The View from Main Street

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By way of brief background, Kentucky Highlands Investment Corporation (KHIC) is a community development corporation (CDC) created in 1968 to reduce chronic poverty and welfare dependency in southeastern Kentucky. The CDC carries out its mission by utilizing a venture capital approach to investing in businesses that provide job opportunities for residents living in the area. In addition to making equity investments in businesses, KHIC also provides a variety of debt financing that is tailored to start-up or expanding businesses. KHIC also provides extensive technical assistance and support to such businesses. KHIC is independent from any governmental or quasi-governmental control and operates as an independent private, tax-exempt corporation.

KHIC was formed as a Title VII Community Development Corporation, one of the nation’s first CDCs. It received both operating support and funds for investment from the Office of Economic Opportunity, the predecessor to the Office of Community Services. KHIC is governed by a Board of Directors, all members of which have lived in the area it serves. One-third of the Board consists of low-income individuals.

In the 30 years since its creation, KHIC continues to serve the people of southeastern Kentucky in counties that are among the nation’s most distressed. Since its creation, KHIC has invested more than $45 million in more than 100 businesses that have created over 5,000 jobs.

These jobs are primarily in the manufacturing segment. The companies have provided goods and services in excess of $1 billion and have paid more than $400 million in wages to employees in southeastern Kentucky. Currently, the wages earned by employees working in these companies are more than $50 million per year. KHIC estimates that almost 10 percent, or about 5,000 people, of all the households in the KHIC service area have at least one breadwinner in a company in which the CDC has invested.

FINANCING FOR RURAL AMERICA

Much of the job creation—and thus the economic betterment of communities and states—has come from businesses employing 20 people or less. Small business creation and expansion serve as an engine of economic growth in urban and rural areas. Such growth entails some risks, however, as small businesses have new ideas or bring new services and products to areas that may not be familiar with them. The entrepreneurs behind these businesses risk their own savings on these ventures, but they also need debt and equity financing to help them succeed.

In urban areas, there are many banks and investors providing entrepreneurs and small businesses with potential sources of investment capital. In rural areas, however, this rarely is the case. The Economic Research Service of U.S. Department of Agriculture has found that new and small businesses have fairly limited access
to credit. Small, locally owned, rural banks are generally conservative in their practices, lending to the people and businesses they know. In fact, products that are available from urban banks are not available in rural markets. The rural banks do not have the demand for such products as current asset-leveraged revolving loans and, therefore, have not developed the expertise to provide this service.

Further, it should be noted that the venture capital industry is aggregated on both coasts and other urban centers where technology is being created, leaving a void for equity capital in rural markets. Although there is a significant amount of equity capital looking for deals, who is putting the deals together for rural America?

**AVAILABILITY OF EQUITY CAPITAL**

We are fortunate to have a variety of successful loan programs such as the Small Business Administration and U.S. Department of Agriculture that address the needs of small rural companies. However, equity or venture capital is the most vital, and by far the most difficult, form of capital for an entrepreneur to secure. Generally speaking, rural entrepreneurs have a particularly hard time accessing this form of capital as they operate far from major financial centers where firms specializing in this type of investment activity are frequently located. In addition, they lack access to family wealth and may need significant technical or business assistance before they can tap into conventional sources of venture capital. Furthermore, without this critical equity component, an entrepreneur may not be able to attract additional financing—such as bank loans—that is necessary to establish or expand a business.

What has become increasingly clear from KHIC’s experience in Kentucky is that rural businesses have a need for far more equity or venture capital than community-based lenders can provide. In rural Clay County, Kentucky, KHIC participated in the founding and start-up of a company that manufactures casements for the retail industry. This is not a high tech company with double-digit annual growth, therefore not a candidate for traditional venture capital. However, there is still the need to provide equity financing to start this company. KHIC has invested over $500,000 of equity in this company. Today, that company employs over 175 people that had no other opportunity for employment in their home county. The company’s sales are growing on a healthy curve and profitability is following that sales growth. This company would not be located in rural Clay County, Kentucky, if it were not for the equity investment made by KHIC.

**DEVELOPMENTAL VENTURE CAPITAL**

Entrepreneurs in rural areas require equity investors, like KHIC, who are able to actively participate in the development and well-being of their businesses. Fortunately, a field of small, early stage, community development venture capital funds is emerging to address this capital gap. In short, they are utilizing venture capital to promote community economic development. These funds are targeting businesses that are often passed over by pension funds or other traditional institutional investors due to the remote location of the investment, the size of the transaction, or the inclusion of nonfinancial considerations, but are beyond the scope of foundations and other community funders. In addition, many state-funded economic development programs or funds may have a technology bias or are constrained from participating in early-stage deals.

Each of these community development venture capital funds reflects the particulars of locale
and capital structure. However, they do share the common objectives of creating jobs and generating wealth in economically distressed rural regions; providing entrepreneurs solutions to social and environmental problems; shaping the culture of young companies with respect to equity, sustainable community development, and environmental impact; and yielding competitive long-term investment returns. These organizations have formed an alliance consisting of about a dozen community development venture capital funds, many of which, like KHIC, have existing track records, extensive knowledge of their markets, and equity investment experience or partners who bring significant venture capital experience.

FUNDING FOR DEVELOPMENTAL VENTURE CAPITAL

Raising dollars for these developmental venture capital funds is very challenging. These funds are experiencing risk-adjusted returns of 8 percent to 12 percent for their investors. However, traditional venture capital is raising dollars with the suggested ROIs of 35 percent plus. Therefore, the alliance of the development equity funds has pursued demonstration guarantee programs through the U.S. Department of Agriculture. Such a demonstration program was authorized in the 1996 Farm Bill but failed to be appropriated in the 1999 budget. Foundations are a source of seed money to start these equity funds but not a solution to providing long-term investment dollars. Perhaps an avenue to capitalize these rural equity funds is the topic of this conference. The need is imminent to alleviate the collision course that this country is on when one considers the “Welfare to Work” issue that is looming before us in the next 24 to 36 months.

CONCLUSION

There is a widespread shortage of equity funds available for rural America. Even though there are significantly improved communication avenues available that make the geography smaller and smaller and help the entrepreneur and the equity provider communicate, there is not a vehicle in place that will provide this much-needed equity. Aggressive, young MBAs who have experience in traditional venture capital do not necessarily want to make career moves to rural communities where substantial technical assistance is required for the equity investments in fledgling start-ups. The support infrastructure does not exist in rural America. The logical technical assistance provider is the venture capital professional. This further lack of infrastructure complicates the issue because it pushes up the typical fund overhead from about 3 percent to manage the investments to above 7 percent, which ultimately lowers the internal rate of return for the equity fund.

Rural models, perhaps like the KHIC model that has a 30-year track record of success, should be developed throughout rural America. Of course, initial funding would have to be provided through state and federal government investments, foundations, endowment funds of colleges that serve a particular rural area, individuals who would diversify their investment portfolio to include a lower expected return on some of their investments, and other more patient sources of investment capital.

There is an optimistic future for rural equity funds because there is now an escalated interest at all levels trying to understand a delivery system that is acceptable. In fact, the Kauffman Foundation is funding a training program where qualified participants spend time learning the “how-to-practice” aspect of venture capital. These people will return to areas that are in need of developmental venture capital.