ESTABLISHING NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: LESSONS LEARNED

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Study of Nontraditional Venture Capital Institutions

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The RUPRI Rural Equity Capital Initiative was funded by a grant from the U.S. Department of Agriculture’s Fund for Rural America. The purpose of this project was to examine innovative institutions that are making venture capital investments in rural places across the country and develop lessons learned from these institutions that might be applied in other areas. The project research team included Deborah M. Markley (chair), principal of Policy Research Group, a consulting firm in Chapel Hill, NC; David L. Barkley, Professor and Co-Coordinator, Regional Economic Development Research Laboratory, Clemson University, Clemson, SC; David Freshwater, Professor, Department of Agricultural Economics, University of Kentucky, Lexington, KY; Ron Shaffer, Professor, Department of Agricultural and Applied Economics, University of Wisconsin, Madison, WI; and Julia Sass Rubin, Ph.D. candidate in Organizational Behavior, Harvard University.

As part of this project, 23 case studies of nontraditional venture capital institutions or programs were completed during 1998, 1999 and 2000. The information from these visits forms the basis of a four-part series that describes the lessons learned from the experiences of these institutions, the rationale for nontraditional institutions, the process for establishing nontraditional venture funds, and detailed case studies of each institution. The specific publications are:

- **Establishing Nontraditional Venture Capital Institutions: Lessons Learned.** This publication describes lessons learned from the case studies. Advantages and disadvantages of different organizational structures are discussed and characteristics of successful nontraditional venture funds are presented.

- **Nontraditional Venture Capital Institutions: Filling a Financial Market Gap.** This publication provides an overview of the venture capital industry, discusses impediments to making venture capital investments in rural areas and non-high tech business enterprises, and suggests roles for nontraditional venture capital in small market areas.

- **Establishing Nontraditional Venture Capital Institutions: The Decision-Making Process.** Based on information from the 23 case studies, the research team outlined a decision-making process for establishing nontraditional venture capital funds. This publication describes the sequential steps in this process and discusses the interrelated nature of the decisions made at each point in the process. Specific examples illustrate the process.

- **Case Studies of Nontraditional Venture Capital Institutions.** This publication provides detailed case studies of the 23 institutions included in this project. The history of each institution is described, along with its organizational structure, investment experience, and future concerns or opportunities for the fund. The perspective of some portfolio companies is also included.

This report, along with other publications produced for this project, are available from the RUPRI website ([www.rupri.org/pubs/equitycap/index.html](http://www.rupri.org/pubs/equitycap/index.html)) or by contacting RUPRI at 573-882-0316.
Establishing Nontraditional Venture Capital Institutions: Lessons Learned

The availability of venture capital for entrepreneurs and businesses is recognized as critical for new business start-ups and business expansions. Yet venture capital investments are concentrated in a small number of regions and industries (Figure 1). According to the 1999 PriceWaterhouseCoopers Moneytree survey, 67.1 percent of venture capital investments in the United States were in California, Massachusetts, New York, and Texas, and 91.0 percent of the investments were in technology-based companies, including internet-related businesses. Moreover, per capita venture capital investments for the United States were approximately $143.00 in 1999, yet only six states exceeded the national average (Massachusetts, $597.00; California, $522.00; Colorado, $335.00; Washington, $215.00; New Hampshire, $199.00; and Connecticut, $159.00). Alternatively, 24 states had per capita venture capital investments less than $20.00, or investments less than one-seventh of the national average. States with relatively low per capita capital investments were concentrated in the Plains, Midwest, and South Central regions.

The industrial focus and geographic concentration of venture capital activity contributed to the view that certain industries and regions of the country are underserved by traditional venture capital firms. The uneven allocation of venture capital investments among regions and industries potentially reflects the distribution of good investment opportunities. However, it also may reflect market failures that result from imperfect information and high transactions costs. In response to this perception of market failures, “nontraditional” venture capital institutions—defined as funds or programs established to address venture capital needs and/or to enhance economic development prospects in regions and industries underserved by traditional venture capital funds—have evolved (Table 1).

This paper summarizes the lessons learned from in-depth case studies of 23 nontraditional venture capital institutions. The advantages and shortcomings of alternative institutional types, a recommended decision-making process for establishing a nontraditional institution, and shared characteristics of successful nontraditional institutions are provided. An important cautionary lesson also is drawn from these case studies: establishing a nontraditional venture capital institution is a difficult process. While lessons can be learned from the experiences of existing institutions, creating a venture capital institution requires careful consideration of the need for venture capital in the targeted region and the chances for success of the fund.

The information presented in this report is a summary of findings from a research project undertaken for the Rural Equity Capital Initiative of the Rural Policy Research Institute (RUPRI). Other reports in this series include:

3. “Case Studies of Nontraditional Venture Capital Institutions.”

The publications are available on the RUPRI Web site (www.rupri.org/pubs/equitycap/index.html).
Figure 1. Per Capita Venture Capital Investments by State, 1999.
Source: 1999 Pricewaterhouse Coopers Moneytree Survey (www.pwcmoneytree.com)
Table 1. Characteristics of Nontraditional Venture Capital Institutions

A. Nontraditional institutions operate outside of regions and industrial sectors where venture capital investments are concentrated, for example, in small market areas (small metro areas and rural communities) and in the more traditional industries.

B. Nontraditional institutions expect a financial return on investments that is less than the 30-40% annual return anticipated by traditional venture capital institutions.

C. Nontraditional institutions generally operate with a geographic focus or geographic restrictions such as a specific community, state, or region.

D. Nontraditional institutions may have a dual bottom line of acceptable financial returns and social and economic benefits to the service area. Thus, nontraditional institutions are capitalized by funding sources that value economic and social returns in addition to financial returns (for example, state government, local government, nonprofit foundations, Community Development Finance Institutions, Small Business Administration, commercial banks, pension funds, civic minded individuals).

Traditional Venture Capital Institutions

In general, traditional venture capital funds are organized as limited partnerships with a predetermined life of ten years. The limited partners provide capitalization of the funds, and the venture capitalists serve as general or managing partners. The funds invest in portfolio companies the first one to three years, targeting investments with an expected return of at least 30 percent a year. Proceeds from the investments are harvested in the later years of the partnership and distributed to the limited partners. The managing partners generally receive an annual management fee of 2-3 percent of fund capital and a predetermined percentage of the profit or earned interest on the fund’s investments (for example, 20 percent). The original investment in the fund by the limited partners and the remaining gains on the partnership (for example, 80 percent of earned interest) are returned to the limited partners. In sum, limited partnerships incorporate the structure, incentives, and checks and balances necessary to encourage a common goal (maximize the rate of return on fund investments) for the investors, managing partner, and portfolio companies. This type of traditional venture capital institution is considered a relatively efficient means of raising funds from investors and allocating these funds among investment alternatives.²

Traditional venture capital institutions do not, however, aggressively seek investment opportunities in small metropolitan areas and nonmetro communities because deal flow is sparse, costs per investment are relatively high, exit opportunities are limited, and local business environments are less supportive (Table 2). Thus, alternative types of venture capital providers have evolved to serve the venture capital needs of small market areas and traditional industries. Nontraditional institutions can function in these markets because of assistance or subsidies from public or private organizations or because of goals other than maximizing fund profits.
Table 2. Impediments to Traditional Venture Capital Investing in Small Market Areas

A. **Limited Deal Flow.** The economic base of small market areas is relatively concentrated in low-tech, slow-growth sectors. These sectors do not provide numerous investment opportunities with the high rates of return favored by traditional venture capital funds.

B. **Higher Costs Per Investment.** Investment opportunities are more limited and geographically dispersed in small market areas than in metro areas. Thus, the venture capitalist serving small market areas will experience higher time and travel costs for identifying prospects, conducting due diligence, and monitoring investments.

C. **Limited Opportunities for Exiting Deals.** Many businesses in small market areas are family owned with the goals of transferring ownership to the next generation and/or maintaining the current business location. Such goals limit exit strategies and reduce attractiveness of the investments to venture capitalists.

D. **Lack of Favorable Local Business Environment.** Small market areas offer relatively limited business infrastructure and human capital to facilitate management of new companies. Thus venture capitalists may have the additional expense of acquiring business services and managerial and technical personnel from outside the area or providing extensive technical assistance to existing company management.

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**Nontraditional Institutions**

Case studies were undertaken to provide insights into the funding, organization, and operation of nontraditional venture capital institutions and programs (Table 3). Site visits to 23 institutions were conducted during 1998, 1999, and 2000. Visits generally included interviews with program directors/managers, founders or champions of the program, and when possible, owners of two or three of the program’s portfolio companies. Information collected included history of the institution, sources and uses of funds, institutional organization and operations, characteristics of investment portfolio, status of portfolio companies, constraints/concerns with current operations, and goals or directions for future operations. The objective of the analysis was to better understand the advantages and shortcomings associated with alternative institutional structures and the shared characteristics of successful programs. The institutions selected for site visits were not chosen to document “best practices,” indeed four of the programs are no longer active.

The case-study institutions represent six general types of nontraditional programs: publicly funded and publicly managed institutions, privately managed funds with public funding or incentives, certified capital companies (CAPCOs), community-level equity programs, community development venture funds, and Small Business Investment Companies (SBICs). Programs differ primarily in terms of sources of capitalization, organizational and management structure, and investment goals. Summary characteristics of the alternative nontraditional institutions are provided below.
Table 3. Site Visit Venture Capital Institutions by Category

A. **Publicly Funded, Publicly Managed Institutions**
   a. Small Enterprise Growth Fund (Augusta, ME)
   b. Minnesota Technology Corporation Investment Fund/MIN-Corp (Minneapolis, MN)
   c. Iowa Product Development Corporation/Iowa Seed Capital Corporation (Des Moines, IA)

B. **Privately Managed Funds with Public Funding or Incentives**
   a. Iowa Capital Corporation (Des Moines, IA)
   b. Colorado Rural Seed Fund (Boulder, CO)
   c. Northern Rockies Venture Fund (Butte, MT)
   d. Oklahoma Capital Investment Board (Oklahoma City, OK)
   e. Partner Funds: Pacesetter and MESBIC Venture Funds (Dallas, TX)
   f. Magnolia Venture Capital Fund (Jackson, MS)
   g. Kansas Venture Capital, Inc. (Overland Park, KS)

C. **Community-Level Equity Programs**
   a. Ames Seed Capital Fund, Inc. (Ames, IA)
   b. Siouxland Ventures, Inc. (Sioux City, IA)
   c. McAlester Investment Group (McAlester, OK)
   d. Montana Rural Electric Utility Cooperatives

D. **Certified Capital Companies (CAPCOs)**
   a. Louisiana CAPCO Program (Baton Rouge, LA)
   b. Missouri CAPCO Program (Jefferson City, MO)

E. **Community Development Venture Funds**
   a. Coastal Ventures Limited Partnership (Portland, ME)
   b. Kentucky Highlands Investment Corporation (London, KY)
   c. Cascadia (Seattle, WA)
   d. Northeast Ventures (Duluth, MN)
   e. Appalachian Ohio Development Fund (Athens, OH)

F. **Small Business Investment Companies (SBICs)**
   a. First United Ventures (Durant, OK)
   b. North Dakota SBIC (Fargo, ND)
   c. North Carolina Economic Opportunities Fund (Raleigh, NC)

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a MIN-Corp and Kansas Venture Capital, Inc. recently became private venture capital institutions and MIN-Corp is also considered a community development venture fund. However, both institutions were started with significant public support (funding and/or management).

b Kansas Venture Capital, Inc. is also an SBIC.

c The Montana Rural Electric Utility Cooperatives’ investment activity occurred in a number of communities throughout the state: Medicine Lake, Great Falls, Sun River, Opheim, and Culbertson.
Publicly Funded, Publicly Managed Programs

The institution is usually capitalized with state money made available through appropriations or sale of bonds. Fund management is provided by a public or quasi-public agency (for example, State Department of Commerce). Institutional goals generally are related to promoting economic development and/or improving state venture capital markets.

Privately Managed Programs with Public Funding or Incentives

State monies generally are placed in private venture capital institutions, and/or public incentives such as tax credits are used to encourage the placement of private monies in the funds. A private party manages the fund, though government representatives may serve on the institution’s board. Investment goals generally are to maximize the fund’s internal rate of return (IRR) subject to state restrictions on the location and type of investments.

Certified Capital Companies

Certified Capital Companies (CAPCOs) are privately funded, privately managed institutions created by state enabling legislation. Capitalization of CAPCOs is provided by insurance companies in exchange for 100 percent state tax credits over 10 years on premium taxes paid by insurance companies. CAPCOs place approximately 40 percent of the raised capital in zero coupon bonds as collateral on the insurance companies’ investments, thus not all certified capital raised from insurance companies is available for investments in qualified businesses. CAPCOs must invest the certified capital in specific types of qualified in-state businesses according to a specific investment schedule, for example, 50 percent of certified capital invested in qualified businesses within 5 years. CAPCO investment goals are to maximize IRR from fund investments, while meeting the state’s regulatory requirements.

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 like the chamber of commerce provide funding for capitalization. Fund management generally is conducted by a subcommittee of investors, and investment goals promote local economic development subject to a favorable return to fund investors.

Community Development Venture Funds

Community development venture capital funds were created to make investments that would lead to job creation and other social benefits in distressed communities, such as rural Appalachia or an urban center. 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 area.

Small Business Investment Companies

Small Business Investment Companies (SBICs), privately owned for-profit investment institutions, provide long-term loans and equity capital to small businesses. These institutions are licensed and monitored by the U.S. Small Business Administration and, as a result, may use borrowed federal funds in addition to private funds to finance new and established small businesses. The SBIC structure has been used widely since its inception; however, this study found only one SBIC located in a nonmetropolitan area and few SBICs with a significant rural focus.
Advantages and Disadvantages of Alternative Institutional Types

Each of the six program alternatives has distinct advantages and disadvantages and the most desirable program type for a particular situation will depend on program goals, available funding sources, existing venture capital infrastructure, target industries, and political environment. The advantages and shortcomings of the three publicly assisted venture capital programs (publicly funded and managed; publicly funded, privately managed; CAPCOs) are summarized in Table 4. Comparisons of the three programs that are primarily privately funded and managed (community-level equity funds, community development venture funds, and SBICs) are provided in Table 5.

Based on the 23 case studies conducted for this project, the research team concluded that there is no single best model for a nontraditional venture capital institution. No program dominated the others in terms of likelihood of success, and successful and unsuccessful institutions were observed for all program types. However, the successful nontraditional venture capital institutions in small market areas generally shared six characteristics:

- Management was skilled and experienced, and an incentive system was in place that rewarded management for increasing the value of the fund.

- Institution's resources were allocated for generating deal flow via marketing or deal creation.

- Capitalization of the fund was optimal for providing a diverse portfolio and follow-on investments.

- Institution’s management gave significant, but not always primary attention to fund IRR in order to maintain the long-run sustainability of the fund.

- Institution maintained a system for conducting rigorous due diligence on prospective investments and provided assistance to portfolio companies once investments were made.

- Potential for political pressure or interference in fund management was minimized.

Thus, the keys to successful nontraditional venture capital programs are the management and administration of the program, not the selected structure. Successful institutions provide the necessary resources and incentive system to encourage and permit the development of deal flow, close scrutiny of investment opportunities, and postinvestment monitoring and assistance. However, establishing a nontraditional venture capital institution is not an easy task. Many of the successful case study programs struggled at some point in their history. Their experience suggests that the process of creating a successful nontraditional venture capital institution requires the same commitment to due diligence as the venture capital investment process itself.
<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td><strong>Publicly Funded, Publicly Managed</strong></td>
<td><strong>Publicly Funded, Publicly Managed</strong></td>
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<tr>
<td>• Programs can be designed to meet policy objectives such as economic development or industry targeting</td>
<td>• Political pressure to make investments in specific communities or firms may exist</td>
</tr>
<tr>
<td>• Economic and social impacts are more likely to be considered in investment decisions</td>
<td>• Public programs find it is difficult to attract most talented fund managers</td>
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<td>• Lower returns on investments can be justified by potential social returns</td>
<td>• Private venture capital firms are reluctant to co-invest with public funds</td>
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<td>• Some state constitutions do not permit equity investments by state agencies</td>
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<tr>
<td><strong>Public Funding or Incentives, Privately Managed</strong></td>
<td><strong>Public Funding or Incentives, Privately Managed</strong></td>
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<tr>
<td>• Political pressure to make specific investments is diminished</td>
<td>• Political pressure may be present in selecting private venture capital fund</td>
</tr>
<tr>
<td>• Program can offer the higher salaries and profit sharing necessary to attract experienced fund managers</td>
<td>• State economic development objectives may be undermined by focus on fund rate of returns or concentration of investments in specific industries or stage of business development</td>
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<tr>
<td>• Private investors more willing to invest in privately managed funds, providing leverage for public capital</td>
<td>• Economic performance of the fund may be limited by restrictions on geographic location or eligible businesses</td>
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<tr>
<td>• Private venture capital funds more willing to co-invest with other private funds, increasing syndication opportunities</td>
<td><strong>Certified Capital Companies (CAPCOs)</strong></td>
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<tr>
<td>• Private fund managers generally are available to assist management of portfolio companies</td>
<td>• The State generally receives little or no share of the profits on CAPCO investments made possible by state tax credits of 100 percent over 10 years to insurance company investors</td>
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<tr>
<td><strong>Certified Capital Companies (CAPCOs)</strong></td>
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<tr>
<td>• Political pressure to invest public monies in specific private venture capital funds is avoided</td>
<td>• CAPCOs make limited seed and start-up investing</td>
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Table 5. Advantages and Disadvantages of Privately Funded and Managed Venture Capital Institutions

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<th>Community-Level Equity Fund</th>
<th>Community-Level Equity Fund</th>
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<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
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<tr>
<td>Funds focus investments on specific location, increasing economic development impacts</td>
<td>Deal flow is limited to a relatively small geographic area, affecting the profitability and sustainability of the fund</td>
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<td>Investors in the fund may realize profits from investments as well as indirect benefits such as higher retail and real estate sales</td>
<td>Managerial resources and expertise for conducting due diligence on investment prospects are limited</td>
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<tr>
<td>Funds can target areas overlooked by traditional and state-level venture capital funds</td>
<td>Inadequate fund size to provide diverse portfolio and follow-on investments</td>
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<tr>
<th>Community Development Venture Capital Institutions (CDVC)</th>
<th>Community Development Venture Capital Institutions (CDVC)</th>
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<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
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<tr>
<td>Funds focus on social goals, such as job creation, increasing the economic development impacts of fund investments</td>
<td>Deal flow is limited and in many cases must be developed, resulting in higher operating costs for the fund</td>
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<tr>
<td>Funds target geographic areas (rural), populations (low income), business stages (very early start ups) and industries (traditional manufacturing) that are often overlooked by traditional and state-level venture capital funds, potentially enhancing economic development impacts</td>
<td>Funds may require continued subsidy to cover operating costs</td>
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<tr>
<td>Smaller average deal size (less than $200,000) is more appropriate for many rural investments</td>
<td>Pool of qualified fund managers with experience in community development investing is limited because of the relative youth of the CDVC industry</td>
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<td>The provision of extensive technical assistance to portfolio companies potentially improves success rates</td>
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<th>Small Business Investment Companies (SBICs)</th>
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<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
</tr>
<tr>
<td>SBICs are able to leverage private capital with federal funds provided through the Small Business Administration (SBA)</td>
<td>Fund organizers may not be able to raise enough capital to meet the minimum size requirements of the SBA, making the SBIC structure less useful in small market areas</td>
</tr>
<tr>
<td>Licensing requirements set minimum standards for qualified fund managers, improving the overall quality of fund management</td>
<td>Regulation by the SBA, which stipulates allowable management fee percentages and requires extensive reporting on activities and financial status, creates extra administrative overhead that may be difficult for small market funds to comply with</td>
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<td></td>
<td>SBICs are constrained regarding qualified investments though these constraints are reduced for participating securities SBICs.</td>
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Decision-Making Process for Establishing Nontraditional Institutions

The case studies also revealed that founders and managers of nontraditional institutions encountered a series of issues similar to those all organizers need to consider when developing or designing an institution. An understanding of this decision-making process will enable others to learn from the experiences of the case-study programs and design a nontraditional venture capital institution that works best given their goals, market conditions, and institutional constraints.

The recommended decision-making process has seven principal steps or stages (Figure 2). Although the process is presented as sequential, different institutions (for example, CAPCOs vs. community development funds) may reorder the stages. In addition, feedback loops between the various stages are implied. Decisions made early in the process affect later choices, and constraints identified later in the process like fund raising or lack of deal flow may force modifications to earlier decisions.

First, the decision makers must identify or recognize the impetus for creating a nontraditional venture capital institution. The site visit institutions were motivated by a desire to: (1) promote overall regional economic growth and development, (2) create jobs in distressed communities and for low-income individuals, or (3) address inefficiencies and gaps in local venture capital markets.

The impetus for starting an institution will affect the geographic area served and the type of business targeted for investments. Thus, in step 2 of the process market analysis of investment opportunities (deal flow) in the prospective service area is conducted. This information, in turn, helps determine whether an effective demand for a venture capital institution exists, what niche the institution may occupy, the potential size for the fund, and the managerial expertise required. If deal flow is inadequate to support a venture capital fund, fund organizers need to re-evaluate the reasons for establishing the institution, investigate alternatives for increasing deal flow, or end the process.

If market analysis demonstrates the need for a venture capital institution, the next step is to more specifically articulate the institution’s goals (step 3). One set of case-study funds seeks to maximize financial returns (for example, with a target IRR of 30 percent or more). These institutions face the challenge of making high profit investments while overcoming the high information and travel costs that discourage traditional venture capital institutions from serving the area. Other nontraditional institutions also attempt to maximize financial returns but realize that such returns will be less than those expected by traditional venture capital funds. However, social returns from investments such as jobs, income, retail sales, and housing starts are considered as benefits of the investment process and valued by the founders of the institution. Finally, a third group of funds seeks to maximize social benefits while earning an IRR sufficient to ensure the institution’s long-term sustainability. These institutions have a dual bottom line of acceptable financial and social returns.

In step 4 the institution’s size is selected based on funds available for investments. Institutional size also is related to deal flow (step 2) and the type of management selected to run the fund. Based on the case studies, $10 million is the preferred minimum size for a self-standing nontraditional fund. A $10 million fund is large enough to support a professional management team, to permit
a diversified portfolio of investments, and to provide a reserve of capital for follow-on investments. If deal flow or fund raising prospects result in a potential fund much less than $10 million, then fund organizers have three alternatives. They can re-evaluate goals and area and industry focus to increase deal flow and potential investors. The institution can operate a smaller fund and subsidize the costs of the smaller institution by partnering with a public or private organization. Finally, the organizers can terminate their plan for a venture capital institution and investigate other ways to assist area businesses.

**Figure 2. Steps in the Decision Making Process for Creating a Nontraditional Venture Capital Institution**

1. Recognize impetus for creating a nontraditional venture institution
2. Conduct market analysis; estimate local deal flow/how to create deal flow
3. Articulate institution’s goals and objectives
4. Select institution’s size and management
5. Identify sources of funds to capitalize institution
6. Select legal and organizational structure
7. Manage investment activity
Next, funding sources for capitalization of the institution must be identified, though potential funding sources are a consideration throughout the process. Funding for the capitalization and management of the site-visit institutions came from public funds (state and federal), private funds (individuals, commercial banks, and public utilities), private funds with public incentives (tax credits), and nonprofit foundations. Organizers of an institution must have a realistic view of the availability of alternative sources of funding and the implications of these sources for management structure. In addition, organizers need to understand any restrictions that are placed on funds invested in the institution. For example, if a foundation is identified as a lead investor, the foundation’s goals will be instrumental in setting the goals of the venture capital institution. If the state is the lead investor, restrictions on investments to in-state firms will be likely. These constraints will influence the options available to institutional organizers in other stages of the decision making process.

Finally, organizers select the appropriate legal and organizational structure to manage the institution’s investment activity. The case-study institutions included for-profit, nonprofit, and public enterprises with structures ranging from angel networks to limited liability partnerships to corporations. Each structure has advantages and disadvantages with respect to generating deal flow, raising capital, attracting qualified management, and attaining the institution’s goals and objectives.

The establishment of a nontraditional venture capital institution is complicated, time consuming, and expensive. In addition, all institutions interviewed for this study said they would do things differently if they had the opportunity to start anew. That is, decisions regarding goals, funding, management, and investments would have been different had the institutions known the implications of their decisions. Thus, using a structured decision making process can reduce the likelihood of inappropriate decisions and increase the probability of establishing a successful nontraditional venture capital institution.

**Conclusion**

During the last 25 years, numerous nontraditional venture capital institutions were established to assist entrepreneurs and businesses in regions and industries overlooked by traditional venture capital funds. Many of these institutions remain in existence, making a positive impact on the local economy and providing a strong demonstration of the potential for venture capital activity in the area. For example, Kansas Venture Capital, Inc. (KVCI) has invested in 30 companies and has created or retained almost 3,000 jobs. KVCI was successful enough that it contracted with Kansas to repay the original public investment of $5 million made in 1986-1987. Some nontraditional venture capital institutions, on the other hand, have been failures both in terms of financial returns and economic development impacts. The Colorado Rural Seed Fund was unable to make successful investments in rural western Colorado; and by 1998, the value of the fund had declined from $500,0000 to $100,000.

Differences between successful and unsuccessful nontraditional institutions often are not great. In general, the successful institutions do a slightly better job of (1) selecting the appropriate organization, management, and funding for the institution’s goals; (2) generating sufficient deal flow to permit a profitable investment portfolio; (3) rewarding management for growing the fund; (4) insulating the
institution from political agendas; and (5) providing assistance to portfolio companies after investments are made. It is important to note, however, that many successful nontraditional programs would not be considered a success when measured against the IRR expectations of the traditional venture capital industry. Thus, when evaluating the success of a nontraditional venture capital program, it is important to compare that institution’s performance against its goals, not the goals set by the traditional venture capital industry.

Establishing and maintaining successful nontraditional venture capital institutions is not an easy process. Success is not guaranteed even for those institutions that follow a careful decision-making process. And, no one type of program or institution can meet the venture capital needs of all businesses in all areas. However, the greater the due diligence in setting up a venture capital program, the greater the likelihood of success.

The Appalachian Ohio Development Fund (AODF) provides an interesting example of a new nontraditional institution that is following a carefully designed development process. Founders of AODF conducted deal flow analysis of the southeastern Ohio service area prior to fund raising to ensure the availability of sufficient investment opportunities. In addition, the founders developed strategic alliances with area universities, economic development agencies, financial institutions, and nonprofit organizations to assist area businesses before, during, and after financing. AODF is organized as a $15 million limited partnership, managed by professional venture capitalists with oversight provided by an investment committee consisting of experienced venture capitalists. In sum, AODF is a self-standing nontraditional fund, managed by professionals with the appropriate incentives, and supported by a network of local institutions and services. AODF followed a decision-making process that greatly increases the probability of economic development benefits to the service area and attractive financial returns to investors. Equal attention to detail in establishing other new nontraditional institutions should significantly increase the availability and sustainability of such programs. In contrast, if the establishment of nontraditional venture capital institutions is not done with adequate due diligence and careful consideration of the lessons learned from the experience of other institutions, these programs are less likely to have success and provide benefits to their communities or regions.
Endnotes


3. The Small Business Investment Company is a legal structure used by a number of different traditional and nontraditional institutions. For example, SBICs can be organized as developmental venture funds or as publicly assisted programs. However, since the SBIC structure is relatively common, it is considered separately during the discussion of program types.


6. For more information on SBICs, see D. L. Barkley, et al. “Equity Capital for Nonmetropolitan Businesses: An Introduction to Alternative Sources and Directory to Related Web Sites.” Rural Policy Research Institute, PB99-