The Fight For Ownership

6-7 minutes

I am stating the obvious in this opening sentence, but I need it for the post: In each round of funding for a startup, the founders sell a portion of their equity in exchange for cash. While there's variance, it's accepted that founders will experience roughly 15-30% ownership "dilution" in each round of financing — 15% seems to be quite founder-friendly, with some wiggle room, while 30% would be considered high and extractive. In this exchange, the investors use language like "ownership" while founders use language such as "dilution" – in terms of equity, one side is buying ownership while the other is experiencing dilution.

Conventional wisdom in venture capital is that institutional firms of a certain size would need to buy 20% (or more) in each of its portfolio companies and use reserves to maintain that ownership over time. But along the way, a whole slew of forces came together to challenge this notion: Tremendous cultural interest in investing in technology startups (including a rich online knowledge repository), zero interest rates making money more easily available, software platforms to harness crowdfunding and SPVs, globalization and larger end markets, a growing install base of computer and mobile users, the distribution ease and lock-in power of software subscription economics, and so on… The result is that, for startups that are working and being pursued, the competition for their equity is so fierce that they can leverage these forces to minimize their dilution. And, for startups that are not working yet (or just at the napkin stage), founders can draw a line in the sand for the equity they'd like to sell in exchange for those first dollars in.

I am focused on meeting founders early, even as they're tinkering with their ideas. And, I've spent the last seven years helping a bunch of those early founders raise multiple rounds of venture capital. What I've realized in 2020 (and I realize it can change with a market correction), is that with each new year, the new crop of founders that enter the world of startups are growing increasingly savvy, alert, and aware of the consequences of selling too much equity in each round of financing. It's not uncommon to meet a founder at the pre-seed (sorry) stage who begins their discussion with saying that they're looking for 10% dilution in that small, early round. The total dollars in many cases matters less — it's the dilution they want to put ropes around. Doing this is smart because it warns the investor, especially ownership-hungry ones, "hey, that ain't happening here." It also gives them wiggle room in the event a good set of investors come by and express a need for some more ownership, that 10% line-in-sand founder has room to stretch a bit. As companies mature to Series A, the institutional firms would always try to get their 20% and join the board, often cutting out earliest investors (and asking founders to help them waive those rights), but today there is more competition for those Series A dollars, and many of the pre-seed firms can dip into reserves or other funds to put money to work.

The result of these colliding forces is that getting to that holy grail of 20% ownership and maintaining it is growing increasingly more difficult. It is one of the major reasons Haystack fund sizes have been intentionally and proactively constrained. We are in a position to ask for 5-12% ownership, and we hope to earn the right to maintain that across a few rounds. Our pitch is that, to a founding team of 2-3, that we will never own more than they do in the company (unless something weird happens). Having a lower ownership threshold empowers Haystack to cut a smaller check that's still meaningful to the fund; it enables the fund to offer advice and guidance to founders where our interests are aligned, not at odds; and we can help form and/or join strong syndicates in rounds without creating drama.

It reminds me of that Bruce Lee quote, "Be like water." Or whatever it is. Go with the flow. Once you start asking for more and more ownership, the competition set increases, founders put up their guard, and they expect a ton of platform services as a part of the bargain. Sure, there are some GPs and even fund franchises who can demand the 20% land and hold it, and founders are happy and will continue to be happy making that trade. But, I don't think it's a large group who can lay claim to such market position. In fact, the number who can is getting smaller. Stretching this out over 10 or 20 years, founders could very easily have more access to vertical-specific crowdfunding, debt financing products, or even low-interest loans backed by predictable revenue streams. These financial advancements will cut at the business model of larger funds, but they won't eat the whole pie. As a result, we will see even the largest investment firms (including hedge funds, etc.) going earlier and earlier. It's already been underway for the last 3-5 years in venture capital. Today's pre-seed and seed rounds are really the only consistent places to find alpha in a blind-pool portfolio model. It is possible at the growth-stage to pay high prices and hit a Zoom or Datadog, as 2020 shows, but these are part of a handful of exceptions and not the rule. So, the fight for ownership has moved into the first or second rounds of a new company's life. If it's working after the second round, the price will be perfect, and it won't be as much of a deal — and certainly not 20% style. The game now is getting in early, and if and when something works, holding on to it for dear life. This is the new fight for ownership.