Financing the New Rural Economy

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> The New Economy is a knowledge and idea-based economy where the keys to job creation and higher standards of living are innovative ideas and technology embedded in services and manufactured products. It is an economy where risk, uncertainty, and constant change are the rule, rather than the exception (Atkinson and Court).

The transition to the New Economy accelerated in the last half of the 1990s. Using new economy index measures, one can see that rapid growth in service sector activity from 1990 to 2000, at 45 percent, overshadowed the performance of the nation's manufacturing sector, at 22 percent (Atkinson and Court). We now live in an economy where 80 percent of all workers do *not* produce things. Even within the manufacturing sector, the high tech industries' share of value added in manufacturing increased to almost 25 percent. This fundamental restructuring of our nation's economy was associated with a sustained period of economic prosperity that only now shows signs of instability.

The important issue from the perspective of this conference, *Exploring Policy Options for a New Rural America*, is the extent to which rural America is participating in this economic revolution. In a recent U.S. Department of Agriculture briefing, McGranahan and Gale noted that:

> Although rural areas experienced a 3.2 percent growth in earnings from 1995 to 1998, this growth rate was significantly lower than the 4.9 percent rate in urban areas.
>
> The source of earnings growth in the 1995-98 period was expanding producer services; yet producer services remain a primarily urban activity.
>
> Growth in earnings from high tech manufacturing activities grew more rapidly in urban than in rural areas during the 1995-98 period (4.0 percent vs. 2.9 percent).
>
> Rapid growth in urban high tech manufacturing and the decline in rural apparel and textile manufacturing helped urban manufacturing earnings outpace rural earnings, reversing a trend that had persisted over the past several decades.
>
> Although rural is no longer synonymous with agriculture, a number of rural counties continue to be dependent on farming (556 counties) in spite of growth in other sectors of the rural economy (e.g., services, manufacturing).

These statistics suggest that rural America's journey along the road to the New Economy is not yet complete. However, the New Economy has made inroads into the traditional economic base of many rural communities. Rural manufacturers adopt technology and management innovations at a rate similar to their urban counterparts (Gale).

> A rural Indiana machine-tool shop adopts the latest computer-aided manufacturing technology and

> retrains workers to virtually eliminate hand tooling, increasing the plant's efficiency and competitiveness.

While there continue to be concerns about access to broadband, Internet, and other telecommunications issues, rural areas are increasingly linked to the national and global economies as never before.

> A custom furniture manufacturer in rural North Carolina manufactures upscale home accessory items that are marketed through high-end mail order and Internet outlets.

Historically, the agricultural sector was dramatically transformed by the adoption of new technologies. Today, innovations in technology such as the application of GIS and agribusiness strategies such as product differentiation continue to redefine how the nation's food supply is produced.

> Under the leadership of the Great Valley Center in the San Joaquin Valley, strategic planning is under way to "redefine the role of production agriculture in the New Economy" (Great Valley Center).

The success of the New Rural Economy is dependent on the ability of rural institutions, such as local governments, financial institutions, and educational institutions, to adapt to and support this process of change. North's concept of "adaptive efficiency" is particularly relevant here—the ability of institutions to innovate, continuously learn, and productively change. From the perspective of rural capital markets, the important question to consider is whether rural financial intermediaries can adapt to meet the needs of New Economy businesses. The first step in addressing this question is to understand the changing structure of rural capital markets; specifically, what institutions provide the debt and venture capital to rural businesses and how are these markets changing? The second step is to identify where the capital gaps exist, specifically for businesses that might be defined as part of the New Economy. Finally, the lessons learned from innovations in rural capital markets need to be identified and applied to policy options for the broader rural economy.[1]

Structure of Rural Capital Markets

Within any rural capital market, it is important to distinguish between those intermediaries that provide debt capital and those that provide venture capital.[2] Commercial banks and Farm Credit System (FCS) institutions are the primary sources of debt capital for rural businesses and farms. Venture capital markets are less well developed in most rural communities, but innovative models for providing venture capital through nontraditional institutions exist and are discussed in more detail later in this paper.

Rural debt capital markets

There has been significant consolidation of banking assets in the U.S. over the past decade. From 1988 to 1997, the number of banking charters in the U.S. declined by 30 percent and the number of banking organizations declined by 27 percent (Haynes, Ou, and Berney). While there were 14,000 commercial banks in 1973, the number declined to 9,500 in 1996 and to 8,774 in 1998 (Collender and Shaffer). The decline in number of banks was associated with an increase in bank concentration. From 1988 to 1997, the percent of bank assets controlled by the eight largest institutions increased from 22 percent to 36 percent. At the same time, banks with less than $100 million in assets controlled 14 percent of bank assets in 1979 but only 7 percent in 1994. This wave of consolidation and increased concentration has affected rural markets through the merger of rural independent banks into larger regional entities and through the acquisition of small rural banks by large statewide, regional, and national bank holding companies. As a result, the number of rural banks declined from 6,469 in 1990 to 5,493 in 1995 (*Credit in Rural America*).

In spite of these changes, rural debt capital markets work relatively well. Rural banks are in good financial condition. From 1990 to 1995, problem loans to equity declined from 10.6 percent to 5.2 percent. Return on assets increased from 0.9 percent to 1.2 percent, while the equity capital to assets ratio increased from 8.6 percent to 10.0 percent (*Credit in Rural America*). Farm Credit System institutions also fared well during this period, with problem loans to risk capital declining from 37.5 percent to 7.2 percent. Return on assets increased from 1.0 percent to 1.7 percent, while risk capital to assets increased from 11.6 percent to 16.2 percent.

While rural debt capital intermediaries are in good financial condition, rural markets continue to be narrower than urban markets. In 1994, 27 percent of rural counties were served by two or fewer banks. Measures of market structure suggest that few rural markets have enough competitors and equality of market shares to ensure real competition (*Credit in Rural America*). This lack of competition is mitigated for farm borrowers to some extent by the presence of Farm Credit System institutions and other public programs.

How has consolidation affected rural banking markets? Based on a review of past research, the Rural Policy Research Institute's Rural Finance Task Force concluded that "in communities where a local bank is merged with a large holding company or becomes a branch of a large and distant bank, there often is a reduction in lending to local businesses or a change in business focus of the newly merged bank" (RUPRI). This conclusion is supported by other research that evaluates the small business lending patterns of large versus small banks. Berger and Udell found that large banking organizations make fewer small business loans than other banks. Strahan and Weston found that small banks owned by large banking companies make fewer small business loans than independent banks; however, the authors found no evidence that mergers result in reduced small business loans in a bank's portfolio. Alternatively, the presence of large banking institutions may benefit rural businesses that have more complex banking needs or larger capital requirements.

Of equal importance are the differences in large and small bank approaches to small business lending. Collender and Shaffer conclude that small banks have informational advantages that allow them to do relationship lending while large banks must rely on transactions-based lending. Relationship lending relies on information gained about a business through deposit and other relationships that the borrower and lender may have. As a result, the lending decision is less reliant on financial reports and credit scoring. Relationship lending may be particularly important for New Economy firms that may be operating in a sector unfamiliar to local bankers or have a limited operating history. The banker may be able to use information gained through previous banking relationships with these entrepreneurs as a supplement to the more limited financial information available. Transactions-based lending, in contrast, relies primarily on analysis of financial statements and credit scoring criteria, a process that helps to reduce transaction costs for the bank. With continued consolidation in the banking industry, this difference in small versus large bank lending behavior may affect small business borrowers negatively. If information about small businesses is lost as small banks merge into larger institutions, relationship lending will be replaced by transactions-based lending (Cole, Goldberg, and White).

Rural Venture Capital Markets

The availability of venture capital, risk capital from outside investors, is recognized as a critical ingredient for new business start-ups and business expansions. Yet venture capital markets are "unorganized and often non-existent in rural communities" (RUPRI). Nationally, venture capital investments are concentrated in a small number of regions and industries. According to the 1999 PriceWaterhouseCoopers Moneytree survey, 67.1 percent of U.S. venture capital investments were in four states (California, Massachusetts, New York, and Texas), and 91.0 percent of the investments were in technology-based companies, including Internet-related businesses. The distribution of venture capital investments across states indicates that many regions of the country are relatively underserved by traditional venture capital institutions. For example, per capita venture capital investments for the United States were approximately $143.00 in 1999; yet only six states exceeded the national average (Massachusetts, $597.00; California, $522.00; Colorado, $335.00; Washington, $215.00; New Hampshire, $199.00; and Connecticut, $159.00). Alternatively, 24 states had per capita venture capital investments of less than $20.00, or less than one-seventh of the national average. These states were concentrated in the Plains, Midwest, and South Central regions.

The lack of well-developed rural venture capital markets may be a response to limited good investment opportunities. However, it also may reflect market failures that result from imperfect information and high transaction costs. Specifically, traditional venture capital institutions do not aggressively seek investment opportunities in small urban areas and rural communities because deal flow is sparse, costs per investment are relatively high, exit opportunities are limited, and local business environments are less supportive than in more urbanized places (Barkley et al. 2001b). To meet the venture capital needs of rural businesses and entrepreneurs requires the creation of nontraditional venture capital institutions that represent an adaptation of the traditional model to the constraints of investing in rural markets.

Gaps in Financing the New Rural Economy

There is consistent evidence over time that small businesses depend primarily on commercial banks to meet their credit needs (Elliehausen and Wolken; Cole and Wolken). Consequently, as rural banking markets change, small business borrowers face several capital access challenges. Small businesses may prefer to deal with smaller banking institutions, where relationship lending is practiced and valued. Relationship lending reduces the information costs for the small business borrower (Haynes, Ou, and Berney). However, finding a small bank lender may be a challenge for small businesses in some rural areas. If a small business borrower does borrow from a large banking institution, the borrower may find that the larger bank is more likely to rotate loan officers out of a rural branch or even shut down the branch. This decision would effectively eliminate the business borrower's relationship with the bank. Small business borrowers may prefer dealing with local banks because these banks may be more willing to maintain loans to business borrowers, even when local economic conditions decline. This safety net can provide stability to business borrowers in the short run (Collender and Shaffer).

While these concerns relate to small business borrowers in general, what about rural businesses and entrepreneurs that are part of the New Rural Economy? How well can rural financial intermediaries adapt to the needs of a different rural borrower from the routine manufacturer or farmer of the past? In terms of resources, rural banks and Farm Credit System institutions have sufficient deposit base and access to national money markets to respond to an increased demand for loans in their rural communities (*Credit in Rural America*). As economic activity expands, rural financial intermediaries should be up to the challenge.

However, there is evidence that certain types of borrowers may not be well served by today's rural banking markets. As summarized by the RUPRI Rural Finance Task Force:

> Most rural borrowers with relatively routine credit needs are well served by existing lenders. However, borrowers with large debt capital needs, borrowers needing debt capital for start-up businesses, and borrowers needing debt capital for businesses unfamiliar to their lenders can expect difficulties in obtaining the credit they request.

The businesses described here are likely to include many New Economy firms. Many New Economy firms in rural places are likely to be start-up enterprises, requiring venture capital or debt with equity type features. This type of capital is unavailable from traditional rural financial intermediaries, banks, and FCS institutions. Rural borrowers with complex or large financing needs, such as a manufacturer upgrading a plant with the latest computer-aided manufacturing technology, may find it difficult to acquire capital within the local market. These borrowers face increased transaction costs as they are forced to look outside the local market for capital. Businesses with limited traditional collateral are also likely to face credit constraints. This set of businesses includes those firms whose collateral, such as human capital, patents, and software innovations, may be unfamiliar to local lenders (*Credit in Rural America*). New Economy firms trying to operate within a more traditional rural economy may have difficulty finding a banker who can understand and evaluate the prospects for a new high tech business enterprise.

From the perspective of venture capital, New Economy firms are ideally suited for attracting venture investment. These firms tend to be in sectors such as high tech and business services that are the focus of traditional investors. However, the most significant capital gap faced by rural entrepreneurs and businesses is the lack of equity or venture capital. In a paper presented at the Federal Reserve Bank of Kansas City's 1998 conference on *Equity for Rural America*, Brophy and Mourtada showed that "entrepreneurial firms within rural America have captured a very small cumulative share of the U.S. market for the private and public equity portions of finance in the years between yearend 1985 and yearend 1998." This period, it should be noted, was associated with increased venture capital investments and IPO (initial public offering) activity for the U.S. as a whole.

When viewed from this national perspective, the critical need in rural America would appear to be venture capital. However, recent work by the Appalachian Regional Commission (ARC) identified both a lack of venture capital and limited management expertise and institutional capacity to support the creation of new funds or programs in rural Appalachia (Appalachian Regional Commission). ARC's efforts suggest the rural venture capital gap cannot be filled with capital alone. Capacity building, both in terms of institutional and management capacity, is an important part of the solution to developing an effective venture capital industry in rural America.

Most start-up businesses require some outside source of venture capital investment to augment the personal equity invested in the business. For New Economy businesses located in many urbanized parts of the U.S., the traditional venture capital market is well developed and there are options for seeking venture capital investments. However, options such as formal angel investor networks and traditional venture capital firms are unlikely to reach into rural America. What are the impediments to traditional venture capital investing in rural America?[3]

- **Limited deal flow**. The economic base of most rural areas is relatively concentrated in low tech, slow growth sectors. These sectors do not provide the numerous investment opportunities with the high rates of return favored by traditional venture capital funds. As a result, even rural firms in sectors favored by traditional investors do not have access to venture capital.

- **Higher costs per investment**. Limited and spatially dispersed deal flow results in high search costs for identifying prospective deals and higher time and transportation costs for conducting due diligence and monitoring investments. As a result, traditional venture funds are not willing to look outside their established urban markets, even if some good investments exist in rural America.

- **Limited opportunities for exiting deals**. Many businesses in rural communities are family owned with the goals of transferring ownership to the next generation or maintaining the current business location. Such goals limit exit strategies and reduce the attractiveness of investments to traditional venture capitalists. Even New Economy businesses in rural areas may be tied to the local area, by family or lifestyle concerns, in ways that limit exit opportunities.

- **Lack of favorable local business environment**. Rural areas offer relatively limited business infrastructure and human capital to facilitate management of new companies, particularly New Economy firms that may require more sophisticated services such as patent attorneys. Thus venture capitalists may have the additional expense of acquiring business services and managerial and technical personnel from outside the area, or providing extensive technical assistance to existing company management.

Rural entrepreneurs and businesses, particularly those involved in New Economy activities, are likely to experience some difficulty meeting their debt and venture capital needs. While debt markets work relatively well in most rural areas, more sophisticated and unusual business credit needs may go unmet in rural markets, precisely the credit needs that New Economy businesses might have. However, the presence of financial intermediaries, commercial banks and FCS institutions, offers the opportunity to implement programs or policies to address the credit needs of New Economy businesses. Of even greater concern is the lack of financial intermediaries in rural markets that can provide venture capital. The policy challenge in this environment is great since it involves the innovation of new types of financial institutions that can address the rural venture capital gap. This challenge, however, is made easier through the lessons learned from institutional innovators across the U.S.

Innovations in Financing Rural America: Nontraditional Venture Capital Institutions

In 1997, the RUPRI Rural Equity Capital Initiative was funded by a grant from the U.S. Department of Agriculture's Fund for Rural America. The purpose of the project was to examine innovative institutions that are making venture capital investments in rural places across the country and develop lessons learned from these institutions that might be applied in other areas. The project grew out of a concern about the venture capital gap in rural America and an interest in providing input to the policy debate regarding how best to fill that gap.

As part of the project, 23 case studies of nontraditional venture capital institutions or programs were completed between July 1998 and November 2000. The institutions range from a community-based angel investor group to a statewide, publicly supported venture fund; from a community bank Small Business Investment Company (SBIC) to a statewide private SBIC with community bankers as investors; from a community development venture fund operating in depressed Appalachian counties to a community seed fund in the Heartland.

All these institutions have one thing in common. They are nontraditional venture capital institutions that reflect important innovations or adaptations of the traditional venture capital model. In trying to understand whether these types of institutions might be a potential source of venture capital for businesses in the New Rural Economy, it is important to understand the characteristics of these institutions and what separates them from traditional funds. These nontraditional venture capital institutions had the following characteristics:

- They operate outside of regions and industrial sectors where venture capital investments are concentrated such as in rural communities and non-high tech industries.

- They expect a financial return on investments that is less than the annual return anticipated by traditional venture capital institutions.

- They generally operate with a geographic focus or geographic restrictions such as a specific community, state, or region.

- They may have a dual bottom line of acceptable financial returns and social and economic benefits to the service area. Thus, nontraditional institutions are capitalized by funding sources that value economic and social returns in addition to financial returns, such as state government, local government, nonprofit foundations, Community Development Financial Institutions Fund, Small Business Administration, commercial banks, pension funds, and civic-minded individuals.

These characteristics make nontraditional venture capital institutions well suited to addressing venture capital needs of rural businesses, both new and old economy enterprises. The regional or community orientation of these types of funds puts the fund manager in a better position to evaluate the risk-return tradeoff of small regional businesses. Since many of these funds operate with a lower expected return threshold, managers are willing to stay in a business for a longer period of time. While this extended investment period may reduce the fund's returns, it may allow the fund manager and business owner to develop an acceptable exit strategy that keeps the business operating within the region.

While nontraditional venture capital institutions are making investments in small urban centers and rural places, the industry is relatively new and, as a result, is not widespread across rural America. What have we learned about these institutions and their ability to invest in rural entrepreneurs? How can we encourage the creation or expansion of nontraditional venture capital institutions to other parts of rural America?

Lessons learned about nontraditional venture capital institutions

Lesson one. There is no single best model for establishing a nontraditional venture capital institution. The RUPRI study considered a variety of institutional types including publicly funded and managed programs, publicly funded and privately managed programs, public incentive or tax credit programs, and privately funded programs including community development venture capital institutions. Some models were independent stand-alone funds, while others were established as part of existing organizations. Each alternative has advantages and disadvantages that must be considered.[4] The choice of a model depends on several factors:

- The goals of the program founders—Is the purpose to maximize financial returns or to achieve economic development goals while earning sufficient financial returns to ensure fund sustainability?

- The funding sources available—Can the fund be capitalized at a level where it can operate independently (minimum of $10 million), or will a smaller fund need to be part of an existing organization?

- The existing venture capital infrastructure—Are there venture funds operating in the region that can be encouraged to expand into rural areas or do new institutions need to be created?

- The specific industries or stages of business that are targeted—What type of deals exist in the targeted region (e.g., start-up enterprises or existing businesses seeking to expand), or will deal development be needed before investment begins?

- The current political environment—Is there public support for creating venture capital capacity, or has past experience created a more cautious political environment?

Lesson two. Although the choice of institutional structure for a rural-focused nontraditional venture capital fund may vary from situation to situation, there are a number of general observations that can be made about the process. One, there are important advantages to a privately managed venture capital fund, including management decisions that are insulated from political influence. However, some form of public involvement, either the provision of capital or incentives, may be necessary to create a nontraditional venture capital fund with a primarily rural focus. Two, imposing a rural or strict geographic constraint on the operation of a venture fund means that other constraints need to be relaxed. For example, a strictly rural fund may need to be capitalized by patient capital, investors that do not expect to achieve high levels of return over a relatively short time horizon. These investors may include the public sector, foundations, or individuals motivated by social returns. Three, rural-focused funds must operate to overcome both limited deal flow and lack of a supportive business environment. As a result, higher operating costs are likely and must be factored into the design of a rural-focused venture fund.

Lesson three. Establishing a nontraditional venture capital institution is a complicated, time consuming, and expensive process. In addition, decisions made early in the creation process may be altered by the realities experienced later on. However, the founders and managers of the venture funds included among the RUPRI case study institutions considered a set of similar issues while they were developing their own structures. These issues or decision points are summarized by the RUPRI research team and organized into a decision making process for establishing a nontraditional venture capital institution (Barkley et al. 2001a). Understanding this decision process will help other individuals or groups learn from the experiences of others and design a nontraditional venture capital fund that works best given their goals, market conditions, and institutional constraints. There are several key points in the decision making process:

- Recognize the impetus for creating a nontraditional venture capital institution—What are the goals? What are we trying to achieve?

- Conduct a market analysis to estimate deal flow or investigate how to create additional deal flow—What deals exist already? What do we have to do to create deals?

- Articulate the institution's goals and objectives with respect to financial returns and economic development—Are we trying to maximize financial returns or meet economic development goals?

- Select the institution's size (based on fundraising opportunities), investigate alternative management structures, and select an experienced management team.

- Identify potential sources of funds to capitalize the institutions—Do we focus on public funds, private funds, or some combination?

- Select the legal and organizational form and manage investment activity.

While this process appears to be sequential, there are implied feedback loops between the various decision points. Decisions made early in the process may affect later decisions and constraints identified later in the process may force the modification of earlier decisions. Different organizations may begin the process at different stages. For example, a public program may constrain the organizational structure of a fund, effectively eliminating any choice in how the fund is structured.

Lesson four. Successful nontraditional venture capital institutions generally shared the following characteristics:

- A skilled management team was rewarded through an appropriate incentive structure recognizing sound investment behavior that achieved institutional goals.

- Adequate resources were devoted to deal flow development and creation.

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

- Managers gave significant, but not always primary, attention to fund rate of return to maintain the long-run sustainability of the program.

- Fund managers conducted rigorous due diligence prior to investments and adequate technical and management assistance post-investment.

- Fund was structured to minimize political interference in investment decisions, even when public capital was used.

These lessons learned are useful to individuals and organizations interested in creating rural-focused nontraditional venture capital funds because they help avoid the reinventing-the-wheel problem. However, from a policy perspective, it is useful to consider what it will take to expand these institutional innovations to other parts of rural America.

Expanding nontraditional venture capital capacity in rural America

The 23 institutions included in the RUPRI study are located in only 15 states. Many of these institutions do not have a strictly rural focus. At the time of the study, there was only one rural community bank SBIC licensed in the U.S. (Durant, Oklahoma). Now, there is also one statewide rural-focused SBIC (North Carolina). How can public policy encourage the creation of more rural-focused venture capital funds?

Since many nontraditional venture capital institutions must rely on patient sources of capital, expanding or maintaining public financial support for these initiatives at the state or national level is one way to support the development of new or expanded rural venture capital investment activities. The Community Development Financial Institutions (CDFI) Fund (U.S. Treasury Department) is an ongoing public program that provides support to community development financial institutions. Several of the funds included in the RUPRI study received CDFI grants to support their deal flow development and technical assistance activities. The New Markets Venture Capital Program, passed by Congress but funded at a reduced level in the current budget, is another program that has the potential to support the creation of new venture capital capacity in rural America.

Partnerships between rural community banks and venture capital institutions can expand the capacity of rural financial markets to meet both the debt and equity capital needs of local businesses and entrepreneurs. For example, a statewide private SBIC, Kansas Venture Capital, Inc., was capitalized with public funds and investments from over 300 state banks. Leadership for the creation of this fund came from the state bankers' association. While this SBIC does not have a strictly rural focus, the model could be applied to other more rural regions. The concept of partnerships is being used in another recently established rural-focused fund, the Appalachian Ohio Development Bank. During fundraising, the fund sought investments from local banks, investments that, in turn, could qualify for Community Reinvestment Act credit. The fund established another partnership with Ohio University to provide business development and technical assistance.

Significant time and resources are required to determine the feasibility of creating a rural venture capital fund. Before a fund is created, the organizers need to evaluate the market and potential deal flow, cultivate potential sources of capital, identify a management team, and form partnerships within the region.[5] This start-up process can take up to a year and $300,000-$400,000. One public policy option is to establish a fund that can make grants to cover the costs of this process. Without such a fund, smaller rural areas will be less likely to undertake the rigorous start-up process and will either (1) decide against pursuing the creation of a venture fund without adequately investigating the potential or (2) jump into the creation process without doing the groundwork necessary for success. Supporting this start-up process, either at the state or federal level, would help encourage the thoughtful creation of rural venture funds.

Conclusions

The transition to the New Economy is not complete in rural America. However, many traditional rural businesses are adopting new production processes and new business management ideas, while some rural entrepreneurs are creating new types of rural industries. The success of both activities depends on the ability of rural financial institutions to recognize and adapt to this change. On the debt capital side, rural financial markets work relatively well and rural institutions should continue to have access to the resources needed to meet rural business capital needs in the future. The presence of both commercial banks and FCS institutions creates an environment in which institutional innovation is possible and, to ensure long-term survival, even necessary. On the equity capital side, the lack of venture capital institutions located in or serving rural areas creates a significant venture capital gap. The real issue is how to create venture capital capacity in rural America.

Fortunately, lessons learned from those innovative institutions that are investing in small urban centers and rural communities help to smooth the way for the creation of other nontraditional venture capital funds. There is no single best model for meeting the venture capital investment needs of rural businesses. The establishment of a nontraditional fund requires a decision making process that considers multiple factors including the goals of the fund organizers, sources of capital, different institutional structures, and both the political and economic realities of the targeted market. While the impetus for creating rural venture funds is likely to come from the local community, the public sector can play a supportive role in this process.

Public support for the creation and expansion of rural-focused venture capital institutions may be direct or indirect. The public sector can be involved in the creation of funds through direct public investment in partnership with private investors and managers. There is also an indirect public role through programs that support the start-up process, deal flow development, and technical assistance activities of nontraditional venture funds. In either form, public support of efforts to overcome the constraints on venture capital investing in rural America is a vital component of the set of policy options needed for a New Rural America.

Endnotes

[1] This step draws upon research completed for the Rural Policy Research Institute's (RUPRI) Rural Equity Capital Initiative. The research team for this project included: Dr. Deborah M. Markley, chair; Dr. David L. Barkley, Clemson University; Dr. David Freshwater, University of Kentucky; Dr. Ron Shaffer, University of Wisconsin-Madison; and Julia Sass Rubin, Harvard University. The project was funded by a grant from U.S. Department of Agriculture's Fund for Rural America. Project publications can be obtained from *http://www.rupri.org/pubs/equitycap/index.html*.

[2] Financial capital is not homogenous. There are major variations among different types of financial capital, the most important being the distinction between debt and equity or venture capital (Brealey and Myers). Debt creates specific obligations for the borrower to repay the loan on a predetermined schedule. Failure to meet the repayment terms typically allows the lender to attempt to recover the outstanding debt, even if the borrower is forced into bankruptcy. Equity or venture capital conveys a share of ownership in the firm to the individual or institution that provides the funds. The investor gives up the right to a predetermined repayment schedule and a preferential claim on the assets of the firm in exchange for a share of future profits (or losses).

[3] These impediments are drawn from case studies of nontraditional venture capital institutions completed for RUPRI's Rural Equity Capital Initiative and presented in Barkley et al.

[4] For a more detailed discussion of the advantages and disadvantages of program alternatives, see Barkley et al. For more information about the specific institutions included as case studies for the RUPRI project, see Markley et al.

[5] For a more detailed discussion of the start-up process for one fund, the Appalachian Ohio Development Fund, see Markley et al.

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