



Those High-flying Angel Investors: VC Panel Talks Up Creative Financing for Start-ups

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Software manufacturing, software programs to defeat spam, new business data technology and web services are all areas of opportunity for entrepreneurs, according to venture capitalists taking part in a panel on creative financing at a recent Wharton Entrepreneurship Conference. And those entrepreneurs who cut costs, sign on angel investors and find other creative ways to finance their start-ups will be rewarded with more equity in their firms, assuming they become successful.



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"You would be amazed how little capital [it requires to get a company going] if you are creative about it," said David Flaschen, an advisor to Flagship Ventures, of Cambridge, Mass., and former chief executive of Donnelley Marketing Inc.

Flaschen advised entrepreneurs seeking venture capital to be willing to accept professional management. "Right from the start, make clear that you value the concept of 'foundership' much more than 'CEOship,'" he suggested. "What you should say is, 'I want to make this company interesting and strong enough that we can hire the most effective chief executive officer.'"

One way to help finance a company in the early stages is to get customers to pay up front, said Flaschen, and, if possible, get vendors to make concessions to help the company's revenue stream. "Even before you go out and raise money, ask 'How can I do this with as little money as possible?'" If an entrepreneur takes less financing, then investors have less control. "The dirty little secret is, it is not a lot of fun to have a VC partner in your business. It is a lot more fun to own a majority stake, or 100%. The more you strive for that, the happier you will be."

Flaschen sees opportunities today in software manufacturing, particularly with the growth of open-source software development, and is also interested in the idea of defeating spam by creating unique addresses for each Internet transaction.

Herding Cats

Bob Greene, co-founder of New York-based Oncore Capital, likes the potential of new business data technology. Theoretically, everything in manufacturing, "from the loading dock to the front door of Wal-Mart, will be data-enabled. We can't predict how far it is going to go, but it's fascinating."

His biggest obstacle to financing new ventures is price. "I am always looking for a great idea and a large market opportunity with strong leadership and a fair price. The last piece is usually what doesn't intersect. I like a lot of companies, but I can't always negotiate the right entry point." Typically he looks for companies run by the classic entrepreneur. "You have to be half-crazy to be an entrepreneur and do a startup. A great leader is manic and will go to the mat. So I look for those qualities."

He also looks for a leader who is able to articulate the company's vision, and he tries to be open minded

about financing first-time entrepreneurs. "In our industry investors say they don't want to back a younger person's first business. But everyone starts somewhere. Often creative, groundbreaking ideas come from people who don't know how hard it is." In addition to leadership, he focuses on the basic idea behind a start-up. "One of the biggest challenges is finding an idea that hasn't been done five times."

Greene warned that angel investors, a layer of financing that usually comes between friends and family and venture capital, is becoming increasingly sophisticated. "It's not what it used to be. It's getting more organized and more professional." Angel investors can be valuable to a start-up because they can offer advice and contacts in addition to early, high-risk capital.

Yet it remains difficult to round these angel investors up. "The process of getting angel money is, in my observation, a little bit like herding cats," he said. "It's a confederation of 12 to 15 wealthy individuals who are doing this somewhere between a hobby and a part-time activity." Angel investors tend to travel frequently and miss meetings, or have trouble following up. "This is a great group to go after, but it can take awhile. You can't go in there and have a half-hour meeting over breakfast and they write you a check. That happened in the bubble phase, but not now. To get eight of them to all write checks requires many, many meetings."

Companies should take on more than one source of funding, he said, adding that he likes to co-invest in new companies with other venture capitalists to provide additional "brain power." "You should try to take a round (of financing) with three venture funds together so that when you hit a problem - and you will hit a problem - you don't have just one decision-maker." He suggested that when building a syndicate of investors, companies should look for venture funds that have worked successfully together in the past. Greene also warned that venture capitalists will be as just as involved in a firm they take a 15% stake in as they would with a 50% investment.

Venture investors, for their part, should be careful they don't take on too much equity in a firm, diminishing the founders' incentive to succeed. Greene does not like to leave founders with anything less than 20% to 25% of their companies. His firm has metrics for how much of the firm a recruited chief executive and chief financial officer should retain. "I tell the CEO and the management team, 'If it's not working for you, you're not going to do a good job for me. Slavery is over.'"

Customers as References

Vincent J. Schiavone, an entrepreneur and investor who now operates Prioratus LLC, an incubator and advisory service for start-ups, is currently working on several companies that are developing web services. "What interests me most is how you synch all the devices and communications we already have. I think that is a huge area of optimization and simplification."

Schiavone, who is also a member of Robin Hood Ventures, a Philadelphia angel group, said angel investors should not be considered in the same camp as friends and family and should be used as mentors. "Angel investing is not dumb money. At Robin Hood, we don't steal from the rich and give to the poor. It's a very hard group to get dollars from and a very hard group to live with."

According to Schiavone, too many entrepreneurs don't put enough thought into the sales part of their businesses before approaching investors. "In the early days, the founder often wants to work on the product, but we want to see the sales people." Entrepreneurs should also try to introduce investors to customers who can serve as a reference. "We want to see the people who are taking the risk with you because your technology is good." In addition, entrepreneurs must develop strategies for different points of exit. As an entrepreneur, Schiavone said he would be willing to give up more control along the way to people who can help.

"Pick your VCs or angels carefully," he said. "From a serial entrepreneur's point of view, it's not about

giving up control ... but you want to make sure you give up control to someone who knows about the business."

Chris Starr, managing director of Innovation Philadelphia, a local economic development organization, suggested that investors are showing strong interest in companies with revenue, but pre-revenue firms are not getting funded. To fill the gap, companies are becoming much more aggressive in gathering early so-called friends and family money. "One of the most important things you need to do at the first stage is to milk the 'friends, family and fools' for all it's worth," said Starr.

In the past, companies were able to raise about \$100,000 at this stage, but recently he had a company that came in with \$2 million. Others have raised \$500,000 from these early investors. "We are starting to see people get creative about extending their networks from existing family across the country and around the world."

A second increasingly important source of early funding for resourceful entrepreneurs is government. Starr noted that the federal government has \$2.5 billion available for various small business programs that recognize the need to provide funding for high-risk technologies the private markets won't touch yet. State and local governments are also getting into the business, with innovative programs to nurture start-ups on the bet they will grow into successful companies that can provide jobs and enhance the tax base.

Competition for government financing is generally less intense than it is for venture capital, he said, adding that, unlike venture money, it comes with far fewer strings. "These are grants," he pointed out. "It's free money. It's not debt. Similarly, it's not equity. It's not going to dilute anyone."

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