

High-Flying Internet Valuations Due to Fall

Tom Stein, Contributor

Joe Kraus of Google Ventures expects Social TV to be the hot trend in 2012

In 2011, the consumer Internet helped give rise to the social-media fueled Arab Spring. It also was dominated by stories of the rise, fall and rise again of Groupon, preceding its IPO. Plus, there was the domination of Facebook, which ended the year amid more discussion over its supposed IPO in 2012.



Todd Chaffee, General Partner
Institutional Venture Partners

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But the biggest story for Internet investors in 2011 was valuations, and the fact that every half-way decent startup is now getting priced as if it's the next Facebook or Groupon.

"It's crazy out there," says Tim Chang, a managing director at Mayfield Fund, who says that valuations are spinning out of control. "We're seeing these Y-Combinator-backed companies reaching \$10 million pre-money valuations before they've even launched."

Jeff Clavier, an angel investor and the founder of SoftTech VC, says he has seen seed stage valuations explode from an average of about \$2 million pre-money in 2007 to about \$9 million pre-money today. And that's during a period when nearly every other business sector worldwide is going south.

Clavier believes Silicon Valley exists in a parallel universe.

"Europe is on the brink of annihilation and despite a few big deals, IPOs and M&As are hard to come by," he says. "Despite all that, people are ready to throw money at hot startups at any price. That is really dubious."

Even beyond the seed stages, certain growth stage Internet companies are attracting goofy prices, to the point where a \$1 billion valuation is actually the new \$100 million valuation.

"Many firms are going nuts to buy their way into momentum deals and are offering \$1 billion-plus valuations to buy hot logos for their portfolios," Chang says.

One such example is cloud-based file hosting service Dropbox, which raised \$250 million from Accel Partners, Benchmark Capital, Greylock Partners, Index Ventures, Institutional Venture Partners and Sequoia Capital, among others, in its latest round in October at a reported valuation of \$4 billion.

VCs, such as Clavier and Chang, don't think the stratospheric prices are sustainable. They think that 2012 may be the year when Internet startups come crashing back to earth.

"This will mostly end in tears," Chang says. "We have been immune to macro economic trends, but this is the year when reality finally catches up."

But some investors, like Todd Chaffee at IVP, believe that hyper-growth consumer Internet companies are here to stay, and that, if anything, the industry can expect to see more turbo-charged companies in the months and years ahead.

"Just look at the rocketship growth of companies, such as Zynga, Groupon and Living Social," he says. "In the history of the venture industry, I don't think we've seen three companies that have gone to scale so quickly and reached over \$1 billion in revenue so quickly."

Chaffee notes that the Internet is now firmly embedded in the lives of billions of people. "That's no longer some grandiose concept. It's a reality," he says.

Thus, companies are able to take advantage of that install base of 2 billion active Internet users and 5 billion mobile phone users "to scale like we've never seen before," he says.

The Next Hot Trend

So what, potentially, is the next hot thing to catch on with the masses?

Joe Kraus, a partner at Google Ventures, is fascinated by the rise of generalized artificial intelligence for use in consumer Internet. He says this is a trend that stormed the market quickly in 2011 with the Siri personal assistant iPhone app and IBM's Watson supercomputer, which did battle on "Jeopardy."

"These were two significant data points, and I think we are just at the beginning of this trend toward real-life interfacing with AI systems," Kraus says. "It will happen much more quickly than people think."

He points out that AI systems have been overhyped for the past 50 years with limited success. But this time, he says, it feels different. It feels real.

"I don't know what the ramifications are, but I would love to invest in the trend," he says. "I can see many new [AI-related] startups coming along and changing the nature of how we work, play and learn."

Another trend that excites Kraus is the new ways people are watching TV. He thinks the current TV market, along with the approximately \$80 billion it generates each year from advertising, is ripe for disruption.

"TV viewing has been basically the same for last 50 to 60 years, but the way we watch TV and the information we get from it is about to change radically," he says.

He cites his portfolio company Miso, a provider of a social TV platform that adds original synchronized content to TV episodes. When fans of the TV show "Dexter" check-in using Miso's iPhone app, they can vote on who they think will be Dexter's next victim, share dialog from the show and receive alerts when their friends tune in. Similar social TV apps are available from VC-backed ClipSync and soon from ConnectTV.

"As TV goes from these traditionally closed systems to an open system, the magic gets unlocked," Kraus says. For Clavier, the trick is to always look for new horizons, and to avoid investing in the same types of deals he did in previous years. For 2012, he's looking at companies that can take common services or experiences and improve upon them in a mobile environment.

"What do you think about fashion or ecommerce or booking a flight in a mobile context?" he asks. "My

sense is we will find interesting companies around the utility of the mobile workflow."

As for Chaffee, his sense is that many great deals lie ahead in the consumer Internet.

"Other than valuations, we are good to go," he says.