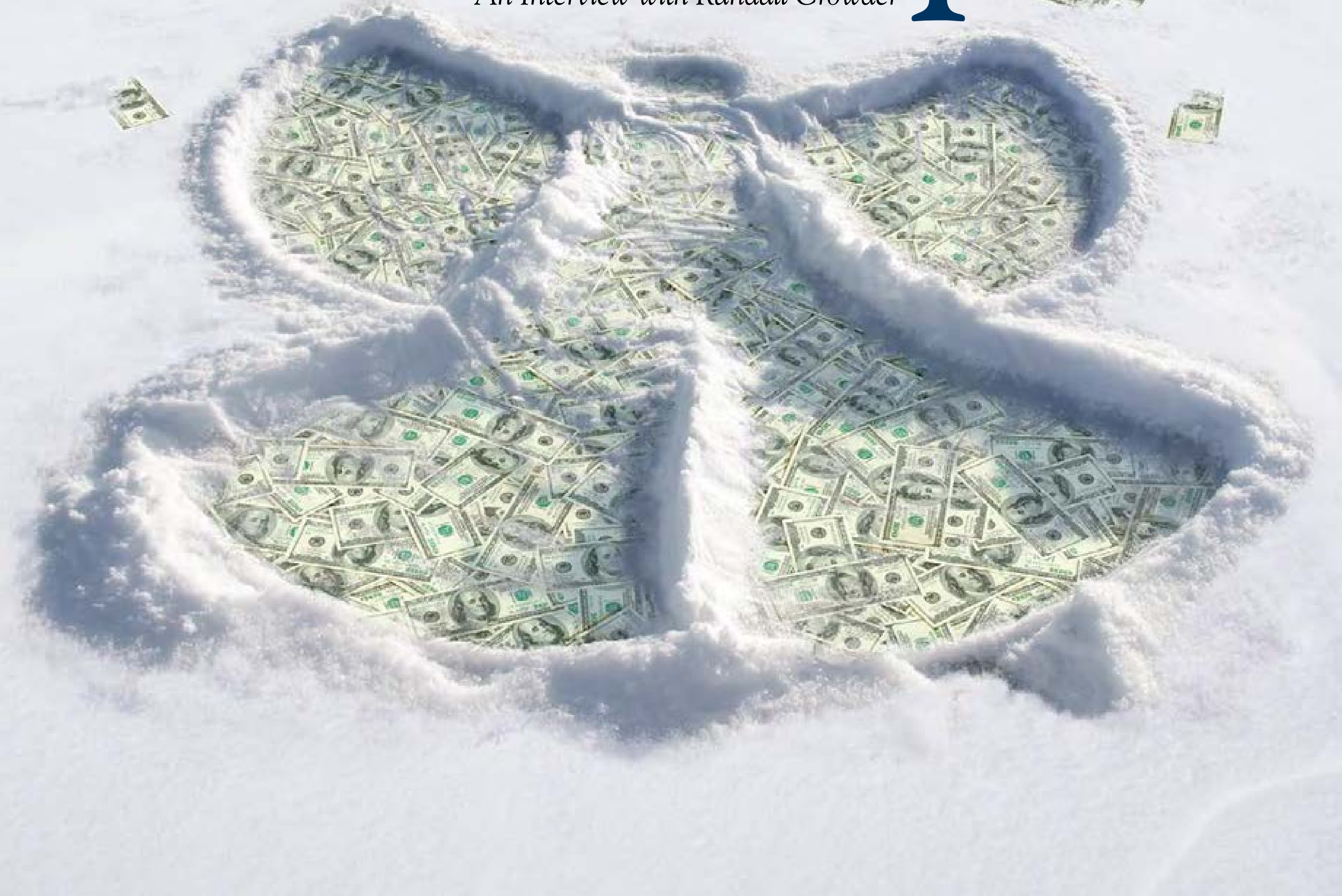
A Review of the Texas Economy from the Office of **Susan Combs, Texas Comptroller of Public Accounts** • February 2012

# FISCAL NOTES

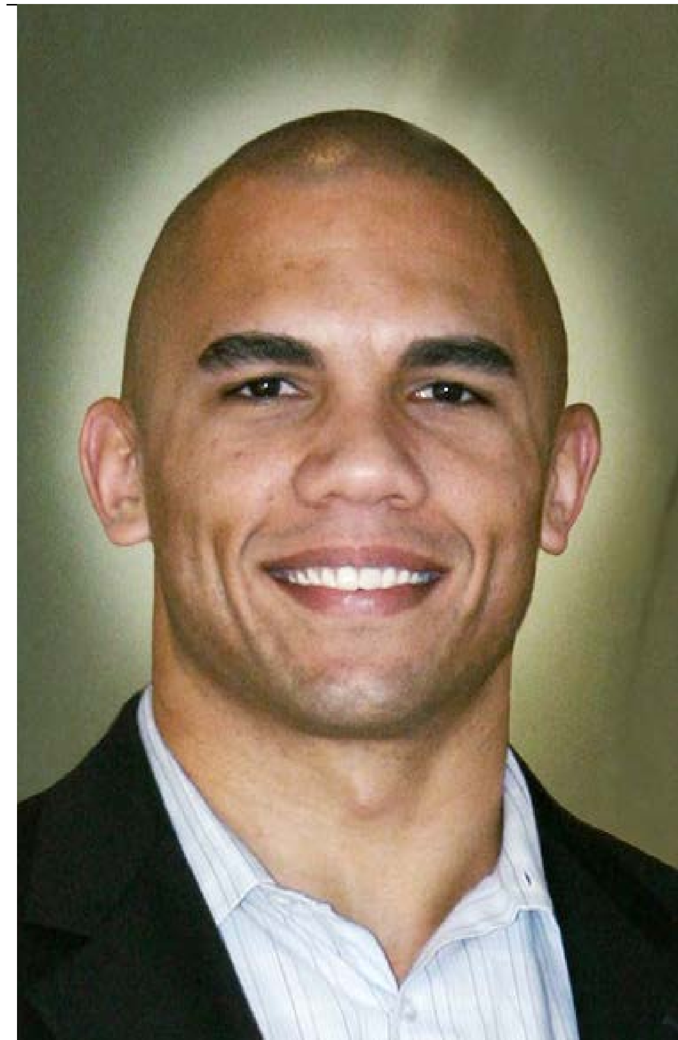
# Angel and Venture Investing in Texas

*An Interview with Randall Crowder*



# Buying a Piece of the Future

BY BRUCE WRIGHT



Randall Crowder,
Managing Partner,
Austin's TEXO Ventures and
former Executive Director,
Central Texas Angel Network

## **Angel** *and* **Venture Investing** *in Texas: An Interview with* **Randall Crowder**


No economy can prosper if it puts barriers in the way of new businesses and the jobs they create. And as you might imagine, the main barrier most budding entrepreneurs face is a lack of money.

Fortunately, when the banks won't help, an entire investment industry is willing to step in — if the idea and the team behind a new business look promising. The efforts of individual "angel" investors and venture capital firms have helped some of the nation's most successful companies get their starts.

One Texan uniquely poised to discuss these forms of investment is Randall Crowder, a managing partner at Austin's TEXO Ventures and former executive director of the *Central Texas Angel Network*, a partnership of angel investors that provides investment and assistance to early-stage companies in Central Texas.

A West Point graduate and recipient of two Bronze Stars in Iraq, today Crowder makes strategic investments in new players joining Texas' burgeoning health care industry. He agreed to speak with *Fiscal Notes* about Texas' angel and venture investing climate.

***Fiscal Notes*: First, since you have experience in both fields, I'd like to ask you to distinguish between angel and venture investing for our readers.**

**Randall Crowder:** Most people think that you're either an angel or a venture capitalist, a professional money manager. If you answer only to yourself and maybe your spouse, you're an angel. If you manage someone else's money, you're probably a professional money manager.

While *angel* investors can certainly include friends and family — that's where many entrepreneurs get their initial cash — angel investors are typically wealthy individuals who make individual investments in a company that often range anywhere from $25,000 to $250,000.

And it's probably appropriate to mention "super-angels," a term that's kind of in vogue lately. A super-angel is really just a very active angel who may invest more than a typical angel — someone with significant wealth and experience.

On the other hand, a *venture capitalist* is a professional money manager, because they are largely deploying money on behalf of other people and organizations, such as private wealth managers, pension funds and endowments. Reputable venture capital firms are effectively service providers that really understand how to invest in and build companies.

**FN: Are the angel and venture roles fundamentally different in other ways?**

**Crowder:** When entrepreneurs are just getting going, they need money but they also need help. That's where angels can be really effective. A lot of angels are former businessmen and women who understand how to start and grow a business. Many made their money doing it themselves.

So with that initial capital often comes a lot of mentoring, saying here's what you need to do next, here's how to incorporate your company, here's what lawyer you should use, here's what accounting system you should use — a lot of the blocking and tackling needed to start a business effectively.

But because angels traditionally invest small amounts of capital, they tend to focus primarily on early-stage companies. For the same reason, angels generally don't invest in capital-intensive industries, the things that cost a lot of money to commercialize, like pharmaceuticals or clean technology, where it can often take hundreds of millions of dollars to go to market.

*Fiscal Notes* **is available at** fiscalnotes.org.

Angels tend to prefer companies with products that can get to market relatively quickly such as software.

While angels are a wonderful source of capital early on, many companies need more money to grow, money beyond what angels are willing to commit.

**FN: And that's when venture capital steps in, right?**

**Crowder:** Well, don't get me wrong, many venture capitalists also help start businesses.

At TEXO Ventures, for example, we're committed to providing capital to early-stage health care companies, while also collaborating on solutions to many of the issues that new companies face. Being successful businessmen and entrepreneurs ourselves helps us identify with what our entrepreneurs are experiencing. But we typically look to invest in companies after friends, family and seed investors have gotten the company to its first "value inflection point," its first milestone as a business, which is often a proof of concept.

Different venture capital firms have different investment strategies, but it's a safe bet that many like to invest $1 million to $5 million in an initial round of financing. That money is often used to execute a company's go-to-market strategy.

But there are also some very large venture capital firms with billions under management that specialize in the later stages, in growth capital.

**FN: And these investments are made to own a chunk of the new company, right?**

**Crowder:** You got it. Traditionally, you're always investing for equity positions in the company because you want to see the upside if the company is acquired or goes public.

That said, there are always new models popping up. For example, certain groups now are doing arrangements that look more like a loan — they invest in a company and are paid back through a revenue sharing arrangement. But many investors don't agree with this model, because they believe that early revenue should fuel the growth of these young companies rather than being pulled immediately back out.

**FN: The economy is still fairly rocky, so — how's business in Texas these days? And how badly did the recession slam our investment community?**

**Crowder:** Well, while things are clearly not ideal for many investors, many folks believe that what's happening in venture capital is just a market correction.

Ever since the Internet bubble, the venture capital industry has expanded rapidly, and many believe the supply has just outpaced the demand. It's not unlike what happens to specific sectors like social media. Investors witness the success of a company like Facebook and then rush to fund anything that has a social media angle to it.

To be brutally honest, there are easier ways to make money than venture capital. Identifying compelling investment opportunities and ushering them through to a successful exit is hard, hard work. Especially in the early, critical stages of a company's life, you find yourself continually facing financing risk, managing go-to-market strategies and fighting to differentiate yourself from competitors who are just as hungry and committed as you are.

So when you hear all this doom

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and gloom, I'd probably contend that the venture capital industry is really just going back to where it was when it really worked well. The market is, in a way, ridding itself of people and firms that weren't effectively adding tangible value.

Right now, if you're a proven, effective leader, either as an entrepreneur or as an investor, people still trust you and still want to invest with you. And if you're a good entrepreneur with a good idea, you can absolutely find money for your company.

I believe that quality across the board is increasing. The folks that are still doing business are of a higher caliber and the deals that are getting done right now are of a higher quality.

Take the Central Texas Angel Network [CTAN], for example. Throughout the economic crisis and for the past three years that I ran it, CTAN doubled the amount it invested each year, quickly becoming one of the most active angel networks in the country.

> Every **large** business was once a **small** business, and **small businesses** are **critical** to our role as an economic **superpower**.
>
> — Randall Crowder

I think angels have actually benefited from the fact that there are fewer venture capital firms out there. They are beginning to see deals they may not have seen before, deals that would have typically been funded by venture capital.

**FN: And do you see any hurdles facing angel and venture investing in Texas?**

**Crowder:** People often ask me why Austin hasn't followed in the footsteps of Silicon Valley. The interesting dynamic here is that there are so many *other* opportunities to invest in.

Throughout Texas, investors gravitate towards real estate as well as oil and gas investments; many people with significant wealth don't even consider investing in startups. After all, that's what drove and what continues to drive much of this state's wealth — land and natural resources. So a lot of investors here aren't really interested in the idea of investing in some small company in the hopes of it growing and being worth something some day.

**FN: But it's an important part of the state's economic mix, obviously.**

**Crowder:** Absolutely. Look, I believe innovation is our last great competitive advantage in America, but the world is catching up very, very quickly.

Successful investments can lead to a critical mass of entrepreneurial resources that are vital to maintaining a strong climate of innovation. Some call this "reseeding," or "clustering." For example, once a company like eBay goes public — and they had early help from a large venture capital firm, by the way — many of the managers view that kind of success as their benchmark. Now *they* want to go start a company and take it public.

But these people want to leverage their local network and the resources that have been developed around these successful companies, so tomorrow's great entrepreneurs often never leave today's breeding grounds of success.

For instance, an interesting thing is happening right now in Austin with health care. There are now more than 100 companies here in the areas of research, diagnostics, pharmaceuticals and medical devices. And that's all without a medical school. Things will only get better if and when we can get a medical school here.

As these companies sell or go public, key members of the management will likely stick around, and I'd be willing to bet they may just start their own companies. This is the power of reseeding. It's what builds a compelling ecosystem.

And that's why TEXO Ventures loves health information technology. There's already a wonderful health care base in Texas, but Austin is also a vibrant technology community, people who have spent entire careers in information technology and software. Now, they're finding they can apply their skills and knowledge to the health care industry.

And health care is probably five to seven years behind other industries in technology adoption, so Austin is poised to become a great incubator for this burgeoning subsector. It's also going to be a lucrative market opportunity.

**FN: What do you think of the state's Emerging Technology Fund [ETF], which helps tech entrepreneurs take their ideas to the marketplace?**

**Crowder:** Well, I believe in the ETF. I think it helps.

What we have to avoid are situations when young, aspiring entrepreneurs lack access to sources of capital whether through the ETF, grants, angels or venture firms, and leaving Austin for places like Silicon Valley. They need hope and the ETF represents some of that hope.

I don't believe the ETF should go away, but it should stop trying to bear the burden of funding companies on its own.

For example, the ETF could consider working more closely with established venture firms and act as a passive syndicate partner. Each time a qualified professional money manager that was already vetted by the state invested in a company, the ETF could be offered opportunities to co-invest when appropriate.

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Under that model, smaller venture firms would still apply their experience and credibility to the process, but they would be able to "swing a bigger stick" by having access to capital beyond what they've managed to raise on their own.

**FN: What could Texas government do to ensure that more investment capital reaches its entrepreneurs?**

**Crowder:** Perhaps I'm biased, but I'd love to see large institutions like the Teacher Retirement System and The University of Texas Investment Management Company (UTIMCO) commit as limited partners to more of the venture firms right here in Texas.

Granted, they have a tough job. You can imagine how much pressure they're under, from public policy makers, alumni and other constituencies. While venture capital is only a small piece of what they do, I'd like to see them really push a strategy that would allow them to consider some of the smaller [venture] funds that are a significant engine of innovation and commercialization in Texas.

Look, for all intents and purposes, capital is a commodity. The only reason TEXO Ventures gets to invest in marquee deals is because we sell ourselves, and because of what we bring to the table beyond capital. We believe in our companies and they believe in us.

I would love to see institutional investors view themselves as salesmen, too. They should proactively seek out professional money managers that can help them drive better returns, rather than only focusing on established brand names within the industry. That'd be akin to me only investing in entrepreneurs that have taken a company public. If every investor subscribed to that strategy, we wouldn't be funding many companies.

Fortunately, some institutional investors are beginning to understand the importance of finding the next generation of great investors.

The question is, how do we *encourage* people to invest in small companies? Every large business was once a small business, and small businesses are critical to our role as an economic superpower. We need people out there pursuing their dreams, pioneering innovative solutions to the problems that we face. That's our key competitive advantage as a country.

Great investors understand this and they are passionate about supporting it.

Which brings me full circle back to angels and what motivates them. Angels are not keeping their lights on through their investments in startups. Most do it because they're passionate about being mentors and building businesses. Nonetheless, a funny thing happens when you're passionate about something — you often find yourself quite successful.

And it's this success that will continue to fuel innovation. For example, The *Wall Street Journal* reports that Eric Lefkofsky's initial $1 million investment in Groupon will likely return him more than $4 billion. Having already committed to funding startups through his firm Lightbank, you can see how many more companies he can fund now!

That's what our goal is. To drive this idea of continually advancing technology, services, innovation — the things that will continue to make America great. **FN**

Links to Texas venture capitalists can be found at *http://www.gaebler.com/Texas-venture-capital-firms.htm.*
To keep abreast of new developments in cutting-edge Texas industry, visit *Texas Innovator*.