



NATIONAL ASSOCIATION OF INVESTMENT COMPANIES

Equity Capital in Emerging Domestic Markets and Its Critical Role in Driving Growth in the Broader U.S. Economy

Executive Summary

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The Emerging Domestic Markets Opportunity

The racial and ethnic make-up of the U.S. is changing so rapidly that by 2050, ethnic minorities are projected to make up more than half of the nation's population. That growth, combined with improvements in their education levels and increases in their purchasing power, has generated a whole new asset class for investments, typically called Emerging Domestic Markets, or EDM.

EDM businesses can indeed make very attractive investments. Prior analysis conducted by the Kauffman Foundation and Professors Timothy Bates and William Bradford has shown that the financial returns from investments in EDM businesses made by private equity firms compare favorably to returns achieved by traditional PE firms, and they outperform the returns generated from public market indices over similar periods of time.¹ While investments in EDM businesses have long been associated with a “social discount” – the assumption that a focus on social development will bring lower returns – Bates and Bradford's work suggests that they can generate competitive market returns and can be attractive on the basis of their financial merits alone.

A further virtue of EDM as an asset class: Because these investments are made mostly in small and middle-market businesses, they offer the benefits of risk diversification for investors mostly exposed to large buy-out funds. In addition, by putting money into smaller EDM-oriented funds, investors can develop diverse relationships with young and rising managers who will develop into the fund management stars of the future.

Despite its tremendous potential for returns, this asset class has long struggled to raise the equity capital needed to fuel substantial growth. The many players in the sector – from minority-owned businesses and EDM-oriented private equity firms to large corporations and the federal government—all have a stake in the success of EDM. How best can private capital boost growth in this increasingly critical sector of the American economy?

Why EDM Matters

EDM presents attractive business opportunities with tremendous potential for growth. Any company whose owners or investors belong to an ethnic minority, whose business primarily targets minority customers, and/or whose business is located in the inner-city or in Low to Moderate Income (LMI) neighborhoods, can be considered part of the EDM

¹ Bates, Timothy and William Bradford, *Minorities and Venture Capital: A New Wave in American Business*, The Kauffman Foundation, July 2003; Bates, Timothy and William Bradford, *Venture Capital Funds Investing in Minority-Owned Businesses: Evaluating Performance and Strategy*, The Kauffman Foundation, September 2008.

asset class. Those minority owners of businesses are attaining higher education levels, making them significantly more qualified to start or run a business than in the past. As the growing minority customer base increases in wealth and educational attainment, its purchasing power grows with it. And inner city neighborhoods, where many minority customers live, are also becoming wealthier, just when the renewed trend toward urbanization is driving the demand for more retail opportunities in these neighborhoods.

The rise of EDM is critical to the continued growth of the U.S. economy. Over the next 40 years, the nation's population will age considerably as the proportion of people older than 65 increases from 12 percent in 2000 to 20 percent by 2050. As the population ages, and as life expectancy increases, fewer workers will be available to support each retiree. In 2000, it took 4.7 workers to support each retired person; by 2050, that number will decline to just 2.7. Thus, to ensure that the pensioners of the future have access to resources in retirement, as much of the working age population as possible must be employed and productive.

By 2050, however, the majority of the retired population will be non-Hispanic whites, according to Census projections, even as ethnic minorities are expected to account for more than 50 percent of children under the age of 18 by as early as 2023. Thus, the human capital of the future, on which the economy will depend, increasingly will be composed of ethnic minorities. For continued growth and productivity in the overall U.S. economy, those minorities must be tightly integrated into the nation's workforce.

Minorities continue to be unemployed at higher rates than the majority white population. It will be up to the private sector to create most of the jobs needed to absorb the millions of younger, increasingly minority workers coming into the workforce over the next several decades. EDM businesses will play a critical role in supporting minority entrepreneurs and employing a higher proportion of minorities than traditional businesses. And the U.S. government must play a critical role in promoting innovation and entrepreneurship, both within EDM and throughout the wider economy, if the U.S. economy is to create needed jobs in the future.

The vital importance of EDM extends far beyond the borders of the U.S. More than 75 percent of the world's GDP is generated outside of the U.S., where 95 percent of the world's population lives. Many of the world's fastest growing economies are in Asia and South America. For the U.S. economy to grow and remain competitive in the global market, it is essential that U.S. businesses capitalize on the opportunities arising in these developing markets. EDM businesses and fund managers have a competitive advantage in exploiting these opportunities, given their various language capabilities, cultural affinity with these countries, and existing family and business networks in these markets. In this way, too, EDM can serve as a growth engine for the U.S. economy.

Given the shifts in the nation's demographics and the rise of a truly global economy, the U.S. must act now to increase investment in its emerging domestic markets to keep the economy productive and competitive in the global market. Only by building sizeable EDM businesses and creating adequate employment opportunities for tomorrow's

workers can the U.S. maintain the social and economic balance needed to ensure improving standards of living and a decent life for both the young and the old.

The Current State of EDM

The development of the EDM business sector has come a long way since the federal government began sponsoring programs to aid minority-owned businesses in the 1960s. Since then, the number of minority businesses has grown quickly, especially in the past 15 years, when their rate of growth was more than double that of the overall rate of business growth – minority-owned businesses have grown from just 7 percent of all U.S. businesses in 1987 to 18 percent in 2002.

Moreover, as the minority customer base has grown in size and purchasing power, large corporations have learned just how important that base can be. In response, they have created numerous supplier diversity programs to build relationships and serve these customers better. The increasing minority population has led to the creation of several businesses targeted at serving these customers in industries such as Media and Entertainment and Telecommunications. Launched in 1980, the Black Entertainment Television network, for instance, has become the premier African American television network, currently reaching 87 million households in the U.S.

Inner city businesses have made remarkable progress as well. The average revenue of the 100 largest inner city companies, as determined by the "Inner City 100" list compiled by Initiative for a Competitive Inner City and Inc. magazine, has grown at a compounded annual rate of 59 percent, from \$6 million in 2003 to a record \$39 million in 2007. At the same time, the increasingly attractive market opportunity presented by EDM has attracted the attention of private investors, who have started allocating capital to programs supporting emerging money managers and EDM-focused PE funds.

Most EDM businesses, however, still do not compare favorably to their peers in the mass market, in a number of critical areas. The typical minority business remains much smaller than its mass market counterpart, and very large EDM businesses are still rare. Minority-owned businesses with receipts greater than \$1 million account for more than 64 percent of total revenues and create 58 percent of the new jobs generated by the minority-owned business segment. Yet they represent just 2 percent of the total number of minority businesses, compared to 5 percent of non-minority businesses. And while businesses targeting minority customers have successfully entered such industries as Media and Entertainment, their success in operating in other industries, including Retail, Financial Services, and Internet, has been much more limited. And while the growth of "Inner City 100" companies has been encouraging, most inner cities continue to face declining employment and large gaps between demand for retail businesses and the available supply.

How Can Private Equity Help?

Despite the generally optimistic outlook for EDM businesses, it is critical to understand the significant challenges they face in their efforts to grow larger and diversify into more high growth industries: They continue to experience limited access to capital, especially equity capital; they struggle to increase the breadth and depth of their management teams; they often lack the ability to build the internal capabilities needed to compete effectively; and they typically have only limited networks of relationships with potential business partners and customers.

The private equity industry can help EDM businesses overcome many of the challenges they face. Private equity funds can provide the equity capital needed to help these businesses grow. But they can help in other ways as well, by performing the same kinds of activities they typically perform for all their portfolio companies: hiring talented managers, providing strategic and operational guidance, and building relationship networks. Private equity funds have exactly the right set of tools to change the trajectory of EDM businesses.

Private equity is a specialized form of ownership that often enables companies to grow and prosper. In private equity, general partners raise investment funds from limited partner investors. These limited partners (LPs) are often public pension funds or other large institutions, but may also include wealthy families and individuals. The general partners identify companies they believe have significant potential for growth and then use the funds they have raised, along with their own capital, to acquire the companies. Over time, often four or five years, the general partners use their management skills to help grow and improve the business. Eventually, the private equity firm sells the company or takes it public. Generally, 80 percent of the profits are allocated to the limited partner investors, while 20 percent goes to the general partners. In smaller private equity firms of the type that generally invest in EDMs, this 20 percent “carried interest” profit usually represents the most important source of income for the firm.

The general impact of PE investments on innovation, entrepreneurship and job creation has been documented in several studies, including a series of studies conducted for the World Economic Forum by a research team led by Professor Josh Lerner of Harvard Business School.²

In this study, researchers analyzed a representative sample of National Association of Investment Companies (NAIC) member firms’ portfolio companies to determine the economic impact of PE and VC investments on the company and the broader economy through revenue growth, job creation and support for minorities.

The NAIC member firms are either owned or managed by ethnic minorities or invest in underserved markets. NAIC members are among the nation’s pioneers and leading

² *The Global Impact of Private Equity Report 2009*, “Private Equity, Jobs and Productivity,” World Economic Forum, January 2009.

experts on private equity investment in the EDM asset class. The group has a solid history of investing in numerous minority-owned, minority-focused and inner city businesses in underserved markets nationwide.

The findings of this study mirror those of the World Economic Forum examination of the broader private equity universe. Specifically, the study found that the PE business model is particularly well-suited to making a significant impact on the success of businesses in the EDM space. PE firms not only provide capital to finance business expansion but also help shape strategy, recruit talent, make operational improvements and enhance relationships. Portfolio companies whose lack of capital constrained their expansion could now pursue a wider variety of growth opportunities, and they achieved returns above the average of typical U.S. businesses.

Given their deep understanding of the EDM marketplace and its customers' needs, minority fund managers are uniquely positioned to identify and make promising investments in EDM. Their strong relationships with the minority business community gives them excellent access to proprietary deal flow, and many firms such as ICV Capital, Vista Equity Partners, Palladium Equity and Pharos Capital have made successful investments in traditional non-EDM markets as well. The study's analysis shows that the investments made by NAIC member firms have had a major impact in supporting the growth of a number of sizeable EDM businesses, with great benefits to minorities and the overall U.S. economy from job creation and the development of minority communities.

At the seven representative companies studied—CSA Group, Driftwood Dairy, Systems Integrators Inc., Tower of Babel, Marshall Retail Group, Samy Company, and V-me—revenues climbed at an average annual rate of 35 percent between the time they received their first infusion of PE money and the present, or when exited. The growth these companies enjoyed meant the creation of new jobs that paid higher salaries and provided better benefits than the national average, and the majority of these new jobs went to minorities.

- The seven companies created a total of 1,454 jobs with 498 of the jobs, or one third, created after the PE investment.
- The companies reported median average annual job growth of 14 percent post PE investment compared to a 1 percent rate of increase for U.S. non-farm jobs between 2003 and 2008³
- 66 percent of the total new jobs went to minorities, compared to an overall minority employment rate of just 30 percent.⁴
- These new jobs paid an average salary of \$47,000, 15 percent higher than the U.S mean income of \$42,504 for full-time civilian workers.
- 68 percent of those new employees had health benefits.

³ Bureau of Labor Statistics, *Current Employment Statistics, Benchmark information for all employees, seasonally adjusted*.

⁴ U.S. Census Bureau: Bureau of Labor Statistics, *Employed persons by detailed industry, sex, race, and Hispanic or Latino ethnicity*, 2008.

Several of these companies offered additional training and development programs designed to help their employees learn new skills and grow into management roles within the organization.

By making investments in traditionally undercapitalized businesses that are owned by minorities or minority investors; that employ minorities; or that operate in underserved geographical areas, NAIC member firms have succeeded at supporting the continued economic growth and well-being of the nation's minority population, an effort that is critical for the long-term growth of the U.S economy. As the proportion of minorities among the overall population of the U.S. continues to grow, it is vital that investments in EDM increase if that development effort is to continue. Increasing the flow of capital to EDM funds and businesses is essential to build the foundation required for the future growth of America.

Limited Access to Investment Capital

Yet EDM-focused private equity funds continue to struggle to gain access to PE capital, for several reasons. As promising as the asset class may be, many limited partners, general partners and intermediaries are simply unaware of its strengths. Even if they do understand the sector, they remain concerned about the higher transaction costs associated with investing in smaller funds and businesses due to the scale of the investment, as well as the higher perceived risk. Perhaps the biggest impediment is the misconception that investing in EDM brings with it lower than average returns in the form of a "social discount." In fact, funds that are focused on EDM, including the members of the NAIC, invest primarily to generate financial returns. Any additional economic or social benefits they achieve are purely the result of investing in traditionally underserved markets, as noted in the previously cited Kauffman studies, *Minorities and Venture Capital I & II* by Bates and Bradford.

Some of the larger public pension funds have come to realize EDM's potential for providing competitive returns; as such, they have begun allocating capital to EDM funds through direct allocations and funds-of-funds. While this is certainly a step in the right direction, the allocation of capital to EDM funds is still very low compared to the overall capital base of these LPs. Despite their significant minority populations, for instance, several states, including Florida and Ohio, have yet to commit any funds to EDM-focused PE firms. Even in California and Texas, where the major state pension funds have taken a leadership role in EDM investing, their allocation to EDM is less than 1 percent of their total capital base, even though minorities account for more than 50 percent of the population of both states and account for a significant share of the state employees who contribute to the pension funds.

How can the flow of equity capital to EDM businesses be increased? The industry must focus on financial returns to increase the overall awareness of the competitive returns generated by investments in EDM businesses. It must improve the efficiency of capital

allocation by promoting funding sources such as fund-of-funds. And it must simply increase the level of investment by every type of investor.

A number of other players also have played important roles in supporting EDM, and will continue to do so. Institutional investors such as pension funds, funds-of-funds, banks and insurance companies have long supported EDM by creating special programs to allocate capital to both EDM businesses and emerging fund managers. Foundations such as the Kauffman Foundation and the Milken Institute, and researchers such as Tim Bates, William Bradford, Michael Porter, Gregory Fairchild, and Janneke Ratcliffe have worked hard to highlight the opportunities, challenges and importance of EDM. And large corporations such as PepsiCo, Toyota, General Electric, Ford, Wal-Mart and Procter & Gamble continue to support the growth of smaller minority businesses through supplier diversity programs, partnerships, and training.

New Challenges

EDM and the Credit Crisis. The current economic environment and the freeze in credit markets have made access to capital more difficult for many players. The easy credit of the past few years brought about higher leverage levels in the PE industry, and the sudden tightening of credit markets is forcing PE firms and companies alike to undergo a process of deleveraging that presents both challenges and potential opportunities for EDM-focused PE funds and businesses.

Every PE fund with highly leveraged deals in their portfolios has been forced to re-evaluate the amount of leverage in the portfolio. Lower valuations will likely make exiting many of these investments more difficult and unattractive, at least in the near term. Some PE firms also are struggling to raise new money from LPs because their own portfolios are declining in value and they may find themselves over-allocated in PE as a result of the recent greater declines in public equities than in PE investments.

Still, many PE funds with cash to invest may find that the current environment holds real opportunity. Because the valuations of target companies have declined so much, new investments can be made at significantly lower multiples. And they should be able to capitalize on other funds' need to raise cash by buying their assets at bargain prices.

EDM funds that traditionally have used lower leverage and have been able to generate competitive returns due to the high growth of EDM businesses should be able to position themselves to potential LPs and traditional PE funds as particularly attractive investment vehicles. That is especially true now that the volume of larger PE deals that were typical of the past few years has declined, limiting the investment opportunities for traditional PE funds. These smaller investments can be made by the large traditional PE funds via a fund-of-funds or directly in partnership with a smaller EDM-focused firm, as was the case with TPG Capital and Pharos Capital's recent investment in American Beacon Advisors Inc., which provides investment advisory services to institutional and retail markets.

Minority-owned businesses themselves face a challenging business environment. Such businesses have long had difficulty in accessing capital, and the current credit crunch is making it even more difficult to achieve growth. On the other hand, the Obama administration's proposed stimulus package is likely to increase spending in industries such as Infrastructure, Healthcare, Education and Energy, all of which EDM businesses should be targeting as a way to expand their businesses.

Government Policies. In the past, the federal government has taken a leadership role in initiating the flow of equity capital to EDM through its various Small Business Investment Corp. (SBIC) programs, but that role has diminished in recent years. Yet smaller minority businesses will always require access to equity capital to achieve the scale necessary to make them attractive to PE investors. To that end, the government must take a more active role, both as an equity investor and by creating more incentives to encourage the flow of private capital to smaller EDM businesses with the potential to grow into sizeable businesses.

On another front, in response to rising budget deficits and the current financial crisis, the Obama administration has included a proposal to raise taxes on carried interest—the share of a fund's profits that is returned to the managers—as ordinary income. At the same time, it appears likely that lawmakers will insist on increased regulation of the financial services industry. Both proposals could have a profound effect on private equity, EDM and the U.S. economy. While the changes in taxation would increase tax revenue by an estimated \$2 billion to \$3 billion annually, the projected \$1.2 trillion 2009 budget deficit would be offset by just 0.3 percent.

The upside of these proposals may be limited, but the downside for EDM-focused PE funds—and the minority-owned businesses that depend on them for equity capital—is potentially significant. Smaller PE firms, including most EDM funds, are significantly more reliant on carried interest for their income than larger firms, and more affected by the higher fixed costs of increased regulation. As a result, many small PE firms could face the threat of shutting down. And since large PE funds do not typically invest in small and middle-market businesses, “Main Street” entrepreneurs and EDM companies that are dependent on smaller PE firms for vital capital and business support could be impacted severely. The government should carefully consider how its tax and regulatory policies will impact the ongoing development of EDM businesses.

Key Recommendations

Supporting the growth of EDM is critical for the economic health of the nation's minority population and for the overall U.S. economy. But maintaining and extending that support will require significant collaborative efforts among all the key stakeholders. The supply of capital remains the primary factor constraining the growth of EDM, yet the more capital is made available, the faster EDM businesses can reach the scale needed to make real contributions to the overall economy.

To ensure the continuing success of this critical market, all the key stakeholders must increase their level of involvement in the area, working together to increase capital flows to the sector, build awareness of its potential for financial returns, and improve the internal operating capabilities needed for EDM businesses to compete.

Below is a summary of recommendations for how the key stakeholders involved in EDM can help the sector reach its full potential:

Investors should increase awareness of the attractiveness of EDM and allocate more capital to EDM

- Raise awareness of EDM and its potential for financial returns
- Increase capital allocations to EDM
- Direct financial consultants to increase awareness of EDM and efficiently allocate capital to the space through such vehicles as funds-of-funds
- Sponsor and support “emerging manager” programs
- Serve as champions for EDM based on their own successful investing experiences
- Work with organizations like NAIC to learn more about EDM and EDM fund managers

EDM-focused funds should build and publicize their track record of competitive returns to dispel the notion of a social discount in EDM investing

- Emphasize their primary focus on financial returns in EDM investing to dispel the notion of a “social discount”
- Continue to build a track record of competitive financial returns
- Diversify management talent and expertise to build upon unique capabilities of minority fund managers
- Partner with other minority funds and larger traditional PE funds
- Expand their investor base and increase the strength of their relationships with senior decision makers at LPs and consultants

Large, traditional PE funds should continue efforts to get more involved with EDM, including partnerships and co-investments to increase their understanding of the space

- Support minority fund managers through internal diversity initiatives
- Develop increased awareness of EDM as an alternative asset class to mainstream private equity
- Partner with EDM-focused funds to co-invest in EDM and acquire expertise in the space

NAIC should continue to increase awareness of EDM by sponsoring research and facilitating interactions among key stakeholders

- Increase networking opportunities for plan sponsors, fund managers and entrepreneurs
- Increase awareness of EDM among LPs, large GPs and investment consultants
- Highlight successful fund managers and their flagship deals
- Sponsor and publish research on EDM, including best practices for minority businesses seeking capital
- Communicate the importance of EDM and the critical role of its member firms to policy makers

EDM businesses should focus on building larger businesses by effectively utilizing the capital markets and supplier diversity programs

- Understand the full range of products in the capital markets and the criteria they use when financing businesses
- Make their businesses more attractive for external financing by standardizing financials and operations and broadening their customer base
- Make use of minority business enterprise (MBE) status and deploy a variety of partnering strategies, including supplier development programs, to expand business
- Continue to serve the growing minority market while taking advantage of opportunities to compete in mainstream markets
- Focus on growth sectors and attractive industries of the future

Corporations should support the development of EDM businesses through employee and supplier diversity programs and partnerships

- Develop a diverse employee base including a committed supplier diversity team
- Create a strategic and competitive supplier diversity program to capture share in EDM
- Support growth of minority suppliers by facilitating access to capital and entering into partnerships with EDMs

Government should focus policies and resources on developing larger minority businesses and increasing private sector involvement in EDM

- Refocus efforts to develop and grow EDM businesses
- Encourage more private sector participation in EDM
- Increase the knowledge base and data available on EDM business loans and company performance
- Develop the infrastructure needed to promote the EDM sector
- Ensure that EDM businesses are adequately represented in new government stimulus packages
- Consider the impact on EDM of tax and regulatory changes such as the taxation of carried interest as ordinary income

- Consider setting up a separate fund to invest exclusively in EDM. Government participation as an investor in this space will increase the awareness of EDM on the part of other investors.

Conclusion

The Emerging Domestic Markets sector has long been underserved and undercapitalized. Now, however, it is poised for explosive growth and that presents an exciting and rewarding opportunity for private equity investors, as well as mainstream corporations and EDM businesses themselves. Exploiting this opportunity will require all the major key stakeholders in the field to shift their mindset and consolidate their efforts to increase the capital supply to EDM to support the growth of all EDM businesses, large and small. A concerted effort will benefit not just the investors and businesses in this increasingly important sector, but the U.S. economy as a whole.