Entrepreneurial Investment Capital: A Critical Part of Our Entrepreneurial Ecosystem

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Outline

- Steve Ringlee
- Iowa’s Scorecard in Entrepreneurial Activity
- Founding Capital: FFF and Angels
- Venture Capital
- Government Capital
- Community Capital
- Private Equity Capital
- Business Advice for Startups
Iowa’s Entrepreneurial Scorecard

- **Price Waterhouse “MoneyTree” (2007)**
  - Trend is Down

- **Milken Institute “New Economy Study“**
  - VC Investment: 45th
  - IA: 38th Overall
  - State Science & Technology Index (2004): 37th, down 2
Founding Capital: FFF

• Friends and Family Finance
  – Source of most initial startup capital: network
  – $5k to $500k
  – Savings, credit cards, bank loans, mortgages
  – Personal accountability: you are accountable to your family and friends
  – Usually no involvement in business
  – Related to “bootstrapping”
Founding Capital: Angels

- *Amazon*: Jeff Bezos 1994
  12 angels: $100,000
- *Google*: Larry Page and Sergey Brin 1998 maxed out credit cards
- *Sun Microsystems*: Andy Bechtolsheim Angels: $100,000
- *NewLink Genetics*: Chuck Link
  Iowa angels supported over $15m
Who are Angels?

- SEC Rule 501: Accredited Investors
- Guardian Angel: experienced with Rolodex
- Operational Angel: executive experience
- Entrepreneurial Angel: startup experience
- Hands-Off Angel: investor only, no time
- Control Freak Angel: high ego density
Angels vs. Venture Capital

- VC: pension money in funds, larger & later deals
- Angels: individual money in clubs, smaller & earlier deals

- All VC Deals: $26b averaging $7.5m per deal in 3,800 companies
- Seed and Early Stage VC: $1.2b averaging $3.8m per deal in 312 companies
- Angel: $26b averaging $500k per deal in 51,000 companies
US Angel Market Growth

• 2006: $25.6 billion in 51,000 ventures
• 2005: $23.1 billion in 49,500 ventures
• 2004: $22.5 billion in 48,000 ventures
• 2003: $18.1 billion in 42,000 ventures,
• 2002: $15.7 billion in 36,000 ventures

National Venture Capital Association
## Where Do Angels Invest?

<table>
<thead>
<tr>
<th>Sector</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Healthcare</td>
<td>21%</td>
</tr>
<tr>
<td>Software</td>
<td>18%</td>
</tr>
<tr>
<td>Biotechnology</td>
<td>18%</td>
</tr>
<tr>
<td>Retail</td>
<td>8%</td>
</tr>
<tr>
<td>Electronics/Hardware</td>
<td>2%</td>
</tr>
<tr>
<td>Media</td>
<td>4%</td>
</tr>
<tr>
<td>IT Services</td>
<td>3%</td>
</tr>
<tr>
<td>Industrial/Energy</td>
<td>6%</td>
</tr>
<tr>
<td>Fin/Bus Products</td>
<td>6%</td>
</tr>
</tbody>
</table>
# Angel Fund Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>IA</th>
</tr>
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<tbody>
<tr>
<td>1996</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>1999</td>
<td>98</td>
<td>1</td>
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<tr>
<td>2000</td>
<td>138</td>
<td>1</td>
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<tr>
<td>2001</td>
<td>126</td>
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<td>2002</td>
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<td>2003</td>
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<td>2004</td>
<td>123</td>
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<td>2005</td>
<td>132</td>
<td>7</td>
</tr>
<tr>
<td>2006</td>
<td>164</td>
<td>10</td>
</tr>
<tr>
<td>2007</td>
<td>171</td>
<td>12</td>
</tr>
</tbody>
</table>

Center for Venture Research - University of New Hampshire
How Do Angels Invest?

• Lemmings: social decisions
• Some due diligence investigation, but most decisions made on the basis of gut feel and the quality of the business plan
• Semi-active involvement depending on angels
## Equity Capital for Entrepreneurs

<table>
<thead>
<tr>
<th>Stage</th>
<th>Pre Seed</th>
<th>Seed/ Start-Up</th>
<th>Early</th>
<th>Later</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source</td>
<td>Fdrs</td>
<td>FFF</td>
<td>Angels</td>
<td>Venture Funds &amp; Iowa Fund of Funds</td>
</tr>
<tr>
<td>Demand</td>
<td>$25K</td>
<td>$100K</td>
<td>$500K</td>
<td>$2,000K</td>
</tr>
</tbody>
</table>

Information/Funding Gap now being filled by Angels

Angel-to-VC Capital Gap

Center for Venture Research - University of New Hampshire
The Road Ahead

• Recognize the critical role of angels
• Create sustainable Iowa angel market growth and returns
• Convert latent angels into investors
• Encourage training, networking and cooperation
• Deal with the second funding gap
• Work on the angel - VC relationship
Venture Capital

- What VC Is
- Size and Scope
- Iowa’s Challenges
Venture Capital

- Professionally managed equity capital invested alongside management in high potential, rapid growth companies for high returns.
- Organized into closely-held partnerships
- Funded by pension funds, foundations, wealthy individuals, corporate strategic investors
Venture Capital

- Finances new and rapidly growing companies;
- Purchases equity securities;
- Assists in the development of new products or services;
- Adds value to the company through active participation;
- Takes higher risks with the expectation of higher rewards;
- Has a long-term orientation
Venture Industry

- 800 VC firms nationally
- Heavily concentrated on both coasts
- General Partners paid fees + percentage of profits
- Average fund lifetime: ten years
- Investment criteria for each fund
- See many deals, invest in very few: 1 in 400
Stages of Venture Capital Investing

• **Seed/Start-Up Stage**
  The initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months.

• **Early Stage**
  The company has a product or service in testing or pilot production. In some cases, the product may be commercially available. May or may not be generating revenues. Usually in business less than three years.

• **Expansion Stage**
  Product or service is in production and commercially available. The company demonstrates significant revenue growth, but may or may not be showing a profit. Usually in business more than three years.

• **Later Stage**
  Product or service is widely available. Company is generating on-going revenue; probably positive cash flow. More likely to be, but not necessarily profitable. May include spin-outs of operating divisions of existing private companies and established private companies.

• **Acquisition, Turnaround or Recapitalization**
  of public and private companies
VC Challenges in Iowa

- Few local VCs
- Many VCs are geographically focused
- Iowa deals are either “early or late”
- More difficult to assemble management teams in Iowa
- Remote from national technology centers
VC Opportunities in Iowa

• http://www.iowaentrepreneur.com
• Pappajohn Entrepreneurship Centers
• Small Business Development Centers
Government Capital

- Federal:
  - **SBIR**: Small Business Innovation Research
  - **ATP**: Advanced Technology Program
  - **Agency Partnering**

- Iowa: Department of Economic Development
  - **EVA**: Entrepreneurial Ventures Assistance
  - **Targeted Funds**: Power Fund, Values Fund
  - **Innovation & Commercialization Funds**
Community Capital

• **CDFI’s**: A $21b source of capital
• Targeted toward lower demographics
• **Community Development Finance Institutions**: 
  – Banks: for-profit, insured
  – Loan Funds: non-profit
  – Credit Unions: member owned
  – Venture Capital: for profit, targeted VC
• **New Markets Tax Credit** funds: $15b
• **Rural Business Investment Company** funds
Private Equity Capital

• Leveraged Buyouts: acquisition of an existing firm using debt capital
• Beginnings: use leverage via debt to enhance returns in breakup and restructuring
• Now: use operating improvements, build platform firms, build value
Private Equity Deals

• Best deals:
  – Established firms with stable cash flows and clean balance sheets with little debt and good asset base
  – Strong market position
  – Good management team
  – Divestible assets
  – Potential for expense reductions
  – Good synergy opportunities

• Large market of funds seeking such deals in every size category
Private Equity Deals

- Multiple layers of debt: senior, mezzanine
  - Senior debt: 50%, from banks, insurers
  - Mezzanine debt: 30%, from funds and insurers
  - Equity: 20%, from management, funds, investment banks, sub debt holders
- Huge worldwide market: $110b invested in 2005
Angel/VC Criteria

• Business Plan Evaluation Template:
  – 1-8: “Is it a Business?”
  – 9-14: “Can You Keep It?
  – 15: “Can You Do It?”

Source: Wayne Brown Institute
Angel/VC Criteria

• 1. *Is it a New Combination?*
  
  **LOW**  
  If the discovery is new for us, but not for other companies
  
  **MED**  
  If the discovery provides a definite improvement over existing supply for present demand, or demand for present supply
  
  **HIGH**  
  If the discovery is a real breakthrough
Angel/VC Criteria

• 2. *Is there a Product-Market Match?*
  
  **LOW**  If there are no purchase orders
  
  **MED**  Offers added features to the market (*e.g.* convenience) such that some orders or sales exist
  
  **HIGH**  Matches a market want or need so well that sales backlogs or large quantity purchase orders exist
Angel/VC Criteria

- **3. Is there a Net Buyer Benefit?**
  - LOW If there is price discount pressure
  - MED If there is price stability
  - HIGH If there are "stock-outs" and price premiums
Angel/VC Criteria

• **4. Are there Margins?**

  LOW  If the expected margins *for the venture* are far below *(typically less than 15%)* documented industry averages and/or expectations

  MED  If the expected margins *for the venture* are in a similar range *(i.e. 16% and 30%)*

  HIGH If the industry margins *for the venture* far exceed *(over 30%)* industry averages
Angel/VC Criteria

• **5. Is Volume sufficient?**
  - **LOW**  If the expected volume is not sufficient to achieve venture objectives
  - **MED**  If the expected volume should be sufficient to achieve venture objectives
  - **HIGH** If the expected volume far exceeds venture objectives
Angel/VC Criteria

- **6. Is it Repetitive?**
  - **LOW** A "once-only" purchase, or extremely sporadic and unpredictable
  - **MED** Purchases are occasional
  - **HIGH** Purchases are frequent and reasonably predictable
Angel/VC Criteria

• 7. *Is there a Long-Term Need?*
  
  **LOW**  If the new discovery (*product/service*) is a fad with limited future need, short life cycle
  
  **MED**  If the product/service need extends only over the short term
  
  **HIGH**  If there is a foreseeable long-term need for the product/service, long life cycle
Angel/VC Criteria

8. Are Resources Sufficient?

- **LOW**: If resources are effectively non-existent or limited
- **MED**: If resources are few, or at risk if growth exceeds plans
- **HIGH**: If resources are plentiful and anticipated to be readily available in the future
Angel/VC Criteria

• 9. *Is it Non-Imitable?*

  LOW  Easily imitated, no isolating mechanisms in place
  MED  Partially protected by isolating mechanisms
  HIGH Isolating mechanisms are sufficiently strong so as to permit little or no imitation
Angel/VC Criteria

10. Is it Non-Substitutable?

- **LOW**: There are substitutes that directly reduce product demand
- **MED**: There are substitutes that indirectly reduce product demand
- **HIGH**: There are no substitutes
Angel/VC Criteria

• 11. *Is There No “Stick-up”*?
  
  LOW  There is a lot of economic bargaining power in suppliers or buyers
  
  MED  There is some economic bargaining power in suppliers and buyers
  
  HIGH Suppliers or buyers have little or no economic power over the venture through bargaining
12. Is Uncertainty minimized?

- **LOW**: High risks in technology, management
- **MED**: Risks and management tools identified
- **HIGH**: Risks are low because of planning, insurance, statistical control processes, incentives, etc.
Angel/VC Criteria

• **13. Is Ambiguity reduced?**

  LOW  There is an absence of long-term planning and adaptation processes conducted in a heterogeneous group setting

  MED  Some planning and adaptability-preparedness is undertaken

  HIGH Information sought, decision structures in place, and organized to manage ambiguity
Angel/VC Criteria

• **14. Can You Do It?**

  LOW  If members of the venturing team possess little or no experience and specialization in the business

  MED  If the venturing team has some experience and unique knowledge in the business

  HIGH If the venturing team is familiar with the industry and has worked for at least five years therein and can perform specialized tasks critical to the venture's success
Business Advice for Startups

• Best business plan expert in the Midwest: Mike Upah at ISU Pappajohn Center
• Open Discussion!