CASE STUDIES

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RUPRI Rural Equity Capital Initiative
Study of Nontraditional Venture Capital Institutions

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The RUPRI Rural Equity Capital Initiative was funded by a grant from the U.S. Department of Agriculture’s Fund for Rural America. The purpose of this project was to examine innovative institutions that are making venture capital investments in rural places across the country and develop lessons learned from these institutions that might be applied in other areas. The project research team included Deborah M. Markley (chair), principal of Policy Research Group, a consulting firm in Chapel Hill, NC; David L. Barkley, Professor and Co-Coordinator, Regional Economic Development Research Laboratory, Clemson University, Clemson, SC; David Freshwater, Professor, Department of Agricultural Economics, University of Kentucky, Lexington, KY; Ron Shaffer, Professor, Department of Agricultural and Applied Economics, University of Wisconsin, Madison, WI; and Julia Sass Rubin, Ph.D. candidate in Organizational Behavior, Harvard University.

As part of this project, 23 case studies of nontraditional venture capital institutions or programs were completed during 1998, 1999 and 2000. The information from these visits forms the basis of a four-part series that describes the lessons learned from the experiences of these institutions, the rationale for nontraditional institutions, the process for establishing nontraditional venture funds, and detailed case studies of each institution. The specific publications are:

- **Establishing Nontraditional Venture Capital Institutions: Lessons Learned.** This publication describes lessons learned from the case studies. Advantages and disadvantages of different organizational structures are discussed and characteristics of successful nontraditional venture funds are presented.

- **Nontraditional Venture Capital Institutions: Filling a Financial Market Gap.** This publication provides an overview of the venture capital industry, discusses impediments to making venture capital investments in rural areas and non-high tech business enterprises, and suggests roles for nontraditional venture capital in small market areas.

- **Establishing Nontraditional Venture Capital Institutions: The Decision-Making Process.** Based on information from the 23 case studies, the research team outlined a decision-making process for establishing nontraditional venture capital funds. This publication describes the sequential steps in this process and discusses the interrelated nature of the decisions made at each point in the process. Specific examples illustrate the process.

- **Case Studies of Nontraditional Venture Capital Institutions.** This publication provides detailed case studies of the 23 institutions included in this project. The history of each institution is described, along with its organizational structure, investment experience, and future concerns or opportunities for the fund. The perspective of some portfolio companies is also included.

This report, along with other publications produced for this project, are available from the RUPRI website (www.rupri.org/pubs/equitycap/index.html) or by contacting RUPRI at 573-882-0316.
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Case Studies of Nontraditional Venture Capital Institutions

Overview

The lack of venture capital infrastructure in most parts of the U.S. places a constraint on local economic development. Without this infrastructure, potential entrepreneurs cannot be identified and their ideas will not make it to the marketplace. Similarly, the lack of capital might be limiting the growth potential of existing firms within a community or state. With this as background, the Rural Policy Research Institute’s (RUPRI) Rural Equity Capital Initiative designed a research project that would provide information to leaders and policy makers at the community and state levels as they consider how to enhance their economic development strategies through the creation of nontraditional venture capital institutions or programs.

The project was designed to identify innovative institutions or programs that make venture capital investments in parts of the U.S. not served by traditional venture capital institutions such as less urbanized states or regions and rural areas. The nontraditional venture capital funds included in this project generally expect to earn rates of return that are less than those sought by traditional venture capitalists and they often operate with a geographic or community focus. The funds may operate with a dual bottom line, considering both social and financial returns on investments. A common characteristic of these nontraditional venture capital institutions is the attempt to fill venture capital gaps that exist in their markets and to overcome impediments to making venture capital investments in their regions.

Research Methodology

In choosing the case study institutions, the research team did not attempt to document best practices; indeed four of the programs are no longer active. Instead, the objective of this analysis was to better appreciate the advantages and disadvantages associated with alternative program structures and the shared characteristics of successful programs. Toward that end, the case study institutions represent a range of organizational structures and operating experience. The programs differ primarily in terms of the sources of capitalization, organizational and management structure, and investment goals.

The research team concentrated its analysis on types of institutions that were either relatively widespread or had the potential for greater adoption. The team believed that this approach would provide more useful information than studying unique and non-replicable combinations of resources and opportunities. If a strategy had been tried in multiple places by different organizations, it seemed more likely to be transferable to yet another place than one that had been tried in only what might be unique circumstances.

The RUPRI research team completed case studies of 23 nontraditional venture capital institutions across the U.S. These case studies were completed between June 1998 and November 2000. A team of two researchers met with each institution’s staff and, in most cases, founders, to learn about the history, structure, operation, and investment experience of each institution. When possible, owners of two or three portfolio companies of each institution also were visited to get their perspective on the investment experience.
This publication provides a descriptive case study of each institution. All of the information included in these case studies was obtained during the site visits with the institutions. The institutions are organized into two principal categories: publicly assisted venture capital programs and private venture capital funds including community development venture funds. Some background information on specific institutional structures, such as Small Business Investment Companies, is also provided.

**Publicly Assisted Venture Capital Programs**

Publicly assisted venture capital programs have been created, usually at the state level, as one response to the perceived shortage of venture capital for businesses. Although the institutional structure of these programs differs from state to state, we found three primary types of publicly assisted programs: publicly funded and publicly managed institutions, privately managed institutions with public funding or incentives, and certified capital company programs. Two funds, MIN-Corp and Kansas Venture Capital, Inc., received state support during the early years of operation but currently operate as private organizations. These two institutions are included in the publicly assisted category to reflect their status when the funds were first established. The following case studies of publicly assisted programs are provided in this report:

- Small Enterprise Growth Fund (Augusta, Maine)
- Minnesota Technology Corporation Investment Fund/MIN-Corp (Minneapolis, MN)
- Iowa Product Development Corporation/Iowa Seed Capital Corporation (Des Moines, IA)

**Privately managed with public funding or incentives**

- Oklahoma Capital Investment Board (Oklahoma City, OK)
- Partner Funds: Pacesetter and MESBIC Venture Funds (Dallas, TX)
- Colorado Rural Seed Fund (Boulder, CO)
- Northern Rockies Venture Fund (Butte, MT)
- Kansas Venture Capital, Inc. (Overland Park, KS)
- Iowa Capital Corporation (Des Moines, IA)
- Magnolia Venture Capital Fund (Jackson, MS)

**Certified capital company programs**

- Louisiana Certified Capital Company Program (Baton Rouge, LA)
- Missouri Certified Capital Company Program (Jefferson City, MO)

**Private Venture Capital Funds**

The private venture capital funds included in the RUPRI study are organized into three categories: community-level funds, community development venture capital funds (CDVCs), and Small Business Investment Companies (SBICs). In some cases, a fund could be classified in two groups, e.g., a CDVC organized as an SBIC; however, the funds are placed in the category that best reflects their operating mission and structure. In addition, at least one of the public funds, MIN-Corp, is
considered a CDVC. The following case studies of private venture funds are provided in this report.

**Community-Level Venture Capital Funds**
- Ames Seed Capital Fund, Inc. (Ames, IA)
- McAlester Investment Group (McAlester, OK)
- Siouxland Ventures, Inc. (Sioux City, IA)
- Montana Rural Electric Cooperatives

**Community Development Venture Capital Funds**
- Coastal Ventures Limited Partnership (Portland, ME)
- Kentucky Highlands Investment Corporation (London, KY)
- Northeast Ventures (Duluth, MN)
- Cascadia (Seattle, WA)

**Small Business Investment Companies**
- North Dakota SBIC (Fargo, ND)
- First United Ventures (Durant, OK)

The private funds range from small, community-based angel networks to statewide venture capital investment activities. Most of these private institutions were designed to provide venture capital to businesses located in a particular geographic region with the goal of earning acceptable rates of return while enhancing local economic activity. The funds classified as community development venture capital funds were created to make venture capital investments that would lead to job creation and other social benefits in distressed communities, whether in rural Appalachia or an urban center. These funds have a dual bottom line, balancing the goal of enhancing economic development benefits in a community with that of achieving a rate of return that supports fund sustainability over time. The third group of private funds is SBICs, a specific institutional structure licensed by the Small Business Administration. While the SBIC structure has been used widely since its inception, this study found few rural-focused SBICs. These few funds are discussed here. Finally, two of these funds, Appalachian Ohio Development Fund and North Carolina Economic Opportunities Fund are included as emerging models since they have been created recently:

**Emerging Models**
- Appalachian Ohio Development Fund (Athens, OH)
- North Carolina Economic Opportunities Fund (Raleigh, NC)

Case studies of these twenty-three nontraditional venture capital institutions are presented in this report. Each case study includes the name of the primary person(s) interviewed during the visit and the date of the visit. The information contained in each case study is current as of this visit date. Some institutions may have increased or reduced their investment activities since that time. For questions regarding these programs, please contact Deborah M. Markley, Chair, RUPRI Rural Equity Capital Initiative.
Case Study 1: Small Enterprise Growth Fund (Maine)
Contact: Theresa Hodges, Program Manager, SEGF, Bangor, ME
Date of Visit: July 1998

The Small Enterprise Growth Fund (SEGF) is a publicly funded, publicly administered program of the state of Maine that provides investment capital for companies preparing to commercialize an innovative product or service. SEGF was started in 1997 with the mission “to fill capital gaps that exist for early stage companies that have established market demand and developed a strong management team but need capital to support the commercialization process.” The fund targets early stage, high growth, high public benefit businesses in marine sciences, biotechnology, manufacturing, exporting, software development, environmental services and technologies, financial services, and value-added natural resources. Eligible businesses are those that have 25 or fewer employees, sales of $2,000,000 or less in the previous years, and the potential for both high growth and public benefits. The Finance Authority of Maine (Augusta, Maine) administers the Small Enterprise Growth Fund, under the direction of the Board of the Small Enterprise Growth Fund.

History of SEGF
Tom McBrierty, former Commissioner of the Department of Economic and Community Development for Maine, was the principal champion of SEGF. McBrierty assumed the Commissioner's job in April 1995. During the following months, McBrierty toured Maine to assess the state's strengths and weaknesses regarding economic development. Based on this tour, McBrierty found that access to patient capital was limited for small businesses in early stages of development.

In the fall of 1995, McBrierty initiated legislation for the development of a patient capital fund. The purpose of the public fund was to fill the void attributable to a lack of private sector investment activity. The legislation was submitted in January 1996 and the state legislature approved a bond referendum for November 1996. In November, the voters approved a $5,000,000 bond issue for the capitalization of SEGF. The Small Enterprise Growth Fund began the process of soliciting, screening, and making investments in the summer of 1997.

The SEGF was established as a revolving fund, administered by the Finance Authority of Maine (FAME), and managed by a volunteer board of one public sector representative and 10 private sector representatives. The structure for SEGF was selected by McBrierty based on (1) a 1995 research study by Charlie Spies (FAME) of other public sector venture capital programs and (2) conversations with individuals experienced in venture investing. No other state programs were found to be appropriate models for Maine; however, the review of other states' efforts did provide useful information for the organization and administration of SEGF. The combination of publicly administered (by FAME) and privately managed (by private sector board) was selected because FAME has the infrastructure for and experience in handling loan applications and the Board provides experience and expertise in venture investing and high technology businesses. Moreover, the private board members bring multiple perspectives to the deals and their decision-making process is
relatively insulated from political pressure.

The principal supporters for starting the SEGF were the governor, the legislative oversight committee for FAME, and the Commissioner of Economic Development. There was no formal opposition to the formation of SEGF, but some individuals believed part of the investments should be targeted at specific industries such as cranberries and others desired an organization where the funds were allocated to different state organizations rather than used to capitalize SEGF. Moreover, banks and venture capital funds were skeptical that the fund would contribute much given the limited capitalization and legislated restrictions on investments.

SEGF’s principal objective is to make investments in successful companies so as to cover operating expenses and maintain a self-perpetuating investment fund. SEGF focuses on investments in businesses that create new jobs in Maine, such as a manufacturing firm that exports outside the state, rather than businesses that compete with existing Maine firms like retail businesses. SEGF does not have any written formula for considering the social returns on their investments. They do not require that their portfolio companies achieve any target number of jobs per dollar invested. There is no explicit geographic focus for the fund’s investments except that the investments must benefit businesses in Maine. SEGF attempts to distribute the investments throughout Maine, and, all else being equal, SEGF would give some preference to deals that would benefit low income, slow growth communities over investments in Southern Maine. To date, approximately 33 percent of the closed deals and 40 percent of the prospective deals are in nonmetropolitan areas.

Structure of SEGF

The Small Enterprise Growth Fund is administered by the Finance Authority of Maine (FAME) with management and oversight provided by an 11-member board appointed by the governor. FAME is a state agency that manages loan guarantee and direct lending programs. FAME’s responsibilities for SEGF include: developing and distributing promotional materials, distributing and reviewing applications, providing completed applications to the Board, and arranging and coordinating site visits. FAME staff is experienced in managing revolving loan funds and in making commercial loans. FAME did not have experience in venture investing; thus a separate Board was created to bring multiple perspectives to deals and better insulate the process from political pressures.

The SEGF Board, by law, is constituted of 10 volunteers appointed for one-year terms plus the Commissioner of Economic Development as an ex officio member. Board members include one commercial lender, one attorney, five individuals with venture investment experience, and three individuals with high-tech development experience. Board members are responsible for reviewing applications, making site visits to companies, providing due diligence, and making final investment decisions. A Board member may also serve as a mentor to companies receiving funding, however, the Board does not have the resources to become actively involved in the management of the portfolio companies. Board members may make investments in companies receiving SEGF assistance, but members doing so may no longer vote on SEGF decisions that affect those companies.
**Fund Operation**

The SEGF was established as a self-perpetuating investment fund, capitalized through a state bond issue of $5,000,000. There is no schedule for repayment of the $5,000,000 provided by the state for the capitalization of SEGF. The fund does not pay interest on the monies provided for investment purposes since such payments would force SEGF to structure their investment instruments to generate some cash flow to cover interest payments. However, since the funds for capitalization of the program were raised from bond sales, the implicit cost of funds to the state is the interest paid to bond holders.

Annual operating expenses for SEGF are taken out of the fund. In FY 1998, the operating budget for SEGF was $103,000. FAME staff is reimbursed $58,000 for its services, expenses for outside legal council equal $19,000, and other administrative expenses (phone, mail, publications, travel, etc.) total $26,000.

At this point in time, FAME and the Board subsidize the administrative and management costs of SEGF. FAME estimates that approximately 1.5 FTEs of FAME staff is devoted to SEGF operations, and the Board devotes a minimum of one day a month to SEGF activities. At the time of the visit (August 1998), FAME contracted with the SEGF Board to provide services for approximately $80,000 a year. FAME estimates that the true operating costs for a program like SEGF would be the cost of a two-person office, including one investment specialist, and one assistant, with contracting expenses for outside legal assistance. The need for staffing may increase in the future if greater due diligence is required as a result of greater interest by Maine businesses and/or an expansion of SEGF capitalization. In addition, greater SEGF staff commitments may be necessary as the staff assumes more responsibility for monitoring past investments as the Board turns over and new Board members are less familiar with the operations of portfolio companies.

When asked about the ideal combination of resources to operate a program like SEGF, SEGF former director Charles Spies offered three suggestions. One, the ideal size of the fund should be closer to $10,000,000 than $5,000,000, and SEGF should have the ability to make follow-on investments. Two, the minimum investment size should be increased from $150,000 to $500,000. Three, SEGF would probably have greater ability to leverage private capital to support the fund's mission via new fund investors if SEGF were managed by a private fund manager with delegated authority by the Board.

**Investment Policy and Practice**

**Investment Instrument**

Initially, SEGF was prohibited by legislation from taking a strictly venture capital position in its portfolio companies. Consequently, SEGF investments were structured as convertible debentures with the conversion rights diminished over time as the portfolio company paid down the debenture. For example, a company would be given a loan for $150,000 at prime for five years. Interest could be deferred for up to two years, a very important feature for the early-stage companies SEGF serves. However, interest would be increased by .5 percent for each six months deferral. In addition, SEGF would take warrants for 15 percent of the outstanding shares of stock at the time of the investment, including put and call options. The call option would allow the company to buy back the warrants at
cost ($150,000) during the first two years and for $300,000 in years three to six. The put option would come into play in year seven, when SEGF could require the company to buy out the warrants for $375,000 (payable over three years). The warrants and options remain even after the loan is repaid.

SEGF's experience with the original investment structure has been mixed. However, companies have had difficulty with the complex structure of the deal. Understanding the paperwork required considerable consultation with legal experts and was time consuming and costly, particularly relative to the total capital received (up to $150,000). In addition, some firms disliked the investment structure because they could calculate the total potential cost to them, a priori, and they often considered this cost to be excessive.

Based on early experience, SEGF changed its investment structure to a less complicated convertible debenture. This structure is in keeping with the legislative intent, permitting debt with venture capital features rather than pure venture capital. The convertible debenture operates as follows:

The company can receive a debenture of up to $150,000 with a term of six years at prime plus 1.25 percent (interest rate adjusted quarterly).

The company has the right to defer principal and interest payments for three years, with a three-year amortization of principal and interest thereafter.

If the company chooses to prepay the debt prior to the third anniversary, the company must pay a penalty equal to all interest that would have accrued between the funding of the debt and third anniversary.

At anytime after Year 3, SEGF may convert the debenture into common stock. The amount of common stock (percent of ownership) acquired by SEGF will be a function of the amount of the original debt (plus interest) and the pre-investment valuation of the company.

At anytime after Year 6, SEGF may require the company to purchase all stock held by SEGF, at a price determined by negotiation or appraisal. The repurchase may be paid over three years with interest at 12 percent per annum.

This new structure is more straightforward for companies, even though it may result in a larger return to SEGF than the original investment structure if company growth is strong. However, the conversion rights diminish over time as the company pays down the debenture and conversion rights are eliminated once the debenture is paid off. While this structure addresses some of the concerns companies have expressed about the program, a pure equity position would allow companies to avoid the cost of short run debt repayment entirely. Recently, SEGF was given authority to make equity investments.

Income Tax Credits

Firms acquiring investment capital from SEGF are required to have matching venture capital from another source, a stipulation included to provide for due diligence by an outside party. FAME is not responsible for finding partners for the firms needing matching funds.
However, Maine provides state income tax credits to venture capitalists investing in Maine companies and FAME publicizes the availability of these credits. The Maine Seed Capital Tax Credit Program (created in 1989) allows investors in eligible Maine firms to receive a credit for 30 percent of the amount invested. The credit is used against Maine state income tax, and can be taken over 15 years, at a rate of not more than 50 percent of the credit per year. Investors using the credit are limited to $200,000 of investments over 3 years in eligible companies. Companies can be prequalified as eligible by showing that they are manufacturing companies or companies that make out-of-state sales equal to the amount of the tax credit. They also must have less than $3,000,000 in annual sales, and the program will consider both actual and projected sales in determining eligibility. Companies can use this prequalification as a selling tool in raising venture capital funds.

FAME has the authority to approve up to $5,500,000 in tax credits as of 1998. Through 1994, the program has supported $6.9 million in informal venture investments in Maine companies through tax credits worth about $2 million.

**Investment Process**

The typical investment process can be described as follows. After the initial pre-application phone interview with FAME, the company can complete a Stage 1 application. This is a two-page application that requires the company to describe itself and its capital needs. The application was designed by the Board to minimize both the company’s time invested in this stage and the Board time in reviewing applications. The Board also views this application as the first step in the investment process—being able to describe the company and its needs succinctly. These Stage 1 applications are reviewed by FAME for completeness and then included in the monthly Board package. At the monthly board meeting, the Board reviews all the Stage 1 applications and either rejects the application or decides to seek additional information in Stage 2.

For each company that makes it to Stage 2, the Board sets up a subcommittee of three or four members who make site visits to these companies. FAME sets up the site visits, participates in the visits, and summarizes the visits in two to three pages for review by the subcommittee. At the next monthly Board meeting, these summaries are included in the Board package and reviewed by the entire Board. Prior to this meeting, the Board members work their networks within the state to get more information on the technology, business ideas, management team, etc. of each company. This is the due diligence that is completed before each investment decision is made. After the Stage 2 summaries are reviewed, a decision is typically made whether or not to proceed with investment negotiations with the company.

SEGF does not take a seat on the company’s board as part of their investment deal. However, going into a deal, the Board will make recommendations to the company on things that need to be done before an investment can be made. After the deal, SEGF has limited leverage with the company so they try to get changes made initially.

**Exiting the Deal**

Ideally, the company's owners will purchase SEGF's common stock at the time the company desires to exit the deal. Alternatively, SEGF has the right to force
Potential clients become aware of the SEGF primarily through FAME and their outreach activities. FAME staff members make presentations to groups, conduct seminars across the state, and handle all the public relations for SEGF. Clients also learn about SEGF through trade groups, such as the Maine Software Developers Association and the Maine Investment Exchange. Other clients learn about the program through word of mouth and the Office of the Commissioner of Economic Development. FAME and SEGF are seeking additional means of promoting the program since they desire to increase application flow from two to three a month to five to six a month.

SEGF's Future

At the time of our interview with SEGF, the program had funded three businesses and signed funding commitments with two others. No deals have been exited, so it is too early to assess the success of the program. However, FAME staff recognizes shortcomings or concerns with the current program structure, and changes in SEGF structure and operations are being considered. First, SEGF will use its new authority to offer the option of a preferred stock position in its portfolio companies instead of convertible debentures. With a preferred stock investment, the fund can take a more active role on the boards of its portfolio companies, and the portfolio companies will have more flexibility regarding exiting their deals. A pure equity position also will allow the portfolio companies to avoid the cost of short-run debt repayment. Second, SEGF is investigating means of improving Board efficiency in terms of management and making appropriate investments. The Board needs to develop a revolving structure so that there is some institutional

Summary of Investment Activity

During their first year of operation, SEGF received approximately 110 phone inquiries regarding the program and 45 completed Stage I applications (2-page form). Total funding requested by the 45 applicants was approximately $6,000,000. The disposition of the 45 applicants was as follows.

- 24 denied
- 7 withdrew applications
- 1 application not yet presented to the Board
- 1 application in Stage II
- 7 applications approved but term sheets are pending execution
- 2 companies have signed commitments
- 3 companies have been funded

Seventy-five percent of the 24 denials occurred during Stage I with the remaining 25 percent denied after the site visit. (Note: Four more companies were funded in late 1998 after the change to investment structure was made. Spies expects to have investments closed on a total of nine companies by December 31, 1998.)
memory on the Board and the Board does not have complete turnover of members at one time. The Board is also considering developing a mentor program where members with relevant expertise would be available to provide advice and support to the management of specific portfolio companies. Third, funding for SEGF needs to be increased from $5,000,000 to $10,000,000 to permit larger initial investments and follow-on investments. Fourth, management of SEGF should be conducted by a private fund manager with delegated authority by the Board. Such a structure would provide a greater ability to leverage private capital to support the fund’s mission and better maintain due diligence with portfolio companies. Finally, programs need to be instituted to develop or ensure adequate deal flow for SEGF.

To help SEGF deal with these challenges, legislative changes are needed. SEGF has a legislative initiative that calls for increasing capital and increasing the cap on investments. There is also a need to develop the entrepreneurial base in Maine. This will require more business development infrastructure within the state such as incubators, R & D programs, and technology transfer payments.

One growth opportunity identified by Spies was in attracting out-of-state companies into Maine to increase deal flow. He sees some potential here but is constrained from devoting resources to pursuing this area by the time required to start up SEGF and ensure that it runs smoothly.

When asked to identify factors critical to increasing rural venture capital investing, Spies identified two issues. One, he suggests that angels are important to rural venture capital investing. However, angels, by definition, are hard to find and hard to organize. He feels it is important to understand how to identify angel investors and get them out of the woodwork without stepping on their toes. Angel networks are one possibility. The Maine Investment Exchange (MIX) is a new forum for introducing angels and businesses at breakfast meetings. MIX now meets quarterly. Two, he noted that smaller venture funds are important to rural venture capital investing. These funds, like Coastal Ventures and SEGF, provide a way to focus on smaller deals that can later be used to try to attract larger venture funds. He noted that venture capital forums have significantly increased in participation and sophistication over time. In Maine, a forum is held once a year and it provides a good opportunity for FAME and venture funds to talk to companies about what they need.
Case Study 2: Iowa Seed Capital Corporation
Contact: George Lipper, Iowa Department of Economic Development, Des Moines, IA
Date of Visit: June 1999

Iowa Seed Capital Corporation (ISCC) is a private, nonprofit entity, incorporated on July 1, 1994. Prior to that date, the program was operated as the Iowa Product Development Board (IPDB), a quasi-state agency established in 1983. ISCC and IPDB received annual appropriations of state funding to support their investment activities. Total state appropriations from 1984 to 1997 equaled $13,476,466. ISCC’s mission was to “support qualified Iowa entrepreneurs in need of financial assistance when such assistance cannot be acquired from conventional sources due to risk levels inherent in young companies...” The underlying goal of ISCC/IPDB was to help diversify the state economy and promote economic development by providing seed capital to small businesses with innovative products, services, or ideas. State funding for ISCC ended in 1997 and the program was terminated in 1998. ISCC/IPDB invested in approximately 70 Iowa businesses from 1984 to 1998.

History of ISCC
The Iowa Product Development Board (predecessor of ISCC) was started in 1983 as one of several state responses to the severe downturn in the state’s farm economy. IPDB was established as a quasi-state agency with a seven-member board of directors appointed by the Governor. Early funding for IPDB was limited to annual state appropriations of $729,000 in 1984, $200,000 in 1985, and $285,000 in 1986. IPDB initially was housed in the Iowa Department of Economic Development (IDED) and relied on part-time assignment from an IDED staff member for investment assistance. The limited state appropriations and the lack of staff support resulted in a relatively obscure existence for IPDB in the early years.

Initial investment activity by the IPDB did not result in many “winners” or “home runs” for the program. First, because of the condition of the Iowa economy in the 1980s, the principal objective of IPDB was to promote economic development and not to maximize the portfolio’s internal rate of return. Thus IPDB's portfolio contained investments to businesses that would not have received funding from private venture capital funds. Second, there was pressure to make at least one investment a month. The IPDB Board of Directors met once a month and they expected investment decisions to be made at these meetings. Third, most early investments were royalty-based venture investments with payback set at 300 percent of the original investment. These royalty-based investments significantly reduced IPDB’s upside gains from investments in successful companies. IPDB selected royalty-based investments because there was some uncertainty (disagreement) regarding whether the Iowa Constitution permitted the use of venture capital investments by a state agency.

Starting in 1987, annual appropriations for IPDB increased to approximately $1,000,000 to $2,000,000 per year. Additional funding was made possible by the dedication of state lottery receipts for economic development programs. At this time, the Board of Directors hired a staff (president and clerical person) to manage the fund. However, adherence to state payroll guidelines precluded the hiring of an experienced professional venture
capitalist. IPDB’s mission continued to be facilitating new business start-ups rather than financial performance, and the program continued to have the reputation as a “deal of the month” venture/seed capital fund. In addition, political pressure was present to make deals in geographic areas in the state outside of Des Moines, Ames, Iowa City, and Cedar Rapids.

In 1994, the IPDB was renamed the Iowa Seed Capital Corporation and restructured as a private, non-profit corporation. Restructuring occurred in an effort to avoid a merger with another state program (Wallace Technology Transfer Foundation) and as a response to the state Auditor’s questions as to whether IPDB’s venture capital investments were in violation of the Iowa Constitution. ISCC staff included a professional fund manager and management investment decisions were more insulated from state politics than those of IPDB. However, salary for ISCC’s staff (president, investment manager, investment manager/executive assistant, and office manager) continued to be limited by state regulations to levels below that paid at private venture capital funds. ISCC’s investment strategy focused more on IRR than economic development, and the quality of the investments improved under ISCC. Yet ISCC’s overall investment portfolio was weak due to poor investments made in earlier years, and the program lost its supporters (champions) in the state legislative and executive branches due to retirements and election turnover. State annual appropriations for ISCC ended in fiscal year 1997, and the program was forced to operate out of its limited reserves and investment returns. Yet, ISCC remained a target of legislators wanting to cut the size of government or start competing programs. ISCC was shut down on June 1, 1998 with responsibility for liquidating the portfolio turned over to the ISCC Liquidation Corporation.

Structure and Operation of ISCC
ISCC was organized as a private, non-profit corporation with a seven member Board of Directors. The rationale for this structure was to permit venture capital investments and better insulate ISCC from political pressure regarding the location (in state) of investments. ISCC staff consisted of a president, investment manager, executive assistant, and 3/4-time accountant. The Iowa Department of Economic Development paid staff salaries. The early goals of IPDB/ISCC were to foster economic development in Iowa by providing financial assistance for businesses to launch innovative products, supporting qualified entrepreneurs, and promoting the creation of new jobs and diversification of the state economy through new business development.

Funds available for investments and expenses were provided through annual appropriations from the state and net receipts from earlier investments. State appropriations from 1984 to 1996 ranged from $200,000 to $2,268,751 per year and total state appropriations for the life of the program equaled $13,476,466. Net receipts from investments provided an additional $4,315,835 for the program budget, though annual net receipts were small (less than $100,000) until 1992.

State appropriations for ISCC ended in fiscal year 1996 and program activity for 1997 and 1998 was funded through net receipts from past investments. Net receipts from previous investments were insufficient to continue the program since extensive losses were realized on many investments and returns on “good”
investments often were limited by the 300 percent royalty payback agreement. The program was shut down on June 1, 1998.

If ISCC were created again, George Lipper suggests that the program should be structured as a private, not for profit, state sponsored venture capital fund. The fund should be independent of the state bureaucracy, subject only to annual audits by the state. In addition, other structural changes recommended include: capitalization up front at $10 to $15 million, life of fund limited to 10 years, ability to hire professional venture capitalists and pay competitive salaries plus carried interest if fund is profitable, not subject to state restrictions on travel expenses and entertainment, and management goal to maximize fund growth and IRR. That is, ISCC should be structured so that it functions similar to a private venture capital limited partnership.
Case Study 3: Minnesota Technology Corporation Investment Fund (MIN-Corp)
Contact: Julia Sass Rubin, Harvard University, Boston, MA
Date of Visit: July 1998

The Minnesota Investment Network Corporation (MIN-Corp) is a nonprofit community development venture capital fund that promotes community economic development by making equity and near-equity investments, primarily in small technology-based manufacturing companies located in rural Minnesota.

History of MIN-Corp
MIN-Corp grew out of the Greater Minnesota Corporation (GMC), which was established as a public corporation by the 1987 Legislature to foster economic development, especially in rural Minnesota. In 1991, the Minnesota Legislature revised GMC, turning it into the state’s technology-based economic development organization and renaming it Minnesota Technology Inc. (MTI). At that time, the Legislature also authorized MTI to create a Seed Capital Fund, which was to make equity and equity-type investments in early stage and small technology-based Minnesota companies, with a focus on rural Minnesota.

MTI capitalized the seed fund with $7 million and expected it to raise additional capital from private sources. From 1992 to 1997, the seed fund invested $5.4 million in 16 companies. However, fund organizers were unable to raise any private capital in order to re-capitalized the fund. The seed fund was operated as a department within MTI and governed by MTI’s Board of Directors, which was made up primarily of political appointees. The private sector’s reluctance to invest in the seed fund was based on the perception that investment decisions might be influenced by political considerations rather than sound financial analysis.

In 1998, in order to address these concerns, MTI allowed the fund to become the Minnesota Investment Network Corporation, a separate nonprofit organization. MTI transferred the Seed Fund’s assets to MIN-Corp and agreed to cover all of the new entity’s operating expenses until July 2000. To help re-capitalize MIN-Corp, MTI committed $2 million, which MIN-Corp had to match by raising an additional $2 million from outside sources. If the matching funds were not raised, then the fund’s assets would revert back to MTI.

MIN-Corp was able to raise the $2 million match and, by the end of 2000, had a total capitalization of $10.5 million.

Structure of MIN-Corp
MIN-Corp’s strategy consisted of three components, designed jointly to finance and assist rural Minnesota technology and manufacturing companies from their earliest stages through the point at which they were able to attract funding from large private venture capital funds. These components were an equity fund, regional investment networks, and a small business investment company (SBIC).

The regional investment networks were to be modeled after the Lakes Venture Group in Alexandria, Minnesota. This group has 18 partners who have invested $200,000 in six companies across the state. MIN-Corp contributed $48,000 to the investment group and was involved in helping the Group define its investment strategy. MIN-Corp’s goal is to use this model to organize ten regional investment networks around the state, with MIN-Corp offering help and advice, but taking only a limited stake in any
individual network. The objective is to have locally controlled funds, made up of angel investors who can jointly raise at least $1 million. Through the end of 2000, MIN-Corp had invested in an additional regional network.

The third component is a $20 million SBIC that can draw on SBA leverage to make larger investments in regional businesses. Since its creation in 1998, MIN-Corp has been working to raise capital for the equity fund. At the same time, other providers with a Midwest focus have emerged to fill the need for larger equity investments. As a result, MIN-Corp has put the SBIC on hold for the time being.

MIN-Corp Organization

MIN-Corp’s mission is to promote community economic development by building the capacity for equity investing, primarily in rural Minnesota companies. The fund must invest 80 percent of its dollars in rural Minnesota companies or operations. The other 20 percent of investments must be within the state, but are otherwise not restricted. As of June 30, 2000, the end of MIN-Corp’s fiscal year, 85 percent of the fund’s dollars were invested in rural Minnesota and 90 percent of the companies were located in low-to-moderate income areas.

The fund invests in technology-based manufacturing companies. However, technology is broadly defined. MIN-Corp is looking for companies that provide high growth, value-added manufacturing that, in turn, contributes to job creation, income growth and increased wealth in the community. The fund will not invest in retail enterprises, traditional service businesses (such as restaurants), commercial real estate developments, and farm, mining or forest activities. While the fund has sectoral restrictions on investments, it can invest in companies at all stages of development.

MIN-Corp operates with a staff of five people and a fiscal year 2000 operating budget of approximately $600,000. MIN-Corp’s operating expenses were covered by MTI through July 1, 2000, and are subsequently being paid out of its operating budget. MIN-Corp’s Board of Directors also serves as its investment committee. Board members have backgrounds in venture capital, banking and corporate management.

Investment Policy and Practice

MIN-Corp receives referrals through a broad network of business service providers, economic development professionals, and entrepreneurs throughout the state. The fund’s staff reviews approximately 200 potential investments per year.

The investment process has several steps. A preliminary evaluation is made, based on information included in the business plan. This process takes one to two weeks. If the deal is considered a candidate for investment, MIN-Corp contacts the company to arrange a meeting and to gather additional information. The due diligence phase takes at least one to three months and involves detailed analysis of the project. This stage also includes preliminary negotiations about the details of the investment. If the project passes due diligence, MIN-Corp’s management makes a formal decision to recommend the investment to the Board. Once the Board approves the investment, the deal is closed.

MIN-Corp requires that all its portfolio companies receive matching outside capital. Rural companies must match each dollar of MIN-Corp investment with one dollar of additional
equity; urban companies are required to match at the rate of two dollars for every dollar MIN-Corp invests. In addition, the investment deal typically allows MIN-Corp to take a seat on the portfolio company’s board, or to have board observation rights, and to receive financial information at least monthly. Companies are also required to report job creation figures to MIN-Corp annually.

MIN-Corp works with its portfolio companies to arrange additional rounds of financing, to help recruit management and board members, and to provide management training as needed. In addition, MIN-Corp works with a number of organizations that provide needed services to MIN-Corp’s portfolio companies. These partners include MTI, Minnesota Department of Trade and Economic Development, Minnesota Cooperation Office and other private consultants.

As of the end of 2000, MIN-Corp had invested more than $8 million in 19 companies. Most of the investments were seed or start-up stage businesses. MIN-Corp had also exited seven investments. The exit mechanisms included stock buy-backs and loan amortizations by the company’s owners, sales to outside companies, and an initial public offering.

**Future of MIN-Corp**

MIN-Corp is still holding the majority of its investments. The fund’s long-term success will depend on how successfully it is able to exit many of the remaining portfolio companies. Since the fund is a nonprofit, its primary concern is the preservation and growth of capital in order to enable it to continue providing equity to its target market.
Case Study 4: Oklahoma Capital Investment Board
Contact: Michael Tharp, President, OCIB, Oklahoma City, OK
Date of Visit: August 1998

The Oklahoma Capital Investment Board (OCIB) was established to encourage equity and near-equity investments in Oklahoma businesses that have the potential to create jobs and to diversity and stabilize the Oklahoma economy. OCIB’s strategy is to invest in private venture capital partnerships as a way of building the infrastructure of a venture capital industry in Oklahoma rather than investing directly in individual companies. These partnerships are forged with funds that have investment strategies that are consistent with OCIB’s objectives. Since its establishment in 1992, OCIB has formed partnerships with eight private limited partnerships, committing $26 million to these funds.

History of OCIB
The Oklahoma Capital Investment Board was founded on the principle that risk capital was needed in Oklahoma to support the growth of entrepreneurial firms that could create jobs and economic growth in the state. However, another guiding principle was that risk capital is best provided by qualified, professional investors rather than directly by the public sector. As a result, the design selected for the OCIB was that of a “fund of funds.” OCIB makes investments in private, limited partnership (LP) venture funds that meet the strategic objectives of OCIB, that is, funds that have expertise in sectors that are deemed to be strategically important to the Oklahoma economy. In this way, OCIB can help encourage the growth of a venture capital industry within the state and demonstrate the potential for Oklahoma investment opportunities.

Structure of OCIB
OCIB is structured as a state-beneficiary public trust. The program is based on a funding mechanism and structure designed to minimize the likelihood that public funding assistance will be necessary, to insulate the program from political interference, and to ensure qualified professionals manage funds. Oversight and management of Oklahoma’s venture capital program is provided by the Oklahoma Capital Investment Board, consisting of five trustees appointed by the Governor, three full-time employees (president, comptroller, and administrative officer), and an outside due diligence advisor (to provide an additional opinion on the investment process). The trustees are individuals with investment experience who understand the risk-reward relationship of the potential investments. The Board meets quarterly to review and make decisions regarding in which funds to invest and to determine any potential conflicts of interest with investments. The OCIB operating budget is approximately $350,000 per year, with funds coming from consulting and guarantee fees, not state appropriations.

OCIB operates as a “fund of funds,” making investments in private venture capital funds, not in individual portfolio companies. The capital for OCIB’s investment in private funds comes from institutional lenders and investors through the Oklahoma Capital Formation Corporation. Principal and interest on these borrowed funds are guaranteed, if necessary, by $50 million in tax credits, with limits of $10 million of tax credits per year. The tax credit purchasers currently are comprised of a consortium.
of public utility companies that have contractually agreed to purchase tax credits on a dollar for dollar basis annually through 2015. Proceeds from OCIB guaranteed lenders and investors are in turn invested in limited partnerships of existing venture capital firms. Returns from investments in these funds will be used to meet OCIB’s guaranty obligations and to make future investments in other limited partnerships. State tax credits will be used (sold to the utilities) only in the case that investment returns are insufficient to meet OCIB’s guaranty commitments. OCIB is currently borrowing private capital and is guaranteeing both principal and interest. OCIB hopes that eventually the returns from their investments in LPs are of sufficient magnitude that funds for future investments come from investment returns instead of guaranteed private capital.

**Fund Operation**

OCIB investigated over 600 limited partnerships and selected eight of these based on the fund’s track record, industry emphasis, interest in the state, and plans for generating deal flow and conducting business in the state. OCIB seeks to invest $1 million to $5 million in each partnership and maintain a 10 to 20 percent share of the fund. The Board estimates that a $1 million to $5 million investment will be sufficient to encourage the fund to actively seek Oklahoma deals, but the 10 to 20 percent share ensures that a number of other investors (limited partners) are conducting due diligence on the fund’s investments. A small share for the state also helps to ensure that state politicians will have little leverage on the general partner’s investment decisions. Finally, venture capital companies generally focus their investment activities by industry type, such as communications and health care, and stage of business development, such as research and development, start-up, and expansion. The division of OCIB investments among multiple funds better permits the targeting of investments and diversification of the state’s investment portfolio.

In selecting partner funds, OCIB conducts due diligence on the fund. OCIB is looking for evidence that the fund is actively building and growing firms. In addition, OCIB is looking for funds that provide a good strategic fit with the Oklahoma economy. For example, one partnership may focus on early stage biotech ventures while another may focus on later stage, more traditional manufacturing activities, both sectors of importance to Oklahoma. Once the due diligence is complete, OCIB negotiates the partnership agreement. Although OCIB does not restrict limited partnerships to investments in Oklahoma, this negotiation process includes a plan for how the partnership will identify Oklahoma deals and what “best efforts” will be taken to make investments within the state.

OCIB closed its first partnership in 1993 and has committed a total of $26 million to eight private funds. These funds have drawn $18 million and invested (including co-investments) $66 million in 11 Oklahoma firms. The annual internal rate of return since the inception of the program is 29.6 percent. To illustrate the partnership model used by OCIB, one partnership was included in this case study. Pacesetter Growth Fund received a $3.5 million investment from OCIB in 1997. Pacesetter was included in this study because of its focus on investing in firms owned or managed by minority individuals. This partnership case study is provided below.
**OCIB’s Future**

OCIB believes it has designed a program with numerous advantages over more traditional state sponsored programs. First, if the limited partnerships are successful, the state will realize significant economic benefits at no cost. No current state appropriations are made and no future tax revenues are sacrificed to initiate the program. Second, the program can become self-financing and self-sustaining through surpluses generated by earlier investments. Third, the selection of portfolio companies for investments is conducted by professional venture capitalists with their compensation related to the success of their investments, that is, an appropriate incentive systems in place. Finally, the experiences of the private venture capitalists in Oklahoma will alert them to the state’s investment opportunities and contribute to the development of a venture capital infrastructure in the state.

**Partnership Case Study: Pacesetter Growth Fund**

Pacesetter Growth Fund (Texas) is capitalized with $48 million and provides private venture capital to firms owned by or managed by minority individuals. OCIB’s $3.5 million investment is less than 10 percent of Pacesetter’s total capital. Pacesetter, in turn, has formed a marketing alliance with BancOne Oklahoma Corporation in Oklahoma City to originate Oklahoma deals and serve as a referral source for Pacesetter in the state.

Pacesetter is managed through MESBIC Ventures Holding Company, Inc. Two other funds under MESBIC are Specialized Small Business Investment Companies (SSBICs) that provide equity and equity-like financing to viable businesses that are owned by minority entrepreneurs. MESBIC Ventures established the first minority SBIC in 1970 in response to a belief that there were systematic capital gaps for minority business owners. MESBIC began in the 1970s by making small loans and venture capital investments ($50,000 to $100,000) in African-American owned companies. These initial investments required large amounts of assistance in business management and marketing. MESBIC’s philosophy has been to work with potential clients to improve their business plans, and they often act as a broker to connect the business owner with qualified professionals who are looking for opportunities to be part of a minority-owned company as part-owners. As the educational and business skills of minority entrepreneurs increased in the 1980s, the size of investments increased to $100,000 to $150,000, and more investments were made in manufacturing enterprises. The 1990s brought another change in investments, with more minority managers seeking investments to fund buy-out activities requiring investments of $500,000 to $1 million. The size of buy-out investments and potential rate of return on these investments provided the impetus for the creation of a new fund, Pacesetter.

Pacesetter’s investment strategies represent a major shift in philosophy for MESBIC Ventures. In the past, MESBIC has been a patient investor, willing to wait for its return. However, Pacesetter’s investors expect returns without consideration of any social objectives, such as growing minority business opportunities. As a result, Pacesetter will focus more on structuring deals so that the capital is returned on time. In keeping with this objective, Pacesetter will focus on making larger investments, $1.5 to $4 million, and will participate with other
venture funds. Although Pacesetter will not take operational control of a business, it does require presence on the board, monthly financial reports, and participation in the strategic decisions of the firm. In addition, Pacesetter will hold sufficient convertible preferred stock that it can gain control of the company if things go wrong.

Pacesetter is viewed as serving the needs of companies that have grown out of the other MESBIC funds and as a device for helping the growing number of minority-owned opportunities requiring large investments. Investments will be targeted to existing firms, two to three years old, with a consistent track record. The partnership with OCIB made sense for Pacesetter because they had an established presence within the state. Prior investments had been made in five Oklahoma companies. In spite of the relatively small investment from OCIB, the contacts in Oklahoma and partnership with BancOne allow Pacesetter to have a physical presence in the state that they might otherwise not have had.

MESBIC Ventures Holding Company structure can be likened to a professional baseball organization. At the “farm” level, MESBIC still makes investments that have a chance of developing into successful businesses and that serve their original mission of supporting minority entrepreneurs. These deals are usually small, $100,000 to $250,000, and structured with personal guarantees and warrants to capture the upside potential of the deal. MESBIC’s original funds also make investments at the “semi-pro” level, investments of $250,000 to $2 million. Finally, the larger investments, the “pros,” will go through Pacesetter. The founders hope that, like a baseball system, the deals at the lower levels can be moved up through the system as the businesses grow and succeed.
Case Study 5: Colorado Rural Seed Fund
Contact: Pete Bloomer, CEO, Colorado Venture Management, Boulder, CO
Date of Visit: October 1998

The Colorado Rural Seed Fund (CRSF) is a state sponsored venture capital fund targeted to businesses located on the western slope of the Rockies. The state was concerned about the concentration of economic activity in a narrow central corridor of the state, east of the Front Range, and that very little new economic activity was taking place on the west slope. CRSF was the vehicle created to stimulate economic development in this region. The Colorado Rural Seed Fund is a publicly funded, but privately managed venture fund. Colorado Venture Management (CVM) of Boulder, Colorado manages CRSF.

Background on Colorado Venture Management
CVM is a small, specialized venture capital company that has been in operation since 1979. The firm directly manages six venture funds totaling $17 million and ranging in size from $1.6 to $6 million. These funds include the Northern Rockies Venture Fund in Montana (see following case study). CVM focuses on start-up and early-stage businesses in several western states. The partners have considerable experience in venture capital investing in markets that are not usually seen as prime venture capital locations.

As a start-up fund, CVM is usually the lead investor in the first outside round of financing that a business receives. In this role, the partners expect to work closely with the owner/entrepreneurs and the management experience that the partners bring to these companies is one of the strengths CVM brings to its investments. In addition, CVM works with other venture capital firms to structure second round investments for the companies that need more capital to grow. Marketing its investments is an important function for CVM because they frequently exit investments by bringing other venture capitalists into a business.

As a start-up fund, CVM devotes significant time to due diligence and monitoring investments in the early stages. Due diligence is required at the assessment stage and must rely to a large extent on the prior experience of the fund’s managers since the firms often have no financial, sales, or product information. Once an investment is made, CVM invests considerable time in helping the company get started. Although these upfront costs tend to be high, management fees are typically fixed at 2.5 percent to 3 percent. As a result, CVM does not want to have more than 10 to 12 active investments per fund, and each investment should be no more than 10 percent of the funds available for investment.

History of CRSF
The Colorado Rural Seed Fund was established in 1990 with public funds provided by the Colorado Housing Finance Authority (CHFA). CHFA, a quasi-state agency, received appropriated funds from the state to invest in a venture fund that would be focused on rural areas in the western half of the state. CHFA provided $250,000 to the CRSF on a non-recourse basis, that is, there was no obligation to repay the funds unless CRSF realized a profit. Two additional private investments of $50,000 each were received, along with a $150,000 investment from CVM, selected to manage CRSF. The CSRF had a board, appointed by the Governor, to ensure that
the fund operated within the mandate established by the state. The state viewed CSRF as a pilot program that, if successful, could be replicated in other parts of the state.

With total capitalization of $500,000, CVM expected to make investments in the $50,000 to $100,000 range. While investments in this range might violate CVM’s limit of 10 percent per individual investment, smaller investments would have limited the growth opportunities for the portfolio companies. Larger investments would have given CVM too much control of the business and, in many cases, would exceed the venture capital needs of the rural businesses.

**Structure of CRSF**

CRSF was structured as private, for-profit, limited partnership. Because the state did not require a return on its investment (except the return of the original investment if the fund were profitable), the other investors in CRSF received significant leverage on their contributions. The state was willing to provide this leverage to private investors because it recognized that investment opportunities in the targeted region would be limited and returns on investments would likely be lower than the typical expected venture capital rate of return.

**Investment Policy and Practice**

When CVM manages a venture fund, it sets a target annual rate of return on investments at 50 percent or more. However, with the CRSF, CVM reduced its target rate of return to 30 percent. The expected rate of return was reduced for two reasons. One, the leverage provided by the state funds meant that an investment with a 30 percent rate of return would yield an effective rate of return closer to 50 percent to the private investors in CRSF. Two, the investment environment in rural Colorado was not expected to generate deals with rate of return prospects of 50 percent or more. In retrospect, CVM notes that this strategy was not effective. To increase deal flow, CVM took on higher risk, lower return investments than they would normally consider. A better long-term strategy, according to partner Pete Bloomer, would have been to screen investments more stringently and to be more patient in terms of time required to recover their capital investment.

A major problem for the CRSF was generating adequate deal flow. CRSF’s target area included approximately 60 percent of the state’s territory but only 10 percent of the population and no city larger than 30,000. The economic base of the area was limited, with tourism, mining, agriculture and related service businesses the dominant activities. Deal flow was limited by the lack of many sectors that are traditional candidates for venture investments. In addition, investment opportunities were limited by a limited entrepreneurial culture within the local population and a significant unwillingness by businesses to consider giving up any ownership share. Distance also proved to be a problem. For a start up fund, it is important for managers to be in close contact with portfolio companies, particularly when there are management problems with the firm. In this case, both extensive travel time and limited travel funds constrained the fund manager’s ability to monitor firm performance.

CVM encountered both management and marketing problems with the investments it was able to make in the region. In general, the basic ideas behind the companies were sound. In some cases, however, the management team could not adequately implement production plans.
In other cases, the remote location and lack of contact with markets made it difficult to get the product into broad distribution to allow the company to grow. By the time these problems were identified because of the difficulty monitoring investments, major damage to the companies had already occurred. In addition, CVM could not always attract new management talent to these firms because of the businesses’ remote locations in western Colorado.

The CRSF was unable to identify sufficient deals within the restricted geographic territory identified by the state. As a result, the state agreed to expand the eligible territory to include portions of rural eastern Colorado. But, quality deal flow remained low and the CRSF continued to struggle financially. By 1998, only one of the CRSF’s investments remained active and the value of the fund had declined to approximately $100,000.
Case Study 6: Northern Rockies Venture Fund, L. P. (Montana)
Contact: Steve Huntington, Fund Manager and General Partner
NRVF, Butte, MT
Date of Visit: October 1998

The Northern Rockies Venture Fund (NRVF) is a private, limited partnership venture capital fund formed for the purpose of investing in early stage entrepreneurial businesses in Montana and other states in the northern Rocky Mountain region. The General Partner and manager of NRVF is Colorado Venture Management, Inc. (CVM) of Boulder, Colorado. NRVF is one of six limited partnership venture capital funds managed by CVM, including the Colorado Rural Seed Fund (see previous case study). For each of the limited partnerships outside of Colorado, a local person is designated as the fund manager and a general partner (along with CVM) for the fund. Steve Huntington, of Butte, Montana, serves as fund manager and a general partner for NRVF. The state of Montana, through the Montana Science and Technology Alliance, provided $1,000,000 of the $2,055,000 for fund capitalization. Individuals, corporations, pension funds, and other business entities provided the remaining capital for NRVF. NRVF typically invests no more than 10 percent of its capital in any one portfolio company and investments usually are made in the form of direct equity. NRVF anticipates having 10 to 12 companies in its portfolio at the time it is fully invested, and NRVF's goal is to liquidate the fund within its 10-year life. Fund managers hope to start another venture capital fund serving Montana and the Northern Rockies region some time after investments made by the first fund begin to become liquid.

History of NRVF

The state of Montana’s participation in the NRVF is one part of what was a multi-faceted economic development effort to stimulate the state's economy through new business development related to the development and commercialization of innovative applied technologies. The Montana economy experienced severe income and employment losses during the 1979 to 1982 recession due to the closing of copper mines and smelter, the permanent shut-down of a major wood and paper products manufacturer, the ceased operations of the Milwaukee Railroad, and reduced agricultural production due to drought. In response to the prolonged (10 quarters) and severe recession of 1979 to 1982, the executive and legislative branches of the state government undertook several initiatives including the Montana Economic Development Project, creation of a Department of Commerce, the Build Montana Program, and the Governor's Advisory Council on Science and Technology. Concurrent to these government initiatives, the voters of Montana passed a constitutional initiative requiring that 25 percent of new receipts to the state's Coal Severance Tax Trust Fund be invested in the Montana economy.

A major recommendation of the Governor's Advisory Council on Science and Technology was the development of the Montana Science and Technology Alliance (MSTA). The MSTA's goals were to strengthen research and development capabilities in the state, encourage the development of new products from public and private R & D organizations, facilitate technology transfers, and assist in the commercialization of new applied technologies. The MSTA began operating
in 1987 with a Seed Capital Fund and a Research and Development Fund. Through 1997, MSTA invested approximately $15 million in R & D and $15 million in seed capital (including $2 million in early stage venture funds).

The MSTA investment programs are considered by some to be very successful but political support for the programs eroded over time. Many in the state legislature do not believe that the state should be involved in the venture capital business. In addition, returns from MSTA investments were not as quick or large (in terms of employment) as desired by government officials. Other problems include a private board for investment decisions that is selected to have representatives from all areas of the state instead of individuals with the appropriate expertise. And the state's public universities were not strong supporters of the program because an outside board was established for each research and development project, and the universities were subject to relatively stringent payback requirements.

Despite the success of the MSTA programs, MSTA had limited success in attracting private investors to co-invest with the state in specific R & D or seed capital investments. Thus, efforts were undertaken to stimulate the private capital market through the development of an angel network (Montana Private Capital Network), an SBIC (Glacier Fund), and a private venture capital fund (NRVC). In 1993, MSTA set aside $2 million from the Coal Severance Fund to match private venture capital investors for the capitalization of a private venture capital fund and an SBIC. Colorado Venture Management, Inc. (CVM) was selected to manage the venture capital fund because CVM had earlier advised MSTA regarding its R & D and seed fund programs, and because of CVM’s history as an early stage venture fund manager. All of 1994 was required by CVM to raise the $1 million match from 16 private investors. CVM considered raising more than $1 million from private sources but had little success in locating high-net-worth individuals who were interested in investing in a fund that would invest primarily in Montana. NRVF was the only private venture capital fund in Montana, and the absence of a track record in Montana or the “demonstration effect” of other private funds made it difficult to raise private capital.

NRVF was fully funded ($2,055,000) in March of 1995. By mid-1998, NRVF had made seven investments totaling over $1,000,000, and the fund expects to have investments in 10 to 12 companies by the time NRVF is fully invested (target date is Summer 1999). NRVF is viewed by the state as a “demonstration” project to show that private venture capital funds can be successful in Montana. For budgetary purposes, the state of Montana (through MSTA) projects a return of approximately 7 percent per year on state monies invested in NRVF. However, the MSTA’s expectation is that NRVF will provide returns similar to those produced by a successful venture capital fund. The impetus for investing state funds in NRVF was based on both the prospect of market rates of return and ancillary returns such as improving Montana’s business climate for entrepreneurial development. The state has not indicated a strong willingness to provide matching funds using tax dollars for other venture funds.

Structure of NRVF

The Northern Rockies Venture Fund is a closed-end, limited partnership with capitalization of about $2.1 million.
Seventeen investors have contributed to the capitalization of the fund — nine individuals; seven corporations, pension funds, or other business entities; and the state of Montana through MSTA. The state contributed $1 million from the Montana Coal Severance Tax Fund. Originally, the MSTA's investment pool was to be financed through the sale of zero coupon bonds secured against the Coal Severance Tax Trust Fund. However, the state supreme court ruled that it was unconstitutional to pledge the credit of the state against uncertain levels of private obligations. Thus the use of funds from the non-trust portion of the Coal Severance Tax Fund avoided the constitutional prohibition against directly investing in private companies.

The general partner of NRVF is Colorado Venture Management, Inc. of Boulder, Colorado. NRVF is one of six limited partnership venture capital funds managed by CVM. CVM principals located in Boulder, Colorado and the Montana fund manager located in Butte make NRVF investment decisions.

NRVF has no specific guidelines with respect to product or industry focus, stage of investment, or community preference. However, the state requires the fund to invest in deals that also would qualify for investments by MSTA, and 75 percent of the fund's investments must be in Montana firms or firms with a significant Montana presence. The state does not stipulate any specific economic development considerations such as jobs created from the fund's investments. Yet, NRVF managers believe that a successful venture capital fund will result in economic development and promote the economic and social goals of the state.

The goal of NRVF is to be a successful venture capital fund by maximizing the fund's rate of return. NRVF seeks a return of 10 times the money it has invested in each portfolio company within five years from the date of the original investment by focusing its investments on pre-seed, seed, and early stage deals. Other desirable characteristics of prospective portfolio companies include:

- significant growth prospects;
- a patented technology or other proprietary position which provides their products or services with a significant advantage in national or international markets;
- a senior manager with significant experience in the industry;
- well-considered marketing and sales strategies;
- owners interested in achieving a high multiple return through selling equity shares within 5 years;
- reasonable requirements for venture capital;
- a realistic opportunity for investor exit;
- a presentable business plan at the time of proposal.

**Fund Operation**

Total capital under management at NRVF is $2,055,000. Funding for the NRVF came from the Montana Coal Severance Tax Fund ($1,000,000), nine individuals, and seven corporations, pension funds, and other business entities. Average investment (excluding the state of Montana) is $50,000 to $100,000. Three investments are for $125,000 each and a couple of individuals invested $10,000 each.

Of the $2,055,000 under NRVF management, approximately $1,750,000 will be available for investment in
portfolio companies. Principal expenses associated with the fund are fund formation expenses ($56,876), legal and accounting expenses projected for the life of the fund ($120,000), and management fees paid through April 1998 ($200,363). Management fees amount to 3 percent of capital under management annually. Total management fees to be paid over the life of the fund, if the fund is open for ten years, are $616,500. A management fee reserve fund of $216,137 is set aside; however, these funds may be used for new investments if funds derived from liquidations are available to pay the management fee.

The management fee of 3 percent is higher than the 2 to 2.5 percent generally charged on larger funds. For its other funds, CVM charges higher management fees on the front end of the fund's life, but the fees are reduced over time so that they average 3 percent over the life of the fund. Expenses associated with fund operations are higher in the early years because the manager must allocate significant time traveling the state to visit with lawyers, accountants, high-net-worth individuals, local development offices, chambers of commerce, universities and investment bankers to inform them of NRVF availability. Early expenses also are higher because of the need to identify, evaluate, and select investments.

The management fee is divided between CVM and the local manager. Steve Huntington estimates that he and CVM managing partners contribute at least the equivalent of one full-time person for fund administration and promotion. As local fund manager, Steve Huntington allocates at least 33 percent to 50 percent of his time to run the fund. The management fees are not sufficient to compensate for the time contributed by CVM and the local manager. The return to management (CVM and the local manager) will come primarily from the net proceeds on liquidated investments. The general partners will receive 20 percent of the fund's value after the original $2,055,000 is returned to the state and private investors. The remaining 80 percent will be divided among the state and private investors according to their shares in the original fund.

At a minimum, CVM requires quarterly financial statements and annual budgets and plans of work from companies in the NRVF portfolio. The general partners also maintain frequent contact with most of their portfolio companies as a result of active involvement on the companies' boards of directors. CVM does not provide specific consulting or ancillary services to their portfolio companies; however, CVM does provide referrals and connections to external management and engineering services. Other assistance to portfolio companies includes helping to evaluate new markets, adding members to management teams, capital planning, and syndicating follow-up rounds of financing.

**Investment Policy and Practice**

**Investment Goals**

Typically, the NRFV will invest no more than 10 percent of capital ($205,000) in any one portfolio company and prefers to place its investments in stages by disbursing lesser amounts initially, and increasing its total investment as the portfolio company meets development milestones. In addition to NRVF capital, fund managers may use their contacts to solicit the involvement of other venture capitalists, corporations, NRVF Limited Partners, and other investors in an attempt to syndicate investment rounds of up to $1
million if such financing is necessary to meet the growth objectives of a portfolio company. The NRVF prefers to syndicate the deals since bringing other investors to the deal helps spread risk, provides additional due diligence, and provides sources of additional funding for follow-up investments. However, many times these additional investors are high-net-worth individuals who are not particularly sophisticated in terms of making deals. Thus due diligence generally remains with NRVF.

Investments in portfolio companies will usually be made in the form of direct equity (common or preferred stock). Investment positions will be sold after equity shares of portfolio companies have increased in value and have achieved liquidity, typically through acquisition of the company by a third party or through an initial public offering of company stock. Through such exit vehicles, the NRVF will seek a return of ten times the money it has invested in each portfolio company within five years from the date on which the fund makes its initial investment in the company. Liquidation of the complete NRVF portfolio is projected to be no later than 10 years from the date the fund was opened or around the year 2005. Distributions as a result of liquidations of individual investments are expected between years five and ten.

The NRVF prospectus states that “the NRVF is seeking investment opportunities in high technology, biotechnology, services and light manufacturing.” Special areas of interest include computer-related products, medical products and applications, communications, electronics, and consumer products. Deal flow in Montana was not expected to be sufficient to limit deals to a narrowly focused segment of the state's businesses. Thus, the NRVF does not restrict itself to deals in the above listed industries. However, the NRVF does maintain a distinct preference for investments in pre-seed, seed, or early stage deals because such deals are more likely to result in rapid firm growth and high investment returns.

**Investment Activities**

NRVF seeks investments that provide the potential for returns of ten times the money invested in each portfolio company within five years from date of investment. However, NRVF realizes that only a few of its portfolio companies are likely to attain the target return. Out of 10 firms funded, NRVF expects to get at least one “incredible home run,” three that provide market rates of return (at least 25 percent per year), three that will return NRVF's money, and three that will lose money.

As of October 1998, the NRVF had made investment commitments to seven companies. Total investment commitments equaled $1,151,000, including $300,000 held in reserve for follow-on investing for the seven portfolio companies. Funding available for investments in new portfolio companies is approximately $450,000 (excluding monies held in the management fee reserve fund). Investment size ranged from $25,000 to $200,000, with three investments made through the purchase of common stock, one investment through the purchase of preferred stock, one investment through convertible debentures, one investment as a limited partner, and one investment as a short-term note (bridge loan) payable on demand and secured by the company's proprietary software. Three of the above investments also include warrants to purchase additional common stock. No
investment liquidations or write-offs had occurred as of November 1998. The fund anticipates being fully invested by mid-year 1999 with 10 to 12 companies in the investment portfolio.

The current employment impact of NRVF's portfolio companies on the Montana economy is relatively small. Nutritional Laboratories has 42 employees in Lolo, Montana, but the company is anticipating rapid employment growth in the near future. H.S. Trask has 38 employees in management and sales in Bozeman. The production of H.S. Trask's shoes is subcontracted to firms in Maine and Arkansas, thus an expansion of Trask's market will impact Montana employment only to the extent that additional management and sales personnel are needed. The remaining portfolio companies have only three to four employees each in Montana.

**Generating Deals**

NRVF is promoted throughout the state to lawyers, accountants, bankers, investment firms, economic development agencies, universities, and the state Department of Commerce and others who are knowledgeable of new business opportunities. The above individuals or associations generally provide referrals and deals are initiated by prospective firms. If the prospective deal meets the basic requirements of a good investment opportunity, the NRVF requests a business plan. NRVF does not help in the writing of these plans. Once the plan is submitted, NRVF will review the plan, and if interested, undertake the required due diligence. The due diligence is conducted by the Montana manager with the help of CVM and limited partners in NRVF that may have some special expertise or knowledge pertaining to the firm or industry. Generally, however, NRVF's limited partners are not involved in the decision-making process regarding acceptance or rejection of the deal. Next, NRVF will develop a term sheet for the deal that includes the form of the investment (common stock, preferred stock, convertible debentures, warrants); specific covenants (veto power, registration rights, anti-dilution provisions); and stipulations regarding share of the company, board seat, milestones, and growth projections. Finally, the term sheet is presented to the prospective company and negotiations are initiated. The typical investment process from referral to closing takes four months.

During the investment process, NRVF generally seeks co-investors to spread risk, attain extra due diligence, and provide sources for follow-up investments. However, NRVF is the lead fund in these syndicated deals and thus responsible for developing documents that detail the terms of the deal. Steve Huntington emphasized that during the deal process, the fund must be sure that the owners of the companies are motivated by the prospects of reaping the up-side of the deal, that is, capital gains. Steve Huntington believes there is sufficient deal flow in Montana to meet the state's requirement that at least 75 percent of the investments are in Montana businesses or businesses that significantly impact the Montana economy. Good deal flow exists in the state because of the people attracted to Montana’s quality of life, the existence of strong research-oriented universities, and the improving economic situation in the northern Rocky Mountain region. In addition, because NRVF is the only fund in the state doing deals with small, start-up companies, it is
exposed to almost all such opportunities arising in Montana.

The principal sources of potential prospects are financial professionals such as bankers and D. A. Davidson & Company (investment banker), local economic development agencies, and lawyers and accountants. According to the November 1997 report to the NRVF Limited Partners, NRVF had reviewed 99 deals as of November 7, 1997. Seventy-four of these potential deals were rejected, withdrawn, or discontinued; 14 deals were under consideration pending further contact with the companies; five deals were under active considerations; and six deals had received financing commitments or completed financing.

Steve Huntington predicts that NRVF will see about 100 deals a year and NRVF will invest in about 3 to 5 percent of the deals that are presented to them. Out of the approximately 100 inquiries a year (generally in the form of a phone call plus executive summary), 30 to 40 inquiries are serious ideas that warrant further study, 15 deals warrant additional time and due diligence, and three to five are funded. Generally, deals are not funded because the market is not big enough, the technology is not special enough, the deal is too capital intensive, such as biotechnology investments, or management is inexperienced. However, the fund will work to improve investment opportunities that lack certain management expertise. Adding new members to the management team can sometimes save good deals with inexperienced management if the business is willing to accept such significant changes in order to secure NRVF funding.

Exiting Deals
As of November 1998, NRVF had not exited any deals or had any of its deals fail. NRVF’s goal is to exit each deal three to five years after the initial investment either through an Initial Public Offering (IPO) or through the acquisition of the company by a third party. In addition to the sale of common or preferred stock at time of exit, NRVF may use warrants to acquire additional shares and registration rights that provide NRVF shares with favorable treatment when it is time to qualify those shares for sale in the public financial market. Some portfolio companies may turn out to be poor prospects for IPOs or sale to a third party. For these firms, NRVF will attempt to receive some return, sometimes by making their stock holdings attractive to the majority shareholders to encourage a management or shareholder buy-out.

A necessary feature of NRVF portfolio companies, like most venture capital funds, is that the companies' founders are interested in starting and growing a company and then realizing gain through equity appreciation. A motivation for many small business owners is to pass the company on to succeeding generations instead of achieving liquidity and return on equity holdings. Steve Huntington stated that NRVF probably would not enter into deals with business owners who are motivated by the desire to grow the company to provide jobs for future generations because such companies, while laudable in their own right, do not constitute venture capital opportunities.

Steve Huntington does not believe that the Montana state government would be particularly concerned if a portfolio company moved out of state as a result of the acquisition of a portion of the NRVF portfolio. According to Huntington, such
things happen in the business world and attempts to prevent such out-of-state moves would hamper the fund’s success. The state, as an investor in the fund, is interested in the return on its investment and in demonstrating that a venture capital fund can succeed in Montana. Huntington states that most portfolio companies will not be relocated and the fund’s financial success will pave the way for future efforts of this type. In that regard, the state is a winner from both financial and economic development perspectives. Moreover, the NRVF’s fiduciary responsibility to all of its limited partners requires that the fund and its interest in portfolio companies be managed to maximize financial return.

**NRVF’s Future**

Steve Huntington suggests that future limited partnerships providing venture capital in Montana would be improved if structured differently than NRVF. First, the fund should be at least $5 million so that larger investments could be made, more funding would be available to support staffing for fund management and administration, and investments could be large enough to provide the fund with greater leverage in structuring its deals and relationships with portfolio companies. Second, the fund should get on the public employees pension fund's list of acceptable investments. Such a designation would provide access to a very large pool of funds from which the state invests in venture capital funds around the country. Third, the fund should secure a wide range of investors so that 75 percent of their investments are not mandated in Montana. In Montana, there is an insufficient deal flow for a larger fund to be successful according to venture industry standards.
Kansas Venture Capital, Inc. (KVCI) is a licensed Small Business Investment Company (SBIC) that provides venture and mezzanine capital to Kansas-based businesses. KVCI is a for-profit entity, with capitalization of approximately $15 million. Principal sources of capital for KVCI are Kansas-based banks and national and regional financial institutions with branches in Kansas (common stockholders) and the state of Kansas (holder of non-voting preferred stock).

The operating mission of KVCI is “to provide venture capital, loans, and management assistance to Kansas-based small businesses having potential for significant growth and long-term equity appreciation.” KVCI's operating goals are (1) build long-term shareholder value, (2) enhance the Kansas economy, (3) establish a self-sustaining entity, and (4) become the largest and most active Kansas-based venture fund. KVCI investments are targeted primarily at later stage manufacturing companies needing capital for expansions, acquisitions, or ownership transitions. Preferred size for an initial investment is $500,000 to $1,000,000, though larger venture capital needs are addressed through participation in syndications with other venture investors. KVCI is located in the Kansas City suburb of Overland Park, Kansas.

History of KVCI

KVCI was started in 1976 as a subsidiary of the Kansas Development Credit Corporation (a state program). The Kansas Development Credit Corporation (KDCC) pooled loan funds from Kansas banks in order to provide a source of loanable funds for loans that were considered too risky for an individual bank. KDCC investment activities were restricted to loans, and KDCC “learned the hard way” that interest earned on sound investments was not sufficient to cover losses. Thus KVCI was created to provide a source of venture capital financing for Kansas businesses and provide an investment strategy where returns from “good” investments are sufficient to cover the costs associated with “bad” investments.

Initial capitalization of KVCI was provided through the sale of common stock to Kansas banks. Funds raised through this initial stock offering were modest (approximately $1,000,000). The KDCC also sought and received licensing from the U.S. Small Business Administration (SBA) for KVCI to operate as an SBIC, though SBA funding has not been used to leverage KVCI funding raised from Kansas banks.

KVCI was relatively dormant from 1977 to 1986, with most of the KVCI’s capital invested in U.S. Government and Agency securities. However, a downturn in the Kansas economy led to the promotion of a set of economic development initiatives before the state legislature. One of these legislative initiatives (Kansas Venture Capital Risk Credit Act) authorized the use of state funds for the capitalization of KVCI. Another legislative initiative (Kansas Venture Capital Company Act) authorized the use of state income tax credits for private investments in certified Kansas venture capital companies.

The Kansas Bankers Association (KBA) championed the concept of revitalizing KVCI and creating a public/private partnership between state banks and state government. KVCI was lifted out of KDCC and operated as a
stand alone SBIC. The state did not want to be actively involved in the management of the fund in order to avoid the political fallout that would occur when investment losses would precede successes.

KVCI was recapitalized at this time (1986 to 1987) with $6.5 million raised from Kansas banks and a $5 million match from the state of Kansas. State money came from general state funds. The goal, initially, was to raise $10 million from banks and qualify for an additional $10 million from the state. Kansas banks were encouraged to participate in stock purchases based on a percentage of bank capital, and approximately 350 banks became common shareholders and continue to hold most (99 percent) of the common shares. Banks purchasing stock in KVCI were provided tax credits (25 percent of state income tax). The state of Kansas is a nonvoting, preferred shareholder. With the recapitalization, KVCI became independent of the Kansas Development Credit Corporation and hired a professional management team.

State money came with the requirement that investments be made only in Kansas businesses or those with a significant percentage of their operations in Kansas. Legislation also required a 15-member board including eight bankers, five individuals from the business community, and two venture capitalists. Board members serve three-year terms and the board selects replacements. The board plays a policy and oversight role and its members refer potential investments to KVCI from time to time. The bankers on the board are selected to give geographic representation across the state.

KVCI's mission has been a dual one: promote economic development in Kansas and enhance shareholder value. KVCI believes they need to improve their financial performance to accommodate shareholder concerns about return and liquidity and to position themselves to raise more capital in the future.

Privatization for KVCI is planned in the near future. Legislation was passed July 10, 1998 allowing KVCI to redeem the state's preferred stock at cost ($5 million) at a rate of $1 million/year for five years. This legislation will serve the interests of both the state and KVCI. The state is interested in moving away from partnerships with private firms for investment purposes and KVCI is ready to position itself for future growth. After the state's investment is redeemed, KVCI will likely broaden its focus to a larger geographic region. The fund will likely maintain its Kansas focus in the future since their network and contacts are primarily in Kansas. However, the move to privatize the institution did not occur because KVCI felt geographically constrained. KVCI believed that having the state as a partner made KVCI more conservative than they want to be in the future and on certain occasions, the state’s investment in KVCI has been viewed negatively by prospective private investees. State involvement also increased pressure to expand the number of deals and make investments in specific areas of the state. KVCI feels that they can participate in bigger deals in the future (perhaps at less risk) through partnering with other investment companies (out-of-state). And, out-of-state investors may be more willing to partner in large Kansas deals if KVCI could reciprocate and share in non-Kansas deals.

KVCI investments historically have been focused on manufacturing firms, though a small shift in investment activity
to services and more technology-oriented businesses is anticipated in the future. KVCI has concentrated its investments in mezzanine, expansion, and later stage financing (where it believes its management team is best suited). KVCI was approached by the state of Kansas to determine its interest in managing a state venture capital fund targeted at early stage, seed capital, and high tech firms (Ad Astra Fund). KVCI did not assume responsibility for managing the Ad Astra Fund because they believed that their expertise was not in this area of financing.

**Structure of KVCI**
KVCI is organized as a for-profit SBIC with total capitalization of $14.7 million. The rationale for this structure initially was to tap into the leverage available through the SBA. Although KVCI has been a licensed SBIC since 1977, they have not drawn on SBA funds until very recently. Dalton attributes this limited use of SBA funds to the past level of activity and size of deals.

KVCI is not likely to change its principal structure in the future but is likely to use leveraging more. KVCI plans to do larger deals in the future and these will require greater leveraging. In addition, with privatization, KVCI will need to develop a liquidity plan for shareholders, that is, banks, in the future and a plan for replacing state funds. These funds will likely be replaced through (1) gains, (2) leveraging, and (3) raising outside capital to replace the preferred stock with more common stock.

If KVCI were being created again, Dalton suggests that the mission needs to be clearer. That is, the fund's dual objectives (economic development vs. IRR) need to be more specifically defined. He suggests that it may not be realistic to balance economic development objectives with earning an acceptable IRR for shareholders.

**Fund Operation**
KVCI operates with a budget (approved annually by the KVCI Board) of about $700,000 to $800,000 annually. This amount covers salaries and compensation, rent, advertising, legal, accounting, auditing by SBA, and travel. Salaries make up approximately 50 percent of this total. A management of fee of 2.5 percent of the fund total is an accepted industry standard and part of SBIC regulations, and KVCI is in line with this standard.

Original sources of investment funds for KVCI were the bank common shareholders and the state. Bank investors make up 99 percent of the common stock, with a few individual and corporate shareholders as well. KVCI does not pay regular dividends to shareholders so the cost of investment funds is difficult to measure. KVCI has recently taken advantage of the SBA leverage program and their cost of funds is approximately 7 percent. There is also an implied cost of capital to KVCI that is the return required to attract additional capital to the fund. Dalton suggests that a reasonable internal rate of return for a mezzanine, later stage investment fund would be 18 to 25 percent.

KVCI employs five people, three of whom are executive officers. The officers have backgrounds in finance and banking, particularly investment banking. Most of the officers' venture capital experience has been on the job at KVCI.

When asked about the ideal combination of resources for a venture fund, Dalton offered the following observations. The optimal size of the fund would depend on the size of the state's economy and number of potential deals.
From the perspective of fund management, they need to be close to the deals — get out to talk to prospects and visit their facilities. This proximity needs to be maintained in some way. The operating budget should reflect the rule of 2.5 percent of the fund for management, with salaries taking about 50 percent of the operating budget. In terms of staffing, Dalton suggests one professional to one support staff.

The ideal size of a venture capital fund can be determined, in part, by staffing. Dalton suggests that one professional can successfully manage seven to eight portfolio companies. The size of each of these deals, however, is going to be tied to the market. Small and large deals take the same amount of time (and small may even take more time) but the potential return to the fund is less in the smaller deal.

**Investment Policy and Practice**

**Investment Process**

The preferred investment tool for KVCI is subordinated debt with warrants. They also use preferred stock, common stock, stock with warrants, and convertible subordinated notes. Some deals involve a combination of these instruments. The 1997 annual report shows the following dollar distribution of these instruments across deals:

- Stock purchase warrants and convertible subordinated notes, 12.5%
- Preferred stock, 27.0
- Common stock, 17.4
- Loans with warrants, 43.0

Dalton described the process by which a typical deal is identified and completed. First, business service providers (attorneys, bankers, and accountants) typically refer prospective companies to KVCI. The good service providers do some filtering for KVCI, sending them only the deals they think KVCI may find attractive. KVCI also participates in midwestern venture capital forums, but they generally find few clients at forums because most forum attendees need early stage financing.

KVCI receives approximately 150 inquiries per year, 90 percent of which are unsolicited. Most of the unsolicited inquiries do not fit KVCI's investment criteria of Kansas, later stage investments. It is very uncommon for KVCI to participate in a deal that was unsolicited, that is, not a referral. The remaining deals come from referrals and about three-fourths of those may not fit their criteria or KVCI and the firms cannot work out an investment deal. The end result is that KVCI typically funds three to four deals per year.

For the deals that come from referrals, the process of exploring these deals is very time consuming. KVCI staff looks over business plans, meets with management, seeks outside information about the company, and visits the plant. Generally, when a company approaches KVCI, they have a business plan and a perceived need in terms of capital. The company may have an idea about the structure of a possible deal, so deal structure is not a major issue in the early stages. KVCI focuses on the company, the management, the need for capital, why the firm is seeking capital, and what purpose will the capital be used.

Once KVCI has gone through this process of initial discussions and the exchange of information and it appears as though the company is a likely candidate, more in-depth financial analysis will take place. The end result is a deal structure and amount of capital that they feel
comfortable investing. A key to this process is flexibility in terms of the structure of the deal and financial products used. The best product, from KVCI's perspective, is sub debt with warrants — long term, interest only, no amortization. KVCI is rarely in the first secured position and most of the time the debt is unsecured.

After the financial analysis and structuring is completed, KVCI develops a term sheet that presents the structure of the deal — terms, price, management, fees, life insurance requirements, etc. A typical KVCI deal includes 10 to 12 percent interest on the sub debt portion of the deal, with warrants for a minority ownership stake depending on the company valuation. Once the company pays off the debt, the warrant must be exercised within five years (SBA rule). The expected time frame for KVCI to be in an investment is five to seven years. KVCI can invest up to $1.5 million in any one venture, but their initial target investment range is $.5 to 1 million. Larger deals also will be considered if KVCI can find co-investors that are willing to participate. KVCI's stated minimum investment is $250,000. Deals range in size from KVCI being a small partner in a deal, with less than a 1 percent ownership share to turnaround deals where KVCI may temporarily own the majority of a company. KVCI does not get involved in the day-to-day operations of the company. Generally, KVCI has a seat on the board, with a larger role taken in some deals. KVCI may increase its participation on the board in the event of default and in some cases has the right to take control of the board in an extended default period. KVCI has three officers who make the investment recommendations to the Investment Committee comprised of five to six directors. Typically, it takes from 90 to 150 days from initial contact to investment in a portfolio company. KVCI believes that management of these companies is the key to a deal.

In addition to capital, KVCI provides managerial services to their portfolio companies, particularly in terms of strategic planning and acquisitions. These services are not a precondition of the deal, although KVCI will help find management resources if needed. Typically with a failing company, KVCI may require more frequent board meetings, increased reporting by the company, visits by consultants, and in extreme situations and depending on the size of KVCI’s ownership position, will suggest changes in management. KVCI will attempt to determine what is wrong in a declining situation and how to fix it.

Exit strategies are always defined in the initial deal but they generally are negotiated at a later date. What KVCI expects, in most cases, is the sale of the firm to a larger company or, in some cases, an IPO. The deal contract has puts in it starting in Year 5 that allows KVCI to sell the warrants back to the company at some multiple of pre-tax income or fair market value. KVCI works with the portfolio company during the exit transaction to facilitate an orderly and affordable wind-down of the relationship.

**Investment Activity**

Since 1978, KVCI has done 28 deals, 17 are currently on the books, five are no longer active, and seven were exited successfully. KVCI will consider deals in any industrial sector except natural resources, real estate, and financial institutions, all areas precluded as a result of SBIC licensing. Almost three-quarters of KVCI investments have been to manufacturing firms and non-high tech
firms. Almost half of their investments go to firms with $5 to $10 million in revenues, small to medium sized firms. Funds are primarily used for expansion/acquisition (49 percent) and recapitalization/turnaround (37 percent). Only 14 percent of KVCI’s investments have been in start-up or early stage firms. While KVCI does not focus specifically on rural communities, almost one-third of their investment is in towns with population of less than 15,000.

Dalton estimated that for the type of later stage deals that KVCI does, two out of ten deals fail; six out of ten perform on average (three may meet or slightly exceed expectations, three may fall just below) and make a little bit of money; and two out of ten exceed expectations. KVCI initially prices each deal to achieve a 35 to 40 percent annual return on investment based on management’s projections. Anticipation of such a high return is needed to cover the deals that fail or break even and still meet the desired return on the portfolio of 18 to 25 percent net of expenses. KVCI is achieving returns at the low end of this range right now and would like to get their returns closer to the high end.

In the past, KVCI had to balance the trade off between creating jobs and earning a targeted IRR. KVCI made four investments that they considered to be primarily economic development deals where the targeted rate of return (35 to 40 percent) was never anticipated. The results of these deals have not been very satisfactory and KVCI does not expect to participate in such deals in the future.

**Future of KVCI**

The biggest short run challenges facing KVCI are transitioning out of the state partnership, continuing to grow the portfolio and increasing IRR. In the long run, KVCI faces the challenge of managing the evolution from a state affiliated fund with an economic development focus to a larger, more aggressive private venture fund. Future goals of KVCI also include increasing the size of the fund and activity levels, expanding their geographic territory, meeting the needs of their common shareholders for liquidity, and achieving an acceptable IRR in the process. KVCI is dealing with these goals and challenges by maintaining good relationships within the state, their shareholder base, referral sources and their co-investors.

The constraints KVCI faces are primarily related to deal flow. KVCI would like to manage seven to eight deals per professional, but they are currently below this rate. They see the ability to increase deal numbers as they expand geographically. SBIC regulations have not presented a constraint on the operation of KVCI. State legislators and local leaders have historically put some pressure on KVCI to invest in more rural businesses. Critical factors inhibiting greater investing in rural areas relate to the higher costs of creating deal flow in rural areas. The deal flow in rural areas is low and, as a result, search and monitoring costs are much higher. KVCI’s perceived need to meet face to face with potential portfolio company managers and visit their facilities also does not bode well for rural investing. Dalton describes venture capital as being opportunistic — more deals are done in metro areas because that is where most of the deals are.
Case Study 8: Magnolia Venture Capital Fund (Jackson, MS)
Contact: Committee on Performance Evaluation and Expenditure Review, MS Legislature, Jackson, MS

History of Fund
In April 1994, the state of Mississippi passed the Venture Capital Act of 1994. The act provided for the creation of a private, non-profit corporation (Magnolia Capital Corporation) that provided capitalization to a private, for-profit corporation (Magnolia Venture Capital Corporation) for the creation and management of a private, for-profit limited partnership venture capital fund (Magnolia Venture Capital Fund). The purpose of the public-private venture capital program was “to increase the rate of capital formation, stimulate new growth-oriented business formations, create new jobs for Mississippi, develop new technology, enhance tax revenues for the state, and supplement conventional business financing.” In addition, the act stipulated that 70 percent of investments were to be in start-up businesses (less than three years old) with existing businesses eligible for the remaining 30 percent.

Funding for the Mississippi program came from two sources. First, the state issued $20,000,000 in general obligation bonds with proceeds deposited in the state treasury’s venture capital fund. The state loaned Magnolia Capital Corporation (MCC) $20,000,000 with the requirement that $6,176,000 be re-invested in zero-coupon bonds to repay the $20,000,000 loan in 15 years. MCC then used the remaining $13,823,400 to pay costs of the bond offering, support operations, and capitalize Magnolia Venture Capital Corporation (MVCC). MVCC then created the Magnolia Venture Capital Fund Limited Partnership (MVCF) to act as the partner in making capital investments in businesses and sought a minimum of $4,500,000 of private investments for additional capitalization of the fund (the minimum private contribution required by law). One investor (Clements Limited Partnership) provided all private contributions to the fund ($5,000,000).

Problems with the Structure of MVCC
MVCC provides the classic example of potential problems with publicly sponsored venture capital programs if public oversight is inadequate and the incentive systems do not reward making sound investments and growing the fund. The Mississippi Legislature Joint Committee on Performance Evaluation and Expenditure Review (PEER) concluded that the state Department of Community and Economic Development was negligent in compelling MCC to comply with statutory reporting requirements. MCC failed to compel MVCC to produce annual report information, and the MVCC board failed to oversee MVCC’s business activities. However, the mismanagement of program funds was further encouraged by not incorporating a system that rewarded fund managers for allocating fund expenses in a way that increased fund value. That is, the Mississippi program failed primarily because it did not hire skilled management and compensate management appropriately.

MVCC was organized with a five-member board and six employees. Lax management and oversight by MVCC’s board and questionable business practices by employees resulted in a program with high costs but no desirable economic benefits — the epitome of a bad publicly sponsored venture capital program.
During its two and one-half year history, MVCC incurred expenses of over $4,500,000 while approving only one venture capital investment of $650,000. The largest expenses consisted of $2.2 million for salaries, benefits, and bonuses for MVCC employees and approximately $1.1 million in management fees to a company owned by MVCC’s chair and CEO. The Chairman/CEO of MVCC personally benefited from approximately $1.98 million in direct and indirect payments from MVCC. MVCC also spent lavishly on office furnishings, entertainment, and travel. Other expenses included contracts between MVCC and companies owned by MVCC board members. In sum, MVCC’s expenses during its brief history accounted for about one-third of its initial funding from the state ($13,791,906). Management misappropriation of funds encouraged MVCC’s private investor to withdraw most of its contribution, and the program was placed under the protection of Chapter 11 reorganization.
Case Study 9: Iowa Capital Corporation
Contact: Jude Conway, President, Capital Management Associates, Des Moines, IA
Date of Visit: July 2000

The Iowa Capital Corporation (ICC) is a for-profit venture capital corporation created as a result of state legislation passed in 1986. The purpose of this legislation was to encourage banks and other financial institutions to get more involved in venture capital activity in Iowa. The ICC, over time, became a venture capital subsidiary of one of its investors, the Central Iowa Power Cooperative (CIPCO), an electric power generation and transmission cooperative.

History of ICC
In 1986, the Iowa legislature passed a large economic development package, using lottery money, as a potential stimulus to the struggling Iowa economy badly hurt by the farm crisis. One piece of this legislative package was the creation of the Business Development Finance Corporation (BDFC). The BDFC was designed to encourage bank and insurance company involvement in venture capital activity within the state by providing a one dollar public match for every two dollars of private capital raised. Originally, the BDFC created one venture fund, the Venture Capital Resource Fund (VCRF). The VCRF was capitalized with $6.65 million from Iowa banks and insurance companies and $4.65 million from the state. VCRF became operational in 1988.

In 1989, another state appropriation of $2.65 million was provided to BDFC, again requiring a 2 for 1 match. Initially, banks and insurance companies were approached to capitalize a new fund, ICC. Lack of interest led the founders to approach first investor owned utilities and then rural electric utility cooperatives (RECs) in Iowa. While three RECs initially agreed to invest in ICC, only two cooperatives, Corn Belt and CIPCO, actually made investments. The state’s $2.65 million was matched with subscriptions of $3.3 million from CIPCO and $2 million from Corn Belt. Fifty percent of each cooperative’s subscription was required in the first six months and the remaining subscriptions could be called when needed. ICC became operational in 1991.

Private investors in ICC held a preferred stock position while the state had a common stock position. The preferred stock holders were to receive their original investment plus an annual return of 9 to 15 percent on their investment before the state would receive any return on its investment. Thus private investors, in this case the cooperatives, had a preferred position regarding any returns from ICC investments. This preferred position was important in attracting funding from the generation and transmission (G&T) cooperatives. The CIPCO Board of Directors, at that time, was reluctant to invest in a traditional venture fund. However, the preferred position (with guaranteed 9 to 15 percent annual return) was attractive to CIPCO directors.

Allied Merchant Banking Corporation (AMBC), a merchant banking subsidiary of Allied Insurance, Des Moines, Iowa, was selected to manage ICC. When Allied phased out its merchant banking activities in 1993, the contract to manage ICC was transferred to Capital Management Associates (CMA), formed by two former staff at AMBC. CMA, in turn, became a subsidiary of CIPCO in 1993 as part of CIPCO’s strategy to diversify its business activities.
Structure of ICC

ICC was organized as two funds: one for CIPCO and one for Corn Belt. Dual funds were necessary because CIPCO and Corn Belt had different investment goals and did not want to invest in the same deals. Corn Belt was primarily interested in investments with an economic development impact in their service area. Alternatively, CIPCO’s principal objective was to make deals with high potential IRR, with the location of these deals a secondary concern. Each fund had a separate investment committee that reviewed deals and made investment recommendations. The investment committee was made up of two private sector members and one public sector member, all of whom had to be approved by the Board. The 12 member Board of Directors consisted of seven directors who were representatives of state agencies (Departments of Economic Development, Insurance, and Banking) and five directors who represented the cooperatives.

ICC Operation

Originally, ICC expected deals to be identified by the local RECs, yet very few deals were identified this way. ICC also expected to concentrate its investments in the service territories of its investor cooperatives, primarily rural Iowa. Yet, there was limited deal flow in these areas that met venture capital standards. As a result, most of the deals came through contacts that Allied (and later CMA) had within the state and from other midwestern venture capital funds that were looking to syndicate deals. In the early years, CMA reviewed about 25 to 30 deals per year for ICC, a level that was not sufficient to provide adequate investment opportunities. As ICC broadened its investment approach to focus on deals within Iowa rather than deals only within the cooperatives’ service territories, the deal flow increased to 50 per year and ICC invested in a higher percent of those deals.

In the original offering memorandum, the life of ICC was set at nine years. After nine years, the fund was to be liquidated and the investors would receive returns on their investments. In 1999, the state was interested in the divestment of ICC, in spite of its success. A new Iowa Director of Economic Development in the state had identified an alternative use for the state funds. In addition, the state attorney general had changed an earlier ruling on the permissibility of the state holding venture capital positions in a fund like ICC. However, the state could not liquidate its investment because the state was paid only after the preferred shareholders, Corn Belt and CIPCO, received their original investment plus return.

CIPCO was not interested in the divestment of ICC for several reasons. First, CIPCO did not believe the time was optimal to harvest the investments. Second, liquidation would have created a significant tax liability for the cooperative because of ICC’s corporate structure. Third, CIPCO wanted to remain involved in venture capital investing and liquidating the fund would eliminate the venture capital capacity created in ICC.

An alternative strategy was suggested by CIPCO whereby CIPCO would buy out the state and Corn Belt’s shares of the fund. Both the state and Corn Belt exited ICC with more than their original investment. The decision to buy out the state’s investment in the fund was optimal for CIPCO for several reasons. The move provided CIPCO with more control over how and when the divestment in ICC would occur and the burdensome
paperwork and logistics created by state involvement were eliminated. In addition, privatization eliminated state interference in ICC investment decisions. A decision by the president of the ICC board, a public sector member, to veto a Corn Belt investment at an earlier point in time had negatively affected the investment climate within ICC.

ICC operations have changed to some extent because of the buyout of the state and Corn Belt. ICC is now operated as an in-house CIPCO fund. The Board and investment committee members are composed of CIPCO staff and board members. ICC has taken a more strategic approach to investment decisions as well, focusing on investments within the broadly defined utility industry such as businesses in the electrical power, biotechnology, telecommunications, and agricultural industries. CMA continues to investigate deals in a similar way as before the reorganization, however, there is greater freedom to make deals within the service area that have lower expected rates of return but promise economic development benefits.

CMA, a subsidiary of CIPCO, manages ICC. A 2.25 percent management fee (approximately $175,000 per year) is paid to CMA by CIPCO for fund management. CMA does not receive a share of carried interest on ICC investments. CMA’s staff commitment to ICC is 75 percent of CMA president Jude Conway’s time, 10 percent of another CMA staff member’s time, and 15 percent of a CMA accountant.

**Investment Policy and Practice**

Over the life of ICC, staff reviewed 250 to 300 deals. CMA staff reviewed the business plans submitted to ICC, provided due diligence, and made recommendations to the investment committees. Jude Conway of CMA outlined the investment decision-making process. Each business plan is given an initial review, at which time CMA can turn down a deal without input from the investment committee. This initial review allows the staff to grade the investment and determine whether the deal is consistent with the type of investments ICC makes. If a deal makes it through this first cut, others within CMA review the deal. If the deal is still viewed as acceptable at this point, the due diligence process of CMA begins. This process takes 60 to 90 days. If a deal passes due diligence, CMA makes a positive recommendation on the investment to the investment committee. The investment committee for each fund (CIPCO or Corn Belt) makes the final positive or negative decision on the investment, although an applicant has the right to appeal a negative decision to ICC’s Board of Directors.

When CMA brings a deal to the investment committee, the deal structure is already worked out. The only work left to complete on the investment is the legal document. The preferred investment instrument is equity. ICC has no borrowed funds so there is no need to structure deals with a debt component that can generate a flow of income to ICC. However, debt is sometimes used as bridge funding or as part of a syndicated deal. Debt with warrants generally is used in these cases. Although ICC does not require a seat on the portfolio company’s board as a condition of investment, a representative of CMA or some other entity is on the board of 10 out of the 17 current portfolio companies. ICC provides some services to its portfolio companies, including identifying management issues and bringing in management expertise.
Since most investments have been restricted geographically, there have been few sector or stage restrictions on ICC investments. Most of the investments have been in early to middle stage companies, however, some later stage investments have been made in cases where CMA knows the company and management team. The preferred exit strategy for these investments is an IPO, but ICC also had some exits via acquisitions. In identifying viable deals, CMA looks for companies that have at least some potential for an IPO.

From 1991 to 2000, CIPCO’s fund in ICC had invested $4,062,722 in 15 companies. The valuation of these investments, as of December 31, 1999, was estimated at $10,747,706. As of August 31, 2000, the value of investments was $15.3 million. Over the same period, the Corn Belt fund invested $625,030 in two companies. As of August 31, 2000, the value of the investments was $342,824. The difference in performance of these two funds could be attributed to important differences in the investment philosophies of the two cooperatives. Corn Belt’s primary motivation for involvement with ICC was concern with economic development. Corn Belt maintained a focus on doing investments that created economic development within the cooperative’s service territory. As a result, only investments within that service territory were considered and brought to the Corn Belt investment committee. CIPCO, on the other hand, viewed involvement in ICC as a way of diversifying business activities, as a way of earning a return on investment, and as a means to promote economic development. There was an informal policy change over time and CIPCO began to emphasize rate of return over regional location of investments. As a result, CIPCO looked at more deals and was able to make investment decisions that generated greater returns on investment.

**ICC’s Future**

CIPCO hopes to leverage current investment successes into a larger fund that could make larger investments and rely less on other venture capital funds to find deals. CIPCO management noted that $25 million would be a good size for ICC, but money from other sources such as other G&T cooperatives and utilities would be required to reach that size. If the fund were being established again, the minimum fund size would be $10 million, and a LLP or LLC structure would be preferable to the corporate structure currently used for ICC.

The principal challenges to ICC in the future are that the CIPCO Board may decide to become more passive once all funds are invested and rest on its laurels. Alternatively, CIPCO could lose interest in the fund and decide to liquidate ICC and use the money elsewhere within the cooperative. One danger of having ICC as a subsidiary of CIPCO is the possibility that ICC funds could be siphoned off to other parts of the parent enterprise.

ICC would not have started without the state’s matching investment and a preferred position for the REC investors. However, CIPCO executives suggest that such public-private venture capital funds need to be organized so that the management of the fund is better insulated from state/political interference. State participation in fund management, through representation on the board, was viewed as detrimental to ICC because:

- The government representatives on the board tended to have their
own agenda based on which agency they represented.

- Government representatives had expectations about the type of deals, expected returns, and timing of exits that did not result in high expected IRR.
- Government representatives favored businesses that were labor intensive and had potentially large economic development impacts.
- Public board members wanted to focus on investments that could not get funding from any other sources.

Strong public sector representation on the ICC Board hampered the fund’s ability to achieve a high IRR. ICC management recommends that public involvement on the board of programs like ICC should be minimal unless the public sector board members have significant experience in venture capital investing and that political interference and agendas are kept to a minimum.
Case Study 10: Louisiana Certified Capital Companies Program
Contact: Mike Williams, LA Economic Development Corporation, Baton Rouge, LA
Date of Visit: July 1999

Introduction to Certified Capital Companies
Public involvement in venture capital programs can occur through enabling legislation that encourages private sector investment. To this end, one program that has received increased attention by states in the past 10 years is the Certified Capital Companies (CAPCOs) program. This program allocates tax credits to insurance companies to encourage investment in private venture capital firms (referred to as CAPCOs) certified under the enabling legislation. The first CAPCO legislation was passed in Louisiana (1983), with more recent adoptions in Missouri (1997), New York (1997), Wisconsin (1997), and Florida (1998). Despite minor differences among states, the typical CAPCO model has the following characteristics with respect to sources of capital, certification process, qualified businesses, returns to state treasury, and reporting requirements.

- **Source of Capital**—Tax credits (100 percent at rate of 10 percent per year) are allocated to insurance companies in return for investments (certified capital) in certified capital companies (CAPCOs). Credits are usually transferable or saleable by the insurance companies. Most states place a cap on the total and annual amount of tax credits available and then determine a process for allocating credits among CAPCOs.

- **Certification Process**—Specific certification requirements established by the state include: minimum capitalization (typically $500,000); principals with a minimum of venture capital investing experience (two to five years); and establishment of an in-state office. To maintain certification (and retain the tax credits for the insurance company investors), CAPCOs must meet specific investment milestones and invest the equivalent of 100 percent of certified capital before any liquidating distributions can be made, i.e., before any gains from the investments can be distributed to the partners. The CAPCOs are permitted, however, to make qualifying distributions that include management fees (usually a maximum of 2.5 percent of capital available for investment) and other expenses necessary to the operation of the fund.

- **Qualified Businesses**—States define qualified businesses to meet their specific economic development objectives. Generally, the business must be small (at least by the SBA definition), be located and operated within the state, and most of the employees must reside in the state. Qualified businesses are usually manufacturers or others engaged in commerce and the export of services and certain sectors generally are specifically excluded (banking, real estate, professional services, insurance,
and retail). CAPCO investments must be in “qualified businesses.”

• **State Returns**—The return to the state for future tax revenues sacrificed (due to tax credits) is the new tax revenues attributable to the businesses that start, expand, and remain within the state as a result of the CAPCO program. Only recently have some states crafted or amended their legislation to permit state participation in the returns to CAPCO investments, as described in the Louisiana and Missouri case studies. Through these changes, states can share in the upside returns from investments in state businesses along with the additional tax revenues that may be generated through the investments.

• **Reporting Requirements**—CAPCOs are required to report to some regulatory authority on an annual basis. Information reported includes identity and amount of capital received from each investor, the amount of tax credits allocated to each investor; the identity, type, size, and location of qualified businesses in the portfolio; the amount of investment made in each business; jobs created by these companies (reported by the CAPCO but not independently verified by the regulatory authority); and audited financial statements.

Over a dozen states have considered CAPCO legislation and the legislation has evolved over time as states attempt to better regulate the timing of the CAPCOs’ investments and target these investments towards specific types of businesses. CAPCO legislation is proposed for a variety of reasons usually related to economic development. In addition, in most states, this approach is promoted as a means of increasing the supply of privately managed venture capital in a state and creating a pool of experienced venture capital managers that can become part of a state’s permanent venture capital infrastructure. The Louisiana and Missouri CAPCO programs have the longest history and are illustrative of the performance and operation of these programs.

**History of the Louisiana CAPCO Program**

Louisiana Certified Capital Companies (CAPCOs) were authorized by the 1983 Legislature (Act 642). The goals of the program included:

- Diversifying and stimulating Louisiana’s economy.
- Attracting new jobs and preserving existing jobs.
- Retaining in Louisiana the financial resources necessary for a growth economy by providing venture capital to qualified businesses.
- Developing a venture capital infrastructure and attracting experienced venture capital management.

The program was to initiate on July 1, 1984 and terminate on December 31, 1989. Since that time, the legislation has been reauthorized, with a current sunset date of December 31, 2000. The 1983 legislation created a 200 percent insurance premium tax credit (at 20
percent a year for 10 years) for investments by insurance companies in a CAPCO and a 35 percent income tax credit that could be taken in the year of investment or carried forward to subsequent years. However, there was little activity under the CAPCO program until 1988. This inactivity was a function of (1) a weak economy and, consequently, a weak pool of potential investments and (2) regulatory restrictions within the insurance industry that prevented insurance companies from investing in “equity” ventures. The National Association of Insurance Commissioners (NAIC) required insurance companies to invest in rated instruments or to hold assets in reserve against other investments. The CAPCO program became attractive to insurance companies when a “bond” instrument (fully insured, fully guaranteed, AAA rated) was developed by the CAPCOs that guaranteed a specific return to the insurance companies and was rated by NAIC. The CAPCOs tried to attract insurance company capital using a more traditional limited partnership structure with a 20/80 split, but they were not successful.

The structure of the “bond” instrument is included in the private placement memorandum (PPM) that is negotiated between the CAPCO and each insurance company. However, the general structure involves the set-aside of 40 percent of the certified capital in zero coupon bonds that guarantee the principal invested by the insurance company. The CAPCO also guarantees the stream of tax benefits over the 10-year period, either through a parent organization, such as a bank, or through a private insurer. The insurance company takes no equity position in the CAPCO and, as a result, does not share in any future liquidating distributions of the fund.

The 200 percent tax credit was maintained until 1989, when the credit was reduced to 120 percent, spread over a minimum of ten years. In 1998, the tax credit again was reduced to 110 percent over ten years. From 1988 to 1991, average annual certified capital raised by CAPCOs was $4.5 million. This average increased over the 1992 to 1996 period to $27.5 million per year. In 1997 and 1998, the average jumped to $180.7 million as a result of almost $180 million raised via income tax credits. Almost 70 percent of total certified capital raised under the program was raised in 1997 and 1998.

The original legislation placed no limit on the total amount of premium or income tax credits the state would provide. In 1998, the legislature placed a $72,727,272 annual limit on investments in CAPCOs that would result in a premium tax credit. However, no limit on income tax credits was enacted. In 1999, the Office of Financial Institutions proposed a limit on income tax credits of $11,428,571 annually. This proposal was in response to CAPCO investments received at the end of 1998 that resulted in sizeable income tax credits.

In order to retain their certification (and tax credits for their investors), CAPCOs must follow a schedule for investing certified capital in qualified businesses. Within 3 years, at least 50 percent of the investment pool must be invested with 30 percent in qualified investments. Within 5 years, at least 80 percent of the investment pool must be invested with 50 percent in qualified investments. For funds certified before December 31, 1998, the CAPCO may voluntarily decertify once 60 percent of the investment pool has been invested in qualified investments. For funds certified
after this date, voluntary decertification can occur only when 100 percent of certified capital has been invested in qualified investments. No distribution to venture capital owners can be made before these decertification thresholds are reached, with the exception of qualified distributions (management fees, debt service).

The 1983 legislation provided no return to the state from the investments made by CAPCOs in qualified Louisiana businesses. In 1998, Act 70 of the legislature added a state profit sharing component to the CAPCO program. The state will receive 25 percent of the returns above the amount necessary to achieve a 15 percent internal rate of return on a pool of certified capital (including value of the tax credits). In part, this change was implemented to expedite the investment process.

As CAPCOs increased in size, they sought larger investments and later stage investments. To retarget investments toward smaller companies, the state will require that, beginning in 2000, up to 10 percent of certified capital be invested in either:

- approved capital management funds focused on pre-seed, seed, or early stage investments of less than $1 million or
- CAPCOs whose primary focus is investments in businesses located in economically distressed areas or certified economically disadvantaged businesses or Louisiana businesses and affiliates of less than $1 million.

**Structure of the Louisiana CAPCOs**
A CAPCO must meet a number of criteria for certification. An application is submitted to the Office of Financial Institutions (OFI), Department of Economic Development, the regulatory body for the CAPCO program. Initial capitalization must be at least $200,000. The regulators determine that the board members, partners, and/or managers of the fund are “thoroughly acquainted with the requirements of the capital company’s tax credit program and the certification and decertification procedures.” The CAPCO is required to pay a fee of .2 percent of total tax credits generated (up to a maximum of $5,000). Prior to 1996, each CAPCO had a one-year funding window, after which no further capital could be raised. The program was changed to allow CAPCOs to raise separate pools of capital without being recertified. However, each pool must be closed before any investments made can be considered “qualified investments.”

Once a CAPCO has received commitments for capital investments, these binding commitments are submitted to OFI on October 1st each year. OFI allocates the available tax credits by (1) dividing the total credits available by the number of CAPCOs seeking credits and (2) reallocating any excess (when original allocation exceeds a CAPCO’s requested amount) among the other CAPCOs on a pro rata basis. Requests for allocation of income tax credits are due December 1st every year. Income tax credits are allocated the same way in the first stage but, in the second stage, the excess is divided among the remaining CAPCOs. By 1995, the larger CAPCOs (BankOne and Advantage Capital) started to dominate the process. They had more contacts and better access to insurance companies and, as a result, to certified capital.

The CAPCO legislation outlines a decertification process, both voluntary and involuntary. Voluntary decertification
can occur when a CAPCO has invested 100 percent of certified capital in qualified Louisiana businesses (60 percent for CAPCOs certified prior to December 31, 1998). This decertification process allows the CAPCO to distribute gains on investments to partners and the state. A second type of voluntary decertification occurs when a CAPCO cannot meet some requirement and surrenders their certification. Involuntary decertification occurs when a CAPCO fails to meet investment benchmarks, such as 50 percent invested within 3 years, or when a CAPCO fails to raise required certified capital. Only six CAPCOs have been decertified since the program’s inception. Three were voluntarily decertified, having met their investment target of 60 percent. Two faced involuntary decertification when they failed to meet certification requirements and one surrendered its license voluntarily when fundraising goals were not met.

Investment Policy and Practice

In order to earn tax credits for their investors, CAPCOs must have at least 50 percent of their certified capital invested in qualified Louisiana businesses within three years. These investments must “further economic development within Louisiana.” Investments can meet this requirement if at least 50 percent of the investment in the business is used for at least two of the following:

- Hire more Louisiana employees.
- Purchase/lease equipment or land for use in Louisiana operations.
- Purchase inventory.
- Capitalize a Louisiana business to assist in securing debt.
- Increase or preserve cash flow for Louisiana operations.
- Preserve or expand Louisiana corporate headquarters.
- Support research and development within Louisiana.
- Fund start-up businesses that will operate primarily in Louisiana.
- Provide economic benefit not otherwise described here, approved by the regulatory authority.

CAPCOs can make qualified investments in qualified Louisiana businesses in two forms—as venture capital investments or as financing provided by a certified Louisiana BIDCO (usually in the form of subordinated debt). Seven CAPCOs are licensed as both a CAPCO and BIDCO. These BIDCO/CAPCOs could count their loans as part of total certified capital invested. Since most BIDCOs are SBA preferred lenders, BIDCOs can make loans and sell the guaranteed portion on the secondary market. This mechanism provided a means of turning over certified capital quickly and making the capital available for reinvestment. In turn, voluntary decertification of a capital pool could occur more quickly when a CAPCO and BIDCO were combined. Recent changes in CAPCO legislation make this rapid decertification more difficult since a pool of certified capital must be closed before investments can be considered “qualified investments.” As a result, SBA guaranteed loans already on the books of a BIDCO could not be considered as certified capital investments made by future certified capital pools.

Qualified Louisiana businesses have the following characteristics:

- Operate primarily in Louisiana (more than 50 percent of assets located in LA; more than 50
percent of net income generated in LA; more than 50 percent of salaries and wages paid to LA employees).

- Net worth not more than $18 million.
- Average annual net income not more than $6 million.
- Not more than 500 employees.

Investments can be made in most business sectors, with the exceptions of oil and gas exploration, gaming, real estate, and banking. The CAPCO can invest no more than 15 percent of certified capital in any one company. Each CAPCO is required to report annually to the Office of Financial Institutions, including total certified capital raised and from what sources, total investments made and to what firms, total number of jobs created or retained in qualified Louisiana businesses receiving investments, and total tax credits generated.

As of December 1998, there were 22 CAPCOs certified in Louisiana. Of these 22, 10 were organized by Advantage Capital, two by BankOne, and the remaining 10 by other companies within the state. Over the 1988 to 1998 period, CAPCOs raised $517,105,626 in certified capital, 63 percent of which came from insurance companies. Total tax credits, both income and premium tax credits, associated with this certified capital equal $464,915,989. The maximum amount of credits that could have been used through 1998 was $143,600,013.

Over the same period, the CAPCOs invested $149,460,307 in 122 qualified Louisiana businesses. Average investment per business was $1,225,084. The total number of jobs created or retained through these investments was 3,834. This employment figure is reported by the CAPCOs to the Office of Financial Institutions but is not independently verified by the regulatory agency.

The cost of the CAPCO program to the state is the foregone revenues from both premium tax and income tax collections. However, in Louisiana, it is important to note that insurance companies have other means of reducing their premium tax burden. Another state program allows the insurance companies to offset up to 95 percent of their premium taxes by holding specific Louisiana investments, such as state or municipal bonds and CDs in Louisiana banks. In addition, there is an administrative cost associated with managing and regulating the CAPCOs. Darin Domingue, Office of Financial Institutions, estimated that the equivalent of about 2.5 positions was allocated to administering and examining the CAPCO program.

**Louisiana CAPCO Program’s Future**

The following observations on the Louisiana CAPCO program are made based on discussions with staff in the Department of Economic Development and the Office of Financial Institutions.

1. The Louisiana legislation was the result of efforts by the Department of Economic Development to stimulate economic activity during a period of economic downturn in the state economy. It was not the result of lobbying efforts by the insurance or CAPCO industry.
2. Louisiana businesses have a source of venture capital they did not have prior to the CAPCO program and there is a demonstration effect for other venture funds in the state.
3. The lack of a cap on tax credits issued, particularly in terms of the income tax credit, created the potential for large, unexpected obligations on the part of the state.

4. During the certification process, the emphasis in the management review appears to be on familiarity with CAPCO regulations rather than on venture capital investment experience.

5. Continued reauthorization of the CAPCO legislation creates a situation where industry resources are devoted to lobbying activities rather than investment activities. However, this reauthorization process does permit periodic reevaluation of the program.

6. CAPCO investment decisions are relatively insulated from political pressures that are typical of state direct investment programs. However, the legislative process is not insulated from CAPCO or insurance company influence. There are strong lobbying efforts on the part of the CAPCOs in support of continued reauthorization of the CAPCO legislation.

The legislation creating the Louisiana CAPCO program required an evaluation of the impact of the program. This evaluation, completed in 1999, is provided in “Annual Report of the Department of Economic Development on The Louisiana Capital Companies Tax Credit Program,” (Baton Rouge, Louisiana, December 1999). While the program was acknowledged to have increased venture capital capacity in Louisiana, it was described as an inefficient means of providing new venture capital and expensive to the state. Also, the study identified a need to narrow the investment focus of the program to encourage investments that would generate greater economic development benefits for the state.
History of the Missouri CAPCO Program

The Missouri CAPCO program was started in 1997 with the purpose of inducing “private investment into new or growing Missouri small businesses, which will result in the creation of new jobs and investment.” Advantage Capital championed the original legislation, with a sponsor in the state legislature. The Department of Economic Development supported both the concept and the modifications to the bill as it went through the legislative process. The result is legislation that is more restrictive than the Louisiana model. Several factors made a tax credit program attractive to policymakers. One, Missouri is constitutionally prohibited from making any direct investments in businesses, so economic development strategies in the state rely on tax credits. Two, Missouri has a cap or limit on state tax revenues and revenues collected in excess of this cap are returned to taxpayers. As a result, tax credit programs have been attractive, particularly during the recent economic expansion. Three, the Missouri State Retirement Fund’s past experience with venture capital investing was not positive, suffering from poor management and political pressures.

The Missouri CAPCO program provides a 100 percent premium tax credit to insurance companies who invest in CAPCOs. The original legislation called for a 120 percent credit, but was defeated. The original allocation called for $50 million in tax credits in 1997 and another $50 million in 1998. The state viewed this initial $100 million as a demonstration to see how the CAPCOs performed. An additional $40 million allocation of tax credits was made in 1999, with the money targeted to “distressed communities” in the state.

When CAPCO legislation was passed, the state placed an initial cap of $25 million on total capital that any CAPCO could raise. This cap was designed to encourage creation of other CAPCOs in the state, not just the larger, established Advantage Capital. From the insurance company perspective, there are no incentives to invest in the CAPCOs with the best venture capital investors, but rather with those CAPCOs that have attractive investments instruments and good records of compliance with legislation. The experience of Kansas City Equity Partners (related by Chip Cooper) suggests that the track record of Advantage Capital in Louisiana gave them a competitive advantage with the insurance companies, as compared to newer CAPCOs. For example, Kansas City Equity Partners had to abandon plans to create a CAPCO because it was unable to close a deal with two state insurance companies due to the complexity of creating a financial instrument that was acceptable to the insurance companies.

Structure of the Missouri CAPCO Program

The Missouri Department of Economic Development manages the CAPCO program. To maintain certification, the CAPCO must meet certain investment milestones. Within the first two years, the CAPCO must invest 25 percent of certified capital. Within three years, they must invest 40 percent and, within four years, they must invest...
50 percent. In addition, each CAPCO must invest 100 percent of total certified capital before the CAPCO can make distributions to investors or voluntarily decertify.

Similar to the revised Louisiana legislation, Missouri legislation allows the state to capture some of the return on investments made in portfolio companies by the CAPCOs. The Missouri Development Finance Board will receive 25 percent of any distribution in excess of the amount required to generate a 15 percent IRR (including value of tax credits) for CAPCO investments. Given the short operating history of the program, it is unclear what the magnitude of the return to the state will be.

A CAPCO must meet a number of criteria for certification. An application is submitted to the Department of Economic Development, the regulatory body for the CAPCO program. Initial capitalization must be at least $500,000. Regulators must be satisfied that the owners are familiar with CAPCO statute and rules. The CAPCO must be located and headquartered in Missouri and its primary business activity must be making investments in Missouri businesses.

Once a CAPCO is certified, the CAPCO can begin to receive commitments for capital investments (certified capital) from insurance companies. The Department of Economic Development announces an allocation date and each CAPCO must submit binding commitment letters requesting tax credits. When requests for tax credits exceed the total amount available, the credits are allocated on a pro rata basis. As a result, there is some incentive for CAPCOs to apply for as large a pool of credits as they can raise, since the final allocation will depend on their application amount relative to other CAPCOs.

### Investment Policy and Practice

Missouri legislation is more restrictive than Louisiana legislation regarding the definition of businesses that qualify for investments. CAPCO investments must be made in qualified businesses, defined as:

- Employing 200 or fewer persons (80 percent of employees in Missouri).
- Annual revenues less than $4 million ($3 million if less than 3 years old).
- Independently owned and headquartered in Missouri.
- In need of venture capital (require capital for expansion, sales growth, modernization, etc.).
- Unable to obtain conventional financing (turned down by bank or unable to qualify for bank lending).
- Involved in manufacturing, processing, assembling, conducting research and development, or services where 1/3 of revenue is derived from outside Missouri.

Investments can be made in most business sectors, with the exception of retail, real estate, insurance, and professional services. The CAPCO can invest no more than 15 percent of total certified capital in any one company.

Since 1997, four CAPCOs have been active in Missouri, one established by Advantage Capital, one by BankOne, and two established by Missouri-based firms. In 1997, the state allocated $50 million in tax credits to three CAPCOS. These CAPCOs, in turn, made investments totaling $27,201,756 in 12 firms. Average investment was $2,266,813, ranging from $600,000 invested by one CAPCO to a
$4,209,632 co-investment venture by two CAPCOs. In 1998, another $50 million in tax credits was allocated to the three CAPCOs involved in the first round of credits and one additional CAPCO. These CAPCOs invested a total of $5,020,001. All but $504,000 invested by the new CAPCO in one firm represents follow-on investment in existing portfolio companies. Average employment in the 15 portfolio companies, at the time of the initial investment, was 18, ranging from 5 to 47.

**Future of the Missouri CAPCO Program**

According to Borgmeyer, the CAPCO program improves the infrastructure and environment for venture capital in the state. The program has improved the education of investors as to what venture capital involves. The program also provides a demonstration effect for other venture funds and has functioned to attract additional venture capital to the state through co-investment on CAPCO deals. He also suggests that firms receiving CAPCO investments would not have obtained venture capital or would not have attracted additional investors without the CAPCO investment.

Chip Cooper agreed with this assessment, suggesting that the outcome of the CAPCO program is positive. He noted that CAPCOs are likely doing deals that would not have gotten done without this additional source of capital. He views the CAPCO program as “priming the pump,” although whether it is the best way to do so is a question for analysis. In addition, since the CAPCOs have a lower cost of funds, they can offer more favorable terms to their portfolio companies than other venture funds. However, this process may influence the valuation of portfolio companies, reducing the rate of return and “crowding out” investments by other venture capital funds.

Although Missouri’s CAPCO legislation is more restrictive in terms of the definition of a qualified investment, the legislation has not encouraged seed capital investment within the state. According to Advantage Capital, as the investment criteria become more restrictive, the CAPCOs invest in firms that are larger (closer to the maximum allowable size) and do fewer seed deals. They argue that if there are fewer restrictions, there will be more seed investment since they offset the higher risk seed deals with investments in larger, less risky business ventures. The experience in Louisiana, however, suggests that CAPCOs have focused on relatively large companies and large deals, even without restrictions on company size.

**Missouri Seed Capital Coalition**

The lack of seed capital investment in Missouri led to the creation of the Missouri Seed Capital Coalition that pushed a new piece of legislation, the New Enterprise Creation Act. This legislation was passed in 1999. The purpose is to get professional venture capital management attention to the issue of commercializing university research. Members of the coalition felt that the need was greatest for seed deals and these deals are the most difficult to do. As a result, the new legislation is focused on encouraging seed investment through use of a tax credit.

This new legislation created the Missouri Seed Capital Investment Board consisting of eight individuals appointed by the governor who represent major research universities within the state (public and private) and who have
experience in technology, finance, and/or business development. Also, the director of the Department of Economic Development and up to four representatives from qualified economic development organizations will be on the board. This board will be responsible for implementing this new legislation.

The concept behind the legislation is that the availability of tax credits to aid in fundraising will attract qualified venture managers, interested in doing seed investments, to Missouri. A Qualified Economic Development Organization, most likely one of the innovation centers, will act as fiduciary for the tax credits, recognizing that the innovation center managers do not have the capacity to make investments or choose fund managers. The innovation center will work with the Missouri Seed Capital Investment Board to develop the strategy for recruiting these funds. This strategy will include reducing the operating costs of prospective funds in three ways. One, the board will get commitments from investors up-front in order to reduce fundraising costs. The legislation allocates $20 million in tax credits, over five years, which will be used to get commitments from investors for $20 million to capitalize one or more seed funds. The board, in turn, will negotiate with interested private venture capital funds to secure the maximum venture capital position possible for the state. Two, the board will organize a deal flow network within the state to help reduce the costs of developing qualified deal flow. Three, the board will work with the SBIC to prequalify the tax credits as private capital so that the funds will have access to SBA leveraging.

A RFP will be prepared for interested private venture funds. Fund managers will have to meet requirements similar to those used by the SBIC to evaluate the experience of the management team. The funds must also show a willingness to work with the state innovation centers and universities in terms of identifying the commercial potential of university research. Each fund would be licensed by the state, but fund managers would make investment decisions.

Proposals from venture funds would be reviewed by the innovation center (which would actually contract with the funds to use the tax credits) and then presented to investors. At this point, investors and the innovation centers would have to decide in which fund(s) to invest. In this way, the choice of what funds receive investments is left primarily in the hands of private investors, rather than the state.

This legislation is designed to support an evergreen fund. The innovation centers, not-for-profits, will be awarded substantial ownership in the funds created. To ensure continued investment over time, all of the innovation centers’ earnings from these investments must be reinvested in future Missouri seed capital funds.

Endnotes

2. For a more detailed discussion of certified capital companies, see David L. Barkley, Deborah M. Markley, and Julia Sass Rubin,

Case Study 12: Ames Seed Capital Fund
Contact: David Maahs, Ames Chamber of Commerce, Ames, IA
Contact: John Parks, Iowa State University Research Park Corporation, Ames, IA
Date of Visit: June 1999

The Ames Seed Capital Fund, Inc. (ASCFI) is a corporation organized by the Ames (Iowa) Economic Development Commission (AEDC), a non-profit organization of the local Chamber of Commerce. ASCFI was organized with the dual goals of providing an attractive IRR for investors and assisting local economic development, with economic development given the higher priority. ASCFI maintains four pools of funds, capitalized primarily by Ames residents and businesses. Capitalization of ASCFI’s funds ranged from approximately $300,000 to $740,000, and by the summer of 2000, the four funds had made investments in 18 area businesses. The focus of these investments is technology-oriented businesses that sell a majority of their products or services outside of the state of Iowa.

History of ASCFI
The ASCFI was started in 1986 in response to the development of a research park by Iowa State University (Ames, Iowa). It was anticipated that the research park would stimulate new business ideas and that venture capital would be needed to assist these business start-ups with technology transfer and early stage capital needs.

The driving force behind the development of ASCFI was a small group of community leaders, led by local businessman Erb Hunziker. Potential investors for ASCFI were presented with the concept in a series of breakfast meetings. The key selling point in the fund raising was the potential to encourage new value-added businesses and stimulate economic development in Ames. Three months were needed to raise approximately $740,000 in pledges (from about 75 investors) for the capitalization of ASCFI’s first fund.

ASCFI’s initial fund invested about $440,000 in 11 companies. Investments by ASCFI enabled the portfolio companies to qualify for additional assistance from the state in terms of low interest and forgivable loans. The portfolio companies were primarily technology-oriented businesses such as computer software, medical devices, and hybrid seeds, some of which were located in the ISU Research Park. ASCFI management anticipates that Fund I will provide a break-even return to investors.

In 1993, a second fund was established with $327,000 in pledges from approximately 40 investors. ASCFI contacted the same individuals and businesses that invested in Fund I, but some of these earlier investors declined participation because of unfulfilled expectations regarding the return on Fund I investments. Fund II invested $266,667 in three companies, including a follow-on investment in one of the Fund I portfolio companies. Like Fund I, Fund II had the dual goals of attractive rate of return on investment and promotion of local economic development. The key selling point continued to be the potential for encouraging new value-added businesses in order to provide maximum economic impact to the community.

In 1996, ASCFI initiated a third round of fund raising to capitalize two funds, Equity Fund and Incentive Fund. The development of two separate funds was the result of the difficulty of providing a fund that could attain a competitive IRR and provide significant economic development impacts. The
Equity Fund raised $450,000 in pledges from 50 investors, and as of 2000, the fund had made investments in four local high technology businesses. The Incentive Fund received $300,000 in pledges, $150,000 from the City of Ames and the remainder from investors that directly benefit from local economic development, such as banks and local businesses. The objectives of the Incentive Fund are to provide low-interest loans and grants to attract and stimulate business development in Ames and to leverage the state of Iowa loan programs.

**Structure of ASCFI**

David Maahs, Executive Director of the Ames Economic Development Committee (AEDC) of the Ames Chamber of Commerce, manages the Ames Capital Seed Fund, Inc. Each fund within ASCFI maintains a Board of Directors elected by the shareholders in (subscribers to) the fund. Each of the separate funds also selects an Investment Review Committee consisting of the Ames City Manager and (primarily) the larger investors in the fund. The Board of Directors is responsible for the oversight of all fund operations through the designated Investment Review Committee.

Subscribers provide capitalization for each of the ASCFI funds through pledges, with $5,000 stipulated as the minimum pledge. According to the subscription agreement, “the subscribers must be bonafide residents of the state of Iowa or have their principal place of business or office in the state of Iowa.” The subscribers agree to provide all or any part of their pledges upon demand by ASCFI for a period of six years from the date of accepting the subscription agreement.

Subscribers to ASCFI’s funds include local angel investors, area businesses such as real estate and construction companies, community financial institutions, and the City of Ames. Fund I had pledges of $740,000 from 70 to 80 subscribers. Only $437,300 of these pledges was invested, with individual subscribers responsible for their share of total pledges. Fund II had $327,300 in pledges from 35 to 40 individuals and companies, and $266,667 was invested from this fund during the period 1993 to 1996. The Equity Fund had approximately $450,000 in pledges from 50 subscribers, of which about $250,000 was invested by the summer of 2000. The Incentive Fund had received pledges of $300,000, and had invested $200,000 by the summer of 2000.

**Investment Policy and Practice**

Businesses interested in acquiring capital from ASCFI must meet five qualifications:

- demonstrate a sound business plan.
- show potential to develop or retain jobs in the area.
- sell goods or services outside the local economy.
- be unable to secure total financing from traditional sources.
- agree to counseling with the Small Business Development Center and/or the ISU Innovations System.

In addition, the potential portfolio company must have other funding available before ASCFI assistance is provided. That is, the application for investment is submitted by the business only after other sources of financing have been pursued and a financing gap identified.
Deal flow among qualified businesses is generated primarily by the Executive Director of the AEDC (David Maahs) and President of the Iowa State University Research Park Corporation (John Parks). Some pre-screening of applicants is provided by the SBDC. The Executive Director of AEDC, the Fund Investment Review Committee, and an external venture capitalist (John Papajohn of Des Moines) review applications meeting the qualification requirements. Other venture capital companies that have partnered with ASCFI on the deal provide additional due diligence on the prospective portfolio companies.

ASCFI does not require a position on the Board of portfolio companies as a prerequisite of their investments. ASCFI does not believe that a seat on the Board is necessary if: (1) they are partnering with other venture capital companies and these companies are represented on the Board, or (2) the portfolio company provides timely financial records and progress reports.

ASCFI will work with the portfolio company to determine the expertise and motivation of the company’s management. Specifically, is the motivation of the researcher/entrepreneur to own and grow a company or to develop an idea and sell the start-up to others? If the researcher is not interested in long-term ownership, or current management is not experienced in growing a company, then ASCFI will help put together a new management team to take the company to the next level.

As of summer 2000, the four funds maintained by ASCFI had invested in 18 companies. Fund I made 11 investments, three were write-offs, five repaid the original investment, and three are current. Fund II made only three investments, one write-off and two current. ASCFI has converted Fund II to a limited liability partnership. The Equity Fund has four investments in high tech businesses (integrated circuits, computer software, chemical instrumentation, and specialty metals manufacturing). None of the Equity Fund investments had been exited as of summer, 2000. Exiting strategies for Equity Fund Investments include IPO, sale to outsider, or repayment through royalty agreement.

**ASCFI’s Future**

David Maahs suggests that community-level venture capital investment programs, such as ASCFI, should not attempt to mix economic development and IRR goals. Separate funds or programs should be provided as ASCFI has done with their Equity and Incentive Funds. A suggested size for a community-level venture capital fund is $500,000, an amount considered large enough to provide a good mix of investments. For capitalization of the fund, Maahs recommends the identification of champions and the smallest core of investors necessary to meet the target amount. A business plan should be developed for the prospective fund including analysis of prospective deal flow and potential strategies for exiting investments. Finally, it is recommended that a community-level venture capital fund develop a procedure that ensures external due diligence on prospective deals. Two proposed alternatives for due diligence are to employ outside consultants or to partner with other venture capital funds on the investment. In addition, the community-level fund should rely on the local SBDC for assistance in developing business plans for prospective portfolio companies and in screening these companies.
The McAlester Investment Group (MIG) is an investment network formed by McAlester residents interested in growth of their community. McAlester, Oklahoma is a small community with a population of about 16,000 located over 100 miles from Oklahoma City. The investment network was an attempt to support business development and relocation in the community.

History of MIG
MIG was established in 1992 by a group of 10 individuals who wanted to “make McAlester grow.” The members of the group were all long-term residents of the community and had known each other for a long period of time, in some cases as far back as high school. A number of the members had been involved with the McAlester Economic Development Organization. All of the members had been involved with building their own small to medium size businesses in the town. The members’ business backgrounds were diverse, but about half of the members have significant real estate interests in the community.

The impetus for creating MIG was the members’ belief that McAlester had untapped potential for growth, given its historically high levels of unemployment and its relatively close proximity to the larger, faster growing Dallas, Tulsa, and Oklahoma City urban centers. Their past experience and understanding of the industrial recruitment process led them to conclude that any firm attracted to McAlester would expect some financial incentive to relocate. Given this necessity, the group felt that such a financial incentive should take the form of a venture capital investment, with the potential for a share of future profits, rather than a debt, tax credits or infrastructure investment.

The group did not target any particular industrial sector for their investments. However, MIG realized that investments would have to be in firms that could be viable in the McAlester economy. In addition, no member of MIG was willing to risk the majority of their assets in the investment group, so investments would have to be made in smaller, start-up enterprises.

Structure of MIG
MIG is organized as a for-profit corporation with each member initially having an equal share in the company. However, MIG can also be viewed as a vehicle for a group of angel investors to combine resources and make investments. These investments are made with the expectation of earning a modest return on investment, while encouraging economic development in the community. The rate of return to members is the sum of the direct financial return on the investment and the additional return to members from maintaining the business climate within McAlester and the value of their other business assets, including real estate values.

MIG operates on a consensus basis with all members having an equal share in decision making. Funding for MIG comes from member contributions and, in principle, MIG raises an equal amount from each member. However, over time there have been situations where some members have made larger investments than others have. And, not all members invest in each company that receives a MIG investment.
Investment Policy and Practice

MIG began by trying to acquire an existing shell corporation to use as a holding vehicle for its direct investments. Although an inactive shell corporation was acquired, the cost of bringing the corporation into compliance with SEC requirements was high and MIG decided against pursuing this activity. However, this effort, along with past involvement in community economic development activities, helped to generate the initial deal flow for MIG. MIG has not had to undertake special efforts to develop deal flow in McAlester since there have been more than enough deals presented to them.

MIG makes investments in start-up businesses, where the owner has a good idea but limited resources. In several cases, MIG has invested in a business where the owner was close to bankruptcy. The argument for making these types of investments is that people with good ideas and money will not be willing to move to McAlester and give up some ownership in their company. Only when resource limitations are extreme will these business owners be willing to give up some ownership of their idea in exchange for the money to make their business a reality.

In structuring these investments, MIG tries to minimize its members’ direct investment in the firm. MIG will help arrange debt financing and use of government programs, such as SBA. However, given the start-up firms MIG targets, MIG members frequently must act as guarantors for these loans. One alternative way of structuring its investment in a firm is to provide the firm with land and a custom building. If the firm is successful, MIG can eventually sell the land and building to the firm. If the firm is not successful, MIG retains the building and land asset for future sale or use by another firm.

MIG members do not take an active role in the management of their portfolio companies. The members have their own business interests and they frequently make investments outside their own area of expertise. As a result, members have limited involvement in the production, marketing and sales of portfolio companies. However, members are more active in terms of the financial activities of MIG’s portfolio companies. MIG strives to have a majority interest in the portfolio company and maintains strong financial oversight requiring current financial information. In some cases, a MIG member must co-sign all payments made by the firm. For each portfolio company, one MIG member is assigned a lead role and, if the firm gets into trouble, that member may assume a more active role in the firm’s daily operation.

MIG members meet monthly, at which time the financial condition of each portfolio company is reviewed. The management team for the company may be asked to come and provide information to the group. MIG has replaced portfolio company managers that have not met expectations and has demanded control of the company in exchange for additional investment. Once MIG invests in a firm, they will go to great lengths to keep the investment alive, even committing more of the members’ time to running the business.

MIG does some limited due diligence prior to making an investment, but members concede that they probably do not do enough. However, given the type of companies in their portfolio, improving due diligence is a challenge. Start-up firms often have nothing more than pro forma business statements and plans for MIG members to review. The firms also
have limited assets and, as a result, MIG members assume considerable risk. Most of MIG’s troubles with investments have come from investing in a company when the ideas and plans were not complete, when the business owner turned out to be less than honest, and when some major unforeseen event affected the investment. Frequently, MIG invests in a good idea rather than good management. While this problem may reflect a lack of experienced managers in McAlester, it presents a problem for the investment group.

MIG has successfully exited two deals. Exits have been through purchase by a larger investor and through owner buy back of MIG’s investment. MIG does not have an established timeframe for exiting an investment and there is no specified exit strategy for most of the deals. At the time of the case study, MIG was seeking exit strategies for several firms. In these cases, the firms required more investment to grow to a profitable stage and MIG had neither the resources nor the will to move these firms to the next level. However, because these firms have an unclear future, it is difficult to attract new investors and MIG is left to struggle with the firms until an alternative is identified.

**MIG’s Future**

At the time of the case study, MIG was no longer making new investments. MIG funds were completely invested and they were not soliciting new business plans. However, if an ideal opportunity were presented, the group would consider making another investment. MIG currently has one part-time employee, a receptionist, and there are no plans to expand the staff. It is not clear whether MIG will continue to make investments in McAlester in the future, given its current resource and organizational constraints.
Case Study 14: Siouxland Ventures, Inc.
Contact: Edward G. Andrews, Siouxland Chamber of Commerce, Sioux City, IA
Date of Visit: June 1999

History of Siouxland Ventures
Siouxland Ventures, Inc. (SVI) is a for-profit corporation established to provide a ready source of venture capital in the three-state region (Iowa, Nebraska, South Dakota) centered on Sioux City, Iowa. The Siouxland Initiative, an economic development program of the Siouxland Chamber of Commerce, administers SVI. The principal goals of SVI are to serve the local small business entrepreneur by providing needed venture capital, facilitating the leveraging of other private and public capital, and assisting in bringing new, innovative technologies to the marketplace. Businesses targeted for assistance by SVI are manufacturing, information technology, Internet, and software development.

Siouxland Ventures, Inc. was started in 1991 with funding from the Siouxland Initiative and 18 private investors. The Siouxland Initiative (SI) was formed three years earlier (1988) by the Siouxland Chamber of Commerce to provide grants, low interest loans, and forgivable loans to area businesses. The incentive for starting SI was the serious downturn in the area economy in the late 1980s. The Siouxland Chamber of Commerce raised $2.7 million (85 percent private, 15 percent public) to support the staffing and incentives programs of the Siouxland Initiative.

Structure of SVI
In 1990, SI provided a grant to a small local computer company (Gateway) to assist with expansion efforts. The company grew rapidly and members of the Siouxland Chamber of Commerce proposed starting a program where returns on investments would refurbish the fund. In 1991, Siouxland Ventures, Inc. was started with capitalization of $450,000. Funding for SVI was provided by Siouxland Initiatives (60 percent) and approximately 18 companies and individuals that had previously invested in SI. SVI was established as a for-profit corporation, and the investment goal was to maximize return on investments. The potential economic development impact of investments, such as jobs created, was not a criterion in the SVI investment decisions. However, SVI portfolio companies must be located in the Sioux City metropolitan area.

SVI Operation
Administration of SVI is provided by a President of the fund, a Board of Directors (elected from investors in SVI), and a Business Review Committee (a subset of the Board). All management positions are voluntary, and no management fee is charged to the fund. However, the Siouxland Chamber of Commerce does provide subsidies-in-kind (office, part-time director) for the day-to-day operations of SVI.

Deal flow for SVI was generated through publicity in local newspapers and through the Siouxland Chamber of Commerce. Entrepreneurs or businesses interested in SVI assistance are encouraged to use the local SBDC to develop their business plans. Due diligence on prospective investments is provided by the Business Review Committee and a local private financial analyst under contract with the Siouxland Initiative.

Investments by SVI in portfolio companies are made in the form of common stock only, with an investment maximum of $100,000 per company. SVI
will take only a minority ownership position in their portfolio companies. A seat on the board of portfolio companies is required; however, SVI representatives to the boards of portfolio companies serve SVI on a voluntary basis. Thus, SVI representatives do not have the incentive to give as much time to their board responsibilities as would management of a typical venture capital fund.

**Investment Policy and Practice**

SVI investments were focused on early stage businesses and new business start-ups. As of the summer of 1999, SVI had invested in five companies including such diverse businesses as plastics recycling, food products, watercraft, and computer software. Three of the five businesses are no longer in business, one investment was classified as break-even, and one company is still operating. In the case of one of the business failures, SVI attempted to replace the founders of the company with individuals that had more experience in managing business start-ups. However, SVI did not have experience in identifying and recruiting management expertise, and they were not successful in finding replacements for the company’s founders.

**SVI’s Future**

According to SVI management, the fund might have had more success in creating new businesses if three changes in fund management had been made. First, SVI needed access to external expertise (resources) for assistance with due diligence and investment decisions. SVI’s board had numerous individuals representing corporate investors in the fund. These individuals did not benefit directly from their investment decisions; thus, they did not have the incentive to give significant time to due diligence or investment decisions. Second, an employee of the Siouxland Chamber of Commerce conducted the management of SVI on a part-time basis (10 to 20 percent time commitment). The operation of SVI would have benefited from management that could allocate more time to the fund and an incentive system that rewarded management for successful investments. Third, SVI needed additional information on other sources of venture capital in the area such as angel investors or foundations. Partnering with others on investments would provide another source of due diligence on prospective deals and help leverage SVI investments.

At the time of the interview with SVI management, discussions were ongoing concerning the future of the program. Two alternative directions of operations were being considered. One, SI may seek additional capitalization for SVI, with a minimum target size of $2.5 million. A larger fund could employ a full-time manager and better network with other venture capital funds. Two, SI may cease operating a venture capital fund because of the SVI’s relative lack of success. SI will change its focus to developing a network of potential angel investors and serving as the “point” organization to generate deal flow. In this sense, SI will function as a conduit between angel investors and entrepreneurs needing venture capital. But SI no longer would be involved (through SVI) in due diligence or direct venture capital investing.
Cooperatives may be well suited to making venture capital investments for a number of reasons. One, cooperatives provide services to members when investor-owned firms will not provide them or charge a price that make local residents unwilling to purchase a significant quantity. With venture capital, the case has been made that venture capital investments are geographically and sectorally concentrated in the U.S. Traditional venture capital firms have not shown much willingness to invest in firms outside their urban markets. Two, cooperatives, in contrast to traditional venture capital firms, can take a long-run view of investments. Cooperatives may prefer that a business remain in the community, that is, the cooperative service area, rather than pursue an exit strategy that requires the sale of the business to an outside entity. This perspective may be more in line with that of the business owners, particularly in family-held and rural businesses. Three, cooperatives pool the resources of their many local customers, acting as an intermediary between the community and local businesses. Community residents benefit from investments in two ways—through the financial returns that may be generated and through the external benefits that derive from economic development within their community.

Utility cooperatives in Montana have been aggressive in making venture capital investments as part of their efforts to adapt to economic change. The following four cases provide examples of different strategies applied in different sectors. In each case, one or more cooperatives elected to use member equity to invest in a firm that was either vital to the community or the investment provided the cooperative with an opportunity to improve the local economy. Montana cooperatives have been active in making equity investments for several reasons. The regulatory structure that allows cooperatives to make venture capital investments is in place in the state. The cooperatives determined that these investments were in the best interests of their members. The demonstration effect was important, and once a few cooperatives began the process, others recognized the opportunity and looked for alternative investment strategies.

**Montola Growers Incorporated**
Sheridan Electric Cooperative is the sole stockholder in Montola Growers Inc. (MGI), an oilseed crushing plant located in Culbertson, Montana. Sheridan has owned MGI for roughly two years and bought the plant one year after its previous owners closed it. The plant has been in operation since 1959 and has gone through three prior changes of ownership. The plant is relatively small by current standards but it is highly flexible in terms of the range of oilseeds it can process and its relatively modern capabilities, including a wax removal process that allows it to perform functions that other crushing plants cannot. As a result, it is able to extract a much higher percentage of the available oil from the raw seed than is usual in the industry. The plant also has a highly experienced labor force, with many employees working at the plant for decades.

The plant is the only oilseed crushing facility east of the Rockies that crushes safflower to produce a high quality cooking oil that has desirable health characteristics. Safflower has historically
been grown in the region surrounding the plant and MGI holds a patent on three varieties of safflower developed at the Montana State University. These patents give it the opportunity to contract with farmers to produce safflower that has particularly desirable health characteristics and relatively high yields. At present the plant also crushes canola, soybeans, crambe and sunflowers on a contract basis for other firms. MGI employs between 30 and 40 people depending on the season and currently operates three shifts for 11 months of the year. Wages start at $8 per hour and most workers earn $10 to $12 per hour and there is little turnover. When the plant reopened after being shut down for a year, all the previous workers returned.

Sheridan Electric provides power to the plant and it is the single largest load for the cooperative. Roughly 8 percent of Sheridan’s revenue is from power sales to MGI. Since the plant operates on three shifts with a continuous process, the load is relatively stable making it even more desirable. After the previous owner closed the plant because it was not meeting the profit targets set by the corporation, the Cooperative faced the likelihood that it would have to raise electric rates for its remaining customers. Initially there were hopes that a new buyer would reopen the plant but the only people interested in purchasing the plant wanted to break it up to sell for parts or scrap.

At this point, Sheridan decided to purchase the plant. There were a number of reasons that made it desirable to keep the plant in the community. First, the plant accounted for a large share of the Sheridan load. Second, while the plant employs only 40 people at peak times, the community of Culbertson has a population of roughly 800, making the plant the largest private employer in the county. In addition, the wage level is relatively high for the community. Finally, a significant number of farmers in the surrounding area supplied the plant with safflower and they now faced no viable demand for the crop. Without the plant, farmers would have to produce lower valued crops and suffer reduced income. Because the plant had been in the community for a long time, there was considerable awareness of its history within Sheridan’s Board of Directors and some farmers who served on the Board previously contracted to deliver safflowers. However, Sheridan is a $6 million cooperative and the oilseed plant is a $10 million receipts per year enterprise, so the purchase resulted in a major expansion of the cooperative’s activities.

The estimated salvage value of the plant was somewhat in excess of $1 million but Sheridan was able to negotiate to buy the facility for $400,000. In reality the effective price was lower because the crushing plant had capital credits (patronage credits) of $170,000 that would have had to be paid by Sheridan as they matured. The previous owner agreed to discount the credits to a present value of $60,000 and include them as part of the purchase so the actual net cost to Sheridan for the plant was $340,000. These funds came from the cooperative’s accumulated capital (member equity). Prior to the purchase, a special meeting of the cooperative was held and the membership approved the purchase by almost a two-to-one margin.

Sheridan also recognized that to make the plant viable over the longer term a significant amount would have to be invested in upgrades. Initially these upgrades were expected to cost about $500,000 and the cooperative felt that even if the venture was unsuccessful it
would be able to recover its investment by selling the plant for scrap, since bids of this amount had been received earlier. However, repairs and upgrades cost $2.5 million. A local bank provided a loan of $1.1 million using the oilseed plant as collateral and the balance was financed through a loan from the Cooperative Finance Corporation using Sheridan’s assets as collateral. The bank loan has recently been refinanced through a Business and Industry loan from USDA. In addition, a $400,000 operating loan was obtained from the same local bank.

From the time of the initial concept, Sheridan identified an exit strategy. Since the plant had a relatively stable relationship with the group of farmers who produced safflower in the surrounding area, they were obvious candidates to purchase the plant through the formation of a grower cooperative. At present, there are 240 farmers who provide safflower to the plant. Most are located relatively close to Culbertson in eastern Montana or western North Dakota, but some are in South Dakota. They produce about 50,000 acres of safflower that account for three months production at the plant. Because safflower oil has a relatively small niche market, MGI does not believe it can expand production beyond 100,000 acres, requiring 400 to 500 producers. By creating a closed cooperative that requires both a commitment of capital and a promise to deliver a specified quantity of safflowers each year, Sheridan believes it can recover its investment, recapitalize the plant and ensure a stable flow of raw material. Sheridan is working to get the cooperative registered in North Dakota where state laws are more favorable, there is expertise in starting this type of cooperative and the state government is more supportive of the idea. If the venture is successful, Sheridan intends to retire the debt associated with the loans secured by cooperative assets and reinvest some portion of its repaid equity investment in preferred stock in MGI to generate an ongoing stream of income for the cooperative.

Sheridan’s experience with MGI has raised its interest in other types of equity investments that can help stimulate economic development. These investments may include other agricultural processing firms and may include start-up activities if clear synergies with local farmer skills are there and if they add significantly to Sheridan’s load. In addition, Sheridan has discussed investing in an electrical, heating and plumbing service business that would support both new construction and provide repair services.

The Lefse Shack
Northern Electric Cooperative purchased the Lefse Shack, a small specialized bakery in Opheim, Montana that produces lefse, traditional Norwegian potato bread. The lefse is sold to customers across the country but mainly in Montana and North Dakota. The Lefse Shack had been in business in Opheim for over twenty years as a family business. Two years ago, the owner decided to retire and there were offers from investors outside the state who wished to purchase the business and relocate it to either Minnesota or North Dakota. While the recipe for lefse is readily available, the previous owner appears to have had a particularly good recipe and had developed a set of specialized machinery for the production of lefse that reduced the amount of hand labor and resulted in a consistent product. These two items plus the good will in the business gave it enhanced market value and made it
attractive as a business that could be relocated to another place.

However, the founder wanted the business to stay in Opheim where it was a major private employer. Since Opheim is a very small community, approximately 100 people, the loss of 14 full time and 13 part time jobs would have caused a major decrease in employment and income. The closest community where comparable work might have been available is fifty miles away. Since the jobs at the Lefse Shack pay close to minimum wage, the workers would be competing in that segment of the labor market and the cost of commuting to work would exhaust much of their earnings. For Northern Electric, which has its headquarters in the town, this may have been a relevant issue. In addition, most of the potatoes used by the firm are purchased from a single farm in Northeast Montana.

Clearly the workers were interested in remaining in the community and Northern Electric was able to purchase the company from the owner for a price significantly less than the amount that had been offered by out-of-state investors who wanted to relocate the plant. It appears that the fact that the majority of the labor force had more than ten years of employment with the firm, creating a sense of responsibility, and the previous owner’s attachment to the general community clearly influenced the decision to accept a lower price from Northern. In addition, the previous owner agreed to finance a considerable portion of the sale. One might conclude that by taking a lower price the previous owner made his own equity investment in the Lefse Shack.

Northern Electric was able to retain the workers and promote one of the most experienced to manager. Northern provides bookkeeping and financial services for the enterprise, but does not involve itself in production. The firm has earned a modest profit that supplements the income of the cooperative and Northern has no plans to sell the firm since it sees it as an integral part of the local economy. The same year Northern acquired the Lefse Shack it purchased half the distribution territory of a propane company. Northern and the owner of the remaining half have a non-compete agreement. At present, Northern has no plans to purchase other businesses because they are unable to identify any opportunities in the area.

For the Lefse Shack to expand, major infusions of capital and concerted efforts to expand markets beyond the traditional ones it has currently captured would be required. Most importantly, significant expansion may require relocation to another community because of limited local labor availability. There may not be enough people in Opheim to allow significant expansion using the current production methods.

**Northwinds Publishing and Printing**

Northwinds is a printing and publishing company located in Great Falls, Montana. It is owned by seven cooperatives, three electric (Sun River, Vigilante, and Glacier) and four telephone (Three Rivers, Nemont, Triangle and Blackfoot). In 1989, three of the telephone cooperatives, Three Rivers, Nemont and Triangle created a publishing company, Montana Directories, because they believed that investing in a publishing company made sense because they had significant direct publishing expenses for telephone books. In 1992, these three companies joined with Blackfoot and the three electric cooperatives to create a start-up printing company called Metcap. This company
provided an opportunity to reduce external printing costs and generate revenue from commercial sales. Each cooperative contributed a small amount of venture capital to start Metcap, but all pledged guarantees to finance the purchase of a five-color press and set up the printing operation in Sun River, a small community outside Great Falls. In addition, the Montana Association of Electric Cooperatives (MECA) agreed to guarantee a portion of the debt issued by Metcap. Because of these guarantees, Metcap had no problems borrowing money and, as a result, Metcap started out with limited venture capital and a large debt load. Montana Directories continued as a separate publishing company but it used Metcap as a printer.

The cooperatives hired a manager and established a board of directors for Metcap that consisted of the general managers of the seven cooperatives, the group of individuals who had developed the concept. With the initial equipment, they could produce the cover for telephone books but had to contract with another firm for the printing of the directory listings. This constraint resulted in limited revenue opportunities. Plans to do commercial printing were not fully successful because there were several other printing operations in the area that focused on the same niche and had more experience. As losses mounted, additional investments were required and the three electric cooperatives, MECA and Blackfoot became less enthusiastic about the project.

In 1995, the three telephone cooperatives that owned Montana Directories made a major venture capital and debt infusion to purchase an existing printing company in Great Falls, AA Printing, that had a web press capable of printing the actual telephone book listings. At the time, the new company had a viable business and was roughly three times the size of the Metcap Sun River operation. By late 1995, the losses at Metcap had reached a point that the company was no longer viable. However, closing the company would have triggered the loan guarantees and caused major losses for all the participants. To avoid these losses, the participants, except MECA, agreed to make a new capital infusion into Metcap and retire some of its debt, in effect increasing their venture capital contributions. MECA remains as a guarantor for some of the loans. At the same time, Montana Directories agreed to absorb Metcap, which gave three of the telephone companies a much larger share in the resulting business. The new business assumed the name Northwinds Publishing and Printing.

At that time, the cooperatives replaced the management, but the Board remained the same. By consolidating the two businesses, the cooperatives believed they could become more competitive by offering a broader set of capabilities to customers. However, the fact that the presses were in different buildings, twenty miles apart, and that binding and mailing were split between the two buildings made the operation inefficient. In addition, the integration of the two businesses did not proceed smoothly. To address this problem, the investors decided to build a new facility that could house both presses and all the staff, which now numbered 60, and would allow a more orderly production process. Additional funds from the Rural Telephone Finance Corporation were borrowed, but once again the cooperatives had to provide guarantees.

Losses continued and in February 1998 the Board determined that once again they had to recognize that the
business might not be viable. They replaced the manager with a professional accountant who was charged with establishing how bad conditions were and closing the operation. After a short time, it was determined that with better management and greater focus it might be possible to turn the company around and sell it as a viable enterprise. The five-color press has recently been sold and the company now concentrates on getting better use of the web press, since it is the largest commercial web press in Montana. The company still focuses on producing telephone books but now prints the directory listings and contracts out production of the color work for covers. It is also targeting a wide range of commercial printing services.

The Board for the reorganized company now consists of three telephone cooperative managers and two electric cooperative board members. Unlike earlier times the Board now meets monthly and is required to vote on significant management decisions. The number of employees has declined to 42 and will decline further when the operation moves to the new building. Orders have increased by 40 percent since March 1999 and the seven cooperatives are now considering retaining their holdings in the company, even though they are not likely to see a positive return on their investment for a number of years.

**Evergreen Rail Industrial Park**

Flathead Electric Cooperative owns the Evergreen Rail Industrial Park (ERIP) as a wholly owned for-profit subsidiary. When the cooperative relocated to its current building in the mid-1960s, it purchased almost 40 acres of land. Most of the land was initially rented for farming purposes but as property values in the area increased, by the mid-1990s the cash rents were only just covering property taxes. A portion of the land was sold in the 1980s to the Bonneville Power Association for an administrative and operations building. As development in the area increased, the value of the land as an industrial site increased, particularly since it already was zoned for industrial development.

From the start, the cooperative determined that it was in its long-term interest to develop the property in a selective way and recognized that this approach would mean that a considerable period of time might pass before a positive return on investment was recorded. While the cooperative could have sold the land to a private developer, it would have relinquished control on the type of development that would have surrounded it. At least as important in the conceptual stage was the recognition that by undertaking the development function themselves, the return to the cooperative would be much higher and it could be structured in a way that would provide an ongoing source of income for the cooperative. Converting the land from its raw state into a viable development site required further investment to purchase small parcels of land to assemble a complete block with a regular shape. In addition, significant investments in water, roads and sewage systems were required. To provide sufficient sewage capacity required a long negotiation with the local government because sewage treatment facilities were in short supply. The fact that the community regarded the cooperative as a good corporate citizen helped in negotiating for a significant allocation of sewage capacity to the site. Because the cooperative had a design plan that was endorsed by the community and the cooperative made a commitment to
follow the plan, it was relatively easy to work with the local government.

In 1995, the cooperative created a wholly owned subsidiary with the cooperative as the sole shareholder. A separate Board was created to oversee ERIP and develop the land as a light industry park. This board consists of two members of the Board of Flathead, the Flathead general manager and two members of the Flathead Cooperative who are not Flathead Board members. Flathead provides staff for ERIP. These actions were carried out by Flathead Board decision, but there was considerable prior discussion and notification of the membership. Since no assets were disposed of, there was little controversy and since the cooperative believes it can generate a 10 to 12 percent rate of return on the investment, members are generally supportive.

To reduce cash outflows, the cooperative sold three lots and used the proceeds to pay for development expenses. Other lots are being leased on a 15-year basis with renewal terms and price escalator clauses included in the original lease. For the most part, ERIP is being marketed to existing businesses that are looking for a new location and can pay the current price. But if a company with limited cash came to ERIP and the company was seen as a desirable tenant for the park, there is some possibility of Flathead providing a different lease structure that back-loads payments to allow the company to locate at the park. While there are no targeted industries, Flathead is trying to ensure that the property is used in ways that are consistent with the basic design philosophy. At present, the project is not generating a positive cash flow. But, positive returns should develop after one or two more lots are leased.

Recently Flathead became involved in a major investment opportunity. It is working to buy out the local investor-owned power company that now serves the urban part of its region. This acquisition will quadruple the number of customers served by Flathead and double the number of miles of line it operates. Because of this major expansion, efforts to market ERIP had slowed considerably at the time of the site visit, but are expected to resume once the merger is completed.

Endnotes
Case Study 16: Coastal Ventures Limited Partnership
Contact: Julia Sass Rubin, Harvard University, Boston, MA
Date of Visit: June 1998

Coastal Ventures Limited Partnership (CVLP) is a for-profit community development venture fund serving, primarily, the state of Maine. Coastal Enterprises Inc. (CEI) a nonprofit community development corporation that has been providing loans and technical assistance to Maine small businesses for over 20 years established CVLP. CVLP’s objective is the creation of livable wage jobs, with benefits, for low-income residents of Maine. CVLP also invests in businesses that produce socially beneficial products and services and use progressive management practices, such as providing opportunities for employee ownership.

History of CVLP
CVLP grew out of CEI’s belief that there was an unmet need for equity capital for Maine businesses and that meeting that need could help spur economic development in the region. In 1988, Ron Phillips, the President of CEI, hired Nat Henshaw to be a loan officer at CEI. Prior to Nat’s hiring, CEI had closed five equity investments, two of which were made with no expectations of substantial financial gains. Nat had a traditional venture capital background and was brought in with the hope that he could help CEI develop its equity portfolio. With Nat’s assistance, CEI made an additional 11 equity investments from 1989 to 1994. In 1994, CEI launched and began to capitalize CVLP, which was devoted exclusively to the provision of equity.

Structure of CVLP
In setting up CVLP, CEI created CEI Ventures, Inc., a for-profit subsidiary of the non-profit parent organization. CEI Ventures serves as the general partner for CVLP, a for-profit limited partnership. CVLP has two other groups of investors, its employees, who are special limited partners, and its outside limited partners. CVLP was capitalized with $5.54 million from over 20 institutional investors, including $1.9 million from 10 banks and other financial institutions, $2.6 million from eight foundations, and $1.02 million from CEI, the Community Development Financial Institutions (CDFI) Fund of the U.S. Government, and National Community Capital, one of the CDFI industry’s trade associations. The fund was set up with a 10-year life, with the option of extending that for two more years.

CVLP operates with a staff of three: a president and vice president who perform due diligence and post-investment oversight, and an administrative assistant who handles the accounting, administrative and some of the legal work for the fund. The fund’s operating budget for 1999 was $165,000, which consisted primarily of salaries and benefits. The fund shares office space with CEI, and CVLP’s staff perform lending services for CEI in exchange for that space. The fund’s 3 percent management fee on capital covers salaries and other expenses. CEI and the staff of CVLP also participate in a 20 percent carried interest.

CVLP Operation
CVLP sees about 80 business plans per year. CVLP’s staff review these plans and conduct appropriate due diligence. If a deal passes due diligence, the fund’s president or vice president prepares an
investment memorandum that he submits to the Board of Advisors. The Board then makes the decision regarding whether to proceed with the investments. Members of CVLP’s Board of Advisors have considerable equity capital and general finance experience.

CVLP focuses its investments on the state of Maine. However, the fund has the capacity to invest anywhere in the United States, and has done so in the past. This strategy is intended to broaden CVLP’s network of co-investors and facilitate reciprocal co-investments in Maine businesses. CVLP co-invests with a number of traditional and developmental venture capital funds, as well as with angel investors.

Portfolio companies must report both financial and social performance to CVLP on a quarterly basis. They also provide CVLP with monthly reports on the number of low-income individuals they have hired. CVLP, in turn, reports this data to its shareholders on a quarterly basis and also provides a portfolio valuation at that time.

**Investment Policy and Practice**

CVLP’s policy is to make equity investments in Maine businesses with growth potential. The goal for the fund as a whole is a rate of return of 11 percent to the limited partners. The fund’s ideal rate of return for individual investments is 20 percent, recognizing that many deals will generate negative returns. However, there is no explicit rate of return that individual investments must achieve. In determining in which companies it will invest, CVLP weighs the projected financial returns against the risk, the amount of investment required, and the social benefits generated by the business.

While there is no hurdle rate of return for CVLP’s investments, businesses must meet certain social criteria. Each business must sign an agreement with CVLP that commits the business to targeting 50 percent of the jobs it creates as a result of the growth that CVLP is financing to low-income people. These low-income individuals are referred to the business through CVLP’s various partners.

CVLP also considers wage rates in making investment decisions. Although there is no formal agreement requiring them to do so post investment, in order to qualify for CVLP financing, companies must pay wages of at least $7/hour, or $6.50/hour if the company pays for employee health benefits. CVLP also looks for companies that generate other social goods, such as environmentally beneficial products. The fund does not invest in firms that pollute the environment and generally will not invest in defense-related businesses.

CVLP investments range from $50,000 to $500,000. No single investment can exceed 10 percent of CVLP’s total capitalization and the goal is to have an average deal size of $250,000. The investment portfolio is diversified by both sector and stage of business.

CVLP views its primary function as helping to raise additional money for its portfolio companies from banks and follow-on equity investors. CVLP looks for portfolio companies that have strong management teams and that will require limited technical assistance. If necessary, however, the fund’s staff does provide management assistance to its businesses and also helps them to recruit management team members. CVLP also introduces portfolio companies to other service providers, such as lawyers and accountants, and to CEI’s Small Business Development Company for help with specific business needs. CVLP generally
takes a position on its portfolio companies’ boards of directors. Directors of CVLP’s general partners are also sometimes asked to sit on portfolio company boards.

By the end of 2000, CEI had fully exited two businesses and partially exited two others. The fund had also fully written off one additional company. Although the fund’s preferred exit strategy is an employee stock ownership plan (ESOP), which would support CVLP’s goal of creating wealth for Maine residents and retaining jobs and income within the state, CVLP’s exits to date have consisted exclusively of external and management buy-outs. This is consistent with the primary exit methods used by other CDVC funds.

Through the end of 2000, CVLP had made 17 investments, which had created 672 jobs and sustained 1,880 more. Of the new jobs created, 302 went to low-income employees and 60 to former public assistance recipients. The average starting wage for CVLP portfolio companies is $14 an hour. Ninety eight percent of the jobs created provide health insurance. Sixty three percent also provide retirement benefits and 32 percent provide employee educational assistance.

**Future of CVLP**

CVLP began investing in 1996 and anticipates being fully invested by the end of 2001. In October 2000, CEI staff began raising money for a second fund, which could be as large as $20 to $30 million. As of the end of January 2001, CEI had raised almost $12 million and anticipated that the fund’s first closing would take place in March 2001. The capital commitments to date had come primarily from banks. CEI had also obtained commitments from individual investors and from the Finance Authority of Maine.

The second fund will still focus primarily on the state of Maine, but will also serve the entire New England region and will have the ability to make investments anywhere in the United States. The fund’s primary objective will still be the creation of high-quality jobs for low-income individuals. However, CEI is changing its low-income job creation objective from 50 to 30 percent of all the jobs created to more accurately reflect the CDC’s experience in this area. The other significant change is the size of investments, which will increase from an average of $250,000 to an average of $1 million per company. This reflects both the larger size of the second fund and the growing need for investments in that size range, as traditional venture capitalists continue to raise larger funds and make larger investments.
Case Study 17: Kentucky Highlands Investment Corporation
Contact: Julia Sass Rubin, Harvard University, Boston, MA
Date of Visit: November 1998

Kentucky Highlands Investment Corporation (KHIC) is a community development corporation that serves nine Appalachian counties in southeastern Kentucky. KHIC invests in start-up and expanding enterprises that are located, or willing to move into, its region. In many cases, KHIC works to create new businesses to meet market needs, designing and financing business plans and recruiting entrepreneurs to run the businesses.

History of KHIC
KHIC is one of the original Title VII Community Development Corporations (CDCs) funded by the federal Office of Economic Opportunity. KHIC, originally titled Job Start Corporation, was created in 1968 by six local community action agencies. The organization had very broad social and economic development goals.

In the early 1970s, Job Start began making investments in local entrepreneurs in exchange for an equity stake in their businesses. The CDC adopted the Kentucky Highlands Investment Company name to make the organization seem more business-friendly and, in 1978, formed Mountain Ventures, a small business investment company (SBIC) to more aggressively pursue equity investments.

As one of the first CDCs to make equity investments in externally owned companies, KHIC promoted this new approach to economic development. The organization was the subject of numerous articles in national publications. Other CDCs have also used venture capital investments as a means of promoting community economic development, including Impact Seven in Wisconsin, Coastal Enterprises in Maine (see previous case study), and Northern Community Investment Corporation in Vermont.

Structure of KHIC
KHIC, the parent company, is organized as a nonprofit corporation, with no time limit on its life. KHIC is a certified Community Development Financial Institution. It is also a United States Department of Agriculture Intermediary Relending Program lender, a non-bank Lender for the USDA Business and Industry Loan Guaranty Program, an SBA micro lender, and the lead entity and administrator for the Kentucky Highlands rural empowerment zone, which serves the counties of Jackson, Clinton and Wayne.

KHIC’s has three subsidiaries: the Kentucky Highlands Management Corporation, a for-profit corporation that oversees the provision of consulting services; the nonprofit Kentucky Highlands Community Development Corporation, a tax credit community development program; and the Kentucky Highlands Development Corporation, a for-profit holding company with two subsidiaries. The Kentucky Highlands Development Corporation’s subsidiaries are Mountain Ventures Inc., a for-profit SBIC that makes venture capital investments, and the Kentucky Highlands Real Estate Corporation, a for-profit that develops and maintains an inventory of available industrial sites and buildings that it leases or sells.

KHIC Operation
KHIC’s broad mission is to actively plan, initiate and promote community,
social, and economic development activities in its region. KHIC operates primarily in a nine county area in southern and eastern Kentucky. Mountain Ventures Inc., however, can make equity investments in any of the 49 Appalachian Kentucky counties.

While KHIC does not have any specific industry focus, it does look for manufacturing investments because of the higher quality jobs, considering both wages and benefits, associated with these industries. KHIC is willing to invest in businesses at all stages of development, including very early seed-stage. Most importantly, companies must be located (or willing to relocate) in the KHIC region and they must generate jobs for low-income residents of Appalachian Kentucky.

KHIC received a total of $14 million in federal money through the Title VII program. This capital has grown through retained earnings and new investments and grants received over the life of the corporation. As of the end of 2000, KHIC had a total of $49 million in investments and available capital. Because KHIC uses a combined financial statement for all its operations, it is difficult to identify exactly the amount of capital available for venture capital investments.

KHIC covers its operating expenses by both profits earned on investments and grants that it receives from federal agencies, foundations, and others. KHIC does not receive a management fee on any of the capital that it controls.

Deal flow in KHIC’s region is very limited. KHIC reviews approximately 50 potential investment opportunities a year and invests in 20 of them. Because of the weak deal flow, KHIC relies on internal deal development for many of its investments. KHIC has an incubator on-site and works extensively with portfolio companies, both before and after making a financial investment. Deals also come to KHIC because of its reputation within the region and because its staff is actively involved with existing portfolio companies. From this involvement, staff often identify deals or deal prospects that may become KHIC investments in the future.

**Investment Policy and Practice**

When an entrepreneur or a management team approaches KHIC about a potential investment, a staff member begins by reviewing the business plan. If the plan is adequate, staff proceeds with due diligence. If the plan is incomplete but the staff has confidence in the management, KHIC helps to revise and complete the business plan before proceeding with due diligence.

The due diligence process includes an evaluation of a company’s management, market, customers, and supply of necessary inputs (raw material, equipment, labor and capital). It also includes a review of the financial structure of the business. The staff may also contact potential co-investors. KHIC leverages four to five outside dollars for each dollar that it invests. In doing so, it routinely partners with traditional and developmental venture capital providers, angels, economic development agencies and lenders in the region.

Once a deal passes due diligence, a recommendation is made to the entire KHIC Board of Directors. KHIC does not have a separate investment committee. If the deal receives Board approval, the legal documents are prepared and the deal is closed.

Portfolio companies are required to provide at least quarterly financial statements and job creation numbers to KHIC. In addition, KHIC staff is actively
involved in the management of the portfolio companies. The staff provides extensive technical assistance to the companies, including in the areas of marketing, sales, and finance, and, if necessary, may become involved in a portfolio company’s day-to-day operation.

The preferred exit strategy for KHIC investments is to arrange a buy out by a larger company that agrees to keep the portfolio company in the region. Owner buybacks and employee stock ownership plans have also proven viable exit strategies.

**Future of KHIC**

KHIC is the oldest and largest community development venture capital fund. It is widely regarded as a model for effective rural economic development. Over its lifetime, KHIC has provided more than $78 million in investment capital to Southeastern Kentucky businesses and communities. The fund is continually growing through earnings on its investments, as well as new grants and loans from local and federal sources, and expects to provide over $62 million in investment capital to its region over the next 10 years.
Northeast Ventures (NEV) was established in 1989 in Duluth, Minnesota. Its mission was to promote regional economic development in northeastern Minnesota through investments in growing businesses. NEV was created as a permanent source of venture capital that could be used to support the region’s recovery and growth following the collapse of the mining industry.

History of NEV
Northeast Ventures was created in response to the economic devastation that northeast Minnesota experienced in the early 1980s, following dramatic declines in demand for Minnesota ore. In 1985, the Blandin Foundation, based in Grand Rapid, Minnesota, convened a series of meetings for Northern Minnesota economic development professionals and community leaders, to discuss ways to address the economic crisis. Nick Smith, President of the region’s largest law firm, strongly advocated for the creation of a venture fund that could encourage long-run economic growth. Smith felt that access to equity capital, versus more debt or attempts to attract large out-of-state manufacturers, was the key to economic revitalization. He based this conviction on years of experience working with local businesses.

The Blandin Foundation encouraged Smith and a group of other business leaders to pursue the idea. The group surveyed community leaders, bankers and local service providers to better understand the need for capital, particularly equity, within the region. They also looked for examples of successful rural equity providers, but found few that could serve as models for northeast Minnesota’s situation.

The founders decided to establish a parent entity, the Northeast Venture Corporation, and two subsidiary organizations. The for-profit Northeast Ventures Development Fund would be structured as a C-corporation. It would be capitalized with $5 to $10 million and would make venture capital investments. The nonprofit Northeast Entrepreneur Fund would raise $750,000 and would provide loans and management assistance to very small businesses and the self-employed. In early 1989, the Blandin Foundation provided seed capital for the project and Smith was asked to head it up.

Structure of NEV
NEV was organized as a for-profit C-corporation for three reasons. First, the shareholders wanted the model to be replicable and believed that a for-profit fund would make it easier to attract private capital and increase the chance of success and replication. The fund’s managers and investors also felt that nonprofits were less focused on financial returns. Second, the organizers wanted to create a permanent venture capital institution for northeast Minnesota. A permanent fund could continue investing in the region indefinitely. It was also an easier concept to sell to the local residents and investors. Consequently, using an LLP structure with a limited life was ruled out. Third, organizers wanted to encourage the active involvement of investors, which is legally limited in an LLP. Using a Limited Liability Company (LLC) structure was not an option because Minnesota had not passed LLC legislation at the time that Northeast Ventures was being organized.

In 1994, the parent NEV was merged into the Northeast Ventures Development
Fund, with the Development Fund’s board serving as the board of directors for the new entity. The microenterprise fund remained a separate non-profit organization. This merger helped to reduce overhead costs for the venture capital fund. In 1996, Northeast Ventures structure changed again to incorporate Iron Range Ventures, a nonprofit formed to raise grant capital for NEV’s activities. Iron Range pays 6 percent of its capital under management to NEV as part of a management contract. NEV, in turn, takes no annual management fee, covering expenses out of profits, cash reserves and Iron Range management fees.

By the end of 2000, NEV’s total capitalization had reached almost $15 million. The capital came from foundations, a public utility, two quasi-public state organizations, and the Community Development Financial Institutions fund of the U.S. Government.

NEV operates with a staff of six, which includes a CEO, president and two vice presidents, all of whom perform due diligence and post-investment oversight. The staff also includes two administrative assistants who handle the accounting and administrative work for the fund. One of NEV’s vice presidents also serves as the president of Iron Range Ventures.

NEV’s 2000 operating budget was $910,000, most of which was made up of salaries, benefits and other labor costs. Approximately one seventh of the operating budget consisted of interest expense from program related investments—foundation investments that take the form of low-interest loans.

All of NEV’s staff members participate in the fund’s 20 percent carried interest. This is the realized gain less investments and any write-offs or write-downs.

**NEV Operation**

NEV targets investments to companies that have the potential to grow, to be profitable, and to create jobs for low- and moderate-income people. The fund also looks for companies that have a reason to be located in northeastern Minnesota, and want to be there for the long-term; and managers who have progressive ideas about how employees should be treated. For example, NEV is interested in managers and entrepreneurs who offer equity opportunities and various forms of incentives to all levels of employees.

However, NEV does not have specific minimum requirements that its portfolio companies must meet in terms of social benefits creation. While NEV does consider wages in its investment decisions and does advocate for higher wages when feasible, the fund does not set a minimum wage level. Portfolio companies are required to provide health insurance to full-time employees, but the programs do not have to be fully funded by the company. Portfolio companies have to use the Minnesota job service to identify potential employees, but are not obligated to hire the employees recommended.

NEV targets investments to businesses located in northeast Minnesota, which must constitute 85 percent of the fund’s portfolio. The other 15 percent can be invested outside the region, with most investments to date going to the Minneapolis-St. Paul region. This flexibility to invest a small portion of the portfolio outside the region enables NEV to partner with other venture funds that may, in turn, reciprocate by investing in companies in northeastern Minnesota. It also provides NEV with an opportunity to improve returns by targeting larger, syndicated deals, led by other venture funds.
capitalists. Such deals do not require as much due diligence or technical assistance by Northeast Ventures.

NEV has no specific sectoral focus and its investments, to date, have included a broad-range of industries. NEV does not invest in locally focused retail or service businesses. In general, the fund looks for companies that can sell to national or international markets, export products, and bring new income into the region.

As originally conceived, NEV would diversify its portfolio across business stages, doing some start-ups and other later stage investments. However, the reality of deal flow in the region has meant that NEV has done more early stage and start-up investments than anticipated. These deals require that NEV stay in the investment longer, potentially lowering its rate of return.

Portfolio companies must report employment information to NEV on a quarterly basis. Companies also must indicate how many of their employees are new hires, and how many of those were low- or moderate-income individuals at the time of hiring. Most NEV portfolio companies also provide monthly financial information, including income statements, balance sheets and cash flows. Some of the companies report this information on a quarterly basis.

**Investment Policy and Practice**

NEV identifies potential deals through its referral network within the community. The fund networks with other venture capitalists and is part of several organizations of economic development professionals. Information about NEV included in its annual report is sent periodically to bankers and other service providers within the region. These activities have helped create a high profile for NEV within the region, so that prospective deals are regularly directed to the fund.

NEV receives about 150 inquiries per year. About one-third of the contacts they receive come as business plans and the staff performs serious due diligence on approximately 10 to 12 of these businesses. When NEV considers an investment in a business, the staff looks at both financial and non-financial information. Although NEV does not generally consider deals with less than a 25 percent expected internal rate of return, the fund has made investments that had strong job benefits but lower expected financial returns. It also has turned down financially promising deals that offered no job benefits. In making investment decisions, NEV considers the environmental impacts of its potential portfolio companies, in addition to their job quality, benefits, and management practices.

When NEV receives a prospective investment, the fund’s management determines who will perform due diligence on the investment, based on overall workload and skills relative to the company. As that person performs due diligence, he also discusses the deal with his colleagues. If the decision is made to pursue the investment, the person who performed due diligence writes up a formal investment recommendation for NEV’s board, which also serves as the fund’s investment committee. The recommendation covers the financial considerations, such as markets, management, product and production, as well as the potential social impacts of the investment. The majority of recommendations are presented at a board meeting. The board must authorize any investments over $25,000. Smaller investments can be made with the approval of the fund’s Chairperson and
President. The entire deal approval process typically takes 3 to 4 months and the shortest turnaround time is six weeks.

NEV’s investments have ranged from $10,000 to $300,000 per round, with an average investment of $423,000 per company. The fund cannot invest more than 10 percent of its total assets in any one company. NEV structures most of its investments as preferred stock. The deals may also include debt, which is usually used as part of a follow-on investment package.

As of December 31, 2000, NEV had invested approximately $11.4 million in 27 companies. NEV works closely with its portfolio companies. Whenever possible, the fund takes a seat on the portfolio company’s board and is very actively involved in the operations of those companies. NEV’s management originally tended to become more involved with those portfolio companies that were doing either very well or very badly. Those companies in the middle tended to get less of their time. The fund subsequently hired more staff to address this problem.

In addition to the assistance that NEV’s management provides directly, the fund also draws on its extensive local network to assist its portfolio companies in various ways. While these are all services provided by most venture capitalists, NEV’s portfolio companies tend to require more intensive involvement by the fund because they are young, mostly start-up firms.

NEV’s goal in designing an exit strategy is to earn a good financial return while leaving the business in a situation where it can thrive in the region. While an IPO is a preferred exit strategy, it is an unlikely one for most NEV companies because IPOs require very high growth rates and, generally, a technology focus. Acquisition by another company, while more common, may ultimately lead to the new owner moving the company outside the region. Employee stock ownership plans and owner/management buybacks are the exit options most likely to keep the company local. They also distribute ownership, promoting one of NEV’s objectives. To date, however, NEV has not exited any of its companies via either method. In total, NEV has exited four deals profitably, broken even on one, written off five more, and made three exploratory investments in which it ultimately chose not to invest beyond an initial development agreement.

**NEV’s Future**

Northeast Ventures’ primary challenge is to develop successful near-term exit strategies for a number of its investments. NEV has been in operation for more than ten years and has exited approximately half of the companies in which it has invested. Unless NEV is able to profitably exit more of its current investments, it could find it difficult to attract new investors and have the liquidity to make additional investments.

NEV is continually searching for ways to increase its impact on Northeastern Minnesota. One of the options that the fund is exploring is the possibility of changing its legal status to a nonprofit. As a for-profit C-corporation, any profits that NEV earns on its investments are taxed at both the corporate and the individual investor levels, reducing the amount of capital left for ongoing reinvestment. NEV’s management is also considering creating a second fund, which would be a for-profit, to augment and enhance what NEV is able to accomplish in its region.
Case Study 19: Cascadia’s Rural Development Investment Fund
Contact: Julia Sass Rubin, Harvard University, Boston, MA
Date of Visit: November 1998

Cascadia is a non-profit revolving loan fund headquartered in Seattle, Washington, which provides loans and technical assistance to entrepreneurs unable to acquire capital from other sources. The fund focuses on distressed communities in Washington and Oregon. The Rural Development Investment Fund (RDIF) is a program created by Cascadia to provide equity-like investments to entrepreneurs in the region.

History of RDIF
Cascadia was established in 1985. In the early 1990s, the rural communities of Washington and Oregon experienced economic upheaval because of downturns in the timber and fisheries industries. While Cascadia’s program of providing loans and technical assistance to individual entrepreneurs helped those individuals and families, the region-wide economic crisis called for a different approach. Cascadia needed to provide a more patient form of capital in order to help new companies that had the potential to create significant numbers of jobs in the region.

In 1994, in order to address this need, Cascadia began developing a high-risk financing tool that would promote private economic development in its target areas. The objective was to be able to make high-risk investments in small businesses that have the potential to diversify rural economies and create or retain family wage manufacturing jobs. Cascadia called this effort the Rural Development Investment Fund (RDIF) and began to raise capital for a pilot phase designed to demonstrate the need for, and explore how best to structure, such a program.

During the five year RDIF pilot phase, Cascadia successfully raised and invested a total of $885,000 in grant capital. In 1999, following the successful completion of the demonstration project, Cascadia began fundraising for a permanent fund. As of December 2000, Cascadia had commitments for more than $5 million from state and federal governments, foundations, and banks, the minimum size objective set for the fund. However, Cascadia will continue to raise capital in the hope of growing the RDIF to $10 million.

Structure of the RDIF
Given the perceived need for equity in the region, the RDIF was initially expected to make primarily equity investments, such as preferred and common stock. However, the industries typically located in Cascadia’s target area, such as the production of value-added timber and fishery products, were not strong candidates for IPOs and other traditional venture capital exits. To address the potential difficulty of exiting such investments, Cascadia created a new instrument — the participation agreement (PA).

The PA is a low interest, subordinated loan with an ongoing fee that is revenue based. The fee is calculated based on financial projections negotiated between RDIF staff and the company’s management. The parties agree to a five-year projection of revenues and then the fee is set as a percent of monthly revenues that will generate an 18 percent to 22 percent internal rate of return for the fund. In many instances, participation payments can be accrued for a period of time or until an agreed upon level of sales is reached, thereby
providing a degree of “patience” to the capital.

The PA provides several benefits over traditional equity investments:

- The RDIF acquires no share of the business so the entrepreneur does not have to give up ownership.
- An exit strategy via amortization of the debt is in place from the start, avoiding any need to liquidate the company in order for RDIF to earn a return.
- The cost to the entrepreneur is based on the growth rate of the company. When growth, that is, revenues, is high, the cost to the company is also high. However, when growth is slow, the costs are also relatively low.
- More traditional lenders view PAs as equity versus debt. As a result, this capital can be used to leverage additional debt from other financial institutions.
- The structure is relatively simple and reduces attorney fees for both RDIF and the portfolio company.
- The PA provides immediate and systematic cash flow to the Cascadia RDIF, which is particularly important for a small start-up fund.
- The revenue-based fee can be decreased when a company achieves various social goals, such as providing employee benefits or improving the environment.

RDIF Operation
Cascadia has high visibility among both the economic development and small business communities in the region. Most of the Cascadia revolving loan fund’s deals come through a referral network established over many years. For the RDIF, deal flow has come primarily from companies that initially sought financing from the revolving loan fund. Cascadia anticipates advertising the RDIF program more extensively in the future.

RDIF’s explicit geographic targets are Washington and Oregon’s distressed rural communities. Cascadia is also considering expanding the program to include Idaho and Western Montana. RDIF is targeted toward value-added industries that are likely to be competitive in these rural areas, including secondary wood products, value-added agriculture and fisheries, and manufacturing based on recycled products. Most of the existing portfolio companies are manufacturers; however, RDIF does not exclude any industries from consideration, provided that the industries provide some competitive advantage to the rural areas in which they are located.

RDIF can invest in businesses at any stage of development. The existing PA instrument, however, is most appropriate for companies with cash flow. Therefore, RDIF has not yet funded any seed or early stage investments. In the future, RDIF may use an alternative investment instrument for companies at very early stages of development.

Like other community development venture capital providers, RDIF considers both social and financial criteria in making investments. On the social side, RDIF is looking for high-quality job creation in rural communities within its target areas. That means investing in companies that have the ability to create jobs that pay a living wage and provide benefits. Although stringent guidelines for such social benefits are not written into the terms of each RDIF participation agreement, the contract does indicate that
the borrower must work with the local welfare-to-work office and make an effort to fill vacancies with low-income people. On the financial side, the company must be able to repay the participation agreement, including the revenue-based fee that, in combination with interest on the loan, generates a targeted 18 to 22 percent rate of return on investment for Cascadia.

The RDIF currently operates with a staff of one loan officer, who also has some responsibilities within Cascadia’s revolving loan fund. During 2001, Cascadia expects to hire an additional loan officer to cover eastern Washington, Oregon, and possibly Montana and Idaho. RDIF’s 2000 operating budget was less than $130,000 and was fully covered by the program’s earned income. Cascadia expects the program to continue to be self-sufficient even after a second staff member is added.

**Investment Policy and Practice**

A Cascadia loan officer performs due diligence on all prospective investments. If the project looks promising, s/he then brings the deal before the entire staff. Deals that meet with staff approval are presented to the Board’s loan review committee. The loan review committee can approve deals of $300,000 and under. Deals over $300,000 must be approved by first the loan review committee and then the Board’s executive committee. The function of the loan review committee is to consider the business soundness of a proposed investment. The executive committee considers the investment’s potential social benefits and the impact on RDIF if the investment were to result in a loss.

As with the Cascadia loan fund, RDIF provides its portfolio companies with post-investment technical assistance. At present, this assistance is provided entirely by RDIF’s staff. Because staff is limited, RDIF provides no pre-investment technical assistance. Through the end of 2000, RDIF had invested $2,505,000 in 15 companies in the region.

**Future of RDIF**

To date, Cascadia has been successful in both raising capital for the RDIF program and becoming financially self-sufficient. It also has become a model for the use of near-equity to address many of the limitations inherent in making developmental equity investments in rural regions. The program’s long-term success will depend on its ability to continue performing both socially and financially.
First United Ventures (FUV) is the first rural bank Small Business Investment Company (SBIC) licensed by the U.S. Small Business Administration (SBA). FUV is a subsidiary of First United Bank of Durant, Oklahoma, a community of about 13,000 people located 120 miles from the state capitol, Oklahoma City.

History of FUV
First United Bank is part of a bank holding company, 75 percent of which is owned by the Massey family and the remaining 25 percent by the bank employees. In addition to his responsibilities with the bank, Greg Massey is Chairman of the Board of Rural Enterprise, Inc., a local economic development agency. In this capacity, Massey identified the need for venture capital to support economic development within the community and region. As a banker, Massey was also able to identify deals that required venture capital. Based on this experience, the bank chose to create an SBIC. The SBIC structure was chosen rather than a bank community development corporation because the bank had a relationship with SBA and found the national association to be more forceful and helpful.

First United Bank has $50 million in equity. SBA requires a minimum investment of $2.5 million to create and license an SBIC. Bank regulations require that no more than 5 percent of venture capital be used to capitalize a venture capital fund. First United Bank was just large enough to create FUV. The SBIC is licensed to operate in Oklahoma plus northern Texas (a region equivalent to the third congressional district). Initially, FUV was not expected to operate as a leveraged SBIC.

Structure of FUV
First United Ventures is a wholly owned subsidiary of First United Bank. Although the bank owns the SBIC, the bank and FUV have separate boards. FUV was capitalized in 1998 with $2.5 million from the bank. The SBIC structure includes $2 million in common stock and $500,000 in non-voting preferred stock. While it is not possible to bring outside investors into the bank SBIC, the Oklahoma tax credit may be used to package some syndicated investment deals. The state of Oklahoma provides a 20 percent tax credit to individuals who invest in qualified Oklahoma small businesses along with investments from qualified small business capital companies. It is possible that the SBIC can qualify as a small business capital company under the Oklahoma legislation. This designation would facilitate co-investing with local or regional angel investors.

FUV Operation
The primary goal of FUV is to invest in businesses that will earn a rate of return for the bank and that will contribute to economic growth in the region. FUV plans to target later stage investments, particularly buy outs, rather than targeting growth or start-up companies. The management team has extensive and varied financial and business experience that can be brought to their investment clients. FUV expects to work extensively with the owners and managers of their investments, providing assistance with financial control, management practices, and strategic decision making. The management team
also is well connected with local service providers who can advise the portfolio companies in more technical areas.

Deal flow is expected to come from the contacts the fund managers have in urban areas throughout the region. In addition, management expects to use local business service providers such as accountants and attorneys to identify potential deals. Rural Enterprise Inc. is expected to feed potential deals to FUV. Fund managers expect that banks and REI will provide debt to some deals in conjunction with venture capital provided by FUV.

Investment Policy and Practice

Once deals are identified and the fund managers have conducted due diligence, FUV is committed to being flexible in the way it structures investments for each client. FUV plans to use some combination of the following investment instruments, depending on the company’s needs:

- Convertible debt, with conversion terms set to achieve rate of return objectives without putting FUV in a position of controlling the company.
- Convertible preferred, the preferable way for FUV to take a venture capital position in a company.
- Common stock, a less desirable instrument for FUV because of the greater risk involved.
- Debt with warrants or options, considered in unusual circumstances only.

FUV expects to maintain a portfolio with 50 percent debt (convertible debt) and 50 percent equity concentrated in convertible preferred.

FUV expects to have a seat on the portfolio company’s board as a term of the investment. This seat will allow FUV to provide extensive assistance to the company as needed. The board seat also will permit closer monitoring of the investment and strategic decisions made by the company. However, FUV does not want to be in a position of controlling a company, unless the control is exercised with SBA approval to attempt a turnaround for a company.

The fund managers will negotiate an exit strategy with the portfolio company. However, because of the relationship between the fund and its parent bank, fund managers are more interested in continued business growth than they are in a rapid exit. As a result, it is unlikely that businesses will be forced to liquidate in order to arrange an exit for the fund. The fund plans to be a patient, long-term investor. Since there is no shareholder pressure to achieve short-run results, fund managers will view their portfolio companies as theoretical business partners. Exit strategies will assume a less significant role for FUV as a result.

At the time of the case study, FUV had made one investment in a local cable company. The deal was structured using convertible debt and common stock.

FUV’s Future

The SBIC faces two primary challenges for the future. Maintaining adequate deal flow is the greatest challenge. The fund managers need to identify quality deals and need to be able to weed out those deals with less potential to succeed. Another challenge relates to the fund’s size. With total capitalization of $2.5 million, fund managers are limited in terms of the number of investments they can make and the degree to which the fund can provide
follow-on investments. The fund’s SBIC structure provides one means of addressing this issue since the managers can tap into SBA leverage to enhance their ability to invest in the region.
Case Study 21: North Dakota SBIC
Contact: John Cosgriff, Fund Manager, NDSBIC, Fargo, ND
Date: June 1998

History of NDSBIC
The North Dakota SBIC (NDSBIC) emerged from the Myron Nelson Fund, started in the late 1980s as a way of getting venture capital to North Dakota businesses. However, fund organizers were not successful in attracting investors to the fund. The Board of Directors of the Myron Nelson Fund and some state economic development professionals decided to pursue the idea of an SBIC as an alternative. In May 1995, the SBIC was licensed.

The mission of the NDSBIC is to make a profit and to return to its investors a rate of return commensurate with the risk involved in businesses located primarily in North Dakota. The SBIC’s goal is to make investments to support the establishment, expansion, and rehabilitation of North Dakota small businesses, although investment outside the state may be considered.

Structure of NDSBIC
The NDSBIC is organized as a for-profit limited partnership with 73 limited partners and one general partner, InvestAmerica. InvestAmerica manages other venture funds in the Midwest. The SBIC has a limited life, 12 years, and a decision will be made in the near future regarding whether or not to seek a second round of investment. The fund was capitalized with $5,150,000 plus the leverage the fund can access through the SBA. To encourage investment by limited partners, fund organizers used the rationale that potential investors would be investing in North Dakota and that only half of the investment would be at risk. The limited risk is unique to NDSBIC for two reasons. One, the state allowed investors to claim a tax credit of 25 percent of their investment, in the year the investment was made. Two, the Bank of North Dakota, a state-owned bank, put into escrow an amount equal to 25 percent of the investment as a guarantee for investors should the NDSBIC fail. The limited risk and the perceived benefits from investing in the state persuaded investors to capitalize the fund.

NDSBIC’s Operation
The NDSBIC targets by stage of investment, that is, later stage companies, but there is no sectoral targeting. The fund managers concentrate on businesses that are established enterprises with a developed product, sales history, and a need for capital to support expansion and growth. Start-up companies are not targeted because these investments would require more hands on management than the general partner, InvestAmerica, is able to provide. The geographic focus of the fund is North Dakota, with additional investments permitted in the upper Midwest and Great Plains regions. The expanded geographic area allows NDSBIC to syndicate deals and co-invest with other venture capitalists in the region, hopefully bringing additional resources into North Dakota.

The general partner operates the ND office on an annual operating budget of $200,000. A 2.5 percent management fee assessed against NDSBIC’s private capital plus SBA leverage covers operating expenses. The general partner also gets 20 percent of the carried interest in the fund, with 80 percent going to the limited partners. The general partner allocates one junior partner to the ND office. The main staff of InvestAmerica consists of three senior partners, one junior partner and two staff.
Deals are identified through the general partners and through deals brought to the fund manager by banks and members of the Advisory Board. Fund managers are looking for businesses with the following characteristics:

- Minimum of $5 million in sales.
- In existence for 3 years and potentially profitable.
- Positive cash flow.
- Proven and experienced management team willing to commit their own capital to the business.
- High gross margins in growing market segments.
- Sustained unfair competitive advantage.

NDSBIC does not consider social benefits of investments when investment decisions are made. The philosophy of fund managers is that economic development and job benefits will follow from the investments being made in growing, expanding North Dakota companies. However, the Bank of North Dakota president is on NDSBIC’s Board and, as a result, state impacts are part of the discussion regarding investments. Secondary goals are considered but not required. These include promoting economic activity, creating opportunity for entrepreneurs, attracting outside capital to the state, promoting rural development, and encouraging small business access to capital.

**Investment Policy and Practice**

The partners are responsible for conducting due diligence on the investments. In general, a decision requires 6 to 9 months; however, when there is some history with a company and the company knows what it is looking for in an investment, a decision can be made more quickly (90 to 120 days). If a company passes the due diligence stage, NDSBIC structures the investment using four instruments:

- Loans with an attached warrant—amounts of up to $250,000; terms of at least five years with interest due on a current basis at rates that comply with SBA regulations.
- Subordinated debt with amortization and equity—amounts of up to $350,000 in the first round and $200,000 in follow-on investments; terms of at least five years with interest due on a current basis; equity portion structured to include warrants and in some cases preferred stock.
- Subordinated debt with equity but amortization dependent on company profitability—similar to the above but interest payments and principal amortization based on company profitability.
- Common stock investments—up to $200,000 first round investments with up to $400,000 in follow-on rounds; terms include a put after five years.

NDSBIC expects to have only 6 percent of its investments structured as debt, 79 percent structure as debt with equity features, and about 15 percent structured as pure equity.

In additional to capital, NDSBIC expects to be represented on the board of its portfolio companies. The fund managers provide assistance to the firms, particularly in terms of finding additional capital, both debt and venture capital, finding new management, and planning...
for expansion and acquisition. Portfolio companies are required to submit annual financial reports and meet with NDSBIC fund managers as needed. NDSBIC will provide additional services to portfolio companies but has not yet done so for its current portfolio companies.

NDSBIC expects to be in an investment for five years, at which time an exit is arranged. The major problem with the exit is company valuation. NDSBIC requires companies to use the same price/earnings ratio at the beginning of an investment as they use at the exit. Fund managers are less concerned with the form of exit than they are with getting their capital out of an investment so it can be used in future investments.

NDSBIC has invested in 14 ND companies. It has exited only one investment through an acquisition. The typical investment is in the range of $300,000 to $600,000.

**NDSBIC's Future**

At the time of the visit, NDSBIC was into year 4 of their 12-year life. The fund organizers will have to decide whether the fund will close at the end of year 12 or whether a second round of capital will be raised. After years five to seven of the fund, the managers expect to be harvesting past investments and, if approved, raising additional capital.

Another issue affecting the success of NDSBIC, according to the fund manager John Cosgriff, is the climate of entrepreneurship in North Dakota. Cosgriff asserts that business owners within the state tend to be risk averse and are not aggressively pursuing new business opportunities. As a result, these firms are unlikely to be candidates for venture capital investments and the owners are unlikely to accept the terms required of a typical venture capital investment. This attitude, Cosgriff states, affects the ability of any fund to make venture investments in a state like North Dakota.

A second factor affecting fund performance relates to the cultural attitudes people in the region have toward business ownership. Cosgriff suggests that the focus of many rural business owners is to build a business to pass on to future generations. These business owners are generally not interested in sharing ownership of the business with a venture investor. There is a certain distrust of outside ownership, particularly when it comes to considering options for cashing out the investment. Cosgriff asserts that this culture is limiting to venture capital investment in the region and that effective utilization of venture capital requires a less insular view of the world. It also requires viewing businesses as engines to create marketable value rather than just as part of an inheritance for future generations.
**Portfolio Company Perspectives**

During the case study visits, the research team interviewed the managers of two or three portfolio companies, when possible. In several cases, the funds had not yet made investments or the portfolio companies were not located close enough to the fund to permit visits. In total, 12 companies were visited for this project. Although each portfolio company had a unique venture capital investment experience, some common themes were identified.

**Common Themes**

*Companies had limited alternatives for acquiring the capital they needed.* In most cases, the portfolio companies had already tapped personal sources of equity, such as personal savings, family, and friends, and needed a larger infusion of capital than these informal sources could provide. Many of these companies had approached other sources of capital, such as banks, but were unable to secure the capital they needed. As a result, the business owners often pursued venture capital as an option when other avenues of finance were exhausted.

*Portfolio companies are not likely to attract traditional venture capital investment.* Most of these portfolio companies offered prospects for slower growth than traditional venture capitalists target. In addition, most of these portfolio companies were in more traditional manufacturing sectors and not the high tech sectors sought by traditional venture capitalists. (See box listing the primary business activity for each portfolio company.) Finally, all of these portfolio companies were located outside the markets or regions where traditional venture capital funds are located and where most venture capital investments are made.

**Primary Business Activity of Portfolio Companies**

- Chemical, biological and physical sensors for biomedical and environmental industries
- Jams and jellies
- Touch free car wash equipment and overhead truck wash equipment
- Cattle vaccines
- Electronic charting systems for doctors
- Leather shoes
- Herbal supplements
- Tools to reduce injuries for fleet maintenance workers
- Aluminum window units for commercial buildings
- Insulation, industrial fibers, landfill cover, erosion control materials made from recycled newspapers and magazines
- Ceramic filters for telecommunications companies
- Support services for internet providers
Nontraditional venture funds provided more than capital to their portfolio companies. Portfolio companies received business assistance such as marketing and sales and management assistance from the staff of the venture funds. In some cases, the assistance was provided prior to the investment, as a requirement of the investment. The venture fund managers also helped to identify management staff, such as a chief financial officer, to complete a portfolio company’s management team. In most cases, a venture fund partner was on the company’s board, providing more focused assistance in the operation of the business as needed. In one situation, however, the venture fund had a volunteer board making investment decisions. As a result, the ability to provide technical assistance and more general mentoring for the portfolio companies was limited, a limitation recognized by the portfolio company. Finally, the venture funds brought another important resource to their portfolio companies, contacts with other venture capitalists that often facilitated additional rounds of financing.

Venture capital investment provided portfolio companies with credibility to approach other financial intermediaries. In a number of cases, the venture capital investment gave the portfolio company the ability to secure additional funding from other sources, such as banks. The venture investment reflected the due diligence of the venture fund and the assessment that the company had reasonable growth prospects. For young and start-up businesses, this endorsement was important in securing additional debt financing from banks, even those that had previously denied loan requests.

Venture fund goals did not always match up well with portfolio company goals. Several examples show the importance of the venture fund’s goals being compatible with the portfolio company’s goals. For the manager of one portfolio company, the goals of growing his business, creating jobs, and remaining within the region were consistent with the goals of Northeast Ventures, the community development venture fund that invested in his company. As a result, the relationship between the venture fund and company was that of a partnership moving toward a common objective. In the case of the Northern Rockies Venture Fund, both the fund and portfolio company managers had common goals to develop successful businesses that would be sold either within or outside the region, and the entrepreneurs would then create new enterprises in the state. In this model, the entrepreneurs were tied to the region but the businesses might not be.

An example of conflict between venture fund goals and portfolio company goals was seen in Kansas. The inconsistency between fund and company goals created problems during the exit negotiation. The goal of the portfolio company manager was to run a successful business in his Kansas community into the future. However, the goal of the venture fund was to exit the investment by selling the company and dividing the proceeds. Since this alternative was not acceptable to the business owner, another exit strategy involving a management buyout was negotiated. However, this strategy increased the time required for the venture fund to get its return and reduced the company’s cash flow for other projects. The conflict also created some ill will regarding the investment on the part of company management.
The overall venture capital investment experience of these portfolio companies has been positive. The portfolio companies interviewed were generally positive about their venture capital investment experience. In most cases, the venture investment was necessary to the maintenance, growth and, in some cases, survival of these companies. And, the nontraditional venture fund was the only source of capital that these companies could acquire on terms favorable to the business. However, it is important to note that most of these investments were active investments, that is, an exit strategy had not been identified or implemented. The experience of several of these companies suggests that the exit stage of the investment is the most fraught with difficulties and potential conflicts between a portfolio company and its venture fund. However, when the goals of the venture fund are consistent with those of the portfolio company, these conflicts may be minimized.
Emerging Models

A number of funds were started during this project and were not included in the case studies. However, two emerging funds are included because of some unique features. The Appalachian Ohio Development Fund is the first fund created as part of an effort to establish developmental venture capital institutions in more rural parts of the U.S. The discussion below highlights the process used to establish this fund and the partnerships developed as part of this effort. The North Carolina Economic Opportunities Fund is being organized as a statewide rural-focused SBIC. Although other statewide SBICs exist, the rural focus of North Carolina’s fund makes it unique.

Case Study 22: Appalachian Ohio Development Fund (Athens, Ohio)

Contact: Karen Mays, Director, Council for Hometown Jobs and Growth, Chicago, IL

Date of Visit: November 2000

The Appalachian Ohio Development Fund is a $15 million development venture capital fund established in 2000 to serve a twenty-nine county area in southeastern Ohio. The Fund’s mission is to “serve as a catalyst for shared and sustainable economic growth in Appalachian Ohio by providing equity capital and expertise to small businesses . . . and generating attractive financial returns to investors.” Thus, AODF has the dual bottom line of economic development benefits and respectable internal rate of return (IRR). The AODF is the first of a series of development venture capital funds planned by Wilhelm & Conlon Public Strategies, Inc. and the Council for Hometown Jobs and Growth (both of Chicago, IL). No investments had been made by AODF as of November 2000.

Fund Structure and Investment Strategy

The AODF is organized as a for-profit, limited partnership with a 10-year life (two one-year extensions permitted). The general partner of the fund is Adina Partners, a peripheral entity of Wilhelm & Conlon Public Strategies, Inc. Limited partners are primarily financial institutions with ties to the 29 county service area.

If the Fund is profitable, the general partner will receive 20 percent of carried interest (profits on investments), while limited partners will receive their original contributions to capital plus 80 percent of carried interest. The Fund manager, business development officer, and administrative support staff will be located in Athens, Ohio. An annual management fee of 2.5 to 3 percent will be charged against initial fund capitalization to support management-related expenses. The AODF also maintains an Investment Committee consisting of venture capital professionals and an Advisory Board of local and industry representatives.

The Appalachian Ohio Development Fund plans to make equity investments in the form of convertible preferred stock in the amount of $200,000 to $2 million per firm. AODF will target a broad range of industries, including high technology, manufacturing, distribution services, tourism-related services, and value-added food processing and agriculture. AODF will seek co-investments from other venture capital funds to provide additional due diligence and to better leverage their investment activities. The projected IRR on the Fund is 20 percent, thus AODF investments will be made in
firms with high growth potentials. In addition, job creation opportunities provided by prospective portfolio companies will be a consideration in the investment decision.

**Process for Establishing Fund**
Wilhelm & Conlon Strategies, Inc., in conjunction with the Appalachian Region Commission, Ohio University, and other local government and business leaders, undertook three principal activities during the process of establishing the AODF. One activity was to select the target area or set of counties that appeared to exhibit both the need and opportunity for venture investments. Southeastern Ohio was selected as the service region because Wilhelm and Conlon Strategies had participated in economic development programs in the area and one of the founders of Wilhelm and Conlon was a former resident of the area. For this target region and nearby metro areas, secondary data (income and job levels, unemployment rates, demographics, business numbers and start-ups) were analyzed to determine market potential. Information on investment prospects and deal flow also was collected from local colleges and universities, chambers of commerce, banks, and incubators. This information provided insights into numbers of potential deals and industry types and business stages of firms seeking equity capital.

The second activity entailed identifying a manager for the AODF and establishing technical assistance networks and services for prospective firms and portfolio companies. Alliances with local universities and technical colleges were critical relationships in the technical assistance network (see next section for more detail).

Activity three was fund raising. Information from the assessment of potential deal flow was used to determine the optimal size of the fund, with $10 million selected as a desired minimum fund size. Area banks were contacted, primarily those institutions for which personal contacts and prior relationships existed. One selling point for bank participation in AODF was that investments in the fund would qualify for Community Reinvestment Act (CRA) credit. However, AODF noted that fund raising was easier when more emphasis was placed on fund IRR and less on the social goals of the fund. The fund raising process took two years in Ohio, but a less time consuming process for raising capital is anticipated for later development venture capital funds started by Wilhelm and Conlon Strategies.

The final activity of the process was the establishment of a local investment office and the initiation of investment activity. The local funding sources were involved in shaping the goals and objectives of AODF’s investment activities.

In summary, the process of establishing AODF required almost two years. Approximately $400,000 was needed for the “catalyst role” of selecting the service area, investigating deal flow, establishing partnerships and strategic alliances, fund raising, and support for the local field office of the Council for Hometown Jobs and Growth. For AODF, the majority of the $400,000 of organization costs was borne by Wilhelm and Conlon Strategies. The costs associated with establishing future funds such as a Southern Illinois fund are anticipated to be approximately $250,000, less than AODF start-up costs because a more systematic approach has evolved.
Technical Assistance/Strategic Alliances

An important feature of the AODF is the development of technical assistance and strategic alliances in conjunction with the more typical services of a venture capital fund. For example, to identify prospective investment opportunities (deal flow), alliances were established with area banks, economic development agencies, colleges and universities, lawyers and accountants, nonprofit development corporations, and chambers of commerce. In addition, AODF established a partnership with the Ohio University (Athens, OH) Regional Entrepreneurship Initiative (REI) for the purpose of increasing deal flow while reducing investment risks. Specifically, REI provides technical, business and financial assistance to area firms, helps local businesses become “venture capital ready,” refers business prospects to AODF, and provides assistance after financing. AODF, in turn, provides a source of venture capital for promising new businesses identified and assisted by REI.

The second principal component of technical assistance is the local field office of the non-profit Council for Hometown Jobs and Growth (CHJG). CHJG is not legally affiliated with AODF; however, it serves as a liaison between the technical assistance network, prospective firms, and the fund. Council functions also include maintaining communication with local stakeholders, measuring the economic development impact of AODF investments, and providing leadership in issues regarding local technology infrastructure. The Council field offices will employ one to two individuals with funding for field office operations ($150,000/year) provided by local or regional sources.
The North Carolina Economic Opportunities Fund (NCEOF) is the latest innovation in North Carolina focused on expanding capital resources to businesses in the state. The North Carolina Enterprise Fund, established in the late 1980s, was to focus on the more rural parts of the state. However, over time the fund migrated into urban markets seeking higher rates of return. A study commissioned by the state Department of Commerce, completed in 1998, found a venture capital gap in rural North Carolina characterized by deals too small for traditional venture capitalists (less than $2 million) and too large for many private investors (greater than $500,000). The study identified the businesses facing this capital gap as small to medium sized (average revenue of $7 million), existing businesses (not start-ups) that were run by competent managers, and with above average growth rates and revenues per worker.

With this study as background, preliminary discussions were held to consider the creation of a venture capital fund to meet these capital needs. A focus group of state bankers was held in July 1999 and the structure selected for the institution was the participating securities SBIC. Shortly after the concept for this institution was proposed, Governor Hunt established the Rural Prosperity Task Force, chaired by former White House Chief of Staff and investment banker Erskine Bowles. The 25-member Task Force was asked to examine and recommend ways to help the rural economies in the state recover from plant closings, the decline in the tobacco industry, depressed agricultural prices, and other changes in North Carolina’s traditional rural industries. One of the areas addressed by the Task Force was access to capital.

The Task Force spent almost a year considering the need for capital in rural North Carolina and alternative institutional structures used by other private equity funds across the country. In February 2000, the Task Force recommended that a venture capital fund, using the SBIC structure, be created with the support of the state’s largest banking institutions. In July 2000, the Governor, the Secretary of Commerce, and the chair of the Rural Prosperity Task Force announced the creation of the North Carolina Economic Opportunities Fund.

**Fund Structure and Investment Strategy**

The NCEOF will be structured as a participating securities SBIC and the SBIC license is in process. The SBIC structure will allow the fund to leverage two dollars in federal investment for each dollar in private capital raised. The NCEOF has signed subscription agreements from the state’s six largest banking institutions to invest $30 million, 10 percent of which was required at closing. These institutions are participating for a number of reasons, including the prospect of earning higher returns from successful businesses. In addition, the banks are attracted by the potential for creating economic activity in North Carolina’s rural counties. The banks can also receive Community Reinvestment Act (CRA) credit for these investments. The NCEOF is also seeking investment of another $20 million from other institutional investors, including the state’s trust funds, utility companies, and...
smaller regional banking institutions. If NCEOF raises $50 million from the state’s institutional investment community, a total fund of $150 million, including federal investment, would be available for investing in rural North Carolina businesses.

The NCEOF management team will seek out growing businesses that have the potential to generate net rates of return for the portfolio in the 15 to 20 percent range. While targeted returns are lower than those sought by traditional venture funds in more recent years, these market based risk adjusted returns are in line with historical net returns to well-performing private equity funds. NCEOF expects to invest in deals with less risk than the high tech and life sciences start-up investments recently favored by traditional venture investors. According to the fund’s managing partner, NCEOF is a private equity fund rather than a more narrowly defined venture capital fund. As a result, they can use a range of investment instruments, ranging from pure equity to debt with some equity-type features. Fund managers expect to exert some degree of influence over portfolio company management, including board participation, and to provide firms with access to an extensive network of management assistance.

NCEOF will consider deals from counties across the state, with the exception of the six large urban counties that currently receive the almost all the venture capital investments in North Carolina. To help identify these businesses, NCEOF will use North Carolina’s well-developed network of business service providers, including the University of North Carolina system, the nine regional Department of Commerce offices, commercial banks, and other investors. The management team includes individuals with venture capital investing experience, investment banking experience, and economic development finance experience.