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Fund Fills the Gap in Seed-Stage Investments

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Yogi Berra once famously said about his favorite restaurant: “It’s so crowded, no one goes there anymore.” The same could be said about seed-stage investing and today’s venture capital investors.

For several decades, the VC industry has delivered above-average risk-adjusted financial returns, and capital invested in venture capital funds has grown exponentially. While capital has increased, the number of qualified professionals in the VC industry has only grown slightly. The result is that each individual VC professional now manages considerably more capital than before, but their available time has not changed. As a result, almost no professional VC firm can consider initial investments of as little as \$50,000 – typical of seed-stage investments – especially when these investments may well require similar time commitments to those of \$5 million. The aggregate result is clearly seen in industry data, which shows a drop in professional VC seed-stage investing of at least 50% over the past ten years.

Seed-stage entrepreneurs, however, need not abandon all hope. The departure of most professional VC firms from seed-stage investing has opened up a funding “gap” that remains attractive to those interested in high-risk, high-return investments of more modest size, and with either the personal time or the ability to rely on outside resources to provide the mentoring and other assistance required. Angel investors – high net-worth investors – are the most prominent entrants into the seed-stage funding gap.

More recent players are specialized funds, often sponsored by larger, more established VC firms or associated with institutions. The “Venture Acceleration Fund” at Los Alamos National Laboratory (LANL) and the Lobo VentureLab’s “Gap Fund” at the University of New Mexico are two local examples. The New Mexico Gap Fund, created by Flywheel Ventures with the sponsorship of the New Mexico Small Business Investment Corporation, is another.

The New Mexico Gap Fund provides \$25,000 to \$100,000 to seed-stage entrepreneurs at the most formative stages, and seeks to make approximately 15 such investments over the next three years. Launched in early 2007, we have already funded three promising New Mexico startups which typify the strategy of the NM Gap Fund. In all cases, the entrepreneurs had invested their own capital and were seeking their first outside funding. All were led by solid entrepreneurs with experience in the technology start-up world, but who hadn’t yet found “home run” success. Two of the three companies are based on disruptive technologies licensed from Los Alamos National Laboratory, and all target very large, growing markets. None of the companies had a

completed product, and none had more than two employees. In short, these were compelling opportunities but with little of the “traction” that professional VC firms typically require in today’s funding environment.

Another key aspect of the Gap Fund is reducing the time spent both by entrepreneur and investor on elements of the start-up process that are necessary for success, but best provided by a third-party expert. These include the legal, patent, accounting, human resources, web development, public relations, and corporate governance activities that often distract and slow down entrepreneurs from focusing on their core mission.

Perhaps most importantly, the aim of the New Mexico Gap Fund is to change the character of the relationship between the entrepreneur and the venture capitalist during fundraising. Too often, a seed-stage entrepreneur’s relationship with a potential or existing investor is based on the golden rule – “He who has the gold, rules”. We believe this dynamic not only creates dysfunction in the post-investment board room, but also unnecessarily lengthens the due diligence process due to the unnatural stress and examination placed on the entrepreneur outside of the world in which he or she is most capable: operating the start-up.

The New Mexico Gap Fund idea is new and experimental, but the early success is promising. Already, the first three Gap Fund companies have gone on to secure nearly \$750,000 of additional funding from various sources. Most importantly, along with angel investor groups and other funding sources mentioned, we believe the Gap Fund will help accelerate the rate at which the very *idea* of a seed-stage funding “gap” in New Mexico is archived in history for good.

Finance New Mexico is an initiative of the New Mexico Small Business Investment Corporation (NMSBIC), New Mexico Small Business Development Center (NMSBDC), Empowering Business Spirit (EBS), the New Mexico Venture Capital Association (NMVCA) and other partners to assist individuals and businesses in obtaining skills and funding resources for their business or idea. To learn more about resources available to New Mexicans, go to www.FinanceNewMexico.org.

