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## VCs Aim to Out-Angel the Angels

Responding to the emergence of a new breed of wealthy investor, venture capitalists are boosting their early-stage investments in startups

by [Aaron Ricadela](#)

In October, as startup Jaxtr hit up venture capital firms for its first round of funding, it landed an unusual arrangement. Instead of taking a few million in cash from a firm that would hope to one day book a fat return, Jaxtr took a loan—just \$1.5 million, from no less than four VC firms and three angel investors. None got the usual perk of a seat on Jaxtr's board. The result is plenty of independence for Jaxtr, a maker of software that routes calls from blogs and MySpace profiles to cell phones. "You're still basically on your own," says Jaxtr Chief Executive Konstantin Guericke, one of the co-founders of networking site LinkedIn.

Jaxtr's tale illustrates the new calculus governing high-tech venture capital. For years, angel investors and traditional venture firms existed in a sort of symbiosis. Wealthy tech-industry veterans willing to open their checkbooks for \$100,000 or so—the angels, as they're known—could bootstrap promising young companies before serious money, to the tune of six or more figures, from venture firms arrived. Angling for a slice of Jaxtr, however, were both groups: Mayfield Fund, Draper Fisher Jurvetson, Draper Richards, and the Founders Fund on one hand; angel investors Ron Conway, Reid Hoffman, and Rajeev Motwani on the other. "The company was a bit in the driver's seat," one investor says.

### ANGELS WITH DEEPER POCKETS

What put Jaxtr in the driver's seat is a turnabout in traditional roles for angel investors and venture capitalists. Venture capitalists are responding to the emergence in recent years of what have come to be known as super-angel investors, who sink multimillion-dollar investments into Web startups and other tech companies, often carrying them further into their life span before they knock on VCs' doors. Professional angels and boutique angel funds have been a driving force behind emerging Web companies including Kevin Rose's Digg and Revision3, Marc Andreessen's Ning, search engine Powerset, and online music site Last.fm, to name a few (see BusinessWeek.com, [Slide Show: "Tech's Next Gen: The Best and Brightest"](#)).

"We have the flexibility to invest like an angel or a later-stage venture capital firm," says David Weiden, a general partner at Khosla Ventures, an angel-investment fund headed by Sun Microsystems ([SUNW](#)) co-founder Vinod Khosla. "Because we're investing our own money, we can scale down to whatever we want." Khosla investments range from \$100,000 to \$25 million, in areas including Internet technology and clean energy.

### NEW ANGELS IN TOWN

Other super-angels, including Silicon Valley veteran Conway, PayPal co-founder Peter Thiel's Founders Fund, Philadelphia-based Josh Kopelman, and LinkedIn chairman and founder Hoffman, possess similar range, able to keep plugging capital into adolescent companies while swooping in to nab hot startups with an agility big VCs have been hard-pressed to match. "We're not under pressure to put huge amounts of money into every deal," says Mike Maples Jr., who has invested in Digg and Revision3. "The venture guys can't really do that."

Or can they? VC firms on both coasts are responding to the rise of super-angels by seeding startups with more small

investments and using loans instead of cash to test ideas from unproven entrepreneurs. In a sense they're aiming to out-angel the angels. The theory is that the investments take less legwork than nurturing companies through traditional rounds of funding, letting VCs get in on promising projects without much risk. "It's their answer to this dilemma," says Conway, an early investor in Google ([GOOG](#)) (see BusinessWeek.com, 2/20/06, "[A Search Engine for Every Subject](#)"). If the trend holds up, it could give Web entrepreneurs more choices about how they structure their companies and spark innovation. That's if the VCs and super-angels don't trip over each other as they compete for access.

## GOING TO SEED

Mayfield Fund has increased its number of seed investments below \$500,000, which sometimes include debt convertible to stock. It has funded Web startups including tech-support site Fixya, Wikiyou (which says it's assembling Web users' "collaborative, unauthorized biographies"), and Jaxtr that way. The approach lets investors quickly vet ideas, then "move on if it doesn't work, or double down if it pans out," Mayfield Managing Director Raj Kapoor said in an e-mail.

Charles River Ventures in November announced a program called QuickStart to seed early-stage companies with \$250,000 loans, which the firm can convert into stock if the company decides to raise capital. Nearly half of Union Square Ventures' current investments are for less than \$1 million, double the company's initial plan laid out in 2003, partner Fred Wilson wrote in his blog last October. And Mohr Davidow Ventures has also doubled its number of seed-round deals, to about 10 a year, compared with half that 18 months ago. It's also using loans to invest smaller amounts in untested companies. The seed-financing efforts could become even more aggressive.

"Maybe we need to do this with more companies," says Nancy Schoendorf, a general partner at Mohr Davidow. About half of the firm's seed investments turn into larger Series A rounds, but trimming that fraction could increase profits. "It means we're not taking enough risks," she says. "You want to spend more time with great entrepreneurs, but then be hard-nosed before you put more money in. In theory, it should give us better returns."

## ANGELS DEFEND THEIR TURF

VCs' newfound pluck doesn't sit well with everyone. "They're encroaching on our business," says Howard Hartenbaum, a general partner at angel fund Draper Richards, who sold Internet phone company Skype to eBay ([EBAY](#)) for \$2.6 billion in 2002. "Some entrepreneurs are saying, 'Why should I take the money from you if I can take a loan from a VC?' It's easier money to get."

But there's a hidden cost to the loans, according to Hartenbaum. If portfolio companies that have taken on debt don't meet development milestones, VCs can pull the plug before the equity round. "Now, the entrepreneur has to go to other investors and say, 'Charles River doesn't like us,'" he says.

Hoffman, who has invested in about 30 companies including Flickr, Six Apart, Digg, Powerset, and IronPort Systems (bought by Cisco Systems ([CSCO](#)) for \$830 million on Jan. 4), says it's unclear whether VCs can take on lots of small deals and still return enough of their funds' value to the endowments and other institutions that front the money. "VCs are still trying to figure out what they should be," he says. "It's an open question whether those ideas work or not."

## COOPERATION IS POSSIBLE

To be sure, VCs and super-angels are still striking plenty of harmonious deals. Conway cites RockYou, a slide show site he invested in alongside Kopelman's First Round Capital and traditional VCs Sequoia Capital and Lightspeed Venture Partners. Now, he says, he's introducing RockYou's founders to his friends at News Corp.'s ([NWS](#)) MySpace, while the startup taps Sequoia's and Lightspeed's networks, too. "That's kind of the best of all worlds," Conway says. "You've got even more great minds thinking about the company and using their Rolodexes."

And a few old-school VCs have always been willing to reach down to take small stakes in rock-star companies—most notably Sequoia and Draper Fisher. What's more, the super-angels have hardly pushed traditional angels aside: Sun co-founder Andy Bechtolsheim, Netscape vets Andreessen and Ram Shriram, eBay founder Pierre Omidyar, and Motwani—Google founders' Larry Page's and Sergey Brin's computer-science professor at Stanford University—all fit the profile of lower-stakes angel investors. Even some new faces are jumping in. Skype and Joost co-founder Niklas Zennstrom has started investing with a partner through a group called Atomico.

Yet as VCs shape new strategies for muscling in on promising deals, some say there are scenarios they may never be able to touch. Microsoft ([MSFT](#)), Google, and Yahoo! ([YHOO](#)) "love to acquire" small software companies for between \$10 million and \$30 million, whose technology they can turn into aspects of their sites, says Bill Gurley, a partner at Benchmark Capital. "There's a big opportunity to build features for these large companies," he says. But once VCs get involved and start pumping \$10 million or \$20 million into startups, they need the sale price to be more like \$100 million to make the return their models demand.

"There's a huge opportunity to make a lot of money," Gurley says, "but not for the VCs." So he's steering clear for now. "There are lots of ways to make money in this world," he says. For the handful of VCs trying to tread on angels' turf, the hope is that opportunity lies where until now there has been resignation.

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