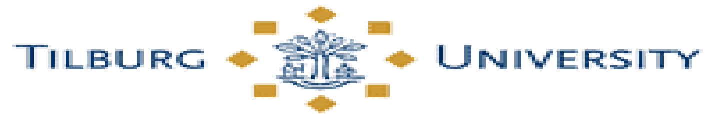

TILBURG LAW SCHOOL

SEED STAGE INCUBATORS AND ACCELERATORS: INTRODUCING THE NEW GENERATION OF VENTURE CAPITAL FUNDS

Master Thesis

LLM International Business Law

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INTRODUCTION

In the light of the financial events from the last decade, despite all controversial statements on the issue, it cannot be denied that the traditional venture capital industry is inevitably changing with respect not only to the operation of the investment cycle, including screening and decision-making practices of venture capitalists, and the appearance of alternative ways of exit, but with respect to the increased need for a new category of investors; investors that are flexible and able to adjust to the new trends on the market. Angels (or super-angels) and big international corporations were the first ones to open up the venture capital business not only to adopting new investment strategies, but to new participants as well.[1] The result is that a new generation of venture capital funds has emerged from that change – a new type of seed stage investors with their own unique structure and rules that could be able to fill in the gaps in the current VC[2] cycle. Researchers call them differently: micro VCs; incubators or accelerators; substitutes of MBA programs; or even boot camps.[3] In general, it should be said that they are still investment funds providing start-up companies with the very initial seed stage capital, but the main area of their specialization is mentorship – coaching and nurturing founders through the very first steps of entrepreneurship. With their mentorship programs micro VCs are adding non-monetary value to starting companies and even reducing the time of reaching their liquidity event. Even more – in a way they are setting up new rules of how companies should be started.

In order to understand the way those VC accelerators work and the impact they have and would have on the industry, we have to first overlook the initial reasons that led to their appearance. With the lately experienced exit difficulties, low investment returns, overfunding

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[1] It is hereby important to mention that angel investing is moving towards a professionalization and nowadays angel groups constitute an important part of angel investing and seed stage funding in general.

See Ibrahim, Darian M., *The (Not So) Puzzling Behavior of Angel Investors*, Vanderbilt Law Review, V. 61, 2008.

[2] Hereinafter in this thesis, VC would be used as to refer to venture capital, venture capital fund(s), or venture capitalist(s), depending on the context.

[3] Hereinafter, this new generation of venture capital funds would be referred to as either micro VCs, or incubators, or accelerators.

and the increased number of venture capital funds, being the main factors responsible for the new VC cycle, the need for alternative sources of liquidity on all levels of funding would come as no surprise.

In the last ten (10) years the venture capital industry has been slowly but surely deviating away from its traditional pattern of modus operandi. The lazy IPO market in the years after the dotcom bubble and the low valuations in acquisition deals that VC baked firms tend to get in the years right before the financial breakdown in 2008,[4] had a huge drawback impact on venture capital market and were only the first signals that something went wrong along the way, leading observers to make the alarming statement that *"the high-risk, high-return venture capital business may have turned into all risk and no return"*[5].

The limited exit opportunities and low returns on investments in that period, laid down the foundations of the new VC cycle that would influence the behavior of venture capitalists and further change the direction of the industry in years to come. The new VC cycle is basically characterized by longer lock-in periods of VCs in the companies they fund. In the past years the time of "baking" a company has increased significantly. Reaching a liquidity event has become more time consuming and if in the traditional VC cycle the preferred by investors exit through IPO could be reached within three (3) years from the initial funding, within the new VC cycle this period is much longer – up to six (6) years through a trade sale, and nine (9) – through an IPO[6]. Even for promising high growth companies takes more time to reach an exit event (trade

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[4] See Helft, Miguel, *A Kink in Venture Capital's Gold Chain*, The New York Times, October 7, 2006. Available at: http://www.nytimes.com/2006/10/07/business/07venture.html?pagewanted=all. Accessed on: June 28, 2012.

See also: *Saying Goodbye: New Exit Strategies for Today's Venture Capitalists*, March 3, 2010. Available at: http://knowledge.wharton.upenn.edu/article.cfm?articleid=2440. Accessed on: June 28, 2012. *("As the IPO market struggles with those issues, M&A transactions have become "the dominant form of exit," according to Amit. However, M&A isn't generating sufficient returns for investors: In the third quarter of 2009, "only two of the 22 disclosed deals had a return of 10 times or higher.")*

[5] See Helft, Miguel, supra (note 4).

[6] See Mendoza, Jose Miguel and Vermeulen, Erik P. M., *The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* (2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011. Available at: http://ssrn.com/abstract=1829835.

sale or IPO). These changes in the operation of the VC investment process led to the opening up of a liquidity gap(s) which could be crucial for the future development of the company and therefore for the return on the investment made. Due to that, venture capitalists have become more risk-averse and careful in their financing endeavors than ever. Financing high-risk start-ups without having the possibility for a profitable future exit and falling short in fulfilling the expectations of fund's investors is costly and no longer anticipated by venture capitalists. When VCs cannot reach high value exit this could have an impact not only on the return of the investment and future distributions to investors, but on the reputation of the fund as well - something that is of significant importance in the venture capital industry. As a result, changes occurred not only in the decision-making process of investment funds regarding use of the made commitments, but in the structure of VCs in general.

Nowadays the typical VCs are in a way "restructuring" their investment practices and the tendency is for giving funds to more mature companies instead of start-ups in their early stages. Investors are now more eager to finance companies that would be able to provide them with a bigger downside protection[7] and that do not represent as much risk and uncertainty.[8]

For further information on the matter see also *Saying Goodbye: New Exit Strategies for Today's Venture Capitalist*, March 3, 2010, supra (note 4). The article refers to a statement made by Frank Quattrone, co-founder and CEO of San Francisco based investment bank Qatalyst Partners, according to whom: *"[…] Companies now have to wait longer to go public, stretching the investment period of their VC backers. All of a sudden, the VCs who are used to getting companies public within three to five years of the first venture round need to fund them for three or five more years."* The article further states that:"*At the same time, returns have been shrinking: 1998 was "really the last vintage that made significant amounts of money. […] Returns on venture funds raised in seven of the last 10 years have been negative."*

[7] Although it is true that venture capitalists could get from start-ups (as well) preferred shares, board seats, different voting rights or other preferences that are usually used in the industry, the risk with them is higher than with companies in a more mature and late stage of development. Starting companies do not have revenue yet; do not have steady clients and customers. They are still in the process of creating reputation and connections. Basically, they lack all the things that a company in more developed stage possesses and that are also adding value to a deal.

[8] See *Saying Goodbye: New Exit Strategies for Today's Venture Capitalist*, March 3, 2010, supra (note 4).

According to Frank Quattrone: "*[…] IPOs were once within reach of companies with annual revenues of between $30 million and $50 million, a few consecutive profitable quarters, a good management team, and good investment bankers and attorneys. But this changed after the dotcom crash, and investors "wanted safety" in large, very mature companies with revenues of $150 million or more. […]"*

This movement of "fresh money" to mature stages of venture capital creates inefficiency in the venture market which leads to a seed funding gap for start-up companies. When there is a liquidity gap this means that companies are falling short on capital and cannot proceed with their business. Even though this could be viewed as more important for the growth of more mature companies[9] that is not always the case. This illiquidity is influencing in great extent start-ups since low investment return for VCs means lower re-investment in funds afterwards which could lead to more demands on behalf of venture capitalists in the process of choosing their next investment target.[10] Hence, unable to find financial support in may be the most crucial period of the development of their companies, entrepreneurs might be even discouraged to proceed with their ideas and business plans[11] which on the other hand could even lead to reduce of innovation in general.

However, lately it could be argued that the created from the longer exit period need for alternative investment options is satisfied and the liquidity gap is filled in by the recently emerging private secondary markets.[12] They provide both investors and shareholders with the opportunity to trade their stock before a traditional liquidity event is reached. The fast growth of secondary markets, such as Share Post and Second Market for instance, helps for the quicker "recycling" of venture capital and gives the so much necessary alternative to IPOs and M&A deals. Nonetheless, it should be noted that in the past two years the IPO market is slowly going

[9] Liquidity gaps could be seen as well in the event that an investment is made in installments and would rely on reaching relevant milestones for each round of funding from that VC. It is common for mature companies to receive venture capital in installments where each installment has its own triggering event (which could be defined as a milestone liquidity event). In the case that this event is not likely to happen, the future round of capital, i.e. the next round of investment in the whole VC cycle for this company, will not be granted. Investment in milestones is very favorable for VCs due to the fact that this is one way to understand if the product that is being developed is not only worthed the investment, but in fact is capable to work. Most of the time those milestones are connected with reaching specific technical requirements. However, this could lead to VCs acting opportunistically by setting up higher and difficult to achieve a milestone conditions.

[10] See Ibrahim, Darian M., *The New Exit in Venture Capital* (2010), Vanderbilt Law Review, Vol. 65, January 2012.

[11] See Mendoza, Jose Miguel and Vermeulen, Erik P. M., *The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* (2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011. Available at: http://ssrn.com/abstract=1829835.

[12] See Ibrahim, Darian M., supra (note 10).

back to its more efficient days and is again vital and moving, with more filings for IPOs and high returns.[13] On the other hand, mergers and acquisitions deals as a mean of exit are lately experiencing a drop compared to previous years.[14] It seems that the illiquidity in the new VC cycle could be overcome and this time by both traditional and new exit opportunities. However, this comeback of the most anticipated from venture capitalists exit does not mean that all the problems that occurred in the past decade will just disappear. On the contrary – adjusting to the new economic situation along with the new trends that emerged from the new VC cycle, the venture capital market has already changed its path of behavior for good.

According to Mark Suster[15], significant impact on the VC industry had also the overfunding (due to high commitments on part of investors) in the years before the dotcom bubble.[16] (See Figure 2). Here it should be taken into account that usually the lifetime of an investment fund is ten (10) years with the possibility for extending it, upon the discretion of investors, to two (2) additional years. On one hand, this overfunding would enhance competitiveness between companies and their products, but on the other, it might create inefficiency of the market. Funds would be able to provide higher amounts of capital to more

[13] This statement is based on a research of PricewaterhouseCoopers, *PwC US IPO Watch Q1 2012: A buoyant first quarter produces strong IPO returns. ("Building on momentum carried over from the fourth quarter of 2011, the US IPO market showed significant strength in the first quarter of 2012, resulting in the highest first quarter volume since 2007. New issuers saw strong aftermarket investor interest in their IPO stocks, creating positive returns for 80 percent of current quarter IPOs.").* Available at: http://www.pwc.com/us/en/press-releases/2012/a-buoyant-first-quarter.jhtml. Accessed on: June 28, 2012.

[14] See Rao, Leena, *Dow Jones: 20 Companies Raised $1.4B In Q1 2012 IPOs; M&A Deals Decline,* TechCrunch, April 2, 2012. Available at: http://techcrunch.com/2012/04/02/dow-jones-20-companies-raised-1-4b-in-q1-2012-ipos-ma-deals-decline/. Accessed on: June 28, 2012.

[15] Mark Suster is an ex-entrepreneur and investment partner in South California based venture capital fund GPR Partners.

[16] See Suster, Mark, *It's Morning in Venture Capital*, May 23 2012. Available at: http://www.bothsidesofthetable.com/2012/05/23/its-morning-in-venture-capital/. Accessed on: June 19, 2012.

In this article Suster refers to that as "the funding problem" and states that: *"In 1998 there were around 850 VC funds and by 2000 there were 2,300. Thomson Reuters data shows that around $10 billion of LP money went into VCs per year pre bubble. By 2000 the total LP commitments had mushroomed to more than $100 billion."*

companies which inevitably could lead to performance problems.[17] The higher is the amount of capital invested in a portfolio company, the bigger would be the pressure on that company for higher return on the investment. Which in a market with more competitors is not that easy to be achieved.[18] The same source refers to a certain normalization of the market in the beginning of 2012 due to the lifespan of the funds established during the VCs boom period. Now, there are fewer active venture capital funds with decreased amount of commitments on part of their limited partners which could lead to more stability in the industry.[19] (See Figure 3)

As a result of all the above mentioned, in this overregulated industry, in order to successfully operate their funds, venture capitalists have to try to find alternatives to the status quo in which the industry is working. With exit harder to reach and liquidity events pushed further in the development of each VC baked company, investors have to find a way to increase their opportunities to reach exit sooner. They have to create a "new product" on the venture capital market, new strategy that would be more successful and would help companies to achieve higher performance, which is inevitably connected to reaching (any) liquidity event. In the light of that, it would be more efficient for the venture industry to become more entrepreneurs friendly when negotiating the terms of an investment. In the light of this it should be noted that, currently, a lot of IT companies, for e.g., that could end up being "the next big thing", are having serious doubts regarding taking investment from and closing the deal with a VC. They simply do not want to be pushed around and told what to do.[20] That is why VCs have to seriously think about the direction they should head to in the next years.

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[17] *Ibidem* (note 16).

[18] *Ibidem* (note 16).

[19] *Ibidem* (note 16). According to Suster *"[…] the number of active venture capitalists has shrunk by more than 2/3rds in the past decade to less than 750 today and still shrinking. Put simply, more deals and fewer venture capitalists mean better access to deals, more stability for winners and great returns for the best in our industry."*

Also there: *"Money flowing into our industry has also massively downsized. LP contributions to VC firms shrunk from 2000 and by 2005-2008 had stabilized to around $30 billion per year. By 2010-2011 this had shrunk by half again, averaging under $15 billion."*

[20] See Empson, Rip, *Camera+ Turned Down Acquisitions from Adobe, Google, Twitter; Also Says "F*ck The VCs"*, TechCrunch, June 8, 2012, where John Casasanta, founder of Tap Tap Tap, explains why VCs are

That is in fact what micro VCs (incubators and accelerators) are doing – they are very entrepreneurs' friendly, acting more like co-founders than investors and may be that is one of the main reasons for their start-ups' high performance. By means of non-monetary value adding services – the mentorship programs they are offering – they enhance the value of the new start-up companies and give them the necessary "push" without the need to monitor too strictly. They are still monitoring, however using different means from the traditional harsh contractual investment provisions – through giving advice and being involved in the creation and innovation process behind the business ideas of their portfolio companies. When not given any pressure by investors, entrepreneurs are incentivized to work harder and nurture their ideas, hence building quality products that are the key to a successful performance.

The purpose of this thesis is to examine the role that the new generation of seed stage investors have in the VC cycle. Being the innovators "on the other side of the table", these incubators and accelerators are setting forth the tendencies that would rule the venture capital market at least in the next couple of years. Their mentorship programs are creating high value companies that could emerge in companies with big reputation and influence on the economy in general. What is more, they became the spine of innovation and creativity nowadays by encouraging entrepreneurs to think "out of the box" and create products that could really solve problems.

The first chapter herein will set an outline of the structure of this new type of early stage investors within a comparison between its most significant features and the typical venture capital funds.

In the second chapter attention would be paid to the similarities in the investment behavior of angels, in particular angel organizations, and VC incubators and the reasons behind their decision for investing in start-ups.

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dangerous for entrepreneurs. Available at: http://techcrunch.com/2012/06/08/camera-plus-turns-2-says-eff-the-vcs/. Accessed on: June 28, 2012.

The third chapter of this work will examine closely the new investment strategy introduced recently by micro VCs – their collaboration in seed funding with angels and traditional venture capital funds. Discussion will be presented on the advantages and disadvantages of investing by convertible debt and what could be the possible outcome of these collaborations for investors in the future.

In the fourth and last chapter of this thesis attention will be mostly paid to the innovative value-adding services incubators are using to support their portfolio companies.

The role that this new generation of venture capital funds has within the new VC cycle is very significant. Their presence is filling the liquidity gap that opened between the stages of seed funding and mature funding. With venture capitalists moving their funds towards more mature companies, the incubators became a small but important part of the industry. Seed capital is exclusively important for companies especially when they are too small for bigger investments and too big for angels. In general, micro VCs' funding strategy could be defined as providing small amount of capital for small stake of stock while emphasizing on non-financial support and mentoring entrepreneurs. The result is more knowledge, more connections and start-ups becoming a part of a network with high reputation amongst investors. This could even guarantee them a future funding round under very good and favorable conditions.

The idea of providing mentorship and managerial support to those starting companies along with the money invested is not a new concept in venture capital business. However, it is the manner in which incubators are providing it that is of high significance to the VC industry. If before the focus was mainly on the capital funded and therefore on the return, then now it is on the contrary – more attention is paid to the non-financial services that funds could offer to start-ups once an investment is made.

Even though this new generation of seed stage incubators and accelerators is still falling within the category of venture capital funds, when compared with the typical VCs, in terms of their investment practices and strategy, they have significant differences. These differences could be better analyzed in the light of the pre-investment and post-investment activities of both traditional funds and incubators regarding the evaluation of a future investment. In the literature there are several studies that set forth the main steps in this decision making process. As a basis of the further analysis would be taken the steps proposed in the work of Tyebjee and Bruno (1984)[21] which are as follows: (i) deal origination, i.e. finding potential business

[21] Based on Kollmann, Tobias and Kuckertz, Andreas, *Evaluation Uncertainty of Venture Capitalists' Investment Criteria* (May 2009), Journal of Business Research, Vol. 63, No. 7, 2010, Available at SSRN: http://ssrn.com/abstract=1886225. This paper is referring to the research of Tyebjee and Bruno (1984).

opportunities; (ii) deal screening, i.e. due diligence; (iii) deal evaluation of the company; (iv) deal structuring, i.e. negotiating terms and conditions of the deal; and (v) post-investment activities – support from the VC to the portfolio company after closing the deal. Those steps are still present in the investment process of incubators and accelerators. However, they are not that distinctive as in the traditional VCs and they might include different evaluation strategies and criteria.

However, for more clearance of the exposition herein, these five (5) steps would be separated and included in two larger groups. The first group refers to the selection procedure, which actually includes the steps from (i) to (iv).[22] The second group refers to the post-investment activities, which include monitoring of the investment, services provided to the portfolio company and exit strategy.[23] Therefore, the comparison hereinafter would be made in the light of this separation of investment evaluation procedure – first I would look at (a) the selection process[24] and, secondly, at (b) the post-investment activities as explained above. However, due to fact that there is not enough relevant information regarding this issue, the exit strategies of incubators will not be hereby examined and compared with those of venture capital funds.

The research herein is based on the characteristics of the top four (4) incubators and accelerators in venture capital business in the United States nowadays, according to a current ranking of Forbes from April 2012.[25] This ranking is using as a main criterion the value of the start-ups and their performance after the "incubation" process (depending on the amount of funding raised or of trade sale in the event they got acquired straight afterwards). In order to

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[22] The separation herein is based on the separation used in Ahlstrom, David; Bruton, Garry D. and Yeh, Kuang S., *Venture capital in China: Past, present, and future*, 23 February 2007. Available at: http://www.bm.nsysu.edu.tw/tutorial/ksyeh/articles/APJM-VC%20in%20China-2007.pdf. Accessed on: June 28, 2012.

[23] Based on *ibidem* (note 22).

[24] For the purposes of this thesis, it should be noted that the selection procedure referred to herein includes the steps of (i) deal origination, (ii) deal screening, (iii) deal evaluation and (iv) deal structuring.

[25] See Geron, Tomio, *Top Startup Incubators And Accelerators: Y Combinator Tops With $7.8 Billion In Value*, Forbes, April 30, 2012. Available at: http://www.forbes.com/sites/tomiogeron/2012/04/30/top-tech-incubators-as-ranked-by-forbes-y-combinator-tops-with-7-billion-in-value/. Accessed on: June 28, 2012.

make an outline of the new tendencies in seed funding, the incubating programs that all four investment funds are offering to entrepreneurs, were closely examined and compared with the corresponding features of the typical funds. The analyzed herein micro VCs are as follows[26]: Y Combinator[27], TechStars[28], DreamIt Ventures[29] and Angel Pad[30]. It should be noted that the organizational structure of these incubators is in a way unique by itself. They combine the characteristics of a typical business incubator with the characteristics of an investment fund while at the same time anticipating the angels' friendly behavior (and term sheets) towards entrepreneurs.

It could be said that within micro VCs cycle the first three evaluation steps overlap and are not that distinct as opposed to traditional VCs. In a traditional fund the whole process of finding and screening a potential portfolio company in general is very time consuming and costly.[31] It could usually take couple of months (and couple of meetings including presentation of the business plan) from the moment of the first contact with entrepreneurs to the decision of investors to start negotiating over the conditions of the future financing. The main factors that venture capitalists usually consider in this process are a combination of the qualities of the founder, of the product and of the investment by itself. What VCs usually look for in deal origination is the personality and background of the entrepreneur.[32] Of significance for their

[26] The funds are referred to in the order as they appear in Forbes' ranking.

[27] Y Combinator is a California based seed fund, established in 2005 from the essayist, programmer, and investor Paul Graham. Since then it has invested in over 460 starting companies. It could be said that this is the pioneer among those new incubators. See: http://ycombinator.com/. Accessed on: June 28, 2012.

[28] TechStarts was established in 2006 in Boulder and today has locations in New York City, Boston, Seattle, and San Antonio, as well. See: http://www.techstars.com/. Accessed on: June 28, 2012.

[29] DreamIt Ventures was founded in 2007 by successful ex-entrepreneurs. Its headquarters is in Philadelphia, but the fund runs programs also in New York and from 2012 in Israel. See: http://dreamitventures.com/. Accessed on: June 28, 2012.

[30] Angel Pad is founded by Thomas Korte and other ex-Googlers in 2010. It is located in San Francisco. See: http://angelpad.org/. Accessed on: June 28, 2012.

[31] See Steven N. Kaplan and Josh Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, (2010). According to them: *"VCs spend a large amount of time and resources screening and selecting deals."* Available at: http://www.people.hbs.edu/jlerner/KaplanLerner.JACF.pdf. Accessed on: June 28, 2012.

[32] See Kollmann, Tobias and Kuckertz, Andreas, *Evaluation Uncertainty of Venture Capitalists' Investment Criteria* (May 2009).

decision are his commitment to the undertaken project and leadership abilities, as well as his experience and high qualification in the field of the proposed business venture. Then, they take into account the product – its substance and quality, its market sale ability, as well as its patentability.[33] All of that is considered in the light of the current economic conditions and characteristics of the potential market and the financial characteristics of the venture, regarding its capability of return on investment and exit opportunities.[34] Therefore, very important step here is the presentation of the business plan from the entrepreneur.

As to incubators, the deal origination and screening process could be as well time consuming – depending on different incubators it could be up to three (3) months. However, what is of importance for them during this period of looking for a new start-up to couch is not that much what they would get in the end (when the product is good enough and would sell without any problems). Money is not the drive of their decision-making process. Since mostly incubators are founded by ex-entrepreneurs, what is significant for them is enhancing innovation and creativity. To be able to do that they would need qualified entrepreneurs that have build something just for the idea of solving a problem they encountered, not because of the market trade ability of this idea. That is why even the start of the investment process with accelerators is different from what is known up to now.[35]

As already mentioned above, the selection procedure with incubators starts with a different application process. All starts with on-line application form. Usually applications are opened twice a year, depending on the fund and on the location.[36] Some are setting different application deadlines (early and late deadlines) that give them the possibility to examine more

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[33] *Ibidem* (note 32).

[34] *Ibidem* (note 32).

[35] Although nowadays most venture capital funds have as well anticipated the on-line application process as well.

[36] Funds with more locations as TechStars and DreamIt Ventures have one application period for each of their locations. For further information go to: http://www.techstars.com/program/schedule/ and http://www.dreamitventures.com/about/Schedules.php.

carefully the applications received.[37] These seed funds do not require presentation of a business plan or a slide presentation as it is usual for the typical VCs or any other kind of documentation – something that is of importance in this overregulated business environment. Accelerators do not emphasize on business and marketing strategies that early in the process because they know from experience with previous batches that good teams could come up with something better or even go in a completely new direction in the working progress. In any case, the initial business plan, if there was one to begin with, would inevitably be tailored closer to Demo Day. That is why attention is paid on the entrepreneurs as individuals (their educational and experience background), but what most of the accelerators are mainly looking for are teams with strong connection between the founders and strong determination to succeed in their business endeavor. Their decision making criteria is based on the desire of this type of investors to find the successful team. The idea matters as well but they are mostly looking for people who could bring any idea to a higher level. Everyone can have a great idea but not everyone will have the (right) abilities to develop it. So far it has been one successful strategy for incubators.

What is more, recently micro VCs introduced a new kind of application procedure, separate from the usual ones, which gives the possibility of individuals to apply without even having an idea. This is a further proof that they are looking more for the right people to mentor, than for the right (by financial criteria) business idea. Y Combinator is the pioneer in this new investment trend.[38]

As to the deal evaluation practices of traditional venture capital funds it could be said that incubators, through the value they are adding, are reducing the need of due diligence in the next investor rounds of the start-ups they mentor. VCs simply do not need due diligence because they know what the reputation of mentors in these incubators is. Mentorship programs are setting forth the right conditions that could lead their graduate companies to high

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[37] Moreover, the application procedure for individuals is separated from the one for entrepreneur's teams. Usually mentors encourage entrepreneurs to apply and develop the start-up as a team since when there are two and more founders they can all contribute with different perspective, knowledge and abilities. However, incubators do not deny the opportunity for individuals to apply to their programs as well.

[38] For further information look at: http://ycombinator.com/noidea.html. Accessed on: June 28, 2012.

performance in the future.[39] The result is one emerging tendency of building trust on the market between investors at the different VC stages regarding their start-up selective skills.

When it comes to negotiating the terms and conditions of an investment to be made, the traditional venture capital funds have very harsh requirements. One of the reasons for this is the fact that the agency relationship between VCs and founders is based on information asymmetries since founders are not always disclosing all the information they have. They might sometimes even withhold such on purpose due to its negative influence on closing the deal. That is why it is common for investors to want more contractual protection in case something goes wrong. The other reason for these harsh terms is of course very trivial – traditional VCs are financial intermediaries and it is their job to make higher returns on the committed capital.

On the contrary, the amount of capital invested from micro VCs in seed stage is very small – usually varies between $ 10,000 and $ 25,000.[40] This is because nowadays the initial costs for starting a company are not that high. Technology is cheaper and easier to get, there is no additional need for marketing and advertisement since there is Internet and once posted news can get around faster than ever. That is why most start-ups do not need the big investments that traditional VCs are offering; at least not in the very beginning. They are in this early stage of their business when the only thing that matters is to further develop the

[39] As the oldest and biggest by alumni network accelerator, Y Combinator could be the one to provide the most accurate example of data on start-ups performance. However, due to the fact that YC does not disclose this type of information officially, as a proof of the above statement it could be used the companies' performance of the second top incubator – TechStars. According to the data provided on their website, from 126 start-ups mentored so far, 100 are still active, 10 were acquired, and only 16 failed. That stands for approximately 88% of successful performance of the companies they baked. For further information go to: http://www.techstars.com/companies/stats/.

[40] The seed funding that incubators provide can vary between funds, however, it can also vary in between start-ups. The practice of each of the four incubators researched is to provide one fixed amount for all accepted teams and on top of it to provide another fixed amount for every founder of the start-up, which is limited up to a number (for most of them is up to 3 founders).

idea/product/service. And as Mike Maples, a tech investor and ex-entrepreneur, states the result is that "*when it comes to funding, $ 500,000 is the new $ 5,000,000"*. [41] (See Figure 4)

In terms of structuring the deal, the important difference between those two types of VCs, is mainly regarding the percentage of ownership and control they get over the company in exchange of capital. Traditional VCs have developed certain methods that could be seen in probably every term sheet no matter the fund. They opt for more sophisticated and strictly regulated conditions.[42] The strictest provisions that are common to appear on a VC term sheet are, first and foremost, with respect to the purchase of preferred shares in the company which preferred shares inevitably bear different from the common stock's voting rights. Next, there are the liquidation preference and redemption rights. Third, it is common for venture capitalists to want board seats or management representation. They want to intervene in order to better monitor – either straight from the beginning if they require to appoint the CEO, or to have this possibility at a later stage. [43] After VC's investment founders' ownership in the company usually gets diluted since VCs would get high percentage of the outstanding shares.

In its nature venture capital is a high-risk investment and it is therefore common for venture capitalists to want downside protection. On the other hand, the protection covenants and provisions from traditional term sheets, such as liquidation preference and redemption, preferred dividends, special voting rights, etc. are either not imposed at all on entrepreneurs from incubators at such early stage, or incubators do not contract for such high burdens on the future financial performance of their companies. One very significant characteristic of VC accelerators is that they like to be viewed as co-founders in the start-ups they fund. For the small investments they make they get small stake of the company's shares. Usually this varies

[41] See Levy, Steve, *Meet the Next Billionares*, Newsweek, May 2007. Available at: http://www.thedailybeast.com/newsweek/2007/05/20/meet-the-next-billionaires.html. Accessed on: June 28, 2012.

[42] According to Steven N. Kaplan and Josh Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, (2010): "*VCs engage in sophisticated contracting and structuring of their investments.*" Available at: http://www.people.hbs.edu/jlerner/KaplanLerner.JACF.pdf. Accessed on: June 28, 2012.

[43] According to Steven N. Kaplan and Josh Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, (2010).

between 2-10% with an average of 6-7%. This is very favorable for founders since their ownership does not get diluted that much and the conditions of investment are not that strict and burdensome as with the traditional VCs. The shares that incubators require are common and they do not really get any kind of preferences and special rights. Moreover, accelerators do not want board seats – one very preferred method of keeping the control closer to the VC fund. Their philosophy is not to interfere in managing the business of the company and not to be the ones to determine the direction of its further development, but to help founders build something of significance. And what could be more anticipated from entrepreneurs than investment with no heavy conditions attached to it. Incubators do not want to intervene in the way a start-up is governed – the more freedom founders have, more creative they will be and in the end the value of their idea would be higher.

The period after closing the deal is as well different in venture capital funds, on the one hand, and the new type of seed funds, on the other. Accelerators are moving away from the monitoring strategies established from venture capitalists. Instead of relying on contractual arrangements as a self regulating mechanism of monitoring[44], they are reaching out to new means that would enable them not only to reduce the information asymmetries with entrepreneurs, but to reduce even the uncertainty in the future performance of their portfolio companies. By intensive mentoring through these couple of months in the program incubators are in fact monitoring closer than traditional VCs ever do. Incubators management is involved on a daily basis with the work of their entrepreneurs, giving advices, but also getting familiar with their products and services, with their "ups and downs". In that way in the end of the program they would have one very thorough assessment on all funded (and mentored) start-ups. Furthermore, due to the experience gained so far in batch seed finding, seed investors would be even able to project the performance outcome of start-ups afterwards.

Via their mentorship programs, seed stage incubators help reduce the agency costs between later stage VCs and entrepreneurs. In general, venture capitalists are not that familiar with the abilities of entrepreneurs, hence all downside protection methods and rights they use

[44] Those are the investor's protective covenants discussed above.

when closing an investment round. But when a start-up is mentored in one of those successful incubators, they are more willing to fund its next round without even doing due diligence. All that accelerators do is to prep and nurture the abilities entrepreneurs already have in order to be ready to dive into business. Hence, we can define that these incubators' mentorship programs are by themselves a new form of monitoring the start-up.

Micro VCs provide all types of non-financial services that venture capital funds offer. They help entrepreneurs with incorporation; contact them with accountants and lawyers; help them to recruit personnel. What is more, they introduce to the industry new value-adding services. In order to understand the impact those new services have on start-ups, first it should be explained in more details the operation structure of micro VCs.

One of the new tendencies that incubators are introducing to the venture capital industry is the funding in batches. That means instead of financing separately the portfolio companies, investing in and mentoring all of them in one investment period. Because of that most incubators have only one or two investment rounds through the year.[45] It happens to be more effective both for venture capitalists and entrepreneurs when the mentorship process gets together number of entrepreneurs with different skills and knowledge that could be shared. According to the examined funds herein, this kind of investment strategy creates value and efficiency for each start-up as a result of the opportunity for founders not only to work on their business idea in a high productive and extremely creative environment, but they get to see how others are dealing with their products, and also receive feedback and help from them. The number of the teams[46] funded differs from program to program and might be from ten (10)

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[45] For instance, Y Combinator has two sessions, but TechStars in all its locations has only one session through the year.

[46] Teams, because when applying to the program the different entrepreneurs have achieved different stage of development of their business idea. Some might not have established their legal entity yet, others might be couple of months ahead, or even couple of years. The incubators analyzed do not put these as additional requirements to the entrepreneurs. If it is the case that a company is not established yet, they would help the founders with the paperwork and will connect them with trusted lawyers and accountants. In the opposite situation they would look at the performance of the company so far and suggest strategies and direction for its later (next) phase.

to fifty (50) or even more[47]. Furthermore, this strategy provides investors with a lot of data afterwards and produce trustworthy network between the entrepreneurs "baked" together.

The structure of incubators' programs is very unique and interesting by itself. As it was mentioned above, the investment and tutoring process takes place for a couple of months (usually three). During that period all start-ups from the same batch should live and work at the place where the incubator is located. The mentorship cycle includes the day-to-day individual work of the entrepreneurs over their ideas; meetings with mentors; weekly events (for e.g., Y Combinator is organizing weekly dinners) where entrepreneurs are given the possibility to communicate with the other teams from the batch, mentors and alumni altogether. One of the important steps is launching the product. Incubators encourage entrepreneurs to launch as soon as possible – it is the only certain way to see if the idea is good for the market and will be successful. If it gets picked up even when it is just one step further from the prototype, so it has future in it. In addition, potential customers could provide developers with useful advice and constructive feedback so as to build in the end a product or service which is valuable and efficient.

The whole process ends up with the so-called Demo Day on which every start-up presents its project to future investors. Usually, a week before Demo Day, incubators organize something like a rehearsal for all presentations (pre-demo day). This is very important for entrepreneurs since they can receive feedback from mentors and the others in the batch. The mentorship program by itself represents a mini VC cycle, reaching its liquidity event on Demo Day.

One very significant value that VC incubators are adding to the industry is their reputation. Through the past couple of years all four of the researched herein incubators have build their high reputation amongst venture capital investors. Partially, due to the successful performance of their former baked companies, partially due to the background of the mentors and partners in those incubators. It is common for VCs to reject an entrepreneur because of the

[47] For instance, Angel Pad usually invests in batches of 12-15. Y Combinator, on the other hand, nowadays has more than 50 start-ups in a batch. In the last batch, winter 2012, there were 66 start-up teams.

lack of previous knowledge about him. But undoubted is the fact that start-ups baked in those four accelerators are most likely to get future rounds of funding very quickly after they finish the mentorship program. Not only that, but some of the promising ones can even get acquired – and this liquidity event could happen only three months into business. Investors trust the mentors and that is one of the reasons they prefer to invest in companies baked in those exactly incubators.

From a first glance on the structure of this new generation of seed funding programs, it looks like those VC incubators are deviating far away from the typical model of venture capital financing and with their mentorship programs are getting closer to the model of business incubators. However, all the "innovations" incubators are introducing in this field could only be referred to as value-adding and creating efficiency to the industry. They have a twofold direction. The first one, and very important by no means, is that seed stage funding should care even more about the training of entrepreneurs. By sharing their experience and knowledge with entrepreneurs, mentors are giving them the needed push to continue developing. Moreover, providing more value-adding services and giving support even after they "graduation" of the program, is the key to enhancing start-ups' performance on the market. Next, they are bridging the investment rounds and making the period of liquidity gaps shorter. That is in the light of Demo Days – events that are pulling together a big number of well accredited investors (angels, VCs). The outcome is acceleration of the baking process of start-ups – some, as mentioned in the previous paragraph, could even get acquired almost straight after Demo Day.

The agency relationship between VC incubators and start-ups they "bake" is quite different. What seed funds are doing through their mentorship programs is reducing or even removing opportunism (of both sides) in this early stage. They manage to reduce the typical agency problems by playing the role not that much of an investor, but of a co-founder. In that way, having the mutual interest to pick up and develop a good idea that afterwards will be easily financed by later stage funds, incubators are enhancing the trust founders have in them.

Hence, increasing the level of comfort founders would have when engaging in contract arrangements with this category of venture investors.[48]

[48] See: Annamalai, Thillai Rajan, *Venture Capital and Efficiency of Portfolio Companies* (October 5, 2010). IMB Management Review, Vol. 22, No. 4, pp. 186-197, 2010. Available at SSRN: http://ssrn.com/abstract=1735843.

According to Ramesh Emani, panelist in *Round Table on Venture Capital and Efficiency of Portfolio Companies*, the comfort level an entrepreneur has with a certain investor is the consideration that would lead him in making the decision to deal or not with this exactly investor.

CHAPTER II

This chapter will compare the investment behavior of angels and incubators on grounds of the evaluation steps used previously in Chapter I. The comparison that should outline their similarities and differences, however, would be based on angel groups, who still posses all characteristics of angel individuals, due to the fact that the first ones with their structure and organization are closer to incubators. In addition, attention should be paid to the fact that this new generation of micro VCs are mostly founded by ex-entrepreneurs and their incentives for funding in early stage companies are significantly similar to those of angels. Therefore their behavior and conditions of financing would be similar as well.

Angel investing is specialized in providing seed capital to high-risk companies. It is basically the first investment in a start-up, after the financial support of family and friends. Although angel investors have for long been the spine of entrepreneurship and innovation, with the recent changes that left an impact on the operation of the traditional VC cycle they have become even more important part of the investment process in general.[49] They are the category of investors that was able to fill the liquidity gap between seed stage and later stages of funding and to build the bridge leading start-ups from their early phase of development to venture capitalists (See Table 1). The relationship between angels and entrepreneurs reduce uncertainty, information asymmetry (mostly in pre-investment activities) and agency costs (in post-investment activities).[50] And in that is their main resemblance with accelerators.

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[49] For data on the importance and share of angel investing in venture capital see Sohl, Jeffrey, *The Angel Investor Market in Q1Q2 2011: A Return To The Seed Stage (“Total investments in Q1,2 2011 were $8.9 billion, an increase of 4.7% over Q1,2 2010, according to the Center for Venture Research at the University of New Hampshire. A total of 26,300 entrepreneurial ventures received angel funding in Q1,2 2011, a 4.4% increase from Q1,2 2010, and the number of active investors in Q1,2 2011 was 124,900 individuals, virtually unchanged from Q1,2 2010. The increase in total dollars and the matching increase in total investments resulted in a deal size of $338,400 in Q1,2 2011, comparable to the deal size in Q1,2 2010 of $337,300.”).* Available at: http://www.unh.edu/news/docs/2011Q1Q2AngelAnalysis.pdf. Accessed on: June 28,2012.

[50] See Ibrahim, Darian M., *The (Not So) Puzzling Behavior of Angel Investors*, 2008.

Table 1

Venture capital funding stages before Incubators

<table>
<tr><th>Stage</th><th>Pre-Seed</th><th>Seed/Start-Up</th><td rowspan="3">Funding Gap between $500,000 and $2,000,000/$5,000,000 (depending on region)</td><th>Early</th><th>Later</th></tr>
<tr><th>Source</th><td>Founders, Friends and Family</td><td>Individual Angels</td><td colspan="2">Venture Funds</td></tr>
<tr><th>Investment</th><td>$25,000 to $100,000</td><td>$100,000 to $500,000</td><td colspan="2">$2,000,000/$5,000,000 and up</td></tr>
</table>

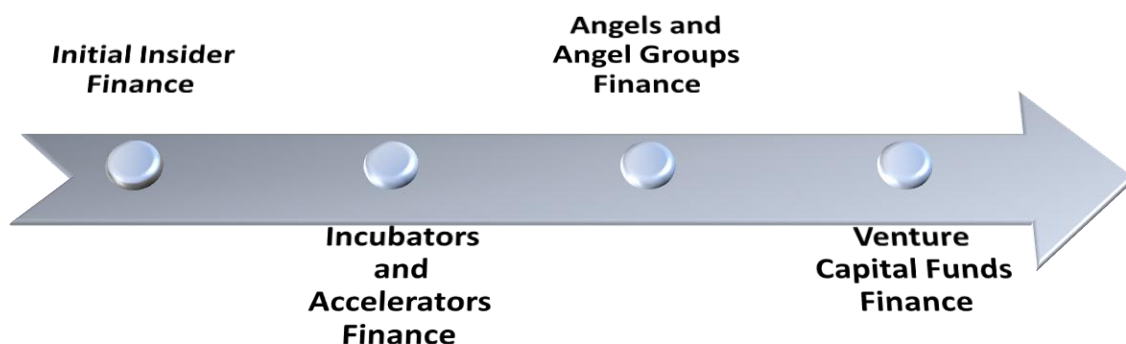
Source: *Angel Resource Institute*[51]

Arguably, the fast growing and innovative incubators are slowly overtaking the role that angels have in start-up funding (See Figure 1). The rapid growth and development of micro VCs in the recent years, in addition to the emergence of angel groups and networks, is pushing the niche occupied by angel investors closer to the next funding stages in the venture capital cycle. Now it is more common and anticipated from start-ups first to go through a mentorship program in one of those accelerators and afterwards to raise additional capital through angels, angel groups or VCs, depending on the needs and the development stage of their company. It could be even argued that this shift in the venture industry is enhancing the process of bridging the liquidity gaps further in the cycle. With the emergence of more and more accelerators, the

[51] See Angel Capital Education Foundation, *Important Things for Entrepreneurs to Know About Angel Investors*, available at: http://www.angelresourceinstitute.org/data/Documents/Resources/AngelCapitalEducation/What_Ents_Should_Know_About_Angels.pdf. Accessed on: June 28, 2012.

number of early investors on the VC market is higher and therefore the need of seed capital could be easily satisfied. However, by doing that, incubators are displacing the focus of the market in the early stages of start-ups. Before, angels were the ones setting up rules towards entrepreneurs in order to invest in them. Nowadays, it is the other way around – as a result of the structure of incubators' funding cycle (and in particular Demo Days when an investor has to act quickly if he wants to close a deal with certain start-up since he would not be the only one interested in it) angels are the ones going after entrepreneurs. Therefore one question arises hereby – are incubators "stealing" the deal flow of angels? And another question – did incubators become competitors of angels because of the more entrepreneurial contractual arrangements they are offering? This issue would be further examined in Chapter III of the thesis, along with and in the light of the introduction of a new investment strategy of accelerator funds – the collaboration for funding start-ups with other categories of investors by means of convertible debt as the main financial instrument.

Figure 1



Timeline of the stages of the investment cycle after the emergence of Incubators and Accelerators

Notwithstanding all the above said, with the recent trend of professionalization of angel investing[52] and the rapidly growing network of angel groups and organizations in the past years, it is obvious that the traditional angel investing is changing as well and with it – the "angel" terms of the made investments. The creation of angel groups could be very beneficial for both investors and entrepreneurs, since it can reduce the information asymmetries between them. In terms of investing, angels in the group are sharing all relevant information that they were separately aware of regarding different entrepreneurs and business proposals. As a result of the increased data they are able to make more informed decisions. In addition, they could provide founders with diverse knowledge, expertise and business interests which, on the other hand, could improve screening practices and the selection process of start-ups in general. In the light of the comparison in question, that is exactly what micro VCs' mentors are doing as well.

If we look at their structure and operation, angel groups have a lot of resemblances with incubators. With the emergence of the micro VCs however, their place seems to be taken by those new players on the venture capital market.

Typically, angel groups are established on a regional basis and their investments are more locally oriented – they usually invest in companies close to their office so that it could be easier to visit them, give advice and share additional knowledge and expertise. However, this is not the case of accelerators. In their programs they can accept start-ups and entrepreneurs not only from different cities, but from other countries as well. Another significant advantage of angel organizations is the possibility for their members to invest as a syndicate[53] and pool their funds together. In that way they would be able not only to invest in more companies, but to offer them even higher amounts of capital.[54] Hence the illiquidity in the new VC cycle could be

[52] See Ibrahim, Darian M., *The (Not So) Puzzling Behavior of Angel Investors*, 2008.

For further information on the issue see also: http://www.angelcapitalassociation.org/. Accessed on: June 28, 2012.

[53] This possibility is upon the discretion of each angel investor since different investors have different interests and not everyone could be interested in the same investment opportunity or in the same terms and conditions attached to it.

[54] According to the 2011 HALO Report of the Angel Resource Institute: *"The median size of angel & angel group syndicate rounds was $700K in 2011. This represents a 40% increase from the $500K reported median*

easily overcome. On the other hand, higher amounts of seed capital funds could lead to higher return on investment.

With the creation of angel groups, angel investing has become more structured and formal. Even though the deal origination and screening process of traditional angels is informal and not that thorough as in the other types of investors, usually, when an entrepreneur would like to approach an angel investor the various networking and business contacts he could refer to is very important. That, for someone who does not have connections in the industry, is harder and more time consuming. Angel organizations still anticipate the entrepreneurs' friendly behavior and terms used by angel individuals, however the selection process is more formal and sophisticated. Now there is on-line application process – a practice that is used by incubators as well and that provides for easier access to venture funding by entrepreneurs. Traditional angels perform less due diligence than traditional VCs. However, with angel groups the screening process has a more formal structure than with individual angels – meetings with slide presentations and individual meetings afterwards. The business plan is very important part of the application and evaluation process. For angel organizations it is important what are the entrepreneur's plans for the future direction of his business and what are his estimated expectations on the company's financial performance. That is may be the main difference with incubators – for them the business plan is not that important and comes as an afterthought, in most cases in terms of developing the product and seeing what the outcome would be. Incubators are more involved with the product/service and the team behind it, and not that much with the business strategies that should be anticipated later on. According to the mentors in different incubator's programs, the business plan is important, but it is not that crucial to have it done in the very beginning, since founders have to know what exactly they are going to build, for what type of customers and market, in order to develop any strategy further. Sometimes during the mentorship program founders could end up with another, better idea or decide to go in different direction and in that case they would still have to change their initial business plan.

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round size in 2010." Available at: http://www.angelresourceinstitute.org/halo-report/. Accessed on: June 28, 2012.

In terms of the ongoing comparison, one very distinctive characteristic of incubators that comes as a result of the selection process is that they are financing and mentoring more start-ups in one investment cycle than angel organizations. Statistics show that angel groups receive an average of thirty (30) applications, but in the end they invest on average only in 1-2 start-ups.[55] On the contrary, when consulting with different sources on this issue, a conclusion could be made that on the average micro VCs could receive around five hundred (500) or more applications. For instance, according to alumni in Y Combinator, per investment cycle they could get more than one thousand (1000) applications, and this number for TechStars is big as well – more than six hundred (600) per round.[56]

When it comes to deal evaluation there are not much differences, as well. Both angels (individuals, as well as groups) and incubators take as the most important factor the team behind the idea. For angels, trustworthiness, commitment and good team are the factors being mainly considered. The same are relevant to incubators. Nonetheless, the main reasons behind angel investing could be grouped in two (2) categories: (i) financial reasons and (ii) non-financial reasons. The first category is almost self-explanatory – with respect to return on investment. As to the non-financial incentives of angels to invest, they are mostly linked to the fact that they are ex-entrepreneurs who miss the thrill of taking risk and starting a new business venture; or because as ex-entrepreneurs they would like to give something back to the "society" – the so-called profit philanthropy[57]. Moreover, their investment is relationship-driven – they usually invest in entrepreneurs who they know or who were referred to them. Because of that angels are not that easy to interact with.

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[55] According to Angel Resource Institute's research on *Important Things for Entrepreneurs to Know about Angel Investors.* Available at: http://www.angelresourceinstitute.org/data/Documents/Resources/AngelCapitalEducation/What_Ents_Should_Know_About_Angels.pdf. Accessed on: June 28, 2012.

[56] The stated number of applications received in Y Combinator and TechStars is not based on official sources or statistics since incubators do not disclose officially that kind of information. However, it is based on the comments, in different blogs or articles, of their alumni, partners or other people with access to this kind of information.

[57] According to Brad Feld, a managing director of an investment fund in Boulder, Colorado. See: http://www.feld.com/wp/archives/2006/10/is-it-angel-investing-or-for-profit-philanthropy.html. Accessed on: June 13, 2012.

As to negotiating and structuring the terms of the deal, both types of early investors discussed hereby in Chapter II are using the same strategy of favoring the situation of entrepreneurs. Both angels and accelerators do not adopt that much strict conditions in the way traditional VCs do. They both offer to entrepreneurs simple and more informal contractual arrangements. They do not require for all the usual protection rights and founders' ownership does not get that diluted – like micro VCs, angels do not acquire high percentage of ownership in their portfolio companies. What is more, both types of investors discussed herein prefer to purchase common stock and do not want to have the control over the board or the management team. Requirements for seats on the board or management representation in the start-up they are funding are not that commonly used. In the case of angels and angel groups one of the reasons why they do not want as much protection as venture capitalists is that they are investing their own money. Another reason is that after angels, in the next funding round VCs would come and in the case of more complicated contractual relationship between the entrepreneur and the angel investor, with more rights and protection covenants, venture capitalists would not want to invest if the contract is not ameliorated to their needs.

However, lately the contractual arrangements of angels and especially of angel organizations are becoming more formal and moving towards a more VC standard term sheet, including more protection rights and preferences. One of the explanations for this recent change could be the higher amount of capital provided in angel investing lately.[58] Angel organizations still have the same non-monetary reasons as angles, but here the return is important as well, hence the moving towards more venture capital-like contracts. The situation might be that in the end incubators will be the ones providing more friendly terms. Therefore, incubators today come as the preferable deal. Nowadays, they are the ones that offer to entrepreneurs more favorable conditions.

[58] According to *Things Angels Bring to The Table*: "*The typical angel investor can invest from $25,000 to $250,000 per deal; however, the amounts may vary and can be much higher (anywhere from $150,000 to $1.5 million).*" Available at: *http://www.go4funding.com/Articles/Angel-Investors/Things-Angels-Bring-To-The-Table.aspx*. Accessed on: June 28, 2012.

The post-investment activities of incubators that come after closing the deal have the same grounds as those of angel investors. Accelerators use other, non-contractual means of controlling the investment and monitoring process is more informal, built mainly on the relationship of trust, as it is between the angel investor and the entrepreneur. Trustworthiness is one of the things that angels are looking for in entrepreneurs when they are making their investment decisions. This is a consideration factor used in angel organization and anticipated by incubators as well.

Another similar characteristic is that angel groups provide the same value-adding services as micro VCs. They are counseling entrepreneurs, giving them advice and additional expertise and knowledge. Nonetheless, incubators have more organized and intensive mentorship programs – they know exactly what outcome they want to achieve in the end of the program.

One of the most important non-financial values that both incubators and angels (as individuals or groups) are adding to their portfolio companies is, first one, steady and well acknowledged reputation and, secondly, a network of alumni – something more valuable than the capital funded. In respect of that the founder of Y Combinator, Paul Graham, "*compares the effect to a coral reef, a self-generating ecosystem whose members provide nourishment for one another"*.[59]

As a consequence of all the similarities in the investment behavior of incubators and angels, it should come as no surprise to the venture capital market their recent collaboration in co-funding for start-up companies. The reactions of observers, researchers and investors regarding the introduction of this new investment strategy were very ambiguous and fluctuated between statements such as that it would be in the best interest of both collaborators and entrepreneurs; that this is the new direction the VC market is headed to; or even that it would disrupt the industry and would have a bad impact on other types of investors (i.e. angels when investing as individuals). It could be noted that one particular collaboration instigated the

[59] See Levy, Steven, *Y Combinator is Boot Camp for Start-ups*, June 2011, Wired Magazine. Available at: http://www.wired.com/magazine/2011/05/ff_ycombinator/all/1. Accessed on: June 13, 2012.

abovementioned “discussion” with respect to its proposed funding terms. It is the one between Y Combinator and angel investors Ron Conway and Yuri Milner. The investment conditions they are offering to start-ups would be examined in the next part of this thesis – Chapter III. However, with respect to the purpose of this Chapter II, it should be noted herein that those investors use as a financial instrument for their investment a convertible debt (instead of the usual share purchase). The convertible debt, which by its characteristics is actually a loan, is an instrument that is commonly used by angels because of its mild and more informal conditions. It is used as a bridge investment between the seed stage and the later stage of a company when venture capital fund’s financing would come. The convertible debt is providing the needed seed capital and is bridging it with the next funding round. Moreover, it could be flexible in its terms and accelerate the closing of the deal. It might be the case that because of these characteristics the convertible debt is the most convenient instrument to be used in incubators-angels collaborations.

CHAPTER III

In order to provide more opportunities for progress to their start-ups in their very early business stage, incubators have reached another peak in their development. May be the most innovative investment strategy they introduced to the venture industry lately is the collaboration with angels and venture capitalists in order to provide additional funding to portfolio companies. Y Combinator, TechStars and Angel Pad are now offering additional blanket investments in the form of a convertible debt to each start-up accepted in their mentorship programs. The proposed terms differ by incubator but all of them are extremely entrepreneurs' oriented and are the same for all companies in the programs. This new strategy put micro VCs in even more advantage position when it comes to providing start-up's capital. On the other hand, angels and angel groups are concerned by accelerators' behavior since they would not be able to compete on such favorable terms. With these collaborations incubators are not only bridging the gaps in between the different stages in the VC cycle, but are setting forth a new direction in seed funding regarding the financial instruments and conditions used when closing the deal.

This trend of investing by convertible debt instead of purchasing equity of the start-up is very well anticipated by early investors and is quickly replacing the traditional share purchase.[60] However, the consequences of using convertible debt on such favorable for entrepreneurs terms could in the future have a disrupting effect for investors. Hereinafter would be presented the different conditions of the convertible debt bridging investment that the four researched incubators are offering. Their term sheets differ mainly with respect to the type of collaborators involved. It should be taken into account that the collaboration with angels provides for more soft terms, while the one with venture capital funds has more standard requirements.

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[60] According to Paul Graham in 2010 all companies, in both investment cycles of Y Combinator, closed further investing using convertible notes instead of share purchase. In his statement he is referring not only to the convertible notes offered from the recently introduced collaboration, but to convertible notes used to close next rounds of investment in general. However, still it should be notified that the type of investors referred to as preferring this financial instrument is not disclosed.

In the case of Y Combinator, the collaboration is with two of the most significant angel investors in Silicon Valley – Ron Conway and Yuri Milner. They are pooling together, through the new established Start Fund[61], $ 150,000 in convertible debt and are offering it under the same conditions to each of the Y Combinator start-ups. Every founder's team has the right not to accept the loan.[62] The interest rate on the note is lower than usual – it is 2% (or the applicable federal rate)[63], with a maturity date in two years after closing. The automatic conversion to shares has as a triggering event financing round of $ 1,000,000 in equity of the company. The important fact herein is that they do not request any protection of the investment – the debt is with no conversion discount and/or valuation ceiling ("*provided that the transaction documents provide for a right to purchase a pro rata share of future financings"*[64]) – something which is not usual for such kind of financial instrument. As a result, in the event of future conversion, Start Fund will get percentage of the stock that is worth only $ 150,000 – what was actually the amount of the convertible note. They also provide for an optional maturity conversion into preferred stock series AA "*based on a $ 5,000,000 valuation. The Series AA has a 1x non-participating liquidation preference, weighted-average anti-dilution, basic protective provisions (adverse changes to the Series AA, number of shares of Series AA, or merger/asset sale), right to maintain proportionate ownership, ROFR/Co-Sale rights and basic information rights."*[65]

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[61] Start Fund is established for the purposes of this investment as a syndicate/collaboration between SV Angel, Ron Conway's angel fund, and Yuri Milner, well accredited angel investor.

[62] However, that was not the case with the first batch of start-ups the debt was introduced to. According to Arrington, Michael, *90% of Y Combinator Startups Have Already Accepted The $150k Start Fund Offer*, TechCrunch, January 29, 2012. In this article he is stating that out of 43 companies, 36 has signed the paperwork even before the end of Demo Day. Available at: http://techcrunch.com/2011/01/29/90-of-y-combinator-startups-have-already-accepted-the-150k-start-fund-offer/. Accessed on: June 28, 2012.

[63] According to *What Are The Terms of Yuri Milner/SV Angel's Start Fund $150K Investment Into Y Combinator Companies?*, Startup Company Lawyer, January 31, 2012. Available at: http://www.startupcompanylawyer.com/category/convertible-note-bridge-financing/. Accessed on: June 28, 2012.

[64] *Ibidem* (note 62).

[65] *Ibidem* (note 62).

TechStars as well made such collaboration for additional capital but with a VC syndicate instead.[66] They are offering to entrepreneurs in their batch $100,000 in convertible note given right after acceptance in the incubator. However, their terms are more investor protected and include provisions regarding conversion discount and valuation cap.[67]

As to Angel Pad, they teamed up with two venture capital funds for additional financing of $100,000 in convertible note, on discretion of entrepreneurs if they will accept it or not. Their blanket investment as well has more traditional conditions and includes a valuation cap. This means that all the companies in the batch that decide to take the loan would get the same valuation.[68]

Those collaboration investments are extremely innovative for venture capital industry. They are moving the relationship between investors and founders on another level. On one hand, they are the best deal that could be offered to a high-risk start-up – the additional capital provided could accelerate even more the development of the project which could result in easier and quicker launch of the product. In the meantime, these kinds of investments remain quite risky for investors due to the mild conditions they bear.

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[66] According to Tozzi, John, *TechStars Will Offer $100,000 to Each of Its Startups*, Bloomberg, September 21, 2012, this VC syndicate includes "*Foundry Group, IA Ventures, Avalon Ventures, DFJ Mercury, SoftBank Capital, SVB Financial Group, RRE Ventures, Right Side Capital Management, as well as TechStars alums and other angels."* Further information available at:

http://www.businessweek.com/smallbiz/running_small_business/archives/2011/09/techstars_raises_24m_to_offer_every_startup_100000.html. Accessed on: June 28, 2012.

[67] According to TechStars' posted template of bridge investment available at: http://www.techstars.com/docs/. Accessed on: June 28, 2012.

However, it should be noted that there is no sufficient information on the exact rate of the discount or the valuation they opt for.

[68] See Siegler, MG, *Halo Effect: All AngelPad Companies Will Get $100K Investment Offers From 2 VC Firms*, TechCrunch, August 1, 2011. Available at: http://techcrunch.com/2011/08/01/angelpad-investment/. Accessed on: June 23, 2012.

See also Lynley, Matthew, *Incubator AngelPad will drop extra $100k in participating startups*, Venture Beat, August 1, 2012. Available at: http://venturebeat.com/2011/08/01/angelpad-100k-funding-early/. Accessed on: June 23, 2012.

By definition, convertible debt is a loan that could be either converted to equity or paid off at the maturity date. The conversion to equity could happen automatically after next investment round occur. Convertible notes do not require setting valuation of the company at this stage. The share price would be determined at the next funding round. The consequence is that the debt holders, with the conversion of their debt into shares, would be considered as if they invested in this exactly round. In general it could be said that the convertible debt is bearing the same risk as the purchase of equity but without the downside protection in shares. That is why, for investors' protection, the typical deal when a convertible note is issued includes price protection provisions – either a conversion discount, or a valuation cap, or both.

Conversion discount is used as a financial mechanism in order to compensate the early investor for the risk he is taking by financing at seed stage when the uncertainty of a future financing performance is higher. The average discount rate used is 20% but it can vary between 10% and 35%. When there is a discount on a convertible note this means that when the event triggering the discount occurs (that is when the preferred shares funding round is closed), the debt (issued as bonds or notes) converts into shares at a conversion price which would be the price of the debt discounted by the arranged percentage rate. Like that, the investor would get more shares for the price he paid in the beginning with the issuance of the convertible debt. What is more, the discount rate could be negotiated as to increase over time, e.g. monthly.

Valuation cap, on the other hand, is used to provide more upside protection in case that the valuation in the next round of financing would be higher than expected. When the parties have agreed upon a valuation cap and the valuation that the company gets in the equity financing is higher than what was contracted for, this means that the early investors would get more shares for the price of the note that they "paid", than in the event of no set valuation cap.

However, this is not the case with the blanket investment offered to Y Combinator's portfolio companies. With no discount and no cap on their convertible debt, it could be said that investors are not very well protected. The risk and uncertainty are higher because of the fact that they are investing on the blind, in seed stage and without even seeing the entrepreneurs and their projects. In the future, if a company's performance is not what was

expected, a lot of issues might occur. How they will be compensated for the risk they are taking? Furthermore, what could be the incentives behind this kind of investment? Because of the fact that this investment process is still in a too early phase and because also there is no information regarding the outcome of these convertible notes disclosed so far, it cannot be said for sure that these conditions would create risk for investors by all means. Arguably, the incubator and its mentors' reputation are the key factors that herein impact for investing on these terms. Ron Conway's and Yuri Milner's main incentive to invest is their trust in Y Combinator, its mentors, and the reputation this micro VC gained through the years of experience in couching successful entrepreneurs. "*This is a bet on the quality of Y Combinator startups in general*."[69] And even though these angels might not be protected with conversion discount and valuation cap this does not necessarily mean that their return on the investment would not be far better in the future. It is true that they cannot get more shares for the price "paid" in the convertible note in the next funding rounds. However, it should be taken into account that they are not investing only in one or two Y Combinator's companies – they are investing in all of them, and up to date the statistics show that the performance of this accelerator's companies is higher than the average. According to Forbes *"the total value is $ 7.78 billion, for an average of $ 45.2 million per company"*.[70] Therefore, it seems like a very good bet after all.

In general, the use of convertible debt seems more convenient for both investors and entrepreneurs. For sure it saves a lot of paperwork and negotiation. Its terms and conditions are very favorable for founders. In the short run the results are positive for founders since it pushes the valuation of the company forward, to a stage when the business will be more developed and could get high valuation. Moreover, it reduces the dilution of ownership at such early stage.

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[69] See Arrington, Michael, *Start Fund: Yuri Milner, SV Angel Offer EVERY New Y Combinator Startup $150k*, TechCrunch, January 28, 2011. Available at: http://techcrunch.com/2011/01/28/yuri-milner-sv-angel-offer-every-new-y-combinator-startup-150k/. Accessed on: June 13, 2012.

[70] See Geron, Tomio, *Top Startup Incubators And Accelerators: Y Combinator Tops With $7.8 Billion In Value*, Forbes, April 30, 2012.

However, it is too early to say what the possible consequences could be and if this trend would be successful and efficient instrument in seed funding. What is more, some observers were disturbed that it could even lead to a disruption of the balance on the market due to the fact that now angels would not be able to compete with micro VCs on these favorable terms. These recent collaboration activities between incubators and other types of venture investors are setting up very high standards for single angles or even angel groups. They cannot reach the terms now offered to start-ups companies and are concerned that their deal flow would seriously decrease. Moreover, angels are concerned that the incubators are inflating the valuations of the companies by putting investors to kind of bid for them on and after Demo Day. Therefore another question arises herein – could this result in opportunistic behavior from angels? There is no firm answer to this question yet. Further discussion with respect to this issue might result from the recent attempts for price fixing, collusion and lowering valuations in angel term sheets. As a proof to this statement come the organized at 2010 secret angel meetings in San Francisco that commentators conveniently named as "Angel Gate".[71]

[71] According to Arrington, Michael, *So a blogger walks into a bar*, TechCrunch, September 21, 2010: *"It is absolutely unlawful for competitors to act together to keep other competitors out of the market, or to discuss ways to keep prices under control. And that appears to be exactly what this group is doing."* Available at: http://techcrunch.com/2010/09/21/so-a-blogger-walks-into-a-bar/. Accessed on: June 28, 2012.

For further information on this see the reaction of Ron Conway towards the meetings and the angels involved in them at: http://techcrunch.com/2010/09/23/ron-conway-angel-email/. Accessed on: June 28, 2012.

CHAPTER IV

It could be argued that the most important "asset" this new generation of venture capital funds is introducing to the industry is the successful example of emphasizing more on non-financial support than capital. The mere concept of value added services is not new for traditional venture capitalists or for angels. Adding value in order to maximize the return on investment is one of their main investment strategies. VCs are *"building and leveraging network of investors, industry forums, business and thought leaders, investment banks, audit and legal firms".*[72] The different investors and funds, especially nowadays with the specialization of some VCs, are able to provide entrepreneurs with diverse intellectual and relationship capital and along with that to help attract future investors in the company.

However, in addition to what was already mentioned previously in Chapter I and Chapter II of this thesis, what is new in applying this strategy for maximizing the positive outcome of a venture investment, are the means used by incubators. They as well are supporting start-ups with incorporation paperwork, auditing and legal services, strategic business and marketing planning, recruitment of key employees, obtaining additional funding and providing business contacts. Nonetheless, the means accelerators use to do that are in their way innovative, more structured and determined. Mentors are well aware of the fact that the intellectual capital and relationship capital they are bringing to founder teams would create more value if it is presented in the right way. All of the researched herein incubators are organized in such a way as to be able to advice and consult all portfolio companies up to their individual needs. From providing share work space[73] and special software for booking office hours with mentors, through organizing special events with alumni and outside mentors, micro

[72] See: Annamalai, Thillai Rajan, *Venture Capital and Efficiency of Portfolio Companies* (October 5, 2010).

[73] Hereby it has to be stated that because of this exactly "service" some of the VC incubators provide – the co-shared office space – some researchers compare them with the typical business incubators. However, it cannot be said that accelerators fall in their category since there is one very significant difference between those two "players" on the market. Business incubators do not work as investment funds. They offer office space to the companies who, as tenants, have to pay for that. With VC incubators it is not like that – entrepreneurs are not obliged to use the space provided by investors. They could even work from the coffee shop next door. In the end the thing that matters is the idea to be "baked".

VCs are becoming more involved with the growth pace of each start-up in the current batch. Moreover, with their value adding services they are reducing the agency costs and information asymmetries between them and entrepreneurs and in that way are enhancing the efficiency on the market of the seed stage funding.

Start-up companies are the ones that most need additional support, knowledge and expertise. Mentors are not only providing them with general advice, but, because of the fact that most of them are ex-entrepreneurs (or developers), they could really help with sufficient knowledge when it comes to the actual developing of the product or service. As a result they are more familiar with the business and products of their companies than traditional VCs and can address not only their negative sides, but the positives as well.[74] And because most incubators encourage founders to launch their product as soon as possible since the market (i.e. the potential customers) could be the best corrective when it comes to expectations for future performance, mentors could get involved even in formulating, testing, and evaluating prototypes. On the contrary are the traditional venture capitalists – not only they are not able to pay equal attention to all their portfolio companies, but it might be the case they do not acknowledge that different ventures have different value added needs.

Reputation and alumni network are the most valuable assets of incubators. In venture capital the role of the reputation market is to work as to prevent opportunistic behavior mainly on part of venture capitalists. However, with incubators the reputation market is not used as such a control mechanism but works more as an incentive for future investors to invest in incubator's portfolio companies after Demo Day.[75] This could be referred as to *"the so-called signaling effect. It means that a backing by a reputable VC may provide certification that the*

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[74] *Supra* (note 71). According to Ramesh Emani.

[75] See Gilson, Ronald J., *Engineering a Venture Capital Market: Lessons from the American Experience*. Stanford Law Review, Vol. 55, April 2003. Available at SSRN: http://ssrn.com/abstract=353380 or http://dx.doi.org/10.2139/ssrn.353380.

For further information see also Vermeulen, Erik P. M., *Towards a New 'Company' Structure for High-Tech Start-Ups in Europe* (December 2000). Available at SSRN: http://ssrn.com/abstract=255619 or http://dx.doi.org/10.2139/ssrn.255619.

portfolio firm has hidden value and can shift doubt to confidence and encourage potential partners to co-operate with the start-up firm."[76]

Accelerators' network of alumni is growing bigger with each cycle. Because they are funding in batches their alumni network is growing quickly and according to Paul Graham, Y Combinator's founder, it has become a self-sustained ecosystem with its own inner structure. The companies are not only helping each other with contacts but, in the process of funding, the start-ups in one batch happen to be each other's beta users and are able to provide product/service developers with constructive feedback. Arguably, one of the reasons behind the decision of some of the accelerators to accept more start-ups with every investment cycle they do is the emerging of that alumni network. The more alumni they have, the more sustained would be the provided support during and after the end of the mentorship program. All four of the researched in this thesis micro VCs are not only using their alumni companies and founders as business connections or using their products and services, but they are as well inviting them as mentors[77] and even partners. Moreover, as is the case of Y Combinator, nowadays the alumni are the first ones to screen through all received applications and give feedback to mentors.

Along with the traditional value from reputation and network, what incubators bring to the industry as innovation is the support of entrepreneurs before and after the mentorship program. What they try to do before the program is matching individual founders with each other. Incubators have designed special websites where they help entrepreneurs to find and

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[76] See Luukkonen, Terttu and Maunula, Mari, *Non-Financial Value-Added Of Venture Capital: A Comparative Study Of Different Venture Capital Investors*, Helsinki: ETLA, Elinkeinoelämän Tutkimuslaitos: The Research Institute of the Finnish Economy, 2007, 36 p (Keskusteluaiheita, Discussion Papers ISSN 0781-6847, No. 1067). Available at: http://www.etla.fi/files/1706_Dp1067.pdf. Accessed on: June 28, 2012.

[77] One very good example for using alumni as mentors is given by TechStars and their new RisingStars program, which was just recently introduced to the industry (it will start in July 2012). The idea behind this program is to help underrepresented entrepreneurs in their first endeavors into IT business by assigning them to a mentor – one of TechStars' alumni – and giving them the opportunity to retrieve knowledge and expertise through the period of one year, without any obligations. TechStars is not providing capital or taking equity from the participants, neither is guaranteeing their acceptance into the 3-months mentorship program. However, they do not require any payment as well.

For further information on this visit: http://www.techstars.com/risingstars/. Accessed on: June 27, 2012.

build their team. These websites serve as a database of the profiles of hundreds of individuals, specialized in different field (business, marketing, developing, etc.) and looking for their fellow co-founder. With providing potential entrepreneurs with this kind of platform, micro VCs start adding value to their potential start-ups long before they even apply for mentoring. One of the incubators has even organized a founder's speed dating event.

As to the afterwards support – accelerators have as well special websites for recruiting personnel for their alumni. There they publish which ones of their alumni companies are looking for employees along with description and requirements. What is more, they even organize working days events.

As a result of all abovementioned, all new investment trends and practices and the innovation in value-added services in particular, it can be concluded that incubators and their mentors are *"changing the way companies are started"*.[78]

[78] According to Thomas Korte, the founder of Angel Pad: *"We're changing the way companies are started. I think the likelihood of them succeeding is going to be much, much higher, no matter if they go to TechStars, Y Combinator, or here".* Available at: http://www.xconomy.com/san-francisco/2010/11/15/changing-the-way-we-start-companies-qa-with-angelpads-thomas-korte/4/. Accessed on: June 13, 2012.

CONCLUSION

The purpose of this thesis was to introduce the new generation of seed funds that emerged on the venture capital market as a result of all changes that occurred due to the financial events from the past decade. As a basis for this research were used the investment and work operation activities of the four top U.S. incubators and accelerators at the moment. Y Combinator, TechStars, DreamIt Ventures and AngelPad are building successful start-ups with high performance and that is why they were the most appropriate choice hereby. The four chapters hereby include and examine the main characteristics of this new type of investors in venture industry and outline the most significant features in their way of operation. Along with the differences and similarities that micro VCs share with the typical investors in the start-ups funding cycle, attention was paid to the new and very innovative tendencies they brought to this business.

By comparing the investment practices of traditional venture capital funds to the new incubators, I was able to conclude that incubators, through their mentorship programs and constant support, created a new strategy, a new method for monitoring portfolio companies during their first stage of venture financing. The years of experience of their managing and advisors teams in mentoring and "prepping" entrepreneurs for the next stages of the VC cycle come as further proof that this strategy could be not only successful, but is able to create the so needed balance in the agency relationship between founders and (next) investors. The comparison in Chapter I also showed that micro VCs are still falling into the category of investment funds. They are operating like such, and even though the common used term for them is "incubators", they do not possess the characteristics of the typical business incubators which are operating only as to provide shared office space and administrative services to starting companies. In general, incubators are venture capital funds which differ from traditional ones in the way they implement their investment strategies and their investment practices. When compared to the pre-investment and post-investment practices of the traditional VCs, accelerators' ones differ by the evaluation criteria used in deal selection process. In the process of screening applications for their mentorship programs, mentors

accent mostly on the qualities of the entrepreneurs and on the business idea and not that much on return on investment. Along with that, they prefer more informal and not that strict contractual arrangements that would not impose unnecessary covenants on start-ups.

Furthermore, the comparison in Chapter II of angels and angel groups, on one hand, and accelerators, on the other, showed that the latter have anticipated the angel's investment behavior and mild terms and conditions towards the entrepreneurs they are funding and mentoring. In doing so they try to emphasize more on the vital elements in one investment, i.e. the founders and their product or service to be build, and not that much on the legal and finance formalities of the deal. As ex-entrepreneurs, the mentors in these incubators know that in order to enhance innovation and creativity, entrepreneurs should be encouraged to work and develop products that would have the capabilities to really create value once they are launched to the market. Imposing stricter covenants that could be burdensome for the future finance performance of start-ups is not the "tool" used herein. What is more, with the new trend of co-investment (the collaboration between incubators and/or angels and venture capitalists examined in Chapter III) micro VCs are creating innovative rules in venture industry and setting up the prerequisites for the more efficient development of companies in this early seed stage.

The value that this new generation of seed funds brings to the venture capital market could not yet be evaluated in its entirety. It is true that by introducing new investment strategies that could be very successful for investors, incubators are bringing innovation to the VC industry. Moreover, together with angels they are enhancing the process of bridging the liquidity gaps between the different financing stages. Their combination of angel investment behavior and term sheets, investment collaborations, high reputation, very well structured and organized alumni network and new types of value-adding services seems to be the key to a successful performance of their portfolio companies.

There is no firmly positive or negative attitude towards incubators and accelerators that prevail on the VC market. Some observers state that what those seed funds are doing is not only good for the industry by itself, for entrepreneurs and even other investors, but is good for

innovation in general. Others, however, are of the opinion that lately there are more than needed investment funds from this type, which in the future might end up creating the next "bubble". The truth is that incubators emerged as the natural extension of angels and venture capitalists in a period when were most needed in this industry. And they are creating value to the market, nurturing successful entrepreneurs and high performance companies.

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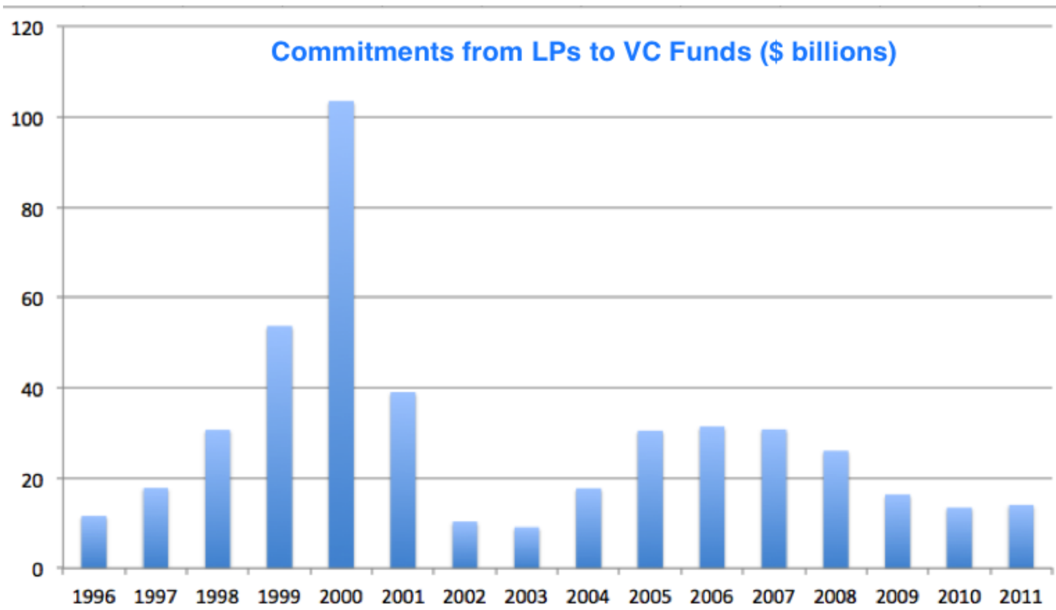
Appendices

Figure 2



Source: *Both Sides of the Table*

Figure 3

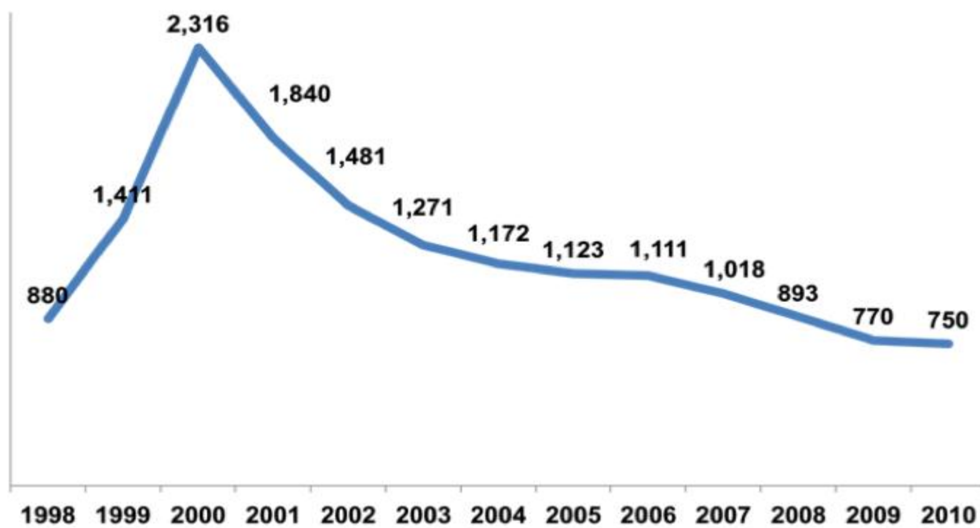


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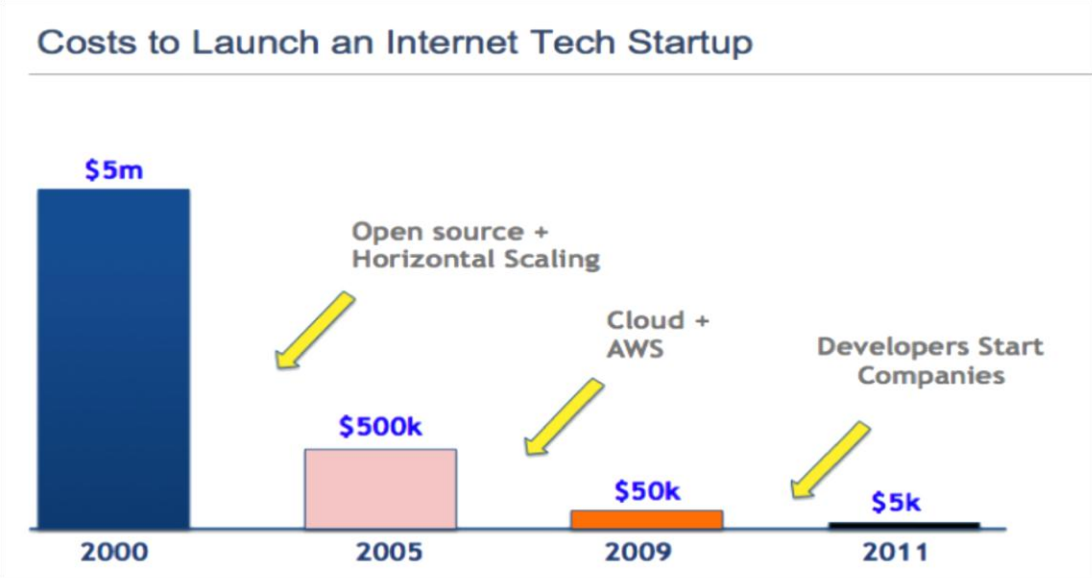
Figure 4



Source: *Both Sides of the Table*