Venture City Series

Share

The Early Capital Gap

This is the third in a series of articles on Rebuilding the Entrepreneurial Economy.

by Daniel Lovering

Photo: Brian Cohen

The economy was falling apart when Mark Kurtzrock launched Metis Secure Solutions into the headwinds of one of the worst recessions in the nation's history.

"It was pretty tough to find resources," said Kurtzrock, president and CEO of the Oakmont-based maker of emergency notification systems, which opened its doors in November 2008.

The company was fortunate to have an advantage: $300,000 in funding from a local business development agency, which bought it time to focus on product development and finding customers during a liquidity crisis that severely restricted financing for businesses throughout the United States and much of the world.

Metis Secure Solutions survived to raise another $2 million, mostly from a private investor group.

And in February of this year, the company closed on a $1.6 million venture capital deal, succeeding in the world of institutional funding that some Pittsburgh entrepreneurs find difficult to navigate, given that venture capital firms are relatively scarce in the region. "Really good ideas, I think, find a way of getting funded," Kurtzrock said. "You just have to be deadly persistent about it."

Indeed, many local start-ups have raised tens of millions of dollars in recent years, both through local professional investors and funds elsewhere. But a shift in the venture capital industry and among angel investors, or wealthy individuals, toward later-stage firms has created problems for entrepreneurs looking for an infusion of capital early in the lifecycles of their companies.

From 2004 through 2007, about 60 percent ($330 million) of the venture capital invested in Pittsburgh-area start-ups went into companies at the expansion stage, meaning they had products on the market and significant revenue growth, if not profits.

But from 2008 through the first three months of this year, the biggest share – 45 percent ($206 million) -- was invested in more established, later-stage companies, with products widely available and a greater likelihood of profitability, according to a report by the National Venture Capital Association and PriceWaterhouseCoopers.

Venture capitalists "more and more invest in downstream opportunities," said Raymond Vennare, co-founder and executive vice president, strategic planning, of the medical device company, ThermalTherapeutic Systems. "We have entrepreneurs here bursting at the seams. What we don't have is capital. What we don't have is a core venture capital community. But we have very strong angel communities."

The city's angel investors have become increasingly organized in recent years, forming groups such as BlueTree Allied Angels. Such wealthy individuals -- who tend to be community-focused and may take a hands-on approach -- coupled with economic development agencies, have helped numerous entrepreneurs start their companies.

Without them, "Pittsburgh would be a backwater," Vennare said. "You'd have a bunch of entrepreneurs who couldn't paddle upstream."

As venture capital has become more scarce amid an industry-wide downturn and broader economic turmoil, angel investors have also shifted their priorities.

Ringing in 2015
The State of Aging in Allegheny County
Growing Smarter
Reasons to Give Thanks
Boo, N'at
Congressional Districts - 2014
Is Better Good Enough?
Bike City
Eco Tips Series
The Federal Reserve Bank of Cleveland Report on Pittsburgh
Pittsburgh Emerges as a Low-Price Leader in Health Insurance
Frigid, Snowy and Gray
Pittsburgh Today and Tomorrow 2014
Immigrants Wanted
Attendance Matters
Shale Gas and the Environment
Value in Visitors
Transit's New Era
Rough Roads Aplenty, Despite Improvements
Has Pittsburgh Been Naughty or Nice?
The Path to Sustainability
10 Pittsburgh Reasons to be Thankful
The Pittsburgh Regional Environmental Survey
Pittsburgh Then and Now
What We Say (and do) About the Environment
The Arts Engine
STEM
Finding Common Ground
Pittsburgh Today and Tomorrow 2013
Defying the Economy
Getting Younger
Economic Transformation
A Nice Place to Visit
An Educated Population
Creative Spark
Of Two Minds
Compliance, Finally

"At one time, where many companies anticipated follow-on funding from VCs, now angels have to step up where they never had to before," said Catherine Mott, chief executive officer of BlueTree and chair of the national Angel Capital Association. "So there is a decline in writing checks in the first round that angels normally do."

The gap between getting seed funding and venture capital has been called the "valley of death," she said.

Art Boni, director of the Donald H. Jones Center for Entrepreneurship at Carnegie Mellon University's Tepper School of Business, said local angel investors, "which typically in most regions will come in very early on, are waiting for somebody else to de-risk the investment before they put their money in."

The reason, he said, was that the Pittsburgh region, until very recently, had produced few successful exits -- significant acquisitions, mergers or public offerings of start-ups that pay off for investors. "Now we're beginning to see some of that."

Among the recent successes was Knopp Neurosciences, a biopharmaceutical company that last year sold global licensing rights to its Lou Gehrig's disease drug to Massachusetts-based Biogen Idec in a deal valued at up to $345 million.

Venture capitalists agree that Pittsburgh's entrepreneurs could use more capital, while acknowledging the impact of tough times in the industry and the economy, as well as the inherent limits of a market the size of Pittsburgh.

"You can never have enough money sloshing around, looking for deals … from the entrepreneur point of view," said Joel Adams, general partner of venture firm, Adams Capital Management, which has offices in Pittsburgh, Boston, Austin, Texas and Palo Alto, Calif. "From the investment point of view, obviously that hurts. Too much money chasing too few deals is never a good thing, but I think more funds here would be a good thing."

Adams noted that seed and early stage investments have declined nationally in the past 10 years. "There just isn't the money available, and that's because the limited partners, the people who do those investments, are off to greener pastures."

Those entrepreneurs who have been able to secure venture funding, however, have found that it can come with strings attached. Several Pittsburgh start-ups have had to move their headquarters away to be closer to investors, while leaving some operations in Pittsburgh.

"We take all the risk, you get all these people excited, we take the state-funded money or the economic development money, we take the angel money, and then when it comes to getting the funding, large funds want you to come to where they are," Vennare said. "They want to be able to drive to their investments, for the most part. We have to stop that, and the only way to do it is to get a strong venture community in Pittsburgh.

Vennare said that one way to build a larger venture community would be for large firms, such as Berkshire Hathaway or Bain Capital, to open offices and "put a humungous amount of money into just a few companies and help create anchor industries, whether it's life science, biotech, software engineering, robotics. It's going to take someone like that to step up."

But raising capital poses different challenges for different types of companies. And there are many ways of doing it, from taking out second mortgages to running up credit card accounts. Software start-ups that may not need as much capital as a biotech firm, for example, may be able to launch their business with angel funding alone. Others may choose to avoid venture funding altogether.

"When they invest in you, they are expecting a five-to-10x return on their investment, and if you can't honestly provide that, you're going to have major, major problems down the line," said Luke Skurman, founder and chief executive officer of College Prowler, which publishes college guidebooks and online reviews. "Things can happen where they can block the sale of the company."

For Kurtzrock, the Metis Secure Solutions chief executive, the example set by Pittsburgh biotech firms that have successfully raised capital provides inspiration. "There's a way to get it done. But you've got to fight a little bit harder coming from a region like Pittsburgh."

If you're a Carnegie Mellon grad, it might be a bit easier. Ten startups, seven from Pittsburgh, were just selected for the Open Field Entrepreneurs Fund (OFEF), a program that awards $500,000 to companies from across the U.S. and mentors them through the early stage. (See the full Pop City story.)

CMU alumnus and Flip Video Camera creator Jonathan Kaplan and his wife established the fund to provide early-stage business financing and support to alumni who have graduated from CMU in the last five years.

As part of CMU's Greenlighting Startups initiative,OFEF provides $50,000 in matching funds to each recipient. They also gain access to other funding sources, receive personalized mentoring and attend an annual OFEF business workshop. CMU will provide legal and accounting support for OFEF recipients.

Posted June 20, 2012

The Pittsburgh Today project is in collaboration with the University Center for Social and Urban Research of the Univ. of Pittsburgh.