# How to Negotiate a Winning Term

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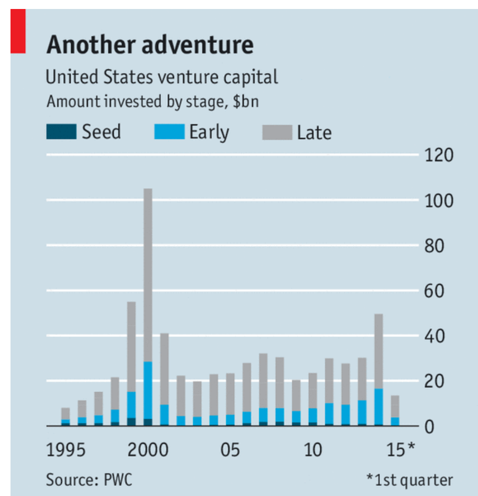
http://www.economist.com/news/finance-and-economics/21651248-industry-specialises-spotting-potential-insurgents-faces-some-its?frsc=dg%7Ca

PARTYING like it's 1999 might be unwise, but venture capitalists have reason to open a few bottles of Dom Pérignon. In the first three months of the year American VC funds invested $13.4 billion, continuing their best run since early 2000, before the dotcom bubble burst (see chart). The comeback has fuelled an already heated debate about whether the technology sector is foaming again. It has also attracted competition from a host of alternative forms of financing. Could VC, which has fostered so many disruptive companies, itself be disrupted?

The VC industry has not changed much since it emerged in America in the late 1950s. Most VC partnerships are as low-tech as it gets. They are best understood as brotherhoods (only 6% of partners are female) that invest money in high-risk ventures. Ideally, their cash comes with two even scarcer resources: advice in the form of experienced board members and access to VC firms' connections. "It's an industry based on personal relationships," explains Reid Hoffman of Greylock Partners, one of its stalwarts. "I can't ask somebody else to make an important recruitment call," says Peter Fenton of Benchmark Capital, another top Silicon Valley firm.




As a result, the sector lacks something that venture capitalists consider essential for most technology startups: it is not "scalable"—that is, able to grow rapidly. Adding partners to a VC firm tends to reduce returns. "The more people you put around the table, the more risk-averse you get," says Andy Rachleff of Stanford's Graduate School of Business, who co-founded Benchmark Capital.

The process of starting and building a business, however, is evolving fast. Thanks to cloud computing and smartphones, among other things, it has become much cheaper and easier to get going. This has led to an explosion of young firms seeking, at least initially, sums not worth a VC's attention: first financing rounds in the tens of thousands of dollars are common, as opposed to the millions that prevailed during the dotcom bubble.

Conversely, once startups have found a big market, they now need much more money to grow. Hiring top developers, acquiring customers and opening offices abroad can gobble up hundreds of millions. All this typically has to happen fast, since many startups operate in winner-take-all markets. Increasing startups' needs for private capital even further, few strive to list themselves on a stockmarket as soon as possible, put off by the tangles of red tape associated with such a move.

At the same time, the low returns on many other investments have driven more money towards startups. In America alone VC funds raised more than $30 billion in 2014—nearly twice as much as the previous year, according to the National Venture Capital Association. They are now managing investments of $157 billion. But rival forms of finance for new firms are also growing fast. For instance, America now boasts more than 300,000 "angels", rich individuals who put money directly into fledgling companies, according to the Centre for Venture Research.

The "seed stage", when a startup raises its first money, is especially vulnerable to disruption. Most ventures are experiments with an uncertain outcome; investing is often a case of "spray and

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pray". Many startups are now launched on crowdfunding sites, where they can raise equity or money for pre-sold products. Firms can also solicit funds on AngelList, a social network of sorts for both founders and angels. Meanwhile, "accelerators" such as Y Combinator and Techstars invest small sums in entrepreneurs with bright ideas, polishing their offering over a few months before serving them up to VCs.

Another set of newcomers in the seed stage are VC firms that limit the size and number of their investments to allow them to focus on helping their wards. These range from "micro funds", with assets of less than $100m, to somewhat bigger ones, such as First Round Capital in Philadelphia, Union Square Ventures in New York and Mosaic Ventures in London.

The other end of the financing spectrum, the "late stage", in which companies need cash more than advice, also has lots of new entrants. Big institutional investors are now providing startups with much of their capital. When Zenefits, which offers web-based payroll services, recently raised $500m, the financing round was led by Fidelity, a big asset manager, and TPG, a big private-equity firm. Such deals are essentially "private IPOs". For tech firms, these now outnumber public ones, according to CB Insights, a financial-data service.

This model was pioneered by DST Global, a Russian fund, which invested more than $500m in Facebook starting in 2009, allowing the social network to postpone its listing. Though welcomed back then, such private IPOs are increasingly seen as feeding what Bill Gurley of Benchmark calls a "risk bubble". Late-stage investors, he recently wrote, have "essentially abandoned their traditional risk analysis" to get a stake in a "unicorn"—a no-longer-so-rare startup valued at more than $1 billion (the latest census revealed more than 100 of these magical creatures around the world).

Given the competition from below and above, many venture firms are concentrating on filling the gap between the early and late stages. But even in this area, the pressure is mounting, thanks to the technological forces venture capital has helped to unleash, argues Fred Destin of the European arm of Accel, another Silicon Valley firm.

Online media, from CrunchBase to Twitter, allow entrepreneurs to see which VC firms and partners have done which deals. Startups are also much more connected and talk about their experiences online or at one of the legions of tech conferences. Most want to get financed by the best-known VC brands. As a result, business is getting much tougher for weaker funds, many of which have already fallen dormant or closed down.

Nor is it business as usual at the top of the heap. The very attributes that make it hard for the most prestigious venture-capital firms to grow rapidly have shielded them from competition to some extent. Their contacts are unrivalled, and their experience raising other firms from obscurity to fame and fortune is rare. But this environment still requires sharp elbows.

It may be cheaper to start a firm today, but in America the startups with a chance of making it really big each year still number around 15. Over 30 years, just 7% of the industry's investments brought a tenfold return, and these accounted for 65% of the industry's profits, reckons Fred Giuffrida of Horsley Bridge Partners, a "fund of funds" that spreads its bets across many VC firms.

To get in on these deals, VC firms often outbid each other, which is one of the main reasons tech firms' valuations have reached such dizzying heights. Stories abound of entrepreneurs calling at one office after another on Sand Hill Road near Stanford University, where most of the top VC firms are based, with the valuation of their company soaring at each stop.

The increased competition is not limited to money. When Marc Andreessen and Ben Horowitz, two former entrepreneurs, launched their firm in 2009, they opted for a new, more corporate model: its main partners still make the investment decisions, but dozens of specialised partners then help portfolio companies with everything from recruiting to public relations. This approach—plus clever marketing—has proven popular with entrepreneurs, putting Andreessen Horowitz among the most sought-after VC investors.

Older firms are following its lead. Most grand VC firms in Silicon Valley have hired at least one specialist partner, often to help startups in the war for talent. Many also use software to keep track of entrepreneurs, business partners and technology trends. Some are trying to "scale their

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network", in the words of Danny Rimer of Index Ventures, a firm with offices in both San Francisco and London. Among other things, it fosters exchange among the executives of its portfolio companies. For now, the changes are small—but disruption usually ends up claiming victims.

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