When VCs Won't Budge, 'Mentor Capitalists' Step In

Tal Golan knew he invented potentially game-changing technology in the fight against spam. Proving that to investors was a different story.

While venture capitalists in 2003 were intrigued by Golan's product - a hardware box that checks for spam before the message reaches corporate email servers - they kept telling him the same thing: he lacked the right pedigree for an investment.

"I didn't have the right degree, I didn't work for five years at Cisco and Oracle, then start up three companies," said Golan, who previously founded a small software development and consulting firm. "The reality is that VCs invest in people first, second and third, then the technology."

Undeterred, Golan operated out of his garage in Costa Mesa, Calif., for three years and invested roughly $750,000 in his company, Sendio Inc., by maxing out credit cards and refinancing his mortgage, betting the financial security of his wife and young children. By late 2005, the device was selling but it was clear he needed to take his business to the next level. That's when he linked up with Momentum Venture Management LLC, an unconventional firm that promised to give him the credibility needed to court VCs.

Matt Ridenour and Andy Wilson, veteran start-up executives, incorporated Momentum in late 2004 to work full-time with a company's founders to shape their business plan, find credible management, finish a product and gain customers - a process that typically takes them about nine months to complete. At that point, they shop the company to VCs with hopes of securing a $4 million to $5 million Series A round.

Momentum is one of several firms that have cropped up in recent years to fill a funding void left by VC firms shifting their investments downstream and bypassing the traditional guy in a garage. This has left many unseasoned entrepreneurs like Golan to fend for themselves to bring intelligent ideas to fruition. But it's also opening up an opportunity for smaller firms willing to take on higher risk and lend more credibility than traditional angels.

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"If you're an entrepreneur, seed and Series A deals are really tough to get right now," said Beau Laskey, a managing director at Burbank, Calif.-based early-stage firm Steamboat Ventures. "Venture firms are looking for customers and traction."

The 'Mentor Capitalist'

Last year, Dave Whorton, a former partner at TPG Ventures and associate partner at Kleiner Perkins Caufield & Byers, rounded up $50 million from institutional investors to create a fund that starts with an entrepreneur's raw business plan, which most venture capitalists welcomed before the technology-stock crash in 2000.

"There's a tremendous amount of entrepreneurship today, but there aren't a lot of investors who can get involved really early on," said Whorton, managing director of Menlo Park, Calif.-based Tugboat Ventures. "Funds have just gotten so large, and many venture capitalists don't have the time or energy to get their hands dirty early in the process."

Whorton prefers to call himself a "mentor capitalist," someone who "bolts themselves" to the entrepreneur to "get under the young company's skin." Tugboat, currently managed by just Whorton, invests a little bit of money into the start-up - as little as $50,000 to $100,000 to keep the business running with the hopes of big things down the road.

Whorton served as a founding chief executive of mobile email company Good Technology Inc. before last year's acquisition by Motorola Inc. and co-founded now-public Internet pharmacy Drugstore.com Inc., which he helped incubate while at Kleiner

Perkins. He takes the experience he gained and applies it to his portfolio companies, which are currently in stealth mode, and serves as an advisor and board member. But he stresses he's not interested in an operating role with the company.

Other firms, like Y Combinator, act more like incubators, paying a start-up's expenses while helping it build a prototype and pitch to investors and acquirers. Mountain View, Calif.-based Y Combinator selects several start-ups each summer and winter and houses them for at least three months. About ten weeks in, it hosts an investor day where start-ups pitch their wares to potential investors. Y Combinator typically invests a few thousand dollars in return for a 2% to 10% stake.

Nine Months Of Nurturing

But Los Angeles-based Momentum takes it several steps further with a distinctive model that dedicates far more time than a typical angel or seed-stage investor while assuming considerable risk. Momentum first spends about six weeks - usually for a fee of less than $20,000 - validating a business plan, confirming the chemistry with the founding team and completing due diligence before committing to the start-up. Upon approval, one of three Momentum partners then installs himself as the CEO, moving the founder to the chief technology officer role and eventually bringing on a new CEO months later. At some point during the process, Momentum provides a bridge loan - typically $250,000 to $500,000 from a small bridge fund pooled from wealthy individuals - to keep the company going, all for a 'nominal' monthly stipend.

"We're solving an intractable problem in the early-stage business ecosystem," Momentum Managing Director Wilson said. "Entrepreneurs are often stuck in that vicious business cycle of needing money to recruit business talent, build a product and attract customers, yet they can't raise the money unless they have those pieces in place."

Typically a Momentum partner works with two companies at a time, spending half of his time on each, with an operating associate subbing in the other half as a project manager and director of operations. Momentum's ultimate goal is to deliver the company to venture capitalists and secure that first round of capital, when the firm's bridge investment converts, often at a discount, into Series A preferred stock. It's at this point the firm gets paid for its work after having deferred the majority of its management fees during the previous nine months.

Long-time venture capitalist Lou Volpe, a managing general partner at Waltham, Mass.-based Kodiak Venture Partners, believes Momentum's model is unique and would consider investing in a start-up seeded this way, but questions the firm's scalability. "Whipping a company into shape, enforcing operating discipline and building an executive team takes a lot of energy and time," Volpe said. "These guys are going to be limited with their scale."

So far the firm has taken all seven of its start-ups to the Series A level, focusing on Los Angeles-area technology companies that require less than $10 million in funding to break even on a cash-flow basis. The seven have raised a total of $30 million in Series A funding from venture capitalists. The firm had its first exit in 2006 when Discovery Communications Inc. acquired Academy123 Inc., which had raised a $5 million Series A round the year after Momentum brought the company to venture firms Arcturus Capital and Hanseatic Group.

In the case of entrepreneur Golan, it took about 10 months to get Sendio through the Momentum-coached process and into the hands of VC investor Kline Hawkes & Co., which provided $4 million in Series A capital in October 2006. Sendio now has about 275 customers, and earlier this year projected to have 1,500 customers and sell $7.8 million worth of product by the end of 2007.

Before linking up with Momentum, Golan said he pitched his plan to angel coalitions, but found them unwieldy as investors. "You have to make like 100 presentations to 100 guys and the only thing that qualifies them is money," Golan said. "It's kind of like 'American Idol,' you make the pitch, move on to the next round, and try to get 10 people to agree on everything. I'd rather take the risk on the credit card than have to deal with angels."

Klaus Koch, a Kline Hawkes investor who led the firm's investment in Sendio, said a firm like Momentum is especially beneficial to VCs because it's bringing only companies with proven business models and customers.

"Momentum comes in and takes out the significant risk," Koch said. "They're pitching us with all the information we need and cleaning up the legal issues. They really understand what a VC wants, and for a firm like us that manages $270 million, that's very valuable."

By Scott Austin
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