WTF VC - Fall 2023

What is going on, where the opportunities are, and what to avoid
hot takes from @lessin

Introduction

As we approach venture capital 'AGM' season this fall, I wanted to spend some time distilling what I think is going on with the big picture of seed investing in 2023 with a particular eye to what has changed in the last 12-24 months, and where I think we are going in the mid-term.

The entire game of seed investing has very very quickly and <u>violently</u> changed in the last 18 months. There is a lot to be excited about; however, seed investors who do not recognize the 'new world' of today and change how they operate quickly are going to have a <u>very</u> <u>bad</u> <u>time</u>.

Here are my 'hot takes' on where we are today; and what it all means if you are a seed investor going forward.

WHERE WE ARE

When it comes to understanding where we are today in the VC markets, there are four major themes that matter:

1. **The 'shutdown' of the VC factory line & death of the 'factory farmed' unicorn narrative** that dominated silicon valley for the last 10-15 years. In particular what matters is understanding why this pipeline has stopped and why it is extremely unlikely to restart. The public market wants organic, pesticide free, au natural

1. **The awkward 'crowd' into seed investing by multi-stage firms** (and even just late-stage firms) as they look for where the 'can' deploy capital given the factory 'shutdown' & based on the incentives of all the people they hired to 'write checks' to build a track record & get ahead.

1. **The mirage of AI and LLM startup investing** fueled by magical thinking — make no mistake it is great great and impactful technology - but tech that is fundamentally an extending innovation rather than a disruptive one for incumbents.

1. **The post-pandemic fundamental cultural change impacting startups** Economic randomization, personal reprioritization, and the search for self reliance and security are all dramatically shifting where talent goes and what it wants.

WHAT TO DO AS A SEED INVESTOR

But what does it all practically mean? Where do we go from here? When it comes to what comes next / where smart investors should be going, to me there are a few key conclusions about what to do

1. **Stay Away From the Seed Equity 'Killing Fields'** of .AI & companies and heavily capital dependent businesses. These are the two hallmarks of disaster for early stage capital in this new environment.

1. **Prioritize Capital Efficiency Over Scalability of Investment 'Opportunity'** Seed investors should focus on places where dollars are scarce and valuable to companies, they need not be concerned with which companies can 'scale' their dollar demand like late-stage funds. Spending money to create the opportunity to spend more money is seed-inefficient & businesses don't need to 'choose' between early discipline and ultimate scale.

1. **Prioritize Financial Optionality for Investments & As a Fund** You can't trust the next round will be there when you need it. You can't trust the public market will be there when you want to exit. Companies can't rely on the old pattern of building for the next 'round' vs. building companies and being opportunistic when capital exists. Funds need to actively develop liquidity options vs. just patiently waiting for an exit to the public market or an acquirer (as PE firms learned a generation ago)

1. **Exercise Patience and Discipline & Work With Partners Who Do As Well** You need to work only with founders who love what they do and embrace the marathon. You need LPs that trust you over the long term.

WHAT TO DO AS A SEED INVESTOR

And practically where should you be investing? Here is what is 'hot'

1. **Small Business 'Platforms' - Revenge of Existing Mainstreet** It is easy to forget that an enormous percent of the US economy is made up of small businesses, and with some noted 'marketplace' exceptions – platforms for small businesses are under-invested in and under-appreciated.

1. **Businesses in a 'Box' / Franchises - Create New Entrepreneurs** Capital light opportunities that allow them to own and operate small businesses. Don't take employees and make them 1099, turn them into owners who are building wealth in equity and can earn $500K+.

1. **Sneaky 'Not-So-Lifestyle' Businesses - The Real Future of SaaS / Software Entrepreneurship** The economy is larger than you think. There are many companies where the 'TAM' might look 'small'... but it is plenty big to generate single-billion dollar outcomes very capital-efficiently.

1. **Creators / Communities - The Best Under-funded Entrepreneurs** There will be many many more self-made billionaire creators in vertical niches that have built trust and relationship with specific deep fanatical audiences. Financing them to build faster better communities and products is great white-space.

* **And What of Crypto?** Crypto remains deeply interesting seed area, because it is one of the only areas where you can imagine a 'next great platform' which is seriously disruptive to incumbents. While disruption is unlikely in this era, it is important to stay open to any space which can generate $100B disruption.

TLDR;

$1B Seed Backed 'Small businesses' FTW: It has never been easier for super small lean teams to build serious businesses with <u>extreme</u> capital efficiency and getting profitable early. *There will be more software and community driven 'billionaire' founders of tightly held companies in the coming years than ever before* & seed investors are ideally positioned to provide the single 'shot' of high risk capital for liftoff and do very very well backing these shots.

$10B Factory-Farmed Unicorns & The The Multi-Stage Firms Designed to Build Them Are F*ed: The 10B manufactured startup where multi-stage 'Asset Managers' charging VC carry could buy up and predictably manufacturer of the public markets is a broken thesis from the last decade. This goes away along with all the funds trying to profit off this model in a low interest rate phenomenon, with the possible exception of regulatory capture based industries (government contracting, etc)

$100B Platform Wins: were never manufactured… and never can be. This period is very very unlikely to yield platforms that look like this but you have to keep your mind open for where they 'can' happen (crypto, etc.) … probably NOT AI.

MIND THE $10B FACTORY FARMED UNICORN GAP

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DISCLAIMER

Of course, whenever speaking in such broad terms there will be exceptions to all of the above. The IPO market is shut down - and will remain so - but there will still be your odd IPO. AI is a terrible investment theme for venture capital, but someone will randomly make money.

That said, hopefully this outline can provide a blueprint for where to hunt for the capital, and capitalists, who continue to embrace the entrepreneurial engine of the US and the 'tech ecosystem' on board terms through a period of very obvious washouts and wipeouts.

PART-1

WHERE WE ARE TODAY

TODAY

THE VC FACTORY MODEL IS SHUT DOWN & NOT COMING BACK

THE CROWD INTO SEED IS PREDICTABLE AND TERRIBLE

AI DRIVEN STARTUP INVESTING REPRESENTS 'MAGICAL THINKING' BY VCs

TODAY

1. THE VC ‘FACTORY’ LINE IS SHUT DOWN ISN’T TURNING BACK ON. PUBLIC DEMAND FOR ‘FACTORY FARMED’ UNICORNS DIDN’T PLAY OUT AS HOPED.

Over the last 20 odd years VC effectively reorganized itself into a ‘factory’ line. Each stage funded a certain type of ‘development’ of a company with specific inputs and expected outputs, and fed that product to the next stage - taking the markup along the way.

THE 'FACTORY MODEL' OF VC WAS BUILT ORIGINAL ON THREE KEY PILLARS

I. **Standardized of public market demand** for factory farmed 'tech' Unicorns in the 1-10B range.
No one ever had the gall to assert that you can manufacture 100B companies; but there was the belief you could predictably manufacture public unicorns.

II. Private Market **Legibility**. Easy to measure and model private metrics.
Working backwards from the template for manufactured 'public' companies; private markets developed agreed upon metrics and valuation frameworks which allowed private capital to work efficiently and scale up.

III. Ample **supply** of factory inputs: LP capital, entrepreneurs, and quality startup employees
Belief in standardization of public market demand and private market metric- transparency created the 'trust' need to draw in LP capital, founders, and tons and tons of willing startup employees being paid in unicorn-dream-currency and rainbows of SaaS 'impact'

THE 3 PILLARS OF THE FACTORY MODEL OF THE 2010s

I. STANDARDIZATION OF PUBLIC MARKET DEMAND FOR FACTORY FARMED 'TECH' UNICORNS IN THE 1-10B RANGE.

Things are only worth what the public market is willing to pay for companies 'rolling off the line'.

For a long time there seemed to be nearly insatiable demand from the public market for 1-10B manufactured 'tech' stories with clear metrics that could be delivered with reasonable predictability.

The public market (even before the pandemic funny-money era) would gobble these stories up in a somewhat predictable way if packaged right.

THE 3 PILLARS OF THE FACTORY MODEL OF THE 2010s

II. LEGIBILITY - EASE OF MEASURING AND MODELING PRIVATE METRICS

The opaqueness of VC and high diligence required to really understand a business were historically blockers to the standardization and scale of the VC model, but reverse engineering from public market demand the whole industry became legible, efficient, and much much bigger.

With clarity and manufactured consistency of what late-stage VCs had to 'roll off the line' to sell to the public market, it became possible for the whole ecosystem to reverse-engineer and standardize the metrics companies needed to be worth at different stages and 'peg' valuations to those stages for intermediate products.

This trend towards startup standardization, measurement, and 'legibility' at all stages allowed the VC factory run way more efficiently and dramatically scale up. It allowed different funds to specialize in different stages of startup production - doing just one step - and passing the goods along for markups.

THE 3 PILLARS OF THE FACTORY MODEL OF THE 2010s

III. AMPLE SUPPLY OF FACTORY INPUTS: LP CAPITAL, ENTREPRENEURS, AND QUALITY STARTUP EMPLOYEES

So you have market demand, you have the metrics and legibility to allow for factory stages and handoffs between rounds. But of course, you also need the supply of raw materials to run the factory.

LPs brought the 'raw' capital. ZIRP helped, but even more so the confidence in the predictable public market demand for the 'finished' unicorn product and the more they bought into the legibility and measurability of the venture factory, the more money they were willing to supply.

Founders & Startup Talent Showed Up. The last decade saw a standardization to scale tallent as well. Take an Ivy League degree and a few years at a well known tech company, add a 'unicorn' style idea that plugged into the factory model and voila! Since kids trusted the factory model of VC - 'hit these metrics and you are on the way', they were willing to jump as founders.

TODAY: THE VC FACTORY LINE BROKE

All three of these factors have broken, and they aren't getting fixed

At the end of COVID and end of the ZIRP money party, everything in tech took a bashing… but there is now a major divergence afoot. The big ass tech platforms are back in style having recovered most of their value. But the VC factory line, once smashed in that era, hasn't come back in the same way — and it won't for a long long time (if ever). Why?

THE MODEL BROKE & ISN'T GETTING FIXED

I. ~~**Standardized of public market demand** for factory farmed 'tech' Unicorns in the 1-10B range.~~

Turns out that most of the factory farmed VC stories flopped in the public market. There are exceptions, but it turns out that you can't manufacture value that way.

II. ~~Private Market **Legibility**. Easy to measure and model private metrics.~~

With no public market benchmarks supporting the pattern of building, the legibility of the entire startup ecosystem is thrown into chaos. No one knows what metrics are worth what dollars anymore. We are back to a bespoke marketplace.

III. ~~Ample **supply** of factory inputs: LP capital, entrepreneurs, and quality startup employees~~

Without public market metrics and without private market legibility, the LP capital can't come in at the same scale; founders will always show up - but no the way they did, and employees are far more hesitant to leave good jobs to go on startup adventures with more uncertain personal and financial outcomes.

’I'm here to guess what the music might do a week, a month, a year from now. That's it. Nothing more. And standing here tonight, I'm afraid that I don't hear a thing. Just...silence.'

- Margin Call

1/ End-Of-The-Line 'Unicorn' Demand From Public Market is Dead

WHY THE FACTORY MODEL BROKE

End-Of-The-Line 'Unicorn' Demand From Public Market Died Because…

(A) **The upper-bound on big tech company scale has been released, so 'why not buy more microsoft'?**. The biggest companies can stay efficient and profitable and keep getting bigger, meaning that the public market has less of a reason to bother 'dicking around' with 1-10B baby tech stories. People -both funds and individuals - can stick with Tesla, Meta, Microsoft, Amazon, etc. if they want exposure to tech. There is no reason to look further to deploy capital safely and with upside.

WHY THE FACTORY MODEL BROKE

End-Of-The-Line 'Unicorn' Demand From Public Market Died Because…

(B) **The Adverse Selection Problem Has Destroyed Public Market Trust in Tech** (#Thanks_Chamath). Coming from an era of nearly infinite private capital, the private firms chose to hold for themselves their best companies forever (Stripe, Canva, Etc.) plying them with ever more money and give to the public market the 'trash' they didn't want to hold.

<u>The private firms kept the gems, and dumped via SPACs and low float IPOs the stuff they didn't want.</u>

Being repeatedly sold a 'bill of goods' by the private market players and given no taste of the good stuff has destroyed a ton of trust in tech IPOs… which is why even good ones like Klavio - which skipped the late stage private market racket - end up being met with tepid response from the public market.

WHY THE FACTORY MODEL BROKE

End-Of-The-Line 'Unicorn' Demand From Public Market Died Because…

(C) **Too many 'tech' pretenders got the 'tech' treatment** In an effort to scale up the amount of capital the private ecosystem could handle, people squinted at too many stories and funded them / let them go public as 'tech' companies that were not:

DTC commerce, Telemedicine, Micro-mobility, On-Demand Services, etc. which everyone squinted at as 'tech' turns out (shockingly) to not be… and in the process these trends have eroded a lot of trust.

WHY THE FACTORY MODEL BROKE

End-Of-The-Line ‘Unicorn’ Demand From Public Market Died Because…

(D) **Bonus problem, the acquisition side-door has also closed** Antitrust regulation makes it impossible for big-tech companies to want to deal with the BS of buying inventory from the factory (defective or not) when the public market wasn’t buying that make and model in a specific color. And, even without that, a history of acquires and integration pains made the old stalwart cut-rate bulk buyers of startups more reserved than they were in the past.

2/ Private Market Legibility has Evaporated

WHY THE FACTORY MODEL BROKE

Private Market Legibility Has Evaporated.

If the final goods / unicorns rolling off the VC line into the public markets are of unclear value… you know what is even less clear? The value of intermediate products still on the line at their series A, B, C, D, etc.

This is obviously an immediate / specific problem because all those 'intermediate' goods without a clear market don't transact. They just sit rotting on the line without being able to access the capital they expected to.

But in reality, the problem of it becoming once again unclear what startups are worth has far deeper / more insidious issues including…

WHY THE FACTORY MODEL BROKE

Private Market Legibility is Gone Which Hurts Because…

(A) **Lack of agreed upon metric 'values' and market pricing drops the value of all startups**. If it takes more time to get to know / diligence a company to any sense of trust and investment vs. being a 'market participant' that just means there will be way fewer bidders. Fewer bidders / lower demand means lower price plain and simple, which means startups get less capital to operate (or have less equity retained to operate, pick your poison!)

WHY THE FACTORY MODEL BROKE

Private Market Legibility is Gone Which Hurts Because…

(B) **Early Capital risks getting wiped out, even on their successes** With a legible factory you can as a VC know the rules - if you deliver your stage of production, the later stage VC workers take it down the line and everyone is expected to profit.

When the legibility goes away and the market gets looser, **it is perfectly possible for your money-losing startup to get 'cornered' where they need capital at a late stage even if they are doing well and ultimately successful.**

What does that mean for you? It means cram-down, wipe out, so-long… The founders can get re-upped for their work, but you as the 'investor' in the startup earlier on the line are hosed. **If you can get wiped out not just on failures, but also on successes with even one slight bobble for one round, it changes what you need to make the math work** and how defensive you need to be about the capital you allocate to startups.

WHY THE FACTORY MODEL BROKE

Private Market Legibility is Gone Which Hurts Because…

(C) **Startups go slower and take fewer risks** … simple enough but important to say. Less legibility into the startup process and value means that the whole ecosystem slows down. You invest less of the capital you have, go methodically, take fewer risks, which also means fewer surprise / windfall successes in broad strokes (and with obvious exceptions).

It is just like playing a video game. If you have nearly infinite 'lives' you can take bigger risks. The second you are down to your last life, or find yourself playing a round of 'license to kill' in GoldenEye – you go more slowly.

3/ Input supply of LP capital and founders for traditional ‘VC’ supply chain is evaporating.

WHY THE FACTORY MODEL BROKE

Supply of Capital, Founders, and Employees is Weakening

(A) **Obviously LP capital spigot is 'off'**. They aren't getting the money back to re-invest. Other opportunities all of a sudden pay better. And, the factory they invested in with predictable and scalable use of their dollars to generate the unicorns public markets demand — kaput.

There is, as everyone knows, still boatloads of stockpiled LP capital sitting around in VC warehouses — and luckily that money doesn't rot very fast even with 4% inflation — but with no new supply of capital available VCs are stingy with the input rightfully.

WHY THE FACTORY MODEL BROKE

Supply of Capital, Founders, and Employees is Weakening

(B) **The quality founder pipeline has slowed**. This whole startup game for entrepreneurs is a heck of a lot less fun and profitable now than it was before.

Gone are the easy / safe path back to big companies as they cut jobs and hiring. **Gone** is the 'legibility' of your net worth years ahead of any liquidity. **Gone** is any path to the public market and 'riches' for your startup labor vs. a decade + of illiquidity even when it works.

All of a sudden, the VC startup game which seemed like a no-lose amazing opportunity looks deeply fraught. Are there exceptions? Of course. Do people still dream? Yes. Is the American entrepreneurial spirit and yearn for purpose and self direction intact, emphatic YES! But all that energy isn't going into the VC backed safe McDonald's factory version of entrepreneurship as it was with trust for the VC platforms and demand from the public market

WHY THE FACTORY MODEL BROKE

Supply of Capital, Founders, and Employees is Weakening

(B) **Quality 'employees' are harder to attract**. Same story as founders, though even in some ways rougher. Being a 'startup' employee went from being a crazy fringe thing your parents would hate to a seemingly mainstream fine thing to do. There was no risk if there was a path back 'home' to a big company, and tech startups could pay with LP cash nearly on-par with big companies anyway.

With predictable 'factory farmed' unicorns, the theory was that even if you were at the wrong company this time, a few years from now you will get a 'success'. This all turns out to be quite sus and the employees figured this out, making it much harder to un-stick real talent from safe jobs.

WHY THE FACTORY MODEL BROKE

Conclusion

Don’t hate the player, hate the game. VC has always been a ‘niche’ / cottage industry. I don’t grudge the attempt in the ZIRP period by a bunch of firms to standardize and ‘scale up’ the industry and become ‘asset managers’ against the marketing of ‘software eating the world’.

But we are returning to where things were – which is fine for seed investors so long as they recognize this reality and return to good seed investing vs. feeding the beast.

TODAY

THE VC FACTORY MODEL IS SHUT DOWN & NOT COMING BACK

THE CROWD INTO SEED IS PREDICTABLE AND TERRIBLE

AI DRIVEN STARTUP INVESTING REPRESENTS ‘MAGICAL THINKING’ BY VCs

TODAY

2. THE CROWD INTO SEED IS PREDICTABLE, INEVITABLE, AND BAD NEWS

The crowd into seed investing by every multi-stage and late stage firm is infinitely predictable. Why? Well you have a ton of money and talent with nothing to do / no clear and obvious bets to place - but a hunger to do ‘something’ and advance.

THE CROWD INTO SEED

The People Problem.

There are too many VCs - especially early career ones - whose real incentive is to spend money, not make money.

If you hire a bunch of people to handle more and more capital, and those people advance by 'doing deals', but no deals are to be done, they look for any angle they can to deploy capital.

If they can't do it at the later stages, then they look earlier and earlier up the line looking for opportunities to take meetings, meet founders, and ideally write any sort of check they can put on their resume. It will be healthy for everyone when venture across the boards starts meaningfully cutting headcount, but until then the VCs as factory workers have to do something with their time, and taking seed meetings becomes the obvious answer (other than writing long AGM notes).

THE CROWD INTO SEED

The Capital Problem.

Capital once raised wants to be deployed Big firms can't justify writing late stage checks the way they were, but the money is still burning a hole in their pocket.

They are paid to spend it, so they at least need to spend a little.. to show they are doing some work and not just X-ing.

The nice part about seed investing is that the dollars are small, so the big honking funds with later stage mandates can feel ok writing what are relatively baby checks for them into seed companies while they wait. Sure, the math makes it impossible for any of those checks to return their funds, but it is cheap / might work, gives them a sense of purpose, and allows them to stay 'in market' as investors vs. truly just sitting on the sidelines.

THE CROWD INTO SEED

…So, it is infinitely reasonable why you see continued seed activity while the factory line is shut down.

The people - especially junior people - have clocks ticking on their careers. Doing nothing is hard and advances no one… and spending a bit of money here or there by big firms is a rounding error if it doesn't work, and is a fine way to stay in-market.

THE CROWD INTO SEED

The problem is continued distortion of ‘traditional’ seed.

The problem, of course, is that all this twiddling around in seed isn’t great for the ecosystem.

The seed market is small, and so even ‘rounding error’ checks from late stage investors swamps it with cash. This leads to higher pricing on any reasonable story than companies should get — creating bad long-term deal dynamics. It also means a bunch of founders and talent get misdirected / sent down the wrong path by over-eager capital.

When will this end? Who knows - not anytime soon, and so long as the distortion is in play it means that run of the mill ‘YC style’ seed pricing has not corrected / possibly won’t. This is a serious and perpetual drag on any ‘mainstream’ seed investing you might want to do.

Said differently, a bunch of firms in the 2010s realized they could **build Asset Management businesses and brand them as VC 'investors'** and in the process get really big, and make crazy high fees scalably (for asset managers).

This was a fabulous business model for them (at least for a while… fees are way more predictable than returns!), but what they did ended up piling capital into 'venture capital' with nowhere to go & drawing way too many people, who are wayy to incentivized to write checks – all into a very small pond.

Now all those bored people & piled up dollars are fishing in a very small seed pond.

TODAY

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3. AI DRIVEN STARTUPS IS ‘WISHFUL THINKING’ BY VCs

But what of generative AI you say! Well, this is what you call wishful thinking… a clear example of a narrative generated out of desperation in the VC community vs. good sense. The AI startup opportunity is largely a mirage of thirsty investors trying to cling to an old way of doing things after similar spun up stories on Metaverse (and yes in its peak froth moment Crypto) didn’t play out, and the last narrative around ‘on demand services’ mostly crumbled.

AI Startups are Wishful Thinking by VCs

What AI / LLMs Actually Are

AI / LLMs are indeed exciting technology and has real business application & lot of people are going to make a lot of money on it.

It is, unfortunately for VCs however, not a 'platform shift', but rather a classic extending innovation - much like the growth in 'mobile' and to a lesser extent 'cloud' but deeply distinct from the rise of the Internet.

Two types of players are going to benefit form this extending innovation: First, the big existing platform players. Second, tiny mom and pops.

The very big and the very small will benefit – the middle is F*ed

AI Startups are Wishful Thinking by VCs

Big Existing Platforms Will Benefit

Microsoft, Amazon, Meta, Adobe, etc. The existing gorillas with enormous amounts of private data and huge distribution are all very well setup to take advantage of this wave both as (a) platform providers and (b) by tacking 'AI' features on to their existing products in powerful ways.

There was a ton of hullabaloo about 'mobile' as a great platform shift, but with rare exception - the winners of mobile were the existing players. Putting the internet in your pocket mostly just benefited Microsoft, Amazon, Meta, Adobe, etc…. In fact, it is very hard to argue that there is a single $100B true mobile company that was generated, while companies like Apple (iPhone) and Meta (WhatsApp and Instagram) made hundreds and billions of dollars off the shift.

This time, it is going to be those same players making huge strides again, but this time it will be by making dramatically better and more targeted ads (Meta), Adding and distributing tools through their existing products (Adobe) etc.

So when people ask ‘who will be the Adobe of AI, the answer at this point should be quite clear… it will be Adobe’.

It is far too easy for them to just tack on another tool into existing workflows and they have the talent to do it easily (unlike the shift from shrink wrapped software to the web, which was at least significantly different enough it caused some turbulence).

AI Startups are Wishful Thinking by VCs

Tiny Mom and Pops Will Benefit

Tiny tiny mom and pops will also benefit from AI just as they did from 'the cloud'. The ability to use the leverage of AI to market better, produce better products with fewer people, etc. is really great for solo-entrepreneurs, boostrappers, etc.

There is no question that AI tools are just pure productivity and leverage for them. These aren't AI businesses, but these are classic businesses that will with AI tools be able to act like and compete with much larger firms than ever before.

There are - by the way - interesting ways to think about AI as a sweetener on small business capabilities as a VC… and what that means for the inevitability of historically 'small' / 'lifestyle' businesses… bot more on that later.

Surely if there is opportunities for huge platforms and for small businesses there must be startup opportunities as well? Maybe, but probably not.

AI is a classic extending innovation – it isn't disruptive

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

NO MOAT The tech is all largely open-source. Everyone can use the same APIs. Anything you do as a startup is going to be easy for someone with more data and distribution to clone and plug in without talking to you… and anything you can do so can a thousand other startups.

So something like character.ai might be an interesting small scale experiment to prove a point, but unlike a network like Instagram, where Meta had to buy their way in early … in this case, meta is perfectly capable of building and launching their own characters no problem, and no acquisition needed. Same goes for a Spotify doing language translation of podcasts. Great idea, tried by many startups… until Spotify just decides to do it on their own.

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

Tech is moving too fast Even if you found a cool ‘angle’ to build a specific product, the core tech of AI is moving too quickly for startups to build sticky customer relationships that are meaningful. If you build a product and get a customers to adopt your product, it is true they will stick with you if a competitor comes around and is 110% better, but if a new generation of AI tools is 5x better, they will all switch for the advantage. This is why you keep seeing ‘flash in the pan’ success in the AI space where something is cool for a week or a month and then disappears, there is no way to build a sustainable advantage.

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

People aren't dumb enough to get cornered 2x – AI is too much of a repeat of 'cloud' for anyone to use just one service.

The AI moment is a lot like the cloud computing moment of a generation ago on repeat, but people won't get fooled twice. Cloud is a good business when a customer builds so completely in one environment that the switching cost becomes egregious and the platform players (Amazon) can generate lock-in with customers on commodity services in death-by-a-thousand cuts… No one is this stupid second time around. Everyone is more than willing to use ALL the AI services in concert / in parallel and everyone is ready to always just switch dynamically to the best player of the moment for a given job. This absolute cutthroat approach makes it hard to extract any margin unless you really have secrete sauce in data or distribution.

..Oh and don't forget data portability laws – any advantage that one service gets through experience with a customer is going to be easily portable to the next AI platform

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

Models depreciate too quickly. Sure, but you are talking about seed… Isn't it a great thing for bigger VCs that hard-core model building AI companies need so much capital? No. Terrible idea. Especially as the cost of training models plummets, AND the life-span of the value of model goes to months with better and better things coming out, dumping money as a bulge bracket VC into model building is a deeply losing game, buying an expensive and rapidly depreciating commodity asset. Yuck.

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

But what of new 'marketplaces' of AI? This is an argument that some make. There are certain marketplaces. / services that can be made with AI that never could have existed before… where in theory two AIs / multiple AIs working on behalf of people can negotiate deals that humans never could.

Maybe, but I am skeptical. It is far easier to see a world where the existing marketplaces add AI functionality and get better — Ebay + a agent that knows what you want… Zillow that reaches out to you with home ideas, or negotiates for you. Vs. new from zero marketplaces.

AI Startups are Wishful Thinking by VCs

AI startups & their investors are going to get crushed

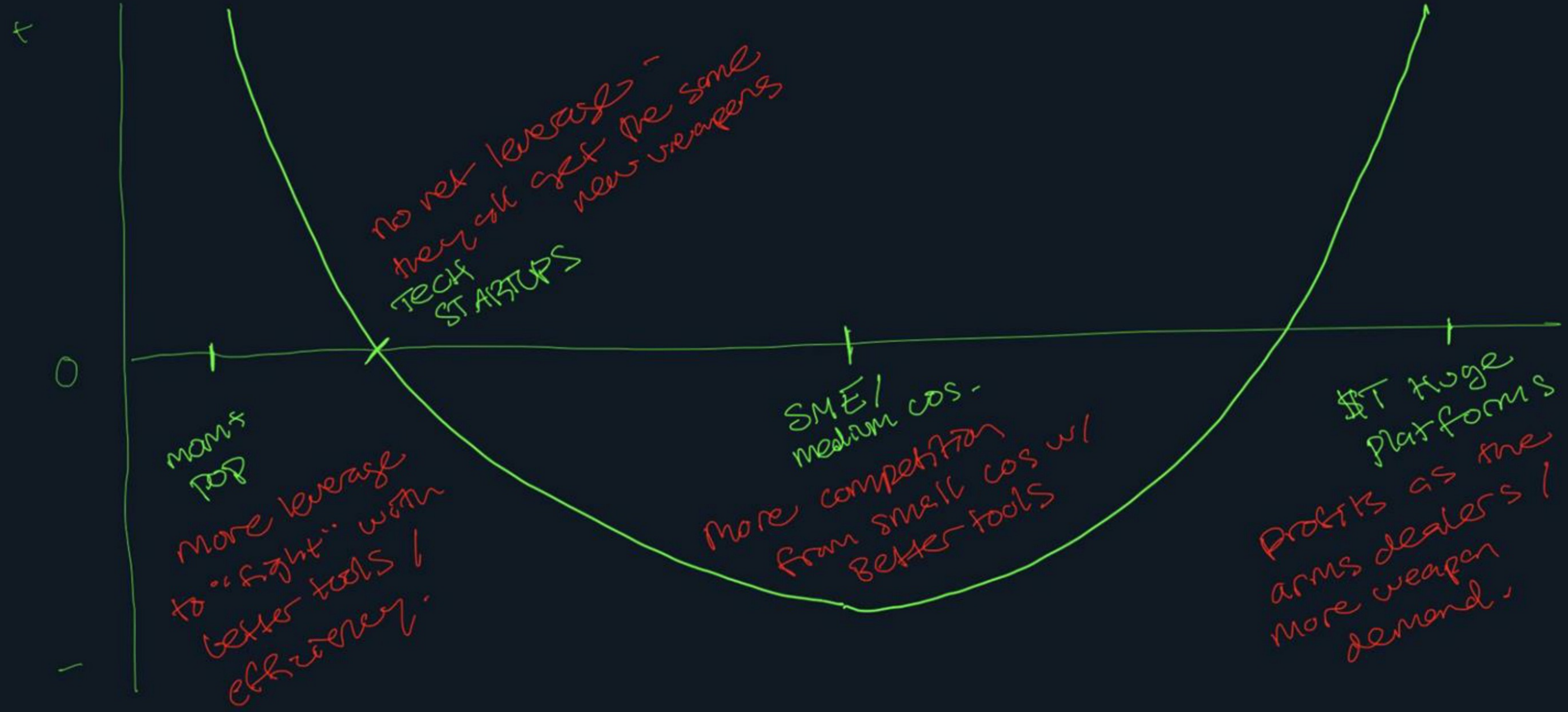
Even if you think I am wrong and there are startup opportunities (perhaps they are but they are few and very far between) the problem with any theme like AI is that the businesses **will be so picked over and so outrageously priced, it isn't even worth bothering playing.**

I do think if you think about the distant distant future of the implications of where AI will take us (the final death knell of the public web, as everyone hides their data behind paywalls), the future of 'agents' working on behalf of users across digital services negotiating for you, etc. there are some pretty trippy / mind bending places that LLMs might take you… but we are many many steps away from the point where founding companies like that is going to make sense.

There will be exceptions, but on any reasonable timeline and in any reasonable case — VCs investing in AI businesses in the hope that they can look like the venture ecosystem of old are kidding themselves and are going to produce way way sub-par returns. AI as the last minute 'savior' of traditional VC is just too cute of a story to possibly be believable.

Who wins / loses from AI?

Arms Race.



TODAY

4. THERE IS A POST_PANDEMIC SHIFT IN TALENT AND STARTUP CULTURE

OK - so factory broken, seed crowded, and AI a pipe dream for VCs - somehow the post pandemic culture shift in talent and startups - which is tectonic - is only the fourth most important thing going on in the ecosystem. The pandemic dramatically impacted work culture broadly, and startup culture in particular in three important ways:

(1) Economic Randomization People bias for today… consumption and cash, they don’t trust their startup equity being valuable at liquidity +10 years

(2) Personal Reprioritization People want to live their lives and live well now, not live for a ‘change the world’ narrative which seems randomized and out of reach.

(3) Self Reliance and Security People are prioritizing self-reliance over reliance on communities and organizations.

Post Pandemic Cultural Shifts Change the Game

Economic Randomization

Has Created Cultural Bias for Today (and Cash)... and Away from Startup Equity That Won't Be Liquid for a Decade

Random lockdowns, Who Kept / Lost Jobs, Who Got Rich on Random Equities or NFTs, Who Lost Everything, Who Died. The hallmark of the pandemic era was random feeling upheaval.

Just like the depression generation became obsessive savers, the pandemic generation has become obsessively focused on the present and dismissive of the future (NB, unfortunate given many of the long-term problems the world faces at the moment).

But the pandemic generation is very understandable biased towards consumption today vs. saving for the future, and very biased towards making cash now vs. being willing to invest time and effort in long-term equity appreciation (especially in illiquid startups) where the value of their work is both unknown and untrusted.

sam lessin 🏴‍☠️
@lessin

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This really isn't hard to understand ... you fully randomize the economy during covid ... everyone says "f-it" live for today and why save? who knows what tomorrow will bring!

PERSONAL FINANCE

Americans Are Still Spending Like There's No Tomorrow

Concerts, trips and designer handbags are taking priority over saving for a home or rainy day

Post Pandemic Cultural Shifts Change the Game

Personal Reprioritization

Live Your Life > ‘Change The World’

A lot of the ‘tracked’ people in the world had their lives sufficiently disrupted that their horizons dramatically expanded. They would have never thought they would end up living {insert place} or doing {insert job}.

This expansion of horizons makes far broader possible outcomes of how they want to live and spend time completely acceptable and easy in a way that was never the case before. More people easily self select for less traditional ‘ambition’… they left the corporate track and will never come back. More people envision living differently than they would have conceived pre-pandemic. This is creating more diversity in lifestyle and work-style than ever before.

Post Pandemic Cultural Shifts Change the Game

Search for Security and Self-Reliance

Self Reliance is the new idealized norm

Your tech company might actually fire you. This creates an enormous drive / interest post pandemic towards personal security and self-direction / control. When the ground all of a sudden feels shaky to everyone and prior-assumptions are questioned, the response of looking for opportunities to control their own destiny.

What does this mean? Practically people trust their employers less - especially mid-market ones - not everything is up and to the right. They are more interested in building their own businesses / cash flows, etc. and less excited about reliance on outside forces — less certain that their job will continue to exist in a few years as it does today regardless of how they perform.

PART-2

WHERE WE ARE GOING

Where To Go

Such Doom and Gloom…

So, hopefully if you take even part of my assessment of where we are in the VC world as correct - you conclude as I do that we are in a very chaotic period. There are some things I feel certain are quite fixed — like the dominance of big platform players — but when it comes to the question of where to invest a seed fund, all the bets of the last generation are generally off, and while I think there will be great opportunities, they will look different than they did last decade. Here is where I think smart investors (like us) should go:

Themes

The Four Things To Get Right

1. **Stay Away From the Seed Equity 'Killing Fields'** of .AI & companies and heavily capital dependent businesses. These are the two hallmarks of disaster for early stage capital in this new environment.

1. **Prioritize Capital Efficiency Over Scalability of Investment 'Opportunity'** Seed investors should focus on places where dollars are scarce and valuable to companies, they need not be concerned with which companies can 'scale' their dollar demand like late-stage funds. Spending money to create the opportunity to spend more money is seed-inefficient & businesses don't need to 'choose' between early discipline and ultimate scale.

1. **Prioritize Financial Optionality for Investments & As a Fund** You can't trust the next round will be there when you need it. You can't trust the public market will be there when you want to exit. Companies can't rely on the old pattern of building for the next 'round' vs. building companies and being opportunistic when capital exists. Funds need to actively develop liquidity options vs. just patiently waiting for an exit to the public market or an acquirer (as PE firms learned a generation ago)

1. **Exercise Patience and Discipline & Work With Partners Who Do As Well** You need to work only with founders who love what they do and embrace the marathon. You need LPs that trust you over the long term.

Themes

Practically Where to 'Hunt' as a seed investor / what to <3

1. **Small Business 'Platforms' - Revenge of Mainstreet** It is easy to forget that an enormous percent of the US economy is made up of small businesses, and with some noted 'marketplace' exceptions – platforms for small businesses are under-invested in and under-appreciated, but there is huge opportunity.

1. **Businesses in a 'Box' / Franchises - Create New Entrepreneurs** Capital light opportunities that allow them to own and operate small businesses turning employees into owners.

1. **Sneaky 'Not-So-Lifestyle' Businesses - The Real Future of SaaS** The software economy is larger than you think. There are many companies where the 'TAM' might look 'small'... but it is plenty big to generate single-billion dollar outcomes very capital-efficiently.

1. **Creators / Communities - The Best Under-funded Entrepreneurs -** There will be many many more self-made billionaire creators in vertical niches that have built trust and relationship with specific deep fanatical audiences. Financing them to build faster better communities and products is great white-space.

* **And What of Crypto?** Crypto remains deeply interesting seed area, because it is one of the only areas where you can imagine a 'next great platform' which is seriously disruptive to incumbents. While disruption is unlikely in this era, it is important to stay open to any space which can generate $100B disruption.

Themes - The Details

Avoid the Killing Fields

Will we ever invest in an AI oriented company? Yes. But it is going to have to be a pretty unique one vs. having a thematic approach to the space, which will be overcrowded, overhyped, and over invested at too high of prices no matter what. We don't expect many if any companies to fit the bill.

Will we ever invest in a company that requires several rounds of financing? Yes. But it will have to be a very special opportunity. For a seed fund to make money on a high-capital requirement business everything needs to line up perfectly, down-rounds and any moment of capital scarcity can easily lead to a wipe out even with success. Those odds aren't great without perfect market conditions.

Themes - The Details

Prioritize Capital Efficiency vs. Scalability, Where Multi-Stage Funds Can't Play

Look for spaces where seed capital works well, but large multi-stage funds are structurally challenged in addressing.

In particular look for companies that are highly capital efficient and can get big, but do not provide opportunities to shovel-late-stage money that large funds structurally need to succeed.

This is offensive for us. We can address these businesses with our check sizes in ways that just make way less sense for multi-stage firms. But it is also defensive. Companies that burn too much money even when good eventually have a hiccup, and that is when seed investors get wiped out of even good investments. We generally need to play away from businesses with that type of risk.

Themes - The Details

Prioritize Financial Optionality For Investments (and as a fund)

Companies need to be setup so that the next 'round' is always an option, never a requirement to be clear; this is not how companies have operated over the last several years - where the capital markets were legible and efficient enough that you could just go out and singularly hit the metrics needed for the next round. Now, the game has to be to focus on building a sustainable real business with seed capital and positioning yourself to be 'opportunistic' when a round comes together. For later stage capital - for the founders and seed investors - it is imperative to not put yourself in a position where a 'financer of last resort' comes in to play (very contrary to the interests of multi-stage firms who would love to be the only one at the party when the bill for something they like comes due).

Funds also need to build flexibility in how they realize returns. The game of simply waiting until a company is public or bought is no longer responsible. Like the PE world has figured out over the last many years, firm-to-firm sales need to become the norm (and these sales should be far more viable for actually healthy capital that don't need every ounce of available capital to survive)

Themes - The Details

Exercise Patience and Discipline

VC has historically been a slow moving game…. **But over the last many years the rat-a-tat-tat of markups (if not realizations) has trained founders and VCs on a drumbeat of 'external' validation** in some forms.

People need to go back to the game as it was, and be comfortable waiting longer periods of time for external validation, confident in their internal KPIs and that they are systematically building healthy businesses.

Patience and discipline, for founders, funds, and LPs is the new game & willingness to stay the course without relying on the validation of others.

Where To Go

Practically

You don’t want to be in the category of people hunting the factory-farmed unicorns anymore. You need to either be in things that have a 100B story (few and far between, but very rewarding) or in categories and with founders that can be capital efficient and produce 500M - 1B outcomes without requiring round after round of financing. Here is where to look…

Practically

I - 'Small Business' Platforms - Enable Mainstreet to Fight Back

The story was to simply crush small businesses with big efficient machines of tech; but tech is now understood and distributed enough for the little guys with brands and customers to fight back

Mainstreet has been systematically under-appreciated and unloved by venture capital. **The only time VCs have generally dipped into 'small businesses', it has been in the form of 'Uber' where you try to take a bunch of small taxi-companies and/or individual operators and wipe them out and turn them into 1099 workers.**

What the world is ready for however - is going to be platforms that empower small businesses and their owners to build on their existing brands, loyal customer bases, etc.

There is massive generational turnover in the bulwark of american small businesses in this moment as we have seen play out in the rise of things like **Teamshares.** The next generation isn't going to just 'shut these businesses down' and go work for Accenture, and they are tech literate to leverage new tools around financing, crm, analytics, etc. not just putting up a website and starting a facebook page.

Practically

II - Businesses in a Box - Create New Entrepreneurs

Consider opportunity for thousands of hard working IQ-100 people to make $1M a year and build equity vs. being converted to 1099 workers

Part of the genius of the United States is people want freedom, they want destiny control. Everyone wants to be an entrepreneur (so much so that when they aren't, for now they are all 'digital creators' …). **The american ethos is be anything but a salaryman.. But in practice it is hard to start a company / get into business… which is why Americans have fallen into MLM traps, or been convinced that 1099 employment is 'working for yourself'**

The way to think about it is this – *what platforms can you create where individuals who work hard can build meaningful equity with their effort – what platforms can you create which give a reasonable number of people a reasonable chance to make $500K to $2M a year and build an asset they can someday sell to someone else?*

We are seeing things like this pop-up for Personal Trainers, Farmers, and Nurses.. And think there are many opportunities going forward.

Practically

III - Not-So-Lifestyle Software - The Real Future of SaaS

There will be hundreds to thousands of $1B billionaires using leverage of AI and cloud to make super capital efficient & lean 'niche' businesses.

Calendly, Muckrack, Squarespace, GoodRX, Zapier… the list of killer businesses started with little or no financing by small teams that grew off profits is much longer than most in the industrial VC complex would want you to believe.

Many of those businesses could have been written off for most of their formative years as 'lifestyle' small businesses which could only every get so big, or wouldn't be really defensible. Yet, here we are. They are killer businesses that get to the point they can go public, take PE buyout deals, or short of all that get rolled up by **constellation**.

We are thrilled to be looking for / hunting these types of companies - especially SaaS companies. We are sick of money incinerating SaaS, but think there are enormous opportunities in spaces many think are 'too small' (and perhaps are for the multi-stage-VC-firm design)

You get a good business with high probability; and the cherry on top is optionality on a whole lot more.

benedictevans now •••

There's a whole class of productivity app where it's hard to tell if it's 50 people in Mountain View or 3 people in Vienna

1 reply · 1 like

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lessin now •••

100%

Slow Special*

Practically

IV - Creators as 'Individuals' + Communities

This one is a 'slow' special… for several years now we have been seeding creators who have built vertical / niche communities and followings on things like Youtube. We give them a few million dollars for <10% of everything they do in their creative careers for the next 30 years.

Why? Well we believe that many of the next generation of great entrepreneurs build their 'cults', 'communities', and 'brands' as individuals first and their product offerings later – an inversion of history.

The Mr. Beasts are too mass market for us to back at seed, but demonstrate the upper potential… but the world is full of deep extremely valuable niches where individuals have become the trust nexus / brands that matter & those folks have shockingly terrible access to early stage financing even after they have demonstrated growth, engagement, and even early monetization.

We think investing directly in creators and their communities is one of the most target-rich and under appreciated investment opportunities in the world.

Creators raising venture capital: Unsettling or genius?

Amanda Silberling

@asilbwrites / 2:00 PM EDT • October 12, 2023

Comment

Image Credits: Bryce Durbin / TechCrunch

When Slow Ventures announced that it would set aside $20 million to invest in individual creators, GP Sam Lessin responded to onlookers' confusion with a memorable quip: "it's def not indentured servitude."

Though Lessin's remarks weren't very reassuring, these sorts of venture deals — investments in people, as opposed to companies — have started to seem a little less bizarre. Companies like Spotter and Jellysmack underwrite

I am happy to take "a little less bizarre" … for now :)

Practically

V - And Crypto.

Of course I can't leave out crypto (which requires / has its own separate storyline, ask us).

Here is the deal with crypto in short – if there is going to be a disruptive $100B platform that is threatening to existing incumbents vs. supports them – it isn't going to be in AI and it isn't going to be in VR/AR… it is going to be in crypto, because the bones of crypto are so deeply at-odds with the structure of the current financial and contracting platforms of the world.

At the same time, crypto as a model provides ample opportunities for companies to be highly capital efficient, grow on cashflows, and generate meaningful liquidity for investors. These are all great properties for a post-industrial venture capital landscape (heck we learned a lot of what informs our thinking today from experiencing un-diluted crypto wins vs. watching other successful seed investments of ours go through round-based VC meat grinder of dilution).

So yes, while crypto has many many uphill battles ahead of it – the fundamental ideas and tech is so powerful and so disruptive, and the properties of good crypto businesses so in-line with the future of how we see seed VC being effective, it is impossible to ignore.

Conclusion

Chaos is a Ladder…

There is no two ways about the fact that we are in a new era of VC in general and seed in particular.

Many of our peers will continue to play the game as it was played over the last decade. We are skeptical of that. Many others will deploy untold capital into 'AI' companies. We will be open minded, but largely sitting that out.

That said, as seed investors - we have never been more clear on the power of great entrepreneurs with a few million dollars in their pocket leveraging modern tech and accessing the largely global frictionless environment.

This might not be the era of $100B platform builds, but I think in the next decade we will see more billionaires minted than ever before in history - creators with vertical communities, founding teams with vertical software, you name it… and the right seed capital partners on that journey with them are going to do extremely extremely well.

The multi-stage platforms built for deploying private capital at scale are endangered.

The right seed funds will do great… if they stay disciplined

Questions?