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Silicon Valley startups - Profitability or growth?

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For the last decade, startup companies in technology were supported by excessive venture capital funding and encouraged to prioritize fast growth over everything else. However, as investors in the stock market became more skeptical about the financial performance of fast-growing tech companies, entrepreneurs have started to rethink their priorities and have considered becoming more financially responsible. For example, Travis VanderZanden, the chief executive of startup company Bird Rides, declared at a tech conference in San Francisco last week that his company was switching its focus to profitability.

The stumbles of some high-profile startups after reaching the public market have motivated this change of strategy. WeWork, the office rental startup company, withdrew its initial public offering in September as investors became increasingly wary of its huge losses and corporate governance problems. S&P Global Ratings dropped WeWork's credit rating to "B-" and its outlook to "negative" due to concerns about the company's ability to raise additional capital. As the market questioned WeWork's financial performance, its valuation went down from $47 billion to $10 billion recently.

Similarly, the stock price of ride-sharing application leaders, Uber and Lyft, have plummeted in value for months after they went public in 2019. Investors in the stock market are less willing to buy shares when they see huge losses on the financial statements and no prospect of making profits in the near future. Uber's market cap went down to around $49 billion from a pre-IPO valuation of $76 billion. Lyft's valuation also went down from $15 billion to $11.6 billion.

The concern over profitability in the public market has made some venture capitalists rethink their evaluation strategies. Fred Wilson, a venture capitalist at Union Square Ventures, wrote in his blog that how companies trade in the public market should give venture capitalists an insight into how they should finance and value businesses in the private market. Financial transactions in the private market are initiated by the issuers, so private investors tend to make more irrational decisions when they finally have an opportunity to invest and hopefully gain advantages from onboarding early. In contrast, investors in the public market can choose to buy or sell shares at any time they want, so valuation of companies in the public market are more rational, especially when the company has been trading in the market for a material amount of time. Therefore, as the public market becomes more cautious when it comes to growth companies, venture capitalists probably should rethink about their valuation strategies and start to pay attention to financial performance as well.

Although more investors and entrepreneurs started to focus on the financial performance of startup companies, the widespread tradition is to spend a huge amount of money and invest everything in the business for growth at early stages. The rationale behind this strategy is that investing heavily in growth would help the business become more competitive in the market, and the huge losses sitting on the financial statements now would be turned into more enormous profits in the long run. Therefore, venture capitalists are willing to pour in huge amount of money without focusing on the financial performances of a startup. In fact, funds raised from venture capital companies is still at record high in the past three quarters of 2019 despite the fact that investors are expecting a possible correction after several years of sharp rise in valuations.

However, the life of a startup is full of unpredictability. It is a wise decision to shore up cash flow, an essential aspect for any business, in order to survive at hard times. It is interesting to see how new companies will adjust their strategies to deal with the increasing concerns over their financial strength in the market.