

Despite challenges, firms tap venture capital for growth

Businesses that need funds but cannot get bank loans turn to venture capitalists

By ANDREW DOLLARD

In 2005, David Henderson, the CEO of New Scale Technologies Inc. in Victor, knew that his firm's design for a tiny electric motor had great potential in the market for cell phone cameras. But the company needed to further develop its product in order to bring it to market, something which it could not afford to do.

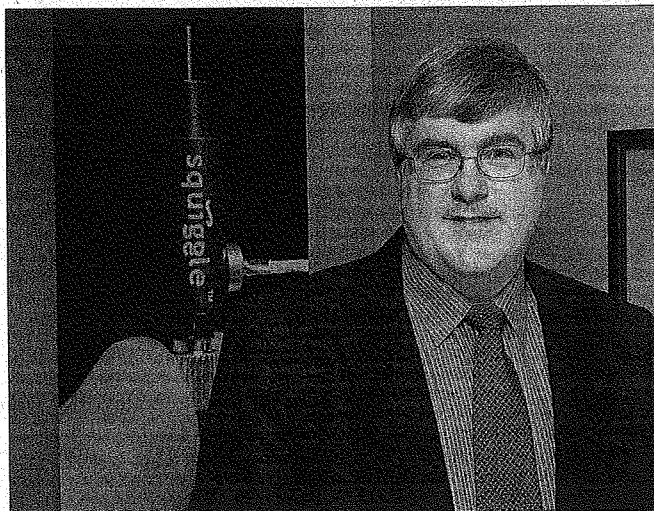
"Our investment needs exceeded our ability to fund from our cash flow," Henderson says.

Along with little revenue, New Scale had few assets, and the company was still too risky to tap bank financing.

"Banks basically loan money to companies that have positive cash flow, a track record of revenue and some tangible assets," Henderson says. "The qualities of our company at that point, and the opportunity we had, were not something a bank would be interested in."

So, Henderson turned to Rochester's small venture capital community for help. In October 2005, New Scale received an investment of \$700,000 from a group of investors including Rochester venture capital firm Trillium Group LLC, individual angel investors from the Rochester Angel Network Inc. and Istria Inc.

For young businesses like New Scale that need funds to expand but are unable to get a traditional bank loan, venture capital can provide financing at a critical point in



File photo by Kimberly McKinzie

"Banks basically loan money to companies that have positive cash flow, a track record of revenue and some tangible assets. The qualities of our company at that point, and the opportunity we had, were not something a bank would be interested in," says David Henderson, CEO of New Scale Technologies, of his decision to pursue venture capital.

the business' life. It allows a firm to make relatively risky new investments that cannot be funded from ongoing operations.

"The reason venture capital exists is because startup companies don't have assets, generally, or they have intangible assets, and banks only lend on value that is very clear, like assets," says Jose Coronas, general partner at Trillium.

He says New Scale displayed the three qualities that make for a good venture cap-

ital investment: unique technology, potential to serve large markets and a solid management team.

Venture capitalists like Trillium typically invest in unproven businesses in the hopes of reaping big returns. Unlike banks, which typically make money by charging interest on a loan, venture capitalists take an equity stake in the businesses they invest in, with the expectation of selling that ownership after a few years.

"VCs look to invest in companies that are going to be high-growth," says Jennifer Tegan, a partner at Cayuga Venture Fund, a venture capital firm based in Ithaca. "In order for us to get a return, the company has to be acquired or it needs to go public on the stock market."

Venture capitalists "aren't interested in small businesses that may be great businesses but aren't ever going to get acquired or go public," she says.

These investors typically want a say in guiding the direction of the company, typically through one or more seats on the company's board of directors.

"We put in a lot of money, and we take a percent ownership stake in that company," Tegan says. "So we weigh in heavily on strategic decisions, including who the top management officers of the company will be, at what point additional funding is needed, all kinds of important business decisions that are then out of the hands of just the entrepreneur."

While venture capital firms take a more involved role in a business than do banks, many limit that role to strategic decisions and guidance.

"We're just active board members who bring our expertise and counsel to the management team, but there is still a management team driving that company," Coronas says. "Ideally we don't like to do any more than we have to. The good companies don't take up a lot of time."

George Daddis Jr., president and co-founder of Allworx Corp., a telephone and network hardware manufacturer and consulting firm in East Rochester, says "good venture capitalists won't get involved in

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the direct operations. They will stay in an oversight and a strategic role."

Daddis has led his company through several rounds of venture capital funding, including an investment from Cayuga. Allworx was able to secure a bank loan to use as working capital. It turned to venture investors, however, to fund new product development and to expand marketing and sales efforts. Allworx last year was acquired by Paetec Holding Corp. in a \$25 million cash deal.

Venture capitalists usually contribute finance savvy and help with executive recruitment, drawing on extensive contacts within the business community.

"We won't invest in something where we don't think we can help the company to some significant degree through our own relationships and contacts," Tegan says.

At Allworx, Daddis says its venture investors recruited the firm's chief financial officer, Christopher Hasenauer, and helped establish a strategic relationship

with Vonage Holding Corp., a voice over Internet protocol company. The investors also brought in Allworx's current board chairman, Garry McGuire Sr., formerly an executive with telecom firms Avaya Inc. and Nortel Networks Corp.

Venture capital can provide financing at a critical point, allowing a young firm to make relatively risky new investments.

"You can imagine that a small firm wanting to break into telephone systems would run the extra mile to get someone like that," Daddis says; "and to have the VC bring him on board was very valuable."

Unlike in markets such as Silicon Valley or Boston, which together accounted for nearly half the venture capital investments in the United States in the third quarter of 2007, the amount of venture capital in

Upstate New York is tiny, according to the MoneyTree Report compiled by PricewaterhouseCoopers and the National Venture Capital Association. Less than 0.5 percent of all venture investment nationally during that period was in the region.

The venture community in the Rochester area is smaller than in other parts of the country. Often, venture capitalists, along with angel investors, will pool their resources for a particularly alluring deal.

"The VC marketplace in the Upstate New York region is a fairly close-knit community," Daddis says. "I would say that realistically there's anywhere from six to 12 firms that you would think of to go to."

Tegan says venture capitalists in the region work together and, when possible, collaborate on deals.

While small, the market for venture capital in the region is growing.

"We're beginning to see more capital in the area, though not ever enough for what is needed," Coronas says. "There are a lot of entrepreneurs and a lot of technology

in this region."

He encourages firms to do as much as possible with existing resources. That, he believes, helps establish more ownership.

Daddis suggests that entrepreneurs should delay seeking venture capital funding for as long as possible to have a better negotiating position with investors.

"What can I do to get a product out there with as minimal capital as possible? Can I get a product out and establish some revenue? And then, use that revenue, without any outside financing, to establish the next phase," he says.

Once a firm has proved that its business model works, Daddis says, venture capitalists get interested and entertain offers.

"It's a lot of hard work, and there's a lot of temptation to run out and get funding to try to make it easier, but it's not the best path," he says. "You want to essentially prove your worth and then use the funding to scale it up."

Andrew Dollard is a Rochester-area freelance writer.