Panning for Gold in Inner City Markets

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Romance-seekers used to depend on contacts through friends, relatives, colleagues, or even luck to find true love. Then came the Internet, and online dating sites, which now offers a way to select a mate by sorting through thousands of people. The experience of investors seeking businesses for investment returns is not so different. Investors have always relied on referrals, industry insider knowledge, and other personal networks. Yet over the years, in many markets, they have culled information from large databases such as Thompson Financial, Standard & Poor's, or Dun & Bradstreet in order to find vital sources of deals. In well-developed securities markets, these data are rich and meaningful enough to foster a robust capital market.

This system for sharing data breaks down, however, when seeking information on privately held companies, especially smaller companies, because most information is kept confidential. For sources that do provide data about private companies, some of the data may be estimated according to an "average" firm in that industry. Other data show only broad ranges for sales or number of employees. These figures can be way off and difficult to track over time. Because investors continue to use familiar habits and sources when looking for privately held businesses, they may overlook good investments.

Companies located in low- and moderate-income (LMI) and predominantly minority areas—emerging domestic markets—have an added burden because they are not part of the investors' network of contacts. In addition, inner cities are often misperceived as lacking any businesses of size and scale, so investors are not looking for opportunities there.

Initiative for a Competitive Inner City's Inner City 100

To show the investment opportunity in mixed-income, high-density, and predominantly minority urban areas, the Initiative for a Competitive Inner City (ICIC), a national not-for-profit founded by Harvard Business School Professor Michael E. Porter, launched the Inner City 100 program in 1998. Skepticism that enough fast-growing companies would be found evaporated in light of the nearly 10,000 nominations for the Inner City 100 over the past nine years. The program has proved that there are ample possibilities for investment in emerging domestic markets, or EDMs, but strong mechanisms do not exist to connect the larger universe of inner-city companies to potential investors. One missing element is market data, and the Inner City 100 program itself offers a promising strategy to fill this gap.

Each year, ICIC seeks nominations across the country's inner cities and selects the top 100 fastest-growing companies from among the applicants. An applicant must: (1) be an independent for-profit corporation, partnership, or proprietorship; (2) be headquartered in or have 51 percent or more of its physical operations in economically distressed urban areas; (3) have 10 or more employees; and (4) have a five-year operating history that demonstrates sales of at least $200,000 in the first year and at least $1 million in the fifth year. A company's operating history also has to show an increase in sales from the fourth to fifth years. The ICIC then ranks the companies according to revenue growth.

Trends in Emerging Domestic Markets: What the Data Show

What is truly exciting about the ICIC program is not only its annual impact but, more important, its cumulative punch. Having solicited nearly 10,000 nominations, ICIC then checks that companies meet the inner city location and revenue growth criteria before asking for a full application. ICIC has now compiled full applications from more than 2,500 companies. All companies that appear on the final list of winners must have their financial information verified by an independent auditor. This strong foundation is the place to build a database of privately held inner-city companies.

To round out company profiles, ICIC conducts surveys on such factors as workforce, strategy, CEO information, and industry sector. The companies are asked about the sources of their current funding as well as the source of their start-up financing and their prospects for growth. ICIC has also begun developing an Impact Index that measures the community benefit of these companies.

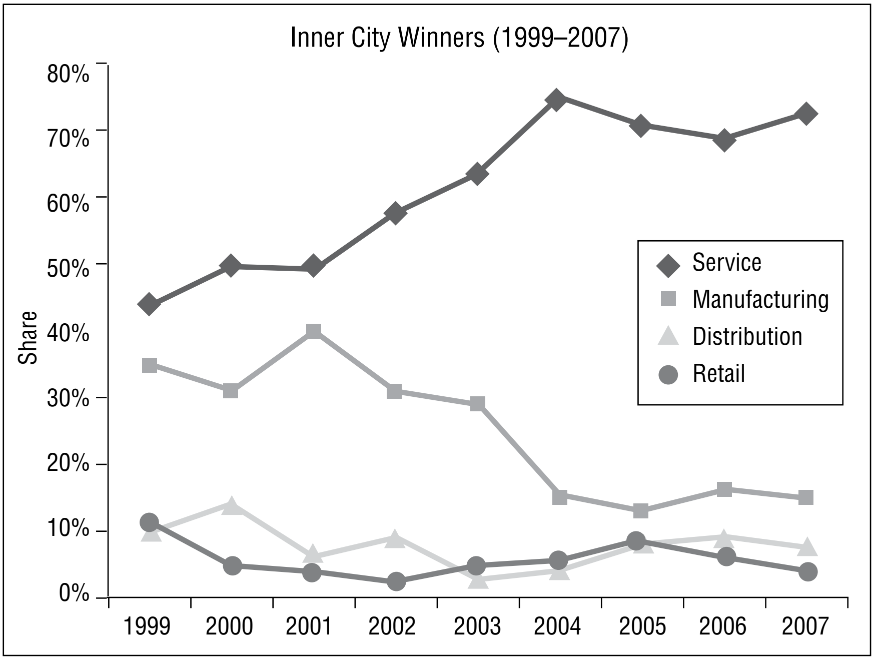
Table 1. Characteristics of Inner City 100 Companies 1999–2007 (winners only).

	Average
Average Year-5 Revenues	$23 million
Median CAGR of Revenues	43%
Average full-time employees	112
Minority CEO (in %)	32%
Female CEO	17%

Chosen by revenue growth, the winning companies have a median annualized revenue growth rate of 43 percent, with average revenue of $23 million, and on average employ more than100 people. About one-third have a minority CEO, and 17 percent have a female CEO (Table 1). Reliable figures on minority CEOs located in inner cities are difficult to come by, but the true proportion likely is higher.

Since ICIC began, the concentration of services companies has grown from 44 percent to 73 percent, while the proportion of both retail and manufacturing firms has fallen by more than half (retail from 11 percent to 4 percent, manufacturing from 35 percent to 15 percent). Again these figures are only for the 100 fastest-growing companies. Crucially, the database contains information on applicants as well, not just the winners.

Sector Breakdown



More data are available to round out the economic picture. Returning to the real estate example, commercial property investors use fee-based data sources to evaluate prospective deals—for instance, CBRE TortoWheaton data provide information about financial returns for specific properties and other information about leases and occupancies. But real estate investors take into account more than just transactions when evaluating a deal. They also look at the market as a whole, examining industry trends and employment across the metropolitan region. Often, they identify "hot" markets—particular metro areas—to target.

Business investors have to ask other questions as well. Can the company get the workforce it needs? Is it located within a growing cluster of successful firms? Are suppliers or customers accessible in the region? What is the condition of the infrastructure, and how accessible are sources of energy, water, and transport?

These broader economic data—demographics, retail spending, overall investment—are collected for ICIC in its State of the Inner City Economies (SICE) effort, which tracks the economic competitiveness of inner-city economies. SICE tracks job growth and organization growth by industry cluster, resident demographics, and retail spending and considers a host of data about the business environment, ,clarifysuch as access to infrastructure>. By looking at high-performing inner cities, investors might identify places with strong business fundamentals or a business-friendly climate for investment.

Identifying primary markets might be harder than it appears.From 1995 to 2004, jobs located in inner cities of the 100 largest urban areas grew about 1 percent cumulatively. Yet this aggregate performance masks large variation. Ten inner cities grew their employment base by more than 15 percent over this period, with Anaheim and Jersey City growing by more than 30 percent!

Income data show similar variation. Taken together, more than 22 million inner-city residents had a median household income of $25,000 in 2004. Once again, there is diversity in the numbers. The percentage of residents with income between $35,000 and $50,000 is comparable to the nation as a whole (14 percent to 17 percent nationwide).

Even if they have good sources of data, investors face several challenges. First, essential data are missing. For example, investors need consistent information about returns on investment over a period of time, using standard financial measures, to allow them to place the investments into their broader portfolio, or to characterize the risk to their own investors. They also need to understand how returns are affected by the business cycle.

Second, beauty is in the eye of the beholder. While every investor is looking for a strong balance sheet, each one has a particular niche or angle they find most attractive. Investors need to be able to make investment decisions using characteristics that are salient to their own circumstances. For example, some investors may be seeking highly leveraged companies, while others might concentrate on cash flow.

Third, investors need a searchable platform that fits with their retrieval and analysis systems. Using financial analysis software, data users want to apply their own models or selection criteria to the data. Finally, they need to analyze and use the data while allowing the company to maintain its competitive secrets.

With the right amount of investment and collaboration, these issues could be overcome to create a robust database for investors. Many other markets have overcome similar obstacles. Getting real estate firms to collect data in a standardized way and be protected from confidentiality concerns was not an easy process, but the industry recognized the value to everyone as a whole. Multiple listing services perform a similar function, as do data collected by the insurance industry. But it is interesting to think about how certain geographic areas can systematically be overlooked. In a conversation with ICIC, one collector of commercial real estate data admitted that his organization doesn't cover the inner-city market, and so even this well-established database is not as exhaustive as it seems. Without reliable data about companies, the engine of the capital market lacks the right spark.

Going forward, I suggest five steps to start building a comprehensive database:

1. **Collect more extensive financial information over a multiyear period.** Company screens often use a set of simple rules about financial statements such as debt-equity ratios and profit growth. These data could allow the creation of an inner-city investment index, which, like Standard & Poor's 500 Index, would allow investors to track and analyze the risks and returns.

2. **Combine ICIC data with other sources.** Many sources of business data, such as business credit reports, can be linked to the ICIC data. The Ewing and Marion Kauffman

Foundation operates a database, administered by Fintel LLC, that contains small business data from a sample of companies across the United States. This sample can be crossed with inner-city geographies to show aggregated figures for return on investment and other data by inner-city market. The State of the Inner City Economies itself serves as a kind of umbrella for a host of private and public sources and could be expanded to include more.

3. **Invest in technology to share data while maintaining adequate controls that protect confidentiality.** Companies need a searchable, accessible portal to run their own analyses. Currently, the ICIC data are stored on SQL servers that are queried internally. A web-based portal could serve as a window into this data platform and allow easy but controlled access. Agreements with inner-city companies should emphasize that providing a controlled window into their finances will help companies as a whole. As with other databases, confidentiality can be protected and competitive advantage preserved even with more transparency.
4. **Expand marketing efforts to include more firms and cover more inner-city markets.** Inner City 100 applicants are partly a reflection of ICIC's efforts and the marketing efforts of partners like the U.S. Conference of Mayors and corporate partners. SICE data currently cover the 100 largest inner cities. Over time, this coverage could be expanded to smaller cities, inner ring suburbs, and other underserved areas.
5. **The system should be mission-driven and built specifically for investor purposes.** Databases that try to be comprehensive can be unwieldy for investors, especially given the time pressure of making investment decisions. Information that is important to economic development practitioners, marketers, and planning officials could muddle the picture for investors. Investors need a format that suits their needs. The most successful market information systems are built around a single customer focus. For example, the private company PCi provides data and software that helps bank compliance officers meet obligations under the Community Reinvestment Act Others may find the software useful, but it was built with a core purpose in mind. Commercial real estate databases are similarly purpose-specific.

Capital investment in business is not a panacea for economic development. Workforce, education, and other private and public policies matter. More narrowly, having data is not the only lever needed to help raise capital, no more than Match.com is the only dating game in town. ICIC's Inner City Economic Forum's Capital Connections program recognizes this, again echoing the matchmaking world, by providing "speed dating" to match investors and businesses. Companies and investors trade places in 20-minute sessions designed to pitch their businesses, and businesses are educated about private equity even before investment.

The great advantage of data is that more of it offers more benefits to everyone. Once the initial investment in data collection and dissemination takes hold, an additional investor will not crowd out another. In economic terms, data are non-rival. Each investor's consumption of information, like breathing, does not diminish the use by others.

Creative users build tools to filter and sort through data. The airlines reservation system SABRE is an example. First, the computerized reservation system stitched together fares across a dizzying combination of routes. Later, Internet websites tapped into the extensive system to sift through them for fares. Computerized software in the mortgage industry uses data about borrowers to automate the underwriting process, extend credit to millions of homeowners previously shut out of the market, and provide an income stream to lenders.

Moreover, because investors, whether lenders or equity providers, typically provide technical assistance with investment, the companies themselves can benefit from the interaction. So without a better system, inner-city companies that might be able to grow with such assistance don't receive it, and the situation of underinvestment persists. With fewer companies able to grow, the market as a whole might look less promising than it really is.

There is good reason to believe that building upon ICIC's set of data about inner-city companies and economies can benefit the market and help investors snare promising firms that could use capital and technical assistance. With some creative thinking, institutional investors and foundations, government agencies, or nonprofits have the capacity and the means to make this happen.

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