

Angel groups fill VC void

Investment dollars drop 50% in Q3

Brad Cherniak, Financial Post Published: Monday, December 14, 2009

Venture capital is an industry in flux, the fallout of which will be felt for years in North American emerging growth companies.

Third-quarter VC activity in Canada was down about 50% year over year in terms of dollars invested and in the volume of deals, industry sources say. In the United States, investment dollars fell 33% in the quarter, while volume was down less than 5%. Overall, new investment activity is trending at about US\$15-billion -- half the levels of the boom years.

Antoine Paquin, a veteran venture capitalist with Rho Canada and a successful entrepreneur, says it's no surprise capital levels are being rationalized to balance excess supply and dwindling demand based on high-return economics. Simply said, the cost of capital needs to be high to warrant superior returns.

The carnage is centred in the fat part of the distribution curve, mid-sized funds with little defining competitive advantage other than their cash, and "me-too" business models that were the rage in boom times. This segment will be ugly for years to come, with no obvious solutions other than to let the fire burn, and the mediocre investments and funds fall.

Interestingly, things are stirring in the early-stage investing. The beauty of unfettered private capital markets is that cash flows out of disaster areas and into those of opportunity, quickly.

Early stage venture capital is fairly unique in that, by definition, the companies invested in have not been around long enough to pile on multiple rounds of capital. They are learning from the errors of those that went before them and have created capital-efficient business models to require less startup and growth capital and time to achieve profitability, operating flexibility and safety.

The market is democratizing, with the power distributed so that the new players will find it hard to achieve the dominance of traditional Tier 1 VCs -- and that is a good thing for investors and the companies they invest in. I see a willingness of VCs to allow others into their sandbox. U.S.-based firms such as First Round Capital, Launchpad, SoftTech and Felicis Ventures are working with upstarts in the space and angel investors, which traditionally were looked at with derision and curiosity by VCs. This new class of "super angels" blur the line between angels and VCs.

At the 2009 National Angel Summit in Toronto in October, I learned from the managers of angel groups that these non-profit organizations aim to make the sector more professional and make it easier for individual angels to collaborate. These groups are a force for change because they will allow the sector to do bigger deals with a broader range of businesses, helping fill a void in the VC space. If the angel world is to coalesce into real power centres, it will be because of these groups.

While this independent venture capital sector is still in its infancy -- only 50 were counted across the United States and a handful in Canada a few years ago -- to a certain extent, it marshalls cash for investment and is not burdened by a massive overhang of capital that is flattening portfolio returns.

One summit speaker noted Canadian angels invested \$2.2-billion last year, which far exceeded investments by VC funds. And investment activity remains relatively strong, especially in volume. Still, there is work to do

to make angel investing more efficient and scalable. The angel community seems to sense opportunity, but isn't clear how to capitalize on it.

In the VC world, everyone seems to follow the same investment philosophy and look for the same types of investment in the same sectors, even relying on the same "serial entrepreneurs" to execute on them. There are strengths to this model, but in the long run it is highly cyclical and unsustainable. The strength of the angel sector will be sustained if individual or groups of angels find their niche. The challenge will be one of marketing, reaching the types of companies they want to invest in. The angel groups jobs will be to bring together angels with similar interests and broadcast their investment parameters to the market.

Governments can best help by fostering a healthy, investment-friendly macroeconomic environment. If they do one thing, I hope it is to control the out-of-control deficit beast. I live in fear of two words --national strategy -- the killer of real innovation and entrepreneurialism.

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