Alumni Ventures

Network-Powered Venture Capital

eGUIDE

Unlocking the Potential of Early-Stage Investments

Exploring strategies to back promising startups and navigate various stages of initial funding

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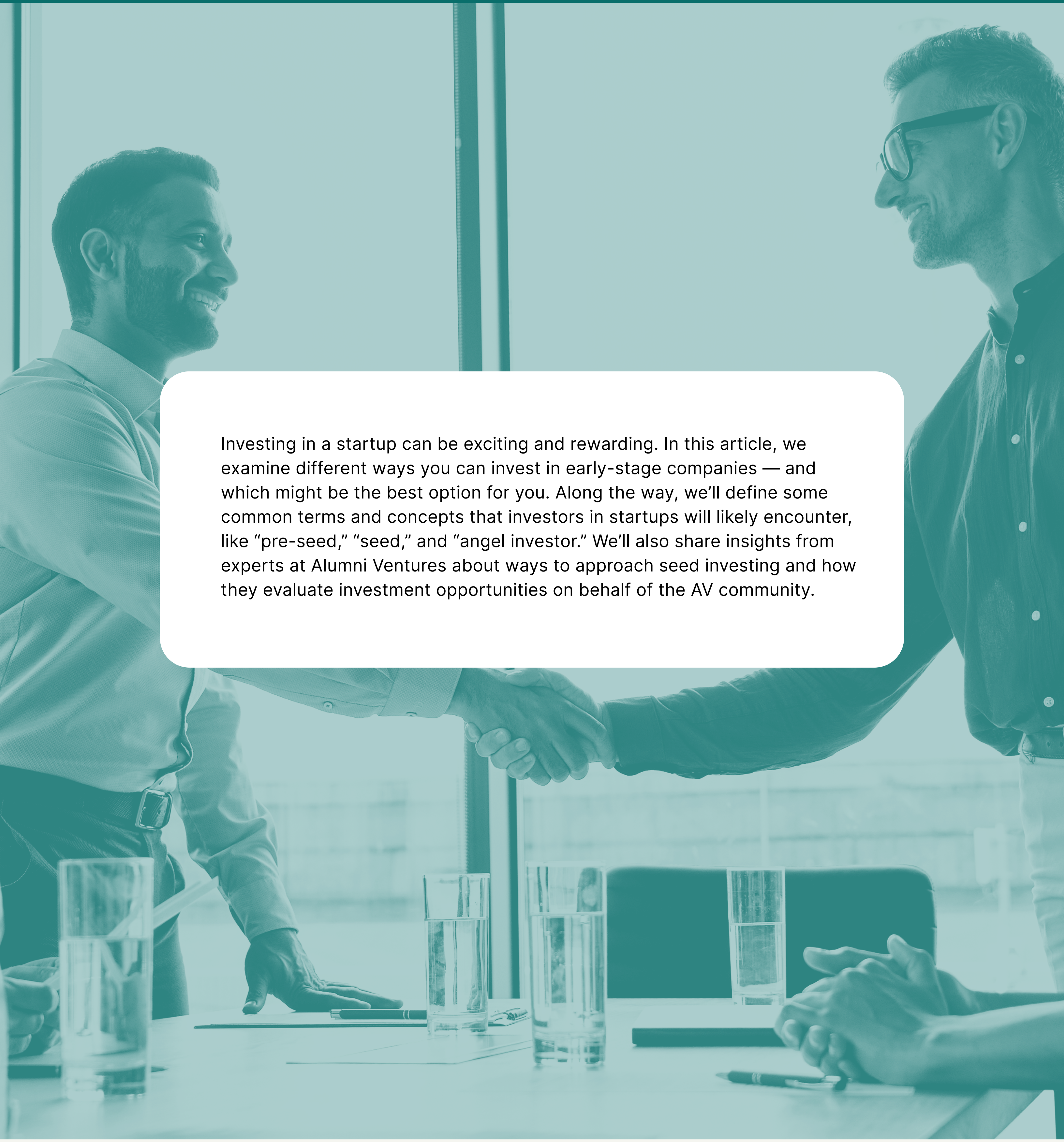


Investing in a startup can be exciting and rewarding. In this article, we examine different ways you can invest in early-stage companies — and which might be the best option for you. Along the way, we'll define some common terms and concepts that investors in startups will likely encounter, like "pre-seed," "seed," and "angel investor." We'll also share insights from experts at Alumni Ventures about ways to approach seed investing and how they evaluate investment opportunities on behalf of the AV community.

What Exactly Is a Startup?

Traditionally, a *startup* is defined as a newly established private company that's designed for rapid growth. That typically means it is supplying a product or service that appeals to a large market, vs. other small businesses which appeal to more focused markets.

Most startups launch as very small operations while they develop their initial idea, and then seek additional funding as they build out their businesses. Often, that funding comes from angel investors or VCs like Alumni Ventures, who fund startups that they think can earn a high return on investment. For this reason, startups need to demonstrate sizable market opportunity, potential, and ability to scale.

By the nature of this business type, startups are typically built with top-end revenue goals and an exit strategy in mind. Exits provide liquidity to investors in a variety of ways,[1] including an initial public offering (or IPO), merger with a special purpose acquisition company (or SPAC), other s [forms] of business acquisition such as an asset purchase, or a direct listing.

Investors should approach seed investing with the understanding that most startups fail,[2] and many others will return only the money you initially put into them. Statistics show that successful small businesses are built over years, not months, according to Forbes.[3] For example, one of the most successful startups, Airbnb, took nine years to become profitable[4] and is now an $82 billion company.[5] This highlights the importance of a long-term portfolio built with patient capital and diversified by stage, sector, and geography.

As Catherine Lu, a Managing Partner for Alumni Ventures' Seed Fund, put it, "The best companies actually take the longest to return back your money."

[1] "How do startups "exit" or provide liquidity to investors?" *U.S. Securities and Exchange Commission*, July 12, 2023.

[2] Patel, Neil. "90% Of Startups Fail: Here's What You Need To Know About The 10%," *Forbes*, January 16, 2015

[3] "Why Building a Great Business Takes Time," Siimon Reynolds," *Forbes*, September 19, 2012.

[4] "Airbnb Has Quietly Become Profitable, 9 Years After Being Founded," OFFICECHAI Team ,January 27, 2017.

[5] "Market capitalization of Airbnb (ABNB)," *Companiesmarketcap.com*, accessed September 5, 2023.

Despite the risks, seed investing offers investors a robust chance of capturing value by backing companies in their early stages when valuations are typically lowest. If you were to wait until a startup goes public to invest, you might be missing out on up to 95% of the gains,[6] which are often accrued by investors before the IPO. For example, some early investors in Uber saw a 4901x return post-IPO.[7]

In venture capital, returns are thought to follow a rule known the Pareto principle stating that 80% of the wins come from 20% of the deals. Chris Dixon of venture firm Andreessen Horowitz, a CB Insights Smart Money VC, has referred to this as the "Babe Ruth effect,"[8] in reference to the legendary Major League Baseball player. Babe Ruth would strike out a lot, but also made slugging records. Likewise, VCs swing hard, and occasionally hit a home run. Those wins often make up for all the losses and then some — they "return the fund."

In addition to the potential for significant returns, investors can be attracted to startup investing as part of a portfolio diversification strategy. By supporting a company in its earliest stages, investors can also potentially share their knowledge and expertise, striving to further their chances of success.

For all of those reasons, early-stage funding of startups has exploded in the past decade, according to Crunchbase.[9] Over the course of 12 months in 2021, investors put $329.5 billion into startup investments across all stages, per Crunchbase data. That's an increase of 92 percent from 2020 levels, which were themselves record-setting.

[6] Mittal, Alex."Why You're Missing 95% of Gains When Investing in Public Tech Companies," *Inc.com*, April 18, 2016.

[7] "From Alibaba to Zynga: 45 of the Best VC Bets of All Time," *CB Insights*, June 9, 2021. NOTE: Uber was founded in 2010, before Alumni Ventures existed. Only investors holding all their shares from the initial investment through the entire period would have experienced these gains. This is an outsized example of the potential of venture investments, but it should not be expected. Venture investments involve a substantial risk of loss, including the loss of all capital invested.

[8] "From Alibaba To Zynga: 45 Of The Best VC Bets Of All Time And What We Can Learn From Them," *CB Insights*, June 9, 2021.

[9] Teare, Gené. "How Seed Funding Has Exploded In The Past 10 Years," *Crunchbase*, October 28, 2021.

What Is Seed (and Pre-Seed) Investing?

What Is Seed (and Pre-Seed) Investing?

There are multiple stages of startup funding: Seed, Series A, Series B, Series C, and so forth. Seed funding is a startup's earliest funding stage.

A recent article on the Finmark blog[10] defined seed-stage funding as "the first formal round of financing for a startup, typically occurring once the company has developed a minimum viable product, demonstrated some traction, and has a clear plan to grow its business."

Businesses at this stage are typically taking on the costs of salaries, marketing, and product development — and higher costs than revenue alone. The average cost of starting a tech company, for example, is $1 million.[11]

Outside funding amounts in the seed stage can range in the millions of dollars, depending on the startup's valuation and funding requirements. The median valuation for seed-stage startup funding rounds has grown consecutively year-on-year since 2020 and was $10.9 million as of June 30, 2023, according to a report released by PitchBook and the National Venture Capital Association.[12]

Ron Levin — a Managing Partner who heads the AV Seed investment team[13] — says that seed rounds are typically, but not always, the first round of funding that involves institutional investors, such as venture capitalists or strategic corporate investors.

But what happens before that stage, in the earliest days of a startup's life, when funding is vital and potentially even harder to raise? In recent years, a new term has emerged to describe this stage: the pre-seed round.

Startups typically seek pre-seed investments to turn an idea into a viable business. Often, they use the funding to assemble a team and build an initial product and prototype.

Entrepreneurs are often surprised at the limited options available for pre-seed money. It is likely that most traditional financial organizations will only invest in companies with demonstrated traction, rather than just an idea.

10 "Startup Funding Explained: Pre-seed, Seed, & Series A-D," *Finmark.com*, April 6, 2023.

11 "How Much Does It Cost To Start A Tech Startup," *FasterCapital.com*, May 20, 2023

12 "PitchBook-NVCA Venture Monitor," NVCA.org.

13 AV Communications Team. "Alumni Ventures and "Angel" Chris Adamo Partner on Seed-Stage Investing," *Av.vc*, October 30, 2022

Still, there are several popular options for securing a pre-seed investment:

- **Family and Friends:** Sometimes thought of as a separate category occurring before pre-seed, this type of funding can be a good option for companies just getting started that may not yet have gained credibility with professional investors. Friends and family invest the most money in startups in aggregate, committing over $60 billion per year. In fact, 38% of startup founders report raising money from their friends and family.[14] The average individual investment amount is $23,000.[15]

- **Angel Investors:** It's no coincidence that pre-seed is also commonly referred to as an "angel round" — it's at this stage that angel investors can make the biggest impact. An angel investor is typically a high-net-worth individual[16] ($1+ million in liquid assets) who invests their own money directly in early-stage (and sometimes later-stage) businesses. These investors are often accredited and may have a background as current or former entrepreneurs themselves.

[14] "Types of Investors," *Fundable.com*.

[15] Hower, Lewis."Raising startup funds from friends and family the right way," *SVB.com*.

[16] Spinelli, Brian."Five Financial Strategies for High-Net-Worth Individuals," *Kiplinger.com*, June 20, 2023.

- **Crowdfunding:** This is a technique of soliciting money from a large number of individuals using permitted internet platforms to sponsor a project. According to Crunchbase, there are 1,300+ crowdfunding groups in the U.S.

- **Startup Incubators and Accelerators:** These collaborative programs provide both support and resources such as training courses, office space, and access to active investors. Y Combinator is among the best-known startup accelerators, investing in nearly 3,000 companies since 2005.[17]

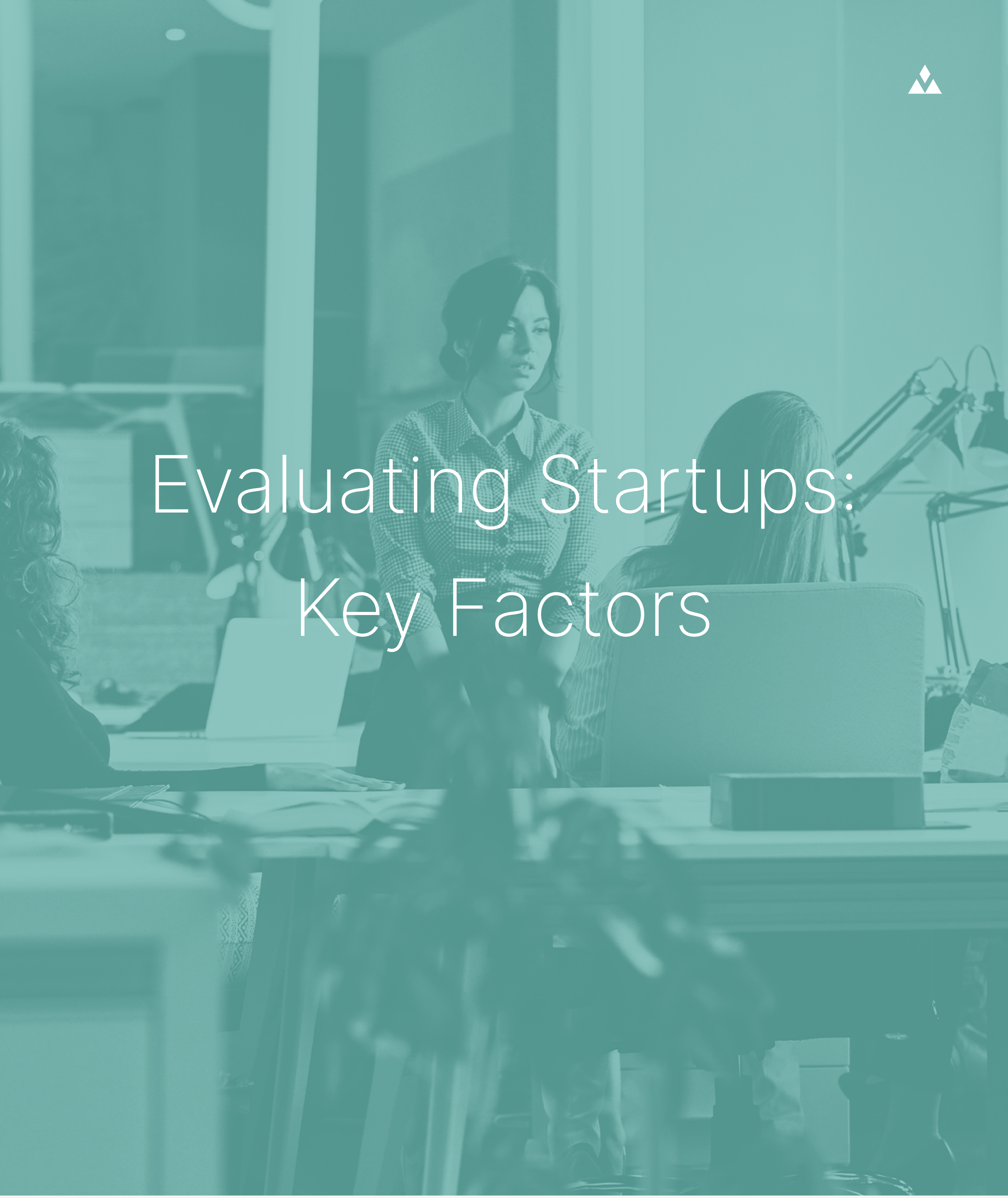
- **Venture Capitalists:** VC firms are generally known for keeping their powder dry until a startup's Seed or Series A round. However, that has changed in recent years. By one count, over 80 active VCs and funds[18] have invested at the pre-seed stage, with rounds of ~$1 million. One reason VCs invest in pre-seed funding is to gain better access to successful startups in the later rounds. At the same time, a startup's founders have to effectively pitch their product idea to potential VC investors and convince them that it has a high potential for growth and profit.

For a startup to attract a full seed round, the company typically needs to show an almost completed product, an advanced prototype, or some kind of traction/demand metrics. It's here that venture capitalists more commonly begin to enter the picture.

At the same time, angel investors can be invited into seed rounds — or indeed, any round. Among the celebrated angel investors, Shark Tank creator and billionaire Mark Cuban commonly participates in startup rounds through to a company's IPO. However, because angels invest their own money, it's generally harder for all but the most high-net-worth individuals to afford participation in rounds as companies scale and the cost to participate grows higher.

[17] Levy, Steven. "How Y Combinator Changed the World," *Wired.com*, December 21, 2021.

[18] "Active Pre-Seed Investors: A definitive list," Taskablehq.com, October 7, 2021.



Evaluating Startups: Key Factors

When angels and VCs are determining whether or not to invest in a startup, there are many factors to consider. Among those factors cited by our AV experts:

1. The Team

This is perhaps the most important element in any startup's success. Is the team experienced and passionate about their product? Do they have the skills and drive to execute on their business plan?

"You need to invest in high-quality founders who are strong operators, who are strong storytellers and fundraisers, who can be good stewards of capital and are not going to waste the money," says Lu. "They have a good plan, they have a good head on their shoulders, and they have a vision that you believe in — and have been able to get others to believe in as well. That's going to be incredibly important for recruiting."

Levin adds, "There should be a founder or team of co-founders who have either deep domain knowledge or a track record of entrepreneurial or professional success. An investor should also look for validation from other investors who choose to invest in a company."

2. Market Size

To size the market, you identify the potential number of clients or customers, as well as the total revenue or sales for a product or service within a given market. These data are essential when considering funding, as they give investors an idea of the market potential for profit and scaling. While a startup founder is expected to provide such data in their pitch deck, investors often do their own research to validate their estimates. Positive signs include if the market is very fragmented with a lot of small players — ripe for a breakout leader. Or if it is old and calcified, a market may be ripe for a new entrant with an edge.

3. The Product

How well-suited is the product or service in addressing the market? Does the company have a product that is compelling and differentiated from its competitors? Does it have a clear go-to-market strategy?

Lu advises answering another key question: “Is it something that can become very large and capture the imaginations of other VCs down the line — as well as first hires who are taking incredible risks to join the company?”

4. Financials

What is the burn rate? How much money does the startup need to achieve its goals? What is its revenue model? What is its customer base and how broad and secure is that base?

Also, it’s a good idea to evaluate its margins and ability to scale — the company should be able to chart a realistic path to get to profitability.

5. The Exit Strategy

What is the company’s exit strategy? Is there a potential buyer for the company? Or can the company IPO? What have been the exit prices for some comparable companies?

6. Valuation

This is a crucial metric in finance, as it sets the worth of an asset or company. But it's tricky to arrive at a fair valuation since startups are quickly growing, with a lot of unknowns in their future.

Lu advises, "If the company practically has nothing and, as of mid-2023, they're raising $30 or $40 million that's post-money, that's definitely higher than the market right now. So, I would at least look closely to see if it's worth that premium or not. You can run the math on what the eventual exit has to be to hit your desired return-on-investment metrics."

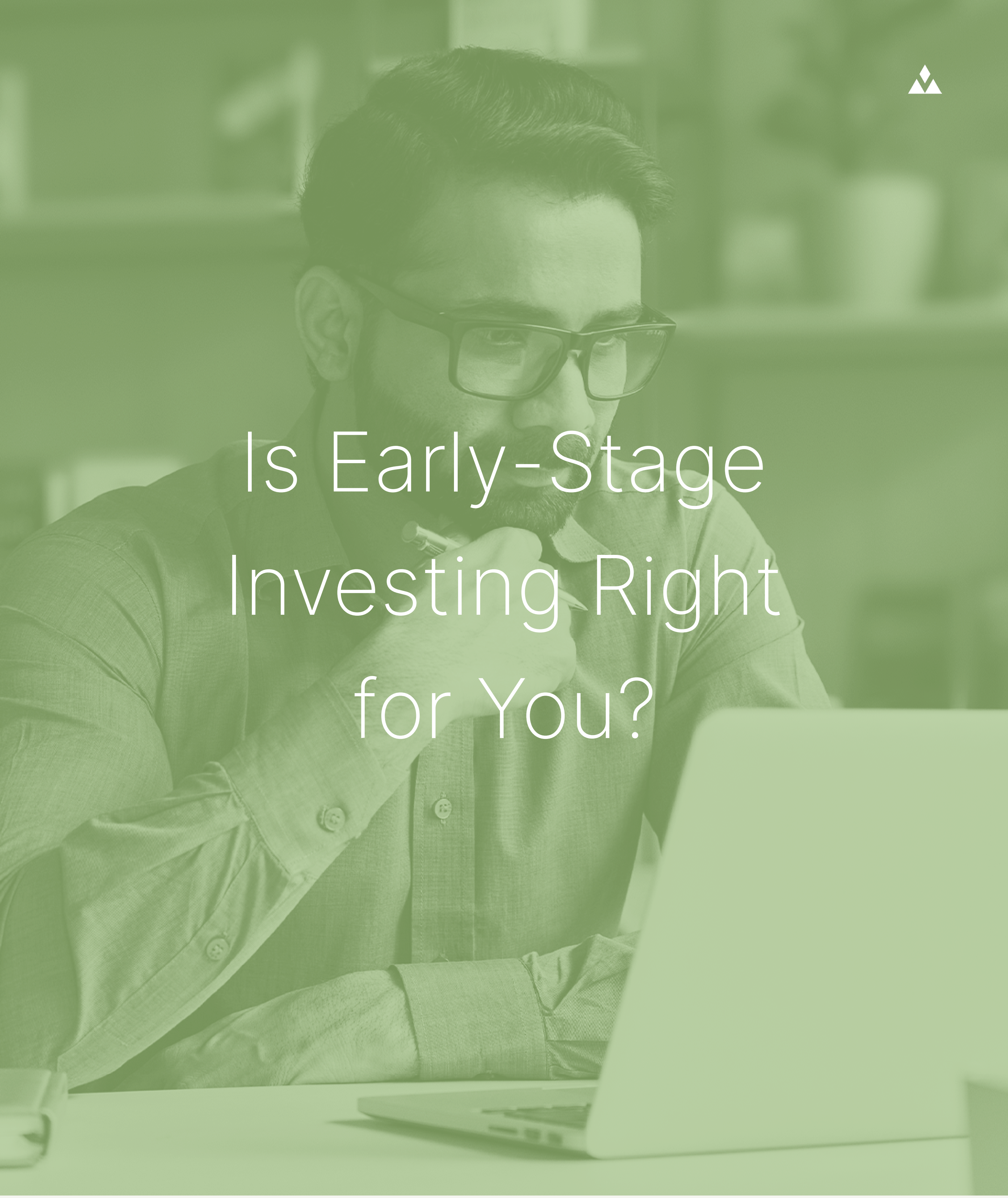
7. Co-investors

"An investor should also look for validation from other investors who choose to invest in a company," says Levin. Look at the track record, expertise, size of the commitment, ability to invest in follow-on rounds, and strategic value.

ANGEL INVESTORS' BROADWAY DEBUT

The term "angel investors" began as a description of wealthy individuals who provided money for Broadway productions on the brink of closure. According to Wikipedia[19], it was in 1978 that William Wetzel — founder of the University of New Hampshire's Center for Venture Research — applied the term to describe investors who supported entrepreneurs raising seed capital.

[19] "Angel investor," Wikipedia.com, August 29, 2023.



Is Early-Stage Investing Right for You?

To answer that question, Lu said it's important to consider whether you want to go it alone as an angel investor or decide it is better to invest in seed-stage startups through a venture firm like Alumni Ventures.

It comes back to that risk-reward equation mentioned earlier. Approximately 10% of startups fail within the first year, according to the U.S. Bureau of Labor Statistics,[20] which means as an individual investor you should consider "cutting at least 50 to 60 checks to have a diversified enough portfolio to [potentially] start seeing some good returns," says Lu.

"You should have a large amount of capital at your disposal that, if you lost it, you would be personally fine," Lu recommends. "So, say you wanted to do 50 deals and you wanted to put $25,000 to work in each, then you need $1.25 million. And if you multiply that by two to get $2.5 million, that would provide about half in reserve for follow-on investing. I would want to put more money into the best-performing companies in order to increase the returns that I might ultimately have."

Also worth considering is the considerable time commitment involved in sourcing and then evaluating companies. Lu speaks as the full-time manager of the AV Seed Fund, who dedicates her resources and that of her team to this extensive evaluation process. An individual who may also be busy with full-time employment, family, and other obligations might not have the time to properly research a deal, let alone create a portfolio.

For instance, an academic study[21] that looked at 1,137 exits from 539 angels concluded, "More hours of due diligence positively relate to greater returns." This translates into an overall return multiple of 1.1x in 3.4 years for angels who spent fewer than 20 hours in diligence vs. 7.1x for those who spent more than 40 hours.

[20] Howrath, Josh. "Startup Failure Rate Statistics (2023)," *ExplodingTopics.com*, March 16, 2023.

[21] Boeker, Warren and Wiltbank, Robert."Returns to Angel Investors in Groups," November 14,2007.

In general, Levin says investors should also consider diversification. "I would be thinking in terms of a portfolio of investments, with seed or angel representing a percentage of my total investments."

In addition to dealing with the complexities of mastering diverse sectors for portfolio diversification, raising and managing the required funds, and navigating initial investment risks, there's also the significant hurdle of accessing the best deals.

However, for those individuals eager to roll up their sleeves to find, evaluate, track, and diversify deals, seed and angel investing might be right for you. But Lu believes others who have a keen interest — but not the time, expertise, or access — might wish to consider Alumni Ventures as an alternative. Writing one check for a diversified portfolio is much more accessible to an accredited investor compared to finding the time, resources, and capital to build a portfolio on their own.

"Providing easy access to early-stage ventures is one reason Alumni Ventures exists," says Lu. "As part of the Seed Fund here at AV, I consider our approach as one of the best ways to get promising deals in a very diversified portfolio, at the earliest stages of venture investing. And to also have a team of professional investors do the sourcing, diligence, and monitoring on your behalf."

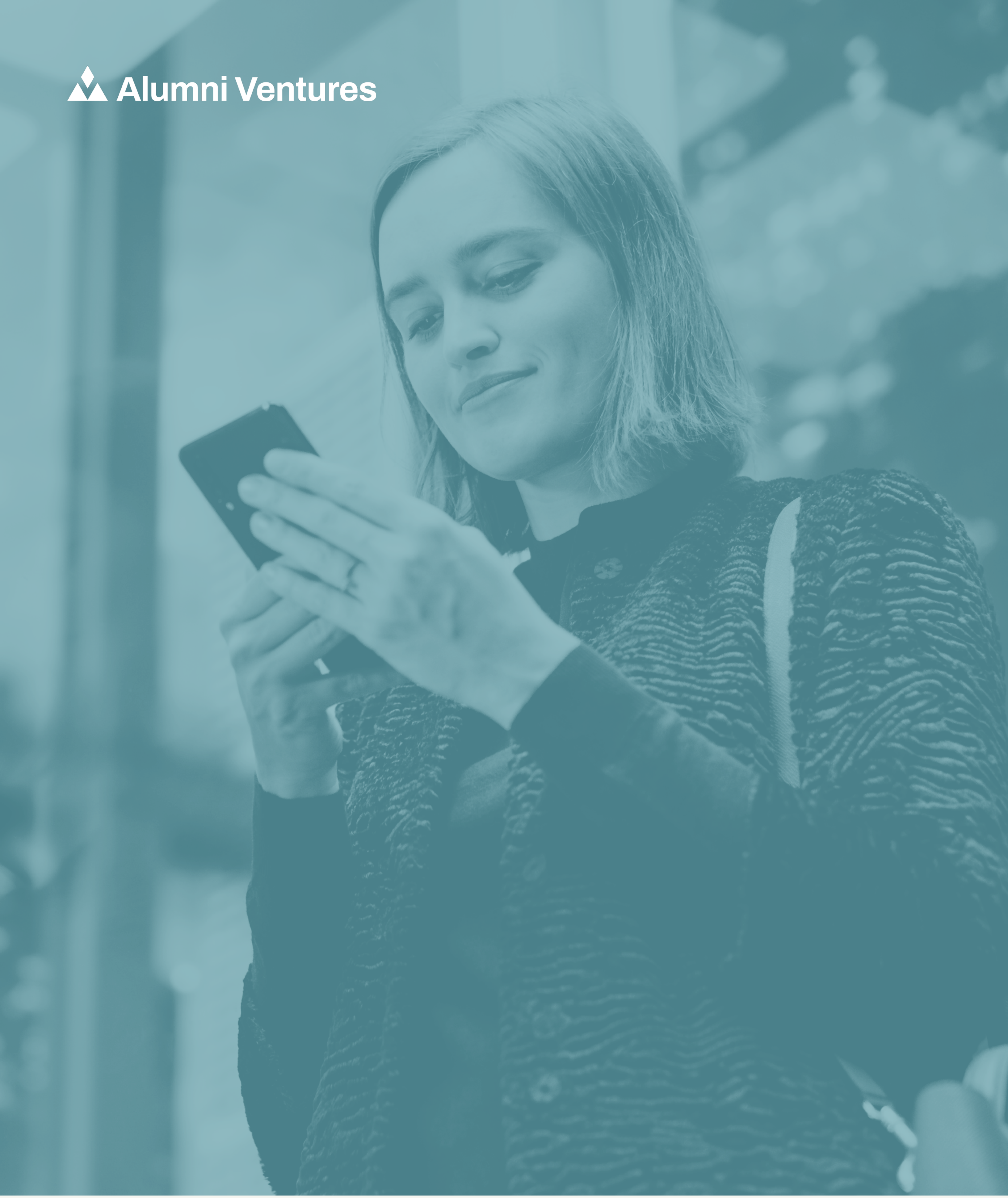
Round	Pre-Seed	Seed
Typical size	Amount can range from $50k-250k	Amount can range from $2.5M-7.5M
Stage	Idea stage and/or MVP (a minimum viable product)	MVP; start of operations
Fund source	Friends & Family Angel Investors VCs (in some cases)	VCs Angel Investors
What is it for?	Product-market fit	Go-to-market
What is it spent on (primarily?)	Salaries Product development	Salaries Product development Sales & Marketing
Revenue traction	No revenue traction is needed	Revenue traction is needed at the time of pricing
Target Timeline	~12 months	~12-14 months

From the Garage Up

A surprising number of the world's most successful startups originated in garages and other unlikely birthplaces. Just a few of these entrepreneurs:

- Jeff Bezos, now among the world's richest persons, launched Amazon in a garage owned by his parents, Jacklyn and Miguel Bezos, who also backed their son with a $245,000 loan and are now themselves billionaires.[22]
- Bill Gates and Paul Allen founded Microsoft in a garage in Albuquerque, before upscaling to the Sundowner Motor Hotel.
- In Under Armour's early days, Kevin Plank was selling his products out of his grandmother's basement.
- Sara Blakely created Spanx in her Georgia apartment when she wasn't selling fax machines door to door.
- It was in a Harvard dorm room that 19-year-old Mark Zuckerberg built a prototype of what would become one of the world's most valuable and influential companies: Facebook.
- Mattel was launched by Ruth Handler in a garage workshop.
- Epic Games was started by Tim Sweeney in his parent's basement.

[22] "Meet Jeff Bezos' billionaire parents, Jacklyn and Miguel 'Mike' Bezos" *Luxury Launches*, August 20, 2022.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