

INSIGHTS FROM
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Venture capital: Lessons from the dot-com days

Startup valuations have yet to fully reflect the market's ongoing downdraft. The correction could prove as protracted as that of the dot-com crash

THE NASDAQ 100 index hit rock bottom during intra-day trading on Oct 10, 2002, down 77 per cent from its all-time high on Mar 10, 2000. An estimated 100 million individual investors lost US\$5 trillion in the stock market. It took more than 15 years for the tech-heavy index to revisit its peak.

Between such dot-bombed firms as Webvan and eToys and unicorned startups like Theranos and FTX, when it comes to venture capital (VC), the New Economy of the late 1990s and today's gig economy share a few commonalities.

New lexicon, old tricks

Unlike public markets, VC is all about inside information. Proprietary deals are recipes for success. At the same time, early-stage investors usually follow one trend after another instead of pursuing predictable performance.

The current craze for generative artificial intelligence (AI) – 44 per cent of minted unicorns last year operated in AI and machine learning – follows the mad but short-lived dash into non-fungible tokens (NFTs) or the metaverse, which came soon after the race into anything vaguely related to blockchain and cryptocurrencies, which likewise came on the heels of huge investments in augmented reality and electric vehicles (EVs).

Piling up losses to scale up

Beyond the buzzwords, one distinction between the recent tech bubble and its predecessor is a new dimension of loss-making. Today's valuations and deal sizes exceed those of the dot-com era. In 1999, the collective losses of the 200 largest dot-coms were US\$6.2 billion on total annual sales of US\$21 billion. That year, Amazon reported a US\$720 million loss on sales of US\$1.6 billion. Twenty years later, Uber alone lost US\$8.5 billion on US\$14 billion in revenue.

The bets have scaled up, yet they do not provide better odds of success. Both dot-coms and unicorns sought to establish market dominance by outpacing rivals, even if they employed different tactics. In 2000, as companies were being "Amazoned", they were losing to smaller, nimbler rivals. By contrast, when they are "Uberised", incumbents are now losing to larger competitors.

Startups have become better at driving sales, not at turning a profit. Ad-hoc profits are also



Unicorns follow a market strategy first tested in the dot-com days: launch innovative business ideas and grow the top line exponentially while racking up huge losses. The trick is to ensure almost unlimited access to financing. PHOTO: PIXABAY

easier to manufacture – as WeWork did with its community-adjusted earnings before interest, taxes, depreciation, and amortisation (Ebitda), for instance – than positive, recurring operating margins.

The unicorn generation

Unicorns follow a market strategy first tested in the dot-com days: launch innovative business ideas and grow the top line exponentially while racking up huge losses. The trick is to ensure almost unlimited access to financing.

Thanks to unprecedented money-printing throughout the 2010s, the number of unicorns rose from fewer than 200 in 2015 to more than 600 in 2020. They passed the 1,000 mark in 2022 and now exceed 1,200. Advocates of such richly valued enterprises point to the pioneers of the Internet revolution – Amazon and Google, for example – that are now among the most valuable companies in the world. They rarely mention previous market darlings like AOL and Netscape.

That a handful of companies become extremely successful does not imply that a long tail of market participants will justify such august hopes.

Overcapacity is another major risk. Numerous multi-billion-dollar food delivery services emerged during the pandemic, just as dark fibre was overbuilt during the Internet's early days. As the 2015 to 2021 vintages turn into vinegar, many startups will meet a similar, humbling fate. While they remain under private ownership, their true worth is unclear.

Stock markets can be temporarily mispriced, but eventually, they offer a reality check to companies seeking to float. At its initial public offering (IPO), Instacart sold at a 75 per cent discount to its 2021 private valuation.

Yet despite regulations introduced after the dot-com crash, stock markets remain easy to manipulate, as the initial coin offerings (ICOs) of the late 2010s and the more recent glut of special purpose acquisition companies (Spacs) illustrate. Unfortunately for those unicorn backers

Two VC bubbles

	1994 TO 2003	2014 TO 2023
Defining the era	Dot-coms	Unicorns
Performance	Limited or no revenues, ubiquitous losses	Large revenues, larger losses
Launch locale	Garage or dorm room	Accelerator, co-working space, work from home (WFH)
Buzzwords	Eyeballs, B2B, B2C, click-and-mortar, anything "e" (eCommerce, eBanking, etc), New Economy	Big data, clickbait, blockchain, deepfake, anything "tech" (edtech, fintech, proptech, etc), machine learning, mobile apps, gig economy
Hot sectors	Online advertising, e-tailing, web portals, search engines, Internet Protocol, dark fibre	Electric vehicles, virtual/augmented reality, cybersecurity, anything as a service (XaaS), crypto, artificial intelligence (AI)
Ownership	Publicly listed	Privately owned as well as ICOs and Spacs

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hoping to attract unsophisticated punters, the blank-cheque bubble quickly fizzled out.

The big long

Until two years ago, historically low interest rates artificially turbocharged the valuation of illiquid, risky assets. Central banks' reluctance to turn off the quantitative easing (QE) spigot amplified this trend.

With easy access to cheap capital, financiers and entrepreneurs adopted behaviours distinct from those of the dot-com era. Then, VC backers engineered artificially inflated valuations by introducing portfolio companies to public markets and creating "first-day pops" with the cooperation of unscrupulous underwriters.

Nowadays, price jumps for newly listed tech stocks are quite tame compared with their Nasdaq counterparts in the 1990s, when open-source developer VA Linux's stock soared 733 per cent on Dec 9, 1999.

Transaction volumes are also much lower. In 2019, there were 159 US IPOs, one-third as many as in 1999. It is not for lack of public appetite. Rather, venture capitalists realised that by exiting early they left too much money on the table. Apple listed in 1980, almost four years after its inception, at a US\$1.8 billion market capitalisation. Amazon's 1997 IPO valued it at US\$438 million less than three years after the company launched.

Today, funding is driven by the VC firms' desire to hold onto startups longer. They breed unicorns in-house, which requires bankrolling portfolio companies for several more rounds of financing. They profit by inflating valuations in the years leading up to their exit, keeping most of the value expansion under wraps. The bad news for public investors is that it is much harder to register a 100-per-cent-plus price increase if a company floats or markets itself for tens of billions of dollars, as Facebook, Uber, and many other unicorns did.

Assets are kept in portfolio longer, although the exit timeline varies considerably on a case-by-case basis. Facebook was VC-backed for about nine years. Uber listed around 10 years after being set up. Airbnb waited 12 years.

If VC backers fail to convince public markets to eventually take full custody, however, they could lose out or be stuck with zombies when the investment cycle ends. WeWork's price tag soared from US\$5 billion in December 2014 to US\$47 billion four years later – a very respectable 840 per cent price jump. But then its sponsors struggled to exit via Spac at a discounted US\$9 billion valuation. Its equity is now close to zero.

Mind the valuation gap

A business's value factors in several years' worth of growth. The difference between a mature, publicly listed corporation trading at 20 times net earnings and a leveraged buyout valued at 20 times Ebitda or a startup valued at 20 times revenues is one of expectations. Early-stage investors are prepared to account for future exponential growth.

But the recent spurt of VC extravagance altered the valuation metrics. The main misconception is that a unicorn's post-money valuation is equivalent to a public corporation's enterprise value. Due to the small number of parties involved in negotiations, early stage markets do not have as reliable a price-discovery mechanism.

The skewed distribution of unicorn valuations demonstrates that startup transactions are not settled like those of listed stocks. According to CB Insights, as of Dec 31, 2023, approximately one in three unicorns globally were priced exactly at US\$1 billion. Fewer than 5 per cent were "worth" US\$1.1 billion, while about 4 per cent were valued at between US\$1.1 billion and US\$1.2 billion. Venture capitalist Brad Feld once stated that he had "never, ever felt like the 'billion-dollar' aspiration, which we are now all calling 'uni-

corn", made any sense as the financial goal of the company".

Yet there are two main reasons why more than 1,200 unicorns worldwide are granted US\$3.8 trillion in combined paper value. Because dot-com IPOs 20 years ago gave VCs a bad name, generalising the unicorn status in-house is a less controversial method to engineer extravagant valuations. "First-day pops" have been privatised and occur in mostly unregulated parts of the economy.

Tech entrepreneurs often make unsubstantiated claims to build hype. Through a process dubbed "management by press release" during the dot-com era, they announce months in advance that their next round of fundraising will be set at US\$1 billion or more. This negotiation tactic, called "anchoring", serves to sway prospective investors.

The unicorn club's representatives generate free media coverage. Such "blitzmarketing" is extremely valuable in a crowded startup environment, yet it hardly reflects true business fundamentals. Over 80 per cent of the Internet startups that went public in the late 1990s were loss-making in the year preceding their float. The same ratio applies to the current generation of tech IPOs.

A long winter

What impact will higher inflation and interest rates have on startup creation? Despite the prevalent depressed mood, the current environment is not impeding deal activity per se. After all, in the late 1990s, the federal funds rate was 5 per cent to 6 per cent.

Rather, an unbridgeable gap between investor expectations and startup prospects is to blame. Last year, VC funding fell 67 per cent over the prior year and the number of funds raising money fell to its lowest point level in a decade. With dry powder slowly evaporising over the past 12 months, particularly in European VC, a rise in zombies, bankruptcies, and insolvencies could be on the horizon.

As appetite for VC products boomed in the 2010s, many unskilled practitioners attracted capital. Given their lack of track records, as many as half of them might never do so in today's strenuous climate.

Performance will plummet. The average 1999 venture fund generated an internal rate of return of minus 4.29 per cent, and the average 2000 vintage had a return of minus 2.51 per cent. It is no surprise then that projected IRRs turned negative in late 2022.

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The writer is a private capital adviser. He is the author of several books, including *The Debt Trap and The Good, the Bad and the Ugly of Private Equity*.