

TALKING POINTS
APPALACHIAN REGIONAL COMMISSION
February 21, 1999

- I. **Impetus for the New Markets initiative:** We have extraordinary economic growth but it is not reaching everywhere -- e.g., parts of Appalachia and inner cities are left behind. As President said in SoTU, if we can't use this opportunity to try to redirect some of the economic engine to address underlying problems, when will we ever be able to do so.

- II. **Goals of the initiative:** Our goals are very similar to those of the ARC's own entrepreneurial initiative. (*See briefing book tab.*) That effort is very impressive and shows that there are ways to address these problems that can get bipartisan support. We tried to build on, and be complementary to, that effort and others similar.
 - A. **Incentives for private investment in communities.** Gov't can't do it alone. We have been more successful in the lending area, at creating incentives for the private sector to lend in underserved communities (CRA and CDFIs, for example). But, there isn't much that we do to prompt the private sector to make equity investments in businesses in underserved communities. As ARC's own study of the capital needs of Appalachia showed, the hardest dollars to find are the first dollars -- equity capital to grow businesses and create jobs.

 - B. **Building relationships.** There is a whole world of venture capitalists who have clubs that meet to hear investment proposals from small businesses. But their contacts and relationships are in suburbs, not necessarily inner cities. On the other hand, we have a small but growing community of community development experts in CDCs and CDFIs and state community development agencies. But never the two shall meet. This program is designed to give the investment community strong incentives to build ties to the community development community because, if they do so, they can get generous gov't-guaranteed leverage and tax credits to enhance the returns on their investments.

 - C. **Building capacity of small businesses.** In addressing the needs of really small businesses and microenterprises in underserved areas, it becomes clear that they need more than just capital -- they need expertise. (E.g., a good CFO, a new accounting system, methods to analyze their costs, etc.) Many have real growth potential but they need not only investment but a helping hand. A central innovation of this initiative is that, for smaller businesses, we marry technical assistance with investment -- having the investors decide how best to apply the technical assistance to yield maximum returns on their investment.

- III. **How we developed the new markets proposal:** With those goals in mind, we looked around the Federal government at tools in the arsenal and found one that had promising potential -- the SBIC program.

- A. Over 40 years, the SBA's *small business investment company* (SBIC) program has provided roughly \$20 billion in equity and debt financing to more than 85,000 different companies, helping them at a critical stage to grow from small businesses to household names, like AOL and Staples. It really helped to create the venture capital market in the United States.

- ***How SBICs work:***

- A private venture capital manager applies to SBA for approval of a new venture capital fund (the SBIC) based on a business plan and their financial management expertise.
- SBA's approval means that for every dollar the fund gets from private investors the SBA will guarantee debt of two dollars, up to _____. (Average size of an SBIC is \$36 million.) So, if private investors put up \$10 million, the government will guarantee debt of \$20 million, creating a fund of \$30 million to invest in growth businesses.
- Because of the government guarantee, the \$20 million in debt demands a lower rate of return, thus enhancing the return available to the private investors on their \$10 million dollars.
- With the fund of \$30 million, the fund manager finds an array of businesses with growth potential and provides them equity capital with which to grow.
- Returns are expected on the debt and the federally guaranteed debt must be fully repaid before returns are paid to the private investors. As a result, our losses have been few and, because guarantee fees are charged, guaranteeing the debt costs the government very little.

- B. But we found that, while it had been successful, only about 20% of its work served underserved communities. That wasn't acceptable. So the VP challenged the SBA to find new ways to retarget the SBIC program to meet the needs of underserved communities. They responded to that challenge with extraordinary creativity and dedication.

IV. Elements of the New Markets Proposal:

- A. ***SBICs for Low-Mod Communities.*** First SBA figured out how to provide incentives to make it more attractive for the venture capital firms created under the SBIC program to invest in low-mod communities.
- Specifically, SBICs making investment in low and moderate income communities will be eligible for a new financing that does not require a

return on their investment for the first five years (although interest accrues during that period). ***Patient capital*** -- allowing businesses time before they have to show a return on the investment.

- In addition, SBA will provide greater leverage -- 3x rather than 2x.
- Finally, SBA will make the investment rules more flexible to better meet the needs of companies in underserved areas.
- ***(SBA will be implementing these program modifications this year without legislation.)***

B. ***New Market Venture Capital Firms.*** Next, SBA realized that SBICs won't work for the smaller firms and those that need expertise as well as capital. So they proposed a new program -- know as New Market Venture Capital Firms -- modifying the SBIC concept to meet the needs of smaller businesses in underserved areas.

- SBA will select 10-20 firms, whose management has a solid track record with community development.
- The equity funds of private investors will be matched (one-to-one) with government debt of guarantees up to \$10 million per fund, creating up to \$20 million dollar investment funds. Interest on this debt will also be deferred for the first five years.
- In addition, investors must provide at least \$1.5 million in technical assistance over the first five years to the target firms. SBA will match that with up to \$1.5 million in federal funds. This \$3 million will not require any rate of return. With this additional investment in the firms not requiring any return, the return produced by the company enhances the return to the investors, making it worth their while to help small firms needing intensive technical assistance.
- (This will require new legislation.)

C. ***APICs:*** But that left us with a challenge. To really make an impact on a community -- to create 100, 200, 400 jobs at a time -- you need to deal with larger firms that are growing and creating new facilities or relocating. So we enlisted the help of HUD and designed a program to create ***American Private Investment Companies (APICs)***.

- For years, America has OPIC -- the Overseas Private Investment Corporation -- which has an investment fund program like the SBIC program on a larger scale, to promote growth in emerging markets abroad. We needed a tool to promote growth in emerging markets at home.
- Under this program, fund managers would seek approval for government guarantees for debt of up to \$200 million, to equal private investment of up to \$100 million, to create investment funds of \$300 million. That is

large enough to allow investments in significant sized firms that have opportunities to grow.

- The APIC could invest in a corporate subsidiary set up to fund a new plant or back-office operation in an underserved area or become joint venture partners in a business spin-off from an existing firm.
- Unlike the New Markets and SBIC programs, where we rely on the financial incentives of the investors to protect the government's interest, in APICs, the specific investments will be approved by HUD and SBA to ensure they serve public purposes.
- (APICS also require new legislation.)

D. ***Tax Credit:*** Finally, we considered how to ensure that these new great investment vehicles (as well as existing vehicles like CDFIs, Community Development Corporations, and state enterprise funds) have investors rushing to their doors to take advantage. The fact is that large companies and wealthy investors don't want to know the details of SBICs, NMVCs and APICs -- they just want to invest with qualified fund managers who can promise a healthy rate of return. Let the managers then worry about which investments they use. The solution we propose -- ***a tax credit.***

- Equity investments in investment vehicles serving underserved communities are eligible for a tax credit worth up to 25% of the equity invested. (The credit is actually 6% a year, which has a net present value of approximately 25% of the amount invested.)
- Credits would be allocated to the targeted investment funds that could use the tax credits to attract investors.
- Eligible investments are in areas with either (a) a poverty rate of at least 20%; or (b) median family income which does not exceed 80% of metropolitan area income (or for rural areas, 80% of the median income of non-metropolitan areas statewide). (*See nationwide map.*)
- This is a very generous definition of underserved -- and we picked it so that these programs will work well with other governmental programs that target areas with greater needs.

E. ***Other pieces as well:***

- Increasing by two and a half times the U.S. commitment to microenterprise, including doubling the level of microenterprise lending and a huge new commitment to technical assistance for microenterprise under a proposal for new legislation known as PRIME.
- A \$30 million increase in funding levels for CDFIs.
- New small business lending firms targeted to underserved markets.
- BusinessLINC -- an initiative of the Vice Presidents to encourage large businesses to work with small business owners and entrepreneurs to

improve the economic competitiveness of smaller firms in distressed areas.

- V. **Example: flexibility to meet the needs of the investor, the fund managers, and the businesses getting the investment.** Say an investment manager wants to create an investment fund targeted at the needs of Appalachia. Here's what he'd do.
- A. *Develop an investment strategy and a small investment management team (with community development capacity) to create an APIC, for example (or an SBIC-LMI or NMVC firm, depending on the business strategy).*
 - B. *Get approval from SBA/HUD, which will provide them with the commitment to guarantee debt to match private investment.*
 - C. *Get an allocation of tax credits from the agency that approves the vehicle. (Treasury will allocate credits to SBA, for example, to suballocate to funds.)*
 - D. *With tax credit and guarantee in hand, the fund manager then seeks investors, able to provide firm estimate of expected rates of return, knowing effect of tax credit and low cost leverage.*
 - E. *APIC manager finds business opportunities.*
 - F. *Government pools their debt and places it with investors lowering the cost of borrowing.*
- VI. **Or an investment manager could assemble a "fund of funds" that includes an APIC, an SBIC targeted at low-mod areas, an NMVC firm, and other targeted investments, some or all of which would be eligible for the tax credit allocation. Large investors, in particular, may find the "fund of funds" the best way to spread their risk.**
- VI. **Bottom line:** This package of programs should leverage \$15 billion in investment in underserved areas with 5 years of program activity (although some of the investment will be in out years).
- Includes \$6 billion leveraged through tax credit
 - \$12 billion leveraged through investment vehicles
 - Assume 50% overlap of tax credit so to prevent double counting -- estimate \$15 billion.

NMT
Talking Points

*Set New
Market
3rd Way*

New Markets Initiative

Talking Points

- The New Markets Initiative is a “Third Way” approach to economic and community development in the United States. It is based on the lessons we have learned from traditional approaches to revitalizing distressed communities. It builds on the strengths of our empowerment zone initiative. And it attempts to replicate in distressed areas the ways that small businesses have generated new jobs in growth areas of the country.
- **Old way:** Deep government subsidies and government planned redevelopment of distressed areas. “Government can do it all.”
- **Third way:** Government incentives to steer private investment into underserved communities. Successful revitalization is led by private sector.
- **Old way:** Jobs created by attracting companies to relocate plants and corporate headquarters.
- **Third way:** Jobs created by nurturing home grown small and mid-sized businesses that also will create wealth for owners in the community and remain loyal to the area.
- **Old way:** Focus on housing as the centerpiece of community development.
- **Third way:** Focus on creating economic activity through investment in small and mid-sized business and retail. Recognize the untapped buying power of lower income communities. Across the country, one-third of consumer expenditures are made by households with income less than \$30,000.
- **Old way:** Expand access to credit through programs that encourage lending in underserved areas.
- **New Way:** Expand access to credit **and capital** through programs that encourage lending **and investment** in underserved areas. “Equity” – the “first dollar in” – is often the hardest financing to find for businesses in distressed communities.
- My “New Markets” initiative is designed to harness the power of the private sector to revitalize communities. The new initiative will allow me to challenge major financial institutions and corporations that are leading America’s current economic growth to take the lead in investing in America’s own “New Markets” --- inner-city areas, in cities big and small, and distressed rural areas like parts of Appalachia.

Background

The Clinton plan for New Markets includes:

- Creation of a New Markets Tax Credit and loan guarantee incentives to stimulate billions of private capital investment in targeted areas;
- Formation of America's Private Investment Companies (APICs) to promote growth and private equity investments in emerging markets in America;
 - Just as the United States has the Overseas Private Investment Corporation (OPIC) to spur investment in emerging markets overseas, we can help to stimulate private investment in distressed areas here in America.
- Promotion of targeted Small Business Investment Companies (SBICs), based on the existing Small Business Administration programs, to provide equity and debt financing for small business in low and moderate income areas; and
- Development of New Markets Venture Capital Firms to provide long-term, patient growth equity capital and technical assistance for small firms that require both in order to take advantage of market opportunities.



Sarah Rosen
04/22/99 10:58:25 AM

Record Type: Record

To: Lisa Green/OPD/EOP@EOP

cc:

Subject: Third Way briefing materials

----- Forwarded by Sarah Rosen/OPD/EOP on 04/22/99 10:58 AM -----

JONATHAN A. KAPLAN

04/22/99 10:36:32 AM

Record Type: Record

To: Carl Haacke/OPD/EOP@EOP, Sarah Rosen/OPD/EOP@EOP, Thomas A. Kalil/OPD/EOP@EOP, Brian V. Kennedy/OPD/EOP@EOP

cc: Brian A. Barreto/OPD/EOP@EOP, Melissa G. Green/OPD/EOP@EOP, Sharon H. Yuan/OPD/EOP@EOP
Subject: Third Way briefing materials

The President will participate on Sunday afternoon in a discussion with Schroeder, Blair, Kok, and perhaps others (moderated by Al From of DLC) on the Third Way. This will be open press and will likely be a free-wheeling talk.

Please provide talking points and several Q&As on the subjects listed below, per our discussion this morning, to Sharon Yuan by 3:00 pm this afternoon. We will try to get additional time for this, but you should assume that we face that deadline. (Please be sure to have a point and not simply blather on about the subject, and provide very interesting facts that the President can cite.)

Issues: 3 part economic strategy (Carl)
job creation (Carl)
impact of technology on job creation (Kalil; Carl)
opportunity issues; training and employability (Kennedy)
new markets (Sarah)

Barreto will shortly provide you with a copy of the materials that we provided the President for the last Third Way discussion in New York in September. This should help with both content and format. (Melissa, I think Gene will want to review this older document as well.)

Thanks.

Kaplan



U.S. Department of
Transportation

Office of the Secretary
of Transportation

Memorandum

Call Marianne Smith

Subject:

Sarah Rosen

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Reply to
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As we discussed -