

CDVCA

COMMUNITY DEVELOPMENT
VENTURE CAPITAL ALLIANCE

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Emerald City Ventures II: Vignette

Sally Sprague hesitated over the doughnuts on the conference room table at Emerald City Ventures' office. "It's OK," laughed her colleague, Joe Bartolini, "they're low-carb." "Then I'll take two," she replied. "Deciding how to raise the 2005 fund will be hard work."

Founded in 1998, Emerald City Ventures (ECV) was a community development venture capital fund (CDVC), investing to stimulate jobs and economic development in disadvantaged communities throughout its four-state region. It had raised a first fund of \$20 million in 1999. Now, as 2004 drew to a close, the general partner team of Sprague and Bartolini were preparing to go back in the market to raise money for their next fund. They were committed to their social mission and to providing a reasonable return for their limited partners (LPs). They differed, however, on the amount that they should raise.

Bartolini observed:

In the prospectus for our first fund, we didn't even dare mention a target rate of return. It looks like we'll have a decent track record now, both financially and socially. I ran some numbers and when we look at our exits so far, combined with the current state of the portfolio, things are looking pretty good. Even with fees, our LPs should conservatively see about a 9% return. Of course, that's assuming nothing unexpected happens! And on the social side, we've created or retained almost 200 jobs. With that track record, we should be able to raise \$20 million or even \$25 million.

"But I still think we should raise a larger fund this time, at least \$50 million," said Sprague. "And that changes a whole lot."

Bartolini took the last chocolate glazed pastry. "We've been talking about this for three months now," he said, "We need to get that prospectus out, so we'd better decide. I'm going to need some strength."

Ann Leamon prepared this case from general experience with the help of Kerwin Tesdell and Kelly Williams of CDVCA and many other experts. Cases are intended to serve as subjects for class discussion only; not as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Community Development Venture Capital

Since the mid-1990s, CDVC funds had become a more important part of the community development landscape. With their focus on a “double bottom line” of both social and financial return (some funds added a third bottom line of environmental sustainability), they appealed to the growing public awareness of the importance of helping people help themselves. Many banks, also, had seen CDVC funds as a way to fulfill some of their Community Reinvestment Act (CRA) obligations. Between 2000 and 2004, the amount of capital under management had more than doubled (from \$400 million to \$870 million), and the number of CDVC funds either active or in formation had risen from 55 to 82¹ with many others in operation or in formation overseas. Despite the growth in total money under management, however, each CDVC firm tended to manage relatively small funds. The average size of an established fund had grown from \$8.9 million in 2000 to \$12.9 million in 2003. This compared to traditional venture capital (VC) funds that averaged in excess of \$125 million with some, raised in the bubble of late 1999-2000, in excess of \$1 billion (see **Exhibits 1** and **2** for data on traditional VC firms contrasted with CDVC firms).

ECV's Funds

Sprague and Bartolini had founded ECV after ten-year careers in traditional VC (Sprague) and economic development (Bartolini). They had met through volunteer work in inner city development. “Our first fund,” said Bartolini, “therefore focused on that issue. We were able to raise the money from foundations, the U.S. Treasury, banks and some of Sally’s previous partners. Besides, we were there at the height of the bubble and lots of people had made lots of money and wanted to give back in a way that might also yield some returns. Deal flow, though, was a real challenge.”

Sprague explained, “We started doing small deals, largely because that was what we’d been exposed to in our volunteer work. I knew that we’d spend as much time and effort on a \$500,000 deal as I would spend on a \$5 million investment at my old firm, but I was surprised at how much time and effort it took to train the entrepreneur in basic business methods.”

“And some of our early deals were under \$300,000,” said Bartolini:

We ran into some problems we really hadn’t anticipated—like exits. It’s hard for a micro-company to get big enough that there’s a profitable exit. And there was the matter of expectations. Some entrepreneurs at that level just don’t see the process in the same way that we do. Their business is what they DO, it’s part of who they are. Why would they want to sell it?

ECV had some difficult times initially. Sprague said, “We provided a lot of loans with equity kickers, because they’re self-liquidating and provide a return from the start. But as the banker, you don’t have a lot of control until the company’s in trouble. When it’s up against a covenant, you have a lot of power but then it may be too late. Those early deals were too small, too labor-intensive, and, in the final analysis, really didn’t create a lot of additional jobs.”

The partners soon turned to larger deals that leaned more toward equity positions. “We got into a couple of good small inner-city software firms,” said Bartolini. “They did very well and were recently purchased at a great multiple.”

¹ Data from Brian Schmitt, CDVCA Database, 2005, accessed March 2, 2005.

ECV II

Bartolini and Sprague felt they had two options for their second fund. One was obvious: raising roughly the same amount from the same type of investor. The second was to raise a larger fund, perhaps as much as \$50 million. This had a number of attractions. The first was a matter of simple economics: ECV had struggled to support itself on the meager management fee from the ECV I. The fee from a larger fund would make the firm more viable and provide the staff a reasonable level of compensation. ECV's small fund size had also limited the types of deals it could do and the companies in which it could invest. With a larger fund, ECV could take a larger position or invest in later-stage companies. "In short," said Sprague, "we'd be a bigger player." Moreover, a larger fund would avoid the situation ECV had encountered several times, when one of its companies began to grow rapidly—just as everyone had hoped—only to find that ECV lacked the funds to support its expansion. Some companies had failed due to lack of cash; others had just not achieved their potential. The least-bad outcome of this unhappy situation had occurred when the company managed to attract additional capital from outside investors—but at terms that sharply reduced ECV's ownership and eventual financial return. Sprague had described this situation as, "You put a kid through college and someone else goes to graduation!" ECV would put hundreds of hours into nurturing a company from its early stages and someone else with more capital would reap the rewards.

The problem with raising a \$50 million fund, as Sprague and Bartolini knew all too well, was the scarcity of socially motivated investors in ECV's region. To appeal to a broader group of investors, ECV would have to revise its approach to marketing. As Sprague explained:

The issue is what you think of first thing in the morning. We have a social mission and we also have a responsibility to our investors to earn strong financial returns. Can we raise \$50 million or more with our social mission front and center? That is, can we raise that kind of money saying that we create jobs while also providing a financial return, or do we have to say we generate a financial return first while also creating jobs? It's a delicate difference, because we are truly committed to both our social and our financial goals. I think we can achieve both; the question is which we lead with.

Bartolini was not certain. He said:

The important thing is that we have a track record in our field of CDVC. You can raise a first fund with a good story and, admittedly, good timing. We already have some results from this fund, so we can use the story and results to date to raise the same amount of money with the same goals. Looking beyond to our third fund, we really have to have results. Can we get them if we shift our focus? Will we be addressing a whole different constituency if we increase our fund size? I'm not sure I support this.

It all hangs together...

Raising more money would pose some significant challenges, in terms of organization, deal flow, and limited partners.

Organization

Thus far, ECV had managed to invest its funds with the help of one investment director and two associates. A larger fund would increase the income from management fees. It would also require that the firm either add staff or increase its deal size. Each alternative offered benefits and drawbacks.

New staff would bring additional expertise and contacts. But the additions might disrupt the close-knit team and would certainly increase the difficulty of communication. ECV had long considered opening a second office in the northwestern part of its region to increase coverage and visibility and facilitate contacts with entrepreneurs. “But if you think adding someone down the hall would complicate things,” said Bartolini, “just imagine coordinating two offices!”

The other alternative, increasing deal size, would avoid the complication of expanding staff. However, deploying more money per deal would mean that ECV either moved into later stage companies or took larger stakes in companies at their current stage. Later stage companies held some appeal, the partners agreed. “These are often firms that are already profitable,” said Sprague. “They need extra money to ramp production or add a sales force. These can be both financially and socially good deals. Financially, the company is more stable to start with. It’s closer to reaching a liquidity event. It’s easier to evaluate because there are records from the years it’s been in business.”

“And on the social side,” added Bartolini, “you’ll be adding double-digit numbers of jobs, not doubling employment from four to eight. That would please some of our social investors who keep asking us to ‘measure our impact.’”

“At the same time,” said Sally, “some of the companies we feel best about are the small ones that we were responsible for starting. Without our money and assistance, they just wouldn’t exist. That doesn’t show up very well in job creation numbers, but it’s what we’re here for.”

Taking larger stakes meant that ECV would be placing larger bets on still-risky companies and sometimes taking a majority position. In the most extreme situation, they might be the only venture backer. “It’s nice to share a stake with another firm,” admitted Sprague. “Two sets of contacts are better than one, and sometimes the other venture backer can really add some expertise.”

Deal Flow

Deal flow might also be a challenge. “There seems to be a nice number of firms in our current deal size,” said Bartolini. “Are there enough in the next stage up, especially in our region? A lot of the bigger firms move to larger cities with better market access and a larger work force.”

Moreover, many of the most compelling investments from the social side, particularly in ECV’s rural areas, were smaller companies that needed less capital. “Would we be leaving these companies behind if we got larger?” asked Bartolini. “Often we’re their only option for financing.”

Sprague replied:

Remember, we’re not talking about multi-million dollar companies. Supporting somewhat larger companies—firms with a million in revenues, say—can have a significant impact too. And more than just our dollars are important. Don’t you think we could play a role just by being on the board of a growing company? Entry-level jobs are always being created. Even software and biotech companies crawling with PhDs need people to empty the trash cans, wash the test tubes, and sort the mail. We might be able to act almost as a conscience,

reminding them to look to the local work force and maybe even setting up programs that train people for their needs.

Limited Partners

Addressing these challenges presupposed that the firm raised the money. “To get \$50 million, you have to talk to LPs that are totally returns-focused,” said Bartolini. “It’s not enough to go to friends, the banks that supported us before, and the development and charitable groups. We would need the heavy financial hitters.”

The LPs that traditionally invested in venture capital funds included endowments, foundations, pension funds, and insurance companies. Pension funds had been freed to invest in private equity by the 1979 “prudent person” ruling, which held that high risk/high return investments should be part of a portfolio to diversify the risk profile. For ECV to raise money from the traditional financially oriented LPs, though, would be a challenge from a number of perspectives. For one, the financial LPs wanted “venture returns,” with an internal rate of return (IRR) in the high teens at least. Calculating a meaningful IRR required a history longer than ECV’s. In approaching the financial LPs, ECV would have to contrast its skeletal return data with the more robust information available for traditional VC firms (see **Exhibit 3** for comparative performance data).

“Some of these funds date back to the 1960s,” said Bartolini:

Our industry only started in the mid-1990s. So when an LP looks at tying money up for 10 years, who are they more comfortable with? They want to get in the top tier VC firms because that’s where most of the above-market returns are. Anything beyond that and you might as well be in the public equity market and have liquidity.² New funds get money because some LPs are willing to take the risk just to get into the asset class. But CDVC doesn’t have that buzz. People don’t feel they need CDVC to balance their portfolios.”

Most CDVC funds targeted a different mix of LPs, chief among them banks, which had supplied 40% of capital raised in 2003 (see **Exhibit 4** for sources of CDVC funds). All of them, though, faced mounting pressure. Both Sprague and Bartolini knew that their own bank LPs increasingly needed to show that their CRA investments produced competitive rates of return. In fact, CRA units as a whole were being required to act as profit centers, just like the other departments. The current federal administration had reduced emphasis on the CRA, jeopardizing a significant pool of social investment. Lastly, the recent spate of bank mergers meant that head offices often combined, reducing the attention that the new head office paid to the acquisition’s former headquarters.

The government, both federal and state/local, had also supplied funds for investment, whether through CDVC or other Community Development Financial Institutions, but these too were either threatened or shrinking. Even foundations faced increased pressures, both from groups raising funds and from incomes squeezed by low interest rates and the sluggish stock market.

With its explicit social agenda, ECV had raised money from the program arms of foundations such as Ford and MacArthur. “When Ford and MacArthur funded us,” said Bartolini, “they wanted to be sure we were mission-driven. Remember, MacArthur invested a total of \$1.8 million! But if we change our sales pitch to de-emphasize our social mission, will we lose investors like Ford and MacArthur? Will they be sensitive to the need of our fund and our industry to attract more market-

² See for instance research by Antoinette Schoar and Steve Kaplan, quoted in *The Economist*, “Survey: Pick Carefully,” *The Economist*, November 27, 2004, p. 6.

rate investors, or will they insist on an exclusive low-income job creation focus that can turn off other investors?”

Bartolini suggested that their contacts at the program side of several foundations might introduce them to the investment departments at those organizations. “That’s where the big money is,” he pointed out.

“I know some of the guys in the foundation investment groups,” sighed Sprague. “They invest in the bluest of blue chip funds, and they’re scared to death of investing in anything that looks at all social for fear they’ll be inundated with requests.”

“That’s true,” said Bartolini. “But I understand that’s changing at some foundations, where they’re experimenting with social investment from their endowments. But we’d still have to show the financial returns to reach that money.”

Pension funds had provided the capital that fueled the explosive growth in the traditional VC industry. But getting into the pension funds had proved a challenge for CDVC funds. “The idea is,” said Sprague, “that a big pension fund is perfectly happy if its pensioners choose to give money to job creation programs. But the pension fund wants to be sure that those pensioners have every possible penny, so they tend to stick with the big, blue-chip funds.”

“But there are a few exceptions,” pointed out Bartolini. “CALPERS³ has adopted an initiative to invest \$500 million in underinvested areas, and they’re a market leader. We’ll still have to show we can achieve risk-adjusted market rates of return, I think they’re worth a shot.”

“On second thought, though,” he said, “I guess this is a different risk profile. We have all the risk of VC but we can’t prove the returns yet.”

Another way to balance the missions and reach a larger potential LP audience was a hybrid strategy. In this case, ECV would assemble a portfolio of investments that offered a mix of financial and social returns. “Any job created is a benefit,” said Sprague. “Just by supporting sustainable companies that create jobs, we’re helping society. If we can balance a higher-return company that creates jobs in an industrial park against a lower-return company creating jobs in the inner city, maybe that’s the way to go.”

“It might be a hard sell,” cautioned Bartolini. “We might become nothing to anyone. The financial focus will muddy the waters for the social folks, and the financial folks may not want to take the hit on returns from investing in the social opportunities. I think you have to lead with one or the other.”

Back to the Future?

A second option was raising another fund of \$20 million or \$25 million from socially oriented LPs. Bartolini preferred this approach:

We’ve made our mistakes, we’ve learned a lot, and we know this business, Sally. Let’s get the money raised and get back to work. We know the LPs. We have a track record. Our LPs like us, they like our results. We know the size of the companies, the deal flow, the things the companies are likely to need. Our companies are usually past the raw start-up stage but

³ The California Public Employees Retirement System, with over \$180 billion under management.

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they're not too expensive. They create jobs. We can really influence them to provide benefits. We usually have board seats and meaningful ownership positions. We're playing a unique role in this market, and if we move up-market, there will be no one else to replace us. And we're more sure we can raise the money.

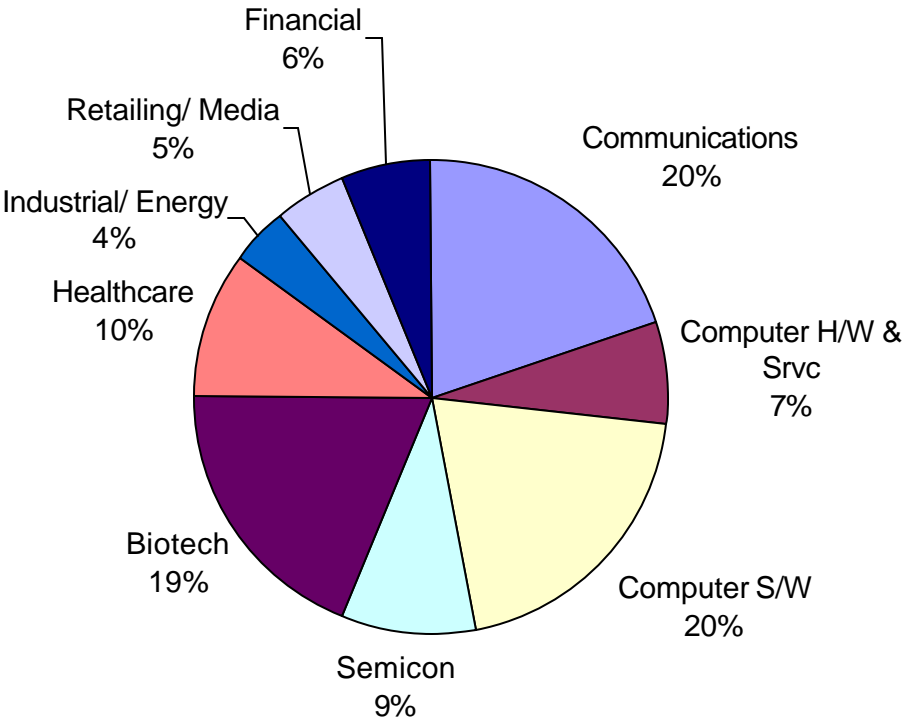
"But we've been there," said Sprague dejectedly:

We've done that. I'd really like to try something else. Raising a larger amount of capital will provide the scale to run our fund in a way that makes economic sense, and more money will give us the heft to have a greater social impact in our communities too. All we have to change is the way we pitch ourselves to investors. You and I both have the strong commitment to our social mission that will keep us on track.

"But is it possible to just change our sales pitch to investors and not change what we're about more fundamentally?" asked Bartolini. "I know you're as dedicated to our social mission as I am, but if we push our deal size and target market into the traditional VC mold to meet the requirements of our investors, what will keep us from acting like a traditional VC fund? And then what's the point? We'd be no different than they are, and we set out to make a difference."

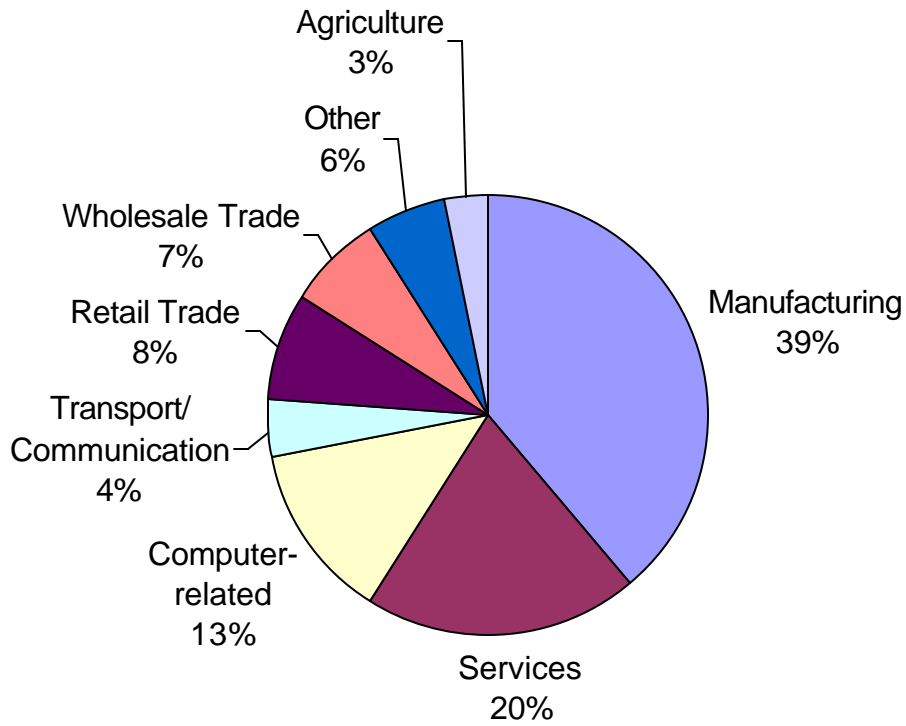
Sprague and Bartolini smiled at each other over the doughnut crumbs, as they realized that they had been having this debate in one form or another for years, and would continue to do so for a long time.

Exhibit 1a Investment Sectors for Traditional VC Firms, 2003



Source: Adapted from NVCA Yearbook 2004: Executive Summary, p. 8.

Exhibit 1b Investment Sectors for CDVC Firms, 2002



Source: Brian Schmitt, CDVCA Database, 2005, accessed March 2, 2005.

Exhibit 2 Funds and Fund Sizes

	2000	2001	2002	2003	2004
Capital Under Mgmt. (\$ Millions)					
CDVC	\$400	\$605	\$690	\$830	\$870
Traditional VC	\$228,000	\$257,000	\$258,000	\$257,000	na
Number of Funds					
CDVC (established & in formation)	55	73	76	79	82
Traditional VC	2,926	3,172	3,256	3,317	na
Avg./Fund (\$ Millions)					
CDVC	\$ 8.9	\$ 11.2	\$ 11.9	\$ 12.4	\$12.9
Traditional VC	\$ 131.3	\$ 135.9	\$ 138.2	\$ 145.2	na

Source: *NVCA Yearbook 2004*, p. 18 and p. 20; CDVC numbers from Brian Schmitt, CDVCA Database, 2005, accessed March 2, 2005.

Exhibit 3a Net Returns to LPs in Traditional VC Funds

Fund Type	1 Yr.	3 Yr.	5 Yr.	10 Yr.
Seed/Early Stage	-7%	-23%	55%	19%
Balanced	11%	-14%	19%	13%
Later Stage	25%	-19%	4%	14%
All Venture	8%	-19%	23%	16%

Source: Adapted from *NVCA Yearbook 2004: Executive Summary*, Thomson Venture Economics, 2004, p. 10.

Note: Returns are calculated net of fees, for investment horizon ending 12/31/2003.

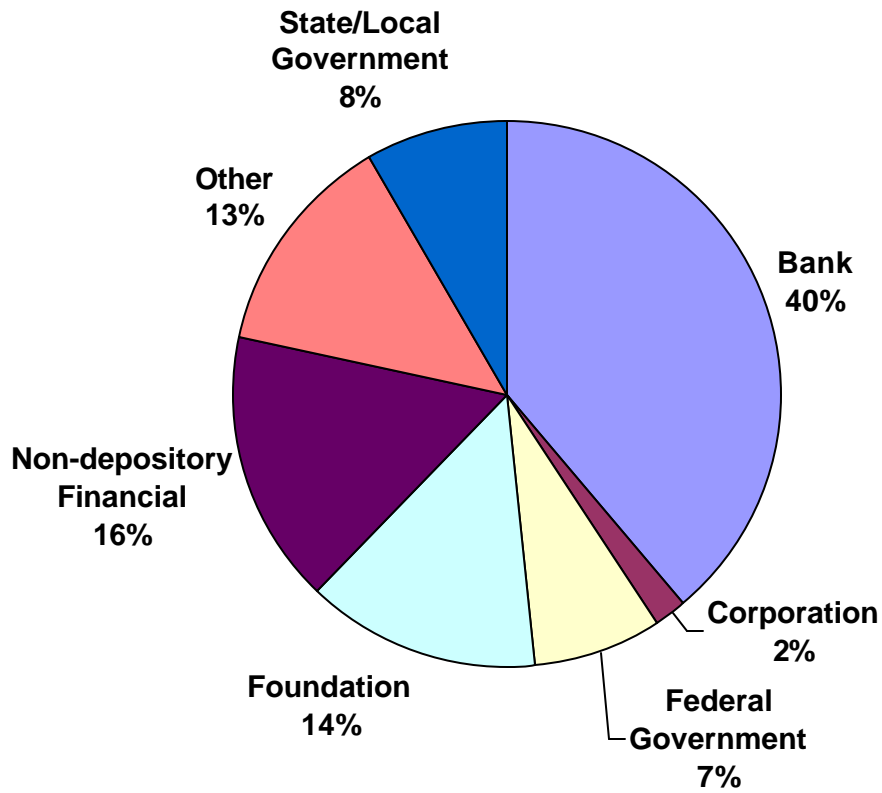
Exhibit 3b Returns to CDVC Funds

	Gross IRR
CDVC Fund 1 1984-1994	16.5%
CDVC Fund 2 1990-2002	11.8%
MBE Fund 1989-1995	6.6%
CDVC proxy 1992-2001 (w/ dilution)	8.0%
CDVC proxy 1992-2001 (w/constant ownership)	14.0%

Source: Brian T. Schmitt, "Financial Returns and Double-Bottom Line Venture Capital – What Do We Know?" November 2004, from www.cdvca.org accessed February 4, 2005.

Note: The two CDVC Funds are different organizations. The MBE Fund = Minority Business Enterprise. The CDVC proxies reflect performance of investments made by investors with similar aims to CDVC organizations. Note that Gross IRR does not adjust for fees that LPs pay GPs to manage the fund.

Exhibit 4 Sources of Funding for CDVCs



Source: CDVCA Database, 2005. Capital by source of investor, outstanding as of the end of 2003.

