Statement of Robert A. Rapoza
President
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September 11, 2008

Senate Committee on Small Business and Entrepreneurship

Hearing on

Business Start-Up Hurdles in Underserved Communities: Access to Venture Capital and Entrepreneurship Training

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Introduction

Thank you, Chairman Kerry, Ranking Member Snowe and honorable members of the Senate Small Business Committee, for this opportunity to testify today as you discuss the ways to help entrepreneurs in economically distressed communities secure the capital and technical support they need to thrive.

My name is Bob Rapoza and more than thirty years ago I started a consulting firm in Washington, DC with the explicit goal of representing nonprofit community development organizations, to assist these organizations shape federal policy, and to encourage greater investment in the underserved communities they serve. Today my firm has the good fortune of representing a diverse group of talented organizations across the country including Boston based Youthbuild, and Coastal Enterprises Incorporated based in Wiscasset, Maine as well as the Community Development Venture Capital Alliance, the New Markets Tax Credit Coalition, and Friends of the SBA Microloan Program.

My testimony this morning will focus on two federal programs that have been of great value to my clients and to community development organizations across the country: the New Markets Tax Credit (NMTC) Program and the New Markets Venture Capital Program (NMVC).

Both the NMVC and the NMTC were signed into law in 2000 as part of a bi-partisan legislative package designed to revitalize ailing urban and rural communities. The NMVC and the NMTC are both designed to increase the flow of private capital to businesses operating in low income communities, both programs have demonstrated success, and both have the potential to do more if extended and expanded by Congress.

Background on the New Markets Venture Capital Program

Congress enacted the NMVC program in December 2000 as part of the Consolidated Appropriations Act of 2001 (P.L. 106-554). The NMVC program was authorized as part of a broader initiative designed to target federal assistance to improve local economies and the NMVC program was the Small Business Administration's (SBA's) piece of the initiative.

The goal of the NMVC was to ensure that patient venture capital and operational assistance is available to businesses operating in poor communities. While modeled after the SBA's existing Small Business Investment Company (SBIC) program, the NMVC is unique in three ways:

1. Its purpose is the creation of wealth and job opportunities for individuals living in low income areas;
2. It targets venture capital investments to high-growth small businesses in poor urban and rural areas; and
3. It provides supplementary technical support to give companies a boost in their business operations.

These are not explicit goals for SBIC financing and I believe it is critical that the SBA have a program in its portfolio that **does** intentionally target venture capital to businesses operating in distressed areas.

Congress appropriated $22 million as subsidy to support $150 million in NMVC debenture guarantees and an additional $30 million in grant financing to support up to fifteen NMVC Companies. In July, 2001, half of this money was obligated to support six NMVC Companies that were designated by the SBA. In the fall of 2002, SBA agreed to designate seven additional NMVC companies in 2003. However, Congress unexpectedly rescinded the remaining monies - $24.25 million - in the Fiscal 2003 Omnibus Appropriations Bill ($10.5 million for subsidy cost of debenture guarantees and $13.75 million for grant financing) forcing the SBA to cancel plans for additional NMVC Companies.

Though the reach of the NMVC program was scaled back with the recession of funds for the second round of NMVC Companies, the six existing NMVC companies, have used the debentures and operational assistance grants to find and invest in strong, high-growth companies in low-income, underinvested areas that can generate market-rate returns for investors and foster economic growth and job creation in some of the country's most distressed urban and rural communities.

According to the most recent survey of NMVC companies conducted by CDVCA:

- The six NMVC companies invested more than $48 million in 75 companies all based in low-income communities, with 53% of these investments in manufacturing, agriculture, forestry and fishing enterprises;
- Virtually all of the NMVC capital was invested in seed, early and expanding companies, and very little in later stage;

- The average NMVC investment is $1.7 million as compared to traditional venture capital investments which average $9 million;
- NMVC companies directly invested $48 million in companies and leveraged an additional $136 million in investments in the companies from both individual investors as well as other venture funds;
- NMVC companies provided more than $6 million in operational assistance grants to 163 companies to fund such things as a business plan that plotted the success of a Vermont importer of organic fair trade products and a business plan for a Maine software business that used the plan to secure a $1.2 million equity investment; and
- NMVC companies created 368 new jobs and maintained another 1,626 jobs that were at risk.

These are impressive outcomes for a start-up federal program. The findings of the CDVCA survey indicates a healthy demand for venture capital in poor communities and also demonstrates that NMVC Companies can effectively respond to that market demand.

Background on the New Markets Tax Credit Program

The New Markets Tax Credit was established in the Community Renewal Tax Relief Act of 2000 in order to stimulate investment and economic growth in low income urban neighborhoods and rural communities that are traditionally overlooked by conventional capital markets. The NMTC does this by providing investors with a seven-year, 39 percent federal tax credit for investments made through vehicles known as Community Development Entities (CDE). These CDEs use capital derived from the tax credits to make loans to or investments in businesses and projects in low income urban and rural communities.

The original NMTC authorization provides $15 billion in Credit allocations between 2000 and 2007. This was the most significant federal investment made in community development in over 20 years.

In December 2005, Congress provided an additional $1 billion in New Markets Tax Credit allocations for Gulf Coast communities devastated by Hurricane Katrina, of which the first $600 million was awarded by the CDFI Fund in June 2006. Finally, the Tax Relief and Health Care Act of 2006 extended the Credit through 2008 with an additional $3.5 billion in Credit authority and language requiring the Department of Treasury to better target the Credit to non-metro areas.

To date, the CDFI Fund has awarded five rounds of Credit allocations totaling $16 billion and allocations are currently pending for the sixth allocation round. The CDFI Fund received $21 billion in allocation requests from 239 CDEs for the $3.5 billion of available Credits for 2008 – the last allocation authorized under current law.

To date, NMTC investments in low income communities total over $11.5 billion and more than 250 CDEs are using the Credit to invest in businesses and support a wide variety of economic development initiatives in poor communities. NMTC financed projects range from an investment by a faith-based CDE in a new childcare facility on the west side of Chicago, to the development of the first new supermarket in the Congress Heights section of Washington, DC in over a decade, to financing the expansion of manufacturing facilities in rural Minnesota in order to retain businesses and jobs, and financing the expansion of a community health center in Holyoke, Massachusetts.

The *2008 NMTC Progress Report* released by the New Markets Tax Credit Coalition found that CDEs are continuing to raise capital and deploy funds faster than required by law and regulation and the demand for Credit financing is growing. The report also indicates that CDEs are targeting areas with poverty rates higher than 30 percent, incomes below 60 percent of area or statewide median, and unemployment rates greater than 1.5 times the national average, far beyond the requirements of the law and regulations governing the program.

The Coalition's report also found that 87 percent of the NMTC capital raised is being used to finance loans to qualified businesses and 13 percent of the NMTC capital raised by CDEs is being invested as equity in qualified businesses. More than 40 percent of the CDEs responding to the survey indicated that they provide both debt and equity to businesses.

The Coalition report found that 56 percent of the NMTC financed transactions are in real estate businesses which include child care facilities, charter schools, health care facilities, mixed use and commercial developments. More than 35 percent of the NMTC investments, both debt and equity are made in non-real estate businesses and the remaining 9 percent of the NMTC investments reported were made in other CDEs or used to purchase loans from other CDEs.

In addition, a recent Government Accountability Office (GAO) report found that the program is effective at increasing investment in low income communities. According to GAO, 88 percent of investors indicated they would not have made the same investments in low income communities without the NMTC. In addition, the GAO report showed that the total dollar amount of investments and number of investors participating in the New Markets program is increasing. At the same time investor returns on the Credit are decreasing, suggesting greater efficiency.

The NMVC and the NMTC Working Together

While both the NMVC program and the NMTC program have been successful and have met if not exceeded expectations in terms of attracting new private capital to capital starved markets, the two programs have not worked together as initially intended.

To date only one NMVC Company has also been certified as a CDE and that entity is the Southern Appalachian Fund which was created through collaboration between Technology 2020 Finance Corporation a CDFI based in Oak Ridge, Tennessee and Kentucky Highlands Investment Corporation a CDFI based in London, Kentucky.

As the only entity that is both a licensed NMVC Company and a certified CDE, the Southern Appalachian Fund is the only entity to have financed businesses using capital raised with the NMTC as well as capital raised with SBA debentures.

In 2001 the Southern Appalachian Fund was conditionally approved by the SBA as a NMVC Company and between July, 2001 and July, 2003 raised the $5 million in private capital required to become a New Markets Venture Capital Company and to qualify for the SBA guaranteed debentures made available through the NMVC program. In addition, after raising the required match an additional $3 million in operational assistance grant funding was made available to the Southern Appalachian Fund to support the business ventures in which it invests. In 2003, the Southern Appalachian Fund also applied for and secured a $2 million NMTC allocation as one of the Round I NMTC Allocatees.

Since 2003, the Southern Appalachian Fund has invested a total of $6.6 million in eight portfolio companies of which $1.7 million, or 25 percent of the fund, was generated by NMTC investments and the remainder generated by private capital and SBA debentures. At the time the investments were made, the eight portfolio companies employed a total of 76 individuals and as of December 31, 2007 the companies employed 201 persons which is an increase of 125 jobs.

The $6.6 million in NMVC/NMTC investment has effectively leveraged an additional $40.3 million in private investment in the eight growing companies. This represents approximately $6 in leverage for each $1 invested by the Southern Appalachian Fund and the investments have resulted in a $12 million increase in gross revenues for the portfolio companies, wages have increased $6 million and payroll taxes increased by more than $1 million.

Only six of the ten investors in the Southern Appalachian Fund invested to take advantage of the NMTC. The other four investors are nonprofit organizations without federal tax liability and therefore unable to claim the benefits of a federal tax credit. As the Southern Appalachian Fund makes a capital call in order to invest in a business the QEIs are issued on a pro-rata basis according to the amount each NMTC investor has invested in the Fund.

One of the eight portfolio companies that the Southern Appalachian Fund has invested in is SmartFurniture, Inc., a furniture company that has a patented shelving product and is based in Chattanooga, Tennessee. The company designs and distributes its unique furniture products to customers in all 50 states and Canada. The Southern Appalachian Fund invested when the company’s only employee was its owner and founder. Between 2004 and 2007, the Southern Appalachian Fund has closed five investments with the company totaling $923,525 which enabled the company to leverage an additional $5.6 million in outside private capital. The capital and technical support provided by the Southern Appalachian Fund allowed the company to expand from a single employee shop in 2004 to employing 37 individuals in 2007 with all employees enjoying full health benefits as well as retirement benefits.

Recommendations:

In closing I would like to strongly encourage the Committee to reauthorize the NMVC as well as the NMTC program to ensure that community development organizations can continue to use these federal tools to attract private investment capital to capital starved communities.

That said, I would like to suggest that four technical changes be made to the current NMVC statute. These changes are designed to enable NMVC Companies to operate more effectively and to allow the NMTC and the NMVC programs to work in tandem as intended originally.

I applaud Senator Kerry and Senator Snowe for incorporating these changes in S.1662 the Small Business Venture Capital Act that was reported out of Committee last year. All four of the recommendations suggested below are included in your bill and I am hopeful they will be enacted into law.

First, I recommend amending current law to align the definition of "Low Income Geographic Area" within the NMVC statute with the definition of "Low-Income Community" as defined in the New Markets Tax Credit (NMTC) statute (IRC Sec 45D(e)). This change would have an immediate impact on CEI as well as Kentucky Highlands Investments Corporation since both entities are NMVC companies as well as New Markets Tax Credit allocatees that under current law find it difficult to use the two programs together because of disconnect in the targeting requirements. Ensuring that those areas eligible for NMVC investments are also eligible for NMTC investments that will allow NMVC Companies to combine the resources and leverage the impact they can have in targeted communities and with targeted businesses.

In 2004, the NMTC statute was amended to expand the definition of a "Low Income Community" to include a low income geographic area as well as a low income Target Population. If the NMVC program and the NMTC program are to work together effectively the Target Population must be applied to the NMVC program as well as the NMTC.

Secondly, I recommend that the current NMVC statute be amended to ensure that conditionally approved NMVC companies have a full two years to raise the private capital required to secure final approval. Twenty-four months is typically the minimum time needed to raise the capital required by law and we ask that the statute be clarified to grant NMVC companies the full 24 months needed. This change, if adopted, would only apply to future NMVC funds when the program is reauthorized, since all six of the current NMVC companies have raised their capital.

Thirdly, with respect to the operational assistance grant funding, I recommend that the Committee eliminate the provision that requires NMVC companies to provide a cash match in order to secure operational assistance grants. We suggest that the Committee instead put in place a formula that bases the size of a NMVC's operational assistance grant on the amount of private investment capital raised by the NMVC Company. Specifically we suggest that the NMVC formula be modeled after the Rural Business Investment Company (RBIC) program which is jointly administered by the SBA and the USDA. The RBIC program is similar in structure and purpose with the NMVC program but under the RBIC program a participating Rural Business Investment Company receives an operational grant that is equal to ten percent of the private capital raised by an RBIC or $1 million, whichever is less. Such a formula simplifies the current NMVC program and provides a great deal of relief to NMVC companies that find it difficult to raise the private match for operational assistance funds.

And finally, I strongly recommend that Congress provide new funding for the NMVC program so additional NMVC companies can be licensed and secure debenture and operational assistance funding. I support the language included in S. 1662 which would provide $30 million to support the NMVC program annually.

With regard to the NMTC, I strongly urge the Senate to pass tax extender legislation before the close of this Congress. As I mentioned in my testimony, the last NMTC allocations authorized under current law will be announced by Treasury next month and unless Congress votes to extend the NMTC through 2009 there will be no allocations available for the coming year. Senator Rockefeller and Senator Snowe introduced S. 1239, the New Markets Tax Credit Extender Act of 2007, which provides a five-year extension and we are grateful and pleased to see 26 Senators have already co-sponsored that bill. We are also pleased to have a one-year extension of the NMTC included in Senator Baucus' tax extender bill. S. 3335 and we hope to see the Senate pass that bill in the near future.

With the credit crunch intensifying we cannot afford to see an important program like the NMTC taken off the table.

I thank you for this opportunity to testify today and Chairman Kerry and Ranking Member Snowe I thank you for taking the lead as members of the Small Business Committee and as members of the Senate Finance Committee to see that tools like the NMTC and the NMVC are made available.

Thank you.