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A Return to Demand-driven Capital

By Bill Gurley

6-8 minutes

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Keep your ear to the Ground
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-Heather Nova

As a venture capitalist and writer, I am often asked to comment on the state of the venture capital market and the outlook for start-ups in general. The recent pullback in Internet stocks has increased the frequency of such questioning, and it is safe to say that in general, Silicon Valley is abuzz with prognostications. Although I am generally bullish about the amazing opportunities for innovation, as well as the overall outlook for Internet start-ups, there is one issue that causes me to pause: something I will call "supply-driven capitalism."

One way to think about the state of the venture capital and start-up markets is to contrast the demand for start-ups with the supply of start-ups. Start-up demand is driven by the problems of consumers and businesses that are left unsolved by current corporations, or when technology or innovation allows those needs to be serviced better, faster or cheaper. The Internet is an extremely disruptive technology that allows for many of these opportunities in virtually every market. As such, the demand for start-ups is quite high.

The supply of start-ups is driven by a combination of entrepreneurial interest and capital availability. It would be hard to characterize entrepreneurial interest as anything but extremely high, with many students from "Top 10" MBA programs forgoing $150,000-a-year careers in investment banking and consulting firms to enjoy the thankless, low-salary, yet-highly-rewarding career of a start-up founder. Equally robust is the growth in venture capital availability. Venture capitalists invested a record $22.7 billion in 1,557 U.S. companies during the first quarter of this year, according to a report from the National Venture Capital Association.

With start-up demand and supply both at all-time highs, it is difficult to determine whether there might be an imbalance in the current market. Higher prices for venture deals may reflect movement between the supply of venture capital relative to the supply of entrepreneurial interest, but it does not necessarily reflect on the actual demand for start-ups. How much innovation is needed, and do we have enough companies providing it?

One way to gauge this is to look at the marginal start-up (or perhaps a large group of them) and try to understand the primary incentive for the creation of the business. On average, today's start-ups are far too often "supply-driven" as opposed to "demand-driven." In other words, the ideas for the start-up are born purely in the mind of the entrepreneur; they do not attack, identify or leverage a real problem or opportunity in the marketplace. Although this is almost impossible to definitively measure, such a signal would be a strong indicator of risk in relation to a match between start-up demand and supply.

To shed more light on this concept, let's look back several years to a time when there were fewer start-ups and when new companies received less exposure. Frequently, the idea to start a new company would be born by an obvious need identified by the entrepreneur. Many times this need was discovered by the work being done in the entrepreneur's existing job. Take, for instance, a systems integrator who develops an application for a customer and then finds that two or three other companies all have an nterest in the product. Eventually the systems integrator realizes there is more value in the application business and shifts direction. You might think of this as a pull or demand-driven start-up.

Many successful companies over the years have started with this demand-side bias. Cisco Systems was started when several people at Stanford University noticed the need to integrate heterogeneous computer networks. They had demand for the product right there at Stanford. Soon others wanted the product, and before you knew it, a company was born. Likewise, Michael Dell began offering direct sales and support of branded PC products in Austin, Texas. The PC was complex, difficult to purchase and hard to use, and people appreciated the hands-on relationship. When Dell became supply-limited with regard to branded PCs, he began to build his own. The customer valued the relationship more than the brand.

There are many more examples such as these, and all have a similar theme. The market began to emerge along with the supply of a product. There are numerous stories of venture capitalists attending sales calls and receiving a bird’s-eye view of the intensity and breadth of the demand for the new product. In other words, there was some certainty of demand before the formation of the start-up.

Today, more entrepreneurs are starting companies with more of a gut feel that someone will eventually need or want their product or service. This form of "ivory tower" capitalism is dangerous, primarily because the start-up may be left with the enormous burden of establishing a market rather than participating in one. To use a sports analogy, it is much easier to surf a wave than to create one.

A second risk to the supply-driven start-up is the relatively low barriers to entry that typically exist with such a concept. Let’s face it: If you can think up a company in your head, there are likely five other people who can do the same. And with a growing infrastructure for start-ups, you can bet your bottom dollar that you will be one of many as opposed to one of few. This is the problem that emerged in the oft-cited example of the pet e-tailing market, as well as in many vertically specific business-to-business exchanges. At last count, there were something like six venture-backed seafood exchanges. I doubt that the canneries are crying out for that much innovation just yet.

I suspect what’s at work is that Plato-esque idea that creation is much more intellectually appealing than combing the earth for steadfast problems to solve. But keep this in mind: Even a sexy Internet company like eBay was born of demand instead of supply. Founder Pierre Omidyar’s girlfriend wanted a place to trade Pez dispensers online. The company rose after the market voted. I suspect that entrepreneurs and venture capitalists alike would be well-served to return to the boring, but perhaps more successful, world of demand-driven capitalism.