

Minorities and Venture Capital

A New Wave in American Business

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EXECUTIVE SUMMARY

Do minority-owned businesses in the United States have access to venture capital (VC) funds? What kinds of minority business enterprises (MBEs) get VC support? Where are venture capital funds that flow into minority-owned firms coming from? Do venture capital firms investing in businesses owned by African-Americans, Hispanic Americans and Asian Americans make or lose money—and how does that compare to the VC industry overall?

These questions are particularly timely today in view of the shifting demographics in America—particularly in the business world—where more and more minorities are attempting to start new businesses and to grow existing firms. With sufficient venture capital support, minority business enterprises can thrive and grow. Unfortunately, the reverse also is true. Whether or not the VC “tap” is opened up for MBEs will depend in part on a greater understanding of how such funding support works—or fails to work—in the real world.

KEY FINDINGS

No previous research effort has successfully identified and studied the venture capital firms that concentrate on making equity investments in minority business enterprises. This groundbreaking analysis of 24 venture capital funds making 117 minority-oriented investments found that:

• **Minority enterprise venture capital investing is very profitable.** The average investment per firm was \$562,400; the average gross yield per firm was \$1,623,900, generating an average net return of \$1,061,500.

• **Minority-oriented venture capital funds do NOT concentrate their investments heavily in high-tech firms.** Unlike the broader VC industry, which is in the midst of a steep slump after betting heavily on investments in “dot-coms” and other high-tech concerns, funds focused on MBEs support a more diverse range of industries.

• **Public pension funds are the leading source of VC funds for MBEs.** Knowledge of the high returns generated by successful minority venture capital should serve to increase flow of funds to minority business enterprises from public pension and other funding sources.

METHODOLOGY

This analysis began with an initial survey of 50 venture capital funds operated by active members of the National Association of Investment Companies (NAIC). Members of NAIC are investment companies bound together by their shared interest in financing minority business enterprises.

The front-end survey sought to identify NAIC member funds that are:

- Actively investing venture capital in small firms.
- Targeting their investments largely to MBEs.
- Investing with a primary focus on generating attractive monetary returns.

Of the 50 surveyed venture capital funds:

- 48 responded.
- 36 “passed” the three-part test for inclusion in the broader analysis.
- Of the 36 qualifying funds, 24 responded to a second and more detailed questionnaire. This response rate of 66.7 percent exceeded our expectations by a comfortable margin.

Our analysis of the survey responses from the 24 funds focused on three questions:

- When investments in MBEs are sold off or liquidated, what kinds of monetary returns are earned by the venture capital funds?
- What kinds of MBEs attract venture capital investments and how do the funds interact with their minority business clients?
- Where do minority venture capital funds raise their financial capital?

THE FINDINGS

RATES OF RETURN

Our analysis shows that the average mature, minority-oriented venture capital fund is highly profitable. The rate-of-return analysis focusing on the realized investments made by VC funds is most meaningful in evaluating the profitability of mature funds. Many of the surveyed minority-oriented VC funds, in contrast, were young funds, meaning that they were not in existence before 1996.

The survey data provided by the 24 minority-oriented venture capital funds that were examined in detail allowed us to measure the timing and amount of dollars flowing into investments, and the returns harvested from mature investments. We used this information to calculate fund investment performance. For investments in firms that had been made during the 1989-1995 period, we focused on the returns of 117 investments that had been realized by year-end 2000.*

A key finding: Returns earned from the mature venture capital investments were **NOT** dominated by a few highly profitable deals. Among the 117 harvested investments, 64 of them yielded positive returns and 53 produced negative returns. (See Table 1 on next page.) The cash outflows associated with these 117 investments totaled \$65.8 million, producing an average investment size of \$562,400 for the firms receiving venture capital.

Cash flows received by the funds when these investments were harvested added up to \$190.1 million. The venture capital funds netted \$124.2 million from the 117 investments, an average of \$1.06 million per investment. If this net cash flow stream were discounted at a 20 percent rate, it would have a residual value of \$13.8 million.

* Multiple investments in one firm were counted as one investment; thus, 117 firms were analyzed to measure investment performance.

TABLE 1:
Investment Performance Measures for the
Minority-Oriented Venture Capital Funds*

A. Payback Analysis	
Number of investments	117
Number with positive payback	64
Percent with positive payback	54.7%
B. Average investment performance (\$ thousands)	
Mean investment outflow	\$562.4
Mean investment gross return	\$1,623.9
Mean investment net return	\$1,061.5
C. Internal rate of return analysis	
Mean IRR (11 funds)	23.9%
Median IRR (11 funds)	19.5%

* Includes data on 11 minority-oriented venture funds surveyed in 2001 that made equity investments in 1989 through 1995.
Source: 2001 survey of minority-oriented VC funds

Table 1 also reports the internal rates of return (IRRs) generated by combining the cash inflows and outflows of the 1989-95 investments going to each fund over 1989-2000. This results in one overall IRR (only) for each fund. In essence, this fund-specific IRR calculation measures the profitability of minority-oriented venture capital funds from the perspective of the investors in the funds. The IRRs of the funds ranged from -32 percent to 79 percent, with a median of 19.5 percent and a mean of 23.9 percent.

How do these numbers compare to relevant VC industry benchmarks?

In order to compare investment performance, an analyst must have available benchmark funds that invest in the same risk category as these funds. Unfortunately, no such data are available. Venture Economics and the National Venture Capital Association derive a Private Equity Performance Index. Venture Economics tracks the performance of over 1,400 U.S. venture capital and buyout funds on a quarterly basis. Venture Economics calculates that, as of early 2001, the 10-year trailing average annual return for the Private Equity Performance Index was 20.2 percent.

Regression analysis was used to explain variance patterns in the IRRs produced by the 117 investments in small businesses.

Higher IRRs were associated, in the regression analysis, with:

- Larger dollar sizes of investments in firms.
- VC general partners being actively involved with their portfolio companies.
- Funds that were diversified by industry.

Lower IRRs were associated with:

- Making smaller investments in firms.
- Being chartered by the U.S. Small Business Administration (SBA) and receiving funding from it.
- Funds that were above average in terms of total capitalization.

In other words, a fund that generates above-average IRRs on its investments could be described as follows:

- Making investments averaging \$1 million or more per firm (well above the fund average of \$562,400).
- Not accepting funding from the federal government (SBA).
- Taking a highly active role in the affairs of its portfolio companies.
- Not being a particularly large fund.

This last finding—the largest funds generated lower IRRs on investments than smaller funds—was surprising. Yet our findings show that potential disadvantages of being, for example, a smaller (\$20 million) fund instead of a larger (\$50 million) fund can be overcome, in part, by being actively involved in syndicated investments.

What we see from the rate-of-return analysis is a decidedly favorable picture of minority-oriented venture capital funds. A word of caution is in order, however, because some of the funds produced low rates of return on their venture capital investments. Our view is that minority venture capital is a young industry in the process of sorting itself out. We expect this process will play itself out as follows:

- First, the highly profitable funds will use their track records to expand via launching additional funds.
- Second, less profitable funds may stagnate and, perhaps, disappear over time without having undergone the process of self-renewal via launching new funds.

USE OF FUNDS

Our analysis found that minority-oriented VC funds did not make the “mistake” common to the wider venture capital industry of over-concentrating in dot-coms and other high-tech ventures. While high-tech investments were present in most of the VC portfolios, such investments did not dominate the portfolios.

We found that a typical minority venture capital fund might be invested in broadcasting, high-tech electronics manufacturing, and a restaurant chain. Some funds specialize narrowly, investing their capital in firms operating in one industry niche, such as communications. But the typical VC fund surveyed for this analysis was invested in three or four or more diverse industry sectors.

Twenty of the 24 surveyed minority-oriented venture capital funds invested in communications firms. (See Table 2.) The orientation in this sector leaned to radio stations instead of broadband, although investments were sometimes made in high-tech areas of communications. A stronger high-tech orientation appeared among the 12 funds that had invested in firms in the electronics manufacturing fields, including computer-related enterprises.

The majority of the companies in which the minority VC funds invested, however, cannot be characterized as high-tech. Manufacturing firms operating in areas outside electronics were a popular investment choice: 15 of the funds invested in a diverse group of such firms. A wide array of service industries was a common focus for investments. Excluding medical services, 16 of the surveyed funds invested in service firms. The specific line of services that was most popular was medical services, a field in which nine of the funds had invested.

TABLE 2:
Investing in MBEs: Number of Funds Investing in Select Industry Groups*

Communications	20 funds
Manufacturing: other than electronics and computer-related	15 funds
Manufacturing: electronics and computer-related fields	12 funds
Trade: wholesale and retail	13 funds
Services, except medical	16 funds
Medical	9 funds

*Source: 2001 survey of 24 minority-oriented VC funds

The minority-oriented funds varied enormously in size, and the trend has picked up steam in recent years as some of the more established firms in the industry have raised more substantial amounts of funds. Based on the standard of initial capital raised, seven of the 24 surveyed funds started out with less than \$10 million. At the other end of the spectrum, five VC firms began operations with over \$50 million. The overall range for initial capitalization was from \$2 million to over \$500 million.

Investing in MBEs operating in a variety of industries and offering a range of equity and hybrid financial products requires considerable depth in managerial expertise. The small funds appeared to struggle with limited managerial staff. Being small, in addition, made it difficult to achieve diversification in portfolio investments in an industry where such diversification is vitally important for spreading risks. A pragmatic and popular strategy in such circumstances is to invest in MBEs by being a participant in syndicated business investments. In fact, an outstanding feature of the minority-oriented venture capital industry is the near universal participation of funds in syndicated investments.

TABLE 3:
Fund Participation in Syndication of Business Investments*

Funds active in any form of syndication	24 funds
Funds that have acted as the lead firm in syndicating an investment	20 funds
Funds that have participated in a syndicated deal that they did NOT lead	21 funds

*Source: 2001 survey of 24 minority-oriented VC funds

Syndicated Investments. Among the 24 surveyed venture capital funds, all 24 respondents had participated in syndicated business investments. (See Table 3.) Remarkably, 20 of the funds had acted as the lead firm in syndicating an investment. For larger venture capital investments, syndication is a standard practice. An attractive opportunity to invest \$10 million in equity in a promising minority business venture—absent syndication—would be overly risky for most of the minority-oriented funds. Rather than losing the deal, however, the fund may choose to syndicate it, investing, perhaps, \$2 million of its own funds and parceling out \$8 million to other minority-oriented VC funds.

Widespread syndication is symptomatic of the extensive networking that exists among minority-oriented venture capital funds. Through membership in the NAIC and in the midst of frequent interaction on business investments, the general partners in this sector have developed considerable expertise in working together. An important benefit of this development is the ability of the funds to finance larger deals while enhancing the diversification of their investment portfolios.

Level of Involvement. Minority funds with the highest levels of involvement in their portfolio companies earn higher rates of return on their realized equity investments than the less active funds. Thus, the evidence strongly suggests that highly active general partner involvement with client firms adds value to the portfolio companies.

When VC funds purchase equity in MBEs that are privately held, they typically buy into firms that are small and young. Large differences exist between what the entrepreneurs and investors know about the underlying condition of the firm. Such gaps in information regarding the true condition of the small businesses receiving equity capital are one of the main reasons why the general practice of VC investing is inherently risky. A successful venture capital fund must alleviate these information gaps. Tools to achieve this involve scrutinizing firms intensely before providing equity capital and monitoring them closely afterward. Monitoring and information tools of the venture capitalists include taking seats on the firm's board of directors, participating in long-range planning undertaken by client firms, and, when necessary, participating in the management of day-to-day operations.

By serving on a firm's board of directors, venture fund general partners not only learn more about a firm's operations, they also position themselves to provide advice and support for client firms. This study surveyed the 24 minority-oriented venture capital funds to learn more about their interactions with client firms. Indeed, all but one of the 24 responding funds indicated that general partners sit on the board of directors of client firms, 21 responded that they often do this, and two funds indicated that they "sometimes" sit on boards.

We collected data from the 24 survey respondents on four kinds of general partner involvement in management of their portfolio firms:

- ☞ Advise on long-term planning.
- ☞ Assist with hiring.
- ☞ Assist in day-to-day operations.
- ☞ Participate in execution of exit strategy.

All of the 24 surveyed minority venture funds responded that they advised on long-term planning and were actively involved in execution of exit strategy. The venture funds varied somewhat more regarding assisting client firms with hiring. Although this type of interaction with their clients was nearly universal (23 of 24) among the surveyed venture funds, only seven provided such assistance often; more frequently, the fund general partners responded that they sometimes assisted with hiring (16 funds). Assisting in the day-to-day operations of portfolio companies was something none of the surveyed minority venture funds did frequently. Yet, such intense involvement was undertaken sometimes by 18 of the 24 funds.

SOURCES OF FUNDS

Of the 24 surveyed VC funds, capital was raised from eight major sources. In order of importance (by dollar amount raised), the sources funding the minority-oriented VC industry are:

- 8th Public pension funds.
- 7th Commercial banks and insurance companies.
- 6th Intermediaries known as “fund of funds.”
- 5th Corporate pension funds.
- 4th Corporations.
- 3rd State and local governments.
- 2nd Federal government.
- 1st Miscellaneous sources, including foundations, endowments, families and individuals.

Overall, the surveyed VC funds tapped a median of three types of financial-capital resources. The 24 funds responding to our survey raised more than \$1.3 billion (from fund inception through year-end 2000).

Of the 24 responding NAIC member funds that were both MBE and venture-capital-oriented, those funds attached to older, more established investment firms typically had access to a wider variety of financial capital sources than the industry newcomers. Banks and insurance companies were accessible funding sources for both the minority VC industry veterans and newcomers: 14 of the 24 funds tapped this capital source. (See Table 4 on next page.) Pension funds—public as well as corporate—and the fund of funds most commonly provided capital to minority-oriented VC funds that had an established track record of successful investing in MBEs.

Public pension funds have invested more capital in minority VC funds than any other source, but they have concentrated their investments in six large funds. (See Table 4.) Government funding sources serve a heterogeneous mix of VC firms, and they rank toward the bottom of the list of major capital sources. The federal government as a VC funder appears to be fading into insignificance, as newer funds are not raising capital from this source. The expanding capital sources are typically the biggest providers—banks, pension funds, and the fund of funds.

TABLE 4:
Funding Sources Most Often Utilized
by Minority-Oriented VC Funds

Major sources	Number of funds tapping this source	Approximate range of capital raised
1. Banks, insurance companies	14	\$1 million to over \$50 million
2. Corporations	10	\$1 million to over \$7 million
3. Fund of funds	7	\$8 million to over \$25 million
4. Public pension funds	6	\$20 million to over \$400 million
5. Corporate pension funds	6	\$4 million to \$25 million
6. Federal government	5	\$3 million to \$9 million
7. State, local government	5	\$1 million to \$20 million
8. All other sources	18	Under \$100,000 to over \$12 million

Source: 2001 survey of 24 funds

Among capital sources, some of them routinely provided \$10 million or more to the individual minority-oriented VC funds, while others provided \$1 million or less. The median amount that individual funds raised from public pension funds was \$55 million. (See Table 5.) Indeed, the surveyed funds occasionally raised amounts of capital exceeding \$100 million per fund from public pension funds. The larger-scale minority-oriented VC funds were most often capitalized by the public and corporate pension funds, the fund of funds, and banks.

Because industry newcomers are not likely to tap pension funds or the fund of funds, the bank/insurance company group is critically important to the industry's long-term development: their funding is accessible to new industry entrants. Similarly, the smaller sources of capital can play an important development role when they provide funding to firms and funds that have not yet established a track record in the minority VC industry.

Prominent among the sources that most often invest relatively small dollar amounts in minority-oriented VC funds are:

- 8th Government.
- 8th Corporations.
- 8th Foundations and endowments.
- 8th Individuals and families.

TABLE 5:
Median Dollar Amount of Capital Raised,
by Source
 (rounded to the nearest million)

1. Public pension funds	\$55 million
2. Fund of funds	\$15 million
3. Banks, insurance companies	\$14 million
4. Corporate pension funds	\$11 million
5. State, local government	\$5 million
6. Federal government	\$4 million
7. Corporations	\$3 million
8. All other sources, including foundations, endowments, families, and individuals	\$1 million
9. Total raised through year-end 2000: all sources	\$1,326.9 million

Source: 2001 survey of 24 funds

LESSONS FOR THE FUTURE

The minority VC sector now has total capital under management estimated at \$2 billion. Among the 24 funds responding to our 2001 survey, \$1.3 billion had been raised through year-end 2000. In 1998 alone, five of the surveyed minority-oriented VC funds raised over \$700 million in capital from institutional sources.

What does the future hold for minority-oriented VC funds? Based on our analysis, we would offer three observations:

- If the influx of new money entering the minority-oriented VC industry is successfully invested, then this surging financial industry niche may sustain its rapid growth trajectory.
- The investment mix of the minority VC funds is less risky than the overall industry. Hence, the minority sector has little exposure to the continuing fallout from the “Internet bubble.” Its broader industry mix will sustain its profitability in the early years of the 21st century (while the mainstream industry generates losses). Because of this, the minority sector may exhibit less of the extreme boom and bust nature that has plagued the overall VC industry since its inception.
- Some profit-oriented funding sources may shy away from minority VC funds today because of the mistaken assumption that such ventures are inevitably low-return “social investing” propositions. As knowledge of the high returns generated by successful minority venture capital spreads, this ill-informed aversion should lessen, thereby increasing the flow of funds to minority business enterprises.

This report is presented in abstract form.
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