

Morgan Stanley

# Beyond the VC Funding Gap

Why VCs Aren't Investing in Diverse Entrepreneurs,  
How it's Hurting their Returns, and What To Do About It



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## Beyond the VC Funding Gap

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## Foreward

Over the past five years, Morgan Stanley has worked to identify, define and address a trillion-dollar inefficiency in today's marketplace, commonly known as "the funding gap" facing women and multicultural entrepreneurs. We've invested directly in high-growth-potential tech and tech-enabled startups led by women and multicultural entrepreneurs through our in-house Multicultural Innovation Lab. And we've helped investors who want to put their capital to work and gain more exposure to diverse founders.

We've taken a data-driven approach to addressing the funding gap, and we ignited industry-wide conversations last year with our [Trillion-Dollar Blindspot](#) report. This report illuminated the magnitude of the funding gap and the potential to earn above-market returns, and called out some of the perceptions and behaviors of investors that perpetuate the uneven funding landscape. Our goal was to galvanize investors to take concrete steps to expand their lens by identifying more opportunities to invest in women and multicultural founders and realize sound returns.

Despite the trillion-dollar opportunity that female and multicultural entrepreneurs represent, investors have largely upheld the status quo, despite the data suggesting that they should be prioritizing these entrepreneurs. The funding imbalance in venture capital is particularly problematic, as their investment decisions have the potential to have transformative effects on our society. VC-backed companies drive growth and innovation globally. They've transformed existing industries and created new ones.

Aiming to better understand the attitudes and behaviors behind the funding gap and identify strategies and solutions that will help address it, we went directly to the source and surveyed nearly 200 U.S.-based VCs and diverse entrepreneurs who've successfully raised venture capital.<sup>1</sup>

We found that the VC industry has yet to prioritize investing in women- and multicultural-founded startups, despite acknowledging the opportunity that these companies represent. In particular, when they encounter a woman or multicultural founder, VCs are rigid in applying their definitions of "fit" and are unlikely to educate themselves about the product, market segment or opportunity before them. In an industry driven by generating superior returns, VCs who aren't actively pursuing investments in women and multicultural founders may be leaving money on the table.

At Morgan Stanley, we aim to connect capital to ideas so that businesses can grow, new products can be created and communities can thrive. We believe that capital can work to benefit all of society and view the funding gap facing women and multicultural entrepreneurs as a significant market inefficiency that investors can and should address. That's why we established the Multicultural Client Strategy Group, a team dedicated to developing and implementing the firm's strategy for accessing this market.

This is a report about VCs for VCs. It is part of our broader strategy to change investor attitudes and behaviors and inspire action by offering new insights to help VCs seize these opportunities with the potential to earn above-market returns. The recommendations that follow are grounded in the insights that investors shared with us, our experience putting capital to work, and Morgan Stanley's commitment to putting clients first, leading with exceptional ideas, doing the right thing, and giving back.

– Thomas Nides, Vice Chairman, Morgan Stanley

# Introduction

Despite awareness of the opportunity that women and multicultural entrepreneurs represent, venture capitalists (VCs) are not making these investments a priority and could be missing out on returns. To better understand why, Morgan Stanley went directly to the source and surveyed nearly 200 U.S.-based VCs and diverse entrepreneurs who have successfully raised venture capital to identify strategies to help address the funding gap facing women and multicultural entrepreneurs.<sup>1</sup>

We found that the VC industry has yet to prioritize investing in women and multicultural founded startups, despite acknowledging the opportunity they could be missing, and when they do encounter a woman or multicultural founder, VCs are rigid in applying their definitions of “fit” and are unlikely to educate themselves about the product, market segment or opportunity before them.

This rigid application of “fit” surprised us, especially considering how inconsistent such behavior is with the reputation of an industry that has aggressively sought opportunities to take calculated “expansion risks” to invest in new and emerging markets—often with minimal precedent or data beyond their own due diligence to back the potential payoffs.

The bottom line: VCs who aren’t actively pursuing investments in women and multicultural founders may be leaving money on the table.

This report makes the business case to VCs—and their Limited Partners—that closing the funding gap is a strategic imperative, and provides them with the playbook they need to go out and take advantage of an emerging market right here in the U.S.

## Morgan Stanley’s Playbook for VCs

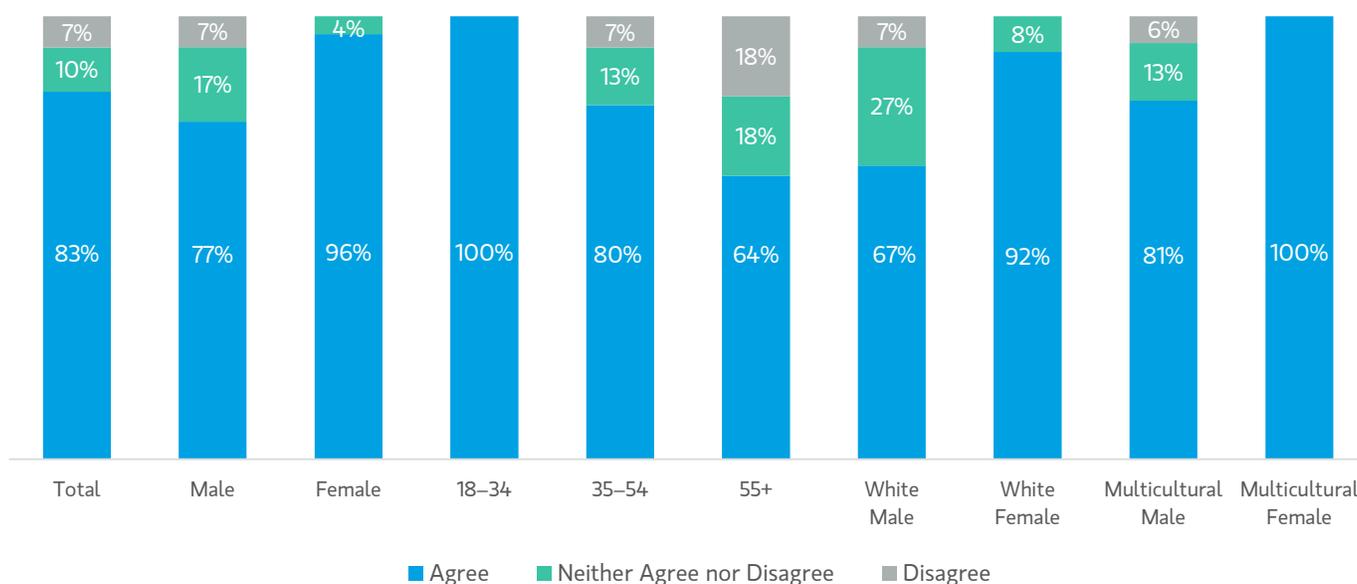
1. **Redefine how you think about “fit” for your portfolio.** Adjust your definition of “expansion risk” to include companies founded and led by women and multicultural entrepreneurs.
2. **Diversify.** Having more women and multicultural investment professionals at your fund is one of the most effective strategies for increasing investments in diverse founders. It also decreases overall risk. The more diverse perspectives VCs have, the more likely they are to recognize opportunities and identify potential pitfalls.
3. **Hold your firm accountable and be a first mover.** Develop a comprehensive strategy to increase the diverse entrepreneurs in your portfolios and make it public.

1. “Diverse entrepreneurs” defined as women or people of color. Ninety-one percent of the entrepreneurs surveyed have raised at least \$1 million in venture capital.

## What We Found: The Issue Is Systemic

Despite acknowledging the opportunities that companies founded by women and multicultural entrepreneurs present, a majority (60%) of the VCs we surveyed say that their portfolios hold too few of these companies. An overwhelming majority (83%) say that they can prioritize investments in companies led by women and multicultural entrepreneurs *and* maximize returns.

### It Is Possible to Have an Investment Strategy That Intentionally Invests in Female and Multicultural Entrepreneurs While Still Maximizing Returns

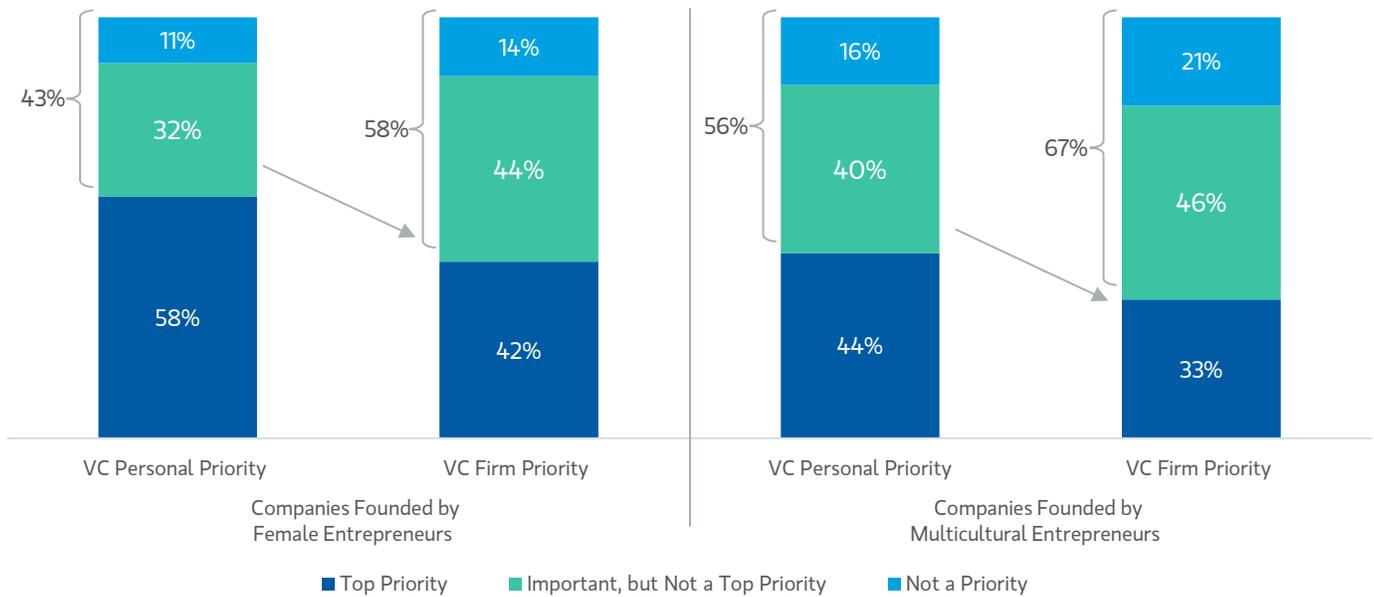


### Younger VCs say that closing the funding gap by investing in more diverse founders isn't simply the *right* thing to do, it's the *smart* thing to do.

- 100% of VCs under the age of 35 agree that strategic investing in multicultural- and women-owned businesses while maximizing returns is possible.
- 80% of VCs under the age of 35 say they have a fiduciary responsibility to fund women and multicultural entrepreneurs. This is in comparison to only 27% of VCs 35 and older who believe they have a fiduciary responsibility.

However, these sentiments haven't translated into actions. According to the VCs we surveyed, most venture capital firms aren't prioritizing strategies to diversify their portfolios. When asked if incorporating more women and multicultural entrepreneurs is a firmwide priority, three in five investors say no. Among the white male VCs we surveyed, 13% prioritize investments in multicultural founders and just one third (33%) prioritize investments in companies founded by women. These percentages stand in stark contrast to the women and nonwhite male VCs surveyed, who are almost twice as likely as white male VCs to prioritize investments in diverse founders.

## To What Extent Do You Personally Prioritize Finding Opportunities With the Following Types of Companies?



**Even among investors who say that they do prioritize investing in diverse entrepreneurs, their methods of finding companies may be holding them back.** These investors continue to rely on a traditional approach (e.g., connections within their networks, “warm” introductions, etc.) to find diverse entrepreneurs.<sup>2</sup> This approach may explain why more than half (53%) of male VCs also believe that there are not enough women founders out there and 43% say the same about multicultural entrepreneurs.

### Morgan Stanley’s Perspective

Over the past three years, Morgan Stanley has received **750 applications from women and multicultural entrepreneurs from 22 countries.** Our conclusion: There is **NO** supply issue.



2. Nearly all (96%) of the VCs we surveyed report that they source their investment opportunities “directly from my own network” and 89% use “warm introductions/referrals from someone I know.” The next closest response was “incubators/accelerators” at 60%.

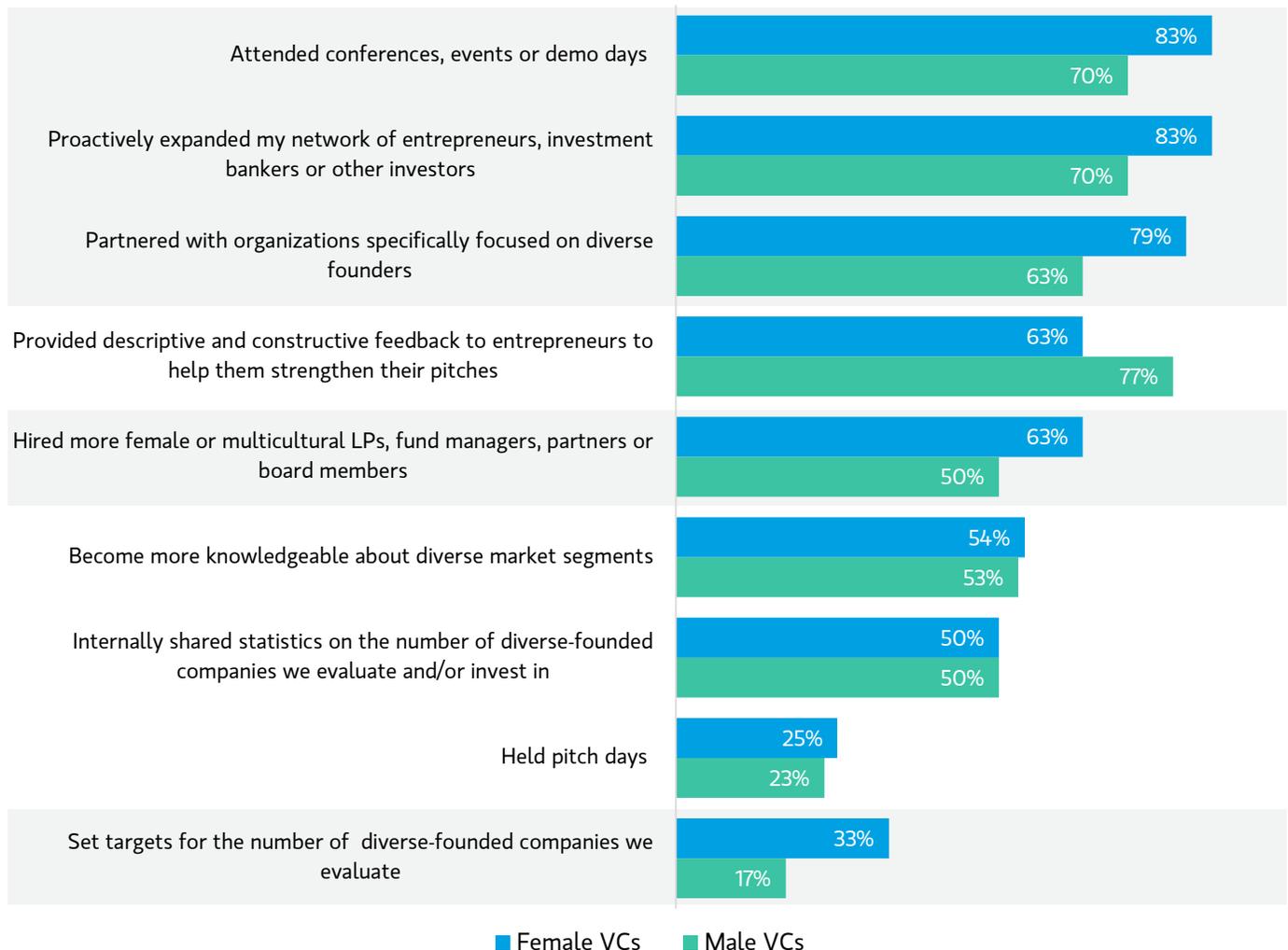
**The entrepreneurs we surveyed report a lack of diversity within VC firms, despite evidence that diversifying the makeup of investment professionals can help firms improve their exposure to women and multicultural entrepreneurs.**

Our survey found that diverse VC firms, when looking at either gender or race, have a higher percentage of diverse founders in their portfolios. Among VCs who have hired more diverse fund managers, LPs, partners or board members, 71% report it as a “very effective” way to increase the diversity of companies and founders they invest in. We also learned that women VCs are much more likely than their male counterparts to have taken specific actions to diversify their portfolios.

“Most VCs are made up of white men. They don't have the experience or the mindset that things can be done differently. They think they want to invest in women, but until there is more diversity in the senior partner ranks, it won't change.”

– Entrepreneur surveyed by Morgan Stanley

**Have You or Your Organization Done Any of the Following Things to Increase the Diversity of the Companies That You Evaluate, in Terms of Inclusion of Female- and Multicultural-Founded Companies?**



The multicultural founders we surveyed agreed with nearly two-thirds of the multicultural founders reporting that they have had more success with diverse VC firms.

Still, diverse VC firms remain the exception, not the rule. Just 11% of the entrepreneurs we surveyed say that they have interacted with VC firms with gender and racial diversity.

Fewer than a third (29%) of VC firms have at least one female partner, according to AllRaise, 2% of investment professionals are black, and 1% are Latino, according to another estimate.<sup>3</sup> In other words, the onus is on entrepreneurs to find firms with partners who are more likely to see the potential in their business.

VCs have a reputation for parachuting into unfamiliar territories and doing their due diligence to grasp new opportunities to generate big returns. Indeed, the industry is built on betting on the untested and unproven, seeking out new, emerging and even nonexistent markets. From software and the Internet in the 1990s to mobile communications and social media in the early 2000s to cloud computing and autonomous vehicles in the past decade, VCs have consistently made big bets—often with no precedent or data beyond their own conviction that those investments would succeed.

However, when it comes to investing in companies with diverse founders, our survey found that VCs often say these opportunities aren't the right "fit" for their fund. Every VC firm uses its own strategy and investment criteria to determine whether a company is the right fit for its portfolio. "Fit" is an evolving concept that can change as VCs seek out opportunities to invest in new products, sectors, markets or geographies outside of their traditional investment criteria.

Pushing the boundary of "fit" is what's known as taking a calculated expansion risk. Successful VCs have aggressively pursued such opportunities by educating themselves and consulting outside experts to advise them on products or companies beyond their investment criteria.

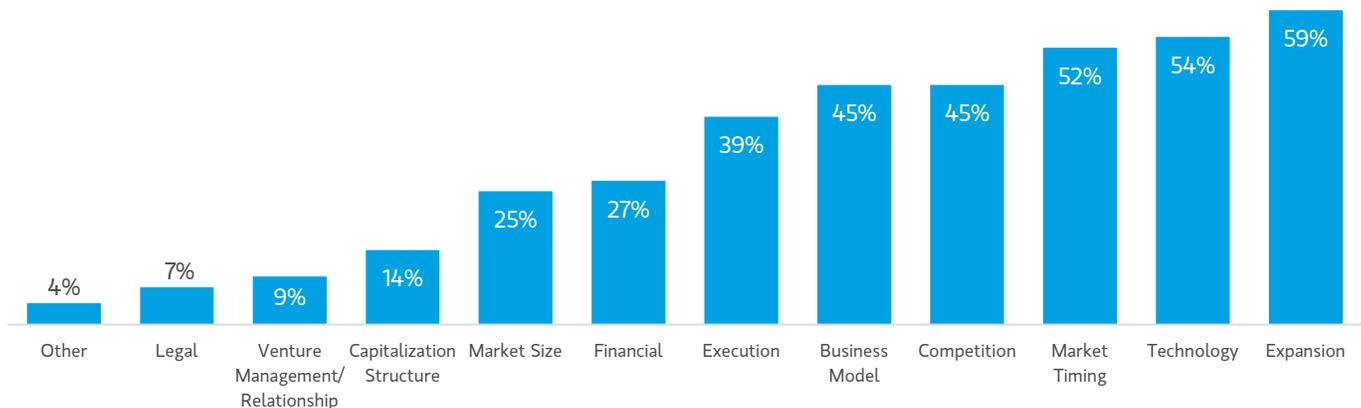
But our survey results suggest that VCs are less likely to take steps to determine how diverse-led businesses could be the right "fit" for their fund. They aren't doing their homework on these companies, and therefore aren't considering businesses led by female and multicultural entrepreneurs as opportunities to take calculated "expansion risks," compared to other new investment areas.

There is a claim for market-related issues, but often it's because they are not personally familiar with the market, rather than there being no market available."

– Entrepreneur surveyed by Morgan Stanley

Case in point, the VCs we surveyed cited "expansion risk"<sup>4</sup> as the top type of risk they are willing to embrace to maximize returns, and on average, 19% of the companies in their portfolios represent an expansion or divergence from their typical investments.

In comparison to other types of equity investors, venture capitalists often take informed risks with the aim of achieving higher returns. Below is a list of various types of investment risks.



Note: We included an "e.g." for each of these types of risk that we should probably include in the chart. See next slide for details.

3. Richard Kirby (2018). Where Did You Go to School? <https://blog.usejournal.com/where-did-you-go-to-school-bde54d846188>.

4. "Expansion risk" was defined as investing in a new product, market or geography outside of a VC's typical investments.

**Savvy VCs know that taking calculated expansion risks can yield outsized returns.** Consider Genentech, a biotech company that was acquired for \$46.8 billion in 2009. According to CB Insights, when founding partner Tom Perkins led Kleiner Perkins Caufield & Byers's investment in Genentech in 1976, the "biotech" industry barely existed. With no expertise in the subject himself, Perkins had to teach himself the basics. He sought out advice from researchers and experts and went outside of his comfort zone to make an investment in what he later referred to as "one of the largest payoffs in history."

Companies and products founded by women and multicultural entrepreneurs that address a market inefficiency or need they've identified based on their personal experiences are the exact types of calculated expansion risks that VCs should be considering. An overwhelming majority (88%) of the VCs we surveyed view the lived experiences of underrepresented entrepreneurs as a competitive advantage in identifying problems to be solved and markets to be addressed, yet our research suggests that VCs aren't likely to educate themselves on the product, market segment or opportunity, particularly when the product or customer isn't one that the VC is familiar with.

"Not the right fit for me" and "market-related issues" are among the top reasons cited by VCs for not investing in more diverse founders, suggesting that their field of vision may be too narrow. VCs that are able to adjust their lens will better see such opportunities.

### The Entrepreneur Perspective

According to the entrepreneurs we surveyed, conveying "fit" is by far the most significant challenge they face when trying to convince VCs to invest in their business. Entrepreneurs cite the **top three challenges**, ordered below, as:

- Investors not thinking the company is aligned with their investment strategy
- Investors not understanding the market opportunity
- Investors not being interested in or excited by the market



### Below Are Some Challenges That Entrepreneurs May Face Pitching VCs and Convincing Them of the Opportunity. Which, If Any, of the Following Challenges Did You Face During Pitching?



Note: From entrepreneur survey, not VC survey

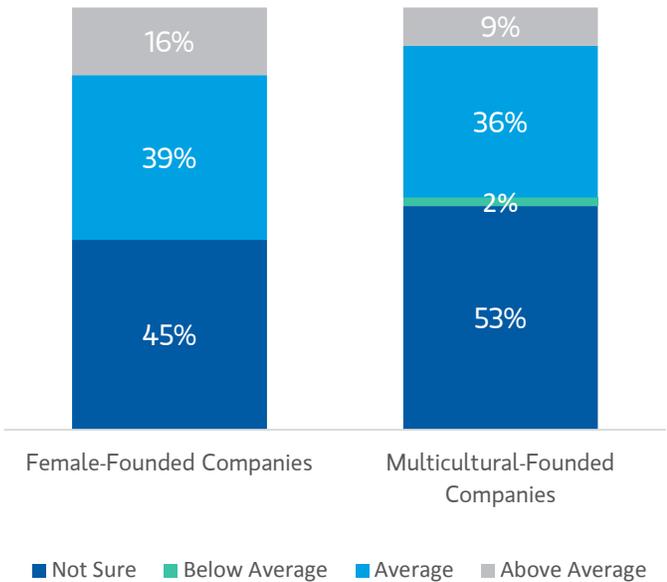
# Morgan Stanley's Message to VCs: You're Missing a Trillion-Dollar Opportunity

**The Trillion-Dollar Opportunity**

To help put the cost of unequal access to capital into context, consider a scenario where revenues for women and multicultural entrepreneurs 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 the 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.



**Generally speaking, how do the financial returns of the following types of companies in your portfolio compare to the average return for your overall portfolio?**



Despite being famously data-driven, VC firms are not acting on the data on diverse entrepreneurs and could be missing out on returns.

Investors' lack of awareness of women and multicultural entrepreneurs starts at home. Nearly half (45%) of the VCs we surveyed don't know how the returns from companies with women founders compared to their overall portfolio returns. Most VCs (53%) say they were unsure about the returns from multicultural-founded companies

However, some analysis of their own portfolios may show that companies led by diverse entrepreneurs meet or exceed average returns. Consider a 2018 Boston Consulting Group study of 350 startups in the Boston area that contains this startling finding: On average, women raised less than half as much money as their male counterparts, yet they earned 78 cents per dollar invested, compared with 31 cents for the men. A prominent seed-stage venture firm also found that teams with at least one female founder did 63% better than all-male founder teams when looking at the change in valuation since the initial investment.

A closer look at the broader marketplace would reveal that companies serving diverse customers represent a huge opportunity to capitalize on consumer segments with plenty of room for more growth. For example:

- Women drive 83% of all U.S. consumption, through both buying power and influence
- African Americans spend \$1.2 trillion annually in the U.S.
- Latinx consumers' buying power is expected to reach \$1.7 trillion by 2020

The larger market trends and demographic shifts will only exacerbate the gap between funding and returns.

## The Opportunity: Six Companies With a Woman or Multicultural Founder That Paid Off



### HopStop

Founder: Chinedu Echeruo

Funding: \$2 million

Valuation: Sold to Apple for an estimated \$1 billion



### Mayvenn

Founder: Diishan Imira, Taylor Wang

Funding: \$36 million

Valuation: Unknown



### Sundial Brands

Founders: Nyema Tubman, Richelieu Dennis

Revenue: Expected \$240 million in 2017, Acquired by Unilever

Valuation: Estimated \$1 billion in 2018



### Duo Security

Founders: Dug Song, Jonathan Oberheide

Raised: \$119.8 million

Acquired for: \$2.35 Billion by Cisco in 2018



### Carol's Daughter

Founder: Lisa Price

Raised: \$18 million

Revenue: \$27 million when acquired by L'Oreal

Valuation: Acquired by L'Oreal in 2014 for an estimated \$100 million



### Nextdoor

Founders: Nirav Tolia, Sarah Leary

Raised: \$408 million

Valuation: \$2.1 billion

# The Morgan Stanley Playbook for VCs

Diverse entrepreneurs hold the key to a trillion-dollar market. Consider the potential magnitude for expansion if VCs invested the same amount of time, capital and resources in growing these companies as they did in once-opaque areas, such as the internet or emerging markets. To help VCs access returns from diverse entrepreneurs for their LPs, Morgan Stanley has developed the following playbook to seize these opportunities and put their capital to work.

## Redefine How You Think About “Fit” and Expansion Risk for Your Portfolio

Adjust your definition of “expansion risk” to include companies founded and led by women and multicultural entrepreneurs. This can help expand your networking efforts among diverse entrepreneurs and help you better understand the opportunities they present.

Consider the idea that diverse entrepreneurs are more seasoned players with lower risk. By the time most diverse entrepreneurs get to pitch VCs, they’ve already run the gauntlet and can often demonstrate a stronger proof of

concept, management expertise and success metrics when compared with their white, male counterparts.

Women and multicultural entrepreneurs are an emerging market in the U.S. in the same way the internet was 20 years ago or cloud-computing a decade ago. In addition to chasing new markets and products, consider investing in the new perspectives that diverse entrepreneurs offer and the markets they serve.

## Diversify

Having more women and multicultural professionals at your fund is one of the most effective strategies for increasing investments in diverse founders.

By looking inward at your hiring and retention practices and prioritizing diversity, you can improve the delivery of results for your LPs. The traditional sources for entry-level VC talent—top business schools—have large enough pools of women and multicultural graduates to fill the need.

In addition to helping VC firms source more diverse entrepreneurs and see market opportunity more clearly, firm diversity also decreases overall risk: The more diverse perspectives VCs have, the more likely they are to recognize opportunities and identify potential pitfalls.

## Hold Your Firm Accountable and Be a First Mover. Institutional Investors Can Help.

Develop a comprehensive strategy and make it public. Share data about your internal and portfolio diversity. Establishing goals for investing in more women and multicultural entrepreneurs can be an effective strategy for VCs to show their investors their commitment to effecting change; according to our survey, 86% of VCs agree that such goals would benefit themselves and their LPs.

Institutional investors are increasingly focused on the societal implications of what and who VCs are investing in. Yes, returns are important, but the broader ability of VCs to shape key markets hasn’t gone unnoticed. The capital that

institutional investors manage ultimately belongs to individuals, who expect them to make smart investment decisions that reflect their needs, perspectives and values. These investors have a responsibility to consider social issues when they invest their assets under management. Working with VCs who invest in more women and multicultural entrepreneurs will help to meet this expectation.

# Methodology

## Survey Methodology

This report is based on two surveys conducted on behalf of Morgan Stanley by Brunswick Group between August 19, 2019, and September 13, 2019, in the U.S. The surveys were conducted online among:

- 58 VCs who are almost exclusively leads or co-investors with an average equity check size of \$9.4 million
- 141 women or multicultural founders who have raised VC funding for at least one of their businesses (91% percent of the entrepreneurs surveyed have raised at least \$1 million in venture capital)

The VCs and entrepreneurs who were invited to participate in the survey were provided by Morgan Stanley.

The profiles of the survey respondents were as follows:

Venture capital respondents:

- White men: 26%
- White women: 21%
- Multicultural men: 26%
- Multicultural women: 21%
- Declined to answer: 5%

Entrepreneur respondents:

- White women: 67%
- Multicultural women: 28%
- Multicultural men: 4%

The definition of “multicultural” that was provided to respondents in the survey was “Black/African-American, Hispanic/Latino, Asian, and all other nonwhite persons.”

## 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 was 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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