Startups as an investment asset class

Mr. Sanjay Mehta
sanjay@mehtaventures.co

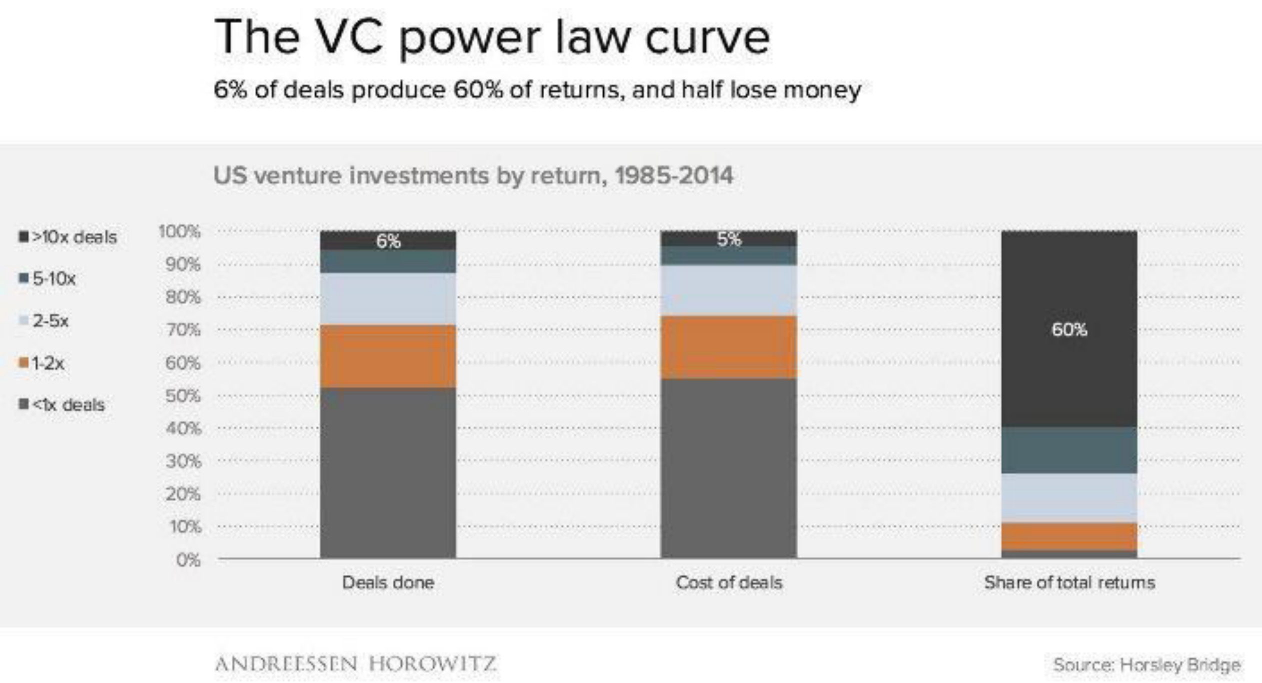
Funding startups is glamorous, but the big question is how much returns it can generate as an investment asset class.

Start-ups are young emerging companies working on breakthrough innovations that would fill the need gap or eradicate existing complexities in the ecosystem. These companies are in constant endeavor for new development & research new markets. They have agility embedded in their inventive thinking. Angel investor funds a startup for several reasons but the first & foremost reason is that they believe in that idea, project or passion. They want to the make the entrepreneur start-up successful with help of disposable capital available at their end. Investing in startups is more an art less of science - it isn't meant for everyone, is subjective. There is no method to this madness nor a defined college degree to help you learn venture investing. Every deal, experience and strategy shared in public domain is anecdotal. **Angel investor provides capital for small entrepreneurs but are not in money lending or financing business.** The finance they provide is for that first round of seed capital to make the idea vision in a reality. Entrepreneurs can also find angel investors in its family and friends who will support them with capital on terms favoring entrepreneur. Angels risk their money in people, team & idea which are fragile in nature. Hence it is called as risk capital investment.

Angels are individuals who are with good successful background, their names evoke trust in minds of customer or future investors. They back the Start-up by associating their name which provided entrepreneurs required creditworthiness in market.

Why I love startups as an asset class for investment is because I can offer my time besides capital. In other investments like public equities or real estate I can't influence an outcome. **Venture investing is a people business** so if you like meeting, working & helping people then your chance of success are very high. With early stage startups as their lead investor I work closely with founders to create a positive outcome. So before beginning a discourse on the merits and demerits of investing in startups, let's first understand investing in startups from the bottom up.

What is investing? It is the process of putting money into various physical or abstracted assets with the expectation of making a profit. One can expect to make a profit on the money invested by seeing an increase in the value of the asset - whether real or perceived - and selling off the asset at the increased value. When you invest in a company - public or private - you invest in the asset that is the company itself; you get a part of the ownership of the company. As the value of the company increases, so does the profit you can make by selling off your stake. A key difference between investing in public companies and private ones like startups is that in public companies, selling off your stake is much easier and near instantaneous. The same cannot be said about private investments - hence it is one of the most illiquid asset classes. It can give you huge profits, but those profits will be only on paper for the most part as realizing an exit takes a lot of time. **It is an illiquid investment**



One basic fundament that every early stage investor should know is that startups follow the law of power - a small percent of the startups you invest in will give you the majority of your profits. Take for example Andreseen Horowitz's portfolio. They're one of the top VC firms - and about 60% of their returns comes from about 6% of their deals. What does this tell us? It means to truly make a profit from startup investments, one should be able to access that 6% of deals. The rest of your investments may or may not materialise significant returns for you - but that 6% of your portfolio is where the return is. If you invest in few startups it's like buying lottery; it's the portfolio approach which helps the early stage investor create mega returns.

Having given this background, let us come to the question at hand - "Are startups a good investment?" Startups are high risk high return investments which follow the power law. It is not about the number of hits you have, but the magnitude of those hits. That's where we find the answer to our question. The wealth creation opportunity that startup investments provide is nearly unparalleled. But it is also extremely risky, and conditional. So when are startups good investments?

It is a good idea to invest in startups when one has the appetite and the capacity for the high risk involved. Investor with mission to give first, help founders and build business will win this game. One must be capable of creating a significantly sized portfolio of investments in the hope that some of the investments are part of the 6% and give one huge return. One can create a startup portfolio by investing about 5 - 10% of their total investment capacity in such an illiquid asset class. It is worth noting that the money invested here must be thought of as a sunk cost - until and unless an exit is realised. The investors must be able to stay patient with their capital - the best companies can give returns after 10 years.

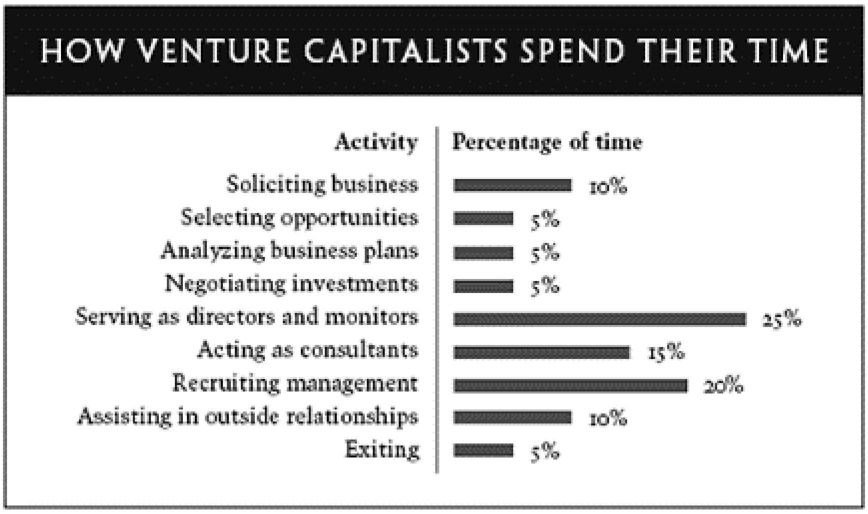
The toughest part of investing in startups is gaining access to the top tier of deals that can give you the huge hits. When one has access to those 6% of deals, it is a great idea to invest in startups. One cannot ascertain at the get go if a particular investment will provide the returns you hope - but one can invest in startups that can give unparalleled returns you hope for if they work out. To gain access to the top startups, one has to put in time and effort to become a part of the startup ecosystem, become a part of various investor networks, and collaborating with other lead investors and VC firms.

Startup Investments can provide disproportionate wealth creation opportunities. Before investing in startups, every investor should ask themselves - Am I ready to take on the capital risk? Do I have the required time & effort to build a portfolio? And last but not the least - Do I have the patience to wait for the disproportionate return?

Investing in early stage companies is about capturing the value between the startup phase and the public company phase.

About the author

Private Investor, Mehta Ventures-Family Office Investments, Director Rainmaker360, Startup, Estate, Crypto, CORE-Media. Awarded Angel Investor Of The Year 2017 by Let'sVenture. Investor in Block.one EOS decentralized platform & societal infrastructure for deploying smart contracts. More at https://www.linkedin.com/in/mehta-sanjay/



Source & Courtesy: https://hbr.org/1998/11/how-venture-capital-works