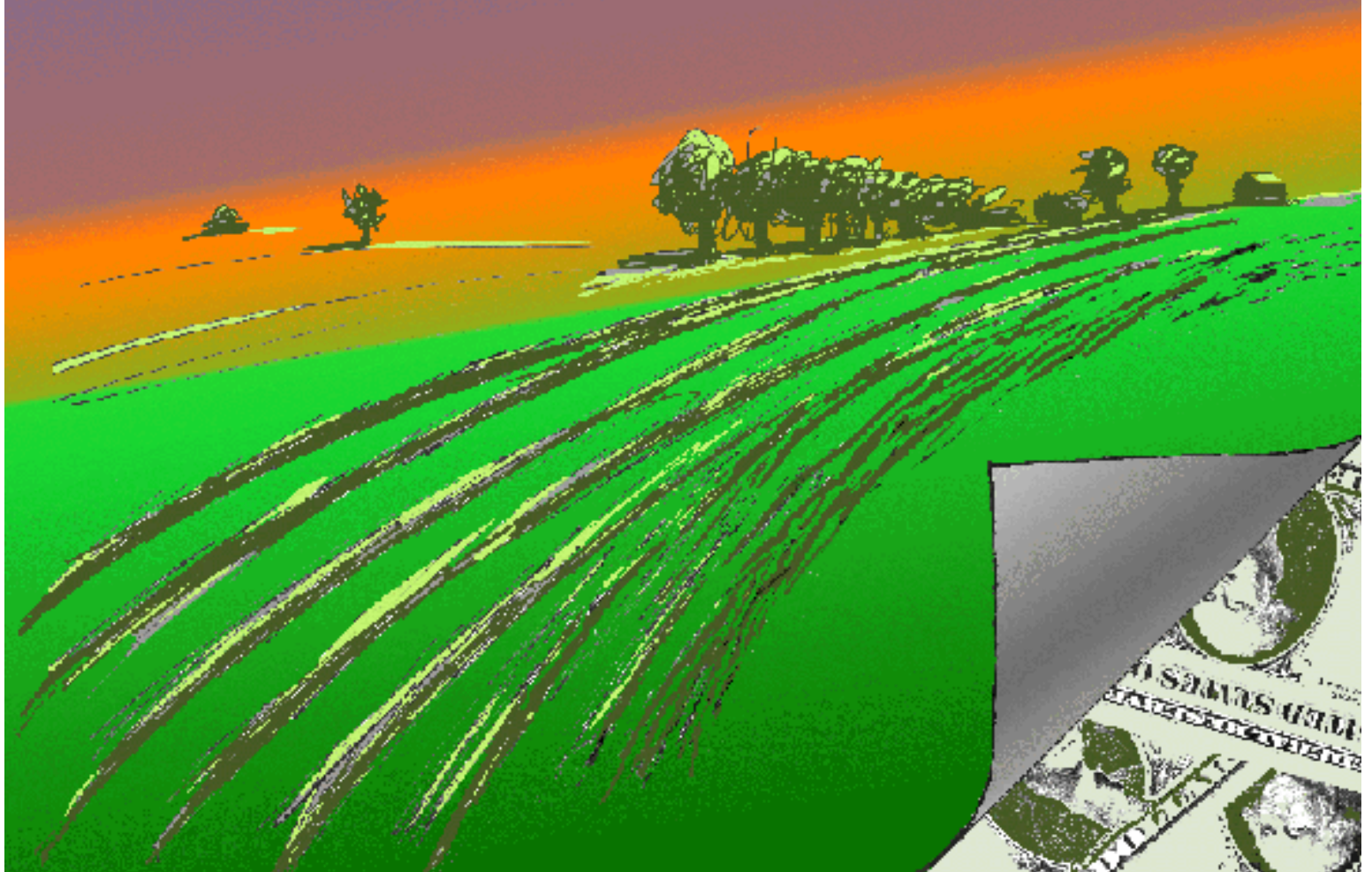


NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: FILLING A FINANCIAL MARKET GAP

**David Freshwater, University of Kentucky
David L. Barkley, Clemson University
Deborah M. Markley, Policy Research Group
Julia Sass Rubin, Harvard University
Ron Shaffer, University of Wisconsin**

**P2001-11B
Part 2 of 4 of the Final Report
RUPRI Rural Equity Capital Initiative
Study of Nontraditional Venture Capital Institutions**

Funding provided by USDA Fund for Rural America



Rural Policy Research Institute's (RUPRI) Rural Equity Capital Initiative

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.

Nontraditional Venture Capital Institutions: Filling A Financial Market Gap

In spite of the growth and success of the venture capital industry in the 1990s, many areas of the United States are not served by traditional venture capital institutions. Research conducted by RUPRI's Rural Equity Capital Initiative suggests, however, that viable alternative sources of equity capital exist and that alternative institutions can play an important role in providing firms with the financial resources required for growth. While these nontraditional venture capital institutions rarely earn the same rate of return as do traditional funds, they can be profitable and can promote economic development in urban and rural communities.

This paper provides an overview of why nontraditional venture capital institutions have evolved and summarizes the role they may serve in local economic development. First, the traditional venture capital industry is described, including discussions of traditional venture capital institutions and their investments. Next, gaps in the supply of venture capital, impediments to closing these gaps, and implications of venture capital shortages on the local economic development process are examined. The final section summarizes the role of nontraditional venture capital institutions in filling financial market gaps and the challenges in developing and maintaining these institutions. Throughout this discussion, nontraditional venture capital institutions are defined as funds or programs established to address venture capital needs and enhance economic development prospects in regions and industries underserved by traditional venture capital funds.

The Traditional Venture Capital Industry

Traditional Venture Capital Institutions

Traditional venture capitalists act as conduits between investors and entrepreneurs seeking equity capital. In doing so, venture capitalists bring investors and entrepreneurs together in a more efficient manner, make better investment decisions than investors may be able to do on their own, and provide nonfinancial assistance to entrepreneurs that improves the risk-return relationship for both investors and entrepreneurs.¹

Venture capital institutions control pools of money to be used for investments in companies that show considerable promise of high future profits. Venture capitalists provide cash to companies in return for a share of ownership and control. In addition to providing money, venture capitalists generally exercise considerable control over the management of the companies.² In principle, venture capital funds attempt to invest in firms that have the potential to generate annual returns on investment in excess of 30 percent, and that can be readily sold within three to seven years from the time of the original investment. Venture capital funds then seek other innovative ideas and begin the cycle again. Although traditional venture capital funds demand a high rate of return, they can rapidly provide entrepreneurs with large amounts of money, offer critical advice in management and marketing, and with their investment, give the new firms credibility in the marketplace.

Venture capitalists have four principal tasks or responsibilities.³ They assemble pools of money from investors,

identify companies in which to invest, and monitor the management of those companies after the investments are made. Finally, they develop a strategy for exiting the investments, considered by some to be the most challenging task.⁴ The exit strategy returns cash to the venture funds allowing them to begin the cycle again. In recent years the preferred exit strategy has been an initial public offering (IPO) of stock. Other exit strategies include a private sale or the purchase of the firm by a larger business, both of which return money to the funds. In those cases where firms are not successful, venture capitalists may exit by selling their shares at a loss or by liquidating the companies.

High profit potential, a short time horizon, and a clear set of rules governing exit decisions are central parts of the venture capital process. From this perspective, investing in a firm that makes only modest profits is only slightly better than investing in a firm that fails. In either case, exiting the deal to return money to the investors is not easy. Unfortunately the majority of investments fall into this category, thus venture capital funds have to achieve some large successes to offset inevitable losses.⁵

An important distinction in investment strategies among traditional venture funds is willingness to be the lead investor. The lead investor has the primary responsibility for day-to-day management of the relationship with the portfolio company. Consequently, the lead investor of the fund must have considerable expertise in the firm's particular business and should be able to either assist or replace the management of the firm to protect the interest of the fund. During the investment period, the venture capitalists in the lead fund are very involved in the management of their portfolio companies. This high degree of

participation limits the venture fund because fund managers can monitor only a small number of portfolio companies and because the fund must have expertise in the sectors in which it invests. While many venture funds assume such an active role, venture funds based in financial centers like New York or Chicago are more likely to be passive investors because they are experts at assembling pools of money, not at operating companies.⁶ Consequently, new venture capital funds with expertise in a specific industry or location may be able to partner with passive venture funds in financial centers looking for opportunities to place their money.

The Traditional Venture Capital Market

In the last decade, the power of venture capital to stimulate economic growth has been clearly demonstrated through the rapid growth of the computer, telecommunications, and biotechnology industries.⁷ Venture capital funds have been able to identify promising new ideas in these industries and, by financing the creation of new companies, to move their ideas rapidly to implementation.

Despite the great interest in adopting the venture capital model across industries and regions, the majority of venture capital investments continue to be in businesses in early stages and expansion phases in the advanced electronics and biotechnology sectors and in California and the Northeast. In 1999, for example, 90 percent of venture capital investments were in technology-based companies, including Internet-related businesses.⁸ Almost 40 percent of the investments made by venture capital firms responding to a PriceWaterhouseCoopers survey were in computer-related fields (software, hardware, new media, or networking). The next largest sector was

telecommunications and electronics (telecommunications, semiconductors, and instruments) with 16 percent of all investments, followed by business services with 13 percent and health-related sectors (medical devices, biotechnology, and health services) with 11 percent.

Some industrial sectors do not, however, seem well suited to the venture capital model. For example, despite the growing demand for new drugs and the vast profits associated with successful drugs, few venture capitalists invest in pharmaceuticals. The cost and time required to move an idea to market are so great that a more appropriate development model, the large integrated drug company, has evolved. In addition, only four percent of the reported venture capital investments went into manufacturing activity and only one percent into publishing and broadcasting, sectors that generally lack rapid growth rates and high probabilities for a quick and lucrative exit.

Another important factor in venture fund investments is the stage of development of the firm that receives financing. Thirty-seven percent of investments for the third quarter of 2000 went to expanding firms with a business track record.⁹ Financing for early stage firms, with limited operating histories, accounted for another 34 percent of funds. Only 12 percent of the \$17.6 billion invested by venture funds during this period went for start-up financing. Admittedly, firms in later stage development typically require larger amounts of capital than firms just starting operations.

Almost 40 percent of 1999 venture capital investments, according to PriceWaterhouseCoopers, were in the Silicon Valley. The next largest concentrations of investments were in

New England (11.6 percent), New York metropolitan area (7.1 percent), and Los Angeles metropolitan area (7.0 percent). Alternatively, both the North Central and South Central regions of the nation had less than 2 percent of reported 1999 venture capital investments, and some states reported no venture capital investments. The geographic concentration of venture capital funds parallels the concentration of investment activity. Proximity to portfolio companies is important to venture capital institutions because they need to closely monitor investments and, at times, to participate directly in the management of client firms. Thus, more remote rural areas and states outside the existing venture capital corridors, for example, Boston to New York, have few funds and limited venture capital investments

Gaps in the Supply of Venture Capital

Given the clear, persistent geographic and sectoral concentration of venture capital investments, the traditional venture capital model is not likely to be appropriate for areas of the United States not already participating in the venture capital investment process. If the traditional venture capital model were directly appropriate to all regions and sectors in the United States, by now venture capitalists would be active nationwide. Many states have less than a handful of venture capital funds, and states with many funds have regions lacking access to capital. Rural areas and smaller cities far from larger metropolitan centers seldom have venture capital institutions and investments.

Impediments to the Venture Capital Investment Process

Traditional venture capital funds choose not to operate in rural places and

in many smaller metropolitan areas because of:

- *Investment opportunities with profit potential below that sought by traditional venture capital funds.* Small market areas do not provide the investment environment venture capitalists prefer: a large number of firms with high projected growth rates and the likelihood of lucrative exits.
- *Too few investments to provide adequate deal flow.* In sparsely populated areas, few firms need and qualify for venture capital investments. As a result, the cost of searching out promising entrepreneurs and identifying prospective deals is higher.
- *Too great a physical distance between investment opportunities.* Venture capital investing is a hands-on process that often requires frequent contact with portfolio companies. If a traditional venture capital investor cannot travel easily and quickly to visit a firm, the investment is not likely to be made.
- *Inadequate infrastructure to support venture capital investment.* Attorneys, accountants, bankers, and business consultants are often needed to help put a deal together and ensure the success of the investment. Such a business service infrastructure is limited outside larger urban places.
- *Difficulty in defining a viable exit strategy.* Most businesses located in rural or small market areas are unlikely to provide rapid, lucrative exits. For example, IPOs are not a

viable exit strategy for many traditional manufacturing enterprises and businesses found there.

- *Limited interest by many small business owners in accepting the conditions set by the venture fund in order to get its money.* To many rural business owners, particularly in family-owned businesses, giving up any ownership stake in exchange for capital is unacceptable. Concerns about the intergenerational transfer of the firm may make a business owner unwilling to accept the terms of a venture investment.
- *Difficulty in attracting venture capital staff to the region.* A venture capital institution is only as good as its management team. In more isolated regions, venture institutions may have difficulty attracting and keeping the qualified staff needed to invest successfully. Recruiting management for portfolio companies when an injection of new leadership is required may also be more difficult.

If venture capital is to become a significant source of funding for rural and small city businesses, the impediments must be addressed.¹⁰ One way of dealing with a portfolio of lower profit opportunities is presented as an example. Traditional venture capitalists focus strictly on the financial rate of return on their investment, thus only benefits that can be captured in the net worth of the portfolio firm are important. However, from a larger social context, some benefits of an investment are not reflected on a firm's balance sheet. Property values may rise in a community, as a result of new business activity. Individuals with real estate investments may accept a lower rate

of return on an equity investment in a local business if its presence leads to increased rates of return on their property holdings. McAlester Investment Group of McAlester, Oklahoma was started by individuals who have significant local property holdings, which allows them to benefit both from their venture investments and any increase in local property values that those investments produce.

The Role of Finance in Local Economic Development

In general, rural America consistently lags behind urban America in terms of income levels, employment growth rates, and various other measures of economic well-being. Some rural places enjoy levels of prosperity that equal or exceed those of all but the wealthiest urban places; however, most rural areas fall well below national standards in terms of income and employment levels. Similarly some cities and parts of most metropolitan areas also have persistently slow rates of economic growth. Government programs can provide temporary support for the most disadvantaged urban and rural areas, but the only way to ensure long-term development of lagging parts of America is to enhance levels of private enterprise. Thus, those interested in enhancing economic activity in these places ask: what barriers exist to increasing the number and success rate of local businesses, and what policies or programs can be put in place to remove these barriers?

Many have argued that future prosperity for small towns and rural areas will require a new economic base of small- and medium-sized firms. With roots in their communities, these firms would use local resources to produce goods and services in growing demand in

the global economy. But, creating this new economic base requires the support of entrepreneurs and their firms, a key component of which is access to equity finance. If potential entrepreneurs do not believe funds are available to bring their ideas to reality, they will not act upon them. Thus, while a supply of venture capital may not create a demand for these funds if the entrepreneurs are not present, the recognized absence of a supply may convince a potential entrepreneur not to try to start a business. Without this venture capital infrastructure, potential entrepreneurs cannot be identified and their ideas will not make it to the marketplace.¹¹

Surveys of small- and medium-size business owners and some academic studies, consistently argue that more businesses would be in place and existing businesses would grow faster if more money were available. The underserved businesses generally are involved in introducing new production practices or new goods and services to a region. Lenders unfamiliar with those innovations do not have the expertise to assess the underlying risks and returns, and consequently, are reluctant to expose themselves to losses. Such problems are typical for all forms of small businesses and for both debt and equity capital (see Figure 1). Almost by definition, innovative enterprises are not well understood, and lenders are understandably reluctant to take on risks whose magnitudes they cannot assess. However, this problem is more critical in rural areas and in smaller communities because a local financial institution may be the primary or only source of capital for area businesses. With fewer alternatives, businesses in these communities are more likely to lack access to both debt and equity capital.

Figure 1
Debt Versus Equity Capital

Financial capital is not homogenous. There are major variations among different types of financial capital, the most important being the distinction between debt and equity finance (Brealey and Myers).

Debt Finance: Debt finance creates specific obligations for the borrower to repay the loan on a predetermined schedule. Failure by the borrower to meet the repayment terms typically allows the lender to attempt to recover the outstanding debt, even if the borrower is forced into bankruptcy.

Equity Capital: Equity capital conveys a share of ownership in the firm to the individual or institution that provides the funds. The equity investor gives up the right to a predetermined repayment schedule and a preferential claim on the assets of the firm in exchange for a share of future profits (or losses).

This longstanding concern has led to many initiatives at the federal and state levels to increase the availability of funds to small businesses. In addition, private organizations, including foundations and community groups, have tried to develop programs to expand the supply of business capital. However, most new programs provide loans, rather than equity. Because both debt and equity capital are usually necessary for start-up and expanding firms, a critical financing gap may still

exist even where ample debt capital is available.¹² Thus a core issue facing those seeking to implement a locally based economic development strategy is whether they can develop programs to provide better access to equity capital.¹³

An alternative perspective of regional economic development argues that local development is not constrained by a shortage of capital, but by inadequate investment opportunities. Proponents of this view argue that capital markets are

indeed efficient and seek out opportunities, and that the reason many small businesses cannot attract funding is because they fail to offer the risk adjusted rate of return that can be earned on investments elsewhere.

The two perspectives lead to different conclusions about local development opportunities, needs, and appropriate policy interventions. This research found anecdotal evidence to support both perspectives. On the one hand, nontraditional venture capital institutions and their portfolio companies are operating successfully in locations unserved by traditional venture capital funds. On the other hand, in some locations nontraditional funds and their portfolio companies were short lived. Thus, the focus of the RUPRI research project was to provide insights into the characteristics of small market locations where a nontraditional institution might succeed and to ascertain what kinds of institutions were most likely to prosper in these locations.

Role of Nontraditional Venture Capital Models to Consider

The 23 nontraditional venture capital institutions and programs selected for this research were designed to increase the supply of venture capital in specific small market areas (Table 1). They represent a wide range of institutional types, operating in diverse economic and political situations. Most programs are not easy to implement, nor are they practical for all places. In almost every case, the nontraditional institutions accept a lower rate of financial return than the traditional venture capital model. But, the nontraditional approaches also focus on goals other than maximizing the financial rate of return on investments.

During this research, no ideal nontraditional venture capital institution was found among the broad spectrum of organizational types currently being used across the nation. However, many varied programs can be drawn upon for guidance. To help determine the right model for a given situation, the research team identified some common issues:

- *New or add-on enterprise.* Will the venture capital institution be structured as part of a larger entity, such as a community development organization, or will it be free standing?
- *Privately capitalized and managed or publicly assisted institution.* Will capital be raised from the public sector, from private investors, or from some combination of public and private investors?
- *Fund Size.* How much money will be sought from investors to capitalize the fund?
- *Rate of return driven or developmental.* Will the institution try to maximize financial return to investors, or will it try to achieve some other goal, such as job creation, subject to meeting a target rate of return?
- *Investment focus.* Will investments be made across all industrial sectors or in specific sectors? Will investments be targeted to firms in a particular business stage, such as start-ups, or will firms in all business stages be eligible?

Table 1. Site Visit Venture Capital Institutions by Category

A. Publicly Funded, Publicly Managed Institutions

Small Enterprise Growth Fund (Augusta, ME)
Minnesota Technology Corporation Investment Fund/MIN-Corp (Minneapolis, MN)^{a, b}
Iowa Product Development Corporation/Iowa Seed Capital Corporation (Des Moines, IA)

B. Privately Managed Funds with Public Funding or Incentives

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

C. Community-Level Venture Capital Programs

Montana Rural Electric Utility Cooperatives^d
Ames Seed Capital Fund, Inc. (Ames, IA)
McAlester Investment Group (McAlester, OK)
Siouxland Ventures, Inc. (Sioux City, IA)

D. Certified Capital Companies (CAPCOs)

Louisiana CAPCO Program (Baton Rouge, LA)
Missouri CAPCO Program (Jefferson City, MO)

E. Community Development Venture Funds

Coastal Ventures Limited Partnership (Portland, ME)
Kentucky Highlands Investment Corporation (London, KY)
Northeast Ventures (Duluth, MN)
Cascadia (Seattle, WA)
Appalachian Ohio Development Fund (Athens, OH)

F. Small Business Investment Companies (SBICs)

North Dakota SBIC (Fargo, ND)
First United Ventures (Durant, OK)
North Carolina Economic Opportunities Fund (Raleigh, NC)

^a MIN-Corp received state support during earlier years of operation.

^b MIN-Corp is also a Community Development Venture Capital Fund.

^c Kansas Venture Capital, Inc. is structured as a SBIC, but had not used SBA leverage at the time of the case study. It was capitalized with state funds but is in the process of becoming strictly private.

^d The Montana Rural Electric Utility Cooperatives' investment activity occurred in a number of communities throughout the state: Medicine Lake, Great Falls, Sun River, Opheim, and Culbertson.

- *Degree of involvement with portfolio companies.* How involved will the institution be in the day-to-day operations of the firms in which it invests?

In general, there is a relationship among these factors and the region that will be served by the nontraditional venture institution. Remote rural communities seeking to establish a venture capital institution will usually be restricted to start-up stage investments. Rural institutions probably will have to accept relatively low rates of return because of the type of firms in which they invest, their smaller fund sizes and higher administrative costs per dollar of investment, and the necessity of providing high levels of assistance to their portfolio companies. In addition, rural funds are likely to require some form of public or nonprofit investment for capitalization.

In contrast, nontraditional funds that operate in metropolitan areas across a state have more flexibility. These institutions generally will be larger and, as a result, may choose to focus on start-ups, but they also may be able to focus on later stage investments. In addition, because the market is larger, they may have the opportunity to concentrate on specific industries. Thus, the choices facing venture capital institutions operating in larger places are less limited.

The Nontraditional Venture Capital Dilemma

Many rural and urban places face real challenges in resolving venture capital shortfalls.¹⁴ Success in establishing a venture capital institution lies in finding ways to resolve the impediments. Where local markets are small, it is harder:

- to find people with the skill to assess a business plan.
- to get enough business volume to allow the venture capital institution to cover its costs.
- to find competent managers to take over the operation of businesses that get into trouble.
- to get any sort of value for the assets of failed businesses.
- to find buyers for businesses that are nominally successful when it is time to exit.

Each case study institution provides guidance on how these problems can be addressed, but clearly no institution has been able to completely resolve all problems. Trying to solve one part of the puzzle, such as focusing on a narrow range of industries to ensure competence, creates other management problems such as maintaining adequate deal flow. Ultimately the challenge for any institution interested in making venture capital investments is to identify the most important risks and opportunities in its investing environment and then to design an organization that is compatible with its assessment. This research project has identified a number of key issues that existing nontraditional venture capital institutions addressed during their development. The decision making process identified from the experiences of these institutions provides important insights for those considering the creation and support of nontraditional venture programs in other communities and regions.

Endnotes

1. A. K. Gupta and H. J. Sapienza. "Determinants of Venture Capital Firms' Preferences Regarding the Industry Diversity and Geographic Scope of Their Investments." *Journal of Business Ventures* 7 (1992):347-362.
2. W. Sahlman. "The Structure and Governance of Venture Capital Organizations." *Journal of Financial Economics* 27 (1990): 473-521.
3. B. Elango, V. Fried, R. Hirsrich, and A. Polonchek. "How Venture Firms Differ." *Journal of Business Venturing* 10 (1995): 157-179.
4. J. Macintosh. "Venture Capital Exists in Canada and the United States." in P. Halpern (ed.), *Financing Growth in Canada*. Ottawa; Ontario: Ministry of Supply and Services, 1997.
5. See Sahlman (1990).
6. R. Florida and M. Kennedy. "Venture Capital, High Technology, and Regional Development." *Regional Studies* 22 (1998):34-48.
7. "Venture Capital: Money to Burn." *The Economist*. May 27, 2000, 71-73.
8. PriceWaterhouseCoopers, *National Venture Capital Survey, 1999* (www.pwcglobal.com).
9. PriceWaterhouseCoopers.
10. The fourth report in this series, "Case Studies of Nontraditional Venture Capital Institutions," provides examples of how specific organizations approached these problems. This publication is available on the RUPRI web site (www.rupri.org/pubs/equitycap/index.html).
11. R. Gaston. "Financing Entrepreneurs: The Anatomy of a Hidden Market." in R. D. Bingham, E. W. Hill, and S. B. White (editors), *Financing Economic Development: An Institutional Response*. Thousand Oaks, California: Sage Publication, 1990.
12. R. Brealey and S. Myers. *Principles of Corporate Finance*, 3rd Edition. New York, New York: McGraw-Hill, 1988.
13. While the supply of investment funds in an area is critical, the ability of potential investors to assess the wisdom of an investment is equally important. In the jargon of venture capital, the notion of due diligence is a vital concept. Due diligence refers to the investor's ability to look into the plans of the entrepreneur to determine if a viable business can be developed. Without this ability, more money will not ensure a significant increase in economic development, because too much money will go to projects with little future. Thus the two important requirements for addressing the financial needs of small market areas are money and expertise in investing that money.
14. S. J. Waddell. "Emerging Socio-Economic Institutions in the Venture Capital Industry: An Appraisal." *American Journal of Economics and Sociology* 54(1995):332-338.