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Venture Investing in Flyover Country: Playing Small Ball in the Age of the Unicorn

It's no secret that Silicon Valley and less than a handful of other venture centers ("Venture Centers") absorb more than 80 percent of all venture capital investment. Single venture rounds in the Venture Centers regularly exceed aggregate annual venture dollars invested in many States. Whether we like it our not, out here in flyover country we may hit a venture capital home run now and again, but as a rule we are more suited for playing the venture capital equivalent of small ball.

Fortunately, while small ball may not grab a lot of national headlines, it can be just as lucrative, on a cash-in/cash-out basis (and IRR, if that's your preferred metric), as the big ball game Unicorn investors play in the Venture Centers. The key to generating those returns is understanding how small ball venture capital investing is best played.

To understand small ball VC, a good place to start is Silicon Valley circa the 1960s to the 1980s. It was a time when the nurture venture capital model – a version of small ball – ruled the venture capital universe. When a $50 million venture fund leading a $5 million B round was big news.

The small ball VC model is characterized by two critical elements. First, hands-on investing by venture investors with the personal experience, networks, and commitment to get down and dirty with entrepreneurs, often before as well as after their investment. Folks who see themselves more as company builders than investors. Second, an emphasis on weaning portfolio companies off of risk capital sooner rather than later – even if that means leaving some growth upside on the table. When you put these two elements of small ball risk capital together, you get the nurture venture investing model.

My contention is that today's flyover country venture investors, or at least the large majority of the same with sub-$200 million pools of capital, should play the nurture/small ball venture game that was played so well by their Silicon Valley forbearers. They should look for deals that are capital

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efficient; where they are willing – and able – to get down and dirty with their portfolio entrepreneurs and add real value beyond capital before and after investing; and, where the initial goal as of the date of the investment is a company that is profitable, or at least cash-flow neutral, within three rounds of venture capital representing an aggregate investment of something less than $10 million.

The nurture/small ball venture model reflects two key realities of venture investing outside the Venture Centers: limited numbers of smaller venture investors; and generally, less experienced entrepreneurs. The first reality demands capital efficiency – defined here as building a company that can (even if it chooses not to) sustain itself from operations with limited capital investment. The second rewards value added investors that can be effective mentors to their portfolio entrepreneurs, so that they can, in effect, punch above their weight.

An important reminder. The small ball venture game is not about smaller returns, just smaller deals. Whether looking at cash-on-cash or IRR, small ball venture investors are looking for the same returns – on smaller investments – as their big ball peers. (Indeed, shorter exit horizons might even give small ball players an advantage on IRR returns – though that, in my view, reflects a weakness of IRR as a return measure more than an advantage of the small ball model.)

As attractive as the small ball venture model is in flyover country, it comes with a variety of caveats and footnotes. Herewith a few of the more important ones.

1. The precision of the model offered above – sub-$200 million funds; three rounds totaling $10 million to self-sustaining operations – should not be interpreted as hard and fast rules of the road for every corner of flyover country. The key variables (fund size; aggregate risk capital budget per portfolio company; number of rounds) will vary depending mostly on the breadth and depth of risk capital access and entrepreneurial talent of a particular region. The important point is that outside of major Venture Centers, risk capital investors and entrepreneurs need to calibrate their investment model to reflect the quantitative and qualitative risk capital and entrepreneurial deficits of their region compared to those of the major Venture Centers.

2. There are always exceptions – most of which prove the rule. It goes without saying that if Peter Thiel wants to start a company in Sticksville USA he won’t have any trouble (assuming the idea passes the blush test; probably even if it doesn’t) employing the Unicorn/Big ball venture model despite the location. Sticksville resident Joe Sixpack, though, with same idea, will.

3. This model does indeed suggest that businesses that are inherently not capital efficient, and cannot achieve self-sustaining operations without tens of millions of dollars or more of risk capital, should stay away from flyover country (again, allowing for the Peter Thiel exception). Biopharmaceutical startups, for example, should mostly locate in Venture Centers.

4. Note that the early focus on attaining self-sustaining operations does not preclude a later, opportunistic shift to a big ball venture investment play. A small ball deal can – and many do – evolve into a Unicorn opportunity, either before or after obtaining self-sustaining operations. The key is not counting on that when the initial investment is made.

5. Small ball may not offer the glamour of Unicorn investing, but smaller, less established “off brand” investors often don’t have access to the big ball headliners in any event. For smaller and less proven flyover country venture funds, doing the best small ball deals is probably a better strategy

than scrambling to get in what will likely be the dregs of the big ball deals. When life hands you a lemon …

As the venture capital industry has grown – last year the industry was two orders of magnitude bigger than it was in 1980 – the spillover from Silicon Valley has fueled the emergence of a number of self-sustaining, regionally important secondary and even tertiary venture investing centers. Places like my own Northeast Wisconsin “New North” can realistically talk about playing the high-impact entrepreneurship and investing game. And maybe even winning at it – if they are willing to forgo the industry headlines, and focus on honing and executing a small ball venture investing game plan.

Related People

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125