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Options for Investors in Microenterprise: The Role of Community Capitalism

by
Michael Stegman,
Center for Community Capitalism
University of North Carolina at Chapel Hill
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Origins of Center for Community Capitalism at UNC

- Founded in 1997, CCC stems from my work at HUD on president's national urban policy report in 1995

"Poor communities represent an untapped economic opportunity for our whole country. While we work together to open foreign markets abroad to American-made goods and services, we also need to work together to open the economic frontiers of poor communities here at home…"

President Bill Clinton, August 1995

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Community Capitalism's Guiding Principles

1. In Community Capitalism, business *supported* by *the government* and community sectors, drives investment, job creation, and economic opportunities in distressed communities;
2. Urban neighborhoods are profiled by measures of economic strength rather than social pathologies;
3. Promising inner-city entrepreneurs have access to capital;
4. Corporations make inner-city investment decisions for business reasons instead of charity.

CC has Real Policy Implications

- The Low Income Housing Tax Credit vs. the New Market Tax Credit
- Brownfields tax credit – helps compensate for cleaning up site, but can't use it unless underlying development has strong market potential;
- Deep federal subsidies that don't leverage private at-risk capital are neither sustainable, nor have the potential to achieve scale.

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Differences between NMTC & LIHTC reflect "Marketization" of CD finance

NMTC

Tax credit parameters:
- Taken over 7 years
- 39% nominal value
- Based on QEI in CDE
- May not be tied to specific project, and credit may not be enough to generate adequate returns
- Potentially large recapture risks—based on QLICIs, reinvestment, etc.
- Targeted to QLICIs in low income neighborhoods
- Must invest in QLICIs—broadly defined
- Flexible CDE investment strategies
  - Direct equity investment
  - Direct loans
  - Purchasing loan pools

LIHTC

Tax Credit parameters
- Taken over 10 years
- 90% nominal value (~70% PV)
- Based on project cost basis
- For many projects, credit is sufficient to meet equity needs & generate sufficient IRR based on cash flow
- Targeted to LMI families
- Modest recapture risk—based on tenant compliance
- Must rent to income eligible households – maintain income targeting
- Less flexibility – rental housing only

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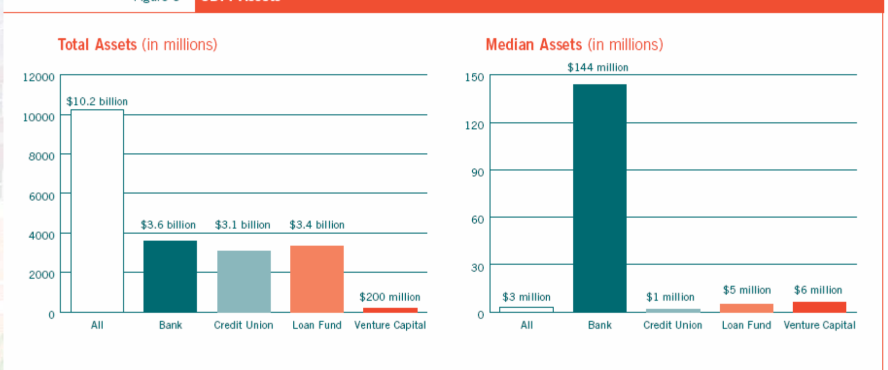
The CDFI industry is tiny

Figure 6 CDFI Assets



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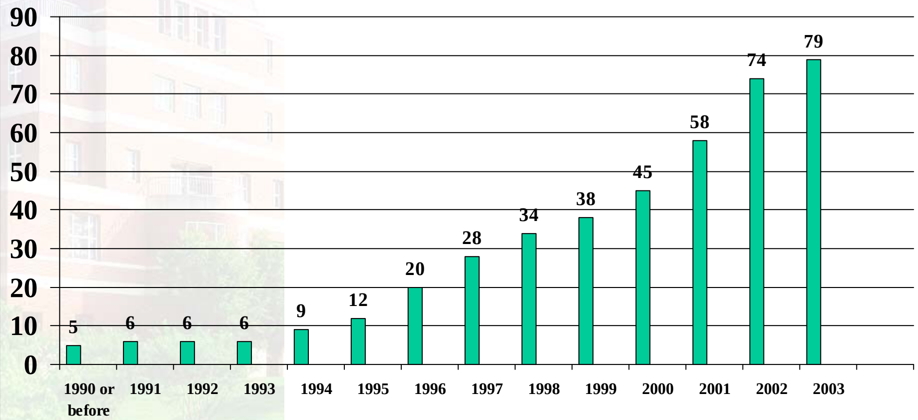
Number of CDVC funds 1990 to 2003



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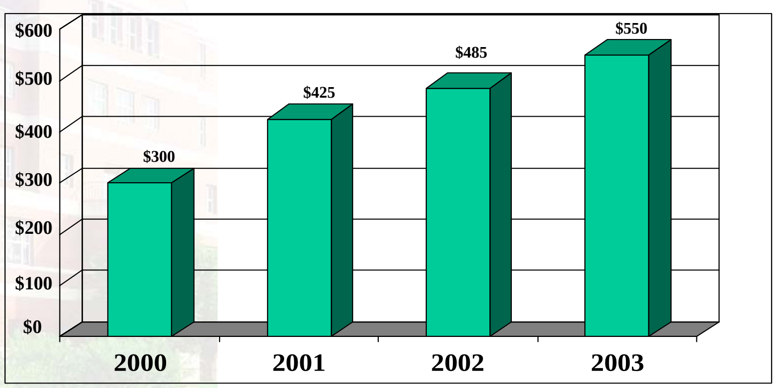
CDVC capital under management (in millions), 2000 - 2003



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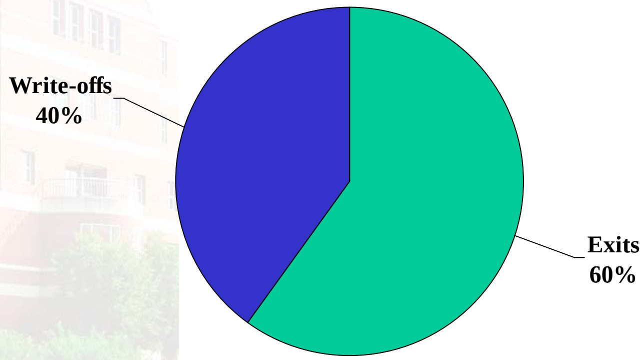
CDVF exits versus write-offs

(N= 137: 82 exits & 55 write-offs)



With declining CDFI appropriations, NMTC is becoming tail that wags the dog

- Total NMTC:
  - equals more than 100 years of direct CDFI appropriations.
  - Doubles or triples the supply of CDFI capital in circulation.
  - Six+ times the supply of community development venture capital (equity) available to invest in small businesses in distressed communities.

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How much capital is chasing DBL deals?

(really hard to tell)

Type	Capital ($B)	# funds	Avg. fund ($MM)	Avg. trans ($MM)	Underserved
CDVC	$ .87	68	$13	.2	Small firms, early stage Focus: quality LI jobs 24% rural
SBIC & SSBIC	$ 21.5	450	$50	.6	5% minority/3% women 22.5%LMI area 50% early stage
NAIC	$ 4	40-50	$90	.5*	Minority-managed funds
CUI-EDM	$ 6	40-50	$120		Urban markets (60% overlap with NAIC)
VC	$250	2000	$125	7.3	

** From Bradford & Bates survey of 24 funds*

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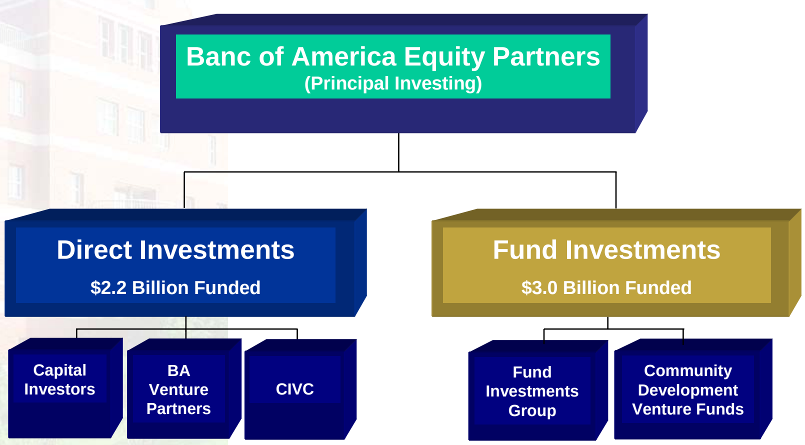
Once located on CD/CRA side of bank, BoA CDVF now on private equity side



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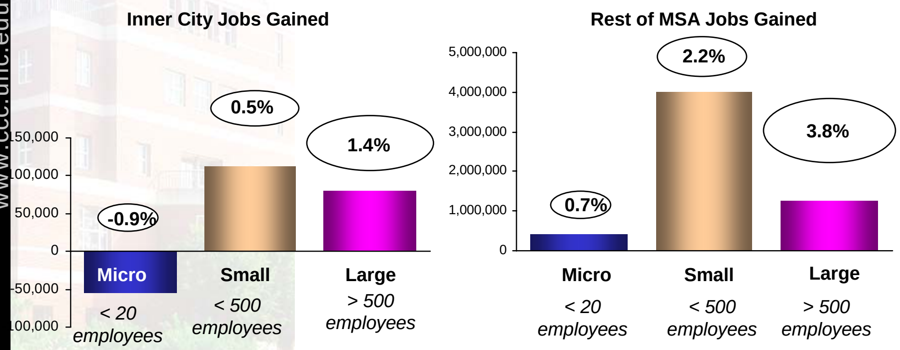
Profile of inner city job creation inconsistent with CDFI capabilites

Establishment Size
(%, 1998-2001 CAGR)



Job growth is driven disproportionately by growing companies to scale, not micro-enterprises

Source: State of the Inner City Economies, ICIC

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Emerging Domestic Markets (EDMs)

"Demographic trends, on their own, are insufficient triggers to expansive growth. However, the combination of long term trends in educational attainment, population growth rates, enabling institutions and capital markets suggest expansive potential in EDMs over the coming years."

Gregory Fairchild *In Your Own Backyard: Investment Opportunities in Emerging Domestic Markets*, Council of Urban Investors, undated

Changes in capital provision in domestic emerging markets since CCC founded

Glass is Half Full

- New Market Tax Credit;
- HMDA reporting for business loans;
- Focus on domestic emerging markets by commercial private equity funds;
- CDVC funds have $300+ million under management, now dwarfed by $2.6+ billion "double bottom line private equity funds;
- Banc of America $195 million California Community Venture Funds – a fund of funds including CalPers/ CalSters;
- New companies specializing in market information needs of EDM investors;
- Between 1977 and 1995, number of minority MBAs grew fourfold to ~13,000; they now fill managerial ranks of leading companies.

Glass is Half Empty

- Declining appropriations for CDFIs;
- Increasingly return-driven community development finance system;
- CDFIs losing market niche to mainstream banks;
- Need to do more to prepare local populations for jobs in expanding companies.

California Community Venture Funds

CCC/BofA Benchmarking Partnership

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•Some questions that will help answer question of role of microenterprise vs. market-based equity funds

- ❑ Are funds that focus on underserved markets more likely to invest in minority- or women-owned companies, or companies that are located in inner cities and rural areas?
- ❑ Are minority/women managed funds more likely to invest in minority/women owned companies, or those located in underserved communities?
- ❑ Do minority- +/or women-owned companies hire more minorities? More women-minorities? More low- and moderate-income residents? Are they more likely to locate in underserved geographies?
- ❑ Do the companies provide benefits to employees, and does the absence or presence of benefits systematically vary by characteristics of fund managers?
- ❑ If Wall Street investment funds cherry pick best deals, where does this leave CDFIs on the risk-reward continuum, and the federal role in community economic development?

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