

Donde Comen Dos, Comen Tres: Investment Discrimination Against Latino-Owned Businesses

By Thomas Catalano

AUTHOR BIO

Thomas Catalano is a senior at Loyola High School of Los Angeles. He is highly passionate about the field of economics and plans to study it in college. Thomas is also interested in the intersection between economic principles and behaviors with his Latino identity. He is involved in extracurricular activities at his high school, including Co-Editor-In-Chief of the newspaper, Co-Editor-In-Chief of the yearbook, Co-Captain of the Public Forum Debate Team, Chapter President of Junior State of America, and a member of the Varsity Tennis Team. He is currently engaged in an independent research capstone project on cultural narratives of Latino people found in literature.

ABSTRACT

The paper addresses the systemic underinvestment of Latino-owned businesses in the United States. The research examines the disparity in access to capital for Latino-owned businesses, the mechanisms through which this disparity is rooted and persists, and the impacts that this early-stage disparity plays on the future success of businesses. The work employs comparative data between Latino-owned businesses and white-owned businesses to empirically establish the investment disparity.

Keywords: *Latino-owned businesses; disparity; investment disparity; United States.*

INTRODUCTION

Investing in Latino-owned businesses in the United States is an opportunity that is missed by early-stage investors, which systematically underfund such companies. According to the most recent report by Bain & Company in collaboration with the Stanford Latino Entrepreneurship Initiative, US Latinos had an economic output of \$2.7 trillion in 2019, which makes them the world's seventh largest economy. Although Latinos made up only 19% of the total US population, they were responsible for 82% of the growth in the US labor force from 2010 to 2017 and approximately 50% of net new small business growth from 2007 to 2017. Employment at Latino-owned businesses grew at twice the rate of non-Latino-owned businesses from 2014 to 2016. Despite the rapid economic growth of the Latino population in the US, Latino-owned businesses (LOBs) are massively underfunded compared to white-owned businesses (WOBs) with similar profiles. If investors funded LOBs equitably, they would generate \$1.4 trillion in additional revenue today and \$3.3 trillion in additional revenue by 2030 (Saenz et al., 2021).

While some may argue that this disparity in investment across racial groups is a result of the investment potential of the companies, LOBs exceed WOBS in revenue growth across companies of all sizes. Rather, the structures encoded in investment culture and in the Latino economic community systemically disadvantages LOBs in the investment stage of startups. The landscape of investment in the United States is primarily controlled by investors (angel groups, venture capitalists, private equity, etc.) and includes LOBs as well as their white counterparts.

This paper seeks to answer the following question: In the United States, to what extent do early-stage investments by angel investors and venture capitalists create a

systemic advantage for WOBS over LOBs? The following research examines the disparity in access to capital for LOBs, the mechanisms through which this disparity is rooted and persists, and the impacts that this early-stage disparity plays on the future success of businesses.

Obtaining Capital

Minority-owned businesses face significant difficulty in obtaining capital to fund their startups. One study found that Black and Hispanic-owned businesses experience higher rates of rejection and smaller size investments by investors (Lee & Black, 2017). Another study found that while 40% of WOBS obtained the investment capital they sought, only 20% of Hispanic-owned businesses obtained the investment capital they sought (Small Business Credit Survey, 2021). According to the aforementioned 2021 report by Bain & Company (in collaboration with the Stanford Latino Entrepreneurship Initiative), less than 1% of funds invested by top venture capital and private equity firms are directed towards Latino-owned enterprises. For example, LOBs only received \$680 million of \$487 billion invested by the largest venture capital and private equity firms. Less than 2% of investment in the seed/angel round is given to LOBs. The founder diversity of venture capitalist-backed businesses breaks down to 77% white and 2% Latino. Additionally, LOBs have to enlist double the amount of investors to reach the same level of investment as their white counterparts. On average, WOBS receive three times more funding per private equity investor and two times more per venture capitalist than LOBs. Mature employer LOBs are 30 to 50 percentage points less likely to have funding needs sufficiently met by angel investors and 16 percentage points less likely for national banks than WOBS; small employer LOBs are 19

percentage points less likely to have funding needs met by local banks (Saenz et al., 2021).

As a result of their limited access to funding, LOBs typically must resort to less conventional ways to fund their startups, such as personal savings, grants, and payday loans. Small LOBs are 1.3 times more likely to invest personal wealth into their companies than small WOBs; larger LOBs are 1.4 times more likely to rely on friends and family (Saenz et al., 2021). According to the Stanford Latino Entrepreneurship Initiative, the three most common sources of funding for these businesses are personal savings, credit cards, and friends, compared to the sources of personal savings, commercial loans, and personal bank loans for non-Latino owned businesses (MacBride, 2015). These less stable alternatives to traditional early-stage investment lead to higher costs and more risk for LOBs, which “sets a vicious cycle in motion, forcing LOBs to turn to expensive forms of debt, including hard-money lending, and creating challenges with cash flow, profitability, and obtaining later equity investments as these businesses seek to scale” (Saenz et al., 2021).

Disparities

The primary root behind the disparities in the investment landscape for minority-owned companies is the personal wealth and assets statistically typical of Latin Americans. While the mean family wealth of white families is \$983,400, the mean family wealth of Hispanic families is \$165,500 (Bhutta et al., 2020). The racial disparity in wealth translates to the gap in access to capital as a business owner: “Latinos have one-eighth the wealth of White households, making a Latino entrepreneur’s access to friends and family financing severely limited in comparison to White entrepreneurs. As a result, debt may be among the only startup financing options available” (Orozco and Furszyfer, 2021).

Low levels of personal wealth limit investment opportunities for Latino entrepreneurs. Low levels of assets account for one-quarter of the gap for business entry for Mexican Americans (Fairlie and Robb, 2010). Differences in home equity are one example of an asset that causes the investment discrepancy across racial groups: “Less than half of Hispanics and African Americans own their own home compared with three-quarters of non-minorities. The median equity of Hispanic and African American homeowners is also substantially lower than for non-minorities (\$49,000 for Hispanics, \$40,000 for blacks, and \$79,200 for whites). Homes provide collateral and home equity loans provide relatively low-cost financing. Without the ability to tap into this equity many minorities will not be able to start businesses” (Fairlie and Robb, 2010). The differences in home equity are especially important because Latinos are required to pay more collateral than white people on average (Orozco and Furszyfer, 2021). The racial differences in personal wealth and assets are a major mechanism through which the cycle of systemic underfunding of Latino businesses is created and persisted.

Another reason for the disparities in access to startup investment is racial discrimination in lending practices. A study conducted by the Minority Business Development Agency of the U.S. Department of Commerce found that “African Americans, Hispanics, and Asians were all more likely to be denied credit, compared with whites, even after controlling for a number of owner and firm characteristics, including credit history, credit score, and wealth” (Fairlie and Robb, 2010). The investment industry also systemically discriminates against immigrants, which make up one-third of LOBs. Because employment history, credit history, and other records are more difficult to evaluate for immigrants, investors often reject immigrant entrepreneurs seeking funding for their

businesses (Orozco and Furszyfer, 2021). Bain & Company also found that “cultural expectations, language gaps, and loan approval processes” can play a role in LOBs getting funded. In addition, the research found that “Latino business owners may struggle navigating the current structures and processes of the financing world and face challenges packaging a loan application or business data in ways likely to maximize the odds of being funded” (Saenz et al., 2021). The cultural and structural components of the investment industry create a pervasive and persistent disadvantage for Latino businesses, perpetuating a system of discriminatory investment practices.

Consequences

The consequences that this systemic disparity inflicts upon the Latino economy are devastating to the prospects of long-term entrepreneurial success. Early stage investment from angel investors, venture capitalists, private equity firms, and private investors is “a critical enabler of growth for businesses,” but the underrepresentation of Latinos in the investments presents a significant barrier for Latinos seeking to grow their businesses (Saenz et al., 2021).

As a result of the lack of access to capital, LOBs are often forced to reduce operational capacity or shut down altogether. Between February and April 2020, for example, the number of Latino business owners dropped by 32% and the number of immigrant business owners dropped by 36% (Fairlie, 2020). The rare, inconsistent flow of capital to LOBs is most apparent as these companies approach the \$1 million revenue mark. This period represents the critical window for investment, as firms at this size typically struggle with profitability and cash flow as they attempt to scale. LOB growth often decelerates as WOB growth accelerates in this stage; however, the few LOBs that are able

to reach the \$5 million revenue mark experience growth at nearly double the rate of WOBs, a testament to the viability of LOBs when they receive equitable investment (Saenz et al., 2021).

The disproportionate investment across racial groups creates a vicious cycle that often leaves LOBs with no options other than to turn to expensive forms of debt, leading them to more challenges with cash flow, profitability, and receiving future investment (Saenz et al., 2021). Research conducted by the Stanford Graduate School of Business found that while Latinos start new businesses more often than the general population, their businesses are often smaller in size and revenue than their non-Latino competitors (MacBride, 2015). The systemic underinvestment of LOBs wreaks devastating consequences on Latino entrepreneurs seeking a prosperous and stimulating economic endeavor, or at least an equal opportunity as white entrepreneurs to get there.

Conclusion

This paper establishes the disparity in the investment of LOBs compared to WOBs using empirical, comparative data on the frequency and sizes of investment. There are socio-economic and political mechanisms through which this disparity is rooted and perpetuated, including the personal wealth and assets of business owners, racial discrimination against Latinos, and cultural barriers to navigating the structures of the investment industry. This investment disparity has devastating effects on the potential for success among LOBs. The investment landscape of the United States is a discriminatory landmine for Latino entrepreneurs; beneath each step is an explosive device of systemic rejection.

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