



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Paul Krutko

SUBJECT: SEE BELOW

DATE: October 25, 2006

Approved

Date

12/30/06

COUNCIL DISTRICT: Citywide
SNI AREA: NA

SUBJECT: Authorizing the City Manager to execute an Investment Management Agreement with Pacific Community Ventures.

RECOMMENDATION

- (a) Adoption of a resolution authorizing the City Manager to execute an Investment Management Agreement with Pacific Community Ventures (PCV) as the Investment Manager for an Economic Development Catalyst Program (EDCP) to create a resource for strategic investment to support the growth and expansion of San Jose's small businesses, for a term of 10 years and a City capital commitment of up to \$3 million to capitalize the EDCP.
- (b) Approval of two five-year options to extend the agreement at the City's discretion.

OUTCOME

Execution of an agreement with Pacific Community Ventures to provide Investment Management services will better leverage available City funds and increase economic impact in terms of enhanced job creation and an expanded tax base. The intent is to invest early in high growth "gazelle" companies that will have significant capital and job growth (eBay is an example of a gazelle company). The City is piloting a new, experimental business model in order to achieve these objectives.

EXECUTIVE SUMMARY

The Economic Development Catalyst Fund represents a partnership between the City of San Jose and Pacific Community Ventures (PCV) to support high growth small businesses within San Jose. The City will dedicate up to \$3 million to support the creation of the EDCP. Acting as the

City's investment advisor, PCV will leverage the City's capital contribution 5.7:1. PCV has extensive experience in working with small businesses and provides investees with a wide range of funding and technical assistance to help in the expansion of small businesses and in the enhancement of the local tax base and job creation. As the fund manager, PCV, which was chosen through a competitive RFP process, will receive a 3% management fee for identifying and servicing the small business investments. The City and PCV will share 80/20 respectively in the profits of the investments made in the various small businesses. This new investment model represents a pioneering and innovative approach for the City to focus its support and resources in support of high growth small businesses.

BACKGROUND

From 1994 through the present, the City of San Jose operated a small business loan and guarantee program called the Development Enhancement Special Fund (DESF). Through two separate Council actions in 1994 and 1995, \$3,500,000 was made available to capitalize the DESF. The DESF has supported small businesses with 52 loan guarantees and 41 direct loans. A total of \$7,693,000 in private capital was made available to small businesses through loan guarantees, leveraging City funds nearly 2.2:1. \$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.

While these numbers may seem impressive, in a city economy with 54,000 small businesses, the opportunity to support the growth of selected small businesses into leading regional, national and/or global companies exists. In turn, this growth (like eBay, from one employee ten years ago to 11,600 today, with 2,170 employed in San Jose) creates new customers and opportunity for existing small businesses throughout the City. The concept is to support small business growth that would move the entire San Jose economy rather than to provide financial assistance to businesses that are incremental players in a market niche already served by a number of other small businesses.

To explore the City's opportunities to help seed gazelle companies, the Office of Economic Development (OED) forwarded a recommendation to City Council at its meeting on October 18, 2005 to proceed with a process to select a Fund Manager to establish and manage a new Economic Development Catalyst Program (EDCP). 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. The sale of the DESF portfolio will be addressed in a separate memo.

The intent of the RFP was to determine whether a private sector partner existed to create a program to provide capital investment, technical assistance, and information targeted to job-generating companies with high growth potential. By offering a substantial City capital participation, the goal was to leverage substantial venture capital investment in San Jose

companies from the private sector. A threshold criterion of the solicitation is that the community impact achieved through the creation of the EDCP will surpass that of the DESF. Additionally, proposals were sought that would achieve a higher rate of return than the 4% rate historically earned through the DESF.

The RFP identified that the City's objectives in exchange for an investment of up to \$3 million 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.

The City's capital commitment, and any funds to be added to this capital commitment, will 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 small business investment operations, recapture the City's investment, and to compensate the Investment Manager and other investors.

On May 2, 2006, City Council authorized OED to negotiate a contract with Pacific Community Ventures (PCV), the highest-ranking proposer. PCV was selected to provide investment management services 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 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.

Although the EDCP Request for Proposal did not require responses to have an emphasis on benefiting low- to moderate-income communities, PCV's proposal successfully met OED's objectives in creating the EDCP and will also benefit these communities. As mentioned above, PCV has both a financial and social focus; however, nothing would preclude PCV from providing investment advice to the City regarding investments that do not meet PCV's social objectives.

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 (e.g., benefits, career ladders, training, etc.). Since 2000, 1,531 low and moderate-income employees have worked in nine 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.

ANALYSIS

PCV had originally proposed to manage the City's capital commitment through a separate Limited Liability Corporation. However, based on extensive negotiations with PCV over various legal and business points surrounding the transaction, it was subsequently determined that, due to: (1) PCV's concerns regarding potential public disclosure of confidential portfolio company financial data and (2) the City's concerns regarding limited approval of individual investments (both applicable to limited partners), the City has developed an Investment Management Agreement to formalize the terms under which investments will be made on behalf of the City. Although the originally contemplated deal structure has changed as a result of confidentiality and disclosure concerns, the proposed Investment Management Agreement, developed through close coordination with the City Attorney's Office, preserves the intent of the EDCP, as well as the terms and conditions for investment as set forth in the RFP.

PCV's fairly traditional, limited investment approach will provide the City with straight equity investments in the form of preferred stock, with customary rights such as a liquidation preference, dividend rights, and common stock conversion privileges. Occasionally, they may provide secured short-term convertible notes with warrants (bridge financing), with the objective of converting the notes to preferred stock.

The City Manager or his designee will review and approve all investments recommended by PCV's investment committee to be made through the EDCP. In addition to the development of an annually-updated Investment Plan consistent with the City's EDCP investment policy objectives and requirements, PCV will provide the City with annual investment activity and social return on investment reports to include, as it becomes available, the following information: (1) names of companies receiving investment, (2) amounts invested in each company, (3) rate of return from distributions of interest, dividend income, and proceeds from sale of stock, (4) number and quality of jobs created through the City's capital commitment and related leveraged investments, (5) status of the EDCP account, and (6) status of the capitalization of portfolio companies.

Approximately \$2.4 million will be available for the EDCP from the existing DESF account, of which some \$1.8 million (net of fees addressed below) will actually be invested in San Jose's small businesses. It is contemplated in the Investment Management Agreement that returns from small business investments will be used over time to bring the total City investment to the \$3 million level.

For every dollar that the City provides, PCV will provide a match of at least 5.7:1. Given this leverage ratio, over \$10 million will be made available for San Jose investments through PCV and other co-investors (based on the City's \$1.8 million currently available for equity investments), for a total of over \$12 million to expand and grow local small businesses. This

experimental business approach, apparently without precedent for municipal investments, will be subject to ongoing departmental assessment. Staff will provide information annually to Council regarding the status of the program.

PCV charges 3% of the total capital commitment as a management fee for the first five years, and 90% of the prior year's fee for the sixth through the tenth year. The management fee is calculated as a percentage of the City's total commitment of \$3 million, and will be used to identify potential investments as well as co-investors to leverage each of the City's capital contributions. PCV's fees for the first year will be \$90,000, or 3.75% of the \$2.4 million of currently available capital; in contrast, the historical cost of internally administering the DESF program has been close to \$187,000 per year.

In addition to the management fee described above, PCV will receive a 20% share of any profits generated through EDCP investments. Such profit-sharing arrangements are a typical part of the total compensation due to the Managing Member of a private equity investment fund, and because the Investment Manager will provide services to the City that are similar in most respects to those provided by a venture capital fund manager to its limited partners, the City has agreed to include a similar distribution in the Investment Management Agreement.

Staffing Impact - An Economic Development Officer has been funded through the interest income generated from the DESF for administration of the fund. Upon City Council's approval of the EDCP, staff will execute an Investment Management Agreement with PCV. The position will remain in the City's workforce, but funding will be shifted to the Redevelopment Agency (RDA). The position will be refocused on enhancing small business support services through RDA programs and will include continued administration of the City's Revolving Loan Fund (RLF), RDA's Small Business Loan Program (SBLP), and other duties as assigned by RDA to support small business efforts.

RDA and OED have agreed to aggressively market the RLF and SBLP in tandem in downtown and SNI areas. Total funds available at the time of this memo in the RLF are \$470,000 and in the SBLP, \$445,151. OED will continue to provide financial administration (loan administration and servicing) of the RLF and SBLP through an existing economic development officer and available support staff.

PUBLIC OUTREACH/INTEREST

- ✓ **Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- ✓ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

- Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

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. OED worked extensively to ensure a broad distribution of the EDCP RFP to potential providers of these services, using local media (Mercury News, El Observador) and direct solicitation. The RFP and RFB 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 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.

This memo will also be posted on the City’s website for the November 14, 2006 City Council agenda.

COORDINATION

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

FISCAL/POLICY ALIGNMENT

The execution of an Investment Management Agreement with PCV to provide investment management services 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).

COST SUMMARY/IMPLICATIONS

1.	CITY’s Capital Commitment, EDCP	\$3,000,000
	Management Fee @ 3% of Commitment per annum (over 10 years)	<u>\$ 781,703</u>
	TOTAL AMOUNT TO BE INVESTED THROUGH EDCP	\$2,218,297
	TOTAL AGREEMENT/CONTRACT AMOUNT:	\$3,000,000
2.	SOURCE OF FUNDING: Development Enhancement Special Fund (DESF)	

DESF	Fund 439 Cash and Securities as of Sept. 2006 (FMS)	\$2,925,315
LESS: Reserve for Loan Guarantees @ \$0.50/\$1.00		\$ 69,869
LESS: RDA Small Business Loan Program (SBLP) Cash		\$ 445,151
TOTAL CASH AVAILABLE FOR EDCP		\$2,426,206
Estimated proceeds from sale of DESF loan portfolio, subject to date of closing		\$ 171,156
TOTAL FUNDS AVAILABLE FOR EDCP		\$2,597,362

3. FISCAL IMPACT: No ongoing fiscal impact.

BUDGET REFERENCE

Fund #	Appn #	Appn. Name	Total Appn	Amt. for Contract	Adopted Budget Page	Last Budget Action (Date, Ord. No.)
439	0073	Loans	\$200,000		XI-24	6/27/2006 Ord# 27801
439	7999	Reserve for Loan Guarantee	\$1,100,000		XI-24	6/27/2006, 27801
439	7999	Unrestricted	\$1,527,911		XI-24	6/27/2006, 27801
Total			\$2,827,911	\$3,000,000*		

* It is anticipated that returns from small business investments will be used over time to bring the total City investment to the \$3,000,000 level.

CEQA

Not a project.



PAUL KRUTKO
Director, Office of Economic Development

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