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For Start-Ups, Web Success on the Cheap

By MIGUEL HELFT

SAN FRANCISCO, Nov. 8 — When Seth J. Sternberg and two colleagues started Meebo, a Web-based instant-messaging service, they didn't go looking for venture capitalists. Using their credit cards, they financed the company themselves to the tune of $2,000 apiece. It was enough to cover their biggest expense — leasing a few computer servers at $120 a month each.

Within a month of its introduction in September 2005, Meebo was getting as many as 50,000 log-ins a day, and it needed more servers. It decided to take a modest $100,000 from three angel investors, wealthy individuals who typically contribute small amounts but do not get involved in management decisions.

“We had a bunch of V.C.'s talking to us about potentially putting more money in,” Mr. Sternberg said. “We said no. A lot of things happen when you raise a V.C. round, and they really slow you down.”

Eventually, Meebo did raise money from venture investors — about $3.5 million from Sequoia Capital. But that was after the company was well on its way to showing that its service was a hit; Meebo had about 200,000 daily log-ins.

In the last couple of years, hundreds of other Internet start-up companies in Silicon Valley and elsewhere have followed a similar trajectory. Unlike most companies formed during the first Internet boom, which were built on costly technology and marketing budgets, many of the current crop of Internet start-ups have gone from zero to 60 on a shoestring.

Some have gone without venture capital altogether or have raised far smaller sums than venture investors would have liked. Many were sold for millions before venture capitalists could even get in. That has been a challenge for venture capitalists, who have raised record amounts in recent years and need places to put that money to work.

“V.C.'s hate it; they want you to take big money,” said Jay Adelson, who is the chief executive of two start-ups, Digg and Revision3. Digg took some venture money, but far less than backers offered, and Revision3 has been running on about $850,000 raised from a group of angel investors.

Several venture firms are seeking to adapt. Just last week, Charles River Ventures announced it would offer loans of $250,000 to entrepreneurs as a way to gain access to promising start-ups. Other firms are also giving out small loans, albeit not as a part of any formal program.

For its part, Mohr Davidow Ventures has increased the number of “seed” investments — small sums given to embryonic companies — to about 10 a year from 5. And Union Square Ventures, which was formed in 2003, has made nearly half of its investments at $1 million or less, a departure from its initial plan to make first-

round bets of $1 million to $3 million, according to its Web site.

“I think there is in the V.C. community a sense that the rules have changed or are changing,” said John Battelle, a journalist and entrepreneur, who is a host of a technology conference in San Francisco this week that will include a panel on the subject. “How does the V.C. who is set up for a model that requires millions, if not tens of millions, revamp for a different scale?”

And as large firms try to go small, they are encountering a new crop of competitors who are happy to bankroll start-ups on the cheap and are fueling the current Internet boom. They include a large pool of angel investors and a number of small venture funds whose specialty is to invest tens of thousands of dollars, or hundreds of thousands at most.

There is even a group called Y Combinator, whose rule of thumb for investing in start-ups is $6,000 per employee. One of its investments, Reddit, was acquired last week by Wired Digital, which is owned by Condé Nast Publications, for an undisclosed sum.

“I came to the conclusion that $500,000 was the new $5 million,” said Michael Maples Jr., an entrepreneur who created a $15 million venture fund aimed at investing in companies that required little capital. Mr. Maples sees himself not so much as a competitor to venture capitalists, but as someone who is filling the gap between angels, who may invest $250,000 or so in a start-up, and venture investors, whose typical early-stage bet is closer to $5 million.

Several forces are allowing companies to operate cheaply compared with the first Internet boom. They include the declining costs of hardware and bandwidth, the wide availability of open-source software, and the ability to generate revenue through online ads.

“It’s a great time to be an entrepreneur,” Joe Kraus, a veteran of the dot-com boom, wrote in a widely noted blog posting last year. Mr. Kraus said it took $3 million to get his first start-up, Excite.com, from idea to product, much of it spent on servers and software, which have since become much cheaper or even free. His new start-up, JotSpot, was started on just $100,000.

With the notable exception of YouTube, many recent acquisitions involved Internet start-ups that simply could not effectively use large amounts from venture capitalists or produce large returns, said Paul Kedrosky, a venture capitalist and blogger.

“The problem is that as a V.C., these companies don’t soak up enough capital,” Mr. Kedrosky said.

To succeed, a firm with a $250 million fund needs a handful of investments from $10 million to $15 million that can return payouts of $150 million or more, Mr. Kedrosky said. But even a twentyfold return on a $1 million investment will not do much for the success of a large fund, Mr. Kedrosky said.

For smaller funds, the economics are far different. For starters, those who manage them do not earn huge management fees. Instead, they are almost always among the largest investors in the fund, so they will earn a return if the investments pay off.

“I think large venture funds in this economic model have a challenge,” said Josh Kopelman, managing director of First Round Capital. Since starting First Round in 2004, Mr. Kopelman has made about 30 investments that range from $250,000 to $500,000. Mr. Kopelman, who made a fortune as a serial entrepreneur, is the largest investor in First Round’s $50 million fund.

Y Combinator is aiming at even smaller firms, and its approach is decidedly unorthodox. It chooses companies for financing in two batches of 8 to 12; one batch is selected in the winter from companies based in Silicon Valley, the other in the summer from those in Cambridge, Mass.

“When you change the amount of money, a lot of things change,” said Paul Graham, one of four partners in Y Combinator, who made millions when his company, Viaweb, was sold to Yahoo in 1998. “We have to mass-produce things. We can be more risky. We are like mice, and V.C.’s are more like elephants. They can only make a few deals, so each one has a whole amount of weight and worry attached to it.”

As for the target investment of $6,000 for each employee, an explanation on Y Combinator’s Web site makes it clear that Mr. Graham and his colleagues are not looking for computer science entrepreneurs who want to be pampered: “C.S. grad students at M.I.T. currently get $2,000/month to live on, so this represents three months’ living expenses. Though in fact most groups make it last longer.”

Established venture capitalists, however, say the new crop of capital-efficient start-ups represents an opportunity, not a problem.

“Companies have bootstrapped themselves in earlier eras,” said Gary Morgenthaler, a general partner at Morgenthaler Ventures. “There is no shortage of companies that need venture capital and company-building skills.”

Jon Feiber, a general partner at Mohr Davidow Ventures, said it was “incredibly good and healthy” that many Internet start-ups were able to do more with less.

“A small percentage of those companies will lend themselves to the model of a larger fund,” Mr. Feiber said. “If your goal is to generate something of huge value and scale, it is going to take more than $300,000 or $400,000.”

JotSpot, the company that Mr. Kraus started on $100,000, may fit that mold. The company eventually took in $4.5 million from a pair of venture capital firms, and last week it was acquired by Google for an undisclosed sum.

“I think it could be a great time to be a venture capitalist,” Mr. Kraus said in an interview. “Like in any competitive market, fear and hope are the two competing forces.” And for venture capitalists, the success of scrappy start-ups may simply be heightening the fear. “I think there is a lot of fear that people won’t get into the best deals,” Mr. Kraus said.

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