

Report ON THE INDUSTRY

2002

CDVCA

Community Development Venture Capital Alliance

Acknowledgements

Much of the research presented in this report was made possible thanks to CDVCA's participation in the CDFI Data Project (CDP). The CDFI Data Project (CDP) is a collaborative initiative to create a data collection and management system that produces high quality, comprehensive data about Community Development Financial Institutions (CDFIs). The Ford and MacArthur Foundations provide support for the CDP. This exciting initiative brings together: the Association for Enterprise Opportunity, the Aspen Institute, Community Development Venture Capital Alliance, the Corporation for Enterprise Development, the National Community Capital Association, the National Community Investment Fund, the National Federation of Community Development Credit Unions, and the CDFI Coalition, the national trade association for CDFIs.



A Letter from the President of CDVCA

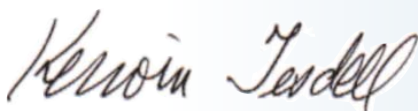
It is with pleasure that we bring to you CDVCA's third annual report on the community development venture capital industry. This report provides summary data on the overall industry through the end of 2002 with detailed analysis of data from 27 funds through the end of 2001.

Community Development Venture Capital (CDVC) funds bring the business building power of equity investment to the challenges of job creation and development of economically distressed areas. By adding their investment capital and entrepreneurial expertise to the wealth of ingenuity and innovation in communities, CDVC funds help businesses to flourish in areas where traditional venture capital tends not to flow. Their investments create financial returns for investors as well as social returns in the form of good jobs that pay living wages and allow people to rise out of poverty and begin to build wealth.

The growth of small businesses is integrally connected to healthy economies and successful communities. With the awareness of the role equity capital can play in developing such businesses, the CDVC industry is one of the fastest growing sectors of community development finance. Since the end of 2000, the industry has grown from 52 domestic CDVC funds actively investing or in formation with \$300 million in capital under management to 79 funds investing or in formation with \$550 million in capital under management at the end of 2003. This growth has taken place during one of the most difficult fundraising environments the venture capital industry has ever faced. In the year 2000, the venture capital industry raised \$106 billion in new capital. In 2002, the venture capital industry was able to raise only \$6 billion. During those same years the CDVC industry grew by 62 percent.

It is our hope that this report is of practical value to practitioners, investors, policymakers, and others interested in community development finance. Thank you for your interest, and I strongly encourage you to contact CDVCA with your further questions about the industry.

Sincerely yours,



Kerwin Tesdell

I n t r o d u c t i o n

Community development venture capital (CDVC) funds use the tools of venture capital—patient capital and business management expertise—to grow small businesses that create good jobs for low-income people and promote entrepreneurial capacity in economically distressed urban and rural areas. Community development venture capital funds have grown dramatically in the past ten years from just a few funds in the early 1990s to nearly 80 organizations actively investing or in formation.

This report is divided into two sections. Section I describes the industry as a whole as it looked at the end of 2002 and is based on CDVCA's on-going research. Section II provides a much more detailed analysis of the industry as it looked at the end of 2001 and is based on our annual survey of the industry.

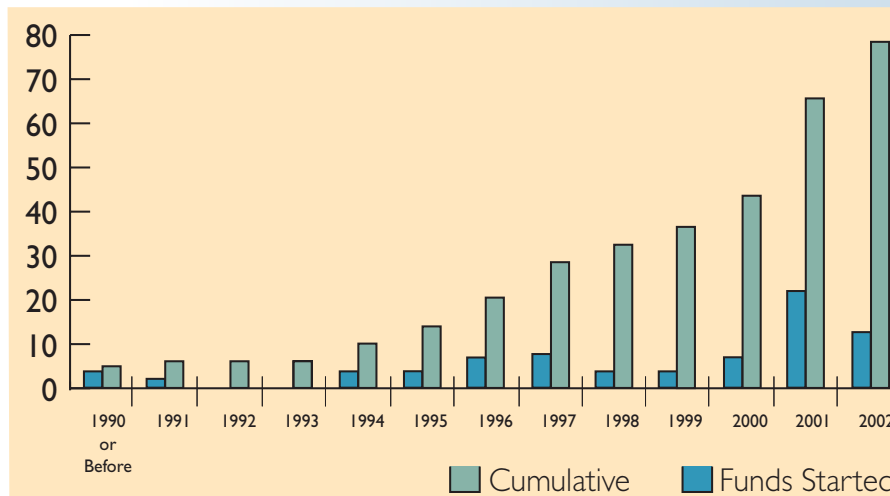
I. The CDVC Industry at the End of 2002

This section presents summary information on the CDVC industry as of the end of 2002. Data include the number of CDVC funds over time, capital under management, recent fund formation activities, fund legal structures and fund models, information about fund's boards of directors and investment committees, as well as the types of companies in funds' portfolios.

Number of funds, stage, and capital under management

The number of CDVC funds has grown dramatically over the past ten years, from just a half dozen funds investing in the early 1990s to 79 funds actively investing or in formation by the end of 2002.

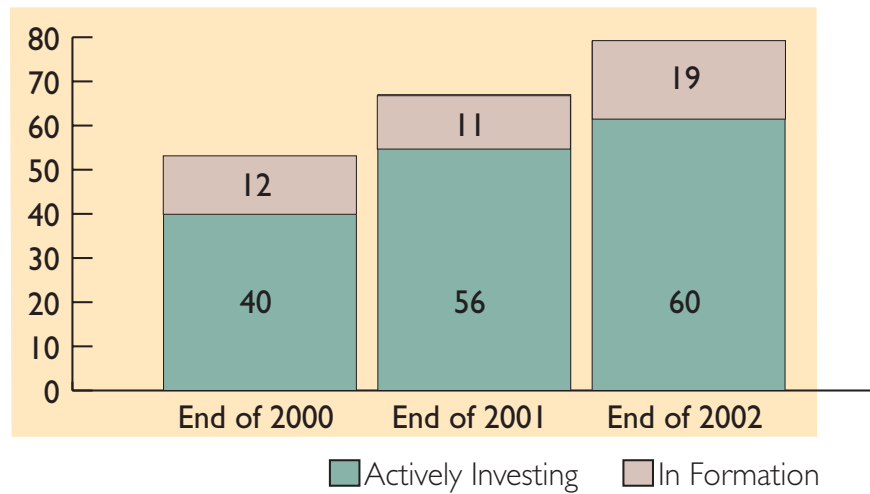
Growth of CDVC Funds through 2002





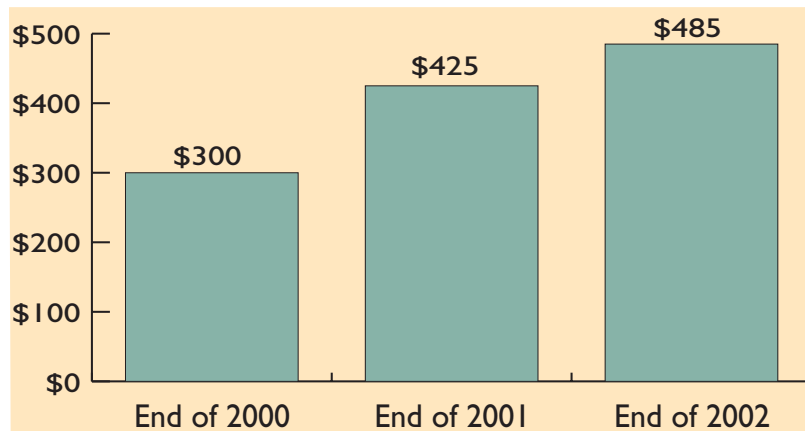
From 2000 to 2002
CDVC capital under
management grew by 62
percent—from \$300
million to \$485 million.

Number of Funds by Stage, 2000 to 2002



CDVC capital under management continued to show strong growth in 2002. Over the last three years total capital under management grew from \$300 million at the end of 2000 to \$485 million at the end of 2002. The strong growth suggests that investors are becoming increasingly comfortable with the CDVC model.

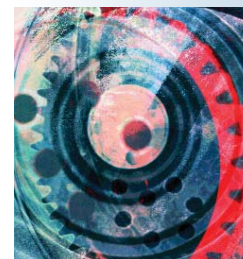
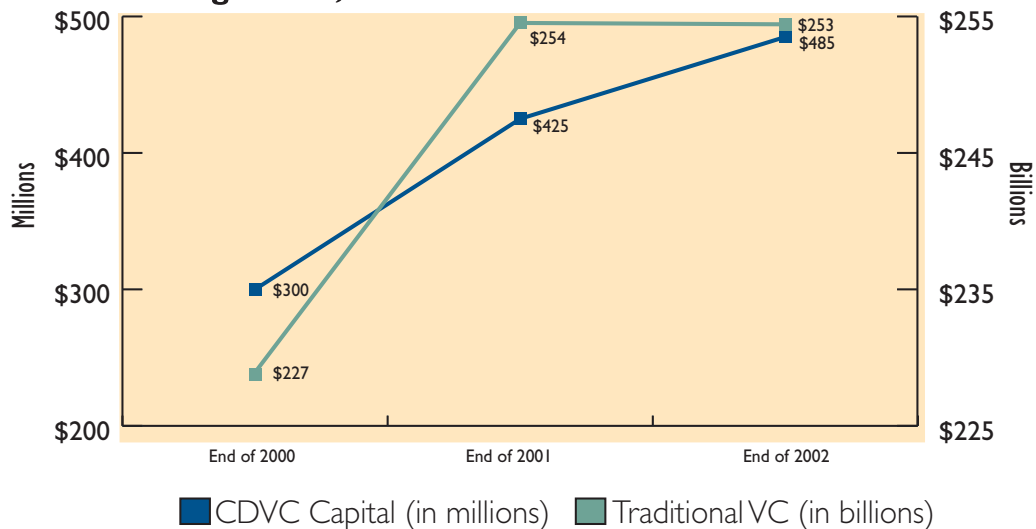
CDVC Capital Under Management, 2000 to 2002 (in millions)



From 2000 to 2002 CDVC capital under management grew by 62 percent—from \$300 million to \$485 million. Considering how the VC industry has sputtered along over the past few years, any growth in CDVC funds' capital under management is extraordinary. CDVC capital under management grew 14 percent from 2001 to 2002; while traditional VC capital under management actually dropped from \$254 billion to \$253 billion—the first drop in capital under management since 1991.¹

1. [National Venture Capital Association 2003 Yearbook](#). (NVCA: Arlington, Virginia) Figure I.01.

CDVC Capital and Traditional VC Capital Under Management, 2000 to 2002



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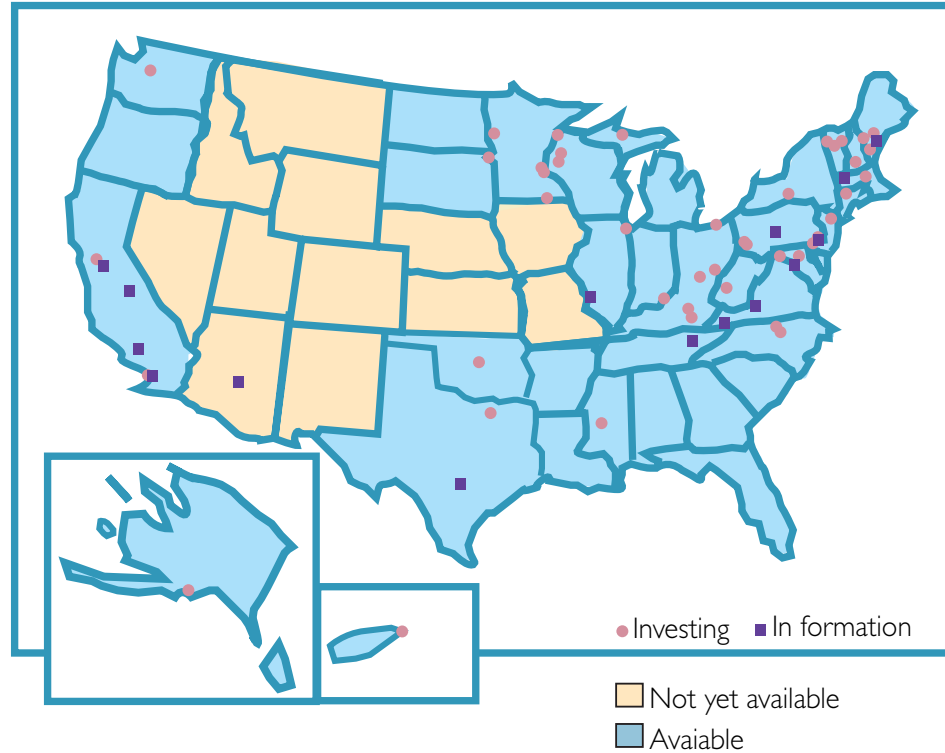
Just over half of the growth in the industry during 2002 came in the form of new capital coming into a few new funds, including Adena Ventures, LP, a New Markets Venture Capital (NMVC) company. The remaining growth came from increases in total assets among evergreen funds, as well as the discovery of new organizations involved in the practice of CDVC.

While the SBA formally certified one NMVC Company in 2002, the remaining six conditionally certified companies continued to raise capital in the worst VC fund raising environment in 10 years. For 2002, new capital commitments in traditional VC were down 80 percent from 2001. Despite the difficult climate, all of the six remaining NMVC companies had raised the necessary private capital for their funds and the SBA certified five in the second half of 2003.



Commitment to a particular geographic area, whether it is a rural region or an urban center, is one of the distinguishing features of the CDVC industry.

CDVC Funds, Active or In Formation



Geographic Distribution

CDVC funds focus their activities in specific investment areas. CDVC fund investment areas are in places that traditional venture capital funds tend to overlook. For example, CDVC funds are active in many communities in Appalachia, rural Minnesota, and Baltimore—places not typically associated with venture capital. Commitment to a particular geographic area, whether it is a rural region or an urban center, is one of the distinguishing features of the CDVC industry.

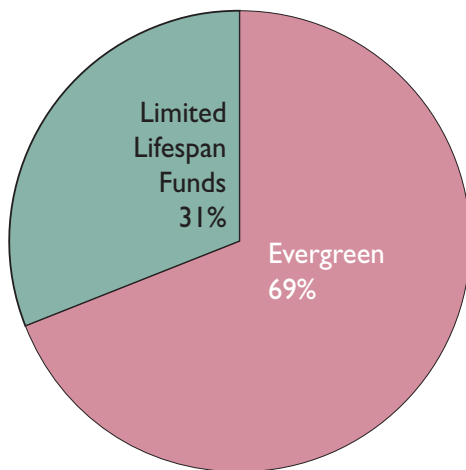
CDVC funds are also active in regions that have become synonymous with venture capital—such as Silicon Valley and Boston, but they often invest in neighborhoods and smaller towns that are overlooked by traditional VC firms. For example, Boston Community Venture Fund (BCVF) manages two CDVC funds in that city, but while traditional VC firms invest in companies along the Route 128 corridor or around the city’s renowned research univer-

sities, the companies in which BCVF typically invests are located in low-income areas like Roxbury or smaller, less wealthy towns such as Taunton, Massachusetts. Similarly, Pacific Community Ventures (PCV) manages two CDVC funds in the San Francisco Bay Area. PCV invests in Silicon Valley and throughout California, but its portfolio companies are in places like East Palo Alto and San Francisco's Mission District, rather than in the more affluent cities like Menlo Park and Palo Alto, where traditional VC funds are most active.²

Fund Models and Legal Structures

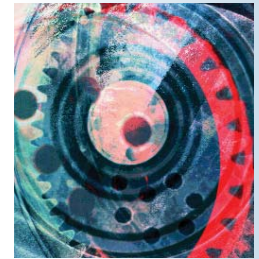
Community development venture capital funds use a variety of organizational structures to achieve their double bottom line goals. Some of these structures are borrowed directly from the world of traditional VC, while others are innovative solutions unique to the CDVC industry. This section describes two models used by CDVC funds, as well as the legal structures used in these models.

CDVC Models for Funds Actively Investing



Like their traditional VC counterparts, CDVC funds can be categorized either as “limited lifespan” funds or as “evergreen” funds. As the name suggests, limited lifespan funds are incorporated for a limited time, typically ten years. Evergreen funds are ongoing enterprises and operate without a predetermined termination date.³

The limited lifespan model uses two separate legal entities: an investing entity (the “fund”) and a managing entity (the “firm”). For both CDVC funds and traditional VC funds that use the limited lifespan model, the fund is a for-profit entity, either a limited partnership (LP) or a limited liability company (LLC); however, while all management firms in traditional VC are for-profit, in the world of community development venture capital the managing firm may be a for-profit or a not-for-profit.



Community development venture capital funds use a variety of organizational structures to achieve their double bottom line goals.

2 See Brian T. Schmitt, 2002. “Assessing the Availability of Traditional Venture Capital in the US: A Preliminary Analysis.” (New York, NY: The Community Development Venture Capital Alliance). November.

3 Some funds have termination dates that are twenty or more years out. In this analysis, these funds are treated as evergreen funds.



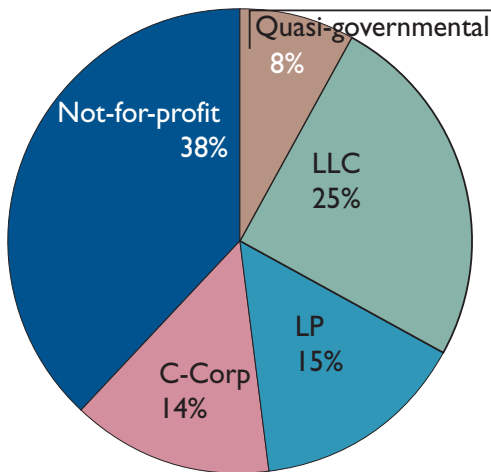
Like their traditional VC counterparts, CDVC funds can be categorized either as “limited lifespan” funds or as “evergreen” funds.

By contrast, the evergreen fund model combines both the capital pool and the management team into a single corporate entity. Evergreen funds are either for-profit (a C-corporation or an LLC) or not-for-profit (typically a 501(c)3).

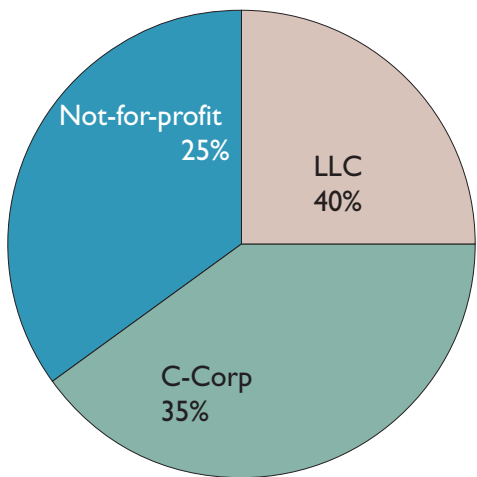
In CDVC both limited lifespan funds and evergreen funds often mix for-profit and not-for-profit entities. As noted earlier, in the limited lifespan model, a for-profit firm or not-for-profit firm can manage the for-profit fund. For example, Pacific Community Ventures is a 501(c)3 that manages two for-profit funds, PCV Fund I, LLC and II, LLC. Similarly, for-profit evergreen funds may have a not-for-profit affiliate; Northeast Ventures, Inc. of Duluth, Minnesota is a C-corporation with a not-for-profit subsidiary, Iron Range Ventures, Inc. Several CDVC funds are also subsidiaries of large not-for-profits. For example, Coastal Ventures, LP and Coastal Ventures II, LLC are for-profit CDVC funds managed by CEI Ventures, Inc., a C-corporation, all of which are subsidiaries of Coastal Enterprises, Inc., a not-for-profit multi-service community development corporation headquartered in Maine.

Of the 19 funds in formation at the end of 2002, fifteen were limited lifespan funds and four were not-for-profit evergreen funds. For these 15 limited lifespan funds, the investing entities will be split between LLCs and LPs and the managing firms will be 60 percent for-profits (LLCs exclusively) and 40 percent not-for-profits.

Corporate Structure of the Investing Entity



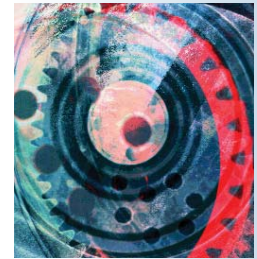
Corporate Structure of Managing Firms for Limited Lifespan Funds



More than half of all CDVC funds actively investing at the end of 2002 were for-profit entities—a limited liability company (LLC), a limited partnership (LP), or a C-corporation. Thirty-eight percent of funds were not-for-profits and the remaining 8 percent were quasi-governmental organizations, typically funded by the state government with an emphasis on economic development and job creation in distressed areas of the state.

Of the 33 for-profit funds that were actively investing at the end of 2002, 18 were limited lifespan funds managed by a separate legal entity. The corporate structure of these 15 management firms—3 firms managed 2 funds each—shows that the vast majority, 75 percent, are managed by for-profit entities: (40 percent of the managing firms were LLCs, 35 percent were C-corporations) only 25 percent were not-for-profits.

Of the 33 CDVC organizations that are for-profit funds, either limited lifespan funds or evergreen funds, 61 percent are “hybrids”; that is, they mix a for-profit fund with a not-for-profit affiliate. In some cases the not-for-profit affiliate is the management firm; in other cases the management firm is a for-profit and the parent is the not-for-profit. The hybrid structure allows the organization to receive grant dollars that can be used to cover the developmental costs associated with growing young businesses in distressed regions.



More than half of all CDVC funds actively investing at the end of 2002 were for-profit entities.

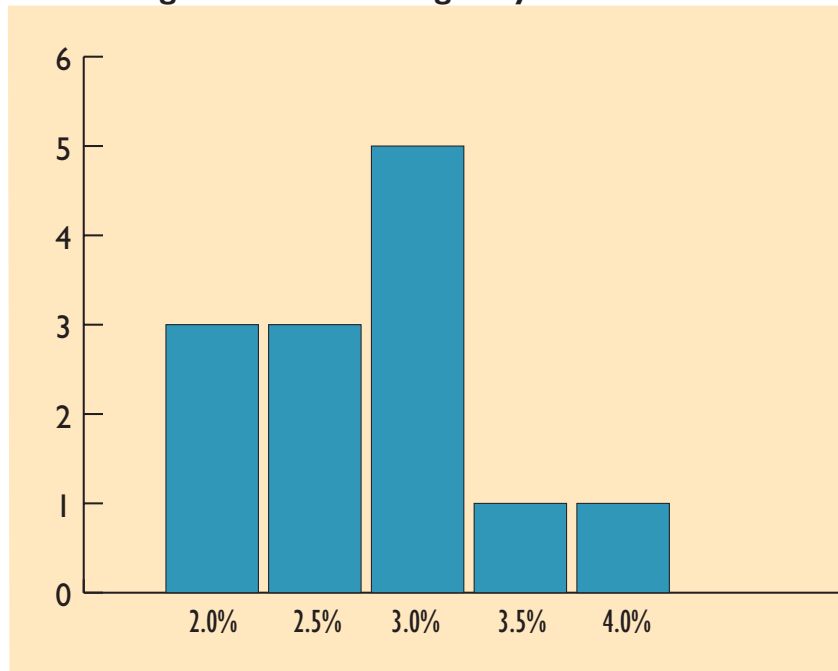


The management fee is intended to cover the basic costs incurred by the firm as it manages the fund.

Fund Dynamics: Management Fees, Expenses, and Compensation

In the limited lifespan model, the fund pays a management fee to the firm—between 2 and 3 percent of total committed capital in the world of traditional VC and between 2 and 4 percent of total committed capital in the world of CDVC. The management fee is intended to compensate the managing firm for managing the fund, including the (relatively) small base salaries for the managers.

Management Fees Charged by CDVC Funds

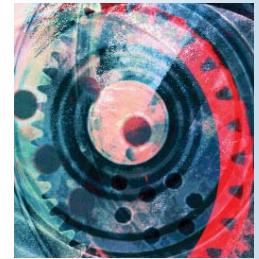


In contrast, evergreen funds cover their operating costs through direct use of capital and/or current income generated by the fund's ongoing investment activities. Not-for-profit funds, and for-profit funds with not-for-profit affiliates, also use grant dollars to help to cover the costs of creating greater social impacts from their investments by providing the technical assistance required by the businesses and entrepreneurs in which CDVC funds invest.

Like traditional VC funds, CDVC funds often use incentive pay to align the interests of the managing firm with the interests of the investors. For limited lifespan funds, profits from the fund's investment activities are allocated back to investors and to managers according to the rules described in the operating agreement. Although the details can vary substantially from fund to fund, one typical arrangement is to first return all initial profits to the investors up to the amount of their original capital contributions; after this, all additional profits are allocated 80 percent to the investors and 20 percent to the managing firm. This 20 percent of profits, known as the "carried interest," provides the bulk of the compensation for management firm.

Evergreen funds also use incentive pay to motivate their investment professionals. Most for-profit evergreen funds have created bonus packages that link the staff's compensation to the successes of their portfolio companies.

Because they are ongoing enterprises, the return on investment for evergreen funds is different. For for-profit evergreen funds, returns from investment activities may be paid out to investors through dividends or they can be retained and used for future investments. For not-for-profit evergreen funds, money earned on their equity investments can be used in three ways: (1) to pay their long-term debt obligations, since not-for-profits cannot have equity investors, (2) to cover operating expenses, and (3) to increase the net assets of the corporation and be re-invested in future deals.



Like traditional VC funds, CDVC funds use incentive pay to align the interests of the managing firm with the interests of the investors.

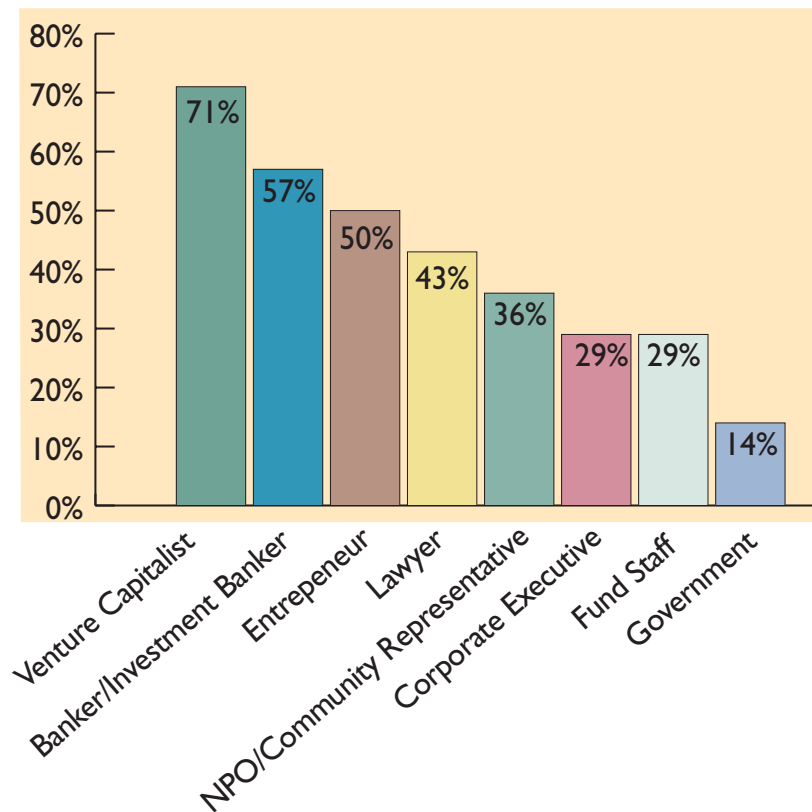


Seven out of ten CDVC fund investment committees have at least one experienced venture capitalist.

Investment Committees

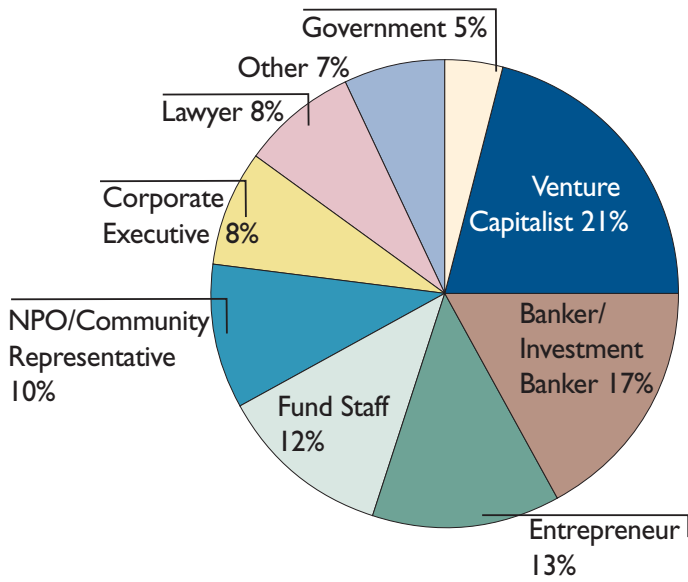
Most CDVC funds have investment committees that make investment decisions. Fund staff investigate a prospective portfolio company through a rigorous due diligence process and then make a recommendation to the investment committee. CDVC investment committees range from three to ten members and the average investment committee has about six members. The process brings together the insights and expertise of a variety of people, which helps to ensure the inclusion of as many points of view as possible.

CDVC Fund Investment Committee Members by Category



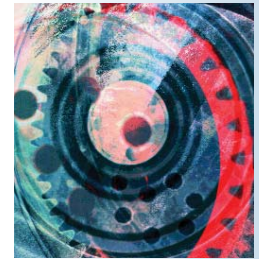
The chart above shows that venture capitalists are the professional category most common to all CDVC fund investment committees. Seventy-one percent of all CDVC funds had at least one venture capitalist on their fund's investment committee. More than a third of CDVC fund investment committees had two or more venture capitalists. Bankers, including investment bankers, were the second most common professional category on CDVC fund investment committees. Sixty-seven percent of investment committees had at least one banker or investment banker. Experienced entrepreneurs are represented on one half of all investment committees. Lawyers, typically with small business lending and investing experience, are on 43 percent of all investment committees.

CDVC Fund Investment Committee Total Pool



Bankers, including investment bankers, account for an additional 17 percent. Entrepreneurs account for 13 percent of the pool and fund staff account for 12 percent. Community representatives including persons who work with local or regional not-for-profits make up 10 percent of the pool. The remainder of the pool is made up of corporate executives, lawyers, government officials, and others.

The previous section presented information on the fund investment committees by committee; this section shows information on all persons who make up the pool of persons who participate in CDVC fund investment committees. Venture capitalists make up the largest percentage of persons staffing fund investment committees and account for 21 percent of the pool. Bankers, including investment

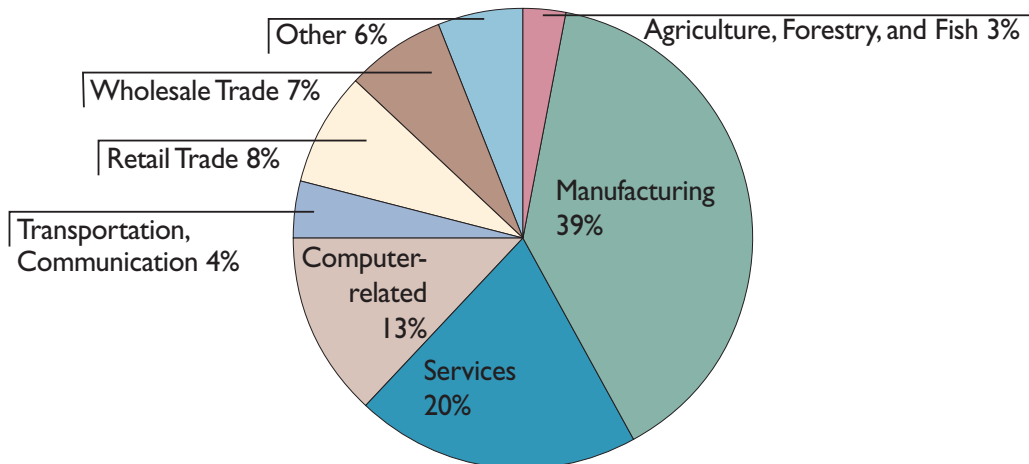


One-third of all of the persons on CDVC fund investment committees are either venture capitalists or successful local entrepreneurs, oftentimes with strong ties to the funds' investment areas.

Portfolio company information

Like their traditional VC counterparts, the companies that receive CDVC investments are high growth businesses that promise good financial returns. But a closer look shows that CDVC investing is concentrated in different sectors than traditional VC. Nearly 4 out of 10 CDVC portfolio companies are in manufacturing and 2 out of 10 are involved in services. Service companies

CDVC Portfolio Companies by Sector



range from home health care services to off-site computer repair services. Thirteen percent of CDVC investments are in computer related industries, including Internet service providers (ISPs) and software development.

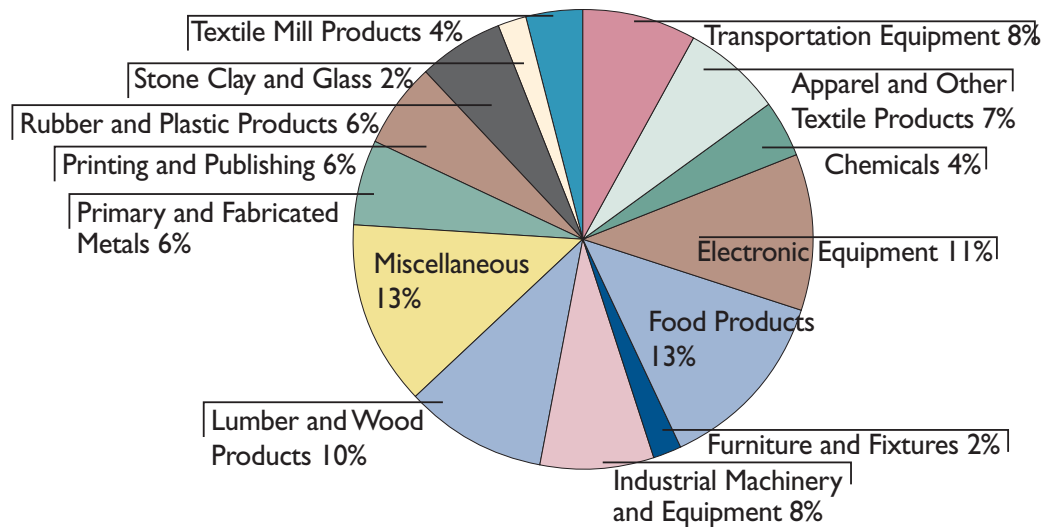
While computer related businesses are a primary focus of traditional VC funds—accounting for 4 of 10 initial investments in 2002—the computer related businesses in which CDVC funds invest are noticeably different.⁴ For example, the ISPs in which CDVC funds invest provide Internet services in inner-city neighborhoods and rural areas. Similarly, the software companies are typically located in small towns in West Virginia or in rural Minnesota, not places traditionally associated with the “new” economy. These CDVC investments help to diversify the local economic base and bring economic opportunities to these distressed regions.

The plurality of CDVC portfolio companies is in the manufacturing sector with a wide range across all sub-sectors. Food-products manufacturing accounts for 13 percent of all manufacturing companies and electronic equipment manufacturers accounts for 11 percent. CDVC funds are partial to investing in manufacturing because it tends to create good entry-level jobs and also offer upward mobility. In addition, the manufacturing sector is generally overlooked by traditional VC funds and struggles to find patient capital.



CDVC funds invest in a wide range of business sectors. The variety helps fund to diversify their risks and to diversify the local economies, which they are working to strengthen.

CDVC Manufacturing Companies by Sub-sector



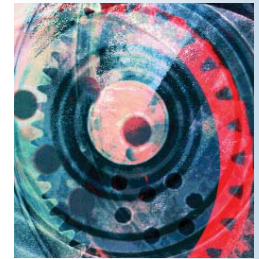
⁴ National Venture Capital Association 2003 Yearbook, (NVCA: Arlington, Virginia). Figure 4.01.

The Venture Capital Investment Cycle

In *The Venture Capital Cycle*, Harvard Business School professors Paul Gompers and Josh Lerner write, “To understand the venture capital industry, one must understand the whole ‘venture cycle.’” The venture capital cycle starts with fund raising, proceeds to the “investing in, monitoring of, and adding value to” portfolio companies, and culminates in the harvesting of those investments through “exits”.

The cyclical nature of venture capital is especially pronounced for funds organized as limited lifespan funds, but evergreen funds are also strongly shaped by the demands of equity investing. Although evergreen funds frequently make some debt investments that generate current income, the bulk of the financial returns are made by the fund selling its equity interests in the companies in which it invests. There are several ways that the fund can exit from its equity investment—the sale of its equity to a new investor, to employees of the portfolio company as part of an employee stock ownership plan (ESOP), to management as part of a management buyback, or, in a few cases, an initial public offering (IPO), in which the fund sells its equity in a public stock market such as the Nasdaq or the over-the-counter (OTC) market. In the world of community development venture capital, the most common form of exit is the sale of the company to a third party.

Because management fees are charged from the outset and exits typically do not happen until 5 to 7 years after the initial investment, VC funds display a J-shaped return curve. That is, funds show losses in their early years, but profits take off as they begin to exit their investments.



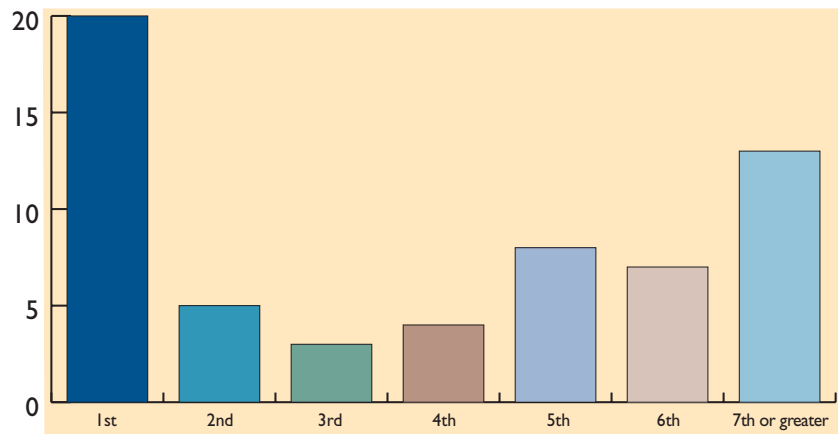
Management fees are incurred from the outset, while returns on investments can take several years; the effect is what VC investment professionals call the J-curve.



Forty-seven of the 60 active CDVC funds are still in the investment stage of the VC cycle.

The fact that most CDVC funds are still young coupled with the J-curve nature of equity investment returns means that it is still too early to make a definitive assessment of the financial returns to CDVC investing. The table below shows that the vast majority of CDVC funds—47 out of 60—is still in the investment stage and has yet to enter the harvesting stage. What's more, the older CDVC funds with seasoned investments on their books are facing the worst private equity market ever. IPOs have plummeted over the past few years and merger and acquisition activity, the more likely exit for CDVC, is down more than 25 percent from its high in 2000.⁵

CDVC Funds by Their Year in the Investment Cycle



⁵ National Venture Capital Association 2003 Yearbook. (NVCA: Arlington, Virginia) Figures 6.06 and 6.11.

II. In-depth Analysis of 2001 Data

The previous section examined in a broad way the CDVC industry as it stood at the end of 2002. This section provides a more detailed analysis of 27 CDVC funds that participated in CDVCA's 2002 annual survey, which collected information through the end of 2001. This section covers in detail such topics as: sources of capitalization, total dollars invested, average investment sizes, fund management costs, exits, and the social impacts of CDVC funds' activities. When categorized into two peer groups, these 27 funds offer an excellent representative view of the entire industry.

CDVC Peer Groups

Funds were assigned to one of two peer groups based on their capital under management and their investment focus. Peer Group 1 funds have more than \$5 million of capital under management and focus on equity investing. Equity investing includes common and preferred stock; as well as near-equity investing that focuses on debt with equity participation, such as convertible

Summary Data for the Two Peer Groups

	Peer group 1	Peer group 2
No. of respondents	20	7
Total Capital Under Management (in millions)	\$226.1	\$13.6
Avg. Fund Size (in millions)	\$10.8	\$2.3
Median Fund Size (in millions)	\$10.5	\$1.9
Fund Investment Type		
Equity ¹	\$69.5	\$8.0
Debt	\$45.7	\$2.6
Total	\$115.2	\$10.6
Corporate Structure		
For-profit	14	2
Not-for-profit ²	6	5
Fund Model		
Limited Lifespan Fund	8	0
Evergreen For profit	6	2
Evergreen Not-for-profit	6	5

(1) Includes equity, debt with equity participation, and debt with revenue participation.

(2) Includes one quasi-governmental fund in Peer Group 1.



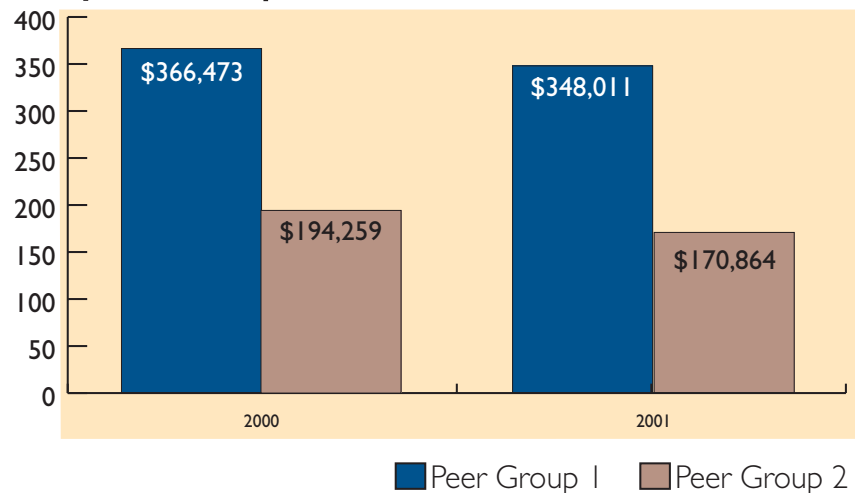
Peer Group 1 funds have more than \$5 million of capital under management and focus on equity investing. Peer group 2 funds have less than \$5 million in capital under management and their investment activity tends to be debt with revenue participation.

debt and debt with warrants. Peer group 2 funds have less than \$5 million in capital under management and their investment activity tends to be debt with revenue participation, which is known as royalty agreements or participation agreements.⁶ This section categorizes the 27 respondents to the 2002 survey into two groups in order to facilitate comparisons. Summary data for the two peer groups are presented in the table below.

There are other differences between the two groups. Peer Group 1 funds are more likely to be for-profit, while Peer Group 2 funds are more likely to be not-for-profit. In terms of fund models, 8 of the 20 Peer Group 1 funds are limited lifespan funds, while the remaining 12 are evergreen funds evenly split between for-profit and not-for-profit funds. All 7 of the Peer Group 2 funds are evergreen funds, five not-for-profit and 2 for-profit.

Comparison between Peer Group 1 and Peer Group 2 funds of average investment per company shows that Peer Group 1 investments are larger than average per company investments for Peer Group 2. Over the past two years Peer Group 1 investments have been about \$350,000 per company, while for Peer Group 2 average investments are about \$180,000 per company.

Average Dollars Invested per Company by Peer Group, 2000 and 2001

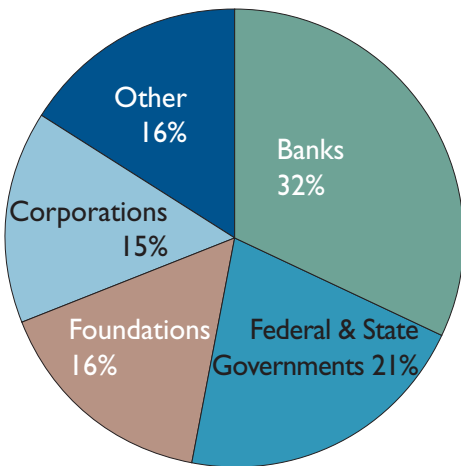


⁶ The two previous CDVCA annual reports on the industry distinguished between “equity-focused” funds and “near equity” funds, which correspond to Peer Group 1 and Peer Group 2, respectively.

CAPITALIZATION: Peer Group 1

Peer Group 1 funds managed a total of \$221.3 million in capital, \$176.8 million in the form of equity and equity grants and \$44.5 million in the form of debt. Banks were the single largest provider of capital and accounted for 31 percent of all equity and debt invested into Peer Group 1 CDVC funds. Federal and state governments were the second largest provider of capital to Peer Group 1 funds and accounted for 21 percent of all capital. The remaining 47 percent of total capital was nearly evenly distributed among foundations (16 percent), corporations (15 percent), and other investors (16 percent), which included fund parents, individuals, and others.

**Capital Contributions
by Source, Peer Group 1**



Eighty percent of all of Peer Group 1's capital contributions came in the form of equity and equity grants investments; 20 percent came in the form of debt. The large percentage of equity reflects Peer Group 1's investment focus, which is common, preferred, and convertible preferred stocks— instruments that generally do not generate current income that could be used to pay interest on borrowed capital.

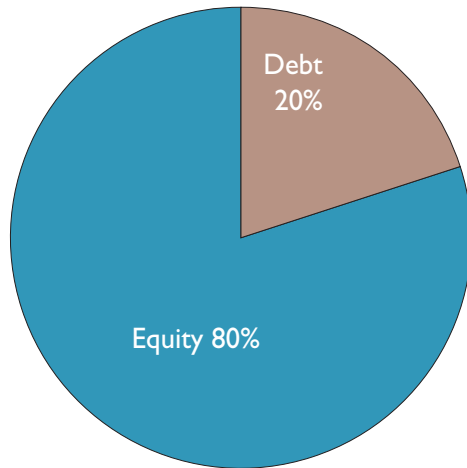


Peer Group 1 funds managed a total of \$221.3 million in capital.



Banks accounted for 36 percent of all equity capital, the single largest equity provider.

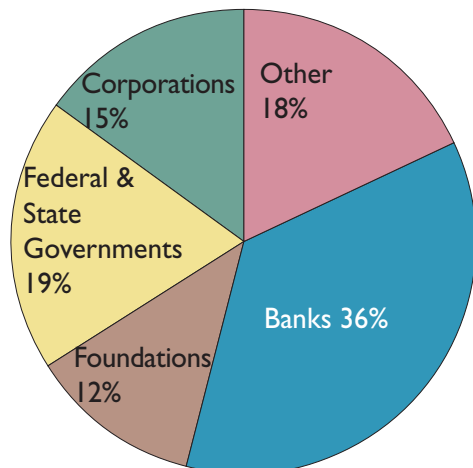
Equity and Debt as a Percentage of Total Capital Contributions Peer Group 1



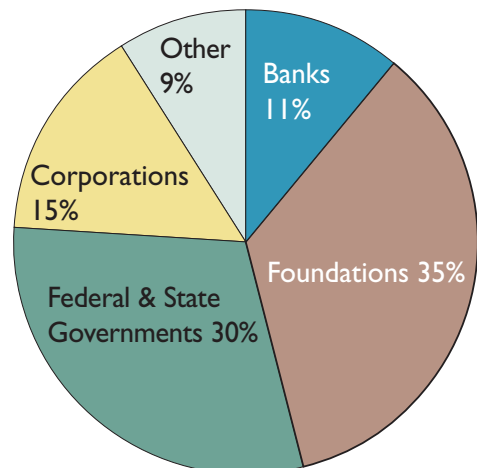
Looking more specifically at where equity contributions come from shows that banks are larger contributors of equity capital than they are of debt to Peer Group 1 funds. Banks accounted for 36 percent of all equity capital, the single largest equity provider. Federal and state governments were the next largest contributor of equity capital and accounted for 19 percent of the total equity. The Department of Treasury's Community Development Financial Institutions Fund (CDFI Fund) is the primary federal agency that capitalizes CDVC funds.

Foundations were the single largest provider of debt capital for Peer Group 1 CDVC funds, and accounted for 35 percent of all debt. Federal and state governments were the next largest source of debt and accounted for another 30 percent. The amount of federal debt dollars is likely to be higher in 2003 thanks to the Small Business Administration's certification of the New

Equity Capital by Source Peer Group 1



Debt Capital by Source Peer Group 1

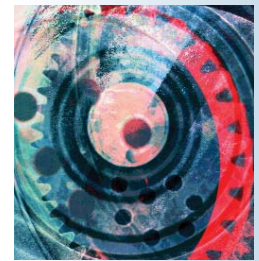


Markets Venture Capital (NMVC) companies. The SBA will guarantee debentures, the proceeds of which are used to match on a roughly dollar-for-dollar basis, the private capital raised by the NMVC companies.

Capitalization: Peer Group 2

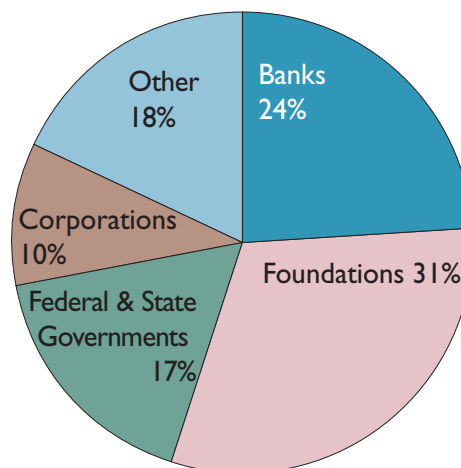
The seven Peer Group 2 CDVC funds were capitalized with a total of \$17.6 million, \$11.6 million in the form of equity, including equity grants for the not-for-profits, and \$6.0 million in the form of debt. Foundations were the largest provider of capital to funds in Peer Group 2, and accounted for 31 percent of the total capital contributions. Banks were the next largest capital provider and accounted for 24 percent of the total. Federal and state governments contributed 17 percent of the total capital and corporations accounted for 10 percent. The remaining 18 percent came from other sources including individuals, parent organizations, and other sources not elsewhere categorized.

Two-thirds of the total capital contributions to the Peer Group 2 CDVC funds came in the form of equity, which includes grants in the case of not-for-profits. Long-term debt, which is borrowed by the fund and then invested into portfolio companies, accounted for 34 percent of total capital.



Foundations were the largest provider of capital to funds in Peer Group 2, and accounted for 31 percent of the total capital contributions.

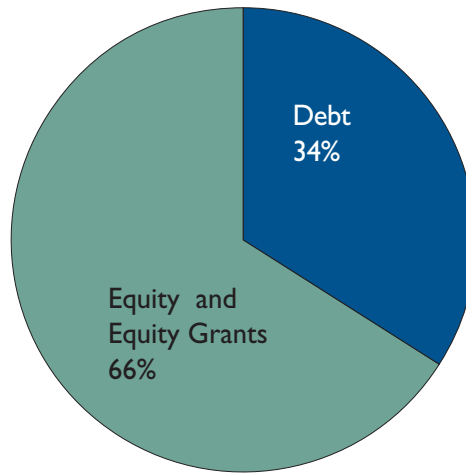
**Capital Contributions by Source
Peer Group 2**





Banks were the second largest capital provider to Peer Group 2 funds and accounted for 24 percent of the total

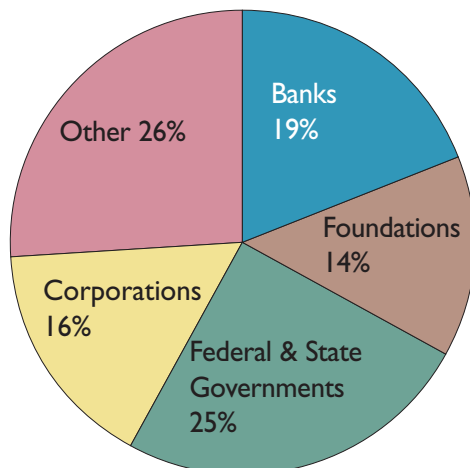
Equity and Debt as a Percentage of Capital Contributions Peer Group 2



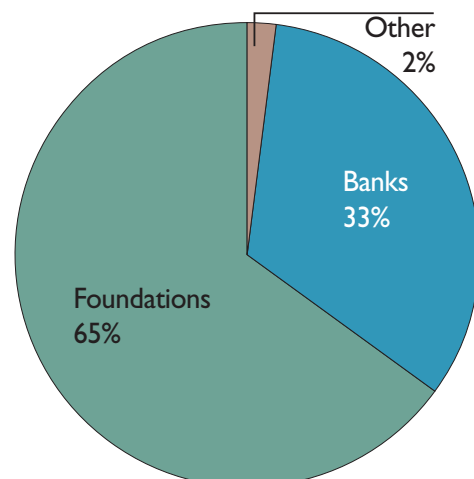
The \$11.6 million of equity capital invested into the seven Peer Group 2 funds came from the following sources: 25 percent came from federal and state governments, 19 percent came from banks, 16 percent from corporations, and 14 percent from foundations. Other sources provided the remaining 26 percent of the equity.

Banks and foundations were the two largest sources for debt capital for the seven Peer Group 2 CDVC funds. Foundations provided 65 percent of the debt capital and banks provided an additional 33 percent. The remaining 2 percent came from other sources.

Equity Capital by Source Peer Group 2



Debt Capital by Source Peer Group 2



FINANCING ACTIVITIES TO 2001: Peer Group 1

At the end of 2001, the 20 Peer Group 1 CDVC funds had \$115.2 million of investments outstanding in 331 portfolio companies. Equity investments accounted for \$69.5 million of that total and debt accounted for \$47.7 million, a portion of which was lent to companies in which the fund also had an equity investment. The average equity investment round was \$321,791, while the average loan outstanding was \$240,446. The average total investment per company was \$348,011.

Investment Activity Outstanding at end of 2001

	\$ Invested	# Rounds	Average Investment per Round
Equity	\$69,506,960	216	\$321,791
Debt	\$45,684,676	190	\$240,446
Sum	\$115,191,637		
Total # of Companies			331
Average Investment per Company			\$348,011



At the end of 2001, the 20 Peer Group 1 CDVC funds had \$115.2 million of investments outstanding in 331 portfolio companies.

Peer Group 1 funds invested a total of \$33.0 million during 2001, \$23.4 million in the form of equity and \$9.6 million in debt. The 20 funds participated in 101 rounds of equity funding, averaging about five investments per year. The average round of equity investments completed during 2001 was \$232,013 per round. The funds made 76 loans over this period, averaging \$125,482 each.

Investment Activity During 2001

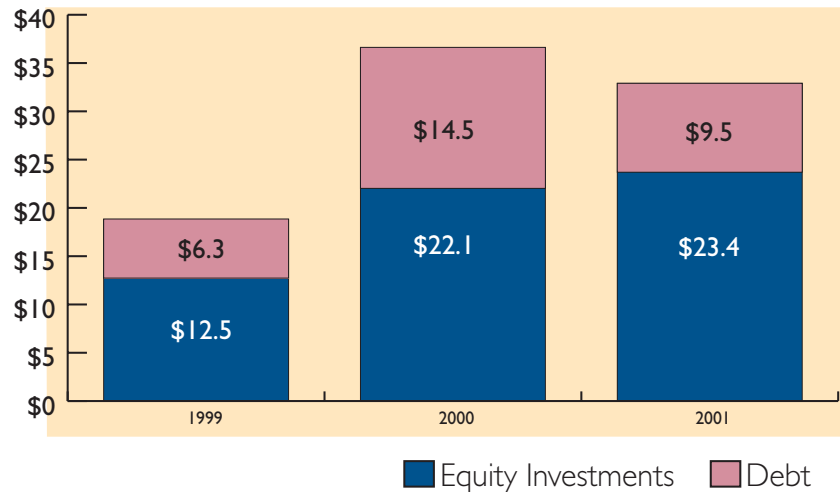
	\$ Invested	# Rounds	Average Investment per Round
Equity	\$23,433,354	101	\$232,013
Debt	\$9,536,623	76	\$125,482



For Peer Group I funds, equity investments rose from \$22.1 million in 2000 to \$23.4 million in 2001.

Peer Group 1 funds' total dollars invested per year dropped slightly from \$36.6 million in 2000 to \$32.9 million in 2001. Equity investments, however, rose from \$22.1 million in 2000 to \$23.4 million in 2001. Despite the slight dip from 2000 to 2001, total dollars invested in 2001 were still 76 percent higher in 2001 than in 1999. By comparison, traditional VC investments in 2001 were 25 percent below their 1999 level.⁷

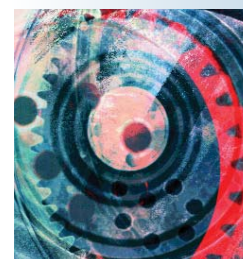
**Investment Activities During the Year by Type
Peer Group I, 1999 to 2001 (in millions)**



Peer Group 1 CDVC funds' average per round investment varied over the three-year period 1999 to 2001. In 1999, the average equity investment per round was \$194,710; this number rose in 2000 to \$279,469, and then dropped slightly to \$232,474 in 2001. Average loan size displayed a similar pattern, rising substantially from 1999 to 2000, and then falling slightly from 2000 to 2001. With only three years of data it is too early to say definitively whether average investments per round are on the rise. On the one hand, the data for 2000 and 2001 are both above the 1999 figures and anecdotal information from fund managers suggest an interest in doing larger deals. On the other hand, company valuations have dropped from the frothy days of the late 1990s, which means that VC investors now get the same ownership stake in the company with a substantially smaller investment.

Financing Activities to 2001: Peer Group 2

At the end of 2001, the seven Peer Group 2 CDVC funds had \$10.5 million in investments outstanding, \$7.9 million in the form of equity and \$2.6 million in the form of debt. As noted above, virtually all of Peer Group 2's equity investments were in the form of near-equity with a strong weighting toward debt with revenue participation. The average equity investment per round for equity rounds was \$221,837 and the average debt investment was \$86,267. The average investment per company at the end of 2001 was \$160,215.



At the end of 2001, the seven Peer Group 2 CDVC funds had \$10.5 million in investments outstanding, \$7.9 million in the form of equity.

Investment Activity Outstanding at end of 2001

	\$ Invested	# Rounds	Average Investment per Round
Equity	\$7,986,147	36	\$221,837
Debt	\$2,588,017	30	\$86,267
Sum	\$10,574,164		
Total # of Companies			66
Average Investment per Company			\$160,215

Peer Group 2 funds invested \$1.4 million during 2001, \$515,450 in the form of equity and \$861,109 in the form of debt. The average equity investment by these funds was \$128,863 and the average debt investment was \$86,111.

Investment Activity During 2001

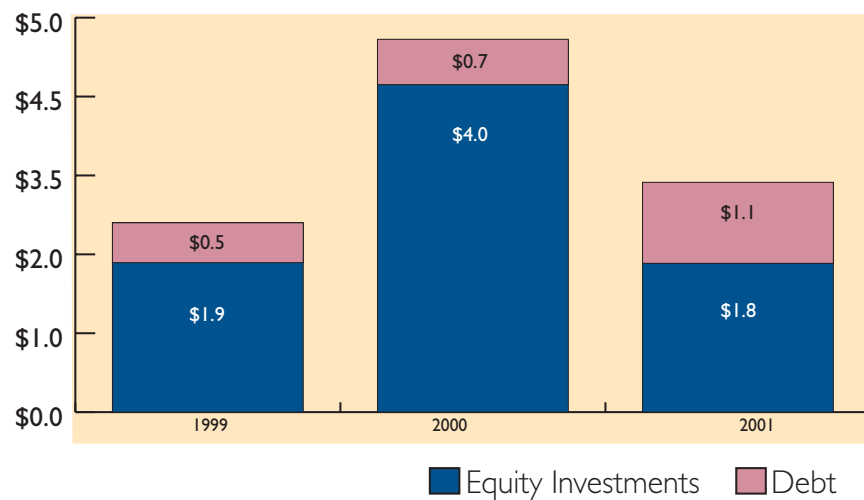
	\$ Invested	# Rounds	Average Investment per Round
Equity	\$515,450	4	\$128,863
Debt	\$861,109	10	\$86,111



Average equity investment size for Peer Group 2 funds has fluctuated over the three-year period 1999 to 2001.

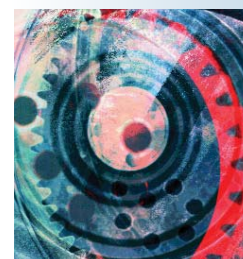
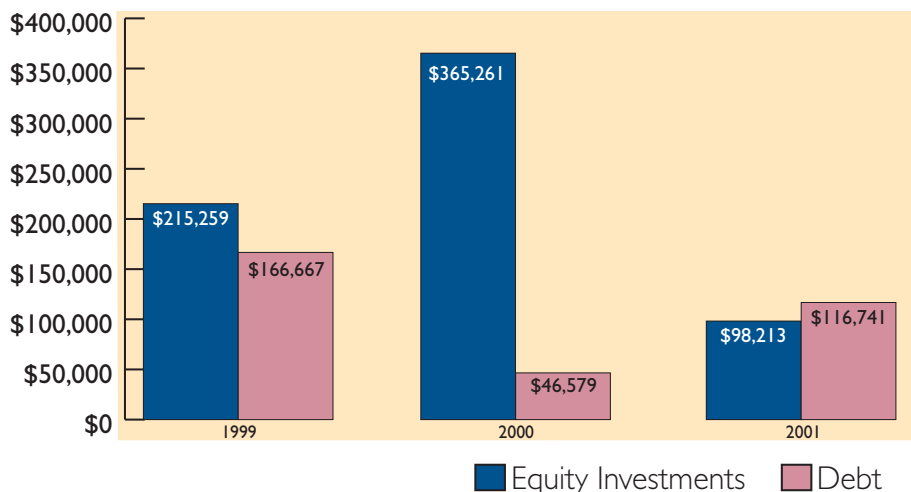
Peer Group 2 funds show a similar trend in investments over the three-year period 1999 to 2001 as Peer Group 1 funds. Total investments per year were \$2.4 million in 1999, rose to \$4.7 million in 2000, and dropped in 2001 to \$2.9 million. Looking specifically at their equity investments, Peer Group 2 funds' investments in 1999 were \$1.9 million, more than doubled to \$4.0 million in 2000, and then fell to \$1.8 million in 2001.

Investment Activity by Type by Year
Peer Group 2 Funds, 1999 to 2001 (in millions)



The size of the average equity investment per round fluctuated over the three-year period. In 2001 the average equity investment per round for Peer Group 2 funds was \$98,213, while in 2000 the average investment per round was \$365,261, and in 1999 it was \$215,259. The dramatic variation is due to the two new funds making only small investments in their first years of operation, and the fact that one fund made two unusually large investments in 2000.

Average Investment Per Round by Type Peer Group 2, 1999 to 2001



CDVC funds cover their operating costs either through a management fee paid by the fund to the managing firm in the case of limited lifespan funds; or, in the cases of a single corporate entity, through current income earned on investment activities and interest earned on idle funds.

INTERNAL OPERATIONS: REVENUES AND EXPENSES

The first section of this report describes two different models of venture capital funds: limited lifespan funds and evergreen funds. The difference between these two models is significant when describing both the costs associated with operating the fund and the revenues that are generated to cover those costs.

Depending on the fund's model, CDVC funds cover their cost of operations either through a management fee paid by the fund to the managing firm in the case of limited lifespan funds; or, in the cases of a single corporate entity, such as a C-corporation or a not-for-profit, through direct use of the fund's capital, current income generated from the fund's investment activities and interest earned on idle funds. In addition, not-for-profit funds and hybrid funds can use grants to help cover the costs associated with providing extensive technical assistance to the small businesses in their portfolio.

Of the twenty Peer Group 1 CDVC funds in the survey, eight were limited lifespan funds and twelve were evergreen funds (six for-profit and six not-for-profit). All seven of the Peer Group 2 funds were organized as evergreen funds. The following sections summarize the operating income and expenses for each of the two Peer Groups for the applicable models.

Peer Group 1—Revenues and Expenses for Limited Lifespan Funds

The seven limited lifespan CDVC funds paid a management fee of between 2.0 and 3.25 percent of committed capital to their managing firms. Fund management fees covered between 13 and 100 percent of the firm's total operating costs, however, the wide range reflects the variety of funding strategies and organizational structures rather than actual differences in the efficiency of one managing firm over another.

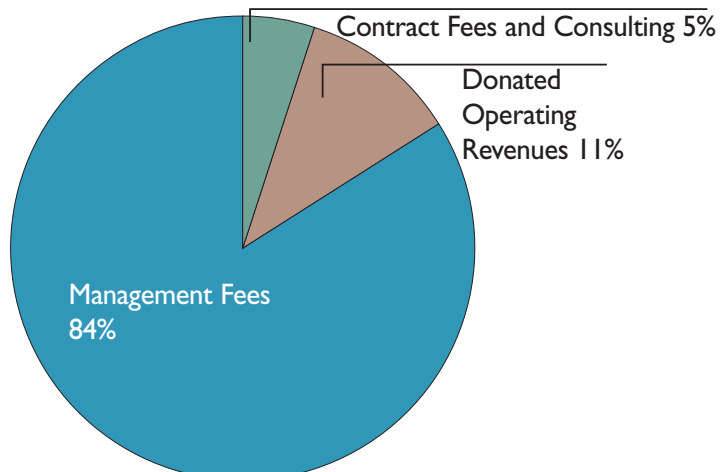


The seven limited lifespan CDVC funds paid a management fee of between 2.0 and 3.25 percent of committed capital to their managing firms.

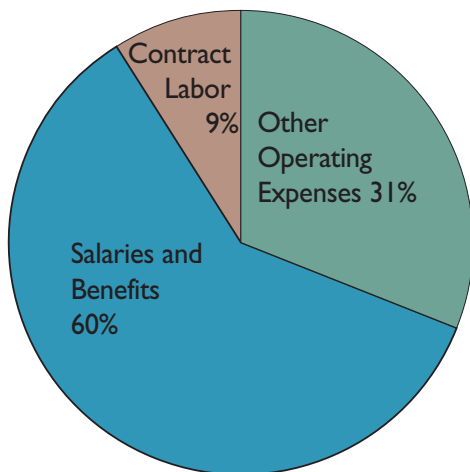
CDVC organizations provide extensive one-on-one technical assistance to their portfolio companies, as well as companies in which they consider making investments. However, some organizations also provide additional business advisory services over and above the responsibilities associated with managing the fund's investment portfolio. These responsibilities can include sponsoring workshops and training programs, organizing business roundtables, and other programs designed to promote, in a general way, the growth of local companies and local entrepreneurial capacity. While most organizations provide these services through the parent or a separate subsidiary under the parent some have chosen to include these activities in the managing firm's responsibilities, with a commensurate increase in the managing firm's staff, revenues, and expenses. In the exhibits that follow, firms that provide business advisory services within the managing firm are excluded from the revenue and expense summaries in order to provide an apples-to-apples comparison.

Management fees are by far the largest source of income for CDVC management firms and accounted for 84 percent of all operating income. Donated revenues accounted for another 11 percent of operating income, while contract and consulting fees charged to portfolio companies accounted for the remaining 5 percent.

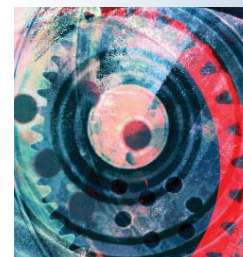
**Managing Firms' Revenues by Category
Limited Lifespan Funds**



**Managing Firms' Expenses by Category
Limited Lifespan Funds**



Managing firms' expenses can be allocated to three categories: salaries and benefits, which accounted for 60 percent of total operating expenses; contract labor, including the firm's accounting and legal service needs, which accounted for 9 percent of operating expenses; and other operating costs, such as overhead, which accounted for 31 percent of total operating costs.



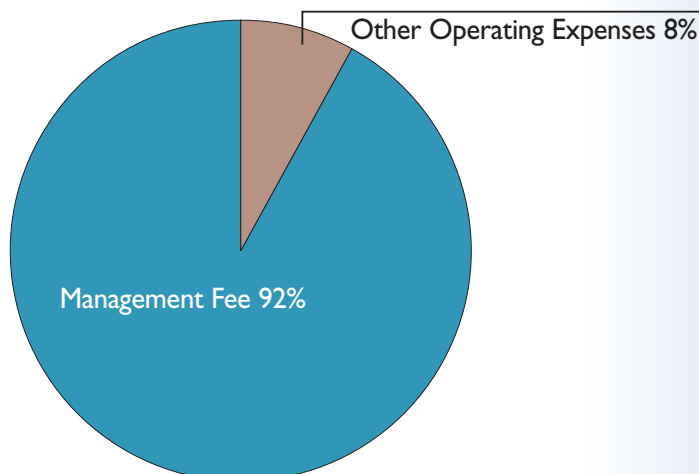
On an unweighted basis, management fees alone covered an average of 72 percent of each firms' total operating expenses and 100 percent or more of each firm's labor costs for all firms but one.

Firms total revenues—management fees, contract fees and consulting, and donated operating revenues—covered 100 percent of total operating expenses for three of the firms, while the remaining three firm's total operating revenues covered between 72 and 90 percent of their total operating costs. Other grants and holding company net income were used to make up the difference between total operating revenues and total operating expenses.

On an unweighted basis, management fees alone covered an average of 72 percent of each firms' total operating expenses and 100 percent or more of each firm's labor costs for all firms but one.

As described above, the firm's primary revenue source is the management fee paid by the fund; it is also the fund's primary expense. Management fees accounted for 92 percent of the fund's expenses; the remaining 8 percent of operating costs incurred by the funds were for various legal and accounting costs and other incidental costs such as bank fees.

**CDVC Funds' Expenses
Limited Lifespan Funds**





Evergreen funds cover their operating costs through current income generated from their investment activities, contract income, grants, and interest earned on cash and marketable securities.

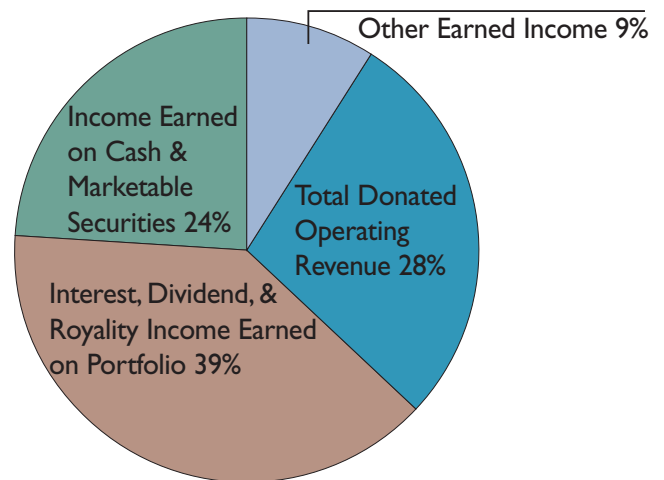
Peer Group 1—Revenues and Expenses for Evergreen Funds

Evergreen funds cover their operating costs through direct use of the fund’s capital, current income generated from their investment activities, contract income, grants, and interest earned on cash and marketable securities.⁸

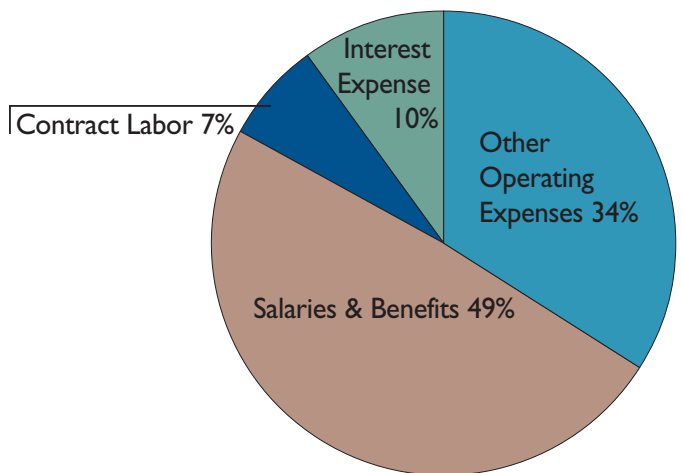
Current income earned on investments—interest, dividends, and royalty income—accounted for 39 percent of the total operating income earned by the 12 evergreen funds. Donated operating revenues was the next largest source of revenue and accounted for 28 percent of all operating income. Income earned on cash and marketable securities accounted for 24 percent of operating income. Contract fees and consulting, financing fees, and other earned income accounted for the remaining 9 percent of operating income.

Salaries and benefits were the single largest expense for the 12 Peer Group 1 evergreen funds and accounted for 49 percent of total operating expenses. Interest expenses on long-term debt were 10 percent of total operating costs, while contract labor, accounting and legal fees, accounted for 7 percent of operating

Operating Revenues for Evergreen Funds Peer Group I



Operating Expenses for Evergreen Funds Peer Group I



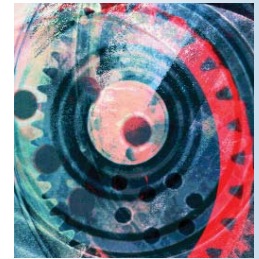
⁸ Technically, two of the twelve evergreen funds paid a management fee to a separate managing firm similar to the limited lifespan model described above. However, the funds themselves are evergreen funds and they are included in this analysis.

expenses. Other operating expenses, which include rent, travel, furniture, supplies, and all other costs not elsewhere classified, accounted for approximately one-third of funds' expenses.

Peer Group 2—Revenues and Expenses for Evergreen Funds

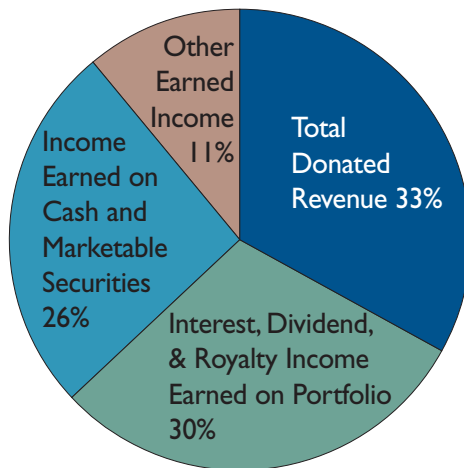
The seven Peer Group 2 funds all operate as evergreen funds, covering their costs of operation through the direct use of capital, current income generated by their investment activities, as well as by interest earned on uninvested capital and grants.

Grant dollars are the primary source of operating revenues for these funds and accounted for 33 percent of all operating revenues. Interest and royalty payments paid on fund investments were the next largest source of revenue and accounted for 30 percent of operating revenues.



Interest and royalty payments paid on fund investments were the second largest source of revenue for Peer Group 2 funds and accounted for 30 percent of operating revenues.

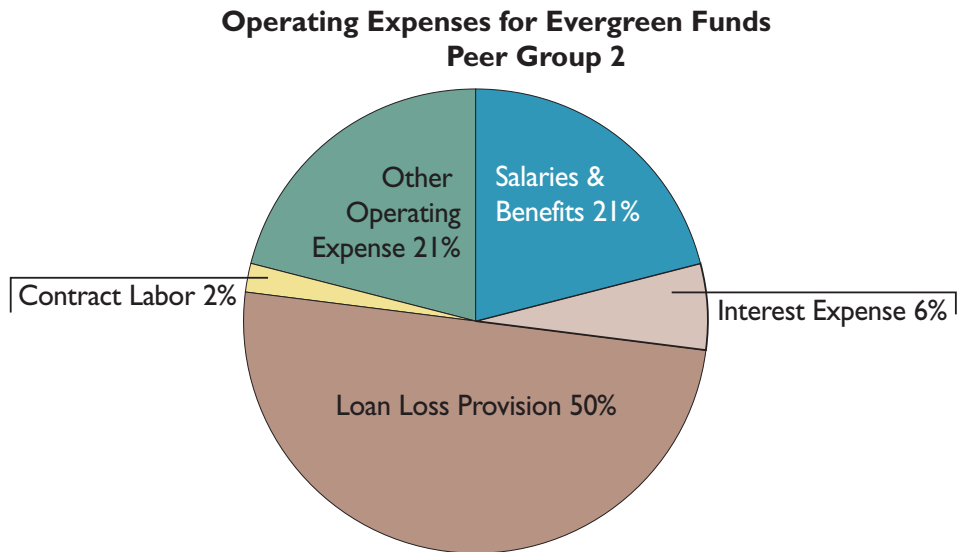
**Operating Revenues for Evergreen Funds
Peer Group 2**





In addition to direct technical assistance, CDVC funds also provide a variety of other services that promote local business growth and help to build the entrepreneurial capacity of the regions in which they invest.

Expenses for Peer Group 2 funds can be allocated across the following categories: salaries and benefits, interest expenses, loan loss provision, contract labor, and other operating expenses. In 2001 loan loss provision was the largest single expense and accounted for 50 percent of total operating expenses. Loan loss provisions are determined by fund managers and reflect the high-risk lending activities pursued by these funds. Salaries and benefits accounted for 21 percent of expenses, while interest expenses accounted for 6 percent. The remaining expenses went to contract labor, 2 percent, and other operating costs, which accounted for 21 percent of total expenses.



TECHNICAL ASSISTANCE

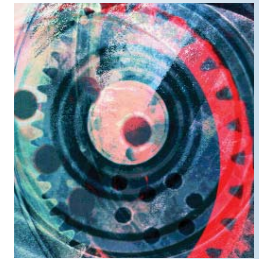
CDVC funds provide a variety of targeted technical assistance (TA) services to the companies in which they make investments, as well as to the many companies in which they consider investing. This one-on-one assistance includes sitting on portfolio company boards, arranging follow-on financing with new investors, working to fill holes in the management team, to name just a few of the activities that fund managers perform for their portfolio companies.

In addition to direct technical assistance, CDVC funds also provide a variety of other services that promote local business growth in a general way, as well as help to build the entrepreneurial capacity of the regions in which they invest. For example, fund managers educate community stakeholders on the role of patient capital and community development venture capital in promoting regional employment growth; some funds provide training programs to local entrepreneurs; some funds organize venture fairs, where local entrepreneurs can pitch their companies to potential investors. Finally, some CDVC funds or their parents sponsor extensive business advisory services

9 National Venture Capital Association 2003 Yearbook (NVCA: Arlington, Virginia) Figures 6.06 and 6.011.

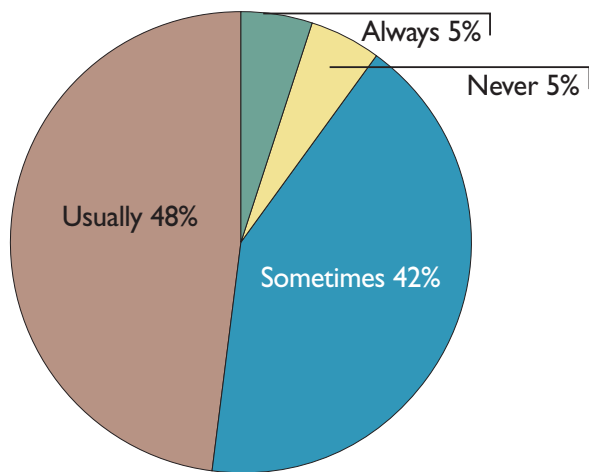
that bring together local experienced business professionals with less experienced entrepreneurs, thereby creating mentoring relationships and promoting local networking.

Sixteen of the Peer Group 1 funds answered questions on technical assistance and reported providing 27,893 hours of one-on-one TA to 381 businesses in 2001, or an average of 73 hours per company. It is difficult to measure the impact of the TA that fund managers provide to their portfolio companies, however, anecdotal information suggests that it is critical to the CDVC investment process. A common assessment among many entrepreneurs is that the TA they receive from the CDVC fund is as valuable as the financing. While the business management expertise is fundamental to venture capital investing in general, it is especially important for CDVC since, in so many instances, the funds are investing where there is virtually no traditional VC activity and where there are oftentimes few entrepreneurial role models.



Peer Group 1 funds provided an average of 73 hours of technical assistance to 381 businesses in 2001.

Fund Staff Serves on Portfolio Company Boards Peer Group 1



One of the ways in which CDVC funds provide technical assistance is by sitting on the boards of their portfolio companies. Among Peer Group 1 funds, 42 percent say that they “sometimes” sit on the boards of their

portfolio companies. Nearly half, 48 percent, of Peer Group 1 funds say that they “usually” sit on their portfolio company boards, and 5 percent said that they “always” sit on their portfolio company boards.

Five of the seven Peer Group 2 funds reported information on the training and technical assistance that they provide. These funds provided 3,154 hours of TA to 139 companies for an average of about 23 hours of TA per company in 2001. In general, Peer Group 2 funds did not sit on the boards of their portfolio companies.

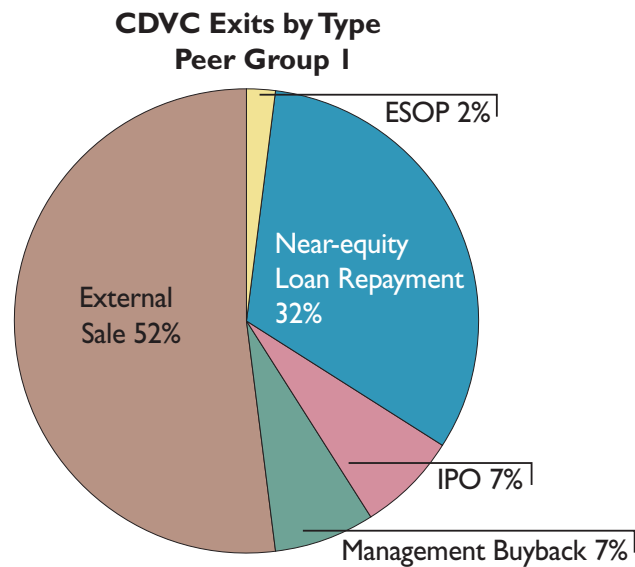
EXITS

CDVC funds realize their returns by selling their ownership stake in the company. This “exit”, as it is called in the industry, can be an external sale to a third party buyer, management buyback, sale to employees in the form of an employee stock ownership plan (ESOP), or an initial public offering (IPO)—the initial sale of the stock into the public equity markets. Near-equity loan repayment is another type of exit.



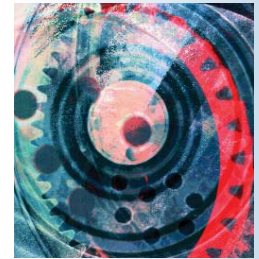
External sale is the most common form of exit for CDVC funds, accounting for 52 percent of all exits reported by Peer Group I funds.

External sale is the most common form of exit for CDVC funds, accounting for 52 percent of all exits reported by Peer Group 1 funds. Near-equity loan repayment was the second most common form of exit and accounted for 32 percent of all exits. Management buyback and IPOs accounted for 7 percent each and ESOPs were the exit vehicle in the remaining 2 percent of exits.

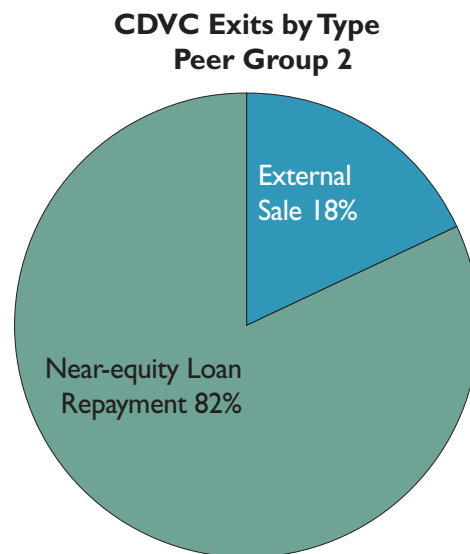


By contrast, traditional VC funds exit their deals through IPOs and mergers and acquisitions (M&As). Over the ten-year period from 1990 to 2000, IPOs accounted for 57 percent of all traditional VC exits and M&As accounted for the remaining 43 percent, according to the National Venture Capital Association. But during 2001 and 2002 IPOs accounted for only 8 percent of exits while M&As accounted for the remaining 92 percent.¹⁰

As described in previous sections, Peer Group 2 funds tend to use near-equity financing instruments and, in particular, debt with revenue participation. As a result, 82 percent of their exits occurred as a near-equity loan repayment and payment of the revenue-based “kicker”. The remaining 18 percent of exits reported by the group were an external sale of the business.



Eighty-two percent of Peer Group 2 fund exits occurred as a near-equity loan repayment and payment of the revenue-based “kicker”.



As described in Section 1, VC investing is a highly cyclical process. Funds make long-term equity investments into small businesses that offer high growth potential. In the traditional VC world, the investment horizon is typically between 4 and 7 years, although it can vary based on the stage of the company as well as the overall market; during the later stages of the market boom of the 1990s funds sometimes exited from their investments in just a couple of years. Such short investment horizons are unlikely to be the case going forward.

SOCIAL RETURNS

CDVC funds pursue a variety of social returns—creating good employment opportunities for low-income persons, building the entrepreneurial capacity of distressed regions, and growing wealth in low-income communities, to name a few of the primary goals.



CDVC investments made into portfolio companies during 2001 helped to maintain 7,018 jobs and the job growth at these portfolio companies increased 5.7 percent over the year.

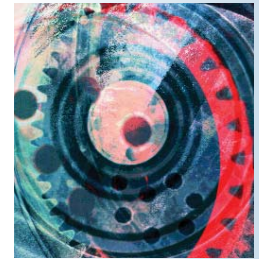
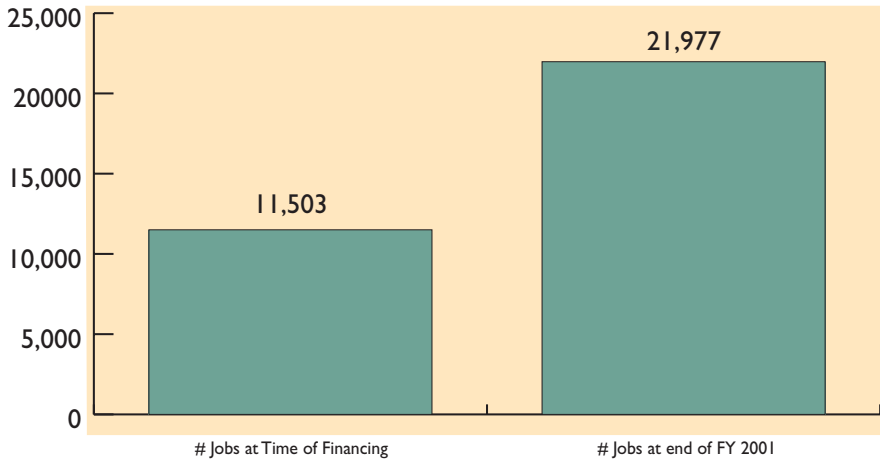
The survey asked funds about the number of jobs maintained and created in the companies in which the funds invested. These employment measures are the most common social impact measures and are used by virtually all funds. This section presents the data for all funds that tracked jobs, including both Peer 1 and Peer 2 funds. Job impacts, which include jobs maintained and net jobs added after financing, were measured for both the short term and long term. Short term job impacts include only companies that received financing during 2001—the number of jobs in the company at the time of the financing and the number of jobs in those companies at the end of the year; long term job impacts are based on all financings regardless of year of initial investment and include all businesses in the portfolio at the end of 2001.

Short-term job impacts were substantial: in CDVC investments made into portfolio companies during 2001 helped to maintain 7,018 jobs. Job growth over the year at these portfolio companies was 5.7 percent.

Looking at all companies in the funds' portfolios regardless of year-financed shows substantial increases in the number of jobs in portfolio companies since receiving their first CDVC investment. For the 18 funds reporting job change numbers, net job change increased 91.1 percent—portfolio companies collectively had 21,977 jobs at the end of 2001, up from 11,503 jobs in those same companies when they received their first investment.

Job Change at Portfolio Companies from Financing Activities Since Inception

For the 12 funds that reported information on low-income job impacts.

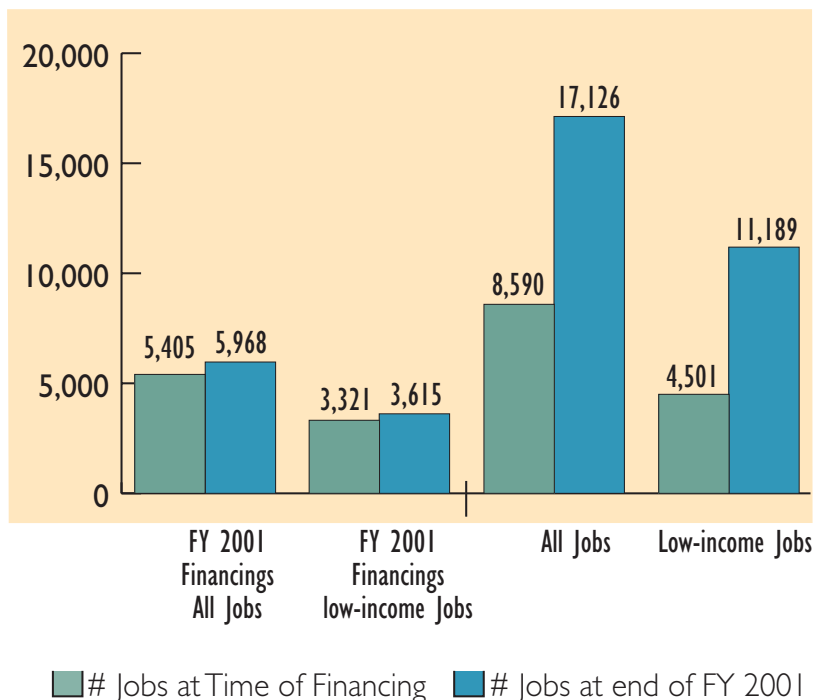


Total employment at all CDVC portfolio companies grew 99 percent for all companies financed through 2001, while the number of jobs for low-income persons at these same companies grew 149 percent.

CDVC funds are particularly interested in promoting job opportunities for low-income persons and 12 of the 18 funds specifically track job opportunities for low-income persons. The chart below presents the numbers for this subset of twelve.

Job Change from Financing Activities

(For the 12 respondents who reported low-income job impacts)





Including write-offs and losses, the most mature CDVC fund portfolios appear to be producing net IRRs between 8 and 12 percent.

Looking first at long-term net job change, the right hand side of the chart on the previous page shows that employment grew from 8,590 total jobs at the time of initial investment to 17,126 jobs at the end of 2001. For low-income job change the number of jobs grew from 4,501 jobs to 11,189 low-income jobs. For short-term net job change, the left hand side of the chart shows that the total number of jobs in companies financed during 2001 was 5,405 and the total number of jobs at the end of the year was 5,968.

These job change numbers reveal several significant facts about CDVC investing and the types of companies in which CDVC funds invest. First, comparing the rate of job change for all jobs versus the rate of change for low-income jobs shows that these companies add jobs for low-income persons at a much higher rate than they add jobs in total. Total employment at these companies grew 99 percent for all financing activities through 2001, while the number of jobs for low-income persons grew at a much higher rate—149 percent. (Excluding low-income jobs from the total jobs, non-LMI job change increased 45 percent from the time of first investment to the end of 2001.)

A second fact is that low-income job change is a long-term impact of CDVC and does not typically show up in the earliest years of the investment. Looking at the left hand side of on the previous page shows short term job creation is nearly the same for both low-income and non-low-income jobs. Portfolio companies experienced a 10 percent increase in the total number of jobs (from 5,405 to 5,968) and a 9 percent increase in the number of jobs for low-income persons (from 3,321 to 3,615) during the first year of the investment. Non-low-income job change increased 13 percent over the period. The results show that early hires are more likely to be professional positions, as the companies expand and enhance their management teams before moving to create entry-level positions.

FINANCIAL RETURNS

The cyclical nature of VC investing and the J-shape of the profit curve make it impossible to know the financial returns of CDVC funds to investors based on the first few years of the fund's life. However, a few older funds reported gross internal rates of return (IRR) of up to 60 percent on individual successful investments and the unweighted average IRR on these exits was 22 percent. These are gross IRRs earned by the fund on a limited number of investments, excluding write offs, and they do not represent returns to investors. Including write-offs and losses, the most mature fund CDVC portfolios appear to be producing gross IRRs between 8 and 12 percent.



About CDVCA

The Community Development Venture Capital Alliance (CDVCA) is the trade association for domestic and international community development venture capital funds. CDVCA promotes use of the tools of venture capital to create jobs, entrepreneurial capacity and wealth to advance the livelihoods of low-income people and the economies of distressed communities.

CDVCA works on many fronts to build, strengthen and support the community development venture capital (CDVC) field.



CDVCA:

- ◆ Promotes best practices and advances the skills of professionals in the field through training programs, publications, networking opportunities, and direct consulting services.
- ◆ Operates a Central Fund that makes investments in member funds and co-investments with other funds in businesses to create jobs for low-income people.
- ◆ Serves as the global resource for information and research on the CDVC field.
- ◆ Advocates for legislation and changes in regulations that will benefit CDVC funds and the communities they serve.
- ◆ Serves as the voice for the CDVC industry in the U.S. and around the world, increasing the visibility of our member funds and for the importance of the global CDVC field.
- ◆ Works to encourage the traditional venture capital and angel capital communities to become more active in community development finance.

The first part of the document discusses the importance of maintaining accurate records of all transactions. This includes not only sales and purchases but also any other financial activities that may occur during the course of the business. Proper record-keeping is essential for determining the true financial position of the company at any given time.

In addition to record-keeping, it is also important to have a clear understanding of the company's financial goals and objectives. This will help to guide decision-making and ensure that the company is on track to achieve its long-term success.

Finally, it is important to have a strong understanding of the company's financial statements. This includes the balance sheet, income statement, and cash flow statement. These statements provide a detailed view of the company's financial performance and are essential for making informed decisions about the future of the business.

By following these guidelines, you can ensure that your company's financial records are accurate and up-to-date. This will help you to make better financial decisions and ensure the long-term success of your business.

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