



WHY NEW BLACK VENTURE CAPITAL FUNDS WILL GENERATE OUTSIZED RETURNS AND HELP CLOSE THE RACIAL WEALTH GAP

A new report by:

Culture Shift Labs

Since 2006

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Understanding Venture Capital in 2021

Few outside (and even inside) the venture investing industry know that twenty percent of today's US public companies were started with venture capital backing. In 2021, these companies account for just over 30 percent of the market value of all public firms. Silicon Valley has been the envy of a world that seeks to emulate the US's venture financing success story. But the institution at the center of this success story—the Venture Capital (VC) firm—is not well understood. The impression one gets is that this is a closed community that invests in mainstream founders addressing mainstream markets and mainstream consumers—a community that is very difficult to understand and very difficult to change.

For starters, 2020 was as complicated as it was misleading in the VC world. "Start-up funding touches new records amid pandemic" shared Bloomberg, noting a record high of \$130 billion last year.[1] This record though was also a significant contraction. Fewer start-ups got funded, and it was only the mega-rounds (\$3.4 billion to SpaceX and Epic Games alone) and the doubling down "unicorns" (225 of them) that drove VC investment up 14% from 2019. Similarly, investing in small, new, and niche deals (and their investment managers) looks to have taken a nosedive in 2020. If one looks only at the total investment and round counts, this is the impression one would get, though again, this is not exactly the story. The global portion of deal volume to female-only and female/male co-founded businesses has remained steady since 2017: 13% to female/male and 6% to female-only founders and their businesses.[2]

[1] "Startup Funding Touches New Records Amid Pandemic" Lizette Chapman, January 13, 2021, Bloomberg Online

[2] "Global VC Funding To Female Founders Dropped Dramatically This Year [2020]" Gené Teare, December 21, 2020 Crunchbase News Online



VC in
2021

However, total funding in relative dollar terms to female-founded startups has declined in 2020; a 27% decrease that is only expected to widen once deal stats for late 2020 show up in early 2021 numbers. We see the same type of contraction in total US VC fundraising. In this space, 2020 was a year for the record books: \$69B was raised. Though here again, fewer got funded: just 287 funds, compared with 589 funds in 2018. Looking at just one set of numbers really won't give you the whole story, though we agree, there is a flight to the relative safety of "mega-rounds", "unicorns" and "experienced managers".

How then should we look at the opportunity to invest in diversity in 2021?

Accelerating investments in diverse founders and their companies has been a hot topic of late. For some it is socially responsible to invest in diversity, minority-owned businesses. For others, it is a smart niche or alternative asset play, an open market with little competition and the potential for outsized returns. While many LPs and consequently VCs, are interested, how investing in diverse founders will work is a tough question. Large VCs and large LPs clearly have little appetite. There are however other sources of venture capital. But with even less insight into the inner workings of these VCs and LPs, how are we to understand their strategies and their approaches? How do their investing processes differ? How are they building their diverse deal pipeline? What are the nuances to transacting with diverse founders? And most critically, how do we get in on their returns, if indeed they are making outsized returns?

Is investing in diverse-led companies really worth the effort?

Alternatives have been on the radar of many for two decades. During the first wave, alternative funds (including small, new and niche funds) did deliver outsized returns. But as they grew, these funds became more bureaucratic, more rigid, less flexible and in the end, their returns declined to commodity-like levels. They became "institutional grade." Over the past five years a second wave of alternative funds seems to have taken shape - again focused on small, new, and niche plays as they had 20 years ago.



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Has this effort paid off? Among the few venture capital operations that have experimented in earnest, there are some who would definitely say "yes, no question about it". One firm, a Mid-Atlantic-based operation, was willing to share their experiences: they are a diverse-led investing team, with a decade long track record. Though this fund did not have a specific diversity investing mandate, they ended up investing in 26 companies where 40% of the portfolio co CEOs were women and over 80% of the C-suite teams were gender or ethnically diverse. As their numbers showed in the first 12 months, 100% of the portfolio gains were attributable to women-led companies, and 77% of the gains were attributable to mixed-ethnicity teams. (Note: the forecasted returns all exceeded the originally set return targets). Though the numbers evened out over the next year's performance period, it was without question that the diverse-led companies and the diverse management teams performed better. According to the CEO, there are at least ten things different about this investing operation, yet two things stand out. First, the willingness to look with a less biased eye at diverse-led businesses. Second, the reinventing of the operating model for supporting different types of founders and their teams (women and executives-of-color) got the kind of guidance and coaching they needed. Since their inception there has been only been one failed business (an enviable 5% write-off rate).

Beyond being socially responsible, this VC has demonstrated that there is good business to be had in backing diverse founders and ethnically-diverse management teams if LPs are willing to work with emerging managers. (Note: for more data on the potential for returns in other diverse-led companies in other assets classes, please see UBS Equity Research, or contact one of the authors).



Looking deeper into Diverse-investing, Diverse-led VCs

A team of strategist-researchers from Culture Shift Labs (CSL) undertook a three-month study of Black VC community in late 2020. The results were surprising to many. First off, the universe of diverse-led VC firms is larger than many appreciate. Within the total universe of approximately 1,350 U.S. VC firms (National Venture Capital Association estimate), at least 80 are led by Black partners (6%). If we add venture banking hybrids and Small Business Investment Companies (SBICs), there are probably an additional 50 more firms. What we also know is that this 6% receives proportionally less investment capital than other groups. Though the figures are illusive, it is understood that like female-led VC firms, Black-led VC firms are underrepresented. (Female-led VC firms received a paltry 2.8% in VC firm funding in 2019, and an even worse, 2.3% in 2020). So, while the foundations for investing in diversity, or rather the vehicles for investing in diversity, exist, serious attention needs to be paid to scaling up and becoming fully funded.

To understand how that could happen, CSL funded an initial exploratory research effort with 82 of these Black-led US VC firms to gather baseline data on their AUM, their strategies, and structure.

This research comes at an opportune moment as US companies committed over \$35 billion towards racial equity investing in response to the events of 2020[3]. Leading the charge is JPMorgan Chase that has already pledged to invest \$30 billion over the next 5 years. Other large corporations (and their venturing arms) like Apple, Cisco, Citi, Goldman Sachs, Facebook, Google, PayPal, and Walmart are making significant moves to invest in minority-owned businesses and diverse-led VC firms. Meanwhile, large asset managers like BlackRock and Vanguard are promoting racial equity by pushing portfolio companies to implement greater racial diversity on their boards.

[3] Weber, Lauren. "Companies Have Promised \$35 Billion Toward Racial Equity. Where Is the Money Going?" The Wall Street Journal, Dow Jones & Company, 21 Dec. 2020, www.wsj.com/articles/companies-have-promised-billions-toward-racial-equity-where-is-the-money-going-11608570864.

How much money is on the move towards diverse-led companies?

A lot more than most people realize. The truth is the movement of money for reasons of diversity has been happening for a few years already. In June 2018, the \$191 billion New York City Pension Fund formally set diversity as a criterion for investment manager evaluations and selections. Other large LPs are following suit. Why? Firstly, it has been widely researched and documented in the financial services industry that diverse leadership teams tend to be more innovative and tend to make better management decisions. Quicker and better decisions then lead to superior commercial outcomes and higher enterprise values. Secondly, investing in diverse markets provides better economics. A study published in the Proceedings of the National Academy of Sciences [DB1] found that in racially and ethnically diverse marketplaces, pricing bubbles were far more unlikely to exist. In diverse markets, the study found, market pricing was 58% more likely to reflect the true value of the assets. Price bubbles (read: exaggerated valuations) were much less likely to occur. Better market pricing equals better deal prices for the investor.

The bottom line is that for whatever reason – be it ethical or be it the pursuit of returns – it looks like billions (possibly even tens of billions) are inching towards investing in diverse founders and their ventures. The year 2021 could very well be a game changer for those 80 or so Black-led VC firms and their diverse-led investment opportunity pipelines.

Who exactly is going to get these billions?

Consider for a moment, a challenge that might very easily get handed down from an investment committee at a large institutional LP: "We need to show we are doing something to support Black and Latino entrepreneurs. Tell us how we are going to put \$100M to work this year?" To many fund managers, such a challenge might seem easy for the first hour, then frustration sets in. Where are all the Black-owned new ventures? The Black-owned businesses? Where are the Black-led investment firms that might have Black-led investment pipelines? Who do I know at these firms? Do I even know anyone, anywhere that can introduce me? So, while new mandates and challenges like the one above are plentiful, the networks needed to bridge from "traditional VC firm" to the "Black VC firm community" (and their deal pipelines) are sorely lacking. Beyond introductions, the investing processes, unbiased perspectives and tools required to realize diversity investing objectives are largely absent. The answer to the question is: it should be all of them.

Key Takeaways

- Black-led VC firms seek to nearly double their AUM in 2021 – from \$4.3 billion to over \$8 billion.
- Just 50 new Black-led VC firms with full funding would be poised to invest in range of 1,000 to 1,250 companies in the coming years, potentially creating as many as 10,000 to 15,000 jobs.
- When these companies get acquired or listed in the public stock exchanges, the wealth they create could contribute significantly towards closing the racial wealth gap.
- There is good business to be had in backing diverse founders and ethnically diverse management teams. One pioneering firm, a Mid-Atlantic-based operation with a diverse-led investing team, found that in the first 12 months, 100% of the portfolio gains were attributable to women-led companies, and over 75% of the gains were attributable to mixed-ethnicity teams, far exceeding normal and customary returns in their target asset classes.
- Fund investors seeking to accelerate their investments in diversity may be able to do so by engaging and looking closely at LP investment or deal syndication opportunities with these +80 firms.

What does the Black-led VC firm ecosystem look like and how much new investment capital can it actually absorb today?

CSL's initial research identified 84 Black-led VC firms in the US; about 60% of what is believed to be the total Black-led VC firms, hybrid firms, and SBIC universe in the US. Our Black-led VCs reported a total AUM of \$4.3B. The upper limit of total AUM is \$7.3B, though there are many reasons one could legitimately reduce this estimate. Most of the firms are micro-VCs with an average size of \$82M. Median AUM is hovering around \$50M.

Research also suggests that the majority of these 84 are also at an early stage of evolution with 69% of the GPs managing their first fund. It would thus be fair to label these groups as “emerging managers.” This is excellent, in that these are the types of managers that are known to produce outsized returns, if managed in the right way. As emerging managers though, they are unlikely to have the bureaucracy of older and larger alternative funds (i.e., most simple governance structures, infrastructure, and regulatory compliance systems that meet the expectations of the large institutional LPs).

Most interestingly, researchers found that this population of 84 firms is aiming to raise an additional \$3.8B in the coming year 2021. Over three quarters of them (77%) will aim to raise under a \$100M.

Theoretically then, it looks as if about \$5.9 billion in new capital could be deployed in the larger, Black-led VC firm universe. Though again, there are many reasons why the full deployment of new investment capital into this Black-led VC universe might not happen in 2021 (the ongoing pandemic is expected to put a damper on new capital investments, especially in alternative spaces). There may, however, be more opportunity than just what has been mentioned. If we expand the Black-led traditional VC firm universe to include Black-led but corporate-owned Venture Capital (CVCs), hybrid Black-led Venture Banks, and Black-led SBICs, then the numbers do go up. CSL's strategist-researchers are very confident that over \$5B will get deployed in this expanded Black-led venturing universe in 2021. As it is probably helpful to mention, the reason for this confidence is that through their personal networks, they are privy to already \$2B in second fund launches underway for 2021.

Where are these deals getting done? For those in the traditional venture hotbeds, putting money to work in Black-led VC firms is likely to be easier. Geographically, 60% of the firms CSL researched and 70% AUM is concentrated in the Bay Area, New York City, Washington D.C. and Boston (see Figure 1). Only 5 firms with a total of \$90M of AUM were identified in the Midwest.

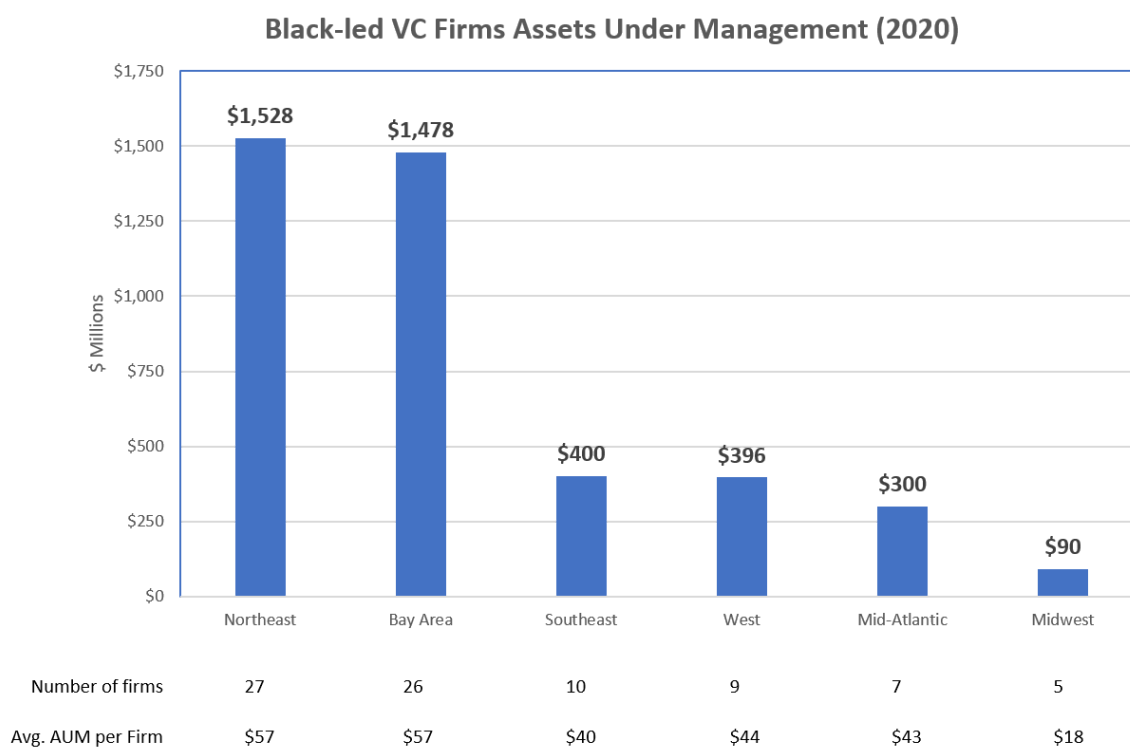


Figure 1. Geographic Distribution of the 84 Surveyed Black-Led VCs in the US

It is worth noting that 26% of these Black-led VCs are headed by a Black female. That is interesting in so far as 26% is not a small percentage when compared with the "less than 10%" figure talked about in the traditional VC firm universe. Here again, data is sorely lacking and what should be easy question to research – "What percentage of VC firms are headed by women?" – is actually a frustrating exercise.

What the future holds?

We think the future is bright for Black VCs and the firms they lead. We think this is a very fair supposition in part because of the October 2020 report by FastCompany.com: "New data shows the number of woman-led VC funds is exploding." The years 2018 and 2019 seem to have been the watershed moment where an appetite for investing in women-led VC firms and their funds took off. According to a 2020 study published by "Women-in-VC," there are 275 new VC funds led by women, about 75 of which were started in the last two years. Truly, the space is exploding.

It is encouraging to see the proof that when there is investor appetite, more VC firms get launched. As the women-led VC universe is exploding, we predict the same explosion will occur for Black-led VC firms over the next two years.

We foresee a very beneficial expansion of the ecosystem and increased economy-wide opportunity. Imagine fifty (50) new Black-led VC firms with full funding would be poised to invest in range of 1,000 to 1,250 companies in the coming years, potentially creating as many as 10,000 to 15,000 jobs.


When these companies have meaningful exits—get acquired or listed in the public stock exchanges—the wealth they created could contribute significantly towards closing the racial wealth gap.

When this new wealth is reinvested, it is more likely to flow to a next generation of Black founders. Just as it was said for the future of women founders, it too can be said for Black founders: the potential for a positive flywheel is awe-inspiring.[4]

Want to learn more and join in our Black VC Insights & Action Community?

The objectives of our community are to further increase the number of Black-led VC firms, to significantly expand the average AUM, to ensure greater participation among investors and founders and leaders, and to capture untapped opportunities in exciting market niches and emerging industry sectors. To join an executive planning team, please contact: Andrea Hoffman at agh@cultureshiftlabs.com.

[4] Data and text paraphrased from the online article on FastCompany.com "New data shows the number of woman-led VC funds is exploding." October 22, 2020.

The background of the bottom section features a dark blue background with silhouettes of several people in business attire, appearing to be in a meeting or collaborative work environment. One person in the center is holding a document or tablet.

"Our world had been designed for the 1%. That's a broken model that we must change if we are to achieve racial equality and realize the financial and economic prosperity that comes from it."

Former tech company CEO

To support the pursuit of these goals, CSL will launch a new research initiative to further map the Black-led VC firm universe and identify pathways to grow the ecosystem. We are seeking the support of corporate and LP partners to join this research effort through financial sponsorship. As an impact-focused consultancy, our goal is to extend this research to generate actionable insights for investors.

We see six areas of research needed to nurture the Black VC ecosystem:

1. Understand better the hurdles and information gaps as seen from both the perspectives of the Institutional Corporates/Institution LPs and the Black VC firms, with the aim of identifying trouble-spots that need to be worked through.
2. Understand the roadblocks to growing the total AUM and increase the number of Black VC firms.
3. Conduct expert interviews among industry catalysts to identify options and accelerating the creation of networks for stimulating Black-led VC firm activity in under-represented regions (e.g., Midwest and Southern states) and increase alignment of Black-led VC firms with future growth sectors.
4. Identify the venues and forums needed to link Black-led VC firms with corporate and LP investors seeking “quick wins” in terms of capital investment.
5. Identify potential programs with partners and enablers which can help to increase the proportion of Black-led VC firms with woman leadership and operating in under-represented regions.
6. Identify networks of corporates, investors, and talent that can help incubate Black-led VC firms focused on future growth sectors of the economy where they are currently under-represented.

We have a historic opportunity to address the racial equity challenge in the US and in the rest of the world. CSL believes that its proposed research effort will help corporate investors, institutional LPs and other investors take deliberate, practical steps to deliver on their racial equality commitments by creating processes, playbooks and connections that drive systemic change. For further information, please contact Andrea Hoffman at agh@cultureshiftlabs.com.

About the Authors

Andrea Hoffman, Founder & CEO, Culture Shift Labs

Andrea is a strategist, dealmaker, 2x author, and the founder and CEO of Culture Shift Labs. She has been at the forefront of diversity and innovation since 1999 with an expertise in racial equality. Andrea consults with Boards, CEO's and their teams, with a focus on Tech, Fortune 500s and the Investment Communities to help them rethink capitalism and impact.

Peter Classen, Chief Transformation Officer, Culture Shift Labs

Peter is a Chief Transformation Officer with an expertise in research, strategy formation, and implementation, especially in the areas of alternative investments. As relevant to this effort he has contributed to the strategies and plans for 34 venturing-investment funds. He designed his first alternative-led fund in 1996, has been a partner in a venture-bank and has served as the Group COO of a Saudi-International Investment Co. with a global portfolio.

William Crowder, Aperture Venture Capital

William is Founder and Managing Partner at Aperture Venture Capital, a new seed-stage venture fund that brings together corporations, mission-driven investors and founders from diverse backgrounds to reshape the start-up landscape in a way that traditional VC firms have been unable to do. William has 20 years' experience in venture capital and digital innovation and is a diversity investing pioneer who has helped build diversity-investing platforms for Comcast Ventures, Morgan Stanley, and Dreamit Ventures.



ABOUT CULTURE SHIFT LABS

Culture Shift Labs (CSL) is a diversity and innovation consultancy that provides services under three pillars: **Advising, Strategy, and Activation**. Since 2006, we have been a recognized leader in integrating social and financial returns in ways that improve businesses and society. Our **Knowledge + Network™** Formula powers those outcomes in tangible ways.

Our clients are first-movers, visionaries, and early adopters who are eager to accelerate their diversity and innovation objectives. Culture Shift Labs serves F500, Tech Companies, Institutional LPs, Investors—Private Equity, VC, Impact, Family Offices— and Nonprofits.

Our range of consulting services accelerate board, leadership, workforce, business and corporate development, and corporate social responsibility. The Katapult Talent Database of 10,000+ Black/Latinx experts delivers results. This private network grows daily.

Our consulting services are supported by our Culture Shifting Weekends—annual invite-only summits that narrow the inequality gap in tech, venture, entrepreneurship, and on boards and the C-suite, as well as enabling deals and collaborations among our Culture Shifting Community. The New York City event is the largest gathering of Black VCs in the US and has helped to channel over \$410MM to the Black and Latinx venture firms who have attended our events.

In the course of 2020, the Culture Shifting VC investors grew from 40 in January to 150 by November. This extraordinary momentum is showing no signs of slowing down, with LPs actively seeking to invest in Black and Latinx venture fund founders.

Culture Shift Labs

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