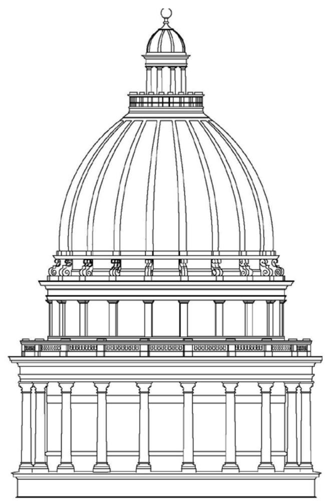
REPORT TO THE

UTAH LEGISLATURE

Number 2014-08



A Performance Audit of The Utah Fund of Funds

August 2014

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

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JOHN M. SCHAFF, CIA
AUDITOR GENERAL

August 2014

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of the Utah Fund of Funds** (Report #2014-08). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff

John M. Schaff, CIA
Auditor General

JMS/lm

Digest of
A Performance Audit of
The Utah Fund of Funds

Chapter I
Introduction

The Utah Fund of Funds (UFOF) was created by the passage of the Utah Venture Capital Enhancement Act (UVCEA) during the 2003 Legislative General Session. It was envisioned that the UFOF would encourage Utah job growth, help diversify the state's economic base, and help maintain a well-trained workforce.

UFOF Must Balance Dual Missions of Economic Development and Investment Returns. The UVCEA was passed as a means to enhance economic development in Utah through the in-state mobilization of venture capital. The legislation also requires that the fund maintain a focus on its rate of return to protect state tax dollars. Though not entirely at odds, these two missions do not always lead to the same investment decisions and therefore must be balanced.

The UFOF must balance dual missions of economic development and return on investment through its two oversight boards.

Legislation Passed in 2014 Addressed Some Significant Legislative Audit Concerns. Some risk areas identified in this audit were addressed by the passage of House Bill 243 during the 2014 Legislative General Session. Among other concerns, House Bill 243 disallowed the financing of new investments with debt and reduced the amount of tax credits available to the program.

Chapter II
Reported Economic Impact of UFOF Overstated and Inconsistent

Lack of Consistent Methodology Has Resulted in the UFOF Overreporting Its Economic Impact. The UFOF lacks a consistent methodology for determining its effect on the Utah venture capital market and the state's economy as a whole. Because impact is not adequately tracked or documented, the UFOF has reported every new job created in companies that have received investments from UFOF investment managers. We are concerned that the UFOF has been unable to quantify or estimate its involvement in total new job creation. Additionally, reported income tax revenue was overstated.

The UFOF lacks a consistent methodology for determining its effect on the Utah venture capital market. As a result, the program has overreported its economic impact.

UFOF Economic Reports Are Inconsistent and Difficult to Interpret. UFOF economic reports contain substantial inconsistencies in their reported numbers from year to year, even within the same report. These inconsistencies make gauging the true economic impact of the program difficult.

Chapter III
Economic Impact in Utah Not Adequately Tracked

Evidence of Economic Development Impact is Needed to Adequately Judge UFOF Success. In reviewing the UFOF's investment decisions, it appears that staff and board members have made clear efforts to address both missions. However, despite these efforts, it is unclear precisely how impactful the program has been in attracting capital to Utah. We believe that if the economic development benefits of the program cannot be quantified, the Legislature cannot adequately weigh benefits against risks and should consider whether it is a program in which the state should be involved.

While the UFOF has made clear efforts to address both missions, it is unclear precisely how impactful the program has been in attracting capital to Utah.

Economic Development Activities and Impact in Utah Not Adequately Tracked. Though the UFOF tracks its investment portfolio very closely, the program lacks the same rigor for its economic development efforts. Currently, the UFOF does not have an economic development plan or metrics that are consistently tracked and reported, but program management reports that they are currently in the process of developing one.

Utah Venture Capital Market Is Improving But UFOF Impact Is Unclear. National venture capital statistics show that the Utah market is improving. However, the lack of program metrics makes it difficult to show whether the UFOF has had a meaningful part in this improvement.

Chapter IV
Financing Costs Negated Investment Gains

UFOF Investment Gains Negatively Impacted by Atypical Financing Costs. UFOF's cost of financing has consumed all of its portfolio gains, heavily impacting the program's bottom line. Before accounting for financing costs, UFOF portfolio performance is slightly above the median performance of funds of funds in the general market. However, net of all program and financing costs, the portfolio's performance is currently negative but approaching break-even. If the program's performance continues to improve, the risk of tax credit redemption will diminish.

UFOF's financing costs have consumed all portfolio gains, heavily impacting the program's bottom line. However, UFOF portfolio performance is currently negative but approaching break-even.

UFOF Has Not Adequately Reported Investment Performance Publicly. Because statute historically lacked clear reporting standards, the UFOF has not consistently reported investment performance measures. For example, the most recent annual report of the UFOF showed a net internal rate of return that did not account for financing and administrative costs. The failure to report program costs was misleading and significantly affected the reported number. The passage of House Bill 243 during the 2014 Legislative General Session modified and increased investment performance reporting requirements.

Public reporting of investment performance has been misleading.

Financing Costs Are Atypical; Administrative Costs Appear Reasonable. Because of the uncommon structure of the UFOF, options for initial program financing were limited. The UFOF accepted financing terms that proved to be very costly for the program though, at the time, the interest rate was not unreasonable. To date, $37.3 million in financing costs have consumed all investment returns. UFOF administrative costs, as a percentage of assets under management, appear to be in line with other private funds of funds.

UFOF Made Positive Changes to Its Portfolio In Response to the 2008 Recession. The UFOF appears to have made a number of sound strategy decisions in response to the 2008 economic recession. Upon the recommendation of the UFOF fund advisor, the UCIC board pursued a strategy which took advantage of poor market conditions and generated positive returns for the portfolio.

UFOF Strategy for Fund II Is Equity Financing Instead of Debt. Because of the negative aspects of debt financing, House Bill 243, passed in 2014, prohibits its use going forward. The intent of the UFOF moving forward is to raise equity investment financing for the program's next fund (Fund II). To date, because of financing costs, the UFOF has been unable to build up any redemption reserves.

Moving forward, the UFOF will seek equity financing as debt financing is now prohibited. To date, because of financing costs, the UFOF has been unable to build up any redemption reserves.

Chapter V
Oversight of UFOF Can Continue to Improve

UFOF needs to improve policies and procedures and document justifications for bonus and severance payments.

UFOF Needs to Develop Comprehensive Policies and Procedures. While both oversight boards have discussed specific policies and procedures in their meetings, some of the policies discussed were never developed. Additionally, statute is more restrictive than current UFOF bylaws on conflicts of interest with regard to investments. We also found that assistance from the Attorney General's Office was insufficient but has been improving. Additionally, the Governor's Office of Economic Development should support the UCIB in fulfilling its statutory responsibilities.

Significant Bonus and Severance Payments Made to Staff Without Documented Merit. We found that significant bonus and severance payments have been paid to UCIC staff without any developed criteria or documentation to support such actions. Between 2005 and 2013, UCIC directors and staff (up to three positions at any given time) were given $330,000 in bonuses and severance payments. Because of insufficient documentation, we could not validate if the bonuses were justified.

Statutory Language Regarding UCIC Board Chair's Term Could Be Clarified. The statute is unclear on how long a UCIC board chair may occupy his or her seat. The Legislature should consider modifying the statute to clarify that the UCIC chair may serve multiple terms.

Three Years Were Spent Performing A Prolonged Program Assessment. For multiple reasons, the UFOF spent three years in a period of program assessment. Ironically, this prolonged period of investment inactivity came on the heels of the 2008 Legislature raising the program's contingent tax credit ceiling, with the support of the UFOF, in order to avoid a halt in the program's investment activity. The UFOF engaged in this assessment period intending to measure program impact and develop a funding allocation strategy for the future. However, until recently the UFOF accomplished little beyond refinancing loans.

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Chapter I
Introduction

The Utah Fund of Funds (UFOF) was created by the passage of the Utah Venture Capital Enhancement Act (UVCEA), ***Utah Code*** 63M-1-1201 through 1224, during the 2003 Legislative General Session. In passing this legislation, it was envisioned that the UFOF would encourage Utah job growth, help diversify the state's economic base, and help maintain a well-trained workforce. The Utah Capital Investment Corporation (UCIC) is an independent quasi-public corporation created to operate the UFOF in order to boost ***venture capital***[1] investments in Utah-based companies.

It was envisioned that the UFOF would encourage Utah job growth, help diversify the state's economic base, and help maintain a well-trained workforce.

To obtain financing for the program, the UFOF issued ***contingent tax credits*** as collateral for financing from an investment bank. In its 2012 annual report, the UFOF stated that it has borrowed $130 million (including a $20 million revolving line of credit) to invest in 28 venture capital and ***private equity*** funds which, in turn, have invested in individual companies (both in and out of Utah). These investments have already been made in what the UFOF refers to as Fund I. The performance of the fund, the operating expenses, and the timing of cash disbursements determine if contingent tax credits will be redeemed. If UFOF cash flows are insufficient to meet cash obligations, the banks will redeem their tax credits in the amount of the default.

The UFOF was initially established and approved for $100 million in contingent tax credits in 2003. Due to legal concerns regarding the constitutionality of the program, no financing was raised until 2006. In 2006, the UFOF entered into an agreement with an investment bank and raised $100 million to invest. In 2008, the Legislature authorized raising the amount of contingent tax credits available to the program to $300 million. In 2012, the UFOF refinanced and increased its loan to $130 million with a regional and a national bank, paying off the original obligations to the investment bank. These current loans will mature in October 2017 and had a total outstanding balance of $100.7 million as of June 30, 2014. During the 2014

In 2006, the UFOF entered into its first agreement with an investment bank and raised $100 million to invest.

[1] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix A.

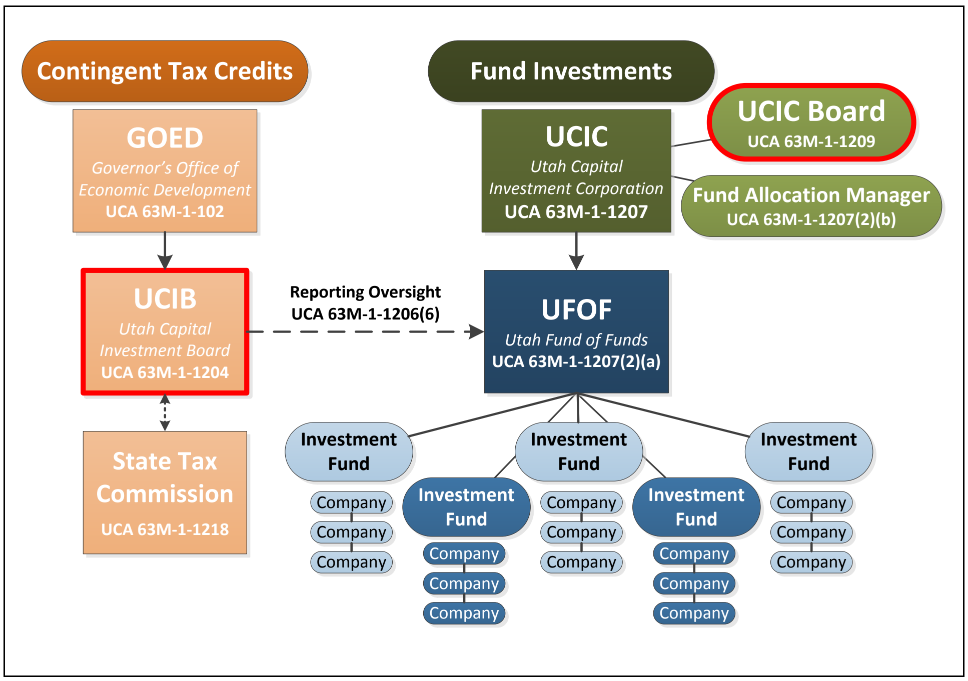
Legislative General Session, additional changes were made to the UFOF, which will be discussed later in this chapter.

UFOF Is Directed By Two Governing Boards

UFOF is directed by two governing boards: the Utah Capital Investment Board (UCIB) and the Utah Capital Investment Corporation (UCIC) board.

The operations of the UFOF are directed by two governing boards, the Utah Capital Investment Board (UCIB) and the Utah Capital Investment Corporation Board of Directors (UCIC board). Figure 1.1 illustrates the organizational structure of the UFOF.

Figure 1.1 UFOF Has Two Governing Boards: the UCIB and the UCIC Board. The UCIB provides public oversight of the UFOF and authorizes the issuance of contingent tax credits while the UCIC board oversees the operations and investments of the UFOF.



Source: *Utah Code*, Figure created by OLAG

As shown in Figure 1.1, the UFOF is governed by two boards. The UCIB is the government oversight board of the UFOF. The UCIB approves transactions involving the pledging of Utah state tax credits (contingent tax credits) and ensures the UFOF is fulfilling its statutory mandate. The UCIC board of directors oversees the operations and investment decisions of the UCIC which, in turn, operates the UFOF as a separate limited liability company (LLC). UCIC board oversight includes final approval for all investment decisions, financing agreements, budgets, employee compensation, and fund strategy. It is also noteworthy that all UCIB and UCIC board members serve voluntarily with no compensation.

Utah Capital Investment Board (UCIB) Provides Public Oversight

The UCIB was created within the Governor's Office of Economic Development (GOED) and provides public oversight of UFOF activities. The UCIB provides oversight primarily in the form of approving the issuance of contingent tax credits and publishing an annual report of UFOF activities.

The UCIB is charged with issuing Utah state contingent tax credits. The board also ensures that the UFOF is achieving its statutory purposes including spurring economic development in the state.

Members of the UCIB are the state treasurer, the director of GOED or the director's designee, and three members appointed by the Governor and confirmed by the Senate. The statute states that "the purpose of the board is to mobilize venture equity capital for investment in a manner that will result in a significant potential to create jobs and to diversify and stabilize the economy of the state." All UCIB duties and powers are laid out in ***Utah Code*** 63M-1-1204 and 1206. Selected portions of the statute are included in this report as Appendix B.

The UCIB has statutory authority to create administrative rules, expend funds, and enter into contracts. Ultimately, the UCIB is responsible for authorizing the issuance of contingent tax credits and ensuring that the UFOF is achieving its statutory purposes of spurring economic development and protecting against the redemption of contingent tax credits.

Utah Capital Investment Corporation (UCIC) Board of Directors Manages UFOF Operations

The UCIC is an independent, quasi-public corporation that was created to organize the UFOF, select an investment fund allocation manager, and manage UFOF operations. UCIC activities are overseen and guided by the UCIC board of directors. UCIC activities include making investment decisions, entering into financing agreements, approving budgets, approving compensation, and developing and approving investment strategies.

The UCIC selects the UFOF's fund allocation manager, invests funds, approves budgets and compensation, and develops and approves investment strategies.

An appointment committee selected the first UCIC board of directors and vacancies are now filled by election of the remaining members. Board members serve four-year terms and ideally have expertise in areas pertinent to the operations of the UFOF. The UCIC board chair is elected by the UCIC board.

The Boards Are Tasked with Enhancing Venture Capital within the State of Utah

The UVCEA charges the UFOF to mobilize private investment in a broad variety of venture capital partnerships.[2] Private equity is a broad term defined by the California Public Employees Retirement System (CalPERS)[3] as the investment of private capital in companies that are not quoted on a stock market. CalPERS further states that private equity investments can be used to develop new products and technologies, expand working capital, make acquisitions, or strengthen a company's balance sheet. It can also be used to resolve ownership and management issues.

Venture capital is just one type of private equity investment that focuses on the launch, early development, or expansion of a business. There are other types of private equity, such as ***mezzanine*** or ***buyout*** investments, that each correspond to different stages of company maturity. The UFOF is charged to invest in fund managers that have demonstrated expertise and a successful history in the investment of venture capital funds.[4]

UFOF Must Balance Dual Missions of Economic Development and Investment Returns

The UFOF was set up to fulfill two important missions: enhance economic development in the state and focus on investment rate of return.

The UVCEA was passed as a means to enhance economic development in Utah through the in-state mobilization of venture capital. The legislation also requires that the fund maintain a focus on its rate of return to protect state tax dollars. Though not entirely at odds, these two missions do not always lead to the same investment decisions and therefore must be balanced.

According to the UVCEA, the Legislature found that Utah was suffering from "a critical shortage of ***seed*** and venture capital," which

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[2] See ***Utah Code*** 63M-1-1202(1)(c); (2)(a) included in Appendix B

[3] With over 1.6 million members in its retirement system and an investment portfolio worth over $280 billion, CalPERS is considered to be an investment industry authority.

[4] See ***Utah Code*** 63M-1-1215(1)(c)

was "impairing the growth of commerce in the state." The Legislature saw a strong need to enhance Utah's venture capital culture and increase venture capital investment to create new jobs and help diversify Utah's economic base. To this end, the statute states that the UFOF should conduct its affairs in a way that maximizes its direct economic impact for Utah.

However, statute also explains that the program should invest in the best venture capital managers regardless of location and maintain a focus on the program's rate of return to protect state tax dollars. These provisions ultimately create a dual and, at times, conflicting mission for the UFOF, as not all investment opportunities provide both a strong return and a strong economic impact for Utah. The balancing of these two missions is discussed in further detail in Chapter III of this report.

The Utah Venture Capital Enhancement Act (UVCEA) permits the UFOF to invest in the best venture capital managers, regardless of location, in order to protect state tax dollars.

UFOF Seeks Investments With Utah Angle

In helping the UFOF accomplish its dual mandates of increasing economic development and protecting state tax dollars, the UCIC has tasked itself with five primary functions. These functions are:

- Investing in venture capital and private equity funds to increase capital in Utah
- Supporting early investments (such as seed investments)
- Providing entrepreneur investment training and ***matchmaking*** (that is, introductions to sources of investment capital)
- Encouraging ***early-stage*** innovation and ***accelerator*** support in alignment with state objectives
- Marketing Utah to a national audience of private market investors

With these five functions and the program's statutory mandates in mind, the UFOF seeks to invest in top fund managers who have some clear potential to invest capital in Utah. We reviewed the ***due diligence*** documentation for each of the 28 funds in the portfolio and saw a

As reflected in its due diligence and investment decisions, the UCIC seeks funds with clear potential to invest in Utah.

consistent effort by the UFOF fund allocation manager to identify funds with potential to make investments in Utah companies.

The program works by leveraging its investment relationships to attract attention to, and hopefully investments in, private companies in the state. The UFOF also has encouraged fund managers to spend time meeting with growing Utah companies in order to facilitate potential investments. However, as will be discussed in Chapters II and III, these efforts have not been adequately documented and their ultimate impact on the state's economy is therefore not clear.

Legislation Passed in 2014 Addressed Some Significant Legislative Audit Concerns

During the 2014 Legislative General Session, legislation was passed disallowing debt financing. The legislation also reduced the contingent tax credit ceiling from $300 to $225 million.

Some risk areas identified in this audit were addressed by the passage of House Bill 243 during the 2014 Legislative General Session. Foremost, we were concerned about the practice of using debt-based financing as a means to raise capital because of unpredictable cash flows, significant interest rates, and because this practice is not common in the industry (see Chapter IV). Moving forward, the legislation disallows the financing of new investments with debt.

Other risk areas that House Bill 243 addressed include the transparency of economic development reporting (see Chapters II and III) and financial reporting (see Chapter IV). House Bill 243 also reduced the amount of contingent tax credits that can be issued from $300 million to $225 million. This contingent tax credit ceiling of $225 million includes the $130 million in loans already exercised. This reduction in contingent tax credits has no effect on current investments (Fund I) but caps the amount available for Fund II investments at $75 million.

Audit Scope and Objectives

The audit request of the UFOF was for us to review operations and to determine whether the program is achieving expectations. Specifically, we were asked to evaluate the economic development numbers being reported by the UFOF and determine whether the UFOF is operating effectively and efficiently at promoting venture capital investments in the state. Concerns about the operations of the

UFOF are pertinent because of the potential liability to the state in the form of future tax revenue reductions if contingent tax credits are monetized. This chapter has addressed the statutory creation, purposes, structure, and changes of the UFOF. The remainder of the audit request will be addressed in the following chapters:

- Chapter II – Economic development reporting
- Chapter III – Economic development impact and planning
- Chapter IV – Investment strategies, costs, and reporting
- Chapter V – Oversight of operations

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Chapter II
Reported Economic Impact of UFOF Overstated and Inconsistent

Legislators requested that we evaluate the economic development data being reported by the Utah Fund of Funds (UFOF). UFOF's economic development reporting has not been sufficient for lawmakers to draw informed conclusions about its performance and has lacked consistency. We found that the UFOF has:

UFOF's economic development reporting has lacked consistency and has not been sufficient for lawmakers to draw informed conclusions about its performance.

- Overreported its economic impact
- Included inconsistent job creation and tax revenue information in its annual reports

Specifically, past administrators of the UFOF have taken credit for economic development activity in companies receiving investments, regardless of the program's relevance in a given investment (whether or not the investment would have happened with or without UFOF involvement), and has inconsistently reported results such as jobs created and tax revenues generated. This chapter will present our review of the UFOF's reported data while Chapter III will discuss the underlying causes of the reporting deficiencies.

Lack of Consistent Methodology Has Resulted in the UFOF Overreporting Its Economic Impact

The UFOF lacks a consistent methodology for determining its effect on the Utah ***venture capital***[5] market and the state's economy as a whole (see Chapter III). The UFOF has inconsistently reported to the Legislature every new job created in companies that have received investments from UFOF investment managers. While we were able to validate the direct jobs that were reported, we are concerned that the UFOF has been unable to quantify or estimate its involvement in new job creation. In addition, reported income tax revenue was overstated. The UFOF needs to both ensure that data from its 28 fund managers are accurate and up to date, and develop a methodology to calculate

The UFOF lacks a consistent methodology for determining its effect on the Utah economy and has overreported its impact on the creation of jobs and tax revenue.

[5] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix A.

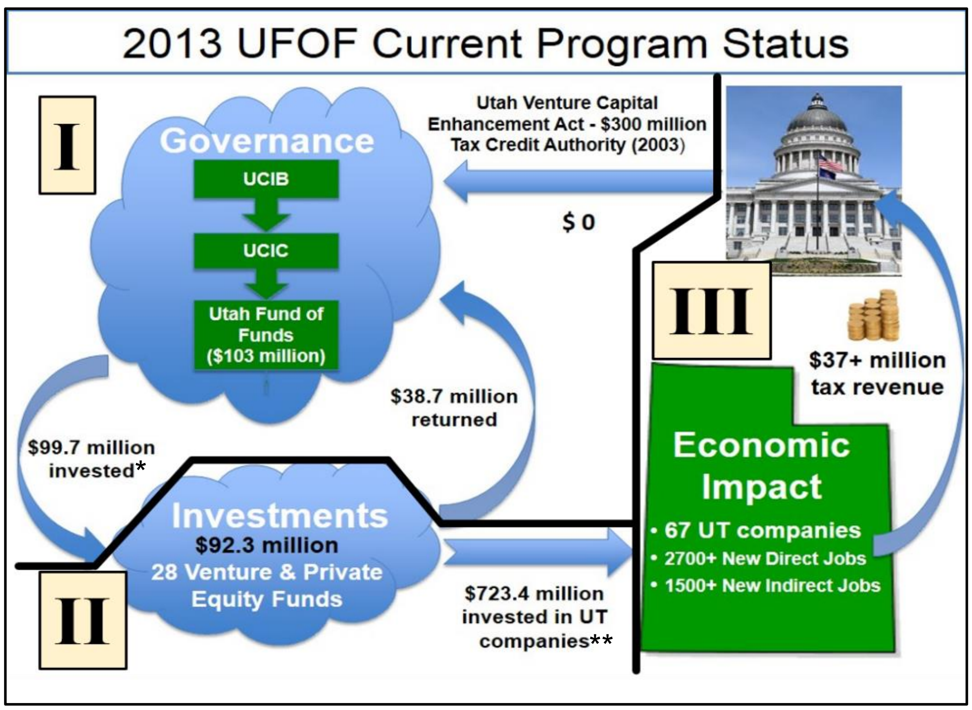
and report data on its effect in overall economic development attributable to the program.

In 2013, the UFOF released a status report on the investments and economic impact of the program to date. The UFOF 2012 Annual Report, published in October 2013, contains similar information. Based on these documents, questions about the validity of the UFOF's reported activity and impact were raised by legislators.

In 2013, the UFOF released a program status report as shown in Figure 2.1.

Figure 2.1 shows the most recent program status report issued by previous management of the UFOF. We divided this diagram into three sections for purposes of discussion following the figure.

Figure 2.1 UFOF Economic Impact Report Released in 2013. UFOF is unable to show how influential its investments have been in the economic impact reported in this figure.



**The $99.7 million reflects capital invested by UFOF into funds which had generated $131 million of total value as of this date ($92.3 million of unrealized value shown immediately below and $38.7 million of value returned to UFOF).*

***This $723.4 million represents capital invested by the 28 investment funds, not by the UFOF itself.*

We were specifically asked to examine the numbers contained in Figure 2.1. The following information discusses each section of the figure: governance, investments, and economic impact.

I. Governance: All Investment Returns Have Been Used to Pay Financing and Administrative Costs

Figure 2.1 illustrates the governance structure of the UFOF, including the oversight board (UCIB), investment board (UCIC), and the UFOF itself. When the economic impact report shown in Figure 2.1 was released, the UCIB and the UCIC had approved a total of $99.7 million in investments to 28 different fund managers, with $38.7 million in capital being returned to date (as discussed in Chapter IV, returns are expected to rise with time). The UFOF reported that all $38.7 million of investment returns had been used to pay financing and administrative costs or to meet ***capital call*** obligations. The $103 million shown in Section I represents the outstanding loan balance at the time of reporting. For updated investment numbers and analysis, see Chapter IV and Appendix D.

All $38.7 million of revenue returned to the program has been used to pay for the financing and administrative costs of the UFOF or to meet capital call obligations.

II. Investments: The UFOF Has Overreported its Economic Impact

The figure's second section shows that the UFOF had, as of the end of March 2013, $92.3 million worth of investments in 28 private investment funds. These 28 private fund managers used this capital, along with capital from many other investors, to invest $723.4 million in Utah companies. The majority of these Utah investment dollars have come in the form of ***buyout capital***. Appendices D and E provide a more current, detailed analysis of UFOF investments by strategy and geography.

UFOF investments make up only a small portion of the entire pool of capital invested with its portfolio fund managers. As of September 30, 2013, UFOF capital represented just 2 percent of all Utah investments from UFOF portfolio funds (See Appendix E, Figure E.1). In our discussions with the current UCIC director and members of the UCIC board, it was clear that the UFOF cannot take full credit for the $723.4 million invested in Utah. Five states we reviewed with similar ***private equity*** or venture capital programs have reported economic impact much like the UFOF. We believe that the UFOF has overreported its economic impact by reporting all investment activity regardless of impact. This is discussed further in Chapter III.

UFOF investments make up only a small portion of the entire pool of capital invested with its portfolio fund managers.

The current UCIC director indicated to us that for "…the UFOF to somehow take credit for the $723 million aggregate invested is

The current UFOF director stated that it is misleading for the UFOF to take credit for the $723 million aggregate invested in Utah.

clearly misleading, but highlighting these kinds of transactions is one of the goals of the program." We agree that it is appropriate for the UFOF to highlight the investment and economic impact activity related to the program, but the information reported should provide all relevant details and the full context of what the UFOF believes is its true impact. As will be discussed in Chapter III, the UFOF needs to develop an economic development plan with metrics that are tracked and reported to help determine an accurate measure of impact.

III. Economic Impact: Lack of Plan with Metrics Has Resulted In Unknown Impact and Overstated Economic Development

Because the UFOF lacks an economic development plan with appropriate metrics to track, they have been reporting job growth in any Utah company that has received investments from fund managers with which the UFOF invests, resulting in impact being overstated. We found that:

- UFOF documentation was not complete or up to date and was therefore difficult to validate
- An independent sample of employment data supports the data reported by the UFOF however, UFOF impact is overstated
- Economic impact of income taxes is overstated and not well documented
- UFOF reported companies that received investments, but has not reported the companies that have since gone out of business
- The UFOF needs to coordinate with the Governor's Office of Economic Development (GOED) to ensure that both entities are not reporting the same jobs

An economic development plan with consistently tracked and reported metrics can help the UFOF improve the accuracy of its reported economic development activities.

These points are discussed in more detail in the following sections. We believe that through the development of an economic development plan with consistently tracked and reported metrics, the UFOF can improve the accuracy of its reported economic development activities.

Reported Job Data Was Difficult to Validate Because it Was Not Well Documented. Using data provided from its portfolio fund managers, the UFOF reported over 2,700 new direct jobs (see

Figure 2.1, Section III). Because the fund manager data were not current or complete, we contacted a sample of UFOF portfolio fund managers directly who provided us with employment data. We did not contact any companies directly because *early-stage* and high-growth companies typically prefer not to divulge such information.

Due to inadequate documentation, we directly contacted four UFOF fund managers and found that jobs reported do exist. However, UFOF impact is unknown.

We requested job creation data from a sample of four fund managers from the UFOF portfolio that made investments in Utah companies. This sample of four fund managers account for over 70 percent of the new direct jobs in Utah reported by the UFOF. The job numbers submitted by the funds, though not a perfect comparison as they were more current than UFOF data, showed an additional 771 jobs beyond what the UFOF had in their records. It appears, therefore, that the jobs reported by the UFOF were supported by the data provided by the fund managers.

We are concerned that the UFOF has not maintained adequate records on jobs created. When we reviewed UFOF employment records, we found that 53 percent of the employment numbers were more than one year old. Since the beginning of the audit, the UFOF has been more diligent in ensuring that documents from their fund managers are up to date. We recommend that the UFOF continue to ensure that reports from its fund managers are consistently updated.

We are concerned that the UFOF has not maintained adequate records of jobs created. We found that 53 percent of all the employment numbers were more than one year old.

In addition to the 2,700 direct jobs discussed previously, the more than 1,500 new indirect jobs shown in Figure 2.1 were calculated using a questionable methodology. To derive this number, the UFOF multiplied the number of direct jobs with an economic multiplier obtained by the Bureau of Economic and Business Research (BEBR) in a 2010 study. The indirect jobs reported in Figure 2.1 were therefore based on outdated multipliers. In addition, the previous director of the UFOF stated that the original calculation of indirect jobs appeared to be too large and the number was therefore artificially reduced with no specific methodology supporting the reasoning and extent of the reduction.

Reported Jobs Appear to Be Accurate but UFOF's Impact Is Overstated. While we believe that the jobs associated with these companies exist, our primary concern is whether or not investments in these companies would have taken place regardless of UFOF involvement. As previously discussed, if it would be misleading for the UFOF to take credit for the aggregate $723.4 million invested in

Utah companies (see Figure 2.1), then it is reasonable to conclude that UFOF cannot take full credit for the aggregate number of jobs associated with the investments.

If it would be misleading for the UFOF to take credit for the aggregate $723.4 million invested in Utah companies, then it is reasonable to conclude that UFOF cannot take full credit for the aggregate number of jobs associated with the investments.

Economic Impact of Income Taxes Paid Is Overstated and Not Well Documented. As noted in Figure 2.1, the UFOF reported over $37 million in new tax revenue generated from new jobs. As with the jobs number reported, we are concerned that the UFOF has not maintained adequate records on reported payroll. As previously discussed, when we reviewed source documents from the fund managers, we found that 53 percent of the payroll numbers were more than one year old. Like the jobs data, the UFOF has been more diligent recently in ensuring that documents from their fund managers are up to date and we recommend that this follow-up continue.

The formula that the UFOF used to derive the over $37 million in new tax revenue was:

Job Years **x** Average Salary
x Applied Multiplier (Approximately 2)
x Tax Rate of 5 Percent
= Reported Tax Revenues

A job year defines the amount of time a job has existed. For example, one job that existed for five years would be five job years. This metric does not appear to be commonly used in economic development settings; we could not identify industry publications that utilized this concept. As shown in the formula, job years was multiplied by the average salary of new employees in companies that have received investments from UFOF affiliated funds.

It is unclear why the UFOF artificially reduced the indirect jobs number in an effort to be conservative, but did not do so when calculating tax revenues. This results in the impact of indirect jobs being inconsistent.

The UFOF then multiplied the job years/average salary number by approximately two, accounting for all assumed indirect jobs. It is unclear why the UFOF artificially reduced the indirect jobs number to be conservative, but did not do so when calculating tax revenues. By doing this, the estimated $37 million of tax revenue generated by UFOF investments reflects a larger total of indirect jobs in its calculation methodology.

We attempted to validate sampled payroll data with four fund managers, but two could only provide job numbers without corresponding payroll information. In some instances, the average salary used by the UFOF was higher than the supporting documentation showed. Because supporting documentation was lacking, we could not validate income taxes paid.

While we recognize that fund managers in this industry typically do not track and provide job creation and payroll information, clearly the UFOF needs to develop a methodology to consistently track and validate economic development data that are essential to prove that the UFOF is fulfilling its mission.

Reporting of Utah Companies Receiving Investments Does Not Account For Companies That Have Gone Out of Business. The 2012 Annual Report of the UFOF, released in October 2013, reports 70 Utah companies receiving investments from UFOF portfolio funds. However, UFOF data prepared as of December 2013 show that 12 of those 70 companies had actually gone out of business. We believe that a better picture of program impact would be presented if the number of defunct companies was disclosed and included in the calculation.

UFOF should clearly report companies that have received investments but have since gone out of business.

In contrast, an economic study of the UFOF was completed in 2010 by BEBR. The calculations in this BEBR study were adjusted to reflect the number of companies that were no longer active in order to calculate a more accurate estimate of economic impact.

UFOF Should Coordinate with GOED to Ensure That Both Programs Are Not Counting the Same Jobs. We found that two companies received UFOF investments as well as grants from GOED, resulting in the potential for two economic development programs to report the same jobs twice. We therefore recommend that the UFOF coordinate with GOED to ensure that they are not reporting the same jobs in their respective economic reports.

UFOF Economic Reports Are Inconsistent and Difficult to Interpret

In addition to the annual financial audit of UFOF accounting records, the UFOF is required in statute to provide the Legislature and Governor a separate report of its activities and progress in meeting statutory objectives. The Utah Venture Capital Enhancement Act (UVCEA) states that "the [UCIB] shall, in consultation with the [UCIC], publish an annual report of the activities conducted by the

Utah fund of funds." [6] These reports have historically showcased the program's economic impact in measures like jobs created, tax revenue generated, and events held. However, these reports contain substantial inconsistencies in their reported numbers from year to year, even within the same report. To illustrate, Figure 2.2 shows that the UFOF has inconsistently reported jobs created in its annual reports.

UFOF's annual reports contain substantial inconsistencies in their reported numbers from year to year, even within the same report.

Figure 2.2 Reported UFOF-Generated Jobs in Utah Have Varied Significantly Over Time. Numerous inconsistencies in program reports undermine the ability to measure impact and determine accountability.

2006 Annual Report
- 729 Utah employees

2007 Annual Report
- 1,300 jobs
- 1,000 new jobs
- 973 Utah employees

2008 Annual Report
- 2,007 new jobs

2009 Annual Report
- 3,449 new jobs
- 2,900 new jobs

2010 Annual Report
- 1,227 new jobs
- 4,130 jobs supported as a result of these investments

2011 Annual Report
- 1,300 new jobs
- 1,600 jobs created
- 3,500 direct and indirect new jobs

2012 Annual Report
- 2,700 new jobs
- 6,600 jobs supported by partner fund investments

Source: UFOF annual reports, Figure created by OLAG

From Figure 2.2, one can see how inconsistently the UFOF has reported jobs created. In most years, UFOF annual reports contain different numbers within the same report. For example, in 2009, the UFOF reported 3,449 new jobs created on one page and 2,900 new jobs created on another page. In 2010, the UFOF reported 1,227 new jobs created on one page and 4,130 new jobs supported as a result of investment activity on another page.

[6] See ***Utah Code*** 63M-1-1206(6) included in Appendix B

Additionally, Figure 2.3 shows a similar inconsistency in the reporting of program-generated tax revenue. Note that while there is some consistency in reporting from year to year, conflicting numbers and terminology make evaluating the program's economic impact difficult and unclear.

Figure 2.3 Reported UFOF-Generated State Tax Revenue Has Varied Significantly Over Time. Though some consistency is clearly seen, conflicting numbers make the reports difficult to understand.

2007 Annual Report • $18 M / year	***2008 Annual Report*** • $18 M / year • $18 M / 1,000 employees / year • $36 M "new annual tax revenue" • $90 M by year end 2009
2009 Annual Report • $18 M / 1,000 employees / year • $52 M "new annual tax revenue" • $54 M since inception • $70 M as of year end 2009 • $90 M by year end 2009	***2010 Annual Report*** • $13 M "to the state already" • Projected $75 M during life of fund • $12.8 M to date
2011 Annual Report • $30 M "incremental" tax revenue • $33 M "incremental" tax revenue • Projected $75 M to the state by 2020	***2012 Annual Report*** • $37 M "in new state tax revenues"

Source: UFOF annual reports, Figure created by OLAG

Figure 2.3 clearly shows the level of inconsistency in the tax revenue totals reported by the UFOF. The 2009 Annual Report alone presents a very confusing picture of program impact by presenting several different measures of tax revenue. For example, the 2009 Annual Report shows $70 million in tax revenue generated on one page and $90 million in tax revenue generated on another page. The 2010 Annual Report then estimated significantly less tax revenue the following year. These inconsistent reports make gauging the true economic impact of the program highly difficult.

Inconsistencies in reported jobs and program-generated tax revenues make evaluating the UFOF's economic impact difficult and unclear.

Additionally, the program's 2012 Annual Report states that a medical device symposium is hosted each year by the UFOF to discuss financing and industry trends with entrepreneurs and investors. Despite this claim, this event did not take place in 2012 or 2013. The 2012 report, along with the 2011 Annual Report, then implies that ongoing middle market symposia have been hosted with similar

In its 2012 Annual Report, the UFOF implied that ongoing economic development events were held during the year that were not actually held. The UFOF agrees that these events should not have been reported.

regularity though such an event has not taken place since September 2010. Events like these are important activities to support the venture capital community in Utah and the UFOF should be involved in these endeavors and track their efforts. However, events that have not been held should not be reported as such. While UFOF staff agree that these events should not have been reported as occurring, they clarified in our discussions that they were not held in an effort to reduce costs and protect the program's ***contingent tax credits***.

While it may be difficult to correlate actions and results with regard to economic development, the picture of economic development activity and impact presented in UFOF annual reports has been inconsistent and difficult to understand. We recommend that the UFOF develop a set of program metrics, track and report them consistently from year to year, and arrange their annual reports in a way that clearly presents this information to the reader.

Recommendations

1. We recommend that the UFOF continue to highlight all relevant economic impact associated with the program but develop a methodology to consistently track and validate economic development data that will measure the impact attributable to the program.

2. We recommend that the UFOF ensure that reports from its fund managers are accurate and consistently updated.

3. We recommend that the UFOF clearly report companies that have received investments but have since gone out of business and account for those companies in estimates of economic impact.

4. We recommend that the UFOF work with GOED to ensure that both programs are not taking credit for and reporting the same jobs created.

5. We recommend that the UFOF develop a set of program metrics, track and report them consistently from year to year, and arrange their annual reports in a way that clearly presents this information to the reader.

Chapter III
Economic Impact in Utah Not Adequately Tracked

The Utah Venture Capital Enhancement Act (UVCEA) was passed as a means to enhance economic development in Utah through the in-state mobilization of ***venture capital***.[7] The legislation also requires the Utah Fund of Funds (UFOF) to maintain a focus on its rate of return in order to protect state tax dollars. Though not entirely at odds, these two missions do not always lead to the same investment decisions and therefore must be balanced. This chapter addresses the economic development mission of the UFOF, while Chapter IV addresses the investment mission. We believe that if the UFOF is unable to demonstrate meaningful economic impact in Utah, the Legislature should consider whether it is a program in which the state should be involved.

We believe that if the UFOF is unable to demonstrate meaningful economic impact in Utah, the Legislature should consider whether it is a program in which the state should be involved.

Though the UFOF seeks the best fund managers, regardless of location, it is unclear how influential the program has been in the Utah venture capital market. This uncertainty is due to a lack of consistently tracked program metrics. In order to establish better accountability and sufficiently report program relevance, the UFOF should create an economic development plan with metrics that are consistently tracked and reported.

Evidence of Economic Development Impact is Needed to Adequately Judge UFOF Success

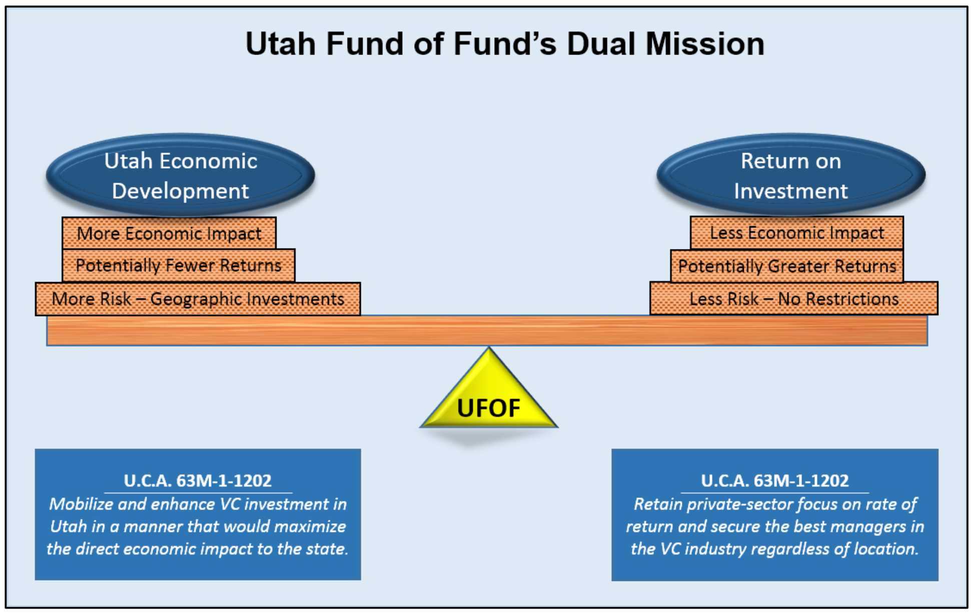
The statutorily defined purposes of the UFOF clearly establish it as an economic development program as the majority of the purposes are aimed at addressing needs in Utah (see Appendix B). However, while the UFOF is an economic development program, it is also directed to maintain a focus on investment returns and to invest in the best investment funds regardless of the fund's physical location. Those investment funds are then free to make the best investments in companies regardless of the company's location, whether in or out of Utah.

[7] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix A.

Placing a larger focus on one mandate or the other may put the UFOF in an unbalanced position.

Figure 3.1 illustrates that placing a larger focus towards one mandate or the other may position the UFOF in an unbalanced position. For example, a strict focus on economic development with geographic restrictions on investments may produce a less diversified (more risky) portfolio. In contrast, a strict focus on financial returns (or avoiding ***contingent tax credit*** redemption) may increase the potential for better financial returns at a cost of less economic development impact in Utah.

Figure 3.1 The UFOF Has Two Statutory Mandates: Economic Development in Utah and Return on Investment. The UFOF must address both mandates in order to fulfill its statutory purpose.



Source: ***Utah Code***, *Figure created by OLAG*

It appears that the staff and board members have made clear efforts to address both missions in Fund I investments.

The dual missions of economic development and ***return on investment*** (ROI) create what was described as a healthy tension by the former UCIC board chair (who served from 2005 to 2014). In reviewing UFOF investment decisions, it appears that the staff and board members have made clear efforts to address both missions throughout the first fund. On the side of economic development, ***due diligence*** documents for nearly every fund in the portfolio show an effort to invest in fund managers with clear potential to make investments in Utah. On the side of ROI, portfolio analysis and subsequent investment and governance decisions reflect a clear effort to avoid redeeming the program's contingent tax credits.

However, despite these efforts, it is unclear precisely how effective the program has been in attracting capital to Utah. We believe that if the economic development benefits of the program cannot be quantified, the Legislature cannot adequately weigh benefits against risks and should consider whether it is a program in which the state should be involved. To better gauge the value of the program, we believe that the UFOF should be held to a high standard of accountability in tracking and reporting the program's economic impact, especially considering the 2014 expansion of the program's reporting requirements in House Bill 243. The balance of this chapter addresses this point.

We believe that the UFOF should be held to a high standard of accountability in tracking and reporting the program's economic impact, especially considering the 2014 expansion of the program's reporting requirements in House Bill 243.

Economic Development Activities and Impact in Utah Not Adequately Tracked

Though the UFOF tracks its investment portfolio very closely, the program lacks the same rigor for its economic development efforts. Currently, the UFOF does not have an economic development plan or metrics that are consistently tracked and reported but program management reports that they are currently in the process of developing one. We therefore recommend that the UFOF develop program metrics and an economic development plan that will be accurately tracked and consistently reported each year in the program's annual report to the Legislature. National data show that the venture capital market in Utah is growing but the lack of program performance data makes it difficult to determine the relevance of the UFOF in the Utah market.

Currently, the UFOF does not have an economic development plan or metrics that are consistently tracked and reported.

UFOF Investments Are Closely Monitored But Economic Development Efforts Lack Similar Rigor

With the assistance of a fund investment advisor (currently LP Capital Advisors), the UFOF meticulously tracks and analyzes the performance of its investments. Though the UFOF also tracks some economic impact indicators, for example, jobs created in Utah companies receiving investments and the resulting tax revenue generated, these efforts lack sound methodology, consistency, and should be more comprehensive. The primary concern here is that the lack of metrics ultimately results in the UFOF's inability to show relevance in the market. As noted in Chapter II, the UFOF has not adequately tracked jobs and tax revenue and has inconsistently reported such numbers.

The legislation governing the program has always required an accounting of economic development efforts on an annual basis, but this requirement was further refined and expanded with the passage of House Bill 243 during the 2014 Legislative General Session. The law now requires the UFOF to include in each annual report an evaluation of the state's progress in accomplishing the findings and purposes stated in ***Utah Code*** 63M-1-1202, such as:

Legislation governing the program has always required an accounting of economic development efforts but this requirement was expanded with House Bill 243.

- Increasing the availability of venture capital for emerging, expanding, and restructuring enterprises in Utah
- Creating new jobs and diversifying the state's economic base
- Enhancing the venture capital culture and infrastructure in the state to increase and promote venture capital investments in Utah

This requirement to report the program's progress in accomplishing its statutory goals creates a clear need for the UFOF to improve its program measurement efforts and measure its activities in a consistent, reliable way.

Anecdotal Evidence Supports Some Impact and Shows Room For Improvement. In a November 2013 interim committee meeting, the UFOF was asked what would have happened in the Utah venture market without UFOF investments. Because no other measures are available, the UFOF was only able to provide anecdotal examples of the program's relevance in certain specific investments. UFOF staff have also shared examples with the audit team in which the program's due diligence efforts and capital commitments provided valuable credibility for some of the fund managers with which they have invested. While these anecdotes are useful and valid, they do not provide an overarching, sufficient measure of full program impact.

While anecdotal evidence supports some positive influence, Utah's entrepreneurial community could be made more aware of the resources available through the UFOF.

Further, we spoke with several prominent individuals within the Utah entrepreneurial community. We wanted to gauge their knowledge of the UFOF and the resources available through the program, but found that many were unaware of the UFOF as a resource for growing businesses and Utah entrepreneurs. Encouragingly, once they were made aware of how the program operates, these individuals expressed excitement at the potential value of the UFOF as a partner. We therefore recommend that the UFOF increase marketing efforts within the state as part of its economic development plan.

An Economic Development Plan with Metrics Would Help Identify Impact

The UFOF needs to develop an economic development plan and determine how best to measure and report program impact. Without metrics, it is difficult to determine program impact and, therefore, difficult to assess the value of this program relative to the risk of its investments.

The importance of sound program evaluations, specifically in economic development programs, is emphasized by Josh Lerner, a professor of investment banking at Harvard Business School and a recognized expert on this subject. He wrote:

> The future of initiatives should be determined by their success or failure in meeting their goals… Careful program evaluations will help ensure better decisions. These evaluations should consider not just the individual funds and companies participating in the programs, but also the broader context.[8]

We believe, and UFOF staff and UCIC board members concur, that the program can develop a better picture of its relevance in Utah by tracking efforts such as meetings with entrepreneurs and subsequent introductions to investors, local events attended or sponsored, and instances of fundraising assistance. These types of activities are important facets of strengthening the venture capital community in Utah. The UFOF has already purchased software to meet this need and appears to be working towards implementation.

We believe, and UFOF staff and UCIC board members concur, that the program can develop a better picture of its relevance in the Utah market.

PEW Offers Guidance for Developing An Economic Development Plan

A 2012 report by the PEW Center on the States provides a framework for creating an economic development plan. The report shows that many states have largely failed to measure tax incentive programs' effectiveness relative to their intended goals, while other states are measuring economic impact, drawing clear conclusions, and

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[8] *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed and What to Do About It*, 2009, p. 186

making informed policy decisions about their tax incentive programs. Utah is listed in the report as "trailing behind" this latter group because this type of analysis has not been performed here.

The PEW report suggests some key questions to ask when evaluating governmental economic development programs. These questions could assist the UFOF in the development of program metrics as part of an economic development plan. PEW recommends considering the following:

Asking questions of cause and effect, timing, and indirect impacts could assist UFOF in developing an economic development plan.

- **Cause and effect:** To what extent did tax incentives change businesses' decisions, and how much did the state program reward what would have happened anyway?
- **Unintended beneficiaries:** How much of the benefit of an incentive flowed across state borders?[9]
- **Timing:** When will the costs and benefits of the incentive occur and how long will they last?
- **Indirect impacts:** To what extent do the investments of companies receiving incentives filter into the broader economy, causing further economic gains?

For example, with regard to cause and effect, the UFOF could better determine the influence they had in promoting investments into the state and identify investments that likely would have happened regardless of their involvement. This could be done by tracking introductions to entrepreneurs which have led to investments. Another consideration could be that of unintended beneficiaries. The UFOF could identify fund managers in their portfolio that have not invested in Utah companies as originally anticipated to guide future investment decisions. Without tracking and reporting such activities, the state may be taking on liabilities without commensurate rewards. The UFOF should therefore use these questions to design an economic development plan with associated metrics pertaining to both its statutory mission and the questions raised by the PEW study discussed here.

[9] See Appendix E for an analysis of where UFOF investments are geographically distributed.

Utah Venture Capital Market Is Improving But UFOF Impact Is Unclear

National venture capital statistics show that the Utah market is growing over time. However, the lack of program metrics mentioned previously makes it difficult to show whether the UFOF has had a meaningful part in this improvement.

While Utah's capital markets are improving, UFOF needs to demonstrate how they contribute to this improvement.

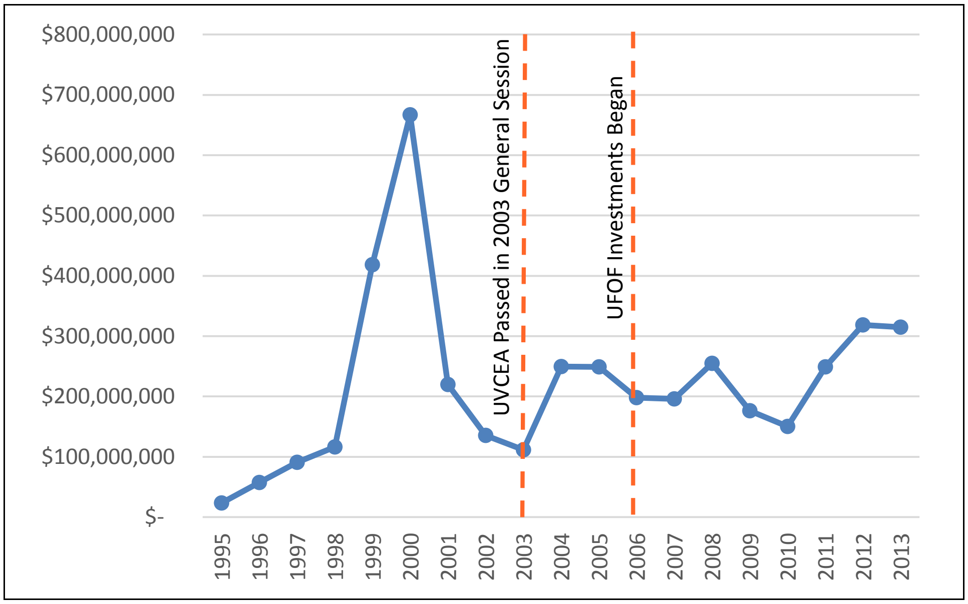
National Data Show that the Utah Venture Capital Market Is Growing

Each quarter, PricewaterhouseCoopers and the National Venture Capital Association collaboratively issue the MoneyTree Report, showing the venture capital dollars invested in each state since 1995. Using this data, it is possible to show how the amount of venture capital invested in Utah compares to the amount of venture capital invested in the rest of the nation. Since the technology bubble of 1999 through 2000, Utah has performed well relative to other states, though the total venture capital in the state is still dwarfed by the largest market players.

Figure 3.2 shows the total venture capital dollars invested in Utah from 1995 through 2013. Overlaid on this chart are two significant dates in the foundation of the UFOF program: the passage of the UVCEA, which created the UFOF, and the date the UFOF first started making investments.

Total Utah venture capital investments increased after the 2003 passage of the UVCEA, but before the UFOF entered the market as an investor.

Figure 3.2 Total Venture Capital Investments in Utah Show a Positive Trend Since 1995. The amount of venture capital invested in Utah increased significantly from the time the program was created to the time of the first UFOF investments**.**

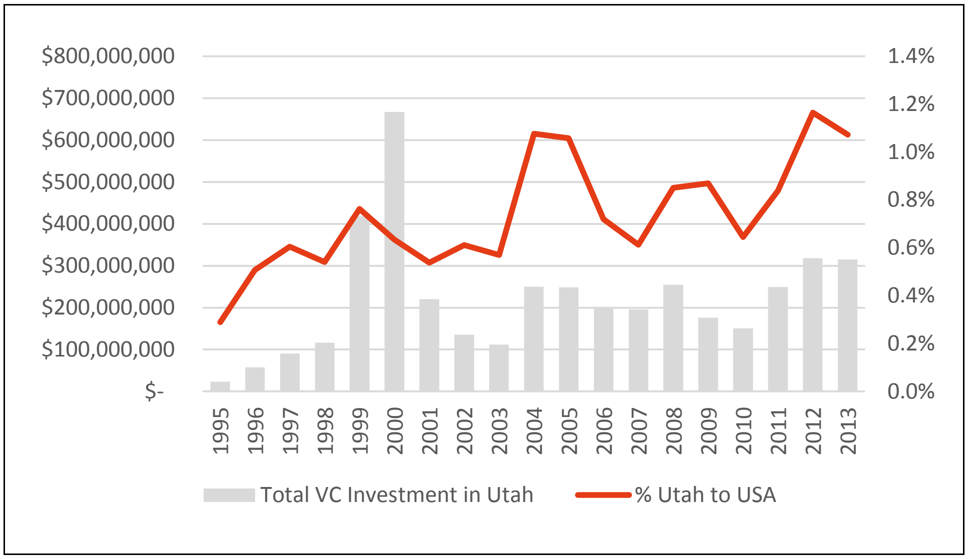


Source: PWC MoneyTree Data, Figure created by OLAG

This figure shows that, aside from a wild swing from 1998 through 2002 (which happened nationwide), Utah has seen a generally positive trend in total venture capital dollars invested, culminating in two of its best years ever in 2012 and 2013. What is interesting here, however, is that total Utah venture capital investments increased after the 2003 passage of the UVCEA, but before the UFOF entered the market as an investor.

Additionally, Figure 3.3 shows the percentage portion of venture capital investment in Utah relative to the national total over the same time period.

Figure 3.3 Venture Capital Investment in Utah as a Percent of the Nation Is Relatively Small, But Growing. Utah's small portion of national venture capital appears to be increasing over time.



Source: PWC MoneyTree Data, Figure created by OLAG

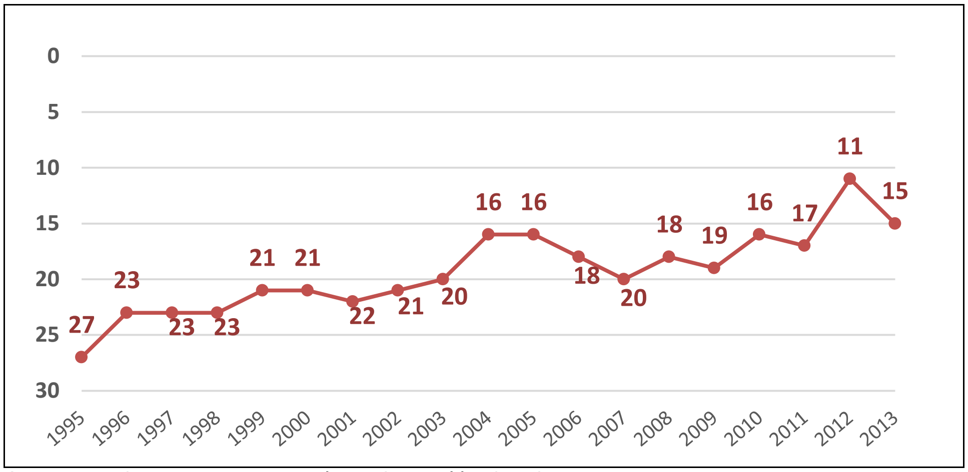
Though Utah's portion appears small, it is important to note that 30 of the states and territories in this data set each represent less than 0.5 percent of national venture investment.

As shown in Figure 3.3, Utah's portion of the nation's venture capital investments is very small (between 0.5 and 1 percent) but is increasing over time. Though this percentage appears small, it is important to note that 30 of the states and territories in this data set each represent less than 0.5 percent of national venture investment. The top ten states alone accounted for just over 82 percent of all venture capital investment from 1995 through 2013,[10] with California accounting for almost 45 percent. For further information, a discussion of UFOF affiliated investments as a percent of Utah's venture capital market can be found in Appendix D.

Taking the data one step further, we can track Utah's rank for total venture investment dollars each year compared to all other states and territories. Figure 3.4 shows that, though Utah has almost always ranked in the top 25, it is steadily moving up the ranks over time.

[10] These ten states are, in order, California, Massachusetts, New York, Texas, Washington, Colorado, New Jersey, Pennsylvania, Virginia, and Illinois.

Figure 3.4 Utah's Rank for Total Venture Investment Appears to Be Increasing Over Time. UFOF needs to track its impact on data such as Utah's rank of total venture investments compared to the nation's venture investments.



Source: PWC MoneyTree Data, Figure Created by OLAG

Utah has almost always ranked in the top 25 and has improved its position over time.

The Utah venture capital market appears to be trending upward both in total dollars and in its size relative to other states. The difficulty, however, is determining whether or not the UFOF has accelerated this improvement or not. This issue is addressed in the next section.

Without Program Metrics, It Is Very Difficult To Show UFOF Relevance

The data previously discussed show that the Utah venture capital market has been trending upward since at least 1995. However, it is unclear whether or not the UFOF played any significant role in accelerating this trend of increasing venture capital investment.

Given that the UFOF represents such a small percentage of the funds in which it has invested (0.6 percent), it is unlikely that a large amount of influence can be attributed to its involvement, but impact can and should be tracked.

UFOF invested capital represents approximately 0.6 percent of the capital invested by all 28 funds in the UFOF portfolio. Given that the UFOF represents such a small percentage of the funds in which it has invested, it is unlikely that a large amount of influence can be attributed to its involvement. However, without supporting data accounting for all UFOF economic development activities, it is difficult to make a more concrete measurement of cause and effect. For additional analysis and discussion of UFOF-related investments in Utah, see Appendices D and E.

Recommendations

1. We recommend that the UFOF develop an economic development plan with metrics that are consistently tracked and reported to ensure that the UFOF is being held accountable to its economic development mandate. Examples of metrics that should be consistently tracked and documented include:

    - UFOF relevance in jobs created by companies in Utah receiving investments from UFOF portfolio funds
    - Introductions and ***matchmaking*** efforts and their importance in investments made
    - Events sponsored and attended and measured outcomes of events
    - The mobilization of venture capital into the state as compared to other states

2. We recommend that, once an economic development plan is developed and approved, UFOF improve its outreach throughout the state to inform pertinent parties of its purpose and services.

3. We recommend that, once an economic development plan is developed and approved, UFOF report performance relative to its metrics.

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Chapter IV
Financing Costs Negated Investment Gains

While investment returns of the Utah Fund of Funds (UFOF) portfolio have been improving, financing costs have consumed all returns. To date, no ***contingent tax credits***[11] have been redeemed and the state has not made any appropriations to the UFOF. Whether or not this situation changes is entirely dependent on fund performance and when loans are set to mature. This chapter evaluates the UFOF's investment performance, reporting, and costs. Specifically, we found that:

While financing costs have consumed all returns, no contingent tax credits have been redeemed to date. Whether or not this situation changes is entirely dependent on fund performance and when loans are set to mature.

- Positive investment performance has been negated by financing costs
- UFOF has not adequately reported investment performance
- Administrative costs appear reasonable
- UFOF made positive changes in its portfolio investment strategy in response to the 2008 recession

Some of our primary concerns with the UFOF were addressed by the Legislature with the passage of House Bill 243 during the 2014 Legislative General Session. Details of the new law are noted in each relevant section of this chapter. To date, the UFOF has not been a cost to the state because no contingent tax credits have been redeemed, but fund performance will determine whether contingent tax credits will have to be redeemed in the future. If contingent tax credits are redeemed, then the state will forgo future tax revenues.

UFOF Investment Gains Negatively Impacted by Atypical Financing Costs

UFOF's cost of financing has consumed all portfolio gains, heavily impacting the program's bottom line. Net of all program and financing costs, the portfolio's performance is currently negative but

[11] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix A.

Net of all program and financing costs, the portfolio's performance is currently approaching break-even. If the program's performance improves, the risk of tax credit redemption will diminish.

approaching break-even. Before accounting for financing costs, UFOF portfolio performance is slightly above the median performance of comparable ***funds of funds*** in the general market. If the program's performance improves, the risk of tax credit redemption will diminish.

UFOF Financing Costs Bring Positive Fund Performance Below Break-Even

A fund of funds invests capital in a number of investment funds to diversify its exposure to a larger number of investments. In the case of the UFOF, investments were made in 28 ***private equity*** (PE) funds[12] which, in turn, invested in privately held companies.

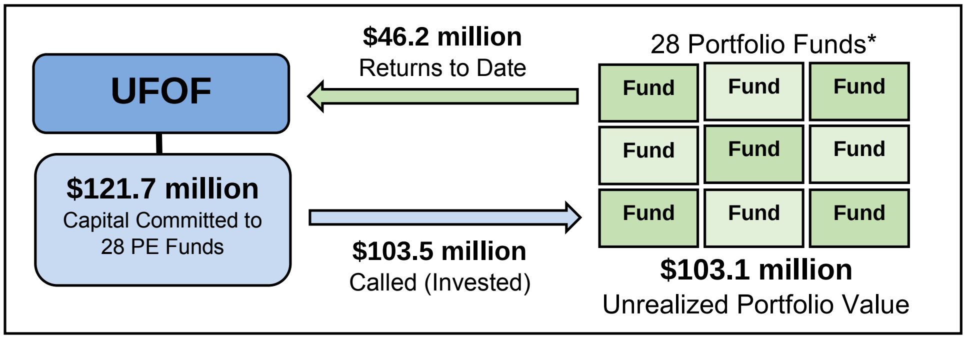
PE funds invest capital in companies over a three-to-five-year period and distribute the capital and earnings to investors over several years. During the investment period, PE funds work with the companies into which capital is invested on various value-creation initiatives to facilitate growth and an increase in value. The goal is that the PE fund will successfully exit from the investment, capturing the resulting value by, for example, selling the company or taking it public with an ***initial public offering***. Once the PE fund exits the company and realizes the investment value, the investors (the UFOF in this case) receive a proportional share of any returns.

Figure 4.1 Illustrates UFOF Investments and Returns as of December 31, 2013. As of that date, the UFOF had committed[13] $121.7 million to 28 different PE funds. Those funds had drawn $103.5 million of the committed capital and, in return, had distributed $46.2 million of investment returns to the UFOF in the form of cash and stock (the UCIC holds stock only for a brief period; they currently hold none). The remaining unrealized portfolio value, shown at the bottom right of Figure 4.1, was $103.1 million. It is called unrealized because the PE funds had not yet liquidated these holdings. This unrealized value is calculated by each of the 28 fund managers for their respective holdings and audited annually to ensure the appropriate application of Generally Accepted Accounting Principles. These valuations are marked to market which gives a

[12] Appendix C lists all 28 fund names
[13] Investors like the UFOF initially make "commitments" to funds. The funds then draw on this promised capital as needed throughout the life of the investment.

degree of freedom to fund managers with respect to methodologies that may be applied.

Figure 4.1 Basic UFOF Portfolio Investments and Returns as of December 31, 2013. This flowchart illustrates UFOF commitments, returns, and unrealized portfolio value.



Source: Data from LP Capital Advisors, Flowchart created by OLAG
** Appendix C lists all 28 fund names*

With this basic diagram of UFOF investments and returns established, we will now discuss program costs and measures of fund performance. Two primary industry measures to gauge fund performance are the ***investment multiple***[14] and the ***internal rate of return (IRR)***.[15]

Figure 4.2 Illustrates UFOF Investments, Costs, and Portfolio Performance as of December 31, 2013. Figure 4.2 repeats the numbers from Figure 4.1 and combines them into relevant categories. The columns in Figure 4.2 were calculated with the numbers from Figure 4.1 as follows:

- Total Invested: $103.5 million
- Total Value: $149.3 million ($46.2 million returns + $103.1 million unrealized value)

[14] The investment multiple is total investment value divided by total invested cash. If invested cash was $100 and the current value is $105 after receiving a $25 cash distribution, the multiple would be ($105 + $25)/($100) = 1.30x. This reads "1.3x" or "1.3 times invested capital."

[15] The IRR is the interest rate at which the net present value (NPV) of a project or program's cash flows is equal to zero. Also known as the compounded annual return to date. See Appendix A for an expanded definition of IRR.

- Investment multiple[14]: This is calculated after accounting for each level of program costs. The multiple in the first row of Figure 4.2, for example, is calculated as $149.3 million/$103.5 million = 1.44x.

- Net IRR: This is calculated inclusive of all program cash flows at each level of program costs shown and represents an annualized rate of the program's returns over time.

Figure 4.2 UFOF Investments, Costs, and Portfolio Performance as of December 31, 2013. Financing costs ($37.3 million) have by far represented the largest expense to the program and have drastically impacted bottom-line IRR.

	Capital Invested and Costs	Total Value	Investment Multiple	Net IRR
Total Invested	$103.5*	$149.3	**1.44x***	**10.6%***
Admin. Costs	10.2	-		
Subtotal	**113.6**	**149.3**	**1.31x**	**7.8%**
Financing Costs	37.3	-		
Grand Total	**$150.9**	**$149.3**	**0.99x**	**-0.3%**

**No program or financing costs are included in this number*
Source: Data from LP Capital Advisors, Table created by OLAG
Note: Dollar values in millions; Small discrepancies in addition are due to rounding errors

Financing costs of $37.3 million have by far represented the largest expense to the program and have drastically impacted bottom-line internal rate of return (IRR).

Figure 4.2 calculates the investment multiple and IRR without costs and again after adding each of the two major cost categories (administrative and financing). As shown, administrative costs from program inception to the date of this table total $10.2 million and reduce the investment multiple and IRR to 1.31x and 7.8 percent respectively. It is at this level of calculation that the program should be compared to other funds in the market. This comparison is discussed in more detail later in this chapter.

The financing costs shown in Figure 4.2 are not typical for other funds of funds in the general market. Other funds raise equity capital and therefore do not have to satisfy interest payments while their investments mature over multiple years. These costs, by far the largest of the program, total $37.3 million from inception to the date shown in this table and reduce the investment multiple and IRR to 0.99x and -0.3 percent respectively. In other words, for every dollar of investments and costs, the UFOF portfolio has ultimately generated $0.99 of value which, at the end of December 2013, reflected a bottom-line loss of $1.6 million.[16] The -0.3 percent IRR is a similar

[16] i.e. $149.3 million – $150.9 million = -$1.6 million; see next paragraph

measure of portfolio performance. It signifies that the portfolio has earned the equivalent of a negative 0.3 percent compounding interest rate for each year of operation.

It should be noted that this $1.6 million loss and the associated performance metrics reflect a snapshot of the best information available and could go up or down based on actual performance. It is based largely on the unrealized value of assets ($103.1 million) and the assumption that the portfolio will ultimately be sold at that value.

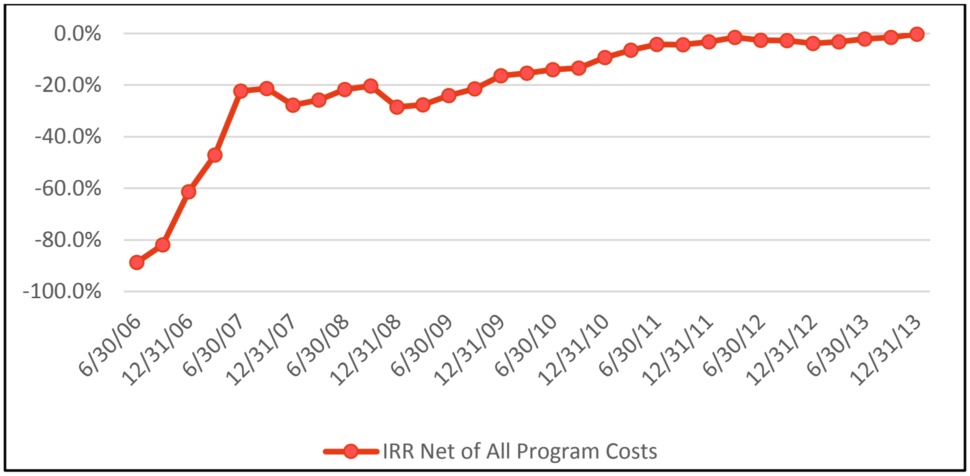
Current performance reflects a snapshot of the best information available and could go up or down based on actual performance.

This assumption is uncertain because research shows that unrealized value does not always match the value of a company when sold. Additionally, attempting to sell a PE portfolio before full maturation would likely result in a discounted price to reflect the remaining risk plus some required rate of return. To liquidate a private equity portfolio can take several years and involves several considerations of economic and industry health and activity. It is the UFOF fund allocation manager's job to stay well apprised of this information, predicting cash flows and making strategy decisions accordingly.

Despite Financing Costs That Are Atypical for the Industry, UFOF Portfolio Appears to Be Approaching Break-Even. Contrary to early projections of substantial program losses, Figure 4.3 shows that the UFOF portfolio IRR, net of all administrative and financing costs, has improved substantially as its underlying funds' investments have matured and returned value over time. This is the result of both positive portfolio performance and the program paying less in financing expenses as a result of loan refinancing in 2012.

As shown in Figure 4.3 and in the previous figure, the most recently reported IRR for the UFOF is a loss of -0.3 percent.

Figure 4.3 UFOF Quarterly Internal Rate of Return from Inception through December 31, 2013. The program's most recently reported IRR, net of all program costs, is -0.3 percent.



Source: Data from LP Capital Advisors, Figure created by OLAG

The UFOF fund manager projects (and their financial models illustrate) that the fund could reach a break-even point in the near future as the majority of portfolio investments are realized.

As illustrated in Figure 4.3, the IRR at the inception of the program was significantly negative. This was due to initial program costs and is not uncommon in venture capital and private equity investments. The improvement of IRR over time is similar to the ***j-curve effect*** defined in Appendix A. The UFOF fund manager projects, and their financial models illustrate, that the fund could reach a break-even point in the near future as the majority of portfolio investments are realized. Breaking even is contingent upon a handful of factors, including when investments mature and generate cash distributions, the price they get relative to book value, and potential changes to financing terms or interest rates when current UFOF financing comes due in 2017.

Financing Costs Make UFOF Difficult To Compare to Other Funds of Funds

The UFOF portfolio, independent of its financing costs, appears to be performing well compared to other funds of funds in the open market. This comparison of investment results is fair because most private funds raise equity investments and do not bear financing costs. Because financing costs are a reality of the current UFOF portfolio, they have to be considered as part of overall performance but are removed here merely to illustrate comparable fund performance.

The UFOF portfolio performance (without financing costs) as of September 30, 2013, was a multiple of 1.26x with an IRR of

6.9 percent. Because of the confidential nature of industry benchmark data, we are unable to make a specific comparison in this report. But we can state that, when financing costs are removed from consideration, UFOF performance is slightly above median performance compared to the 54 funds of funds included in the benchmark data. Additionally, most of the funds of funds included in the national benchmark data are focused entirely on generating positive returns while the UFOF must place higher priority on Utah-based ***venture capital*** investments. The UFOF fund allocation manager stated that since 2006, ***buyout*** funds have generally produced higher returns than venture capital funds and that UFOF's higher allocation toward venture capital therefore puts the program at a slight disadvantage in this benchmark comparison.

When financing costs are removed from consideration, the UFOF performance is slightly above median performance compared to 54 funds of funds included in national benchmark data.

However, we must emphasize again that when financing costs are taken into account, as previously shown in Figure 4.2, UFOF performance is affected negatively.

Improved Investment Performance Minimizes Risk of Monetizing Contingent Tax Credits

If investment performance continues to generate sufficient cash to satisfy administrative, principal, and interest costs, the UFOF could avoid any contingent tax credit redemption, which is one of the key objectives of the program. As discussed in Chapter I, the UFOF had been authorized to use up to $300 million of contingent tax credits to raise financing for the program. Program financing has been raised by pledging tax credit certificates to investors to make up for potential shortfalls in investment returns.

If investment performance continues to generate sufficient cash to satisfy administrative and financing costs, the UFOF could avoid any contingent tax credit redemption, which is one of the key objectives of the program.

House Bill 243, passed during the 2014 Legislative General Session, reduced the contingent tax credits available for the next phase of UFOF investments (Fund II) to $75 million and prohibits any further use of the credits to raise new debt financing. This prohibition is based on the high cost of such financing outlined in the previous sections of this chapter. In Iowa and South Carolina, similar programs have fallen short and sold their contingent tax credits at a slight loss on a secondary market to cover cash needs.

UFOF Has Not Adequately Reported Investment Performance Publicly

Because the Utah Venture Capital Enhancement Act (UVCEA) historically lacked specific reporting standards, the UFOF has not consistently reported investment performance measures. The UFOF did report the fund's internal rate of return (IRR) in the most recent (2012) annual report, though this number reflected performance as of the second quarter of 2013 and was presented without accounting for any administrative or financing costs. The 2014 passage of House Bill 243 significantly modified and increased reporting requirements in ***Utah Code*** 63M-1-1206 specifically to address this issue.

Public Reporting of UFOF Investment Performance Has Been Misleading

UFOF reporting of investment performance has been misleading because costs have not been publicly reported.

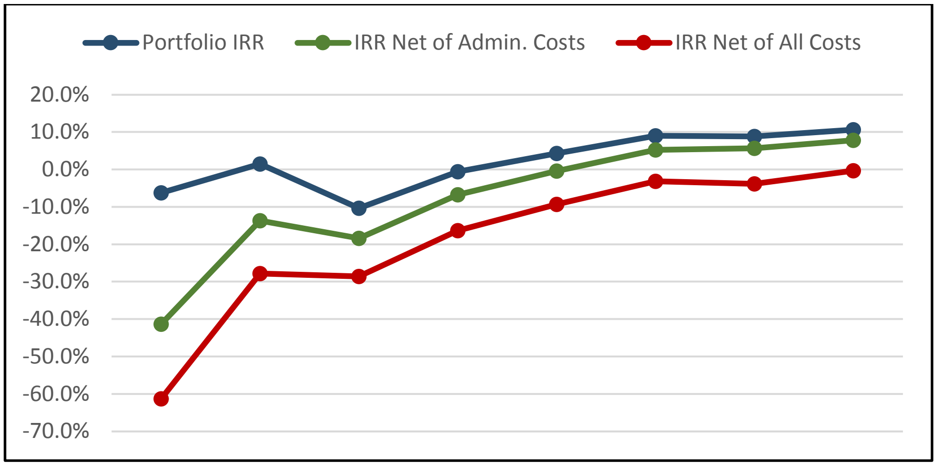
UFOF reporting of investment performance has been misleading because costs have not been publicly reported. The fund allocation manager for the UFOF has consistently reported investment performance to the governing boards of the UFOF with a complete picture of performance both before and after costs, but staff for the UFOF have presented investment performance to the public without properly accounting for costs, which is misleading.

Historically, the UFOF has not been explicitly required in statute to report fund performance metrics like IRR and investment multiple. However, we believe these are very important measures as they speak to the core activities conducted by the UFOF[17] and the potential risk of tax credit redemption. Because of this lack of clear reporting requirements in statute, the UFOF has only reported fund performance information on a limited basis.

As illustrated in the previous section of this chapter, administrative and financing costs have a significant impact on fund performance. Figure 4.4 shows how performance was affected before and after each level of accounting at the end of each calendar year in which the fund has operated.

[17] See ***Utah Code*** 63M-1-1206(6)(a) in Appendix B

Figure 4.4 UFOF Program IRR Since Inception. Portfolio performance is shown here before and after all program costs. The UFOF has reported portfolio IRR when they should be reporting IRR net of all costs.



	Dec. 2006	Dec. 2007	Dec. 2008	Dec. 2009	Dec. 2010	Dec. 2011	Dec. 2012	Dec. 2013
Portfolio IRR	**-6.3%**	**1.4%**	**-10.3%**	**-0.6%**	**4.3%**	**9.0%**	**8.8%**	**10.6%**
IRR Net of Admin. Costs	**-41.4%**	**-13.7%**	**-18.4%**	**-6.8%**	**-0.4%**	**5.3%**	**5.7%**	**7.8%**
IRR Net of All Costs	**-61.3%**	**-27.8%**	**-28.6%**	**-16.3%**	**-9.3%**	**-3.2%**	**-3.8%**	**-0.3%**

Source: Data from LP Capital Advisors, Figure and table created by OLAG

Figure 4.4 shows a significant difference between program IRR when operating and financing costs are taken into account. Only by reporting investment performance net of all costs can the program's potential impact on state tax revenues be clearly seen.

Only by reporting investment performance net of all costs can the program's potential impact on state tax revenues be clearly seen.

UFOF Has Not Accounted for Costs in Reported Performance Data. The UFOF 2012 Annual Report showed a 10 percent net internal rate of return. This number was generated by rounding up the 9.5 percent IRR achieved as of June 30, 2013. The problem here is twofold. First, this rate of return is presented without accounting for any program costs. Doing so clearly does not reflect the true performance of the fund and the potential future tax obligation of the state. Second, this rate of return reflects performance halfway through calendar year 2013, six months beyond the end of the year ostensibly being reported on.

The 10 percent IRR reported by UFOF in their 2012 Annual Report did not account for program costs. When accounting for these costs, UFOF performance was reduced to -0.3 percent.

To the second point, it is true that the UFOF cannot issue an annual report until several months after year-end due to normal delays in obtaining fund financial information. However, reporting financial and performance information from two different periods in one clearly delineated annual report does not accurately portray 2012 program performance.

Verbal reports from the UFOF to the Legislature on fund performance have also not accounted for costs.

UFOF Representatives Verbally Reported Similarly Inflated Performance Measures to the Legislature. In two interim committee meetings during 2013, a 1.3x investment multiple was reported that did not account for the program's financing costs. Though this lack of cost information was made clear in one meeting, bottom-line performance indicators were notably absent from both discussions, despite clear questions from legislators.

Consistent with House Bill 243, we recommend that the UFOF more clearly and consistently report investment performance by showing calculation methodologies (what costs are and are not accounted for) and noting date ranges for specific performance measures. We encourage the UFOF to separately present current performance measures with its annual program reports but recommend that the reports primarily focus on performance data for the reporting year in question. Annual and supplemental data should be clearly labeled to distinguish the two.

2014 Legislature Addressed Problems With Fund Reporting

Recognizing the problems outlined previously, the Legislature clarified statutory language about UFOF reporting requirements. Specifically, House Bill 243 modified ***Utah Code*** 63M-1-1206(6) to include several specific items that must be included in the UFOF's annual report. These items include:

House Bill 243 significantly increased the investment performance reporting requirements of the UFOF.

- Detailed balance sheet, revenue and expense statement, and cash flow statement
- Net annual rate of return and net rate of return from inception, after accounting for all program expenses
- Detailed information regarding all yearly expenditures
- Aggregate compensation information
- General description of the program's investment plan
- Other economic development measures (discussed in Chapters II and III of this report)

In addition to compliance with these requirements going forward, we recommend that the UFOF prepare a brief summary of these performance measures going back to the beginning of program operation.

Financing Costs Are Atypical; Administrative Costs Appear Reasonable

Because of the uncommon structure of the UFOF and its contingent tax credits, board members explained that options for initial program financing were limited. The UFOF accepted financing terms that proved to be very costly for the program although, at the time, the interest rate was not unreasonable. On the other hand, UFOF administrative costs, as a percentage of assets under management, appear to be in line with other private funds of funds.

Early Options for Financing Were Limited for the UFOF

We investigated the reasons for the UFOF's high financing costs and found that the program's structure, uncommon in the industry, was a major factor. UCIB and UCIC board members explained that the unique nature of the program's contingent tax credits led to significant difficulties in obtaining initial financing. After reviewing several options, very few of which were considered realistic, the board accepted a financing arrangement with an investment bank that entailed somewhat onerous terms. The terms of the arrangement required mandatory withdrawals of capital and assessed prepayment penalties, limiting the ability of the UFOF to reduce interest costs as cash became available.

Initially, the UFOF accepted a financing arrangement with an investment bank that entailed somewhat onerous terms. In 2012, the program was able to refinance.

To increase repayment flexibility and reduce the program's annual interest obligation, the UFOF successfully refinanced the program in late 2012 with both a national and a regional bank, each underwriting 50 percent of the total loan balance (refer to all three portions of Figure 4.5). The obviously beneficial change was just recently executed because exiting the first financing agreement and negotiating a new loan structure was a complicated, costly, and difficult process. According to UFOF staff, the difficulty of the transition was increased by the illiquidity of the capital markets at the time.

A brief overview of current UFOF financing terms is shown in Figure 4.5. Refinancing allowed the UFOF to entirely retire its financing terms with the initial investment bank with which the program was financed.

Figure 4.5 Summary of Current UFOF Financing. The outstanding balance of all loans as of June 30, 2014, was $100.7 million. Note that the loan is comprised of three portions.

Term A Loan
• $80 million ($13 million interest reserve) • Maturity: October 22, 2017 • 3.9% fixed rate • Prepayment penalty of 4% within one year, 3% after one to two years, 2% after two to three years

Term B Loan
• $30 million (no interest reserve) • Maturity: October 22, 2017 • 90-day LIBOR* + 2.95% • $2 million repayments due quarterly beginning June 30, 2014

Revolving Credit Line
• $20 million ($3 million interest reserve) • Maturity: October 22, 2017 • 90-day LIBOR* + 3.1% • Amount of line declines by $1 million per quarter beginning December 31, 2014

Source: Utah Fund of Funds
**LIBOR: London Interbank Offered Rate. See Appendix A for definition.*

The revolving credit line serves as a flexible option to meet short-term capital needs and therefore carries a more variable balance. The outstanding balance of all loans as of June 30, 2014, was $100.7 million. The interest rates on this portion and the Term B loan are variable, tied to the London Interbank Offered Rate or ***LIBOR***.

Even with the refinancing, the debt financing model has proven to be costly. For this reason, the 2014 Legislature prohibited further UFOF debt financing.

Even with the refinancing, the debt financing model has proven to be costly. For this reason, the 2014 Legislature prohibited further UFOF debt financing. In March 2014, the UCIB issued a letter of intent not to seek debt financing in its efforts to raise capital for its next fund. The letter states, in part, that "The Utah Capital Investment Board only intends to monetize tax credits for equity-based financing of future funds." Raising equity financing would eliminate the ongoing accrual of interest and provide more flexibility in relation to the cash demands of the UFOF because disbursements to equity investors are made only when investments mature.

Administrative Costs Appear To Be in Line with Industry Norms

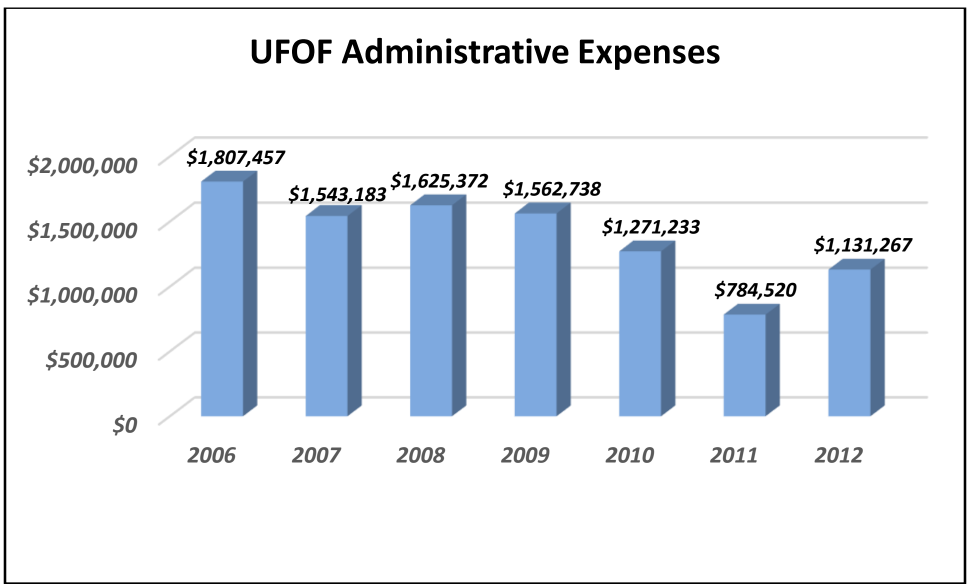
UFOF administrative costs appear to be in line with industry standards. This is particularly noteworthy as Utah appears to have more staff and better performance than other states' venture capital programs.

The UFOF operates with both a fund allocation manager and a professional, in-house director, while other states typically use one or the other. We initially questioned the UFOF structure as redundant, but now understand that the director and the fund allocation manager serve complementary roles. For example, because the fund allocation manager is restricted from fundraising in their consulting contract with the UFOF, the director is responsible for raising equity capital for the next fund.

Figure 4.6 summarizes UFOF administrative expenses by year. These costs decreased over time as the UFOF ceased investment activity and the program's fund allocation manager's fees were reduced to reflect a more limited role of maintaining the portfolio.

UFOF administrative costs appear to be in line with industry standards. This is particularly noteworthy as Utah appears to have more staff and better performance than other states' venture capital programs.

Figure 4.6 Annual UFOF/UCIC Administrative Expenses. Expenses have fallen in recent years as the fund has ceased investment activity.



Sources: LP Capital Advisors and UFOF Audited Profit and Loss Statements from 2009 – 2012.
Note: Audited profit and loss statements for 2013 not available at time of reporting.

The administrative costs of the UFOF shown in Figure 4.6 hover around 1 percent of assets under management. Appendix F shows a detailed breakdown of these costs by sub-category. While current costs are relatively low, they will rise when the UFOF starts investing again, primarily as a result of the fund allocation manager's fees increasing.

UFOF Made Positive Changes to Its Portfolio In Response to the 2008 Recession

The UFOF appears to have made a number of sound strategy decisions in response to the 2008 economic recession. In 2008, the current manager, LP Capital Advisors (LPCA), was hired with the main task of establishing UFOF's second fund. However, LPCA believed that some issues in Fund I needed to be addressed first because of the economic downturn at the time. Specifically:

- The first fund had an excessive cash balance
- The first fund was too heavily weighted toward seed and *early-stage* investments

As the economy entered the recession, it was projected that the investments would likely take longer to mature (to regain value lost when the economy dipped). This meant that, with the program's debt financing structure, the delay to maturation could cause an increased loss due to interest costs.

During the recession, the UCIC board approved of a strategy and ultimately made seven more fund commitments that have provided substantial positive returns to the portfolio.

LPCA projected heavy program losses and recommended that the UFOF take advantage of poor economic conditions to invest the program's idle cash while prices were low. These commitments would also help diversify the first fund, which focused on risky seed and early-stage investments. The UCIC board approved this strategy and ultimately made seven more fund commitments that have provided substantial positive returns to the portfolio. It appears, then, that LPCA's portfolio analysis and UFOF's actions taken in response were sound and significantly beneficial to the program.

UFOF Strategy for Fund II Is Equity Financing Instead of Debt

Because of the high cost and low compatibility of debt financing with the UFOF's private equity investments, House Bill 243, passed in 2014, prohibits the use of debt financing going forward. The intent of program management and the program's governing boards is to raise equity investment financing for the program's next fund (Fund II). Because the financing costs have been so significant with Fund I, UFOF has been unable to build up any redemption reserves, as called for in statute.

UCIB Rules Currently Under Consideration Will Address Equity Fundraising Needs

The UCIB recently drafted administrative rules to govern the way contingent tax credit certificates will be approved and issued to investors. This step was taken in anticipation of issuing certificates to equity investors, instead of authorizing a debt-based structure as was done with Fund I.

As discussed previously, in March 2014, the UCIB issued a letter of intent not to pursue debt financing in the future. These actions have positioned the UFOF to pursue equity-based instead of debt-based financing, which the Legislature prohibited during the 2014 Legislative General Session.

Because of Significant Finance Charges, No Profits Have Been Generated to Build a Redemption Reserve

The statute requires that the UFOF establish a redemption reserve with profits generated from the investment portfolio. Without profits, no redemption reserve has been established. The lack of profits is a direct result of the significant financing charges the UFOF has had to pay. However, if the UFOF is successful in raising an equity-backed Fund II, the hurdle of financing costs will no longer exist and, assuming positive returns, the UFOF should be able to establish the statutorily required redemption reserve.

The statute requires that the UFOF establish a redemption reserve with profits generated from the investment portfolio. Without profits, no redemption reserve has been established.

Recommendations

1. We recommend that the UFOF more clearly and consistently report investment results in the future by showing calculation methodologies (including when costs are and are not accounted for) and noting date ranges for specific performance measures.

2. We recommend that UFOF annual program reports primarily focus on performance data for the reporting year in question and that annual and supplemental data are clearly labeled to distinguish the two.

3. We recommend that, in addition to complying with the new reporting requirements found in ***Utah Code*** 63M-1-1206, the UFOF prepare a brief summary of these measures going back to the beginning of program operation.

Chapter V
Oversight of UFOF Can Continue to Improve

The oversight of the Utah Fund of Funds (UFOF) has improved and the Utah Capital Investment Board (UCIB) and Utah Capital Investment Corporation Board of Directors (UCIC board) should continue this improvement. The UFOF still needs to develop comprehensive policies and procedures and should work with the Attorney General's (AG's) Office and the Governor's Office of Economic Development (GOED) in doing so. Additionally, significant bonus and severance payments have been made to staff without documented merit and statutory language regarding the UCIC board chair's term could be clarified. Finally, the UFOF spent three years in a prolonged period of program assessment. Contributing to this prolonged period of program assessment was an inability to measure performance due to the lack of economic development metrics, administrative rules, and policies and procedures.

The UCIB and UCIC boards should continue improving the operational oversight of the UFOF.

UFOF Needs to Develop Comprehensive Policies and Procedures

The UFOF needs to ensure that comprehensive policies and procedures are developed to guide all significant operations. While both oversight boards have discussed specific policies and procedures in their meetings, some of the policies discussed were never developed. Additionally, statute is more restrictive than current UFOF bylaws on conflicts of interest with regard to investments. UFOF staff report that they are currently working to develop comprehensive policies and procedures that cover operations and will bring conflicts of interest bylaws in line with statute. We also found that assistance from the Attorney General's (AG's) Office and the Governor's Office of Economic Development (GOED) has improved and recommend that this assistance continue. Finally, the UCIB should ensure that UFOF annual reports are adequate and GOED should support UCIB in its efforts.

Of the 19 policies and procedures mentioned in board meeting minutes, the UFOF was not able to locate 8 of them.

Some Policies and Procedures Have Not Been Developed

The two UFOF boards (UCIB and UCIC board) have referenced a number of policies and procedures in their meeting discussions that have never been developed. For example, we reviewed the minutes of all UCIB and UCIC board meetings from 2006 through 2013 and found mention of 19 different policies and procedures. Of that list of 19, with the assistance of UFOF staff, we were not able to locate 8 of these policies and procedures (see Figure 5.1).

Figure 5.1 UCIC and UCIB Minutes Mentioned Policies and Procedures That Could Not Be Produced. Of the 19 mentioned policies and procedures, 8 could not be located.

Missing Policies and Procedures Mentioned in Board Minutes

Formal policies for the following topics were not found:

- Board members using UFOF due diligence for private investment
- Procurement Policy
- Budgeting Policy
- Surplus policy
- UFOF's position on event sponsorship
- UFOF's position on investment into political groups
- UFOF's position on sponsoring nonprofit groups or associations
- UFOF's position on renewing contracts for current funds in the portfolio

Source: UFOF, Figure created by OLAG

Figure 5.1 provides a list of significant policies and procedures that the UFOF is currently lacking. In the UFOF 2007 financial audit report, auditors summarized the potential consequences of not having adequate policies and procedures. They stated, and we concur with, the following:

> …policies and procedures should include clear definitions of authority, reporting relationships, responsibility, and accountability for all areas and functions of the Fund and should be in writing. The lack of adequate written policies and procedures results in confusion with assigned responsibilities, accountability,

and proper procedures. This situation weakens the internal controls at the Fund and could allow errors or misappropriations to occur without detection.

The lack of adequate policies and procedures results in confusion with assigned responsibilities, accountability, and proper procedures.

The UFOF needs to thoroughly review existing policies and procedures and ensure that all pertinent operating areas are addressed. Policies and procedures will help ensure that day-to-day operations proceed as intended and ensure accountability.

Regarding Investment Conflicts of Interest, Statute Is More Restrictive Than UFOF Bylaws

The UCIC has a conflicts of interest bylaw that is not as restrictive as statute with regard to investments. ***Utah Code*** 63M-1-1209(6)(b) states that UCIC board members may have "…no interest in any *venture capital* investment fund allocation manager…or investments made by the Utah Fund of Funds." With regard to investments, the UCIC bylaws give allowances that statute does not. The UCIC bylaws allow UCIC board members to inform the board of a potential conflict, to disclose all material facts of the issue, and to recuse themselves from voting on anything related to that interest.

The UFOF needs to ensure its bylaws, with regard to investment conflicts of interest, are in line with statute.

Though we did not find any conflicts with current UCIC board members that would violate ***Utah Code***, UCIC bylaws should not allow something that statute does not. UFOF staff indicated some concern that the language of the statute could possibly prevent qualified people from serving on the UCIC board. We therefore recommend that UFOF staff work with the Legislature to determine whether a statutory amendment could both ensure the ethical standards of the law are met and not prevent qualified people from serving. Until an amendment is made to this statute, the UCIC board should change its bylaws to reflect statutory language on conflicts of interest. UFOF staff were not aware of this issue, but reported to the audit team that they are working to bring the bylaws into compliance with the statute.

Attorney General's Office and Governor's Office of Economic Development Assistance Should Continue

Since the beginning of this audit, we have seen improved assistance to the UCIB from the AG's office and GOED. For example, we have observed the AG's office and GOED assisting the UCIB in drafting administrative rules to direct the future issuance of ***contingent tax*** *credits* and establishing a target rate of *return on investment*. We believe that this assistance needs to continue to help ensure that the UFOF is properly overseen.

Although past support of the Attorney General's Office has been limited, its support to the UCIB has been improving.

Assistance from the Attorney General's Office to the UCIB Has Been Improving. While the AG's involvement with the UCIB has been significantly improving, past involvement was limited. As a governing board of the state, the UCIB is entitled to legal counsel from the AG's office and is to defer to their attorneys when drafting and adopting rules. However, the UCIB and the AG's office had limited interaction in the early years of the UFOF operations.

For example, AG's staff attended just under half of the UCIB board meetings from 2007 through 2013. Prior to 2012, the AG's representative had attended six board meetings in five years, or 29 percent of all UCIB meetings in that time frame. Figure 5.2 illustrates the number of UCIB meetings along with the AG representative's attendance.

Figure 5.2 AG Representative Attendance At UCIB Meetings Has Improved. The AG's representative to the UCIB has not been involved in many of the past board meetings, but attendance has significantly improved.

AG's Office Representation at UCIB Meetings

	Total UCIB Meetings	***Total UCIB Meetings AG Rep. Attended***
UCIB Meetings from 2007-2011	21	6
UCIB Meetings from 2012-2013	8	8
Total	29	14

Source: UFOF, Figure created by OLAG

The AG's office is statutorily required to give legal counsel to the UCIB. However, although Figure 5.2 shows limited interaction between the UCIB and the AG's office, AG representatives are not statutorily required to attend all UCIB meetings. Instead, they review agenda items they believe could require legal counsel and attend meetings according to perceived need or when asked to participate. We spoke with the AG representative that now oversees the UCIB who said they believe they can do better at making sure the UCIB has the legal support they need.

The AG representative that now oversees the UCIB believes the AG's office can ensure the UCIB has the legal support it needs.

While the UCIC board retains private legal counsel, the UCIB does not. The UCIB will, therefore, need continued counsel from the AG's office on drafting and maintaining policies, procedures, and rules, in addition to other issues that may arise. We recommend that the UCIB work with the AG's office to ensure that legal counsel is assigned and actively participating in meeting the needs of the UCIB.

The UCIB Should Ensure Annual Reports are Adequate and GOED Should Support UCIB in Its Efforts. In addition to its other duties, the law requires that the UCIB, in consultation with the UCIC, draft annual reports of UFOF activities which are to be given to the Governor and multiple Legislative committees. As discussed near the end of Chapter II, these reports have so far presented inconsistent information and made evaluating the program's performance and economic impact difficult and unclear.

The UCIB should ensure that the information presented to the Legislature and Governor provides a clear and consistent picture of program performance and impact.

Where statute gives primary responsibility for publishing the annual reports to the UCIB, the UCIB should ensure that the information presented to the Governor and Legislature in the reports provides a clear and consistent picture of program performance and impact. UCIB members report that efforts to do so have been improving in recent years. We believe they can continue to improve especially considering the recent legislation that expanded the program's annual reporting requirements.

Moving forward, GOED should continue to support the UCIB since the UCIB was statutorily created within GOED.

Additionally, GOED's executive director, who is a member of the UCIB, recently stated that GOED has no responsibility to ensure the UCIB fulfills such statutory mandates. This is concerning because the statute clearly created the UCIB within GOED. Because of that clear statutory relationship, GOED should provide support necessary for the UCIB to fulfill its statutory mandates. For example, GOED staff recently assisted in the development of UCIB administrative rules. This type of support should continue as needed for the UCIB to fulfill its responsibilities.

Significant Bonus and Severance Payments Made to Staff Without Documented Merit

From 2005-2013, significant bonus and severance payments ($330,000) were given to staff without any developed criteria or documentation to support such actions.

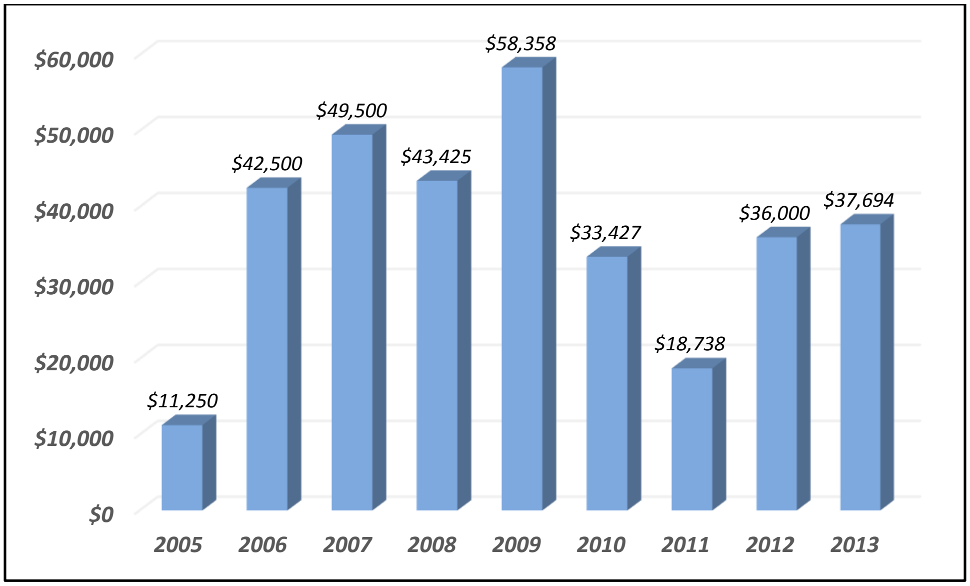
We found that significant bonus and severance payments have been made to UFOF staff without any developed criteria or documentation to support such actions. Between 2005 and 2013, UFOF staff (an executive director/president, vice president, and administrative assistant) were given $330,000 in bonuses and severance payments. Because of insufficient employment contracts and a lack of documentation, we could not validate that the bonuses were justified. Because the UFOF did not follow its bylaws requiring them to keep minutes from its compensation committee meetings, no documentation was available for us to review. Currently, the new executive director is working to ensure that staff have contracts that establish criteria for bonuses.

Bonuses Paid Without Any Developed Criteria

The current director explained to us that prior to his administration, staff were paid annual bonuses that were not specifically tied to performance. It was reported to us that, historically, bonuses at UFOF were used to pay managers closer to what they were worth in the private sector, but we found little criteria for determining if (and what amount of) bonuses were to be awarded.

While little criteria exists on how the UFOF determined bonuses, we did document that $330,000 in bonus and severance payments were made from 2005 to 2013, which represents 16 percent of total compensation related expenses for the time period. Figure 5.3 shows how much UFOF awarded in bonus and severance payments from year to year for its three employees.

Figure 5.3 UFOF Awarded More than $330,000 in Bonus and Severance Payments to Three Staff Members from 2005 through 2013. Historically, bonuses have not been closely tied to portfolio performance or other indicators. In fact, little criteria existed on how bonuses were determined.



Source: UFOF, Figure created by OLAG

In addition to the lack of criteria for bonuses, the UFOF lacked formal employee contracts. According to the current executive director, past staff were paid without written employment contracts in place. Although a lack of documentation has revealed governance and accountability issues, we are encouraged with the current direction. During our audit, employment contracts were being drafted and criteria for awarding bonuses were being addressed.

Bonus Decisions by Board's Compensation Committee Were Not Documented

UCIC policies and procedures establish a compensation committee that oversees the compensation and annual reviews of all UFOF staff. The program's bylaws stipulate that the meeting minutes must be kept by the committee when it meets to determine issues such as bonuses. Because no minutes were kept, we could not document any discussions where bonuses were awarded, or that such meetings were even held. We recommend that the UCIC board ensure that bylaws are followed and that minutes from subcommittee meetings are kept.

In addition to the UFOF's lack of employee contracts, bonus decisions were not documented in meeting minutes, as required in UCIC's bylaws.

Statutory Language Regarding UCIC Board Chair's Term Could Be Clarified

The statute is unclear on how long a UCIC board chair may occupy his or her seat. In ***Utah Code*** 63M-1-1209(4)**,** it is stated that board members may serve successive terms and that the board shall select a chair whose term is for one year. However, it is silent on whether chair terms may be served successively or not.

Since statute is unclear on how long a UCIC board chair may serve, the Legislature could consider clarifying it.

Due to the complex nature of the program and the value of institutional knowledge in decision making, we feel it is prudent to allow a chair to serve for multiple terms. In addition, investment fund managers often seek to partner with organizations where long-term relationships can be established over multiple funds. Thus far, this has been the case, as the first UCIC chair was appointed in 2005 and served until early 2014. Having discussed this issue with the current UCIC chair, we recommend that the Legislature consider modifying the statute to clarify that the UCIC chair may serve multiple terms.

Three Years Were Spent Performing A Prolonged Program Assessment

For multiple reasons, the UFOF spent three years in a period of program assessment. Ironically, this prolonged period of investment inactivity came on the heels of the 2008 Legislature raising the program's contingent tax credit ceiling, with the support of the UFOF, in order to avoid a halt in the program's investment activity. The UFOF engaged in this assessment period intending to measure program impact and develop a funding allocation strategy for the future. However, until recently the UFOF accomplished little beyond refinancing loans.

The UFOF spent a prolonged period assessing the program. We believe the assessment could have been shortened with improved oversight.

While we clearly see the value in planning, we believe that this process could have been shortened with improved oversight. As Chapters II and III of this report indicated, the UFOF still does not have an economic development plan with metrics that measure their impact. Further, the UFOF sought an additional strategy beyond the one developed by its statutorily mandated fund allocation manager. The additional strategy was ultimately rejected by the UFOF, contributing to lost time and money.

Because of this interruption in activity, some members of the program's boards believe the UFOF has missed good investment opportunities and potentially damaged the program's reputation and relevance in the market.

UFOF staff and members of the board cited multiple factors that contributed to this period of non-investment. These factors include:

- Poor market conditions caused by a broad economic recession
- Large projections of potential program losses
- Lack of a clear program strategy relative to the program's statutory mandates
- Lack of permanence and direction in the UCIC director's position

The UCIC is now working to raise funds under a clear Fund II strategy.

Some board members stated, and we agree, that this period of inactivity could have likely been shortened. The UCIC is now working to raise funds under a clear Fund II strategy.

Recommendations

1. We recommend that the UCIB and UCIC boards thoroughly review their policies, procedures, and administrative rules to ensure that all pertinent operating areas are addressed, including issues addressed in this report, along with economic development metrics that will be tracked and reported.

2. We recommend that the UCIC board change its bylaws to reflect statutory language on conflicts of interest.

3. We recommend that UFOF staff work with the Legislature to determine whether a statutory amendment could be made concerning conflicts of interest that would ensure ethical standards are met without unduly preventing qualified individuals from serving on the UCIC board.

4. We recommend that the UCIB work with the Attorney General's Office and the GOED to ensure that the board receives adequate support.

5. We recommend that the UCIC board ensure that bonus and severance payments be tied to performance. We further recommend that the UCIC board follow policies regarding documentation on decisions regarding compensation/bonuses.

6. We recommend the Legislature consider amending ***Utah Code*** 63M-1-1209(4)(d) to clearly allow the UCIC board chair to serve terms in succession.

7. We recommend that the UCIC board ensure employment contracts are up-to-date and that staff are held accountable to them.

Appendices

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Appendix A
Glossary of Terms

The definitions here were taken primarily from:

- *California Public Employees' Retirement System (CalPERS) (www.calpers.ca.gov)*
- *Preqin (www.preqin.com)*
- *National Venture Capital Association (www.nvca.org)*

Accelerator – A program that helps new companies define and build early products, identify potential customers, connect with peers and entrepreneurial mentors, and find capital and employees. Some accelerators also provide ***start-up capital*** and/or office space. Programs typically involve groups or "cohorts" of early companies and last from 3-6 months. The programs usually culminate in an event allowing participant companies to make pitches to a group of potential investors. Examples include the Y Combinator in Silicon Valley and BoomStartup in Utah.

Buyout Capital – Also known as corporate restructuring. Buyout capital is used to acquire a company or business division from the current shareholders. The acquisition will usually include a new business plan and/or management structure with the intent of improving the company's performance.

Capital Call – Also known as a drawdown, this is the actual act of transferring capital into a fund's portfolio companies. When a fund manager decides where it would like to invest, it will approach its investors (limited partners) in order to draw down some of the capital which is already committed to the fund.

Contingent Tax Credits – As used in this report, tax credits issued by the Utah Capital Investment Board (UCIB) to an investor in the Utah ***Fund of Funds*** (UFOF) that are available against Utah corporate and individual income tax liabilities if UFOF performance falls short of agreed-upon terms. For example, if an investor in the UFOF was contractually guaranteed a 3 percent return and the UFOF only generated a 2.5 percent return, the investor would redeem his or her tax credits in the total of the shortfall.

Due Diligence – The process of completing the investigation and analytical process that precedes a commitment to invest. This is done to identify potential risks and benefits, inform the decision process, and optimize deal terms.

Early-Stage Capital – Type of venture capital that invests only in the early stage of a company's life. The two main categories are ***seed*** and ***start-up***.

Fund of Funds – A financial instrument that invests in a number of ***private equity*** partnerships.

Growth Equity – Growth equity is a subcategory of ***venture capital*** and comprises the final phase of venture investing. This capital is used by companies that need continued financing and guidance prior to exiting the ***venture*** investing sphere by means of an ***initial public offering*** or selling the company.

Initial Public Offering (IPO) – An initial public offering is the sale or distribution of a company's shares to the public for the first time.

Institutional Investor – An organization whose primary purpose is to invest its assets or those held in trust by it for others. This class includes pension funds, investment companies, universities, and banks.

Internal Rate of Return (IRR) – The IRR is the interest rate at which the net present value (NPV) of a project or program's cash flows is equal to zero. Also known as the compounded annual return to date. Take for example the -0.3 percent IRR reported by the UFOF as of December 31, 2013 (See Chapter IV, p. 34). This rate is calculated using all program cash flows as of that date and therefore represents a snapshot of fund performance. As of this date, the UFOF had effectively earned -0.3 percent interest on all money invested into the program after accounting for every cash inflow and outflow.

Investment Multiple – The investment multiple is total investment value divided by total invested cash. If invested cash was $100 and the current value is $105 after receiving a $25 cash distribution, the multiple would be ($105 + $25)/($100) = 1.30x. This reads "1.3x" or "1.3 times invested capital."

J-Curve Effect – A pattern of early negative performance followed by drastic improvement that is common in ***private equity*** investments. Known as the J-curve because of the curved shape of the graph when increasing portfolio values are plotted. This major improvement occurs because early administrative costs drag performance down, but later returns overcome those initial cash outlays.

LIBOR– (London Interbank Offered Rate) An interest rate at which banks can borrow funds from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association.

Matchmaking – The pairing of people with good business ideas and people with money to invest.

Mezzanine – Mezzanine debts are debts that incorporate equity-based options, such as warrants, with a lower-priority debt. Mezzanine is often used to finance acquisitions and ***buyouts***.

Private Equity – The investment of private capital in companies that are not quoted on a stock market. Private equity investments can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also be used to resolve ownership and management issues.

Return on Investment (ROI) – The gains or returns produced from a given investment net of the original cost of the investment. The result of this calculation can change depending on the investor's definition of both returns and costs.

Seed Capital – See ***Start-up Capital***.

Start-up Capital – Start-up capital refers to the funding required to start a new business, whether for office space, permits, licenses, inventory, product development and manufacturing, marketing or any other expense. Start-up capital is also referred to as seed capital.

Venture Capital – Venture capital is just one type of ***private equity*** investment and focuses on the launch, early development, or expansion of a business. It can be broken down by ***early-stage***, late-stage, and ***growth equity***. The Utah Venture Capital Enhancement Act appears to give a broader definition to the term when it states that a need exists to increase "venture equity capital" for "emerging, expanding, and restructuring enterprises." This would appear, then, to include companies that are past the early stage of their development. Notwithstanding, statute gives consistent priority to venture capital investments (See ***Utah Code*** 63M-1-1202 and 63M-1-1215).

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Appendix B
Fundamental UFOF Statute

Certain sections from the Utah Venture Capital Enhancement Act (UVCEA) are specifically cited in the report and are included here for ease of reference. The full text of the UVCEA can be found in ***Utah Code – Title 63M: Governor's Programs – Chapter 1: Governor's Office of Economic Development: Sections – 1201-1224.***

Section 1202 details the Legislature's original findings and purposes for creating the program:

***Utah Code* 63M-1-1202**
Findings
(1) The Legislature finds that: **(a)** fundamental changes have occurred in national and international financial markets and in the state's financial markets; **(b)** a critical shortage of seed and venture capital resources exists in the state, and that shortage is impairing the growth of commerce in the state; **(c)** a need exists to increase the availability of venture equity capital for emerging, expanding, and restructuring enterprises in Utah, including enterprises in the life sciences, advanced manufacturing, and information technology; **(d)** increased venture equity capital investments in emerging, expanding, and restructuring enterprises in Utah will: **(i)** create new jobs in the state; and **(ii)** help to diversify the state's economic base; and **(e)** a well-trained work force is critical for the maintenance and development of Utah's economy.
Purpose
(2) This part is enacted to: **(a)** mobilize private investment in a broad variety of venture capital partnerships in diversified industries and locales; **(b)** retain the private-sector culture of focusing on rate of return in the investing process; **(c)** secure the services of the best managers in the venture capital industry, regardless of location; **(d)** facilitate the organization of the Utah fund of funds to seek private investments and to serve as a catalyst in those investments by offering state incentives for private persons to make investments in the Utah fund of funds; **(e)** enhance the venture capital culture and infrastructure in the state so as to increase venture capital investment within the state and to promote venture capital investing within the state; **(f)** accomplish the purposes referred to in Subsections (2)(a) through (e) in a manner that would maximize the direct economic impact for the state; and **(g)** authorize the issuance and use of contingent tax credits to accomplish the purposes referred to in Subsections (2)(a) through (e) while protecting the interests of the state by limiting the manner in which contingent tax credits are issued, registered, transferred, claimed as an offset to the payment of state income tax, and redeemed.

Next, sections 1204 and 1206(6) describe the Utah Capital Investment Board (UCIB) and its duties and powers. Specifically, 1206(6) describes the responsibility of the UCIB to publish an annual report to be submitted to the Legislature and the Governor.

Because section 1206 was significantly modified with the passage of House Bill 243 during the 2014 Legislative General Session, we have included both the language that existed prior to the 2014 session and after. This was done to provide context to the program's reporting under the language as it has existed for most of the program's existence.

***Utah Code* 63M-1-1204 and 1206(6) – Pre-2014 General Session**
Board Duties and Powers
63M-1-1204. Utah Capital Investment Board. **(1)** There is created within the office the Utah Capital Investment Board to exercise the powers conferred by this part. **(2)** The purpose of the board is to mobilize venture equity capital for investment in a manner that will result in a significant potential to create jobs and to diversify and stabilize the economy of the state. **(3)** In the exercise of its powers and duties, the board is considered to be performing an essential public purpose. **63M-1-1206. Board duties and powers.** **(6) (a)** The board shall, in consultation with the corporation, publish an annual report of the activities conducted by the Utah fund of funds, and submit the report to the governor and the Business, Economic Development, and Labor Appropriations Subcommittee. **(b)** The annual report shall: **(i)** include a copy of the audit of the Utah fund of funds and a valuation of the assets of the Utah fund of funds; **(ii)** review the progress of the investment fund allocation manager in implementing its investment plan; and **(iii)** describe any redemption or transfer of a certificate issued under this part. **(c)** The annual report may not identify any specific designated investor who has redeemed or transferred a certificate. **(d)** **(i)** Beginning July 1, 2006, and thereafter every two years, the board shall publish a progress report which shall evaluate the progress of the state in accomplishing the purposes stated in Section 63M-1-1202. **(ii)** The board shall give a copy of the report to the Legislature.

As can be seen in the next section, 63M-1-1206(6) as modified by House Bill 243, contains significantly more requirements and specific reporting mandates than the prior language. Specifically, the majority of changes were made to subsection 1206(6)(b). This amendment to the statute was made to address the reporting concerns addressed in Chapters II, III and IV.

***Utah Code* 63M-1-1206(6) – Post-2014 General Session**
Board Duties and Powers

(6) (a) The board shall, in consultation with the corporation, publish on or before September 1 an annual report of the activities conducted by the Utah fund of funds, and submit the report to the governor; the Business, Economic Development, and Labor Appropriations Subcommittee; the Business and Labor Interim Committee; and the Retirement and Independent Entities Committee.

(b) The annual report shall:

- **(i)** be designed to provide clear, accurate, and accessible information to the public, the governor, and the Legislature;
- **(ii)** include a copy of the audit of the Utah fund of funds described in Section 63M-1-1217;
- **(iii)** include a detailed balance sheet, revenue and expenses statement, and cash flow statement;
- **(iv)** include detailed information regarding new fund commitments made during the year, including the amount of money committed;
- **(v)** include the net annual rate of return of the Utah fund of funds for the reported year, and the net rate of return from the inception of the Utah fund of funds, after accounting for all expenses, including administrative and financing costs;
- **(vi)** include detailed information regarding:
    - **(A)** realized gains from investments and any realized losses; and
    - **(B)** unrealized gains and any unrealized losses based on the net present value of ongoing investments;
- **(vii)** include detailed information regarding all yearly expenditures, including:
    - **(A)** administrative, operating, and financing costs;
    - **(B)** aggregate compensation information separated by full- and part-time employees, including benefit and travel expenses; and
    - **(C)** expenses related to the allocation manager;
- **(viii)** include detailed information regarding all funding sources for administrative, operations, and financing expenses, including expenses charged by or to the Utah fund of funds, including management and placement fees;
- **(ix)** review the progress of the investment fund allocation manager in implementing its investment plan and provide a general description of the investment plan;
- **(x)** for each individual fund that the Utah fund of funds is invested in that represents at least 5% of the net assets of the Utah fund of funds, include the name of the fund, the total value of the fund, the fair market value of the Utah fund of funds' investment in the fund, and the percentage of the total value of the fund held by the Utah fund of funds;
- **(xi)** include the number of companies in Utah where an investment was made from a fund that the Utah fund of funds is invested in, and provide an aggregate count of new full-time employees in the state added by all companies where investments were made by funds that the Utah fund of funds is invested in;
- **(xii)** include an aggregate total value for all funds the Utah fund of funds is invested in, and an aggregate total amount of money invested in the state by the funds the Utah fund of funds is invested in;
- **(xiii)** describe any redemption or transfer of a certificate issued under this part;
- **(xiv)** include actual and estimated potential appropriations the Legislature will be required to provide as a result of redeemed certificates or tax credits during the following five years;
- **(xv)** include an evaluation of the state's progress in accomplishing the purposes stated in Section 63M-1-1202; and
- **(xvi)** be directly accessible to the public via a link from the main page of the Utah fund of fund's website.

(c) The annual report may not identify a specific designated investor who has redeemed or transferred a certificate.

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Appendix C
List of Private Equity Funds with Which The UFOF Currently Invests

In alphabetical order, the 28 firms that manage the funds that currently comprise the UFOF portfolio:

1.	5AM Ventures
2.	Allegis Capital
3.	Apax Partners
4.	Ares Management
5.	Blackstone/GSO Capital Partners
6.	Clarus Ventures
7.	Cross Creek Capital
8.	Epic Ventures
9.	Fenway Partners
10.	Foundry Group
11.	Frazier Healthcare Ventures
12.	Highway 12 Ventures
13.	Hummer Winblad Venture Partners
14.	Khosla Ventures
15.	Mercato Partners
16.	New Enterprise Associates
17.	Pelion Venture Partners
18.	Pine Brook Road Partners
19.	Rosewood Capital
20.	RWI Ventures
21.	Shasta Ventures
22.	Sorenson Capital
23.	SV Life Sciences
24.	TA Associates
25.	TriVentures Management
26.	University Venture Fund
27.	UpStart Ventures
28.	vSpring Capital

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Appendix D
Updated Investment Information and Analysis

The investment information discussed in Chapter II was reported as of March 31, 2013. We focused on that date to address a specific status report that was given to legislators by the UFOF. Figure D.1 presents investment information updated as of September 30, 2013 (Compare to Figure 2.1, Chapter II, p. 10). Portfolio data from this date was the most complete information available at the time of the audit that allowed our comparison to the national data set in the analysis discussed in this appendix.

Figure D.1 UFOF Had Invested $106.9 million as of September 30, 2013. The funds comprising the UFOF portfolio, in turn, invested $753.6 million in Utah companies.

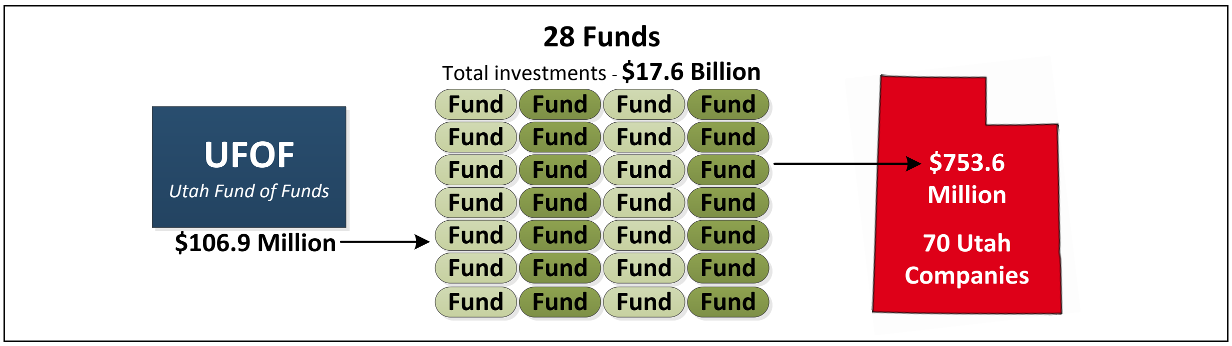
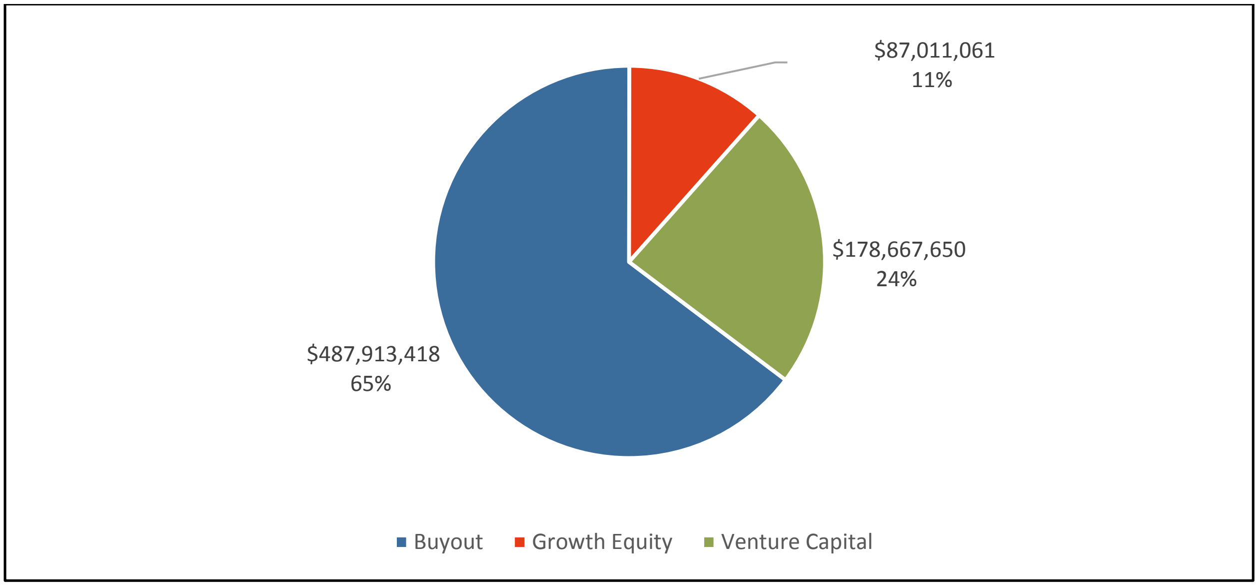


Figure D.1 shows that as of September 30, 2013, the UFOF had invested $106.9 million dollars in 28 ***private equity***[18] funds. These 28 funds, in turn, invested $17.6 billion worldwide with $753.6 million of those investments being made in Utah companies.

Sixty-five Percent of the $753.6 Million Invested in Utah Companies Was Buyout Capital. The three primary private equity strategies are: 1.) ***venture*** capital, 2.) ***growth*** equity, and 3.) ***buyout*** capital. Figure D.2 shows a percentage and dollar breakdown of the $753.6 million by these three strategies. As shown, the majority of these investments is comprised of buyout investments.

[18] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix A.

Figure D.2 The Majority of In-State Investments Made by UFOF Portfolio Funds Were Buyout. Sixty-five percent of Utah investments attributed to UFOF portfolio funds is comprised of 15 large buyout investments.



This figure shows that $487.9 million (65 percent) of the $753.6 million invested in Utah companies was made by buyout funds. This $487.9 million was the result of 15 investments as opposed to the remaining $265.7 million, which was comprised of 55 venture and growth investments.

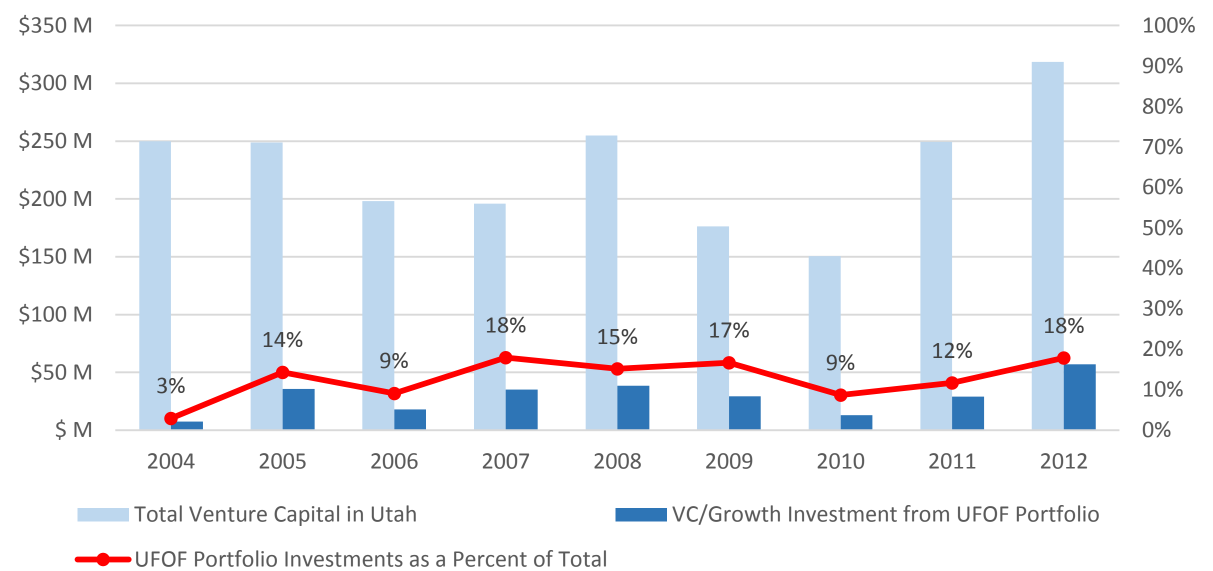
Considering that the main focus and mission of the Utah Venture Capital Enhancement Act is to mobilize venture capital into the State of Utah, it is noteworthy to find that a majority of the dollars invested in Utah by UFOF portfolio funds were large buyout deals. It should be noted here, however, that the statute does not prohibit this type of investing by the program.

A Portion of the $753.6 Million Was Invested in Utah Companies Before UFOF Entered the Market. The first UFOF investments were made in May of 2006. These first investments were made in funds that had been active in the market and had already made investments in Utah companies as early as 2004. Of the $753.6 million invested in 70 Utah companies discussed previously, $47.5 million was invested in 15 companies before UFOF made any investments. All 15 of these were venture capital investments. This, therefore, precludes any inference of cause and effect between UFOF investments or efforts and this specific list of 15 Utah investments.

UFOF Portfolio Fund Investments Represent a Relatively Small Portion of Venture and Growth Capital Investments in Utah. In addition to internal UFOF data, we obtained national venture capital data and compared the total UFOF portfolio investments to total venture capital investment in Utah. This comparison was done to show the portion of the Utah market that the UFOF-affiliated investments represent. Because the national data exclude buyout capital, we will subtract those dollars from the total and compare only the venture and growth investments over time. Subtracting buyout investments from the total $753.6 million of UFOF portfolio capital invested in Utah leaves $263.6 million of venture and growth capital investments from 2004 through 2012.

Figure D.3 shows this $263.6 million divided into the years in which it was invested and compares it to the total reported venture capital investments in Utah.

Figure D.3 UFOF Portfolio Venture Capital Investments in Utah Compared to Total Reported Venture Investments in Utah. Venture/growth investments by UFOF portfolio funds represent, on average, 13 percent of annual venture capital investments in Utah.



	Total Venture Capital in Utah	VC/Growth Investment from UFOF Portfolio	UFOF Investments as a Percent of Total
2004	$ 249.8	$ 7.4	3%
2005	$ 248.8	$ 35.7	14%
2006	$ 198.1	$ 18.1	9%
2007	$ 196.0	$ 35.2	18%
2008	$ 254.8	$ 38.6	15%
2009	$ 176.3	$ 29.4	17%
2010	$ 150.5	$ 13.1	9%
2011	$ 249.3	$ 29.2	12%
2012	$ 318.4	$ 56.9	18%
		Average	***13%***

Note: Though UFOF investment activity began in 2006, investment activity in two UFOF portfolio funds took place as early as 2004. This timing is discussed earlier in this appendix.

Figure D.3 shows that an annual average of 13 percent of venture capital investments in Utah from 2004 through 2012 came from UFOF portfolio funds. The remaining 87 percent of all venture capital investments in Utah came from venture and growth investment funds not associated with the UFOF portfolio. Whether the investments associated with the UFOF would have happened with or without the UFOF is a primary concern identified throughout this report; a number of recommendations in Chapters II and III are geared towards helping the UFOF identify and report this information.

Appendix E
Geographic Distribution of UFOF Investments

Figure E.1 shows the geographic distribution of investments made by all 28 funds in which the UFOF is invested. These numbers reflect the UFOF portfolio funds' investments as of September 30, 2013. The last column of Figure E.1 shows the portion of total investments attributable to the UFOF by its percent of ownership. This column sums to the total $106.9 million[19] of capital invested by the UFOF portfolio funds into their respective portfolio companies.

Figure E.1 The Portion of Investment Dollars in Utah Attributable to UFOF Is Relatively Small. Of the $753.6 million invested in Utah, $15.2 million (2 percent) is directly attributable to the UFOF.

Region	Dollars Invested by Portfolio Funds	Dollars Attributable to UFOF
U.S. (Net of Utah)	$ 13,079,612,346	$ 82,290,104
International	3,249,167,491	8,147,151
Utah	**753,592,129**	**15,221,231**
Undisclosed	552,010,216	1,247,068
Grand Total	**$ 17,634,382,182**	**$ 106,905,554**

Source: Data from LP Capital Advisors, Figure created by OLAG

This figure shows that $753.6 million (4.3 percent) of the $17.6 billion of the 28 UFOF portfolio funds' investments were made in Utah. Of the UFOF's total invested capital (dollars attributable to UFOF), 14.2 percent is invested in Utah ($15.2 million / $106.9 million). The other $91.7 million, 86 percent of the UFOF $106.9 million of investments, ended up in companies outside of Utah.

The UFOF statute states that the program should secure the services of the best managers in the venture capital industry, regardless of location. This appears to be in line with industry research done by Josh Lerner, a Harvard Business School professor of investment banking and recognized expert on this subject, who wrote:

> …[G]overnments should emphasize the development of strong interconnections with venture funds elsewhere. …[S]trong connections to major markets seem critical to success. Growing a venture capital industry in

[19] This total differs from the $103.5 million of UFOF invested capital discussed in Chapter IV (pp. 32-35) because the total here is not adjusted for management fees, fund expenses, and temporary returns of capital by UFOF portfolio funds.

> isolation, however appealing to policymakers, is unlikely to be a winning strategy.[20]

We agree that geographic restrictions should not be placed on the UFOF, but believe that an economic development plan with metrics that are consistently tracked and reported is essential to ensure that the UFOF is being held accountable to its economic development mission in Utah. Chapters II and III discuss this issue in further detail.

[20] *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed and What to Do About It*, 2009, p. 153

Appendix F
Detailed Administrative Expenses from 2006-2012

Figure F.1 summarizes the UFOF's administrative expenses from 2006-2012. These costs include salaries, bonuses, and related compensation for both UCIC staff and contracted labor, as well as expense information for a variety of other administrative cost categories. The 2013 data the UFOF gave us did not include the full calendar year and was therefore not included in this comparative annual cost analysis.

Figure F.1 UFOF's Administrative Expenses Are Similar to the Industry Standard. The typical fund of funds' administrative expense total is roughly one percent of overall committed capital.

Administrative Expenses	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Interest Earned	$268,620	$268,506	$55,382	$3,034	$0	$3,335	$0
Management Fee - Advisors	750,000	750,000	843,977	700,000	587,500	250,000	250,000
Salaries and Related	150,891	183,264	266,868	346,978	350,582	179,219	207,249
Contract Services	89,007	119,417	146,302	112,168	139,594	174,758	244,623
Occupancy and Office Expenses	15,188	37,216	58,137	59,010	50,377	35,438	120,058
Marketing, Travel and Entertainment	38,079	100,159	186,796	204,928	96,703	49,708	60,249
Legal Fees	478,918	52,538	35,299	100,509	12,000	82,061	200,462
Professional Fees - Accounting	0	19,135	28,040	15,438	23,150	37,500	35,696
Other (insurance, taxes, interest expense, bank charges, and software)	29,904	16,130	5,593	20,803	11,462	(27,498)	12,935
Total Administrative Expenses (net of interest earned)	**$1,807,457**	**$1,543,183**	**$1,625,372**	**$1,562,738**	**$1,271,233**	**$784,520**	**$1,131,267**

Sources: Auditor Analysis of LP Capital Advisors' Data and UFOF Audited Profit and Loss Statements from 2006–2012.
Note: Audited profit and loss statements for 2013 not available at time of reporting.

Figure F.1 shows the UFOF administrative expenses since 2006. As discussed in Chapter IV (pp. 43-44), these costs hover around 1 percent of assets under management. Since that time, the UFOF's administrative expenses have been as low as 0.64 percent up to 1.48 percent of committed capital from 2006-2012. The industry standard for a fund of funds' administrative expense is within this range, approximately 1 percent of total committed capital. For more information on UFOF's administrative expenses, see Chapter IV.

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Agency Response

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utah capital
INVESTMENT

July 22, 2014

John M. Schaff
Legislative Auditor General
W315 State Capitol Complex
Salt Lake City, Utah 84114

Dear Mr. Schaff:

Thank you for your agency's review of the Utah Fund of Funds ("Utah Capital" or the "Program"). We appreciate your staff's thorough analysis and will fully implement recommendations. Utah Capital continues to be an important part of Utah's growing technology and life science sectors. Although Utah continues to be below national averages, the legislative audit team identified "Utah's small portion of national venture capital appears to be increasing over time" (Chapter 3, Figure 3.3). We are fortunate to be affiliated with outstanding venture capital and private equity managers that invest in Utah. The Program has continued to improve over its history and we view the implementation of the audit recommendations as part of our goal to be the best fund of funds program in the country. Specific details about recommendation implementation are below.

No debt-based financing - Consistent with my own strategy, training and experience over the last 15 years, as well as the boards' initiatives when I began as director in September 2013, Utah Capital no longer will utilize a debt-based structure to finance new investments, outside of short-term working and committed capital needs, consistent with the recommendations of this legislative audit and HB 243.

Economic impact reporting - We agree that economic reporting has been inconsistent over the years as we have sought better ways to measure impact. In particular, methodology changes were not adequately and consistently described in our public reporting. We are currently developing a set of quantifiable metrics – many of which were recommended during the course of this legislative audit – that can be used to measure the non-investment activities of the Program. Utah Capital will share any supported methodology in its annual published report.

Additionally, specific changes to economic reported data include:

1 – Utilize a third party to collect, vet and report all active Utah-based jobs affiliated with the investment portfolio (companies that have gone out of business will be clearly delineated in an aggregate number, consistent with underlying fund manager confidentialities). This is a natural extension of annual financial reporting and will be done in conjunction with staff to alleviate any concerns with our portfolio funds in tracking and reporting this sensitive data. Utah Capital also will coordinate with GOED on job reporting and identify any duplicate scenarios.

2 – State income tax revenue analysis will be conducted in a cost effective manner with third party resources available to Utah Capital.

3 – Community, industry and entrepreneurial events will continue to be supported, tracked and reported.

Economic development plan - Based on the analysis and recommendations in this legislative audit report, Utah Capital will refine and formally adopt its economic development plan. Current and past initiatives, including fund investment, entrepreneurial guidance, introductions between businesses and capital providers as well as Utah funds and new institutional investors, will be addressed in the economic development plan. Utah Capital will formally adopt this modified economic development plan in the next UCIB and UCIC quarterly board meetings.

Investment result reporting - Similar to economic reporting, public investment reporting will be further standardized to be consistent year over year with clear delineation between net portfolio performance and overall program performance (including cost of the Utah Fund of Funds I debt-based financing and other

	administrative costs) and continue in aggregate according to confidentiality provisions with underlying fund managers.
Policies and procedures -	Utah Capital presently operates with investment guidelines as well as other policies and procedures. We will continue to update governance guidelines and our policies and procedures to include a more comprehensive version, which will include legislative auditor identified areas as well as others in production. Updated policies and procedures will be formally adopted at the next UCIB and UCIC quarterly board mtgs.
Employee contracts -	Utah Capital has executed employment contracts with all current employees, which include compensation commensurate with education and work experience, specific responsibilities, target goals and measurement criteria for bonuses, vacation time and termination clauses.

We appreciate the guidance received by the legislative audit team. We feel implementing these recommendations will continue to improve the organization. We also are pleased to note the many positive areas of the Program noted by the legislative audit team, including:

Investment management -	While the audit report highlighted deficiencies in economic reporting and debt structure, overall investment performance has been positive. Although ultimate performance at the end of the life of the Fund is unknown, the portfolio achieved an 8.0% net IRR (0.1% net of financing and administrative costs) as of March 31, 2014. This is particularly notable given the dual mission of the Program (Chapter 1, "UFOF Must Balance Dual Missions of Economic Development and Investment Returns"). Furthermore, no tax credits have been used to date while other "similar programs have fallen short and sold their contingent tax credits at a slight loss on a secondary market to cover cash needs" (Chapter 4, "Improved Investment Performance Minimizes Risk of Monetizing Contingent Tax Credits).
Program assessment -	Although pointed out as an area of concern, we are very pleased with the work accomplished following the 2008 financial crisis (Chapter 4, "UFOF Made Positive Changes to Its Portfolio in Response to the 2008 Recession"). During this period of economic uncertainty, the UFOF: 1 – Refinanced its existing debt-based structure, cutting its cost of capital by approximately 40% during a period in which several banks were hesitant to execute new loans. 2 – Continued its non-investing activities of entrepreneurial outreach and training, venture capital fund hosting, and medical device and middle market symposiums. 3 – Hired a new consultant in 2008 that recommended several private equity strategies which have generated positive results to-date.
Program efficiency -	The legislative audit analyzed Program costs and found administrative costs were reasonable. We agree that administrative costs associated with the Program continue to be sensible, as described by the legislative audit team, "UFOF administrative costs, as a percentage of assets under management, appear to be in line with other private funds of funds" (Chapter 1, Financing Costs Are Atypical; Administrative Costs Appear Reasonable).

We are excited for the future of Utah Capital as we continue to build on our existing relationships to improve the Utah economic environment through our investment and economic plan. Utah Capital will continue to evolve into a stronger organization with an equity financing structure (which reduces potential risk to tax credits compared to the current debt finance structure), improved reporting and the continued participation of talented individuals.

Sincerely,

Bret Jepsen	Robert Majka	Scott Peterson
Managing Director	Utah Capital Investment Board Chair	Utah Capital Investment Corporation Chair