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MANY startups are living with bad decisions they made when cheap capital flowed freely.

Massive value destruction was driven by Founders playing Hungry Hungry Hippo, trying to accumulate as much revenue as possible.

A few thoughts on how to learn from their mistakes: 🧵 👇


Business 101

The first goal of a startup is to manufacture a product at a lower cost than it can be sold for.

The second goal is to scale enough to overcome G&A costs.

The third goal is to generate profit by capturing additional market share with positive operating margins.

Revenue Isn't True North

Maximizing revenue is a silly goal.

Maximizing profitable revenue is a great goal.

This requires capturing economic rent that's in excess of the cost it takes to find and serve your customers.

Some revenue passes this test and other revenue doesn't!

## VC’s Are Simple Animals

What’s crazy is that the VC and Startup communities are addicted to revenue multiples as their primary method of determining “enterprise value”.

The why: It’s simple, directional and doesn’t require interpreting detailed forward looking financial models.

Using revenue multiples to determine enterprise value only requires two pieces of data: Revenue and a Revenue Multiple.

The alternative requires having perspective on versions of the company that are possible but have yet to be built.

## Obvious Second Order Effect

Guess what happened once Founders realized that VCs were valuing startups using revenue multiples?

They started playing a game of Hungy Hungry Hippo with the goal of accumulating as much revenue as they could!

## Enterprise Value Arbitrage

Not only were revenue multiples used in the calculation of enterprise value, STUPIDLY HIGH multiples were being used REGARDLESS OF MARGIN.

Typical early stage companies were assigned 10-20X multiples and the outliers were commanding 100X+ multiples!

This meant that for every $1 of revenue that a startup generated, VCs were willing to believe that $10-$20 of enterprise value had been created.

This meant that playing the game of selling dollars for quarters made sense.

This isn’t Business 101. This is a path to Bankruptcy.

To a Founder, investing $10MM to get $5MM of annual revenue made sense if it increased the value of the company by $100MM and set the stage for attracting the next investor.

It was true for high quality revenue. It was true for low quality revenue. It was just true.

## It’s About the Future, Isn’t it?

Another justification for chasing revenue: VCs are supposed to invest with a 7-10 year horizon in mind but they aren’t structured to act this way.

If a company doesn't show “progress” between rounds it will struggle to raise more capital.

This fuels the misconception that VC investors are much more patient than public company investors but the reality isn't that simple.

The discount rate for public company investors is probably 10-12% while it's 30-40% for VCs.

Guess who is definitionally more patient?

The reality is that public company investors are focused on quarterly results and a company's 2-year forward projections while VCs are focused on the results between funding rounds and the progress towards a compelling vision.

So while investing in long term drivers of value creation in the startup world is important, the reality is that if a startup isn't up and to the right between rounds it's in trouble.

Accumulating revenue to justify raising and investing more capital has always been the answer.

Back to Business 101

What Founders need to internalize is that Darwin is back from vacation which has forced VCs to return to evaluating startups holistically. Valuations are no longer a simple function of revenue.

And if Darwin doesn't like you, extinction is very likely.

This means that Founders have to figure out how to manufacture a product at a lower cost than they can sell it for then scale to overcome G&A costs then generate profit by capturing additional market share with positive operating margins.

Business 101, not Hungry Hungry Hippos.

And IPO and M&A multiples are now 1/3rd of what they were at peak so everyone needs to internalize this.

VCs have to pay less to generate their target returns so Founders need to be more efficient than they have been pre-correction or risk suffering massive dilution.

Implications

For many startups, this new playbook requires a refactoring of their business plans.

Efficient marketing > Maxed-out growth

Many startups are finding that the last 20-30% of their growth can be cut with negligible (and sometimes positive) results.

Staging OpEx and G&A growth > Hiring far ahead of results

Controlling the pace of hiring helps a Startup stay nimble, focused and extends runway. Cracking the code on a business takes time and reducing burn saves capital to "figure it out". Focusing on the core business > Investing in multiple S-curves

The biggest mistake Founders made when capital was cheap was to invest in too many S-curves at the same time. This burns A LOT of capital and reduces focus on producing proof that the core business is working.

TL;DR: Founders should stop playing the valuation arbitrage game and focus on de-risking their startups in stages. Chasing bad revenue is silly. Over-hiring is silly. Resourcing too many new things at the same time is silly.

Build a solid core business and it will all work out!

And if you thought this was a good thread, it would be helpful to like, comment and/or share the first post.

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