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Venture Capital In New Mexico: Yesterday, Today & Tomorrow

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I. History of the VC Industry

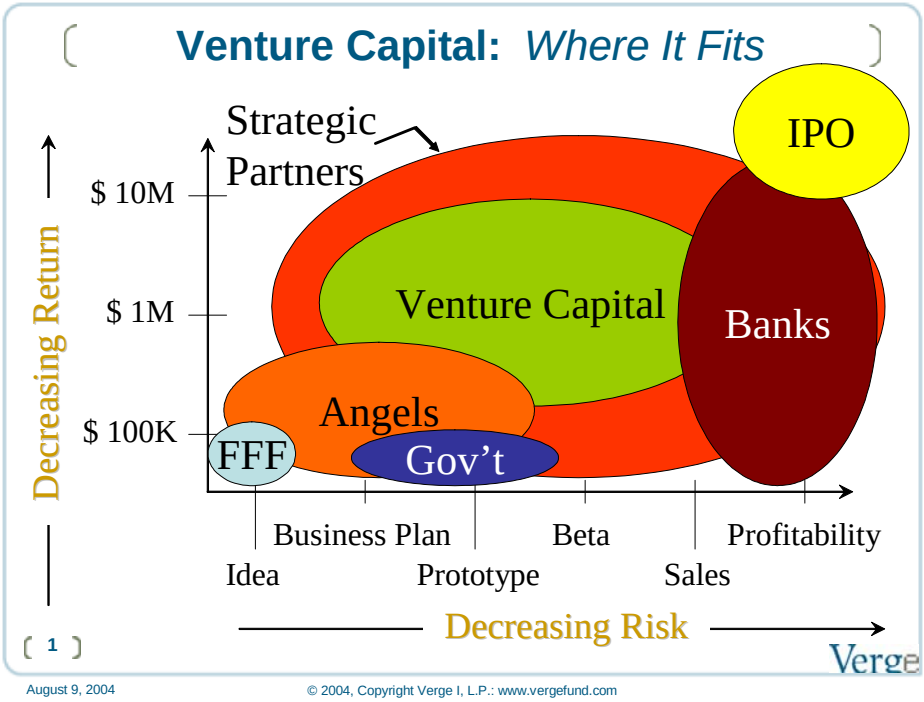
The past 10 years have seen a remarkable transformation in the American economy, as we have truly moved from an industrialized society to an information and knowledge society. Do not get me wrong; I am not going to dazzle you with a lot of new-era words about how our old way of life is dead, and how somehow we are moving to an environment where we will never manufacture anything again and where whatever we order on eBay or Amazon will magically come out of our printer. I should say, however, that if anyone knows how to make a pizza magically appear from my printer, come see me afterwards, because that would be cool (and a good investment!). I will be referencing the tech bubble of the late 1990s quite a bit, and if there is one thing that the bubble did, it was to overhype all things technology. Nonetheless, there remains no question that technology has changed the way all of us do business. The growth of the technology industry, of course, like the growth of the industrial industries before it, and the growth of the railroads before that, all depended upon capital. It all depended upon capital. But where railroads and manufacturing plants had very high capital costs for infrastructure, once that infrastructure was built, they could start making money almost immediately. The technology industry is unique in American business because of the tremendous amount of time – and money – required just to make the widget work. This change – infrastructure PLUS development cost – required a new approach to investment, one that was more patient then ever before, more daring than ever before, and yes, even greedier than ever before: venture capital.

Venture capital did not, of course, start with the tech explosion of the last ten years, or even in the last twenty. Modern venture capital really began just after World War II, when the same families that had become rich in old line industries, names like Carnegie and Morgan, Mellon & Rockefeller, decided that it was time to tame the new frontiers of innovation and business. Arguably, the first formal VC firm was a group called Advanced Research and Development, or AR&D, which was run by "General" Georges Doroit, a professor at the Harvard Business School, who funded companies such as Digital Equipment Corporation. Digital has an Albuquerque connection, of course; its old factory has become the very successful @25 development. But while the early roots of venture capital may have been on the East coast, it was in the more relaxed environment of the West coast, in the fertile valley south of San Francisco, where technology and venture capital most flourished, and ultimately grew into household names. Here was where Intel was born, where Apple grew, and where a $5 million investment in eBay became more than $4 billion by mid-1999 (and is worth <u>more</u> today). It is also where a $150 million investment in a company called WebVan by the same venture capital firm, Benchmark Capital turned into $0 – a stark reminder than no one – no one – gets it right all of the time. So, as is the case with most industries, as the venture capital industry became more mature, enterprising VCs moved out to newer, emerging markets. These were centers of technological excellence and business acumen in their own right, places like: Seattle, Washington; Austin, Texas; or the Research Triangle Park in North Carolina. There were, also, early activities here in New Mexico. I do not know much about the early efforts at venture capital here in the State, so I will not presume to analyze them. I do know that these efforts did

not produce the fruits of success as had been hoped, and so the venture capital industry remained fairly dormant until the mid-1990s.

II. What is a Venture Capitalist and Why do I care?

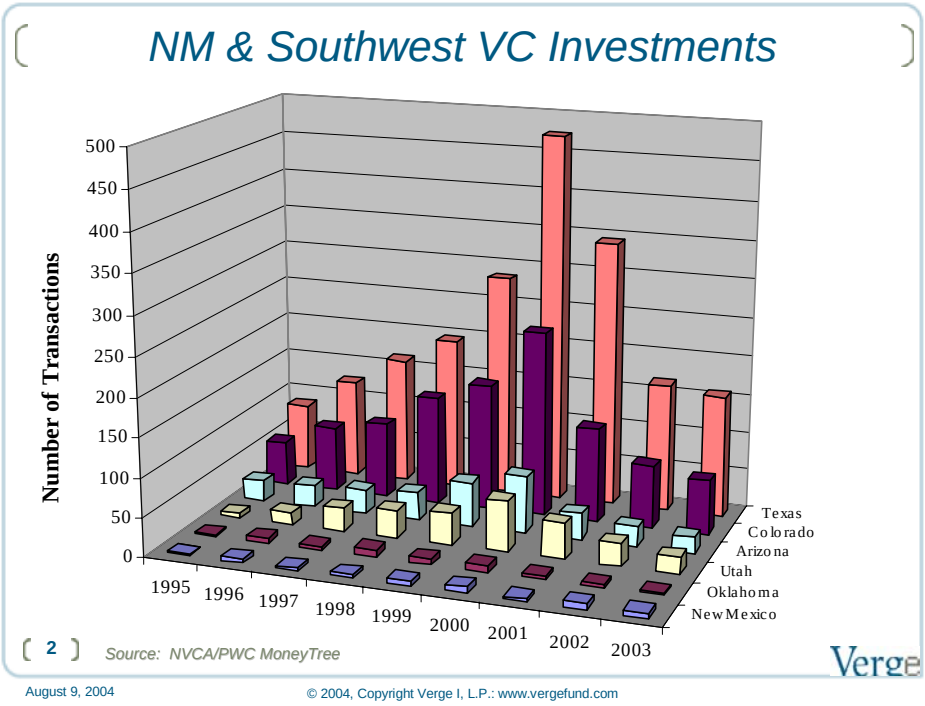
Before I go on, I should take a minute to talk about definitions. Specifically, what is venture capital? When I first agreed to do this talk, I did not appreciate that I would need to do it without my old friend "Powerpoint" and the visual crutches it provides. Not being able to shake the technology totally, I do have a few charts – two to be exact, and there are copies on the tables – but I promise not to rely on them too heavily. The first one shows where venture capital fits in the universe of available funding options. There are really two points that I would like you to take away from this eye-chart of a graph: First, that VC is only one mechanism in the overall set of fundraising options that are available to entrepreneurs – and hardly the biggest one at that. It is the best known, to be sure (other than commercial banking, of course), but it is one piece of the overall funding spectrum needed for companies to start, grow and be prosperous. Second, I want to draw an important contrast for you between "angels" and "venture capitalists." Both invest in private equity and both are important. Angels are high net-worth individuals, investing their own money. Venture capitalists are professional investors investing other people's money. Why is this distinction important? It is important because it helps to explain why VCs say "no" so much, but it also highlights the fact that in most cases, angels invest in a far greater range of projects, for typically fewer dollars, and for reasons that may or may not be 100% economically driven. By contrast, VCs are easy to understand: it is all about the money! We invest for financial return. In the earliest days of venture capital, VCs often invested at the seed stage, when the product might not be finished, the business strategy might not be fully fleshed out, and the management team would have several holes. As the industry grew more mature and as funds have gotten larger, however, VCs have moved away from the early stages, in favor of more mature deals, and have left seed stage investing primarily to the purview of angels. In the post-bubble VC industry, some firms such as my firm, Verge, and Flywheel ventures in Santa Fe, and others, are willing to reach down and invest fewer dollars at the earliest stages of a company's development. Nonetheless, most seed-stage investing today is today done by angels. In 2003 – last year – angels in the United States invested roughly the same amount as venture capitalists did ($18.1 Billion vs. $18.8 billion), But while the VCs invested that amount in just under 3,000



companies, angels invested in over 42,000 companies. Let me say that again. Angels invested just as many dollars, but they did it in more than 10 times as many deals.

III. Venture Capital in New Mexico in the last 10 years

The 1990s were an amazing time for the venture capital industry in the United States. The amount of both deal activity and venture capital investment exploded. But what about New Mexico? There is no way to characterize historical venture activity in New Mexico except as sluggish. If you look at the other chart on the handouts, you will see the harsh truth: New Mexico lags significantly behind other states in our region for number of VC financings (defined for these purposes as New Mexico and its adjoining 5 states). New Mexico is, of course, the smallest state in this six state region, accounting for less than 5% of the population. Unfortunately, we have made up, on average, less than 2% of the venture capital deal activity for the region. The most interesting comparison is with Utah, a state with a population only 25% larger than New Mexico. In 1995, New Mexico had 2 venture financings, and Utah had 6. However, due to a number of factors, including the aggressive support of the state government, the formation of support organizations such as the Utah Information Technology Association, and the creation of the first truly locally-based venture capital firms in the state, Utah took off. At the height of the bubble, 1999, we had 8 financings in New Mexico and Utah had 65. As venture capital financings have come back to Earth, the gap has closed again to about 4 to 1, but we are still trailing far behind.



Perhaps as important as the low number of financings has been the equally low number of "exits," or liquidity events. In the private equity world, whether professional VC or angel investing, the typical mechanism for investors is to buy stock in a company, gaining a substantial percentage of the overall ownership, adding value to the business as it grows and develops, and then selling it for a lot more than what we paid for it, either through an acquisition to a larger company for cash or stock, or through an Initial Public Offering, or IPO. Very simple: buy low, sell high. *Theoretically*. These exits, of course, are what really creates wealth (and also increases the number of expensive German cars being sold in a local market). We have had some here in New Mexico, to be sure: the purchase of MicroOptical Devices by Emcore is one of the most publicized, but there have been others. The acquisition of Indigo Medical by

Johnson & Johnson, is one example, the recent purchase of MesoFuel by Intelligent Energy of the U.K. is another. Several angel backed or bootstrapped deals have also provided liquidity events for their shareholders and investors: CVI Laser, ProLaw Software and HealthFirst are all examples of technology companies which were founded here, grew up here, and ultimately provided exits. What we have not yet had here is the "big exit." The Dell IPO, which single-handedly transformed the Austin economy. The creation of a Micron PC in Boise, or a Quantum Hard Drives in Boulder, or WordPerfect in Salt Lake City. We have not had that…yet!

So, is that it? Are we going to always stay in the backseat of this technology revolution? I certainly would not be here in New Mexico if I believed that. Many steps have been taken over the last several years in support of the venture capital industry that are beginning to really pay dividends, and which I believe have us poised for much stronger growth for the future.

IV. Venture Capital in New Mexico today

The venture capital industry in New Mexico today is markedly different than even a few short years ago. When I moved back to New Mexico to open the office for Murphree Venture Partners in the fall of 1997, there were only two venture capital firms in the state, and only one interested in investing locally (interestingly, that one firm had its partner move out of the state three years ago). Today, there are 16 firms that have either an office in New Mexico or a stated desire to invest in companies here in New Mexico. The number of VC firms in New Mexico has more than doubled in the last three years alone. Doubled – during the post-bubble crash years of 2001 to 2003. Along with that increased presence has come increased deal activity. Both 2002 & 2003 saw effectively the same number of deals as in the peak bubble years of 1999 & 2000. Our deal activity remains small compared to the other states in our region, but it is definitely growing. It is a great time to be in venture capital in New Mexico.

Why has this occurred? Has the VC industry suddenly come to our senses and realized that NM is the place to be? There is some of that. As the bubble burst, and deal flow dried up, VCs began to look to new markets, and NM was unexplored territory to most. However, as is so often the case, the main reason is more obvious: they followed the money. In 1994, at the urging of the economic development community, including many of you in this room, the State Legislature passed legislation allowing the State Investment Council to invest a portion of the Severance Tax Permanent Fund into "New Mexico Venture Capital Funds." The original law brought on only one taker, and so it was modified in 1997 (it was somewhat dramatically overhauled in 2003, but I will get to that). New Mexico Venture Capital Funds are VC firms that agree to (1) open an office in New Mexico, (2) staff it with a full-time investment professional with three years experience, and (3) invest or "cause to be invested" an equivalent amount in the State as what they receive from the State Investment Council. Of the 16 firms I mentioned before, 13 have received state funding. Make no mistake, the State Investment Council's ability and willingness to invest in venture capital firms that would make a commitment to New Mexico, particularly in the economic downturn of the last few years, has been a significant factor in bringing so many VC firms to New Mexico.

Something else extremely remarkable has happened, and this may be the best indicator of all. This year, in 2004, for the very first time, we now have venture firms which not only include New Mexico as part of their core investing strategy, but which have their headquarters here as well. True New Mexico Venture Capital Firms. Investment professionals who have experience in New Mexico; entrepreneurs and operators who have built successful companies in New

Mexico. This is a significant moment in the development of the private equity industry in the state.

Of course, it is unlikely that anyone in this group would be unaware of the recent changes to the State's private equity program, particularly with the press attention is has drawn. In its 2003 session, the State Legislature increased the allocation to the "New Mexico Venture Capital Program," or "Regional" program to the roughly $200 million that it is today, and – in addition to creating greater flexibility in how the SIC can invest in venture funds – allowed for direct co-investment into New Mexico businesses. This effectively makes the SIC a venture capital firm itself. However, the rules on this "direct co-investment program" are very clear. The SIC can only co-invest along with other investors, and can not be more than 50% of the capital invested in the company. Unlike the investment program for venture capital funds, which has been around for several years, and which had a well-defined process for the allocation and investment of money, the direct co-investment program was new ground, and the SIC had some early fits and starts. They have made a few direct investments themselves, but decided as of this spring to delegate the screening, due diligence and investment structuring to Ft. Washington Capital Partners, a professional money management firm out of Cincinnati, which now has an office here and will be adding a full-time professional within the next few weeks. The direct co-investment program is definitely a leap for the State, but with the selection of Ft. Washington, there is now a set of professional eyes examining and scrutinizing each deal, to make sure that it has both the growth potential that we all want to see and a strong overall chance of success.

The co-investment fund; 16+ venture firms in the state; local venture firms focused on this market; a marked increase in deal activity. All in all, the prospects look strong for New Mexico. There is, however, always more that we can do…

V. Where New Mexico goes from here: A VC perspective

Like all of us here, I love being in New Mexico, and I would like to see the market grow and prosper. I would like to see our economy develop and build many more opportunities for the sons and daughters of New Mexico – so many of whom, classmates and friends of my own childhood – would love to come back, if they felt the opportunities existed. In building a New Mexico venture capital firm, focused on that part of the market – the seed and pre-seed stages – where my partners and I see both the greatest opportunity and the greatest need, we at Verge hope to create some of the companies that will become the foundation of New Mexico's economy for the next 10, 20 and even 50 years. There is more to do, of course, and I would be remiss, with such an audience as this, to not at least humbly suggest three areas where we can all contribute to help the local economy grow, particularly the technology economy.

First, we must continue to support corporate recruitment. I become very frustrated when I hear people say that corporate relocation and expansion is dead as an economic development tool, and we should put all our efforts in our home-grown companies. I believe, and my experience working in Austin, Texas bears this out, that any successful economic development strategy must include corporate recruitment. However, we need to raise the bar for what we expect in return for our incentives and effort: not just manufacturing jobs, but the marketing, sales, engineering, finance and corporate headquarters jobs as well. The people that work at these large organizations will be ultimately build the skills to start their own entrepreneurial endeavors, and will be strong contributors to the tax base in the meantime. We also need to be thinking strategically about which companies can provide leverage in our efforts. Where are our greatest

needs, and how can they be filled? We must continue to support relocation and expansion in our community.

Second, we need to grab a hold of our best local prospects and provide whatever support we can muster. Specifically, to me, that means continuing our steadfast support of Eclipse Aviation. I am not an investor in Eclipse, so I have nothing to gain directly from their success. However, there are a great many New Mexicans who have voted with their dollars and invested in the Eclipse vision of a new generation of air travel. Eclipse has a great many challenges still to overcome in an industry where you can count the survivors on one hand but you need a calculator to keep track of the failures. Not only does Eclipse have a great team, and strong prospects for success, but more importantly to me, it represents our nearest and best chance for an economy-transforming company. Just as Dell Computers redefined the local economy in Austin, Texas (where they still employ over 7,000 people today), Eclipse can bring wealth, jobs and an entirely new entrepreneurial outlook to Albuquerque. It is not the only deal that we should back; it is not the only hope for New Mexico, but it has the potential, it has the vision, and it belongs to us, now. We must support them.

Finally, and most importantly, I would challenge each of you in whatever way possible to become angel investors, and to begin to participate in private equity. I mentioned earlier that angels do over 10 times as many deals as venture capitalists. Here in New Mexico there is a dedicated, but too small, group of high net-worth individuals who make private equity investments. We need more angel investing: $25,000 or $50,000 increments represent the critical seed corn that operating companies need to first get off of the ground. More importantly these nascent entrepreneurs need the advice and support of established business professionals. Do not misunderstand me. I am not suggesting that you break the bank or cash in your retirement, but for those of you who can allocate a few percent of your net worth and have $100,000 or more to invest in a few companies – do! You might not think you know where to find deals – you do. They are down the street or here in the room; people with great ideas in need of capital. You might not think you know how to evaluate them – you do. The process will not be as extensive as with a venture capital firm, but you can tell pretty quickly if someone knows her stuff, and will be a good choice to develop a business and build the value of your investment. You might not have the technology background to understand all the bells and whistles – that's OK. You can get experts to help with the technology, and besides, technology is only a small portion of what makes a business successful, even a technology business. You might be worried that all your deals will not be successful – they won't. You have to be willing to invest in at least a couple of deals in order to spread out your risk. We will do our part as VCs, but we must work together to grow private equity in New Mexico. It is going to be hard, but if we can continue to increase the number of New Mexicans investing in New Mexico, and adding the other types of value; advice, support & contacts, then we will soon see the same growth as other communities in our region. We will be building the core operating companies that will increase our tax base, fill our real estate, use our retail, and which will ultimately create more opportunity – and wealth – for us, for our friends and for our families.