

As we enter a new millennium, the nation continues to ride the wave of economic growth that brought the twentieth century to a close. But while national unemployment levels are undeniably low, many hard-working Americans still lack jobs that pay enough to support a family. The national economic boom has been unprecedented in length, but its effects have not spread out evenly across all our communities. Many local economies have actually experienced a decline in jobs and median incomes.

Rural communities, particularly in the Pacific Northwest, have generally not enjoyed the same levels of prosperity as urban and suburban centers. In Washington state, rural poverty and unemployment persist, despite unprecedented economic growth in the Puget Sound region. A 1998 study by the Corporation for Enterprise Development found the state of Washington to have the second highest urban/rural income disparity in the nation.

The situation is similar in rural communities throughout the country. Rural areas simply do not have enough well-paying jobs to go around. In Washington and Oregon, rural communities have historically been dependent on primary resource extraction industries: agriculture, forest products and fishing. All three industries are in precipitous decline. Many family farms have succumbed to the falling prices in foreign export markets that have resulted from the globalization of commodity food markets. Remaining farmers have been pummeled by several recent years of unusually harsh weather conditions that have greatly diminished harvest volumes.

Communities dependent on the timber and fishing industries have also been hard-hit—facing restrictive environmental regulations and dwindling



CASCADIA'S RURAL DEVELOPMENT FUND BRINGS INVESTMENT INTO RURAL COMMUNITIES

By David Kleiber, Loan Officer, Cascadia

resources. The decline in the volume of timber harvested from national forest lands has resulted in the closure of dozens of sawmills in the rural Northwest—mills that historically offered the best paying jobs in town. The recent closure of the coastal ground fishery, coupled with the listing of local salmon runs as endangered, has all but eliminated the once viable regional fishing industry.

Many Northwest rural communities have tried to compensate for this rapid and continuing job loss by developing alternative sources of revenue and job growth. Some have successfully transitioned to a tourism-based

economy. While this strategy may keep a community alive, it doesn't provide the same level of economic prosperity. Tourism and service industry jobs do not compare in terms of wages and benefits to the manufacturing jobs that were lost.

THE CHALLENGES OF JOB CREATION

Rural communities face several obstacles in the struggle to maintain a viable economic base and create quality family-wage jobs. In the rural Pacific Northwest, most communities lack the technical infrastructure to attract the computer, information processing and biotechnology industries that have

been the primary drivers of the incredible urban economic dynamism in the region. While technology-based businesses might be attracted to the quality of life in rural areas, rural communities cannot offer the high speed, wide bandwidth telecommunication services on which many high-tech businesses depend.

Instead, rural residents must find ways to create jobs from within. This entails conceiving of new ways to add value to the limited resources still on hand. In areas dependent on the fishing and timber industries, this means creating value-added timber and fish products to ensure that profits derived from the processing of these raw materials will stay in the community. Instead of shipping logs overseas, for example, rural manufacturers must use the logs to create marketable finished products that will double, triple or even quadruple the revenue earned from each tree.

Creating an essentially new manufacturing base in a poor community can be quite a challenge. Entrepreneurs traditionally rely on family, friends and business partners to provide startup and working capital for their businesses. This isn't always possible for business owners in rural communities, where local wealth has been stretched thin by poverty and unemployment resulting from the demise of the local primary manufacturers.

In Washington, a number of state agencies and private nonprofit organizations, including Seattle based Cascadia Revolving Fund, offer loans to small rural businesses that cannot secure bank financing for all of their needs. But, like a bank, most of these sources of capital require collateral as a secondary source of repayment in case of default. Cascadia's experience in working with rural businesses has demonstrated that entrepreneurs in eco-

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nomically distressed communities frequently need unsecured risk capital.

On a balance sheet, risk capital most frequently takes the form of owner's equity—or the money the business principals invest as permanent capital in exchange for stock in, or ownership of, the business. These funds are generally used to build an asset base that is then borrowed against through a bank or other lender to provide the company with more capital. Without sufficient equity, a business will have difficulty borrowing additional capital from a bank.

DEVELOPING THE INSTRUMENT

Cascadia spent four years testing the feasibility of creating a fund for making equity investments in rural northwest businesses resulting in the *Rural Development Investment Fund* (RDIF). During this initial pilot phase, the RDIF was capitalized by foundation grants and program-related investments as well as grants from state and federal agencies involved in rural economic development.

Cascadia originally thought to model the RDIF on the venture capital industry, in which professionally managed funds purchase a percentage of the ownership of young companies that have the potential to dramatically increase in value. The key to this model is the exit strategy. Venture funds anticipate that their ownership interests (stock) will become liquid (sold and converted back into cash) when these

new companies successfully offer their shares for sale to the public. The ability to make an initial public offering (IPO) depends on the company's management team and technology, and the team's ability to apply that technology to meet the needs of a large market.

The more Cascadia studied this type of investment strategy, the clearer it became that this model would not work well for the rural economies of the Northwest. While many companies would welcome the access to patient venture capital, the exit strategy for Cascadia was not clear. Most existing businesses in these communities are simply not likely IPO candidates. Given this reality, Cascadia structured a financial instrument that balances the company's need for equity-like capital with Cascadia's need for a relatively straightforward exit. The resulting product is called a Participation Agreement (PA)—a deeply subordinated, long-term, low-interest loan, coupled with a revenue-based fee called a Participation Payment. The loan is amortized over an extended period at a low rate, resulting in very reasonable monthly loan payments. The company may choose to accrue a designated number of Participation Payments, thereby deferring the impact on the business' cash flow until the proceeds of the loan have been invested and the company's sales, profitability and cash flow have improved. Given the characteristics of the target market for the RDIF, there are several advantages to this product over a standard equity investment:

- the touchy issues surrounding the purchase of a piece of an entrepreneur's company, and the valuation of that company, are avoided;
- the PA provides a source of current cash flow to cover operating costs for Cascadia—a very important consideration for a relatively small fund;

- ▶ investment recovery is not dependent on a “liquidity event” such as an IPO, but is instead amortized like an ordinary loan;
- ▶ like true equity, the entrepreneur pays a higher rate of return only if the business is growing and successful—if not, their cost of funds is lower;
- ▶ though not as patient as true equity, the entrepreneur can delay the impact on business cash flow by accruing a certain number of Participation Payments;
- ▶ traditional lenders view the PA debt as equity, thereby allowing the “investment” to leverage additional debt;
- ▶ the basic debt structure of the PA provides greater loss protection to the RDIF than common or preferred stock investments;
- ▶ the simplicity of structuring and closing the deal minimizes legal fees on both sides and
- ▶ reductions in the revenue-based fee over time can be tied to progressive work force compensation programs, employee benefit improvements, positive environmental actions or other community/social goals.

The key to the long-term success of any high-risk investment fund is to earn sufficient income on successful investments to compensate for the inevitable losses sustained on those that fail. Due to the subordinated collateral position of investments made by Cascadia’s RDIF, most losses we ex-

INVESTEE PROFILE: EDDYLINE KAYAKS

Tom and Lisa Derrer started Eddyline Kayaks in their garage 29 years ago. The company is now one of the top sea kayak manufacturers in the industry, developing and producing several quality kayak models and a line of paddles. In addition to Eddyline’s Burlington, Washington production facility, the company operates a retail outlet offering instruction, rentals and touring.

Product designer Tom Derrer is a true innovator in the sea kayak industry. He was among the first to develop a mid-priced kayak that offers the features and performance of a more expensive fiberglass boat. Eddyline’s new kayaks, made from an innovative composite material, filled a long-vacant niche in the sea kayak market.

Despite its quality product, Eddyline couldn’t obtain a loan to produce the new boats. Research and development costs had been high, and the company had incurred significant losses. Cascadia was able to offer Eddyline a subordinated loan through its Rural Development Investment Fund. The RDIF’s \$100,000 loan enabled the company to purchase equipment to produce the new kayaks, and add five employees to an existing staff of twenty—a boon in rural Skagit County, which has historically been dependant on the timber industry for jobs.



perience will be complete losses (i.e. there will likely be insufficient value in the collateral of a client company at liquidation to fully pay all senior creditors). For this reason, the RDIF targets a rate of return of 18–22% from successful investments—considerably higher than that of a typical loan. Equity capital is never cheap. First, investors demand a rate of return that compensates them for the assumed risks. Also, high rates of return are the only way (short of raising additional capital) to maintain the capital base of the fund. Compared to the current target rates of return for traditional venture capital (40–60% internal rate of return in three years), Cascadia’s Rural Development Investment Fund is comparatively inexpensive.

The RDIF is distinguishable from traditional venture funds in other important ways as well. Most venture funds are structured as limited partnerships with a predetermined life—investors are typically promised a return on their money in seven to ten years. As a non-profit organization, Cascadia has the advantage of being able to continually reinvest recovered capital in new businesses to make the RDIF an

“evergreen” resource for economic development in the northwest. The PA instrument also has the advantage of generating current income so that the fund does not have to rely on philanthropic dollars to cover operating costs. This enhances the RDIF’s future as a self-sustaining financial resource.

In its relatively short life span, the RDIF has achieved a significant impact on job creation in the rural Pacific Northwest. Typical “investees” include a manufacturer of specialty wood products employing 46 people, a manufacturer of wall panels supporting more than 20 employees, and a manufacturer of log and timberframe buildings that provides ten jobs.

While the Rural Development Investment Fund does not offer true equity investments that a traditional venture capitalist would recognize, its Participation Agreements meet a very real need in the rural finance market. Currently in its fifth year of operation, the RDIF has proven to be an effective catalyst for job creation, and a useful instrument for filling the niche that venture capital firms occupy in the mainstream urban financial marketplace. *CI*



ABOUT THE AUTHOR

DAVID KLEIBER joined Cascadia as a loan officer in 1993, and became associate director one year later. Prior to joining Cascadia, Mr. Kleiber was an assistant vice president and loan officer for Rainier National Bank’s Forest Products Corporate Banking Group. Following this, he worked for a consulting company placing pension fund investments into timberland and then for a small independent Northwest sawmill as export sales manager. Dave then left for Nepal and three years of service in the Peace Corps as a forestry consultant, which was followed by contract work there with the World Bank and the United Nations Development Program. He returned and began work at Cascadia where he initiated the formation of the Rural Development Investment Fund, a quasi-equity investment arm of Cascadia that focuses on assisting rural manufacturers with the potential to create family wage jobs. Mr. Kleiber earned a master of business administration in marketing from the University of Washington and a bachelor of science in forestry from Michigan State University.