

# Community Development Venture Capital: A Strategy for Rural America

*By Kerwin Tesdell*

Community development venture capital (CDVC) funds focus their equity investments in underinvested markets, often in rural areas. CDVC funds provide attractive financial returns to investors, and at the same time are a powerful force for economic growth and job creation. Venture capital is in short supply in rural America. Traditional venture capitalists talk privately about the “one-plane” rule: if they have to change planes to visit an investment, they are loath to make the trip. What happens when visiting a prospective investment requires not only changing planes, but also renting a car after landing for a two-hour drive? To quantify an answer, the Community Development Venture Capital Alliance (CDVCA) geocoded a broad database of businesses receiving investments from traditional venture capital funds. We found that less than one percent of the investments were made in rural areas. By comparison, our database of CDVC investments shows a much healthier level of rural investment—about the same proportion of rural to non-rural investments as the overall number of businesses in these locations.<sup>1</sup>

CDVC funds focus on markets where other venture capitalists typically do not compete. Rather than participating in bidding wars for pieces of Silicon Valley high-tech firms, rural CDVC funds nurture long-term relationships with entrepreneurs in their regions. When an excellent investment opportunity arises, they have the relationship to capture the investment at a favorable valuation on attractive terms. CDVC fund managers have deep ties to their communities and markets, where they have the capacity not only to pick winning investments, but also to add significant value to investee companies. They sit on the boards of these companies, and help with strategic planning, marketing, lining up additional financing, and anything else necessary to make the businesses in which they invest successful. After all, they are financial partners in these businesses. Traditional venture capitalist funds from outside of a CDVC fund’s region are often eager to co-invest with a CDVC fund—despite the required plane change—knowing that they have a dedicated and knowledgeable local investment partner.

Investors are finding that community development venture capital funds can offer attractive financial returns and diversity for their investment portfolios. The CDVC industry is still young, so the newer, traditionally-structured limited partnership and LLC funds have not completed their investment and harvest cycles. Early exits, however, indicate the potential for excellent financial results. A CDVCA study of a portfolio of exits (including all

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<sup>1</sup> CDVCA. “Assessing the Availability of Venture Capital in the US: A Preliminary Analysis.” (2003); “Most Venture Capital Flows to a Handful of States.” *Wall Street Journal* 5 Nov. 2002: B3.

write-offs) achieved by three older, not-for-profit, perpetual-life CDVC funds yielded a 15.5 percent internal rate of return.<sup>2</sup> Higher returns may be expected from the newer, traditionally-structured funds, under pressure from investors to exit in a timely manner and to provide superior returns. The positive judgment of investors is demonstrated by funds operated by management groups such as Coastal Venture Partners in Maine, Kentucky Highlands/Tech 2020 in Kentucky and Tennessee, and Adena Ventures in Ohio, as well as a number of more urban CDVC funds. They are successfully attracting increasingly larger and more sophisticated investor groups, as they raise larger second and third funds.

For banks, CDVC funds can offer a particularly attractive investment opportunity. In addition to satisfying the CRA Investment Test, CDVC funds can be an important economic partner, helping banks to develop their business lending markets. Fast-growing ventures nurtured by CDVC funds are excellent future lending clients. And once CDVC portfolio companies have reached a level of maturity that can accommodate senior debt, venture capital equity investments are often accompanied directly by larger bank loans. Every banker knows the importance of the ratio of equity to debt in making senior lending possible, and venture capital funds provide the vital commodity of equity capital.

The term “community development” evokes inner-city urban communities, where community development corporations develop low-income housing and address other social needs. But the pioneers of community development venture capital are rural funds, and still many of the most experienced and accomplished CDVC funds focus on rural markets. Business development and job creation are at the heart of the rural agenda to promote economic well-being. However, in many cases, this involves smokestack-chasing: state and local governments luring large companies or manufacturing plants to a small community for the jobs they bring. All too often, this zero-sum strategy just moves jobs from one community to another, and job gains ultimately prove temporary, as these highly mobile companies move on to the next opportunity to take advantage of tax breaks and low wages, either in the U.S. or abroad. By contrast, CDVC funds nurture indigenous entrepreneurs—individuals with deep roots in communities who build fast-growing and lasting business enterprises tied to a local labor force. The positive-sum CDVC strategy creates permanent jobs and indigenous wealth, deeply rooted in rural communities.

*Kerwin Tesdell is the president of the Community Development Venture Capital Alliance, a network of venture capital funds that provide equity financing for rapidly growing businesses in underinvested rural and urban areas in the United States and throughout the world. He is also an adjunct professor at New York University, where he teaches courses in double bottom line finance at the business school and community development law at the law school.*

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<sup>2</sup> CDVCA. “CDVCA Report on the Industry 2004.” (2005)