

New Opportunities for Equity

A Critical Examination of Community Development Venture Capital

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ABSTRACT

Community Development Venture Capital (CDVC) is emerging as a new mechanism to infuse underserved businesses and entrepreneurs with equity capital. Community Development Venture Capital attempts to link private sector models of capital generation with socially motivated outcomes, namely job creation for low-income workers, while establishing an alternative model to investing in business. This thesis investigates the burgeoning urban CDVC industry through case studies of three organizations, Silicon Valley Community Ventures, Boston Community Venture Fund and Murex Investments. These brief studies focus on two issues: the relationship between Fund investors and Fund investments, and the social impact measures of the Fund's investments. The analysis centers primarily on the changes between the CDVC's first and second Funds to understand the changes occurring in the industry and explore the potential ramifications of these industry shifts. This thesis argues two main points. First, investors in CDVC Funds have influence over the type of investments CDVC Funds make, but these influences have not been examined as they relate to the overall social impact that changes in investment patterns may have on the CDVC industry. Potentially, the changing nature of CDVC investors has a considerable effect on the nature and impact of social returns on investments. Second, the overall measurement of the social impact of CDVC's has not been developed or implemented in a rigorous or systematic fashion. This lack of social impact measurement is detrimental to the industry. To ensure that CDVC's live up to the philosophy of the *double bottom line*, the attention to measuring the social returns on investment must be increased and more comprehensive. The direction of Funds toward this more comprehensive approach to measurement will position Funds to align their investors with their outcomes; ultimately creating a system of similar effectiveness to the traditional Venture Capital. In traditional Venture Capital, motivations are aligned to provide the highest financial returns possible. When CDVCs are able to articulate and document the full range of their impact, financial and social, they too will be able to align their motivations with investors who understand and support both inputs in the *double bottom line*.

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LIST OF ACRONYMS

BCVF	Boston Community Venture Fund, LLC I and LLC II
BCC	Boston Community Capital
CalPERS	California Public Employees Retirement Services
CAPCO	Certified Capital Companies
CDFI	Community Development Financial Institution
CDVC	Community Development Venture Capital
CDVCA	Community Development Venture Capital Alliance
CRA	Community Reinvestment Act
FTE	Full Time Equivalent
GP	General Partner
IPO	Initial Public Offering
LP	Limited Partner
MI	Murex Investments
NMTC	New Markets Tax Credit
NMVC	New Markets Venture Capital
PRI	Program Related Investment
RHD	Resources for Human Development
SBA	Small Business Administration
SBIC	Small Business Investment Company
SSBIC	Specialized Small Business Investments Company
SVCV	Silicon Valley Community Ventures, LLC I and LLC II
VC	Venture Capital

Introduction

Community Development Venture Capital (CDVC) is emerging as a new mechanism to infuse underserved businesses and entrepreneurs with equity capital. It distinguishes itself from the traditional Venture Capital (VC) industry by pursuing the *double bottom line* approach to investing, focused both on the financial returns and social returns of its investments. It further distinguishes itself from public sponsored Venture Capital (primarily Small Business Investment Companies [SBIC's] and Specialized Small Business Investment Companies [SSBIC's]), by working significantly outside of the public sector in the for-profit or nonprofit sector, is capitalized substantially by private sources, explicitly incorporates social measures as indicators of success, and generally makes smaller investments than SBIC's and SSBIC's. Finally, Community Development Venture Capital is distinct among economic development initiatives targeted at business development because it focuses on equity and growth oriented or "larger" small businesses rather than micro-enterprise development or self-employment.

Community Development Venture Capital attempts to link private sector models of capital generation with socially motivated outcomes, namely job creation for low-income workers, while establishing an alternative model to investing in business.

This industry's origin dates back over thirty years but has grown rapidly within the last ten years¹. Recently, the industry has begun to institutionalize itself, indicated both by the creation of a national trade association (The Community Development Venture Capital Alliance CDVCA) and increased engagement with other institutions including the federal government and the banking industry. The goals of these Funds, to pursue the *double bottom line*, is predicated on the

¹ Rubin, Julia Sass 2001: "Community Development Venture Capital: A Bottom Line Approach to Poverty Alleviation" April 2001.

feasibility of obtaining 'venture like' financial returns on investment while substantially forwarding the social objectives of the Fund. These two purposes are often not inherently aligned, and currently much of the struggle in the industry is to create a model that effectively and efficiently addresses these two goals. Are these Funds, which attract socially motivated capital, utilizing it most effectively to address various community and economic development goals? Is the Venture Capital financing model the most efficient way to target funds towards businesses that can improve the economic development of targeted low-income populations or regions? Given the relative youth of the industry, the answers to these questions are still far from being understood.

This thesis investigates the burgeoning urban CDVC industry through case studies of three organizations, Silicon Valley Community Ventures (SVCV), Boston Community Venture Fund (BCVF) and Murex Investments (MI). These brief studies focus on two issues: the relationship between Fund investors and Fund investments, and the social impact measures of the Fund's investments. The analysis centers primarily on the changes between the CDVC's first and second Funds to understand the changes occurring in the industry and explore the potential ramifications of these industry shifts. As the CDVC industry grows there are indicators that the type of Fund investor is transitioning from primarily socially motivated foundations to financial institution investors who are concerned equally with the financial and social returns from their investment. This trend is highlighted as banks enter into CDVC Fund investment primarily as satisfaction of their Community Reinvestment Act (CRA)² compliance. The CRA investments made from Banks represent a significant funding stream for economic development therefore its direction into CDVC Funds should be examined.

² The Community Reinvestment Act is legislation that requires most commercial banks to provide products and services for the inhabitants of their entire service area. This legislation requires that banks create and implement products and strategies to ensure access to credit to its entire constituency. This law was passed primarily because of discriminatory lending practices of many banks. There are three tests banks must pass: service, lending and investment under CRA.

This thesis argues two main points. First, investors in CDVC Funds have influence over the type of investments CDVC Funds make, but these influences have not been examined as they relate to the overall social impact that changes in investment patterns may have on the CDVC industry. Potentially, the changing nature of CDVC investors has a considerable effect on the nature and impact of social returns on investments. Second, the overall measurement of the social impact of CDVC's has not been developed or implemented in a rigorous or systematic fashion. This lack of social impact measurement is detrimental to the industry. To ensure that CDVC's live up to the philosophy of the *double bottom line*, the attention to measuring the social returns on investment must be increased and more comprehensive.

Thesis Organization

Chapter one provides a background on the Community Development Venture Capital industry. First, this chapter will discuss entrepreneurship within the broader context of economic development and highlight why entrepreneurship and business development are a vital and an increasingly utilized strategy for community economic development. It will discuss the necessity of equity capitalization for small business development and the current lack of this type of capital in inner city urban markets. Chapter one will then turn to a brief discussion of the capital market opportunities and failures as they relate to traditional and Community Development Venture Capital. The recent emergence of the CDVC industry significantly limits the amount of research on this topic; as such this chapter will focus on placing CDVC's within the larger context of entrepreneurship as a vehicle for economic development and within the framework of the traditional Venture Capital industry.

Chapter two will focus on three case studies, Boston Community Venture Fund (BCVF), Silicon Valley Community Ventures (SVCV) and Murex Investments (MI). Boston Community Ventures is located in Roxbury Massachusetts and

grew out of a successful nonprofit Community Loan Fund established in 1985. Boston Community Ventures has been highlighted as one of the most successful young CDVC Funds. BCVF has focused its investment primarily within low-income communities of Massachusetts; however, it has begun expansion throughout the Northeast. Boston Community Venture Fund has completely invested its Fund I and is over halfway through raising its second Fund, which has begun to make investments. Silicon Valley Community Ventures began in 1998 and is located in San Francisco. The focus of SVCV is the low-income areas of the Northern California Bay area, including San Francisco, Oakland, East Palo Alto and San Jose. SVCV also has begun raising a second fund. Finally, Murex Investments is located in Philadelphia, Pennsylvania and invests in the greater Philadelphia region, which includes portions of southern New Jersey and Delaware. Murex Investments was designated in 2001 as a New Markets Venture Capital Fund. This program, which is detailed further in this thesis, grants it access to up to \$5.5M federal matching capital for its venture fund as well as a grant for \$1.65M for technical assistance as it raises its second fund. Murex Investments raised its first Fund and has invested approximately one half.

These three Funds are focused on urban communities, and indicate job creation as their primary social impact measure. However, each approaches investing in distinct ways, has different sources of funding and record and monitor their social impact using distinct methods. These distinctions are important for several reasons. First, the approach to investing, or philosophy of each Fund, directly influences the types of investments it makes and the kinds of social impact measures it utilizes to screen investment. Second, sources of funding may play an important role in understanding the types of risk taken and businesses in which investments are made. Most importantly, these distinctions are included in a host of variables that will affect a Fund's ability to achieve sustainable social returns on investment. The chapter will end with a comparison of the three Funds around the issues of Fund size, Fund investors and investment objectives.

Chapter three will explain and review results of a survey administered by this author to investors in Community Development Venture Capital funds. The survey focuses on the key investment objectives of these funders. The survey was administered as a web based survey³ and was 'distributed' to respondents by requesting their completion of the survey through email contact. CDVC funders approached included investors listed by CDVC Funds via their websites and/or annual reports and through contact information gathered at the March 2002 Annual Community Development Venture Capital Alliance (CDVCA) conference. This chapter will also address trends in the CDVC industry. This includes the move of many mature and relatively successful CDVC Funds towards larger capitalization and larger initial investments. For example, The Reinvestment Fund, closed its first fund in May 1998 at \$10M, and expects closing its second fund, Urban Growth Partners, at \$50M. It is proposed in this thesis that this industry growth will likely affect the types of businesses the industry is able and willing to invest in and potentially the social impacts achieved by these funds. Second, an introduction of new funders into the investor pool may have further ramifications on the industry, for example Silicon Valley Community Ventures has secured a \$10M commitment from CalPERS, the largest US pension fund for its second fund SVCV LLC II. Pension funds have recently played a big role in transforming the fundraising of traditional Venture Capital and although it is too soon to know if other pension funds will follow CalPERS lead, there could be significant impact on the CDVC industry by the introduction of these large pools of capital. The increased participation of banks as CDVC funders has also been well documented by the Community Development Venture Capital Alliance, and will be reviewed. The paper will then report on two new policies that may significantly affect the Community Development Venture Capital Industry. These policies, New Markets Venture Capital and New Markets Tax Credits are recent legislation that attempts to

³ See Appendix 1 for survey form. Two surveys were administered via phone after web based attempts elicited no response from investors.

increase the level of capital earmarked for small business equity investing, as well as provide a stimulus for new investors in CDVC funds. These two programs can potentially play a role in shaping where and how CDVC's conduct their business. This chapter will conclude with an analysis of the varied trends, and argue for increased attention to the alignment of investors and Fund investments.

Chapter four will discuss further the types of social impact indicators utilized by the industry and specifically by the three Funds detailed in this thesis. I will first analyze Funds social returns based on job creation/retention. This section will also introduce a new perspective to use when reviewing the social impact of CDVC funds, by investigating the Portfolio Company locations as they relate to urban/high poverty areas. I contend that this is an important tool to use to evaluate the social impact of CDVC Funds and can be relatively simple to conduct. This chapter will further make an argument for the need to increase the level of rigor and type of social impact indicators utilized and administered. Further it will be argued that the sources of funds used to capitalize CDVC Funds and the stated purpose of the industry necessitate increased attention paid to the social return component of the *double bottom line* investment strategy. This chapter will conclude by providing recommendations to capture opportunities to improve the social impact measurements as well as the industry benefits to increasing these measurements.

Chapter five will provide a conclusion to this thesis. I will synthesize the two key issues the thesis has addressed; influence of investors on CDVC investments and the impact of and overall lack of substantial measurement of the social returns provided by these types of investment. I will reiterate recommendations put forth in chapters three and four. This thesis concludes with a call to the industry to live up to its *double bottom line* credo and rigorously address the social impact that CDVCs are posed to make in urban economic development.

Why Study Community Development Venture Capital?

The study of Community Development Venture Capital is important to understand urban economic development for several reasons. First, economic development strategies have and continue to focus on entrepreneurship and business development as a vehicle for wealth accumulation and economic revitalization of low-income areas. The financial development of any business requires both equity and debt components. Community Development Venture Capital represents a unique method of introducing equity capital to businesses that may otherwise not receive or have access to equity. These companies also often locate in and/or employ residents of low-income urban areas. Second, Community Development Venture Capital proposes to incorporate both a financial and social bottom line. Because of this dual bottom line approach to investing, CDVC Funds have access to a variety of funding sources, such as foundations, philanthropic individuals, banks satisfying CRA credits, and other socially motivated investors. These investors often represent pools of capital that would otherwise be directed to some other community/economic development benefit. The degree to which, how, and the results of measuring social returns on investment are key to understanding the social impact of these funds and should inform how community/economic development dollars are allocated to this industry. Finally, as extensively documented, urban high poverty areas have been losing businesses to suburban areas for a long period in the US, activities that encourage development of inner city business that employ low income/low skilled inner city residents may be able to play a key role as a catalyst in encouraging the return of 'good paying jobs' into the inner city. Ultimately, "it is the engine of investment capital, coupled with entrepreneurship, that drives job and wealth creation".⁴ It is the expansion of these resources into the underserved low-income inner city that will contribute to the economic and physical revitalization of these communities.

⁴ p7 California State Treasurer 2000: "The Double Bottom Line: Investing in California's Emerging Markets" Policy Paper.

Chapter One

Economic Development & Entrepreneurship

Economic development has been popularly defined “as the process of creating wealth through the mobilization of human, financial, capital, physical and natural resources to generate marketable goods and services”.⁵ This relatively broad definition has been challenged by some, who believe that “part of the reason for the vigorous debate surrounding inner-city economic development is due to this definition”, and believe that there is a “tendency to widen the definition of economic development to include virtually everything...[and] individuals and organizations have tended to focus on one or a few specific elements of economic development ... and assert their primacy”⁶. Richard Bingham in Financing Economic Development simplifies this discussion to say, “essentially it [economic development] is the creation of jobs and wealth”⁷. Finally, Kieschnick and Parzen narrow this definition of economic development by tying it to the *type* of jobs and wealth created as, “an increase in economic activity that results in a wider distribution of the quantities being measured”⁸. This outlook specifies that not only are jobs and wealth created, but they are created in such a way as to increase the distribution of these capital gains. This is the definition of economic development the CDVC industry occupies; traditional Venture Capital may create jobs and wealth but Community Development Venture Capital is concerned with the quality of those jobs and the expansion of that wealth to new people/businesses.

Economic development, as a distinct initiative of American policy, is a late twentieth century phenomenon, with many tracing its modern history to the late 1960's/early 1970's. Ed Blakely, a prominent academic and practitioner of urban economic development, refers to the ‘three waves’ of economic development

⁵ American Economic Development Council definition

⁶ p310 Porter, Michael in *The Inner City* eds. Boston and Ross

⁷ p7 Bingham, Richard *Financing Economic Development*

⁸ p5 Parzen and Kieschnick *Credit Where Its Due*

policy. The first wave was industrial attraction, or 'smokestack chasing', the practice of many states to lure companies by using tools like subsidized loans or direct payments to companies for relocation expenses, tax deductions and industrial recruitment programs. The intention is to attract large businesses into a local market that will create a demand for large amounts of labor and increased property tax revenues over the long run. Natural conflicts that arise are the small number of very large businesses and the competition from other localities for this finite resource. The second wave began in the 1980's and "shifted the focus from attracting out of state firms to retaining and expanding existing firms"⁹. Tools used in this wave included technical assistance, increasing investment capital, business incubators and creating new businesses. The third wave, which it is hypothesized US economic development is currently experiencing, is focused on local economic development that creates strategic partnerships between private and public networks that leverage capital (both human and financial) to increase local business competitiveness. Blakely states that the coming of this 'third wave' does not necessarily circumvent the first two waves but rather provides a new way to address the economic development strategies of these two waves. Henry Cisneros, in his essay "Urban Entrepreneurship and National Economic Growth" confirms this shift from the old paradigm of economic development. He writes, "communities using this [new] approach examine their regions heritage, its comparative advantages, in light of its national and international market trends and develop a strategic vision to guide realistic development. They emphasize retaining existing entrepreneurs and helping them expand locally rather than relying on new firms from other regions to come in and spur growth."¹⁰

The focus on entrepreneurship and business development within the context of local and regional development is well positioned within the field of economic development. In the context of urban economic revitalization much of the focus

⁹ p230 Blakely, Edward *Planning Local Economic Development*

¹⁰ p4 Cisneros, Henry 1995: "Urban Entrepreneurship and National Economic Growth"

on entrepreneurship and business creation has been on entrepreneurial training, small business lending and recently microenterprise development. Each of these three aspects of business development is vital to overall urban economic development, and should be viewed as part of a continuum of policies and practices focused on increasing inner city entrepreneurship. Entrepreneurial training is a key component of making individuals 'ready' to begin or expand small business and is supported by various non-profits and Community Development Corporations concerned generally with capacity building among urban residents and business owners. Small business lending programs provide access to capital for individuals and companies that may not fit the underwriting profile of traditional commercial banks. Participants in small business lending range from Community Development Corporations to Bank owned CDCs, and various Community Development Financial Institutions (CDFIs). The Small Business Administration and the regulations of the Community Reinvestment Act further federally support small business financing. Finally, microenterprise programs, which gained currency in the 1990's and grew out peer lending programs in developing countries, generally fit both training and access to capital together to promote and support very small business development. These programs support home based business to small neighborhood scale industries, (generally with no more than five employees) and are centered extensively on the benefits of self-employment. These entrepreneurship programs, however, do not address two primary issues that are key to Community Development Venture Capital. First, the infusion of equity into small and growing businesses and second, growth-oriented businesses that currently or potentially have the ability to create employment opportunities for a significant amount of local residents.

In Planning Local Development, Ed Blakely identifies twelve basic tools central to business development in the inner city:

1. one stop centers
2. **start-up and venture financing**
3. small business development centers/small business lending
4. support for women owned enterprises

5. group marketing systems
6. promotion and tourism programs
7. research and development investment
8. incubation services/centers
9. microenterprise programs
10. technology and business clusters
11. empowerment zones
12. entrepreneur training

and a strategy which includes at least one of four basic initiatives;

- 1. encouraging business creation**
- 2. attraction of new businesses**
- 3. retention and growth of businesses**
- 4. increase in innovation and entrepreneurship of local residents.**

(bold mine; represents tools and strategies utilized by CDVC's)

Community Development Venture Capital may be seen within the context of both the 'new paradigm' of economic development as described above and as a mechanism that fits into several of the basic strategies laid out above for local inner city economic development. As will be further developed in the overview of Community Development Venture Capital to follow, the industry attempts to provide a new synthesis (third wave) of second wave economic development objectives. By increasing capital access to new and/or growing businesses (within specific industries/sectors) CDVC Funds seek to both spur and retain new businesses providing necessary equity and needed management assistance. These businesses are then better able to provide high wage/low skilled jobs for inner city residents. The Funds focus on business creation and retention, not attraction away from other regions. Additionally, CDVC Funds create new public/private networks to fulfill their missions. CDVC Funds pull from a diversity of human and financial capital. Management often comes from the community development field, as well as traditional Venture Capital or mainstream financial markets. The industry's funding sources include: government (local, state and federal), foundations, financial institutions, individuals as well as a recent introduction of pension and insurance company funds. They are able to leverage their investment in companies with investments by other private and public

institutions, creating a new network of stakeholders in business development, as described in the third wave of economic development put forth by Blakely.

Community Development Venture Capital's unique position within the realm of entrepreneurial-based economic development is two fold. To the degree that it is able to address the continued focus of business development in suburban areas or overseas, it is potentially a player in the reversal of this trend away from inner city business development. The industry's influence in the creation or retention of small to medium sized businesses that provide living wages in inner city locations that have, for the past thirty years, lost industry to outside locations can be seen as a vital contribution of this field. Second, and perhaps most importantly, Community Development Venture Capital is a crucial entrant in to entrepreneurial-based economic development because,

“risk capital funding (equity) is perhaps the weakest link in a strategy of entrepreneurial based economic development. Entrepreneur's access to risk capital is the single most critical barrier to business start-up and growth. Once personal and family funds are exhausted, entrepreneurs face the challenge of raising external capital. This task is daunting because most firms do not meet the stringent requirements of venture capital professionals”¹¹

This apparent dearth of, or difficulty in, accessing equity for entrepreneurs is well documented¹². In mainstream financial markets this equity gap is filled through several mechanisms. First, business owners will generally turn to their personal savings and assets in search of equity. Second, entrepreneurs will reach out to a wider social network of family and friends to informally 'invest' in their business. The next stage of equity investment will likely be the attraction of 'angel' investors into businesses. Angels are wealthy individuals who provide equity in exchange for an ownership stake in a company and may provide advice or technical

¹¹ p266 Bingham, Richard *Financing Economic Development*

¹² see Rubin, Julia S; Porter, Michael; Dymski, George

expertise (depending on the 'angel'). The final stage in equity investment is the institutional investor, or venture capitalist. Venture capitalists again, provide equity in exchange for an ownership stake in a company and will provide technical and management assistance to the companies in which it invests. This final stage in equity is arranged so that relatively large investments (\$5-20M) are made so that potential gains offset significant risks and transaction costs.

Equity investment, like all financial transactions, occurs within a market. A market is defined simply as the space within which funds flow between investors, borrowers and intermediaries. The assumption in capital market theory is that markets act competitively (perfectly) such that all of the players make rational decisions to achieve the highest return on investments given high degrees of safety, liquidity and ease of transactions. Whenever rational decisions that would efficiently allocate resources to 'good investments' don't happen, a failure has occurred. Competitive markets only work when several key things are in place. First, all information is known, second there are no barriers to entry into the market and third, there are no transaction costs. Practically this is rarely, if ever the case. Rational equity capital needs that are not satisfied by the traditional equity financing market can be considered a *market failure*. Community Development Venture Capital can be understood as a supply side response to a capital market failure of Venture Capital. CDVC's make investments in companies that the traditional Venture Capital industry does not because of a lack of information, or a perceived risk associated with a particular type of business or community; appreciably higher transaction costs than traditional Venture Capital given small investment size, lower expected financial rates of return and the absence of social returns factored into traditional Venture Capital economics.

Community Development Venture Capital therefore uses the financial model of Venture Capital in its infusion of equity into new and growing businesses in an attempt to combat the market failures. A brief discussion of the structure and

current state of Venture Capital is important to understand prior to an evaluation of the Community Development Venture Capital field. This paper will now turn to a review of traditional Venture Capital.

Venture Capital Financing

Fundamentally, Venture Capital does one thing, it provides equity capital for businesses to start, improve or grow their enterprise. It does this because most often companies and their owners lack the necessary capital to conduct research, purchase hard assets, secure debt or otherwise engage in activity that makes their firm more profitable. Venture Capital exists to fill that gap. This capital gap can occur for several reasons. "The four critical factors [are]: uncertainty, asymmetric information, the nature of the firm's assets and conditions in the relevant financial and product markets".¹³ Uncertainty is most poignant in new companies that do not have a proven track record. Without this track record companies are often unable to find financing from the traditional financial market such as banks and trade credit. Asymmetric information generally refers to the entrepreneur's knowledge about their business, which may influence business decisions. These decisions often seem ill advised to an outside observer because they are not privy to the same 'inside information' as the entrepreneur. A key third obstacle is assets. New businesses often have soft assets (like a patent or product innovation) they may not, however, have significant hard assets (like real estate); this limits their ability to obtain debt based on some form of equity/collateral requirement. Finally, various market conditions influence the general difficulty of securing financing for an unproven or expanding business.

Practically, venture capitalists do more than simply invest money in a company. Venture Capital has become a relatively institutionalized process with distinct mechanisms established to help ensure that the investment made will result in a profitable return. Venture capitalists often perform high levels of due diligence on

¹³ p127 Lerner and Gompers *The Money of Invention*.

a company, and look for strong management teams and new ideas that are likely to have a competitive advantage in the current marketplace. Once an investment is made, Venture Capitalists then often take an active role in their Portfolio Company, usually taking a seat on the company's board and will influence business and management decisions. Last, venture capitalist investors sell their investment through a variety of ways including management buyout or initial public offering's in the hopes of receiving a significant return on their investment to compensate for what they believe is a hefty risk in investing in that company. Venture Capital has been criticized for some of the Funds' aggressive Portfolio Company management tactics that may include; replacement of company management, sale of portions of businesses and other actions that may override the entrepreneur's choice for the business' direction. All this is done in an effort to secure the highest possible financial return on the VC's investment.

It is important to understand how Venture Capital, and therefore most CDVC Funds are organized to understand the opportunities and limitations of this financial tool. Venture Capital investments are organized through the raising of a 'fund'. A Fund is raised by *General Partners (GP)* who then attract *Limited Partners (LP)* to act as the Fund's investors. The General Partners take all of the responsibility for managing the Fund and for their work receive a management fee (usually 2%-3% of the Fund's capital) and 20% carried interest (or the returns from investment). The Limited Partners receive a return of their initial investment plus 80% of any additional returns on investment. A Fund will most often have a limited 'lifetime' of 10 years, within which Portfolio Companies are invested in and exited with (hopefully) positive returns on the investment. Traditional venture capitalists will generally look for expected rates of return between 25-40% (called a hurdle rate) during due diligence before making any investment. The industry long-term average rate of return is between 17-25%.

Traditional Venture Capital has grown in the past two and half decades from a

Table 1 Pricewaterhousecooper/Venture Economics/NVCA		
Venture Capital Fund Investment in United States Portfolio Companies		
Year	Companies	Investment(\$M)
1991		369.3
1992	1053	3826.0
1993	943	4563.0
1994	953	3794.1
1995	1144	5070.8
1996	1665	9639.5
1997	2270	14350.4
1998	2693	19175.8
1999	3835	52416.8
2000	5324	99636.5
2001	3058	36537.3

\$1B industry in 1976 to peak at a \$100 B industry in 2000. Table 1 illustrates this growth over the past ten years; the industry's capitalization approximately grew 1000% between 1991 and 2001.

For the year 2000 the funders of traditional Venture Capital were led by public/private pension funds, with banks/insurance companies and endowments rounding out the top investors (see Table 2). The expansion of pension fund investing indicates that overall industry growth is likely to continue. For example, CalPERS, the largest state pension fund in the US recently raised its venture fund investing from 5% to 16% of its investment portfolio. Pension funds control the largest concentrated amounts of 'investible' dollars in the US, and CalPERS is the largest pension fund in the US.

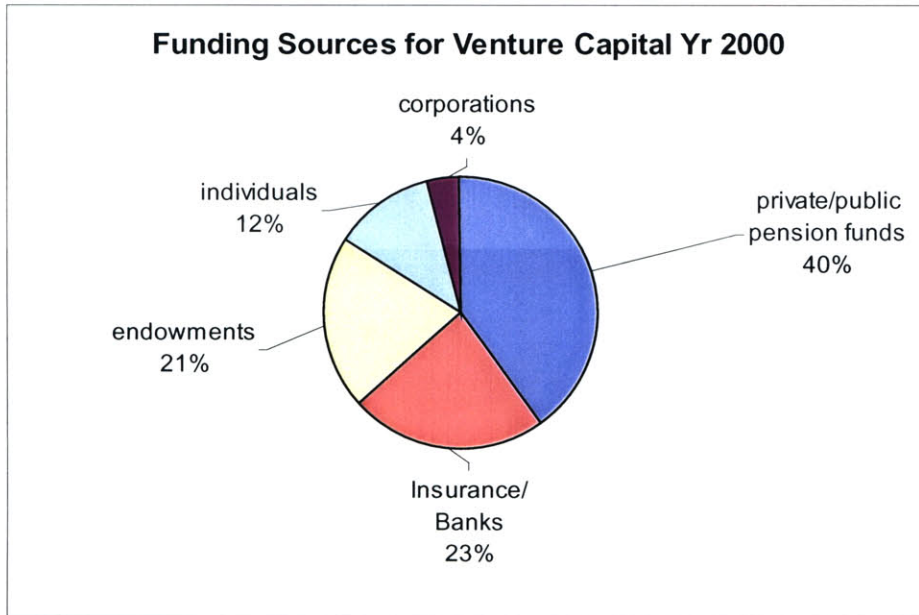


Table 2 Source Gompers and Lerner

In 2001 \$36.5B was invested¹⁴, down from historic investment activity in 2000 of \$100B and initial investment in portfolio companies was on average \$7M (again down from a high of \$10M in 1999 and 2000). Additionally, the average size of a Venture Capital fund was \$141.8M in 2001 (down from \$173.1M in 2000). In 2000 the investments by traditional Venture Capitalists by industry are as follows:

¹⁴ www.nvca.org 2002: "Venture Capital Investment Increases in Q4 for First Time Since Mid-2000 2001 Finishes as 3rd Strongest Year for Venture Capital" March 2002 .

INDUSTRY	AMT invested (in \$M)	% of total
internet specific	47851	46%
communications	17628	17%
computer software	14374	14%
semiconductors/electronic	6099	6%
medical health	3614	4%
other products	5279	5%
biotech	2764	3%
computer hardware	2279	2%
consumer related	1666	2%
industrial/energy	1424	1%
Total	102978	100%
<i>source: www.nvca.org</i>		

Table 3

It is expected that the Venture Capital industry will go through several fluctuations in the coming years. For example, in 2001 investment in biotechnology increased as an overall percentage of all Venture Capital investment from 3% in 2000 to 8.2%. Other industry focus changes may also occur. Additionally, overall Venture Capital investing has decreased since 2000 highs due to several key factors: 1) Over-saturation of Internet related investments and subsequent losses 2) Overall US economic downturn; 3) Events related to September 11, 2001 terrorist attacks.

Some Venture Capital experts go beyond the financial attributes of Venture Capital and insist that venture capitalists not only invest in risky companies that would otherwise not receive financial backing, but spur innovation and significantly contribute to regional economic development and job creation. A report sponsored by the National Venture Capital Association and conducted by WEFA (Wharton Econometric Forecasting Association) tracked all venture-backed companies from 1970 through 2000 to track their aggregate job creation and revenues for the year 2000. According to this study, these companies *created 4.3 million jobs and had revenues of \$736B in 2000*. This type of tracking shows that traditional Venture Capital may substantially contribute to job creation and the overall wealth of regional economies. Some believe this helps

to prove that, “Venture Capital can play a role in spurring the growth of new jobs, the employment skill base, and entrepreneurial activity.”¹⁵ They do not, however, discuss the nature of the job creation nor the types of entrepreneurs supported by the Venture Capital industry. The degree to which Venture Capital satisfies the definition of economic development as a mechanism to, “increase economic activity that results in a wider distribution”¹⁶ of wealth is not examined. Without this further distinction Venture Capital may be seen as a tool for economic growth rather than for economic development. Last, any discussion regarding the economic development merits of Venture Capital should be tempered by acknowledging that, “ the objective of a Venture Capital firm is to generate long term capital appreciation through debt and equity investment...[E]ven though Venture Capitalists assist in the creation of jobs and the economic development of business within a region, the important driving factor is the realization of substantial capital gains.”¹⁷

Community Development Venture Capital

Community Development Venture Capital (CDVC), like traditional Venture Capital, provides equity or patient capital to businesses in various stages of creation and growth. As such, the capital invested into CDVC Portfolio Companies is risky and the goal is, like traditional Venture Capital, to secure financial returns on investments that incorporate the high-risk levels (e.g. high risk = high return). CDVC's however incorporate an additional measure by which they evaluate potential investments, social returns. There is a diversity of social screens utilized in the CDVC industry. Most often the primary social screen is the somewhat ambiguous objective of poverty alleviation. Functionally, this has meant a focus on high wage/low skill job creation providing living wages for low skilled/low income workers. Additional CDVC Fund social goals include: growth of entrepreneurial capacity, promotion of minority and women owned businesses, expansion of good employment practices, production of goods beneficial to high poverty communities, promotion of environmentally sustainable businesses and

¹⁵ p8 Gompers and Lerner *The Money of Invention*.

¹⁶ p6 Parzen, and Kieschnick *Credit Where it's Due*.

commercial/economic development and stability of high poverty neighborhood or regions.¹⁸ As a final point, most Funds operate within a distinct geography; about half of all CDVC Funds are located within rural areas and focus on improving business opportunities for rural communities. The other half of Funds are regionally and/or urban focused and concentrate on low-income urban neighborhoods as their primary investment target area.

In the industry this dual focus (social and financial) is called the *double bottom line*. Taking into account the dual objectives of these Funds, and the subsequent limitations that places on investments¹⁹, expectations on the rates of financial return are often below the goals of traditional venture capitalists; expected rates are around 10-15% as opposed to traditional VC hurdle rates of 25-40% or higher.

CDVC Funds should also be seen within a greater community of alternative financial institutions that can in part be described as Community Development Financial Institutions (CDFI). Currently, CDFI's represent community loan funds, credit unions and increasingly Community Development Venture Capital funds. Approximately 550 organizations nationwide were identified as CDFIs and in 2001 they had combined resources of \$6B.²⁰ These organizations provide 'alternative financing' to a host of different projects from housing to childcare to social service organizations to businesses.

The first, (and still operating) CDVC organization is the Kentucky Highlands Investment Corporation, which in 1978 formed a venture fund to provide equity

¹⁷ p108 Davis, Barry *Entrepreneurship, Intrapreneurship and Venture Capital*.

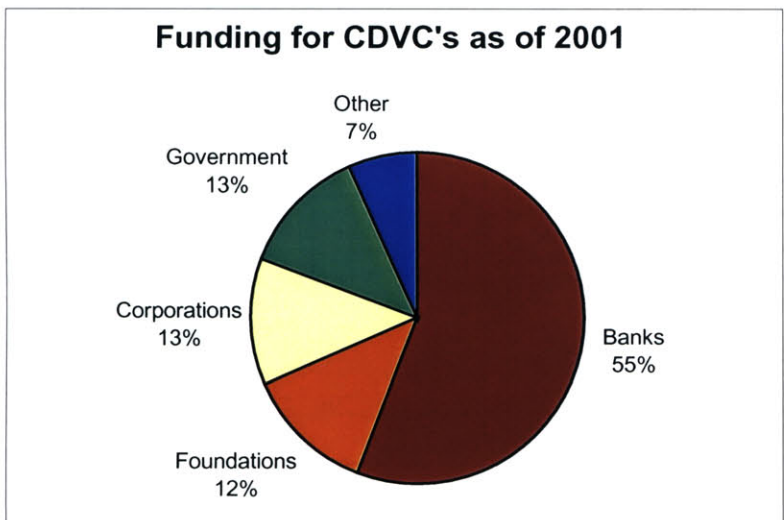
¹⁸ Schmitt, Brian T. 2001: "Measuring Social returns in Community Development Venture Capital" unpublished report sponsored by the Rockefeller and Hewlett Foundations, May 1, 2001.

¹⁹ As an example because CDVC funds are interested in the creation of 'good jobs', or living wage jobs for relatively low skilled workers, many focus on investment in manufacturing companies, as opposed to high tech companies which may also create jobs but likely create high skilled jobs inaccessible to many low income/low skilled workers.

²⁰ Nancy Andrews, 2001 : "Equity with a Twist: The Changing Capital Needs of the Community Development Field" April 2001.

investments for companies in or willing to relocate to Kentucky. Kentucky Highlands is a Community Development Corporation, and its venture fund was and continues to be primarily capitalized by the US government.²¹ Northeast Ventures of Minnesota, another Fund with a long history, was first capitalized in 1987 without the sponsorship of government but rather primarily by foundations.²² This model of capitalizing funds without the heavy reliance on government funding has become a trademark of the CDVC industry, focused instead on raising capital from financial institutions and foundations.

Table 4 Source CDVCA research presented March 2002



The field of Community Development Venture Capital is a small but growing industry. According to the CDVCA²³, there are currently sixty domestic Funds and ten international Funds.

Domestic Funds are capitalized at a total amount of \$400M. Much of this capitalization has come recently, with a growth of \$100M under management between 2000 and 2001. The Funds are predominately capitalized by banks followed by foundations, corporations, government and other (which includes insurance companies, individuals and recently pension funds). Of the sixty domestic Funds, the most common organizational structure is a non-profit, followed by limited partnerships.²⁴ CDVC Funds follow traditional Venture Capital structures. CDVC Funds have thus far invested in about 250 Portfolio

²¹ Rubin, Julia Sass 2001: "Community Development Venture Capital: A Double Bottom Line Approach to Poverty Alleviation" April 2001.

²² Ibid

²³ CDVCA presentation CDVC: An Update on the Industry, CVDVCA Conference March 2002

²⁴ CDVCA presentation March 2002 CDVC structures: 52% nonprofit, 17% limited partnership, 13% limited liability company, 13% c-corporation and 5% 'quasi-governmental as of end 2001-

Companies and this investment is most heavily concentrated in manufacturing, totaling approximately 49% of all investments. This contrasts starkly with traditional Venture Capital that has concentrated 80% of investments in high technology companies. The sixty Funds however, include Funds that primarily provide debt as well as those concentrated on equity investment. Of the sixty Funds there are currently twenty-five Funds that act primarily as an equity vehicle. These twenty-five Funds are most often organized as Limited Liability Companies, with the Limited Partner-General Partner management structure and had invested in 162 businesses by the end of 2000. Average total financing per Portfolio Company was \$330,000, significantly less than the initial investment levels of traditional Venture Capital at \$7-10M. Finally, these twenty-five equity focused Funds had exited approximately fifty-four deals: sixteen were written off, twenty were exited through external sales, six through near-equity loan payments, six through management buyback, five through IPO and one through an employee stock option (ESOP) by 2000. As calculated by CDVCA the net capital gains (losses) for year end 2000 for these twenty-five Funds was \$6.1M gains and \$2.1M in losses (\$4M gains) for for-profit Funds and \$7.9M (\$8.2M positive earnings and \$3M negative earnings) for non profit Funds. Social returns, measured in terms of job creation/retention, as of the end of 2000 include the maintenance of 11,788 jobs and creation of 4,590 jobs.

A 2000 report by Boston Community Capital²⁵ notes several current obstacles for the CDVC Industry. The three primary industry challenges noted are: 1) Growing to Scale; 2) Operating Challenges; and 3) Pipeline and Dealflow. The scale of the industry affects the ability of Funds to successfully invest and obtain its *double bottom line* in several different ways. Funds are on average relatively small. CDVC Funds are likely to be capitalized between \$5-20M. This reduces both the amount and size of deals that they can enter. The industry's youth leaves it without a substantial track record; many CDVCs have yet to exit their

²⁵ Boston Community Capital 2000: "No Exit" Phase I Report to the Ford Foundation October 5, 2000

first Fund. Finally, key informational and capital barriers exist, as people don't know what CDVC is and those who do have proportionately less money to invest in CDVC Funds. Operationally, CDVC's face several additional challenges: first, there is difficulty attracting top venture fund managers given the reduced pay scale of CDVC's. This effectively lowers the overall expertise CDVC Fund management. Additionally, the fixed overhead costs of due diligence on smaller deals, which fit both investment capabilities and social criteria, result in lower return margins given standard management fees for venture funds. Finally, pipeline and deal flow create unique challenges for CDVC Funds. CDVC Funds cite relationships with SBA lenders or other community economic development organizations as often their first entry point when locating potential deals. This has proved limiting because often these organizations focus on microenterprises or local independent shops which are often not suitable for equity investment. CDVC's have also reached out to Banks, other CDVC's and traditional venture capitalist to find deals. These again, suffer from the lack of a 'good fit'; often Venture Capital and bank referrals lack the social component necessarily to make a CDVC investment likely.

CDVC Funds have, however, continued to grow as noted above, and many Funds are currently raising second funds that will, at close, be significantly larger than their first. Additionally, the overall change in the Venture Capital industry (the bottoming out of internet companies) has made the CDVC return projects of 10-15% more reasonable in the current investment market. Finally, programs like New Markets Venture Capital and New Markets Tax Credits have introduced the federal government as a new financial partner in CDVC funds. These trends will be discussed in further detail in chapter three.

Alternative Venture Capital

It should be noted there is a long history of creating alternatives to the traditional Venture Capital industry to attempt to address some of the market failures addressed previously. The Small Business Administration (SBA) created two

programs, SBIC and SSBIC (formerly MESBIC) as mechanisms for attracting investment into small businesses. The SBIC program, established in 1958, provides SBA matching debentures for funds raised by venture firms which specifically focus on small businesses; Venture Capital firms can be designated as SBIC's and receive various benefits (but also restrictions) when investing in these businesses. Some SBIC's mirror traditional Venture Capital firms, though many are capitalized at smaller amounts and have smaller individual investments. SSBIC's were introduced in 1969 and are Venture Capital firms which focus on investing (both equity and long term debt) in minority owned businesses. This program was intended to work similarly to the SBIC program with the distinction of investing in enterprises owned by minorities. This program has, however, been phased out and only those venture firms existing prior to 1995 are licensed and can still operate under this program. The US Congress terminated the licensing of new SSBIC companies because, among other reasons, they have on the whole been deemed as unsuccessful in providing equity capital to growth oriented minority businesses²⁶. It is important to note that, in addition to SBA funding, these two programs often receive funding from financial institutions that can, in many cases, receive CRA credits for their investments.

Many states have also established state sponsored Venture Capital funds, these programs generally began in the 1970's and have continued since in various incarnations. Many times these Funds focus on encouraging particular types of industry within a state. These funds are important to mention within the context of CDVC because they often have their own 'social screens' that may include a particular type of business or business owner (minority/women) or particularly geography currently underserved by Venture Capital. Most recently a 'new' type of state sponsored Venture Capital has begun to grow, Certified Capital Companies (CAPCOs), which are funded by insurance companies. "As an

²⁶ Please see Timothy Bates for a detailed discussion on SSBIC's and their creation, operation and effectiveness on encouraging minority entrepreneurship.

incentive to invest in CAPCOs, insurance companies receive a \$1 credit on premium taxes for each \$1 invested (tax credits are spread over ten years)".²⁷ As of November 2001 five states had CAPCOs operating in their state and eight additional states were in the process of legislating these entities. Primarily, CAPCOs are intended to promote venture activity within the sponsoring state or particular sections of that state with a potential additional requirement to focus on early stage business. However, an in depth discussion of these alternative venture capital funds is not within the scope of this paper.

Below is a chart which briefly compares traditional Venture Capital, Community Development Venture Capital SSBIC'S and SSBIC'S along the target categories: company size, company stage, industries, social return, financial return, investment horizon, investment form, restrictions on investment, geographic limitations and average investment size.

²⁷Barkley, David L., Markley, Deborah M., and Rubin, Julia Sass 2001: "Certified Capital Companies (CAPCOs): Strengths and Shortcomings of the Latest Wave in State-Assisted Venture Capital Programs," *Economic Development Quarterly*

Comparison on Venture Capital Fund Models in the United States

	Traditional VC	CDVC	SBIC	SSBIC
Target Company Size	Medium-Large	very small -small	small -medium	very small-small
Target Company Stage	all stages (focus on later stage)	early-growth stage	early -growth stage	all stages
Target Industries	high tech bio-tech services	none (some focus on manufacturing)	high tech bio-tech services	all industries
Target social Return	none	job creation asset creation environmental protection entrepreneurial development goods and services for socio-economically disadvantaged and minority groups inner city/rural revitalization	small business development	small business development for minority and economically disadvantaged entrepreneurs
Investment Form	equity	debt & equity	debt & equity	debt
Investment Horizon	short-medium term	short-long term	short-mid term	short-mid term
Restrictions on Investment	none	none (provide social return)	SBA small business	SBA, minority/women owned
Average investment Range	\$5-\$10M	\$300,000-\$1M	\$1-\$5M	unknown
Geographic Target	regional national international	low income communities regional state	regional national	regional national

Table 5 modified from BCC Phase I Report to the Ford Foundation October 5, 2000

The differences between these four models of Venture Capital illustrated above consist of three primary variations. First, there are distinctions in the business sectors that each Fund type is most likely to invest in. Traditional VC is looking most often to invest in very high growth, likely IPO businesses; this has created a focus on high tech industries which have in recent history proved to provide the most substantial returns. SBIC's are also active in this market, most often with similar sector companies that have a reduced capacity for large-scale equity

investment. SSBIC's have traditionally focused more of their investment in equity-like products. As opposed to true equity, this debt investment has required SSBICs to look for businesses with high levels of hard assets to provide asset based lending products. In fact, one of the primary businesses that SSBICs have successfully invested in is taxicab medallions, with a high asset worth. CDVCs have both equity and debt investments, twenty-five of the sixty CDVC Funds primarily provide equity to their Portfolio Companies. The Portfolio Companies most likely to create good quality jobs, has translated into a focus on the manufacturing sector, which is generally a slower growth industry, and less likely to achieve IPO status. Fund capitalization is the second key difference. SBICs and SSBICs rely heavily on government financing and to varying degrees on debt from the SBA. Traditional VCs are invested at higher levels and almost solely with equity investment. CDVC Funds have a variety of funding sources, are capitalized at relatively small amounts, but increasingly are being capitalized by banks that use the investment as a satisfaction of their CRA requirements. As referred to above, these four VC models provide varying levels of investment. This third difference is illustrated by the relatively large traditional VC investments of \$5M-\$20M, the SBIC investment size of \$1M-\$5M, and the CDVC investment average of closer to \$300,000-\$500,000. As it has been laid out it seems that these four models of Venture Capital investment have investment strategies that do not overlap. They are differentiated by investment size, investment sector or investment capabilities and philosophy. The degree to which they remain separate, yet each fulfilling a particular unmet capital need in a profitable manner, appears likely to satisfy distinct niches in the equity financial market. However, as will be illustrated through this thesis, changes in the CDVC industry may change its ability to satisfy its current strategy of; low investment size, and manufacturing (high job quality) sector focus guided by socially motivated criteria.

Chapter Two

This paper will now turn to three brief case studies used to examine the mission and the investment philosophy as well as the influence of investors on CDVC Funds. The CDVC Funds were chosen for the following reasons. The three Funds, Boston Community Venture Fund, Silicon Valley Community Ventures and Murex Investments are all urban based and primarily urban investment focused Funds. All three Funds, as with most CDVC Funds, place job creation as their primary social impact return. These Funds have also embarked on the raising of a Fund II, however through different strategies, and are at different stages of capitalization. Finally, attention was paid to geographic diversity. Key members of each fund were interviewed²⁸ during March 2002 to collect the primary data for these cases studies; additional information was provided by public and internal Fund documents as well as industry documents.

Murex Investments

Fund Development

Murex Investment (MI) is a Community Development Venture Capital organization located in Philadelphia, Pennsylvania and was founded in 1998. Murex Investments is a wholly owned subsidiary of Resources for Human Development (RHD), a multi-service workforce development organization that has focused significantly on increasing and supporting employment opportunities for the mentally challenged. RHD is a \$90M nonprofit founded in 1970 and currently operates over 130 social service oriented programs. The mission of Murex Investments is to *invest in companies that transform distressed areas by maximizing social and financial returns for investors, entrepreneurs and employees*. To ensure the satisfaction of this mission, Murex Investments requires that each business it invests in, “locate in a distressed area and/or

²⁸ See Appendix 3 for interview questions.

employ a majority of low income people; pay a living wage with benefits; and offer profit-sharing and ownership to all employees.”²⁹

The investment strategy of Murex Investments Fund I has been influenced by a pedagogy that strongly supports worker ownership. The initial interest in beginning a CDVC Fund was the ideal of replicating the business practices of Mondragon in Basque, Spain.³⁰ The Mondragon Cooperative Corporation (MCC) has been upheld as an example of a successful organization based on the fundamental principles of worker inclusion and democracy. Today, the company is comprised of about 150 cooperatives in the Basque region of Spain; the cooperatives employ roughly 42,000 workers. The main focus of the Association of the Mondragon Cooperatives is the creation of owner-employee jobs; MCC also has a unique approach to business development. The new enterprise and the MCC bank agree to stay together until the business is profitable. If the business runs into trouble the bank will loan additional capital at roughly half the initial rate. If the company is still in financial trouble the interest rate will be dropped to zero, and if more assistance is needed the bank may donate capital to the business. Eventually, even if the company has to go through drastic changes like new managers or new product lines, the business becomes successful and is able to repay the loans. This pedagogy influenced MI to initially concentrate on solid businesses in need of ‘turn around’ assistance, the idea is to add the capital necessary for a company to eventually become successful, instead of divesting in a company because of its current financial troubles. The value is placed on the retention of the company, the quality jobs it creates, and the incorporation of employee ownership in to business plans. MI’s strategy to address these issues is by providing intensive technical assistance for the necessary improvements to business practices. Murex Investments was able to follow this investment philosophy, a decidedly risky approach to investing in ‘near death’ turn around companies, in part because Fund I’s capitalization was

²⁹ Murex Investments internal document .

³⁰ Interview Murex Investments Fund Manager March 2002

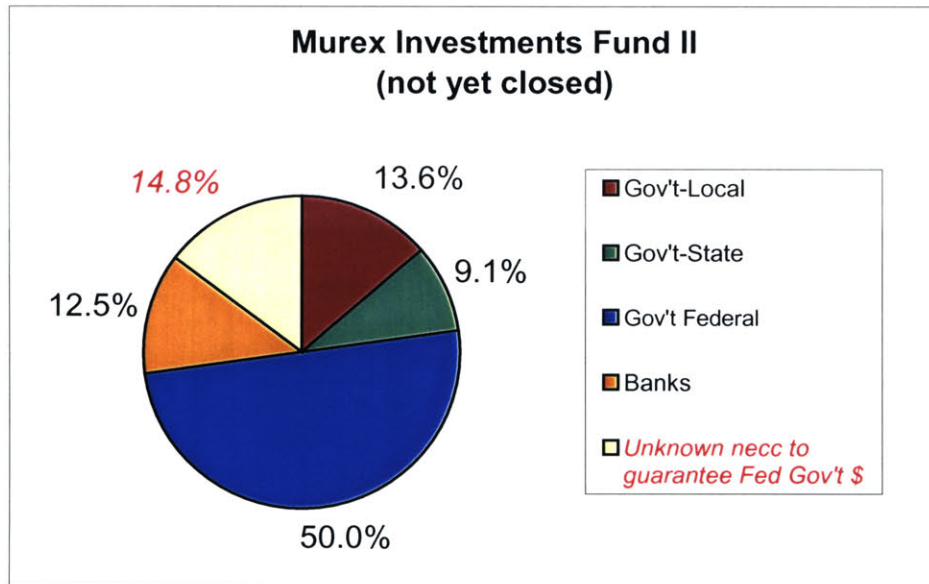
made up entirely of grant funding.³¹ They were able to adhere very closely to the maintenance of their social impact strategy with each investment. Murex Investments believes the key component of their investment strategy is to provide intensive technical assistance to companies.

Investors and Investment

Murex Investments capitalized its first Fund at \$5.2M and invested a total of \$2.75M of Fund I in seven companies. MI believes that these investments have resulted in the creation or retention of 200 'quality jobs'. Fund I was capitalized 100% by grant funding with no requirements for financial return on investment. Fund I investors were two banks, City and State government. Any returns received by this first Fund were to be reinvested in the Fund, not distributed.

For their second Fund Murex Investments has been designated as a New Market Venture Capital organization. This new federal program (to be analyzed in further detail in chapter three) provides the Fund with \$5.5M of debenture, at 6.5% interest, from the (SBA) given they are able to raise an equal amount of capital from non-federal government sources. Additionally, this designation comes with a \$1.65M grant for technical assistance given Murex Investments can raise a matching \$1.65M in grants for technical assistance. Currently, MI has raised \$4.25M of the required match and has until the end of 2002 to raise the additional \$1.25M required to receive the NMVC matching debenture. Assuming that Murex Investments receives \$5.5M from the NMVC designation their current capitalization of Fund II is represented below:

³¹ Ibid



For Fund II Murex Investments is anticipating a financial return of 10%-12%, and will invest in approximately thirty companies, an average of \$350,000 per Portfolio Company. Murex Investments has further defined its investment criteria in Fund II. They propose four broad categories of financing opportunities.

1. Growth Companies: Murex investments expects to invest between \$400K-\$600K per deal in 8-10 companies.
2. Turn-arounds: MI expects to invest \$300K-\$500K in four high growth turn around deals.
3. Early Stage/Development: Murex Investments intends to invest in six to eight early stage companies at an average of \$75K-\$150K and to utilize its grant funding for technical support significantly in this category of business.
4. Expansion/ESOP's: MI will invest \$300K-\$600K per deal in six to eight expansion/ESOP deals.³²

Fund II has several key differences from Fund I. First, unlike Fund I, Fund II is funded by a mix of debt and equity investment, all anticipating some type of return on investment. The government investors (local and state) anticipate, at a minimum, return of their capital. The federal government anticipates a return of principle and accrued interest on debt, local and state government investors will

³² Murex Investments internal document.

participate in any additional returns on investment. Financial institutions expect returns comparable with the MI projections of 10-12%, and satisfaction of CRA credit requirements. The changing investors have significantly affected the investment strategy of Murex Investments. Where in Fund I they focused on 'very high risk' investments that had the potential to significantly satisfy MI's social impact goals and overall philosophy, Fund II will take a more even approach to investment. It plans to pursue some investments that are more capable of providing higher financial returns while satisfying less of the social mission of the Fund. This translates into a hybrid approach of investing, aiming to have a blended return rate of 10-12%, acknowledging that some more socially beneficial deals will be offset by more traditionally financially viable deals.³³ Fund II will reduce its emphasis on turn-around businesses, drawing Murex Investments away from its original Fund development motivations.

Silicon Valley Community Ventures

Fund Development

Silicon Valley Community Ventures (SVCV) was founded in 1998 as a nonprofit organization that manages Silicon Valley Community Ventures Investment Partners, LLC I. The organization began as a response to both the tremendous wealth generated in Silicon Valley in the late 1990s and the inequality of that economic growth. SVCV attempts to "address these inequities, by providing Venture Capital, business advice and critical business resources to businesses in low-income communities throughout the Bay Area"³⁴. Its mission is "*to invest in and develop businesses, which provide substantial economic benefits to low income communities.*" In addition to this stated mission, SVCV's work is based in part on a philosophy of bridging gaps between different sets of people and communities, creating new business networks among parties that have

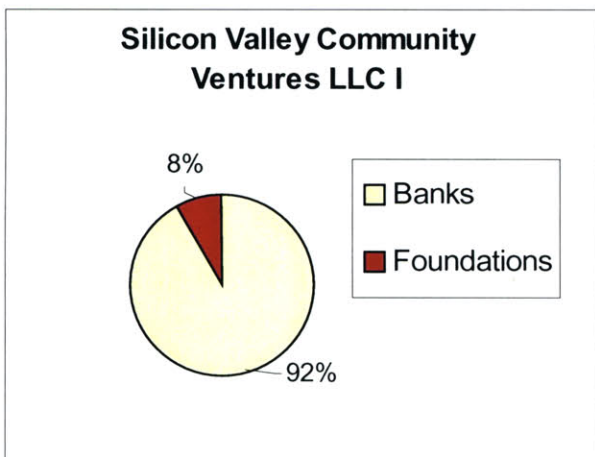
³³ Interview with Murex Investments Fund Manager March 2002.

³⁴ SVCV Case Study presented at CDVCA conference March 2002.

previously been unknown or inaccessible to each other yet mutually beneficial³⁵. SVCV provides two integrated but distinct services to the communities and businesses it serves: 1) Investment Capital; 2) Business Advisory services. Business Advisory services are provided by a network of *pro bono* business executives/successful entrepreneurs that agree to provide long-term support and technical assistance to businesses that qualify for the program. Currently, only companies who participate in this program are then able to acquire SVCV equity investment, however not all businesses assisted through this program will receive SVCV investment. SVCV has invested \$2.23M in nine Portfolio Companies and has advised a total of forty-one companies (including those invested in).

Investors and Investment

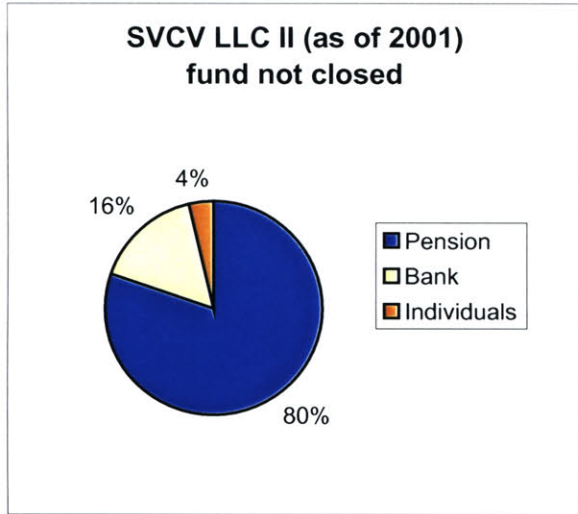
Silicon Valley Community Ventures Investment Partners LLC I raised a Fund of \$6.25M. \$5.75M (or 92% of investment for Fund I) came from banks and \$.5M (8%) was invested from foundations. SVCV is currently raising SVCV Investment Partners LLC II and (as of late 2001) it is capitalized at \$12.45M. While this fund is not yet closed current investment/commitments are broken down as follows: \$10M from pension funds, \$2M from bank investors and \$.45M from individual investors. The projected capitalization of this fund is \$25M. The inclusion of a



large pension fund investment in Fund II is seen by many in the Community Development Venture Capital industry as a coup, representing a new and deep pool of potential investment for this industry. That SVCV was able to secure funding from the largest and most highly capitalized pension fund in

³⁵ Penelope Douglas, CEO of SVCV at CDVCA conference March 2002.

America is also seen as a positive next step in the development of CDVC Funds.³⁶ SVCV is expecting a 10-15% rate of return on equity investments in Fund II. SVCV plans to revise its investment strategy in Fund II by creating a



blended fund. SVCV will provide two groups of funding. **Group A** will represent equity investments in later stage companies and **Group B** will represent investment in earlier stage companies, those requiring significant technical assistance through the Advisory group, and will include both long term convertible debt as well as equity.³⁷ The goal is to create a Fund that will both provide expected rates of

return of 15% and also have the capacity to accept larger equity investments as Fund capitalization rises. SVCV's investment strategy for Fund II has also changed from Fund I as Murex Investments did. Silicon Valley Community Ventures will take a hybrid approach such that, "Investments in high potential companies with a high need for SVCV services, good financial and high social return will be balanced by strong companies with high financial return potential, little need for additional SVCV services, and good social return."³⁸

³⁶ CalPERS committed \$10M in SVCV Investment Partners II through its Innovative New Funds" category within CalPERS' "California Initiative," a \$500 million private equity investment program targeting development in California's underserved markets.

³⁷ Interview with SVCV Fund Management March 2002.

³⁸ Interview SVCV May 2002.

Boston Community Venture Fund

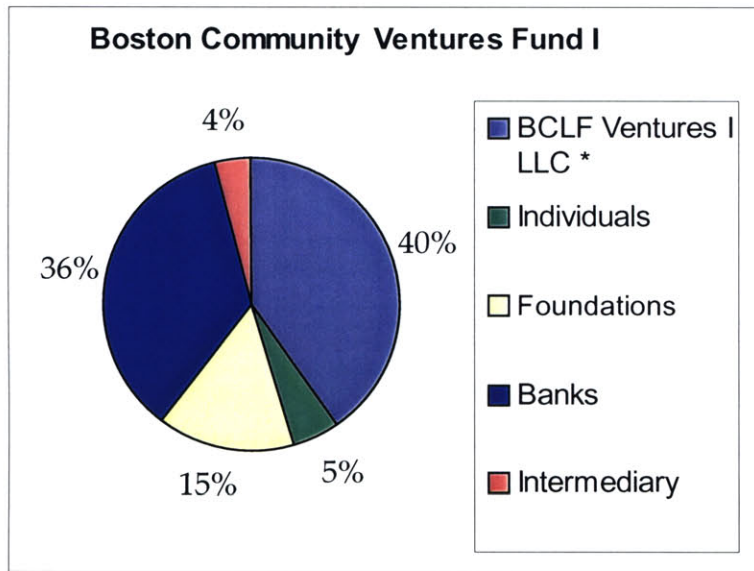
Fund Development

Boston Community Venture Fund is a nonprofit CDVC established in 1996. BCVF is an affiliate of Boston Community Capital, founded in 1985 as a Community Loan Fund, and one of the first designated Community Development Financial Institutions (CDFI's) in the United States. The affiliate, Boston Community Loan Fund, has acted as a financial intermediary providing over \$70M in loans over the past seventeen years to organizations involved in affordable housing and community development projects/organizations in Massachusetts' low and moderate-income neighborhoods. BCVF's mission is an extension of Boston Community Capital's mission to, *"build healthy communities where low-income people live and work"*. Boston Community Venture Fund fulfills this mission by "providing the needed equity investment to high potential, emerging businesses that create stable jobs, provide quality goods and supply valuable markets which enhance the environment or reduce pollution; or that can otherwise demonstrate a sufficiently socially responsible purpose to the satisfaction of the Fund."³⁹ Boston Community Venture Fund considers itself an 'urban community venture fund' and focused in high poverty Massachusetts areas with its first Fund, Fund II however, has expanded the target geography to all of the Northeast. Further, while BCVF's has maintained a urban/regional target it defines this focus broadly. For example, a company may be located in the suburbs but draw a considerable portion of its employees from nearby urban areas; this type of business could likely be a BCVF Portfolio Company.

Boston Community Venture Fund further defines its investment philosophy. They diligently invest in only those companies for which the social impact goals of BCVF are satisfied 'naturally' by the business and make rational business sense. Practically, this means BCVF is interested in Portfolio Companies who will have some logical reason for locating within a high poverty area, or need for

³⁹ BCVF Investment Policies and Procedure, internal document .

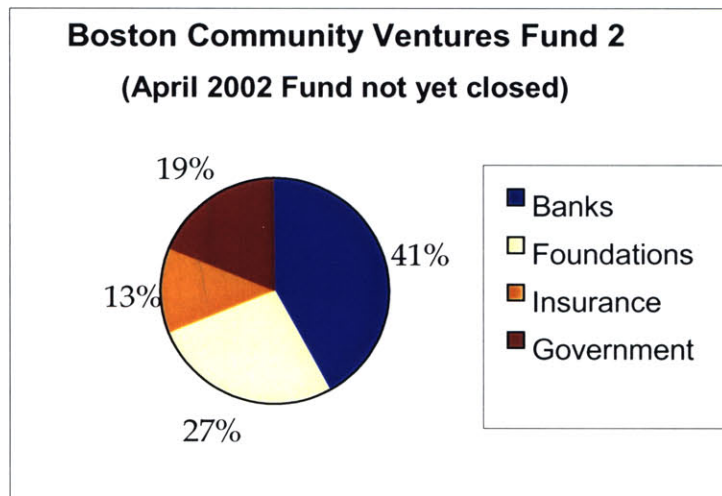
relatively low skilled labor. BCVF will not invest in, nor encourages, Portfolio Companies that move to a particular location, specifically to take advantage of BCVF or other funding opportunities. In this sense, BCVF believes it pinpoints situations where otherwise potentially profitable businesses are explicitly left out of the traditional equity market. They do not look to manipulate businesses to satisfy their social impact goals.



Investors and Investments

Fund I⁴⁰ was capitalized at \$5.2M and made investments ranging from \$50,000 to \$650,000. Fund I made investments in eleven Portfolio Companies, and have exited three. One investment was

liquidated, and second resulted in the sale to company management of preferred stock with a 17% return on investment and the final resulted in a partial loss of investment. These investments were relatively small, two at \$50,000 each and the sale of preferred stock of \$130,000. BCVF has been in the process of raising its



⁴⁰ * While BCLF invested 40% in Fund I, the capital for this investment was obtained by receiving loans from Boston Community Loan Fund. Several financial institutions financed this and collectively provided \$1.65M in equity equivalent notes the BCLF.

Fund II since year-end 2000, and has had one closing. Fund II expects full capitalization at \$20M, and currently has \$15.9M committed/received and \$3M in discussion (as of April 2002). Fund II has already made four investments and made a commitment for a fifth.

Fund I and Fund II will have several strategic differences. Already, the Fund II investments are significantly higher than Fund I, the range of invested and committed dollars is \$200,000-\$750,000, (vs. \$50,00-650,000) and the minimum investment for Fund II was raised to \$100,000 and maximum raised to \$1.5M. Further, Fund II has established specific Portfolio Company assumptions and will focus the bulk of its investments (52%) on growth oriented business, 27% of capital is slated for early stage business and 21% of capital for expansion of businesses. This breakdown further estimates that the average investment will be just over \$1M per company.⁴¹ These projections are based on the increased experience of the Fund management and recognize the monitoring capacity of each Fund partner given larger Fund capitalization. Fund II is a larger Fund resulting in a change of investment focus “we [BCVF] tend to put to work larger amounts of money per deal...and hence that may preclude doing deals that are too early and/or undeveloped”.⁴² Another difference between Funds I and II is the expansion in target area. Fund II will focus 50% of its capital within Massachusetts and 50% will be available for investment throughout the Northeast. Finally and significantly, Boston Community Venture Fund made no commitments for financial returns during the course of raising Fund I, however projects an 11%-15% return as it continues to raise and invest Fund II.

One key investor change between Fund I and Fund II is the absence of individual investors. BCVF has not pursued individual investors in Fund II. This was done for several reasons. First, BCVF’s track record was such that larger investors showed significant interest in investment and second, because individual

⁴¹ BCVF II, LLC Private Placement Offering August 2000.

⁴² BCVF Interview May 2002.

investors, on average, had less capital to invest. There is a sentiment that the inclusion of large national foundations and their collective increased investment places additional pressure in Fund II to clearly identify and maximize social benefits of each investment.⁴³ Finally, Fund II has acquired investment from the insurance industry⁴⁴, introducing a new category of investor into Boston Community Venture Fund.

⁴³ Ibid

⁴⁴ Investment made as part of the Property/Casualty Initiative which requires Massachusetts insurance companies to make investments within the communities they serve.

Fund Comparisons

	Murex	SVCV	BCVF
Capitalization			
Fund I	\$5.2M	\$6.25M	\$5.2M
Fund II (projected)	\$11M	\$25M	\$20M
% growth in capitalization	112%	300%	285%
Largest Limited Partner			
Fund I	Local Gov't	Banks	Banks
Fund II (not yet closed)	Fed Gov't	Pension	Banks
Project Financial Return			
Fund I	0%	10%	0%
Fund II	10-12%	10%-15%	11-15%
Average Invest Size			
Fund I	\$390,000	\$248,000	\$470,000
Fund II (projected)	\$350,000	\$1,000,000	\$1,000,000
% change	-10%	+303%	+113%
Investment Objectives			
urban	✗	✗	✗
job creation for low income workers	✗	✗	✗
career training/job ladders	✗	✗	✗
local ownership	✗		
worker ownership	✗		
entrepreneurial growth	✗	✗	✗
support women and minorities			✗
environment			✗
investment in high poverty areas	✗	✗	✗
increased goods and service			✗

Table 6 Fund Comparisons

This chart above summarizes the three case study Funds along several lines to illustrate some of the synergies between the Funds as well as highlight the changing nature of CDVC Funds as seen through these organizations. First, each Fund's capitalization will grow considerably given current Fund projections. Murex Investments will see the lowest growth at 112% and SVCV the highest at

300%. Following this capitalization growth is a growth in investment averages for two of the three Funds. SVCV and BCVF will raise average investments to \$1M, an increase of over 100% for both Funds. Murex Investments will maintain the same relative levels around \$350,000. Murex Investments is in line with CDVC industry specifications that indicate the average industry investment is \$330,000, while SVCV and BCVF will be far ahead of industry average. Additionally, all three Funds raised the financial rate of return projections between Fund I and Fund II. These changing levels of investment and their potential implications for the CDVC field will be explored in the next chapter. Finally, a review of each Fund's stated⁴⁵ investment objectives show some important synergies. All three funds are focused on urban investments, job creation for low-income workers, career paths/job ladders general entrepreneurial growth within their investment, geography, and investment in high poverty areas. These synergies play a key role in determining the types and methods of social objectives measurement that should be completed by each Fund and the industry as a whole. Chapter four will revisit these synergies when exploring each Fund's social return measurements.

⁴⁵ Other investment goals may play a part in investment decisions or Funds may include goals not demarcated for them in this chart, however they are not explicitly stated in investment written investment criteria reviewed by this Author .

Chapter Three

Chapter three will focus on the relationships between Funds and their investors. It will introduce data collected during a survey of CDVC Fund investors, present key funders investment criteria discussed at the CDVCA Annual Conference March 2002, and analyze both the potential impact of new legislation on investment as well as the case information provided above. This section will report on the changing nature of funding for CDVC's and explore potential effects they may have on the CDVC's investment strategy.

Survey Methodology

The survey was administered over the Internet as a web-based survey⁴⁶. The survey was sent to twenty-three investors in urban equity focused Community Development Venture Capital Funds. The dissemination of the survey was limited by several factors: 1. The CDVC industry is relatively small; there are only sixty funds and of that number only twenty-five are equity-focused funds; 2. This thesis is concerned only with urban funds, which represent about half of all CDVC funds; 3. The funders of CDVCs are not necessarily public information, and thus finding who they are can be an obstacle; 4. Time was a constraint. However, given the limited number of investors contacted to participate in the survey, the response rate of 52% (twelve investors) and completion rate of 43% (ten investors) is respectable. Finally, the information gathered in this survey was not intended to establish statistically significant results, but rather provide an illustrative context from which to explore CDVC investors.

Survey Results

The survey was given out to twenty-three CDVC investors. The survey distribution was 57% to banks/financial institutions, 39% to foundations and 4%

⁴⁶ Please see Appendix 1 for an example of the Community Development Venture Capital Investor Survey, two surveys were administered via telephone; all surveys were completed between March 10 –April 2, 2002.

(1) to government organizations. However the completion rate did not represent this same distribution. Survey response was 50% foundations 50% banks/financial institutions and 0% government organizations. Finally, this compares with overall industry funding (equity and non-equity focused Funds) of Banks (55%), Foundations (12%), Corporations (13%), Government (13%) and Other (7%).

Summary of Survey Results	Banks	Foundations	Total
Total Amount Invested	\$204M*	\$12.5M	\$216.5M
Number of Funds Invested in	40*	8	48
% providing debt	0%	20%	10%
% providing equity	100%	60%	80%
% providing both	0%	20%	10%
Use Investment to Satisfy CRA (banks only)	100%		
Use PRI's to Fund Investment (foundations only)		40%	
How do you weigh your investment returns?			
equal social and financial	80%	100%	90%
solely social	20%	0%	10%
solely financial	0%	0%	0%
Would you invest in a CDVC fund again?			
yes	80%	100%	90%
probably	20%	0%	10%
doubtful	0%	0%	
no	0%	0%	
<i>*result is heavily skewed by two Banks which includes SBIC/SSBIC investments with CDVC</i>			

Table 7 Source Authors survey

The summary of survey results⁴⁷ above indicates that Banks are more likely to invest equity in CDVC Funds than foundations. Sixty percent of foundation survey respondents invested equity in CDVC Funds, compared to 100% of bank investors surveyed. This survey also indicates that Banks that do invest utilize their investment as part of the satisfaction of Community Reinvestment Act⁴⁸ investment requirements. This was further confirmed through individual interviews with bank CRA investment officers who stated that if CDVC Funds did

⁴⁷ Please see Appendix 2 for complete survey results.

⁴⁸ The Community Reinvestment Act has three 'tests' a financial institution must pass in order to receive positive ratings investment in CDVC's satisfies the investment test of CRA.

not qualify for CRA credit their bank would not invest in these Funds⁴⁹.

Interestingly, while almost all respondents indicated they weighed the financial returns and social returns equally they also indicated they would invest in a CDVC Fund again, even though evaluation of financial returns was considered premature.

Financial rate of return expectations varied among the different respondents. The range went from a low of 1% interest on long-term debt to a high of 20% rate of return on equity. This high degree of variation may indicate: 1. A diversity in the CDVC Fund's and their ability to achieve particular returns; 2. A diversity in the type, length and expectations of funders and their investments; 3. An over or under estimation of the Fund's ability to achieve financial returns (either by the Fund or the Investor). There are likely other reasons for such a wide range in expected rates of return, however, the variety is noteworthy. The industry is still young, and as such has not yet established a track record; this makes it difficult for both the Fund and potential investors to make reasonable estimations of the type and likelihood of returns. Importantly, for the CDVC industry, this variety which thus far is not based on actual returns may also influence potential investments toward certain 'financially high performing' Funds as stated by Fund managers' projections. This concern was voiced by one Fund Manager who stated, "The diversity in the type and amount of social returns that CDVC Funds accomplish may affect their ability to achieve high financial returns, however, if investors receive the same benefits (tax credits or CRA credits) regardless of specific social measures, they are likely to invest in the financially high performing Funds. This limits other funds with higher social returns but lower financial returns from attracting these investors."⁵⁰ The diversity in expected financial rates of return was also noted as a key challenge in investing in CDVC Funds. One bank investor during a phone interview stated that their institution is working to create a financial returns matrix to better evaluate the types of returns

⁴⁹ Interviews conducted at CDVCA Annual Conference March 4-6.

⁵⁰ Interview with Murex Investments Fund Manager.

it should expect from CDVCs. Currently they use long-term Venture Capital rates of return as their benchmark.

Most respondents indicated that CDVC Funds had made investments that 'met expected social goals'. However, one investor responded that the CDVC Fund had fallen short of social goals and another stated the Fund had exceeded expected social goals. This indicates that thus far investors feel that CDVC funds have been able to meet the types of social goals they state they will reach.

Last, there were some further indications of differences between financial institutions and foundations. Two indicators were expected financial returns and primary social returns desired. Foundations responded that their expected rates of financial returns were between 1% and 10%. One percent return expectation was on debt and expectations for equity investment ranged from 5-10%. Banks, on the other hand, provided only equity and their expected rates of return were between 10-20%. Even when taking out differing return expectations for debt and equity, foundations still peaked at a 10% expected return on equity, versus banks whose minimum was a 10% return on equity. This is an important difference because, as identified by the CDVCA, financial institutions are the primary growing investor pool for CDVCs. The growth of banks may then increase the pressure for CDVC Funds to provide higher financial rates of return. These higher return expectations likely require CDVCS to invest in higher growth industries that may or may not be aligned with social return objectives.

Second, there was an interesting difference in the primary social objective of investments between foundations and banks. Foundations were most likely to cite job creation as the primary social driver for investment, yet banks most often cited the expansion of women and minority businesses owners as the primary driver. This is interesting in light of the three case study Funds. All three consider investment in minority and women owned business a positive aspect of investment, but only BCV incorporates this social objective explicitly in its

investment strategy. It is not clear whether the objective of increased minority business ownership is widespread across the CDVC and banking industries. It may reflect banks' history of investment in SSBICs as a satisfaction of their CRA requirement, which does target entrepreneurs of color, or if as noted by one bank respondent, "investment in communities of color and businesses owned by people of color is seen by the [Bank] as serving our overall strategic goals. We see the growth of these communities, especially within our footprint, and want to create more opportunities for them to become our customers."⁵¹ Whatever the motivation the apparent disconnects between Fund objectives and investor objectives is necessary to address as CDVCs rely more heavily on financial institutions as Limited Partners.

Survey Comments

Qualitatively, the survey left room for investors to make comments about the CDVC industry and their investment in it. These comments provide insight into how investors make their investment decisions and the methods they utilize to evaluate these investments. Some investors seem primarily interested in understanding whether CDVC Funds represent a sustainable method of community development investment:

"In addition to the potential job creation benefits, these investments demonstrate the job and enterprise creation potential of the CDVC model"

"Within the next few years the organization intends to spend another \$17M in this area (CDVC) to further test this model."

"It will be some time before we are able to assess the extent that these investments have yielded expected social and financial returns."

Other investors see the industry as simply another way to satisfy their investment requirements.

"Our primary purpose is to make CRA qualified investments to meet the investment test of the CRA examination."

Finally, several investors indicate that they are beginning to treat the industry as a more mature investment model, and therefore are looking for these Funds to

⁵¹ Interview March 2002 with Bank CRA Vice President

increase professionalism within the industry and meet expectations both financially and socially.

“Besides fulfilling our social mission, we’ve seen many current CDVC Funds with more seasoned Fund managers. This is the main reason we’re interested in investing in CDVC Funds.”

“Previously, investments in CDVC Funds have been primarily motivated by social returns, however, moving forward more emphasis will be placed on the financial returns of CDVC Funds. We will shift the weight of our evaluation to about 70% based on financial returns. Further future investments will be made more selectively and on the basis of strong fund management. The key driver in our investment will be the Funds’ ability to meet expected financial goals.”

“What Funds advertise as their social mission and what they legally agree to is often quite different. The broadness of the legal requirements allows funds to justify investments as social investments. It is very difficult to define social impact. We view co-investment with traditional VC’s as CDVC’s losing their niche. CDVC Funds sold the idea of financial returns, based on an untapped market, this was supposed to increase likelihood of financial returns, but so far this hasn’t panned out.”

The comments made by investors speak to the range of motivations they may have for investment. As confirmed by survey responses, it seems fair to assume that the investors who participated expect to continue, at least for the time being, their investment in CDVC Funds. Some are waiting to see if the model ‘pans out’ and if financial returns are truly achievable. There is indication of investors’ expectations for an increased professionalism of the trade, an entrance of experienced Fund managers in the market and seeing this development as a key to continued investment. These comments also speak to the move of some investors from looking primarily (or equally) at the social and financial returns to concentrating more heavily on the financial returns of this industry. Finally, there is some question that arises both for the industry’s ability to define social impact of their investments as well as the degree to which these Funds have made a commitment to particular social goals. This raises the question of whether, given the increased financial return expectations of investors, Funds will be able to commit to meeting specified social goals. Or, as noted by one investor, if Funds

will maintain or increase the definition of what satisfies social return criteria to satisfy financial return projections.

CDVCA Access to Capital Panel⁵²

During the annual Community Development Venture Capital Alliance conference March 2002, a panel discussion of CDVC funders discussed their background investing in CDVCs as well as the criteria they look for when making investments. The panel included representatives from Fleet Bank, JPMorgan Chase, the MacArthur Foundation and HB Heron Foundation. Their comments are helpful to understand the criteria by which investors evaluate potential CDVC fund investments and how these key industry players see the future of CDVC investments.

Fleet Bank through its Community Banking Division invests between \$30-\$40M annually in a variety of 'community development ventures within its nine state footprint'. Fleet has made investments in four CDVC's, Coastal Ventures in Maine, The Reinvestment Fund in Philadelphia, Boston Community Ventures and NYCIC, in New York City. Fleet discussed the primary indicators they look for when deciding to make an investment in CDVCs:

1. Key management team (number 1 priority is track record)
2. Potential deal flow and unmet capital need
3. Experience
4. Relationship

JP Morgan Chase makes community development investments in SBIC's and real estate funds as well as CDVCs. They have invested in three CDVCs: NYCIC, Boston Community Ventures LLC II and The Reinvestment Fund. They require that any investment made is CRA eligible and they will invest in Funds only if they have a minimum capitalization of \$15M.

Chase's primary indicators for investment include:

1. Community development impact (CRA eligibility, wealth creation, place based, job creation)

⁵² All information in the section comes from the Author's notes during the CDVCA Annual Conference March 4-6 2002.

2. Investment strategy –stage orientation, target industries, average investment size well defined, role as investors, exit strategy, deal sourcing
3. Management team (background, track record, full time team, turnover)
4. Financial return expectations (level of social impact derives amount of expected financial return, minimum return 10%)
5. Investment within footprint New York, New Jersey & Texas primary, mid Atlantic and northeast secondary.

The **MacArthur Foundation** has invested in three CDVC Funds, Sustainable Jobs Fund, Northeast Ventures and Kentucky Highlands. They utilize their Program Related Investment (PRIs) allocation for CDVC investments. The Foundation expects to invest \$20M in CDVCs over the next 2-3 years, however, it will move away from rural oriented funds towards more urban focused Funds. They intend to provide \$10M that will go to established leaders in field \$10M available for new urban focused Funds. The foundation's investment goal is to see funds prove out their *double bottom line* hypothesis, grow to scale, create viable exit strategies and significant community impact. The MacArthur Foundation's investment requirements look at two key areas.

1. How the CDVC expects to achieve social impact including detailed mechanics of how they will be achieved and track record of social impact
2. Past achievement of the organization within their given field

Finally, the **HB Heron Foundation** sees investment in CDVC Funds as furthering the Foundation's core mission of wealth creation. They have invested \$8M in CDVC Funds including Coastal Ventures, Self Help Ventures and BCV.

HB Heron looks for a well defined and appropriate:

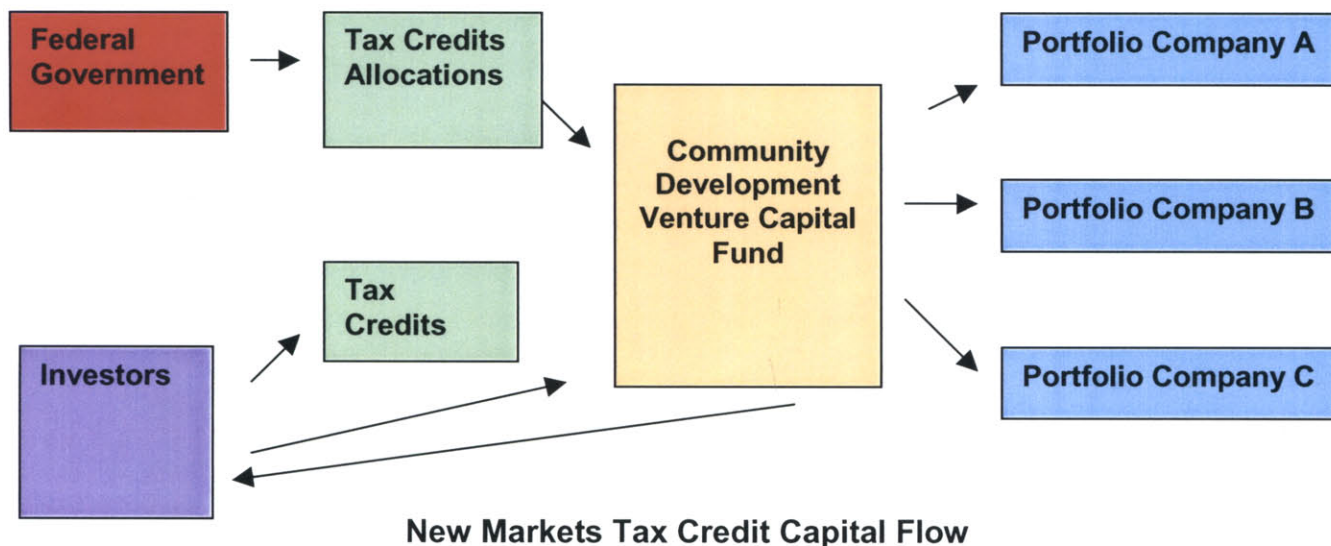
1. Exit strategy
2. Measurement of social impact
3. Financial return

In addition, HB Heron requires Funds to target low to moderate income, seek to monitor social impact, include management with venture experience, have internal capital at risk, verifiable networks to mainstream venture capital, fundraising ability and an investment strategy appropriate to the targeted market. The Foundation believes that expansion of the funder pool will not occur until the CDVC model is proven. However, they have made Fund II investments based

on extensive portfolio evaluation and the likelihood of realized returns. Last, they believe that it is the Fund's responsibility to create the measurements for social return and then utilize them, however they have not yet seen appropriate social impact tools developed by most of the industry.

Legislation and New Capital

In December 2000, two important pieces of legislation affecting the CDVC industry were passed⁵³. The first, administered through the CDFI Fund in the Department of Treasury, is the New Market Tax Credit (NMTC) program intended to stimulate private capital investment in projects that will facilitate economic and community development in poor rural and inner city neighborhoods. Investment is encouraged through tax credits. This program has been funded at \$15B in tax credits to be distributed over a course of seven years, beginning in 2002. The assumption is that by increasing the after tax return on investment, investors will be presented with a lower risk/higher return offering. This, in turn, will increase levels of investment, as well as introduce new investors to investment in community/economic development projects.



⁵³ Community Renewal Tax Relief Act 9 Public Law 106-554, code 45D of the IRS Code.

The program is administered through designated Community Development Entities (CDEs); most Community Development Venture Capital Funds qualify as CDE's. There are several regulations in place stipulating the use of these tax credits.

1. All projects invested in must be completed in communities that have a 20% poverty rate or are 80% of the metropolitan or state median income (whichever is greater).
2. Within the first seven years of investment all capital from investments must be used substantially for eligible purposes (e.g. no more than 15% of invested capital can be utilized for administrative costs), an investor may not cash out of their investment and the organization must maintain its CDE designation and its investments must maintain their community benefit.

Discussions with case study CDVC Funds, as well as with the National Community Capital Association, (the trade organization for all CDFI's) indicates that the tax credit is not likely a useful tool for the industry. Two of the three Funds view the regulatory stipulations of the tax credit as significant obstacles that inhibit them from taking advantage of the tax credit. The major impediments are the recapture requirement and the mandatory investments timeline. An interview with National Community Capital, the CDFI National trade organization, revealed the sentiment that, "NMTC works well for commercial real estate; real estate is by its nature place-based and requires long term investment, yet its applicability to CDVC is unclear."

The second piece of legislation passed in December 2000 is the New Markets Venture Capital (NMVC) program. This \$180M program, administered by the SBA, provides capital to for-profit investment funds whose objective is to promote economic development, wealth creation and new jobs in low-income areas. The SBA requires that Funds invest equity capital in smaller enterprises⁵⁴. The SBA provides up to \$7.5M in long-term debt to a designated NMVC Fund along with \$1.65M in grants for technical assistance to Portfolio Companies. A designated

NMVC organization then must raise a minimum of \$5.5M to match the SBA loan and another \$1.65M to match the SBA grant. Currently, there are seven NMVC designated funds, and all are raising their matching commitments to meet the year-end 2002 deadline. The SBA anticipates providing funding for a total of fifteen NMVC funds through this legislation.

The New Markets Venture Capital program could have several potential effects on Community Development Venture Capital. First, the introduction of a large amount of debt may significantly alter the way Funds manage their capital. Although NMVC regulations do not require payment on debt during the first five years of the Fund, it requires interest payments during years six through ten and a principle balloon payment at the end of year ten. These payments on interest will, of course, come prior to any returns received from equity investors and may affect a Fund's ability to make those returns. These payments are, like any other debt, scheduled and as such do not take into account the position of the Fund. For example, if a Fund anticipates several profitable exits in year eight, but has to make payments on debt in year six and year seven prior to exit, a potential capital conflict arises. Additionally, if a Fund chooses to manage its capital to establish a reserve in anticipation of their debt payments they may constrain their ability to make initial or follow-on investments in Portfolio Companies, which could reduce that company's ability to gain profitability. Effectively, a Fund would have to reserve 32.5% of its SBA debenture to secure its ability to repay its debt at the five year deferred deadline.

NMVC has also been criticized as an approach that has been tried before and has had limited success. Professor Timothy Bates⁵⁵ has been a primary source of research on SSBIC's (MESBICs) and evaluates New Market Venture Capital

⁵⁴ The SBA defines smaller enterprises as companies with a net worth of \$6M or below and annual net profits not exceeding \$2M.

⁵⁵ Timothy Bates, Distinguished Professor Wayne State University: An analysis of the SSBIC program: Problems and Prospects 1996. The Minority Enterprise Small Business Investment Company Program: Institutionalizing A Nonviable Minority Business Assistance Infrastructure 1997.

in light of his past research. He writes, "The SBA's emphasis on providing debenture financing to equity-investing CDFI's-whether the MESBICs in the past or the NMVCs of the future-highlights a basic incongruity between the objective of venture-capital investing and the incentives that such funding creates."⁵⁶ Bates adds, "because (NMVC's) niche is earlier stage small businesses relative to SSBICs and mainstream venture capital firms, NMVC investments are riskier and more likely to take longer to reach maturity than the five to seven year industry wide norm. It is quite possible that NMVCs, after five years of operation, will have few if any equity investments that are ready for acquisition or sale to investors; most may still be immature investments. Yet, at the five-year point, all of the deferred interest on the NMVC debenture financing from SBA comes due."⁵⁷

Bates also notes significant accounting issues that arise with the NMVC debt capitalization. Although repayment of debt is deferred for the first five years, the deferred interest is accrued annually; this accrual is reflected on a Fund's income statement, reducing net income; and as a liability on the balance sheet it lowers a Fund's net worth. This combination of Fund capital reductions, Bates believes, will create challenges for Funds attempting to raise money from outside investors.

The key challenge that arises for the CDVC industry from either program is the shift towards increased government involvement and subsequently the increasing regulatory nature of these Funds. One of the key strengths of CDVC's, noted by several Fund Managers, is the unregulated nature of Community Development Venture Capital, which has been referred to as a 'tool of the industry.'⁵⁸ If Funds rely on the tax credits or SBA debt to raise capital their fund management will be forced to adhere to these growing rules and

⁵⁶ Bates, Timothy 2002: "Government as Venture Capital Catalyst: Pitfalls and Promising Approaches" Economic Development Quarterly Vol. 16 No 1 February 2002

⁵⁷ Ibid

⁵⁸ Kerwin Tesdell CEO CDVCA, CDCVA Annual Conference 2002

restrictions. CDVCs currently are a diverse group, and define their success differently, invest in different types and stages of business and have varied social goals. NMTC/NMVC, if heavily utilized, may establish a direction for the CDVC industry that provides it with less flexibility to achieve self-defined success measure. The flip side, however, could be a clarified process for accountability of CDVC funds, which receive government, foundation and CRA guided bank investments to ensure that the social goals are clearly articulated, measurable and are indeed being met. Whichever outlook the industry takes it is necessary to evaluate the influence of government involvement on individual funds as well as the industry.

Changing Face of Investors-A Fund's Perspectives

The three organizations discussed in chapter two have distinct origins, investments philosophies and varying future prospects, yet all three fall under the umbrella of Community Development Venture Capital. As such, they all have made a commitment to fulfill the credo of the *double bottom line*, requiring financial and social returns, on their investments. This thesis is concerned with exploring how these Funds have been able or propose to measure their ability to fulfill the social bottom line of their investment. One area to investigate is the influence investors may have on the Funds they invest in. While the Venture Capital model is established in such as a way to exclude Limited Partners (or investors in Funds) from participating in the actual investment decisions made by General Partners (Fund management), it has been recognized that investors influence fund management in traditional Venture Capital.

In traditional Venture Capital the implied pressure from investors is for a private equity firm to maximize its profits and therefore the returns it provides its Limited Partners. The potential pressure of investors then is closely aligned with the mission of the traditional VC. However, actions of investors can still affect a private equity firm's ability to make and manage investments. One example has been the increased investment made by pension funds into Venture Capital.

Practically, the larger investment size made by pension funds has moved venture capitalization to higher levels (see trends in Venture Capital Chapter 1); this has, in turn, required venture funds to make larger investments. Venture funds now focus on businesses that have the capacity to accept large amounts of equity, \$7-20M, rather than the smaller amounts Venture Capital previously provided. This changes the types and stages of businesses that venture funds can target, and provides a reasonable example of how, within the LLC model, LPs can affect fund management.

Is it realistic then to expect that Limited Partners in CDVC Funds may influence the types of investments funds make? At a cursory level it seems reasonable given the traditional Venture Capital experience and CDVC's emulation of that model. An examination of the three cases provides indications that the nature of LP investment may effect General Partner investments. The three Funds discussed above have changing LPs as they raise their second fund.

Murex and NMVC

Murex Investments will rely on the federal government for half of its fund capital. This is expected to have several effects on the management of the fund. First, the New Markets Venture Capital program will involve, like most government programs, a significant amount of paperwork and recording. This will affect MI's management. Currently, MI's three person staff does not rely heavily on monitoring to assess the social impact of its investments. The close relationship it maintains with its Portfolio Companies creates an environment where MI management feels they 'know' the impact their investments have made. Additionally, because they are interested in multiple factors that create their social impact criteria they have relied on anecdotes and stories to convey the social impact of their investments. However, the increased reporting requirements will require a considerable amount of MI's staff time. The Fund's investment strategy is based on providing intensive technical assistance yet this

may be compromised by additional administrative tasks necessary to utilize the NMVC capital given the limited human resources of the Fund.

As discussed above, the structure of NMVC is a debenture to be repaid over the course of ten years with interest deferred until year five and a balloon principle payment at year ten. This debt structure will dramatically change the investment strategy of MI. MI's first fund was 100% grant money, allowing them time and flexibility to target difficult turn-around businesses. In fact, after four years MI has invested only \$2.75M of the total \$5.2M they raised. If MI was utilizing NMVC capital now they would have to make cumulative interest payments within a year and likely would draw this from their capitalization, given they have not yet exited any of their businesses. This reduces the overall capital Murex could commit to Portfolio Companies and potentially reduces the social impact the Fund can make. This is further highlighted by the new investment strategy of MI described in chapter two which refocuses its strategy away from primarily turn-around businesses, to devoting a maximum of \$2M (18%) out of their \$11M Fund toward this type of investment, versus almost 100% of Fund I devoted to turn-arounds. MI will also look to co-invest in more traditional VC in more traditional 'looking' deals that locate within their target area to address this quicker investment timeline. MI recognizes that these investments may have reduced social benefits, outside of location in low-income neighborhoods. Another key change based on the changing nature of Fund capitalization is the projected financial rates of return. MI made none for Fund I, and has projected returns between 10-12% for Fund II. These changes to MI are more than simply administrative. The original goals of Murex Investments, while ideal, were to forward principles of worker-ownership, local ownership and moving towards a financial self-sustaining community in the imitation of Mondragon Cooperatives in Spain. The degree to which Murex strays from this philosophy may establish a more credible CDVC but may lose its philosophy, core strategy (high levels of technical assistance) and degree of social impact along the way.

Pension Funds, Hybrid Investment and SVCV

Silicon Valley Community Ventures was highly capitalized in Fund I by banks. They seem, in this respect, to have been ahead of the trend of increased bank activity in the CDVC trade. However, SVCV recently received an investment from CalPERS, the California state workers pension fund. CalPERS has over \$150B it invests in a variety of assets. In 2001, CalPERS began a program to make investments in California emerging markets (rural and inner city markets) totaling \$475M, \$10M of which was committed to SVCV. Many in the CDVC industry have viewed this investment as a coup. Industry experts hope this investment is an indicator of the future involvement in pension funds in the CDVCs. Viewing this investment as an introduction of this 'category' of investor to CDVC's is likely premature, because CalPERS made this commitment as part of a particular socially motivated program. The degree to which other pension funds will follow suit and make socially motivated investments does not seem a foregone conclusion. Rather, it may present an opportunity for advocacy on the part of the CDVC industry to lobby statewide pension funds. The rationale may be similar to the one used to justify Community Reinvestment Act capital requirements. However, the pursuit of pension fund money must also be balanced with a reasonable assessment of how it could affect the industry. For a large pension fund an investment of \$10M is relatively small, and may indicate the type of minimum investment feasible. Are CDVC Funds in a position to accept this investment amount, which is larger than the industry average? Would the entrance of pension funds into the CDVC market increase average capitalization of Funds? Are the types of companies they invest in now the same companies that would be able to accept equity investments comparable with these potentially higher capitalization? If not, how do social impacts change?

SVCV already has established that the types of deals it participated in Fund I will not be the same types of deals it will participate in Fund II, "the deals in the first Fund were just too expensive, given high due diligence and low financial returns

and aren't going to be done in Fund II⁵⁹. Instead, SVCV will take a hybrid approach to investment. Group A investments will be companies with \$20M plus in revenues in need of equity for expansion and growth. Group B investments will be companies that need up to about \$.5M and likely in the form of convertible debt. This hybrid method of investment is SVCV's approach to dealing with the high cost and risk-adjusted returns of previous investments. The goal is a blended return to meet the projected 15% return rates. They believe they will still be able to further their mission, however, the mainstay of investments moving forward will be with later stage companies.

Increased Capitalization and Increased Expectations: BCVF

Boston Community Venture Fund is also moving toward a larger capitalization for Fund II, and thus larger investments. Fund II will likely close between \$18-20M. Their investors have changed in several respects from Fund I to Fund II. Fund I gathered much of its capital from local foundations and individuals. Fund II however, is drawing capital from national foundations and has not pursued individual donors. Additionally the strategy, along with growing the fund size from \$5M in LLC I to \$20M in LLC II, is to raise minimum investments from about \$50,000 to \$500,000 in Fund II. This strategy will therefore have significant affects on the type of businesses BCVF invests in, and in what type of investment they will participate. BCVF will not be taking a 'hybrid' approach to investing, as is the trend with SVCV and MI. BCVF feels it will be able to maintain its adherence to its social mission regardless of the increased investment size. The idea is basic. Invest larger amounts in larger businesses, within specified socially beneficial industry sectors or communities, and you are able to affect more people, and create or retain larger number of jobs. The question still remains however; will BCVF be fulfilling a niche? Will they be addressing businesses that would be unable to attract equity from other market players, particularly SBIC's? A BCVF manager stated, "we may compete [or partner] with SBIC's for a small portion of our deals, perhaps the top 20%, which

⁵⁹ Interview with SVCV Fund Manager March 2002

would represent perhaps the bottom 20% of an SBIC's deal; this is not a negative prospect⁶⁰. BCVF contends that because they still intend to concentrate on historically slower growth sectors underserved by traditional VCs, they will still address distinct capital gaps. A second key distinction between Fund I and Fund II is BCVF projected financial returns. Fund I made none, however, Fund II has projected returns of approximately 11-15%. This, as a matter of course, adds additional pressure to BCVF to make investments that will satisfy the financial return expectations made. Fund Managers believe that their experience and larger investments will make this a reality. A secondary goal of these financial projections is to establish a track record of financial returns. It is believed that if they are able to meet the financial expectations, they will effectively move towards creating a new asset class. If BCVF is able to provide financial returns between 11%-15%, they believe it will provide a new class of investments for foundation's PRIs, social investors, and attractive investment for banks, regardless of CRA satisfaction. Further, this strategy plays into the Fund's goals of achieving financial sustainability, being able to manage the Fund without any grant contributions.

⁶⁰ Interview with BCVF Manager March 2002

Investment Trends

Several trends become apparent by looking at both the funders and the cases:

1. Larger capitalization of funds
2. Increased focus on financial returns: by investors and fund managers
3. Hybrid approach to investing and later stage investments
4. Increased professionalism within industry
5. Increased bank Limited Partners
6. Introduction of federal government: increased debt and regulations

These trends, if proven true, require that CDVC evaluate their *double bottom line* model of investment. Larger capitalization of Funds means a movement into a new category of equity investments for many Funds. How does this change who their Portfolio Companies are? Does this change the type, level or degree of social impact? Are they fulfilling the same niche, or will they move into the realm of SBIC's, who arguably have more experience, higher capitalization and proven track records of success? Could these movements into this larger market place them at a competitive disadvantage? What effect does the move towards increased bank participation have? Will Funds be limited by satisfying banks investment motivations, e.g. Portfolio Companies within bank footprints, or demands for higher financial returns? Table 8 below looks at potential positive and negative ramifications of these trends. These changing investors' trends can have several potential effects on the industry. First, the move toward higher capitalization will likely lead to an increase in investing in later stage companies that have the capacity to accept higher investments from the Funds. This moves CDVC Funds away from their original niche of early stage businesses (see VC model comparisons chapter one). This move may also refocus the industry on the retention of jobs rather than the creation of employment. Other ramifications of later stage investment may include: the failure of CDVC Funds to expand the entrepreneurial landscape (e.g. women and minorities) by targeting established companies and reduced likelihood of spurring real estate development and focus instead on neighborhood stability. The increased capitalization also moves CDVCs further into the realm of SBICs in terms of the investment size, it also

influenced MI and SVCV's to take a hybrid investment approach competing for similar types of VC deals. This places CDVCs in a position where they must compete with more experienced, and perhaps better managed Funds. Increased co-investment may also reduce the Funds' ability to incorporate social return expectations on the firms in which they invest. The added reliance on government debt, through the NMVC program positions CDVCs to struggle with an inevitable conflict between the expectations of their debt investors and their abilities to function as equity investors in their Portfolio Companies. Finally, the trend toward increased bank participation could add limitations requiring Funds to focus within the banks' footprint, increase the pressure for financial returns and have their funding be at the whim of legislation which potentially can overturn or revise the CRA regulations.

TRENDS	+	-	?
Larger Fund Capitalization	helps to alleviate high transaction costs	higher min investments eliminates some current CDVC eligible businesses from industry	leads to higher minimum investments
		movement towards later stage companies	
	allows Funds to make larger impact on individual Co's	moves CDVC out of its current VC niche/increases competition	changes focus from early to growth and/or late stage
Increased Financial Returns	proves that socially beneficial investments can be profitable	potential move away from manufacturing or other 'quality job creators'	focus on higher growth businesses and business sectors
	brings new investors into the market	Gives financial returns primacy over social returns in investment strategy	increases possibilities for co-investment
Hybrid Investment Approach	allows Funds to concentrate technical assistance more efficiently	reduces the overall capital directed at businesses with high social returns	
	increases potential for financial returns and Fund sustainability	disproves viability of model of double bottom line	
Professionalization of Industry	Increases potential for appropriate due diligence, valuations and 'good investment decisions'	reduces role of the community developer in CDVC decisions	increases pay scale necessary for CDVCs
	Increases LP's willingness to Invest	adds pressure to raise larger funds and increase financial returns	
Increased Bank Participation	increased capital	limitations to Bank 'footprint'	increased pressure to provide financial returns
	hands off approach to regulating use of capital	hands off approach to regulating use of capital	
		Subject to potential changes in legislation	
Increased Federal Government	increased capital	debt structure doesn't match VC structure	increased regulations establish clear social return objectives and reporting
		Subject to potential changes in legislation	
		increased restrictions diminish CDVC 'tool' as unregulated	

The CDVC industry is still at a relatively early stage where its development path is open to take a variety of directions. There is a distinct need for the CDVCA, industry managers, investors, outside researchers and practitioners to make key decisions, evaluations and critiques about what it means to pursue a *double bottom line* and how to create a mechanism that does that most effectively. The industry has been to some degree limited by its youth; many of the ideas and ideals have to still pan out. I contend it is important to remain critical of this model until it is proven. The capital invested by banks, foundations and other social investors are dollars that would likely be invested in other community development projects, given they are often PRI's, grants or CRA related investments. An increased level of critique must be incorporated into the current discussion around the effectiveness of this industry. CDVCs Funds are funded by socially motivated capital and so must be evaluated in such a manner that recognizes the potential impact of that capital in other investments. This has not yet occurred.

This report will now turn to the second area of investigation; the social returns of Community Development Venture Capital Funds.

Chapter Four

This thesis is interested in how the CDVC model of community investment is able to address the social return component of the *double bottom line* approach the industry utilizes. It is both beyond the scope of this thesis, as well as premature, given the CDVC's development stage to quantitatively address the social impact of the industry, or even the three case study organizations. This paper will, however, attempt to review social returns on investment qualitatively. This chapter will lay out the social impact criteria evaluated by each case study Fund, the methods used to gather social impact information and the results of this data gathering. Next, it will explore information that was provided during CDVC Fund case interviews to gain a deeper understanding of the Fund's approach to social impact data gathering. This section will then provide recommendations to move the CDVC industry toward a more thorough and rigorous evaluation of its social returns. Finally, I will conclude with a discussion about why social impact data is vital to the industry as well as a rationale for the immediate increased attention paid to this area of the industry.

Murex Investments

The stated mission of Murex Investments is to *invest in companies that transform distressed areas by maximizing social and financial returns for investors, entrepreneurs and employees*. They are interested in several measurements of social impact: 1. Maintaining local ownership of businesses; 2. Living wage job creation; 3. Increasing management proficiencies and 4. Increasing opportunities for employee ownership. Murex Investments monitors job creation information annually but does not systematically evaluate Portfolio Companies progress in its other social impact indicators. They do, however collect this information on an ad hoc basis. They believe that their 'close relationships with Portfolio Companies ensures they have a clear understanding of how each company is

doing”⁶¹ regarding the various measures. Murex Investments estimates that it has created and/or retained 200 jobs through its Portfolio Companies; Murex Investments also sets a floor wage of \$7.90 for all employees of its Portfolio Companies. This is \$2.70 above the Pennsylvania minimum wage of \$5.15 but below the proposed area living wage of \$11per/hour. Additionally, one out of the seven Portfolio Companies is minority owned (African American). The Funds designation as a New Market Venture Capital Fund will require however that the organization establish much more formal social impact measurements. Specifically, new monitoring will include annual reports indicating an assessment of the FTE jobs created, the impact of financing on revenues and profits of the Portfolio Company, taxes paid by the firm and its employees, and a record of employees living within low income census tracts. NMVC regulations require that 80% of all investments must be made to Portfolio Companies residing in a low-income geographic area. The low income eligible area is defined as one with a minimum of 20% poverty, at least 50% of families within the tract have below 60% of the area median income, and/or within empowerment/EZ zones.

Silicon Valley Community Ventures

Silicon Valley Community Venture’s mission is to: *invest in and develop businesses, which provide substantial economic benefits to low-income communities*. It measures its ability to reach this mission through the administration of two surveys to Portfolio Companies. In 2000 SVCV worked with outside consultants to develop a social measurement tool. This tool is now administered with Portfolio Companies providing data on a quarterly basis⁶². Portfolio Companies (both invested in and advised) submit measurement information via fax. The measurement focuses on three primary social impact criteria: high quality employment opportunities in low income communities, strategically located businesses that can help fuel community development; and

⁶¹ Interview with MI fund Manager March 2002.

⁶² Due to privacy issues SVCV did not share an example of the actual survey.

investing in entrepreneurs who are role models in their communities. This measurement distinguishes employment generated by Portfolio Companies by specifying 'designated employees'; "An employee is considered a 'designated employee' if:

1) s/he was hired in an entry-level position with a starting salary of equal to or less than **(\$x/hour)** or in a managerial position with a starting salary equal to or less than **(\$y per year)**, AND s/he was hired from a non-profit organization, job training program, or welfare-to-work agency

OR

2) S/he was hired in an entry-level position with a starting salary equal to or less than **(\$z/hour)** or in a managerial position with a starting salary of less than **(\$w/hour)** AND s/he resides in a designated neighborhood (LMI zip codes within the Bay area)⁶³

Silicon Valley Community Ventures has tracked job creation and 'designated employee' information since the spring of 2000. All information below is for the time 4/1/2000 through 12/31/2001.

Total designated employees at SVCV portfolio companies⁶⁴	463⁶⁵
Total Designated Employees Hired	350
Total Designated Employees Leaving	252
"Net New" ⁶⁶ Designated Employees	98

⁶³ Information from interview with SVCV March 2002. For the wages and salaries, they are arrived at through discussion with the companies. The zip codes were determined by which zip codes in the cities of San Francisco, Oakland, San Jose, and East Palo Alto overlapped with LMI census tracts. For any given portfolio company, a 3.5 mile buffer zone was incorporated. The wage levels (**WXYZ**) are negotiated with each Company.

⁶⁴ Including those employed 4/1/00 or the time of investment, in addition to those hired.

⁶⁵ There is some overlap between years - many employees were employed during both years.

⁶⁶ "Net new" employees' number does not represent a "retention" number. SVCV does not have employee level data that states, for any employee who left, when that employee was hired. They

SVCV's measurement tool is the only one from the reviewed cases that systematically attempts to identify the characteristics of the jobs created, and provides, net job creation numbers. Gathering net job creation data gives a more realistic approximation of job created than the other two Funds that do not do this type of analysis. While Silicon Valley Community Ventures has established a comparatively rigorous measurement process to monitor achievement of their primary social impact goal, job creation, they do not set specific goals or hurdles for companies to reach particular job creation goals. "In general, it is unlikely that we [SVCV] would require a company to hire a certain number of people. However, we are explicit about our mission and goals in that area, and we would not be involved with a company if our services and/or investment were not likely to help them hire or retain a significant number of designated employees."⁶⁷

To further the Fund's goals of creating good quality jobs they retain a consultant that helps companies set up wealth-sharing programs for employees. Finally, depending on the particular deal, the term sheet (a document, which specifies the roles and responsibilities of parties in the investments,) could include one or more of the following stipulations:

1. Provide a specific type of training to employees;
2. Provide a wealth sharing vehicle to employees;
3. Work with a local workforce development program if it is not able to hire low-income employees from surrounding neighborhoods.

SVCV administers a second survey annually⁶⁸. This survey attempts to collect information on employer practices and includes information on wages and benefits as well as employee training. According to the 2001 Annual Report all designated employees within SVCV Portfolio Companies earn above the minimum wage. SVCV companies have an average wage of \$10.55per/hour;

have surveyed companies, however, to guesstimate average retention for entry-level positions: 64% of portfolio companies state entry-level retention at a minimum of 12 months.

⁶⁷ Interview SVCV staff March 2002.

⁶⁸ The first survey was administered in 2001.

this is higher than both the minimum wage of \$6.75per/hour and the area living wage of \$10 per/hour⁶⁹.

While minority and women ownership is not a driving factor for social impact measures for SVCV three of the nine Portfolio Companies are minority owned (1 Latina, 1 African American and 1 Asian American owned).

Anecdotally, SVCV's investment in *Just Deserts*, a producer of premium quality bakery products for retail and wholesale distribution, is an example of comprehensive social returns on investment. Post investment *Just Deserts* constructed a new home for its manufacturing and distribution center which employees fifty workers (mostly blue collar) in East Oakland. The creation of this new facility in Oakland represented new commercial development in a census tract that has a poverty level of 25%, is 97% minority and 43% of the population is below area median family income. *Just Deserts* retained most of its original employees (95%) by providing 'relocation packages', including a transportation subsidy, relocation expenses and a cash bonus for those who chose to make the move from San Francisco to Oakland. These employees also benefited from a higher minimum wage. The Oakland Living wage requires a \$9.25 per/hour wage representing an increase from the *Just Deserts* original minimum wage. This relocation translated into a higher wage for current employees (plus defrayed relocation costs and ongoing transportation subsidy), provided commercial real estate development in a high poverty tract in Oakland, and also opens up the possibility of new employment being filled by local East Oakland residents.

Providing comprehensive assessment, incorporating indicators like, real estate creation/rehabilitation in high poverty areas, increased property taxes, wage rate increases and community perception creates a more well-rounded and versatile approach to understanding the impact of CDVC investment. Methods to quantify

⁶⁹ Executive Summary of Comprehensive Assessment, SVCV April 2002.

and compare these types of social impact indicators would propel the industry into a deeper understanding of its impact and ultimately provide lessons to more effectively continue the practice of *double bottom line* investment.

Boston Community Venture Fund

BCVFs investment principles state that, “although the Fund views job creation as a primary indicator of social return, the Fund will also invest in businesses that provide quality goods and services to low income communities or other disadvantaged populations; that are headed by minority or women or other underrepresented populations; that enhance the stability of low income neighborhoods; that produce, distribute or sell products in demonstrated services to low income communities”⁷⁰. BCVF does not impose particular mission driven policies on a business; as a result it requires no minimum satisfaction of job creation or other social benefit goals. BCVF monitors the progress of its social goals by requiring Portfolio Companies to provide quarterly job creation and wage information. BCVF is required by the CDFI Fund (one of its contributors) to report on the accomplishment of several goals. Goals 1 and 2 refer to the ability of BCVF to raise and disburse capital. Goal 3, as identified by the CDFI Fund, is to “stimulate job growth by helping to meet the investment needs of businesses that build healthy communities in part through offering opportunities for decent jobs to low income people”.⁷¹ The total number of people employed by Portfolio Companies’ is the measure of this goal; this number, however, does not disaggregate jobs created, jobs retained and jobs specifically filled by low-moderate income people. In March 2002 BCVF reported 1008 full time equivalent employees were working in positions created or retained in Portfolio Companies⁷². This number includes at least 360 jobs placed by a Portfolio Company whose primary business is the permanent placement of welfare recipients and other low-income people in employment. BCVF also maintains

⁷⁰ BCV Investment Policies and Procedures, internal document .

⁷¹ BCLF Ventures, Inc. Annual Report for Awardee, March 2001.

records for the average salary range for entry-level workers within each Portfolio Company as well as the career ladder potential within each company. The average salary for an entry-level position within a BCVF Portfolio Company was \$9.54 per/hour⁷³ in March 2001. This is \$2.79 per/hour above the minimum wage (\$6.75) for Massachusetts but below the living wage set for Boston at \$10.25⁷⁴

Of the eleven investments made in Fund I, two were made to African American owned businesses, one (exited company) was worker-owned by majority African American and Latino employees and one investment was to an Asian American owned business. Forty-five percent of BCVF businesses are owned by women. Finally, BCVF does not provide or specifically encourage any job placement or job training within its Portfolio Companies. This is noteworthy given one of its Portfolio Companies is a welfare to work placement agency, providing potentially a win-win situation for the individual company and the social returns on investment. BCVF states that, "Where there is an overlap with [the placement agency], we'd certainly make a connection, but we wouldn't force it"⁷⁵. This hands off strategy is a key factor in the BCVF investment philosophy that looks for companies that have a social mission that emerges from their business model and is in no way contrived by the Fund. The point of the policy is a recognition that absent financial return, social return cannot sustainably exist.

⁷² BCLF Ventures Annual Report for Awardee, March 2002

⁷³ BCLF Ventures Inc. Annual Report for Awardee, March 2001

⁷⁴ www.livingwagecampaign.org Note that over ½ of BCVF's Portfolio Companies are located outside of the Boston Metropolitan area and as such a Boston Living wage may not represent the living wage in the applicable area for each Portfolio Company.

⁷⁵ Interview BCVF April 2002

	Murex	SVCV	BCVF
Portfolio Companies	7	9	11
Fund Life (in years)	4	4	6
Jobs Created/Retained	200	463	648**
Jobs Created/Retained Annually	50	115.75	108
Jobs per Investment \$\$ (investment/jobs)	\$13,750	\$4,751	\$8,024
Wages			
average	\$7.90	\$10.55	\$9.54
% above minimum wage	35%	36%	29%
% above/below living wage	-28%	5%	-7%
Minority Ownership	14%	33%	36%
Job Placement/Training Assistance	YES	YES	NO
** BCV jobs created subtracts jobs attributed to Portfolio Company that 'places' jobs			

Table 9

This chart analyzes each Fund on its primary social objective, job creation. BCVF has created/retained the largest number of jobs amongst the Funds; however, Silicon Valley Community Ventures seems to create/retain jobs at a higher rate than the other two Funds. Silicon Valley Community Ventures also appears to have the lowest 'jobs per investment' rate of just under \$5,000⁷⁶. Finally, even though BCVF is the only Fund that explicitly states increased minority ownership as a social objective of investment, SVCV and BCVF have similar rates of minority ownership among its Portfolio Companies. Silicon Valley Community Ventures is the only Fund whose companies, on average, provide higher than area living wages for its entry-level employees. BCVF Portfolio Companies provide an average wage very close to the Boston metro area living wage, serving as one indication of the good quality jobs its businesses create/retain. Murex Investments, given this analysis, is the most costly of the three Funds, providing a lower overall wage with lower rates of job creation and minority ownership.

The following summary of Portfolio Company locations is intended to provide an additional perspective on the potential social impacts of the three CDVC funds and their investments. The logic is that CDVC Fund investments in high poverty, high minority concentrated and inner city areas would represent 'unlikely' investments in the traditional capital markets. This investment, creating new or stabilizing places of work in the inner city, providing new or maintaining commercial real estate, and creating or maintaining access to work for low income communities could be seen as satisfying some of the social impact criteria cited by each CDVC Fund, that thus far have not been extensively monitored, with the exception of SVCV. The data⁷⁷ gathered to create 'Portfolio Company Location Summaries' comes from the Federal Financial Institutions Examination Council, which is the interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions in compliance with the Community Reinvestment Act. These data are directly related to the requirements Banks must satisfy in order to meet their CRA investment test. This information is key given the significant investment of Banks into CDVC Funds. These banks, as established in chapter three, utilize CDVC Fund investments as part of the satisfaction of the CRA investment test. The degree to which Portfolio Companies are in low and moderate and/or high minority communities may also be important in understanding both the CRA impact these investments make as well as guide banks' investment decisions in CDVC Funds. The results of this analysis for the three case study Funds are divergent. The degree to which each Fund makes investments in Portfolio Companies that satisfy these prescribed criteria varies by Fund.

⁷⁶ The jobs created/retained are arrived at by different methodologies for each Fund, the likelihood that these number correlate across Funds is unlikely and this data should be reviewed for illustrative purposes only.

Murex Investments Portfolio Companies are likely to be located within low and moderate-income census tracts, (72%). MI is the only CDVC Fund to have made investments in a Portfolio Company located in a tract with over 50% of the population below the poverty level. Additionally, 57% of their investments are made in communities between 80-100% minority⁷⁸ and 71% of investments are made within the center city.

A review of Portfolio Company locations for SVCV indicates that their investments tend to be in low and moderate-income census tracts. Additionally, these companies are often located within moderately high poverty areas, most are in census tracts that have between 11-30% of its residents below the poverty level. These companies tend to be located in minority communities; 56% of companies are located in census tracts with an 80-100% minority population.

A summary of Portfolio Company locations indicates that BCVF Portfolio Companies are likely to be located within middle or upper income census tracts (63% of all Portfolio Companies in Fund I). Sixty-four percent of BCVF Portfolio Companies are located within low poverty areas (areas with 10% of or less population below the poverty threshold). Finally, BCVF Portfolio Companies are not likely to be located within high minority census tracts; 73% of companies are located in tracts with a population composed of less than 20% minorities.

These varying results raise several questions. Does the physical location of a Portfolio Company matter for the social impact of the Portfolio Company on low and moderate-income workers? How does one evaluate the impact of creating new workplaces in the center city and high poverty communities? Does the location of Portfolio Companies within, or outside, of low-moderate income communities make a difference for these companies ability to retain workers? Is

⁷⁷ www.ffiec.gov based off of 1990 Census data which is appropriate given time period of investments.

⁷⁸ It is interesting to note that the full 43% of other investments are made in communities with less than 20% minority population

a census tract an appropriate level of measurement and is it the level of measurement utilized by investors? The answers to these questions are important both for internal measurement of the Funds' ability to achieve its mission as well as external measurement for investors to understand the impact of their investment. It also affects the likelihood of investments satisfying CRA requirements. For example, BCVF, which has the majority of its Portfolio Companies located outside of low and moderate-income census tracts, may believe: 1) That the census tract does not appropriately represent the broader community within which the Portfolio Company is located; and 2) The income level of a census tract is not an appropriate measure of their primary social impact measure, job creation 3) A more appropriate measure, given Fund mission, is an analysis of employee residence within high poverty neighborhoods/census tracts. To date these questions (and answers) are not addressed. The lack of these data could lead to a misunderstanding of the Funds' ability to address social impact within their CRA driven investors assessment area. Conversely, MI and SVCV which both have the majority of investments in low-moderate income and high poverty areas can utilize this to their advantage when attracting institutional capital. Furthermore, they may also be able to have significant social impact both through job creation as well as through inner city commercial real estate stabilization or generation.

MI Portfolio Company Location Summary		% of Census Tract
Number of Portfolio Companies		7
Census Tract Income Level		
	Low	29%
	Moderate	43%
	Middle	29%
	Upper	0%
% below poverty in Census Tract		
	0-10%	29%
	11-20%	29%
	21-30%	14%
	30-50%	0%
	above 50%	29%
% Minority (includes Asian American)		
	0-20%	43%
	21-40%	0%
	41-60%	0%
	61-80%	0%
	81-100%	57%
Located in Center City (Yes)		71%

Table 10A

SVCV Portfolio Company Location Summary		% in Census Tract
Number of Portfolio Companies		9
Census Tract Income Level		
	Low	33%
	Moderate	33%
	Middle	33%
	Upper	0%
% below poverty in Census Tract		
	0-10%	22%
	11-20%	22%
	21-30%	67%
	30-50%	11%
	above 50%	0%
% Minority (includes Asian American)		
	0-20%	0%
	21-40%	22%
	41-60%	11%
	61-80%	11%
	81-100%	56%
Located in Center City (Yes)		78%

Table 10B

BCVF Portfolio Company Location Summary		% Census Tract
Number of Portfolio Companies		11
Census Tract Income Level		
	Low	9%
	Moderate	27%
	Middle	45%
	Upper	18%
% below poverty in Census Tract		
	0-10%	64%
	11-20%	9%
	21-30%	18%
	30-50%	9%
	above 50%	0%
% Minority (includes Asian American)		
	0-20%	73%
	21-40%	9%
	41-60%	9%
	61-80%	0%
	81-100%	9%
Located in Center City (Yes)		55%

Table 10C

Evaluating Social Returns

A review of both the job creation and wage criteria and well as the location summary for the three case study Funds demonstrate that, given the evaluated indicators and this author's methodology, Silicon Valley Community Ventures has been the most successful in achieving social returns on investment. While it is not possible to link these results to their social measurement infrastructure it is integral to this thesis argument that SVCV is the only Fund that has both established a significant measurement tool to evaluate its social impact and created mechanisms to support the growth of social returns on investment. SVCV has met or exceeded several of its goals and has clearly defined and measured multiple goals, not just job creation. It is the only Fund reviewed which provides financing to companies that, on average, have above area living wages for their entry-level positions. SVCV has the highest job creation growth rate of the three Funds; 67% of its companies are located in low and moderate income census tracts; 67% of its companies are located in tracts with over 60% minority population; 33% of the Portfolio Companies are owned by minority entrepreneurs and given the rudimentary job creation cost matrix, SVCV seems to have the lowest investment dollar leveraged per job created. Importantly, SVCV has done this *without adding constraints* like social return contracts or quotas to their Portfolio Companies. Comparatively, Murex Investments, which does well investing in companies in high poverty and high minority census tracts, has a high investment cost per jobs created/retained at its Portfolio Companies. Additionally, employees of MI companies are likely to be at comparatively lower wages given area minimum and living wages. Finally, BCVF, which has invested the highest amount of capital in the most Portfolio Companies, is, given this analysis, the least likely to invest in companies in high poverty areas; 36% of its Portfolio Companies are within low and moderate census tracts or in minority communities; with only 9% of companies are located in census tracts with over 60% minority populations. The Fund does, however, invest in companies whose average entry-level wages are near area living wage and the Fund.

While this thesis does not provide directives for the nature of measurements to be developed and implemented by funds, it does propose that the CDVC industry, still in its developmental stages, collect this type and other of raw data about its Portfolio Companies. Information regarding indicators such as firm location, real estate rehabilitation or stabilization, Portfolio Company real estate taxes, and proximity to public transit are relatively easy to gather (given both the public nature of most of this information as well as small investment portfolio) and would provide base data from which to evaluate and then use as new measurements are created. This type of analysis can be used to deepen the social impact analysis that exists around CDVCs and ultimately assist the industry in creating a more effective investment model.

Recommendations

Measuring the social impact of Community Development Venture Capital funds makes sense given the *double bottom line* approach to investing of the CDVC industry. Much of the discussion around CDVC's has been in trying to create the appropriate business practices to achieve financial returns, and to persuade investors that these financial returns are rational and reasonable. Yet, the social impact of these Funds is still unproven. If this industry is truly a double measurement of financial and social impact then proper attention must be paid to both the indicators and measurement of social returns. A CDCVA report, "Measuring Social Returns in CDVC"⁷⁹ takes an initial look at the ways that several Funds measure social returns and the complexities of understanding and implementing these measures. The report focuses most of its analysis on job creation since it is the primary indicator Funds use for social returns. The article speaks to several ongoing challenges faced in the measurement of social impact. First, how does a Fund ascertain that their investment created a job, and does any job that is created post-investment qualify as one the Fund created? These are a particularly acute question to understand in light of many Funds' move

⁷⁹ Schmitt, Brian T. 2001: "Measuring Social returns in Community Development Venture Capital" unpublished report sponsored by the Rockefeller and Hewlett Foundations, May 1, 2001.

towards increased co-investment or investment through a hybrid strategy that places CDVCs alongside or in competition with other Venture Capital funds. If a Fund co-invests, would another type of venture capitalist (SBIC/SSBIC) have invested; and if so, to what degree is the CDVC providing new access to capital?

A second related issue that is highlighted in the Report looks at the nature of equity as a longer-term investment. Is it appropriate to evaluate Funds' ability to achieve social returns in the short run when equity investment has a five to ten year lifetime? This question, while reasonable, can be accounted for. CDVC Funds can evaluate social returns on similar timelines. So, by collecting good data along the life of an investment, an organization would be able to measure the social returns of the Fund in a manner, which respects the investment cycle. It could evaluate social returns when determining follow-on investments, during the course of engagement as the Fund makes managerial/operational changes and finally look at social returns at exit. This way the Fund's social returns are constantly aligned with the financial returns. It also would require an assessment of the ultimate benefit of the investment, so for example, if a Fund 'created' 100 jobs through an investment by year five, but in year eight when exit occurs, the Portfolio Company reduced staff resulting in the Fund's creation/retention of fifty jobs; those fifty jobs would be the ultimate job creation return measure.

CDVC's, however, do not have an established social returns model to follow. Some, like SVCV, are creating these models in relative solitude. The work of creating and implementing a new measurement methodology is complex. The apparent complexity is further exacerbated by the fact that the CDVC industry has still not defined itself. Its organizations have a varied set of goals and missions, they are at various stages of development, and new types and sizes of CDVC Funds are constantly appearing. To this end, industry experts have made comments that, "the field of CDVC is too young to begin to codify its social return

measures”.⁸⁰ I contend, however, that this is the time for individual Funds and the industry overall to address the social return measurement of CDVC. The *double bottom line* investment strategy requires that Funds examine their social returns, with equal rigor as the measurement of financial returns. Not to do this negates the idea of a *double bottom line*, and perhaps as one observer put it, “makes social returns one input into the financial bottom line, but not its own or equivalent bottom line.”⁸¹ Utilizing the Venture Capital model as the method of equity investment provides already established tools to measure the financial returns of CDVC’s. Now is the appropriate time to develop more comprehensive social returns measures for several reasons:

1. The industry is young, and relatively small. There are only about sixty Funds total in the US and twenty-five equity-focused Funds. These Funds have invested in a total of 162 Portfolio Companies invested in. This indicates that on average each Fund has 6.5 Portfolio Companies. The small and manageable nature of the Fund-Portfolio Company relationship may be more conducive to experimenting with and implementing social measurement apparatus. The current measures seem to be unevenly administered and limited in scope.
2. The CDVC industry is growing, both in the number of Funds as well as the capitalization of Funds. Most organizations that are raising second Funds are significantly increasing the capitalization of those Funds. For the three Funds in this study, their Fund II’s will be between 120% and 300% greater than Fund I’s. This increase in capital indicates a greater devotion of community development dollars (investments that would have been utilized for some other broadly defined community development activity) to CDVC’s. The process of understanding how, and how much, these funds leverage ‘community development dollars’ to create actual community development is key to making resource allocation decisions.
3. The CDVCA is growing both in membership and capacity. It has recently hired a full time researcher. CDVCA could play a critical role in creating and helping to implement social measurement strategies. It can also act as a clearinghouse for best practices in social measurement, and promote these findings through its various publications and events.

⁸⁰ Ibid.

⁸¹ Interview by Author April 2002.

4. There is an implicit argument that all Venture Capital activity creates employment. In fact, the traditional Venture Capital industry cites that it created four million jobs through venture backed companies in the year 2000 alone. The claim of the CDVC industry is that they create particular types of jobs, for certain underserved workers as well as a host of other social impact criteria. Yet, these social returns are not well defined nor measured. The CDVC industry must define how they add more value, both to investors who may look for traditional Venture Capital financial returns as well as investors who look for high social returns.
5. Development and utilization of comprehensive social returns measurements will allow individual Funds and the CDVC industry to evaluate, replicate and innovate the model to increase both facets of the *double bottom line*.

Next Steps

While it is recognized that CDVC Funds have various social return measures and weigh even similar measure differently there is evidence of industry wide indicators beyond the obvious measures of job creation that will deepen the understanding and ultimately the impact of CDVCs. Looking back to chapter two, there were several social impact indicators common to all three Funds.

Job Creation and Living Wages

The types of data presented in this thesis and the significant measurement tools developed and utilized by SVCV are indicators of how these returns can be measured. While most Funds currently measure job creation/retention rates among their companies, they measure this social impact indicator with a varying degree of rigor. For this measure to be meaningful there must be an increased attention paid to differentiating created and retained jobs, a fair assessment of jobs created given co-investments, an evaluation of net jobs that takes lay-offs, resignations and terminations into account and a clear delineation that the jobs created are filled by low income workers. Funds also speak to the creation of good jobs. One relatively simple proxy for this can be benefits/wages analysis. An evaluation of living wage jobs created or available at a company given internal job training and the amount of workers who receive a living wage and some basic benefits will provide another way for Funds to evaluate their ability to

create good jobs. Evaluation and assistance in establishing links between Portfolio Companies and job training/placement agencies working with Low income communities can also be a valid measurement tool. This type of evaluation will help to inform Funds about the types of investments that translate into higher wage positions and better evaluate the companies, sectors and stages of investment that result in these better jobs. Further, it will allow Funds to compare the impact they can make relative to other investments.

An evaluation of employee wages prior to working at a Portfolio Company may provide real indicators of poverty level pre/post employment or use of public assistance or multiple jobs to supplement income. Requiring wage information for prior employment is a relatively standard business practice and would provide vital information about poverty alleviation.

Urban Focus

An analysis of the degree to which an urban/regional Fund is affecting an urban core can also deepen social impact. First, to what degree is the Fund maintaining its urban focus, and to what degree is that an expectation of funders? As noted above, some funders are concentrating investment in urban Funds and many Banks have specific focus areas for CRA related investments. A GIS exercise can provide some of this initial information, as well as a review of CRA qualified investment areas. A second and more well rounded analysis would include an evaluation of employee residences, again given GIS systems an easy test to see if employees, at the time of employment reside in high poverty urban communities. Further analysis could review the types of public transportation and supportive services that enable workers from these areas to conventionally work at Portfolio Companies that may or may not be located in high poverty communities. This can be accomplished in such a way that does not provide disincentives for companies to expand or for employees to move into higher income neighborhoods. For example, if an employee lives in a high poverty neighborhood at the time of employment and after two years lives in a higher

income neighborhood, that could perhaps be seen as a positive externality of employment with the Portfolio Company. Another possibility could be a Company located in a CRA eligible census tract at the time of investment which, by exit ,no longer qualifies because its surrounds have had considerable investment may represent a positive externality of investment.

Entrepreneurial Growth

A measurement of entrepreneurial growth was also commonly cited as a social returns indicator. It is suggested that, “one good proxy [for entrepreneurial capacity] is deal flow”.⁸² Another possibility is measuring the degree to which CDVCs’ investment in entrepreneurs in under-invested categories. This may include, specific sectors; like environmentally sustainable businesses or manufacturing; particular areas; like high poverty urban or rural communities; or certain populations; namely women and people of color. If, for instance, CDVC’s were able to, where traditional VC’s focus 80% of their investments in high tech, invest successful in environmentally sustainable businesses or, where only 2% of traditional Venture Capital is directed toward people of color, direct higher amounts to minorities; they could establish a competitive advantage of successful investment in an untapped market and further provide access to capital among under-served constituencies. Additionally, an assessment of the allocation of investment to non traditional businesses/business owners may provide one proxy for interpreting how CDVCs provide access to capital that encourages new entrants into entrepreneurship.

Stability and/or Development in High Poverty Areas

A final social return measure could be the physical impact of investment. Areas for further development are indicated by the location analysis in this thesis. Funds can assess the location of their Portfolio Companies in many ways to begin to understand impact. Retained or increased property taxes in high poverty areas is another potential positive externality of Portfolio Company

⁸² Ibid.

investment, an ongoing assessment of company property taxes can enhance the depth of CDVC impact. The degree to which Portfolio Company real estate construction or revitalization acts as a catalyst for infrastructure or real estate development is another opportunity to evaluate the impact of CDVCs. This can be a difficult measure to exact, however some opportunities can be a longitudinal analysis of development which evaluates trends in development prior and post Portfolio Company real estate development. A final analysis could appraise the multiplier effects of Portfolio Companies, analysis could include mapping of the supply chain of the company to evaluate its impact on local suppliers/purchasers. CDVCs can include the development of implementation strategies to help Portfolio Companies effectively support these local businesses, expanding CDVCs influence over local markets.

CDVC Funds are entrepreneurial, view their work as innovative and attempt to reduce the constraints within which they work. The assumptions of financial measurements of success are not seen as a limitation yet the incorporation of social measurement is. Social return measurements can be flexible and inventive. They can take into account the individuality of each Fund, yet still allow the industry to self regulate, and ensure that Funds who claim to be CDVCs share a certain principle in common. It may not be the specific goals they measure but rather that the measurement, evaluation and support of social returns are seen as vital to a Funds ability to succeed. Funds have a responsibility to be as actively engaged in appraising the social returns of their Funds as they are in valuing their financial returns. A traditional VC's reputation is doing 'whatever it takes' to achieve financial returns' to be constantly engaged with its Portfolio Companies to ensure that the returns required are met. CDVCs must act with the same energy on both inputs into their bottom line. It is the opinion of this author that an approach to Portfolio Company management that does not actively support the attainment of social returns, but rather relies on market forces to shape social return outcomes among its investments, is limiting the potential effects and viability of this community development investment tool.

Venture capitalists promote, advise and sometimes dictate particular managerial/operational practices of their companies. CDVCs can add significant value by working to create and implement business practices that sustainably and profitably support good quality jobs for low-income people in distressed or underserved markets.

There are opportunities for investors to participate in the social goals of their CDVC Fund's, without over-stepping the Limited Partner boundaries. First banks, if they utilize CRA designated capital to fund CDVCs, should negotiate some agreed upon portion of the CDVCs investment are located and/or considerable persons reside at time of employment in CRA eligible census tracts. For financial institutions to ignore these basic requirements of their investments dismisses the intention of CRA to target capital in spaces that are under-served and should be a fundamental and better monitored requirement of CRA eligible capital. Second, as investors make Fund II investments and review the CDVC's track record, social indicators should be equally weighed with the real/expected financial returns in an investor's analysis of management's experience. There may also be a role for information sharing or grant assistance, particularly among foundations, to assist Funds in the development and measurement of social impact tools. However, it is the Funds' responsibility, given the pressures by investors to increase financial returns, to confirm that they are distinct, they value equally the financial and social returns on investment and they expect their investors to share those values.

There is also a role for CDVCA to play in establishing and promoting the implementation of social impact measures that are common among Funds. As noted above it is critical that this is done while the industry is still relatively young. It sets the stage for Funds, current and future, to incorporate social returns measurements as part of the central structure of their organizations. It is clear that CDVCA has begun to research, evaluate and monitor the social returns of CDVCs; it can continue and expand this work. It can also act as a voice to

investors, particularly banks or new entrants into CDVC funder pool, to maintain alignment between CDVCs dual outcome approach and their expectations as a Limited Partner. Finally, CDVCA can provide technical assistance and/or grants to Funds to help develop and implement tools that will deepen the industry's understanding of social impact and spur innovation to further hone CDVCs' ability to meet the their mission.

Conclusion

The study of Community Development Venture Capital is important to understanding urban economic development. First, economic development strategies have and continue to focus on business development. Community Development Venture Capital represents a unique method of introducing equity capital to businesses that may otherwise not receive or have access to equity. These companies often locate in and/or employ residents of low-income urban areas. Second, Community Development Venture Capital proposes to incorporate both a financial and social bottom line. Because of this dual approach to investing, CDVC Funds have access to a variety of funding sources; these investors often represent pools of capital that would otherwise be directed to some other community/economic development benefit. Finally, as extensively documented, urban high poverty areas have been losing businesses to suburban areas for a long time in the US, and activities that encourage development of inner city business that employ low income/low skilled inner city residents may be able to play a key role as a catalyst in encouraging the return of good paying jobs into the inner city.

This thesis explored two related questions. First, how do investors in CDVC Funds influence the type of investments the CDVC Funds make and do these influences impact overall social returns? Second, what are the type, comprehensiveness and results of current social return measures in the CDVC industry? These two issues are related in a very distinct and powerful way; to be able to respond to the pressure of increased expected financial returns, Funds' must be able to show the value of their social returns.

It has been shown through this thesis, by examining three Funds' changing investors and investment strategies, that the industry is undergoing considerable restructuring. Concrete strategic changes have been made in Fund IIs for all

three CDVCs. These changes can be attributed to several factors: overall Fund experience, industry growth and changing market conditions. However, I propose that a factor in the changes is also result of the shifting nature of Fund investors. As chapter three illustrates there is a trend toward increased pension, large foundation and federal government involvement in CDVCs. Additionally, increased bank participation, spurred by CRA credit given for CDVC investments. This is a movement away from local foundations, local government and individuals. These changes have, in part, affected Fund capitalization. Funds are moving towards higher capitalization to address both the high cost of operations and because these new players have higher levels of capital to invest. The higher capitalization in turn creates a need for higher investment levels, which affects the type, nature and stage of businesses that become Portfolio Companies.

These trends have various potential effects on the CDVC industry; significantly there is the trend toward increased prominence placed on the financial returns of CDVCs. Given this, the measures and results of the social returns of CDVC Funds are key to understand. Currently, Funds have industry-wide inconsistent evaluations techniques, or simplified social measures, focused primarily on anecdotal evidence or loosely concentrating on job creation as the sole systematically monitored indicator of social impact success. All of these factors decrease the effectiveness of the Funds, the industry and ultimately the ability to attract aligned funding. Funds are changing strategies, like the move toward hybrid investing, in a response to investor pressures. A stronger position for the industry would be to establish their investor criteria that values, as they do, social and financial returns equally. To do this they must be able to explicitly understand and convey the types of social impact that their Funds have on targeted communities. Simply counting up the number of jobs created cannot do this. This does not appropriately speak to the mission of the Funds, and places undue limitations on what the impacts of CDVCs are and can be. Silicon Valley Community Ventures has established a social return measurement that takes

into account multiple factors such as job creation and retention, living wage standards, benefits, and location impact among other criteria. SVCVs systems do not set specific requirements on its Funds and represents a direction that the industry pursue.

The movement of Funds toward this more comprehensive approach to measurement with CDVCA's support will position Funds to align their investors with their outcomes ultimately creating a system of similar effectiveness to the traditional VC. In traditional Venture Capital, Limited Partners and General Partners motivations are aligned to provide the highest financial returns possible. When CDVCs are able to articulate and document the full range of their impact, financial and social, they too will be able to align their motivations with investors who understand and support both inputs in the *double bottom line*.

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APPENDIX 1

Community Development Venture Capital Investor Survey

Name of Institution

Type of Institution Bank Foundation Government Agency Pension
Fund Insurance Co. Other

CDVC Funds Invested Fund 1

CDVC Funds Invested in Fund 2

CDVC Funds Invested in Fund 3

Number of Rounds Invested in each fund Fund 1

Number of Rounds Invested in each fund Fund 2

Number of Rounds Invested in each fund Fund 3

Amount of Total Investments

Type of Investment (choose all that apply)

- Equity
- Debt
- Other

Given investment type what are expected returns? (e.g. 15% return on equity, 5% interest rate on debt)

Qualifying investment program (choose all that apply)

- part 24
- CRA
- PRI
- Other

Primary reason(s) for investment (please choose a MAXIMUM of two)

- satisfies CRA/part 24
- attractive potential financial return
- fulfills primary mission of organization
- diversification of investments
- strength of CDVC management team
- other

How did you weigh the financial and social objectives of the Fund in your initial investment decision?

- solely financial equally financial and social solely social

If the investment decision was based with consideration to the social goals of the CDVC Fund which social mission was most closely aligned with your organizations reasons for investment?

- growth of minority business ownership
 growth of women business ownership
 growth of environmentally sound businesses
 increased employment opportunities for low income/low skilled labor
 increase in businesses located in the inner city

What methods are used to gather information about your investment? (check all that apply)

- quarterly/annual reports
 seat on investment committee
 visits/communication with portfolio companies
 other

Do you believe the investments made by the CDVC are fulfilling their social mission?

- always
 mostly
 sometimes
 rarely
 never
 I don't know

Do you believe that the CDVC investment(s) made by your institution have?

- met expected social goals exceeded expected social goals fallen short of expected social goals

Do you believe that the CDVC investment(s) your institution has made have

- met expected financial goals exceeded expected financial goals fallen short of expected financial goals

If your investment qualified under CRA/part 24: What percentage of your annual CRA investment did the CDVC Fund investment represent that fiscal year?

Would your organization consider investing in a CDVC Fund again? yes

- probably doubtful no

Please provide any additional comments that you think may be important in understanding why your organizations has chosen to invest in Community Development Venture Capital Funds.

APPENDIX 2

INVESTOR SURVEY RESULTS	
Surveys	23
Responded	12
Complete	10
Bank Respondants	5
Foundation Respondants	5
Total Number of Funds Invested in*	48
Total Amount of Capital Invested*	\$ 207,750,000
Type of Investment	
Debt	1
Equity	8
Both	1
Expected Returns on Investment	
0-1%	1
1.1-5%	2
5.1-10%	2
10.1-15%	2
15.1-20%	2
over 20%	1
Qualifying Investment Program	
CRA	5
part 24	3
PRI	2
Other	0
Primary Reason(s) for Investment (can choose 2)	
Satisfies CRA/part 24	5
Attractive Potential Financial Return	1
Fulfills Primary Mission of the Organization	4
Diversification of Investments	1
Strength of CDVC Management Team	0
Other	1
How did you Weigh Financial and Social Returns on Investment?	
equally social and financial	9
solely social	1
solely financial	0
Which Social Mission is Most Closely Aligned with your Organization's Reason for Investment	
growth of minority business ownership	3
growth of women business ownership	1
growth of environmentally sound businesses	0
increased employment opportunities for low income/low skilled labor	4
increase in businesses located in the inner city	2
What Methods do you Use to Gather Information (check all that apply)	
Quarterly/Annual Reports	9
Seat on Investment Committee/Advisory Board	3
Visits to Portfolio Companies	3
Other	0
Do you Believe Investments Madew by the CDVC are Fulfilling their Social Mission?	
always	1
mostly	6
sometimes	0
rarely	0
never	0
I don't know	3
Have CDVC Investments	
met expected social goals	8
exceeded expected social goals	1
fallen short of expected social goals	1
Have CDVC Investments	
met expected financial goals	3
exceeded expected financial goals	0
fallen short of expected financial goals	1
NA**	6
If your Investment Qualified under CRA/Part 24 what Percent of Annual CRA investment does CDVC represent?	
2.5%	1
less than 5%	2
three year average 26%	1
don't know	1
Would you invest in CDVC again?	
Yes	9
Probably	1
Doubtful	0
No	0
* skewed by two respondants that include SBIC/SSBIC investments with CDVC investments	
** in comments section organizations stated they were unable to make a determination on financial returns yet	

**APPENDIX 3
THESIS INTERVIEW LIST**

Elyse Cherry
CEO and founder
Boston Community Capital
March 2002

Andrew Chen
Sr Fund Manager,
Boston Community Venture Fund
March 2002

Michelle Haigh
Analyst,
Sustainable Jobs Fund
March 2002

Dick Jones
CFO and founder
Boston Community Capital
February 2002

Kevin Jordan
VP, Urban Investment Group
Goldman and Sachs
March 2002

Josh Lerner
Professor
Harvard Business School
Author: The Venture Capital Cycle
The Money of Innovation
January 2002

Pete November
Director Business Advisory Services
Silicon Valley Community Ventures
March 2002

Community Development Division
Bank of America
February 2002

Julia Sass Rubin
Post Doctorate
Harvard Business School

Brian Schmitt
Research Officer
Community Development Venture
Capital Alliance
March 2002

Community Development Finance
First Union Corporation
March 2002

Trevor Smith
Portfolio Manager
Silicon Valley Community Ventures
March 2002

Joel Steiker
Sr. Fund Manager
Murex Investments
March 2002

Beth Lipson
Manager, Special Projects and
Financial Services
National Community Capital
April 2002

APPENDIX 4 INTERVIEW QUESTIONS FOR CDVC FUNDS

Questions Regarding Investors/CRA Requirements

1. Who are your investors and how much did each investor commit to your fund?
(note I have partial list of investors, any additional?)
2. How do you believe the investment objectives of these varying investors differ? How do you believe your investors weigh the financial and social objectives of their investment?
3. How have investor's objectives influenced the CDVC Funds investments goals and strategy?
4. Have you seen/or do you see a potential for conflict arising from having investors with differing objectives? How have these conflicts been managed? (vs. VC's whose investors primarily have the same motivation- profit maximization).
5. What is the role of Banks as investors in CDVC's and do you see it changing?
6. Have you made any specific commitment to your investors to meet certain social or financial goals? What are those commitments? How have those commitments affected the types of businesses you invest in?
7. Are you familiar with the CRA/part 24 requirements for financial institutions? Do you believe that the mission of your fund qualifies as satisfying the intentions of CRA?
8. Do you know whether any of your investors have utilized their investment as a satisfaction of their CRA requirements? Do you know what percentage of their CRA funds are invested in your Fund?
9. Have the requirements of the CRA affected the types of businesses you invest in? Do you believe that all of the businesses you invest satisfy CRA req's?
10. Do you plan to raise a second fund? If so, what investors to you hope to target for fundraising, why? *If already raised/raising fund 2- what are investors' criteria for investment? How does this differ from their criteria in Fund 1 investments?*
11. What type of ongoing reporting do you make to your investors? How do you report social returns?
12. What returns have your investors earned to date, financial/social? What percentage of the financial returns has been distributed? In what form are financial returns distributed?

Questions Regarding Impact Of Fund On Inner-City Revitalization

1. How do you measure the impact of your investments on the economic development of your target area? (qualitative and quantitative measures)
2. Do you know if any of the businesses you have invested in have utilized previously abandoned/vacant real estate in high poverty urban areas? *If so, where, how many, course of reintegration into real estate market?*
3. How do you find your portfolio companies?
4. What types of connections do you have with local economic development/SBA/ agencies? Have these connections helped identify potential portfolio companies?
5. What is the total number of FTE's at your portfolio company? How many are newly created jobs since your fund's investment in the company?
6. What number of the jobs that have been created by portfolio companies have gone to low-income **residents of high poverty urban areas**?
7. What number of the jobs that have been created by portfolio companies **are located within high poverty urban areas**?
8. Have you ever experienced a company whose bottom line would be positively affected by re-locating outside of the inner city? How do you (would you) handle this in relation to your social and financial missions?
9. The traditional VC industry is focused on the management team, and will often bring in new management if they feel the current team is ineffective, have you been in that situation? How was that handled?
10. Have there been any difficulties focusing on an urban marketplace? Are their factors which may/are pulling you away from concentrating investments in __?
11. What do you believe are the key obstacles to investing in companies that are located in or willing to locate in the inner city? How has your fund attempted to overcome these challenges?
12. What type of growth do you see for your organization?
13. What do you believe is your organization's current role and impact in affecting economic development change in the inner city of _____?
14. Are their aspects unique to your fund, or general industry practices that you believe would be helpful to know when attempting to understand CDVC's potential impact on inner city neighborhoods?