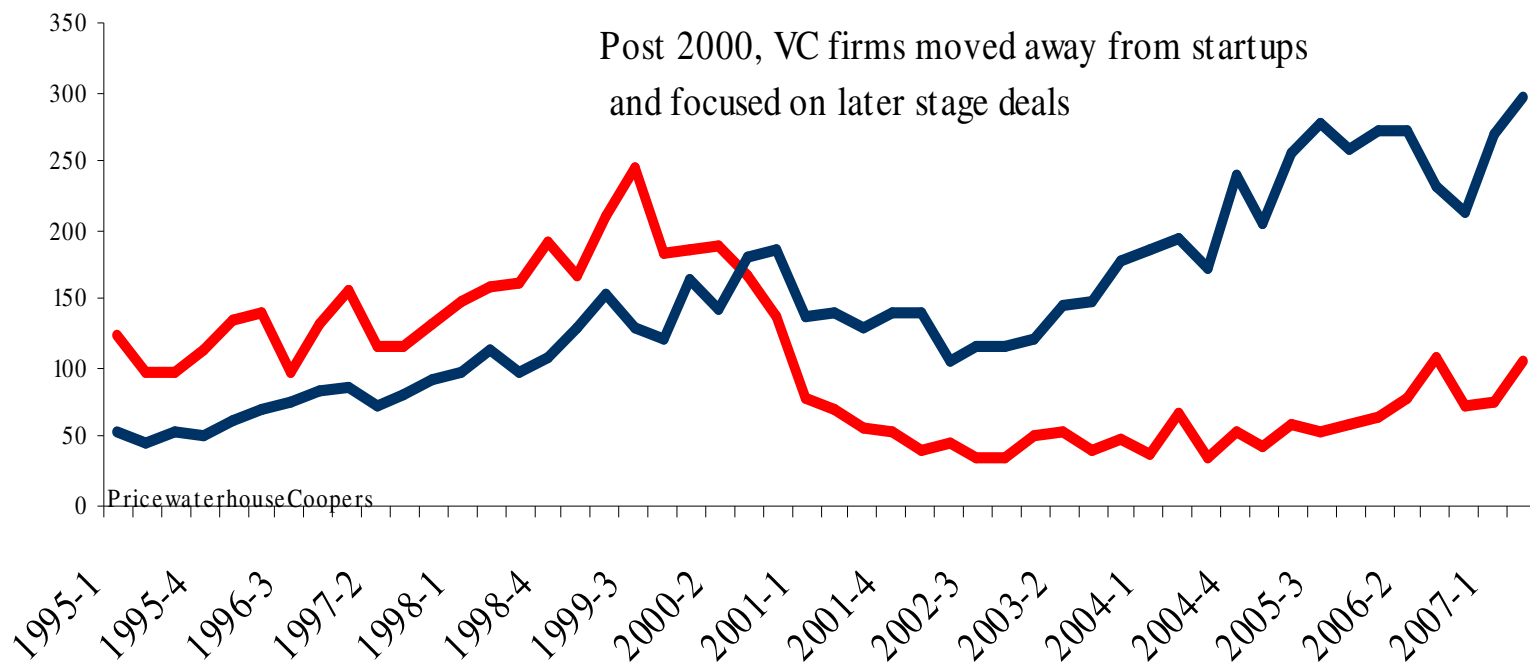
Wisconsin demonstrates the 65% increase in \$ invested

- Individual angels put in \$14 million in 2005
- Group investing increased 65% to \$5.6m
- 9 deals in 2004 to 20 in 2005.
- All tax credit used
- Angel investors say availability of tax credits and certified new business ventures increased angel deals and the focus in state.
- **Angel Investing Activity in Wisconsin in 2005**; Prepared by Dr. David J. Ward President and Founder of NorthStar Economics, Inc. January 31, 2006

Why not Venture Capital? They focus on Later Stages

Startup vs Late Stage Deal Count

— Startup/Seed Deals — Later Stage Deals

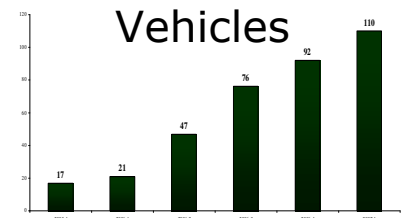


Angel Investing brings along additional Capital

Local Angel AIF Investment - Oil Purification Systems, Inc

- Eliminates the need for engine oil changes in large trucks.
- Angels invested in 2005 and 2007.
- 12x Revenue Growth in 18 months.
- Capital raised \$7.5 million total. CT Angels invested \$500k
- 4 angel groups, 12 angels participated.
- Currently have 15 employees up from none in 2004.

OPS Evaluation Fleets
have over 38,000
Vehicles



Evaluation Fleets

Why Angel Tax Credit Now?

- Angel investor market has shown signs of a retreat in first half of 2007 from the growth of the past several years with 6% decline in total investments over first half of 2006
- Rhode Island implemented a tax credit in 2007.
- Massachusetts is considering a tax credit in 2007 and 2008.

Angels complements existing programs

- Angels manage themselves (50 players per staff)
- Decisions based on their interests and expertise.
- Take on smarter risk
- Investments earlier and more diverse
- They can work more quickly and fill “fund gaps”
- CII can fund seed by working alongside angel groups in investing in similar companies.
 - Angel groups have a synergistic relationship with CII’s

SB 1366 – Version JF from Commerce (for reference purposes only)

General Assembly **Substitute Bill No. 1366**
January Session, 2007

____SB01366CE_FIN031907____ **AN ACT ESTABLISHING TAX CREDITS FOR ANGEL INVESTORS.**

Be it enacted by the Senate and House of Representatives in General Assembly convened:

Section 1. (NEW) (Effective July 1, 2007, and applicable to income years commencing on or after January 1, 2007) (a) As used in this section:

(1) "Angel investor" or "investor" means an accredited investor, as defined by the Securities and Exchange Commission, who may seek active involvement in the business, such as consulting and mentoring, but "angel investor" or "investor" does not include (A) persons controlling fifty per cent or more of the Connecticut business invested in, (B) a Connecticut venture capital company, or (C) any bank, bank and trust company, insurance company, trust company, national bank, savings association or building and loan association for activities that are a part of its normal course of business;

(2) "Cash investment" means money or money equivalent in consideration for qualified securities;

(3) "Connecticut business" means any business owned by an individual or a partnership, association or corporation, and domiciled in Connecticut, or any corporation, even if a wholly-owned subsidiary of a foreign corporation, that does business primarily in Connecticut, or does substantially all of such business's production in Connecticut;

(4) "Qualified securities" means (A) any form of equity, including a general or limited partnership interest, common stock, preferred stock, with or without voting rights, without regard to seniority position and whether or not convertible into common stock, any form of subordinate or convertible debt, or both, with warrants or other means of equity conversion attached; or (B) a debt instrument, including a note or debenture that is secured or unsecured, subordinated to the general creditors of the debtor and requiring no payments of principal, other than principal payments required to be made out of any future profits of the debtor, for at least a seven-year period after commencement of such debt instrument's term.

(b) There shall be allowed a credit against the tax imposed under chapter 229 of the general statutes for a cash investment in the qualified securities of a Connecticut business by an angel investor. The credit shall be in an amount equal to thirty-five per cent of such investor's cash investment, provided no credit shall be greater than one hundred twenty-five thousand dollars. The credit shall be taken in the year in which such cash investment is made by the angel investor.

(c) To be an eligible cash investment qualifying for a tax credit pursuant to this section, such investment shall be in a business that (1) has been approved as a qualified Connecticut business pursuant to subsection (d) of this section, (2) has had annual gross revenues of less than five million dollars in the most recent income year of the business, (3) has fewer than twenty-five employees, more than half of whom reside in this state, (4) have been operating in this state for less than ten consecutive years, (5) is primarily owned by the management of the business and their families, and (6) received less than one million dollars in the tax credits provided by this section. No investor may claim a credit pursuant to this section for cash investments in Connecticut Innovations, Inc.

(d) (1) A Connecticut business may apply to the Commissioner of Economic and Community Development for approval as a Connecticut business qualified to receive cash investments eligible for tax credits pursuant to this section. The application shall include (A) the name of the business and a copy of the organizational documents of such business; (B) a business plan, including a description of the business and the management, product, market and financial plan of the business; (C) a statement of the business innovative and proprietary technology, product or service; (D) a statement of the potential economic impact of the enterprise, including the number, location and types of jobs expected to be created; (E) a description of the qualified securities to be issued, the consideration to be paid for the qualified securities, the amount of any tax credits requested and the earliest year in which such tax credits may be redeemed; (F) a statement of the amount, timing and projected use of the proceeds to be raised from the proposed sale of qualified securities; and (G) such other information as said commissioner may require.

(2) The Commissioner of Economic and Community Development shall, on or before August 1, 2007, and monthly thereafter, compile a list, categorized by estimated amount of tax credit and type of qualified securities offered, submitted by qualified Connecticut businesses. Any angel investor that intends to provide a cash investment to a business on such list may apply to the Commissioner of Revenue Services to reserve a tax credit in the amount indicated by such investor. The aggregate amount of all tax credits which may be reserved by the Commissioner of Revenue Services shall not exceed fifteen million dollars in any one fiscal year.

(e) (1) The amount of such credit allowed to any investor pursuant to this section shall not exceed the amount of tax due from such investor under chapter 229 of the general statutes with respect to such taxable year. Any tax credit not used in the taxable year during which the cash investment was made may be carried forward for the five immediately succeeding taxable years until the full credit has been allowed.

(2) Any credit allowed pursuant to this section may be sold, assigned or otherwise transferred, in whole or in part, to one or more taxpayers, and such taxpayers may sell, assign or otherwise transfer, in whole or in part, such credit. If an investor sells, assigns or otherwise transfers a credit to another taxpayer, the transferor and transferee shall jointly submit written notification of such transfer to the Commissioner of Revenue Services not later than thirty days after such transfer. If such transferee sells, assigns or otherwise transfers a credit under this section to a subsequent transferee, such transferee and such subsequent transferee shall jointly submit written notification of such transfer to the Commissioner of Revenue Services not later than thirty days after such transfer. The notification after each transfer shall include the credit certificate number, the date of transfer, the amount of such credit transferred, the tax credit balance before and after the transfer, the tax identification numbers for both the transferor and the transferee, and any other information required by the Commissioner of Revenue Services. Failure to comply with this subdivision shall result in a disallowance of the tax credit until there is full compliance on the part of the transferor and the transferee and for a second transfer, on the part of the transferee, and the subsequent transferee.