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How Fleet Development Ventures Invests in Underserved Markets

by Daniel L. Coleman, *Director, Private Equity, Fleet Development Ventures*



Broadcasters at a recent conference sponsored by American Urban Radio Networks (AURN). Access.1 Communications, which received funding from Fleet Development Ventures, was one of the two founding partners of AURN which provides 300 weekly shows targeting African-Americans.

A minority entrepreneur hopes to expand a business started with funds raised from family and friends... An inner-city developer seeks to provide affordable housing through construction of a multi-unit apartment complex in a distressed neighborhood... A woman business owner has an unexpected opportunity to buy out her partner.

Each of these individuals faces not only just tough decisions but also potentially even tougher hurdles to find the funding they'll need to reach their goals.

Although loans to small inner-city businesses have become increasingly available, none of these situations would likely attract the interest of an equity investment firm. When that happens it's not only the entrepreneur who fails to benefit, but also the community. Too often, minority, women, and inner-city business owners have found themselves unable to secure the equity capital they need to grow their enterprises.

The minority venture capital sector of the U.S. economy has an estimated \$2 billion in capital under management — less than 1 percent of the \$250 billion in U.S. venture capital overall. In other words, less than 1 percent of the venture capital dollars available are being focused on meeting the needs of the more than 30 percent of Americans (about 80 million) who are minorities. The situation is not much better for women-owned businesses: although women own 40 percent of all businesses in the U.S., women-owned businesses reportedly receive less than 5 percent of all venture capital investment according to a 2003 study by the Ewing Marion Kauffman Foundation.

A mission to serve the underserved

Meeting the equity investment and lending needs of the traditionally under served is the primary mission of Fleet Development Ventures (FDV), which directs a \$100-million equity fund specifically targeted to minority- and women-owned and managed enterprises and companies situated in low- and moderate-income (LMI) areas.

“FDV is one of the few places in America where a minority businessman seeking equity capital is taken seriously and can actually receive funding,” says Sidney Smalls, CEO and majority owner of Access.1 Communications Corp., one of the largest African-American radio broadcasting networks

in the United States. A successful owner-operator of radio stations for over 30 years (including one of the largest AM stations in New York City), Smalls recently sought capital to expand his business. But he quickly discovered that of the nation's approximately 1,700 private equity funds, fewer than 10 focused on his marketplace and had sufficient funding to meet his needs.

FDV had its roots in the profitable urban retail model that Fleet (then BankBoston) had launched to serve the needs of urban low- to moderate-income consumers. Through this retail franchise, senior bank management began to identify the lending and equity capital needs of inner-city businesses, particularly those owned by minorities and women. In 1997, BankBoston Development Company (FDV's predecessor) opened as a bank subsidiary community development corporation, approved by the Office of the Comptroller of the Currency (OCC) as a Part 24 initiative. It was the first private equity investment fund for urban communities created by a commercial bank. Two years later, when BankBoston and Fleet National Bank merged, the combined banks' community-based equity investment efforts were consolidated and renamed Fleet Development Ventures.

FDV's investment philosophy has been to generate superior financial returns by providing at-risk capital financing and business consulting to entrepreneurs and small businesses in disadvantaged communities, with an eye toward creating a new wave of entrepreneurs and having an overall positive economic impact on the larger community. We see these markets as attractive not only in their own right but also because there is such a substantial unmet need for equity financing and because there are so few competing sources of capital. To date FDV has invested more than \$100 million in 20 businesses led by women and minorities and in 25 funds that target these markets.

FDV offers several product lines to further its mission. It provides Fleet's business line lenders with mezzanine-type, quasi-equity capital that assists lenders who are making "stretch" (higher than normal advance rates on collateral) commercial and real estate loans in LMI communities. The group also invests in a number of CDFI-type funds that have high community impact yet typically deliver lower-than-market returns on their investment portfolios.

A sound deal structure

FDV has demonstrated that market-rate returns are attainable from investments in our target markets. In doing so, we've dispelled the myth that our target populations and communities are incapable of competing and succeeding in the market economy. FDV equity investments typically must generate a market rate of return (IRR), with the return on the overall portfolio expected to exceed 20-25 percent.

FDV uses the same techniques as mainstream venture capitalists in serving the equity capital needs of FDV's niche market. In 2002 we successfully exited a multi-million-dollar communications deal with an IRR exceeding 30 percent — a rate of return that many mainstream private equity funds would envy. According to the Kauffman Foundation, the average yield among for-profit minority private equity funds was 23.9 percent. This compares to a 20.2 percent average return for all private equity funds over the past 10 years.

FDV uses a two-channel investment strategy in our target markets, each representing approximately 50 percent of investment activity within the unit:

Direct Channel involves FDV investing directly in a company, usually in the form of convertible preferred stock, thereby giving FDV an agreed percentage of ownership in the company. In almost all cases FDV has taken a seat on the company's board of directors (or observation rights), and always

is an active adviser to management. The normal term of the investment is five years. “Liquidity,” or an exit from the investment, is provided for by a put option, or the right to require redemption of the stock. Such exits are typically accomplished by the company’s re-capitalizing its balance sheet or selling the business. Exits by an initial public offering (IPO) are rare.

The target investment profile is an expansion-stage, late-stage or mature company with sales in excess of \$1 million that has either established cash flows or will reach cash flow break even in the near future. Seed-stage investments are generally avoided. The average investment has been in the range of \$2-\$2.5 million with a typical maximum of \$5 million per deal. FDV’s targeted industry groups include media and communications, technology, specialty manufacturing, and services.

SelecTech, Inc., illustrates our direct-channel strategy. Located in a low-income area of Taunton, MA, SelecTech is an innovative manufacturer of high quality flooring tiles and other products, using recycled plastic and requiring no adhesives or floor preparation, so they can be installed much faster at much lower cost. FDV’s investment will help the company to meet the substantial growth potential for its highly marketable new product.

Indirect Channel consists of fund investments. FDV requires that the fund demonstrate a market rate of return, while at the same time having a positive impact on FDV’s target markets. FDV has invested in some of the most successful equity funds that provide capital to minorities and women. An example is Opportunity Capital of Fremont, CA, one of the most experienced and successful of minority private equity investment groups.

Equally important to FDV’s mission are our investments in Small Business Investment Companies (SBICs). These private equity funds are licensed by the Small Business Administration (SBA) and receive financial support from the agency in the form of government loans at favorable rates. SBICs are one of the few sources of capital for small companies seeking less than \$1 million.

Untapped potential

FDV has been one of a handful of investors who have demonstrated that investing in underserved markets can be profitable, and that it just makes good economic sense to seek out these untapped opportunities. It’s a strategy that has helped spur FDV’s own growth, while also serving to attract other investors to the marketplace.

The recent tough economic environment has been accompanied by a sharp contraction in private equity investment generally, including among minority- and women-owned businesses. The challenge during this uncertain economic period is not only to invest prudently and profitably in underserved businesses, but also to provide advice and guidance to help these firms build strong management teams and winning strategies.

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“Part 24” Community Development Investment Process Streamlined

Many national banks have used the “Part 24” community development investment authority to support community development corporations (CDC) and other entities focused on providing small

business financing and technical assistance. Over the years, national banks have invested more than \$60 million in 150 small-business focused CDCs.

In August, OCC published revisions to 12 CFR 24 that streamlined the process for making Part 24 public welfare investments in small businesses and other community development investment activities. The changes include:

- Providing that a bank may make a Part 24 investment for any activity that would receive positive consideration as a “qualified investment” under the CRA regulations.
- Simplifying the requirements for making public welfare investments and removing the requirement that a bank must demonstrate community support for its investment.
- Updating the definition section of the regulation to reflect the additional types of community development investment structures that have become more common in recent years and that are permissible under the governing statute.
- Providing that, unless a bank receives OCC’s approval to use another accounting method, Generally Accepted Accounting Principles should be used when determining the value of a bank’s community development investments to comply with the rule’s investment limits.
- Simplifying the regulation’s investment self-certification and prior approval processes.
- Expanding the list of examples of qualifying public welfare investments that satisfy the rule’s requirements.

The rule and revised CD-1 form are available on OCC’s Web site at <http://www.occ.treas.gov/cdd/pt24toppage.htm>.

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