

Arkansas Institutional Fund

Annual Report

January 1, 2015, Through December 31, 2015

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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: July 11, 2016

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.

The annual audit of the activities conducted by the AIF can be found on page 10.

The review of the progress of the AIF in implementing its investment plan can be found on page 11.

There has been no use, 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).

The statistical information and data supporting this report was compiled by Cimarron Capital Associates I, LLC, which served as the Fund Manager through the year ended December 31, 2015. Effective December 31, 2015, the ADFA Board of Directors approved the termination of the DIG Agreement, and appointed 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 and relied on information compiled by Cimarron Capital Associates. The Arkansas Venture Capital Investment Trust shall compile the 2016 annual report and subsequent reports thereafter so long as it is Replacement Fund Manager.

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. Through 2015 AIF had 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. The second round was launched in 2014 with a plan to commit approximately \$30 million to eight to ten private equity, seed and venture capital funds. Commitments have generally ranged from \$2.0 - \$7.0 million in size and have been subject to ADFA approval. At fiscal yearend 2015, AIF has issued or closed on 12 commitments totaling \$38.2 million.

For fiscal year 2015, in-state investment showed an increase with aggregate funding of over \$5 million with \$4.7 million in six new Arkansas companies and \$325,000 in four follow-on investments in Arkansas companies by AIF investee funds and their co-investors. This fiscal year continued the trend of earlier than expected returns with an additional \$6,562,738 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 2015 were to consider AIF's longer term financing strategy in the face of potentially rising interest rates, to continue to recruit additional tax credit purchase consortium members, to close on outstanding conditional commitments as warranted and to select and make commitments to qualified groups with demonstrated, successful investment track records and a strong strategic fit with and commitment to Arkansas investment opportunities.

In 2015 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. The Arkansas Teacher Retirement System was identified as a possible source for this debt. While efforts were made on the purchase consortium, no additional members were added. One outstanding commitment to a venture fund was closed in 2015 to commence investment round two.

In 2014, an independent professional assessment of the economic impact of the AIF and other programs of the Arkansas Venture Capital Investment Trust was performed and an economic impact report was produced as the result of the assessment. The conclusion of the assessment states, "*All total, the AIF created an economic impact of \$401.1 million in Arkansas from 2004 to 2013.*"

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 expects 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. The cash surplus generated through disciplined investment becomes an on-going resource for development finance activities.

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

The AIF program is based on principles that emphasize the use of private sector expertise and traditional investment disciplines. In building new capital companies in the state, ones that will endure for many years, there is no substitute for a careful investment process that seeks out the best talent available to serve the needs of Arkansas businesses. The following are basic 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.
- ◆ Risk capital is best provided and managed by qualified, professional investment groups.
- ◆ A responsive state program can demonstrate to potential investors the high level of commitment Arkansas has for entrepreneurial ventures.
- ◆ 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 successful targeting of venture investments to the state requires the careful selection of fund managers who can demonstrate the ability to successfully invest in economic sectors that are indigenous to or developing within the state. Such managers must commit to marketing their resources aggressively, to being highly visible to their primary markets within the state and to taking actions that help build the permanent presence of venture capital talent within Arkansas.

Investment Objectives

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

1. The highest possible risk adjusted rate of return as measured by cash on cash returns net of all fees, expenses and carried interests.
2. A reasonable diversification among investments within the total AIF portfolio.
3. A limited life structure that aligns fund management, general partner and limited partner interests and goals.
4. A distribution policy that returns cash to limited partners as rapidly as possible, consistent with the full deployment of assets, given the nature of the underlying portfolio.
5. An allocation policy that minimizes tax consequences.
6. A structure that recognizes AIF's regulated investor status.

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 is defined as one having 50% or more of its assets or 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.

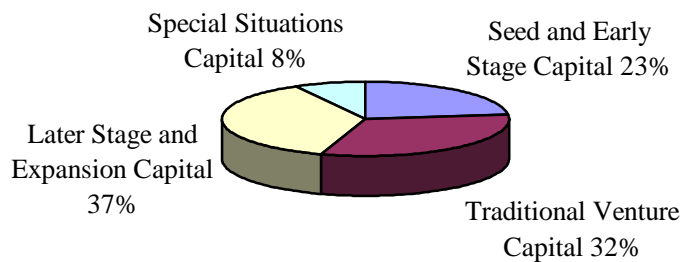
Funding Mechanism

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. 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 earlier than expected \$6,562,738 in distributions to AIF from its investee funds.

Resource Allocation Targets

It is AIF's intention to catalyze the formation of risk capital from early stage seed capital through later stage capital and special situations. AIF, over time, is committing approximately \$70 million to private equity, seed and venture capital funds that provide seed and early stage capital, traditional venture capital, later stage and expansion capital, and special situations capital, in approximately the percentages of 23%, 32%, 37% and 8%, respectively.

Allocation Targets



Until such time as AIF determines otherwise, these percentages will continue to serve as approximate targets for AIF across its portfolio of investments. The allocation plan may be modified from time to time based on unique opportunities and perceived shifts in the market demand for capital.

Activities Audit

- AIF's current line with Bank of the Ozarks provides the financing capability to meet all current needs and cover all current commitments. In 2015 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. AIF will continually evaluate, and implement as warranted, potential improvements in funding structure efficiencies particularly given the changing economic factors.
- AIF held follow-up meetings with candidates for the tax credit purchase consortium. While some progress was made, no new commitments were obtained this year.
- AIF reviewed and/or interviewed 413 private equity and venture capital funds.
- One new conditional commitment to a risk capital fund was closed, the first in investment round two.
- AIF is serving as an advisor to the Northwest Arkansas growth capital initiative which is working to put together a substantial early stage fund.
- 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 and others) and participates actively in regional and national organizations contributing to the growth and expertise in related finance areas.
- AIF, with its ad hoc leadership group, actively participated in drafting research park enabling legislation. As a result, Act 1045 was passed in the 2007 Arkansas General Assembly and in 2008 the Chamber employed a nationally recognized group to develop and present a plan. During the course of 2009 the sponsoring institutions for the authority were identified and commitments obtained. The project now has staff and is in the implementation phase.
- A number of AIF investee funds employ Advisory Boards and/or a Regional Associate across or in specific areas of Arkansas to help them identify potential investee companies.
- Two AIF investee funds work on providing training to targeted groups on the effective use of risk capital.
- AIF supported ADFA in completing an independent professional assessment of the economic impact of the AIF and other programs of the Arkansas Venture Capital Investment Trust. An economic impact report was produced as the result of the assessment. The summary conclusion regarding the AIF was: *"All total, the AIF created an economic impact of \$401.1 million in Arkansas from 2004 to 2013."*

Investment Plan Implementation

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. The total of conditional and closed commitments is 12.

Prior years' closed commitments include: a \$100 thousand commitment to Fund for Arkansas' Future II; a \$5 million commitment to Noro-Moseley 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.

As AIF makes investments in funds, AIF requires that, during their investment period, they actively and aggressively prospect for deals in the state. SSM addressed this requirement by forming an Advisory Board made up of three Arkansas business leaders with access to local deal flow and by employing Ted Dickey as their Arkansas Regional Associate to help their firm source deals. Ted has chaired the selection committee of the Arkansas Venture Capital Conference. Prolog Ventures formed an Advisory Board made up of five Arkansas science and business leaders to help them access and assess Arkansas deal flow. In addition, they employed Mike Smith Jr. as their Arkansas Regional Associate. They actively co-led, with MB Ventures, a process for evaluating the UAMS intellectual property portfolio. The FAF is composed of approximately 50 Arkansas "angel" investors who source deals from throughout the state. MB Ventures took on the task of training scientists and academicians on how to commercialize science. Meritus Ventures trains rural entrepreneurs on the effective use of risk capital through one day "boot camps". Petra Growth Fund employed Todd Wood as their Arkansas Regional Representative to help source deals. Noro-Moseley Partners recruited a five member Advisory Board made up of people knowledgeable in the early stage deal flow stream in Arkansas. Fulcrum Equity Partners has employed Jeff Amerine as a Venture Consultant to help identify potential Arkansas investment opportunities. Both Noro-Moseley VII and FAF II continued their prior efforts with their respective new investment vehicles. Technology Operators Fund II has already made an investment in an Arkansas company and is actively seeking additional opportunities.

Progress on In-state Investment Goal

Through fiscal year end 2015, \$78.6 million has been invested in Arkansas companies by AIF funds, their co-investors and leverage made possible through their investments.

In-state investment continued to increase with the aggregate funding of \$6.1 million in six new and four follow-on investments in Arkansas companies by AIF investee funds and their co-investors. As the program continues to produce results various transactions demonstrate how the AIF program complements other Arkansas resources, including Innovate Arkansas, the Ark and ADA's Direct Venture Investment programs, to support Arkansas entrepreneurs.

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

Date	12/31/15
\$ Drawn by AIF Funds	\$28,307,434
# of AR companies receiving investment	37
\$ Invested	\$24,306,125
\$ Co-invested	\$33,909,416
Subtotal investment	\$58,215,541
\$ Leverage	\$20,395,100
\$ Total	\$78,610,641
\$ received by AR companies per \$1 Drawn by AIF Funds	\$ 2.78

<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 statistical information and data supporting this report was compiled by Cimarron Capital Associates I, LLC, which served as the Fund Manager through the year ended December 31, 2015. Effective December 31, 2015, the ADFA Board of Directors approved the termination of the DIG Agreement, and appointed 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 and relied on information compiled by Cimarron Capital Associates. The Arkansas Venture Capital Investment Trust shall compile the 2016 annual report and subsequent reports thereafter so long as it is Replacement Fund Manager.

Professionals and Advisors

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

Gary L. Betow of the firm Conner & Winters provides general counsel legal services to AIF. John R. Tisdale of the firm Wright, Lindsey & Jennings 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 is performing the annual financial audit as required by the ADFA.

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

BALANCE SHEET	12/31/2015
Assets	
Cash	180
Investments	<u>16,615,778</u>
Total Assets	16,615,958
Liabilities and Members' Deficit	
Current Liabilities	
Accounts Payable	20,987
Payable to Fund Manager	138,243
Distributions payable to member	121,782
Accrued interest payable	62,373
Line of Credit	<u>24,228,567</u>
Total Current Liabilities	24,571,952
Members' Deficit	(7,955,994)
Total Liabilities and Members' Deficit	16,615,958

INCOME STATEMENT	1/1/15 THRU 12/31/15
Income	
Investment Income (Loss), Net	4,786,576
Impairment loss	(311,994)
Miscellaneous income	<u>1,000</u>
Total Income (Loss), Net	4,475,582
Expenses	
Fund Manager fees	421,550
Guaranty fee	50,000
Interest expense	756,960
Professional fees and investment expenses	87,274
Other	6,368
Total Expenses	1,322,152
NET INCOME (LOSS)	3,153,430
MEMBERS' DEFICIT, BEGINNING OF YEAR	(10,987,642)
Distributions to member	(121,782)
MEMBERS' DEFICIT, END OF YEAR	(7,955,994)