The Future of Startup Funding

August 2010Two years ago I  
wrote about what I called "a huge, unexploited  
opportunity in startup funding:" the growing disconnect between  
VCs, whose current business model requires them to invest large  
amounts, and a large class of startups that need less than they  
used to. Increasingly, startups want a couple hundred thousand  
dollars, not a couple million.   
[1]The opportunity is a lot less unexploited now. Investors have  
poured into this territory from both directions. VCs are much more  
likely to make angel-sized investments than they were a year ago.  
And meanwhile the past year has seen a dramatic increase in a new  
type of investor: the super-angel, who operates like an angel, but  
using other people's money, like a VC.Though a lot of investors are entering this territory, there is  
still room for more. The distribution of investors should mirror  
the distribution of startups, which has the usual power law dropoff.  
So there should be a lot more people investing tens or hundreds of  
thousands than millions.   
[2]In fact, it may be good for angels that there are more people doing  
angel-sized deals, because if angel rounds become more legitimate,  
then startups may start to opt for angel rounds even when they  
could, if they wanted, raise series A rounds from VCs. One reason  
startups prefer series A rounds is that they're more prestigious.  
But if angel investors become more active and better known, they'll  
increasingly be able to compete with VCs in brand.Of course, prestige isn't the main reason to prefer a series A  
round. A startup will probably get more attention from investors  
in a series A round than an angel round. So if a startup is choosing  
between an angel round and an A round from a good VC fund, I usually  
advise them to take the A round.   
[3]But while series A rounds aren't going away, I think VCs should be  
more worried about super-angels than vice versa. Despite their  
name, the super-angels are really mini VC funds, and they clearly  
have existing VCs in their sights.They would seem to have history on their side.   
The pattern here seems the same  
one we see when startups and established companies enter a new  
market. Online video becomes possible, and YouTube plunges right  
in, while existing media companies embrace it only half-willingly,  
driven more by fear than hope, and aiming more to protect their  
turf than to do great things for users. Ditto for PayPal. This  
pattern is repeated over and over, and it's usually the invaders  
who win. In this case the super-angels are the invaders. Angel  
rounds are their whole business, as online video was for YouTube.  
Whereas VCs who make angel investments mostly do it as a way to  
generate deal flow for series A rounds.  
[4]On the other hand, startup investing is a very strange business.  
Nearly all the returns are concentrated in a few big winners. If  
the super-angels merely fail to invest in (and to some extent  
produce) the big winners, they'll be out of business, even if they  
invest in all the others.VCsWhy don't VCs start doing smaller series A rounds? The sticking  
point is board seats. In a traditional series A round, the partner  
whose deal it is takes a seat on the startup's board. If we assume  
the average startup runs for 6 years and a partner can bear to be  
on 12 boards at once, then a VC fund can do 2 series A deals per  
partner per year.It has always seemed to me the solution is to take fewer board  
seats. You don't have to be on the board to help a startup. Maybe  
VCs feel they need the power that comes with board membership to  
ensure their money isn't wasted. But have they tested that theory?  
Unless they've tried not taking board seats and found their returns  
are lower, they're not bracketing the problem.I'm not saying VCs don't help startups. The good ones help them a  
lot. What I'm saying is that the kind of help that matters, you  
may not have to be a board member to give.  
[5]How will this all play out? Some VCs will probably adapt, by doing  
more, smaller deals. I wouldn't be surprised if by streamlining  
their selection process and taking fewer board seats, VC funds could  
do 2 to 3 times as many series A rounds with no loss of quality.But other VCs will make no more than superficial changes. VCs are  
conservative, and the threat to them isn't mortal. The VC funds  
that don't adapt won't be violently displaced. They'll edge gradually  
into a different business without realizing it. They'll still do  
what they will call series A rounds, but these will increasingly  
be de facto series B rounds.  
[6]In such rounds they won't get the 25 to 40% of the company they do  
now. You don't give up as much of the company in later rounds  
unless something is seriously wrong. Since the VCs who don't adapt  
will be investing later, their returns from winners may be smaller.  
But investing later should also mean they have fewer losers. So  
their ratio of risk to return may be the same or even better.  
They'll just have become a different, more conservative, type of  
investment.AngelsIn the big angel rounds that increasingly compete with series A  
rounds, the investors won't take as much equity as VCs do now. And  
VCs who try to compete with angels by doing more, smaller deals  
will probably find they have to take less equity to do it. Which  
is good news for founders: they'll get to keep more of the company.The deal terms of angel rounds will become less restrictive  
too—not just less restrictive than series A terms, but less  
restrictive than angel terms have traditionally been.In the future, angel rounds will less often be for specific amounts  
or have a lead investor. In the old days, the standard m.o. for  
startups was to find one angel to act as the lead investor. You'd  
negotiate a round size and valuation with the lead, who'd supply  
some but not all of the money. Then the startup and the lead would  
cooperate to find the rest.The future of angel rounds looks more like this: instead of a fixed  
round size, startups will do a rolling close, where they take money  
from investors one at a time till they feel they have enough.  
[7]  
And though there's going to be one investor who gives them the first  
check, and his or her help in recruiting other investors will  
certainly be welcome, this initial investor will no longer be the  
lead in the old sense of managing the round. The startup will now  
do that themselves.There will continue to be lead investors in the sense of investors  
who take the lead in advising a startup. They may also make  
the biggest investment. But they won't always have to be the one  
terms are negotiated with, or be the first money in, as they have  
in the past. Standardized paperwork will do away with the need to  
negotiate anything except the valuation, and that will get easier  
too.If multiple investors have to share a valuation, it will be whatever  
the startup can get from the first one to write a check, limited  
by their guess at whether this will make later investors balk. But  
there may not have to be just one valuation. Startups are increasingly  
raising money on convertible notes, and convertible notes have not  
valuations but at most valuation caps: caps on what the  
effective valuation will be when the debt converts to equity (in a  
later round, or upon acquisition if that happens first). That's  
an important difference because it means a startup could do multiple  
notes at once with different caps. This is now starting to happen,  
and I predict it will become more common.SheepThe reason things are moving this way is that the old way sucked  
for startups. Leads could (and did) use a fixed size round as a  
legitimate-seeming way of saying what all founders hate to hear:  
I'll invest if other people will. Most investors, unable to judge  
startups for themselves, rely instead on the opinions of other  
investors. If everyone wants in, they want in too; if not, not.  
Founders hate this because it's a recipe for deadlock, and delay  
is the thing a startup can least afford. Most investors know this  
m.o. is lame, and few say openly that they're doing it. But the  
craftier ones achieve the same result by offering to lead rounds  
of fixed size and supplying only part of the money. If the startup  
can't raise the rest, the lead is out too. How could they go ahead  
with the deal? The startup would be underfunded!In the future, investors will increasingly be unable to offer  
investment subject to contingencies like other people investing.  
Or rather, investors who do that will get last place in line.  
Startups will go to them only to fill up rounds that are mostly  
subscribed. And since hot startups tend to have rounds that are  
oversubscribed, being last in line means they'll probably miss the  
hot deals. Hot deals and successful startups are not identical,  
but there is a significant correlation.   
[8]  
So investors who won't invest unilaterally will have lower returns.Investors will probably find they do better when deprived of this  
crutch anyway. Chasing hot deals doesn't make investors choose  
better; it just makes them feel better about their choices. I've  
seen feeding frenzies both form and fall apart many times, and as  
far as I can tell they're mostly random.   
[9]  
If investors can  
no longer rely on their herd instincts, they'll have to think more  
about each startup before investing. They may be surprised how  
well this works.Deadlock wasn't the only disadvantage of letting a lead investor  
manage an angel round. The investors would not infrequently collude  
to push down the valuation. And rounds took too long to close,  
because however motivated the lead was to get the round closed, he  
was not a tenth as motivated as the startup.Increasingly, startups are taking charge of their own angel rounds.  
Only a few do so far, but I think we can already declare the old  
way dead, because those few are the best startups. They're the  
ones in a position to tell investors how the round is going to work.  
And if the startups you want to invest in do things a certain way,  
what difference does it make what the others do?TractionIn fact, it may be slightly misleading to say that angel rounds  
will increasingly take the place of series A rounds. What's really  
happening is that startup-controlled rounds are taking the place  
of investor-controlled rounds.This is an instance of a very important meta-trend, one that Y  
Combinator itself has been based on from the beginning: founders  
are becoming increasingly powerful relative to investors. So if  
you want to predict what the future of venture funding will be like,  
just ask: how would founders like it to be? One by one, all the  
things founders dislike about raising money are going to get  
eliminated.   
[10]Using that heuristic, I'll predict a couple more things. One is  
that investors will increasingly be unable to wait for startups to  
have "traction" before they put in significant money. It's hard  
to predict in advance which startups will succeed. So most investors  
prefer, if they can, to wait till the startup is already succeeding,  
then jump in quickly with an offer. Startups hate this as well,  
partly because it tends to create deadlock, and partly because it  
seems kind of slimy. If you're a promising startup but don't yet  
have significant growth, all the investors are your friends in  
words, but few are in actions. They all say they love you, but  
they all wait to invest. Then when you start to see growth, they  
claim they were your friend all along, and are aghast at the thought  
you'd be so disloyal as to leave them out of your round. If founders  
become more powerful, they'll be able to make investors give them  
more money upfront.(The worst variant of this behavior is the tranched deal, where the  
investor makes a small initial investment, with more to follow if  
the startup does well. In effect, this structure gives the investor  
a free option on the next round, which they'll only take if it's  
worse for the startup than they could get in the open market.  
Tranched deals are an abuse. They're increasingly rare, and they're  
going to get rarer.)   
[11]Investors don't like trying to predict which startups will succeed,  
but increasingly they'll have to. Though the way that happens won't  
necessarily be that the behavior of existing investors will change;  
it may instead be that they'll be replaced by other investors with  
different behavior—that investors who understand startups  
well enough to take on the hard problem of predicting their trajectory  
will tend to displace suits whose skills lie more in raising money  
from LPs.SpeedThe other thing founders hate most about fundraising is how long  
it takes. So as founders become more powerful, rounds should start  
to close faster.Fundraising is still terribly distracting for startups. If you're  
a founder in the middle of raising a round, the round is the top idea in your mind, which means working on the  
company isn't. If a round takes 2 months to close, which is  
reasonably fast by present standards, that means 2 months during  
which the company is basically treading water. That's the worst  
thing a startup could do.So if investors want to get the best deals, the way to do it will  
be to close faster. Investors don't need weeks to make up their  
minds anyway. We decide based on about 10 minutes of reading an  
application plus 10 minutes of in person interview, and we only  
regret about 10% of our decisions. If we can decide in 20 minutes,  
surely the next round of investors can decide in a couple days.  
[12]There are a lot of institutionalized delays in startup funding: the  
multi-week mating dance with investors; the distinction between  
termsheets and deals; the fact that each series A has enormously  
elaborate, custom paperwork. Both founders and investors tend to  
take these for granted. It's the way things have always been. But  
ultimately the reason these delays exist is that they're to the  
advantage of investors. More time gives investors more information  
about a startup's trajectory, and it also tends to make startups  
more pliable in negotiations, since they're usually short of money.These conventions weren't designed to drag out the funding process,  
but that's why they're allowed to persist. Slowness is to the  
advantage of investors, who have in the past been the ones with the  
most power. But there is no need for rounds to take months or even  
weeks to close, and once founders realize that, it's going to stop.  
Not just in angel rounds, but in series A rounds too. The future  
is simple deals with standard terms, done quickly.One minor abuse that will get corrected in the process is option  
pools. In a traditional series A round, before the VCs invest they  
make the company set aside a block of stock for future hires—usually  
between 10 and 30% of the company. The point is to ensure this  
dilution is borne by the existing shareholders. The practice isn't  
dishonest; founders know what's going on. But it makes deals  
unnecessarily complicated. In effect the valuation is 2 numbers.  
There's no need to keep doing this.  
[13]The final thing founders want is to be able to sell some of  
their own stock in later rounds. This won't be a change,   
because the practice is now quite common. A lot of investors  
hated the idea, but the world hasn't exploded as a result,  
so it will happen more, and more openly.SurpriseI've talked here about a bunch of changes that will be forced on  
investors as founders become more powerful. Now the good news:  
investors may actually make more money as a result.A couple days ago an interviewer   
asked   
me if founders having more  
power would be better or worse for the world. I was surprised,  
because I'd never considered that question. Better or worse, it's  
happening. But after a second's reflection, the answer seemed  
obvious. Founders understand their companies better than investors,  
and it has to be better if the people with more knowledge have more  
power.One of the mistakes novice pilots make is overcontrolling the  
aircraft: applying corrections too vigorously, so the aircraft  
oscillates about the desired configuration instead of approaching  
it asymptotically. It seems probable that investors have till now  
on average been overcontrolling their portfolio companies. In a  
lot of startups, the biggest source of stress for the founders is  
not competitors but investors. Certainly it was for us at Viaweb.  
And this is not a new phenomenon: investors were James Watt's biggest  
problem too. If having less power prevents investors from  
overcontrolling startups, it should be better not just for founders  
but for investors too.Investors may end up with less stock per startup, but startups will  
probably do better with founders more in control, and there will  
almost certainly be more of them. Investors all compete with one  
another for deals, but they aren't one another's main competitor.  
Our main competitor is employers. And so far that competitor is  
crushing us. Only a tiny fraction of people who could start a  
startup do. Nearly all customers choose the competing product, a  
job. Why? Well, let's look at the product we're offering. An  
unbiased review would go something like this:  
  
 Starting a startup gives you more freedom and the opportunity to  
 make a lot more money than a job, but it's also hard work and at  
 times very stressful.  
  
Much of the stress comes from dealing with investors. If reforming  
the investment process removed that stress, we'd make our product  
much more attractive. The kind of people who make good startup  
founders don't mind dealing with technical problems—they enjoy  
technical problems—but they hate the type of problems investors  
cause.Investors have no  
idea that when they maltreat one startup, they're preventing 10  
others from happening, but they are. Indirectly, but they are. So  
when investors stop trying to squeeze a little more out of their  
existing deals, they'll find they're net ahead, because so many  
more new deals appear.One of our axioms at Y Combinator is not to think of deal flow as  
a zero-sum game. Our main focus is to encourage more startups to happen,  
not to win a larger share of the existing stream. We've found this  
principle very useful, and we think as it spreads outward it will  
help later stage investors as well."Make something people want"  
applies to us too.Notes[1]  
In this essay I'm talking mainly about software startups.  
These points don't apply to types of startups that are still expensive  
to start, e.g. in energy or biotech.Even the cheap kinds of startups will generally raise large amounts  
at some point, when they want to hire a lot of people. What has  
changed is how much they can get done before that.[2]  
It's not the distribution of good startups that has a power  
law dropoff, but the distribution of potentially good startups,  
which is to say, good deals. There are lots of potential winners,  
from which a few actual winners emerge with superlinear certainty.[3]  
As I was writing this, I asked some founders who'd taken  
series A rounds from top VC funds whether it was worth it, and they  
unanimously said yes.The quality of investor is more important than the type of round,  
though. I'd take an angel round from good angels over a series A  
from a mediocre VC.[4]  
Founders also worry that taking an angel investment from a  
VC means they'll look bad if the VC declines to participate in the  
next round. The trend of VC angel investing is so new that it's  
hard to say how justified this worry is.Another danger, pointed out by Mitch Kapor, is that if VCs are only  
doing angel deals to generate series A deal flow, then their  
incentives aren't aligned with the founders'. The founders want  
the valuation of the next round to be high, and the VCs want it to  
be low. Again, hard to say yet how much of a problem this will be.[5]  
Josh Kopelman pointed out that another way to be on fewer  
boards at once is to take board seats for shorter periods.[6]  
Google was in this respect as so many others the pattern for  
the future. It would be great for VCs if the similarity extended  
to returns. That's probably too much to hope for, but the returns  
may be somewhat higher, as I explain later.[7]  
Doing a rolling close doesn't mean the company is always  
raising money. That would be a distraction. The point of a rolling  
close is to make fundraising take less time, not more. With a  
classic fixed sized round, you don't get any money till all the  
investors agree, and that often creates a situation where they all  
sit waiting for the others to act. A rolling close usually prevents  
this.  
[8]  
There are two (non-exclusive) causes of hot deals: the quality  
of the company, and domino effects among investors. The former is  
obviously a better predictor of success.[9]  
Some of the randomness is concealed by the fact that investment  
is a self fulfilling prophecy.[10]  
The shift in power to founders is exaggerated now because  
it's a seller's market. On the next downtick it will seem like I  
overstated the case. But on the next uptick after that, founders  
will seem more powerful than ever.[11]  
More generally, it will become less common for the same  
investor to invest in successive rounds, except when exercising an  
option to maintain their percentage. When the same investor invests  
in successive rounds, it often means the startup isn't getting  
market price. They may not care; they may prefer to work with an  
investor they already know; but as the investment market becomes  
more efficient, it will become increasingly easy to get market price  
if they want it. Which in turn means the investment community will  
tend to become more stratified.[12]  
The two 10 minuteses have 3 weeks between them so founders  
can get cheap plane tickets, but except for that they could be  
adjacent.[13]  
I'm not saying option pools themselves will go away. They're  
an administrative convenience. What will go away is investors  
requiring them.  
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