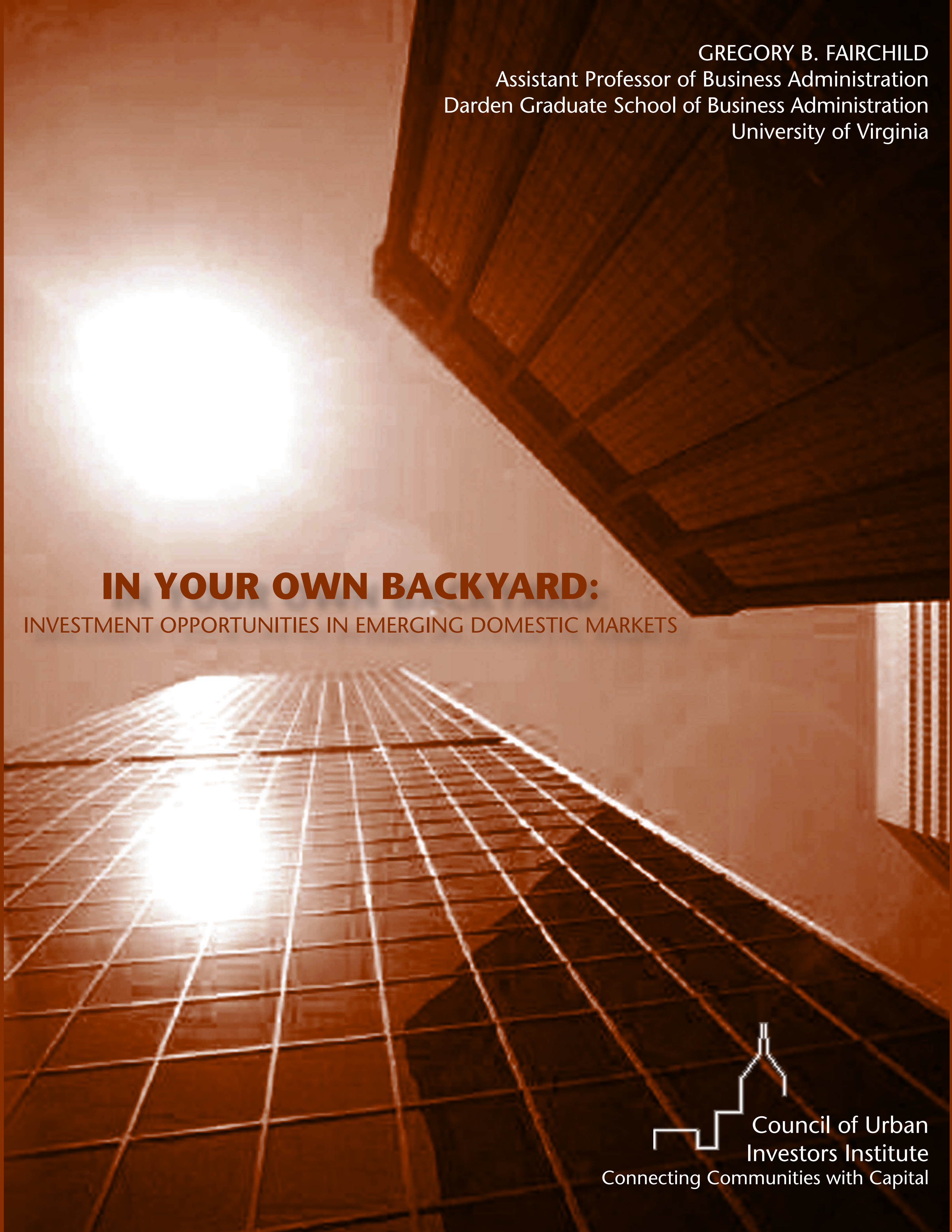

GREGORY B. FAIRCHILD
Assistant Professor of Business Administration
Darden Graduate School of Business Administration
University of Virginia

IN YOUR OWN BACKYARD:

INVESTMENT OPPORTUNITIES IN EMERGING DOMESTIC MARKETS

Council of Urban
Investors Institute
Connecting Communities with Capital

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Investors Institute
Connecting Communities with Capital

Dear Friends,

The Council of Urban Investors Institute (CUI Institute) is pleased to sponsor this informative report on investment opportunities in America's Emerging Domestic Markets (EDM). Founded in 2002, The CUI Institute was established to facilitate independent fact-based research to address the most important issues shaping the debate on investment with emerging managers in EDMs. We believe that EDMs represent an exciting asset category within alternative investments that has tremendous investment opportunity.

Your interest underscores your commitment to expanding the reach of institutional capital deeper into the growing community of emerging investment managers in EDMs. We hope that you will find this research interesting and thought-provoking and will help us communicate the importance of the opportunity presented by EDMs to the broader marketplace.

We look forward to working with you to encourage the implementation of the recommendations advanced by this report as well as developing new opportunities to realize the vast potential in America's Emerging Domestic Markets.

Thank you for your support.

The Council of Urban Investors Institute

contents

"We must reach out to the talent of diversity to expand our investment horizons. There is a large and growing pool of talented ethnic and minority managers who have roots in and knowledge of underserved markets. We need to call on their networks and their skills to find the new vistas of emerging market opportunity."

- Phil Angelides, California State Treasurer

We cannot take a breather until we've overturned barriers to the development of underserved markets, until every citizen is able to fully participate in the economy. The longer the economy keeps running along, the greater the window of opportunity for us to bring more Americans into this prosperous mainstream.

Michael H. Moskow,

- President and CEO, Federal Reserve Bank of Chicago

"We know that capital and a great idea create the foundation of a new business, but too many communities that have great ideas lack the capital they need for economic growth. We need to make that capital available so every small town and every urban area has the chance to strengthen their economy and create jobs… Capital and expertise are the building blocks of business development and expansion, but the communities hit hardest by job losses and poverty are the ones least likely to have these assets. . . Traditional financial companies have little experience investing in low-income or minority markets. "

- U. S. Senator John Edwards, North Carolina

executive **summary**

While the recent state of stagnation in the economy has fostered considerable hand-wringing, political debate and consternation, times of market depression and malaise are by no means new features of U.S. economic history. Waves of accelerating and decelerating capital investment and growth are components of our economic narrative.

Historically, periods of rapid expansion have generally been associated with the deployment of capital to burgeoning technological innovations. More recently, technological innovations -- the personal computer, telecommunications and the silicon chip – have led to a flurry of investment activity and growth. Another, non-technological change of the past century continues to influence our economy in numerous ways. The generation born following the close of the Second World War, now known as the baby boom generation, has demanded many changes in business and policy, as they have grown and matured. Today, another recent demographic trend promises further change in our economic lives: the rapid growth of Emerging Domestic Markets (EDM).

While the rapid growth in Latino, African-American and Asian-American populations has generated considerable attention among government officials and policy experts, considerably less attention has been paid to the influence of these trends on economic opportunity and investment. This report is an effort to fill the gap in understanding by providing information about the influence of these trends on the entrepreneurial landscape. We believe that these trends are critical to business practitioners and present many opportunities for investment and innovation. We provide data on the burgeoning economic opportunities in EDMs, the professionals and firms operating in these markets, and we provide ideas on how policymakers, government officials and opinion leaders can assist in fostering investment in these markets.

Most of us have simply been unaware of the potential these markets hold. A growing cohort of professionals, from academia, public and non-profit organizations, and the private sector are already mining these markets and have come together to author this report. Our intent is to move beyond creating awareness of these opportunities to facilitating access to capital and sharing best practices in investment and management. We highlight several case studies of successful investments in EDMs and many of the professionals that are active in this investor base.

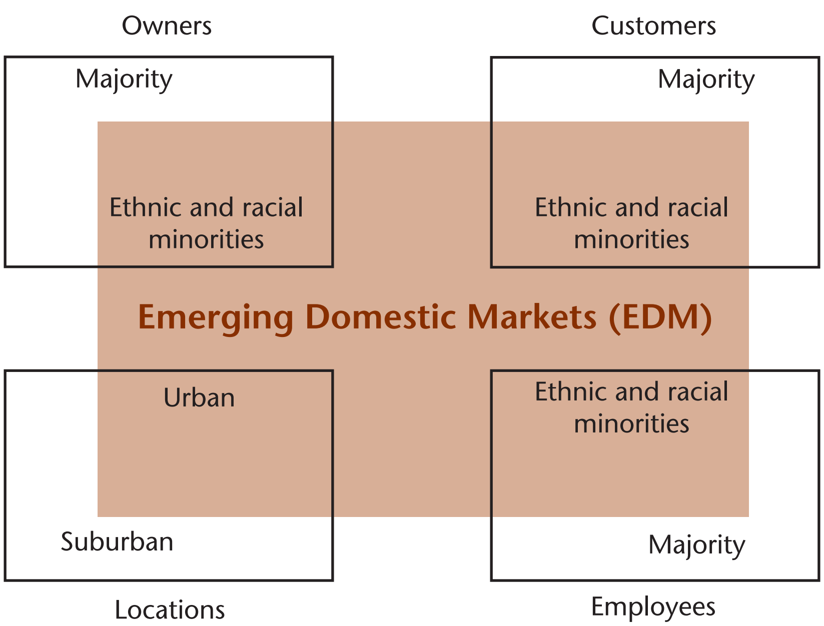
After exploring contemporary market dynamics and the future potential of these asset classes, we advance the following recommendations to those who concur that EDM markets present a unique diversification opportunity:

- Encourage plan sponsors to make direct investments in EDM private equity firms in excess of $150 million.
- Invest in EDM-focused Fund-of-Funds as a means of participating in smaller emerging manager funds; and
- Require gatekeepers to hire and promote the development of diverse professionals in majority private equity firms.

We invite you to join us. We are working to assist the collective business community in fostering entrepreneurship that would leverage the burgeoning opportunities in these markets. We foster investment and innovation through sharing best practices, providing capital, and assisting opinion leaders in developing policy to enhance the pursuit of opportunities in these markets.

what are **emerging** domestic markets?

We use the term Emerging Domestic Markets (EDM) to describe the category of investments discussed in this report. EDMs can alternatively be defined by demography (ethnic minorities) or geography (inner city neighborhoods). A firm may be considered a part of this asset class either due to customer base or firm ownership.[1] The shaded areas below graphically illustrate the categories of economic activity that are considered EDM markets.



Similar to what have been termed emerging markets in the international sphere, these markets represent both clear economic potential and risk for inexperienced investors. At the same time, their location within the U.S. provides distinct advantages relative to international emerging markets. First, EDM firms are proximal, providing for ease of interaction between investors and firm management not found overseas. Second, EDM firms operate within legal and institutional structures that are familiar to the domestic investment community. Third, EDM firms don't face country-related political risks that are often necessary considerations when investing outside of U.S. borders. These markets have traditionally been underserved by the business and financial community, even though they have recently exhibited above-average growth rates, which are described in greater detail later in this report.

drivers of emergent **opportunity**

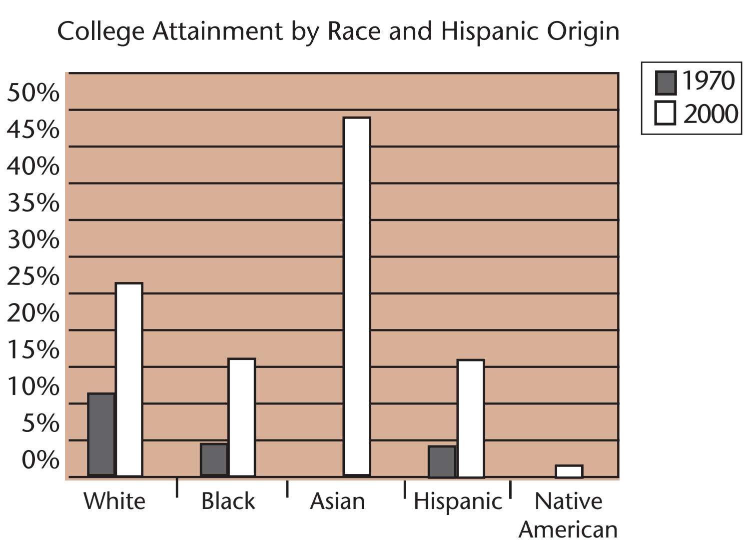
Encouraging Social and Economic Indicators

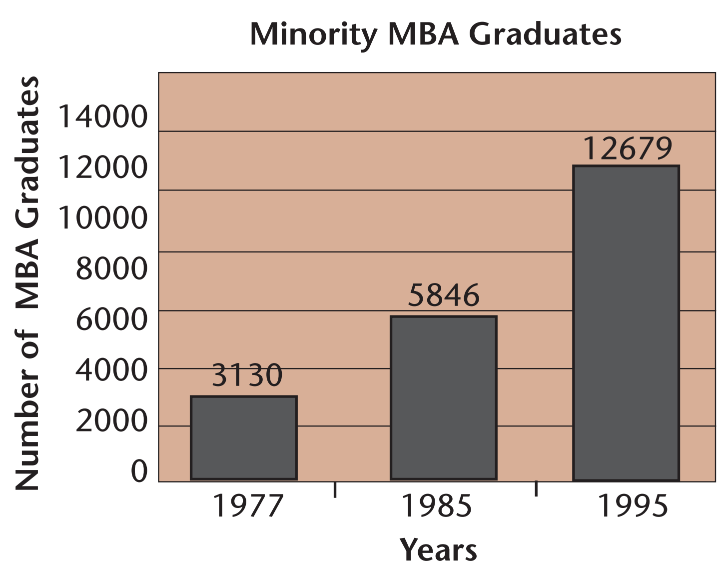
As the investing community regains confidence in capital markets following their volatile performance at the close of the last century, attention has turned to asset classes that will provide promising returns and spur the next growth engine of the US economy. Our research indicates that EDMs are such an asset class, providing significant potential for sage investors. Demographic trends, on their own, are insufficient triggers to expansive growth. However, the combination of long term trends in educational attainment, population growth rates, enabling institutions and capital markets suggest expansive potential in EDMs over the coming years.

Rising Educational Attainment

Gaps in the educational attainment of racial and ethnic minorities, relative to the majority population have been a key area of public policy action for at least the last half century. The fruits of these public investments are beginning to ripen, and while gaps remain, they are considerably smaller than in prior decades. Secondary and post-secondary (college) educational attainment has improved across all population groups. In a generation, contemporary college and high school graduation rates for minority group members have now surpassed the 1970 educational attainment of non-minority groups (See charts below.) This is matched by the expansive growth of minority educational attainment in graduate business training. Between 1977 and 1995, the number of minority students receiving MBA degrees grew fourfold, to nearly 13,000.[2] These graduates now fill the managerial ranks of our country's leading corporations.

The Promise of Human Capital Investments in Education



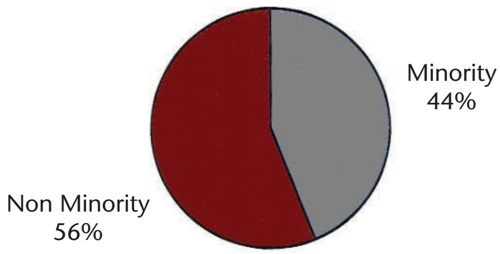


Source: MBDA and Milken Institute

Expanding Spending Power

Consistent with demographic growth trends, minority purchasing power is also forecasted to expand significantly. The disposable income increase in the United States is projected to be $6.9 trillion between 2000 and 2045. The increase in minority group members' collective purchasing power between now and 2045 is expected to be in the $ 2-3 trillion range,[3] even if current income disparities between racial and ethnic groups are maintained.[4] Eliminating current income disparities could result in a disposable income increase for minority groups of $4.8 trillion. Hence, the minority groups' share of the total US purchasing power increase during the 2000-2045 period should not be smaller than 44% and could be as large as 70%.

Minority Share of Disposable Income Increase - Constant Income Disparity Assumption 2000-2045



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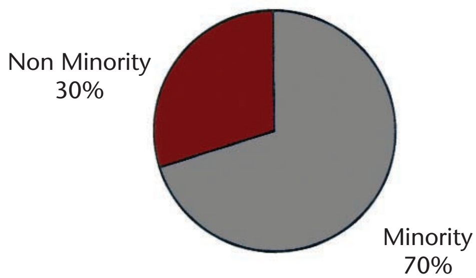


Resurgent Inner City Communities

Segregation by race and class are longstanding features of the American social landscape. Depressed communities are common to all developed nations, and while our country has made considerable strides toward reducing segregation over the last 50 years, its economic effects still linger. In fact, one can argue that the unemployment, poverty and other economic problems that exist in depressed communities are the legacies of segregation.

Inner city areas are often populated with minorities. By definition, however, inner city areas are based not on demography but on an urban location's poverty rate, unemployment rate and income profile. While an estimated 82% of the population of U.S. inner cities are minorities, not all minorities live in inner city areas[5]. In fact, the majority of U.S. ethnic and racial minorities do not live in inner city areas.

As efforts to diminish the stultifying effects of these exclusionary trends continue, recent work indicates that our nation's inner cities are expanding opportunity spaces. A number of indicators suggest that these areas are more attractive as locations for business investment than previously or widely perceived. America's urban inner cities show significant untapped potential

- First, inner city poverty is decreasing (from 34.9% in 1990 to 31.0% in 2000).[6]
- Second, homeownership in inner cities is rising (from 29% to 32% during the1990s).[7]
- Third, the educational attainment of inner city residents is improving. Between 1990 and 2000, inner city high-school graduation rates increased over 10% and college-graduation rates increased over 30%.[8]
- Fourth, there is a clear pattern of migration back into previously-unattractive urban neighborhoods in all major U.S. cities and many of these new inner city residents are the groups that past redevelopment efforts attempted to attract: youthful, single, college-educated, professional.
  - Analysis of 2000 U.S. Census data shows that college-educated, single and married people between the ages of 24-39 made up a greater proportion of movers into central cities than suburban or rural areas.[9]

Toward a Pluralistic Society

The ethnic and racial diversity of the U.S. population has increased markedly over the last three decades. A description of our country as composed of majority and minority ethnic groups is increasingly becoming inaccurate as our Hispanic, African-American, and Asian populations consistently show rapid growth. In 2000, these formerly-described minority groups represented respectively 51% and 47% of the California and Texas population[10]. Other populous states, like Florida and New York show similar patterns and are projected to reach racial plurality in the near future (Florida, 35%; New York, 38%).[11] According to the most recent projections, half of the US population will be part of a minority group by 2050.[12] These demographic changes are already evident in contemporary business practice, where, strategy development regularly involves ethnic marketing and employee or supplier diversity programs.

An Eye Toward the Future: The Youthful Skew of EDMs

In addition to promising growth trends and economic indicators, EDM markets are younger than others, which offers investors the opportunity for long-term relationship building within the community. Census data shows that 31.4% of the population under the age of 18 is composed of ethnic minorities, versus 22.6% of those over 18. Studies of inner city residents estimate that over 42% of inner city residents are under the age of 25.[13] Investments in loyalty-building with EDM consumers now will pay benefits over the long term as these young people become leaders in their communities.

promising trends, **troubling** gaps

Although the current picture of minority-owned businesses grossly understates the future potential of EDMs, multiple macroeconomic trends indicate strong potential in these markets . For example, minority-owned businesses have outgrown majority-owned[14] businesses over the past decade. Yet, they remain mostly small, clustered in specific geographic areas and below their "demographic parity level"[15] for prevailing business development metrics, such as number of firms, gross receipts and number of employees. We show these data in greater detail below.

Small, Yet Rising: Minority-owned Businesses

Relatively speaking, the bulk of minority-owned businesses are small in receipts and employees. Using the most recent data available from the U.S. Census, we find that minority-owned businesses represented 14.9% of all closely-held firms, 4.4% of total employment and 7.0% of total receipts.[16] On average, minority-owned firms had receipts of $195K, and 7.3 employees. This compares with $411K and 12.4 employees for all majority-owned firms.[17]

Though smaller in size and receipts, minority-owned firms are growing faster than all firms. The chart below shows the ten-year growth rates in firms and revenues for minority-owned firms and all firms. Additionally, there are a growing number of sizable minority-owned firms, generating over $1MM in annual receipts. These firms represented 2.8% of all minority firms in 1997 and generated 66% ($387 billion) of the total receipts. For perspective, firms over $1MM in receipts represent 5% of all firms, but are 90.9% of total revenues, when we include majority-owned businesses.

	1987	1992	1997	10-yr CAGR
Number of minority-owned firms (millions)	1.2	2.2	3.0	9.8%
Number of all firms (millions)	13.7	17.3	18.4	3.0%
Total Revenues of minority-owned firms ($ billions)	$78	$209	$335	15.7%
Total Revenues of all firms ($ billions)	$1,995	$3,324	$4,661	8.9%

From a sector perspective, the industries generating the largest amount of sales for minority businesses were wholesale trade (26%), services (23%) and retail trade (20%).[18] These firms and industries will provide immediate investment opportunities and spearhead the growth of EDM in the next 10 years. As our collective business experience and knowledge increase, they will be leveraged by these vanguard businesses to tap an expanding customer base and to attract investors with the promise of supernormal shareholder returns.

Untapped Industries. Untapped Opportunities

In many of the leading industries in the U.S. economy, minority owners are still under-represented. Transportation, communications and utilities businesses, which have provided much of the U.S. economic growth of the last decade, only account for 3.6% of sales generated by minority firms. This is about half these sectors' representation among all U.S. firms. Similarly, minority manufacturing firms generated 11% of the total sales volume of minority-owned firms compared to 22% for all U.S. manufacturing.

Despite accounting for 12% of all firms with paid employees, minority-owned businesses employed only 4% of the active population and contributed only 3% of the total amount of sales generated by all U.S. firms. When compared to the proportion of minority groups in the general population (30% according to the most recent census) these figures look even smaller. This disproportion is one measure of the growth potential of minority businesses.

From an investment perspective, however, these businesses will only become attractive if and when they reach a critical size and are competitive in the marketplace. This can be achieved in numerous ways (alliances, partnerships, government initiatives or consolidation). It is clear, though, that given the scale of the issues at stake, both the government and providers of capital will need to support these firms to ensure full success. Success in EDMs is equally dependent on these two types of actions (improvement of the overall competitiveness of minority-owned firms and financial investment in established minority businesses). They will feed each other in a virtuous cycle of growth in EDM markets. Investments made in stable, sizable EDM ventures will generate rising returns, and advance the quality of professionals operating in EDM sectors.

The potential for high investment returns in EDMs has roots in the contrast between the powerful macro trends described above, and the often overlooked business opportunities present in these markets. These macro forces will create powerful demand for products, employees and managers that can meet the needs of these markets. However, unmet demand is insufficient as a basis for business development. Given a globally competitive market, these firms must link best practices and top-quality personnel with quality resources and funding to build long term competitive advantage.

the promise of **demographic** parity

Recent economic census data shows that minority-owned businesses are growing faster than their majority-owned counterparts. However, the current data also shows that this sector of the business economy is still at a nascent stage, with considerable challenges ahead. In 2000, minority groups totaled 30% of the US population but minority businesses accounted for only 14.6% of the total number of firms and less than 5% of employees and sales in the economy[19].

Demographic parity exists when the percentage of a given business metric (number of firms, sales, employees) represented by a particular demographic group is equal to that group's population weight. "Firms Metrics" parity is similarly defined as the state where the percentage of gross receipts and employees of existing minority firms in the economy equals the current percentage of minority firms in the economy. For example, to reach demographic parity in 1997 representing 30% of all firms, an additional 3.1 million minority-owned businesses would need to be founded. If parity was achieved, these firms would generate an incremental $4.9 trillion in sales and employ an incremental 26.3 million persons.[20]

Similarly, reaching the "Firms Metrics" parity would require existing firms to generate an additional $670 billion in sales, adding 15.5 million new employees. Following the "Firms Metrics" hypothesis, if existing minority-owned firms were able to employ comparable numbers of employees as all firms, our nation's unemployment woes could be greatly diminished. Studies have highlighted the role of small firms in the 1980s employment growth and recent statistical research has shown a correlation between the race or ethnic origin of the business owner and the race or ethnic origin of the employees.[21,22]

In 2010, minority groups will account for 34% of the total U.S. population. Assuming that existing minority businesses grow at the same rate as the rest of the economy (3.4% compounded annual real GDP growth rate), the receipts demographic parity gap will have increased to $8.1 trillion and 35 million employees would then be needed to fill the employee demographic parity gap. [23]

The macroeconomic impact of investments in these firms should provide spillover benefits. In addition to the jobs created in inner city neighborhoods and other positive benefits, the increased level of revenue should close the income disparity gap that currently exists between minority and majority households and expand the U.S. population tax base.

Attractive Markets. Underserved Demand

While the demographic trends shown above suggest a sizable and attractive market of minority customers, demand remains largely underserved. For example, recent studies have shown that retailers located in inner city areas have generated on average 40% more dollars per square foot than retailers in other locations in the greater metropolitan areas.[24] One reason for the strong performance of inner city retail is the purchasing behavior of the inner city customer: the average annual inner city household spends $33 more on women's and children's apparel than the U.S. household spending average. One might intuitively assume that lower income leads to more price-conscious purchasing patterns, however, the price/demand elasticity of inner city shoppers is actually comparable to that of the rest of the U.S. population and the high population density of these areas drives inventory turnover and overall retail sales.[25]

New scholarship has shown that inner cities offer a unique set of competitive advantages to businesses seeking to locate their firms. For example, following an extensive study, Harvard Business School Professor Michael Porter[26] identified four key competitive advantages of inner city locations:

- Strategic Location - Businesses located in the inner city benefit from the proximity of large urban areas (businesses, infrastructure, people).
- Local Market Demand - The size and nature of inner city demand make for very attractive business opportunities in an economy where most markets are clogged with competitors.
- Integration with Regional Clusters - Inner City businesses can benefit from the proximity of networks of high performing corporations generally existing in U.S. urban centers
- Human Resources – Inner city locations have qualified, available labor that many employers have overlooked. Quality workers at a fair price.[27]

Each year, the Initiative for a Competitive Inner City compiles a ranking of the 100 fastest-growing inner city firms (The Inner City 100). The base statistics for these firms may surprise some readers. These “Inner City Gazelles” had a five-year average growth rate of 872%, with compound annual growth rates averaging 62%. These 100 firms employed an average of 137 full time employees and 23 part-time workers. Average sales were a whopping $26.5 million.[28]

In 1990, **Pathmark** opened a 47,000 square foot supermarket in Newark’s Central Ward (Newark, NJ). Prior to the opening of the supermarket, the state of the local retail offering was dismal. Grocery products were of poor quality and more expensive in than in Newark suburbs. As a result a very small percentage of Central Ward residents purchased their groceries in their neighborhood, in spite of the transportation costs incurred to shop in other locations (most residents didn’t own a car). Ten years later, through a combination of a tailored product offering and community based partnership efforts, the store was one of the most profitable in the Pathmark chain, employing 350 people and serving more than 50,000 customers every week. Similar results have been experienced by a number of national chains, including Blockbuster Video, Starbucks Coffee, Loews Cineplex Movie Theatres (in conjunction with Johnson Development Corporation), and Fresh Fields grocery stores.[29]

And yet, retail businesses are not flocking to inner city locations to fill unmet demand. Studies show that over 23% of total inner city spending was not served within the local neighborhood.[30] In New York City’s Harlem, unmet retail demand reached 60% of the total retail demand.[31] Given the success enjoyed by retailers who have ventured in these markets, these numbers are even more surprising.

The Risk Profile of EDM Investments

In addition to their intrinsic growth potential, EDMs present fewer and different risks than International Emerging Markets (IEMs). EDMs offer similar growth prospects to foreign markets in Asia, Latin America or Eastern Europe, but provide natural hedges against the typical risks faced by investors in these markets. In EDM investments, risks are limited to the business economic performance uncertainty (financial risks), while political uncertainty and exchange rate fluctuations risks (which have triggered most of the recent foreign emerging market turmoil) are irrelevant.

Further, international governments may have environmental, political or human rights policies that are unpalatable to many investors. In 2002, the California Public Employees Retirement system (CalPERS), decided to add new requirements to its criteria for investment in international emerging markets. After the inclusion of issues such as environmental protection, human rights, and a free press, CalPERS decided to cease investments in Indonesia, Thailand and Malaysia.

Risk Features of Foreign and Domestic Emerging Markets[32]

Risk Factors	Emerging Domestic Markets	Foreign Emerging Markets
Political Risks		
- Expropriation	No	☑ Yes
- Instability	No	☑ Yes
- Contract law	No	☑ Yes
Currency Risks		
- Currency fluctuation	No	☑ Yes
- Monetary policy	No	☑ Yes
Financial Risks	No	☑ Yes
Child Labor, Free Press and other Human Rights abuses	No	☑ Yes

While considerable attention and dollars have flowed to foreign emerging markets, only a fractional component of available investment dollars is chasing opportunities in our own backyard. While some of this lack of investor attention results from inaccurate and outdated perceptions of EDM opportunities, a good deal of the gap is explained by the ways in which some professionals operating outside of this asset category frame EDM investments. For example, EDM investments are sometimes described as "socially-responsible" investments. Unfortunately, this framing of EDMs may lead fiduciaries to the conclusion that EDM investments are not associated with market-competitive returns. Given that the prime directive for any fiduciary is to create returns for investors, investments for social reasons are less attractive, and some would argue, irresponsible. We believe that it is only through careful, objective analysis of economic fundamentals that dollars should be placed in EDMs.

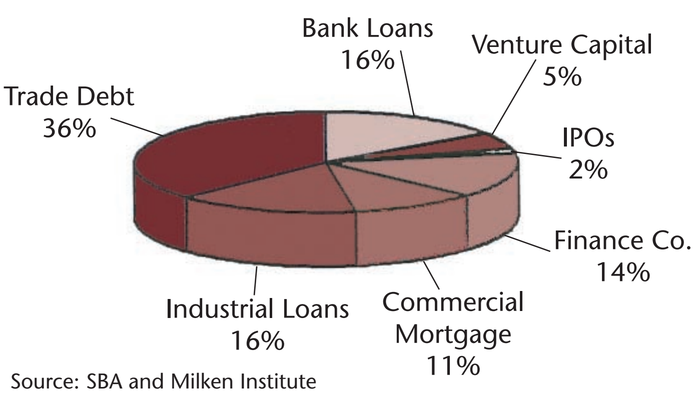
funding the future **growth** of EDM firms

Nascent firms' need for capital at startup is similar to the needs exhibited by newborns and infants for sustenance and nurturing early in their life cycle. During infancy, restricted resources and support place the firm's survival at risk. The level of current capital funding for minority businesses is inadequate, both in its size and scope, and if uncorrected, will stifle the growth of these vital components of development. The disparity in minority business owners' access to capital mirrors the disparities in minority-owned firm's performance (e.g., sales, number of employees).

The Funding Gap

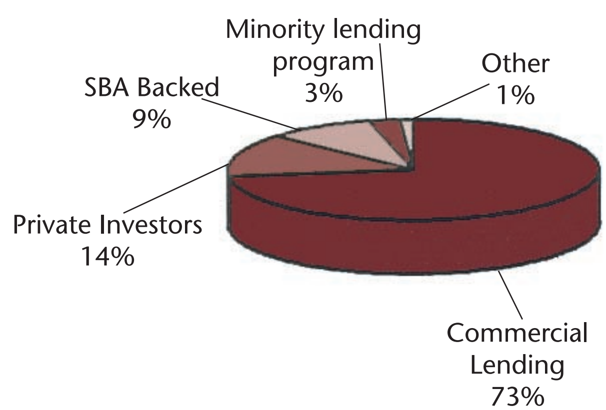
According to the most recent U.S. Census' Characteristics of Business Owners survey, two thirds of black business owners and more than half (58.6%) of Hispanic business owners used less than $5,000 as startup capital.[33] At the higher end of the range, only 2.9% of black business owners and 6.7% of Hispanic business owners capitalized their firms with more than $50,000. Similarly, 14.9% of Hispanic-owned firms and 12.5% of black-owned firms reported borrowing between 25% and 100% of their firm's capital using business or personal loans. Comparatively, 22.5% of majority-owned firms were able to fund their businesses through loans from commercial lenders.

US Small Businesses Financing Sources



Source: SBA and Milken Institute

Minority Businesses Financing



The disparity in access to commercial loans is compounded by the importance of these loans to minority businesses. Historically, minority business owners have relied almost solely on commercial lending to fund their businesses. The even greater shortfall for these entrepreneurs has been in accessing alternative sources (equity, venture capital, mezzanine and senior debt). According to a 1993 survey published in the Wall Street Journal, 73% of minority-entrepreneurs reported using commercial bank credit as their principal funding source.[34] The remainder was made up of private investor's funds (14%), SBA-backed funds (9%) and minority lending program funds (3%). Corporations, pension funds and private equity funds accounted for only 1-2% of minority businesses funding.

The failure rates of minority-owned businesses also offer insight into the risks firms face when inadequately funded. While the failure rate of minority-owned businesses (28.7% and 25.1% for Black and Hispanic-owned businesses[35]) exceeds the failure rate of majority-owned businesses, reasons advanced by minority firm owners suggest funding disparities, rather than operational abilities, are responsible. Insufficient access to business and personal loans is cited more often as a reason for failure in minority-owned firms (23.9% and 14.6% respectively) than in majority-owned companies (10.0%). Correlatively, the percentage of firms failing due to low sales revenues is smaller for minority-owned firms than for majority-owned firms. Better access to capital should therefore contribute to fewer failures and in turn reduce or eliminate the perceived risk differential between minority-owned businesses and non-minority-owned businesses.

Even among the “Inner City Gazelle” firms noted above (Inner City 100), finding adequate capital remains a challenge. These firms, while clearly successful, report challenges in the capital access process. Over half of these firms reported finding either that limited sources of capital were available or that they were unable to obtain capital necessary to grow their businesses. The vast majority reported that their primary source of startup capital came from personal assets. Only 15% reported receiving capital from banks or credit providers.[36]

Several theories have been advanced to explain the persistent disparities and inadequacies in minority business funding. The disparities in access to commercial lending have often been justified by the unattractive (poor) business characteristics of both minority firms and owners. Due generally to the above-mentioned legacy of segregation, and specifically to lower home ownership rates for minorities, much of the potential asset value generated through real estate ownership is unavailable to minority entrepreneurs seeking capital.[37] These explanations however, are generally perception-driven and insufficient, as they beg the question of the causal relationship between the inadequate funding and the performance and size of minority-owned businesses.

Venture capital, also called “smart money,” provides entrepreneurs advantages that debt funding does not. First, venture capital funding does not require regular debt service, allowing firms flexibility in operations during times of unexpected contraction in the business marketplace. Second, these financial products engage investors as partners in the business, securing their assistance (either through active participation, advisory roles or both) in ensuring the business fortune. Equity funding is a critical need for the next stage of EDM firm development. The strategic, partnership and operational benefits of equity funding will allow promising entrepreneurs to stretch into the industry sectors that are ripe for growth in the economy overall. Recent estimates suggest that less than 4% of the private equity funds working in the marketplace currently support the development of minority-owned businesses.[38]

The Opportunity

EDM businesses are growing at a faster rate than the economy as a whole. Making the conservative assumption that the EDM growth trend will flatten and that existing minority businesses will grow in the next 10 years at the same average rate of the remainder of the economy, the potential market value creation is $20-30 billion for the next five years and $40-60 billion for the next 10 years[39]. Even under the most conservative growth scenario, the potential market value creation still seems to require more capital than the $6-7 billion currently committed to minority oriented private equity funds. Equity capital for small businesses comes mainly from venture capital (77%) and marginally from Initial Public Offerings of stock (IPOs) (23%).[40] However, as noted above, few minority-owned firms are tapping these funding sources.

If the EDM Asset Class is Viable, Why Aren't More Investors Involved?

An inquisitive reader might wonder why EDM investments are overlooked by equity investors. With a market of equity investors seeking new ways to put capital to work and a rising cadre of entrepreneurs prepared to pursue these markets, why is there such a gap in equity funding to EDM firms? Prevailing economic theories tell us that markets are efficient and that smart investors don't leave money "on the table."

We identify five reasons for the lack of interest in investments in Emerging Domestic Market firms: 1) limited experience with investments in this asset class; 2) the perception that these investments are for social purposes rather than economic opportunities; 3) the mixed past performance of government-sponsored programs; 4) an outdated perception of minority-owned businesses; and 5) a public policy agenda that has been focused outside of business development. We discuss each of these below.

First, the equity investment community has had limited past experience with EDM businesses. In part, this is the legacy of past racial segregation. Historically, private equity investment firms have mirrored residential patterns, remaining largely racially homogeneous. As a result, the number of investment firms operating in the marketplace is small. Thus, the collective investment marketplace lacks exposure to businesses that employ, serve or are managed by minorities.

Second, as mentioned, the term "social venture" is often associated with EDM firms. Social ventures are firms formed for the primary purpose of ameliorating some societal ill. While it is certainly the case that the success of EDM firms will have societal benefits – job creation, for instance – the basis for investments in EDM firms is financial return. For example, as investments in biotechnology or telecommunications firms create additional societal benefits, the primary reason that investors pursue these markets is their potential for long-term growth and financial return. The EDM asset class is no different.

Large-scale, government-sponsored programs of the past, including those designed to spur economic development, have shown mixed results and have left many wondering about the viability of inner-city and minority-owned businesses. Federal Reserve Board Chairman Alan Greenspan, speaking before an audience of community-development professionals, recently called for more research that would determine the efficacy of past efforts to revitalize inner-city communities. "Undeniably, impressive local community development initiatives have been undertaken, and individual testimonials reveal advances in the economic well being of many beneficiaries", he said. "However, the absence of formal data collection and research for the numerous neighborhood revitalization efforts over the past several decades has resulted in a reliance on mostly anecdotal reporting at a neighborhood or individual level."[43]

Fourth, a prevailing view of minority-owned and inner-city businesses is that these firms are small, undercapitalized and operating largely as subsistence businesses serving local communities. Such a perception is only partially accurate, as the data presented above suggests. Today's minority-owned and inner-city businesses extend beyond barber shops, bodegas, and neighborhood storefronts. Due to strides in educational attainment and professional experience, there is a cohort of capable and experienced minority managers primed to lead entrepreneurial ventures who will be seeking investment capital to support their efforts

Fifth, the predominate thrust of U.S. public policy involving minorities and inner cities has focused on workforce diversity – improving the hiring and promotion prospects within existing firms. These efforts have transformed our nation, creating a large and growing minority middle class. The nation is prepared to move beyond these efforts to creating wealth and assisting in the next wave: transition to firm ownership and market leadership.

These reasons explain the current low level of investor interest in the EDM asset class. A careful analysis of current characteristics of EDM opportunities and the potential returns to investments in these markets shows that these markets are poised for expansion.

the economic **performance**

Promising Metrics

EDM-focused private equity firms have yielded better returns than the general private equity market over the past decade. Recent research conducted on 24 minority-focused venture capital firms that made investments during the 1989-1995 period (117 total investments) indicate that the internal rate of return of the funds ranged from -32% to 79%, with a median of 19.5% and a mean of 23.9%. This mean IRR of 23.9% compares favorably to the 10 year trailing average annual return for the Private Equity Performance Index of 20.2%.[44] Of 117 individual EDM private equity investments analyzed, 64 yielded positive returns.[45] The cash flow generated from these investments totaled $65.8 million, resulting in an average of $562,400 per investment. The EDM firms' net return totaled $124.2 million, an average of $1,061,500 per investment. This study is one of the first of its kind, and further studies are needed to chart the growth of investments in these markets.

	Minority-focused Private-Equity Funds Returns[46]			
	High	Low	Mean	Median
IRR (cash on cash)	79%	-32%	23.9%	19.5%

EDM Investment Firms

Company	Capital ($million)
21st Century Group	80
Ark Capital Management	31
Ascend Venture Group, LLC	60
Atlantic Coastal Ventures, LP	NR
Axxon Capital	50
Bank of America Principal Investing	440
Bastion Capital Corp.	125
Black Enterprise/Greenwich Street Mgmt. Co.	91
Blue Capital Management, LLC	122
Canyon Johnson	200
Carthage Partners	20
Detroit Investment Fund	52
Fairview Capital Partners	1700
Fulcrum Venture Capital Corporation	40
Goldman Sachs Urban Investment Group	NR
Hispania Capital Partners	125
ICV Capital Partners, LLC	130
Inroads Capital Partners	50
JP Morgan Chase Community Development	300
JME Opportunity Partners	30
Kline Hawkes & Co.	300
Milestone Growth Fund	21
MMG Ventures	20

New Vista Capital	73
New York City Investment Fund	95
Nogales Investors, LLC	89
Opportunity Capital Partners	135
Pacesetter Capital Group	201
Palladium Equity Partners	231
Parish Capital Advisors, LLC	300
Pennington Partners & Co	90
Pharos Capital Group, LLC	150
Polestar Capital Partners	40
Progress Investment Management Company	65
RGG Capital	25
Reliant Equity Partners	110
SB Partners	22
Smith Whiley & Company	120
Solera Capital LLC	300
Syncom Management Company	400
TCW/Latin America Partners, LLC	300
Telecommunications Development Fund	50
TSG Capital Group	740
United Enterprise Fund L.P.	30
UrbanAmerica L.P.	200
Yucaipa Corporate Initiatives Fund	600
Total	6,603

Case Studies of Exemplar Firms: Stories Behind the Numbers

Caribbean Restaurants, Inc.

Company Description

Caribbean Restaurants Inc. (CRI) operates the oldest and largest fast food franchise in Puerto Rico. CRI holds the exclusive franchise from Burger King Corporation to own and operate restaurants in Puerto Rico. CRI operates over 150 restaurants, making it one of the five largest Burger King franchisees worldwide.

History

The company began in 1963 as a single Burger King franchise in San Juan. By 1976, the business had grown to 18 restaurants and was sold to H.J. Heinz Company who owned the business for 15 years and grew it to 86 units. By 1996, the year that private equity firm American Securities Capital Partners (ASCP) purchased the company, CRI had grown to 107 units.

CRI's "first-mover" advantage in 1963 created an enduring brand image and a reputation for quality and service. CRI's Chief Executive Officer, Luis Arenas, has been with the business since 1964 and several other members of senior management have been with the company for over 15 years. This continuity of senior management and their collective knowledge of the Puerto Rican marketplace, the fast food industry and the local community have been critical to the franchise's success. CRI has developed irreplaceable long-standing relationships with many of the Commonwealth's business leaders.

Management believes community involvement in Puerto Rico is an important success factor for the company. CRI has a long-standing tradition of active community leadership for a multitude of causes. Its involvement in, and commitment to, the community of Puerto Rico over the last 35 years has earned the Company a variety of awards and recognition.

Under ASCP's ownership, CRI embarked on an aggressive unit expansion plan to further penetrate the growing Puerto Rican market. By leveraging the experience of management and the strategic guidance of ASCP, CRI grew the number of units from 107 in 1996 by 21% to 130 units in 1999.

In addition, the CRI's gross and operating margins are among the highest of any Burger King fast food franchise in the world. CRI's organizational structure, financial reporting and controls, well trained staff, and below average employee turnover all contribute to impressive restaurant operating margins that have regularly approximated 23% over the 5 years up to 1999.

Sales grew from $136.9 million in 1996 to $184.3 million in 1999.

Transaction:

In September 1999, CRI was recapitalized through a majority sale to an equity investor. The $270 million transaction, combined with an earlier debt recapitalization in 1997 produced a realized 84% internal rate of return or 3.7x ASCP's original $34.1 million of invested capital.

Carver Bancorp

Company Description

Carver Bancorp, Inc. one of the largest African-American operated financial institutions in the U.S. Carver's branches are principally located in economically disadvantaged inner city communities. Carver is headquartered in Harlem and has six branches in Manhattan, Brooklyn and Queens, and approximately 40,000 deposit accounts and 900 lending relationships.

History

Carver Bancorp, Inc. is the holding company for Carver Federal Savings Bank which was formed in 1948 to meet the credit and financial service needs of African-Americans in the New York City area. Carver converted from a mutual to a stock savings bank in 1994 and is traded on the American Stock Exchange under the symbol "CNY".

Carver's strategy is a "Hometown Banking" initiative that seeks to take advantage of the Carver brand and the growing economic development within the communities it serves. The bank intends to grow in scale through increased deposits, marketing efforts, offering a broader financial product mix, building new branches and leveraging technology to broaden its distribution outside its historical geography.

In January 2000, Carver Bancorp, Inc. announced that it has entered into strategic alliances with Provender Capital Group, L.L.C., a New York-based minority and woman-owned private equity investment firm and Morgan Stanley Dean Witter & Co., under which Carver received $2.5 million in new capital. This investment provided Carver with capital to pursue its new growth strategy, access to new financial products and services, and additional long-term equity partners. Provender was attracted to Carver by its high brand recognition, loyal depositor base, highly regarded CEO with strong leadership, economic growth in upper Manhattan, under-banked market and historically under-managed with significant operations improvement potential.

Additionally, in March 2004, Carver announced the signing of a definitive agreement to purchase Independence Federal Savings Bank in Washington D.C. for $32.6 million. With total combined assets to over $750 million, the acquisition will make Carver the largest African-American operated community bank in the country. The transaction is subject to certain regulatory conditions but is expected to close during 2004.

Transaction

Provender Capital Group invested $1,500,000 in Convertible Preferred Stock in January 2000 for a 4.9% ownership interest. The stock pays a 7.875% dividend semi-annually to the fund. Provender has one of nine board seats.

DeliMex

Company Description

DeliMex is a producer of frozen ethnic foods headquartered in San Diego, California. DeliMex focuses on well-defined niches with innovative and highly differentiated products of superior quality, taste and packaging. DeliMex's flagship products are the frozen taquito and tamale which were originally sold through the warehouse club channel.

History

DeliMex was founded in 1984 by Oscar Ancira Sr. with manufacturing facilities in both San Diego and Monterrey, Mexico. When the Ancira family sold their business to private equity firm, Fenway Partners in 1997, DeliMex's products were being sold in over 375 Price/Costco and Sam's outlets and over 4,100 retail supermarkets which represent approximately 16% of the total retail market. The Company's geographic focus of both club and retail distribution is in the Southwest and West. In Mexico, the Company enjoyed 90% share of the frozen pizza market and produces various Mexican products for sale in Mexico. Sales of their two primary products, taquitos and tamales, grew at a CAGR of 41% and 20% respectively from 1993 to 1996.

With the help of Fenway, DeliMex has successfully positioned itself as the leader in the niche of high quality, value-priced, authentic ethnic frozen food. DeliMex was able to win share by providing a unique line of high quality products which are positioned to benefit from the growing demand for handheld, convenient, ethnic foods.

Fenway was not only a financial sponsor in this transaction but also provided operating advice and assistance. Fenway's investment professionals were able to deepen management infrastructure, finance the expansion of DeliMex's facilities, create a national brand and further product development.

As a partial result of Fenway's efforts, revenues grew from $90 million to $159 during the time of Fenway's ownership. DeliMex's well established reputation in the club stores reflects its ability to be consistent category leader and successfully launch new products which draw traffic to the freezer aisle.

Transaction

In 2001, DeliMex was sold to H.J. Heinz Company producing a positive return to Fenway's original investment of approximately $28 million of invested capital.

Radio One

Company Description

Radio One Inc is the largest radio broadcasting company in the US primarily targeting African Americans. Headquartered in Washington D.C., Radio One owns and/or operates 67 stations in 22 markets and programs five channels on the XM Satellite Radio, Inc. system. Thirty six of these stations are in 14 of the top 20 African American radio markets

History

Washington D.C. based Radio One, Inc. was founded by current Chairperson Cathy L. Hughes and her husband in 1980. Hughes began her career in radio as General Sales Manager of WHUR-FM, the Howard-University owned, urban contemporary radio station. Hughes found Syncom Venture Partners, an early stage venture capital fund providing growth capital to minority entrepreneurs and underserved markets, when looking for financing to purchase her first radio station, WOL-AM, and expand into music programming. Syncom funded the acquisition of WOL-AM and several stations thereafter.

When Hughes began to reach scale in 1985, she brought in her son Alfred Liggins III, who took on increasingly more challenging management roles. A graduate of Wharton's Executive MBA program, Liggins engineered Radio One's expansion into other national markets after becoming President. To further professionalize Radio One, Hughes brought in Scott R. Royster as CFO. Royster was a principal at TSG Capital Group LLC, a minority-owned private equity firm, which became an investor in Radio One in 1987. In 1987, Hughes purchased another radio station in Washington D.C, WMMJ-FM, for about $7.5 million and began to broadcast a new musical format targeting African-Americans. This began Radio One's strategy of purchasing underperforming radio stations, changing to an urban format and using programming, marketing, and operating skills to cut unnecessary costs. With the help of private capital from Syncom, TSG and others Radio One ramped up its consolidation efforts and acquired several urban radio stations. When the company reached critical mass, Hughes decided that the public markets offered a great opportunity to validate the business premise in the public markets and use public capital as a cheaper source of capital to continue her acquisition strategy.

Today, Radio One, Inc. is the nation's seventh largest radio broadcasting company and the largest primarily targeting African-American and urban listeners. Hughes' stations now reach over 18 million African American listeners daily

Transaction

In 1999, Radio One went public representing the 2nd largest black-owned broadcast corporation and the 16th-largest media company in the United States with the rapid initial investment of approximately $1.7 million.

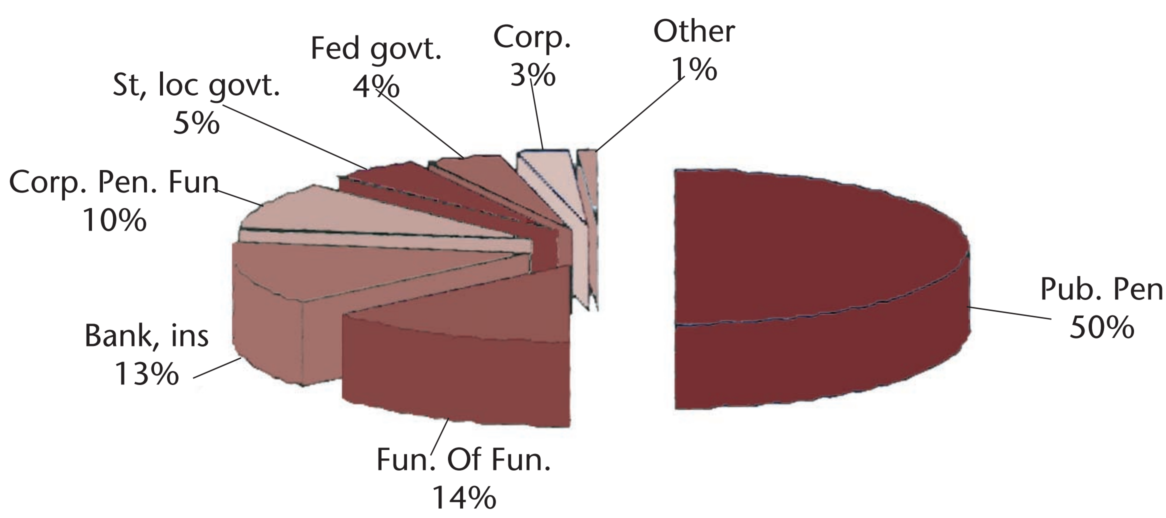
best practices of institutional actors in **EDMs**

There is a sense that institutional investors have been wary of investing in EDM-oriented private equity firms because of perceptions of low quality of opportunities in this market or low quality of the professionals working in these markets.[47] These erroneous assessments have partially been corrected over the last 10 years as institutional investors began to recognize the untapped potential of the EDM market niche. Some institutional investors have taken on new initiatives, designed to increase their EDM investments.

While institutional investors are playing an increasing role in EDM private-equity, the overall structure of committed capital shows the nascent stage of institutional investors commitment to EDM-focused investing. Today, EDM-targeted venture funds manage over $2 billion of the total $650 billion US private equity capital pool.[48] Investors in these funds include: pension funds, banks, insurance companies, private companies, fund of funds, endowments, foundations, families, and individuals. Public pension funds (51%), Private Equity Funds of Funds (14%) and Banks and Insurance companies (13%) hold the lion's share of capital committed to minority-owned venture funds.[49] For comparison, U.S. public pension funds capital commitments ($18 billion) represent only .5% of their total committed capital.[50]

Where Do EDM-Targeted Private Equity Firms Get Their Funding?

Investors in EDM-targeted Private Equity Funds



Source: Bates, Timothy and William Bradford. Minorities and Venture Capital: A New Wave in Amerian Business. Kauffman Foundation 2000.

Given the strong performance of EDM private equity firms, an increasing number of institutional investors have become interested in committing capital to this asset class. However, the majority of the EDM firms are less than $200 million, in terms of total committed capital. The firm's size makes it difficult for many plan sponsors to invest at the level they prefer. This creates minimum investment and concentration constraints that may deter some from entering the space.

Case Studies of Institutional Investors Committed to EDM

The following are exemplar plan sponsors and firms committed to investing in the EDM asset class.

CalPERS

Pension Fund

California Public Employees Retirement System (CalPERS)

Description

CalPERS provides retirement and health benefits to more than 1.4 million public employees, retirees, and their families and more than 2,500 employers. Their goal is to efficiently and effectively manage investments to achieve the highest possible return at an acceptable level of risk.

In May 2001 CalPERS Investment Committee approved an allocation of $475 to the California Initiative Program. In total 10 private equity firms will invest the capital for this program. Approximately $250 million has been invested to date in 45 businesses. The California Initiative invests in traditionally underserved markets primarily, but not exclusively, located in California. The objective is to discover and invest in opportunities that have been bypassed or not reviewed by other sources of investment capital. These opportunities will offer attractive risk-adjusted returns commensurate with their asset class. In addition to the capital raised by the California Initiative the selected fund managers have raised almost 150% more capital from other investors other than CalPERS.

Sponsors

California State Treasurer Phil Angelides
Fred Buenrostro, CEO, CalPERS
Richard J Hayes, Senior Investment Officer for Alternative Investment Management Program, CalPERS
Joncarlo Mark, Portfolio Manager CalPERS

Program

California Initiative Program

Criteria

Target investments in funds focused on underserved markets include women or ethnic minority owned or managed companies, companies located in or employing residents of low and moderate income areas, and companies located in urban or rural areas with a primary focus on California.

Selected Funds

American River Ventures
Bank of America
Draper Fisher Jurvetson
Nogales Investors
Garage Technology Bank
Green Equity Investors
Opportunity Capital
Provender Capital
Pacific Community Ventures
Yucaipa Corporate Initiatives Fund

Progress Investment Management

Fund Manager
Progress Investment Management Company

Description
Founded in 1990 and headquartered in San Francisco, Progress Investment Management Company creates diversified, risk-controlled multi-manager investment funds in a variety of asset classes for institutional clients. Minority owned and managed, Progress specializes in working with smaller, entrepreneurial money management firms with innovative investment strategies. Progress manages approximately $3.8 billion in total assets in public equities and fixed income securities with $100 million focused on private equity partnerships. Progress is unique in that it is the only firm working in the emerging manager space funding investment strategies in both public securities and private equity.

Progress, dedicated to seeding emerging private equity managers, manages $100 million funds on behalf of other investors and incubates and supports emerging managers.

Sponsors
Thurman V. White, President of Progress Investment Management
Donna K. Gilding, Chief Investment Officer and former Chief Investment Officer for the New York City Comptroller's Office

Representative Programs
New York Common Retirement Fund (CRF)
Massachusetts Bay Transportation Authority Retirement Fund (MBTARF)
State Universities Retirement System of Illinois (SURS)
Shell Oil

Criteria
1) Emerging firms - firms that are independently owned and have less than $2 billion in assets under management in publicly-traded securities, and newer (including first-time) partnership.
2) Minority- and woman-owned firms.
3) Firms with a short track record, a niche focus or a low marketing profile.

Selected Funds
Ascend Ventures Fund
Bastion Capital Fund
ICV Partners
Pharos Capital Fund
Syndicated Communications Ventures Fund IV

New York City Retirement Systems

Pension Fund

New York City Retirement Systems

Description

New York City Employees' Retirement System has approximately $73 billion under management. They system invests for its 237,000 retirees and beneficiaries and more than 344,000 City and City affiliated employees. In October 2003, New York City Comptroller William C. Thompson, Jr., on behalf of the New York City Retirement Systems, issued a request for qualifications (RFQ) targeting discretionary managers to invest up to $175 million in emerging private equity funds. Thompson and the Retirement Systems hope to take advantage of the market opportunity presented by small, first-time funds, particularly those owned by women or members of minority groups. They are currently in the process of selecting one or two fund-of-funds to manage this program.

Sponsor

William C. Thompson, Jr., New York City Comptroller

Criteria

The goals of this initiative include:

- Maximizing the risk-adjusted return on capital invested;
- Taking advantage of the market opportunity presented by small, first-time funds, particularly those owned and operated by women or members of minority groups, seeking to raise institutional capital to invest through private equity limited partnerships; and
- Using niche strategies to achieve value unavailable to investors pursuing broader strategies.

Representative Programs

New York City Employees' Retirement System
Teachers' Retirement System of New York City
New York City Police Pension Fund
New York City Fire Department Pension Fund

recommendations

How can plan sponsors participate in EDMs?

Plan sponsors are becoming increasingly interested in EDMs as an additional source of diversification for their portfolios. EDM firms represent an opportunity to invest in an additional asset class offering strong return potential with limited penetration. We have evaluated the best practices of plan sponsors who are making successful investments in America's Emerging Domestic Markets to develop the following set of recommendations for other sponsors who wish to participate in this burgeoning market:

- ### Make direct investments in EDM-focused funds with $150 million+ in committed capital

Like their international counterparts, EDM investments should be undertaken by investment professionals with experience in these communities. Therefore, to optimize the opportunity that EDMs represent, sponsors should build relationships with, and invest directly in, EDM funds. These funds will have solid networks of relationships and experience to best source, evaluate and manage opportunities.

- ### Invest in EDM-focused funds via a funds-of-funds approach

Due to the demography of the private equity industry, many EDM-focused investors will be newer funds with fewer assets under management and shorter investing track records. Conversely, most municipal sponsors have billions of dollars in assets to invest on behalf of their employees, retirees and beneficiaries. Even with percentage allocations in the single digits, it is inefficient for many of these municipal sponsors to make direct investments of less than, for example, $25 million per investment company. However, this investment size is often too large for smaller funds due to concentration constraints. Therefore, we recommend that plan sponsors adopt a fund-of-funds approach to EDM investing. This will allow them to efficiently fund smaller, emerging managers in the space, thereby building total investment and experience in the EDM markets.

- ### Require gatekeepers at partner investment funds to monitor diversity hiring practices of investment professionals at majority firms

One of the challenges of EDM investing is familiarity with the cultural and social context in which that investment occurs. Firms seeking to enter this space, require not only that familiarity, but specific knowledge of the unique forces that influence EDM firm viability. One of the ways to build up that knowledge base is to recruit, develop and promote investment professionals who have EDM expertise. Plan sponsors can encourage private equity firms to diversify their workforces to include professionals with that experience and monitor firms' efforts toward that goal.

conclusions

The cornerstone of America's capitalist society is opportunity -- the notion that each participant in society, if given the chance, can succeed. Today, a confluence of factors, including demographic change, immigration, movement back into urban centers, and rising educational attainment are sweeping the country, creating novel opportunities for shrewd investors. The efforts of these investors are likely to lead to strong and stable growth in new sectors of our economy.

Although a number of economic indicators have shown strong growth in EDM businesses, challenges remain. For example, while EDM firms employ a greater number of the chronically underemployed, these firms generally employ fewer people overall. Additionally, EDM firms have grown faster than other firms in number, but represent a smaller fraction of firms than their demographic representation would lead us to expect. Furthermore, these firms have grown more rapidly in revenues, but still lag behind other firms in average revenues.

In the past, some explained the lag as due to limited economic opportunity in EDM markets and limited skills of EDM firm managers. We now know that those characterizations inaccurately describe the contemporary EDM firm or its management. In fact, minority markets are growing at a rapid pace, and the educational gains of the past half century have produced a cadre of managers with the requisite skills and cultural knowledge to leverage these opportunities.

A dynamic cadre of EDM investors has emerged as a catalyst to this growth. These investment professionals have been educated in the leading institutions of higher education and have been trained at some of the country's most prestigious financial organizations. By taking their passion, skill and networks into this growing market, they are providing their business partners with supernormal returns. While their work may have societal benefits, their firms are committed to achieving competitive economic returns.

The ability to aggressively pursue these new opportunities in an aggressive manner is somewhat diminished by the scarcity of startup and growth capital. For this reason, studies consistently show that EDM firms lag in the amount of funds used to capitalize their businesses. When funded, they tend to show an over-reliance on debt, as opposed to equity capital as a source of funds. In addition, they have yet to benefit from the counseling, networking and social support that often accompanies venture capital.

The natural question that arises from this discussion of EDM markets and firms is, "How do we now use this information to participate in the opportunity that EDM presents?" This question is most relevant to those investors interested in bridging the funding gap that exists for EDM companies between equity and debt financing. Our recommendation to these investors, likely plan sponsors, who are focused on their fiduciary duties to explore all opportunities to generate financial returns on behalf of their beneficiaries, and have interest in doing so by exploring EDMs as an opportunity is to do the following:

- Make direct investments in EDM-focused funds with $150 million+ in committed capital
- Invest in EDM-focused funds via a funds-of-funds approach
- Require gatekeepers at partner investment funds to monitor diversity hiring practices of investment professionals at majority firms

This report has profiled the economic opportunity resident in EDMs, while providing a map for leveraging this market to reap financial and societal returns through investment. We hope that what you've read has piqued your interest and provoked you to learn more about exploring the vast and varied opportunities presented by America's Emerging Domestic Markets.

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