FEDERAL RESERVE BANK
OF SAN FRANCISCO

Community Investments Vol. 10, Issue 4 Community Development Venture Capital: The Double Bottom Line

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Fall 1998

Kentucky Highlands Investment Corporation has worked for thirty-two years to alleviate poverty in the heart of Appalachia. In Duluth, Minnesota, Northeast Ventures has spent a decade tackling the economic devastation brought on by dramatic reductions in the region's ore mining industry. In 1996, Boston Community Ventures was established in one of the poorest sections of Boston to foster the creation of quality jobs and the growth of socially responsible businesses. Meanwhile, similar efforts have sprung up in such diverse locations around the world as Nizhny Novgorod, Russia; Zagreb, Croatia; and Lima, Peru.

What do these organizations have in common? They are all community development venture capital (CDVC) funds, members of a new but rapidly growing field of organizations that use the tools of venture capital to create good jobs, productive wealth, and entrepreneurial capacity to benefit disadvantaged people and economically distressed communities. They seek to apply the powerful engine of growth that has driven the economic expansion in Silicon Valley, and other hotbeds of business development, to communities that the current prosperity has passed by.

CDVC funds make equity and equity-like investments in highly competitive small businesses that hold the promise of rapid growth. These fast growing companies produce a "double bottom line" of not only financial returns, but also social benefits in the form of good jobs and healthier communities. The investments typically range from $100,000 to $1 million, much smaller than most traditional venture capital investments.

The companies in which CDVC funds invest generally employ between ten and one hundred people. Investors in CDVC funds include foundations, banks, insurance companies and other corporations, government, and private individuals. They invest because of an interest in the social and financial returns of the funds; they too are interested in the double bottom line.

The CDVC Industry

There are currently more than forty CDVC funds operating across the United States and Canada. In the U.S. alone, such funds have more than $330 million under management. CDVC funds have also become a powerful economic development tool in economies in transition in Eastern Europe and in developing economies in Latin America.

CDVC funds come in many different forms, including not-for-profit, for-profit, and quasi-public organizations. Their structures encompass for-profit "C" corporations, limited partnerships, limited liability companies, community development corporations (CDCs), and Small Business Investment Companies (SBICs). Despite this structural diversity, CDVC funds all share a commitment to the creation of good jobs through business investment.

CDVC funds use a multitude of investment techniques to accomplish their missions. These range from the purchase of preferred and common stock to the provision of subordinated debt with equity "kickers" such as warrants or royalties. CDVC funds, as compared with lenders, thus structure their financing so that they enjoy the "upside" when a company does well, but also the "downside" when a company does poorly. For this reason, CDVC funds take a much more active role than a lender ever would in advising, and sometimes even helping manage, an investee's business, in order to help it succeed and grow rapidly. This often-intensive entrepreneurial and managerial assistance is the heart of the economic development impact of CDVC.

Why Community Development Venture Capital?

There are a number of reasons that community development venture capital is a powerful tool for economic development.

- Equity capital is vital to the success and growth of small businesses, particularly during their expansion stage when large numbers of jobs and productive wealth are being created. Because equity capital is high risk, it is very difficult to access.
- Equity capital is in particularly short supply in low-income areas and among minority entrepreneurs. The primary source of risk capital for most small businesses is personal savings and loans from friends and family. In low-income areas, these tend to be lacking. Traditional venture capital firms provide financing for only a tiny portion of businesses nationally, and venture capital is almost completely absent from low-income urban and rural areas.
- Equity capital leverages other financing. Banks and other lenders will not make loans to businesses unless they maintain a prudent ratio of equity to debt capital. An infusion of equity capital is often the linch pin for assembling other financing for new or expanding businesses.
- CDVC funds target companies that are highly competitive and thus likely to expand rapidly. These companies not only provide substantial financial returns, they also create large numbers of good jobs and have the financial resources to offer decent wages, employee benefits,

worker training, and opportunities for career advancement. This sector of small, competitive businesses can form the backbone of a successful local economy.

- CDVC funds provide significant entrepreneurial and managerial assistance to businesses. Unlike lenders, equity investors become partners with their investee companies, sitting on their boards of directors and providing other substantial assistance by identifying additional financing, making contacts with customers and suppliers, and helping with executive recruitment. For businesses in low-income areas, this assistance is often as crucial as the financing itself.
- Some CDVC funds operate, or have relationships with, workforce development programs that help place unemployed people in jobs that are created by their financing activities.
- Some CDVC funds go beyond providing financing and technical assistance to existing businesses. They start and nurture businesses, and then recruit local business people to own and operate them. In this way, CDVC funds are able to jump-start business develpment in even the most economically distressed areas.

The Difficulties of the Double Bottom Line

A focus on social returns differentiates CDVC funds from traditional venture capital funds. Like traditional venture funds, however, CDVC funds must also deliver financially to remain in operation. This double bottom line of social and financial objectives presents many challenges that are different from those that traditional venture capital funds encounter. Among the challenges that the CDVC industry faces are problems in raising capital and reaching scale, difficulties in attracting experienced talent, and high costs of operation.

Problems In Raising Capital and Reaching Scale

The pool of potential investors that share an interest in the social component of the double bottom line is limited, and CDVC funds generally do not offer traditional venture capital returns. For this reason, CDVC funds find it difficult to raise large amounts of capital, and the average size of a mature CDVC fund in 1996 was only $5.8 million. This is significantly smaller than most traditional venture funds, and also less than the approximately $10 million minimum generally thought necessary to help cover operating expenses, attract experienced fund managers and allow for investment diversification. Substantial new sources of risk capital must be found for funds in the CDVC industry to reach an economic scale where the full power of the model may be demonstrated.

Attracting Experienced Talent

Only a small number of individuals have the skills necessary to operate a successful equity investment program. Most of them work for traditional venture funds and are highly compensated for their work. Those with the necessary skills and experience to produce the double bottom line of making successful financial investments while also creating social benefits are even more scarce. The relatively small number of CDVC funds currently operating has thus far been fortunate in attracting extraordinarily talented and dedicated people. Creating opportunities for training and apprenticeship learning will be necessary to allow the CDVC industry to continue its rapid expansion and retain its high quality.

Costs of Operation

The economics of CDVC funds are fundamentally different from those of traditional venture capital funds: CDVC funds are generally more expensive to operate, as a percentage of funds under management. Increased scale would help this problem, but, for at least two reasons, costs will always remain an issue. First, the size of the average CDVC investment is significantly smaller than that of the average traditional venture investment, although the cost of making a smaller investment is often as great as making a larger one. Also, CDVC funds often become even more involved in providing entrepreneurial and managerial assistance to their investee businesses than do traditional venture capitalists, and this too is expensive. The smaller investment size and greater business assistance are both integral to achieving the social benefits of CDVC funds. For investment returns not to be unduly reduced, a model must be developed that will help pay for the social benefits produced by CDVC funds from a source other than investment earnings alone.

Future of the Industry

Economic development professionals, as well as leaders in finance and business, are increasingly turning to CDVC as an effective way to help build healthy communities and make durable improvements in the lives of disadvantaged people. While CDVC shows great promise, the jury is still out regarding the full measure of its effectiveness. As existing funds mature and newer ones are formed, they are sharing knowledge and best practices with each other, and efforts are under way to measure the full social benefit and financial returns of the industry. Together, these funds are experimenting with and building a model that is different from traditional community economic development, but is not quite venture capital either. It is a new hybrid that borrows sophisticated tools of finance and business development and applies them in promising new ways to some of the most serious and intractable problems of our time.

The Community Development Venture Capital Alliance (CDVCA) promotes use of the tools of venture capital to create good jobs, productive wealth, and entrepreneurial capacity that benefit low-income people and distressed communities. CDVCA’s members operate funds in low-income urban and rural areas throughout the United States and around the world. It seeks to build the field of community development venture capital by providing training, offering opportunities for peer exchange and learning, increasing members’ access to capital and other resources, providing individualized consulting services, developing standards and best practices, and advocating for the field. It also encourages and facilitates involvement of the traditional venture capital communities in community development finance.

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