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Investing in Rural Empowerment Zones and Enterprise Communities: Profiting with Community Development Venture Capital in Rural Kentucky

By Michael Hayes, Kentucky Highlands Investment Corporation

Betty Neeley was first. Then Katherine Cox. Sheila Hartsock and Brenda Gabbard were next.



Pictured here is a worker on the assembly line at Mid-South Electronics, the largest employer in Jackson County, Kentucky. With over 700 associates, Mid-South Electronics specializes in the design and manufacture of a broad range of products for the appliance, telecommunication and automotive industries. Kentucky Highlands has provided the company more than \$7 million in financing.

When these four residents of Jackson County, Kentucky were hired by Specialty Plastic Products in April 1995, they didn't know they were pathfinders. But they were the first Kentuckians to benefit from the Kentucky Highlands Empowerment Zone, created in December 1994 (under the Community Empowerment Program, enacted in 1993) with a \$40 million grant award overseen by the U.S. Department of Agriculture.

More than 3,200 men and women have followed in their footsteps.

Specialty Plastic Products (now Specialty Defense Systems) was the first company to receive financing through the Empowerment Zone's Development Venture Fund. The company, which manufactures a state-of-the-art backpack for the Marine Corps, has gone through four expansions and now employs more than 250 people. The Fund has provided almost \$2 million in loans to the company and more than \$17 million to over 40 other ventures in the three empowerment zone counties. These companies have directly created more than 3,200 jobs.

"The empowerment zone is the best thing that has happened to Jackson County," Sheila Hartsock says. "In the past, our greatest worry was finding and keeping any kind of employment. Now we have jobs

that pay well and offer good benefits."

The empowerment zone initiative is one of many tools that Kentucky Highlands Investment Corporation (KHIC) uses to promote economic development in southeastern Kentucky. Founded in 1968, KHIC is one of the original Title VII community development corporations (CDCs). In 34 years of operation, KHIC has invested more than \$90 million in over 175 business ventures which have created

more than 7,500 new jobs.

KHIC is one of the seven New Markets Venture Capital Companies named by the U.S. Small Business Administration (SBA), is a core member of the Rural Local Initiatives Support Corporation (LISC), holds a Small Business Investment Corporation (SBIC) license from the SBA, was one of the original Community Development Financial Institutions (CDFI) named by the U.S. Department of Treasury, was one of the eight rural Tax Credit CDCs, and is a lender under the U.S. Department of Agriculture Business & Industry Guaranty program.

Bank Partnerships Key to Success

With approximately \$50 million in assets, KHIC views itself as both a facilitator and a project lender. Forming partnerships with banks is vital for long-term stability and success.

“We’re a relatively small CDC,” says Jerry Rickett, KHIC’s president. “For projects over \$1 million, we’re always looking for participation with banks. Without their involvement, the exposure would be too great for us.”

An example of this partnership is KHIC’s use of the U.S. Department of Agriculture’s Business & Industry Loan Guaranty (B&I) program. Designated as the first eligible nonbank lender in the nation by USDA in 1996, KHIC originates and secures federal guaranties up to 90 percent on loans between \$1 and \$10 million.

“We don’t have sufficient capital to fund a \$5 million loan and retain it in our portfolio, even with a federal guarantee,” Rickett notes. “We have to find banks who can participate in order to leave us with available resources for the next project.” Thus, when KHIC completed a \$5.2 million package for an expansion at Mid-South Electronics, a portion of the loan was sold to Wells Fargo Bank using Farmer Mac as an intermediary. USDA regulations require KHIC to service the loan and retain at least 5 percent in its portfolio.

Small as well as large banks can take advantage of the USDA guarantees. Last year KHIC closed a \$1.5 million B&I loan for an expansion at Fantasy Custom Yachts, which builds high-end houseboats. McCreary National Bank, a \$30 million bank in Whitley City chartered less than ten years ago, purchased a portion of the loan at closing for its portfolio.

KHIC has also been able to form partnerships with federal banking partners. For example, the National Cooperative Bank has provided gap financing on several bank debt packages, and the Federal Home Loan Bank of Cincinnati has used the Economic Development Advance (EDA) program to provide fixed-rate, long-term loans to member banks in the KHIC service area. First National Bank of Manchester was able to fund an expansion and refinance existing debt for Phillips Diversified Manufacturing, a contract electronics manufacturer.

KHIC also originates and manages revolving lines of credit for area businesses. These lines are typically secured by inventory and accounts receivable and can be as large as \$4 million. KHIC establishes the advance rate formulas, monitors collateral, uses a lockbox payment system and provides a daily reconciliation to the borrower. Again, because of the size of these loans, KHIC seeks participation from banks within the service area.

Southeast Kentucky Rehabilitation Industries (SEKRI) is a rapidly growing sheltered workshop with 400-plus employees producing chemical protection suits for the military. With over \$25 million in annual sales and sizeable orders, the nonprofit needed a line of credit, but its mission of serving disabled and disadvantaged persons created difficulties in securing an operating line. KHIC stepped in and with two local banks, Union Planters Bank and Union National Bank, was able to finance a \$1.1 million facility.

A Resource for the Entrepreneur

Generally speaking, rural Americans must grow their own businesses if they are to prosper. That's true of KHIC's Appalachian service area, distant from traditional investors and research universities. KHIC, one of four Small Business Investment Companies (SBICs) in Kentucky and the only one outside of Louisville, provides both debt and equity support to area entrepreneurs in all businesses and industries except coal mining and retail. Mountain Ventures, Inc., KHIC's SBIC, has been an equity partner for several locally-launched companies that have grown to the point of being purchased by companies like Alcoa, Ecolab, and IBM. In each case KHIC's debt and equity investment was subordinate to significant bank participation, which has also helped KHIC provide important support services for entrepreneurs including leased turnkey office space and business education programs developed with Eastern Kentucky University. Since its creation in 1980, KHIC's SBIC has generated an internal rate of return in the low double digits.

KHIC's newest investment tool was acquired in 2001 when the organization, in partnership with Technology 2020 Finance Corporation of Oak Ridge, Tennessee, was conditionally approved by the Small Business Administration as a first-round New Markets Venture Capital company — one of only seven such designations. Technology 2020, also a CDFI, will work with KHIC to provide equity investments in seed, early stage, and growth companies primarily located in low- and moderate-income areas throughout southern Appalachia with an emphasis on creating quality and sustainable jobs. The Southern Appalachian Fund, the investment pool created by the two organizations, has until December 31, 2002 to secure \$5 million in investment capital and \$1.5 million in technical assistance support from outside sources. Then the SBA will provide up to \$7.5 million in debentures as leverage and a \$1.5 million grant to provide technical assistance to area entrepreneurs.

The New Markets Venture Capital designation takes KHIC beyond its southeast Kentucky base for the first time: the Southern Appalachian Fund's focus will include all of Kentucky and Tennessee, northern Alabama, northern Georgia and northern Mississippi. The Fund will focus on start-up, early-stage or conventional (with growth potential) small business in low-income and distressed areas. The initial funding for portfolio companies is expected to range from \$250,000 to \$750,000.

The Southern Appalachian Fund will be capitalized by selling limited partnership interests. In addition to limited partner capital contributions, the Fund may also receive low-interest loans from foundations, financial institutions or other parties. The minimum subscription from investors-limited partners is \$100,000. First distributions will be made to the partners until they have received a return of their capital contributions. Thereafter, distributions will be made 25 percent to the General Partners and 75 percent to the Limited Partners.

KHIC is making a difference in the lives of rural Americans — and in an area traditionally associated with intractable poverty. The key is to be able to operate on many fronts, leaving no potential funding arrangement unexplored. As the above examples clearly show, KHIC couldn't do it without its bank partners.

For more information, contact Jerry Rickett, President, Kentucky Highlands Investment Corp., at (606) 864-5175, or by e-mail at khicnet@khic.org.

Progress in the Kentucky Highlands Empowerment Zone

The three-county area of southeastern Kentucky designated in 1994 as the Kentucky Highlands Empowerment Zone (KHEZ) has recorded marked progress:

- Population grew by 11.9 percent during the 1990s (to 30,478), higher than the statewide increase of

9.7 percent and in sharp contrast to the rest of the state's Appalachian counties, which lost population during the decade.

- The percentage of residents living in poverty dropped from 35.2 percent to 27.5 percent in 1998 (the latest year for which figures are available). Although still much higher than statewide rates (which dropped from 19.7 percent to 15.3 percent), the KHEZ rate declined more dramatically.
 - Employment stood at 22,001 as of June 30, 2002, up 43.3 percent since December 1994, compared to 9.9 percent statewide during the same period.
 - The Development Venture Fund, a revolving loan fund designed to supply financing for new and expanding businesses, was capitalized with \$11 million. As of June 30, \$18,254,022 in loans had been approved. In addition, \$3,810,219 in business loan repayments beyond the \$11 million benchmark capitalization had been relent.
 - Businesses obtaining financing through the Development Venture Fund have created 3,245 new jobs and attracted \$120 million in private investment.
 - The Alternative Crop Fund and the Production Loan Fund have provided 155 loans to farmers in the Empowerment Zone, including zero-percent-interest loans to encourage shifting from tobacco-based agriculture.
 - Among the new community facilities financed have been two post-secondary schools, a youth center, a library, two theaters, extensive water-sewer system expansions, three industrial parks, recreation improvements, ambulance and health care facilities, and child-care centers.
 - Of the original \$40 million Empowerment Zone grant award, \$33,299,466, or 83.2 percent, has been expended, and \$4,018,220 of loan repayments has been reinvested. All funds are committed.
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What Are Rural Empowerment Zones and Enterprise Communities?

The United States Department of Agriculture (USDA) administers the rural empowerment zone (EZ) and rural enterprise community (EC) program which affords rural communities real opportunities for growth and revitalization. The goals of the programs are:

- Economic opportunity in the creation of new jobs and the retention of existing jobs, sustainable community development in the form of comprehensive physical development combined with accessible human services.
- Community-based partnerships in which the residents are actively involved in the most important elements of revitalization.
- Strategic vision for change which culminates in a comprehensive map for revitalization and progress.

The first empowerment communities were designated in 1994 (Round I) and there have been subsequent designations in 1998 (Round II) and 2002 (Round III). There are now a total of 56 empowerment communities which have been designated in the three rounds. The benefits of designation are:

- Grant funds for start-up and leveraging of CD activities.
- Work opportunity tax credits for younger workers.
- Zones businesses are eligible for "front loaded" section 179 tax deductions instead of lengthy

depreciation schedules.

- Tax incentives for qualified environmental cleanup costs in the tax year the cost is paid or incurred.
- Enhanced tax-exempt bond financing benefits including public school improvements.
- Employer tax credits.

For more information, please visit the USDA's Empowerment Zone and Enterprise Community website at www.ezec.gov.