Tech Bubbles, Crowdfunding Collapses and More: Fearless Predictions for 2016 in the Global Start-up and VC World

What does 2016 have in store for start-ups and venture capital? Your guess is as good as ours. But just for fun, read our own Dale Huxford's attempt to look into the future and see if you agree.

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You'd think, with all the emphasis on Big Data these past few years and all the wicked-smart data scientists scraping info from every corner of the web, that all these articles predicting next year's trends would be more accurate than they've typically been. But alas, it appears the old Steve Jobs quote – "You can't connect the dots looking forward; you can only connect them looking backwards" – is no less apt today than it was when he made it famous in 2005.

Personally, I prefer the predictive philosophy of my friend's father, who once told me there was a 50/50 chance that any prediction would turn out to be correct. He reasoned that only two potential outcomes exist in any situation: Either something will happen, or else it won't. In his mind, life is all just one long sequence of coin flips.

Granted, I pretty much slept through stats classes in undergrad and business school, but I'm pretty sure that's not the way probabilities work. But since I can't afford to hire data scientists, I'll go with his approach. And if it turns out I'm wrong, I reserve the right to channel my inner Steve Harvey and change my mind at any time.

One important note: I don't have any insider knowledge about any of these, so don't bet your kid's future education on any of the below. All predictions are simply my own conclusions drawn from tea leaves, data points, the lens of my own experience and a healthy dash of intuition sprinkled in.

Prediction #1: We'll see a few high-profile crowdfunding collapses

Two quick notes for context here: First, I'm not a crowdfunding hater. Quite the opposite, in fact. Given the right circumstances and the right project, I love crowdfunding in principle – it's a fantastic way for some companies to raise funds for a project from a broad community of early adopters and influencers who then have a vested interest in spreading the company's gospel far and wide. Used cleverly and correctly and in the right context, crowdfunding is a really excellent fundraising tool.

Second, I'm not really talking about MfG (money-for-goods) crowdfunding platforms, like Kickstarter or Indiegogo. Yes, we've seen a few campaigns on those sites that, after reaching a fundraising goal, failed to deliver on what they'd promised for whatever reason. (See, for example, the recent bankruptcy of Zona, which raised $3.6M on Kickstarter, then failed to deliver on almost 15,000 pre-orders to its Kickstarter donor community. Or better yet, just google "kickstarter + fraud.") But in general, MfG donors are essentially just pre-ordering products or services; they're not counting on the company's success to make future mortgage payments.

Instead, I'm mainly talking about MfE (money-for-equity) platforms. For historical and legal reasons I won't get into due to lack of space, the current crop of MfE platforms have really only existed since 2012. And that's significant. Why, you ask? Because from 2012 until now – in other words, for the entire time that crowdfunding has existed – the overall start-up economy has been riding a steady wave both onward and upward in terms of both funding and valuation levels.[1] It's been a good few years. If you're new to the game (as many crowdfunding investors are), you could be excused for thinking that, like San Francisco real estate or an aging hipster's hairline, start-up investments can only go up-up-up in value. And when times are good, investing in start-ups is really easy. I mean, hey – so long as all arrows are pointing up and to the right, I could do funding deals on cocktail napkins.

But there's a reason we don't do funding deals on cocktail napkins. And that reason can be summed up in two words: downside protection. Investing in early-stage tech start-ups is potentially perilous, and it goes far beyond the usual commercial challenges faced by any business. Venture capitalists (VCs) and early-stage start-ups engage in a delicate tango where the start-up seeks (and in truth, needs) as much

1 There's an argument, of course, that the crowdfunding platforms deserve at least some of the credit for the past few years' good start-up times, as they've created alternative avenues for start-up funding and increased competition amongst investors. And there's probably some truth to that.

flexibility as possible to potentially pivot or turn or pursue business ideas and markets that perhaps weren't on the menu at investment time; while the VC seeks some assurances that the company's founders or execs aren't going to use the investment proceeds to build flying cars (unless that's what was originally intended) or, worse, run away to Cancun and drink Mai Tais for the next 10 years. And that balance is largely what much of the investment documentation surrounding a VC funding deal (in combination with the default corporate law of the jurisdiction in which the company's incorporated (for US start-ups, usually Delaware)) is designed to address, with most VCs negotiating for – and ultimately receiving – a fairly privileged set of oversight and decision-making rights for so long as they hold their investment shares.

But if you find a VC in a rare moment of candor, they'll likely admit that even when armed with a fabulously sophisticated set of investment documents, they've all been burned at one time or another by start-ups behaving badly. It happens more often than you might think. You just can't anticipate every single possible scenario in what amounts to a very fuzzy start-up future.

Which brings us to two additional deterrence tools VCs typically wield when they invest in start-ups. First, there's the reputational deterrent. Once you clear out the tourist riff-raff, the start-up world in general (and Silicon Valley in particular) is a pretty small place. Investors talk to each other. A lot, in fact. If a company founder has behaved badly in the eyes of the company's investors, you can basically guarantee that is the last time you'll ever see that founder at the grown-ups' table. And second, VCs have truckloads of cash and resources, and if all else fails they can (and, on very rare occasions, they will) resort to legal action to prevent the company from frittering away its investment capital.[2]

Now think about your typical crowdfunding investor in this context. On the one hand, most crowdfunders are afforded zero opportunity to negotiate for oversight or control terms in their favor; they're stuck with a generic set of investment terms offering them no real voice over management or operations. But in addition, neither the reputational component (many crowdfunded companies feature unknown or unvetted founders or execs) nor the threat of legal action (many crowdfunders have neither the resources nor the incentive to impose legal action for investments that are, typically, quite small on an individual basis) are in play, either. So in other words, none of the usual tools VCs have to keep their companies in line and to monitor their investments are usually realistically available for crowdfunders. And that creates a ripe opportunity for abuse by the company/founders.

So yes, as some of these crowdfunded companies approach the end of their runways and find the 2016 fundraising climate much darker than it was when they initially raised funds, they may have to get a bit creative/mercenary for the next fundraising cycle, or to orchestrate an exit that provides the founders with a cushy landing spot at the expense of investors' equity value. And when that happens, I predict we'll hear from quite a few crowdfunding investors wondering how they could have gone from holding a significant stake in what they believed to be a future unicorn company to now holding a piece of paper representing diluted or worthless shares in a dissolving company. I guess we'll see how it plays out…

Prediction #2: We'll see some creative attempts to solve the early-employee liquidity dilemma

So, a few basic truths:

- **Fact #1:** The very earliest employees at start-ups usually accept a certain risk-reward trade-off when it comes to compensation – that is, their salary and any other cash component of their compensation is usually somewhat below-market, but they also often receive an equity award (usually in the form of an option to purchase a certain number of shares of common stock at a pre-determined price).
- **Fact #2:** For those holding company options (or for those who hold shares that were issued upon exercise of company options), the imputed "value" of those options (or shares) might impress your future mother-in-law, but unless you can turn that piece of paper into cold hard cash, it's not going to buy you a pizza or a Tesla or a modest home within Cupertino Union School District. And turning options or shares of a private company into cash is not as easy as you might think. Oftentimes, there are layers upon layers of restrictions or conditions that combine to make the path to liquidity entirely outside the control of the stockholder or optionholder. In fact, often the only path to liquidity is if the company undertakes some sort of exit (sale of the company, IPO, liquidation), at which point they may be able to realize some sort of cash value in exchange for the equity. But whether a company exits, and when it elects to do so, is entirely outside most employees' control.
- **Fact #3:** The public markets in 2015 were not especially kind to tech companies, and the market's recent response to several high-profile tech-ish public offerings was sort of a collective "… meh …" At the same time, outside of a handful of mega-mergers in bio/pharma and life sciences, 2015 was also a quiet year for tech M&A transactions. What 2015 will be remembered for, mostly, is the number of private, venture-backed mega-financing rounds – that is, private funding rounds in which companies raised the type of money historically only available via public markets. This trend has enabled some of the highest flying tech companies to remain private for much longer than they would ordinarily be able. And if things remain steady in that department, ***it may be quite some time before we see some of today's largest private start-ups go public or undertake any other sort of exit transaction.***

Now with the above in mind, imagine you're an early employee at a fast growing tech company. You took a massive risk when you joined the fledgling company four years ago. You busted your tail and endured many sleepless nights doing the jobs of four people in the very early days, all in exchange for a salary that's roughly 40% what that dude who lives down the hall and works at Salesforce probably gets paid. You've helped the company grow to amazing heights and eye-watering valuations, and soon after your company raised a Series C round in 2013 at a $1B+ valuation, you started to hear whispers around the office about possibly going public soon. Which would be

2 Bear in mind, it's ***extremely rare*** for a VC to actually take legal action against one of its portfolio companies (or against the founders/execs of one of its companies). For one thing, it's bad for business; no VC wants to be known as a fund that likes to sue its portfolio companies when things go badly. That would be a reputation-killer for any VC. But that doesn't mean a VC won't sometimes threaten to go down that road. Happens more often than most people realize. Sometimes the threats are explicit; other times, implied, but they usually surface in situations where the VC believes the company hasn't been 100% truthful or transparent with them. I often counsel my client companies: "VCs love good news, and they can generally handle bad news, *but VCs do not like surprises*. Be truthful and transparent, even when the news isn't good."

great for you because you're not sure how much longer you can put up with your two creepy roommates and their respective significant others with whom you share a dilapidated three-bed townhouse near San Francisco's panhandle. You want – in fact, you NEED – liquidity!

And there's the rub. It's known as the early-employee liquidity dilemma. You have a piece of paper that says you are rich. You're the envy of all your friends. But in reality, you're still working for below-market wage, you have zero control over when you may be able to cash in that piece of paper, and now there's no real urgency for your company to seek out an exit event. You've been waiting, patiently, for a lot longer than you had anticipated, you've been putting off major life decisions for far too long, and now you're getting anxious and annoyed. And while the founders have no doubt looked after themselves by negotiating to take a bit of money off the table (i.e., selling some of their founder shares to outside investors) at the last two funding rounds, early employees often are not afforded the same opportunity.

So here's my prediction: As more and more high-flying tech companies raise massive sums from private investors and do all sorts of corporate jiu jitsu to avoid the need to go public, I predict we'll start to see some very creative efforts – both from early employees as well as from outside investors seeking to acquire early-employee equity in marquee tech companies – to enable early employees liquidity opportunities. And I think we'll start to see companies, which up to this point have been fairly restrictive in terms of transferability of shares, start to loosen their grip to an extent in order to accommodate those early employees and keep them happy. So watch this space…

Prediction #3: The so-called "tech bubble" will *not* burst overall (but smaller bubbles within the larger bubble will start to deflate)

In case you haven't noticed (hah!), there's been some chatter lately as to whether we might sort of, kind of, maybe, possibly be in the midst of another tech bubble.

To be honest, I don't spend a lot of time thinking about whether or not we're in a bubble at the moment. For one thing, it's a meaningless debate where each side starts with its desired conclusion and then works backward to support that conclusion with selected data points. But mostly I avoid the debate because it's really, really hard to say.

Instead, I tend to focus on individual subsets of the overall tech ecosystem, and I ask myself whether those subsets are in line with history and practice, or whether they seem overheated or out of whack relative to the rest of the ecosystem. My reasoning: If we are, indeed, in the midst of a Tech Bubble (capital T, capital B), then it's likely that one or more of the tech economy's foundational components is likely contributing to the overall inflation.

So, where do I think we'll see some correction in the coming year?

- **Silicon Valley is in the midst of a developer bubble** – I've asked some of my client companies why they and their competitors feel the need to raise so much more money when, in truth, it's never been cheaper or easier to launch and scale an online company. This isn't 1997; we live in a world where hosted server and data storage costs are minimal and mega-flexible to accommodate a growing company's needs, where cloud-based computing allows companies to manage and update their systems without expensive IT staff on call 24/7, where developers can turn to resources like GitHub and Heroku and MySQ and tons of others, etc. And yet their answer is almost always the same: In Silicon Valley, it's really, really expensive to hire good developers. In fact, last I checked, average salary for rank-and-file developers at start-ups around the Valley was around $145K/year. Now compare that to, say, Berlin, where average salary for mid-tier developers is approximately €55K/year. I'm no expert, but I'm pretty sure there's an arbitrage opportunity there for a few clever companies to exploit. And if investors start to pull back on funding and companies look for creative ways to stretch out their runway as long as possible, I suspect we'll start seeing more companies looking outside the Valley for developer talent.
- **We're in the midst of a "lifestyle fund" bubble** – This one isn't entirely fair on my part, I'll admit. But we've seen a huge increase in the number of smaller-type funds (usually < $10M under management) usually formed and managed by one or (at most) two individuals, each of whom has at least one successful or semi-successful exit in his or her past, but who appreciate that great truism, which is that building and scaling a company is really, really hard; whereas, throwing $50K darts with someone else's money is a lot easier. I call these "lifestyle funds," and there's a ton of them around right now. And while there's a time and a place and a role for early seed-stage investors, it also seems that given the proliferation of accelerators and incubators and corporate seed programs and other early-stage resource fillers, I'm not sure lifestyle funds are filling any sort of niche in the ecosystem that isn't already ably filled, nor have I seen many of these funds add any real value beyond the size of their checks. I suspect we'll soon see quite a few of these start to burn through the end of their cash without much in the way of ROI, and it's going to be a lot more difficult for folks to raise anything beyond what they've already done.
- **We're in the midst of a "supply-chain solution" bubble** – Many of the best known start-up success stories from the past few years are really aimed at creating efficient supply and distribution chains linking producers of goods and services with customers or end-users. There has not, however, been much focus on creating more (or more efficient) supply itself. For example, we now have hordes of companies focused on delivering food from restaurants to customers quickly and efficiently. Which is great. That's really less of a tech solution, and more of a supply-chain solution. But we've seen it all over the consumer marketplace – in food and beverage delivery, grocery delivery, services delivery, household product delivery … But while most of the focus has been on the supply chain itself and on the consumer-facing UX, start-ups haven't paid as much attention to the production side of that equation. I predict that will change in 2016.

Conclusion

So, I was listening to a pitch the other day from a brand-new company pitching an idea that, to be honest, didn't sound all that revolutionary or, indeed, much different than four or five other companies I could've named off the top of my head that have already started in the same space. So I asked them how they intended to distinguish themselves from the others, all of whom have substantial headstarts in terms of time, money and marketshare. At which point one of the co-founders looked right at me, cocked one eyebrow a tad, tilted his head to give me a really condescending half-smile that made it obvious he'd, like, totally anticipated this question and said to me: "The way the market is growing in this space, there's plenty of room for all of us and many more." And then he sat back in his chair and started to fold his arms across his chest, but before doing so – and I swear, I'm not making this up – he fist-bumped himself for a job well done.

Perhaps I'm not as bullish on 2016 as this young gentleman. But I'm not bearish, either. Lean(er) times tend to bring with them much-needed financial discipline and cost-saving strategies that oftentimes form the bedrock of better times ahead. So with that in mind, I wish all of you – the dreamers, the chancers, the risk-takers, the visionaries, and especially those of you (clients and otherwise) who allow me to live cathartically through your start-up experiences – the very best in 2016, and I look forward to all the adventures to come.

And I promise to never, ever, ever fist-bump myself during a pitch. Or any other time, for that matter.

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