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By Michael Volker

Funding Startups: Angels and VCs square off, Remembering Colin Lennox

This month, I want to deal with the subject of financing startup ventures. What financing options are available to startups? This continues to be a major challenge for entrepreneurs. We'll take a look at how VCs and angels approach this and some of the issues. I also have an idea to share with you as to what could be done to mobilize more early stage capital. This could be of interest to investors willing to risk relatively small amounts.

Entrepreneurs are the champions of innovation. They're the ones who take ideas and intellectual property (IP) into viable business ventures. As a country, we're spending close to $20 billion annually in doing R&D. To bring it closer to home, government spending on R&D in BC's post-secs and research institutions is in the $1 billion range (this excludes industry's R&D expenditures). It's this investment by taxpayers that's going to waste because a lot of this IP isn't getting to market.

Last week, I attended the **Canadian Venture Capital Association's** (CVCA) annual conference in Calgary where I learned some interesting facts. Poor returns and lousy deal flow were the main complaints.

In 2003, Venture Capitalists invested $1.5 billion across the country with a measly $108 million (7%) of that in B.C. That's the lowest of the past five years. Of course, this doesn't include angel activity and non-institutional investing (such as the many private placements done in junior public companies, or "PIPEs" - Private Investment in Public Enterprises) which I estimate would triple or quadruple that figure. Although the actual numbers are somewhat elusive, the private sector is doing the lion's share of investing in B.C. That pales in comparison to the amount spent on R&D. That's why we keep hearing about the "valley of death" funding problem - taking the outputs of the R&D process and getting them commercialized.

Of that $108 million invested in BC., $44.8 million went into one company, **Neuromed Technologies Inc**., a UBC spinoff focusing on small molecule drugs to treat neurological disorders such as pain and stroke. That investment puts new meaning to the adage that VCs are looking for deals that alleviate some "pain". Not to be outdone, **Aspreva Pharmaceuticals Corp** of Victoria, raised $80 million in the first quarter of 2004. Aspreva is addressing the rare disease treatment niche that big pharmas tend to ignore. These investments in Biotech companies also point out different sector dynamics, i.e. biotechs are generally more capital intensive and generally take much longer to generate earnings.

Startup entrepreneurs will tell you that there's virtually no risk capital available to them. On the other hand, venture capital firms claim that half of private equity investment is allocated to so-called seed or early-stage companies. Here's the problem with that statement: early stage or seed is *not* the same as investing in a startup. A startup often has little more than the idea, maybe a prototype, and one or two evangelists behind it. VCs do not invest in these companies.

They'll only invest when a business plan has been prepared by at least a small team led by an acceptable CEO and after doing tons of due diligence on the company's technology and its market thrust. But, it takes money - however little - to go from startup to seed. And then they'll only invest in those companies that have a plausible $100m+ exit strategy with a top notch team. I don't know any that'll invest in a $10m acquisition candidate (even though many end up there anyway).

Angels are successful entrepreneurs who are keen to put some of their own time and money towards helping others in getting their ventures launched. Angels look for reasons why they should invest; VCs look for reasons why they should *not* invest. And, you can't fault VCs for that. If they're investing my money, I want them to be very cautious and look at the downside. For angels, investing is a hobby but for VCs it's more of a business. I've observed that many angels have morphed into VCs. Maybe they run out of money and decide it's time to invest someone else's! in any event, when they do, they cease acting like angels. That only makes sense - they now have a fiduciary obligation to other stakeholders and they can no longer "wing" it as angels do.

VCs charge healthy management fees for investing someone else's capital (usually pension funds and private money from families and high net worth individuals) plus performance fees that kick in when there are healthy capital gains. Angels get paid only when such gains are realized. A popular cartoon depicts VCs showing off their yachts with the caption, "but where are the investors' yachts?". In spite of their diligence, VC funds have not performed all that well in comparison to other investment asset classes. As one attendee at the CVCA conference noted, "the returns suck!". The 9-year return for all VC categories is only 4.7% as compared to 9.6% for the S&P TSX. Interestingly, early stage returns were slightly better at 5.4% over 9 years. Forget about returns in less than five years (they're negative!).

On the other hand, deal flow is a big concern. VCs will tell you that there's a paucity of good deals. One obvious reason for this is that no one is supporting startups and therefore fewer VC prospects emerge.

I've been doing small-time (as in small amounts) angel investing since the mid-80's. In 1999, along with a few colleagues, we formed **VANTEC** - the **Vancouver Angel Network for Technology** (see link at www.vef.org for details). I've seen literally hundreds of deals. I invest in a few each year. One thing if learned from all this - in addition to spotting those to steer clear from - is that angel investing (and VC investing, too) is a numbers game. Even if you find a great person or team with a superb technology, the odds of building a successful company are low. Those you expect to do well - even with funding, advisors, great boards, etc - can flop while others that look like long shots end up as big winners.

If you look at the top 20 companies on the **T-Net** list you'll soon see that most are not doing what they originally had in their first business plans. The winners shifted their strategies and adapted to market and technology conditions.

A US study by **Venture Economics**, made the point that to get some big winners, you have to be in at least 16 deals - for the numbers to work. That explains why I hear so many angels saying things like, "I'm in a half dozen deals and none are doing well", or "I hate to tabulate how much I've sunk into my deals". I have a serious concern: unless they start getting some good hits, they may abandon this hobby. The problem is that very few angels have the time or money to spend on a couple dozen projects.

One of my favorite stories and an excellent example of how angel investing works involves

Waterloo's **Research in Motion** (RIM) with its ubiquitous **Blackberry** email PDA. Back in 1987, **Mike Lazaridis**, a UW engineering dropout, approached me about investing $30K in his company so that he could meet payroll. He'd already been going for three years and had just a few employees. There was no Blackberry - the company was making a shop floor automation system. Later, it developed a film editing product and several years after that got into wireless pagers.

The term "angel" was not known then. I fancied myself as a bit-playing VC. That was easy because there were hardly any VCs (or angels) back then. The RIM story demonstrates how angels differ from VCs. After a couple of meetings we agreed to terms. I was asked if 15% of RIM was acceptable for the $30K. I thought, sure, why not - it's more than 10% and it's not too much dilution for the founder. Indeed, valuations are meaningless at this stage. RIM valued itself at $200K. Today, it's worth more than $10 billion!

Whereas VCs generally like to justify a valuation, angels look at it more from the perspective of what the ultimate value might be and does the going-in percentage give them the opportunity to get a 100-bagger plus when going out? It doesn't need to get more complicated than that! Another difference entails due diligence. VCs can spend thousands in checking out a technology and its prospects. Angels - typically industry savvy ones - rely a lot more on their gut feeling and judgement.

Angels often get involved hands-on in a mentoring role - guiding and coaching the nascent entrepreneur. VCs will demand board positions and will demand and exert considerable control over the venture (often by MBAs without the proverbial scar tissue). Their primary interest is to protect their investment which is an interest that is not always aligned with the best interests of the company -hence the source of many governance tensions and conflicts.

It's my humble view that bankers and investors have no idea what it takes to be on the front line of a startup. The ups and downs of being an entrepreneur - scoring a sale or missing payroll or running out of credit - cannot be appreciated by those who've not been there. Angels relate to that and it makes them more empathetic in dealing with their proteges.

There's a tension between angels and VCs. Angels complain about "cramdowns", "washouts" and "down-rounds" - jargon to describe getting excessively diluted with diminished chances of any upside gains. One well-known local angel lamented that angels should not blame VCs for this problem. It's angels doing dumb deals that causes this problem. Angels, being entrepreneurs themselves, identify with their companies and give them the benefit of higher valuations.

To prevent this, some angels are getting fancy. Instead of taking common shares and being like a co-founder (an image they like), angels are starting to use convertible preferred shares or convertible debentures to give them some extra protection. Personally, I believe that entrepreneurs need to understand that angels and early investors should be given a much larger slice. Giving up one-third of the business for a first round, be it $500K or $1m, is a simple reality that has to be recognized. For those that agonize over giving up percentage points, consider this: When an angel gets 15% instead of 10%, that represents 50% more shares to her, but to the entrepreneur it means giving up only 6% more (do the math!).

Although we drool when we hear of the $454 million buyout, these are not the norm. However, there are many examples of buyouts in the $10-$50million range. The very first two deals that came to the VANTEC group's first meeting in 1999 - **ActiveState Corp** and **QImaging Technologies** - sold out in less than five years for approximately $30 million and $20 million respectively. To get a 10-bagger, angel valuations would have to have been $3 million and $2 million (I don't have the facts, but my guess is they were higher). Both the entrepreneur and the investor have to address the target sell-out price and focus on this rather than get too bogged down at coming up with some present value calculation.

The problem with angel investing from the entrepreneur's perspective is finding them and getting their attention and then getting enough capital to achieve some goals (starting with too little cash is a common mistake). All it takes, though, is one or two angels that can then lead the entrepreneur to other angels and to angel pools. But, short of angels, there aren't many options.

Going public on a junior stock exchange such a the **TSX Venture Exchange** (TSX-V) is a viable option (that works if you need around a million dollars or more and want to attract a large shareholder base). My favorite example of a company that took this route was Vancouver's **QLT Inc**. another UBC spinoff. I remember when QLT was trading at a buck! However, there weren't enough angels back in the late 80's and VCs certainly weren't interested. However, the cost - in time and money - can be prohibitive and doesn't make sense for companies that just need to get going. At another conference this week, a panel discussion concluded that the up-front cost of going the public route, however small, runs around $100K and the annual cost of being public is of the same magnitude. So, if you only raise $1 million, you've got less than $800K to work with in your first year. Taking this option will still require some up-front angel or love money regardless.

The challenge from the angels' perspective is to be in enough deals to get a good overall return. To address this, many angels have formed their own boutique funds. One popular vehicle for this is a special form of company called a **Venture Capital Corporation** (VCC) in BC or Quebec. In BC, investors in a VCC get a 30% refundable tax credit - this is a great way to get more dollars at work since the Province is sharing in the risk. It also allows non-bona-fide angels to be just like angels. That's what prompted me to form **WUTIF Capital (VCC) Inc** - the Western Universities Technology Innovation Fund (see www.wutif.ca). It does exactly that - pool capital to invest small amounts (alongside others) in a large number of startups. The only problem from an investor's perspective is that the Fund's board makes the investment decisions for them.

Some angels have also formed **Capital Pool Companies** (CPCs) on the TSX Venture Exchange. However these are not venture funds, they are typically one-shot funds looking for a single promising investment. In essence, they are just another way of going public.

I've always liked the junior public markets. My soapbox speech draws on the success of the resource sector in raising high risk money for exploration and how this model could be used to fund tech firms, i.e. bring in many small investors to share the risk. Any losses won't result in suicides or permanent depression. And the odds of good gains are still better than a lottery. The TSX-V bills itself as a public venture capital market. And, that it is - providing an alternative to VCs, but not to angels. You still need the angels or a reasonable facsimile thereof.

Here's the conundrum: how can you get many investors into many startup deals without the cost (and trauma) of going public on an exchange? And, letting them pick and choose what they want to invest in? What we need is a more public venue (like an exchange) to get companies noticed and financed (not to actually trade their shares every day).

How about this for a "new" idea? It seems so obvious that it doesn't even sound all that new: Why not have something like a website where startups can list and promote themselves? Of course, they'd have to be careful to comply with securities rules and regulations (e.g. companies should not offer their shares to the public without a prospectus - although in B.C. a more simple, less expensive offering memorandum will now suffice).

This would create a market for investors and investees to meet each other rather than relying on the word-of-mouth and networking that presently takes place.

So, what are the options available for startups? Here's a summary breakdown:

1.Love money (family, friends, relatives)
2.Angels - typically $500K-$1M
3.Angel Pools (VCCs and CPCs)
4.Junior Public Venture Capital (TSX Venture Exchange)
5.***New Idea***: Web Site (market) for Startup Opportunities
6.VCs (early stage - a long shot! don't waste your time unless you're more than a startup)

As a final note, the **National Angel Organization** (NAO) was formed two years ago and will hold be holding its annual summit meeting in Calgary in the last week of September following on the heels of the **Banff Venture Forum**.

Remembering Colin Lennox

The technology community suffered a loss when **Colin Lennox** of Victoria passed away suddenly last Friday May 28th.

Colin was a great supporter of, and mentor to, dozens of Island tech companies over the past decade. When he returned from Ottawa in the early nineties, I worked with him when I was with the **BC Advanced Systems Institute** (BC/ASI) and Colin became our point man on Vancouver Island. In this capacity, he lent helping hand to many, many companies - especially startups.

Colin spent his life gathering experience in the world of technology including: an engineering apprenticeship at a British Nuclear Research Establishment, earning a degree in electrical engineering, summering for Bell Telephone, designing triplicated analog multi-channel majority voting for the control of the NRU nuclear reactor, five years at a research laboratory in the wilds of Manitoba, being the third employee of a then little-known start-up called **Macdonald Dettwiler** (MDA), serving as the Vice-President of Business Development for AECL Research transferring technology and staff from the labs there into business units and eventually into the private sector.

In 1991 he moved as far west as possible, arriving in Victoria that fall. He soon became the Island rep for BC/ASI and worked part-time (so to speak!) until 1999. At the same time, **Bob Skene**, the then Executive Director of a new industry association known as **VIATeC**, invited Colin to use an office at the VIATeC premises to stage his ASI efforts along with mentoring local technology firms.

Colin utilized his wealth of knowledge and experience to start the VIATeC CEO Club, assist with the strategic development of VIATeC and mentored Bob Skene. Colin drafted several key proposals and projects including VIATeC's participation in the Access to Capital program and the SR & ED tax program. As a member of the VIATeC team, Colin provided every VIATeC employee, past and present, with an endless source of information, experience and laughter.

Few of us will ever know the loss of knowledge and enthusiasm that passed with Colin but all who knew him considered him a valuable mentor that provided sage advice and a unique perspective while maintaining a level of enthusiasm for the future that rivaled the most ambitious young man.

Colin took a great interest in **Pearson College of the Pacific**. Donations can be made to the

Canadian Family Scholarship Fund in his memory by calling 250-391-2481. His wife Pat, children and grandchildren are planning a celebration of his life in August and hope that all who miss the man in the waistcoat will join them.

I've always looked forward to heading over to the Island and tagging along with Colin to visit some of the emerging tech companies he was helping. The visits will never be quite the same.

Business Centre for non-downtowners

If you don't have a **Vancouver** "office" but find yourself downtown occasionally without a "home", you are invited to use **SFU's TIME Business Centre**.

TIME is an acronym for **Technology, Innovation, Management, and Entrepreneurship**. The Business Centre (looks like an airport business lounge) is open to technology entrepreneurs and business people to use as a drop-in downtown office facility. Need to plug-in? Make some calls? Do some work? Hold a meeting? There are some great facilities for holding your company's AGM. Why hang out at MacDonald's when you can work productively at the TIME Centre? Drop by and check it out! It is located at SFU's downtown campus at 515 West Hastings St. You won't believe the price!

If you're an entrepreneur looking for a place to get your company started, there's some great office space available at the **TIME Centre**. There's also access to various resources, e.g. tech advisors, access to capital (e.g the **VANTEC Angel Network**), mentors, etc. Worried about the high cost of being downtown? Well, not to worry - some payments can be in the form of equity. Check www.sfu.ca/time for contact info.

WUTIF...you wanted to invest in a tech startup? The **Western Universities Technology Innovation Fund** (WUTIF), is an "angel fund" catering to tech startups based in BC (not limited only to universities). **WUTIF Capital** is a VCC that offers investors a 30% BC refundable tax credit. Due to the limitations on the VCC program, WUTIF expects to use up the tax credits available to it by mid-2004. So, if you're keen to co-invest with angels in up and coming companies, this is a good way to get started. Check www.wutif.ca for details. Pooling and risk-sharing is the way to go!

Michael Volker, a technology entrepreneur, is Director of the University/Industry Liaison Office at Simon Fraser University, past Chair of the B.C. Advanced Systems Institute, Chair of the Vancouver Angel Network and past Chair of the Vancouver Enterprise Forum. He owns shares in many of the companies he writes about.

What Do You Think? Talk Back To Mike Volker

Tech Futures is a bi-weekly column that focuses attention on new and emerging BC publicly listed technology companies.

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