Entrepreneur & Innovation Exchange
Published online at EIX.org on January 23 2024
DOI: 10.32617/1013-65afc338d2f86

Micro Venture Capital: A Growing Source of Startup Funding

Mario Daniele Amore (HEC Paris)
Annamaria Conti
Valerio Pelucco

KEYWORDS: Venture Capital, Strategic Entrepreneurship Journal, funding for startups.

The venture capital industry has witnessed a surge in investments by micro venture capital (or "micro VC") firms, which have emerged as a crucial player in the startup ecosystem. These are investors which run relatively small funds, averaging $25 million. Traditional venture capital firms, by contrast, often operate funds of $100 million or more. Micro VC funds also tend to make smaller investments: often $100,000 or less, compared to several million dollars or more for traditional VC funds.

Small VCs have been on the rise. Our data shows that from 2010 to 2020, the number of deals by micro VCs increased by 219%. This trend mirrors the 200% increase in the number of deals by traditional VCs, and the 256% increase in the number of deals by business angels. As of 2020, the early-stage deals concluded by micro VCs represented 21% of the total early-stage deals.

These figures underscore the importance of micro VCs. Yet, we know little about micro VCs' organizational structure and strategic choices. Can micro VCs be a viable source of capital? What are its advantages and limitations? Our study, which was recently published in the Strategic Entrepreneurship Journal, aims at answering these important questions for entrepreneurs seeking capital to fund their ventures. (You can find a link at the end of this article.)

What We Studied

We looked at how micro VCs invest (in terms of number of rounds, capital per round, syndication, etc.) as well as at how ventures backed by micro VCs perform, relative to those ventures backed by traditional VCs.

Our data analysis leverages the richness of Crunchbase and PitchBook datasets and delves deep into the micro VC phenomenon. Although there is no formal definition of what a micro VC is, our data indicate that these manage smaller funds as compared to traditional VCs: the median size of a micro VC fund is $25 million (compared with $81 million for traditional VC fund). Micro VCs are often organized as partnerships and so resemble traditional VCs rather than business angels. However, despite having this trait in common, our evidence points to important organizational differences between micro VCs and traditional VCs.

How Micro VCs Are Different

First, micro VCs' limited partners (LPs) are predominantly foundations, wealthy individuals, and family offices rather than institutional investors. Second, these LPs have smaller assets under management than the LPs of traditional VCs, which are mostly private and public pension funds (arguably more sophisticated investors compared with those behind micro VCs). Third, micro VC top managers are more likely to be former entrepreneurs who may or may not have a track record of success, whereas traditional VC top managers tend to be successful entrepreneurs or individuals with VC experience. Because of these differences, micro VCs are relatively more prone than traditional VCs to engage in "spray and pray:" spreading their thinner capital across a relatively larger number of early-stage startups to maximize their shots on goal and, possibly, their portfolio returns.

These organizational and strategic features have important implications for how micro VCs invest. First, micro VCs invest in geographically closer startups than traditional VCs. Second, micro VCs are less likely to invest in previously successful entrepreneurs and less likely to professionalize their investees through the replacement of their CEOs than traditional VCs. Third, micro VCs invest in smaller rounds and are less likely to participate in syndicates, to syndicate with other traditional VCs, and to stage their investments.

Importantly, our research found that micro VCs do not serve as an early-stage screening tool for later-stage traditional VCs, while business angels and other traditional VCs are more likely to fill that role. In fact, we saw that the focal rounds financed by micro VCs are less likely to be followed by rounds financed by other traditional VCs relative to focal rounds financed by business angels or traditional VCs.

Taken together, these results suggest that, in addition to possessing less financial capital than traditional VCs, micro VCs have fewer non-financial resources at their disposal, making it too costly for them to implement standard strategies to monitor the startups in their portfolios. Therefore, micro VCs may find it optimal to engage in spray and pray, possibly investing in early-stage startups that require relatively little financial and non-financial capital. By doing so, they may overcome difficulties in finding appropriate co-investors for ex-post monitoring and avoid diluting control.

What Investors Told Us

Along with gathering our data, we talked with a small sample of European micro VCs. These investors portrayed micro VCs as relatively disengaged. They invest small amounts in many early-stage startups; do very little due diligence; their shareholder agreements are not sophisticated; they rarely take board seats or lead investments in their portfolio startups; and they seldom replace the founders as the CEOs. These differences affect what happens to the startups in their portfolio: Startups backed by micro VCs have a lower likelihood of exiting via acquisition or IPO.

Conclusions

Micro VCs play a pivotal role in democratizing access to entrepreneurial finance by allowing ventures to get funding from a new type of investors. Moreover, micro VCs encourage more kinds of limited partners to access the VC industry. Unlike traditional VCs, which often cater to very well-endowed institutional investors or very high-net-worth individuals, micro VCs embrace a more inclusive approach. By lowering the barrier to entry, these funds empower a broader spectrum of investors, including those with (relatively) modest financial resources, to enter the VC ecosystem.

This democratization of access may foster diversity in investment portfolios and encourages a wider array of innovative ideas to receive funding. Additionally, it promotes economic inclusivity by giving emerging entrepreneurs and businesses, who may have been overlooked by larger VC firms, an opportunity to contribute to the overall growth of the startup ecosystem.

Micro VCs might be a viable funding choice for entrepreneurs who do not secure financing from traditional venture capitalists to scale their businesses, especially when the capital requirements are moderate. Unlike their larger counterparts, micro VCs are often more approachable for early-stage startups seeking funding in smaller amounts. This can help entrepreneurs with innovative ideas that may not align with the investment preferences of more established venture capital firms.

Because they write smaller checks, micro VCs are well-suited for founders steering startups with modest capital requirements. Unlike traditional VCs that often deal with large-scale investments, micro VCs specialize in providing smaller amounts of capital that align with the specific needs of early-stage ventures. For founders leading startups with lower capital demands, securing funding from micro VCs might allow them to obtain the necessary financial support without the burden of excessive capital that might come with traditional venture capital. This tailored approach might be desirable for entrepreneurs seeking to receive the right-sized investment, avoiding unnecessary dilution of equity, and ensuring a more efficient allocation of resources for their business.

Explore the Research

Micro Venture Capital (https://onlinelibrary.wiley.com/doi/full/10.1002/sej.1478) , Mario Daniele Amore, Annamaria Conti and Valerio Pelucco, *Strategic Entrepreneurship Journal,* September 2023

EDITOR'S NOTE: This article was produced in partnership with Strategic Entrepreneurship Journal, a leading academic journal, as part of our effort to highlight actionable cutting-edge research on entrepreneurship. Click here (https://eiexchange.com/content/bringing-research-based-insights-to-a-wider-audience-our-partner) to read other insights from SEJ.

EIX.org (2024)
DOI: 10.32617/1013-65afc338d2f86