@DaveMcClure
@500Startups http://500.co
Phoenix, March 2015 #VentureMadness

500

"Silicon Valley 2.0"
Make Lots of Little Bets.
Expect Most to Fail.

PRESENTED BY
INVEST SW

VENTURE
MADNESS

IN PARTNERSHIP WITH
THE ARIZONA COMMERCE AUTHORITY

2015

[This Talk]

- Changes in Building Technology Startups
- Changes in Venture Capital Investing
- Building Startup Ecosystems
- Global Entrepreneurship

Dave McClure

Founding Partner & Chief Troublemaker, 500 Startups

00's & 10's:

- **VC**: Founders Fund, Facebook fbFund, 500 Startups
- **Angel**: Mashery, Mint.com, SlideShare, Twilio, Wildfire, SendGrid
- **Marketing**: PayPal, Simply Hired, Mint.com, O'Reilly

80's & 90's:

- **Entrepreneur**: Aslan Computing (acq'd by Servinet/Panurgy)
- **Developer**: Windows / SQL DB consultant (Intel, MSFT)
- **Engineer**: Johns Hopkins'88, BS Eng / Applied Math

500 Startups
Global Seed Fund & Startup Accelerator

- **What is 500?**
  - $150M silicon valley VC fund + startup accelerator
  - 50 people / 15 investing partners / 12 countries / 20+ languages
  - Locations: SV/SF, MEX, BRZ, IND, CHN/TWN, KOR, SE Asia, UK, MENA
  - 2000+ Founders / 200+ Mentors
  - Community + Content + Conferences

- **~1000+ Portfolio Co's / 50+ Countries**
  - **Wildfire** (acq GOOG, $350M)
  - **MakerBot** (acq SSYS, $400M)
  - **Viki** (acq Rakuten, $200M)
  - **Simple** (acq BBVA, $117M)
  - **Sunrise** (acq MSFT, $100M)
  - Credit Karma
  - Twilio
  - SendGrid
  - Udemy
  - TheRealReal
  - Barkbox
  - HomeJoy

[This Talk]

- Changes in Building Technology Startups
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Changes in Tech Startups

- **LESS Capital** required to build product, get to market
  - Dramatically reduced cost for servers, software, bandwidth
  - Funding Platforms: KickStarter, Angel List, Funders Club, etc
  - Access to online platforms for 100M-1B+ consumers, smallbiz, etc

- **MORE Customers** via ONLINE platforms (100M+ users)
  - **Search** (Google, Baidu)
  - **Social** (Facebook, Twitter, LinkedIn)
  - **Mobile** (Apple, Android)
  - **E-Commerce** (Amazon, Ebay/PayPal, Alibaba)
  - **Media** (YouTube, Pinterest, Instagram)
  - **Comm/Msgs** (WeChat/WhatsApp, Email, Voice, SMS, etc)

- **LOTS of little bets:** Accelerators, Angels, Angel List, Small Exits
  - Capital + Co-working + Mentoring -> Design, Data, **Distribution**
  - "**Fast, Cheap Fail**", network effects, quantitative + iterative investments

Before & After 2 Dot-Com Crashes
LEAN Startup: Simpler, Faster, Cheaper, Smarter

500 startups

Before 2000

"Big, Fat, Dinosaur Startup"

- Sun Servers
- Oracle DB
- Exodus Hosting
- 12-24mo dev cycle
- 6-18mo sales cycle
- <100M people online
- $1-2M seed round
- $3-5M Series A
- Sand Hill Road crawl
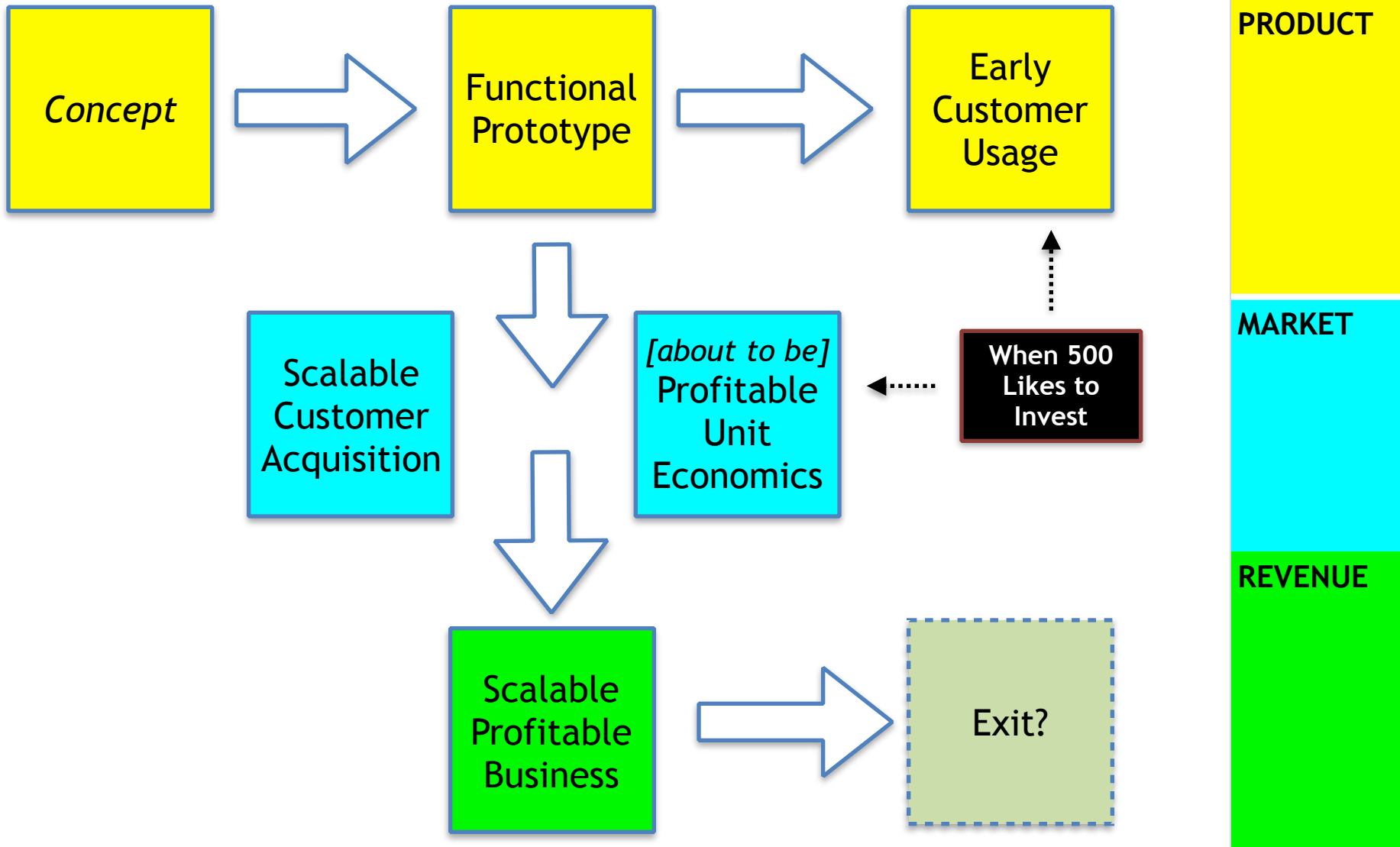
After 2008

"Lean, Little, Cockroach Startup"

- AWS, Google, PayPal, FB, TW
- Cloud + Open Source SW
- Lean Startup / Startup Wknd
- 3-90d dev cycle
- SaaS / online sales
- >3B people online
- <$100K incub + <$1M seed
- $1-3M Series A
- Angel List global visibility

Startup Founder Education

- ~~Business Plans / Revenue Projections~~
- Software + Design/UX
- Lean Startups + Continuous Deploy (Iterate)
- Metrics Framework + Continuous Testing
- **Functional Prototypes / Customer Development**
- **Scalable [Internet] Marketing & Sales**
- **Cash-Flow Positive Unit Economics**
- **Pitching + Fundraising (Angel List)**
- Monetization + Payments
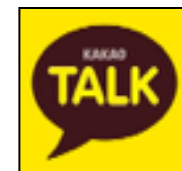- Customer Service + Support

Startup Risk Reduction

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```
Concept  →  Functional     →  Early
             Prototype          Customer
                                Usage
                │                  ↑
                ↓                  ┆
Scalable        [about to be]  ┄┄  When 500
Customer        Profitable         Likes to
Acquisition     Unit               Invest
                Economics
                │
                ↓
Scalable        →  Exit?
Profitable
Business
```

PRODUCT

MARKET

REVENUE

Platforms 2.0
Search, Social, Mobile, Video, Messaging

500startups

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Industry Changes

- Financial Market **Crises** (2000, 2008)
- Startup Efficiency, **Lean Startup Movement**, Reduced Capital Costs
- Growing Market, **Global Distribution Platforms**, "Growth Hacking"
- Improved Monetization, **Payments Infrastructure**
- Developing **Startup Ecosystems**, Global M&A

- **Micro VC: Seed Funds** (ex: **First Round Capital**)
- Incubators & Accelerators (ex: **Y Combinator**, **500 Startups**)
- Funding Platforms (ex: **Angel List**, **Kickstarter**)
- Global Market of Angel Investors, Accelerators, Seed Funds

more info: http://PreMoney.co

Investor Education

- **Startups are NOT Real Estate**
- **Most Startups Fail / Power Law Returns**
- **Portfolio Approach (20+ investments)**
- Legal Structure, Financial Structure
- Syndication + Co-Investment
- Access to Downstream Capital
- Exits & Liquidity
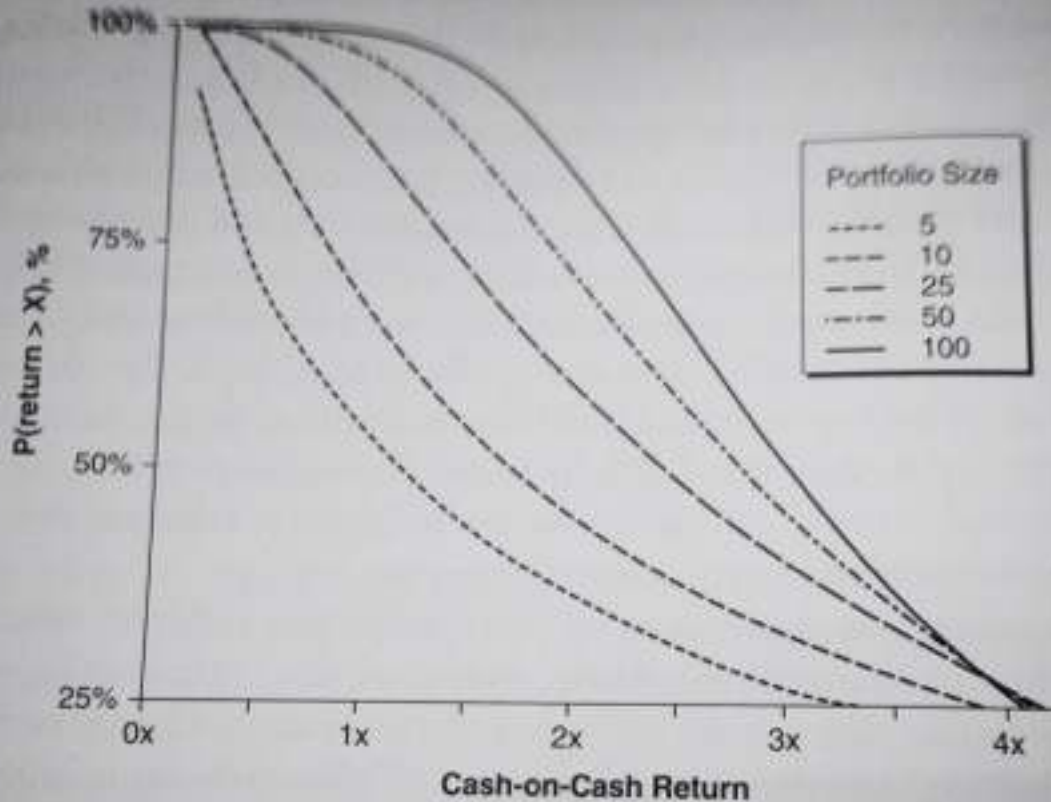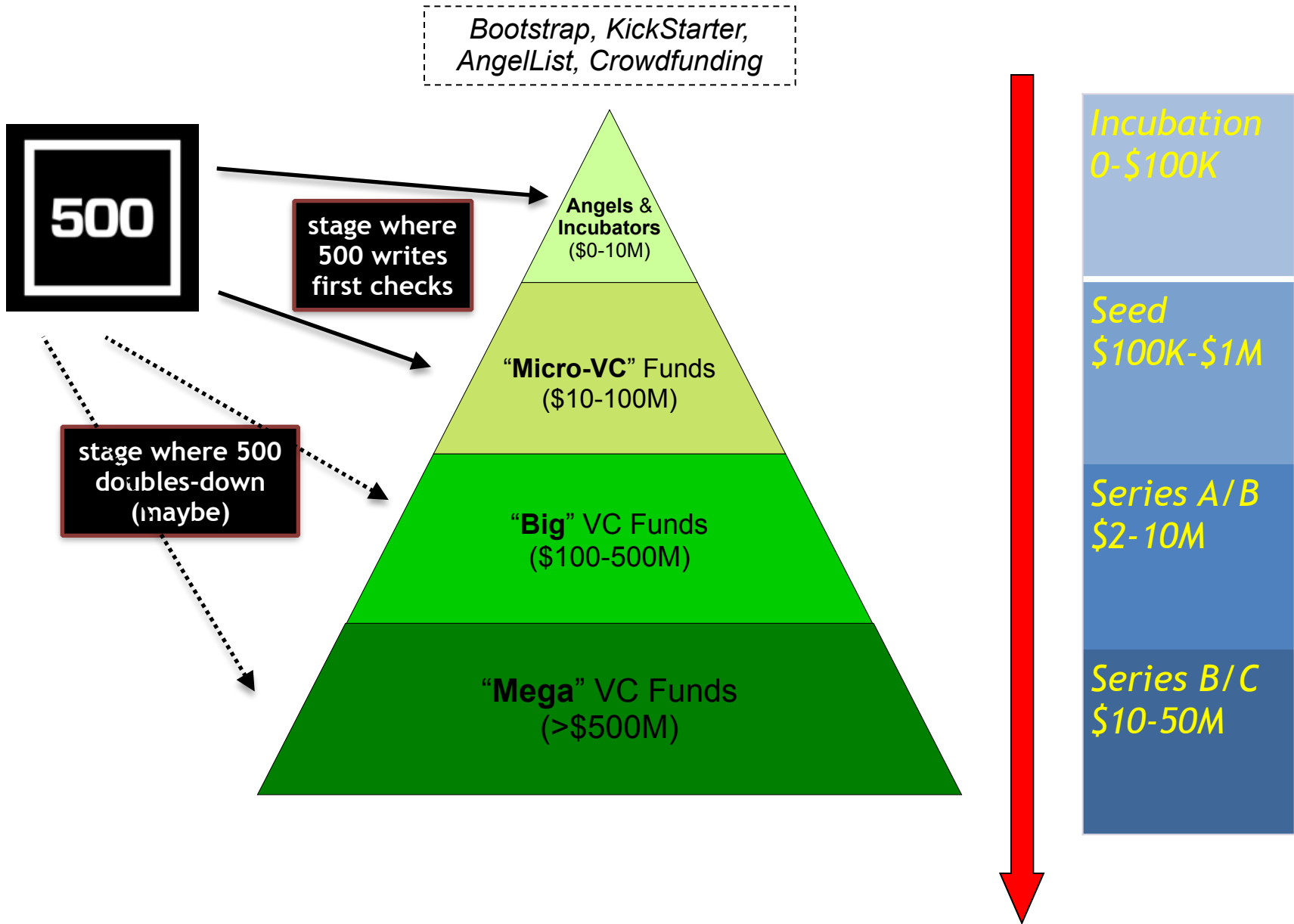
Portfolio Diversification
"Spray, not Pray"

Figure 3.1 Probability of Angel Returns Based on Portfolio Size
Source: *Data Driven Patterns of Successful Angel Investing* by Sim Simeonov, www.slideshare.net/simeons/patterns-of-successful-angel-investing-8306787

Investor Ecosystem

Bootstrap, KickStarter, AngelList, Crowdfunding

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stage where 500 writes first checks

stage where 500 doubles-down (maybe)

Angels & Incubators
($0-10M)

"Micro-VC" Funds
($10-100M)

"Big" VC Funds
($100-500M)

"Mega" VC Funds
(>$500M)

Incubation
0-$100K

Seed
$100K-$1M

Series A/B
$2-10M

Series B/C
$10-50M

500 Strategy: *Lots of Little Bets**

Quantitative Investing *before* Traction

250+ companies @ $25-100K (1st check)
- Assume high failure rate (up to 80%)

Double-Down *after* Traction

50+ 'winners' @ $100K-$1M
(2nd + 3rd check)
- Target 10+ exits @ $100M+

1) make lots of little bets on pre-traction, early-stage startups

2) over the next 2 years, double-down on top 20%

3) wait 3-10 years for returns:
-10-20% small exits @1-5X ($5-25M+)
-5-10% larger exits @5-20X ($25-250M+)
-1-2% unicorns @20-50X+ ($250M-1B+)

*See Peter Sims book: "Little Bets"

The Lean Investor

Make <u>lots of little bets</u>:

- Start with many small "experiments"
- Filter out failures + small wins
- Double-down on stuff that looks like it's working

- **Incubation**: $0-100K (*"Build & Validate <u>Product</u>"*)
- **Seed**: $100K-$1M (*"Test & Grow <u>Market</u>ing Channels""*)
- **Venture**: $1M-$10M (*"Maximize Growth & <u>Revenue</u>"*)

Startup Due Diligence

pro tip: focus on product + customers over team + market

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- ~~Business Plans~~
- ~~Revenue Projections~~

- Can The Team Build the Product? Can They Ship, Market, & Sell?
- Are They Liars, Crooks, or Fools? Are They Lazy or Slow? Are They Crazy?

- **Does Product Work? Does It Solve a Problem? Better Than Competition?**
- **Are There Users / Customers? How Many? Do They Pay? How Much?**
- **Are the Unit Economics Profitable? What is timing of Revenue / Expense?**
- **Does The Customer Acquisition Strategy Scale? Show Me The Proof.**

- Will The Business Survive & Grow? Will the Founders Quit? Sell Early?
- If It Works, Will Anybody Buy The Business? Who / Why / How?

Investment Stage #1:
Product Validation + Customer Usage

- Structure
  - 1-3 founders
  - $25-$100K investment
  - Incubator environment: multiple peers, mentors/advisors

- Test Functional Prototype / "**Minimum Viable Product**" (**MVP**):
  - Prototype->Alpha, ~3-6 months
  - Develop Minimal Critical Feature Set => Get to "**It Works! Someone Uses It.**"
  - Improve Design & Usability, Setup Conversion Metrics
  - Test Small-Scale Customer Adoption (10-1000 users)

- Demonstrate Concept, Reduce Product Risk, Test Functional Use
- Develop Metrics & Filter for Possible Future Investment

Investment Stage #2:
Market Validation + Revenue Testing

- Structure
  - 2-10 person team
  - $100K-$1M investment
  - Syndicate of Angel Investors / Small VC Funds

- Improve Product, **Expand Customers**, Test Revenue:
  - Alpha->Beta, ~6-12 months
  - Scale Customer Adoption => "**Many People Use It, & They Pay.**"
  - Test Marketing Campaigns, Customer Acquisition Channels + Cost
  - Test Revenue / Unit Economics, Find Profitable Customer Segments

- Prove Solution/Benefit, Assess Market Size
- Test Channel Cost, Unit Economics, Revenue Opportunity
- Determine Org Structure, Key Hires
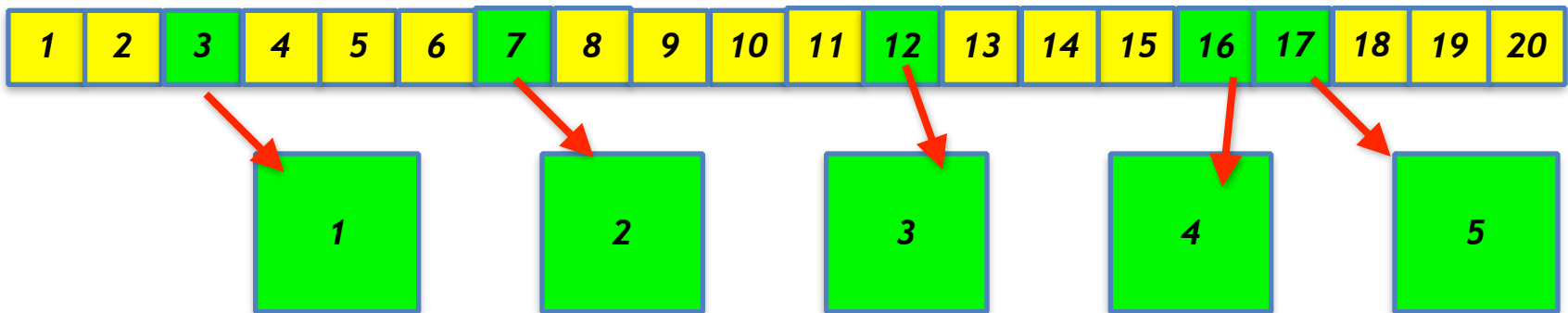
Investment Stage #3:
Revenue Validation + Growth

- Structure
  - 5-25 person team
  - $1M-$10M investment
  - Seed & Venture Investors

- **Make Money (or Go Big)**, Get to Sustainability:
  - Beta->Production, 12-24 months
  - Revenue / Growth => "**We Can Make (a lot of) Money!**"
  - Mktg Plan => Predictable Channels / Campaigns + Budget
  - Scalability & Infrastructure, Customer Service & Operations
  - Connect with Distribution Partners, Expand Growth

- Prove/Expand Market, Operationalize Business
- Future Milestones: Profitable/Sustainable, Exit Options

Building a Portfolio Budget & Allocation Strategy

- How long will it take companies to exit? (3-7 yrs)

- How much money do you have to lose? (<5-10% net worth)

- *(How much time do you have to spend/waste? sure about that?)*

- **Simple allocation for $1M investment budget over 5 years**
  - 50% 1st checks + 50% 2nd checks
  - 20 x 1st checks @ $25K each, 1 / qtr ($500K)
  - 5 x 2nd checks @ $100K each, 1 / year ($500K)

Tracking Investments

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- Set expectations for **monthly** investor updates & hold accountable

- Get & review monthly/quarterly financials

- **WATCH THE BURN:** ask what the monthly [net] burn rate is & compare to previous

- **WATCH THE CASH:** ask how much cash is left & calc # months @ current burn rate

- Raise new round before <6-9 mo's cash; Worry if <3 mo's of cash.

- Share info with co-investors on how your companies are doing (they may have diff info)

- Focus your energy on things that are working.

- Remember: try to be helpful, do no harm, don't be an ass.

When / How to Double-Down?

- **When to "follow-on" (write 2nd check):**
  - user/customers are scaling
  - revenue/profit is increasing
  - unit economics improving
  - other experienced investors putting in more money
  - founders never talk about selling / don't ask for your money

- **When NOT to double-down:**
  - founders begging you for money
  - still no product / no revenue / un-profitable
  - team isn't shipping product fast / frequent
  - valuation too high / raised too much money
  - can't increase ownership by at least 50-100%
  - even if making progress; exit still not likely
  - you have other / better alternatives

The Flat, The Elbow, The Wall

- Invest @ *"The Flat"* when prices are low

- Double-down if/when you detect *"The Elbow"* (if valuation isn't crazy)

- Don't invest @ *"The Wall"* unless capital is infinite — if valuation starts running away, you usually can't buy any meaningful ownership relative to existing.
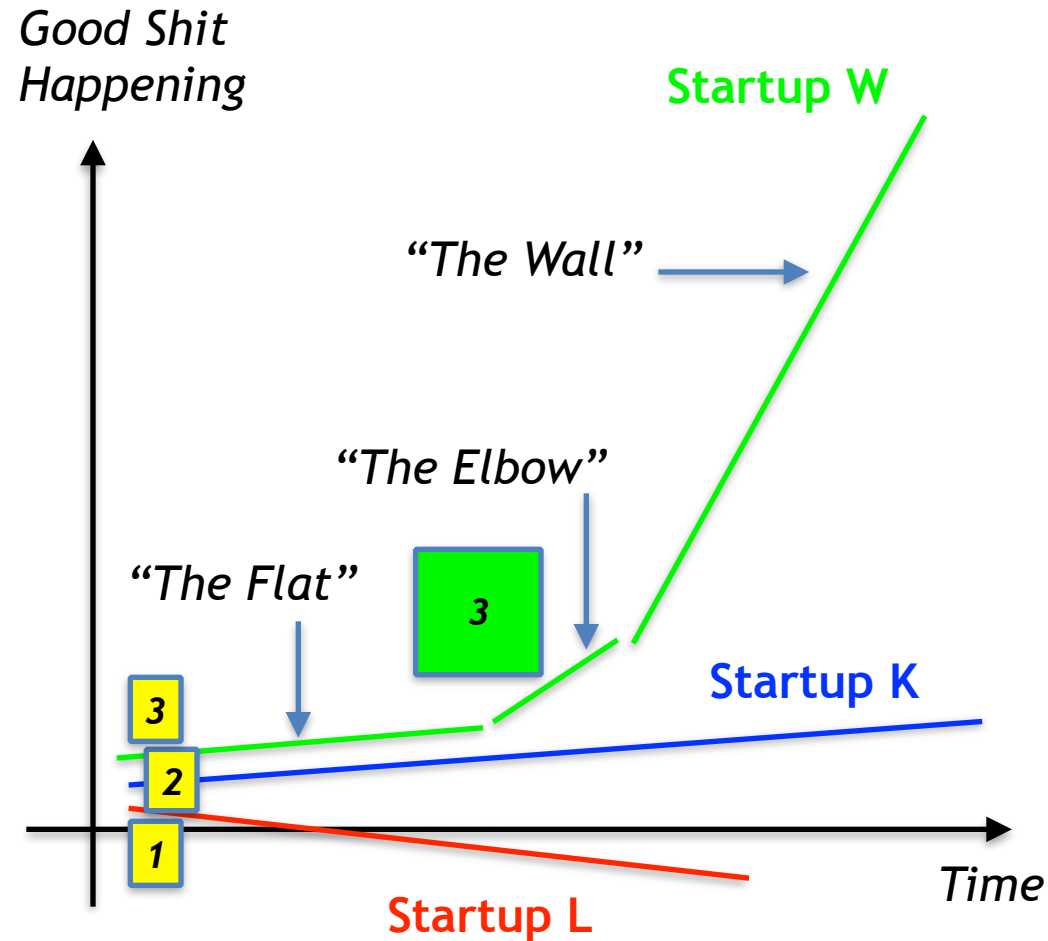
Good Shit Happening

Startup W

"The Wall"

"The Elbow"

"The Flat"

3

3

2

1

Startup K

Startup L

Time

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Startup Investor Ecosystem

500 startups

Bootstrap, KickStarter, AngelList, Crowdfunding

Y-Combinator

SV Angel

Angels & Incubators ($0-10M)

SoftTech (Clavier)

Felicis (Senkut)

"**Micro-VC**" Funds ($10-100M)

First Round

Union Square

"**Big**" VC Funds ($100-500M)

A16Z

Sequoia
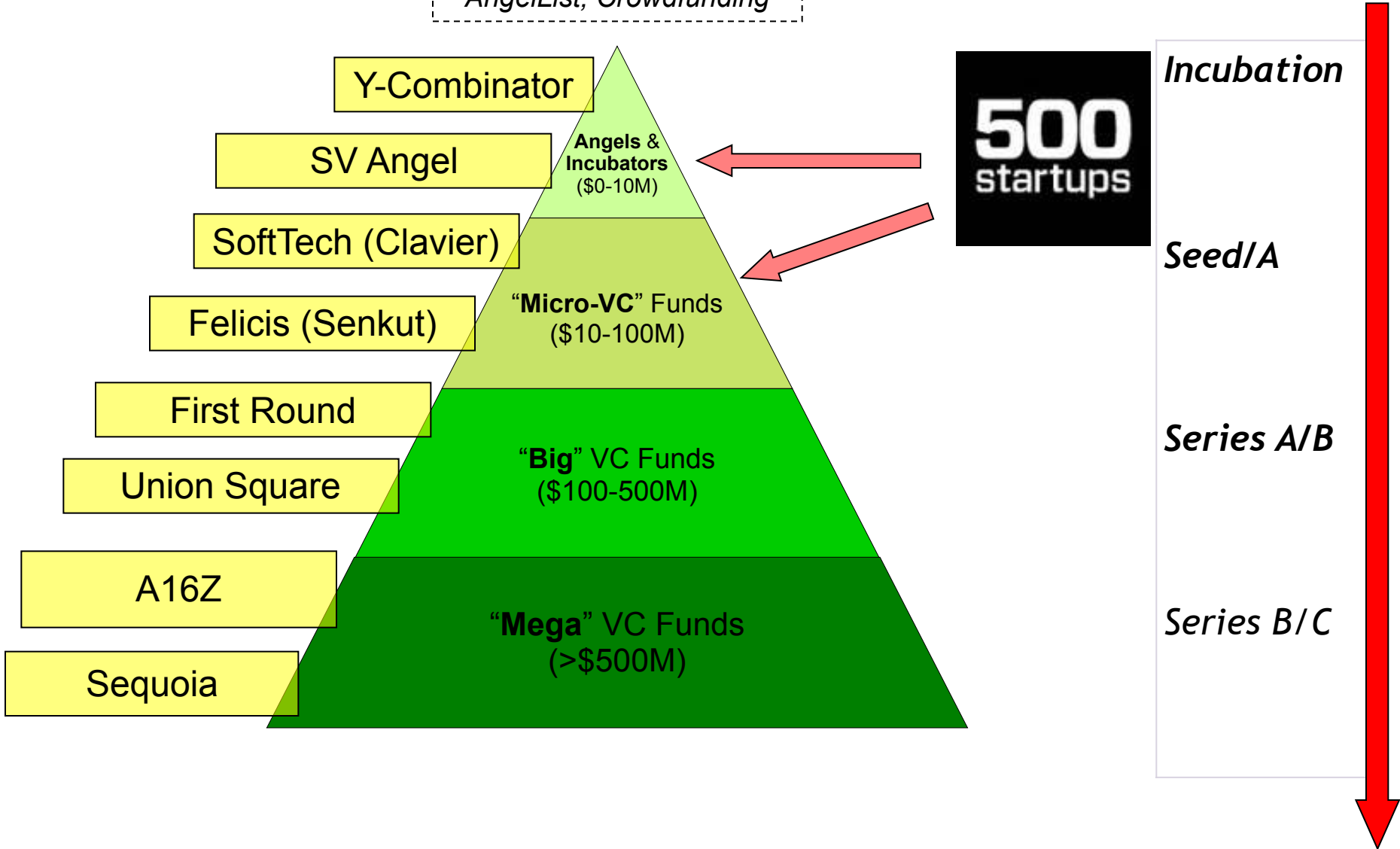
"**Mega**" VC Funds (>$500M)

500 startups

Incubation

Seed/A

Series A/B

Series B/C

Critical Ecosystem Factors

- <u>Optimism & Belief</u> ("Silicon Valley")
- Mentorship + Education (Knowledge)
- Universities + Companies (People)
- Capital, Legal, Finance (Infrastructure)
- Engineering + Design / UX (Product)
- Platforms + Distribution (Customers)
- Online Payments (Monetization)
- IPO / M&A Market (Exits)

Example Startup Ecosystem

- 1,000 Bootstrap Startups ($0-10K)
  - = 1,000 Parents/Garages/Basements @ $0-500/mo food+rent
- 300 Accelerator Startups ($10-100K)
  - = 10-20 Accelerators @ $1-5M/yr, 20-50 co's/yr
- 100 Seed-Stage Startups ($100K-$1M)
  - = 5-10 Micro-VC Funds @ $10-30M/yr, 10-20 co's/yr
- 30 Series A/B Startups ($1-10M)
  - = 3-5 Early-Stage Funds @ $25-100M/yr, 5-10 co's/yr
- 10 Later-Stage Companies ($10-100M)
  - = 2-3 Later-Stage Funds @ $50-250M/yr, 3-5 co's/yr
- 1-3 Mature Company IPOs ($100M+)

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Local vs Global?

- Emerging / Developing Markets
- Global Languages: **English**, **Chinese**, **Spanish**, **Arabic**
- Critical Factors: **Education, Mentorship, Capital**
- Capital Availability: **Incubation, Seed, Series A**
- Positive Macro: SmartPhones, Tablets, Payments, Logistics, Growing Middle Class, **Distribution Platforms**
- Wealthy Global Users, Shoppers, Travelers

How Big is Seed Stage Startup Market?

500 VCs invest in 10,000 startups/yr @ $500K/startup = $5B/yr

How many people are entrepreneurs? How many startups get started every year?

• ~1% of Humanity is "Entrepreneurial" (def'n: "can create a $10M rev/yr business")

• 1% x 7B ppl = 70M entrepreneurs, each of which starts 1-5 businesses lifetime (70 yrs)

• **hypothesis**: talented entrepreneurs can create 1-5M new "startup" businesses every year

NOW: let's say we *ONLY* do the top 1% => the best 10,000 startups in the top 200 metros

How many metros? How many investors / metro? How many startups / metro?

• 1 [micro] VC can fund 10-20 startups/yr * $50K-$500K = ~$1-10M/yr annual budget

• global metros of 1-10M+ ppl can generate 100-1,000 startups / year

• 1-5 VCs in top 200 metros = 500 VCs x 20 startups/yr = 10,000 startups/yr

• **hypothesis:** 500 VCs invest $500K each -> 20 startups/yr = $5B/yr -> 10,000 startups

… so forget about **500 Startups**, and start thinking about **500 VCs**.

Questions? Comments?

- More?
  - http://500.co (our company)
  - http://500hats.com (my blog)
  - https://angel.co/500startups (our fund)
  - **Dave McClure**, @DaveMcClure