Venture Capital Funds Investing in Minority-Owned Businesses:

Evaluating Performance and Strategy

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The internal rate of return on investments that were initiated after 2001 and were realized by yearend 2006 was an impressive 29.1 percent.

Executive Summary

The strong performance of minority-oriented private equity funds in the 1990s drew increased attention and additional funding to this important source of capital for minority-owned businesses. New data from a recent survey of minority-oriented funds allows for an analysis of their investment strategies during the economic downturn at the start of the 21st century and in their investment returns across the boom-bust cycle. Key findings from the study are presented below.

- The decline in returns from minority-oriented private equity funds at the turn of the century mirrors the falling investment returns throughout the venture capital industry and the stock market at that time. Comparisons suggest that minority-oriented funds outperformed both the NASDAQ and the S&P 500 stock indices for most of the time period considered.
- The sharp drop in the surveyed funds' returns in 2000 is especially significant because their investment volume was at an all-time high during that year. This increase in volume was fueled by substantial growth in funding from public pension funds, a funding source that was previously only available to a handful of minority-oriented private equity funds.
- Minority-oriented funds, particularly the newer generation of funds that emerged during this period, diversified their investments, focusing increasingly on investments in high-tech lines of business and in nonminority-owned businesses. Regression analysis indicates, however, that there were higher returns for funds that invested in minority-owned companies and old-economy industries.
- The minority-oriented venture capital industry already is recovering from its turn-of-the-century downturn. The internal rate of return on investments that were initiated after 2001 and were realized by yearend 2006 was an impressive 29.1 percent.

Introduction

Major changes have swept through the minority-oriented private equity funds industry since the late 1990s. Many of the venture capital firms that focus their investments on minority-owned business enterprises (MBEs)[1] experienced much success in the early 1990s, offering evidence of what scholars call the underserved market hypothesis. Explaining the attractive returns from these funds, this hypothesis suggests that MBEs typically have less access to debt and equity capital than similarly situated nonminority-owned firms, and, therefore, constitute an underserved market segment that may offer higher returns to funds that specialize in financing the minority-business client group.

While earlier research has documented the success of these firms during a booming economy, new data from a recent survey allow for analysis of these funds' performance during an economic downturn, as well. These data illustrate the impact of the broader economic environment on the minority-oriented venture capital industry and permit the identification of strategies linked to successful equity investing over the course of the boom-bust cycle. This report presents key findings from the study. More in-depth analysis of these findings can be found in the full report, "Evaluating the Performance of Funds Targeting Equity Investments to Minority-Owned Businesses."

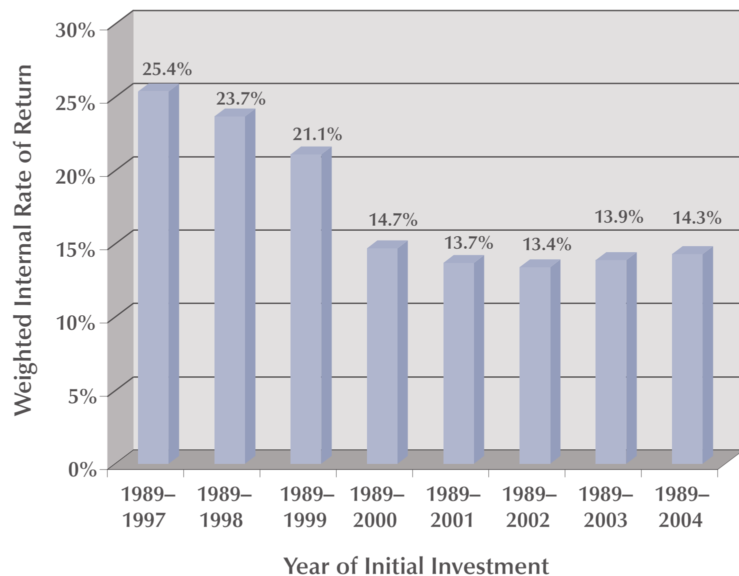
[1] Minority ownership refers to firms predominantly owned by African-Americans, Latinos, and Asians.

Many of these venture capital firms that focus their investments on minority-owned business enterprises (MBEs) experienced much success in the early 1990s, offering evidence of what scholars call the under-served market hypothesis.

Investment Performance

The surveyed minority-oriented private equity funds' performance in the late 20th century and early 21st century reflect the economic turbulence of this time and the highly-cyclical nature of the venture capital industry as a whole. Investment returns throughout the venture capital industry fell sharply during the early years of the 21st century, and the data from the minority-oriented funds presented in Figure 1 mirror this trend. This chart aggregates investments made by minority-oriented funds based on the time period of initial investments. As this time period is extended beyond 1997 in annual increments, the internal rate of return (IRR)[2] declines significantly through 2002 and then levels off. Thus, for the final group of funds—encompassing all realized[3] equity investments from the period between 1989 and 2004—the weighted IRR value is 14.3 percent, significantly less than the 25.4 percent IRR for the oldest group of investments, those initially funded between 1989 and 1997.

Figure 1: Internal Rate of Return on Realized Investments



Source: 2007 survey of minority-oriented VC funds

2 The IRR is perhaps the most widely used measure of venture capital investment performance. The IRR is defined as the discount rate at which the investment's cash flow returns equal the cost of the investment. Our method of IRR calculation effectively treats the cash flows of all of the surveyed funds as one large investment for each of the periods—eight IRRs for the eight time periods. Results are thus a series of measures of the financial returns generated collectively by all surveyed minority-oriented funds; overall IRRs produced by the individual twenty-three funds varied widely. These IRR values are not net of carried interest and applicable fees.

3 Realized investments represent completed transactions, while unrealized investments reflect the estimated value of investments that are still held and have not yet been liquidated in a transaction. Unrealized investment valuation is inherently more subjective than valuation of realized investments, as there is uncertainty about the value of the former, while the latter typically have been converted to cash.

Direct comparisons of the performance of the surveyed funds to that of the stock market or of mainstream venture capital funds are complicated by differences in costs associated with the investments, as well as thornier data comparability problems. However, both the stock market and mainstream venture capital funds experienced similar declines during 2000, and the analysis presented in Table 1 suggests that the minority-oriented funds outperformed both the NASDAQ and the S&P 500 stock indices for most of this time period.[4] Data from Venture Economics[5] (a proxy for mainstream fund performance) indicate that the mainstream funds experienced similar losses. Mainstream funds that began investing in 1999 had an average IRR of -2.4 percent through March 2007, and the funds that began investing in 2000 generated an average IRR of 0.5 percent through March 2007 on their investments in portfolio companies.

Table 1:
Comparison to NASDAQ and S&P 500 Stock Indices
Weighted IRRs and PMEs for Investments
(based on cash flows through year-end 2006)

Initial Funding	IRR of Surveyed Funds*	PME: NASDAQ**	PME: SP 500**
1989–1997	25.4%	1.28	1.41
1989–1998	23.7%	1.13	1.27
1989–1999	21.1%	0.92	1.15
1989–2000	14.7%	0.96	1.04
1989–2001	13.7%	1.02	1.07
1989–2002	13.4%	1.11	1.14
1989–2003	13.9%	1.06	1.12
1989–2004	14.3%	1.07	1.13

* IRR values for 1989–2004 are based upon 307 realized investments made by NAIC funds. These IRR values are not net of carried interest and applicable fees and thus do not directly measure returns earned by limited partners, the institutional investors providing capital to these NAIC funds.

** PME comparisons are based upon realized investments. A PME value greater than one indicates higher returns were earned by the surveyed funds relative to the stock market comparison group.

Source: 2007 survey of minority-oriented VC funds

[4] The public market equivalents (PMEs) compare what the surveyed funds earned on their investments in portfolio companies to what they would have earned if they had invested the same cash flows (in the same years) in the S&P 500 index of stocks and the NASDAQ index. A PME value of one would indicate that cash invested by the surveyed funds earned exactly the same returns (using IRR as the measure of returns) as equivalent cash invested in the S&P 500 or NASDAQ. A PME of less than one indicates that investing in the stock indices would have yielded higher returns, while a PME greater than one shows that investing in the portfolio companies of the survey respondents was the more profitable alternative.

[5] Venture Economics collects data from VC firms nationwide, including the entire range of equity-investing funds—early-stage, buyout, mezzanine, etc. These data are, therefore, the closest to being representative of the VC industry nationwide of all available data sources.

Both the stock market and mainstream venture capital funds experienced similar declines during 2000, and the analysis suggests that the minority-oriented funds outperformed both the NASDAQ and the S&P 500 stock indices for most of this time period.[4]

The sharp drop in the surveyed funds' investment returns in 2000 is especially significant because their investment volume was particularly high at that time. In fact, investment volume grew steadily throughout the 1990s, peaking in 2000 for both minority-oriented and mainstream funds. More than 35 percent of the equity investing undertaken by the surveyed funds (during the sixteen years of equity investing analyzed in this study) was initially funded in the year 2000. And more than 25 percent of the funds tracked in this study first began investing equity capital in small businesses in that year. Table 2 illustrates this sharp increase in volume in the year 2000, with $168.2 million invested in portfolio companies in that year. The surveyed funds, like the rest of the VC industry,[6] were investing quite heavily at the peak of the cycle.

Table 2:
Sum Invested in Portfolio Companies by all Surveyed Funds (realized investments grouped by years of initial funding)

Year of Initial Funding	Amount Invested (in millions)*
1989	$3.1
1990	$4.4
1991	$3.6
1992	$12.6
1993	$16.9
1994	$14.5
1995	$11.8
1996	$33.7
1997	$17.0
1998	$33.1
1999	$39.2
2000	$168.2
2001	$58.6
2002	$26.4
2003	$17.3
2004	$19.5
All years 1989 to 2006	$479.8
Years 1998 to 2001 only	$299.1

* Includes realized investments only

Source: 2007 survey of minority-oriented VC funds

[6] A record number of mainstream funds—180 of them, according to Venture Economics—began investing in 2000 as well.

This large volume of top-of-the-cycle investing produced devastating consequences, particularly for the minority funds that began investing in 2000. Realized returns for investments initiated in 2000 alone were 2.2 percent overall through yearend 2006. Table 3 compares the IRRs generated for the investments that the surveyed funds initiated between 1989 and yearend 1997 with those initiated between 1998 and 2001. The former group of investments—now largely realized—was highly successful, generating a collective IRR of 22.4 percent. The latter—initially funded between 1998 and 2001—had generated an IRR of 0.9 percent as of yearend 2006. While many of these investments are unrealized, these data illustrate the stark contrast in the two time periods and the boom-bust nature of the venture capital industry during this time.

This pattern mirrors the trend in the venture capital industry more generally. As reported earlier, mainstream funds, according to data from Venture Economics, also reached their highest volumes in 1999 and 2000 and saw similarly low returns on these investments. The year 2000, it appears, was a time of peak activity for the entire U.S.-based private equity capital industry; the entire industry invested heavily at the top of the boom-bust cycle.

An alternative measure of the financial returns earned by the surveyed minority-oriented funds provides additional insight into this change in fund performance over time. Table 4 compares a range of outcomes of the 172 realized investments initially funded between 1989 and 1997 to the returns on the 135 individual realized investments initially funded between 1998 and 2004. These earlier investments handily outperformed the later group. While 62.8 percent of the investments originating in the earlier period had positive paybacks, only 34.8 percent of the realized investments initiated between 1998 and 2004 yielded returns exceeding the amount invested by the applicable equity capital fund. The other measures reported in Table 4 underscore how profoundly the returns of investments initiated between 1998 and 2004 differ from those that originated in the 1989 through 1997 period. Not only did the average investment size soar, but there also was a sharp decline in average net return. This pattern is analogous to the performance difference derived from investing in alternatives like the NASDAQ index stocks during the 1990s boom period, as opposed to investing at the top of the cycle.

Table 3:
Peak and Trough IRR Values for Investments in Portfolio Companies

Year of Initial Funding	IRR*	IRR**
1989–1997	25.4%	22.4%
1998–2001	-1.6%	0.9%

* Includes realized investments only.

** Includes realized investments, as well as partially realized and unrealized investments.

Source: 2007 survey of minority-oriented VC funds

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Table 4:
Investment Performance Measures for the Minority-Oriented Equity Capital Funds

	Realized Investments Initiated from 1989 to 1997	Realized Investments Initiated from 1998 to 2004
A. Payback Analysis		
Number of investments	172	135
Number with payback greater than zero	108	47
Percent with payback greater than zero	62.8%	34.8%
B. Average investment performance ($ thousands)		
Mean investment outflow	$832.2	$2,503.9
Mean investment gross return	$1,880.4	$2,593.6
Mean investment net return	$1,048.2	$89.7
C. Performance gauges		
Mean IRR *	17.7%	-26.0%
Median IRR *	15.2%	-12.0%
Composite IRR **	25.4%	1.0%

*IRRs are based on individual investments and are not weighted.
**Treating the cash flows as one large investment effectively weights this IRR.

Source: 2007 survey of minority-oriented VC funds

The extraordinary growth in investment volume during 1999 and 2000 was fueled by funding from public pension funds. It was not until the late 1990s that public pension funds became a significant source of capital for more than a handful of minority-oriented private equity funds. By yearend 2006, however, more than 50 percent of the financial capital resources of the minority-oriented funds had been provided by public-sector pension funds. Attracted by the minority-oriented funds' attractive returns in the late 1990s, these institutional investors most often entered just before the industry's downturn. Capital flows to minority-oriented private equity funds (and venture capital funds in general) from both public pension funds and funds of funds reached a peak in 1999 and 2000. As a result of this timing, as well as other factors, the investment returns of funds financed by public pension funds have lagged behind those of minority-oriented funds without such financing.

Table 5 offers further information regarding capital investments that the surveyed funds have received from institutional investors. Growth in capital resources raised by the minority-oriented funds has come primarily from two types of closely-related institutional investors in recent years—public pension funds and funds of funds. New minority-oriented funds with no track record beyond the prior work experience of the founders traditionally were denied access to public-pension-fund capital. Since the late 1990s, these industry newcomers have been increasingly successful in raising large amounts of capital from this vitally important institutional investor. Since the public pension funds also have been important sources of capital for many of the funds of funds, pension fund money has been financing the minority-oriented funds indirectly, as well, via growing access to fund-of-fund money. Other major sources—banks, insurance companies, corporations, and corporate pension funds—have been growing slowly, relative to the two dominant sources of funds. Government sources of capital other than pension fund money were once the major capital source for many funds, but have become insignificant to the minority-oriented funds over the course of the past decade.

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Table 5:
Sources of Funding for Surveyed Funds through Yearend 2003

	Number of Funds Tapping This Source	Approximate Range of Capital Raised
A. Major Sources		
1. Banks, insurance cos.	15	$1 million to over $45 million
2. Fund of funds	10	$6 million to over $24 million
3. Corporations	8	$1 million to over $150 million
4. Public pension funds	9	$6 million to over $100 million
5. Miscellaneous sources	7	$0.1 million to $25 million
6. Corporate pension funds	6	$7 million to $80 million
B. Other Sources		
1. Federal government	6	$3 million to over $17 million
2. State, local, government	2	$4 million to $5 million
3. Individuals, families	5	Under $100,000 to under $1 million
4. Foundations, endowments	6	Over $1 million to $5 **million**
C. Median $ Amount of Capital Raised, by Source (rounded to the nearest million)		
1. Public pension funds		$49 million
2. Fund of funds		$18 million
3. Banks, insurance cos.		$12 million
4. Corporate pension funds		$25 million
5. State, local government		$4 million
6. Federal government		$5 million
7. Corporations		$3 million
8. Foundations, endowments		$2 million
9. Individuals, families		$0.3 million
10. Miscellaneous sources		$1 million
D. Total raised through yearend 2004: all sources		**$1,760.3 million**

Source: 2004 survey of minority-oriented VC funds

Investment Strategy

The performance of minority-oriented funds appears to mirror that of mainstream venture capital funds, but a closer look at investment choices and strategies reveals the extent to which their investment strategies also have converged, as well as differences in strategic orientation within the group of minority-oriented funds themselves. Table 6 presents the surveyed firms' industry group choices, revealing that investment in various high-tech lines of business has increased sharply since a similar survey in 2001.[7] Investments in the communications industry continue to represent a sizable portion of all investment, and these investments are increasingly in the more high-tech areas of the communications industry. In addition, a significant number of firms invested in portfolio companies in the software and information technology fields.

This increasing orientation toward high technology reflects the trend in the larger venture capital industry and was especially noticeable among the newer minority-oriented funds. In fact, top-of-the-cycle investments were much more heavily concentrated in high-tech fields than those initiated before 1998. Still, the majority of the minority-oriented funds' investments cannot be characterized as high tech and, as a group, these funds are more widely diversified and less heavily invested in high-tech industries than are the mainstream funds.

There also has been an increase in the minority-oriented funds' investment in nonminority-owned businesses. Since 2000, 25 percent of the portfolio companies receiving investments (realized by yearend 2006) from the surveyed funds were nonminority-owned. Before 2000, more than 95 percent of

Table 6:
Portfolio Company Industry Patterns

Number of surveyed funds investing in selected industry groups	
Communications	20 funds
Software and information technology	13 funds
Manufacturing (electronics and computer-related fields)	6 funds
High tech (software, information technology, and manufacturing–electronic and computer)	15 funds
Manufacturing (other than electronics and computer-related fields)	11 funds
Trade (wholesale and retail)	11 funds
Services (except medical)	16 funds
Medical	7 funds

Source: 2007 survey of minority-oriented VC funds

[7] See Bates and Bradford, 2003.

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portfolio companies were minority-owned. This trend, too, is more prevalent among the newer minority-oriented funds.

The newer minority-owned funds' tendency to invest in high tech and in nonminority-owned businesses is a harbinger of larger differences between the strategies of newer minority-oriented funds and the older minority-oriented fund vanguard. In fact, discussions with industry leaders, including past board chairmen of the NAIC, point toward a divergence within the funds investing in MBEs. The older generation represents the pioneers who created the minority-oriented venture capital industry in the 1970s and 1980s. The general partners of these firms express a commitment to alleviating the restricted access to investment capital that has traditionally handicapped MBEs, and they tend to focus on MBEs that often are operating in old-economy lines of business.

The general partners at the newer generation of funds are more likely to be graduates of prestigious MBA programs and to have work experience at Wall Street investment banks. When they search for opportunities to invest equity capital in small businesses, they typically tap racially diverse professional networks and their deal flow is similarly diverse. They often invest in nonminority-owned firms and are more likely to invest in high-technology companies, many of which are not minority-owned. Finally, they enjoy greater access to public pension fund capital than the first-generation veterans do.

While there appear to be a variety of investment strategies, both groups are devoted to generating high financial returns on their equity investments in small businesses. Regression analysis allows for an understanding of the investment strategies and characteristics among both groups that were most successful over the course of both the boom and bust phases of this investment cycle. Using the IRR of individual realized equity investments as the measure of fund performance, this analysis considers the effects of industry investment choices, investment size, minority focus, general partner involvement with portfolio companies, investment timing, and fund generation.[8]

Results indicate that there were statistically significant higher returns for funds that made the following strategic choices:

- Investing in minority-owned companies rather than nonminority-owned businesses
- Making larger rather than smaller investments in portfolio companies (a $2,000,000 investment, for example, is associated with higher IRR values than a $300,000 investment)
- Assisting portfolio companies actively (assisting with hiring is a concrete example of such beneficial general partner involvement)
- Investing in old-economy industries

Strategy alone, however, did not completely explain variance patterns in investment returns. Minority-oriented funds unfortunate enough to be actively investing in portfolio companies in the peak years of 1999 and 2000 produced sharply lower IRRs, in comparison to investments initiated in off-peak years. And new-generation funds emerged as more successful investors after controlling for other factors.

[8] This analysis includes IRRs of realized investments initially funded between 1989 and yearend 2001 (277 investments made by twenty-three funds) and the cash returns generated by these investments are tracked through yearend 2006.

Conclusion

Funds specializing in making equity investments in minority-owned business enterprises have expanded rapidly in size and scope over the past decade. Many new funds were created and began investing by yearend 2000. Large-scale investment of public pension fund resources helped to fuel this rapid growth of private equity investing among the minority-oriented funds. And a new generation of general partners entered this industry segment in the late 1990s, bringing with them investment strategies that produced expanded equity investment into high-tech lines of business and into firms owned by nonminorities.

This rapid change among the minority-oriented funds coincided with significant changes in economic conditions. These funds reached the height of their investment volume just as the venture capital industry as a whole experienced a substantial downturn. While the minority-oriented funds realized sharply declining returns through this period, minority venture fund performance broadly mirrored the investment returns produced by the venture capital industry as a whole during the economic downturn of the early 21st century.

The minority-oriented funds have diversified their investments in recent years, focusing increasingly on investing equity capital in high-tech lines of business. Among the new-generation funds, in particular, funds' investment practices often resemble those of the mainstream venture capital industry. As the minority-oriented funds collectively have altered their investment practices, they have experienced declining average returns on their realized equity investments. Beyond the perils of investing at the peak of the boom-bust cycle, the convergence with investment strategies of mainstream funds itself often has contributed to declining returns.

Results of regression analysis of equity investment performance identified the most successful strategies among the minority-oriented funds over the course of the boom-bust period. High returns flowed disproportionately to the funds investing most actively in old-economy fields, investing in minority-owned companies, and making larger investments in portfolio companies. Active general partner involvement with the portfolio companies also appeared to make a significant positive difference in the returns realized.

The new-generation funds, finally, actually earned higher returns on their realized equity investments, controlling for other factors. Indeed, they invested at the top of the cycle, favored high tech, and often invested in nonminority-owned small businesses—and all of these practices hurt their investment returns. They also appear to have learned from their mistakes. Isolating the new-generation trait from these other factors indicates that new-generation funds actually outperformed the older generation of traditional minority-oriented funds.

Since these funds now dominate this sector in terms of financial capital resources available for investment, their viability bodes well for the future of

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minority-oriented funds. Their strong performance may, in fact, be driving the sharp increase seen in returns for minority-oriented investments initiated by the surveyed funds after 2001. The internal rate of return solely for the investments that had been realized by yearend 2006 was an impressive 29.1 percent, indicating that recovery from the minority-oriented venture capital industry's turn-of-the-century downturn appears to be underway.

Appendix: Methodology

Data for this report are drawn from surveys of private equity funds attached to firms that were active members of the National Association of Investment Companies (NAIC) in 2003. Members of NAIC are investment companies bound together by their shared interest in financing MBEs. Not all of these companies, however, invest exclusively or even heavily in MBEs. A subset of the member firms was chosen for this study through a pre-survey in 2004, resulting in the selection of a group of equity-investing firms that were:

1) Investing equity capital in small businesses,
2) Targeting investments to MBEs, and
3) Investing with a predominant goal of generating attractive monetary returns.

Qualifying funds were surveyed in 2004 and again in 2007 to track their investment cash flows through yearend 2006. The 2004 survey had a final response rate of 63.2 percent, and the 2007 survey had a final response rate of 62.2 percent. The dataset includes information on twenty-three funds with 395 equity investments totaling $783.4 million that were initially funded between 1989 and 2004. Three hundred seven of these investments were fully realized by yearend 2006. Discussions with industry leaders, including past board chairmen of the NAIC, provided context for the data, as well as further insight. More information on the methodology can be found in the full report.

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Since minority-oriented funds now dominate new-generation investing in terms of available financial capital resources, their viability bodes well for the future.

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