A New Kind of Venture Capitalist Makes Small Bets on Young Firms

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Published: September 21, 2008

From the day he founded Etsy in 2005, Rob Kalin refused to raise money from venture capital firms to expand his company, which hoped to bring the sale of handmade crafts from small local fairs to the international marketplace of the Web.

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Union Square Ventures' partners are, from left, Brad Burnham and Fred Wilson, the co-founders, and Albert Wenger. The firm has become a magnet for Web entrepreneurs.

He met with several top firms, but they all wanted a 20 percent stake in his start-up company, and he was hesitant to give an investor that much. When one of his board members advised him to visit Fred Wilson at Union Square Ventures in 2006, he went grudgingly, certain the meeting would turn out like the others.

Instead, Mr. Kalin was impressed when Mr. Wilson said he would settle for less than 5 percent of the company in the first round of fund-raising.

Union Square Ventures has built its portfolio making small bets on young companies.

"We say, 'Let's go on this ride together,' and if we do get great traction, we'll try to invest in a second round as well," said Brad Burnham, who co-founded the firm with Mr. Wilson.

As Mr. Kalin soon discovered, the small initial stake was not the only thing that distinguished Union Square from its competitors. Grounded in a philosophy of discipline and openness, the three-partner firm focuses on services that use the Web to change a market rather than simply make it more efficient.

The partners become active in the management of their portfolio companies, and they make a point of personally using the products of those firms, which currently include the Web darlings Twitter and Meetup.

“It never feels like they’re doing this for someone else’s money,” Mr. Kalin said. “They love the challenge.”

Union Square’s nurturing approach and keen eye for promising ideas have made it a magnet for Web entrepreneurs. At the Web 2.0 conference in New York last week, Mr. Wilson drew excited whispers — and more — from participants.

“I waited as if he was a very good-looking girl,” said Fabio De Bernardi, a London entrepreneur who slipped him a business card and hoped to pitch a shopping site.

Mr. Wilson has a particular celebrity in technology circles because of the blog he has written since 2003, A VC, which gets 25,000 visits in an average week, according to Sitemeter, a research firm. In addition, readers of TheFunded.com, a social networking site for entrepreneurs, rated him their favorite venture capitalist in 2007.

“In New York, Fred has got a following like John Doerr or Michael Moritz on the West Coast,” said Moshe Koyfman, a principal at Spark Capital. Mr. Doerr and Mr. Moritz are two of Silicon Valley’s most successful venture capitalists.

Union Square’s reputation has been burnished by its track record of helping entrepreneurs sell their companies in a tough environment. Three companies financed by Union Square have already been sold for big profits. Yahoo bought Del.icio.us, a Web bookmarking service, in 2005 for a reported $30 million, returning Union Square seven times its investment after only nine months. In 2007, Google bought FeedBurner, a service to help bloggers track their R.S.S. feeds, for a reported $100 million, and AOL bought Tacoda, a behavioral focusing service for online advertisers, for a reported $275 million.

The Union Square partners are quick to tamp down hype about their magic touch. The firm is just four years old, and their first fund is less than halfway through the typical life of a venture capital fund, which means losses in some holdings could still offset some of the early gains.

“It could easily turn around,” Mr. Wilson said.

His caution comes from experience. During the dot-com boom, Mr. Wilson was a partner at Flatiron Partners, which invested in high-profile start-ups like Kozmo.com, TheStreet.com and the Industry Standard.

“We got successful very quickly. People were saying we were the best V.C. firm,” Mr. Wilson recalled. But when the boom ended, many of the firm’s companies flamed out, and Flatiron wrote off one-third of its investments.

In 2003, over breakfasts at French Roast, Mr. Wilson and Mr. Burnham, formerly with AT&T Ventures, discussed quitting the venture business. Instead, the pair decided that what they really needed to do was form a different kind of firm geared to the special needs of the new crop of Web companies.

Mr. Burnham had spent his career investing in companies that made chips and routers, which differentiated themselves from competitors through groundbreaking technology.

Web services start-ups, on the other hand, use simple, off-the-shelf technologies and cost very little to get up and running. Their business advantage comes from their Web sites' artistic design and ease of use, and their challenge is attracting and retaining users.

"That's a different business than the historical bread and butter of the V.C. industry," said Mr. Burnham. "So we had to change."

Mr. Wilson and Mr. Burnham decided to make very small initial investments, often less than $1 million in a first round of financing, in exchange for 5 to 12 percent of the company, instead of the usual 20 percent. Then, if the company did well, the firm would invest more in future rounds.

Because they join companies so early, they take a hands-on approach to building them and seeing them through the growing pains of start-ups. They have kept their team small, adding just one partner, Albert Wenger, and they must all agree before they make an investment, so no one can point fingers when they make mistakes.

In the case of Etsy, Union Square has taken an active interest in the company through four rounds of financing. Mr. Wenger, an engineer who made a personal investment in Etsy before joining Union Square, essentially served as Etsy's chief technology officer until the company hired one, running all tech-related meetings.

Mr. Wilson coined Etsy's slogan, "Buy Handmade." At one board meeting, when Mr. Kalin presented a long list of fancy new features he wanted to add to the site, Mr. Wilson stood up and crossed each one off the list. Instead, he advised Etsy to focus on creating a bare-bones site that worked well.

Although Etsy had a business plan when it came to Union Square Ventures, the partners are sometimes willing to take a chance on a team with a good idea but no clear path to making money — which does not seem so different from the anything-goes investing of the Internet bubble.

Twitter is one example. The service, which lets users send short messages with updates on what they are doing, is popular with a tech-savvy crowd but crashes frequently and has not figured out a way to earn significant revenue.

“People are too impatient,” Mr. Wilson said, defending his investment. “I’ve made more money in my career investing in very early-stage companies where the business model was not clear. No revenue, just a product, but it was clear people would use it.”

He and his partners are avid users of the Web 2.0 technologies in which they invest, which they say is essential to understanding how the services work and why people use them. They also embrace the values of openness and sharing that drive these services. The firm has invited entrepreneurs to submit pitches via podcast, which are then put up on Mr. Wilson’s blog, giving competitors easy access. Mr. Wilson’s blog posts receive 20 to 200 comments from readers, which the partners mine for investment ideas and research. One-third of their investments grew out of these comments, including Twitter, FeedBurner and Zemanta, Mr. Wilson said.

Union Square’s investment strategy will continue to be tested. It is much harder to find promising Web start-ups now than three years ago. There are so many services and so much more capital financing them, and users have less time and attention for new offerings.

The partners said they planned to look at how Web services might transform sectors not yet touched in a big way, like education and the environment.

“We have only begun to investigate the impact of information technology on behaviors, habits, needs. We believe it can be profound,” Mr. Burnham said.

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