Thank you. Good afternoon. As Chief Operating Officer, I tend to give talks that are more focused on operations, numbers, deals, and this sort of thing. On the other hand, Nick Smith, our CEO, is more likely to talk about our formation, spirit, and vision. In preparing to speak at this conference, Nick and I had a conversation during which I asked him, “Anything in particular you think I should include or exclude?” He said, “In my experience people tend to find all that operational stuff pretty boring.” So, you will have to bear with me. I am going to try not to include too much operational detail, but I may revert.

ORIGIN OF NORTHEAST VENTURES CORPORATION

To help you understand what Northeast Ventures is and what we are trying to accomplish let me start by describing how we came to be. The first element of that would be our geography. Northeast Ventures does not refer to the northeast United States, though we’ve had some confusion on that point originating from Boston in the past. Rather, northeast refers to northeastern Minnesota, an area that makes up approximately one-quarter of the state of Minnesota. This region covers approximately 19,000 square miles, and has a population of slightly greater than 300,000 people. It has one city of 85,000, which is Duluth, two cities with populations slightly greater than 10,000, and three or four cities in the 7,000 to 10,000 population range. Everything else is smaller, down to the smallest place you can imagine. It was interesting this morning to hear people talking about rural and small. I think there’s a tremendous need for definition here. I have had people in New York refer to Minneapolis as rural. Minneapolis refers to Duluth as rural. Duluthians refer to Tower, Minnesota, as rural. It’s entirely a matter of perspective.

Regional economy of northeastern Minnesota

It is also helpful to understand a bit of our economic history and tradition. Northeastern Minnesota has been reliant for 150 years—probably more—on extractive industries controlled elsewhere. I will refer to that situation as foreign ownership. By foreign I don’t mean outside the United States, but rather ownership residing in Cleveland, Pittsburgh, and other cities in the eastern United States which have historically controlled the timber and mining interests in northeastern Minnesota since their inception. One result of that foreign ownership has been that the people of northeastern Minnesota have not developed a strong tradition of entrepreneurship. Examples of business success most often cited in northeastern Minnesota have tended to be managers of mining or timber facilities, and as a result, a sort of employee mentality has been quite prevalent in the region.

This became very clear in the early and mid-1980s as our region faced a very severe economic crisis. You may recall that at that time the U.S. steel industry was experiencing tremendous difficulties. As its main supplier, the mining industry in northeastern Minnesota was decimated. In
a very short time period, direct employment in
the mining industry of the region went from
greater than 16,000 people to fewer than 5,000
people and we lost over $2 billion from our
gross regional product. This does not even take
into account the indirect effects of this tremen-
dous upheaval. We had cities, small cities but
cities nevertheless, which had unemployment
rates in excess of 75 percent, and counties with
unemployment rates in excess of 30 percent. It
was a real disaster. Given our reliance on the
region’s major industries over time, we were not
well prepared for this downturn. As a result, our
region’s reaction to this permanent shift in eco-
nomic conditions, while perhaps understand-
able, was a bit immature. We got mad. Very
mad. We were mad at the people who owned
those mines. We spent a lot of time being angry
and less time focused on how to get out of this
situation. I think this was fairly characterized by
a billboard posted along side Interstate 35 lead-
ing south out of Duluth that said, “Would the last
one to leave please turn out the lights?”

Conference of regional leaders

It was against this economic backdrop in 1985
that a foundation based in northern Minnesota
called the Blandin Foundation gathered a group
of what they referred to as regional leaders for a
series of one-day conferences over a period of
three months. Nick Smith, who is the founder of
Northeast Ventures and, as I mentioned earlier,
our CEO, was one of those in attendance. Those
of you who know him know that he’s not bashful
about sharing his views, and he wasn’t then
either. He talked about his experience, which
was more than 25 years as a corporate attorney,
and of the consistent problem his clients had
faced in trying to access equity capital for business
growth. Northeastern Minnesota had a wealth of
debt capital products. We had two large system
banks and many small independent banks which
had been able to support local business in ways
the larger system banks had not. We also had a
wealth of both public and private subordinated
debt funds that had been used very creatively,
and usually in combination with the region’s
banks, to achieve development objectives. The
equity capital that existed in northeastern Min-
nesota, however, was largely inaccessible
because it was not available in any organized
fashion. Equity availability in northeastern
Minnesota tended to be more along the lines of,
“Do you have a rich uncle?” While some busi-
ess people were able to secure equity capital
through personal relationships, the vast major-
ity of businesses seeking equity capital did not
have such relationships, and equity capital, as a
result, was largely inaccessible.

Equity capital model

Nick made this point clearly and often at the
conference. At the conclusion of the conference,
he was asked to undertake an effort to create a
locally focused venture capital fund. This was
something he had no real experience doing, but
he accepted the challenge and spent the next
four years trying to figure out what to do and
how to do it. During those four years he talked
with venture capitalists, foundations, banks, and
others to try to find an equity capital model
which could be replicated in northeastern Min-
nesota. He visited Kentucky Highlands and also
Tom Miller, who was in New York but had come
from Kentucky Highlands. Through these visits
he put together a model of Northeast Ventures.1

ORGANIZATION OF NORTHEAST
VENTURES

Northeast Ventures Corporation was conceptu-
alized as a fund that would have a geographic
focus in the seven counties of northeastern Minne-
sota. It would have a clearly stated double
objective of financial and social goals. We did
not, and do not, believe that the two are mutually
exclusive. Northeast Ventures Corporation would have a strict equity focus, rather than the broader financial program offerings of some other institutions that practice rural equity, which might also run subordinated debt funds or other financing programs. Northeast Ventures would focus on providing equity finance only because, as I mentioned earlier, our region was already well served by a variety of debt financing programs, a condition that still exists today. We also decided to structure Northeast Ventures as a corporation. We felt that this structure helped meet one of our objectives, that of permanence, and I’ll talk about that in a moment. Though we understood the argument that a series of limited partnerships can, in essence, provide permanence, a corporate model made that objective clear from the outset. Finally, it was decided to organize Northeast Ventures as a for-profit entity. We felt that the for-profit identification had strong cultural implications in terms of how business would be conducted.

**Operation principles**

We also identified a number of principles that would guide our operations. First was permanence through financial self-sufficiency. We did not see Northeast Ventures as a temporary undertaking, nor did we see its investment activities as a charitable undertaking. Second, we were committed to competence. We felt that there was often pressure in staffing development finance programs to recruit the most affordable personnel, and we do not believe their success rates spoke very well of that approach. We also believed strongly that there needed to be a critical mass. At that time, we set a minimum of $5 million and said if we couldn’t raise that $5 million, we would not begin operations. We had seen a number of funds in the $1 to $2 million range that, frankly, could not afford their first loss. When that loss occurred, it put them into a negative spiral that led to their demise. It was our belief that our losers were likely to materialize before our winners and that we needed to have some staying power to survive. That has, in fact, been our experience. Finally, we wanted to keep politics out of our operations. We did not want a structure or investors that would enable state legislators to call us in the middle of the night and tell us which deals to do.

**Success factors**

In addition to these principles, we also identified some success factors for our operations.

As I mentioned earlier, one is permanence through self-sufficiency. Another is local wealth creation and control. Given our history of foreign ownership, we felt it was very important that the businesses we would be seeking to create have a strong element of local ownership. A businessperson who lives within a particular community addresses situations of growth and movement of a company far differently than someone who lives in another part of the world. We also thought it would be very important that we demonstrate an ability to attract market driven venture capital to our deals as coinvestors. We did not see ourselves as being the only investor active in northeastern Minnesota and thought that the ability to attract market-driven capital to our investments would prove the non-mutual exclusivity of our financial and social objectives. Finally, we sought to foster a spirit of entrepreneurship in northeastern Minnesota. Though this is something that is very intangible and difficult to measure, we felt, and still feel, that it was critically important.

**Funding**

So we had the concept pretty well laid out, but it turned out that conceptualizing this fund and funding it were far different things. We really had no idea what to expect with regard to returns
generated by the fund we were proposing to create. Given our primary geographic focus, we anticipated that we would need to be fairly general in our approach to businesses and that this would lead to higher transaction costs. Given the uncertainty with regard to how Northeast Ventures might perform over time, we chose to offer investors a 0 to 5 percent return which, as you might imagine, quite effectively limits the universe of interested investors. We had one potential investor who said, “Oh please don’t do that. You’ll set the cause of venture capital in Minnesota back 50 years.” Another said, “Well, I’m interested in what you’re doing, but I don’t know if it’s an investment or a contribution.” And so fund raising was, and is, an ongoing challenge.

As a result of the unique fund raising challenge faced by Northeast Ventures, we chose to focus on what we call nontraditional investors. Nontraditional to us meant that we were looking for investors who, like Northeast Ventures, had interests beyond purely financial as a basis for their involvement. We were looking for institutions that had the betterment of northeastern Minnesota as a goal or the proof of concept of a rural equity model for replication elsewhere as a goal. Those are the kinds of investors we ultimately attracted.

Our founding shareholders, in my view, were really pioneers. They had no more experience at this than we did at the time. The Blandin Foundation, Northwest Area Foundation, Minnesota Power, Minnesota Technologies, and The Northland Foundation put together a combined $4.7 million in common stock purchases. We had, and this is a bit of an aside, also secured a $2 million commitment from a state agency which was ultimately declined due to concerns over potential political interference as discussed earlier. Declining that investment was particularly difficult since it represented $2 million of a $6 million total, without which the $5 million minimum commitment I spoke of earlier was not complete. Walking away from their money was very difficult, but in hindsight it was the correct thing to do.

In the summer of 1989, the founding shareholders agreed to commence operations, though the $5 million threshold had not been achieved. A condition of the start-up, however, was that if $5 million was not secured by the end of 1989, the fund would be liquidated.

I’m afraid I’m now going to revert to some of that boring operational stuff. Since our beginning in 1989, our capital base has risen to what will at the end of this year be $11.5 million. We have received additional investment from the Ford and MacArthur Foundations in the form of PRI debt. We’ve also been fortunate to receive funding through the Community Development Financial Institutions Fund, as well as grant funds through an affiliate nonprofit.

INVESTMENTS AND PERFORMANCE

We made our first investment late in 1990; it was a $225,000 investment. From that investment through the current year we have invested over $1 million thus far, and have a few investments that we expect to close before yearend. We have invested a little over $7.5 million in 23 companies.

Current portfolio status

A brief overview of the performance of that portfolio indicates some progress, some disappointment, and significant remaining potential. Of the companies in which Northeast Ventures has invested, we’ve exited two profitably, with one yielding an annually compounded rate of return of approximately 27 percent, and the other approximately 34 percent. On the other
hand, we’ve had four complete write-offs. Of the remaining companies in our portfolio, I believe seven or eight are looking very strong. It’s clear to me that some of them will be IPOs, and that others will have that route as a possible exit, but will also make very attractive acquisition candidates. We also have two or three portfolio companies that are in precarious financial positions, and I candidly don’t know the outlook for their ultimate survival. One of these companies has characteristics that would enable it to turn quickly and achieve profitability rapidly, while another would be more difficult to turn around. As a result, these companies absorb a lot of our time. For the remaining six to eight companies in our portfolio it is in some cases too early to tell and in others too late to achieve the hoped-for financial goals. For the companies in which we have invested only recently, it is simply too early to know how they will progress. We certainly have high hopes and believe the companies represent opportunities, but it is difficult to say what the future will bring. In others, it is very clear to us that they will never achieve the financial returns we had hoped for at the time we invested. On the other hand, they are functioning in small towns in northern Minnesota, employing people, and paying taxes. We take some comfort in the fact that we have accomplished at least a part of our objective.

How Northeast Ventures will ultimately achieve an exit from some of these companies is difficult to predict. Clearly, exiting these slower growth portfolio investments will be an ongoing challenge. It is also important to note that companies invested in by Northeast Ventures have already created more than 600 jobs, which is a very important measure for us as well.

Lessons

So, what have we learned about our operation?

Risk and balance. We have learned that our portfolio is much more heavily weighted to early-stage companies than we had originally anticipated. When we began Northeast Ventures, we had a vision of doing some early stage investing, some expansion investing, and some ownership transition or restructuring investments. We thought we would have a much more balanced portfolio with a more balanced risk distribution. That is not how things have worked out. The investment opportunities which have been available to us have been largely early stage, start-ups and seed investments. Well over 80 percent of our portfolio is made up of these types of early-stage investments. This fact has a number of implications for Northeast Ventures. Our portfolio is higher risk than we thought it would be, individual portfolio companies absorb more of Northeast Ventures’ management time than we had anticipated, and achievement of some of our employment-related objectives has been somewhat delayed.

Portfolio management. We have also found, not surprisingly, that identifying and recruiting appropriate management for our portfolio companies has been quite difficult. Most of our companies don’t come to us with multiperson, multifunctional, ready-made management teams. Additionally, recruiting management personnel to the remote areas of northeastern Minnesota is quite difficult. It is not impossible, however, as there are a number of people who would like to return either to their hometown or area or to a more rural setting. Clearly, such individuals represent a minority of the management pool we would hope to attract, and management recruitment will be an ongoing challenge for us.

Deal flow. A previous speaker said that deal flow stinks. I think that was charitable. Deal flow represents issues for us, with respect to both quantity and quality. These are constant challenges for us. Structurally, we started out as
one nonprofit and two for-profit entities, we then merged the two for-profits into one, and have recently added an additional nonprofit. We’ve been through a number of structural gyrations over the years as we try to fine-tune our operations and target it toward our objectives, and these are issues with which we continue to wrestle. For-profit or nonprofit, corporation or limited partnership—these are issues for which I don’t believe there has been a clear-cut right or wrong approach, but rather they are issues that we continue to examine.

**Neglect of the portfolio’s middle companies.** Another thing we’ve learned about the operation of our portfolio is that we have tended to somewhat ignore the middle of our portfolio. This is not a good thing. The companies in our portfolio that are doing very well can absorb a lot of our time, and it’s fun. The companies in our portfolio that are doing badly can absorb a lot of our time, and it’s less fun. What sometimes happens, I think, is that those companies in the middle of our portfolio tend to get less of our attention than they deserve. By so doing, it is my belief that we inadvertently increase the likelihood that they will slip into the lower category of those in trouble, and we’ll end up spending more time on them in the long run. So we are currently looking at some ways by which we can focus additional resources, both human and otherwise, on those companies in the middle of our portfolio, and hopefully increase the likelihood of their ultimate success.

**Investment exit.** Investment exit is another area of ongoing challenge. It is clearly easier to get into an investment than to get out. We are constantly looking for creative ways to exit investments, and some of the vehicles employed to exit these investments are going to be more of a process than an event. Nothing would make us happier than to have a company next door to one of our portfolio firms buy it and simply give us the check for our ownership position. I think it is far more likely, however, that we will be dealing increasingly with the creation of ESOPs, which is very attractive to us in light of our social objectives, and other means of transferring ownership over time.

**Similarities among equity organizations.** We have also learned that there are others around the country with objectives similar to ours. This has been a very gratifying realization for us. Organizations in Kentucky, Maine, Washington, and everywhere in between are either doing or trying to do similar equity-related investing. One of the things I believe we as a group at the Community Development Venture Capital Alliance have come to realize is that the deals we’re working with have some similar characteristics. Of course, this isn’t absolute, nothing ever is, but community development venture capital (CDVC) investments tend to be smaller, less high-tech, come with less skilled management, and require more pre- and post-investment involvement on the part of fund management. The investment impact of those characteristics is they tend to have higher transaction costs, longer hold periods, reduced liquidity, and result in lower returns, which is not very glamorous.

**Regional focus**

This leads to the obvious question of, “Why o we do this?” I think for us at Northeast Ventures, the reason we do this is because we have a very strong commitment to place. Those of us involved in Northeast Ventures are from northeastern Minnesota. We love it, we want to be there, and we want that same opportunity to be available for others who want to live and work in northeastern Minnesota. Increasingly, I think both people and capital have no commitment to place. I believe that’s a shame. Northeastern Minnesota and the deals we do there are not for everyone, but they are for some. We’re
trying to create that opportunity for everyone
who wants it.

Our mission’s focus on northeastern Minne-
sota serves as a double-edged sword. At times it
seems it would be very nice to be able to look
outside the borders of our region for deals. By
doing so, we could reduce our risks, find more
attractive investments, make more money, and
I’m convinced, accomplish all these things
while at the same time exerting less effort. The
catch, however, is that that is not what we were
created to do. That’s not why our shareholders
have invested all of this money and all of this
faith in us. Our mission forces us to make deals
even when we can’t find deals. And that is, of
course, where a lot of the challenges come from,
but it’s also what we’re about.

Partners

We also have a strong commitment to working
with partners. We work with a variety of part-
ners in our investments, including traditional
venture funds, angel investors, economic devel-
opment groups, and banks both large and small.
We seek these partners because we believe we
can accomplish more working together than we
can by ourselves. We also work with others
across the country in the CDVC effort to build
an experience base that will lead to recognition
of an asset class. My hope is that by providing
some level of predictability of returns in this
fledgling industry of CDVC, the field may be
able to get just a sliver of somebody’s asset allo-
cation over time. If we could accomplish that, it
would result in tremendous improvement in the
level of capital availability for equity invest-
ment in the rural United States. We also, as I
mentioned at the beginning of my remarks, are
committed to fostering the spirit of entrepre-
neurship in our region. That objective is less
tangible than some of our others, it is clearly a
long-term undertaking, it is difficult to measure,
but it is also critically important.

CONCLUSION

To conclude, I will share a brief story that
Nick likes to tell about a man walking down a
beach who sees that the tide has washed in thou-
sands and thousands of starfish. As he walks
along, he finds a young child who is picking up
the starfish one at a time and flinging them back
into the sea. He walks up to the child and says,
“Why are you doing this? Don’t you realize
there are millions of starfish in the ocean and
that this isn’t going to matter at all?” The child
picks up another starfish, throws it back into the
ocean, and says, “It matters to that one.” That’s
really what we are trying to do at Northeast
Ventures. We do not see ourselves as the sole
solution to anything, but we do see ourselves as
part of something that we believe is very impor-
tant to our community and to our country.

ENDNOTES

1 A model was also created for a companion fund, the
Northeast Entrepreneur Fund. The Entrepreneur Fund
is primarily a microenterprise development organiza-
tion, with strong nurturing, training, and basic business-
readiness elements to its activities. It is organized as a non-
profit, has its own board of directors and management, and
has its offices roughly 70 miles north of Northeast Ven-
tures in the city of Virginia, Minnesota.