Angels Flee From Tech Start-Ups

Lisa Krantz for The New York Times

Drew Smith, an angel investor in Portland, Ore., has invested $25,000 in each of four start-ups, but now he is cutting back.

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Technology entrepreneurs are having a devil of a time finding angels.

Stephanie Diani for The New York Times

Rose Ors, a founder of TwoSmartDogs, a Web site based in Los Angeles, abandoned her plans and is looking for a job.

Angel investors are the optimistic financiers who give entrepreneurs their crucial first infusion of cash to bring their ideas to life. Now, in the midst of a punishing economic downturn that is sparing few companies, these patrons are cutting back on their bets and threatening the very foundation of the technology economy.

Unlike venture capitalists, angels invest small amounts of their own money — as little as $10,000 and usually less than $1 million — in very young companies. But like all investors, many angels suffered deep losses when the market plunged last fall.

That has left them skittish, investing in fewer technology start-ups and demanding more of those they do consider, leaving founders struggling to find money at the stage they need it most. The slowdown, entrepreneurs and investors say, could stunt the growth of new companies and have long-term effects on innovation.

For TwoSmartDogs, an Internet start-up in Los Angeles that was building an online hub for adult education classes, this sudden pullback was disastrous.

In 2007, the company raised $715,000 in its first round of angel financing from eight investors. When the founders approached current and new investors for more capital in September, they were met with silence.

"There was real interest," said Rose Ors, a founder of the company. "But the economic meltdown ended all conversation."

Unable to raise money, Ms. Ors and her partners decided to shut down the company and look for new jobs.

The angels who rejected them are not unusual. Half of the investors surveyed in November by the Angel Capital Association, the industry's trade group, said they invested less than they had predicted in 2008, and one-third said the number of deals and dollar amounts they invest would decrease again this year.

"Crashes make liquidity vanish, and venture investing — especially angel investing — runs on liquidity," said Steven McGeady, an angel investor and former executive at Intel. "When the markets go wonky, everyone sits on cash until the situation resolves itself. This makes capital hard to find, and if a company is caught unprepared or at the wrong time, that can be the end."

Many professional angels — those who invest as a full-time job, rather than as a side project — are still financing start-ups, if at a slower pace. They say the best opportunities come during downturns, as companies' valuations fall significantly. The median valuation of start-ups seeking angel financing fell 25 percent, to $3 million, from the third to the fourth quarter of 2008, according to Angelsoft, a Web service for angel investors and entrepreneurs.

"It's getting tougher for companies to raise money, but I think the good ones are still getting it done," said Ron Conway, a prominent professional angel investor in Silicon Valley who has invested in companies including Google and Facebook.

Yet unlike Mr. Conway, most angel investors are hobbyists — wealthy friends and relatives of entrepreneurs who invest as a way to diversify their portfolios — and they have been hit the hardest.

Dan Martin, an angel investor based in San Francisco who made millions when his family sold its aerospace contracting business in 2003, has invested several hundred thousand dollars of that in a handful of start-ups.

Last year, though, the Martin family's stock holdings lost close to 30 percent of their value. Now the Martins are shying away from risky angel investments and looking elsewhere for returns, including in undervalued public companies.

Investing in the stock market "smells to me like a much better opportunity than investing in the friend of a friend who wants to open a green Chuck E. Cheese restaurant or software to let people choose their dental implants," Mr. Martin said. "Those could be great ideas. But that versus Pfizer stock is an easy choice for us right now."

During normal economic times, several years after a start-up raises angel financing, it seeks larger amounts of money from venture capitalists to grow. But as venture capitalists also cut back on investments, many angels are wary of investing in a start-up without the assurance that the company will be able to raise more money to keep growing.

"A lot of companies view us to be the on-ramp to the venture capital superhighway, and a number of angels are less convinced that they should count on the superhighway this year," said John O. Huston, chairman of the Angel Capital Association.

Some angels are considering only low-cost companies that could become profitable without venture financing. Others are acting less like angels and more like venture capitalists, spending much more time than is typical advising companies, including taking seats on boards.

Aydin Senkut, a former Google employee who has invested in 40 companies, is serving on the board of one of his investments, ImageShack, a media hosting site, and spends two hours a week working at the start-up. "Where I can really help is building the next growth stage," he said.

Some angels who are still investing have become pickier, making demands of start-ups that they would not have a year ago. When David Levine started Wireless Environment, which makes motion-sensor light-emitting diode bulbs, in November 2006, he quickly raised $135,000 from family members and business school friends, with few questions asked.

The angel investors he met with this fall, though, were far more demanding. "I could not believe the complexity," he said. "For small investments compared to their net worth, they brought in financial advisers and a whole list of questions."

Some made impossible requests, like proof of patents, which take several years to acquire. Others would not even meet with him. "I think we have a very compelling business, we've hit all our milestones. I set up lunches with friends and they just keep putting them off," he said.

In December, he raised $400,000 in convertible debt from JumpStart, a nonprofit organization that makes early-stage investments in companies in northeast Ohio. Because it took so long to raise money, Wireless Environment has been forced to slow its growth, focusing on its technology at the expense of inventory and sales.

Some angel investors are putting less of their own money on the line by finding other people to invest with them. Co-investments increased in 2008, according to the Center for Venture Research, and half of those surveyed by the Angel Capital Association said they would increase co-investing with other angels this year.

Since Drew Smith retired as a venture capitalist three years ago, he has invested around $25,000 in each of four young companies, including a market research software start-up and one that makes technology to play Web videos on phones.

Now, he said, “I’m cutting back. For me to make an individual investment on the order of $25,000, it would have to be a really great opportunity.” Instead, he is investing smaller portions alongside other investors. “I can reduce my bite size a little bit in terms of what goes into each investment, but still stay active.”

The real impact will hit Silicon Valley two or three years down the road, said Mark Heesen, president of the National Venture Capital Association. That is when start-ups that receive angel financing today would typically turn to venture capitalists for their first round of institutional investments, known as a Series A.

“If we don’t have angels, that hurts us. Where are we going to be getting our next Series A deals if those entrepreneurs aren’t out there with the ability to move their idea forward?”

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