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How Private Equity Investment Can Benefit Rural America

By **Tim Lavender** (June 11, 2020, 4:14 PM EDT)

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Rural America significantly lags the economic advances enjoyed by its more prosperous urban neighbors. While there are many causes for these trends, the relative decline in rural prosperity begs for a new wave of economic development targeted to these regions.[1]

Opportunities for raising capital that rely less on the public sector and more on the willingness and availability of capital from the private sector abound, in our view. The combination of low interest rates and the lack of long-term fixed asset investing opportunities has produced a significant demand from the investment community.

The recent wave of rural business investment companies, or RBICs, established by the U.S. Department of Agriculture is evidence of both the need for such funds as well as the opportunities that these funds can present. A common platform for all of these efforts is required to build an increased awareness of the opportunities for investment in rural America.

This article will focus on how the RBIC program works, along with the expanded definitions in the recent final rule issued by the USDA Rural Business-Cooperative Service, in March.[2]

Through this final rule, the Rural Business-Cooperative Service finalizes and amends its regulations and incorporates new program requirements established in the Agricultural Improvement Act of 2018[3] for the Rural Business Investment Program.

Finally, we will discuss how private equity players are seizing upon important investment opportunities that are transforming the American rural landscape.

What Is the RBIC program?

The RBIC program, an investment program sponsored by the USDA, provides innovative small businesses in rural America with access to capital to help them grow and create jobs.

There are challenges when trying to find capital and debt for businesses in rural America: a gap in financial awareness and scale, and conservative borrowers.

Many venture capitalists are large funds with hundreds of millions of dollars to spend. But, while they are often happy to make a $500 million to $600 million loan, they are reluctant to make a $4 million to $5 million loan. At that $4 million to $5 million or so loan level, these venture capitalists would require closing too many transactions to fulfill their portfolio needs and would increase the need to monitor all of these smaller investments.

Enter private equity financing, which can help fill an important role particularly as some private equity firms are combining a number of projects into one venture in order to overcome the scale issue.[4]

Importantly, a new report from the Small Business Administration's Office of the Inspector General said the agency didn't tell private lenders to prioritize borrowers in underserved and rural markets when implementing federal relief, so rural and other underserved businesses may not have gotten much-needed funds from the $669 billion Paycheck Protection Program under the Coronavirus Aid, Relief, and Economic Security, or CARES, Act.[5]

RBICs Defined

RBICs are private, collaborative investment funds shared between select private equity funds and other farm credit associations. The funds are managed by skilled professionals who have a solid history of public-private partnerships in underserved markets. The RBIC program, in partnership with state and federal economic development programs, successfully brings businesses, technologies and jobs to communities that have historically lacked access to investment capital. These funds, backed by the USDA, provide all type of investment capital (subordinated or unsecured debt, and equity (common and preferred stock)) to select companies in rural areas in order to provide the capital necessary for growth.

Under the Rural Business Investment Program, for-profit RBICs make loans and capital investments in rural areas with the objective of fostering economic development on returning maximum profits to the RBIC's investors. The program stipulates that a minimum of 75% of funds must be invested in rural areas with populations of 50,000 or less and a minimum of 50% invested in smaller enterprises. Only 10% of the funds can be invested in urban areas.

March 2020 USDA Final Rule Expanding Select Definitions

Rural Business Concern Definition Revised and Broadened

The final rule revised and broadened the definition of "rural business concern" to better align with the statutory definition. The interim rule defined a rural business concern as an "enterprise whose Principal Office is located in a Rural Area." By requiring the rural business concern's principal office to be located in a rural area, the Rural-Business Cooperative Service, an agency of the U.S. Department of Agriculture, determined this restriction was hampering the full implementation of the program.

The statute authorizing the program defines a rural business concern, in part, as one that "primarily operates in a rural area." By focusing on the location of the principal office, it unnecessarily limited the effectiveness of the program. In addition, per the authorizing statute, the key aspect, as noted above, is that the rural business concern "primarily operates in a rural area." The current definition misses this key feature.

Revised Rural Business Concern Investment Definitions

The final rule revised select definitions to be consistent with the 2018 Farm Bill and to remove various other definitions that are no longer needed.

Section 4290.50: Definition of Rural Business Concern

A rural business investment had been defined as being "located in a Rural Area at the time of the initial financing." If the initial investment was made in a business enterprise located in an area not considered rural, it required the RBIC to carry the investment as a nonrural investment. If the investment was implemented to help facilitate the relocation of the business to a rural area, the final rule states that the RBIC should be able to reclassify the initial investment as a "rural business concern investment."

Section 4290.210: Changes Address Multiple Closings Under Minimum Capital Requirements for RBICs

To better align the program with the realities of raising private equity funds, the agency is adding a new paragraph to this section (see Section 4290.210(d)) that specifically allows for multiple closings. The prior regulation required an RBIC to raise the amount of funds it has identified in its application by the end of the second year from when it received its "green light" letter. However, it did not adequately address situations in which the RBIC might raise and close on capital in increments before the end of second year. Such multiple closings are not uncommon for non-RBIC funds.

Section 4280.700 Requirements Concerning Types of Enterprises To Receive Financing

The agency revised the requirements found in this section in three ways, as described below.

1. The prior regulation identified minimum levels of financing that must be received by rural business concerns, smaller enterprises, and small business concerns and a maximum level of financing that can go to urban area investments. While the authorizing statute contained requirements for the minimum percentage of financings that had to be received by rural business concerns and maximum percentage in urban areas, it did not specifically identify similar requirements for either smaller enterprises or small business concern investments.

Revision: While the final rule kept the financial requirements for smaller enterprise investments, it dropped the financing percentage requirements for small business concern investments (i.e., removing Section 4290.700(c) from the regulation). This simplifies the implementation of the program and helps reduce potential overlap with programs administered by the Small Business Administration.

2. The prior regulation required the percentage requirements to be met on both the percentage of the number of concerns receiving Financing within the RBIC's portfolio and the percentage of dollars the RBIC provided to the concerns in its portfolio. Requiring both percentages to be met unnecessarily complicated the program.

Revision: The final rule revised the percentage requirements to be applied to the amount of dollars the RBIC would spend on concerns in the three remaining areas (i.e., rural business concerns, smaller businesses, and urban areas).

3. The prior regulation required RBICs to comply with the financing percentages starting the first year after issuance of the certificate. This is unnecessarily restrictive and does not allow an RBIC sufficient time to implement the program.

Revision: The final rule revised the regulation to require that the financing percentages be met by the third year after the RBIC receives its certificate, and each subsequent year thereafter. Removing reference to Small Business Concern/Small Business Concern Investment in Sections 4290.370(h), 4290.610(b), and 4290.760(a). The authorizing statute for RBIC does not require small business concerns and the agency is removing this reference to allow for more flexibility for RBICs.

Section 4290.720(g): Foreign Investment Exceptions

In general, the prior regulation prohibited financings to an enterprise if the funds would be used substantially for a foreign operation or more than 49% of the employees or if tangible assets of the enterprise were located outside the United States. There was one exception — allowing a financing used to acquire foreign materials and equipment or foreign property rights for use or sale in the United States.

The final rule determined that the restriction on financing of foreign investments was unnecessarily restrictive — it was prohibiting investments in rural America that would provide more opportunities for job creation and general economic stimulus. Therefore, the final rule added a second exception that would allow the financing of a subsidiary of foreign-owned entities when that subsidiary is based in the United States with a minimum of 51% U.S. ownership (see Section 4290.720(g)(2)(ii)).

Section 4290.720(i): Entities Ineligible for Farm Credit System Assistance

The final rule increased the limitation on RBICs controlled by Farm Credit System institutions from 25% to 50% before the rural business investment company is prohibited from providing equity investments to companies that are not otherwise eligible to receive financing from the Farm Credit System.

Private Equity Investing In Rural America

Regional financial firms have often played an historic role in financing local rural businesses. A key example is production and distribution agriculture. These same resources have sponsored exciting developments in Ag technology. But there is a new wave of economic development sponsored by a new group of private equity investors. While Ag and Ag technology are well established as a target of many investors, this acceptance needs to extend to a broader class of assets that reside in the rural geography. A variety of other players are trying to address this need, most notably private equity investors.

Lewis & Clark

St. Louis-based investment firm Lewis & Clark AgriFood made its first investments in January from a pair of new investment funds. The firm invested in Fargo, North Dakota-based AgTech startup Bushel Inc.

The investment was part of a $19.5 million Series B financing closed by Bushel, a developer of agricultural software for use by grain and retail growers. The portion of the round from Lewis & Clark AgriFood came from the firm's AgriFood Fund II and RBIC funds.[6]

Open Prairie

With assistance from Illinois-based private equity firm Open Prairie,[7] Shenandoah Valley Organic completed a $15 million funding round in late 2019.[8]

Blue Highway Growth Capital

Blue Highway Growth Capital is building a $50 million RBIC fund and also has partnerships with the Farm Credit System in addition to M&T Bank. Blue Highway's strategy is to invest $2 million to $5 million in small businesses with growth potential, typically with $5 million or more in existing revenue and no other outside source of capital.[9]

Steve Case

Steve Case, the billionaire co-founder of America Online, is also trying to get more venture capitalists to invest in often-overlooked smaller towns and cities in the middle of the country. His main weapons: a $150 million investment fund and a "Rise of the Rest" bus tour designed to lure news coverage.[10]

Conclusion

Rural communities in the United States are home to more than 60 million people. These communities feed our nation. And they are leading the country in sustainable energy, generating 99% of America's wind energy and pioneering efforts to harness solar energy. And, yet, the investor experience in U.S. rural communities in some ways mirrors that of impact investors in search of deals overseas in developing regions, where a mismatch exists between the levels and kinds of returns investors seek, and what small and growing businesses can offer.

In our view, select private equity firms investing in rural businesses have the ability to bridge this divide and they are doing so as we write this article.

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Disclosure: Kelley Drye represents Open Prairie.

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[1] See, "Rural America is ripe with potential, starving for capital," The Hill (July 28, 2018). See also, "The Role of Equity Capital in Rural Communities," Scruggs & Associates LLC, funded by the Ford Foundation (February 2009).

[2] Rural Business-Cooperative Service (RBS), 7 CFR Part 4290 (March 24, 2020) (the Final Rule).

[3] Agricultural Improvement Act of 2018 (115th Congress Public Law 334), Public Law No: 115-334 (December 20, 2018).

[4] See, "Investing in Rural America: Don't Fear the Venture Capitalist: What Outside Investment Can Bring to Rural America," Progressive Farmer (December 23, 2019). See also, "Investing to Revitalize Rural America," Cornerstone Capital Research (April 4, 2019).

[5] "Watchdog report: SBA didn't tell lenders to prioritize rural businesses for relief loans, so they got

shortchanged," The Rural Blog, (May 11, 2020). See also, "Why are hundreds of people in big cities receiving bailout money meant for farmers?," 60 Minutes, (May 2020).

[6] "St. Louis-based investment firm makes first deal from new $186 m funds," St. Louis Business Journal (January 14, 2020).

[7] The Open Prairie Rural Opportunities Fund is an $81 million private equity fund licensed by the USDA as an RBIC. See link, https://www.openprairie.com/.

[8] "Shenandoah Valley Organic Raises $15 Million in New Funding to Drive Continued Growth," Open Prairie, Press Release (December 19, 2019).

[9] "New Funds Gives Rural Businesses Access to 'Patient Capital,'" Daily Yonder (November 21, 2019).

[10] "Venture capitalist spreading funding to Middle America," 60 Minutes (Sharyn Alfonsi) (March 17, 2020).