Morgan Stanley

The Growing Market Investors Are Missing

The trillion-dollar case for investing in female and multicultural entrepreneurs

Women and people of color have long faced barriers starting their own businesses and raising capital to fund them. Some barriers have been structural, others cultural, but all have been costly — and often in ways we'll never be able to quantify. We can only imagine what businesses might have taken off, what products consumers might have enjoyed, and what innovations and returns might have been realized had women and people of color enjoyed equal access to capital and opportunity.

Several years ago, at Morgan Stanley, we came to a view that the marketplace was missing the opportunity to find and finance businesses run by people of color and women. Our instinct told us there was a funding gap in the marketplace. We launched the Multicultural Innovation Lab to learn more about this gap and help close it. The Multicultural Innovation Lab leverages our own networks to find these innovators, advise them on their business plans and connect them to potential investors. We've now been through two cohorts of Lab participants, and the experience has validated our belief that there's a marketplace inefficiency here that needs to be addressed.

To dig deeper and examine why this funding gap exists, we have sponsored the research in this report. The findings from this survey of the investing community give us further confidence that we and other investors should be challenging ourselves not only to identify great business and product ideas by diverse teams, but also to propel them.

There have been plenty of reports on the obstacles these entrepreneurs face. We decided to flip that question on its head, and ask why aren't investors seeing these opportunities? And what we find is a gap in investors' perceptions versus reality, in terms of how much they invest in women and multicultural-led businesses, and also in how they evaluate these businesses in their investment decision-making process.

By illuminating that gap, we aim to open investors' eyes to the opportunities they are missing. We hope that by identifying this blind spot, this report galvanizes investors to take concrete steps to expand their lens by identifying and investigating more opportunities to invest in women and multicultural-led businesses and realize strong returns.

Women and multicultural entrepreneurs abound today, in every sector of the economy, representing opportunity for investors willing to find and fund them. Whether one looks at economic returns or demographic trends, the data points in a similar direction: There is a compelling, numbers-driven case for investing in businesses run by people of color and women, and doing so not only creates returns for investors, but advances the next generation of leading companies and emerging industries, while creating jobs and economic growth.

No single initiative or investor will solve this imbalance in access to capital. It will take a concerted effort by a broad range of investors. The effort is worth it — for entrepreneurs and investors — as well as for their consumers and communities.

Sincerely,

James Gorman, Chairman & CEO

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The Growing Market Investors Are Missing

Executive Summary

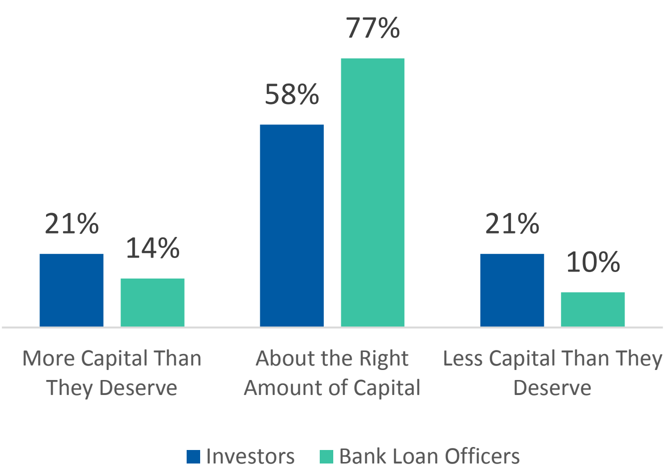
This report reveals a trillion-dollar marketplace inefficiency: The funding gap facing businesses owned by women and people of color in the United States.

Morgan Stanley wanted to understand why this inefficiency persists today, so we went directly to the gatekeepers of capital to learn their perspectives, and in the process, uncovered an important driver: **Investors don't see the imbalance.**

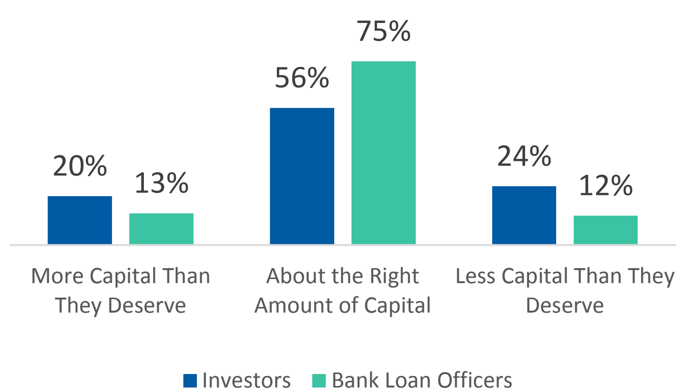
Our survey showed a clear disconnect between how investors perceive their investments in businesses owned by women and people of color, and how much they actually invest.

Nearly eight in ten investors say that multicultural and female entrepreneurs receive the right amount, or more, of capital than their business models deserve, yet these same investors dramatically underinvest in this population.

Women-Owned Businesses Receive ...



Minority-Owned Businesses Receive ...



Investors reported a substantial funding gap in their own investments. The median investment by equity investors in business opportunities is nearly $1 million. **Yet, for women and minority-owned businesses (WMBEs), median investments are only $213,000 and $185,000, respectively.** These reported investment amounts do not explicitly control for the difference in the size of the business, but this gap reflects findings observed by other studies — that WMBEs do not raise as much as their counterparts even when controlling for firm characteristics.

The bottom line: Investors report that WMBEs receive a fraction of the capital, yet most believe that the funding landscape today is balanced. Only when investors see their missed opportunities will these investment flows change.

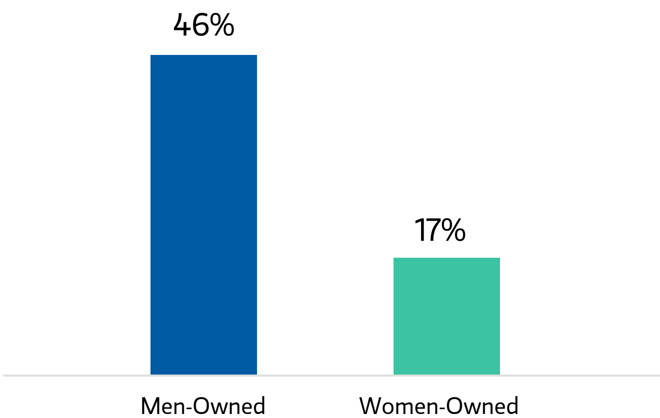
Why Do Investor Perceptions Not Match Their Actual Behavior?

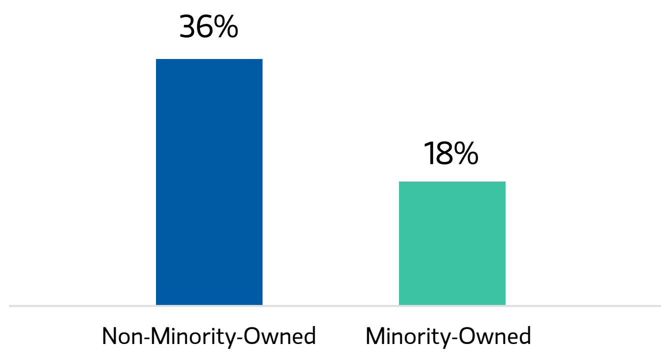
Women and multicultural entrepreneurs have trouble making it in the door.

If investors don't see women and multicultural business owners, then they aren't even aware of the opportunities. Our research found that investors are much less likely to be exposed to WMBEs than to male and non-minority businesses. Specifically, investors are nearly three times more likely to review male-led business opportunities "very frequently," even though male-led businesses are only 1.5 times as common as women-owned businesses.[1] Similarly, investors are twice as likely to review non-minority businesses than minority businesses.

Encouragingly, investors report moving forward with two in five of the opportunities they evaluate, regardless of the demographics of the business owners. It is not a matter of getting turned down by investors, but rather making it in the door in the first place.

% of Investors Personally Reviewing Business Opportunities "Very Frequently" in Past 12 Months

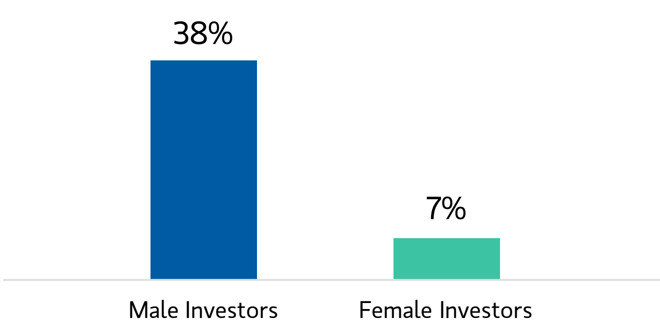




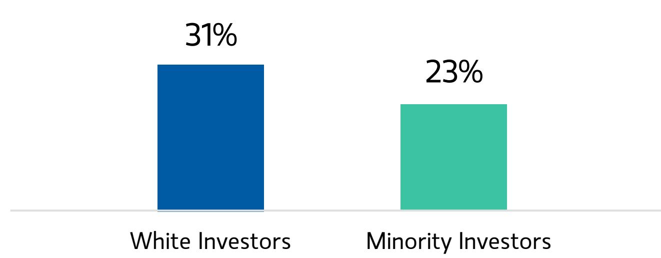
Investors, especially white and male investors, aren't working to increase the diversity of candidates they consider.

WMBEs are not a criterion that investors prioritize when looking at opportunities. Among the investors we polled, nearly 40% of men say that investing in women-owned businesses is not a priority at all, compared to only 7% of female investors. Similarly, 31% of white investors say they do not prioritize investing in minority-owned businesses.

% of Investors Who Say Women-Owned Businesses Are NOT a Priority



% of Investors Who Say Minority-Owned Businesses Are NOT a Priority



1. Survey of Business Owners and Self-Employed Persons (2012). United States Census Bureau. https://www.census.gov/programs-surveys/sbo.html

Investors judge women and multicultural entrepreneurs by different standards.

Investors told us that when considering investment opportunities, various factors are weighted differently depending on the race and gender of who is in front of them. Investors expect WMBEs to check additional boxes beyond those like a quality management team and a sound business strategy that are required for all types of businesses. For example, investors cite that displaying confidence is disproportionately important for WMBEs: 24% of investors say that a confident applicant is important when considering a women-owned business, and 23% say the same when considering a minority-owned business, compared to only 14% when considering businesses in general. The same is true for needing to deliver a convincing pitch.

Investors perceive businesses owned by women and people of color as riskier.

Investors are twice as likely to think that WMBEs perform **below** market average compared to non-minority and male-owned businesses. In actuality, data indicate that when multicultural entrepreneurs receive angel capital, their returns consistently match the market yield rate, while women-owned firms yield returns that lead the market by 2%.[2]

Investor Perceptions of Businesses Performing "Below Market Average"

Investors may not be familiar with the market the WMBE is targeting

Investors report being less likely to connect to the sectors that female and multicultural entrepreneurs serve. Nearly half of investors (47%) cite an entrepreneur's sector as an important reason why they invest in businesses in general, but that number drops to 36% for WBEs and 33% for MBEs.

Morgan Stanley sees this borne out in the experiences of Innovation Lab pariticipants, where PE and VC firms are often reluctant to invest in a product or service that serves a consumer they don't understand.

2. Minority Business Development Agency (June 2011). *Minority Women Owned Firms Are Fastest Growing*.

The Trillion-Dollar Opportunity

Despite a portion of investors who think minority-owned businesses are more risky than non-minority businesses, the majority of investors perceive WMBEs as equally capable of delivering returns as businesses in general. More than nine in 10 (92%) investors say that women-owned businesses achieve at-or above-market returns, while 81% say the same of minorities.

Using data from the U.S. Census Bureau's 2012 Survey of Business Owners, we know revenues for WMBEs were $2.4 trillion. Hypothetically, had revenues (and, thus, the number of businesses) been proportional to women's and minorities' percentage in the labor force — 56% — then 2012 gross receipts would have increased to $6.8 trillion, suggesting a missed opportunity of up to $4.4 trillion.*

Meaningful progress will require investors to commit to change

Our research brings to light several areas that investors need to address in order to capitalize on the market inefficiency, including:

- **Set targets, not quotas**. Commit to finding these entrepreneurs by setting targets for the number of WMBEs that you evaluate and the percentage of WMBEs in your portfolios.
- **Hold yourselves accountable for measurable outcomes**. Track statistics on how many diverse companies you are seeing and how many diverse companies you're investing in, and share those stats with your Limited Partners.
- **Reconsider your screens**. Expand the criteria for evaluating potential investment opportunities. This requires a shift in your mindset from valuing entrepreneurs based on their pedigree — like a degree from a certain university — to the hard skills they bring to the table and the caliber of their ability to understand the unique market, anticipate demand, and serve the customer properly.
- **Be transparent**. Be clear about what you're looking for — the process and criteria for securing an investment remains a mystery for many. If you know before taking a meeting that the company isn't a fit for you, don't take the meeting and be upfront with the entrepreneur about why their company isn't the right fit.

This report is one element of Morgan Stanley's Inclusive Innovation and Opportunity initiative, which includes a series of programs aimed at changing the investment landscape for multicultural and women entrepreneurs. The initiative is led by Carla Harris, Vice Chairman, Global Wealth Management and Multicultural Client Strategy Group head, who is responsible for marshalling Morgan Stanley's unparalleled experience, expertise, and its global network of investors to change the investment and tech landscapes.

Methodology

While the report focuses on investors, interspersed throughout are snippets from interviews with several of the entrepreneurs who make up this year's Multicultural Innovation Lab cohort as well as interviews with experts in the field. In a conversation driven by numbers, their words and observations remind us that this issue, at its foundation, is about people.

More specifically, this report is based on:

- An online survey of 101 investors (e.g., private equity professionals, venture capitalists and bankers who provide capital to businesses) and 168 bank loan officers. The survey was conducted on behalf of Morgan Stanley by Brunswick Group between August 20 and September 13, 2018.
- Fifteen in-depth interviews with individuals with sector expertise from academia, venture capital firms, incubators, and civil rights organizations, as well as members of the second Multicultural Innovation Lab cohort. A full list of interviewees can be found in the appendix.
- A review of existing research reports and studies on the topic of women and minority-owned businesses (WMBEs).

*Methodology described in full on page 17.

The Funding and Growth Landscape

Then and now

In 1944, Joseph Pierce conducted the first survey of black entrepreneurs in America. He reached out to roughly 4,000 firms across 12 cities and asked them to identify the biggest barriers to their growth and success. The most common response: A lack of financial capital.[3]

In the nearly 75 years since that survey, much has changed for multicultural entrepreneurs in the U.S., but the struggle to access capital, from business loans and seed funding to working capital to private equity, has remained near constant. In study after study, the numbers differ slightly, but the overall trend doesn't: Women and people of color are able to raise only a fraction of the capital as compared to white male entrepreneurs, even when controlling for business characteristics. This creates a significant barrier for women and people of color, across geographies and across industries, to enter the market, let alone compete in it. The lack of access to capital — the lifeblood of any commercial enterprise — means women and people of color are forced to pursue a growth strategy that is more conservative thus robbing investors of outsized (or additional) returns and the economy of jobs and opportunities. While these strategies may keep them in business, it prevents them from growing in a way that will capture the attention of the gatekeepers of additional capital.

Putting it into perspective

There has been a marked increase in the number of WMBEs over the past decade. According to the American Express State of Women-Owned Businesses Report, the overall number of businesses in America increased 44% from 1997 to 2017, while women-owned businesses increased 114%. Over the past decade, SMB Insights reports the number of small businesses owned by people of color jumped from just over 6 million to more than 11 million, an increase of 79%, which was about 10 times the overall growth rate for all small businesses in that same time frame.

Despite this growth, WMBEs still remain underrepresented: Women-owned firms make up 36% of businesses, despite representing 51% of the U.S. population; firms owned by people of color comprise 29% of total businesses, yet represent 39% of the population.

While WMBEs have increased sharply in number, they tend to be smaller and grow at slower rates than non-minority businesses. The critical question: Does the funding gap contribute to the small size or is it the other way around? Do smaller sized businesses dictate the amount of capital contributed? If seed and Series A funding is small, then the growth capital investments contributed are likely to be smaller than normal market sizes at these stages of development. This gap in business size and growth may help explain some of the funding gap — but it doesn't justify it.

GROUP	**% of Population** (Census Population Estimates 2017)	**% of All U.S. Businesses** (2012 SBO)	**% of Paid Employees** (2012 SBO, among firms classifiable by gender and race)	**% of Sales** (2012 SBO, among firms classifiable by gender and race)	**Average Gross Receipts per Business** (2012 SBO)
Minority-owned	39%	29%	13%	12%	$173,552
Non-minority-owned (White, Non-Hispanic)	61%	70%	86%	88%	$552,079
Women-owned	51%	36%	15%	12%	$144,000
Men-owned	49%	55%	73%	79%	$638,000

Note: These numbers do not include businesses that are equally owned by women and men.

3. Institute for the Study of Labor (November 2007). African Americans' Pursuit of Self-Employment.

The funding landscape in one word: Uneven

Part of the reason WMBEs are smaller and have slower growth rates is their initial capitalization levels — the early lifelines of funds that help get businesses off the ground. Using Kauffman Firm Survey data, the National Women's Business Council found that:

- Women-owned businesses start with smaller amounts of capital than other firms, even when controlling for education and experience, credit scores, and firm characteristics (e.g., industry, growth potential).
- On average, women started their businesses with $75,000; for male-owned businesses, that figure was $135,000.
- Of high growth-potential firms, men start with more than double the financing of women. And of top-ranked firms by employment and gender, men start with six times more financing than women.

The picture for businesses owned by people of color is even worse: On average, white entrepreneurs receive three times more startup capital than their black counterparts — $106,720 versus $35,205 — in their founding year. [4]

WMBEs are also less likely to raise capital from external sources and are more reliant on personal financing, when controlling for firm characteristics. For example, men-owned firms are nine times more likely than women-owned firms to receive outside equity (18% of funding for men-owned firms came from outside equity versus 2% for women). This gap also occurred in high-growth potential businesses, where 18% of funding came from outside for men versus 6% for women. [5]

We know that of the success of WMBEs are disproportionally hurt by the cost of and lack of access to capital. According to the U.S. Department of Commerce Minority Business Development Agency, lower levels of startup capital among African-American firms are the most important explanation for why African-American-owned businesses have lower survivor rates, profits, employment, and sales than non-minority-owned businesses. Similarly, research shows that women-owned businesses are overrepresented in the bankruptcy population, which can be attributed to six factors, two of which are lower access to capital and lower capitalization.[6]

Where VC dollars go

Although only 0.6% of businesses seeking outside equity investment raise venture capital (VC),[7] it is an area we focus on given how critical it is to entrepreneurs, high-growth businesses, and the greater U.S. economy. VC funding comes with next-level guidance and business development recommendations, which have proven vital to growing and developing young businesses to reach their potential. A 2015 study found that a fifth of public U.S. companies received VC funding; and that 43% of public companies founded after 1979 were venture-backed at some point.[8]

It is across these equity investments where we see some of the biggest disparities:

- In 2018, the Kauffman Foundation found that less than 2% of startup financing went to women founders and only 1% went to African-American and Latino founders.
- ProjectDiane found that in 2017 black women raised about $250 million in VC funding, a fraction of the more than $80 billion total that was invested across VC deals in the U.S. that year.

Business loans and lines of credit are much more common. Of small business applicants who applied for financing in 2016, 86% sought a loan or line of credit.[9] Yet, multicultural entrepreneurs are three times as likely to be denied loans with financial institutions compared with non-minority firms.[10] According to the Federal Reserve Banks of Atlanta and Cleveland, nearly seven in ten non-minority-owned firms that apply for funding receive the full amount they requested, while the same is true for only four in 10 firms owned by people of color.

4. Stanford Institute for Economic Policy Research (December 2016). Black and White: Access to Capital among Minority-Owned Startups.
5. National Women's Business Council (April 2014). Access to Capital by High-Growth Women-Owned Businesses.
6. Bosse, Douglas A., and Porcher L. Taylor, III (January 2012). *The Second Glass Ceiling Impedes Women Entrepreneurs.* The Journal of Applied Management and Entrepreneurship 17, no. 1, 52-68.
7. Kauffman Foundation, Alicia Robb, Arnobio Morelix (October 2016). Startup Financing Trends by Race: How Access to Capital Impacts Profitability.
8. Stanford University Business Insights (October 2015). How Much Does Venture Capital Drive the U.S. Economy?
9. Federal Reserve Bank of New York (August 2017). Small Business Credit Survey 2016.
10. Brookings Institution, The Hamilton Project (March 2015). Minority and Women Entrepreneurs: Building Capital, Networks, and Skills.

What Perpetuates the Funding Gap?

There are a broad range of historic, cultural, and systemic factors that created and contribute to this disparity in funding — and which help perpetuate it today. Many of these have been well-documented: The lack of gender and racial diversity among the investment community, a reliance on well-established social networks, and bias (both deliberate and unconscious).

Our data highlighted other key behaviors, attitudes, and beliefs that persist among investors and bank loan officers. Importantly, it's not academics or politicians talking about these issues — investors are saying this about themselves. These not only help explain the situation today, but also inform some changes that could help create a better tomorrow.

Cognitive dissonance: Investors see parity in the marketplace, yet report making unequal investments themselves

- Nearly eight out of 10 (79%) investors who responded said that women-owned businesses "receive the right amount of capital that their business model and fundamentals suggest they deserve" or "receive more capital than they deserve," and 76% said the same about minority-owned businesses.
- Bank loan officers were even more likely to voice this opinion: 91% said they thought businesses owned by women received the right amount, or more, capital. While 88% said the same about minority-owned businesses.
- And yet the investors surveyed also reported that their own median investments approached nearly $1 million overall ($969,000), while their median investments in women and minority-owned businesses are $213,000 and $185,000, respectively. These dollar amounts do not control for firm characteristics explicitly, but the funding gap is observed across every measurable sector of focus within the survey, suggesting that any propensity for women and people of color to start businesses in lower revenue or growth sectors is not a factor in the funding gap.

"These investment amounts may reflect differences in the size of the businesses, but this isn't something that the investment community or entrepreneurs should accept, especially since smaller initial capitalization levels are a contributing factor to why WMBEs remain smaller than their counterparts.

We need to be asking ourselves what would happen if WMBEs were funded at the same rate: How might fund returns be positively impacted? How would returns to limited partners be impacted? To what degree would we see job creation accelerated? In what industries?

The economic impact of these inequities is consequential to both investors and all who participate in this economy."

– Carla Harris, Head of Multicultural Client Strategy Group

Median dollar amount of capital provided to businesses over the past twelve months

	Business Investments Overall	Sector: Tech	Retail/Consumer	Health	Manufacturing
Businesses overall	$969,000	$1,000,000	$750,000	$2,500,000	$1,000,000
Women-owned businesses	$213,000	$475,000	$375,000	$750,000	$100,000
Minority-owned businesses	$185,000	$475,000	$450,000	$600,000	$300,000

"They're not out there"

Research from Babson College shows that 92% of the partners in the venture capital industry are men, and most likely white, "and probably most of those or a good percentage of them went to elite business schools," says Dr. Candida Brush, Vice Provost of Global Entrepreneurial Leadership at the college, a pioneer of research in women's entrepreneurship. Most investors not only rely on, but sometimes require, referrals from their networks — which tend to be people just like them. This leaves many women and minorities on the outside looking in.

Those surveyed indicated that it wasn't a question of turning down WMBEs who pitch or apply to them. Rather, they reported, it was because far more white men make it into the room to deliver their pitch.

- Investors said they funded roughly the same percentage of WMBEs as non-minority and male-led firms, but 46% of them said they "very frequently" reviewed businesses led by men and 36% said they "very frequently" reviewed businesses led by non-minorities. Compare that to just 17% for businesses led by women and 18% for businesses led by people of color.
  - Older, male and white investors report being even less likely to personally review WMBE opportunities. For example, only 49% of white investors report reviewing minority-owned businesses very or somewhat frequently, compared to 67% of minority investors. Similarly, only 57% of male investors say they frequently review businesses owned by a woman compared to 90% of female investors.

> "Some of the big VCs have been on the record saying if you're not smart enough to get a warm intro then I don't want to see you," *says Freada Kapor Klein, founding partner at Kapor Capital.* "Warm intros have nothing to do with smarts. They have everything to do with zip code."

- Bank loan officers described similar, albeit more pronounced, dynamics, with 68% of them saying they "very frequently" reviewed applications from men, while under a quarter said the same about both women and people of color.
- Female (38%) and minority (28%) investors are more likely than white (13%) or male investors (8%) to cite diversity of management as a key factor in reasons why they invest in women-owned businesses. A similar pattern holds true for minority-owned businesses.

Businesses owned by women and people of color are not a priority for investors

Perhaps not surprisingly, evaluating WMBEs is not something that investors prioritize when looking at opportunities. Businesses owned by women (18% top priority) and by minorities (20% top priority) are much less of a priority compared to sector-specific businesses (49%), geographically-specific businesses (40%), and tech-focused businesses (47%).

However, what is surprising is the extent to which WMBEs are not factored in as a priority at all. Nearly three in 10 investors (29%) say that opportunities with WMBEs are not a priority for their firm. This compares to only 19% who say specific geographies are not a priority, 11% who say the same about emerging technologies, and 7% who say the same about sector-specific businesses. The lack of prioritization is much more acute when we look at the demographics of investors. Male investors are five times more likely than female investors to say that women-owned businesses are not a priority (38% versus 7%, respectively). Additionally, white investors are more likely than minority investors to say that minority-owned opportunities are not important (31% versus 23%, respectively).

> "No sound investment strategy should be based solely on the race or gender of its business owner, but given the dearth of investment dollars chasing these talented entrepreneurs of color and women, there is tremendous untapped potential for extraordinary returns."
>
> *— Carla Harris, Head of Multicultural Client Strategy Group*

A lack of understanding and imagination in evaluating businesses

For entrepreneurs, communicating their vision and value proposition is challenging enough. This becomes even more difficult for entrepreneurs whose product solves a problem or addresses a gap in the marketplace that isn't familiar to the investors they're pitching.

> "You are often pitching to people who aren't going to understand the magnitude of the problem you're addressing, so they definitely aren't going to understand the magnitude of the market opportunity."
>
> *– Tanya Van Court, Founder and CEO of Goalsetter and Multicultural Innovation Lab participant*

That was indeed Richelieu Dennis' experience with Sundial Brands, a skin care and hair care manufacturer (with brands including SheaMoisture and Nubian Heritage) that is focused on addressing consumer needs traditionally ignored by mass market companies. "We talked to many private equity firms who either didn't see the vision, didn't understand the mission, or didn't see the opportunity to serve a consumer that they didn't understand. So they were reluctant to invest behind it. And then for those who did, they saw it with so much risk that the capital they were willing to put in came at such an expensive cost that it really didn't make sense to do it." It wasn't until he built a business that was already several hundred million dollars in revenue that he found a "credible partner" who was "willing to give us capital at a cost at which our contemporaries got capital."

As Carla Harris points out, investors clearly did not recognize the fact that people of color are brand loyal, represent $1.4 trillion of spending power, and spend a disproportionate amount of disposable income on beauty and haircare products compared to other demographic groups (black consumers spend nine times more than their non-black counterparts on hair and beauty products).[11] "It is this lack of understanding that will cause investors to miss extraordinary opportunities that cater to black and Latino/a consumers," says Harris.

We see this borne out in our survey, where investors seem less likely to connect to the sectors that businesses run by women and people of color serve; 47% said sector was a compelling reason why they invest in businesses in general, but that number dropped to 36% for WBEs and 33% for MBEs.

11. Nielsen (February 2018). *Black Impact: Consumer Categories Where African Americans Move Markets*

Extra boxes to check

Our survey respondents conveyed that, consciously or not, they evaluate businesses owned by women and people of color differently than they do businesses in general. Everyone has preconceptions and biases (both known and implicit), and investors are no exception — but these seldom work for the benefit of women and people of color when trying to source funding.

When it came to raising money for his company, Rhoden Monrose, another entrepreneur in the Multicultural Innovation Lab, says, "For the most part, there was a lot of skepticism, and the goalpost was always pushed back further and further. 'Oh, this is a good idea, but you don't have a website.' So I built a website. 'Oh, this is a cool website, but you don't have any traction.' So we go to Citigroup to do a pilot, but it was an unpaid pilot. So then it was, 'That is only one company, and it's unpaid.' So I got a paying client."

"No, I'm not risky"

One of the most difficult perceptions that women and multicultural entrepreneurs contend with is the misconception that they are riskier investments (to say nothing of their ideas).

Data suggests that firms invest in white men based on potential, but women and people of color only get investment based on demonstrated performance. In a recent analysis of pitch sessions between VCs and entrepreneurs, venture capitalists (women and men alike) tended to ask men questions about the potential for gains, while they ask women about the potential for losses.[12] As Kapor Klein puts it, "If you're a woman or a person of color, you have to de-risk your business before you get investments."

The survey findings bear this out. Investors are twice as likely to believe that minorities perform below the market average compared to non-minorities (19% versus 10%, respectively). The same is true for women versus men (8% versus 4%, respectively).

"There is a pervasive misconception that multicultural and female-owned businesses pose inordinate risks," asserts Harris. Yet in actuality, "by the time a woman or a person of color gets to a VC boardroom to present, that opportunity has been scrubbed down repeatedly such that the operational, business and market risks have largely been accounted for. All that remains is the execution risk that is inextricably tied to the financial risk."

"Yes, I belong"

Studies have shown that men are often believed to be more competent and as having more agency than women.[13] In the tech world, says Darlene Gillard, a founding partner of digitalundivided, "[multicultural] women sometimes go into meetings [and] they have to spend the first half of the meeting explaining how they got there. You know, 'yes, I am actually tech,' and 'yes, I do know blockchain.'" Proving one's credibility and legitimacy is a discussion men don't have to have, and yet another bias they don't have to overcome.

Param Jaggi, who co-founded Hatch Apps, a company in the Multicultural Innovation Lab, saw these biases play out in many of the pitch meetings he attended with his co-founder, Amelia Friedman. "We'd be in a room with an investor, and the investor would look only at me," he recalled. "Then I have to point out that she has all the answers."

Investors told us that confidence and a convincing pitch are more important for women and minorities to demonstrate compared to their counterparts: 14% of respondents said that a "confident applicant" is important when considering businesses in general and that number jumped to 24% for women, 23% for minorities.

12. Academy of Management (April 2018). *We Ask Men to Win and Women Not to Lose: Closing the Gender Gap in Startup Funding.*
13. Sarah Thébaud (February 2015). *Status Beliefs and the Spirit of Capitalism: Accounting for Gender Biases in Entrepreneurship and Innovation.*

The bottom line: A vicious cycle from start to finish

At every stage, from idea to action, these entrepreneurs are less likely to be able to take the same kinds of risks that non-minority male entrepreneurs can; they have less room to innovate and a much smaller margin for error. The disadvantages mount up, as does the human toll of overcoming them, in ways difficult to quantify but easy to imagine. This, predictably, means that investor networks don't change and that successful WMBEs remain the exception rather than the rule.

Consider the experience of Louise Broni-Mensah, a member of this year's Multicultural Innovation Lab cohort, and an alum of Y Combinator (where she and AptDeco Founder and CEO Reham Fagiri from the inaugural Innovation Lab cohort were the first black female founders accepted to the prestigious Silicon Valley incubator in 2014).

Louise's company, Shoobs, is an online clearinghouse for information and ticket sales for urban culture, nightlife and entertainment. She was showing 40% month-over-month growth when she was accepted into Y Combinator, and already had high-profile business partners like Live Nation UK. She walked out with less than $200,000 in funding, a pittance compared to what her male classmates were attracting, including several who couldn't point to the same kind of performance that she could.

Even after she joined Morgan Stanley's Innovation Lab earlier this year and drew up plans to expand Shoobs to New York City, Louise has remained understandably cautious about how she grows her business. "People often say that sometimes female entrepreneurs don't take as many risks as their male counterparts," Louise says. "But I think that has got to do with the lack of funding, because if you have more funding, you take more risks. I have got a list of stuff that I would love to take risks on right now and I just can't. I don't feel comfortable doing it because I don't have access to that capital."

"If women and people of color are given the same opportunities from the go," she continues, "you would see differences in terms of how they take risks in their businesses."

Ten questions investors should ask themselves when evaluating WMBEs

Based on our survey findings, we have identified 10 key questions that we recommend investors consider when reviewing opportunities presented by multicultural and female entrepreneurs. Honest answers may very well open doors to multimillion-dollar opportunities.

1. What is causing me to view this investment as a **risk**?
2. Is my "gut" reaction coming from **experience or perception**?
3. Do I believe that this person **understands this market** and the consumer that this business will serve?
4. How can I **get smart about the market** that this business will serve?
5. How much **previous scrutiny** has this company received relative to my average investment?
6. Am I considering **the value of the diversity** — or lack thereof — of the management team?
7. How much harder, if at all, was it for this woman or person of color to arrive in this pitch room? Does that **journey deserve a premium** compared to other companies and management teams that I have considered?
8. How do I **assess confidence** in a woman versus a man? In a person of color relative to a white entrepreneur?
9. Has this entrepreneur's journey been a function of **risk aversion** fueled by lack of capital or are they **too conservative**?
10. How do **projections** change if this business is appropriately capitalized?

The Business Case for Change

There is no question that the systemic failure to find and fund female and multicultural entrepreneurs represents a market inefficiency. "I don't think people appreciate the inordinate opportunity that's out there," says Harris, "representing or investing in communities and entrepreneurs that haven't had access."

"The next set of emerging markets is right here in the U.S."

– Marc Morial, former Mayor of New Orleans, President and CEO, National Urban League

There are a number of nationwide trends that underscore this opportunity:

- Women-owned businesses now represent 39% of all American firms.[14]
- While the overall number of businesses in the U.S. increased 44% from 1997 to 2017, the number of women-owned businesses increased 114%.[15]
- For black women, rates of business ownership soared 322% between 1997 and 2015, when there were some 1.5 million businesses owned by black women, collectively generating total annual revenues of $44 billion.[16]
- Between 2016 and 2018, the number of businesses founded by black women doubled,[17] while data shows that the total venture capital raised by black women in 2017 increased roughly five-fold, from less than $50 million in 2016 to nearly $250 million.[18]
- And between 2007 and 2017, the number of small businesses owned by minorities jumped from just over 6 million to more than 11 million, an increase of 79%, which was about 10 times the overall growth rate for small businesses in that same time frame.[19]

And it's not that women and people of color are simply starting more businesses despite the many headwinds they face, it's that these businesses are profitable and generate at-or above-market returns:

- Ninety-two percent of investors say that women-owned businesses achieve at-or above-market returns, while 81% say the same of minorities.
- Businesses founded by women ultimately deliver more than two times the revenue per dollar invested than those founded by men.[20]
- A prominent seed-stage venture firm found that teams with at least one female founder did 63% better than all-male founder teams when looking at how much the company values have changed since the firm's investment in them.[21]
- Companies with gender and ethnically diverse executive teams are consistently positively correlated with higher profitability than their peers.[22]

14. American Express (2017). *State of Women Owned Businesses Report*.
15. American Express (2015, 2017). *State of Women Owned Businesses Report*.
16. ProjectDiane2018 (June 2018). *The State of Black Women Founders*.
17. ProjectDiane2018 (June 2018). *The State of Black Women Founders*.
18. Pitchbook (June 2018). *Start-ups founded by black women raised 5x more VC in 2017*.
19. SMB Insights (November 2017). *Minority Growth: The Force Driving Small Business Growth*.
20. BCG (June 2018). *Why Women-Owned Startups Are a Better Bet*.
21. First Round, *10 Year Project*.
22. McKinsey & Co. (January 2018). *Delivering through Diversity*.

Marc Morial points to other sources: "If you look at longitudinal studies of minority and women-owned businesses in America, it demonstrates that their growth rates are faster than the S&P 500." Indeed, a study that analyzed the growth trends of male- and female-owned companies from 1997-2014 found that businesses owned by women saw a 72% growth rate compared to 45% for male-owned companies.[23] Their record on paying back loans is strong as well. Morgan Stanley's own Capital Access Fund, which is administered in conjunction with the National Urban League and the National Development Council, had given out roughly $3.2 million in loans through mid-2018. Not one recipient had defaulted.

Together, these two trends speak to a market that has grown in size and generated strong returns — in spite of being underfunded and overlooked. The opportunity, were we to approach economic parity, is tremendous.

Kapor Klein summarizes it bluntly: "Investors shouldn't be leaving money on the table," she says. And she's ready to counter anyone who might suggest it's hard to source such deals because there aren't enough viable entrepreneurs in these populations. Her answer when asked if she has any problem finding these opportunities: "None. Zero. Zip. We get somewhere near 3,000 pitches a year."

The Trillion Dollar Opportunity

To help put the cost of unequal access to capital into context, consider a scenario where revenues for WMBEs are proportional to their representation in the U.S. labor force. Using data from the U.S. Census Bureau's *2012 Survey of Business Owners* and the U.S. Department of Labor's Bureau of Labor Statistics, we know revenues for women and minority businesses were $2.4 trillion. Had the number of women and minority-owned businesses and portion of revenues matched their percentage in the labor force — 56% — then 2012 gross receipts would have increased to $6.8 trillion, **suggesting a missed opportunity of up to $4.4 trillion.**

23. American Express (2014). *2014 State of Women-Owned Business Report*

The Way Forward

The solution, of course, isn't for investors to fund every woman or multicultural entrepreneur they come across. But it does involve investors making the effort to meet these kinds of entrepreneurs in the first place, and understand the markets they're serving and the new kinds of businesses they're building. The way forward doesn't start with a checkbook; it starts with a commitment to discard old habits and outdated mindsets.

Investors can show their peers that these are sound, considered investments undertaken because of the ideas and innovations their founders bring to the table. And they can signal to these entrepreneurs — and to society at large — that they are basing their decisions on merit and potential, not pedigree, not gender, not skin color. The responsibility to change doesn't fall to investors alone. Public policy has an important role to play in these issues, and entrepreneurs themselves can adapt to better navigate today's landscape. But this is a report written by investors, for investors. The financial industry can't solve the issue, but it can lead the way, and start meaningful change. Here's how:

Set targets, not quotas. Commit to finding these entrepreneurs. VCs can — and should — set targets for the number of WMBEs that they evaluate and the percentage of WMBEs in their portfolios. This approach has proven effective for state and local governments, which have stipulated that a certain portion of contracts go to businesses owned by women, people of color and veterans. Targets maintain awareness and provide a benchmark against which a firm can measure its progress. Quotas force investments, while targets encourage them.

Recognize that both women and people of color need investment. Pattern-matching is an even more acute problem for African American women who are often furthest away from the patterns that most investors are comfortable with. Don't believe you've solved the problem by investing in white women alone.

Hold yourselves accountable for measurable outcomes. Track statistics on how many diverse companies you are seeing and how many diverse companies you're investing in and share those stats with your Limited Partners.

Expand your reach. Eliminate barriers by conducting proactive outreach to more women and people of color. If VC firms are not seeking out relationships with female and multicultural entrepreneurs, the pipeline will never grow stronger. There are a number of ways to seek them out and encourage them to come to you. For example:

- Hold "pitch days" specifically dedicated to women and people of color
- Attend conferences that female and multicultural entrepreneurs attend and present at
- Use investment and commercial banking relationships to source opportunities, especially since it gives you direct exposure to companies that have already passed an initial screen of "readiness."
- Make your intentions known and partner with organizations specifically designed to support women and multicultural entrepreneurs. These partnerships will extend your network and provide you with guidance.

Reconsider your screens. Expand the criteria for evaluating potential investment opportunities. This requires a shift in your mindset from valuing entrepreneurs based on their pedigree — like a degree from a certain university — to the hard skills they bring to the table and the caliber of their ideas.

Investors would also be well served to take into account:

- The intrinsic or experiential knowledge of the market or product;
- An entrepreneurs' exposure to the problem that the business is solving; and
- The value of diverse founding teams.

Be transparent. Be clear about what you're looking for — the process and criteria for securing an investment remains a mystery for many. If you know before taking a meeting that the company isn't a fit for you, don't take the meeting and be upfront with the entrepreneur about why their company is not the right fit for you.

Provide descriptive and prescriptive feedback. Level the playing field by offering feedback that entrepreneurs can use to strengthen their pitches. Taking time to educate founders could yield you more than your investment of time and capital. Doing so may also lead more investors to reflect and really consider *why* they're passing up opportunities to invest.

Hire more women and people of color to be part of your fund. There must be a concerted effort to build a diverse pool of investors who can help generate a natural pipeline of women and multicultural founders, as well as bring different perspectives to the fund. At Kapor Capital, which funds an outsized portion of WMBEs, the deal flow is traceable to the demographics of their partners. When the investor community starts letting more diverse investors sit at the table, we'll see measurable progress in the funding gap.

Appendix

Survey Methodology

Using the U.S. Census Bureau's 2012 Survey of Business Owners (SBO), which is conducted every five years and is the most recent data set available, we estimated the potential cost of inequality (opportunity) to our economy.

Online survey of 101 investors and 168 bank loan officers (BLOs) between August 20 and September 13, 2018.

Given that a primary objective of the research was to understand experiences and opinions of investors who evaluate women and minority-owned businesses in the early stages of the business cycle, we included screening criteria for investors based on the firm's minimum capital investment size.

Investors are defined as:
Bankers at investment banks, retail banks or commercial banks who provide capital to businesses, evaluate potential investment opportunities and make a minimum capital investment of $5 million or less.

PE professionals who evaluate potential investment opportunities and make a minimum capital investment of $25 million or less. A majority (85%) of the PE professionals surveyed provide growth or mezzanine financing to businesses.

VC investors who evaluate potential investment opportunities and make a minimum capital investment of $5 million or less. A majority (89%) of VC investors surveyed provide seed, start-up or early stage funding to businesses.

Family office investors who evaluate potential investment opportunities and make a minimum capital investment of $5 million or less.

Bank loan officers are defined as:
Bankers who provide loans or lines of credit to businesses in their job and have sole or shared responsibility in the decision-making process at their firms when it comes to providing businesses with either a loan or a line of credit.

Methodology for Opportunity Calculation

Using the U.S. Census Bureau's 2012 Survey of Business Owners (SBO), which is conducted every five years and is the most recent data set available, we estimated the potential cost of inequality (opportunity) to our economy.

These figures are **not meant to make definitive claims or predictions about the market; rather, they should be viewed as points of reference** to allow readers to put the situation into perspective.

To understand the economic parity, or the ideal, percentage of women- and minority-owned businesses, we reference labor force percentages. Statistics from the 2015 Bureau of Labor Statistics indicate that 42.7% of the labor force is white men, while 56.5% comprises women and minorities. We did not use U.S. population data (currently 36.7% white male; 63.3% women and minority), which takes into account nonworking populations like children and the elderly.

Census data from the 2012 SBO indicates that total revenues (defined as sales, receipts, or value of shipments of firms with or without paid employees) from male-owned and female-owned U.S. businesses (which excludes publicly held companies and other firms not classifiable by gender, ethnicity, race and veteran status) equaled approximately $11.9 trillion. To produce a separate revenue statistic for women and minorities combined, we added women-owned business revenue numbers to those of male minority-owned businesses.

Actual revenues for women and minority-owned businesses were $2.4 trillion in 2012. Hypothetically, if the revenue of women and minority-owned businesses were proportional to their percentage in the labor force — 56% — then revenue would have increased to $6.8 trillion. This is an increase of $4.4 trillion.

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Appendix

In-Depth Interviews

Abiodun Johnson. CEO & Co-Founder, Co-Sign. (Morgan Stanley Multicultural Lab Participant).

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Elizabeth Durand Streisand. Co-Founder & CEO, Broadway Roulette. (Morgan Stanley Multicultural Lab Participant).

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Marc Morial. President and CEO, National Urban League.

Param Jaggi. CEO, Hatch. (Morgan Stanley Multicultural Lab Participant).

Rhoden Monrose. Founder & CEO, CariClub. (Morgan Stanley Multicultural Lab Participant).

Rica Elysse, CEO, BeautyLynk. (Morgan Stanley Multicultural Lab Participant).

Richelieu Dennis. CEO, Sundial Brands. (Morgan Stanley Access and Opportunity with Carla Harris Podcast)

Salisa Berrien. CEO, COI Energy. (Morgan Stanley Multicultural Lab Participant).

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