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After barely changing at all for decades, the startup funding business is now in what could, at least by comparison, be called turmoil. At Y Combinator we've seen dramatic changes in the funding environment for startups. Fortunately one of them is much higher valuations.

The trends we've been seeing are probably not YC-specific. I wish I could say they were, but the main cause is probably just that we see trends first—partly because the startups we fund are very plugged into the Valley and are quick to take advantage of anything new, and partly because we fund so many that we have enough data points to see patterns clearly.

What we're seeing now, everyone's probably going to be seeing in the next couple years. So I'm going to explain what we're seeing, and what that will mean for you if you try to raise money.

Super-Angels

Let me start by describing what the world of startup funding used to look like. There used to be two sharply differentiated types of investors: angels and venture capitalists. Angels are individual rich people who invest small amounts of their own money, while VCs are employees of funds that invest large amounts of other people's.

For decades there were just those two types of investors, but now a third type has appeared halfway between them: the so-called super-angels. [1] And VCs have been provoked by their arrival into making a lot of angel-style investments themselves. So the previously sharp line between angels and VCs has become hopelessly blurred.

There used to be a no man's land between angels and VCs. Angels would invest $20k to $50k apiece, and VCs usually a million or more. So an angel round meant a collection of angel investments that combined to maybe $200k, and a VC round meant a series A round in which a single VC fund (or occasionally two) invested $1-5 million.

The no man's land between angels and VCs was a very inconvenient one for startups, because it coincided with the amount many wanted to raise. Most startups coming out of Demo Day wanted to raise around $400k. But it was a pain to stitch together that much out of angel investments, and most VCs weren't interested in investments so small. That's the fundamental reason the super-angels have appeared. They're responding to the market.

The arrival of a new type of investor is big news for startups, because there used to be only two and they rarely competed with one another. Super-angels compete with both angels and VCs. That's going to change the rules about how to raise money. I don't know yet what the new rules will be, but it looks like most of the changes will be for the better.

A super-angel has some of the qualities of an angel, and some of the qualities of a VC. They're usually individuals, like angels. In fact many of the current super-angels were initially angels of the classic type. But like VCs, they invest other people's money. This allows them to invest larger amounts than angels: a typical super-angel investment is currently about $100k. They make investment decisions quickly, like angels. And they make a lot more investments per partner than VCs—up to 10 times as many.

The fact that super-angels invest other people's money makes them doubly alarming to VCs. They don't just compete for startups; they also compete for investors. What super-angels really are is a new form of fast-moving, lightweight VC fund. And those of us in the technology world know what usually happens when something comes along that can be described in terms like that. Usually it's the replacement.

Will it be? As of now, few of the startups that take money from super-angels are ruling out taking VC money. They're just postponing it. But that's still a problem for VCs. Some of the startups that postpone raising VC money may do so well on the angel money they raise that they never bother to raise more. And those who do raise VC rounds will be able to get higher valuations when they do. If the best startups get 10x higher valuations when they raise series A rounds, that would cut VCs' returns from winners at least tenfold. [2]

So I think VC funds are seriously threatened by the super-angels. But one thing that may save them to some extent is the uneven distribution of startup outcomes: practically all the returns are concentrated in a few big successes. The expected value of a startup is the percentage chance it's Google. So to the extent that winning is a matter of absolute returns, the super-angels could win practically all the battles for individual startups and yet lose the war, if they merely failed to get those few big winners. And there's a chance that could happen, because the top VC funds have better brands, and can also do more for their portfolio companies. [3]

Because super-angels make more investments per partner, they have less partner per investment. They can't pay as much attention to you as a VC on your board could. How much is that extra attention worth? It will vary enormously from one partner to another. There's no consensus yet in the general case. So for now this is something startups are deciding individually.

Till now, VCs' claims about how much value they added were sort of like the government's. Maybe they made you feel better, but you had no choice in the matter, if you needed money on the scale only VCs could supply. Now that VCs have competitors, that's going to put a market price on the help they offer. The interesting thing is, no one knows yet what it will be.

Do startups that want to get really big need the sort of advice and connections only the top VCs can supply? Or would super-angel money do just as well? The VCs will say you need them, and the super-angels will say you don't. But the truth is, no one knows yet, not even the VCs and super-angels themselves. All the super-angels know is that their new model seems promising enough to be worth trying, and all the VCs know is that it seems promising enough to worry about.

Rounds

Whatever the outcome, the conflict between VCs and super-angels is good news for founders. And not just for the obvious reason that more competition for deals means better terms. The whole shape of deals is changing.

One of the biggest differences between angels and VCs is the amount of your company they want. VCs want a lot. In a series A round they want a third of your company, if they can get it. They don't care much how much they pay for it, but they want a lot because the number of series A investments they can do is so small. In a traditional series A investment, at least one partner from the VC fund takes a seat on your board. [4] Since board seats last about 5 years and each partner can't handle more than about 10 at once, that means a VC fund can only do about 2 series A deals per partner per year. And that means they need to get as much of the company as they can in each one. You'd have to be a very promising startup indeed to get a VC to use up one of his 10 board seats for only a few percent of you.

Since angels generally don't take board seats, they don't have this constraint. They're happy to buy only a few percent of you. And although the super-angels are in most respects mini VC funds, they've retained this critical property of angels. They don't take board seats, so they don't need a big percentage of your company.

Though that means you'll get correspondingly less attention from them, it's good news in other respects. Founders never really liked giving up as much equity as VCs wanted. It was a lot of the company to give up in one shot. Most founders doing series A deals would prefer to take half as much money for half as much stock, and then see what valuation they could get for the second half of the stock after using the first half of the money to increase its value. But VCs never offered that option.

Now startups have another alternative. Now it's easy to raise angel rounds about half the size of series A rounds. Many of the startups we fund are taking this route, and I predict that will be true of startups in general.

A typical big angel round might be $600k on a convertible note with a valuation cap of $4 million premoney. Meaning that when the note converts into stock (in a later round, or upon acquisition), the investors in that round will get .6 / 4.6, or 13% of the company. That's a lot less than the 30 to 40% of the company you usually give up in a series A round if you do it so early. [5]

But the advantage of these medium-sized rounds is not just that they cause less dilution. You also lose less control. After an angel round, the founders almost always still have control of the company, whereas after a series A round they often don't. The traditional board structure after a series A round is two founders, two VCs, and a (supposedly) neutral fifth person. Plus series A terms usually give the investors a veto over various kinds of important decisions, including selling the company. Founders usually have a lot of de facto control after a series A, as long as things are going well. But that's not the same as just being able to do what you want, like you could before.

A third and quite significant advantage of angel rounds is that they're less stressful to raise. Raising a traditional series A round has in the past taken weeks, if not months. When a VC firm can only do 2 deals per partner per year, they're careful about which they do. To get a traditional series A round you have to go through a series of meetings, culminating in a full partner meeting where the firm as a whole says yes or no. That's the really scary part for founders: not just that series A rounds take so long, but at the end of this long process the VCs might still say no. The chance of getting rejected after the full partner meeting averages about 25%. At some firms it's over 50%.

Fortunately for founders, VCs have been getting a lot faster. Nowadays Valley VCs are more likely to take 2 weeks than 2 months. But they're still not as fast as angels and super-angels, the most decisive of whom sometimes decide in hours.

Raising an angel round is not only quicker, but you get feedback as it progresses. An angel round is not an all or nothing thing like a series A. It's composed of multiple investors with varying degrees of seriousness, ranging from the upstanding ones who commit unequivocally to the jerks who give you lines like "come back to me to fill out the round." You usually start collecting money from the most committed investors and work your way out toward the ambivalent ones, whose interest increases as the round fills up.

But at each point you know how you're doing. If investors turn cold you may have to raise less, but when investors in an angel round turn cold the process at least degrades gracefully, instead of blowing up in your face and leaving you with nothing, as happens if you get rejected by a VC fund after a full partner meeting. Whereas if investors seem hot, you can not only close the round faster, but now that convertible notes are becoming the norm, actually raise the price to reflect demand.

Valuation

However, the VCs have a weapon they can use against the super-angels, and they have started to use it. VCs have started making angel-sized investments too. The term "angel round" doesn't mean that all the investors in it are angels; it just describes the structure of the round. Increasingly the participants include VCs making investments of a hundred thousand or two. And when VCs invest in angel rounds they can do things that super-angels don't like. VCs are quite valuation-insensitive in angel rounds—partly because they are in general, and partly because they don't care that much about the returns on angel rounds, which they still view mostly as a way to recruit startups for series A rounds later. So VCs who invest in angel rounds can blow up the valuations for angels and super-angels who invest in them. [6]

Some super-angels seem to care about valuations. Several turned down YC-funded startups after Demo Day because their valuations were too high. This was not a problem for the startups; by definition a high valuation means enough investors were willing to accept it. But it was mysterious to me that the super-angels would quibble about valuations. Did they not understand that the big returns come from a few big successes, and that it therefore mattered far more which startups you picked than how much you paid for them?

After thinking about it for a while and observing certain other signs, I have a theory that explains why the super-angels may be smarter than they seem. It would make sense for super-angels to want low valuations if they're hoping to invest in startups that get bought early. If you're hoping to hit the next Google, you shouldn't care if the valuation is 20 million. But if you're looking for companies that are going to get bought for 30 million, you care. If you invest at 20 and the company gets bought for 30, you only get 1.5x. You might as well buy Apple.

So if some of the super-angels were looking for companies that could get acquired quickly, that would explain why they'd care about valuations. But why would they be looking for those? Because depending on the meaning of "quickly," it could actually be very profitable. A company that gets acquired for 30 million is a failure to a VC, but it could be a 10x return for an angel, and moreover, a *quick* 10x return. Rate of return is what matters in investing—not the multiple you get, but the multiple per year. If a super-angel gets 10x in one year, that's a higher rate of return than a VC could ever hope to get from a company that took 6 years to go public. To get the same rate of return, the VC would have to get a multiple of 10^6—one million x. Even Google didn't come close to that.

So I think at least some super-angels are looking for companies that will get bought. That's the only rational explanation for focusing on getting the right valuations, instead of the right companies. And if so they'll be different to deal with than VCs. They'll be tougher on valuations, but more accomodating if you want to sell early.

Prognosis

Who will win, the super-angels or the VCs? I think the answer to that is, some of each. They'll each become more like one another. The super-angels will start to invest larger amounts, and the VCs will gradually figure out ways to make more, smaller investments faster. A decade from now the players will be hard to tell apart, and there will probably be survivors from each group.

What does that mean for founders? One thing it means is that the high valuations startups are presently getting may not last forever. To the extent that valuations are being driven up by price-insensitive VCs, they'll fall again if VCs become more like super-angels and start to become more miserly about valuations. Fortunately if this does happen it will take years.

The short term forecast is more competition between investors, which is good news for you. The super-angels will try to undermine the VCs by acting faster, and the VCs will try to undermine the super-angels by driving up valuations. Which for founders will result in the perfect combination: funding rounds that close fast, with high valuations.

But remember that to get that combination, your startup will have to appeal to both super-angels and VCs. If you don't seem like you have the potential to go public, you won't be able to use VCs to drive up the valuation of an angel round.

There is a danger of having VCs in an angel round: the so-called signalling risk. If VCs are only doing it in the hope of investing more later, what happens if they don't? That's a signal to everyone else that they think you're lame.

How much should you worry about that? The seriousness of signalling risk depends on how far along you are. If by the next time you need to raise money, you have graphs showing rising revenue or traffic month after month, you don't have to worry about any signals your existing investors are sending. Your results will speak for themselves. [7]

Whereas if the next time you need to raise money you won't yet have concrete results, you may need to think more about the message your investors might send if they don't invest more. I'm not sure yet how much you have to worry, because this whole phenomenon of VCs doing angel investments is so new. But my instincts tell me you don't have to worry much. Signalling risk smells like one of those things founders worry about that's not a real problem. As a rule, the only thing that can kill a good startup is the startup itself. Startups hurt themselves way more often than competitors hurt them, for example. I suspect signalling risk is in this category too.

One thing YC-funded startups have been doing to mitigate the risk of taking money from VCs in angel rounds is not to take too much from any one VC. Maybe that will help, if you have the luxury of turning down money.

Fortunately, more and more startups will. After decades of competition that could best be described as intramural, the startup funding business is finally getting some real competition. That should last several years at least, and maybe a lot longer. Unless there's some huge market crash, the next couple years are going to be a good time for startups to raise money. And that's exciting because it means lots more startups will happen.

Notes

[1] I've also heard them called "Mini-VCs" and "Micro-VCs." I don't know which name will stick.

There were a couple predecessors. Ron Conway had angel funds starting in the 1990s, and in some ways First Round Capital is closer to a super-angel than a VC fund.

[2] It wouldn't cut their overall returns tenfold, because investing later would probably (a) cause them to lose less on investments that failed, and (b) not allow them to get as large a percentage of startups as they do now. So it's hard to predict precisely what would happen to their returns.

[3] The brand of an investor derives mostly from the success of their portfolio companies. The top VCs thus have a big brand advantage over the super-angels. They could make it self-perpetuating if they used it to get all the best new startups. But I don't think they'll be able to. To get all the best startups, you have to do more than make them want you. You also have to want them; you have to recognize them when you see them, and that's much harder. Super-angels will snap up stars that VCs miss. And that will cause the brand gap between the top VCs and the super-angels gradually to erode.

[4] Though in a traditional series A round VCs put two partners on your board, there are signs now that VCs may begin to conserve board seats by switching to what used to be considered an

angel-round board, consisting of two founders and one VC. Which is also to the founders' advantage if it means they still control the company.

[5] In a series A round, you usually have to give up more than the actual amount of stock the VCs buy, because they insist you dilute yourselves to set aside an "option pool" as well. I predict this practice will gradually disappear though.

[6] The best thing for founders, if they can get it, is a convertible note with no valuation cap at all. In that case the money invested in the angel round just converts into stock at the valuation of the next round, no matter how large. Angels and super-angels tend not to like uncapped notes. They have no idea how much of the company they're buying. If the company does well and the valuation of the next round is high, they may end up with only a sliver of it. So by agreeing to uncapped notes, VCs who don't care about valuations in angel rounds can make offers that super-angels hate to match.

[7] Obviously signalling risk is also not a problem if you'll never need to raise more money. But startups are often mistaken about that.

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