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Community Development Venture Capital

Producing Results for Entrepreneurs, Investors and Communities

SUMMER 2006

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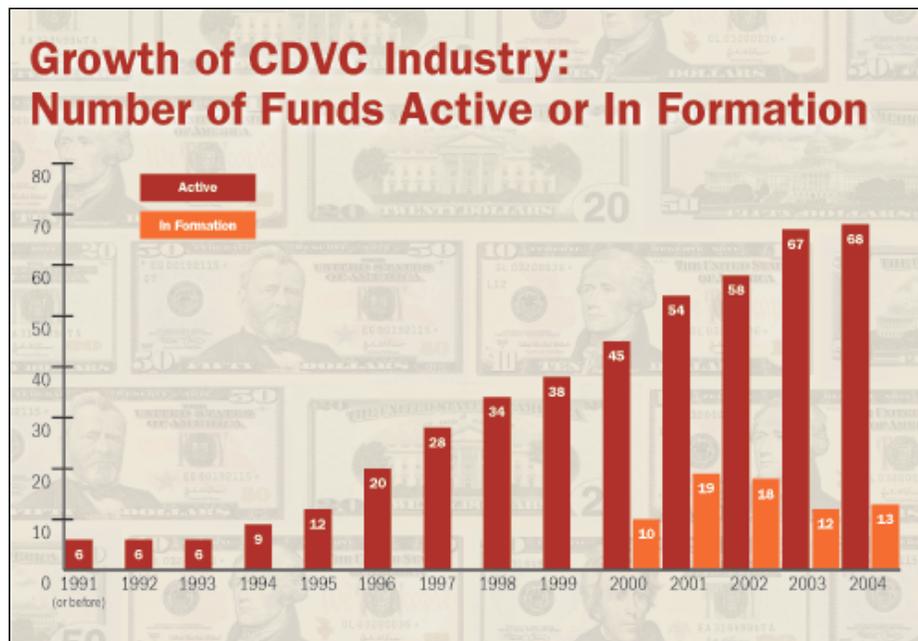
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*By Amy Simpkins
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Access to capital, particularly equity capital, is a barrier faced by many entrepreneurs looking to start and expand businesses in low-income and rural areas. However, these are the very areas where innovation and business expansion may have a significant impact on the health and vitality of local economies.

Community development venture capital (CDVC) is an equity financing tool that benefits both entrepreneurs and communities. [\(See related story below\)](#) Sometimes called “double bottom line” investing, CDVC funds invest in businesses in low-income areas, adding equity, entrepreneurial experience and ingenuity to underserved markets.

In the following interview, Kerwin Tesdell, president of the Community Development Venture Capital Alliance (CDVCA), answers questions about the CDVC industry and the power such equity investment can have on many local economies that need social and financial returns.



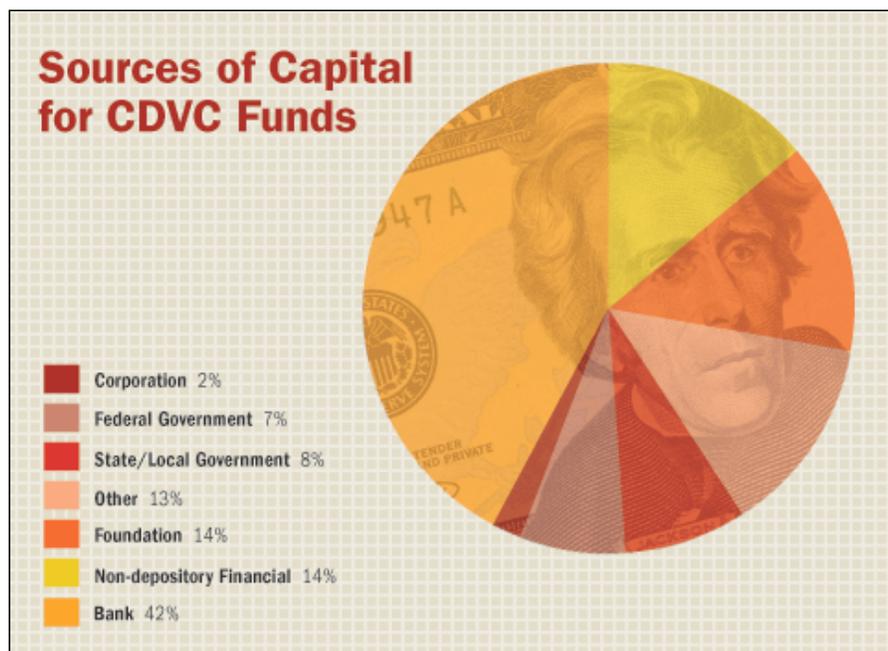
1. What do you mean by double bottom line investing?

Most venture capital funds have a single bottom line: financial returns to investors. CDVC funds are serious about providing market financial returns to investors, but they also focus on a second, developmental bottom line: creation of good, entry-level employment and the provision of equity capital to businesses in underinvested areas. This second bottom line does not have to detract from the first. Our funds seek out businesses whose success and rapid growth will satisfy both bottom lines.

2. Why do you think venture capital is an important part of community development?

Community economic development is fundamentally about making things happen in a business and in an economy that would not otherwise happen. Venture capital financing does that. When a smaller business wants to develop a new product line or finance a new plant, it cannot do so prudently with debt alone; it needs equity capital to expand. But equity capital is in short supply in most inner city and rural areas of the nation. Traditional venture capital is almost nonexistent, and low-wealth communities tend not to have the wealthy family members and angel capitalists who finance most businesses.

A dedicated source of equity capital can be a powerful force for economic development in a low-wealth area. Equity capital can help leverage larger amounts of more senior debt financing. In addition, CDVC funds become partners in the businesses in which they invest, sitting on their boards of directors, helping them with marketing plans, lining up customers, attracting other financing, and providing other assistance necessary to make sure the businesses succeed. The combination of equity capital and intensive business building is the most powerful model of economic development I know.



Banks often invest in community development venture capital (CDVC) funds as a way to help meet their CRA investment test criteria. Additional information about CRA-qualified investments may be found at www.frbsf.org/cdinvestments and at www.ffiec.gov/cra/default.htm.

3. Where do CDVC funds typically operate? Are there geographic areas of focus?

CDVC funds operate in underinvested inner-city and rural areas throughout the United States. Some operate in a single state or area, while others work in broader, multistate regions. In addition, CDVC funds are being established in other parts of the world, including eastern and western Europe, Asia, Africa and Latin America.

4. Is there a structure that is common in CDVC funds?

The vast majority of CDVC funds are established as for-profit LLCs or LPs with 10-year lives and traditional venture capital terms. These offer investors familiar financial terms. In addition, many CDVC funds have affiliated not-for-profit organizations that enhance the social value of the fund's investment activity by providing extensive pre-investment and post-investment support to companies, mentoring opportunities to entrepreneurs, and workforce development and wealth-building services to employees. Some CDVC funds, themselves, are organized as not-for-profit organizations.

5. Who typically invests in CDVC funds?

Banks are by far the largest group of investors, accounting for approximately 42 percent of all CDVC investments, and this percentage is increasing over time. Other important investors in CDVC funds include nondepository financial institutions, such as pension funds and insurance companies; foundations; federal, state, and local government; and wealthy individuals.

6. What is the average return on investment for CDVC funds and how do you measure the double bottom line?

CDVC is a young industry. No funds structured as limited partnerships or LLCs with limited life spans have wound up, so no definitive statistics regarding financial returns to LPs—comparable to the NVCA Yearbook statistics—can currently be compiled for this industry. However, to provide a preliminary answer to the question of financial returns in the industry, CDVCA assembled a model portfolio of all exited investments from the three oldest CDVC funds in the nation. We looked at all exits of investments made between 1972 and 1997. These include 24 full and partial exits and seven complete write-offs. This model portfolio yielded a 15.5 percent annual internal rate of return, weighted by dollars invested, including write-offs. Because the three funds studied were all perpetual life funds, and two of the three were not-for-profits, we would expect that returns for the newer for-profit funds with pressure to exit within a limited period of time will produce higher financial returns.

CDVCA and the CDVC industry have made great strides in the development of methods to measure social impact. In 2005, CDVCA released its Measuring Impacts Toolkit, which is a sophisticated methodology and survey instrument for measuring the social returns of CDVC investments. Among other things, the toolkit measures job creation, job quality and availability of jobs to low-income people. It also looks at such factors as where investments are located, dollars leveraged and tax dollars produced. For example, administration of this methodology shows that the average increase in employment in CDVC-financed companies is 89 percent, with a 124 percent increase in low-income employment and a 37 percent increase in middle- and higher-income employment.

7. Can you briefly describe any industry trends in CDVC?

Average fund size and investment size are increasing. CDVC funds are becoming more sophisticated, with more staff members having traditional venture capital experience. At least seven fund management groups in the industry have successfully formed second and third funds, indicating investor acceptance of the model. There is increasing co-investment, both within the CDVC industry and between the CDVC industry and traditional venture capital funds. While dollars from investors who are primarily socially motivated continue to increase in absolute terms, in percentage terms, market-rate investors such as banks, pension funds and insurance companies now dominate the industry. While in certain respects the CDVC industry is moving toward traditional venture capital in form, our data indicate that it is not losing its social impact.

8. What are the major challenges you see in making successful CDVC investments in the current market?

Quality deal flow is key to successful venture-capital investing of any type, and this is particularly true of CDVC investing. CDVC funds are expanding their geographic scopes and using increasingly sophisticated methods of deal-flow generation to meet this challenge. Management teams in portfolio companies are often less fully developed and experienced, requiring substantial entrepreneurial and managerial assistance from fund staffs. Exits present a challenge for the smaller companies and markets where initial public offerings are less common, and investment bankers are not roaming the streets looking for acquisition targets. These factors make the job of the community development venture capitalist even more challenging than that of

the traditional venture capitalist. At the same time, CDVC funds tend to be smaller than traditional funds because of the limited availability of double bottom line investment capital, yielding smaller management fees to pay staffs. The industry needs more \$100 million funds with the scale to fully fund the operation of a developmental venture capital fund.

9. If an organization is interested in forming a CDVC fund, what are the first steps you would recommend? What resources or tools could you recommend?

Think carefully about the goals of such an effort, the resources available and the market to be served. Learn from those who have gone before you. A first stop is CDVCA's web site, www.cdvca.org. Fund profiles and links to the web sites of leading CDVC funds provide a good introduction to the industry and contacts with leaders in the field. Twice a year, CDVCA offers an introductory training session designed for new entrants to the field, and our annual conference offers broad exposure to the industry. Finally, for more in-depth assistance, CDVCA offers consulting services to help organizing groups perform market studies, design funds, write business plans and offering documents, apply for government funding, and identify management teams.

About CDVCA

CDVCA is a network for the growing CDVC industry. CDVCA supports and promotes the CDVC industry through advocacy, investment, research, consulting, and communications.

CDVCA promotes using venture capital to create jobs, entrepreneurial capacity and wealth among low-income people and the economies of distressed communities.

CDVCA represents more than 100 member organizations from across the country.

To Timbuk2 and Back: Money Flows Both Ways

When Pacific Community Ventures (PCV) first came to know Timbuk2, it was a small firm specializing in the niche market of bicycle messenger bags. But the fund managers at PCV saw something special in this small company and decided to invest in the business, its leadership and the employees.

What PCV saw was an investment opportunity poised for both financial and social returns. Timbuk2 had a thriving, high-margin e-commerce business, strong brand equity and scalable production capacity. Timbuk2's location in San Francisco's Mission District, a low- to moderate-income area, also appealed to PCV. The company employed 40 low- to moderate-income workers in its urban manufacturing facility, and 100 percent of its employees received health insurance, job training and strong wages.

Four years ago, PCV made its initial investment in the company. PCV is a 501(c)3 organization managing two profit-making investment funds with \$20 million under management. PCV targets areas that have traditionally not received venture capital, investing in and developing selected businesses that provide substantial economic benefits to low-income communities. These benefits are measured in terms of the number of jobs with good wages, comprehensive benefits and marketable skills that portfolio companies are able to provide to low-income individuals.

With PCV's investment and hands-on technical assistance, Timbuk2 reorganized its operations and management, expanded its product offerings distribution, and achieved profitability. In the process, the company's annual revenue more than tripled. The company now has distributors in Canada, Japan and Europe and its product line includes computer carrying cases and other urban-lifestyle bags and accessories, in addition to its well-known custom messenger bags offered on its "Build Your Own Bag" web site.

Through this infusion of capital and resources, the company was positioned for significant expansion that not only made a solid return for investors, but created a considerable benefit to employees and the low-income community where the business is located.

Initial investors saw a return of nearly four-and-a-half times their original investment in just three years. PCV's exit through the sale of the company to a private-equity investor group will provide the financial resources and strategic marketing expertise to fuel the next growth phase.

This exit does not mean the company will be leaving the community so many of its employees call home. In an era of outsourcing, the company is committed to maintaining its manufacturing presence in the Mission District. This dedication to the local economy means stabilization of jobs in an area with traditionally low employment rates and low wages.

The sale of the company is not only good for investors, but employees as well. The transaction triggered a significant cash bonus to Timbuk2's nonmanagement employees, who all participate in the company's Employee Wealth Sharing Program. The company program was established by the CEO and PCV as a part of their double bottom line investment strategy. Through this, lower-income workers share significantly in the financial value they helped create.

As a reward for their hard work and dedication, the wealth creation program distributed more than \$1 million to 40 employees in a one-time bonus. The cash payout to each employee was based on a formula accounting for tenure, grade level, annual salary and performance and was as much as twice employee's annual pay.

More than half the employees receiving the payout work in factory and warehouse positions and reside in low- to moderate-income communities targeted by PCV. In addition, PCV conducted on-site financial management workshops for employees receiving cash

payouts to help them understand options for investing and saving the money through programs such as the company's 401(k) retirement fund, 529 education savings accounts and other personal investment tools.

PCV's cofounder and president, Penelope Douglas, sees the sale of Timbuk2 as a success in the community development venture capital field. Not only have considerable financial returns to investors been realized, but in providing equity capital to businesses in underinvested markets, significant returns have been made to the community through the creation and stabilization of good jobs, wealth-building opportunities and entrepreneurial capacity.

"Investment funds are judged on the quality of their investments and the ability to secure financially successful exits," Douglas says. "This double bottom line success will have important implications for the credibility of the community development investment movement as a whole. This is proof the model works."

—By Amy Simpkins



Timbuk2 employees receive a replica of a check for \$1 million, the amount of a cash bonus they divided when the company was sold. The payout was a result of the company's Employee Wealth Sharing Program. (Photo courtesy of Sing Tao Daily.)

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