

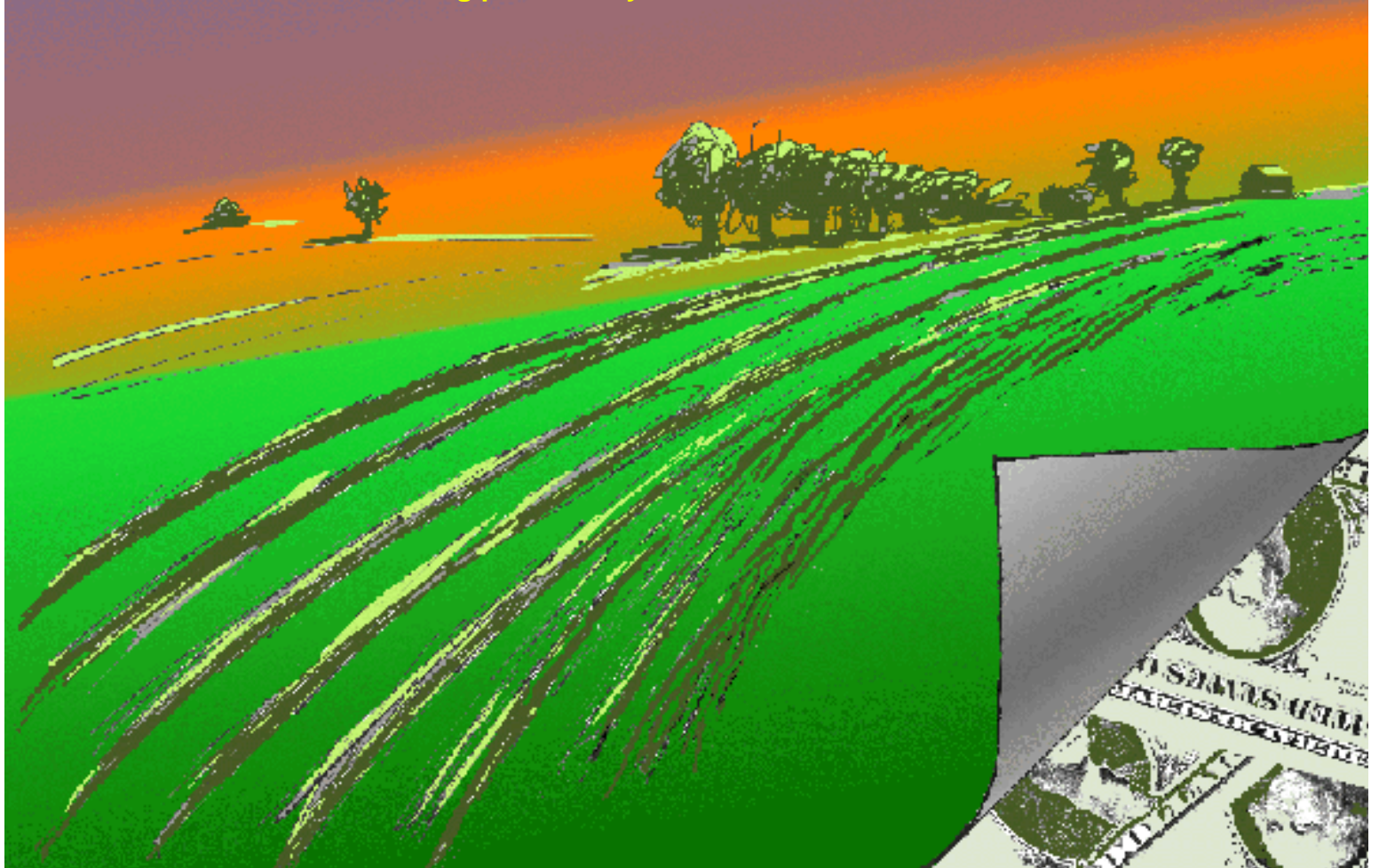
ESTABLISHING NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: THE DECISION MAKING PROCESS

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Study of Nontraditional Venture Capital Institutions

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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.

Establishing Nontraditional Venture Capital Institutions: The Decision Making Process

Rural areas, nonmetropolitan communities, and small geographically isolated metropolitan areas often are overlooked by traditional venture capital funds because of the relatively high cost of finding and managing investments in small market areas. Yet opportunities for quality venture capital investments are present in smaller markets, and successful nontraditional venture capital institutions have been established to promote entrepreneurial and business development in such areas. In some cases, venture capital institutions focus on local small business communities, such as Northeast Ventures (NEV) in Minnesota, McAlester Investment Group (MIG) in Oklahoma, and Ames Seed Capital Fund (ASCF) in Iowa. In others, a broader concern about economic development prospects spurs state governments to provide venture capital through groups like Kansas Venture Capital Inc. (KVCII), Northern Rockies Venture Fund (NRVF) in Montana, and the Oklahoma Capital Investment Board (OCIB). Whether venture capital is provided by private or public institutions, organizers consider similar questions or issues when developing and designing institutions.

This paper provides an overview of the decision-making process followed in establishing nontraditional venture capital institutions. An understanding of this process will enable communities to learn from the experiences of others and to develop venture capital institutions tailored to their goals, market conditions, and institutional constraints. A well-organized decision-making process increases the probability of establishing a successful nontraditional venture capital

institution and increases the availability of support to worthy area businesses.

This decision-making process is based on on-site interviews with founders and managers of 23 venture capital institutions across the country (Table 1). The decision making is presented as a sequential process (Figure 1); however, clear feedback loops exist among the various stages of the process. Decisions made early in the process constrain later choices. In addition, if constraints are subsequently identified in the process, such as in fundraising or deal flow, modifications and adaptations to earlier decisions or goals may be needed.

Based on the site visits, no single best model for a nontraditional venture capital institution exists. The organizational form chosen for an institution will depend on the economic structure of the targeted region; the capital needs of resident businesses; the goals of the organizers, managers, and investors; and for public entities, the statutes regulating public institutions. However, despite the underlying variability in market areas and differences in goals, organizational structure, and investment portfolios, the concepts outlined in the decision process appear applicable to all the institutions visited. Indeed, institutions that clearly articulated how they approached each decision element were more successful than those with a less precise notion of what they hoped to achieve and how they planned to accomplish it.

The organizational frameworks of nontraditional venture capital institutions vary. The venture capital institution may be a freestanding, independent entity. In other cases, the institution may be a subsidiary of another organization, for

example, a bank Small Business Investment Company (SBIC). Venture capital investing also occurs as an extension of the core activities of an organization such as a state agency, rural electric cooperative or community

development corporation (CDC). However, regardless of the organizational form a nontraditional venture capital institution ultimately assumes, organizers can gain by using the decision-making process outlined here.

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
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)^{a, b}

C. Community-Level Equity Programs

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

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)
Cascadia (Seattle, WA)
Northeast Ventures (Duluth, MN)
Appalachian Ohio Development Fund (Athens, OH)

F. Small Business Investment Companies (SBICs)

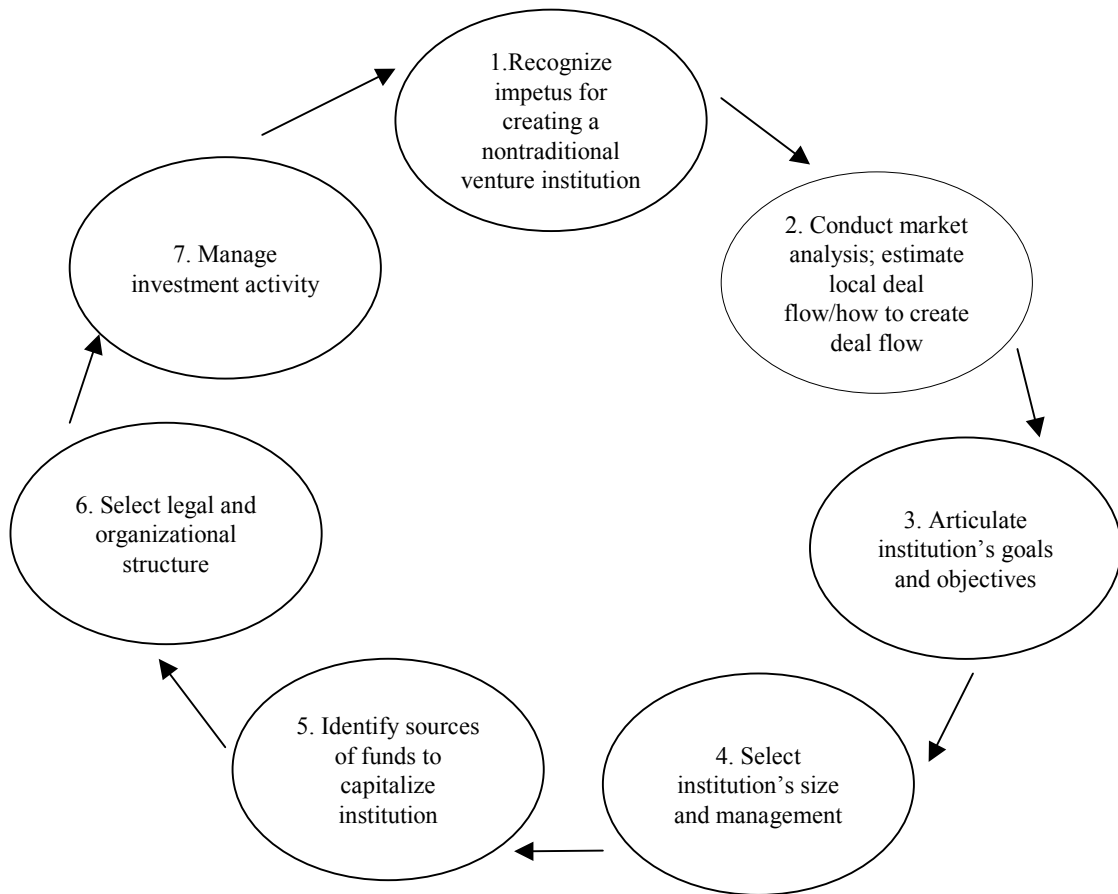
First United Ventures (Durant, OK)
North Dakota SBIC (Fargo, ND)
North Carolina Economic Opportunities Fund (Raleigh, NC)

^a MIN-Corp and Kansas Venture Capital, Inc. recently became private venture capital institutions and MIN-Corp is also considered a community development venture fund. However, both institutions were started with significant public support (funding and/or management).

^b Kansas Venture Capital, Inc. is also an SBIC.

^c 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.

Figure 1.
Steps in the Decision Making Process for Creating a Nontraditional Venture Capital Institution



Impetus for Starting a Nontraditional Venture Capital Institution

Why create a venture capital institution? Some institutions visited were created in response to concerns about the level of state or local economic development activity (Figure 2). The founders believed that local business development and job creation were hampered by a lack of venture capital and that successful venture capital investments could be made in area businesses at rates of return less than those sought by traditional venture capitalists. Investments in venture capital funds were made to

indirectly stimulate income and employment. Institutions created to stimulate regional economic development generally were established primarily to make investments in firms that could grow and remain in the region, increasing regional income and employment. For example, local business people created the MIG, an organization of angel investors, to help stimulate business development in the town of McAlester, Oklahoma.

Other institutions were established to meet the venture capital needs of area businesses and, as a result, to demonstrate that the local economy could support

venture capital investments. Founders of these institutions recognized a demand for venture capital in the region and the failure of national venture capital institutions to meet that demand. Kansas bankers, recognizing a need for venture capital, established KVC, an SBIC. KVC focused on meeting the venture capital needs of existing Kansas businesses, although economic development concerns were a secondary issue. OCIB responded to the need for venture capital in Oklahoma by investing in partner funds that could, in turn, invest in Oklahoma businesses. OCIB wanted to stimulate the Oklahoma venture capital market by bringing Oklahoma deals to the attention of established regional and national venture capital funds. However, investment in Oklahoma businesses is not specifically required. NRVF was created to stimulate the private capital market in Montana after attempts to attract private investors to an earlier state program were unsuccessful. While the earlier state program grew out of economic development concerns, NRVF was created to address the inadequacies of the private venture capital market in Montana and to earn good returns for the investors and managers of the fund.

A third group of institutions was created to use venture capital investments to create jobs, entrepreneurial capacity and wealth to benefit primarily distressed communities and low-wealth individuals. The institutions considered both financial and social returns in making investments. For example, NEV was established in response to the downturn in northeast Minnesota's mining industry. The need for venture capital was identified as an impediment to the creation and expansion of businesses in the region. Kentucky Highlands Investment Corporation (KHIC)

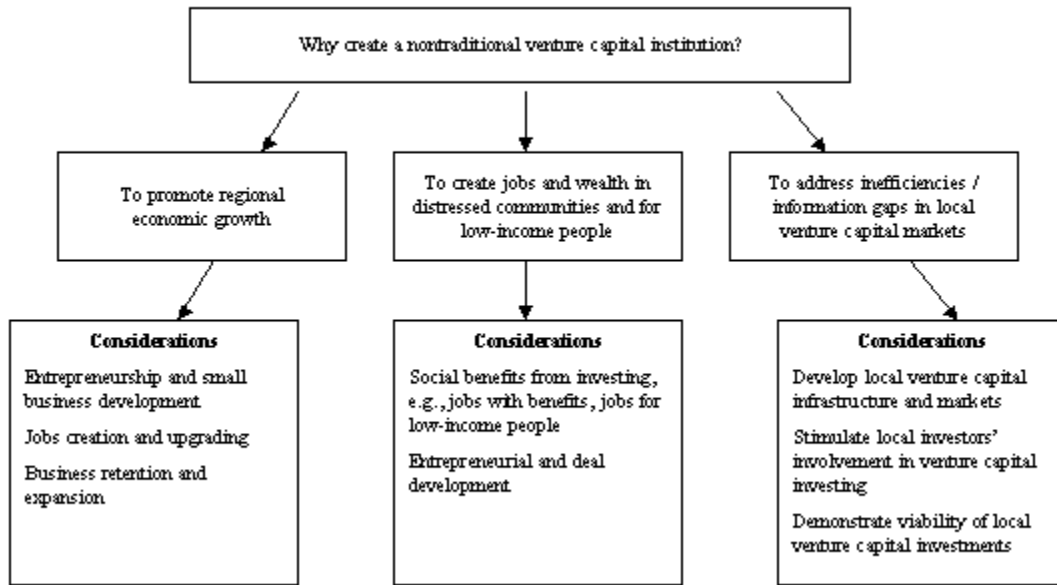
focused on creating economic opportunities within the distressed Appalachian region by developing potential deals, investing in the region's businesses and entrepreneurs, and bringing entrepreneurs into the region to create new enterprises. In these examples, creating economic development and social benefits for specific segments of the population were important objectives.

Market Analysis and Estimation of Local Deal Flow

Developing an appreciation for the need for venture capital in the relevant local, state, or regional market area is a critical second step in the creation of a nontraditional venture capital institution. This understanding, in turn, helps determine whether an effective demand for the venture capital institution exists, what niche the institution might occupy, and what would be an appropriate size for the fund. In addition to evaluating the need for venture capital, it is important to identify the climate for venture capital investing in the region. Are potential entrepreneurs familiar with venture capital investing available, or will some educational effort be required to develop this familiarity?

For some institutions, particularly community development venture funds (CDVCs), adequate deal flow was not central to their creation. Almost by definition, CDVCs targeted populations where deal flow was limited or nonexistent and had to be developed. KHIC had to create deals by attracting entrepreneurs to the region and by providing extensive assistance to promising local entrepreneurs during start-up of new businesses.

Figure 2. Impetus for Starting a Nontraditional Venture Capital Institution



For other funds, however, a market analysis can help to determine the focus of the venture capital institution and provide the information needed to make decisions on structure, size, and targeting of the institution. The need for venture capital varies with the stage, sector, and level of technology of resident industries, as well as with their potential for growth. Established firms, experiencing only moderate growth, may have limited need for venture capital and may be able to meet capital needs from retained earnings or borrowing. New, rapidly growing companies have more limited access to debt capital and are more likely to have capital needs that outpace their ability to generate retained earnings. Consequently, such businesses may have a greater need

for venture capital. An estimate of the potential need for venture capital can be obtained by understanding the structure of the local, state, or regional economy. It is important, however, to recognize that measuring the need for venture capital is subjective.

Analysis of a market area determines whether potential deal flow is sufficient to justify creating a venture capital institution (Figure 3). Because institutions tend to invest in a small percentage of deals reviewed, deal flow must be adequate. For example, KVC I reviews about 150 deals annually, yet it makes investments in only three or four deals. Analysis of investment opportunities in specific industry sectors and development stages is equally important to assessing overall deal flow. Venture capital

firms generally specialize in specific industries like manufacturing or computer software or in specific stages of development like start-ups, expansions, or transfers of ownership. The targeting of investments occurs because different types of investments require different types of expertise for the fund manager.

How can a community assess potential deal flow? When the impetus for creating a rural venture capital institution comes from within a region, such as with NEV, knowledge of potential deals is typically part of the rationale for the institution. NEV's founder's years of experience working with small businesses in the region provided the baseline information that defined the need in northeast Minnesota. Pacesetter, a venture capital fund based in Dallas, Texas, was established by its parent, MESBIC Ventures, because of an identified need for later stage venture capital for minority businesses in which MESBIC had originally invested. However, in spite of their assessment of deal flow, venture capital institutions may be faced with a very different pool of potential deals than anticipated. This situation affects investment strategies and the time frame for exiting investments. For example, the early market research undertaken by NEV did not reveal that most of their deals would be in early stage businesses.

When nontraditional venture capital institutions are created because of lack of capital availability, however, assessing deal flow is more problematic. Networking with organizations that know the needs of small businesses and entrepreneurs takes on added significance. Networking with banks, Small Business Development Centers, chambers of commerce, and local economic development offices can provide the local

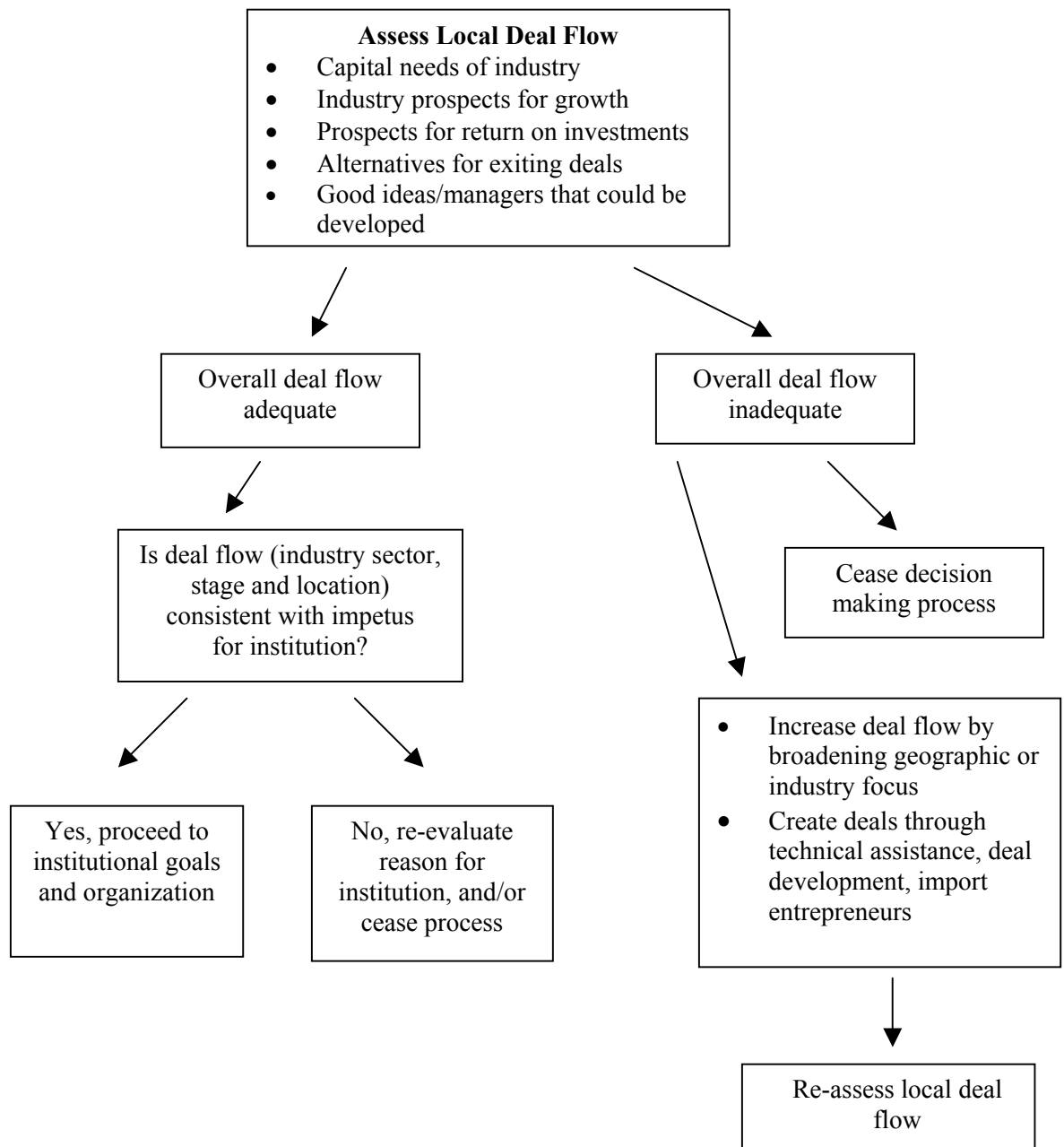
knowledge important to identifying potential deal flow.

If overall deal flow in the institution's proposed service area is considered inadequate to support a successful fund, organizers can choose to cease the decision making process or investigate alternatives for increasing deal flow (Figure 3). Broadening the geographic region served or industry sector targeted can increase deal flow. Colorado Venture Management's (CVM) Colorado Rural Seed Fund (CRSF) focused on the western slope of the Rockies, an area with a small population and a limited economy, was not successful. However, NRVF, CVM's recent initiative, fosters greater deal flow by operating statewide in Montana.

The industry focus of an institution can be expanded rather than limiting investments to a small number of specific sectors. The Iowa Capital Corporation (ICC), for example, focuses on industries strategic to the electric power industry, but ICC will consider firms in most manufacturing sectors.

Small community-based funds and CDVCs may have difficulty broadening their geographic region or industry focus. They often are already generalists and cannot spread their staff and resources over a broader geographic region without compromising their potential impact. They can, however, develop deal flow by providing support services for entrepreneurs and new businesses through incubators, technology transfers, and assistance in developing business plans. Institutions with a strong developmental orientation, like KHIC, have created deals by coupling technical assistance with venture capital. In regions where role models for entrepreneurs are limited, entrepreneurial development must precede the development of sound business deals.

Figure 3. Market Analysis



Articulation of Institution's Goals

After the need for venture capital has been demonstrated and potential deal flow identified, the institution's goals must be more specifically articulated (Figure 4). Some nontraditional funds want to maximize financial returns. Their managers believe that investment opportunities in the area offer the potential for earning an overall annual rate of return of 30 percent or more, an internal rate of return (IRR) on a par with that earned by traditional venture institutions. These investments are not currently undertaken by traditional institutions because of an imperfect flow of information, but the deals are available to regional investors who recognize the investment opportunity. Profit maximizing institutions face the challenge of making sound investments while attempting to overcome the factors of distance, high transaction costs, and lack of information that discourage the extension of traditional venture funds into more geographically isolated markets. NRVF and OCIB are organized around this principle. Finding a source of capital to fund the demonstration effort constrains the development of these types of institutions. In some cases, public investment can play an important role in this demonstration phase.

Other institutions also seek to maximize financial returns, but recognize that investment opportunities in small market areas offer potential IRRs that are lower than those expected by traditional venture funds. They work to maximize IRR, given that the expected rate of return will be lower than those accepted by traditional venture funds. Social returns from investments such as jobs, income, retail sales, and housing starts are not valued explicitly in the decision-making

process, although they are considered to be positive results of the investment process. However, investors in the venture capital institution may be able to capture benefits from other externalities, such as increased property values in the community or improved general quality of life.

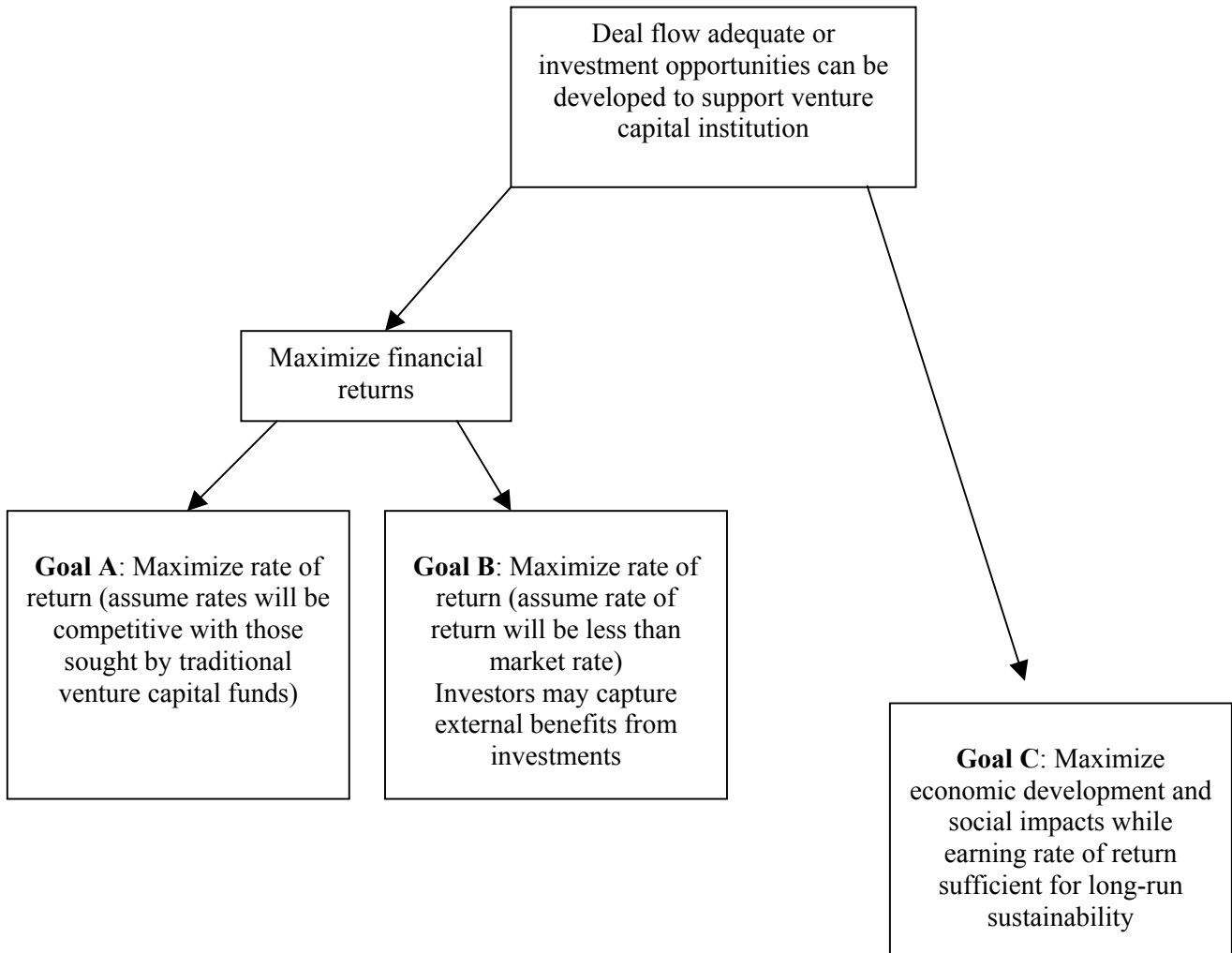
Some institutions seek to maximize social benefits or returns while earning an IRR that is sufficient to ensure the institution's long-term sustainability. Institutions such as ASCF, Coastal Ventures Limited Partners (CVLP), and MIN-Corp, consider potential financial and social returns in the decision making process. While both IRR and social returns can be considered, managers and investors must determine how these two variables are balanced, based on their mutual goals. For example, managers may choose to invest to achieve the highest possible IRR, subject to achieving certain minimum social benefits. Alternatively, social benefits could be maximized subject to achieving a minimum rate of IRR. Achieving consensus on these tradeoffs is critical to the decision-making process.

Selection of Institutional Size and Management Alternatives

Institution Size

The optimal capitalization of a nontraditional venture capital institution depends upon the institution's goals, organizational structure, and sources of funding. In addition, capital available should be closely related to investment opportunities or deal flow. If capitalization is large relative to deal flow, the institution may be encouraged to make questionable investments. If capitalization is low compared to estimated deal flow, then investment opportunities may go unfunded.

Figure 4. Goals of the Institution



The institution should also be financially able to support a professional management team. While it is difficult to set an absolute minimum size for a venture capital institution, an estimate can be made for funds driven by rate of return based on observations from site visits. First, each partner or manager in an institution generally can manage six to eight deals or investments. Second, investments must be large enough to justify a seat on the board of a portfolio company, if that is a requirement of the institution. Third, most

institutions have a requirement that no investment account for more than 10 to 15 percent of total capital in the institution. And fourth, a management fee of 2 to 3 percent of total capital is charged annually to cover operating expenses. Therefore, a fund with a 10-year life allocates approximately 20 to 30 percent of the initial value of the fund to management fees.¹

Based on observations from the site visits, a minimum of \$10 million enables a freestanding institution to operate without

subsidy of operating expenses. A \$10 million fund with a 10-year planning horizon would have \$7 to \$8 million available to invest in portfolio companies after allocations for management fees. Such a fund could make seven to eight investments averaging \$1 million per investment. Generally, the initial investment in a portfolio company would be less than the \$1 million average since part of the fund's investment capital will be set aside for additional investments. More than seven to eight investments could be made if initial deals are exited profitably and earnings are reinvested in the fund.

For small community-based institutions and CDVCs, operating budgets may be covered by grant money, monetary and in-kind contributions from partner organizations and retained earnings. As a result, institution size may have less influence on the ability of these institutions to hire experienced, committed managers.

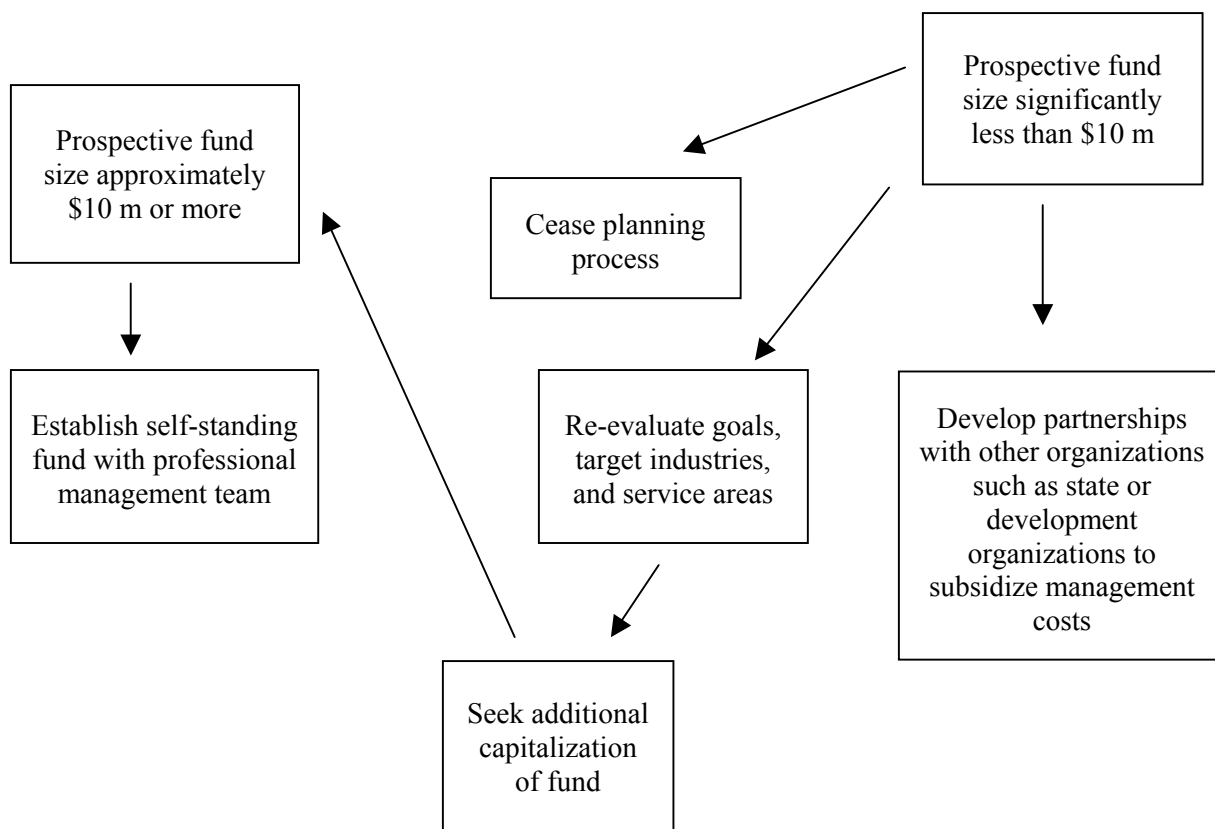
If prospects for raising a \$10 million fund are limited given the goals and focus of the institution, then the organizers have other alternatives (Figure 5). One, the organizers can cease planning for a venture capital institution and investigate other means of assisting new area businesses. Two, the organizers can reevaluate the proposed goals, area, and industry focus of the institution to determine whether the institution can become more attractive to potential investors. Three, alternatives to a freestanding venture capital fund such as partnerships with public or private organizations, could be investigated as a means to subsidize management of the fund. For example, CVLP, a \$5.5 million fund, is part of Coastal Enterprises, a community development corporation in Maine. Operating costs for CVLP are

subsidized by the parent organization, enabling the smaller venture capital fund to be viable. Alternatively, the Small Enterprise Growth Fund (SEGF) in Maine uses a volunteer board for due diligence and investment decisions to reduce management costs. Small, local funds such as ASCF and Siouxland Ventures Fund (SVF) rely on the local chamber of commerce for administrative support.

Management Alternatives

With the goals and size of the institution established, a professional management team must be secured to run the venture capital institution. Most institutions noted that professional management was critical to the success of the fund. In small market areas, organizers must consider whether experienced professional investors can be hired from within the local labor pool or whether professionals can be attracted to the local area. In addition, the institution's goals will play a role in determining the characteristics of the management team. If the goal of the institution is to maximize IRR, the fund must be large enough to support an experienced management team, relying primarily on an average management fee of 2½ percent. In addition, the potential to earn significant returns on the investments must be sufficient. For institutions with dual goals, management must be motivated by concern with the social benefits of investments and be comfortable with the tradeoff between financial and social returns. Since the community development venture capital industry is relatively young compared with traditional venture capital, the pool of professional, socially motivated investors is more limited. Consequently, institutions with dual goals may have to rely more heavily on hands-on training than more traditional venture capital funds.

Figure 5. Fund Size and Management Alternatives



In addition to finding professional management, attention must be given to establishing an incentive structure for management that is consistent with the goals of the institution. Most traditional and profit maximizing nontraditional funds are structured so that the management team shares in any profits earned when investments are exited. Even smaller community-based and community development venture funds provide some way for fund managers and staff to share in the returns from profitable investments.

If the incentive system does not reward good investment decisions, the institution may not achieve either its financial or social goals. The Magnolia Venture Capital Corporation (MVCC) in Mississippi provides the classic example of potential problems with an institution when oversight is inadequate (in this case, public oversight) and the incentive system fails to reward sound investments and fund growth. Lax oversight of Magnolia’s management and board and questionable business practices by employees resulted

in a program with high costs and no discernible economic benefits.²

Sources of Funds

Potential sources of funds must be considered throughout the decision-making process. When organizers begin to discuss the creation of a nontraditional venture capital institution, it is important that they have a realistic view of alternative sources of funding for capitalizing the institution and the implications of these sources for management structure. In addition, organizers need to understand any restrictions or covenants that are placed on funds invested in the institution. For example, if foundations are identified as lead investors, their goals will be instrumental in setting the goals of the institution. If the state is the lead investor, restrictions on investments to in-state firms will be likely. These constraints will influence the decision-making options available to institution organizers.³

Funding for the capitalization and management of the site-visit institutions came from public funds, private funds (individuals, commercial banks, public utilities), quasi-private funds backed by public incentives (tax credits), and nongovernmental organizations (nonprofit foundations). Each funding source has its own advantages and constraints.

Public Funds

A number of institutions were capitalized either completely or in part by public funds, both state and federal. KVC, MIN-Corp, NRVF, Iowa Seed Capital Corporation (ISCC), CRSF, and SEGF received substantial state investments. Public capital may be compatible with goals of maximizing IRR in the low to moderate range or meeting the dual objectives of moderate IRR and social

benefits. Federal investment funds come from the Small Business Administration (SBA) for Small Business Investment Companies (SBICs) and investments made by the Community Development Financial Institutions (CDFI) fund. NEV, CVLP, and KHIC received CDFI funding, and North Dakota SBIC and First United Ventures (FUV) in Oklahoma tapped the leveraging available through SBA. Title VII (no longer available) program funds for community development corporations provided capital to KHIC.

The experience of site visit institutions suggests several caveats to the use of public funds, particularly state funds. Funding for a venture capital institution should be provided in one lump sum as opposed to annual appropriations over a period of time. Annual appropriations of state funding tend to be subject to the vagaries of the political process. This uncertainty with respect to future funding availability may encourage suboptimal investment decisions on the part of the venture capital institution; for example, the institution may feel pressure to invest the year's appropriations regardless of the availability of good deals. In addition, failures among the institution's portfolio companies are likely to occur before successes, cooling legislative support for future appropriations for the institution.

In some cases public funds come with restrictions, such as limiting investments to in-state firms or firms in a particular industry sector or region. While such restrictions may meet certain economic development objectives, they create obstacles that limit the institution's ability to develop sufficient deal flow or to partner with venture capital investors outside the state or region. The ICC has reimbursed Iowa and KVC has refunded the state's investment in the institution in

order to overcome limitations resulting from public investment. In both cases, however, the repayment plans were beneficial to both the state and the venture capital institution since state resources were made available for other uses. A state constitution may limit the type of investments an institution can undertake with public funds. SEGF was prohibited from making pure venture capital investments and, as a result, used a complicated debt with warrants investment structure that initially limited the number of deals. After changes to SEGF's investment structure were made within the confines of the state's constitutional restrictions on venture capital investments, deal flow increased.

A venture capital institution with significant public funding may have difficulty raising capital from private sources or finding private venture capital firms willing to coinvest in potential deals. MIN-Corp, for example, found that private sources of capital were reluctant to invest in the fund because they presumed the fund could continue to draw on public resources. In addition, federal programs such as the CDFI fund will not invest in institutions with state control. More seriously, private venture capital firms are reluctant to coinvest with public funds because they perceive public funds may be subject to political interference. They fear political pressure to invest in specific firms, industries, or geographic areas at the expense of the fund's return on investment. According to the site visits, the potential for and impacts of political interference are perceived to be serious enough that public funds must be organized in a way that insulates them from external pressures. Potential investors must see clearly that this political interference is eliminated.

If public funding is available for capitalization of the venture capital institution, considerations must be given to the tradeoffs between public and private management of the funds. For example, public funds can be invested directly into portfolio companies through a public or quasi-public institution like SEGF or ISCC. SEGF is administered through the Finance Authority of Maine, using staff resources and an advisory board to make investment decisions. The state is engaged in direct investing in this institutional structure.

The publicly managed approach, then, has the advantages of better targeting investments and of subsidizing management costs. The principal disadvantages are the potential for political interference in fund management and the difficulty in attracting experienced venture capitalists to run the public program.

As an alternative to public management, public capital can be managed by private venture funds like NRVF, OCIB, and KVIC. In the OCIB model, capital comes from institutional lenders and investors through the Oklahoma Capital Formation Corporation (OCFC). Principal and interest, if necessary, are guaranteed by \$50 million in state tax credits with limits of \$10 million per year. The funds are used to form partnerships with private venture funds that have successful records of venture capital investing. These partnerships, in turn, focus their efforts on identifying and making investments in Oklahoma businesses, although they are not restricted to in-state investing. This model is particularly relevant when prospective deals in the region are expected to achieve relatively high IRR.

Private management of public funds provides greater insulation from political pressure and higher potential for

competitive rates of return on the state's investments. However, private managers generally are less interested in the economic development impacts of investments. Thus, some targeting of privately managed funds might be needed to make this strategy relevant to the creation of nontraditional venture capital funds.⁴

Private Funds

For nontraditional venture capital institutions that expect to achieve only moderate IRR or to focus on achieving social benefits as well as moderate IRR, private funds have certain limitations. Private investors interested solely in earning high IRR are unlikely to invest in venture capital institutions with dual objectives or in institutions where expected returns are below traditional venture capital market targets. However, the focus on social benefits and economic development goals may enable an institution to attract investments from banks seeking to meet Community Reinvestment Act (CRA) requirements. Although the CRA has been used most effectively in urban markets, the increasing presence of national banks may increase CRA's usefulness in small towns and rural areas. The Appalachian Ohio Development Fund (AODF) was successful in using CRA requirements to attract bank financing for capitalization of its fund.

Angel investors can be an important source of private capital for a venture capital institution. In addition, angels can be coinvestors in deals made by venture capital institutions. Angel investors also are an important source of matching capital for public funds that have private matching capital requirements like SEGF.

Some regions or states use unconventional sources of private venture

capital. Utilities, for example, may invest in venture capital institutions that operate in their region. The principal sources of funding for ICC were two regional electric cooperatives, and NEV received an investment from a state utility. Alternatively, in Montana, utility cooperatives made direct venture capital investments in existing and start-up businesses in their service areas. Utility cooperatives are in a unique position to provide venture capital to business enterprises because they may be willing to accept a moderate rate of return on their funds in order to maintain businesses within their service area as customers. Most utility cooperatives also are in a position to take a long-term view of investments, given their commitment to the region and their members' strong roots in the community. However, state regulatory constraints may limit the ability of a utility cooperative to make venture capital investments.⁵ Moreover, with industry deregulation, electric power cooperatives will have less incentive to participate in venture capital programs since the new businesses will not necessarily be power customers of the area cooperative.

Public Incentives for Private Investments

State tax credits to encourage private investments in private venture capital funds are a hybrid of the public funding and private funding alternatives. The certified capital companies (CAPCO) programs of Louisiana, Missouri, and other states are one example of this funding process. Under CAPCO programs, the state provides tax credits to insurance companies that invest in certified venture capital companies. In general, the insurance companies receive one dollar of tax credit spread out over 10 years for each dollar invested in a CAPCO. The tax

credits are applied to the taxes paid on premiums earned by insurance companies on insurance policies written in that state. The CAPCOs, in turn, must invest in specific types of state businesses according to a specified time schedule.

CAPCO programs have been successful in attracting private funds for venture capital investments and in encouraging the expansion of the venture capital infrastructure in the states adopting the program. However, under CAPCOs, unlike the public funds alternative, the public bears significant costs for tax credits with all or most of the fund's returns on investments going to the CAPCOs and insurance companies.⁶

Funding from Nongovernmental Organizations

Nongovernmental organizations, such as foundations, are more likely to be focused on economic development objectives and to accept lower returns on their investments than private sources of funding. National foundations provided an important impetus to the creation of some of the first venture capital funds focused on rural or developmental markets. For example, primarily national and regional foundations initially capitalized NEV. This foundation support, in turn, helped determine the institutional structure of the fund. As more venture capital funds are created, foundation support will likely change. Foundations may look to some intermediary that can conduct due diligence on funds and reduce the burden of dealing with individual funds. For nontraditional venture capital institutions, support from regional foundations may become increasingly important in the future.

Legal and Organizational Structure

In choosing an appropriate legal and organizational structure, organizers should consider the goals and constraints under which they will operate. In some cases, institutions can operate independently, without affiliation or subsidy from a parent organization. However, particularly for the smaller funds created by some nonmetropolitan communities, an independent structure may not be viable. As a result, affiliation with an existing organization may be crucial for success.

For-Profit vs. Nonprofit Organization

Venture capital institutions typically are for-profit enterprises. However, particularly for institutions balancing IRR with economic development goals, a nonprofit subsidiary or partner provides institutional flexibility. The nonprofit can receive grants for technical assistance to help offset the venture capital fund's operating costs. NEV's institutional structure features both nonprofit and for-profit entities. KHIC features a parent institution organized as a nonprofit community development corporation and several for-profit subsidiaries, including an SBIC.

Limited Liability Partnerships and Corporations

Most private venture capital funds are organized as limited liability corporations (LLC) or partnerships (LLP), where the general partners manage the investments and the limited partners provide the majority of capital for the fund.⁷ These funds typically have a limited life of ten years. Investments are made during the first three to five years and then exited during the later stages of the fund. Returns to investment are distributed to partners, not retained in the fund to support future investments.

LLPs are attractive if the institution is seeking significant private funding, for example, NRVF. Private investors prefer LLPs because of the limited financial liability, absence of managerial responsibilities, and fixed investment time period. Alternatively, LLCs provide more flexibility than LLPs and do not have a limited life. LLCs provide a more permanent presence with more favorable tax treatment of gains than corporations have.

Corporations

Some institutions are organized as corporations. NEV, established to serve the northeast Minnesota region, used a corporate structure because the investors, primarily foundations, wanted to create a permanent presence in the region. The corporate structure was in line with the economic development goals established for the fund. However, when a corporation realizes a gain from the exit of a successful investment, corporate tax liabilities place a significant burden on the institution. The tax treatment for LLPs and LLCs is more favorable since gains are taxed at individual, not corporate levels.⁸

Small Business Investment Companies (SBIC)

Although not a separate legal form, the SBIC is a popular way to establish venture capital funds. SBICs are private venture capital institutions, licensed by the SBA. The license allows an institution to leverage private capital with SBA-guaranteed funds, where SBA funds are offered at a fixed interest rate payable semiannually. Until recently, most SBICs borrowed money from the SBA. SBICs typically provided subordinated debt with the option to acquire equity in their portfolio companies, an investment instrument that enabled the SBIC to cover

its SBA interest costs. Since this instrument is not well suited to investments in start-up enterprises, SBICs generally focus on later stage enterprises and expansion capital.

In 1992, the SBIC program changed to facilitate more venture capital investing. Participating securities SBICs can defer interest payments until the SBIC realizes gains through the sale of the investments, so obstacles to making pure equity investments are fewer. In addition to interest payments, SBA receives a 10 percent participation in the SBIC's profits. This new institutional structure is better suited to making investments in promising early stage companies. North Carolina is in the early stages of capitalizing a rural-focused state venture capital fund, using the participating securities SBIC model. The fund has received an initial \$30 million commitment from large banks in the state, with more fundraising planned from smaller state banking institutions.

Angel Networks

An angel capital network is a less institutionalized form of venture capital institution. Angel investors have high net worth and are successful entrepreneurs, providing capital and management expertise to a limited number of start-up companies. As part of the informal capital market, they are estimated to be the largest source of capital to new firms.⁹ While angels typically operate independently, networks are formed to share information and pool capital resources. The MIG and ASCF, angel networks serving a very specific geographic region, pool the resources of successful business people to make investments in their communities. MIN-Corp, a nonprofit institution operating in Minnesota, represents a more institutional approach to angel networks. It is organizing angel investment networks,

structured as LLCs. While three networks are currently operating, ten are planned.¹⁰ As with most nontraditional venture capital institutions visited, the level of coordination, the quality of due diligence, and success of investments of angel networks can vary significantly. More analysis of these networks and their applicability to rural markets is needed.

Management of Investment Activity

Finally, decision makers must determine how to conduct the institution's investment activities (Figure 6). Specifically, how will the institution screen prospects, select investment instruments, and exit deals? To a large extent earlier decisions will dictate choices. For example, a decision to use a volunteer board will affect how due diligence for prospective investments is conducted. A decision to focus on very early stage investments will dictate an investment instrument structured more like pure equity than debt.

Screening Prospective Investments

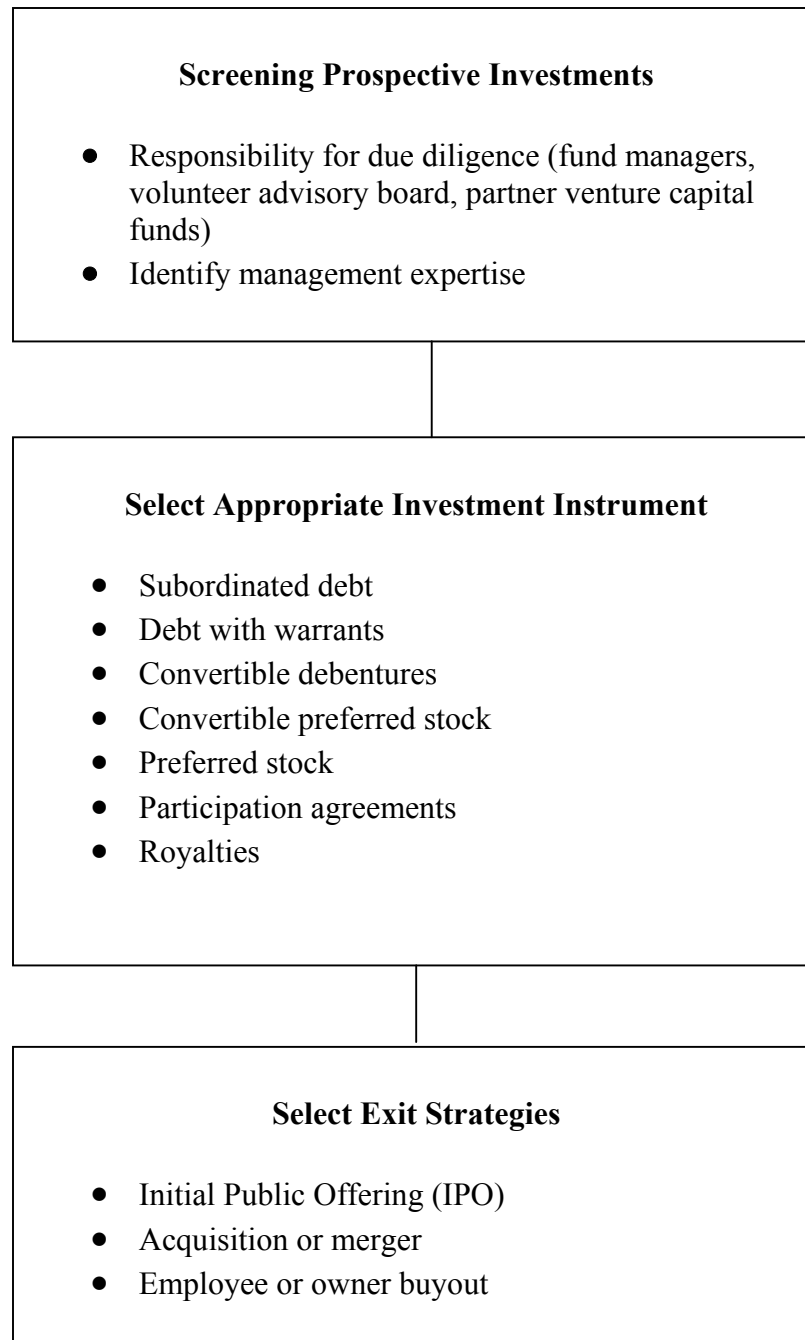
Establishing a thorough system for conducting due diligence on prospective investments is a key component to building a sustainable venture capital institution. In many institutions, professional managers conduct due diligence with very limited input from investors. KVC uses this approach. The general partners make all the investment decisions for the investors, over 300 Kansas banks. In other cases, an advisory board provides the technical expertise to conduct due diligence, aided by fund staff. SEGF operates in this manner since the fund does not have a full-time professional manager. Members of the advisory board review business plans, visit entrepreneurs, and do the market analysis required to identify viable investment opportunities.

The fund can operate at lower cost by using the volunteer advisory board, but this system limits the number of deals that can be considered. In addition, it is difficult to coordinate this type of organization, and the costs of coordination may become burdensome to the institution. Under the SEGF model volunteer members of the board are not considered part of the management team, a significant limitation. While they are given responsibility for conducting due diligence, they are not accountable for their investment or strategic decisions. Their lack of accountability could affect the quality of investment decisions made.

Due diligence on prospective investments for the small, local fund ASCF is provided by several resources. Businesses seeking funding from ASCF agree to counseling with the Small Business Development Center or Iowa State University Innovations System. After prescreening, applicants are reviewed by the executive director of the Ames Economic Development Committee, a division of the Ames Chamber of Commerce, the fund investment review committee, and a private venture capitalist under contract with ASCF.

Venture capital institutions can also spread the risk or burden of due diligence by partnering with other institutions, such as larger venture capital funds, on investments or by requiring a matching investment from another source. The managers or advisors for each institution conduct their own due diligence, reducing the risk that a critical flaw in the business plan, for example, might be overlooked. This strategy is particularly important for smaller venture capital institutions, because larger deals can be put together through partnering and the burden of due diligence can be shared.

Figure 6. Management of Investment Activity



In some cases, due diligence performed on a prospective company concludes that the company has a good proposal, but the venture capital institution is not confident that current company management can achieve what is proposed. Therefore, a second part of the screening process determines if the needed management expertise is available locally or can be attracted to the area. If the local economy provides infrastructure and support services, entrepreneurial development and small business growth will be more successful. CRSF noted difficulty in finding people willing to relocate to rural Colorado to manage and grow their portfolio companies. As a result, portfolio companies did not develop as anticipated. Alternatively, KHIC and NEV brought entrepreneurs into the region and built deals around them. The provision of venture capital alone may not be sufficient to build successful businesses that can contribute to the overall economic development process.

Selecting Investment Instruments

Investment instruments used by a venture capital institution include pure equity such as stock and quasi-equity instruments such as debt with warrants, debt with equity kickers, royalties, participation agreements, and convertible debt. Most institutions have a preferred investment instrument, and the choice of instrument will depend, to some extent, on the source of funds and the institution's preferred exit strategy. For example, SBICs traditionally used subordinated debt or debt with warrants to generate a stream of current income that could be used to cover interest costs on SBA leveraged funds.

One cautionary note on investment instruments is drawn from SEGF. The fund originally used a complicated subordinated debt instrument with puts and calls. Portfolio companies had to incur the expense of hiring legal expertise to interpret the instrument in order to make an investment decision. As a result, some firms simply did not pursue the potential investment. The complicated structure was due, in part, to state constitutional restrictions on the fund taking a pure equity position in the firm. However, the fund recently restructured the investment instrument as a convertible debenture and has had more success in attracting new potential deals and meeting the needs of their existing portfolio companies.

Structuring venture capital deals can also be difficult in markets where the entrepreneurs are unfamiliar with equity capital. An equity investment requires giving up some ownership stake in the business, at least in the short term. For family-owned businesses, the owner's goals of passing the business to the next generation may be threatened by an equity investment in contrast to an investment instrument structured as debt with equity features.

Involvement in Portfolio Company Management

The level of involvement with portfolio company management is a function of the expertise of the venture capital institution's staff. Many traditional venture capital funds require a seat on the portfolio company's board as a condition of investment. The managing partners have technical expertise that they can contribute to the company's board. This board presence allows investors to follow management decisions and, if necessary,

intervene in the decision-making process. The nontraditional venture capital institutions visited are involved in the management of their portfolio companies at different levels. Some institutions require a board seat and maintain active involvement in company management. In some cases, new management, such as a chief financial officer, is brought into the company as a condition of investment. Other institutions, such as SEGF, do not always take a seat on a company's board since oversight of investments is the responsibility of a volunteer board.

The level of involvement with portfolio companies also varies over the life of the investment. If a company is doing well, the venture capital institution is unlikely to intervene in management decisions. If the company encounters problems, the managing partners may provide assistance themselves or through outside consultants, they may make an additional investment to strengthen the company, or they may be involved in replacing an existing company management team with a new team. The level of involvement depends on the expertise and resources of the venture capital institution's managers.

Exiting the Deal

Exit strategies present important challenges to venture capital investors. In a recent study of Canadian markets, survey results show the importance of exit potential to venture capital investment decisions. According to the study, venture capitalists consider the prospects for a profitable exit when deciding whether to invest and what the terms of investment will be.¹¹ Most venture capital institutions exit successful investments through an initial public offering (IPO) of stock, acquisition by another firm, or employee or owner buyout. For traditional

manufacturing firms that dominate small towns and rural areas, IPOs are less likely to be successful, particularly in the current volatile market. While acquisition is a viable strategy in small market areas, this strategy may not work for institutions that have the dual objectives of competitive IRR and economic development benefits. The sale of a company to an outside party may provide positive financial returns to the venture capital institution, but if the plant relocates, economic development impacts may be negative. For institutions with an interest in economic development, an employee or owner buyout provides liquidity to the venture capital institution and retains economic benefits in the local area. However, unless the owner or employees borrow funds to finance purchase of the business, payments are usually structured to fit within the cash flow limitations of the business and are typically made over a relatively long period of time. As a result, the financial return on the investment is likely to be smaller for the venture capital institution.

Summary and Conclusions

The establishment of a venture capital institution is complicated, time-consuming, and expensive. It is even more difficult in small market areas than urban centers. Nonmetropolitan communities and rural areas have a relatively small number of firms that are familiar with and receptive to the concept of venture investments. These areas often lack the management expertise, support services, and infrastructure beneficial for entrepreneurial and small business development. Businesses have relatively few options for exiting deals with venture capitalists. The costs of managing a venture capital institution with a small market focus also can be high due to the

geographic dispersion of portfolio companies.

The relatively unfavorable environment for venture capital investments in small market areas partly explains why venture capital investments are highly concentrated in metropolitan areas. Yet this study finds examples of successful venture capital institutions that are located in nonmetropolitan communities and rural areas. In general, these nontraditional venture capital institutions can function in the limited investment environment because (1) they have a patient source of investment funds, (2) they are willing to accept less than the market rate of return in exchange for external or social benefits, or (3) they are affiliated with organizations that subsidize

their costs and can capture the external benefits.

Despite the success of a number of nontraditional venture capital institutions, all institutions interviewed for this study said that they would do things differently if they had the opportunity to start anew. That is, earlier decisions regarding goals, funding, management and investments would have been made differently had the institution known the implications of their decisions. They would have benefited from a formalized decision-making process demonstrating the linkages between early decisions and those that followed. The decision-making process described here can be used as a guide to creating nontraditional venture capital institutions in small urban centers and rural communities across the U.S.

Endnotes

1. An option for smaller funds may be to have a staggered fee schedule. Fees can be higher in the initial years and then be reduced over time so that the average is 2 to 3 percent.
2. Barkley, David L., Deborah M. Markley, and Julia Sass Rubin, 1999, "Public Involvement in Venture Capital Funds: Lessons from Three Program Alternatives," Columbia, MO: Rural Policy Research Institute, University of Missouri, P99-9.
3. Organizers also must consider who will be responsible for the costs of creating the venture capital institution. Both time and money are required to create an organization and raise the funds to capitalize it. According to Pete Bloomer of Colorado Venture Management (Boulder, Colorado), it takes approximately one year and \$300,000 to create a venture capital fund.
4. Interested readers may refer to Barkley, Markley, and Rubin (1999) for a more thorough discussion of the advantages and disadvantages of alternative publicly-assisted venture capital programs.
5. For more information on the Montana cooperatives, see Freshwater, David, 1998, "Utility Cooperatives as a Source of Equity Finance: Montana Examples," Department of Agricultural Economics, University of Kentucky, Staff Paper No. 386, (November).
6. For a more in-depth discussion of CAPCO programs, refer to Barkley, David L., Deborah M. Markley, and Julia Sass Rubin, 2001. "Certified Capital Companies (CAPCOs): The Latest Wave in State-Assisted Venture Capital Programs," *Economic Development Quarterly*, forthcoming.
7. For a discussion of LLPs and LLCs, see Sahlman, W. A., 1990, "Structure of Venture-Capital Organizations," *Journal of Financial Economics*, 27:473-521.
8. Executives with Iowa Capital Corporation noted that they would not have selected the corporate structure had they known how successful the fund would be. ICC is investigating alternative structures such as LLC or LLP to reduce the fund's tax liabilities. Northeast Ventures is in the process of converting from a C corporation to a nonprofit corporation largely because of the tax consequences associated with the corporate structure.
9. Gaston, Robert J., 1990, "Financing Entrepreneurs: The Anatomy of a Hidden Market," chapter in *Financing Economic Development: An Institutional Response*, edited by Richard D. Bingham, Edward W. Hill, and Sammis B. White, Sage Publications.
10. For more information, see Jossi, Frank and Paul Duncan, 1998, "Angels take Wing," *Ventures*, (October): 34-36.
11. MacIntosh, Jeffrey G., 1997, "Venture Capital Exits in Canada and the United States," *Financing Growth in Canada*, edited by Paul Halpern, University of Calgary Press.