

Morgan Stanley

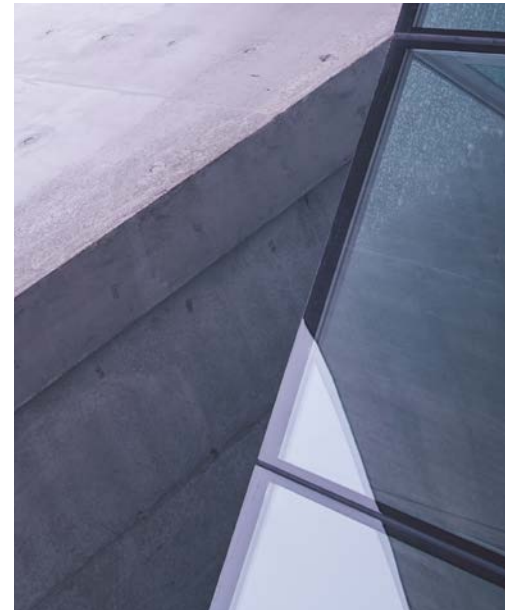
Venture Capital and Racial Equality:

**How Attitudes and Actions Are Evolving and
What Continues to Hold the Industry Back**



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A Note from Tom Nides

In the wake of nationwide protests sparked by the tragic killings of George Floyd, Breonna Taylor and others, the United States is engaging in a heightened discourse and reckoning around systemic racism, particularly against Black Americans. These conversations are causing families, communities and organizations alike to ask themselves difficult and uncomfortable questions on how to create a more diverse, equitable and inclusive society. In recent months, the private sector, including financial services companies, has realized that it can be a catalyst for promoting social change and, more specifically, racial equity.

When it comes to the venture capital (VC) funding gap facing women and multicultural entrepreneurs, Morgan Stanley has a long track record of bringing attention to investors' [Trillion-Dollar Blindspot](#) and offering strategies to address it by regularly releasing data-backed research and prescriptive methodologies to achieve more equitable funding. While the industry faces a moral imperative to narrow this funding gap, it also should embrace the strong business case: Many studies have found that companies with more gender and racial diversity in their leadership are more profitable. This is one of our main motivations for establishing the Multicultural Client Strategy Group—a team dedicated to developing and implementing Morgan Stanley's strategy for addressing this market inefficiency. With 2020 as a potential pivot point on these issues, we are pushing ourselves, as well as our industry, to become more honest and introspective about our attitudes, biases, actions and barriers to addressing inequality.

As part of our effort to better understand what perpetuates the funding gap and identify solutions to address it, we went back to the VC community to assess the impact of the renewed national conversation around inequality on investors' views of the funding gap, particularly as it relates to Black and multicultural entrepreneurs. This report summarizes our findings and outlines opportunities for continued progress toward equality.

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Shifting Attitudes and the Impact of Racial Injustice Conversations

This year, more VC firms assigned greater value to the investment opportunity that multicultural-founded companies present, and say that they are more likely to invest in multicultural- and women-founded companies in the coming year.

The national discourse around systemic racism and the demand for racial equity in America appears to have shifted VCs' attitudes toward investing in multicultural-founded companies. More than 3-in-5 (61%) VCs say that the Black Lives Matter movement has affected their investment strategy. This positive shift in VC attitudes and actions is considerable. In 2019, 12% of VCs surveyed said that the racial diversity of their portfolio company founders was not an important factor in their investment decisions. Today, VCs unanimously acknowledge the importance of racial diversity among their portfolio companies' founders.

61% VCs

say the Black Lives Matter movement impacted their investment strategy

12% VCs

say racial diversity in portfolio company founders is not an important factor





VCs recognize that multicultural-founded companies are at a structural disadvantage when it comes to funding and are badly underrepresented in their own portfolios. VCs are most likely to say that there are too few Black entrepreneurs (80%) and multicultural entrepreneurs (72%), compared to women entrepreneurs (58%). VCs' satisfaction with their own portfolio reflects the same dynamic: Just 17% say they are satisfied with the rate at which they invest in multicultural-founded companies, while 36% are satisfied with the rate in which they invest in women-founded companies. While VCs plan to diversify in many ways, the visible underrepresentation and heightened dissatisfaction with their underinvestment in multicultural-founded companies could mean a more targeted focus on multicultural-founded companies moving forward. In what could be a breakthrough, more than two thirds of VCs we surveyed (68%) say that they are more likely to invest in multicultural-founded companies in the coming year.

80%

say there are too few Black entrepreneurs

72%

say there are too few multicultural entrepreneurs

58%

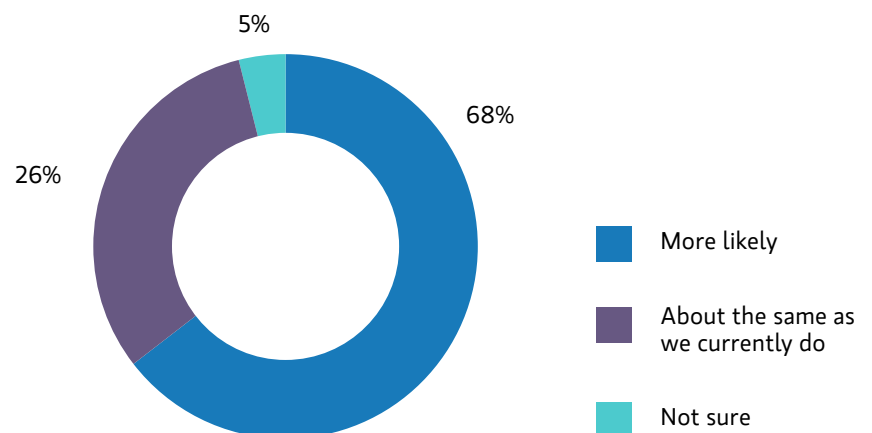
say there are too few women entrepreneurs

68%

are more likely to invest in multicultural founders

To what extent are you more or less likely to invest in the following types of companies in the next 12 months?

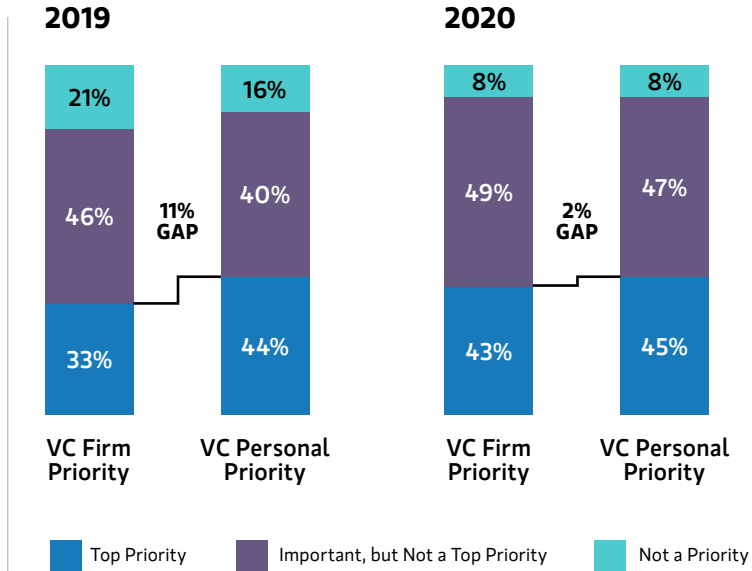
Multicultural-founded companies



Numbers do not add up to 100% due to rounding.

Additionally, VC firms' priorities are now catching up with individual investors' priorities in this area. Of those surveyed, 45% say that finding opportunities with multicultural entrepreneurs is a personal priority (about the same as last year) and, in a 10-percentage-point increase from last year, 43% of VCs say that finding opportunities with multicultural entrepreneurs is a top priority for their firm as well. Closing this gap is especially important, with more than 90% of VCs agreeing that fund managers have a responsibility to their clients to actively explore investing in women- and multicultural-founded companies.

To what extent does your firm prioritize finding opportunities with multicultural-founded companies?

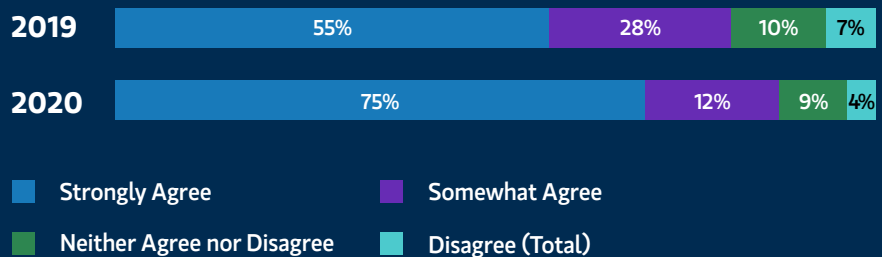


Moreover, this year marked a sharp increase among those who strongly agree that “it is possible to have an investment strategy that intentionally invests in women and multicultural entrepreneurs, while still maximizing returns,” from 55% in 2019 to 75% in 2020.

More VCs now track the financial returns of multicultural-founded companies in their portfolio, something we advocated for in our 2018 survey report. This year, 59% are aware of the performance of their multicultural-founded portfolio companies, up from 47% in 2019. Notably, almost all VCs who track such returns say that multicultural-founded company returns are performing on, or above, average, relative to their entire portfolio, mirroring research showing that companies with diversity in senior leadership can often generate higher profitability.¹

To what extent do you agree or disagree with the following:

“It is possible to have an investment strategy that intentionally invests in women and multicultural entrepreneurs while still maximizing returns”?



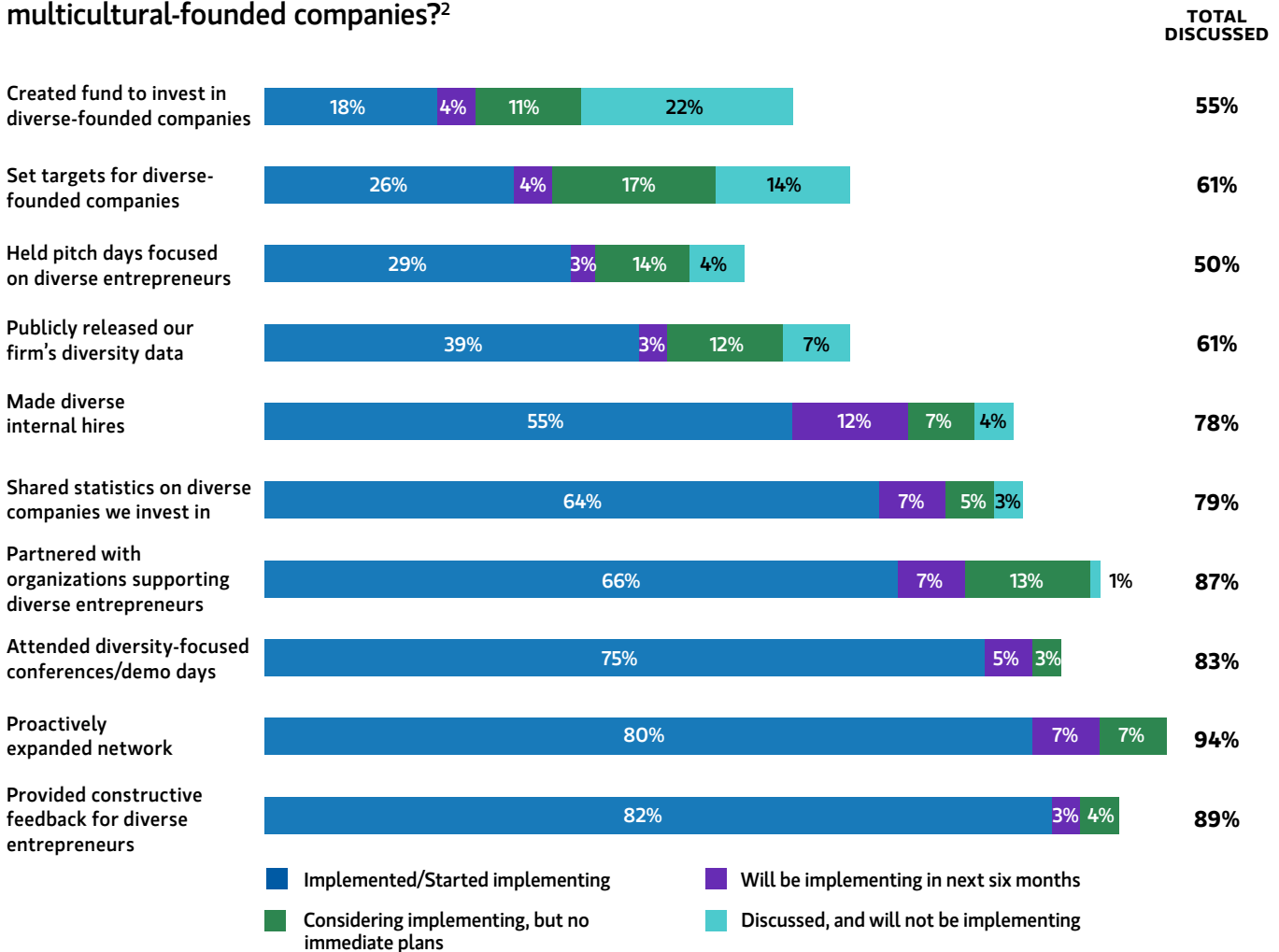
¹ McKinsey (2018). Delivering through diversity. <https://www.mckinsey.com/business-functions/organization/our-insights/delivering-through-diversity>

Turning Intention into Action

VCs are taking important initial steps to implement changes around increasing diversity and are discussing ways to make additional changes that will help close the funding gap.

Among those who consider diversity a top priority, nearly all respondents (92%) say that their VC firm has publicly disclosed diversity as an investment priority. But saying so publicly isn't enough—acting on their promises starts with internal discussions on how to increase the diversity of the founders in their portfolios and implementing their strategy, which is exactly what VCs are reporting.

Have you or your firm done any of the following things to increase the diversity of the companies that you evaluate, in terms of inclusion of women- and multicultural-founded companies?²



² Abbreviated answer choices shown

The number of VC firms saying that they internally share statistics on the number of women- or multicultural-founded companies they evaluate and invest in has sharply increased—to 64%, from 48% in 2019—suggesting a higher level of self-accountability.

Uneven Progress

Traditional VCs are less likely to prioritize or take action toward investing in multicultural-founded companies when compared to women or multicultural VCs.

While we have observed a shift in attitudes and actions to address racial inequality in the VC space in the past year, that shift hasn't prevailed among white men, who make up the majority of the VC industry.³

Our survey found clear indications that traditional VCs actively think about racial diversity among their portfolio company founders: 59% say BLM has affected their investment strategy and only 17% expressed satisfaction with the number of multicultural entrepreneurs in their portfolios. Traditional VCs' attitudes have shifted toward more inclusivity in the past year, but a gap still exists between them and women and multicultural VCs. Traditional VCs are much less likely to believe that it is possible to maximize profits by investing in diverse entrepreneurs, and they are less likely to have taken actions to address racial representation among their portfolio company founders.

Compared to women and multicultural VCs, traditional VCs are less likely to believe that they can have profitable investment strategies that emphasize diverse entrepreneurs, and they are less likely to have taken action.

³ NVCA-Deloitte Human Capital Survey (2018). Diversity & Inclusion in the VC Industry. <https://www2.deloitte.com/content/campaigns/us/audit/survey/diversity-venture-capital-human-capital-survey-dashboard.html>

59%

say BLM has affected their investment strategy

17%

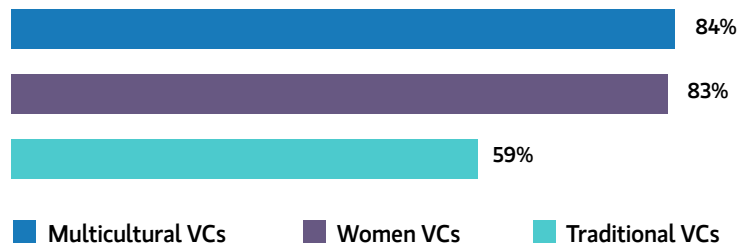
expressed satisfaction with the number of multicultural entrepreneurs in their portfolios



To what extent do you agree or disagree with the following:

% Strongly Agree

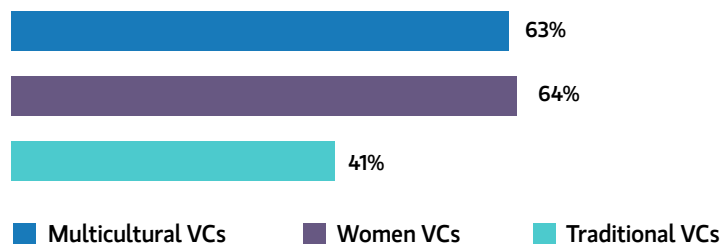
It is possible to have an investment strategy that intentionally invests in women and multicultural entrepreneurs while still maximizing returns.



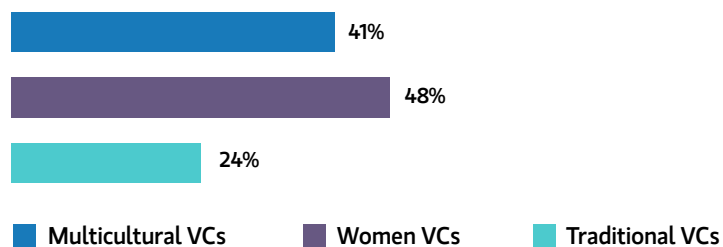
Have you or your firm done any of the following things to increase the diversity of the companies that you evaluate, in terms of inclusion of female- and multicultural-founded companies?⁴

% already implemented or have started implementing

Hired more women or multicultural LPs, fund managers, partners or board members



Publicly released figures regarding gender and racial/ethnic composition of my organization's portfolio



⁴ Two actions among 10 total actions tested

Traditional VCs' reasons for not investing in multicultural entrepreneurs shifted this year. Last year, 27% of traditional VCs said that multicultural companies are "not the right fit for me"—a ratio that fell to 12% this year, suggesting that the national conversation around racial justice and diversity may have encouraged more of them to "get out of their comfort zone" and explore once unfamiliar sectors, markets and opportunities. As we reported last year, companies and products founded by women and multicultural entrepreneurs that address a market inefficiency or need, based on their personal experiences, fall exactly into the categories of calculated expansion risks that VCs should be considering.

However, gaining exposure to diverse entrepreneurs remains a significant challenge for traditional VCs. The perception that there are "not enough multicultural entrepreneurs" or that they "can't find multicultural entrepreneurs and/or don't have the relationships" remains a consistent theme among traditional VCs vs. women and multicultural VCs. Indeed, we found minimal progress in traditional VCs' efforts to increase their exposure and take active measures to expand their network ("not enough" was 60% in 2019 and is 65% in 2020; "can't find" was 33% in 2019 and is 47% in 2020). Still, the shift in mindset marks an important first step.

Limited Partner Buy-In Is Key

LPs inhabit a unique position to encourage VCs to invest in more diverse-founded companies.

The past year has seen only a modest increase in VCs' perception that investing in companies with women and/or multicultural entrepreneurs is a priority to their LPs, from 55% in 2019 to 59% in 2020. To change investing behavior, LPs must fully and openly embrace the importance and financial benefits of investing in more women- and multicultural-founded companies. Equally important, LPs who feel strongly about making diversity a priority should convey that expectation to their VCs and consider setting concrete targets for investing in women- and multicultural-founded companies.



Forward Accountability

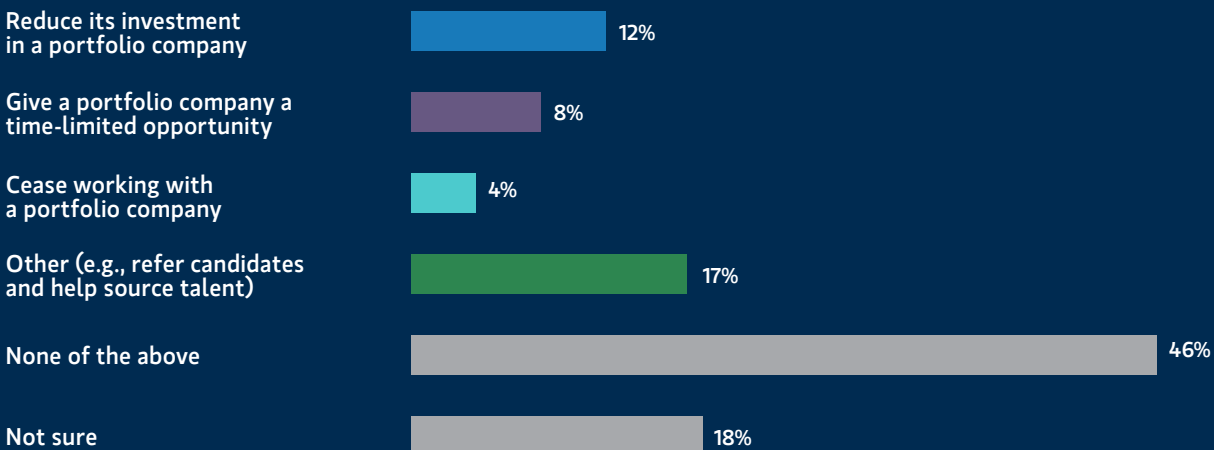
VCs can play a greater role in addressing inequality by implementing accountability practices with their existing portfolio companies.

To address racial inequality, VCs can start with their existing investments. Among those surveyed, 80% say that it is important for a portfolio company to share publicly the gender and racial/ethnic diversity of their partners, board of directors or C-suite. However, 64% of VCs are either unwilling to hold a portfolio company accountable for failing to do so, or are unsure whether their firm would be willing to act. Only 12% say that their firm is willing to reduce its investment in a portfolio company for insufficient diversity; even fewer (4%) say that their organization would be willing to stop working with a portfolio company due to lack of diversity.



In which ways does your organization hold portfolio companies accountable for achieving or maintaining sufficient diversity?

My organization is willing to...



Seize the Opportunity

Morgan Stanley's Playbook for VCs

We are encouraged by this year's data, but to ensure that intentions translate into real change, we need to be diligent about holding ourselves—and each other—accountable. To help VCs boost diversity and access returns from a widely untapped pool of multicultural and women entrepreneurs, Morgan Stanley has developed a playbook to seize these opportunities and put their capital to work:

- Take steps to **expand your network**.
- **Set active diversity targets** with realistic, sustainable goals.
- **Share research** on the business case for investing in women and multicultural entrepreneurs and **continue tracking financial returns** for women- and multicultural-led portfolio companies.
- **Publicly release your firm's diversity metrics** to measure your progress, but **don't get complacent** with progress.
- **Hold portfolio companies accountable** in meaningful ways.
- **Diversify your own firm**, which will lead to new perspectives and connections with more diverse entrepreneurs, thereby improving results for your LPs.

In the coming years, it will be critical to understand if the attitudinal shifts and intentions observed this year translate into measurable progress. Transparency is the tactic that will lead to true change. To help VCs assess their progress, Morgan Stanley plans to revisit key metrics that will reveal whether the industry has improved measurably, including:



VC Progress Report

2020 Results

32% Average percentage of multicultural-founded companies in firm's portfolio.

26% Cited that the reason they do not invest in more multicultural-founded companies is because they cannot find multicultural entrepreneurs or do not have the right relationships.

45% Started implementing changes to invest in more multicultural-founded companies.

55% Hired more women or multicultural LPs, fund managers, partners or board members.

64% Internally shared statistics on the number of women- and multicultural-founded companies their firm evaluates and/or invests in.

39% Publicly released figures regarding the gender and racial/ethnic composition of their organization's portfolio.

33% Hold portfolio companies accountable for achieving or maintaining sufficient diversity.

Methodology

This report is based on a survey conducted on behalf of Morgan Stanley by Brunswick Group between August 5 and 8, 2020, in the U.S. The survey was conducted online among 76 venture capitalists who are almost exclusively leads or co-investors, with an average equity check size of \$2.65 million. The VCs who were invited to participate in the survey were provided by Morgan Stanley.

THE PROFILES OF THE SURVEY RESPONDENTS WERE AS FOLLOWS:

22%

Traditional
(white men)

29%

White
women

17%

Multicultural
men

25%

Multicultural
women

7%

Declined
to answer

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

