Maryland Investment Financing Programs

June 1998

Maryland’s Department of Business and Economic Development (DBED) provides financing for technology-based businesses using three investment vehicles: the Challenge Investment Program, the Enterprise Investment Fund, and the Maryland Venture Capital Trust. All three programs provide equity capital to emerging technology businesses. Taken together, the programs address a continuum of financing needs for technology companies.

The Challenge Investment Program provides initial financing for small start-up companies to cover the costs associated with bringing a product to market. The Enterprise Investment Fund provides second and third stage financing in partnership with private investors. The Venture Capital Trust invests public money in privately managed venture capital partnerships to increase the availability of venture capital in Maryland. DBED’s four-person investment financing staff administer the programs.

**Challenge Investment Program**

**Program Description**

The Challenge Investment Program (CIP) was created in 1988 to provide emerging technology companies with initial financing support for the commercialization of new technology-driven products and services. CIP, initially a grant program, was changed to an investment program in 1992. CIP makes small, high-risk investments in start-up firms. CIP funds can be used to help offset the costs of final testing and market development. In return for its investment, the state receives a royalty payment tied to the achievement of certain thresholds or revenues and capital structure.
CIP invests $750,000 annually in up to fifteen Maryland companies. A CIP recipient is required to obtain a private sector third party co-investor match or commitment of an additional $50,000. The typical CIP recipient is a small start-up company that has no access to bank financing. To be eligible, a company must have no more than 25 employees and annual sales revenues of $1 million or less. In reality, most have one to two employees and no sales.

Applications are received on an ongoing basis. Applicants must have a comprehensive marketing and business plan. After a preliminary review, a limited number of applicants are chosen to submit more information and to be interviewed. The evaluation criteria include (1) market potential for the technology; (2) ability of the company to attract private investment; (3) impact of the product or services on the Maryland economy; and (4) credibility of the company’s financial projections.

A company receiving a challenge fund investment signs an agreement, which stipulates that the company will pay a 2 percent royalty on revenues in excess of $500,000 for a period of ten years. The firm must also pay a one-percent royalty on equity raised in excess of $1 million. The return is capped at $150,000 for the royalty on revenues and $150,000 for the royalty on equity making the total maximum return $300,000. The company must also agree to stay in the state of Maryland for a period of three years. If a CIP firm moves out of state in less than three years, it is required to pay back $150,000.

CIP investments are limited to technology companies. To date, the majority of CIP’s investments have been in biotechnology, information technology and advanced materials companies, sectors that have experienced strong growth in Maryland.

CIP is not established in statute. It exists under the auspices of the Enterprise Investment Fund (described below) and receives an annual appropriation. Firms receiving CIP investments are considered potential candidates for EIF investments.

Accomplishments

During the four years in which it has operated as an investment fund, CIP has made $50,000 investments in 58 companies. Staff estimates that these companies employ approximately 300 people. As of 1997, two CIP companies have become EIF companies and another five to six are in the EIF pipeline.
Lessons Learned

The CIP program began as a grant program. Staff has found that the move to an investment program requiring a payback has helped introduce the discipline of the marketplace to the program thereby strengthening it. Another change that was made is that the program initially accepted applications once a year and then twice a year. Applications are now accepted on an ongoing basis. This has allowed the program to respond more effectively to the financing needs of the firms being assisted. Finally, while the program is designed to provide a return to the state, staff emphasize that the type of investments made by CIP, small investments in pure start-up companies, are high-risk investments and should be viewed as such.

Enterprise Investment Fund

Program Description

In 1993, the Maryland General Assembly created the Enterprise Investment Fund (EIF). The Fund makes direct equity investments in emerging high technology companies. EIF invests in firms that have a patented or proprietary product, manufacturing process, sales force and marketing strategy in place. EIF investments, which range from $150,000 to a maximum of $500,000, can be used for start-up costs including recruiting and hiring staff, operating costs, and product marketing. By statute, DBED’s investment cannot exceed 25 percent of the total ownership of the enterprise. DBED’s advisory board is considering providing follow-on funding on a case by case basis.

Investment decisions are based on the potential for returns, the promotion of economic development, and the creation of jobs. A company that receives an Enterprise Fund Investment must agree to keep its principal place of business in Maryland for at least five years. If a company moves out of state before five years, it has to pay the money back at fair market value on demand. The state takes an equity position—through the purchase of common and preferred stock, the purchase of warrants, making investment as a limited partner, or the acquisition of royalty rights—in the businesses which receive EIF funds. The term is a maximum of 15 years, although the state aims to liquidate its investments within seven years. Any returns to the fund remain in the fund to be reinvested.

All EIF investments must be reviewed and approved by the funds’ Investment Advisory Board. The five-member Board is appointed by the Secretary of Business and Economic Development subject to approval by
the Governor. The current Board includes two venture capitalists, the CEO of a biotechnology company, an economic development specialist, and the associate dean of the College of Engineering at the University of Maryland.

To date, the majority of the Fund’s investments have been made in biotechnology and information and computer technology companies, growing sectors of Maryland’s economy. Other industries targeted by the Fund include telecommunications, environmental services, aerospace, health services, manufacturing, and life sciences. Applicants must submit a detailed business plan and financial statements, including pro forma projections, for at least three years. A full description of the product or services is also required.

The legislature appropriated $2 million in FY98 for the program. The Fund anticipates making about six new investments.

**Accomplishments**

The Enterprise Fund has invested $6.2 million in 18 companies. These companies employ approximately 600 people. EIF’s investment has been matched by approximately $140 million in private investment. To date, the Fund has received only a small amount of revenue from interest and royalty payments. As of March 1998, however, DBED estimates that EIF’s investments are worth about $30 million, driven primarily from one investment which is currently worth $23 million. These gains have yet to be realized.

**Lessons Learned**

Maryland officials attribute the success of the program to several factors including:

- Expertise of the staff. People with extensive experience in the private sector staff the DBED investment group.
- The use of a private sector advisory board. The Board, with its knowledge of technology businesses and the venture capital process, provide tremendous guidance to the staff.
- Careful screening of companies. The Fund only invests in companies that have significant venture capital backing. The state, which never serves as the lead investor, requires a three-to-one match.
- The Fund seeks to invest in technology that is marketable. They depend on the expertise of the private venture capitalist to determine if there is a market for the technology.
• The Fund provides second and third round financing, rather than very early financing. Initial start-up capital is available through the Challenge Investment Fund.

**Maryland Venture Capital Trust**

**Program Description**

In 1990, the Maryland General Assembly passed legislation authorizing the Maryland Venture Capital Trust. The Trust was created to respond to a perceived need for seed and early-stage venture capital in the state. The program created a state-sponsored but privately managed venture trust that was designed to become a “fund of funds” investing state and public pension funds in a number of diverse venture capital partnerships each managed by a different venture capital firm. A Board of Trustees appointed by the Governor governs the Trust, a 501-(c) (3) organization. DBED provides administrative support for the Trust.

The Trust spent two and a half years obtaining commitments from state and city pension systems. In addition to the $2 million initial commitment from the state, the Maryland State Retirement and Pension System invested $15 million. The Employees Retirement System of the City of Baltimore invested $840,000 and the Fire and Police Employees Retirement System of the City of Baltimore invested $1.26 million for a total commitment of $19.1 million.

Once the commitments were obtained, the Trust solicited proposals from experienced venture capital companies to create funds that would invest, in part, in Maryland companies. It took two years to select eight private venture capital firms to manage the trust’s venture capital partnerships. The firms were selected based on 1) their proven financial management performance and 2) their commitment to invest in Maryland-based companies. Four of the eight firms are Maryland-based. The other four, while not based in Maryland, have committed to investing an equivalent amount in Maryland companies as the amount invested in the fund by the Trust. The Trust invested from $1.5–$3 million in each fund.

The funds vary somewhat in the types of investments they make. Two of the funds emphasize seed capital, one focuses exclusively on biotechnology, one focuses on medical and medical device companies, and the others focus on a mix of early-stage companies. Some focus solely on technology companies, others have a more varied portfolio of companies.
By and large, the Trust has experienced a good working relationship with the eight partnerships, which are now in their fourth year of actual investment activity in individual companies. Three of the eight partnerships are fully invested and managing their investments to maturity. The other five partnerships are continuing to make investments. The Maryland Venture Capital Trust does not participate in the management, operation, or decision-making process of the funds in which it invests. However, the EIF has co-invested with three of the eight partnerships in Enterprise deals.

**Accomplishments**

The accomplishments of the Maryland Venture Capital Trust can be measured in terms of the financial performance of the funds and economic benefit to Maryland. By December 1996, a total of $15.8 million had been invested by the Trust in all eight partnerships. Public stock offerings and private sales of several companies in four of the partnership portfolios has already returned to the Trust $3.7 million, representing the Trust’s partnership interests in those companies. The Trust’s Annual Report notes, however, that the eight venture capital partnerships have an operating life of 8 to 10 years, the time over which their investment cycles should be complete and their rate of returns realized. The overall financial performance of the Trust can only be measured over a similar period of years.  

The Trust has succeeded in leveraging its resources. Total investment in the eight venture capital partnerships is $327 million. By the end of 1996, the eight partnerships reported that they had invested approximately $50 million in 29 Maryland companies, more than two and one-half times the initial investment of $19.1 million committed by the Trust. Six of the firms have met or exceeded the minimum goal for investing in Maryland companies; the two that have not met their goal are still in the early stages of finding investments. The 29 Maryland companies in which investments have already been made have combined annual sales of more than $600 million and employ more than 2,400 people.

**Lessons Learned**

Maryland’s public pension systems, unlike those of some states, had no history of investing in venture capital prior to the establishment of the Trust. Strong support from the Governor was required to convince the

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pension funds to invest. Even with this support, obtaining commitments from the pension funds was a lengthy process.

The initial plan was to invest in early stage funds with a presence in Maryland. This proved to be unrealistic due to the small number of venture capital firms based in Maryland. As an alternative, the Trust invested in out-of-state funds that agreed to make a “best effort” to invest in Maryland companies at a level equivalent to the amount invested by the Trust in the fund. In the staff’s opinion this approach has succeeded and venture capitalists are more aware of opportunities for investing in Maryland companies today.

The Venture Capital Trust is structured to leverage private sector investment and to leave investment decisions to the marketplace. While this has worked well in Maryland, it requires strong partnerships with the private venture capital firms. The Trust does not participate in the decision-making process of the funds in which it operates and therefore cannot intervene if a fund makes investments that do not support the state’s goal of supporting emerging technology firms. One of the funds in which the trust had invested did not pursue the type of investments that the state was seeking and subsequently failed. The DBED investment financing staff and the fund managers in all the other cases work closely and share information on a regular basis.

The idea of creating a second Venture Capital Trust has been discussed but no decision has been made to do so. Staff believes that if a second Trust is created, it should be no larger than about $40 million. This would allow the trust to invest $15–20 million in each venture capital partnership. Investments of this size would keep the program manageable and allow the investment to be large enough to guarantee that the partnership would make investments in the state.
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