

# Venture Capital for Communities

by Kerwin Tesdell, President, Community Development Venture Capital Alliance

Community development venture capital (CDVC) is one of the fastest growing sectors in the field of community development finance. From a handful of funds in 1990, the industry has grown to more than sixty funds in the United States, and at least another twenty funds operating or in formation in other parts of the world. In the last year alone, CDVC under management in the U.S. has grown to \$400 million, up \$100 million dollars from the end of 2000. Almost \$40 million of this increase was raised by three established managers that have successfully closed on second funds.<sup>1</sup>

## THE DOUBLE BOTTOM LINE

CDVC funds use the tools of venture capital to create jobs, wealth and entrepreneurial capacity to benefit low-income people and distressed communities. They are mission-driven funds that invest in businesses that promise rapid growth. This growth creates not only financial returns for the fund and its investors but also social returns in the form of good jobs for low-income people—a double bottom line.

CDVC funds apply disciplined equity investment practices in places where other venture capitalists do not go: inner cities and distressed rural communities. They offer financing to minority- and women-owned firms and

those that are environmentally focused. They invest in such businesses as new-economy manufacturing companies and promising new service-sector firms, which can offer good employment to large numbers of low-income people. They seek to apply principles that have helped create unprecedented economic growth in places from Silicon Valley to areas often left behind such as rural Appalachia, inner-city Baltimore and Nizhny Novgorod, Russia.

## THE IMPORTANCE OF EQUITY CAPITAL

Equity capital is vital to all businesses. It provides a cushion against slow business climates and is relatively patient and flexible. As any banker analyzing debt/equity ratios can tell you, without sufficient equity, companies cannot borrow additional funds. Most important for economic development, equity provides the seed funding to start new companies and allows established companies to develop new products or build new plants—activities that create significant new employment and economic opportunity.

Equity capital is difficult for any company to raise. Most entrepreneurs raise initial equity capital from their own savings and those of family and friends, but this is particularly hard to come by in low-wealth communities. A ready source of equity capital can thus be an extraordinarily effective tool for fueling the creation of new wealth in economically distressed areas and also new job opportunities for people who need them.

CDVC funds seek to create good

jobs that pay a living wage. To produce the financial portion of the double bottom line, CDVC funds must seek out companies that hold the promise of rapid growth. Companies that are growing and successful can afford to pay higher wages than companies that are just scraping by. Successful companies tend to offer better benefits to their employees, as well as job training and opportunities for advancement, and to attract and retain the workforce they need for expansion.

By providing equity and near-equity investments to businesses that otherwise would not have access to them, CDVC funds create a powerful engine of economic growth. Equity investments are made through the purchase of common or preferred stock, while near-equity investments might be made through a subordinated loan that carries an “equity kicker,” such as royalties or warrants to purchase stock. These investments each carry significant risk of loss but are structured so that the fund will share the “upside” of the business if the business does well.

## MORE THAN MONEY: ENTREPRENEURIAL AND MANAGERIAL ASSISTANCE

CDVC funds become part-owners of the companies in which they invest, tying their own success directly to the success of their portfolio businesses. As a result, CDVC funds invest not just money but a great deal of time and effort in helping the companies in which they invest succeed. They typically take seats or observer rights on the boards of their portfolio compa

<sup>1</sup> This includes Silicon Valley Community Ventures of San Francisco, California, which closed its second fund with a \$10 million commitment from the California Public Employees' Retirement System—the first capital ever committed to a CDVC fund by a retirement fund.

nies. Fund staff may help with such activities as raising additional capital or marketing a new product. Fund staff may even fill the chief financial officer function for a company for a period of time, then help recruit a new head of finance. Extensive entrepreneurial and managerial assistance is central to the economic development function of CDVC funds and often proves as important to the success of portfolio companies as the financing itself.

Taking this assistance a step further, several funds have learned to act as intermediaries between local workforce development programs and the businesses in which they invest. Adding value to portfolio companies by helping to recruit trained employees from distressed areas and disadvantaged populations augments a fund's social and financial bottom lines. Likewise, some funds have learned how to help their portfolio companies use government tax incentives and other programs in empowerment zones and other economically distressed communities. In this way, the funds make it not only financially possible but also attractive for a business to locate in a low-income area and hire area workers.

## FACTS AND FIGURES

While CDVC funds share a common mission, they take a number of legal forms, including: limited liability companies; limited partnerships; regular "C" corporations; and not-for-profit tax-exempt corporations. Their capital comes from sources that share their interest in a double bottom line return, including foundations, banks fulfilling their Community Reinvestment Act obligations, other corporations, government and wealthy individuals.

Although foundations and other socially motivated investors led the way in the development of the industry, banks have now supplanted these investors as the leading source of capital for the industry. While they pro-

vided a little over a third of the equity capital to CDVC funds started before 1998, banks provided about two-thirds of the equity capital raised by funds formed after that year. And the range of legal structures used by CDVC funds offer banks a variety of investment options including the purchase of interests in a limited partnership or limited liability company, the purchase of stock in a corporation, straight debt, equity equivalent investments<sup>2</sup> and capital grants.

Based on a survey of 25 CDVC funds, the average capitalization per fund was \$12.7 million at the end of 2000 and the median for these funds was \$6.2 million. However, newer CDVC funds are starting out larger. The three funds that raised capital in 2001 each began life in the \$12 to \$13 million range.

Because most CDVC funds are relatively young, it is impossible to quantify precise financial or social returns. However, a sample of the older funds indicates that they have created approximately one job for every \$10,000 invested. These job creation numbers are particularly impressive in light of the fact that the funds surveyed were all operating in very depressed rural areas. And, of course, the money invested is not spent, but returned to investors or recycled to invest in other companies to create more jobs in the future.

## OPPORTUNITIES AND CHALLENGES AHEAD

The environment in which CDVC funds and their investors operate has changed significantly during the past year. New funds are forming at a rapid pace, mature funds are successfully

raising money to start second funds and two new federal programs have been introduced that will further boost the field: the New Markets Venture Capital (NMVC) and New Markets Tax Credit (NMTC) programs, both enacted in December of 2000.

In July of 2001, the Small Business Administration conditionally designated seven new NMVC companies. The NMVC program provides capital in the form of zero coupon debentures<sup>3</sup> and operating assistance grants to NMVC funds that invest in small businesses in low-income areas. NMVC companies must raise matching funds from the private sector for both the capital and the technical assistance grant. The seven funds aim to raise between \$5 million and \$12.5 million in private capital and an additional \$1.5 to \$3 million in private operating assistance grants. The target date for a second round of NMVC selection is the fall of 2002.

The New Markets Tax Credit provides a dollar-for-dollar credit of 39% of the amount invested in a community development venture capital fund, spread out over a period of seven years. A community development venture capital fund that wishes to participate in the program would apply to the Community Development Financial Institutions (CDFI) Fund for an allocation of tax credits. If such an allocation is awarded, the fund can go to the market to raise capital with the tax credit as a strong inducement to investors. The NMTC program will pump \$15 billion into community development venture capital funds and other investments in low-income urban and rural areas of the country with \$2.5 billion available in 2002.

These two programs together offer unprecedented opportunities to the

---

2 For more information on equity-equivalents (or EQ2s), please refer to Mark Pinsky's article on page 10.

---

3 Unsecured debt backed only by the integrity of the borrower, not by collateral, and documented by an agreement called an indenture. One example is an unsecured bond.

## ABOUT THE AUTHOR



KERWIN TESDELL is president of the Community Development Venture Capital Alliance ([www.cdvca.org](http://www.cdvca.org)), the trade association of community development venture capital (CDVC) funds. It provides training, technical assistance and consulting services to the field; operates a Central Fund that invests in and co-invests with CDVC funds; performs and publishes research; and advocates for the field.

Community Development Venture Capital Alliance  
330 Seventh Avenue, 19th Floor  
New York, New York 10001  
212-594-6747

community development venture capital industry. At the same time, they offer some challenges. The industry must be careful that the regulatory definition of New Markets investing—based on geography—does not replace the more nuanced and powerful methods that mission-driven CDVC funds use to produce their social returns. These methods take into account not only the area in which a business is located but also a complex mix of factors including the types of jobs the business is likely to create and the types of people who are likely to take those jobs.

Perhaps more important than any legislation is the fact that community development venture capital is becoming an established and recognized industry. Someone raising a CDVC fund six or seven years ago faced a

difficult task of trying to define for investors this unusual activity with few points of reference; now those raising funds have an entire industry to point to. Investing in CDVC funds is an established activity and a number of larger institutional investors have staffs of people with expertise and budgets dedicated to that purpose. People are building careers in CDVC funds, developing a unique set of skills that combine those of venture capital finance and economic development. At the same time, the CDVC field is changing rapidly, with an unusual spirit of experimentation and learning that will serve it well in the search for innovative ways to produce double bottom line results. *CI*

## THE FEDERAL RESERVE BANK OF SAN FRANCISCO

IN PARTNERSHIP WITH

## THE UNIVERSITY OF SOUTHERN CALIFORNIA

PRESENT THE

# NATIONAL COMMUNITY DEVELOPMENT LENDING SCHOOL

JULY 21–25, 2002



## Join Us

for five days of intensive training on the key issues and current industry trends relevant to community development lending in today's business environment. Training in five core areas—single-family and multi-family housing, small business, commercial real estate and community-based facilities lending—stresses the day-to-day mechanics of underwriting community development loans and ensuring their long-term profitability.

A redesigned and challenging curriculum has been developed by an advisory committee of community development bankers, training professionals and representatives of bank regulatory agencies to focus on structuring and underwriting community development loans. Each course is developed to ensure that students receive the most current, relevant, challenging and applicable instruction available. In addition, students will have the opportunity to participate in evening roundtables and seminars that focus specifically on issues that have been raised during the day's courses.

## WATCH YOUR MAIL . . .

A brochure and registration application will arrive soon.

## FOR PROGRAM AND REGISTRATION INFORMATION

Check our website at <http://www.frbsf.org/frbsf/events/index.html>

## REGULATORY OVERVIEW

### INVESTMENT TYPE: COMMUNITY DEVELOPMENT VENTURE CAPITAL

**Definition:** Community development venture capital organizations (CDVC) use the tools of venture capital to conduct community and economic development activities as defined in the CRA regulation. CDVC funds make equity and equity-like investments in small businesses that hold the promise of rapid growth and a “double bottom line” of not only financial returns, but also community and economic development benefits. 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). CDVCs fund investments ranging from the purchase of preferred and common stock to the provision of subordinated debt with equity “kickers” such as warrants or royalties. Investments in CDVCs should be carried as investments on the investing institution’s balance sheet in accordance with Generally Accepted Accounting Principles (GAAP).

**CRA Applicability:** A lawful investment, deposit, membership share or grant to a community development venture capital fund that has as its primary purpose community development will be considered a qualified investment/community development investment under the CRA regulation.

### FEDERAL RESERVE SYSTEM CONFERENCE

*Please mark your calendars for*

## **The Federal Reserve System’s Sovereign Lending Conference**

### ***“Banking Opportunities in Indian Country”***

A national conference to encourage initiatives and partnerships that increase access to credit and capital and strengthen local economies

THE DOUBLETREE PARADISE VALLEY RESORT

SCOTTSDALE, ARIZONA

NOVEMBER 18–20, 2002

*More information will follow*