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Venture Capitalist Sounds Alarm on Startup Investing

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11-14 minutes

Silicon Valley is a risk-driven place. But over the past year, it may have taken on more than it can handle, according to one prominent venture capitalist.

"I think that Silicon Valley as a whole, or that the venture-capital community or startup community, is taking on an excessive amount of risk right now—unprecedented since '99," said Bill Gurley, a partner at Benchmark, referring to the last tech bubble.

Mr. Gurley, who often voices his opinions on his blog, Above the Crowd, sat down with The Wall Street Journal as part of a Journal event series called "Tech Under the Hood." The investor in Uber, Zillow, OpenTable and other Web startups spoke on a wide range of topics. What follows is an edited excerpt of a conversation specifically about potential cracks in the tech-startup investing scene.

WSJ: I want to read you something from your blog. You quoted Warren Buffett's famous quote, "Be fearful when others are greedy and greedy when others are fearful." And then you wrote: "Although we may have not reached the level of observing obvious greediness, there is most certainly an absence of fear. Those that managed companies in 2008, or 13 years ago in 2001, know exactly how fear feels. And this is not it." What did you mean by that?

Mr. Gurley: Every incremental day that goes past I have this feeling a little bit more. I think that Silicon Valley as a whole or that the venture-capital community or startup community is taking on an excessive amount of risk right now. Unprecedented since '99. In some ways less silly than '99 and in other ways more silly than in '99. I love the Buffett quote because it lays it out. No one's fearful, everyone's greedy, and it will eventually end. And there are reasons, which might take all night to explain, why this business is cyclical over time, and the more chance you have to see different cycles and to see how it slips away, you can see it.

There's a phrase that I love: "discounted risk." Do people discount risk? Right now you've got private companies raising $200, $400, $500 million. If you're in a competitive ecosystem and you raise that amount of money, the only way you use it—because these companies are all human-based, they're not like building stores—is to take your burn up.

And I guarantee you two things: One, the average burn rate at the average venture-backed company in Silicon Valley is at an all-time high since '99 and maybe in many industries higher than in '99. And two, more humans in Silicon Valley are working for money-losing companies than have been in 15 years, and that's a form of discounted risk.

In '01 or '09, you just wouldn't go take a job at a company that's burning $4 million a month. Today everyone does it without thinking.

WSJ: Because the equity looks so valuable?

Mr. Gurley: Yeah, it's a whole bunch of things. But you just slowly forget, and half of the entrepreneurs today, or maybe more—60% or 70%—weren't around in '99, so they have no muscle memory whatsoever.

So risk just keeps going higher, higher and higher. The problem is that because you get there slowly the correcting is really hard and catastrophic. Right now, the cost of capital is super low here. If the environment were to change dramatically, the types of gymnastics that it would require companies to readjust their spend is massive. So I worry about it constantly.

WSJ: You used the word silly—a lot of silly stuff going on since '99. Give us an example.

Mr. Gurley: I'll give you something that's tactical. Part of it is why it's cyclical right. For the first time since '99, in the past 12 months, I've been in board meetings where the company says, "Our only option is a 10-year lease," at record pricing on a per square foot basis here in San Francisco, which is two or three times what the rent was three years ago. And so this is why it's all cyclical—because the landlords get greedy. They wouldn't do a 10-year lease if they thought that the rates were low. So they're implicitly telling you they want to lock this in for 10 years, which is its own form of greed because what happened in '99 is half the companies went bankrupt and they couldn't pay the lease over the 10-year period.

Anyway, it's those kinds of things that happen. The most obvious one is just the acceptable burn rate. And that can be seriously, negatively reinforced by the capital market. In the software-as-a-service world, where the risk is potentially among the highest, Wall Street has said it's OK to lose tons of money as a public company. So what happens in the board rooms of all the private companies is they say, "Did you see that? Did you see they went out and they're losing tons of money and they're worth a billion. We should spend more money." And there are people knocking on their door saying, "Do you want more money, do you want more money?"

So it takes the burn rate up.

WSJ: As a result, is Benchmark pulling back?

Mr. Gurley: There are two types of answers to that question. How do we go about investing on a day-to-day basis in terms of new things? And I happen to believe that innovation happens more continuously, even though there are financial cycles, so you can't afford not to be out on the field. But I do think you want to look out for what is the long-term viability of something. I'd much prefer to do a Series A [funding deal] right now than I would later-stage because of this type of risk. So that's one type of answer.

The other type of answer is what you advise your companies to do. That's really difficult because if you have a competitor that's going to double or triple down on sales and you just decide, "Oh, well I'm not going to execute bad business decisions, I'm just going to sit back," you lose market share. So, choosing not to play the game on the field doesn't work, so you're left with trying to advise someone to be pragmatically aggressive with some type of conservative backdrop or alternative strategy in case the world shifts. But it's hard.

WSJ: And you see people apps like Yo or Snapchat. These things get hefty valuations but in reality what we're talking about right now is eyeballs. And once upon a time I remember people were really intrigued by eyeballs, and that didn't work out.

Mr. Gurley: I don't have that criticism as much simply because we've seen so many proven cases now of taking huge market share and then monetizing. That was said against Facebook, and that was said against Twitter. I think the jury is out on our sale of Instagram and whether we sold it too soon. And so I don't necessarily buy into the well, you're not monetizing so it's not valuable.' And I guess [WhatsApp's sale to Facebook for $19 billion] is another data point.

But I think it's different to employ a bunch of people when you don't have the wherewithal to fund yourself through and what type of risk are you taking (in that situation). Anyway, it's something I think about constantly. And, unfortunately, I've come to believe that bad business behavior is coincidental with the best of times in our field.

WSJ: What do you mean by that?

Mr. Gurley: So, the crazier things get, the worse people execute. I was thinking of writing this so I'll test it out on this group.

So I took my family down to the Galapagos this summer and read this book on the way down there called "The Beak of the Finch" which is about this couple that has lived on Daphne Island for 40 years studying the finch. And, amazingly, when there are huge El Niño years and floods bring tons of food to this island, the finch population goes up like three or four times. Inevitably, when the rains are normal the next season there is massive death. Simply because once you get the food level back to a sustainable level. So, from a fitness perspective, excessive amounts of food lead to a lower average fitness and I think the same thing happens here.

Excessive amounts of capital lead to a lower average fitness because fitness, from a business standpoint, has to be cash-flow profitability or the ability to generate cash flow. That's the essence of equity value. And so I think we get further and further away from that in the headiest of times.

WSJ: So who loses? Who is way ahead of themselves? Name some names.

Mr. Gurley: That's obviously loaded. I do think there is a high likelihood that we'll see some high-profile failures in the next year or two. I actually think that could be healthy for the ecosystem. You remember in March when the IPO window closed for like three weeks and everyone thought that the world was coming to an end? Like you really have to work hard to remember it because it reversed itself so quickly. I think having events like that can lead to sanity.

And another element is that most people don't think about liquidation preference. This is pretty technical, but liq preference piles up on a startup. It's not common stock, it's preferred, and it has a debt-like element on the ability to get your money back. So if your liq-preference stack gets so big it makes it is really hard to raise the next incremental round of financing, unless you have some kind of financial behavior that says it definitely should be worth more. They calcify a bit. That's probably the right metaphor.

WSJ: So what does that mean exactly? Last in, first out?

Mr. Gurley: Sometimes that happens when terms shift. But at the very least, your return horizon might be impacted by, you know, now we've got private companies raising between $200 million and $1 billion. If the company ends up being worth not that much, then you don't even get your money back. And your return payout at different points on the horizon may be negatively impacted by the fact that so many people could take their money back instead.

So one of the first things that happens when that starts to become a problem is that you start to see derivative terms, which gets to what you were talking about—first money out. And those things are guaranteed returns against an IPO or some type of debt. You have creeping PIK dividends (dividends paid in preferred stock), that kind of thing. And that then starts to change your return profile for everyone underneath it.

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Corrections & Amplifications

An earlier version of this article misspelled Warren Buffett's surname as Buffet in two instances.

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