Silicon Valley North #65 **May, 2004**

The Way I See It… by Michael C. Volker

Angels vs VCs: No competition for startups

Entrepreneurs are the champions of innovation. They're the ones who transform intellectual property into viable business ventures. As a country, we're spending close to $20 billion annually in doing R&D. However, Venture Capitalists invested only $1.5 billion last year – a 5 year low - in such businesses.

At the recent Canadian Venture Capital Association's (CVCA) annual conference, poor returns and a lack of good companies were cited as the main reasons for this. The 9-year return for all VC categories is only 4.7% as compared to 9.6% for the S&P TSX index. Interestingly, early stage returns were slightly better at 5.4% over 9 years. The dismal returns fortify the VCs' belief that there's a paucity of good deals.

Startup entrepreneurs will tell you that there's virtually no risk capital available to them. Yet, VCs claim that over half of their investment dollars go to seed and early-stage companies. Here's the conundrum: early stage or seed is *not* the same as investing in a startup. A startup often has little more than an idea and one or two evangelists behind it. VCs do not invest in these. They'll wait until there's a solid business plan and the makings of a good team. And then they'll only invest in those companies that have a plausible $100m+ exit strategy. I don't know any that'll invest in a $10m acquisition candidate (even though many end up there anyway). It takes money - albeit little - to go from startup to seed. Thank goodness there are angel investors (successful entrepreneurs) around to pitch in.

There's a growing tension between angels and VCs. Angels complain about "cramdowns", "washouts" and "down-rounds" - jargon to describe getting excessively diluted by follow-on VCs 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.

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 $1 million, 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.

Another option for entrepreneurs is the junior public market. The TSX Venture Exchange promotes itself as a public venture capital market. Consider 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 smaller 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. While this may be a competitive alternative to institutional venture capital, it only makes sense for companies that are well beyond the startup stage.

What's needed is a mechanism for bringing many smaller investors to startups without the cost (and trauma) of going public on an exchange. Why not have a public venue, perhaps internet-based, to get nascent companies noticed and financed but not to actually trade their shares every day? Perhaps the TSX-V could facilitate this and use it as a loss-leader to provide future listings.

I suspect that some securities regulations, although recently relaxed in some jurisdictions such as British Columbia, might thwart such an initiative. In B.C., for example, is has become much easier lately for firms to sell their shares to third party investors. Some rules might still need to be changed to allow companies to raise capital more easily from a large number of investors without going public prematurely.

The way I see it, we need to get creative about financing new ventures to encourage innovation and the commercialization of our intellectual output.

Michael Volker is a high technology entrepreneur and director of Simon Fraser University's Industry Liaison Office. He oversees Vancouver's Angel Technology Network and is past-Chair of the BC Advanced Systems Institute and the Vancouver Enterprise Forum. He may be reached at mike@volker.org.