

MINUTES OF THE SENATE COMMERCE COMMITTEE.

The meeting was called to order by Chairperson Karin Brownlee at 8:30 a.m. on January 23, 2003 in Room 123-S of the Capitol.

All members were present except: Senator Dave Kerr, excused

Committee staff present: April Holman, Legislative Research
Deb Hollon, Legislative Research
Mitch Rice, Revisor of Statutes
Jodie Anspaugh, Secretary

Conferees appearing before the committee: Mark Drabenstott, Vice President and Director, Center for the Study of Rural America, Federal Reserve Bank of Kansas City

Others attending: See attached list.

Chairperson Brownlee mentioned that the appointees from Kansas, Inc. and KTECH that are being voted on in the Senate today. Jodie Anspaugh has information on the appointees, if anyone is interested.

Chairperson Brownlee announced that Chuck Banks from USDA will speak about the Farm Bill and rural economic development at the joint meeting of the Senate Commerce and Agriculture Committees.

Mark Drabenstott from the Federal Reserve Bank of Kansas City is head of the Center for the Study of Rural America and spoke to the committee about rural economic issues (Attachment 1).

Mr. Drabenstott brought a copy of the Center for the Study of Rural America's 2002 Annual Report and a copy of the proceedings from the 2002 national conference hosted in Kansas City on rural policy issues (both are available from the Federal Reserve Bank of Kansas City), to help identify the best strategies for developing regional economic development nationwide. He brought a copy of their monthly publication called "The Main Street Economist," a newsletter that highlights one economic issue facing rural America each month (Attachment 2).

Mr. Drabenstott stressed a need to focus more on product agriculture, rather than commodities agriculture. Many farmers cannot survive in a commodities-based agriculture system when the largest farms are so big. The newest opportunity in farming is known as "Farmaceuticals." In Iowa, a group of farmers is working to grow a plant that creates an enzyme needed for cystic fibrosis drugs. An \$80 million processing plant to extract the enzyme will be built. This will create high-skill, high-wage jobs. To improve the Iowa project, ISO-9000 standards are needed and farmers from many different communities and counties must be willing to work together to ensure identical growing conditions.

E-commerce is an area with much potential. Broadband should be seen as the beginning, not the end or final goal. A two-pronged attack is needed to develop new businesses: the right infrastructure and entrepreneurial support. Good rural policy will consider three things: place, partnering between rural firms, and regional competitiveness.

Mr. Drabenstott had a question and answer period. ISO 9000, economic growth indicators, regional partnering, and broadband were discussed.

The meeting was adjourned at 9:30 a.m.

The next meeting is scheduled for January 24, 2003 at 8:30 a.m.

SENATE COMMERCE COMMITTEE

GUEST LIST

DATE: Thursday, Jan. 23, 2003

NAME	REPRESENTING
Amber Kjelskus	Sen. Pete Brungardt - intern
Dann Teske	Ks Farmers Union
NED WEBB	KDOCH
Pat Hubbell	Kansas Railroads
Barole Jordan	KDA
Charles Heath	Senator Emler
Ron Seebert	Haw law firm
Sook Park	KDOCH

**New Horizons for the
Kansas Economy**

Mark Drabentstott
Center for the Study of Rural America
Federal Reserve Bank of Kansas City

Center for the Study of Rural America, FRBKC

**New Horizons for the
Kansas Economy**

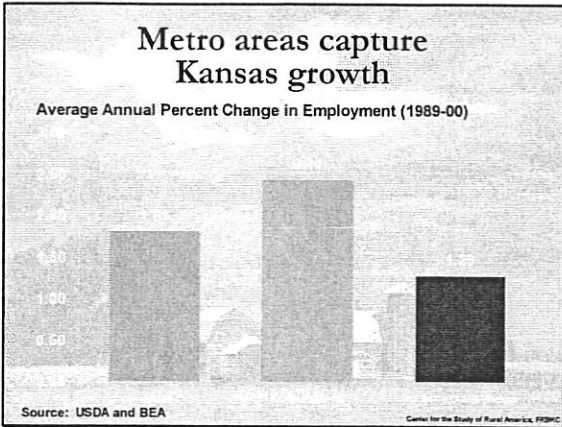
- New rural realities in Kansas
- A new horizon of opportunity
- New strategies for the new horizon

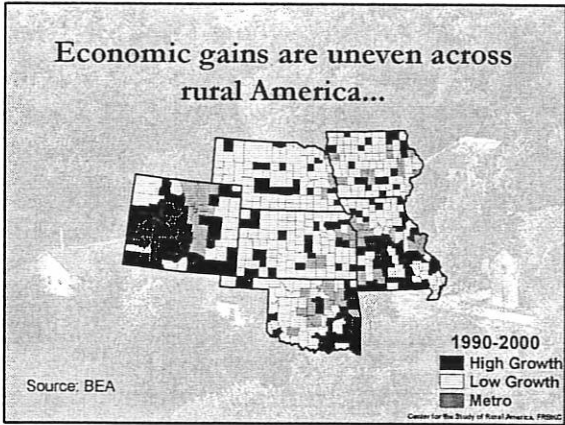
Center for the Study of Rural America, FRBKC

New realities for rural Kansas

- A weak rural economy
- Lagging incomes
- A dwindling farm impact
- Stagnant or falling population

Center for the Study of Rural America, FRBKC

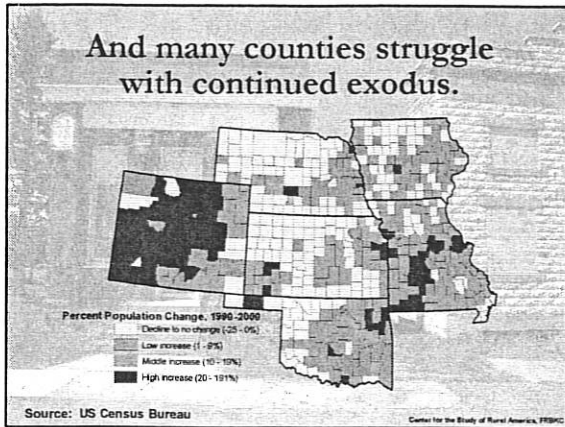




A majority of farms need new economic options.

- In a future with two agricultures...
 - One based on *commodities*
 - One based on *products*...
- Where do small and mid-sized commodity producers go?
- For many commodities, this is 80 percent or more of the farms.

Center for the Study of Rural America, FRBNC



In sum...

- New economic engines needed...
- That go beyond commodity agriculture...
- To boost economic growth...
- And stabilize rural communities.

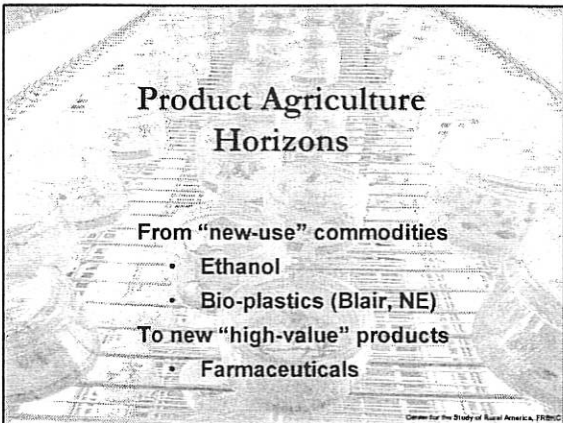
Center for the Study of Rural America, FSRAC

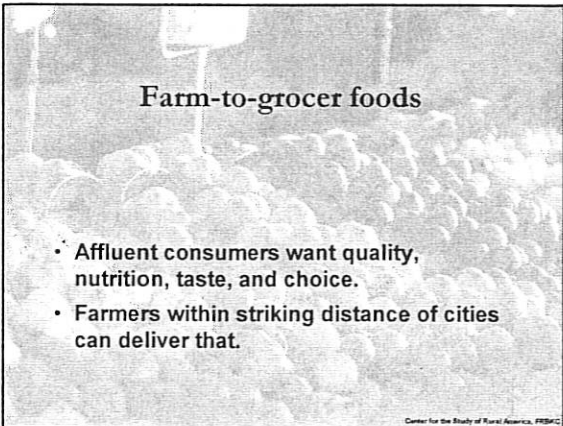
New Economic Horizons

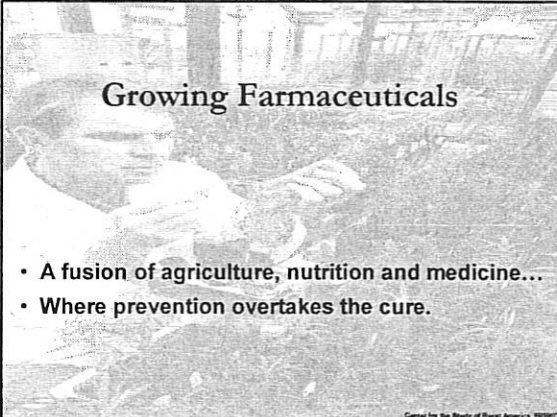
Technology heralds new opportunities...
 Diminishing distance...
 Creating new value...
 And launching new products.

Center for the Study of Rural America, FSRAC









Growing Pharmaceuticals

- A fusion of agriculture, nutrition and medicine...
- Where prevention overtakes the cure.

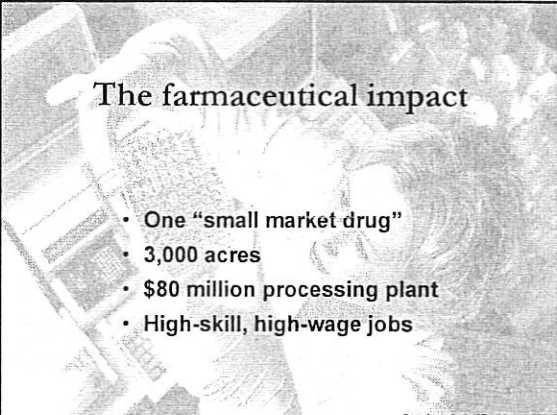
Center for the Study of Rural America, FFRMC



Growing Pharmaceuticals

- Big potential for reducing health care spending
- The highest value farm products ever
- High skill, high wage jobs
- All built on the power of life science, information technology, and advanced manufacturing

Center for the Study of Rural America, FFRMC



The pharmaceutical impact

- One "small market drug"
- 3,000 acres
- \$80 million processing plant
- High-skill, high-wage jobs

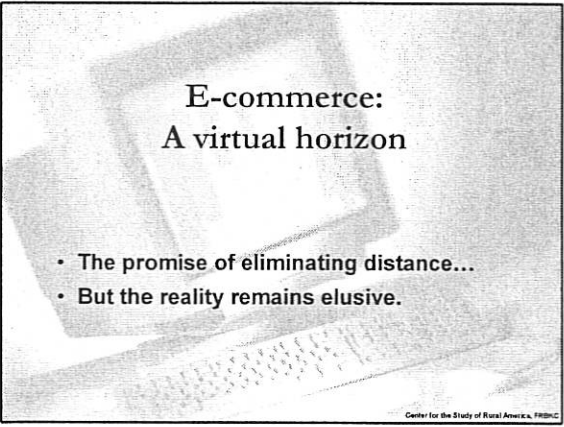
Center for the Study of Rural America, FFRMC



How to get there?

- ISO 9000 attention to quality
- Several hundred farmers - all on the *same* page
- Multi-community, multi-county partnership.
- University support for technology and business assistance.
- Giving up commodities.
- Science-based regulations.

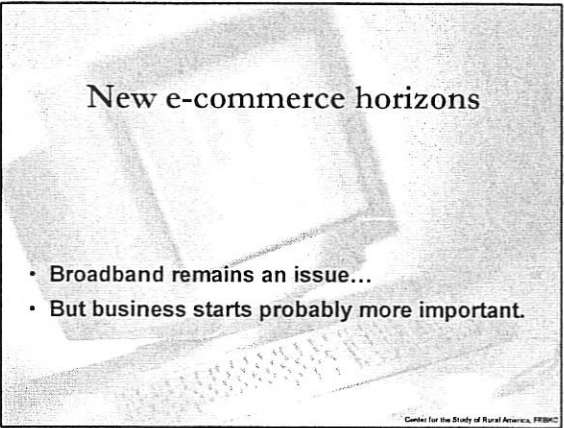
Center for the Study of Rural America, FRSAC



**E-commerce:
A virtual horizon**

- The promise of eliminating distance...
- But the reality remains elusive.

Center for the Study of Rural America, FRSAC



New e-commerce horizons

- Broadband remains an issue...
- But business starts probably more important.

Center for the Study of Rural America, FRSAC

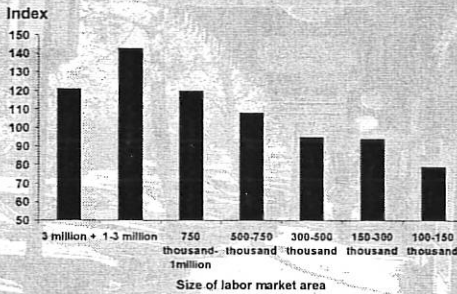
The "Aurora, NE Horizon"

- A local technology solution...
Hamilton Telecom
- And other local leadership...
- Led to new business growth.
Software 4

Center for the Study of Rural America, FFSB/C

Rural places tend to have fewer growth firms.

High-Growth Company Index (1991-1997)



Source: National Commission on Entrepreneurship, 2002

Center for the Study of Rural America, FFSB/C

The Common Thread of the New Frontier



- In the past, *independence*.
- In the future, *interdependence*.

Center for the Study of Rural America, FFSB/C

New Strategies for the New Horizon

- Farm policy alone won't suffice.
- New policies will be needed.
- And new local actions.

Center for the Study of Rural America, FRSAC

A New Frontier for Rural Policy

Three new focal points:

- Place
- Partnering
- New competitiveness

Center for the Study of Rural America, FRSAC

Why place?

- Place is what differentiates rural communities
- Place is ultimately what we value in rural America...

If we value it at all.

Center for the Study of Rural America, FRSAC

Why partnering?

- Most rural firms are small
- Clusters or networks make small firms competitive
- A clear focus of rural development globally.

Center for the Study of Rural America, FRBNC

Why regional competitiveness?

- Krugman and Porter:
Regions matter in a global economy.
- The constant challenge:
Create new competitive advantage -
don't protect the old.


Center for the Study of Rural America, FRBNC

U.S. rural policy still lags shifts in the rural economy...

Spending in the 2002 Farm Bill (2002-11)

Category	Relative Spending
Commodity support	High
Agricultural trade	Medium-High
Conservation	Medium
Research	Low-Medium
Energy	Low-Medium
Rural development	Low
Miscellaneous (includes crop insurance)	Low

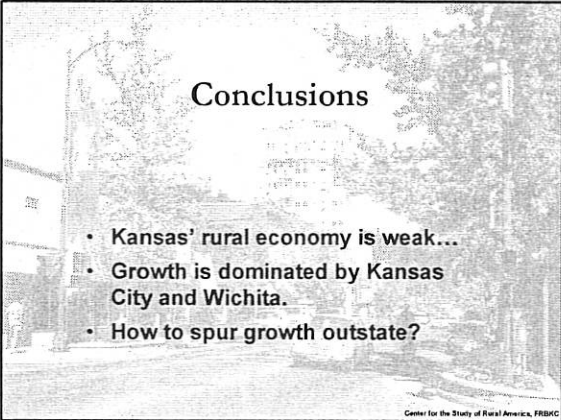
Source: Calculations based on CBO estimates. Excludes nutrition program spending. Center for the Study of Rural America, FRBNC



New Local Actions

- Think and act regionally.
The power of critical mass.
- Foster more entrepreneurs.
The power of equity capital.
- Find institutions that will help you.
The power of synergies.

Center for the Study of Rural America, FSBRIC



Conclusions

- Kansas' rural economy is weak...
- Growth is dominated by Kansas City and Wichita.
- How to spur growth outstate?

Center for the Study of Rural America, FSBRIC



Technology opens new horizons of opportunity

- Launching new products...
- Eliminating distance...
- And forging new partnerships.

Center for the Study of Rural America, FSBRIC

**But new businesses...
Signal a new way of doing
business.**

- Regional partnering.
- Renewed commitment to entrepreneurship.
- New investments in research and infrastructure.
- New rural policies.

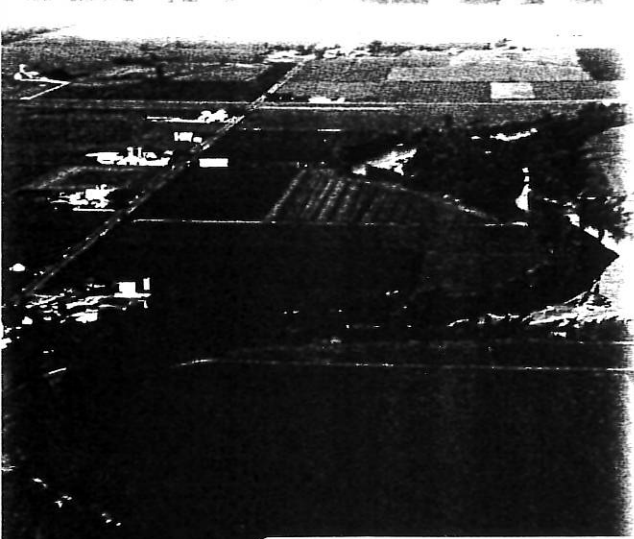
Center for the Study of Rural America, FFS&C



November 2002

The Main Street ——— Economist

Commentary on the rural economy



Venturing into Rural America

Kendall McDaniel
Associate Economist
Center for the Study of Rural America

Venture capitalists have long referred to the area of the U.S. between New York and California as the “fly-over states.” As a rule of thumb venture capital fund managers rarely drive more than a few hours to meet an entrepreneur, no matter how good the deal looks. This is evident in the fact that two-thirds of all venture capital investments go to just five states. And nearly all of these investments are made in metropolitan firms. Rural entrepreneurs, especially ones in remote areas, are at a distinct disadvantage when trying to raise capital for starting or growing their business.

Helping rural entrepreneurs attract venture capital is a key challenge for many rural leaders. One way to provide rural entrepreneurs with venture capital is to create nontraditional venture capital funds. Nontraditional funds are finding opportunities in the poorest counties of Kentucky and the old

Senate Commerce Committee

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Attachment 2-1

**This article benefited from the work of Brian Schmitt, Director of Research at the Community Development Venture Capital Alliance (CDCVA).*

Iron Range of northeastern Minnesota, among others. Still, many rural entrepreneurs wait anxiously for more dollars to venture into their area.

Venture capital investments often bypass rural America

The tidal wave of venture capital investments during the latter half of the 1990s largely missed rural businesses. Rural counties hold 19.2 percent of all U.S. business establishments, yet only 1.6 percent of all venture capital investments went to rural firms. By contrast, metropolitan firms received 98.4 percent of all venture capital investments, more than their 80.2 percent share of U.S. business establishments.¹

The shortfall in rural investments during the 1990s was substantial. Venture capital investments averaged \$61.6 billion per year from 1998 to 2000, an all-time high. However, less than \$1 billion of this amount went to companies in rural counties. If the dollars invested mirrored the actual number of business establishments in rural counties (19.2 percent), nearly \$12 billion would have been invested in rural firms over this period of time.

As the economic expansion of the 1990s subsided, so did venture capital investments. Venture capital investments peaked at roughly \$29 billion in the second quarter of 2000. But venture capital investments have declined dramatically since then. Only \$4.5 billion was invested in the third quarter of 2002, down from \$13.2 billion in the third quarter of 2001.²

Even more troublesome for rural entrepreneurs is the fact that venture capital investments are becoming more concentrated. A small number of states and industries are receiving the lion's share of investments. Two-thirds of all venture capital dollars went to companies located in just five states—California, Massachusetts, New York, Texas, and Colorado. The 25 states in the bottom half of the rankings received only 3.5

percent of all venture capital investments despite having 20 percent of the country's business establishments.

Of course, this concentration is a reflection of the venture capital industry's strong preference for a few "hot" industry sectors—the dot.coms of the mid-to-late 1990s and, more recently, a push toward biotechnology. Nonetheless, the effect of this concentration is that literally millions of companies in dozens of states are left with little or no access to venture capital. And because few, if any, rural areas have a strong high-technology sector, the gap between the venture capital provided to entrepreneurs in metropolitan and rural areas is significant.

How can rural leaders close the venture capital gap?

Rural communities require investments in both new and expanding businesses to provide the jobs and income to fuel future economic growth. New firms require capital and technical assistance to turn ideas into viable business enterprises. Existing firms must make capital investments to remain competitive in today's global economy. Therefore, capital access problems for new and existing firms often translate into slower growth rates for rural communities.³

The reason most often cited for the lack of venture capital in rural America is that rural projects are too small and promise lower rates of return than are needed to attract large national or regional venture capital funds. So, rural leaders need to work together to build projects of the scale necessary to attract traditional venture capital dollars. Pooling projects may also help spread risks, partly offsetting the need for higher returns.

Not all forms of capital are lacking in rural areas. Researchers and rural leaders indicate that debt capital is usually available for rural enterprises and that many rural banks hold significant deposits. The capital access problem, therefore, may lie in the ability of rural leaders to encourage the use of local capital for entrepreneurial

endeavors. Rural leaders may need to create public sector equity funds, entice private sector foundations to support rural equity investments, or form private/public partnerships that utilize currently available tools such as community development corporations and small business investment corporations.⁴

It is also important to identify potential investors in rural communities and to recognize the differences between large national or regional investors and local investors. Larger investors usually participate in traditional venture capital funds which choose from many opportunities around the globe. These funds base investment decisions solely on financial returns.

Local investors, on the other hand, may be more interested in the prosperity of their region and might accept lower financial returns for increased social benefits. Thus, local investors may be willing to wait longer for the "payoff" on their investment. Nontraditional venture capital funds may be a good fit for local investors of this mindset. Nontraditional funds typically have a "double-bottom line" of financial returns and social benefits, adding payoffs such as maintaining local ownership of a firm, creating jobs for local residents, or boosting incomes and wealth in distressed communities.

To be sure, no single model of non-traditional venture capital fund will work for all rural areas. Some of the successful ones, however, have found ways to function in limited investment environments because they have a patient source of investment capital, they are willing to accept lower returns for added social benefits, and they are affiliated with organizations that can subsidize their costs.

Two of the most successful venture capital providers in rural America are Kentucky Highland Investment Corporation and Northeast Ventures. Kentucky Highlands operates in some of the poorest counties of Kentucky, while Northeast Ventures serves the old Iron Range of northeastern Minnesota. Both were formed to help rural communities

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Attachment 2-2

obtain the capital needed to boost their region's economy. These two organizations are part of a broader class of nontraditional venture capital funds called Community Development Venture Capital (CDVC) funds.⁵

There are more than 70 CDVC funds in formation throughout the world. They assemble pools of investment capital from banks, foundations, corporations, religious institutions, wealthy individuals, and government. Over half of the money contributed comes from commercial banks that receive credit for their investments under the Community Reinvestment Act. And half of CDVC fund investments go to the manufacturing sector. These funds have been very successful in creating jobs, boosting entrepreneurial capacity, and building wealth in distressed communities.

CDVC investments mirror the overall distribution of U.S. business establishments. Of the portfolio companies that received investments from CDVC funds, 76 percent were located in metropolitan counties, slightly below their 80.2 percent share of U.S. business establishments. Rural counties received 24 percent of CDVC investments, slightly above their 19.2 percent share of U.S. business establishments. These funds provide a good option for rural investors and leaders.

The primary difference between CDVC funds and traditional venture capital funds lies in their mission and exit strategies. Traditional venture capital funds base investment decisions solely on financial returns, striving for returns in excess of 20 percent per year. And they usually exit investments through initial public offerings, or IPOs. CDVC funds accept lower financial returns, closer to 10 percent per year, in exchange for social returns such as new jobs and wealth creation in distressed areas. Due to their social goals, they typically exit investments by selling their stake to another company in the area. Still, CDVC funds and other nontraditional venture capital funds face significant challenges when operating in rural America.

Financing rural businesses presents many challenges

The double-bottom line of nontraditional funds presents a unique set of challenges. In addition to accepting lower financial returns, these investors get more involved in firm decisions and have fewer exit strategies. Nontraditional funds also face twin problems due to their geography—limited deal flow and increased costs.

Nontraditional funds typically face limited deal flow due to the fact that they operate in smaller, more remote, or distressed areas. Therefore, fewer deals are available and the ones that are available usually require managerial assistance as well as capital. In addition, many rural areas rely on the manufacturing sector, which requires large initial investments and often takes longer to realize returns. Thus, the time and money required from investors in nontraditional funds may be larger (and the financial returns smaller) than in traditional funds.

Nontraditional funds may also have fewer opportunities to exit an investment. Traditional funds target firms that can be readily sold within three to seven years, usually through an IPO. Since one of the objectives of nontraditional funds is to preserve or expand jobs in a particular area, an IPO or sale to an outside investor may violate fund objectives. More generally, less wealth is available in rural communities to "buy-out" the investors. Nontraditional funds generally seek local investors or another firm in the area for help in exiting an investment.

Financing rural entrepreneurs remains one of the toughest challenges facing rural America today. State and local leaders are trying to facilitate the transfer of venture capital dollars to rural entrepreneurs in various ways. Some states have offered tax incentives to spur venture capital investment in certain areas, others have established business development centers to facilitate the transfer of technology and skills to entrepreneurs as well as reduce overhead, and some have even developed programs to link young or beginning entrepreneurs with existing business owners.

Rural leaders can play a role in this process by fostering a culture of entrepreneurship and acceptance of venture capital in their communities. They can work with surrounding communities to pool investment capital or projects. In turn, rural entrepreneurs can form networks among themselves or partner with other organizations to boost management capacity and ensure that dollars invested in rural enterprises yield attractive returns for investors.

Policy issues

Venture capital is an important ingredient in helping many rural entrepreneurs and communities reach their fullest economic potential. Many researchers and policymakers have concluded that insufficient equity capital in rural America impedes progress.⁶ Traditional venture capital funds do not appear to be the answer for rural America. They tend to focus on certain industries in relatively few regions of the country. Nontraditional funds may be a way to close the rural venture capital gap.

Public policy may be able to help in the building of new venture capital institutions. For instance, policymakers might expand the capital authority of current institutions. They might also use public funds to help establish investment pools or regional investment boards at new nontraditional funds. Finally, they could help form networks of funds to pool risk across regions.

Regardless of the form new rural equity funds take, policy experts and rural leaders agree that equipping rural businesses with better technology and management skills is a key to success. Linking young or beginning entrepreneurs with more experienced entrepreneurs is one effective way of improving outcomes. Policymakers, community leaders, and rural entrepreneurs both young and old have a stake in this. Each must do their part to ensure that more capital ventures into rural America.

Senate Commerce Committee

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Attachment 2-3

THE NEW POWER OF REGIONS: A POLICY FOCUS FOR RURAL AMERICA

Regions are a critical way for rural America to seize new economic opportunities. Evidence is mounting that investments in regional competitiveness can open the door to powerful economic synergies for rural businesses and communities alike. Yet, U.S. rural policies still focus on individual firms and towns.

To shed light on why regional synergies are so important to the rural economy of the 21st century—and how public policy can encourage these synergies, the Center for the Study of Rural America hosted a conference, "The New Power of Regions: A Policy Focus for Rural America," May 9-10 in Kansas City, Missouri.

A distinguished group of rural experts from the United States and beyond were on hand to share their ideas. Our audience included national leaders from government, business, finance, and academe.

Main Street Economist subscribers will receive a copy of the proceedings soon. To request additional free copies, please visit our website at www.kc.frb.org or write us at:

Public Affairs Department
Federal Reserve Bank of Kansas City
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Kansas City, Missouri 64198



THE NEW POWER OF REGIONS
A Policy Focus for Rural America

Endnotes

¹Schmitt, Brian. 2002. "Assessing the Availability of Traditional Venture Capital in the US: A Preliminary Analysis." *Community Development Venture Capital Alliance*.

²For more information on the venture capital industry, see <http://www.pwcmoneytree.com/moneytree/index.jsp>

³Recognizing the venture capital gap between rural and urban America, USDA commissioned the Rural Equity Capital Task Force. This effort, led by members of the Rural University Policy Research Institute (RUPRI), provides a solid base of information on venture capital in rural America. For more information on the task force or RUPRI, see <http://www.rupri.org/pubs/archive/reports/P2001-11/index.html>

⁴There are many different types of non-traditional venture capital funds. RUPRI classifies them based on their organization structure. They studied non-traditional

venture capital funds in six main categories—publicly funded, publicly managed funds; publicly funded, privately managed funds; certified capital companies; community-level equity funds; community development venture capital institutions; and small business investment companies.

⁵CDVCA is the trade organization for both domestic and international CDVC funds. Its mission is to promote the use of venture capital to create jobs, entrepreneurial capacity, and wealth to advance the livelihoods of low-income people and the economies of distressed communities. For more information on CDVCA, see www.cdvca.org.

⁶The Center for the Study of Rural America sponsored two conferences on the subject of capital in rural America. Proceedings for "Financing Rural America" and "Equity for Rural America: From Wall Street to Main Street" are available at www.kc.frb.org

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