



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Paul Krutko

SUBJECT: SEE BELOW

DATE: April 12, 2006

Approved

Kay Winer

Date

4/30/06

COUNCIL DISTRICT: Citywide
SNI AREA: NA

SUBJECT: Authorization to negotiate a contract with Pacific Community Ventures as the Fund Manager for an Economic Development Catalyst Program (EDCP) for Fund Management services.

RECOMMENDATION

Authorization to negotiate a contract with Pacific Community Ventures as the Fund Manager for an Economic Development Catalyst Program (EDCP) for Fund Management services.

The competitive selection of a Fund Manager for the EDCP will further the City's Economic Development Strategy by helping to: (a) "Support Start-Up and Growth of Local Businesses" (Initiative 5), (b) "Diversify San Jose's Economic Base and Preserve/Create Middle-Income Jobs" (Initiative 8), (c) "Develop Retail to Full Potential and Maximize Revenue Impact" (Initiative 13), and (d) "Engage Private-Sector Leadership for San Jose's Economic Strategy" (Initiative 15).

OUTCOME

Negotiation of a contract with Pacific Community Ventures, the highest-ranking EDCP proposer, for subsequent Council approval, to provide Fund Manager services to leverage City monies and increase economic impact in terms of enhanced job creation and an expanded tax base.

BACKGROUND

From 1994 through August 2005, the City of San Jose operated a small business loan program called the Development Enhancement Special Fund (DESF). The DESF has supported small businesses with loan guarantees and direct loans; a total of \$7,693,000 in private capital was made available to small businesses through loan guarantees, and \$2,390,000 was provided as direct loans, resulting in approximately 1,243 jobs retained or created with \$2,550,000 in new sales tax revenues generated. A total of 1.8 FTE, one Economic Development Officer and one Sr. Office Specialist, are currently funded through the use of the interest from the DESF for administration of the fund.

In an effort to enhance the economic impact for San Jose's small business community, the Office of Economic Development (OED) forwarded a recommendation to City Council to proceed with a process to select a Fund Manager to establish and manage a new, expanded Economic Development Catalyst Program (EDCP). The intent of such a program is to provide financial services, technical assistance, and information targeted to job-generating companies with high growth potential. Such an approach appears to have the possibility of leveraging substantial venture capital investment in San Jose companies from the private sector. It is a fundamental objective of the City of San Jose that the community impact achieved through the creation of the EDCP will surpass that of the DESF.

In order to serve as a catalyst for economic growth, while encouraging the private sector to sustain and drive that growth, the City of San Jose will endeavor to provide up to \$3 million to assist in capitalizing the EDCP. The City's objectives as they relate to the creation of this EDCP are: (1) to build the City's tax base, (2) to create jobs for local residents, (3) to facilitate the integration of other programs and services targeted to the small business community, and (4) to create the opportunity to participate in the financial success of companies receiving investment from the EDCP.

Although the EDCP's jurisdiction may eventually include communities located outside of the City of San Jose, the city's capital contribution (CCC), and any funds to be added to the CCC, would be invested within the jurisdiction of the City and used only to fund private businesses. The return from those business investments will be used to further capitalize the EDCP's investment operations, recapture the City's investment, and to compensate the Fund Manager and other investors.

At its October 18, 2005 meeting, City Council directed staff: (1) to release a Request for Proposals (RFP) to select a Fund Manager for the EDCP, and (2) to provide information relating to the sale of the DESF portfolio as part of the capitalization of the new EDCP. The EDCP RFP was released on December 7, 2005, and a Request for Bids (RFB) for the sale of the DESF portfolio was released on January 17, 2006. Information regarding the outcome of the DESF RFB will be provided to City Council in an additional memo.

Both documents were posted on OED's website (www.sjeconomy.com), the Silicon Valley Workforce Investment Network's website (www.svwin.org) and the City's BidLine Service. A representative of Federal Deposit Insurance Corporation (FDIC) distributed the documents to local banking institutions. Additionally, copies of the RFP and RFB documents were sent to over 30 members of the local financial services community. EDCP Technical Assistance Conferences were held on January 6 and February 7, 2006. Nine firms attended these conferences.

ANALYSIS

Proposals

Three firms provided proposals in response to the EDCP RFP. Staff from OED, Redevelopment, and Retirement evaluated the proposals and participated in interviews with the proposers, ranking them as follows:

Ranked List Determined by Evaluation Panel

Rank	Proposing Entity
1	Pacific Community Ventures
2	California Economic Development Lending Initiative
3	Bay Area Equity Fund Managers I / JP Morgan

The evaluation criteria used as the basis for scoring the proposals and interviews were:

1. Demonstration of the Need
2. Qualifications and Experience
3. Business Approach/Work Plan
4. Leveraging
5. Local/Small Business Preference

Specific information regarding the evaluation criteria was presented to City Council on October 18, 2005. Price was not a factor in the evaluation of these proposals.

All three proposals received in response to the EDCP RFP offered high-quality, attractive financing options and small business technical assistance strategies. Due to the RFP's market-based approach, responses varied by size of investment, types of portfolio businesses, and expected rate of return to the City. None of the three proposals received points for Local and Small Business Preference, as they did not qualify under the requirements of the ordinance.

Pacific Community Ventures, the highest-ranking proposer, was selected based on: (1) the quality of their response to RFP requirements, (2) their business approach, (3) their track record of providing similar services as those requested in the RFP, and (4) their ability to leverage City funds for enhanced local economic impact.

Pacific Community Ventures

Pacific Community Ventures of San Francisco, California, established in 1999, is an equity investor focused on the simultaneous creation of both a financial and social return on investment. Their target market includes small businesses with approximately \$5 million in annual revenues in specific industry sectors such as value-added manufacturing, business services, and specialty consumer products. PCV supports its portfolio companies through a combination of equity investments and intensive technical assistance. Its typical investment ranges from \$1 million to \$1.5 million. Its investors have included Wells Fargo, California Public Employees' Retirement System (CalPERS), United Commercial Bank, and the CDFI Fund of the United States Department of the Treasury.

PCV proposes to manage the city's capital contribution (CCC) through a separate, to-be-established, Limited Liability Corporation. For every dollar that the City provides, PCV will agree to provide a match of at least 6:1. Assuming an investment of \$1 million per company, the CCC would be \$150,000, and PCV, through the above-stated funding sources, would fund \$850,000. The source of funding for PCV's match includes available funds from two other existing funds under PCV's management (PCV 1 and PCV 2), and a planned third fund (PCV 3) that will be operational by July 15, 2006. Given that PCV often provides a second round of financing to its portfolio companies prior to exit, the total expected number of companies to be supported with the CCC is between 12 and 14 over a three- to four-year period.

PCV has a very sophisticated methodology for tracking and calculating their social rate of return, including an assessment of the qualitative aspects of job creation (i.e., benefits, career ladders, training, etc.). Since 2000, 1,531 low and moderate-income employees have worked in PCV-financed companies; over 70% of these employees are minorities and 36% are women. During 2004, new low and moderate-income employees received an average of over 51 hours of training during their first three months of employment at PCV-financed companies.

PCV would charge a management fee of 3% of committed capital. In addition, they would receive 20% of available cash flow once the City and other limited partner equity investors have received an amount equal to their capital contribution. The expected return on the CCC is 14% to 16%.

The California Economic Development Lending Initiative

The California Economic Development Lending Initiative (CEDLI) also provided a responsive proposal. Created in 1995, CEDLI is supported by 43 financial institutions. CEDLI has invested in over 400 companies during this time and has experienced less than a 3% default rate. They provide mezzanine financing in the range of \$90,000 to \$300,000 per investment. For every dollar that CEDLI would use of the CCC, CEDLI would provide a match of one dollar of

subordinated debt directly from its own funds. In addition, and as part of the operating agreement with its 43 banking institutions, the member banks will provide 2 dollars of senior debt for every 2 dollars of subordinated debt provided by CEDLI. Hence, the match of the CCC is 3:1.

JP Morgan

Though the RFP was for \$3 million, JP Morgan's proposal centered upon a minimum \$10 million request for funds. In addition, they would only commit to use "best efforts" to reinvest the CCC and related leveraged investments within the City of San Jose. Their target range was approximately \$5 million per investment.

With the City Council's authorization to negotiate an agreement with PCV to create and manage the EDCP, the City would negotiate a detailed term sheet that would form the basis of the operating agreement to be executed between the City and PCV, once PCV's first round of funding is committed. The agreement would be conditioned upon the closing of PCV 3 by September 1, 2006. In the event that a contract with PCV is not successfully negotiated by September 30, 2006, the City would negotiate a contract for Fund Manager services with the next highest-ranked proposer.

Next Steps

In order to establish the viability of the Economic Development Catalyst Program, staff recommends authorizing negotiations prior to resolution of the outstanding issues below. If negotiations with PCV are successful, staff will return with a proposed agreement for Council approval along with proposed solutions to the following issues:

- Disposition of the positions currently funded by the DESF.
- Reappropriation of the monies in the DESF.

Council authorization of negotiations with PCV will not have any immediate budgetary impacts and are not considered in the City Manager's 2006-2007 Proposed Operating Budget that will be reviewed and discussed by the Council in May 2006. Any subsequent request for Council approval of an agreement will include recommendations for appropriate budgetary and position adjustments as necessary.

PUBLIC OUTREACH

Staff held a series of focus groups and other types of consultations with a wide range of stakeholders to assess the need, viability, and the City's approach in identifying a sponsor for a small business investment fund of this nature. Feedback received from these stakeholders provided sufficient impetus to move forward with an RFP for a Fund Manager.

OED worked extensively to ensure a broad distribution of the EDCP RFP to potential providers of these services, using local media and direct solicitation. The RFP and RFB documents were posted on OED's website (www.sjeconomy.com), the Silicon Valley Workforce Investment

Honorable Mayor and City Council

04-12-06

Subject: Economic Development Catalyst Program RFP

Page 6 of 6

Network's website (www.svwin.org) and the City's BidLine Service. A representative of FDIC distributed the documents to local banking institutions. Additionally, copies of the RFP and RFB documents were sent to over 30 members of the local financial services community.

COORDINATION

This memorandum was coordinated with the City Attorney's Office, the Budget Office, the City Manager's Office, Finance, Employee Relations, Retirement Services, and the Redevelopment Agency.

COST IMPLICATIONS

At this time, there are no cost implications associated with the negotiation of the agreement. Should such an agreement be reached, the City investment amount is estimated to be \$3,000,000 drawn from the Development Enhancement Special Fund (Fund 439). The actual program funding will be based on the negotiations, approval, and completion of the sale of the existing DESF portfolio, subject to a final review of Fund 439 and the remainder obligations.

The existing DESF has adequate capital to fund the cost of the project, provided the existing portfolio is successfully sold on the private market. The remaining funds should be adequate to maintain the DESF's remainder obligations associated with loan guarantees, servicing and collections on the existing portfolio.

CEQA

Not a project.


PAUL KRUTKO
Director, Office of Economic Development

For questions please contact Paul Krutko, Director of OED, at 535-8179.