Nontraditional Sources of Venture Capital for Rural America

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Three types of nontraditional venture capital institutions are investigated: publicly funded and publicly managed, publicly funded and privately managed, and community-level equity funds. Each type has distinct advantages and disadvantages depending on program goals, funding sources, existing venture capital infrastructure, target industries and areas, and political environment. Successful nontraditional institutions tend to have skilled and experienced management, allocate resources to finding or generating investment opportunities, give significant attention to the fund's profitability, and enjoy insulation from political pressure or interference.

The availability of venture capital for entrepreneurs and businesses is recognized as critical for new business startups and business expansions. Consequently, a community's prospects for economic development are linked to local businesses' access to venture capital (Florida and Smith). However, the supply of venture capital is concentrated geographically, and venture capital investments are focused in a small number of regions and industries. According to the 2000 PriceWaterhouseCoopers survey, 71 percent of U.S. venture capital investments were in five States (California, Colorado, Massachusetts, New York, and Texas), and 91 percent of the investments were in technology and Internet-related companies.

The industrial and geographic focus of venture capital investments has contributed to the perception that geographically isolated and/or sparsely populated regions of the country and traditional, nonhigh-tech industries are underserved by traditional venture capital firms. "Small market" areas such as nonmetro communities and rural areas are especially overlooked by traditional venture capital firms because of the relatively high cost of finding or creating deals and managing the investments (Markley et al.). In response to this perception of a venture capital shortage in small market areas, many States and communities have developed nontraditional sources of equity capital for local entrepreneurs and businesses.

"An important key to the success of local small and large businesses . . . is access to equity capital" (Alan Greenspan, 1999)

This article summarizes the experiences of three types of nontraditional venture capital programs serving small market areas: public venture capital funds; publicly assisted, privately managed venture capital funds; and community-level equity funds. The more successful nontraditional venture capital programs (both in promoting business development and providing an acceptable return on investors' capital) were characterized by professional management, an incentive system that rewarded management for fund growth, adequate investment opportunities in the service area (i.e., deal flow), insulation from political interference, adequate resources for investigating potential investments (i.e., due diligence), and a focus on internal rate of return. The lessons learned from successful and unsuccessful programs will enable nonmetro areas to better assess their potential for operating a nontraditional venture capital program and the preferred organizational model for their situation.

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Street scene, Salem, New Jersey. Photo courtesy Jack Harrison.

Impediments to Traditional Venture Capital in Small Market Areas

Most traditional venture capital funds, according to Sahlman, are organized as limited partnerships with a predetermined life, usually 10 years. Capitalization of the fund is provided by the limited partners and the venture capitalist acts as general or managing partner. The fund invests in portfolio companies in the first 1 to 3 years, targeting investments with an expected return of at least 30 percent a year. Proceeds from the investments are harvested in the later years of the partnership and distributed to the limited partners. The managing partners receive an annual management fee (generally 2-3 percent of fund capital) and a predetermined percentage (e.g., 20 percent) of the total profit or earned interest on the fund's investments. The funding provided for initial capitalization and the remaining share of total profits (e.g., 80 percent) from the partnership are returned to the limited partners.

Nonmetro areas are rarely targeted by traditional venture capital investments because of four characteristics of these areas.

- Rural businesses are relatively small and concentrated in low-tech, low-growth sectors. Such businesses generally do not provide investment opportunities of the size and anticipated rate of return favored by traditional venture capital firms. In addition, the smaller size of rural investments results in higher fund management costs, for a given fund size, thus further reducing the net returns from investments.

- Rural entrepreneurs and business owners are reluctant to give up ownership in their businesses in exchange for equity capital. Many rural businesses are family owned and managed with the goal of transferring ownership to the next generation, not selling to a third party. Thus, alternatives for selling or liquidating investments (exiting deals) in small market areas may be more limited than in traditional venture capital markets.

- The cost of making and managing a venture capital investment is often higher in small market areas. The limited and dispersed investment opportunities or deal flow in nonmetro areas result in higher costs for identifying or creating deals and higher time and transportation costs for conducting due diligence and monitoring the investments.

- Rural communities offer relatively limited business infrastructure and human capital to meet the management needs of new companies. Venture capital firms investing in rural firms may have the additional expense of acquiring business services and managerial and technical personnel from outside the community.

The disadvantages associated with venture capital investments in small market areas have encouraged States and communities to investigate nontraditional sources of venture capital. Nontraditional venture capital institutions differ from traditional venture capital limited partnerships primarily in terms of the institution's goals and/or sources of capitalization. Nontraditional institutions typically are initiated to promote regional economic development and/or address perceived inefficiencies in the local venture capital market. Funding sources for nontraditional institutions are public and private organizations and individuals—such as State and local governments, banks, nonprofit foundations, utilities, landowners, and business people—that have an interest in the economic development of the region. These investors are more willing to accept a lower rate of return (relative to the target return for traditional venture capital funds) because of the potential for spillover benefits in terms of new tax revenues, increased demand for local real estate, or new markets for local goods and services.

Case Studies of Nontraditional Sources of Venture Capital

Insights into the funding, organization, and operation of nontraditional sources of venture capital are provided through case studies of 21 venture capital institutions or programs (see box "Conducting the Case Studies"). This article focuses on the 11 venture capital programs categorized as either publicly funded, publicly managed funds; publicly funded, privately managed funds; or community-level equity funds (see "Site Visit Venture Capital Institutions, by Category"). These program types provide excellent examples of nontraditional institutions locating in nonmetro areas or making investments in nonmetro businesses.

Publicly Funded, Publicly Managed Venture Capital Funds

Three venture capital programs typify public funds serving small market areas: Minnesota Technology Corporation Investment Fund (MTCIF/MIN-Corp); Iowa Product Development Corporation (IPDC)/Iowa Seed Capital Corporation (ISCC); and Small Enterprise Growth Fund of Maine (SEGF). The three programs were established as nonprofit corporations with management provided by employees of existing State agencies or quasi-public organizations (Minnesota Technology, Inc. for MTCIF; Iowa Department of Economic Development for IPDC; and Finance Authority of Maine for SEGF). For each program, oversight and investment decisions were provided by a board of directors appointed by the Governor. In the case of SEGF, the volunteer board is also responsible for due diligence on prospective investments. (Due diligence by venture capital institutions refers to indepth evaluations of prospective firms' management expertise and qualifications, product market competition and opportunities, and growth prospects for sales and profits.)

Publicly funded, publicly managed venture capital programs generally are capitalized through State appropriations or bond sales. The MTCIF was capitalized in 1991 with $7 million from Minnesota Technology, Inc., a State-sponsored program. SEGF was capitalized in 1997 through a State bond issue of $5 million, and the IPDC/ISCC received annual appropriations from 1983 to 1996 totaling $13.5 million. Public funding for these programs came with the restriction that the programs' investments must be in businesses located in the State or in companies with a significant instate presence. In the case of MTCIF, 80 percent of the program's investments must be in nonmetro counties. Restrictions on the location and type of venture capital investments reflect the programs' goals of promoting State economic development, subject to maintaining the fiscal integrity of the funds.

The three public venture capital funds have been aggressive in pursuing investment opportunities in their respective States. The IPDC/ISCC invested in over 70 Iowa businesses, MTCIF invested in 16 Minnesota companies, and the SEGF funded or committed funding to 13 Maine businesses. In addition, the MTCIF and SEGF leveraged their investment activity in State businesses through requirements that their portfolio companies obtain matching funding from private sources of venture capital.

Public funding and management imposed limitations on the operations of IPDC, MTCIF, and SEGF, and the three programs evolved over time to address these concerns. For example, the housing of IPDC in the Iowa Department of Economic Development precluded the hiring of a professional venture

Conducting the Case Studies

Site visits to the selected institutions were conducted during 1998 and 1999. Visits generally included interviews with current program directors/managers, founders or champions of the program, and, when possible, owners of two or three of the program's portfolio companies. Information collected included history of the program, sources and uses of funds, program organization and operations, characteristics of investment portfolio, status of portfolio companies, constraints/concerns with current operations, and goals or directions for future operations. The institutions selected for site visits were not chosen in an attempt to document "best practices;" indeed, three of the programs are no longer active. Instead, the objective of this analysis was to better appreciate the advantages and shortcomings associated with the alternative program structures.

Indepth case studies of the institutions will be available in 2001 on the Rural Policy Research Institution (RUPRI) web site (www.rupri.org). In addition, analysis of Small Business Investment Companies and community development venture funds is provided in recent publications by the Kansas City Federal Reserve Bank (1999) and on the RUPRI web site.

capitalist due to adherence to State payroll guidelines. In 1994, IPDC was restructured as a private, nonprofit corporation (Iowa Seed Capital Corporation). ISCC staff now included a professional manager, investment decisions became more insulated from State politics, and the financial performance of the fund improved. MTCIF was also reorganized as an independent nonprofit organization (MIN-Corp) in order to more readily raise additional capital for their investment fund. MTCIF's management believed that its public connection (and resulting perception of potential political interference) did not readily permit fundraising from the private sector and foundations. Finally, SEGF is investigating a change in structure from a publicly funded, publicly managed program to a publicly funded, privately managed fund. This change in ownership structure is viewed as a means of enhancing ability to leverage private funds and maintaining better due diligence and postinvestment services.

These public/private funds usually were started as a way of increasing the supply of professionally managed venture capital in the region, and/or enhancing the venture capital infrastructure and management capacity.

Publicly Funded, Privately Managed Venture Capital Funds

Six of the studied venture capital programs placed public monies in privately managed venture capital funds. Each program required "matching" funds from private sources and, in three of the cases, inducements were provided to encourage private investments. These public/private funds usually were started as a way of increasing the supply of professionally managed venture capital in the region, and/or enhancing the venture capital infrastructure and management capacity. The goal of public/private funds generally was to maximize profit or internal rate of return (IRR) from the fund's investments; social objectives (e.g., increasing employment and income) were not as prominent as in public venture capital programs. In public/private venture capital programs, the State sacrifices control over investment decisions (and social objectives) in return for the more limited financial risk associated with private, professionally managed funds.

Capitalization of the public/private funds differed among the six case study programs. Kansas Venture Capital, Inc. (KVCI) was capitalized in 1986/87 with $6.5 million from banks with headquarters or offices in Kansas and $5.0 million from the State. The 350 or so banks that invested in KVCI were provided tax credits of 25 percent against the State privilege (banking) tax. The Iowa Capital Corporation (1991) was funded with a State appropriation of $2.65 million that was matched (two-for-one match required) with subscriptions of $5.3 million from two Iowa electric cooperatives. As an incentive to co-invest, the electric cooperatives were to receive their original investment plus an annual return of 9 to 15 percent on their investment before the State would receive any return on its investment. The Colorado Rural Seed Fund (CRSF) was started in 1990 with $250,000 from the Colorado Housing Authority, $150,000 from the managing partner, and $100,000 from private investors. The State of Colorado did not require a return on its investment, so private investors could receive significant leverage on their investments. Two of the public/private programs (Magnolia Venture Capital Fund (Mississippi), Northern Rockies Venture Fund (Montana)) required partial private funding for capitalization. However, no special incentives were offered by the States as inducements for private investors. Finally, the Oklahoma Capital Investment Board (OCIB) required no direct public funding, but the State made available a pool of tax credits that could be sold, if needed, to pay back borrowed funds. Thus, the tax credits provided by the State serve as collateral on OCIB's borrowed funds. (To date, OCIB has not drawn on the available State tax credits.)

Four principal organizational structures were used by the six programs studied. Magnolia, Northern Rockies, and Colorado Rural Seed Fund were established as limited partnerships, with the State as a limited partner in each fund. KVCI is a for-profit corporation and Small Business Investment Company (SBIC). The Iowa Capital Corporation also was established as a for-profit corporation, but is considering changing to a limited partnership as a means to attract additional private capitalization. Finally, the Oklahoma Capital Investment Board (OCIB) is a State-beneficiary public trust that functions as a $50-million "fund of funds" for private venture capital limited partnerships. OCIB seeks to invest $1 million to $5 million in each limited partnership and maintain a maxi-

Site Visit Venture Capital Institutions, by Category

A. Publicly funded, publicly managed funds

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

B Publicly funded, privately managed funds

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

C. Community-level equity funds

- Ames Seed Capital Fund, Inc. (Ames, IA)
- Siouxland Ventures, Inc. (Sioux City, IA)
- McAlester Investment Group (McAlester, OK)

D. Certified capital companies (CAPCOs)

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

E. Community development venture funds

- Coastal Ventures (Portland, ME)
- Kentucky Highlands Investment Corporation (London, KY)
- Cascadia (Seattle, WA)
- Northeast Ventures (Duluth, MN)

F. Small business investment companies (SBICs)

- First United Ventures (Durant, OK)
- North Dakota SBIC (Fargo, ND)
- Pacesetter and MESBIC Venture Funds (Dallas, TX)

mum 20-percent share in each fund. OCIB believes that a $1-million to $5-million investment will encourage the funds to seek Oklahoma deals, but the 20-percent maximum share ensures that State politicians will have little leverage on the funds' investment decisions.

Public funding for the public/private programs generally came with restrictions on the location and activity of prospective portfolio companies. Investments were restricted to instate business, or—for KVCI, ICC, Magnolia, and CRSF—businesses with a significant instate presence. Montana required that 70 percent of NRVF's investments were with instate firms. The OCIB had no specific instate requirements, but private limited partnerships making little or no investments in Oklahoma firms were less likely to receive OCIB funding in the future.

The six publicly assisted, privately managed venture capital funds performed differently with respect to stimulating new businesses and providing the State a positive return on its investment. OCIB committed $26 million to private funds, and these funds had drawn $18 million and invested (including co-investments) $66 million in 11 Oklahoma firms. OCIB claimed an internal rate of return on investments of 29.6 percent. KVCI made 26 investments in Kansas businesses and ICC invested in 15 Iowa companies. Return on investments made by ICC and KVCI were sufficient to permit the two programs to refund the State's contribution and restructure as private venture capital programs. NRVF had 6 investments by summer 1998, and anticipates 10 to 12 portfolio companies at the time it is fully invested. No deals were exited at the time of the site visit.

Alternatively, both CRSF and Magnolia must be considered failures in terms of economic development impacts and internal rate of return. The value of CRSF's investments had declined from $500,000 in 1990 to $100,000 in 1998. CRSF's lack of success demonstrates the problems associated with rural venture capital funds. The availability of investment opportunities (deal flow) was limited due to the area's principal economic base (tourism, agriculture, mining, business services) and an unwillingness by businesses to give

Advantages and Disadvantages of Nontraditional Venture Capital Programs

Advantages

Publicly funded, publicly managed

- Programs can be designed to meet policy objectives such as economic development or industry targeting
- Economic and social impacts are more likely to be considered in investment decisions

Publicly funded, privately managed

- Political pressure to make specific investments is diminished
- Program can offer the higher salaries and profit sharing necessary to attract experienced fund managers
- Private investors more willing to invest in privately managed funds, providing leverage for public capital
- Private venture capital funds more willing to co-invest with other private funds, increasing syndication opportunities
- Expertise generally is available to assist management of portfolio companies

Community-level equity fund

- Funds focus investments on specific location, increasing economic development impacts
- Investors in fund can supplement returns with indirect benefits (spillovers) from investments
- Funds can target areas overlooked by traditional and State-level venture capital funds

Disadvantages

Publicly funded, publicly managed

- Political pressure to make investments in specific communities or firms may exist
- Public programs find it is difficult to attract most talented fund managers
- Private venture capital firms are reluctant to co-invest with public funds
- Some State constitutions do not permit equity investments by State agencies

Publicly funded, privately managed

- Political pressure may be present in selecting private venture capital fund
- State economic development objectives may be undermined by focus on returns or concentration of investments in specific industries or stage of business development
- Economic performance of the fund may be limited by restrictions on geographic location or eligible businesses

Community-level equity fund

- Deal flow is limited to a relatively small geographic area
- Resources for conducting due diligence on investment prospects are constrained
- Inadequate fund size to provide diverse portfolio and follow-on investments

up ownership shares. Distance also was a problem as it was difficult and expensive to maintain close contact with portfolio companies. In addition, CRSF had difficulty in attracting management to rural Colorado to "turn around" companies in trouble. Finally, Magnolia Venture Capital Fund provides the classic example of potential problems with venture capital programs if management is inadequate and the incentive systems do not reward fund growth. During its 2½-year history, MVCF incurred expenses of over $4.5 million while approving only one investment of $650,000. MVCF management was convicted of misappropriation of funds and the program was terminated in 1997.

Community-Level Equity Funds

Three of the nontraditional venture capital institutions in our study operated small investment funds focused on local businesses and entrepreneurs: Ames Seed Capital Fund, Inc. (ASCFI) of Ames, Iowa; Siouxland Ventures, Inc. (SVI) of Sioux City, Iowa; and McAlester Investment Group (MIG) of McAlester, Oklahoma. The three community-level programs were organized as for-profit corporations. ASCFI was established in 1986 by the Ames Economic Development Commission, a nonprofit organization of the local chamber of commerce. ASCFI maintains four funds, ranging in size from $300,000 to $740,000, capitalized primarily by Ames residents and businesses. SVI was capitalized in 1991 with $450,000 from 18 private investors and the Siouxland Initiative (an economic development program of the Siouxland Chamber of Commerce). MIG was formed in 1992 by 10 area businessmen who contributed $20,000 to $30,000 each for capitalization of the fund. MIG operates more like a formal network of angel investors than a corporation, and a consensus of shareholders is required before an investment is made.

Both ASCFI and MIG were started with the dual goals of providing an attractive rate of return for investors and stimulating local economic development. Investors in these two funds were willing to accept less than traditional venture capital rates of return because, as local business and property owners, they would benefit indirectly from new business activity in the areas. Alternatively, SVI's investment goal was to maximize returns on its investments, and economic development impacts were not criteria in their investment decision. However, SVI's investments were restricted to Sioux City, Iowa and surrounding areas.

Each community-level fund relied on part-time management, usually an employee of the local chamber and/or individuals selected from the fund's investors. These individuals lacked either the experience or the time for adequate due diligence, investment selections, or followup. In addition, the SVI board had many individuals representing corporate investors (e.g., local banks, real estate firms, manufacturers), and these individuals lacked the incentives to be actively involved in management decisions.

The investment experiences of community-level funds is mixed. MIG successfully completed (exited) 2 investments and is credited with helping to create 1,400 area jobs. ASCFI's 4 funds made 18 investments: 5 successful exits, 4 write-offs, and 9 still active. However, the rate of return on ASCFI's early funds was below investors' expectations. SVI's investment portfolio, on the other hand, was not a financial success. SVI invested in five area businesses, three of which were write-offs, one break-even, and one still operating.

The community-level funds demonstrate the difficulty of dually pursuing an acceptable return for fund investors and promoting local economic development when deal flow is restricted to the local economy. ASCFI has established separate funds focusing on economic development and maximizing fund rate of return in order to enhance the financial performance of their venture funds. Community-level funds also struggle with procedures to ensure adequate due diligence on prospective deals. Due diligence might be supplemented by employing outside consultants or partnering with other venture capital funds on investments.

Lessons Learned

This study of nontraditional venture capital programs for small market areas did not find a "best" model. Each program alternative has distinct advantages and disadvantages (see "Advantages and Disadvantages of Nontraditional Venture Capital Programs"), and the most desirable program type for a particular situation will depend on program goals, available funding sources, existing venture capital infrastructure, target industries, and political environment. For example, publicly funded, publicly managed venture capital institutions can be designed to achieve specific economic development goals, and lower returns on program investments can be justified if investments provide positive economic and social impacts. However, the public programs may experience difficulty in attracting experienced managers, may be subjected to political pressures, and may not be able to leverage public investments through partnering with private venture capital firms.

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Publicly funded, privately managed institutions address many of the shortcomings of the publicly funded and managed programs. Private management of public venture funds generally provides better insulation from political interference in fund investments, a salary and incentive package attractive to experienced fund managers, and greater opportunities for attracting private capitalization or co-investments with private funds. The benefits of private management come at a cost. The privately managed fund, with its focus on specific industries and on maximizing the fund's internal rate of return (IRR), is less likely to be concerned with specific State economic development objectives.

Finally, community-level funds provide an alternative for local economies that are bypassed by traditional and publicly assisted venture capital institutions. These community funds can provide significant local economic and social benefits. However, venture capital programs in small market areas generally have relatively high risks and low IRR as a result of limited deal flow and inadequate resources for fund management.

Conclusions

During the last 20 years, numerous nontraditional venture capital institutions were developed to assist entrepreneurs and businesses in regions and industries overlooked by traditional venture capital funds. The three types of nontraditional institutions addressed in this study offer distinct advantages and shortcomings with respect to program management, financial viability, and regional economic impacts. In addition, examples of successful and unsuccessful institutions were observed for all program types. The successful venture capital funds in small market areas generally shared six characteristics.

- Skilled and experienced management was hired and an incentive system installed to reward management for increasing the value of the fund.

- Program resources were allocated for generating deal flow via marketing or deal creation.

- Capitalization of the fund was optimal for providing a diverse portfolio and follow-on investments.

- Program management gave significant attention to fund IRR in order to maintain the longrun sustainability of the program.

- Program maintained a system for conducting rigorous due diligence on prospective investments.

- Potential for political pressure or interference in fund management was minimized.

In summary, the key to a successful nontraditional venture capital program is the management and administration of the program, not the selected structure. Moreover, regardless of program type, successful nontraditional venture capital funds helped the local economy and demonstrated the potential for venture capital activity in the area. For example, Kansas Venture Capital, Inc. has invested in 30 companies, 6 of which are located in nonmetro counties, and has created or retained over 2,600 jobs. In addition, KVCI will repay the State of Kansas its original $5 million investment in the fund. Thus, the economic development benefits from the publicly funded, privately managed institution are realized at little or no cost to the State. KVCI demonstrates that creating a successful nontraditional venture capital institution can be good public policy in "small market" areas such as nonmetro communities and rural areas. RA

For Further Reading . . .

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