Alumni Ventures

WHITE PAPER REPORT • January 2021

The Diversity Gap and Opportunity in Venture Capital

Marco A. Casas
Senior Principal, AV Seed Fund
Alumni Ventures

av.vc

Executive Summary

Many Alumni Ventures Group investors are interested in making an impact through their venture investments. Do they have to sacrifice strong portfolios to achieve this goal? In this article, we'll show that venture investing for impact and for potential profit are not mutually exclusively goals. We will demonstrate the need — and opportunity — for investing in diverse founding teams and in business models addressing systemic biases, and we will examine the evidence for why these investments might offer the chance for attractive gains.[1]

The Diversity Opportunity

Investing in underrepresented founders represents a big opportunity — potentially over-a-trillion-dollars big, according to Morgan Stanley. In a recent survey, the bank suggests that "had the number of women-and minority-owned businesses and the portion of revenues matched their percentage in the labor force — 56% — then 2012 gross receipts would have increased to $6.8 trillion" — nearly triple actual gross receipts — "suggesting a missed opportunity of up to $4.4 trillion."

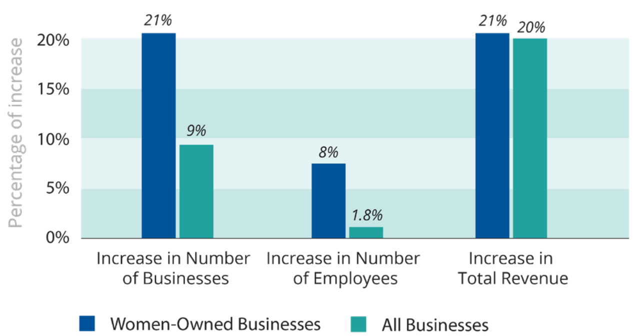
Even if a portion of those businesses could be in market segments ill-suited for venture capital financing, such enormous revenue differences suggest significant potential. And not only is the underrepresented economy massive, it is also outpacing the overall business economy in a number of growth metrics. From 2014 to 2019, the number of women-owned businesses grew 2X faster on average than the number of all U.S. businesses (and businesses owned by women of color grew an impressive 4.5X the national rate). Over the last 10 years, minorities started over 50% of the 2 million new businesses started in the U.S., according to the U.S. Senate Committee on Small Business and Entrepreneurship.

ABOUT ALUMNI VENTURES

AV has been giving accredited investors access to venture capital portfolios since 2015. We believe that investing in venture allows accredited individuals to diversify their investment portfolios into another key asset class, tapping into private markets and the most entrepreneurial segments of the economy.

Women-Owned Business Growth, 2014-2019

As of September 23, 2019



Source: The annual State of Women-Owned Businesses Report, commissioned by American Express, based on U.S. Census Bureau data adjusted by Gross Domestic Product data,

1 Note that you'll see some variation in statistics on a particular topic depending on source. We don't think any such slight variation impacts our conclusions.

Women and minorities account for approximately 66% of the U.S. population, and racial minorities will most likely be the main engine of U.S. population growth for the next decade and beyond. Furthermore, women and minorities hold a strong majority of U.S. consumer buying power.[2]

The Opportunity Disconnect

Comparing the above numbers with venture industry statistics, it becomes clear that there is a big disconnect between the market opportunity represented by women and minorities — both entrepreneurs and consumers — and the VC capital chasing after it.

According to PitchBook, only 2.1% of the total VC capital in the U.S. went to female-founded companies between January and November 2020. Female "co-founded" companies (where at least one member of the founding team was female) did better, with 12% of U.S. VC capital. But relative to the numbers mentioned above, that's still a disappointing figure. Minority founders haven't fared much better, having only raised 2.4% of the total U.S. VC capital from 2015 to August 2020, according to Crunchbase.

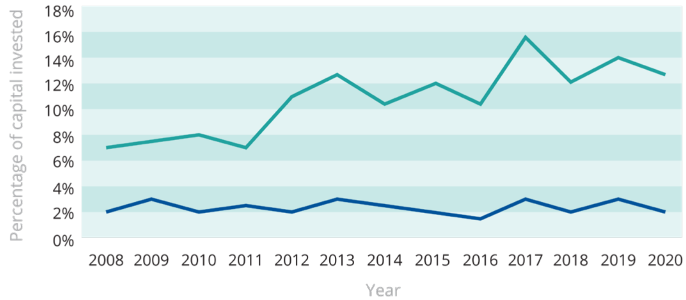
The question is: why?

Within the VC industry, a common explanation for the disconnect is that the market simply is not providing VC investors with diverse investment opportunities or talent — an argument often referred to as "the pipeline problem." But the proliferating number of diverse start-ups and the increasing percentages of college degrees being awarded to women and minorities raise questions about the theory's continuing validity.

At least three factors are often highlighted by founders from underrepresented groups as major reasons for the big disconnect between capital and opportunity.

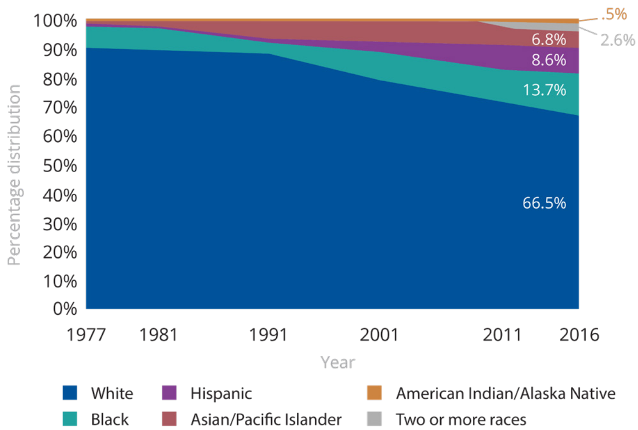
Female (Co-) founded VC Capital Percentage

As of November 30, 2020



Source: https://pitchbook.com/news/articles/the-vc-female-founders-dashboard

Percentage Distribution of Master's Degrees Conferred to U.S. Citizens, by Ethnicity, 1977–2016



Source: Digest of Education Statistics: 2017, https://nces.ed.gov/programs/digest/d17/tables/dt17_323.20.asp

2 According to the same Morgan Stanley survey, women drive 83% of all U.S. consumption through buying power and influence; Black consumers spend $1.2 trillion annually in the U.S.; Latinx consumers have buying power of approximately $1.7 trillion.

include the threat of unconscious bias, VC's lack of familiarity with the problems diverse founders aim to solve, and a lack of direct pathways to Silicon Valley or friends-and-family capital for diverse founders to start their businesses.[3]

Multiple studies have suggested that unconscious biases regularly lead to stereotyping women and minorities and to unequal standards and expectations.

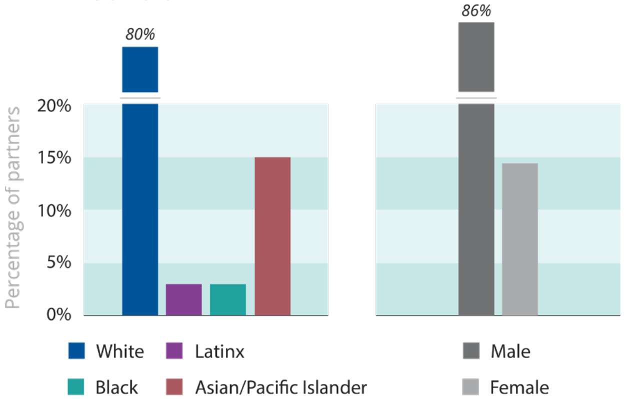
On gender bias, researchers have found differences in the way VCs discuss male and female entrepreneurs — women were more likely to be questioned on "their credibility, trustworthiness, experience, and knowledge," while men were "commonly described as being assertive, innovative, competent, experienced, knowledgeable, and having established networks." Another study demonstrated that the type of questions VCs ask entrepreneurs can vary depending on the entrepreneur's gender — with women getting asked "prevention" questions about potential for losses, and men getting asked "promotion" questions about potential for gains.

On race biases, a recent PNAS study found that VCs were twice as likely to expect diverse founders to underperform the market, while holding them to higher standards. At the fund manager level, Stanford instructors have found that (oddly enough) funds led by people of color face more bias the better they perform.

The white-male-dominated demographic composition of the venture capital industry also likely contributes to the disconnect. As of 2018, 80% of VC's investments partners were white, 15% were Asian, 3% were Black, and 3% were Latinx. Partners were 86% male and 14% female.

Venture Capital Investment Partners

As of 2018



Source: NVCA-Deloitte Human Capital Survey, 2018, https://www2.deloitte.com/content/campaigns/us/audit/survey/diversity-venture-capital-human-capital-survey-dashboard.html

3 Note that digging deeper into these issues can be controversial as they can generally be quantified only through surveys and studies of a subset of the VC industry — which does not always allow us to understand the collective behavior of the industry.

False Dichotomy

We believe that venture funds can invest for profit *and* make a positive impact by investing in underrepresented founders serving underrepresented consumers.

Consider the findings of VC firm Kapor Capital, which in 2019 reported that their Impact Portfolio ranked in the top quartile of venture funds of comparable size: "It has long been our hypothesis that there need not be a conflict between gap-closing impact and financial returns, and now, for the first time, we have data to show it."[4]

Similarly, we are encouraged by a growing body of data demonstrating that backing diverse teams is a winning investment strategy.

- McKinsey's latest survey on diversity and inclusion — covering over a thousand large companies across 15 countries — shows that both gender-diverse and ethnically diverse teams are likely to outperform homogenous teams.

- When it comes to venture capital specifically, an innovative analysis by Kauffman Fellows and MaC VC demonstrated that teams with more than one race or ethnicity deliver better returns than non-diverse teams — up to 30% higher median realized multiples (RMs) on successful exits. And even beyond the founding team, if a company's executive team is ethnically diverse, it stands to return up to 64% higher RMs, according to the same study.

Data for female-founded ventures is also promising. In 2015, VC firm First Round analyzed a decade of its

We believe that venture funds can invest for profit *and* make a positive impact by investing in underrepresented founders serving underrepresented consumers.

4 From Kapor's Impact Report: "The majority of Kapor Capital investments are still illiquid at this stage of our portfolio, which means that these values remain estimates. In calculating IRR and TVPI we have used the valuation techniques that are broadly employed in Venture Capital for this stage (For example, we used the value of the last round of investments for our companies)."

investments and found that companies with a female founder performed 63% better than their investments with all-male founding teams. Further, a 2018 BCG study of 350 companies that graduated from the MassChallenge accelerator program found that female-founded or co-founded startups generated [47 cents more] in revenue-per-dollar-raised than male-founded startups (78 cents versus 31 cents, respectively).

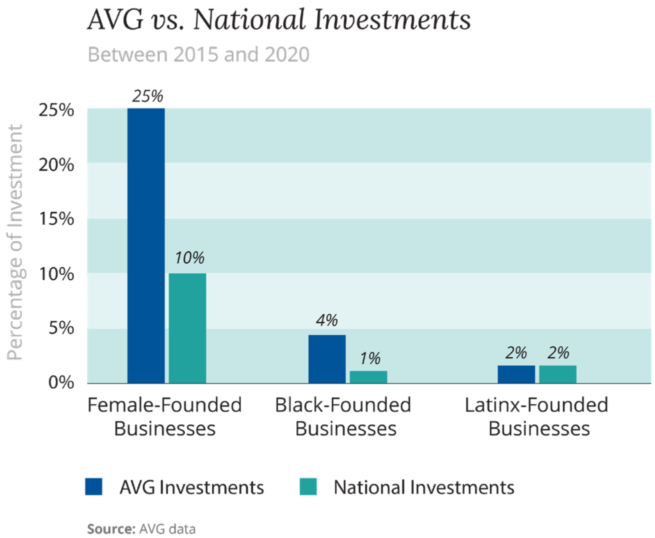
Finally, there's also strong evidence that diverse investment teams make better investment decisions. Harvard Business School's Paul Gompers describes the difference in outcomes between homogeneous partnerships and diverse ones as "dramatic," noting that the comparative success rates for IPOs and acquisitions were 26.4% to 32.2% lower for investments by partners with shared ethnicity.

A 2018 BCG study found that female-founded or co-founded startups generated 47 cents more in revenue-per-dollar-raised than male-founded startups.

What We're Doing at AV

Based on the plentiful evidence of opportunity in diversity investing, AV has decided to do more in terms of impact investing. Since our founding about five years ago, we've done better than most VCs when it comes to diversity investing:

- Across all of our funds since inception, AV has invested more than twice as often as other VC firms in companies with at least one female founder or CEO. Nearly 25% of AV's total investments went to such companies while (according to Crunchbase) only 10% of all VC investments went to female-founded and mixed-gender teams.
- We also outperformed when it came to investing in Black founders, with 4% of AV's investments having at least one founder who identifies as Black vs. 1% from the VC industry overall.
- We estimate that we were on a par with the 2% national average for investing in Latinx.



But we want to do better. And we intend to do so without changing our standards for what we consider a desirable investment. AV's new Anti-Bias Fund will invest in opportunities (1) that rate as attractive investments (based on our standard scorecard and deal vetting) AND (2) that also feature underrepresented founders and/or business models that address systemic bias.

Our contention is that you have the potential to do well and do good through venture investing.

As for diversifying the face of VC talent, we're trying to do our part there as well. In addition to an increasing number of diverse Managing Partners and employees, we run several programs designed to foster more diverse talent in the venture world (our Venture Fellow Program, 10KEnterpreneurs, and VentureCorps).

We hope that combining these initiatives will prove a virtuous circle. We believe more diverse VCs will be better attuned to the promise of diverse founders and businesses — and that successful track records by those VCs in investing in successful diverse founders will lead to more deliberate hiring of diverse venture talent.

Conclusion: Making Conscious Efforts to Foster Diversity in VC

The good thing about the barriers to diversity and inclusion outlined above is that they can be addressed. VC funds can actively hire more diverse talent and invest in diverse companies. And even when it comes to unconscious biases, people can deliberately adjust and compensate for them.

We see signs of this adjustment taking place. Alumni Ventures Group is by no means the only venture capitalist firm making more concerted efforts to commit to greater diversity in their industry and portfolio. We are hopeful that these changes will grow in step with the evidence that investing in diverse team members, founders, and businesses is not only right but also smart.

To learn more about AV and our Anti-Bias Fund, visit www.avgfunds.com/focusedfunds/antibiasfund.

Our contention is that you have the potential to do well and do good through venture investing.

About the Author

Marco Antonio Casas
Senior Principal, AV Seed Fund
Alumni Ventures Group

Marco Antonio Casas is a Senior Principal at AV Seed Fund, where he focuses on pre-seed and seed investments. To date, Marco has invested in over 40 companies where at least one member of the founding team identifies as female or minority, including real estate unicorn Compass and size-inclusive brand Universal Standard. Prior to AV, Marco was a fellow at VEF, an emerging markets fintech VC. Before that, he spent over a decade in emerging markets investment banking and institutional sales. Marco has a BA from Middlebury College and MBA degrees from Columbia University and London Business School. He is a Council of Foreign Relations (CFR) Term Member and has been named to Business Insider's "100 rising-star VCs who represent the future of venture capital." Marco is a proud first-generation immigrant from Venezuela who got to New York City by way of Swaziland and Russia.