A Fund of Funds Investment Strategy to Create an Enduring Venture Capital Ecosystem in Wisconsin: Money for Minnows

Many states have significant levels of research and development activity, large and well-funded university systems, and a pool of entrepreneurial management talent. However, most states lag far behind such entrepreneurial leaders as California and Massachusetts in the number of new companies that are formed each year. One of the primary reasons for this discrepancy is that California and Massachusetts have well established angel investment networks and a venture capital ecosystem that is highly supportive of entrepreneurs and new company formation. Most other states, including Wisconsin, do not.

To help address this lack of seed stage investment capital and help increase the number of new companies formed in Wisconsin, in 2005 the State passed ACT255 which provides tax incentives to angel investors who invest in new companies. In addition, the Wisconsin Technology Council, in conjunction with the Wisconsin Angle Network, has worked to increase the level of angel investing in Wisconsin. Despite these efforts, Wisconsin remains in the bottom five states nationwide in terms of new company formation, and is in the bottom third in terms of venture capital investment on a per capita basis.

"Money for Minnows" is an investment strategy that has been successfully employed to begin to improve the entrepreneurial ecosystem in Wisconsin. The strategy was initially formulated by Kegonsa Capital Partners in their management of Wisconsin based venture capital funds. Sun Mountain Capital, a private equity firm that has worked closely with Kegonsa, also manages the New Mexico state fund of funds program and has successfully built a venture capital ecosystem that now has over 20 venture capital funds with offices in the state of New Mexico.

The projections in this paper are based on the historical performance of Kegonsa Capital Partners investing in Wisconsin-based companies using the Money for Minnows investment strategy and the historical results of the New Mexico venture capital ecosystem. In summary, where there is an unmet need there is an opportunity to achieve significant investment returns.

Unmet need in Wisconsin

In a recent survey of venture capital funds across the United States, the venture capital investment segment that has the highest number of venture capital funds is at the Seed investment stage. These funds are typically $25 million or less in size, and they invest small amounts at the company formation stage. 35% of all venture capital funds in the United States are Seed investment funds. These Seed funds generate deal flow for the $25 to $100 million dollar investment segment.

Table One: Number of VC Funds by Investment Segment - 2011

# VC Firms	Investment Segment	$ MM Under Mgt	Percentage
266	Seed	<$25	35 %
224	Early Stage	$25 - $100	30 %
150	Growth	$100 - $500	20 %
110	Late Stage	>$500	9 %

Source: Angel Capital Association

The Wisconsin entrepreneurial ecosystem currently has four funds actively investing in companies based in the State: Venture Investors V (Madison), NEW Fund II (Appleton), Midwest Capital Fund II (Milwaukee) and the Wisconsin Super Angel Fund (Milwaukee). Venture Investors is a balanced fund investing across the investment spectrum – seed to late stage - into companies with a technology focus. Both the NEW Fund and the Midwest Capital Fund have a target investment size of $1-3 million. Currently there is only one venture capital fund with a seed stage focus, the Wisconsin Super Angel Fund.

Despite being located in Wisconsin and a strong desire to make investments in the State, the majority of investments made by Venture Investors, NEW Fund II and the Midwest Capital Fund II have been in companies located outside of the State or in private equity types of investments, not in venture capital investments. When surveyed, these funds have indicated that their most significant challenge is the lack of quality investments in Wisconsin at the $3 million investment stage. Midwest Capital has made eight investments with only one in a Wisconsin-based company. NEW has made six investments – two in new Wisconsin ventures, two out of state and two in private equity investments in existing companies, not venture capital investments. Of Venture Investor's nineteen portfolio companies, nine companies are located in Wisconsin.

The experience of these VC funds is very different than the experience of the Kegonsa Seed Fund I ("KSF"). KSF has invested in thirteen portfolio companies, all of which were located in Wisconsin at some time during the company development. KSF typically invests at the company formation stage and the average initial investment is approximately $388,000. KSF found a high quality investments investing at the seed stage as demonstrated by its returns. This investment strategy has delivered a rate of return greater than the national average return using the Thomson Reuters Private Equity Performance Index as a comparative index. The Kegonsa Seed Fund has returned all investment capital to the Fund's Limited Partners with six portfolio companies still being active. The "Money for Minnows" strategy of investing small amounts across a broad portfolio small of companies was first employed and coined by the KSF.

This strategy contrasts with the strategy of "Whale Hunting", which involves making larger investments in a few select companies, often in targeted technology sectors, on the assumption that these select companies will be the big winners in their market. Fund managers employing the Whale Hunting investment strategy make multiple investments of increasing dollar amounts in a few select companies.

The unmet need and investment opportunity in Wisconsin is venture capital funds with less than $25 million in committed capital with a Seed investment focus - Money for Minnows.

Investment Criteria and Assumptions

The projections in this paper assume a $35 million Fund of Funds program (Badger Fund of Funds). The Badger Fund of Funds will help create or invest in Seed stage venture capital funds that are based in Wisconsin. In addition, these investments in Seed funds will be complemented by investments in growth stage funds. The new Seed funds will employ the Money for Minnows investment strategy successfully deployed by the Kegonsa Seed Fund. Approximately two thirds of the investment capital is contemplated to be invested in seed and early stage funds and one third of the investment capital invested in growth stage venture capital funds.

The rate of return, new company formation, and the effects of investor leverage projections are based on the actual results of the Wisconsin based seed and growth venture capital portfolio funds managed by Kegonsa Capital Partners (see about Kegonsa Capital Partners).

The projected success rate of the Badger Fund of Funds and the resulting creation of a robust venture capital ecosystem in Wisconsin is based on the actual results of the New Mexico fund of funds program managed by Sun Mountain Capital (see about Sun Mountain Capital).

Results

Venture Capital Fund Formation

This paper expects the Badger Fund of Funds to invest in six to eight Seed venture capital funds and two to four Growth stage venture capital funds in the first four years of operation.
Like the Kegonsa Seed Fund, each Seed venture fund will invest, on average, into three new portfolio companies each year with 75% of the portfolio companies being created by an entrepreneur and 25% of the portfolio companies being created by the fund management and a product inventor. In addition, each Seed fund will make two follow-on investments into existing companies each year as per the KSF experience. Each Growth fund will invest in three new portfolio companies a year. Table two summarizes Kegonsa Capital Partner's Wisconsin venture investing experience using the Money for Minnows investment strategy. Similar assumptions are projected for the Badger Fund of Funds program.

Table Two: Wisconsin Seed and Growth VC Fund Investment Data

Venture Capital Fund	Kegonsa Seed Fund	Kegonsa Coinvest Fund	Badger FofF VC's
Investment period			
First investments in new companies	2005-2009	2007-2012	2015- 2018
Follow-on investments in existing	2010 -2012	2008 -2013	2019 -2020
Number of Seed/Early stage funds	1		6
Number of Growth funds		1	2
$$ invested in new companies			
Total $$ Invested by fund	$8,677,000	$7,600,000	$31,500,000
Total Dollars invested by others	$31,170,000	$60,800,000	$98,900,000
Average $ Seed investment	$388,000	NA	$450,000
$$ invested in follow on investments			
Average Early Stage Investment	$1,920,000	NA	$1,500,000
Average Growth Stage Investment	NA	$2,605,000	$4,500,000

If the Badger Fund of Funds were to implement the Money for Minnows strategy using the investment parameters detailed in Table Two, projected company formation results would be:

Table Three: Badger Fund of Funds Analysis

Year	New Seed VC	New Growth VC	Invest in New Ventures	Follow on Investment in Existing Company	VC Investments per year
2015	3		8	4	12
2016	2	1	13	8	21
2017	1	1	22	15	37
2018			22	16	38
2019			16	15	31
2020			9	11	20
2021			1	6	7
2022				4	4
Totals	6	2	91	79	170

The Badger Fund of Funds anticipates that by year four Wisconsin venture capital funds will be making, on average, an investment in a new Wisconsin company every two weeks.

Eco System Creation

Currently the State of Wisconsin has four ventures funds that are actively making new investments. Of these, only one new fund has been created in the last four years and only one fund is focused on making investments at the Seed stage.

Sun Mountain Capital became the investment manager for the State of New Mexico's in state fund of funds program in 2007. The program was begun in the mid 1990's with a $50 million fund of funds program. Sun Mountain has supported the creation of 15 newly formed venture capital funds active in

New Mexico to help build the venture capital ecosystem in the state.. Of those 15 newly created venture capital funds, 8 of them were able to raise a subsequent fund without an investment from the state. Their ability to raise a follow on fund was a direct result of their successful investment track record.

Table Four: Comparison Wisconsin vs. New Mexico VC Eco System

Investment Focus - stage of company development	# Venture Funds New Mexico	# Venture Funds Wisconsin
Seed – no revenue	10	1
Early Stage - revenue	8	2
Growth – breakeven	5	0
Late state - profitable	4	0
Balanced – tech focus	2	1
Total	29	4

If the Wisconsin ecosystem were to grow like New Mexico's ecosystem, an assumption could be made that half of the Badger Fund of Funds portfolio funds would raise a second fund in years 2018 to 2022 – building an enduring venture capital ecosystem.

Investment returns

The Badger Fund of Funds will invest primarily into Seed and Growth venture capital funds following the Money for Minnows investment strategy. These funds will invest in newly created Wisconsin-based companies. This approach was designed to mirror the investment approach of the Kegonsa Seed Fund. The Kegonsa Seed Fund has delivered a rate of return greater than the national average return for venture capital investing using the Thomson Reuters Private Equity Performance Index as a comparative index. Over the past five years the 20 year average annual return for the Thomson Reuters Private Equity Performance Index for Seed/Early stage venture capital funds has ranged from 18 to 30%. The average return for all venture capital investment segments (i.e. Seed to Late stage) has ranged from 12 to 18% annual internal rate of return. The goal of the Badger Fund of Funds will be to achieve returns equal to or greater than national average returns based on the Thomson Reuters Index.

Risk management

Certain sub-asset classes of private equity pose greater strategy risk than others. Seed and Early stage venture funds have historically featured higher risk/higher return profiles than Later stage venture funds and Growth equity funds. Strategy risk in this asset class is mitigated by diversification - manager, sector, geography and investment style. A fund of funds will diversify as much as its investment mandate reasonably allows. Its portfolio should include a range of funds with different areas of investment focus and feature varying investment styles and approaches to investing.

The general partner of the Badger Fund of Funds will monitor and, as necessary, actively participate in the management of the portfolio venture funds. This participation will likely be at the Investment Committee or the Limited Partner Advisory Committee level. Venture funds managed by Kegonsa Capital Partners have included an investment committee made up of both investors and non-investors that provided advice and governance.

About Kegonsa Capital Partners

Kegonsa Capital Partners, LLC ("KCP") is a Wisconsin-based venture capital management firm. KCP is the general partner of the Kegonsa Seed Fund I, LP (the "Seed Fund"); the premier Wisconsin seed venture capital fund, and the managing member of the Kegonsa Coinvest Fund, LLC (the "Coinvest Fund"); a Wisconsin-based Growth stage venture capital fund.

The Seed fund focuses on creating new companies or being the Seed stage investor in newly created companies. The Coinvest Fund focuses on being the lead investor for second and third round investments, typically with an investor syndicate, in growing new companies or being the Growth stage investor.

About Sun Mountain Capital

In 2007 Sun Mountain Capital became the manager of the New Mexico Private Equity Investment Program (the State of New Mexico's Fund of Funds program). Since Sun Mountain's involvement, the New Mexico program has seen its investment returns improve by over 20%. In addition, the program has attracted over $1.3 billion of investment capital to companies based in New Mexico from investors located outside of the state. Currently over 20 venture capital funds have offices in New Mexico and investment professionals active in the state.

In early 2011, Sun Mountain was selected to be the investment manager for the country of Mexico’s $85 million fund of funds and direct investment program. To date, investments have been made in 9 funds and 7 portfolio companies. The program’s investment stage breakdown is approximately 59% Growth and 41% Seed venture capital.

Prior to forming Sun Mountain Capital, its team was involved in the management of three other state based private equity fund of funds programs in Utah and Ohio.