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FULL COMMITTEE HEARING ON: EXPANDING EQUITY INVESTMENT IN SMALL BUSINESS

HEARING

BEFORE THE

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HOUSE OF REPRESENTATIVES

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FULL COMMITTEE HEARING ON EXPANDING EQUITY INVESTMENT IN SMALL BUSINESS

Thursday, March 26, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. Jason Altmire [chairman of the Subcommittee] presiding.

Present: Representatives Altmire, Ellsworth and Fallin.

Chairman ALTMIRE. I now call this hearing to order.

This hearing of the Investigations and Oversight Subcommittee is called to order, and there is no question that the recession has hurt the balance sheets of small businesses. Profits are down in nearly every industry, and conventional forms of financing from bank loans to credit lines are limited.

Under normal circumstances, accessing capital is something of an obstacle. Since the dramatic meltdown of our financial markets last September, accessing capital has become especially challenging and not just for businesses seeking traditional funding. Even high growth start-ups are struggling to secure equity investment, such as venture capital.

Historically, high growth firms have relied on equity capital to get their businesses off the ground. For entrepreneurs who have solid business plans but lack immediate marketable products, venture capital and angel investment financing is crucial to the success of these companies. These forms of financing allow these companies the time they need to research and develop. In some cases funding may also come with managerial and technical experience. These kinds of resources have helped launch countless new businesses from software start- ups to biotech firms.

Many of today's industry leaders and innovators from Apple Computers to Sun Microsystems got off the ground with equity capital, and yet today this important form of investment has become increasingly hard to come by. In my home region of Pittsburgh, we have had the opportunity to team up with businesses in Cleveland Ohio to help facilitate venture capital investments. This partnership has attracted over 80 national venture capital funds to invest in more than 60 health care venture capital investments in the tech belt region.

Cleveland and Pittsburgh are now ranked second and third in national health care investment. Although this is one good example of the high quality investments that can be achieved through venture capital, it is important to consider how the current economic

situation is affecting these investments. By one estimate the Small Business Administration leaves $60 billion in unmet capital needs annual, and in an economic downturn these additional needs must be met elsewhere, such as venture capital, angel investing and other equity investing mechanisms.

In today's hearing we will discuss the decline in these investments and look for ways to respond to this challenge. Equity capital is the fuel that feeds the start-up communities' best and brightest. These are the businesses that create new jobs and revolutionize entire sectors of the economy. In 2006, angel investment alone helped generate 200,000 positions. Equity investment not only spurs small business growth, but also sparks the development of new products and industries.

Unfortunately, however, the deepening recession has dampened the equity capital markets and stunted small business growth. Amid growing uncertainty in the economy, many venture capital and angel investors are pulling back. In the last quarter of 2008, venture capital investments plunged $5.4 billion. That is more than a 33 percent drop from the same time last year.

Meanwhile angel investment has also declined considerably. In a recent study by the Angel Capital Association, half of those surveyed said they had invested less than expected in 2008 and one-third predicated their investments would decline again this year.

The current investing climate is the most tentative we have seen since the dot.com meltdown nearly a decade ago. Few industries have been untouched by this downturn, and it goes without saying that businesses of all sizes are suffering.

Of course, this will not always be the case, and once the clouds begin to clear and the economy starts to recover, we expect to see renewed growth in investment. In the meantime, there are a handful of policy measures worth considering, which we will touch on today. Those initiatives have the potential to not only bolster the entrepreneurial community, but jump start the economic recovery.

Small businesses will play an integral role as the country continues to work its way out of this recession. Following the downturn of the mid-1990s, entrepreneurs stepped up to the plate to create 3.8 million new jobs. Much of that growth was fed by equity capital, and many of those businesses, mere start-ups at the time, have since grown into industry leaders.

Entrepreneurs can help initiate that same kind of transformation today, but not without the resources necessary to create the new products that unlock those new markets.

I look forward to hearing our witnesses' thoughts on how we can help small businesses survive during this economic downturn, and I thank them in advance for their testimony.

And with that, I would like to yield to Ranking Member Fallin for her opening statement.

Ms. FALLIN. Thank you, Mr. Chairman, and good morning to all of our panelists. We appreciate you joining us today. We know that you are all very busy trying to make money. So we thank you for coming to testify.

And, Mr. Chairman, I want to say just thank you for calling this very timely meeting on an important subject for our nation and especially for our small businesses and for our venture capitalists

and our entrepreneurs of our nation who I believe are the backbone of America and ones who generate our jobs and help move our economy forward, and especially during these challenging times for our nation. We need to do all that we can to support our businesses and especially encourage innovation and entrepreneurship.

So thank you all for coming here today and welcome to our Small Business Committee. We want to listen to you to hear from the experts in the industry and to be able to share this information today with our colleagues here in the House.

Over the past several months this Committee has held numerous briefings detailing the credit crunch that is affecting America's small businesses, and due to the worsening economy, small businesses are finding it is very hard right now to find the capital that they need to purchase inventory to make payroll, to pay rent, to support their businesses, and it is a very tough time.

The credit crunch affecting small businesses has been well documented. We know that it is an issue. No less of a problem although and maybe somewhat less publicized is the current shortfall in equity investment. We in Congress must look at all ways that we can stimulate small business growth as this will play a vital role in our nation's economic recovery.

Equity investment, which includes the venture capital, the angel investing and private equity, has played a crucial role for a long time in the formation of small businesses for many decades. Unfortunately, these concepts are often some of the most misunderstood in entrepreneurship.

Now, it was commonly held that venture capitalists are involved only in early stage financing of relatively small, rapidly growing technology companies. This type of investment may be better viewed as a professionally managed pool of equity capital in exchange for a piece of ownership in the pie. Venture and angel capitalists provide a wide range of services from finding additional investors to financial planning, to providing very valuable skills to a firm and to a business, and not surprising, the current economic conditions are having a negative impact on the amount of money that is available, the size of the venture capital investments in small businesses.

Global financial markets have constricted dramatically, and there is little doubt that we are facing some unprecedented economic times. And due to this ongoing turmoil, businesses especially or small businesses are finding it very difficult, as the Chairman just stated, to raise capital from banks or even in the stock market. And there are times, I must say, I wonder about how we are affecting that by some of our talk here on Capitol Hill.

Following public exchanges have been having a double impact on the companies seeking financing not only for the devaluing of private stock values and holdings, but also wiping out vast amounts of equity capital. When private investors see their portfolios shrink, they become more conservative. Money that might have gone to early stage private investments is sometimes headed off to safer harbors like CDs, mutual funds, or even bonds.

And the amount of money involved nationally fluctuates from year to year, but over the past three years, venture capital dollars

invested in the total number of deals have remained somewhat steady, around $28.6 billion and around 3,811 deals per year.

That being said, 2008 saw the first yearly decline of total investments of venture capital since 2003. Venture capitalists investments in 2008 experienced an eight percent decrease in dollars, a four percent decrease in deal volume from 2007, and this decline in investments has reached all industries. I do not think anybody has been immune from it in all stages of development.

So this hearing today is to allow us as members of the Small Business Committee an excellent opportunity to be able to hear from you, those of you who are working every day in these marketplaces, to know what we can do to better help you.

And, Mr. Chairman, I will just say as I mentioned a few moments ago, I think sometimes our rhetoric here on Capitol Hill and maybe in the national media, some of the policies have really had an effect upon all of our investors, our entrepreneurs in raising money. I had the opportunity to visit with some of our small business owners from across our nation this week, and one of the things they told me was they said in these challenging times for our business community and with a recession and the different policy changes that are being debated here in Washington where they are dealing with financial markets, where it is dealing with stability, Wall Street, whatever it might be, they said just quit changing the rules on us. You know, we do not know from day to day what is going to happen with bailouts, stimulus, all the different things that we are debating here in Washington. Just do not change the rules. Just give us some certainty, and we will let loose our money and we will spend it.

Right now we are scared. We are worried in a way that it is talking about raising capital gains, talking about raising corporate income taxes, taxes on small businesses. All of those things concern our business and our investors, and the equity markets.

So we are looking forward to hearing from you. We have been very blessed in Oklahoma to have OCAST, Oklahoma Center of Science and Technology, and some state funds and many different venture capital funds in our state, and I know it is very important to not only our state, but to our nation.

So thank you, Mr. Chairman, for bringing up this issue and holding that hearing today. We appreciate you, and I will yield back my time.

Chairman ALTMIRE. I thank Ranking Member Fallin, and I also want to thank Congressman Ellsworth for being here from Indiana. We look forward to hearing from him later.

And I want to explain to the witnesses the process we have. We are going to move from your left to your right across. We are going to introduce you one at a time, and you have five minutes to speak. The light that you see in front of you is going to start on green. When you have one minute left it is going to turn yellow, and when you are out of time, it is going to turn red, which means sum up, but I will be lenient.

I thank you all for being here because you do have other places you could be a this point, but this is an important enough issue to you that you made the trip, and we do want to thank each and

every one of you for offering your expertise to the Committee, and we look forward to hearing from you.

Now, Ms. Pamela Hendrickson is Chief Operating Officer of the Riverside Company, a private equity firm with headquarters in Cleveland and New York, which focuses on investments in small and middle market companies.

Ms. Hendrickson.

STATEMENT OF PAMELA HENDRICKSON, CHIEF OPERATING OFFICER, THE RIVERSIDE COMPANY

Ms. HENDRICKSON. Thank you.

Chairman Altmire, Ranking Member Fallin, thank you very much for having me this morning.

As you said, I am Pam Hendrickson, Chief Operating Officer of the Riverside Company. We're a private equity firm that has spent the last 21 years investing in small companies around the world. Recent newspaper headlines might have some people believing that the private equity industry is made up of former investment bankers who used black box financing to acquire companies in big cities and then vaporized the assets and the employees. That is not what we do.

We have invested $1.8 billion in 211 companies. We work with them for about five years, and when we sell them, typically their earnings have risen by 100 percent. Today I want to talk for a few minutes about how we do that.

Unlike venture, which helps companies in the start-up phase of their life cycle, we help companies that are in a bit of a later stage. We have three mechanisms by which we create value.

First, we increase the earnings of the companies we buy.

Second, we earn a bigger multiple upon sale because we have built a much stronger company.

And, third, on occasion we restructure the balance sheet.

I am happy to tell you only eight percent of our gains have come from restructuring the balance sheet. For us it is all about growth.

About 60 percent of the companies we buy are family owned businesses in small communities, like Oneida, New York or Paris, Kentucky. The founders and owners typically have most of their net worth tied up in these companies, and when they decide to sell their business, it is generally because they are seeking liquidity for retirement or to secure the financial future of their families.

For example, we purchased CPI, a training company based in Brookfield, Wisconsin. The company was for sale because the owner had been diagnosed with a terminal disease and wanted to insure that his employees would be safe and his business would be ongoing.

We quickly evaluated this opportunity and were able to close this transaction in 30 days. Today, through the addition of new programs, some international growth and some modest price increases, CPI has increased its sales by 25 percent, and the employees are prospering.

On other occasions we work with young management teams that need both capital and additional expertise to grow, one in Washington, Pennsylvania, in fact, and sometimes we actually create a small business from what we affectionately call a corporate orphan,

a non-core division of a large company that has suffered due to lack of capital and attention.

Such was the case with Just Right Manufacturing in Mattoon, Illinois. Just Right was a division of Federal Signal, a manufacturer of safety products that help prevent catastrophic industrial accidents, and it really needed attention. We bought it, founded a top management team, and realigned its pricing strategy.

Since our acquisition, the company has grown earnings 40 percent and kept a lot of jobs in Mattoon.

We help our companies in many ways other than simply providing capital. First, we give them access to our strong lender network. In 21 years, our senior lenders have lost money only once. So they like working with us. Our debt ratios are low, 2.9 times operating earnings versus the industry average of four and a half times.

Second, we pool the purchasing power of our 50 U.S. companies so that they get the benefit of being part of something bigger. For example, on a pooled basis, our company spent $25 million with FedEx so that each of them gets treated like Hewlett Packard.

Third, we have done a tremendous amount of work helping our companies manage their health care benefit costs. Through our programs we have held per employee per year cost nearly flat since 2006 at $8,000. The industry average is 36 percent increase.

Recently we actually got a nice compliment from the United Steel Workers who were impressed that we were able to continue offering such great benefits.

We also improve financial controls and bring in strong outside directors. As the PE industry continues to contribute increasing percentages of GDP, it is understandably gaining the attention of the regulatory bodies just across the aisle, I think. One area of particular concern to us are the new FASB 157 or mark to market regulations. While we fully support marking to market and have always done so, the new regulations require that we use outside resources and a more public company approach. Last year we did a transaction every eight days. So we are constantly in the market, and we really know how to value companies.

Unfortunately, we are now being forced to value companies during our hold period in a way that is different from how we value them ourselves when we buy and sell them. In addition, these regulations are costing our investors an additional $500,000 per year due to the additional time required from our auditors and outside consultants.

Getting the U.S. economy out of the doldrums will undoubtedly be driven by the growth of small business, but we need debt, and despite our great lending relationships, the debt markets remain tight. We have wondered whether there might be an opportunity for some form of public-private partnership through which the SBA could provide some debt at the fund level.

We have a lot of skin in this game, and the future of our firm is based purely on our track record. Just as companies compete for capital so we compete for investor capital. It's a very democratic process, not based on status or where we went to school, but based purely on our performance. So we have to grow our companies.

Thank you.

[The prepared statement of Ms. Hendrickson is included in the appendix at page 24.]

Chairman ALTMIRE. Thank you, Ms. Hendrickson.

Now we will turn to Sherrill Neff. Mr. Neff is founding partner of Quaker Bio Ventures, a venture capital firm located in Philadelphia that invests primarily in life science companies with outstanding growth potential. Mr. Neff is testifying today on behalf of the National Venture Capital Association, the leading trade association that represents the U.S. venture capital industry with over 450 member firms.

Welcome, Mr. Neff.

STATEMENT OF P. SHERRILL NEFF, QUAKER BIO VENTURES, ON BEHALF OF NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. NEFF. Thank you, Mr. Chairman, Ranking Member Fallin, Mr. Ellsworth.

I am a founding partner of Quaker BioVentures, which is a Philadelphia based venture capital firm investing only in life sciences companies with outstanding growth potential across all stages of development. We raise money from institutional investors of many types and invest those funds for the long term in innovative start-up companies. All of our funding and efforts go toward company growth, not financial reengineering.

In most cases, venture capital is the only funding source for these companies at their stage of development, as the risks are way too high for traditional bank and other financing. Venture capital is a relatively small asset class, and it should probably stay that way, with approximately $28 billion, as Representative Fallin mentioned, invested on an annual basis over a fairly consistent period of time, with a notable blip in the early part of the 2000-2001 period.

Last year that capital went into 3,800 different companies in the United States. Despite our size, our industry has created exponential value for that investment dollar. Venture backed companies account for more than 10.4 million United States jobs and $2.3 trillion in U.S. revenues, or 18 percent of the entire GDP. And we estimate that one out of three Americans have benefited personally and directly from venture backed medical innovation.

Organ regeneration and development of drug therapies for macular degeneration are just two of many, many innovations represented in our portfolio of over 30 companies, which also contribute thousands of jobs to the regions in which we invest.

While the venture capital community is not in need of rescue by any means and, in fact, has money available to invest in emerging growth companies, there are critical ways in which policy makers can support our efforts to continue to build innovative American companies.

First, we support maintaining capital gains tax treatment for the carried interest portion of our investment return. This tax policy has proven to motivate venture capitalists to make long-term investments in creating new companies and jobs that did not exist before. Encouraging this investment behavior is exactly what Congress intended when it enacted capital gains tax legislation many, many years ago.

It is critical that VCs continue to be rewarded in a manner commensurate with the huge risks we take. Otherwise our risk-reward equilibrium will be thrown off, and even highly promising companies will not get funded because we cannot justify the risk.

The President's budget has a provision to change the carried interest tax rate to ordinary income effectively tripling taxes of those most responsible for new company creation. At a time when our country needs to create jobs, such a change is counterproductive for economic growth. We ask that you look very carefully at each industry impacted by the change in the carried interest tax rate and enact policies that are fair but continue to promote long-term investment rather than to choke it.

Next, we need government funding for basic research to fuel the innovation pipeline from which we draw to create our companies. A great example in our portfolio is a company based in Connecticut called Optherion, developing truly novel therapies for macular degeneration.

Optherion was created from NIH funded technologies in four universities, the University of Iowa, the University of Pittsburgh Medical Center, Rockefeller University, and Yale University. We have combined all of these technologies together with an experienced management team, have raised over $30 million in venture capital funding, and the company's drugs will begin human testing later this year.

We applaud the allocation of a significant chunk of stimulus dollars to continuing basic scientific research in the universities' academic centers.

In other areas, such as the SBIR grant program, venture backed companies have been unfairly excluded, in our opinion, from applying as there is a misconception that venture backed companies are not small businesses. This, as you know, is not true. Venture backed companies are often without revenues and with employee counts in the single digits. Without federal funding these companies often cannot move forward with basic research projects.

We commend this Committee for passing legislation last year addressing this issue and hope to permanently resolve this issue this year.

Third, we ask that the government look at the many instances where regulation has created additional burdens and uncertainties that threaten the growth of small companies. For instance, many companies are struggling with the cost of Sarbanes-Oxley compliance, which continues to place a very expensive burden on small entities.

In our sector, the life sciences sector, regulatory uncertainty at the FDA continues to have an adverse impact on our ability to make investment decisions. When the rules are changing, you do not know what you are investing in, and it is very, very difficult to decide that without clarity.

Lastly, the government can protect innovators better through an approach to patent reform that recognizes the disproportionate burden for smaller companies when defending against patent infringement. This protection in our opinion should include a post grant review process that is limited to a very short period, 12 months, so

that small companies are not subject to endless patent challenges by large corporations.

It also involves meaningful infringement penalties in situations so that we can really deter large companies from infringement that today is not adequately costly to them.

Another area of protection that is important to us is the protection of companies that have invested millions of dollars, decades of development, bringing novel biologic therapeutics to market. If generic alternatives are allowed to enter the market shortly after the original is made available, the original innovators will not be able to recoup their investments. No investor will be able to fund them profitably, and innovation will stop or slow.

The venture capital industry remains committed to investing in the most promising innovative small businesses our country has to offer, but we need to maintain an environment that allows these companies to thrive. As Congress considers policies that impact start-ups and the start-up community, we appreciate the opportunity to offer an ongoing voice that supports the viability and growth of these entities.

Thank you.

[The prepared statement of Mr. Neff is included in the appendix at page 36.]

Chairman ALTMIRE. Thank you, Mr. Neff.

And to introduce the next witness, Mr. Walker, I will turn it over to Ranking Member Fallin.

Ms. FALLIN. Thank you, Mr. Chairman.

We are very pleased to have a fellow Oklahoman up here today, Mr. Tom Walker who is the President and Chief Executive Officer of I2e. He brings tremendous energy and leadership to the creation of commercialization and entrepreneur development initiatives in Oklahoma's advanced technology sector.

And Tom is a founding member of the Board of Directors of the National Angel Capital Association, serves on the board of the Oklahoma Biosciences Association and the Oklahoma Manufacturing Alliance, and has been a great leader in our state in venture capitalism.

So, Mr. Walker, we are glad to have you here.

STATEMENT OF TOM WALKER, PRESIDENT AND CEO, I2e, ON BEHALF OF BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. WALKER. Thank you. It is my privilege, Chairman Altmire, Ranking Member Fallin, Mr. Ellsworth.

Thank you for this opportunity to testify today regarding the difficulties facing the venture capital and angel capital industries, and in particular, how it is impacting the biotechnology industry.

My name is Tom Walker. I2e is a nonprofit corporation in Oklahoma that assists advanced technology companies, and we provide specialized commercialization services and access to risk capital in the earliest stages of a company's life, especially to those companies facing the funding gap that we commonly refer to as the valley of death. We accomplish our goals through the assistance of the State of Oklahoma actually, through OCAST. We have invested in over 100 start-up companies over the past ten years.

However, today I am testifying on behalf of the Biotechnology Industry Organization, an organization representing more than 1,200 biotechnology companies, academic institutions, state biotechnology centers, and related organizations involved in the research and development of health care, agriculture, industrial and environmental biotechnology products. The overwhelming majority of biomember companies are small, early stage, research and development oriented companies. America's leadership position in this industry today is really threatened by the economic environment that we find ourselves in.

The total capital raised by the biotech industry has fallen 56 percent in the last year. Almost half of all public U.S. biotech companies have less than one year of cash remaining on hand. The amount raised through initial public offerings has fallen by 97 percent, from $1.9 billion to $5.8 million. The slowdown in private investments has been dramatic as well, as venture capital investors find they can no longer afford the high risk that is characteristic of investment in biotech.

So I will briefly mention a few approaches to sustain emerging biotechnology companies in this time of need. First, allow small companies access to the NIH Recovery Act funds. As part of the Economic Recovery Act, Congress appropriated $8.2 billion to the National Institutes of Health. These dollars will largely be used for basic research and must be spent within the next two years.

Historically, NIH grants go to research institutions. So if we could just allow a small percentage of those funds, the Recovery Act funds, to go to small businesses, it would have a tremendous impact in this time of need in developing new technologies and therapeutics, things of that nature in the biotech industry.

Second, we should enact new tax incentives for investment in biotechnology. One thing in particular, President Obama's budget proposed to eliminate capital gains taxes on investments in start-up companies. Yet details on this proposal have not been forthcoming. So I would urge members of Congress to work with the Obama administration to refine the proposal in order to make it as useful as possible for small, capital intensive companies greatly in need of new funds.

Third, I would like to bring up amending the SBIR eligibility rules related to venture capital. This has been a highly successful program for injecting government dollars into small, innovative firms. The SBIR program currently excludes companies that receive a majority of their funds from venture capital investors. So enactment of the SBIR reauthorization and considering changes to allow for greater participation of companies that receive VC funds is more important than ever in this current economic climate.

Fourth, I would like to consider creating a funding mechanism for high growth companies, a new funding mechanism, perhaps a grant, even a loan program that is really targeted to high tech companies, really targeting a specific stage even for those companies that are unable to raise funds should be considered. This program need not be permanent or add to the deficit, especially if structured properly. I think there are terrific best practice examples at the state levels that we could look at to really model a program for the SBA.

A private investors wait on the sidelines for the financial markets to recover, government can help to fill the funding gap through narrowly targeted measures. I would suggest that we are far better off spending a little money today rather than seeing a whole generation of America's most cutting edge, science based industries decimated by the current capital environment.

Thank you.

[The prepared statement of Mr. Walker is included in the appendix at page 48.]

Chairman ALTMIRE. Thank you, Mr. Walker.

We turn to Catherine Mott. Catherine Mott is the founder and CEO of BlueTree Capital Group, an organization located in Wexford, PA, that provides the professional staff to facilitate and manage the Allied Angels organization.

In 2003, Catherine Mott started Western Pennsylvania's first business model angel network, BlueTree Allied Angels.

Welcome, Ms. Mott.

STATEMENT OF CATHERINE MOTT, FOUNDER AND CEO OF BlueTREE CAPITAL GROUP, LLC

Ms. MOTT. Thank you, Chairman Altmire and Ranking Member Fallin and all of the members of the council.

I took the liberty to title my discussion today "Entrepreneurs Can Lead Us out of the Crisis." Before I elaborate on the title, please allow me to explain my company's BlueTree Capital Group and BlueTree Allied Angels.

BlueTree Capital Group was created as an entity to purposefully aggregate angel investors to invest in early stage companies. We are a member of the Angel Capital Association, our professional support organization whose testimony you will hear from John May today. Because BlueTree is located in Pittsburgh, PA, we are fortunate to be strengthened by three outstanding universities that serve as very fertile ground for a multiple spin-out of ideas into companies.

Please do not confuse us with Silicon Valley, Boston or San Diego. We are Midwest town with a very small but vital venture capital presence. The companies created in Pittsburgh are less likely to be funded by VCs or even by super rich angles like Marc Andreessen, who is the founder of Netscape, but instead they are funded on the backs of hard working professionals whose average annual salary is between 200 and $400,000.

I tell you this because most angel investors look like us, not like Marc Andreessen, whose multiple millions lead people to think that they can invest in start-ups under any circumstance and in any economic climate.

The average angel investor in the U.S. is at the lower end of the wealth spectrum and is not located in Silicon Valley or Boston. This is an important distinction for the Committee. The current economic crisis has crippled the average angel investor's ability to invest because their net worth has dropped to a point where they no longer can place marginal capital at risk on start-up companies.

At BlueTree Allied Angels, since September 2008, two-thirds of our 53 investors have ceased investing in early stage companies. Why should this matter? Well, it matters because they fund compa-

nies that banks or other sources of capital will not or cannot fund. It matters because these investors are the mechanism that fills the funding gap between friends, family, and institutional financing. Without this mechanism, there would be no Alcoa today. It matters because entrepreneurs are the fertile soil for job growth and recovery. It matters because funding entrepreneurs can lead us out of the economic crisis.

This recessionary crisis is more than a downturn caused by bad lending practices and Wall Street avarice. The greater underlying dynamic is at work and it has been at work for some time. A fundamental change is taking place in the global marketplace. It is a rapidly changing, technology driven global economy.

The United States, the nation that brought the world electricity, the telephone, radio, TV, and the personal computer, could be losing the race for its own history. China, Germany and India and other countries are aggressively encouraging and setting the stage for an economy that will flourish in this new technology driven age.

For example, contrast the U.S. capital gains tax rate to the zero percent capital rate and Hong Kong, Singapore, and even Germany. The current U.S. economy and its tax policies are not built for this rapidly changing, technology driven new world.

In addition to fixing our U.S. debt and credit infrastructure, the U.S. needs a healthy equity capital infrastructure that can rapidly respond to the demands of a new age and the new competitive forces of the world. The real danger for the U.S. lies in merely fixing the old economy and ignoring the new economy.

Only entrepreneurs have the flexibility, the freedom and the risk everything ambition to find the path back to prosperity, and it is the passion and commitment of angel investors funding these entrepreneurs that makes it possible. Yes, passion and commitment; about half of the angel investors provide more than money to entrepreneurs. They provide experience, guidance, business consulting, and contacts from their Rolodex.

The passion and commitment also exist in tolerating investment loss. Like our venture capital friends, in an average angel investor portfolio of 18 companies, the angel investor will see five of these companies go bankrupt and only one or two will deliver an outstanding return. It might be better explained metaphorically. Five will strike out, ten will make it to first or second base and return a moderate amount of capital to investors, and one and maybe two will be a Hank Aaron home run.

The hidden cost of this economic crisis is that angels have lost their wings. They are retracting as a result of the weak market and a stymied economy. I greatly appreciate the opportunity to speak with you today because as policy makers, you can make a difference by setting a tone with legislative initiatives that can help reverse the downward spiral of investing in business building and job growth.

Regardless of where we fall in the political spectrum, all of us in this room have to agree that innovation and building businesses are imperative elements of American economic strength. There have been recent policy initiatives to restore our national communications and travel infrastructure, but that infrastructure has no value unless we restore the financial infrastructure for building

sustainable companies. Nice, new bridges do not mean a thing unless we are creating sustainable jobs whose tax base can pay for the nice, new bridges.

If capital does not start flowing soon to start-ups and early stage businesses in this country, we will be faced with years of lost innovation. We will lose the good paying jobs and the healthy tax base to other parts of the world that are aggressively facilitating innovation and start-up companies. I hope you will consider the six suggestions that are in my brief that I have submitted to you, and I appreciate this opportunity to speak.

Thank you.

[The prepared statement of Ms. Mott is included in the appendix at page 54.]

Chairman ALTMIRE. Thank you, Ms. Mott.

We will hear next from Mr. John May. He is the founder and managing partner of New Vantage Group, a leading angel investment firm that mobilizes private equity into early stage companies and provides advisory services to both funds and private investors. Mr. May is testifying today on behalf of the Angel Capital Association, the leading organization of angel groups with over 165 member groups and another 22 affiliate organizations throughout North America.

Thank you for being here, Mr. May.

STATEMENT OF JOHN MAY, NEW VANTAGE GROUP, ON BEHALF OF ANGEL CAPITAL ASSOCIATION

Mr. MAY. Thank you, Chairman Altmire, Ranking Member Fallin and Mr. Ellsworth.

It is great to be here and to be included in this discussion. I actually have enjoyed organizing angels, high net worth individuals in this Washington, D.C. area, and it occurred to me I should extend an invitation. Any time you want to see the way we operate, come on and let us know and you will come to attend a breakfast meeting with us. I will not charge you for the first meeting, and we really would enjoy sharing with you this new phenomena of angel groups as opposed to sole practitioners.

The Angel Capital Association is only six, seven years old. It came out of a great relationship with the Kauffman Foundation in Kansas City, and it really is the organization which is trying to professionalize and to learn best practices on how to grow early stage companies with the time and money of high net worth individuals, as opposed to institutional money, to round out our community.

As you know, start-up companies and high growth companies need capital beyond the customer, beyond bank financing, and what is a uniquely American phenomenon over the centuries has been individuals investing their own after tax dollars in strangers' opportunities to try to get high growth companies to provide jobs and economic development in their region. Ninety percent of us invest within one or two hour drive time of our own community, and we look for long-term capital gain, and we will touch on that in the testimony.

We have been organizing the development of these angel groups. We have realized in the little bit of research that is done we are

probably at about the same size in terms of capital deployed as the institutional venture capital industry, about 25 to $30 billion a year, but our groups tend to do 50,000 or 100,000 transactions a year in all 50 states, whereas as you know, the traditional institutional venture capitalists are really looking for the cream of the crop and heavily are dominated by larger transactions into a smaller number of high growth companies.

What we are trying to do is to develop the local high net worth individuals doing it (investing) to develop our own local economy. We have a real problem in today's economy because the engine of angels' activity is their own personal net worth, and that is down, as you know, in the economy. So we mention that the number of angel investors is going to be reduced by this economic crisis. Their propensity to spend their wealth on high risk, early stage ventures is down right now. That needs to be reinvigorated, and just as entrepreneurs are finding people who have left and been laid off are starting businesses, and entrepreneurs are looking for capital, the banks, and institutional venture capitalists and so forth are not as robust as they were.

So what can we suggest? So in the testimony we just suggest five areas that we would like to suggest that might be appropriate for governmental attack, and we can hopefully have a dialogue and talk about these in a few minutes.

One obviously is tax policy. Low long-term capital gains is the underlying commitment that we have to spend our time and our money for three, five, seven years. Obviously the most important thing would be to not have that highly taxed when it comes out. So angels are very dependent upon a 15 percent or lower capital gains tax rate.

Second, the idea of many states, 22 states in the United States, and many foreign countries have tax credits that are applied to the investment that you make in a qualified company so that you are incentivized and can diversify your portfolio further because you get a 20, 25 percent tax credit for taking this risky investment. It has been done at the state level successfully in the United States, including some of the states represented here. We would recommend that you look at not only the capital gains tax rate, but the pros and cons.

Maryland, for example, has a 50 percent tax credit for an investment in a biotechnology company, but it only has a certain amount of capital, six million a year, and they sit in line on July 1st to be able to have the company apply for its position in that pool of six million, and it is exhausted usually in the first half of the year. So there is something here that incentivizes individuals.

Next, education training and awareness. Think of just a few dollars were used at the university level, at our nonprofit, the Angel Capital Education Foundation to further in all 50 states the development of angels, the encouragement of entrepreneurs to approach high net worth individuals and have less mystery and the whole idea of how to approach an angel, how angels should develop their risk profile of making these investments.

I am the lead instructor in one such Power of Angel Investing Seminar, and you should just see the light go on when people are

sitting there in Charleston, South Carolina, in Boise, in Chicago, and realize that you can do this with some help.

Third, we really do think we should keep angel investing at a private level. We do not see any need for a governmental office or an SBA program to highlight angel education activity, Website development. We think that is best done at the private level. It is tax policy and some other things that might need governmental hand.

Fourth, accredited investor standards have been very constant over the last two decades. We would prefer not to see any change in the sophistication standard that is used by the SEC to allow for angels and entrepreneurs to deal with high net worth individuals as accredited investors, the million dollars of net worth, for example.

There has been some discussion of indexing that or changing that. That would be detrimental to entrepreneurs because then the sophisticated angels would not necessarily have that position because it was raised.

And last, there is the idea of leveraging private equity, and similar to Tom's discussion, we would urge you to think about a loan program or a co-investment program similar to Scotland and some of the other countries of the world where if an angel or an angel group makes a commitment, does the due diligence and has a relationship with an entrepreneur and takes risk capital and makes the investment, the idea would be that this loan program or a federal program would match that to some degree and then would make the government entity an investor in these companies, but would not need any bureaucracy, would not need any administration. It would follow an angel group that would make the investment, and it would increase the money that was available to entrepreneurs.

I have gone on too long. I apologize, but I do want to suggest that there is a lot of meat here that we would love to have further discussion with you afterwards, and we are always available at angelcapitaleducation.org to answer any questions that you might have.

[The prepared statement of Mr. May is included in the appendix at page 59.]

Chairman ALTMIRE. Thank you, Mr. May.

Finally we will hear from Mr. Patrick Dalton. He is the President and Chief Executive Officer of Apollo Investment, a leading provider of investment capital for small, middle market companies generating both current income and capital appreciation through debt and equity investments.

Welcome, Mr. Dalton.

STATEMENT OF PATRICK DALTON, PRESIDENT AND COO, APOLLO INVESTMENT CORPORATION

Mr. DALTON. Thank you, Chairman Altmire, Ranking Member Fallin, Mr. Ellsworth.

I am very pleased to be here today. My name is Patrick Dalton. I am the President and Chief Operating Officer of Apollo Investment Corporation, an SEC regulated business development company commonly known as a BDC. For five years since our IPO, Apollo Investment Corporation has invested over five and half bil-

lion dollars in 124 small and middle market companies across the U.S., and today we have up to $700 million of available capital on our balance sheet.

As successful as our company and our industry have been, I am here today to let Congress know that the mission that this body gave to BDCs 29 years ago to provide much needed capital to small and mid- size companies is in danger unless prudent policy steps are taken now.

I am not here to ask for money. Far from it, I am here to ask for some common sense policy help so that we can use the money that we already have to originate new loans and to support the very companies that this Committee feels so strongly about.

But first, the good news. We estimate that the nation's BDCs currently have a combined loan- investment portfolio of over $30 billion that provides capital to over 1,400 small and middle market businesses. These loans are the life blood of these Main Street businesses that support over 1.2 million U.S. jobs. In 2007, we estimate that the BDCs provided approximately 50 percent of all the junior debt capital loans, known as mezzanine loans to small and mid-size businesses throughout the U.S.

As many of you know, Congress created the BDCs in 1980 under amendments to the Investment Company Act of 1940, in direct response to the crisis in the capital markets that threatened small businesses in the late 1970s. Today we are in what many believe is a once in a century recession. Small and middle market businesses have once again been abandoned by the traditional sources of capital.

BDCs remain among only a few investment vehicles that are continuously dedicated to lending to small businesses. Our industry is lending in excess of $30 billion. None of us wants to see capital of that magnitude withdrawn from or otherwise unavailable to small and middle markets.

It is our strong belief that BDCs occupy a unique regulatory space. Like banks, we originate, restructure, and we make loans directly to companies with the intention of holding most of these loans to maturity. However, unlike banks, we are much less levered, with a maximum leverage ratio of debt to equity of a mere one to one.

Further, we are required by statute to invest at least 70 percent of our capital in small and middle market U.S. businesses, and while we make similar discrete, hold to maturity loans as banks, BDCs are obligated to mark to market 100 percent of our loans, while the banks only mark to market a minority of their loans.

We are regulated by the same division of the SEC as mutual funds, but we are not a mutual fund. We do not trade liquid securities. Instead, we make individualized loans.

BDCs have always used fair value principles to value our portfolio. Prior to the implementation of FAS-157 in its interpretive guidance, the industry used fair value measurements based upon underlying credit fundamentals, that is, the collectability of interest and principal in the pricing of new mezzanine loans.

Unfortunately, we have been forced by changes in the accounting rules in order to practice to fix what was not broken. The accounting community now requires that our illiquid assets be valued as

if they were trading assets being sold into a hypothetical market, too often drawn from a series of distressed asset sales or other illiquid assets that are not at all comparable to our individualized performing loans. We believe that this practice has caused artificial asset value write-downs for the BDCs without meaningful regard to the credit quality of our underlying assets and has misled investors.

And most important to the mission of this Committee, the same accounting asymmetry results in many fewer loans and perhaps the succession of all origination activities to the small business community by the BDCs. Every BDC finds itself hoarding cash rather than making loans so that they will not trip their statutory one- to-one asset coverage test that I mentioned earlier.

Apollo Investment Corporation I am very pleased to state has recently reported that we are in compliance with all of our covenants. Yet we still must be cautious about using any of our $700 million of available capital toward making new loans. We have, therefore, voluntarily chosen to curtail new lending activities until such a time that there is a resolution to this issue. This means that while we have the ability and the desire to lend, we are unable to do so because of the policy and interpretive guidance of FAS- 157.

As many of you know, the leadership of this very Committee has written the SEC asking that regulatory reform be taken quickly before further deterioration occurs, but as of today, we are still in need of your help. We have made three suggestions to the Commission, and it is to those three suggestions that I want to return.

First and foremost, we ask that the BDCs be expressly included in the work that the FASB and the SEC have been tasked with by the House Financial Services Committee to respond with improvements to mark to market accounting. If we are able to offer true value accounting for a hold to maturity loans, we could and we would resume lending.

Second, we ask that BDCs be given temporary authority to raise preferred stock and treat those shares as equity rather than debt.

And, third, we also ask you for temporary relaxation of the asset coverage limits.

In closing, let me end where I began. I am not here to ask for taxpayer money. I am not asking for a bailout of an industry that made bad decisions. I am here solely to ask for your help in returning us to the public purposes for which you, the Congress, created BDCs 29 years ago. It would, indeed, be a shame if common sense did not prevail.

Thank you.

[The prepared statement of Mr. Dalton is included in the appendix at page 67.]

Chairman ALTMIRE. Thank you, Mr. Dalton.

For questions we will go back and forth, and I wanted to open up by asking Mr. Neff a question.

In your testimony you talked about the large investments made by a small group of venture capitalists. Can you further explain why venture capital is so important to the economy in context with how what you do is different from the big buyout groups and the hedge funds?

Mr. NEFF. That is a lot to chew, but I will give it a try. When we come upon an investment that interests us, it typically has gotten either a terrific group of management around it if it is a raw start-up, and the idea is so compelling that we invest a lot of time and a lot of consulting help and a lot of effort in trying to understand the opportunity.

And then when we do decide to try to put together a group of venture capitalists to actually form a syndicate to make an investment, at that point we give birth to that company or if it is a company that has been funded through the angel networks or through other programs, we then bring another round of investment intensity to the company and help to propel the next stage of growth.

The important point is that our companies are receiving our capital in order to invest in research and development or in order to invest in job growth, and in order to invest in economic growth. These companies were not generally using any of our capital to pay off other shareholders, to buy positions of ownership from other shareholders, to repay debt and those kind of things that are shuffling the financial deck, if you will, but not being invested in core economic growth.

So I think that venture can be contrasted from the buyout firms in that regard. Now, I do not mean to contrast ourselves unnecessarily from firms like Pam's because they invest so much in growth equity at a slightly later stage than we do, but I think that there is definitely from a policy perspective; in my mind, there is a real difference between firms who primarily invest in job growth and in fueling company growth when compared with firms that generally invest in highly leveraged transactions and a reshuffling of the financial deck.

Chairman ALTMIRE. Thank you.

And I am going to ask another question, and then I am going to turn it over to Ms. Fallin. For this question I would like all of your opinions who have an interest in answering. We will start with Mr. Neff since we are on him.

And in your testimony in particular you focused upon the President's proposal to apply no capital gains tax for investments for small businesses, and from your perspective in the investment of the entire panel, how broadly should this tax be applied in order to maximize its benefits to the small business community?

Mr. NEFF. I think there will need to be a lot of discussion in terms of what the parameters of its application are, but I think that if we can adequately define what a small business is and we can adequately define the purpose of the proceeds of the investment so that it creates jobs, so that it creates funding for research and development and early commercialization activities, I think that that is where that tax incentive ought to be focused. If it is focused instead on things that are less productive to economic growth, then that is where it ought to be cut off.

Mr. MAY. At the Angel Capital Association conference summit that we had last year, about 380 credited investors representing the different groups, all of us were there, and this is herding cats. These are all very interesting people, but they all have a lot of opinions.

The one common public policy position we came up with that everybody agreed on was low or no long-term capital gains, and we would be very happy with the venture capital standard or whatever.

It is time that makes a difference to us. So whether you make it two years, three years, five years, to have zero capital gain, that is the key thing that will keep angels, we believe, continuing to invest in start-ups.

Mr. WALKER. I would just echo the other comments that were made. It is a definitional issue on what is a start-up or a small business that really needs to be defined, and then the use of proceeds and make sure that the infusion of capital is for economic development purposes.

The time factor on the capital gains is really key to investors.

Ms. HENDRICKSON. I agree with that. I think it is the time factor, and obviously private equity has been a little bit a the vortex of this in terms of the carried interest discussion, but you know, when you think about what we do, we are putting both our money and our sweat equity into a company that makes chimneys, and we are working with that company for five years. So if that is not a capital gain, I am not quite sure what is.

Chairman ALTMIRE. Ms. Mott.

Ms. MOTT. If I might add, it is more than the time frame element here at risk. We are competing with a zero percent capital gains rate in Hong Kong, Singapore, China, other parts of the world, and I do not think we can keep up with innovation and funding innovation at the same rate if we cannot keep attracting capital, and I think it is a very critical point.

Chairman ALTMIRE. Mr. Dalton, do you have anything to add?

Mr. DALTON. We are a lender. We have 90,000 public shareholders. So the conversation for our business is not relevant.

However, I hear the panel's point, and I think it is a good one. Private equity in general does put a lot of sweat equity and does, you know, take a lot of time. We have the benefit of seeing small companies get to a later stage and become middle market companies. So I think that it is a worthwhile discussion that ought to be had and not necessarily carving out specific groups.

Chairman ALTMIRE. Thank you.

We are going to have votes on the floor momentarily. So what we will do is just keep asking you questions until they call those votes and then we will adjourn.

So I will turn it over to Ms. Fallin.

Ms. FALLIN. Thank you, Mr. Chair.

I was listening to some of your comments about who the investors are and how much money they have and, in particular, I heard one comment that the angel investors are not the Silicon Valley type investors, but they are people who make between 200 and 400,000 a year and have some extra cash that they want to invest into venture capital. I think it was you, Ms. Mott, who said that, and that two-thirds of you investors now are strapped financially and many of you said they are sitting on the sidelines waiting to see what the rules are here in Washington and what the game is going to be.

And in light of all of that, when we look at some of the budget proposals that we are seeing right now in Congress, especially as it relates to people who make over 250,000 a year and some possible tax increases on those people, it seems to fall in that 200 to $400,000 range that you are talking about for the angel investors.

So how would the proposals that we are seeing here with the administration and Congress on raising taxes for those making over 250,000 affect the ability or maybe the availability of the angel investing funds from those people who are in that market range?

and if I could ask all of you that.

Ms. MOTT. We have already been impacted dramatically. When you see your net worth decline by 46 percent, you know, it impacts the marginal income you have to invest, but let me put it this way. Typically what you can invest if you are doing good, practical portfolio management, five to ten percent of your investable assets is what you risk in this asset class. So whether it is hedge funds or anything, because it is considered a very risky asset class, suddenly you see that go down, and that five to ten percent you had you no longer have.

And so additional taxes are only going to impact that marginal piece that you can invest at risk because it really is at risk. Five of these companies out of 18 you will lose. They will go bankrupt. You will lose your money on.

Ms. FALLIN. Okay. Mr. Walker.

Mr. WALKER. Thank you.

I agree. We are taking essentially that money that would be available for start-up companies away. There are other things we could do. For example, Mr. May's testimony on a tax credit or incentive to those private investors who make targeted investments in emerging growth companies. So perhaps that is a catalyst to help offset this discussion.

Ms. FALLIN. Yes, sir. I like that idea.

Mr. May.

Mr. MAY. As I say, it is almost impossible to get three of us, much less, you know, 380 at a conference or 12,000 to agree on any one public policy area, but the key thing we find is that these are people who are dedicated to doing this. They love to recycle their funds and their time and give back to the community.

So one of our concerns is that there are so few people that are very wealthy that ever do this. I mean, it is just amazing that it is in the blood of a lot of people and you are right. We need to have as much capital in their hands as possible because they know what to do with it and they take the risk of multiple portfolio companies, but we have not ever sort of come up with any one magic bullet, and so that is why we try to, as you say, explore a variety whether it is sidecar funds, whether it is encouraging the later stage money that will pick up when we run out of money, whether it is low capital gains. I just think all of the things you are exploring are important, and yes, anything that would reduce our amount of capital is not necessarily good, but that does not mean that they will spend it on angel investing unless that level playing field is also worked on.

Ms. FALLIN. Sir?

Mr. DALTON. For our company and the BDCs in general, our investors are really Mom and Pops who invest to get the dividends, fixed income. So they are participating in private equity. So I think what is important is that, you know, they have transparency and the confidence and the appropriate sort of rules so that they can understand what we are investing in and where the credit worthiness of our portfolios are, yet the accounting issues are making that transparency challenging for us.

So I do think that it is less of an issue about sort of the taxes at that level, but people are investing in BDCs as a way to get access to private equity, but also wanting to sort of get that current income, and because of the lack of transparency, the entire BDC stocks have had a downward spiral, and not because of book value but because the concern about tripping covenants based upon assets that move every day, based upon hypothetical markets, 100 percent of our portfolio.

Yet we hold over 90 percent as an industry to maturity for the liabilities are fixed. So we have had to pull back our capital to protect against that when we should be lending our capital and have the desire to lend and available capital to the middle market and small companies.

Ms. FALLIN. Okay. Mr. Neff.

Mr. NEFF. Let me try to be very direct. There is no question that increased tax rates have an adverse impact on capital formation. I do not think I need to say anything more. Capital formation, whether it is institutional like I do or whether it is individual like some of these folks do, is very fragile and anything that increases uncertainty and anything that increases a feeling that you have less capital available to you has an adverse impact on the ability to pool that capital and deploy it effectively.

Ms. HENDRICKSON. I agree with Mr. Neff. Most of our investors are institutional investors, university endowments, pension funds. So they are not directly impacted by that particular tax provision. They are mostly impacted, frankly, by the destruction in the equity markets and the fact that they have no liquidity at this point.

Ms. FALLIN. Mr. Chairman, if I can ask one more question if possible, because I know we have got to go vote, one of the things I am concerned about is we are talking about tax policy as we are hearing various hearings about bonus money and callbacks and retroactively taxing and things like that. Do you ever get concerned, as I do, that some of our U.S. investment money, some of our corporate money may go out of the country if we start increasing capital, increasing capital gains tax, increasing corporate tax I should say, increasing capital gains tax, and changing the rules all the time; that they may just take it to one of those foreign countries you were talking about that had zero capital gains tax?

Mr. DALTON. Yes.

Ms. FALLIN. Okay. That is good.

[Laughter.]

Ms. MOTT. You know, some of my colleagues are already in China. They are in Australia on the West Coast. So, yes, they are already looking.

Mr. WALKER. Yes, I think maybe another way to look at this again is we should be doing things that are catalysts for small

business creation regardless of the industry, and the more we can quit changing the rules and keep a level playing field and provide some incentives as a catalyst to create companies is the way to go.

Mr. NEFF. I think what you have addressed has more of an impact on foreign capital flowing into the U.S. than it does on U.S. capital flowing outside of the U.S. because an individual U.S. citizen making an investment in Hong Kong will have U.S. taxes on that, not Hong Kong taxes on that.

But the other way around is definitely true. If big pools of foreign capital, which traditionally do flow into this country, can get much lower tax rates outside of this country, they are not as likely to flow into this country.

Ms. HENDRICKSON. I agree with Mr. Neff. That is the same issue for us.

Ms. FALLIN. Thank you, Mr. Chairman.

Chairman ALTMIRE. You are welcome. Thank you.

I am going to try to squeeze one more in before they call this vote. It starts with a question that Ms. Mott brought up in her testimony, but again I'll open it up for the whole panel. She commented on the role that government can play in helping to educate potential angels and grow angel networks, and I was wondering if, in your opinions, does adequate support framework exist for the industry to take up new resources and implement these new education programs. So we will start with Ms. Mott.

Ms. MOTT. The framework exists in the Angel Capital Association and the Angel Capital Education Foundation, but I think additional funding is required to expand that reach. Like Mr. May, as a matter of fact, on Monday I will be in Austin, Texas teaching a course, an ACEF course, to angel investors for term sheets and due diligence, but I know we have very limited resources, and a lot of us do this out of the goodness of our heart, not because we get paid.

But I can only imagine if the ACEF and the ACA could expand those courses to Web based courses. I think we could reach a greater number of people to learn about this asset class because it is very convoluted, and the more people who become comfortable with it, the more inclined they would be to engage in it. So, yes, support for the ACA and the ACF because I think the structure is already there in many ways and perhaps maybe Mr. May could elaborate on that.

Mr. MAY. Well, I was just going to say whether it is through the trade association, the nonprofit, or whether it is through entrepreneurship centers at universities, the greatest upswelling over the last several years in a lot of the graduate programs have been in the entrepreneurship centers and programs all over the United States, and this is a subcomponent of that, is access to capital. We help train people to be entrepreneurs and then we do not adequately show them how to write a business plan, negotiate a term sheet, and understand valuation at this stage because it is less transparent than the later public companies.

So we definitely would recommend that tax policy is great in some of these other areas, but anything that could be done to increase public awareness and education would be significant.

Mr. WALKER. A key point to that question is as we talk about the capital gap widening in the country and a lot of areas in the U.S. are smaller population centers, but we are still growing biotech companies and emerging growth companies, and anything we can do to help organize those early stage capital resources just helps the system start up more entrepreneurial based ventures.

Chairman ALTMIRE. Perfect timing.

[Laughter.]

Chairman ALTMIRE. I ask unanimous consent that members will have five days to submit statements and supporting materials for the record. Without objection, so ordered.

Thank you all very much for being here. This was very instructive. This is going to help the Committee as we move forward and address these issues. We really appreciate your time.

Mr. MAY. Thank you, and come to a meeting any time you want.

Chairman ALTMIRE. We will take you up on that.

This hearing is now adjourned.

[Whereupon, at 11:23 a.m., the Subcommittee meeting was adjourned.]

Testimony of Pamela B. Hendrickson
Chief Operating Officer, The Riverside Company
The Committee on Small Business
Subcommittee on Investigations and Oversight
United States House of Representatives
Washington, DC
Thursday, March 26, 2009

Chairman Altmire, Ranking Member Fallin, and members of the subcommittee: Good morning. My name is Pam Hendrickson and I am the Chief Operating Officer of The Riverside Company, a private equity firm headquartered in Cleveland and New York, which invests in small businesses around the world. (To us "small businesses" are companies with annual revenues of approximately $35 to $40 million; the average number of employees at companies we buy is about 130.)

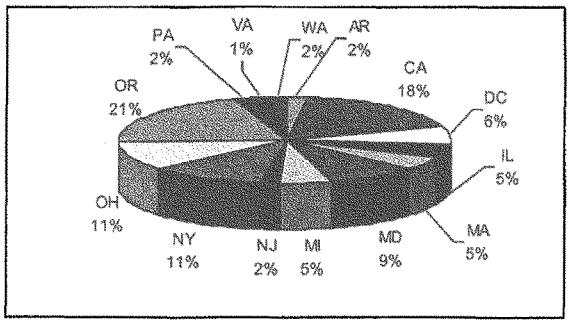
I appreciate this opportunity to share my perspective on how Riverside and others in our field add value to small businesses.

MEET THE RIVERSIDE COMPANY

If you read the newspapers lately, it seem as if some people have the impression that the private equity industry comprises of a cadre of former investment bankers who use financial black boxes to acquire companies in big cities on the coasts and then vaporize their assets and employees.

That is just simply not what we do. Our business model is highly dependent on our ability to generate gains for our investors by improving the underlying value of the companies we buy through sales and earnings growth. Because we invest a lot of our own personal money, our interests are strongly aligned with our investors.

Who are those investors? Nearly 40% of our assets under management come from 21 public and private pension funds and 10 college endowment funds based in 16 different states.



Our investors have entrusted $2.7 billon of assets to us, and have achieved a net internal rate of return (IRR) of 54% on the 46 investments we've realized (that is, on the companies we've sold). Because we focus on the small end of the middle market, the companies we work with are situated in communities all over the Unites States – cities such as Jacksonville, Florida and Minneapolis, Minnesota , as well as small towns like Oneida, New York (population 11,000); Ozark, Missouri (population 10,000); and Paris, Kentucky (population 9,000).

Unlike Venture Capital, which helps companies in the startup phase of their lifecycles, The Riverside Company helps companies that are in a later stage of development and are already profitable (with five years of positive earnings) move to the next level.

Many private equity firms have some sort of specialty; ours is size. We are the largest buyout firm focused solely on small companies. Since our founding 21 years ago, we've invested $1.8 billion in 211 "little leaders" of niche industries around the world; companies that seek to boost their growth through a partnership with Riverside. We do not participate in hostile takeovers. Today, we own 50 companies in the U.S. employing roughly 10,000 people.

That figure of 10,000 employees does not include our staff of nearly 200 employees worldwide, including 125 in the U.S. Our level of activity (we made 31 acquisitions and realized eight investments in 2008) requires a large staff of transactors and operators as well as our own support staff to handle functions like marketing, investor relations,

human resources, finance and administration. Our staff is as geographically diverse as our portfolio; only 42 people, or 34% of our U.S. staff, are in New York City.

I am focusing my discussion today primarily on our work in the U.S., but it is worth noting that while the LBO industry was born in America more than 25 years ago, it has been "exported" to most countries around the world. Most major private equity firms, including Riverside, remain American-owned but have expanded into other geographies that offer similarly attractive investment environments (that is, a stable government, capitalism, reasonable regulation, etc.).

After 21 years as an investor in small companies, Riverside has developed a fairly standard operating procedure that works well for the companies we buy. We typically double or triple the earnings of our investments, often by buying other companies to "add-on" to the parent company and by providing specific business expertise that enables our companies to expand. When we execute an add-on strategy, we work with one of our current investments to find, evaluate, and acquire related businesses as a means to support our companies' growth strategies. The add-ons provide opportunities for geographic expansion, new product lines or brands, new services, specialty management expertise, or market share gains. To date, we've invested in 163 U.S.-based companies, 78 of which have been add-ons. On average, we sell a company five years after acquiring it. Companies we've sold have seen an average improvement in sales of 96%, and an average improvement in earnings of 100%.

Private equity transactions can create value through any combination of three factors: earnings growth, multiple expansion (because we improve companies during our ownership we generally receive a higher multiple of earnings on exit than was paid for at acquisition), and balance sheet restructuring. Only 8% of Riverside's total profit in the U.S. has come from balance sheet restructuring (which typically entails paying down the debt used to finance the acquisition), leaving the majority of value to come about equally from earnings growth and multiple expansion. Therefore, our value to small businesses is

not predicated on financial engineering or balance sheet restructuring, as often depicted by media coverage.

We have only done three dividend recaps in our 21 year history (paying a dividend to investors mid-ownership by re-leveraging the company and taking out equity). We are conservative in our debt positions relative to S&P's Leveraged Lending Review, which recently reported that average debt contributions for 2008 were 57%. Our average debt contribution for 2008 was 32%. The current leverage ratio for our U.S.-based companies is 2.9 times earnings compared to S&P's reported 4.5 times operating earnings.

At Riverside, we're earning a living by providing capital and operational resources to help our companies grow. I'd like to share with you some of the ways in which we do this...

CREATING VALUE

Many of the companies we acquire, 60% in fact, are sold to us by the companies' founders or family owners, who are seeking liquidity. These entrepreneurs have the majority of their net worth tied up in their company and need access to that money, most often for retirement and estate planning. Taking their companies public typically is not an option with such small companies. Without private equity, these founders would have drastically reduced options for continuing their businesses, handling succession planning, and securing for their children and grandchildren the rewards of their entrepreneurial successes.

Here are two poignant examples where our ability to deploy capital quickly was key to the continued growth of small businesses:

Riverside purchased CPI, a training company in Brookfield, Wisconsin, and Media Source, a promoter and seller of children's books in Plain City, Ohio, both from patriarchs who, sadly, were dying of cancer. In both situations, the families were unable or unwilling to take over the business. Both of these men wished to sell their companies

quickly and without disruption, while also rewarding the existing senior management teams. Riverside was able to help achieve these goals in an expeditious manner. Since the transaction, CPI has increased sales by 25% through the addition of new training programs, international growth, and a modest price increase. Similarly, Media Source has increased sales by 30% due to increased subscriptions with existing customers and the hiring of additional sales representatives to further growth. Both companies are positioned for continued success.

Riverside also invests in companies and management teams that wish to take their businesses to the next level, but do not have the resources, capital, or know-how to do so. Such was the case with Universal SmartComp, a Washington, Pennsylvania-based company that operates a physical medicine network for workers' compensation medical claims. Riverside invested $15 million in the company in early 2008, and SmartComp has since grown both its sales and earnings by 50%, hiring 27 new employees (a 34% increase) to help expand sales.

In other investments, we can help *create* small businesses by acquiring what we affectionately refer to as "corporate orphans." Occasionally, a large company has a non-core business division that suffers due to lack of capital and attention. Four years ago, Riverside acquired Justrite Manufacturing, located in Mattoon, Illinois, which manufactures safety products and containers that help prevent catastrophic industrial accidents. Formerly, Justrite was a business unit of Federal Signal. Since Justrite was acquired by Riverside, it has benefited significantly from increased attention and resources, recording sales and earnings growth of nearly 40%. Riverside supported the company with a temporary CEO (one of our operating executives) early in our investment, while we searched for a top management team. In addition, Riverside introduced Justrite to a consulting firm that helped it analyze pricing strategy, providing a fresh and professional analysis of opportunities to better align its pricing with its value proposition, thereby increasing profits. As the company continues to grow as a result of these initiatives, it has been able to keep jobs in Mattoon.

This example of in-house management expertise and relationships with valuable consulting services highlights the value-add provided by our operating team and the Riverside "Toolkit". We have 23 operating partners and executives available to assist our companies. In addition, we have pre-screened, proven consulting partners to help in specific areas such as sales growth, manufacturing, IT development, and so on.

In addition to supplying equity capital to our companies, Riverside brings to them a network of lenders with whom we've developed close relationships over the last two decades. We partner with lenders that will support our companies in good times and bad. They are willing to do this because we've only once lost principal on our senior debt in the 163 deals we've done in the U.S.

One situation where our strong lender relationship proved beneficial was with GE Antares, our partner lender for United Central Industrial Supply ("UCIS"), a Bristol, Virginia-based distributor of consumable coal mine supplies that we acquired in August 2004. Less than one year after our investment in UCIS, we found an attractive add-on opportunity that would enable it to broaden its product line and services. GE Antares made the transaction possible by supplying additional debt to the company. Because UCIS continued to perform well and was in good financial standing, GE Antares extended another term loan to the company for a second add-on acquisition, which enabled UCIS to improve its market position in the West. When Riverside ultimately sold UCIS to another private equity firm in April 2006, its leverage was only 2.4 times operating earnings. During our ownership of UCIS, the company increased organic sales and EBITDA by 40% and 90% (pro forma for acquisitions), respectively.

Another way in which we strengthen the companies that we acquire is through the introduction of more sophisticated financial and operational controls. To that end, we require annual audits to ensure the financial statements provided to our investors, lenders, and other stakeholders can be relied upon for decision making. We partner with Deloitte & Touche, McGladry Pullen and BDO Seidman, three large international accounting firms, to perform these audits. For the vast majority of our companies, these audits are the

first detailed, in-depth audits ever done for their businesses – and any process and control improvements suggested by the auditors are acted upon by our management teams. In the Riverside Micro-Cap Fund alone, which was established in the summer of 2005, our portfolio companies have received over 20 unqualified opinions from our auditors, and no company has had a qualified opinion to date – a testament to the strong financial controls implemented after Riverside invests in a company.

A business that is not measured cannot be managed, and therefore we place great value on upgrading the financial organization and systems in every company in which we invest. This upgrading consists of hiring experienced, qualified financial leaders, investing in business systems, and ensuring assets are safeguarded.

Riverside's investment in Respiratory Care Services, Inc. (RCS), which provides respiratory care equipment and services to nursing homes and is headquartered in Carmel, Indiana, included the hiring of a very experienced CFO and Controller (the first CFO ever hired for this business), and the implementation of business software called Fast Track. The newly hired CFO and Controller have made great strides in improving financial controls including a rigorous budgeting process, weekly cash forecasting, tight management of accounts receivable, and improved billing processes. Utilizing the latest in handheld communication tools, the Fast Track software being implemented now at RCS replaces a completely paper based, manual system and will ensure that 30,000+ pieces of respiratory care equipment -- oxygen concentrators, nebulizers, CPAP machines, etc. -- are tracked and billed accurately and timely.

Another "control" that Riverside brings to our small companies is corporate governance. Each of our companies has a Board of Directors, often for the first time, and most have two Outside Directors that bring industry expertise and general business experience to the company. During our first few months of ownership, each of our companies develops a written strategic plan to provide a road map for growth. Our boards then help the companies to follow the plan by providing industry expertise and business smarts to look ahead and even around corners. And of course they make sure that we have the right

CEO and top management team, supported by the right capital structure, implementing the right strategic plan and the right incentives and rewards.

Our boards make sure that winners get rewarded appropriately, that losers get fired, and that the company legacy and culture is preserved. From our perspective, this is capitalism at its finest.

An example of a particularly effective board was that of Caprock Communications, which was acquired by Riverside in April 2002. Caprock is a Houston, Texas-based communications provider for the off-shore energy, maritime, construction and mining industries as well as disaster relief and government applications. After our investment, we added two Outside Directors to the Board: the CEO of a multinational oilfield services company and the head of a premier satellite technology consulting firm. The new director who had served as CEO of the oilfield services company brought excellent experience and was a good mentor to Caprock's first-time CEO, Peter Shaper. Additionally, he knew everyone in the oilfield business and made multiple introductions for Caprock. The consultant was one of the world's experts in Caprock's key satellite technology and introduced the company to Telematika, an Indonesian company that Caprock then acquired in September 2004 to establish an immediate and significant presence in the Southeast Asian market.

One challenge that our small companies constantly face is their relationship with large vendors. They are relatively small and aren't always very important customers. Because of that, they sometimes find it difficult to get good service and good pricing. We are able to help our small companies achieve big-company benefits through purchasing programs that give them access to top tier suppliers at discounted, "big company" rates. On a pooled basis our 50 U.S. portfolio companies spend approximately $25 million with FedEx, for example, and we negotiate discounts that reflect this level of spend, in a way that our individual companies could not. This program has proven to be a real safety net for one of our companies that was using DHL to ship their product, herbs such as thyme and basil, to customer distribution centers throughout the country. When DHL shut their

doors in January, our company didn't skip a shipment, thanks to FedEx's ability to take on that business with a day's notice.

Participating in these purchasing programs also enables many of our companies to do a better job sourcing, simply by best-practice sharing. For example, we're currently facilitating a steering committee for the purchasing of corrugated cardboard, and have five companies sharing ideas on white paper standards for rate fluctuations, effective recycling programs, negotiating strategies and vendor relationships.

Another big–ticket item for our small companies involves healthcare benefits. Riverside understands the importance of providing benefits to our employees and has therefore taken an active interest by pooling our purchasing of benefits with partners, including United Healthcare for medical, Guardian for dental and SunLife for life and disability coverages.

Recognizing that "claims are claims" (that is, the cost of medical premiums is 100% correlated to what employees spend on healthcare); we believe that the best way to curb the cost of healthcare is to make employees better healthcare consumers. In the end, of course, that approach also makes for healthier employees. We help our U.S.-based companies tackle this challenge through development of three-year strategic plans for benefits. These plans are intended to address healthcare costs as well as education on trends and programs that will help employees develop healthier lifestyles. In fact, less than a month from now, Riverside along with our benefits broker and consultant, Oswald Companies, is hosting a (free) Human Resources Forum for all HR professionals within our portfolio. Since Riverside launched the healthcare program in 2006 we have held our PEPY (per employee per year) cost near flat, starting at $8,059 in 2006 and increasing less than 1% to $8,083 in 2009. In contrast, industry trend increases would have resulted in a 36.0% higher PEPY of $10,992.

One company that participated in this program is Nordco, a Milwaukee, Wisconsin-based manufacturer of railroad "maintenance-of-way" equipment. In fact, the United Steel

Workers of America, which represents many of Nordco's employees, complemented Riverside for continuing to offer "comparatively generous benefits" according to a September 2008 United States Government Accountability Office report on Private Equity.

Another way in which Riverside has supported Nordco over the last five years is by bringing add-on acquisition opportunities to the management team. In line with this "buy and build" strategy, Nordco has made three acquisitions: JER Overhaul, DAPCO Industries and DAPCO Technologies, and Central Power Products, Inc. As a result of these, as well as impressive growth from Nordco's core business, revenues have increased from $39 million in 2002 to $137 million in 2008 and employment increased from 106 to 343. Excluding "acquired" employees, employment increased by 116, or 51%.

Riverside also helps our companies by looking out for new opportunities that will enable them to further grow and develop. One example is GTI Diagnostics, which is based in Waukesha, Wisconsin and manufactures medical diagnostic test kits for transplantation, blood bank and coagulation laboratories. When we bought the company in July of last year, the CEO had great hopes for expansion, particularly into the large markets in China, but had neither the capital nor the expertise to make that happen. Riverside has a dedicated operating resource on the ground in China (the former President of Danaher-Asia) whose knowledge and experience has been instrumental in helping GTI. He is in China this week with the senior management team of GTI to begin the process of navigating the SFDA, the Chinese equivalent of the FDA, to qualify GTI's products in China. They are also meeting with several blood banks in China's major cities to understand their needs and educate them on the benefits of GTI's leading solutions. During the course of Riverside's hold period, we expect China to grow into a meaningful market for GTI's products. It is worth noting that GTI employs a highly skilled workforce in Wisconsin, and GTI's intent its not to have jobs follow the demand to Asia. If anything, GTI expects to grow its team in Wisconsin as demand for the company's products grows around the world.

CHALLENGES FACING PRIVATE EQUITY

As private equity continues to contribute an increasing percentage of GDP, it is understandably gaining the attention of regulatory bodies. Given the current economic climate, it seems that some of this increased attention is inevitable.

However, I would like to comment on a couple of areas where we have concerns, particularly with respect to FASB regulations. FASB 157, the so-called "mark to market" regulation, for example, does not allow us (as an industry) to apply the same methodology we use to evaluate potential acquisitions and exits as we do to value our unrealized investments. Instead, it applies a more public-company, academic approach to unrealized investments. As professionals with decades of experience evaluating small, private businesses, we worry that applying a more academic approach to valuations is actually less meaningful. It also could be doing investors a disservice because it implies some level of risk reduction that just doesn't exist in our world. This disparity is exacerbated by today's extremely volatile public equity market, because these methodologies assume that our assets are much more liquid than they actually are. Furthermore, it costs our investors approximately $500,000 more per year due to the additional time spent by our internal team, outside consultants, and auditors.

On another front, debt markets, despite our strong relationships with lenders, remain very tight. In the current environment, it is difficult for us to secure the debt we need to buy our small companies. We have, in fact, wondered whether there might be some form of partnership that we could structure with the SBA to provide debt at the fund level. Both the SBA and a wide range of small companies would then get the benefit of our capital, our global network, and our operating expertise.

Today's global recession represents a difficult test of our investment strategy: Buy "little leaders" and help them grow at an accelerated pace. So far, we're faring better than most. While U.S. GDP fell by 6% in the fourth quarter last year, our U.S. companies' revenues *increased* by 8% for the year. While five of our 49 companies owned at the end of 2008

did experience sales declines of greater than 10% from the prior year, 17 companies, or 35%, grew sales by greater than 10% from the prior year. Our companies have planned for a slower 2009, though the first two months of the year lead us to be cautiously optimistic, with continued growth of a modest 2% versus prior year. It is at times like these that our companies most appreciate the additional resources that Riverside can offer.

We bring a wide range of knowledge and expertise to bear – both from inside Riverside and outside – as we decide which companies should receive precious equity capital, and which should not. We're mindful that these are important decisions and we don't make them capriciously. We have a lot of skin in the game; our future as a firm is based on our track record – and we're only as good as our recent transactions indicate. Just as companies compete for our capital, so we have to compete for the investment capital of our limited partners, and it is a very democratic (small d) process. It isn't based on who you are in status or where you went to school. It is performance driven.

Thank you for your time.

House of Representatives Committee on Small Business
Subcommittee on Investigations and Oversight
March 26, 2009
"Expanding Equity Investment in Small Business"

Testimony of:
P. Sherrill Neff, General Partner
Quaker BioVentures
Philadelphia, PA

Introduction

Chairman Altmire, Ranking Member Fallin, and members of the Committee, my name is Sherrill Neff and I am a partner at Quaker BioVentures, a venture capital firm based in Philadelphia, Pennsylvania. I am also a member of the National Venture Capital Association based in Arlington, Virginia. My views today represent 460 member firms which together currently have approximately 90 percent of all the venture capital under management in the United States.

Quaker BioVentures is a venture capital firm investing in life science companies with outstanding growth potential. The firm leads investments across the spectrum of the life sciences industry, including biopharmaceuticals, medical devices, human diagnostics, specialty pharmaceuticals, and healthcare services. We invest in companies at all stages of development, from raw start-ups to much later stage companies, and prefer to lead or co-lead investments, taking an active role on the Board of Directors at those entities in which we invest. We have investments in 31 different life sciences companies, all of which are headquartered on the East Coast of the United States, primarily in the Mid-Atlantic and Southeastern regions. Founded in 2003, the firm manages over $700 million in committed capital.

I would like to thank the Committee for the opportunity to share with you today an overview of the venture capital industry and the broad issues we are facing in the current economic climate. We believe that amidst the challenges our country is facing, there is tremendous opportunity for the private sector and government to work together, not only towards recovery but beyond -- towards a future in which our country is once again thriving economically, technologically and socially.

Venture Capital Investment Overview

To begin, I would like to explain briefly how the venture capital industry creates and grows small businesses. Typically, venture capital firms raise money from institutional investors with a long term focus such as pension funds, endowments and foundations. Our commitment is to invest those funds in promising young start up companies. Once a venture fund is raised, we look for the best and brightest entrepreneurs in which to invest, usually within a specific industry sector in which we have an operating expertise. And venture capitalists typically look for companies that are innovating in a significant way. For this reason, we are readily associated with information technology, life sciences, and most recently the clean technology industries. We often find these innovators in university and government labs, through others who are already in our network, or we work with entrepreneurs who we have successfully funded in the past.

In order for an investment to be considered for venture capital, the entrepreneur typically has a product or service that has gone through the discovery or prototyping process. The product is ready to be clinically tested, proceed through the lengthy regulatory process toward approval, and eventually commercialized. We stay invested in these companies – both financially and through the sweat equity we provide – from 7-10 years, often longer and rarely less. All of the venture funding is directed towards growing the company – both in employee hiring and in research and development expenditures. We do not engage in financial re-engineering nor do we typically utilize debt. The ultimate goal is to build the business until it can go public or become acquired, generating a return for our institutional investors. In most cases, venture capital is the only source of funding for these companies as the dollars required are too great for angels, friends or family, and the risks are too high for traditional bank financing.

In 2008, the venture capital industry invested more than $28 billion into over 3800 companies in the United States. This level of investment has been remarkably consistent over a number of years, averaging $26.3 billion into 3500 companies each year for the past five years. The industry is not interested in seeing these numbers grow substantially as we have learned from the technology bubble burst of 2000 that our asset class is not infinitely scalable. Yet we would very

much like to sustain existing investment levels and that promise has been significantly threatened in the wake of the current economic crisis.

No asset class is immune to this recession and the venture capital and start-up communities are no exception. We believe that our industry will contract as a result of the economic crisis but how much remains a question. Since venture capital is a critical driver of job creation and economic growth and has differentiated the US economy from all others for decades, this is an important question for Congress to be asking.

Venture-Backed Companies Drive U.S. Economic Growth

The venture capital industry is a relatively small asset class compared to other areas of private equity. In 2008, venture capitalists in the aggregate managed approximately $197 billion in assets or just 0.02 percent of the US GDP. Thomson Reuters estimates that there were fewer than 900 venture firms in the United States employing approximately 7,500 professionals last year. Yet despite our small size, our industry has created exponential economic value through the tens of thousands of companies in which we have invested.

According to the econometrics firm Global Insight, venture-backed companies currently account for more than 10.4 million jobs and $2.3 trillion in US revenues, representing 9 percent of US private sector employment and 18 percent of US GDP. Companies that were once small venture-backed businesses include: Google, Genentech, Intel, Cisco, Starbucks, Microsoft and FedEx. The venture industry has been recognized for its contribution to the creation of entire industries including the Internet, software, semiconductor, and biotechnology sectors, all which began with the funding of several hundred start-ups which grew in scale and now employ millions of Americans. And today our industry is actively creating yet another sector – the clean technology sector – which is our fastest growing area of investment and comprises companies operating in renewable energy, conservation, power management and sustainability.

Innovation is the cornerstone of all of our investments. As my area of expertise is life sciences, I would like to take a moment to share some of the groundbreaking areas that the venture industry is funding. We estimate that 1 out of every 3 Americans is positively impacted by a venture-

backed medical innovation. The industry invested nearly $8 billion last year, almost 30 percent of total venture capital investment, in more than 850 biotechnology and medical device companies.

At Quaker BioVentures, we have investments in amazingly innovative companies such as: (1) **Biolex**, which is producing protein drugs from a prolific aquatic plant organism known as duckweed, and has a late stage product for Hepatitis C infections; (2) **Amicus**, which is developing novel treatments for genetic diseases like Parkinson's Disease; (3) **Tengion**, which regenerates entire human organs from a patient's own cells;(4) **Neuronetics**, which has recently launched sales of an FDA-approved medical device for treatment-resistant major depression disorder; (5) **Optherion**, which is developing a novel drug therapy for the early, or "dry" form of age-related macular degeneration, a horrible and prevalent disease of the eye; (6) **Precision Therapeutics**, a molecular diagnostics company with highly specialized testing to support oncologists in their selection of the drugs most likely to have a beneficial effect in the treatment of gynecological and other cancers, and (7) **Regado Bioscience,** which is developing novel, controllable anticoagulation systems that we believe will be much safer and predictable than other methods of anticoagulation. Not only are these companies innovating; they are also employing. The Quaker portfolio alone represents several thousand jobs in the regions in which we invest. The same holds true for every venture capital firm around the country.

As active investors, venture capitalists are very proud of the work that we do and value that we create. But we do not profess to be able to do this alone. We rely heavily on the support of policy makers and regulators to foster an environment that encourages measured risk taking and capital formation. Our industry remains fragile, particularly in the wake of the recession and uncertainty of the capital markets. Yet we believe that most of these challenges can be mitigated with sound public policies and regulation.

Unlike many other areas within the financial services sector, the venture capital community is <u>not</u> in need of rescue and, in fact, has money to invest in emerging growth companies. We remain committed to finding and nurturing the most promising entrepreneurs in the United States and put forth that venture-backed companies continue to innovate and create the very jobs that

will drive economic recovery. But our industry is not without challenges, and today I would like to discuss ways in which policy makers can support our efforts to build great, innovative American companies.

Venture Industry and Government Together

The venture capital industry believes that what is good for entrepreneurs is good for venture capitalists, and ultimately for the economy. For that reason, we focus our advocacy efforts on advancing policies that help our portfolio companies thrive throughout their life cycle. We have historically found the federal government to be a supportive partner in bringing the best ideas out of the labs and garages and transforming them into vibrant companies that employ Americans and develop valued products and services globally. From nurturing the innovation pipeline to supporting the deployment of capital, policy makers and regulators have an important role to play alongside the work that venture capitalists do in bringing such companies to life. I would like to spend some time discussing those roles.

Supporting Long Term Investment

Historically, no other asset class is as committed to the high risk, long-term investing as venture capital is, and for good reason. Venture investing is not for the faint of heart. We don't just write a check and walk away. Once invested, a venture capitalist works hand-in-hand with company management to address market challenges and grow a business over many years. Approximately one third of our companies fail, and we must rely on the successes to balance our returns. But as I have mentioned, those successes have proven to be extremely valuable for our country's economy and, I would say, essential for the future of economic growth.

Our system has worked for decades in large part because the capital gains tax structure has motivated venture capitalists to make these longer term, high risk commitments. The result has been the creation of assets – new companies and jobs – that did not exist before. Encouraging this investing behavior is exactly what Congress intended when it enacted capital gains tax legislation years ago. It is critical that venture capitalists continue to be rewarded in a manner

commensurate with the huge risks we take. Otherwise our risk/reward equilibrium will be thrown off, and even highly promising companies will not get funded because we can not justify the risk.

The NVCA supports the existing tax structure as it applies to venture capital investment, which includes capital gains tax treatment for the carried interest portion of our investment return. This tax policy is proven to motivate investors for the long term and it supports investment in seed and early stage companies. As you may know, carried interest is only earned by venture capitalists after many years in the life of the fund, and only after a fund has returned all of the capital committed by its institutional investors. It is never guaranteed and rewards only those venture investors who have successfully built new companies.

The Administration's budget now has a provision to change the carried interest tax rate to ordinary income, effectively doubling or tripling the taxes of the very people most responsible for new company creation, job creation, and economic growth. At a time when our country needs to create jobs and rebuild industries, such a change is counterintuitive to economic growth. Tax policy is put in place to affect certain behaviors. We ask that the Congress look carefully at each industry impacted by a change to the carried interest tax rate and enact policies that are fair but continue to promote long term investment, not deter it.

Despite our concern over the President's carried interest tax proposal, we do believe that the Administration understands the importance of investment in small business. This understanding was evidenced in the President's inclusion of a zero capital gains tax rate for investment in small businesses in his budget proposal. While this provision was not detailed, we hope that Congress will consider the spirit in which it was included and perhaps apply this concept in its own budget to offer incentives for new investment in long term growth.

Nurturing the Discovery Pipeline.

The business of commercialization, that is, bringing innovations out of the labs and into the market, is indeed a long term process. Venture capitalists enter the life cycle very early, often

after the initial discovery process has been completed. We do not fund basic research but rather search for concepts that have been vetted through the basic research process and show promise for the broader public marketplace. We most often find these opportunities in university and government labs, where scientists have successfully accessed Federal funding to advance their work.

For example, my firm, Quaker Bioventures, recently helped to form Optherion, a Connecticut-based company, which as I mentioned earlier is developing novel therapies for "dry" AMD, a disease of the eye. This company was created from technology funded by the NIH at the University of Iowa, Yale University, the University of Pittsburgh Medical Center and Rockefeller University. We put these novel technologies together with an experienced management team, and helped the company to raise over $30 million in its initial round of funding. The company's drugs will begin human testing next year. Another recent startup we helped form is Maryland-based Arginetix. With the seed capital we provided, the company licensed NIH-funded technology from both the University of Pennsylvania and Johns Hopkins University. Arginetix is developing novel therapies for pulmonary arterial hypertension (PAH).

It is critical that the federal government continue to fund basic research, not just in life sciences but in other industry sectors such as energy and information technology as well. We were heartened to see the recently passed stimulus bill include a sizable allocation for basic research. It is critical that such funding continues if we want our innovation pipeline to remain strong. The venture industry is eager to leverage the most exciting scientific breakthroughs once the government has funded their discovery.

Yet, one of the areas that have been especially problematic in the area of basic research funding has been the definition of small business, particularly as it relates to eligibility for Small Business Innovative Research (SBIR) grants. Recent interpretations of the program have excluded certain companies from applying for these important grants if they have previously received venture capital. There is a misconception that venture-backed companies are not small businesses because of they have venture capital investors. However, I assert that nothing could be further from the truth. Venture-backed companies that apply for SBIR grants are the epitome

of small businesses, since they are often without any revenues and with employee counts in the single digits. They are just as fragile as their non-ventured counterparts and equally, if not more, worthy of consideration for grant money. Many of these companies would seek federal funding for discovery projects that their venture capital investors do not fund but may some day be appropriate for commercialization.

The venture capital community has been advocating for changes to the SBIR program to allow venture-backed companies to compete unequivocally for grants. This change in definition would expand and enhance the pool of applicants to include scientists and entrepreneurs who have already been vetted by the venture industry, certainly not a guarantee of success, but definitely a positive affirmation for the long-term promise of the businesses in question. The SBIR program is the perfect opportunity for the government and venture capital industry to work together on discovery projects that have significant potential to emerge from the lab, reach the marketplace and improve the lives of Americans. Yet today, this can not happen as companies must choose between venture funding to grow their business and government funding to sustain their innovation pipeline. We are not asking that venture-backed companies have exclusive access to these grants; we just want the opportunity to compete. We commend members of the House of Representatives for passing legislation last year which addresses this issue. We hope that the reauthorization of the SBIR program ultimately embraces this opportunity so together we will keep innovation flowing and continuously improve the quality of life for Americans.

Eliminating Regulatory Uncertainty

While venture capitalists are in the business of taking risk, we do indeed have risk thresholds that we cannot easily cross. If a company faces too many uncertainties on its road to success, often we will not make that investment, but seek other companies with a clearer pathway to success. In the last decade, unfortunately we have seen many instances where regulation has created additional burdens and uncertainties that threaten the funding of companies.

For example, many of our companies are struggling with the cost of Sarbanes-Oxley compliance which, while well-intentioned and necessary, has placed a disproportionate regulatory burden on

smaller entities that do not have the financial or human wherewithal to effectively comply, without giving up other endeavors. Venture capital funding that should be focused on research, or on sales and marketing, are today being directed towards accounting compliance. The Securities and Exchange Commission has put in place extensions for complying with this law, but has yet to permanently exempt these small cap companies. Our portfolio companies need certainty around this area of compliance so they can commit to a financial controls system that is appropriate and lasting, and instead begin channeling their funds towards growth.

In the life sciences sector, the regulatory uncertainty and lack of consistent leadership at the Food & Drug Administration has had a sustained adverse impact on the rate of new drug and device approval, and therefore on the new investment rate of venture capital firms into innovative companies in this sector. When the rules are not clear – and venture capitalists don't know whether a regulatory approval process will take three years and $15 million, or 10 years and $200 million – it is impossible to commit funds responsibly. We intend to continue to work with the FDA towards a certain and streamlined approval pathway for the most novel technologies and therapeutics.

Protecting Innovation

Venture-backed companies are in the business of improving the way we live and work. But for an innovation to be brought to market successfully and thrive there, that breakthrough must be protected from others that might infringe on the years of research and development work that preceded a market launch. There are two distinct areas that the government can support innovators in this way.

The first is the area of overall patent reform. Improving the quality of our patent system is critical to our country's innovation leadership. Many of our country's most promising innovative companies are also our most fragile. Therefore we support comprehensive patent reform that recognizes that defending against infringement is disproportionately burdensome for smaller companies. These companies do not have the resources to constantly defend their patents or fight with larger corporations who have the ability to infringe at a relatively low cost.

As Congress examines patent reform, we urge you to consider the challenges of these small companies and ensure that the law adequately protects them.

This protection could include a post-grant review process that is limited to 12 months so that small companies are not subject to the uncertainty and cost associated with endless challenges to their patents by large corporations. It also involves making sure that large infringers are subject to meaningful penalties that reflect the full value of the innovation in question. Such penalties are necessary deterrents for large companies that justify the cost of infringing because that cost is so low. The NVCA intends to be the voice for these small companies as patent reform is discussed this year, and we welcome the opportunity to work together with members of Congress toward reform.

The second area is more specific and involves companies that discover and develop novel biologic therapeutics for patients. Currently there is a debate as to when outside companies can enter this market and offer generic or similar alternatives, called follow-on biologics. I cannot stress the importance of protecting the innovative companies that have invested tens of millions of dollars and decades of development to bring these breakthroughs to market. If generic or quasi-generic alternatives enter the market shortly after the original biologic is made available, the biologic company will not be able to recoup its investment and these innovations will disappear as no investor will be able to fund them profitably. The result will be an elimination of an entire field of breakthrough medicine, and nobody will win. Patients and physicians will surely lose. We are currently advocating for sound protection of intellectual property in the area of follow-on biologics for a reasonable length of time in order to ensure ongoing incentives for innovation.

Reinvigorating a vibrant exit market.

The most immediate challenge that the recession has brought to the venture industry is the complete shutdown of the venture-backed IPO market. In 2008, there were just six venture-backed companies that went public on US exchanges. In a healthy year, this number should approach 150 offerings. To date in 2009, no venture-backed companies have gone public.

This situation is of deep concern from both a venture industry perspective and an economic one. From an industry perspective, many venture firms have mature companies that are ready to go public but will not do so under the current conditions. Consequently, some firms are forced to support these companies, both with dollars and time, much longer than originally planned. Because of this, they take their attention away from backing new innovative companies and returns are driven down. Economically, venture-backed companies that go public are significant creators of jobs. A separate Global Insight study revealed that more than 90 percent of the headcount growth at venture-backed companies takes place following an IPO. The current clog in the IPO pipeline, if it continues, will compel more companies to seek the acquisition exit route which, while respectable and profitable, does not result in the same level of economic value creation as an IPO does.

While the recession is to blame for the dramatic drought, there are also fundamental structural problems within our capital markets system that have made it difficult for small cap companies to go public. The cost imposed by Sarbanes-Oxley as well as the elimination of sell-side research resulting from the Global Settlement, better known as the Spitzer settlement, have changed the economics of going public in such a way that small cap companies are delaying or abandoning the IPO altogether. We believe that a full SEC review of the current regulations is in order, not to determine if the regulations are appropriate overall but to assess their impact on small companies and institute exemptions where appropriate. The one size fits all mentality of the last eight years needs to be re-examined and addressed for the sake of these smaller players. Precedent has shown that tiered compliance can be effectively applied and we would hope that there would be opportunities to do so in the coming year.

Conclusion

Over the years, the federal government and the venture capital industry have so often enjoyed a symbiotic relationship that has helped spur innovation and further our country's economic goals. Today, we face significant but not insurmountable challenges as we look towards economic recovery and job creation. The venture capital industry remains committed to investing in the

most promising, innovative small businesses our country has to offer. We do not need bailout money or additional money to invest – we simply need an environment that allows these companies to thrive. As Congress considers policies that impact small venture backed companies, we appreciate the opportunity to offer a voice that supports viability and growth for these entities. No other asset class supports the premise more that small businesses are the life blood of the US economy than venture capital. We are confident that you share our commitment to this sector and look forward to working with you as we move forward.

Thank you.

HEARING TESTIMONY OF TOM WALKER
PRESIDENT AND CEO, i2E

ON BEHALF OF
THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

BEFORE THE HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT

MARCH 26, 2008

Chairman Altmire, Ranking Member Fallin, and Members of the Subcommittee:

Thank you for providing the opportunity to testify before you today regarding the difficulties facing the venture and angel capital industries and how it is impacting the biotechnology industry.

My name is Tom Walker and I am the President and CEO of i2E in Oklahoma. i2E is a private non-profit corporation that assists the creation of advanced technology companies and knowledge based jobs in the state of Oklahoma. We provide specialized commercialization services and access to risk capital in the earliest stages of a company's life. Our efforts to create an entrepreneurial infrastructure for advanced technology opportunities have become recognized as an innovative venture development organization in North America. We manage a proof-of-concept fund, a seed capital fund, an angel investment group, commercialization services and a statewide collegiate business plan competition. Our efforts are funded through the generous support of the Oklahoma Center for the Advancement of Science and Technology and other partners in the state of Oklahoma

i2E is usually the first source of capital for the companies in which we invest. Much of our time is spent assisting technology based entrepreneurs in accessing risk financing in the capital gap or the so called "valley of death". This is the point in time where companies are primarily pre-revenue and need risk capital to develop their product or technology offering. This capital gap has only become wider in the economic downturn and it is making it more difficult for innovation-based companies to start up and grow, not only in Oklahoma but throughout the U.S. Consider that in Oklahoma there are not a large number of organized venture capital funds. However, over the past several years, with a focus on specialized services geared towards the capital gap, we've witnessed over $300 million in angel and venture capital investment in over 150 advanced technology companies throughout our state.

Prior to 1998, when I joined i2E, I worked with Battelle Memorial Institute, an international science and technology enterprise that explores emerging areas of science and develops and commercializes technology. I hold a B.S. in Mechanical Engineering from the University of Oklahoma, and a Master of Business Administration from Oklahoma City University. I am a founding member of the Board of Directors of the National Angel Capital Association and I serve on the boards of several technology companies as well as industry Boards, such as the Oklahoma Bioscience Association.

Today I am testifying on behalf of the Biotechnology Industry Organization, an organization representing more than 1,200 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The overwhelming majority of BIO member companies are small, early stage research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy. In fact, almost 80 percent of BIO members have less than 50 employees, and almost 90 percent have less than 100 employees.

Biotechnology is an innovative, research-intensive industry whose products have the ability to improve public health and is an industry vital to our economic recovery. In recent years, the biotech industry has produced groundbreaking treatments for illnesses such as HIV/AIDS, multiple types of cancer, and heart disease. There are currently more than 400 biotech drug products and vaccines in clinical trials targeting more than 200 diseases including various cancers, Alzheimer's disease, diabetes, multiple sclerosis, and arthritis.

The biosciences continue to be recognized, most recently by President Obama, as a key driver of modern economic progress. Total employment in biosciences in the U.S. grew to 1.3 million in 2006, with these employees spread throughout all fifty states. Further, taking into account the indirect and induced employment as a result of the biosciences, the total employment impact of the sector is 7.5 million U.S. jobs.[1]

In recent years the biosciences sector has outperformed the overall private sector across a multitude of categories. Employment in the biosciences grew 5.7 percent since 2001, compared with a smaller 3.1 percent increase in employment in the overall private sector. Three-quarters of bioscience job growth has occurred since 2004. Further, the average annual wage of the bioscience worker is approximately $71,000, as compared with an average annual wage of $42,000 for the private sector as a whole. This is a difference of 68 percent.[2]

Additionally, life-extending drugs create enormous increases in societal wealth. Authors of a recent study found that from 1970 to 2000, gains in life expectancy added about $3.2 trillion per year to our national wealth.[3] Further, they reported, a one percent reduction in cancer mortality

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[1] Beyond Borders: Global Biotechnology Report 2008, Ernst & Young.
[2] *Id.*
[3] Murphy, Kevin M. and Robert H. Topel. "The Value Of Health And Longevity," Journal of Political Economy, 2006, v114(4,Aug), 871-904.

rates would be worth about $500 million annually. Curing cancer entirely would be worth about $50 trillion.[4]

The role of the biotech industry in stimulating economic growth and job creation in the 21st century innovation economy is apparent. Unfortunately, the ongoing financial crisis facing our nation continues to have a profound impact on biotech companies. On average, it takes more than a decade and $1 billion to bring a biotech product to market. As a result, biotech companies go for years without product revenue, instead relying on financing from investors. Emerging biotech companies – comprising over 85 percent of the industry – are therefore highly dependent on well-functioning capital markets to finance their long term, capital intensive research and development projects. Over the past year and a half, the credit markets have seized up. Consequently, less capital is available for investors to put at risk, and the little capital available is dedicated to shorter-term, lower-risk options. Thus, while investments in some parts of the economy have declined, investment in small innovative biotechnology companies has plummeted.

Both public and private companies have been negatively impacted by the decrease in equity investment. 120 public biotechnology companies – 30 percent of all public biotechs – are now trading with less than six months of cash on hand. This represents an increase of more than 90 percent since 2007. Further, 180 companies – another 45 percent – have less than one year of cash remaining. In 2007, life sciences companies raised $1.9 billion through initial public offerings (IPOs). In 2008, this number fell 97 percent, to only $5.8 million. The slowdown in private investments has been dramatic as well. The total capital raised by the biotech industry has fallen 56 percent in the last year.

The impact of this decline in investment has already been felt substantially. In the last six months, more than 28 companies have shelved promising drug development programs in a number of therapeutic areas including Alzheimer's disease, multiple sclerosis, diabetes, and cancer. Over 100 small biotech companies have been forced to lay off over 7,000 employees, and 2,000 of those lost jobs have come in 2009 alone. Since November of 2008, at least ten biotech companies have sought bankruptcy protection. These problems are accelerating at an alarming pace.

The decline of the biotech industry jeopardizes not only America's patient population, but also America's competitive edge in the 21st century global economy. Biotech is an industry where the U.S. is the undisputed global leader and one of the dwindling number of industries that is not exporting jobs. But the gap is closing quickly. As U.S. biotech companies face financial uncertainty, other countries are increasing their investments and intellectual property protections to encourage domestic biotech growth. Experts predict that by 2050 China will have the world's largest drug market because of the Chinese governments' commitment to enhancing the capability for new medicine development and production. India is in the process of establishing a National Biotechnology Regulatory Authority, an entity that would encourage early stage innovation, technology transfer, and startup formation. Other countries that are even closer to home, such as Canada, are also making substantial investments to grow their biotechnology

[4] Murphy, Kevin M. and Robert H. Topel. "The Value Of Health And Longevity," Journal of Political Economy, 2006, v114(4,Aug), 871-904.

sectors. Canada's favorable R&D tax laws are enticing U.S. companies to spend significant amounts of their capital abroad instead of in the U.S. If America loses its global standing as the leader in biotech, high paying U.S. jobs will be lost and an important contributor to our economy will be weakened.

Before the economic crisis, the biotech industry was growing at rates faster than ever before. In 2006, venture capitalists invested $7.2 billion in the U.S. life sciences and medical devices industry, an increase of over $4.5 billion since 1998. Investors understood the promise of the biotechnology industry and investment was climbing quickly. Unfortunately, according to a joint study by BIO and Thompson Reuters, the current economic crisis has forced over 80 percent of biotech investors to change their investment approaches. They can no longer afford the high risk that is characteristic of investment in biotech. Even angel groups, which include biotechnology and medical devices as two of their top three interests for investment, are cutting back on investment. The Angel Capital Association says that investment activity was down ten percent in 2008 and predicts additional declines this year.

The frozen capital markets have brought the biotech industry to the brink of disaster. Unfortunately, this problem was not dealt with in the recently-enacted stimulus package. Small, emerging life sciences companies were left out of the legislation. As Congress moves forward with more legislation to encourage economic recovery, action must be taken to help American biotech companies through this time of unprecedented economy uncertainty. If such action is taken, the biotech industry can re-emerge after the crisis as the vibrant and growing industry that is so important to America's future. If nothing is done, however, decades of innovative science could be lost and America's economic prospects will be weakened.

Congress should consider options to inject new capital into the life sciences sector at a time when it is sorely needed. This could be done directly, such as through new grant programs or changes to the federal tax code. Or this could be done indirectly, by enacting incentives to encourage investors back into this critical sector of our economy. I would like to briefly mention a few approaches to sustain emerging biotechnology companies in this time of need.

1). Allow Small Life Sciences Company Access to NIH Recovery Act Funds

As part of the Economic Recovery Act, Congress recently appropriated $8.2 billion to the National Institutes of Health (NIH). These dollars will be used for basic research and must be spent within the next 2 years. BIO recently sent a letter to acting NIH Director Raynard Kington, supporting new grant programs that NIH might propose and encouraging NIH to make small biotechs eligible for these programs. Traditionally, less than one percent of NIH dollars – aside from the SBIR/STTR program – have gone to companies. If ever there was a time for NIH to make more of its R&D dollars available to small, struggling companies, now is that time. New grant programs at NIH available to small companies would be a "win-win" for America's life sciences industry and the America public, as it would help to sustain research into a wide variety of new therapies at a time when private-sector funding has dropped precipitously. I hope NIH will choose to make this money available to small, private sector life sciences companies.

2). New Tax Incentives for Investment in Biotechnology

Congress should consider reforms to the federal tax code to make investments in biotechnology more attractive to today's risk-averse investors. One proposal that BIO is helping to formulate would create a new "Therapeutic Investment Tax Credit." This credit would encourage new investments in next generation therapies and would be designed to direct capital to those companies pursuing therapeutic breakthroughs by allowing the companies to allocate their credits to third party investors in exchange for cash. This approach has already been tried in the renewable energy sector and has proved greatly successful in encouraging investment in that particular industry sector. Congress should consider such an approach for America's life sciences companies as well.

Congress should also consider lower capital gains rates on investments in cutting-edge small companies. I am pleased that President Obama's budget proposed to eliminate capital gains taxes on investments in start-up companies. However, we have not yet seen the details of this proposal and it is unclear how the budget would define a "start-up" company. Section 1202 of the tax code currently provides a 50 percent exclusion on the gain from sales of certain small business stock held for 5 years or more. This percentage was temporarily raised to 75 percent in the Economic Recovery Act. Unfortunately, Section 1202 has not been successful in helping to encourage investments in companies in high-technology fields due to certain restrictions. For example, corporations are not eligible to make use of this incentive, thus shutting out a large percentage of those who might otherwise be willing to make investments in small companies. Additionally, investments are limited to those companies with less than $50 million in gross assets. This may sound like a large number, but it excludes many emerging companies in high-technology fields, companies whose intellectual property might have high valuations even though the company is cash poor. I hope that members of this committee, and others in Congress, will work with the Obama Administration to refine this proposal in order to make it as useful as possible for small, capital-intensive companies greatly in need of new funds.

Finally, I would note that many of the companies – in biotechnology and other high-tech fields – reliant upon investor capital are also highly R&D oriented. While there are incentives for R&D for large, established companies, there are not similar incentives for emerging companies. The federal research and development tax credit, for instance, is only helpful to those companies already profitable and paying federal income tax. Small, start-up companies do not receive such a benefit. I would respectfully suggest that Congress consider options to provide R&D incentives for those companies not yet profitable. After all, these are many of the companies with the most promising research.

3). Amend the SBIR Eligibility Rules to Allow Greater Participation by Small, R&D-Focused Companies

In the current economic environment, every dollar of new funding is that much more important to a struggling company. As such, it is tragic that one of the few, highly-successful programs for injecting government dollars into small, innovative firms – the SBIR program – currently shuts out many of America's most innovative small companies. This is due to the fact that the SBIR program currently excludes companies that receive a majority of their funds from venture capital

investors. This restriction is antithetical to the very notion of supporting small, capital-intensive business that must rely for their R&D funds on private sources before they have a product for sale. I know that Chairman Altmire, along with Chairwoman Velazquez and Ranking Member Graves, are working to fix this problem in the SBIR reauthorization bill that the committee will consider later this year. I would urge you to move this legislation as expeditiously as possible, given the funding shortfall facing many innovative industries. The reauthorization of SBIR, with the changes to the VC rules, is more important than ever in the current economic climate.

4). Funding Mechanism for High Growth Companies

While the SBIR program, as I noted, has been very successful, it is not nearly enough to fill the funding gap we are currently facing. As such, a new funding mechanism, perhaps a grant program or a loan program, focused specifically on the high-growth companies unable to raise funds today should be considered. This program need not be permanent; it could simply exist for the next few years as our economy recovers. Depending on how such a program was structured, it need not exacerbate the government's deficit situation, as companies saved today would pay back the money in future years of profitability. There are terrific best practice examples at the state levels that could be used as models for this federal program.

The important point is that as private investors wait on the sidelines for the financial markets to recover, government can help to fill the funding gap through narrowly targeted measures. I would suggest that we are far better off spending a little money today, rather than seeing a whole generation of America's most cutting-edge science-based industries decimated by the current capital crisis.

I would like to thank the committee again for the opportunity to testify today and I look forward to answering whatever questions members of the committee might have.

TESTIMONY

CATHERINE V. MOTT, CEO

BLUETREE CAPITAL GROUP
AND
BLUETREE ALLIED ANGELS

SUB-COMMITTEE ON INVESTIGATIONS AND OVERSIGHT COMMITTEE ON SMALL BUSINESS,

U.S. HOUSE OF REPRESENTATIVES

MARCH 26, 2009

Chairman Altmire and all of the members of the sub-committee: thank you for this opportunity to speak at this hearing on behalf of my colleagues who invest in start-ups and early stage businesses. I took the liberty to title my discussion today: "Entrepreneurs Can Lead Us Out of the Crisis".

Before I elaborate on the title, please allow me to explain my companies, BlueTree Capital Group and BlueTree Allied Angels. BlueTree Capital Group was created as an entity to purposefully aggregate angel investors to invest in early stage companies. We are a member of the Angel Capital Association, our professional support organization, whose testimony you have heard today from John May.

Because BlueTree is located in Pittsburgh, PA, we are fortunate to be strengthened by 3 outstanding Universities that serve as very fertile ground for multiple 'spin-out' of ideas into companies. Please do not confuse us with Silicon Valley, Boston, or San Diego. We are a mid-west town with a very small but vital venture capital presence – the companies created in Pittsburgh are less likely to be funded by the VCs or even by the super-rich angels like Mark Andreessen (founder of Netscape), John Doerr (Intel executive and Venture Capitalist), or Jeff Bezos (Amazon founder),.....but instead they are funded on the backs of hard-working professionals whose average annual salary is between $200,000 and $400,000. I tell you this, because most angel investors in the US look like us, not like Mark Andreessen, John Doerr, or Jeff Bezos whose multiple millions ($$) lead people to think that they can invest in start-ups under

any circumstances and in any economic climate. The average angel investor in the US is at the lower end of the wealth spectrum and is not located in Silicon Valley or Boston.

This is an important distinction for the committee -- the current economic crisis has crippled the average angel investor's ability to invest because their net worth has dropped to a point where they no longer can place discretionary/marginal capital "at risk" on start-up companies. According to the Spectrum Group, a research consultancy group, affluent households with $500,000 or more in net worth declined by 28% last year. At BlueTree Allied Angels, since September 2008, 2/3 of our 53 investors have ceased investing in early stage companies.

Why should this matter? – After all, these are affluent people who can likely weather a tough economy. That is surely true in most cases for them personally, but their financial ability to invest has been severely curtailed.

It matters because they fund companies that banks or other sources of capital will not or cannot fund.

It matters because these investors are "the mechanism" that fills the funding gap between friends/family (or credit cards) and institutional financing. Without this mechanism there would be no Alcoa today. Alcoa was funded by 2 angel investors in 1907 in the Pittsburgh region. (*Alcoa founder and patent holder, Charles Martin Hall; he moved from Oberlin, OH to Pittsburgh because 2 Pittsburgh angel investors believed in Hall's idea.)*

It matters because entrepreneurs are the fertile soil for job growth and recovery. We want Americans to fill the thousands of jobs a healthy growing economy can create.

It matters because funding entrepreneurs can lead us out of the economic crisis.

This recessionary crisis is more than a downturn caused by bad lending practices and Wall Street avarice. A greater underlying dynamic is at work and has been at work for some time —a fundamental change is taking place in the global marketplace –it is a **rapidly changing, 'technology-driven' global economy**. The United States, the nation that brought the world electricity, the telephone, radio, TV, and the personal computer, could be losing the race for its own history. China, Germany, and other countries are aggressively encouraging and setting the stage for an economy that will flourish in this new 'technology-driven' age – For example, contrast the US 15% capital gains tax rate to the 0% capital rate in Hong Kong, Singapore, and even Germany. The current U.S. Economy and its tax policies are not built for this rapidly changing technology-driven new world. In addition to fixing our debt and credit infrastructure, the US needs a healthy **"equity capital infrastructure"** that can rapidly respond to the demands of a new age and the new competitive forces of the world. The real danger for the US lies in merely fixing the old economy and ignoring the new economy.

Only entrepreneurs have the flexibility, the freedom and the risk-everything ambition to find the path back to prosperity – and it is the passion and commitment of angel investors funding these entrepreneurs that makes it possible. Yes, passion and commitment. About half of the angel investors provide more than money to entrepreneurs. They provide experience, guidance, business consulting, and contacts from their Rolodex for customer introductions or vendor/supplier relationships; for

example, one of our investors is a retired CFO and he provides financial strategy consulting for our some of our portfolio companies. Another one of our investors helps companies with their supply-chain strategy; and for a BlueTree portfolio IT company, several of our BlueTree investors provided multiple leads for customers.

The passion and commitment also exists in tolerating investment losses. Like our venture capital friends, in an average angel investor portfolio of 18 companies, the angel investor will see 5 of those companies go bankrupt and only 1 or 2 will deliver an outstanding return. It might be better explained metaphorically: 5 will strike out, 10 will make it to first or second base and return a moderate amount of capital to investors, and 1, maybe 2, will be a Hank Aaron home run.

Let's think about the home-runs for a minute – in the best companies that appeared in the past 30 years. Google, Microsoft, Apple, or even any of the wireless providers (*In Pittsburgh, the home runs are companies like Respironics, Fore Systems, McKesson Automation*) – EACH OF THESE burst onto the scene because someone, or some group of people, decided to invest in an idea before it was a product. Those early investments funded innovation. They funded growth. They created jobs, and they changed the world. Those investors are the angels we are losing today.

The hidden cost of this economic crisis is that angels have lost their wings. They are retracting as a result of the weak market and a stymied economy.

I greatly appreciate the opportunity to speak with you today because as policymakers, you can make a difference by **setting a tone with legislative initiatives** that can help reverse the downward spiral of investing in business building and job growth. Regardless of where we fall on the political spectrum, all of us in this room have to agree that innovation and building businesses are imperative elements of American economic strength.

There have been recent policy initiatives to restore our national communications and travel infrastructure, but that infrastructure has no value unless we restore the **"financial infrastructure"** for building sustainable companies. Nice new bridges don't mean a thing unless we are creating sustainable jobs whose tax base can pay for the nice new bridges.

If capital does not start flowing soon to start-ups and early stage businesses in this country, we will be faced with years of lost innovation. We will lose the good paying jobs and the good healthy tax base to other parts of the world that are aggressively facilitating innovation and start-up companies.

Please consider the following suggestions for leading the direction in restoring our country's **funding infrastructure** and helping our **Entrepreneurs lead us out of crisis**.

1. Repeal the Capital Gains Tax **OR** Change the Capital Gains rate to be something significantly lower than the current rate. Perhaps a 0% capital gains rate when having made the investment in any year in which the company had earned less than $100,000 in annual revenues. Then a 5% capital gains when having invested in any year in which the company earned between $100,000 and $500,000. Then 10% for $500,000 to $1,000,000 and 15% across the board for the rest. This

would be a middle of the road solution if a match to the 0% of Hong Kong, Singapore, and Germany was unattainable by Congress.

By changing the capital gains rate, policy makers can encourage angel investors (and venture capital) to get back into the game of building companies and risking their capital to find that 1 in 18 companies that can be the next Hank Aaron home run.

This also sets the tone that America is serious about not losing our history of innovation to China or any other part of the world.

2. Do not treat us or our venture capital partners like Private Equity Funds or Hedge Funds. Unlike traditional PE Funds, we don't FLIP companies in 3 years or strip out their value – INSTEAD, we build value; we build companies by nurturing them over 6 – 12 years. The average holding period for a portfolio start-up company that exits via a merger or acquisition is ~6.5 years and via an IPO is ~8.3 years (*Price Waterhouse Coopers/Thompson Reuters*). The recession will undoubtedly lengthen this average holding period.

   Some angel investor groups create a small venture fund to invest in early stage companies; the carried interest for managing these small funds is miniscule because the fund size is small. And the carried interest "holds a manager's feet to the fire" to ensure a successful outcome === it encourages results and supports the patience required to build companies over a 6 to 12 year time frame.

   Please don't discourage the investment behavior by increasing capital gains rates for us or our venture partners who co-invest in many of our portfolio companies.

3. Change the tax for "warrants" to be treated as capital gains instead of ordinary income. Many early stage companies lack the data to set an equity price for their company. As a result, they offer investment opportunity via a debt instrument instead of an equity instrument. Warrants added to the debt instrument can help attract the vital and necessary risk capital to get a company started -- it can be an extra reward for the earliest risk takers (aka, first round of investors who take the biggest risk) – taxing as capital gains would encourage more investors to engage in taking the earliest risk.

4. Policy makers can create state innovation funds and programs – put money into the "investment infrastructure" by allocating money to states to match angel investor funds that focus on investing in start-ups. The term "Start-ups" will likely need to be well-defined. Require the replenishment of the original capital when certain benchmarks are achieved; then begin the cycle again by deploying the returned capital in another fund.

5. Help breed sophisticated and educated angel investors via an education program. There are numerous individuals who would invest in building companies if they understood the value and

the process. Federal funds could be allocated to professional support organizations like the ACA (Angel Capital Association) and the ACEF (Angel Capital Education Foundation) to expand educational resources. These organizations focus on supporting best practices and encouraging co-investing among sophisticated investors in order to better facilitate the growth of companies.

6. Reduce the burden of Sarbanes-Oxley compliance. The cost for taking a company to the public markets has become prohibitive. Companies need to be harvested so new crops of companies can be planted. Sarbanes-Oxley impedes the harvesting process and is punishing the 98.9% who are law-abiding responsible companies applying good accounting and legal practices. The **business building system and infrastructure** needs an economically healthy ability to harvest its companies to create new wealth that will then be re-planted (re-invested) in a whole new crop of companies.

Thank you for considering these opportunities to restore our economy.

TESTIMONY OF
JOHN MAY
CHAIRMAN EMERITUS
ANGEL CAPITAL ASSOCIATION

SUB-COMMITTEE ON INVESTIGATIONS AND OVERSIGHT
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

MARCH 26, 2009

Chairman Altmire, ranking member Fallin, and all of the other members of the sub-committee, thank you for holding this hearing on expanding equity investment in small businesses – and dealing with the impact of the economy on angel investments in start-ups. Our resources are essential for start-up companies, but are in jeopardy because of the economic recession.

My name is John May, and I am co-founder of New Vantage Group in Vienna, Virginia firm that organizes and manages four angel investor networks comprising over 250 men and women private investors in the mid-Atlantic region. I am pleased to represent the Angel Capital Association and growing community of sophisticated private investors known as "angel investors" who invest money and expertise in high potential start-up companies. The Angel Capital Association (ACA) is the professional alliance of angel groups in the U.S. and Canada, and includes 165 member angel groups in 44 states. More than 7,000 accredited angel investors belong to our member angel groups. ACA is focused on building the skills of angel investors so that they are better mentor capitalists to start-up companies and on increasing the number of angels participating in high quality groups in the United States.

Start-up Companies and Angel Investors

Innovative high-growth, start-up companies are critical for job growth and economic vitality in any year, and are even more so during an economic recession. A recent Census Bureau study[1] found that start-up companies create new jobs at a higher rate than all employers as a whole – in other words, if you excluded the jobs from new firms in normal years, overall employment in the country would decrease. Angel-backed companies have been some of the most prolific job creators and innovators in recent times: Google, Yahoo, Amazon, Facebook, Costco, and PayPal are just a few examples of these businesses. Without the angel investors who helped these companies get started, these businesses might not be around today.

[1] John Haltiwanger, University of Maryland, Ron Jarmin, U.S. Bureau of the Census, Javier Miranda, U.S. Bureau of the Census, *Business Dynamics Statistics: An Overview*, 2009.

Many of these promising firms need capital, mentoring and other support to hire new people and develop new innovations. Angel investors are the source of capital for about 50,000 companies every year, but it looks like that number will significantly decrease this year because of the economy, unless action is taken to promote investment and minimize investor risk.

Angel investors are high-net-worth individuals who provide money for start-up firms with growth potential. Many of them started, built and sold their own companies and are now in a position to invest not only their money by their time in new businesses. The nation's leading expert on entrepreneurship, the Ewing Marion Kauffman Foundation, estimates that angel investors may be responsible for up to 90 percent of the outside equity raised by start-ups after the capital resources of their founders, friends, and family are exhausted.[2] These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The best angels provide more than capital to small businesses. These "mentor capitalists" give back to the entrepreneurial economy by making high risk investments directly in early-stage companies in their communities and using their entrepreneurial experience to mentor the companies as they grow. Many top angels got into this type of investment as a way to "give back" to their communities – by investing in local companies and providing them with mentoring and connections, they can help create jobs in their towns.

Until late 2008, the angel investment market increased each of the last five years by both amount of investment and number of small businesses funded. The Center for Venture Research estimates that angels invested $26 billion in 58,000 companies in 2007, an increase of 1.8 percent over 2006.[3] ACA surveys have also shown annual increases of 5 or more percent of average total investment by member angel groups over the last few years until late 2008.

One way in which angel investors are becoming better resources for entrepreneurs is through the formation of angel groups, in which angel investors join together to invest in these companies, share best practices, and bring the power of the group to help make the start-ups successful. There are currently about 300 angel groups in the United States, with at least one organization in almost every state in the country.[4] These groups add efficiency to capital raising for small businesses because they can be easily

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[2] Marianne Hudson, Ewing Marion Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.
[3] Jeffrey Sohl, Center for Venture Research, University of New Hampshire, *The Angel Investor Market in 2007: Mixed Signs of Growth*, 2008.
[4] Angel Capital Education Foundation database - www.angelcapitaleducation.org/dir_resources/directory.aspx, 2009.

located by entrepreneurs, lead to larger investments as individual angels combine their capital with other investors, and provide better feedback as angels work together to evaluate investment opportunities.

The Economy's Impact on Angels and their Start-up Investments

The toll of the economic recession on small businesses is becoming increasingly well known. Many jobs are being lost, companies going out of business, and promising companies, potentially capable of generating thousands of new jobs every year, are not getting started. When you combine the impact of the recession on angel investors individually and as an asset class, the impact on small businesses will be even worse. Here are several important facts to keep in mind:

- **The number of potential angel investors is down dramatically**. According to Spectrem Group, the number of "qualified investors" (defined by either net worth or income, and those primarily eligible by securities law to make angel investments) fell by 27 percent last year. Even more troubling, those most likely and able to invest in small businesses, individuals with a net worth of $5 million or more, fell by 28 percent to 840,000 in 2008.[5] We believe that overall angel investment will decline even more, as those who are still meet net worth definitions are less likely to make angel investments as they continue to worry about the impact of the recession on the rest of their net worth.

- **Angel group investment down as investors lose wealth**. Based on a survey of ACA member groups in December, 2008, the economic recession is having a negative impact on angel group investment – with a ten percent reduction in 2008 and a prediction of additional declines in 2009.[6] More than half the groups that had lower investment activity said that uncertainty in the public stock market lowered investment activity. Other significant reasons included a loss in member angel wealth and the need to reserve additional capital for existing portfolio companies.

- **Just as more entrepreneurs are trying to start companies, angels must focus on existing firms.** Angel group members are taking their mentor capitalist roles seriously and focusing on supporting the companies in their portfolios with mentoring, suggesting ideas to minimize costs, and helping locate additional capital when they can. They are trying to make sure that these growing companies do not go out of business and more jobs are lost as a result. While this is helpful for companies that have already received angel investment, it is bad news for new entrepreneurs (some of whom are trying to start businesses after being laid off from corporate jobs). The concern is that, on a national basis,

[5] Spectrem Group, *The Spectrem Millionaire Investor Index*, 2009
[6] Angel Capital Association, *ACA Angel Group Confidence Report*, 2008

many promising start-ups may not be able to get angel investment as easily because of the focus on supporting existing portfolio companies.

There is also some good news. There is angel money on the sidelines, which can and will be put to good use, given the right incentives, which we outline below.

Angels are Different than Venture Capitalists

While angel investors and venture capital firms (VCs) are complementary, there are several things about angel investors that make them quite different:

- In general, angels invest in start-up and early stage companies, while VCs provide "growth capital" for companies that are further along in their development. Individual angels are investing $10,000 to $200,000 per company, with angel groups making average investments of $281,000 per company in 2008.[7] This compares to average VC investment of more than $7 million for the last several years.[8]

- Angels, by definition, risk their own personal capital in companies, not "other people's money" like venture capitalists. Given a 2007 academic study in which some of the most skilled and active angel investors lost money in 52 percent of all of their investments, angels take incredible risks in backing start-up companies.[9]

- The estimated overall sizes of the angel and VC markets are roughly the same - $20-$30 billion per year – but the number of companies they invest in is different by a factor of 15. In 2007, VCs made 3,800 investments, while angel investors made an estimated 57,000 investments.[10] And while more than two-thirds of all VC investments were in California, Boston, and New York, and half of all states had only one or no VC deals, angel investments happened in every American state.

Ideas for Catalyzing Angel Investment in Early-Stage Entrepreneurs

As the Angel Capital Association considers the federal role in supporting a healthier angel capital market for innovative small businesses, we recommend five inter-related concepts. The recommendations are in priority order for maintaining or increasing the flow of high quality angel capital to the early-stage companies that need this money to keep and create jobs.

[7] Angel Capital Association, *ACA Angel Group Confidence Report*, 2008.
[8] PricewaterhouseCoopers MoneyTree Survey, 2006-2009.
[9] Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups*, 2007.
[10] PricewaterhouseCoopers MoneyTree Survey, 2006-2009 and Jeffrey Sohl, Center for Venture Research, University of New Hampshire, *The Angel Investor Market in 2007: Mixed Signs of Growth*, 2008.

1. Balanced tax incentives

Most ACA member angels tell us that the 15 percent capital gains rate for their successful investments has been one of the most important reasons for the increase in angel investments in the last six years. These capital gains rates have rewarded risky angel investments, but also put more attention on strong investment processes to ensure that the companies receiving the investment had the best chance of success. Any significant increase in capital gains rates will contribute to decreases in this type of risky investment. At a time when all other economic indicators point to less capital for small business and the sheer number of potential investors has plummeted in one year, why increase capital gains taxes for individual investors who take great risks to directly support innovative, start-up companies? ACA strongly encourages Congress to keep capital gains tax rates for angel investments in truly early-stage businesses at 15 percent or less when it renews laws for long-term capital gains this year.

In the current economic times, Congress may also want to complement a lower capital gains tax for successful early-stage investments with a tax credit for investments in innovative small businesses. Federal ordinary income tax credits for angel investments in small business start-ups could improve the flow of angel capital to small businesses in communities throughout the country. Twenty-plus states and several foreign countries have instituted income tax credits over the last decade. These credits are generally offsets against other investor tax liability and help lower the exposure angels face when investing time and money in high-growth, high risk opportunities in their neighborhoods.

A federal tax credit could ensure that innovative small businesses in all states and communities would benefit from the investor credits, rather than those in only certain states. A nationwide credit would enhance the benefits in states that have such programs, as federal ordinary income tax obligations are much larger than for those states. In addition, a tax credit in all parts of the country could help encourage more syndication among angel groups in different states, which is becoming more and more important for entrepreneurs that need the combined funding of multiple angel groups, often crossing state boundaries. The federal government could learn from the experience of different states as it considers ways to ensure maximum economic results by having angels invest in the kinds of innovative companies that truly need this kind of capital.

A 2008 study of Wisconsin's angel tax credit program and related initiatives found that the state's initiatives helped increase early-stage investments in Wisconsin small businesses by 43 percent in 2007 over 2006. Angel groups in the state increased their investments during the same time period by 57 percent and more than doubled the number of small businesses that benefited from Wisconsin's policy

initiatives.[11] ACA would be pleased to work with legislators and policy makers to develop an income tax program that addresses any existing policy concerns and helps meet goals to support the start-up and growth of small businesses that create high-paying jobs.

2. Education, training and awareness

As tax incentives are considered, it is important to ensure that investors have access to the best information and best practices to make good investments and support their portfolio companies. ACA works with two non-partisan, charitable organizations – the Kauffman Foundation and the Angel Capital Education Foundation – that provide high quality education for angel investors, potential angels, university leaders, and support organizations that help small businesses that need equity investment. An outside evaluation of these education programs found that they increased the number of accredited investors who made angel investments and increased their confidence in making good investments because they had a better understanding of best practices for evaluating investment opportunities and working with entrepreneurs.

Grant funding to national organizations like the Angel Capital Education Foundation to "scale" this type of education, so that it reaches hundreds of thousands of potential or new angels instead of just thousands of investors, could increase the number and quality of angels throughout the country.

Grant support of awareness campaigns – so that potential angels are aware of this type of investment as a potential opportunity – could also help increase the number of active angels from the pool of more than 4 million potential angels (who may have never heard of or thought of angel investing). In the United Kingdom, such awareness campaigns are leading to significant increases in the number of angel investors. Americans may want to adapt such a program here that is national in scope to leverage resources and that connects to strong education programs to ensure confidence and knowledge of best practices so that new angels make the best possible investments.

Awareness campaigns could be targeted in particular to women and minorities to consider angel investments. Through interviews and a few studies, it appears that many businesses receive equity investment because of the social networks they have developed. If more women or minorities became angels, one school of thought is that more women and minority entrepreneurs would receive investments because they may more easily connect to the networks of women and minority investors.[12]

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[11] David Ward, NorthStar Economics, *2008 Risk Capital Report: Wisconsin*, 2008.
[12] Marianne Hudson, Maggie Kenefake, and Mary Jane Grinstead, Ewing Marion Kauffman Foundation, *Women and Angel Investing: an Untapped Pool of Equity for Entrepreneurs*, 2006.

These education and awareness campaigns could be done well and for results in all parts of the country for less than $10 million. I am a lead instructor for one of these programs and have seen with my own eyes the benefits in diverse areas – rural, urban, university town, seacoast town – of increased activity after seminars and training. I personally recommend action in this arena.

3. Keep angel investment activities in private hands

A few federal initiatives or draft legislation have recommended the establishment of government offices to oversee angel investment or to operate angel investment initiatives. The Angel Capital Association believes that such intervention would not have the intended result of improving entrepreneurs' access to angel capital and/or it would lead to frustration by both small businesses and investors. Past federal government experiments to create databases or Web sites to match small businesses in need of capital with investors have not worked. Instead, there are non-profit links to all angel groups, such as the Web site of the Angel Capital Education Foundation (www.angelcapitaleducation.org) and some privately-based sites that try a variety of ways to connect entrepreneurs and investors.

4. Accredited investor standards and impact on high growth company investing

Beyond these legislative suggestions, one other fundamental of early-stage venture capital infrastructure should be noted and preserved. Maintaining the regulatory definition of sophisticated investors – "accredited" by the definition provided in securities law – will allow angels of all types to continue to participate in our venture capital system. Abruptly increasing the threshold of net-worth above the current $1 million – for this particular asset class activity – could have potentially detrimental impact on seed stage funding in the United States. This is particularly true given the significant drop in the number of high net-worth individuals in 2008.

5. Leveraging private investments

If simple, non-bureaucratic techniques of directing federal funds to co-invest with angel groups could be developed, entrepreneurs may more easily access the funding they need and angels may be more easily able to diversify their investments in this risky asset class. Several groups, such as i2E Inc (which manages a seed capital fund in Oklahoma that co-invests with angel investors), the Ohio TechAngels (which has a co-investment $2.5 million fund raised from The Ohio State University, Nationwide Insurance and the State of Ohio) and CommonAngels in Boston (which has raised a $10 million co-investment fund from private sources in their region) have successfully developed innovative "side car" funds to leverage dollars invested into entrepreneurs in their region on the personal investment decisions of members of their angel groups. Scotland pioneered a government fund that automatically co-invests with qualified accredited investor groups to spur economic development and growth of high impact

companies at a low overhead and bureaucratic cost. While there are a variety of opinions on this concept, many of our members hope you will consider such an innovative approach for American entrepreneurs, particularly as the economic recession has reduced the amount of private capital available in the last six months. (Or, alternatively, give a tax credit for funds invested in side car funds.)

Summary and Final Thoughts

Thank you for this opportunity to describe the unique role and significant impact that angel investors have in our economy and to provide some thoughts on the effective federal roles in supporting the growth of high impact companies and jobs in our economy in the coming years.

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support start-ups and early-stage businesses. Focusing on the combination of keeping capital gains taxes to a minimum and developing well thought-out income tax incentives could ensure that more deserving small businesses get the capital they need, especially during our current tough economic times.

We also encourage you to let entrepreneurs in your districts know that angel groups are interested in learning more about angel investment to link to every known angel group on the Angel Capital Education Foundation Web site, www.angelcapitaleducation.org, and to review the "Info for Entrepreneurs" section to learn more about the angel investment process.

I would be happy to answer any questions you have and for the Angel Capital Association to provide you with additional information when you need it.

"Expanding Equity Investment in Small Business"

Testimony before the Sub-Committee on Oversight and Investigations Committee on Small Business United States House of Representatives

March 26, 2009

Patrick Dalton
President & Chief Operating Officer
Apollo Investment Corporation

Chairman Altmire, Ranking Member Fallin, and members of the Sub-Committee

My name is Patrick Dalton. I am President and Chief Operating Officer of Apollo Investment Corporation, an SEC regulated Business Development Company (commonly known as a "BDC"). We are publicly traded on the NASDAQ stock exchange. For the five years since our IPO in April 2004, Apollo Investment Corporation has invested over $5.5 billion in 124 small and middle-market businesses across the United States, with current access to additional available capital of approximately $700 million.

As successful as our company and our industry have been, I am here today to let Congress know that the mission this body gave the BDCs 29 years ago— to provide much needed capital to small and mid-size companies—is in danger unless prudent policy steps are taken now. I am not here to ask you for money. Far from it. I am here to ask for some commonsense policy help so that we can use the money we have to originate loans and support the very companies this committee cares so strongly about.

But first, the good news.

We estimate the nation's BDCs currently have a combined loan and investment portfolio of over $30 billion that provides capital to over 1,400 small and middle-market businesses, with an average loan of $14 million. These loans are the lifeblood of Main Street businesses that support over 1.2 million U.S. jobs. In 2007, we estimate that BDCs

provided approximately 50% of all junior debt capital loans (known as subordinated or mezzanine loans) to the small and mid-sized businesses throughout the United States.

I want to offer you two investment examples so you can see the type of work we are doing. In September 2004, Apollo Investment Corporation partnered with another BDC to provide a $45 million mezzanine loan to support the acquisition of Anthony, Inc. a San Fernando, CA manufacturer of glass refrigerator and freezer doors with over 550 employees. In 2005, we provided $45 million in mezzanine loans to LVI Services, Inc., a New York City-based company that employs over 2,000 workers. LVI provides integrated remediation, demolition, restoration and emergency response services to a broad range of clients throughout the U.S. The examples are typical of the type of loans that we, and indeed the BDC industry at large, provide to small and mid-sized businesses. The common themes running through these investments are:

1. an inability of small and mid-sized companies to secure financing from mainstream commercial banks;
2. a close working relationship between us and company management throughput the life of the investment; and
3. a hold-to-maturity philosophy where our exit is defined by the company's repayment of loan

As many of you know, Congress created BDCs in 1980 under amendments to the Investment Company Act of 1940 in direct response to the crisis in the capital markets that threatened small businesses during the late 1970's. Today, we are in what many

believe is a "once in a century recession". Small and middle-market businesses have been abandoned once again by the traditional sources of capital. BDCs remain among the very few investment vehicles, along with the SBICs, that are continuously dedicated to lending to smaller businesses. Our industry is lending in excess of $30 billion. None of us wants to see capital of this magnitude withdrawn from, or otherwise unavailable to, the small and middle-market.

It is our strong belief that BDCs occupy a unique regulatory space. Like banks and other commercial lenders which are not subject to the 1940 Act, we originate, structure, and make loans directly to companies with the intention of holding most of these loans to maturity. However, unlike those institutions, the 1940 Act imposes several important differences. We are a much less levered investment vehicle than banks, with a ratio of debt to equity of a mere 1:1. Further, we are required by statute to invest at least 70% of our capital in small and middle-market U.S. businesses. And while we all make similar discrete hold-to-maturity loans, BDCs are obligated to mark-to-market 100% of our loans, while the banks and other commercial lenders only mark-to-market a minority of their assets.

BDCs are regulated under the 1940 Act and therefore fall under the supervision of the Investment Management Division of the SEC, whose primary function is regulating mutual funds. Mutual funds -- unlike BDCs -- must invest and trade primarily in liquid assets and are required to stand ready to redeem shareholders at Net Asset Value at any time. Yet, as described above, unlike mutual funds, BDCs are originators of illiquid

loans to small and mid-sized companies that take many months to complete and which we intend to hold-to-maturity.

Because we are regulated under the 1940 Act, we have always used fair value principles to value our portfolio. Prior to the implementation of FAS 157 and its interpretive guidance, the industry used fair value measurements based on the underlying credit fundamentals - that is, the collectability of interest and principal and the pricing of new mezzanine loans.

The record of "Back Testing" of our values demonstrates the high accuracy of this methodology. When our fair values are compared to our exit values achieved when the loans were repaid, one finds that our valuations over many years were within a very tight range.

Unfortunately, we have been forced by changes in accounting rules and auditor practice to "fix" what wasn't broken. With the implementation of FAS 157, the accounting community now requires that our illiquid assets be valued as if they were trading assets being sold into a hypothetical market too often drawn from a series of distressed asset sales of other illiquid assets that are not at all comparable to our individualized, performing loans. We believe that this practice has caused artificial asset value write downs for the BDCs, without meaningful regard to the credit quality of the underlying assets.

Ironically, investors—who are supposed to be protected by accounting rules-- are no longer able to discern the difference between the credit worthiness of a BDC's assets and general market dislocations that have nothing to do with the performance of our loans.

And most important to the mission of this Committee, this same accounting asymmetry results in many fewer loans -- and perhaps the cessation of all origination activities -- to the small business community by the BDCs. Every BDC, under the current interpretations of FAS 157, finds itself hoarding cash rather than making loans so they will not trip their statutory one-to-one asset coverage test that I mentioned earlier.

Mr. James Kroeker, the Acting Chief Accountant of the SEC in his testimony on Mark-to-Market Accounting before the House Financial Services Committee stated, "When mark-to-market accounting is not applied, unrealized investment losses are only recognized if the value of the investment is impaired. For debt securities that will be held to maturity, such impairment is generally only recognized if it is probable the investor will fail to recoup the invesment's contractual cash flows - that is, when credit loss has occurred."[1] Let me state for the record, that the BDC industry applauds Mr. Kroeker's statement, and agrees 100%. However, these insights have been denied to BDCs since the implementation of FAS 157.

[1] Testimony of James Kroeker, Acting Chief Accountant, U.S. Securities and Commission, House Subcommittee Hearing on Capital Markets, Insurance, and Government Sponsored Enterprises, "Mark-to-Market Accounting: Practices and Implications," (March 12, 2009).

Apollo Investment Corporation, I am pleased to state, has recently reported that we are in compliance with all of our covenants. Yet, we still must be cautious about using any of our $700 million of available capital toward originating new loans. We have, therefore, voluntarily chosen to curtail new lending activities until such time as there is a resolution to this issue. **This means that while we have the ability and desire to lend, we are unable to do so because of the policy and interpretive guidance that has emerged post-FAS 157.**

Unfortunately, some of the other established BDCs have already violated their Asset Coverage test, largely I believe, due more to volatility in the general markets rather than overall weakness in their own portfolios. The result has been an industry-wide downward spiral in stock prices with little or no regard to fundamental performance, thereby preventing us all from raising new capital. This situation has impacted the overall industry and hurt the BDCs' public equity investors and the small business community.

Our industry has had several meetings and discussion with the Investment Management Division of the SEC. We have also met with the Acting Chief Accountant of the SEC, as well as with each of the Commissioners of the SEC. We would like to thank each of them for the time and effort they put into understanding our issue. We also applaud the new Chairman of the SEC for meeting with our industry so soon after she was sworn in as

Chairman to learn about our industry and the very serious challenges that we face in fulfilling our mandate.

And as many of you know, the leadership of this Committee has written the SEC asking that regulatory reforms that might mitigate this problem be taken quickly before further deterioration occurs.

But as of today, we are still in need of your help. We have made three suggestions to the Commission and it is to those three suggestions that I want to return.

1. First and Foremost, we ask that BDCs be expressly included in the work that FASB and the SEC has been tasked with by the House Financial Service Committee to respond with improvements to Mark-to-Market Accounting. If we were able to offer true fair value accounting to our "hold to maturity" loans, we could—and would -- resume lending.

2. If we are denied relief from current accounting procedures under FAS 157, we ask that BDCs be given temporary authority to raise preferred stock, and treat those shares as equity rather than debt for the asset coverage test purposes. While this will not solve the problem, it may help some BDCs ride out the storm, and there is past precedent to justify it.

3. Also consistent with prior actions for other industries, we are asking for a temporary relaxation of the asset coverage limits. Again, while this will not solve the underlying problem, it will assist select BDCs, and in conjunction with the preferred stock proposal outlined above, assist some additional BDCs, in returning to more active lending in the market place.

In closing, let me end where I began.

I am not here to ask for taxpayer money. I am not asking for a bailout of an industry that made bad decisions or was too highly leveraged. I am here solely to ask for your help in returning us to the public purposes for which you—the Congress-- created BDCs 29 years ago.

It would indeed be a shame if common sense did not prevail. Thank you.

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