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Novatorque's Rough Road Offers Lessons for VCS

by: Sean Foote, Labrador Ventures – April, 2007

Because motors are so outside of our domain of expertise, companies like Novatorque get penalized for being unique.

Sean Foote

As seen in the...

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Normally a company not getting funded by VCs isn't really news. At least not to us. But what if the company is in cleantech, literally the hottest investment technology on the planet, and has proven technology, a strong management team and checks the boxes of all the other "usual suspects" required for investment? It should at least be able to find some small amount of funding, somewhere, especially in the heavily over-funded world of venture capital.

This is the world of Novatorque. The motor (yes, motors!) technology company has been at it for three years. The founders have put in $3 million of their own money, the company was officially incorporated one and a half years ago, and John Petro, Novatorque's CEO, has been hard at work trying to raise money for the past nine months. And the results? Zip. Nothing. Nada. At least not yet.

It hasn't been for a lack of trying. Petro has met with lots and lots of VCs. But the answer has still been the same – pass! – even if the reasons have been all over the map: too early, too different, too expensive, too risky, too little upside, too much downside, too new, too old. The real reasons, however, may lie in the unique psychology of seed and early stage investors.

Would you rather be sexy or rich?

The first and perhaps most glaring problem with Novatorque, as it tries to capture the hearts and minds of investors, is that it's not an energy producer. No sexy nanosolar panels here. No never-ending supply of biofuel. No hydrogen fuel cells to power the next generation of cars around the planet.

In fact, perhaps Novatorque's biggest sin is that it conserves energy, as opposed to producing it.

Investors often look at companies through the prism of human nature, so this should all make sense. People in general would rather spend than save, move forward rather than retrench, grow rather than contract. We want the same for our startups. They should "go big or go home." They should prove that they can do more of something, not less of it. And the data on cleantech investing bears this out. VCs have concentrated so heavily on energy producers over energy savers that of the 14 venture-backed cleantech deals tracked by the PricewaterhouseCoopers "MoneyTree" report in Q4 2006, only one was in the area of energy conservation. The rest focused on energy production. And even that single deal, EnerNOC, was more about energy transmission and distribution across the electricity grid, than it was about pure energy savings.

Says Petro: "It's just not as sexy, interesting or cool to save energy. And it doesn't have as obvious a market. You can sell energy, but it's less clear how to sell energy savings."

Old New Thing...

There are other, more traditional, reasons why Novatorque hasn't gotten funded. The first falls under the general category covered in an earlier column, Return on Time (ROT). VCs have a limited amount of time and bandwidth to give to any one company. This time is being stretched to the extreme as each VC is required to deploy more and more capital due to the increasing size of venture funds.

The paradox of VC "bandwidth" is that despite often incredible exposure to lots of technology, there's actually only a limited amount of industry knowledge we are exposed to outside of the traditional core areas of VC investment. If a company sits within the Internet, Web 2.0, software, networking, biotech, telecom or other traditional VC-funded spaces, we're usually all ears, largely because we know something about these sectors and can get up to speed on them relatively quickly. To quote a friend at a venture firm in its third decade: "A new

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disk drive company, if it were to suddenly appear on the investment horizon, could obtain venture funding from several funds like us that made money in the space – in the 1980s. And that's not because the world needs another disk drive company."

When it comes to reaching outside the box, we're not comfortable. We don't have the time it takes to be fully educated on a new market, and that lack of knowledge and expertise means risk. Or as Petro puts it: "Nobody really understands motors. Motors are outside everybody's area of expertise. Motors are a 100-year-old technology, and the industry hasn't generally needed venture capital, so there aren't any funds set up to focus on motors."

In fact, because motors are so outside of our domain expertise, companies like Novatorque get penalized for being unique. If there were 20 other companies in the motor technology space getting funded, you can be sure that Novatorque would get quite a few looks. But with few comparisons, it's difficult if not nearly impossible to tell relative value. And without relative value and/or a high probability of a market for exits, we're left exposed to more risk than we'd normally deem acceptable.

Even when this hurdle of being unique is overcome – take Tesla Motors, for example, the fully electric sports car that has received an unusual amount of attention and VC funding – there are still distinctions. Energy-saving motors for cars are suddenly hot. Energy-saving motors for pretty much anything else? Not so much. "Mention electric motors and everybody wants to know if it can run a car," says Petro. "You'd think cars were the only use for electric motors. People are intensely aware of how much impact cars have on carbon emissions and on how much energy cars use, but people don't think much about how energy is used by the zillions of small electric motors in their lives. Those emissions are happening at the electricity plant run by the utility."

Thus, cleantech from an investment standpoint, is still largely understood at the more personal level, rather than at the utility or grid level. If it's motors for the HVAC or refrigeration markets, we don't get it because we can't see the inefficiencies or carbon emissions. And the time it would take to get up to speed on such markets, let alone be assured of follow-on fundings and exits, just doesn't exist within the typical venture capital firm.

Moreover, lack of understanding of an industry sector increases the fear of the unknown. It's a scary proposition to invest in a market where you're going up against large corporate giants who could seemingly throw an infinite amount of "cap ex" into R&D budgets and, in short order, make a company like Novatorque irrelevant. GE could squash Novatorque, but then again, Visa could have squashed Paypal, IBM could have crushed Apple, and Sony could have created YouTube.

Pick Words Carefully!

Other reasons for Novatorque failing to find funding are somewhat more self-inflicted, by failing to play to the unique psychology of early stage VCs. Novatorque describes its business model as a licensing play, and VCs simply don't like licensing. We're never sure the patents are solid enough, we hate it when our companies get sued by larger players, and in general, we like our companies to make their own "things."

If Novatorque had instead described "licensing" as the equally possible "outsourced manufacturing," that might be a different story. That would mean we would still have some control over the sales channel, and could likewise add value into and through the pipeline. Outsourced manufacturing has become intellectual shorthand for the prudent use of capital in startup company boardrooms.

All of this may just be a timing issue. As VCs grow more comfortable with cleantech – with energy savers as much as energy producers, with a variety of new technologies and perhaps new business models – it will likely grow easier for the Novatorques of the world to get funded. Dan Adler, vice president with the California Clean Energy Fund, says there are multiple examples of cleantech startups that have been looking for venture funding for years, only to have a market shift, a policy shift, or a "tipping point" move their way to finally secure funding.

Adler notes this dynamic with a company called Fat Spaniel, which recently received multiple offers for its round of financing. "Fat Spaniel may have been a bit ahead of its time before the policy environment caught up to it, with government raising the importance of real-time monitoring for solar incentives," Adler says.

At the end of the day, it always comes down to convincing another group of complex humans to part with some money in exchange for the glimmering belief in more money returned later. Be it sex-appeal, greed, language or timing, the answer is not just about a slick *PowerPoint* presentation and a buttoned down business model. For Novatorque, it's about navigating VC psyche.

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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