February 2, 2015

Hon. James L. Seward
New York State Senator – 50th District
41 South Main Street
Oneonta, NY 13820

Dear Senator Seward,

During your recent visit to my home, we had an engaging discussion about the importance of finding ways to step up the level of private investment into early stage tech companies Upstate.

In response to your request for my input on possible public policy options, I embarked on a review of current incentives offered in New York State and then followed up with interviews of other private investors regarding their experience with these incentives.

This letter summarizes findings from my review and will conclude with some recommendations for initiatives that would encourage more private investment in early stage tech companies with potential to fuel the kind of company and job creation that leverages our assets and be consistent with trends of the innovation economy.

Why startup investment is critical to growing jobs in the new economy

From a startup entrepreneurs' perspective, the barriers to launch an emerging tech company with high growth potential are lower now than ever before.

There is also increasing recognition that more of our best and brightest graduates are choosing to pursue these opportunities even in lieu of accepting highly compensated employee roles inside large corporations.

Notwithstanding our region having a top tier higher education footprint and many other assets that should be powering the growth of early stage tech companies, Upstate New York ranks dead last of the 18 regions of the United States tracked by PW Coopers on the key metric of venture capital (VC) investment – the proxy for where we believe tomorrow's jobs will be located geographically.

From a job creation standpoint, economic studies profiled in the book *The New Geography of Jobs* demonstrate that innovation companies with a product or service being sold to non local customers generate more than 5 jobs in the local community for each job in the innovation company. This is more than triple the job multiplier of the manufacturing industry.

Startup companies are very different than traditional small business. Their profile puts them squarely in the space of the innovation companies in this most critical category of job creators. Specifically, companies in this category have attributes like:

- paying higher salaries than almost all other industries (reflecting the high education and skills needed broadly across a tech company's workforce)

- contracting out for many outside services (which in turn creates other jobs)

- having potential to grow more quickly than any other kind of business

- not being dependent on government support, tax incentives or special regulatory measures

- whether successful or not, often times spawn new companies from the ranks of their existing team members

- when successful, generate wealth which is re-invested in the community

Appendix I provides additional context for defining startups, factors involved in where they choose to locate and the large disparity in startup capital between the New York metro area and Upstate.

Individual angel investors are the key source of earliest stage, highest risk capital

Even with a terrific business concept, the high hurdles encountered in bringing an innovation product to non local customers makes it difficult to grow this kind of business from zero revenue to positive cash flow in a period of time that entrepreneurs can self fund.

While the most promising startup opportunities eventually find their way to institutional investor support from venture capital (VC) firms, in almost all cases those startups receiving VC have raised one or more earlier rounds of funding from accredited "angel" investors – individuals who meet SEC mandated standards demonstrating sufficient personal wealth to assume the high risk involved in making an illiquid, speculative stock investment.

This highest level of risk capital is not appropriate to be assumed by government or institutional sources. In the NY metro area there is a large and growing number of active participants as private angel investors. But in Upstate New York, too many of the people with the requisite financial capacity and business acumen remain on the sidelines because they:

- haven't heard about successful "exits" - sale or IPO of an area company where early stage investors reaped large returns (even though such exits are happening across Upstate NY)

- aren't aware of the availability of startup investment opportunities or how to participate as an investor

- have no visibility to tax incentives NYS makes available to mitigate some of the risk assumed by the speculative investment.

If increasing the amount of private angel investment is accepted as a worthwhile goal, we believe that one of the greatest leverage points NYS has to do so would be to increase visibility of existing incentive programs that targets growing more emerging technology companies.

NYS Qualified Emerging Technology Company (QETC) program features adequate Incentives – but few investors know about it.

NY PBA Law 3102-e is the implementing statute codifying the QETC program. The Tax and Finance Department's summary of the program is enclosed as Appendix 2.

Essentially, a startup applies to be QETC certified and when approved, becomes eligible for tax credits across three areas:
- Capital tax credit (for qualified investors)
- Employment tax credit for hiring related to qualifying research and development activities
- Refundable tax credit for purchase of qualifying materials and equipment

Prior to my assessing policy input for you, I had the uninformed view that QETC investor tax credit had too many steps and too little incentive for me to pursue in my own angel investing activities. (As a point of reference I have made 14 direct investments in NYS startups, have had a hand in creating 4 seed funds Upstate that engage more than 100 angels and am also a Limited Partner in 6 professionally managed funds that invest in NY startups. Collectively, this activity makes me one of the most active and connected startup investors across the region).

Now that I've been through this policy assessment, I conclude that the QETC investor tax credit, which can be up to 20% of the investment, is enough of an incentive to be a motivating factor in an individual's decision on whether to invest in a NY startup company.

What's significant about my change in view is that given my startup investor background and being an active promoter of the startup ecosystem through my non profit Upstate Venture Connect, I should have had greater awareness about QETC than I did.

I attribute my earlier reticence to the fact that almost none of the investors I interacted with had any knowledge of the QETC program. The program had no visibility to my accountants or legal advisors, including those who were also active in the startup community.

This lack of visibility across the spectrum of people who should be "in the know" is really an opportunity for improvement to be capitalized on.

Instead of coming up with a new policy, my recommendations are all centered around options to make the existing QETC program more visible and accessible so it can achieve its intended purpose of stimulating both new company and job creation in the emerging technology industries.

Recommendations to improve QETC visibility, accessibility and success

1. <u>Increase transparency of QETC program results</u>. Appendix 3 includes an excerpt from PL 3102-e that specifies an annual report is to be prepared by the New York State Science and Technology Foundation to aggregate statistics regarding QETC program participation. I've been unsuccessful in my efforts to locate a copy of this report, including through program manager contacts at NYSTAR. The report would be most helpful to baseline current program utilization so that goals could be set for increasing the level of QETC participation. Easy public access to the report would also help build investor confidence in the viability of the QETC program.

2. <u>Designate leadership responsibility for growing QETC participation</u>. While administration of the QETC tax credits is handled by the Department of Taxation and Finance, and the Science and Technology Foundation reports on it; my search through public records and conversations with program managers inside Empire State Development could not identify a specific leader or agency with a charter to grow the QETC program. Without the designation of a leader being held accountable to grow the program, there won't be a mechanism to implement initiatives that would increase investor participation and in turn spur the sought after new company and job creation intended by the QETC statute.

3. <u>Fund program enhancements to increase QETC visibility and accessibility</u>. Here is just a brief sampling of a few alternatives with potential to broaden awareness of and participation in QETC:

    a. **Create a QETC portal**. Even with a determined search effort, information about QETC is difficult to locate and digest. A QETC portal could aggregate and organize content with navigation designed for the audiences of emerging tech companies, investors, accountants, legal advisors and other QETC stakeholders in the emerging tech ecosystem. Importantly, the portal should list companies that received QETC certification each year as this will be another avenue to connect these companies to resources who can help them.

b. **List phone numbers for QETC customer support**. None are currently visible.

c. **Permit online application for QETC certification and credits**. Current process is paper based and is an impediment to growing participation.

d. **Leverage other state funded emerging tech programs to bring visibility to QETC**. State funded programs like Startup New York, Innovate NY Capital Fund, Small Business Technology Investment Fund, Centers for Advanced Technology etc. already have dedicated web properties and advertising that generate traffic and create awareness about New York's emerging tech opportunities. Adding a pathway for interested users to navigate from these other programs into a QETC portal would be an efficient and cost effective mechanism to spread awareness. Some of these programs might even offer ties to QETC as an option for private sector participation alongside the state funded investment in specific companies.

e. **Explore partnerships with private sector organizations**. Non profit organizations like Upstate Venture Connect and Upstate Venture Association of New York could help facilitate partnerships across their respective member networks as well as engage and educate private capital providers like seed funds, angel groups, venture capital funds etc.

Thank you for the opportunity to provide input on how best to increase the amount of early stage private investment in New York State.

Let me know if I can help clarify anything mentioned in this submission or if I can assist in the communication of these ideas with others you might recommend.

I appreciate your interest in the topic and also assure you of my readiness to help advance the dialogue from here.

Warmly,

Martin Babinec
Founder and Chairman

Appendix 1

What are startups and where do they locate?

Startups are new companies with a product and/or service that has not existed before. Such products and services are usually developed to reach global (i.e, mostly non-local) customers – which by definition means they have a distinctly different set of business challenges than a traditional small business selling to local customers.

While startups are frequently enabled by development or deployment of new technologies, the range of industries can be diverse.

These days, startups are not generally powered by heavy investment in plant or equipment assets. Availability of low cost real estate, cheap energy, low wage workforce or an employer friendly regulatory environment **are not** factors in where they decide to locate at the time of company formation.

What startups have in common is that they are powered by the knowledge and innovation of a highly skilled team who forgo opportunities in traditional industries to direct their talents in developing a new company with high growth potential that is advancing a new industry or disrupting an existing one.

So the key factors driving where startups actually locate has to do with a combination of:

1. **Talent:** Local density of other like minded individuals – or more specifically, accessibility to lots of other best and brightest talent who possess both specialized skills and shared startup ambition. Talent is different from our traditional economic development focus on "workforce" where the assumption is that individuals are tied to location and have insufficient opportunities available to them. Talent, in contrast, is universally in demand and able to relocate (or work remotely from wherever one chooses to live).

2. **Seed Funding:** Access to risk capital – with a multi-year development cycle and no revenues or ability to secure bank loans, startups are dependent on finding sources of investment capital to underwrite their high risk before the first customers are even on board.

3. **Ease at which entrepreneurs can get connected to the resources who can help them:** The top startup hubs are all marked by a connected network of experienced entrepreneurs

who help first timers in key decisions and getting connected to the right resources.

Startups require risk capital

Since most startups are creating businesses based on new technologies, new markets, disruptive business models or in many cases entirely new industries, the time span from business conception to sufficient customer adoption to generate positive cash flow is typically much longer than traditional businesses.

Startups are not suitable candidates for loans from either commercial or government sources since the risk of failure is high and there are no assets to serve as collateral.

Without commercial debt capacity, the only way a startup overcomes this long development cycle is by forging a path that is attractive enough for outside investors (i.e., who are not personally connected to the entrepreneur as friends or family). These investors buy shares of stock in the startup because of their belief that the company has extraordinary growth potential which will create an future opportunity to sell their shares for many times their original investment.

To achieve such an outcome, growing startups will typically go through multiple rounds of equity fund raising, each stage raising larger amounts and at higher company valuations. The investor risk goes down as the startup grows in revenue and profitability.

The hardest to secure and most important stage of equity financing is the very first round of outside investors. This is where the business and team are most unproven, and often before the first dollar of revenue has been generated.

This first stage of risk capital is typically taken on by angel investors – high net worth individuals putting their own money on the line with hopes the investment becomes the seed for building a very large and transformative company. Capital for later rounds often comes from professional investors such as venture capital firms.

Beyond the infusion of capital to startups, angel investment funds also link seasoned entrepreneurs and local business people with first time entrepreneurs building startups in their communities. Such a network (where everyone's incentives are aligned towards promoting the growth of the company and the local community) is a critical foundational element that is present in NYC today, but often lacking in Upstate metro areas.

Bifurcation of New York State's two startup worlds

Professional venture capital firms raise large investment funds from multiple sources then pick the most promising startups to make investments which can range from $100,000 as a seed investment to a pre-revenue company to $2 million or more in the Series A investment level – sufficient funds that can immediately transform a young company with a small amount of revenues to a fast track in growing their customer base.

Price Waterhouse Coopers tracks the placement of venture capital investments, breaking the U.S. into 18 regions for reporting purposes. Since these regions reflect where the institutional professionals are investing in startups with the greatest growth potential, it is also a reliable indicator of where tomorrow's job growth in new industries will be.

New York State has 2 of the 18 regions reported – New York Metro and Upstate. Taken together, New York State venture capital investments rank second behind only California. However, of the $3.253 billion of venture capital invested in New York in 2013, only $115 million of that was invested in Upstate startups – which means 96.5% of all venture capital in New York State got invested in New York metro startups.

More limited reporting of angel investments seem to mirror the venture capital trends in the disparity between NY metro and Upstate.

Even though NY metro startups raise about 30 times the amount of startup capital as Upstate, we don't conclude that the entrepreneurs there are 30 times better or smarter than the ones Upstate.

And since the two regions have similarly sized populations, educational institutions and the same state regulatory environment, we attribute the widely divergent gap between NY metro and Upstate startup activity to the aforementioned factors of 1) talent density; 2) accessibility to early stage risk capital; and 3) the ease at which first time entrepreneurs can locate the right resources who are qualified to help them.

All three of these factors can be positively influenced by getting more individuals to step up and become startup mentors and investors - encouraged with tax incentives and defined pathways to participate made more visible through state led initiatives.

Appendix 2

New York State Qualified Emerging Technology Companies

This link provides access to the PDF that will be used for Appendix 2:

http://www.tax.ny.gov/pdf/memos/corporation/m99_2_1c.pdf

Appendix 3

Excerpt from PL 3201-e Regarding QETC Reporting Requirements

The New York state science and technology foundation shall prepare a report, no later than March thirty-first, two thousand four, analyzing the effectiveness of the tax credits created by subdivisions twelve-E and twelve-F of section two hundred ten of the tax law, in light of their influence on the start-up, growth, and retention of emerging technology companies in the state, on job growth within high technology companies, and on the expansion of collaborative research and development undertaken by industry and academia. The department shall annually provide the New York state science and technology foundation with aggregate statistics, pursuant to existing legal requirements for confidentiality of taxpayer records, on the number of taxpayers applying for such credits, the number of employees employed full time by qualified emerging technology companies, and the total amount and the amount of incremental basic research payments, made to a qualified organization. This report shall be delivered to the governor, the speaker of the assembly, the temporary president of the senate, and the chairpersons of the assembly committee on economic development, job creation, commerce and industry and the senate committee on commerce, economic development and small business. - See more at: http://codes.lp.findlaw.com/nycode/PBA/10-A/1/3102-e#sthash.XJDlU21l.dpuf