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Small Business Research Summary

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The Viability of the Minority-Oriented Venture Capital Industry: Implications of Diversifying Investment Strategies

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Purpose

The number of minority-oriented equity capital funds grew significantly during the period of the 1990s. Early financial performance was positive, but more recently, these funds have invested in fewer minority-owned businesses and have increased their non-minority-owned high-tech investments. To better inform these equity capital funds and public support for these funds, research is needed to evaluate these changes.

Background/History

Minority-owned businesses have been smaller on average than non-minority-owned businesses. In this study minority ownership refers to firms predominantly owned by African Americans, Latinos, and Asian Americans. Studies and data have consistently shown that minority-owned businesses have also had less financing than non-minority-owned firms—a possible cause for their smaller size. Minority-oriented equity companies were created in an effort to increase capital for this underserved market.

Minority-oriented equity companies grew in numbers over the last few decades. Like all equity companies, their financial performance was affected by the growth of the technology run-up in the 1990s and the subsequent bursting of the bubble in 2000.

Overall Findings

Controlling for factors such as the industry of the businesses in which the funds invested and the bursting of the capital bubble in 2000, the researchers found that investing in minority-owned businesses increased returns for minority-oriented equity capital funds. The fact that investments in minority-owned businesses netted large returns indicated that this was an underserved market.

The models also found that the newer funds and funds that were active in the management of the firms had higher returns. Investing in high-technology companies and participating in syndicated investments tended to lower returns. It is not clear if syndicated investment returns were lower because they tended to be riskier and larger than other investments or because the venture capital funds tended to look for partners on investments they believed would not perform as well as their other investments.

The research also uncovered evidence that minority-oriented equity capital funds that funded a larger share of minority-owned businesses were less likely to be active in the management of these businesses.

Overall, minority-oriented equity capital funds that used a "follower" strategy—for example, funding syndicated investments, non-minority-owned businesses, and high-tech firms—tended to have lower returns.

It is not clear if the results from the research are skewed from the massive run-up in venture capital funds in the 1990s and the very slow recovery of the market after the bursting of the bubble in early 2000.

Policy Implications

The findings suggest that effective support for minority-oriented equity capital would require steering funds toward newer ventures, encouraging involvement in the management of the investments, and limiting these funds' investments in non-minority-owned businesses.

Scope and Methodology

In 2001, 24 of 38 members of the National Association of Investment Companies responded to a survey about their funds' traits and investments. Follow-ups were conducted in 2004 and 2007. From these minority-oriented VCs, about 300 investments were tracked to the year 2006.

This report was peer-reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at **advocacy@sba.gov** or (202) 205-6533.

Additional Information

This report is available on the Office of Advocacy's website at **www.sba.gov/advocacy/7540**. To receive email notices of new Advocacy research, news releases, regulatory communications, publications, and the latest issue of *The Small Business Advocate* newsletter, visit **www.sba.gov/updates** and subscribe to the Small Business Regulation & Research Listservs.