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VCs Change Their Tune

By DIANA RANSOM

The pressure of the recession hasn't been all bad. It's forced many small businesses across the country to reinvent themselves by developing new revenue streams and strategies to cope with dwindling resources.

The venture-capital firms that support those businesses have also had to make adjustments. Just as small retailers have had to devise new ways to pinpoint customers willing to spend but also able to pay, VC firms have had to seek out entrepreneurs ambitious enough to try starting a business in this environment but also smart enough to manage their risk.

The challenge has been formidable. Faced with a near-frozen market for initial public offerings and few mergers or acquisitions, many venture-capital firms have thrown more of their resources behind only their portfolios of existing businesses. Some have ceased investing altogether. In fact, 64 of the 721 U.S. venture-capital firms that invested in companies between Oct. 1, 2007 and Sept. 30, 2008 haven't made an investment since then, according to according to Dow Jones VentureSource, a research firm owned by News Corp., which also publishes SmartMoney.com and The Wall Street Journal.

It's difficult to judge how many VC firms will shutter due to the rocky economy because it takes time for those firms to officially close their doors, says Emily Mendell, a spokeswoman for the National Venture Capital Association. However, anecdotal evidence suggests closures are underway, says Joe Rubin, a director at the FundingPost, a networking group for venture capitalists and entrepreneurs in Stratford, Conn. "We're also seeing the 'walking dead,'" says Rubin, referring to firms that are in business but lack the cash to attract new investments. "They will not raise their next fund, and, eventually, they'll close their doors," he says.

To stave off a shutdown, a handful of venture-capital firms are changing their models. Some are carving out new, more liquid niches. Others are seeking out smaller companies to invest in or restructuring their broader investment strategies.

Here are three VC firms that are changing the way they do business:

Firm: LaunchCapital
Location: Cambridge, Mass.
Fund Size: Would not disclose total fund size. Invests $6 million a year; $3 million goes to its new small business division.

Investing millions (or billions) in biotechnology and clean-tech firms is standard practice at many traditional venture capital firms. LaunchCapital, a VC fund based in Cambridge, Mass., has set its sights on humbler targets. The seed-stage, industry-agnostic firm recently developed a debt-financing division, LaunchCapital Small Business, aimed at helping community-based start-ups get off the ground.

"A year ago, our financial backers recognized that the current VC model needs some refining." says Elon S. Boms, the founder and managing director of LaunchCapital. "They asked us to think about innovating LaunchCapital and expanding into small businesses."

Under the new program, LaunchCapital makes three-year, non-recourse loans available to start-ups worth up to $150,000. Companies have three years to repay those funds at a rate of 10% to 14%. They'll also owe a 2% to 15% cut of the company's free cash flow. LaunchCaptial Small Business has issued funding for just three businesses in the Boston area so far. However, it plans to expand into five U.S. cities over the next two years — making three to five investments per city, per year.

Firm: Liquidity Works
Location: New York
Fund Size: $25 million

Kyle Harris, the managing director of Liquidity Works, understands that customers make a business successful. And although his New York-based early-stage fund won't invest in a company unless it has lassoed at least one big customer, he will help you do some wrangling.

Unlike traditional VCs that may shepherd a business through multiple stages of development, Liquidity Works invests in companies that have products in hand, Harris says. "Rather than sink a lot of marketing dollars helping new companies drum up customers, we bring them a $10 million customer and then start investing."

From there, Liquidity Works invests by buying equity or debt or it takes a commission. Which method it chooses depends on the company and the schedule for repayment. "With the credit market shrinking up, we changed to a revenue model that doesn't require as much passive investment," Harris says. Plus, "we don't have the dilutive effect that the third round often has," he says. "We're adding value."

Firm: Vested for Growth
Location: Concord, N.H.
Fund Size: $5 million

Vested for Growth doesn't require companies that receive its funding to give up an equity stake — as typical VC firms do — nor are those companies obliged to offer up collateral. Rather, they must fork over 0.25% to 4% of gross sales for a period of three to five years. That royalty will vary depending on pricing, a deal's risk and the size of the sale, says John Hamilton, the Concord, N.H.-based fund's managing director. "Our niche is to focus on bringing growth capital to established businesses — a segment of the economy that's often missed by traditional venture capital," says Hamilton. The fund is open only to New Hampshire-based businesses that have been around for 10 to 15 years, have $2 million to $20 million in annual sales, 10 to 200 employees and gross profit margins of 25% or higher. Although Vested for Growth has invested between $100,000 and $500,000 in nine companies since 2003, Hamilton says the fund plans to ramp up its investments.

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