

# The Abell Report

*What we think about, and what we'd like you to think about*

Published as a community service by The Abell Foundation

## Abell Salutes:

*"The Door"—for young people in East Baltimore, a school away from school, a home away from home—and for many, a family where there is no family.*

**"To equip and empower individuals and organizations, both Christian and secular, to fulfill the Biblical call to reconciliation, justice and renewal..."**

*Mission Statement, "The Door"*

The edifice at 219 N. Chester St. in the heart of old East Baltimore was once the Friedens Evangelical Lutheran church. It is not that anymore; the original congregants have long abandoned the sanctuary and moved on. It now houses "The Door," a community service agency carrying out the ancient mission of the old church in a way that surely would have pleased its founders: "Helping those," Door founder and President Joe Ehrmann puts it, "who need help." Here, over the course of the year, more than 350 neighborhood young people from ages six through 21 enjoy a school away from school and a home away from home; and for many, a family where there is no family.

### ***A Purpose In Common:***

The Door offers a variety of programs under at least five names. In-

*(continued on page 5)*

## Underfunded Venture Capital Pool In Maryland Puts Maryland's Hi-Tech Start-Up Businesses at Disadvantage

***67 Percent of Maryland's Start-up Technology-Related Businesses Say They Have A Need For Financing Not Available Through Banks. There Are Proven Solutions—If There Is Political Will***

Venture capital is the mother's milk of new business formation. It can make the difference between a healthy start-up business and an unhealthy one, and sometimes the life or death of one. Though the success of new business formations is vital to the Maryland economy, sixty-seven percent of technology-related Maryland businesses say they have a critical need for financing not available through commercial banks.

It follows that if Maryland hopes to stay competitive with other states in this area of economic development, it will have to develop programming that addresses this need. That need is underscored by recent findings:

- In a report by the Carnegie Commission Task Force on State technology policy, Maryland did not make it into the top ten states in appropriations for technology programs.
- In a study of publicly-funded state venture capital investment programs conducted in 1991, Maryland was ranked 11 out of 17 states in the amount spent on venture investments.

- In an examination of state pension fund-sponsored venture capital programs, Maryland lagged behind 10 other states in the amount spent on and percentage dedicated to venture investments.

The net results of Maryland's lackluster performance in providing venture capital to its emerging growth companies is only too clear: while other states are developing the venture capital needed to support the growth of start-up technology companies, Maryland is falling further and further behind.

As a result, it is the state's economy that is suffering; the state's leadership has its work cut out for it.

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### ***The Problem is a Capital Gap***

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According to a study of biotechnology funding by Dr. Zoltan Acs, Professor of Economics and Finance of the University of Baltimore, evidence suggests that active and experienced venture capital networks are

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critical to new business formation and regional economic development.<sup>1</sup> Mr. Acs found that "...Maryland has not developed the sophisticated 'venture capital networks' that are needed to promote science-based industries like biotechnology." He adds, "Among Maryland biotech firms using venture capital, only 43 percent obtain any venture capital from within the state, and that capital represents only a small portion of the total venture capital."

Mr. Acs also found that while there are 24 venture capital offices in the Baltimore-Washington region, the figure represents less than two percent of the entire U.S. venture capital industry. The average size of the Maryland firms is \$34 million, compared to the U.S. average of \$46.2 million.

According to Mr. Acs, given the percentage of Maryland companies engaged in biotechnology, Maryland should have between \$130 million and \$182 million invested by the venture capital industry. Instead, only \$84 to \$112 million of venture funding is invested in Maryland companies, a shortfall of \$18 to \$98 million in biotechnology alone.

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### ***The Private Sector Has Not Filled the Gap***

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In addition, according to a recent survey of 159 technology-re-

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lated Maryland businesses conducted by the Maryland Department of Economic and Employment Development (DEED), 67 percent expressed a critical need for financing the development of new products or processes—an activity not typically funded by commercial banks. As the survey points out, venture capital firms fund only those companies with healthy profit potential, leaving behind those with even moderate profit potential, many of whom nonetheless create jobs.

Similarly, because venture capitalists historically fund only those companies at later stages of development, many start-up and seed-stage companies are also left behind. For example, Mr. Acs points out that only 29 percent of the venture firms nationally have a specific preference for early stage investments. Walter Plosila, president of the Montgomery County High Technology Council, claims that early stage companies receive less than six percent of available venture funds.<sup>2</sup> According to the Acs study, in Maryland only three funds are dedicated solely to seed stage investments (Catalyst, Triad/Zero Stage, Calvert) while another six from D.C. and northern Virginia claim a preference for seed funding.

Clearly, the private sector has not filled the gap facing emerging Maryland companies. Given the shortage of private sector alternatives, high-tech entrepreneurs have turned to the state for assistance—only to find insufficient opportunities even there.

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### ***Maryland's Venture Capital Programs: Despite Successes, Less Than Impressive***

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Over the past several years, the state has made impressive strides in developing the infrastructure necessary to foster high technology industries. The accomplishments include: the Maryland Bioprocessing Facility, the Columbus Center for Marine Research, regional technology councils, business incubators, Maryland Biotechnology Institute, and Maryland Industrial Partnerships program (MIPS). Despite this success, however, the state's involvement in direct equity financing has been less impressive.

In 1990, the Maryland State Legislature approved the formation of the Maryland Venture Capital Trust, a non-profit intermediary charged with raising funds from the state employees pension fund for investment in private seed venture capital funds. In 1992 the Venture Capital Trust raised \$19.1 million from both DEED and the state employees pension fund which it has invested in seven private seed venture capital funds (\$1.6-million is still outstanding).

The Maryland Venture Capital Trust has been an important element in helping to establish and grow the "venture capital network." Unfortunately its impact will be limited: while \$19 million might appear to be a large amount, the size of the fund is actually disappointing compared to both the potential for its size and the record of the competition. Only one tenth of one percent of the state retirement funds are dedicated to this effort compared to two percent or

more found in California, Massachusetts, New York, Illinois, Connecticut, New Jersey, Ohio, Indiana and Pennsylvania, states ambitiously developing their high tech industries.<sup>3</sup> Another 12 states have programs in operation or under development with a number of them setting a five percent goal for economically targeted investments.<sup>4</sup>

Edwin Warfield, publisher of Warfield's, the popular local business magazine, points out in a recent editorial that if the state pension fund was to dedicate even two percent of its assets to venture capital, the fund would amount to \$300 million, and give Pennsylvania and Massachusetts a run for their venture capital money.<sup>5</sup> Even one percent (\$150 million) would be more than Connecticut, Ohio, Pennsylvania and Indiana dedicate to venture funding and would represent a significant improvement over current levels.

In addition, the trust has no authority over the investment criteria used by venture capitalists (beyond a stated preference for investing in Maryland companies.) As a result, the trust cannot utilize its funds (or any increase in funds) to specifically address the capital gap facing emerging companies.

Recognizing the need to help fill the capital gap, DEED recently announced the formation of the Maryland Enterprise Investment Fund (MEIF). MEIF will make equity investments of \$150,000-\$250,000 in high tech companies in information technology, telecommunications, biotechnology, health services, environmental services, manufacturing and aerospace. Two million dollars have been earmarked for the first year; one commitment of \$250,000 has been made in a biotech company.

Administered through the secretary's office, guidelines for MEIF have not yet been published. It is not clear how the funds will be managed and investment decisions made. Also unclear is whether the program will be independently managed, an important consideration in an election year.

In addition to MEIF, the state will continue to seek an increase in funding for the Challenge Investment Program which makes investments of up to \$50,000 in emerging companies. The program was capitalized at \$500,000 for fiscal year 1994. Ten firms received investments in fiscal year 1993.

Although the Challenge Investment Program is an important source of financing to emerging companies, it operates on too small a scale and too limited resources to make a significant economic development difference. It also falls under the umbrella of DEED and is, as a result, also vulnerable to political changes.

While impressive gains have been made, Maryland still lags behind many other states in the amount of capital available for and invested in emerging growth companies. The consequence, affecting everyone living and working in Maryland, is that the need to develop a critical mass of high tech companies in Maryland remains thwarted while other regions make meaningful progress.

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### *What the Competition Is Doing:*

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A number of other states have established their own seed venture funds to help fill the capital gap facing new enterprises. Successful

programs in Connecticut, Massachusetts, Indiana, and New York, among others, have helped those states to launch and sustain a critical mass of high-tech companies. Indiana has invested more than \$40-million to establish and develop 63 companies since its inception in 1983. Connecticut has invested \$18 million in 74 different projects over a 15-year period. By comparison, Maryland has invested only \$1.7-million in approximately 30 companies through the Challenge Investment Program since its inception in 1989.

According to a 1990 study, 23 states are running 30 different direct venture programs responsible for \$192-million in public venture capital.<sup>6</sup> Eleven used private managers, while 19 were organized as state corporations with authority to select and manage direct investments.

According to another study of 23 publicly sponsored seed funds, the average state-sponsored seed fund was capitalized at \$5.2-million.<sup>7</sup> The typical fund made 22 investments of \$264,000 which created 373 jobs and generated sales of \$49-million. On average, the funds recorded a failure rate of 8.5 percent.

Another study by Emory University Business School in 1991 examined 19 public and combination seed funds throughout the country and found \$211-million under management, an increase of more than 300 percent since 1988.<sup>8</sup> The average fund had a failure rate of 10 percent and \$2.4-million under management, made 36 investments, and created 635 jobs.

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## *Criticism and Other Points of View:*

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Support for programming to increase the state's pool of venture capital is not without its critics. Richard Florida and Donald Smith in their article in *Issues In Science and Technology*, "Keep The Government Out of Venture Capital" (Summer, 1993) argue that the numbers of jobs produced by start-up high tech companies are often inflated and that public venture capital programs are not cost effective. They point to a survey by the University of Wisconsin that finds taxpayers paying more than \$7,362 per job created.<sup>9</sup> Advocates respond to the finding that while the costs-per-job created appears to be high, it is actually minimal when compared to the costs to the state in foregone taxes and increased services of keeping one person on unemployment. Compared to the size of the grants offered by many states to lure manufacturers, the investments made by public venture funds are, they insist, a bargain.

Others argue that public investments should be managed by the private sector, not a public corporation or agency whose investment decisions may be driven by political motives or whose management may be less efficient than the private sector. Nearly 10 states allow private venture firms to manage more than \$75.6-million in public funds. Among the most successful of these is Pennsylvania, which has helped to generate more than \$1.5 billion in private venture capital through \$33-million of public funds invested directly into venture capital firms.<sup>10</sup> Publicly-sponsored seed venture funds have also met with success.

Clearly, not all public funds can be considered successful, and some states have abandoned their efforts. However, the failures are often attributable to problems with organizational structure, management and investment strategy. According to a Georgia Institute of Technology study, the success of these funds is directly related to the role of the public sector in managing the investments, the quality of the fund managers, and the target and size of investments.

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### *One Model: Massachusetts Technology Development Corporation (MTDC)*

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One striking model of success in state venture capital is the Massachusetts Technology Development Corp. (MTDC) which was created in 1979. Through a series of state grants totalling \$5.2-million along with \$2.9-million in federal EDA matching funds, \$8.1-million was utilized to establish MTDC, which is considered by many to be the most successful state-sponsored seed venture capital fund in the nation. Indeed, with a rate of return of 15.7 percent between 1979 and 1990, MTDC has outperformed some private seed funds and all pension funds.

Though MTDC has not generated the returns expected from a private seed venture fund (20 percent or more), proponents argue that the program accepts more risk than traditional funds. Additionally, MTDC is considered more economical than state technology grant programs because it is able to sustain its own operations, leverage other private

dollars, and recycle its money back into the technology community. Most importantly, MTDC has helped to fill the capital gap facing emerging companies in Massachusetts.

Because MTDC does not have to distribute money to shareholders or limited partners, every penny earned is reinvested in more companies. As a result, MTDC has invested a total of \$15.4-million in Massachusetts entities. Another \$2 million has been invested by MTDC for the Massachusetts Pension Reserve Investment Trust, which brings the total portfolio to \$17.4-million.

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### *MTDC's Results Are Impressive*

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The economic development results of MTDC are impressive:

- More than \$288-million in private capital is leveraged,
- 59 companies which generate \$450-million in sales and purchase more than \$100-million in goods and services have been established,
- 5,000 new jobs have been created,
- \$200-million in annual payroll is generated contributing \$11-million per year in state taxes and \$57-million per year in federal taxes.

From an economic development perspective, MTDC has invested \$1,600 for every job that it created (compared to \$169,000 per direct job spent by Alabama to lure Mercedes Benz). More importantly, the dollars spent represent an investment (not a grant) which will be repaid and reinvested in the economy. To put icing on the cake, the state has created a critical mass in several new

industries that have now begun to generate their own spin-off activity.

One weakness of public seed funds is that states usually need to subsidize operations or increase the capitalization of the fund in order to pay for operations. For example, private funds take two to five percent of the total capital for annual operations. For an \$8-million fund this amounts to an operating budget of \$160,000 per year, which is hardly enough to attract the staff necessary to run the fund. As a result, the fund must either increase the size of the capital base to make the operations more economical or seek a source of funds to subsidize operations.

In Massachusetts, the state subsidizes MTDC through a de facto loan of \$1.4-million paid out over 10 years. MTDC has since re-paid \$750,000 of the loan and the Commonwealth waived the remaining \$650,000. This "subsidy" of \$650,000 amounts to \$65,000/year, which is minimal compared to the return in taxes and jobs. Since 1988, MTDC has sustained its own operations through gains, interest and fees.

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## Conclusion

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In the past few years, Maryland has embarked on an ambitious and

commendable strategy to develop its high technology industries. Unfortunately, the capital gap facing emerging technology companies is still present.

The Maryland Venture Capital Trust has been an important first step in alleviating the gap but it does not go far enough. Even with an increase in funding (which is needed), a gap still remains due to the limited investment criteria of venture capital firms. The Challenge Investment Program, while important, has been subject to limited resources and scale, offering little hope of providing a solution. It is too early to know how the Maryland Enterprise Investment Fund will help, but the funding level should be increased to have any meaningful impact.

Although it is growing, the size of the private venture capital available is still too small to support the needs of the many emerging growth companies in Maryland. Public programs have proven insufficient. In order to develop high tech industries and to stay competitive with other states, Maryland needs to develop mechanisms that will make available more venture capital for more emerging growth companies. A well-managed state seed fund will go a long way to help these companies meet their need for capital, and the state's need to provide it.

## "The Door"

(continued from page 1)

cluded: "Dooring the Week," "Community Anchor," "Family Matters," and S.T.O.M.P. (Skill-building Teen Occupational Mentoring Program). The varied programs have a purpose in common. Simply put, it is to provide young people of the neighborhood with the support they need to make it in the world. That means support for education; for enrichment and stability of peer, parenting and family relationships; for preparation for a place in the job market. It is a tall order, but by any measure, The Door is filling it.

### *Results are both soft and hard . . .*

The Door does it creatively and lovingly in classrooms and assembly areas, through volunteer and paid teachers and mentors, through the involvement of parents, professional counselors and community leaders. Results are both soft and hard.

For example, in a program designed to improve the reading skills of the students in the neighborhood elementary school (Commodore John Rogers Elementary, P.S. 27), The Door formed a partnership with ALPHA (literacy specialists), the school, and The Abell Foundation. Earlier, The Door had experimented with the effectiveness of ALPHA's learning methods with 28 students in a summer program. At the end of the nine week period the children had gained an average of one year in reading ability, with 40 percent making even greater strides. Results were so encouraging that, in the spring of 1994, with funding by The Abell Foundation, The Door undertook to provide the program in P.S. 27. This fall the program will be expanded to reach more than 40 children.

(continued on page 6)

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- 1 "Financing Maryland Biotechnology," Zoltan Acs, *Economic Development Quarterly*, Sage Publications, November 1992, p. 373.
  - 2 Letter to the Editor, Walt Plosila, *Issues in Science and Technology*, Fall 1993, p. 17.
  - 3 "The one Percent Solution: How to Create Thousands of Jobs, Part II," Edwin Warfield IV, *Warfield's Business Record*, June 18, 1993, p. 31.
  - 4 Edwin Warfield, *Warfield's Business Record*.
  - 5 Edwin Warfield, *Warfield's Business Record*.
  - 6 "State Venture Capitalism, State Politics, and The World of High-Risk Investment," Peter K. Eisinger, *Economic Development Quarterly*, Sage Publications, May 1993, p. 132.
  - 7 The 1989 Survey of State Sponsored Seed Capital Funds, Advanced Technology Center, Georgia Institute of Technology.
  - 8 Edwin Warfield IV, *Warfield's Business Record*.
  - 9 "Keep Government Out of Venture Capital", Richard Florida and Donald Smith, *Issues in Science and Technology*, Summer 1993, p. 66.
  - 10 Plosila, *Issues in Science and Technology*.

## "The Door"

(continued from page 5)

### *Attitudes, hopes, dreams . . .*

"The Abell grant," Ms. Elaine Kindler, director of development, says, "is enormously important to us. It allows us to take The Door beyond these walls into the world outside. It will give us the opportunity to help so many more young people."

But beyond the facts are the intangibles: the attitudes, hopes and dreams of the students and their teachers who are a part of The Door family.

Here is seven-year-old Tysheka: "I really like the tutoring in reading and arithmetic. If I weren't here at The Door, I would beg to get in!"

And 10-year old Michael "I like that when we have a problem, we can talk. Instead of fighting."

### *"The Door made learning interesting"*

A persuasive case is made by 15-year old Tarnisha. She was a student at The Door and is now back as part of the Junior Staff. She is a sophomore at Mergenthaler Tech, and has a report card showing that she is carrying six major subjects and that her grades range from 100 to no lower than 89. She will graduate as an L.P.N. and plans to go on to medical school.

"The Door made learning interesting for me," she says. It's the way the work is taught here. I was led to stick with a problem until I solved it."

And then there is Door student Ke-Nena: "I like to work the computers, but I like, too, to be able to talk with my friends about serious things. Things like drugs, and teen age pregnancy—there's a lot wrong in this world and I like to think what I learn at The Door will help me help people with these problems."

Ke-Nena is 10 years old.

## Some Recent Grants by The Abell Foundation

- Achieve the Dream Foundation** \$30,000  
Seed funding for a pilot entrepreneurship curriculum project to be developed and tested in Maryland's Challenge schools, those schools experiencing the lowest performance scores and having the largest minority student bodies with low self-esteem. The multi-discipline, four-week program for eighth graders and semester-long program for high schools will focus on reviewing case studies, meeting with successful entrepreneurs and developing business plans. Positive outcomes, measured by changes of career goals, number of entrepreneurship started, increased attendance rates, and decreased dropout and retention rates will be expected.
- Babe Ruth Birthplace Foundation** \$20,000  
Toward costs of the Babe Ruth League, establishing a baseball league for approximately 540 inner city children ages seven to ten years of age who have limited or no physical education opportunities.
- Baltimore City Public Schools/Ingenuity Project** \$92,600  
A three-year grant for an initiative to stimulate the study of math and science at an advanced level by offering 60 students from two schools the opportunity to attend an additional class a day "Scientific Process and Methods,") to work with mentors, and to compete in national competitions.
- Baltimore Development Corporation** \$60,000  
For a feasibility study of a proposed Aquatorium to be located in downtown Baltimore.
- Calvert School** \$691,738  
A multi-year grant for the continuation and expansion of the implementation of the Calvert School curriculum at Barclay Elementary School to be phased in over four years to include Barclay Middle School.
- Glenwood Life Counseling Center** \$95,000  
For costs to initiate a family planning program to include group and individual counseling sessions for clients receiving substance abuse treatment.
- Kids Voting Maryland** \$25,000  
To provide initial funding to establish a non-partisan pilot project to educate and involve children in the electoral process. Students in grades kindergarten through 12th grade from Harford County will participate in an eight-week curriculum designed to develop skills for gathering information about political issues and candidates and for making critical decisions.
- Light Street Housing Corporation** \$117,202  
Toward renovation costs of three houses for participants in the Support for a Change Program, a multi-faceted program designed to help homeless men find employment and affordable housing.
- Mid Atlantic Arts Foundation** \$5,000  
For seed funding for the three-day Mid Atlantic Jazz Showcase to promote jazz as a daytime family entertainment at Rash Field in August.
- YWCA** \$5,000  
For a part-time consultant to develop a residential drug treatment program to include an "Oxford House" concept living arrangement for substance abusing women and their children.