The New Funding Landscape

October 2010After barely changing at all for decades, the startup funding  
business is now in what could, at least by comparison, be called  
turmoil. At Y Combinator we've seen dramatic changes in the funding  
environment for startups. Fortunately one of them is much higher  
valuations.The trends we've been seeing are probably not YC-specific. I wish  
I could say they were, but the main cause is probably just that we  
see trends first—partly because the startups we fund are very  
plugged into the Valley and are quick to take advantage of anything  
new, and partly because we fund so many that we have enough data  
points to see patterns clearly.What we're seeing now, everyone's probably going to be seeing in  
the next couple years. So I'm going to explain what we're seeing,  
and what that will mean for you if you try to raise money.Super-AngelsLet me start by describing what the world of startup funding used  
to look like. There used to be two sharply differentiated types  
of investors: angels and venture capitalists. Angels are individual  
rich people who invest small amounts of their own money, while VCs  
are employees of funds that invest large amounts of other people's.For decades there were just those two types of investors, but now  
a third type has appeared halfway between them: the so-called  
super-angels.   
[1]  
 And VCs have been provoked by their arrival  
into making a lot of angel-style investments themselves. So the  
previously sharp line between angels and VCs has become hopelessly  
blurred.There used to be a no man's land between angels and VCs. Angels  
would invest $20k to $50k apiece, and VCs usually a million or more.  
So an angel round meant a collection of angel investments that  
combined to maybe $200k, and a VC round meant a series A round in  
which a single VC fund (or occasionally two) invested $1-5 million.The no man's land between angels and VCs was a very inconvenient  
one for startups, because it coincided with the amount many wanted  
to raise. Most startups coming out of Demo Day wanted to raise  
around $400k. But it was a pain to stitch together that much out  
of angel investments, and most VCs weren't interested in investments  
so small. That's the fundamental reason the super-angels have  
appeared. They're responding to the market.The arrival of a new type of investor is big news for startups,  
because there used to be only two and they rarely competed with one  
another. Super-angels compete with both angels and VCs. That's  
going to change the rules about how to raise money. I don't know  
yet what the new rules will be, but it looks like most of the changes  
will be for the better.A super-angel has some of the qualities of an angel, and some of  
the qualities of a VC. They're usually individuals, like angels.  
In fact many of the current super-angels were initially angels of  
the classic type. But like VCs, they invest other people's money.  
This allows them to invest larger amounts than angels: a typical  
super-angel investment is currently about $100k. They make investment  
decisions quickly, like angels. And they make a lot more investments  
per partner than VCs—up to 10 times as many.The fact that super-angels invest other people's money makes them  
doubly alarming to VCs. They don't just compete for startups; they  
also compete for investors. What super-angels really are is a new  
form of fast-moving, lightweight VC fund. And those of us in the  
technology world know what usually happens when something comes  
along that can be described in terms like that. Usually it's the  
replacement.Will it be? As of now, few of the startups that take money from  
super-angels are ruling out taking VC money. They're just postponing  
it. But that's still a problem for VCs. Some of the startups that  
postpone raising VC money may do so well on the angel money they  
raise that they never bother to raise more. And those who do raise  
VC rounds will be able to get higher valuations when they do. If  
the best startups get 10x higher valuations when they raise series  
A rounds, that would cut VCs' returns from winners at least tenfold.  
[2]So I think VC funds are seriously threatened by the super-angels.  
But one thing that may save them to some extent is the uneven  
distribution of startup outcomes: practically all the returns are  
concentrated in a few big successes. The expected value of a startup  
is the percentage chance it's Google. So to the extent that winning  
is a matter of absolute returns, the super-angels could win practically  
all the battles for individual startups and yet lose the war, if  
they merely failed to get those few big winners. And there's a  
chance that could happen, because the top VC funds have better  
brands, and can also do more for their portfolio companies.   
[3]Because super-angels make more investments per partner, they have  
less partner per investment. They can't pay as much attention to  
you as a VC on your board could. How much is that extra attention  
worth? It will vary enormously from one partner to another. There's  
no consensus yet in the general case. So for now this is something  
startups are deciding individually.Till now, VCs' claims about how much value they added were sort of  
like the government's. Maybe they made you feel better, but you  
had no choice in the matter, if you needed money on the scale only  
VCs could supply. Now that VCs have competitors, that's going to  
put a market price on the help they offer. The interesting thing  
is, no one knows yet what it will be.Do startups that want to get really big need the sort of advice and  
connections only the top VCs can supply? Or would super-angel money  
do just as well? The VCs will say you need them, and the super-angels  
will say you don't. But the truth is, no one knows yet, not even  
the VCs and super-angels themselves. All the super-angels know  
is that their new model seems promising enough to be worth trying,  
and all the VCs know is that it seems promising enough to worry  
about.RoundsWhatever the outcome, the conflict between VCs and super-angels is  
good news for founders. And not just for the obvious reason that  
more competition for deals means better terms. The whole shape of  
deals is changing.One of the biggest differences between angels and VCs is the amount  
of your company they want. VCs want a lot. In a series A round  
they want a third of your company, if they can get it. They don't  
care much how much they pay for it, but they want a lot because the  
number of series A investments they can do is so small. In a  
traditional series A investment, at least one partner from the VC  
fund takes a seat on your board.   
[4]  
 Since board seats last about  
5 years and each partner can't handle more than about 10 at once,  
that means a VC fund can only do about 2 series A deals per partner  
per year. And that means they need to get as much of the company  
as they can in each one. You'd have to be a very promising startup  
indeed to get a VC to use up one of his 10 board seats for only a  
few percent of you.Since angels generally don't take board seats, they don't have this  
constraint. They're happy to buy only a few percent of you. And  
although the super-angels are in most respects mini VC funds, they've  
retained this critical property of angels. They don't take board  
seats, so they don't need a big percentage of your company.Though that means you'll get correspondingly less attention from  
them, it's good news in other respects. Founders never really liked  
giving up as much equity as VCs wanted. It was a lot of the company  
to give up in one shot. Most founders doing series A deals would  
prefer to take half as much money for half as much stock, and then  
see what valuation they could get for the second half of the stock  
after using the first half of the money to increase its value. But  
VCs never offered that option.Now startups have another alternative. Now it's easy to raise angel  
rounds about half the size of series A rounds. Many of the startups  
we fund are taking this route, and I predict that will be true of  
startups in general.A typical big angel round might be $600k on a convertible note with  
a valuation cap of $4 million premoney. Meaning that when the note  
converts into stock (in a later round, or upon acquisition), the  
investors in that round will get .6 / 4.6, or 13% of the company.  
That's a lot less than the 30 to 40% of the company you usually  
give up in a series A round if you do it so early.   
[5]But the advantage of these medium-sized rounds is not just that  
they cause less dilution. You also lose less control. After an  
angel round, the founders almost always still have control of the  
company, whereas after a series A round they often don't. The  
traditional board structure after a series A round is two founders,  
two VCs, and a (supposedly) neutral fifth person. Plus series A  
terms usually give the investors a veto over various kinds of  
important decisions, including selling the company. Founders usually  
have a lot of de facto control after a series A, as long as things  
are going well. But that's not the same as just being able to do  
what you want, like you could before.A third and quite significant advantage of angel rounds is that  
they're less stressful to raise. Raising a traditional series A  
round has in the past taken weeks, if not months. When a VC firm  
can only do 2 deals per partner per year, they're careful about  
which they do. To get a traditional series A round you have to go  
through a series of meetings, culminating in a full partner meeting  
where the firm as a whole says yes or no. That's the really scary  
part for founders: not just that series A rounds take so long, but  
at the end of this long process the VCs might still say no. The  
chance of getting rejected after the full partner meeting averages  
about 25%. At some firms it's over 50%.Fortunately for founders, VCs have been getting a lot faster.  
Nowadays Valley VCs are more likely to take 2 weeks than 2 months.  
But they're still not as fast as angels and super-angels, the most  
decisive of whom sometimes decide in hours.Raising an angel round is not only quicker, but you get feedback  
as it progresses. An angel round is not an all or nothing thing  
like a series A. It's composed of multiple investors with varying  
degrees of seriousness, ranging from the upstanding ones who commit  
unequivocally to the jerks who give you lines like "come back to  
me to fill out the round." You usually start collecting money from  
the most committed investors and work your way out toward the  
ambivalent ones, whose interest increases as the round fills up.But at each point you know how you're doing. If investors turn  
cold you may have to raise less, but when investors in an angel  
round turn cold the process at least degrades gracefully, instead  
of blowing up in your face and leaving you with nothing, as happens  
if you get rejected by a VC fund after a full partner meeting.  
Whereas if investors seem hot, you can not only close the round  
faster, but now that convertible notes are becoming the norm,  
actually raise the price to reflect demand.ValuationHowever, the VCs have a weapon they can use against the super-angels,  
and they have started to use it. VCs have started making angel-sized  
investments too. The term "angel round" doesn't mean that all the  
investors in it are angels; it just describes the structure of the  
round. Increasingly the participants include VCs making investments  
of a hundred thousand or two. And when VCs invest in angel rounds  
they can do things that super-angels don't like. VCs are quite  
valuation-insensitive in angel rounds—partly because they are  
in general, and partly because they don't care that much about the  
returns on angel rounds, which they still view mostly as a way to  
recruit startups for series A rounds later. So VCs who invest in  
angel rounds can blow up the valuations for angels and super-angels  
who invest in them.   
[6]Some super-angels seem to care about valuations. Several turned  
down YC-funded startups after Demo Day because their valuations  
were too high. This was not a problem for the startups; by definition  
a high valuation means enough investors were willing to accept it.  
But it was mysterious to me that the super-angels would quibble  
about valuations. Did they not understand that the big returns  
come from a few big successes, and that it therefore mattered far  
more which startups you picked than how much you paid for them?After thinking about it for a while and observing certain other  
signs, I have a theory that explains why the super-angels may be  
smarter than they seem. It would make sense for super-angels to  
want low valuations if they're hoping to invest in startups that  
get bought early. If you're hoping to hit the next Google, you  
shouldn't care if the valuation is 20 million. But if you're looking  
for companies that are going to get bought for 30 million, you care.  
If you invest at 20 and the company gets bought for 30, you only  
get 1.5x. You might as well buy Apple.So if some of the super-angels were looking for companies that could  
get acquired quickly, that would explain why they'd care about  
valuations. But why would they be looking for those? Because  
depending on the meaning of "quickly," it could actually be very  
profitable. A company that gets acquired for 30 million is a failure  
to a VC, but it could be a 10x return for an angel, and moreover,  
a quick 10x return. Rate of return is what matters in  
investing—not the multiple you get, but the multiple per year.  
If a super-angel gets 10x in one year, that's a higher rate of  
return than a VC could ever hope to get from a company that took 6  
years to go public. To get the same rate of return, the VC would  
have to get a multiple of 10^6—one million x. Even Google  
didn't come close to that.So I think at least some super-angels are looking for companies  
that will get bought. That's the only rational explanation for  
focusing on getting the right valuations, instead of the right  
companies. And if so they'll be different to deal with than VCs.  
They'll be tougher on valuations, but more accommodating if you want  
to sell early.PrognosisWho will win, the super-angels or the VCs? I think the answer to  
that is, some of each. They'll each become more like one another.  
The super-angels will start to invest larger amounts, and the VCs  
will gradually figure out ways to make more, smaller investments  
faster. A decade from now the players will be hard to tell apart,  
and there will probably be survivors from each group.What does that mean for founders? One thing it means is that the  
high valuations startups are presently getting may not last forever.  
To the extent that valuations are being driven up by price-insensitive  
VCs, they'll fall again if VCs become more like super-angels and  
start to become more miserly about valuations. Fortunately if this  
does happen it will take years.The short term forecast is more competition between investors, which  
is good news for you. The super-angels will try to undermine the  
VCs by acting faster, and the VCs will try to undermine the  
super-angels by driving up valuations. Which for founders will  
result in the perfect combination: funding rounds that close fast,  
with high valuations.But remember that to get that combination, your startup will have  
to appeal to both super-angels and VCs. If you don't seem like you  
have the potential to go public, you won't be able to use VCs to  
drive up the valuation of an angel round.There is a danger of having VCs in an angel round: the so-called  
signalling risk. If VCs are only doing it in the hope of investing  
more later, what happens if they don't? That's a signal to everyone  
else that they think you're lame.How much should you worry about that? The seriousness of signalling  
risk depends on how far along you are. If by the next time you  
need to raise money, you have graphs showing rising revenue or  
traffic month after month, you don't have to worry about any signals  
your existing investors are sending. Your results will speak for  
themselves.   
[7]Whereas if the next time you need to raise money you won't yet have  
concrete results, you may need to think more about the message your  
investors might send if they don't invest more. I'm not sure yet  
how much you have to worry, because this whole phenomenon of VCs  
doing angel investments is so new. But my instincts tell me you  
don't have to worry much. Signalling risk smells like one of those  
things founders worry about that's not a real problem. As a rule,  
the only thing that can kill a good startup is the startup itself.  
Startups hurt themselves way more often than competitors hurt them,  
for example. I suspect signalling risk is in this category too.One thing YC-funded startups have been doing to mitigate the risk  
of taking money from VCs in angel rounds is not to take too much  
from any one VC. Maybe that will help, if you have the luxury of  
turning down money.Fortunately, more and more startups will. After decades of competition  
that could best be described as intramural, the startup funding  
business is finally getting some real competition. That should  
last several years at least, and maybe a lot longer. Unless there's  
some huge market crash, the next couple years are going to be a  
good time for startups to raise money. And that's exciting because  
it means lots more startups will happen.  
Notes[1]  
I've also heard them called "Mini-VCs" and "Micro-VCs." I  
don't know which name will stick.There were a couple predecessors. Ron Conway had angel funds  
starting in the 1990s, and in some ways First Round Capital is closer to a  
super-angel than a VC fund.[2]  
It wouldn't cut their overall returns tenfold, because investing  
later would probably (a) cause them to lose less on investments  
that failed, and (b) not allow them to get as large a percentage  
of startups as they do now. So it's hard to predict precisely what  
would happen to their returns.[3]  
The brand of an investor derives mostly from the success of  
their portfolio companies. The top VCs thus have a big brand  
advantage over the super-angels. They could make it self-perpetuating  
if they used it to get all the best new startups. But I don't think  
they'll be able to. To get all the best startups, you have to do  
more than make them want you. You also have to want them; you have  
to recognize them when you see them, and that's much harder.  
Super-angels will snap up stars that VCs miss. And that will cause  
the brand gap between the top VCs and the super-angels gradually  
to erode.[4]  
Though in a traditional series A round VCs put two partners  
on your board, there are signs now that VCs may begin to conserve  
board seats by switching to what used to be considered an angel-round  
board, consisting of two founders and one VC. Which is also to the  
founders' advantage if it means they still control the company.[5]  
In a series A round, you usually have to give up more than  
the actual amount of stock the VCs buy, because they insist you  
dilute yourselves to set aside an "option pool" as well. I predict  
this practice will gradually disappear though.[6]  
The best thing for founders, if they can get it, is a convertible  
note with no valuation cap at all. In that case the money invested  
in the angel round just converts into stock at the valuation of the  
next round, no matter how large. Angels and super-angels tend not  
to like uncapped notes. They have no idea how much of the company  
they're buying. If the company does well and the valuation of the  
next round is high, they may end up with only a sliver of it. So  
by agreeing to uncapped notes, VCs who don't care about valuations  
in angel rounds can make offers that super-angels hate to match.[7]  
Obviously signalling risk is also not a problem if you'll  
never need to raise more money. But startups are often mistaken  
about that.Thanks to Sam Altman, John Bautista, Patrick Collison, James  
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