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The trouble with too much seed capital

By Jonathan Moules Author alerts

Xenios Thrasyvoulou has followed the Silicon Valley rule book when it comes to ambitious tech start-ups. Barely a year after launching his freelance jobs website, PeoplePerHour, the London-based founder secured a £500,000 investment from a group of angel investors, including Michael van Swaaij, creator of eBay's European operation.

This in turn attracted the interest of the venture capital industry and negotiations soon opened with a group of firms. By October 2012, five years after Mr Thrasyvoulou had launched his company with a few thousand pounds of his own money, he was sitting on a funding pile of $10.5m.

Success? A cause for celebration? Not according to Mr Thrasyvoulou. "It was total chaos," he recalls. PeoplePerHour's headcount grew from a band of six people to 50 in a year and he hired a board of executive directors on six-figure salaries – all in an effort to have the scale to hit a target imposed by investors of sixfold year-on-year revenue growth.

The potential pitfalls of raising large amounts of money early in a company's life have come to fore, with several relatively young tech businesses attracting 10-figure investments, creating multibillion-dollar valuations. Groupon, a pioneer in daily deals, has struggled since its 2012 initial public offering, which valued the business at £12.65bn, due to fickle consumers and a crowd of copycats. From an initial high of $20 a share the price bottomed at $5 in 2013.

Uber, which raised $1.2bn in June, barely five years after it was founded, is building its revenue fast. But observers still question whether a taxi app business, even one with aspirations to replace private car ownership, as Uber has said, can achieve the scale to justify an $18.2bn valuation.

More important metrics

Fred Wilson, co-founder of Union Square Ventures in New York, highlighted the folly of raising too much money too soon in his daily blog. "The fact is that the amount of money start-ups raise in their seed and series A rounds is inversely related with success," Mr Wilson wrote last year. "Yes, I mean that. Less money raised leads to more success. That is the data I stare at all the time."

Mr Wilson believes the error is for start-ups to try and raise lots of money so they can maximise their "runway" – Silicon Valley jargon for the amount of time a new venture can last before running out of cash. "Getting somewhere fast is the game they should be playing," he wrote in his blog. "You can always raise more money if you are doing well on the metrics that matter."

The benefits of plan B

John Mullins, associate professor of management practice at London Business School, argues that if you raise too much money in the seed round, "it may be enough to execute plan A, but this is probably not the best way to develop the business". Rather, he argues that some of the most successful start-ups of recent years were actually based on a plan B or even plan C rather than the original idea. Having to carefully manage how cash is spent forces founding teams to try different ways of working or adopt strategies that were not in the original business plan.

Xenios Thrasyvoulou: order out of chaos

An example of this is Skimlinks, a business that started in 2006 as a web tool for users to skim through items online, bookmarking them to compare on a single page. The founders got a bank loan and persuaded friends to invest to get started. But the company almost ran out of cash finding a viable revenue model and, with the financial crisis, struggled to raise more money from investors. It is was in this moment of crisis that co-founder Alicia Navarro had the idea of selling the back-end technology to other companies as a white-label service – turning a failing business-to-consumer model into a successful business-to-business venture. More than 200,000 websites now use Skimlinks's technology, including Gawker Media and The Huffington Post.

The value of advice

Equity fundraising in and of itself is arguably not as important as the experience of the people giving it to you. The problem, explains Prof Mullins, is that the quality of their support cannot be guaranteed just because the backer writes a large cheque. "I am increasingly worried that the so-called advice and support given by VCs and angels is not helpful," he says.

Although large venture capital funding rounds are still largely a US phenomenon, Prof Mullins believes the problem of start-ups raising too much money too soon is more of a problem in Europe. The advantage of California's Silicon Valley community is that they have a generation of entrepreneurs who have built businesses and then decided to move over to help develop other people's businesses, Mr Mullins notes. These people tend to make better decisions as venture capitalists.

Customer-funded growth

Prof Mullins cites the example of EnGrande, an online platform in Barcelona created specifically to enable people to book one- and two-star hotels which had previously been ignored by other travel websites. The company did not take a penny in funding, instead using its customers' cash to finance growth by taking 15 per cent of the booking fee upfront and investing that money in Google adwords to generate more sales. The business was sold in 2010, seven years after it launched, to a private equity house for €25m. "[The founder] never raised a single euro in investment," Prof Mullins notes. "He was just very careful how he used the cash his customers paid."

Retain a majority stake

Carefully negotiating the terms of any funding deal can be key to avoiding the worst excesses of over zealous backers. Shortly after Mitesh Patel and his wife Olga Nuryaeva founded Lenstore, an online spectacles retailer, they decided to forgo several offers of VC investment in favour of two angel investors who agreed to provide a relatively small amount in return for a low double-digit stake. "It allowed us to freely make decisions and keep our business nimble, although we did, throughout, greatly appreciate the expert guidance of our angel investors," Ms Nuryaeva says.

Today, Lenstore is one of the largest ecommerce contact lens retailers in the UK. Last year it was acquired by GrandVision, owner of the high street chain Vision Express. "Continuing to hold a large stake in the business is highly motivational for any entrepreneur," Ms Nuryaeva says. "Large seed and A round fundraisings can have the propensity to demotivate entrepreneurs, as they are working to maximise the value of an ever smaller shareholding."

At PeoplePerHour, Mr Thrasyvoulou chose to stand up to his institutional backers, demanding a change of strategy from rapid top line growth to one of reaching profitability in a year. He was able to do this because he had retained a majority stake. Changing tack was not easy as it involved halving the size of the workforce, including making most of his senior management team redundant. But PeoplePerHour has since then roughly doubled turnover year-on-year and is making 20 per cent margins on its service. "It has calmed things," Mr Thrasyvoulou adds.

Lessons: Stay level when raising funds

Xenios Thrasyvoulou, founder of PeoplePerHour, a freelance jobs website, offers the following advice for approaching a funding round:

Think long-term
"Don't get caught up with the popular perception that start-ups should grow big, quickly."

Negotiate hard to retain control
"Watch out for clauses that allow the investors to take their money back if they do not like the strategic direction."

Do not buy the hype
"Be honest with yourself about what you can deliver."

Do not be scared to say no
"Too many founders are in awe of the money and the valuation it brings."

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