Where entrepreneurs can still find private capital

Karen E. Klein

Even though VC and angel investments are down, small rounds are available to solid companies from private investors.

Venture capital investments dropped dramatically in the first quarter from 2009 from 2008, and angel investments dropped as well, according to the latest figures. But that doesn't mean startup and early-stage companies are not looking for—and getting—private funding.

Mark Heesen, president of the National Venture Capital Assn. headquartered in Arlington, Va., says he has noticed angels and venture capitalists looking at early-stage deals more seriously today than in the recent past. "Valuations are good right now, so I'm seeing VCs interested in shepherding along these early-stage companies that can't get traditional financing, and not only in the typical entrepreneurial hotbeds but all around the country. There's a kind of schizophrenic activity going on with VCs trying to keep late-stage companies alive when they can't go public and there's no acquisition market, but also seeing a lot of really good deals out there in early-stage firms."

Jeffrey Sohl is director of the Center for Venture Research at the University of New Hampshire, which has done research on angel investment since 1979. He says there is a huge uptick in interest from entrepreneurs who cannot tap traditional funding sources, such as second mortgages or friends and family, but that angels are funding about 10% of the deals they see, which is at the same level as 2008. "The number of deals seems to be staying flat, but the dollars invested went down about 30% because company valuations are down, as is the net worth of angel investors generally," he says.

Dramatically lower valuations

Elon Boms, managing director of LaunchCapital, says his Cambridge (Mass.) venture capital firm is looking to make as many as 40 investments this year. The firm, with 17 young companies in its portfolio, raises pre-seed money for startups in the development stage and typically invests $125,000 to $150,000 in syndication with angel investors and smaller VC firms.

"From LaunchCapital's perspective, it's a great time. Valuations have come down dramatically, people are willing to work for free initially, and the cost to start a business has come down dramatically," Boms says. "Companies are getting better at starting businesses cheaper, and they're coming to us with full-blown beta products that have been totally bootstrapped."

Would-be entrepreneurs faced with the empty pockets of friends and family and quick rejections from bank lenders have also turned to angel investors like the Tech Coast Angels, a 300-member investment group based in Southern California. Luis Villalobos, the group's founder, says their most recent "fast pitch" session, which typically attracts 70 or 80 entrepreneurs, this year fielded more than 250.

"Entrepreneurs are very resourceful and they'll do whatever they can, including tuning down their needs and finding ways to make do with less," he says. His group recently invested growth capital in Bikestation, a turnkey firm that designs, builds, and manages facilities for bicycle parking and services in a dozen U.S. cities, with four more under construction.

Shovel-ready projects

"We like it when we see companies that have already been commercialized or can get aid from the stimulus package," says Raulee Marcus, a Tech Coast Angels member who has joined the board at Bikestation.

She says the firm's stations are linked to existing transit facilities and shovel-ready jobs projects. "We're calling them 'stimulus-ready' companies, because having some wind at your back is very important today," Marcus says.

These groups will admit that some of their members are skittish about investing, particularly those who have lost considerable net worth in the stock market decline. "A couple of individuals who have been hit hard told me they're nervous and they're kind of holding off," says John Dilts, founder and president of Maverick Angels in Westlake Village, Calif. "Surprisingly, though, it has not had a significant effect on the group. Our members like the fact that they can see the entrepreneurs whose companies they're investing in, as opposed to trusting their money to money managers."

Dilts' group has also seen a dramatic increase in deal flow: "We're seeing deals that probably should be friends-and-family deals, as well as deals that would have been before venture capital firms in the past," he says.

For instance, Dilts says, his group held a pitch session last week in which they heard from the winners of a University of Southern California business-plan competition as well as from a 20-year veteran of the medical industry. The students have a startup firm that doles out consumer rebates online, while the medical executive has developed a newfangled heart monitor that purports to be a significant improvement on the current design. "In the past, a guy with that kind of pedigree and product probably could have approached a major venture capital firm for funding," Dilts says.

Money on the sidelines

Smaller VCs and angel groups are also being contacted by established companies whose venture partners are doing a "down round," and pulling some of the funds they invested previously. Marcus says the Tech Coast Angels has benefited from the sorting-out process going on in the venture capital world. "The second- and third-tier VCs are really beating up their companies, and they're losing money themselves," she says. "A lot of those companies are coming to us because they know we have a good rapport with the leading VCs."

And while the numbers show that many investors are holding back currently, LaunchCapital's Boms says that the recent drop in venture funding won't last forever. "It's not going to stay this way, and when it rebounds it will feel like an aggressive uptick because there is a lot of money on the sidelines now," Boms says.

But even when private investment money comes back strongly, Boms says, the leaner approach being taken by today's startups may not go away soon—something he says is not a bad thing. "In the future, the rate of innovation hopefully will not change, but I think the ultimate funding dollars may change," he says.

For the time being, his firm is looking for even smaller deals. They are getting ready to launch a new fund focused on smaller, community-oriented businesses that might have gone to local banks for funding in the past. "We've created an entity that will allow us to invest in those community businesses that have slower growth potential but still are headed by great entrepreneurs," Boms says. The fund will offer non-recourse loans with interest rates between 10% and 15% and a small warrant component that allows the investors to participate in upside potential. It is expected to be announced formally in the next month or so, he says.

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