Startup Financing
- Different Than A Decade Ago

University of British Columbia
Sauder Business School

BAEN 505 –
Venture Capital Finance of Entrepreneurship

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My Background and Perspective

- I am a geek, techie, nerd
- PhD in Electrical and Computer Engineering from University of British Columbia in 1982
- Started my first company at grad school
- Nexus grew to be the world's 2nd largest manufacturer of cable TV headends
- Sold in 1993 to Scientific Atlanta and is now part of Cisco

My Tech Investment Funds

- When we sold Nexus, it was the first time I had money to invest
- Been an enthusiastic tech investor since
- Founded and managed a:
- Hedge fund – 1996 to 2000
- Venture Capital Seed fund – 2002 to 2006
- Angel fund – 2005 to present
- Now run a boutique M&A Advisory firm

My Investments and Financings

- I’ve made about 100 early-stage technology investments
- Slightly less than half produced a return
- I’ve been directly involved in over 100 technology company financings
- All were successfully completed
- I’ve worked directly on several dozen exits

The World Has Changed

- Many big parts of the financial ecosystem
- That worked for a hundred years
- Don’t work at all anymore
- The economy has changed
- The whole world is changing
- Faster than ever before

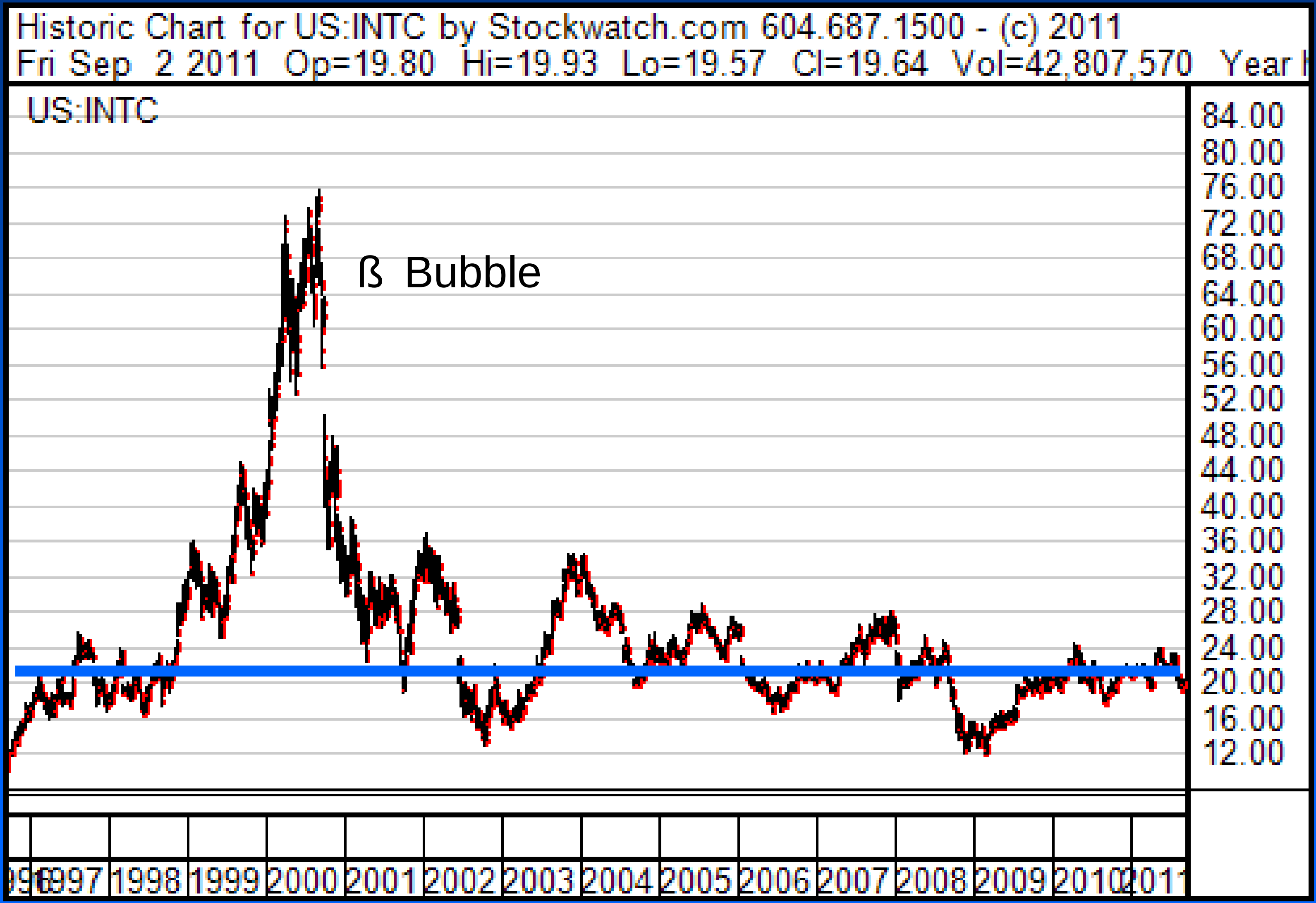
Canada’s Most Valuable Corp

- Nortel was founded in 1882
- In 2000, Nortel’s value was a third of the entire TSX index – Canada’s most valuable
- Market cap was $398 Billion
- Employed 94,500 people
- Bankrupt in 2009
- Assets sold to companies around the world

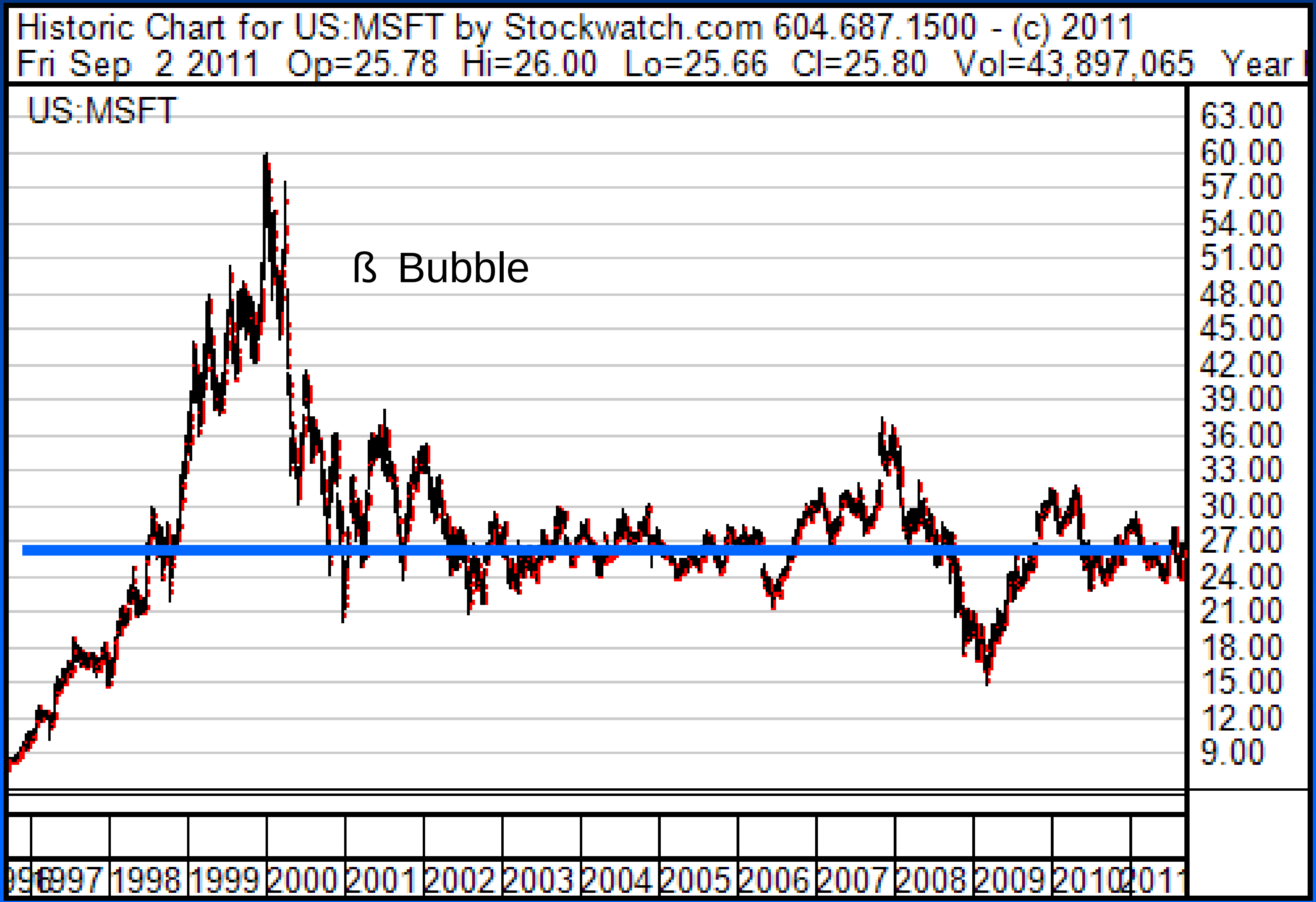
Other Big Tech Companies

- Was Nortel just a single example?
- Or a made in Canada failure?
- What about the other big, great tech companies?

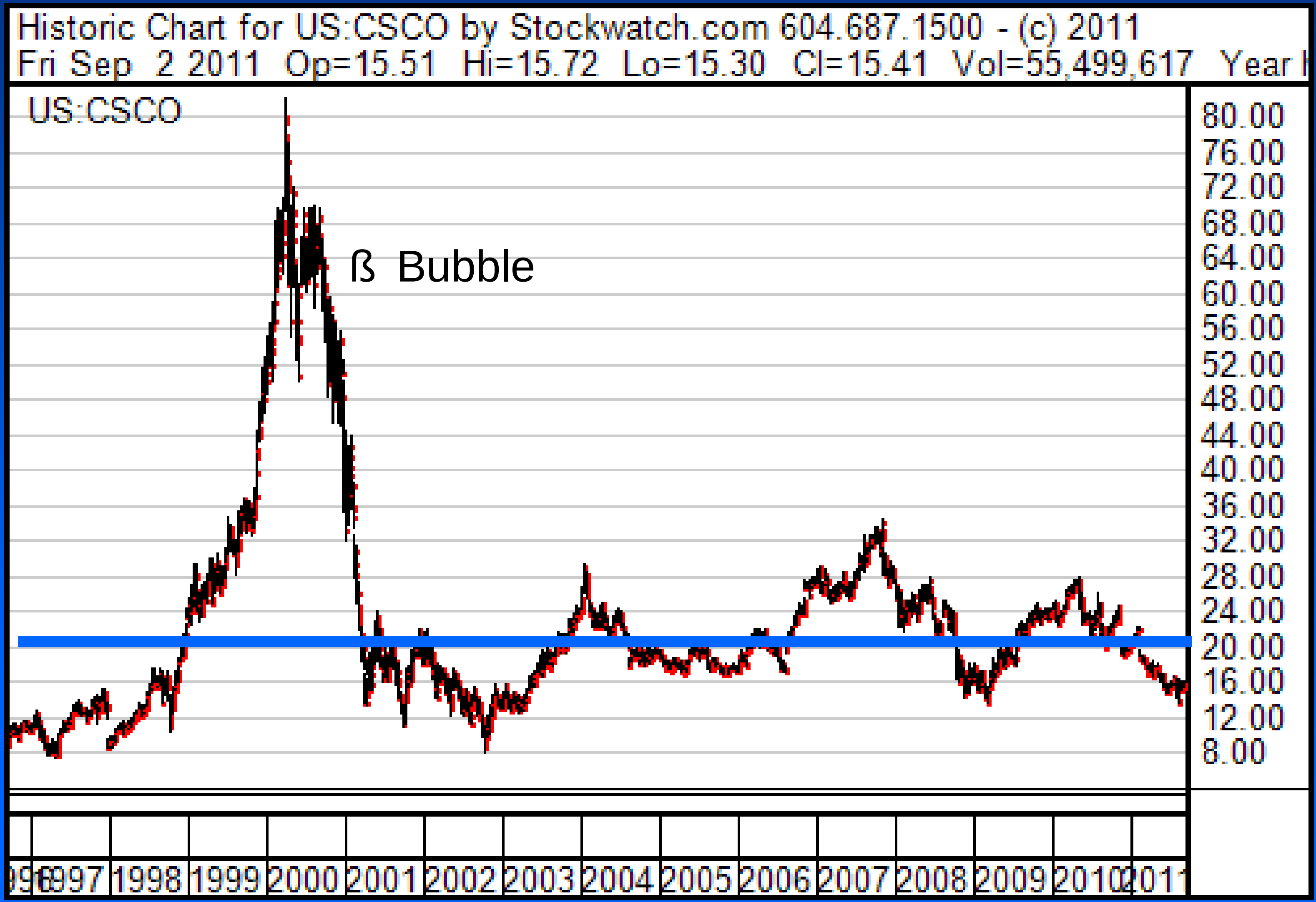
Intel – 15 years



Microsoft – 15 years



Cisco – 15 years



None Are Creating Wealth

- For their investors,
- And more importantly for their employees
- For decades, these greats were all built on the increasing value of their stock options
- That’s what used to bring, and retain, the best and the brightest
- To these big companies

Opportunities Then and Now

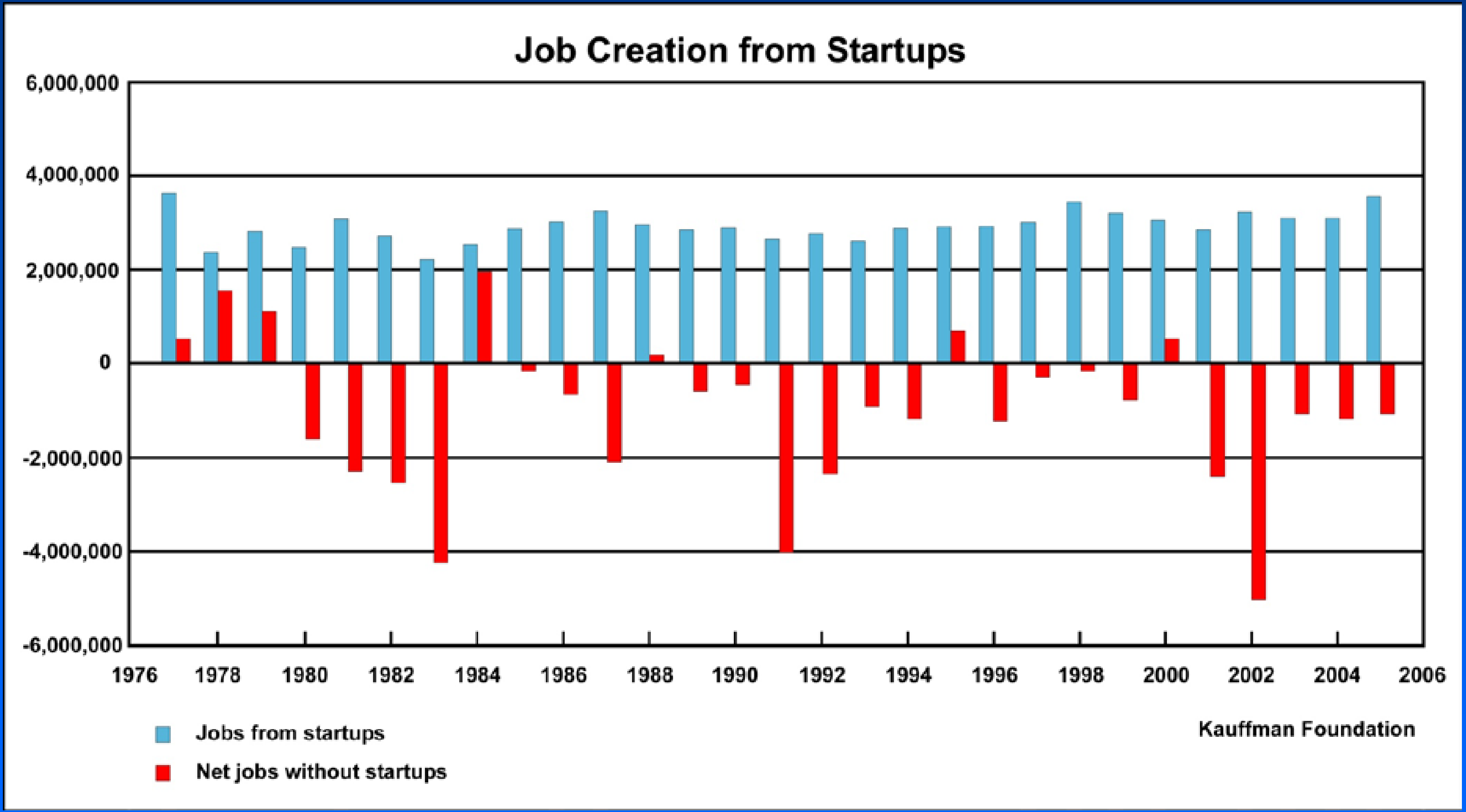
- When I graduated from university,
- Most of the new grads wanted to get jobs in the big companies
- To learn ‘how it was done’
- To work somewhere that was safe and stable
- Today, working in a big company seems to be a pretty risky proposition
- And certainly not a very lucrative one

Startups create all the economic growth

Startups Create All the Growth

- A decade ago, big was an advantage
- Today being big seems to be the opposite
- All of the economic growth now is happening in small companies
- In fact, startups have created ALL of the new jobs for the past three decades

Startups Create ALL The Jobs



Innovation Happens in Startups

- The best and the brightest now work in startups
- Startups are where the opportunities are
- Where the excitement is
- Where the smart people create the innovations
- That’s why all the economic and employment growth is created by startups
- And why nerds can earn more that football players, rock musicians and movie stars

Capital Efficiency

New Startup Economics

- Third, it’s amazing how little it costs to build a tech company today
- Back when I was an entrepreneur, hardware and software companies needed $10s millions
- Which gave rise to the huge VC funds
- And was one of the reasons innovation used to happen primarily in big companies
- Today, entrepreneurs can build companies for $100,000s and, in some cases, $10,000s

Why It Costs So Little Today

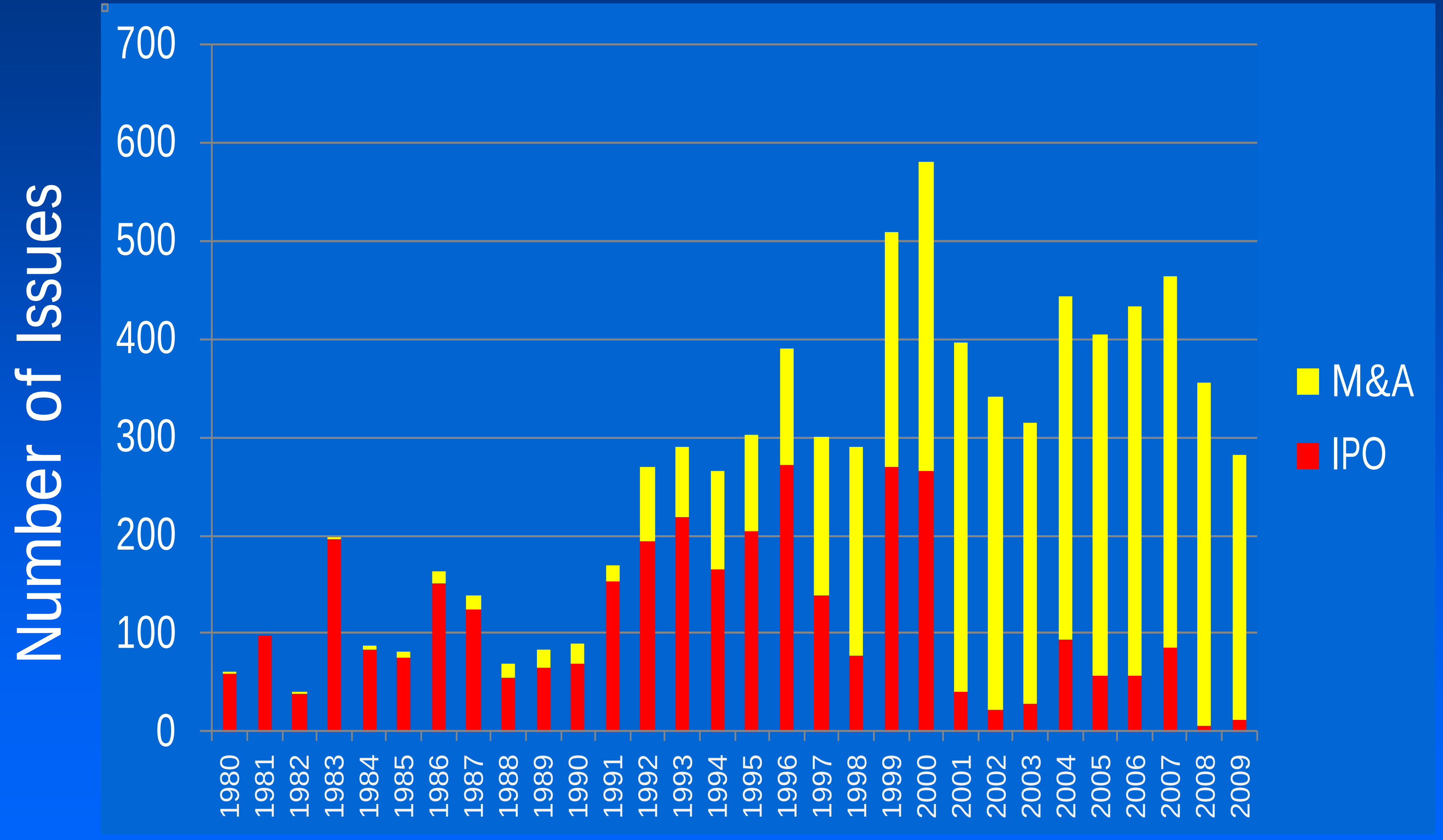
- It’s the internet
- Fundamentally changing how we work
- And build companies
- Instant access to the entire global market
- Another example - open source software
- More importantly - virtual companies

Many Startups Need No Capital

- After being an investor for 20 years,
- I’m amazed by how many of the most successful companies I see
- Or have helped to sell
- Have raised no capital at all
- Or just a little from friends and family
- These bootstrapped companies are usually stronger and produce higher returns

Finance -
It All Starts With
The Exit

A Decade of Completely Different Exits



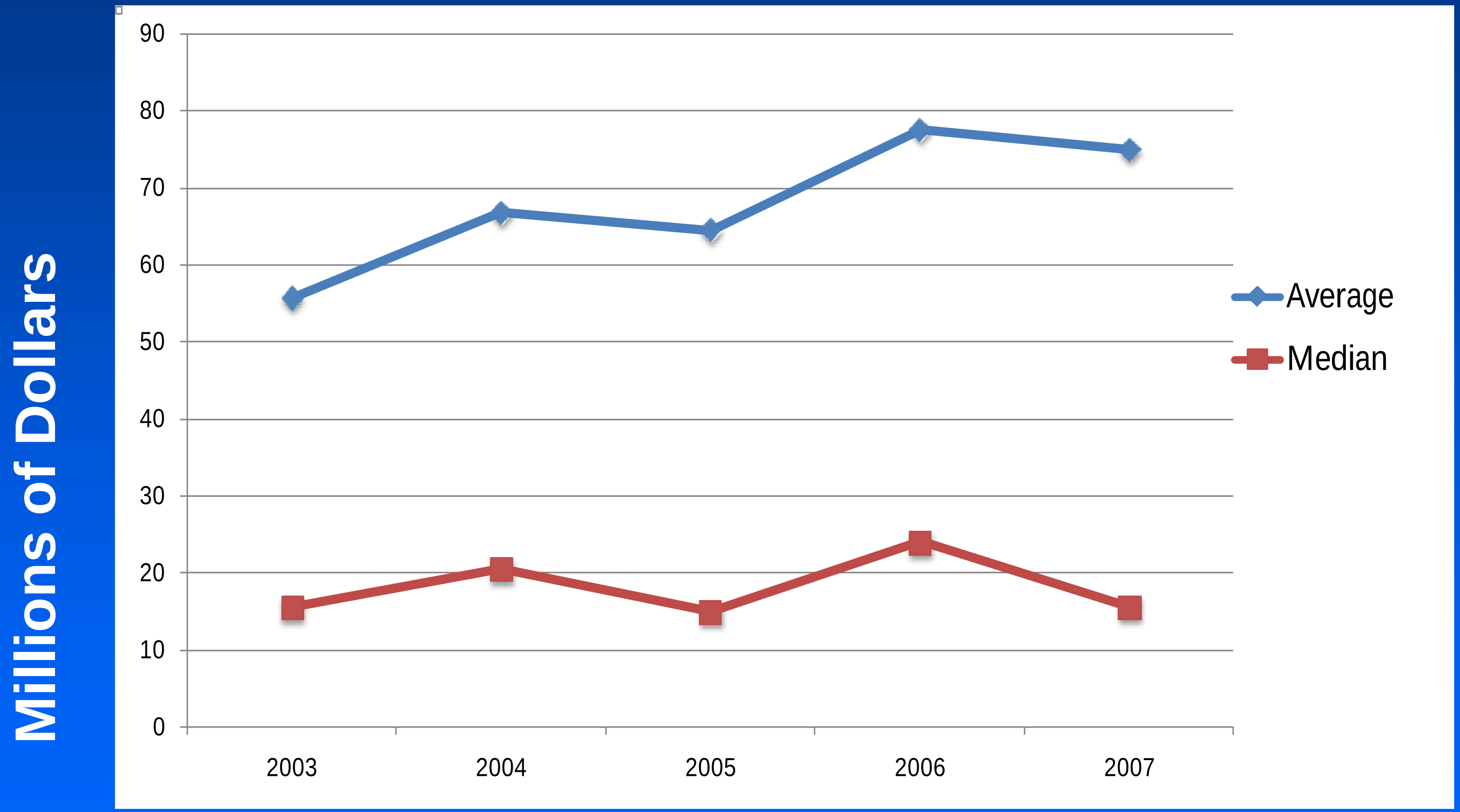
Source: NVCA

Most M&A Exits are under $15 million

We Always Hear About The Big Exits

- The media always reports the really big exits
- Like YouTube selling for $1.6 billion,
- Club Penguin selling for $350 million, or
- AdMob selling for $750 million
- Those exits are now very rare occurrences
- The ‘new’ big story is the number of smaller exits

US M&A Transactions
(private sellers only)



Mergerstat® Review - 2008

Most Exits Are Under $15 Million

- Mergerstat database shows the median price of private company acquisitions is under $20 million, when price is disclosed
- But the price is not disclosed in most smaller transactions
- I estimate the median price to be under $15 million

What Changed?

How Big Companies Think

- One of my friends from a Fortune 500 company explained it this way:
  - We (big companies) know we aren’t good at new ideas or startups
  - We basically suck at building businesses from zero to $20 million in value
  - But we think of ourselves as really good at growing values from $20 million to $200 million or more

“Under $20 Million Is Easy”

- A company priced at $100 million is already out of our sweet spot to buy
  - $100 million also requires board approval
  - But at $20 million, it’s really easy for me to get it approved just inside my division

- Many big companies are spending more on M&A than internal R&D
- Today, it’s the best way for them to grow

Google Wants Even Earlier Exits

- I was surprised recently to learn just how early Google wants to do acquisitions
- Charles Rim one of the top Google M&A guys:
- “90% plus of our transactions are small transactions. … less than 20 people, less than $20 million and that is truly the sweet spot”
- “we do prefer companies that are pre-revenue”
- http://www.exits.com/blog/google-wants-even-earlier-exits-than-in-early-exits/

Big Corps Have Too Much Cash

- For a decade, big companies have been accumulating cash
- Many big companies have so much cash that it's a problem – shareholders complain
- Google has $20 billion
- Cisco has $45 billion
- Microsoft has $57 billion
- Apple has $95 billion ß cash and investments

Big Companies versus VCs

- Big company corporate development and M&A teams now consider VCs their competitors, a fascinating development
- They know VCs will hold on for huge exits and don’t see VCs as adding a lot of value
- So they acquire exciting companies before VCs invest

Who Else Is Buying?

- The most familiar buyers are Fortune 500 companies
- But medium sized companies are also aggressive buyers – especially public ones
- Private Equity funds are also coming back into the market now that debt is available
- Also many individuals not ready to retire
- Today there are more buyers than sellers

Tech Companies Then and Now

Nexus and many 1990's tech companies

Friends and Family Investors → Angel Investors → Venture Capital Investors → Institutional Investors → Exit to Fortune 500

10 – 14 years

Club Penguin, Flickr, and many 2009 tech companies

Friends and Family Investors → Exit to Fortune 500

2 - 4 years

Examples of Early Exits

Weekender Sold in 10 Days

- “Weekender” – build a company in a weekend
- In 2009 when I wrote “Early Exits”
- I speculated that one day: “They’ll probably define an early exit as selling the company before the end of the weekender”
- That almost happened in November 2009
- A team of entrepreneurs in London built a business in one day and sold it online in ten days: www.24hour-startup.com <– great video

A B.C. Really Early Exit

- This is a Vancouver company but they asked me to keep their details confidential – for now
- This startup wanted to test the idea for their first product, so they called on a US customer
- The customer asked to buy the company
- The CEO called me for help
- Three months later the money was in the bank
- Company was less than 12 months from startup and still hadn’t launched the first product

A New <u>Really Early</u> Exit

- Anyone heard of the company PumkinHead?
- How about About.me?
- About.me was acquired by AOL
- Just four days after its public launch
- That may be a new record
- But a better way to measure is from startup

Big Exits In Just 2 – 3 Years

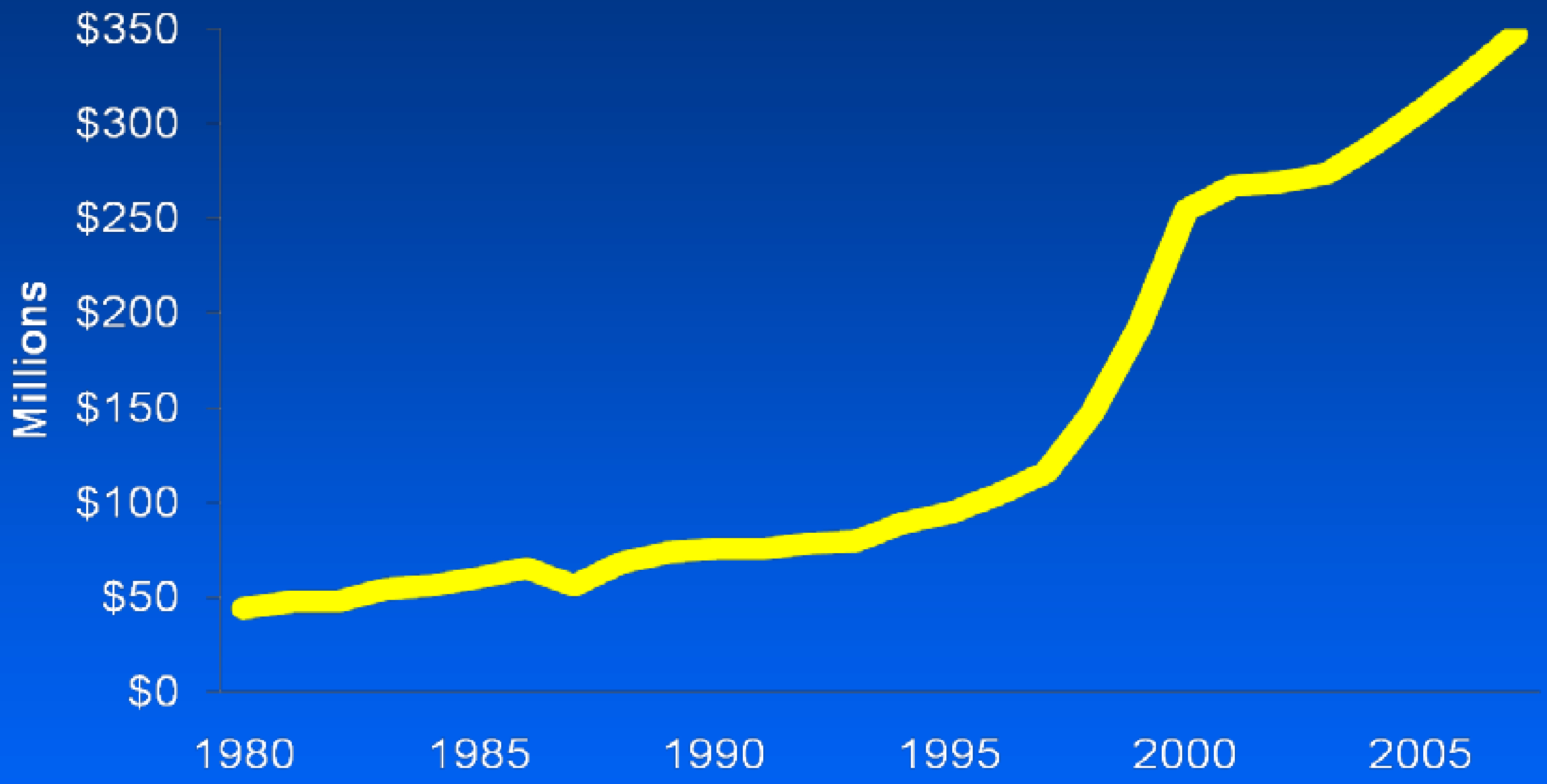
- Flickr sold for $30 million at 1.5 years old
- Delicious sold for $30+million 2 years from startup
- Club Penguin for $350 million at 2 years old
- YouTube sold for $1.6 billion at 2 years old
- Playfish sold for $275 million at 2 years old
- Mint sold for $170 million at 3 years old
- AdMob sold for $750 million at 3.5 years old

A Golden Era For Entrepreneurs

- There has never been a time before when
- It was so easy for so many entrepreneurs
- To create such valuable companies
- On so little capital, and
- Sell them so early
- For so much money

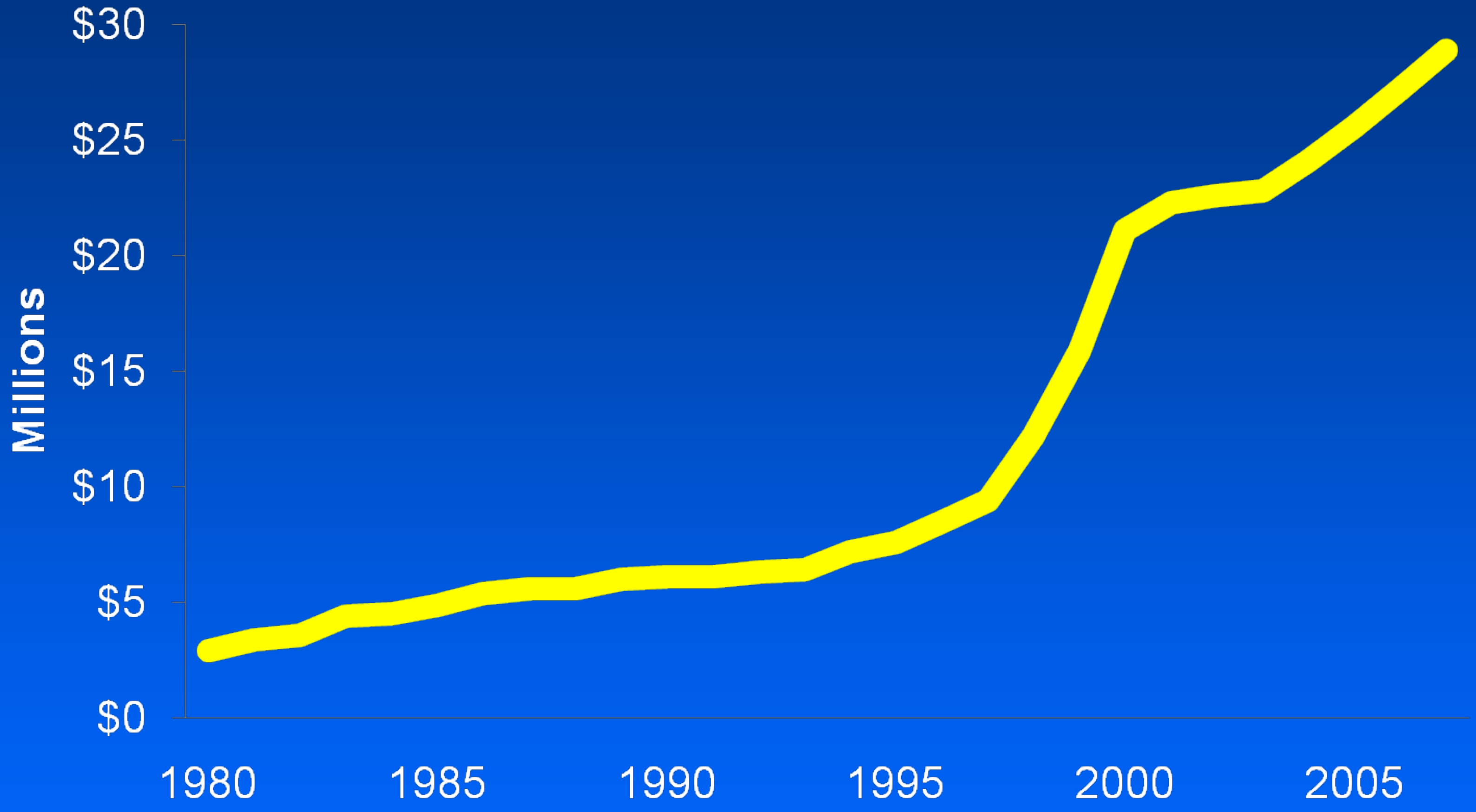
The <u>V</u>enture <u>C</u>apital Model is Broken

Size of Average VC Firms



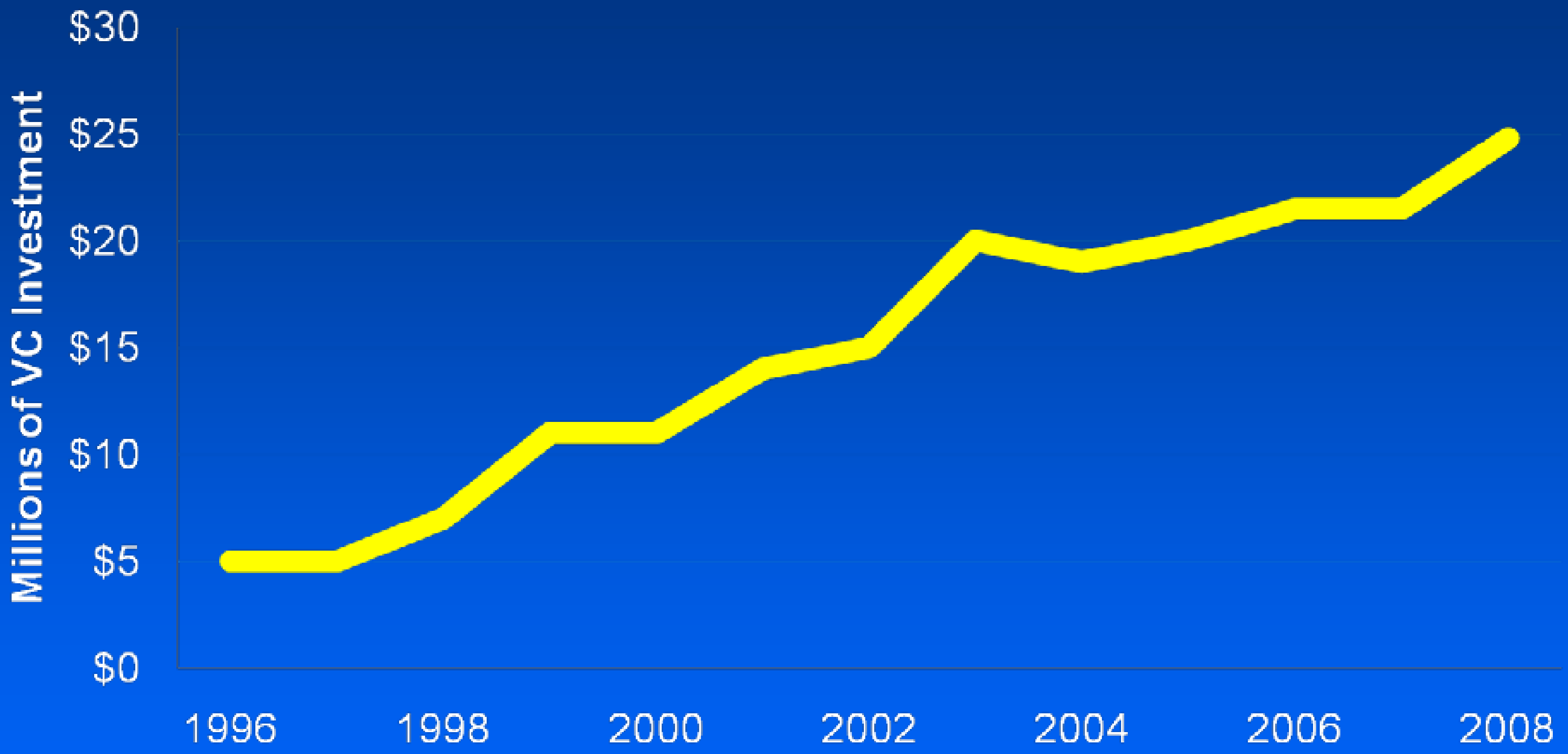
Source: US National Venture Capital Association, Thomson Financial

Average Capital per VC Principle



Source: US National Venture Capital Association, Thomson Financial

VC Investment Prior to M&A Exit



Amount of VC investment prior to M&A exit in millions. 2008 data for Q1
Source: Jeffries Broadview, Dow Jones VentureSource

VC Fund Math

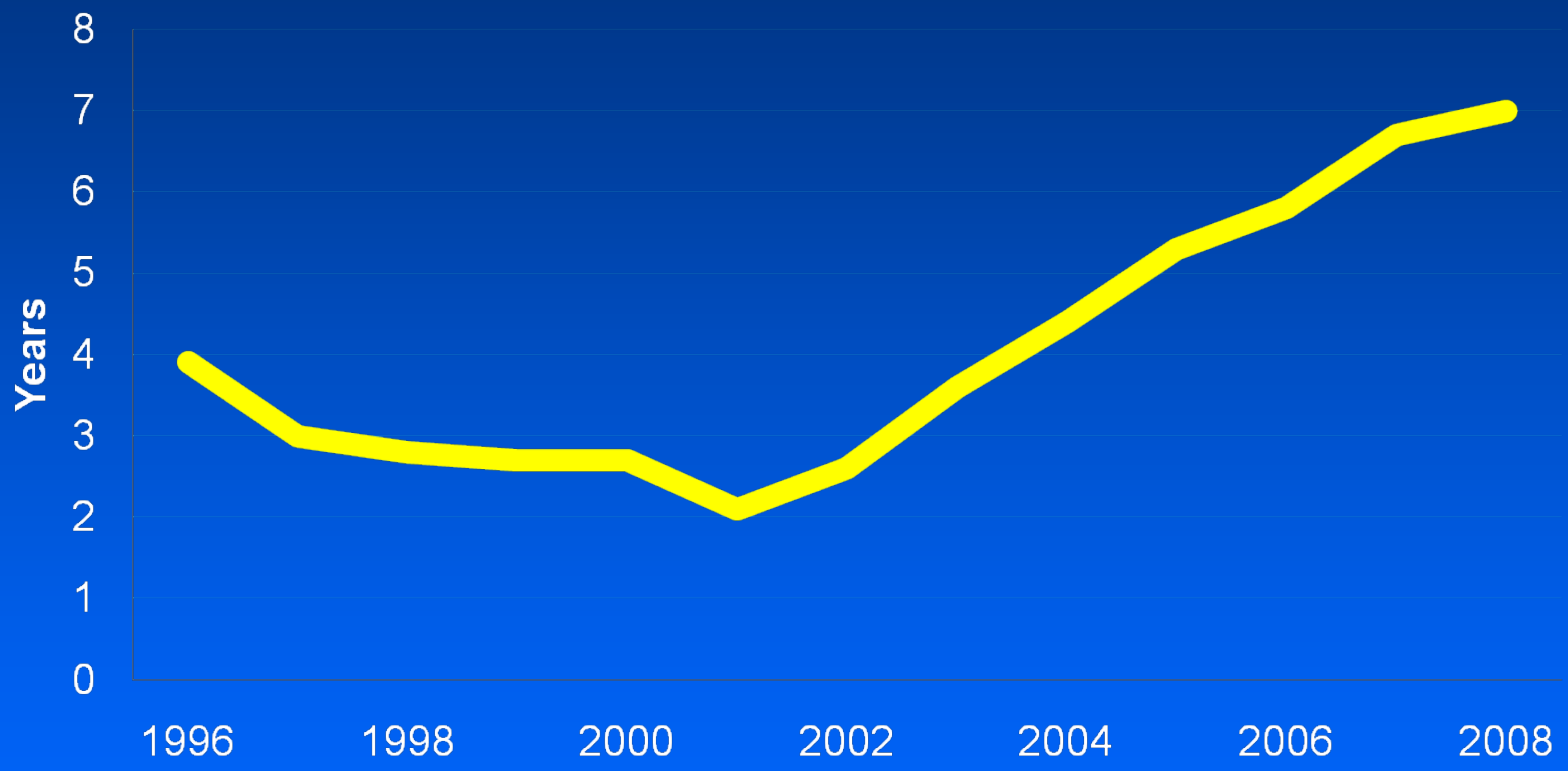
- VC funds have gotten much larger
- Seldom write a check for under $5 million
- Traditional funds <u>only invest money once</u>
- All fund returns come from < 20% of deals
- Limited partners expect an IRR of 20%
- Simple math shows that VC’s winners must produce a <u>30x returns</u>

92+% of M&As Don’t Work for VCs

VCs Need Exits over $100 million

Data from Mergerstat

Time from VC Financing to M&A Exit



Median Time from initial VC financing to exit in years. 2008 data for Q1.
Source: Jeffries Broadview, Dow Jones VentureSource

Venture Capital Is Broken

Summary:

1. VC funds are far too large
2. Too few IPOs and huge M&A exits
3. Start-ups need less money
4. Big companies and private equity funds consider VCs competitors

The End of Old Model VCs

- Traditional VC returns over the past decade
- Have been negative
- Based on inaccurate, very optimistic data
- Even after factoring out the bubble in 2000
- Not a cyclical change
- I think there may be a time when a new form of smaller, leaner VC funds can work

More On The Broken VC Model

- If you are interested in reading more on why the traditional VC model doesn't work anymore:

  http://www.angelblog.net/The_VC_Model_is_Broken.html

Angel Investing

Angel Investing Is Still New

- Organized angel investing is still quite new – first groups formed in mid 1990s.
- Angel investing today is where traditional Venture Capital was in the early 1980s
- We are still discovering the best practices and don’t have enough hard data
- ACA, the Kauffman Foundation and academics such as Rob Wiltbank and Josh Lerner are conducting invaluable new research

Who Are These Angel Investors?

- The biggest difference between VC funds and angel investors is
- That angels invest their own money
- Angels do not earn fees
- They only make money when the values of their investee companies increase
- Which completely changes their behavior

Angel Investor Math

- Small Investments ($10-25K) can make sense
- Returns > 300% over a few years are attractive
- Can easily reinvest the gains (unlike VCs)
- Exit objectives much more aligned with entrepreneurs than traditional VCs

Angels and VCs – Growing Apart

Today, we have a much clearer understanding of the difference between angels and VCs. From an exit perspective, there are three:

1. Minimum investment size
2. Minimum return required
3. Acceptable time to exit

Angels or VCs But Not Both

- Research May 2008 - University of Maryland - unique historical database of 182 Series A deals from the bankrupt Brobeck law firm
- “Outcomes inferior if angels and VCs co-invest”
- Angels alone “as likely as the VC-backed firms to have successful liquidity events”
- Does the current environment favor angels?

Angels, VCs and IPOs

- 2009 report by J. Sohl, Univ. of New Hampshire analyzed 665 IPOs from 2001 to 2007
- 13% had only angels, 33% only VCs, 16% both
- VC backed firms had “higher underpricing”
- “Angels’ incentives are more closely aligned with (nonVC) pre-IPO shareholders”
- “managers (entrepreneurs) prefer early stage funds from angels”

More Validating Research

- April 2010 - Kerr and Lerner from HBS
- Assisted by angels James Geshwiler, Warren Hanselman, Richard Sudek and John May
- “Angel funded firms are significantly more likely to survive at least four years and to raise additional financing”
- “Angel funded firms also more likely to show improved venture performance and growth”

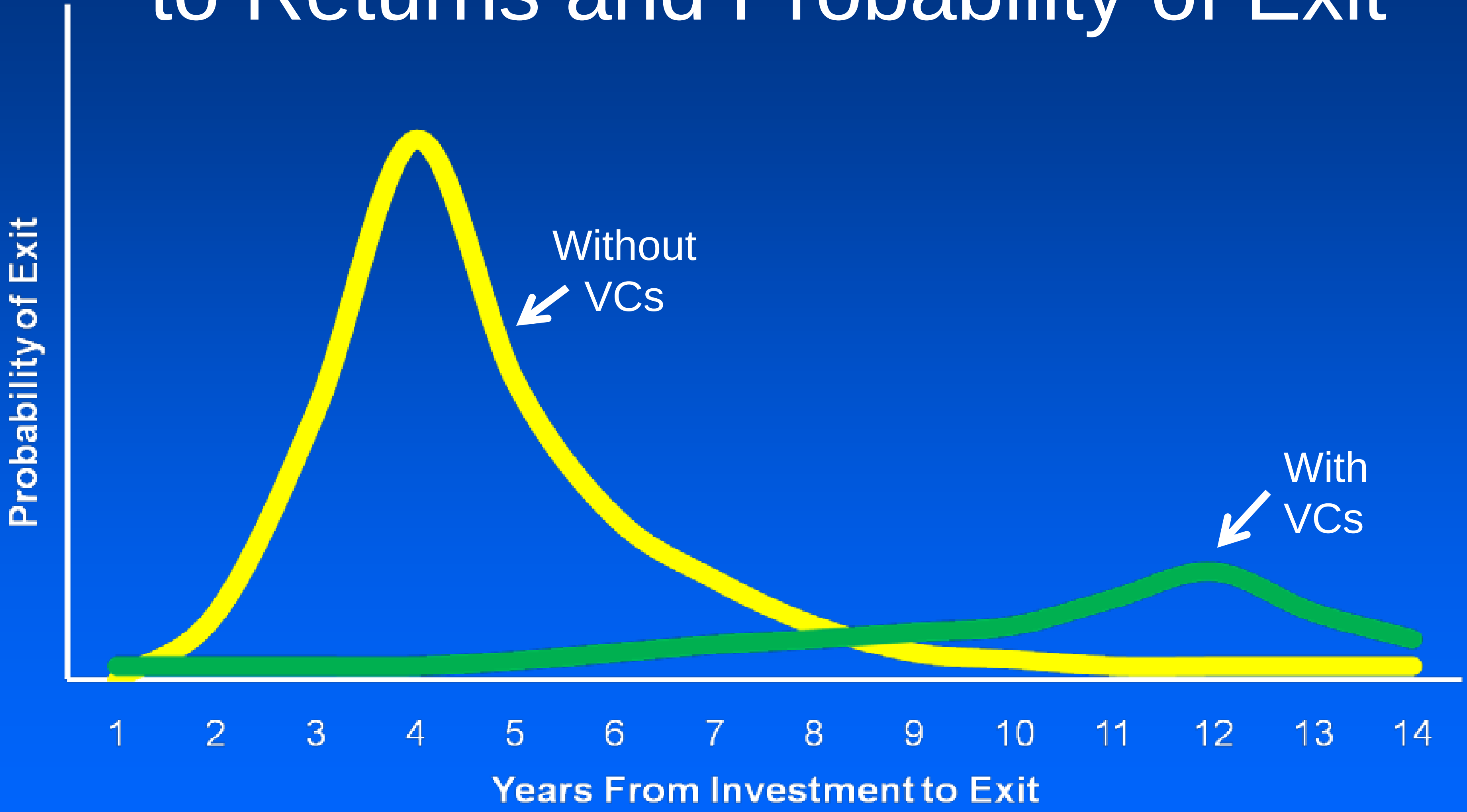
Outcomes When VCs Co-Invest
(compared to angel-only returns)

Source: Robert Wiltbank, PhD Willamette University with Funding from the Kauffman Foundation

The Bottom Line

- When traditional Venture Capital funds follow on in angel investments, statistically:
  - It takes about a decade longer to exit
  - The risks increase substantially
- We don’t have data yet, but I believe today the extra time, higher risks and dilution mean lower average returns for both the angels and entrepreneurs when VCs invest

What We Think Happens to Returns and Probability of Exit



Is Co-Investing with VCs Ever OK?

- What we have shown are statistics
- There are, of course, situations where the best decision is to have VCs follow on
- It all depends on the type of company

When Do VCs Make Sense?

	Angels only	With VCs
Amount of capital required to prove the business model	Under $5 -10 million	Over $5 -10 million
Years before being able to exit	2 to 5 years	Over 10 to 12 years
Most likely value of the company at the time of the optimum exit	Under $50 million	Over $100 million

Not an option, or preference, this is pre-determined by the ‘type’ of company

How Many Companies Need VCs?

- I wish I was a professor and could hire a grad student to work on this
- This is my belief based on observation,
- But without enough hard data to prove
- I watch most of the BC tech companies
- Since I started my VC fund in 2002
- I have been asking the question:

How Many BC Companies Need VCs?

- I believe that in the entire province
- In the technology sector
- That there have been fewer than five
- Companies that actually needed
- Venture Capital financing
- In the past <u>decade</u>
- Conclusion: There is still an excess of VC $

Who Actually Finances Startups?

- The majority of entrepreneurs still believe traditional VCs finance most startups
- Probably due to the NVCA's PR program and lobbying efforts
- The data shows that Angel Investors finance 27x more startups than traditional Venture Capital Funds
- More at: www.AngelBlog.net/Angels_Finance_27_Times_More_Start-ups_Than_VCs.html

Financing Today's Startups

- In America, Venture Capital Funds invest about $20 billion/year – and declining
- Angel investors also invest about $20 billion each year – and I think that number is growing
- Canada is about 10% of the US
- Even more surprising, Friends and Family investors invest about <u>3 to 5 times more</u> than either VCs or Angels
- From "Fools Gold" by Scott Shane 2009

Angel Syndication

- Just a couple of years ago, the conventional wisdom was that angel investment topped out at around $1 to 2 million per company
- ACEF and ACA started talking about co-investment just a couple of years ago
- Now I often see groups of angels investing <u>$5 million to $10 million</u> in one company, over several rounds
- More than enough for today's companies

New Financing Models

- It’s not just the economy that’s changing
- Business models are also changing
- New forms of startup capital are evolving
- Revenue Capital
- Incubators
- Crowd sourced financing
- University students running actual angel funds i.e. Willamette and Baylor

Summary

- Entrepreneurial finance has changed dramatically in the past decade
- I do not believe these are cyclical changes
- The changes in the global economy
- And fundamental technological changes mean
- We need to develop new ways to finance tomorrow’s companies

Resources

- www.Exits.com/Blog – blog on exits
- www.AngelBlog.net – blog for entrepreneurs and angel investors
- www.Early-Exits.com – book on exit strategies for entrepreneurs and Angel investors
- www.BasilPeters.com – for this PowerPoint and videos of previous talks