

COMMUNITY DEVELOPMENT VENTURE CAPITAL: A DOUBLE-BOTTOM LINE APPROACH TO POVERTY ALLEVIATION

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The community development venture capital (CDVC) industry consists of domestic and international organizations that use the investment tools of venture capital to create jobs, entrepreneurial capacity, and wealth that benefit low-income people and distressed communities. CDVC providers make equity and near-equity investments in small businesses with the intention of producing a “double bottom line” of financial and social returns, including livable wage jobs and healthy communities. This paper describes and analyzes the domestic CDVC industry, compares CDVC to other forms of venture capital, and provides an overview of recent CDVC industry trends.

Credit alone is not the answer. Businesses must have equity capital before they are considered viable candidates for debt financing. Equity acts as a buffer against the vagaries of the marketplace and is a sign of the creditworthiness of a business enterprise. The more opaque the business operations, or the newer the firm, the greater the importance of the equity base.

Alan Greenspan

Federal Reserve Conference, March 1999

Access to equity capital is critical for business success, especially for young companies, which lack the cash flows necessary for debt repayment. The creation and growth of such companies is the path to revitalization for many depressed regions and a means to economic opportunity for low-income populations (Eisinger, 1988).

Fostering such economic revitalization is the goal of the community development venture capital (CDVC) industry, a group of domestic and international organizations that use the tools of venture capital to create jobs, entrepreneurial capacity, and wealth to benefit low-income people and distressed communities. CDVC providers make equity and near-equity investments in small businesses with the intention of producing a “double-bottom line” of financial and social benefits, including livable wage jobs and stronger communities.

Equity investments consist of preferred and common stock. Near-equity investments consist of debt that is convertible to equity and debt with warrants, royalties, or participation payments. Near-equity can be structured to act like equity, with deferred payments that give young firms the patient capital they need in their early years.

This paper will describe and analyze the domestic CDVC industry, compare CDVC to other forms of venture capital, and review recent CDVC industry trends. The data for this paper come from a multi-year, ongoing research project that is the first comprehensive examination of community development venture capital. It includes three years of open-ended interviews, case studies, and interactive surveys of all existing domestic CDVC providers. This paper updates earlier findings by including data through December 31, 2000.

The paper is organized as follows: The first section discusses community development venture capital in the context of other alternative forms of venture capital. The second section provides a history of the domestic CDVC industry. The third section describes the industry’s composition and capitalization. The fourth section analyzes CDVC investments. The fifth section examines fund-level issues, such as legal structures, boards of directors, investment committees, and operating costs. The sixth section discusses the domestic industry’s financial and social performance to date. The paper concludes with a review of recent industry trends.

Alternative Forms of Venture Capital

Community development venture capital has arisen in response to the limitations of the private venture capital industry. The most significant of these limitations is the fact that most regions of the U.S. have little access to private venture capital because the venture capital industry is geographically concentrated in only a handful of states. In 1999, just five states accounted for more than 67 percent of the total dollars invested in the U.S. (NVCA, 2000). Forty-three percent

of all the investments made by private venture capital firms went to the state of California alone, with 80 percent of that total invested solely in the northern California/Silicon Valley region (PricewaterhouseCoopers, 2000).

Even in those states where equity capital is more readily available, it is increasingly concentrated by industry and deal size. More than 90 percent of all private venture capital investments made during 1999 was in technology-related businesses (PricewaterhouseCoopers, 2000), and the average venture capital investment was \$13.2 million (NVCA, 2000). As a result, companies seeking investments of \$1 million or less, in non-technology related industries, have a very difficult time attracting patient capital. This difficulty is only exacerbated if those companies are located in low-income areas, which are often underserved by traditional financial institutions.

Federal and state governments have tried to address the limitations of the traditional venture capital industry. Both small business investment companies (SBICs) and state-sponsored venture capital programs were created for that purpose. Unlike community development venture capital, however, these approaches do not specifically target low- and moderate-income communities.

SBIC Programs

Congress created the Small Business Investment Companies program in 1958. At that time, the domestic venture capital industry was small and lacked a visible institutional structure (Fenn & Liang, 1995). SBICs were designed to provide early-stage business finance and thereby increase the supply of venture capital (Gompers, 1994). SBICs are privately owned and operated companies that make equity and debt investments in small businesses, with the intention of maximizing profits for SBIC investors. They are licensed by the U.S. Small Business Administration, which also provides them with access to matching investment capital. As of September 30, 2000, 336 SBICs were in operation with more than \$10 billion in private capital under management (SBA, 2001c).

In 1972, Congress expanded the SBIC program by creating Minority Enterprise Small Business Investment Companies (MESBICs) to provide access to equity and debt to minority entrepreneurs (Bates, 1997). MESBICs were subsequently renamed Specialized Small Business Investment Companies (SSBICs), and their mission was broadened to serve “the needs of entrepreneurs who have

been denied the opportunity to own and operate a business because of social or economic disadvantage” (SBA, 2001e).

In 1996, Congress ended the issuance of new SSBIC licenses but allowed existing SSBICs to continue operations (SBA, 2001e). As of September 30, 2000, only 59 of the 286 SSBICs licensed over the life of the program were still active. The 59 funds had a combined total of \$143 million in private capital under management (SBA, 2001d).

State-Sponsored Venture Capital

State-sponsored venture capital programs emerged in the early 1970s, at a time when the venture capital industry was underfunded and actually appeared to be in decline. Until that time, traditional state approaches to economic development had consisted almost entirely of “smokestack chasing” — the use of tax breaks, public subsidies, and relatively low wages to lure existing businesses from elsewhere in the country (Eisinger, 1988; Osborne, 1990).

The first state-sponsored programs were created in Connecticut and Massachusetts in the hope of addressing imperfections in the financial markets. In the late 1970s and early 1980s, a small group of former Massachusetts development officials helped diffuse the idea of state-sponsored venture capital funds to the rest of the nation (Osborne, 1990).

By capitalizing funds that invested only in specific geographies, states hoped to encourage local small business formation and growth in order to create jobs and enhance their tax base (Eisinger, 1991). As of 2000, more than 30 states were operating one or more such funds, with an additional 19 states offering tax credits or other incentives for individuals or businesses that made local equity investments (Barkley, *et al*, 2000).

Poverty Alleviation versus Growth: The Need for CDVC

Although both SBICs and state-sponsored venture capital were intended to spur economic growth and job creation, only SSBICs were created specifically to serve disadvantaged populations. SSBICs do so by investing in minority-owned businesses. For the most part, they do not take into consideration the economic standing of the entrepreneur or her employees. Furthermore, the majority of the 59 SSBICs that still operate are very small, with a median \$1.7 million of private capital under management (SBA, 2001d). The program’s small size significantly

limits its impact, especially since the SBA can no longer grant licenses to new SSBCs.

More generally, the broader economic growth objectives of the SBIC and state venture capital programs overlook the fact that such economic growth does not necessarily benefit all residents of the areas in question. This is illustrated by the recent experience of the Silicon Valley region.

From 1991 to 1997, the region underwent an unprecedented economic boom. Incomes for the richest fifth of the Valley's residents rose by nearly 20 percent, more than double the statewide rate. At the same time, real income for the poorest 20 percent of all Silicon Valley households fell by eight percent (Friedman, 1999).

Furthermore, employment in Silicon Valley's blue-collar industries fell by 20 percent, compared with a 24 percent rise in California as a whole, as the Valley's economy shifted away from its traditional manufacturing base toward high-end professional and lower-end service jobs. Manufacturing jobs have historically provided opportunities for the working poor to advance, and their decline helps explain some of the Valley's growing income inequality (Friedman, 1999).

In contrast to the SBIC and state-sponsored venture capital programs, the community development venture capital industry's primary purpose is to create high-quality jobs for low- and moderate-income individuals. The industry's mission is to alleviate poverty by making equity and near-equity investments in companies that create such jobs. This emphasis on poverty alleviation has been the focus of the CDVC industry since its beginnings.

History of the CDVC Industry

The current community development venture capital industry dates back to the 1960s and the origins of community development corporations (CDCs). CDCs were created in response to inner-city and rural poverty. The early CDCs received federal assistance under the Title VII program, in the form of grants for administrative overhead and program investment funds, which supported a broad range of activities. These activities included business and economic development, workforce training, and housing and community development (NCEA, 1981).

As a part of their business and economic development missions, a number of the CDCs used the federal funds they received to begin their own business ventures. Given the limited business experience of those running the CDCs, and the generally high rate of new business failures,

this proved an expensive and ineffective way to create community jobs (Miller, 1994).

In 1972, frustrated with the failure of this approach, one of the Title VII CDCs, the Job Start Corporation of London, Kentucky, began investing capital in outside entrepreneurs in exchange for an equity stake in their enterprises. In 1978, the CDC, renamed as the more business-friendly Kentucky Highlands Investment Corporation (KHIC), formed a venture-specific subsidiary, Mountain Ventures, to more aggressively pursue outside equity investments (Miller, 1994).

Kentucky Highlands felt that part of its mission was to “spread the word” about this new approach to community economic development (Miller, 1998). It was so successful in this effort that articles about KHIC began appearing in national periodicals such as *The National Journal*, *The Washington Post*, and *The Wall Street Journal* (Pierce & Hagstrom, 1979; Berry, 1979; Gigot, 1981).

At approximately the same time that Kentucky Highlands was experimenting with equity investments in private enterprises, a number of states were exploring the creation of venture capital funds. The Massachusetts Community Development Finance Corporation was signed into law in 1975 (Osborne, 1990). It was unique among state-sponsored venture capital funds because of its explicit focus on low- and moderate-income populations.

Community development loan funds (CDLFs) also have contributed to the evolution of the CDVC industry. CDLFs raise capital from socially-conscious individuals and religious institutions, which agree to a below-market rate of return on their investments if those funds are used for community economic development purposes. The loan funds then lend this capital to organizations, individuals, and businesses involved in such purposes, which have been unable to qualify for funding from more conventional sources (Stevens & Tholin, 1991). Several of the current CDVCs are subsidiaries of community development loan funds.

One of the oldest and best-known CDVC funds was created without the assistance of a parent organization or a state government. Northeast Ventures Development Fund of Duluth, Minnesota was launched in 1987 at the initiative of community leaders. The fund looked to local and national foundations for part of its capitalization and was able to convince both the Ford and the John D. and Catherine T. MacArthur foundations to make their first investments in a CDVC provider.

By securing funding from national foundations, Northeast Ventures also increased awareness of community development venture capital. This proved to be crucial in 1992, when several CDVC providers approached these foundations to ask for financial assistance with setting up a trade association.

With the backing of the Ford and MacArthur foundations, community development venture capital funds began meeting twice a year, comparing best practices and formulating plans for the future of the industry (Teddell, 1998). In 1994, the Community Development Venture Capital Alliance, the industry's trade association, was officially incorporated. Since that time, the industry has grown both in size and in public awareness, culminating with the December 2000 passage and signing of the federal New Markets Venture Capital legislation, designed to provide \$150 million in grants and matching capital to CDVC providers.

CDVC Composition and Capitalization

Current State of the Industry

There are more than 50 CDVC providers, actively investing or in formation, across the United States. Nineteen of them are dedicated specifically to making equity and near-equity investments. The term equity-focused will be used to describe these 19 funds through the rest of the paper.¹ An additional 13 make occasional equity and near-equity investments but primarily provide other types of financial products and services.² There are also more than 20 providers that are at various stages of fundraising but have not yet begun investing. In addition, several banks have subsidiaries that make CDVC investments, and various other organizations occasionally co-invest with CDVC funds.

Industry Capitalization

The domestic CDVC industry is capitalized at more than \$300 million. As of the end of 2000, the 19 equity-focused CDVC providers had a total capitalization of just over \$190 million (Table 1). Co-investment funds, bank community development corporations, organizations that made only occasional equity investments, and funds in formation accounted for an additional \$110 million.³

The average equity-focused fund is capitalized at approximately \$10 million. However, the median fund size is \$5.5 million, reflecting the disparity between the sizes of the largest and smallest funds. Newer

CDVC providers, which are not yet fully capitalized, account for four out of the six smallest funds.

The CDVC industry's total capitalization is dwarfed by that of traditional venture capital. As of 1999, traditional venture funds had over \$134 billion under management, and 20 percent of traditional funds had individual capitalizations of \$300 million or more (NVCA, 2000).

Although the CDVC industry is relatively small, it is growing rapidly. Only six of the 19 equity-focused funds are more than five years old. Furthermore, the industry's total capital under management increased by almost 60 percent between 1999 and 2000 (Figure 1).

Geographic Distribution

Most domestic CDVC providers invest in and are located on the East and West coasts of the United States and in the states of Minnesota and Ohio. At present, there are 26 states with no access to community development venture capital, including the majority of the states located in the Midwest, the mountain region, and the South (Figure 2).

Unlike the traditional venture capital industry, however, which consciously chooses to invest the majority of its resources in the technology corridors of California and Massachusetts, the absence of CDVC capital in so many states is primarily the result of the relative youth of the industry. Even in states such as California and Massachusetts, which have access to both traditional and community development venture capital, the geographic distribution of the investments is very different. Traditional venture capital is concentrated in high-technology regions, such as California's Silicon Valley and along Route 128 in Massachusetts. Conversely, CDVC investments are found primarily in low- and moderate-income areas, such as West Oakland, California and Roxbury, Massachusetts.

The CDVC industry is almost evenly divided between funds that focus on urban and on rural areas. Seven of the equity-focused funds have a rural focus, four have an urban focus, and five cover regions that include both rural and urban areas.

Sources of Capital

By far the largest share of total domestic CDVC dollars, approximately 31 percent, has come from banks and financial institutions. Moreover, banks and financial institutions are playing an increasingly important role in financing the CDVC industry. They accounted for 56

percent of the capital for the newer equity-focused funds that raised their capital and began investing between 1998 and 2000. This trend reflects the greater overall awareness of the CDVC industry and the increasingly favorable view that bank regulators have of CDVC investments as a way of meeting a bank's Community Reinvestment Act obligations (Figure 3).

Even as their share of total dollars is growing, banks continue to provide a relatively small percentage of the capital for rural CDVC providers. Through the end of 2000, less than 15 percent of all bank dollars invested in community development venture capital was invested in the seven rural funds. Furthermore, the two largest rural funds, Kentucky Highlands and Northeast Ventures, have received no bank capital at all.

There are several reasons for this. First, rural areas are served primarily by smaller banks, which are under less pressure to comply with the Community Reinvestment Act. Second, the smaller banks have fewer dollars to invest. Third, banks are generally more likely to invest in CDVC providers that promise a more market-like rate of return. This is an obstacle for rural funds, which face fewer investment opportunities and thus a lower quality of deal flow. Rural companies also can be difficult or time consuming to reach, increasing the time involved in overseeing an investment and raising a fund's cost of overhead.

The federal government is the second most important source of CDVC investment capital, providing 25 percent of all CDVC dollars. However, more than three-quarters of this capital was invested in just one fund — the Kentucky Highlands Investment Corporation (KHIC). KHIC received its initial capitalization during the 1970s from the Title VII program of the Office of Economic Opportunity. KHIC is also the lead entity for a rural empowerment zone, capitalized by the U.S. Department of Agriculture. Ninety-four percent of all the federal dollars invested in the other CDVC funds comes from the U.S. Treasury Department's Community Development Financial Institutions (CDFI) Fund.

Foundations and state and local governments were the third and fourth most important sources of CDVC capital. They provided 17 percent and 11 percent, respectively, of total CDVC dollars.

Capital Structure

The 19 equity-focused CDVC providers are capitalized primarily with capital grants and equity investments, which together account for more

than 80 percent of all their capital. In fact, more than half of the equity-focused funds are capitalized entirely with equity. Only three CDVC providers draw more than half of their investment capital from debt.

Program-related investments (PRIs) by foundations are the primary source of CDVC debt, accounting for 35 percent of all debt dollars invested in CDVCs. Almost 40 percent of foundation dollars invested was invested in the form of PRI debt.

The federal government and banks and financial institutions are also significant sources of debt, representing 26 and 21 percent respectively, of the total debt dollars invested in CDVCs. However, both provide significantly more equity than debt. Debt accounted for only 18 percent of the total dollars invested in CDVCs by the federal government and only 14 percent of the total dollars invested by banks and financial institutions (Figure 4).

CDVC Investments²

Dollars Invested

As of the end of 2000, CDVC providers had invested a total of \$129 million of equity and near-equity in their portfolio companies. The 19 equity-focused funds accounted for 90 percent of this total. The dollars invested annually have been increasing as new and larger CDVC funds have begun investing.

Stage and Industry Focus

A majority of all CDVC funds (90 percent) invest in companies at all stages of development, from seed to expansion stage, and in all industries. This strategy enables CDVC funds to consider the largest possible number of high-quality investments within their geographic regions.

CDVC funds that serve larger geographic regions are able to apply some sectoral screens to their investments. For example, the Sustainable Jobs Fund (SJF) invests, in part, in businesses in the recycling, manufacturing, and environmental industries. SJF focuses on the eastern United States, an area large enough to allow SJF to apply such screens and still identify sufficient high-quality deal flow.

Although few CDVC providers have a specific sectoral investment strategy, the majority of them do target companies that will create manufacturing jobs. They do so because the quality of manufacturing jobs is high, in terms of both wages and benefits. Manufacturing jobs can

also employ individuals with lower education and skill levels, making such jobs an important path to economic opportunity (Mayer, 1998; Phillips-Fein, 1998).

Fifty percent of all investments made by equity-focused funds through the end of 1999 were in manufacturing companies. Only 26 percent of the investments were in service-related businesses, the fastest growing segment of the U.S. economy, but one that tends to provide lower pay and fewer benefits to its workers (Figure 5).

Thirty percent of all investments made by equity-focused CDVC providers have been in technology-related companies. This is in sharp contrast with private venture capital funds, which made more than 90 percent of their 1999 investments in technology-related companies (PricewaterhouseCoopers, 2000).

Because of their rapid growth rates and profitable exits, technology investments have yielded large payouts for their investors. However, many of the jobs technology companies create require advanced degrees and are not available to individuals with less education and fewer skills. Technology investments are also concentrated in specific regions, such as Silicon Valley and Route 128, versus the low- and moderate-income communities that CDVC providers serve.

Co-Investments

Fifty-five percent of the investments made by the 19 equity-focused CDVC providers included another investor who was not part of the portfolio company's ownership or management. Forty-two percent of all CDVC co-investments were made by traditional and developmental venture capitalists. Angel investors were the source of an additional 38 percent of all co-investments. The remaining 20 percent were made by foundations, banks, community organizations, and local and state governments.

Deal Structures

Forty-three percent of the investments made through December 31, 2000, were structured as pure equity. This consisted of either preferred stock (26 percent), common stock (15 percent), or, in a few cases, membership shares in a limited liability company (two percent). Near-equity — debt with equity features, such as warrants, royalties, or participation agreements — made up another 10 percent of investments. Debt that is convertible to equity accounted for an additional seven percent.

The remaining 40 percent of investments were in the form of straight debt, primarily made in conjunction with equity or near-equity investments (Figure 6).

Fifty-eight percent of the straight debt investments were made by the two largest rural funds. This reflects the difficulty rural businesses have in accessing both debt and equity capital from traditional sources. The problem is particularly severe for young companies, which often lack the significant cash flows and collateral that bank lenders require.

Deal Sizes

CDVC investments range in size from \$10,000 to more than \$1 million per company. The average CDVC investment is \$186,000 per round and \$393,000 per company.

These figures are significantly smaller than the traditional venture capital industry's \$13.2 million average per round investment (NCEA, 2000). They are also smaller than the investments made by SBICs. As of the end of the 2000 fiscal year, average per round investments were approximately \$903,933 for participating security SBICs and \$432,571 for debenture SBICs (SBA, 2001a).

Investment Exits

Given the youth of the CDVC industry, any analysis of exits is based on limited information and is weighted towards the older funds. As of December 31, 2000, the 19 equity-focused funds had invested in 237 companies and had exited 63 of them. Thirty-seven of those exits were profitable.

The primary form of exit for CDVC providers has been through sale to an external buyer, which accounted for more than half of the successful exits to date. The second most frequent form of exit has been management buy-back, including the repayment of near-equity investments. Approximately half of the equity buy-backs were negotiated into the original contracts via a "put," which stipulated when and under what terms the stock would be repurchased by the company's owners (Figure 7).

Both external sales and management buy-backs are delicate undertakings for CDVC providers. When an outside company acquires a CDVC portfolio company, the portfolio company may be moved to another location or closed down entirely. On the other hand, new owners may also bring additional capital and expansion opportunities. In contrast,

management buy-backs usually ensure that a portfolio company will not relocate, but they may be less profitable than other forms of exit.

Because most CDVC investments are in early stage companies, it can take as long as seven to 10 years for these companies to have the cash flow needed to buy out their investors. The long holding period limits a CDVC provider's liquidity and cuts into an investment's internal rate of return.

Initial Public Offerings (IPOs) are generally the most lucrative means of exit for venture capitalists. But IPOs are still relatively rare for CDVC portfolio companies. To date, there have been five IPOs, including two whose stocks are still being held by their CDVC investors because of the stocks' low trading prices. As with the vast majority of recent initial public offerings, all five of the companies are in technology-related industries. Only 30 percent of all equity-focused CDVC investments are in the technology sector, versus more than 90 percent of traditional venture capital investments (Pricewaterhouse-Coopers, 2000). Additionally, only a few CDVC portfolio companies can demonstrate the significant growth potential that IPOs require. As a result, IPOs are unlikely to become the primary exit option for CDVC funds.

From the standpoint of social returns, employee stock ownership plans (ESOPs) appear to be the ideal exit option for CDVC-funded companies: they empower workers while ensuring that the company stays local. In practice, however, ESOPs can be costly to implement in the smaller companies in which most CDVC providers invest. As a result, as of December 31, 2000, there had been only one exit from a CDVC portfolio company via an employee stock ownership plan.

Twenty-six of the 63 CDVC exits to date have resulted in a partial or complete loss of capital. The loss rates for CDVC funds vary, as they do for traditional venture capital funds. Since the 26 failed CDVC investments are cumulative and represent a group of funds at various stages of development, evaluating these 26 investments as a percentage of total CDVC investments does not provide useful information.

It is still too early to determine whether CDVC loss rates will be greater or less than those of traditional venture capital funds. According to Venture Economics, over a sixteen-year period, more than one-third of 383 investments made by a group of traditional venture capital funds resulted in an absolute loss, and more than two-thirds resulted in capital returns of less than double the original amount invested (1988).

CDVC Structure and Practice

CDVC Fund Structures

Unlike traditional venture capital funds, which are for-profit and usually structured as either limited liability companies or limited partnerships, community development venture capital providers use a multitude of both nonprofit and for-profit legal structures. Seven of the equity-focused providers make investments through a nonprofit structure, nine others through a for-profit structure, and one through a quasi-public structure. Two of the funds make investments through both a nonprofit and a for-profit structure (Figure 8).

All but one of the nonprofit providers are structured as a 501(c)(3). The for-profit funds are more evenly divided by legal form, including five limited-liability companies, three limited partnerships, and three other corporate forms (C and S corporations).

The C and S structures are used primarily for subsidiaries of existing organizations. The advantage of these forms — their unlimited life span — can also make it more difficult for C and S corporations to attract investments. While it can be easier to raise capital for a CDVC with a limited life span, these structures force the general partners to raise money for a new fund every five to 10 years.

It is very common for a for-profit domestic CDVC fund to be affiliated with a nonprofit organization, which enables it to raise grant funds, helps it provide more extensive support to its portfolio companies, and supports other charitable activities. Ten of the equity-focused funds have used this “hybrid” approach.

At least two of the CDVC providers that are currently structured as nonprofits may subsequently convert to a for-profit structure. Both were set up by existing nonprofit organizations. Using a nonprofit legal structure to make their initial investments has enabled these organizations to move into this type of investing more gradually, without having to create a new organizational form.

Social Screens

Social screens are inherent in the idea of community development venture capital since CDVC providers focus on serving low-income populations and distressed communities. Beyond geographic targeting and job creation objectives, however, the CDVC industry is very diverse in the type and number of social screens that individual funds apply to their investments. This diversity reflects the fact that social screens can

restrict deal flow and thus may be difficult to use in many of the regions in which CDVC providers operate.

For example, the Kentucky Highlands Investment Corporation (KHIC) looks for investments that create jobs for low- and moderate-income individuals in its nine-county Appalachian area. The fund does little additional social screening since KHIC's deal flow is very limited, and the fund is concerned that the application of extensive additional social screens might leave it with few viable investment options. KHIC also believes that, in regions with very high unemployment and a large unskilled population, any job creation is beneficial.

Unlike KHIC, Coastal Ventures, LP (CVLP) uses a number of social screens in identifying its portfolio companies. CVLP is located in Portland, Maine and can invest anywhere in the state, as well as in neighboring states. Maine attracts many entrepreneurs, who move to the state for lifestyle reasons. Thus, CVLP's larger geographic area and higher quality deal flow enable it to impose additional social screens on its investments. For example, CVLP requires its portfolio companies to make the best effort possible to hire specific populations of workers and to provide them with health care and other benefits. CVLP also is able to give preference to companies with environmentally friendly products and socially progressive management practices.

Many CDVC providers give preference to companies owned by women or ethnic minorities. A subset of the traditional venture capital industry also focuses on these populations but does not screen its investments for their positive impact on low- and moderate-income individuals. There are traditional venture capital funds, however, that combine a focus on women- and minority-owned businesses with a limited geographic target area. By doing so, they restrict their deal flow and may encounter many of the challenges faced by CDVC funds.

Technical Assistance

One of the unique aspects of community development venture capital is the intensive technical assistance that most CDVC funds provide to their portfolio companies. Because the majority of CDVC funds are geographically restricted, they are faced with relatively few potential investment opportunities. This restricted deal flow may require the funds to invest in companies with limited management experience. As a result, the funds must find ways to bring in outside expertise to increase the companies' level of knowledge and market readiness. Outside consultants can be expensive for young companies, so most

CDVC providers use their own staff to provide that expertise. However, the extra time that staff invests in each deal increases the cost of operations for the funds and reduces the time that fund staff has available for other investments.

The high costs associated with providing technical assistance to their portfolio companies has led some CDVC funds to experiment with alternative ways of paying for such services. One innovative approach was piloted by Silicon Valley Community Ventures (SVCV), a two-year-old CDVC fund focusing on Northern California's Bay Area. SVCV created a Business Advisory Program, which recruits experienced business professionals to provide expertise to entrepreneurs on an ongoing, volunteer basis. SVCV only invests in companies that have gone through the Business Advisory Program, saving SVCV staff the time and resources needed to prepare potential portfolio companies for investment.

Another means of offsetting the cost of technical assistance is via a nonprofit affiliate that can raise grant revenues specifically for that purpose. The Sustainable Jobs Fund (SJF) has used this approach. SJF has partnered with the National Recycling Coalition (NCR), a 20-year-old nonprofit trade association that has been able to raise grants to help pay for some of SJF's ongoing technical assistance costs.

The Enterprise Corporation of the Delta (ECD), which serves the Delta regions of Mississippi, Arkansas, and Louisiana, has reduced the cost of technical assistance by relying on the services of alt.Consulting, a nonprofit consulting firm that specializes in serving smaller and less experienced businesses. Unlike for-profit consulting firms, alt. consulting has been able to raise grants to offset some of its cost of operations.

Boards of Directors

Bankers comprise the largest group of board members for the 19 equity-focused CDVC providers, holding 18 percent of all board seats. This reflects the significant portion of CDVC capital that comes from banks and financial institutions, as well as bankers' financial expertise and resulting desirability as board members. The overall percentage of bankers is also somewhat inflated by one CDVC fund, whose board accounts for 37 percent of all the bankers serving on CDVC boards. Representatives of community organizations (15 percent), entrepreneurs (13 percent), and government employees (10 percent) all account for a significant number of CDVC board seats. Twenty-eight percent of all CDVC board members are women (Figure 9).

Investment Committees

Bankers also comprise the largest group of investment committee members for equity-focused CDVC funds, holding 24 percent of all investment committee seats. As with boards, one CDVC fund accounts for 22 percent of all the bankers that serve on CDVC investment committees (Figure 10).

Venture capitalists play a greater role on CDVC investment committees (12 percent) than they do on CDVC boards of directors. Conversely, community organizations play a major role in setting CDVC board direction, yet account for only nine percent of all investment committee seats. With 14 percent of all investment committee seats, entrepreneurs have a significant presence on both CDVC investment committees and boards of directors.

Three CDVC funds do not have a separate investment committee. Instead, their entire board of directors makes investment decisions. Seventeen percent of all CDVC investment committee members are women.

Cost of Operations

For fiscal year 2000, CDVC funds had operating budgets ranging from \$116,000 to more than \$2 million, with a \$600,000 median operating budget for a \$10 to \$15 million fund. Staff salaries made up approximately 70 percent of funds' operating expenses. These figures exclude all interest payments.

Traditional venture capital funds cover their operating expenses by charging their investors an annual fee, based on a percentage of invested capital. This fee is usually between two and three percent of the total committed capital. A number of CDVC funds have adopted this practice because it is familiar to banks and financial institutions, which invest in both traditional and community development venture capital funds. These CDVC funds charge their investors an annual fee of approximately three percent of total capital. However, this fee rarely covers a CDVC fund's true cost of operations.

There are several reasons why management fees do not fully cover operating expenses for most CDVC funds. First, all venture funds must cover the fixed costs of staff and facilities. Because CDVC funds are significantly smaller in capitalization than traditional venture capital funds, three percent of their total capitalization is usually not enough to cover these fixed costs. The average equity-focused CDVC fund was

capitalized at approximately \$10 million as of December 31, 2000, substantially less than the \$217 million average size for a traditional venture capital fund (Venture Economics, 2000).

CDVC funds also have higher operating costs than traditional venture capital funds because of the much smaller size of their investments and the need to provide extensive technical assistance to many of their portfolio companies. Smaller deals require as much oversight as larger ones, forcing CDVC providers to hire more staff than a comparably sized traditional venture capital fund. The need to provide technical assistance also requires additional staff, further increasing CDVC funds' costs of operations.

Because CDVC providers have higher operating costs and smaller fund sizes than traditional venture capital funds, looking at CDVC operating expenses as a percentage of total capital is not an effective way to evaluate operating efficiency. Many CDVC providers also receive operating subsidies from their parent or partner nonprofit organizations, a fact that further complicates any analysis of operating costs as a percentage of total capital.

Staff Composition and Compensation

The typical CDVC fund staff consists of one senior fund manager and one or two junior fund managers. Three funds have two or more senior fund managers, and four funds do not have any junior investment staff.

Senior managers generally are responsible for fundraising as well as some due diligence. Most senior fund managers are also involved post-investment, with oversight and the provision of technical assistance to their portfolio companies.

The typical senior fund manager has at least 10 years of traditional or developmental finance experience. However, only 22 percent of the senior fund managers running equity-focused funds had any direct venture capital experience prior to assuming their current positions.

Junior fund managers are responsible for due diligence, deal oversight, and the provision of technical assistance. Junior fund managers are likely to have an MBA or another advanced degree and two to five years of traditional or developmental finance experience.

CDVC fund managers are compensated at a lower level than their traditional venture capital counterparts. Traditional venture capital funds structure their managers' salaries to consist of a base salary and a much larger bonus paid out of carried interest.⁴ Management base

salaries are in the hundreds of thousands of dollars, and carried interest in a successful fund will usually be in the millions of dollars (Sahlman, 1990). In this way, the funds are able to attract experienced and proven talent in an industry where the talent pool is relatively small.

In contrast, the salary range for senior CDVC fund managers is \$50,000 to \$350,000, with a mean salary of \$122,000 and a median salary of \$92,500. Junior CDVC fund managers earn between \$60,000 and \$130,000, with a mean salary of \$85,500 and a median salary of \$81,500.

Fifty percent of all CDVC funds offer a performance incentive of either a bonus or carried interest. Twenty-nine percent of all CDVC funds provide fund managers with a bonus, based on individual and fund performance. The bonuses range from eight to 30 percent of salary. Twenty-one percent of all funds offer a carried interest of 10 to 25 percent of net fund profits. To date, only one fund has distributed any carried interest payments. An additional 29 percent of CDVC funds are considering adding such incentives.

Community development venture capital providers face a number of obstacles that prevent them from offering salaries comparable to those received by traditional venture capital fund managers. First, many CDVC providers have nonprofit legal structures or are for-profit subsidiaries of nonprofit organizations. The pay levels of nonprofit organizations are generally lower than those in the for-profit sector. Even the purely for-profit CDVC funds are limited by their relatively low levels of capitalization, which translate into fewer dollars available for salaries. CDVC compensation is also constrained by the fact that CDVC profits are lower and operating expenses are higher than those faced by traditional venture capital funds.

Social and Financial Performance

Any attempt to measure the exact social and financial performance of domestic community development venture capital providers is limited by the relative youth of the industry. Most CDVC funds are less than five years old and have exited only a small portion of their investments.

Only four of the 19 equity-focused funds in existence through December 31, 2000, were created ten or more years ago: the Development Corporation of Austin (Austin, MN); the Kentucky Highlands Investment Corporation (London, KY); the Massachusetts Community Development Finance Corporation (Boston, MA); and Northeast Ventures (Duluth, MN). Of these four funds, only Northeast

Ventures is a freestanding fund that has not received an ongoing operating subsidy. The overwhelming majority of Northeast Ventures' investments, however, have been in early-stage companies, which has extended the average investment holding time for the fund.

As of the end of 2000, Northeast Ventures had exited from approximately half of its portfolio companies and was still holding the majority of its most financially promising investments. As a result, an evaluation of the financial performance of Northeast Ventures is still premature.

The other three older funds have received ongoing operating subsidies from their parent entities, making it difficult to estimate their true overhead expenses. They have also used a combination of debt and equity investments that is often difficult to disaggregate.

Despite the difficulty in evaluating CDVC funds financially, the older funds do provide some indication of the industry's social impact. The Development Corporation of Austin, Kentucky Highlands, and Northeast Ventures together have created more than 4,000 jobs at an average cost of less than \$10,000 per job.⁵ This compares very well to the average cost of \$35,000 per job created by SBICs (Christensen, 2000). These figures are even more impressive in light of the fact that the jobs created were primarily in manufacturing, with livable wages and benefits, and located in economically depressed rural regions.

Recent Trends

Three of the oldest for-profit, limited-life CDVC providers recently began raising their second funds. Two of the three have already held their first closings. This is an impressive feat, especially since both of these CDVC providers took two years to raise most of the capital for their first funds.

These three follow-on funds will invest in larger geographic areas, be capitalized at higher levels, and make larger investments than did their predecessors. In short, while they will maintain their primary focus on job creation for low-income individuals, they also will look and act more like traditional venture capital funds.

This trend towards larger funds, bigger deals, and larger geographic target areas is also evident among some of the newer CDVC funds, which raised their capital and began investing between 1998 and 2000. Interestingly, most of the investment capital for both of these groups has come from banks and financial institutions, which provided 74 per-

cent of the dollars raised by the follow-on funds and 85 percent of the capital raised by this group of newer funds.

The newer funds also include a group of nonprofit CDVC providers that target rural geographies, make small, generally near-equity investments, and offer intensive technical assistance. Only one of them has attracted bank investments, in the form of low-interest loans. In general, this group of providers has found raising capital to be slow and very difficult.

It is not surprising that banks choose to invest in those CDVC funds that project the highest rates of return. Such funds, in turn, must cover broader geographies to maximize deal flow and make larger investments to decrease overhead costs. The challenge for the industry is to identify alternative funding streams that will provide a comparable source of capital for those CDVC providers that focus on harder-to-serve, primarily rural areas. Many CDVC providers are hoping that the federal New Markets Tax Credit program, enacted in December 2000 and designed to stimulate \$15 billion in equity investments for community economic development, will do just that.

The next few years will be critical ones for the community development venture capital industry. As more CDVC funds exit their investments, the industry's financial performance will become more apparent. This, in turn, will help determine how easy it will be for future CDVC funds to raise capital and where that capital will come from. While preliminary data indicates that CDVC providers are creating high-quality jobs at a low cost, more research is also needed to fully understand the industry's social impact.

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Table 1
Distribution of CDVC Capital Under Management by The 19 Equity-Focused Funds

FUND SIZE	NUMBER OF CDVC FUNDS	TOTAL \$ UNDER MANAGEMENT (In Millions)
\$0 - \$5,000,000	6	\$15.7
\$5 - \$10,000,000	5	\$33.5
\$10 - \$15,000,000	4	\$51.5
\$15,000,000 +	4	\$90.3

Figure 1
CDVC Dollars Available by State - As of 12/31/2000
(excludes organizations in fund-raising stage)

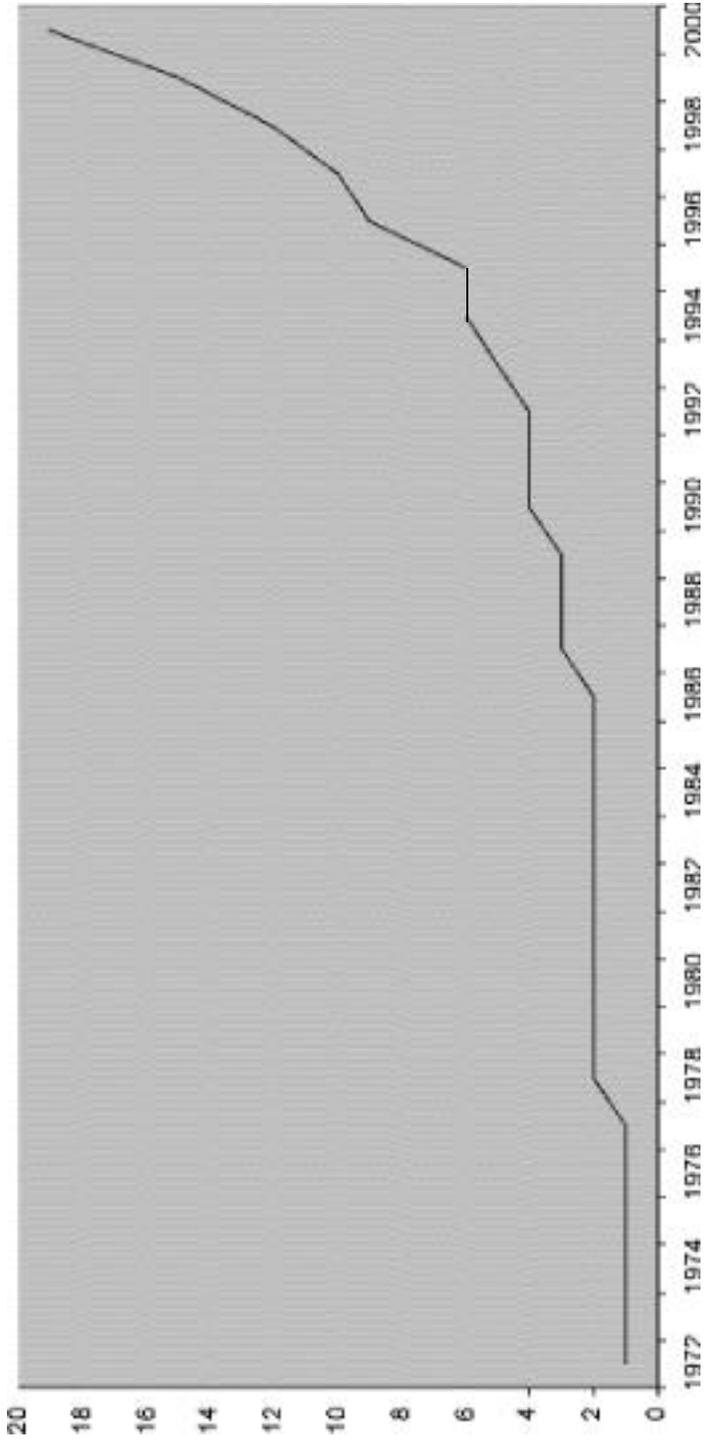




Figure 2

Figure 3
SOURCES OF EQUITY-FOCUSED CDVC CAPITAL UNDER MANAGEMENT
(cumulative as of 12/31/2000)

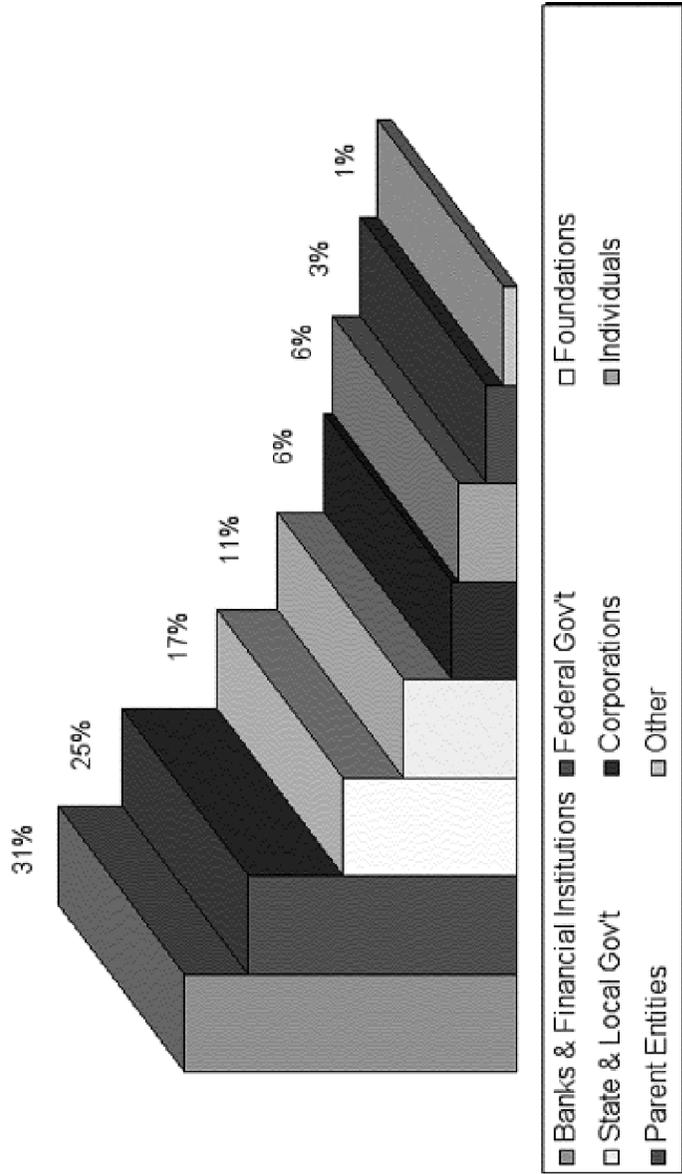


Figure 4
SOURCES OF EQUITY-FOCUSED CDVC CAPITAL - EQUITY vs. DEBT
(cumulative as of 12/31/00 - in millions of dollars)

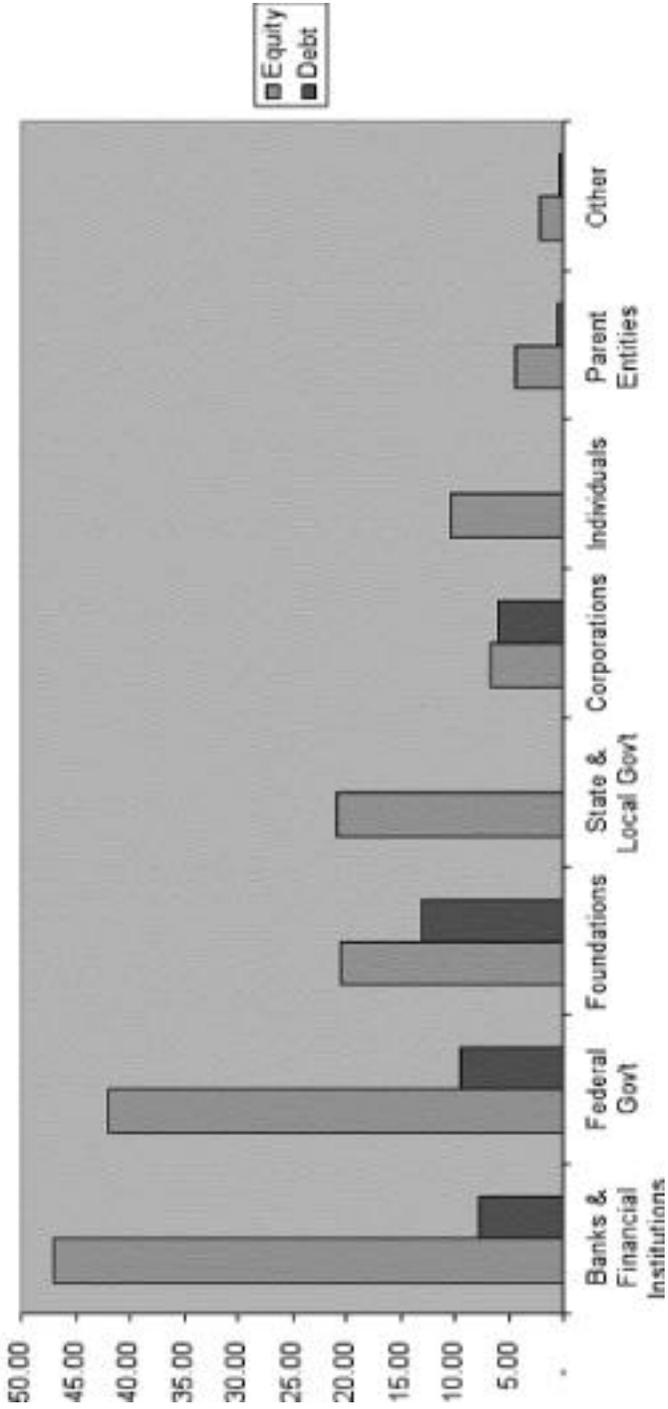


Figure 5
INVESTMENTS BY INDUSTRY
(equity-focused CDVC providers - cumulative as of 12/31/00)

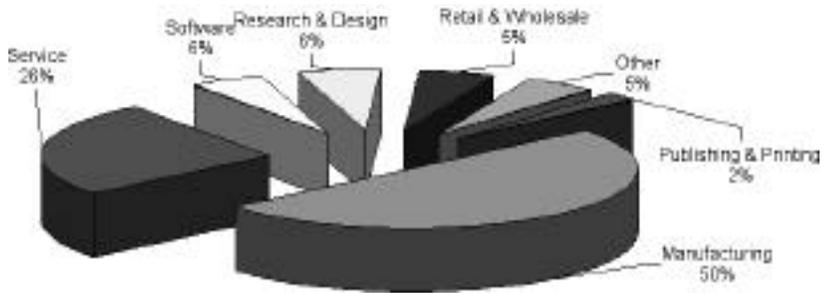


Figure 6
INVESTMENTS BY TYPE
(equity-focused CDVC providers - cumulative as of 12/31/00)

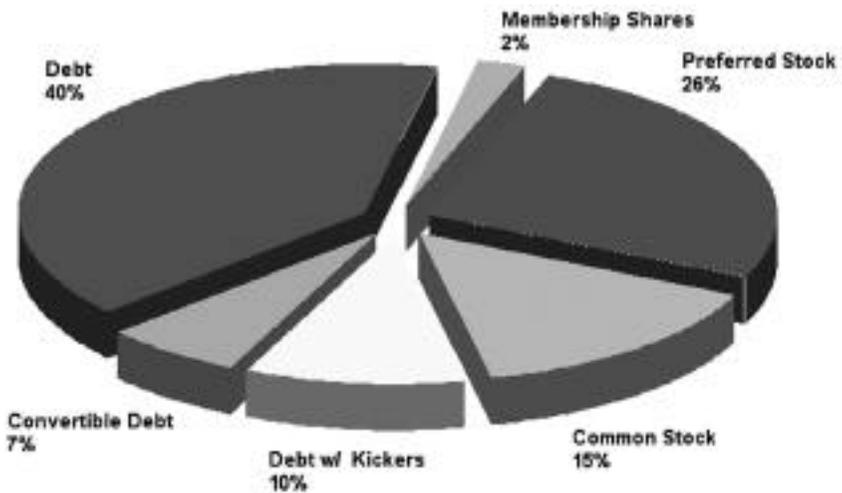


Figure 7
SUCCESSFUL EXITS
(equity-focused CDVC providers - cumulative as of 12/31/00)



Figure 8
LEGAL STRUCTURES OF EQUITY-FOCUSED CDVC PROVIDERS
(as of 12/31/00)

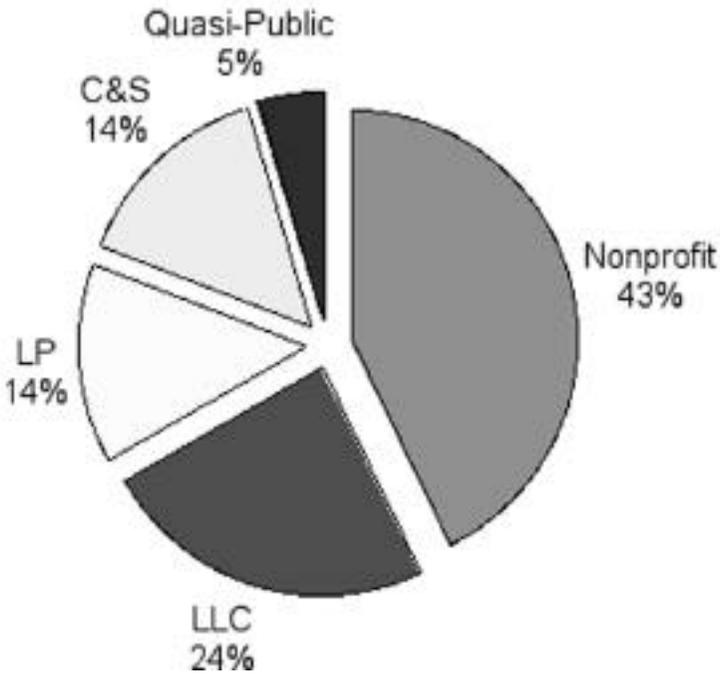


Figure 9
BOARDS OF DIRECTORS' COMPOSITION
(equity-focused CDVC providers - as of 12/31/00)

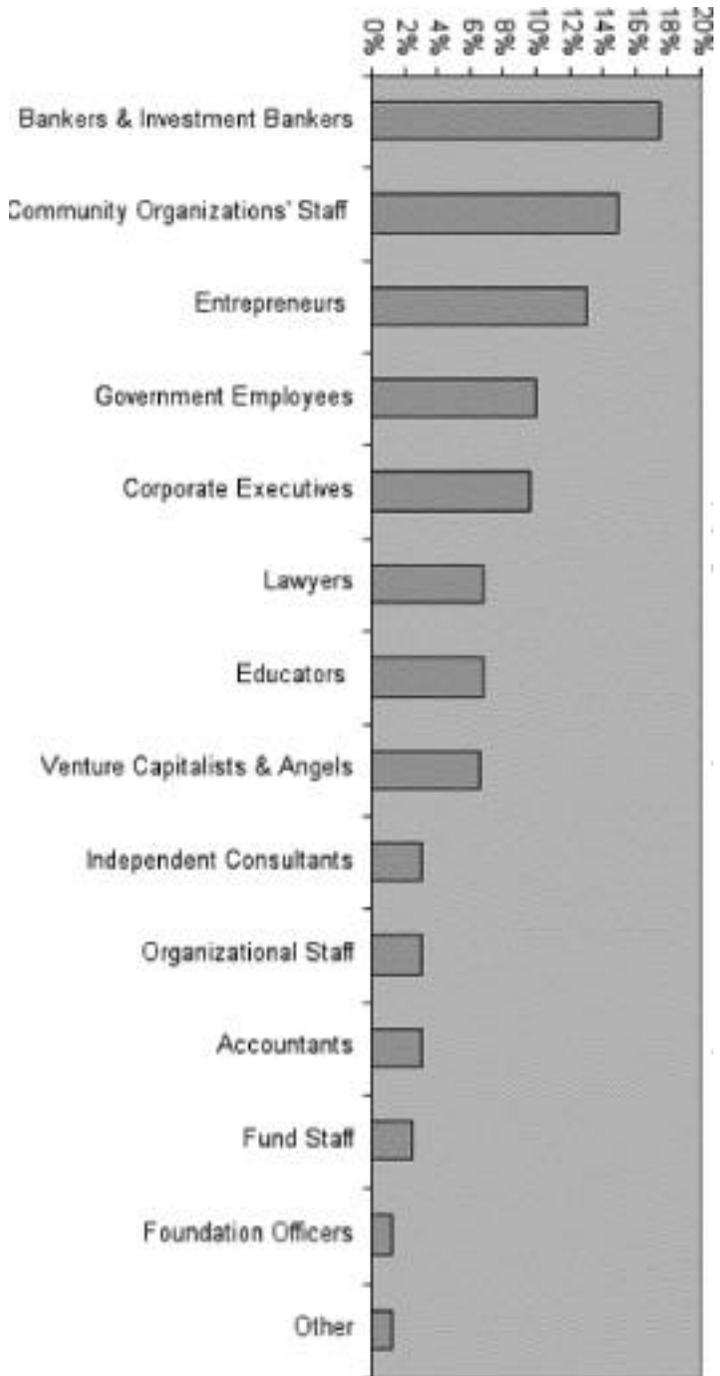
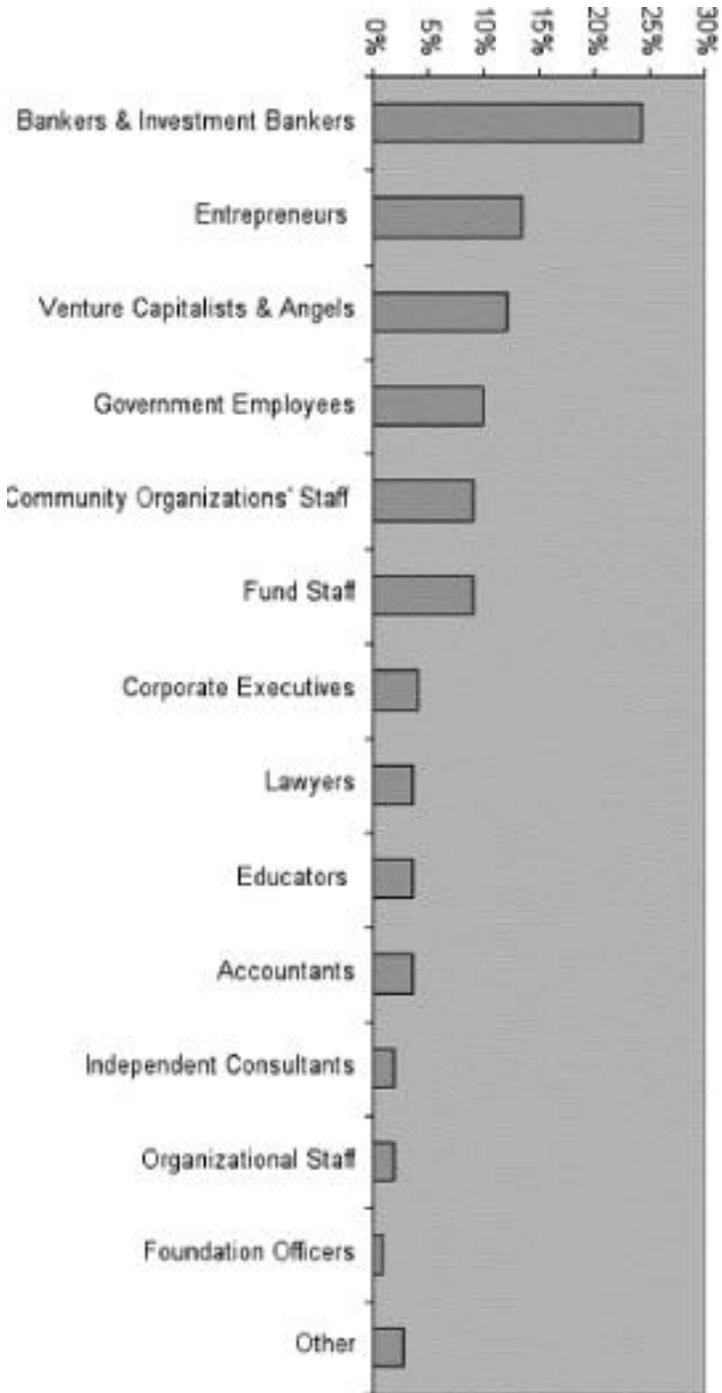


Figure 10
Investment Committees' Composition
(equity-focused CDVC providers - as of 12/31/00)



Notes

- ¹ Except where noted, the fund-level information in this report is as of December 31, 2000 and is based solely on the 19 equity-focused funds.
- ² Funds that make only occasional equity and near-equity investments do not segregate the capital they use for these investments. Thus, it is difficult to determine exactly how much capital is available for such investments. The figures in this report are estimates, based on conversations with fund staffs.
- ³ The analysis of investments excludes DVCRF's 2000 investments, Kentucky Highlands' investments prior to 1985, and Massachusetts Community Development Finance Corporation's deal-level data.
- ⁴ Carried interest consists of the share of profits that are allocated to the general partners of a venture capital partnership. It usually equals 20 percent of the total profits. See Gompers, P. and Lerner, J. (1999) "The Venture Capital Cycle," Cambridge, Massachusetts: MIT Press, pp. 57-94.
- ⁵ Comparable information is not available for the Massachusetts Community Development Finance Corporation.

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