May 23, 2012

It’s Morning in Venture Capital

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Many observers of the venture capital industry have questioned whether its best days are behind it. They are frustrated by the past decade of subpar returns for the sector. The most recent report to weigh in on the troubles of the industry was produced by the esteemed Kauffman Foundation.

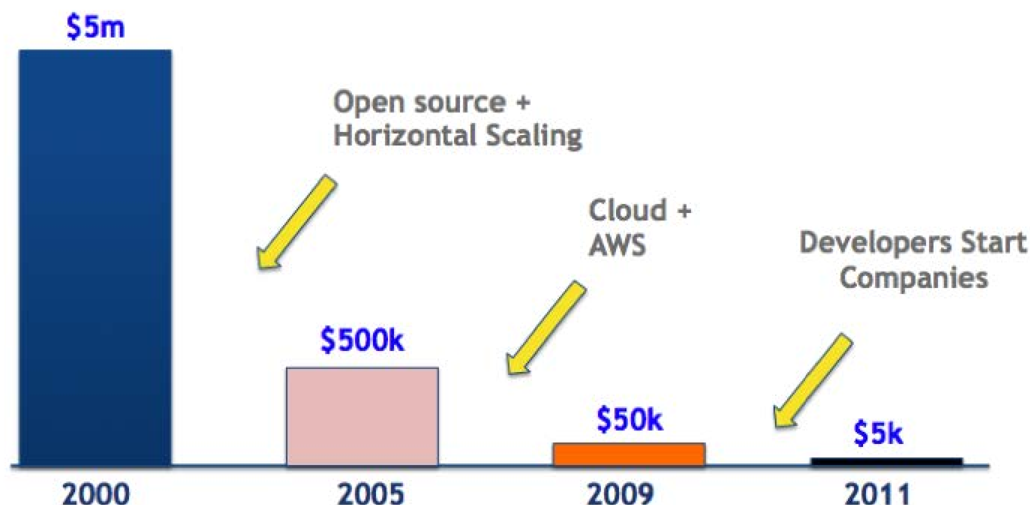
There are obvious reasons the industry has had less-than-desirable returns, including: massive over-funding of the sector, huge increases in inexperienced venture capitalists that took a decade to peter out, and the massive correction in the value of the public stock markets that closed many exit opportunities for half a decade.

I can’t help feel a bit of rear-view mirror analysis in all of “VC model is broken” bears in our industry. I have been close to the tech & startup sectors for more than 20 years and I can’t think of a period in which I felt more optimistic about the innovation and value creation I see in front of us.

Looking ahead at the next decade I am excited by what I believe will be viewed as one of the best and most rational investment periods for venture capital due to seven discrete factors:

1. The number of startups being created has increased by an order of magnitude

Cloud computing and the open source movements have brought down the costs of starting a company by more than 90%. If you want to understand the details of why this is, I covered it in detail in this post, Understanding Changes in the Software Industry.



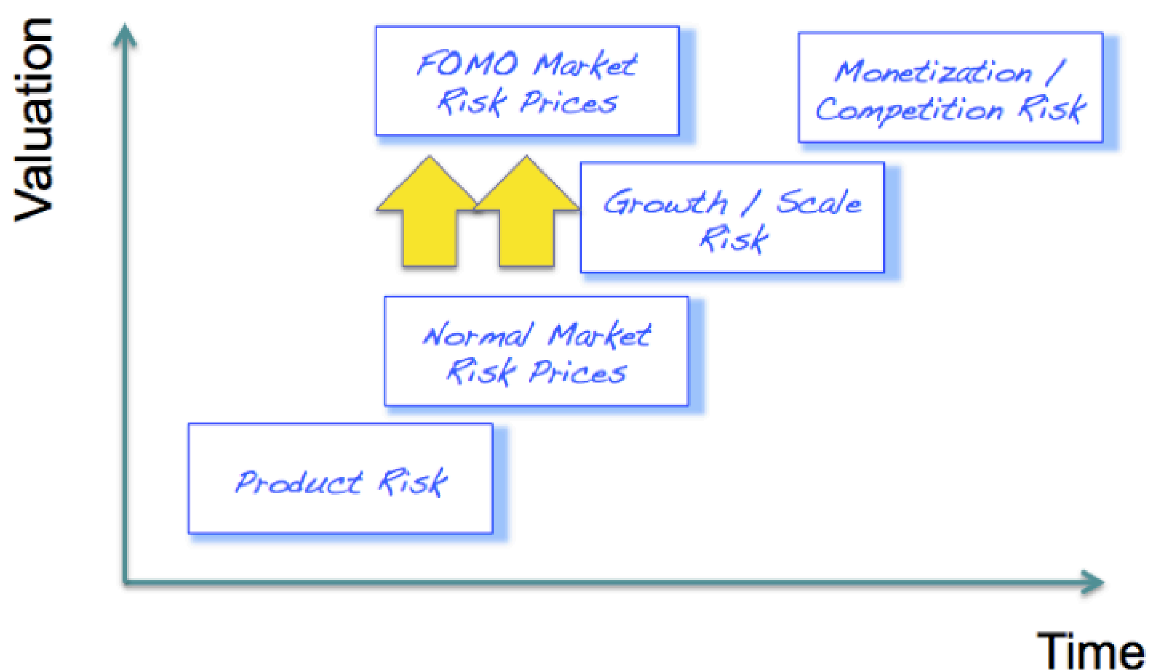
This has led to the creation of incubators, accelerators and seed funds. From this we have seen a commensurate boom in the number of startup companies. When I was graduated from university in 1991 it was only the *really* committed who eschewed the corporate world for creating tech startup businesses.

When I came out of college LA Law was one of the most popular shows on TV and made being a lawyer sexy, so most of my peers made that career choice.

But in 2012 a visit to any major college in America will show you the massive increase in aspirations of our young talent to become the next Mark Zuckerberg and build a future Facebook. The movie, "The Social Network" might have had more of an impact on creating future entrepreneurs than any other event of the past 5 years. Thank you, Aaron Sorkin!

Contrary to some press reporting, the boom in startups, the creation of accelerators and seed funds as well as the deserved popularity of AngelList do not signal doom for our industry. They are, in fact, great news for traditional venture capitalists. The most successful of these businesses will still need venture capital to scale their businesses.

They need a combination of capital and experience to separate from the rest of the pack – the low cost of starting a business means it is even more vital to become the market leader more quickly. What the explosion in startups really means for our industry is a much bigger pipeline of potential deals if we VC's can be patient.



Yes, it's true that FOMO (fear of missing out) is driving some irrational behavior and valuations amongst uber competitive deals and well-financed VCs. I've written in detail about that in this post, "On Bubbles, And Why We'll Be Just Fine."

It doesn't seem too irrational for seed or A deals, just a bit higher than the norm. And by the C round it seems like investors feel more confident in setting a fair market value. But in a race to be sure you don't miss the next Pinterest, some people are paying huge premiums for "market risk" B rounds. Some will pay off, others will not.

For those patient enough to source great companies at reasonable prices and prepared to weather the next inevitable downturn, I believe firmly there will be economic rewards for discipline and patience.

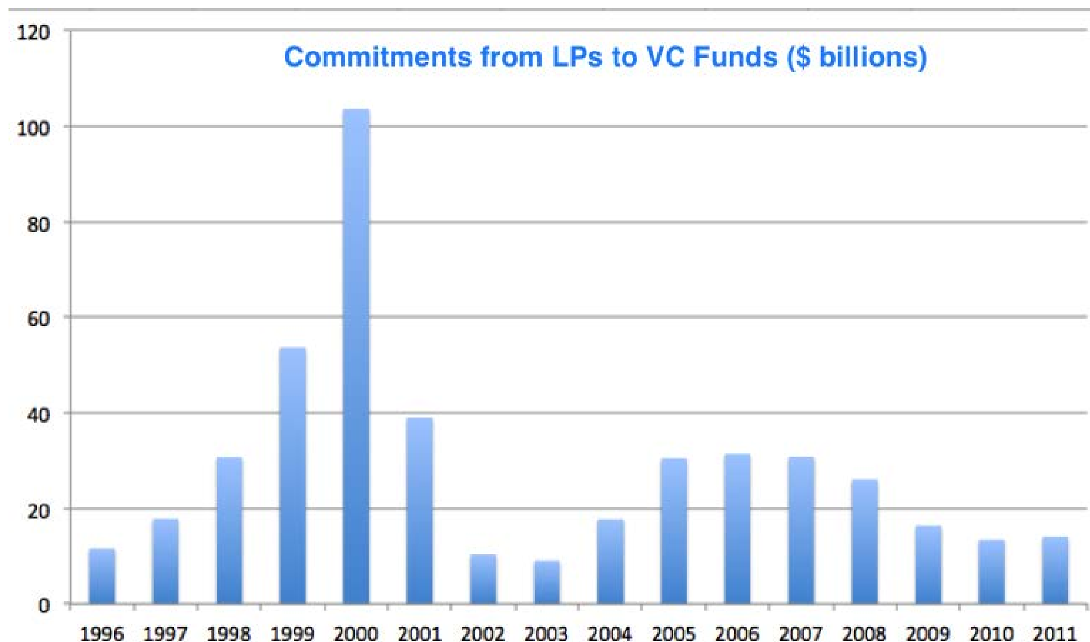
2. The number of venture capital funds has shrunk by two-thirds

To really assess what opportunities the VC industry has over the next decade, one needs to first look at some of the root causes of poor returns in the past decade.

The Funding Problem

In 1998 there were around 850 VC funds and by 2000 there were 2,300. Thomson Reuters data shows that around $10 billion of LP money went into VCs per year pre bubble. By 2000 the total LP commitments had mushroomed to more than $100 billion.

Everybody knows that most funds are 10-year funds (and that strangely 10-year fund really means 12-year funds). So it is unsurprising that an over-funding environment and the commensurate returns hangover would have lasted until about – well – 2012



Just why does over-funding dampen returns? For starters we saw a huge influx of inexperienced managers enter the VC industry proving clearly that being a VC is not a purely quantitative job.

But on micro level, over-funding also creates performance problems for specific companies. In a rational funding environment you might see 3 or 4 great competitors slug it out over the market, each with enough funding to prove their performance until the next milestone where the market decides whether they deserve more funding. They compete on features, price and execution.

In an over-funding environment companies are encouraged to eschew revenues in a land grab to acquire eyeballs, clicks, page views or whatever other vanity metrics give VCs the false comfort that they're sitting on a gold mine. Try charging customers for your product when you have 12 competitors giving the product away free finances by $20 million of VC.

The Exit Problem

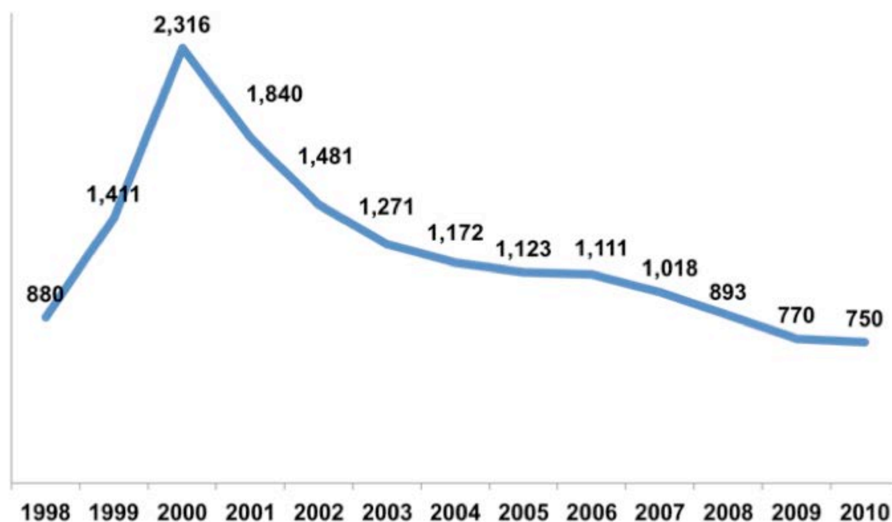
And of course the funding problem coincided with the stock market correction that took away most exit options for years to come. IPO markets had burned an entire cycle of retail stock investors and many institutional investors to boot.

The numbers of potential buyers had decreased dramatically both because large companies were shedding jobs and because many past buyers simply lacked resources to make acquisitions. And in a market with too much capacity (too many startups) the leverage was completely in the hand of buyers at M&A activity finally picked up.

So of course returns from 2000-2010 were subpar *on average* for the industry.

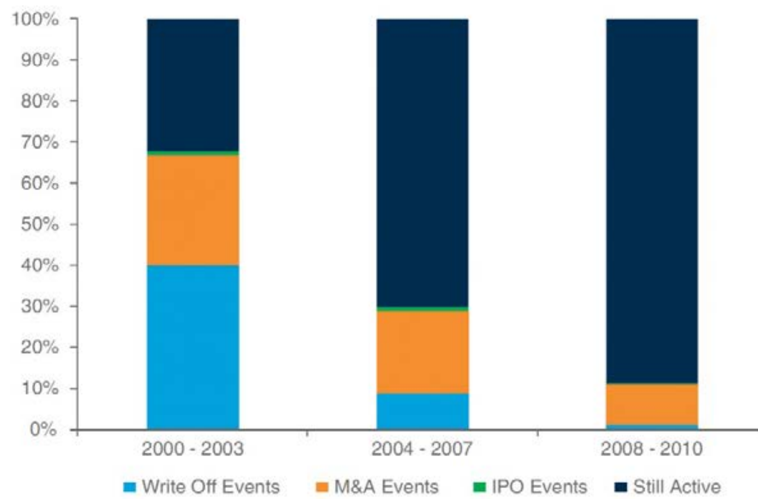
Today's Normalization

Fast forward to 2012 and none of these conditions hold.



While the number of startups has increased exponentially, the number of active venture capitalists has shrunk by more than 2/3rds in the past decade to less than 750 today and still shrinking. Put simply, more deals and fewer venture capitalists mean better access to deals, more stability for winners and great returns for the best in our industry.

Money flowing into our industry has also massively downsized. LP contributions to VC firms shrunk from 2000 and by 2005-2008 had stabilized to around $30 billion per year. By 2010-2011 this had shrunk by half again, averaging under $15 billion.

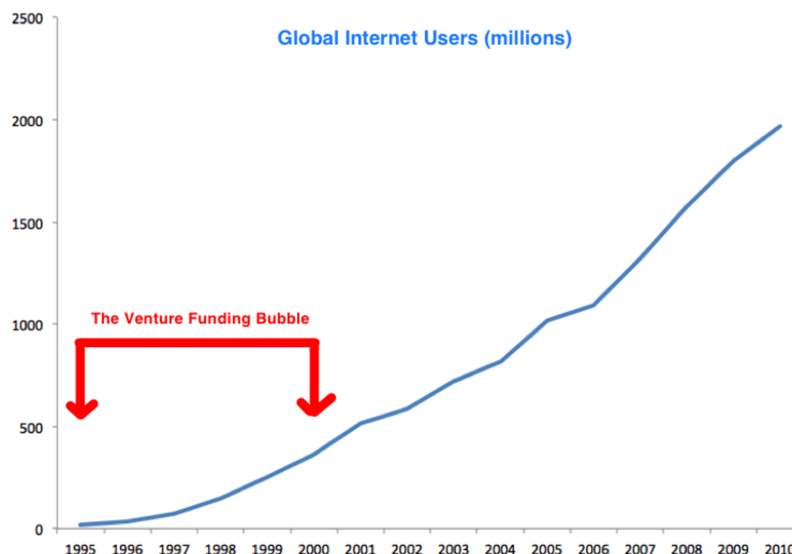


It's also worth noting as data would suggest from this SVB venture funding report, lower costs to build tech & operate businesses implies the possibility of lower loss ratios in portfolios. It will take some time to prove out this hypothesis, but the data above suggests it may be the case.

So it's hard to make a compelling argument that the performance on average in the past decade will prima facie have any predictive powers in determining the next ten. In fact, the market conditions would argue for quite the opposite, which is what makes rear-view-mirror analysis so blurred.

3. There are 20x more consumers online

In 1997, the year the Kauffman Report begins its analysis; there were 70 million users online globally. In 1998 it was 150 million, 1999 250 million and by 2000 it had crossed 350 million. Even at this staggering pace it still represented less than 6% of the world's population.



By the end of 2011 the Internet population was estimated at 2.3 billion, with 275 million in North America alone (source: Internet World Stats) and an astounding global penetration of 33% of the world's population. Considering how much world poverty exists this penetration rate is truly mind-boggling.

Put simply – doing business online is significantly more valuable than it has ever been. There is no sector of the economy that isn't being transformed by the online community that is now voraciously consuming media, applications, communications and buying global products.

To ascribe past poor performance in our industry to the current market situation we face is myopic.

4. We're online all the time and at high speed

It's not just that more people are online, it's that we're online all the time.

Internet usage a decade ago was less than 1 hour per day and was restricted to narrowband communications. Today we're online 3.1 hours per day on average, and that's excluding the other 13 hours a day where we have our mobile devices, our connected TVs, our iPads and Kindles and soon our cars connected to the web.

The ability to interact, transact and disrupt is an order of magnitude greater at broadband speeds than at 56k dial-up modem speeds. Just how transformative is broadband? As of January 2012 consumers were watching 4 BILLION video views per day on YouTube. A decade ago the idea of even watching video online would have been laughable.

THAT is disruption. And as the recent VC fundings of Maker Studios, Machinima, Movie Clips, Big Frame and Fullscreen will attest – opportunities for massive growth in our sector are anything but moribund. The video industry will be disrupted just as books, newspapers and music before it.

And retail, financial services, hotels, the auto industry, taxis, flowers and every inefficient or protected industry out there is being altered by technology changes that change market dynamics and create opportunities for the innovative, the nimble and the risk takers.

5. Mobility really changes everything

It's not just that we're connected to the Internet at higher speeds and for longer; we're actually always tethered to the web. In fact, the majority of Americans are now carrying computers in their front pockets.

The opportunity to transact at the point of purchase increases the sheer number of revenue opportunities. This world of local meets retail meets digital advertising portends to technology disruption and with it VC opportunities.

This never existed a decade ago. Heck, this opportunity didn't exist three years ago.

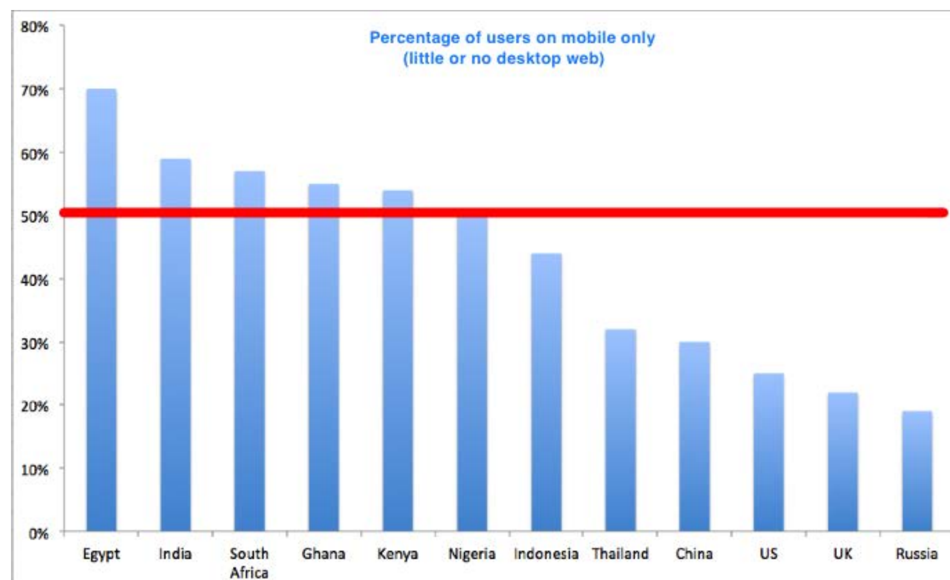
According to Google data 30% of all restaurant searches now come via mobile devices. Our societal behavior is now to look up things we want to book or purchase at the point & time of need.

The desktop web introduced banner ads that offered "brand advertising" opportunities akin to television. Mobile devices deliver "bottom of funnel" sales opportunities that deliver real & immediate economic results.

Search for a restaurant, book a table, eat in 30 minutes. Search for movies times, book your tickets, see a show. Bottom of the sales funnel.

The mobile world brings enormous business opportunities and changes to business models that were unthinkable when VCs made investments ten years ago that produced the last decade of results.

And the future?



Nearly 25% of US users access the web primarily through only mobile devices and these are our youth and thus our future. It is estimated that more than 30% of all YouTube videos are now being consumed on mobile devices and I've seen actual data that shows in some youth genres mobile video consumption now exceeds 50% of video views.

When you look at the developing world this is the majority of users (due to lack of landline infrastructure) and it portends future opportunities in payments, entertainment, application development and services.

This doesn't seem like the end of VC to me, it feels more like the 2nd inning.

6. Everybody is now payment ready

Often overlooked in the importance of what has changed during the past decade is that we're all payment ready now. We're all one-click away from buying, watching, renting or ordering just about anything.

When you order an Amazon Kindle it comes pre-configured with your user name already configured into the device so that you can click a single button and buy shit. And buy people are doing en masse. It's not a tablet – it's an order entry device!

A decade ago most of the country was fearful of entering their credit cards or using mobile banking. Today all of our banking and payment information is accessible online and we are one-click from buying from Amazon, iTunes, the AppStore and PayPal.

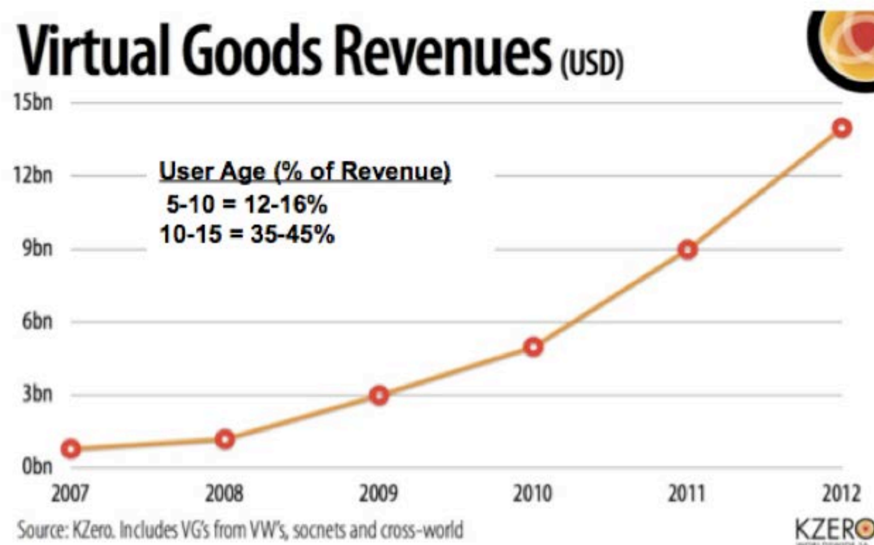
Businesses are also one-click from advertising through Google and now Facebook. Web businesses can now grow revenue before they can even afford sales people.

This trend is often overlooked yet the results or palpable. When businesses really work – they explode financially at a pace that we haven't seen in history and with limited investments to prove out this case.

If you think back to just the past couple of years we've seen enormous growth on limited capital in businesses like Words With Friends and OMGPop (both now Zynga) as well as Angry Birds.

This has spawned growth in related VC-backed businesses like Burstly, TapJoy and Flurry who help enable real-time transactions in mobile apps.

The whole ecosystem grows rapidly because the distance between, "I like this application" and "give me an upgrade" is one click with none of the traditional abandonment that comes with having to pull out your credit card.



Consider this: 5 years ago VCs were debating whether US consumers would ever adopt "virtual goods" in the way that Asian consumers did and thus saw the popular rise of QQ (TenCent) in China (which did $5 billion in revenue in the past 12 months).

Virtual goods are in fact booming on a global basis and in many instances deliver a much higher ARPU than advertising revenue. 2012 virtual good revenue is expected to top $12 billion this year. [thank you to Kidlandia for the chart]

And here's the thing – 55% of the entire market of purchasers are 15 years old or younger. There is no stronger evidence of the power of one-click purchasing (as these people clearly don't have credit cards).

Imagine how these consumers look in 10 years time. Will they really even understand cash? Unimaginable to you? Just remember that 10 years ago you had no: YouTube, Facebook, iPhone or iPad. In fact, you were cool because you had a Palm Pilot while your friends still used a Filofax (yes, you know I'm on to you).

7. We're all socially linked

And finally it can't be ignored that we're not only payment ready, but we're socially connected. Look at the rapid adoption of Groupon, LivingSocial or Instagram as proof of how rapidly businesses can grow through viral means.

It's not just that businesses can monetize more easily, when people like products or services they are diffused more rapidly through the population than has ever been the case.

Nowhere was this more evident than the rise of Zynga, one of the fastest growing companies in history. But this is also spreading through non-game types of businesses.

Evidence Fab: Just 18 months ago they started selling products and through a unique offering and a flawlessly executed social model they are reportedly on par to cross $100 million in sales in 2012.

That type of growth on limited VC dollars was unthinkable a decade ago.

Morning in VC

These seven factors are leading to better and more sustainable opportunities in venture capital than have been present at any time in our investment histories.

We have lower costs to create companies – leading to more early stage innovation. We have a more normalized venture market with less capital and fewer firms. We have consumers who are online at higher speeds and for more of their days. People are connected all the time and when they're mobile. Each of these pocket computers is payment ready & social linked.

Given these seven factors – it's hard to look in the rear view mirror and imagine you can see the future.

I believe it's truly morning in the technology sector. And I remain convinced this bodes well for our venture capital industry.