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Centerfold: Technology Incubators and Portfolio Companies

December 2006 Vol. 6, No. 4

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The passion and perils of seed investing

Seed investors and start-up entrepreneurs need to have special qualities. Jonathan Saacks, Partner at Genesis Partners, describes those individuals best suited for the rough and tumble world of seed.

Investing in technology start-ups at a very early or seed stage has always been popular among both professional investors and angels. Figures from the National Venture Capital Association and PricewaterhouseCoopers show that in the third quarter of 2006, US venture capital investments in seed and early stage companies soared by 60 percent from 56 to 90 deals; and the amount invested nearly tripled to $329 million from $114.3 million. Recently, seed investing has become even more popular for several key reasons.

First, it is widely understood that the earlier an investment, the higher the potential return. This stems from the ability of an early investor to acquire significant ownership at a lower valuation. An economist would counter that these higher potential returns are offset by higher potential risk, but investors are able to partially mitigate the risks of early stage investing by deploying less capital and by exerting greater control over the direction of a business in its early stages. Early stage investors are effectively buying the "option" of deploying additional capital at a later stage.

Jonathan Saacks

Second, there is an increased perception among investors that "mega-exits" are becoming harder to come by. As overall growth in the technology sector approaches GDP growth, IPO markets have demonstrated far less appetite for early stage technology companies. Stricter regulatory environments have also increased the cost of being public, and large technology companies are increasingly seeking to make acquisitions at lower valuations.

Wise venture investors still seek to identify and invest in billion dollar companies, but early stage investing provides a way of mitigating risk in a more challenging exit environment.

Third, some spaces, such as software and the Internet, as well as increased utilization of open source software, low-cost grassroots distribution channels, and viral marketing, have reduced the forecast burn rate of many companies, allowing smaller investments at earlier stages to generate attractive returns. Finally, early stage investing is understood as a good way to generate quality proprietary deal flow.

An entrepreneur seeking to establish a company must have seed capital, be it from his own pocket, an angel or a VC. Seed investing, however, is a specialty with distinct challenges, and it is not appropriate for all venture investors. Successful seed investors should have a high appetite for risk, a willingness to be active board-level contributors to the strategy and direction of the company, and the flexibility to adapt with the company as it explores various opportunities and adjusts its business plan. Likewise, not every entrepreneur is appropriate for seed investment. An entrepreneur receiving seed capital must be able to lead the process of market validation and team-building.

Entrepreneurs should be particularly careful in choosing a seed investor, as this is one of the most important decisions he or she will make. The early relationship between an entrepreneur and investors will help determine the cultural DNA of the enterprise and the dynamics of the board. Entrepreneurs must be careful to select investors whose expectations and objectives are aligned with theirs. Too often, entrepreneurs who are seeking a significant exit mistakenly partner with angels or VCs who are unable to deploy sufficient capital during the company lifecycle and are content with a more moderate exit. This can make it difficult for the company to raise the capital required to execute on the entrepreneur's vision. In addition, seed stage entrepreneurs must select investors with experience in early stage investments – investors who are able to help the entrepreneur with the unique challenges of very early businesses and who are not likely to panic when the direction of the company becomes momentarily unclear, as it often does in the early stages.

The seed investor is unique in that he needs to make an important long-term decision in the midst of risks and uncertainty. A seed stage investor should go into an investment with his or her eyes wide open to the reality that multiple rounds of financing will be needed to grow the company and with a realistic sense of the amount of capital he or she will need to commit in order to avoid dilution. On one hand, the investor should be able to offer advice and guidance, and be willing to roll up his or her sleeves to assist the company initially in many areas, including strategy, administration and logistics. On the other hand, the investor needs to be confident enough to give the founders and management the freedom and space they need to manage the company as they see fit. The temptation for an investor to micro-manage a seed investment is ever-present and should be avoided.

Perhaps the most important element of success in seed investing is the most intangible: Passion. A critical element in VC investing at any stage, passion is especially vital in seed investing. Investors must fully buy into the vision of the entrepreneur and "fall in love" with the idea while retaining a healthy skepticism. Above all, the

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The passion and perils of seed investing

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investor needs to be convinced by the drive and commitment of the entrepreneur. This energy is essential in getting the company started and convincing investors, employees, and customers that the company is going to change the world and grow from seed stage to exit. Seed investing is characterized by significant risks, but it can be the source of immense returns if both investor and entrepreneur bring the right mix of commitment, skill and passion. ■