Community Development Venture Capital in Rural Communities

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Abstract

Access to equity capital is a critical component of business entrepreneurship. Rural economies, however, rarely attract traditional venture capital. Community development venture capital (CDVC) has evolved to address the patient capital needs of such underserved geographies. Like traditional venture capitalists, CDVC providers make equity and near-equity investments in small businesses. However, their investments are predicated on a company's potential to contribute to the betterment of a low- or moderate-income community as well as its likelihood for rapid economic growth. This paper examines the universe of CDVC providers that invest in rural geographies, to understand the various organizational models that they use and determine which ones appear best suited for which environmental factors.

The 26 CDVC providers that invest in rural geographies have used one of three approaches: 1) primarily equity investing via a for-profit limited life partnership or limited liability corporation structure, capitalized primarily by external equity investors; 2) primarily near-equity investing (e.g., debt with warrants), via a nonprofit community development loan fund structure; and 3) equity and near-equity investing via a range of legal structures. Funds formed after 2001 have used only the first two approaches. These two approaches have both benefits and drawbacks. Which one a particular organization chooses depends on the kinds of investments that it believes to be most appropriate for its target market, and its capacity to raise capital for such investments. The paper concludes with policy recommendations designed to increase the supply of developmental venture capital in rural areas.

Introduction

Access to equity capital is a critical component of business entrepreneurship. Young companies lack the cash flows necessary to repay their debts. They need patient capital, such as equity and near-equity, to develop their products and get them ready for market.[1] The creation and growth of such companies is the path to economic prosperity for many rural regions (Barkley 2003). It also is a means to economic opportunity for rural residents.

Rural economies, however, rarely attract traditional venture capital (Schmitt 2003; Markley 2001). This is due in part to the structural impediments these economies pose for the traditional venture capital model. Because the primary driver of traditional venture capital is profit maximization, investments tend to occur in locations with strong deal flow in the form of potential investment opportunities, as well as the supporting infrastructure—technological, managerial, legal, and financial expertise—necessary to take ideas to market. Locations close to desirable quality-of-life amenities also attract venture capitalists, which can minimize travel time and operating expenses by living near their investments. Areas such as Silicon Valley in California and Route 128 in Massachusetts embody such characteristics and consistently draw a disproportionate share of traditional venture dollars.

In contrast, rural geographies are characterized by limited deal flow and supporting infrastructure, and large distances that make oversight difficult. Because of these structural impediments, many of the venture capital funds that focus on rural areas tend to be developmental in nature. Unlike traditional venture capital, which has a primary objective of financial returns for investors, developmental venture capital is designed to foster both social and financial returns. In the case of rurally focused developmental venture capital firms, the social returns often are in the form of general economic growth, or specifically targeted growth designed to benefit low- and moderate-income communities.

Community development venture capital (CDVC) is one form of developmental venture capital that has evolved in rural areas. Like traditional venture capitalists, CDVC providers make equity and near-equity investments in small businesses. However, their investments are predicated on a company's potential for high-quality job creation for low- and moderate-income individuals, as well as its likelihood of rapid economic growth. As a result of this dual bottom line, many CDVC funds are willing to invest in companies in numerous industries, stages of development, and locations. They also are willing to make investments of under $3 million, which traditional venture capital funds are increasingly reluctant to do. This flexibility, as well as the operating models that it has fostered, further differentiates CDVC funds from traditional venture capital,

[1] 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.

and may make this model particularly well-suited to address the structural impediments that rural areas present.

The earliest providers of community development venture capital, formed during the 1970s and 1980s, had a primarily rural focus. They included the Kentucky Highlands Investment Corporation (KHIC), Northeast Ventures, Northern Community Investment Corporation, Coastal Enterprises Incorporated, the Development Corporation of Austin, the Minnesota Technology Corporation Investment Fund, and Southern Ventures. More recently, the industry has seen the creation of CDVC funds focused on the rural regions of Oklahoma, New Mexico, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, North and South Carolina, Georgia, Alabama, and Mississippi.

A major obstacle to increasing the supply of equity capital in rural geographies via community development venture capital funds is the model's need for subsidy to offset the economic challenges that rural geographies pose for equity investing (Rubin 2006). The present economic, political, and normative environments seem hostile to overtly subsidy-based models, particularly those intended to benefit low- and moderate-income populations (Rubin, forthcoming). This has limited both the growth of new CDVC funds and the capitalization levels of existing ones.

Another obstacle is the lack of information about the various models these funds are using. Most prior research has focused on one or a handful of developmental venture capital organizations. Given the diversity within the field, such sampling significantly limits the generalizability of any findings to the broader field.

The existing research also is out of date; the latest comprehensive deal-level data on the CDVC industry was collected in 2003, and the most recent organizational research on multiple funds dates back to 2000. Developmental venture capital is a rapidly changing field, and prior studies no longer accurately reflect the state of either developmental or rural venture capital. For example, several of the organizations that were at the core of previous studies are no longer in existence or have stopped providing equity capital (e.g. Cascadia, Southern Ventures, Northeast Ventures - Iron Range Ventures).

Additionally, two new sources of developmental venture capital have been created, with important potential implications for rural geographies: the New Markets Venture Capital (NMVC) and Rural Business Investment Company (RBIC) programs. The programs were modeled on the community development venture capital industry, and were designed to increase the supply of equity and near-equity capital flowing into distressed and rural communities, respectively. Both programs, which are administered by the Small Business Administration

(SBA) of the U.S. Department of Commerce, provide selected NMVC and RBIC companies with matching debt capital for making investments and grants to offset overhead expenses.[2]

Policy-makers and funders need comprehensive and current information regarding whether and how existing CDVC funds are meeting rural communities' patient capital needs; the research presented in this paper is intended to help provide this information. The paper examines the universe of existing rurally focused community development venture capital funds in order to understand the various organizational models that these funds use to serve their target markets, and to determine which models appear best suited for which environmental factors. This research also examines the nine rurally focused funds that no longer are making equity and near-equity investments, to try to understand why they have terminated this kind of investing and whether their experience can provide guidance for existing and future CDVC funds. The paper concludes with policy recommendations that emerge from this research and are designed to increase the supply of developmental venture capital in rural areas.

Literature Review

The first rurally focused developmental venture capital fund was the Kentucky Highlands Investment Corporation (KHIC), a Community Development Financial Institution (CDFI) that served a nine-county region of Appalachian Kentucky.[3] Thomas Miller (1993), a former President of KHIC, wrote an unpublished manuscript that described how the organization began providing debt and equity financing, as well as its subsequent experiences with these forms of developmental finance. Miller also tried to measure the outcome of KHIC financings, from the beginning of these activities in 1972 to 1993, by calculating job creation figures for KHIC-financed businesses and those for which KHIC provided substantial technical assistance. He concluded that KHIC had more than repaid the dollars that the Federal Government had invested in the organization, and had achieved both operating and capital self-sufficiency. He also argued that the KHIC experience proved that a "nonprofit organization can build, at an acceptable cost, a number of large-scale ventures in a chronically depressed rural area far from urban centers, and employ a significant number of previously unemployed people." Miller argued that capital was "necessary" for making this happen, but secondary to entrepreneurial attitudes and talent within the nonprofit organization (p. 158).

Waddell (1995) conducted case studies of six "socially guided venture capital organizations" and interviewed the management of three more (p. 324). The nine included five that were rurally

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[2] Six NMVC Companies and one RBI Company were selected and received matching capital during the first round of both programs. All seven are still active funds, and five of them (four of the NMVC Companies and the RBI Company) have a focus on rural geographies. Subsequent rounds of both programs were eliminated when Congress and the Bush administration eliminated the funding set aside for this purpose. For more on the NMVC and RBIC programs, see J.S. Rubin (2006). Financing rural innovation with community development venture capital: Models, options and obstacles. *Community Development Investment Review,* San Francisco Federal Reserve, Volume 2, Issue 4.

focused. However, Waddell's analysis did not differentiate between the rurally and urban-focused funds.

Waddell found common themes among the funds, including the challenge of making small investments and combining social and financial objectives. He concluded that "while promising, socially-guided private funds' experience is too short to reach any firm conclusions" (p. 337).

Jegen (1998) interviewed the managers of nine socially-oriented venture capital funds, including the five rurally focused funds that had been part of Waddell's study. Like Waddell, Jegen did not differentiate between the rurally and urban-focused funds in his analysis.

Jegen's analysis focused on the tensions such funds face between their financial and social objectives. He identified a number of challenges facing the funds, including limited deal flow, small fund sizes, the need for ongoing subsidies, limited exit strategies, difficulties in finding co-investors, and lower financial returns. He concluded, however, that "there is growing evidence that this hybrid investing model can succeed and that venture capital can be an important new tool in community development" (p. 198).

Lerner and Jackson (1996) wrote a teaching case study of Northeast Ventures (NEV), a rurally focused CDVC fund that served seven counties in northeastern Minnesota. The case study detailed Northeast Ventures' history and the challenges facing the fund as of 1996. These included the difficulties of raising additional capital given the fund's limited northeast Minnesota geography and perpetual life legal structure.

Manno (1998) and Rooney (1999) also prepared teaching case studies on specific investments of two rurally focused CDVC funds, Coastal Enterprise Ventures and the Kentucky Highlands Investment Corporation. The case studies were designed to provide experience financially valuing and negotiating a CDVC transaction and analyzing a CDVC workout situation, respectively.

Rubin conducted case studies of 34 community development venture capital funds and interviewed an additional 30 CDVC providers and industry observers, in order to understand the organizational models that CDVC funds used and what differentiated them both from traditional venture capital funds and from other types of community development institutions (2002; 2001a). She found that CDVC funds made investments that differed from those of traditional venture capital in their industry focus, stage of development, size, and location.

Rubin also found that, unlike traditional venture capital, CDVC funds used a diverse set of organizational structures for making investments. Rubin attributed this to two factors: the industry's early stage of development and its ability to stave off the emergence of a dominant

[3] In 2003, KHIC expanded its service area to 22 counties.

model by using the double bottom line objectives to minimize performance comparisons between funds.

Barkley, Markley, Freshwater, Rubin, and Shaffer conducted 23 case studies of nontraditional venture capital institutions or programs that were making venture capital investments in rural places across the country, including five community development venture capital funds, and produced a number of publications that summarized the lessons learned from these institutions that might be applied by those seeking to start a rurally focused venture capital fund (2001 a, b, c, and d).[4] They found that the differences between the successful and unsuccessful institutions "often are not great" and that "establishing and maintaining successful nontraditional venture capital institutions is not an easy process" (pp. 12-13).

Hughes, Mallory and Szabo (2004) surveyed six venture capital funds that provided equity funding to businesses located in West Virginia, including three developmental venture capital funds, to understand their motivation for investing in a rural market, their experiences working with rural entrepreneurs, and their expectations of return. The authors found that the primary barriers to access to venture capital in rural areas were the "lack of deal flow and entrepreneur support networks and culture," and rural business owners' lack of understanding of how venture capital works (p. 12). They did not find that the venture capital managers they surveyed were willing to accept lower rates on return than those operating in urban areas.

The Community Development Venture Capital Alliance (CDVCA), the CDVC trade association, gathered annual data on a subset of its membership between 2001 and 2003, and produced reports describing the industry (Schmitt 2004; CDVCA 2002 and 2001). CDVCA also used this data to analyze the locations of 176 historical investments made by CDVC funds versus those made by traditional venture capital funds. CDVCA found that semi-rural and rural counties received a slightly higher percentage of CDVC investments (24 percent) than the percentage of businesses establishments located in those counties (19.2 percent). By contrast, only 1.6 percent of all traditional venture capital investments went to these counties (Schmitt 2003).

In addition to these studies, the CDFI Data Project (CDP) collects CDFI data annually. The CDP data is limited by the fact that only a portion of the CDVC funds in existence have chosen to participate. In 2005, the latest year for which CDP data is available, only 19 of the 89 funds that CDVCA indicated were in existence completed the CDP survey, and some of those provided only partial information. Additionally, the information the CDP gathered does not include any deal-level data.

The CDFI Fund also collects data annually through the Community Investment Impact System (CIIS). This data is limited to CDFIs that received awards in fiscal year 2003 or later. It

[4] The five case studies of rural community development venture capital funds were done by Rubin, in conjunction with her dissertation research.

includes institution-level variables□"organization's financial activity and position; ownership characteristics; staffing levels and composition; technical assistance and training services; loan sales and loan purchases." It also includes transaction-level variables□"details on each loan or investment that a CDFI makes, including borrower and project addresses; borrower socio-economic characteristics; loan or investment terms; repayment status; and community development outcomes" (Fabiani and Greer 2007, p. 5). The CIIS should eventually become a good source of data on CDFI Fund-certified CDVCs. Currently, however, its usefulness is limited by the small number of reporting CDVC funds (only 9 of the 28 CDFI Fund-certified CDVCs provided fiscal year 2003 data to the CIIS), and the lack of transaction-level data for prior years. Additionally, many CDVC funds are either not CDFI Fund-certified or have not received awards from the Fund, and thus are not required to provide information to the CIIS.

Methodology

This research is designed to improve our understanding of the various organizational models that rurally focused CDVC funds use to serve their target markets, and to determine which models appear best suited for which environmental factors. Additional questions that it tries to address include:

- How do the investments these funds make compare with those made by traditional venture capital funds?
- Are relatively small CDVC funds that serve a single rural region of a state, or that serve rural markets in multiple states, as sustainable as larger CDVC funds that serve both rural and urban markets?
- How do the types of clients served and financing offered differ for these different types of CDVC funds?
- Are these different types of CDVC funds (in terms of size and geographic focus) able to meet the capital and technical assistance needs of the rural markets that they serve?

This research also examines the nine rurally focused funds that are no longer making equity and near-equity investments, to try to understand why they have stopped.

Data was collected from 35 organizations that make up most of the universe of known CDVC providers that invest primarily or partially in rural geographies[5] Twenty-six of these

[5] This study does not include a group of community development corporations that make occasional equity investments from their assets. These include Midwest Minnesota Community Development Corporation (CDC), Impact 7, Northeast South Dakota Economic Corporation, and Northern Community Investment Corporation. It also does not include CDVC funds that focus on urban geographies.

organizations currently make equity and near-equity investments in such geographies, or are trying to raise additional capital and exit investments recently completed. Table 1 presents information on the 26 organizations still making investments.

Table 1: CDVC Providers That Serve Rural Markets

				CDFI Fund Certified					Public	
		Organization's Name	Program's/Fund's Name	VC Fund	Other	NMVC	RBIC	SBIC	Fund	Other
1		Adena Ventures				1				
2		CEI Community Ventures, LLC		X		1				
3		Coastal Ventures I, LP		X						
4		Coastal Ventures II, LLC		X						
5		Development Corporation of Austin								X
6		Kentucky Highland Investment Corporation	Mountain Ventures	X				X		
7		Meritus Ventures					X			
8		Southern Appalachian Fund, LP				X				
9		MetaFund Corporation		X						
10		Midwest Minnesota CDC			X					
11		Montana CDC	Montana Fund		X					
12		Natural Capital Investment Fund, Inc.			X					
13		NH Community Loan Fund	Vested for Growth		X					
14		New Mexico Community Capital		X						
15		Penn Ventures Partners				X				
16		RAIN Source Capital		X						
17		Renaissance Ventures, LLC		X						
18		Northern Initiatives			X					
19		ShoreBank Enterprise Cascadia	Product Innovation Fund		X					
20		Small Enterprise Growth Fund							X	
21		SJF Fund I		X						
22		SJF Fund II		X						
23		Virgin Islands Capital Resources, Inc.		X						
24		West Virginia Jobs Investment Trust							X	
25		Western MA Enterprise Fund, Inc.			X					
26	p	Wisconsin Rural Enterprise Fund, LLC – s								X
Note:		Families of funds								
		NMVC = New Markets Venture Capital Company								

Nine of the 35 organizations made equity or near-equity investments in the past and have chosen not to continue doing so. Table 2 presents information on these organizations.

The data was collected between March and September 2007, by telephone interview with the venture fund managers.[6] In-person interviews were not used because of time and budget considerations.

Table 2: CDVC Providers That Have Ceased to Operate

	Organization's Name	Program's Name	Year Fund/	Year Fund/	Organizational Structures				Primarily	
			Program	Program	Dedicated For-Profit		Dedicated	Program	Debt or	Pilot
			Began	Stopped	LP/LLC	Evergreen	Nonprofit	Of CDFI	Near-Equity	Program
			Investing	Investing						
1	Anoka Sherbourne County Capital Fund		1997	2007	X					
2	Cascadia	Rural Development Investment Fund	1996	2004				X	X	
3	CL Fund	Income Participation Program	2000	2004				X	X	X
4	MACED	Strategic Capital Fund	1998	2001				X		X
5	Northeast Ventures Corporation		1990	2005		X				
6	Iron Range Ventures		1996	2005			X			
7	ShoreBank BIDCO		1992	2005		X			X	
8	Southern		1988	1997		X				
9	Vermont Community Loan Fund		2000	2000				X	X	X

[6] Twenty of the funds had also been interviewed between 1998 and 1999, as part of the author's doctoral dissertation research.

Note: Families of funds

During the interview, each manager was asked to explain the organizational and economic models the fund used to cover operating and technical assistance expenses, and the process the fund used to select and make investments. Managers also were asked for investment-level data from the fund's inception. This included the name, location, and brief description of each portfolio company, as well as the size, structure, and date of all investments.[7] Finally, the funds were asked for any social impact metrics that they collected in connection with their investments.

The data was collected via telephone interview because many of the questions were nuanced or required extensive clarification or follow-on questions that made them inappropriate for a mail survey, and in-person interviews had been ruled out for time and cost reasons as stated above. Telephone interviews also have better response rates than mail surveys.

Findings

What organizational models have CDVC funds used to invest in rural geographies? What are the differences in types of clients served or financing offered for these different types of CDVC funds? Which models appear best suited for which environment?

The existing CDVC funds that invest either exclusively or partially in rural geographies fall into three general categories:

1. Funds that have adopted a legal structure as a for-profit limited life partnership (LP) or liability corporation (LLC), are capitalized primarily by external equity investors, and themselves make primarily equity investments in their portfolio companies.
2. Nonprofit community development loan funds that make primarily near-equity investments, such as debt with warrants or royalty agreements.
3. The remaining CDVC providers, which make both equity and near-equity investments and use a variety of legal structures to do so.

[7] Between January and April of 2008, investment-level data through December of 2007 was collected from a subset of the CDVC funds, to allow their investments for all of 2007 to be compared to conventional venture capital data that is collected annually by Thomson Financial and compiled by PricewaterhouseCoopers and the National Venture Capital Association.

Table 3: Organizational Models for CDVC Funds That Invest in Rural Geographies

	Organization's Name	Program's Name	Organizational Structures					Primarily	
			Dedicated For-Profit		Dedicated	Program	Public	debt or	Pilot
			LP/LLC	Evergreen	Nonprofit	of NP CDFI	Fund	near-equity	Program
	Equity Focused Limited Life Funds								
1	Adena Ventures		X						
2	CEI Community Ventures, LLC		X						
3	Coastal Ventures I, LP		X						
4	Coastal Ventures II, LLC		X						
5	Meritus Ventures		X						
6	New Mexico Community Capital		X						
7	Penn Ventures Partners		X						
8	Southern Appalachian Fund, LP		X						
9	SJF Fund I		X						
10	SJF Fund II		X						
	Near-Equity Focused Funds								
1	Montana CDC	Montana Fund				X		X	X
2	Natural Capital Investment Fund, Inc.				X			X	
3	NH Community Loan Fund	Vested for Growth				X		X	X
4	Northern Initiatives					X		X	
5	ShoreBank Enterprise Cascadia	Product Innovation Fund				X		X	
6	Western MA Enterprise Fund, Inc.					X		X	X
	All Other CDVC Providers								
1	Development Corporation of Austin				X			X	

2	Kentucky Highland Investment Corporation	Mountain Ventures		X					
3	MetaFund Corporation			X					
4	RAIN Source Capital				X				
5	Renaissance Ventures, LLC			X					
6	Small Enterprise Growth Fund						X		
7	Virgin Islands Capital Resources, Inc.				X			X	
8	West Virginia Jobs Investment Trust						X	X	
9	Wisconsin Rural Enterprise Fund, LLC			X					

Limited-life, for-profit equity providers

Ten of the 26 rurally focused CDVC providers in existence are structured as limited-life for-profits that are capitalized with externally raised equity dollars and focus primarily on making equity investments. This also is the organizational model used by almost all conventional venture capital providers. Not surprisingly, the funds in this group have the largest capitalizations on average of all the CDVC funds, with $20.6 million under management. They also are more likely to invest in a multi-state geography, with 8 of the 10 covering two or more states.

Near-equity providers

The second organizational model consists of nonprofit community development loan funds that make primarily near-equity investments, such as debt with warrants or royalty agreements. These organizations invest either directly from their loan fund assets or from pools of capital that they raised or set aside specifically for this purpose. There are six such entities, three of which view their near-equity investments as pilot programs, designed to help them determine whether they will commit additional resources to this strategy on an ongoing basis.

These six funds have the smallest average capitalizations, with only $1.5 million under management. The small capitalizations reflect the challenges of raising capital, particularly for the experimental programs. They also may reflect the different economic model of near-equity investing that, unlike equity, does not require a dedicated staff and thus may be feasible with a relatively small pool of capital.

Four of the six near-equity programs limit their investments to a multi-county or single-state geography. This reflects the geographic target areas of their parent entities, as well as the challenges of covering a multi-state geography with so few dollars under management.

Diverse CDVC funds

The remaining nine CDVC providers use a variety of organizational models to make both equity and near-equity investments: two of the funds are public entities; three are nonprofit funds; and four are for-profit funds. Each of these legal structures is evergreen, enabling the funds to continue investing indefinitely versus having to cease operations at the end of a predetermined lifespan. The funds have an average of $9 million under management, and with only one exception they invest exclusively in single-state geographies.

These nine funds reflect largely non-replicable capitalization structures that were feasible because of unique circumstances. For example, the two public entities were capitalized by their respective states. Renaissance Ventures was capitalized by individual investors who took advantage of a generous tax credit created for such purposes by the state of North Dakota. The Wisconsin Rural Enterprise Fund was established by the Northwest Wisconsin Regional

Planning Commission and capitalized entirely by cooperatives and public entities in its area. The Oklahoma Metafund was able to attract bank investors to its evergreen nonprofit structure because Tom Loy, the fund's creator, was a well-known and respected ex-banker.

These nine also are among the oldest CDVC funds in existence, formed between 1972 and 2000.[8] In contrast, 8 of the 10 equity-focused funds and four of the six near-equity funds were formed after 2000. The fact that the funds in this group are older on average than those in the other two groups would seem to reflect their evergreen structure, which protects them from having to cease operations as of a predetermined date. Being evergreen is not unique to these funds, however. Five of the six near-equity providers also have an evergreen structure, yet only two of those five were organized prior to 2001.

More likely, the diversity of organizational forms and capitalization strategies these nine funds display relative to those in the other two groups is a function of their greater age. These nine funds were formed in the early years of the CDVC industry, when it did not have a dominant organizational model for making equity investments. Such a model, which mirrors that of conventional venture capital and is exemplified by the funds in group one, emerged in the late 1990s and became institutionalized around 2001. This made it difficult for funds formed subsequent to that time to raise capital if they wished to use other organizational structures. To understand how this occurred, it is helpful briefly to review the history of CDVC organizational models.

The oldest CDVC funds are exemplified by the Kentucky Highlands Investment Corporation. KHIC, which began making equity investments in 1972, combined a nonprofit parent entity, a small geographic target area, relatively small investment sizes, early-stage investing, and intensive technical assistance to its portfolio companies. This is an expensive model that requires significant subsidy (Rubin 2006). Such subsidy was much more readily available in the 1970s, when the federal government's Office of Economic Opportunity provided Community Development Corporations such as KHIC with grant dollars that could be used for business development and financing.

Almost all of the rurally focused CDVC funds currently in existence, however, were formed after 1980, when federal dollars for community development venture capital were in much shorter supply. As the funds in group three demonstrate, the CDVC funds formed in the 1980s and 1990s used a range of for-profit and nonprofit organizational models to make both equity and near-equity investments. A few of these funds adopted the for-profit, limited life organizational models more similar to traditional venture capital, in order to appeal to institutional investors such as commercial banks, who were more familiar and comfortable with such models.

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[8] The oldest of these nine funds, the Kentucky Highlands Investment Corporation, was formed in 1968 but did not begin making equity investments until 1972 (Miller 1993).

This is exemplified by Coastal Ventures LP, which was formed in 1996 and relied on banks for a third of its investment capital. Several of the other funds formed in the late 1990s also adopted a limited life, for-profit model and relied on banks for a significant portion of their investment capital. They included SJF Fund I, and the urban-focused funds Boston Community Ventures, DVCRF Ventures, and Silicon Valley Community Ventures. These funds were among the most active and high-profile ones in the industry, which helped increase awareness of the use of this organizational model for community development venture capital.

In 2001, the sources of capital willing to invest in CDVC began to contract, a result of both economic and political factors. The technology stock market bubble burst and thereby caused financial returns for conventional venture capital to decline dramatically. This decline tempered enthusiasm for all forms of venture capital. The stock market decline also shrank foundation assets, leaving fewer dollars for investment. Politically, the tepid support of the Bush Administration for both the CDFI industry and enforcement of the Community Reinvestment Act translated into fewer federal and bank dollars available for community development finance.[9]

With very few exceptions, the CDVC providers that subsequently were able to raise capital were those that could take advantage of the New Markets Venture Capital (NMVC) and Rural Business Investment Company (RBIC) programs, created by the federal government for this purpose. The NMVC and RBIC programs enabled participating funds to obtain leverage and subsidy dollars from the SBA: the former to expand the private equity dollars they raised, and the latter to offset the structural challenges posed by investing in distressed, rural geographies. This in turn helped these funds attract private investors. Of the seven equity-focused funds in this study that raised the bulk of their capital after 2001, five were part of either the NMVC or RBIC program. Both programs required participating funds to adopt the limited-life, for-profit model of traditional venture capital.

As the funds in groups one and two exemplify, the CDVC providers formed subsequent to 2001 had only two organizational options: raise a limited-life, for-profit fund that makes primarily equity investments, or focus on near-equity. The factors that determined which options a given fund selected included the kinds of investments that the fund believed most appropriate for its target market, and its likely capacity to raise capital for such investments.

Because the near-equity providers in group two are focused primarily on smaller and more rural geographies, most of them felt that pure equity investments were inappropriate for their target markets. In particular, they identified as the critical factors in their decision to offer a near-equity product the challenges of limited deal flow, entrepreneurs unwilling to give up ownership, and the difficulties with exiting equity investments

[9] For a detailed discussion of these changes and their effect on CDVCs, see Financing Organizations with Debt and Equity, Chapter 5 in Financing Low Income Communities. Julia Sass Rubin (Ed).

An equally important consideration for the near-equity providers, however, was how feasible it would have been for them to raise a fund to make primarily equity investments. A fund that makes equity investments needs to be capitalized with equity dollars, whereas near-equity investments are debt-based and thus can be made with debt capital. With the exception of a few well-capitalized CDFIs, which can set aside some of their assets for this purpose, most organizations need to raise such capital from external sources. As already discussed, this is very challenging, particularly for those organizations that do not have a financially successful track record of making equity investments.

Given the challenges of CDVC investing and fund capitalization in rural geographies, some of the organizations that were considering offering either near-equity or equity products for the first time decided to begin by testing the idea via a pilot program. This also pointed them towards near-equity investments, which they saw as more similar to traditional debt and thus not requiring specialized expertise that generally is too expensive for a small fund to sustain.

What is the difference in investment performance for these different types of CDVC funds?

It is too early to compare directly the financial performance of the different CDVC models. None of the equity-focused funds have had sufficient exits to calculate internal rates of return, and most of the near-equity providers have made only a few investments, the majority of which are still in their portfolios. It also is difficult to attribute overhead costs to the near-equity providers, as those often are absorbed by the parent nonprofit organizations. Such a comparison should become feasible over the next five years, as both sets of funds exit more of their investments.

Theoretically, the equity-focused funds that have larger capitalizations, make larger investments, and cover broader geographies should perform better financially than either the more geographically targeted equity providers or the near-equity funds. The broader investment geographies should translate into greater deal flow and, consequently, higher quality portfolio companies with better financial prospects than those available to more geographically targeted funds. Higher-quality portfolio companies should require less technical assistance, reducing the cost of making and overseeing these investments.

Equity providers should perform better financially than those making near-equity investments for several other reasons beyond the differences in geography covered. First, equity allows for a much higher financial upside than does near-equity. It is difficult to build the potential for triple-digit financial returns into what is basically a loan without alienating the portfolio company being financed. Additionally, as discussed previously, some of the CDVC near-equity providers are still experimenting with this approach via pilot programs, and lack the investing experience of the equity fund managers.

Are relatively small CDVC funds that serve a single rural region of a state or that serve rural markets in multiple states as sustainable as larger CDVC funds that serve both rural and urban markets?

Only 5 of the 26 CDVC providers that serve rural geographies focus exclusively on those geographies. They are the Development Corporation of Austin, Kentucky Highlands Investment Corporation/Mountain Ventures, Northern Initiatives, ShoreBank Enterprise Cascadia's Product Innovation Fund, and the Wisconsin Rural Enterprise Fund. All five serve one or more counties of a single state.

The primary reason that so few CDVC funds have adopted an exclusively rural approach is the difficulty that it poses for a fund's sustainability. As discussed previously, rural geographies by definition have less deal flow, which means venture funds that invest in those geographies must invest in companies that may not be ideal candidates for venture capital, and provide them with the technical assistance necessary to raise their quality of operations (Rubin forthcoming; Barkley 2003; Barkley and Markley 2001). This kind of technical assistance is expensive and can reduce a venture fund's overall profitability (Rubin forthcoming; Barkley 2003; Barkley and Markley 2001).

Focusing on an exclusively rural geography also makes it more difficult for a CDVC fund to raise capital from financially motivated investors, which have significantly more dollars to invest than socially motivated investors. The majority of investors in the CDVC funds that have an exclusively rural focus are motivated by social rather than financial objectives.

Have these different types of CDVC funds (in terms of size and geographic focus) been able to meet the capital and technical assistance needs of rural markets?

One of the ongoing challenges in conducting research on venture capital is measuring demand for this product. This is even more the case when it comes to CDVC funds, as many of their potential portfolio companies do not realize that they need equity or near-equity capital. It thus is very difficult to answer conclusively whether different types of CDVC funds have met the capital and technical assistance needs of rural markets.

What is clear, however, is that there are benefits and drawbacks in this respect for both of the primary models the industry uses. Because the for-profit, limited life CDVC funds have larger capitalizations than the near-equity providers, they are able to bring more dollars to rural geographies. As equity providers, they also are able to offer rural companies particularly patient capital to foster their growth.

Because most of these funds cover a multi-state geography, however, they do not focus their investments on any given rural market, which means that those investments have less of a cumulative development effect on any individual rural geography. In contrast, the near-equity funds are able to focus, and potentially have a cumulative effect, on specific rural geographies. However, they have fewer investment dollars available and those dollars are primarily in the form of near-equity, which requires fairly immediate repayment by the portfolio companies and thus restricts their ability to meet the patient capital needs of those geographies, particularly for early-stage investments.

Both CDVC models provide their portfolio companies with technical assistance. The intensity of this assistance varies for each fund and is contingent on how much subsidy specific CDVC funds have to offset its provision.

The New Markets Venture Capital and the Rural Business Investment Company programs each incorporate technical assistance grants to help offset the cost of providing such assistance. Those limited-life, for-profit CDVC funds capitalized outside these two programs have either relied on subsidy raised by a nonprofit affiliate organization to offset the cost of providing technical assistance, as is the case with SJF Venture Funds I and II; absorbed the cost of technical assistance by reducing their profitability; or limited their technical assistance provision so as not to incur the additional expense. Both of the latter options are undesirable. Reducing an individual CDVC fund's profitability also reduces its sustainability; limiting the provision of technical assistance can reduce either the quality or the developmental impact of the transactions in which a CDVC fund invests.

Most of the near-equity providers have drawn on the resources of their parent entities to cover the cost of providing technical assistance. This has been funded by grants and other arrangements that the parent entities were able to use for this purpose. The Montana Community Development Corporation (CDC), for example, incorporates an SBA Small Business Development Center within its operations and uses the center to help meet the technical assistance needs of its debt and near-equity clients.

Several of the near-equity providers saw the significant time and resources required to provide technical assistance as a major deterrent to near-equity's financial viability, particularly given its lower financial returns relative to pure equity. At least one near-equity provider chose not to continue making such investments because the financial returns did not justify the time and resources involved.

How do the conditions of CDVC financings, in general and in rural geographies in particular, compare with those made by traditional venture capital funds?

The differences between CDVC financings and those of traditional venture capital funds are in the geographies that receive the capital; the sizes of investment; the industries that receive financing; and the provision of technical assistance. The data below includes only the 10 limited life, for-profit, equity focused CDVC funds in order to enable meaningful comparison to traditional venture capital funds which are generally of the latter structure. Because of the limited number of CDVC transactions, the CDVC data includes investments from the inception of the 10 funds, while the traditional venture capital data is for the years 2005-2007 only. This three-year period should reflect a broader time period as the geographic distribution of dollars by traditional venture capital funds has been fairly stable for the last decade.

Geography

According to the MoneyTree Report, which PricewaterhouseCoopers and the National Venture Capital Association compile based on data from Thomson Financial, 10 states accounted for 85 percent of all the dollars invested by the traditional venture capital industry between 2005 and 2007 (Lipper 2008). In contrast, these 10 states accounted for only 30 percent of all the dollars invested by the 10 rurally focused limited-life CDVC funds. The top 10 states that accounted for 80 percent of the total number of investments for the traditional venture capital industry received only 25 percent of the investments that the 10 CDVC funds made. (See Table 4)

Table 4: Ten States That Received the Most Traditional Venture Capital Dollars

Dollars Invested

	Traditional VC	CDVC
California	47.5%	1.1%.
Massachusetts	11.3%	6.0%
Texas	5.1%	0.0%
New York	4.6%	4.1%
Washington	4.0%	0.0%
New Jersey	2.9%	1.4%
Pennsylvania	2.7%	16.3%
Colorado	2.4%	0.0%
Maryland	2.3%	1.5%
North Carolina	1.9%	0.6%
	84.7%	29.9%

Number of Investments

	Traditional VC	CDVC
California	41.5%	1.2%
Massachusetts	11.1%	8.0%
New York	5.0%	4.6%
Texas	4.9%	0.0%
Washington	4.1%	0.0%
Pennsylvania	3.5%	8.8%
Maryland	2.9%	0.7%
Colorado	2.5%	0.0%
New Jersey	2.4%	1.2%
Virginia	2.4%	0.0%
	80.3%	24.5%

Note: For 10 equity-focused, limited life CDVC funds only. CDVC investments from inception of funds. Traditional VC dollars for 2005 to 2007, based on MoneyTree data.

The states that were in the top 10 for dollars invested by the rurally focused, limited-life CDVC funds received 83 percent of all the dollars invested by these funds, but only 20 percent of traditional venture capital dollars. The top 10 states in number of investments for these CDVC funds received 84 percent of the CDVC total, but only 23 percent of traditional venture capital investments. (See Table 5)

Table 5: Ten States That Received the Most CDVC Dollars

Dollars Invested

	CDVC	Traditional VC
Pennsylvania	16.3%	2.7%
Maine	13.1%	0.0%
Tennessee	12.8%	0.2%
Ohio	9.3%	0.4%
Kentucky	6.8%	0.2%
West Virginia	6.3%	0.0%
Massachusetts	6.0%	11.3%
New York	4.1%	4.6%
Vermont	4.0%	0.1%
New Mexico	4.0%	0.3%
	82.7%	19.8%

Number of Investments

	CDVC	Traditional VC
Maine	16.8%	0.1%
Tennessee	15.7%	0.5%
Pennsylvania	8.8%	3.5%
Ohio	8.0%	1.1%
Massachusetts	8.0%	11.1%
West Virginia	6.5%	0.1%
New Hampshire	5.3%	0.7%
New Mexico	5.3%	0.5%
Vermont	4.6%	0.2%
New York	4.6%	5.0%
	83.6%	22.8%

Note: For 10 equity-focused, limited life funds only. CDVC investments from inception of funds. Traditional VC dollars for 2005 to 2007, based on MoneyTree data.

These differences reflect the rurally focused CDVC funds' intentional focus on geographies that are underserved by traditional venture capital. They also reflect the different way that CDVC and traditional venture funds approach their target market. Unlike traditional venture capital funds, which tend to be national in scope but to concentrate their investments in only a handful of states, the limited-life CDVC funds are mostly regional in scope, targeting a handful of states and investing fairly evenly among them.

Size of investments

In 2007, the average traditional venture capital investment in a specific company was $7,711,962.[10] By comparison, the average investment by a CDVC fund in 2007 was $459,000.

This difference is explained in large part by the significant difference in the capitalization levels of traditional and CDVC funds. The traditional venture capital industry has experienced significant growth over the last two decades, with the size of the average venture fund increasing from $30 million in 1985, to $138 million in 1996, and almost 176 million in 2006 (National Venture Capital Association 2008; Onorato 1997). Since larger investments have transactions costs comparable to smaller ones, traditional venture capitalists have increased their investment sizes as capitalization levels have grown, in order to reduce transaction costs per fund and thus increase profits. By contrast, the average limited-life, equity-focused CDVC fund increased in size from $7.2 million in 1996 to $20.6 million in 2007. Fewer dollars under management by CDVC funds translates into smaller deal sizes.

The smaller CDVC investment sizes also reflect a different focus on the part of these funds relative to traditional venture capitalists. As the average investment sizes for traditional venture

[10] This consists of all equity dollars that company received, including those invested by traditional venture capital firms, individual investors, state venture funds, and CDVC funds. However, traditional venture capitalists account for the overwhelming majority of the dollars invested (MoneyTree 2008).

capitalists have grown, companies that need less than $3 million in equity capital have found it increasingly difficult to attract the interest of traditional venture capitalists. This is particularly true for those firms located in geographies or operating in industries that are underserved by traditional venture capital. By making smaller investments, CDVC funds are thus addressing an additional capital access gap in the market.

Industries financed

As shown in Table 6, ten industries received 90 percent of the traditional venture capital dollars in 2007. By contrast, those industries received only 63 percent of the dollars invested by the rurally focused limited-life CDVC funds. The 10 industries that received 88 percent of the CDVC dollars accounted for only 67 percent of the dollars invested by traditional venture capital funds.

Table 6: Investments by Industry for CDVC and Traditional Venture Capital

Top 10 industries in Dollars Invested by Traditional Venture Capital Funds

	Traditional VC	CDVC
Software	17.8%	11.8%
Biotechnology	17.0%	1.4%
Medical Devices and Equipment	13.5%	5.2%
Industrial/Energy	10.3%	5.9%
Telecommunications	6.9%	5.6%
Media and Entertainment	6.7%	10.4%
Semiconductors	6.2%	2.0%
IT Services	4.6%	4.2%
Networking and Equipment	4.2%	0.0%
Business Products and Services	2.8%	16.3%
	90.0%	62.8%

Top 10 industries in Dollars Invested by Rurally Focused Community Development Venture Capital Funds

	CDVC	Traditional VC
Consumer Products and Services	20.1%	1.5%
Business Products and Services	16.3%	2.8%
Software	11.82%	17.8%
Media and Entertainment	10.39%	6.7%
Industrial/Energy	5.9%	10.3%
Telecommunications	5.6%	6.9%
Medical Devices and Equipment	5.2%	13.5%
IT Services	4.2%	4.6%
Financial Services	4.1%	1.9%
Healthcare Services	4.0%	1.0%
	87.6%	67.0%

Note: For 10 equity-focused, limited life CDVC funds only. CDVC Investments from inception of funds. Traditional VC dollars for 2007 only, based on MoneyTree data.

The differences are even more dramatic for the top five industries, which received 66 percent of the traditional venture capital dollars and only 30 percent of the CDVC dollars. The top five industries for CDVC investments received 65 percent of all the rurally focused limited-life CDVC dollars, but only 39 percent of the dollars invested by traditional venture capitalists. Consumer Products and Services, the industry that received the most dollars from the CDVC funds, did not even make the top 10 list for traditional venture capital, while Biotechnology, which was closely behind Software for the industry that received the most traditional venture capital dollars, did not make the top 10 list for CDVC investments.

The differences reflect the limited geographies served by the rurally focused community development venture capital funds, which are more likely to include companies in the consumer products and services industries than in biotechnology. The differences also reflect the CDVC funds' smaller capitalizations and consequently smaller investment sizes. Industries such as biotechnology have higher start-up costs than consumer products and services, which require investment sizes that preclude most CDVC funds. Finally, the differences reflect the generalist nature of most CDVC fund investing. Given their limited geographies, these funds have to be opportunistic in looking for the highest-quality investment opportunities. Unlike many traditional venture capital funds, they cannot afford to specialize by industry or stage of investment. They also cannot afford to hire the in-house technical expertise found in many of the specialized traditional venture funds.

Technical assistance provision

As discussed previously, CDVC fund managers provide their portfolio companies with greater levels of technical assistance than that provided by traditional venture capitalists. While both CDVC and traditional fund managers take seats on the boards of their portfolio companies, offer strategic advice and introductions to relevant customers and suppliers, and replace management when appropriate, most CDVC fund managers are willing to go beyond those activities, sometimes even assuming specific management roles at their portfolio firms. CDVC fund managers provide this greater level of technical assistance to compensate for the lower-quality deal flow from which they select their investments, and which sometimes results in portfolio companies that are less market-ready than those that receive traditional venture capital (Rubin 2001b).

What factors are responsible for the apparent failures of Cascadia Rural Development Fund, Northeast Ventures, and Southern Ventures, and the decision of other CDVC funds not to continue making equity and near-equity investments?

Nine of the 35 CDVC providers in this study are no longer making investments. Between them, these nine organizations had approximately $38 million under management.

Two of these organizations, the CL Fund and the Vermont Community Loan Fund, are community development loan funds that were exploring adding near-equity investments to their business financing offerings. They each decided not to make a more significant commitment to such financings. The CL Fund determined that their pilot near-equity program was not generating the level of financial returns to justify the risk involved. Vermont Community Loan Fund made only one near-equity investment before deciding not to commit the resources to raising the capital necessary for ongoing near-equity investing.
Seven other rurally focused CDVC funds also ceased operating after several years of investing: the Anoka Sherbourne County Capital Fund, Cascadia's Rural Development Investment Fund, the eastern Kentucky-based Mountain Association for Community Economic Development (MACED), the sister funds Northeast Ventures and Iron Range Ventures, the ShoreBank BIDCO, and Southern Ventures, one of the first CDVC funds,. The factors responsible for this varied for each of the funds, as follows.

The Anoka Sherbourne County Capital Fund was created by the Anoka County Economic Development Partnership, a public private partnership set up by Anoka County, Minnesota, in order to spearhead economic development for the country. As part of that effort, Roger Jensen, the head of the partnership, created the Anoka County Capital Fund. The Fund was subsequently expanded to cover Sherburne County, and became the Anoka Sherburne County Capital Fund.

The Fund was capitalized primarily by local banks and utilities, and received ongoing operating support from various sources, including Anoka County. The fund was set up as a limited liability corporation, which was scheduled to cease operations in September 2007. In 2003, Mr. Jensen, who had been the fund's manager, died unexpectedly. Following his death, there was not sufficient support from the county and the partnership to continue operations. Given this lack of support and the pending date of termination, the Fund's board of directors has focused on managing the existing investments and winding down the fund.

Cascadia's Rural Development Investment Fund (RDIF) was a program of the Cascadia community development loan fund. RDIF, which made near-equity investments in the rural areas of Washington and Oregon, had unacceptably high losses, due primarily to poor investment choices by the program manager. The program's losses undermined the financial solvency of Cascadia, which ultimately merged with the ShoreBank Enterprise Pacific CDLF.

MACED made a limited number of equity investments in the late 1990s, using grant dollars that it had raised for that purpose. The investments were made as part of other financings that appeared to need equity. MACED stopped making such investments in order to enable its new leadership to evaluate its investment strategy, and may resume making equity investments in the future.

Northeast Ventures and Iron Range Ventures were forced to stop investing because they ran out of capital and could neither exit existing investments to free up additional investment capital nor attract new investors. A number of factors contributed to this outcome. First, the two entities were set up as a for-profit evergreen fund and a nonprofit fund, respectively. Both models are less attractive to bank investors than limited life for-profit funds. Since they could not attract bank investors, the two funds had to rely on foundations for more than half of their total investment capital. Two-thirds of the foundation dollars and 44 percent of the funds' total capital were in the form of such long-term debt. This led to a mismatch between the sources and uses of capital, in which the two CDVC funds took in debt capital, but invested it primarily as equity in their own portfolio companies. These equity investments did not produce the stream of income that Northeast and Iron Range Ventures needed in order to repay their loans.

The situation was compounded by the sparse and primarily early-stage deal flow in the northeast Minnesota geography served by the two funds. Exiting such transactions is challenging and can take many years, which not only restricts a venture fund's ability to reinvest the capital but also discourages new investors.

An additional problem for Northeast and Iron Range Ventures was their substantial overhead expenses, which were a further drain on available capital. In 2000, for example, the fund had almost $15 million under management and an annual operating budget of $910,000. Approximately 85 percent of this budget consisted of salaries, benefits, and other labor costs, while approximately 15 percent consisted of interest expense related to their capitalization.

The ShoreBank BIDCO, a wholly-owned for-profit subsidiary of ShoreBank, invested in the economically disadvantaged areas of Michigan's Upper and Lower Peninsulas. The fund, which primarily made subordinate loans, was capitalized with debt from ShoreBank, the State of Michigan, and the Ford Foundation. Although generally profitable, the BIDCO suffered some losses beginning in 2000, as a result of the economic slowdown in the region. The fund also covered some of the same territory as Northern Initiatives, a nonprofit ShoreBank subsidiary with a lower cost of capital. Given the duplication, ShoreBank ultimately decided to close the fund.

Southern Ventures was a for-profit subsidiary of the Southern Development Bank of Arkansas. The fund was a Small Business Investment Company, capitalized by local and state governments, individuals, and national and local foundations. Southern Ventures ceased operations in 1997, after writing off most of its investments and being forced to relinquish its Small Business Investment Company SBIC license.

This analysis was intended to identify any potential consistent reasons for why these nine CDVC providers stopped making investments. The diversity of factors responsible for each fund's closing, however, indicates that such consistent reasons do not appear to exist.

Conclusions and Recommendations

This study examined the community development venture capital funds that invest in rural geographies in order to improve our understanding of the various organizational models that these funds use to serve their target markets, and to determine which models appear best suited for which environments. The study found that existing CDVC providers fall into three categories: limited-life, for-profit equity providers; nonprofit community development loan funds that make primarily near-equity investments; and a group of funds that make both equity and near-equity investments using a diverse set of organizational models. All the funds in the third group, however, were capitalized prior to 2000, reflecting the institutionalization shortly after that of the limited-life, for-profit model for making equity CDVC investments. CDVC providers formed subsequent to that time appear to have only two options; raise a limited-life, for-profit fund that makes primarily equity investments, or focus on near-equity provision. The factors that determine which option a given fund selects include the kinds of investments that the firm believes to be most appropriate for its target market and its ability to raise equity capital.

This research also found that only three equity-focused CDVC funds were capitalized after 2004. Additionally, five of the seven equity-focused funds capitalized after 2001 were capitalized with the assistance of the New Markets Venture Capital or Rural Business Investment Company programs. This speaks to the difficulty of raising an equity-focused CDVC fund, particularly after 2001, when the sources of capital willing to invest in CDVC began to contract as a result of both economic and political factors.

It also speaks to the need for incentives to motivate investors to capitalize new CDVC funds. These incentives can be in the form of federal tax credits, to encourage investments in rural and otherwise underserved geographies by reducing the risk of capital loss. While less efficient than direct appropriations, tax credits are more politically feasible in the current funding environment (Rubin and Stankiewicz 2003). Investors also are familiar with tax credits because of their experience with the New Markets and Low Income Housing tax credit programs. In fact, the New Markets Tax Credit program was intended to encourage business equity investments in low-income geographies. However, the program's requirement that all qualified investments be held for a period of seven years or reinvested in another qualified investment within one year of exit in order to avoid the risk of tax credit recapture for the investors has made it very difficult to use for non-real estate based equity provision (Seidman 2007; Rubin and Stankiewicz 2003).

Other potential incentives could include expansion of the Community Reinvestment Act (CRA) to more types of financial institutions, such as mortgage and investment banks and insurance companies, as well as financial institutions with a stronger rural presence such as the farm credit bank system and the federal home loan banks. The CRA investment test also could be adjusted to place greater emphasis on the provision of business vs. real estate equity.

While helpful to the formation of new CDVC funds, the NMVC and RBIC programs could benefit from changes in the kind of capital they provide to selected funds. Both programs currently match private equity capital raised by selected venture funds with debt, which creates a sources-and-uses mismatch for these venture funds. One way to address this challenge is to create a Fund of Funds within the U.S. Small Business Administration that would enable the agency to act as an equity investor in the New Markets Venture Capital and Rural Business Investment Companies. In this scenario, the federal government would become a limited partner in the funds, with the same rights as other equity-investing limited partners. The NMVC and RBIC funds could still be required to raise equity capital from private sources in order to qualify for the SBA investment. States such as Arkansas, Ohio, West Virginia, and Iowa have used this approach when creating programs designed to encourage local venture capital investments.

A final recommendation is to decouple the technical assistance grants from the NMVC and RBIC programs, and to move the provision of such grants to the CDFI Fund, where any certified CDVC fund could compete for this capital. The amount of technical assistance awarded could correspond to minimum fundraising targets. For example, a fund that raised $2.5 million in investment capital would be eligible for a $500,000 technical assistance grant, while a fund that raised $10 million in investment capital would be eligible for a $2 million dollar grant. Having a range of fundraising minimums would address the needs of near-equity providers and entities that operate in smaller markets, as well as venture funds that target equity and invest in broader geographies. As with existing CDFI Fund funding, the technical assistance would be based on a pool of capital that is appropriated annually and awarded on a competitive basis.

Standardizing the level of technical assistance subsidy and making it available to all certified CDVC funds has several advantages. First, given the important role that technical assistance plays in the CDVC economic model, it would be beneficial for all CDVC funds to be able to access the subsidy capital that technical assistance requires. Second, separating the private equity and technical assistance funds enables certified CDVC funds to approach additional market-oriented investors when raising the equity capital they need for investing. The technical assistance subsidy should offset the additional costs involved in the CDVC model, enabling the funds to produce competitive financial returns while meeting their social objectives. This could increase the number of investors, and thus the amount of capital, available for community development venture capital.

Decoupling the technical assistance subsidy and investment capital leverage aspects of the NMVC and RBIC programs also would enable individual CDVC funds to target the kind of capital that they need and the geographies that they wish to serve, rather than having to comply with all aspects of these programs to qualify for either. While most CDVC funds need subsidy to provide technical assistance, not all of them need leverage, especially if it is in the form of debt, as in the current NMVC and RBIC programs. The geographic restrictions of the NMVC and RBIC programs also exclude many underserved areas, discouraging the formation of CDVC funds that would target those geographies.

The CDFI Fund is well-suited to manage such a program. It has extensive experience awarding grant capital and selecting CDVC funds to receive investments of various kinds. By requiring that CDVC funds be certified CDFIs in order to be eligible for the technical assistance grants, the Fund also would encourage more venture funds to serve low-income populations and geographies, and would act as a counterweight to the profitability pressures exerted by market-oriented investors.

In combination, these recommendations would aid the formation of additional CDVC funds throughout the United States. This will make equity and near-equity capital available to the rural geographies not being served by conventional venture capital, and help spur community economic development in many low-income communities.

Author Biography

Julia Sass Rubin is an Assistant Professor of Public Policy at the Edward J. Bloustein School of Planning and Public Policy at Rutgers University. Dr. Rubin's research is in the area of community economic development and community development finance. At present, she is continuing her research examining the use of venture capital and lending for economic development and poverty alleviation. She also is looking at the formulation and likely impact of the New Markets initiatives, and the capital needs of social enterprises. Dr. Rubin has advised a number of organizations in the area of developmental finance, including the United States Small Business Administration, the CDFI Fund of the U.S. Treasury Department, the John D. and Catherine T. MacArthur Foundation, the Appalachian Regional Commission, the Overseas Private Investment Corporation, The Urban Institute, and the New Jersey Redevelopment Authority. Previously, she consulted for McKinsey & Company and worked in brand management for the Procter & Gamble and Eastman Kodak Companies. Dr. Rubin earned her PhD and MA from Harvard University, an MBA with distinction from Harvard Business School, and an AB with honors from Harvard-Radcliffe College. She was a post-doctoral fellow at the

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