Investor Herd Dynamics

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The biggest component in most investors' opinion of you is the opinion of other investors. Which is of course a recipe for exponential growth. When one investor wants to invest in you, that makes other investors want to, which makes others want to, and so on.

Sometimes inexperienced founders mistakenly conclude that manipulating these forces is the essence of fundraising. They hear stories about stampedes to invest in successful startups, and think it's therefore the mark of a successful startup to have this happen. But actually the two are not that highly correlated. Lots of startups that cause stampedes end up flaming out (in extreme cases, partly as a result of the stampede), and lots of very successful startups were only moderately popular with investors the first time they raised money.

So the point of this essay is not to explain how to create a stampede, but merely to explain the forces that generate them. These forces are always at work to some degree in fundraising, and they can cause surprising situations. If you understand them, you can at least avoid being surprised.

One reason investors like you more when other investors like you is that you actually become a better investment. Raising money decreases the risk of failure. Indeed, although investors hate it, you are for this reason justified in raising your valuation for later investors. The investors who invested when you had no money were taking more risk, and are entitled to higher returns. Plus a company that has raised money is literally more valuable. After you raise the first million dollars, the company is at least a million dollars more valuable, because it's the same company as before, plus it has a million dollars in the bank. [1]

Beware, though, because later investors so hate to have the price raised on them that they resist even this self-evident reasoning. Only raise the price on an investor you're comfortable with losing, because some will angrily refuse. [2]

The second reason investors like you more when you've had some success at fundraising is that it makes you more confident, and an investors' opinion of you is the foundation of their opinion of your company. Founders are often surprised how quickly investors seem to know when they start to succeed at raising money. And while there are in fact lots of ways for such information to spread among investors, the main vector is probably the founders themselves. Though they're often clueless about technology, most investors are pretty good at reading people. When fundraising is going well, investors are quick to sense it in your increased confidence. (This is one case where the average founder's inability to remain poker-faced works to your advantage.)

But frankly the most important reason investors like you more when you've started to raise money is that they're bad at judging startups. Judging startups is hard even for the best investors. The mediocre ones might as well be flipping coins. So when mediocre investors see that lots of other people want to invest in you, they assume there must be a reason. This leads to the phenomenon known in the Valley as the "hot deal," where you have more interest from investors than you can handle.

The best investors aren't influenced much by the opinion of other investors. It would only dilute their own judgment to average it together with other people's. But they are indirectly influenced in the practical sense that interest from other investors imposes a deadline. This is the fourth way in which offers beget offers. If you start to get far along the track toward an offer with one firm, it will sometimes provoke other firms, even good ones, to make up their minds, lest they lose the deal.

Unless you're a wizard at negotiation (and if you're not sure, you're not) be very careful about exaggerating this to push a good investor to decide. Founders try this sort of thing all the time, and investors are very sensitive to it. If anything oversensitive. But you're safe so long as you're telling the truth. If you're getting far along with investor B, but you'd rather raise money from investor A, you can tell investor A that this is happening. There's no manipulation in that. You're genuinely in a bind, because you really would rather raise money from A, but you can't safely reject an offer from B when it's still uncertain what A will decide.

Do not, however, tell A who B is. VCs will sometimes ask which other VCs you're talking to, but you should never tell them. Angels you can sometimes tell about other angels, because angels cooperate more with one another. But if VCs ask, just point out that they wouldn't want you telling other firms about your conversations, and you feel obliged to do the same for any firm you talk to. If they push you, point out that you're inexperienced at fundraising — which is always a safe card to play — and you feel you have to be extra cautious. [3]

While few startups will experience a stampede of interest, almost all will at least initially experience the other side of this phenomenon, where the herd remains clumped together at a distance. The fact that investors are so much influenced by other investors' opinions means you always start out in something of a hole. So don't be demoralized by how hard it is to get the first commitment, because much of the difficulty comes from this external force. The second will be easier.

Notes

[1] An accountant might say that a company that has raised a million dollars is no richer if it's convertible debt, but in practice money raised as convertible debt is little different from money raised in an equity round.

[2] Founders are often surprised by this, but investors can get very emotional. Or rather indignant; that's the main emotion I've observed; but it is very common, to the point where it sometimes causes investors to act against their own interests. I know of one investor who invested in a startup at a $15 million valuation cap. Earlier he'd had an opportunity to invest at a $5 million cap, but he refused because a friend who invested earlier had been able to invest at a $3 million cap.

[3] If an investor pushes you hard to tell them about your conversations with other investors, is this someone you want as an investor?

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Russian Translation