QUARTZ

More Startups Have an Unfamiliar Message for Venture Capitalists: Get Lost

The New York Times

Jan 11, 2019

Erin Griffith - NYT News Service

On a sunny Saturday morning in New York City a few months ago, a group of 50 startup founders gathered in the dank basement of a Lower East Side bar. They scribbled notes at long tables, sipping coffee and LaCroix while a stack of pizza boxes emanated the odor of hot garlic. One by one, they gave testimonials taking aim at something nearly sacred in the technology industry: venture capital.

Josh Haas, the co-founder of Bubble, a software-writing startup, told the group that he and venture capitalists “were pretty much totally on different wavelengths” about the trajectory of his business.

Seph Skerritt, founder of Proper Cloth, a clothing company, said that the hype around raising money was a trap.

“They try to make you feel inferior if you’re not playing that game,” he said.

The event had been organized by Frank Denbow, 33, a fixture of New York’s tech scene and the founder of T-shirt startup Inka.io, to bring together startup founders who have begun to question the investment framework that has supercharged their field. By encouraging companies to expand too quickly, Denbow said, venture capital can make them “accelerate straight into the ground.”

The VC business model, on which much of the modern tech industry was built, is simple: Startups raise piles of money from investors, and then use the cash to grow aggressively — faster than the competition, faster than regulators, faster than most normal businesses would consider sane. Larger and larger rounds of funding follow.

The end goal is to sell or go public, producing astonishing returns for early investors. The setup has spawned household names like Facebook, Google and Uber, as well as hundreds of other so-called unicorn companies valued at more than $1 billion.

But for every unicorn, there are countless other startups that grew too fast, burned through investors’ money and died — possibly unnecessarily. Startup business plans are designed for the rosiest possible outcome, and the money intensifies both successes and failures. Social

media is littered with tales of companies that withered under the pressure of hypergrowth, were crushed by “toxic VCs” or were forced to raise too much venture capital — something known as the “foie gras effect.”

Now a counter movement, led by entrepreneurs who are jaded by the traditional playbook, is rejecting that model. While still a small part of the startup community, these founders have become more vocal in the last year as they connect venture capitalists’ insatiable appetite for growth to the tech industry’s myriad crises.

Would Facebook’s leadership have ignored warning signs of Russian election meddling or allowed its platform to incite racial violence if it had not, in its early days, prized moving fast and breaking things? Would Uber have engaged in dubious regulatory and legal strategies if it had not prioritized expansion over all else? Would the tech industry be struggling with gender and race discrimination if the investors funding it were a little less homogeneous?

“The tool of venture capital is so specific to a tiny, tiny fraction of companies. We can’t let ourselves be fooled into thinking that’s the story of the future of American entrepreneurship,” said Mara Zepeda, a 38-year-old entrepreneur who in 2017 helped start an advocacy organization called Zebras Unite. Its members include startup founders, investors and foundations focused on encouraging a more ethical industry with greater gender and racial diversity. The group has 40 chapters and 1,200 members around the world.

“The more we believe that myth, the more we overlook tremendous opportunities,” Zepeda said in an interview.

Some of the groups are rejecting venture capital because they have been excluded from the traditional VC networks. Aniyia Williams, who started the nonprofit Black & Brown Founders, said a venture-funded system that encourages many failures for every one success is particularly unfair to black, Latino and women founders who “are rarely afforded the opportunity to fail, period.” Members of these organizations, she added, see more value when whole groups in their communities thrive, rather than venture’s winner-take-all model.

Other founders have decided the expectations that come with accepting venture capital are not worth it. Venture investing is a high-stakes game in which companies are typically either wild successes or near total failures.

“Big problems have occurred when you have founders who have unwillingly or unknowingly signed on for an outcome they didn’t know they were signing on for,” said Josh Kopelman, a venture investor at First Round Capital, an early backer of Uber, Warby Parker and Ring.

He said he was happy that companies were embracing alternatives to venture capital.

“I sell jet fuel,” he said, “and some people don’t want to build a jet.”

Right now, that jet fuel seems unlimited. Venture capital investments into U.S.-based companies ballooned to $99.5 billion in 2018, the highest level since 2000, according to CB Insights, a

data provider. And the investments have expanded beyond software and hardware into anything that is tech-adjacent — dog walking, health care, coffee shops, farming, electric toothbrushes.

But people like Sandra Oh Lin, chief executive of KiwiCo, a seller of children's activity kits, say that more money is not necessary. Oh Lin raised a little over $10 million in venture funding between 2012 and 2014, but she is now rebuffing offers of more just as her company has hit on a product people want — the very moment when investors would love to pour more gas on the fire. KiwiCo is profitable and had nearly $100 million in sales in 2018, a 65 percent increase over the prior year, Oh Lin said.

"We are aggressive about growth, but we are not a company that chases growth at all costs," Oh Lin said. "We want to build a company that lasts."

Entrepreneurs are even finding ways to undo money they took from venture capital funds. Wistia, a video software company, used debt to buy out its investors last summer, declaring a desire to pursue sustainable, profitable growth. Buffer, a social media-focused software company, used its profits to do the same in August. Afterward, Joel Gascoigne, its co-founder and chief executive, received more than 100 emails from other founders who were inspired — or jealous.

"The VC path forces you into this binary outcome of acquisition or IPO, or pretty much bust," Gascoigne said. "People are starting to question that."

Who Dares Question the Hoodie

Venture capital was not always the default way to grow a company. But in the last decade, its gospel of technological disruption has infiltrated every corner of the business world. Old-line companies from Campbell Soup to General Electric started venture operations and accelerator programs to foster innovation. Sprint and UBS hired WeWork to make their offices more startup-like.

At the same time, startup culture — hoodies and all — entered the mainstream on the back of celebrity investors like Ashton Kutcher, TV shows like "Shark Tank" and movies like "The Social Network." Few questioned the Silicon Valley model for creating the next Google, Facebook or Uber.

Those who tried to buck the conventional method experienced harsh trade-offs. Bank loans are typically small and banks are reluctant to lend money to software companies, which have no hard assets to use as collateral. Founders who eschew venture capital often wind up leaning on their life savings or credit cards.

Jessica Rovello and Kenny Rosenblatt, the entrepreneurs behind Arkadium, a gaming startup founded in 2001, initially avoided raising venture money. It took four years before the business earned enough to pay them a salary. The sacrifices were "very real and very intense," Rovello said. Nevertheless, the business grew steadily and profitably to 150 employees.

By 2013, though, as investors poured capital into some rivals, the lure of easy money became too tempting to pass up, and the company raised $5 million. Tensions ensued as Arkadium's investors expected the company to continue raising money with the goal of selling or going public. Rovello wanted to keep running the company profitably, growing revenue at 20 percent per year and developing a new product that could take years to pay off.

In September, Arkadium used its profits to buy out the investors, allowing the company to remain independent and grow on its own terms. Rovello said she had no regrets about stepping off the venture-funded path.

"If your end game is having a business that you love and continuing to thrive and making careers for people," she said, "then I'm winning."

New Kinds of Capital

In September, Tyler Tringas, a 33-year-old entrepreneur based in Rio de Janeiro, announced plans to offer a different kind of startup financing, in the form of equity investments that companies can repay as a percent of their profits. Tringas said his firm, Earnest Capital, will have $6 million to invest in 10 to 12 companies per year.

Hundreds of emails have poured in since the announcement, Tringas said in an interview.

"They're almost entirely from people who assumed there was no form of capital that matched any version of their expectations," he said.

Earnest Capital joins a growing list of firms, including Lighter Capital, Purpose Ventures, TinySeed, Village Capital, Sheeo, XXcelerate Fund and Indie.vc, that offer founders different ways to obtain money. Many use variations of revenue- or profit-based loans. Those loans, though, are often available only to companies that already have a product to sell and an incoming cash stream.

Other companies are inspired by the investor buyouts executed by Buffer, Wistia and Arkadium, and are asking investors to agree to similar deals — at potentially lower returns on their investments — in the future.

Indie.vc, based in Salt Lake City and part of the investment firm O'Reilly AlphaTech Ventures, offers startups the option to buy back the firm's shares as a portion of their total sales. That caps the firm's return at three times its investment. In the typical venture capital model, the earnings for a home-run deal are limitless.

When Indie.vc started three years ago, it saw two or three applications a week, mostly from venture capital rejects. Now it gets as many as 10 applications a week, mostly from companies that could raise venture capital but do not want to, said Bryce Roberts, the firm's founder.

"We think there is going to be a tsunami of entrepreneurs who have experienced the one-size-fits-all venture model and want to cherry-pick the pieces of it that work for them," Roberts said.

Some venture capitalists have applauded the shift; their style of high-risk investing is not right for many companies. In a recent blog post, Founder Collective, a firm that has invested in Uber and BuzzFeed, praised Roberts' offerings while warning founders of the dangers of traditional funding.

"Venture capital isn't bad, but it is dangerous," the post reads. The firm created ominous warning labels and brochures to send to its companies.

Privately, some venture capitalists have bemoaned the way they are locked into rigid investment mandates with perverse incentives.

"We heard from many investors who said, 'I can't say this publicly, but I'm in the machine and I know it's broken, and I know there is a better way,'" Zepeda said.

Others have dismissed the trend, according to Roberts.

"It's amazing how thin-skinned and threatened VCs tend to be around people who question their model," he said.

Even if venture capitalists ignore the companies rejecting their model, some of *their* investors — endowments, pension funds and mutual funds — are exploring ways to participate. The tech industry's year of bad headlines has inspired some soul-searching.

"I think we should, as investors, take seriously our role in driving some of these destabilizing forces in society," said Rukaiyah Adams, chief investment officer at Meyer Memorial Trust, an investor in venture capital funds and nonprofits. "As one of the controllers of capital, I'm raising my hand and saying, 'Wait a minute, let's really think about this.'"

Still, the new growth models represent a tiny percentage of the broader startup funding market. And venture capitalists continue to aggressively pitch their wares — even to companies that are not interested.

Notion, a collaboration software company based in San Francisco, has just nine employees and close to 1 million users, many of whom pay $8 a month. The company is handily profitable. Aside from a small seed round in 2013, it has avoided outside funding.

Venture capitalists, desperate to get a piece of the company, have dug up Notion's office address and sent its founders cookie dough, dog treats and physical letters, company executives said. Every few months, a new investor inevitably shows up unannounced at Notion's gate.

Notion's ambitions are big — the company wants to replace Microsoft Office. But its executives do not believe they need hundreds of millions of dollars in financing to do it, nor do they want the strings that come attached.

"We're not anti-VC," said Akshay Kothari, the company's chief operating officer. "We're just

thinking for ourselves, rather than for them or other peers."

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Allison Baum
Managing Partner at Fresco Capital
Jan 12, 2019

As a co-founder of a VC fund, I see both sides of this, as I am an entrepreneur myself and also an investor. I have to constantly remind myself that raising money is not an indicator of success - profitability is. With constant media coverage of funding rounds and "unicorns", it is all too easy to forget that.

Your path as a business should be shaped by your mission, your customers and the problem you are solving, not by your TechCrunch-fueled image of what "success" looks like.

Jeanna Liu
Tech/Media M&A Banker, Investor, Startup Advisor
Jan 11, 2019

This is an important story. We (esp the media) have been putting VCs on a pedestal for a very long time, going so far as to use VC funding as a proxy for a startup's success.

As someone who makes a living raising later stage growth capital for startups and helping them exit, I have seen too many startups who should never have taken VC funding suffer the consequences of that narrative.

But VCs are not villains here. The reality is that they are just one type of capital suitable for only a small segment of business-model-specific companies. They should not be viewed as the default method for funding growth.

Spencer Camp
UX/UI Designer • MSc. USC Design, Business, & Technology

Jan 11, 2019

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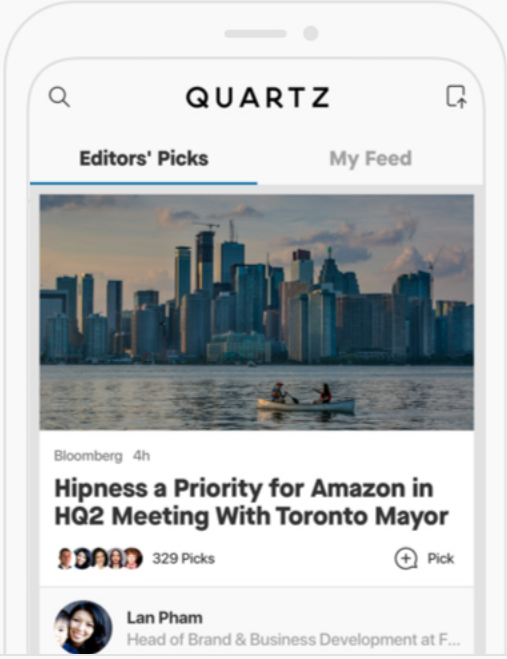

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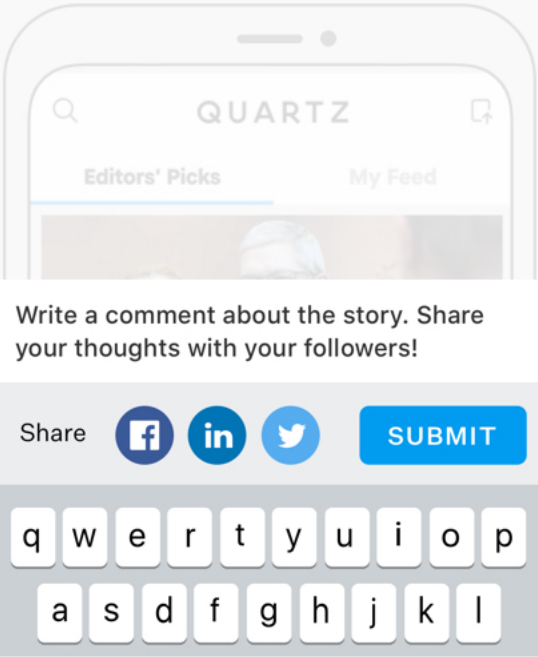

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