The Challenges of Evolution: EDM Initiatives in Private Equity in Conception and Practice

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The term "emerging domestic markets" (EDM) has generated considerable practical and scholarly interest in economic opportunities in communities that have largely been overlooked by the investment community as a whole. The explicitly economic perspective offered by EDM and the positive associations with international emerging markets have contributed to growing investor interest in low-income and minority communities. However, the lack of clarity in definitions may have created unintended consequences for the investment professionals attempting to develop these markets. In this essay, I describe three examples of how loose definitions have created dilemmas for private equity professionals managing what have been termed EDM-targeted funds. If we agree that language matters, then these cautionary tales call for a greater degree of clarity among opinion leaders when discussing these opportunities.

One area of growing research interest, including my own, has been the performance of the private equity funds generating returns through investments in what have been called EDMs. Although careful studies of the industry are in their nascent stage, a select group of private equity firms has been operating in the arena for several decades such as Syncom Ventures, Pacesetter Capital Group, and Opportunity Capital Partners. Timothy Bates and William Bradford have been answering the question many have wondered: Do these funds produce market-rate returns? Their work indicates that these funds generate comparable returns to those operating in the general market (see Bates and Bradford, 2004; Bates, Bradford and Rubin, 2006).

Over the past 12 months, I have interviewed private equity funds, funds-of-funds, emerging manager administrators, and pension fund trustees on their varied perspectives on the industry as it evolves in definition, scope, and diversification. While the specific focus of my research has been on understanding the role of social relationships in influencing fund-raising, syndication, and valuation of portfolio firms, fieldwork has revealed other challenges that arise from indistinct definitions in practice. Many popular conceptions about the missions of these funds, their strategic orientations, and the professionals who run them do not always match the reality in the field, and I discuss why these differences can create considerable challenges.

Emerging Domestic Markets versus Minority Markets

Some evidence of the increasing regard for EDM as a descriptor is the decision in 2005 by the decades-old National Association of Investment Companies (NAIC) to sponsor the *Journal of EDM Finance* as its industry's trade publication. I should note that I wrote an article for the publication's inaugural issue that provided my own definition of the term (Fairchild, 2005). My fieldwork reveals some ambiguity about the use of the term. Some funds have embraced it, citing the well-developed tastes potential fund investors have for international emerging markets (Asian Tigers, Ireland, former Eastern bloc nations, for example). However, more than one investment professional expressed reservations about the direct comparison to developing international regions. Some questioned whether it was a wise strategy to legitimate America's minority markets, entrepreneurs, and professionals through comparisons to intact nations with dramatically different histories and different institutional and economic contexts.

Still others expressed dissatisfaction with the fuzzy definitions of the term and questioned whether women-owned firms should be included in some popular definitions. While everyone acknowledged that the inclusion of women in the definition was helpful in attracting capital to the space, others objected to the inclusion of women as an underserved market. Firms with long histories of investment in minority markets and dedicated to growing minority-owned firms felt that the fundamental challenges for white women firm owners were substantially different from those of minority managers of either gender. The inclusion of women in some definitions left some investment professionals having to explain to potential portfolio companies or pension fund investors that their expertise related to race and ethnicity, and not to gender.

Confusion with Community Development Venture Capital

Given the centrality of minority consumer and labor markets in many EDM definitions, many of the funds' investment professionals expressed frustration with confusion they experienced in explaining the explicitly investment-driven objectives of their funds relative to the related, but mission-driven Community Development Venture Capital funds (CDVCs).

These managers viewed their peers as mainstream, economically oriented private equity firms, and many felt that equating their funds with community-development funds reflected a belief that minority markets were not viable investments on economic terms alone. "This is not a hobby or a charitable activity," said the founding manager of one long-term, minority-targeted fund. The manager went on to explain the rationale for the fund's decision to decline the invitation to pitch for investment funds from a leading multinational investment bank because they were offering "sorry money" (funds without the expectation of market-return discipline). "We don't attend social entrepreneurship events," said another. "Why is it that whenever the owners, markets, or employees are black or brown, the investment is mission driven? If we believe in the fundamental growth opportunities in these markets, the mission or community impact is simply an added benefit." Another frequently expressed frustration was that potential fund investors with a "social" orientation were often surprised by the market-rate compensation demanded by the investment teams. Finally, some felt that such confusion diminished the interests in larger funds in co-investing in the industry, and my own research shows an unusually high level of syndication with other minority-targeted funds.

Fund-Raising Rhetoric versus Investment Profile

A third area of challenge for the evolving industry is the variance between the rationale under which funds were raised and the eventual portfolio of companies invested. Many states and localities have created emerging manager programs in efforts to expand the pool of investment professionals deploying public pension funds in the field (and the definitions of these programs vary as well). Many pension fund trustees have an interest in increasing investments in minority and low-income communities, and have created initiatives designed to foster this type of investment activity (CalPERS' $475 million initiative is an example). In response, an increasing number of funds have responded, marketing their purported expertise in underserved markets, inner-city areas, or their social connections to often overlooked minority entrepreneurs. However, once funds have been raised, finding viable deals that fit these profiles may be limiting, and dilemmas can result (e.g., an ostensibly inner-city focused fund deciding whether to invest in an attractive firm located in a rural county). As a result, some of the dollars that pension fund trustees have earmarked for placement in minority communities are not reaching them.

If public policy and investor interest in EDM private equity expands, questions of definition, explicit or implicit social missions, and clarity of investment principles will likely grow as well. Industry associations should work to educate potential investors on the diversity of strategic orientations within the field, as well as the factors that critically delineate them from seemingly similar investing arenas. If the greater investment community fully embraces EDM-focused funds, questions about differentiators of performance across funds will surely follow. Scholars should move beyond efforts to answer whether the set of EDM funds offers market rates to determining how variance in strategic orientations results in return differences across funds. For investment funds defined by consumer markets or demography of managers rather than by product categories, or industries, critical answers may be more than just semantic.

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