

Technology, Media & Telecommunications

Global VC view: Funding startups in the next normal

The boom that tech startups have been experiencing has continued through the pandemic. Two leading venture capitalists talk about how investing in them is changing.



In this premier episode of the *McKinsey on Startups* podcast, Daniel Eisenberg speaks with two experienced venture capitalists, Roelof Botha of Sequoia Capital and Pär-Jörgen (PJ) Parson of Northzone, about the overall startup investing landscape and the challenges and changes their industry is experiencing in the wake of the global pandemic. An edited transcript of their conversation follows.

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Daniel Eisenberg: Hello, and welcome to McKinsey On Startups. I'm Daniel Eisenberg. Soaring IPOs, strong funding rounds, unprecedented demand for digital products and services around the world -- in recent years, startups and venture capital have experienced a boom many say can only be matched by the original dotcom boom of the late '90s.

But this amount of success has raised all sorts of questions about the future sustainability of these times, particularly in whatever amounts to the next normal in a post-COVID world. On today's episode, we are going to explore those issues, and more, with two leading experienced venture capitalists who offer global perspectives.

Roelof Botha is a partner at Sequoia Capital. In addition to leading the U.S. office and serving as one of three stewards of the global Sequoia partnership, Roelof focuses on internet services and software investments. He has spent over 20 years building companies in Silicon Valley, including YouTube and Instagram. He's currently director of such companies as 23andMe, Bird, Eventbrite, Square, and Pendulum Therapeutics, among others. Before joining Sequoia, Roelof was the CFO of PayPal,

leading their IPO in 2002, and the sale to eBay later that same year.

Pär-Jörgen (PJ) Parson is a general partner at Northzone, and focuses on disruptive businesses, and consumer internet, health, and Fintech. Over the years, his investment portfolio has featured the likes of Spotify, iZettle, Avito, PriceRunner, and Videoplaza, as well as currently such names as fuboTV, and Spring Health. Before joining Northzone in 2004, Parson ran his own investment firm.

Roelof, PJ, thanks so much for joining us today.

Roelof Botha: Thank you.

PJ Parson: Thanks, Daniel.

Daniel Eisenberg: Roelof, let me start with you. As you look back on the last five years of the startup investing landscape, what do you think are the most important changes or developments?

Roelof Botha: Interesting question. The most obvious one is what's happened in the last 12 months with COVID, and the way that it's accelerated the future that Silicon Valley has been building. We've seen many companies sort of achieve in 2020 what we thought they might achieve in 2025 as the future got pulled forward.

The specific things I'm excited about are that the grip of big tech on consumer-facing companies seems to be slipping, either because of regulatory scrutiny, or because they themselves are going to moderate their behavior. And then COVID itself has led to a whole raft of opportunities for companies to deliver services to consumers in a very differentiated way.

Startups can just move so much faster, so much more nimbly than the big incumbents. And then the other big trend is cloud computing and the associated explosion of machine learning, because of the abundance of data.

Daniel Eisenberg: PJ, from your vantage point, particularly in Europe, what do you see as the biggest changes and developments.

PJ Parson: I think the most important thing is that over the past ten years Europe has gone to a completely different place in terms of innovation, access to capital, and access to talent. And that has paved the way for basically a new breed of entrepreneurs that are building companies with a different mindset than in the past.

Over the past year, practically all the startups we look at that address one of the legacy markets that is typically dominated by the financial industry, or retail, for instance, are outperforming the legacy incumbents on pretty much all parts of the business.

The cost of capital is lower for them, they have more access to talent, and they typically have lower customer acquisition costs. Also, their operating costs and their operating structure are far more efficient and effective to solve the needs of the modern consumer. So, unlike any time in the past 25 years, today I see that the future belongs to the startup ecosystem. And they're scaling at a pace that I've never seen before.

Daniel Eisenberg: Just as a follow up, PJ, Roelof was talking about this opportunity for consumer-focused startups to compete more effectively against the grip of big tech. Is that something that you also see in Europe, startups faring well not just against industry incumbents but also tech incumbents?

PJ Parson: So I think one of the differences is that Silicon Valley is at the forefront of developing new technology, new businesses, and new business models. Whereas, I think many of the very successful entrepreneurs coming out of the European ecosystem are addressing existing markets with disruptive technology solutions that in many cases have been proven in other settings.

So it's a different version of innovation, I would say. Big tech obviously has a tremendous impact on, for instance, cost of customer acquisition if you're a consumer company. It has a tremendous impact on how you market. But I think that is only a small part of the market that these promising European companies are actually addressing.

What remote work means for innovation hubs

Daniel Eisenberg: Roelof, how do you view the pace of innovation globally right now? Where do you see up and coming hubs? And what are the next generation technologies you're most excited about?

Roelof Botha: That last question's a dangerous one. You know, you're asking me to have a crystal ball here. I'm not negative on Silicon Valley's potential. I think Silicon Valley will continue to be a hub of incredible innovation. But the truth is that there are just many more places in the world where people can build interesting companies.

And we're seeing this today all across the U.S. I think in the last six months, we've made five investments in companies that are not based in Silicon Valley, or not headquartered in Silicon Valley. Part of that is because of COVID. Part of that is because of the ability for technology to enable remote work.

And, you know, opportunity is not as evenly distributed as talent. There's fantastic talent all over the world. So we do look for these pockets of innovation. Now, there's a whole branch of economic theory around clustering, and how industries tend to cluster, because there's a very rapid exchange of ideas.

I do wonder how much that changes in an era of Zoom and communications technologies that make it effortless to communicate across the globe. But I still think you need

this concentration of talent. And it's not just the obvious things about the engineering talent, or the design talent, or the product management talent. It's having real estate that is understanding of the trials and tribulations of startup companies, attorneys that understand how to work with startups, financial executives who understand startups that you can recruit. There's a bunch of second order effects. But I'm very optimistic that you'll see an explosion of startups all around the world.

Daniel Eisenberg: Going back to your point about remote work and COVID. Obviously, the pros and cons of remote work have been widely covered and debated over the last year. What do you see as some of the more surprising or less discussed effects of this remote shift, on startups specifically?

Roelof Botha: Oh, there's a huge impact. I think it's especially difficult for companies that are starting during COVID, because so much is about building trust in a small company. You have a dozen, two dozen, three dozen employees. How do you recreate that sense of trust of being in a shared space?

I remember what it was like to be in Palo Alto at PayPal when we were a burgeoning little company, and the rapid exchange of ideas, the ability to quickly sort out misunderstandings, which I think is harder to do over a Zoom, because everything is scheduled.

You want to give somebody a little bit of feedback, and now suddenly it becomes a big deal instead of just a quick hallway conversation or a chat over coffee. So those are some of the challenges. The benefit, obviously, is the ability to recruit talent wherever that talent may be.

Silicon Valley has just become so expensive and so competitive for top talent. And the big companies are so profitable that their ability to pay is, you know, unrivaled. So it does enable these companies to grow all over the world.

Take Unity, for example, which we first partnered with in 2009 for their first financing. They have development offices in over a dozen countries around the world, because they've been able to pick off great talent wherever it resides.

And they've built it as a strength to be able to manage a remote and distributed workforce. Now like anything, it's a double edged sword. There are pluses and minuses. And you just have to make do as best you can.

Daniel Eisenberg: PJ, are there changes that remote work is having on startups that you expect to remain permanent, versus those that you think might be more fleeting? And by the same token, do you see any of these changes impacting how VCs themselves operate long term?

PJ Parson: I think this was already in motion before COVID. There is the blockchain community, for instance. They almost take pride in building companies where people haven't met in real life. And also if you ask a 25-year-old today, they have a bunch of friends that they've never met in real life. They've been gaming together. They've been forming real authentic relationships that way. I think it's also a generational thing that you can build trust in that different way.

So for those sort of peripheral markets, this is like gold. Because they have a tremendous challenge in recruiting top talent if they require people to move to Trondheim in northern Norway, or to, you know somewhere in the middle of Finland, or what have you.

But with this way, you can actually build a real good roster of talent regardless of where you're located. So I think it's here to stay. That said, for me at least a meeting in real life is unrivaled when it comes to real creative problem solving, and discussion, and sort of moving the relationships forward.

I think it has had a tremendous impact on the VC community insofar as that pretty much all the companies that have an international mandate to invest have gone super international because they, or we, have all decided that we can make a substantial investment without meeting in person.

And that has also substantially increased the competition for a deal. For pretty much all the deals or opportunities that we're looking at these days, regardless of whether it's in Europe or the east coast of the U.S., we meet maybe ten, 15 other VCs that would never have been in the running in the past.

Roelof Botha: To pick up on that, we have this saying now that all roadshows have become Zoom shows, because they're just so compressed. And it's extreme for the companies that went public last year.

It was obviously the first time we'd witnessed this. The two week traditional roadshow on a plane visiting a dozen cities became a one week event, which is incredibly efficient for the management team. And that obviously is trickling down to earlier stages of financing.

The risk, in my mind, especially at the earlier stages, is that you're not just raising money, you're recruiting a business partner. You're recruiting an investor who's going to be with you on a journey. Like I mentioned earlier with Unity and Square, these are companies where I've served on the board for over a decade.

And that's a big decision that you're making. While entrepreneurs can gain from the efficiency of running an online process, I do think it's really important that they not lose the intimacy of picking their business partner.

Diligence and deal making in the Zoom age

Daniel Eisenberg: Roelof, in this virtual environment, how challenging is the diligence process, making decisions about who you want to partner with?

Roelof Botha: This is the number one question we've wrestled with at our offsites over the last several months.

In my mind, whenever you make a decision the goal is to make it with high conviction, a high conviction "No," or a high conviction "Yes." So the way we've tried to do that, given the compressed timelines, is to have more of a prepared mindset.

We did this by developing two dozen "landscapes" last year. These aren't a Ph.D. thesis. It's a couple of pages of somebody's thinking on a particular category that we then present to the rest of the partnership. And everybody's attuned to an idea, such as what's happening with the emerging data stack, what are the services in and around cloud data warehousing that may emerge?

That was one of the landscapes we developed. So when we meet a company, we already have a framework in which to position them. And that way we can make a much faster decision.

It doesn't mean that we come up with the precise nuances of the right idea. That's part of the brilliance that you look for in the founder. Then once you're in process, I think the biggest challenge is the inability to go visit somebody, to walk around their office, to get a feel for their culture.

You have to substitute for that by being even more diligent with customer references, off balance sheet references. So if it's an enterprise technology company, for instance, you have a network of CIOs to call to understand what they think about this company's value proposition. And I'd say we've done a lot more with personal references than we may have in the past as a substitute for that in-person judgment.

Daniel Eisenberg: PJ, you talk about the increased competition, and there's obviously so much capital out there to deploy. What are

you looking for in a startup these days? Are there things startups should be doing to win you over as an investor that are any different in the past, or is it still all about the fundamentals?

PJ Parson: I think it's pretty much the same. You can simplify the concepts here. We really like a team that has this capacity to recruit world-class skills, and to capture the hearts and the minds of the people that really matter in their industry. You can diligence that even remotely. But you sort of feel it immediately when you sit in a room and talk to someone who really knows their stuff.

The second thing for us is that the market is big enough that it can create a massive business over time.

And the third one is that we would like to see a fundamentally different shaded product, one that has the capacity to really stand out with just a modest amount of marketing. Those three very simplistic arguments held five years ago, and they still hold for me today.

Funding and fundamentals

Daniel Eisenberg: PJ, some people talk about a funding bubble. How do you see the massive amounts of capital in the industry impacting startup priorities and decision making?

PJ Parson: I think there has been this very popular concept of "blitz scaling," the idea of extremely fast decision making and building capabilities.

The flipside of that is there was a lot of sloppiness, such as poor company culture, that started to happen. And I think now we're in a situation where we have even more money coming into the market, but also very strong KPIs have been produced thanks to the increase in digital usage and demand during the pandemic.

You can also see a lot of false positives in this environment that might not sustain for the long haul. So the challenge for us as investors, I think, is to see when you're building something really

quickly, with so much access to capital, that is quality can vary greatly between different opportunities.

Daniel Eisenberg: Roelof, it sounds like it can be a little harder in this environment to know what is truly sustainable. Is that something you and your team have to think about a lot?

Roelof Botha: Sure. That could also go back to the question you asked PJ about what we look for. I agree with him completely. You know, the business fundamentals are the same. The shape of it is different, just like the shape of businesses today are different from the ones we funded 20 years ago.

Because the market has changed, the opportunities have changed. The two questions I like to ask typically are, "Who cares," and, "Why now?" And, "Who cares," sounds a little whimsical, but the idea is, what is the problem you're addressing, and why do you have a compelling solution?

And PJ talked about this. It has to be compelling. You want to build a product or a service where your customers find you, and you don't have to go find them. That's when you build something truly distinctive. And then the next question obviously is, is it a sustainable advantage?

And "Why now" is just, what are the environmental reasons that make it propitious to start this company today? Because big companies have so many advantages. You need to have some kind of disruptive change.

In terms of sustainable advantage and durability, I think it's something we wrestled with more in the second quarter last year, right after COVID struck. Because we had companies like DoorDash and Instacart who were benefiting tremendously in food delivery and grocery delivery.

And the question obviously is, does it sustain, or is this a blip? And conversely, we had companies like Airbnb and Eventbrite that obviously saw enormous decreases in revenue because of the curtailment of travel. I'd say, given that COVID has continued for 12 months, and we're likely in for at least another six to 12 months, it actually creates an environment for behavior change to become more set.

And I think that is really interesting in terms of the opportunities we get. So, take tolerance for working over Zoom, for example. Maybe it's something you endured for a few months, and you were looking forward to going back to the way things used to work. But now I think maybe you've gotten used to it, and you see the advantages. You also see the disadvantages, of course. But my guess is that Zoom is going to be a firmament in how people operate from now on. There are so many companies that have had to embrace inside sales instead of direct sales.

Because obviously, their salespeople couldn't travel. And now they understand the benefits. There are services like Gong that help you record your phone calls with customers, that help with training the rest of the sales team. You can analyze what works, what doesn't. Productivity has just been raised for everybody. And, so, I think a lot of these things are going to be much more durable than we may have imagined six months ago.

Judging the soaring valuations

Daniel Eisenberg: So, PJ, there's obviously continuing talk about valuation bubbles. When you look at the future, or even the present, do you feel that there's enough economic value creation to justify the number of unicorns or decacorns?

PJ Parson: Yeah. So that's a very, very difficult and dangerous question. No offense, of course. But I think there are some signs that the entire market is sort of on zero interest rate steroids.

We have a situation where the valuations are high, there is no doubt about that. But then the question is, will they produce returns at the scale that we were hoping for?

And you know, for most of the startups that we have looked at over the past 25 years, very few of them actually get even close to their plans. Some of them do. And they become these unicorns or decacorns, or even more.

But I think this time it's like a change of scenery for the digitally-powered, innovation-powered economy. I think many tech startups get more bang for their buck, they scale more, they create higher returns on their business models.

And since many of these business models are also going from sort of selling units to selling a subscription that's like software-as-a-service (SaaS), for instance, that it's also a totally different profile of earning. So I think there are certainly arguments for this being frothy, absolutely. But I think also that there are companies that are growing at the rate now that we haven't seen before.

Daniel Eisenberg: And then, Roelof, I don't know if you want to dive into another dangerous question?

Roelof Botha: Go for it. We're on a roll

Daniel Eisenberg: Just get your thoughts on the valuation question?

Roelof Botha: I always think of valuation as in, beauty is in the eye of the beholder. And when it comes to private valuations, one person is placing a value on the company. It doesn't mean it's in a public setting. But, of course, the public market is a big barometer. I'm sure PJ experiences this -- as soon as multiples in the public market trade up from ten times revenue to 15 times revenue, I promise you, the entrepreneur walking in wants to reset to the new public comparable.

The challenge that we have is, do we close the doors for business in an environment like this? And I think the answer to that is a resounding, “No.” If you had closed your doors for business in 1999, you would’ve missed both Google and PayPal. Those would’ve been terrible decisions. And Sequoia invested in both. They seemed like expensive prices at the time, and they were.

But those companies outperformed the market. PayPal raised money at a \$500 million valuation with zero revenue in March of 2000. We went public, and then sold to eBay for \$1.5 billion at the end of 2002. It was a decent return for people who held then. And today, PayPal is worth about \$300 billion. Google looked like an expensive investment with no revenue. We invested \$10 million at 100 post back in 1999. And today it’s one point north of a one trillion dollar company. So it just puts the burden on investors like PJ and myself to be very judicious. Do we believe this company is so distinctive that even if multiples compress, its performance in the long run will yield a great return? That’s the question we have to face.

Tools, talent, and scaling

Daniel Eisenberg: How much is talent an issue? Is there still a talent crunch?

Roelof Botha: It is. And part of it is because the menu has changed so dramatically, the menu of opportunity. Because software is infiltrating so many industries—and PJ talked about this earlier—it’s just all industries are now affected. It’s not this little corner in Silicon Valley that builds technology for a small subset of sectors.

It’s woven into the fabric of everything we do as a society today. When I was at PayPal, there were about 200 million people on the internet 20 years ago, on dial up by and large. Today, you have billions, and they have very high speed connections.

I mean, the shape of the opportunity fundamentally has changed. And that is both

exciting but also a limiter. It explains partly, by the way, why we see many more McKinsey founded companies than we did 20 years ago. Because McKinsey people are trained in a whole variety of industries. And they all see interesting opportunities for new businesses. And that’s fantastic, obviously. The problem is there are 25 million people on the planet that write software for a living. That is the bottleneck.

And that’s the reason I’m very excited for people to get retrained, for more and more people to study computer science, not to necessarily become computer scientists or software developers, but for them to bring software development expertise into everything they do. It’s more applied software, in their different domains.

Daniel Eisenberg: And, PJ, do you see similar issues in Europe??

PJ Parson: Well, in the European setting, most of the talent in the past has gone to sort of traditional industries, banks, and consulting firms. And it’s actually been very difficult to recruit to risky startups, and the incentives in many European countries have been to look for safe revenue, rather than the potential upside of an exciting startup.

But that has changed dramatically. So now I think access to the talent pool is fundamentally different. And what I think is encouraging is that although we only have 25 million software developers in the world, there is a tremendous push now to increase the level of abstraction with no code type of movements, where people like you and me could actually start to code, or to build really exciting products.

And I think that’s the next level of business development, that we will have almost like a box of Lego that works for all of us to build really cool businesses with high performance, low cost, and strong customer satisfaction.

Roelof Botha: That's why you've seen such momentum behind tools-based companies, in one camp, and why cloud computing has made such a big difference. So there's the famous story of Steve Jobs talking about the importance of tools; how humans when walking are one of the slowest or least efficient creatures around but when they are on a bicycle, that changes things dramatically, because now you've put a tool at the disposal of the human. So the same things happened with software development. People who are trained become far more productive than they were before because of far more powerful tools that are available today.

And cloud computing really simplifies things. No longer do you need to stand up your own physical co-location center. No longer do you need to database it in Australia, because you can get a database as a service on one of the cloud vendors. All these things have abstracted the complexity, and make it very easy for you, if you have a business idea, to be able to leverage technology to create a valuable company.

Daniel Eisenberg: And Roelof, does that help overcome any challenges of scaling? What do you see as the biggest obstacles that could prevent a promising startup from scaling?

Roelof Botha: Well, in a very practical sense, the challenges we had in early days at PayPal and YouTube were based on database constraints. So, PayPal was built on a relational system. We used Oracle at the time. It was really expensive, by the way. I hated having to write the checks for that.

But the relational system that Oracle had built was built for traditional legacy companies. It wasn't built for web-scale, for millions or tens of millions of customers. And so that was a bottleneck. At YouTube, they moved onto open source, and they were using MySQL, also a relational database.

But it too was a bottleneck that caused the site to struggle with scalability. Today, companies will stand up on AWS or Google Cloud, or Azure. And you might use a service like Mongo, or you might use RDS, or one of the other cloud native

database solutions that have wonderful auto-scaling capabilities.

So it's amazing that the technology now removes a lot of those technical reasons that impede growth. Then scalability becomes the function of customer acquisition at some level. And as we discussed earlier, you want to have a product that customers run to, and you don't have to spend a lot of money marketing them.

Then this scalability challenge is really a management issue. And, again, that's part of why I think more and more McKinsey people and MBAs are having a big influence in many of these tech companies, because it's a management challenge. How do you motivate people? Are we making the right strategic decisions?

One of the things I like to point out is that a company probably has two to three crucial decisions every single year. And the team needs to wrestle with those. These are big decisions that affect the ultimate outcome. They're not the everyday execution issues, which clearly matter. But you need to lift your head and focus on those.

I think the challenge maybe is a little bit like with a teenager where their brain can grow very quickly, but they may still be a little bit clumsy physically. So, I think that the technology can move very quickly. And the productivity of the engineering team is fabulous. But then you need to catch up with other parts of your business, your go to market capability, your sales function, marketing, product marketing, human resources, talent management, all these other business issues also need to catch up with the company's growth.

Startup fundraising pitfalls

Daniel Eisenberg: I know we're coming up on time here, so I want to ask each of you a concluding question: When you look at so many startups and pitches constantly, what do you

see as the most common mistakes or pitfalls as they try to raise capital?

PJ Parson: Well, I would say one of the most common mistakes is that you haven't really thought through how much you can achieve with the money that you're thinking about raising. So it becomes almost like a circular reference in the conversation, and then an unproductive discussion. What we would like to see more about is, okay, what is the big next big inflection point that you can reach? And how much capital do you need to get to that big inflection point – where you can get access to customers more easily, or you can scale at a different speed, or you can start to prove your business model?

And when that is not thought through, then it basically starts to sputter really early in the conversation. So when I get the question, “What do you need to hear in a pitch,” well, I want to see what can you achieve in a reasonable timeframe. And what is the kind of capital you need to do that, in order to sort of really be a different company at that point in time?

Daniel Eisenberg: And Roelof, when you look at mistakes or pitfalls?

Roelof Botha: There are two that I think about. The first is substance versus form. You need to be authentic. You need to just tell your business story, and explain what it is you do, and try not to make it performance art.

The second one is choosing your business partner. I spoke about it earlier. Fundraising is

a recruiting exercise for your future business partner. There are people like PJ or myself who have decades of experience, who can help you see around corners. I'm sure that between the two of us, we've made more mistakes than any of these founders hopefully will make.

And the goal is to learn from the mistakes we've made, which means you don't have to repeat them. And so you're recruiting a business partner. Don't just take the highest valuation. Don't just take the easiest money.

Find somebody whom you trust, who's going to be at your side, somebody who you can call on a Sunday night when something blows up at the company, when you have a squabble with your cofounder, when your biggest business partner goes sour on you. Who are you going to turn to for advice to help you navigate those moments? That is what you're looking for. And, so, take the fundraising exercise a lot more seriously as a recruiting exercise.

Daniel Eisenberg: Well, I want to thank both of you. This has been a great, really insightful conversation. Roelof Botha of Sequoia, PJ Parson of Northzone, thanks again for joining us.

PJ Parson: Thank you.

Roelof Botha: You're welcome.

Daniel Eisenberg: And I want to thank our listeners for tuning into *McKinsey On Startups*. We hope you'll return for future episodes.

Roelof Botha is a partner at Sequoia Capital and **Pär-Jörgen (PJ) Parson** is a general partner at Northzone. **Daniel Eisenberg** is a senior editor in McKinsey's New York office.

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