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# A time for angels

## After nearly three years of defensive investing, venture capitalists and private investors once again need to consider funding start-ups.

**By Rick Brimacomb and Mark Sides**

Signs of life.

That's what the most recent survey of U.S. venture capital activity revealed. In the second quarter of 2003, investments by venture capital firms increased for the first time in more than three years. Most significantly, first-round investments — those that provide seed money to companies in their early stages of growth — also climbed, rising 12 percent compared to the first quarter of 2003.

While it's too early to declare an end to the downward spiral of venture funding, the results are the first sign that private investment markets are finding their way back to a more-normal growth cycle. Forget the up-and-down market from 1999 to 2001 — that was a "Dallas moment," a dream from which we've now awakened. Except for that three-year period, venture investment has grown at a solid, stable pace since 1980.

But the hangover continues, particularly for start-up companies. While other segments of the venture industry are slowly returning to historical norms, the market for start-up and seed money continues to lag, despite the better performance in the second quarter. In 2002, seed money represented less than 2 percent of U.S. venture capital investment, a stunning reversal from the 1980s and 1990s, when it regularly represented anywhere from 15 to 25 percent of overall investment. Last year, the percentage of companies receiving first-round financing was at its lowest point in more than a decade.

### Moving upstream

The problem isn't a lack of venture money. In fact, the market is awash in money. The amount of "overhang" — committed capital that hasn't been invested yet — totaled $80 billion at the end of 2002, nearly four times the total venture capital investment for the year. That means there's several years' worth of money waiting to find a home.

So how come those investment dollars aren't finding their way to start-up companies?

First, the sheer size of investment during the bubble has moved many venture capital firms upstream. From 1980 to 1996, the average money manager in a venture capital firm was overseeing less than $10 million in investments. By 2002, the average jumped to $30 million. At many larger funds, it's $60 million or more. The average fund size is nearly double what it was just five years ago.

When you've got that much money, it's hard to invest it in small chunks. A few years ago, deals in the $1 million to $5 million range were common, even at large venture capital firms. Not anymore. Money managers want investments of $10 million or more — deals that are beyond the reach of start-ups.

Venture capitalists also got burned on emerging companies during the crash and are now doubly cautious. Rather than take a risk on an unknown quantity, they've chosen to make follow-on investments in companies with which they're already familiar or new investments in more seasoned companies. Those more-mature companies also tend to be priced attractively these days, making it easier to find bargains.

In addition, the traditional exit strategies for venture capital investors — public offerings and merger deals — have largely been unavailable. Although there are welcome signs of life in those markets, too, there isn't much incentive to pour money into early-stage companies without a way to get it out at a substantial profit.

These factors have created a vacuum effect — sucking money out of the bottom of the market and driving it to more-established companies. The time is ripe, however, for angel investors and others who were burned in the downturn to take another look at the start-up market. As the overall investment picture brightens, wealthy individuals, pension funds, corporations and other sources of private investment need to steer seed money to promising entrepreneurs.

Start-up companies are job engines. We are unlikely to see sustained improvement in unemployment without healthy growth among new companies. (Venture-backed companies already are responsible for more than 350,000 jobs in Minnesota.) Start-up companies also are sources of new ideas — the kind of innovations that create new markets and drive economic growth. Accordingly, it's in the best interest of all Minnesotans to encourage the formation and financing of new venture-backed companies.

Why now? We've learned important lessons from the problems of the past few years. Standards for emerging-company investments are much higher. Entrepreneurs and investors alike are closely scrutinizing business plans and rejecting those built on rosy forecasts. Those companies that do meet the threshold are much more likely to be successful, having built their plans on a careful, realistic analysis of their markets.

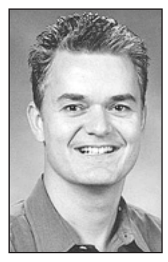
In addition, the surplus of talent in the current job market — which causes so much economic pain — can nonetheless be a boon for start-up companies, which are now better able to recruit experienced managers, scientists, engineers and technology professionals.

### The 'new normal'

No one expects a return to the unrealistic venture capital market of 2000. Instead, we are groping our way to a new normal, based on more-traditional rates of growth and criteria for business investment.

A study in 2003 by the National Venture Capital Association indicates that the net return on private equity fund investments during the past 20 years has exceeded 15 percent — not the blazing performance we experienced during the upward curve of the bubble, but a very solid historical return nonetheless. The study also shows that the performance of investments in early-stage companies has been fully competitive with those in later-stage companies.

Obviously, seed funding requires more due diligence to separate ill-conceived ideas and plans from those that have a legitimate chance of success. But this is a market we cannot ignore. If we continue to invest nearly all of our venture capital in existing companies and ideas, we will bypass a major source of long-term economic vitality.

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