The Viability of the Minority-Oriented Venture-Capital Industry Under Alternative Financing Arrangements*

By

Timothy Bates, Distinguished Professor
Wayne State University
College of Urban and Labor
3198 Faculty Administration Building
Detroit MI 48202
#313 577 0769
Tim.bates@wayne.edu

and

William Bradford, Endowed Professor
University of Washington
Department of Finance
203 Mackenzie Hall
Seattle WA 98195
#206 543 4559
Bradford@u.washington.edu

*Financial assistance from the E.M. Kauffman Foundation is gratefully acknowledged as is the research assistance of Jannel Lee Allen.

ABSTRACT

The minority business-oriented venture-capital (VC) industry grew rapidly in the 1990s, as did their target market of large-scale minority-owned firms. This niche of the venture-capital industry has traditionally relied upon the U. S. Small Business Administration (SBA) for funding and guidance. In the 1990s, another branch of the minority VC industry arose that was funded largely by public pension funds. Our comparative analysis of the SBA and pension fund branches of the VC industry indicates that the former is stunted while the latter is thriving. Our analysis indicates that the SBA is too unstable an agency for promoting the minority venture-capital industry. In contrast to SBA's propensity to alter policy based on shifting political priorities, the pension funds have been a stable, reliable source of support for the growing minority venture-capital industry.

A. Introduction

From its inception in 1970 through the early 1990s, the segment of the venture-capital industry that financed minority business enterprises (MBEs) relied upon government sponsors for funding and direction. Nearly all of the minority-oriented venture-capital funds were chartered by the U.S. Small Business Administration (SBA) and operated within its regulatory framework. Over the past decade, the minority venture-capital industry has transformed itself, largely shedding its reliance upon SBA funding while adopting the organizational framework – the partnership – of the mainstream venture industry. Why did this transformation take place and what were its consequences?

This study utilizes detailed survey information describing minority venture-capital funds to illuminate the causes and consequences of its transformation. As the industry has moved away from reliance upon the SBA, average fund size and the aggregate industry capitalization have both increased dramatically. A dynamic, profitable minority venture-capital industry emerged by year-end 2000; after-tax net income for the collective SBA-chartered industry in 1993, in contrast, was negative (Bates, 1997). Funding provided to MBEs has soared in recent years.

Our analysis compares the performance of SBA-chartered minority venture-capital funds to those beginning operations in the 1990s that chose not to be SBA chartered. We find that the latter group was heavily shaped by the public sector. We do not seek to promulgate the advantages of unfettered free enterprise over the burdens of public-sector partnership. Our findings, instead, point out how differing public-sector strategies have served to impact the minority-business development mandate of the minority venture-capital industry. We conclude by recommending that the SBA model, and its close relatives throughout the public sector, be altered (or abandoned) in favor of far-sighted government policies that reward venture-capital funds for financing viable small businesses.

B. The MESBIC/SSBIC Industry

The birth of the minority-oriented venture-capital industry traces back to President Nixon's first urban initiative, Project Enterprise, which was launched by executive order on November 6th, 1969. One result was the creation in 1970 of the Minority Enterprise Small Business Investment Company (MESBIC) program. MESBICs were privately owned investment companies, chartered by the SBA, devoted to investing patient capital – venture capital and long-term debt – in black-owned businesses. By 1972, MESBIC's mandate had been expanded to "facilitate capital formation in the minority community" (Hansley, 1992, p. 2; cited in Bates, 1997). In practice, patient capital was extended largely to black and Hispanic-owned firms as well as a few nonminority-owned businesses that operated in urban minority communities.

Private capital invested in MESBICs was leveraged by SBA funds, and MESBICs actively making equity (venture capital) investments in MBEs were favored over debt providers when the SBA provided matching funds. In theory, the MESBICs and the SBA were partners pursing the common objective of financing MBEs. In practice, the SBA was a regulator – not a partner – and the contents of its regulations were moving targets, keeping MESBICs guessing as to what their operating parameters were at any point in time (Bates, 2000).

Pioneering studies of state venture-capital programs, undertaken by Peter Eisinger in the 1980s, noted a profound deficiency in their political viability. At first glance, these programs pursued the same objectives as a variety of government interventions into the private sector: the state venture-capital programs sought to stimulate business formation, job creation, and tax-base expansion. Yet, there was a major difference. Venture-capital investment is the ultimate form of patient capital, with returns – if they are forthcoming – often not realized until seven or more years after the initial investment. "By contrast," notes Eisinger, "the political culture of states stresses short-term achievements, useful as ammunition in the electoral cycle" (1993, p. 137). Venture-capital programs often lacked a strong political constituency. Priorities changed; budget crises came and went; venture-capital programs withered in this political environment. Regarding reasons for defunding state venture-capital (VC) programs, "claims of effectiveness or lack thereof did not figure in the actual decisions to terminate…" (Eisinger, 1993, p. 135).

The MESBIC program, like the state VC programs analyzed by Eisinger, repeatedly felt the impact of shifting political priorities. SBA funding policies that promoted venture-capital investments during the 1970s had evolved, by the 1980s, into funding practices that undermined MESBIC venture-capital investments (Bates, 1996). Executive and legislative branch support for the MESBIC program witnessed in the 1970s was replaced, during the Reagan administration, with numerous efforts to kill the program entirely. Renamed the Specialized Small Business Investment Company (SSBIC) program, Congress attempted to reform and revitalize the program in the late 1980s. In 1995, finally, it was merged into the Small Business Investment Company (SBIC) program by the Clinton Administration. Following this seeming downplaying of minority venture capital, the Clinton White House, in the same time period, was creating its own version of community development financial institutions (CDFIs), some of which closely resembled MESBICs of the Nixon Era (Bates, 2000).

An entirely different type of government institution – the pension fund – surpassed the SBA as the nation's predominant funding source for the minority-oriented venture-capital (VC) industry during the 1990s (Bates and Bradford, 2003). Alteration of the "prudent man" rule by the U.S. Department of Labor in 1979 opened the door to pension-fund investment in venture capital. A 1989 survey of the 126 largest public pension funds in the country revealed that 14 of them held investments in venture capital (Institute for Fiduciary Education, 1989; cited in Eisinger, 1991). The boldest of this subset were on the threshold of revolutionizing the minority-oriented venture-capital industry. In 1992, the California Public Employees Retirement System (CALPERS) invested $25 million each into two minority-focused VC funds -- Fairview Capital in Connecticut and Bastion Capital of Los Angeles (Hellman, 1999). For the first time, minority-oriented VCs were being viewed as competitive investment opportunities by a public pension fund.

Public pension funds were initially prodded to make in-state investments in venture capital (as well as residential mortgages) by public officials and constituent groups (Rosentraub and Shroitman, 2004). Most were initially uneasy with the concept, feeling that political pressure to fund an in-state economic development agenda might conflict with their fiduciary responsibilities to retirees (Eisinger, 1991). The priorities of pension fund managers are clear and invariant: they seek attractive monetary returns when they invest funds in venture capital. Resistance dropped only after some of the pioneer public pension funds realized attractive returns on their venture-capital investments. The minority-oriented venture-capital funds have gained credibility with pension funds by providing such returns (Bates and Bradford, 2003).

Investments from public pension funds are attractive to the minority-oriented venture-capital industry, in comparison to SBA funding, for several reasons. First, the problem of ever-shifting political priorities – manifested as inconsistent SBA regulations and policies – has not plagued pension funds. To please the public pension funds, the minority-oriented VC funds are required to deliver attractive financial returns.

Second, pension funds have long time horizons. Reflecting their obligations to retirees, present and future, public pensions funds are long-term investors, seeking a stream of returns on their investments that stretches over decades. A venture-capital investment return period of seven or eight or nine years is not a problem.

Third, investing, via venture-capital funds, in minority-owned businesses is politically popular in states having substantial minority populations. Although a secondary consideration that is outweighed by rate-of-return considerations, the political value of being recognized as a funding source for MBEs is by no means a trivial consideration for state pension funds. In all cases, the pioneer funds that financed minority-oriented VCs in the early 1990s operated in states having large and politically influential minority constituent groups. MBE-targeted public pension fund investing, in light of its popularity and attractive financial returns, has grown rapidly.

C. Minority-Oriented Venture-Capital Funds: Comparison of Funds Chartered by the SBA and Funds Established as Partnerships

Our comparative analysis of the SBA-affiliated versus private partnership minority-oriented VC industry began with a survey in 2001 of 50 venture-capital funds operated by active members of the National Association of Investment Companies (NAIC). Members of the NAIC are privately owned investment companies bound together by their shared interest in financing MBEs. Founded in the 1970s, all of the NAIC members were initially MESBICs. Reflecting the trend away from SBA affiliation that began in the 1990s, most NAIC member funds today have no SBA ties (Bates and Bradford, 2003).

Our front-end survey sought to identify NAIC member funds that were: 1) actively investing venture capital (equity capital) in small businesses; 2) targeting their investments largely to MBEs; and 3) investing with a primary focus on generating attractive monetary returns. Of the 50 surveyed venture-capital funds, 48 responded and 36 passed the three-part test for inclusion in our broader analysis. Funds were most often excluded because their investments in MBEs were more debt (than equity) oriented; several were excluded because their investment focus was industry (or geographic area) specific, and MBEs were not the primary recipients of their investments. Of the 36 qualifying funds, 24 responded to our more detailed questionnaire; 10 of these responding to our 2002 survey were SBA chartered and 14 were not (Bates and Bradford, 2003).

A brief explanation of sources and uses of financial capital among venture-capital funds is in order. Small business investment companies chartered by the SBA must initially raise capital from private sources – banks, insurance companies, and private corporations most often. Private capital in hand, they then obtain a charter from the SBA, which conveys the right to borrow from the SBA at subsidized rates. Back in the 1970s, MESBICs most often raised capital by selling preferred stock to the SBA. Since the 1980s, SBA capital was forthcoming, most often, in the form of loans to MESBICs; typically, those loans carried interest rates close to the borrowing costs of the U.S. Treasury (Bates, 1996). Private investment dollars leveraged by the SBA (sources of funds) were then used to make equity and long-term debt investments in MBEs (uses of funds).

Among the 10 surveyed SBA chartered funds analyzed in this section, note that only six utilized SBA funding (table one). MESBICs <u>not</u> selling stock to or borrowing from the SBA were most often divisions of commercial banks. Traditionally, banks were not allowed to make equity investments in businesses <u>unless</u> they did so via a SBA-chartered small business investment company such as a MESBIC.

Venture-capital funds not chartered by the SBA are commonly set up as partnerships. The <u>general partners</u> are the ones who establish these funds, raise capital from investors, and utilize that capital to make equity investments in firms such as MBEs. The <u>limited partners</u> are the institutional investors – pension funds, insurance companies, and banks – that provide the bulk of the capital that is used to make the venture-capital investments. If those investments turn out to be profitable, the general partners and the limited partners split them. A common arrangement is for the limited partners to retain 80 percent of the profits, while the general partners collect 20 percent, plus a small fee for managing the venture-capital fund. Among the 14 minority-oriented partnership VC funds analyzed in this section, well over half of their aggregate investment capital was raised from public pension funds.

1. Sources of funds

Beyond public pension funds and the SBA, where do the minority-oriented VCs raise financial capital? Note (table one) that seven VC funds raised capital from an institutional source known as a "fund of funds". Public pension funds often seek to diversify the risks of their investments in minority VC funds by providing capital to a fund of funds. This intermediary is selected because of its knowledge of the VC industry, and it uses its public pension fund dollars to invest in minority-oriented VC funds. Thus, a public pension fund might invest $100 million directly in a minority VC fund. Alternatively, the pension fund may choose to invest in the minority-oriented VC sector by investing $100 million in a fund of funds, which, in turn, invests $25 million each in four different minority-oriented VC funds. Investing directly or via a fund of funds, the public pension funds invested more capital into the 14 partnership minority-oriented VC funds than all other sources combined (table one).

[Table one about here]

When we undertook this study, we expected to find that the minority-oriented VC funds holding SBA charters were capitalized primarily with government funds. Partnerships, we thought, would draw their funding primarily from private-sector institutional investors. Our findings indicated otherwise. Among the 24 funds surveyed for this study, the 14 partnership VC funds attracted the majority of their capital from public pension funds, while the ten with SBA charters raised less than 30 percent of their capital from government sources (table one).

An earlier survey of its membership was conducted in 1999 by the NAIC to determine the sources and dollar amounts of initial capitalization that had launched its members' funds. Reflecting all fund startup capitalization raised since the inception of MESBICs in 1970, 34 responding funds reported capitalization of $1,242.0 million raised from ten sources (table two). As of yearend 1998, over 50 percent of this industry capitalization ($629.9 million) had been contributed by public pension fund direct investments in minority-oriented VC funds. SBA funding – traditionally dominant – accounted for roughly five percent of the industry's capitalization (table two). Banks, insurance companies, and corporate pension funds -- in addition to public pension funds -- were more important suppliers of capital, for the minority-oriented VC industry, than SBA funding.

[Table two about here]

The VC funds that we surveyed in 2001 pursued widely differing strategies in their search for capitalization. Among the ten SBA-chartered funds, none had received pension fund money, either directly or through a fund of funds intermediary. Banks and insurance companies provided nearly half of their aggregate capital; the SBA and private corporations provided most of the rest (table one). Among the partnership VC funds, in contrast, capital was raised from a broader array of private and public funding sources (table one): four of these 14 funds tapped five or more sources each. Based upon the survey responses, a partnership VC fund seeking to raise capital from institutional investors would be well advised to approach four types: 1) public pension funds, 2) banks, insurance companies, 3) fund of funds, and 4) corporate pension funds. Note that bank funding of minority-oriented VC is shaped by public policy considerations: the investments made by banks typically qualify for Community Reinvestment Act credit.

2. Uses of funds

Stark differences in overall fund size and individual investment size typify VC funds chartered by the SBA, versus those set up as partnerships. The average partnership minority-oriented VC fund had over six times the capitalization of the VCs chartered by the SBA -- $11.9 million versus $80.6 million (table three). Thus, the shift in the minority-oriented VC industry from its SBA origins to its present-day public pension fund-supported partnership form has coincided with an increase in capital resources. The average venture-capital investment in MBEs undertaken by the partnership VC funds, furthermore, was nearly four times larger ($1,504,000) than the SBA fund average ($390,900) – see table three.

[Table three about here]

We collected detailed cash outflow and inflow information on each of the small business investments made by the 24 surveyed minority-oriented VC funds. We used this information to calculate financial returns on investments made during the 1989-1995 period that had been realized by yearend 2000. Thus, the investments included in our financial return calculations were at least five years old by yearend 2000 (Bates and Bradford, 2003).

Eleven of the surveyed minority-oriented funds made realized venture-capital investments that were at least five years old by yearend 2000, and a total of 118 small businesses received these investments. Multiple investments by a fund in one firm were treated as one investment. For the 118 investments, we report in table three the average amount invested, amount realized, and net cash yield for the VC investments made by SBA-chartered and partnership funds. All of the investments described in table three had been "harvested" (sold or otherwise liquidated).

For the SBA-chartered funds, the average investment made in MBEs was for $390,900, and this investment at maturity yielded $1,290,100, generating a net yield of $899,200. Among the partnership VC funds, in contrast, the amount invested in the average deal was $1,504,000, and this investment yielded a gross payoff of $4,503,300 when it was realized; the average net yield, therefore, was $2,999,300 (table three). Note, however, that the variances attached to these mean dollar amounts were large.

The minority-oriented VCs invest hundreds of thousands of dollars into the average MBE venture-capital recipient, and these investments are often held for seven or more years before they are realized. In many cases the initial outlay never is recouped. The payback of a VC investment – defined simply as the amount that an investment returns when it is realized minus the amount initially invested – was calculated for each of the 118 investments under consideration. A one million dollar investment that returns $100,000 when it is realized, for example, has produced a payback of minus $900,000. Among the partnership VCs (table three), only 50 percent of the investments in MBEs produced positive paybacks; for the SBA-chartered VCs, 56 percent of them generated positive paybacks.

Why would a venture-capital fund invest large sums into risky investments that take years to pay off when, in fact, roughly half of these investments never do produce a positive payback? Such investing makes sense only if some of the VC investments produce extremely high yields. Such high yields are, in fact, apparent in the net gain figures reported in table three. Note that the partnership funds invested, on average, over $1.5 million per MBE venture-capital recipient (table three) and only 50 percent of those yielded positive paybacks. Yet the average amount realized per deal was over $4.5 million, yielding a net gain of nearly three million per investment (table three).

These return figures ignore the time value of money, which is vitally important for judging the profitability of such long-term investments. Discounting the cash inflows and outflows of the 118 venture-capital deals at a 20 percent rate yielded average residual values of $250,472 and $174,332, respectively, for the partnership and SBA-chartered fund investments (table three). The average return per venture-capital investment exceeded a 20 percent annual rate of return threshold. Obviously, many of the VC investments yielded handsome returns.

In the venture-capital industry, the standard benchmark for profitability is the internal rate of return (IRR). We have calculated IRRs for each of the 118 venture-capital investments, where the IRR is defined as the discount rate at which the investments' cash flow returns equal the cost of the investment. For the empirically common case of the negative cash flow VC investment, the resultant IRR, of course, has a negative value.

Our calculations of mean and median IRRs for the individual investments of the minority-oriented venture capital funds yielded mean IRRs of -1.7 percent and 7.9 percent, respectively, for the SBA-chartered funds and the partnership funds; corresponding median IRR values were 6.4 percent and 2.3 percent. These unimpressive IRR descriptive statistics – perhaps suggesting low rates of return on VC investments in

MBEs – are depressed, in part, by the large number of deals lacking positive paybacks (table three). The nature of venture-capital investing is more clearly understood by delineating the generally higher returns produced on larger investments from the generally lower returns produced on smaller ones (Bates and Bradford, 2003).

Consider a VC fund that has realized only two investments: $50,000 was invested in one deal, resulting in an IRR of -30 percent, while two million dollars was invested in the second deal, producing an IRR of +30 percent. Calculation of mean and median IRRs, in this case, produces values of zero and zero, and yet, the two deals (pooled) yielded substantial profits to the VC fund. Interpretation of IRR statistics is tricky, and the fact that IRR values are insensitive to investment size is simply one of several common problems that arise when interpreting IRR values (Bates and Bradford, 2003). Pooling of investment cash flows can often clarify whether VC investment returns are attractive or paultry.

For the 118 VC investments under consideration, we treated all of the cash inflows and outflows as two big investments (i.e., pooling the investment cash flows), one for all SBA-chartered funds and one for partnership funds. From this framework, we calculated IRRs. The overall IRRs for SBA-chartered funds and partnership funds were 33.7 percent and 26.2 percent respectively. The larger deals dominated the smaller deals: the larger gains registered by many of the positive payback VC investments swamped the small losses generated by many of the negative payback VC investments. We are left with high overall rates of return from both the SBA-chartered and the partnership branches of the minority-oriented venture-capital industry. Once again, we conclude that

VC investments in MBEs are highly profitable overall in the time period under consideration.

D. VC Investing in MBEs: The Nature of the Target Market

The target market for venture-capital investments constitutes a small subset of the nation's minority business community. VC funds seeking to invest in MBEs commonly target firms whose owners and top managers have strong educational credentials and considerable managerial expertise. In addition, firms receiving investments from the minority-oriented VCs commonly have annual sales in the one million dollar plus category, as well as excellent prospects for future growth in sales revenues (Bates and Bradford, 2003).

Among black-owned businesses, Census Bureau data indicate that only 8,682 of the 800,000 plus firms covered by the 1997 economic census generated annual revenues exceeding one million dollars (U.S. Bureau of the Census, 2001). Yet this subset – barely one percent of all black-owned businesses – employed 384,424 of the 718,341 workers on the payrolls of black businesses in 1997. These 8,682 firms not only accounted for 53.5 percent of all jobs generated by the nation's black business community; they also were expanding at roughly six times the rate of black firms generating under one million dollars in annual sales. Helping to finance this high rate of firm growth (and job creation) is the task of the minority-oriented venture-capital industry.

E. Why is the Minority-Oriented Venture-Capital Industry Moving Away from SBA Charters?

The SBA chartered VC funds analyzed in this study are solidly profitable. Analysis of realized investments in MBEs, summarized above, revealed that the average VC investment of $390,900 yielded, at the point when it was sold, a net gain of $899,200 (table three). Recognizing the time value of money, the investments of the SBA-chartered VCs were subjected to net present value and IRR tests of rates of return. By either measure of profitability, average returns were high, actually exceeding average returns reported by minority-oriented partnership VCs in the case of the IRR measure (table three).

SBA-chartered minority-oriented VCs are clearly decreasing, while the partnership minority-oriented VCs have become dominant in the industry. Traditionally the major source of funds for minority-oriented VCs, SBA funding accounted for only about five percent of the industry's capitalization in yearend 2000. Public pension funds now dominate as the source of capital for minority-oriented VCs, while banks and insurance companies rank second (table one). The SBA-chartered minority VCs are fading into oblivion and the reasons behinds this development appear to reflect the concerns voiced by Eisinger (1991; 1993) over a decade ago: shifting political priorities decimated the industry.

In this study of 24 minority-oriented VC funds, 10 of them are SBA-chartered and 14 are partnerships having no SBA affiliations. Looking solely at minority-oriented VC funds established before 1996 – 11 funds – eight were SBA-chartered and three were partnerships. Among minority-oriented VC funds chartered from 1996 to 2000, in contrast, (13 funds) two were SBA-chartered and the remaining 11 were partnerships (table four). Obtaining a charter from the SBA was traditionally the norm for minority-oriented VC funds; now it is a rarity. What caused the change?

[Table four about here]

Recall that the attraction luring small business investment companies to form and seek charters under the MESBIC program was the promise of cheap matching funds from the SBA. MESBICs most often tapped SBA funding by selling preferred stock to the SBA. While the preferred stock was legally a balance-sheet liability for the MESBICs, it was attractive because it required payment of only a three percent dividend to the SBA, <u>and</u> this dividend payment could be legally deferred during the early years of operations. The SBA's willingness to buy preferred stock from MESBICs declined dramatically during the 1980s, and this funding source was effectively dead by 1989 (Bates, 1996).

In its place the SBA offered small amounts of expensive debt financing to MESBICs in the 1990s, and even that source of funds was unreliable. Because expensive debt financing was inappropriate for funding equity investments in MBEs, VC-oriented MESBICs were forced to seek new sources of financial capital (Bates, 1997).

Thus, the minority-oriented venture capital industry entered the 1990s in a crises state because its traditional source of cheap capital – SBA-subsidized funds – had dried up. Congress facilitated the industry's search for new funding sources by passing into law in 1989 the preferred stock repurchase program. This enabled MESBICs to repurchase their outstanding preferred stock (all of which was owned by the SBA) at a discount. The minority-oriented VCs had to buy back this preferred stock before they could realistically begin their search for new funding sources. As preferred stock owner, the SBA had a claim on all payouts of profits generated from venture-capital investments – present and future. Public pension funds – like other institutional investors – would not fund the venture-capital investments of MESBICs, knowing that the profits generated by those investments were subject to prior claim by the SBA. Congress passed the preferred stock repurchase program to allow the MESBICs to wipe out the SBA's claim to those profits (Bates, 1996).

Once the repurchase program was implemented by the SBA, many MESBICs bought back their stock for 35 cents on the dollar. Upon retiring their SBA preferred stock, some of the MESBICs dropped their charters and terminated relations with the SBA entirely. The buyback program not only enabled MESBICs to extinguish SBA claims on payouts of profits; it also resulted in dramatic shrinkage of the liabilities on the balance sheet of MESBICs, thus increasing their attractiveness to private investors. Thus, Congress had passed and the SBA had implemented a preferred stock repurchase program that potentially opened up vast new possibilities to attract funds into the minority VC industry.

A sympathetic Congress had indeed given the MESBICs a golden opportunity to restructure and diversify their sources of funding. The *manner* in which the SBA administered the preferred stock repurchase program, however, destroyed that potential. Most of the damage was rooted in the fact that it took the SBA investment division five years to implement the new program. The repurchase program (Public Law 101-162) was passed in November 1989; the first MESBIC permitted to repurchase its preferred stock did so in June of 1994. MESBICs poised to restructure were left in limbo for five years (Bates, 1996).

During this five year period, the repurchase pricing formula – determining what each MESBIC would pay to repurchase its stock – bounced around from under 35 percent of the preferred stock face value to over 60 percent. Permissible methods of payment for stock repurchase were left unclear, keeping the MESBICs in a state of perpetual turmoil. Another source of ongoing change and uncertainty was the staff assigned by the SBA to implement the stock repurchase program. Primary oversight for the repurchase program changed from SBA Associate Administrator for Investment Robert Lineberry to his successor Berky Kalik in 1990, to Wayne Foren in 1991, and Robert Stillman in 1994. Stillman, in turn, delegated program responsibility first to the office of investment director, Joseph Newell, in early 1994 and then to special assistant to the office of investment Ed Cleveland later that year. The specified group of SBA analysts actually handing the repurchase applications underwent numerous changes as well.

Changing repurchase transaction conditions and terms and administering personnel created a period during which MESBICs in the program often found it impossible to infuse any type of financial capital – from pension funds or SBA or private sources – into their funds. In response, some discontinued operations. Overall, the SBA provided something of a blueprint for limiting a program's success: 1) delay implementation as long as possible; 2) continually change those responsible for program oversight and implementation; 3) constantly change the program rules (Bates, 1996).

Implementation of the preferred stock repurchase program produced a five year funding freeze for the MESBIC portion of the minority-oriented VC industry. Relations between the MESBICs and SBA had been poisoned. In response to five years of SBA paralysis, the stronger minority business investment companies began to exit from the

MESBIC program, transforming themselves into purely private small business investment companies. The weaker MESBICs often failed outright or abandoned their SBA charters.

Repurchase program veteran Donald Lawhorne, head of Dallas MESBICs, observed, “Political winds may change; fresh input may seek to reshape the MESBIC program; the SBA’s long-term career bureaucrats undermine all of this” (quoted in Bates, 1998, p. 99). MESBICs that survived the restructuring period and retained their SBA charters, finally, never did succeed in tapping the public pension funds for capital. Restrictive SBA regulations continued to scare off potential pension fund investments (Bates, 1996).

F. The SBA Model is Profoundly Flawed

The driving force behind rapid growth of the minority business community lies in the expanding pool of college educated, professionally trained, managerially experienced minorities seeking to start their own businesses (Greene and Owen, 2004). Growth is most rapid at the high-end: employer firms grossing over one million dollars in annual sales revenue are particularly prominent. Serving the financing needs of these high-end MBEs, minority VC funds have expanded rapidly in size and scope (Bates and Bradford, 2003).

The SBA-chartered venture-capital funds described in this report have clearly prospered in the 1990s (table three). Examination of the plus and minus aspects of SBA affiliation certainly must recognize this solid financial performance. Yet we believe that strong financial gains from actual venture-capital investments were overshadowed, for the MESBICs, by SBA-imposed constraints that limited their ability to finance high-growth minority-owned firms.

These constraints stand out clearly when SBA-affiliated minority VCs are compared to their private partnership peers. First, the average SBA fund reported a capitalization of $11.9 million versus $80.6 million for the minority-oriented VC partnership funds. Average amount invested in venture-capital deals, similarly, was much lower for the SBA-chartered funds, relative to the partnership funds (table three). Small overall fund size and small deal size are reflections of SBA constraints on the fund-raising activities of the MESBICs. Despite their profitability, the SBA-chartered funds have been locked out of the funding source – public pension funds –that has been the primary pool of financial capital underwriting the growth of the minority-oriented VC industry.

The administrative competence of the SBA's investment division – implementers of the infamous preferred stock repurchase program (section D above) – has certainly been an impediment for the SBA-chartered funds. Yet their minimal ability to fund and oversee the MESBIC industry is broadly symptomatic, we believe, of more fundamental problems – shifting political priorities and the absence of powerful political constituencies dedicated to protecting and expanding the minority venture-capital industry. The result is a crippled group of MESBICs lacking the resources to participate meaningfully in the rapidly growing market for financing the equity-capital needs of large-scale MBEs.

Furthermore, we are cautious about interpreting their profitable record of venture-capital investing as evidence of success among SBA-chartered VC funds. The ten SBA-affiliated funds examined in this study are a subset of what was previously a much larger MESBIC industry. They are the survivors of a Darwinian sorting-out process that left a trail of widespread MESBIC-fund failure and forced liquidation in the 1980s and 1990s (Bates, 1997). The fact that a handful of well managed VC funds actually survived and prospered under SBA's stewardship is not, by itself, evidence of MESBIC program success.

As a final exercise, we utilize OLS regression analysis in this section to identify the fund characteristics that help to predict the IRRs of realized individual VC investments. What traits are associated with higher IRRs? Does the SBA charter trait predict higher or lower IRRs, other things equal?

Discussions with VC fund managers indicate that their preferred VC investment size is in the one-to-two million dollar range, considerably more than the $390,900 average typifying the investments of SBA-chartered funds. Larger investments, we hypothesize, are associated with higher IRRs, other things equal. Fund status as a SSBIC requires adherence to restrictive and changing SBA regulations, which, we hypothesize, depresses IRRs, other factors constant. The bigger funds, finally, may benefit from the greater diversification opportunities achievable through their larger scale of operations.

Among the 118 venture-capital investments under consideration, communications firms were more likely to receive equity investments than any other line of MBEs. In 1982, favorable tax benefits became available to minority firms purchasing broadcast properties, effectively subsidizing such transactions. The minority-oriented VCs participated in these transactions and learned the economies of the industry. Although Congress repealed the tax benefit in 1995, many of the 118 VC investments under consideration were made while it was in effect. Thus, a defunct tax benefit may be shaping the returns generated from financing MBE purchases of communications firms, and the funds specializing in such transactions may be impacted. We control for this in our regression analysis: VC funds are considered to be communications oriented if 40 percent or more of their investments (by dollar volume) were in that industry segment.

VC funds attempt to moderate their investments risks by alleviating information asymmetries (Gompers and Lerner, 1999). This is done by monitoring their clients; monitoring tools include general partners taking seats on the firms' board of directors, participating in client firms long-range planning, and, when necessary, participating in day-to-day management decision making. For each of the VC funds under consideration, data were collected on whether these types of monitoring were undertaken never, sometimes, or often. Funds scoring relatively high in such monitoring activities were identified as "highly active" with MBE portfolio firms. The highly activities funds, we hypothesize, generate higher IRRs on VC investments, other things equal (Bates and Bradford, 2003).

Several fund traits used as regression analysis explanatory variables have potentially conflicting impacts upon venture-capital investment IRRs. The minority-oriented VCs, for example, participate actively in syndication of venture-capital investments with other minority-oriented VC funds. The big funds that originate most of the syndicated investments may keep the best deals for themselves or, alternatively, syndicate large deals without respect to quality in order to diversify their portfolios broadly. We hypothesize that the funds originating syndicated investments (syndication lead funds) generated higher IRRs, other things equal, that other funds. Minority-oriented VCs invest most often in communications: there may be advantages rooted in past tax breaks; specialization may be advantageous: alternatively, broader industry diversification may be a preferable strategy. High levels of general partner involvement in the affairs of their portfolio companies, finally, may reflect either the need to work out problem investments, the positive value of general partner expertise, or both (Bates and Bradford, 2003).

Table five presents the regression analysis results explaining IRRs for the individual small-business investments undertaken by the minority VC funds. We have divided the SBA-chartered fund identifier variable into two separate variables delineating 1) SBA-chartered funds utilizing SBA funding from 2) SBA funds that did not rely upon SBA funding. The noteworthy finding is that VC funds investing money provided by the SBA generated lower IRRs on their venture-capital investments than other funds, other factors constant. Being SBA chartered per se was not related to lower returns. Rather, the more specific circumstance of relying upon SBA as a funding source -- and thereby being exposed to applicable restrictive rules and policies -- was linked to lower returns.

[Table five about here]

Other regression analysis findings indicate, first, that larger venture-capital investments earned higher yields (table five). Second, investments by VC funds that were highly active in the affairs of their portfolio companies had higher IRRs, other things equal. Third, the investments of communications-oriented funds had lower IRRs than investments of diversified minority VC funds.

A minority-oriented VC fund generating above average IRRs on its small business investments can be described as 1) not accepting funding from the SBA, 2) taking a highly active role in the affairs of its portfolio companies, 3) making investments in the $ one million plus range per firm (above the $390,900 average firm investment of SBA-chartered funds), and 4) investing in a range of different industries (see, also, Bates and Bradford, 2003). The weaker performance of funds raising capital from the SBA is consistent with the fact that few minority-oriented funds started since 1995 have chosen to affiliate with the SBA.

G. Concluding Remarks

Government policies have always shaped the ability of minority oriented venture-capital funds to raise financial capital from institutional investors in order to fund their investments in MBEs. The Community Investment Act encouraged commercial banks to become a funding source for this niche of the venture-capital industry. In the 1970s, SBA funding launched the minority oriented venture-capital industry. Public pension funds, finally, have provided the majority of the institutional funding that permitted the minority VCs to expand rapidly since 1992.

NAIC-member funds oriented toward investing venture capital in minority-owned businesses had achieved an aggregate industry capitalization of nearly $200 million by 1990. The SBA was their major funding source. By yearend 2000, minority VC fund aggregate capitalization exceeded two billion dollars; public pension funds provided most of this (tables one and two; see, also, Bates and Bradford, 2003).

The SBA-chartered VC funds analyzed in this study appeared to be solidly profitable (table three). The high variance of applicable profit measures, however, compromised their reliability. When we utilized OLS regression analysis to explore one profitability measure -- IRRs generated by realized venture-capital investments -- we found that SBA-chartered funds were lagging. We conclude that relying upon the SBA for funding was linked to lower investment returns, other things equal.

The totality of evidence, we believe, indicates that public pension funds are an appropriate source of funding for the minority venture-capital industry and the SBA is not. While the former have the patience to serve as venture-capital funders, the SBA is not a sufficiently stable institution to serve as a capital source for minority VC funds. Public policies that encourage pension fund investments in the minority VC industry are more promising than those seeking a role for the SBA. Specifically, SBA policies and rules that inhibit SBA-chartered funds from raising money from public pension funds need to be removed. The SBA's limited capacity to facilitate growth and development of the minority venture-capital industry, we conclude, reflects its short-term orientation toward prevailing political pressures and priorities. As Eisinger noted, priorities change; budget crises come and go; venture-capital programs wither in this environment (1993).

References

Bates, Timothy, 1996, "An Analysis of the SSBIC Program: Problems and Prospects," Report to the U.S. Small Business Administration under research grant SBIC –94-001-1 (January).

_______, 1997, "The Minority Enterprise Small Business Investment Company Program: Institutionalizing a Nonviable Minority Business Assistance Infrastructure," Urban Affairs Review 32 (5): 683-703.

_______, 1998, "Is the U.S. Small Business Administration a Racist Institution?," The Review of Black Political Economy 26 (1): 89-104.

_______, 2000, "Financing the Development of Minority Communities: Lessons of History," Economic Development Quarterly 14 (3): 227-41.

_______, and William Bradford, 2003, Minorities and Venture Capital (Kansas City: E. M. Kauffman Foundation).

Eisinger, Peter, 1991, "The State of State Venture Capitalism" Economic Development Quarterly 5 (1): 64-76.

_______, 1993, "State Venture Capitalism, State Politics, and the World of High-Risk Investment," Economic Development Quarterly 7 (2): 131-9.

Green, Patricia, and Margaret Owen, 2004, "Race and Ethnicity," in William Gartner et al., eds., Handbook of Entrepreneurial Dynamics (Thousand Oaks, CA: Sage).

Gompers, Paul, and Josh Lerner, 1999, The Venture Capital Revolution (Cambridge: MIT Press).

Hellman, Thomas, 2001, "Allied Equity Partners," case # SM-61, Graduate School of Business, Stanford University (February).

Rosentraub, Mark, and Tamar Shroitman, 2004, "Public Employee Pension Funds and Social Investments: Recent Performance and a Policy Option for Changing Investment Strategies," Journal of Urban Affairs 25 (3): 325-37.

U.S. Bureau of the Census, 2001, 1997 Economic Census: Survey of Minority-Oriented Business Enterprises, Company Statistics Series (Washington, D.C.: U.S. Department of Commerce).

Table one: Sources of Funding for Minority-Oriented VCs (2002 survey)

A. SBA-Chartered VC Funds

Major Sources	**# Using this source**	**Median $ amount by source**	**Range of capital raised**
Banks, insurance companies	6	$12.4 million	$1.0 to $16.6 million
Corporations	6	$3.4 million	$1.5 to $7.5 million
SBA	5	$5.0 million	$3.0 to $9.0 million

B. Partnership VC Funds*

Major Sources	**# Using this source**	**Median $ amount by source**	**Range of capital raised**
Fund of funds	7	$15.0 million	$8.0 to over $25.0 million
Banks, insurance companies	7	$14.0 million	$5.0 to over $50.0 million
Public pension Funds	5	$55.0 million	$20.0 to over $400.0 million
Corporate pension funds	6	$11.4 million	$4.0 to $25.0 million
Corporations	4	$2.2 million	$1.7 to $2.7 million
State, local government	4	$5.7 million	$1.0 to $20.0 million

*VC funding is measured at the point of startup. Thus, all of the above dollar amounts reflect fund initial capitalization.

Table two: Sources of Funding Reported by NAIC Member Firms (1998 Data)

Sources	$ Amount raised by NAIC member firms, all years to 1998
1. Public pension funds	$629.9 million
2. Banks, insurance companies	$236.6 million
3. Corporate pension funds	$110.9 million
4. Fund of funds	$65.5 million
5. Federal government (SBA)	$63.7 million
6. Miscellaneous sources	$35.1 million
7. State, local government	$33.8 million
8. Corporations	$33.0 million
9. Foundations, endowments	$25.5 million
10. Individuals, families	$8.0 million
Total, all sources	$1,242.0 million

Table three: Investment and Performance Comparisons: SBA-Chartered VC Funds versus Partnership VC Funds

A. Fund Capitalization (mean)

SBA Chartered	Partnership
$11.9 million	$80.6 million

B. Traits of Realized Investments in MBEs (means)

	SBA-Chartered	Partnership
Amount invested	$390,900	$1,504,000
Amount realized	$1,290,100	$4,503,300
Net gain	$899,200	$2,999,300
Payback positive?		
Yes=	56%	50%
Net present value, 20% discount rate	$174,332	$250,472

Table four: Declining Presence of Minority-Oriented VC Funds Chartered by the SBA (2002 survey respondents)

A. # Funds Chartered before 1996

All	SBA-Chartered	Partnership
11 funds	8 funds	3 funds

B. # Funds Chartered 1996 to 2000

All	SBA-Chartered	Partnership
13 funds	2 funds	11 funds

C. All Survey Respondents

All	SBA-Chartered	Partnership
24 funds	10 funds	14 funds

Table five: OLS Regression Analysis: Explaining Internal Rates of Return on Individual VC Investments in Minority-Owned Firms

Variable	Regression Coefficient	Coefficient Standard Error	Variable Mean
Constant	.909	1.404	-
Investment size (log)	.302*	.076	5.42
SBA charter with SBA $	-.577*	.225	.50
SBA charter without SBA $	-.190	.179	.35
Communications focus	-.434*	.186	.30
Syndication lead	-.293	.196	.40
General partner involvement	.578*	.202	.73
Fund size (log)	-.331	.187	7.16
R^2 .167 S.E.E. .384			

*α = .05