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DOW JONES REPRINTS

VC's New Math: Does Less = More?

Thiel Seeks to Change Old Habits by Investing Small on Start-Ups

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Three years ago, Peter Thiel, who runs a small venture-capital concern called Founders Fund, plowed $500,000 into a little-known social-networking Web site called Facebook Inc. Later on, his company invested a bit more.

That was a good call. The paper value of Mr. Thiel's initial stake has increased more than 50 times. Facebook now ranks among the hottest online properties, with some 59 million users and investors such as **Microsoft** Corp. piling in.

Drew Friedman

Peter Thiel clicked

wisely with his Facebook investment.

Mr. Thiel, the former CEO of online-payment company PayPal, is making waves in Silicon Valley with an investment strategy that differs significantly from the traditional approach. His company invests only modest amounts of money, sometimes just a few hundred thousand dollars, and focuses on entrepreneurs Mr. Thiel and his partners often know personally. He also takes an uncharacteristically hands-off approach to company management.

Already, the gambit has yielded several potential winners like Facebook.

The venture-capital world "definitely needs to be shaken up," says the 40-year-old Mr. Thiel, an avowed libertarian who helped bankroll the movie "Thank You for Smoking," a satire about improving the reputation of cigarettes.

His company also reflects how a new type of venture capitalist is emerging, as start-up costs for Internet companies decline sharply. Many start-ups now need a bankroll of no more than a few hundred thousand dollars to get rolling, compared with the millions of dollars required a few years ago.

Other companies capitalizing on this trend include First Round Capital in the Philadelphia suburb of West Conshohocken, Pa., run by former Internet entrepreneur Josh Kopelman, who started online-commerce site Half.com and later sold it to **eBay** Inc., and Silicon Valley concerns such as True Ventures and Baseline Ventures. Many of the companies now manage money for outside investors, unlike informal "angel" investors who typically make small, one-time investments with their own money.

Most traditional VC companies want to invest larger sums, several million dollars, say, for large stakes in start-ups and then exert control over the companies' operations. Some demand "liquidation preferences," or guaranteed returns if companies are sold.

Web of Connections

Some investments by Founders Fund and its partners:*

Investment	Details
Facebook	Web social-networking company. First invested in 2004. Founders Fund partner Sean Parker was a former Facebook president.
Slide	Web software company started by Max Levchin, a PayPal co-founder. First invested in 2004.
IronPort Systems	Network-security firm started by Scott Banister, an early PayPal investor and co-inventor of some PayPal patents. First invested in 2001.
Powerset	Web-search company started by Barney Pell, a friend of Founders Fund partner Luke Nosek; Pell also played on the Stanford University chess team with Peter Thiel. First invested in early 2006.

*Founders Fund raised a $50 million fund, mostly from the fund's partners, in 2005; prior to that the fund's partners, including Mr. Thiel, invested individually.

Sources: Founders Fund, the companies.

'Cushy Jobs' of VCs

Venture capitalists often can be too quick to fire start-up founders and replace them with professional managers, Mr. Thiel says. He blames a cultural divide: Many VCs "have these very cushy jobs, they get paid a lot," and often can't relate to founders, he says.

With so much money chasing deals in Silicon Valley these days, start-ups can afford to be choosy in picking their financial backers. They are increasingly turning to companies like his that offer less of a "command and control" model, he says.

Mr. Thiel and his fund's other partners, including two other PayPal co-founders, Ken Howery and Luke Nosek, also claim an advantage because of their front-line experience starting companies themselves. Mr. Thiel also runs a hedge fund, Clarium Capital.

The Facebook coup was one of several Founders investments that have generated "a healthy amount of envy" from other venture capitalists, says Max Levchin of Slide Inc., a start-up maker of software called widgets, or mini-applications used to decorate Web pages. In 2004, Mr. Levchin invited Mr. Thiel to be one of Slide's first investors, meaning bigger venture companies such as Mayfield Fund and Khosla Ventures could only invest later, for more money.

Heart in San Francisco

Mr. Thiel, who based Founders Fund in San Francisco rather than the traditional VC hotspot of Sand Hill Road in suburban Menlo Park, Calif., is structuring deals differently from how traditional venture capitalists do. Significantly, the fund often buys only a 5% or 10% stake in a company and sets up a special class of stock that start-up founders can sell while they are building their companies -- and before venture-capital investors see profits. That way, the thinking goes, the company founders can reap some financial reward and stay motivated to build the company before an IPO or company sale, which can take years.

Some traditional investors don't think founders should make money before backers do, since early paydays might distract them from the task at hand.

All of this is causing traditional VC firms to re-examine the way they invest in tiny tech start-ups. VC concerns including Trinity Ventures, for example, are now letting a few of their entrepreneurs "take money off the table" early on by selling stock.

Many big venture firms have also started looking at much smaller deals. Accel did six deals less than $1 million this year, although the company says that was in response to increasing valuations for larger-sized investments.

About a year ago, Charles River Ventures announced a program to offer $250,000 loans to fledgling Internet start-ups, far smaller than its usual investment size. Charles River is now also making equity investments in companies through its QuickStart program.

Partner George Zachary said his company launched the program because it was encountering many companies that didn't need a traditional, multimillion-dollar VC investment and the attendant hand-holding.

Just how successful Mr. Thiel's investing tactics are remains to be seen; Founders Fund hasn't yet seen any payout from the Facebook stake. However, it recently collected a big return when one of its investments, computer-security and antispam concern IronPort Systems Inc., was sold to **Cisco Systems** Inc. for $830 million.

Some Backlash

Mr. Thiel acknowledges his company faced resistance from blue-chip investors when it set out to raise money for its latest, $220 million venture-capital fund. One large institutional investor, who declined to be named, said he was put off by Founders Fund's anti-establishment pitch. Others wonder whether Founders Fund could soon tap out its close-knit network of entrepreneurs and run out of companies to fund.

"The early-stage venture game has always been about getting in early and getting in cheap," says Founders Fund partner Sean Parker, who helped start companies including online-music service Napster and online address-book company Plaxo Inc. "Some of those deals are now going to funds like ours."

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