THE SILICON VALLEY MOB

Since the pandemic started, there's been approximately 61,260 tech layoffs. Close to 30% of the layoffs came from public tech companies, 85% of those companies are unprofitable. No deep insights here, just the simple fact that the once growth hyper focused startups grew to be publicly traded companies without ever sorting their unit economics, and now their mediocracy has real consequences on real people. This includes household names such as Uber, Lyft, Casper, and Eventbrite which we've all used, and raises the question: why did we allow so many unprofitable companies to IPO? When did losing money become acceptable and the new normal for publicly traded companies? Chamath Palihapitiya's "VC Ponzi Scheme" monologue comes to mind.

https://www.youtube.com/watch?v=NVVsdlHslfI

One of Silicon Valley’s most outspoken investors slams the ‘bizarre Ponzi balloon’ of the Silicon Valley's Kleiner Perkins and Greylock

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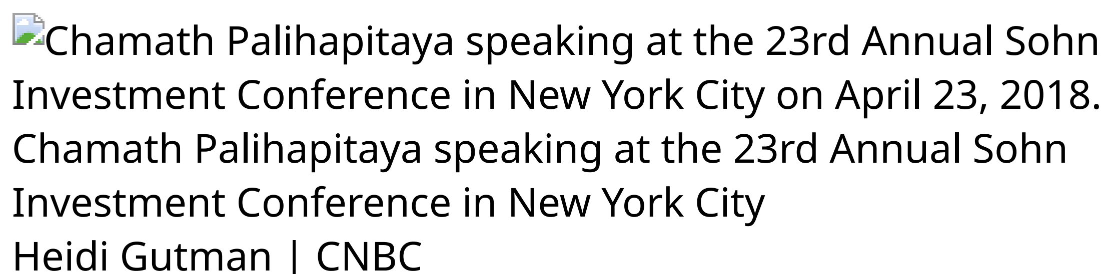
Key Points

- Palihapitiya said venture capital firms are “creating a dangerous, high stakes Ponzi scheme” for which their limited partners and tech employees are left “holding the bag.”


Chamath Palihapitaya speaking at the 23rd Annual Sohn Investment Conference in New York City on April 23, 2018.
Chamath Palihapitaya speaking at the 23rd Annual Sohn Investment Conference in New York City
Heidi Gutman | CNBC

Chamath Palihapitiya, one of Silicon Valley’s most outspoken tech investors, doubled down on calling the venture capital and tech start-up economy a Ponzi scheme on Wednesday.

In a letter released by Social Capital, his venture firm, Palihapitiya wrote that “the dynamics we’ve entered is, in many ways, creating a dangerous, high stakes Ponzi scheme” and a “bizarre Ponzi balloon.”

Palihapitiya argues that “start-up valuations are massively inflated” as venture firms invest in each others’ companies, push start-ups to use their funds to pay for user acquisition, and then raise investments from more firms. All the while, the venture firms can profit from management fees long before any of the start-ups they bet on are successful.

“These markups, and the paper returns that they suggest, allow VCs to raise subsequent, larger funds, and to enjoy the management fees that those funds generate,” he wrote.The cycle hurts two groups in particular, Palihapitiya wrote -- the so-called “limited partners” who invest money in venture capital funds, and the employees of the tech start-ups supported by those funds. Limited partners don’t see returns until “many years down the road,” as the typical venture fund runs seven to ten years. Meanwhile, start-up employees give up the cash compensation they’d earn at a big company for stock options, which are difficult to cash out and often end up worthless, as later investors dilute their value or the start-up fails. This is not the first time Palihapitiya, who was an early Facebook employee, has called Silicon Valley’s start-up ecosystem a Ponzi scheme. “We are, make no mistake … in the middle of an enormous multivariate kind of Ponzi scheme,” Palihapitiya said at a San Francisco conference three weeks ago. Palihapitiya’s comments come after a turbulent year for Social Capital. The firm has seen the departure of numerous employees, and in September, Palihapitiya said Social Capital would no longer accept outside

investment from limited partners. “We think not, and we believe it’s time to wait patiently as the air is slowly let out of this bizarre Ponzi balloon created by the venture capital industry,” Palihapitiya wrote in his letter.

Startups spend almost 40 cents of every VC dollar on Google, Facebook, and Amazon.”

Chamath Palihapitiya, CEO of Palo Alto-based Social Capital – a “technology holding company” – and an early Facebook executive responsible for increasing its userbase (he left in 2011 to found Social Capital), has been accused of being outspoken before. And after his excellent but, well, outspoken commentary in his firm’s 15-page first annual letter, he will surely be so accused again.

As he lays bare how the startup and venture-capital ecosystem works – who ends up as “bag holders” is “not who you think,” he says – he steps on toes and says out loud what everyone is trying to keep quiet. Of course, these dynamics cannot last, and he says “It’s time to wait patiently as the air is slowly let out of this bizarre Ponzi balloon created by the venture capital industry.”

Below are the most salient excerpts on this topic from Social Capital’s first annual letter:

“Big Tech [‘the Googles and Amazons of the world’] will get bigger and will leave less room for obvious companies doing obvious things. The demands of innovation are going up, and the quality of the ideas and teams working on those ideas matter now more than ever in this David v. Goliath landscape.”

“Of course, one would think that investors should become more circumspect about the utility of their capital during times like these. Curiously, the opposite is currently true and is setting up for a massive rude awakening.”

“Since the great financial crisis, the quantity of capital that has made its way into the tech ecosystem seeking to fund the next generation of successful businesses has steadily increased. We don’t just have big companies anymore. We also have big funds [such as the Softbank Vision Fund, ‘which has a minimum check size of $100 million and a target of $50 billion per year of investment.’]”

“However, these mega-funds only tell half the story: there has also been a continuous surge of seed capital flowing into the industry as successful founders, builders, and fund managers reinvest their own money into the earliest stages of technology startups. They invest not only in pursuit of future returns, but also for the social cachet associated with claiming, ‘I’ve backed the next big thing.’”

“Whether small or big, everyone wants into the party.”

“The collective returns reflect the new reality that venture capital does not deliver a premium for its investors. In fact, the VC industry reliably trails the S&P.”

Today in VC investing, “The hardest thing for most startups today is the path to market: first finding product-market fit and a way to reach customers, and then building a ruthless machine to acquire, monetize, and retain them. Because of this, when the VC industry invests capital into fast-growing startups today, the plurality, if not the majority, of invested capital will go into user

acquisition and ad spending, for better or worse (usually worse).”

“Startups spend almost 40 cents of every VC dollar on Google, Facebook, and Amazon. We don’t necessarily know which channels they will choose or the particularities of how they will spend money on user acquisition, but we do know more or less what’s going to happen.”

“Advertising spend in tech has become an arms race: fresh tactics go stale in months, and customer acquisition costs keep rising.”

“Unfortunately, today’s massive venture-backed advertising, sales, and user acquisition playbook has morphed into one that champions growth at any cost.”

“And it is creating a big bill that will soon come due.”

“One important reason why ‘growth for its own sake’ has come to dominate the tech industry is because of the powerful network effects that come from size (again, the byproduct of living in a world dominated by Big Tech).”

“In an internet-connected world, several kinds of businesses – platforms, marketplaces, aggregators, and social networks, to name a few – stand to become enormously valuable and profitable should they reach a certain critical mass. There’s a reflexivity to these network-based businesses. They reason, ‘as we become large, our product will become better and our business more valuable. Therefore, we should spend money to become large. We’ll obtain that money by raising equity at a high

valuation, which is justified by how large and valuable we will become once we spend the money.'"

"In a world where only one company thinks this way, or where one business is executing at a level above everyone else – like Facebook in its time – this tactic is extremely effective. However, when everyone is acting this way, the industry collectively becomes an accelerating treadmill."

"Ad impressions and click-throughs get bid up to outrageous prices by startups flush with venture money, and prospective users demand more and more subsidized products to gain their initial attention."

"Such is the world of user acquisition in tech today: as growth becomes increasingly expensive, somebody must be footing the bill for all of this wasteful spending. But who?"

"It's not who you think, and the dynamics we've entered is, in many ways, creating a dangerous, high stakes Ponzi scheme."

"The Shuffle Game: Over the past decade, a subtle and sophisticated game has emerged between VCs, LPs [limited partners], founders, and employees. Someone has to pay for the outrageous costs of the growth described above. Will it be VCs? Likely not. They get paid to allocate other people's (LPs) money, and they are smart enough to transfer the risk."

"For example, VCs habitually invest in one another's companies during later rounds, bidding up rounds to valuations that allow for generous markups on their funds' performance. These markups, and the paper returns that they suggest, allow VCs to

raise subsequent, larger funds, and to enjoy the management fees that those funds generate.”

“Picture this scenario: if you’re a VC with a $200-million fund, you’re able to draw $4 million each year in fees. (Typical venture funds pay out 2 percent per year in management fee plus 20 percent of earned profit in carried interest, commonly called “two and twenty”). Most funds, however, never return enough profit for their managers to see a dime of carried interest. Instead, the management fees are how they get paid. If you’re able to show marked-up paper returns and then parlay those returns into a newer, larger fund – say, $500 million – you’ll now have a fresh $10 million a year to use as you see fit.”

“So even if paying or marking up sky-high valuations will make it less likely that a fund manager will ever see their share of earned profit, it makes it more likely they’ll get to raise larger funds – and earn enormous management fees. There’s some deep misalignment here.”

“Highly marked-up valuations, which should be a cost for VCs, have in fact become their key revenue driver. It lets them raise new funds and keep drawing fees.... [T]he modern venture model translates into higher costs of, well, just about everything. We have higher salaries, higher rents, higher customer acquisition costs, Kind bars, and kombucha on tap!”

“So if it’s not VCs, who ends up holding the bag?”

“It’s still not who you’d necessarily expect. Later-stage funds, who invest large follow-on rounds into these marked up companies, do indeed pay inflated prices – but they also usually get their money out first upon a liquidity event, and are also happy to

exist in ‘Fee-landia.’ In some cases, high prices may even work to their advantage. They’re able to hold certain late-stage companies hostage to their high valuations by demanding aggressive deal structures in return for granting “Unicorn Status” (the billion-dollar valuation that VCs so crave). Unlike in other pass-the-buck schemes, the bill is not getting passed from early investors to later investors.

“The real bill ends up getting shuffled out of sight to two other groups.”

“The first, as you might guess, are early stage funds’ limited partners, particularly the future limited partners that invest into the next fund. Their money, after all, is what pays the VC’s newly trumped up management fee: marking up Fund IV in order to raise money for more management fees out of Fund V, and so on, is so effective because fundraising can happen much faster than the long and difficult job of actually building a business and creating real enterprise value. It might take seven to ten years to build a company, but raising the next fund happens in two or three years.”

“The second group of people left holding the bag is far more tragic: the employees at startups. The trend in Silicon Valley today is for a large percentage of employee compensation to be given out in the form of stock options or restricted stock units. Although originally helpful as a way to incentivize and reward employees for working hard for an uncertain outcome, in a world where startup valuations are massively inflated, employees are granted stock options at similarly inflated strike prices.”

“Overall, you can understand how this arrangement endures: VCs bid up and mark up each other’s portfolio company valuations today, justifying high prices by pointing to today’s user growth and tomorrow’s network effects. Those companies then go spend that money on even more user growth, often in zero-sum competition with one another.”

“Today’s limited partners are fine with the exercise in the short run, as it gives them the markups and projected returns that they need to keep their own bosses happy. Ultimately, the bill gets handed to current and future LPs (many years down the road), and startup employees (who lack the means to do anything about the problem other than leave for a new company, and acquire a ‘portfolio’ of options.)”

“The antidote is two-fold. First, we need to return to the roots of venture investing. The real expense in a startup shouldn’t be their bill from Big Tech but, rather, the cost of real innovation and R&D. The second is to break away from the multilevel marketing scheme that the VC-LP-user growth game has become.”

And at the other end of the boom spectrum that cannot last, the Fed is warning about “leveraged loans,” lambasting the favorite strategies of “collateral stripping,” “incremental “facilities,” “cov-lite,” and “EBITDA Add-Backs.”