Addressing the Funding Gap for Women and Diverse Entrepreneurs

By Onome Adejemilua

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Historical Landscape for Women and Diverse Entrepreneurs

As key drivers of innovation and productivity, entrepreneurs are fundamental to the prosperity and growth of the U.S. economy. Robust entrepreneurial activity and small business ownership provide the basis for economic prosperity and are critical to the long-term vitality and success of our country.[1]

In recent years, diverse and female business owners have risen as essential players in the U.S. entrepreneurial landscape, accounting for a sizeable portion of the economy and driving job creation. By 2015, diverse-owned companies had grown to approximately 8 million, a 38% jump from 2007, employing more than 8.7 million people and generating roughly $1.4 trillion in annual gross revenues.[2] By 2019, there were more than 13 million businesses owned by women, employing approximately 9.4 million people and generating $1.9 trillion in revenue.[3]

As the face of entrepreneurship grows beyond the traditionally non-diverse, male portrait, the map of entrepreneurship has also expanded beyond the conventional hubs of Silicon Valley and Boston into burgeoning metropolises.[4] New Jersey's largest cities have similarly experienced increased levels of entrepreneurial activity in recent years, with Newark emerging as a prominent destination for entrepreneurs and startups, particularly in the technology industry.[5]

Despite the growing number of female and diverse entrepreneurs, and their influence on the economy as a whole, these businesses face obstacles and barriers to growth, especially as it pertains to funding and investment.[6] While funding sources for these groups are historically scarce, venture capital financing, in particular, critical to providing startups with scale-up capital, has continued to lag.

This article will discuss the challenges faced by diverse and women entrepreneurs in the venture capital ecosystem, with particular emphasis on the gap in accessing capital. It will examine the innovative ways that the industry is tackling the funding gap—ways that are not only designed to produce more equitable results, but generate higher returns for investors. It will also address how New Jersey is playing an active role in collaborating with industry players to improve access to capital and close the funding gap.

Closing the funding gap, however, will ultimately require a commitment to changing the venture capital (VC) culture from being reliant on the subjective, bias-prone pitching process to adopting a more data-driven approach to sourcing, evaluating and selecting investment opportunities.

Obstacles to Capital Access—The Funding Gap

Access to capital is critical to the success of any new business.[7] Businesses that start with strong financials are more likely to succeed, as a strong financial condition allows entrepreneurs to take advantage of expansion opportunities and make critical infrastructure investments.[8] Studies show that young companies supported by accelerators that received financial and nonfinancial assistance in the form of mentorship and technical assistance experienced approximately 30% more revenue growth and approximately 50% more employment growth within two years of raising capital than those that did not raise capital.[9]

Despite the importance of early capitalization to the growth and development of startups, entrepreneurs from underrepresented demographic groups tend to face hurdles in securing base and early-stage capital. Historically, women are less likely to receive funding in early-stage decisions from angel investors and venture capital firms.[10] Based on data from Pitchbook, in 2017, all-women founding teams raised 2.2% of total VC funding (accounting for fewer than 5% of deals) compared with all-men teams that raised about 79%.[11]

The disparity is even more glaring for ethnically-diverse founders. Findings in a study conducted by Diversity VC and RateMyInvestor demonstrated that from 2013 to 2017, of the 4,475 investments made by 135 venture capital firms reviewed in the study, only 1% and 1.8% were led by Black and Latino founders, respectively.[12] These numbers have taken even sharper dives during the COVID pandemic, as, in the face of uncertainty, investors have remained close to their networks and put on hold initiatives promoting diversity and inclusion.[13]

Insular Networks of Venture Capital

A closer examination of the culture within the venture capital industry may provide clues as to why there is such an imbalance in access to capital. The venture capital industry is a notoriously insulated and non-diverse, all-boys club.[14] Women and people of color have historically been underrepresented in the VC ecosystem on both sides of the aisle, as founders and funders.

Research shows that 92% of the partners in the venture capital industry are men and most are non-diverse.[15] Given that most investors rely on referrals from their networks, which tend to be people just like them, female and diverse entrepreneurs are left with uneven access to the social and intellectual capital necessary to secure funding.[16]

Bias in the Pitching Process

Another culprit of the funding gap is the apparent bias in the VC investment process. Multiple academic studies have demonstrated that a strong gender bias exists in many elements of the pitching process.[17] One study established that investors prefer pitches presented by male entrepreneurs compared to pitches made by female entrepreneurs, even when the content of the pitch was exactly the same.[18] There, the participating investors who were asked to rate presentations voiced by men and women, using identical slides and scripts, consistently rated the men higher, with attractive men being evaluated as the most persuasive.[19]

Another study examined how bias factors into the questions that entrepreneurs are asked during the pitching process. The research found that investors tend to pose questions to male entrepreneurs that are of a promotional nature (i.e. highlighting the upside and

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potential gains) while female entrepreneurs received questions of a preventative nature (i.e. highlighting potential losses and risk mitigation).[20] The difference in questioning appeared to have substantial funding consequences for startups with the female entrepreneurs who fielded mostly prevention questions raising roughly seven times less than the entrepreneurs who were asked mostly promotion questions.[21]

Diverse entrepreneurs also tend to be perceived by investors as risky investments.[22] In a survey conducted by Morgan Stanley, pitches by diverse entrepreneurs were often times unsuccessful to investors, who were disproportionately white men, because the investors admitted to being less likely to connect to the sectors that the diverse entrepreneurs serve.[23] Because they were unfamiliar with the consumer base, they struggled to see the vision and market need being met by the entrepreneur's product.[24]

If the criteria for evaluating investment opportunities is largely reliant on whether investors are familiar with the consumer or marketplace, then that puts diverse and women entrepreneurs at a significant disadvantage. Equally important, it results in missed opportunities for investors seeking to capitalize on a broader market.

Mitigation Efforts—Tackling the Funding Gap in New Jersey

Bridging the access gap will require innovative measures and a commitment to adjusting how the industry evaluates investment opportunities.

Intentional Funding

One approach is to embrace "intentional funding"—investment strategies that deliberately invest in female- and diverse-led businesses. New Jersey is taking promising steps in this direction. By supporting and working in tandem with groups striving for a more inclusive VC ecosystem, the state is partnering with organizations that connect investors with female and diverse entrepreneurs.

In February 2020, the New Jersey Economic Development Authority, together with First Lady Tammy Murphy, joined forces with Golden Seeds, an angel investment firm, to launch the New Jersey chapter of the organization.[25] Golden Seeds is a national angel investor network committed to investing in female-led startup companies to ensure that those startups have access to the capital they need to succeed and remain competitive.[26] Founded in 2005 and headquartered in New York City, Golden Seeds has over 275 members dedicated to evaluating, funding and helping companies with at least one woman in an upper management role with an equity position.[27] Through its partnership with Golden Seeds, NJEDA is embracing the opportunity to increase capital to female-led startups.[28]

Another New Jersey-based initiative has also adopted the intentional funding model to enhance investment opportunities to diverse founders. The Black and Latino Angel Investment Fund of New Jersey, launched by the Center for Urban Entrepreneurship & Economic Development at Rutgers Business School, provides founders of color with pre-accelerator funding necessary to grow their ventures.[29] In addition to providing seed capital, the fund sponsors a capacity-building program to help technology ventures gain the training and mentorship necessary to scale up.[30]

The state has also adopted initiatives that incentivize investments in diverse and female-led startups. The Angel Tax Credit Program, which provides eligible individuals and entities investing in qualifying emerging technology companies with refundable tax credits of up to 20% of their qualified investment, also provides for an additional 5% bonus for investments in a business located in a qualified opportunity zone, low-income community or a business that is certified as minority or women-owned by the state.[31] To be eligible for the tax credit, the emerging technology company must (i) employ fewer than 225 full-time employees (75% of whom work in New Jersey); (ii) do business, employ or own capital or property in New Jersey; or (iii) or maintain a New Jersey office.[32] The company must also conduct one of the following activities in the state: (1) incur qualified research expenses; (2) conduct pilot-scale manufacturing; or (3) commercialize one or more of the following eligible technologies: advanced computing, advanced materials, biotechnology, electronic devices, information technology.[33]

The NJEDA further promotes women and diverse entrepreneurs through its NJ Accelerate Program which selected the Morgan Stanley Multicultural Innovation Lab as its first "approved accelerator."[34] Created by NJEDA to encourage startups to establish operations in New Jersey following graduation from approved U.S. accelerator programs, NJ Accelerate has committed to providing up to $250,000 per startup in direct loans to match the funding from any approved U.S. accelerator program, plus up to six months of rent support to eligible businesses.[35] To be eligible, the startup will have had to (i) successfully graduate from an approved accelerator program, (ii) set up its operations in New Jersey within six months and (iii) maintain 50% of its employees in New Jersey.[36] The program also includes a 5% bonus for startups that are certified as women and minority-owned businesses.[37]

In addition to galvanizing entrepreneur participation in accelerator programs, NJ Accelerate also encourages accelerators to launch in New Jersey. For approved accelerators, the program will match up to $25,000 for each event hosted by the accelerator in New Jersey, including "demo days" road shows, in-person classes, pitch competition and networking events, and provide an addi-

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tional 5% bonus for accelerators demonstrating written policies and practices for attracting and promoting startups owned by female or minority entrepreneurs.[38]

Ditch the Pitch

While intentional funding is advancing the ball in the right direction, another approach that is gaining momentum and likely to accelerate progress in closing that gap is the "ditch the pitch" movement. In a recent article published in the *Harvard Business Review,* the authors advocated eliminating the pitching stage in the VC investment process in favor of a more data-driven approach to assessing a startup's potential and profitability.[39] Underscoring that the pitching process is prone to bias that produces gross funding imbalances, they argued that analyzing a startup's sales data was a more reliable predictor of a venture's success than the founder's ability to deliver a pitch.[40]

Early-stage sales data delivers nonbiased indicators of customer need, product fit, marketing skill, sales funnel and customer relationship management, and, ultimately, the founder's ability to assemble and manage a team to deliver results.[41] If the goal is to pick the best startups and deliver high returns for investors, advocates of this approach urge that the pitch should be dispensed entirely because it promotes a selection process that favors male-centric characteristics. Instead of listening to pitches, investors that champion the pitch-less approach support a more data-focused selection process.

Some funds gather data in online applications and select companies based on specific metrics, relying on algorithms to do the deal sourcing work.[42] Another tactic is to outsource the initial selection to accelerators.[43] One fund sourced companies based on recommendations from a partner accelerator which evaluated companies after observing their performance over several weeks.[44] Following the first evaluation, the top performers received small initial investments.[45] After a longer diligence period of six to nine months, the companies' performance were evaluated again with top performers earning an even larger investment, with the potential to receive subsequent rounds based on the companies' performance over time.[46] With this approach, the fund focused on the actual performance data from the startups and ended up with a more gender-balanced investment portfolio.[47]

Changing the Landscape

The funding gap is a deep and entrenched problem in early-stage investing that requires the use of as many tools at one's disposal. While the state has largely focused its efforts on encouraging intentional funding, it should consider ways to promote alternative investment strategies that emphasize a numbers-oriented approach to deal sourcing and evaluation.

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