President Trump Should Create a United States Backed VC Fund to Invest in Overlooked, Underestimated and Left Out Entrepreneurs

A United States backed Venture Capital Fund can provide the most needed financing to "garage entrepreneurs" who are overlooked, underestimated and do not meet the typical "background qualifying" characteristics that most traditional investment firms seek in entrepreneurs.

Many countries have gigantic sovereign wealth funds that effectively compete against privately funded investment firms. From Saudi Arabia to Singapore, their government owned investment firms invest in companies and funds globally. This provides them access to stake in foreign firms and effectively control those companies. For example, Uber and WeWork or almost any company backed by Softbank group is controlled by foreign nation or firm. Those foreign funds are driven to finance companies worldwide, exert influence and generate profits for their countries. In United States, nearly all capital is provided by investment firms who are tiny compared to foreign sovereign wealth funds. Corona Virus pandemic is forcing us to think whether America can do more to help economic recovery.

We are living in an unprecedented challenging time which requires American innovative entrepreneurs to get extra but modest support that will produce exponential returns and will benefit America in the long run.

Unfavorable Economic Conditions

According to Goldman Sachs and the Federal Reserve, we could see 15% to 32% unemployment due to the pandemic. The economic crisis would be so deep that many currently employed Americans or upcoming graduates would not have jobs. This could last for several years depending on the recovery time. What previous economic crises have showed is that many would not return to work or would not be able to find work. In order to avoid becoming permanently dependent on government assistance, a significant number of them will attempt to create new enterprises.

Unfortunately, without the support I propose below, they will face almost insurmountable barriers to launching their new enterprises.

On March 27th, President Trump signed a historic $2 trillion economic stimulus bill. Of that, small businesses would get $377 billion or 19% of the total. Similar stimulus of $450 billion was subsequently signed. This amount would primarily be provided as loans and relief to small businesses through the Small Business Administration. While the SBA loans and relief will help many small businesses that have already achieved some scale and some success, a large portion of very small one or two person startup businesses – which are often the most innovative – will be left out.

Shortage of Capital

Only private investment firms or angel investors cannot provide the type or amount of investment capital needed to get "Main Street" businesses started, and get them employing people to reverse the decline in employment numbers resulting from the sudden shuttering of so many businesses during the "corona crisis."

Even during the normal course of operations, United States does not have institutions that are able to offer support for most of the potential entrepreneurs who want to venture into the business world but lack the startup capital. These entrepreneurs often are looked down upon because they do not have friends and family who are willing or even able to provide the startup capital needed to finance the first stage of investment popularly known as the “friends and family” round.

The barriers to the crucial first stage success for these entrepreneurs are manifold.

First, fewer than 5% of entrepreneurs receive any funding from individual “angel” investors. These angel investors are the rare investors who have the freedom to invest their own money. Since they are not investing the money of other people or institutions, they can decide to trust their experience or instincts, and make a decision without the level of vetting that typically occurs when someone is investing other people’s money. But the number of these investors and the total dollars they control is nowhere near sufficient to fund most of the entrepreneurs who are worth funding.

Only slightly less than 2% of entrepreneurs receive funding from venture capital firms. Sadly, with a very few exceptions, the 2% that receive venture funding are people who share similar characteristics, and those are not necessarily merit based nor accurate predictors of success. Among other things, these characteristics include their family background, ethnicity, and attendance at certain educational institutions.

Second, first generation entrepreneurs whose families have little or negative net worth would almost certainly not get any funds to start their business. In Silicon Valley, a small number of angel investors and an even smaller number of “pre-seed” venture firms are writing first checks to firms that have not had the capital to demonstrate proof of concept or product market fit. Unfortunately, it is nearly impossible for this small group of investors to fund more than a small percentage of qualified entrepreneurs. In addition, these investors also look for people who have the same characteristics as the 2% group.

Third, venture firms lack diversity of professionals in terms of gender and race. This deprives the decision making investment professionals from sourcing and funding great entrepreneurs of diverse background. Very few venture capitalists even attempt to seek to find entrepreneurs with “other characteristics.” According to Black VC, only 3% of venture capitalists are Blacks, with even fewer controlling the $80B+ invested annually in the US. At the partner level where most of the investment decisions are made, only 2% are Blacks. Realizing the gap, some diversity focused funds have been introduced, but these funds face the same obstacles as the first time “resource-deprived” entrepreneurs. These funds have a difficult time raising funds and are often so small in size that they cannot make the type of investments that venture capital firms typically make to be successful. A study conducted by Diversity VC found that most venture-backed startups are “overwhelmingly white, male, Ivy League-educated and based in Silicon Valley.”

That should be especially troubling for Americans who want to see the heartland thrive.

Other troubling findings were:

1. Just one percent of venture-backed founders were black.
2. Women-funded startups received only 9 percent of investments.
3. Latino founders made up 1.8 percent of those receiving funding.

Fourth, the majority of venture capital funded companies fail. While it is easy to say that most startups fail, looking from another lens, it could also be said that the venture capital firms often do not pick the best 2% of startup companies when they choose which companies to fund. This raises another important question. Of the 98% not funded, how many potentially great companies did not receive funding, simply because they did not fit into the typical characteristics that investment firms apply when making investment decisions?

Often, entrepreneurs raise a few thousand dollars from their closest family and friends and use that small sum of money to test their ideas by developing products or solutions. Then they reach out to angel investors or venture capital firms. Unfortunately, most startup entrepreneurs do not get any angel or venture capital to get started. The resulting shortage of capital eliminates many potential entrepreneurs from having a chance to achieve their dreams. Most never get an opportunity to launch their business. Many excitedly register their business and attempt to start running it, but soon realize they will not be able to obtain financing. Most of them shut down, becoming another statistic on the list of failed companies.

That excludes a lot of talented and capable people from contributing to our economy. New institutions are needed to meet the need for capital for the emerging entrepreneurs. “Main Street” entrepreneurs that each employ a handful of people yet, when aggregated, provide a solid foundation for our economy. Most of these “Main Street” entrepreneurs are local. Most of them will not be scalable. Their value to society is not that they might become very large nationally recognized companies that employ tens of thousands of people. Their value is that tens of thousands of them can generate some jobs with low six figure salaries and many jobs with decent five figure salaries. Obviously, society needs some way other than angel investors and venture capital to underwrite the capital needs of these businesses.

Government Attempts to Finance Businesses But With Different Structure

The United States government does provide some support to various agencies with the intent that these agencies will help small businesses launch and ultimately thrive. For example, SBA provides funds to small business investment companies (SBICs) that make investments in small businesses.

Unfortunately, the SBICs do not meet the need for capital to be available to the “garage entrepreneurs” who comprise the majority of startup companies. Rather, the SBICs mostly operate as growth equity or debt capital providers for businesses that are well past the seed stage. Even more unfortunately, the SBICs often look for the same elite characteristics as many prominent angel investors and most venture capital firms.

It is time for America to support its most overlooked potential entrepreneurs. These are the entrepreneurs who do not have a recognized or impressive family background, do not have a brand name, do not have personal funds or powerful connections, and do not have family and friends with first stage funds to invest. When the existing types of individual angel investors and venture capital firms are unable to place bets on the ability of these promising American entrepreneurs to succeed, America should step in and help.

The Fund Can Support Entrepreneurs by Investing Directly In Privately Held Early Businesses

Now is the right time. With all the businesses shuttered and employees laid off due to the “Corona Crisis” America has never had so great a need to stimulate exponential growth in the number of startup companies and the number of people they can employ.

What is needed is a new program to fund as yet unknown American entrepreneurs through the first stage of development of their businesses. These first stage investments would be very small, with dollar amounts comparable to what angel investors and “pre-seed” venture capital firms provide, typically ranging from $25K to $250K.

These small checks would help a lot of entrepreneurs get started quickly, and help each of them employ a few people right away. In light of the many small businesses that are shuttering at a tragic rate, this program could be titled the “Main Street Capital Fund.” The program could be organized as a completely independent fund directly under the Executive Branch. Like a typical private fund management business, it would have professional investment managers and operate independently.

Operating independently is crucial. The investments that America needs now need to be made quickly and with a less cumbersome process than the process most private investors and professional venture capital firms have to use when considering an investment.

A major difference between the Fund and a private venture capital fund would be the expected return. While a venture capital firm typically seeks over a 1,000 percent return, the Main Street Capital Fund could seek a more reasonable and consistently achievable return. In order to do this, the Fund would adopt certain investment criteria that differ from the criteria used by most angel and venture capital investors.

First, the Fund would be nondiscriminatory in choosing the entrepreneur characteristics, and could aggressively endeavor to replace the family background and educational characteristics generally favored by most current investors with characteristics that are merit based and more likely to correlate with small business success.

Second, the Fund would invest in a much higher percentage of companies than the venture capital industry standard of 2%.

Third, to minimize the delays inherent in large government agencies attempting to review hundreds of thousands of applications, the investment committees could be convened by professionals appointed by you as the president, who would then invite successful local entrepreneurs and representative citizens from diverse background to serve on the committees. The program would have no shortage of volunteers, and this local control would a wonderful counter example to centralized administrative control.

With $1 billion of committed capital, the Fund can provide early financing of $25,000 each to 40,000 companies. That is a lot of companies.

$1 billion is equivalent to mere 0.05% of $2 trillion stimulus. Applying typical venture capital return assumptions, if 10% of these companies achieve a 1,000% return, $1 billion would generate $100 billion of gains which could be redeployed in subsequent Funds to finance tens of thousands of new entrepreneurs. As well, many more than 10% of these companies will achieve some return, generating lesser though still significant gains that can be similarly redeployed.

If the United States government is willing to take equity stakes in airlines to help the airline industry, the government can certainly take equity stakes in seed stage startups as well. By providing the first round of financing to startup or "garage entrepreneurs", America can help these entrepreneurs create businesses and employ people. The economic gain from starting a seed funding program will be exponentially higher than the cost of starting or managing the program.

To avoid deterring entrepreneurs who are reluctant to take on debt in a time of great uncertainty, these investments should be structured as equity. To avoid deterring entrepreneurs who would be reluctant to give up control of their businesses and to avoid the risk of government getting involved in the management of a large number of private businesses, these investments should be structured as nonvoting stock, or stock with voting rights limited to exceptional decisions, such as adding private investors or selling the business.

In sum, while the government may not be able to create entrepreneurs, it can create the conditions for potential entrepreneurs to have a chance to get started and thrive.

If it really wants to.

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