As venture capital dries up, tech startups discover frugality

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Tech startup Appthority's office has plush conference rooms, soundproof phone booths, an enormous kitchen and a view of San Francisco Bay. It has ping-pong and foosball tables, beer on tap and 11 types of tea.

The cybersecurity company owns none of it. And that's how the company's president and co-founder, Domingo Guerra, likes it.

"Any time you have flexibility and you don't have a liability, it looks good on the books," Guerra said. Although his 30-person company has raised $20.25 million from venture capital firms such as Venrock and U.S. Venture Partners, it operates out of a WeWork co-working space, where amenities such as Wi-Fi and office furnishings are included in the rent.

As investor sentiment in the tech industry cools, startups are facing a new reality: Money doesn't always come easily. The abundant venture capital funding that convinced companies they could stay private longer is now harder to come by - such funding in Silicon Valley fell 19.5 percent in the first quarter of 2016 compared with the same period in 2015. And Wall Street has grown so skeptical of Silicon Valley that not a single tech firm has dared to go public so far this year.

In this climate, having good-looking books is now top of mind for startups that don't want to go the way of companies such as Foursquare, which halved its valuation in order to raise money earlier this year, or

SpoonRocket and Shuddle, which shut down after running out of money.

To that end, small and midsize startups are trying to outlast the downturn by cutting back on one of tech's trademark innovations: outlandish spending.

There was a time, for example, when Appthority was thinking about getting its own office. But after heightened investor scrutiny stretched the company's latest fundraising process to seven months - more than its previous rounds - Guerra decided a co-working setup was its smartest bet.

"If we had leased our own office, most landlords wanted us to sign a five- to 10-year lease, and they were asking for a seven-month security deposit, which would have been six figures," Guerra said. "From an investment perspective, it was a lot of liabilities."

A few blocks away from Appthority in San Francisco's Financial District, Wonolo - an on-demand staffing startup that has raised $8.9 million from investors such as Coca-Cola Founders and CrunchFund - has slowed down hiring.

"We're not rushing to make a hire just because a position has opened up," said AJ Brustein, Wonolo's co-founder and chief operating officer. "We're being smarter about who we hire, and that might mean we're taking longer than we'd want."

Waits of up to two months, Brustein said, ensure the company finds the right person and reduces the chances of hiring someone who might be a poor fit, which would ultimately be costly.

The company has also opted for a modest office, choosing to take out a yearlong sublease on a 7,000-square-foot space to accommodate its 27

employees.

The decision came after a fundraising push that started in October dragged into January. By then, "it was very clear every single VC in the Valley was writing about doom and gloom," Brustein said. "We kept that in consideration when we moved into an office - it's not necessarily the type of office we would have gotten six months ago, but it was one that we could pay for."

Commercial real estate firms have noticed the shift. Cushman & Wakefield's San Francisco market leader J.D. Lumpkin said that tech startups are starting to make "scrappier, more responsible real estate decisions" to avoid spending huge amounts of money on a lease.

Subleasing is on the rise - even larger tech companies such as Twitter and Dropbox are renting parts of their offices to startups - and a growing number of deals on ambitious office spaces have been put on hold.

"Some startups are doing well, like Lyft and Fitbit," said Robert Sammons, Cushman & Wakefield's director of research in San Francisco, who noted that those firms are still expanding into bigger offices and snapping up long-term leases. "But for some startups, their growth patterns haven't panned out."

It's a reality check, Sammons said. Tech has traditionally spent more on leasing and renovating real estate than other industries.

Payments company Square, for example, built an atrium into its office. Github has a full wet bar.

Numerous startups have spent millions making their offices workplace wonderlands. And, Sammons said, "board members are now saying, 'What are you doing? You're not even profitable.'"

Real estate is only one of many considerations for startups navigating the downturn, said Dale Chang, vice president of portfolio operations at venture capital firm Scale Venture Partners, which has invested in companies such as Box and DocuSign.

"I advise our companies to be smart at all times about growth," Chang said. "Even in frothy times, I don't think going out there and spending a lot of money is the right strategy."

Instead, Chang advises his portfolio companies to focus on the core set of activities that the company was set up to do. Making an app? Hit the ball out of the park with it. Offering software as a service? Make it best in class. Anything that isn't integral to that - marketing, hiring, office expansions - can be slowed down.

Startups that have raised funds in recent months have had to alter their investor presentations to address that too.

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Invoca, a 160-person Santa Barbara company that makes analytics tools for marketers, closed a $30 million round in March after a seven-month fundraising process that stretched out like bubble gum.

Its previous rounds took half the time. Going into it, the company's chief executive, Mark Woodward, said investors were "way, way, way more conservative compared to prior months," and were no longer just interested in companies with high growth. They wanted to know the quality of Invoca's technology, the market opportunity, the business model, its competitive position, and how defensible that position was.

"They wanted to know if Facebook or Google decided to enter our market, would they wipe us out tomorrow?" Woodward said.

When the company raised funds two years ago, the money went toward aggressive hiring of sales and marketing teams and research and development. The latest round, Woodward said, will get the company to self-sustainability, at which point it won't need to raise funds again.

"We're not increasing spending by a dime on marketing," Woodward said. "We're not chasing Uber-sized top-line growth - that's expensive and risky. Just because we have money in the bank doesn't mean we're going to spend it."

Back in San Francisco, Jeff Burkland, the founder of Burkland Associates, a firm that offers chief financial officer services to startups, said that over the years he's seen companies try different strategies to extend their runway.

Slowing down hiring is one. Finding shorter, more flexible leases is another. In extreme cases, founders might decide to not take a salary, or move some of their work to offshore contractors.

Building a war chest before a downturn hits is also an option; a move that rewards those who take advantage of frothy times by accepting funding well before they need it.

If a company had plans to raise funds within the next two years, Burkland advised them last year to get it over with.

Which is why Segment, a data hub startup where Burkland is the CFO, raised funds last fall even though the company didn't need the extra cash yet.

"We felt like the market was too warm to stay that way," said Peter Reinhardt, Segment's chief executive. "We had all this investor interest, and we felt like it wasn't going to be that great in six months."

The fundraising process - emailing investors, setting up meetings, signing a term sheet - took only 11 days.

Ultimately, Burkland said, it's about staying nimble and being adaptive. Trimming excess, finding flexibility and, sometimes, being scrappy. You know, like a startup.

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