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Venture Capital and Underserved Communities

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Abstract

Access to equity capital is critical for the growth of businesses, especially for young companies, which lack the cash flows necessary to repay loans. To meet this need, a thriving venture capital industry has evolved, fostering job creation, economic growth, and innovation in the United States. Not all companies, however, have been equally able to access such investments. Firms owned by women and people of color and those located in rural and distressed urban regions of the country have been underserved by the venture capital industry. This note analyzes the factors responsible for this and proposes policies designed to ensure a more equitable economic landscape.

Keywords

access to venture capital, rural and distressed urban communities, women and minority entrepreneurs, developmental venture capital

Access to patient capital, in the form of equity or near-equity investments, is critical for the growth of businesses, especially for young companies, which lack the cash flows necessary to repay loans.[1] To meet this need, a thriving venture capital industry has evolved over the past five decades, fostering disproportionately large levels of job creation, economic growth, innovation, and wealth creation in the United States (Timmons and Bygrave 1997; Mason and

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Harrison 1999; Bygrave et al. 2001; Lerner 2009a; Byrt 2009).[2] Not all companies, however, have been equally able to access such investments. Firms owned by women and people of color and those located in rural and distressed urban regions of the country have been underserved by the venture capital industry, hindering their ability to grow and succeed.

This note analyzes why these populations and geographies are underserved and proposes policies designed to ensure a more equitable economic landscape. The note is organized as follows: The first section reviews the limitations of the existing venture capital industry. The second section examines why certain populations and geographies are underserved by this industry. The final section proposes policies to address these inequities.

Limitations of the Venture Capital Industry

Private equity is an asset class that consists of equity investments in privately owned companies—those not traded on a public stock exchange. Venture capital is a subcategory of private equity that refers to equity investments in young companies, ranging from early stage to expansion.[3] Most venture capital firms are partnerships of professional fund managers who raise money from pension funds, financial institutions, endowments, wealthy individuals, and corporations and invest those funds in such a way as to maximize profits for their investors.

Venture capital investments tend to occur in locations that have a strong deal flow in the form of potential investment opportunities—particularly technology-related investments. In addition to investment opportunities, such locations also have the supporting infrastructure—the technological, managerial, legal, and financial expertise—that is necessary to take ideas to market (Florida and Kenney 1988a, 1988b; Florida and Smith 1991, 1992). Venture capital fund managers also prefer to invest in companies that are geographically close to where the managers are located, to minimize travel time and maximize the ability to collect information about those firms (Florida and Kenney 1988a, 1988b; Florida and Smith 1991, 1992; Sorenson and Stuart 2001; Powell et al. 2002; Zook 2005, Chen et al. 2009).

Areas such as Silicon Valley in California and Route 128 in Massachusetts embody such characteristics and consistently draw a disproportionate share of institutional venture capital dollars. Between 2006 and 2008, these two states accounted for 60% of all dollars invested in the United States. The geographic concentration of the venture capital industry goes beyond these two states, however, with just 10 states accounting for 84% of all the dollars invested between 2006 and 2008 (PriceWaterhouseCoopers 2009). Such geographic

concentration has remained remarkably consistent for more than two decades (Florida and Kenney 1988a, 1988b; Mason 2007).

Venture capital investments are also highly concentrated by industry and size of investment. Just five industries—software; biotechnology; medical devices and equipment; industrial/energy; and telecommunications—received almost 66% of all the dollars invested between 2006 and 2008 (PriceWaterhouseCoopers 2009). Over the past two decades, investments per company have increased as the capitalization of the average venture capital fund grew from $30 million in 1985 to almost $176 million in 2006 (National Venture Capital Association 2008; Onorato 1997). Since larger investments have comparable transaction costs to smaller ones, venture capitalists have increased their investment sizes in line with their capitalization levels to reduce transaction costs and increase profits. In 2008, the average investment for the venture funds that participate in the PriceWaterhouseCoopers MoneyTree Survey was $7,024,800 per company, further limiting venture capital investments to portfolio firms that can absorb fairly large infusions of capital.

This concentration of venture capital investments by geography, industry, and size of investment helps explain why, historically, fewer than 3% of all privately held companies in the United States have been able to access venture capital dollars (Maier and Walker 1987; Bates and Bradford 1992). Some populations and geographies, however, appear to be *disproportionately* underserved by institutional sources of venture capital.

Women-led firms, for example, drew only 5.0% of all U.S. venture capital investments in 2001 (Brush et al. 2001). Even this small percentage reflected an increase from the 2.6% of all venture capital investments that went to women-led firms between 1957 and 1998 (Brush et al. 2002).

Historically, people of color also have been disproportionately underserved by institutional sources of venture capital. For example, Bates and Bradford's (1992) analysis of the 1982 Characteristics of Business Owners Survey found that African-Americans were limited in their access to venture capital, even when controlling for other variables.

While there is substantial ongoing research examining access to debt capital for women and people of color, more current research on access to equity capital for these populations is much more limited. There clearly is a need to address this dearth of information to determine if women and people of color continue to be disproportionately underserved by the venture capital industry.

As previously mentioned, some geographies are also disproportionately underserved by institutional venture capital. As Table 1 illustrates, 18 states jointly accounted for less than 1% of all the dollars invested by venture capital firms between 2006 and 2008, with each state receiving less than $100 million

Table 1. Eighteen States that Each Received $100 Million or Less in Private Equity Dollars (2006–2008)

State	% of total private equity dollars invested (2006–2008)	% of total U.S. population (2006–2008)	% of state's population that is rural (2006–2008)
Alabama	0.09	1.5	45.7
Alaska	0.00	0.2	35.3
Arkansas	0.05	0.9	48.2
Delaware	0.09	0.3	28.2
Hawaii	0.05	0.4	9.4
Idaho	0.06	0.5	36.5
Iowa	0.05	1.0	40.0
Louisiana	0.05	1.4	30.5
Maine	0.03	0.4	59.9
Mississippi	0.01	1.0	53.5
Montana	0.02	0.3	47.0
Nebraska	0.03	0.6	31.1
North Dakota	0.00	0.2	43.8
Oklahoma	0.04	1.2	35.2
South Dakota	0.01	0.3	48.0
Vermont	0.07	0.2	62.6
West Virginia	0.05	0.6	53.8
Wyoming	0.01	0.2	35.8
Total 18 states	0.72	11.3	40.9
Total United States			22.9

Source: PriceWaterhouseCoopers (2009) and American Community Survey 2006–2008 Three-Year Estimates.

over that three-year period. Although these states are primarily rural, venture capital also is in short supply in many urban areas, including most cities outside of the 40 largest U.S. metro areas, as well as in distressed larger cities (Carlson and Chakrabarti 2007).

Why Some Populations and Geographies Are Disproportionately Underserved by the Venture Capital Industry

Leaving aside possible discrimination, the most likely reason that minority and female entrepreneurs are disproportionately underserved by the venture capital industry is the information failure that results from a lack of common

networks between a primarily White and male venture capital industry and an increasingly large population of minority and female entrepreneurs. Venture capitalists heavily rely on their networks in identifying investment opportunities, conducting due diligence on those opportunities, and monitoring investment performance (Mason 2007). Since traditional venture capitalists' networks include few women and people of color, they have limited access to and understanding of companies owned by these populations. This translates into higher search costs in identifying, conducting due diligence on, and monitoring firms owned by women and people of color (Brush et al. 2001, 2004). Brush et al. came to this conclusion after conducting an extensive analysis of women entrepreneurs' access to venture capital and eliminating alternative explanations for why women-owned firms received such a small percentage of all venture capital investments. Their hypothesis is further supported by the fact that this small percentage has grown as the number of women in the venture capital industry, whose own networks include women entrepreneurs, has increased.

The network commonality hypothesis is also consistent with Bates and Bradford's research on access to venture capital for companies owned by people of color. Specifically, Bates and Bradford examined minority-focused venture capital funds, a specialized subset of the broader venture capital industry that targets its investments to companies owned by entrepreneurs of color. They found that minority-focused venture fund managers identified the bulk of their investment opportunities through relationship networks that are different from those utilized by conventional venture capitalists (Bates and Bradford 2007). They also found that the minority-focused venture capital funds had financial returns that were comparable to or better than those of conventional venture capital (Bates and Bradford 2002, 2003a, 2003b, 2007, 2008; Bates, Bradford, and Rubin 2006). These funds' strong financial performance undermines the possibility that companies owned by entrepreneurs of color attract fewer venture capital investments because they do not represent a financially attractive investment opportunity.

Fortunately, the information failure that has contributed to women and minority entrepreneurs being underserved by conventional venture capital appears to be diminishing. As previously discussed, while still small, women's access to venture capital increased as the number of women in the venture capital industry grew.

While more research is needed to confirm this fact, there is reason to believe that access to venture capital for people of color also has improved as the minority-focused subsector of the industry has experienced dramatic growth. In 1984, the largest privately run venture capital firm that invested

primarily in companies owned by people of color had $18 million under management (Scott, Reynolds, and Hayes 1994). By the end of 2008, however, members of the National Association of Investment Companies (2008), the trade association of venture capital funds that target companies owned by entrepreneurs of color, had more than $10 billion under management. Between 2001 and 2004 alone, two of the most significant sources of capital for venture investing—public pension funds and funds of funds—almost doubled the dollars they committed to this subset of the venture capital industry (Bates and Bradford 2007).

Although access to venture capital for women and minority entrepreneurs appears to be improving, as at least some venture capitalists overcome the information failure that helped keep these populations underserved, the lack of venture capital in rural and distressed urban geographies is unlikely to resolve on its own. Companies located in rural and distressed urban geographies present obstacles for venture capital investors that go significantly beyond a lack of network commonality and are more challenging to resolve. These obstacles include

- Greater difficulty and travel time for venture capital investors to reach their portfolio companies (Brophy 1997; Freshwater et al. 2001; Barkley and Markley 2001; Carlson and Chakrabarti 2007)
- The absence of developed investment infrastructure, entrepreneur support networks, and entrepreneurial culture (Freshwater et al. 2001; Barkley and Markley 2001; Barkley 2003; Hughes, Mallory, and Szabo 2004; Carlson and Chakrabarti 2007)
- A lack of understanding of how venture capital works (Freshwater et al. 2001; Barkley and Markley 2001) and an unwillingness to give up company ownership on the part of local entrepreneurs (Freshwater et al. 2001; Barkley and Markley 2001; Hughes, Mallory, and Szabo 2004; Rubin 2008)

Overcoming these obstacles translates into higher operating costs for the venture capitalists, lowering their profitability. As long as high-quality investment opportunities are available elsewhere, purely profit-oriented venture capitalists have little incentive to take on the additional costs of investing in rural and distressed urban geographies.

As a result, most of the venture capital funds that invest in these geographies are developmental in nature (Freshwater et al. 2001; Barkley and Markley 2001; Barkley 2003; Rubin 2008). Rather than investing with a single bottom line of profit maximization, they seek both financial and social

returns.[4] For developmental venture funds that invest in rural and distressed urban geographies, the social returns are in the form of targeted economic growth and job creation, which provides a mission-related reason for the funds to focus on these more challenging communities (Freshwater et al. 2001; Barkley and Markley 2001; Barkley 2003; Rubin 2008).

Developmental venture funds address the higher operating costs associated with investing in rural and distressed urban communities through subsidies (Barkley and Markley 2001; Barkley 2003; Rubin 2008). Rubin (2009a) examined 47 such funds, which constitute the majority of geographically focused developmental venture capital funds created over the past 40 years. She found that all 47 funds relied on subsidies from the private and public sectors to raise their investment capital and to cover their higher cost of operations.

The private- and public-sector subsidies consisted of a willingness to accept lower rates of financial return in exchange for investments in the venture funds as well as grants to offset the venture funds' higher operating expenses. Public-sector subsidies also took the form of long-term debt that the venture funds could use to leverage the equity they raised from private-sector investors and tax credits to help attract those private-sector investors. In addition to capital, the public sector also provided inducement through the Community Reinvestment Act (CRA), which encourages commercial banks to invest in venture funds that target underserved geographies.[5]

Over the past decade, subsidies for developmental venture capital have become increasingly scarce, for both economic and political reasons. Economically, the bursting of the technology stock market bubble in 2000 and the 2008 stock market collapse dramatically lowered financial returns for conventional venture capital. This tempered investor enthusiasm for all forms of venture capital (Lerner 2009b). The stock market declines also shrank foundation assets, leaving fewer dollars for investment, while the 2008 recession devastated state governments, whose coffers had just begun to recover following the 2001 to 2004 financial crises (Rubin 2008).

Politically, the George W. Bush administration ended funding for two federal programs that provided developmental venture funds with matching investment capital and overhead grants—the New Markets Venture Capital (NMVC) and Rural Business Investment Company (RBIC) programs (Rubin 2006). The Bush administration also oversaw the 2005 regulatory revisions to the CRA, which served to weaken the act (Rubin 2008).

The decline in these sources of subsidy has resulted in a dramatic reduction in the number of new geographically focused developmental venture funds. While 14 new funds were capitalized between 2000 and 2005, only 2 new

funds were capitalized between 2006 and 2009 (Rubin 2009a).[6] Such trends need to be reversed if rural and distressed urban communities are to be given access to venture capital and the job and wealth creation and economic growth that it helps to foster. The final section of this note examines how best to accomplish that objective.

Increasing Access to Venture Capital

The lack of venture capital in rural and distressed urban geographies is unlikely to resolve on its own. The higher operating costs associated with investing in these geographies deter most conventional venture capitalists. To increase access to venture capital for these communities, new sources of subsidy are needed to support the creation of additional geographically focused developmental venture capital funds.

The rationale for such subsidies goes beyond economic fairness. Josh Lerner (2009a, 67-68) points out that "an extensive body of economic thought in public finance . . . emphasize[s] that "subsidies are an appropriate response in the case of activities that generate positive 'externalities,' or benefits to others that are not captured by the firm or individual undertaking the activity."

Lerner (2009a), who has researched and written about the venture capital industry for almost two decades, argues that "pioneering entrepreneurs and venture capitalists generate positive externalities that benefit others" because "there is a 'virtuous cycle' in entrepreneurship and venture capital. Activities by pioneering entrepreneurs and venture capitalists pave the way for subsequent generations: in a given city, it is far easier to recruit the staff for the one-hundredth start-up, or to find a lawyer to structure the one-hundredth financing, than the first" (p. 66). In other words, subsidies to stimulate the creation of new geographically targeted developmental venture capital funds will result in positive externalities in the form of increased entrepreneurial activity, economic growth, and job creation.[7]

Furthermore, as rural and distressed urban geographies attract more venture capital investments, many of the barriers that raise the cost of operations and discourage purely profit-driven venture capitalists from investing are likely to diminish. As noted earlier, these barriers include the absence of a developed investment infrastructure, entrepreneur support networks, and entrepreneurial culture, a lack of understanding of how venture capital works, and an unwillingness to give up company ownership on the part of local entrepreneurs. As these barriers are overcome, they in turn will reduce the need for further subsidies.

Lerner (2009b) points out that such a cycle played out on a large scale in the case of the Small Business Investment Company (SBIC) program, created by Congress in 1958. The program "led to the formation of the infrastructure for much of the modern venture capital industry. Many of the early venture capital funds and leading intermediaries in the industry—such as law firms and data providers—began as organizations oriented to the SBIC funds, and then gradually shifted their focus to independent venture capitalists. Similarly, public programs played an important role in triggering the explosive growth of virtually every other major venture market around the globe." In fact, Lerner (2009a, 68, 69) argues that "many pioneering venture funds have garnered . . . low [financial] returns" and posits "that no matter how promising the returns of entrepreneurial activity ultimately are, in a venture market's early years, low returns are likely."

Given that initial financial returns are low, only governments have an incentive to make the early investments necessary to stimulate the critical mass of entrepreneurial activity that ultimately attracts private-sector investors. The majority of many U.S. states have long recognized this fact and have invested in programs designed to foster venture capital activity within their boundaries (Rubin 2009b). However, the limited oversight capacity of state governments has made these programs particularly vulnerable to capture by special interests (Lerner 2009a). State programs also are rarely targeted to rural and distressed urban regions, preferring to focus on statewide economic growth (Rubin 2009b). Most state venture capital programs also restrict the resulting venture funds' investment geographies to that state's borders, limiting both the venture fund's investment opportunities and its pool of potential investors. Perhaps most importantly, the current economic position of most states makes such discretionary budget expenditures unlikely.

In light of the weak economic position of most states and the decreased assets of private foundations, the federal government is the most viable source of subsidy for new developmental venture capital funds. This subsidy can be delivered via the New Markets Venture Capital and Rural Business Investment Company programs, which require participating venture funds to predominantly invest in rural and distressed urban geographies. The NMVC and RBIC programs use federal subsidy dollars to provide participating venture funds with matching investment capital and overhead grants, significantly leveraging the capital that these venture funds are able to raise from the private sector. The two programs also require potential NMVC and RBIC fund managers to undergo a rigorous selection process, which serves as a signal of quality for private-sector investors (Rubin 2009a).

These programs' ability to target venture capital to rural and distressed urban geographies is fairly significant—prior to their elimination by the George W. Bush administration, the two programs helped capitalize seven venture capital funds that accounted for 41% of all the investment dollars raised by geographically focused developmental venture funds since 2000 (Rubin 2009a). The level of subsidy necessary to support the programs, however, is relatively small. For example, the 2005 federal budget appropriated $10 million for the RBIC program, which was sufficient to create two to three new venture funds, each with up to $31 million in capital under management (Rubin 2006). In addition, the Small Business Administration, which has administered both programs, is well suited to this task, having overseen the SBIC program—the federal government's first foray into venture capital—for over 50 years.

Last October, in recognition of the need for these programs, the U.S. House of Representatives reauthorized the NMVC program and provided it with $120 million for operating grants and matching capital. Senator John Kerry introduced similar legislation in the Senate.[8]

The federal government also can increase private sources of subsidy by strengthening the CRA and expanding its reach to more types of financial institutions. Such institutions could include mortgage and investment banks, insurance companies, and financial institutions with a stronger rural presence such as the farm credit bank system and the federal home loan banks.[9] In addition to creating new sources of investment capital for rural and distressed urban communities, strengthening and expanding the CRA would discourage the kind of destructive financial practices that precipitated the recent subprime and foreclosure crises and the subsequent economic decline (Seidman 2007). In combination, these recommendations would aid the formation of additional developmental venture capital funds that disproportionately target underserved areas of the United States, helping to spur job creation, economic development, innovation, and wealth creation in these communities.

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Notes

1. An equity investment consists of cash that a company receives in exchange for partial ownership of that company, in the form of preferred or common stock.

A near-equity investment consists of a loan with special features, such as warrants, royalties, or participation payments, that enable the lender to participate in any financial gains if the company receiving the capital is successful.

2. Disproportionately large relative to the amount of capital invested (Byrt 2009). In addition to the venture capital industry, entrepreneurs can access equity from noninstitutional sources such as individual "angel" investors, family members, or personal savings. However, each of these sources presents potential limitations for the populations and geographies discussed in this note. For example, Becker-Blease and Sohl (2007, 504) found that "women entrepreneurs receive a small proportion of the total angel capital awarded," and obtaining capital from family members and personal savings is not an option for entrepreneurs who lack such resources.
3. The private equity industry also includes firms that invest in mature companies to facilitate their expansion and restructuring. Those kinds of transactions are not the focus of this note.
4. Developmental venture capital funds pursue a range of social objectives, including economic development of distressed urban and rural geographies, creation of high-quality jobs for low-income populations, the building of wealth for women and people of color, and creation of products that benefit society such as those that lower poverty or contribute to a cleaner environment. For more on developmental venture capital, see Rubin (2009b).
5. The Community Reinvestment Act was enacted by Congress in 1977 to encourage regulated financial institutions to fulfill their "continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered" (National Community Reinvestment Coalition 2008). The 1995 revisions to the Community Reinvestment Act, in combination with increasingly intense consolidation in the banking industry, led to a broadly perceived strengthening of the act that helped capitalize a generation of developmental venture funds. Commercial banks, which did not invest in any of the 47 developmental venture funds prior to 1996, accounted for 32% of the investment capital raised by these venture funds between 1996 and 2007 (Rubin 2009a).
6. Moreover, one of the two funds was part of the Rural Business Investment Company program, which was subsequently eliminated by the Bush administration.
7. An examination of the developmental venture capital industry points to another positive externality resulting from the creation of venture funds that invest in underserved geographies and populations—an increase in the number of venture capitalists experienced in investing in these communities. These venture capitalists are likely to continue investing in the historically underserved communities in which they launched their careers, using their prior successes to raise larger subsequent venture funds (Rubin 2009a).
8. Both the House (H.R. 3854) and Senate (S. 1831) bills make modifications to the original New Markets Venture Capital (NMVC) legislation, some of which could

make the resulting program less effective. For example, the Senate bill directs the Small Business Administration to certify a NMVC company in each geographic region, which could reduce the quality of venture funds being selected. Both bills broaden the definition of allowed investments to include businesses that employ low-income populations as well as those located in low-income geographies. This provision could reduce the NMVC venture funds' incentive to focus their investments on the most underserved communities. Both bills also focus the program on investments in manufacturing concerns, which may not be consistent with the kinds of companies that exist in underserved geographies.

9. Federal legislation along these lines has been introduced in the two most recent Congresses and has been a priority for Representative Barney Frank, who chairs the House Financial Services Committee. In February 2008, Frank held a hearing to examine ways to enhance the Community Reinvestment Act.

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