

Kerwin Tesdell:

Great. Well, thanks very much. I've moved over here. Can folks hear me? I do have a microphone. It's coming through? Great.

Okay, well, what we thought just to start out is to have a presentation – ah, it moved. Good. A little presentation just to get us all on the same page thinking about what this industry is. First of all, I want to introduce the model. I think most of you are familiar with it. Just think about what developmental venture capital is, how it works, what it's trying to accomplish; give you a little statistical overview of the industry and particularly what's happening in rural America; talk about a topic that I know is on everyone's minds and particularly the minds of investors, what kind of financial returns do we produce in this industry and also what kind of social returns do we produce in this industry; and finally, I'll give you my take on some of the challenges of doing developmental venture capital in rural areas and some ideas about policy recommendations to meet some of these challenges. And again, this will be the first of a series of these, of different people from different viewpoints giving you their ideas, their thoughts about what some of these challenges are and what can be done on the policy level to deal with some of these challenges.

So first of all, what is this model? We talk about a double bottom line. We have a financial bottom line. We seek to produce market rates of return for our investors. If we didn't do that, we wouldn't live to fight another day and be able to raise more funds to invest in communities. Secondly, we have a second bottom line. We produce social returns in the form of creation of good jobs, particularly good jobs for people who don't have significant economic opportunity in our economy and produce economic activity in underinvested areas. And in particular, today we'll be talking about investing in rural areas. So let's look first from the economic development standpoint. Why focus on this tool of developmental venture capital as compared with a lot of the other things that were mentioned this morning, loan funds, and there's workforce development and all kinds of things you can do?

Why focus on equity capital today? And I think the first answer is equity is very important. If you talk to any businessperson, and you say, "What do you need?", I guarantee the first answer will be, "I need money," and you dig a little bit deeper, and usually in that conversation, they'll say, "Well, the thing I really have had trouble raising is the equity capital for my business."

Traditional venture capital is virtually nonexistent in many of the rural areas that we're talking about, and I'll show you a slide of a

study that we did a couple of years ago that shows that. Also, traditional venture capital tends to be available for a very narrow slice of types of businesses, and those types of businesses often locate in places like Silicon Valley and not places like rural Appalachia. So having a dedicated source of equity capital in rural communities can be a very powerful source of economic development, and particularly because most businesses do not raise venture capital. They get money in other ways.

We've talked about the financing of businesses from the three Fs. It's the friends, families and fools who provide that kind of capital for businesses, and those sources also often are not as available in rural areas. You don't have the rich uncle, the golfing buddy, whatever, who's going to stake you in your business. So another reason that a source of equity capital that's really focused in your region can be a very powerful tool for building strong businesses, for building rapidly growing businesses.

Equity capital leverages debt. There are a bunch of bank regulators in the room, bunch of bankers. You all know about debt equity ratios and things like that that you look at as you make loans. To make that debt equity ratio work, you need equity. And so, the equity capital venture capital is what allows, often, bankers to come in with large amounts of money in the larger term to finance a business.

And also, I think an important point is even developmental venture capital doesn't finance any business that comes along. Developmental venture capital is very selective. The system of developmental venture capital seeks out businesses that have the potential of growing very rapidly, of succeeding in a major way. And after all, that is what you need in your communities, in rural communities in particular, is businesses that are not marginal, that are gonna grow rapidly, are gonna produce well-paying jobs because they need to, because they're increasing their workforces, they're creating opportunities for job advancement, bringing new technologies into communities. These are the kinds of businesses that venture capital naturally gravitates toward.

I think another important point is that venture capital provides more than money. I think that if you speak with any of our fund managers – and you will have that opportunity in a few moments – they'll tell you that as important or perhaps more important than the money they provide is the extensive entrepreneurial and managerial assistance that the venture capital model, and particularly the developmental venture capital model provides, and

I'm sure you'll be hearing about that in a moment.

We all talk about technical assistance and things like that. I can tell you, from having participated now in deals with a bunch of our members, technical assistance does not begin to capture what developmental venture capital funds do with businesses. They take seats on the board of directors. They are partners in the businesses in which they invest. Whatever needs to be done, it's not a cookie cutter, "I'll write your business plan in this way," – whatever needs to be done to make that business a success, the venture capital fund will do, whether it's helping with marketing, going out on marketing calls with the CEO to get a new major client, lining up other financing and then, finally, participating in that exit.

I just spent about a good portion of a month of my life with Ray Moncrief in the back here on an exit that just closed successfully last week in which we doubled our money in about a year, which was very nice, as did Ray – excuse me, in about a year. And I can tell you, Ray was – this was virtually a full-time job for him, leading this company through what became a very successful process.

So we're here to talk about developmental venture capital, and the first question is why make a special effort? Don't we have capital markets out there? We're in a building that does a lot of studying of efficient capital markets. Wouldn't this happen anyway?

And CDVCA actually got a hold of a proprietary database. We happen to have an intern who was also working at Merrill Lynch, a volunteer, and we borrowed their database of venture capital investments across the nation that had addresses of all the businesses in which these funds in their proprietary database had invested, and we ran these addresses through a mapping software, and we discovered that less than one percent of all the venture capital investments that had been made in that database went to rural areas. Less than one percent.

Steve?

Male: [Inaudible – off mic.]

Kerwin Tesdell: Yes, it's the federal definition. Probably some of you – so this is really rural. This is not Lexington, Kentucky, near a rural area. This is rural America. And we also did the same thing with our database Community Development Venture Capital investments, and we found that about – so this is a narrow definition, and we found, though, that about 19 percent of developmental venture

capital investments were made in rural areas, which actually corresponds almost exactly with the number of businesses that are located in rural areas, so this really shows that when you make an effort to do some targeting – and it’s certainly true that a lot of our funds are urban funds as well as rural funds, so it’s not that this group was particularly targeting rural areas. But this is a group of funds that proves that you can make venture capital investments, where if you talk to the traditional venture capitalists, they’ll say, “No, it’s not possible. Those deals don’t exist in rural America.”

Now, I said I was stealing the thunder of one of my slides. It’s this one, that developmental venture capital was really born in rural areas. Kentucky Highlands was the initial pioneer in this area. We’ll hear from Ray from Kentucky Highlands. Others like CEI came along soon afterwards with this model, and still, when you look across our membership, a lot of funds have been formed in urban areas as well as rural areas, but rural America is really a strength for developmental venture capital, and you ask the question, “Why? Why would that be?”

And I think the reason is that if you’re in a rural area, and you think about what do we need, jobs sort of jumps out at you. In where I live, in things like New York City, things like housing coming to the fore, and when you’re involved in community development in an urban area, you have a variety of – whether it’s crime or housing or various other things that you’re working on, in rural America, my experience says jobs really jumps out at you. Business development, economic development, some of the other problems that people talk about, about migration and “Our kids aren’t staying in our community” really boils down to jobs. If the economic opportunity were there, people would be staying. So I think this is why we’re seeing this focus on developmental venture capital as an important tool for creating economic opportunity and good jobs.

A little bit about what the industry looks like. First of all, our markets, we focus on investing in rapidly growing businesses, typically with proprietary technologies, other competitive advantages. One way I think of what we do is 50 years ago, if you had a high school education, or maybe you didn’t have a high school education, you could get a job at the auto plant or the iron mine, earn a decent wage, support your family, have medical benefits, have a pension. We all know those jobs are disappearing or gone in our economy.

So we’re really asking the question, “Where in the new economy

are those good businesses that will provide that kind of good employment that will be successful in our economy?”, and that’s where Community Development Venture Capital invests. We invest in underinvested markets in rural areas of the country where other venture capitalists are not looking. And what that means is we’re not in a bidding war with five other funds in Silicon Valley all going after the same deal that leads to better valuations in investments and ultimately higher returns for investors.

In addition, we tend to invest in different types of companies from traditional venture capital funds. We’re investing in different places. We’re also typically investing in smaller companies, typically a little lower tech. So our returns will tend to vary less closely with other venture capital funds. So I’m addressing this now from the investor standpoint when you’re assembling your portfolio investments, and you’ve got a bunch of investments in Silicon Valley, in terms of portfolio management, diversifying your risk, investing in a developmental venture capital fund, particularly one in a rural area, can diversify your risk, and sort of an additional reason to invest in this kind of fun.

Who runs these funds? Experienced venture capitalists and also people who have experience and understanding of economic development. You look at the fund managers of these funds, and one thing that jumps out at you is their really strong roots and understanding of the community.

The people you’ll be hearing from in a panel in a moment spend their lives traveling around their region, going to every business meeting, every conference, every venture fair, talking to the local lawyers, the local accountants, the local economic development agencies, and anything that comes along in their region, they know about, and they’re the first place that folks go. They have the networks to be able to check people out, good trustworthy person, not good trustworthy person.

Those roots are very important to be able to invest successfully in these areas. They’re experts in helping the kinds of businesses that exist in rural areas grow, businesses that have significant workforce because part of their mission is economic development and job development, not just in investing and getting a return.

And very often, they’ll have the relationships with the local economic development agencies. They will be able to help the company find the area to build the plant that has the special bond and the workforce development grant and all the things, the

package that comes together to make a business successful. That is a way that they add value to a business the way a Silicon Valley venture capitalist would add value to a business by helping them do the latest Internet thing.

And finally, many of our funds have been very successful in getting experienced venture capitalists, other business leaders to volunteer on boards of directors, on investment committees, on advisory boards in ways that a traditional venture capitalist would not be able to do. So all reasons that investors should look very seriously at investing in these sorts of funds.

Just a few numbers. Nationally, we count 92 funds and funds in formation around the United States. There are more, as I mentioned, in other parts of the world. Our latest data shows almost a billion dollars, and we think that number is over a billion dollars. We're collecting the latest numbers now. So significant industry. Also growing industry. This shows numbers of funds over the last 10, 15 years and also funds under management growing steadily.

Who invests in these funds? We're very happy to be here at the Federal Reserve because banks are the largest group of investors in our funds. If you looked at this pie chart maybe ten years ago, the slices of the foundations of the more social investors would be much larger, and what's happened over time is that those investors have remained involved in the industry in terms of absolute numbers, but that really rapid growth that you saw in the chart has been picked up by the banks, by other financial institutions and now, increasingly, penchant funds, insurance companies, other financial investors that have been able to come in with larger amounts of money, and I think it's an indication that this model is succeeding.

In terms of structure, these are generally traditionally structured funds. We look a little strange on the double bottom line social side, so our advice to people is to look pretty plain vanilla on the financial side so as an investor you sort of know what you can expect. The exception is many of our funds have associated not-for-profit organizations.

So, for example, Bonnie from SJF runs one of these operations, and these are organizations that are able to build a bunch of supports around – if you think of the economic fund as the economic engine, the financial engine, these are the supports that are built around the engine to boost the social return, to provide

added technical assistance to businesses, to work with the workforce of the businesses to encourage wealth development and workforce development, job training. Really, many of them act as an HR department for the fund. Many of them have programs and mentoring, entrepreneurial mentorship. And also measuring the social impact of the funds, all things that enhance the financial value, in many cases, of the funds, but also the social value of what they do.

This is just an idea of the kinds of investments that over time our funds have made. As you can see, manufacturing is a large part. These are statistics that look historically at all of the investments of the Community Development Venture Capital industry, and I think manufacturing is large for a couple reasons. One is this is where you find businesses that typically produce good employment, which is one of our goals.

A second reason is what I was talking about before, that a lot of the funds in our membership are rural funds. And particularly their older portfolios tend to be very concentrated in manufacturing. That is probably less true if you looked at a pie chart of investments made in the last three years, I think you'd see less manufacturing, probably more services, probably also a little more high-tech as funds have done more.

Hang around venture capitalists very long, and immediately they start talking about exits. This is how do you get your money out of the deal. This is not a self-amortizing loan where the money comes back automatically. About half of the exits come from sales to outside companies. Surprisingly –

[End of Part1SideA, Beginning of Part1SideB]

Kerwin Tesdell: ...come from initial public offerings. That's the sky-high homerun, often, for an exit – management buybacks. ESOPS are nice because you have both a financial exit but also a good social story in the form of worker ownership. And then, also, some of our funds concentrate not so much on pure equity as they do on what we call near equity, where you do have more of a self-liquidating kind of instrument.

Big question. What are the financial returns in this industry, and the honest answer is that we're still at a stage where it's too early to provide the definitive data that you would get from the National Venture Capital Association statistical yearbook, which is dollar-on-dollar returns to limited partners in venture capital firms.

Really the first of these traditionally structured funds will not be winding up for another year or two, and even then, we'll just get dribs and drabs of a little early information.

So what CDVCA did is it looked at – we looked at the portfolios of three of the largest funds. They actually happen to all be rural funds – largest and oldest funds, I should say. Oldest funds. They happen to all be rural funds. They were also typically not for profit. They also, all of them, had a perpetual life. So all things that you would sort of expect – the perpetual life and the not-for-profit status, you would expect to perhaps decrease returns as compared with a traditionally structured funds.

We looked at all the 31 exits that occurred during a certain time period where we felt that we had a cohort of investments that were generally mostly exited. We found 31 exits. 24 of those were successful. 7 of them were total write-offs. So we really did look at the good and the bad. We treated these as an overall portfolio, and we found a gross internal rate of return of 15.5 percent, which is probably not something that a Silicon Valley venture capitalist would put at the top of their private placement memorandum, but I think it clearly shows that you can invest. You can invest in rural areas and make money. And in fact, we expect – and what we're seeing now in the early portfolios of some of the traditional venture capital funds is we're seeing what we think are significantly higher returns than 15 percent.

On the social side, in the same way we are rigorous about measuring our financial returns, increasingly now we're very rigorous in measuring our social returns. We look at job creation, particularly for people with lesser economic opportunity. Then we look at the quality of those jobs. What kind of wages do they pay? Do they provide medical benefits? Do they provide opportunities for training and advancement, opportunities for employee ownership and wealth building?

And as I said, we measure the social returns as rigorously as we measure the financial returns, and I think if you are interested in this, there is a tool called The Measuring Impact Tool Kit that the Heron Foundation was a supporter of the development of this that really steps through with Excel spreadsheets and data definitions and is a very complete package in all the different kinds of areas that you'd want to cover in measuring social returns.

I'll just mention that many of our funds also look at additional social impacts, increasing women and minority ownership.

Environmental sustainable businesses is a growing area now. Many of our funds are focused on investing in cleantech and similar industries, products that are useful to communities and companies that have good employment practices.

I cut down on the number of slides here. We've actually sliced this up a number of ways, but what we see in all of our data is that our funds are doing what they say they're supposed to do, which is increasing employment, but particularly increasing employment for lower income people without the computer science PhDs, the people who do not have as great opportunities in our economy.

On more of a geographic level, we looked at the number of investments – I think this is in dollar terms – dollar investments in rural areas. 41 percent of our investments are in new markets, tax credit areas. 37 percent are in CDFI Fund qualified areas. And 12.5 percent are in the very lowest income areas which qualify under the old CDFI Fund hot zone criteria. And I should say these are not necessarily dollars that come from Linda's program. This is overall for all the investments in our industry that don't necessarily have particular government limits on them.

Let me use the last few minutes just to talk a little bit about the challenges I see in rural development, venture capital and some ideas about how to address those challenges. So I'll be sort of the first voice in this chorus that we're going to try to develop over the day.

First challenge is raising capital, and I think this is particularly challenging in rural areas for several reasons. First off, there are fewer large institutions and large corporations' headquarters in rural areas, and these kinds of institutions like to make investments where their headquarters are, where the largest number of employees are, and unfortunately, that tends not to be rural areas.

Also you have fewer sophisticated investors. You need a certain level of experience and sophistication to be able to invest effectively in venture capital, and very often, the various financial institutions, banks and others, in rural areas just don't have the experience of making large number of these investments, and therefore, they tend to shy away from investments and venture capital.

I already mentioned obviously you have a less wealthy population in rural areas for making individual investments, and also – and I think this is a particularly important point for this audience – my

sense is it's often more difficult to get large amounts of investment from banks in rural areas, and that's because of the way CRA works, that CRA is geographic. Banks are to invest in areas where they take deposits, and in my experience in particular, the nicest place to be is where all the banks want to rush in.

So I get calls all of the time of, "Do you have a fund in North Carolina or in Florida or in Texas?", or wherever the bank is currently moving into, and unfortunately, rural areas tend not to be the hot areas that banks are expanding in, and therefore, they get a lot less attention motivated by CRA, and I'd be actually interested in reactions to the regulators in the room to this.

One ramification of the difficulty of raising this money in rural areas is that you often have smaller funds. This leads to less favorable economics. In particular, management fees are calculated as a percentage of funds under management. If you have a \$10 million fund, two to three percent management fee, you do the calculation, you maybe have \$300,000 a year for all of your operating expenses, and it's very difficult to run a fund on that amount of money.

Also, I think often you have difficulty attracting and retaining strong management to run a smaller fund. Venture capital are – size matters. They like to tell their friends, "I'm managing \$100 million or \$200 million," and an opportunity to go to a rural area and manage a \$10 million fund is sometimes less attractive, and it's more difficult to get what you really need, which is that very experienced management, not to say anything negative about the excellent managers that we have in this room. *(Laughter)* Of course, the exception to the room – rule.

Also, in this difficulty of attracting strong managers, many people who do venture capital just like to live in urban areas, and in my experience, our members have often had trouble attracting people to rural areas, and that's then compounded by the smaller fund size.

Some additional points: fewer co-investors, harder to find co-investors, greater distances. You gotta get in your car and drive for two or three hours to visit your companies, which increases your cost. You often find smaller companies, smaller deal sizes, which also increases your cost. It often costs as much or more to invest \$500,000 into a company as it does to invest \$5 or \$10 million into a company.

Deal flow quality, sophistication of management and particularly that rounded out management team. If you're sitting in Silicon Valley, the business plans you tend to see are the three people who just left Intel, Stanford MBAs, the guy with the perfect marketing background and CFO and the president who has led two venture-backed companies to exit and now is on his third. You tend not to see those teams in rural areas, and I think that's where what I was talking about before, all that entrepreneurial and managerial expertise, the experience that these funds bring. They have led companies through this development process before. That's where that expertise really can be valuable, and I think you'll hear a little bit about things like the operational assistance money that comes with the rural business investment program that can help address some of those problems as well.

And also, fewer of what I would call support services, the lawyers, the investment bankers, the accountants, the marketing people, the web development people, all the people who, if you're sitting in New York, are a subway ride away, harder to pull those together. And again, the importance of the expertise that the fund itself brings.

What do we do about these sorts of things? I know it's sort of pie in the sky, but we're here to think a little bit blue sky about what could be done. What can be done about CRA to encourage more bank investment into rural areas where perhaps the banking industry is less active? What other things can we do to encourage private investment in this industry?

In particular, one thought is a tax credit that would provide inducement to invest, and I would suggest here on the other side – we're not just looking for any money. I would suggest not doing things like loan guarantees, or investment guarantees that perhaps would – we want to encourage smart, strong investment in companies, and I think the way to do that is through, perhaps, boosting return a little bit but not by protecting people against losses.

I mentioned the fund size problem. Even if you – let's say you can – in your community, you can find the \$10 million, but you can't find the \$20 or \$30 million to get to the fund size you want. Government leverage can lever that \$10 million into \$20 million or \$30 million so that you'll have a decent fund size, and we'll talk about programs that will do that.

You'll be hearing in a little bit, I think, about this concept of

operational assistance money. This is additional grant money that can be provided that a fund can use to pay for the marketing study because they don't have the perfect marketing person to pay for the recruitment of a strong CFO, to pay for the development of the accounting system of the company, to get that deal that a traditional venture capitalist would look at and say, "This really isn't an investable deal. This isn't the right team," to get that company from there to the point where it is an investable, successful company.

And finally, this issue of where do we find the talent to run these funds and to really expand out this model, and I think that requires training, capacity building and, perhaps, some kind of a apprenticeship. Really, this is an apprenticeship business. You can't just go to a classroom and walk out and become a venture capitalist. You need to really be trained in this business, and we need to find some way to accelerate this process.

We had a peer group meeting of our fund managers this couple of weeks ago, and we were talking about how do we get this industry to the next level, how do we get venture capital funds spread across the country, and this was a major issue. Getting people trained and in a position where they can really do this effectively because it's not an easy job.

Just turning the last slide to some specific policy recommendations, we have two programs – the Rural Business Investment Program and the New Markets Venture Capital Program. I see Austin Belton just walked in the room, who formerly ran the New Markets Venture Capital Program. These are both run out of SBA, and they have two of the three components – two of the four components, that I just talked about. They provide government leverage to increase fund size, and they also provide this operational assistance money to pay for some of the more expensive work with businesses that makes it possible to do this business successfully in rural areas.

It was to be linked then to the New Markets Tax Credit, which was to provide the inducement for the private sector capital, and unfortunately, that has not worked out so well. It's very difficult to use the New Markets Tax Credit for venture capital. So I think that's something that we need to address, either to look at some fixes to the New Markets Tax Credit or to think about do we need some kind of new tax credit to incentivize private investment.

Make some procedural, regulatory changes to the CDFI fund FA

component. We'll hear a little bit later from Linda Davenport about that. Most CDFIs are lending institutions. Most CDFIs are perpetual life institutions. And as the CDFI has faced a challenge of creating one application, one set of standards for all CDFIs, often our members feel a little bit left out and a little bit like a square peg in a round hole. So how can we round out those edges and try to work better with the CDFI fund?

And then, finally, looking at changes in CRA. I talked about the big idea of how do we get – how do we change CRA to get more money in rural areas. Very specifically, something we've been working on is simply to get Community Development Venture Capital funds, New Markets Venture Capital funds, Rural Business Investment Company funds specifically listed as qualifying for CRA, and I've been bothering Barry Wides for the last year or two, talking about the injustice that we weren't named in the CRA Q&A, and I'm very happy to say and to thank Barry publicly for his work on that, that in the latest draft of the Q&A, that these organizations are listed specifically, and I think that's going to really help our funds in raising money that's motivated by CRA.

So those are a few of my ideas just to launch us off. We'll have a lot more good ideas from others. This is sort of a final slide to help us think about where we stand, born to raise hell, born to raise capital, and I do just want to take a personal opportunity here to mention – this is a slide that was always at the end of a presentation given by a guy who a lot of you know in this room, Nick Smith, who was the founder of Northeast Ventures, founder of CDVCA, our board chair for ten years. And for those of you who do not know, Nick passed away after a long battle with cancer a couple of weeks ago, and I just want to recognize him. He would have been here at this meeting and really been a major participant. He started a fund in Northeastern Minnesota focused on a very rural area. He really cared about what we're discussing today, and it would have been nice to have him here.

So should I do any kind of questions? Or should we just hop straight into –

Male: *[Inaudible – off mic.]*

Kerwin Tesdell: Yeah, I think we're running a little bit behind. Thank you.

[Applause]