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Entrepreneurs

Where Venture Capital Is Still Flowing

Maureen Farrell, 11.24.08, 7:00 PM ET

Exits are few, but promising start-ups are still getting funded. Check out these hot spots of activity.

A ray of hope in the hard-knocks economy: Despite few foreseeable exits, early stage investors are still making bets in a handful of promising, high-growth sectors.

In fact, venture capitalists have put only slightly fewer dollars at stake as they did this same time last year, before the financial crisis had gained any traction. In the three quarters ended Sept. 30, venture-capital investment was down just 4%, to $22.3 billion, versus the same period in 2007, according to VentureOne, an industry tracker.

Compare that to the relatively comatose market for initial public offerings, which tends to offer the juiciest exits for VC funds. Measured in dollar terms, the 50 IPOs in the first three quarters raised just $30.5 billion, compared with the 261 deals that yielded $60.5 billion in the first three quarters of last year. Only eight companies went public in the last three months, raising a mere $1 billion.

Some VCs say the difficult market has made it easier to find promising companies. "There are [fewer] tourists right now who are just pitching," says Guy Kawasaki, managing director at Garage Technology Ventures, an early stage venture capital fund. "That yields a better entrepreneur."

So what is the smart money betting on?

For funds with longer investment horizons (in the five- to eight-year time frame), energy technology is a huge draw. In the last nine months, VCs have invested $2.1 billion in renewable energy and related technologies, double the amount during the same period in 2007.

Expectations that U.S. President-elect Barack Obama will offer tax incentives and other government aid to spur new energy alternatives are heating up an already percolating sector. Among the potential power sources: wind, water and good old sunshine.

"With Obama's election, investors are even more excited that clean technology and renewable energy companies are positioned well for the next five to 10 years," says Brian Beard, a partner at law firm Wilson, Sonsini, Goodrich & Rosati who specializes in venture capital.

One company on the energy watch list is Fort Collins, Colo.-based AVA Solar, which makes thin-film photovoltaic modules that reduce the cost of solar-power generation. The company nabbed $104 million in funding in June from a consortium of investors**.**

Another longer-term play (made longer yet by the severe real estate slump) is "green" construction, including building materials that cut carbon emissions or are more easily recycled. One standout, Cal Star Cement of Newark, Calif., has created a process to make cement using a fraction of the energy the process normally consumes. The company bagged $7 million in funding in 2006 and expects to close a second larger round by year's end; it plans to build its first factory in the next five years.

On the other side of the investment spectrum are shorter-term bets that, with any luck, can be commercialized much more quickly. "Now, you need to assume that your business model will come through within six months, not six years," says Kawasaki.

Beard concurs: "VCs are putting their money in areas where the entrepreneurs know how much it will take to get into the market."

In the energy sector, this includes energy-efficient devices--including new sensors, controls and lighting--as well as the backbone infrastructure on which they run. "VCs are looking at bite-sized [technologies] that can pass savings onto [consumers] quickly," says Craig Jacoby, partner at law firm Cooley, Godward, Kronish in San Francisco.

Example: Gridpoint makes hardware and software that efficiently throttles electricity throughout a power grid and provides real-time information about energy usage. The Arlington, Va., company just raised $120 million in a fourth financing round in September.

Entertainment is an enticing area, too, maybe now more than ever. "In bad times, people stay home," says Bernee D.L. Strom, managing partner at Revitalization Partners, which provides hands-on executive advisory services for technology firms.

That trend may mean more opportunity for entertainment-focused start-ups that make everything from new set-top boxes that allow viewers to bypass cable companies by broadcasting movies over the Web, to nifty software that helps online publishers place ads targeted to specific viewers.

Keep an eye on Ensequence in Portland, Ore., which develops technology underpinning for what one day may become interactive television. (Want to buy that slick new vacuum cleaner? Just click on the TV ad in real-time and enter your credit card number.) The company has bagged about $77 million in total financing--over half of it last year.

As for the realm of information technology, "cloud computing" promises lofty returns. Traditional computing involves paying for, operating and storing programs in a centralized location (i.e., a desktop computer). In cloud computing, all of that crunching power is distributed among myriad servers and databases that sit atop no central architecture.

Start-ups will lead this paradigm shift, including makers of on-demand software (also called "software as a service," or SaaS) that consumers rent from "the cloud" as they need it, rather than shelling out large, one-time fees for entire programs. "[In this economy], this sector is even more attractive because of the possibilities for large cost cuts," says Laura Sachar, partner at StarVest Ventures in New York.

Attractive, indeed. Cupertino, Calif.-based Parascale, which raised $11.4 million in June, provides cloud-based storage for media-rich Web applications. And earlier this month, Camden, N.J.-based Agilence, a SasS provider that detects fraud during point-of-sale transactions, raised $4 million.