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Bridge Fund's Aim Is To Get Cash to Cos.

FINANCE: Funding's Focus Is New Crowdfunding Option

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San Diego — New federal regulations that went into effect earlier this year have loosened the rules around how startups seeking capital can leverage individuals' interest in supporting new enterprises — and some local businesspeople are positioning themselves to benefit.

The changes, intended to make it easier for private companies to raise money from individuals, were part of a bipartisan bill called the JOBS Act, for Jump-Start Our Business Start-Ups, signed into law by President Barack Obama in 2012.

The U.S. Securities and Exchange Commission, as mandated by Title IV of the bill, adopted rules last year to allow smaller companies in the U.S. or Canada to raise as much as $50 million in a 12-month period, up from $5 million.

Within those rules, often referred to as Regulation A+, are two paths: Tier 1, which allows up to $20 million annually to be raised, and Tier 2, which OKs up to $50 million.

But it's not just companies that could potentially benefit from equity crowdfunding.

Gaining Access

Under the JOBS Act, the public can now join the ranks of investors, putting in up to $100,000 in a 12-month period in companies that go the Tier 2 route, depending on the investor's net income or net worth.

Accredited investors must have earned $200,000 per year for at least two years in a row (or $300,000, for joint income) or have at least $1 million net worth, excluding the value of their home.

While the pool of potential investors for earlier stage companies and small businesses is now bigger, companies still have to pony up funds to complete the documentation required by the SEC.

Alexander Pellegrino, a partner in North Park-based hard money lender Sequoian Investments, is partnering with Serenity Venture Partners managing director David Metzler to create a "venture bridge fund."

Pellegrino estimates that a company pursing a Reg A+ offering will need about $400,000 to cover costs for marketing, legal and auditing services.

Missed Opportunity

Meztler, an investment banker who has started a number of businesses including an unsuccessful competitor to fitness membership company ClassPass called Wildfire Life, said his entrepreneurial struggles spurred his interest in helping new companies pull in cash.

Last year, promised funding for Wildfire from a private equity group failed to materialize, forcing the company's closure, he said. Had equity crowdfunding been allowed at the time, Metzler said he would have gone that route.

Serenity, founded in 2007, is a family office investment fund and boutique consultancy that has raised more than $30 million in angel, venture and strategic capital, according to Metzler.

By year's end, the firm plans to close a venture fund — at the moment backed mostly by Pellegrino — that will specialize in Reg A+ companies. Metzler said they plan to make 45 investments of $100,000 to $500,000 over the next three years.

"I've been early on nearly every trend," Metzler said.

But this time, he believes the timing is right.

"No one has created a fund like this yet," he said.

Pluses, Minuses to New Model

San Diego State University finance lecturer Seth Kaplowitz, a proponent of crowdfunding, said companies who go that route may maintain more control of what they have created.

"Crowdfunding gives a person who creates a business an opportunity to hold on to it for longer," he said. "When you go for venture capital, they tend to take very huge percentages and dictate how you do things."

Rules established by the SEC barring all but the wealthy from investing in early-stage companies are intended to ensure those with fewer funds or little investing experience don't lose everything.

That's a chance unaccredited investors can now take via crowdfunding.

"(Regulators) basically leave it to the theory that you know what you have and you know what you could afford to risk," Kaplowitz said. "You're grownups: handle yourselves accordingly."

A local venture capitalist, however, said he has mixed feelings about the new rules.

"It is very good for little companies, great for institutional investors, but it shifts risk to a group of people who are not trained to identify that risk," said Jay Lichter, head of San Diego venture studio Avalon Ventures.

Some aspects of the JOBS Act, such as the ability for companies to file a confidential draft registration statement for SEC review before going public, as well as the opportunity to reach out to potential investors to gauge interest prior to filing via "test the waters" communications, have been a boon to companies and investors, he said.

However, when it comes to allowing more people to invest their money, "people need to understand it's very, very tricky picking winners and losers," Lichter said. "There are many professionals out there that are certainly not batting 1000."

Inexperienced investors may not understand they stand a "reasonable chance" of losing their money, he said.

A Red Flag

"Frankly, I think there is going to be people who invest who don't have the ability or the network or expertise to determine whether or not there's a probability of success for these companies," Lichter said.

Further, if companies have struggled to raise capital from traditional sources, that is a red flag, he said.

"There's a lot of cash in the system right now," he said. "If a quality company goes out and runs Sand Hill Road and can't raise venture, maybe there's a good reason."

And companies who raise capital this way may also struggle in subsequent efforts to raise capital, Lichter said.

However, Timothy Trombley, an assistant professor of finance at San Diego State University whose primary research focus is venture capital, said the new rules have opened the door for companies unable to attract VC or private equity firms, not due to poor quality, but because they aren’t promising big enough returns.

“The first thing a VC will frequently do when they look at a company’s business plan is, the stereotype goes, look at the back page and see if they find a big number, and if they don’t, throw it in the trash,” he said. “People who invest their money this way aren’t looking at this as a way to get rich.”