



The Use of Community Development Venture Capital for Economic Development

Presented by
Ray Moncrief
Executive Vice President
and Chief Operating Officer

**KENTUCKY HIGHLANDS
INVESTMENT CORPORATION**

ACCESS TO CAPITAL

- ◆ Urban Areas have banks and investors providing entrepreneurs and small business with potential sources of investment capital.
- ◆ The Economic Service of the U.S. Department of Agriculture has found that new and small businesses have fairly limited access to credit.
- ◆ Bank Services
 - ◆ Urban - Developed
 - ◆ Rural - Limited

ACCESS TO CAPITAL

◆ Aggregation of Venture Capital

◆ East Coast

◆ West Coast

“Investors do not treat location within the United States as a distinct factor. Once an opportunity for a deal is presented to an investment banker, a rural location simply means taking a smaller plane or an extra day to travel to the company. Evidence of the declining importance of geography can be seen in the willingness of investment bankers to travel almost anywhere in the world for the right opportunity.”

Senior V.P., Merrill Lynch & Co., Inc. *Equity for Rural America, from Wall Street to Main Street*, August 1999.

ACCESS TO CAPITAL

- ◆ Entrepreneurs in rural areas require equity investors, like KHIC, who are able to actively participate in the development and well being of their businesses.
- ◆ Community Development Venture Capital

The background of the slide features a collage of US dollar bills, including a \$5 bill and a \$10 bill, rendered in a light green, semi-transparent style. A white banner with a wavy top edge is centered across the middle. Overlaid on this banner is a dark green silhouette of the state of Kentucky. The text "KENTUCKY HIGHLANDS INVESTMENT CORPORATION" is written in a bold, black, serif font across the banner, with the word "KENTUCKY" partially obscured by the state outline.

**KENTUCKY HIGHLANDS
INVESTMENT CORPORATION**

KENTUCKY HIGHLANDS

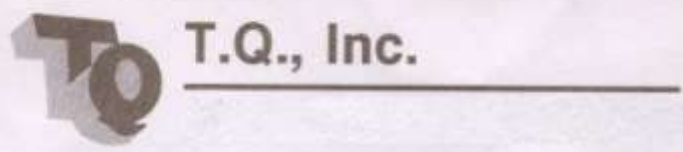
- Founded in June 1968 as part of War on Poverty
- Community Development Corporation
 - Located in Southeast Kentucky
 - Not very successful from 1968 – 1973
- 1974 - Pursued Developmental Venture Strategy
 - There were 36 Title VII CDC's founded in the late 1960's, KHIC was the only one to evolve a Developmental Venture Capital Strategy.
- Founded as 501(c) (3) -- Converted to 501(c) (4)

FINANCING STRATEGIES

- Equity
 - Convertible Preferred
 - Common
- Subordinated Debt with Equity upside
- Senior Secured Debt
 - Term
 - Current Asset Financing – Lines of Credit
- Straight Subordinated Debt

OTHER STRATEGIES

- Packaging – Capital Structure
- Industrial Recruitment
- Real Estate
 - Office Building
 - (3) Plants 150,000 sq ft
- Turnarounds (Necessity)
- Research & Development
- Local Markets



MID-SOUTH ELECTRICS, INC.



PHILLIPS DIVERSIFIED COMPANIES



RESULTS

- Invested in Excess of \$165 Million
- Provided Financing for 500+ Businesses
- Helped created 10,000+ Jobs
- Produced Goods and Services valued at \$ 13.5 Billion
- Paid \$ 1.9 Billion in Salaries & Wages
- Produced an Estimated Tax Revenue \$ 300 Million

EMPOWERMENT ZONE BACKGROUND

- Total Award - \$40 million on December 21, 1994
- \$20 million managed by KHIC - \$20 million Locally
- Consisted of two entire counties and part of a third
- Budgeted \$16 million for Loan Funds - \$4 million for Administration and \$20 million for Community Development
- KHIC served as Lead Entity (project manager) with each county having their own non-profit with Staff
- Project included \$700,000/10 years for Entrepreneurship Training Program

EMPOWERMENT ZONE RESULTS

- Population Increase by 11.9% compared to State increase of 9.7%
- Poverty Decrease at twice the State rate, from 35.2% to 26.1%
- During 10-year period to December 2004, total employment has increased by 6,108 or 39.8% compared to State growth of 10.1%
- Development Venture Fund has invested more than \$11.8 million in local business
- More than 200 farm loans
- Two new schools, new youth center, 2 libraries, extensive water & sewer upgrades, 3 industrial parks, and numerous health care improvements

Developmental Venture Capital VS. Traditional Venture Capital



High Risk – High Return

High Risk – Double Bottom
Line

COMMUNITY DEVELOPMENT VENTURE CAPITAL

◆ NEW MARKETS VENTURE CAPITAL (NMVC)



◆ RURAL BUSINESS INVESTMENT COMPANY (RBIC)





THE
SOUTHERN
APPALACHIAN FUND

OBJECTIVE

The Fund's objective is to provide an attractive return for its investors, while creating jobs and economic opportunities for stakeholders in its geographic area of focus.



THE
SOUTHERN
APPALACHIAN FUND

FUND MANAGEMENT TEAM

- L. Ray Moncrief,
Senior Fund Manager
 - 19%+ IRR over last 21 years of equity investing
 - 21 years in deal structuring and venture investing
 - Turnaround management
 - Workout management
- Grady Vanderhoofven,
Assistant Fund Manager
 - 11 years in technology transfer from invention to commercialization
 - Created 12 start up companies
 - 5 years in deal structuring and venture investing



Ray Moncrief, left, and Grady Vanderhoofven, right



CAPITALIZATION

- Equity: \$12.5M
 - \$5M regulatory capital
 - Agencies / Corporations
 - Banks
 - Foundations
 - \$7.5M SBA match
- Operational Assistance Funding: \$3M
 - \$1.5M cash or in-kind services
 - \$1.5M grant from SBA



LIMITED PARTNERS

- Appalachian Regional Commission
- Bank One
- Concord EFS, Inc.
- Farmers & Merchants Bank
- First Bank
- National City Bank of Kentucky
- Tennessee Commerce Bank
- Tennessee Valley Authority
- The F. B. Heron Foundation
- The John D. and Catherine T. MacArthur Foundation



INVESTMENT FOCUS

- Equity Investments (not loans)
- Company Stage – small businesses
 - Early (50%) – companies generally will have annual revenues less than \$1M and will not be profitable at the time of initial investment
 - Expansion/growth (50%) – companies generally will have annual revenue less than \$10M, may be profitable, and will be positioned for substantial, rapid growth
- Industry Sectors: Broad interest, including manufacturing, software, technology, and service companies

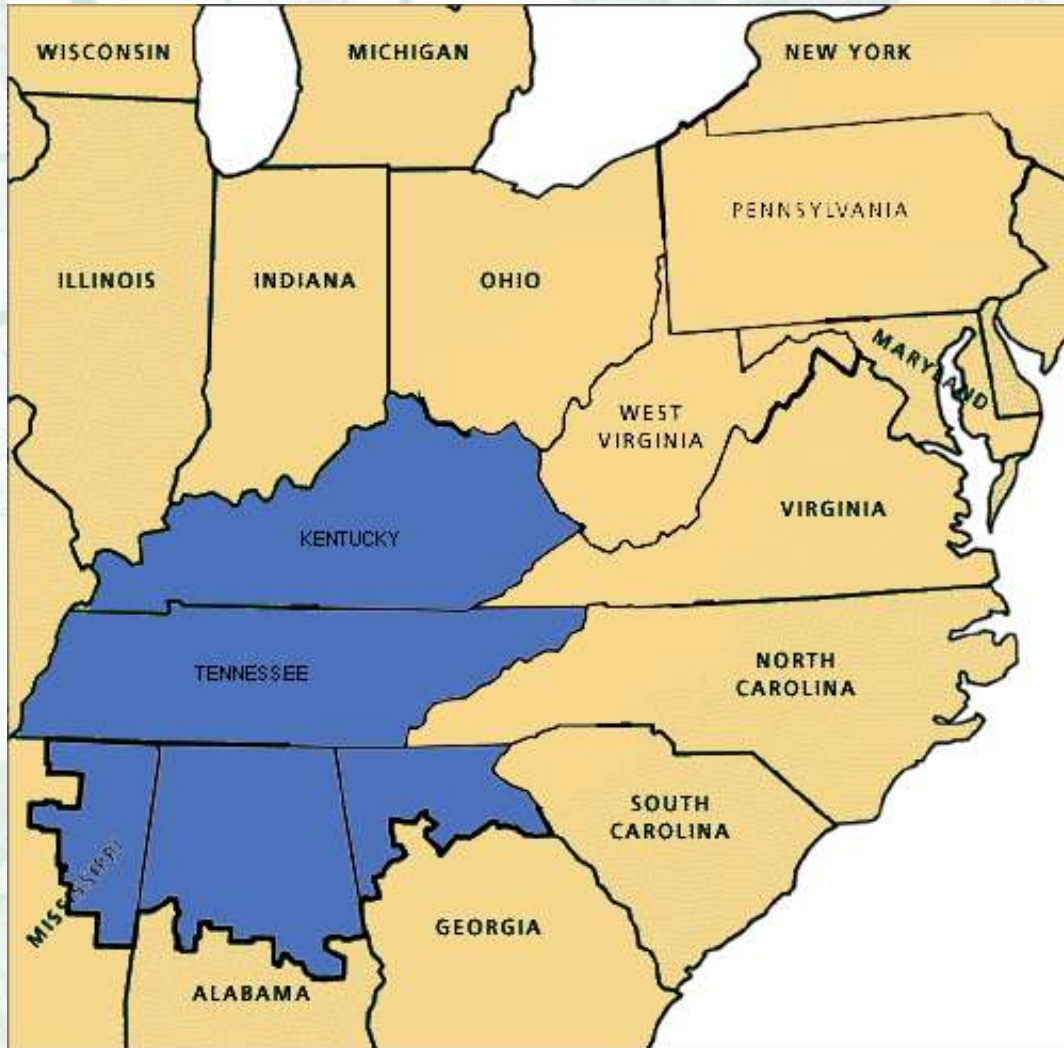


WE'RE NOT LOOKING FOR ...

- Real estate deals
- Traditional retail
- Restaurants
- Individual franchises
- “Lifestyle businesses”



Geographic Focus of Investments



*Low Income
Census Tracts in
Kentucky,
Tennessee, and the
Appalachian
counties of
Georgia, Alabama,
and Mississippi*



**THE
SOUTHERN
APPALACHIAN FUND**

GEOGRAPHIC FOCUS

Low-income census tracts include geographic areas that meet one or more of the following descriptions:

- census tracts or equivalent county divisions with a poverty rate of 20 percent or more;
- census tracts or equivalent county divisions located within a metropolitan area, and that qualify for the Low Income Housing Tax Credit (i.e., in which 50 percent or more of the households have an income below 60 percent of the area median gross income);
- census tracts or equivalent county divisions not located within a metropolitan area, and which have a median household income that does not exceed 80 percent of the statewide median household income;
- a HUBZone;
- an Urban Empowerment Zone (EZ) or Urban Enterprise Community (EC); or
- a Rural EZ or Rural EC.



INVESTMENT STRATEGY

- Number of Investments: 15 – 20 companies over a period of 3 – 4 years
- Investment size: \$200K - \$600K
- Lead or co-invest
- Invest in multiple rounds
 - Milestone-based financing
- Exits: Hold investments 4 – 7 years, and exit via merger/acquisition, management buyout, other
- Targeted return: 15% - 20% IRR



DEAL FLOW

- Fund Managers
- Kentucky Highlands
- Technology 2020
- Board of Directors
- Advisory Board
- Investors
- Other venture capital groups
- Service providers (e.g., attorneys, accountants, bankers)
- Other Regional Stakeholders



IMPACT OF INVESTMENTS

“Double Bottom Line” – Direct impact on economically disadvantaged communities and individuals

- Job creation
- Wealth creation – for entrepreneurs, communities, and investors
- Provide financial support and developmental services to “high risk” early- and expansion-stage small businesses
- Help small business grow and reach a level of financial sustainability
- Focus on communities where equity capital is typically and traditionally not available
- Leverage other community development efforts





www.proteindiscovery.com
Knoxville, TN



www.bbrwm.com
Louisville, KY



www.semisouth.com
Starkville, MS



www.tier1performance.com
Covington, KY



www.vitalstream.com
Knoxville, TN



www.numarkets.com
Etowah, TN



www.smartfurniture.com
Chattanooga, TN



www.tricycleinc.com
Chattanooga, TN



THE
SOUTHERN
APPALACHIAN FUND

The background features a collage of US dollar bills, including \$5 and \$100 denominations, with a dark blue mountain silhouette at the top and a dark green jagged border at the bottom. A central black banner contains the company logo and name.

MERITUS  VENTURES

RURAL BUSINESS INVESTMENT COMPANY

FOCUS ON RURAL MARKETS

- Funded by U.S. Department of Agriculture (USDA) and supervised by the U.S. Small Business Administration (SBA)
- Created, authorized and appropriated in 2002 USDA Farm Bill to establish venture capital funds that invest in rural America
- CRA eligible “of right” for commercial banks
- Modeled after SBA’s Small Business Investment Company (SBIC) Debenture Program
- No more than 10% of fund’s investments, in numbers and dollars, may be invested in *urban business concerns*
- 75% of fund’s investments, in numbers and dollars, must be invested in *rural business concerns*

USDA INVESTMENT INITIATIVE

- USDA's Notice of Funds Available in June 2004 established that 3 funds would be designated as Rural Business Investment Companies
- Requires that each fund raise \$10 million in private equity
- USDA, through the Small Business Administration, will provide guaranteed debentures that allow a RBIC to receive 200% leverage, which will be an additional \$20 million
- \$10 million of private capital combined with \$20 million of SBA leverage equates to a \$30 million fund
- Each RBIC will also receive a \$1 million grant for Operational Assistance
 - Executive Recruitment
 - Market Research
 - Intellectual Property Assessment

GEOGRAPHY



Entirety of:

- Kentucky
- Tennessee
- Arkansas

Appalachian Counties of:

- Ohio
- West Virginia
- Virginia
- North Carolina
- South Carolina
- Georgia
- Alabama
- Mississippi

This geography is desirable because of:

- **Fund Manager relationships**
- **Co-investing opportunities**
- **“Proprietary” deal flow**

FUND MANAGEMENT TEAM

- Aggregate of 30+ years experience of fund managers structuring and investing in companies in rural settings
- Fund Management Team has invested in companies in recreation, injection molding, software development, automobile airbag manufacturing, medical services, medical devices, machine tools information technology, telecommunications, robotics and circuit boards
- Deal flow strong because of years of networking
- Fund Managers have strong relationships with service providers and investors both within and outside of the targeted geography

FUND MANAGEMENT TEAM

- L. Ray Moncrief,
Senior Fund Manager
 - 19%+ IRR over last 21 years of equity investing
 - 21 years in deal structuring and venture investing
 - Turnaround management
 - Workout management
- Grady Vanderhoofven,
Assistant Fund Manager
 - 11 years in technology transfer from invention to commercialization
 - Created 12 start up companies
 - 5 years in deal structuring and venture investing



Ray Moncrief, left, and Grady Vanderhoofven, right

INVESTMENT STRATEGY

- Primarily Equity
- Expansion Stage
 - Sales generally under \$10 million
 - Cash flow positive within 24 months
- Industry focus
 - Manufacturing
 - Service
 - Technology, e.g.
 - Nano
 - Software
 - IT

INVESTMENT STRATEGY

- Investment Size: \$250,000 to \$2,000,000
- Investment Term: three to five years
- Exit Scenario
 - External sale/merger
 - Internal management buyout
 - IPO
- Co-Investing
 - Lead syndication
 - Invest in syndication

INVESTOR'S BENEFITS

- Risk-Adjusted Rate of Return (15% IRR)
- Can borrow \$2.00 for each \$1.00 of private equity, and Limited Partner receives the gain on the borrowed dollars
- Each \$1.00 of private capital will yield \$3.00 of financial and social impact
- Strong SBA oversight with annual audits by SBA required
- Both financial and social reporting requirements to SBA and USDA
 - Financial statements
 - Job creation
- Consistent valuation methodology in accordance with SBA policy
- Limited Partners that are banks will receive CRA credit

LIMITED PARTNERS

- The F.B. Heron Foundation
- Community Development Venture Capital Alliance
- Southwest Georgia Farm Credit
- Pee Dee Farm Credit
- Southwest Florida Farm Credit
- Puerto Rico Farm Credit
- CoBank
- Tennessee Valley Authority
- High net worth individuals
- NCB Development
- National Cooperative Bank
- Mary Reynolds Babcock Foundation
- University of Kentucky
- The John D. and Catherine T. MacArthur Foundation
- Key Bank
- The Huntington CDC
- Kentucky Highlands Investment Corporation
- Technology 2020
- Eclipse Management, LLC



WAZOO
SPORTS.COM

www.wazoosports.com

London, KY



Zipit
Tap into your world.

www.zipitwireless.com

Greenville, SC



singlePIPE
COMMUNICATIONS

www.singlepipecom.com

Lexington, KY



AldisTM

www.aldiscorp.com

Oak Ridge, TN

Ray Moncrief

**KENTUCKY HIGHLANDS
INVESTMENT CORPORATION**

WWW.KHIC.ORG



**THE
SOUTHERN
APPALACHIAN FUND**

WWW.SOUTHAPPFUND.COM



WWW.MERITUSVENTURES.COM

P.O. Box 1738
London, KY 40743

606-864-5175
lrmoncrief@khic.org