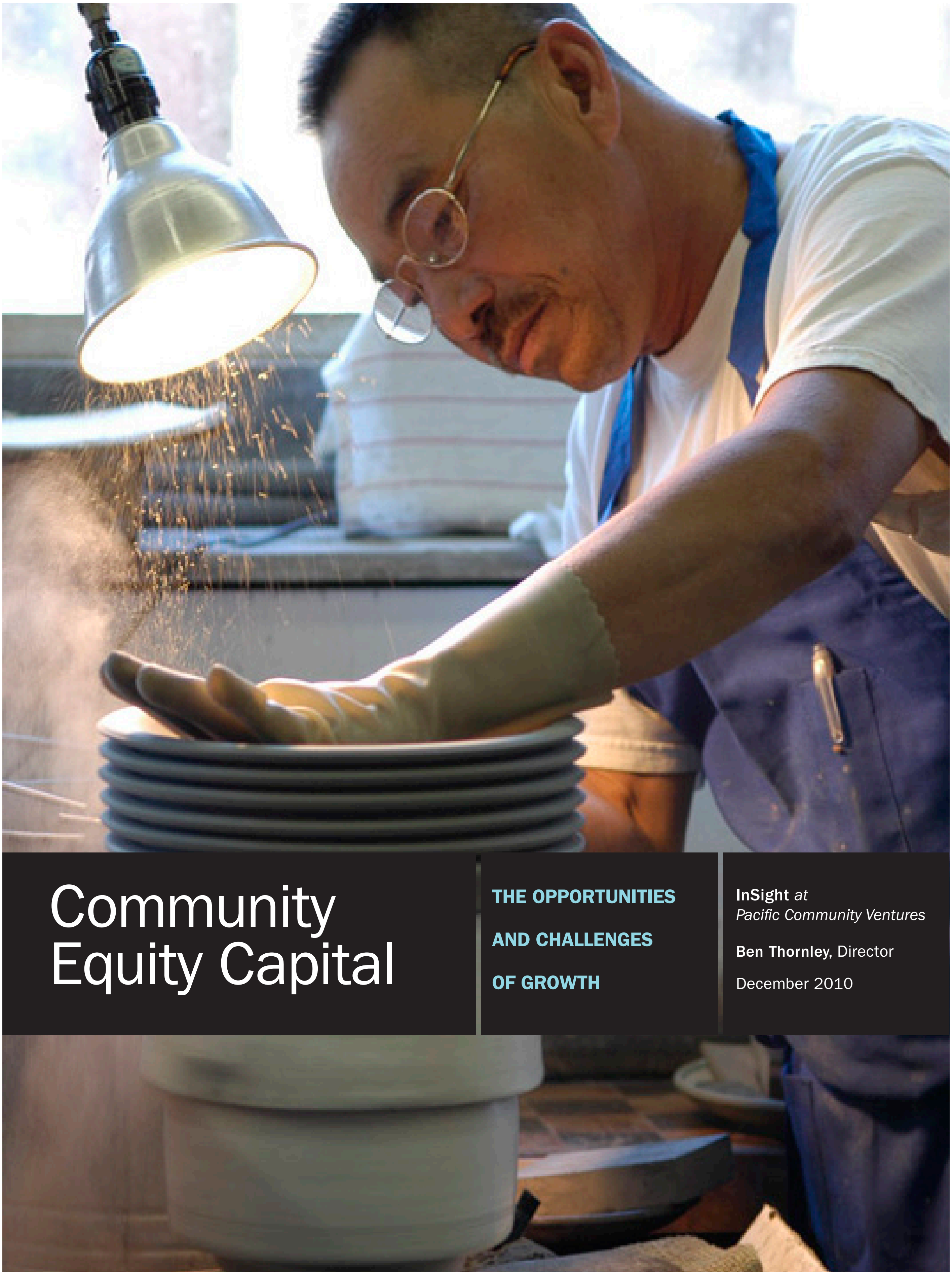

Community Equity Capital

THE OPPORTUNITIES AND CHALLENGES OF GROWTH

InSight *at*
Pacific Community Ventures

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LIST OF ABBREVIATIONS

CalPERS – California Public Employees Retirement System
CDFI – Community Development Financial Institution
CDVC – Community Development Venture Capital
CDVCA – Community Development Venture Capital Alliance
CRA – Community Reinvestment Act
ETA – Employment Training Agreement
GDP – Gross Domestic Product
GP – General Partner
ILPA – Institutional Limited Partners Association
LP – Limited Partner
MESBIC – Minority Enterprise Small Business Investment Company
MRI – Mission Related Investment
MSA – Metropolitan Statistical Area
NMVC – New Markets Venture Capital
PRI – Program Related Investment
SBA – Small Business Administration
SSBIC – Specialized Small Business Investment Company

1. Executive Summary

Community development venture capital (CDVC) funds are a potentially powerful tool for targeted job creation, providing equity capital to proven entrepreneurs and the growing businesses already located in and employing workers from underserved communities.

Yet CDVC funds face an extraordinary challenge — delivering both financial and social impact, even when structural and operational characteristics common to CDVC funds threaten the very private equity model on which the success of CDVC investing depends.

The private equity model is difficult and precise. General Partners (GPs) rely heavily on established business networks to identify prospective deals. When reviewing the hundreds of business plans necessary for making an investment, GPs look for concrete indicators including significant prospects for growth, a unique product or service, and a clear exit strategy.

The operational and structural idiosyncrasies of many CDVC funds have the potential to constrain this model. It may be more difficult for funds to achieve stated objectives if they are required to invest in low-income communities, within set geographic boundaries, they have limited capital, or they are managed by GPs with little experience in the private equity industry.

For example, investing in low-income communities underserved by traditional equity capital — the activity that defines and distinguishes CDVC funds — is especially problematic because markets include fewer profitable investment and exit opportunities, the absence of developed business infrastructure, limited experience of corporate management, and a lack of understanding of how private equity works.

Investors need to be aware of the challenges facing CDVC funds, and should deploy capital in the sector in a way that maximizes the probability of success.

CDVC vs. Venture Capital Investing

While the 'CDVC' label implies that funds invest using a typical venture capital model — i.e. in the very early stages of the development of companies in high-growth industries — CDVC funds use a broader strategy. CDVC funds tend to invest at all stages, with a focus on expanding companies likely to create jobs, often in more traditional industries that employ low-wage workers. As a result, the activity of CDVC funds is referred to throughout this report as 'private equity' investing.

Challenges and Opportunities for CDVC Funds

Despite the difficulties, CDVC funds have been operating in the United States for over twenty years, growing in the aggregate to $2 billion in capital under management and developing a more mature and successful model of investing.

CDVC funds are larger, invest more money in later stage deals, have access to a wider range of investors, and have exposure to a more diversified group of industries than they did just a decade ago — all changes that have enhanced the risk/return profile of the sector.

At the same time, it remains difficult for CDVC funds to raise capital, to quantify the benefits and costs of investing for financial and social return, to catalyze a supportive public policy environment, and to share best practices. Information on performance is lacking, CDVC funds are private and fragmented by nature, and a bifurcation in the industry between funds seeking the support of financially-motivated capital providers like pension funds, and funds focused on core CDVC investors including governments, foundations and banks, is creating tensions.

Whether a CDVC fund targets primarily financially- or socially-motivated investors, GPs should leverage the key learnings from two decades of industry practice. More rigorous sharing of knowledge and data, and a laser-like focus on best investment practices, is imperative.

The Role of Limited Partners

As key collaborators in the creation of private equity funds, limited partners (LPs) are uniquely positioned to support the continued growth and development of the CDVC fund industry. LPs should consider:

1. **PROVIDING MORE FLEXIBLE MANDATES TO CDVC FUNDS**
   Greater flexibility in investment partnerships, most notably moving away from tight geographic restrictions, will ease the pressure of potential 'constraints', reducing the likelihood that a fund faces an uphill battle from inception because of structural or operational characteristics.
2. **INVESTING IN THE STRATEGIES AND THE FUNDS THAT ADVANCE THE INDUSTRY'S DEVELOPMENT**
   Investment strategies advancing the industry's development include:
   - → **Supporting the financially-focused CDVC funds growing the industry by attracting new sources of market-rate capital.** Socially-motivated investors can play a role in ensuring that the important community impacts at the heart of CDVC investing are not altogether swamped by the demand for financial return;
   - → **Investing in fund-of-funds** that are capable of attracting and accommodating larger pools of market-rate capital and bringing more rigor to investments in

socially-focused funds, including through the sharing of best practices by underlying GPs and consolidation of performance reporting; and

- → **Re-capitalizing the new funds of proven GPs,** supporting professionals that have already succeeded in CDVC investing and have a desire to remain engaged.

3. **COLLABORATING CLOSELY WITH OTHER LPS TO UNIFY INVESTMENT OBJECTIVES**
   Collaboration with other LPs to unify investment objectives will create operational economies of scale, reducing costs for funds and supporting the development of a more standardized and consistent system of performance measurement.
4. **FUNDING CAPACITY BUILDING AT THE INDUSTRY LEVEL**
   Additional philanthropic and government funding for capacity building — including research, performance measurement, and channels through which to share expertise — will support the industry's understanding and adoption of best practices.

Realizing the Promise of CDVC Investing

The CDVC fund industry sits at a challenging crossroads. Without the data to conclusively demonstrate successful financial and non-financial performance, the same core group of primarily socially-motivated investors is being asked to support the industry's growth.

To the extent that these core LPs demand stringent social impacts, in narrowly targeted areas, a continued willingness to provide subsidized capital is needed to underwrite the cost-effective community impacts for which CDVC funds are known. The case for ongoing subsidies is strong, but also under threat, with LPs buffeted by the economic crisis and becoming more reluctant to accept below-market financial returns or withdrawing from the sector altogether.

Because fund growth is largely contingent on attracting new financially-focused sources of capital, more GPs operating in low-income communities are embracing a broader social mandate and the essentiality of competitive investment returns.

This trend is either a bifurcation within a broadly defined CDVC industry, or, if CDVC funds are defined more narrowly, a diminishment of the CDVC industry and growth in the broader category of 'social' private equity investing. Either way, the development has significant implications for the creation of funds, for our understanding of the place of equity capital in underserved communities, and for the role and investments of LPs.

Definitions aside, transition in the CDVC fund industry presents a unique opportunity for socially-motivated investors — first, to build a more impactful CDVC sector by supporting rigorous, standardized reporting of performance and other best practices, regardless of the financial or social objectives of underlying funds; and second, to create a more sustainable CDVC sector by catalyzing financially-motivated sources of capital.

2. Research Overview

InSight at Pacific Community Ventures was commissioned by the Annie E. Casey Foundation in 2010 to research and analyze the recent performance of the community development venture capital (CDVC) sector.

This report is intended for an audience of socially-motivated LPs. It describes the challenges of community equity capital investing and makes recommendations to advance the field.

General findings are grounded in a comparison of ten similar funds. InSight leveraged this analysis to create a typology of 'constraints' on the traditional private equity investment process common to the CDVC sector.

While it is difficult to draw definitive conclusions from a sample of ten research subjects, we note that just seventeen CDVC funds have been launched since 2001.[1] Data from eight of these seventeen funds are included in this analysis.

Research undertaken by InSight included surveying academic literature, conducting structured interviews with general partners (GPs) at nine of the ten analogous funds, and collecting additional fund and industry data.

The report makes findings and recommendations primarily at an industry level, focusing on the strategic growth of the sector. Important research on the specific financial innovations necessary for supporting CDVC funds, for example a secondary market to facilitate portfolio company exits, was not included as a part of this work.

About InSight at Pacific Community Ventures

InSight is the thought leadership practice at Pacific Community Ventures, providing investors and policymakers with knowledge and tools to increase the flow of capital to underserved communities. Pacific Community Ventures is a U.S. non-profit organization and Community Development Financial Institution.

In 2010, InSight assessed the social impact of over $1 billion in private equity capital from pension funds, foundation endowments, banks, insurance companies and other institutions.

3. The Community Equity Capital Industry

Community Development Venture Capital (CDVC) funds are private equity investors in the United States seeking financial and social impact. CDVC funds are typically registered with the U.S. Department of Treasury's CDFI Fund as Community Development Financial Institutions (CDFIs) and have an explicit mission of providing equity capital to small businesses with strong prospects for growth in geographic areas underserved by traditional capital. CDVC funds register with the CDFI Fund in order to access government grants of financial and technical assistance.

Markets underserved by traditional equity capital include those defined by the Small Business Administration (SBA) as 'low-Income geographic areas'. These areas have a poverty rate of 20 percent or over, or a majority of metropolitan households below 60 percent of the area median gross income, or non-metropolitan median household income less than 80 percent of the statewide median, or are located within a HUBZone, Empowerment Zone, or Enterprise Community.[2]

A broader definition of markets underserved by 'institutional equity capital' includes all those geographic areas outside of the 774 zip codes in the United States that account for 80 percent of all private equity investments.[3]

By investing in underserved communities, CDVCs create quality jobs for people with limited work opportunities, increase the entrepreneurial capacity of local markets, and spread wealth to business owners and employees.[4]

The CDVC industry traces its origins to the equity investments of Title VII Community Development Corporations in the 1970s. The industry was also bolstered by the expansion of Community Development Loan Funds into equity and by individual states embracing the promise of venture capital as a way to stimulate economic growth in low-income communities.[5,6]

A Note on Data and Definitions

Because the CDVC industry is small, private, and developing, good data is hard to come by — both at an industry and fund level. Data compared across time is usually collected under different conditions, creating problems of inconsistency, while sample sizes are typically small, adding uncertainty. Data presented in this report should therefore be interpreted as indicative, but not conclusive.

The definition of CDVC funds is also ambiguous. Because funds are shaped by the discrete markets in which they operate, they often have very little in common. This, together with the move by some GPs to unapologetically prioritize competitive financial returns, has motivated a robust debate on what, precisely, a CDVC fund is.

Narrowly defined, CDVC funds share a commitment to creating quality jobs and economic opportunities in low-income communities as a primary objective. As discussed below, this typically necessitates the support of public sector and private foundation subsidies. The funds that fall under this narrow definition of CDVC investing — including most of the funds that currently target low-income communities — are typically registered with the CDFI Fund.

Broadly defined, the CDVC industry includes a number of other funds investing and creating jobs in low-income communities as a core but ancillary objective. The primary goal for these funds is earning a market rate of return. These funds are not necessarily registered with the CDFI Fund, and the social impact of their investments often results as much from the benefit to low-income communities of portfolio company products and services as it does from employment practices in underserved markets. Some of these funds may not self-identify as CDVC investors, instead preferring to align with the broader category of 'social' private equity managers.[7]

It is plain to see how the narrow and broad definitions of CDVC funds can become conflicted — with one making the structural case for government and philanthropic subsidies, and the other making the business case for access to a larger pool of prospective market-rate investors.

For the purposes of this report, InSight uses the broader definition of CDVC funds, which is more accommodating of recent industry developments. While the report provides strong evidence of a bifurcation in the CDVC industry, CDVC nomenclature has not been altogether cast aside by most financially-focused funds and remains the most appropriate terminology.

a_ Locating CDVC Funds in the Broader Developmental Equity Sector

CDVC funds are one part of a broader group of GPs investing with social objectives. This includes three additional categories of private equity companies: 'minority-focused' funds investing predominantly in companies owned by people of color; 'state-sponsored' funds with the objective of catalyzing broader economic and entrepreneurial development; and 'social' funds, which invest in companies that 'manufacture or sell socially beneficial products and/or utilize a progressive management approach that benefits employees and customers'.[8]

Minority-focused funds were created in 1969 with the introduction of the federal Minority Enterprise Small Business Investment Companies (MESBIC) program. The objectives of the program were described by Congress in 1972 as stimulating and supplementing the flow of private-equity capital and long-term loan funds to minority small business concerns, which 'are not available in adequate supply'.[9] The MESBIC program was renamed the Specialized Small Business Investment Companies (SSBIC) program and, while it was terminated in 1996, dozens of non-SSBIC minority-focused funds have been created since. The industry's trade association, the National Association of Investment Companies, includes 48 full or affiliate members managing over $10 billion in assets.

State-sponsored funds emerged from the creation of the federal Small Business Investment Program in 1958. The program was intended to kick-start the broader venture capital industry and continues to this day, accounting for over $8.2 billion in loans guaranteed by the Small Business Administration to 317 funds at the end of 2009.[10]. Individual states created similar programs beginning in the early 1970s with the objective of creating jobs and stimulating local economies.[11] According to the National Association of Seed and Venture Funds, 47 funds sponsored by thirty states account for a total of $2.4 billion of invested capital.[12]

Social funds are an emerging industry of over twenty self-identified investors that explicitly pursue a double bottom line of social and financial returns.[13] According to a leading researcher in the developmental equity sector, Assistant Professor Julia Sass Rubin from Rutgers University, the distinction between what she calls 'social venture capital funds' and the much larger, profit-driven 'clean tech' and 'lifestyle of health and sustainability' sectors is as much one of 'intent' and 'self-identification'.[14] Social funds and clean tech funds often invest in the same companies, but for different reasons.[15] The same definitional ambiguity separates the CDVC and social fund sectors, as discussed above. CDVC funds targeting market-rate returns, with an ancillary objective of job creation in low-income communities, are increasingly self-identifying as social private equity mangers.

b_ A Maturing CDVC Industry

Data and definitional challenges notwithstanding, there are now 71 CDVC funds operating in the United States with $2 billion in capital under management, a significant increase from six funds and $100 million in capital in 1993.[16, 17]

As figure 1 demonstrates, the CDVC industry has matured considerably in the past decade:

- → Funds are four times larger, with an average size of over $28 million, up from $6 million;
- → Funds are investing more money in each deal, with an average initial investment of at least $300,000, up from just $10,000;
- → Funds are investing in more developed companies, with over half of the industry's capital invested in the expansion or later stages;
- → Funds have access to a wider range of capital providers; and
- → Funds have exposure to a more diversified group of industries, with investments in the manufacturing sector falling from 50 percent to 18 percent of fund capital.

Nonetheless, CDVC fund investments differ, for the most part, from those in the traditional private equity industry. On industry exposure, the CDVC fund sector invested 12 percent of its assets in technology companies in 2006 compared to 17 percent of total private equity capital deployed to the sector.[18,19] Traditional venture capital companies invested 68 percent of capital in the high-tech industry in 2006.[20, 21] In 2007, about 60 percent of traditional private equity investments were larger than $50 million, of which venture capital investments averaged about $7.7 million, compared to an average investment by CDVC funds of $459,000.[22, 23] The geographic distribution of deals also differs. The top recipient states of CDVC fund capital in 2007 included Pennsylvania, Maine, Tennessee, Ohio and Kentucky. In the traditional venture capital sector, California, Massachusetts, Texas, New York, and Washington were the top recipients of funds.[24]

Figure 1:
The Changing Structure of Community Development Venture Capital Funds, 1999-2008

	1999[2]	2008[2]
SIZE		
Number of funds	48	71
Industry funds under management	$300 million	$2 billion
Average fund size	$6,250,000	$28,169,014
SOURCES OF CAPITAL		
Banks	34%	30%[1]
Foundations	22%	14%[1]
Federal Government	19%	11.2%[1]
INDUSTRY EXPOSURE		
Manufacturing	50%	18%[1]
Service	24%	24%[1]
Sofware/High-tech	8%	12%[1]
Retailing/Media	5%	22%[1]
DEAL SIZE		
Size of initial investment	$10,000 - $1,000,000	$300,000 - $3,000,000
STAGE OF INVESTMENT[3]		
Seed/start-up	33%	15%[1]
Early	23%	34%[1]
Expansion	31%	45%[1]
Later	13%	6%[1]
FUND STRUCTURE		
Non-profit	42%	some[1]
For-profit	40%	most[1]
EXIT STRATEGIES		
External buyer	46%	77%[1]
Management buyback	36%	10%[1]
IPO	15%	10%[1]

1 Data from 2006
2 1999 data from Sass Rubin (2001); 2008 data from Tesdell (2010)
3 Compares 'cumulative investments outstanding' (1999) to 'investments outstanding in the most recent year' (2006), from Tesdell (2010)

c_ Sources of Capital and Insights into Financial Performance

Differences in sources of financing for the four categories of developmental private equity are the strongest indicator of how funds are perceived in the marketplace.

Capital can be characterized as either subsidized or unsubsidized. Unsubsidized capital is invested to maximize financial return. Subsidized capital is invested to generate social impact, and some concessionary rate of financial return, for reasons including satisfying explicit regulatory or mission-related mandates. Examples of subsidized capital include government guaranteed loans, bank investments motivated by Community Reinvestment Act (CRA) obligations, and foundation program-related investments (PRIs).

Figure 2 highlights the especially illustrative differences in the market position of CDVC funds and minority-focused funds. Over two-thirds of CDVC capital comes from subsidized sources including banks, foundations and the public sector. Minority-focused funds receive just 10 percent of capital from banks and a much smaller proportion from foundations and governments.

The 'need for subsidy' column in figure 2 reflects the findings of Assistant Professor Sass Rubin in her recent paper, *Developmental Venture Capital: Conceptualizing the Field*.[25]

Figure 2: Developmental Equity Funds, Sources of Capital

FUNDS	KEY SOURCES OF FINANCING[1]	NEED FOR SUBSIDY[2]
CDVC	Banks: 30% Foundations: 14% State & Local Governments: 13% Federal Government: 11% Corporations: 11% Non-depositary financial: 8%	Yes
Minority-focused	Public pension funds: 51% Fund-of-funds: 10.7% Corporations: 10.7% Banks: 10.2% Corporate pension funds 9.7%	No
State-sponsored	Primarily state governments	Yes
Social	Primarily high-net worth individuals and family foundations	Maybe

1 Sources: CDFI Data Project (2006); Bates and Bradford (2007); Rubin (2009)
2 From Rubin (2009)

As figure 2 demonstrates, support for minority-focused funds from unsubsidized sources of capital, like pension funds, suggests that the underlying conditions driving the lack of financing for minority-owned companies are addressable, without subsidy. In other words, minority-focused funds have succeeded in creating new business networks mitigating the history of deficient relationships between minority entrepreneurs and the 'primarily white and male venture capital industry'.[26] Ergo, the financial returns of minority-focused funds have been shown to be comparable or higher than those of conventional venture capital funds.[27]

On the contrary, the reliance of CDVC funds on subsidized capital implies that the barriers leading to many low-income and rural areas being underserved by traditional sources of capital are more immutable. Taken together, these barriers — including limited investment and exit opportunities, a lack of entrepreneurial infrastructure, and constrained workforces — lead to higher transaction costs, higher operating costs, and lower expected returns.[28]

With over half of the CDVC funds currently in operation created since 1999, definitive financial return information is not yet available.[29] The Community Development Venture Capital Alliance (CDVCA) cites a 15.5 percent gross internal rate of return, based on an analysis of 32 exits from three CDVC fund investments made prior to 1997.[30] However when Senator John Kerry discussed the creation of the SBA's New Markets Venture Capital (NMVC) program on the floor of the U.S. Senate in October, 2000, he characterized the returns of community development venture capital funds as ranging from 5 to 10 percent, compared to 20 to 30 percent for the SBA's Small Business Investment Company program, which supports a traditional private equity model[31]. Portfolio company investments in states underserved by equity capital have recently been shown to deliver financial returns that are comparable to investments in traditional markets.[32] Unfortunately company-level data does not provide insights into fund-level performance.

For social equity funds, the 'maybe' in the 'need for subsidy' column, in figure 2, implies that the funds will either deliver a market rate of return or concessionary rate of return, depending on GP priorities and methods.

Some LPs more clearly delineate investments in developmental equity than others, not least foundations, which utilize both program-related and mission-related investments (MRIs). PRIs are capital deployments that explicitly seek a below-market rate of return in exchange for significant, targeted social impacts. MRIs aim to achieve a risk-adjusted, market rate of return with ancillary social benefits. One of these investors, the F.B. Heron Foundation, publicly lists its MRIs and PRIs online.[33] Heron's equity PRIs tend to be smaller investments, averaging around $500,000. The foundation's equity MRIs average over $1.5 million.

d_ The Investor's Viewpoint

LPs participate in the developmental venture capital industry for a variety of reasons — financial and non-financial — yet all have an interest in the professional management and sound business practices of the funds in which they invest. As unsubsidized capital becomes more prevalent in the developmental equity industry, reflecting the fact it dwarfs the availability of subsidized capital, so too are the providers of those assets seeking to institutionalize successful practices.

Public sector pension funds, in particular, have emerged as leading supporters of developmental venture capital and other strategies under the broad umbrella of 'targeted private equity programs', most notably including geographically-focused funds with an auxiliary economic development objective.

Pension funds are already significant players in the traditional venture capital industry, supplying 18 percent of the industry's assets in 2009 and 23 percent in 2008.[34] As they have in other asset classes, pension funds that are subject to prudent investment guidelines are likely to play a significant role in establishing the ground rules for developmental venture capital investing going forward.

The leading membership organization for pension fund private equity investors, the Institutional Limited Partners Association (ILPA), recently published a review of best practices for the 'creation, implementation and development' of targeted private equity programs.[35]

Drawing from the ILPA report, and an interview with ILPA Chair and Senior Portfolio Manager at the California Public Employees Retirement System (CalPERS), Joncarlo Mark, author Noémi Giszpenc describes ten LP best practices[36]:

1. **PENSION FUNDS CANNOT BE MARKET MAKERS**
   In severely distressed communities, subsidized community development investment funds are more desirable — and more appropriate — sources of capital for catalyzing transformation. Institutional investors require greater returns than may be possible in the early stages of community development, but can provide the necessary liquidity for growth later on.
2. **IT IS BETTER TO USE GEOGRAPHIC RATHER THAN SOCIAL TARGETING**
   Place-based investments have multiplier effects that generate social value beyond the businesses they finance. An emphasis on geography reduces social impact constraints on investment advisors and increases the scope of investment choices while ensuring social returns.
3. **A BROAD, ATTRACTIVE MANDATE CAN DRAW IN OTHER INVESTORS AND LEVERAGE AN INSTITUTION'S CAPITAL**
   A broad focus attracts more capital relative to a narrowly targeted mandate, so that even with imperfect targeting, more capital is available to achieve impact objectives.
4. **MEASURE SUCCESS IN TERMS OF RISK-ADJUSTED RATES OF RETURN**
   The political risk associated with failing to achieve targeted social impact objectives is great, and financial returns relative to similar assets should be the primary indicator of performance.
5. **AVOID INTERFERENCE IN INVESTMENT SELECTION**
   Charges of political interference in investment selection pose a threat to the credibility of an initiative. Boards are advised to select external fund managers rather than individual investments to preserve political distance.

6. **A FUND-OF-FUNDS STRUCTURE ALLOWS LARGER INVESTMENTS**
   While a fund-of-funds structure may be necessary for institutional investors to achieve the desired investment scale for a targeted program, the costs can be considerable. A co-investment model is an attractive alternative for experienced investors.
7. **FUND-OF-FUNDS AND POOLED FUNDS ALLOW DIVERSIFICATION AND REDUCE RISK**
   Pooled funds also offer an additional degree of control, enabling institutions to target reciprocal investments in an area of interest.
8. **DEVELOP APPROPRIATE COMPENSATION TO INCREASE BUY-IN**
   Programs must find ways to compensate internal money managers that are appropriate given the relatively high workload and low returns associated with managing targeted investments.
9. **OUTREACH AND PROMOTION CAN IMPROVE THE INVESTMENT ENVIRONMENT**
   As one of the first pension funds to target private equity, CalPERS' combined investment and outreach strategy has opened the door to institutional investment in the private equity asset class and led to greater acceptance of private equity among entrepreneurs in underserved markets.
10. **SENSITIVITY TO EMERGING TRENDS PROVIDES EARLY MOVER ADVANTAGE IN RAPIDLY SHIFTING MARKETS**
    Investors should be prepared to take calculated risks in emerging markets where demand and readiness are met with a lack of capital, and potential rewards for early investment are great.

e_ CDVC Fund Social and Community Impacts

CDVC funds share a common objective of creating economic opportunities for the residents of low-income communities. Most funds systematically measure non-financial impact, to the extent that government regulators and LPs require the data. Social metrics include employment growth, job quality, opportunities for advancement, and profit sharing practices.[37]

In 2006, fourteen CDVC funds that reported to the CDFI Data Project each created an average of 278 jobs in the portfolios of companies in which they invested. Fifty-five percent of these jobs were filled by low-income workers.[38]

The largest equity program in the United States targeting low-income communities is the $1 billion CalPERS 'California Initiative', albeit using underlying GPs that are more financially-driven than even the most broadly defined CDVC funds. The California Initiative invests in underserved markets, primarily in California, and is independently evaluated by InSight at Pacific Community Ventures. From 2007 to 2009, when employment nationwide and in California declined 6 percent and 7 percent respectively, the California Initiative created and preserved 2,424 jobs.[39] Of all the employees at California Initiative portfolio companies, 75 percent live in low- and moderate-income areas and 87 percent are eligible for medical coverage.[40]

Data analyzed in 2004 by the CDVCA, from 17 CDVC funds, revealed a 46 percent increase in jobs at portfolio companies from the time of investment through the end of 2003. Nine of the 17 funds also reported the income status of employees, demonstrating a 124 percent increase in jobs created for low-income, full-time equivalent workers compared to a 37 percent increase in jobs for non-low-income FTEs.[41]

Two individual GPs recently published rigorous social impact evaluations — the BAML Capital Access Funds (CAF), which manages money for CalPERS, the California State Teachers' Retirement System, and the New York State Common Retirement Fund; and Pacific Community Ventures (PCV), a GP with three CDVC funds totaling $60 million. In difficult market conditions, CAF companies added 1,500 jobs since 2005, with an average salary of $31,452. At the end of 2008, 42 percent of CAF companies were located in low- to moderate-income areas, although the number of employees living in LMI areas was not available.[42] PCV companies experienced 0 percent job growth in 2009 compared to a 4 percent decline in employment nationally. Sixty-four percent of PCV company employees are classified as LMI.[43]

In isolation, the numbers suggest that CDVC funds have succeeded in generating a significant community impact. As a point of reference, 35 percent of all employed individuals in the United States live in LMI census tracts.[44]

However the data is far from conclusive and incentivizing and bringing more consistency and rigor to non-financial performance reporting remains a challenge for the CDVC industry.[45] Without a robust culture of evaluation, the social and community impacts that the CDVC sector is able to provide will remain ambiguous, rendering investors unable to direct resources to the most successful funds.[46]

f_ The Role of Equity Capital in Community Development

CDVC financing can be an important catalyst for economic growth, but it is by no means the only one. Small businesses, in particular, require well-developed physical, social and financial infrastructure to succeed, as well as access to a range of financial services and capacity supports at the appropriate stage in their development.

Communities that have traditionally been underserved by the financial services industry are often marginalized in other ways that affect business development and economic growth. Education and human capital, basic services for families, and other community infrastructure are critical preconditions for economic growth. Business advisory services and other supports also play a role as growing businesses prepare for capitalization.

Other financial tools help to lay the necessary groundwork for private equity activity in low-income communities. Angel investment and owner equity have been shown to play an especially important role in small and early-stage businesses where information tends to be limited and the risk high. Only as information increases and risk declines do businesses gain access to intermediated capital markets, including private debt and equity.[47]

This traditional cycle of financial growth can be problematic in low-income communities where entrepreneurs lack the assets to make early equity investments in growing businesses. Consequently, asset building, financial planning and basic access to banking services can act as important foundations for small business development.

The private equity model itself, while a potentially powerful instrument of growth, is fundamentally an instrument of precision. Most successful portfolio companies share a number of qualities. These include sound financial practices, prospects for significant growth, excellent management willing to work in partnership with new owners, a unique product or service, and a clear exit strategy.[48] Companies with these characteristics may be more difficult to find in both historically underserved communities and industries creating jobs for low-wage workers. When equity-ready companies are located in target areas, there is also no guarantee that they will remain, post-investment.

The limitations of the private equity model is one reason many CDVC funds are housed in non-profit affiliates providing primarily grant-funded technical assistance and other supports to businesses, often at a pre-investment phase of development.

g_ Challenges and Opportunities for the CDVC Fund Industry

CDVC funds sit at an important and challenging juncture. With $2 billion in capital under management, 71 funds, and around twenty years of practice, the industry has had the benefit of internalizing business models that have both succeeded and failed and is populated by seasoned investment professionals. At the same time, just four new CDVC funds have been launched in the last seven years, financial and social returns remain ambiguous, and the continued fragmentation of the sector makes sharing best practices difficult. Add to this the ongoing impact of the financial crisis, and the long-term sustainability and growth of the CDVC fund sector is uncertain.

Key challenges and opportunities for CDVC funds include raising capital, demonstrating financial and social impact, clarifying the role of government, and building industry capacity.

Raising Capital

Raising sufficient capital to fund operations is by far the biggest challenge for CDVC funds at the best of times.[49] GPs launching new funds in coming years face the added hurdle of a transformed financial landscape. On the one hand, banks, foundations and other private investors have been buffeted by the recession and represent an unknown quantity. On the other, a federal government more sympathetic to the role of CDFIs and subsidized capital presents a 'major opportunity', as one interview subject described it.

GPs interviewed for this report were overwhelmingly concerned about the significant risk presented by a more conservative and profit-driven banking sector. For these GPs, CRA-motivated capital was unquestionably becoming more financially-focused and less concerned with social impact. Consolidation in the banking sector has also impacted many long-standing business relationships and has introduced a more conventional, and less concessionary, approach to the way CRA responsibilities are handled by some institutions.[50]

CDVC funds will be looking eagerly to foundations, but bracing for the ramifications of a 28 percent decline in assets through the end of 2008.[51] In a recent article on the impact of the financial crisis on CDFIs, Paul Weech explains that the changing relationship between CDFIs and foundations had predated the recession — namely a shift away from using more generously subsidized program-related investments to support CDFIs. That leaves the mission-related investments (MRI) typically managed out of a foundation's financially-focused endowment as the primary target for CDVC funds. But like CRA-motivated capital, MRIs are primarily profit-driven.

Government sources of capital at the federal level are a potential bright spot for the industry. With $244 million appropriated for the CDFI Fund in 2010 and the President requesting $250 million in 2011, the Obama Administration has taken major steps towards providing core financing for the sector. The American Recovery and Reinvestment Act also provided an extra $100 million of funding to the CDFI Fund in 2009 and The New Markets Tax Credit (NMTC) program, administered by the CDFI Fund, is likely to be another important and burgeoning source of capital. Despite the NMTC's documented bias to real estate investing, 27 Community Development Entities received $1.6 billion in NMTC allocations for 'business financing' activities in 2009.[52,53] At the state level, scant resources will likely add to CDVC fund difficulties.

Demonstrating Fnancial and Social Impact

Difficulties demonstrating and describing industry-wide financial and social impact, principally due to a lack of performance information and disclosure, make it difficult to attract new LPs to the industry.

Broad perceptions and first impressions of financial and social performance are critical, not least for attracting new providers of capital that are unlikely to interact directly with many CDVC GPs and be presented with data in person. This includes pension funds, insurers, private investors, and socially-motivated investment funds.

The most robust litmus test of financial and non-financial returns in the CDVC sector is LPs voting with their feet. On financial returns, LP investments suggest that, except for a small number of GPs increasingly self-identifying as 'social' funds, the sector mostly delivers below-market returns and is therefore in need of subsidized capital. On social returns, CDVC funds have performed sufficiently to justify the continued support in the last two decades of a core group of foundation, bank, and public sector investors, although the dearth of new fund launches presents a worrying picture.

One large LP commented that, even after investing in many of the sector's most prominent funds over a long period of time, they were still unable to come to any definitive conclusions on performance and that, for "every positive experience, there is a negative one".

A key question is whether potential new sources of capital are being left on the table as a result of poor industry-wide impact evaluation and disclosure practices.

Clarifying the Role of Government

There are high hopes for support for CDVC funds from the Obama Administration. The CDFI Fund is well capitalized for the first time in many years and there is a real possibility that the New Markets Venture Capital (NMVC) program will be reauthorized. The NMVC program catalyzed the creation of six CDVC funds from 2001 to 2003.

Nonetheless, the central role of government as both a direct investor and a catalyst for subsidized third-party capital and other supports is an ever-present source of uncertainty. In recent times, the last Bush Administration's handling of the Community Reinvestment Act, the CDFI Fund, and the NMVC program was not helpful to CDVC funds.[54]

As an anchor investor, the government also risks creating disincentives both for investing in the asset class — private equity — and for attracting other sources of capital. A case in point is the NMVC reauthorization bill passed by the U.S. House of Representatives in November 2009, the Small Business Financing and Investment Act of 2009. The Bill mandates that 50 percent of $100 million in debenture authority be used to finance small businesses engaged primarily in manufacturing[55] — a stipulation that could restrict the sector's growth by hampering efforts to attract unsubsidized, financially-motivated capital in need of greater industry diversification.

A number of GPs commented on the need for clarification of the role of government at a number of levels. This included: the stringency of the geographic focus of CDVC funds that are already committed to investing in underserved communities, which can create a potentially unworkable mandate; on the process of accounting for SBA guarantees, which can add significant costs; on the need for additional supports in target communities, for example in small business lending; and on broader support for equity-based community development investing, for example through the NMTC program.

Building Industry Capacity

Industry-wide capacity for sharing best operational and investment practices, evaluating impact, and collaborating on policy priorities remains limited. This is a function of the small size and fragmented leadership of the industry, “which makes the lynch-pin ideas and structural underpinnings of community equity capital difficult to cultivate”, as one GP explained.

The industry’s key representative body, the Community Development Venture Capital Alliance (CDVCA), has limited resources, and academic articles, commentaries, and other research on CDVC best practices are few and far between.

With tenuous geographic ties, it is more difficult for CDVC funds to realize the benefits of being part of an industry cluster — the increased productivity, increased capacity for innovation, and new business formation resulting from more interconnected firms and institutions.[56]. When knowledge is more broadly distributed, as it is in the CDVC fund industry, innovation is often located in the networks of inter-organizational relationships that CDVC funds currently lack.[57]

The CDVC brand is also thought to have lost some luster in recent years, which partly explains why more GPs are preferring to align with the broader category of ‘social’ equity funds.[58] As discussed earlier, the volume of available subsidized capital is dwindling, and pales in comparison to the myriad sources of unsubsidized capital. To the extent that the CDVC brand is associated with below-market performance — albeit for good reason, namely the offsetting social impacts — GPs may be distancing themselves from the sector. Not surprisingly, CDVCA’s annual conference has attracted fewer attendees in recent years.

At a time of transition for the industry, the importance of realizing the value of innovation, clarifying the role and best practices of CDVC funds, and having a prominent voice in Washington is unmistakable.

Summary

The challenges and opportunities discussed above have broad, industry-wide implications. Yet capital is deployed by LPs on a fund-by-fund basis. LPs must be able to analyze and understand the detailed characteristics of each CDVC partnership they are considering supporting, and the predictors of performance.

For the purpose of benchmarking, the general lack of aggregate industry information and data is especially problematic.

The next section of this report describes an analytical model for examining CDVC funds and discusses the practical challenges of community equity investing.

4. An Analytical Model of Private Equity Constraints

In the absence of consistent, widely disclosed performance data, it is difficult to compare and contrast CDVC funds. The following section presents an alternative method of analysis. The method identifies fund structural and operational characteristics that have the potential to lead to underperformance. We call these characteristics ‘constraints’, and describe why and how the constraints have the potential to detrimentally impact the conventional process of private equity investing.

Our analysis begins with the assumption that traditional private equity funds are structured to maximize the probability of success of the investing process. A ‘constraint’ will compromise this process, although it will not necessarily lead to underperformance.

While CDVC funds seek both financial and social returns, and the traditional private equity process is typically intended to maximize financial returns only, the success of a CDVC fund is nonetheless contingent on the context and the confines of equity investing. Social returns, like financial returns, are generated when a CDVC funds identifies and successfully invests in a small company that experiences rapid growth, creating jobs as a result. A constraint is therefore just as likely to handicap the prospects for a social return as it is a financial return.

The constraints discussed below have been identified because they are common to the CDVC industry, usually because of a fund’s mission or mandate, although they apply to all private equity investors. Constraints also vary in the degree to which the literature and experience demonstrates that they potentially impact performance. First order constraints are characteristic of both traditional and CDVC funds and present a potentially significant barrier to a fund’s ability to perform competitively. Second order constraints tend to be limited to funds with explicit social objectives and have a more ambiguous impact on fund performance.

Figure 3: Private Equity 'Constraints'		
	TRADITIONAL FUND	FUND WITH CONSTRAINT
FIRST ORDER		
Geography	No restrictions	Restricted to investing within set boundaries by mission/mandate
Market	Investing in established knowledge– and network–rich markets	Investing in companies and areas underserved by traditional capital
Size	> $150 million	< $20 million
Skill	General Partners have experience managing private equity funds	General Partners may have limited experience in private equity
SECOND ORDER		
Client	Clients with unified objectives	Clients with diverse objectives
Company	Financial screen	Financial and non-financial screens
Deal	No additional actions required of portfolio companies (besides maximizing profit)	Company required to take actions to meet VC mission/mandate obligations

a_ First Order Constraints

Geography

While most private equity funds have willingly invested in confined areas, such as Silicon Valley in California or Route 128 in Massachusetts, some funds are purposefully and arbitrarily restricted to investing within a defined geographic boundary.[59] These areas can include particular regions, states, or cities.

A private equity fund subject to a geographic constraint must ensure that all or most of its capital is channeled to a target area, where investments are intended to generate economic activity and create jobs. Supporting community and workforce development within specified geographies is one of the overarching objectives of some private equity companies, including CDVC funds.

Geographic constraints present challenges to private equity funds that may include limiting deal flow, curtailing a fund's options for diversification, and shrinking the universe of potential investors.

Limited deal flow is the primary challenge posed by geographic constraints. Venture capital funds, in particular, typically look at 450 to 500 business plans in order to make just a few investments.[60] By definition, arbitrary geographic constraints exclude companies with viable business plans, simply on the basis of location.

As one GP subject to a geographic constraint described it: "The deal flow is a challenge... nine out of ten deals are knocked out because of the company's address."

Geographic constraints may also weaken a fund's ability to diversify portfolios. Because companies from the same industry tend to be located within the same region, funds restricted to investing in a particular area may have an involuntary over-exposure to industry-specific risk. Funds with geographic constraints may also be subject to region-specific economic risks.

Market

The 'market' constraint is created by the requirement to invest in communities traditionally underserved by institutional equity capital. As discussed earlier, InSight defines underserved markets as areas located outside of the 774 zip codes in the United States that account for 80 percent of all private equity investments.[61] Funds subject to a market constraint either invest exclusively or mostly in underserved markets.

Rural areas are especially underserved by traditional equity capital. Rural entrepreneurs account for 10 percent of all businesses but receive less than 2 percent of venture capital.[62] Eighteen primarily rural states accounted for less than 1 percent of all venture capital dollars invested between 2006 and 2008.[63]

Underserved markets can also be characterized as those comprised of women- and minority-led businesses. For example, women-led firms receive less than 5 percent of all U.S. venture capital dollars, even though they represent approximately 40 percent of all U.S. businesses.[64]

Private equity funds typically invest outside of traditional markets when a mission or mandate requires the deployment of capital in these areas. For example, most CDVC funds have a primary mission of promoting community development in low-income communities as a condition of registering with the CDFI Fund.[65] These markets are usually underserved.

The reasons that markets remain underserved by traditional equity capital are the same reasons the 'market constraint' poses additional challenges to private equity funds. These include information failure, fewer profitable investment and exit opportunities, the absence of developed financial infrastructure, greater difficulties and travel time to reach portfolio companies, limited experience of corporate management, and a lack of understanding of how equity capital works.[66] In rural areas, isolation creates difficulties in attracting talent and is characterized by a dearth of professional service providers that understand high growth business needs, few other firms in a company's value chain, and a lackluster entrepreneurial culture.[67] The challenges inherent in underserved markets require that private equity funds devote additional time and resources to researching and identifying potential investments, increasing transaction costs.[68]

As Senator John Kerry explained when discussing the creation of the SBA's NMVC program on the floor of the U.S. Senate in October, 2000: "[Businesses that show promise of financial and social returns] tend to be higher risk, need longer periods to pay back money, need intensive, ongoing financial, management and marketing assistance, and have more modest prospects for return on investment".[69]

Size

Every private equity fund has fixed costs associated with its operations. The typical GP charges management fees in the range of 2 to 3 percent in order to cover these expenses, which include staffing and administration. Size becomes a constraint when an insufficient amount of capital creates operational inefficiencies and threatens the fund's optimal investment strategy.

In 1998, a $10 million CDVC fund was considered the minimum size necessary to cover fixed costs. With a 3 percent management fee, this would have supported two full-time fund managers and an administrative assistant.[70] According to a number of GPs, the equivalent fund size today is less than $20 million. The average traditional private equity fund held $420 million in assets in 2006. The average venture capital fund held over $175 million in assets.[71,72]

Funds facing a size constraint may be restricted in the type of investments they can make, both by company and stage. A limited pool of capital may force some funds to do deals at earlier stages, or to make later stage investments in smaller companies than they would like. It is also more difficult for smaller funds to make important, follow-up investments, or to lead an investment round, hampering a GP's influence over a company's operations, particularly as it grows. GPs that lack operational leverage may be handicapped in accomplishing the social goals for which they are accountable.

Smaller funds may also encounter difficulties in recruiting and retaining talented investment professionals. The perception that GPs are likely to receive a lower carry from smaller funds creates a disincentive for experienced investors considering joining the CDVC sector.

Skill

Private equity investing requires a unique set of skills. Expertise is especially crucial during the initial screening of hundreds of potential investments and management teams, when negotiating a deal and memorializing terms to ensure positive financial and social outcomes, and when stepping in to manage or advise portfolio companies — which GPs spend about 60 percent of their time doing.[73]

Funds that lack the requisite level of experience in private equity investing, particularly in the aggregate, may be subject to the skill constraint.

Funds with more aggregate GP experience have been shown to achieve higher levels of financial performance.[74] Funds with inexperienced managers may have insufficient deal flow, which is usually generated through contacts and networks developed over time. A lack of skill or experience can also affect a fund's ability to raise capital. GPs with over ten years of private equity experience have historically accounted for more than 70 percent of total capital raised.[75]

b_ Second Order Constraints

Client

Funds with a diverse group of clients, with varying financial and social objectives, face an additional potential constraint. When LPs are providers of both subsidized and unsubsidized capital, this can create reporting duplication, inefficiencies for funds, and put pressure on the investment process, particularly if LP preferences for non-financial return are especially stringent.

For example, non-profit investors in CDVC funds often include foundation program-related investments (PRIs). A PRI must support a charitable project or activity that directly relates to a foundation's overall mission or face significant financial penalties.[76] Funds with socially-motivated and financially-motivated investors may face additional transaction or operational costs resulting from compliance with the program, regulatory, or customized reporting requirements of investors.

Company

Some private equity funds screen for non-financial, non-geographic criteria when examining potential investments. This is usually linked to an overarching mission. Non-financial criteria can include factors such as the potential to create high quality jobs for low-income workers, or products that benefit the community or environment.

While the presence of a stringent, additional barrier to investment has the potential to restrict deal flow by shaping a fund's outreach and investment practices, most GPs report that, in practice, non-financial objectives are so explicit anyway that companies targeted for investment almost always pass any social screen.

Deal

Equity funds with a social mission sometimes require portfolio companies to take additional actions not ordinarily taken in the course of growing a profitable business. Again, these actions are likely to be closely tied to the fund's non-financial objectives.

For example, a fund creating quality employment opportunities may require a company to provide workers with healthcare, retirement, and other benefits. A fund may require companies to engage the services of a related workforce development organization or to implement a hiring policy accommodating low-income populations.

If these actions are involuntary for the company, they may prove to be a constraint on fund performance by tying the hands of management and leading to an economically inefficient allocation of resources. According to GPs, however, this is rarely the case. While many CDVC funds make non-financial performance expectations an explicit component of a relationship with portfolio companies, these expectations are typically met out of good faith and a shared belief in what constitutes good management practices, not out of compulsion.

c_ Other Constraints

The constraints described above have the most discernable impacts on the private equity process and are the most convenient to compare across funds. There are a number of other fund characteristics that merit consideration, the impacts of which are more difficult to qualify. These include mission, politics, and structure.

Mission

The social mission of a CDVC fund may provide additional insight into the degree to which a fund is constrained. The narrower a fund's mission, in and of itself, the more likely the investment process is to be notably hamstrung by geography, market, client and other characteristics.

Politics

Around a quarter of the capital invested with CDVC funds comes from the public sector.[77] Funds that receive a large portion of capital from government may be at greater risk of political influence.

Structure

The more legally complex a fund and its related entities, the greater the risk that this will create operational inefficiencies and increase transaction costs. This partly explains why, as the CDVC fund industry has matured, GPs have settled on the for-profit LP and LLC legal structures. This transition has helped CDVC funds to attract a wider variety of investors comfortable with the traditional equity capital model.[78]

5. Analogous Fund Comparison

We examine the strategy, structure and operations of CDVC funds in more detail in the following section by comparing ten similar CDVC funds created around the same time, of which nine have been directly interviewed by InSight.

The funds are all CDVC funds, broadly defined, with an explicit dual objective of investing both for financial return and as a tool to create economic opportunities in low-income communities. Data and interviews suggest a mix of primary objectives, with some funds prioritizing financial return (and not necessarily self-identifying as CDVC funds) and others social impact.

Figure 4: Description of Analogous Funds (Dollars in Millions)

	SOCIAL OBJECTIVE	URBAN/ RURAL[1]	REGION	FUND SIZE	YEAR OF INCEPTION
Bay Area Equity Fund	Social and environmental improvement in the Bay Area's LMI neighborhoods	Urban	San Francisco Bay Area	$75 M	2004
Boston Community Venture Fund	Job creation	Urban	Northeast	$14 M	2000
CEI Community Ventures	Job creation	Both	Northeast (ME, VT, NH)	$10 M	2003
Coastal Ventures II, LLC	Quality jobs for low income workers	Urban	Northeast	$12 M	2001
Community Development Ventures, L.P.	Improve the well being of individuals and businesses in distressed urban communities	Both	Maryland	$14 M	1998
Murex Investments	Economic development and job creation in low income areas	Urban	Mid-Atlantic	$14 M	2003
New Markets Venture Partners Fund I	Economic development and job creation in low income areas	Urban	Mid-Atlantic (MD, VA, DC)	$25 M	2003
New Mexico Community Capital	Job creation; job quality	Urban	New Mexico	$15 M	2005
Penn Ventures Partners	Good jobs for low-income and rural people	Urban	Central and northern Pennsylvania	$25 M	2003
Urban Growth Partners	Workforce and economic development in low income communities	Urban	Mid-Atlantic	$48 M	2002

[1] Determined using the zip codes of portfolio companies listed on fund websites or provided directly to InSight. A fund was defined as solely urban when over 75% of the population in company zipcodes was classified as urban by the U.S. Census Bureau.

a_ Structure and Operations

All of the funds are for-profit Limited Partnerships or Limited Liability Corporations (LPs or LLCs) — the preferred structure for traditional private equity investors. The funds are part of a shift toward a more financially-oriented method of managing money in the community equity industry. In 1999, just 40 percent of CDVC funds were structured as for-profits.[79] Eight of the seventeen CDVC funds launched since 2001 are included among the group of ten analyzed in this report.[80]

Some funds are independent. Some are subsidiaries of non-profit organizations. All were created to meet a mix of social, financial, and in a few cases environmental objectives. The most common social objective is job creation in low-income communities. Other priorities of some, but not all funds, include supporting women and minority business owners and executives, investing in socially beneficial products and services, and broader economic development in targeted geographies.

Investors consist almost entirely of 'subsidized' capital providers, especially banks motivated by the CRA, federal and state governments, and foundations. A small number of investors in the funds — sources of primarily 'unsubsidized' capital — include individuals, insurers, other private equity managers, and one pension fund.

Two of the ten funds require that portfolio companies utilize the workforce development and other support services provided by related entities within the same overarching organization. One fund offers these services from a related entity, on an as-needed basis. Another fund offers a related business advising service to a separate group of companies "not quite ready for equity". All funds created as part of the SBA's NMVC program — CEI Community Ventures, Murex, New Markets Venture Partners, and Penn Ventures — were provided with supplemental grant funds to maximize the value of portfolios by engaging third-party advisors to consultant with companies. These 'operational assistance' grants in the NMVC program were intended to offset the expected additional costs of applying the traditional venture capital model to low-income communities.[81]

b_ Investment Strategy

Because most funds are geographically constrained, they tend to be 'industry agnostic', "investing in companies that reflect the strength of the region," as one GP described the process. Nonetheless, funds tend to follow one of two strategies to create both financial and social returns: first, the 'portfolio' approach, in which a fund invests partly in manufacturing and related companies for social return and partly in technology companies for financial return; and second, the 'double bottom line' approach, investing in companies that each meet both objectives.

Taken together, the funds are exposed to a diverse set of industries, including cleantech, life sciences, traditional information technology, manufacturing, health care, education, security, food services and consumer goods.

Funds prefer to hold minority ownership positions, using equity rather than debt, and take at least one board seat upon investment. Typical investment sizes range from $500,000 to $2 million, with one larger fund investing up to $5 million and one smaller fund investing as little at $250,000. Funds usually deploy capital together with co-investors.

Funds target a range of stages of company development, typically contingent on the size of the partnership. The shift in the traditional venture capital industry towards larger funds and later stages of investment is perceived by GPs as having created a need and opportunity for capital both in the earlier stages of a company's life, and at the expansion stage for smaller companies.

Business networks play an important role in generating deal flow. These networks include co-investors, banks, angel groups, and other professional service providers. Universities and provincial government agencies also help to identify potential investments. One fund cited detailed market research, cold-calling, and outreach in the form of a series of educational seminars as a major source of opportunities, while another created a network of former executives incentivized to contribute ideas by the prospect of gaining future employment at portfolio companies.

c_ Geography and Target Markets

All but one of the funds are restricted to investing within a pre-determined geographic boundary, with limited flexibility. For example, funds created as part of the SBA's NMVC program are required to invest 80 percent of assets in a specific group of low-income areas. The six funds not subject to NMVC requirements deploy capital similarly, making few investments outside of their target area.

A number of funds have accommodated geographic constraints by moving portfolio companies into a target area when necessary.

The analysis below utilizes the location of portfolio companies, generally available on fund websites and in three cases provided directly to InSight, to characterize the target markets and geographic investment strategies of funds. The data is imperfect, in as much as funds do not always publicly disclose every investment they have made. Nonetheless, the analysis adds depth to the discussion of geography and sheds lights on the very different conditions experienced by each partnership.

Regional Income and Market Characteristics

Figure 5, below, provides a summary of the income and market characteristics of the areas in which fund portfolio companies are located.

Figure 5: Fund Target Market Income Comparison

ANALOGOUS FUND COMPANY LOCATIONS — INCOME COMPARISON

	2000 CENSUS TRACT MEDIAN HOUSEHOLD INCOME	2000 CENSUS CITY MEDIAN HOUSEHOLD INCOME	PERCENTAGE OF COMPANIES LOCATED IN AREAS UNDERSERVED BY TRADITIONAL CAPITAL	PERCENTAGE OF COMPANIES LOCATED IN LMI CENSUS TRACTS
Bay Area Equity Fund	$57,589	$61,764	6.67%	46.67%
BCV Fund	$54,916	$52,601	68.75%	12.50%
CEI Community Ventures	$32,852	$35,650	62.50%	42.86%
Coastal Ventures II, LLC	$45,478	$35,650	70.37%	16.00%
Community Development Ventures, L.P.	$39,967	$43,681	88.89%	11.11%
Murex Investments	$44,573	$44,655	66.67%	50.00%
New Markets Venture Partners Fund I	$47,759	$45,736	48.48%	30.30%
New Mexico Community Capital	$32,878	$38,272	100.00%	16.67%
Penn Ventures Partners	$42,083	$29,770	100.00%	0.00%
Urban Growth Partners	$34,564	$30,746	71.43%	50.00%

Source: InSight at Pacific Community Ventures, using the Federal Financial Institutions Examination Council, www.ffiec.gov, and U.S. Census Bureau American Fact Finder, 'Fact Sheet: Census 2000 Demographic Profile Highlights — Economic Characteristics', http://factfinder.census.gov/

Every portfolio company is located in a U.S. Census Tract, for which tract-level and city-level median household incomes are available. Each fund includes a group of portfolio companies, ranked for the purposes of this analysis by the household incomes in the areas in which they are located.

Figure 5 shows the median household incomes in the cities and census tracts in which the median company (in the ranking of portfolio companies for each fund) is located. For example, of the fifteen companies associated with Boston Community Ventures, the median income in the area in which the eighth company is located is listed in columns one and two.

Column one displays the median household income for the census tracts and column two displays the median household income for the cities in which the median portfolio companies are located. The city data reflects a larger geographic area and a more regional indicator of the income in target markets. Census tracts are at the neighborhood level.

Column three lists the percentage of fund portfolio companies located outside of the 774 zip codes in the United States that account for 80 percent of all private equity investments.[82]

Column four lists the percentage of companies located in census tracts defined by the U.S. Census Bureau as being of low- and moderate- income (LMI).

The data reveals significant differences between the ten funds. Highlights include:

→ **THE BAY AREA EQUITY FUND** invests in the region with the highest incomes, but in companies in relatively less prosperous communities, including many LMI neighborhoods. Nonetheless, the area in which the Bay Area Equity Fund invests is a mature financial market, with plentiful access to traditional equity capital.

→ **BOSTON COMMUNITY VENTURES** invests in a region and in neighborhoods that are relatively prosperous. However, while the neighborhoods are rarely low- to- moderate-income, the region has been largely underserved by traditional capital.

→ **MUREX INVESTMENTS** invests in the highest proportion of LMI communities and in a region that has largely been underserved by traditional capital.

→ **PENN VENTURE PARTNERS** invests in a region that has been completely underserved by traditional capital, but in no neighborhoods that are classified as low- to moderate-income.

→ **URBAN GROWTH PARTNERS** invests in a region that is relatively less prosperous and largely underserved by traditional equity capital, and in the largest proportion of LMI neighborhoods, together with Murex.

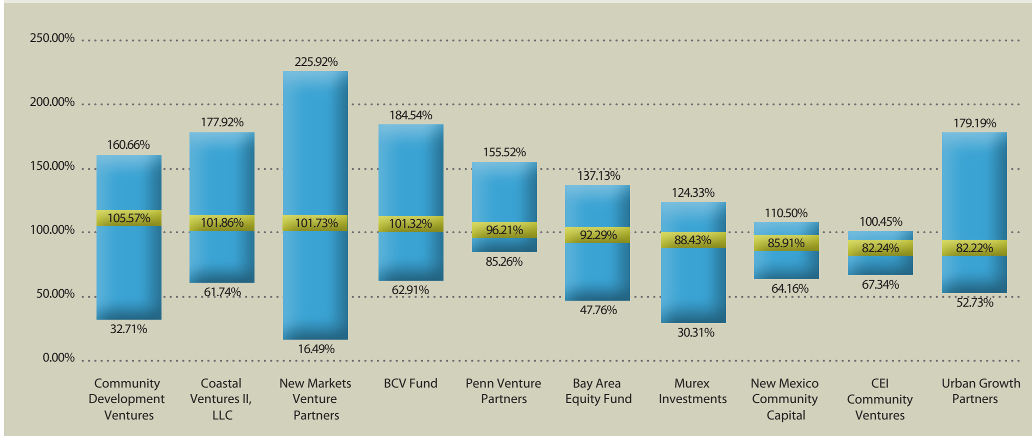
The Geographic Investment Strategies of Funds

Additional insights into the investment strategies of funds can be ascertained by comparing the median city incomes and the median census tract incomes of the areas in which fund portfolio companies are located. This analysis is admittedly esoteric, but is useful for highlighting the subtle differences between funds and the environments in which they operate.

Figure 6, below, presents three pieces of data for each fund: first, the median census tract household incomes of the area in which the median company for each fund is located, displayed in the yellow box and calculated as a percentage of the median city income; second, the median census tract income as a percentage of median city income for the highest-income census tract in which a portfolio company is located; third, the median census tract income as a percentage of median city income for the lowest-income census tract in which a portfolio company is located.

Figure 6: Comparing the Geographic Strategies of Analogous Funds

MEDIAN, MAXIMUM, AND MINIMUM COMPANY LOCATION TRACT MEDIAN HOUSEHOLD INCOME AS % OF CITY HOUSEHOLD INCOME



Source: InSight at Pacific Community Ventures, using the Federal Financial Institutions Examination Council, www.ffiec.gov, and U.S. Census Bureau American Fact Finder, 'Fact Sheet: Census 2000 Demographic Profile Highlights — Economic Characteristics', http://factfinder.census.gov/

Figure 6 illustrates the nuanced geographic investment strategies implemented by the funds. The percentage figure in the center of each bar (in yellow) indicates the extent to which a fund invests in neighborhoods that are generally more or less prosperous than the region in which the fund is investing as a whole. A percentage over 100 indicates that a fund invests in neighborhoods that are relatively more prosperous. A percentage under 100 indicates that a fund invests in neighborhoods that are relatively less prosperous.[83]

The difference between the highest- and lowest-income census tracts in which a fund invests, as a percentage of median city income, reveals the extent to which a fund invests more broadly in a region, by income. The larger the range (the height of the blue bars), the more a company invests in both relatively prosperous and relatively poor neighborhoods.

There are some notable trends in figure 6 that point to a consistent investment strategy for a number of funds. These include:

→ **NEW MARKETS VENTURE PARTNERS (NMVP)** invests in both the most relatively prosperous census tract and the least relatively prosperous census tract, compared to the region in which it is investing. This suggests that NMVP makes a concerted effort to bring together a portfolio of companies from both high- and low-income neighborhoods, in regions that are especially diverse, by income.

→ **NEW MEXICO COMMUNITY CAPITAL AND CEI COMMUNITY VENTURES** invest in the two relatively more prosperous census tracts and two of the three less prosperous census tracts that are *closest* to the median income of the regions in which hey are located. At the same time, the funds invest more than others in census tracts that are less prosperous than the region overall. This suggests that New Mexico Community

Capital and CEI Community Ventures have a narrow geographic investment strategy, targeting neighborhoods with consistent income characteristics, and/or that the regions in which they are investing are more homogenous, by income.

d_ Fund Constraints

While the ten funds have much in common, the 'constraints' method of analysis highlights notable differences that may have handicapped some funds more than others. Figure 7 compares the constraints faced by each of the ten funds, excluding 'skill'. While some funds may have been managed by GPs with less private equity industry experience, InSight does not have access to the data necessary to arrive at that conclusion.

Figure 7: Analogous Fund Constraints*

FUND	FIRST ORDER				SECOND ORDER	
Does the fund face the following constraints?	**GEOGRAPHY**	**MARKET**	**SIZE**	**CLIENT**	**COMPANY**	**DEAL**
Bay Area Equity Fund	✓	×	×	✓	✓	×
Boston Community Venture Fund	✓	✓	✓	✓	×	×
CEI Community Ventures	✓	✓	✓	✓	✓	×
Coastal Ventures II, LLC	×	✓	✓	✓	✓	✓
Community Development Ventures, L.P.	✓	✓	✓	—	—	—
Murex Investments	✓	✓	✓	×	×	✓
New Markets Venture Partners Fund I	✓	×	✓	✓	×	×
New Mexico Community Capital	✓	✓	✓	×	×	×
Penn Ventures Partners	✓	✓	×	✓	×	×
Urban Growth Partners	✓	✓	×	✓	✓	✓

* Excludes the 'skill' constraint

As figure 7 demonstrates, the only fund contending with noticeably fewer first order constraints, relative to others, is the Bay Area Equity Fund (BAEF). Not surprisingly, BAEF is the fund considered most removed from the narrow definition of CDVC investing and the least likely to self-identify as a CDVC fund, among this group of ten. Moreover, BAEF is explicitly considered by some investors, including the F.B. Heron Foundation, to be a mission-related investment, indicating that achieving a market rate of return is paramount.[84]

Funds facing the largest number of constraints (five out of six) include CEI Community Ventures, Coastal Ventures II, and Urban Growth Partners. While these funds have not necessarily underperformed more than others, a larger number of constraints potentially make it more difficult to achieve stated objectives, as discussed earlier.

Findings in figure 7 include:

→ **GEOGRAPHY:** Coastal Ventures is the only fund not to be arbitrarily limited in geographic scope. The fund is free to invest anywhere in the United States, although almost all portfolio companies are located in the northeast by intention.

→ **MARKET:** The only two funds not to have invested in predominantly underserved markets are the Bay Area Equity Fund and New Markets Venture Partners Fund.

→ **SIZE:** The Bay Area Equity Fund, Penn Venture Partners and Urban Growth Partners are the only three funds with more than $20 million in capital.

→ **CLIENT:** Murex Investments and New Mexico Community Capital are the only two funds to have self-reported uniformity in client financial and non-financial objectives. All the other funds include an assortment of LPs with diverse objectives.

→ **COMPANY:** Meaningful, consequential screening for non-financial criteria is self-reported by four funds: The Bay Area Equity Fund, CEI Community Ventures, Coastal Ventures II, and Urban Growth Partners.

→ **DEAL:** Coastal Ventures II, Murex Investments and Urban Growth Partners require that companies commit to achieving specific non-financial targets that influence management practices.

e_ Economic Environment and Context

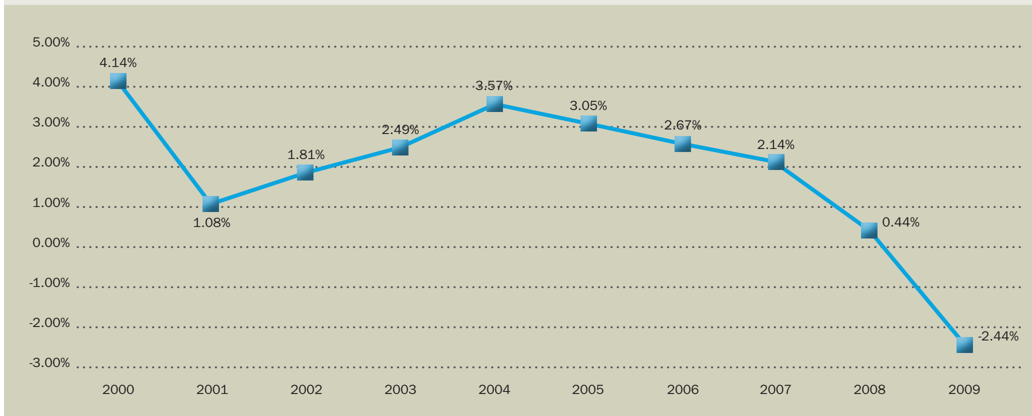
The broader economic climate is likely to have significantly impacted the performance of the ten funds and is best understood as including components of national and industry performance.

The National Economy

The U.S. economy experienced its most significant downturn since the Great Depression in the last decade. While U.S. GDP increased by 2.49 percent in 2003 and a strong 3.57 percent in 2004, growth slowed in 2005 and 2006 and declined rapidly from 2007 to 2009.

Figure 8: U.S. GDP Growth 2000-2009

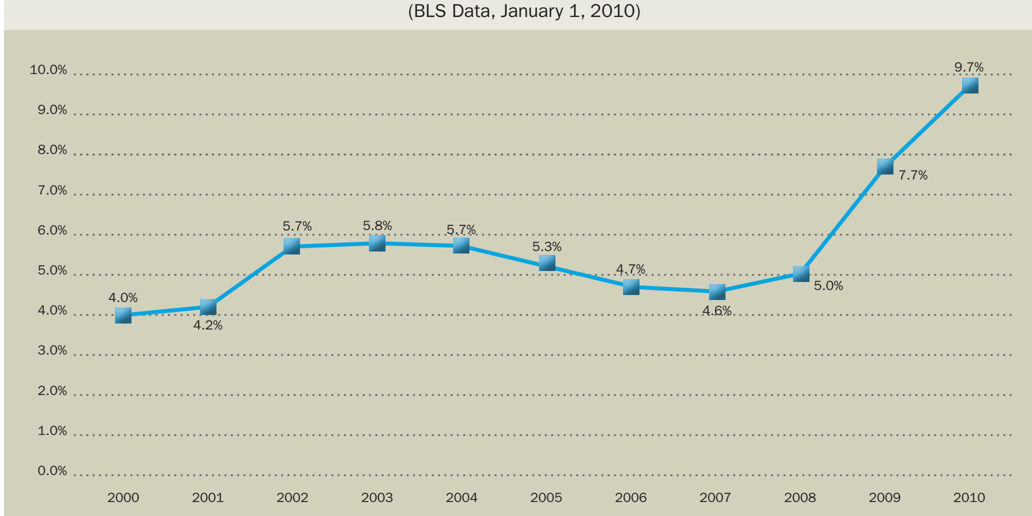
PERCENT CHANGE IN U.S. GDP IN CONSTANT 2005 $'S



U.S. unemployment reached levels not seen since 1983. The Bureau of Labor Statistics reported an unemployment rate of 5 percent in January 2008, 7.4 percent in December 2008 and 10.1 percent in October 2009. In many areas of the country, including the low-income communities in which many of the funds were investing, unemployment rates are considerably higher.

Figure 9: U.S. Employment Rate, 2000-2010

U.S. UNEMPLOYMENT RATES
(BLS Data, January 1, 2010)

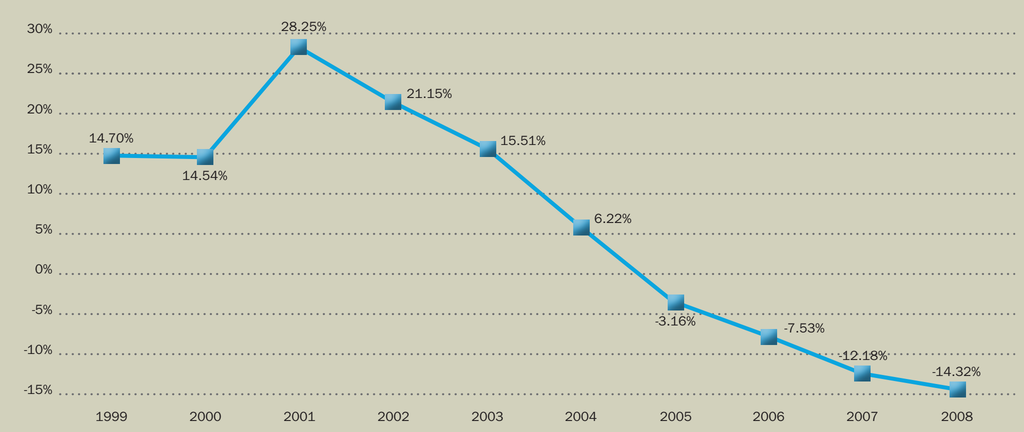


Industry Performance

The fortunes of the venture capital industry have suffered along with the economy. According to Cambridge Associates LLC benchmark statistics for the U.S. private equity industry, net returns to LPs declined through the past eight years, reaching a low of -14.32 percent for funds launched in 2008[85]. While many of the funds in this report started investing between 2002 and 2005, the extremely rapid decline in returns for these vintage years suggest that, unless the funds were able to deploy capital quickly, they likely suffered from the poor economy in later years, as demonstrated below:

Figure 10: Private Equity Fund Returns, 1999-2008

POOLED MEAN NET TO LIQUIDATED PARTNERSHIPS (%) BY VINTAGE YEAR



f_ Performance Measurement

Detailed financial and non-financial performance data for the ten funds was not available. Of the four interview subjects that shared general financial information, three self-reported returns in the first or second quartile when benchmarked against traditional private equity managers. One fund is ‘underwater’, but expecting to generate a market return resulting from an imminent, successful exit. Three of the remaining six funds are known to have explicit financial return targets, two of which range from 8-10 percent, and one of which is a ‘market rate’ of around 20 percent.

Social performance is measured regularly by all funds, usually quarterly, in some cases twice a year, and for one fund annually. The most common metrics used to gauge community development impact are job creation, wages, benefits, professional development opportunities, female/minority ownership, and the geographic distribution of jobs. Indicators on environmental performance are becoming more important for a number of funds.

6. Discussion and Recommendations

a_ Key Findings

CDVC funds are created to accomplish an extremely difficult task — earning social and financial returns, even when a number of structural and operational constraints threaten to undermine the very private equity model on which the success of the strategy depends.

Almost every GP interviewed for this project emphasized the very real difficulties of achieving both financial and non-financial returns. GPs need to be more experienced than colleagues in the traditional private equity world, one argued, because it is that much harder to invest a CDVC fund — harder to find deals, harder to find exits, and harder to manage portfolio companies more closely.

Ideally, data would allow us to directly correlate fund constraints and financial and social performance. Without this information, the following key findings highlight larger industry trends and critical priorities:

1. Highly restrictive or arbitrary target market geographies are especially problematic;
2. Equity capital is sometimes the wrong model for job creation in underserved communities;
3. Operational best practices are undetermined;
4. The link between financial and social performance is ambiguous;
5. The only sustainability is financial sustainability; and
6. Bifurcation in the market is likely.

1. Highly Restrictive or Arbitrary Target Market Geographies are Especially Problematic

Geographic restrictions are an especially difficult problem for CDVC funds. By definition, most CDVC funds have an objective of creating quality jobs in areas that lack access to traditional sources of equity capital. Tight geographic restrictions compound the challenges of deploying capital in underserved markets, including insufficient deal flow and a lack of suitable opportunities for exit.

This is not simply a matter of constraining financial performance. Anemic deal flow is arguably a bigger drag on a fund's ability to achieve social impact, given that fewer companies are likely to meet both financial and non-financial objectives.

Because the core focus of CDVC funds is supporting low-income communities and populations, the nature of geographic constraints should be carefully considered. This could be accomplished in a number ways: by having funds invest in larger areas, by giving funds the flexibility to deploy more capital outside of targeted geographies, or by leaving geography out of the equation altogether, instead incentivizing funds to invest in companies employing target populations, regardless of location.

2. Equity Capital is Sometimes the Wrong Model for Job Creation in Underserved Communities

The notion that equity capital investing is not always well suited to the task of creating jobs in underserved markets was a recurring theme in comments from GPs. In some cases, this may be due to the types of companies likely to meet social and financial objectives. In others, the specific problems that undermine economic opportunities for workers in low-income communities are thought to be better addressed by other strategies.

Most successful portfolio companies have a number of qualities. These include sound financial practices, prospects for significant growth, excellent management willing to work in partnership with new owners, a unique product or service, and a clear exit strategy.[86] Companies with these characteristics are said to be more difficult to find in industries creating jobs for low-wage workers.

One GP argued that equity capital can be “the worst thing for a company” and investing in the wrong types of companies “is the worst thing” for a private equity fund. “We have to be up front about the purpose of venture capital, or you get mixed motivations and a lack of alignment… We realized that largely low-tech companies had a different and more diverse set of needs than could be met by venture capital”, the GP continued.

Said another: “Venture capital is a technique for a very specific kind of company. It does not work for economic development. It works for job creation and socially responsible investment more broadly”.

Commenting on the flexibility needed for companies to grow, another GP noted that “you cannot mandate that a job will stay [in the target area]”. The GP continued: “we need to create an environment that brings growth”.

3. Operational Best Practices are Undetermined

While CDVC funds have converged on key structural characteristics, for example on being created as for-profit LPs or LLCs, there is very little consensus on operational best practices, including the skills and qualifications of successful CDVC GPs, the need for more robust non-financial performance reporting, the costs and benefits of providing ancillary services to portfolio companies, the importance or lack thereof of achieving a market rate of return, and investment strategies that accomplish both financial and social objectives.

This is partly due to a lack of industry capacity and the infrastructure needed to support collaboration. It is also the result of a general lack of data and information. It is difficult to know for certain which funds have in fact been successful and should therefore be elevated as ‘models’ for the industry moving forward.

4. The Link Between Financial and Social Performance is Ambiguous

CDVC funds are not on the same page when discussing the relationship between financial and non-financial performance. Some GPs believe there is no trade-off between the two and that social impact is entirely additive. Others argue that the trade-off is inevitable.

According to one LP, most managers assert a goal of earning a market rate of return regardless of social objective.

While the disagreement may be intractable, and in part a function of the CDVC industry's definitional ambiguity, a more open discussion about financial and social performance, and more data supporting the assertions of each side, would be beneficial. Additional evidence and transparency would enable the industry to more productively consider a number of critical questions: Is there a trade-off between financial and social return? If so, what is the nature of the trade-off and what actions can funds take to maximize financial return, maximize social impact, or maximize both? If there is no trade-off, what are the characteristics of the market-rate investments and portfolio companies that provide an additive non-financial return?

Another LP confirmed that its investments had turned out to very distinct in practice. PRIs required tremendous financial patience, almost never making cash distributions, were concentrated in areas with very little access to traditional capital, and had succeeded as a tool for tackling underdevelopment and underemployment. MRIs had been financially lucrative, making a significant number of distributions to investors, but in two out of six cases had demonstrated "mission creep" that substantially distanced the funds from the social targeting the LP had hoped for.

According to a number of GPs, the very ambiguity of the potential trade-off between financial and social performance is a reason the CDVC brand is losing its luster.

Information clarifying the link between financial and social performance is difficult to solicit for two reasons. First, the private equity industry is 'private', by nature. Second, standardized financial disclosure contrasts with the inherently inconsistent practice of evaluating non-financial returns — for good reason; namely that LP non-financial performance objectives are diverse, necessitating a more customized form of reporting.

Nonetheless, capacity building in the CDVC industry needs to include a more consistent form of non-financial performance measurement, particularly in the aggregate.[87] The CDVCA attempts to collect and aggregate a number of fund financial and non-financial metrics for the industry, but with mixed results. It may be time to revisit this or a similar initiative.

5. *The Only Sustainability is Financial Sustainability*

While LPs have different financial and non-financial objectives, and some will willingly trade one form of return for the other, poor financial performance by CDVC funds generally will spell disaster for the sector.

Even funds with the most ambitious social objectives, and the most impact-driven LPs, are expected to achieve returns above 8 percent per annum — significantly below the market rate for the asset class, but challenging to achieve regardless. Financial success is therefore paramount, particularly when the measurement of non-financial performance remains inconsistent and customized to meet discrete LP objectives.

Financial success is critical to sustaining the industry in its current, primarily impact-driven form, but even more important for growing the sector. If most sources of subsidized capital, including CRA-motivated banks and foundation PRIs, have been "tapped out", as many GPs contend, an important driver of industry-wide expansion will be attracting a more diverse and financially-motivated group of investors.

A related problem is size. Evidence suggests that sources of subsidized finance are insufficient for capitalizing a partnership at more than about $20-$40 million — a scale that remains potentially problematic for delivering both financial and social returns.

One GP noted: "Funds that succeed will be market rate and will figure out how to create other ancillary benefits. You need to be a $50 million fund to have a shot at being effective. Scale is a real issue, and you can only get scale with additional funding sources by demonstrating financial returns".

For the industry to grow, and for funds to reach a more optimal size, market-rate returns will become increasingly important. For funds interested exclusively in the finite pool of subsidized investment capital, financial sustainability will nonetheless be more crucial than ever.

6. *Bifurcation in the Market is Likely*

Evidence points to bifurcation in the CDVC fund industry, broadly defined — between funds created exclusively for subsidized sources of capital, with social impact as a primary objective, and funds created for providers of both subsidized and unsubsidized capital, with financial return as the top priority.

Funds seeking only subsidized capital are likely to be smaller, to target concessionary but attractive financial returns, and to have more narrowly focused social objectives consistent with the discrete goals of local banks, foundations, and government entities. This is the structure of most CDVC funds currently in operation.

Funds seeking both subsidized and unsubsidized sources of capital are likely to be larger, to target market returns, to have broader social mandates, and to self-identify with the 'social' sector as much as they do the CDVC sector.[88]

This bifurcation is likely to be the defining trend in the next decade of the CDVC fund industry's development. It will either bring the industry together, with a greater willingness to share best practices that allow LPs to distinguish between the two categories and to be assured of the highest quality of service and performance in each, or will lead to further fragmentation as each part of the industry grows to perceive the other as counter-productive.

b_ Recommendations for Limited Partners

A number of recommendations follow from this analysis for investors. The recommendations complement the Institutional Limited Partners Association best practices discussed earlier and focus on overcoming barriers to the optimal performance of CDVC funds, laying the groundwork for industry growth and development.

Now, at a time of transition, LPs will play a critical role in shaping the future of the CDVC industry. For socially-motivated investors, there is a unique opportunity to leverage two decades of industry practice to build a more impactful CDVC sector. Whether a CDVC or 'social' equity fund is primarily seeking financial or non-financial return, LPs can demand rigorous, standardized reporting of performance and the incorporation of industry best practices that ensure the success of the fund and communicate this success to the broader industry. There is also an opportunity for socially-motivated investors to create a more sustainable CDVC sector by catalyzing financially-motivated sources of capital, building scale in community equity investing, and ultimately increasing impact.

These two overarching opportunities are realized in four recommendations:

1. Consider providing more flexible mandates to CDVC funds
2. Consider investing in the strategies and the funds that advance the CDVC industry's development, by:
    a. Investing in a small number of larger, more financially-focused funds;
    b. Investing in fund-of-funds; and
    c. Re-capitalizing the follow-on funds of providers with established industry expertise.
3. Collaborate closely with other LPs to unify investment objectives
4. Continue funding capacity building at the industry level

1. Consider Providing More Flexible Mandates to CDVC Funds

Research suggests that a highly constrained mandate is likely to make achieving both financial and social returns more difficult. The private equity model is precise and requires maximum flexibility.

Yet finding the balance is no easy task, particularly for investors motivated primarily by social impact. Provided with a more flexible mandate, investors are likely to target the industries and communities that offer the best prospects for financial return.

The Bay Area Equity Fund (BAEF) is an example of a fund with a more flexible mandate that has succeeded in deploying capital to extremely successful companies, creating hundreds of new jobs. Yet considering the industries and the areas in which the Fund has invested, the jobs created are less likely to have been filled by low-wage workers in underserved communities.

BAEF is testament to the sustainability of the financial-first model of CDVC investing, broadly defined. DBL Investors, the Fund's GP, had raised over $86 million from LPs for its second investment partnership as of July, 2010.[89] For these LPs, including core supporters of impact-driven CDVC funds that also invest with DBL, the social impact provided by DBL is sufficient, at some level.

The challenge for investors motivated by social impact is allowing for flexibility in a mandate, while ensuing that requirements for non-financial return are satisfied, including those that are legally mandated and strictly enforced, as in the case of PRIs.

2. Consider Investing in the Strategies and the Funds that Advance the CDVC Industry's Development

INVESTING IN A SMALL NUMBER OF LARGER, MORE FINANCIALLY-FOCUSED FUNDS

The success of BAEF demonstrates one way in which the industry is likely to evolve. While BAEF is unique, and invests in one of the country's most mature venture capital markets, the idea that a large, financially-motivated, and relatively 'unconstrained' fund can be sustainable is an important, foundational principal for the CDVC industry moving forward, regardless of whether these funds remain within the CDVC fold, or self-identify differently.

Investors can play an important role in supporting these larger funds and ensuring that the important social impacts at the heart of CDVC investing — job creation and economic development in underserved markets — are not altogether swamped by financial return.

Foundations, in particular, typically ask the 'but for' question when making a PRI deployment, according to LPs. In other words, would the investment occur, or would it be different, 'but for' the investment of the foundation? In the case of financially-focused funds, the support of socially-motivated investors may ensure that proven GPs remain committed to creating positive, concrete change in low-income communities.

INVESTING IN FUND-OF-FUNDS

The average size of traditional venture capital funds is now over $170 million.[90] Investors of unsubsidized capital in the sector, particularly pension funds, are accustomed to making significant investments, the transaction costs of which are the same as they would be to make a smaller allocation.[91]

Support for a fund-of-funds vehicle pooling larger sources of capital could provide an important breakthrough for the CDVC fund industry, where the same principals of economies of scale apply.

At one level, a fund-of-funds could be used to secure more unsubsidized capital for the financially-motivated funds described above. While these funds are likely to be large by CDVC fund industry standards, LPs in the traditional venture capital industry would still consider them relatively small.

Another opportunity is to pool the assets of primarily subsidized sources of capital for investment in the smaller funds explicitly targeting below-market returns and a more focused social impact. A fund-of-funds in this sector would support more due diligence of smaller funds and, if the vehicle was national in scope, would shift the focus for many investors away from geography and to the underlying social impacts of equity capital as a strategy for economic development. This is a potentially exciting intellectual step that, together with the data collected and aggregated from underlying GPs, would support the development and dissemination of best practices.

There are many challenges to consider when investing in a fund-of-funds, not least of which includes the additional cost to investors. Each of these challenges would need to be carefully addressed to ensure the viability of fund-of-funds investing.

RE-CAPITALIZING THE FOLLOW-ON FUNDS CREATED BY GPs WITH ESTABLISHED INDUSTRY EXPERTISE

The skills and experiences of professionals in the CDVC fund industry are growing and continuing to develop. As the industry has matured, so too have the business models used by GPs that have been making CDVC investments for the longest time.

This incremental, internal form of industry innovation is crucial. Each follow-on fund launched by experienced GPs with satisfactory performance encapsulates the best ideas from the on-the-ground laboratory of CDVC investing.

There is no substitute for the experience of GPs that have already succeeded in doing this work and have a desire to keep doing it.

3. Collaborate Closely with Other LPs to Unify Investment Objectives

Investors are uniquely influential in the private equity industry, particularly when funds are smaller and the need for capital is great. LPs are typically engaged in the very early stages of a fund's creation and investor financial and non-financial objectives go a long way towards shaping the mandate and even the performance of partnerships.

Investor behavior also plays a significant role in shaping CDVC funds in other ways. Most importantly, if investors have notably divergent preferences for financial and especially non-financial return, this may create an added burden for GPs in achieving and reporting on multiple LP objectives.

If LPs have uniform preferences, on the other hand, GPs can focus entirely on a clear, shared objective and will benefit from operational economies in investing and reporting. Moreover, consolidation of investor preferences for non-financial return could also support the development of a more standardized and potentially catalytic regime of social performance measurement.

While GPs agreed that consolidation of investor objectives would be useful, there was some concern that LPs might only agree on the most arduous and constraining non-financial goals.

4. Continue Funding Capacity Building at the Industry Level

The CDVC fund industry is sorely lacking in industry-wide capacity. Information about the development and performance of CDVC funds is difficult to obtain and often dated, the industry rarely shares best ideas and practices, and the voice of CDVC funds in policymaking circles is reportedly subdued. Foundations and others have historically funded individual organizations rather than learning infrastructures or networks that promote and share best practices.[92]

For the benefit of understanding, sharing, and demonstrating best practices to the wider investment world, the CDVC fund industry needs help. Because industry capacity is partly a public good, certain initiatives will need to be supported by philanthropic and government funders convinced of the social benefits of a vibrant CDVC fund sector.

LPs also have the leverage, more generally, to insist on the dissemination and implementation of best practices from which they will ultimately benefit, including greater transparency and the disclosure of performance information.

7. Conclusion

Community equity investing is challenging, both as a practice, and not least because of limited information about what strategies work, and why. Yet community equity investing can, and is, happening successfully — delivering against the objectives of investors that have a primarily financial interest, and those that prioritize social impact.

The single, most critical ingredient missing from the sector is clarity. How do CDVC funds perform? What distinguishes those that do? What are the predictors of financial and social return in low-income communities? How does the industry move forward on key policy issues of concern and in developing critical new products and infrastructure? Without clarity on these and other questions, it will remain difficult for many CDVC funds to attract new sources of capital.

Investors are in an important position to help, by driving transparency, innovation, and the dissemination of best practices. For the sake of the unique impacts that equity capital can provide in low-income communities — employment opportunities, the development of an entrepreneurial culture, business growth, and local wealth creation — it is essential that they do.

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Interview Subjects

Annie E. Casey Foundation	Christa Velasquez
Bay Area Equity Fund	Nancy Pfund
Boston Community Venture Fund	Sharon Shepard
CEI Community Ventures	Michael Garau
Coastal Ventures	Nat Henshaw
Community Development Venture Capital Alliance	Kerwin Tesdell
The F.B. Heron Foundation	Luther M Ragin, Jnr
Ford Foundation	Christine Looney
Murex Investments	Jim Jaffe
Murex Investments	Joel Steiker
New Markets Venture Partners	Mark Grovic
New Mexico Community Capital	Zach Grafe
Pacific Community Ventures	Penelope Douglas
Penn Venture Partners	Dean Kline
Rutgers University	Julia Sass Rubin
The Reinvestment Fund	Jeremy Nowak
U.S. Small Business Administration	Louis Cupp

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