

# Community Development Venture Capital Funds Bring Relief to an Equity Desert

By Patrick Borunda

**SUMMARY:** Loan funds are beneficial to the Native American community. But they are not sufficient. Without a source of equity ("risk capital"), loan funds alone cannot substantially affect whether Indian Country's public and private enterprises realize their full potential. Today, two sources of community development risk capital, Native American Capital, LP and The Pathfinder Fund, LLC, are committed to the Native market.

## Introduction

Community Development Financial Institution (CDFI) loan funds are playing an increasingly important role in Indian Country. However, they have limitations. Using debt demands a source of equity (unencumbered funds/property used to secure the lender's financial interest). Without new equity sources, Indian Country's equity-poor environment confines lenders to limited new business projects and small scale new capital formation. Smaller investments yield smaller returns than the need -- and promise -- for economic growth in Indian Country.

The 2001 landmark *CDFI Fund Native American Lending Study: Equity Investment Roundtable and Research Report*, first described the "equity desert" subsequently cited in Mark Fogarty's article in the July issue of *American Indian Report*. As Fogarty noted, CDFIs are a vital piece of the capital formation puzzle. However, the majority of CDFIs he mentioned are loan funds, which provide debt capital. Except for small "unsecured" loans, lenders ration debt according to the equity contribution and/or collateral of a borrower. Every industry has a "norm" for its debt to equity ratio. Even the most sympathetic lender is reluctant to lend beyond this norm. Doing so risks overburdening the borrower and possible write-off of a failed loan.

Private enterprises are especially affected by the absence of equity. Equity is the foundation capital for start-up, new product development, and accessing new markets. It permits leveraging debt to finance expansion during successful times. As the 2001 CDFI Fund report noted, the majority of Native-owned companies are small businesses. They have fewer than five employees and are financed with loans under \$35,000. To be sure, small businesses are important employers. They make significant contributions to their communities. But the relatively small size of Native-owned businesses is too often a decision imposed upon owners, rather than a choice made willingly. The size reflects the well-documented "equity gap" in Native American communities. It frequently means that the businesses' possible contributions to the community and economy go unfulfilled. They don't reach their size potential nor do they generate experience managing substantial capital. Without adequate equity, businesses cannot take advantage of debt offers from the new CDFIs.

## **Equity Drives New Capital Formation**

New capital formation is vital to the future of Native American communities. It is the foundation for resilient economic growth, as well as the means for conserving the rewards of economic effort. New capital formation means creating new resources (capital) that strengthen an economy or an enterprise. For example, investing a company's earnings in power generation or in an Internet service provider with enough capacity to service other businesses is new capital formation (technology infrastructure) as is investing in commercial or industrial space that emerging businesses can lease (business infrastructure). Training tribal members to be managers and technicians, able to make decisions that are both good business and culturally appropriate, also creates new capital (human capital).

Unfortunately, new capital formation has not been happening at the pace needed in Indian Country. Absence of "risk capital" and financial expertise have been nearly insurmountable problems, interfering with securing investment from capital markets for large projects and for leveraging long term debt. The result is that projects don't happen, and Native communities fail to get the experience needed to make them happen in the future.

Some large scale business investments have been made in Indian Country in recent years, particularly since the advent of gaming. However, many of these are in tribally-owned enterprises, making only modest contributions to new capital formation. Although there are notable exceptions, over the years tribally-owned enterprises have not convincingly driven new financial and human capital formation.

The fact is that *accelerating* new capital formation is the linchpin to helping Native communities gain economic parity with other Americans. Further, sovereignty is better protected by robust new capital formation than by the courts. The best way to maintain Native control over resources is to deepen the pool of managerial talent and experience in Indian Country. Developing new products and new markets earns revenues through export, replenishing the supply of capital circulating in Native communities. Diversified businesses are less vulnerable to a downturn in markets on which they've depended in the past. At the same time, developing new consumer-oriented businesses keeps capital from leaking into the larger economy – and keeps jobs at home. Adequate equity triggers the new capital formation process.

## **Community Development Venture Capital Funds Provide Equity**

In recent years, the "cutting edge" of community development finance has been community development venture capital (CDVC) funds. The community development finance industry recognized access to debt capital was not sufficient to move rural and other underserved markets into the economic mainstream. CDVCs began to emerge in the mid 1990s. By late 2000, the industry comprised just over 50 funds with \$300 million under management. Today there are over 80 such firms with \$548 million under

management. CDVC Funds invest for the "double bottom line" of financial return and social gains.

Two good examples of CDVC funds are associated with Coastal Enterprises Inc. (CEI) of Maine and Cascadia Revolving Loan Fund in the Pacific Northwest. CEI Ventures, Inc., was formed to invest socially responsible venture capital in Maine, New Hampshire and Vermont. Founded in 1996, CEI Ventures manages \$25.5 million in two funds, Coastal Ventures LP and Coastal Ventures II, LLC. Together, these funds have invested \$12 million in 33 companies. They invest in growing companies that can generate above-average equity returns over a five to seven-year period, and meet social goals. These goals include the creation of high-quality jobs and ownership opportunities for low-income individuals, among other benefits.

One CEI portfolio company utilizes waste from salmon, wild blueberry, and shellfish processors to make organically certified composts, fertilizers, mulches and soils. Another portfolio company develops technical outdoor apparel for women. A third is a direct-mail provider of frozen, high quality, chef-prepared meals marketed via catalog and website.

Cascadia's Rural Development Investment Fund (RDIF) was also established in 1996. Its parent is Cascadia Revolving Fund, a private, non-profit community development loan fund. The RDIF provides quasi-equity investments and technical assistance to small businesses in rural areas of Washington and Oregon. It has \$5.6 million under management and has invested \$4.1 million in more than 20 companies, targeting industries that can demonstrate a competitive advantage in rural areas of its region.

The RDIF makes its quasi-equity investments through the use of a Participation Agreement (PA) -- a low interest, deeply subordinated loan with an on-going revenue-based fee. Many traditional lenders view the PA debt as equity, allowing "investments" to leverage additional debt. The PA allows for an exit over time and the owner is not forced to sell the company to pay off true venture capital investors. Similar to true equity, the entrepreneur pays a higher rate of return only if the business is growing and successful - if not, the cost of funds is lower.

The RDIF seeks value-added wood and seafood products, alternative agriculture and food processing, and manufacturing using industrial by-products or recycled raw materials. Initial portfolio companies included a kayak manufacturer, fish wholesaler/retailer, lumber recycler and several value-added forest products firms.

### **The Pathfinder Fund, LLC, and Native American Capital, LP**

Today there are just two existing CDVC sources exclusively serving Native Americans. Each will acquire CDFI status by the end of 2004 and will be CDEs, eligible for New Market Tax Credit allocations. Like CEI Ventures, both funds will provide assistance with management, strategic planning, financing, and introductions to local and national business communities, along with financial capital. This will typically be delivered via a seat on the portfolio company's Board of Directors.

The Pathfinder Fund, LLC (TPF) is a CDVC entity headquartered in rural southwestern Washington State. Its market area covers 14 states in the 12th and 9th Federal Reserve Districts (the West and Great Plains) plus New Mexico and Colorado. This area is home to almost 60% of all Native Americans.

Pathfinder will focus on -- but not be limited to -- investments in commercial and industrial space, giving small businesses a place in which to locate their enterprises, and in distributed energy. Distributed energy means power sources which may not be connected to the national power grid (e.g., wind, solar, micro-turbine, low-head hydro). It will consider all industries, across all stages of investment, with a primary focus on early stages. It will seek to co-invest with other venture capital firms and private investors, where appropriate. The Pathfinder Fund is a sub-allocattee of CDFI New Market Tax Credits through Community Reinvestment Fund of Minneapolis.

Native American Capital (NAC), LP is a CDVC entity headquartered in Silver Spring, MD. Primarily led and administered by Native Americans, it is the first private equity and venture capital fund specifically serving a national market of all Native American and Alaska Native communities. NAC has received two Native American Technical Assistance grants from the U.S. Department of Treasury's CDFI Fund.

NAC looks for business development opportunities in sectors that are of compelling interest to Indian Country, including infrastructure industries. These range from information technology to alternative energy technologies and services; they include health care goods and services; rural environmental-based businesses; education; basic commerce and retailing, and tourism. NAC seeks relatively large scale projects involving basic tribally controlled assets that it can assist in making available to previously unachievable major project development.

Together, the "sister" funds of Pathfinder and NAC have crafted a "bookend strategy" to address the problems of insufficient business scale and the absence of depth in managerial experience. Pathfinder focuses on growing smaller businesses and developing local management experience (human capital). NAC focuses on catapulting existing businesses to their next level and leveraging opportunities to create infrastructure. These two capitalization strategies combine effectively to draw conventional venture capital and the financial services industry into Native communities' enterprises.

## **Conclusion**

CDFIs are vital to increasing investments in Indian Country. However, CDFI loan funds need additional sources of equity to realize their potential. Specialized CDVC CDFIs can help solve the capital puzzle by providing equity and "quasi-equity" products to promising businesses. CDVC equity will enable CDFI Loan Funds to realize their full potential by making larger loans safe and feasible. CDVC CDFIs will also be indispensable for driving non-governmental new capital formation, providing that equity

and more on a scale that will boost participation from "mainstream" capital markets. This will accelerate new capital formation in our communities – and turn the “equity desert” into a fertile oasis.

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