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VC Mailbag: Startup Funding Crunch Is Likely in 2016

The Federal Reserve announced Wednesday it would raise short-term interest rates by 0.25%. (Andrew Harnik/Associated Press)

Venture capitalists are generally united that the Federal Reserve's quarter-point rate increase will have very little immediate impact on the startup fundraising environment.

That said, if the Fed continues to raise rates–Chair Janet Yellen suggested a "gradual" tightening and fund managers expect several more hikes over the next 12 months–the tide of capital could rush out of Silicon Valley more quickly, leaving plenty of companies short of cash before proving they can be profitable. The Fed's move comes as Silicon Valley's hype machine begins to sputter after helping companies achieve valuations ahead of their business fundamentals.

In light of the rate hike, venture capitalists offered their take on the state of startup investing, and the likelihood of a funding crunch. Here's a roundup, edited for style and clarity.

Rory O'Driscoll, partner, Scale Venture Partners:

Venture-backed companies need to generate 20%-plus net returns to compensate investors for the risk of holding illiquid, loss-making, high-growth companies. A change in the 10-year rate from 2% to 2.25% is lost in the noise.

The cost of capital is going up for venture-backed companies because investors have systematically underpriced risk and overpaid for growth. As companies underperform and raise "down" rounds or go public at lower prices, or still worse, get sold or even shut down, investors will realize they have overpaid and reprice accordingly.

We have reached the end of "sloppy growth." Years of high valuations and cheap capital have put pressure on companies to keep growth going at all costs, otherwise that valuation might come down. Because the number of profitable ways for a company to spend money is finite, at some point the pressure to grow leads to investments that deliver growth, but at the expense of, and not alongside, profits. The cult-like status of "unicorns" and maniacal media-driven focus on company valuation at the expense of company performance has only propelled this trend.

In some vast macro sense, cheap capital from the Fed for 10-plus years may have driven all these speculative investments, but the tide is not turning because of the 0.25% rate increase, but because it is becoming obvious – even before any rate change – that the prices are wrong.

Charles Moldow, general partner, Foundation Capital:

Simple answer is that the actual 25 basis-point move is an optical fiber's diameter from being completely meaningless to Silicon Valley and the startup fundraising environment. The challenge is that it's like pulling loose yarn on an old sweater in that once the pulling starts, no one knows how much of the sweater will be left intact when the exercise is done.

If consumers and corporations envision a world where interest rates are 500 basis points higher than today, then behaviors will certainly change. Credit-card interest payments will be a lot larger, corporate R&D will get cut due to capital cost increases, etc. Rationally, those behaviors should only start when rates have moved up materially, but human nature suggests that people will project into the future and act accordingly today.

That also means that the stock market will weaken as alternative investments (debt) look more attractive, which means net worth will decline, which means consumers will become more conservative with spending. Thus, the cycle becomes self-reinforcing and a small raise could in fact be more material than it deserves to be.

All in all, the Fed increases rates to slow a heated economy which should be a positive relative to lowering rates to stimulate a weak economy. Unfortunately, the chess game suggests you need to stay two or more moves ahead.

Rob Stavis, partner, Bessemer Venture Partners:

The actual raising of the overnight rate by 25 basis points will have very little impact on most venture-backed companies. In fact, the improving economic conditions which are leading the Fed to raise rates should be helping businesses more than the 25 basis points will hurt.

We have been advising our companies for a few quarters that they should assume that short-term interest rates will return to a more normalized level of 1.5% to 2% by 2017, and they should plan accordingly. For most of them that has not had a large impact on planning.

This is particularly true because few early stage, venture capital-backed businesses can take advantage of long-term, fixed-rate debt. To the extent they have debt at all it tends to be shorter term and generally a floating rate. Some of the later-stage, capital-intensive businesses may feel this impact more if they hope to use cheap debt to finance large factories or warehouses; however, rates will still feel relatively low to people who have been around for a while.

A more normalized rate environment will make fixed income alternatives more attractive than they have been in a while and that may lessen the demand for venture capital investments. It is likely that shift will be more relevant for crossover buyers like the hedge funds than changing the demand for high-quality venture fund capacity.

There may be a more pronounced effect for some of the new alternative lending business that benefit from refinancing activity, which may be less attractive in a rising rate environment.

Bruno Bowden, equity partner, Data Collective:

The first rate rise will mainly be important as a signal for further rate rises. Last time the Fed started raising interest rates, it ended up raising them more than 4% in two years.

Confidence in a startup can be fragile. However, it'll typically be up to a year to run out of funds before reality hits. At that point, I expect startups to swallow unpalatable investment terms to try and maintain their valuation. While in reality, your options are now worth significantly less. As a late-stage investor, you're best protection is a ratchet – as we saw with the Square IPO.

For many employees joining in later stages, it'll be painful as their options go from lofty valuations to drowning underwater.

Chris Douvos, managing director, Venture Investment Associates

I think that folks in the startup world sometimes aren't sensitized to the complex lambada of risk-adjusted return optimizations that institutions undertake.

Venture doesn't exist in a vacuum and the "risk-on" mentality that caused many growth-starved institutions to flood startups with capital may reverse itself rapidly. If that happens, VCs could feel a crunch and entrepreneurs may find themselves short of cash and forced to refocus on monetization and profitability efforts in short order.

True: A quarter point rise, especially one that's widely anticipated, shouldn't make much of a difference. However, it's like Mike Tyson used to say about boxing: Everybody has a strategy until they get hit.

With respect to later-stage investors, I think that they are becoming a bit more discerning on price. For a while, there was an implicit bargain that late-stage investors would pay higher prices but would enjoy protection through structuring in exchange. I think the companies, however, are getting more thoughtful about the implications of preference stacks and other structuring tools. In a rising price environment, there was a little bit of whistling past the graveyard, but I think that we'll see both investors and companies more thoughtful about round sizes and structures going forward.

Neeraj Agrawal, general partner, Battery Ventures:

Over the past 15 years, I've seen great companies started in every vintage year and in many types of markets. Of the two major factors that can affect a startup–macro forces (interest rates, employment)

and micro forces (product-market fit, secular technology trends), ultimately the micro forces are more determinant of startup success. Great companies ride major technology waves, such as the shift to cloud computing, and do well across various macro environments. Companies that are struggling get decimated during economic headwinds.

To be fair, we haven't seen rising interest rates in almost 10 years. Probably a majority of VCs/entrepreneurs were not in the business back then. But if we assume we are entering a rising rate environment such as we saw in 1994 to 2000, or 2004 to 2007, we should remember that startup companies did great back then. The first period benefited from the birth of the commercial Internet. The second wave benefited from the rise of SaaS/social networking/mobile.

Looking forward to 2015 to 2020, we are entering the golden phase of cloud computing. To quote Scott McNealy from Sun Microsystems, finally, "the network is the computer." This will drive major efficiency gains in enterprise IT and result in significant innovation. A rise in 25 basis points or even 100 basis points can't compete with such disruptive technology changes.

Bottom line: innovation > interest rates

Michael Greeley, general partner, Flare Capital Partners:

A quarter point increase in isolation will have no material impact in immediate funding activity or investor sentiment.

Frankly, the greater risk today is more macro as well as associated with a spike in bankruptcies of venture-backed companies. But if the messaging this week from the Fed is that we are now on a longer-term path to raise rates to more normalized levels, I would expect to see later stage, non-VC investors like hedge funds and mutual funds to start to pull back if they can generate improved returns in other assets classes.

This retreat will accelerate if we also start to see spectacular failures of some of the unicorns. For early stage investors, accustomed to long holding periods, I do not expect to see any significant impact given it is well-understood that over the long-term that venture capital consistently drives superior returns, upwards of 800 to 1,000 basis points over other asset classes.

For a link to the full article, please see:
http://blogs.wsj.com/digits/2015/12/17/vc-mailbag-startup-funding-crunch-is-likely-in-2016
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