CrossBoundary Advisory

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Reducing Friction, Rebuilding Trust: **Investment Facilitation as a Tool for Economic Growth in US Underserved Markets**

Nathan Kelly
Jake Cusack
Hannah Mae Merten

Erie, Pennsylvania. Photo credit: Authors.

Executive Summary

While programs and policies have mobilized billions of dollars into underserved markets in the United States since at least the 1970s, stark inequality across markets persists: capital concentrates in some markets, while value and growth opportunities are unaddressed in underserved markets.

This white paper argues that there is a need to address the underlying barriers that prevent capital flows to underserved markets.

- Transaction costs and information asymmetries are under-addressed frictions to capital flows in US underserved markets.
- Transaction costs are often higher in underserved markets relative to deeper markets due to novelty and complexity; investors know that when transaction costs are too high, even otherwise commercially viable deals die.
- Information asymmetries between investors and capital seekers breed distrust and cause markets to deteriorate. Without ways to reliably signal quality and credibility, capital providers and capital seekers fail to transact.
- Without efficient and effective capital formation, underserved markets in the US will struggle to grow, while capital and opportunity continue to concentrate in a handful of US markets.
- Investment facilitation provides expertise, resources, and an "honest broker" role to overcome these barriers to reduce inequality within and between communities across the US.

Current programs aimed at US underserved markets focus on the important work of de-risking investments through subsidies and guarantees that increase gross risk-adjusted returns, yet many markets still do not attract investment under these programs. To be effective, solutions must directly tackle the barriers of transaction costs and information asymmetries.

Investment facilitation addresses these barriers and serves as a complement to current policies and programs aimed at underserved markets. It provides expertise, resources, and an "honest broker" role to reduce these barriers at both the intermediary-level and the individual deal-level.

US underserved markets do not lack for supportive policies or even impact-focused capital looking to fund deals yielding both purpose and profit. **Early evidence suggests that the missing bridge between impact capital and US underserved communities is investment facilitation.** Investment facilitation merits a closer look as a tool for economic growth in US underserved markets.

Introduction

In the wake of the murder of George Floyd in May 2020, the 50 largest US public companies pledged nearly US$50B to address racial inequality, more than 90% of which was allocated as loans or investments into Black institutions and communities.

However, in the first year since corporate pledges to address racial inequality were made, 37 companies confirmed disbursing only US$1.7B of the US$50B pledged. Most of those dollars were disbursed in the form of grants, in contrast to the 90% initial allocation towards loans or investments into Black institutions and communities.[1]

We do not think this is an anomaly. Since the introduction of empowerment zones in the 1990s, a litany of government and private programs have sought to promote investment in US underserved markets.[2] Yet most of these programs have achieved middling results, and, by our count, none have reached the lofty goals set out for them.

Despite the political will, availability of public/philanthropic funding, and best intentions of these programs, there is no inevitability to the flow of capital to opportunities in underserved markets. Two unique characteristics of underserved markets prevent programs and policies from reaching their objectives: **high transaction costs and deep information asymmetries.**

1. **Jan, Tracy, McGregor, Jena and Hoyer, Meghan for the Washington Post: "Corporate America's $50 billion promise"** August 24, 2021.

2. Underserved markets are those in which the amount of capital invested is less than the market opportunity. At CrossBoundary, we segment these into three categories: demographic, geographic, and sectoral. **See Appendix 2: What Constitutes an Underserved Market? for additional details.**

Blighted homes in Saint Louis, MO, now believed to be demolished.
Photo credit: Jessica Christian on Unsplash

For the past decade, CrossBoundary has implemented and refined investment facilitation as a targeted approach to address transaction costs and information asymmetries in underserved markets around the world. **We believe investment facilitation has a critical role to play in driving economic growth in underserved markets within the US.**

Background of US policies and programs to mobilize capital

Most programs and policies created to mobilize capital toward US underserved markets have focused on adjusting the gross risk/return profile of investments in these markets.

For instance, Small Business Administration (SBA) guarantees reduce the risks for banks that lend to small businesses; the Empowerment Zones of the '90s and the Opportunity Zones of today provided significant tax breaks for investments made in designated areas of historic underinvestment; the State Small Business Credit Initiative (SSBCI) programs provide cheap capital for states to invest in underserved markets; and the Small Business Investment Company (SBIC) program provides private credit firms cheaper capital to make loans to small business.

Additionally, New Market Tax Credits provide nearly-free developer capital for early-stage projects, while Community Development Financial Institutions (CDFIs) enjoy tax advantages over commercial lenders, along with discounted financing from the US Treasury's CDFI Fund. Even private initiatives have a focus on first-loss (or subordinated) tranches and guarantees to reduce the risk for private capital entering markets through grants, program-related investments (PRIs), and Donor Advised Funds (DAFs).

The amount of capital that has been mobilized through these programs is immense. Empowerment Zones received an estimated US$10B[3] in investment over the life of the program and Opportunity

3. Clinton Presidential Library: Empowerment Zones and Enterprise Communities

Zones received an estimated US$48B between 2018 and 2020[4]. **Yet fundamental questions remain: is the capital reaching its intended targets, and—perhaps even more fundamentally—do the costs of these programs outweigh their benefits? Indeed, those residing in areas of intractable poverty are almost always last to be reached, if they are reached at all[5].** Regarding place-based tax incentives, the Department of Treasury's Tax Policy Unit writes that, "Generally, studies find that economic activity in the targeted region increases while the incentive is in place, but it is less clear whether low-income residents in the targeted areas benefit overall." Even worse, while capital flows may increase in an underserved market during the life of these programs, there is some evidence to suggest that the actual benefits of that investment tend to accrue to those outside of the area[6].

4. Office of Tax Analysis: Use of the Opportunity Zone Tax Incentive: What the Data Tell Us
5. CrossBoundary uses Persistent-Poverty Communities, as defined by the Economic Innovation Group, to identify areas where poverty is most intractable within the US. They are made up of contiguous census tracts that that have maintained high poverty rates for decades. A full explanation of the methodology and recent map of areas can be found at https://eig.org/persistent-poverty-in-communities/
6. Place-based Programs and the Geographic Dispersion of Employment

`Figure 01` **Overview of US federal programs targeting underserved markets**

1953 Small Business Administration (SBA)
- Loan guarantees encourage private commercial lending to small businesses by providing a federal guarantee on the balance in case of small business default
- Small Business Investment Companies (SBICs) raise private capital and, in addition, receive government-backed funding (leverage) to invest in small businesses

1977 Community Reinvestment Act
- Encourages financial institutions to help meet the credit needs of the communities in which they do business, including low- and moderate-income (LMI) neighborhoods

1986 Low Income Housing Tax Credit (LIHTC)
- Offers developers tax credits to subsidize the construction and rehabilitation of affordable housing units

1993 Empowerment Zones
- Used tax incentives and federal investment to encourage local community planning and economic growth in distressed communities

1994 Community Development Financial Institutions (CDFI)
- Created to address the financial services needs of low-income, low-wealth, and other disadvantaged communities that traditional financial institutions often overlooked or avoided due to perceived risks or lower profitability

2000 New Market Tax Credit
- Uses tax breaks to incentivize investors to invest in "Community Development Entities" that oversee economic development and lending to businesses and projects in low-income communities

2002 Rural Business Investment Companies (RBICs)
- RBICs were modeled after the SBIC program but tailored to address the specific challenges and opportunities of rural economies, aiming to attract private investment into rural businesses to stimulate growth. Importantly, they do not include leverage from government sources

2010 State Small Business Credit Initiative
- Designed to strengthen state programs that leverage private lending to small businesses and small manufacturers that were creditworthy but unable to obtain the private loans they needed

2017 Opportunity Zones
- Incentivized private investment in economically distressed census tracts by offering tax benefits to investors

2020 COVID-19 Small Business Support Programs
- Paycheck Protection Program, Economic Injury Disaster Loan, Restaurant Revitalization Fund, more

As practitioners of "blended finance"—a term used to describe the combination of commercial capital (often from the private sector) and concessional capital (often from the public sector) to unlock investment in underserved markets—we believe that until the barriers of high transaction costs and deep information asymmetries are addressed, these programs will continue to underperform their targets.

Transaction costs and their impact on capital flows in underserved markets

Since Ronald Coase published "The Nature of the Firm" in 1937 *(See Appendix 3: The Theoretical Foundation of Transaction Costs and Information Asymmetries)*, economists have understood that transaction costs drive the market structure for goods and services. For example, since the first ecommerce transaction in 1994 (a Sting CD sold between friends) ecommerce transactions have taken off and will represent a quarter of the world's commerce by 2025 largely due to the reduced transaction costs of ordering something online.[7] But beyond this, transaction costs, including legal fees, due diligence costs, and general price discovery also drive the market for investment. Exchanges reduce transaction costs significantly, and as a result, public markets are roughly 18x larger than private markets (SIFMA estimates US$231T in global capital markets in 2022[8] while McKinsey estimates US$13.1T in private markets as of June 2023[9]). **Every fund manager and investment banker knows that transaction costs are an important part of evaluating any investment—and when they are too high, transactions die.**

Yet, most economic development programs aimed at mobilizing capital in US underserved markets fail to account for transaction costs. Much like the "Invisible Gorilla" experiment[10] wherein participants are asked to count the number of times players pass a ball, and therefore miss the dancing gorilla walking across the screen, our focus on the gross returns of investing in US underserved markets has distracted us from the transaction costs hiding in plain sight.

If you're focusing on watching the movement of the ball, you might not notice the dancing gorilla.

Transaction costs at the deal-level vs transaction costs at the intermediary-level

Transaction costs occur at the "deal-level" where they are associated with a specific investment into a single company or asset, and at the "intermediary-level" where they are associated with creating and managing the intermediaries or - what are sometimes thought of as - the "infrastructure" of investing.

As an example—the diligence cost for a private equity firm investing in a company would be a "deal-level" transaction cost, while the legal fees associated with setting up a new private equity fund would be an "intermediary-level" transaction cost. The figure below further defines these.

7. McKinsey & Company: What is e-commerce?
8. SIFMA Securities Industry and Financial Markets Association: Capital markets Fact Book, 2023
9. McKinsey & Company: McKinsey Global Private Markets Review 2024
10. NPR: Bet You Didn't Notice "The Invisible Gorilla"

Figure 02 **Deal-level transaction costs vs. intermediary-level transaction costs**

Deal-level transaction costs: costs associated with making an investment into a single company or asset. These often include:

01 Investment-specific diligence fees (commercial, legal, insurance, financial)

02 Legal fees for creditor agreements, intercreditor agreement, or stock/asset purchase agreement

03 Regulatory diligence fees

04 Transaction coordination fees (e.g. investment banking advisory fee)

Intermediary-level transaction costs: costs associated with creating and managing the intermediaries/infrastructure through which capital can be deployed. These often include:

01 Opportunity identification

02 Pipeline building

03 Fund formation costs (legal/regulatory costs)

04 Fundraising

05 Fund administration and management

For an investor to commit to an investment, they must believe that they will hit their return requirements after accounting for the deal-level and intermediary-level transaction costs. Simply put, the more an investor spends on transaction costs, the higher the return needs to be. That burden is especially taxing in underserved markets for three reasons:

1. **Transaction costs are more correlated to complexity than to transaction size.** It may seem that a US$10M transaction should have one-tenth of the transaction costs of a US$100M transaction, but a US$10M transaction can easily have higher costs than a US$100M transaction if the deal terms are bespoke to that transaction. If you are moving into an underserved market, chances are good that the deal structure will need to have unique, bespoke elements.

2. **Transaction costs are more correlated to novelty than to transaction size.** Each investment creates a wealth of new information about the regulatory environment, market opportunity, optimal transaction structure, valuation, etc. By definition, fewer deals take place in underserved markets than in more developed ones, meaning that much of the information required to close a transaction must be generated for the first time, incurring additional transaction costs.

3. **Overcoming the forces that caused a market to become underserved takes hard work—which almost always appears as a transaction cost.** Using blended finance tools and innovative

financial structures to overcome systemic barriers to investing in underserved markets requires more time from investment professionals to negotiate and design the commercial and legal terms that will be acceptable to all providers and recipients of capital. Far from a "first mover advantage" this creates a "pioneer penalty" whereby investors are disincentivized to be the first into an underserved market.

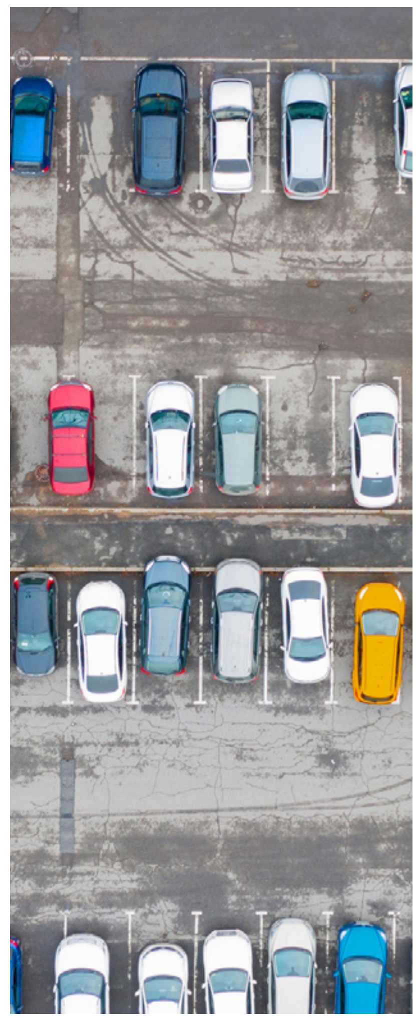
Information asymmetry: how a lack of trust prevents transactions

Whether the underserved market is a geography, a sector, or a demographic group, information asymmetries can have a severe impact on which projects and companies are able to access capital.

The classic Akerlof "lemon problem" uses the market for used cars to demonstrate the chilling effect that information asymmetries have on any market. In this example, a used car buyer knows there are good used cars ("plums") and bad used cars ("lemons") but doesn't know if the car they are about to buy is a good car or a bad car. The seller, on the other hand, knows if the car is a good or bad car. Akerlof demonstrates that in markets where a similar information asymmetry exists, the entire market might dry up, because a seller with a good quality product can never convince a buyer to pay the price required to clear the market for a good quality product, because the buyer is wary of overpaying for a "lemon." *(See Appendix 3: The Theoretical Foundation of Transaction Costs and Information Asymmetries for a more detailed analysis).* **Much as Akerlof's theory predicts, information asymmetry locks capital on the sidelines of US underserved markets.**

For capital seekers:

In many underserved markets there is little trust in the financial system. Companies that would benefit from raising capital have little confidence that they can navigate the process without being taken advantage of by investors or lenders. In the US, we can see this with farmers and



Amid information asymmetries, buyers are wary of overpaying for a product of unknown quality, and the highest quality products flee the market.

Photo credit: Getty images

new loan products, where straying from the standard operating loan structures often leads farmers to believe they are being swindled. In Black neighborhoods that were subject to redlining, trust in the financial system is often broken as well. This distrust is perpetuated by the general lack of credible financial institutions in these markets and the proliferation of predatory lenders and investors in their absence. Moreover, even when entrepreneurs in underserved markets secure an investment, they often do not have access to networks to conduct credible reference checks on the investor that could ensure a strong alignment of interests. In this environment, how can borrowers trust potential capital providers without an honest broker on which to rely?

For capital providers:

Information asymmetries create barriers for capital providers directly and indirectly. Directly, they prevent a capital provider from trusting their own evaluation of an investment opportunity. Even if they could pay to diligence the investment opportunity, their lack of confidence in their own ability to evaluate a deal in that market could prevent them from moving forward with the transaction. Indirectly, meaningful information asymmetries prevent intermediaries and other investors from entering the market, leaving a limited group to help validate an investor's assumptions. **Unfortunately, without confidence in their own investment process—and with a lack of co-investors and intermediaries to follow—capital providers will limit their exposure to the market, even when there is an opportunity for commercial returns.** As a result, credit (and equity) rationing creates a vicious cycle that leaves underserved markets unable to access financing.

Where this level of information asymmetry or distrust exists, investment is unlikely to flow regardless of the terms of the deal on paper.

Putting It all together: a complete picture of gross returns and net returns in underserved markets

The gross rate of return on an investment is the total return before the deduction of any fees, commissions, or expenses.[11]

By providing investors with the kinds of incentives that currently dominate the market (e.g. first-loss facilities, guarantees, cheaper forms of leverage, tax breaks), policymakers are enticing investors to move capital in a socially beneficial direction with the prospect of higher gross returns.

However, what ultimately matters are net returns: the returns after all transaction fees and management fees have been taken out. Our current programs rarely take into account net returns for investing in underserved markets—and that is a mistake.

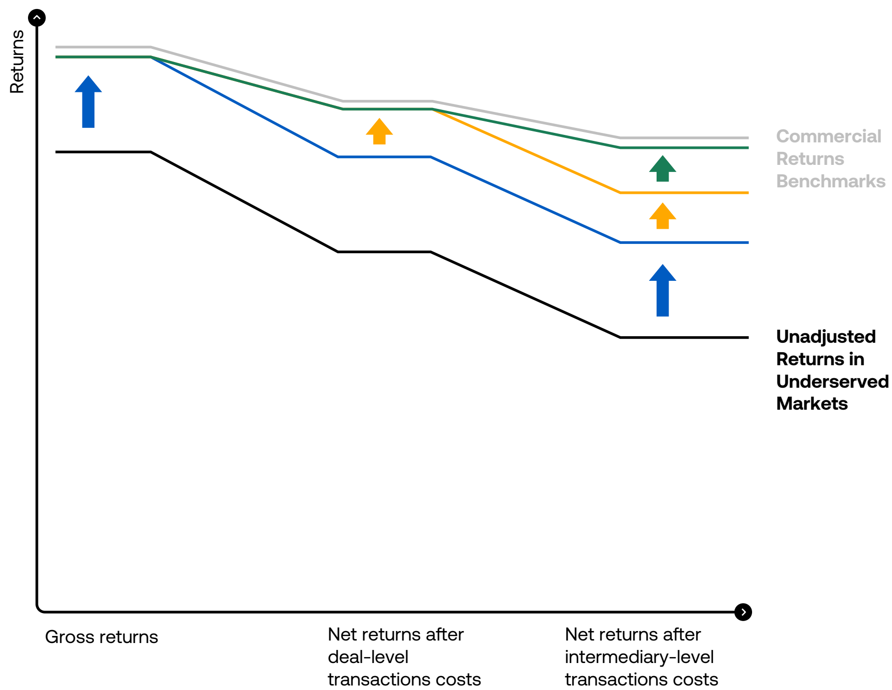
By increasing the gross risk-adjusted return, but doing nothing to address transaction costs directly, investors are still incentivized to participate in transactions that are larger, and in markets that are more well-trodden (but still qualify for the gross return incentive).

You can see the results of this in much of the criticism of Opportunity Zones; see page 13.

11. Gross Rate of Return: Definition, Formula, Vs. Net Return

The chart below illustrates the distinct impacts of programs that target the gross risk/return profile of an investment relative to those that target net returns. In the charts we use the term "Commercial Returns Benchmarks" to indicate the target return profile of investments outside of underserved markets (See Appendix 2: What Constitutes an Underserved Market?).

Figure 03 **Stylized framework of returns**



Enhancing Gross Return

- Tax credits
- Government loan guarantees
- Subsidized insurance
- Concessional leverage
- First-loss facilities
- Other tax incentives (e.g. increased basis)

Investment Facilitation

Reducing or Subsidizing Deal-level Transaction Costs

- Supporting investor due diligence and market education
- Supporting projects and companies in underserved markets through the transaction process

Reducing or Subsidizing Intermediary-level Transaction Costs

- Supporting management costs of first-time fund managers
- Pioneering new blended finance vehicles that create channels from large pools of capital to well-constructed deals

Tools to enhance gross returns—illustrated by the blue arrow above— are already familiar to many investors: tax credits, guarantees, subsidized insurance, first loss facilities, concessional debt, etc. These increase the returns before any transaction costs are taken into account; and while they might entice investors to look at specific markets, in practice, investors are still incentivized to execute transactions with the lowest transaction costs within those markets to maximize their net returns.

Illustrated by the yellow and green arrows above, investment facilitation works to reduce the transaction costs at both the deal-level and intermediary-level to increase the viability of investment in underserved markets. We cover investment facilitation in detail in the next section.

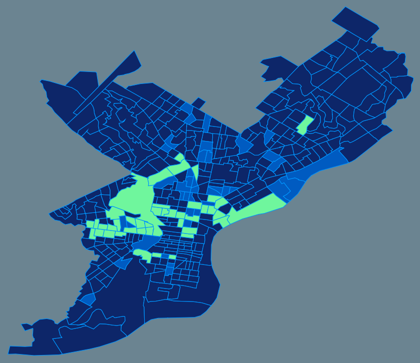
An Opportunity Zone neighborhood in West Philadelphia.
Photo credit: Chris Henry on Unsplash

Criticisms of Opportunity Zones[13]

Opportunity Zones have achieved significant milestones in unlocking capital for underserved markets. But along the way there have been valid questions whether the projects financed from Opportunity Zone funds are truly additional (i.e., wouldn't be financed without the Opportunity Zone tax incentive). Early critics of the program pointed out that relatively few Opportunity Zones received meaningful investment through 2020 (three years after the program began). At that point, 5% of Opportunity Zones had received 78% of the funding, with half receiving no investment at all. Moreover, those receiving investments were generally more affluent: zones with investment had more residents with a bachelor's degree (29% versus 15%), higher median home values (US$242,000 versus US$136,000), higher median incomes (US$43,000 versus US$36,000), lower unemployment (9% versus 12%), and lower poverty rates. But proponents argue that transactions in more deeply underserved markets take longer to close, and that those numbers will even out as the program continues.

Opportunity Zone tracts in Philadelphia, Pennsylvania

Designated Opportunity Zones tracts in Philadelphia (and many cities) do not include all of the most disadvantaged areas of the city.[12]



12. Kennedy, Patrick and Wheeler, Harrison, Neighborhood-Level Investment from the U.S.Opportunity Zone Program: Early Evidence (April 15, 2021). Available at SSRN: https://ssrn.com/abstract=4024514

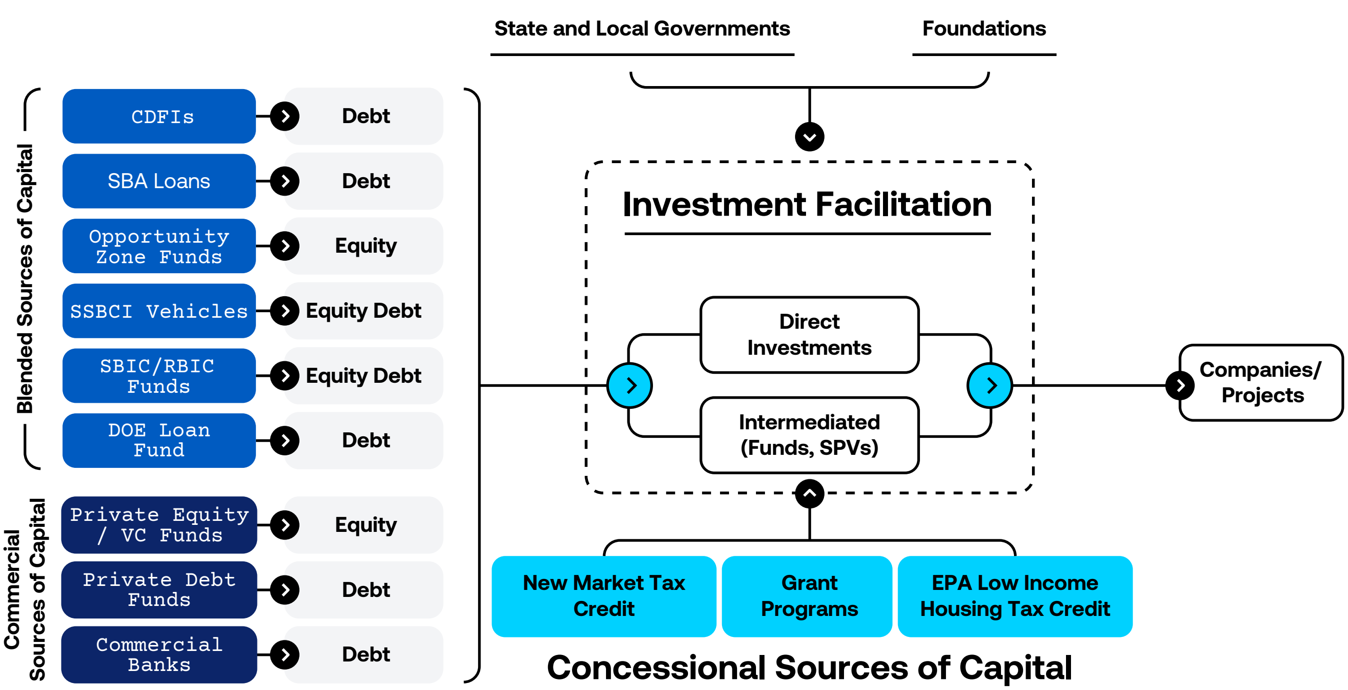
13. Joint Committee on Taxation and Office of Tax Analysis via The Urban Institute: What We Do and Don't Know about Opportunity Zones

Investment facilitation: a tool for reducing transaction costs and overcoming information asymmetries at scale in underserved markets

Investment Facilitation provides targeted firm-level assistance to investors and companies to reduce transaction costs and information asymmetries. This assistance takes place both at the specific deal-level, and at the fund/intermediary-level.

In this model, a team of transaction advisors provides the expertise, networks, and bandwidth required to help investors enter the market intelligently, and helps companies, funds, and projects effectively access the capital they need to grow. **Working on behalf of a neutral third party—frequently a donor—rather than for the capital provider or capital seeker, the team can serve as an "honest broker" to help bridge the information asymmetries that often create prohibitive trust barriers for capital providers considering investments in underserved markets.** In addition, the "honest broker" can help entrepreneurs and users of capital to build trust with investors.

Figure 04 **Overview of investment facilitation**



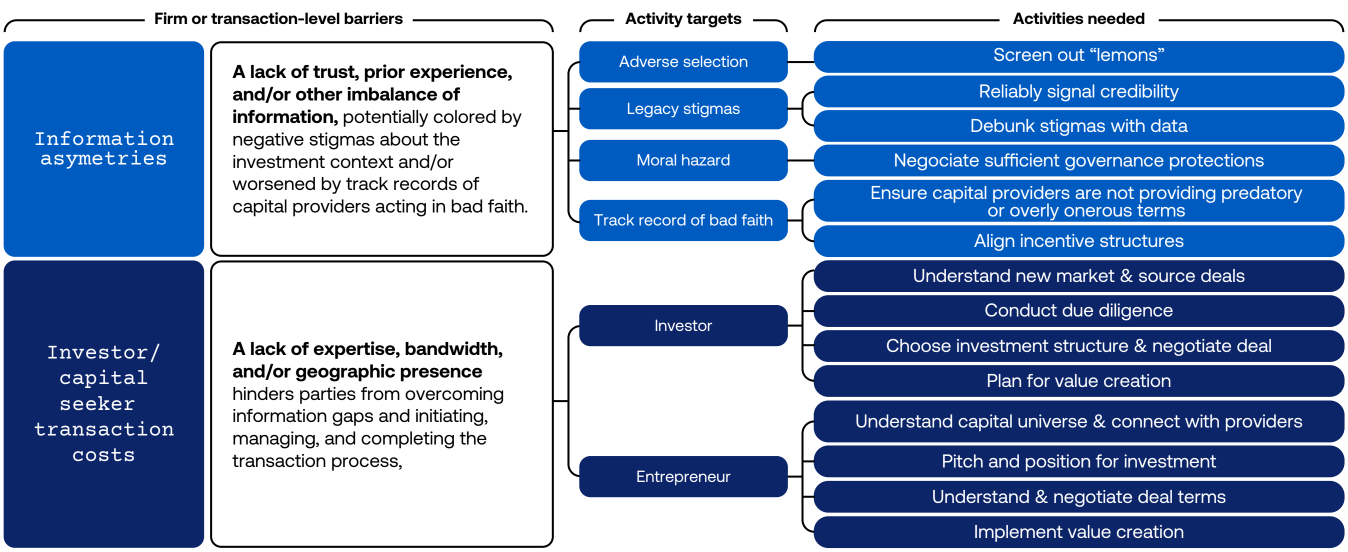
Fundamentally, investment facilitation ensures that capital flows to the investments of greatest impact in underserved markets—whether those are large transactions with standard deal structures, or smaller transactions with innovative deal structures. Implemented in tandem, investment facilitation can help existing tools such as Opportunity Zones, to avoid some of the legitimate criticism they have received over the years (see Opportunity Zone spotlight on Page 13).

Investment facilitation can be done at the intermediary level (i.e., helping to set up and raise capital for new funds/vehicles/facilities that will ultimately invest in projects or companies) or at the direct investment level (i.e., where investors or intermediaries are investing into projects or companies directly). Both are illustrated in the diagram above, which shows an investment facilitation team, funded by either a foundation or a state/local government, working on behalf of that third party to facilitate the flow of capital.

Investment facilitation takes on numerous critical tasks that reduce information asymmetry and transaction costs, thereby enabling transactions to close using the best-suited capital providers. Importantly, the efficacy of investment facilitation is not limited to one type of investor or vehicle, but rather seeks to match an array of capital sources with compatible end uses, ensuring an alignment of interests, mission, and values. The exhibit below highlights several of the many activities that an investment facilitation team undertakes to overcome information asymmetry and transaction costs.

Figure 05

Activities to overcome information asymmetries and transaction costs



In our experience at CrossBoundary, we have found that these activities are best executed on a platform that can advance multiple transactions at once within a given market for several reasons. First, these transactions can take a long time from origination through to execution and value creation. Second, they can have inconsistent workloads (a transaction might require significant amounts of bandwidth one week, and then be in a period of stasis as investors review materials, or a company, project, or fund executes specific initiatives to prepare for raising outside capital). **Finally, investment facilitation is most effective when it can address each stage of the transaction process, supporting both investor and capital seeker in moving through each stage.**

Figure 06 **Investment facilitation through the investment cycle**

Investment Process Stage	Origination	Due Diligence	Structuring and Negotiation	Value Creation and Realization
Investor ("buy-side") portion of process	Scan market and identify pipeline of potential deals	Conduct due diligence and fill information gaps	Choose investment instrument and structure	Close transaction and begin value creation
Example investment facilitation activities	• Providing Market Overview materials • Capital mapping and investor profiling • Developing investment pipelines and profiling opportunities • Analyzing value chain • Networking	• Analyzing market and competitors • Developing business plan and financial model • Conducting financial and commercial due diligence • Holding investor "roadshows"	• Acting as an "honest broker" • Mitigating information asymmetries • Sharing example template legal documents • Researching comparable transactions • Relationship management	• Creating 100-day value creation plan • Providing governance recommendations • Providing status reports • Monitoring investments • Positioning strategically for follow-on investment
Company/Project ("sell-side") portion of process	Understand universe of available capital options	Pitch and position for investment	Understand and negotiate terms	Build business for follow-on investment

Examples from the field: how the McKnight Foundation mobilized capital into Minnesota's underserved markets with an investment facilitation approach at the intermediary-level

After recognizing the staggering gap between corporate commitments and actual capital deployed following the murder of George Floyd, a group of 40+ corporate, civic, and philanthropic leaders in Minneapolis-St. Paul formed the GroundBreak Coalition to help mobilize capital to create a region that is dramatically more inclusive, racially equitable, and climate-ready. The group established three goals to build Black wealth: 1) enable 11,000 new Black homeowners in the region, 2) support 5,000 additional Black entrepreneurs who create 8,000 jobs in the community, and 3) invest in 60 new sustainable, Black-led neighborhood commercial developments. GroundBreak seeks to mobilize US$5.3B of capital in the next decade to achieve these goals. **While several capital providers were willing to extend first-loss facilities, guarantees, and capex subsidies to shift the risk/return profile of investing in this underserved market, the McKnight Foundation recognized that there were significant transaction costs and information asymmetries preventing the mobilization of this capital.** Taking an investment facilitation approach, the McKnight Foundation's relatively small investment to cover the cost of three individuals acting as transaction advisors[14] has already unlocked $1B of capital over two years, and has the potential to unlock $5.3B of private and philanthropic capital for the region in the next ten years.

14. This does not include the McKnight Foundation's contributions to other aspects of The GroundBreak Coalition.

Overcoming the information asymmetries that prevent capital from flowing

In Minneapolis, Black communities have confronted systemic barriers to accessing capital and financial services for decades, creating meaningful distrust of the financial sector as a result of predatory lending and/or persistent denial of capital to borrowers. Engagement beyond a few community-based financial institutions was out of the question for most projects, companies, and individuals. Similarly, for capital providers, the perceived risk due to lack of investment track record prevented financial institutions from extending credit. **One of the first tasks of the GroundBreak coalition was to address this lack of trust and create pathways for capital to flow to the communities they were committed to serve.**

The Coalition developed working groups around each of the large-scale investment opportunities for building Black wealth. These working groups sought the perspectives of Black developers, Black homebuyers, and Black entrepreneurs who crystalized the barriers to accessing debt and equity that could make property development, homebuying, and business growth possible. **By serving as an honest broker and facilitator, the GroundBreak Coalition was able to elucidate the challenges and develop a comprehensive road map to overcome them.**

Downtown Minneapolis.
Photo credit: Josh Hild

Taking an investment facilitation approach, The McKnight Foundation's relatively small investment to cover the cost of three individuals acting as transaction advisors has already unlocked $1B of capital, and has the potential to unlock $5.3B of private and philanthropic capital to the region in the next ten years.

Overcoming the transaction cost barriers for investments into intermediaries

The Coalition quickly identified that there were persistent and pervasive barriers to capital that were preventing wealth building for Black borrowers. To change the flow of capital, they needed to create a novel system of capital allocation by building new pools of capital that borrowers could reliably and repeatably access to meet their capital needs. From this insight they embraced a strategy to build several new vehicles that capital providers can fund, and that meet the needs of Black communities and borrowers in Minneapolis.

Working with capital providers who had pledged resources, but were yet to deploy capital, the GroundBreak Coalition has systemically solved some of the challenges and barriers identified by the community. While the methods for originating and closing loans and investments are clearly broken, the Coalition has used its expertise, bandwidth, and role as an honest broker to repair some of these broken funds/intermediary structures using a suite of new vehicles including:

1. A low-cost, patient capital facility to finance home ownership and commercial real estate development
2. A guarantee facility to support junior and senior loans for commercial real estate development and early-/growth-stage entrepreneurs

There are two principal advantages of the investment facilitation approach that the McKnight Foundation took:

The creation and preservation of transaction knowledge as a public benefit. By funding the transaction costs of designing, creating, and fundraising for new vehicles, other investors, companies, entrepreneurs, project sponsors, and policy makers are getting a deep look at how the financial system works (or doesn't work) in Minneapolis. Publishing status updates and specific terms for different vehicles both reduces the transaction costs for new deals to happen, and overcomes some of the information asymmetry that creates significant distrust between capital providers and capital seekers.

The ability to work with multiple forms of capital to address varying and sometimes compounding issues. By paying for the transaction costs to mobilize capital into Black communities in Minneapolis instead of providing concessional capital to a specific fund, the McKnight Foundation was able to work across a broad range of institutions and capital types. This created an environment where the best capital providers could be identified for each specific challenge.

Without the commitment from the McKnight Foundation to fund an investment facilitation team with the expertise and bandwidth to negotiate with capital providers on a systemic level on behalf of Minneapolis's underserved Black communities, we believe it is unlikely that much of the pledged investment would have materialized. Moreover, by making that investment facilitation team independent of any one fund or investment group, we believe the impact will cut across all segments of the market, and into perpetuity.

Examples from the field: how “Opportunity Zone Prospectuses” are bringing down the cost of origination for investors at the deal-level

In 2018, following the creation of Opportunity Zones, Accelerator for America, and New Localism Associates teamed up with mayors from five cities across the US to develop “prospectuses” to introduce investors to each city’s Opportunity Zones. The prospectuses have reduced the cost for an outside investor to learn about the cities and their Opportunity Zones, and for cities to engage with Opportunity Zone investors by:

01

Providing initial data for understanding the local area

This includes data on demographics, existing industries, infrastructure, and the local workforce, making it more efficient to conduct due diligence.

02

Outlining the benefits available to investors in their Opportunity Zones

This includes tax incentives but also any state or local programs that can be paired with Opportunity Zone incentives. This detailed breakdown helps investors quickly aggregate the dollar value of incentives and model the gross returns of their market entrance.

03

Articulating local goals and development plans

Prospectuses often include comprehensive plans by local governments or economic development organizations, detailing the vision for economic growth and strategic areas for investment. This helps investors align their investments with local development goals, thereby improving their social license to operate and increasing the success rate of their projects.

Street corner in Cincinnati, Ohio now believed to be under redevelopment
Photo credit: Sean Foster on Unsplash

04

Identifying potential partners for financing and development.

The process of creating and distributing these prospectuses can facilitate networking and partnerships between investors, project sponsors, the local government, and community organizations.

Some Opportunity Zone Prospectuses go further by listing specific projects seeking investment, including details about the project scope, expected returns, and community impact. This direct connection to actionable investment opportunities is particularly valuable for investors looking for "shovel-ready" projects. **All of these efforts help bring down the origination costs and market due diligence costs that investors face when entering an underserved market.**

The chance to build on Opportunity Zone Prospectuses with investment facilitation

For cities and regions with existing Opportunity Zone Prospectuses, there is an opportunity to move capital off the sidelines by employing an investment facilitation approach that supports specific transactions through financial close using the activities found in Figure 6: Investment facilitation through the investment cycle.

For these cities and regions, Opportunity Zone Prospectuses have laid the initial groundwork for an investor to understand the area and the general thrust of opportunities within, **but the information asymmetries and transaction costs remain too high for an investor to become meaningfully interested in exploring the opportunity,** not to mention the fractured trust that often remains between capital providers and capital seekers.

In these situations, state and local governments and philanthropic actors would benefit greatly from hiring or standing up an investment facilitation team that supports transactions until close, with a specific mandate to focus on those transactions that align with the long-term development goals of the community. These transactions in-turn create a flywheel effect, where each successive transaction benefits from the precedent set by the previous one. **Eventually – as investment begets more investment – the market is appropriately saturated with investors** that are regularly reviewing opportunities, as they look to expand their portfolio.

CrossBoundary's work in underserved markets globally, and the example of the Groundbreak Coalition (above), prove that a relatively small amount of capital provided toward an investment facilitation approach can unlock incredible amounts of capital.

Conclusion

While programs and policies have mobilized billions of dollars into underserved markets in the US since at least the 1970s, inequality persists both within and between regions.

The evidence suggests that even within these programs, private capital has concentrated investment into a few markets, leaving a broad swath of opportunities and entrepreneurs on the sidelines in others. We can do better.

The existing toolkit of programs and policies have fallen short because they typically focus only on adjusting the gross risk/return profile for investors through incentives, failing to address the underlying transaction costs and information asymmetries that prevent efficient capital flows. These frictions are major barriers that can cause markets to deteriorate or dry up altogether. Without efficient and effective capital formation, the demographic, geographic, and sectoral economies that we care deeply about will struggle to grow.

Investment facilitation directly tackles the issues preventing this critical growth. By providing expertise, relationships, and resources to reduce information asymmetries and transaction costs, investment facilitation helps willing capital providers and seekers overcome barriers to find mutually beneficial deals, rebuilding trust on both sides of the table. If the US is serious about mobilizing capital into its underserved markets, investment facilitation merits greater focus and resources.

Photo credit: Michael Heuser on Unsplash

About CrossBoundary Group

CrossBoundary Group’s mission is to unlock capital to make a strong return and a lasting difference in underserved markets.

The firm has over 200 professional staff across 22 offices. **CrossBoundary Advisory** was founded in 2011 and provides a broad spectrum of investment and transaction advisory services across a range of sectors in underserved markets globally. Our advisory team is a trusted partner for high-impact organizations all around the world. CrossBoundary Investment Management creates investment vehicles in underserved markets that develop projects capable of absorbing capital, including **CrossBoundary Energy**, **CrossBoundary Access**, **CrossBoundary Educational Infrastructure**, **The Fund for Nature,** and Dhow Ventures.

Acknowledgements

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Finally - we want to thank all the individuals who have been standing in the gap to overcome the transaction costs and information asymmetries across US underserved markets. We hope this piece creates a shared language and an appreciation for what you do, which so often goes overlooked.

Appendix 1

Macro-level vs firm-level

In the below framework we characterize the most important barriers to investing in underserved markets in the US, and highlight some of the interventions available to address each.

Figure 07 **Barriers to investments and typical interventions**

	Systemic failure	Barriers to investment	Typical interventions and examples
Macro-level	Lack of quasi-public goods	• Lack of physical infrastucture (transport, energy, water) • Lack of soft infrastructure (educated workforce) • Poor enabling environment (experienced service providers, credible incubators/accelerators)	• Public private partnerships • Workforce development programs • Small business and entrepreneur support programs (Accelerator for America, Venture for America, SBA Small Business Support Centers, Recompete Program)
Macro-level	Lack of capital for perceived risk/return	• Genuine constraints may mean the addressable market is smaller than that of other US markets • Creditworthiness or perceived creditworthiness might be below investors underwriting requirements • Poor soft and hard infrastructure temper rate of growth expectations	• Blended finance facilities that lower the cost of capital (SBIC, CDFI Fund, Place-based Fund) • Government direct investment programs (SSBCI, DOE loan fund) • Tax incentive programs that enhance the return for investors in underserved markets (New Market Tax Credits, Opportunity Zones)
Firm-level	Information asymmetry	**A lack of trust, prior experience, and/or other imbalance of information:** • Investors lack knowledge of market characteristics and participants assume they are at a significant disadvantage • Entrepreneurs lack transaction experience and knowledge of market-standard terms, and fear exploitation	• **GroundBreak Coalition trustbuilding work**
Firm-level	Transaction costs	**A lack of expertise, bandwidth, and/or geographic presence** hinders parties from overcoming information gaps and initiating, managing, and completing the transaction process: • Investors face challenges accessing leads, negotiating with sponsors, and structuring deals • Entrepreneurs face challenges connecting with capital sources, articulating value, and negotiating terms	• **Opportunity Zone Investment Prospectus**

Abundant in US underserved markets

Lacking in US underserved markets

1. Lack of quasi-public goods: Traditional economic development tends to focus on this gap – where the lack of hard and soft infrastructure makes businesses in a certain region (or available to a certain demographic) uncompetitive. By investing in new quasi-public goods that can benefit a number of enterprises, a government or philanthropic institution can create opportunities for entrepreneurs to

be competitive in one or more sectors. Robert Solow's growth curve helped drive the argument for this approach following the Marshall Plan – where billions of dollars lent to European institutions in the wake of World War II drove the creation of new infrastructure upon which today's European economy sits.

2. Lack of capital for the perceived risk return profile: Recently, programs such as the New Markets Tax Credit, the Community Development Financial Institution fund, Opportunity Zone legislation, and SBIC funds have helped unlock capital for parts of the market with a perceived risk/return profile that doesn't meet investor expectations for market returns. These programs target businesses in specific geographies or sectors, aiming to increase investment in areas where it is otherwise limited due to these risk/return perceptions.
3. Information Asymmetry: Information asymmetry is a significant information imbalance between two parties that can be a severe barrier to investment. Akerlov's lemon problem[15] demonstrates how this works for a buyer of a used car – for an investor it works much the same way – I don't know enough about the market or the firm to avoid being taken advantage of (I might "buy" an investment opportunity that looks good on the outside, but has one or multiple fatal flaws). On the other hand, for an entrepreneur or project sponsor raising capital it can be very difficult to know if the terms being offered are "fair." Most investors will have seen more transactions/done more deals – creating an information imbalance about fair market terms. A financial system that has historically excluded or exploited certain demographic groups exacerbates these challenges – preventing highly impactful deals from closing.
4. Transaction Costs: Transaction costs are baked in to every deal closed whether it's at the fund/vehicle level or at the specific deal level. Some of these are "hard costs" – legal fees and others that can be capitalized in the project, while others are "soft costs" – often the time a fund manager or banker spends to close a deal (deal level), or a fund manager or banker spends to create a fund or a facility and fundraise for it (fund/vehicle level). There are also opportunity costs for entrepreneurs and project sponsors who are often taking time away from running the business/project to raise capital, negotiate terms, and close the transaction. Every dollar spent to close a transaction must be made up in returns – meaning transaction costs can kill a deal that would otherwise meet an investor's return threshold. Importantly, transaction costs generally do not shrink or grow in proportion to deal size. For small deals and small funds/vehicles – transaction costs are an often insurmountable barrier to closing a deal.

15. **Akerlof, George A. "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism."** The Quarterly Journal of Economics, vol. 84, no. 3, 1970, pp. 488–500. JSTOR, https://doi.org/10.2307/1879431. Accessed 19 June 2024.

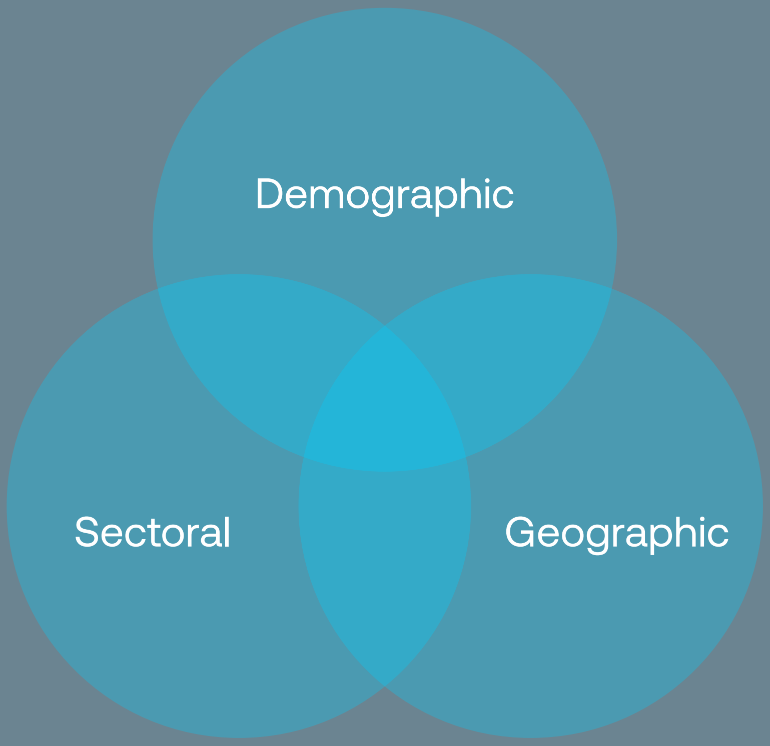
As we can see, solutions attempting to address the capital gaps for US underserved markets have historically tended to focus on addressing macro-level constraints. These have taken two forms: ameliorating the lack of quasi-public goods and closing the financing gap. Since the early 1970s, there has been a focus on programs that will shift the risk/return profile for investments entering underserved market. Examples of this include empowerment zones and the creation of CDFIs (1990s), new market tax credits (2000s), and Opportunity Zones and the SSBCI program (2010s). SBA loan programs also do this, although are not tied specifically to geographic or demographic underserved markets.

Beyond government programs, foundations have pursued similar strategies, creating or providing "concessional" capital to new, exciting vehicles that also shift the risk/return profile for investments in these markets.

It is time to re-weight the focus and apply more resources to the firm-level barriers that limit the amount of capital flowing into underserved markets in the US.

Appendix 2

What Constitutes an Underserved Market?



At a very basic level underserved markets are those in which the amount of capital invested in a market is less than the market opportunity. Some of these are easy to identify by the outcomes – only 2% of venture capital goes to women, the DRC receives less investment despite greater market opportunities.

But some are harder to see – especially in the US where underserved markets might be hidden behind a strong market (e.g. a city like Minneapolis seems to punch above its weight in terms of capital invested, but certain neighborhoods seem impervious to capital flows; farmland seems to be heavily invested in, while organic farmland struggles to raise capital despite strong financial returns).

In order to better see underserved markets we break them into three categories – demographic, geographic, and sectoral. Each has their own problem and solution sets – and while they often overlap (e.g. a certain demographic is concentrated in a certain geography) breaking them down into their respective components allows us to better design solutions for each.[16]

16. Not all investment data is public or easily aggregated. In the below breakdown we use venture capital investments relative to population size as a proxy for how underserved a given market is.

Demographic underserved markets

17. PlanBeyond US Venture Capital Funding Trends Report

18. WashU Olin Business School and the Brookings Institution: "Bridging the Startup Funding Gap for Women, Black and Latinx Entrepreneurs." April 20, 2023.

Venture capital investment in the US is relatively highly concentrated among white male founders, and is underrepresented in Black, Latino, and Native American populations.

Figure 08 **Breakdown of venture-backed founders by race in 2019**[17]

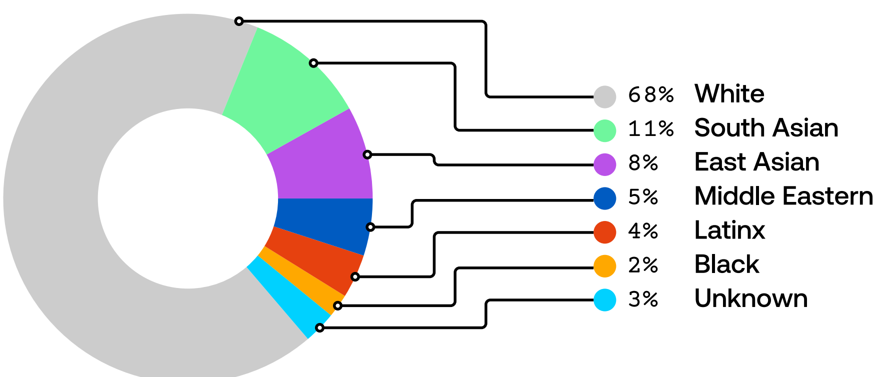
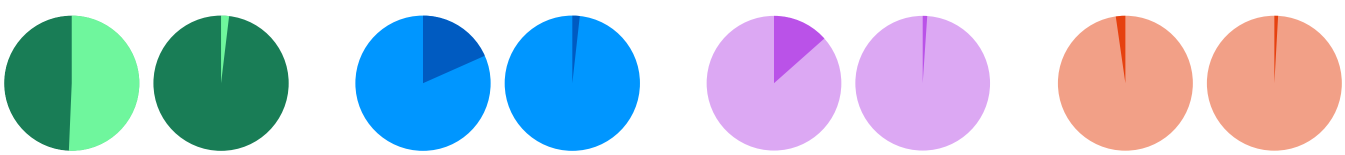


Figure 09 **Lopsided funding support**[18]



Women represent **50.5%** of the U.S. population, yet women-only founding teams receive just **2%** of venture capital funding.

Latinx individuals represent **18.9%** of the U.S. population, yet receive about **2%** of venture funding.

Black individuals represent **13.6%** of the U.S. population, yet receive about **1%** of venture financing.

Native American/Alaska Native individuals represent **2%** of the U.S. population, yet receive about **0.013%** of venture funding.

In 2021, following the murder of George Floyd, US venture capitalists invested a **record high share of deployed capital in Black founders - a meager 1.4%.**[19]

Amid a cooling market for VC and a pullback in societal interest in diversity, equity, and inclusion, that number has been in steady decline ever since; in 2023, only 0.48% of venture capital went to Black founders.[20]

There are lots of explanations for these disparities in funding – with some of them overlapping with geography and sector. For instance, most Native American Reservations are located away from the deepest capital markets of New York, Boston, San Francisco, and Los Angeles which increases the transaction and management costs for capital providers located in those major financial markets. But many are specific to a demographic – redlining may have been defined geographically, but it was a proxy for race. And for Latino businesses, the concern of undocumented workers and lack of data on the market because of a lack of available market research is a specific challenge that both keeps entrepreneurs from approaching the formal channels of capital, and prevents investors from entering the market.

Geographic underserved markets

Geographic underserved markets are – in many ways – the easiest to define. Investing data is often disaggregated by geography, providing a window into how capital overlooks certain geographies. **In 2023, just four markets on the west and east coasts represented 67% of the total value of venture capital investments in the US** - San Francisco, New York, Los Angeles, and Boston. In parallel, entire swaths of the country receive a just fraction of VC investment; in 2023 the Midwest and Great Lakes region combined received 5.7% of venture capital by deal value, and the Southeast received 4.6%, while the West Coast alone accounted for 49.1% of total deal value.[21]

Investing data by geography also depends highly on its granularity. Certainly, **the United States is not an underserved country, but Louisiana is an underserved state. Pennsylvania is not an underserved state, but Erie County is an underserved county.** So, what is the right focus level to evaluate a geography? The Economic Innovation Group has broken down US underserved markets by geography in what we have found is the most granular, well thought through analysis of US geographically underserved markets in their Areas of Persistent Poverty report.[22] Using this lens reveals a long history of areas that have been overlooked by capital, contributing to the extreme economic underperformance by these geographies over many years.

19. Deffenbaugh, Ryan for Crain's New York Business: "Black Founders Raise More Funding, but Large gap Remains." February 14, 2022

20. Davis, Dominic-Madori for TechCrunch: "Funding to Black Founders Was down in 2023 for the Third Year in a Row." January 17, 2024.

21. Author's calculations based on Q1 2024 Pitchbook NVCA Venture Monitor.

22. Economic Innovation Group: Interactive Map of Persistent Poverty Communities

A careful review of these areas reveals histories of injustices, specifically against Black and other minority groups, that have left critical areas under invested-in, as well as key corridors that have lost ground as our economy has become "financialized" with capital increasingly concentrated on the coasts.

Sectoral underserved markets

Underserved sectors are harder to define than underserved demographics or geographies. Investors in the US regularly allocate capital according to sectors so finding those that are overlooked for something other than their fundamental economics can be challenging, but they do exist, and typically they exist as a result of unintended structural challenges. One example that we have found of an underserved sector is regenerative agriculture and organic agriculture. Despite promising long-term economics based in cost and risk reduction (reducing inputs and creating farms that are more resilient to weather shocks) as well as a price premium in the case of organic agriculture, the structure of crop insurance and the existing loan infrastructure fails to take these into account, leaving the sector underserved.

But why should we care?

Much of the research on development economics has taken place outside of the US, comparing a country's per capita income with the amount of outside investment received. Robert Solow's original growth curve has remarkably predicted the impact of investment on country economies. The same is true of underserved markets in any form – without efficient and effective capital formation, the demographic, geographic, and sectoral economies that we care deeply about will struggle to grow. Of course there are other factors that are necessary for economic growth – and capital formation can both an outcome and a driver of those factors (e.g. an educated workforce can attract outside investment, but outside an investment can also increase the education level of a workforce). But, without accurately identifying underserved markets, we can do little to address the very human problems that exist within them.

Appendix 3

The Theoretical Foundation of Transaction Costs and Information Asymmetries

The Nature of the Firm meets the nature of investment

In 1937 Ronald Coase published The Nature of the Firm in which he pointed out that commercial enterprises (or firms) largely exist because they reduce transaction costs to providing services or goods (i.e. it's cheaper to cooperate within a firm). Cooperation from firm to firm, individual to individual, or firm to individual depends significantly on overcoming transaction costs. If these are too high relative to the benefit of the transaction, there are a range of transactions that won't happen even if there is a mutually beneficial deal to be made.

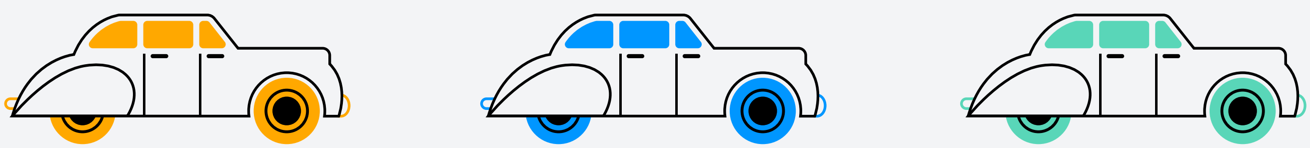
This warning and his subsequent work, which led to Nobel Prize in 1991, shed light on the realities of how transactions occur, and has been the foundation of numerous exchanges and market mechanisms where transaction costs are reduced such that new entrants can enter the markets for goods and services.

While Coase's research focused on products and services transactions, a similar point can and should be made about investment transactions. Flows of capital not only depend on the amount of benefit each party stands to gain at a gross level, but also what it costs to get the transactions done. Ignoring transaction costs and their impact on why a market receives little or no investment capital leads to deep misunderstanding of how capital moves, and it prevents blended finance from having its full impact in unlocking capital for those markets.

Lemons sour markets

George Akerlof's 1970 paper "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" has informed **how we think about "trust" in market structures – including those of underserved markets.**

Figure 10 **Impact of information asymmetry on transactions**



Buyer willingness to pay for a lemon

$1,200

Buyer willingness to pay for a plum

$2,400

Buyer willingness to pay for a car of **unknown quality**

50%
Expected probability that a car of unknown quality is a lemon

50% * ($1,200) = $600

+

50%
Expected probability that a car of unknown quality is a plum

½ * ($2,400) = $1,200

=

$1,800

Lemon seller willingness to sell
$1,000
Buyer overpays for lemon

Plum seller willingness to sell
$2,400
Seller accepts a sub-par price

Under conditions of asymmetric information, both buyer and seller suffer suboptimal outcomes

Adapted from Professor Pinar Dogan, Harvard Kennedy School

In a market where there are high quality products and low quality products, and a seller knows the real quality of the product being sold and the buyer doesn't, the market price will assume the price for the lowest quality product (because it is presumed that the seller won't sell a higher quality product at a lower quality product's price). In some markets, Akerlof predicts, this could mean the market dries up entirely, with no transactions taking place.

So in a financial market, who is the buyer, and who is the seller? While it's easy to conclude that the buyer is the investor (buying a stake in the company, or buying an IOU), the real answer is both. A capital provider is selling a financial product (a loan, an equity investment, etc.) and a capital seeker is selling an "IOU" or a stake in the business or project. Because of this reciprocal dynamic, any solution must establish trust both ways.

Akerlof argues, and indeed we affirm, that institutions must be created to combat the problem of information asymmetry in financial markets in underserved areas. These are often called "intermediaries" and take the form of a financial institution or fund specifically designed to make and manage investments in a certain market. Akerlof discusses the rise of Managing Agents in India as a way to solve this problem, but there are less esoteric examples around the world, including some in the United States, such as CDFIs and SBIC funds.

Unfortunately, both Akerlof's examples and the current intermediary examples in the US tend to miss that in an investment or lending transaction, both the capital provider and capital seeker are selling something, and both are buying something. Therefore, our solutions focus on building the confidence of investors that the intermediary (fund or financial institution) is able to effectively assess the quality of an investment, and manage that investment effectively so it meets the investor's return expectation.

But for the capital seeker, information asymmetries can be an equal barrier to entering the market for investment capital. In fact – in underserved markets, legacies of predatory investor and lender behavior are an equal or even larger barrier to mobilizing capital in that market.

But is there truly an information asymmetry for a capital seeker? Doesn't a capital seeker know the terms in the stock purchase or creditor agreement? Doesn't that eliminate the information asymmetry? Unfortunately, the answer here is no – there are two areas of information asymmetry not covered in the creditor or purchase agreement:

1. Market terms: In order to discern whether the terms of any loan or investment are "good" or "bad" a capital seeker must understand the range of potential terms. In deep, highly liquid financial markets where groups are regularly transacting, understanding the range of potential terms if fairly straightforward. But in underserved markets, where deals are few and far between – the range of potential terms is often ambiguous. Meaning capital seekers have limited means of evaluating whether an offer is "good" or "bad". This keeps capital seekers from participating in the market, believing that it is likely that they're being taken advantage of by the capital provider.
2. Management approach: While terms may be spelled out, how the capital provider will behave in managing the loan or investment is often unknown. Even from a minority equity position, an investor can take a very "hands on" approach to managing their investment – requiring regular check ins and opportunities to input in the operations of the business. Similarly, how a lender will use its covenants is often unknown to the borrower. If a borrower trips a covenant, how will a lender respond? These questions are not spelled out in the creditor or stock purchase agreement, and therefore create an information asymmetry around the "quality" of the deal being offered by the capital provider.

Without a way to overcome these information asymmetries, Akerlof's approach would indicate that the market would deteriorate to only include the worst quality offerings from capital providers, if there is any market at all. Indeed, this is what we often see take root in US underserved markets – lenders requiring extremely high collateral with predatory rates and few, if any, equity investors. Interventions focused on new intermediaries, such as CDFIs and SBIC funds, provide good quality products through government support, but – without a way to rebuild trust with capital seekers – deal flow for these groups can be challenging.

Investment facilitation provides a different intermediary approach that supports capital seekers as much as it supports capital providers, playing an "honest broker" role for both sides – thereby overcoming the reciprocal information asymmetry found in underserved markets.

Unfortunately, both Akerlof's examples and the current intermediary examples in the US tend to miss that in an investment or lending transaction, both the capital provider and capital seeker are selling something, and both are buying something.

A Bridge at Sunset near Redwood, Mississippi. Photo credit: Justin Wilkens on Unsplash

CrossBoundary Advisory

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At the core of CrossBoundary is our purpose

We unlock capital for sustainable growth and strong returns in underserved markets

For more information please contact
nathan.kelly@crossboundary.com