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Creating Opportunity for Diverse- and Women-Owned Small Businesses

Recommendations for the U.S. Small Business Administration's SBIC Program

Tunua Thrash-Ntuk
Executive Director, LISC Los Angeles

Susan Fitter Harris
Susan Fitter Harris Consulting

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Introduction and Acknowledgements

At LISC LA, we know that small businesses are the cornerstone of a vibrant, local economy. They provide goods and services to residents, create jobs, nurture economic opportunity, and foster a sense of community. In Los Angeles, we have some of the most diverse business communities in the country and a long tradition of entrepreneurship among people of color. Small business ownership is the primary tool that communities of color have to build intergenerational wealth for families and communities. But small businesses need flexible capital to grow, adapt, and thrive, especially in these challenging times. For diverse and women business owners, sometimes that capital is all too difficult to find.

> 28 percent of U.S. firms are diverse-owned and 36 percent are women-owned.

As America faces a pandemic that is upending our economy, we are seeing the disproportionate impact of the downturn on small businesses owned by Black entrepreneurs and other people of color. This is nothing new. Although diverse entrepreneurs own 28 percent and women own 36 percent of all U.S. firms, these business owners are less likely to obtain vital investments that help their businesses grow. This brief examines one form of growth capital — equity investments from the U.S. Small Business Administration Small Business Investment Companies (SBIC) program — and looks at ways the program can better serve diverse- and women-owned businesses.

Tunua Thrash-Ntuk
Executive Director, LISC Los Angeles

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The History and Purpose of SBICs

The Small Business Investment Companies (SBIC) program is an initiative of the U.S. Small Business Administration (SBA) through which licensed investment funds provide venture capital necessary for small businesses to expand and grow. Congress created the SBIC program in 1958 through the Small Business Investment Act in order to stimulate the flow of investment capital and bolster the small business sector.[i]

Unlike other SBA lending tools, the SBIC program leverages the expertise of professional investment fund managers to find and invest in growth-oriented small businesses.[ii] Through the SBIC program, the SBA issues debt to venture capitalists, private equity funds and other vehicles that then provide debt and equity to small businesses.[iii] SBICs raise capital from private investors such as banks, pension funds or high net-worth individuals.

Backed by the full faith and credit of the United States government, the SBIC program allows licensees to leverage two times (in some cases three times) their initial investment, providing a ready source of investment capital. Benefits to investors include competitive rates of return (comparable to other private equity funds in the market) and CRA credit for bank investments.

SBIC investment represents a very small segment of the overall venture capital, market[iv] but it is an important one. These investments support companies that are less likely to be considered by private equity investors because they are smaller than traditional private equity borrowers. SBIC investments are also more diverse in terms of geography and industry type than traditional venture capital investments.[v] A 2017 report estimated that 11,681 SBIC-funded small businesses created or sustained almost 9.5 million jobs during the sample period 1995-2014.[vi] Throughout the program's history, Congress and the SBA have made several attempts to ensure that SBICs are serving higher-need market sectors such as diverse-owned small businesses or businesses located in low-income areas. These include the following program variations.

SBIC Program Types

MESBIC – Minority Enterprise Small Business Investment Companies

Congress authorized the MESBIC (pronounced "MEZ-bic") program in 1969 to increase investment in the underserved minority-owned business sector. A review of the program in the mid-1990s found that it did not achieve its goals, but instead suffered from consistent undercapitalization, inadequate staffing, and repeated changes to program requirements, making compliance nearly impossible.[vii]

SSBIC – Specialized Small Business Investment Companies

MESBIC was renamed SSBIC in late 1980s amid attempts at reform. The program continued to have fundamental flaws, however. The overall amount of government leverage available through the program was not significant, so many of the funds created through SSBIC licenses were severely undercapitalized. Second, the nature of the government's leverage funding as debenture was a mismatch with the equity-oriented transactions the funds were supposed to be offering. Overleveraged funds were not able to be successful offering long-term equity financing backed by short-term debentures. By the early 1990s, the number of licensees had declined while losses increased.[viii]

The SBA has not issued any new SSBIC licenses since 1996, the point at which the program was phased out in favor of other models to boost investment in undercapitalized markets, including the Clinton Administration's proposed New Markets Venture Capital program. However, SSBIC legacy licenses do not expire. They can still be purchased and reactivated and a handful investment companies have recently done so.

Impact Investing

The SBA offered Impact SBIC licenses from 2011 until 2017.[ix] These licenses were granted to funds "dedicated to generating social, environmental or economic impact alongside financial return." Impact SBICs must place at least 50% investment in underserved markets and communities. Like LMI incentives (discussed below), these licenses are not specific to investment in diverse- or women-owned businesses.

Low-Moderate Income (LMI) investment incentives

In 1999, SBA began a Low- and Moderate-Income (LMI) initiative to encourage SBICs to invest in small businesses located in inner cities and rural areas "that have severe shortages of equity capital" This ongoing initiative provides incentives to SBICs that invest in small businesses that have at least 50% of their employees or tangible assets located in a low- to moderate-income area (LMI Zone) or have at least 35% of their full-time employees with their primary residence in an LMI Zone.[x] While this initiative provides an important incentive for job creation and retention in such areas, it does not necessarily correspond with investment in businesses owned by women and people of color. Indeed, data shows that entrepreneurs of color are still severely undercapitalized.

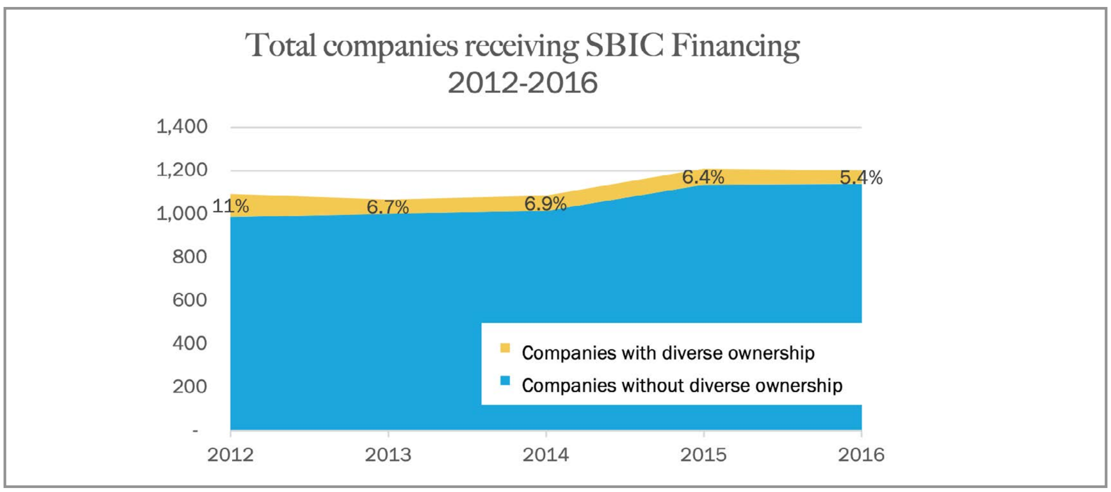
The SBIC Landscape

As of 2016, the SBIC program represented $4 billion in authorization per year. There are 303 active SBICs with $26 billion of assets under management. Both multiple and single licensees made the majority of their investments in four industry sectors: manufacturing, professional services, information, and health care and social assistance.[xi]

From FY2013 through FY2017, SBICs invested over $27 billion in financing in more than 5,641 small businesses. In 2017, 27% of the small businesses financed were located in “competitive opportunity gaps,” which SBA defines as companies located in LMI zones; companies owned by women, entrepreneurs of color, or veterans; or companies led by woman or people of color.[xii]

Looking more deeply into the data, however, makes it clear that the majority of these assets are invested in white- and male-owned firms, even if those firms may be located in LMI areas. In 2008, 12 percent of overall SBIC investments went to business enterprises that were minority-, women- or veteran-owned (MWBE).[1]

By 2013, that number had dropped to 6 percent, where it has remained. Simultaneously, the overall number of companies receiving SBIC investment annually dropped precipitously, from a high of 1,905 in 2008 to 1,077 in 2017, but the dollar amount of overall financing more than doubled, from $2.4 billion to $5.5 billion. SBICs therefore are making larger investments in a smaller cohort of businesses. One SBIC principal interviewed for this report speculated that this pattern is the result of changes in the criteria for licensure and a lower appetite for risk, adding that the SBA is looking for funds with a stable track record, a requirement that often favors larger funds. In addition, those larger funds will typically have a larger average deal size in financing larger, more established companies. “It’s just a reflection of where the market is.”



It is worth mentioning that while the term “small business” may conjure visions of mom-and-pop establishments, the SBA defines a small business for the purpose of the SBIC program as a company with net worth of $19.5 million or less and average net income after-taxes of $6.5 million or less for the prior two fiscal years. By contrast, most diverse-owned businesses are much smaller. As of 2016, only 11% of diverse-owned businesses had paid employees, compared with 22% of non-diverse-owned businesses.

Average gross receipts for diverse firms were $173,552 annually, compared with $552,079 for non-diverse firms.[xiii] Contraction of the industry to a smaller number of more established firms leaves a distinct gap for diverse-owned businesses.

Regardless of other investment trends, the number of MWBEs receiving capital through the SBIC program has been consistently low. In FY 2018, Black-owned or controlled businesses accounted for just 0.6 percent of the $5.5 billion in total SBIC financing for that year. Altogether, diverse-owned or controlled businesses received 2.4% of total financing, women-owned businesses received 1.7% and veteran-owned businesses received 0.3%.[xiv]

Very few SBICs themselves are run by women or people of color.[xv] An estimated 10 percent or less of SBICs had at least one diverse SBIC manager and a similar percentage had at least one female SBIC manager.[xvi] This is significant because diverse leadership drives diverse investment: a review of the SBIC program in 2016 found that SBICs with diverse leadership were more likely to invest in small businesses with racial- and gender-diverse ownership and management.[xvii]

We interviewed several SBICs with diverse leadership and there was consensus among these managers that having people of color and women at the leadership level makes a difference. Deal flow "is all about relationships" according to one interviewee, and diverse leaders have diverse networks in which to form those relationships. That means they are in contact with business owners in the MWBE community, often through deliberate outreach with partners such as the National Urban League, local chambers of commerce and other venues.

A further challenge to diversifying SBIC investments lies in the quality of information about these investments. Data collection about specific support to MWBEs is not robust. Several reports reviewing the SBIC program include the caution that the authors lacked complete data on investment in MWBEs, in part because SBA does not give SBIC licensees clear guidance on how to collect and report their investments in diverse businesses.[xviii]

The Investment Gap

Historically low investment by SBICs in diverse-owned businesses is just a symptom of underinvestment in MWBE across the financing landscape. Small business lending capital has become harder to access overall since the 2007-2009 economic crisis with small business loans falling to 60 percent of their 2006 average level during that crisis and only returning to 70 percent by 2014.[xix]

For MWBEs that challenge is compounded. Research shows MWBE owners are less likely to apply for credit than white male small business owners, instead relying heavily on owner equity than non-diverse businesses do. Approval rates for those who do apply lag behind approval rates for their white male counterparts, even after controlling for differences in creditworthiness. These race and gender disparities are not limited to the start-up phase, but endure over the lives of the businesses. Not surprisingly, these undercapitalized businesses are also more likely to fail.[xx]

Before the pandemic began, there were 8 million diverse-owned firms in the U.S., with $1.4 trillion in combined receipts and 7.2 million paid employees.[xxi] Women-owned businesses employ more than 8 million workers, 7 percent of the private-sector workforce, and generate more than $1.4 trillion in revenues.[xxii] However, traditional private equity and venture capital does not serve diverse or women business owners or those located in low- to moderate-income (LMI) areas in any significant way, with only about 1 percent of traditional venture capital going to Black-owned businesses and even less to Latinx-owned businesses.[xxiii]

The SBIC managers we interviewed agree there is an issue. "There is a significant unserved market of diverse-owned businesses out there," said one. Several interviewees described a scaling gap in the mid-range of capital needs from around $500,000 to $2,000,000 for financing that can help small businesses grow to the point that they are ready for equity investment. "Not a lot of firms are writing checks of that size, and the banks are not. Most SBICs are looking to write $10-25 million checks, and there's not a lot of companies that are raising that type of debt capital in the low-middle market," one manager explained.

But some SBIC managers see opportunity where others see unacceptable risk. A manager at one SBIC that focuses on LMI and MWBE businesses explained that this niche of the market is greatly underserved, which means there is less competition for the types of deals their firm is looking for. As a result, "I am going to find the best of what is available out there." A principal at another firm, which has more than 40% of its small business portfolio invested in diverse-owned businesses, noted they are targeting MWBEs, but still looking for the best quality investments they can find. They look at hundreds of deals each year and select only a handful of the best.

Indeed, MWBE firms represent good opportunities for investors. In a study of the SBIC industry, gender- and racially diverse SBICs performed comparably to white- and male-owned funds.[xxiv] Principals at the SBICs we spoke to, including Impact SBICs, report that they are having success targeting MWBEs for investment. In fact, one investment fund applied for an SBIC license specifically in order to add the right tools to serve this market and seize more opportunity to finance businesses that were not a fit for their other fund models.

Stimulating SBIC investment in growth-oriented, diverse-owned small businesses has multiple benefits. It helps the businesses grow, bringing wealth to MWBE small business owners and their communities; it rewards investors who see healthy returns from these businesses; and it stimulates small business growth, job creation and stability in a time of economic crisis.

Policy and Practice Recommendations

How can Congress and the SBA stimulate greater SBIC investment in small women- and diverse-owned businesses? Our research suggests several steps that could be useful.

1. Set intentional race- and gender-based investment metrics

In order to close the gap in financing for MWBEs, there is a clear need for initiatives that intentionally and explicitly target investments to small businesses owned by women, people of color and veterans. These can exist alongside initiatives that focus on low- and moderate-income neighborhoods, but they should be specific to the small business owners most in need of support. While LMI investment is helpful in encouraging local hiring, it is not a proxy for supporting MWBEs. There is no additional lever to ensure that women- or diverse-owned businesses in LMI areas are receiving the investments targeted to those communities. Indeed, the data would suggest that the termination of SBIC programs intentionally targeting diverse communities in favor of geography-based incentives has negatively affected investment in diverse-owned businesses.

The MESBIC (later SSBIC) program was rooted in sound intentions. The historic poor execution of the program does not mean programs with such intent cannot be successful. The SBIC program currently lacks statutory authority to target gender- or racially diverse companies, but Congressional authorization for new SBIC licenses specifically targeting MWBEs and incentivizing investment could have a significant positive impact. Appropriations to fund the program would also be essential to enable the SBA to capitalize it appropriately, staff it adequately, and match investment to purpose (e.g., using longer-term debt instruments to match the investments the SBICs are making). Such a program has the opportunity to target capital where it is needed.

On the practice side, SBA in recent years has made efforts to identify and recruit funds interested in serving this segment of the market, according to our interviews. These efforts should continue, as should encouragement of specific diversity initiatives like utility set-asides and procurement diversity initiatives. According to one SBIC manager, these initiatives are very helpful in scaling up growth for MWBE firms. Such contractual commitments provide income pipelines that make investment more attractive and less risky.

With legacy licenses in the market, the SBA should redouble its efforts to support the establishment of entities that will focus on diverse businesses. Legacy licenses could be used to pilot a re-established SSBIC program with a sole or primary focus on diverse business investment. To support this objective, we recommend creation of a system to rate SBICs based on the racial and gender diversity of their staffs, boards, and investment portfolios. Similar to Community Reinvestment Act ratings for banks, the system should rate SBICs as “Unsatisfactory,” “Satisfactory,” or “Outstanding.”

In backing equity investments, the federal government should not award its fullest benefit to portfolios that do not represent the desired level of diversity. Portfolio ratings should account for the percentage of diverse businesses or businesses in LMI areas providing quality jobs, and the SBA should be consider increasing the amount federal subsidy for Outstanding SBICs and decreasing federal subsidy for those entities that do not serve diverse markets. We recommend the latter be allowed to leverage one-third of its overall investment pool from the federal government and find the other two-thirds on the marketplace, while SBICs focused on diversity receive two-thirds leverage.

The ratings should also inform price and approval in the sale or trade of SBIC licenses. If an SBIC with a rating of less than Outstanding sells its license and/or transfers its portfolio, the new entity would be required to create a plan and make affirmative steps to achieve an Outstanding rating. Portfolios in Outstanding compliance would likely attract higher prices.

2. Reward investment in the MWBE sector

While research shows MWBEs can provide competitive returns for SBICs, more conventional investors may consider this sector to be potentially high-risk and low reward. It would be helpful to provide incentives for investment in MWBEs. The SSBIC program included tax incentives to encourage investment, including:

a. Deferral of recognition of any capital gains from the sale of securities so long as proceeds were used to purchase common stock or a partnership interest in a SSBIC. This deferral would last for as long as the investor maintained their investment in the SSBIC.

b. Taxpayers could exclude up to 100% of the capital gain upon sale of stock in a SSBIC, provided the qualified small business stock was acquired after September 27, 2010, and was held for at least five years before the stock was sold.

The Tax Cuts and Jobs Act of 2017 repealed these tax advantages for sales taking place after 2017. We know from programs like the Low-Income Housing Tax Credit that tax credits can be a powerful tool to attract investment and accomplish community development aims. According to some interviewees, investment in SBICs needs to be more attractive to entice investors to choose SBICs over other opportunities with lower barriers to entry and higher returns. The return of tax incentives could help attract investors to choose funds that are investing in firms owned by women and people of color.

The Community Reinvestment Act (CRA) obligates banks to invest in LMI communities. Banks can receive CRA credit for their investments in SBICs, regardless of whether those SBICs target diverse businesses. This lack of specificity in the regulations dilutes the intended effect of the credit, which was created to reverse the effects of generations of redlining that harmed diverse communities.

When assessing bank compliance, federal CRA regulators within the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System should scrutinize bank investments in SBICs, awarding higher ratings for investment in SBICs that focus solely or in the majority on MWBEs.

For SBICs themselves, incentives such as an expedited version of the rigorous licensing process or an incentive grant program could spur the establishment of funds specifically focused on the MWBE market. Similar to Community Development Financial Institutions (CDFI) Fund Program awards, grants could support SBICs' reserves on their investments, provided they are investing in the desired sector. Interviewees also suggested the possibility of licensing some smaller funds to do smaller deals. For example, SBIC funds totaling $30-40 million could make $500,000 to $2,000,000 equity investments that would fill a gap in the capital market, but are too small for larger SBIC funds to consider.

3. Build diversity within SBICs

A 2016 report found that SBICs with people of color in their leadership are more likely than White-owned firms to invest in small businesses with diverse leadership. They are also more likely to invest in female-headed companies.[xxv] Our interviews bore this out, with one SBIC describing its diverse team of partners, each of whom has a different network, affording the fund a wide range of contacts in different racial groups and in veterans' and women's networks. However, only 15 percent of active SBICs have any gender or racial diversity in their leadership. Fewer than 10 percent have at least one female investment partner and 10.2 percent have at least one investment partner who is a person of color.[xxvi]

The proposed rating system would scrutinize the diversity of SBIC ownership and leadership as well as portfolio diversity. We recommend the SBA set a goal to increase its investment in SBIC licensees with diverse leadership, including a specific goal for the number or proportion of SBIC funds rated Outstanding under the new system. To support this goal, Congress could request SBA to institute a capacity building program that supports diverse-controlled firms as they work to meet licensure requirements (if necessary). This program could be modeled on the CDFI Fund's Technical Assistance grants, which prepare emerging nonprofit financial institutions to qualify for CDFI certification. SBA national and regional leadership should also continue their efforts to network with firms owned or controlled by women and people of color to encourage them to apply for licenses.

4. Invest in the MWBE pipeline

The SBIC program can help build the pipeline of small businesses that are equity-ready. SBIC Program staff may look to partner with other SBA or Minority Business Development Agency programs to provide access to other forms of growth capital and technical assistance to help MBWEs reach the level of growth at which they can access and use equity funding. One specific recommendation is helping to identify additional sources of lending capital in the $50,000-75,000 range for start-up entrepreneurs, as well as between $250,000 and $2 million for businesses that are more established, but not yet equity-ready.

CDFIs may be well-positioned both to provide this necessary capital and to help small businesses be ready to use equity financing. As mission-driven financial institutions, CDFIs exist to bring economic growth and opportunity to disinvested communities. They typically offer debt financing on more favorable and flexible terms than traditional banks, and couple it with technical assistance to support development goals. There are two barriers that currently keep CDFIs from adding value in the venture capital space. First, CDFIs typically draw on debenture capital, which limits their ability to put out the longer-term, more flexible funds that venture capital requires. Second, underwriting venture capital investments requires specialized expertise, such as market analysis, that many CDFIs do not have in-house. We recommend creating a pilot program of the CDFI Fund to support CDFIs to become effective equity providers. The program should include infusions of patient, flexible capital that can wait for returns to materialize without requiring debenture-style debt service, as well as operating support to bring on analysts and business consultants with expertise in venture capital investment to build knowledge and capacity within the CDFI sector. With this new capability in addition to their existing lending and technical expertise, CDFIs could serve the entire life cycle of diverse small businesses.

Another important component of building the pipeline is ensuring diverse small business owners know about SBICs and how to engage with them. SBA representatives at the regional level frequently make presentations to business owners through Chambers of Commerce and trade associations that want to engage their members. SBA uses these opportunities to make business owners aware of the range of financing options SBA offers, including SBICs and the Community Advantage and 7a lending products. This work is valuable, and SBA should continue to foster partnerships with community-based organizations, small business-focused nonprofits and others to build strong local small business ecosystems that can support MWBEs to grow and thrive. SBA should also incorporate SBICs' outreach efforts to diverse-owned businesses as a factor in the proposed rating system.

5. Collect data

Finally, in order to gauge progress toward equitable investment in small businesses, Congress and SBA will need to enable more robust data collection about the businesses receiving SBIC investments.[xxvii] Experience with Home Mortgage Disclosure Act data and CRA requirements tells us that data collection gives us a more complete picture of the challenges that people of color and residents of LMI communities face in accessing financial services. The proposed rating system would require regular data collection about firms receiving SBIC assistance, which would provide a more exact scope of the issue, as well as allowing for goal setting and benchmarking.

Even if data collection is not statutorily required, Congress should direct SBA to provide guidance for what information would be helpful if voluntarily collected and consider incentives for voluntary compliance.

Conclusion

As the pandemic wears on, American small businesses are suffering their worst losses in recent memory. Entrepreneurship is often seen as the road to the American Dream of independence and prosperity, but diverse-owned businesses – already undercapitalized – are seeing that dream slip away at a higher rate than others in the current downturn.[xxviii] Losing a major share of our small businesses will destabilize communities of color and exacerbate the racial wealth gap in the region. To help these businesses succeed will require the public and private sectors to actively work at dismantling the structural barriers embedded within our systems and policies that persistently leave diverse business owners behind. We believe this moment calls for a deliberate focus on providing equitable access to capital for businesses owned by people of color and women and a renewed commitment to their success.

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LISC LA | 500 S Grand Ave, Los Angeles, CA 90071 | 213-250-9550 | www.lisc.org