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Why Do Investors Keep Funding Unprofitable Startups?

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When I got my start in the startup world, I thought success meant becoming profitable in around five to seven years, preferably sooner. It was an assumption, and you know what they say about assumptions.

To be fair to me — and I love being fair to myself — the vast majority of venture-backed companies in my space were experiencing this lifecycle. First there was the seed round that catalyzed growth. Then came series A, B and C to continue scaling and ultimately reach profitability, or at least a short path to profitability.

D rounds were rare, and I haven't heard of an E or F round. After D it seems like venture capitalists don't bother with the alphabet anymore.

If the brand couldn't raise funding, that was the end. Or, if the startup had plenty of investment but couldn't pave a short path to the black somewhere between A and D, VCs would pull out and cut their losses.

Without funding, brands that still couldn't become profitable would arrive at painful crossroads: stop growing, lay a bunch of people off or get acquired. The acquisition outcome was best, but it didn't guarantee the company would maintain its identity or that the employees would keep their jobs. Usually the acquiring corporation hacked the startup apart and retained only the aspects they believed were most valuable.

Over and over again I saw some version of this story play out. It seemed like profitability was essential for a startup to survive past that five-to-seven-year period.

In recent years, however, I have noticed an increasing number of exceptions to this pattern. At one of the last startups I worked for, we passed our series C and were still far from being in the black.

During a company meeting, our CEO asked our CFO when we were expected to become profitable. The CFO shrugged and said he didn't know. After the CEO pushed him a bit, he estimated it would be some time next year.

It's been about two years since he casually threw out that figure, and the company still isn't profitable. Recently they raised a D round, but it will most likely not be enough to push them into the black.

When I met up with some of my former co-workers for dinner a few months ago, they said the brand still wasn't profitable, and they had no idea when it was projected to start making money. They didn't seem worried about their job security, though.

The implication was that more money would come. There were plenty of venture capitalists out there who would fund them indefinitely. Being profitable just wasn't the top priority.

This revelation was bewildering. What was I missing? Was I the only person who thought it was problematic for a company to rely on funding for well over seven years, perhaps 10 or more?

Fortunately I wasn't alone. Both online and in person I connected with many colleagues who didn't understand why some startups folded — and they lost their jobs — after failing to make money, while other brands tapped into a seemingly limitless supply of VC funding and figured out profitability at their leisure.

To get answers, I reached out to investors and other experts in the startup world. Here are the big takeaways from my conversations with them:

The Amazon Effect

For about two decades Amazon relied on investors to grow and stay in business.

"One of the main reasons for Amazon's success was their ability to raise capital and have a story where people believed they would be profitable," said James Cassel, Founder and Chairman of investment banking firm Cassel Salpeter & Co.

This faith ultimately paid off. In the first quarter of 2019 the e-commerce giant reported about $60 billion in net sales, and it seems like they will maintain these types of massive profits for the foreseeable future.

Now investors are betting on what they believe might be the next Amazon. To draw this comparison, almost all of my sources mentioned two names: Uber and WeWork.

Uber was founded about a decade ago, and it isn't remotely close to being profitable. In an article for Forbes published in June, Columbia Business School professor and former Accenture partner Len Sherman wrote, "Until and unless Uber can find ways to overcome the numerous weaknesses in its business model, the company will never be profitable."

If Uber does fix these problems, however, there is potential for investors to make a killing. Like Amazon, maybe it needs another decade.

WeWork is a similar case. Business Insider recently reported that the company lost $219,000 every hour of every day during the 12 months leading up to March. But, again, perhaps the brand needs another decade.

These indefinitely funded startups don't need to be nearly as titanic as WeWork or Uber, though. The company I mentioned earlier — the one I worked at that is past series D now — had something like 100,000 customers by the time I left. Compare that figure to the 95 million people who used Uber in 2018.

Growth Over Profit

Investors often evaluate startups based on growth, not profitability. Even if the company is burning way too much money, building a big base of customers quickly is attractive to venture capitalists, said Alan Wink, Managing Director of Capital Markets at accounting and consulting firm EisnerAmper.

Sometimes founders need to sacrifice short-term profit for customer acquisition spend and expansion that could provide long-term profit. As long as revenue is high, they have a chance of getting more funding.

"Going for profitability too early often means limiting growth," said Techstars Co-Founder David Cohen, who was also an early investor in Uber.

Choosing not to be profitable in favor of growth — even for many years — can be a successful strategy, so long as that profit can make a huge splash.

"Amazon is a great example of a company that reached that tipping point, and it paid off big time," said Clearbanc Co-Founder and CEO Andrew D'Souza.

Motivations Other Than Profit

It's common for profit to be one of the last issues investors consider. Algorithm Research Founder Ketaki Sharma claimed that, according to her analytics and experience in the business, most venture capitalists choose a startup based on their sector focus before scrutinizing the startup itself.

If an investment firm specializes in healthcare, for example, they try to completely dominate the landscape by pouring money into as many healthcare brands as possible. That way their competitors are left with a smaller slice of the pie and less potential profit. This approach can increase the valuation of their portfolios, and in the investment world this metric is often more important than profit.

Investors can still make money from unprofitable companies. VCs frequently sell shares or take part in acquisition deals.

Another factor is what Glimpse Group CEO Lyron Bentovim called "hype."

"Investors will invest money to have the Uber logo on their site," he said.

When VCs are able to advertise that they work with hot brands, they gain an advantage when pursuing the next promising startup. Even if they lose money on an unprofitable but hyped startup, having such a brand in their portfolio could attract companies that ultimately turn a profit.

Recovering From the Recession

Many of the people I spoke to noted an improved economy and one of the longest bull markets in history as a factor for this increase in potentially risky investments. It doesn't seem like a coincidence that these types of funds have flourished as we recovered from the recession of the late 2000s.

Several experts cautioned, however, that there could be another recession that would cut off access to much of this capital. These comments were in line with predictions from economists and politicians such as Elizabeth Warren.

Shouldn't We Care More About Profit?

Just because it's become more acceptable to deprioritize profit doesn't mean this attitude is ideal.

"There's this behavior pattern where people have forsaken or forgotten profitability in exchange for growth at any cost," said Fresh Technology Chairman Matt Bodnar. "Some companies will implode, and we will look back and say that was ridiculous."

The investor community is constantly enabling startup founders to spend irresponsibly. We shouldn't fool ourselves into thinking growth and profitability are mutually exclusive. After all, there can only be so many Amazons.

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