Study: Diverse private capital groups struggle to match performance of counterparts as result of investor demand

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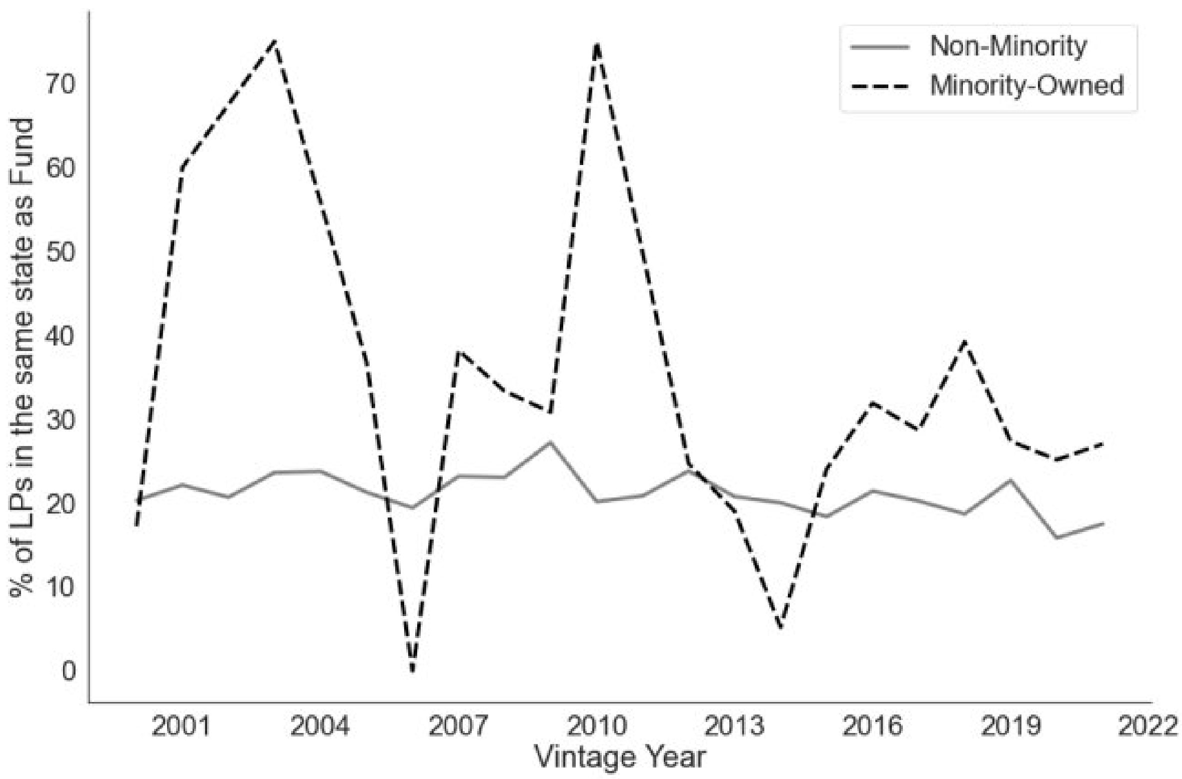

Proportion of Limited Partners in the Same State as the Funds they Back. This figure shows the proportion of a fund's limited partners (LPs) that are located in the same state as the fund by vintage year for minority and non-minority owned groups. The sample comprises U.S.-based and -focused private capital groups that raised a fund between 2000 and Q2 2021 according to PitchBook. Minority is an indicator that equals one if at least 50% of the senior partners or founders are Black or Hispanic. Overall, it appears that minority groups are more likely to have local limited partners. Credit: *SSRN Electronic Journal* (2022). DOI: 10.2139/ssrn.4222385

A new study by Johan Cassel Pegelow, Assistant Professor of Finance at Vanderbilt Owen Graduate School of Management, examines the racial diversity, or rather lack thereof, within the private capital industry.

"Racial Diversity in Private Capital Fundraising," co-authored by Johan Cassel Pegelow, Josh Lerner, Harvard University, and Emmanuel Yimfor, University of Michigan, and posted to the SSRN pre-print server, explores fundraising for minority-owned private capital groups. The study primarily focuses on understanding if the investor side can explain part of the low prevalence of minority-owned private capital groups.

"We show that Black and Hispanic-owned funds are more likely to invest in Black and Hispanic-owned entrepreneurs," says Johan Cassel Pegelow. "This implies that the lack of diversity among private capital groups hampers the ability of minority entrepreneurs to attract the necessary capital to grow their businesses to their full potential."

The authors provide evidence that minorities attempting to enter the private capital industries by raising a first fund appear to face more difficulties in doing so than non-minorities. For those private capital groups that have successfully entered the market, minorities appear to face a different dynamic when attempting to raise follow-on funds. In particular, investors appear to be particularly intolerant of failure in minority-owned funds.

The authors conclude that the evidence is consistent with a story in which part of the underrepresentation of minorities stems from the demand of investors, rather than merely being explained by supply-side factors.

This finding is supported by three main explanations. First, prior research shows that underperforming groups may be inclined to inaccurately inflate their valuations to make it seem as though they are performing better than they are. Therefore, investors may be particularly skeptical about minority groups that report that they are underperforming. If investors believe that minorities are more likely to be inflating valuations at that point, then they would infer that the performance is, in reality, worse than reported. However, the authors do not find evidence consistent with such belief, as minority groups appear to have more conservative valuations for investments still held and that are subject to possible inflated valuations, while exited investments have performed as well as those of non-minority groups.

Second, they are unable to find evidence to support any concerns that minority groups would face difficulties when scaling up, for example, that they would struggle in hiring staff or struggle to scale up and deploy larger amounts of capital if raising a larger fund. However, the data does not support any such notion of difficulties in scaling up.

Finally, the researchers discuss the impact of racial awareness on the ability of diversely owned private capital groups to raise capital. They examine two very different types of racial awareness to evaluate whether this is relevant: variation in racial awareness across the country as a result of high-profile fatal encounters between unarmed minorities and police and the ethnicities of Chief Investment Officers of local public pension funds and endowments. They find that fundraising success is higher for diversely owned private capital groups during periods of high racial awareness (in states and years where there has been high coverage of a fatal encounter of a minority civilian with police). They also find that minority-owned private capital groups are more successful in raising funds if they are headquartered in a state where at least one pension fund or endowment has a Chief Investment Officer that is a minority. Not only does it increase the likelihood of raising a follow-on fund in general, but it also increases the likelihood that the particular pension fund or endowment invests in that fund.

"The evidence is consistent with an idea that investor attitudes matter for the fundraising success of minorities in the private capital industry," says Johan Cassel Pegelow.

The findings of this study have the potential to increase awareness surrounding minority-owned private capital groups, leading to higher levels of investment and performance improvement. The study itself, regardless of findings, provides the opportunity for other private capital groups to learn how they can better support minorities in their industry.

"As our evidence suggests that investor attention to racial issues improves the ability of minorities to raise capital, we can only hope that our research contributes to increasing awareness of the issue," says Johan Cassel Pegelow.

The research is available as a working paper on the *SSRN Electronic Journal*.

More information: Johan Cassel et al, Racial Diversity in Private Capital Fundraising, *SSRN Electronic Journal* (2022). DOI: 10.2139/ssrn.4222385

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