NATIONAL ASSOCIATION OF INVESTMENT COMPANIES

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

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THE BOSTON CONSULTING GROUP

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CHAPTER ONE

WHY EMERGING DOMESTIC MARKETS MATTER

The United States is going through a period of major demographic shifts, driven by a sustained influx of minority/ethnic immigrants in the past few years and higher birth rates among minorities. A recent census bureau report calculates that by 2042, Americans who identify themselves as Hispanic, African American, Asian, American Indian, Native Hawaiian and Pacific Islander together will outnumber non-Hispanic whites. By 2023, so-called minorities will constitute a majority of the nation's children under 18 and a majority of working-age Americans by 2039.

These demographic changes, combined with improvements in educational attainment and greater purchasing power among minorities, have created a separate asset class, identified as "emerging domestic markets" (EDM),[1] which offers a variety of new and attractive investment opportunities.

EDM has been defined, and interpreted, in any number of different ways. To be considered part of EDM, researchers have concluded that a company must feature one or more of the following criteria:

- Ownership (the business owners or investors belong to an ethnic minority group).
- Customer base (the business serves primarily minority customers).
- Geography (the business is located in the inner city or in low-to-moderate income (LMI) neighborhoods).[2]

These markets have long been underserved by the mass-market business and financial community. Yet investors targeting this space can achieve attractive returns by taking advantage of the market's capital inefficiencies and the growing demand for businesses serving this space.

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1. Glenn Yago, Betsy Zeidman, Alethea Abuyuan, The Milken Institute, *A History of Emerging Domestic Markets.*
2. Darden Graduate School of Business Management, The University of Virginia, *In Your Own Backyard: Investment Opportunities in Emerging Domestic Markets.*

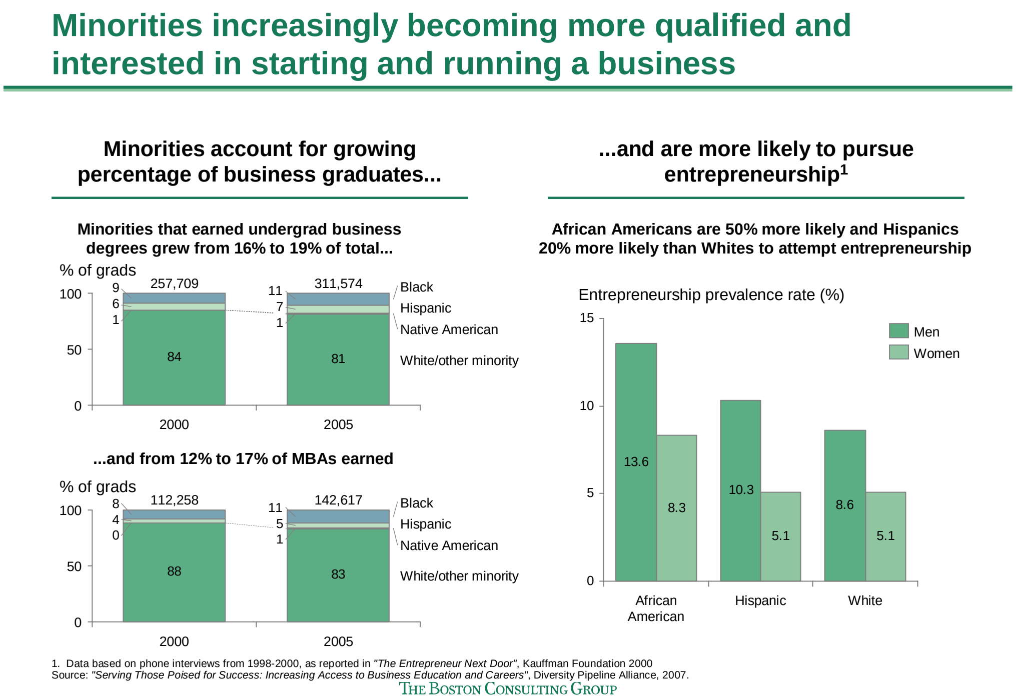
The EDM opportunity is growing rapidly

Financially attractive investments in EDM can be made in three ways.

1. **Ownership.** Investments can be made directly in minority-owned businesses that are started and run by minority entrepreneurs and managers. The attractiveness of investing with minority entrepreneurs and managers has been growing due to a greater proportion of minorities attaining higher levels of education and the increasing likelihood of their starting new businesses *(Exhibit 1).*
    - The percentage of minority students (African American, Hispanic and Native American) who earned undergraduate business degrees increased from 16 percent of all students in the U.S in 2000 to 19% in 2005.[3]
    - The percentage of minority students earning MBAs increased from 12% of total MBA graduates in 2000 to 17% in 2005.[4]
    - African Americans are 50 percent more likely to pursue entrepreneurial business activities than are whites, while Hispanic men are 20 percent more likely to pursue entrepreneurship than are white men.[5]

3. Diversity Pipeline Alliance, *Serving Those Poised for Success: Increasing Access to Business Education and Careers*, 2007.
4. Ibid.
5. E.M. Kauffman Foundation, *The Entrepreneur Next Door, Characteristics of Individuals Starting Companies in America,* 2002.

Exhibit 1:



2. **Customer base.** Investments also can be made in businesses primarily targeting the growing minority customer base. Because the so-called minority customer base is growing faster than the base of white consumers, it has an increasing share of total U.S. purchasing power.
    - Minorities are expected to make up more than 50 percent of the population of the U.S. by 2042 and fully 54 percent by 2050. Indeed, ethnic minorities already make up more than half of the population in states such as California and Texas.[6]
    - Minorities are expected to account for 35 percent to 45 percent of total U.S. purchasing power by 2045, up from just 20 percent in 2000. At that rate, minority purchasing power may surpass $2 trillion by 2010, and reach $5 trillion by 2045.[7]
    - Minorities will account for between 45 percent and 70 percent of the increase in purchasing power over the next 30 to 40 years.[8]

6. *The New York Times*, "In a Generation, Minorities May Be the U.S. Majority," Aug. 13 2008.
7. U.S. Department of Commerce, MBDA, *Minority Purchasing Power:2000 to 2045*, September 2000.
8. Ibid.

3. **Geography:** Investments can be made in businesses targeting inner-city neighborhoods, where increasing urbanization and higher income density will make such investments even more attractive over time.
    - Increasing urbanization is leading to higher population density and even higher spending per square mile in inner cities than in some wealthy suburbs. The number of people in the U.S. living in urban areas is expected to grow at least 30 percent between 2005 and 2030[9], while the price/demand elasticity and attractiveness of inner-city shoppers has been found to be comparable to that of the rest of the U.S. population.[10]
    - While the median income of inner-city households is lower compared to other metropolitan statistical areas, the income per square mile is higher than in other areas, because of the significantly higher population density in inner cities. Moreover, it is estimated that 35 percent of retail demand in inner cities goes unmet by local businesses; indeed, the retail purchasing power of inner-city residents exceeded retail sales in other metro areas by $42 billion in 2002.[11]

EDM investments offer attractive financial returns and diversification of risk

Historically, businesses that are part of the EDM space have had limited access to the capital markets and investments. Because the segment has been underserved and undervalued for so long, investors targeting it have the potential to earn very attractive returns.

Two separate studies conducted on behalf of the Kauffman Foundation by Timothy Bates, distinguished professor at Wayne State University and William Bradford, endowed professor at the University of Washington, support the conclusion that minority investment firms that invest in Minority Business Enterprises (MBEs) can yield significant returns.[12]

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9. United Nations Department of Economic and Social Affairs/Population Division, *World Urbanization Prospects,* 2005.
10. Initiative for a Competitive Inner City, Michael Porter and The Boston Consulting Group, *"Realizing the Inner City Retail Opportunity,"* 2006.
11. Ibid.
12. 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*

In the first study, released in 2003, Bates and Bradford concluded that minority enterprise venture capital investing is very profitable. The study focused on returns from 117 investments made from 1989 to 1995 period and realized by year-end 2000. The average investment per firm was $562,400; the average gross yield per firm was $1,623,900, generating an average net return of $1,061,500. The Internal Rate of Return (IRR) of the funds studied ranged from -32 percent to 79 percent, with a median of 19.5 percent and a mean of 23.9 percent.

The study also concluded that returns earned from the mature investments were not dominated by a few highly profitable deals. Among the 117 harvested investments, 64 of them yielded positive returns and 53 produced negative returns. The cash outflows associated with these 117 investments totaled $65.8 million, producing an average investment size of $562,400 for the firms receiving venture capital.

A second study by the same authors, released in September 2008, concluded that the internal rate of return on investments initiated after 2001 realized by year-end 2006 was 29.1 percent.

Such findings establish the financial attractiveness of EDM as an asset class and invalidate the long-standing mistaken notion that EDM investments are associated with a “social discount” and lower returns. As Phil Angelides, former state treasurer for the State of California, who led the $475 million investment in the California Initiative focused in the EDM space, noted, “Our investments are already demonstrating that many places that have been overlooked have promise for financial return.”

Investing in EDM and in Emerging Managers—minority fund managers or managers at EDM-oriented funds—also offers the benefits of diversification for investors who have exposure to mainstream private equity. Thomas P. DiNapoli, the New York State comptroller and trustee of the NY State Common Retirement Fund (CRF), has directed $1 billion of investments in an Emerging Manager private equity program that focuses on the smaller, more entrepreneurial end of the market. DiNapoli noted, “These investments have created diversification for the Fund.” [13]. DiNapoli’s colleague, Assistant Comptroller Tyson Pratcher, concurred, explaining that instead of focusing on traditional private equity transactions, “the Emerging Managers’ space, in contrast, generally involves smaller transactions that are growth oriented. From an investment perspective,

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Capital Funds Investing in Minority-Owned Businesses: Evaluating Performance and Strategy, The Kauffman Foundation, September 2008.

13. Journal of EDM Finance, *Stepping up to the Plate*, Spring 2008.

the ability to back new talent in the private equity world is very valuable. It adds diversification to our portfolio and it helps keep the industry healthy."

Investing in EDM is critical to the U.S economy given the aging of the population and other demographic shifts

The aging of the sizeable baby boomer generation in the U.S., together with increased life expectancy, will have a significant impact on the nation's social and economic balance:

- The population of older people in the U.S is increasing both in absolute numbers and as a percentage of the whole. The number of people over the age of 65 is expected to more than double in the next several decades, from 35 million in 2000 to 88 million in 2050, and to increase in percentage terms from 12.4 percent of the population in 2000 to 20.0 percent by 2050.[14]
- The increase in the number of people over 65 is driven in part by increasing life expectancy, especially in developed countries like the U.S., where people are experiencing longer and healthier lives. The life expectancy at birth in U.S is projected to increase from 77 years in 2010 to 83 years in 2050, an 8 percent gain.[15]

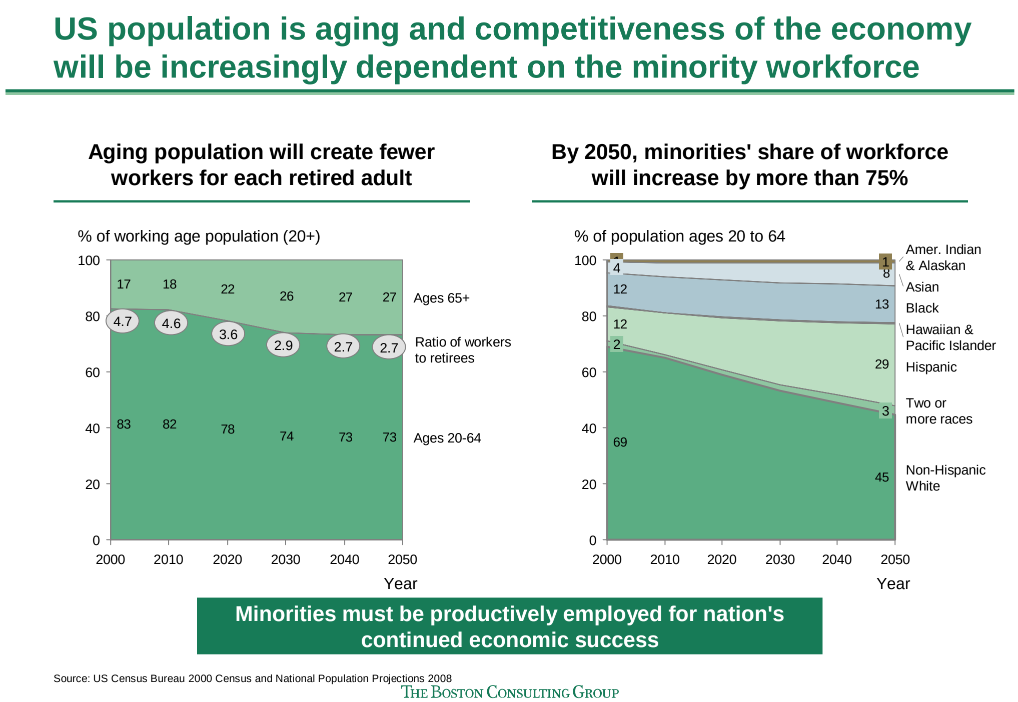
The impact of aging will place an increased burden on the social, healthcare and pension systems, presenting significant new economic challenges for the U.S. Between 2000 and 2050, the ratio of workers available to support each retiree will drop from 4.7 to 2.7.[16] So while the GDP and the economy face the danger of slower growth due to a lower percentage of the population in the workforce, public spending may well increase due to the increase in pension payments, healthcare and other resources required by the older population. If the pensioners and retirees of the future are to have access to the resources they need and be able to exchange their assets and savings for goods and services, the working age population must be fully employed and increasingly productive to keep the U.S economy growing and competitive in global markets.

At the same time, the proportion of non-Hispanic whites who are 65 and older, and of minorities younger than 65, are both increasing. The Census Bureau projects that by 2050, the share of ethnic minorities in the labor pool (people 20 years or older who are

14. US Census Bureau, 2000 and Census and National Population Projections, 2008.
15. Ibid.
16. Ratio of workers to retirees calculated as the ratio of the number people in age groups 20-64 divided by number of people 65 or older.

working or looking for work) will increase by 75 percent, accounting for 55 percent of the total working age population, compared to just 31 percent in 2000 *(see Exhibit 2).*

Exhibit 2:



The implications of this shift are enormous. The available talent pool of the future largely will comprise ethnic minorities. It is critical for the health of the U.S economy that these minorities not only have the right skills and training but also have enough employment opportunities to be integrated successfully into the workforce.

Currently, however, minorities experience higher unemployment rates than the majority white population. The unemployment rate for African-Americans is twice as high as for whites, while Hispanics are unemployed at a rate 37 percent higher than whites[17]. No doubt, there are several factors that contribute to the higher unemployment rates of minorities, including lower education levels. But if the children from these ethnic groups are to become part of the skilled workforce of the future, it is critical to improve their access to educational and training resources and resolve this disparity as soon as possible. Creating access to these resources is a critical, but not the only, step needed to ensure that most of the working-age minority population be fully employed, able to support the

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17. U.S Bureau of Labor Statistics, *Characteristics of the Unemployed*, 2007 – Based on number of people 16 years old or older that were unemployed.

future needs of the nation's elderly population, and maintain the growth of the overall U.S. economy.

Furthermore, the recent economic crisis has significantly reduced the size of the retirement savings of people planning to retire in a few years. Shrinking savings and concerns about the future of the Social Security system could force older people to postpone retirement and remain in the workforce for a few more years. Thus, it is even more critical that the economy create new jobs and businesses to retain the nation's older workforce and simultaneously absorb younger workers.

As of January 2009, the private sector accounted for 83 percent of all non-farm employment.[18] In the future, the private sector will continue to create the majority of new jobs. However, the federal government will play an important role in determining where and how many of those jobs are created by establishing policies and programs that encourage private capital flow and promote innovation and entrepreneurship.

Investing in small to mid-market businesses and helping them grow into larger companies is essential to create and sustain the future jobs the nation will need. EDM businesses play a critical role in supporting minority entrepreneurs and employing a higher proportion of minorities than traditional businesses.[19]

Opportunities in international markets could also support the growth of the U.S economy.

More than 75 percent of the world's GDP and 95 percent of its population lie outside of the U.S.,[20] while some of the fastest growing economies can be found in Asia and South America. For the U.S economy to grow and be competitive in the global market, it is essential that U.S. businesses capitalize on the opportunities in these developing markets. EDM businesses and fund managers have a competitive advantage in dealing with developing markets given their language capabilities, affinity with foreign cultures and existing networks in these markets, and so can serve as an added growth engine for the U.S economy.

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18. U.S Bureau of Labor Statistics, *The Employment Situation: January 2009.*
19. Timothy Bates, *Understanding the Urban Development Potential Of Black-Owned Businesses*, October 2005.
20. CIA, *World Fact Book*, 2007.

- Hispanic fund managers and entrepreneurs can leverage their language and cultural familiarity to selectively pursue business opportunities in Central and South America. This region is home to some of the world's fastest developing economies, including Peru, which is growing at 9 percent annually, Argentina at 7 percent and Venezuela at 6 percent.[21]
- Similarly, Asian Americans can seek business opportunities in the rapidly growing economies in Asia, where China is growing at 10 percent annually, India at 7 percent, and Vietnam at 6 percent.[22]

A recent report by the Minority Business Development Agency notes that the competitiveness of the U.S. and economic growth in the global market largely will depend on the growth and expansion of minority businesses.[23] According to this report, 2.5 percent of minority-owned firms engage in export activities, compared to just 1.2 percent of non-minority-owned firms. "U.S. minority firms are a great American asset and the time is right for them to seize the opportunity to expand and export their goods internationally," said Ronald N. Langston, national director of the Minority Business Development Agency at the U.S. Department of Commerce. "Doing so will not only grow their business but strengthen the national economy and create jobs in minority communities."

Given the impending shifts in the nation's population and the global economy, the U.S must act to increase investment in its emerging domestic markets now, before these shifts are realized. The cost of waiting to act is too high and will only lead to an overwhelming economic burden on the Government and the next generation of workers and taxpayers. By building EDM businesses of size and creating adequate employment opportunities for the younger generations, the U.S can ensure a social and economic balance that will allow the older generation to have access to the resources they will need when they retire.

By creating new jobs and increasing economic activity, investing in EDM can have a significant impact on the U.S. economy.

Investing in EDM has the additional benefit of creating more jobs for minorities, with a significant economic impact on the overall U.S. economy. Eighty-nine percent of the 13

21. Ibid.
22. Ibid.
23. U.S. Department of Commerce and MBDA, *Characteristics of Minority Businesses and Entrepreneur: An Analysis of the 2002 Survey of Business Owners,* April 2008.

million people entering the U.S. labor force between 2006 and 2016 will be members of ethnic minorities. Viable minority businesses will be the driving force in providing them with employment. These new members of the workforce will contribute to the growth of the minority consumer base and further drive minority purchasing power.

Given this combination of supply and demand patterns, a highly compelling case can be made that the growth of EDM businesses is critical to the overall U.S. economy, with more jobs for minorities and increased economic activity. Businesses focused on the EDM space will contribute to economic growth in three main ways.

- *Minority-owned businesses create minority entrepreneurs who become leaders and role models.* As minority businesses expand, their founders and CEOs will emerge as powerful and insightful business and civic leaders who will contribute to and shape policy, public dialogue, and private development, and bridge the gap between minority groups and the corporate world. As their experience and influence expands, they will be poised to aid corporations in tapping into the value of both a minority workforce and minority suppliers. They will inject a fresh perspective and new approaches into the overall business sector. At the same time, they will link fellow minorities and minority entrepreneurs to much-needed corporate resources: capital, markets, jobs, and know-how.

- *Businesses focused on minority customers are tapping into minority consumers' increasing purchasing power with tailored products and services.* Historically, mainstream businesses have underserved minority consumers. Given the nation's changing demographic, however, future economic progress hinges on the ability to effectively integrate underserved minority consumers into the mainstream of American business. Minority-focused businesses in sectors such as Education, Healthcare, and Media and Communication are bringing their products and services within closer reach of minority customers, a process that, in turn, enables those consumers to build their own capabilities to participate in the workforce of the future and contribute more to the U.S. economy. To effectively reach and serve minority customers, these businesses are likely to hire minority employees who live in the same neighborhoods and have greater sensitivity to minority consumers and a better understanding and appreciation of minority customer's needs.

- *Inner-city, minority-owned businesses are contributing to the development of their local neighborhoods.* Minority-owned businesses, often located in inner cities, can make real contributions to the economic development of their neighborhoods.

Minority-owned businesses typically employ a higher proportion of minorities than non-minority businesses,[24] while strong minority-owned businesses can serve as the foundation for a new infrastructure for inner-city economies.

Private equity and venture capital investments made by NAIC member firms have a tremendous impact on their portfolio companies and the overall economy.

This study of specific investments made in EDM companies by private equity and venture capital firms that are members of the NAIC suggests that the private equity business model is particularly effective at driving economic growth in the emerging domestic market.

In the simplest terms, 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 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. In some cases, these companies are undervalued or underperforming. In other cases, they are well run, but can benefit from new management talent and a new strategic direction. 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. The 20 percent profit for the general partners is known as “carried interest.”

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. While these firms also receive income from management fees, the percentage of overall income derived from that source is generally much smaller than at larger firms, which have significantly greater amounts of capital under management and as a result generate significant profits from fee income after payment of fixed costs. Small private equity firms also depend on carried interest compensation to attract talent. Larger financial institutions generally offer annual bonuses far in excess of the base salaries

24. Timothy Bates, *Understanding the Urban Development Potential Of Black-Owned Businesses*, October 2005.

available at small PE firms. By offering a stake in the carried interest, smaller firms can attract talented young financial executives who are much more willing to take a chance. Put another way, the small private equity firms that invest in the EDM space are much more dependent for their success on carried interest—which they earn by building value into the companies they acquire.

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.[25] 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. Founded in 1971, the NAIC is the industry association for private equity firms that invest in an ethnically diverse marketplace. NAIC member firms invest in privately held small to mid-market businesses that have a high probability of growth and the ability to generate significant returns for investors and shareholders.

The findings of this study mirror those of the World Economic Forum examination of the broader PE 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 was constraining their expansion could now pursue a wider variety of growth opportunities, and they achieved returns above the average of typical U.S businesses.

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.

25. *The Global Impact of Private Equity Report 2009*, "Private Equity, Jobs and Productivity," Word Economic Forum, January 2009.

- 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 2008[26]
- 66 percent of the total new jobs went to minorities, compared to an overall minority employment rate of just 30 percent.[27]
- 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.

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.

At the same time, the entrepreneurs and senior managers gained greater visibility and stature within the business community, creating cascading successes. Some of the entrepreneurs have been able to launch multiple successful businesses, becoming serial entrepreneurs, and in the process creating more new jobs and making further useful contributions to the overall economy.

A further benefit involved the purchases made by the companies and by their employees, which in turn support other businesses in the local community and elsewhere. The government benefits, too, through additional taxes paid by the company and its employees. This increased economic activity and the ripple effect it creates keeps the broader economy growing and vibrant.

This study examined more than 125 individual NAIC member-firm investments made in EDM businesses between 1992 and 2008. Of the investments studied:

- 88 percent were in companies owned by a member of a minority group
- 35 percent were in companies that served a specific minority customer group
- 25 percent of the companies were located in inner-city or LMI locations

By making investments in traditionally under-capitalized 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

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

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

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.

Chapter Two

The Current State of EDM Business Development

As documented in the 2005 BCG-Kauffman Report, *The New Agenda for Minority Business Development*, over the past few decades, minority business development has received a great deal of attention in the U.S. While the many gains already made by EDM businesses have been encouraging, a number of problems persist.

On the positive side, EDM businesses have achieved dramatic growth. The number of minority-owned businesses, their average revenue and the number of employees per business have all grown at rates that significantly outpace those achieved by businesses overall. All businesses, large and small, have realized the importance of the minority consumer base and are working to build relationships and product offerings to target these consumers, while many inner-city businesses already have been able to increase their rate of growth and achieve significant gains.

Few minority entrepreneurs, however, have succeeded in expanding their businesses beyond small and often family-run operations, and the number of minority-owned businesses still leaves minorities under-represented in the business community at large. Businesses offering customized products and services to minority consumers have succeeded in just a few industries, despite the market potential in several other industries. Beyond the businesses that have been successful in the inner city, most of these neighborhoods still face high unemployment rates and a large unmet demand for retail opportunities.

While progress clearly has been made, and the disparity between EDM businesses and the mainstream business community has narrowed in recent years, the gap between the two remains wide. Closing this gap presents a variety of unique opportunities for both minority businesses and their investors.

Significant Progress Has Been Achieved in EDM Business Development

EDM businesses have made remarkable progress over the past 15 to 20 years, including greater development of minority-owned businesses and more recently minority consumer-focused businesses and inner-city businesses.

Minority-owned businesses have been growing faster than mainstream U.S businesses. The minority business community has made significant strides and achieved impressive growth in number of businesses, revenue and jobs created.

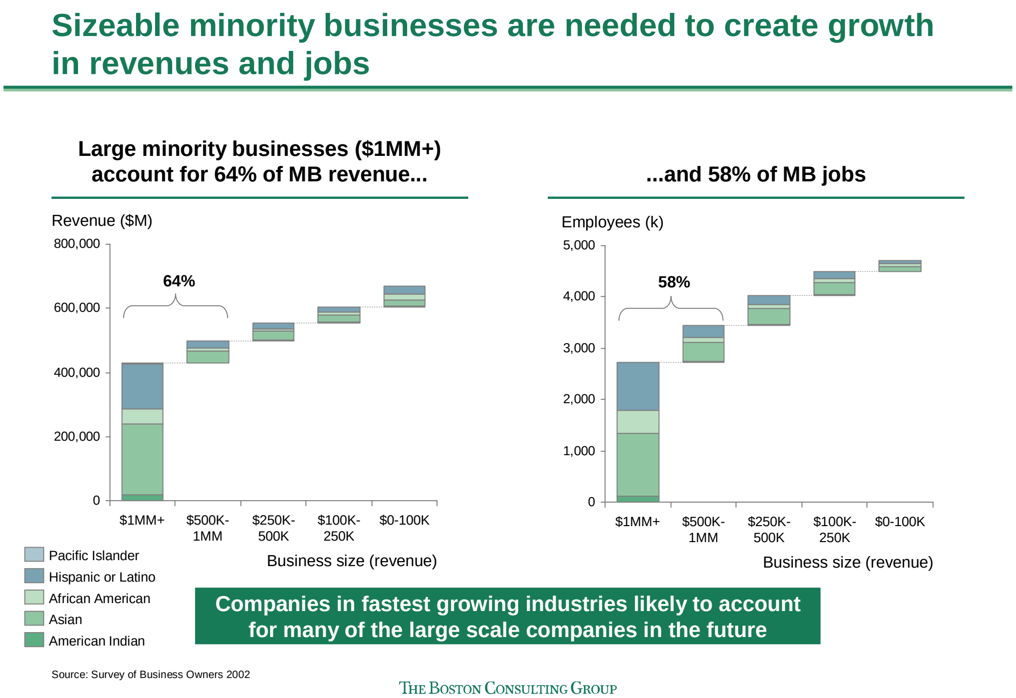
- Between 1987 and 2002, the number of minority-owned firms grew 7 percent annually—a rate more than double that of U.S. businesses overall.[28] Over the same period, the number of minority-owned firms tripled; by 2002 they made up 18 percent of all businesses, up from 10 percent in 1987.
- The growth in the number of minority businesses has outpaced the growth in the minority population itself, as the number of businesses for minorities per-capita grew by 75 percent between 1987 and 2002.
- Revenue from minority-owned firms rose at an annual rate of 10.8 percent per year between 1987 and 2002.
- The number of jobs at minority-owned firms increased from 800,000 in 1987 to 4.7 million in 2002, a 12 percent annual rate of growth.

Driving this growth are the largest minority-owned companies, those with more than $1 million in annual revenue. These 195,000 firms accounted for 64 percent of all the revenue generated by minority-owned firms and for 58 percent of all employment by minority-owned firms *(see Exhibit 3).*

Further helping to fuel this growth is the rapid increase in federal government contracting opportunities, which has grown at an annual rate of 8.6 percent. By 2002, the total government spending on contracts with minority owned businesses added up to more than $15.3 billion.[29] The private sector also has been increasingly active in providing opportunities for minority-owned firms. According to the National Minority Supplier Development Council (NMSDC),[30] purchasing from minority-owned businesses by the private sector has grown at an annual rate of 12 percent annually since 1990; it now amounts to more than $100 billion.

28. Refers to classified businesses in U.S, which are privately held and the ethnicity of the owner is known.
29. The Small Business Economy 2003; *Procurement from Minority- and Women-owned Businesses* pages 94-102; SBA (2003); BCG analysis.
30. National Minority Supplier Development Council Inc., 2007.

Exhibit 3



Businesses focused on minority consumers are growing in select industries. The increasingly large minority population and its rising purchasing power present a rewarding opportunity for companies choosing to concentrate on this traditionally underserved demographic. The past success of businesses in a few industries suggests just how rich this opportunity can be.

A number of businesses have capitalized on the minority consumer opportunity in the media and entertainment industry. Such companies as Black Entertainment Television, Telemundo, Univision and Radio One have already become significant players in the space. Realizing the demand for media offerings targeting the minority audience, these companies developed successful networks built around targeted content. Launched in 1980, Black Entertainment Television was purchased 20 years later for $3 billion after the company became the premier African American television network, reaching 87 million households.

A number of companies targeting minorities, such as Leap Wireless, have emerged in telecommunications as well. Between 2005 and 2007, Leap Wireless grew at an annual rate of 31 percent, from 1.7 million customers in 2005 to 2.9 million in 2007, and more than half of its customers are Hispanics and African-Americans.

While such examples suggest the potential inherent in certain industries to reach minority consumers, other industries continue to lag in the number of businesses needed to serve the growing minority customer base.

Several inner-city businesses have achieved significant growth by leveraging the benefits of proximity to regional industry clusters. Numerous businesses across the country have realized the potential for growth and successful operation in inner cities. Revenue for the companies on the 2007 "Inner City 100" list, compiled by Initiative for a Competitive Inner City (ICIC) and *Inc.* magazine, totaled a record $39 million, up from just $6 million in 2003, a compounded annual growth rate of 59 percent. Over the past 10 years, companies included on the "Inner City 100" have created more than 55,000 new jobs,[31] while companies featured on the list since its inception have generated nearly $23 billion in total sales.

Businesses in nearly all industries have been successful in the inner city. Companies in the "Inner City 100" group come from a broad mix of industries including business services, construction, technology services, transportation, consumer goods, and healthcare. In addition to a diverse industry mix, a variety of inner cities across the country are supporting thriving businesses; the 100 fastest growing companies featured in 2007 are located in 59 different cities in 29 different states. These companies' CEOs typically cited access to regional industry clusters, geographic concentrations of interconnected firms and supporting organizations[32] and to transportation nodes, diversity of the workforce, and workforce availability as leading advantages of being located in the inner city.

Recognizing the success of inner-city companies as proof of the growth opportunities in inner cities and the importance of creating larger inner-city businesses, the Small Business Administration recently created the "Emerging 200 Initiative" to focus on helping businesses capitalize on the inner-city opportunity. The initiative provides selected inner-city businesses with the contacts, resources and motivation to develop successful businesses of scale. The program has selected businesses in 15 large inner cities with significant potential for growth as the initial recipients of SBA support.

31. Initiative for a Competitive Inner City and Inc. Inner City 100 – 2007.
32. Karen G. Mills, Elisabeth B. Reynolds, and Andrew Reamer: *Clusters and Competitiveness: A New Federal Role for Stimulating Regional Economies,* Brookings, April 2008.

EDM Business Leaders

Beyond the potentially attractive financial return and positive impact on the broader economy, EDM investments have also helped foster and create a generation of executives with greater visibility and stature in the business community. These senior leaders are set to become role models and mentors for other budding entrepreneurs. Some examples:

- *Sergio Oliva started as an operations support assistant at hair care products maker Samy Co. He had a high school education with some college credits but was eager to learn and willing to take on more responsibilities. Sergio was initially made supervisor of the Miami warehouse and is now Manager of Warehousing for the East Coast and for distribution nationally. Since he started at Samy, Oliva increases his annual salary by more than 60%; he received another sizeable payout from exercising stock options following the recent sale of Samy to Hoyu.*

- *Eddie Rodriguez originally joined Driftwood Dairy as a baker and rose to become a Plant Superintendent in 2007. In 2008, he was promoted once again to the position of Plant Manager.*

- *In 1998, Frank Washington, an African American entrepreneur, received funding from two NAIC member firms, Opportunity Capital Partners (OCP) and Pacesetter Capital, for Systems Integrators Inc., and later went on to start another business, Tower of Babel, in 2004, which was also funded by OCP.*

- *Moctezuma Esparza, a Hispanic entrepreneur, was funded by SYNCOM for the first time in 1979 for Buenavision and has since become a successful serial entrepreneur starting six different businesses, all of them funded by SYNCOM, including his recent venture, called Maya Entertainment.*

- *Amador Bustos, another Hispanic entrepreneur, has started two businesses, Z-Spanish and Bustos Media, both funded by OCP and Pacesetter.*

Lack of capital continues to restrict EDM business growth

Despite this progress, most EDM businesses are still relatively small, and many operate in low-growth sectors, and that has made it difficult to close the gap between EDM businesses and the overall business sector in the U.S.

Yet ensuring the growth of EDM companies is critical for the future economic development and well-being of minorities, the communities they live in and the overall U.S. economy. A study jointly conducted by the U.S. Department of Commerce and the Milken Institute in 2000 noted, "Economic growth cannot be sustained without the inclusion of minority businesses and an infusion of capital into those businesses."

Minorities account for 32 percent of the U.S. population but remain highly under-represented in businesses. Minority-owned businesses account for just:

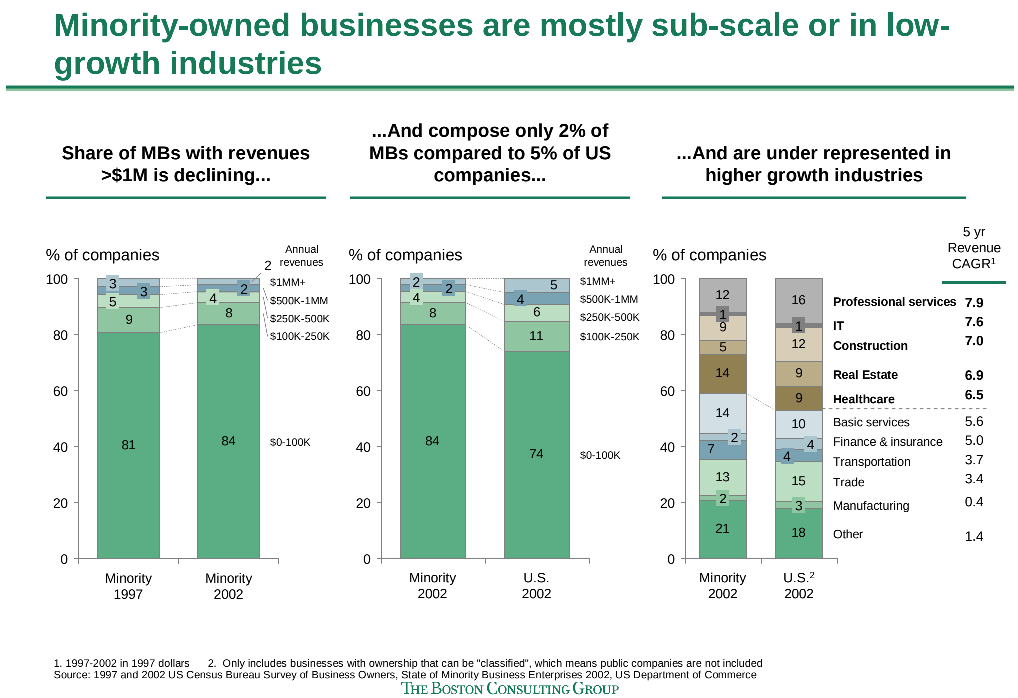
- 18 percent of all classified U.S. businesses
- 8 percent of employment by all classified U.S. businesses
- 7 percent of total gross revenue from all classified U.S. businesses[33]

This drastic under-representation is driven by the fact that most of the minority-owned businesses are either small or in slow-growth industries. Only 2 percent of minority-owned businesses take in $1 million or more in annual revenues, compared to 5 percent of all U.S. businesses.

Furthermore, minority businesses are over-represented in slower growing industries such as Basic Services and Transportation, and under-represented in the faster-growing industries of Professional Services, Construction and Real Estate (see *Exhibit 4).* Several factors contribute to this problem, but none of them are more important than the difficulty they have accessing capital, and especially equity capital. The shortage of capital forces EDM businesses to gravitate towards industries with low capital requirements, to make minimal investment in technologies that could improve productivity, and to remain stuck in a slow-growth or no-growth mode. Increased access to capital is absolutely critical if minority businesses are to achieve growth and scale.

33. U.S. Census population data, U.S. Economic Census, 2002.

Exhibit 4:



Gaps in growth of minority-consumer focused businesses. While minorities make up a sizeable and growing segment of the nation's population, the number of products and services targeting minority consumers significantly lags in market share. This gap hurts both minority consumers whose purchasing needs are not being fully met, as well as the businesses that operate in the segment.

The gap between the large number of minority consumers and the small number of businesses reaching these consumers appears in a variety of contexts:

- **Advertising spend.** U.S. companies spent more than $280 billion on advertising in 2006, yet advertising focused on Hispanic consumers totaled just $3.8 billion, or less than 1.4 percent of the total spend, despite the fact that Hispanics make up 15 percent of the nation's population.[34]
- **Internet access.** The percentage of minority consumers with Internet access significantly lags their majority counterparts. Fully 71 percent of non-Hispanic whites use the Internet, compared to just 60 percent of African Americans and 56

34. "U.S. Ad Spending Growth Slows Way Down," Advertising Age 2007; "Hispanic Ad Spending Still Climbing," eMarketer, 2007.

percent of Hispanics.[35] The gap is even starker when it comes to broadband Internet access: While 43 percent of non-Hispanic whites have broadband access in their homes, just 29percent of Hispanics do.

- **Retail banking.** Minority consumers find themselves in the same position when it comes to retail banking, for the simple reason that there is fewer retail banking locations targeting these consumers. African Americans are 31 percent more likely to be under-banked[36] than the overall U.S. population, while Hispanics are 42 percent more likely.[37]

Gaps in growth of inner-city or LMI businesses. The success of the companies on the "Inner City 100" indicates the significant opportunities that can be found in urban neighborhoods. Yet the nation's inner cities continue to lag their wider metropolitan regions in a number of dimensions. While the number of jobs in surrounding areas grew at a compounded annual rate of 1.9 percent from 1995 to 2002, jobs in the 100 largest inner cities in the U.S. grew at just 0.1 percent.[38] Despite the cheaper workforce, in 2002, the unemployment rate in inner cities was 13 percent, compared with just 5 percent in surrounding areas.

In 2006, the Initiative for a Competitive Inner City and BCG conducted a study on the size of retail supply and demand in inner cities. The results indicate that demand for retail in the nation's inner cities totaled $122 billion, much higher than the retail supply of just $80 billion.[39] Despite that unmet demand, many retailers continue to pursue growth in areas outside the inner cities, which are often already are oversaturated and highly competitive. The study found significant unmet retail demand even in LMI areas, where many retailers overlook opportunities even in sectors like consumer staple goods, where demand is largely price inelastic. West Los Angeles, an area with relatively higher income, boasts five supermarkets for every 100,000 residents, while the lower-income neighborhood of South Los Angeles has only one supermarket for every 100,000 residents.[40]

35. Latinos Online, Pew Internet & American Life Project, 2007.
36. Underbanked defined as individuals who made one or more non-bank financial transactions in the past 30 days, and includes unbanked, defined as no current checking account and no current savings account.
37. Underbanked Consumer Study, Center for Financial Services Innovation, 2008.
38. State of Inner City Economies: Small Businesses in the Inner City, Small Business Administration, 2005.
39. Realizing the Inner City Retail Opportunity: Progress and New Directions, Initiative for a Competitive Inner City and The Boston Consulting Group, 2006.
40. "Urban Areas Struggle to Find Grocers, Fresh Food," Associated Press, 2008.

Why do EDM businesses struggle to grow as quickly as mainstream businesses, and to achieve success in high-growth industries? For several reasons: They often have weaker management teams, they struggle to improve their operational capabilities and their network of relationships is limited. Yet as several studies have documented, the most critical reason is lack of access to capital.[41]

41. Blanchflower, D., Levine, P., & Zimmerman, D., *Discrimination in the Small Business Credit Market,* Review of Economics and Statistics, 85(4), 930-943, 2003; Cavalluzzo, K., L. Cavalluzzo, and J. Wolken, *Small Business Loan Turndowns, Personal Wealth and Discrimination,* May 2003; Cavalluzzo, K., L. Cavalluzzo, and J. Wolken, *Competition, Small Business Financing, and Discrimination: Evidence from a New Survey*, Georgetown University manuscript, 1999.

CHAPTER THREE

PRIVATE EQUITY IN EDM

Private equity capital is a critical source of funding for companies looking to enter a variety of high-growth or and large-scale industries. According to a recent BCG study, successful PE firms are creating significant value by promoting operational improvement and profitable growth in their portfolio companies.[42] The positive impact of PE investments on businesses has been proven by several other studies as well. Companies owned by PE firms outperform their publicly traded peers in several ways:

- 14 percent greater sales
- 5 percent greater EBITDA
- 5 percent greater profitability growth[43]

How can PE firms help EDM businesses grow faster and reach the scale needed to increase their contribution to the overall economy?

Providing access to capital, Private equity funds can provide the capital infusion that EDM businesses need:

- PE funds provide capital for businesses at different stages of their lifecycle, from early and late stage start-ups to mature businesses requiring additional capital or restructuring.
- Investments made by PE firms gives EDM businesses the credibility in the financial markets needed to receive additional debt financing
- PE firms can provide multiple rounds of financing depending on the needs of the company and its potential for growth.

Increasing the breadth and depth of management. Private equity firms often can help companies bolster their management structure by identifying and hiring talented managers or stepping in themselves to fill those roles temporarily.

- Because many minority businesses are run solely by the founding entrepreneur, they often lack the management structure needed to expand. PE firms often assist EDM businesses in identifying and hiring senior managers

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42. BCG and IESE report, *The Advantage of Persistence: How the Best Private-Equity Firms "Beat the Fade,*, February 2008.
43. Gottschalg, Oliver. *Private Equity and Leveraged Buy-outs Study*. Policy Department, Economic and Scientific Policy, European Parliament, November 2007

in positions ranging from the CEO and the CFO to vice president of sales and marketing.

- The credibility a PE investment lends to a minority business can act as a signal of its growth potential of the business, and that in turn can help attract the talent it needs to grow. In our research, we interviewed the CEOs of several portfolio companies; they often noted that they joined the company only because a PE firm had made an investment and that made them feel confident about the company's future prospects. "I would not have joined the company if not for Marwit Capital making an investment," said Mac Berry, the CEO of Driftwood Dairy, a dairy products company based in southern California.
- PE firms can provide the training needed to introduce the founders and managers of EDM businesses to standardized business practices such as audit and governance. After Hispania Capital Partners invested in CSA, an engineering services firm based in Puerto Rico, the firm worked with management to formalize the company's governance process. "Previously, the board meetings were just [founder] J.J. Suarez and I discussing the overall strategy," said Fred Reifkohl, the company's CFO. "Now we have many new board members from Hispania Capital, we provide formal presentations to the board, and we drill down deeper into our strategy. It is a healthy process because [Hispania Capital] forces you to be wiser with your own money."

Improving operational capabilities. The incentives of the general partners at PE firms are closely aligned with the success of the businesses they invest in, so they are more likely to take an active role in helping their portfolio companies shape their strategy and grow their operational capabilities. In addition to funding, PE firms often provide support in the form of:

- Strategic advice: Most GPs at private equity firms are not just financial investors, but also seasoned professionals in the industries in which they invest. Thus, they have domain expertise in these sectors and can advise the EDM businesses in their portfolios on crafting strategies for growth and profitability.
- Operational advice: PE firms maintain a strong focus on creating fundamental value in their portfolio businesses through operational improvements. The GPs and their external advisors, usually executives with considerable experience as senior managers at large corporations, have considerable experience in managing companies and systematically improving their performance.

- Board membership: In most cases, the GPs serve on the boards of their portfolio companies, influencing their strategic direction and providing guidance to their managers.

Marwit Capital's investment in Driftwood Dairy provides an apt example of the impact a PE firm can have in shaping strategy and improving operations at portfolio companies. Marwit helped Driftwood reshape its strategy to focus on small and mid-market business customers and Hispanic consumers that were underserved by both the larger dairies and the smaller independent operators. By refocusing its product line, upgrading its distribution system and targeting new customers, Driftwood significantly improved its ability to serve its niche segment. That success has enabled the company to increase market share and expand into new geographies.

Expanding network of relationships. PE firms can help EDM companies expand their business relationships through the networks they are plugged into and the contacts they have developed through years of experience in their industries.

- Other financiers: PE firms typically have developed strong relationships with banks and other financial institutions, and they can introduce those contacts to the EDM businesses in their portfolios. In turn, financial institutions are more likely to extend loans to businesses that have already captured PE investments.
- Complementary businesses and partners: PE firms are also typically well-connected to the business networks for the sectors in which they operate. Through their personal and professional networks, they can introduce their EDM businesses to complementary partners in the industry, further facilitating their expansion.

Through its relationships with investment banks and other PE firms, for example, ICV Capital Partners helped the Marshall Retail Group (MRG) connect with casino operators to discuss the placement of MRG stores in their casinos. One connection was with Trump Casinos, a prospect that MRG had been trying to reach for years, and it led to the opening of a store in Trump's Atlantic City casino.

John W. Rogers, Jr.

John W. Rogers, Jr., the founder of Ariel Capital Management, is an example of a minority business entrepreneur who has been an inspiration to several minority fund managers and entrepreneurs. Rogers founded Ariel in 1983, at the age of 24, starting with only one major account, $100,000 from Howard University's endowment fund.

Within six months, Rogers and an employee raised an additional $190,000 in investment capital. Twenty-five years later, Ariel has grown to 74 employees with $4.4 billion in assets under management and is one of the largest African-American owned investment firms in the U.S. Rogers is also credited with creating the first two mutual funds in the U.S. managed by African Americans, the Ariel and Ariel Appreciation Funds, both of which received four-star ratings in 2004.

In addition to running Ariel, John serves on the board of directors of three Fortune 500 companies: Aon Corporation, Exelon Corporation and McDonald's. John has also been actively involved in giving back to the community through his roles as director of the Chicago Urban League, trustee of the University of Chicago and member of the John S. and James L. Knight Foundation.

John has won several awards in recognition of his success as an entrepreneur and fund manager, including Arthur Young and Venture magazine's 1988 Entrepreneur of the Year, Sylvia Porter's Personal Finance Magazine's Mutual Fund Manager of the Year in 1988, and U.S. Small Business Administration District's 1989 Minority Small Business Person of the Year. His success has inspired several current minority investment managers and boosted recognition of the talents of minority managers among institutional investors.

EDM businesses remain highly under-represented in access to PE capital

Despite the significant growth in EDM businesses in the past two decades and the emergence of private equity funds focused on EDM, EDM businesses still receive a small proportion of the total PE capital in the US. According to a study by the Milken Institute and the Minority Business Development Agency, only 2 percent of total PE capital in the US is allocated to minority businesses.[44] In large part, this is because large private equity funds by necessity are focused on large transactions, and few businesses in the EDM space can accommodate large capital investments (in the range of $100 million or more). In addition, general partners at traditional private equity firms (GPs), their limited partner investors (LPs), and their investment consultants sometimes have mistaken notions of the "social discount" and higher risk associated with EDM companies.[45]

- **Few minority businesses meet the larger GPs' and LPs' minimum size criteria.** A large proportion of PE capital is concentrated in a small number of large PE firms.[46] The top 25 PE firms—just 1 percent of the total number of firms—control almost 50 percent of total PE capital, and the top 50 firms control 65 percent. All of these firms are looking to invest in a very limited number of portfolio companies, which allows them to work closely with each company. Whether investing in a large company or a small one, the transaction costs involved in closing a deal are fairly similar, further skewing the preference of GPs for larger deals. A $1 billion fund may be willing to make as many as 20 investments, yet its average investment size will still be $50 million, typically in a company with revenues of at least $100 million to $200 million. Most minority businesses are not large enough to meet these criteria, and thus cannot capture the attention of the larger GPs that control most of the capital.

  By the same token, funds focused on EDM are typically too small to attract the attention of larger LPs. Because transaction costs are essentially fixed, LPs prefer to allocate capital in larger amounts, which favors the larger funds. Most of the public pension funds, for instance, prefer to make investments of at least $50 million to $75 million, while limiting their participation in any particular fund to less than 10 percent of the fund's total capital; that restricts their choices to funds

44. Milken Institute and the Minority Business Development Agency*, The Minority Business Challenge: Democratizing Capital for Emerging Domestic Markets, September 2000.*
45. Glen Brenner, Keon Holmes, Robert Munroe, Zuhairah Scott, *The Unique Fundraising Challenges of Private Equity Funds Focused on the Emerging Domestic Market*, HBS Study 2005.
46. Private Equity International 50, Thomson Financial, BCG analysis.

with at least $500 million to $750 million in capital.[47] Yet the average EDM fund manages just $100 million to $300 million, keeping it off the larger LPs' radar. Notably, several large LPs have established Emerging Manager programs as a way to invest in small private equity funds. However, even with the efforts of Emerging Manager programs, investments in smaller private equity funds are disproportionately smaller than investments made in larger private equity funds.

- **Limited awareness of EDM and confusion about its definition.** Limited partners, their consultants and other intermediaries are mostly unaware of EDM and the existence of PE firms that specialize in this space, and investors who have heard the term often feel confused about its definition. Some view EDM as minority-owned businesses, some as businesses serving minority customers, and others as businesses in minority neighborhoods. But the attractiveness of EDM as an asset class is partly driven by the fact that it includes all of the above businesses, and all of them are benefiting from the nation's changing demographics.

- **The "social discount" and skepticism about attractive returns**. The biggest misconception among investors is that EDM investments are often seen as "double-bottom line" or "community development" investments designed primarily to reap social rather than financial returns.[48] Yet the typical EDM fund is focused exclusively on investing for financial returns; the potential economic and social impacts are just secondary benefits. Despite multiple studies that have demonstrated the attractive financial returns generated by EDM funds, this skepticism continues to be the primary challenge EDM funds face in attracting capital.

Even in states with sizeable minority populations, public pension funds allocate a tiny proportion of their capital to EDM relative to the proportion of their minority populations. Pension funds in such states as California, Texas, New York and New Jersey, where minorities account for at least 40 percent of the population, allocate less than 1 percent of their capital to EDM investments *(see Exhibit 5).*

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47. Journal of EDM Finance, *Why We Invest in EDM, Interviews with New York City and New York State Comptrollers*, Summer 2005.
48. The Council of Urban Investors Institute: *In Your Own Backyard: Investment Opportunities in Emerging Domestic Markets.*

Exhibit 5:

Pension funds in several states allocate minimal capital to EDM, despite sizeable minority populations

State	Pension fund assets[1] ($B)	Allocation to PE (%)	Allocation of total assets to EDM & Emerging Managers vs minority population (%): Allocated to EDM + EM	Minority population
California	618	5	0.3	59
New York	418	4	0.2	43
Ohio	195	3	0	18
Texas	172	2	0.3	53
Florida	143	3	0	41
Illinois	127	3	0.4	36
Pennsylvania	106	5	0	19
Wisconsin	92	3	0	15
New Jersey	84	-	0	40
North Carolina	82	2	0	33

1. Includes public pension funds in Pension and Investments Top 200, accounting for funds with $7B+ in assets
Note: PE allocation includes PE, VC and Buyout, EDM definition subject to fund's interpretation and may include Emerging Managers
Source: Pension and Investments Top 200 – Fall 2007, US Census Bureau 2007, Institutional press releases and literature search

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- **Investment consultants to LPs have no incentive to recommend new asset classes like EDM.** The capital distribution decisions made by most large pension funds are influenced by a variety of gatekeepers, including pension fund advisors and investment consultants. Yet these gatekeepers have no incentive to take the risk of investing in new asset classes such as EDM. Instead, they typically prefer larger, well-known fund managers with a strong brand name and an established track record of returns, which they perceive as "low risk." And because the transaction costs involved in researching potential funds essentially are fixed, the consultants tend to focus on a limited number of larger funds rather than a larger number of smaller, emerging funds.

  As Connecticut State Treasurer Denise L. Nappier, the sole fiduciary of the Connecticut Retirement Plans and Trust Funds, put it, "There is an initial screening by consultants when evaluating the strength and suitability of an investment fund and its team of professionals. This becomes an uphill battle for many minority managers because general consultants are comparing them to more established managers with longer track records. . . . Many qualified minority managers fall into this category, and are being prematurely screened out."[49]

49. Journal of EDM Finance, *All Around Strategy*, Spring/Summer 2007

- **Minority investment professionals are under-represented in the financial services industry.** Ethnic minority investment professionals account for only 22 percent of professional positions and 15 percent of management level positions in the financial services industry.[50] While the various diversity initiatives and Emerging Manager programs undertaken by a number of financial institutions have improved this percentage in recent years, minorities remain significantly under-represented relative to their share of the population.

  This under-representation has a significant impact on the flow of capital to EDM. Because there are so few minority investment managers in the industry, the awareness of their talent and the returns they can generate has suffered. This in part explains some of the skepticism about the returns minority managers have generated in EDM. Similarly, because most LPs and their gatekeepers also employ relatively few minorities, they too remain unaware of EDM; hence EDM as an asset class continues to be largely ignored despite its potential returns.

- **Some minority business owners are averse to equity financing.** While the newer generation of minority entrepreneurs is focused on wealth creation, minority business owners have historically been focused on business creation and often do not have the mindset for fast growth. Once the business is sustainable, they are reluctant to change the status quo and are unwilling to cede a stake or operational control of their business in exchange for the equity capital needed to expand the business.

NAIC and its member firms play a critical role in supporting EDM and small and mid-market businesses

The National Association of Investment Companies (NAIC), founded in 1971, is the industry association for private equity firms that invest in an ethnically diverse marketplace. NAIC member companies invest in privately held small to mid-market businesses that have a high probability of growth and the ability to generate significant returns for investors and shareholders.

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50. U.S Government Accountability Office, *Financial Services Industry: Overall Trends in Management-Level Diversity and Diversity Initiatives, 1993-2004*, June 2006.

- **NAIC member firms have pioneered investing in EDM**. NAIC and its member firms are among the nation's pioneers and leading experts in private equity investment in the EDM asset class. Collectively, they have invested more than $2.5 billion in EDM businesses.[51] Although many in the investment community continue to doubt the potential for attractive returns in the EDM space, a number of NAIC firms boast a sustained track record of success. Some NAIC members, such as SYNCOM Venture Partners, have been generating good returns in EDM for more than 30 years, while others, such as Fairview Capital, have pioneered the use of a fund-of-funds model for EDM, and others, including ICV Capital, have expanded the focus of EDM investments to include inner-city businesses.

- **NAIC and its partner organizations play a critical role in facilitating interaction between key EDM players.** NAIC works closely with other minority business organizations to increase the awareness of EDM and to facilitate interactions among the key players. These organizations include the New America Alliance (NAA), The Marathon Club (TMC), the Executive Leadership Council (ELC), and the Association of Asian American Investment Managers (AAAIM).

  NAIC also hosts and sponsors a number of events focused on EDM throughout the year. These include its Annual Meeting and Convention, a three-day gathering of more than 200 influential attendees from private equity firms, banks, corporations and the political sphere and its Trustee and Plan Sponsor Symposium, an event designed to educate pension fund trustees about the EDM space. The NAIC also is closely involved in the Plan Sponsor and Minority Manager Consortium, which brings together minority and emerging managers, consultants, members of the fund-of-funds community and plan sponsors. The NAIC also and supports regular meetings of The Marathon Club that provide educational, professional development and networking opportunities for those interested in the EDM space.

  Other forums such as the Inner City Capital Connections, sponsored by Bank of America Capital Access Funds, an NAIC member, and ICIC also brings EDM entrepreneurs and investors together to promote the growth of EDM.

51. NAIC website.

- **NAIC member firms also have successfully proven their investing expertise in the non-EDM space**. EDM remains the primary focus and expertise of NAIC member firms, and they have the unique capabilities needed to capitalize on opportunities in that space. But it is important to recognize their experience and track record in non-EDM investments. Several minority fund managers at NAIC member firms have multiple years of investing experience at PE firms that aren't focused on EDM investing. Their experience and the network of relationships they developed in the non-EDM space has enabled these managers to continue to make successful non-EDM investments. Firms such as ICV Capital, Vista Equity Partners, Palladium Equity, and Pharos Capital all boast experienced fund managers that can generate competitive returns in both the EDM and the non-EDM space.

    - Palladium Equity Partners is a prime example of a private equity firm run by minority fund managers who have demonstrated investment success outside of the EDM space. Marcos Rodriguez founded Palladium in 1997 and serves as managing partner. Rodriguez, a graduate of Columbia University and the Wharton Graduate School of Business, is also an alumnae of General Electric Manufacturing Management Program. Palladium's principals boast credentials from the world's leading educational institutions and private equity firms and have invested more than $2.5 billion of equity in over 65 companies during the last two decades while developing a distinguished track record of successful partnerships with management teams. Palladium has a focus on companies that are well-positioned to capitalize on the fast-growing U.S. Hispanic market and targets investments in media companies as well as in financial and business services, consumer/retail, food/restaurants, healthcare, and manufacturing businesses. Palladium currently manages over $1 billion of committed equity capital.

    - Willie Woods and Tarrus Richardson of ICV Capital exemplify the new crop of talented minority managers investing across the EDM and the non-EDM private equity spaces. After graduating from Harvard Business School, the two managers, both AfricanAmerican, went into investment banking, developing their skills at such Wall Street firms as Deutsche Bank and the PE firm Joseph Littlejohn and Levy. Since founding ICV Capital in 1998 in partnership with American Securities and ICIC, they have made a number of investments both in the EDM space, particularly in businesses based in the inner city, and outside the EDM space. ICV’s deal with Marshall Retail Group beginning in 2003 illustrates the firm’s investment activity in a non-EDM space. Marshall Retail Group operates more than 70 retail stores; primarily in casino-hotels across the U.S. ICV’s investment in Marshall Retail Group earned an IRR exceeding 55 percent, clearly demonstrating the firm’s ability to successfully invest outside of EDM businesses.

- Vista Equity Partners is another example of a private equity firm run by a minority fund manager who has demonstrated investment success beyond the EDM space. Founded in 2000 in San Francisco by African-American manager Robert Smith, Vista focuses on investing in software and technology-enabled businesses. Like the founders of ICV, Smith has an impressive resumé of educational and professional experience, including Cornell University, Columbia University and Goldman Sachs. The companies Vista has invested in post combined revenues of $3.5 billion, and EBITDA exceeding $1 billion.

The experience and track record of these fund managers support the argument that the EDM funds they manage have both the capacity and the expertise to successfully deploy more capital than they currently have.

CHAPTER FOUR

OTHER KEY STAKEHOLDERS

In addition to private equity firms, a variety of other organizations play key roles in supporting investment in EDM, including limited partners—specifically pension funds and fund of funds—and large, traditional general partners that have begun to partner with EDM focused investment firms. A number of private research groups and foundations further support EDM through investigation and reporting on the space, while numerous large corporations have made EDM a priority via purchasing and mentoring initiatives for minority suppliers.

A select group of limited partners are taking a leadership role in investing in EDM

As the largest source of funding for the EDM space, private equity limited partners such as pension funds, funds of funds, banks, and insurance companies play a critical role in designating how their funds are invested. While most limited partners have shied away from EDM, some have taken a leadership role in allocating capital to the space.

- **Pension funds.** Pension funds, which control an enormous pool of available capital, are motivated to make investments in the communities where their pension beneficiaries live. Some of the largest pension funds, including the California Public Employees Retirement System (CalPERS), the California State Teachers Retirement System (CALSTRS) and The New York State Common Retirement Fund (CRF), have been early movers in allocating a portion of their portfolio to EDM investments. CalPERS Emerging Domestic Market Investment Policy, for example, stipulates that funds should seek to realize competitive risk-adjusted return rates while also helping increase economic opportunities in under-invested areas in the state.

  Public pension funds play an influential role in EDM investing, as they provide more than 50 percent of all EDM investments.[52] In addition to targeting a portion of their assets to EDM investments, a number of pension funds now allocate a

52. Bates and Bradford, *Venture Capital Funds Investing in Minority-Owned Businesses: Evaluating Performance and Strategy*, 2008.

share of investments to Emerging Manager programs. As Exhibit 6 shows, nearly $10 billion in assets across a mix of private and public market equity and real estate have been allocated to Emerging Managers. While not specifically targeted at minority fund managers, these programs typically allocate capital to managers associated with smaller and newer funds. Because many women and minority managers meet these criteria, they are benefiting from this program.

Exhibit 6:

Identified emerging managers programs at public pension plans and foundations include nearly $10B in assets

Contributing fund	Type	Committed capital ($M)
CalPERS	Public Pension	3,500
CalSTRS	Public Pension	1,600
Teacher Retirement System of Texas	Public Pension	1,500
PennPSERS	Public Pension	1,000
New York State Common Retirement Fund	Public Pension	1,000
Maryland State Retirement and Pension System	Public Pension	550
Teachers' Retirement System - Illinois	Public Pension	500
Chicago Community Trust	Foundation	40
Los Angeles County Employees' Retirement System	Public Pension	NA
Indiana Public Employees' Retirement Fund (PERF)	Public Pension	NA
State of Connecticut	Public Pension	NA
City of New York	Public Pension	NA
		9,700+

Asset classes include public and private market equity, as well as real estate

Source: Literature search; fund press releases

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- **Funds of funds.** Even if large investors are interested in allocating financing to EDM, the small size of the typical EDM fund makes it inefficient for them to do so. Funds of funds play an important role in bridging this gap by efficiently allocating money across a wide range of funds, allowing LPs to meet their EDM investment goals without requiring substantial amounts of time and effort. Funds of funds with experience investing in EDM make valuable partners for LPs as they can research the fund managers, invest with the most promising ones, oversee their progress, and report the results back to the LPs, thus providing valuable capabilities that many LPs cannot build in a cost-efficient manner on their own.

- **Banks and insurance companies.** Like pension funds, banks and insurance companies have a unique and influential role to play in EDM investing, thanks largely to the significant assets under management at these institutions. As institutional clients demand more innovative investment products, banks such as Northern Trust have increased their presence in the EDM space with their Emerging/Minority Manager Program.

  As the minority customer base of banks and insurance companies grows, EDM investments also provide a means for these institutions to invest in their customers' communities. The Community Reinvestment Act (CRA) also escalates the role of banks in EDM by increasing the amount of investment they must make in low-to-moderate-income (LMI) areas, which typically overlap with EDM. Banks such as US Bancorp, which has loaned more than $3.1 billion within such reinvestment areas and JP Morgan Chase are among the 5 percent of banks that have earned a CRA rating of "Outstanding."[53] Insurance companies are also allocating capital to EDM—Northwestern Mutual, for instance, makes its EDM investments through GKM Newport, a fund of funds.

Larger traditional PE funds are beginning to support EDM through partnerships with EDM-focused funds

As we noted above, many EDM companies are too small for traditional private equity funds to invest in directly. But a number of larger PE funds are participating in the EDM space by partnering with NAIC member firms. Examples include:

- American Securities and ICV Capital Partners
- HM Capital Partners (formerly Hicks, Muse, Tate & Furst) and 21st Century Group
- The Carlyle Group and RLJ Equity Partners
- TPG (formerly Texas Pacific Group) and Pharos Capital Group
- Duff & Phelps and Hispania Capital
- Fontis Capital and Rustic Canyon Partners
- The Yucaipa Companies and Johnson Capital Management

These partnerships have taken a variety of forms, including co-investments, the sharing of PE deal flow, and helping start up EDM-focused PE firms.

53. Company press releases.

Researchers and foundations have contributed immensely to raising awareness about EDM

Researchers and foundations have played a significant role in supporting EDM, by conducting or sponsoring studies highlighting the importance, opportunities and challenges of EDM. Such studies have increased the visibility of EDM investing and addressed a number of critical questions regarding the space.

- **The Ewing Marion Kauffman Foundation** has sponsored multiple studies focusing on the EDM space, including a 2005 Boston Consulting Group study called "The New Agenda for Minority Business Development," which outlines strategies for closing the gap between minority businesses and the greater business community.

- **The Milken Institute** focuses on creating a more efficient economy by promoting capital-market principles and financial innovations to address social and economic challenges. The institute's Center for Emerging Domestic Markets collects and analyzes EDM-related data and has published several studies on the challenges and opportunities of EDM.

- **The Initiative for a Competitive Inner City (ICIC),** established in 1994 by Harvard Business School Professor Michael Porter, is a national non-profit organization researching the competitive advantage of inner cities and strategies for inner-city development.

- **Academic researchers,** such as Professors Gregory Fairchild, Timothy Bates and William Bradford, have published a number of studies on the EDM space. Bates and Bradford, for instance, have published two landmark studies "Minorities and Venture Capital: A New Wave in American Business" (2003), and "Venture Capital Funds Investing in Minority-Owned Businesses" (2008) that assessed the financial performance of investments in minority-owned businesses and found them attractive relative to mainstream private equity and public market returns.

Large corporations have supported EDM businesses through supplier diversity programs

Large corporations play a vital role in EDM by supporting minority business enterprises through supplier diversity programs. While the purchasing contracts provided by large corporations are a major driver in advancing minority suppliers, other benefits include mentoring programs that ensure supplier success and growth, and influencing the greater business community to develop similar programs. A number of large companies also believe that creating a supplier base that matches their consumer base gives them a significant competitive sales advantage.

The Billion Dollar Roundtable, created in 2001, is made up of corporations that purchase at least $1 billion of goods and services from minority- and women-owned businesses. The group now includes fifteen members: AT&T, The Boeing Company, Chrysler Corporation, Dell, Inc., Ford Motor Corporation, General Motors Corporation, Honda North America, IBM Corporation, Johnson Controls, Inc., The Kroger Co., Lockheed Martin Corporation, Procter and Gamble Company, Toyota Motor North America, Inc., Verizon Communications, Inc. and Wal-Mart Stores, Inc. In addition to recognizing these corporations, the Billion Dollar Roundtable works to promote and communicate best practices in supplier diversity by publishing white papers and collecting statistics. In 2007, members spent a total of $35.2 billion on purchases from minority and woman owned suppliers, representing about 10 percent of their total Tier 1 purchases.

CHAPTER FIVE

PUBLIC POLICY AND EDM

The federal government supports EDM business development through MESBIC/SSBIC/SBIC programs

Beginning in the 1960s, the federal government launched a series of initiatives designed to support EDM businesses and communities. These initiatives were designed either to provide business and employment support or to increase capital flow to socially and economically disadvantaged businesses. These initiatives have focused on a variety of EDM issues:

- **Diversity in government sourcing.** A series of legislative initiatives has required a minimum percentage of federal procurement to be sourced from disadvantaged firms, such as sourcing for the Department of Defense and public works projects.
- **Affirmative action in hiring.** Executive orders in 1964 and 1969 mandated affirmative action in hiring federal government employees and federal contractors.
- **Technical and management capabilities of minority businesses.** A number of agencies, primarily the Small Business Administration (SBA) and the Minority Business Development Agency (MBDA), have been created for or tasked with increasing the capabilities of minority businesses and their owners.

Among the most important initiatives designed to increase capital flow to EDM are:

- **MESBIC/SSBIC/SBIC.** Minority Enterprise Small Business Investment Companies (MESBIC) were essentially the first PE funds investing in EDM. Created in 1970, they were privately owned and invested private capital, leveraged two to four times with loan guarantees from the SBA, in minority owned businesses. The MESBIC program was subsequently merged into the Specialized Small Business Investment Company (SSBIC) program, which later changed its focus strictly to LMI neighborhoods. In 2007, SSBICs invested $583 million in LMI communities[54].

54. National Association of Small Business Companies website, "Highlights and History."

While these programs increased capital flow to EDM, they faced a number of problems. A misplaced focus on investing in the most underprivileged entrepreneurs rather than the most promising, and the disadvantaged structure of the government's investments, made the program unsustainable. Under the "Participating Securities" program, the government took equity-like risk but received debt-like returns; the result was significant losses. In 2004 the government scaled back the program by not licensing any new SSBICs.

Despite these problems, the MESBIC/SBIC program formed the foundation of the modern EDM-focused private equity industry. Many of today's EDM-focused PE funds, including SYNCOM Funds and Pacesetter Capital Group, were originally MESBICs.

- **Community Reinvestment Act (CRA).** The CRA was enacted in 1977 to reduce discriminatory lending practices against minorities and people in LMI neighborhoods by FDIC-insured financial institutions. Since its creation, lenders and community organizations have signed CRA commitments totaling more than $4 trillion.[55]

  The most important impact of the CRA may be on how these financial institutions now view EDM investments. A 2001 study found that 86 percent of financial institutions viewed CRA small business loans as being at least as profitable as non-CRA small business loans.[56] Despite the success of CRA, however, questions remain about the cost of compliance for small institutions and whether to extend the program to other financial institutions.[57]

- **New Markets Tax Credit (NMTC).** Established in 2000, The New Markets Tax Credit awards tax credits to private investors who invest in community development entities (CDE), which are then required to invest those funds in LMI communities. The tax credit, which equals 39 percent of the investment, is spread over seven years. As of October 2007, tax credits had been allocated on $16 billion of invested equity.[58]

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55. *Community Reinvestment Report*. The Federal Reserve Bank of Cleveland, Summer 2007.
56. Yago, Glenn, Zeidman, Betsy, and Abuyuan, Alethea; *A History of Emerging Domestic Markets*; The Milken Institute.
57. Ibid.
58. *New Markets Tax Credit Program Fifth Round (2007) Highlights*; Department of the Treasury.

These initiatives have resulted in much greater capital flows to EDM communities, due primarily to the increased flow of private capital to EDM even as the federal government's share has declined. In 1990, the government accounted for 69 percent of the capital invested in EDM-focused PE funds. By 2000, that had declined to just 19 percent, even though the government's contribution had grown by 70 percent.[59]

The government should be doing more to increase capital flow to EDM businesses. A closer examination of how capital from these programs is allocated raises two primary areas of concern. First, a large portion of the capital does not go to EDM. Only 4 percent of SSBIC capital goes to minority-owned businesses and only 18 percent of CRA small-business loans go to LMI communities.[60] Second, a large portion of the capital is allocated to housing and real estate development as opposed to EDM businesses. Two thirds of NMTC capital[61] and 45 percent of CRA capital[62] support housing and real estate development. Increasing access to low-income housing is important, but to make a real impact on the development of EDM, the federal government needs to also facilitate the creation of sizeable EDM businesses that can contribute significantly to the U.S economy.

Government Tax Policy Potentially Affecting Private Equity Investment and EDM

In response to several recent events, including the financial crisis, new spending proposals, and the election debate over tax policy for the wealthy, Congress and the administration currently are considering new tax legislation that would have a major impact on the PE industry. The legislation under consideration would tax carried interest as ordinary income and increase regulation of the financial industry—the goal being to offset increased spending with increased tax revenue, achieve a sense of tax "fairness," and prevent another financial crisis.

When considering this new legislation, policy makers should weigh both the expected benefits as well as the expected costs to the U.S. economy, to small and middle-market businesses, and to EDM communities. Under the proposed legislation, estimated

59. Brenner, Glen, Holmes, Keon, Munroe, Robert, and Scott, Zuhairah; *The Unique Fundraising Challenges of Private Equity Funds Focused on the Emerging Domestic Market.*
60. CRA National Aggregate Table 2-2, 2007.
61. *New Markets Tax Credit Program Fifth Round (2007) Highlights*; Department of the Treasury.
62. Yago, Glenn, Zeidman, Betsy, and Schmidt, Bill; *Creating Capital, Jobs, and Wealth in Emerging Domestic Markets*; The Milken Institute, January 2003.

revenues to the government could increase by approximately $22 billion over ten years. However, the negative impact is potentially greater, because of the extent to which small private equity firms that invest in the EDM space rely on carried interest to generate the majority of their income. Increasing taxes on carried interest and introducing new regulations could cause disproportionate harm to small and midsize businesses, entrepreneurs, and EDM communities.

Proposed legislation focuses on the taxation of carried interest

President Obama has proposed raising taxes on private equity fund managers and venture capitalists starting in 2011 by taxing their profits as ordinary income instead of capital gains under the long-range federal budget outline.

There are two primary reasons lawmakers propose taxing carried interest as ordinary income. The first is that the expected increase in tax revenue would help offset increased government spending.[63] As the budget deficit grows, there is a renewed emphasis on "pay as you go." The second reason is "fairness".[64] Over the last few years, the size of PE deals and the income earned by GPs has grown larger, attracting more media attention and more pressure on Congress to close perceived "tax loopholes."

Yet the increase in tax revenues from taxing carried interest as ordinary income is likely to be minimal

Using the Black-Scholes method,[65] Michael Knoll of the University of Pennsylvania Law School estimated that by taxing carried interest as ordinary income, government tax receipts would increase by $2 billion to $3 billion annually.[66] The White House budget office's estimates are similar: additional tax revenues of $22 billion over 10 years.

Although $2 billion to $3 billion is a sizeable sum, it would barely make a dent in the amount needed to offset proposed spending. Total 2008 U.S. tax receipts are estimated to

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63. Kirk, William A. *Carried Interest Legislation Threatens EDM Interests*. Journal of EDM Finance, Fall 2007.
64. Ibid.
65. The Black-Scholes method (http://bradley.bradley.edu/~arr/bsm/model.html) is the most widely used model for valuing the value of options. The carried interest paid to GPs is similar to the value of a fractional call option on the total proceeds of all investments.
66. Knoll, Michael. *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income.*

be over $2.5 trillion.[67] Taxing carried interest as ordinary income would increase total tax revenue by about 0.1 percent.

Additionally, tax benefits could be short-lived as partnerships are restructured. Even if the estimated tax benefits are realized, they may not last long. In response to a higher tax burden, GPs are likely to restructure future partnership agreements. There are many possible ways to shift the tax burden away from the GPs to LPs or portfolio companies, thus offsetting the increase in tax revenue. [68]

Proposed policy changes could have a detrimental impact on smaller PE funds, EDM, and the U.S. economy

Even though the proposed policy changes could lead to a minor increase in tax receipts for the government, increasing taxes on carried interest could negatively impact small and middle market businesses and EDM communities.

- ***Smaller investment firms will likely be hurt more severely by increase in carried interest taxes than larger firms.*** Higher taxes on carried interest could harm smaller investment firms disproportionately because the costs in capital and manpower to research and manage a small deal are about the same for both small and large deals. A $100 million PE fund that charges a 2 percent management fee has $2 million dollars per year to allocate to deal expenses and personnel salaries, while a $10 billion fund has $200 million. Hence, smaller PE firms are more heavily dependent upon carried interest as a major source of revenues and compensation for employees.[69]

  If carried interest compensation is reduced, fewer small PE firms may be able to survive financially. With smaller PE firms as risk of shutting down, there would be fewer firms targeting small businesses and Main Street entrepreneurs, including EDM companies. Those firms that do survive may find it much harder to attract quality fund managers, thus making them less competitive. In response, LPs may choose to allocate an even larger percentage of their PE investments to larger funds, giving them an even bigger share of the available capital.

67. Heritage Foundation: *2008 Federal Revenue and Spending Book of Charts.*
68. Knoll, Michael. *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects Taxing Profit Interests as Ordinary Income.*
69. Kirk, William A. *Carried Interest Legislation Threatens EDM Interests*. Journal of EDM Finance, Fall 2007; BCG Interviews of EDM fund managers.

Increasing taxes on carried interest could result in slower job growth, lower wages, and fewer economic benefits for EDM communities

The potential upside from increased tax receipts is likely outweighed by the downside to the economy from the possible negative impact on EDM.

- **The maximum potential upside is $30 million in additional tax revenue from PE investments in EDM.** In 2007, approximately $3.4 billion of PE investments were directed towards EDM. Using Knoll's formula, the expected total increase in carried interest tax revenue from these investments would be $30 million—though the real increase could be significantly lower due to the declines in carried interest over the next few years and the restructuring of partnerships.

- **The potential downside is loss of minority jobs, minority wages, and other lost benefits to EDM entrepreneurs and communities.** Based on just a small sample of representative EDM investments, portfolio companies created over $350 million in revenue and more than 1,700 jobs. In total, EDM investments have created millions of dollars in portfolio company sales and profits, thousands of jobs, millions of dollars in wages and benefits, and millions of dollars in corporate and personal income taxes.

  Thus the economic benefits of PE investments in EDM extend beyond individual portfolio companies and their employees to the communities and the overall U.S economy. By taxing carried interest on EDM investments as ordinary income, however, lawmakers are potentially putting at risk these benefits. The loss of PE investment in EDM, at worst, could mean lost sales and profit growth for portfolio companies, the creation of fewer jobs, and especially jobs for minorities; lost wages and benefits; reduced corporate and income taxes for government; and decreased overall economic activity.

- The impact of raising taxes on carried interest goes beyond the numbers. Also at risk is the development of minority managers like Sergio Oliva, who rose through the ranks at Samy Salon to become the firm's East Coast warehouse manager, and minority entrepreneurs such as Carlos Hernandez, the small business owner who grew his business five-fold by partnering with portfolio company Driftwood Dairy.

As a result, government should carefully consider the impact of potential changes to taxation of carried interest

The creation of new jobs is critical to the effort to lift the U.S. economy out of the current recession. The flow of private capital such as PE to business investments that promotes business development and job growth should be encouraged. Given the already decreased flow of capital to PE, the government should refrain from any policy changes that would further discourage the use of private capital to support new business development and job creation. Policymakers should create incentives to increase the flow of private capital to investments, rather than hinder that flow.

Given the potentially small benefits and potentially high costs of boosting tax rates on carried interest, Congress should carefully consider the implications of any change to the taxation of carried interest.

CHAPTER SIX

RECOMMENDATIONS FOR KEY STAKEHOLDERS

Investors in PE should enhance their awareness of the attractiveness of EDM and increase capital allocation to EDM

- **Develop an increased awareness of EDM and its potential for financial returns.** EDM businesses currently receive just 2 percent of the total PE capital in the U.S., due in part to limited awareness of EDM as an asset class. Yet, EDM investments can generate attractive financial returns. And given the changing demographics of the U.S and the increasing purchasing power of minorities, EDM as an asset class will become increasingly attractive for many years to come. As a first step to reaping the benefits of this growing market opportunity, LPs should take the time to educate themselves in greater depth about EDM.

- **Increase capital allocation to EDM.** In addition to the financial benefits of this asset class, investments in EDM can generate a significant economic impact through the creation of jobs for minorities and in underserved neighborhoods. Pension funds in states with significant minority populations, including California, New York and Texas, have recognized the potential of EDM and its ancillary benefits to their constituents and are already allocating capital to EDM focused funds. To allocate capital efficiently to smaller EDM funds, these pension funds are either investing in funds-of-funds or are creating separate internal organizations that focus exclusively on EDM. The percentage of their capital allocated to EDM is still very small, however, and it must be increased.

- **Direct investment consultants to increase their awareness of EDM and allocate capital to the space using funds of funds.** Consultants have traditionally focused on larger, well-established funds, primarily because their long history of solid returns suggests lower levels of risk, and they can spread out more efficiently the transaction costs involved in research and due diligence. As a result, consultants have been reluctant to consider the smaller EDM funds, despite the attractive returns they can produce.

LPs can play an important and active role in changing the behavior of consultants by creating specific targets and mandates for allocating a certain percentage of their capital to EDM funds and Emerging Managers. Another approach would be to set aside a portion of capital for investments in underserved markets, with an explicit mandate to their consultants to find funds that invest in this space. Finally, LPs should support and leverage funds of funds that specialize in EDM investments, such as Fairview Capital, Bank of America Capital Access Funds, Parish Capital, and Centinela Capital, in order to allocate capital to EDM.

- **Sponsor and support Emerging Manager programs.** Minority fund managers, who are often associated with smaller and newer funds that qualify for Emerging Manager programs, are more likely to invest in EDM. LPs should fund these Emerging Manager programs to support minority fund managers and EDM businesses. According to a report by Northern Trust Global Advisors, emerging managers managing less than $2 billion in assets have been able to generate higher returns in the public equities space than larger, traditional investment managers.[70]

  Simply funding minority managers is not enough to support EDM businesses, however, unless there is an infrastructure in place to generate an ongoing pipeline of talented minority fund managers. To build such a pipeline, financial institutions such as banks, traditional asset managers and private equity firms must hire more minorities and provide them with opportunities to be actively involved in managing investments. Says Willie Woods of ICV Capital Partners: “Some of the minority fund managers could be the next KKRs. If you are an LP, you don’t want to miss them.”

  One such example is Altura Capital, an investment consulting firm that advised CalSTRS on its Emerging Managers program. Alturna has developed a database of Emerging Managers in multiple asset classes including Private Equity (both PE funds and funds-of-funds) that is available through a subscription to the Altura Emerging Manager Information Platform. LPs interested in investing in the emerging managers category can use this database to conduct research and increase their awareness.

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70. Ted Krum, Northern Trust Global Advisors, *Potential Benefits of Investing with Emerging Managers: Can Elephants Dance?*, 2005.

LPs also should ask their consultants and GPs to report on the percentage of minority fund managers within their firm. Having to disclose these metrics may encourage firms to increase their number of minority fund managers.

- **Serve as champions for EDM based on successful investing experience in EDM.** LPs that have been leaders in investing in EDM and have reaped competitive financial returns, including CalPERS, CalSTRS and the New York State CRF, should become strong advocates of EDM. They should actively and frequently publicize the fact that EDM investments are generating attractive returns and share best practices from their experience with the rest of the LP community.

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**. Larger GPs have an important role to play in developing the talent pool of minority fund managers, and they should develop internal initiatives to increase the number of minority fund managers they employ. Large PE firms provide a great training ground for highly talented minority fund managers who could benefit from the experience of working at a well-established fund to earn credibility and recognition in the PE industry. Larger GPs will also gain the internal capabilities and strong relationships needed to invest in EDM. And as more LPs create Emerging Manager programs, larger LPs would have developed the credibility and the minority representation that will help them receive allocations from this pool of capital.

- **Develop increased awareness of EDM as an alternative to mainstream private equity transactions.** Like most LPs, larger traditional GPs have a limited understanding of the EDM asset class and its potential for competitive returns. While most of them agree that the emerging domestic markets are poised for rapid growth, they do not have a clear strategy on how to invest in this space and exploit this phenomenon.

  EDM also is unique in that most of the PE investments in these businesses are typically not as leveraged as mainstream PE investments, a likely result of the historical difficulty EDM businesses have had in obtaining credit financing. That makes EDM investments particularly attractive in the current economic environment, where leverage is harder to obtain.

- **Partner with EDM-focused funds to co-invest in EDM and develop expertise in the space.** With several billions of dollars under management, larger GPs today do not typically invest in smaller companies, because of the high transaction costs involved, relative to the value of the deal. To take advantage of the growing EDM opportunity, larger GPs can partner and co-invest alongside smaller EDM funds. This could be a win-win situation for both sides: The larger funds would not have to allocate significant time to conducting due diligence on EDM companies and picking the right investments; the smaller EDM funds are better positioned to do that. Meanwhile, the smaller funds could leverage the wide network of relationships and the domain and operational expertise of the larger funds to help their portfolio companies.

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 the primary focus on financial returns in EDM investing to dispel any notion of a "social discount."** There is a strong misconception among LPs and consultants that investing in EDM is not truly financially attractive, but rather driven by social development objectives. EDM funds must convince investors and intermediaries that maximizing financial returns is their primary objective. Any other benefits that result from EDM investments—whether they be economic, social, or cultural—are an ancillary, added bonus of investing in minority-oriented and previously underserved markets. Changing this deep-rooted perception will be challenging and will require persistent efforts to emphasize the focus on financial returns.

- **Continue to build a track record of generating competitive financial returns.** The most effective way for EDM funds and minority fund managers to demonstrate their capabilities and the potential of the EDM asset class is by building fact-based evidence of the returns generated on their previous investments.

- **Diversify management talent and expertise to build on the unique capabilities of minority fund managers.** Among the key factors investors and gatekeepers look for when making capital allocation decisions are strong fund management teams. EDM funds should ensure that their management teams have a wide range of capabilities that enable them to produce attractive financial returns. Typically, most EDM funds have

  - Partners with strong finance backgrounds and several years of experience in investment banking or private equity investing, and
  - Partners of minority origin who bring a set of unique capabilities to EDM investing, thanks to their deep understanding of minority entrepreneurs, customers and inner cities and the strong networks they maintain in the EDM space.

However, given their smaller size, EDM funds may not have large management teams with a full range of operational expertise in every sector they might look to invest in. Hence, these funds should strive to

  - Focus on those sectors where the fund's partners have expertise, or attract partners with significant operational experience in particularly attractive target sectors, and
  - Develop a team of external expert advisors who can assist the partners in specific industries as the need arises. Palladium Equity Partners, for example, has assembled a team of expert advisors who spend from one day a month to several days a week assisting different portfolio companies in making operational improvements.

EDM funds could also benefit from having partners on their management team with experience investing outside of EDM. Partners with a track record outside of the EDM space are more likely to have established relationships with investors and consultants who currently do not fund the EDM space, and they can leverage these relationships and contacts to expand the fund's potential sources of capital.

- **Partner with other EDM funds and larger traditional PE funds.** EDM funds can benefit from partnerships or syndicated investments either with other EDM funds or larger traditional funds. The partnerships can help EDM funds in multiple ways, from expanding their range of capabilities to enhancing their credibility in the PE industry.
  - <u>Create a formal structure and process for partnerships:</u> EDM funds should develop concrete processes and formal partnership structures on which the traditional funds can act. EDM funds need to articulate clearly the unique capabilities they bring to table and make a strong case for the mutual benefits to be gained from a partnership.

- Expand range of capabilities: By partnering with other EDM funds or traditional PE funds that offer complementary domain or operational expertise, EDM funds can vastly expand the set of capabilities and support they can provide their portfolio companies. They could also gain access to better deal flow and perform better due diligence on target companies from the increased capabilities and relationships.
- Participate in larger, potentially less risky deals through co-investments: Another benefit of partnering with other funds comes from co-investing in larger deals. Doing so both helps smaller funds participate in larger deals that might not have been possible otherwise and spreads the risk among multiple funds, while bringing to the table the combined capabilities of the partnering funds
- Enhance credibility in the industry: Partnering with larger, traditional firms can bring industry credibility and recognition to smaller EDM funds. This also allows EDM funds to expand their network of relationships, especially with investors who may not be familiar with EDM, and could enable them to tap broader pools of capital that might have otherwise been inaccessible.

  Additionally, enlisting partners from larger funds as advisers to EDM funds could serve the dual purpose of enhancing the credibility of the EDM fund and increasing the awareness of EDM investing among larger funds.

- **Strengthen relationships with senior decision makers at LPs and investment consultants.** EDM funds should develop strong relationships with LPs and their consultants to increase the acceptance of EDM as an attractive asset class. They should start by strengthening existing relationships they may have with key people in the investor community. As these top-performing individuals rise to more senior level positions, they can serve as champions of EDM. Those individuals who move to traditional PE funds will be able to educate them about the potential of EDM as an asset class and play an active role in increasing the capital flow to EDM.[71]

71. Glen Brenner, Keon Holmes, Robert Munroe, Zuhairah Scott, *The Unique Fundraising Challenges of Private Equity Funds Focused on the Emerging Domestic Market*, HBS Study, 2005.

Maintaining strong relationships with LPs also reduces the EDM fund's dependency on consultants. The LPs can, in turn, direct their gatekeepers to research EDM funds and subsequently make direct investments with EDM funds.

EDM funds should also build relationships with other traditional sources of PE capital. Currently EDM funds receive 80% of their capital from three main sources: public pension funds, funds-of-funds, and banks and insurance companies. To increase capital flows, EDM funds should focus on developing relationships at a senior, decision-making level with other traditional sources of PE capital, including corporate pension funds, foundations, endowments, and wealthy individuals.

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

- **Increase networking opportunities for plan sponsors, fund managers and entrepreneurs.** NAIC currently hosts a number of events designed to increase networking relationships by bringing together investors, plan sponsors, funds-of-funds, EDM funds, and entrepreneurs. Interactions between entrepreneurs and fund managers can help increase deal flow, resulting in more successful deals and higher returns and strengthening EDM's claim as an attractive asset class.

- **Increase awareness of EDM among LPs, large GPs and consultants.** In conjunction with its member firms, NAIC should increase the awareness of EDM by explaining the definition of the asset class, highlighting the returns its member firms have achieved and making clear that the focus of EDM investments is financial. In campaigning for the increased awareness and recognition of EDM, NAIC should make use of the full range of communications channels available—from boosting the distribution of the *Journal of EDM Finance* to hosting more networking events and arranging for speakers at other PE industry events.

- **Highlight successful fund managers and their flagship deals.** While PE funds like to publicize the returns they generate at the fund level, they are typically very tight-lipped about individual deals and the returns they generate. Given the wide-spread skepticism about the financial attractiveness of EDM investments, however, it would be beneficial for NAIC and its members firms to provide greater transparency and exposure to their successful deals and the types of competitive returns that EDM investments can achieve.

EDM advocates typically refer to a handful of notable successes, such as Radio One and BET, when making their case for investing in EDM.[72] Yet there are many other examples of highly successful investments made by NAIC member firms that should be highlighted and publicized on a regular basis.

- **Sponsor and publish research on EDM, including best practices for minority businesses seeking capital.** NAIC should continue in its role of sponsoring and publishing research covering a wide range of topics related to EDM, including highlighting the attractiveness of the asset class, the success of its member firms, new trends and developments in the space, and the impact of EDM on the U.S. economy. NAIC should consider partnering with and leverage the services and resources of foundations such as the Kauffman Foundation and the Milken Institute, academic researchers and institutions including Professors Bates, Bradford, Fairchild and Porter, as well as business schools, and consulting firms such as The Boston Consulting Group to conduct studies on its behalf.

  NAIC can also make a significant impact by publishing research on best operational and management practices for EDM businesses. Given their vast collective experience in investing in EDM businesses, NAIC member firms could easily create a list of best practices for professionalizing a business's operational and financial processes. Such a list could also enable fund managers and other financiers to evaluate EDM business more quickly and at lower cost.

- **Communicate the importance of EDM and the critical role of its member firms to policymakers.** NAIC has an important role to play in representing its member firms and the EDM community to policymakers. By leveraging its own research and that of external researchers, NAIC has the potential to help shape future policy decisions that could support the development of EDM infrastructure, direct government spending to benefit EDM businesses and reconsider any regulatory changes that might threaten to reduce capital supply to the EDM space.

72. Ibid.

EDM businesses should focus on growth by effectively leveraging the capital markets and supplier diversity programs

As EDM business seek out ways to grow, they should work to understand the full range of financing options available to them in the capital markets and the criteria the capital markets use in deciding to fund businesses.

- **Learn about financing business growth.** Lack of education concerning the various financing options available to them prevents minority entrepreneurs from taking advantage of the power of capital markets in funding business growth.

  Minority entrepreneurs should take advantage of the education and training programs offered by the government through venues such as the SBDCs and the MBDA or by large corporations through their supplier diversity programs to develop an understanding of the capital markets and the financing options that best suit their business.

- **Realize the importance of equity capital in funding growth.** By resorting to personal finances or debt financing, minority entrepreneurs are limiting the size of potential investments that the cash flow of the business can support to the extent of their personal savings or small loans. The result is slow and incremental growth. Equity capital can provide small and middle market businesses with larger amounts of financing that can help them grow faster.

  Not only can PE funds provide the critical equity capital infusion these businesses need, they can also support entrepreneurs through their experience in the entrepreneur’s business sector, strategic and operational capabilities and network of relationships.

  EDM business owners must understand the key criteria PE funds use to evaluate businesses as potential investments. Business owner should then follow a disciplined approach to streamlining the business to meet those criteria and position the business as an attractive investment opportunity for PE funds.

- **Follow standardized accounting and financial reporting practices to facilitate easy evaluation of the business.** Debt and equity investors alike evaluate the health of the business, its risk profile and profitability, based on standardized accounting and financial statements to conduct their analysis.

EDM businesses seeking external financing must follow a set of professionalized bookkeeping practices to increase the transparency of their operations and financials. Business owners can leverage the training programs offered by the government or enroll in basic accounting and finance courses at local colleges to learn standard practices.

EDM entrepreneurs should also keep their business and personal expenses separate, so that the costs and profitability of the business alone is accurately represented.

- **Broaden the customer base to reduce the risk of concentration.** Minority-owned businesses, especially those that participate in supplier diversity programs at large corporations, often are highly dependent on that one account for a majority of their revenues. EDM businesses need to expand their customer base beyond just one or two major customers to decrease the concentration risk of their business.

- **Develop a business plan that outlines a strategy for growth.** External financiers and equity investors in particular, are interested in the growth prospects of the businesses in which they may invest, and the likelihood of those businesses making a profitable return on their investment. Businesses seeking equity capital should have a business plan that outlines their growth strategy, proposed stages of expansion, and amount of capital infusion needed at each stage. These business plans should also present the unique capabilities that give the company the ability to succeed in its target market relative to its competitors, and the potential exit options for equity investors.

  Several PE firms have stated that they have an open-door policy for entrepreneurs seeking investments. EDM entrepreneurs must use this option to discuss their business plans with a few PE firms to get feedback and advice. To get connected with PE firms, EDM entrepreneurs should seek the help of their local chamber of commerce, other business leaders within their ethnic community, and organizations such as the Marathon Club and NAIC.

- **Build a capable management team that is committed to leading the company's growth plans.** Equity investors often say that one of the most important criteria they look for in a company is the quality of the management team. EDM businesses planning for growth should build a team of experienced and capable managers that can execute on the growth plan. Businesses should showcase the capabilities and commitment of the management team they have in place, and how it might be further supplemented through the PE fund's support.

- **Take advantage of minority business enterprise (MBE) status.** Minority-owned businesses can also use their MBE status to take advantage of special programs and incentives available to support their growth. Even if a business is not more than 50 percent minority-owned to start with, equity financing or a large equity stake by a minority-owned PE fund can help the combined minority ownership exceed the 50 percent threshold required to qualify for these benefits.

- **Use opportunities in supplier diversity programs to expand business.** Several large corporations, most notably the members of the Billion Dollar Roundtable (BDR), have large, well-designed supplier diversity programs to support minority businesses. These include direct purchasing contracts from large minority suppliers and directives to Tier1 suppliers to use Tier 2 and Tier 3 minority suppliers.

  In order to qualify for supplier contracts at large corporations or Tier 1 suppliers, however, EDM businesses must be disciplined and committed to delivering the quality and service levels required. They should leverage education and training programs offered by some large corporations to gain the capabilities required to meet the demands of the corporation.

- **Use various partnering strategies to accelerate growth.** EDM businesses should make use of a variety of partnering strategies such as alliances, joint ventures, mergers and acquisitions, spin-offs and outsourcing to promote faster growth and acquire new capabilities quickly. The increased scale also allows them to compete more effectively against larger businesses. EDM businesses should work closely with their major corporate customers to identify and screen potential partnership opportunities.

- **Continue to serve the growing minority market while taking advantage of opportunities to compete in mainstream and international markets.** As the minority population in the U.S. grows, its purchasing power is increasing rapidly. The potential of this market segment has attracted the attention of all kinds of businesses in multiple industries, including consumer goods, retail, automotive, financial services and telecommunications.

EDM businesses can capitalize on this opportunity by serving as intermediaries linking Corporate America to these new markets, thanks to their better understanding of consumer needs, culture, language and location.

Once EDM businesses succeed in growing within the growing minority consumer market, they should actively look for opportunities to expand into the mainstream market, where attractive adjacencies and favorable opportunities exist. Doing so will enable further growth and the diversification of the customer base and geographic spread.

- **Focus on growth sectors and attractive industries of the future.** Traditionally, EDM businesses have been concentrated in low-growth industries and have struggled to achieve scale. But as they strive to attract equity capital to drive expansion, they need to focus on the growth sectors and industries of the future. EDM businesses need to increase their representation in higher growth industries, such as Professional Services, Information Technology, Security, Construction, and Real Estate, that can provide opportunities for business expansion.

  In addition, the Obama Administration's $789 billion stimulus package, recently passed by Congress,[73] has targeted spending in several industries, creating attractive growth opportunities:

  - **Infrastructure**: Modernizing the U.S electrical grid, expanding broadband coverage nationwide, construction and upgrading of roads and bridges
  - **Energy:** Making investments in energy efficiency and in alternative energy
  - **Healthcare:** Promoting electronic access to medical records at hospitals, and healthcare for all Americans
  - **Education:** Upgrading classrooms, labs and libraries at public schools, colleges and universities

  EDM businesses should focus on these industries, positioning themselves either to capture government contracts directly or to serve as suppliers to holders of government contracts. Some of these industries, including Healthcare and Education, are focused on the consumer and require businesses with special

73. *Time* magazine website: *American Recovery and Reinvestment Plan, Full Remarks of Obama's Stimulus Speech*, January 8, 2009.

capabilities to enable the distribution of these services to the minority population. As the minority population in the U.S grows, these industries can fuel the growth of EDM businesses targeting them for a long time to come.

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.** Corporations can greatly benefit from increasing the diversity of their workforce. The growing minority population represents an increasing portion of corporations' target employee and customer bases. Hiring more minority employees not only helps corporations to effectively integrate the predominantly minority workforce of the future but also positions it to better understand the needs of its minority customer base.

  Beyond creating internal employee diversity programs, corporations should also build experienced teams committed to developing supplier diversity. Such a team should be led by a seasoned executive who is familiar with the corporation's business as well as the environment within which its suppliers operate, and knowledgeable in areas spanning procurement, operations and finance. A team of well-trained buyers, key decision-makers, and leaders will also be needed to support the executive and drive the initiative. The team should have the buy-in and support of top management so that the supplier diversity initiatives receive adequate visibility within the organization.

- **Create a strategic and competitive supplier diversity program to capture share in EDM.** As the BCG-Kauffman report details, a number of studies have shown that using minority suppliers increases brand affinity with minority consumers and helps drive their buying decisions. Major corporations in a number of industries have publicly stated that they have benefited from an increase in brand affinity and higher sales to EDM as a result of supplier diversity programs.

- **Build the business case for a strong supplier diversity program.** Corporations must view their supplier diversity programs as strategic initiatives and create a compelling business case to build a strong program.

- **Match the corporation's requirements with the capabilities of its suppliers, and use those capabilities to expand the program's reach.** Successfully managing a supplier diversity program requires matching the corporation's requirements with the capabilities of its suppliers and categorizing them as Tier 1, 2, or 3; not every minority suppliers will be able to meet the requirements to be a Tier 1 supplier. Corporations should also encourage their suppliers to institute supplier diversity programs of their own. This "snowball effect" will vastly increase the reach of the corporations' diversity initiatives and communicate their commitment to diversity.

- **Support the growth of minority suppliers by facilitating capital access and entering into partnerships.** Corporations should use their resources to assist minority suppliers in securing appropriate financing that will help the suppliers grow and achieve scale. This effort should begin by educating suppliers on the range of financing options available to them and then facilitating communication and capital flow between financers and suppliers. Corporations also should participate in consortia that create pools of available capital for minority businesses. They can also help their suppliers evaluate their strategic decisions and options before the suppliers begin any significant expansion. And they can help minority businesses expand through partnerships such as spin-offs or divestitures of business units, as well as alliances and joint-ventures.

  While these actions directly benefit suppliers, the upside for the corporation in assisting their suppliers is also significant. By helping arrange financing for diverse local suppliers, the proximity and increased scale may reduce the corporation's procurement costs. Corporations might also directly fund a supplier's expansion by taking an equity stake in the supplier, which could lead to greater control over the supplier's operations or a profitable exit for the corporation.

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

- **Refocus efforts on developing larger EDM businesses.** Large EDM businesses are important because they account for a significant percentage of EDM revenue and jobs. The federal government's limited resources should be refocused primarily on specific types of EDM businesses.

- Support EDM businesses with revenue between $500,000 and $5 million. Since PE typically focuses on businesses with revenues greater than $3 million to $5 million, the government should focus on smaller businesses. However, focusing resources on very small businesses (those with revenues of less than $500,000) is an inefficient use of government resources because of the high transaction costs involved in making so many micro investments, the higher risk of working with less established companies, and the small likelihood that a micro business will develop into a sizeable business.
- Enhance EDM business involvement in high growth industries.
- Direct resources to EDM businesses with the most "growth potential," not the most "need."

- **Encourage more private sector participation.** If EDM is to become self-sustaining and flourish, the private sector must get involved—and the federal government should promote that effort.

    - Provide incentives to invest in EDM. The government should provide incentives to the private sector through more programs like the New Market Tax Credit (NMTC) and the Community Reinvestment Act (CRA), while increasing their focus on EDM. Tax incentives for investing in EDM will also help attract private capital to the space.
    - Reform and expand the SBIC. The SBIC is an ideal vehicle for the new focus on companies with revenues between $500,000 and $5 million. While the program has already proved that it can help develop minority businesses, it is not sustainable under its current structure, which takes equity-like risks but is generating debt-like returns, and thus is facing substantial losses. The program needs to be reformed to better align the risk-reward incentives of the government and the SBICs.
    - Set up a government-led fund to invest in EDM. Given the shortage of capital flow to EDM, the federal government should 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.
    - Reconsider taxing carried interest as ordinary income. The negative ramifications to EDM of increasing carried interest taxes have already been discussed in this report. For a relatively minor increase in tax revenue, the job growth and economic impact created by PE investment in EDM could be put at risk. Moreover, increasing carried interest could

potentially hurt and discourage private sector participation in EDM development.

- **Increase the knowledge base and data on EDM business loans and performance.** To properly analyze risk and make sound decisions, both the public and private sectors need access to comprehensive data on EDM businesses, and that is currently lacking. To help build such a database, the government should

    - Increase the collection of data pertaining to EDM business loan characteristics and performance. An effective way to increase capital flow to EDM is to increase the availability of data that can prove that EDM investments and loans offer an attractive risk-reward profile. The government should work with institutions that invest in EDM, such as the SBA and banks, to improve tracking and performance measurement of EDM investments.
    - Fund research on minority business development and performance. The government should partner with foundations and universities in supporting increased research on EDM businesses. Potential partners might include members of the Hispanic Association of Colleges and Universities (HACU), and of Historically Black Colleges and Universities (HBCU), all of which have high minority enrollments and are ideal candidates to take a leading role in furthering such research activities.
    - Provide education and support to EDM businesses to help them gain access to capital markets. Existing programs need to be expanded and outreach needs to be more proactive so that EDM businesses can understand and take advantage of the full range of products available in the capital markets.

- **Develop the infrastructure needed in emerging domestic markets.** There is a strong connection between the development and growth of minority businesses and the inner cities. Developing the infrastructure for low-income communities creates new jobs and reduces transaction costs for businesses operating in those communities.

    It has been shown that regional industry clusters foster innovation, access to resources, and entrepreneurship, and supports business and economic activity within the region. According to studies by the Brookings Institute and the ICIC,[74] a strong correlation exists between cluster strength and patenting rates, entrepreneurship, local wages and per capita GDP.

The Brookings study also points out that the network of these regional clusters within the U.S remains thin. As a result, the U.S economy is not as competitive as it could be and is limited in its capacity to generate and sustain well-paying jobs.

The government should focus on developing inner city infrastructure through a combination of tax incentives and cluster initiative programs.

- **Ensure that EDM businesses are adequately represented in new government stimulus packages.** The proposed stimulus package by the Obama Administration is a great vehicle for supporting EDM development. To increase the impact of the stimulus package, the government should:

    - Direct infrastructure development to inner-city communities that have been historically under-served
    - Use stimulus spending to increase the representation of minorities in high-growth industries such as alternative energy
    - Provide tax incentives for private capital to invest in EDM companies and communities

- **Enable EDM businesses to take advantage of international markets.** Opening international markets to greater involvement by EDM businesses is a great way to help minority businesses grow. Many EDM businesses have a competitive advantage in specific international markets, thanks to their language capabilities, cultural understanding, and relationships in those markets.

  The government already has programs in place that can facilitate opening international markets to greater involvement by minority owned businesses. Programs through the SBA, the U.S. Department of Commerce's MBDA and International Trade Administration (ITA), the Overseas Private Investment Corporation (OPIC), and the Export-Import Bank help small businesses identify and develop overseas opportunities. However, these programs are primarily focused on small businesses. Efforts to reach out to EDM businesses must be

74. Karen G. Mills, Elisabeth B. Reynolds, and Andrew Reamer: *Clusters and Competitiveness: A New Federal Role for Stimulating Regional Economies,* Brookings, April 2008.

increased so that they can take advantage of global opportunities and contribute to the U.S economy.

APPENDIX

Selected case studies of NAIC member firms' portfolio companies

<u>CSA Group</u>

CSA Group, a Hispanic owned and managed, full-service engineering and architectural firm, was experiencing flat revenue growth due to difficulty in obtaining capital to fund expansion.

Based in Puerto Rico, CSA Group is a full-service, project-oriented engineering and architectural firm. For the first 40 years of operations, the firm primarily concentrated on public works projects in Puerto Rico, slowly expanding to the U.S. and Latin America in the 1990s. CSA's owners, senior management and most of the employees are of Hispanic origin.

In the late 1990s, one of CSA's minority owners, J.J. Suarez, bought out the other owners with the intent of shifting the firm's strategic focus. Suarez was born in Cuba, but raised in Puerto Rico, and he believed that the growing Hispanic market in the U.S. and the increased purchasing power of Latin America offered a great opportunity for Hispanic-owned companies like CSA. Suarez intended to grow CSA by focusing primarily on the growing Hispanic market.

Suarez was initially able to refocus the company, but lacked the resources to become a major player in the U.S. market. Successfully winning an engineering contract is largely dependent on a firm's experience and contacts. Without the contacts to learn about potential bids and the finances to bid on numerous projects, CSA's growth remained flat. From 2000 to 2004, revenue fluctuated between $37 million and 42 million, and total employees remained around 300 people.

A private equity investment from Hispania Capital Partners provided a capital infusion along with operational support and enhanced relationships.

In 2001, another Puerto Rican, Fred Reifkohl, joined CSA as its Chief Financial Officer. Around the same time, Carlos Signoret and his partners at HCP were beginning to raise their first fund. Reifkohl and Signoret had a prior relationship, having attended business school at the University of Michigan at the same time, and working together at Chase.

Signoret believed that the growing U.S. Hispanic market was underserved in many business activities and that these inefficiencies, together with favorable demographics in the U.S., offered a great opportunity to invest in and grow companies that served the U.S. Hispanic market. Signoret shared his vision with Reifkohl, who introduced him to Suarez so that they could discuss a potential investment.

During this time, CSA also met with a few other PE firms, but the conversations never progressed very far. “[The other PE firms] just didn’t get it,” said Reifkohl. “They didn’t understand our strategy to focus on the Hispanic market. They wanted us to target the mainstream market.” But because HCP’s founders were Hispanic and believed in the potential of the Hispanic market, “they shared our vision and we were able to directly discuss operations and financials, without having to convince them of our overall strategy,” said Reifkohl. In 2005, HCP invested $10 million in CSA to fund the firm’s growth plans.

HCP’s investment helped CSA achieve impressive growth and generated significant economic impact.

In the years following HCP’s investment, CSA’s growth skyrocketed, creating economic benefits for the company, its employees, and the community.

The impact on the company and its business
Between 2005 and 2008:

- Revenues have almost doubled, increasing from $43 million to $80 million, a CAGR of 17 percent.
- CSA Group became the largest Hispanic-owned full service engineering and architectural firm in the U.S. It is consistently ranked by Engineering News Record (ENR) among the Top 500 Design Firms, and among the Top 200 Environmental Firms in the U.S. Most recently, it was ranked by Zweig White as one of the hottest and fastest growing firms in the country in 2008.

HCP was instrumental in helping CSA expand its financial relationships and network contacts. CSA didn’t have established banking relationships in the various communities in the U.S. where it was bidding for projects, and HCP was crucial in establishing those relationships. HCP also introduced Suarez and Riefkohl to many key contacts and decision makers for engineering and architectural contracts, especially contacts in the U.S. Hispanic market. One of those contacts was at the time the President of the Hispanic Chamber of Commerce, who later moved on to serve on the boards of several of CSA’s current and potential clients.

HCP also helped CSA formalize its governance and decision-making processes. “Previously, the board meetings were just Suarez and me discussing the overall strategy,” said Reifkohl. “Now we have HCP partners on our board, we provide formal presentations to the board, and we drill down deeper into our strategy. It’s a healthy relationship because [HCP] forces you to be wiser with your own money.”

The impact on job creation and employees

Between 2005 and 2008,

- The number of employees has grown from 373 to 558, a CAGR of 14 percent.
- Average salaries increased to $69,000, compared with the U.S. mean income of $42,500 for full-time civilian workers.
- 95 percent of the employees were of ethnic decent, and primarily Hispanic, in 2008.
- 100 percent of employees received medical benefits in 2008.

As CSA has grown, its employees have experienced increased stature and access to more opportunities. Suarez and Reifkohl are regularly asked to speak about their experience as the minority owners of a large company and their experience working with private equity. A few of CSA’s employees have also been asked by the new governor of Puerto Rico to serve in high-level economic development positions, and one was recently appointed.

Impact on the community and the overall economy

By creating several high-paying jobs and supporting other businesses, HCP’s investment has led to increased economic activity and higher tax revenues for the government. In 2008:

- CSA paid $38.6 million in salaries, creating income tax revenues of approximately $13.5 million, if taxed at a rate of 35 percent.
- CSA made purchases from other businesses worth $33.4 million.

Perhaps the biggest impact of HSP’s investment has been the ripple effect generated by the continuing growth of a large Hispanic-owned company. When it enters new markets, CSA often meets with local public officials, who are invariably amazed that such a large minority-owned firm exists. Most people aren’t used to dealing with such a successful minority-owned firm, and working with such a firm provides these officials with credibility among their constituents. “When people see a large, successful Hispanic-owned firm, it gives hope to all of the smaller Hispanic firms that they too can grow and be successful,” said Reifkohl.

<u>Driftwood Dairy</u>

In 2006, Driftwood Dairy, a full service dairy serving the Southern California market since 1918, was looking for new ways to expand its business.

Driftwood Dairy was founded in 1918 by Pat J. Dolan, an Irish immigrant who bought a few cows and started selling milk in Los Angeles. After a few years of operation, Pat moved the dairy to north El Monte in 1928, but in the late 1930s a milk price war broke out, and in 1942 he sold the business.

Four years later, his son Mike, decided to get back into the dairy business on his own, so he assumed the operations at Driftwood Dairy in El Monte on April 1, 1946, which then consisted of one cash-and-carry store and one home delivery route. Over the years, Driftwood expanded its milk production and distribution to include a full range of dairy products, while increasing its customer base. By 2006, Driftwood had sales of $78 million, a huge leap compared to the $6,800 it made in its first month of sales in 1946. However, growth was slowing and Driftwood needed to make additional investments to upgrade its operations and compete effectively with other dairies. But some of the owners of the business were planning to retire and were not inclined to invest more money into the business.

Private equity firm Marwit Capital provided the capital Driftwood needed for expansion, and helped the company shape its new strategy to target the growing Hispanic market in Southern California.

The financing for expansion was provided by Marwit Capital, a private equity firm and a member of NAIC, which made an equity investment in Driftwood Dairy in July 2006 and brought in a new CEO to develop and pursue a growth strategy. The new CEO, Mac Berry, had several years of experience in the food industry at Winn-Dixie and Safeway. Marwit's investment and Berry's positive interactions with Sam Sippl, a partner at Marwit Capital, were highly influential factors in his decision to join Driftwood Dairy. Berry said, "I may not have joined Driftwood if not for Marwit's investment and the quality of its management team".

The founding Dolan family members continued to be closely involved with the business; several hold senior management roles. Marwit worked closely with the Driftwood management to develop a focused growth strategy and make operational improvements. According to Berry, "Marwit's support was exceptional. Every time we needed support, they were instrumental in investigating the problem, providing access to their research and databases, and discussing a solution."

Marwit provided support in several areas of the company, including human resources, insurance, legal affairs, branding, and banking relationships, while playing a major role in reshaping its strategy. With the recent consolidation of dairy industry, many companies had become so big and so focused on retail that they could no longer efficiently service smaller, non-retail clients such as schools, and small businesses such as local hospitals and See's Candy. Marwit helped Driftwood invest in and enhance their core competencies in distribution and sales to capture the niche between small individual dairies and large-scale farms.

With Marwit's guidance, Driftwood increased its focus on the growing base of Hispanic customers in Southern California and created a specialty sales team for the Hispanic market. They began tailoring products to Hispanic customers with dual language printing on all products and sales literature, and bilingual customer service.

They also brought in Laura Trujillo, a specialist in institutional health, to improve their product line. Driftwood created a healthier line of products for schoolchildren, replacing high-fructose corn syrup with cane sugar in flavored milk, offering non-fat flavored milk and soy products for lactose intolerant kids, and becoming the first supplier in California to be compliant with the Clinton Initiative to increase nutrition in schools.

Driftwood and Marwit also worked together to make significant operational improvements in several areas:

- Replaced existing fleet of trucks with newer, greener trucks that performed above California's emissions requirements.
- Added GPS to delivery trucks to monitor and restructure routes.
- Added new software to track customer service and food safety.
- Doubled mix-making capacity and built a new facility to serve businesses like Wendy's.

Marwit's investment helped Driftwood successfully position itself for growth and generated significant economic impact.

In the years following Marwit's investment, Driftwood has been able to strengthen its business with new products and new customers and is once again experiencing faster growth.

Impact on the company and its business

Driftwood made significant progress on several fronts from the time of Marwit's investment in July 2006 to the end of 2008:

- Revenues increased at a CAGR of 14 percent, from $78 million to $102 million in just two years, and the company expects revenues of $120 million by 2010.
- Regained No. 1 market share position in supplying dairy products to schools in Los Angeles, currently serving 71 percent.
- Gained six to seven new hospital accounts.
- Won new accounts through new products, providing cream to Heinz and custom-packaged dairy products for Wendy's in southern California, and is being considered for Wendy's in Nevada.
- Expanded customer base to include schools, hospitals, food product manufacturers, independent markets, restaurants, bakeries, coffee houses, cafeterias and even other creameries.

Impact on job growth and employees

Driftwood has supported job creation in southern California, with several of these new jobs going to minorities. From the year of Marwit's investment in 2006 to 2008:

- The number of employees grew from 239 to 250
- Average salaries have reached $56,000, compared with the U.S. mean income of $42,500 for full-time civilian workers.
- 72 percent of the employees of ethnic descent, primarily Hispanic, in 2008.
- 100 percent of employees received medical benefits in 2008.
- 100 percent of employees received disability benefits in 2008.
- 100 percent of employees received retirement benefits in 2008.

Driftwood almost exclusively trains, mentors, and promotes employees from within the organization, creating opportunities for many minority employees to attain management positions. One example is Eddie Rodriguez, who originally joined Driftwood as a baker and rose to become a Plant Superintendent by 2007. In 2008, he was promoted once again to the position of Plant Manager.

Driftwood also provides employees with training for specialized skills and to improve language skills.

Impact on the community and the overall economy

Driftwood also supports several local businesses, several of them minority-owned, by using them as suppliers, further supporting job creation and increased economic activity.

- Driftwood purchases milk from the regional Dairy Farmers of America, which employs a large proportion of Hispanic workers.
- Plastic bottles are provided by Consolidated, which has part-minority ownership and a large percentage of minority employees.

- In 2008, Driftwood made $80 million in purchases from suppliers, supporting several businesses.
- In 2008, Driftwood paid $14 million in employee salaries, leading to $5 million in tax revenues for the government, calculated at a 35 percent individual tax rate.

Driftwood has also helped develop and foster independent distributors to gain access to strategic markets. Carlos Hernandez, for example, runs a small family business with his own fleet of trucks and does deliveries for Driftwood. Prior to his relationship with Driftwood, he had one truck and no employees. Driftwood put in a good word with his bank so he could get financing and sold him the equipment needed at market rates. Now Hernandez has four trucks and five employees and has become an important delivery channel for the ethnic neighborhoods that he is familiar with.

<u>Systems Integrators, Inc. and Tower of Babel</u>

Systems Integrators, Inc.

Systems Integrators Inc., a provider of publishing systems software to several major newspapers, was in bankruptcy, and because its current owners did not believe in the potential of the business to become profitable again, they were reluctant to invest additional capital.

Systems Integrators (SII) was founded by a software engineer who saw the opportunity in the automation of software-based publishing systems for managing editorial content and classified ads. The company succeeded in selling its software to several major newspapers, and went public in the early 1980s. Later that decade, Citigroup took the company private in a leveraged buyout. Unfortunately, the company was over-leveraged and declared bankruptcy in the early 1990s.

Meanwhile, in 1995, Frank Washington, an African-American entrepreneur and SII's current CEO, was looking to acquire cable systems, including Viacom, at that time a home cable company. But the deal fell apart. Washington had heard of SII and its bankruptcy, and he thought the company had the potential to become profitable again, given the value of its unique technology to newspaper companies. So he approached the owners of SII as it came out of bankruptcy, including Bank of America, Chase and PE firm Cerberus Capital, with the intent to buy the firm. But they wanted Washington to join the company as the CEO hoping he could turn it around. Washington was able to successfully recruit outstanding local talent to help manage through the turnaround and execute on a business plan that enabled the company to attract private equity investors.

SII's original systems were designed to handle only text. But Washington had a vision of expanding its capabilities to include multimedia content, which was becoming popular with the growth of the Internet. But the current owners, including Cerberus, were reluctant to invest any more money in the business. Washington had to look for external sources of capital from investors who recognized the potential of the business and were willing to provide patient equity capital. But, according to Washington, "In 1995, every PE firm wanted to invest in a dot.com and no one was interested in investing in a publishing systems company."

Opportunity Capital Partners (OCP), a private equity firm, believed in Washington's vision and made the investment to buy out the stake of the banks and provide capital to support SII's expansion plan.

Through an investment banker friend, Washington was introduced to Opportunity Capital Partners (OCP) and PaceSetter, both PE firms investing in small to mid-market companies. OCP and Pacesetter, together with a Connecticut-based pension fund, made an investment and bought out the stake of the other investors except for Cerberus, which kept its stake. The investment helped Washington to upgrade SII's systems to be Y2K-compliant and develop a content management system to handle multimedia content.

The upgrade was well timed and well executed. Newspaper companies worldwide were worried about Y2K compliance and SII was able to address their concerns through their upgraded systems. SII used this opportunity to win several new customers and was managing the publishing systems software for one-third of the major newspapers in the world, including the Financial Times, the Chicago Tribune and the Washington Post, as well as major news providers such as Reuters.

During the entire process, OCP—and especially Anita S. Grahams, a partner at OCP—were closely involved with SII. Initially when Washington came on board, he had to focus on cutting costs and streamlining operations to bring the business to break-even and position it for profitable growth. According to Washington "OCP and Anita were great partners throughout this process, helping us with operational issues and acting as a sounding board and a source of valuable advice."

OCP's investment helped SII successfully turn around its business and achieve profitable growth

Impact on the company and its business

The capital and guidance provided by OCP and Pacesetter enabled SII to transform its unprofitable business, gain market share and be profitable again. From the time of OCP's investment in 1998 to the acquisition of SII by a German publishing systems company in 2000:

- Revenues almost doubled, from $22 million in 1998 to $40 million in 2000.
- Net income increased from a loss of $2 million in 1998 to a profit of $6 million in 2000.

Impact on job growth, employees and the overall economy

From the year of OCP and Pacesetter's investment in 1998 to 2000, SII had created several high-paying jobs.

- SII had 185 employees in 2000, an increase of 15 percent, or approximately 20 employees, over 1998.
- The average annual employee salary was $71,000, compared to the U.S. mean income of $42,500 for full-time civilian workers.
- SII offered health benefits and a 401k plan to 100 percent of its U.S.-based employees.
- Tax revenues to the government from income tax on employee salaries would equal $4.5 million at an individual tax rate of 35 percent.

Tower of Babel

Thanks to the successful turnaround of SII and its profitable sale, in 2004, Frank Washington launch Tower of Babel, a local TV station with specialized foreign language programming for several groups of immigrants in the U.S.

With several years of experience in the cable business, Washington realized that about 100,000 Russians lived in the Sacramento area who had no local TV programming geared for them. Washington bought a local TV station and entered into an arrangement with Comcast to carry the station on its Sacramento cable network. Between 2005 and 2007, Washington spent time perfecting the content and running a low-cost breakeven operation.

But to grow further, the company would need to expand both its management team and its programming content, all of which required additional capital. So Washington reached out once again to OCP. Based on Washington's previous relationship with OCP, the PE firm was confident that Washington could reach his vision and maximize the potential of Tower of Babel. In 2007, it made an equity investment together with another NAIC member firm, SYNCOM Funds.

Washington again expanded his management team by recruiting outstanding local talent, including a Chief Operating Officer and a Head of Sales. Steve Orlando, the former CFO at SII, also joined the team. Tower of Babel expanded its programming content to several other foreign languages, including Mandarin, Cantonese, Punjabi, Vietnamese, Indonesian and Korean. Tower of Babel has also enhanced its distribution relationships with Comcast in San Francisco and Time Warner in New York City.

While the company is just starting on its growth path and revenues were a modest $600,000 in 2008, they are expected to triple to $1.8 million in 2009. Future growth plans target expansion to nine new markets, with expected revenues of $26 million by 2013. In 2008, the company had 13 employees at an average salary of $69,000, compared with the U.S mean income of $42,500 for full-time civilian workers. Of those employees, 54 percent are female and 46 percent are minorities.

OCP and Pacesetter's initial investment and support for a minority entrepreneur like Frank Washington has allowed him to launch multiple businesses and create new jobs that contribute to the overall economic growth in the U.S.

Marshall Retail Group

Marshall Retail Group (MRG), an owner and operator of specialty retail stores in casinos in the U.S., needed capital and management support to expand its business.

MRG owns and operates specialty retail stores in major casinos in different U.S locations. It was founded by the Marshall family over 50 years ago as a women's store and has since expanded to multiple store formats, including logo and souvenir stores, apparel and accessories stores, and Harley Davidson licensed apparel stores, with shops in several casinos.

Operations were funded almost entirely with cash flow generated by the business; hence, growth had been slow and incremental. To achieve faster growth, the Marshall family realized they needed more capital investment and experienced management to execute on the growth plan. So they approached several private equity firms for capital and management support.

ICV Capital, a private equity firm, provided the capital needed for expansion, and helped MRG hire a new management team and enhance the company's relationship with other financiers and casinos.

MRG made a pitch to multiple PE firms and finally decided on ICV, primarily because the management teams on both sides shared a common vision and quickly developed a level of comfort and understanding. ICV Capital, led by its founding partners Willie Woods and Tarrus Richardson, showed a degree of interest and commitment that impressed the Marshall family and led to ICV making an equity investment in 2003. MRG had recently hired a new CEO, who was experienced in casino-retail operations, to run the business and pursue an expansion plan.

The new CEO, Michael Wilkins, had run the retail operations at Park Place casinos in the 1990s and was the landlord for some of MRG's stores. The fact that the Marshall family was reaching out to PE funds to make an investment was a major reason Wilkins joined MRG.

While ICV was very involved right from the start, for the most part it let MRG run the business. The MRG deal was one of the earlier investments that ICV made, but they were able to add tremendous value to MRG in several areas that helped grow the business

- Helped MRG develop new store formats.
- Enabled new banking relationships to gain financing.
- Arranged meetings between MRG and big casinos, primarily through ICV's contacts at investments banks and other PE firms that had strong relationships with those casinos.
- As Berry said, "ICV helped us expand our relationships. They set up a meeting for us with Donald Trump, a meeting we had been trying to get for years, and led to a store opening in Trump's casino in Atlantic City"

ICV's investment helped MRG expand its business to several new casinos and double its profitability in just two years

Impact on the company and its business

MRG created new store formats and opened new stores in several new casinos nationwide since ICV's investment in 2003

- MRG currently operates 70 specialty retail stores in major casinos in Las Vegas, Atlantic City, Fort Lauderdale, Pennsylvania, and Tunica.

- ICV's minority ownership gave MRG new avenues for expansion, since most casinos as well as Las Vegas's McCarran Airport have their own initiatives to source from minority-owned companies.

As a result

- Revenue grew from $50 million in 2003 to $90 million in 2008, a CAGR of 12 percent.
- Operating profit more than doubled from $8 million in 2003 to $18 million in 2008.

Impact on job growth and employees

From 2003, when ICV first invested in MRG, to 2008, MRG has supported job creation in several cities in the U.S., with most of these jobs going to women and minorities.

- The number of employees grew from 400 in 2003 to 600 in 2008, a CAGR of 8 percent.
- Average salaries increased from $23K in 2003 to $26K in 2008.
- In 2008, 79 percent of MRG's employees were women and 50 percent were minorities.

Impact on the community and the overall economy

MRG supports several small and minority-owned businesses through the purchase and procurement of goods, promoting further job creation and increased economic activity. The job creation and business growth also lead to higher tax revenues for the government.

In 2008, MRG

- Made purchases of $37 million from other businesses, supporting additional jobs and leading to more tax revenues for the government.
- Paid $1.5 million in corporate income taxes.
- Paid $15.3 million in employee salaries, leading to tax revenues of $5.3 million in tax revenues, if calculated at a 35 percent individual tax rate.

MRG was a successful investment for ICV, and it was profitably sold in 2005 to BRS, another investment firm. In 2008, ICV reacquired MRG after the PE firm saw additional opportunity for growth and because it already had an established relationship with MRG's management. The next phase of expansion is likely to create additional jobs in several locations in the U.S

Samy Company

Samy Co., a manufacturer and distributor of hair care products, was trying to target the mainstream market beyond its primary base of Hispanic consumers and expand its business, but was facing difficulty obtaining financing

Samy Co. was originally started by a popular celebrity hair-stylist, Samy Suarez, along with Luis Delgado, in Miami. The company's products were marketed primarily to Hispanic customers through salons. The cofounders soon realized that their products were well-received, and that they had an attractive growth opportunity in marketing their products not only to the U.S.'s growing Hispanic population but also to the general population.

In order to implement that strategy, they needed capital and a larger and stronger management team that could define the proper growth strategy and build relationships and distribution through retail channels. Obtaining financing for their idea was difficult, however, as most banks and other financiers did not believe in the growth potential of Samy's business.

Hispania Capital Partners (HCP), a private equity firm run by Hispanic fund managers, recognized the market opportunity that Samy could capitalize on and provided the support the company needed in the form of equity capital and strategic and operational guidance.

HCP is a PE firm run primarily by Hispanic fund managers that has made several investments in companies targeting the growing Hispanic consumer base. Once HCP's management had heard of Samy Co., they readily recognized its potential and approached Delgado and Suarez to discuss investment options.

In 2004, HCP made an equity investment in Samy Co. and brought in a new senior management team to develop and execute a growth strategy, including Joe LaHurd, the CFO, Sam Maniaci, the Vice President of Sales, as well as a Director of Operations to support Luis Delgado, who continued to serve as CEO. HCP and Samy worked closely with a consulting firm to develop the strategic plan and expand to multiple product lines. They invested in marketing and opened a flagship Samy Co. outlet in South Beach, Miami to promote the brand's image. HCP's investment also allowed Samy to increase its working capital, which enabled it to carry the higher level of inventories needed to supply a growing number of retail customers. Maniaci was instrumental in expanding Samy's presence into the food, drug and mass retail channels.

“HCP was great to work with,” said CFO LaHurd. “Its management team, specifically Victor Maruri and Jim Bland, provided a leadership role in the company and were highly respected by Samy’s executives.” HCP had unique and helpful insights on Hispanic customers, as well as the access to industry data and metrics that proved invaluable in developing and implementing the growth strategy.

Working with HCP, Samy has been able not only to strengthen its offerings to the Hispanic customers but also to gain market share among mainstream customers.

HCP’s investment helped Samy successfully expand its business to 20 countries and 60 different retail chains. The firm’s support not only created remarkable growth for Samy but also generated significant economic impact.

Impact on the company and its business

Thanks to HCP’s investment and the management guidance it provided, Samy Co. has expanded its product lines and retail presence to target new customers worldwide. Samy currently sells a full range of hair care products through more than 32,000 stores across 60 different retail chains and Home Shopping Networks in 20 countries. The impact of HCP’s investment on Samy’s success and growth has been impressive:

- Revenues quadrupled from $10 million in 2004 to $40 million in 2008, a phenomenal CAGR of 41 percent.
- Samy has expanded from just one product line in 2004 to six in 2008.
- It now sells products around the world, with a major presence in Germany, the U.K., Australia and Canada, and it is currently planning to expand to Latin America, with local manufacturing plants in Mexico and Brazil.
- Samy was acquired by a Japanese hair care products company Hoyu in 2008, leading to a profitable exit for HCP and significant payouts for several of Samy’s employees.

Impact on job growth, employees and the overall economy

From 2004, when HCP first invested in Samy, to 2008, the company has created a number of high-paying jobs in south Florida, with several of these jobs going to minorities:

- The number of employees grew from 17 in 2004 to 60 in 2008, a CAGR of 38 percent.
- Average salary per employee reached $59,000 in 2008, compared to the mean income of $42,500 for full-time civilian workers in the U.S.
- In 2008, 82 percent of the employees were of ethnic descent, primarily Hispanic.
- All of its employees received health benefits in 2008.

- Four fifths of its employees received retirement benefits.
- One quarter of its employees received stock options.

Samy also offers training programs to its employees and supports their growth within the organization. Sergio Oliva, for instance, started as an operations support assistant. He had a high school education with some college credits but was eager to learn and willing to take on more responsibilities. He was initially made supervisor of the Miami warehouse and is now Manager of Warehousing for the East Coast and of distribution nationally. As he rose, Oliva increased his annual salary by more than 60 percent, and received a sizeable payout when he exercised his stock options after the sale of Samy to Hoyu.

Samy's success has also created more visibility, recognition and career opportunities for Suarez and other executives:

- Suarez has his own show on Good Morning America and was named by *USA Today* as one of the Top 10 hair stylists in the U.S.
- Sam Maniaci, the Vice President of Sales, was later promoted to CEO; after the Hoyu acquisition, he became the CEO of Hoyu's North American operations.
- Samy's Vice President of Marketing left in 2007 to become the CEO of Dr. Brandt, a skin care company.

The growth of Samy's business and the jobs created in the process led to increased economic activity in the area and higher tax revenues for the government. In 2008, Samy paid total salaries of $3.6 million, which led to individual income tax revenues of $1.26 million for the government, at the tax rate of 35 percent.

V-me

V-me, a Spanish language television network provides specialty programming to over 50 million U.S. households.

Even though it only began broadcasting in 2007, by the end of 2009, V-me will be the third-largest Spanish language television network in the U.S. The network currently reaches more than 50 million households, including more than 8 million Spanish speaking households. Once the conversion to digital broadcasting is complete, V-me will add another 12 million mainstream households and 600,000 Hispanic households, fully 70 percent of all Hispanic households in the U.S.

While other networks focused on the Hispanic market air general programming content, with an emphasis on sports,, telenovelas, game shows and talk shows, V-me focuses on genres that are popular in the general market, but under-represented in the Hispanic market, including current affairs, “edutainment” (cooking shows, nature programs, documentaries, “how-to”), and children’s programming that balances the entertainment and educational needs of viewers.

Through a unique public-private partnership, V-me leverages the public television broadcasting network for distributing its content. The public television network, including V-me, is delivered to viewers through a number of cable providers, satellite providers and over-the-air broadcasts.

Private equity firm SYNCOM provided early-stage capital and strategic support for V-me.

NAIC member SYNCOM committed to investing $25 million in V-me during the company’s formation in 2006. As V-me met its development milestones, the staged investment provided the firm with additional capital, and later a commitment of $5 million in convertible warrants. In addition to the initial capital commitment, SYNCOM supported V-me in developing its overall strategy and facilitating key introductions. Carmen DiRienzo, CEO of V-me, said, “The relationship with SYNCOM is outstanding. They give us unparalleled guidance and bring a lot of industry experience to the table.” That guidance includes assisting V-me in their expansion strategy, marketing, recruitment, and purchasing of systems. SYNCOM also helped V-me expand its business relationships by providing contacts at marketing firms and with executives who have built similar media companies.

DiRienzo also points out that working with an EDM-focused PE firm was advantageous to V-me because of its strong network of contacts and previous work investing in ethnically-focused media companies. SYNCOM saw the potential opportunity V-me presented in targeting the growing Hispanic demographic, with its increasing purchasing power. The equity investment allowed V-me to grow to its current size, while providing a longer-term horizon to become profitable, something that debt financing would not have allowed. “SYNCOM’s investment has single-handedly made it possible to create a third Hispanic TV market in the US,” DiRienzo said. “Without SYNCOM, I cannot imagine achieving the growth we did.”

SYNCOM’s investment allowed V-me to achieve revenue and job growth in addition to generating a large impact on the community and the overall economy.

In its first year of broadcasting in 2007, V-me had revenues of $700,000. Since then it has been growingly rapidly, doubling its revenues to $1.5 million in 2008. If it reached its projected revenues of more than $8 million in 2009, it will have attained an outstanding rate of growth of over 11 times in just two years.

Impact on job creation and employees

V-me employs 30 full-time employees in addition to 20 freelancers who help with advertising, production, graphics, public relations, and the like. The company’s five-year plan includes hiring an additional 70 employees.

- V-me pays an average salary of $108,000, compared to the U.S mean income of $42,500 for full-time civilian workers.
- 53 percent of employees were minorities in 2008.
- 50 percent were female in 2008.
- 67 percent of full-time employees received medical benefits in 2008.
- 100 percent of full-time employees received disability benefits in 2008.

Other benefits offered by V-me include language training, educational programs and citizenship assistance.

SYNCOM’s investment also enabled CEO DiRienzo to increase her entrepreneurial experience and presence as a businesswoman in the industry.

Impact on the community and the overall economy

- V-me paid salaries of $5.4 million in 2008, leading to individual income tax receipts of $1.9 million for the government, calculated at a tax rate of 35 percent.
- The company made purchases from suppliers of $7.5 million in 2008, supporting a variety of other businesses and jobs.

V-me’s programming includes a number of shows that help non-English speaking audiences learn English, as well as other educational content for children, programs too often overlooked by other networks. As the proportion of Hispanics in the U.S. continues to grow, providing them with educational tools to improve their English language skills will better integrate them into society and the workforce, further driving the growth of the U.S economy in the future. V-me’s programming leads to an increase in the quality of life of an often-overlooked Hispanic viewer base.