Navigating early-stage investment

With low startup costs and the latest web technologies at their fingertips, it's easy to see why the online world appeals to entrepreneurs. But what do investors think — can local online ventures attract the capital they need? By **Vikki Bland**

WHEN ONLINE ventures make it big they really make it big, casting hope into the hearts of scores of fledgling online entrepreneurs and their accountants. And at first glance, it all seems so simple: find a really bright idea for an online product or service, develop it, build a website, get it hosted, market it and then wait for the investors and dollars to roll in. It worked for Trade Me, right — and Google and Amazon, and all those social networking sites started by US college students?

However, business consultants and investors say while New Zealand online entrepreneurs often know the 'whats and whens' of successful online businesses, few understand the 'hows and whys'. As a result, New Zealand venture capitalists, incubator groups and even emerging angel investor organisations are decidedly lukewarm about investing in locally developed online ventures.

Mark Robotham, general manager of New Zealand Trade and Enterprise programme Escalator — which provides needs assessments and up to $25,000 worth of professional services to help qualifying businesses secure further investment funding — says while 350 businesses a year apply for the programme and around 200 qualify, an online venture has yet to impress.

"We see a couple of online companies a month; most not investable propositions. Typically, they have no business model or they plan to rely purely on advertising to generate revenue from the website. In many cases people have invested too much money and the valuation of the company is nowhere near what they've spent on it," says Robotham.

He says investors are mainly interested in looking at established online businesses that can display a set of accounts and proven returns. Concept-only online ventures rarely realise investment unless there are extraordinary circumstances; such as the involvement of specific people with a proven track record of launching successful online or IT ventures. One example is AfterMail founder Rod Drury, now CEO of online accounting software company Xero and a member of the Trade Me Advisory Board. AfterMail was acquired by Quest Software for US$65 million in January 2006 and Drury has attracted Trade Me founder Sam Morgan to the Xero board, increasing investor comfort in the new online business.

However, while having proven names at the helm of an online business are obviously a bonus, it's not a prerequisite. Darren White, a director for business advisors Ernst & Young, says local venture capitalists and investors are savvy about how the online world works and realise a compelling business proposition when they see one. Put another way: if the Google search technology and online business proposition had been developed here, White says there would have been local investors savvy enough to realise the potential of what they were looking at.

Which is exactly how online giant Google got going: an IT industry executive and friend of the founders saw the potential of the technology developed by college students Larry Page and Sergey Brin and wrote the pair a cheque for US$100,000, even before the business was legally incorporated. White says because New Zealand has a limited number of sole investors willing to plough $100,000 into an online venture, like-minded investors would do well to band together to consider funding online ventures with strong value propositions; and online entrepreneurs would benefit from doing the same thing to avoid the common problem of idea overlap.

"We seem to have a lack of investment capital in New Zealand, so that even when an investment deal is successful it may end up being a very conservative deal with a lot of checks and balances," says White. "As an adviser you also see various online ventures that overlap with online ventures being run in another part of the country — there needs to be an aggregation and consolidation of online startups because there's just not enough space for everybody. And investors can bring seemingly disparate companies together when they see a connection."

While there is a sense that online businesses focused only on the New Zealand market have a limited shelf-life and limited opportunity for return ("If Ferrit.com backed by Telecom struggles, then you can only wonder what a small startup company has to face," says White), Trade Me is the obvious and puzzling exception, suggesting online success is as much about gut instinct and understanding the psychology of targeted online users as it is about developing an online value proposition.

White says Trade Me's success suggests online investors and business advisors may have underestimated the revenue potential of locally targeted and marketed online businesses.

"The overriding comment we get from investors is that they're looking for an online product or service able to attract a global market, and logic would suggest the internet lends itself to generating global revenue. But we perhaps haven't gone far enough down the track of being able to analyse whether a local online business lends itself to being a global opportunity — the founders of hugely successful social networking sites like Facebook.com initially wouldn't have had a plan that even went beyond their own city," he says.

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Careful perusal

The *Field of Dreams* scenario of "build it and they will come" is certainly a naïve approach for would-be online entrepreneurs, yet consultants say that while international startups absolutely 'get' the need for extensive market research, online trials and think-tanks with independent advisers, those behind New Zealand's online startups think the idea alone should carry the day. Pradeep Raman, director for fledgling online recruitment site Anonymouse.co.nz, says the New Zealand online market is immature compared with that in other countries; too many startups lack solid value propositions; and the recent sale of Trade Me has made people think online success is easy.

"People spend a lot of money on marketing their sites and then they get no traffic and the sites just disappear. Entrepreneurs get an idea in their mind and they feel it's a great idea, but they don't run any pilot trials and think surveys are bullshit. Online ventures need to start with a good market validation phase," says Raman.

He knows what he's talking about. In New Zealand since 1996, Raman founded his first online business venture — a recruitment service called Myskillpool.com — with partner Swati Sharma and took the idea to the TV show *Dragons' Den* in the hope of attracting funding

Raman says 'dragon' and Slingshot co-founder Annette Presley saw the potential of the idea, but told Raman it needed "sharpening". Raman went away without dragon funding and sharpened, investing $80,000 of his own money in the process. The result won Raman and Sharma the 2006 University of Auckland's Spark Entrepreneurship Challenge, which included $20,000 in seed funding and a nine-month tenancy at the Icehouse, a business incubator, worth $10,000. Now called Anonymouse.co.nz, the new online venture was launched in August and offers job seekers a place to list their credentials anonymously. It charges employers an annual subscription of $300 to respond to unlimited numbers of job seekers with expressions of interest.

Following the path of internationally successful online ventures that understand the importance of partnering, mergers and acquisitions in determining online survival, Raman approached the Employers and Manufacturers Association (EMA), pointing out the synergies between his online venture and the role of the EMA as an employer advisor. When Anonymouse.co.nz launched in August this year it was in partnership with the EMA, which attracted around 900 employers to the service, putting them in touch with more than 600 job seekers and resulting in five permanent placements from 60 contacts to date.

It's a small but determined start, and Raman says he's patient — something else he's learned from watching international online giants like Amazon.com (which famously told early stakeholders it would take five years to reach profitability and actually took seven). He says profitability will take between three and four years and further investment is likely to come from established recruitment companies that want to extend their web presence as well as from investors who are not industry-related. Echoing White, Raman says the latter group is a pretty savvy lot, which is more than can be said for the average online entrepreneurs.

"Investors do understand a lot of stuff about the online market that entrepreneurs unfortunately don't. They know what's required and I have hard questions asked of me and have been grilled by investors who expect amazing stuff."

Robotham of Escalator says smart online investors understand the technology an online business is built on; see market demand for the product or service; and understand how to analyse web metrics — such as the number of unique browser visits per day.

Start spreading the news

The good news for investors and online entrepreneurs alike is that international research suggests any solid online business model will be bolstered by a sudden surge in global online advertising. Independent researcher Budde Communications recently released a study called *2007 Global Internet*, which analyses online trends and developments, as well as emerging business models and the online advertising medium. According to the study, the demand for continually developing online content and services is high and is being driven by global online media giants like Google, News Corp and Yahoo. As a result, the study estimates more than US$2 billion will be spent on advertising on social networking sites alone in the US by 2010, with travel-related services, gambling, adult content, online music and health services also popular.

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Interactive 'Web 2.0' technologies are also good news for the online sector, with Instant Messaging, Peer-to-Peer information sharing services, RSS feeds for news and information and new revenue streams from new advertising models such as pay-per-click ramping up online income and grabbing the attention of investors and the financial services market. A further factor contributing to online revenues and investment is global improvements to home broadband connections throughout developed countries.

Kylie Wansink, Budde's senior analyst of global markets, says the Googles and Yahoos of the online world have quickly taken advantage of the extra speed and capacity of broadband infrastructure with video applications taking centre stage on the web. She says, this year, internet advertising expenditure is forecast to top US$31 billion worldwide, up from US$24.4 billion last year. That's 7% of overall ad spending across all media, up from 5.8% of the total in 2006. And in 2008, internet advertising spending will account for nearly 8% of all spending, with online payment gateways, such as PayPal, doing their bit by providing a simple way for consumers to pay for goods and services online.

There's definitely a train to catch and by all accounts local investors and incubator organisations are more than capable of driving it. The challenge now is for online entrepreneurs to equip themselves for the journey and learn a little more about the landscape they will encounter along the way. ■