COMMUNITY DEVELOPMENT VENTURE CAPITAL ALLIANCE

COMMUNITY DEVELOPMENT VENTURE CAPITAL: A REPORT ON THE INDUSTRY

By Julia Sass Rubin
This report is based on the findings from a three-year study of the CDVC industry, which I conducted as part of my doctoral research at Harvard University and Harvard Business School. I want to thank the Aspen Nonprofit Sector Research Fund, the United States Department of Housing and Urban Development, and Harvard Business School for providing the financial support that made this research possible. I also am indebted to the community development venture capital fund managers and staff members for their time and patience in graciously sitting through lengthy interviews and answering numerous follow-up phone calls and e-mails. Finally, I would like to thank Kerwin Tesdell, Meg Barnette, Brian Schmitt and Christina Mayo of the Community Development Venture Capital Alliance, who consistently have been helpful and good-natured during all phases of my doctoral research. My hope is that this report will be, at least in small part, a demonstration of my gratitude for their kindness. Any errors or misinterpretations in the report remain my own responsibility.
A Letter from The President of CDVCA

The field of community development venture capital (CDVC) has generated a great deal of excitement recently as investors, public policy makers and those active in community development have recognized its potential for revitalizing the economies of urban and rural communities in the U.S. and around the world. As the name implies, community development venture capital combines the tools of traditional venture capital — equity investment and entrepreneurial assistance — with the goals of community development, to stimulate the creation of new businesses, high-quality jobs and healthier communities.

As president of the Community Development Venture Capital Alliance (CDVCA), the association of CDVC funds, I have witnessed first hand the burgeoning interest in this promising field. From a handful of funds in existence just five years ago, the industry has expanded so that this study includes more than 50 providers of CDVC. And more have formed or have begun formation since the research was completed. This rapid pace of growth will only accelerate as the federal government provides recognition and substantial financial support to the industry through the New Markets Venture Capital Program, and the Renewal Communities and New Markets Tax Credit Programs.

Why this extraordinary increase in interest in community development venture capital? First, the need is apparent. The unprecedented economic expansion from which many of us have benefited has left behind significant portions of the nation, as well as countries with developing economies and economies in transition around the world. At the same time, traditional venture capital has proven to be a powerful engine of job and wealth creation for select portions of our economy. CDVC is an attempt to apply this engine in new and powerful ways to create jobs and economic opportunity in neighborhoods and parts of the world that have been left behind. It uses disciplined business and financing practices that are new to efforts at poverty alleviation. It helps create local, fast-growing businesses that are necessary for healthy communities. As globalization of capital markets inevitably increases — creating tremendous wealth but also terrible human costs — CDVC represents a noble experiment in rooting small amounts of capital to community.

With this rapid expansion in interest and activity has come increasing demand for information about the industry. To that end, I am very pleased to present the following report, Community Development Venture Capital: A Report on the Industry. The report, written by Julia Sass Rubin, a Ph.D. Candidate at Harvard University, is the first substantial analysis of the CDVC industry. It will provide an extremely valuable tool for practitioners of CDVC, investors, and others interested in the industry. We owe Julia a tremendous debt for her three years of detailed, in-person interviews and research.

For CDVCA, this report is the first of many research publications we plan to publish in the years to come, as we fulfill our role as a national resource for information and research on the CDVC field. We plan to build on this research by updating the figures contained here, tracking new developments and trends and exploring questions that are not fully examined in this report. In particular, we hope to provide ongoing analyses of the financial and social impacts of CDVC funds as the field comes of age and that information becomes more readily available.

We hope you find this report useful and, as always, welcome your comments.

Sincerely yours,
Kerwin Tesdell
Community development venture capital funds make equity investments in businesses for the purposes of creating jobs for low-income people and strengthening the local economies of distressed regions. Working in urban and rural areas of the United States and around the world, CDVC funds provide patient risk capital and entrepreneurial assistance to small businesses that, because of their size, geographic location, or industry focus, are typically overlooked by traditional venture capital investors.

Although the community development venture capital industry dates back to the 1970s, the CDVC field is still relatively new and largely unknown. The industry experienced a surge in growth during the 1990s, and today there are more than 50 CDVC providers actively investing, or in formation, in the US. But to date, very little information has been collected on the industry as a whole.

This report provides a comprehensive look at the CDVC industry, including a detailed analysis of its size, scope and geographic distribution. The report, which is based on three years of research, also examines the size and type of CDVC funds' investments, their structures and operations, and their financial and social performance to date. By providing an accurate picture of the field, this report should serve as a useful baseline, allowing for the continued tracking of industry data in the years to come.

The study focuses primarily on the United States CDVC industry. Outside of the US, the study examines 11 funds in 9 countries. These funds comprise the international portion of the CDVCA membership, but there are additional community development funds operating in other parts of the world that are not members of CDVCA.
Industry Description and Capitalization

CDVC Funds

- There are more than 50 CDVC providers, actively investing or in formation, across the United States. Unless specified otherwise, the detailed findings in this report are based on 14 of these funds, which focus primarily on making equity and near-equity investments.

- The industry also includes 19 funds that are at various stages of fundraising, but as of December 31, 1999, had not yet begun investing, and an additional 15 funds that make occasional equity investments.

- In addition to these 48 funds, several banks, such as Key Bank and Fleet, have subsidiaries that make CDVC investments. There are also organizations—including the Community Development Venture Capital Alliance (CDVCA), the trade association of CDVC funds, and the Institute for Civil Society, a Massachusetts foundation—which co-invest with CDVC funds.

Geographic Distribution

- Most domestic CDVC providers are located along the east and west coasts of the US, and in the states of Minnesota and Ohio. At present, there are 24 states with no access to community development venture capital, including the majority of states located in the Midwest, the mountain region and the South.

- While traditional venture capital is concentrated in high-technology regions, such as Silicon Valley and Route 128, CDVC investments are found primarily in low- and moderate-income areas, such as West Oakland, California and Roxbury, Massachusetts.

The largest share of CDVC dollars, almost 34 percent, has come from banks and financial institutions.

Industry Capitalization

- The domestic CDVC industry is capitalized at approximately $300 million.

- As of the end of the first quarter of 2000, both mean and median capitalization for domestic equity-focused funds was $9.6 million. The average fund size is increasing rapidly. Funds that raised their capital during 1998 and 1999 had a mean capitalization in excess of $14 million.

Sources of Capital

- The largest share of domestic CDVC dollars, almost 34 percent, has come from banks and financial institutions. Foundations (22 percent) and the federal government (19 percent) have also been significant sources of CDVC capital. Banks and financial institutions are playing an increasingly important role in financing the CDVC industry. This is apparent from the fact that banks and financial institutions provided 58% of the capital for the newer equity-focused funds—those that began investing in 1998 and 1999.

Capital Structure

- Equity-focused CDVC funds are capitalized primarily with capital grants and equity investments, which together account for almost 80 percent of their capital. In fact, half of the equity-focused funds are capitalized entirely with equity. Only one of these funds draws its capital primarily from debt.

- A total of 45 percent of all foundation dollars invested in CDVC funds are in the form of program related investments (PRIs). PRIs are the primary source of CDVC debt, accounting for almost half of all debt investments in equity-focused CDVC funds.

Investments

Dollars Invested

- As of the end of 1999, CDVC funds had invested a total of $104 million of equity and near-equity in their portfolio companies. The dollars invested annually have been increasing rapidly as new and larger CDVC funds have begun investing.
Stage and Industry Focus

- Eighty-six percent of all CDVC funds invest in companies at all stages of development, from seed to expansion.
- Although few CDVC funds limit their investments to specific industries or sectors, the majority, particularly in rural areas, do target manufacturing jobs. This is because the quality of manufacturing jobs is higher, in terms of wages and benefits, than in other sectors. Manufacturing also can be an important path to opportunity for workers with lower education and skill levels.
- Fifty percent of all investments by equity-focused CDVC funds, through the end of 1999, were in manufacturing companies. Twenty-four percent were in service-related businesses.
- Thirty-four percent of all CDVC investments made by equity-focused funds, through the end of 1999, have been in technology-related companies. This is in sharp contrast to private venture capital funds, which made 91 percent of their 1999 investments in technology-related companies.

Deal Structures

- More than half of all CDVC investments made by equity-focused funds were structured as pure equity, either as common stock (24 percent) or preferred stock (24 percent) or, in a few cases, as membership shares in a limited liability company. Near-equity made up another 25 percent of all CDVC investments, and debt that is convertible to equity accounted for an additional 8 percent of investments.

Deal Sizes

- Investments by equity-focused CDVC providers have ranged in size from $10,000 to approximately $1 million. The average CDVC investment is approximately $185,000 per round and $369,000 per company, significantly smaller than the $13.7 million average per round investment made by a traditional venture capital fund.

Exits

- The primary form of exit for CDVC providers has been through sale to an external buyer, accounting for 46 percent of the successful exits to date. This is followed by management buy-backs (36 percent), including the repayment of near-equity investments. Fifteen percent of all successful exits have consisted of Initial Public Offerings (IPOs).

Co-Investments

- Thirty-two percent of all investments by equity-focused CDVC funds included another equity investor. Twelve percent of all CDVC equity co-investments were with traditional and developmental venture capitalists. An additional 7 percent were with angel investors. The remaining 13 percent of the co-investments were from government, foundations, or nonprofit organizations.

Fund Structure and Practice

CDVC Fund Structures

- CDVC funds utilize a multitude of nonprofit and for-profit legal structures. Of the 48 domestic CDVC providers, 42 percent are structured as nonprofits and 40 percent as for-profits.
- Sixty-three percent of the equity-focused funds are structured as for-profits, while only 26 percent of the funds in formation have chosen this legal form. The overwhelming majority of CDVC funds in formation are being organized by existing nonprofit organizations. Utilizing a nonprofit legal structure to make equity investments may enable these organizations to transition into equity more gradually, without having to create a new organizational form. Some of them have plans to form a for-profit fund eventually.

Social Screens

- Beyond geographic and job creation targeting, the CDVC industry applies a wide range of social screens to its portfolio companies. These screens range in number and type. The Kentucky Highlands Investment Corporation, for example, applies few additional social screens to its investments,
beyond the goal of quality job
creation for low-income individu-
als located in the Appalachian
Kentucky counties that KHIC
serves. On the other end of the
spectrum, Coastal Ventures
Limited Partnership
utilizes a number of social
screens in identifying its
portfolio companies, including a
requirement that companies
provide workers with health
insurance and other benefits.

**Technical Assistance**
- Most CDVC funds provide inten-
sive technical assistance to their
portfolio companies, adding to
the cost of operations for the
funds. To offset the extra cost,
many CDVC providers are
adopting innovative approaches
to providing this assistance,
including the creation of non-
profit affiliates that can raise
grant revenue for such purposes,
or contracting with nonprofit
consulting firms that specialize in
providing entrepreneurial assis-
tance to small businesses.

**Cost of Operations**
- For the 1999 fiscal year, CDVC
funds had operating budgets
ranging from $85,000 to $1.8
million, with a $500,000 median
operating budget for a $10 mil-
lion fund. Staff salaries made up
approximately 80 percent of
most funds’ operating expenses.
- To cover their operating expens-
es, a number of CDVC funds
have adopted the traditional ven-
ture capital practice of charging
their investors an annual fee
based on a percentage of invest-
ed capital. CDVC annual fees are
typically three percent, while tra-
tional venture capital funds
charge two to three percent.

**Staff Composition and
Compensation**
- CDVC fund managers are compen-
sated at a lower level than
their traditional counterparts. In
traditional venture capital funds,
management base salaries are
in the hundreds of thousands of
dollars, and carried interest in a
successful fund will usually be in
the millions of dollars. Salaries
for senior CDVC fund managers
range from $50,000 to $350,000,
with a mean salary of $122,000
and a median salary of $95,000.

**Social and Financial Performance**

**Financial Performance**
- The relative youth of the CDVC
industry makes any evaluation of
the financial performance of
community development venture
capital providers premature.
Most CDVC funds are less than
five years old and have exited
only a small portion of their
investments.

**Social Performance**
- Three of the oldest equity-
focused funds together have cre-
ated more than 4,000 jobs, at an
average cost of less than $10,000
per job, compared to the $35,000
per job created by Small Business
Investment Companies (SBICs).

**INTERNATIONAL CDVC INDUSTRY: KEY FINDINGS**

- This report offers a description of the international funds that belong to CDVCA: the 10 members of the Small Enterprise Assistance Funds (SEAF) and the Crocus Investment Fund of Winnipeg, Canada.
- By the end of 1999, the 10 members of SEAF had a total capitalization of approximately $81 million, of
which more than $36 million had been invested in 124 companies in the Baltics, Bulgaria, Bolivia, Peru,
Russia, Croatia, Poland and Macedonia.
- SEAF’s members were capitalized primarily by international development organizations, such as the US
Agency for International Development (USAID).
- The Crocus Investment Fund is a labor-sponsored investment fund that is located and invests in the
Canadian province of Manitoba. The fund has approximately $145 million in assets.
- From 1993 to 1999, Crocus invested more than $76 million in 48 companies. The fund’s investments ranged
in size from $200,000 to $8.5 million, with an average investment of $1.8 million and a median investment of
$990,000.
The community development venture capital (CDVC) industry consists of domestic and international organizations that use the tools of venture capital to create jobs, entrepreneurial capacity and wealth that benefit low-income people and distressed communities. CDVC providers make investments in small businesses that produce a “double bottom line” of financial returns and social benefits, in the form of livable wage jobs and healthier communities.

Today, there are more than fifty CDVC providers, actively investing or in formation, across the United States. There are also more than ten international CDVC providers, located in Canada, Eastern Europe, and Latin America. This report constitutes the first comprehensive overview of this growing industry. It is based on extensive interviews with each of the domestic funds, as well as many of their funders and portfolio companies. The interviews and data collection took place over a three-year period, between June 1997 and May 2000. While the study focused primarily on the United States CDVC industry, it also briefly reviewed eleven international funds.

The report is organized as follows: Most of the report provides an overview of domestic CDVC industry. The first section is a history of the domestic industry. The second section describes the industry’s composition and capitalization. The third section reviews in detail the nature of CDVC investments. The fourth section examines fund-level issues, such as legal structures, boards of directors, investment committees and operating costs. The fifth section discusses the domestic industry’s financial and social performance to date. The sixth section describes the eleven international CDVCA member funds.
The community development venture capital industry dates back to 1972, when a community development corporation (CDC) located in London, Kentucky, began investing capital in local businesses in exchange for an equity stake in these enterprises. In 1978, that CDC, renamed Kentucky Highlands Investment Corporation (KHIC), formed a venture-specific subsidiary, Mountain Ventures, to more aggressively pursue equity investments.  

Kentucky Highlands felt that part of its mission was to “spread the word” about this new approach to community economic development. It was so successful in this effort, that articles about KHIC began appearing in national periodicals, including *Forbes*, *The National Journal*, *The Washington Post* and *The Wall Street Journal*.  

Kentucky Highlands was not the only CDC to use equity and near-equity investments for economic development. Among others, Impact Seven, Inc., of Wisconsin and Northern Community Investment Corporation of Vermont also experimented with these approaches. However, they did not set up separate subsidiaries dedicated to equity provision, preferring to make occasional equity investments from their general funds.

Coastal Enterprises, Inc., of Maine, a CDC created in 1977, also pursued an equity strategy. From 1980 to 1996, Coastal made periodic equity investments from its loan fund. In 1996, feeling the need for a more concentrated equity focus, Coastal created Coastal Ventures, a limited partnership subsidiary dedicated to community development venture capital investing.

At approximately the same time that Kentucky Highlands was experimenting with equity investments in private enterprises, a number of states were exploring the creation of developmental venture capital funds. The first state to adopt such a double-bottom line approach was Massachusetts, which in 1975 signed into law the Community Development Finance Corporation (CDFC). One of the other states that ultimately adopted this model was Minnesota, which in 1991 set up the Minnesota Technology Equity Fund, to increase economic development efforts throughout the state. In 1998, the fund was spun off into a private nonprofit and renamed the Minnesota Investment Network Corporation (MIN-Corp).

In 1978, KHIC formed a venture-specific CDVC subsidiary to aggressively pursue equity investments.

In 1989, Northeast Ventures was launched in Duluth, Minnesota at the initiative of community leaders. It was the first fund established as a stand-alone entity, not sponsored by government or an existing community development corporation. The fund looked to local and national foundations for part of its capitalization, and was able to convince both the Ford and the John D. and Catherine T. MacArthur Foundations to make their first investments in a CDVC fund.
Community Development Loan Funds (CDLFs) have also contributed to the evolution of the CDVC industry. Several of the current CDVCs, including Boston Community Ventures andDVCRF Ventures, are affiliated with community development loan funds. Other CDLFs, such as the Cascadia Revolving Fund of Seattle, have chosen not to offer pure equity. Instead, these funds expanded their existing lending operations into the provision of near-equity — subordinated debt with warrants, royalties or participation agreements. These CDLFs provide near-equity via a dedicated subsidiary, or as an alternative product, by their existing loan funds.

Individuals from the traditional venture capital industry have also been instrumental in forming community development venture capital funds. Both Silicon Valley Community Ventures of California and the Sustainable Jobs Fund of North Carolina and Pennsylvania, were formed at the instigation of traditional venture capitalists.

In 1992, a few CDVC funds met for the first time to share experiences and best practices. This group began to meet on a regular basis and grew into the Community Development Venture Capital Alliance (CDVCA). CDVCA was incorporated in 1995 and hired its first full-time staff member in 1998.
II. INDUSTRY DESCRIPTION AND CAPITALIZATION

States and territories served by Domestic CDVC Providers*
(includes funds in formation)

CDVC Funds
There are more than 50 CDVC providers, actively investing or in formation, across the United States. Unless specified otherwise, the detailed findings in this report are based on 14 of these funds, which focus primarily on making equity and near-equity investments. The industry also includes 19 funds that are at various stages of fundraising, but had not yet begun investing as of December 31, 1999, and an additional 15 funds that make occasional equity investments. In addition to these 48 funds, several banks, such as Key Bank and Fleet, have subsidiaries that make CDVC investments. There are also organizations — such as the Community Development Venture Capital Alliance (CDVCA), the trade association of CDVC funds, and the Institute for Civil Society, a Massachusetts foundation — which co-invest with CDVC funds.

Geographic Distribution
Most domestic CDVC providers are located along the east and west coasts of the United States, and in the states of Minnesota and Ohio.
At present, there are 24 states with no access to community development venture capital, including the majority of the states located in the Midwest, the mountain region and the South. Unlike the traditional venture capital industry, however, which consciously chooses to invest the majority of its resources in the technology corridors of California and Massachusetts, the absence of CDVC capital in so many states is primarily the result of the relative youth of the industry.

Even in states such as California and Massachusetts, which have access to both traditional and community development venture capital, the geographic distribution of the investments is very different. Traditional venture capital is concentrated in high-technology regions, such as Silicon Valley and Route 128. Conversely, CDVC investments are found primarily in low- and moderate-income areas, such as West Oakland, California and Roxbury, Massachusetts.

**Capitalization of CDVC Industry**

**Industry Capitalization**

The domestic CDVC industry is capitalized at approximately $300 million. The 14 funds that focus primarily on making equity investments account for $120 million (40%) of this total, and the 19 funds in formation make up an additional $44 million (15%). Approximately $136 million (45%) consists of capital that is likely to be used for equity investments by funds that invest in equity only occasionally, by bank community development corporations, and by various co-investment funds. As of the end of the first quarter of 2000, both the mean and median capitalization for domestic equity-focused funds was $9.6 million. However, the average fund size is increasing rapidly. Funds that raised their capital during 1998 and 1999 had a mean capitalization in excess of $14 million.
Sources of Capital

By far the largest share of domestic CDVC dollars, almost 34 percent, has come from banks and financial institutions, which are playing an increasingly important role in financing the CDVC industry. Banks and financial institutions provided 58 percent of the capital for the newer equity-focused funds—those that began investing in 1998 and 1999. This reflects the greater overall awareness of the CDVC industry, and the increasingly favorable view that bank regulators have of CDVC investments as a way of meeting a bank’s Community Reinvestment Act obligations. Foundations and the federal government also provide substantial amounts of CDVC capital, accounting for 22 and 9 percent, respectively, of all equity-focused fund assets.

Capital Structure

Equity focused CDVC funds are capitalized primarily with capital grants and equity investments, which together account for almost 80 percent of all their capital. In fact, half of the equity-focused funds are capitalized entirely with equity. Only one equity-focused fund draws its capital primarily from debt.

A total of 45 percent of all foundation dollars invested in CDVC funds are in the form of program-related investments (PRIs). PRIs are the primary source of CDVC debt, accounting for almost half of all the debt invested in equity-focused funds.

Banks and financial institutions are also significant sources of debt, representing 48 percent of all the debt dollars invested in equity-focused CDVCs. However, banks and financial institutions provide more equity than debt. Equity investments constitute 73 percent of the total funds invested by banks and financial institutions.
Dollars Invested
As of the end of 1999, CDVC funds had invested a total of $104 million of equity and near-equity in their portfolio companies. The 14 equity-focused funds accounted for 86 percent of this total. The dollars invested annually have been increasing as new and larger CDVC funds have begun investing.

Stage and Industry Focus
A majority of all CDVC funds (86 percent), invest in companies at all stages of development, from seed to expansion stage. This strategy enables CDVC funds to consider the largest possible number of high-quality investments within their geographic regions.

CDVC funds that serve larger geographic regions are able to apply sectoral screens to their investments. For example, the Sustainable Jobs Fund (SJF) invests, in part, in businesses in the recycling, manufacturing and environmental industries. SJF focuses on the eastern United States, an area large enough to allow SJF to apply its sectoral screens and still identify sufficient high-quality deal flow.
Although few CDVC providers have a specific sectoral investment strategy, the majority of them do target companies that will create manufacturing jobs. They do so because the quality of manufacturing jobs is high, in terms of both wages and benefits. Manufacturing also allows for lower education and skill levels, making such jobs an important path to economic opportunity.\(^6\) Fifty percent of all investments made by equity-focused funds through the end of 1999 were in manufacturing companies. Only 24 percent of the investments were in service-related businesses, the fastest growing segment of the U.S. economy, but one that tends to provide lower pay and fewer benefits to its workers.

Thirty-four percent of all investments made by equity-focused CDVC providers have been in technology-related companies. This is in sharp contrast with private venture capital funds, which made 91 percent of their 1999 investments in technology-related companies.\(^7\) While technology investments have demonstrated the rapid growth rates and profitable exits that make them more likely to yield large payouts for the venture funds, many of the jobs they create require advanced degrees and are not available to lower-skilled individuals. Technology investments are also concentrated in specific regions, such as Silicon Valley, California and Route 128 in Massachusetts, leaving out the majority of low- and moderate-income communities that CDVC providers serve.

### Co-Investments

Thirty-two percent of the investments made by equity-focused CDVC providers include another equity co-investor. Twelve percent of all CDVC equity co-investments were made by traditional and developmental venture capitalists. Angel investors made an additional 7 percent of all equity co-investments. The remaining 13 percent came from government, foundations or community organizations.

Many CDVC deals also include debt co-investments. In fact, by increasing a company’s level of equity, CDVC providers enable it to obtain additional debt.
**Deal Structures**

Half of the investments made by the equity-focused funds through December 31, 1999, were structured as pure equity. This consisted of either common stock (24 percent), preferred stock (24 percent), or, in a few cases, membership shares in a limited liability company (2 percent). Near-equity — debt with equity features, such as warrants, royalties or participation agreements — made up another 17 percent of investments. Debt that is convertible to equity accounted for an additional 8 percent. The remaining 25 percent of investments were in the form of straight debt, often provided in combination with equity or near-equity financing.

**Deal Sizes**

CDVC investments range in size from $10,000 to more than $1 million, per company. The average CDVC investment is $184,610 per round and $369,220 per company.10 These figures are significantly smaller than the traditional venture capital industry’s $13.7 million average per round investment.11 They are also smaller than the investments made by Small Business Investment Companies (SBICs). During fiscal year 2000, average per round investments were approximately $904,000 for participating security SBICs and $433,000 for debenture SBICs.12
**Investment Exits**

Given the youth of the CDVC industry, any analysis of exits is based on limited information, and is weighted towards the older funds. As of June 2000, the 14 equity-focused funds had successfully exited from 33 of the 182 investments that they had made through December 31, 1999.

The primary form of exit for CDVC providers has been through sale to an external buyer, which accounted for almost half of the successful exits to date. The second most frequent form of exit has been management buyback, including the repayment of near-equity investments. Approximately half of the equity buybacks were negotiated into the original contracts via a put, which stipulated when and under what terms the stock would be repurchased by the company’s owners.

Both external sales and management buybacks are delicate undertakings for CDVCs providers. When an outside company acquires a CDVC portfolio company, the portfolio company may be moved to another location or closed down entirely. On the other hand, new owners may also bring additional capital and expansion opportunities. Management buybacks usually ensure that a portfolio company will not relocate, but they may be less profitable than other forms of exit. Because most CDVC investments are in early stage companies, it can take as long as seven to ten years for these companies to have the cash flow needed to buy out their investors. The long holding period limits a CDVC provider’s liquidity and cuts into an investment’s internal rate of return.

Initial Public Offerings (IPOs) are generally the most lucrative means of exit for venture capitalists. But IPOs are still relatively rare for CDVC portfolio companies. To date, there have been five IPOs, including two whose stocks are still being held by their CDVC investors because of the stocks’ low trading prices. As with the vast majority of recent initial public offerings, all five of the companies are in technology-related industries.

Successful CDVC Exits, to date (equity-focused funds)

<table>
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<tr>
<th>Exit Type</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>IPO</td>
<td>15%</td>
</tr>
<tr>
<td>Management Buyback</td>
<td>36%</td>
</tr>
<tr>
<td>External Sale</td>
<td>46%</td>
</tr>
<tr>
<td>ESOP</td>
<td>3%</td>
</tr>
</tbody>
</table>

IPOs require. As a result, IPOs are unlikely to become the primary exit option for CDVC funds.

From the standpoint of social returns, employee stock ownership plans (ESOPs) appear to be the ideal exit option for CDVC-funded companies: they empower workers while insuring that the company stays local. In practice, however, ESOPs can be costly to implement in the smaller companies in which most CDVC providers invest. As a result, as of May 2000, there had been only one exit from a CDVC portfolio company via an employee stock ownership plan.

To date, 16 CDVC portfolio companies have gone bankrupt. Seven additional CDVC investments have resulted in a partial or complete write-off of the equity portion of the investment.
CDVC Fund Structures

Unlike traditional venture capital funds, which are for-profit and usually structured as either limited liability companies or limited partnerships, community development venture capital funds utilize a multitude of both for-profit and nonprofit legal structures. The 48 domestic CDVC funds are split evenly between nonprofit and for-profit legal forms. Nonprofits make up 42 percent of all domestic funds and for-profits account for an additional 41 percent. Quasi-public funds account for 2 percent of the total. Fifteen percent of the domestic funds, all of which are still in formation, have yet to decide on their ultimate legal structure.

The majority (85 percent) of the nonprofit funds are structured as 501(c)(3)s. The for-profit funds are more evenly divided by legal form, with limited liability companies accounting for 42 percent of all for-profit funds, limited partnerships making up 26 percent, and other corporate forms (C and S corporations) totaling 32 percent.

The C and S corporation structures are used primarily for subsidiaries of existing organizations. The advantage of these forms, unlimited life span, can also make it more difficult for C and S corporations to attract investments. While it can be easier to raise capital for a CDVC with a limited life span, these structures force the general partners to fundraise for a new fund every five to ten years.

It is very common for a for-profit domestic CDVC fund to be affiliated with a nonprofit organization, which enables it to fundraise, helps it provide more extensive support to its portfolio companies, and supports other charitable activities. Half of the equity-focused funds have utilized this “hybrid” approach.

There are different patterns between existing equity-focused funds and those funds currently in formation. While 63 percent of the existing funds are structured as for-profits, only 26 percent of the funds in formation have chosen this legal form. The overwhelming majority of the funds in formation are being organized by existing nonprofit organizations. Utilizing a nonprofit legal structure to make their CDVC investments may enable these organizations to move into this type of investing more gradually, without having to create a new organizational form.
Some of these nonprofit organizations plan to transition to a for-profit or hybrid structure, once they have more experience with community development venture capital investing. The Alternatives Federal Credit Union of Ithaca, New York is an example of this strategy. Alternatives is currently raising capital for a CDVC program that will operate from within the nonprofit credit union. This is designed to help Alternatives build a CDVC “demonstration portfolio.” However, Alternatives also intends to create a for-profit limited partnership subsidiary, which will manage its future CDVC investment activities.¹⁴

Social Screens

Social screens are inherent in the idea of community development venture capital, since CDVC providers focus on serving low-income populations and distressed communities. Beyond geographic targeting and job creation objectives, however, the CDVC industry is very diverse in the type and number of social screens that individual funds apply to their investments.

This diversity reflects the fact that social screens can restrict deal flow and thus may be difficult to utilize in many of the regions in which CDVC providers operate. For example, the Kentucky Highlands Investment Corporation (KHIC) looks for investments that create jobs for low- and moderate-income individuals in its nine-county Appalachian area. The fund does little additional social screening, since KHIC’s deal flow is very limited and the fund is concerned that the application of extensive additional social screens might leave it with few viable investment options.

KHIC also believes that, in regions with very high unemployment and a large unskilled population, any job creation is beneficial.

Unlike KHIC, Coastal Ventures, LP (CVLP) utilizes a number of screens in identifying its portfolio companies. CVLP is located in Portland, Maine and can invest anywhere in the state, as well as in neighboring states. Maine attracts many entrepreneurs, who move to the state for lifestyle reasons. CVLP’s larger geographic area and higher quality deal flow enable it to impose additional social screens on its investments.

For example, CVLP requires its portfolio companies to make best efforts to hire specific populations of workers and to provide them with health care and other benefits. CVLP is also able to give preference to companies with environmentally friendly practices and socially progressive managers.

Many CDVC funds give preference to companies owned by women or ethnic minorities. Many CDVC providers give preference to companies owned by women or ethnic minorities. A subset of the traditional venture capital industry also focuses on these populations, but does not screen its investments for their positive impact on low- and moderate-income populations. There are traditional venture capital funds, however, that combine a focus on women- and minority-owned businesses with a limited geographic target area. By doing so, they restrict their deal flow and may encounter many of the challenges faced by CDVC funds. Several of these funds, including the Milestone Growth Fund of Minneapolis, Minnesota and the African-American Venture Capital Fund of Louisville, Kentucky, identify closely with the community development venture capital industry, even though their own primary focus is not on low- and moderate-income populations.

Technical Assistance

One of the unique aspects of community development venture capital is the intensive technical assistance that most CDVC funds provide to their portfolio companies. Because the majority of CDVC funds are geographically restricted, they are faced with a limited number of potential investment opportunities. This restricted deal flow may require the funds to invest in companies with limited management experience.
As a result, the funds must find ways to bring in outside expertise, in order to increase the companies’ level of knowledge and market readiness. Outside consultants can be expensive for young companies, so most CDVC providers use their own staff to provide that expertise. However, the extra time that staff invests in each deal increases the cost of operations for the funds and reduces the time that fund staff have available for additional investments.

The high costs associated with providing technical assistance to their portfolio companies has led some CDVC funds to experiment with alternative ways of paying for such services. One innovative approach was piloted by Silicon Valley Community Ventures (SVCV), a two-year-old CDVC fund focusing on Northern California’s Bay Area. SVCV created a Business Advisory Program, which recruits experienced business professionals to provide expertise to entrepreneurs on an ongoing, volunteer basis. SVCV only invests in companies that have gone through the Business Advisory Program, saving SVCV staff the time and resources needed to prepare potential portfolio companies for investment.

Another means of offsetting the cost of technical assistance is via a nonprofit affiliate that can raise grant revenues specifically for that purpose. The Sustainable Jobs Fund (SJF) has utilized this approach. SJF has partnered with the National Recycling Coalition (NCR), a 20-year-old nonprofit trade association that has been able to raise grants to help pay for some of SJF’s ongoing technical assistance costs. The Enterprise Corporation of the Delta (ECD), which serves the Delta regions of Mississippi, Arkansas and Louisiana, has reduced the cost of technical assistance by relying on the services of alt.Consulting, a nonprofit consulting firm that specializes in serving smaller and less experienced businesses. Unlike for-profit consulting firms, alt.Consulting has been able to raise grants to offset some of its cost of operations.

Boards of Directors
At seventeen percent of all board seats, bankers comprise the largest group of board members for the equity-focused CDVC funds. This reflects the significant portion of CDVC capital that comes from banks and financial institutions, as well as bankers’ financial expertise and resulting desirability as board members. The overall percentage of bankers is also inflated by one CDVC fund, whose board accounts for almost 48 percent of all bankers. Representatives of community organizations (14 percent), entrepreneurs (13 percent) and government employees (11 percent) all account for a significant number of CDVC board seats. There is also a strong presence by venture capitalists (8 percent), lawyers (7 percent), corporate executives (7 percent), consultants (6 percent) and educators (6 percent). CDVC fund staff hold 4 percent of all board seats, and members of their parent organizations hold an additional 3 percent. The remainder is made up of groups that account for less than 1 percent of the total, including foundation officers and real estate executives. Thirty-one percent of all CDVC board members are women.

Boards of Directors’ Composition
(ery-focused funds)
Investment Committees

Bankers make up the largest portion of equity-focused CDVC providers’ investment committee positions (22 percent). As with CDVC boards, one CDVC fund accounts for one third of all of these bankers. Venture capitalists play a much more significant role on CDVC investment committees (15 percent), than they do on CDVC boards of directors (8 percent). Conversely, community organizations, which have a major role in setting CDVC board direction, play a smaller role on investment committees, accounting for only 10 percent of all seats.

At 13 percent, entrepreneurs are a significant presence on both CDVC boards and investment committees. The remaining 7 percent of investment committee seats is filled by groups that each account for less than 1 percent of the total, including foundation officers and members of accounting firms. Two CDVC funds do not have a separate investment committee. Instead, their entire board of directors makes investment decisions.

Cost of Operations

For fiscal year 1999, CDVC funds had operating budgets ranging from $85,000 to $1.8 million, with a $500,000 median operating budget for a $10 million fund. Staff salaries made up approximately 80 percent of funds’ operating expenses.

Traditional venture capital funds cover their operating expenses by charging their investors an annual fee, based on a percentage of invested capital. This fee is usually between 2 and 3 percent of the total committed capital. A number of CDVC funds have adopted this practice because it is familiar to banks and financial institutions, which invest in both traditional and community development venture capital funds. These CDVC funds charge their investors an annual fee of approximately 3 percent of total capital. However, this fee rarely covers a CDVC fund’s true cost of operations.

There are several reasons why management fees do not fully cover operating expenses for most CDVC funds. First, all venture funds must cover the fixed costs of staff and facilities. Because CDVC funds are significantly smaller in capitalization than traditional venture capital funds, 3 percent of their total capitalization is usually not enough to cover these fixed costs. The average equity-focused CDVC fund was capitalized at $8.5 million as of May 2000, substantially less than the $217 million average size for a traditional venture capital fund.15

CDVC funds also have higher operating costs than traditional venture capital funds because of the much smaller sizes of their investments, and the need to provide extensive technical assistance to many of their portfolio companies. Smaller deals require as much oversight as larger ones, forcing CDVC providers to hire more staff than a comparably sized traditional venture capital fund. The need to provide technical assistance also requires additional staff, further increasing CDVC funds’ costs of operations.
Because CDVC providers have higher operating costs and smaller fund sizes than traditional venture capital funds, looking at CDVC operating expenses as a percentage of total capital is not an effective way to evaluate operating efficiency. Many CDVC providers also receive operating subsidies from their parent or partner nonprofit organizations, a fact that further complicates any comparisons of operating costs as a percentage of total capital.

**Staff Composition and Compensation**

The typical CDVC fund staff consists of both a senior and a junior fund manager. Senior managers generally are responsible for fundraising as well as some due diligence. Most senior fund managers are also involved post-investment, with oversight and the provision of technical assistance to their portfolio companies. The typical senior fund manager has at least ten years of traditional or developmental finance experience. However, only 14 percent of the senior fund managers running equity-focused funds had any direct venture capital experience prior to assuming their current positions.

Junior fund managers are responsible for due diligence, deal oversight and the provision of technical assistance. Junior fund managers are likely to have an MBA or another advanced degree, and two to five years of traditional or developmental finance experience.

CDVC fund managers are compensated at a lower level than their traditional venture capital counterparts. Traditional venture capital funds structure their managers’ salaries to consist of a base salary and a much larger bonus paid out of carried interest. Management base salaries are in the hundreds of thousands of dollars, and carried interest in a successful fund will usually be in the millions of dollars. In this way, the funds are able to attract experienced and proven talent, in an industry where the talent pool is relatively small.

In contrast, the salary range for senior CDVC fund managers is $50,000 to $350,000, with a mean salary of $122,000 and a median salary of $95,000. Junior CDVC fund managers earn between $50,000 and $125,000, with a mean salary of $78,000 and a median salary of $75,000.

Fifty percent of all CDVC funds offer a performance incentive of either a bonus or carried interest. Twenty-nine percent of all CDVC funds provide fund managers with a bonus, based on individual and fund performance. The bonuses range from 8 to 30 percent of salary. Twenty-one percent of all funds offer a carried interest of 10 to 25 percent of net fund profits. To date, only one fund has distributed any carried interest payments. An additional 29 percent of CDVC funds are considering adding such incentives.

Community development venture capital providers face a number of obstacles that prevent them from offering salaries comparable to those received by traditional venture capital fund managers. First, many CDVCs have nonprofit legal structures, or are for-profit subsidiaries of nonprofit organizations. The pay levels of nonprofit organizations are generally lower than those in the for-profit sector. Even the purely for-profit CDVC funds are limited by their relatively low levels of capitalization, which translate into fewer dollars available for salaries. CDVC compensation is also constrained by the fact that CDVC profits are lower and operating expenses are higher than those faced by traditional venture capital funds.
Executive Summary

The Development Corporation of Austin, KHIC and Northeast Ventures together have created over 4,000 jobs, at an average cost of less than $10,000 per job.

Any attempt to measure the exact social and financial performance of domestic community development venture capital providers is limited by the relative youth of the industry. Most CDVC funds are less than 5 years old and have exited only a small portion of their investments. Only 4 of the equity-focused funds in existence through December 31, 1999, were created 10 or more years ago: Development Corporation of Austin, in Austin, Minnesota; Kentucky Highlands Investment Corporation; The Massachusetts Community Development Finance Corporation; and Northeast Ventures in Duluth, Minnesota.

Of these four funds, only Northeast Ventures is a freestanding fund that has not received an ongoing operating subsidy. The overwhelming majority of Northeast Ventures’ investments, however, have been in early-stage companies, which extends the average investment holding time for the fund. As of the end of 1999, Northeast Ventures had exited from approximately half of its portfolio companies, and was still holding the majority of its most financially promising investments. As a result, an evaluation of the financial performance of Northeast Ventures is still premature. The three remaining funds have received ongoing operating subsidies from their parent entities, making it difficult to estimate their true overhead expenses. They have also used a combination of debt and equity investments that is often difficult to disaggregate.

Despite the difficulty in evaluating CDVC funds financially, the older funds do provide some indication of the industry’s social impact. The Development Corporation of Austin, Kentucky Highlands and Northeast Ventures together have created more than 4,000 jobs, at an average cost of less than $10,000 per job. This compares very well to the average cost of $35,000 per job created by Small Business Investment Companies (SBICs). These figures are even more impressive in light of the fact that the jobs created were primarily in manufacturing, with livable wages and benefits, and located in economically depressed, rural regions.

V. SOCIAL AND FINANCIAL PERFORMANCE
Established in the early 1990s, SEAF is a Washington D.C.-based nonprofit, with 10 international funds located in Eastern Europe, the Baltic States and Latin America. The oldest of the funds, CARESBAC Polska and North Fund Poland, were established in March of 1992. The newest fund, Fondo Capital Activo of Bolivia, was set up in January 2000. SEAF is also looking to establish additional funds in Central and Eastern Europe, the Balkans and Poland, as well as new funds in Haiti and Southeast Asia.

The Crocus Investment Fund, a labor-sponsored fund, invests in the Canadian province of Manitoba. The fund was established in 1992 by the Manitoba Federation of Labor, with the support of the business community and the Canadian federal and provincial governments. It was designed in response to capital flight from Manitoba, with a primary objective of keeping capital in the province and using it to create jobs in small and medium-sized businesses.

Given the limited nature of research to date, it is difficult to accurately estimate the total size of the international CDVC industry.

The 10 SEAF funds were capitalized primarily by international development organizations, such as the European Bank for Reconstruction and Development (EBRD), the US Agency for International Development (USAID), and the Inter-American Development Bank (IADB). Individual funds also received support from local government and nonprofit sources. For example, approximately half of the $7.9 million dollar capitalization for the Peruvian fund came from the IADB, with the rest supplied by Dutch and Peruvian governmental organizations, SEAF, and a Peruvian nonprofit.

At the end of 1999, the 11 international member funds of CDVCA had a total capitalization of approximately $226 million: SEAF’s 10 funds were capitalized with almost $81 million, while Crocus had approximately $145 million in assets.

This report focuses only on those international funds that belong to CDVCA as of December 31, 1999: the 10 members of the Small Enterprise Assistance Funds (SEAF) and the Crocus Investment Fund of Winnipeg, Canada. Research on international community development venture funds is in a very early stage, and future publications will include a broader range of information on more funds.
The Crocus fund was capitalized via the sale of shares to the Canadian public, and the resulting mutual funds are traded on the Canadian stock exchange. In addition to its individual shareholders, Crocus has also received capital from institutional investors, including the Manitoba Federation of Labor and the Canadian federal and provincial governments. Shareholders receive not only the financial returns from the fund, but also federal and provincial tax credits equal to 30 percent of their investment. The investment can also be made within the individual’s tax deductible Registered Retirement Savings Plan, which is comparable to a US Individual Retirement Account (IRA).

**Investments**

As of the end of 1999, SEAF funds had invested over $36 million in 124 companies, while Crocus had invested over $76 million in 48 companies. The SEAF portfolio is heavily weighted towards agribusiness, which accounts for 37 percent of all investments, and manufacturing, which makes up an additional 20 percent. The remaining 43 percent is made up of publishing (10 percent), wholesale/retail (10 percent), wood products (8 percent), apparel (7 percent), services (3 percent), construction (3 percent) and telecommunications-information technology (2 percent).¹⁹

The Crocus portfolio is also diversified across many sectors. Services account for the largest portion of the investments (40 percent), closely followed by manufacturing (33 percent). The fund also invests in the entertainment industry (9 percent), retail (6 percent), agriculture (6 percent) and research and development (6 percent).

SEAF investments are made up of approximately 65 percent equity and 35 percent debt. The debt is primarily subordinated, but convertible debt is also used by the funds. SEAF investments have ranged in size from $6,000 to $736,000 per company, with an average investment of $293,000. Crocus investments have ranged in size from $200,000 to $8.5 million, with an average investment of $1.8 million and a median investment of $990,000.

**Fund Structure and Practice**

SEAF controls eight of its ten funds: it is a majority-voting shareholder in four, manages three funds for the European Bank of Reconstruction and Development, and manages one independent fund. SEAF is also a non-controlling minority shareholder in two other funds. Seven of the eight funds controlled by SEAF are structured as for-profits. Three of these seven for-profit funds are joint stock companies, comparable to a United States C Corporation. The remaining four for-profit funds are Limited Liability Companies (LLCs), or are in the process of becoming LLCs.

SEAF funds are managed on-site, by a combination of US and home-country staffs. These staffs perform due diligence and provide their portfolio companies with post-investment technical assistance. Most of the fund managers have MBAs and finance experience. The average fund manager’s annual salary is approximately $80,000.
Some of the funds also have an employee bonus pool that is administered at the local level.

Crocus is structured as a Labor-Sponsored Venture Capital Corporation. Its investments are managed by an in-house team of investment analysts, with finance degrees and extensive experience in the investment industry. The fund also has an investment advisory committee, comprised of community members with diverse professional backgrounds.

**Social Screens**

Crocus is one of five Canadian labor-sponsored investment funds (LSIFs) that have signed a declaration of principles and formed the LSIF Alliance. The Alliance’s principles include: a commitment to job retention and creation, and regional economic development; the use of a social audit in the areas of health and safety, environment and employment practices (the audit is performed during the investment analysis of potential portfolio companies); and a focus on improving labor-management relations in portfolio companies. Crocus encourages all its portfolio company owners to expand ownership to their employees and to enable their employees to participate in corporate governance and management. SEAF does not utilize any social screens beyond the geographic location of its portfolio companies.

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(1) Except where noted, the domestic fund-level information in this report is as of December 31, 1999 and is based solely on the 14 equity-focused funds. The domestic fund capitalization data is as of May 31, 2000.


(6) Does not include bank, co-investment and minority entrepreneur funds.

(7) Funds that make only occasional equity and near-equity investments do not segregate the capital they use for such investments. Thus, it is difficult to determine exactly how much such funds have available for equity and near-equity investments. The figures in this report are estimates, based on conversations with fund staffs.


(10) These figures exclude Kentucky Highlands’ investments prior to 1985 and all Massachusetts Community Development Finance Corporation investments.


(17) Comparable information is not available for the Massachusetts Community Development Finance Corporation.


### DOMESTIC CDVC PROVIDERS

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<th>Provider Name</th>
<th>City, State</th>
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<tr>
<td>ACENet Ventures Inc.</td>
<td>Athens, OH</td>
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<td>Alaska Growth Capital BIDCO, Inc.</td>
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<td>Alternatives Federal Credit Union</td>
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<td>Arkansas Enterprise Group</td>
<td>Arkadelphia, AR</td>
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<td>Boston Community Venture Fund</td>
<td>Boston, MA</td>
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<td>California Coastal Rural Development Corporation</td>
<td>Salinas, CA</td>
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<td>California Economic Development Lending Initiative</td>
<td>Oakland, CA</td>
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<td>Capital to People Program - Murex Investments</td>
<td>Philadelphia, PA</td>
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<td>Cascadia Rural Development Investment Fund</td>
<td>Seattle, WA</td>
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<td>Coastal Ventures Limited Partnership</td>
<td>Portland, ME</td>
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<td>Community Action Committee of Pike County</td>
<td>Piketon, OH</td>
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<td>Community Development Ventures</td>
<td>Baltimore, MD</td>
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<td>Community Loan Fund of Southwestern Pennsylvania</td>
<td>Pittsburgh, PA</td>
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<td>Dakota Renaissance Venture Corporation</td>
<td>Fargo, ND</td>
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<td>Development Corporation of Austin</td>
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<td>DVCRF Ventures</td>
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<td>Enterprise Corporation of the Delta</td>
<td>Jackson, MS</td>
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<td>Impact Seven</td>
<td>Almena, WI</td>
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<td>Kentucky Highlands Investment Corporation</td>
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<td>Landmark Growth Capital Partners Fund</td>
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<td>MACED Strategic Capital Fund</td>
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<td>Millennium Fund, LLC</td>
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<td>Minnesota Investment Network Corporation</td>
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<td>Ouachita Enterprise Community</td>
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<td>People Inc. of Southwestern Virginia</td>
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<td>Restoration Capital Fund, Inc.</td>
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<td>Rural Development &amp; Finance Corporation</td>
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<td>Sustainable Jobs Fund, LP</td>
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<td>Vermont Community Loan Fund</td>
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<td>Virgin Islands Capital Resources, Inc.</td>
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### MINORITY ENTREPRENEUR FUNDS

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<td>African-American Venture Capital Fund LLC</td>
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<td>Milestone Growth Fund, Inc.</td>
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### BANK CDVC PROVIDERS

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### INTERNATIONAL CDVC PROVIDERS

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<td>SEAF-Baltics Small Equity Fund</td>
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<td>SEAF-Fondo Capital Activo de Bolivia</td>
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<td>SEAF-Fondo de Asistencia a la Pequena Empresa</td>
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<td>SEAF-SEEF/Nizhny Novgorod</td>
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<td>SEAF-North Fund</td>
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