# A Vision for the Future of Rural Developmental Venture Capital

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The era of recruiting smokestack industries and getting deep subsidies from the federal government to revitalize local economies is over. The economic future of struggling economies across the country will come from those communities themselves, based on local assets, local ideas, and driven by local entrepreneurs. To spark this growth, rural communities will need community development venture capital (CDVC) to help bring them back into the economic mainstream. At Kentucky Highlands Investment Corporation (KHIC), we know there is opportunity in rural places, because we see good deals go unfunded every day.

## How Do We Get From Here to There?

Currently, rural economies are inadequately served by venture capital. As noted in other articles in this *Review*, traditional venture capital is concentrated in very few places. While the venture capital industry in the United States is generally very robust, rural areas have not benefited from the activity in the broader venture capital industry. Pricewaterhouse Coopers reports that the vast majority of U.S. venture capital for the 2nd quarter of 2006 was invested in urban areas. Almost 50% went to Silicon Valley and urban New England, as these areas received approximately $3 billion out of the $6.3 billion total invested.

There are many exceptions to this overall trend, however. Rural CDVC firms like ourselves, state-sponsored venture funds, and a growing number of angel investors are making local investments in their local entrepreneurs. But there are many obstacles to this work. The road ahead for rural CDVC is difficult and made even tougher by some significant challenges that include:

- Insufficient or nonexistent funding of innovative federal programs such as The Small Business Investment Company program, as well as the New Markets Venture Capital program, and the Rural Business Investment Program;
- Potentially waning interest from traditional financial backers, including national and regional banks, and foundations;
- A stalled policy environment at the federal level;
- The difficulty in attracting capital from nontraditional sources, such as pension funds, or university endowments;
- No substantial delivery vehicle to aggregate and invest the needed capital;

- The lingering perception from the prospective investor base that rural investment is too risky and that there is not a significantly developed entrepreneurial mentality outside of the farm-focused farming community;
- Substantially less investment capital, particularly equity, available in rural areas than in traditional venture capital markets;
- The pool of entrepreneurs that is neither as broad nor as deep in rural areas as it is in traditional venture capital markets; and
- The lack of the infrastructure required to support the growth of venture capital and venture-backed companies in rural areas, which means rural companies generally only have limited access to sophisticated and knowledgeable consultants (lawyers, accountants, executive recruiters, and employee support services).

In spite of these obstacles, there are strong trends that point to a future where rural CDVC unleashes the energy of rural entrepreneurs. Rural areas are becoming a richer investing environment thanks to: (1) new technological breakthroughs, (2) the promise of leveraging local intellectual resources such as universities or government laboratories, and (3) "in-sourcing" of jobs from areas with higher living costs (as opposed to sending those jobs overseas).

Generally speaking, some of the greatest opportunities for venture capital investment in rural areas involve technology-based companies that are focused on overcoming infrastructure limitations. For example, the need to improve the delivery of healthcare and related services represents a wellspring of business opportunities in rural areas. Similar opportunity can be found in the need to bring broadband wireless communication and the Internet to rural communities lacking a wired infrastructure. Going one step further, companies that are leveraging the Internet and/or wireless technology (broadband or otherwise) in rural areas are creating some compelling businesses.

In Etowah, Tennessee (population 3800), for example, a company named NuMarkets leveraged the Internet to create a business that allows people in rural east Tennessee to sell consigned products via eBay and similar on-line venues to people all over the world. Antique cash registers that historically had been peddled by a local seller only to local customers or to antiquing tourists driving through Etowah are now sold to buyers throughout the United States and even Europe at prices that are substantially higher than what was once thought possible in Etowah. Tens of thousand of items as unique as antique tractor seats have been found to be in demand as far away as Canada, Europe, Asia, and South America, but that fact was unknown before NuMarkets opened its doors for business and created a conduit for revenue to flow into rural east Tennessee from all over the world. While rural markets frequently are not large enough in and of themselves to support companies in rural areas, the increasing globalization of the economy and the constant shrinking of the world due to technology advances create new opportunities for rural companies that traditionally may have been somewhat isolated or cut-off from large markets.

Universities and similar institutions (for example, national laboratories and community colleges) in rural areas are becoming increasingly proactive and aggressive as engines of economic development and business creation. These institutions not only generate technology that can become the basis of products or services for rural companies, but they can provide access to special equipment and facilities, as well as technical and business know-how to supplement organic know-how in rural companies. For example, SemiSouth Laboratories, Inc. in Starkville, Mississippi was spun out of Mississippi State University (MSU) by two entrepreneurial faculty members. SemiSouth is a leading developer and manufacturer of silicon carbide electronics and electronic material. Silicon carbide (SiC) is a high-power, high-temperature, rad-hard semiconductor being developed and brought to market for exciting new radar, power conversion, and space applications. Applicability in these markets is driven by SiC's power density, stability in harsh environments and thermal tolerance. Specific electronic components that can be made of SiC include power switches, power rectifiers, RF transistors, and sensors. MSU has become the technology center of an evolving cluster of silicon carbide semiconductor companies in rural Mississippi, and MSU seems to understand the myriad benefits to be derived from its active engagement in the company creation process.

Oak Ridge National Laboratory (ORNL) in rural east Tennessee has explicitly and publicly stated a desire to leverage its world-class research and development facilities to spawn and support nanotechnology-based companies. Using discretionary funding derived from the licensing of technology developed by its researchers, ORNL has even provided direct financial support to the Center for Entrepreneurial Growth, a virtual incubator in rural east Tennessee, and ORNL has unveiled plans to locate a technology business incubator physically on the ORNL campus.

The concept of "in-sourcing" or "rural sourcing" seems to be gaining momentum as companies look for ways to out-source in a cost effective manner, while avoiding some of the issues that may be associated with sending work and jobs outside the United States. For example, Mid South Electronics, Inc., in rural East Kentucky, is an electro-mechanical manufacturer of subassemblies for the appliance industry. The vast majority of this type work is moving offshore in search of cheaper labor. Mid South, however, has found a profitable niche where it can provide a quick turnaround on shorter production runs. Mid South is very important to companies like General Electric that sources the majority of its product offshore.

## Ways to Keep the Momentum Going for Positive Trends

There are a number of changes that are necessary to make sure these trends continue. Some changes require both a continuation and expansion of promising public policies. Others speak to the need to foster a more entrepreneurial culture in rural areas. And still others are as simple as success will breed success.

There are a number of policy strategies that are promoting a future where rural CDVC helps struggling rural economies. In 2002 Congress approved a farm bill that included the creation of the Rural Business Investment Program. Within that legislation, a provision was made to start Rural Business Investment Companies (RBICs). RBICs are modeled after the

SBA's Small Business Investment Company and New Markets Venture Capital programs but are targeted primarily to rural America. The program provides for 300 percent leverage of private capital through the use of federally guaranteed, discounted debentures. In other words, for one dollar of private capital (called "regulatory capital") raised by a licensed RBIC, that RBIC can borrow three dollars that will be guaranteed by the USDA. The debentures are "discounted debentures" because five years of interest is deducted on a pre-paid basis, allowing the net proceeds to be invested as equity because there is not a need to generate current income to service interest payments.

The current administration issued a Notice of Funds Availability on June 8, 2004 that would create three RBICs after a national competition. Two applications received "conditional" approval on June 1, 2005, and the two funds were given one calendar year to raise their regulatory capital of $10 million. Only Meritus Ventures, L.P. successfully raised its regulatory capital and was licensed in September 2006.

The Community Development Venture Capital Alliance (CDVCA) is strongly advocating for the inclusion of the RBIC program in the 2007 Farm Bill. Senator Tom Harkin (D-IA) will head the Senate Agriculture Committee in January. He is a strong RBIC advocate and will be a key player in deciding the structure of the 2007 Farm Bill. It is important that additional RBIC's be formed throughout rural America, so that key legislators can point to the success of the RBICs in their home states.

Another key component of rural private equity becoming available is the Farm Credit System. In early 2007, the USAgBank will hold a training program for the System's Chief Executive Officers. The Farm Credit Administration is permitting System institutions to get more actively involved in investing in rural economic development activities, including venture capital.

And some state governments are making important contributions to rural CDVC development. In Arkansas and Oklahoma, state legislatures have produced legislation that has led to the creation of "fund of funds" targeting regional venture funds, but the same cannot be said for a number of similar, rural states.

## More than Just Government: Finding New Sources of Capital

A number of organizations in rural areas have recognized the need to support the process of creating companies that have the potential to attract outside investment and grow successfully. Examples of these types of organizations include Technology 2020 in Tennessee, Kentucky Science and Technology Corporation, Advantage West in North Carolina, Mississippi Technology Alliance, and Arkansas Capital Corporation Group. These groups often sponsor venture forums, manage physical or virtual incubators, provide coaching or mentoring support to budding companies and entrepreneurs, and generally work to facilitate introductions between companies and prospective sources of outside capital.

Similarly, some of the large pension funds (e.g., state and municipal pension funds) and university endowments in rural areas must become active investors in rural-focused venture funds.

Colleges and universities are in a position to donate more than just good ideas and well-trained employees; they are trustees of large pools of capital in their endowments. The University of Kentucky, whose president is a serial entrepreneur, has invested in rural-focused venture funds. These investments from endowments remain generally the exception and not the rule despite the potential multi-faceted benefits to universities in rural states seeking not only to grow their endowments but also to create companies and jobs to "keep the best and brightest" closer to home after graduation.

## Changing the Rural Culture to Foster Economic Innovation

Making rural areas more fertile ground for venture capital investment will require developing a culture that is conducive to the creation and nurturing of entrepreneurs. Venture capital, whether in Silicon Valley, along Route 128, in Austin, TX, or in rural areas of the country, is a tool in the hands of an entrepreneur. Educational and research institutions, banks, foundations, endowments, economic development entities, and venture funds are supporters of entrepreneurial activity. The most important players in the company creation and growth process are the entrepreneurs. Without an energetic, hopeful, capable entrepreneur driving a business, the supporting infrastructure has little likelihood of producing profit-generating, job-producing, shareholder-enriching companies.

While some might suggest entrepreneurs cannot be created, and people must be, in fact, born with an entrepreneurial gene, it clearly stands to reason that communities that don't teach the concept of entrepreneurism are less likely to produce entrepreneurs. Communities that do not celebrate successful entrepreneurs or that unduly criticize those who start business that ultimately aren't successful are less likely to produce entrepreneurs.

Rural communities must establish entrepreneurial support and education systems. This concept goes far beyond building a "bricks-and-mortar" incubator and may not, in fact, even include the creation of facilities or buildings. Putting a person in an office building doesn't make him or her an entrepreneur any more than putting that same person in a garage makes him or her a car. Universities and community colleges, and even high schools, in rural areas should include entrepreneurism in their curriculum. At the Kentucky Entrepreneurship Coaches Institute, Joseph A. Kayne, the Cintas Endowed Chair of Entrepreneurship at Miami University of Ohio, presented the following sobering perspective: "Government (federal, state, and local) spends $18 - $20 billion every year on economic development, excluding tax incentives. However, it is estimated that less than 2 percent of that expenditure supports the development of new entrepreneurs."

A multi-semester course on technology-based entrepreneurship was offered at the University of Tennessee in Knoxville several years ago, and produced half a dozen technology-based start-up companies. One of those companies, Protein Discovery, successfully raised two rounds of venture capital, attracted experienced senior management team members from the West Coast, and is currently alive and growing in a low-income area in east Tennessee.

Fund management teams in rural areas must be willing to roll up their sleeves and work to find quality investments and to support, coach, mentor, manage, and nurture those investments once they are made. Generally speaking, there is little (if any) low hanging fruit to be found with respect to investment opportunities in the typical rural setting. Opportunities can be found, but doing so requires a degree of sifting and searching on the part of fund management teams. Once opportunities are identified, a venture investor in a rural setting will likely find that he must invest substantial time educating the entrepreneur in the prospective investee company about the venture capital process. Once an investment is made, the venture capitalist will likely invest time and energy introducing the company to networks of contacts that can be helpful to the company and must be committed on an ongoing basis to support the maturation of the management team, as well as future fundraising efforts. Being a venture capitalist in Silicon Valley entails a vastly different job description than it does in rural areas of the country, despite the fact that the job title is the same. Succeeding as a venture capital investor in rural areas will require the same financial discipline as is required in more traditional markets, and the industry must be able to attract or create fund management teams that recognize this fact, but it will also require a different degree of engagement.

### Success Breeds Success

A vital aspect to managing the future of rural CDVC is to make sure that all the interests in the activity–entrepreneurs, investors (for-profit, public, and socially-motivated), and communities–are considered. But in the end, rural CDVC funds must make money. Short-term job creation is not a substitute for long-term financial viability. At the end of the day, profit-producing, self-sustaining companies will create jobs and increase wealth in rural areas. Investors in rural-focused venture capital funds will need to invest in fund management teams that can successfully raise capital, deploy it in a manner that produces positive returns for the investors, and subsequently raise more capital. In other words, rural development venture capital funds will have to be able to successfully execute the same cycle that traditional venture funds must execute.

Ultimately, when investors are ready to make investments in rural-focused venture funds, it is imperative that those investments be made in capable and qualified management teams. Rural developmental venture capital will have a short lifespan if the management teams that are deploying the capital are not capable of producing returns that warrant continued and increasing investment by successful investors. To that end, it is critical that practitioners in the industry ensure that key legislators understand the necessity of building capacity in the ranks of rural venture fund managers, so an adequate cadre of professionally trained and experienced rural venture fund managers are available to aggregate and manage capital targeted for investment in rural areas.

## Conclusion

Participation in the "new economy" requires an understanding of current realities. It is a truism that most new jobs in America today are created by small businesses, and small businesses are created by entrepreneurs. Growing small businesses and creating jobs and wealth in rural areas will require the availability of capital to be used as a tool in the hands of entrepreneurs, and the proficiency with which that tool is utilized can be improved and accelerated by including professionally-managed, rural-focused venture capital funds in the process.

Our rural communities are standing at the fork in a road. One path, one of underinvestment, leads to a future that is marked by a vicious cycle of out-migration of jobs, capital, and people. Those who are left behind will be forced to struggle in a place that is increasingly cut off from its metropolitan neighbors. Another path takes stock in the assets and ideas that all communities have, and invests capital in them to generate growth, high-paying jobs, and a more viable economic future. We know rural CDCV is a tool that can help rural communities reach their economic potential. Our challenge now is to make sure all rural communities have the chance to choose the path toward economic growth.

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