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The do-it-yourself startup, and other trends for 2006

by: Sean Foote, Labrador Ventures – January, 2006

Early stage investments will require less money and reach far greater audiences than ever before.

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In 2005, change was everywhere. Blogging changed the whole concept of marketing – as did Google! Digital downloads went mainstream – even into the realm of television. The handheld suddenly had the power of a minicomputer, and then some.

In 2006, many of these trends are going to blossom in ways we never imagined, while others will emerge to significantly change the landscape of VC investing – particularly for seed and early stage investors. And even as the median VC fund approaches $200 million – with more and more partners flying over to China looking for deals – entrepreneurs will realize they will need *less* money than ever before in order to build strong sustainable companies; and VCs will have to adapt.

Costs Come Down and the Internet Grows Up

One trend for 2006 is the rapid decline in storage costs. Storage costs are not something we normally think about in our everyday practice. Yet, such costs have declined dramatically and will continue to do so into 2006 and beyond. One gigabyte of storage now costs just $0.42; five years ago that one gigabyte cost $8. Meaningful? So much so that the entire MP3 business has been enabled by the cheap cost of storage. And as it declines further, music downloads will give way to video downloads and whole new worlds related to digital entertainment will bubble to the surface.

Take this trend out another 5 years and storage costs will reach just $0.02 per gigabyte by 2010 (that's $50 to store all the songs on the Billboard 500 since 1957). Clearly, this is just one game-changing technology trend for any startup relying on storage as an essential part of its business; though for Labrador and other early stage investors, a decline in storage costs might not map directly to any specific investment. It does, however, open up completely new avenues of business models for us to explore; even more so when coupled with explosive trends in Internet usage and broadband-enabled households.

In 2006 (as opposed to 1999) the Internet finally *works!* And it *works* from all sides – from an investment perspective, a marketing perspective, a sales channel and supply chain perspective, and as part of the fabric of telecommunications and media and entertainment. What was envisioned at the height of the bubble – what all of those embarrassingly enlarged valuations were built upon – has finally arrived. And now, with 1 billion people online worldwide – three times as many as during the 1999 Internet boom – and with over 200 million global broadband subscribers (7 times as many as in 2001), conditions are ripe for a whole range of Internet startups to achieve scale with a good idea.

Moreover, advertising on the Web has finally delivered on its promise as one of the most effective advertising solutions to reach the consumer audience. Ad viewership, clickthrough, and conversion can now be highly targeted and measured. Online marketing and advertising possess the advantages of direct mail while being far cheaper than mass media broadcast outlets. In fact, advertisers spent a total of $10 billion in online advertising in 2004 – a 100 percent increase from the year before. And yet with just that $10 billion (the total spent on advertising in 2004 was $420 billion!), online advertisers reached just as many U.S. households as cable, radio, and newspapers, respectively. And at $145 per household, advertisers reached those consumers at half of what it would have cost them through traditional marketing channels.

Here, again, early stage Internet companies can now be built and funded on the cheap, with online advertising budgets running as lean as in the hundreds of dollars, rather than the tens of thousands or hundreds of thousands of dollars startups had to previous earmark for marketing expenses.

The Proliferation of Wireless Everything

Another trend for 2006 is the proliferation of wireless devices worldwide, an explosive trend capable of generating a range of new opportunities within wireless applications. Next year alone, the number

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of WiFi hot spots will grow to 80 million from just 5 million in 2001. Over 1.1 billion cell phones will permeate the global market, up from 420 million in 2002. And, most interestingly, today's and tomorrow's cell phones have as much computing power as the average personal computer did in 1998, not to mention 50 times the data networking capacity.

What does this mean for early stage investors? It means that with a camera on almost every cell phone, with multiple mobile applications offerings to consumers including TV, music and gaming, and with the further build-out of the 3G broadband wireless networks, there will be a range of new opportunities for savvy early stage VCs. These will include network improvements, systems integration, new devices, and a dizzying array of wireless applications.

The downside to such a proliferation of wireless devices? PCs and cell phones will not be running on the same OS, despite Microsoft's desire to have it be so. Software and applications for cell phones will remain fragmented, thus making it nearly impossible to develop to a set standard for all devices. And comprehensive and ubiquitous testing across all wireless devices for any technology startup will be a challenge to say the least. Thus, no immediate relief for companies like mobile game developers, who spend more on device customization and testing than on the game itself.

Yet, the proliferation of wireless devices does mean that marketing, advertising, branding (and, sadly, spamming) will finally extend to the wireless world. And when it does it will be yet another *huge* opportunity for entrepreneurs and early investors, and a seamless and significant extension of the reach of any Internet company into yet another new worldwide channel for customer demand.

The Do-It-Yourself Startup

Still, the biggest opportunity for seed and early stage VCs lies within the changing dynamics of starting a company in the first place. Specifically, startups have become dirt cheap to build from the ground up – particularly Internet startups. "When we went to rebuild ezboard, we went with open standards and open source code for some applications and our startup costs were maybe $1000, not including man hours … drastically less than the hundreds of thousands of dollars the company had originally spent," says Rob Labbatt, CEO of ezboard, an online community network of discussion boards.

Though hardware remains the largest expense for companies such as ezboard, servers now cost just $1000, rather than the $10,000 per piece of equipment they commanded in 1999. Moreover, bandwidth costs are down significantly, as are items like Cisco firewalls – readily available on the secondary market at low, low prices. On the software side, processes and applications have been baked into generic offerings (shopping carts and ad servers no longer need be handcrafted by engineers), whereas databases and the online infrastructure of 1999 either had to be licensed individually, or simply built in-house by high priced software talent. Those days are over.

The emergence of blogging has further changed the nature of marketing as companies are no longer beholden to high-priced public relations firms or the high cost of external advertising. A few well-placed ad words, and some careful evangelizing to the core users of any technology – evangelizing to the *evangelists* – and a company can have a highly effective launch strategy capable of getting it to market via word-of-mouth far faster than ever before.

In fact, today, the overall cost of entrepreneurship is lower than ever before. With costs down, founders can launch a company with a few hundred thousand dollars. This is good news for smaller early stage funds that can invest as little as $250,000 in helping get companies off the ground. "Today favors not the first time entrepreneur or the big VC fund, but the serial entrepreneur or early stage investor who, with a couple hundred thousand dollars or a couple million from well-off friends, can finance a company himself," says Labatt. "It's do-it-yourself entrepreneurship."

Some Trends Never Change

For Labrador and many other VCs, these are the defining trends for 2006 – and they will stay so for a number of reasons.

First, there is no shortage of innovation in technology and business models, built on the backs of long term technology trends similar to massive storage cost declines, the explosive growth of the Web and the widespread proliferation of wireless devices. Second, entrepreneurs will need less money to pursue these opportunities as start-up costs decline at an even more rapid pace over time. Finally, traditional VC firms will continue to bifurcate, with one approach focusing on companies taking advantage of the reduced cost of entrepreneurship and another approach targeting large investments in maturing industries like telecom, semiconductor, ERP, and later, larger investments in these new "reduced cost" early stage startups that will have finally matured up the ladder.

Early investments, the wellspring of traditionally high venture returns, will increasingly be driven by VCs with an efficient way of identifying and managing smaller investments. It's a challenge equivalent to working both harder *and* smarter. ***We're going to be busy in 2006!***

This is one in a series of monthly columns on seed and early stage investing that Labrador Ventures was selected to contribute to the *Venture Capital Journal.*

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