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How Software Is Eating Venture Capital

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I share insights on creative construction.

An entrepreneur I met recently has several Sand Hill Road venture capitalists (VCs) eating out of his hands. Having launched their product on Kickstarter, they are collecting in pre-orders at the rate of upwards of $20,000 a day. With $3 million in pre-orders at hand, VCs are begging to invest - or get in on this opportunity. The pre-money valuation has risen into the “obscene” category. Without Kickstarter, this company would have been laughed out of any VC meeting with a terse comment - “we don’t do hardware!” As Marc Andreessen correctly pointed out, software is eating the world. And now software is eating venture capital! Online portals like Angellist may have just begun nibbling at toes of Sand Hill road. VCs are burying their head in the sand (or silicon, depending on the geography).Foundry Group is one of the first VCs to look at this wave as an opportunity (as opposed to a threat) and have launched FG Angels syndicating investments via AngelList. Give such online marketplaces a few more years and it will reconfigure the VC landscape completely.

Introducing the Founder’s b**:** These days, entrepreneurs don’t need VCs as much as VC’s need entrepreneurs. AngelList processes as much as 500 introductions and moves $10 million each month. The amounts are small today but that’s how it started with online e-commerce purchases – small amounts build trust for larger transactions. First we bought books online, and now we are buying cars, flat screen TVs and more. Similar paths may emerge with investing. The VC, as a middleman is a species that seems to be in trouble. VCs take too long to make decisions and want to push too much money too soon into entrepreneur's hands. Paul Graham of Y Combinator fame, speaking at PreMoney conference in San Francisco, said, “VC’s still need entrepreneur’s imagination and energy but the entrepreneurs don’t need their money as much. Investor’s make more money as founder’s bitches than their bosses.” Ouch!

It ~~is~~ WAS the network stupid: In writing "The Business of Venture Capital", I had the opportunity to talk to several thoughtful LPs (Limited Partners, or those who invest in venture funds). All they cared about in VCs was the ability to source good investments. Can these VCs find the next Facebook? Chris "SuperLP" Douvos of VIAFunds remarked that he found sourcing to be a huge differentiator, "much more than what I was trained to see." Yet sourcing was a function of clubby networks. Ten years ago, it was the network that mattered – you had to know the right VCs. Lip-Bu Tan, Chairman of Walden International, a $1.6 bn venture fund said that it takes a decade to break into the Tier-1 VC investor networks. Other VCs pointed out that the bay area is very network centric, and its very uncommon to find good startups if you don't belong. VCs often bragged (and yet do) about proprietary relationships. All that may be a thing of the past, thanks to burgeoning online platforms.

Commitments into VC funds are down by 54%: LPs are fatigued by the VC jargon and overused terms – proprietary relationships being high up on the list. Former VC Chris Rizik manages Renaissance fund-of-funds. To VCs pitching him, he often asks, "What is it about you that acts as a magnet to entrepreneurs?" If its just money, VCs are in trouble. According to the National VC Association (NVCA), U.S. venture capital firms raised $2.9 billion in the second quarter of 2013, a decrease of 33 percent compared to the level of dollar commitments raised during the first quarter of 2013. The dollar commitments raised during the second quarter of 2013 is a 54 percent decline from the levels raised during the comparable period in 2012 and marks the lowest quarter for venture capital fundraising, by dollars, since the third quarter of 2011.

From finding investments to managing the VC portfolio - the software worms are chomping all over: For the tall portfolio "value-add" claims VCs make, LPs often discount these statements. "I give a lot more importance to sourcing, a lot more than value-add claims" said Erik Lundberg, Chief Investment Officer of University of Michigan Endowment. Funds like Andreessen-Horowitz have now built an army of 75+ team members to serve their portfolio startups. First Round Capital has developed an online platform where its portfolio entrepreneurs can share learning lessons, intelligence (compensation, service providers, option pool size, hiring techniques) directly with each other.

With online investor marketplaces, software is disrupting the first step (or sourcing side) of venture capital, First Round is now pushing the envelope to the next step -- using software tools to add portfolio value. The final frontier of exits remains to be tackled. And with the current pace, it's just a matter of time when software will eat that too.

I support entrepreneurs with seed capital, common sense and creativity - in unequal parts. I am the author of the book - "The Business of Venture Capital" and co-author with VC Brad Feld of "Startup Boards".