

Arkansas Institutional Fund

Annual Report

January 1, 2016, Through December 31, 2016

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Cover Letter

To: Governor Asa Hutchinson
House Committee on Agriculture, Forestry and Economic Development
Senate Committee on Agriculture, Forestry and Economic Development
Arkansas Development Finance Authority

From: Arkansas Institutional Fund, LLC

Date: June 30, 2017

Re: Annual Report per A.C.A. §15-5-1408 of the Venture Capital Act of 2001

We are pleased to provide this annual report on the activities of the Arkansas Institutional Fund (the “AIF”) which serves as the designated investor group chosen by the Arkansas Development Finance Authority (the “ADFA”) to implement the provisions of the Venture Capital Act of 2001.

There has been no use of funds from the ADFA Bond Guaranty Fund. Further, there has been no redemption or transfer of tax credits allowed under subchapter §§15-5-1401 other than the original transfer by the State Board of Finance to the ADFA (see Organization page 13).

On March 31, 2017, AIF entered into a loan agreement with ADFA. The proceeds from this loan were used to repay AIF’s outstanding loan to Bank of the Ozarks. The current outstanding balance owed to ADFA is approximately \$24 million. The loan is current and compliant with all covenants of the loan agreements.

The Arkansas Venture Capital Investment Trust compiled the statistical information and data supporting this report. The ADFA Board of Directors appointed the Arkansas Venture Capital Investment Trust as the Replacement Fund Manager effective January 1, 2016. ADFA is in the process of finalizing a contract with the Replacement Fund Manager to provide administrative services. The Arkansas Venture Capital Investment Trust, in its capacity as Replacement Fund Manager, is responsible for submitting this annual report.

Executive Summary

The mission of the AIF is to increase the availability of equity and near-equity capital for emerging, expanding, relocating and restructuring enterprises in the state. Such investments will help strengthen the state's economic base and create jobs. The method by which AIF addresses this task is to encourage and support the growth of a local capital industry capable of financing companies throughout the risk spectrum, from early stage start-ups to later stage expansions.

AIF is structured as a "fund of funds" venture capital investment program and is capitalized utilizing a guaranty backed first by a \$10 million pledge from ADFA's Bond Guaranty Program and second by \$60 million in Arkansas state income tax credits. The AIF invested in proven, professionally managed private equity, seed and venture capital funds that commit to include Arkansas in active, aggressive, visible deal prospecting.

AIF makes commitments to private equity and venture capital funds over a period of time based on agreed upon staging and performance requirements. AIF committed to two rounds of investment. The first round, launched in 2003, is comprised of 10 commitments, \$33.2 million in aggregate plus one conditional commitment of \$1.0 million for a total of \$34.2 million. Commitments have generally ranged from \$2.0 - \$5.0 million in size and have been subject to ADFA approval. The second round was launched in 2014 and has made one investment commitment totaling \$4 million. The original plan was to commit approximately \$30 million to eight to ten private equity, seed and venture capital funds. However, the termination of Cimarron Capital Associates, I LLC mandates that the AIF shall make no new investment commitments. AIF will honor existing investment commitments. At fiscal yearend 2016, AIF has issued or closed on 11 commitments totaling \$37.2 million.

For fiscal year 2016, in-state investment totaled approximately \$3.3 million in four follow-on investments in Arkansas companies by AIF investee funds and their co-investors. This fiscal year continued the trend of returns with an additional \$3,838,222 in distributions to AIF from its investee funds. Distributions were used to pay down the financing line balance. The first round of investments has recorded two partial unrealized write-downs in the portfolio.

The primary objectives of AIF during 2016 were to consider AIF's longer term financing strategy in the face of potentially rising interest rates, to close on outstanding conditional commitments as warranted, and to complete the fund manager transition from Cimarron Capital Associates I, LLC to the Arkansas Venture Capital Investment Trust.

In 2016 the financing facility was re-evaluated and, given the rising interest rate expectations, plans were instituted to restructure underlying debt into a longer term fixed rate vehicle. On March 31, 2017, AIF entered into a loan agreement with ADFA. The proceeds from this loan were used to repay AIF's outstanding loan to Bank of the Ozarks. The current outstanding balance owed to ADFA is approximately \$24 million. The loan is current and compliant with all covenants of the loan agreements. This loan is structured with a term of three (3) years with a fixed rate of 3.45 percent.

Mission

The mission of the Arkansas Institutional Fund (the “AIF”) is to increase the availability of equity and near-equity capital for emerging, expanding, relocating and restructuring enterprises in the state.

Vision

The AIF encourages and supports the growth of a broadly diversified and sophisticated financial industry capable of providing the necessary risk capital to Arkansas entrepreneurial companies from early stage start-ups to later stage expansions.

Over its first round of investment (which began in 2003) and second round of investment (which commenced in 2014), the AIF program is expected to result in over \$420 million of equity, near equity, and debt capital for Arkansas businesses. The increase in the capital base will strengthen and support the launch or expansion of those companies which are the engines of economic growth that create jobs and diversify and stabilize the state's economy.

AIF manages risk through a prudent investment strategy. By use of a contingent liability funding structure, AIF mobilizes capital and covers all program costs until such time as investment returns materialize. Over the life of the program AIF hopes the state will enjoy significant economic benefits at minimal cost to the taxpayers of Arkansas.

AIF’s program is designed to exceed the stated goal of two dollars invested in Arkansas businesses and projects for every one dollar of principal guaranteed.

By supporting investment in a number of risk capital funds, each with its own team of investment professionals, AIF is able to bring to Arkansas a broad range of professional talent to serve the diverse opportunities within the state. Both the funding structure and delivery system employed by AIF provide a variety of opportunities for meaningful private sector participation in the AIF program.

The AIF’s program is designed to pay for itself and build an asset for the state while minimizing the likelihood that tax credits will need to be sold. If accomplished, the cost to the state will be zero.

Operating Principles

Effective January 1, 2016, the AVCIT became the replacement fund manager. The change in fund manager necessitated a review of the existing operating principles.

The following are principles pursued by AIF:

- Risk capital is necessary to generate and support the growth of entrepreneurial firms, which in turn create jobs and provide economic growth.
- A responsive state program can demonstrate to potential investors the high level of commitment Arkansas has for entrepreneurial ventures. The program shall be managed in a way that limits operating costs and maximizes investment in Arkansas companies.
- The pursuit of a market rate of return provides the best discipline for using limited resources to generate the greatest economic impact.
- The risks of making venture capital investments in Arkansas can best be managed by diversification through a number of investments in separate venture capital funds with proven track records.
- The risks of making venture capital investments in Arkansas require stringent review of the portfolio in order to protect the underlying collateral.

Investment Objectives

Effective January 1, 2016, the AVCIT became replacement fund manager. The change in fund manager mandates that no new investment commitments shall be made by the AIF. The replacement fund manager is required to honor all existing investment commitments. Thus, the new investment objectives are to manage the existing portfolio in a manner that maximizes investment activity in Arkansas, while also taking all necessary steps to protect the underlying collateral.

Strategic Objectives

The strategic objectives of AIF in relationship to private equity and venture capital funds include:

1. The continuous presence during the active deployment period of the investment of the highest quality professional fund management working in the State of Arkansas.
2. A positive public image coupled with aggressive deal prospecting and fund promotion in Arkansas.
3. The highest level of investment or co-investment in Arkansas projects in absolute terms and in relationship to AIF commitments and fund marketing agreements.
 - a. An Arkansas project has historically been defined as one having fifty percent (50%) or more of its assets or employees located within the state. Going forward, an Arkansas project shall only be defined as having fifty percent (50%) or more of its employees located within the state.
 - b. Co-investment is defined as an investment by another entity (other than the fund(s) to which AIF has made a commitment, and their successor funds as applicable) in a project in which the fund has invested at the same time under the same terms and receiving the same benefits as the fund investment.
 - c. Level of investment or co-investment is calculated by adding the two together. For example: if a fund makes a \$250,000 investment in an Arkansas project and attracts an additional \$750,000 in investment(s) from other sources at the same time under the same terms and receiving the same benefits, \$1,000,000 is the level of investment or co-investment in the Arkansas project.
4. The active addressing of one or more of the private equity and venture capital areas of the risk spectrum in Arkansas, in small and mid-sized businesses and in prominent or emerging state industries.
5. A highly cost effective program as measured both by cash-on-cash return to AIF on investments (including total costs and fees to the state) and the impact of the investments on the state economy.

Funding Mechanism

AIF is capitalized through the use of an ADFA guaranty backed first by \$10 million from its Bond Guaranty Reserve Account and second by an Arkansas income tax credit allocation of \$60 million on a contingent basis. The most recent review by the Standard and Poor's rating agency of the ADFA Bond Guaranty Program indicated that the \$10 million first loss pledge has not negatively affected the current "A+" rating of the program. The financing facility is rebid on a periodic basis. Bank of the Ozarks is the most recent successful bidder and held the loan during 2016. On March 31, 2017, AIF entered into a loan agreement with ADFA. The proceeds from this loan were used to repay AIF's outstanding loan to Bank of the Ozarks. The current outstanding balance owed to ADFA is approximately \$24 million. The loan is current and compliant with all covenants of the loan agreements.

If the tax credits are ever needed by the ADFA to meet a call on a guaranty after the use of the Bond Guaranty Reserve Account, the credits may be utilized by the lender or sold to raise cash to meet the further guaranty obligations. AIF has established tax credit purchase contracts at par with six major Arkansas income tax payers for that purpose, or may competitively market tax credits to the statewide pool of all income tax payers. Distributions from AIF portfolio funds are used to pay down the line balance. This fiscal year showed an additional \$3,838,22 in distributions to AIF from its investee funds.

2016 Activities Audit

- The AVCIT is in the process of finalizing the fund manager transition from Cimarron Capital Associates I, LLC. The ADFA Board of Directors named The Arkansas Venture Capital Investment Trust as the Replacement Fund Manager effective January 1, 2016. ADFA is in the process of finalizing a contract with the Replacement Fund Manager to provide administrative services.
- As of December 31, 2016, AIF's current line of credit was held by with Bank of the Ozarks. This line provides the financing capability to meet all current needs and cover all current commitments. In 2015 2016 the financing facility was re-evaluated and, given the rising interest rate expectations, plans were instituted to set a portion of the underlying debt support into a longer term fixed rate vehicle. On March 31, 2017, AIF entered into a loan agreement with ADFA. The proceeds from this loan were used to repay AIF's outstanding loan to Bank of the Ozarks. The current outstanding balance owed to ADFA is approximately \$24 million. The loan is current and meets all current needs to cover existing commitments. AIF will continually evaluate, and implement as warranted, potential improvements in funding structure efficiencies particularly given the changing economic factors.
- AIF reviewed all quarterly and annual portfolio reports, attended all annual meetings of the investment portfolio and routinely discusses potential investment opportunities with the investment portfolio.
- AIF supports related development finance initiatives, including federal programs and those in the state (i.e., Genesis Incubator, the University of Arkansas' office of industry research, research and sponsored programs, UAMS Bio Ventures, the Ark and Innovate

Arkansas, etc. and others) and participates actively in regional and national organizations contributing to the growth and expertise in related finance areas.

Investment Plan Implementation

To date, AIF recruited and considered 413 private equity, seed and venture funds that historically build and grow companies looking to work with those which are willing to make a commitment to aggressively address the Arkansas market. During 2015 AIF closed on a \$4.0 million commitment to Technology Operators Fund II, a \$57 million risk capital fund, the first in investment round two.

Prior years' closed commitments include: a \$100 thousand commitment to Fund for Arkansas' Future II; a \$5 million commitment to Noro-Mosely Partners VII; a \$4.0 million commitment to Fulcrum II Growth Fund; a \$4.0 million commitment to Memphis BioMed Ventures II; a \$2.0 million commitment to Meritus Ventures; a \$5.0 million to Noro-Moseley Partners VI; a \$4.5 million to Petra Growth Fund II; a \$4.5 million commitment to Prolog Ventures II; a \$100,000 commitment to the Fund for Arkansas' Future; and, a \$4 million commitment to SSM Venture Partners III.

Effective January 1, 2016, the AVCIT became replacement fund manager. The change in fund manager mandates that no new investment commitments shall be made by the AIF. The replacement fund manager is required to honor all existing investment commitments.

Progress on In-state Investment Goal

Through fiscal year end 2016, \$81.9 million has been invested in Arkansas companies by AIF funds, their co-investors and leverage made possible through their investments.

In-state investment in 2016 totaled \$3.3 million in four follow-on investments in Arkansas companies by AIF investee funds and their co-investors.

Over the life of the program the AIF targets \$2 dollars of investment for every \$1 dollar drawn by its investee funds.

Date	12/31/2016
\$ Drawn by AIF Funds	\$28,743,922
# of AR companies receiving investment	37
\$ Invested	\$26,981,125
\$ Co-invested	\$34,559,416
Subtotal investment	\$61,540,541
\$ Leverage	\$20,395,100
\$ Total	\$81,935,641
\$ received by AR companies per \$1 Drawn by AIF Funds	\$ 2.85

<i>Company Name</i>	<i>City</i>	<i>Description</i>
National Medical Solutions	Pine Bluff	wound care clinic
BioDetection - Vir. Inc.	Fayetteville	pathogen detection device
NanoMech - Vir. Inc.	Fayetteville	nano manufacturer
SFC Fluidics - Vir. Inc.	Fayetteville	microfluidic instrumentation
Vegrandis - Vir. Inc. **	Fayetteville	medical diagnostic device
Patriot BioFuels	Stuttgart	bio fuel producer
Balm Innovations	Little Rock	skin care products
Infusion Marketing	Little Rock	bank cross marketing
Ceton	Little Rock	cable tv hardware & software
Arkansas Automatic Sprinklers	Cabot	fire protection sprinklers
Duralor *	Fayetteville	nano particle coatings
Movista (Merchant View)	Fayetteville	IT systems for retailers
Collision Hub	Little Rock	auto collision industry web
Rx Results	Little Rock	prescription management
BlueInGreen	Fayetteville	water purification systems
Acumen Brands	Fayetteville	retail ecommerce websites
EZRA Innovations	Little Rock	drug development technology
Red Clay	Bentonville	crowd sourced product design
DataRank (TTAG)	Fayetteville	social analytics for products
Vivione Biosciences	Pine Bluff	bioscience
BRI/Mach	Bentonville	open price point goods supplier
The Ark	Fayetteville	business incubator/accelerator
Labscoop	Little Rock	sales of lab equipment
WellNow Urgent Care	Searcy	health care clinics
The Ark II	Fayetteville	business incubator/accelerator
Btiques	Fayetteville	web hub for boutique shops
Qbox (StackSearch)	Fayetteville	web data search & analytics
Bourbon & Boots	Little Rock	internet retailer
Treatsie	Maumelle	internet curated food collections
Ark Challenge III & IV	Fayetteville	business incubator/accelerator
HRM Services	Fayetteville	online HIPAA security manager
SpotRight	Little Rock	social media data for marketing
Now Diagnostics	Springdale	Medical Diagnostics Test
Hayseed Ventures	Fayetteville	Venture development company
Apptegy	Little Rock	Education software
RaiseTheMoney	Little Rock	Political Fundraising software platform
Menguin	Fayetteville	Retail ecommerce website

* merged into NanoMech in 2010

** merged into SFC Fluidics in 2012

Organization

ADFA was given the authority to implement a Venture Capital Investment Program during the Eighty Third General Assembly.

ADFA utilized a national RFP process to employ the program's Designated Investor Group (DIG). The Arkansas Legislative Counsel approved this professional services contract. The fund management portion of the contract was rebid in March of 2009 and Cimarron Capital Associates I, LLC, a successor to the original successful bidder, was selected as AIF fund manager. Based on past and current performance, the contract was reviewed and extended in December of 2013 and revised in January of 2015.

AIF is structured as an Arkansas limited liability company with two members, Cimarron and the Arkansas Venture Capital Investment Trust (an Arkansas public trust). In 2003 Governor Mike Huckabee authorized the establishment of the Trust to hold ADFA's equity interest in the AIF. The President of ADFA, the President of the Arkansas Science and Technology Authority and the Director of the Department of Finance and Administration serve as trustees for this public trust.

The ADFA Asset Commitment Committee, a committee of the ADFA Board of Directors provides oversight to the AIF program. The ADFA Board of Directors and the Department of Finance and Administration developed and put into place the permanent rules regarding the program. In 2003 the State Board of Finance approved the issuance of \$60 million in Arkansas state income tax credits, which have been transferred to the ADFA. A listing of the ADFA board members can be found at www.arkansas.gov/adfa/board.

The Arkansas Venture Capital Investment Trust compiled the statistical information and data supporting this report. The ADFA Board of Directors appointed the Arkansas Venture Capital Investment Trust as the Replacement Fund Manager effective January 1, 2016. ADFA is in the process of finalizing a contract with the Replacement Fund Manager to provide administrative services. The Arkansas Venture Capital Investment Trust, in its capacity as Replacement Fund Manager, is responsible for submitting this annual report.

Professionals and Advisors

The managing directors of Cimarron Capital Associates I, LLC are Michael A. Tharp, CFA and Robert G. Heard.

Gary L. Betow of the firm Conner & Winters provides general counsel legal services to AIF. Robert Smith of the firm Friday, Eldredge and Clark provides AIF with Arkansas tax and corporate counsel legal services. Robin Painter and Arnold May, both of the firm Proskauer Rose, and Robert Curry of the firm Conner & Winters, provide private equity, seed and venture capital legal advice to AIF.

Thomas & Thomas, LLP performs the annual financial audit as required by the ADFA.

Appendix A -- Summary AIF Financial Audit, Balance Sheet and Income Statement

BALANCE SHEET	12/31/2016
Assets	
Cash	125
Investments	16,996,241
Other Asset	<u>5,324</u>
Total Assets	17,001,690
Liabilities and Memembers' Deficit	
Liabilities	
Accounts Payable	36,215
Distributions payable to member	5,671
Line of Credit	<u>23,822,877</u>
Total Liabilities	23,864,763
Members' Deficit	(6,863,073)
Total Liabilities and Members' Deficit	17,001,690
INCOME STATEMENT	1/1/16 THRU 12/31/2016
Income	
Investment Income (Loss), Net	2,160,818
Expenses	
Fund Manager fees	20,000
Guaranty fee	50,000
Interest expense	746,143
Professional fees and investment expenses	121,732
Other	665
Total Expenses	938,540
NET INCOME (LOSS)	1,222,278
MEMBERS' DEFICIT, BEGINNING OF YEAR	(7,955,994)
Distributions to member	(129,357)
MEMBERS' DEFICIT, END OF YEAR	(6,863,073)