The Current State of the Art in Rural Equity Markets: Leading Edge Institutions

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The Minnesota Investment Network Corporation (MIN-Corp.) is a community development venture capital organization formed in July 1998. The organization’s mission is to promote community economic development by building the capacity for equity investment primarily in rural Minnesota companies. MIN-Corp. helps fill a critical gap for early stage financing in rural Minnesota.

CREATION OF MIN-CORP.

MIN-Corp.’s genesis, financial history, and strategy evolved from the experience gained while managing Minnesota Technology, Inc.’s (MTI) equity fund program from which assets have been used to capitalize MIN-Corp. MTI established an equity investment fund as a pilot program, which began operation in 1993. The program demonstrated the feasibility of supporting the start-up and development of technology-based small- and medium-sized companies through equity or equity-like investments, with a focus on rural Minnesota. MIN-Corp. evolved as an independent organization supporting the mission of MTI, providing a more flexible and responsive organization to meet the equity capital needs of the marketplace. MIN-Corp. was formed to provide an organization designed to engage additional resources to achieve the mission of providing equity to companies in Minnesota.

RURAL CAPITAL GAP

Many studies validate the lack of access to equity capital for the rural area. Capital is critical to establishing and growing companies that hold the promise to create high wage jobs with opportunities for advancement. Capital critically needed for investment can significantly impact the lives of people living in the communities of rural Minnesota.

Reviews of rural credit availability confirm that sources of equity capital are almost nonexistent in rural areas. Charles Morris and Mark Drabenstott of the Federal Reserve Bank of Kansas City found that “while debt markets are generally efficient in rural America, equity markets, and especially venture capital markets, are much less developed.”

The U.S. Department of Agriculture Economic Research Service cites research showing that newly formed rural businesses have far fewer sources of investment capital than those in urban settings for several reasons: (1) regulations prohibit banks from making equity investments and discourage them from making loans on risky ventures, (2) rural bankers are much less likely to refer unsuccessful borrowers to equity investors, and (3) rural areas lack seed and venture capital funds and have relatively few wealthy individual investors.
the University of Wisconsin-Madison found that while venture capital in the nation as a whole became more available throughout the 1980s, in the states where it was most concentrated most of the capital flowed to enterprises operating in urban rather than rural areas.³

Deborah Markley, a North Carolina-based researcher who has conducted analyses of rural credit gaps for the National Governors’ Association and The Aspen Institute among others, synthesized a number of studies on rural credit gaps. Overall, she found that “equity capital is much more limited in rural markets.”⁴

While there are numerous sources of financing in Minnesota, very few are structured to assist start-up operations, provide working capital, or assist businesses without a significant asset base and operating history. A study by the Center for Economic Development (CED) concluded that while debt financing is available in Minnesota and large amounts of equity capital are concentrated in venture capital funds located in the metropolitan area, these venture funds largely ignore rural Minnesota. The CED confirmed that key economic development practitioners throughout the state encounter businesses that are stymied by the lack of investment capital.⁵

MIN-Corp. market study

The management of MIN-Corp. commissioned a study in 1996 to describe and measure market demand for equity capital and to draw a more accurate picture of the need for equity capital by firms in Minnesota. The results of this study were used to formulate policies, practices, and investment strategies to serve the market.

The study surveyed Chief Executive Officers from manufacturing and technology-based high-value-added service industries. The survey included companies with annual sales between $500,000 and $5 million, referred to as “Emerging Growth Companies,” and companies with between $5 million and $50 million of annual sales, referred to as “Middle Market Companies.” These companies were identified as being the type of companies most overlooked by traditional venture capital institutions. The study concluded:

1. Owners of these firms will increasingly come to seek capital from sources other than friends and family, their traditional sources for equity capital. The amount of capital that friends and family can provide is likely to be too small to meet the needs of most of these expanding businesses.

2. Emerging growth and middle market companies in rural Minnesota constitute a substantial market for equity capital. CEOs of the companies surveyed indicated these companies are likely to be undergoing some form of ownership change in the next five years.

3. Over the next five years, there may be over 300 transactions by firms (in rural Minnesota) which will require equity financing chiefly for the purposes of acquisitions, buyouts of founders, and increasingly, for ESOPs. CEOs of emerging growth companies and middle market companies indicate that many transactions requiring equity injections of $500,000 or more are likely in the upcoming years.

In conclusion, equity financing—which could provide patient capital to budding entrepreneurs—is neither plentiful nor accessible in rural Minnesota.

Economic trends

During the early 1980s, rural Minnesota experienced high unemployment, declining family incomes, and increased migration of families to
urban centers due to a severe recession in the economies of Minnesota’s agriculture and mining sectors. These trends have continued in the 1990s. The result is that communities are not only losing their people, they are losing their leadership and hope. New self-sustaining sources of community development and jobs will be required to overcome these permanent changes to the rural economic landscape. Future development will require new techniques that nurture the entrepreneurial spirit of the people by providing capital, expertise, and new technology.

Currently a struggling farm economy and a shortage of workers are slowing economic growth in the Midwest, according to the monthly Mid American Business Condition Index. For the third time this year, the U.S. Department of Agriculture reduced its forecast for 1998 Net Farm Income, down 16 percent from 1997. Edward Lotterman, Federal Reserve Bank agricultural economist, projects rural Minnesota will continue to struggle with historically weak agriculture prices. According to Lotterman, the Federal Reserve Bank has heard reports of a steep decline in agriculture related implement sales, and some bankers report requiring higher collateral on borrowing as a precaution against loan losses.

The Midwestern economy is often associated with agriculture and natural resources. Now service, manufacturing, and government employers play a key role in the stability and growth of regional economies. The process of making these economic changes has been difficult for rural areas. For rural Minnesota, as well as throughout other Plains states, rural populations are dropping, farmers are giving up, main street businesses are disappearing, and schools are closing.

Another way to look at the decline of the rural sector is to compare it to the metropolitan area. From 1980 to 1990, rural counties in Minnesota averaged a population loss of over 5 percent, while the state’s population as a whole grew by 7.4 percent. During the course of the 1980s some of the rural counties lost nearly 20 percent of their residents.

To slow the historic trends and stabilize rural communities, business growth that has been dependent on a region’s natural agricultural resources will now need to be derived from intellectual assets of a region. This means rural business will need greater access to the type of capital necessary to finance the more intangible assets of human capital, retraining, and product innovation. Thus, access to equity capital has become more critical to community development. Equity capital literally buys the time needed to secure the intangible assets to organize a business around an idea or to capture an opportunity to grow the business.

**Barriers**

Equity capital critically needed for investment that can significantly impact the lives of people is lacking in rural Minnesota areas. Barriers that block the flow of equity capital to worthy entrepreneurs in rural areas of Minnesota include:

- Lack of interest of venture capital industry to serve rural areas.
- Lack of expertise and understanding of equity financing by people in need of equity financing.
- Lack of an organized pool of investors in local areas focused on helping local business.
- Lack of understanding by existing regional organizations of the skills needed to evaluate companies and manage the risks associated with equity investing.
• Insufficient equity capital to properly serve the rural market.

• Incomplete equity infrastructure to effectively serve rural areas.

MIN-Corp. is organized to overcome these barriers by engaging additional resources to achieve the mission of providing equity to companies primarily in rural Minnesota.

VISION

MIN-Corp.’s mission and strategies are designed to realign the flow of equity capital in rural community investment in a manner that will:

• create a self-sustaining fund to fill the capital chasm between angel investors and entrepreneurs;

• organize angel investors geographically to respond to regional business opportunities; and

• provide expertise to facilitate the investment of equity capital in companies to benefit communities and increase the quality of life in rural Minnesota.

MIN-Corp. will fulfill its mission by acting as a catalyst that brings together individuals and organizations to pioneer initiatives designed to remove barriers which block the flow of capital needed by small businesses.

MIN-Corp.’s Board of Directors and management have a strategy that in five years results in a highly prized investment network able to 1) develop and retain valuable companies capable of creating good jobs, 2) provide returns to investors, 3) increase a community’s ability to sustain economic development by encouraging local investment and ownership, and 4) enhance local expertise needed to successfully grow companies by recruitment, mentoring, and apprenticeship.

PRODUCTS AND SERVICES

Equity investments

MIN-Corp. makes equity investments in new and existing companies that have credible growth potential but because of their size, location, and stage of development are typically overlooked by traditional venture capital funds.

All investments are structured so MIN-Corp. will participate in the ownership of the company. The most common equity investments instruments utilized by MIN-Corp. are common stock, convertible preferred stock, and subordinated debt with conversion privileges or warrants. The price, ownership, and exit that MIN-Corp. negotiates are based on both the anticipated return potential and the perceived risk associated with that investment.

Regional angel investor networks

Rural Minnesota lacks a reliable network of local investors committed to investing in companies that will build their community’s economy. MIN-Corp. will build the local capacity to make equity investments by organizing groups called Regional Angel Investor Networks (RAIN) made up of investors who are willing to share their expertise and invest their own financial resources into local companies.

These funds pool the intellectual and financial resources of wealthy investors to provide seed equity capital for emerging growth companies in their communities. MIN-Corp. has developed a RAIN template modeled after an existing investor network to present to angel investors, will assist in formation of the groups, and will provide administrative support.
Development services

To enhance the level of success of its portfolio companies, MIN-Corp. provides oversight, assistance with planning and problem solving, and recruits specific expertise for the companies when necessary. Development services include assistance on strategic issues; legal matters; problem solving; finding and hiring key management, personnel, and board members; developing marketing, financing, and growth plans; and raising money from new investors.

Customized seminars

MIN-Corp. organizes customized management programs designed for companies that receive investments through MIN-Corp. and its partners. The purpose of these programs is to enhance the expertise available to companies and to help companies avoid costly mistakes.

CURRENT PORTFOLIO

The management of MIN-Corp. has verified that the rural Minnesota market can be successfully served as measured in economic and social terms. This is evidenced from results achieved by companies currently in MIN-Corp.'s portfolio of investments.

To date, MIN-Corp. has made equity investments totaling over $6 million in 16 companies. In addition to this direct investment, MIN-Corp. management helped facilitate an additional $50 million of financing for these companies. The fair market value of the portfolio has increased by nearly 30 percent over the cost of investment. In addition to the financial results, the companies employ over 600 people, pay average wages and benefits of about $40,000 per employee and generate annual payrolls totaling nearly $27 million.

ENDNOTES


