
Policy Options for Equity Financing for Rural Entrepreneurs

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Rural entrepreneurs and small businesses have limited access to financing from venture capitalists. Of this situation, there is widespread evidence and agreement. There is not, however, agreement as to the principal reasons why entrepreneurs in rural areas have difficulty in acquiring equity capital for new business start-ups and expansions. On the one hand, some suggest (e.g., Florida and Kenney, 1988) that few venture capital investments are made in rural areas because relatively few rural businesses are in the sectors favored by venture capitalists (e.g., software, telecommunications, and biotechnology). On the other hand, others propose that market imperfections (e.g., the high information and transactions costs associated with rural investments) result in a lack of capital availability for promising rural businesses in the “right” industries (Freshwater and others, 2001; Rubel and Palladino, 2000). These alternative perspectives on rural equity markets provide negative reinforcements for one another. For example, a recent analysis of the South Carolina economic environment noted:

“A dearth of good investment opportunities in the state has stunted the growth of venture capital businesses. In turn, as a result of limited investment funding, businesses with good opportunities for investment have difficulty accessing the necessary capital” (DRI-WEFA, 2002, p. 4).

The double-edged sword of little entrepreneurial activity and limited venture capital has encouraged state and local efforts on two fronts: the provision of entrepreneurial and small business assistance programs and the development of nontraditional venture

capital programs. Earlier presentations at this conference discuss alternative programs for promoting entrepreneurship and creating an entrepreneurial environment. The purpose of this paper is to provide an overview of options for enhancing the availability of venture capital in rural areas.

This paper draws on my research with the Center for Rural Entrepreneurship and with the Rural Equity Capital Initiative of the Rural Policy Research Institute (RUPRI). The discussion is organized as follows. The second section provides an introduction to private venture capital funds and the impediments that discourage these funds from investing in rural areas. The third section reviews examples of public and private efforts to build rural equity capital institutions. The final section suggests lessons learned from alternative, nontraditional venture capital programs and policy alternatives to promote the availability of equity capital in rural areas.

TRADITIONAL EQUITY CAPITAL INSTITUTIONS

Most venture capital funds are organized as limited partnerships with a predetermined life, usually 10 years. Capitalization of a fund is provided by the limited partners, and the venture capitalist acts as general or managing partner. Funds typically invest in portfolio companies in the first one to three years. Proceeds from the investments are harvested in the later years of the partnership and distributed to the limited partners. The managing partners receive an

annual management fee (generally 2-3 percent of fund capital) and a predetermined percentage (e.g., 20 percent) of the total profit. The funding provided for initial capitalization and the remaining share of profits (e.g., 80 percent) from the partnership is returned to the limited partners.

There is limited investment activity in rural areas by traditional venture capital funds because of three characteristics of rural equity markets (Barkley and Markley, 2001):

- Rural businesses are relatively concentrated in low-tech, slow-growth sectors. According to PricewaterhouseCoopers Money Tree Survey (Quarter 4, 2002), venture capital investments are focused on five narrow sectors: software (21.3 percent), telecommunications (12.3 percent), medical devices and equipment (11.9 percent), biotechnology (11.6 percent), and networking and equipment (11.2 percent). The industrial sectors, in which rural areas are better represented, received less than 8.0 percent of venture capital investments in the fourth quarter 2002: industrial/energy (3.4 percent), consumer products and services (1.7 percent), electronics/instrumentation (1.3 percent), and retail/distribution (1.2 percent). Small businesses in the more traditional manufacturing, service and trade sectors do not provide the growth potential and anticipated rate of return sought by venture capital firms. Annual rates of return of 20 to 30 percent are desired by venture capital funds as compensation for the investments' high risks.
- Venture capitalists face higher costs for making and managing investments in rural areas. Deal flow is more limited and geographically dispersed in nonmetro areas, resulting in relatively high costs for finding good investment opportunities and higher time and travel costs for conducting due diligence and monitoring the investment. In addition, the typical rural venture capital investment is small compared to investments made in

urban businesses, yet the management costs for the smaller, rural investments are similar or higher. Thus, net returns from investments in rural businesses are reduced by the relatively high costs associated with managing small deals.

- Rural communities generally provide a limited business infrastructure to meet the management and technical assistance needs of the entrepreneur and small businesses. As such, venture capital firms must either provide these services internally (e.g., the venture capitalists allocate more time working with the entrepreneur) or contract with managerial and technical service providers from outside the community. Either way, the absence of supportive services in the area results in higher costs and lower profits for the venture capital firm.

In summary, rural areas are handicapped in their ability to attract traditional venture capitalists by their historical industrial structure and the higher cost of providing capital and assistance to those rural businesses deemed worthy of equity investments. The result is an equity gap, especially for seed capital funds, in the more geographically isolated rural areas (Brophy and Mourtada, 1999). Schmitt (2002, p. 3) documents the severity of the rural equity gap by noting that in 2001, nonmetropolitan counties had 17 percent of all U.S. establishments but only 1.6 percent of the companies receiving venture capital investments, and only 0.8 percent of the dollars invested by venture capital funds.

Proponents of improving access to equity finance in rural areas also justify government incentives on the grounds of net benefits to society and sustainable economic development. First, the social rate of return to some rural investments significantly exceeds the private return attainable by the venture capitalists. Society loses these additional benefits (e.g., the improved housing, healthcare, and education that may result from new job opportunities), if business development is retarded by an absence of venture capital. In recognition of the role

of social return in investment decisions, the National Community Capital Association is attempting to create a rating system for Community Development Financial Institutions (CDFIs) that captures both the financial performance and community development impact of their investment activities. Second, rural America is going through an economic restructuring in which employment opportunities in traditional industries are declining because of firms relocating to low-cost labor markets overseas or businesses adopting new labor-saving technologies. The replacement of lost jobs through the more intense recruiting of other branch plants does not look promising. An alternative strategy is to participate in the national economic transition by creating an environment that facilitates the creation, growth, and success of entrepreneurs and technologically-oriented businesses. And, Florida and Kenney (1988, p. 44) noted more than a decade ago that "venture capital is a crucial element in the process of restructuring."

PUBLIC AND PRIVATE EFFORTS TO INCREASE VENTURE CAPITAL IN RURAL AREAS

The absence of traditional venture capital investments in rural areas has encouraged public policymakers and investors to investigate alternative sources of equity capital for rural entrepreneurs and businesses. Nontraditional programs to increase the availability of rural equity capital have been initiated by private economic development organizations, community development financial institutions, and federal, state, and local public agencies. The breadth of program offerings is reflected in a recent survey of state programs by the National Governors Association (NGA) (2000). This survey identified 33 states with allocated state funds or dedicated state revenues in public or private venture capital funds. In addition, investments in venture capital funds by state pension funds occurred in 19 states, and 17 states provided tax credit incentives for private venture capital investments. Finally, a 2000 survey by the Rural Policy Research Institute (Barkley and others, 2000) identified 18 states that sponsored or participated in venture

capital fairs, and 14 states that assisted in the development of statewide angel networks. The RUPRI and NGA surveys provide an accounting of only those programs in operation at the time of the surveys. Additional publicly assisted equity programs have been started since 2000, while other programs were either closed due to a lack of success or a change in political climate or were reorganized into nonprofit or quasi-public entities.

Nontraditional venture capital programs generally fall into three principal types: public funding of public or private venture capital funds, tax credits to encourage private funding of entrepreneurs or private venture capital funds, and public support for programs that encourage angel investors. Nontraditional programs have been started by all levels of government (federal, state, and local), as well as private and quasi-public business and community development organizations (e.g., chambers of commerce, utility cooperatives, and local investment clubs). This diversity of program offerings permits an assessment of program types and characteristics best suited for success in rural areas. Examples of federal, state, and local nontraditional venture capital programs are provided next, along with summaries of the operations for these programs.

National Equity Capital Programs

Federal efforts to promote the availability of venture capital in rural areas are conducted through four principal programs: Small Business Investment Companies (SBIC), New Markets Venture Capital Companies, New Markets Tax Credits, and Rural Business Investment Companies. All of the above programs except SBICs are relatively new (e.g., no RBICs were in operation by May 2003), thus an assessment of their efficacy is premature. However, an overview of these programs provides insights as to where market gaps may remain and where state and local programs may be beneficial.

SBICs. Small Business Investment Companies are privately owned lending and investing firms that

provide equity, long-term loans, and management assistance to small businesses. SBICs, generally owned by venture capital organizations or commercial banks, must have a minimum private investment of \$2.5 million and experienced management to be licensed by the SBA. Licensed SBICs may borrow federal funds or sell government-guaranteed securities, in addition to private funds provided by investors, to finance small businesses that meet SBA guidelines. Specialized Small Business Investment Companies (SSBICs), also known as Section 301d SBICs, are further restricted to provide financial assistance only to small businesses owned by socially or economically disadvantaged individuals. A SBIC may obtain a leverage of up to three times the value of its private capital, with a special exception allowing a leverage of 400 percent of private capital if at least 50 percent of the SBIC's total investments are in venture capital.

There are approximately 300 licensed SBICs and SSBICs located throughout the United States in every state but Alaska, Montana, Nebraska, and Wyoming. Despite the widespread geographic distribution of SBIC offices, rural businesses have relatively limited access to SBIC funding. First, SBICs typically function as traditional venture capital funds with preferences for investments in high-growth, high-tech, and high-potential businesses—businesses not well-represented in rural areas. Second, few SBICs are located in nonmetropolitan areas, and thus, small businesses in rural communities are not the target client for SBICs. More specifically, only four SBICs are located outside of metro areas (Mountain Ventures Inc., London, Ky.; Sun-Delta Capital Access Center Inc., Greenville, Miss.; First United Venture Capital Corp., Durant, Okla.; and Green Mountain Capital, Waterbury, Vt.), and only one bank-owned SBIC exists in rural areas (First United Ventures). The absence of bank-owned SBICs in nonmetro communities results because most rural banks are unable to meet the \$2.5 million minimum private investment under current banking laws that permits banks to invest a maximum of 5 percent of their capital and surplus into a SBIC.

New Markets Venture Capital Companies (NMVC). The lack of venture capital investments in low income areas (e.g., rural communities and metropolitan cores) encouraged the development of the New Markets Venture Capital Program in 2001. The NMVC Program, administered by the SBA, provides up to \$150 million in debenture guarantees and \$30 million in technical assistance grants for approved NMVCs. A NMVC must raise at least \$5 million of capital from private sources for investments. The SBA will provide the NMVC with matching investment funds (equal to 150 percent of private capital raised) in the form of SBA-guaranteed deferred payments debentures. (SBA will market the debentures for the NMVCs.) In addition, the SBA provides grant funds to the NMVCs to make available technical and managerial assistance to the portfolio companies. The NMVCs must, however, match the SBA dollar-for-dollar (in cash or in-kind contributions) for technical assistance grants received. Finally, at least 80 percent of the businesses receiving a NMVC investment must be small (as defined by SBA) and located in “low-income geographic areas” (e.g., at least half of the area's households have incomes at or below 60 percent of the area median income).

As of May 2003, there were only seven approved NMVCs. Four of these companies have predominantly rural service areas: Adena Ventures, CEI Community Ventures, Pennsylvania Rural Opportunities Funds, and the Southern Appalachian Fund. Noticeably missing from the NMVCs are funds serving the rural areas of the Midwest, Plains, and Mountain states. Initially, 15 to 20 NMVCs were anticipated for approval, however, the current budget and political environments are such that the NMVCs likely will be limited to those already approved.

New Markets Tax Credits (NMTC). The NMTC program, a key element of the Community Renewal Tax Relief Act of 2000, has been labeled “one of the most promising federal community revitalization initiatives in decades” (Williams, 2001, p. 3). A principal goal of NMTC is to induce additional equity investment for businesses in economically distressed areas

through the availability of tax credits to private investors. Under the NMTC program, the Treasury Department (through the CDFI Fund) allocates tax credits to certified Community Development Entities (CDEs). A CDE is a corporation or LLC with the mission of serving low-income people or communities. The CDE will issue equity interests and tax credits to private investors (e.g., lending institutions) who make cash investments in the CDE. The federal income tax credit of 39 percent is spread out over seven years at the rate of 5 percent for the first three years and 6 percent for the remaining four years. The NMTC program is authorized to approve \$15 billion in investments for which tax credits can be claimed (credits to be spread out through 2007).

Investments by CDEs using funding raised through the NMTC program must be “substantially all” in “active low-income community businesses” in

“low-income communities.” Under the NMTC program, “substantially all” means 85 percent of the funding raised using tax credits, though the CDE likely can include in the 85 percent the portion of management fees and technical assistance expenses related to serving eligible portfolio companies in the low-income communities. Low-income communities are defined as those census tracts with poverty rates greater than 20 percent and/or median family incomes that are less than or equal to 80 percent of the area median family income.

In March 2003, the Community Development Financial Institutions Fund announced that 66 Community Development Entities (out of the 821 CDEs) were selected to receive allocations of New Market Tax Credits (NMTCs) through the 2002 NMTC program. The 66 CDEs received allocation authority totaling \$2.5 billion, with awards ranging from \$500,000 to

Table 1

SUMMARY CHARACTERISTICS OF THE NEW MARKET TAX CREDITS 2002 ALLOCATION ROUND

I. Distribution of Allocations

- Sixty-six CDEs received allocation authority totaling \$2.5 billion.
- The average allocation award is approximately \$38 million per CDE.
- Allocation awards range in size from \$500,000 to \$170 million. The median allocation award is \$18 million.
- Six organizations each received allocation awards of at least \$100 million, and 24 organizations each received allocation awards of \$10 million or less.

II. Allocation of Investments

- The 66 allocation recipients anticipate making investments in at least 40 different states and the District of Columbia.
- Twenty-seven (or 41 percent) of the allocation recipients will focus on local markets (e.g., a citywide or countywide area) within one state (22 CDEs) or multiple states (five CDEs).
- Seventeen (or 26 percent) of the allocation recipients will focus investment activities within a statewide service area.
- Twenty-two of the allocation recipients (or 33 percent) will invest nationally or in a multistate area.
- Twenty-one of the 66 allocation recipients (more than 30 percent) indicate that they will mainly target investments to rural communities.

Source: www.cdfifund.gov/program/NMTC.index

\$170 million. CDEs headquartered in California (10 awards, \$434 million) and Ohio (11 awards, \$307 million) received the largest allocations, although some of the awards in those states went to multistate programs. A summary of the 2002 NMTC allocation round is provided in Table 1.

The potential to enhance the availability of venture capital in rural areas is somewhat overstated by the summary statistics of Table 1. First, 30 percent of the allocation recipients indicate they will target investments predominantly at rural communities; however, only 20 percent of the allocations (\$506 million out of \$2.5 billion) are targeted at rural areas. Second, much of the funding generated through the tax credits will be used for loans to businesses or loans for real estate projects (e.g., the rehabilitation of theaters in low-income communities). The amount of additional rural venture capital made available through NMTC programs likely will be much less than the \$506 million target allocation. Third, the NMTC program focuses on low-income/high-poverty census tracts. The more prosperous rural communities—also the rural areas most likely to attract or generate high-tech entrepreneurial activity—will receive little additional venture capital through the NMTC program. In summary, the NMTC program will not eliminate the rural venture capital gap. A need continues to exist for state and local programs focused at rural entrepreneurs and small businesses.

Rural Business Investment Companies (RBICs). The Farm Security and Rural Investment Act of 2002 (commonly referred to as the “2002 Farm Bill”) provides \$44 million in grants and \$280 million in debt guarantees to assist the RBICs to make equity investments in rural businesses. RBICs must be newly formed for-profit entities with management teams experienced in venture capital or community development financing. The RBICs must raise a minimum of \$5 million in private capital, funds that can be leveraged 3-to-1 by U.S. Department of Agriculture (USDA) loans. Seventy-five percent of RBIC total capital must be invested in small enterprises (e.g., net

financial worth less than \$6 million) in rural areas, which are defined as cities or towns with less than 50,000 residents, excluding areas adjacent to a city of more than 50,000 residents.

A promising aspect of the RBIC is the availability of operational assistance grants to assist RBICs, and their portfolio companies, with technical, managerial, or networking assistance. The amount of operational assistance funding is limited to 10 percent of private capital raised by the RBIC or \$1 million. This technical assistance will be especially valuable in rural areas where supportive services for entrepreneurs and small businesses are relatively limited. Unfortunately, like the Treasury Department’s NMTC program, the USDA RBIC program is too new to evaluate. At this time, no funding for RBICs has been approved, thus no information is available regarding investment patterns and economic impacts.

State Equity Capital Programs

States provide the principal laboratories in which nontraditional equity programs are introduced, fine-tuned, and evaluated (Eisinger, 1991). States imitate programs of other states, with changes incorporated to account for different target businesses, perceived unique circumstances in the state’s capital markets, and observed deficiencies or shortcomings in earlier programs. This process of imitation and alteration enables policymakers to discern strengths and weaknesses with alternative programs’ structures and management organizations, information which is useful in designing the next generation of nontraditional venture capital programs. Unfortunately, some states are so eager to imitate others that programs are started before sufficient time has passed to evaluate earlier efforts. In this case, we may find a number of states experiencing similar program shortcomings and unfulfilled expectations. These multiple experiences with similar programs permit program evaluation to move beyond anecdotal evidence to observations of consistent patterns.

State nontraditional venture capital programs fall into three principal types: venture capital funds with full or partial capitalization by the state, state tax credit programs to encourage private financing of venture capital funds, and state-assisted angel networks. Numerous programs exist, or previously existed, for each type, thus the following discussion provides only limited examples of each.

Public Financing of Venture Capital Funds. Early state attempts to enhance venture capital investments in local entrepreneurs and small businesses included state funding of public entities to make venture capital investments (referred to as publicly funded and publicly managed) or state capitalization of private venture capital funds (referred to as publicly funded and privately managed). Examples of these programs are presented in Table 2. The publicly funded venture capital programs are diverse with respect to source of state funding, focus of investment activity, and structure of the management team. For example, the Iowa Seed Capital Fund received funding from the state in the form of annual appropriations, while the Small Enterprise Growth Fund of Maine received a one-time state allocation. Most publicly assisted venture capital funds have a statewide investment strategy, however, Kentucky and Colorado attempted to target rural businesses through the Kentucky Rural Innovation Fund and Colorado Rural Seed Fund.

The success of the publicly funded venture capital programs, measured by an increase in entrepreneurial activity and return on investments, also is quite mixed. Kansas Venture Capital Inc. (KVCII) has invested in 30 companies and has created or retained almost 3,000 jobs. In addition, KVCII repaid the state of Kansas the original \$5 million state allocation for initial capitalization. At the other extreme, the Magnolia Venture Capital Corporation of Mississippi and the Colorado Rural Seed Fund were terminated with negative net returns on investments and no long-term impacts on state employment or business development.

The popularity of publicly funded, publicly managed and publicly funded, privately managed venture capital programs is on the decline. Heard and Sibert (2000) note that such programs found it difficult to attract and retain experienced fund managers (especially programs under state salary guidelines), and state legislators often lost confidence in the programs, as investment losses preceded winners. These programs also were susceptible to political interference, and as a result, private venture capital funds were reluctant to make a joint investment (and leverage) with state-sponsored programs. Inherent shortcomings with the publicly funded models encouraged states to expand the use of tax credit incentives to encourage private equity investments.

Tax Credit Incentives. Numerous states have developed, or currently are developing, tax credit programs with the goal of stimulating private investments in local venture capital funds or area small businesses (see Table 2 for examples). In general, these programs provide tax credits (e.g., credits against future state income or premium taxes) for high net worth individuals, insurance companies, businesses, and financial institutions that make equity capital investments in approved businesses or venture capital funds. The credits may be spread out over several years and may be transferable to other state taxpayers. The availability of tax credits increases the return to equity investments, and thus it makes investments in state businesses more attractive, relative to alternative opportunities. From the state's perspective, long-term program objectives are to increase the pool of individuals and institutions with venture capital investment experience and enhance the state's venture capital infrastructure. The goal of state tax credit programs is captured in the preface to the 2002 Iowa Seed Capital Investment Credit Act (House File 2271):

The purpose of this division is to enhance the quality of life for citizens of this state through the increased availability of and accessibility to venture capital, particularly at the seed capital investment stage, which encourages the creation of wealth through high-paid,

Table 2

EXAMPLES OF STATE-SPONSORED OR ASSISTED VENTURE CAPITAL PROGRAMS

I. State Capitalization of Fund

A. State-Funded, Publicly Managed Venture Capital Funds

- Iowa Product Development Corp./Iowa Seed Capital Corp.
- Kentucky Rural Innovation Fund
- Minnesota Technology Investment Fund
- North Dakota Development Fund
- Small Enterprise Growth Fund (Maine)

B. State-Funded, Privately Managed Venture Capital Funds

- Colorado Rural Seed Fund
- Kansas Venture Capital Inc.
- Magnolia Venture Capital Corp. (Mississippi)
- Northern Rockies Venture Fund (Montana)

II. Tax Credit Incentives

A. Tax Credits for Investments in Businesses and Venture Capital Funds

- Delaware Investor Tax Credits
- Iowa Community-Based Seed Capital Fund
- Maine Seed Capital Tax Credit Program
- Missouri Capital Tax Credit Program
- Palmetto Seed Fund (South Carolina)

B. Certified Capital Companies and Capital Investment Boards

- CAPCOs: Certified Capital Companies (Louisiana, Missouri, New York, Florida, Colorado, Wisconsin, Texas, Georgia, and Alabama)
- Capital Investment Boards or Corporations (Oklahoma, Iowa, and Arkansas)
- Kansas Capital Formation Cos.

III. State-Assisted Angel Networks

- ACE-Net (46 states)
- OhioAngels.com
- Oklahoma Capital Network
- Montana Private Capital Network

new jobs that increase the wage base and promote industrial development and innovative products that use new technology. The purpose of this division is also to encourage individuals to invest seed capital in Iowa businesses and in community-based seed capital funds.

Much variability exists among state tax credit incentive programs with respect to the amount of the incentive and use of the funds raised through the credits. The Delaware Investor Tax Credit, for example, provides a 15 percent credit for investments in approved businesses, while the Missouri Capital Tax Credit program provides a 60 percent credit for investments in qualified businesses in distressed areas (a 40 percent credit is provided in areas that are not distressed). Tax credits used in other state programs encourage capitalization of specific venture capital funds rather than qualifying businesses directly. South Carolina provided a 30 percent credit for investments in the Palmetto Seed Fund, and Iowa provided a 20 percent tax credit for investments in community-based seed capital funds. Investors in Maine can receive tax credits equal to 40 percent of the investment in either a qualified business or private venture capital fund. Finally, state tax credits may be combined with state appropriations to capitalize private funds. Kansas Venture Capital Inc. was capitalized with \$5 million from the state plus \$6.25 million from state banks, with 25 percent tax credits available to bank investors.

State tax credit incentive programs have the inherent advantage that decisions to invest in venture capital funds and/or small businesses are made by the private sector and motivated by the goal to maximize returns on investments. The tax credit incentives are not, however, without detractors. First, the principal beneficiaries of tax credit incentives are high-wealth individuals, thus, these programs are viewed by some as shifting the tax burden from higher income to lower income taxpayers. Second, there is concern that some of the investments made using tax credits may simply substitute for equity investments that would have existed otherwise. In this case, the net increase in equity capital resulting from the availability of tax credits will be significantly less than the investments

credited to the tax-incentive program. Finally, the use of tax credits reduces future revenue flows to state budgets. Proponents of tax credits argue that new business development, stimulated by the expansion of venture capital, will more than compensate for tax revenues lost because of credits. However, new business development also will lead to higher costs for public goods and services (e.g., schools, police, roads, water, and sewer), if the new businesses result in significant population growth (Barkley, Henry, and Warner, 2002). Thus, the net fiscal impacts of tax credit programs are difficult to estimate without information on the costs associated with growth and the economic trends in the absence of a program.

CAPCOs and Investment Boards. Two tax credit incentives programs, CAPCOs and Capital Investment Boards, warrant special reference because of their size (in terms of tax credits allowed) and popularity among states. CAPCOs and Investment Boards have evolved to the point where they often are presented as competing programs for state tax credits. Selection between these two programs is a daunting task for state legislators because the programs are complicated and lobbying efforts can be intense.

Under the CAPCO program, tax credits (typically 100 percent at a rate of 10 percent per year for 10 years) are allocated to state insurance companies in return for investments (certified capital) in state-approved venture capital funds (certified capital companies or CAPCOs). States generally place a cap on the total amount of tax credits available, for example, \$50 million was the limit in Wisconsin's 1997 legislation. However, the CAPCO industry usually comes back to the state for additional tax credits. The CAPCOs must invest the certified capital according to a specific time schedule, such as 30 percent invested within three years and 50 percent within five years. In addition, CAPCOs must maintain an office in the state and invest only in state businesses specified by the enabling legislation (e.g., small business as defined by the SBA). In sum, CAPCO legislation provides a mechanism for using credits on insurance companies' premium taxes

to capitalize a number (usually three to five) of new, private venture capital funds in the state.

An interesting alternative to traditional CAPCO programs is provided by the State of Kansas' Certified Capital Formation Company Act. Kansas' Capital Formation Companies (CFCs) differ from CAPCOs in three principal ways. First, investors of certified capital in CFCs receive tax credits equal to 50 percent (rather than 100 percent) of their investments spread over 10 years. Second, investors in CFCs are not limited to insurance companies but also include financial institutions, foundations, and individuals with a net worth of at least \$1 million. Third, CFCs must invest 100 percent of their certified capital within five years. Relative to CAPCOs, the Kansas program is both less expensive in terms of tax credits used and more efficient in terms of funds invested in the first five years. The Kansas legislation was passed in May 2002, thus insufficient time has passed to determine the program's ability to capitalize CFCs and fund Kansas entrepreneurs and small businesses.

A second *fund of funds* approach is Capital Investment Boards adopted in Oklahoma, Iowa, and Arkansas and under consideration in other states. The Investment Board program is based on a funding mechanism and a structure designed to minimize the likelihood that public funding assistance will be needed, to insulate the program from political interference, and to insure that funds are managed by qualified professionals. Under Investment Board programs, the state creates public or quasi-public agencies to raise capital and manage the *fund of funds*. The capital for the *fund of funds* comes primarily from institutional lenders and investors, and principal and interest on these investments are guaranteed by state tax credits. Capital raised is allocated to selected private venture capital funds that commit a good-faith effort to make equity investments in state businesses and to maintain a presence in the state. Returns on investments in the private venture capital funds will be used to pay back the investors in the state *fund of funds*. The redemption of tax credits will occur only if the

returns to the fund are insufficient to meet the Board's obligations to the original investors in the fund. Thus, there will be no fiscal burden to the state, if venture capital returns cover the cost of acquiring capital.

CAPCOs and Capital Investment Boards offer different advantages and shortcomings (Barkley, Markley, and Rubin, 1999, 2001). CAPCOs can raise money from insurance companies in a short period of time, and some of the certified capital raised is distributed quickly to state businesses. However, CAPCOs are relatively costly to the state budget because they provide 100 percent tax credits. Yet the state gets little or no return from CAPCO investments. CAPCOs also are an inefficient means of raising and distributing venture capital. Out of every \$10 of certified capital raised, CAPCOs only have \$3-\$5 available for investments because the remaining funds are held in escrow to guarantee payment of principal and interest to the insurance companies. Capital Investment Boards are slower than CAPCOs in making investments in state businesses because time is required to develop the Investment Board structure, raise funds for the *fund of funds*, select private venture capital funds, and provide the private funds sufficient time to identify prospects in the state (Markley and others, 2001). A second shortcoming to Capital Investment Boards is that the selected private funds are not required, only strongly encouraged, to invest in state businesses. The principal advantage of Investment Boards is that they will not cause the state to lose tax revenues from tax credits, if the private venture capital funds realize a typical return on investments.

Regional Angel Networks. "Angel" investors are wealthy individuals, often former or current entrepreneurs, who provide seed capital for start-up businesses and equity financing for more established small firms. Angels often understand the business they're investing in because of past investments or entrepreneurial experience. As a result, they provide start-up businesses with valuable business knowledge, industrial expertise, and business contacts. The investment criteria and goals of angel investors tend to be less strict and formal than

those of venture capital firms. Nonetheless, angels have many of the same investment conditions as venture capitalists, such as documented business plans, preferred stock, rights of first refusal, representation on the board of directors, and anti-dilution provisions. Most angels, like venture capital firms, demand some level of involvement in the company's decisions, although some prefer to remain "silent" investors.

Many individual angel investors pool their capital with other angels to form angel groups or "bands." Angel groups are loosely organized investor alliances that provide an effective way for individual angels to review potential investments, distribute due-diligence work, and share information and opinions. This consolidation of capital allows individual angels to diversify their portfolios and invest in larger ventures. Angel groups generally have a more extensive selection process for investment opportunities than individual investors. Many groups require that candidates for investment must already be sponsored or funded by one of the group's members. For other groups, the group administrator sorts through all the candidates' business profiles and selects the most promising ones to be reviewed by a small group of members with relevant expertise. These subgroups then decide which firms will provide a formal presentation to the entire group.

Formal angel networks reduce the transaction costs of angel investing by facilitating the linking of investors and businesses in need of financial assistance. The most comprehensive network is the Angel Capital Electronic Network (ACE-Net), which is operated by a nonprofit organization that evolved out of the 1995 White House Conference on Small Businesses. ACE-Net provides an Internet forum for the listing of security offerings by small businesses. Angels then can efficiently sort through the prospective companies based on factors such as product, location, stage of development, and investment size. Additional programs planned by ACE-Net include research information and educational tools targeted at accredited investors and entrepreneurs.

Accredited angel investor networks are popular and relatively low-cost state and regional venture capital initiatives. Examples of state programs include the Oklahoma Capital Network, Montana Private Capital Network, and Ohio Angels.com. These programs, like ACE-Net, use the Internet to reduce the transaction costs associated with linking entrepreneurs, angels, venture capital firms, and service providers. In addition, a second form of angel network involves organizing local investors to pool money in a fund and provides legal and technical support for the organization. MIN-Corp is attempting to establish 10 such networks in Minnesota, two of which (Lakes Venture Group in Alexandria and Prairie Capital in Worthington) have capitalized funds. The State of Iowa provides tax credit incentives to encourage the development of angel investing and local angel networks. A tax credit of 20 percent of the taxpayer's equity investment is available for individuals who invest directly into a qualifying business or community-based seed capital fund.

LOCAL AND SUBSTATE VENTURE CAPITAL PROGRAMS

State-assisted venture capital programs, unless they specifically target rural areas, generally provide limited benefits for entrepreneurs and small businesses in rural communities. For example, Kansas Venture Capital Inc., one of the more successful state-assisted programs, invested in only six nonmetropolitan businesses (out of 30) in its first 20 years of operation. A relative lack of rural investments is not unexpected given that metropolitan areas in a state generally offer both greater deal flow and an entrepreneurial support environment that reduces the costs of serving urban businesses. One response to the absence of rural venture capital investments by federal- and state-sponsored programs is the creation of local or substate programs. The RUPRI Rural Equity Capital Initiative identified four general types of substate programs: community development venture funds, community level venture capital institutions, rural utility cooperatives, and angel networks (Barkley and Markley, 2001). Angel networks were

presented earlier; thus, the following discussion focuses on the remaining three program types (see Table 3).

Community Development Venture Funds. Community development venture capital funds (CDVC) are created to make investments that lead to job creation and other social benefits in distressed communities, such as rural Appalachia or an urban center (Waddell, 1995; Federal Reserve Bank of Kansas City, 1999; and Tesdell, 2002). These funds have a dual bottom line, balancing the goals of economic development and poverty alleviation with the achievement of a rate of return that supports fund sustainability. Community development funds often are capitalized with investments from foundations, federal agencies, and local organizations, such as banks, that are interested in contributing to economic development in a specific

Table 3
EXAMPLES OF LOCAL
AND SUBSTATE VENTURE
CAPITAL PROGRAMS

I. Community Development Venture Funds

- Adena Ventures (Athens, Ohio)
- Cascadia (Seattle, Wash.)
- Coastal Ventures Limited Partnership (Portland, Maine)
- Kentucky Highlands Investment Corp. (London, Ky.)
- Northeast Ventures (Duluth, Minn.)

II. Rural Electric Cooperatives

- Sheridan Electric Cooperative (Montana)
- Northern Electric Cooperative (Montana)
- Central Iowa Power Cooperative (Iowa)

III. Community-Level Equity Programs

- Ames Seed Capital Fund (Ames, Iowa)
- McAlester Investment Group (McAlester, Okla.)
- Siouxland Ventures Inc. (Sioux City, Iowa)

area. Prominent CDVC funds serving primarily rural areas include Kentucky Highlands Investment Company in Appalachian Kentucky and Adena Ventures of Southeast Ohio.

A recent Brookings Institution report (Moy and Okagaki, 2001) contends that there are fewer capital gaps now than at any time since 1970, and thus, there is a reduced need for CDFIs, such as community development venture funds. May and Okajaki (2001, p.10) note, however, that niches remain for CDFIs including "... (1) products with high transaction costs; (2) customers who require a lot of handholding; and (3) capital needs, which are relatively far out on the risk spectrum." The above niche characteristics are representative of the rural entrepreneurs and small businesses served by rural community development venture capital funds.

Community-Level Venture Capital Institutions. Community-level programs are small, privately funded, privately managed institutions that focus investments on local businesses and entrepreneurs. Local angels, businesses, financial institutions, and organizations, such as the chamber of commerce, provide funding for capitalization. State programs, such as the Iowa tax credit for community venture funds, may have been instrumental in the development of some substate programs. Fund management generally is conducted by a sub-committee of investors, and investment goals promote local economic development subject to a favorable return to fund investors.

The financial success of community-level venture capital programs, as measured by fund internal rate of return (IRR), has not been impressive. These local funds generally restrict their service areas to the extent that adequate deal flow of attractive investment opportunities is a common problem. Fund management also usually is part time and not by a venture capital professional. Thus, management often does not have sufficient time or adequate incentives to conduct needed due diligence on prospects or provide managerial and technical assistance to portfolio companies.

Finally, an underlying goal of most community-level funds is the improvement of the area economy. Attention to job creation potential, as opposed to fund IRR, results in investments that are detrimental to fund profitability and sustainability. In sum, community-level funds have the most precarious financial experiences among the nontraditional venture capital institutions. Sustainability of these funds requires significant attention to deal flow, portfolio management, and return on investments.

Utility Cooperatives. Rural utility cooperatives in Montana and Iowa have provided equity capital to entrepreneurs and small businesses in their service areas. The Montana rural electric cooperatives invested directly in area businesses. Alternatively, in Iowa, two rural cooperatives capitalized a venture capital fund (Iowa Capital Corp.) that invested in Iowa businesses in the co-ops' service areas. In the case of the Iowa cooperatives, the state provided a one for two match to encourage the utilities' participation in the venture capital fund.

Freshwater (1998) notes that utility cooperatives are well-suited for making local equity investments for four reasons. First, an inherent function of cooperatives is to provide service to members. This function usually occurs in terms of input on marketing services, but the concept is applicable to financial services. Second, cooperatives generally have a significant asset base in the form of unallocated surplus, and they have good access to debt-financing. Third, cooperatives can take a long-term perspective on their investments, which is critical for rural equity investments since it may be difficult to develop an exit strategy, such as finding a buyer for the business, especially a buyer who will not relocate. Finally, cooperatives may capture some of the social benefits from their investments in terms of new business and residential customers.

The deregulation of the electric utility industry may dampen rural utility cooperatives' interest in venture capital investing. Electric cooperatives no longer have captive residential and commercial markets, thus,

Table 4

SUMMARY OF SUCCESS FACTORS AND LESSONS LEARNED FROM RECENT STUDIES OF STATE-SPONSORED PROGRAMS

I. Best Practices of State-Sponsored Seed and Venture Capital Programs and Alternatives to Direct State Funding, Beldon H. Daniels and Joseph Lynch, Economic Innovation International Inc., 1998, p. 35.

1. Market is large enough to generate sufficient deal flow.
2. Goals focus first on returns; economic benefit follows.
3. Management matters most and is compensated appropriately.
4. Financial structure focuses on net internal rate of return.
5. Fund size is optimum for early stage focus and follow-on investments.
6. Legal structure is 10-year limited partnership, as preferred by investors.
7. Marketing helps generate deal flow.
8. Public accountability and oversight focuses only on economic and portfolio returns; protects confidentiality and guards against conflict of interest.

II. Growing New Businesses with Seed and Venture Capital: State Experience and Options, Robert G. Heard and John Sibert, National Governors Association, 2000, p. 17-18.

Best Practices (among venture programs)...

1. Rely on experienced, private-sector managers to make day-to-day investment decisions.
2. Recognize that the challenge of capital formation is about knowledge, as well as money.
3. Have a long-term perspective.
4. Treat the state as a valued financial partner.
5. Are not afraid to make money.
6. Are careful not to oversell.
7. Are large enough to make a difference.
8. Are governed by discretion, exercised by trained professionals and experienced laymen.

venture capital investments in area businesses may not result in additional customers for the utility. The separation of the financial return on investments in small businesses from the return on the sale of additional

power may be sufficient to discourage utility cooperatives from participating in equity investments.

LESSONS LEARNED FROM PUBLICLY ASSISTED VENTURE CAPITAL PROGRAMS

Four recent studies have analyzed publicly sponsored venture capital programs with the purpose of identifying best practices and success factors. Two of these studies (Daniels and Lynch, 1998; Heard and Sibert, 2000) investigated state programs in general, while the RUPRI (Barkley, Markley, and Rubin, 1999; Barkley and others, 2001a and 2001b) and Gjovig (2002) papers focused on venture capital programs for rural or geographically isolated capital markets. The lessons learned from the four studies (summarized in Tables 4 and 5) are consistent with respect to the criteria shared by successful publicly sponsored programs: employ

quality management, focus on profits, and maintain sufficient program size to make a difference.

Management must be skilled in venture capital investing and compensated for making successful investments and growing the fund. The management team also must be free from political interference; however, public accountability of economic and portfolio returns should be incorporated into all publicly assisted programs. Program focus must be on maximizing the fund's internal rate of return (IRR). Publicly sponsored venture capital programs that give primary attention to the location or employment generation prospects of a firm are significantly less likely to make profitable investments and grow the fund. Finally, the capitalization of the program must be sufficient to per-

Table 5

SUMMARY OF SUCCESS FACTORS AND LESSONS LEARNED FROM VENTURE CAPITAL PROGRAMS FOR RURAL AREAS AND STATES

I. Establishing Nontraditional Venture Capital Institutions: Lessons Learned, David L. Barkley, Deborah M. Markley, David Freshwater, Julia Sass Rubin, and Ron Shaffer, Rural Policy Research Institute, 2001, p. 7.

1. Management was skilled and experienced, and an incentive system rewarded management for increasing the value of the fund.
2. Institution's resources were allocated for generating deal flow.
3. Capitalization of the fund was optimal for providing a diverse portfolio and follow-on investments.
4. Institution's management gave significant attention to fund IRR.
5. Institution provided assistance to portfolio companies after investments were made.
6. Political pressure or interference in fund management was minimized.

II. Seed and Venture Capital Strategies in Fly-Over States, Bruce Gjovig, NASVF Conference presentation, Pittsburgh, Pa., September 2002.

1. Tax credits are good incentives to attract angel, corporation, and utility investors.
2. Technical assistance is important to reduce risk for seed funds.
3. Need follow-on funding for seed funds and ways to leverage funding.
4. Diversify portfolio of investments.
5. Define exit strategies appropriate for rural areas (few IPOs).
6. Avoid geographic restrictions to good deal flow.
7. Goal/focus is to build infrastructure for entrepreneurship, innovation, and technology.
8. Build infrastructure, not program.

mit a diversified portfolio with funding available for follow-on investments. Publicly sponsored programs rarely have the privilege of focusing on a narrow industrial sector or specific stage of the development process.

Venture capital programs that target entrepreneurs and small businesses in rural areas face especially difficult investing environments because of the relative lack of deal flow and support services. As such, successful rural venture capital programs share five attributes in addition to the necessary but not sufficient conditions of experienced management, adequate funding, and focus on rate of return.

1. *Deal Flow.* The service area of a rural-focused program should be extensive enough to permit the prospects of good deal flow. In addition, significant program resources likely will need to be allocated for identifying potential entrepreneurs and assisting them in developing a business idea to the point of being investment ready. The development of a more entrepreneurial environment for the region and viable candidates for investment may be enhanced through linkages to other area organizations, such as community colleges, chambers of commerce, and SBDCs.
2. *Support Services.* In general, rural entrepreneurs lack the experience of their urban counterparts, and rural small business environments lack the diversity of services needed by new companies. Rural venture capital programs must make available resources for support services for marketing, management, and technical assistance. Ideally, the venture capital program puts together a package of assistance (equity capital plus services) that will maximize the probability of the new firm's success. The focus of the package is the entrepreneur and his/her enterprise, not just the equity capital needs. The importance of support services is recognized in the recent federal NMVC and RBIC legislation, and resources are provided to enhance these services.

The importance of support services should not be interpreted to mean that the rural entrepreneurial support environment should provide a large number of different programs and classes for the prospective and new business owner. Entrepreneurs and small business owners are, in general, too busy growing their companies to take advantage of many informational opportunities. However, the support services should be available through the venture capital institution as the need for the services arises.

3. *Managerial Capabilities.* The management team of a rural venture capital program should possess a blend of deal-making and business management skills. Rural venture capitalists may need to work closely with their portfolio companies to provide assistance with management decisions. With respect to Community Development Venture Capital funds, Tesdell (2002, p. 25) suggests that "Extensive entrepreneurial and managerial assistance is central to the economic development function of CDVC funds and often proves as important to the success of portfolio companies as the financing itself."

In extreme, but not uncommon situations, the rural venture capitalist may find it necessary to assume management of a portfolio company in order to turn it around. Rural venture capitalists find it difficult to attract new management from outside the region to take over a struggling rural company. Thus, the ability to manage a company during a turnaround may make the difference between a good versus a bad investment.

4. *Range of Financial Products.* Rural entrepreneurs need different types of financial assistance during the different stages of business development (e.g., early stage, expansion, acquisition). The efforts of a rural venture capital program will have limited long-term value, if funding is available at one stage but not later. Rural venture capital programs may provide an array of financial instruments (equity

and debt) to meet the changing needs of the entrepreneur, or the program may maintain connections to other capital providers to meet the evolving capital needs of its portfolio companies.

5. *VC Program is Entrepreneurial.* The management of a successful rural venture capital program will aggressively investigate new ways to provide technical assistance and equity/debt programs to meet the needs of area entrepreneurs. The Kentucky Highlands Investment Company (KHIC), for example, provides subsidized rent in its industrial parks in exchange for a share of equity in the company. In addition, grantsmanship within KHIC permits the program to take advantage of a number of federal programs (e.g., New Market Tax Credits), as well as private and foundation funding (Markley and Barkley, 2003).

In summary, the list of desirable attributes for rural venture capital programs exceeds those for statewide programs and traditional venture capital funds. Equity investors consider rural areas to be relatively uninviting markets because of the industry mix, unsophisticated entrepreneurs and small business owners, and absence of entrepreneurial support services. These disadvantages of rural areas may be overcome but only through significant attention to deal flow development and assistance to firms after investments are made.

SUMMARY AND POLICY SUGGESTIONS

Entrepreneurs and small businesses in rural areas do not have similar access to equity capital and entrepreneurial support services as their urban counterparts. Venture capitalists avoid rural businesses because of the relatively high costs of finding, supporting, and liquidating deals in rural areas. The public policy response to this rural equity capital gap is the public funding of venture capital programs or the provision of incentives to increase the private funding of rural entrepreneurs. These policy efforts have resulted in a

wide variety of program types and a diversity of program experiences with respect to financial returns and economic development impacts. These experiments in public policy provide insights into state and local policy procedures related to developing a successful and sustainable rural equity finance program.

First, the federal government is not likely to solve the equity capital needs of rural entrepreneurs and small businesses. Policies at the federal level (e.g., New Markets Venture Tax Credits and Rural Business Investment Companies) are too broad with respect to eligible investments (capital types and geography) to result in significant additional assistance to rural entrepreneurs. For example, most NMTC allocations are targeted for loans and real estate projects, and much of the investment activity of the proposed RBICs could occur in the suburbs of metropolitan areas given the program's relatively generous definition of "rural." A federal role to reduce the rural equity capital gap is possible, if federal legislation can be drafted that focuses on venture capital and rural businesses. Such targeted legislation might include: (1) an extension of the New Markets Venture Capital program to additional underserved nonmetro areas, (2) federal tax credits incentives for individuals (angels) that provide venture capital to rural entrepreneurs and businesses, and (3) tax credit incentives for investors in venture capital funds. But the incentives are proportional to the fund's equity investments in rural businesses.

Second, the real innovation in nontraditional venture capital institutions has occurred at the state and regional levels. A diversity of institutional types exists, yet no best model has evolved from these experiments. All institutional types had examples of successful and unsuccessful programs. The key to creating a successful venture capital institution is to devote significant resources to research and planning, so that the selected program size, structure, and management team best meet the needs of targeted entrepreneurs. Too often a state or community will simply imitate a program of a neighboring state or community, at times even before

the imitated program has been in existence long enough to judge program success. Research will permit the identification of the advantages and disadvantages of the local entrepreneurial environment and the design of a venture capital program appropriate for that environment.

Third, program planning and development also should include time and resources for educating public officials. Equity capital programs can be complicated with the possibility of unintended consequences. A good program is more likely to be selected when more information is provided. Examples of sources of information on public and private venture capital are provided in Table 6.

Fourth, successful state and local efforts to enhance rural venture capital often have a champion—an organization that remains knowledgeable regarding policy alternatives and keeps the issue of capital adequacy before policymakers. Examples of such organizations are KTEC in Kansas and the Carolina Crescent Coalition in South Carolina. These organizations provide the unbiased information and sustained interest in the issue necessary to the development of viable programs to enhance the rural equity market. In summary, there is a thin line between successful and unsuccessful rural equity programs. Attention to detail (i.e., due diligence) in the planning phase of a program may be the critical determinant of the program's success.

Table 6

SOURCE GUIDE FOR INFORMATION ON VENTURE CAPITAL

Rural Policy Research Institute's
Rural Equity Capital Program
www.rupri.org

National Association of Seed
and Venture Funds
www.nasvf.org

Community Development
Venture Capital Alliance
www.cdvca.org

National Governor's Association
Best Practices
www.nga.org

National Venture Capital Association
www.nvca.org

Venture Economics
www.ventureeconomics.com

Community Development Financial
Institutions Fund
www.cdfifund.gov

Angel Capital Electronic Network
acenet.csusb.edu

PricewaterhouseCoopers Moneytree Survey
www.pwcmoneytree.com

Coalition of Community Development
Financial Institution
www.cdfi.org

National Community Capital Association
www.communitycapital.org

Source: Tomaka, 2002; National Community
Capital Association, 2003

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