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Trends and Prospects in Venture and Angel Investments in New Media Companies[1]

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ABSTRACT *How do 'new media' or Internet-related companies raise external equity capital? In this paper, I analyze two markets that entrepreneurs of private Internet-related businesses use in the US to raise equity: the venture capital market and the market for 'angel' capital. Both markets appear to be important sources of capital for private Internet-related firms. In this paper, I try to shed some light on how these markets operate with respect to investments in Internet-related companies. In particular, using data from PricewaterhouseCoopers' MoneyTree Survey, I analyze trends in venture capital investments in Internet-related companies and make comparisons with venture investments in non-Internet-related firms. In addition, I use information and data on the angel market to investigate how important the market for angel capital is likely to be as a source of capital for Internet-related businesses. In doing so I draw on ongoing and new research by myself and others into the operation of these markets. Finally, I make some cautious predictions about how the future prospects for raising money from these two sources are likely to evolve for Internet-related firms.*

Keywords: venture capital, angel capital, internet businesses.

Venture Capital Investment in Internet-Related Companies

Data on venture capital investments are taken from PricewaterhouseCoopers' MoneyTree Survey which is a quarterly survey of 800 venture capital firms nationwide. Responses to the survey (which can be completed online) are collected, and trends are identified and reported on a national and local basis. The survey was started in 1995 and is a recognized major source of information on trends and developments in the venture capital industry.[2]

From 1980 to 1995, the private equity market was the fastest growing market for corporate finance.[3] Since 1995, the growth of the venture market has accelerated markedly even from its earlier fast pace. Table 1 shows total venture capital investments as recorded by the MoneyTree Survey from 1995 through to the third quarter of 1999. The numbers confirm the conventional industry wisdom that venture capital investments have increased dramatically over the past 5 years.

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Table 1. Total venture capital investments in 1999†
($ billions)

1995	1996	1997	1998	1999*
$6.2	$8.0	$11.5	$14.3	$21.0

† Total venture capital investments in 1999 were more than triple those in 1995.
* The first three-quarters of 1999.

Table 2. Venture capital investments in Internet vs. non-Internet related business
($ billions)

	Internet-related	Non-Internet-related
1995	$0.2	$6.0
1996	$1.1	$6.9
1997	$2.1	$9.4
1998	$3.5	$10.8
1999*	$10.8	$10.2

* The first three-quarters of 1999.

Through to the first three quarters of 1999, venture capital investments are already more than triple what they were in the whole of 1995, totalling $21 billion so far this year.

Investments by venture capitalists in *Internet-related businesses* are primarily responsible for this explosion of venture capital investment activity. The Money-Tree Survey is able to breakdown venture investments into Internet-related and non-Internet-related companies. Table 2 indicates that Internet-related venture investments grew from almost nothing in 1995 to almost $11 billion in the first three quarters of 1999. In comparison, venture investments in non-Internet-related firms increased by about $4 billion over this same period (from $6 billion to $10.2 billion). Table 3 indicates that, as a share of total venture investments, investments in Internet-related firms rose from 4% in 1995 to 51% over the first three quarters

Table 3. Internet-related investments as share of total venture investments†

1995	1996	1997	1998	1999*
4%	14%	18%	25%	51%

† Internet-related investments are responsible for the boom.
* The first three-quarters of 1999.

Table 4. Percent of investments in Internet-related businesses at formative stage (1995–1999)

Internet-related companies	Non-Internet-related companies
53%	28%

of 1999. The data indicate that we are truly in the midst of an Internet-related boom in venture capital investment activity.

The MoneyTree Survey also indicates that there are a number of differences between venture investments in Internet-related and non-Internet-related businesses. The first difference concerns the *timing* of the venture investment. Venture investments in Internet-related businesses appear much more concentrated in the formative stages of the company than venture investments in non-Internet-related businesses. Table 4 indicates that 53% of venture investments in Internet-related firms from 1995 through to 1999 were *formative stage* investments, i.e. investments made in the company's seed, start-up or early stage of financing. This compares with only 28% of venture investments in non-Internet-related firms being formative-stage investments. There are plausible reasons for this difference: the life cycle of Internet-related firms from seed stage to IPO appears to be much shorter than non-Internet-related companies, meaning that venture capitalists have greater incentives to make their investments in such companies earlier than in other companies.

Another difference is the explosion in the *size* of the average Internet deal over the past 5 years. Table 5 indicates that the size of the average Internet deal has more than tripled since 1995, while the size of the average non-Internet-related deal has increased by only about 60%. In 1999, the average Internet-related deal was $9.6 billion compared to $6.4 billion for an average non-Internet-related deal.

One question of interest regarding venture investments in the Internet is the composition of investments between different types of Internet-related firms. Table 6 indicates that the biggest beneficiaries of the Internet-related venture capital investment boom have been service providers. Service providers received almost $3 billion in the first three quarters of 1999, compared to about $300 million in 1995. Compared to service providers, software, access and particularly content providers have lagged behind.

Table 5. The average size of Internet-related deals ($ millions)

	Internet-related	Non-Internet-related
1995	$2.7	$4.0
1996	$3.6	$4.0
1997	$4.3	$4.0
1998	$5.5	$4.9
1999*	$9.6	$6.4

* The first three-quarters of 1999.

Table 6. Investments in Internet services companies ($ millions)

	1996	1997	1998	1999*
Content	$92	$150	$255	$652
Access	$253	$534	$754	$1018
Software	$444	$795	$927	$1060
Services	$324	$631	$1571	$2909

* The first three-quarters of 1999.

Angel Investments in Internet-Related Companies

The market for angel capital—where individuals provide risk capital directly to small, private, often start-up firms—operates in almost total obscurity. Very little is known about the market's size, scope, the type of firms that raise angel capital, and the types of individuals that provide it.[4]

An angel investor is a provider of risk capital to small, private firms. By risk capital, I mean equity capital (or near equity capital such as loans or loan guarantees provided by investors that also have an equity position in the firm). The provider is a wealthy individual, not an intermediary such as a venture capital limited partnership. Such individuals are, in addition, not in the top management of the firm to which they provide capital, nor are they employees of the firm or in the immediate family of a member of management or an employee. Angels are 'arms-length' investors in the firm. Indeed, angels are often perceived as the second round of financing a start-up goes through, after the entrepreneur has exhausted all his family and friends money, but before he approaches formal venture capital partnerships. Angels often (but not always) have entrepreneurial backgrounds and tend to invest in start-ups and other small, closely held companies.

Some estimates of the size of the angel market suggest that it is roughly equivalent to the size of the formal venture capital market. For example, Freear *et al.*[5] claim that between $10 and $20 billion is invested by angels each year in as many as 30,000 firms. While there is clearly a great deal of uncertainty about the precise size of the angel market, if we compare this range to the size of the venture

Table 7. Importance of angel investors versus formal venture capitalists among high-tech firms*

Angel only	20%
Both angel & VC	36%
VC only	38%
Neither angel nor VC	6%

Source: Fenn, Liang and Prowse (1998).
* Percent of 107 high-tech firms receiving capital from angels and/or venture capitalists.

capital market in 1998 and 1999 according to the MoneyTree Survey ($14 billion in 1998, and perhaps around $25 billion in 1999), the two markets appear roughly equivalent in terms of total annual investments made.

A recent empirical study suggests that angels are also important sources of finance for *high-tech firms*. In Fenn *et al.* we collected information from 107 initial public offerings in the period 1991–93 in two high-tech industries: computer software and medical equipment.[6] Table 7 indicates that of our 107 high-tech firms, 56% raised external equity capital from angel investors before going public.[7] About 20% of the sample (23 firms) raised equity *only* from angels, while an additional one-third (36 firms) raised equity from angels *and* venture capitalists. Thus while venture capital is more frequent it appears that angels clearly play an important role in financing the firms in our sample. These results support the notion that angels are important suppliers of capital to start-up firms.

While there is little systematic analysis of the characteristics of angel investors, some broad generalizations can be made.[8] First, angel investors are typically wealthy ex-entrepreneurs who prefer to invest in their own areas of expertise. They also prefer to invest earlier in the company's life cycle (at the seed or start-up stage) than do venture capitalists. Angels find their deals by relying on an informal network of friends, relatives and business associates. These characteristics of angels (particularly the first two) suggest that angels might be important investors in Internet-related companies, because there are currently a lot of wealthy ex-entrepreneurs with an Internet-related background that may have a strong interest in investing in Internet-related firms in an early stage of the company's life.

Conclusion

We are in the midst of an Internet-related private equity investment boom. The capacity of the boom to sustain itself may depend in part on the continuing appearance of wealthy ex-entrepreneurs with Internet backgrounds who are willing to make angel investments in Internet-related start-ups. It will also depend in part on returns to Internet investments to continue to attract the interest and the capital of venture capitalists. In this regard, the ability of Internet-related companies to continue to expand into new areas will be crucial as competition in existing areas is likely to be fierce.

Notes and References

1. This paper was presented at a CITI, Columbia University Business School Conference on Venture Capital in New Media (December 1999) organized by Darcy Gerbargh.
2. For more information on the MoneyTree Survey, visit PricewaterhouseCoopers' MoneyTree Survey website at www.pwcmoneytree.com.
3. See G. Fenn, N. Liang and S. Prowse, 'The private equity market: an overview', *Financial Markets, Institutions and Instruments*, 6, 4, 1997, pp. 1–106.
4. Although see S. Prowse, 'Angel investors and the market for angel investments', *Journal of Banking and Finance*, 22, 1996, pp. 785–92; S. Prowse, 'The private equity market: an overview', *Federal Reserve Bank of Kansas City Economic Review*, Third Quarter, 1998, pp. 21–34; and J. Freear, S. Sohl and W. Wetzel, *Creating New Capital Markets for Emerging Ventures*, unpublished manuscript, University of New Hampshire, Durham, NH, 1996.
5. *Ibid.*
6. See G. Fenn, N. Liang and S. Prowse, *The Role of Angel Investors in Financing High-Tech Start-Ups*, unpublished working paper. For each company we collected data on the identity of its

shareholders just prior to the IPO, how many were formal venture capitalists and angel investors, what their equity stakes were in the firm just prior to the IPO, whether they sat on the Board of Directors and whether they had any other relationship with the firm. In addition we collected data on the firm's size, location, age, R&D expenditures and the primary security issued by the company (preferred stock, common stock, or debt).

7. Our definition of an angel investor is any individual that acquires an equity stake primarily in consideration for capital contributions to the company, excluding past and present employees of the company or their relatives.
8. These are largely taken from Prowse, *op. cit.*, 1996, 1998.