REPORT TO THE LEGISLATIVE ASSEMBLY

Re: **Oregon Growth Account**
From: The Oregon Growth Account Board
Date: January 31, 2011

Outline and Background

Senate Bill 496 (2009) required the Oregon Growth Account (OGA) Board to submit a report to the Seventy-sixth Legislative Assembly that:

1. Summarizes the performance of the OGA since its inception;
2. Recommends whether the diversion of funds out of the OGA made by SB 496 ought to be restored, and;
3. Describes the benefits that could be expected by a restoration of funds.

The OGA was created within the Education Stability Fund (ESF) (formerly known as the Education Endowment Fund) by Oregon Laws 1995, chapter 811 during the 1995 Legislative Session in conjunction with the establishment of the ESF. In accordance with the provisions of the Oregon Constitution creating the ESF, the ESF receives 18 percent of Lottery proceeds. Of the Lottery Proceeds placed in the ESF, five percent flow into the OGA (formerly 10 percent, but changed by SB 496). Senate Bill 496 sunsets that decrease in July 2013 and restores the 10 percent flow. The fund began investing in 1999, since lottery revenues were not immediately available for investment, upon passage of the law in 1995.

1. Performance

Since the inception of the Oregon Growth Account's first commitments in 1999, the fund has committed $99.4 million to limited partnerships seeking to place capital with Oregon companies. Through year end 2010, $63.7 million has been funded, leaving $35.7 million contractually remaining to be called for investment.

Overall, the Account has achieved realized returns of approximately $25 million, and the current invested portfolio (unrealized) has an approximate value of $26 million ($23 million of which has been returned to the Education Stability Fund). The internal rate of return (IRR) on the fund, since inception, is negative 7.9 percent, with an investment multiple of 0.8 times invested capital. The current value of the OGA portfolio, plus distributions received, is less than the money that has been invested to date. At least for the initial investments made at the inception of the OGA, the return goals, established by the OGA Board, have not yet been achieved. However, considering the dismal period for venture capital investments nationwide and the fact that not all OGA investments have yet reached maturity, we believe that this program would continue to be useful from both an investment and economic development perspective. Additionally, in 2001, the State Legislature created the "Oregon Resource and Technology Development Subaccount" (ORS 348.706) within the Oregon Growth Account. This undertaking was not at the discretion of the OGA Board, but was a legislative mandate to "make seed capital investments in emerging growth businesses." The legislation stipulated that the first $4 million of funds credited to the OGA be allocated to the subaccount, in addition to a direct allocation of $5 million from the legislature. As of September 30, 2010, the most recent information available, this fund has a return of negative 17.8 percent. Excluding the subaccount mandate, the OGA return improves to negative 5.2 percent, since inception.

Critically, the most recent 10 year period has been one of the most challenging in the history of venture capital, and for global investing in general. According to Thomson Venture Economics, venture capital returned negative 1.6 percent over the trailing ten years ending June 30, 2010, which represents the most current data available (by comparison, public equities, as represented by the S&P 500, lost the same: negative 1.6 percent annually over the same 10 years). Venture capital and early stage investing is a very long term proposition. A typical limited partnership commitment has a life of 10 to 12 years, meaning that the OGA is just now seeing the results of investments made 10 years ago. This is critical to understanding the historical performance of the Oregon Growth Account since $20,869,921 was committed to four funds from 1999-2000. While this was perhaps the worst time to invest in venture capital and private equity, the OGA was able to realize nearly $20 million from those early commitments.

A more institutionalized investment process was introduced into the vetting of opportunities in 2004. Commitments made post this time total $65 million, which is over two-thirds of all the capital committed by the Oregon Growth Account. Of these newer commitments, approximately $28 million has been invested, or 43 percent of the capital, leaving significant capital yet to be deployed. This is critical, as the historical duration from investment to exit for venture capital is approximately three to seven years. The view that the Oregon Growth Account is underdeveloped is further supported by quarterly reviews by the Board's independent consultant that have classified most of these investments as "Too Early to be Meaningful."

2. Recommendation

We recommend that the diversion of funds by SB 496 be restored to 10 percent of ESF proceeds in June 2013, as provided for in the legislation and as approved by the Seventy-fifth Legislative Assembly. While still relatively nascent for an emerging growth business focused portfolio, the OGA has returned $23 million in realized returns to the ESF. The OGA is staffed by the Oregon State Treasury and has been – as with all Treasury-managed funds – administered along the lines of an investment fund with economic development objectives being secondary. The Legislature should be aware of the following risk factors associated with the mandate of the OGA:

1) The fund's statutory mandate to invest only in emerging growth businesses prevents broad diversification across asset classes;
2) The fund's statutory mandate that OGA commitments only be made to management companies that agree to deploy, in Oregon, an amount that is at least equal to the OGA commitment reduces geographic diversification and investment opportunities available to the OGA, and;
3) The relatively small size of the portfolio (for its type), which – in light of the other two restrictions – drastically narrows the focus and increases the risk.

To mitigate these risks, the legislature may want to consider modified statutory mandates to redefine the vision for the Oregon Growth Account, in the coming decade. Though economic development has been a growing ancillary benefit of the investments made, the merit of the OGA is ultimately expected to be assessed in terms of its return on investment in a more benign economic environment. Therefore, the mandates that underpin the portfolio need to provide the OGA flexibility to select the best private investment opportunities each year.

This recommendation may be achieved via multiple avenues. A hypothetical scenario is to augment the mandate to allow the OGA to proactively source investment opportunities without being limited to emerging growth businesses. Rather, the full spectrum of private enterprise would be available for consideration. Further, the scenario would remove the requirement that an equivalent amount of capital, as that committed by the OGA to a limited partnership, be reinvested back into the State as this is often a deterrent for the limited partnership sponsors. Instead, the OGA would focus its efforts on sponsors that have invested in Oregon historically or have plans to invest in Oregon. This revision would enable the OGA to diversify its investments and attract additional capital to the State. Lastly, to ensure that economic development is not overlooked, the OGA would be granted discretion to invest a percentage of its capital in programs and entities established to educate and promote Oregon-based companies.

3. Fund Restoration Benefits

According to recent Lottery revenue forecasts, Lottery revenues flowing into the OGA for the 2011-13 biennium should be approximately $10.2 million. Per these same forecasts, for the 2013-2015 biennium, this means approximately $21.9 million would be available for the OGA, should the fund diversion be restored, as provided in SB 496. As of December 31, 2010, the OGA had approximately $12 million available for investment.

In addition to the increase in funds available for investment, the OGA has also aided the State in terms of economic development: Through September 2010, the most recent data available, 78 Oregon companies have received nearly $137 million via the entities the OGA has committed to. The number of employees affected by these investments exceeds 800, with aggregate total wages paid, for Oregon-based employees, of approximately $30.5 million. Further, through its $99.4 million in commitments, the OGA has brought limited partnerships, representing in aggregate greater than $1.1 billion in investible capital, to Oregon to evaluate and potentially invest in Oregon-based companies.

According to the Oregon Business Development Department annual report, investments in business assistance funds and programs of approximately $25.5 million netted 2,005 new jobs (at the cost of $11,000 per job) and generated income taxes of over half that amount ($13.8 million).

Presently, entrepreneurs and innovators are struggling to find capital to fund their business prospects. The OGA provides a meaningful avenue for the State to fill this gap, by using outside investment firms, with expertise and a mandate to invest capital in Oregon companies.

Summary

While the OGA has struggled to meet its investment goals to date, from a pure return on investment metric, the Board recognizes that the OGA has been successful at leveraging private-sector investments into Oregon companies and serving as a catalyst for economic development efforts. Additionally, the more recent investments have not had sufficient time to mature, such that their ultimate success or failure can be determined at this time. The Legislature should allow the sunset provisions of SB 496 to remain in place, such that the Oregon Growth Account is restored to its historical funding level of 10 percent of the flows to the ESF. Historically, years following recessionary periods have proven to be strong periods in which to put capital to work in emerging growth businesses. Following the last recession that lasted longer than one year (1981-1982), the average return for an investment in emerging growth businesses annualized at 16.3 percent through the ensuing economic cycle, according to data from Thomson Venture Economics. This fund provides critical capital to emerging growth businesses in Oregon, at a time when investment capital is at a premium, with the prospect of long-term financial rewards to the ESF.