The New York Times Magazine

https://www.nytimes.com/2016/05/15/magazine/bubble-indemnity.html

ON MONEY

Bubble Indemnity

By Gideon Lewis-Kraus

May 10, 2016

When Silicon Valley venture capitalists get themselves into image trouble, it's usually because they've been too candid with their low estimate of other people's intelligence. For example, after India recently prevented Facebook from offering free Internet service there, Marc Andreessen suggested in a tweet that the subcontinent might be better off had it remained under colonial administration. It's much less common for V.C.s to soil their own nests in public. So it came as something of a surprise when Chamath Palihapitiya — Sri Lankan war refugee, early Facebook employee, investor in Slack and Box, part owner of the Golden State Warriors — told Vanity Fair in March that if we are in fact in the early stages of a second tech collapse, venture capitalists have only their own mediocre, clubby selves to blame. They should, he said, "focus on using capital as a way to take really big bets on things that just seem totally audacious. Right now we haven't done enough of that, and the result is that most of the things we've funded are mostly crap and largely worthless."

It was a striking admission. This "largely worthless" start-up scene, according to the research firm CB Insights, has raised an estimated $238 billion over the last five years — a remarkable bull run in private technology stocks. Forbes reports that there are now close to 200 "unicorns," to use the Valley term of art for private companies worth more than a billion dollars on paper. Since the financial crisis, these companies, along with their more established public predecessors, have been seen by many Americans as the last redoubt of confidence and productivity in an otherwise uneven recovery. V.C.s have spent years dismissing speculation about a private-equity bubble as merely an expression, by know-nothing spectators, of

resentment and alarmism; media onlookers, they argue, should talk instead about the triumphal progress of the genuinely great start-ups as they try to solve our most difficult problems. Over the past year, however, as allegations of mismanagement and unsustainability have grown — Square went public for approximately half its last private valuation; Fidelity and other large mutual funds wrote down their positions in Dropbox, MongoDB, and Snapchat; and both Zenefits and Theranos were accused of deceptive practices — that confidence has come to look more like hubris.

This past January, after a long autumn of minor misfortune left the market in a stall, I spent a week loitering in the command concourse of American V.C., Sand Hill Road in Menlo Park, Calif., where the soft, spruce-filtered sunlight falls through plate glass into quiet offices of beige on beige. There was some selection bias at work, as all my introductions were brokered by a smart and thoughtful friend, but not a single investor I talked to fit the description of the supercilious techno-optimist — and most, in private, didn't hesitate to concede Palihapitiya's point. Of course they believed private valuations had become preposterous; of course the run in private tech stocks couldn't possibly last; and of course, many start-ups, especially those of the "Uber for garden-gnome rearrangement" variety, are in fact largely worthless.

Where they differed from the naysayers, however, was in their rating of the causes-and consequences; the fault, they said, didn't belong to the technological elite but to everybody else: What has driven inflated valuations, in a time of extremely low interest rates and meager returns elsewhere, is "dumb money," all the alien capital that has flowed into the Valley in recent years. Dumb money is a hedge-funder who's jealous of a V.C. Dumb money is sovereign wealth. Dumb money is an Emirati home office. Dumb money is a Facebook millionaire in a Maserati who wants to look like a player. Dumb money wants to get in on tech because it's a box to check off. Dumb money isn't in it for the long run. Dumb money doesn't actually care about the technology. Dumb money doesn't create value. Dumb money thinks what you lose on the margin you'll make up for in volume. Dumb money wants to get in on Uber at any price, and will accept a "limited-edition private offer" to join

the scarce ranks in a “special purpose vehicle” that bears all the risks of one company with none of the hedging benefits of a portfolio. Dumb money is those pinkish guys with bull necks in Zegna suits. The weird thing about dumb money, unfortunately, is that it can act with fiendish intelligence, insisting on stipulations that guarantee returns at the expense of founders, employees and other investors.

Luckily for the American economy, the dumb money this time around is no longer a mob of deluded pensioners waist-deep in Webvan. (It’s also, the V.C.s noted, a lot less money in total, and at least in theory it’s coming from people who can afford the losses; the last dot-com crash erased an estimated $6.2 trillion in household wealth.) So the coming correction will allow the smart money to roll up its brushed-microfiber sleeves and get back to basics. A lot of $10 billion companies will become $1 billion companies, and $1 billion companies will be acquired for $100 million, and the dumb money will slink away. Operating expenses and burn rates will come way down, and companies that didn’t worry about profitability or unit economics will. There will be layoffs, sure, but the only serious effects will be that the traffic on I-280 will no longer back up three exits, it’ll be easier to get a table at the Village Pub and engineers three minutes out of Stanford will no longer expect $150,000 a year and backlit fountains of complimentary fruit water.

Illustration by Andrew Rae

The main thing that has changed since January is that very little seems to have changed. V.C. investment over the first quarter of the year has remained flat, at about $12 billion, from the final quarter of 2015, though a flight to perceived quality has caused both a drop in the total number of deals and a concentration at the top. The total number of tech I.P.O.s, however, was zero. Yet the flood of money to the Valley has not abated: according to The Wall Street Journal, this has been the single biggest fund-raising quarter for venture capital since the (in retrospect) ominous year 2000.

Bill Gurley, a partner in the firm Benchmark Capital, recently published a blog post in which he reminded his colleagues, in a tone of exaggerated mildness, that table stakes in the industry have perhaps become too high. “Loose capital allows the less qualified to participate in each market. This less qualified player brings more reckless execution, which drags even the best entrepreneur onto an especially sloppy playing field.” Despite warnings like these, companies and V.C. firms have continued to court as much of that loose capital as they still can; almost a decade of

aggressive growth strategy, by even the most prudent, demands it. With an utterly dead I.P.O. market, and no appetite among the big public tech companies to acquire companies with bad balance sheets, venture capital is less liquid than ever, and thus increasingly represents a closed system — a system where it is no longer so easy to distinguish good money from bad.

Defenders of that system argue that all they really need are the expected half-dozen mega-I.P.O.s (Slack, Palantir, Snapchat, Uber, Airbnb) to make enough cash returns to offset the losses. But that fantasy math holds for only a tiny cohort of V.C. firms. It also overlooks the well-being of tens of thousands of employees, especially support staff, who have worked for years for a share in the wealth they've created. Perhaps worst of all, it betrays a callow belief that the genuinely transformative long-term endeavors that V.C.s have come to support — erstwhile academic research into artificial intelligence, bioengineering and sustainable energy — will be somehow insulated from an industry downturn. An exploded bubble could very well mean that those "totally audacious" bets will go unfunded entirely. That might seem like a satisfying comeuppance for the imperious Valley, but it's not something to be smug about. Smart money convinces itself of its highly differentiated intelligence at what might prove to be all of our expense.

Gideon Lewis-Kraus is a contributing writer for the magazine. Adam Davidson will return next month.

Sign up for our newsletter to get the best of The New York Times Magazine delivered to your inbox every week.

A version of this article appears in print on , Page 20 of the Sunday Magazine with the headline: Bubble Indemnity