# Valuations

People have been saying that startup valuations are really high for about 3 years now. I myself feel that they are high, but I have no idea when they are likely to change.

It's mostly investors that talk about valuations being way too high. But they're the ones that keep willingly paying higher and higher prices. In fact, they keep raising larger and larger funds. So I think there has to be a discount rate on the claim.

The most important reason for this is simple capitalism—large pools of money look for the best risk-adjusted return. Interest rates are effectively zero (and negative in Europe!) and will likely remain that way for awhile— the Fed has continually been too optimistic about when the economy will pick back up. So fixed income is bad, and partially because of that, public equities, real estate, etc all feel really expensive.

The fundamental problem driving this lack of opportunity for capital, in my somewhat controversial opinion, is a lack of GDP growth. Startups have growth, though, and so they attract investment interest.

There have been a lot of startup success stories in the last decade, and a lot more people want to invest in startups than ever before except maybe the 2000 bubble. Crowdfunding (probably the most important new force in startup investing) is providing more competition for early-stage investments, and hedge funds and private equity firms are starting to do a lot more late-stage investing. Angel investors are raising funds at an astonishing rate. Some of these new investors invest partially for social status, not just a financial return, and so are willing to pay relatively higher prices.

A lot of these new investors are willing to accept lower returns than VC firms, given the alternative options for investing the capital. But VC firms will continue to invest, of course, even if the prices are higher than they'd like. [1]

The number of good startups is increasing every year, but not as fast as the investment dollars are. And so there is a supply and demand mismatch, and prices are going up.

VC has worked, at least partially, on special access and information asymmetry. (VCs pitch their LPs about this and call it "competitive differentiation".) But access to startups has gotten much easier. If you're a VC firm still depending on this, you're very likely failing.

The good VCs are doing new things to remain on top. Some firms are focusing on providing services like recruiting, business development, PR, and many others to their startups. Some firms are trying to focus on having partners that are former founders. Still others are trying to focus on contrarian investments. All of this is great for founders.

A lot of the traditional "non-starter" terms from VCs are already going away. We're seeing more and more A rounds happen with less than 20% ownership going to the investors, and fewer and fewer requirements about investor control over the company. Unfortunately, some good things are going away also.

It turns out to be really good for a company to have a board—it focuses the company if everyone knows they have to present the key metrics to outsiders once a month. Some investors feel that if they own a smaller percentage of the company, they are willing to put in money but not time. But I don't think this strategy will work for long—if that's the sales pitch, then founders will take the cheapest capital, and the crowd will probably pay more than VCs. If I could ask VCs for only one thing in this new world, it'd be to keep showing up for board meetings. [2]

I believe good angel and venture investors really do add value, and most founders are rightly willing to take somewhat worse terms to work with people they believe will really help them.  But the capital markets are moving fast, and investors will have to keep up (this was part of our thinking about increasing the standard YC offer).

So what should founders do now that valuations are higher?

Definitely don't start a company just because capital is available.  Remember that cheap capital doesn't make starting a company much easier.  It only does stuff like drive up rent.  Success will still take a very long time.  And it's definitely still bad to chase above-market valuations—you'll price out people that will actually help.  Just take market terms and get back to work.

Resist the urge to raise and spend too much money.  The track record of companies that raise $30MM or more in their first round is bad.  You may be one of the exceptions, but for a bunch of reasons, I think it's better to have a small amount of money until everything is working, and only then really hit the gas pedal.

Also, if capital feels cheap, it's psychologically easier to spend.  It's really important to stay frugal.  In addition to the often-discussed correlation of low CEO pay with success, I've noticed that frugal companies have a culture that ends up being much more focused on real results.  Frugal companies also tend to have a long-term focus.  And on a practical level, it's always possible that the capital you've raised now will be the last you've ever raised.  You should treat it that way.

Some day the top-callers will be right.  It certainly feels to me like we may be in the early days of a bubble (though valuations for brand new companies, which felt most out of whack to me six months ago, seem to have come down somewhat). And a macroeconomic collapse—which may happen—would certainly correct valuations in a hurry. But unless some macro event happens, it feels like valuations can stay high. Importantly, a lot of these startups are generating real revenue and earnings.

[1] My guess for what happens is that the great VCs continue to do well. Many investors think new startups will be worth more than most of the startups from ten years ago—markets keep getting bigger, more good people are starting startups, startups are becoming easier to start, distribution keeps getting easier, and interest rates will probably stay low—or it’s possible that VCs will generate still good but lower-than-historical returns.

[2] The increase in valuations has led to some funny new behaviors. One of the funniest examples is a simultaneous obsession with the price other investors are paying—“Even though I thought this price was good yesterday, I found out someone else is getting to invest at a lower price and I’m furious”—coupled with a refrain of “I’ll work really hard for the company and add much more value than your other investors, so I’d like advisory shares or a discount to participate in your round”. I hope investors will stop doing these sorts of things.