Development Investment Capital:

Three Steps to Establishing an Asset Class for Investing in Underserved Markets

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I. Executive Summary—Development Investment Capital Must Become a Bona Fide Asset Class Within Private Equity

Nearly 5 million Californians—over 13% of the state's population—have incomes below the federal poverty level.[1] In 2005, more than half the jobs in the California economy provided full-time, year-round wages that were insufficient to support an adequate standard of living.[2] And, while the state's unemployment rate is down, the jobs being created tend to pay lower wages than jobs lost.[3] Within this economic context, Pacific Community Ventures (PCV), California's first community development venture capital organization, has pioneered and demonstrated an approach to economic development that provides competitive financial returns to investors as it creates quality jobs and an economic climate for growth likely to generate future investment opportunities in underserved markets and low and moderate income (LMI) communities.[4]

PCV has pioneered an approach it calls ***Development Investment Capital: Providing equity capital investment alongside other capacity-building resources to expansion-stage small businesses located in economically disadvantaged areas of California and successfully providing both quality jobs for low income workers and competitive returns for investors.***

PCV is on track to validate that investing in an array of traditional, brick-and-mortar businesses with revenues between $5 and $30 million that are located in distinct, untapped geographies can produce competitive financial returns alongside substantial social returns. Yet, in absolute terms, our impact on California's underserved communities has been limited, particularly when compared to the size of California's population living in these areas. Like other *Development Investment Capital* fund managers, PCV's funds, totaling $20 million, are relatively small in the private equity industry. Limited funds make sourcing deals more difficult, slowing capital deployment, exits and returns. Since investors want to see exits and return (liquidity) before investing, sourcing deals and deploying capital is critical. The small size of *Development Investment Capital* funds limits both the financial returns and the community benefits realized. If the status quo remains, the cycle that limits both the financial returns and community benefits realized from *Development Investment Capital* will continue—monies will continue to trickle into *Development Investment Capital*, and fund sizes will remain small, making deals difficult to source, slowing capital deployment, delaying liquidity, causing monies to trickle in, etc. ***Attracting capital investment to Development Investment Capital is essential.***

To expand, scale and fully realize the potential of equity investment in underserved communities—in both financial and social return—Development Investment Capital must become a bona fide asset class within private equity, routinely recognized by institutional as well as individual investors. Given that with limited capital, funds deploying Development Investment Capital have demonstrated that they can

[1] See "Budget Brief: A Growing Divide—The State of Working California in 2005"; California Budget Project, September 2005; Available at www.cbp.org.

[2] See "Working Hard, Falling Short: Investing in California's Working Families"; California Budget Project; January 2005; Available at www.cbp.org.

[3] Industries that experienced a net job gain between 2001 and 2004 paid an average annual wage of $38,693 while industries that had a net job loss paid average wages of $53,520. See "Budget Brief: A Growing Divide—The State of Working California in 2005"; California Budget Project, September 2005; Available at www.cbp.org.

[4] PCV defines LMI geographies as any census tract:

- At least 20% of the population is living below the poverty line; or
- Within a metropolitan area, the median family income is at or below 80% of the Metropolitan Area median family income or the national Metropolitan Area median family income, whichever is greater; or
- Outside a metropolitan area, the median family income is at or below 80% of the statewide, non-Metropolitan Area median family income or the national, non-Metropolitan Area median family income, whichever is greater; or
- The unemployment rate is at least 1.5 times the national average (the national unemployment rate was 5.8% in 2000).

Others in the Economic Development arena use the terms "underserved" or "disadvantaged" to include low- and moderate-income geographies as well as non-geographically defined markets including ethnic minority communities. In this paper, "LMI" is used interchangeably with "underserved" and "disadvantaged." These terms are synonymous in this paper and include both geographic low- and moderate-income geographies and ethnic minority communities. In many cases, these communities and geographies overlap.

provide competitive financial returns and risk diversification, along with community benefits, we must take steps to accelerate the pace at which Development Investment Capital becomes an established asset class within private equity. We believe three steps should be taken:

A. ***Policymakers should create incentives for investment and/or remove barriers to investment in funds that invest Development Investment Capital.*** The demand created by incentives, combined with continued demonstration of strong returns within the asset class, will push fund managers to create—and investors to fund—the broadly available investment vehicles that are necessary if *Development Investment Capital* is to scale up and fully realize its financial and social potential in a timely manner.
   1. The original objective of the federal New Markets Tax Credit (NMTC) was, in part, to facilitate equity investment in small businesses. Unfortunately, due to specific regulations within the legislation, the NMTC has facilitated investment in real estate in LMI communities, but has not worked for private equity. The NMTC should be extended and revised to facilitate equity investment in small businesses.
   2. Statewide incentives to encourage private equity investment in small businesses in underserved markets are essential. The California New Markets Tax Credit (CANMTC) legislation should be reconsidered and other options should be developed and evaluated.
   3. Other policy options, such as reducing capital gains, and creating mechanisms for individual investment, should be considered.

B. ***Investment managers should fully and accurately assess the community benefits that their Development Investment Capital investments are providing.*** *Development Investment Capital* fund managers have proven that this asset class can produce competitive, risk-adjusted returns. The additional community benefits that *Development Investment Capital* provides are a source of market differentiation that helps attract capital and justifies government incentives. To leverage this differentiation, *Development Investment Capital*'s community benefits must be evaluated and communicated.

C. ***Economic development and business professionals should join together to build capacity among small businesses in the underserved markets targeted by Development Investment Capital.*** Efforts must be made "on the ground" in underserved communities to create the positive, vibrant economic climate where small businesses can flourish. These efforts must include helping to empower existing strong businesses to gain equity financing and helping to build small companies into stronger businesses that may become targets for equity investment.
   1. The volume of businesses served by programs such as PCV's Business Advisory Service should be expanded.
   2. The types of services offered by programs such as PCV's Business Advisory Service should be expanded beyond capacity-building to include helping business owners prepare themselves and their businesses for private equity financing.
   3. PCV's Business Advisory Service model should be replicated in other organizations and regions.

II. Introduction: Investing for Financial and Social Return

A. *Background--Pacific Community Ventures.* Since its inception in 1999, Pacific Community Ventures (PCV) has pioneered an approach to equity investing and economic development that it calls *Development Investment Capital*, providing equity capital investment alongside other resources to expansion-stage small businesses in economically disadvantaged areas of California and successfully providing both quality jobs for low income workers and competitive financial returns for investors, all while helping to create an economic climate for growth likely to generate future investment opportunities. PCV has raised two private equity funds, Pacific Community Ventures Investment Partners I and Pacific Community Ventures Investment Partners II (PCV LLC I and PCV LLC II), totaling $20 million. We have made equity investments totaling $10.1 million in nine active companies, all of which are located in or near low/moderate income (LMI) areas of California and have workforces substantially comprised of residents of LMI communities. In addition to financing, PCV has provided strategic counsel, board-level support, access to business networks and other non-financial assistance to these companies. PCV's investments have been in traditional, "brick-and-mortar" companies, primarily in food, consumer products and business and consumer services. At the time of investment, these companies were at "expansion stage," generally had between $5 and $20 million in revenues, and were beyond market and product risk.

1. *Competitive Financial Returns.* In 2005, PCV completed its first successful investment exit, with the sale of Timbuk2 Designs, a manufacturer of custom messenger bags based in San Francisco's Mission District. PCV had invested in Timbuk2 in two rounds, in 2000 and in 2002. The sale returned over four times PCV's initial investment. As of the end of 2005, PCV LLC II achieved an implied net IRR that put it in the upper quartile of 2002 vintage funds while PCV I has recorded a competitive net IRR compared to other 2000 vintage funds.

   In February 2006, PCV completed its second successful investment exit. At Beacon Fire & Safety, a sales and services provider for fire and safety equipment, PCV invested in the second round of financing in September 2004. The company was successfully sold to large conglomerate Cintas. The terms of the Beacon sale include an "earn out" provision that is likely to result in a strong financial return to PCV.

   PCV currently holds other investments that are operating successfully and are well-positioned for an eventual healthy exit. Among these is Evergreen Lodge, a destination lodging facility near the entrance to Yosemite National Park. PCV invested in Evergreen Lodge in 2003. Since PCV's investment, the property has expanded from 18 to 70 cabins, revenue has increased more than eight-fold and the facility is operating at a healthy margin.

   In its seven-plus years of investment activity, PCV has refined its approach to investing in underserved markets and has redefined its investment criteria and targets. Initially, PCV invested in early-stage companies in underserved markets that often lacked experienced management or independent governance. For the last 5 years PCV has followed a successful investment strategy. PCV focuses on expansion-stage companies located in, or near, and hiring from, LMI areas, and that have proven products and markets, scalability, developed management and the potential for independent boards.

2. *Significant Social Returns.* As PCV has produced competitive financial returns, we have also produced significant non-financial outcomes, also called "social returns". Cumulatively through 2005, PCV's portfolio companies employed over 1,500 residents of LMI areas. On average,

these workers' wages are more than 20% above San Francisco and Los Angeles' living wages.[5] All of PCV's financed companies offer medical benefits and paid vacation to their employees. Nearly 90% of the companies offer dental benefits and paid sick leave. And all of PCV's financed companies provided trade-specific training to their employees.

Increasingly, PCV-financed companies are offering wealth-building plans to their employees. Two-thirds of PCV-financed companies offer retirement plans and one-third have stock option or phantom stock plans. Where possible, PCV negotiates "equity set-asides" at investment, which benefit workers from LMI communities at investment exit. For example, Timbuk2, the manufacturer of custom messenger bags noted above, had 48 employees at the time of PCV's exit, including 34 workers from LMI communities. At the company's sale, these 34 workers from LMI areas (along with 7 other non-management personnel) shared a $1.2 million payout, benefiting from the equity set-aside which PCV required at the time of investment. PCV conducted financial management workshops for these Timbuk2 employees prior to the distributions. More than three-quarters of the non-management employees diverted at least part of their distribution—funds totaling over $217,000—into 401(k) accounts, helping to build long term wealth. Further, PCV's model sufficiently impressed Timbuk2's senior management that the CEO included a similar equity set-aside in the company's agreement with new investors.

Beacon Fire & Safety employs ninety workers who are residents of LMI areas. Over 80% of these employees are eligible for health insurance coverage and for 401(k) accounts with company matching grants. Beacon's LMI employees are also eligible for Individual Development Accounts, another wealth-building vehicle, through PCV.

Evergreen Lodge employs 43 low/moderate income workers. Some of these workers are from the lodge's surrounding low income communities. Other low/moderate income employees participate in Evergreen's program to train Bay Area at-risk youth. As a seasonal business, Evergreen requires significantly more staff in the summer than in the winter. Accordingly, Evergreen works with a Bay Area nonprofit, Juma Ventures, a nationwide leader in combining employment and programmatic support to help young people, to identify, recruit and train at-risk youth who then spend a season working at Evergreen Lodge. These young people learn a specific trade and live in a supportive community, enjoying outdoor experiences that challenge, motivate and inspire. They also have access to college preparatory programs and counseling.

B. ***PCV's experience providing competitive financial return alongside positive community impact is not unique***. By focusing on underserved markets, private equity and venture funds across the country are providing significant community benefits as they produce financial returns that compare favorably to returns across the venture capital and private equity spectrums. Some of these funds focus on LMI geographies, while others focus on underserved market segments such as minority communities. In either case, these private equity investors are uncovering opportunities in markets that have traditionally been overlooked.

For comparison purposes, according to Thomson Venture Economics and the National Venture Capital Association, through third quarter 2005, all private equity produced a ten-year average annual net internal rate of return (net IRR) of 12.4% and a twenty-year return of 14.3%. All venture capital provided average annual net IRRs of 26.5% and 16.5%, for ten and twenty-year horizons, respectively. Later stage venture capital, perhaps most analogous to *Development Investment Capital*

[5] The average wage at PCV-financed companies in 2005 dollars was $13.18, compared to SF living wage of $10.77 and an LA living wage of $9.46.

because of its higher concentration in later-stage and non-technology businesses, provided returns of approximately 13% over both ten and twenty-year horizons.[6]

Several recent studies demonstrate the competitive nature of returns on investments in companies in underserved markets, when compared to broader private equity returns. In 2003, the Kauffman Foundation sponsored a study examining venture capital firms that concentrate on making equity investments in minority business enterprises which have historically been underserved by capital markets. The study looked at 24 venture capital firms making 117 investments in minority-owned businesses. All of the investments were fully-realized by 2000. These 117 investments produced a mean IRR of 23.9% and a median IRR of 19.5%. These returns are comparable to the performance of the Private Equity Performance Index, which produced a ten-year trailing average annual return of 20.2% as of early 2001. The Kauffman study reports that while technology companies were present in most portfolios, non-technology companies tended to dominate the portfolios of the funds in the study.[7]

The Initiative for the Competitive Inner City (ICIC), in partnership with Fintel, Inc., has shown that businesses located in America's inner cities—areas that are generally underserved—are relatively more profitable (measured as return on assets, net income over assets) than American companies overall. According to ICIC, in 2004, the median return on assets for all United States companies was 9%, compared to the median return for inner city companies of 9.9%.[8] While profitability does not automatically qualify a company for equity investment, nor does it translate directly to IRR, it is an obvious prerequisite. The ICIC study dispels any remaining notions that businesses in underserved markets cannot perform.

In addition to PCV, a number of other investment funds that focus on underserved communities have reported strong returns over the last several years. Kentucky Highlands Investment Corp., the nation's oldest community development venture capital fund, reports an 18% average rate of return over a 21-year history.[9] Kentucky Highlands works mostly in rural areas and focuses on investing in companies that create and retain jobs in Kentucky.

As early as 1993, Coastal Enterprises, Inc. (CEI), a Maine-based community venture capital fund, reported sixteen equity investments with an internal rate of return (IRR) of 17%.[10] CEI's successes have continued; in 2005, the fund reported realizing a seven-fold return on its 2001 investment in Recruiternet, a Portland, Maine, software developer. Currently, CEI manages two venture capital funds with total commitments of $25.5 million. These funds make equity investments in companies exhibiting the potential to grow profitably and provide attractive financial returns. At the same time, through these investments, CEI seeks "to create quality employment opportunities, to promote progressive management practices, to support socially beneficial products and services, and to enrich distressed communities."[11]

[6] Data from Thomson Venture Economics and the National Venture Capital Association available at http://bizayhoo.com/prnews/60130/nymo94?.v=30.

[7] Bates, Timothy and Bradford, Willian; "Minorities and Venture Capital: A New Wave in American Business"; Ewing Marion Kauffman Foundation; 2003; Available at www.kauffman.org. In particular, see page 4 of the study.

[8] Data provided at the 3rd Annual Summit of the Inner City Economic Forum, November 15-16, 2005 in Chicago. Presentation available at www.icic.org.

[9] "For Investors with a conscience, options grow"; Christian Science Monitor; September 19, 2005; Available at www.csmonitor.com/2005/0119/p13s01-wmgn.html

[10] "Poverty Alleviation Through Socially Responsible Investment—Case Studies of Community Investing and Social Venture Capital" (a Report to the World Bank Institute); Prepared by Jon Diagle, Carrie Hall, Rania Jamal, Kayja Silva-Leander and Elya Tagar; School of International and Public Affairs, Columbia University; May 2004; Available at http://www.ceiventures.com/images/World_Bank_Inst.pdf.

[11] Quote taken directly from CEI's web site, www.ceiventures.com.

Similarly, through its Boston Community Venture Fund, Boston Community Capital (BCC) has reported a number of successful exits, most recently TracRac, a Fall River, Massachusetts manufacturer of rack systems and power tool workstations.[12] BCC focuses on creating quality jobs in New England. Still more, SJF Ventures (SJF), a North Carolina venture fund, successfully exited its investment in DDF Cosmetics, a manufacturer of skin care products in 2005, realizing a return of three times its investment in less than three years.[13] SJF focuses on companies whose competitive strategies are based on environmental and workforce innovations.

Investors in these community-focused venture funds are often national, regional and local banks and other financial institutions. Some of these institutions were originally attracted to these private equity funds as a way to help meet the regulatory requirements of the Community Reinvestment Act (CRA), which went into effect in 1977. These same financial institutions have found that investing in community-focused private equity yields competitive returns. While there is no comprehensive study of banks' equity investments in economically disadvantaged geographies, at least anecdotally, we know that initially most banks hoped not to lose money on these investments, but today, they expect to make money through them.

III. Realizing the Full Potential of *Development Investment Capital*

PCV and others' experiences suggest that investing in traditional, "brick and mortar" companies in underserved communities can yield competitive, risk-adjusted financial returns alongside substantial social returns. Yet, in absolute terms, PCV and other existing *Development Investment Capital* funds have had a limited impact on California and the nation's underserved communities, particularly when compared to the size of the population living in those areas.

The volume of dollars under management at venture capital funds focusing on underserved markets has grown significantly, from $150 million in 1999 to $870 million in 2005.[14] But these funds remain a miniscule subset of the larger private equity industry; more than $170 billion flowed into private equity funds in 2005 alone.[15] According to the Milken Institute, of the estimated $95 billion in the US private equity market in 1999, approximately $2 billion, or 2%, was managed by firms "whose focus is supplying capital to entrepreneurs from traditionally underserved markets."[16] Regardless of how "underserved" is defined, it is much more than 2% of the market. According to the US Census' Survey of Minority-Owned Business Enterprises, 11% of all C Corporations and 10% of all S corporations in the United States were majority-owned by women or minorities in 1997.[17] Approximately, 8% of the United States population and of all private sector jobs are located in inner city or rural geographies, areas that are generally underserved.[18]

Development Investment Capital is currently a niche sector, generally limited to a small number of investment funds, primarily funded by a small number of progressive institutional investors (foundations and pension funds) and regulation-motivated investors. This niche status limits growth, which in turn

[12] See www.bcvfund.com/news/TracRac.html.
[13] See www.sjfund.com/index.cfm?fuseaction=Page.viewPage&parentid=25&pageId=174
[14] "2005 Report on Socially Responsible Investing Trends in the United States"; Social Investment Forum, page 28, January 24, 2006.
[15] "Going Private"; *BusinessWeek*; Issue number 3973; February 27, 2006; page 55.
[16] Quote taken from "AB 957 Assembly Bill-Bill Analysis"; January 5, 2006;, pages 5-6; available at http://leginfo.ca.gov/pub/bill/asm/ab_0951-1000/ab_957_cfa_20060104_165825_asm_comm.html. Note that the Milken Institute's definition of "underserved" may not be exactly the same as PCV's definition laid out in this paper.
[17] See US Census 1997 Economic Census Survey of Minority Owned Business Enterprises, Company Statistics Series, pages 10 and 13. Available at http://www.census.gov/prod/ec97/e97cs-7.pdf. Note: Data in this report was collected in 1997 and released in 2001. It is the most recent data available.
[18] See "Private Equity, Underserved Markets & the Double Bottom Line"; presentation by Dr. Michael A. Stegman of the Center for Community Capitalism at the University of North Carolina at Chapel Hill to the Small Business Investment Alliance on May 19, 2005. Available at http://www.kenan-flagler.unc.edu/assets/documents/cccDoubleBottomLine.ppt

limits the flow of capital to underserved areas, hindering job creation and purchasing power and thus curtailing the establishment and growth of new markets.

To expand, scale and fully realize the potential of equity investment in underserved communities—in both financial and social return—Development Investment Capital must become a bona fide asset class within private equity, routinely recognized by institutional as well as individual investors. In addition to providing competitive financial returns, *Development Investment Capital* also provides geographic, industry and often target market portfolio diversification for investors, making it deserving of its own asset class designation. As a recognized asset class within Private Equity, alongside Venture Capital, Buyouts, Mezzanine Capital, etc., *Development Investment Capital* investment will be represented in most diversified institutional portfolios. This representation will create demand for additional *Development Investment Capital* investment opportunities and will drive capital to underserved geographies and markets, creating jobs, bolstering purchasing power and helping to establish new markets, healthy for later investment.

Demonstration of competitive financial returns is a major step toward establishing *Development Investment Capital* as a distinct asset class. These returns, which will continue as additional early investments are successfully liquidated, provide a business case and suggest that the market is <u>gradually</u> creating this asset class. The shortage of jobs in the national and state economy that provide full-time, year-round wages that are sufficient to support an adequate standard of living suggests that we should take steps to accelerate the pace at which *Development Investment Capital* becomes an established asset class, to attract more investment to this category, benefiting both investors and workers.

To accelerate the process of firmly grounding *Development Investment Capital* as an asset class—and to fully realize its potential for financial and social return—additional steps are necessary. ***We believe that a three-pronged strategy should be employed to ensure that Development Investment Capital becomes a recognized asset class within private equity, providing solid returns and diversification to investors while at the same time creating jobs in LMI communities and building future markets.***

A. ***Policymakers should create incentives for investment and/or remove barriers to investment in funds that invest in Development Investment Capital.***

B. ***Investment managers should fully and accurately assess the community benefits that their Development Investment Capital investments are providing.***

C. ***Economic development and business professionals should join together to build capacity among small businesses in the underserved markets targeted by Development Investment Capital.***

The following three sections provide detailed support for these recommendations.

IV. Attracting Development Investment Capital Investment: Developing and Implementing Incentives

A. *Precedent for Government Action.* Many of today's widely recognized asset classes were non-existent or tiny niche categories as recently as the 1970s. In almost every case, government action—either the creation of incentives or the removal of barriers—was required to launch an asset class from near obscurity to the mainstream investment portfolio. Several examples can be found in the history of venture capital, mortgage-backed securities and, more recently, tax credits.

1. *Venture Capital.* Government action—the removal of the ban on pension fund investments in venture capital—opened up the floodgates to venture capital and the industry and asset class were launched. "Prior to the 1980s, venture capital was a cottage industry…The annual flow of money into new venture capital funds was never much more than $200 million, and usually substantially less…The Employee Retirement Income Security Act of 1974 (ERISA) prohibited pension funds from investing substantial amounts of money in venture capital…"[19] ERISA was amended in 1979 to permit pension fund investment in venture capital. By 1983, new commitments to venture capital funds approached $5 billion and remained near that level for most of the 1980s.

   The impact of allowing pension fund investment in venture capital is clear. In 1978, when $218 million was invested in new venture capital funds, individuals accounted for the largest share at 32%. Pension funds supplied just 15%. By 1998, when more than $17 billion was committed to new funds, pension funds accounted for 47% and individuals had fallen to just 11%. At its height in 2000, nearly $70 billion was committed to venture capital funds.[20] Absent government action removing the barrier to pension fund investment in venture capital, the industry would not have become the recipient of significant pension fund dollars, and might not have grown to be the substantial asset class that it is.

2. *Mortgage- and Asset-Backed Securities.* In 1968, when Congress established the Government National Mortgage Association (GNMA, a government-owned corporation, commonly known as Ginnie Mae), mortgage and asset-backed securities were non-existent. Since the establishment of Ginnie Mae, which pioneered the issuance of mortgage-backed securities with the guaranty of the United States Treasury, securitization has grown from a nascent industry in 1970 to $6.6 trillion as of mid-2003.[21] Absent government action, the mechanism for securitizing mortgages—providing liquidity to housing markets and spawning a new asset class—would not likely have been established.

3. *Low Income Housing Tax Credit.* More recently, the Low Income Housing Tax Credit (LIHTC) has attracted corporate and individual investors to this new asset class. The LIHTC was initially established in the Tax Reform Act of 1986 for a three-year period. The program was extended in one-year increments before being made permanent in 1993. By 2004, the LIHTC had stimulated the development of nearly 1.5 million affordable apartments in the United States.[22] Through syndicators (intermediaries) as well as through direct investment, corporations (and individuals,

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[19] Gompers, Paul A.; "A Note on the Venture Capital Industry"; President and Fellows of Harvard College, originally published in 1994, revised July 12, 2001; pages 7 and 8.
[20] Ibid, pages 25, 27 and 28.
[21] Statement of Cameron L. Cowan, Partner, Orrick, Herringon and Sutcliffe, LLP, on behalf of the American Securitization Forum, Before the Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, United States House of Representatives, November 5, 2003. Also see GNMA web site at www.ginniemae.gov/about/history.asp?Section=About
[22] "Ernst & Young's Fred Copeman on Housing Tax Credit Investments"; (E & Y partner discussing June 2004 study on LIHTC investment performance) transcript of interview available at http://www.ey.com/global/content.nsf/US/Real_Estate_-_Article_-_Copeman_-_Housing_Tax_Credit_Investments_-_Transcript

largely through publicly registered tax credit funds) have invested in these housing units and realized tax benefits from the housing credits.

According to a 2004 study by Ernst & Young, LIHTC investments have returned benefits that are approximately 1% higher than originally projected. Foreclosure rates have been below that of other real estate assets.[23] "Corporations have found that these investments are a great way for them to lower their effective tax rates, (and) to get some diversity in their investment portfolios…A number of risk factors are very favorable in this asset class."[24] Absent government action establishing (and making permanent) the LIHTC, over one million housing units may not have been built, and this investment asset class might not exist.

B. ***While the New Markets Tax Credit has been successful at bringing real estate investment—primarily debt—to low income communities, previous efforts at creating incentives for investment in Development Investment Capital—equity investment in small, growing businesses—have largely failed***. In addition to the clear precedent for government incentives to encourage *Development Investment Capital* investment, the US government has in fact made some effort to provide these incentives. The New Markets Tax Credit (NMTC) was created as part of the Community Renewal Act of 2000 with the goal to "create a federal tax credit that could do for community development what the Low Income Housing Tax Credit had done for housing.[25] To date, NMTC has been used to raise approximately $3 billion in private equity investment targeted to low income communities.[26] Investors have included large and small banks, unregulated financial services companies, insurance companies and investment pools managed by investment companies.[27]

However, the NMTC has largely failed to bring venture capital investment to small, growing businesses in underserved areas. While the NMTC has channeled capital to underserved areas, nearly all of the investment transactions utilizing the NMTC have been in real estate development and two-thirds have been in the form of debt, not equity. Further, of the 4% of NMTC transactions that are equity investments in non-real estate businesses, many of those have been for real estate-related purposes such as expanding or renovating plants and facilities.[28] Only a tiny proportion of NMTC have gone to equity investments in small, growing business operations.

While real estate development is critical to revitalizing neighborhoods, *Development Investment Capital*—private equity investment in small businesses in these communities—is equally vital to improving these geographies and growing new markets. In other words, debt financing is necessary for equipment and real estate, but equity is essential for the marketing, product development, management team expansion and working capital that growing businesses require. Building small businesses to occupy the real estate, and to create jobs that provide local consumers with purchasing power to spend in the retail outlets in the real estate, is crucial and requires equity investment.

In addition, *Development Investment Capital* investment comes with additional resources—management assistance, mentoring, access to business networks, strategic advising— that often do not accompany debt financing. These additional resources, often provided by private equity investors

[23] "Understanding the Dynamics II—Housing Tax Credit Investment Performance, Executive Summary"; Ernst & Young; June 2004; available at http://www.ey.com/global/content.nsf/US/Tax_-_Tax_Credit_Investment_Advisory_-_Overview
[24] Copeman interview, op cit.
[25] See New Markets Tax Credit Coalition web site at http://newmarketstaxcreditcoalition.org/who/newfiles/intro.htm.
[26] "New Markets Tax Credit Fact Sheet"; New Markets Tax Credit Coalition; available at http://newmarketstaxcreditcoalition.org/reportsETC/newfiles/fact&figure.pdf
[27] "New Markets Tax Credit Reauthorization—Questions and Answers"; New Markets Tax Credit Coalition; January 24, 2006; Available at http://newmarketstaxcreditcoalition.org/NMTC%20Reauth%20Q&A%20Letterhead%20FINAL.doc
[28] "New Markets Tax Credit—A Progress Report"; New Markets Tax Credit Coalition; May 2005; available at http://newmarketstaxcreditcoalition.org/reportsETC/reports.frameset.htm.

that share risk with portfolio company management, can make the difference between business growth and stagnation or bankruptcy.

C. *Making the New Markets Tax Credit work for private equity*. Currently, the NMTC is slated to expire in 2007. While Congress is debating legislation to extend it, it is critical that the NMTC be revised to better facilitate venture capital investment.[29]

1. Several revisions are needed to the provisions that stipulate how tax credit recapture—meaning that investors lose tax benefits realized previously, and often pay an additional penalty—can occur:

   a) Current legislation requires that investments be outstanding for seven years. However, equity investors need flexibility to exit at the right time. Nearly all equity investments, even those in brick and mortar companies, tend to have an exit horizon of less than seven years. The exit timeframe impacts the investment's internal rate of return, the primary financial yardstick used in the industry. The NMTC's seven-year horizon is counter to the private equity model. The artificial, arbitrary, seven-year constraint inhibits equity capital investment.

   b) Currently, the NMTC's "reasonable expectations safe harbor" contains a control criterion, defined as 33% ownership. As a result of this provision, if the company moves from a low income location and the equity investor's interest exceeds 33%, the NMTC is subject to recapture. This provision tends to attract real estate investments as, by definition, real estate is immovable. In contrast, venture-backed companies often grow and relocation makes sense for the company and its employees. Indeed, a company may grow and move its facilities outside of an LMI area but increase the number of employees it has that live in LMI areas. At the same time, within the world of institutional equity investing, as these investments grow, it is not uncommon for an investor's share to exceed 33%. This risk of recapture limits the venture capitalist's flexibility to maximize financial return, and thus repels capital, rather than attracting it.[30]

   c) Current legislation requires that the proceeds from one qualifying active low income investment (QALICI) received within the first six years after investment be re-invested in a new QALICI within one year to avoid recapture. Private equity investments are made as opportunities occur. Investors cannot be in a position where they have to invest to avoid significant negative financial consequences. Additionally, the private equity model generally calls for returning investment distributions to investors, rather than reinvesting them. Funds that succeed in providing competitive returns are generally well-positioned to raise new capital for future investments. An alternative approach to ensuring that NMTC proceeds are invested in QALICIs is to require that a minimum threshold percentage of funds invested *at any one time* be invested in QALICIs. This type of provision would ensure that funds are invested in companies in underserved markets while at the same time preserving the venture capitalist's flexibility to seize opportunity and provide competitive returns to investors.

2. The NMTC legislation should be revised to allow venture fund management fees to count toward meeting the "substantially all" test. The NMTC requires that "substantially all" of the proceeds be invested in qualifying investments. "Substantially" is defined as 85% for the first six years of an investment and 75% in the final year, leaving just 15% (25% in the seventh, final year) for non-qualifying investments and operating expenses. In the case of venture capital funds, where

[29] The authors would like to thank Julia Sass Rubin of Rutgers University for assistance with this section.
[30] See "Improving the New Markets Tax Credit Program for venture Capital"; NMTC report; January 2003; Volume II; Issue I; Published by Novogradac & Company, LLP; pages 1-2; Available at www.newmarketscredit.com.

returns come at investment exit and there is no current income, fund management must be paid out of contributed capital, out of this 15%, as well. Paying fund management fees out of contributed capital will likely violate the "substantially all" test. For example, "a fund that pays a 3 percent per year management fee over a typical 10-year fund life would pay out 30 percent in fees."[31] This typical fund would run afoul of the "substantially all" test. Counting reasonable management fees toward the "substantially all" test would help private equity funds work with the NMTC, helping to attract much-needed equity capital to LMI communities, maintaining the purpose of the original legislation.

D. ***Lack of investment in LMI communities is particularly acute in California and requires action at the state level.***

PCV's portfolio companies and small businesses like them are creating jobs in LMI communities in California, jobs that are critical to the state's economy. Employment at companies with fewer than 100 workers accounted for 54% of all jobs in California in 2004. Between the third quarter of 2001 and the third quarter of 2004, California employment at companies with fewer than 100 employees grew by 28% while employment at companies with 100 or more employees shrank by 3.8%. [32]

Small businesses located in and hiring from underserved areas are the engine for growth in those areas. Consumer spending accounts for between 60% and 70% of spending in the economy.[33] Consumers—particularly lower income consumers—tend to do the majority of their spending within a short distance of their homes. The importance of consumer spending, combined with lower-income consumers' tendency to spend in their local neighborhood, make improving purchasing power by providing jobs for residents of economically disadvantaged areas of California critical to revitalizing those areas. In short, equity investors in businesses that hire residents of underserved communities and that provide living wages and benefits can earn competitive returns while helping to create and grow new markets, markets that these same investors can capitalize on (through other investments) in the future.

Further, while California received approximately 20% of the $585 billion in venture capital investments made globally between 2000 and 2005, these investments were highly concentrated in the high technology and biotechnology sectors. Nearly 60% of all venture capital investments made nationally between 2000 and 2005 were investments in biotechnology and technology-related sectors.[34] Additionally, over 60% of venture capital investment in California during this period was concentrated in 35 zip code areas primarily in the Silicon Valley and economically well-developed areas of San Diego and Orange County.[35] Despite laudable efforts by the California State Treasurer's Office and the California Public Employee Retirement System through its California Initiative, capital flows to underserved markets in California remain insufficient. While incentives to encourage investing in LMI communities are important at the national level, they are especially critical at the state level. A California solution is required.

We understand that efforts have recently been made in the state Assembly to establish a new markets tax credit program in California. Assembly Bill 957, The California New Markets Tax Credit

[31] See "Improving the New Markets Tax Credit Program for venture Capital"; NMTC report; January 2003; Volume II; Issue I; Published by Novogradac & Company, LLP; page 4; Available at www.newmarketscredit.com.
[32] Data provided by the State of California Employment Development Department, Labor Market Information Division, available at http://www.labormarketinfo.edd.ca.gov/cgi/databrowsing/?PageID=67&SubID=138
[33] Steven Levy, Director, Center for Continuing Study of the California Economy, from "California Economy," Forum with Michael Krasny, KQED radio, September 27, 2005. See http://www.kqed.org/programs/program-landing.jsp?progID=RD19. Also see www.ccsce.com.
[34] PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association MoneyTree Survey, available at http://www.pwcmoneytree.com/moneytree/index.jsp.
[35] Based on data provided by Venture Economics.

Program Act of 2005 (CANMTC), which would have established a state-level tax incentive for investment in LMI communities, "died in committee" in January 2006. The CANMTC would have created a state tax credit designed to address the "unmet equity investment needs of small enterprises located in low- and moderate-income geographic areas."[36]

E. ***Creating statewide incentives that work within the private equity business model is essential.*** The CANMTC should be reconsidered and other options developed and evaluated. Under the CANMTC's recapture provisions, recapture would not occur if the underlying companies receiving equity investment relocate or if the investment is redeemed, as long as the overarching fund remains a "qualified community development entity."[37] The fund will remain qualified as long as its primary mission is providing equity capital to low-income communities, it maintains accountability to low-income communities, and it is certified by the Business, Transportation and Housing Agency of the State of California.[38] These recapture provisions are consistent with the private equity business model.

The CANMTC as currently written requires that "85 percent of aggregate gross assets of the qualified community development entity (be) invested in qualified low-income investments."[39] As with the national NMTC, the CANMTC should be revised to allow private equity funds to count reasonable management fees toward the requirement of investing 85% of gross proceeds in qualified low-income investments.

F. ***Federal and state tax credits are just one of many policy alternatives to encourage investment in Development Investment Capital.*** Additional policy options should be explored:

1. *Reducing capital gains taxes*. Reducing the capital gains tax liability when *Development Investment Capital* investments are liquidated would also serve as an added incentive to investors.
2. *Creating mechanisms for individual investment*. Over the past ten years, mainstream American consumers have increasingly invested in the stock market. In rapidly growing numbers, these consumers are investing in socially-conscious mutual funds, individual equities and community development financial institutions. As of 2005, assets valued at nearly $2.3 trillion were in socially responsible investment vehicles, up 258% since 1995. During the same period, the total universe of assets under management increased less than 250%.[40]

   Currently, we are not aware of any investment vehicles that enable mainstream Americans to invest in funds investing *Development Investment Capital*. Calvert Group, Ltd., one of the oldest and largest socially responsible mutual fund companies in the United States, has begun work in this area, providing individuals with the opportunity to invest in loan funds that provide credit to community development entities and micro-enterprises.

   Emerging trends suggest that individuals would like to be able to invest in businesses that benefit community at the same time that they produce competitive financial returns. In 2001, approximately $5 billion were invested in community investing assets, almost exclusively in community development banks, credit unions and loan funds.[41] At that time, the Community

[36] California State Assembly Bill No. 957, amended in assembly January 4, 2006, page 3.
[37] Ibid, page 25.
[38] Ibid, page 22.
[39] Ibid, page 22.
[40] "2005 Report on Socially Responsible Investing trends in the United States—10 Year Review"; Social Investment Forum; Washington, DC; January 2006. Available at www.socialinvest.org. See page 1.
[41] Community investing is defined as investments in community development banks, credit unions, loan funds and venture capital. Note that community development venture capital accounts for less than 5% of community investment while community development banks, loan funds and credit unions account for over 95% of community investment assets. A search of community development

Investing Program of the Social Investment Forum undertook a *"1% or More in Community"* campaign. The program encouraged investors to put at least 1% of their portfolio in community development financial institutions—banks, credit unions and loan funds—with the goal of increasing community investment assets to $15 billion by 2005. The campaign surpassed its goal, reaching nearly $20 billion by the end of last year.[42] There is no data on the proportion of these assets that are controlled by individuals rather than institutions. However, the Community Investing Program targets individuals and provides links to potential community development entities accepting individual investments in amounts significantly below the level which requires investor accreditation, suggesting that individuals are, in fact, making investments in these vehicles.[43]

Existing regulation around investor accreditation and the extensive and prohibitively expensive requirements for registering public partnership offerings make consumer investment in *Development Investment Capital* nearly impossible. Revisions to these regulations, or specific exemptions for *Development Investment Capital*, should be considered.

V. Enhancing Market Differentiation: Measuring and Reporting Social Return

Development Investment Capital fund managers have proven that this asset class can produce competitive, risk-adjusted returns. The additional community benefits that *Development Investment Capital* provides are a source of market differentiation that helps attract capital and justifies government incentives. To leverage this differentiation, *Development Investment Capital*'s community benefits must be evaluated.

Development Investment Capital investments can enable corporations, pension funds and financial institutions to align their interests—making profitable investments—with their stakeholders' interests in investing where they live, work and buy. In addition to direct profit motives, market pressures are causing corporations to increase their corporate citizenship activities, making investments in *Development Investment Capital* even more appealing. According to a 2005 study by the Social Investment Research Analysts Network, nearly 60% of S & P 100 companies are reporting publicly on their social and environmental performance. The United Nations Environment Program and SustainAbility, a corporate social responsibility think tank, report that the number of global corporations issuing annual corporate citizenship reports grew from "a few dozen to a few thousand" in the decade between 1992 and 2002.[44] Corporate CEOs, in a World Economic Forum survey, identified four primary reasons why they support corporate citizenship initiatives: Managing reputation and brand equity; attracting, motivating, and retaining talented employees; protecting license to operate; and enhancing competitiveness and market positioning[45].

To attract investors, fund managers should fully and accurately assess the community benefits that their *Development Investment Capital* investments are providing and communicate these benefits to policymakers, economic development professionals and investors. As noted above, Americans' appetite for investments that provide competitive financial returns alongside significant community benefits is

venture capital funds at www.communityinvest.org finds no entities that accept individual investments below a level requiring investor accreditation. See www.communityinvest.org

[42] "2005 Report on Socially Responsible Investing trends in the United States—10 Year Review"; Social Investment Forum; Washington, DC; January 2006. Available at www.socialinvest.org. See pages 28-35.

[43] See www.communityinvest.org

[44] "Trust Us—The Global Reporters 2002 Survey of Corporate Sustainability Reporting"; United Nations Environment Program and SustainAbility, 2002. See www.sustainability.com/downloads_public/insight_reports/trust_us.pdf

[45] "Responding to the Leadership Challenge: Findings of a CEO Survey in Global Corporate Citizenship"; World Economic Forum, 2002. Available at http://www.weforum.org/site/homepublic.nsf/Content/Global+Corporate+Citizenship+Initiative%5CReports

growing. Clearly articulating these community benefits can only help to attract additional funds to the asset class.

While there is some variation in reporting financial return, standard categories and calculations predominate. The same generally standardized reporting must become the norm in *Development Investment Capital* if the asset class is to scale and realize its full potential. Investment managers must collect a core set of social data, with additional data collection optional based on fund managers' needs. Standardized social reporting will:

- Make reporting the community benefits of *Development Investment Capital* investments timely and affordable for investment managers. Standardization will make reporting minimally time-consuming and will not detract from fund managers' or underlying company managers' core work.
- Enable the industry to demonstrate its community value in the aggregate. The industry's aggregate community benefits will be much more significant, likely to have greater impact—to attract more investment dollars—than disparate, splintered reporting by individual *Development Investment Capital* managers. As *Development Investment Capital* becomes an established asset class, total market size expands greatly, benefiting all fund managers, even if market share proportions remain stable.

VI. Building Deal Flow: Creating More Targets for Development Investment Capital

Building deal flow requires expanding small business capacity and bridging the gap between entrepreneurs in underserved markets and private equity investors. Through its Business Advisory Service, PCV addresses both of these needs to help build private equity deal flow in underserved markets.

A. Expanding small business capacity. Increasing capacity at individual small businesses in underserved communities helps build the next generation of deal flow. At the same time, building this capacity at promising small businesses operating in LMI areas positively impacts those companies' employees as well as the economy in the surrounding community. As small businesses in underserved communities grow, they stimulate the local economy through their own expansion, by employing residents of low-income communities in good jobs, and by adding economic vitality to neighborhoods that have lacked significant business activity. This economic vibrancy provides the climate that ultimately supports multiple businesses suitable for private equity investment.

As noted earlier, inner-city companies, which are often located in LMI communities, earn an attractive return on investment, one that compares favorably to companies in more traditional locations. But many inner-city businesses are too small in revenue to support equity investment. The median inner-city company had approximately $600,000 in sales in 2004, compared to over $4.5 million for all businesses in the country. Inner-city businesses need help building capacity and preparing themselves for long-term growth and private equity investment.[46]

Most private equity investors provide management and governance assistance to the businesses in which they invest. PCV goes two steps further:

- PCV provides a suite of non-financial resources including management assistance, mentoring, access to business networks and specialized expertise and strategic advice to its portfolio companies.
- PCV provides these services, free of charge, to other small businesses located in or hiring from economically disadvantaged areas of California.

[46] These statistics were provided by the Initiative for the Competitive Inner City, using data from the Ewing Marion Kauffman Foundation and Fintel, Inc. See www.icic.org.

Through its Business Advisory Services, PCV helps small businesses in underserved areas to flourish and enhance the economic vitality in their community. From its inception in 1999, through year-end 2005, PCV's Business Advisory Service has provided intensive support to over 80 companies, employing a total of nearly 2,500 workers. An estimated 50% of these companies' employees are residents of LMI communities.

In 2005, PCV commissioned BTW Consultants, a leader in program evaluation, to conduct an independent assessment of the impacts of its Business Advisory Program. BTW surveyed both advisors and advisees, through both written questionnaires and in-depth telephone interviews, to complete this assessment. BTW's study revealed that business owner advisees believe that participating in PCV's Business Advisory Services has had a positive impact on their businesses:

- On a scale of 1 to 5, where 5 means "strongly agree," the average response to the statement, "I have increased my capacity to grow my business," was 4.3. Mean score for the statement, "I have increased my capacity to manage my business," was 4.0.
- Two-thirds of business owner advisees reported that they had developed new business tools as a result of their advising relationship. An additional 30% reported reaching a new business development milestone (e.g., new customer or partner) as a result of their advising relationship. Finally, nearly 20% of advisees reported receiving new debt or equity capital as a result of their advising project.[47]

A. *Bridging the Gap Between Entrepreneurs in Underserved Markets and Private Equity Investors*

According to Inc. Magazine's annual survey of inner city businesses, the overwhelming majority—87%— of entrepreneurs used their personal assets as the primary source of start-up capital. More than one-third of these entrepreneurs started their businesses with $10,000 or less.[48] As small businesses grow, most entrepreneurs take on bank debt to support the next stage of growth, enabling them to continue to run their businesses with minimal "interference" from outsiders. As businesses reach the point where private equity investment is a viable option for later-stage expansion, entrepreneurs often know very little about how to attract private equity investors and are not accustomed to receiving outside management and strategic advice. Further, many businesses at this stage do not have the formal governance mechanisms that equity investors require.

In addition to providing capacity-building assistance, PCV's Business Advisory Services has also begun helping business owners located in or hiring from LMI communities to prepare themselves and their businesses for private equity investment. For example, in September 2005, PCV hosted a one-day workshop entitled *An Insider's View of Private Equity* in conjunction with the Inner City Economic Forum (ICEF) and Banc of America Capital Access Funds (BACAF). At this event, 28 senior executives from 18 inner-city businesses attended panel discussions and instructional sessions and received "coaching" from senior private equity investors.

Less than one month after *An Insider's View of Private Equity*, many of these inner-city business executives were among the 43 urban entrepreneurs representing 25 companies who attended *Inner City Capital Connections 2005*, hosted by BACAF and ICEF, where many were able to present their

[47] Source: "*Advising for Change: A Report on Pacific Community Ventures' Business Advisory Service*"; An independent assessment commissioned by Pacific Community Ventures; prepared by BTW Consultants; page 19.

[48] See "Creating a Marketplace for Inner City Investment: Risk and Rewards" presentation from the Inner City Economic Forum Summit, November 15 and 16, Chicago, available at: http://www.innercityeconomicforum.com/sitemanager/vsmICEF/bin/smRenderFS.php?PHPSESSID=b89d818162857bca6079e4d72bc871be&cerror=

businesses directly to the 44 representatives of 25 private equity funds in attendance.[49] In a post-conference evaluation, over three-quarters of companies agreed that the event helped them "reach a group of investors that I would not otherwise have been exposed to." Further, over three-quarters of fund managers agreed with the statement, "At this conference I expect to learn about at least one company in which I would consider making a potential investment."[50]

C. ***Building deal flow requires expanding and replicating PCV's Business Advisory Service.*** PCV's Business Advisory Services should be widely available to companies with less than $20 million in revenue that are located in LMI areas or hire a substantial proportion of their employees from underserved areas. While PCV has provided invaluable assistance to its advised companies, there are hundreds of businesses in California left untouched by our work that would undoubtedly benefit from participating in PCV's Business Advisory Services. Providing advisory services to these companies would help them expand their capacity and enhance the economic climate in their communities. Some of these businesses will likely grow to meet the thresholds required for private equity investment.

PCV is responding to this need. Through a public/private partnership with support from the California State Treasurer's Office, several foundations and individuals, PCV opened an office in Los Angeles in 2005, followed by an office in San Diego in early 2006. PCV expects to open a fourth office in Fresno, to serve California's Central Valley, in mid-2006. Each of these offices was opened initially to launch and provide Business Advisory Services to small businesses in underserved areas of its region. With "our feet on the ground' in these regions of California, PCV expects to expand its equity capital investing to these areas as well.

Further, PCV's Business Advisory Service should be expanded to include more direct assistance to get companies ready for equity financing. Additional services should include educational events to help management teams prepare business plans for equity investment review, public "forums" where "graduates" of these educational events can meet and "pitch" their companies to potential investors, and assistance establishing and recruiting the governance boards that are required to be in place before equity investors will consider investment.

Finally, PCV's Business Advisory Service model should be replicated in other organizations and regions across the country. PCV has expanded its services geographically across the State of California. But small businesses in underserved markets across the country need help building capacity to enhance the economic climate in their local communities, to spur job growth and attract investment.

VII. Looking Forward

America's—and California's—underserved geographies present an enormous opportunity for both financial gain and social improvement. Through fund managers that provide management and capacity-building resources in addition to capital, investors can integrate private equity investments in businesses in these communities into their portfolios, producing competitive returns, enhancing portfolio diversification and yielding significant community benefits.

As an established asset class, *Development Investment Capital* will deliver on this promise.

[49] Ibid

[50] "Feedback from ICCC: A Summary of Survey Responses from the October 6, 2005 Conference in Los Angeles"; prepared by Janneke Ratcliffe, Kenan Institute, University of North Carolina, in collaboration with the Bank of America and the Inner City Economic Forum.

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