Research Report

SEPTEMBER 25, 2000

THE MINORITY BUSINESS CHALLENGE

Democratizing Capital for Emerging Domestic Markets

MILKEN INSTITUTE

U.S. DEPARTMENT OF COMMERCE
MBDA
MINORITY BUSINESS DEVELOPMENT AGENCY

Norman Y. Mineta

Secretary of Commerce

To sustain the unprecedented growth of the American economy, minority businesses must have access to the debt and equity capital that can fuel their development. Minority business enterprises (MBEs) are an increasingly important sector of American businesses, growing at a much more rapid rate than U.S. companies overall. Asian American/Pacific Islanders, Native American, Latino, and African American businesses are growing at a rate of 17 percent per year, six times the growth rate of U.S. businesses. Their revenues are increasing 34 percent per year, three times the revenue growth rate of domestic companies. However, this growth cannot continue without increasing the amount of capital flowing to the minority business community, through investment in and lending to the MBE market. In addition, new and creative financial strategies must be developed. Through this report, we hope to focus the capital markets on the opportunities presented by minority businesses and ignite innovative thought on ways to access this critical new market.

Robert L. Mallett

Deputy Secretary of Commerce

Minority businesses are one of the primary engines driving the growth of the American economy. Empowering minority-owned businesses by increasing their access to technology, ensuring that MBEs have access to growth capital, and opening new and lucrative markets are integral to maintaining the lifestyle that we Americans enjoy at the dawn of the 21st century. Of these, however, there is no more important goal than increasing financing opportunities for Asian American, Native American, Latino and African American entrepreneurs – businesses that make up the economic infrastructure in many minority communities and are key employers. Through this report, we hope to increase interest and investment by the financial community in this vibrant and untapped sector of the economy.

Courtland V. Cox

Director, Minority Business Development Agency

The Minority Business Development Agency (MBDA) has commissioned a series of reports on minority-owned businesses. The first of these reports, "Mainstreaming Minority Business: Financing Domestic Emerging Markets," arose from recommendations made by the Department of Commerce's Capital Access Task Force on increasing minority business access to capital and was published by the Milken Institute in February 1999. This new study expands upon the "Mainstreaming Minority Business" report and examines the opportunities presented to MBEs by equity financing. In addition, the Census Bureau prepared the "Emerging Minority Marketplace" study in September 1999, which examined minority population growth, and recently completed "Minority Purchasing Power: 2000 to 2045." The "Purchasing Power" report focuses on the growing minority marketplace and the opportunities it presents to minority businesses and large corporations interested in partnerships with minority businesses.

One of MBDA's priorities is to disseminate information for and about minority businesses. Visit our website at www.mbda.gov for more detailed information about these studies and about the minority business community.

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We greatly benefited from your assistance.

The Minority Business Development Agency (MBDA) of the United States Department of Commerce is the only Federal agency specifically created to encourage the creation, growth, and expansion of minority-owned businesses in the United States. The Agency was established in 1969 by Executive Order, and its role was expanded in 1971. Executive Order 11458, signed by then-President Richard M. Nixon on March 5, 1969, prescribed a national program for minority business enterprises. MBDA was originally called the Office of Minority Business Enterprise (OMBE). The name was changed in 1979 to the Minority Business Development Agency.

The Milken Institute is a 501(c)(3) not-for-profit, nonpartisan, nonideological, independent economic think tank founded in 1991. Based in Santa Monica, California, the Institute is a resource for economic and public policy research and analysis, and a center for advancing discussion about economic, financial, social and policy issues. The Institute's mission is to explore and explain the dynamics of world economic performance and growth. The overarching goal is to provide an understanding of the effects of economic, political, technological and regulatory changes on the world economy and its societies as a basis for a better-informed public, more thoughtful public policies, improved economic outcomes, and better lives for

EXECUTIVE SUMMARY

In February 1999, the Milken Institute and the Minority Business Development Agency (MBDA) of the U.S. Department of Commerce and its Capital Access Task Force, began an investigation into the implications of entrepreneurial finance for minority businesses. The findings, documented in a study titled "Mainstreaming Minority Business: Financing Domestic Emerging Markets," reported that minority businesses are growing faster than majority firms in number and revenue yet remain severely constrained by lack of access to capital.[0] This report, continues the work of last year's study, presents new findings and makes concrete recommendations for sustaining the business growth cycle. Here are our findings:

I. The United States is facing serious growth gaps in several areas. We have identified those areas as:

- the gap between the current rate of growth and the rate necessary to sustain future long term economic growth;
- the gap between labor force growth and labor force participation; and
- the gap between the growth of emerging domestic markets and current investment rates in those markets.

Addressing these gaps now will forestall an arrest in productivity and foster greater economic prosperity. Failure to invest in these areas risks bringing continued growth to a halt.

II. Economic growth cannot be sustained without the inclusion of minority businesses and an infusion of capital into those businesses. Absent broad-based institutional investor participation in minority and immigrant business communities – soon to be the new majority of businesses – continued growth in the American economy is impossible, affecting not just minority businesses but putting the nation's macroeconomy at risk.

- Minority-owned firms are surpassing the growth of all U.S. businesses, growing at a rate of 17 percent per year, six times the growth rate of all firms. Minority firms' sales are growing 34 percent per year – more than twice the rate of all firms.

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Growth in the U.S. economy has largely been fueled by carving channels of capital from investors to entrepreneurs, our most important source of job, income and wealth creation.

A fundamental mismatch between these sources of job creation and access to capital persists, especially with respect to the minority business community.

Resolving this mismatch – achieving adequate growth to lower inequality and keep economic prosperity alive — is the greatest economic policy challenge in the new century.

- Growth among entrepreneurial businesses is high, but constrained by lack of debt and equity capital. Minority firms receive just 2 percent of all private equity investments and 3 percent of all Small Business Investment Company (SBIC) investment dollars. This, in turn, limits employment growth and new entrants into the labor force. Access to capital for minority-owned firms is vital for the healthy development of this growing sector of American businesses.

- Growth in the U.S. economy has largely been fueled by carving channels of capital from investors to entrepreneurs, our most important source of job, income and wealth creation. A fundamental mismatch between these sources of job creation and access to capital persists, especially with respect to the minority business community. Resolving this mismatch — achieving adequate growth to lower inequality and keep economic prosperity alive — is the greatest economic policy challenge in the new century.

- Current growth, technology driven, is deep, but not broad, and shared unequally. A broader participation base is mandatory to sustain growth. African Americans represent 12.5 percent of the U.S. population and 3.6 percent of firms. Latinos represent 11 percent of the population and 4.5 percent of firms. Asian Americans represent 4 percent of the population and 3.5 percent of firms.

- The United States macroeconomy faces a labor supply constraint. The U.S. workforce growth rate has fallen from 2.7 percent in the 1970s, to 1.6 percent in the 1980s, to between 1.0 and 1.5 percent today. Projections over the next decade predict continued low growth rates. Within the labor force, 70 percent of the workforce growth is occurring among minority groups. Without their labor force participation, labor shortages will become acute, further limiting productivity and growth. Skilled labor shortages will act as a brake on overall economic growth.

- America's economic future is so inextricably linked with minority and immigrant groups that investment in these communities is essential. Demographic trends point to a disproportionately white retired population, directly or indirectly dependent upon an economic base whose contributors are younger members of diverse racial and ethnic makeup. Women and minorities comprise an increasingly important part of the

U.S. economy that continues to rise in all sectors of the labor market. If pension funds and other institutional investors fail to invest in these emerging domestic markets they will be unable to meet the high yield returns on investment necessary to sustain the aging baby boomer population.

- Language and culture directly link new global markets to fast-growing minority groups in the U.S. Financing these minority business communities will create bridgeheads into global communities as well.

III. Capital gaps exist at every level for financing the capital structure of minority businesses: equity, mezzanine and senior debt.

- Despite advances in venture capital, mezzanine debt and asset-backed securitization, the vast majority of minority firms do not have access to financing technologies available to larger companies.

- Of the estimated $95 billion in the private equity market in 1999, only $2 billion is managed by companies whose focus is supplying capital to entrepreneurs from traditionally underserved markets.

- Funds that include gender and ethnic-specific entrepreneurs and markets remain undercapitalized by the universe of institutional investors, despite the proliferation of specialty fund strategies. More targeted investment funds and instruments need to be designed and built for this new asset class.

- To expand, it is critical that minority businesses gain access to the equity markets. The average venture-backed company employs nearly 100 workers within five years and creates almost twice as many jobs as their nonventure-backed peers. Venture-backed firms experience at least a 40 percent job growth each year as compared to a 2.5 percent decline in jobs for Fortune 500 companies.

- In addition, sales per employee grow twice as quickly for minority businesses as for Fortune 500 companies, growing at an average 16.5 percent as opposed to 7.9 percent for the largest firms. Despite these growth rates, entrepreneurial markets capture only a tiny portion of venture capital, leaving them disproportionately underserved.

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Financing minority-owned businesses serves a dual purpose. It provides needed capital to a fast-growing business sector while creating a vehicle for greater minority participation in the workforce.

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The minority business community is growing, profitable and free of the risk inherent in more distant markets. Failure to invest in this business sector will lower productivity and likewise act as a brake on the economy.

- The robust performance of companies from emerging domestic markets – and the lost opportunity if they remain underfinanced – sends a clear message. Well funded and managed minority firms are successful. Job creation parallels wealth creation in recognizing the imperative of financing emerging domestic markets as a new asset class.

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- Minority businesses are a driving force behind growth and will be a major segment of the U.S. economy in the 21st century as a transition to a more diverse demographic majority emerges. Asset managers need to tap these sources of higher profits and growth in the minority business sector to sustain yields necessary to cover longer-term liabilities demographically driven by the aging majority boomer population increasingly dependent upon the productivity and growth of an emerging new majority of firms and entrepreneurs.

- Institutional investors, insurance companies, banks, diversified financial service firms, private equity investors and pension funds will have to broaden their investment strategy to include securities and firms in emerging domestic markets as a new asset class. Diversity in investment targets ought to become a key part of diversification in portfolio management strategies.

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RECOMMENDATIONS

1. Support more research and development of equity, mezzanine and debt instruments attractive to institutional investors and use those innovative financial instruments to expand the pool of domestic and international capital invested in minority-owned businesses. Sample innovations that have proven effective are securitization of small business loans to develop this emerging asset class and new models of credit scoring that more accurately assess the risk in lending to diverse groups.

2. Encourage the formation of business incubators that will nurture and develop minority entrepreneurs and their businesses. Encourage state and municipal programs to foster minority entrepreneurship, patterned after the many state-based seed funds that exist and establish a National Innovation Development program – patterned after the Small Business Innovation Research program – directed at minorities to nurture and finance high-growth ventures.

3. Establish a jointly led Commerce and Treasury Department interagency council to coalesce and focus investment programs for minority entrepreneurs.

4. Encourage the formation of training and mentoring programs to create more professional minority venture capitalists.

5. Provide greater enforcement of minority procurement programs.

6. Provide tax and other incentives for investment in minority-owned businesses.

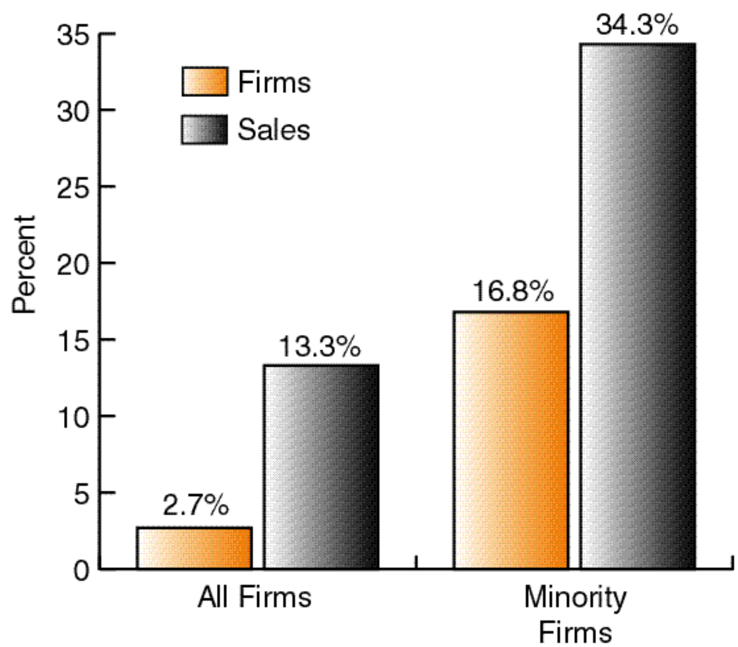
7. Implement the New Markets Initiatives.

INTRODUCTION

Minority-owned firms far surpassed the growth of all U.S. businesses, increasing 17 percent annually in the decade 1987 to 1997.[1] This is six times faster than the annual growth rate of 3 percent for all businesses during that same decade, up from double the rate of all firms as of 1992 as noted in last year's report[2] (see Figure 1). Asian-owned firms increased in number by 18 percent per year. Latino-owned firms increased 23 percent per year, and black-owned firms increased 11 percent per year.

If viewed from the vantage point of sales, the results are similar. Sales across all firms rose 13 percent per year while they rose 34 percent for minority-owned firms during the same time period – more than twice the national average. For Asian-owned firms, sales rose 42 percent per year and for Latino-owned firms, sales rose 46 percent per year. For black-owned firms, sales rose 11 percent per year.

Figure 1
All Firms vs. Minority Firms
Annualized Growth Rates: 1987-1997



Source: SBA Office of Advocacy, Minorities in Business, 1999; SBA Office of Advocacy, "Small Business Economic Indicators, 1998," March 2000;
Note: All firms Sales data annualized from 1990-1997.

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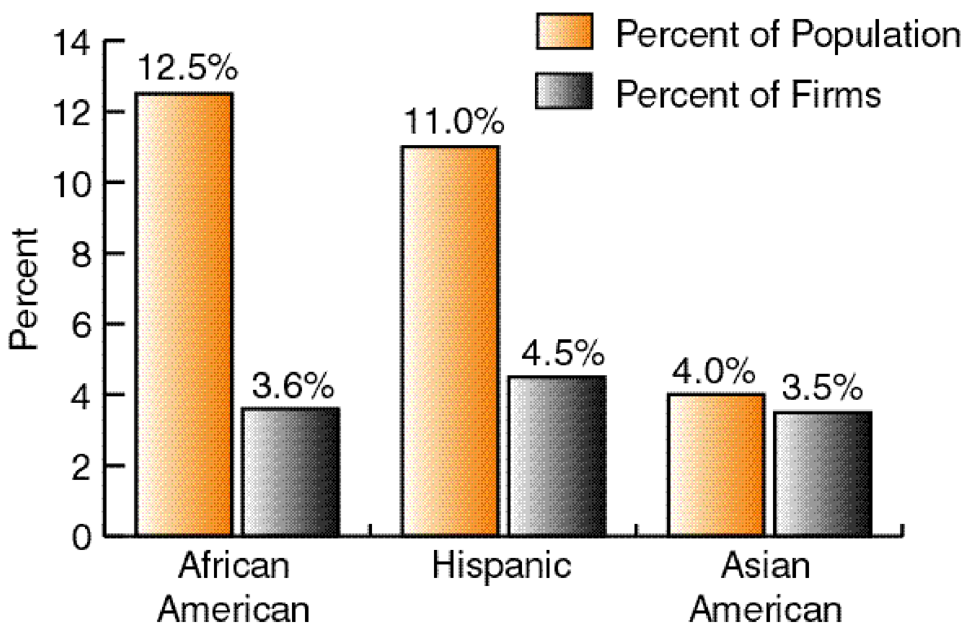
Despite this burgeoning growth, minority business owners are still underrepresented when compared to all businesses.

While minority businesses are growing faster than majority firms in number and revenue, they remain severely constrained by a lack of access to capital.

It has become increasingly evident that this is not simply a minority issue but an American issue.

Figure 2
Population vs. Market Share



Source: SBA news releases, 2000

Despite this burgeoning growth, minority business owners are still underrepresented when compared to all businesses. While minority businesses are growing faster than majority firms in number and revenue, they remain severely constrained by a lack of access to capital. The largest disparity occurs in the African American population. Blacks comprise 12.5 percent of the U.S. population, but own just 3.6 percent of all businesses[3] (see Figure 2). The Latino ownership is similar, comprising almost 11 percent of the population, but owning just 4.5 percent of all businesses.[4]

Federal Reserve Board of Governors Chairman Alan Greenspan says, "I have no illusions that the task of breaking down barriers that have produced disparities in income and wealth will be simple. It remains an important goal because societies cannot thrive if significant segments perceive their functioning as unjust."[5] California State Treasurer Philip Angelides concurs, saying that "the very essence of the American and California dreams has been and remains equality of opportunity."[6] It has become increasingly evident that this is not simply a minority issue but an American issue. Absent broad-based, institutional investor participation in the minority and immigrant business communities – soon to be the new majority of businesses –

continued growth in the American economy is impossible, affecting not just minority businesses, but putting the nation's macroeconomy as a whole at risk. Likewise, necessary yields will not be sustainable to support future pension, health and other liabilities if asset managers fail to invest in this new asset class.

The difficulty is augmented by federal policy that expects banks to lend widely while imposing rules that restrict lending to entrepreneurs. Federal subsidies focus on location rather than business owners. $9 billion per year is targeted at inner-cities, but only 9 percent of that is directed to capital structure development.[7]

Clearly work remains to be done in order to create an environment that promotes economic equality for business ownership in this country. In our last report, we recommended a strategy for increasing economic participation in business ownership by increasing the total amount of credit available to minority businesses and increasing equity investments for early-stage financing.[8] We continue to support these goals and expand them by calling for: 1) research and modifications of financial technologies that will increase liquidity and access to capital, and 2) advocacy of private-public ventures stimulating increased investment in these emerging domestic markets.

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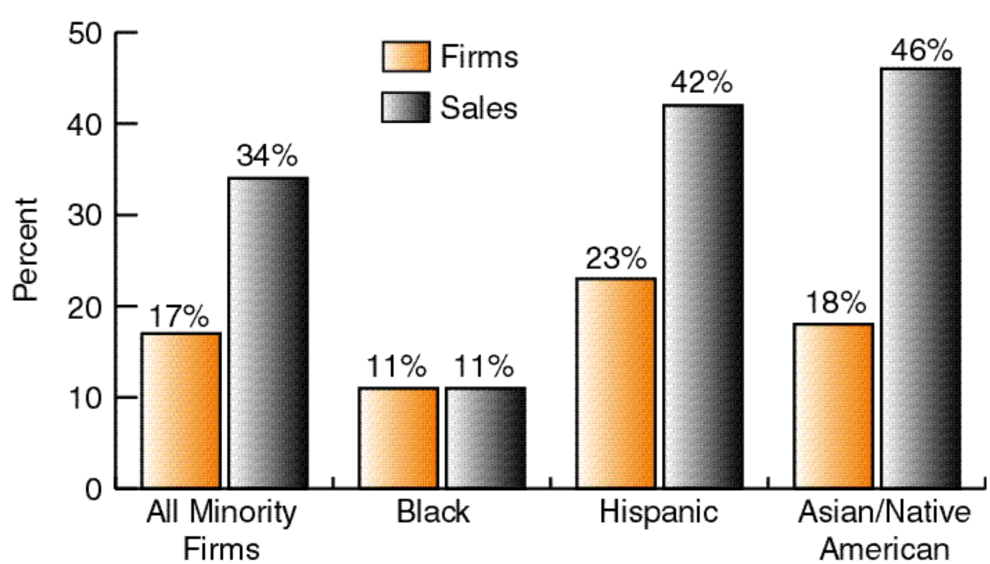
Capital Access and Minority Businesses

Empirical evidence demonstrates that there is a disparity in credit accessibility among certain demographic groups.

Minority businesses' contributions to the national economy are large and growing. As of 1997, four million employees owe their jobs to the existence of the 3.25 million minority-owned businesses.[9] These firms generate $495 billion in revenue annually. Since 1987, the number of minority firms has grown by 17 percent per year while the revenues from these businesses have grown 34 percent annually. Broken down by ethnic group, revenue grew by an estimated 46 percent annually for Asian- and Native American-owned businesses, 42 percent annually for Latino-owned businesses, and 11 percent annually for black-owned businesses (see Figure 3).

Still, capital access remains a large obstacle for many minorities trying to either start or grow their businesses. Empirical evidence demonstrates that there is a disparity in credit accessibility among certain demographic groups.[10] As a result of these difficulties, over half of all small business owners do not even apply for a loan due to fear of denial. This is especially true among minority business

Figure 3
Annualized Growth Rates 1987-1997



Source: SBA Office of Advocacy, Minorities in Business, 1999 owners. Evidence also shows that minorities are more often denied credit and pay higher rates for credit than do white business owners.[11]

As a result, the credit needs of minorities remain substantially greater than those of non-minority business owners, with African American and Latino credit needs exceeding those of white-owned firms by 25 to 77 percent.[12] Whether these lending gaps exist due to discrimination or lender market structure remains a subject of debate, but the credit gap remains nonetheless.

A growing body of economic research documents the fundamental mismatch that persists between the sources of job creation and capital formation.[13] Growth in the economy has been largely fueled by carving channels of capital from investors to entrepreneurs who are the most important source of jobs, income, and wealth creation. Resolving this mismatch – achieving adequate growth to lower inequality and keep economic prosperity alive – is the greatest economic policy challenge in the new century.

The existing lack of debt and equity capital creates business demand constraints. This credit gap limits both businesses' ability to hire new minority labor force entrants as well as their growth rates. At the same time, the United States macro-economy faces a labor supply constraint. Since the 1970s, the U. S. workforce growth rate has been declining. In fact, it has fallen from 2.7 percent in the 1970s, to 1.6 percent in the 1980s, to between 1.0 and 1.5 percent today. Projections over the next decade predict continued low growth rates.

Meanwhile, 56 percent of current workforce growth is occurring among minorities. This number will grow to between 64 and 70 percent over the next 20 years.[14] Unless this growing minority workforce can be tapped, the lack of labor will act as a brake on overall economic growth. The future of the nation's economic growth depends upon the inclusion of minority-owned businesses and the minority business workforce, and access to capital for minority-owned firms is absolutely essential for the healthy development of this growing sector of American businesses.

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This credit gap limits both businesses' ability to hire new minority labor force entrants as well as their growth rates.

As the number of minority workers continues to grow, a sizable recruiting ground is forming for future business owners.

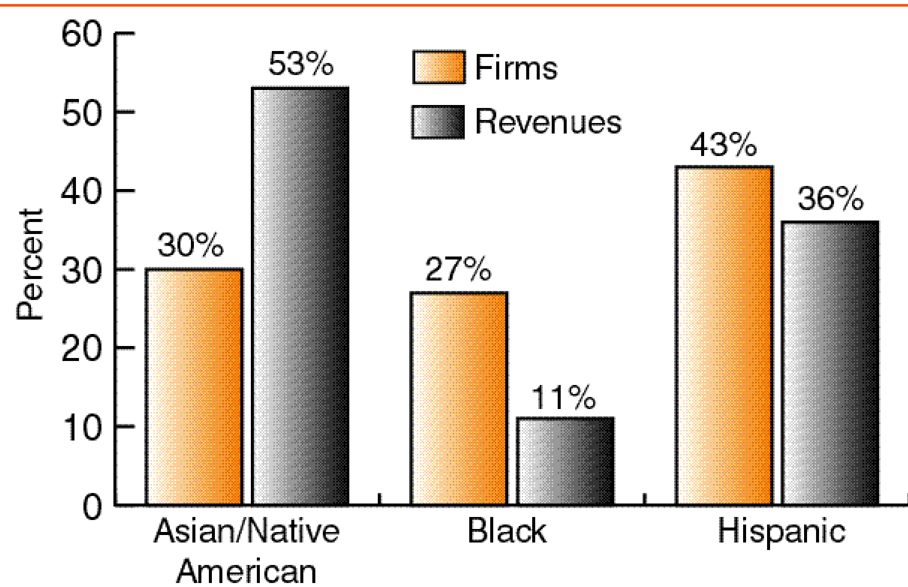
The growth potential of this business sector is enormous and largely untapped.

OVERVIEW OF THE MINORITY BUSINESS COMMUNITY

According to the most recent available census data, 1.4 million Latino-owned businesses, 1.1 million Asian- and Native American-owned businesses, and 880,000 black-owned enterprises are operating in the U.S.[15] The influx of Latino and Asian immigrants into the U.S. has helped bolster these numbers. Many arriving immigrants start new businesses here. Since 1987, the Latino and Asian/Native American-owned annual business growth rates have been 23 percent and 18 percent, respectively. Black-owned firms also saw an 11 percent annual increase.

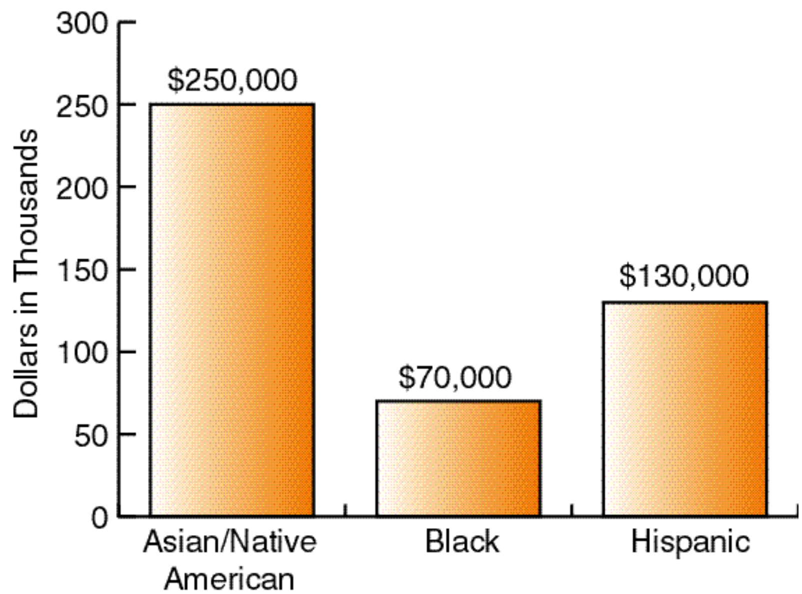
These results are supported by the percentage of minority business owners born outside the United States. In 1992, 48 percent of the Latino business owners and 68 percent of the Asian business owners were immigrants, while less than one-tenth of African American owners were born on foreign soil.[16] As the number of minority workers continues to grow, a sizable recruiting ground is forming for future business owners. The growth potential of this business sector is enormous and largely untapped.

Figure 4
Minority Firms as a Percent of All Minority Firms



Source: SBA Office of Advocacy: "Minorities in Business"

Figure 5
Annual Revenue per Business



Source: SBA Office of Advocacy: "Minorities in Business"

There is a sizeable disparity in revenue earned per business among the differing ethnic groups.

Interestingly, there is a sizeable disparity in revenue earned per business among the differing ethnic groups (see Figure 5). Asian and Native American business owners on the whole are the most financially successful with average revenues of $250,000 per business, followed by revenues of $130,000 for Latino-owned businesses and $70,000 for black-owned businesses. From 1987 to 1997, Asian and Native American-owned firms' average revenue per business more than doubled. Latino performance was also favorable as their revenues nearly doubled as well. African American firms, with a more modest growth rate, had revenues per business similar to 1987.

Native American's make up 116 percent of the average minority firms' sales volume, have 123 percent of the average number of employees, and hire 112 percent of the average number of new hires among minority firms.

According to MBDA and Dun & Bradstreet data on minority businesses (those minority businesses with $500,000 or more in annual revenue and satisfying certain credit standards), Native American firms are performing very well compared to other minority businesses. While they represent just 5 percent of minority firms, they make up 116 percent of the average minority firms' sales volume, have 123 percent of the average number of employees, and hire 112 percent of the average number of new hires among minority firms (see Table 2). Native American business owners are most prevalent in the wholesale trade industry, where 24 percent of these firms are located (see Table 3).

Table 1
Minority-Owned Businesses: Number of Firms, Receipts, and Employment 1982, 1987, 1992, and 1997

	1982	1987	1992	1997a	Percent Change 1987-1997b
ALL MINORITY-OWNED FIRMS					
Number of businesses					
All	736,064	1,211,017	1,979,056	3,245,127	168.0
Businesses with employees	119,232	247,678	313,031	522,942	111.1
Nominal annual receipts (thousands of dollars)					
All	34,181,238	77,744,780	202,683,780	494,703,206	342.8
Businesses with employees	21,820,541	56,394,339	159,252,282	430,647,362	431.5
Employees	445,840	837,158	1,877,690	3,868,649	362.1
HISPANIC-OWNED FIRMS					
Number of businesses					
All	233,975	422,373	771,708	1,401,531	231.8
Businesses with employees	39,272	82,908	115,364	202,037	143.7
Nominal annual receipts (thousands of dollars)					
All	11,759,133	24,731,600	72,824,270	183,799,941	416.8
Businesses with employees	7,435,664	17,729,432	57,187,370	160,408,831	529.2
Employees	154,791	264,846	691,056	1,492,773	463.6
BLACK-OWNED FIRMS					
Number of businesses					
All	308,260	424,165	620,912	881,646	107.9
Businesses with employees	37,841	70,815	64,478	89,686	26.6
Nominal annual receipts (thousands of dollars)					
All	9,619,055	19,762,876	32,197,361	59,303,334	109.1
Businesses with employees	5,704,545	14,130,420	22,589,676	46,034,389	127.2
Employees	121,373	220,467	345,193	583,752	164.8
ASIAN AND NATIVE AMERICAN-OWNED FIRMS					
Number of businesses					
All	201,264	376,711	606,426	1,055,641	180.2
Businesses with employees	43,323	96,457	136,351	248,163	157.3
Nominal annual receipts (thousands of dollars)					
All	13,148,315	34,035,605	99,709,460	275,106,075	462.5
Businesses with employees	8,900,741	25,104,127	81,083,845	245,293,007	580.0
Employees	174,179	360,301	860,408	1,917,244	432.1

a. 1997 numbers were estimated assuming a 1992-1997 growth rate equal to the average of the previous two five-year periods, 1982-1987 and 1987-1992.
b. Growth rates for receipts are calculated using constant 1992 dollars; they are real growth rates, adjusted for inflation. Note: These numbers exclude C corporations and businesses with less than $500 in annual receipts.

Source: U.S. Small Business Administration, Office of Advocacy, based on data from the U.S. Department of Commerce, Bureau of the Census, Survey of Minority-Owned Business Enterprises, 1982, 1987 and 1992.

Table 2
Minority-Owned Firms Breakdown
As Percent of Average of Minority Firms

	Asian	Black	Hispanic	Native American	All Minority Businesses
Number of Firms	32.9%	6.5%	55.3%	5.0%	100.0%
Average Sales Volume	107.7%	117.8%	91.6%	115.7%	100.0%
Average Number of Employees	84.1%	152.0%	100.7%	122.8%	100.0%
Average Number of New Hires	85.2%	140.0%	102.8%	111.6%	100.0%

Source: Dun & Bradstreet Minority Business Data for firms with over $500,000 in annual revenue.

Table 3
Minority-Owned Firms by Industry

Percent in Each Industry	Asian	Black	Hispanic	Native American
Accommodation and Food Services	3.1	0.8	2.3	2.5
Administrative and Support and Waste Management and Remediation Services	4.9	9.1	6.0	5.8
Agriculture, Forestry, Fishing and Hunting	1.2	0.3	1.5	1.3
Arts, Entertainment, and Recreation	0.3	0.2	0.5	0.4
Construction	6.0	17.5	16.1	12.8
Education Services	0.3	0.2	0.2	0.2
Finance and Insurance	2.6	3.8	4.2	3.5
Health Care and Social Assistance	4.8	2.0	4.0	4.0
Information	1.0	2.4	1.1	1.2
Management of Companies and Enterprises	0.1	0.0	0.0	0.0
Manufacturing	11.5	10.6	10.9	11.3
Mining	0.1	0.2	0.4	0.2
Other Services (Not Public Administration)	1.9	2.8	3.3	2.7
Professional, Scientific, and Technical Services	9.7	18.6	8.9	9.7
Retail Trade	11.0	7.8	11.9	11.1
Real Estate and Rental and Leasing	1.5	1.4	2.1	1.9
Transportation and Warehousing	2.1	2.4	3.0	2.6
Utilities	0.0	0.1	0.1	0.1
Wholesale Trade	34.4	14.7	19.2	24.4
Not Classified	3.5	5.2	4.3	4.1
TOTAL	100%	100%	100%	100%

Source: Dun &Bradstreet Minority Business Data.

Table 4
Minority Business Regional Breakdown
Percent of Minority Businesses by State

	Asian	Black	Hispanic	Native American	All Minority Businesses
Alaska	0.13	0.15	0.03	3.54	0.25
Alabama	0.15	0.73	0.13	0.38	0.19
Arkansas	0.02	0.24	0.05	0.13	0.05
Arizona	0.96	0.39	2.19	1.90	1.65
California	49.95	15.86	24.28	61.08	34.04
Colorado	0.72	0.63	1.55	0.70	1.17
Connecticut	0.54	0.97	2.17	0.38	1.46
District of Columbia	0.34	2.09	0.25	0.00	0.38
Delaware	0.09	0.78	0.22	0.13	0.21
Florida	3.21	4.03	15.86	1.90	10.21
Georgia	1.88	6.35	1.15	0.82	1.71
Hawaii	6.56	0.05	0.09	1.39	2.29
Iowa	0.07	0.10	0.08	0.06	0.08
Idaho	0.09	0.00	0.09	0.19	0.09
Illinois	4.10	6.30	4.08	1.65	4.11
Indiana	0.61	1.94	0.90	0.13	0.83
Kansas	0.22	1.41	0.62	1.20	0.57
Kentucky	0.30	1.45	0.55	0.25	0.51
Louisiana	0.35	2.86	1.52	1.14	1.20
Massachusetts	1.61	1.36	3.75	0.38	2.72
Maryland	1.49	8.15	1.27	0.76	1.77
Maine	0.13	0.15	0.37	0.38	0.28
Michigan	1.84	5.14	2.34	1.46	2.31
Minnesota	0.33	0.44	0.33	0.89	0.36
Missouri	0.61	2.52	0.96	1.08	0.95
Mississippi	0.20	1.89	0.34	0.70	0.41
Montana	0.06	0.00	0.14	0.95	0.14
North Carolina	0.87	4.61	0.90	1.58	1.16
North Dakota	0.01	0.00	0.01	0.44	0.03
Nebraska	0.17	0.68	0.22	0.32	0.24
New Hampshire	0.13	0.05	0.47	0.32	0.33
New Jersey	4.54	3.73	6.13	0.70	5.18
New Mexico	0.10	0.05	2.01	1.14	1.20
Nevada	0.15	0.19	0.35	0.32	0.28
New York	10.23	8.54	8.25	1.33	8.58
Ohio	0.78	4.07	1.31	0.76	1.29
Oklahoma	0.25	0.82	0.60	4.56	0.70
Pennsylvania	0.06	0.05	0.03	0.00	0.04
South Carolina	0.22	1.50	0.21	0.06	0.29
South Dakota	0.02	0.05	0.04	0.19	0.04
Tennessee	0.19	0.92	0.22	0.25	0.26
Texas	5.53	8.73	13.60	4.30	10.15
Utah	0.19	0.05	0.28	0.13	0.23
Wyoming	0.03	0.00	0.10	0.06	0.07
TOTAL	100%	100%	100%	100%	100%

Source: Dun & Bradstreet Minority Business Data

Overall, more than 34 percent of the nation's minority-owned firms (approximately one million) are based in California[17] (see Table 4). Florida and Texas are the second and third largest minority business states, each containing over 10 percent of all minority businesses.

A summary of the current statistics for minority-owned businesses follows.

- Of 3.25 million minority-owned, firms with total sales of $495 billion,
  - 1.4 million were Latino-owned firms with total sales of $183.8 billion and average annual revenue of $130,000 per business;
  - 1.05 million were Asian- and Native American-owned firms with total sales of $275.1 billion and average annual revenue of $250,000 per business;
  - 881,646 were black-owned firms with total sales of $59.3 billion and average annual revenue of $70,000 per business.
- It is estimated that the decade 1987–1997 saw minority-owned firms grow at a rate of 17 percent per year, with combined revenue growth of 34 percent per year.
  - Latino-owned firms grew fastest, at a rate of 23 percent per year, with revenue growth of 42 percent per year.
  - Asian– and Native American-owned firms grew at a rate of 18 percent per year, with revenue growth of 46 percent per year.
  - Black-owned firms grew at a rate of 11 percent per year, with revenue growth of 11 percent per year.
- Minority-owned businesses represent approximately 12 percent of all the nation's businesses.
  - Latino-owned firms represent 43 percent of all minority firms and 36 percent of all minority firms' revenue.
  - Asian– and Native American-owned firms represent 30 percent of all minority firms and 53 percent of all minority firms' revenue.
  - Black-owned firms represent 27 percent of all minority firms and 11 percent of all minority firms' revenue.

More than 34 percent of the nation's minority-owned firms are based in California.

1987–1997 saw minority-owned firms grow at a rate of 17 percent per year, with combined revenue growth of 34 percent per year.

Minority-owned businesses represent approximately 12 percent of all the nation's businesses.

The new generation of minority business entrepreneurs seeks not only to target specific minority niches, but also niches within the general population at large.

Minorities seeking to enter high-growth industries such as technology and communications are continuing to mature in their expertise and skill levels.

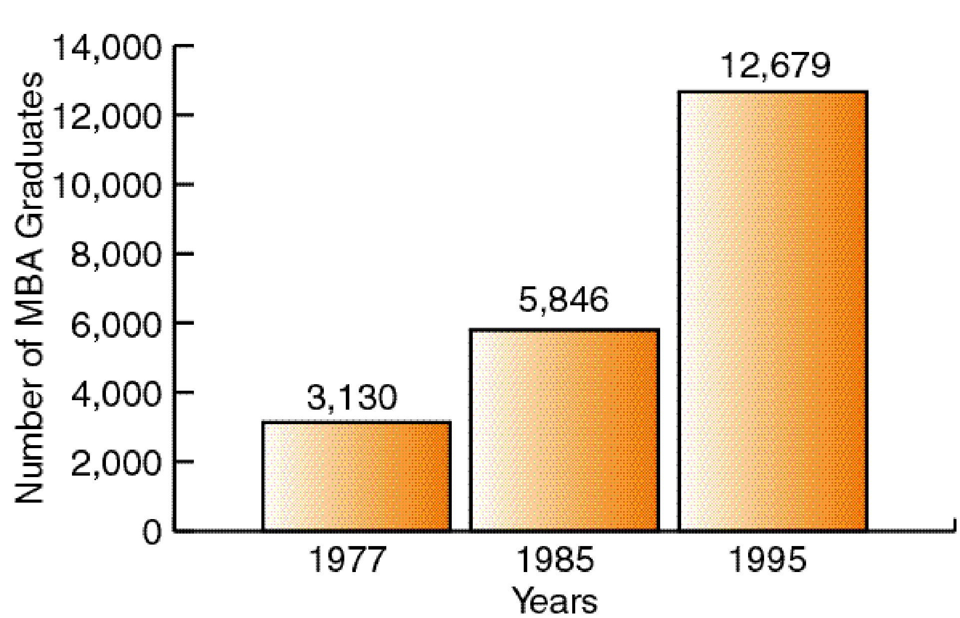
This pool of educated and experienced minorities represents a new source of management.

THE SHIFTING MINORITY BUSINESS INDUSTRY: NEW GROWTH SECTORS

The new generation of minority business entrepreneurs seeks not only to target specific minority niches, but also niches within the general population at large. Minority firms, particularly immigrant-owned, have expressed their desire to enter breakthrough industries such as high tech. Silicon Valley is incubating some of these immigrant and minority dreams. In fact, in the fertile digital economy of Northern California, someone of Indian or Chinese origin starts one in four of every new business endeavors.[18]

Minorities seeking to enter high-growth industries such as technology and communications are continuing to mature in their expertise and skill levels. The number of minorities with professional, administrative and technical skills has grown rapidly. This pool of educated and experienced minorities represents a new source of management. The number of Master of Business Administration degrees conferred upon minority students annually has increased from over 3,000 in 1977 to over 12,500 in 1995[19] (see Figure 6). This means that more than four times as many well-schooled minority

Figure 6
Number of MBAs Conferred on Minorities
1977, 1985, and 1995



business owners are entering the workforce now than did so 20 years ago.

Dun & Bradstreet data, for minority firms with over $500,000 in annual revenue and that satisfied certain credit standards, shows that the highest concentration of African American firms is in the professional (e.g., business, medical, engineering and other services), scientific and technical services industry. Asian, Latino, and Native American firms are most prevalent in the wholesale trade industry[20] (see Table 3).

It is these non-traditional lines of business that have become the fastest growing industry sectors for the changing minority population. Areas such as finance, insurance, real estate, business services, and the wholesale trade industries are experiencing the most rapid growth. Communications, manufacturing and transportation, and utilities are also growing at moderate rates. Meanwhile, industries such as personal services (e.g., health, beauty and home services), construction, and retail trade are no longer growing and are even declining in some instances.[21]

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It is these non-traditional lines of business that have become the fastest growing industry sectors for the changing minority population. Areas such as finance, insurance, real estate, business services, and the wholesale trade industries are experiencing the most rapid growth.

Changes within the minority business community will be further impacted by the changing U.S. demographics.

The customer base of the future will be derived from expanding racial and ethnic group populations and will see a decrease in the white population's influence on consumer preferences and purchasing decisions.

The minority population will account for nearly 90 percent of the total growth in the U.S. population before 2050.

The Minority Marketplace: Growing Demand

These changes within the minority business community will be further impacted by the changing U.S. demographics. U.S. Census Bureau projections of population growth reveal that the U.S. marketplace will not serve the same clientele in 2050 that it does today. The customer base of the future will be derived from expanding racial and ethnic group populations and will see a decrease in the non-minority population's influence on consumer preferences and purchasing decisions.

Even today, the spending power of the minority population is a major force in the marketplace. African Americans are estimated to control $533 billion, Latinos $383 billion and Asians another $229 billion.[22] The minority influence on products and services is not likely to subside and the emergence of a larger, more influential minority business presence is expected. This projection is based upon figures that estimate that the minority population will account for nearly 90 percent of the total growth in the U.S. population before 2050.[23]

Between 1995 and 2005, the minority population will increase from 77.6 million to 86.2 million at a growth rate of 11 percent. At the same time, the non-minority population will increase from 197.1 million to 199.8 million at just a 1.4 percent growth rate. By 2010, Latinos will become the second largest race/ethnic group in the U.S., surpassing the African American population.[24]

By 2050, the overall population is expected to grow by 50 percent from 263 million to 394 million, with minorities contributing 131 million. The minority population will increase by roughly 10 million for each five-year increment while the non-minority population will increase by roughly 2.5 million for the same periods until 2025. By 2040, the non-minority population will stop increasing and actually begin a recession. After 2050, the minority population is expected to surpass the non-minority population in the U.S.

Asians, Pacific Islanders and Latinos are the fastest growing of the minority populations. By 2025, Asian populations will double in 46 states and Latinos will double in 44 states. By 2050, Asians will increase their overall populations by 267 percent, followed by 258 percent for Latinos.

Bridging the Capital Gap: Private Equity and Venture Capital

The growth of minority businesses and the concurrent demographic changes will critically impact the demand for capital by minority business enterprises. However, for minority businesses to grow and develop the economic infrastructure necessary to support the U.S. economy in its unprecedented expansion, new capital channels must be directed to this market sector. Foremost among these channels must be those that increase the equity investment available to minority business entrepreneurs.

While minority businesses have had some access to debt capital, however limited, access to equity financing has been and continues to be scarce. Yet as indicated below, companies that receive equity financing grow sales at a faster rate, hire more employees and have a much greater economic impact than firms that have not received such investment. This section of the report will review the effect of venture capital on business growth, discuss the business sectors that have received the bulk of equity investments and recommend certain strategies for increasing the amount of equity available to minority businesses.

MEASURING BUSINESS FINANCE

Although small businesses represent over 40 percent of total assets, debt and net worth, the small-business share of measurable business financing is less than 10 percent (see Table 5). Small businesses continue to rely primarily on their own internal resources. Despite tremendous advances in the growth of the venture capital, mezzanine debt and corporate bond markets, as well as asset-backed securitization, the vast majority of small-business firms do not have access to the financing technologies available to larger companies. Bringing financial innovation to a broader section of the business market remains an unfinished work. We are still in the early stages of an era of entrepreneurial expansion dependent upon the transfer of capital market financial technology to new growth sectors.

Although venture capitalists focus on small firms, these investors have focused on very limited market sectors. Using California firms as an example, we note that businesses in California have secured nearly $17 billion in venture capital – 47 percent of all venture capital

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■ ■ ■

Foremost among these channels must be those that increase the equity investment available to minority business entrepreneurs.

■ ■ ■

Companies that receive equity financing grow sales at a faster rate, hire more employees and have a much greater economic impact than firms that have not received such investment.

Looking at the category of firms that we have defined as emerging domestic market firms (Asian America, African American, Native-American, and Latino-American), the paucity of investment capital is even more defined.

Of the estimated $95 billion in the private equity market in 1999, only $2 billion is managed by companies whose focus is supplying capital to new entrepreneurs from traditionally underserved markets.

More targeted investment funds and instruments need to be designed and built for this new asset class.

Table 5
Measurable Financing of Business
(Billions of Dollars)

Small Firm		**Large Firm**	
Commercial Paper[1]	0	Commercial Paper[1]	163
Commercial Mortgages[1]	66	Commercial Mortgages[1]	224
Commercial and Industrial Loans[1]	98	Commercial and Industrial Loans[1]	418
Trade Debt[1]	233	Trade Debt[1]	638
Finance Companies[1]	91	Finance Companies[1]	272
Initial Public Offering[1]	10	Initial Public Offering[1]	117
Venture Capital Pool[1]	34	Venture Capital Pool[1]	0
Bond Market[2]	0	Bond Market[2]	1326
Stock Market[2]	0	Stock Market[2]	5828
Bank Loans[1]	98	Bank Loans[1]	418
Total	**630**	**Total**	**9404**

[1] *The Annual Report on Small Business and Competition (1996) SBA. pp.287,296. 1995 Data*
[2] *Federal Reserve Flow of Funds. 1995 Data*

Note: Financing to small businesses represents only 7 percent of the amount of financing received by large firms.

raised during 1999 (See Table 6), but Silicon Valley captured 80 percent of those funds. Underserved entrepreneurial markets abound in California.

Looking at the category of firms that we have defined as emerging domestic market firms (Asian American, African American, Native-American, and Latino-American), the paucity of investment capital is even more defined. Of the estimated $95 billion in the private equity market in 1999, only $2 billion is managed by companies whose focus is supplying capital to new entrepreneurs from traditionally underserved markets.[25]

Despite the proliferation of specialty fund strategies, funds that include gender and ethnic-specific entrepreneurs and markets have remained relatively undercapitalized by the universe of institutional investors.[26] More targeted investment funds and instruments need to be designed and built for underserved asset classes.

The absence of social and business network ties to mainstream funding sources persists for minority business owners. Thus, strategies that seek to increase the number and diversity of capital

Table 6
Venture Capital Investment in California
(In Millions)

	1998	Percent	1999	Percent
Silicon Valley	$4,546	79%	$13,431	80%
LA / Orange County	785	14%	2,357	14%
San Diego	372	6%	952	6%
Sacramento / No. Calif.	66	1%	134	1%
Total for California	**$5,769**	100%	**$16,873**	100%

Source: PricewaterhouseCoopers "Money Tree" Venture Capital Survey

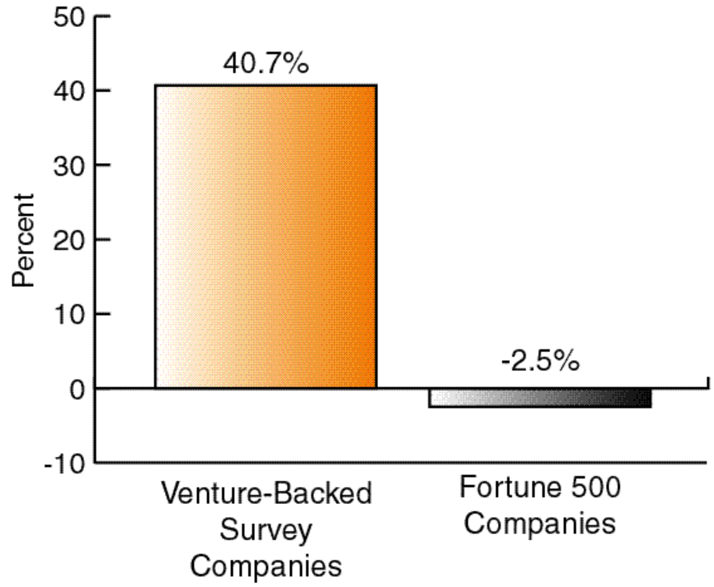
sources, particularly in the equity/mezzanine area of finance, would be most beneficial. It was only recently that minority venture capital funds first received capital from institutional funds and were viewed as competitive private equity investment opportunities. Today, minority businesses indeed offer competitive investment opportunities – opportunities that will continue to grow alongside the growing number of minority businesses.

THE IMPORTANCE OF VENTURE CAPITAL FUNDING IN WEALTH CREATION

In this context, the message to be gleaned from the robust performance of companies from emerging domestic markets and the lost opportunity if they remain underfinanced becomes clear. Job creation parallels wealth creation in this story of the importance of financing emerging domestic market assets as a new asset class. The average venture-backed company employs nearly 100 workers within five years, and these firms create almost twice as many jobs as their nonventure-backed peers. Small venture-backed firms experience at least 40 percent job growth each year as compared to a 2.5 percent

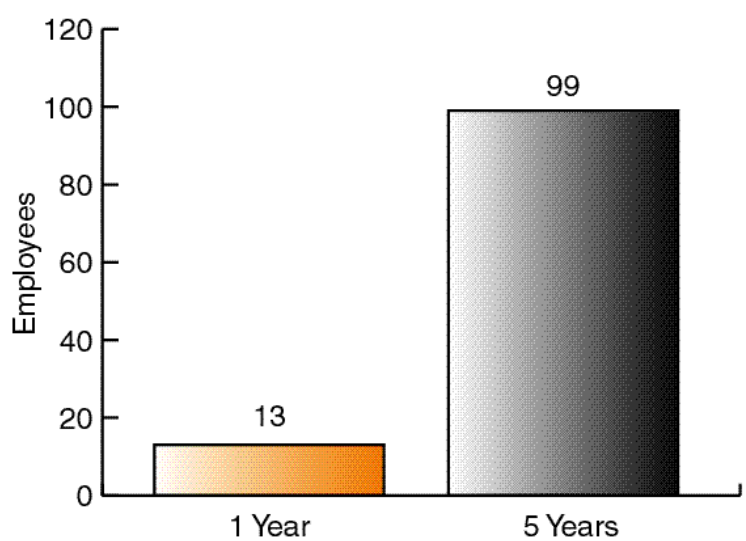
Strategies that seek to increase the number and diversity of capital sources, particularly in the equity/mezzanine area of finance, would be most beneficial.

Figure 7
Compounded Average Annual Growth
1992-1996



Source: PricewaterhouseCoopers "Eighth Annual Economic Impact of Venture Capital"

Figure 8
Average Number of U.S. Employees
by Age of Company

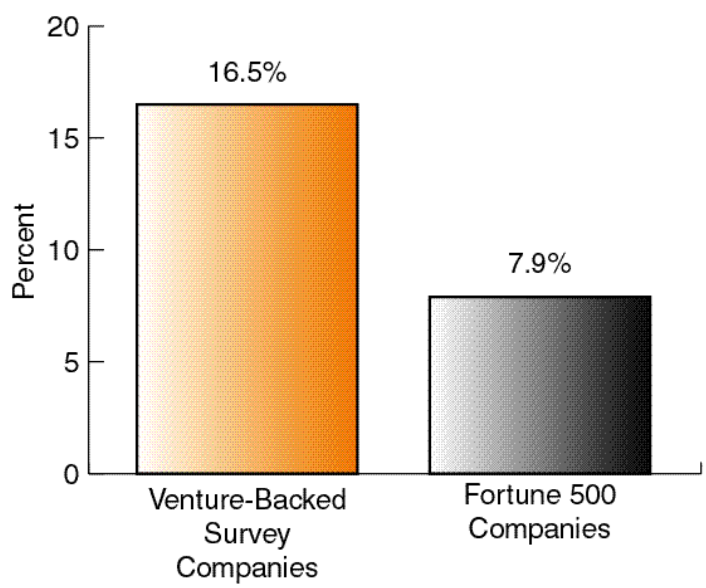


Source: PricewaterhouseCoopers "Eighth Annual Economic Impact of Venture Capital" decline in jobs for Fortune 500 companies (see Figures 7 and 8). These companies grew sales per employee twice as quickly as Fortune 500 companies, with total sales growing at an average 16.5 percent as opposed to 7.9 percent for the largest firms (see Figure 9).

Expanding sources and access to venture capital could further facilitate the process of job and capital formation in emerging domestic markets. Recent developments signal the re-emergence of individual investors as sources of venture capital. Draper Fisher Jurvetson, *meVC*, started a new publicly traded venture fund that is targeted to individuals rather than institutions. Another firm is organizing broker-dealer networks to syndicate venture capital deals to small investors. By spreading risk among thousands of individuals, these companies promise to make venture capital more appealing to small investors and more available to young companies.

An equity guarantee system created by American Venture Resource Association (AVRA) is another risk mitigation innovation that can make investing in emerging domestic market firms safer and more appealing to both individual and institutional investors. Under the guarantee system, AVRA promises to buy investments in failed portfolio companies at 50 percent of their original cost. The guarantee

Figure 9
Compounded Average Annual Sales Per Employee Growth 1992-1996



Source: PricewaterhouseCoopers "Eighth Annual Economic Impact of Venture Capital"

Small venture-backed firms experience at least 40 percent job growth each year as compared to a 2.5 percent decline in jobs for Fortune 500 companies.

These companies grew sales per employee twice as quickly as Fortune 500 companies, with total sales growing at an average 16.5 percent as opposed to 7.9 percent for the largest firms.

Recent developments signal the re-emergence of individual investors as sources of venture capital.

When firms receive strong venture capital funding, their success proves that the actual investment risk is less than perceived by the institutional investment community.

Equity investors such as insurance companies and pension funds ought to fund minority businesses on a large scale to fuel the growth of emerging domestic markets.

is structured so that reduced "downside" risk does not come at the expense of diminished upside potential. This sort of guarantee protection is likely to be particularly appealing to angel and individual investors who cannot reduce venture capital risk by investing in the sort of diversified portfolio that venture capital partnerships typically assemble.

INITIAL PUBLIC OFFERINGS

The capital structure of aspiring IPO-level companies has shifted in the last five years and could provide an indicator of private equity funds targeting minority business IPOs. When firms receive strong venture capital funding, their success proves that the actual investment risk is less than perceived by the institutional investment community. Equity investors such as insurance companies and pension funds ought to fund minority businesses on a large scale to fuel the growth of emerging domestic markets.

While private venture capital investment funds focusing on minority businesses have been emerging more frequently in the last few years, data on venture capital's contribution to minority IPO growth is still

Table 7
Venture Capital-Backed IPOs

Period	Total Number of IPOs	Venture Backed IPOs	Total Raised at IPO ($Bil)	Total Post Offer Valuation ($Bil)	Average Offer Size ($Mil)	Average Post Offer Valuation ($Mil)
1999	544	271	136.2	87.2	87.2	502.7
1998	373	78	17.8	49.2	49.2	229.1
1997	629	138	22.6	39.5	39.5	164.2
1996	868	280	58.6	43.6	43.6	209.3
1995	580	8.2	33.2	40.6	40.6	163.0

Source: Venture Economics and National Venture Capital Association (NVCA) unclear. The National Venture Capital Association (NVCA) and the Venture Economics Group of Thomson Financial Securities Data monitor venture capital investment. They reported in January 2000 that 50 percent of all the 544 initial public offerings in 1999 were venture-backed, up from 20 percent in 1998 (see Table 7). In 1999, 271 venture-backed companies went public, raising $23.6 billion. This is up 288 percent from the 1995 amount of $8.2 billion. Total valuation of those companies on the IPO date in 1999 was $136.2 billion.

Venture-backed companies today are raising more dollars and going public at an earlier age. The median company age of venture-backed IPOs was 4.0 years in 1999, versus 4.5 in 1998 and 5.5 years in 1997.

Other significant observations indicate that in 1999, the average offer size of $87.2 million increased 75 percent from the offer size of $49.2 million in 1998. In addition, post-offer valuations have more than doubled to an average $502 million, up from $229.1 million in 1998.

PENSION FUNDS AND INSURANCE COMPANIES AS CATALYSTS FOR FINANCING CHANGE

Pension funds

Another shift in venture capital backing has occurred through the use of pension funds. In 1997, pension funds supplied 55 percent of new funds for venture capital sources, corporations supplied 13 percent and endowments contributed 10 percent (see Figure 11). Twenty years earlier, in 1978, the share from pension funds was significantly lower at 15 percent, with individuals and families supplying 32 percent, followed by foreign interest with 18 percent and insurance companies with 16 percent[27] (see Figure 10).

Figures from 1998 indicate that minority private equity funds are also benefiting from pension fund distributions, specifically public pension funds, with 45 percent of minority private equity derived from these sources (see Figure 12). The federal government holds the next largest share with 17 percent.

For minority-oriented funds, the recent assistance from institutional capital partners redefines the historical capital reliance on corporations, banks and foundations. These familiar capital sources circulating through the federal SSBIC program have been unable to meet the capital gap that exists for minority-owned enterprises, which in 1992 stood at $140 billion.[28]

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■ ■ ■

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■ ■ ■

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Figure 10
Venture Capital Sources: 1978

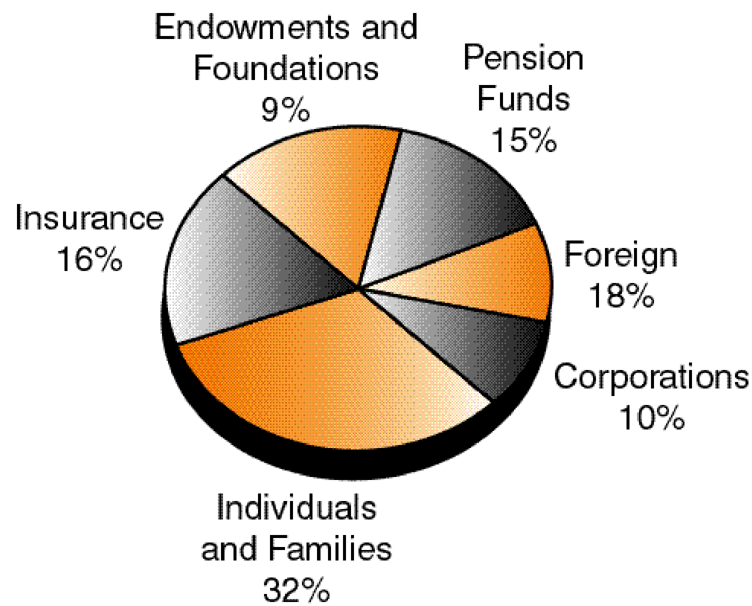


Figure 11
Venture Capital Sources: 1997

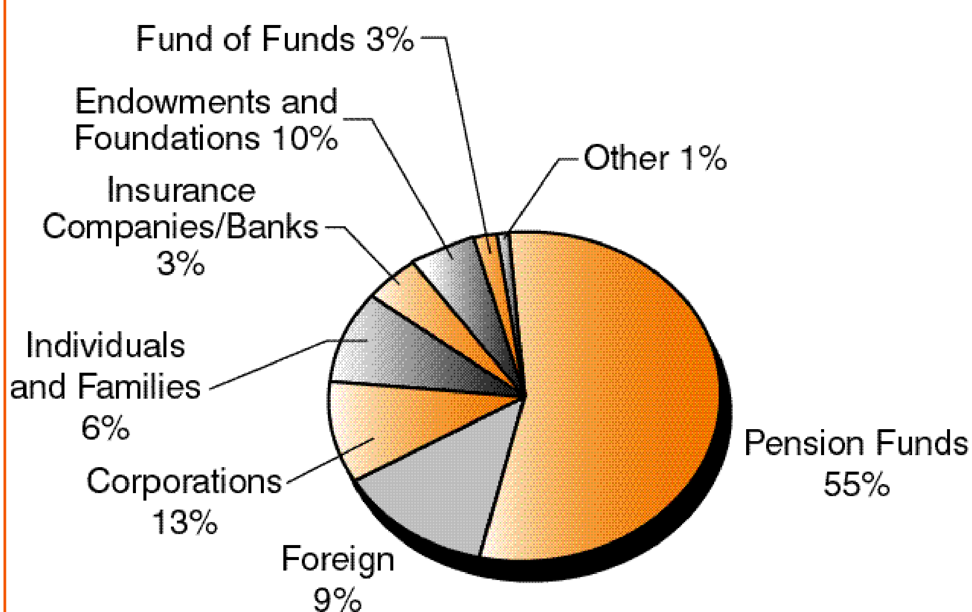
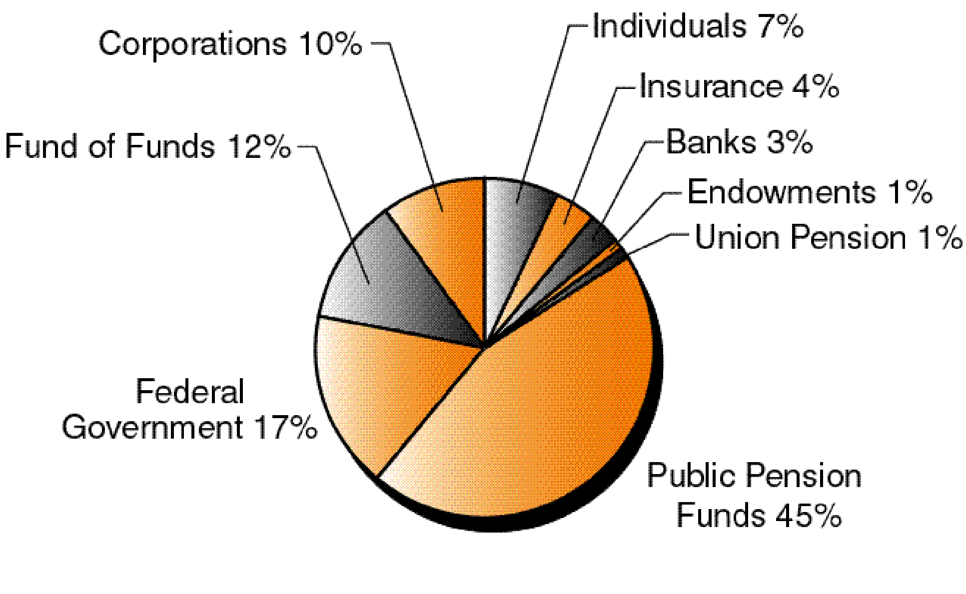


Figure 12
Minority Private Equity Sources
1998



Source: Fairview Capital Partners, Inc.

Insurance Companies

Insurance companies have long been important sources of institutional investments. Insurance companies, along with pension funds, are the primary sources of equity investments. As regulatory pressures on financial institutions and institutional investors increased, insurance regulators were swept up in a wave of activity that stigmatized entrepreneurial firms, reduced the role of insurance companies in corporate finance, and created institutional biases and restrictions in investing in growth opportunities. Changes in risk-based capital standards associated with new classifications reinforced the reluctance of insurance companies to buy below-investment grade securities or engage in private placement of debt/equity.

Insurance companies report the ratios of their book capital to levels of capital that are adjusted for risk. As an insurer's ratio progressively falls below one, successively stronger regulatory actions are triggered. Start-up companies, emerging domestic market companies, and non-investment-grade companies generally carried risk weights much higher than those on investment-grade bonds or other equities. In short, these changes in risk-based capital standards associated with the changes in classifications made it too expensive for insurance

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Minority-led venture capital firms targeting the minority business community have been operating successfully for many years and provide a viable inroad into the minority business market.

Still, private equity funds targeting minority markets are minimal in comparison to the entire private equity market.

companies to invest in growth businesses. As insurance ratios fell and strong regulatory action was triggered, the chilling effect upon growth investment became apparent. Insurance portfolio compositions changed radically in the ensuing flight to perceived safety. This has put emerging companies at a substantial disadvantage in raising necessary growth capital. Legislation could begin to help correct this problem.[29]

MINORITY-FOCUSED VENTURE CAPITAL FUNDS

Minority-led venture capital firms targeting the minority business community have been operating successfully for many years and provide a viable inroad into the minority business market. Still, private equity funds targeting minority markets are minimal in comparison to the entire private equity market. As of 1999, over $2 billion is managed by investment companies whose primary focus is supplying capital to minority entrepreneurs. Though this amounts to less than 1 percent of the total private equity capital managed by U.S. private equity firms today,[30] corporations such as Enron (Enron Economic Development Corp.) are realizing the potential profits available from investing in emerging domestic markets. Through venture capital investments in inner-city communities of at least $1 million per firm, expects their fund to generate returns of 18 to 20 percent. Yet, sufficient deal flow exists to justify investment in this

Table 8
Domestic vs. International Markets

Risk Factors	Emerging Domestic Markets	Emerging International Markets
Political Risks	No	Yes
– Expropriation	No	Yes
– Regime Volatility	No	Yes
– Legal Contract	No	Yes
Currency Risk	No	Yes
Financial Risk	Yes	Yes

largely untapped market, a market that has much less risk than popular emerging international markets and as noted in our earlier discussion, is growing at a much faster rate than the mainstream business community (see Table 8).

The opportunity to fuel the growth of this emerging asset class – the market that will drive the aggregate economy as it becomes the majority market in the 21st century – exists domestically now.

The following is a discussion of several funds with an investment focus on minority markets led by minority entrepreneurs.

TSG Capital Group

The largest venture capital fund in the minority sector is TSG Capital Group. Its history dates back to a MESBIC formed in 1970 called Equico. Once facing bankruptcy, its senior leadership adopted a strategy to drop smaller operations from its investments and concentrate on equity investments in high growth potential businesses serving minority markets. Although TSG faced deficits in its first years of the strategy due to the loss of steady cash flow from its portfolio, its dedication eventually paid off as TSG was able to sustain itself from interest income in bank certificates of deposit without capital infusions from its parent company.[31]

Over the past 16 years, TSG's return was more than 40 percent. Today, TSG boasts $700 million in assets. Its equity investments typically reach $100 million, leading TSG to take a very proactive role in the direction their companies take.

One of TSG's most successful projects was its 1993 investment in Envirotest. TSG engineered its buyout in 1998 for $600 million, realizing a $44 million gain on a $2 million investment.

Syncom Capital Corporation

Syncom Capital Corporation is one of the most successful minority venture capital firms in the nation. Led by its founder Herbert Wilkins, Sr. and firm president Terry Jones, Syncom is seeking to raise $300 million for its venture capital fund, Syncom III.

Syncom began in 1977 as Syndicated Communications Inc., a media investment company. Wilkins soon took control of the fund and set up Syncom Capital Corp. This fund functioned as a MESBIC, investing in minority-owned businesses in the media industry. Mr. Jones helped raise $1 million to get Syncom off the ground in 1978.

Sufficient deal flow exists to justify investment in this largely untapped market, a market that has much less risk than popular emerging international markets and is growing at a much faster rate than the mainstream business community.

■ ■ ■

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Syncom has experienced overall impressive results. Much of this stems from both the rapid growth in the inner-city radio and cable TV industries and the fact that Syncom shared its investments with other funds, limiting its risk in any given investment. Jones also noted that "the minority market is so underserved that we can take the cream. We get the best deals, almost without competition."[32]

Another reason the fund did so well was the advice and business planning assistance that Wilkins and Jones provided to the business owners in whom they invested. One of its most successful investments came through Radio One, whose annual revenues today exceed $40 million. Syncom invested $729,000 in the company and now values its stake at $14 million.

Syncom was averaging annual returns of 20 percent until 1990, when it decided to form Syncom II, which began operations with $35 million. In 1996, Syncom III began with $18 million. As it pursues its goal of creating a $300 million fund, it is expected that Syncom III will achieve over 25 percent in annual returns in the future.[33]

The U.S. Hispanic Chamber of Commerce has created a fund to target Latino businesses.

The U.S. Hispanic Chamber of Commerce Fund

The U.S. Hispanic Chamber of Commerce has created a fund to target Latino businesses. Its initial funding in February 2000 stood at $5 million from Bank One Corp. of Chicago, but its founders have a goal of $75 million. To assist the fund in reaching that goal, Bank One Corp. has pledged to raise another $5 million from other investors. Jeff Gaia, president of Bank One's small-business banking group, expects returns on their equity investments in the 25 percent to 35 percent range.

The fund, operating as a for-profit subsidiary of the Hispanic Chamber of Commerce, is investing in businesses with annual revenues of $4 million or higher. The businesses most likely to be funded are in industries such as manufacturing, high-tech and telecommunications.[34]

In addition to these funds, several other private ventures are attempting to fill the capital access gap.

BankBoston Development Company

In addition to these funds, several other private ventures are attempting to fill the capital access gap. BankBoston was able to creatively operate through the Community Reinvestment Act to finance a private equity fund known as BankBoston Development Company (BBDC). BankBoston has authorized roughly $100 million for investment purposes. While this amount was not exclusively designated for minority businesses, it did infuse some critical equity funds into the capital stream. BBDC primarily backs low-tech, light manufacturing, retail and services industries in urban centers.[35]

MINORITY IPOS

The Chapman Company, a private investment banking firm, maintains an index to monitor Domestic Emerging Market IPOs, which includes ethnic and racial minority-owned and women-owned companies.[42] The DEM Index is composed of 100 companies, of which 62.8 percent are in the technology sector. While not exclusively composed of minority businesses, it provides a benchmark for the performance of domestic emerging businesses in this new marketplace.

The DEM index is regularly compared to other major financial indexes to measure its strength. In 1999, the index has grown considerably when compared to other indexes (see Figure 13). The positive percentage change from 1998 for the DEM Index was 94.8 percent, compared to 19.5 percent for the S&P 500, 19.6 percent for the Russell 2000, 43.1 percent for the Russell 2000 Growth, and 25.3 percent for the Morgan Stanley Europe Australia Far East Index. Its

While not exclusively composed of minority businesses, the DEM Index provides a benchmark for the performance of domestic emerging businesses in this new marketplace.

Figure 13
DEM Index vs. Major Indices

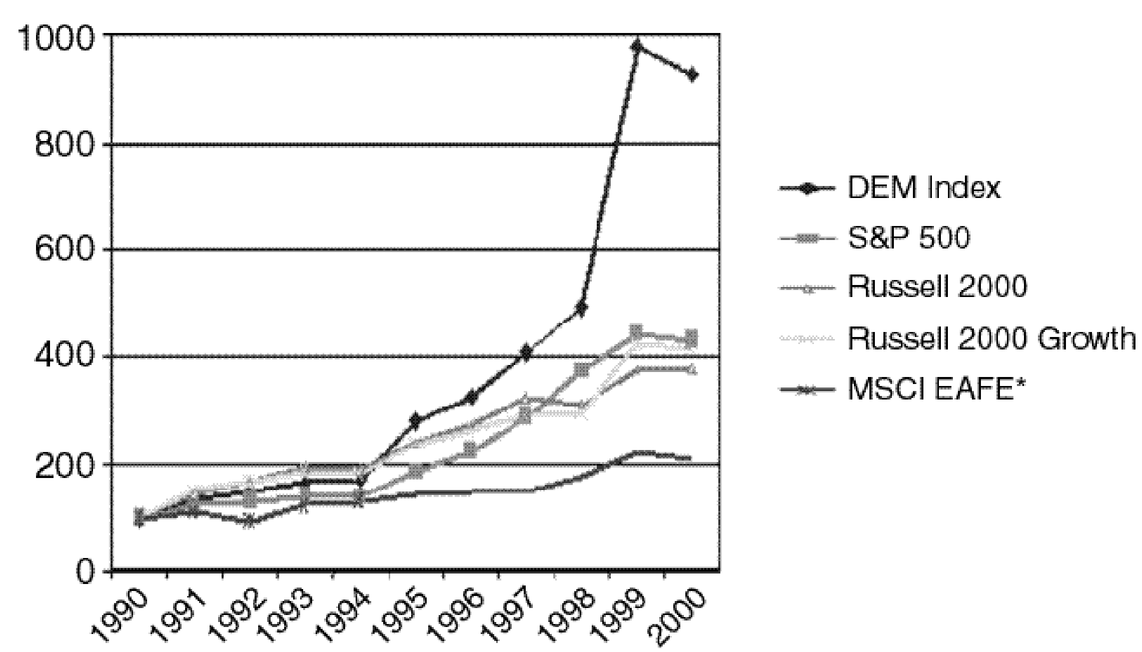


Table 9
Overview of Selected U.S. Funds Focused on Minority Markets

Insurance	Location	Capital (million $U.S.)	Investment Products	Industry Preference	Geographic Preference	Investment Type	Sources of Funding
TSG Capital Group[37]	Stamford, CT	73.4	Equity	Media, Retail, Manufacturing, Diversified	National	Expansion, Later Stage, Acquisition	Fairview, Chase Venture Capital, others
TSG Ventures (affiliate)	Stamford, CT	10.6	Mezzanine	Media, Retail Manufacturing, Diversified	National	Expansion, Later Stage, Acquisition	SSBIC, others
Syncom III* Syncom II & III (affiliate)	Silver Spring, MD Silver Spring, MD	300.0 53.0	Debt & Equity Equity	Communications Communications	National National	National Diversified Early Stage	Fairview SSBIC, Fairview
Opportunity Capital Partners	Fremont, CA	40.0	Equity & Mezzanine	Diversified	National	National Diversified	SSBIC, others
21st Century[38]*	Dallas, TX	100.0	Equity & Mezzanine	Manufacturing	National	Expansion, Later Stage, Acquisition	Hicks, Muse, Tate & Furst
ICV Equity Partners[39]*	New York, NY	100.0	Equity & Mezzanine	Healthcare, Commercial Services, Food Processing, Light Manufacturing, Retail	National	Expansion, Later Stage, Acquisition	American Securities
Bastion Capital Corp[40]*	Los Angeles, CA	125.0	n/a	Diversified	National	Expansion, Later Stage, Acquisition	CALPERs, others
Penman Partners	Chicago, IL	87.9	n/a	Diversified	National	Expansion, Acquisition, Build-ups	CALPERs, others
Black Enterprise/ Greenwich Street[40]	New York, NY	80.0	Equity & Mezzanine	Diversified	National	Expansion, Later Stage, Acquisition	Travelers
Provender Capital Group*	New York, NY	75.0-100.0	n/a	Specialty Finance, Multiunit Franchise	National	Expansion, Later Stage, Acquisition	n/a
MESBIC Ventures	Dallas, TX	64.0	Debt, Mezzanine, & Equity	Electronics, Telecom, Aerospace and Auto Suppliers, Broadcast, Food Manufacturers	Southwest	Expansion, Later Stage, MBO/LBO	SSBIC, others
Pacesetter Growth (affiliate)	Dallas, TX	46.50	n/a	Manufacturing, Telecommunications, Broadcasting, Specialty Food, Distribution	Southwest	Expansion, Later Stage, Aquisition	Oklahoma Capital Formation Corp., others
Atlantic Coastal Ventures	Stamford, CT	50.0	Equity	Converging Technologies, Consolidations	MA to FL	Expansion, Later Stage, MBO/LBO	n/a

Table 9 (Continued)
Overview of Selected U.S. Funds Focused on Minority Markets

Insurance	Location	Capital (million $U.S.)	Investment Products	Industry Preference	Geographic Preference	Investment Type	Sources of Funding
Connecticut-Greene Ventures, L.P. (affiliate)	Stamford, CT	46.5	Debt & Mezzanine	Diversified	National	Expansion, Early Stage, Later Stage, MBO/LBO	n/a
Multimedia Broadcast Investment Corp. (affiliate)	Washington, DC	1.5	Debt & Equity	Broadcasting, Telecommunications	National	Expansion, Early Stage	SSBIC, others
Ark Capital[42]*	Chicago, IL	30.0	n/a	n/a	n/a	n/a	n/a
New Vista Capital	California	20.0	n/a	Technology	California	Early Stage	SSBIC, others
Medallion Vending Corporation	New York, NY	14.5	Debt & Mezzanine	Service, Retail	Mid-Atlantic Northeast	Expansion	SSBIC, others
Capital Dimensions (affiliate)	Minneapolis, MN	n/a	Debt & Mezzanine	Communications, Technology	National	Expansion, Later Stage.	n/a
Polestar Capital	Chicago, IL	13.2	Debt & Equity	Manufacturing	National	Expansion, Early Stage, Later Stage	SSBIC, others
Civic Ventures	St. Louis, MO	10.0	n/a	Diversified	Midwest	Later Stage	SSBIC, others

[37] Direct investments in businesses that are: 1) ethnic minority owned 2) serve ethnic minority consumer base 3) majority-owned with central city operations. Currently has an alliance with Hicks, Muse, Tate & Furst.

[38] Focus on companies that serve, operate in, or are owned by residents of U.S. inner cities. Fund likely to serve fast-growing ethnic markets and involve minority entrepreneurs. Currently has an alliance with American Securities.

[39] Targets investments in middle-market companies that are owned by minorities and women, companies that serve minority consumer markets and mainstream companies that can be converted to minority or female-owned status.

[40] Seeking to invest in African-American-owned companies with $10 million to $100 million in revenues. Currently has an alliance with Travelers.

[41] Invests in minority and women-controlled businesses.

[42] Other information on the DEM Index is available at The Chapman Company's website at www.chapmancompany.com.

Source: Small Business Administration, National Association of Investment Companies, and fund/company reports and the Journal of Private Equity, Summer 1999. Capital for SSBICs reflects regulatory capital as reported by the SBA.
**reflects that the fund is currently seeking to raise this capital in the market.*

compound annual growth rate also exceeded the other indexes at 29 percent compared to 18 percent for the S&P 500, 16.1 percent for the Russell 2000, 17.7 percent for the Russell 2000 growth, and 9.3 percent for the Stanley Morgan Europe Australia Far East Index.

Table 10
Domestic Emerging Market Index - Market Sector Allocation as of January 1, 2000

Risk Factors	Sector Code	Percentage
Consumer Cyclicals	2000	13.9%
Consumer Staples	3000	10.7%
Health Care	3500	0.4%
Financial	5000	9.1%
Capital Goods	6000	1.0%
Technology	8000	62.8%
Utilities	9000	1.4%
Transportation	9500	0.6%

Source: The Chapman Company
This index includes women-owned businesses in addition to ethnic and racial minority business owners.

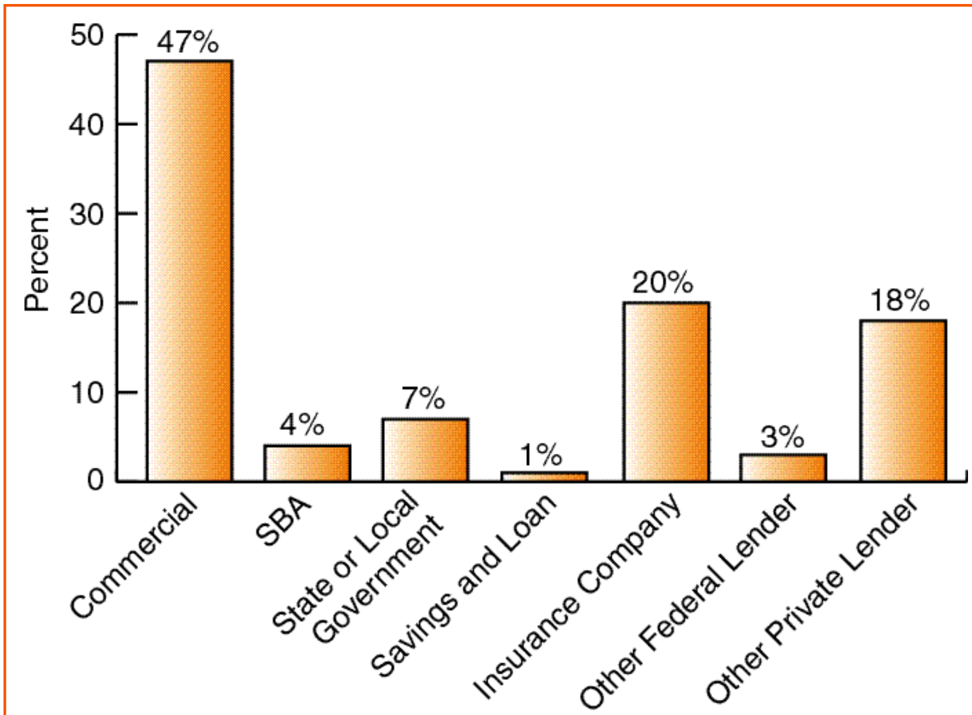
Programs Supporting Minority Business Lending and Investment

In addition to the equity markets, which minority businesses have not accessed, there are many programs that have supported the development of minority business entrepreneurs. The following section will review these programs and suggest possible strategies for enhancement.

SBA data on business characteristics reveals that only 27 percent of minority business owners use commercial bank credit.[43] Of those businesses, we also know that just 15 percent of black owners and 33 percent of Latino owners use commercial bank credit.[44]

The Minority Business Development Agency's database of borrowers paints a somewhat brighter picture of commercial lending to minority businesses. Their sample shows that 47 percent of minority

Figure 14
Minority-owned Firms by Lender Type



Source: MBDA Minority Business Data

SBA data on business characteristics reveals that only 27 percent of minority business owners use commercial bank credit.

■ ■ ■

Just 15 percent of black owners and 33 percent of Latino owners use commercial bank credit.

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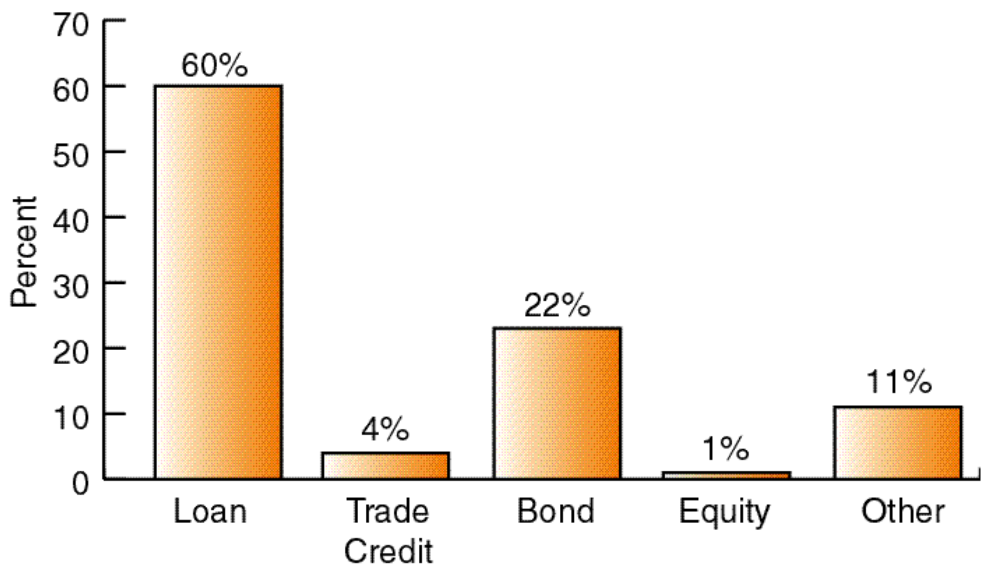
The Minority Business Development Agency's database of borrowers paints a somewhat brighter picture of commercial lending to minority businesses.

Federal policy remains confused. Banks are expected to lend while rules against risky lending restrict them from giving entrepreneurs a chance.

Federal tax breaks and subsidy programs are directed toward geographical places rather than toward people – the business owners themselves.

The federal government initiated a response to this capital gap in recent years through existing programs and new legislative proposals.

Figure 15
Minority-owned Firms by Financial Type



Source: MBDA Minority Business Data

businesses use commercial lenders to fund their firms[45] (see Figure 14 & 15).

Still, federal policy remains confused on this issue. Banks are expected to lend while rules against risky lending restrict them from giving entrepreneurs a chance. Meanwhile, federal tax breaks and subsidy programs are directed toward geographical places rather than toward people – the business owners themselves. Out of 90 programs across 14 federal departments, $9 billion per year is targeted at the inner cities, but only 9 percent of those dollars are directed to capital structure development.[46]

COMMUNITY REINVESTMENT ACT: CATALYZING INVESTMENT IN EMERGING DOMESTIC GROWTH

The federal government initiated a response to this capital gap in recent years through existing programs and new legislative proposals. The Community Reinvestment Act (CRA) was enacted in 1977 to ensure that banks and thrifts met the credit needs of underserved groups in their communities. Specifically, the Act is intended to increase the amount of money lent to older, central city, low-income environments. As a result, about two-thirds of all small-business loans and one-fifth of all small-farm loans are made by CRA reporting institutions.

Thanks to the CRA, over $1 trillion in new investments and loans has been made to underserved communities.[47] California State Treasurer Philip Angelides pointed out that due to the lending initiated by the CRA, these lenders are now "two decades ahead of most other private sector capital sources and pension funds in understanding the extent to which there are solid risk adjusted returns in community reinvestment."[48] The Brookings Institution notes that "conventional businesses are currently in the position that conventional banks were in two decades ago. They are undervaluing inner-city markets and therefore under-serving the inner city."[49] According to CRA data, lending accounts for nearly two-thirds of all capital provided to small businesses by commercial banks and savings associations.[50]

LENDING INSTITUTIONS AND THEIR SMALL-BUSINESS LENDING ACTIVITY

In 1996 and 1997, 91 percent of the institutions covered by the CRA (this includes 99,136 insured commercial banks and 1,867 savings associations) reported extending small-business loans. It is estimated that for 1997 alone, the CRA reported over 2.5 million small-business loans totaling $159.4 billion. That is up approximately 5 percent from the previous year.

CRA findings also indicate that small-business lenders are among the largest of CRA reporters. According to CRA data, in 1997, lending institutions with assets of $1 billion or more originated approximately three-quarters of reported small-business loans. This proportion is higher than in 1996, when large institutions accounted for 60 percent of small-business loans. In addition, larger lending institutions accounted for 70 percent of the dollar amount of small-business loans in 1996 and 74 percent in 1997.

In 1995, the CRA began requiring banks and thrift institutions to report their small-business lending by geographic location. Although there is extensive information available about the number and size of businesses in a given area, there is no available data on the credit history or credit needs of a particular neighborhood. Therefore, it is difficult to determine the effect of racial or ethnic neighborhood composition on small-business lending.

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■ ■ ■

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■ ■ ■

"Conventional businesses are undervaluing inner-city markets and therefore under-serving the inner city."

Neighborhoods with a large concentration of businesses and higher median family incomes have greater access to small-business lending.

When compared to non-minority neighborhoods, minority neighborhoods receive a smaller amount of business loans.

There are fears, that as larger banks swallow up the smaller community banks, relationship lending will die out, further reducing access to capital for minority-owned small businesses.

CRA data analyses show that small-business lending is mostly concentrated in central cities and suburban areas. Studies have also found, however, that neighborhoods with a large concentration of businesses and higher median family incomes have greater access to small-business lending.

The CRA figures show that when compared to non-minority neighborhoods, minority neighborhoods receive a smaller amount of business loans. The Woodstock Institute, analyzing a Federal Reserve Board Study on this issue, discovered that there were indeed large gaps between lending activity in low-and upper-income areas across the nation. In Chicago, for example, the loan-per-firm rates were 50 percent higher in upper-income areas than in lower-income areas.[51]

Another concern about the present banking environment is connected to the trend in bank mergers. Some small business advocates and studies have indicated that large conglomerations decrease the number of smaller banks, which results in reduced lending to small businesses. The relational component of small-bank lending that is lost in mergers with larger banks is an important characteristic in small business lending, as it increases the availability of financing to small businesses and slightly reduces the cost of borrowing.

Small community bank loan officers often rely on the character of the borrower more than on standardized requirements of a financial portfolio. There is evidence that banks that have a long relationship with a firm offer lower loan rates to that firm and there is less likelihood that collateral is required for loans. Lenders also are more likely to extend credit if preexisting relationships exist.[52] There are fears, then, that as larger banks swallow up the smaller community banks, this relational form of lending will die out, further reducing access to capital for minority-owned small businesses.

THE SMALL BUSINESS ADMINISTRATION

The Small Business Administration (SBA) offers loans and loan guarantees for small businesses across the country. The SBA has increased its share of total guaranteed loans going to minority businesses from 15 percent in 1992 to 24 percent in 1998. Minorities share of the SBA's 504 program, which provides long-term fixed-rate financing for major fixed assets, also increased from 9 percent in 1992 to 15 percent in 1998.[53] The total number of SBAloans made to Latino-owned businesses and black-owned businesses have tripled since 1992 and quadrupled for Asians businesses.[54]

The overall value of SBA loans outstanding to Asian-owned businesses in 1992 was $9 billion. The amount of new loans made to Asian businesses has increased from $586.5 million in 1992 to $2.13 billion in 1998. The total value of SBA loans outstanding to Latino businesses in 1992 was $4.25 billion. The amount of new loans made to Latino businesses has increased from $285.7 million in 1992 to $751 million in 1998. The total value of SBA loans made to black-owned businesses 1992 was $1.9 billion. The amount of new loans made to African American businesses has increased from $132 million in 1992 to $383 million in 1998.

Overall, the SBA guaranteed almost 49,000 small-business loans in 1999. Those loans were valued at $12 billion, with 7(a) loans whose maximum loan amount is generally $1 million, comprising $10 billion of that total. [55]

The 7(a) loan guarantee program is the SBA's largest program. With 7(a) loans, small businesses are able to take out a loan after they have failed to gain financing through normal lending channels. Lenders (usually banks) are able to make loans under $100,000 with an SBA guarantee of 80 percent and loans up to $1 million with an SBA guarantee of up to 75 percent.[56] Minority businesses received 28 percent of the 7(a) loans in 1999. This $3.4 billion went to more than 12,000 minority businesses.

Small Business Investment Companies

In addition to small business loans, the SBA administers the Small Business Investment Company (SBIC) program, created by Congress in 1958. Individual SBICs are privately organized and privately managed investment firms licensed by the SBA. SBICs provide lending and venture capital to both start-up and already established small independent businesses in the range of $300,000 to $5 million. Two types of SBICs exist – regular SBICs and SSBICs, or Specialized Small Business Investment Companies. SSBICs are specifically targeted toward minority and women entrepreneurs who may have been denied the opportunity to own and operate a business because of social or economic disadvantage. Of the total SBIC financing, just $128 million, or 3 percent, was distributed to minority-owned businesses.

SBA financing to SBICs offers a benchmark by which to judge the size of the overall investment pool to small businesses. In 1999, the total amount of financing to all SBICs, including SSBICs, was $4.22 billion (see Table 11). While the main focus of this program is on equity investments, over 27 percent, about $1.2 billion, of all SBIC

The SBA guaranteed almost 49,000 small-business loans in 1999. Those loans were valued at $12 billion, with 7(a) loans whose maximum loan amount is generally $1 million, comprising $10 billion of that total.

■ ■ ■

Small Business Investment Company SBICs provide lending and venture capital to both start-up and already established small independent businesses in the range of $300,000 to $5 million.

■ ■ ■

Specialized Small Business Investment Companies SSBICs are specifically targeted toward minority and women entrepreneurs who may have been denied the opportunity to own and operate a business because of social or economic disadvantage.

Of the regular SBICs, financing to minority businesses was nearly $76 million, representing only 1.83 percent of the $4.16 billion total.

SSBIC investments, financing to businesses with 50 percent or more minority ownership, amounted to $52 million.

investments involve debt to some extent, either straight debt or debt mixed with equity.

Of the regular SBICs, financing to minority businesses was nearly $76 million, representing only 1.83 percent of the $4.16 billion total (see Table 12). SSBIC investments, financing to businesses with 50 percent or more minority ownership, amounted to $52 million. This represents 88.67 percent of the $59 million in SSBIC money, with women-owned businesses comprising the rest (see Table 13).

The largest percentage of SSBIC financing was distributed to black-owned businesses, which received 37 percent of SSBIC investment dollars. Asian Pacific-owned businesses followed with 25.89 percent, and Subcontinent Asian-owned businesses received 14.51 percent. Latino-owned businesses received 11.32 percent of the SSBICs financings, with Native American-owned businesses receiving 0.39 percent.

Table 11
Demographics of Total SBIC Program-Financed Small Businesses
Financing Recorded from October 1, 1998 through September 30, 1999
SBIC PROGRAM TOTAL

	Number of Investments	Percent of Total	Amount of Investments	Percent of Total
50% or more Black-Owned	194	6.27	55,469,535	1.31
50% or more Latino-Owned	73	2.36	15,679,482	0.37
50% or more Native American-Owned	4	0.13	3,230,000	0.08
50% or more Asian Pacific-Owned	124	4.01	17,615,391	0.42
50% or more Subcont-Asian-Owned	133	4.30	36,397,767	0.86
Total	**528**	**17.05%**	**$128,392,175**	**3.04%**

Total SBIC Program Financing	**3,096**	**$4,220,913,888**
Non-SBIC Venture Capital Firms	**1,824**	**$12,500,000,000**
Percent Change from Fiscal Year 1998	**(10%)**	**30%**

Source: Small Business Administration

Table 12
REGULAR SBIC

	Number of Financings	Percent of Total	Amount of Financings	Percent of Total
50% or more Black-Owned	101	3.65	33,854,982	0.81
50% or more Latino-Owned	22	0.79	8,987,392	0.22
50% or more Native American-Owned	1	0.04	3,000,000	0.07
50% or more Asian Pacific-Owned	14	0.51	2,312,781	0.06
50% or more Subcont-Asian-Owned	97	3.50	27,823,229	0.67
Total	**235**	**8.48%**	**$75,978,384**	**1.83%**
Total Regular SBIC Financing		**2,770**	**$4,161,805,480**	
Percent of Change		**(2%)**	**33%**	

Source: Small Business Administration

Table 13
SPECIALIZED SBICs

	Number of Financings	Percent of Total	Amount of Financings	Percent of Total
50% or more Black-Owned	93	28.53	21,614,553	36.57
50% or more Latino-Owned	51	15.64	6,692,090	11.32
50% or more Native American-Owned	3	0.92	230,000	0.39
50% or more Asian Pacific-Owned	110	33.74	15,302,610	25.89
50% or more Subcont-Asian-Owned	36	11.04	8,574,538	14.51
Total	**293**	**89.88%**	**$52,413,791**	**88.67%**
Total Specialized SBIC Financing		**326**	**$59,108,408**	
Average Loan Size				
SBIC Program Total			**$1,363,344**	
Regular SBIC			**$1,502,457**	
Bank-Owned SBICs			**$3,598,144**	
Debenture SBICs			**$572,191**	
Participating Securities			**$761,369**	
Specialized SBICs			**$181,314**	

Source: Small Business Administration

NEW MARKETS INITIATIVE

The newest federal proposal is the New Markets Initiative (NMI) that seeks to expand business opportunities in low- and moderate-income areas.

■ ■ ■

The core of the NMI package includes tax credits, venture capital investments, technical assistance and mentoring programs.

■ ■ ■

New Markets Venture Capital Companies (NMVCs) will combine equity venture capital financing and technical assistance to smaller businesses in designated low and moderate-income areas.

The newest federal proposal is the New Markets Initiative (NMI) included in President Clinton's 2001 budget. This economic program, which involves SBA, HUD and Treasury support, aligns with existing SBA programs, but seeks to expand business opportunities in low- and moderate-income areas. The core of the NMI package includes tax credits, venture capital investments, technical assistance and mentoring programs.

The SBA's expansion into the venture capital market will be structured around the SBIC model. Federally subsidized companies called New Markets Venture Capital Companies (NMVCs) will combine equity venture capital financing and technical assistance to smaller businesses in designated low-and moderate-income areas. In 2000, $6 million in funds were allocated, subject to authorization, to provide for $40 million in SBA-backed funds. Technical assistance for these companies would be supported with an additional $9 million appropriation. The 2001 request would increase this amount to $21.66 million in credit subsidies to provide $150 million in SBA-backed funds.[57]

The key difference between SBICs and NMVCs will be the size of businesses targeted for investment. NMVCs will service the lower spectrum of the equity market businesses just above the start-up phase, where community development would be the prime objective rather than profit optimization alone. These finance vehicles are encouraged to invest in very small operations whose owners have little business expertise in the financing process and limited financial resources. In contrast to the $300,000 to $5 million investments made by SBICs, an initial NMVC investment is expected to range from $50,000 to $300,000.

The technical assistance component of NMVCs is expected to strengthen the human capital of the business owners while providing community benefits. Technical assistance for the New Market Initiative Companies would be provided through the BusinessLINC program, which is a partnership between the SBA, the U.S. Department of Treasury and the business community. Through this partnership, large businesses are encouraged to mentor small-business owners in rural areas and inner cities. The President's Budget for 2001 requests $6.6 million for this program. Native American outreach is considered an essential part of this program and $1.25 million has been earmarked for the request.

The potential financial success of NMVC must be examined, however, in light of research and evaluation of the federal experience with Minority Enterprise SBICs (MESBICs), the forerunners of the current SSBICs.[58] Successful MESBICs did not typically invest in smaller firms, but ones with employees and those earning a median sales level exceeding $500,000. Profitable MESBICs were discerning in their investments and based decisions on collateral, home ownership, strong business cash flow and the applicant's business experience – none of which are strictly required for the NMVC-targeted firms. The successful MESBICs were not willing to take risks on firms that demonstrated no clear indication of management talent, ability to tap into growing markets or the potential to become a high-grossing firm.

Mandating funding exclusively to inner-city small businesses on a geographic basis is a limiting strategy.

Transactions of scale are more prudent for job creation – a core economic objective.

Two types of MESBICs were generally more successful: asset-based lenders and high-end venture capital companies investing in minority business enterprises with sophisticated, highly experienced business managers.

Mandating funding exclusively to inner-city small businesses on a geographic basis is a limiting strategy. Research tells us that transactions of scale are more prudent for job creation – a core economic objective.[59] Another concern for investment firms serving small, inner-city operations is high loan default rates. Recent research found that two types of MESBICs were generally more successful: asset-based lenders and high-end venture capital companies investing in minority business enterprises with sophisticated, highly experienced business managers.[60] A firm capable of growth potential and investment return for a MESBIC would most likely have:

- A strong management team
- A proven product/service
- Annual sales exceeding $1 million
- A profitable operation in the past year
- Strong internal accounting and financial controls
- Audited financial statements
- Strong personal credit ratings of top managers
- A written business plan of three to five years

Once the NMI program begins operations, two other federal agencies will become involved in the overall program. First, the U.S. Department of Housing and Urban Development will administer investment companies called (APICs). APICs, America's Private Investment Companies, will provide private capital and government

APICs, America's Private Investment Companies will provide private capital and government backing to finance equity capital investments for the creation or relocation of large-scale businesses in inner cities and rural areas.

The U.S. Department of Treasury will administer the New Markets Initiative Tax Credit that will be worth up to 25 percent of investments by entities serving designated New Markets.

The tax credits could boost investments by $15 billion in these New Markets areas. This should have a positive impact on the growth and development of minority businesses.

backing to finance equity capital investments for the creation or relocation of large-scale businesses in inner cities and rural areas.

In addition, the U.S. Department of Treasury will administer the New Markets Initiative Tax Credit that will be worth up to 25 percent of investments by entities serving designated New Markets. This includes NMVCs, APICs, community development banks and other targeted investment funds. The Clinton administration is seeking $3 billion in the 2001 budget to be allocated towards these credits. This is up from the $1.2 billion over five years that was initially requested in the 2000 budget. The tax credits could boost investments by $15 billion in these New Markets areas. This should have a positive impact on the growth and development of minority businesses.

FEDERAL PROCUREMENT CONTRACTS

Another area where small businesses are directly involved with the federal government is through government procurement contracts. In 1998, small businesses contracted to provide $41 billion dollars worth of work to the U.S. government.[61] This represents 21 percent of the $195 billion in procurement money awarded to all businesses in 1998. Minority-owned businesses were awarded just 5.8 percent of all procurement, receiving $11.3 billion in procurement money for that year. This amount is nearly the same as the 5.5 percent of the total procurement amount that minority businesses were awarded in 1996.

Of the $11.3 billion in federal procurement money that minority firms received in 1998, about 60 percent of those dollars came through the SBA's 8(a) program.[62] The total 8(a) prime contract level in 1998 was $6.3 billion. In California alone, 537 8(a) contract awards worth $270 million were made that year.[63]

Receivables securitization offers another important area of policy and program development. The figures above represent potential securitization of 8(a) loans worth $270 million in California and $6.3 billion nationwide. If all of these loans were securitized, an additional $6.3 billion would be made available to lend to other minority businesses through the 8(a) program.

MARKET-BASED PUBLIC VENTURE CAPITAL POLICY

The Case for CAPCOs (Certified Capital Companies)

An enormous number of experiments in economic development have taken place since the 1980s, as they became increasingly important in state-level public policy. State-assisted venture capital programs have ranged from those that are publicly funded and managed, to those that are publicly funded but privately managed, to those created by the public sector through enabling legislation for private sector venture capital institutions, minimizing state control and state financial risks and rewards (see Table 14). In each case, the common goal is to encourage business creation and expansion alongside job creation and retention. Geographically isolated regions and traditionally disadvantaged populations (rural or minority) are also a target. Increased supply of venture/mezzanine capital can fill gaps as a means of retaining and growing businesses within the state. Table 14 is based on case studies of these various approaches.[64]

State-assisted venture capital programs have ranged from those that are publicly funded and managed, to those that are publicly funded but privately managed, to those created by the public sector through enabling legislation for private sector venture capital institutions, minimizing state control and state financial risks and rewards.

Table 14
State Economic Development Model: Venture Capital

Publicly Funded, Publicly Managed Venture Capital Firms	Publicly Funded, Privately Managed Venture Capital Firms	Certified Capital Company Programs
Iowa Product Development Corp/ Iowa Seed Capital Corp	Colorado Rural Seed Fund	Florida CAPCO Program
Minnesota Technology Corp Investment Fund	Kansas Venture Capital, Inc.	Louisiana CAPCO Program
Small Enterprise Growth Fund (Maine)	Magnolia Venture Capital Corp (Mississippi)	Missouri CAPCO Program
	Northern Rockies Venture Fund (Montana)	New York CAPCO Program
	Oklahoma Capital Investment Board	

Source: Rural Policy Research Institute: "Public Involvement in Venture Capital Funds: Lessons from Three Program Alternatives."

CAPCOs have become increasingly popular as a method of allocating tax credits to encourage and leverage investment in private venture capital firms certified under the legislation.

There are a number of advantages to this privately managed, publicly supported approach to leveraging and diversifying the venture capital community.

Careful consideration of its implementation will optimize the impact of bridging the capital gap for emerging domestic firms and insuring the sustainability of economic growth.

After 10 years of experimentation with more state-directed programs, CAPCOs have become increasingly popular as a method of allocating tax credits to encourage and leverage investment in private venture capital firms certified under the legislation. CAPCOs are essentially insurance companies that set up venture capital funds. In the case of California, this mechanism could build out the geographical and demographic diversity of the state's venture capital infrastructure.

There are a number of advantages to this privately managed, publicly supported approach to leveraging and diversifying the venture capital community. No current state budget expenditures or bond sales are required. The actual cost (present value) of a CAPCO program is reduced by the allocation of tax credits over time. Investments can be insulated from political pressure and limitations inherent in more government directed programs. Finally, the ability to leverage other private funds and increase syndication appears to be improved in this type of program. A number of policy options are available in this legislation. Careful consideration of its implementation will optimize the impact of bridging the capital gap for emerging domestic firms in California and insuring the sustainability of its economic growth.

Mezzanine Financing

Trends in the private equity market suggest an increasing number of public to private transactions in which have evidence little participation. This ownership change process could be enhanced through minority manager/owners' participation. As in the case of both venture equity and senior bank debt, the technology and innovations of the mezzanine market remain largely underdeveloped for the emerging domestic market segment. A mezzanine security represents the layer of capital between senior debt and equity. It is generally structured as subordinated debt or preferred stock with a common equity component provided through the use of warrants or a conversion feature. The availability of mezzanine capital introduces much needed flexibility in the capital structure of firms that are or could become minority-owned.

Ordinarily, mezzanine market security types (subordinated debt with warrants, convertible subordinated debt, and preferred stock) have longer terms, higher coupon rates and expected returns between those of equity and senior debt. In general, their covenants are more flexible than senior debt and enable the firm to withstand greater economic variability in market conditions and staying power to execute competitive strategies.

Privately managed, public purpose equity/mezzanine funds could target business and project financings in inner cities among emerging domestic market firms, and on or adjacent to Native American lands. By bringing private management to public assets or to investments with a significant public benefit, i.e., jobs and community investment, such mezzanine level funds could structure transactions that deal with the risks unique to these investments and the constraints of management capacity and debt service capacity could be structured. Uniting private and public subsidies with private financing, allows a mezzanine fund to take a risk position and leverage other sources of financing.

A potential structure for this type of mezzanine fund could be like that illustrated in Figure 16. The liability side of the fund could be comprised of equity investors seeking not only a market return but a social investment purpose, e.g. foundations, banks and financial institutions seeking to better satisfy CRA requirements, the government (directly or through a government sponsored enterprise), Native American tribal investors and/or insurance companies and other institutional investors seeking business

The availability of mezzanine capital introduces much needed flexibility in the capital structure of firms that are or could become minority-owned.

■ ■ ■

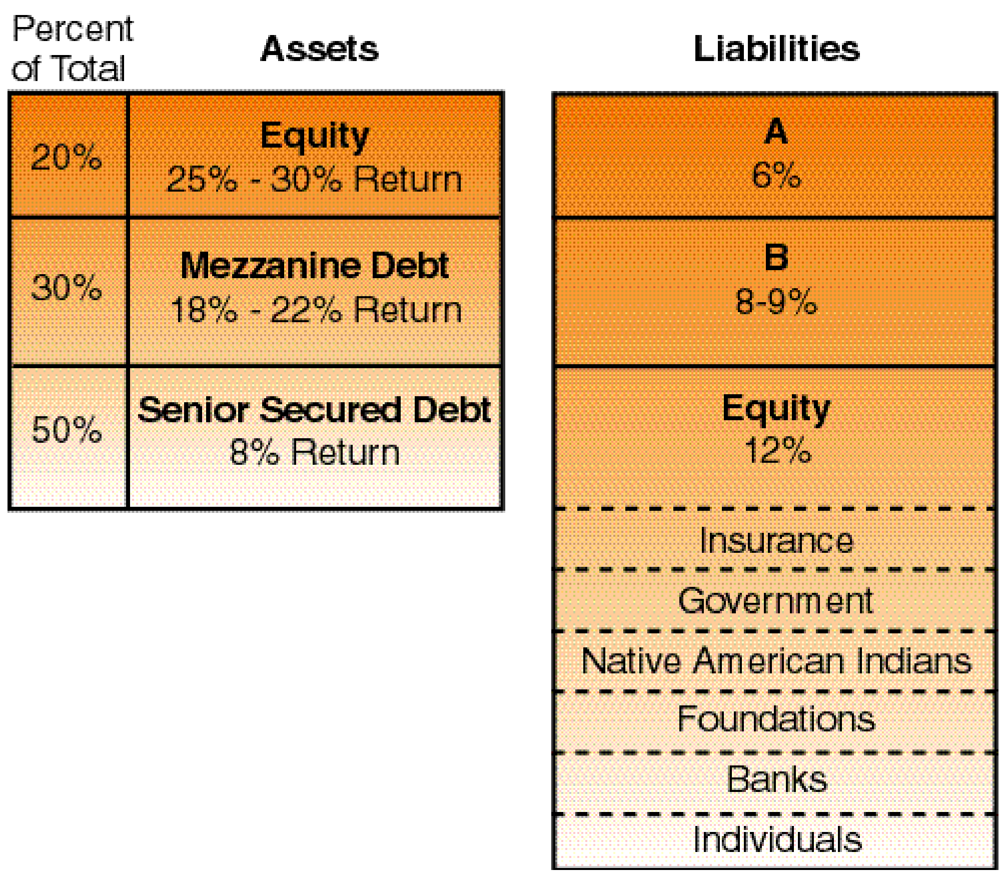
In general, subordinated debt covenants are more flexible than senior debt and enable the firm to withstand greater economic variability in market conditions and staying power to execute competitive strategies.

■ ■ ■

Uniting private and public subsidies with private financing, a allows a mezzanine fund to take a risk position and leverage other sources of financing.

development in these emerging markets. Additional funding would be raised by an investment grade (Single A) issuance at Treasury plus an additional 150 basis point return and a high yield issuance (BB-) at 600 basis points above Treasury yields. The asset side of the balance sheet of such a fund could include senior debt issued at 8 percent returns (about 50 percent of the assets); mezzanine investment yielding 18 to 22 percent returns (30 percent of the fund's assets); and direct equity at yielding 25 to 30 percent returns and comprising 20 percent of the fund.

Figure 16
Mezzanine Fund Model



Secondary Market Securitization

In addition to private equity funds, securitization models for secondary markets are being considered as alternative avenues to capital for minority-owned businesses. Legislative initiatives such as the Riegle Community Development and Regulatory Improvement Act of 1994 removed regulatory restrictions on the securitization of small-business loans. This relaxation of restrictions created investment opportunities through federally regulated banks, thrifts, credit unions and pension plans.[65]

The securitization process involves the pooling and purchase of individual small-business loans from their lenders and packaging these loans into a security, or a Collateralized Loan Obligation (CLO), which is then sold to a third party (see Figure 17). This converts illiquid individual loans into more liquid, marketable securities.[66] The purchaser of the CLO is thus able to hedge against the risk of default on any one of these loans as they own just a small percentage of each loan in the security.[67]

Information deficiencies have led to hesitation in investing in the secondary market for small business loans, both for small businesses in general and for minority businesses specifically. A Brookings Institution report said, "America's inner cities have vastly undervalued assets that are largely unseen by conventional business. The resulting underinvestment reflects a serious information gap affecting neighborhood markets. In today's information age ... little reliable accessible data or knowledge is available about emerging markets."[68]

Minority CEOs from the Inner City 100 listed negative perceptions as another factor that affects investment opportunities for minority businesses. These CEOs, whose companies had annual compound growth rates of 44 percent, "cite negative perceptions about their neighborhoods – especially in regard to crime – far more often than they cite actual crime rates or an inadequate labor pool"[69] as competitive disadvantages. A report to CalSTRS, the California State Teachers Retirement System Board, agreed on both points. This study noted, "Due to market inefficiencies and negative perceptions, it appears that urban areas have been largely overlooked by mainstream investors … despite being attractive investment opportunities."[70]

In addition to private equity funds, securitization models for secondary markets are being considered as alternative avenues to capital for minority-owned businesses.

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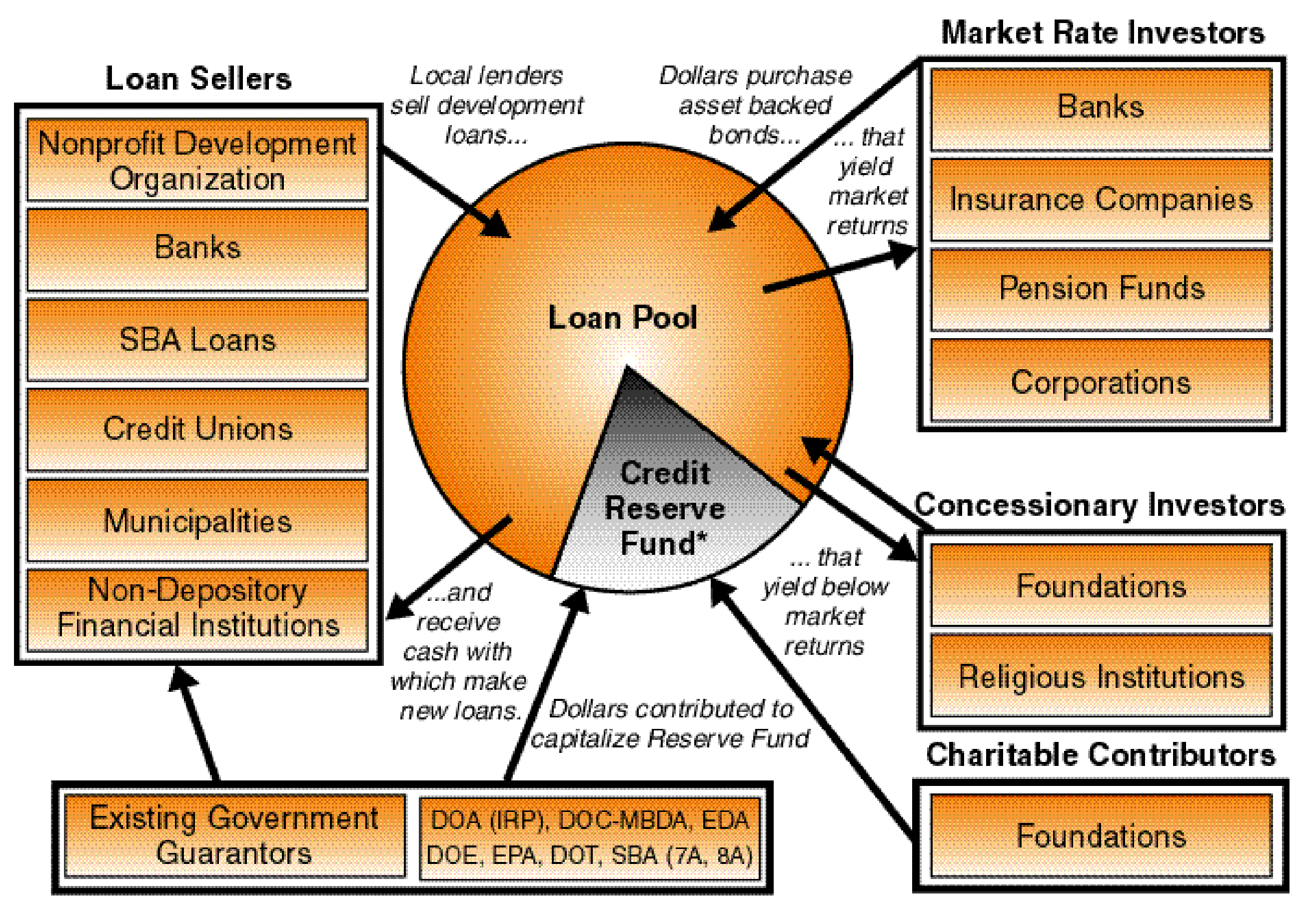
Figure 17
Minority Business Finance Model



*Pools existing guarantees on CLOs.

There is concern, that relationship-based lending will become extinct due to credit scoring and that credit scoring can negatively impact loans made to minority business entrepreneurs.

The introduction of credit-scoring models is anticipated to help promote the securitization process by mitigating these issues. Credit scoring is "an automated method that analyzes a large sample of past borrowers in order to calculate the probability that a loan applicant with certain specific characteristics will default."[71] These models adopt standardized lending terms, documentation and underwriting guidelines, which should result in more refined estimates of loss-probability distributions, allowing for greater potential for securitization.

There is concern, however, that relationship-based lending will become extinct due to credit scoring and that credit scoring can negatively impact loans made to minority business entrepreneurs. Specifically, critics have stressed that banks' relationships with small businesses are "especially important for firms that do not have formal

Table 15
Growth of Small Business Loans at U.S. Commercial Banks[1]
(Billions of Dollars)

Year	Total Business Loans	Commercial and Industrial Loans	Non-farm, Non-Residential Real Estate Total
1993	295.0	157.2	137.8
1994	294.2	154.5	139.7
1995	315.9	165.3	150.7
1996	333.1	175.8	157.3
1997	357.6	196.1	161.5
1998	370.8	197.2	173.6

[1]Business loans of $1 million or less at U.S. domestically charted commercial banks, excluding U.S. branches and agencies of foreign banks. U.S. branches and agencies of foreign banks held approximately $178 billion of commercial and industrial loans on June 30, 1998, almost all of which were greater than $1 million.

[2]Estimate

Source: June 30 Call Reports; Board of Governors of the Federal Reserve System, 1998, p. 37

business plans or audited financial statements typically used in traditional underwriting of commercial loans."[72]

Private companies, such as CFI ProServices Inc. of Portland and Commercial Redevelopment Associates Inc. have attempted to extend the availability of capital to small-business development through secondary markets.

The potential market for securitized small-business loans is sizable, judging from loans made by commercial banks alone (see Table 15). As of June 1998, these banks held $370 billion in small-business loans in original amounts less than $1 million per loan. The growth rate for this volume of loans has been about 6 percent annually since 1994.[73] Yet, between 1992 and 1998, only $2.6 billion of these loan dollars has been offered either publicly or privately and only $700 million has been marketed[74] (see Table 16).

The slow growth of small-business loan securitization is attributed to:

- lack of standardized lending terms
- lack of uniform underwriting guidelines
- the lack of "relationship lending"
- lack of historical data on credit performance

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The slow growth of small-business loan securitization is attributed to lack of standardized lending terms, lack of uniform underwriting guidelines, the lack of "relationship lending", and lack of historical data on credit performance.

An issue of increasing concern to community banks – and small businesses in turn – is a growing liquidity shortage due to shrinking deposits.

Securitization offers a means of escaping this liquidity trap.

An issue of increasing concern to community banks – and small businesses in turn – is a growing liquidity shortage due to shrinking deposits. Banks' average assets grew 6 percent each year as opposed to 4 percent for core deposits (defined as total deposits less time deposits greater than $100,000 and brokered deposits). The loan deposit ratio at commercial banks hit an all time high at 88 percent up from 65 percent 20 years ago. Community bank assets are funded by as much as 72 percent of core deposits as compared to 43 percent at large banks.[75] Securitization offers a means of escaping this liquidity trap.

Table 16
Rated Offerings of Securities Backed by Small-Business Loans[1]
(Volume in Millions of Dollars)

Year	Number	Volume
1992	2	574.0
1993	3	376.3
1994	3	201.9
1995	4	211.9
1996	7	530.0
1997	8	489.1
1998	4	212.9
Total	30	2,596.1

[1]Excludes securities backed by guaranteed portions of SBAloans.
[2]Through July 1998

Source: Moody's SBA; Board of Governors of the Federal Reserve System, 1998, p. 38

California Securitization Pilot Projects

CALCAP SECURITIZATION

Another pilot securitization project is currently underway in California involves California Capital Access Program (CalCAP) loans and further securitization of SBAloans to enhance liquidity and growth of banking in emerging domestic markets. Sparked by our original policy brief on this subject in 1999, CalCAP is a loan portfolio insurance program whereby banks making CalCAP loans set aside a portion of each loan in a reserve fund matched by the state to be tapped in the event of a loan default. This fund allows banks to make riskier loans than would otherwise be justified.

In this first California securitization demonstration project, it is planned that $75 million to $100 million in CalCAP loans will be purchased from banks making these loans. Collateralized Loan Obligations (CLOs) will be created by pooling these loans together and then dividing them up into separate securities. The risk of loss from default on any given loan is therefore minimized and spread across many different CLOs. The CLOs will then be sold on the open market as investment grade securities. The likely investors in these CLOs include pension funds, insurance companies and foundations.

Salomon Smith Barney, the leading underwriter, will determine the credit enhancement methods. The likely methods include private, government and foundation insurers. The State Treasurer's office oversees this project.

COMMUNITY DEVELOPMENT LOAN SECURITIZATION

Another pilot project being contemplated involves community development loans. The securitization process here would be very similar to that of the CalCAP project. Over $50 million worth of loans made by community development organizations will be purchased, pooled, divided and sold as securities on the open market.

The benefit of this form of financing is that the community development lenders are able to use the income from the sale of their loans to increase the amount of community development loans they can make to other minority business enterprises, thereby decreasing

CalCAP is a loan portfolio insurance program whereby banks making CalCAP loans set aside a portion of each loan in a reserve fund matched by the state to be tapped in the event of a loan default. This fund allows banks to make riskier loans than would otherwise be justified.

Community development lenders are able to use the income from the sale of their loans to increase the amount of community development loans they can make to other minority business enterprises.

the capital access gap to minority firms. Whether these proceeds will be subject to the same lending restrictions as are their original sources of capital is of concern to community development lenders.

The CRF purchases loans from community and economic development lending organizations and pools them as collateral for market-rate securities sold to investors.

OTHER SECURITIZATION POSSIBILITIES

Securitization can also be applied to other forms of small-business lending. $3.4 billion went to minority businesses in 1999 through the SBA's 7(a) program, with about $1.4 billion of those loans going to minority firms in California. Another $6.3 billion is available for securitization through the SBA's 8(a) loan program, with $270 million available in California. A Native American Securitization program, called a CALBIDCO, would specialize in long-term SBA loans and sell the guaranteed portion of those loans.

EXISTING SECURITIZATION MODELS

Community Reinvestment Fund (CRF)

The Community Reinvestment Fund (CRF), established in 1988, purchases loans from community and economic development lending organizations and pools them as collateral for market-rate securities sold to investors. Typical lenders from which the CRF purchases loans range from rural community development non-profits to large state agencies. These organizations are then able to use the income from the sale of these loans to increase the number of community development loans they are able to make in any given period of time. The CRF receives support from foundations and individuals interested in community development.[76]

Revolving Loan Funds (RLFs) recycle the loan repayments by re-lending the capital to other businesses in the community.

Revolving Loan Fund

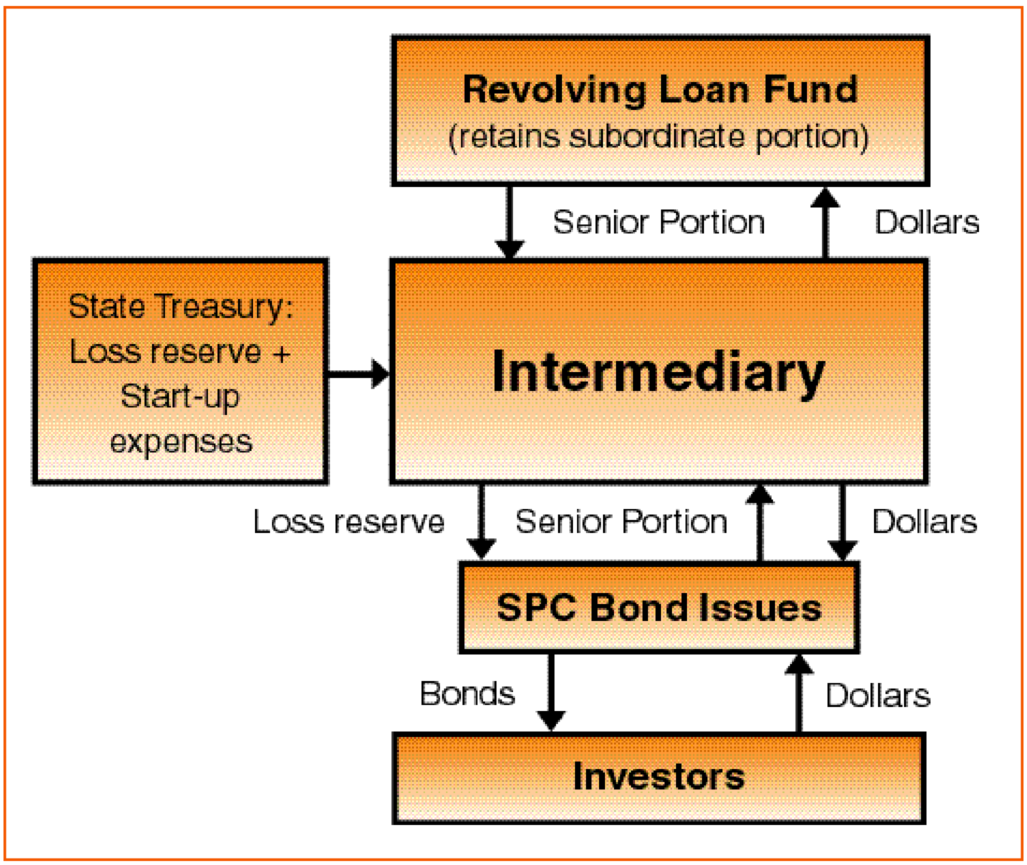
Revolving Loan Funds (RLFs) are "community based financial institutions that promote business development and job creation. They provide loans to local businesses that cannot attract private financing on their own. The funds recycle the loan repayments by re-lending the capital to other businesses in the community."

It is estimated that RLFs need a capital base of $3 million to $3.5 million with an active loan portfolio of at least $2 million to operate effectively. Currently, the median capital base of RLFs in California is less than $500,000. Thus, these institutions require subsidies and support for training and technical assistance services. A model that securitizes these RLF loans into special purpose vehicles (SPCs) is provided in Figure 18.

RLF Statistics (as of March 1998 with 68 percent of RLFs reporting):

- RLFs represent over $375 million in capital.
- Less than 15 percent of RLF loans are delinquent or defaulted.
- The total value of RLF loans made is $208 million.
- The total number of loans made is 2,827.
- The median loan size is $48,000.

Figure 18
Revolving Loan Fund Securitization



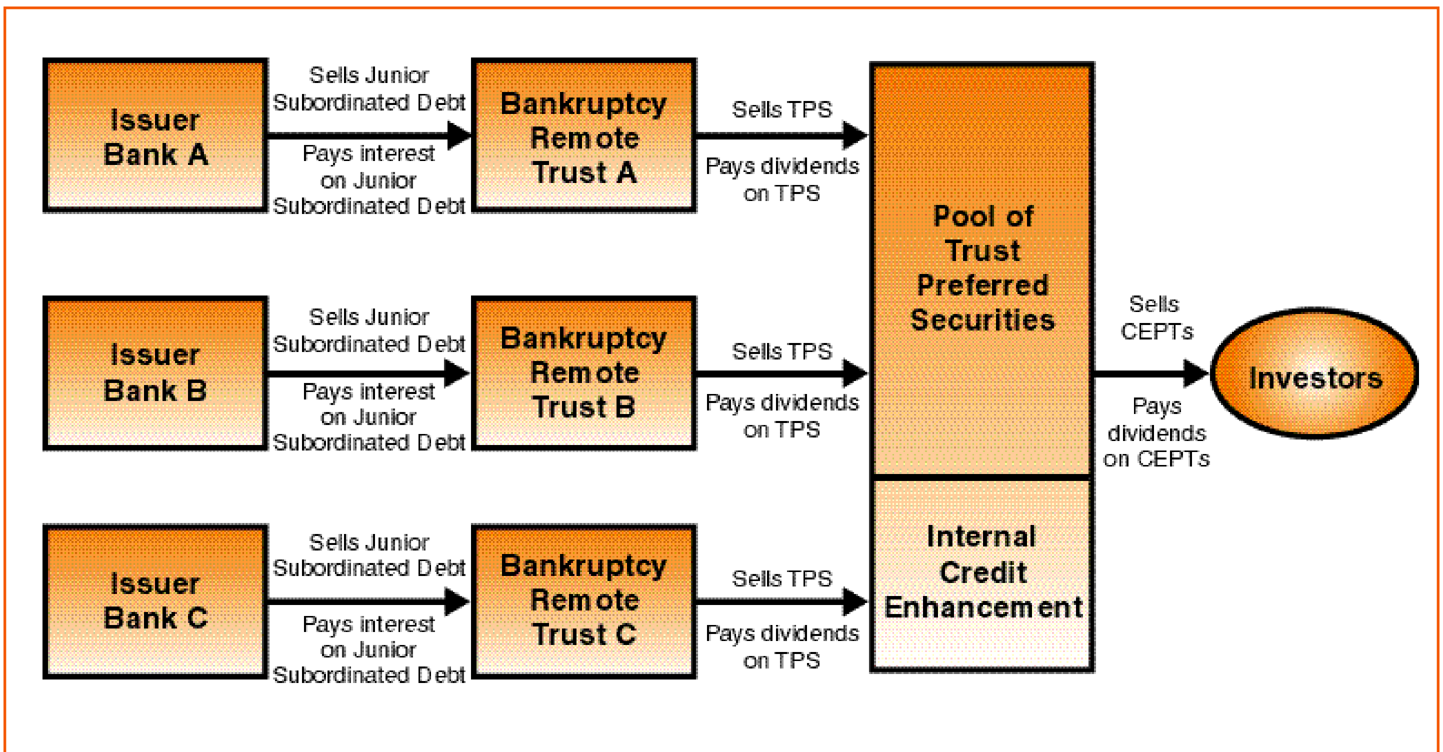
Barclays' securitization model pools together a diversified portfolio of community banks and adds an element of internal credit enhancement called Credit Enhanced Pooled Trust Securities.

Barclays Capital

Barclays Capital has introduced a securitization model based on market issuance of Trust Preferred Securities (TPS). Under the TPS structure, a bank sells its junior subordinated debt to a Bankruptcy Remote Trust, which also receives interest on the debt. This trust sells a TPS to investors in the capital market who receive dividends from the repayment of these loans.

Barclays' Capital takes this securitization method one step further in order to provide this same capital market access to small community banks with low credit rating. To accomplish this, Barclays' securitization model pools together a diversified portfolio of community banks and adds an element of internal credit enhancement. The new investment-grade pooled securities are called Credit Enhanced Pooled Trust Securities (CEPTs). The sale of these loans to the securitizer again allows the community banks to make a new wave of loans to needy businesses that would not otherwise have been made. A CPET Securitization Model is shown in Figure 19.

Figure 19
Barclays Capital's
Credit Enhanced Pooled Trust Securities (CPETs)



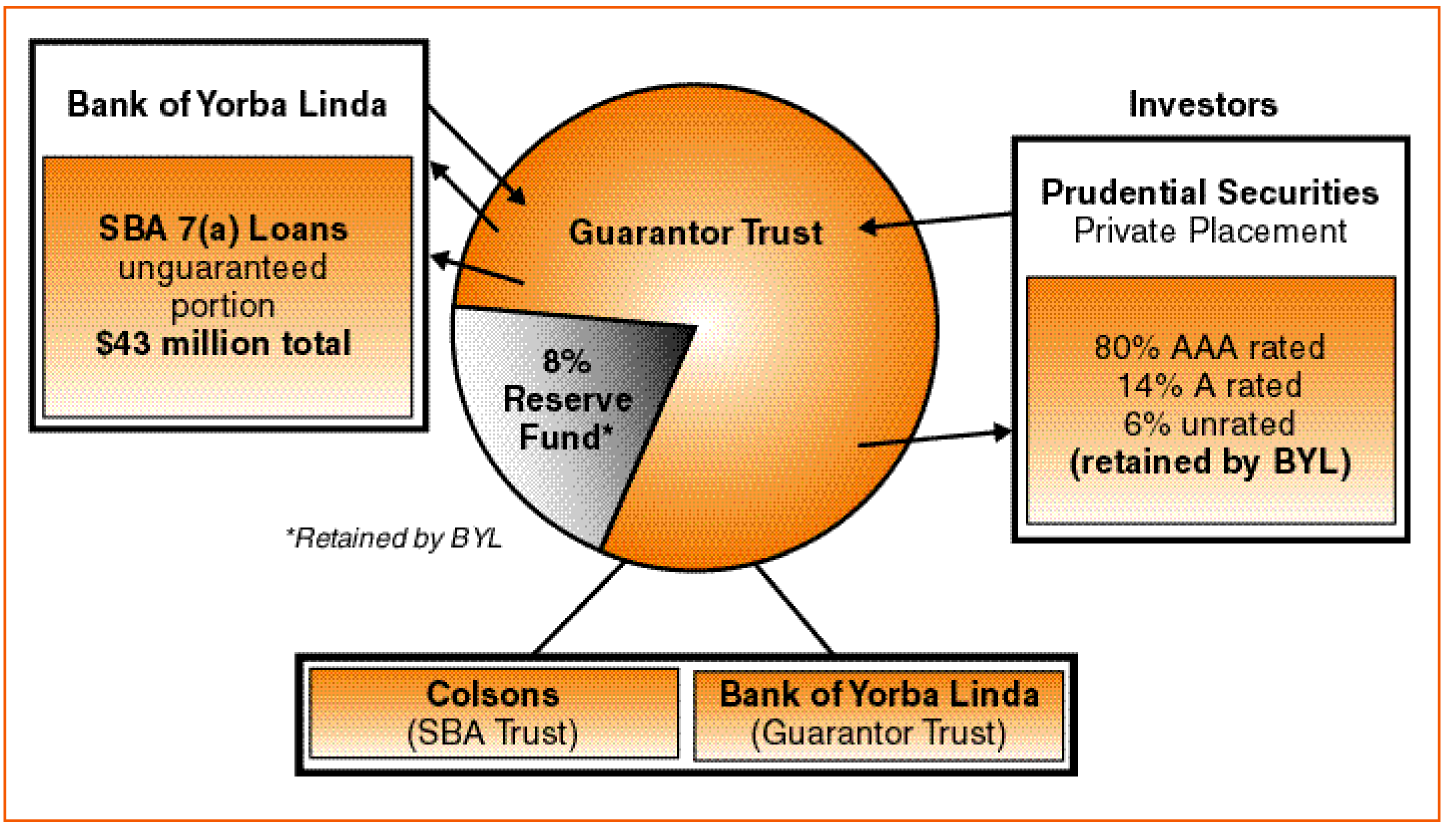
CEPT Statistics:

- The pool consists of at least 30 banks.
- Bank asset sizes range from $100 million to $10 billion.
- The banks have been in existence for at least 15 years.
- The pool size is at least $300 million.
- CEPTs will be issued with 30-year maturity callable after 10 years.

Bank of Yorba Linda

The Bank of Yorba Linda (BYL) is a California commercial bank that provides SBA loans to small and medium-sized businesses. BYL has developed a securitization structure that offers SBA loan-backed adjustable rate certificates. These include AAA rated, A rated and Not

Figure 20
Bank of Yorba Linda Securitization



If established California's secondary loan market would allow designated loans to serve as collateral for State Treasury-issued bonds that would be sold at a private or public sale.

There is also a bill under consideration in New York that establishes a small-business loan secondary market program to be administered by the state's Business Development Corporation. This program would permit secondary market securities to be legal investments for state pension funds, banks, insurance companies and other fiduciaries.

Rated certificates. BYL credit enhancement on these issues is provided by the subordination of the lower-rated certificates. The lowest rated certificates are enhanced by an 8 percent reserve fund that BYL maintains on the unguaranteed portions of its SBA loans. The BYL securitization model is provided in Figure 20.

SBA 7(a) Loans

In addition to the guaranteed portion of SBA 7(a) loans, it is now possible to securitize the non-guaranteed portion of SBA loans. Most recently, Small Business Loan Source has issued nearly $100 million in securities backed by the non-guaranteed portion of these SBA loans. The private placement was conducted online through the Westwood Capital web site, a first for asset-backed securities.[77]

SECONDARY MARKET LEGISLATION

California is at the forefront in adopting legislation to establish a secondary loan market. Senate Bill 661 was approved by the state Assembly and signed by the governor in October 1999. The bill requires the California Industrial Development Financing Advisory Commission to establish a secondary market for community and economic development loans. The lieutenant governor as well as the Department of Insurance's California Organized Investment Network endorsed this bill which would allow private, public or quasi-public economic development lenders to participate. The bill is currently awaiting a funding source to become active.

The mechanics of this particular secondary market would allow these designated loans to serve as collateral for State Treasury-issued bonds that would be sold at a private or public sale. The bill excludes the issuance of industrial development bonds based on this collateralized method.

An original $5 million appropriation would have supplied dollars to fund this plan, but the amount was subsequently deleted in an amendment. If the fund survives its current period of uncertainty, it will be called the Community and Economic Development Fund.

There is also a bill under consideration in New York that establishes a small-business loan secondary market program to be administered by the state's Business Development Corporation. This program would permit secondary market securities to be legal investments for state pension funds, banks, insurance companies and other fiduciaries. It would also direct the NY job development authority and the NY State Urban Development Corporation to guarantee timely payment of these loans.

CONCLUSION

The nation's current business growth cycle can only be sustained if institutional investors recognize the imperative to invest in emerging domestic markets. To this end, numerous financial models have been proposed to close the current capital gaps in equity, mezzanine and senior debt financing. Failure to invest in this asset class will further increase existing labor and capital shortages and act as a brake on overall economic development.

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[36] Seeks control and minority equity positions in companies serving fast growing, underserved ethnic markets (African-American, Latino, and Asian). TSG works with managers to develop strategy, build infrastructure and made add-on acquisitions.

[37] Direct investments in businesses that are: 1) ethnic minority owned 2) serve ethnic minority consumer base 3) majority-owned with central city operations. Currently has an alliance with Hicks, Muse, Tate & Furst.

[38] Focus on companies that serve, operate in, or are owned by residents of U.S. inner cities. Fund likely to serve fast-growing ethnic markets and involve minority entrepreneurs. Currently has an alliance with American Securities.

[39] Targets investments in middle-market companies that are owned by minorities and women, companies that serve minority consumer markets and mainstream companies that can be converted to minority or female-owned status.

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customers would help facilitate the bundling of loans. The pilot project was designed to secure small-business real estate loans secured by land assets. The program was suspended, however, in 1998.

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Glenn Yago, Director of Capital Studies at the Milken Institute, specializes in financial innovations, financial institutions and capital markets. His work includes extensive analysis of public policy and its relationship to high-yield markets, initial public offerings, industrial and transportation concerns, and public and private sector employment.

Yago's most recent projects include Emerging Domestic Markets — U.S. markets whose entrepreneurs belong to groups such as minorities, immigrants and women, and whose access to capital to grow their companies has traditionally been limited. His Capital Studies group established the Milken Institute Capital Access Index. He is also engaged in projects researching and implementing financial innovations to promote peace in the Middle East through economic development. He is a co-author of the recently published *Restructuring Regulation and Financial Institutions*. Yago received his Ph.D. from the University of Wisconsin, Madison.

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