

Worth

Best Practices: Investing

Divining Opportunities

Lee Gimpel
12/01/2007

Last year, Mark Dwight got a call from the venture firm he invested with; the team informed him of two good prospects. Dwight grew up as the son of a Silicon Valley laser pioneer, and wanted to earmark his money for companies in his hometown of San Francisco. But the startups he would be backing were not typical of the futuristic technology firms so common in the Bay Area. Instead of microchips or next-gen software, the fund selected businesses that didn't seem destined for debuts on the Big Board: a bakery and a pharmacy.

Rather than demanding that his money help bankroll the next Google or Microsoft, Dwight happily wrote out a \$100,000 check to cover his capital commitment. This was, after all, exactly what he sought when he invested in Pacific Community Ventures' PCV Investment Partners III fund this year.

Like the 70 other funds classified as community development venture capital, PCV backs small businesses, and in doing so tries to help individual communities or society as a whole. According to Kerwin Tesdell, the president of the New York-based Community Development Venture Capital Alliance (CDVCA), this breed of fund has big aspirations but accounts for only \$2 billion in assets—roughly 0.2 percent of the total venture market in the United States. Still, investor demand for these smaller funds (with assets between \$10 million and \$100 million) is growing.



The recent successes of these funds reflect the heightened interest in venture capital since the tech boom of the 1990s, as well as a movement to apply business principles in philanthropy. Over the past decade, investors began recognizing that businesses attempting to do good can also do well. Assets in socially responsible mutual funds jumped to \$46.5 billion by 2006, up from about \$6.5 billion in 1996, according to the Chicago-based fund tracker Morningstar. Examples of the expansion in community development venture funds include the New York City Investment Fund, which has raised more than \$110 million, and Bridges Community Ventures in London, which attracted more than \$150 million in June for its second fund, surpassing its target amount by 50 percent. Traditional investors are also joining the effort. Henry Kravis, a founding partner of Kohlberg Kravis Roberts & Co., conceived of the New York City Investment Fund and serves as cochairman. Bud Colligan, Macromedia founder and a partner at Accel Partners, also cofounded Pacific Community Ventures.

Not the Same Old VC

This represents a shift from the early days, when the first community development venture capital funds were nonprofit venture capital pools designed to bolster specific communities but not necessarily enrich their financial backers. Today the funds seek competitive market returns for investors. They target community development in cities like Boston and New York, as well as less economically effervescent locales such as northwestern Wisconsin and western Maryland. The funds also might focus on broad regions. For example, the Southern Appalachian Fund emphasizes early-stage and growth companies in low-income areas in Alabama, Kentucky, Tennessee, Mississippi and Georgia.

TOP VIEW Community development venture

Although community funds often consider a second bottom line that entails such criteria as job creation or environmental impact, they must focus squarely on the bottom line to remain competitive with traditional

capital funds offer investors the potential for both financial and social returns. Recent successes among the funds reflect the heightened interest in venture capital since the tech boom of the 1990s, as well as a movement to apply business principles in philanthropy. A composite portfolio of first-generation funds produced a 15.5 per-cent internal rate of return. Although finding the right fund can sometimes prove challenging, today 70 such funds, with assets totaling \$2 billion, invest in local businesses.

venture funds. David Kirkpatrick, the managing director of SJF Ventures in Durham, N.C., downplays the term "community development" because it sends the message of being a "do-gooder" who sacrifices financial returns, he says. He counters that suspicion by calling his Sustainable Jobs Fund simply SJF to appeal to investors.

The biggest differences between typical venture funds and those with a stated community mission are the size and location of the investments—which may affect investment performance. The traditional venture capitalists will argue that the investments they make and the counsel they provide are economic engines, boosting employment and adding wealth to the economy. The community funds also emphasize job creation, but their aim is to create opportunities for low-skilled workers, as opposed to the typical venture capital mold of companies staffed by engineers, computer programmers, PhDs and

MBA's. And although community development investment funds now tend to focus on major metropolitan areas, many still prospect in secondary towns and rural regions. Like Dwight's bakery and pharmacy, they may also consider industries overlooked by traditional venture capital.

"I do think that [PCV and other community funds] are playing in a space that is not under consideration by some other, traditional venture firms," Dwight says. As a result, community funds may face less competition to buy promising companies and, therefore, get better valuations.

The biggest differences between typical venture funds and those with a stated community mission are the size and location of the investments.

However, one of the key advantages in focusing on overlooked areas—less competition—also presents one of its significant challenges: Funds often struggle to find talent. Kip Moore, a former partner at a New York-based firm, now lives in Maine, where he invests in a fund run by Portland-based CEI Ventures. Half-joking, he notes that a company must find either a homesick Maine native or someone with a passion for sailing (a big pastime in the "vacationland" state).

Returning capital presents another challenge in less liquid markets. High-tech companies in Silicon Valley offer clear exit paths for investors through IPOs or acquisitions. A low-skilled manufacturing company in small-town West Virginia doesn't present the same options. (One exception: The market currently favors companies pursuing clean-energy innovations.) Strategic buyers acquire many of the companies even if they are not located nearby, and private equity firms may take over a maturing company in order to grow it to the point where there are more liquidity options. In rare cases, employees buy out a company.

Picking a Winner

It is still too early to fully assess the results of community development venture capital funds. Most of the 10-year funds have not completed their investments, and most managers have only closed one or two funds to date. "To some extent, the jury is still out," admits the CDVCA's Tesdell.

Yet the performance so far shows attractive returns. A composite portfolio of first-generation community development venture capital funds produced a 15.5 percent internal rate of return (IRR), Tesdell says. This compares to a 21 percent average annualized gain for traditional VC firms over 10 years through August, according to Thomson Financial and the National Venture Capital Association. (No special tax breaks accrue to investors to offset the difference.)

"Do I expect those kinds of returns? The answer is yes. Will I be terribly upset if they don't get that level of return? No. They get a little bit of a lower bar because they do demonstrate this social return," says Sunil Paul, who has invested six figures with Pacific Community Ventures.

But fund managers and investors anticipate that second-generation funds will outperform the first as managers become more experienced in satisfying a commitment to the first and second bottom lines. This might even mean passing on deals that would be good for a community but not for investors. When CEI Ventures closed its first fund in 1996, its top managers had backgrounds in business and finance, but little venture capital experience. Nat Henshaw, CEI's president, concedes that his first fund of \$5.54 million "is not blowing the cover off the vault; it's looking like a small, single-digit IRR." However, the \$20 million second fund, which closed in 2001, has returned 24 percent of capital so far.

"There's been clear evidence that the CEI Ventures team has learned a lot," says Moore, who invested \$200,000 in the second fund.

Of course, there is no guarantee that community funds will pay off handsomely—or at all. But with some due diligence, investors can improve their odds of a good return. They benefit from low minimum investments, often less than Moore's \$200,000 and sometimes as little as \$50,000. Getting into the newer funds is also not as competitive as entering older, established VC firms. As with all venture capital funds, investors underscore the importance of finding a solid management team that is comfortable working together and has applicable experience in both venture capital and community development investing. And Tesdell cautions against considering funds influenced by a town council or economic development agency, as politics can trump objective decision-making.

"Venture capital is a tough business. And if you're worried about what's going to be in the papers the next day, it's harder to do that," Tesdell says. "So we recommend that—even if government is involved in helping to organize the fund—that a significant portion of the capital come from private investors."

Finally, investors need to decide if they are willing to give up some financial return to give back to their local communities. After all, funds that focus exclusively on one locality may not produce the highest returns, because the best investments are not always next door.

"The idea of using your personal wealth not just to give away your money but to invest your money in ways that will sort of bring together your investment portfolio and your charitable giving is a new idea that's becoming more and more current," Tesdell says. "There are not a lot of opportunities out there to do that."

Social Gains

Quantifying investment performance is easy, but gauging how well a fund fulfills its stated social mission requires more careful analysis. The Community Development Venture Capital Alliance's publication, *Measuring Impacts Toolkit*, provides investors with a framework for assessing social return. This includes:

- **Job growth:** Are there more jobs? How many part-time workers converted to full-time equivalents?
- **Improved job quality:** Are employees receiving better benefits and more training opportunities?
- **Economic gain:** Are the portfolio companies employing "target" employees—those whose income is 80 percent or less of the area median income?

An example of this type of framework is the Southern Appalachian Fund, based in London, Ky., which was established in 2003 and seeks to invest from \$200,000 to \$1 million in each of its portfolio companies. In May 2005, the fund made its initial investment into SemiSouth, a silicon carbide manufacturer based in Starkville, Miss. At the time, there were 21 employees; in a year, that number had tripled. Nearly 90 percent live in a low-income census area.

Illustration by Ken Orvidas.

Lee Gimpel is a business and technology writer based in Richmond, Va.