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Tech 'seed' investors kick valuations into long grass

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Investors who put up the early "seed" capital for technology start-ups in the US have come up with a novel idea for how to value businesses that in most cases have not started trading: put the issue off until later.

So-called "angels", the wealthy private investors who generally invest amounts of less than $1m to help new businesses get off the ground, have in many instances moved over to making convertible loans rather than taking equity, according to both entrepreneurs and investors.

The loans convert to equity if companies go on to raise later rounds of capital, with the conversion rate linked to the value put on the business by the later round. "It's becoming the standard model," said Frederik Flek, a serial entrepreneur who has raised amounts of between $250,000 and $500,000 from angel investors in the past.

Matt MacInnis, a former **Apple** marketing executive who set up his own company a year ago to create software to enhance standard textbooks for Apple's iPad, says the approach helps resolve a key issue: "How do you value a company that is only three weeks old?"

Deferring the question of what his business, called Inkling, was worth reduced the haggling with investors at the outset, he added.

As compensation for taking greater risk, angels typically receive a 25 per cent discount to the valuation put on a business by its next round of fundraising, though some entrepreneurs have been able to negotiate that down to 20 per cent, Valley insiders say.

Ron Conway, one of Silicon Valley's best-known angels, said that the use of convertible loans had become "very acceptable", in large part because of valuation caps that limit the profit that angels can make if a company's value is deemed to rise quickly. The caps are set at what he called "something reasonable – between $3m and $5m, usually".

Entrepreneurs seldom have power to negotiate the level of caps, which are set at a "default valuation", said Mr MacInnis, though he added that his own business was eventually valued at "many millions more" than its cap when it brought in its first round of venture capital last month.

The convertible loans do not give investors any downside protection if start-ups fail. But they accrue interest at rates of 6-8 per cent, payable when they convert to equity.