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The Three Stages of Startup Risk

Afore

5-6 minutes

Understanding risk, options, and why Afore is upping the Pre-Seed ante

Startups are all about taking risks and being rewarded for diminishing them over time. While there are many things that can go wrong in the lifecycle of a startup, there are three big risks a startup has to overcome before it can be called a genuine business success. Here's a look at the three risks, with a special mention of the one that Afore focuses on.

The **first stage** of risk is when a startup is just getting started. The product is still being built and the market is being discovered. There is little to no traction and it is not clear if there will be customers for the product. The risk is that the product may not get to traction and thus find early signs of product-market fit. This stage is known as product-market fit risk. Nowadays, this kind of risk is associated with the Pre-Seed stage. While most Seed investors prefer to wait for traction, some do take pre-traction risk.

Once a company has shown solid traction, demonstrated demand, and tuned to a big market, the **second stage** of risk appears. At this point, even with those key factors in place, a company has yet to prove that it has a stable business model and knows how to make money from operations in a consistent way. This is known as business model risk and nowadays it usually appears at the Series A stage.

At this stage, VCs typically assess the quality of traction and determine whether or not they are willing to take the business model risk. Both traditional Seed investors and Series A investors take this kind of risk today.

Later on in the lifecycle of a startup, the final stage of risk appears. At this **third stage**, the startup has obvious traction and a fully formed business model, but what remains in question is whether the organization can continue to grow and execute against its market potential. It's this execution and scale risk which will show itself around the Series B or Series C stage and beyond.

> This risk never actually goes away for the life of the company.

No doubt that the three stages of risk above are a simplification of something far more complex, but at a high level of abstraction it's a good framework to understand what risk stage a startup is in and who could be great investing partners to take the risk alongside the founders. Different investors prefer to take on different types of risks. And risk is just one value investors consider, but it's not the only thing.

At Afore, we think a lot about risk because we take most of it on as we exclusively invest in pre-traction, pre-product-market fit stage companies. For us, this is the most exciting kind of risk to take, not only because the rewards are massive if we invest correctly, but also because it's endemic to the type of investors we are as product people.

At each risk stage, VCs that do well end up taking risk that the market overestimated. And the best VCs are experts at the kind of risk they take, so they can beat the market over a long time horizon.

> After two years of running Afore and assessing thousands of pre-traction, pre-product-market startups, our singular, non-obvious insight is that the market consistently overestimates the risk associated with pre-traction companies.

The market ascribes uniform high risk to a lack of data in pre-traction startups. The moment a startup generates some traction, the market's assessment of risk falls sharply correlated with a 2–3X increase in valuation. The market prefers to avoid taking traction risk and is willing to pay-up subsequently. Some investors find a risk "middle ground" preferring to commit smaller amounts of "option value" capital, where a complete loss in many companies is acceptable.

We have two big takeaways from all of this. First, that traditional rules of diligence oriented towards analyzing traction data simply does not apply at the pre-product-market fit stage.

> We have developed a new diligence framework custom to Pre-Seed. One which is oriented towards analyzing the phenomenon that founders are describing — the lightning in a bottle they strive for.

Second, a higher than usual VC workload is necessary to identify the alpha in pre-traction companies and help them get to traction subsequent to our investment. Think of it this way, an investor investing $5M into a company will do an enormous amount of work to diligence and support a company. At Afore, we are willing to do the same amount of work but to write a check ten times smaller.

If you are a founder at the product invention phase looking for a business partner to help you navigate the market towards traction, we are excited to hear from you.