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Finding Business "Idols":
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The Kauffman Foundation

July 2007[1]

Just as Simon Cowell is revolutionizing the music business with his "American Idol" television series, a group of new entrepreneurs is quietly changing the face of the venture capital industry and entrepreneurship.

"American Idol" has proved to be a major success in identifying and establishing entertainment stars. Its winners and contestants have sold tens of millions of albums. The reality show also has tapped industry experts to groom and coach the top talent in the competition.

A similar "Idol" formula is emerging among a new wave of entrepreneurs and venture capitalists who are radically transforming the way high-tech entrepreneurs are identified, their businesses are launched, and the growth of their operations accelerated. The new "Idol-based" models vary in their details, but their contest-based method of selection and subsequent grooming are a common feature. This new approach to finding and nurturing high-tech entrepreneurial enterprises seems to be catching on like wildfire, not only in the United States but in Europe and other parts of the world.

We believe this is a highly significant development that has important implications for the way many other early stage companies may be launched and financed in the future. Here, we describe several variations of this new model of early stage acceleration and venture investing. First, however, we provide some context by reviewing the venture model for financing early stage firms that dominated until the Internet bust in 2000, and the replacement of venture firms by angel financing for early stage firms that has become important in the intervening years.

The "Old" Model of Venture Financing of Early Stage Companies

Venture capitalists used to be well-known for their risk-taking abilities in starting companies at the conceptual level. Further, when the venture capital (VC) model was first created, the typical VC firm raised a moderate-sized fund and assisted in the building of those start-ups in which they invested. The VC would assist not only in the hiring of the management team, but before it was formed, the VC itself

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[1] This paper was prepared by these individuals at the Kauffman Foundation: Bo Fishback (director, Advancing Innovation), Christine Gulbranson (director, Advancing Innovation), Robert Litan (vice president, Research and Policy), Lesa Mitchell (vice president, Advancing Innovation), and Marisa Porzig (research analyst, Research and Policy).

would take an active role in the company. Often VC partners would serve alongside founders as top managers of newly formed companies.

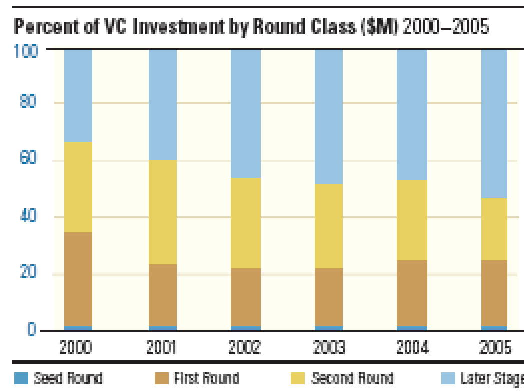
Today, these characteristics are no longer the norm. Current-day venture capitalists are more risk adverse than their counterparts from twenty years ago. Indeed, press reports have widely noted that many VCs have abandoned the early stage market, preferring instead the safer, even if less lucrative, ponds of second- or third-round financings. In addition, as VCs raise larger sums, they need to deploy their funds in large increments—much larger than the amounts early stage start-ups typically require. VCs also would be stretched too thin if they served in management roles in new enterprises. At best, a VC is likely to maintain only a seat on the board of directors and assist if called on for introductions to potential business partners.

These features of the current VC market are reflected in the data. From 2000 until 2005, seed-round investments made by VCs dropped from 281 deals to just sixty-three. Even if the stock market stays "hot," it is unlikely that VCs will return in a big way to seed-stage investment.

Investment by Round Class 2000–2005

Round Class	2000	2001	2002	2003	2004	2005
Number of Deals						
Seed Round	281	142	89	63	85	63
First Round	2669	946	585	560	641	696
Second Round	1372	959	620	493	472	432
Later Stage	1089	836	769	727	756	796
Amount Raised ($M)						
Seed Round	$484.4	$256.0	$117.3	$72.8	$118.3	$54.3
First Round	$28,283.1	$7,502.1	$4,027.1	$3,560.2	$4,489.5	$4,699.3
Second Round	$27,498.9	$12,599.1	$6,276.6	$4,949.3	$5,514.1	$4,351.9
Later Stage	$28,633.8	$13,743.7	$9,203.7	$8,243.7	$9,286.6	$10,595.7

VentureOne VC Industry Report 2006



VentureOne VC Industry Report 2006

The Internet Bust, the Death of the Old Model of Early Stage Venture, and the Rise of Angels for Early Stage Financing

If VCs are getting out of seed-stage investing, who's in? Increasingly, angel investors—wealthy individuals or groups of such people operating on their own without the overhead of a formal management organization—seem to be stepping up to the plate.

First identified by academics in the early 1980s, angel investors have preferred to conduct business quietly in order to avoid unending requests for funding. In his 1983 article highlighting the important role of angels in financing high-growth ventures at early stages, William Wetzel identified the "funding gap" covered by angels as between $50,000 and $500,000 (Wetzel, 1983). With the growth of venture capital funds and a shift in their focus to larger investments at later stages, angels are now even more useful and necessary to many start-ups.

Angels invest their own money in early stages of private, high-growth ventures for a variety of reasons, not simply to earn the highest returns. Angels also cite local economic growth, use of their expertise, and personal enjoyment and enrichment as reasons for funding rapidly growing firms (Shane, 2005). Angels tend to invest close to where they live, often within a three- to four-hour drive from their office, with a few exceptions (Shane, 2005; Freear, 2002). The close geographic proximity allows angels to be involved in the ventures they are funding. Individual angels find deals through their networks and typically invest in ventures that can leverage their industry or operations expertise (Shane, 2005).

Through the 1990s, angels typically invested in companies alone, but in the past decade, a growing number of them have formed angel groups. These groups conduct screening and due diligence, allow individual angels to diversify their holdings, collect knowledge from investors with varied industry experience, and pool capital (Shane, 2005). These groups take a variety of forms, offering investors flexibility in choosing deals in which to invest. Increasingly, angels are coinvesting in ventures with other angels. While the group models vary in formality, they all facilitate a steady flow of quality deals (Shane, 2005). Growing interest in these groups has prompted the recent formation of the Angel Capital Association, which assembles best practices and assists communities in establishing angel groups.

Since the bursting of the Internet bubble, angels are participating in multiple financing rounds. Many angels saw dilution of their investments as they could not keep up with the VCs in multiple financings during the build up of the Internet bubble. As a result, angels in recent years have been adopting terms similar to those in venture investments, with smaller initial placements and reserves for investing in later rounds (Shane, 2005).

Emerging New "Idol-Like" Models of Early Stage Venture Investing

The angel model of funding companies in their early stages may have been the "next big thing" in investment circles a decade back, but a new form of early stage funding is emerging. Call it the "American Idol" form of venture backing or the new "Accelerator" model, but whatever its name, the model differs from what came before.

What is an "accelerator"? It's not your father's business incubator—which was, in many cases, a real estate deal, with start-ups as tenants who paid for shared overhead. An accelerator is much more; it is a full partnership. The accelerator typically provides much more than space and common management services to start-ups. It helps form companies as legal entities, interviews and hires the appropriate initial management team, and lends its own management expertise.

In short, the accelerator becomes the "new company" throughout seed-stage development. Whereas a seed-stage venture firm will assist in building the company on an as-needed basis, and otherwise provide guidance, the accelerator is "the company" from day one of its formation. The accelerator team is the new company's team and assists in both business and product development. Since it is not the norm nor is it necessary from the starting gate to have, for example, a full-time CEO, or VP of marketing, the same management team is assigned to many of the companies in the accelerator. At any one time the same management team could be shared among five start-ups. Additionally, as part of the full-service engagement, the accelerators may offer intensive boot camps that equate to Entrepreneurship 101.

How does a company join or benefit from an accelerator? Enter American Idol. Just as Idol contestants audition their skills before a panel of judges, start-ups wanting the benefits accelerators provide compete for slots on the accelerator's "team." The business idea typically is less important than the individuals. In VC-speak, the jockey is more important than the horse. Accelerators believe that by assembling groups of potential entrepreneurial superstars, they will hatch more and better ideas than if they fund a series of them in isolation. Further, accelerators appear to be concentrating on specific industries or sectors, since it often takes a critical mass of people with similar educational and business backgrounds to come up with cutting-edge commercially successful advances.

The Foundry, Inc., located in Menlo Park, California, was the first-known accelerator. Formed in 1998, The Foundry focuses on medical device development and is funded by notable VC firms Morgenthaler Ventures and Split Rock Partners. Not only does it vet technology brought to it by outside inventors, but much of the technology spun out of The Foundry is developed by its own in-house research team. Additional projects originate from university collaborations. Since its inception, The Foundry has launched more than ten medical device companies and raised over $200 million in financing for these companies. Today, these

companies employ more than 350 people and have generated over $1 billion of value for their founders and investors (The Foundry).

In addition to The Foundry, there are a handful of other accelerators: The Accelerator Corporation in Seattle; TechStars in Colorado; YCombinator in Mountain View, California, and Cambridge, Massachusetts; YEurope; one currently being created by Pfizer in San Diego, California; and one just announced by the University of North Carolina at Chapel Hill in partnership with Alexandria Real Estate. Our impression is that the floodgate has opened and more accelerators will be created both nationally and internationally.

The Accelerator Corporation in Seattle focuses on biotechnology companies. It has well-established partnerships with Alexandria Real Estate, Amgen Ventures, MPM Capital, OVP Venture Partners, ARCH Venture Partners, Versant Ventures, and the Institute for Systems Biology. Currently, roughly $22 million has been invested in six companies by the Accelerator Corporation's investors. The Accelerator Corporation is committed to its portfolio of companies and will assist if needed in their later stages of financing. The newly created accelerator at the University of Carolina at Chapel Hill is modeling itself after the Seattle-based Accelerator Corporation.

YCombinator located in both Mountain View, California, and Cambridge, Massachusetts, has been creating a lot of buzz (Levy, 2007). It primarily invests in software and web development and funds two batches of start-ups each year, one in the summer and one in the winter. The founders/companies come to YCombinator for three months where they undergo an intensive boot camp. After ten weeks, the companies start pitching to investors for financing. Often companies are funded well before the ten-week mark. YCombinator has funded thirty-eight companies thus far, one of which was recently acquired by Google.

All this is likely to be just the beginning. Closely related models are emerging at venture capital firms and universities, which are incorporating competitions and intensive training. For example, Charles River Ventures' CRV Quickstart Seed Funding Program provides select entrepreneurs with a loan that will fund the work necessary to determine if their idea is sound enough to build a company around. CRV will provide up to $250,000 in the form of a convertible note, but it will not hold the individual entrepreneurs liable for repayment. Highland Capital Partners' summer entrepreneurship opportunities for university students (both undergraduate and graduate) include a stipend, an office, and a "boot-camp for start-ups." In London, Seedcamp provides an intensive week-long training and networking event for twenty "teams" of European entrepreneurs and promises investments of 50,000 pounds in each of five "winning" teams, in return for a 10 percent stake in the companies they form.

Conclusion

Being at the cutting edge of the economy, it is not surprising that the “seed-stage investment industry” is in a state of constant flux and renewal. While some pundits may be declaring the demise of the early stage VCs, some VCs and angel investors are already displaying interest in a new form of contest-based accelerator model of picking and grooming the next wave of potentially high-growth start-ups. If the recent past is any guide to the future, watch for further growth in this new form of venture funding—until the next Big Thing in early stage company support comes along.

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