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

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When I was initially asked to be a participant in this conference, I thought I was to come up with strategies or modalities on how to bring equity into rural America. So in starting to prepare for this conference, I read the previous conference book *Financing Rural America* (Federal Reserve Bank of Kansas City). This book and its findings are extraordinary if not daunting. With such distinguished presenters and so much fascinating information about rural capital markets and needs, I was rightfully terrified in trying to come up with some ways to bring appropriate sums of equity into rural America.

ASSESSMENT OF RURAL EQUITY CAPITAL MARKETS

The problem of developing rural equity capital markets is more severe than David Trophy depicted in his article "Developing Rural Equity Capital Markets" in the aforementioned book (Federal Reserve Bank of Kansas City). In this excellent article, Professor Trophy defines rural as anything outside standard metropolitan statistical areas. He also presents evidence that shows rural locations "represent less than 10 percent of the nation's initial public offering (IPO) market over the past decade."

I submit that if you defined rural as it really is, and not as liberally as Professor Trophy has, and exclude some communities with world-class universities and research centers such as Boulder, Colorado, the rural IPO rate would probably drop to something like 3 to 5 percent. That poignantly manifests what a tragically poor job we are doing in equity placement in rural markets. While we are defining rural, permit me to express a seldom lamented concern—the lack of capacity building in rural areas. In this same publication, Dr. Tubs of Maquoketa, Iowa, and former president of American Bankers Association, expressed concern that he was the only participant that "truly lives, eats, and breathes in the rural areas which are the focus of the conference."

CAPACITY BUILDING IN RURAL AMERICA

I am always amazed at the amount of "rural" institutions that serve rural areas from urban centers. When such a concern has been expressed to rural public and private funding sources they appear astonished about the audacity of the inquiry. One wonders just how many institutions exist that serve rural areas from urban centers? In my experience that phenomenon is commonplace. If we are to cure the ills of rural America, should we not endow rural institutions? Should we not build resources, capability, and opportunity where the problems exist? How many institutions administer to the rural leper colonies from their pristine urban clinics? Forgive the avarice, but my organization, Impact Seven

(I-7), has been criticized severely for its location in the target area with all the difficulty of securing staff and other resources. The reasoning is that if we served the rural area from an urban center we would be much larger, and much more effective.

As long as this prejudice is reinforced and rewarded by funding sources, the problems I-7 experience will only be exacerbated. I remember attending a community development venture capital conference at the Ford Foundation. The luncheon speaker, a foundation CEO, spoke about the out-migration of the motivated, gifted, and youthful talent from rural areas. Certainly, one way to ameliorate this situation is to create institutions and concomitant opportunities in rural areas, not urban offices serving rural areas. I fear that Maquoketa, Iowa and Almena, Wisconsin (population 625) are two of the very few that share the preceding vision.

IMPACT SEVEN

One of my tasks is to tell you about Impact Seven. I am tempted to be very indolent and offer a "ditto" to the presentations made by Ray Moncrief of Kentucky Highlands Investment Corporation and Greg Sandbulte of Northeast Ventures Corporation. Many I-7 efforts and purposes are similar to those two corporations; however, it is accurate to say there are many differences as well.

Impact Seven is a 28-year-old nonprofit community development corporation serving Wisconsin. I-7 has numerous nonprofit and for-profit subsidiaries doing many, many different things. As such, we are a very multifaceted firm trying to address many varied socioeconomic problems and opportunities. For the most part, our investments are economically targeted to distressed segments of the state and citizenry.

Economic development projects

Our origin came out of the need to address the lack of business development and the problems of poverty, out-migration, and welfare dependency. Essentially, we are a financier, entrepreneur, developer, consultant, administrator, catalyst, advocate, and facilitator for other socioeconomic efforts. We have a venture capital pool and five revolving loan funds. Some of the many things we have been involved in include economic development projects in which we have created 14,897 jobs. As a housing developer we have created over $45 million in new units of housing now numbering near 1,500 units. Additionally, we have renovated almost 1,200 units of housing and manage over 600 units.

Employment programs

We were once Wisconsin's largest deliverer of employment and training programs. We linked business development and job creation with job placed and placing over 4,000 people in jobs. This was recognized by Harvard as a replicable model in one of their community development courses.

Infrastructure development

Impact Seven has been heavily involved in health programming, multipurpose centers, speculative shell industrial buildings, day-cares, industrial parks, and cooperatives. It would take far too long to elucidate all the physical and social infrastructure development we have been involved in which has supported a myriad of community economic development activities. A few examples would be the Western Wisconsin Development Corporation (a SBA 504 Certified Development Corporation), Lac Courte Oreilles Cranberry Producers, Inc., and the Wisconsin Housing Ministry Partnership. We have over 100 of these kinds of examples in our corporate reserves.

From our 1970 beginnings we gravitated from a strictly venture capital approach to a very multifaceted community development approach. I-7 could not make it using only a venture capital approach to meet the many unmet needs of our target area. If we were to be self-sustaining while addressing problems and opportunities we had to be a one-stop center for community economic development. That was also predicated on the competition for economic development opportunities and the lack of cooperation and availability of resources from agencies that should have been providing them.

BARRIERS TO DEVELOPMENT IN RURAL AMERICA

Turfing

Suffice it to say that certainly one of the barriers to more development in rural America is the immense turfing that goes on among the organizations who do have limited resources to disburse. This is one of the barriers to more infusion of equity capital as well, and this kind of turfing could be controlled by mechanisms already in place were there the will and courage to do so.

Lack of equity education

Rural America critically needs education about equity capital as there is not nearly the understanding and underpinnings for venture capital as there needs to be. Along with educating rural America about equity capital must come the educational process to remove the attitudinal barriers to growth and to instill values conducive to growth and renewal.

Overstated return rates

Impact Seven's major goal is to improve the socio-economic circumstance of the area it works in and to direct its resources to those most in need. We, along with rural America, must be honest in the trade-offs involved. Many rural brethren relate high returns on their equity capital. Of this I am deeply suspect. Keep in mind also that there are so-called rural equity institutions that have invested many, if not most times, in urban ventures. Overstated rates of return in rural areas, in I-7's experience, are a disservice to the goal of bringing more equity capital into rural America by misrepresenting the problems and returns. If we are not going to be honest about what needs to be done, it will not get done right, if at all.

Permit me to tell you about one of our equity investments in a mid-tech company in which I-7 placed $400,000 in a convertible, subordinated, debenture with detachable warrants. We provided capital, secured land, arranged debt financing, identified and trained workers (90 to start), and much more. When we sold back our limited equity position to the parent company we realized a 34 percent average return. The reality is that this investment is an anomaly, as our average return on equity is really about what it is on debt. That is the rural reality I-7 is aware of and that which needs to be changed. No, it is not the 20 to 25 percent returns I have heard of, but I believe it is closer to the truth and the challenges we must address.

The need for rural venture capital is enormous as emerging businesses need equity to attract financing from lending institutions. There are few equity institutions in rural areas, few angels, and few other options for equity financing.

Challenges unique to rural venture capital firms

Surely you have discerned by now that firms like Impact Seven are faced with problems not faced by traditional venture capitalists:

1. We work in rural geographic areas within predominantly rural states that have strong heritages of dynastic family businesses, not world-class ventures that go public.

2. There are no close world-class universities, as in Boulder, Ames, and Iowa City (the "rural areas" that I believe brought Professor Brophy's rural IPOs up) and, hence, few world-class technologies or technologists.

3. There is a lack of technologists in the geographic area to develop high-profile ventures in leading edge businesses, such as biomedical, software, and electronics.

4. There are limited amounts of venture capital available so we cannot invest $2 million plus per venture. Therefore, we do not see the deals with the largest potential and highest internal rates of return.

5. We tend to work in areas that do not have the base of first-class managers with histories of building and taking ventures public who can be summoned for promising ventures.

6. With few high-growth companies in these rural areas, there is little venture capital backed with the potential of going public.

Since many home run potential ventures with annual returns of 60 to 100 percent are not seen to make up for the losses in the average venture capital portfolio, we are forced to minimize risk by avoidance of R&D stage deals. We further reduce our risk by investing in mid-level, low risk of technology obsolescence ventures (with low upside also). While we seek world-class managers, we invariably settle for experienced managers.

One of the key issues is how to find low-cost sources of rural venture capital that are realistic in the types of returns that can be expected on an ongoing basis. While there may be exceptional investments that are case-study venture capital deals, a rural venture capital portfolio will not look like the portfolio of venture capital limited partnerships (VCLP) located in places like Palo Alto, that will have first dibs on highly promising deals. Let's briefly look at the average internal rates of return for venture capital limited partnerships that have the "pick of the litter" (Table 1).

Table 1
AVERAGE INTERNAL RATES OF RETURN FOR VENTURE CAPITAL LIMITED PARTNERSHIPS

VCLPs formed	Average annual return
1969-79	23.3
1980-84	10.0
1985-89	15.2
1990-91	24.1

Even with the PC boom, VCLPs formed in the 1980s had an annual return of approximately 10 to 15 percent.

PROPOSED STRATEGY FOR RURAL EQUITY

What rate of return expectations should we have for rural ventures? With lower equity returns, how do you sell rural opportunities to institutional investors? How do we develop a sustained method of providing equity financing in nonglamorous areas of rural America? Would the following strategy be workable?

1. Promise reasonable returns at 8 to15 percent based on not having many, if any, IPO-

potential companies. If such show up in the portfolio, consider it a positive but don't expect it.

2. Keep the loss ratio reasonable by focusing on ventures where there is local strength, i.e., the need for productive, cost-effective employees, low-to-mid-technology and good—but not necessarily world-class—management.

3. Establish the core fund and the balance on an as-needed basis when ventures with a potential of 15 percent returns are possible.

4. Get 15 percent returns by focusing on subordinated convertible debt with warrants, and sell the warrants within three to five years to get a 15 percent annual ROI.

LEGISLATIVE SOLUTIONS

While federal funding to rural areas has experienced gargantuan cuts in recent years, is it achievable to bring in equity through legislative measure? Incentives could be offered not unlike community development tax credits that have been effectively targeted through HUD, and now the Treasury.

If incentives could be legislated, it would be ideal to obtain incentives to build world-class ventures in rural areas. Thus incentives could be based on nonnatural resource businesses, such as high-value-added technology-based businesses with exports. Such ventures might also receive a tax holiday, and investments in these ventures could also receive tax incentives.

Defining these ventures would be key to prevent dilution of the incentives and abuse of the system, such as the relocation of branch plants by major corporations to rural areas without developing local talent.

By giving them a tax holiday, or a reduction in taxes, their net income after taxes would be higher, resulting in better cash flow and higher potential multiples. In addition, some of these tax incentives could be based on offering deductibility of subordinated debt (principal and interest), allowing for a higher return to the investor.

CONCLUSION

There are many other strategies to pursue, but my time has elapsed. I will end by saying that there is little time and little patience for the many problems facing rural America, and equity capital is one of the critical ingredients to solving rural America's plight.

REFERENCES

Federal Reserve Bank of Kansas City. 1996. *Financing Rural America*, a conference sponsored by the Federal Reserve Bank of Kansas City, December 4-5.