Community Development Venture Capital Funds: Equity Financing to
<u>Create Jobs, Entrepreneurial Capacity and Wealth in Low Income Communities</u>

Abstract:

In the United States and in other nations throughout the world, a new type of venture capital fund has emerged that has a double bottom line, creating positive social outcomes for communities as well as good financial returns for investors. These community development venture capital (CDVC) funds provide equity financing to businesses that have the opportunity to grow rapidly, creating good jobs for low income people, while also building entrepreneurial capacity and wealth in economically distressed communities. While most CDVC funds are located in the United States, others operate in 16 countries around the world in both developed and less developed economies. This paper presents the CDVC industry in the United States and goes on to recommend how the model might be developed and implemented in Korea, both through private initiatives and with encouragement from public policy.

Community development venture capital (CDVC) funds provide equity financing for businesses in financially distressed areas to create good jobs, productive wealth, and entrepreneurial capacity that benefit low-income people and the economies of distressed communities. There are currently 71 CDVC funds located in underinvested inner-city urban and rural communities throughout the United States, which collectively manage $2 billion of capital. (See Figures 1 & 2 below for growth in the number of CDVC funds over time and growth in capital under management by the industry.)[1] CDVC funds also exist in 16 other countries around the world, including countries in Eastern and Western Europe, Asia, Africa, North America, and South America.

[1] Unless otherwise specified, all data presented in this paper was collected and analyzed by the Community Development Venture Capital Alliance (CDVCA) through its survey of the CDVC industry.

Figure #1: Number of Funds Active or In Formation

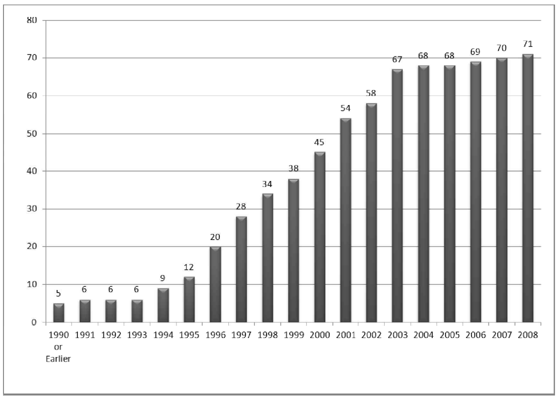
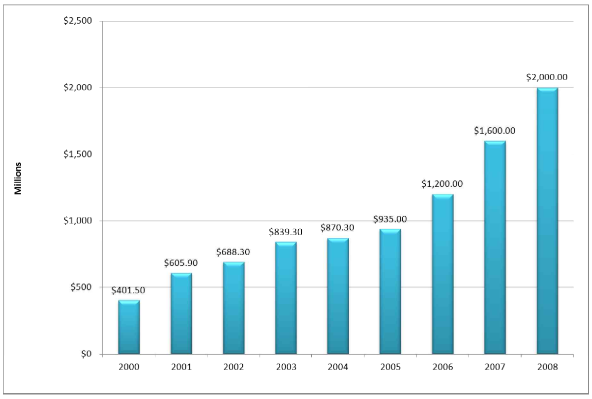


Figure #2: CDVC Capital Under Management



<u>Double Bottom Line, Mission-Driven Funds</u>

CDVC funds have a "double bottom line." Their financial bottom line requires them to earn market rate financial returns for their investors, but they also have a social bottom line, which they achieve by creating good jobs for people who do not have significant economic opportunity. They are mission-driven funds; that is, they invest in distressed areas and create jobs because they are established by social entrepreneurs to achieve social goals, not because of requirements imposed externally by investors or government regulations. Achievement of their financial bottom line is necessary for their continued existence, but achievement of their social mission is their reason for being.

The primary purpose of CDVC funds is to create good jobs for low income people and to help develop financially distressed communities. In addition to these primary goals, many CDVC funds have additional goals, which they achieve by financing the following types of businesses:

- Businesses owned by women and members of minority groups
- Environmentally sustainable businesses and businesses in the "cleantech" industry
- Businesses that make socially beneficial products and products that are useful to people in low income communities
- Businesses with good employment practices
- Businesses that offer their employees opportunities for wealth-building and employee ownership

<u>CDVC is a Powerful Tool for Economic Development</u>

The CDVC model is a particularly powerful tool for economic development for a number of reasons:

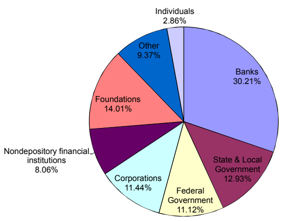
- Equity capital is vital to the success and growth of small businesses, particularly during their expansion stage when large numbers of jobs and productive wealth are being created. Because equity capital is high risk, it is very difficult for most businesses to access.
- Equity capital is in particularly short supply in low-income areas and among minority entrepreneurs. The primary source of risk capital for most small businesses is personal savings and investments from friends and family. In low-income areas, these tend to be lacking. Traditional venture capital firms provide financing for only a tiny portion of businesses, and venture capital is almost completely absent from low-income urban and rural areas.
- Equity capital leverages other financing. Banks and other lenders will not make loans to businesses unless they maintain a prudent ratio of equity to debt capital. An infusion of equity capital is often critical for assembling other financing for new or expanding businesses.
- CDVC funds target companies that are highly competitive and thus likely to expand rapidly. These companies not only provide substantial financial returns, they also create large numbers of good jobs and have the financial resources to offer decent wages, employee benefits, worker training, and opportunities for career advancement. This sector of small, competitive businesses can form the backbone of a successful local economy.
- CDVC funds provide extensive entrepreneurial and managerial assistance to businesses. Unlike lenders, equity investors become partners with their investee companies, sitting on their boards of directors and providing other substantial assistance by identifying additional financing, making contacts with customers and suppliers, and helping with executive recruitment. For businesses in low-income areas, this assistance is often as crucial as the financing itself.
- Some CDVC funds operate, or have relationships with, workforce development programs that help place unemployed people in jobs that are created by their financing activities.
- Some CDVC funds go beyond providing financing and technical assistance to existing businesses. They start and nurture businesses, and then recruit local business people to own and operate them. In this way, CDVC funds are able to jump-start business development in even the most economically distressed areas.

Characteristics of CDVC Funds

CDVC funds use the tools of the traditional venture capitalist for economic development purposes. They invest equity capital in small businesses that do not have publically traded stock. In return for their investments, CDVC funds typically receive an ownership interest in the companies in which they invest. They become economic partners with entrepreneurs and partial owners of businesses.

Like traditional venture capital funds, CDVC funds receive capital from outside investors. In the United States, a broad variety of types of investors invest in community development venture capital funds. About 30% of the industry's capital has been invested by U.S. banks, motivated in part by the U.S. Community Reinvestment Act. Foundations were early investors in the industry, and still account for 14% of capital. State and local governments have provided another 13% of capital and the U.S. federal government has provided 11%. Financial institutions other than banks, such as insurance companies and pension funds, have provided 8%, while non-financial corporations have provided another 11.5%. Finally, wealthy individuals are a growing group of investors in CDVC funds, accounting for almost 3% of capital. As Figure 3 below shows, no one type of investor dominates CDVC funds. This keeps CDVC funds free from undue influence from any one investor group.

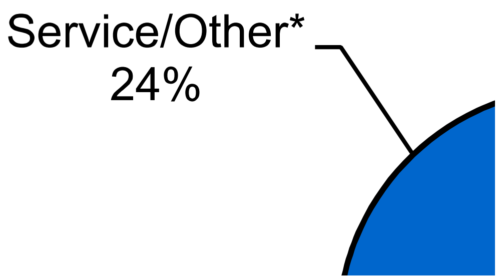
Figure 3: **Sources of Capital for CDVC Funds**



Also like traditional venture capital funds, CDVC funds seek market rates of return from their investments; they must do this to be able to raise additional capital from investors. Many people believe that seeking strong financial returns is not compatible with seeking strong social returns, but this is not true. Companies that provide strong financial returns are companies that grow rapidly. Companies that grow rapidly tend to create large numbers of good jobs. Furthermore, these jobs tend to be high quality jobs, because companies that are financially successful have the resources to pay decent wages. They are expanding rapidly, so they often offer opportunities for advancement and use other positive employment practices to attract new employees.

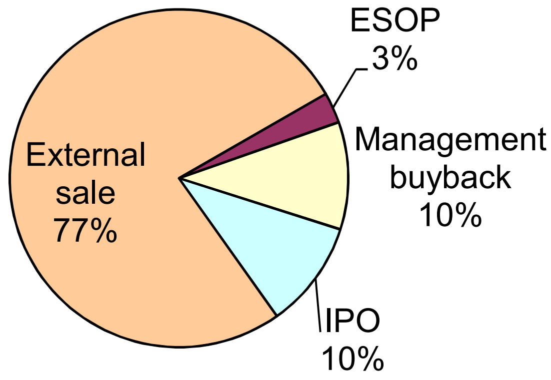
CDVC funds invest in a variety of types of businesses. They are typically generalists, not specializing in particular industries as some venture capital funds do. (See figure 4 for the types of business in which CDVC funds invest.) They do, however, specialize in investing in and adding value to businesses that have significant entry level workforces.

Figure 4: **CDVC Investment Industries (% of investments outstanding)**



Like any other venture capital fund, CDVC funds must "exit" their investments. A lender is repaid by regular payments of interest and principal, while an equity investor is not repaid on a regular schedule. The companies in which venture capital funds invest are growing rapidly, so they are quickly consuming cash rather than producing excess cash to repay loans. For this reason, some 'event' must occur to produce cash to repay the venture capital investor. Figure 5 below presents the frequency with which CDVC funds use various types of strategies to exit their investments. In community development venture capital, like traditional venture capital, this 'event' is most often a sale of a company to another company. Sometimes a company may sell its stock on the public market ("go public"), and sometimes management may purchase the interest of the venture capitalist. From the standpoint of social return, CDVC funds like it when they are able to sell a company to its employees through an Employee Stock Ownership Plan (ESOP), creating an employee-owned company, although that does not happen very often.

Figure 5: **CDVC Exit Types**



Financial and Social Returns

It is necessary for a venture capital fund, CDVC or traditional, to complete a full investment cycle before anything definite can be said about financial returns. Indeed, it is said that venture capital funds can be valued accurately at only two times: before any investments are made (when the fund has only cash) and after all investments are exited; at any point in between, valuation is highly speculative. The CDVC industry is relatively new, and none of the traditionally structured funds have fully exited investments and paid returns to limited partners, so it will be a number of years before a definitive statement can be made about returns.

However, in an effort to get an early answer to the important question of financial returns, the Community Development Venture Capital Alliance (CDVCA) has compiled return information from a model portfolio composed of all exited investments made between 1972 and 1997 by the three oldest CDVC funds. All three had perpetual lives and primarily social investors, and two were not-for-profit organizations. We looked at all of the 31 exits made during the period, including seven full write-offs. Including these write-offs, the model portfolio yielded a 15.5 percent internal rate of return—very much in line with the long-run return record of the traditional venture capital industry. We would expect returns for the more recent, for-profit, limited life funds to be higher, because of the increased pressure to achieve market returns applied by investors and the pressure to exit quickly (which tends to boost returns) resulting from the more recent funds' limited lives.

CDVC funds measure their social returns with the same discipline and rigor that any other venture capital fund measures its financial returns. The Community Development Venture Capital Alliance (CDVCA) is the international trade association of CDVC funds. CDVCA developed a detailed methodology for measuring social returns, which is described in a 74-page publication called the Measuring Impacts Toolkit (MIT). The MIT provides detailed data definitions and survey procedures for measuring job creation, determining the status of the persons receiving those jobs (e.g., individuals from low income households), and the quality of jobs created. Quality of jobs is determined by such factors as payment of a living wage, provision of employee benefits such as medical insurance, opportunities for training and advancement, other good employment practices, and opportunities for employee wealth building and employee ownership. The MIT also provides standards for location of businesses in low-income areas. Finally it provides methods of measuring impact on the environment and other social factors.

Recommendations for the Korean Context

A source of equity capital for small businesses that has a double bottom line investment strategy can be a powerful force for economic development and job creation for low income people and communities in Korea. Lack of capital is a major impediment for development of small businesses throughout the world, and Korea is no exception. CDVC funds provide both equity capital and accompanying entrepreneurial and managerial assistance to businesses, both of which are in short supply in economically distressed communities.

A first step in developing a CDVC fund in Korea is to identify a champion for the project. This champion might be a community organization, a foundation, a university or a federal or local government agency. The champion should be respected in the community and have the ability to convene representatives of the local community, investors, business leaders, philanthropic organizations, and government. The champion also should ideally have access to funds for two purposes: 1) funding initial costs of developing a business plan and fund structure, and 2) making a lead investment to convince others to invest as well.

Any fund that is formed should be professionally managed by people with strong investment experience. But community development venture capital expertise should also be sought to help with designing and structuring the fund. Managers should have not only equity investment experience but also a strong understanding and deep roots in the communities in which they will invest.

Financial and social return expectations should be clear and realistic. They should be articulated clearly to both investors and the community.

Government can play an important catalytic role in starting CDVC funds or providing incentives for the development of a CDVC industry. However, it is a mistake for government officials to control or influence investment decisions. Investment decisions must be free of political considerations. This is particularly important because the venture capital business is a tough one, sometimes requiring business owners to be fired or businesses to be closed down. Government officials concerned about their public image are not well suited for making such decisions. It is best if a CDVC fund is capitalized by a variety of private and public investors, so that no one investor, including government has undue influence over the fund. If government capital is involved, it should supplement private capital.

If government provides subsidies to encourage development of CDVC funds, it should provide *smart subsidy*. Smart forms of subsidy may include the following:

- Provide capital that supplements private capital to allow CDVC funds to reach an economically viable size as funds that are too small do not have the resources to succeed.
- Provide a partial subsidy for operating costs. Investing in low income communities can be more expensive than investing in places like Silicon Valley. Investment opportunities are not as highly concentrated. Average investment sizes are often smaller, because companies are smaller, but transaction costs can be as high for a small investment as for a larger investment, yielding higher costs per dollar invested. Investments in disadvantaged communities may also require expensive levels of entrepreneurial and managerial assistance to succeed.
- Allow fund managers to profit from investing. Private sector investors typically insist that fund managers be given incentive to succeed through carried interests and other financial incentives. The same should be true in CDVC investing.
- Do not guarantee investors' losses. Guaranteeing losses simply encourages unwise investment. Companies that produce low financial returns because they do not grow or go out of business also produce low social returns in terms of job creation. Harness the power of market discipline to create effective investment programs; do not undermine the discipline of the market by subsidizing losses.

Government subsidy may be provided in the following forms:

- Tax credits for investment
- Direct investment alongside private investors
- Subsidy of operating costs by supplementing management fees for certain purposes

Examples of government programs in the United States that provide intelligent subsidy for CDVC funds include the following.

- New Markets Venture Capital (NMVC) Program. Operated by the U.S. Small Business Administration, this program provides both capital to supplement private investments , thereby increasing fund sizes, and also operational assistance grants to funds that invest in low income communities.
- Rural Business Investment Program. Operated by the U.S. Small Business Administration in partnership with the U.S. Department of Agriculture, this program applies the NMVC economic model to funds that invest in underinvested rural areas.
- Community Development Financial Institutions Fund. Operated by the U.S. Department of the Treasury, this program provides matching grants and

investments to mission-driven financial institutions, including CDVC funds, to build their capacity.
- New Markets Tax Credit (NMTC). Operated by the U.S. Department of Treasury, this program provides a tax credit to investors in low income communities.
- Community Reinvestment Act. This law requires regulated U.S. banks to lend in invest in low income communities from which they accept deposits.

Conclusion

CDVC funds have a double bottom line, seeking strong financial returns for investors while also creating good jobs for low-income people and wealth and entrepreneurial capacity in economically distressed communities. While it is most highly developed in the United States, the CDVC fund model operates successfully in countries throughout the world in both developed and less developed economies. This model can be a powerful force for job creation and economic development in low income, low wealth communities in Korea. Creating a fund requires a champion to catalyze fund formation and strong support from a variety of stakeholders in a community. Government policy can also play an important role in helping a CDVC industry to develop in Korea, but it should do so with smart forms of subsidy and without seeking to control individual investment decisions.

For more information about the community development venture capital industry go to www.cdvca.org