Entrepreneuring Through Inflation: Perspectives of Silicon Valley Venture Capitalists

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Abstract

After a four-decade hiatus, inflation has come roaring back to impact all aspects of the economy – from daily consumer purchase behavior to corporate margins. Startup entrepreneurs always face an array of challenges, but high inflation has not been among them since the early 1980s. Given the lack of experience and collective memory of dealing with inflation in an entrepreneurial setting, this research solicited the guidance of Silicon Valley Venture Capitalists in determining the potential strategies that startup entrepreneurs may employ to navigate the current inflationary environment.

Startup entrepreneurs routinely surmount technical, market, and competitive hurdles in building their ventures. They also must navigate unforeseen environmental shocks such as the global pandemic.[1] Beyond these Herculean tasks, sometimes long forgotten macroeconomic challenges reemerge to jolt the business environment and demand a cogent response.

Those of us old enough to recall the 1970s and 1980s realize that the absence of high inflation is not a given. Driven by supply and demand shocks of the pandemic along with historic monetary and fiscal stimulus, inflation has returned to the U.S. economy, with the Labor Department's Consumer Price Index (CPI) hitting 7.9% year over year in February 2022.[2] While inflation today is not at the level reached in the 1970s and early 1980s, hitting 14.4% in June 1980,[3] it still is significantly higher than what it has been for four decades.[4] Thus, the collective memory of entrepreneurs and entrepreneurial managers in dealing with rising inflation is somewhat limited.

The impact of inflation on individuals is fairly clear as higher consumer prices (food, energy, rent, etc.) reduce purchasing power for individuals. However, how does inflation impact the startups that power the innovation economy? Entrepreneurship research has grown dramatically over the last 40 years, and this period of growth coincides with a low inflationary environment. Thus, it is not surprising that there is relatively limited research on the link between entrepreneurship and inflation, and the research that has been done often indicates a negative relationship.[5,6,7] Given the significant increase in inflation in recent months and the limited research on its impact on startups, this paper explores the potential effect of the currently rapidly rising inflation on startup entrepreneurs from the perspective of the venture capitalists (VCs) that finance their high-growth ventures.

Venture capitalists assess the potential of new ventures and do so in the context of the macro environment in which they are likely to operate. VC confidence has recovered strongly since the onset of the pandemic[8] as has the amount of venture investments.[9] For this study nine Silicon Valley VCs provided their commentary as to the likely challenges posed by rising inflation to startup entrepreneurs and possible strategies that entrepreneurs might employ to navigate them.

VC-Identified Challenges for Entrepreneurs from Rising Inflation

While each VC respondent provided a unique perspective on how inflation may impact entrepreneurial ventures, some primary themes did emerge and are summarized in the following.

Rising Input Costs and Margin Pressure. Howard Lee of Founders Equity Partners indicated "Rising inflation will increase all of the input costs to their businesses including wages. This will create margin pressure within the business in an environment where consumer spending is decreasing." John Malloy of BlueRun Ventures agreed, predicting "pressure on employees' salary demands in an already tight market for talent." Mr. Malloy continued, saying, "The biggest impact will be on startups that have hardware, manufacturing elements, and/or supply chain dependencies." Jeb Miller of Icon Ventures concurred, anticipating "some impact on supply chain costs and compensation, hiring and retaining employees, offset by distributed workforce with less need for real estate and travel/meal/amenity costs and more cost efficient marketing and product led sales."

More Fund-Raising Needed with Greater Dilution to Follow. Charles Tan of Lumeira Ventures reasoned "The current inflationary concerns should have minimal impact on entrepreneurs in the near term. If the uptrend persists over the longer term, startups will have to adjust to higher OpEx, which may require more funding. Combined with lower valuations, entrepreneurs should expect more dilution compared to the past few years." Alex Fries of Alpana Ventures explained "The impact to entrepreneurs is based on the capability of raising cash. Angel investors and larger institutions may decide, in a rising interest world to invest in other asset classes." Mr. Fries added "It also depends at the stage the venture is. Those that borrowed money, like growing startups in their D rounds or higher, may be paying higher costs for the capital. Younger startups barely feel the impact of increased inflation. I think the world is global enough that entrepreneurs can find cheaper assets in other parts of the world."

Rising Interest Rates and Fewer Exit Opportunities. Howard Lee of Founders Equity Partners calculated "Rising inflation may also be accompanied by rising interest rates which will dampen the equity markets, generate fewer exits and lower exit values for startups. More importantly, venture funding levels will likely decrease forcing startups to become even more efficient with their capital."

However, Some Responding VCs Expect Little Impact From Rising Inflation on Entrepreneurs. For example, Paul Tuan of Andra Global detailed "Depending on the sector, industry, and product of the venture," he expects "little or no impact with respect to technology." Dag Syrrist of Valedor Partners suggested "Net, net, inflation is of great concern to asset holders (think stock, bonds), not for venture backed startups." Another VC respondent who requested anonymity concluded "In practical terms, entrepreneurs won't think about this. They get their financing from equity investors. Any bank instruments they also use, in the end, will end up as the investors' headache." Another responding VC shared "I have not heard about any entrepreneurs overly concerned about inflation. I suspect they have accepted that we live in strange times and they don't expect the inflation to last, or that they are already used to it. Their main concerns for many years have already been salaries and living costs, especially in the Bay Area. I think they may have already adjusted themselves to that reality for many years to come."

VC-Recommended Strategies for Entrepreneurs Building New Ventures During Rising Inflation

Focus on Execution and Scale. Paul Tuan of Andra Global emphasized that "Product market fit and execution are more important to launching a successful venture than inflation." Charles Tan of Lumeira Ventures encouraged entrepreneurs, saying "Stay focused on growing the company into sustainable and scalable businesses." John Malloy of BlueRun Ventures recommended that entrepreneurs "Add a buffer to your plans to weather component price increases if applicable, and model higher salaries over time."

Digitally Distribute the Workforce. Jeb Miller of Icon Ventures noted there is an "opportunity for Bay Area startups to take advantage of remote workforces beyond offshoring and set up second locations in Toronto, Austin, Atlanta, Boulder, et al." Similarly, Dag Syrrist of Valedor Partners confirmed "the hiring pool is now national for all companies, and, thus, there is greater opportunity to build a much more diverse organization, bringing in new views and ideas." In the same theme, Alex Fries of Alpana Ventures stated "Hire where your $$ gets you more assets."

Become more Capital Efficient. Howard Lee of Founders Equity Partners commented "If one assumes a higher inflation environment is coupled with rising interest rates then entrepreneurs must focus on building businesses with less capital than previously planned." Mr. Lee went on to highlight "Entrepreneurs that quickly recognize the need for cost management, improved productivity, and conservative forecasts based on reduced customer demand will be in the best position to weather the funding and market challenges that will emerge." Another VC respondent who provided comment in confidence recommended "the usual, timeless advice of 'money is oxygen -- steward it appropriately.' "

Raise Financing. Dag Syrrist of Valedor Partners recommended "When offered capital, take it." Similarly, Alex Fries of Alpana Ventures urged "Raise money as soon as possible, while liquidity is high."

Discussion

Long dormant, inflation has returned to levels not seen in four decades. Most entrepreneurs today have never experienced high inflation. For that matter neither have many venture capitalists. However, VCs have the advantage of assessing many types of entrepreneurial ventures in multiple environments; therefore, their insights into this returning inflationary challenge may prove helpful to entrepreneurs as they push through their creations. Please see Table 1.

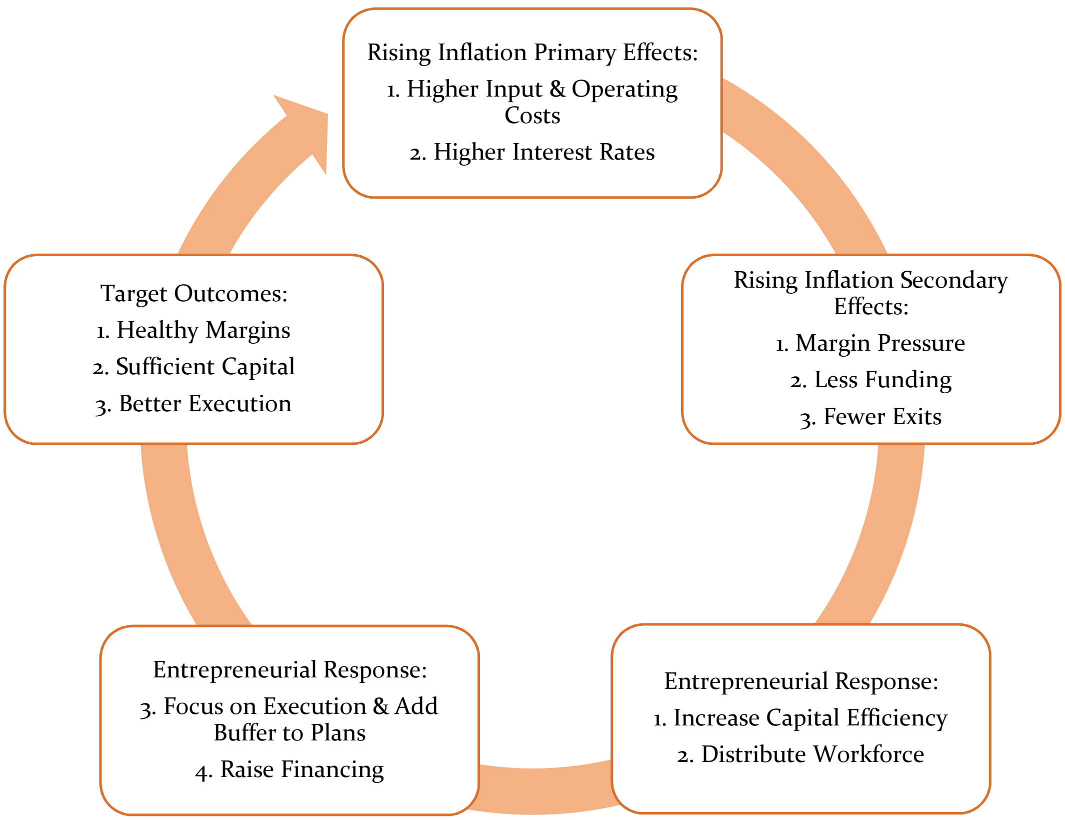
Table 1. VC-Identified Challenges Posed by Rising Inflation and Recommendations to Entrepreneurs on How to Manage Through It

VC Respondent	VC Firm	Inflation Impact on New Ventures	Advice to Entrepreneurs
Alex Fries	Alpana Ventures	Rising cost of capital, particularly for later stage	Raise capital when possible
Charles Tan	Lumeira Ventures	May require more funding and higher dilution	Focus on scale and sustainability
Dag Syrrist	Valedor Partners	National hiring pool but greater attrition	Close on capital raises
Howard Lee	Founders Equity Partners	Harder to hire talent	Build businesses with less capital than previously planned
Jeb Miller	Icon Ventures	Rising costs through supply chain	Use more remote workforce to moderate cost increases
John Malloy	BlueRun Ventures	Increasing salary demands	Model higher costs over time
Paul Tuan	Andra Global	Minor impact from inflation – pending industry sector	Focus on product-market fit
Anonymous	Anonymous	Living costs and salaries	Adjust to the reality
Anonymous	Anonymous	Debt instruments will become headache for investors	Steward capital closely

Entrepreneurs face a myriad of challenges in launching and growing new ventures. Will an inflationary environment be just one more issue to push through, or will secondary effects of inflation such as the rising cost of talent, higher interest rates, and a more volatile public equity market raise the bar for investment in these risky enterprises? Anticipating and responding to new challenges and opportunities are at the foundation of successful entrepreneurship and nimble entrepreneurs must ready themselves to this new challenge to generate scalable ventures that endure through current obstacles in order to serve future markets. Please see Figure 1.

So what will the ultimate impact of rising inflation be on entrepreneurs and the new ventures they create in 2022? Of course, no one knows to a certainty; however, it is of some interest that few technology firms of note founded during the high point of inflation in 1980 are still operating today. (Amgen and Dish Network are notable exceptions.) In fact, oil and car companies, dominated the roster of the highest revenue firms in 1980.[10] Of course, the runaway inflation of that era led the Federal Reserve to tighten the money supply which resulted in rapidly rising interest rates designed to rein in inflation. The Fed action did drive down inflation, but it also drove the economy into a recession.[11] Will it be different this time?

Figure 1. Entrepreneuring Through Rising Inflation



Today's entrepreneurs may benefit from monitoring rising inflation and creating a planning buffer for the turmoil it may cause. If startups can overcome the additional challenge of rising inflation they may, in fact, help 'orchestrate' the optimal functioning of the entrepreneurial ecosystem of which they are apart.[12] Incorporating the advice of venture investors who have financed startups across a range of economic environments is one place to begin.

Author

Mark V. Cannice, Ph.D. is Professor of Entrepreneurship and Innovation with the University of San Francisco School of Management, recent former Chair of the Department, and the Founder of its Entrepreneurship Program. Dr. Cannice's primary research is in venture capital, and he writes a quarterly research report on Silicon Valley Venture Capitalist Confidence, which is indexed globally on Bloomberg Professional Services in 170 countries (Bloomberg ticker symbol: SVVCCI) since 2004 and is referenced regularly by business media. Professor Cannice has published in leading academic and professional journals and is the co-author of Management: A Global and Entrepreneurial Perspective, 15th edition (2020) (published by McGraw-Hill in four languages). Dr. Cannice has advised governments and universities from Asia, Europe, and Latin America on entrepreneurial education, and has been a Visiting Professor with the University of Paris 2 (Panthéon-Assas), a Visiting Associate Professor with the Hong Kong University of Science and Technology and Peking University, and a Visiting Scholar with Waseda University (Tokyo) and Loyola Marymount University (L.A.). He is a former U.S. Naval Officer and holds a Ph.D. and M.S. from Indiana University Kelley School of Business, an MBA from USF, and a B.S. from the United States Naval Academy (Annapolis).

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Endnotes

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