

ANN LEAMON

Acorn Community Ventures

One autumn day in 2005, Andrea Spring of Acorn Community Ventures (Acorn), a community development venture capital (CDVC) firm, stared out the window of her small office as brightly colored leaves drifted earthward. She and her two partners were trying to decide whether to raise a second fund of \$50 million, up from the \$15 million they currently managed, at this point or to wait until they had exited more of their portfolio companies. She was trying to gather her notes and her thoughts before meeting with her partners, Walt Burchell and Tim Yan, but found them scattering like the leaves.

Acorn had closed on its first fund in the Fall of 2000 and invested in 15 companies thus far. One company, an inner-city software firm, had been acquired in late 2001 for eight times invested capital, generating a 700% IRR, but four other investments had failed since. Of the remaining firms, half appeared to be solid performers and the others were struggling, but as Andrea reminded herself, it was really too early to tell for many (see **Exhibit 1** for portfolio).

She was trying to focus on revising a portfolio company description when the door creaked open behind her. “Hey Andrea, let’s get some lunch and think about the second fund,” said Walt. Then, noticing her distraction, he added, “I’m not sure about fund-raising either—how much or from whom.”

“I’m wondering about when, too,” she replied. “I’m trying to come up with a good story. Perhaps we should think about raising a smaller amount; I know that some LPs may be concerned that we’re increasing our fund size so dramatically. Maybe we should try to hang on until we’ve had more exits and can prove the model more compellingly?”

Tim chuckled. “I was thinking we might want to look at raising more money not less,” he said. “The larger institutions need economies of scale. Raising \$50 million might be asking too much from the program-centered groups and too little from the larger groups like pension funds. Some of the companies look very promising; we might be better advised to go out now to get our name out there and raise interest.”

Ann Leamon prepared this case with the assistance of Nat Henshaw. CDVCA cases are developed solely as the basis for group discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Burchell looked thoughtful: “I think CDVC has matured and so have the LPs. There’s more awareness of the opportunities for both financial and social returns in our kind of investing. Other folks are out there raising funds now. What strategies are they using?”

Venture Investing in 2005

Since the mid-1990s, CDVC funds had become a more important part of the community development landscape, with 82 funds established and in formation by 2004. With their focus on a “double bottom line” of both financial and social returns (some funds added a third bottom line of environmental sustainability), they appealed to a growing awareness of the efficacy of private equity techniques—especially active investing—in building businesses.

Increasingly, CDVC firms had adopted the structure and for-profit status of the traditional VC industry. While some CDVC funds were structured as not-for-profit entities, these tended to be small, with an average fund size of \$4.4 million in 2004.¹ The vast and growing majority was comprised of CDVC funds structured like traditional venture capital (VC) limited partnerships, differing primarily through their explicit pursuit of the double- or triple-bottom line.

Unlike traditional VC, which had experienced a rollercoaster ride through the latter 1990s and early 2000s, CDVC firms had seen steady growth in capital commitments, although a similar rise and fall in investment activity. While capital managed by the traditional VC industry had stalled out between 2001 and 2004 at roughly \$260 billion, that for CDVC groups rose steadily over the period, from \$401.5 million in 2000 to \$870 million in 2004, a compound annual growth rate of 60%. For traditional VC, the compound growth rate to 2004 was 6.5% per year.

Despite the growth in total money under management, however, each CDVC fund tended to be relatively small. The average size of an established fund had grown from \$8.9 million in 2000 to \$12.9 million in 2004. This compared to traditional VC funds that had averaged in excess of \$100 million since 1999, hitting \$155 million in 2004.² (See **Exhibit 2** for data on traditional VC firms contrasted with CDVC firms.)

One challenge arising from the small average size of a CDVC fund was the concomitant fee stream. Fees, typically between 2% and 3% of committed capital, funded an organization’s operating costs until investments became liquid. A \$15 million fund generated between \$300,000 and \$450,000 in annual fees, making it more difficult to attract and keep talent (see **Exhibit 3** for average pay in traditional VC operations).

In addition, smaller fund sizes could hamper CDVC firms when successful portfolio companies raised higher-priced rounds. When a good company raised a higher-priced later round, a firm with a small fund might lack the money to maintain its ownership or might run up against contractual limits on the amount of the fund to invest in any one company. While such restrictions served to limit exposure, a firm might also find its position in a profitable company reduced (see **Exhibit 4** for the median prices of rounds).

By 2005, both traditional VC and CDVC firms found that the numbers of deals and the amount invested had fallen. Since the precipitous drop of 2001 and ‘02, though, the numbers had steadied

¹ CDVCA Report on the Industry 2004, p. 8.

² NVCA/Thomson Financial, *NVCA 2005 Yearbook*, p. 18.

somewhat (see **Exhibit 5** for trends). In addition, although holding periods for portfolio companies had risen from timeframes measured in months during the bubble to the historic norm of five-to-seven years, the mergers and acquisitions and initial public offerings markets had regained some vitality, making it conceivable for investors to exit their investments.³

CDVC firms invested less per company in smaller deals than did traditional VC organizations. While traditional VC firms invested an average of \$6.7 million per company in 2003, CDVC firms had invested \$600,000 per company. This in part reflected smaller deal sizes – CDVC deals averaged \$2.6 million in 2003, compared to \$5.5 million per deal for traditional VC.⁴ It also reflected the tendency of CDVC firms to back companies at earlier stages of development than traditional VC firms, and a concentration in different industries. Traditional VC tended to focus on high-tech sectors such as communications, computer hardware, and biotech, along with fabulously expensive semiconductor efforts. CDVC organizations, on the other hand, favored industrial/manufacturing companies, retailing, computer software, and financial firms (see **Exhibit 6a** and **6b** for comparative investment sectors). By 2003, however, CDVC appeared to be trending slightly away from manufacturing investments toward companies in information technology (IT), due to the establishment of CDVC firms in urban areas with more information-related opportunities. Firms prior to 1999 had tended to be in rural regions with a significant manufacturing base.⁵

Returns

One challenge faced by CDVC firms in raising money was the paucity of information on exits and returns. An average traditional VC firm needed roughly seven years before it could judge its returns with any degree of confidence. As one expert in the industry said, “You can measure returns in VC twice: at the start of the fund and at the end of it. Do it at any other time and you’ll be wrong.”⁶

Only three CDVC firms had existed long enough to have a healthy history of returns. None of the three was structured using the traditional LP/LLC structure that most current CDVC funds employed. Two of them were not-for-profit community development corporations that had received most of their capital from government or foundation grants. The other was organized as a for-profit corporation backed primarily by foundations that were program-related-investors. These were not subject to the pressure for exits felt by the current limited-life funds with more market-oriented investors. As of 2003, based on 31 exits (including write-offs) from investments made by these firms between 1972 and 1997, the average internal rate of return (IRR) before fees was 15.5%, for a 2.2x return of capital after an average holding period of 6.1 years.⁷ (See **Exhibits 7a** and **7b** for returns information for traditional VC and CDVC funds.)

Because the study was done in 2003 and one assumes a 10-year fund life, the CDVC sample can be assumed to have a 1993 vintage year. IRRs net of fees for VC funds formed in 1993 averaged 24.4%,

³ Thomson Financial/Venture Economics, “Venture Backed M&A Volume Holds Steady,” *www.nvca.org*, accessed December 8, 2005.

⁴ Some companies received multiple rounds of investment in a single year, leading to a higher per-company investment compared to per-deal amounts.

⁵ CDVCA Report on the Industry 2004, p. 9

⁶ Stan Pratt, founder of *Venture Capital Journal*, personal conversation, December 11, 2002.

⁷ CDVCA Report on the Industry 2004.

with a top quartile of 39.8% and a median of 13%.⁸ The 1993 vintage year, while not the best, produced returns that were higher than usual for the venture capital industry.⁹

The paucity and complexity of returns data posed a challenge when CDVC groups raised funds. One recent study indicated that unless an investor could access a top-quartile fund, over the long run, it was better off in the public markets, where the return was competitive and the investor had liquidity (see **Exhibit 8** for comparative long-term returns to different asset classes).¹⁰ Over a shorter timeframe, however, this conclusion could be argued. For instance, while the CDVC returns of 15.5% fell short of the 24.4% for traditional VC between 1993 and 2003, both venture returns out-performed the 8% generated by the S&P 500 over the same period. It was noteworthy, however, that the CDVC returns came from a composite pool of only 31 companies. The small sample was prey to swings as single companies either performed well or collapsed.

Many VC firms, both traditional and CDVC, encountered the disheartening phenomenon that “lemons ripen faster than plums”—in many cases, companies failed faster than they succeeded, penalizing young firms. Overall, 2004 and 2005 were difficult times to be raising a second fund. Not only had young VC firms to contend with the J-Curve, the need to spend money and build a portfolio before realizing returns, but the exit environment had been moribund between 2001 and 2003. While the mergers and acquisitions market for venture-backed companies had stayed fairly constant, at close to 300 transactions from 2000 through 2004, the deals had occurred at fire-sale prices as firms tried to triage their portfolios.¹¹ The number of IPOs had plummeted from 264 in 2000 to 41 in 2001 and a mere 24 and 29 in 2002 and 2003, finally tripling to 93 in 2004.¹² Commented the president of the National Venture Capital Association, “Liquidity is king in venture capital. It’s been several years since venture-backed companies have had viable liquidity options.”¹³

Assuming that their portfolio companies had survived that “nuclear winter,” few young funds that tried to raise a second fund in 2005 had much to show from their first. In fact, many found that their second fund was more difficult to raise than their first.

Social Returns

In addition to financial returns, another important component of CDVC investing was the creation or retention of entry-level jobs. Many of the earliest CDVC firms had arisen to support job opportunities in rural regions of the United States, whether coastal Maine, Appalachia, or the Southeast. Measuring social gains could occur along a host of dimensions, including employment growth, job quality, opportunities for asset accumulation or profit sharing, and increased entrepreneurial activity within a region.

⁸ NVCA/Venture Economics data, www.ventureexpert.com, accessed December 30, 2005.

⁹ NVCA/Venture Economics data, www.ventureexpert.com, accessed March 23, 2006.

¹⁰ Josh Lerner, Felda Hardymon & Ann Leamon, “Grove Street Advisors,” *HBS Case No. 805-050* (Boston, MA: Harvard Business School, 2004), p. 21. Between 1980 and 2002, the average return to VC, net of fees, was 16.1%, compared to 15.2% for the Dow Jones Industrials.

¹¹ Jeanne Metzger & Joshua Radler, “Venture-Backed M&A Valuations Rose Sharply in Q1,” *National Venture Capital Association/Thomson Venture Economics*, May 10, 2004, <http://vx.thomsonib.com/NASApp/VxComponent/VXMain.jsp>.

¹² Thomson Financial/Venture Economics, “Venture Backed M&A Volume Holds Steady,” www.nvca.org, accessed December 8, 2005.

¹³ Mark Heesen in Metzger & Radler.

A study conducted by the CDVC trade group, the Community Development Venture Capital Alliance, on the employment impacts of 17 CDVC funds found that employment in their portfolio companies had grown 46% between the time of initial investment and the end of 2003. In addition, low-income (often low-skilled) jobs grew 124% at these companies, compared to 37% in non-low-income jobs, which presumably went to workers with higher skills and thus more employment opportunities in the first place.¹⁴ In addition, of the \$66.5 million invested by CDVC funds between 2000 and 2003 for which data were available, over half went to census tracts defined as low- or middle-income.¹⁵

In fact, VC overall, regardless of its explicit community development mandate, appeared to generate jobs. A 2004 study from the National Venture Capital Alliance (NVCA) found that companies funded by venture capital during their growth phase created more jobs than did non-venture-backed companies. In addition, the growth was spread more widely across the United States than might be assumed: while the top state was California, the other four in the top five were Texas, Massachusetts, Pennsylvania and Georgia. Moreover, venture-backed companies in a given sector created more jobs than did those that were not—in biotechnology, VC-backed companies experienced 23% job growth, compared to 5% in the industry overall, while semiconductors, a sector that lost 26% of its jobs between 2000 and 2003 on a national scale, only lost 10% in its venture-backed operations.¹⁶

Sources of Funding for CDVC Firms

Raising money was hard for young funds regardless of the number of bottom lines they addressed. In most cases, family and friends lacked the money necessary to make up a \$20 million fund. Other sources included banks, non-depository financial organizations like insurance companies and pension funds, corporations seeking to augment internal research and development efforts (also called corporate VC), various branches of government, endowments or foundations, and wealthy individuals. Insurance companies and some endowments had long-standing connections to and familiarity with VC investing, due to the match between their own long-term time horizon and that of the asset class. Some had been cornerstone investors in what had become brand-name firms, such as Kleiner Perkins or Sequoia, and thus had a standing invitation to each fund.¹⁷ Others, particularly public pension funds, had only recently become interested in VC investing as the realities of an aging workforce and lackluster returns to the recent stock market made them seek options for higher returns.

One issue all LPs shared was the need to be a responsible fiduciary. Banks, insurance companies, endowments and the like all were entrusted with money from other people and expected to invest it wisely. As one pension fund investor commented, “I always pretend it’s my grandmother. What would she say?” Endowments often played an integral role in financing the life of their associated institution: Yale’s endowment, for instance, had to contribute 5% annually to the university’s operating fund regardless of the performance of its investments that year. Federal law required

¹⁴ Brian Schmitt, *CDVCA Report on the Industry 2004*, p. 23, from the CDVI Data Project and CDVCA’s data collection program.

¹⁵ *Ibid.* p. 26.

¹⁶ NVCA/Global Insight, “*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*,” (Washington DC: NVCA, 2004).

¹⁷ Another phenomenon of these early LPs is that they benefited from the persistence of performance, as discussed in Antoinette Schoar and Steve Kaplan, “Private Equity Performance: Returns, Persistence, and Capital Flows,” *Journal of Finance*, forthcoming, 2005. Performance among VC firms, whether positive or negative, has been found to persist from fund to fund.

foundations to disburse 5% of their assets each year; if performance fell short of expectations, the foundation might find itself donating from the core endowment rather than earnings.

Public pension funds ranged from CalPERS, with \$194 billion under management, to smaller entities like the City of Trenton Firemen's Fund. Freed to participate in private equity by the 1979 "prudent man [sic]" ruling of the Employee Retirement Income Security Act (ERISA), they had first invested in buyout funds, which welcomed money for their enormous deals. As they grew comfortable with private equity, pension funds then started approaching VC firms but were often turned away, as top-tier firms could choose their LPs and opted for those they knew.

One peculiarity of the traditional VC industry was the persistence of performance. Top quartile funds tended to remain in the top quartile, as success increased their deal flow, allowing them to choose the best opportunities, and gave them the cachet and compensation options (especially carry from successful investments) to attract and retain talented partners. Unlike buyout firms, with their almost unlimited fund-sizes, top-tier venture firms could and did limit the amount of money they raised. Although 1999 and 2000 had seen 22 VC firms raise funds of more than \$1 billion, most had chosen to return the money to LPs when the NASDAQ crash had left them struggling to find adequate opportunities in which to invest it. Subsequent funds were significantly smaller and opportunities for new LPs to access established organizations consequently reduced.

Traditional VC firms had found that larger fund sizes posed challenges as great or greater than their benefits. Although more money meant a larger fee stream and an enhanced ability to control deals and maintain or increase ownership in desirable companies, the logistics of disbursing the funds were daunting. If a fund doubled in size, the partners could either double the amount each managed or double the number of managers. If the firm chose the former strategy, each partner either had to invest in twice as many companies, serving on twice as many boards, or invest twice as much in each deal, perforce moving to later-stage deals that often required different skills from those that the partners had successfully used with early-stage investments. If the firm chose to expand, finding new partners that were a good match to the existing group could be difficult. If it set up an additional office, remote communications also presented a risk.

Although their timeframes were similar, pension funds found venture firms an odd match. Not only was it difficult for new entrants to the VC asset class to access the best firms, but often the size of the investment was inefficient for a hundred-billion-dollar pool. As one LP said, "It takes as much time to do due diligence on and manage a \$5 million VC investment as a \$50 million buyout commitment. Our staff is small and overwhelmed as it is; why should we take on more?" As a result, some of the largest pension funds, such as California State Teachers' Retirement System (CalSTRS), had adopted a different strategy: rather than spreading its allocation to many funds, it consistently wrote large checks to a few buyout and VC firms, thereby earning a reputation as a stable, long-term capital source. Between 2003 and 2005, this approach had resulted in 20% annual returns, but such a large bet could backfire should performance falter.¹⁸ Even so, CalSTRS expected to commit between \$2.3 billion and \$3.8 billion annually to reach its 8% private equity target by 2008. As top-tier firms cut back their available allocations, pension funds faced a common dilemma: whether to move into unknown or possibly under-performing firms or to cut back its internal private equity allocation goal.¹⁹ Another challenge that the largest firms encountered was congestion: if they did manage to get into all the good firms, they'd end up competing against one another for deals, and having larger

¹⁸ Laura Kreutzer, "Judgment Day: LPs are Short of PE Goals," *Private Equity Analyst*, January 2006, p. 1.

¹⁹ Laura Kreutzer, "Judgment Day: LPs are Short of PE Goals," *Private Equity Analyst*, January 2006, p. 1.

funds drove up deal prices and reduced returns, thereby creating the phenomenon that the pension funds' dollars were competing against each other out of different pockets.

This, of course, assumed that the pension funds became comfortable with the somewhat arcane nature of the VC industry: the J-curve, the time lag between investment and returns, and the overall uncertainty about the asset class made it challenging for new investors. This was exacerbated by the fact that the time at which many pension funds could get into VC was during the height of a bubble, which turned out to be the worst time to be in the market in terms of returns.

In addition, the recent media push for disclosure of either fund-level or company-level valuation metrics for those VC firms in which public pension funds had invested made top tier firms unwilling to accept public money. Sequoia, a top-performing firm, had dis-invited the University of Michigan from participating in one of its funds rather than disclose its results. While most of the disclosure issues to date had focused on fund-level valuations, the Ohio Bureau of Workers Compensation had caused an uproar when it had appeared to be willing to release company-level valuation data.²⁰

Many pension funds, therefore, used funds-of-funds to manage their VC investments. Although a fund-of-funds charged a fee between 0.5% and 1.2% above that charged by the VC firm, it also helped break down a large pension fund's money into manageable pieces for a smaller VC fund, or aggregated up amounts from smaller organizations to meet a minimum commitment level while allowing the small organization sufficient diversification. A fund-of-funds manager also could tailor the reports submitted by VC firms to supply the pension fund with more aggregated data, thereby assuaging concerns about disclosure. As a result, commitments to funds-of-funds had risen from \$0.8 billion in 1995 to a peak of \$18 billion in 2000.²¹ Few funds-of-funds, however, had invested in CDVC firms (see **Exhibit 9** for funding sources for CDVC firms).

Banks, unlike many institutional investors, were more likely to invest in CDVC funds, because of their Community Reinvestment Act (CRA) obligation to meet the credit needs of the areas where they took deposits. Recently, though, enforcement of CRA had been relaxed, reducing the impetus on banks to make such investments.²² In addition, after investing hundreds of millions of dollars in CRA projects, some observers felt that banks were becoming dismayed by the relative lack of exits.

Other government programs directly provided funding for venture investing in low-income areas. One of these programs was the federal CDFI Fund, which provided matching capital to various types of Community Development Financial Institutions (CDFIs), of which CDVC funds were one type. The award program of the Federal CDFI fund provided capital in amounts ranging from a few hundred thousand dollars to several million. The CDFI Fund also administered the New Markets Tax Credit (NMTC), a program providing tax credits for investments in low-income areas over seven years. Unfortunately, because of technical factors regarding operation of the NMTC, it was very hard to use it to capitalize a venture capital fund.

Larger amounts of capital could be accessed through the New Markets Venture Capital (NMVC) program and the Rural Business Investment Company (RBIC) programs. The NMVC program,

²⁰ For more on disclosure and valuation issues, see Hardymon, Lerner, and Leamon, "Between a Rock and a Hard Place," *HBS Case No. 804-167* (Boston, MA: Harvard Business School Press), and for the Ohio issue, see Dan Primack, "Ohio to Release Portfolio Company Valuations," *Private Equity Week*, December 16, 2005, www.privateequityweek.com/pew/freearticles/1122125009679.html. The state of the situation was unresolved as of January 2006.

²¹ *Private Equity Funds-of-Funds State of the Market*, (Asset Alternatives Research Repot, 2nd edition, May 2003), p. 24.

²² Community Reinvestment Act section of CDVCA website, www.cdvca.org/public_policy, accessed December 27, 2005.

designed specifically for the CDVC industry, provided investment capital and operational assistance grants to match private investments. Appropriations for the program, established in the final weeks of the Clinton administration, were cut after the first six NMVC funds were established. The RBIC program, established during the Bush administration, was based on the NMVC program and operated similarly, but in rural rather than low-income areas. The funding for this program too was cut after the first few funds received conditional SBA approval. While efforts were underway to revive both programs, they would not provide much help to a new fund organizing in the immediate term.

Fund-raising Approaches

By 2005, Acorn was not alone in its efforts to raise money. Some firms, such as SJF Ventures, were trying to raise a second fund as well; others, like CEI Ventures, were in the planning stages for their third fund; and a joint venture between Kentucky Highlands investment company and Tech 2020 in Tennessee had just received approval for a new \$30 million RBIC to follow on its successful NMVTC, the Southern Appalachian Fund. Each was taking a different approach to fundraising, based upon its history, its location, and its goals.

SJF Ventures

David Kirkpatrick and Richard Defieux co-founded Sustainable Jobs Fund (now SJF Ventures) in 1999. “For a start-up fund, we raised our first fund fairly quickly,” Kirkpatrick said. “We were in there at the right time, during the VC craze. In addition, our philosophy resonated with people. Our team’s entrepreneurial and economic development experience, combined with Rick’s successful 20 year VC record, gave investors confidence.”

SJF initially targeted the recycling and environmental industry, reflecting Kirkpatrick’s 17 years spent managing firms in those sectors, and Defieux’s environmental investing focus. The fund, based in Philadelphia and Durham, NC and investing all along the eastern seaboard, aimed to promote sustainable jobs with an emphasis on wealth-building for lower-income people. With a first fund of \$17 million, several of their initial investments were in seed- and early-stage companies. “We thought we’d be getting in early, at a time when we could influence company strategy and growth and get a better price,” Kirkpatrick said. “In retrospect, I think we were underestimating the deal flow we would achieve in expansion stage ventures.”

Partway through the investing cycle of SJF I, the strategy evolved. The sectors of interest grew from companies in recycling and clean energy to include natural and premium consumer products and business services, and the investment stage moved from early to expansion. Explained Kirkpatrick:

We learned that our niche was when the company had a product and a management team. In our region, there’s little VC interest in companies with equity capital needs below \$5 million. The market for equity between \$500,000 and \$2 million is very inefficient—particularly in sectors outside of IT and biotech and locations off the beaten track. We step in when the entrepreneurs have fully tapped their own resources—credit cards, second mortgages, friends and family funds—and help them get to the next step. We can still get a good valuation, but the risk has fallen and the upside is quite significant. We’re able to make a bigger impact on job

creation at this stage than with start-ups. In most cases, we'll let the angels and local early stage funds do the start-up financing.

SJF encouraged its companies to adopt wealth-creation and benefit programs for employees, as well as broader sustainability practices. To support this effort and to broaden SJF's impact, the group in 2001 created SJF Advisory Services, a not-for-profit entity that worked with companies both within and beyond SJF's portfolio to provide entrepreneurial and employee assistance and development programs.

By late 2005, SJF had closed on \$14 million for its second fund, targeted for \$30 million. SJF Ventures II, LP had a more explicit market-rate financial return strategy than SJF I had had in 1999. The organization had been in the market for a year and a half. Kirkpatrick said:

This is a challenge. Banks are doing less CRA investing. In part this is because their existing portfolios aren't doing well, but there's also less political pressure for community reinvestment. For this reason, we have diversified our fundraising, particularly by bringing in more high net worth individuals and families, mostly successful former entrepreneurs. We are also talking with some pension funds with economically targeted investment (ETI) strategies. Through these sources, we hope to further broaden SJF's investor base to make us less reliant on banks and foundations. That should stand us in good stead for our third fund, as well.

Kentucky Highlands Investment Corporation and Tech 2020: Meritus Ventures

In mid-2005, Meritus Ventures, a private for-profit VC fund managed by Eclipse Management, a collaboration of Kentucky Highlands Investment Corporation (KHIC) and Technology 2020, a Tennessee-based firm, was conditionally approved as an RBIC. From offices in Kentucky and Tennessee, Meritus planned to invest throughout southern and central Appalachia. Conditional approval as an RBIC meant that once Meritus had raised \$10 million, it could access an additional \$20 million through the federal government, for a total of \$30 million in investable capital.

Meritus was the third for-profit VC effort to be founded by KHIC, a 38-year-old not-for-profit that had grown its initial \$14 million in grant capital to \$50 million. The second for-profit fund, the \$12.5 million Southern Appalachian Fund, was founded in 2001 as a New Markets Venture Capital fund, targeting specific low-income census tracts in southern Appalachia. LPs in the Southern Appalachian Fund included the Tennessee Valley Authority, the MacArthur Foundation, the F.B. Heron Foundation, and banks. Along with the Farm Credit Commission, these had also committed to Meritus.

Said KHIC's Ray Moncrief, "With a \$30 million fund, we'll be able to do larger deals. In the Southern Appalachian fund, we had wanted to lead some deals that we couldn't due to the smaller fund size. We have great deal flow—we can find deals that other VCs miss because they lack the network in Middle America. There are opportunities in the low-income census tracts. And we can be choosy."

Moncrief expected to cover Meritus' larger geographic reach (from Ohio to Mississippi and east into Georgia) through a network of strategic alliances. "We can lead deals and have local firms fill in, or fill in on deals that others lead. National VCs are looking for promising deals that are well-priced, but they don't necessarily want to go to small cities for board meetings. That won't be a problem—we'll take the board seat and go to the meetings; they can be side-by-side investors."

Coastal Enterprises, Inc. (CEI)

CEI, founded in 1977 as a non-profit that developed job-creating small business ventures in primarily rural regions of Maine, managed a total of \$38 million in its three funds: Coastal Ventures LP and Coastal Ventures II LLC (\$5.5 million and \$20 million), and CEI Community Ventures, a New Markets Venture Capital firm (\$13 million). CEI was planning to raise a \$50 million fund for Coastal Ventures III LP. Ron Phillips, founder and CEO of CEI, explained the approach, saying, “We group potential LPs into different categories. Certain investors are interested in different aspects of our work: some particularly emphasize the social and others the financial. We must draw links between their goals and ours.”

“We’re getting better deal flow as people in our region start realizing that VC is an option,” said Phillips. “The question we have to pose is what people want in their asset portfolios—do you want guns and tobacco or do you want to be helping small businesses? It’s not as if we expect LPs to put their entire endowment with us, but we aim to give them returns in the vicinity of market with a good social story.”

He delighted in the growth in the CDVC industry. “This gets the idea of community-development investing out there in front of LPs. It also provides us more opportunities to co-invest and helps position our companies for success.”

CEI Ventures Inc.: Coastal Ventures LP and Coastal Ventures II LP

Nat Henshaw, president of CEI Ventures, pointed to the organization’s long history in building its VC program:

Coincidentally, our firm is currently in a situation similar to Acorn Community Ventures, though we’ve been in the industry longer and are now working on our third fund. We have grown from small scale at \$5.5 million to \$20 million in our second fund. We expect our third fund to be larger and are actively evaluating an appropriate fund size, likely targeting \$50-100 million.

Initially, we demonstrated that there were interesting venture deals in the community development space by carefully building a model portfolio of small equity investments. Our first fund, CVLP, which closed in 1996 with \$5.5 million, built on that record with investments ranging from compost in eastern Maine to a New Hampshire technology company with \$45 million in sales. We’ve had five exits from this fund. We raised \$20 million for Coastal Ventures II in 2000 and 2001. With this fund, we’ve branched out and are invested throughout the Northeast, from coastal Maine to Norristown, Pennsylvania and west to Plattsburgh, New York. Now at the half-way point of investing CVII, a 10-year fund, we believe our portfolio is performing well. We’ve invested a total of \$11.25 million in 17 companies and have reserves set aside for additional follow-on investments. We’ve had one exit, which has produced a 7X return with good prospects for additional upside through earn-out provisions over the next two years. Three of our portfolio companies have been written-up in value based upon new outside venture financings. Of four portfolio company write-downs, two have secured outside venture rounds to build their businesses further. We have had only one company go out of business. With 75% of the fund drawn down, its performance is on par with that of traditional VC funds. We are pleased that the total carrying value of our portfolio including exits, write-ups, write-downs and write-offs, is higher than its cost basis. In summary, we think the portfolio shows good promise for strong financial returns.

Acorn Community Ventures

From a social perspective, the portfolio companies in these two funds employ more than 2,300 people and 38% of hires were people with low incomes. We have developed a good network throughout the VC community—we're co-invested with more than 30 other VC firms, both CDVC and traditional. With this background, we're poised to raise our new fund.

The two Coastal Ventures funds had been raised from a combination of individuals, banks, foundations, government and non-government organizations, CDVCA, and CEI itself. Henshaw said, "Regardless of the fund size, we have the same number of investments in each. Coastal Ventures II is four times larger than Coastal Ventures I; our investment size rose from \$250,000 per company in the first fund to \$1 million each in the second. It's easier having a larger fund: the numbers are more to scale and we're more of a standard size."

Henshaw felt that \$10 million was the minimum sustainable size for a fund, and that CEI's reputation and track record had facilitated the fund-raising for the Coastal Ventures funds:

Banks knew about us. They lent money to our portfolio companies and knew the importance of our work. By investing with us, they had both a social and a financial return, because we created companies that then did business with them and further gave them CRA benefit. Foundations saw us as providing returns and creating jobs for low-income people. The government investment came through the state's VC program and Community Development Finance Institution (CDFI) funds through CEI (which is a CDFI). We also had investments from high-net-worth individuals who liked the combination of building the community and also getting a return.

In terms of raising another fund, Henshaw said, "We have a fairly broad mandate in terms of geography and sectors. We invest throughout New England, not just in Maine, and in companies ranging from food processing and compost to high tech. We take our social mission seriously but we're also serious about returns."

CEI Community Ventures

CEI Community Ventures (CCV), like the Meritus Fund, was a New Markets VC firm with \$5 million that it had raised independently matched by \$7.5 million from the SBA. It invested exclusively in low-income census tracts in Vermont, New Hampshire, and Maine. Michael Gurau, president of CCV, had joined the operation in November 2001 after seven years with Advent International, and spent the following 18 months raising money. Like Henshaw, Gurau felt that the relationship with CEI had smoothed the process: "CEI was known throughout the region. It had long-standing relationships with regional banks, and there was the sense that CEI understood venture capital. On top of that, I had seven years with a top-tier traditional VC firm, so LPs believed I could find, conduct due diligence on, and close good deals." The fund closed in April 2003.

Gurau felt that traditional VC experience was essential for the industry's growth and health:

To access larger pools of capital, I believe that the industry needs to get closer to VC market-rate returns, coupled with a strong social story. To do this, the industry will need to attract and retain experienced VC staffers who are willing to do the extra work to meet the social mission in addition to achieving near-market rate returns.

CDVC as an industry might want to refine its marketing, Gurau suggested. "Maybe we should call it 'Economic Development Funds with Market Based Returns.' There really is a competitive advantage from operating in underserved regions and sectors—it's an inefficient market; we're one of

the few funds looking for opportunities; and we believe we can find good opportunities at attractive valuations, given limited competition.”

“In light of our dual focus on financial and social returns,” Gurau continued:

...we view our portfolio as a continuum with strong social “plays” that sometimes provide weaker financial returns at one end, and more traditional technology deals with limited social impact, apart from their location in low-income areas, but attractive financial economics at the other. Our “sweet spot” is in the middle. We like sectors such as consumer goods, which seem to offer a hybrid of solid social and financial returns.

CCV had secured capital from the Maine Employers' Mutual Insurance Company (MEMIC), due in part to an individual who served on the boards of both organizations but also to Gurau's background and the firm's strategy. Gurau explained, “It may seem limiting to be focusing on, in our case, a subset of lower-income areas of Maine, Vermont, and New Hampshire, but we made the case for being able to identify and secure uncompetitive opportunities in a region not traditionally served by Boston-area funds.”

For the next fund, Gurau planned to approach land-grant universities and regionally based pension funds as potential LPs. “These groups need returns that don't embarrass them,” he said:

As long as we're within spitting distance of the LPs' target rate for returns in this class of investment coupled with a strong social story, we believe we have a chance to secure meaningful capital to continue our work. The biggest challenge as an industry will be proving that funds with a social mission can make money—even at a subsidized IRR—for investors; investors who bet early on CDVCs and who don't see that return may be reluctant to support future funds in this field.

What the LPs Thought

In general, institutional LPs supported the mission of CDVC firms, but had a high performance hurdle. As an investments officer for one endowment said, “We get very nervous if someone isn't 100% focused on financial returns.” Part of the nervousness stemmed from the need for the investment officers to be careful fiduciaries of their institution's funds, with the additional complication that in some organizations, officers' compensation and bonus might depend on hitting or exceeding a benchmark performance level that was composed of top-tier traditional VC operations.

Said an investments officer at a major foundation:

If a double-bottom-line fund came to me and showed me top-decile returns relative to the mainstream private equity industry and would take a minimum of \$10 million that kept me at less than 20% of the fund, I'd say, ‘Sure, let's talk.’ Otherwise, I'd send them over to the program-related part of the operation, which might give them \$1 million or so. It just wouldn't be prudent for me to invest from the corpus [the body of funds on which the foundation is based] in a fund that is trading off financial returns for social returns. This is not to judge on the worthiness of their mission or their goals; simply that my job is to produce the best possible financial returns to maximize the resources for the program people to then allocate in pursuit of social returns. Because we have no new inflow of funds to the foundation, our endowment grows only through investment gains; these are essential for the organization's survival.

Another challenge for any firm, whether CDVC or traditional VC, was the survival bias. LPs could always say to a new firm, “If you are any good, you’ll be back in four years raising your next fund and I can invest then.”

Not all LPs, however, could access top-decile VC firms. As of 2002, universities overall had only 2.4% of their endowments in private equity, far less than the 14.4% allocated by Yale University, which had one of the most innovative and successful endowment investment policies.²³ While some of this might be due to unfamiliarity with private equity as an asset class and wariness of its perceived risk, another impediment was the issue of access.

Some LPs, whether to compensate for limited access to top-tier firms or to search for the next one, had specific allocations for new firms. In 2004, the New York City Retirement System, New York State Teachers Retirement System, and the San Francisco Employees’ Retirement System together committed \$235 million to fund-of-funds managers that backed new groups. Grove Street Advisors, a fund-of-funds that managed some of CalPERS’ money, typically allocated at least 15% of its annual commitments to first- or second-time funds. Stanford University’s endowment usually invested \$20 million each year in a new fund.²⁴

Even LPs that were interested in new VC efforts faced high risks. “When you commit to a venture capital fund as a limited partner, you’re tying up your money for 10 years based on someone’s past performance,” commented Peter Dolan of Harvard Management Company.²⁵ There was also a sense that since the bubble of the late 1990s, the VC environment had changed, making prior records less reliable as an indicator of future performance.

Ideally, LPs wanted the VC firm to have a clear record of good returns, a well-articulated and executed strategy, and a team that had worked together for long enough to prove their compatibility. If the team had spun out of a top-tier firm in which they had done clearly defined deals, so much the better. Some observers felt that a new team in a new fund was a better risk than even a team on a later fund. Said Dave Mazza of Grove Street, “A new team will almost always figure out a way to work together for the first few funds. After all, it’s their name on the door and their independent reputation to make, and they’ll work really hard. In the fourth or fifth fund, if the personal chemistry has been poor, it’s possible that the partners will part ways. By then, they have made their names, money for their LPs and themselves, and they have a reduced incentive to make it work.”²⁶ Conversely, recent academic studies had shown increasing IRRs to higher-numbered funds, indicating that familiarity among partners might actually improve performance, or that mere survival implied a certain degree of success.²⁷

CDVC firms had raised some money from geographically targeted pension funds, state funds and from foundations with clear mandates toward socially-responsible investing. Pacific Community Ventures had money from CalPERS. CEI’s Community Ventures was the first CEI fund to raise money from the Maine Employers’ Mutual Insurance Company. The New Mexico state government had allocated funding for its CDVC operation, New Mexico Community Capital, which was about to close on \$10 million.

²³ Ibid.

²⁴ Sree Vidya Bhaktavatsalam, “Fund-raising Revives in 2004...,” *Private Equity Analyst*, January 2005, p. 1.

²⁵ Lerner, Hardyman and Leamon, *Grove Street Advisors*, p. 1.

²⁶ Lerner, Hardyman and Leamon, *Grove Street Advisors*, p. 8.

²⁷ Josh Lerner and Antoinette Schoar, unpublished working paper, 2005.

Potential LPs also included labor union pension funds, which would be expected to support the job-creation goals of many CDVC firms. This support, however, was tempered by concern for providing their pensioners with the best returns possible. This issue often led pension funds to invest in low-risk assets, arguing, “We don’t care what our pensioners do with their money. They can certainly invest in socially responsible opportunities. But our job is to get them as much money as possible.”²⁸

To tell their social story, CDVC firms needed to invest in good reporting. Observed Luther Ragin from the F.B. Heron Foundation, an investor in several CDVC funds:

If you’re marketing yourself on a story, you have to have good social reporting. This costs money. Increasingly, we’re seeing that some of the larger funds have better social reporting than the smaller funds. Even with good social reporting, though, you have to be able to generate successful exits. Financial returns may be sub-market, but unless you have exits, it’s not venture capital.

Raising the Funds

Andrea, Tim, and Walt knew that raising a larger fund would present a number of challenges. They had been thinking about adding a new partner, increasing the size of their deals, and possibly looking at later stage opportunities (see **Exhibit 10** for available deals by stage). “We’ve seen a lot of good deals recently, many of which are more evolved,” said Andrea. “If we raise the \$50 million, we may find that we want to do something more along the lines of expansion capital than early stage.”

Walt nodded:

I like early stage; I think we’re investing at an important point in a company’s life and showing a community that someone with energy and a good idea can find backing. Yet you may be right. We see a lot of companies that have a product and five or eight employees and need funding to add another machine or start real marketing efforts. Investing at that point can yield real dividends. There’s less financial risk and we can often see the company double or triple its employment in a fairly short time. Some early stage deals can do that, certainly, but I do think we need to consider a serious move to more established businesses.

“The problem,” said Tim, “is that expansion stage investments often cost more. Would you plan to do this on \$50 million, or less, or more?”

Andrea replied, “I think we’d have to raise a minimum of \$30 million. Of course, our other option would be to raise more, stay with early stage deals, and add a partner or an office so we can cover more territory and more sectors. I’m still not sure which approach makes the most sense.” They had discussed this issue many times.

Walt suggested, “I like Tim’s idea from last week—that we may want to co-invest with firms in other regions, rather than trying to expand our office network. Maybe we could get by with just adding an associate to help with due diligence.”

²⁸ Lerner, Hardyman and Leamon, “CDC: December 2002,” *HBS Case No. 803-167*, (Boston MA: Harvard Business School Press).

“An associate would certainly help,” said Tim. “That seems a better cultural fit than adding a partner. And yet a new partner can bring a new network and augment our expertise. It would be great to add someone with solid operations experience.”

The biggest question was when to enter the market. “Everyone says you have to have exits to be a VC fund,” Walt said. “We had one exit but that was in the bubble; we may have a few more in the next year if the companies keep up their performance and the merger market stays active. If we’re out in the market in six months, with two good exits, four wash-outs, and two in negotiations, will that be enough?”

“If we wait any longer than that, we may run out of money,” Andrea reminded him:

...and you know that there’s nothing more useless than a venture capitalist without a checkbook. We can certainly tell our new LPs that we’ve learned from our history; we’ve found a deal flow of lower-risk, higher-return companies—both social and financial; and we’ve proved we can work together. I’m just hoping we can find the LPs to back us.

She grinned at her partners. “Jock Whitney didn’t want to call it ‘adventure capital’ for nothing!”

Exhibit 1 Acorn Community Ventures Portfolio as of September 30, 2005

	<u>Date of</u> <u>First</u> <u>Investment</u>	<u>Equity</u> <u>Infusion</u>	<u>Current</u> <u>Valuation</u>	<u>Multiple of</u> <u>Investment</u>
Software 1	Sep-00	\$ 750	\$ 6,000	8.0x
Services 1	Dec-00	\$ 1,000	\$ 1,200	1.2x
Software 2	Jan-01	\$ 1,500	-	Out of business
Consumer 2	Mar-01	\$ 1,650	\$ 1,650	1.0x
Software 3	Jun-01	\$ 250	-	Out of business
LifeSci 1	Aug-01	\$ 1,701	\$ 1,201	0.7x
LifeSci 3	Oct-01	\$ 445	\$ 260	0.6x
Consumer 1	Jun-02	\$ 505	-	Out of business
LifeSci 2	Nov-02	\$ 750	\$ 247	0.7x
Software 4	Jan-03	\$ 300	\$ 120	0.4x
LifeSci 5	Mar-03	\$ 250	\$ 250	1.0x
LifeSci 4	Sep-03	\$ 600	\$ 300	0.5x
Consumer 3	Feb-04	\$ 200	\$ 240	1.2x
Software 5	Jul-04	\$ 331	-	Out of business
Software 6	Jan-05	\$ 340	\$ 375	1.1x
Total Amount Invested		\$ 10,572		
Management fees		\$ 1,500		
Total Expenditures		\$ 12,072		

Source: Casewriter.

Exhibit 2 Funds, Firms, and Fund Sizes

	2000	2001	2002	2003	2004
Capital Under Mgmt. (\$ Millions)					
CDVC	400	605	690	830	870
Traditional VC	228,000	257,000	258,000	257,000	261,000
Number of Funds					
CDVC (established and forming)	55	73	76	79	82
Traditional VC	2,926	3,172	3,253	3,310	3,370
Avg./Fund (\$ Millions)					
CDVC	8.9	11.2	11.9	12.4	12.9
Traditional VC	131.3	135.9	138.2	145.2	155.4
Traditional VC Only:					
Average firm size (\$Ms)	251.5	265.1	270.4	278.4	290.6
Number of principals per firm	10.4	10.3	10.3	10.3	10.3

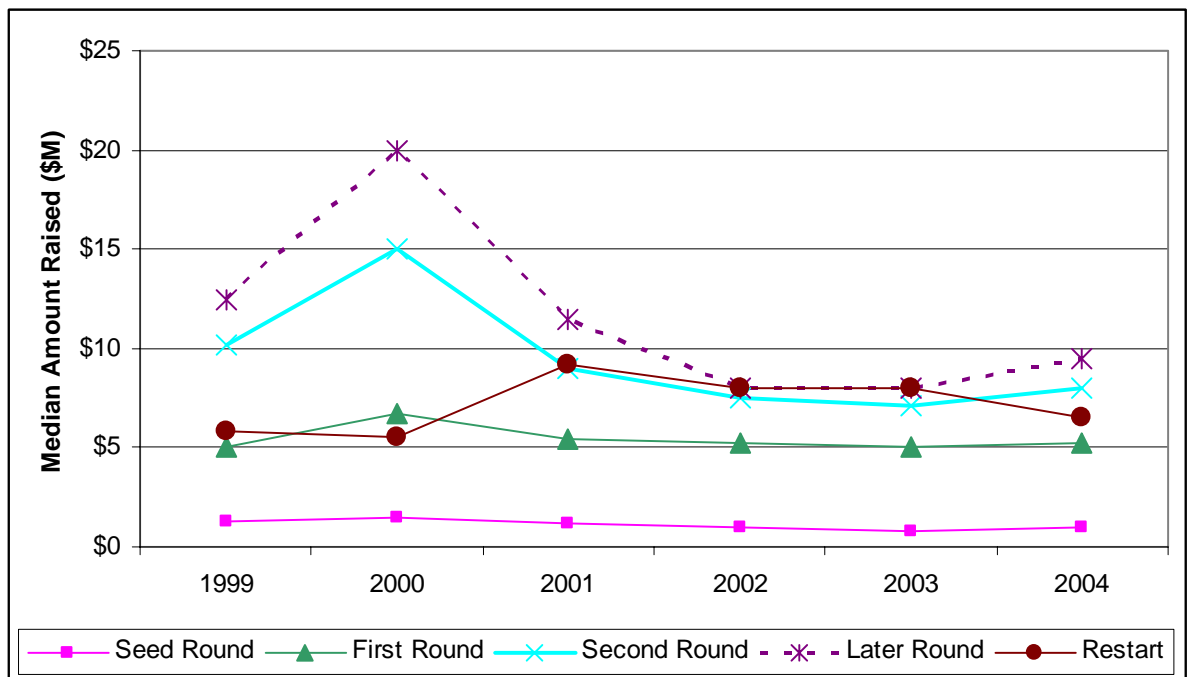
Source: NVCA Yearbook 2005, p. 18; CDVC numbers from Brian Schmitt, CDVCA Database, 2005, accessed March 2, 2005.

Exhibit 3 Average Compensation at Independent VC Firm in 2004

<i>In 000s</i>	Salary	Salary + Bonus	Salary+Bonus+Carry
Managing General Partner	\$ 709	\$ 1,270	\$ 1,425
Partner	\$ 301	\$ 382	\$ 425
Associate	\$ 95	\$ 121	\$ 121

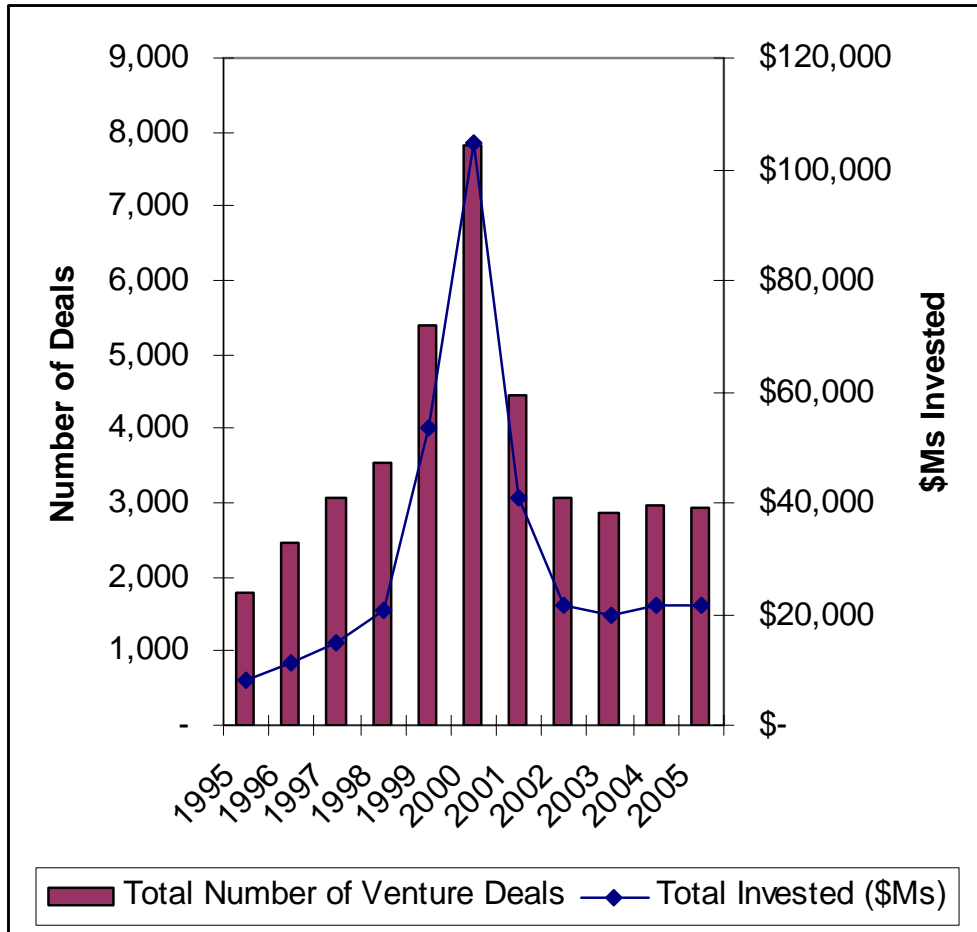
Source: Adapted from *The 2005 Private Equity Analyst-Holt Compensation Study*, www.assetnews.com/products/reports/holt_05.pdf, accessed September 23, 2005.

Exhibit 4 Median Amount Raised in Rounds



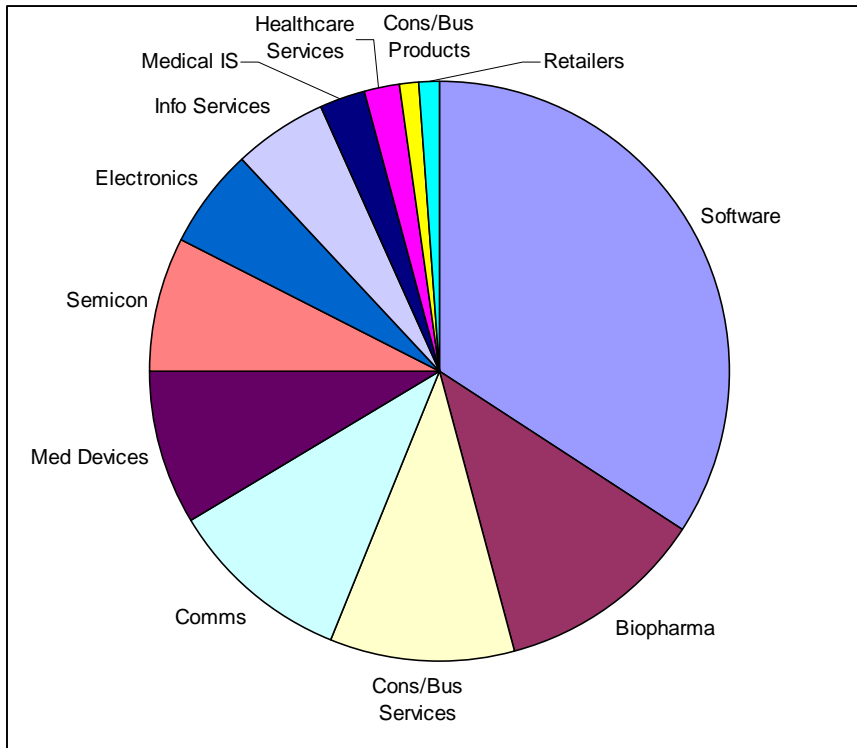
Source: Adapted from VentureOne data, www.venturesource.com, accessed February 27, 2006.

Exhibit 5 Number of Deals and Amount Invested in VC



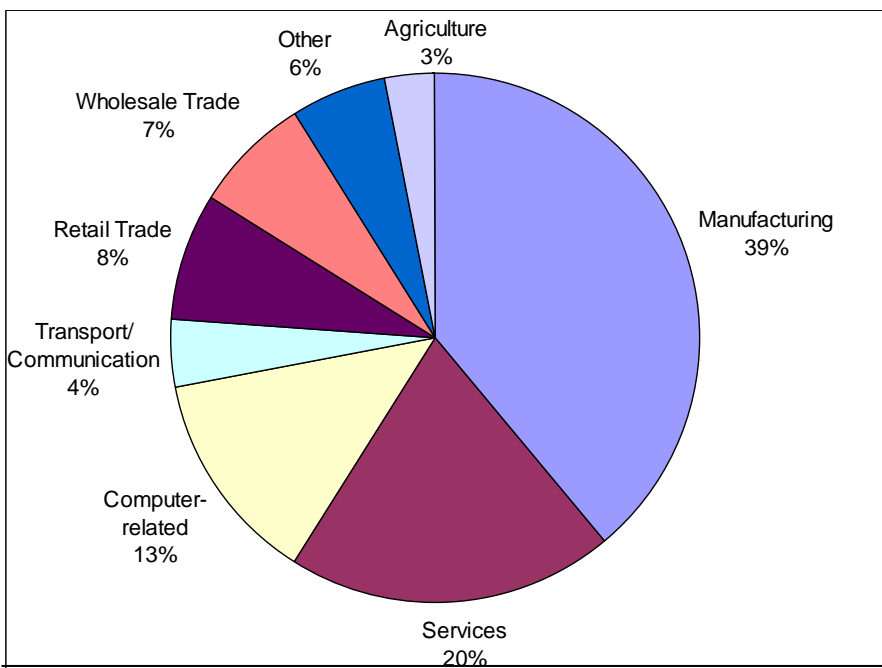
Source: Data from PWC Moneytree, <http://www.pwcmoneytree.com/moneytree/nav.jsp?page=historical>, accessed February 27, 2006.

Exhibit 6a Traditional VC Investment Sectors by Funds Invested, 2004



Source: Data from VentureSource, accessed February 27, 2006.

Exhibit 6b CDVC Investment Sectors, 2004



Source: Data from Brian Schmitt, CDVCA Database, 2005, accessed March 2, 2005.

Exhibit 7a Net Returns to LPs in Traditional VC Funds as of December 2004

Fund Type	1 Yr.	3 Yr.	5 Yr.	10 Yr.
Seed/Early Stage	38.9%	-7.7%	-1.5%	44.7%
Balanced	14.7%	0.0%	0.4%	18.2%
Later Stage	10.4%	0.0%	-4.7%	15.4%
All Venture	19.3%	-2.9%	-1.3%	15.7%
Public Indices				
NASDAQ	8.6%	3.7%	-11.8%	11.2%
S&P 500	9.0%	1.8%	-3.8%	10.2%

Source: Adapted from *NVCA Yearbook 2005: Executive Summary*, Thomson Venture Economics, 2005, p. 79.

Note: Returns are calculated net of fees, for investment horizon ending 12/31/2004.

Exhibit 7b Returns to CDVC Funds

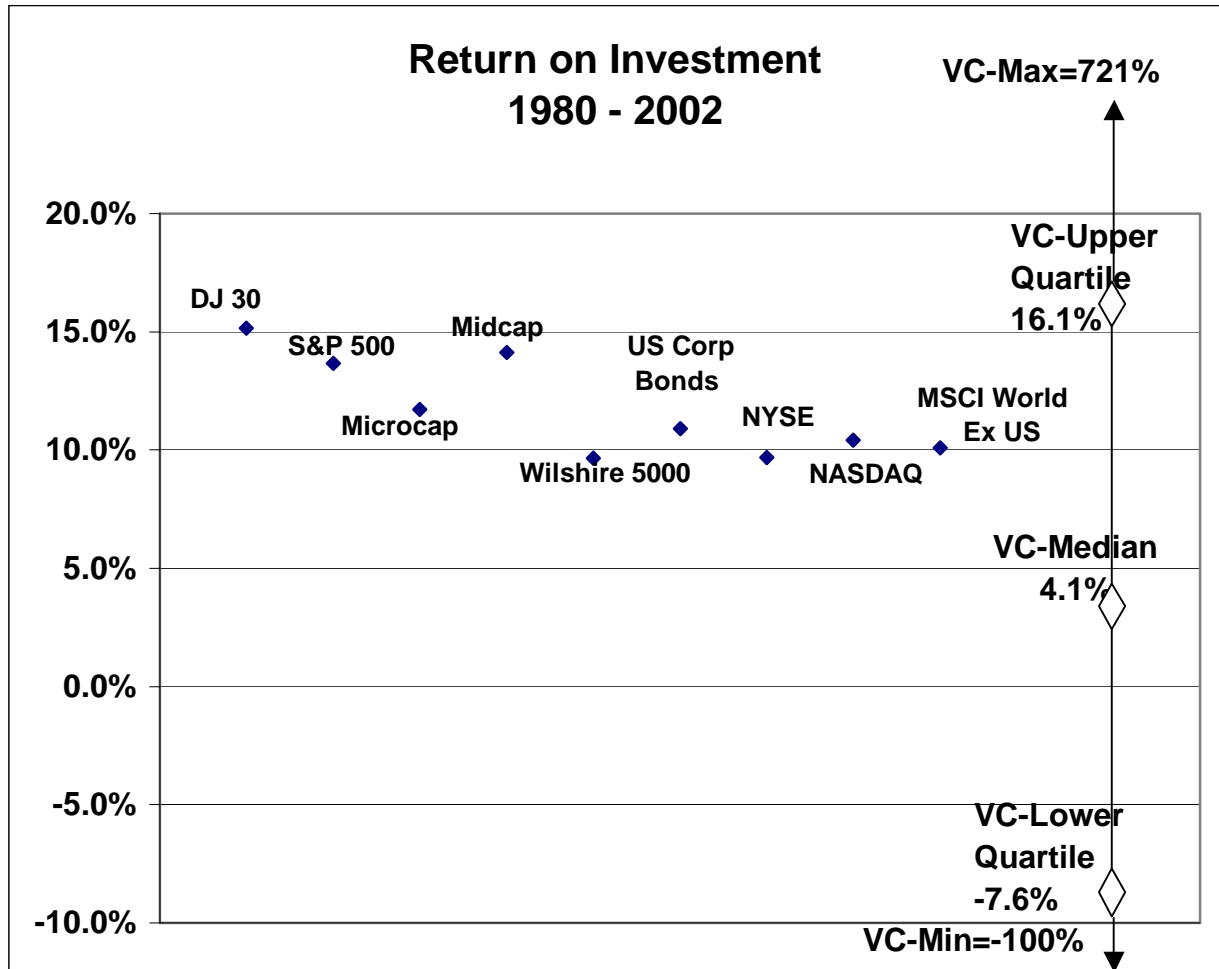
	Gross IRR
CDVC Fund 1 1984-1994	16.5%
CDVC Fund 2 1990-2002	11.8%
MBE Fund 1989-1995	6.6%
CDVC proxy 1992-2001 (w/ dilution)	8.0%
CDVC proxy 1992-2001 (w/constant ownership)	14.0%
3 Funds, 1972-2003 (w/write-offs)	16.1%
3 Funds, 1993-2003 (w/write-offs)	17.4%

Source: Brian T. Schmitt, "Financial Returns and Double-Bottom Line Venture Capital – What Do We Know?" November 2004, from www.cdvca.org, accessed February 4, 2005, and Brian Schmitt, *CDVCA: Report on the Industry*, (NY, NY: CDVCA, 2004), p. 21.

Note: The two CDVC Funds are different organizations. The MBE Fund = Minority Business Enterprise. The CDVC proxies reflect performance of investments made by investors with similar aims to CDVC organizations. Note that Gross IRR does not adjust for fees that LPs pay GPs to manage the fund.

The Three-Funds 1993-2003 information examines those exits that had occurred within 10 years from 2003, when the study was performed. Each case assumes that the eight write-offs occurred between 1993 and 2003.

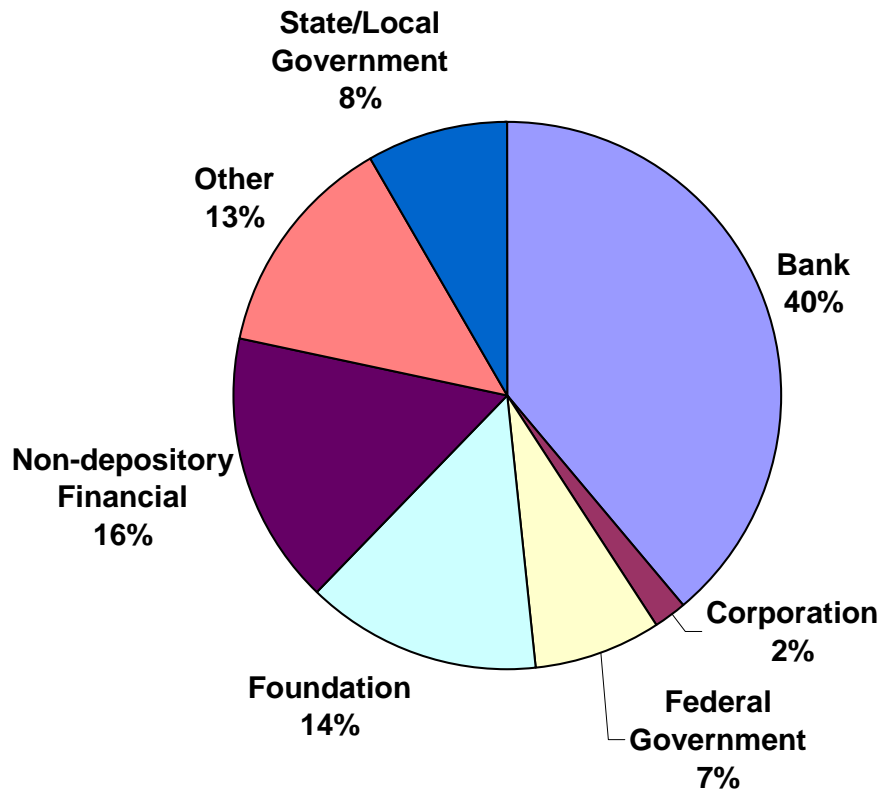
Exhibit 8 Return on Investment to Various Asset Classes 1980–2002



Source: Adapted from Venture Economics (Cumulative IRR for All Venture Capital) and Thomson Financial Datastream; from Felda Hardyman, Josh Lerner, and Ann Leamon, "Grove Street Advisors," *HBS Case No. 804-050* (Boston, MA: HBS Publishing), p. 21.

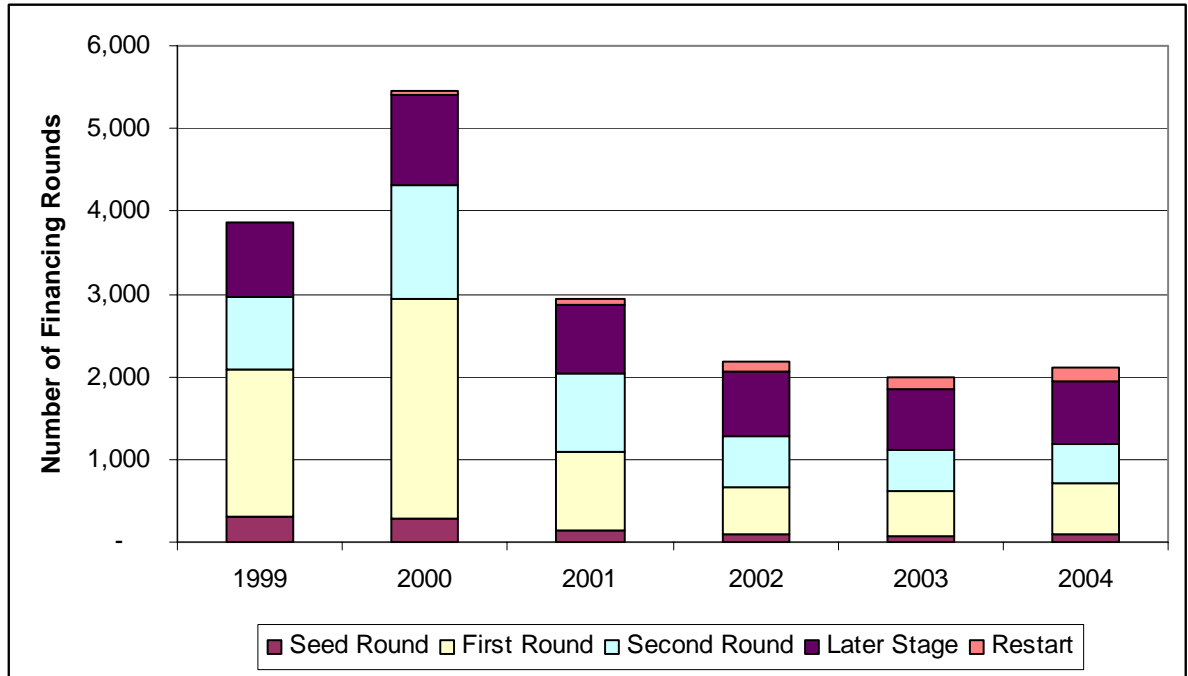
Note: Non-VC options are returns to various stock and bond index funds. All indicators include failed firms.

Exhibit 9 Sources of Funding for CDVCs



Source: CDVCA Database, 2005. Capital by source of investor, outstanding as of the end of 2003.

Exhibit 10 Deals by Stage



Source: Data from VentureSource, accessed February 27, 2006.