

Private Equity Funding for Minority Media Ownership

Vance H. Fried*

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* B.S., Oklahoma State University, 1973; J.D., University of Michigan, 1976; CPA, 1977. Professor Fried is Director of the Entrepreneurship Center and Associate Professor of Management at Oklahoma State University. His research focuses on the private equity industry and the management of firms financed by private equity. He serves as an advisor on private equity to both the private and public sectors and was a principal draftsman of the Oklahoma Small Business Capital Formation Act. Prior to joining Oklahoma State, Professor Fried worked as an attorney in private practice, an executive of an independent oil company, and an investment banker working with small and mid-cap companies. The Author benefited from the comments of John Mowen, Bernadine Santistevan, Herbert Wilkins, and the attendees at the conference, "New Approaches to Minority Media Ownership," sponsored by the Columbia Institute for Tele-Information, July 1998, New York, New York.

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I. INTRODUCTION

The private equity market is a major source of capital in the United States. In 1998, organized private equity firms raised over \$85.3 billion.¹ These firms are very interested in media investing. For example, one private equity firm, Hicks, Muse, Tate & Furst, recently financed the \$2.1 billion purchase of SFX Broadcasting and the \$1.7 billion purchase of LIN Television.² Private equity financing is important to all sizes and types of media companies. Much of the rapid growth of the Internet has been financed by private equity.

The two defining characteristics of the private equity market are in its name. First, it is structured as equity or near equity (e.g., subordinated debt with warrants) investment, not debt. The investor is at significant risk and is looking for long-term capital appreciation. Second, it is an investment in an unregistered (private) security that cannot be purchased or sold in the public market.

Private equity is one of the most expensive forms of finance. Thus, companies that raise private equity tend to be those that are unable to raise funds in other markets such as the bank loan, private debt placement, or public equity markets. Many of these companies are simply too risky to be able to issue debt or need funds beyond prudent debt levels. Investment in these companies may also require a large amount of investigation on the part of potential investors because little public information is available, and there are unique risks involved. The companies may also need investor guidance and expertise in developing their business. The private equity market, where a large investor can take the time and effort to understand such risks and may exert some influence over management in return for its investment,³ may be the only viable alternative.

From the perspective of an entrepreneur or top manager, being part of a company financed by private equity is often far more attractive than being part of a subsidiary of a large company. The private equity investor allows

1. Juan Hovey, *Small Business Finance and Insurance: Brighter Outlook for Private Equity Funding for Small Firms*, L.A. TIMES, Mar. 10, 1999, at C5.

2. Mitchell Schnurman, *Hicks Muse Has a Taste for Food Acquisitions*, FORT WORTH STAR-TELEGRAPH, Sept. 24, 1997, at B1.

3. See generally Vance H. Fried & Robert D. Hisrich, *The Venture Capitalist: A Relationship Investor*, 37 CAL. MGMT. REV. 101, 101-02 (1995).

them to have a significant economic stake in the business. They are co-owners, not just employees. In addition, private equity investors give them much more control over their company. Private equity investors generally try to stay removed from day-to-day operations. Private equity investors function like active board members, not like a chief executive officer and headquarters' staff.⁴ While private equity investors may have investments in several different companies, these companies are usually allowed to operate totally independent of each other.

II. OVERVIEW OF THE PRIVATE EQUITY MARKET⁵

Sometimes a private equity investment is made directly by an investor in a company issuing the stock. However the bulk of private equity comes through the organized private equity market. In this market, an intermediary organizes investors and makes investments on their behalf in the issuing company. Figure 1 presents an overview of the organized private equity market.

A. Issuers

Issuers in the private equity market vary widely in size and their reasons for raising capital, as well as in other ways. Issuers of traditional venture capital are young companies, often developing innovative technologies, projected to show very high growth rates. They may be early-stage companies still in the research and development stage or the earliest stages of commercialization, or later-stage companies that have several years of sales but are still trying to grow rapidly.

Since the mid-1980s, nonventure private equity investment has outpaced venture investment. Middle-market companies, roughly defined as companies with annual sales of \$25 million to \$500 million, have become increasingly attractive to private equity investors.

Public companies also are issuers in the private equity market. Public companies that go private issue a combination of debt and private equity to finance their buyout. Public companies also issue private equity to help them through periods of financial distress and to avoid the disclosures associated with public offerings.

4. See *id.* at 103-04, 109-10; Vance H. Fried & George D. Bruton, *The Involvement of the Board of Directors in Portfolio Company Strategy*, 1 J. PRIVATE EQUITY 51, 51-55 (1998); Vance H. Fried et al., *Strategy and the Board of Directors in Venture Capital-Backed Firms*, 13 J. BUS. VENTURING 493, 494-95 (1998).

5. Much of the material in this Part comes from a general description of the private equity market appearing in GEORGE W. FENN ET AL., *THE ECONOMICS OF THE PRIVATE EQUITY MARKET* (Federal Reserve 1995), which has been modified by the Author to emphasize minority media.

B. Intermediaries

Intermediaries—mainly limited partnerships⁶—manage an estimated 80 percent of private equity investments. Investors are the limited partners. Professional private equity managers, working through a partnership management firm, are the general partners. Limited partnerships have a ten-year life, during which investors give virtually all control over the management of the partnership to the general partners. The general partners are paid an annual management fee but receive a significant amount of their compensation in the form of shares in the partnership's profits.

Slightly different from traditional partnerships are Small Business Investment Companies (SBICs). Small Business Investment Companies can

6. Limited liability companies are becoming popular as a legal structure. In practice, limited partnerships and limited liability companies operate in an almost identical manner.

leverage investor capital with federal government capital through the Small Business Administration (SBA). Today, SBICs play a small role in the overall private equity market, accounting for less than 1 percent of total industry capital. However, one type of SBIC, the Specialized Small Business Investment Company (SSBIC), may be a very important source of financing for minority media. By their charter, SSBICs are required to invest in businesses owned by the socially or economically disadvantaged.

C. *Investors*

A variety of groups invest in the private equity market. Public and corporate pension funds are the largest investor group, providing about 50 percent of the capital. Pension funds are followed by endowments and foundations, bank holding companies, and wealthy families and individuals, each of which holds about 10 percent of total private equity. Insurance companies, investment banks, nonfinancial corporations, and foreign investors are the remaining major investor groups. The federal government is also a supplier of capital through the SBIC program.

Most institutional investors invest in private equity for strictly financial reasons. They expect the risk-adjusted returns on private equity to be higher than the risk-adjusted returns on other investments, and they want to diversify their portfolio by asset class.⁷ While SSBICs receive funding through the federal government and are required to invest in minority-owned businesses, the program is designed so that the private investors in the SSBIC are financially driven.

D. *Industry Segments*

Private equity firms have largely segmented the market based upon characteristics of the companies in which they are investing. The primary characteristics are age, size, and reason for seeking equity. Although the boundaries between segments are not precise, most private equity firms will specialize in one, or sometimes two, of these segments.

1. Early-Stage New Ventures

Early-stage venture capital goes to small companies wishing to grow rapidly. Examples of media companies at an early stage are a new Web site, a start-up cable channel, or a developer of new broadcasting equipment. Early-stage new ventures vary somewhat in size, age, and reasons for seek-

7. See Vance H. Fried & Robert D. Hisrich, *Venture Capital from the Investors' Perspective*, in *FRONTIERS OF ENTREPRENEURSHIP RESEARCH* 258, 260 (Robert H. Bockhaus, Sr. et al. eds., 1989) (discussing why and how investors participate in private equities).

ing external capital. The smallest type of venture in this category is the entrepreneur who needs financing to conduct research and development to determine whether a business concept deserves further financing. The concept may involve a new technology or merely a new marketing approach. Financing may be needed to build a prototype, conduct a market survey, or bring together a formal business plan and recruit management.

A somewhat more mature type of company in the early-stage category already has some evidence that production on a commercial scale is feasible and that there is a market for the product. Such companies need financing primarily to set up initial manufacturing and distribution capabilities so they can sell their product on a commercial scale. Slightly more mature companies may already have basic manufacturing and distribution capabilities but need to expand them and to finance inventories or receivables. The most mature of the early-stage companies are starting to turn profits, but their need for working and expansion capital is rising faster than their cash flow.

Early-stage venture investments are by their nature small and illiquid. A typical early-stage investment might range from \$500,000 to fund the development of a prototype to \$2 million to finance the start-up of an operating company. Investors in early-stage ventures recognize that their investments are for the long term and that they may be unable to liquidate them for many years, even if the venture is successful. Because of their high risk and low liquidity, early-stage venture investments carry high required returns. The discount rate that investors apply to such investments range from 35 to 70 percent per annum.

2. Later-Stage New Ventures

Companies that need later-stage venture funds have less uncertainty associated with the feasibility of their business concept. They have a proven technology and a proven market for their product. They are typically growing fast and generating profits. They generally need private equity financing to add capacity to sustain their fast growth.

Generally, later-stage venture investments are larger than early-stage investments, ranging from \$2 million to \$5 million, and are held for a shorter term simply because the firm is closer to going public or being sold. Because the risk is generally lower and the liquidity higher, later-stage investments carry somewhat lower required returns than early-stage investments, generally ranging from 25 to 35 percent.

3. Middle-Market Private Companies

Many existing television or radio broadcasting companies fit into the middle-market segment. Middle-market private companies differ in a number

of ways from companies seeking venture capital. First, they are generally well established, having been founded decades, rather than years or months, earlier. Second, with annual revenues ranging from \$25 million to \$500 million, they are typically much larger than early-stage new ventures and are in most cases larger than later-stage new ventures. Third, they are often in more mature industries. Fourth, most have much more stable cash flows and much lower growth rates than companies seeking venture finance. Finally, they typically have a significant asset base to borrow against. Consequently, they almost always have access to bank loans. Some of the larger companies in this category may also have access to the private placement bond market.

These companies seek private equity for two primary objectives: to effect a change in ownership or capital structure or to finance an expansion. Although these companies typically have access to bank loans, they often cannot meet their financing needs entirely through debt.

All closely held private companies eventually face the issue of succession of the current management team or the liquidity needs of existing owners. Resolution of the issue typically requires that the company be sold to the heirs of the founding family or to a new management team. In either case, funds must be available to cash out the existing owners. In addition, private equity is used to finance an ownership change when a subsidiary is spun out of a large corporation. Typically, a private equity limited partnership organizes the financing of an ownership change with a combination of private equity and debt (often with multiple tranches).

The purchase of major plant and equipment is a common reason to seek external financing. Certainly many broadcasting companies need money for significant equipment upgrades. In addition, private equity can fund acquisitions. Much of the recent consolidation in both radio and television broadcasting has been funded through the private equity market.

Just as the typical middle-market company is larger than a firm seeking venture capital, the investments are also larger, typically ranging from \$10 million to \$100 million. Discount rates for the equity portion of a leveraged buyout are similar to those for late-stage venture investing. Discount rates may be lower on other types of middle-market financing.

Many private equity partnerships invest strictly in middle-market firms, although many partnerships that specialize in later-stage ventures also finance such deals on a regular basis. They will often invest in smaller transactions and generally look for situations where there is significant room for earnings growth after the acquisition. Many SSBICs fall into this category.

4. Companies in Financial Distress

Private and public companies that are in financial distress make up another group of issuers in the private equity market. Most turnaround partnerships target firms with financial problems that arose simply from being overleveraged—that is, they show positive earnings before interest and taxes (EBIT); a smaller number also invest in firms with definable operating and management problems that are showing negative EBIT. Required returns are high, reflecting the risky nature of the activity, with discount rates from 30 to 40 percent.

5. Public Companies

Along with venture capital, buyouts of large public companies are probably the most publicized use of private equity. Recent media examples include the activities of Hicks Muse through Chancellor and CapStar, and Kohlberg Kravis through PrimeMedia. Companies that undergo public buyouts typically have moderate or even slow growth rates and stable cash flows.

In addition to buyouts, there are a variety of other reasons why a public company might use private equity. Some are raising funds to finance activities, such as planned acquisitions, that they want to keep confidential. Others are pursuing complex business strategies that public retail investors would not be comfortable with, and that require analysis by a large, sophisticated private investor.

Still others use the private equity market due to a temporary interruption of access to the public equity market. Retail and institutional investors may have a herd mentality in viewing the prospects of particular industrial sectors. For example, cable television companies found it almost impossible to issue equity publicly in 1992, and turned to the private market to meet their needs.

III. INVESTMENT CRITERIA⁸

While there are significant differences between private equity firms, there is a fairly common set of criteria they use in assessing an investment, no matter what the industry. These criteria can be grouped into three categories—concept, management, and returns. Concept has four components. First, the investment must be in a firm where there is *significant potential*

8. The material in the next two sections is largely based upon B. Elango et al., *How Venture Capital Firms Differ*, 10 J. BUS. VENTURING 157 (1995); Vance H. Fried & Robert D. Hisrich, *Toward a Model of Venture Capital Investment Decision Making*, 23 FIN. MGMT. 28 (1994) [hereinafter Fried & Hisrich, *Model of Decision Making*].

for earnings growth.⁹ This is obvious for early-stage ventures, which may not even be generating revenues, but it is also important for later-stage investments. It is difficult, if not impossible, to get venture capital rates of return without significant earnings growth. Certainly, a rapidly growing market may increase the likelihood of earnings growth, but many late-stage venture capitalists (VCs)¹⁰ are also interested in earnings growth through increasing market share or significant cost cutting. Investors in broadcasting companies often look to improve earnings through better management and/or economies of scale through consolidation of station operations.

Second, the investment must involve *a business idea (new product, service, retail concept, etc.) that either already works or can be brought to market within two to three years*. Even early-stage venture capital firms (VCFs) are not interested in financing basic research. They want ideas that are ready to be commercialized.

Third, the concept must *offer a substantial "competitive advantage" or be in a relatively noncompetitive industry*. Not only must the concept be sound, but it must be achievable in the face of actual or potential competition. One of the attractions of broadcasting companies is that the industry is relatively noncompetitive with large profit margins. Minority ownership might be seen as a plus if it gives actual competitive advantage in a market.

Fourth, the concept must have *reasonable overall capital requirements*. The amount of money available in the private equity market and the initial public offering market is cyclical. When the environment in these capital markets is harsh, VCs look for concepts where the total cash requirement to achieve self funding is within the reach of the VC and his original investment group. If not, the original investment group is subject to being washed out in subsequent financings even if the company has done moderately well. In addition, excessively high capital requirements drive down return on investment (ROI).

Management is also an important consideration. There are several attributes VCs want managers to possess. First, managers must *display personal integrity*. The VC is entrusting management with a great deal of money. The VC does not monitor management on a daily basis. Once an investment is made, the VC is very dependent on the management. It is vital that the VC trust management to deal honestly and fairly with investors.

Second, management needs to have *done well at prior jobs*. The track record does not have to be with the current company. Association with los-

9. The potential for major earnings growth is much less of an issue for middle-market and public company financings.

10. For simplicity, managers of any type of private equity partnership will be referred to as VCs in the rest of this Article.

ing ventures in the past does not disqualify the entrepreneur if he can show that he personally performed well in the earlier venture. In later-stage investments, the focus tends to be more on performance on the current job.

Management must be *realistic*. Venture capitalists know that there are risks with their investment. Venture capitalists try to judge the manager's ability to identify risk and, where appropriate, develop plans for dealing with these risks. Management also needs to be *hardworking*, *flexible*, and have a *thorough understanding of the business*. Flexibility is especially important for early-stage ventures.

Management must also *exhibit leadership*. This includes not only the ability to lead in good times but also under extreme pressure. Finally, management must have *general management experience*. Management's leadership capabilities and general management experience may not be as significant in an early-stage venture as long as the entrepreneur is willing to add additional management, possibly at the CEO level, to correct this deficiency.

Return has three components. First, the investment must *provide an exit opportunity*. Venture capitalists generally exit their investments by a public offering, sale of the company, or a buyback of the VC investment by the company. Venture capitalists do not expect easy liquidity. Rather, they require the likelihood of some type of exit, but in a two to seven-year period.

Second, as the prior discussion of industry segments shows, the investment must offer the *potential for a high rate of return*. The investment must also offer the *potential for a high absolute return*. Small investments take as much VC time as large. Venture capitalists view their time as valuable and are not willing to spend it on small investments that offer low absolute returns, even if the rate of return is high. This is why VCFs have minimum investment levels.

These are broad generic criteria. The specifics of each criteria may vary from VCF to VCF. Even if two VCs have the same criteria, there may be major differences in their judgment as to how well a particular investment proposal meets these criteria.

IV. THE DECISION-MAKING PROCESS

Investment decisions are made for a partnership by its general partners and their management firm. The limited partners rarely have any role in the investment decision. The management firms are very small, very flat organizations. For example, a firm managing \$50 million in early-stage venture capital would typically have three general partners, one or two associates, and three administrative assistants. Rarely will a private equity firm have more than twenty employees and two layers of management.

The decision-making process can be modeled in six stages as shown in Figure 2. The process is time-consuming and labor intensive. It traditionally takes three to four months for an investment to pass through these six stages and receive funding; currently, however, the time frame is often shorter. In the case of financing for a change in station ownership, there may be an additional period to be spent awaiting Federal Communications Commission approval. On projects where they are a lead investor, early stage VCFs spend about ninety man hours on a proposal to get all the way through the process. Late-stage VCFs may take over 300 hours.

A. *Origination*

The first phase is origination. While VCs generally wait for deals to come to them, they do make themselves known to companies through industry directories. The bulk of the VC's efforts to generate investment proposals focuses on developing a network of referents. While VCs receive many deals "cold" (without any introduction), they rarely invest in them. Most funded proposals are referred to the VC. Occasionally, the VC already knows the founder either through involvement in the management of one of the VC's prior investments or consulting work done for the VC.

Referred deals come from a variety of sources: investment bankers, investors in the VC's fund, commercial bankers, management of firms in the VC's portfolio, consultants who had worked for the VC in the past, and family friends. There are two reasons for this heavy dependence on referrals. First, the VC may place some confidence in the referent's judgment. Second, the referent is more likely to understand what type of investments the VC might find attractive.

Growing minorities of VCs aggressively seek out deals and in some cases may actually help create them. A common strategy for VCFs seeking

to participate in any industry consolidation (e.g., radio or television broadcasting) is to find a top manager from that industry, then give him a check-book with which to acquire existing companies in the industry.

B. Firm-Specific Screen

Many VCFs have firm-specific criteria on investment size, industries in which they invest, geographic location of the investment, and stage of financing. The firm-specific screen eliminates proposals that clearly do not meet these criteria. At most, the firm-specific screen involves a cursory glance at the business plan without any analysis of the proposal.

C. Generic Screen

Most of the deals that get through the firm-specific screen fail to make it through the generic screen. The generic screen is particularly brutal on early-stage ventures, eliminating 80 to 90 percent of the deals. In the generic screen, the VCF quickly analyzes the proposed investment to get a rough idea as to the likelihood that the investment meets the generic criteria discussed earlier. Deals are rejected at the generic screen based upon a reading of the business plan coupled with any existing knowledge the VC may have relevant to the proposal.

D. First-Phase Evaluation

After proposals pass through the generic screen, the VC begins to gather additional information about the proposal. Extensive information is gathered from both company and outside sources. After clearing the generic screen, the proposal's progress through the remaining stages is not a smooth flow as is indicated by the wavy line in Figure 2. As one VC has commented: "It's not a nice slow curve where you sort of get mildly interested and then come to a crescendo at the end. It's more the other way around. And you have peaks and valleys in the middle."¹¹

The first-phase evaluation generally starts with a meeting with the principals of the company seeking financing. As the proposal is being evaluated, a series of meetings with all the top management team will occur. These meetings have two goals: to increase the VC's understanding of the business and to allow the VC to assess the company's management in terms of the management's understanding of its industry, its proposal, and the problems it may encounter. It also provides an opportunity to assess how

11. Fried & Hisrich, *Model of Decision Making*, *supra* note 8, at 32 (quoting an unnamed VC).

management thinks and behaves. The meetings also provide an opportunity to assess the ability of management to react under pressure.

Management's abilities are also assessed by checking the list of references provided, as well as other references not identified by the entrepreneur. The extent of reference checking will vary considerably based primarily on the VC's prior knowledge of the entrepreneur.

Late-stage and buyout investors are more likely to talk to accountants than early-stage investors reflecting the financial history available. Information availability also leads late-stage investors to engage more frequently in library research. Late-stage investors are also more likely to talk to banks, but banks are not viewed as particularly frank sources, especially if owed money. Both existing and potential customers are contacted to determine why they are buying or not buying from the company. Similarly, early-stage investors may contact potential customers before the product has been fully developed.

Formal market studies may also be made, sometimes by outside consultants. Most of the time, VCFs invest without a formal market study. This occurs for several reasons. First, a great deal of information is almost always in the business plan. Second, the contacts with customers and potential customers provide additional information. Third, sometimes the market is not clearly defined. Certainly that is the case for most Internet investments being made today. Formal market studies for breakthrough products can be incredibly inaccurate. For example, in 1950, the best market research predicted the annual market demand for computers would be about 1,000 units by the year 2000.¹²

Technical studies of the product are used much more by early-stage investors than late-stage, since late-stage investors can get a good feel for the state of the company's technology by talking with customers and industry experts. Early-stage investors do technological evaluation in a variety of ways. Several early-stage investors have formal affiliations with technology experts, while other VCFs handle technology assessment on an informal, *ad hoc* basis.

Venture capitalists often discuss the potential investment with the management of some of their existing portfolio companies, particularly those that are in industries closely related to the industry being considered. These portfolio companies might also be customers or potential customers, or suppliers or potential suppliers, of the company being considered for investment and can provide valuable information.

12. PETER F. DRUCKER, INNOVATION AND ENTREPRENEURSHIP: PRACTICE AND PRINCIPLES 191 (1985).

Venture capitalists, particularly doing early-stage investing, also may talk to each other. Because of their experience with proposals they have analyzed and investments they have made, VCs may have knowledge that might be useful to one another. Venture capital firms have traditionally invested through loose syndicates. To some extent, this is to pool capital in order to share risk and increase the absolute amount of capital that can be invested in any one company. However, these syndicates are also formed in order to share knowledge.

Venture capitalists analyze pro forma financial projections prepared by the company to assess the potential for earnings growth. This analysis also provides an understanding of the business concept and information about management's understanding of the proposal and its realism toward its future. The financial projections also provide the basis on which to estimate the potential value that can be received at exit. Late-stage investments have more historical financial information available, which allows a more meaningful analysis.

E. Second-Phase Evaluation

At some point the VCF may develop an "emotional" commitment to the proposal. This marks the start of the second phase of the evaluation process. In this phase, the amount of VCF time spent on the proposal increases dramatically, and the VCF's goal changes. While in the first phase the goal is to determine if there is serious interest in the deal, in the second phase, the object is to determine if there are any obstacles to doing the deal, and if so, how they can be overcome. This second phase is often referred to in the industry as due diligence, although the degree to which VCFs formally recognize the movement of a deal from first phase to second phase varies greatly.

Because of the significant amount of time spent in the second phase, VCFs like to have at least a rough understanding about the structure of the deal, including price, *before* entering this phase. This understanding is usually expressed in a nonbinding "term sheet," which both VCF and issuer sign. This keeps the VCF from devoting significant time to evaluating proposals that ultimately will not be investable because they are priced too high.

F. Closing

After progressing through the second-phase evaluation, the proposal enters the closing stage, where the details of the structure are finalized and legal documents negotiated. After the documents are signed, a check is given to the company. Even though both VCF and entrepreneur have invested large amounts of time to get to this final stage, a surprising number of deals (perhaps 20 percent) that reach this stage are not funded.

G. *Proposals with Serious Problems*

As Figure 2 indicates, a proposal can be rejected at any stage in the process. The VCF has four options when faced with a problem in the proposal. First, the deal may be further investigated. Sometimes deals that are almost rejected by the VCF at the generic screen are ultimately funded after further investigation.

Second, the VCF can mandate that some significant changes in the original proposal be made. It is not unusual for new members of the top management team to be added as a condition of funding. Third, occasionally the VCF may simply go ahead and do the deal even though some serious concerns are present.

Finally, the most common response, by far, is to reject the deal. Interestingly, sometimes proposals that have been previously rejected reappear in a somewhat different form and are accepted.

V. POSSIBILITIES AND PROBLEMS FOR MINORITY MEDIA

The private equity market is an important source of funds for minority media companies. It is a large market, able to meet a variety of financing needs. Many in the market are very interested in media companies. This includes minority-owned media.

However, the minority media entrepreneur must realize that this is strictly a profit-oriented investment market. The same investment process and criteria will be applied to minority media proposals as will be applied to non-minority media proposals. This process may present some problems for minority entrepreneurs since most private equity investors are not minorities.

First, most private equity investments are originated by referral. To be referred, the entrepreneur needs connections with appropriate informal business networks. This is a problem for many entrepreneurs and may be especially problematic for a minority entrepreneur coming from a disadvantaged economic background.

Second, as with any communication, the sender needs to understand the recipient's thought process and tailor his message accordingly. Many entrepreneurs struggle in this regard. Because of cultural differences, this may be a particular problem for some minority entrepreneurs.

Third, to the extent the concept (not ownership) is minority targeted, some white investors may feel that they have an inadequate experience base against which to analyze the investment. As a result, they may choose to spend their time looking at proposals that they can understand more easily.

Finally, a proposal on the margin may be declined with a minority entrepreneur and accepted with a white entrepreneur. This is due to an unconscious, but real, bias in decision making whereby those similar to the deci-

sion maker are viewed more positively. While there is no research specifically investigating the existence of this bias in private equity settings, it has been shown to exist in other decision-making research. From the perspective of Signal Detection Theory,¹³ the investor in the model spends his time in the evaluation stages looking for a “signal” to invest. Whether or not the investor identifies the proposal as a viable investment is primarily a function of the level of the signal (evidence supporting the proposal) the investor receives, the amount of noise (irrelevant information), and the bias of the decision maker.

As used in Signal Detection Theory, bias refers to the threshold amount of evidence required for a proposal to be viewed as viable. One factor that may influence bias is the similarity of the entrepreneur to the investor. Thus, a white private equity investor may interpret the same signal as positive when sent by a white entrepreneur and negative when sent by a minority entrepreneur. That is, more evidence of a viable proposal may be required from a minority entrepreneur. Decision-maker bias is not deliberate; rather, it is an unconscious factor that influences decision making.

However, the similarities bias problem may not be that significant. First, race is not the only way in which people can be similar. Some minority entrepreneurs may have many similarities with private equity investors—for example, education, work experience, hometown, among other things. Second, an investor who is aware of this subconscious bias may make a conscious effort to compensate for the bias. Most importantly, bias is not the primary factor in making the decision. It only works on the margin. The primary factor is the level of the signal (evidence supporting the proposal).

Thus, while there are some potential problems for minority entrepreneurs, they need not be insurmountable for a quality proposal. In addition, SSBICs exist specifically to invest in minority-owned companies. Today, minority-focused private equity firms manage over \$1.4 billion. While most were started with preferential financing through the SBA, several have been successful enough to raise significant additional funds without SBA assistance.¹⁴

Tying into the model presented earlier, minority-focused investors have a firm-specific screen that they only invest with minority entrepreneurs. Otherwise, they are just like any other private equity firm. They will use the same process and criteria.

13. DAVID M. GREEN & JOHN A. SWETS, SIGNAL DETECTION THEORY AND PSYCHOPHYSICS (1966).

14. See Jeffrey A. Tannenbaum, *Where the Money Isn't*, WALL ST. J., May 21, 1998, at R20.

The minority entrepreneur should always remember what one leading minority-focused venture fund refers to as the key fact of venture capital: "You will be seeking a yes answer in a no business."¹⁵ Few proposals, minority or otherwise, make it all the way through the investment process. To be successful, the entrepreneur must be good and persistent.

15. Pacesetter Growth Fund, L.P./MESBIC Ventures Holding Company, *Key Facts About Raising Venture Capital* (visited Mar. 15, 1999) <<http://www.mvhc.com/facts.htm>>.