The crash that shaped the Valley

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There is an adage in venture capital circles that hard times make for the best companies. For many in Silicon Valley, California, the years following the implosion of the technology bubble were a case in point.

Investors and entrepreneurs alike often single out 2002 - when the stock market hit its post-bubble nadir - as the year an unusually high number of successful start-ups were founded.

"The boom brought in a lot of people who thought entrepreneurship was easy," says John Balen, a partner at Canaan Ventures, at the company's Silicon Valley offices on Sand Hill Road. When the bottom dropped out in mid-2000, he says, "all the tourists went home".

Those remaining faced big challenges. By 2002, the Nasdaq Composite index had lost more than two-thirds of its value. The economy was in recession. The collapse of Enron and WorldCom had ushered in a new era of heavy-handed business regulation. Hundreds of failed or failing start-ups had left paper fortunes in tatters.

But to hear the class of 2002 tell it, it could not have been a better time to start a company. "Everyone was scurrying for cover," says Lars Dalgaard, founder and chief executive of SuccessFactors, a maker of human resources software. Investors who pumped an astounding $85bn into start-ups at the height of the dotcom frenzy in 2000 invested just under $20bn in 2002, according to Dow Jones VentureOne and Ernst & Young.

"It was a complete horror. I couldn't pay myself a salary," Mr Dalgaard says. "We had negative bookings because customers had gone out of business."

Like other members of the class of 2002, Mr Dalgaard fought to get meetings with venture capitalists whose fingers had been burned. Yet even when they won the battle for funding, they had to settle for levels of financing far below those seen in the heady days of the bubble.

"In the bubble, hard cash was free," says Bart Schachter, a partner at Blueprint Ventures, a venture capital firm. "You could raise $50m at an $800m valuation. That's free cash, essentially. By 2002, that same company would have had trouble raising $5m on a $10m valuation."

There was also a change in the types of businesstrying to get funding. Semiconductor

makers and telecommunications companies were no longer interesting, Mr Schachter says. "Instead, a whole slew of entrepreneurs started raising money for things that wouldn't require much capital. That made it a great investment environment for venture capitalists, as you had capital efficiency and low valuations."

Caterina Fake, co-founder of Flickr, the photo-sharing website that was bought by Yahoo last year for an estimated $30m (£16.5m), says the limited resources available at the time contributed to Flickr's success. "Maybe it's my contrarian nature but it always seemed to me that it's the constraints that make you creative," says Ms Fake. "It's the whole adage of necessity being the mother of invention."

Stewart Butterfield, her husband and co-founder, agrees: "There's a really interesting interplay between the constraints you choose and the constraints that are given to you and what you do as a result."

Flickr started out as a lean operation. Mr Butterfield and Ms Fake spurned venture investment and bootstrapped the company using their own savings and a small amount raised from friends and family. "We weren't able to hire a ton of people, and we couldn't have a huge marketing budget. It really made us knuckle down and think hard about every piece of the product," says Ms Fake.

In the days of the bubble, by contrast, a new company might throw a lavish launch party and hire dozens ofpeople before it had so much as a revenue model. "During the bubble days, the perspective was that the success factors were always around the corner," says Ben Nelson, former chief executive of Snapfish, an online photo storage and printing site. That mentality, more than anything else, may have contributed to the boom's excess. (See below left.)

In contrast, many companies set up after the boom placed an emphasis on generating revenues and customers from the start.

"It was a pretty risky time to do anything," says Mena Trott, co-founder of Six Apart, a maker of blogging tools. Rather than look for investors before they had a substantial customer base, Ms Trott and her husband, Ben, decided to continue developing Movable Type, their blogging application, while running the company from their apartment.

By the time Six Apart agreed to accept funding from Joi Ito, a Japanese blogger and venture capitalist, Movable Type was the most widely used blogging technology on the planet.

For entrepreneurs in capital-intensive industries the post-bubble years were even tougher going. Yet Eric Chen, a former stock market analyst who became chief executive and co-founder of Brion Technologies, a semiconductor start-up, says that the difficult funding environment of 2002 was a big part of what made him decide to take the leap when his fellow co-founders approached him with a business plan.

"I was very aware of the business cycles that are intrinsic to the industry," he says. "I was

also of a contrary school of thinking. At the time I was approached, that was an important part of the thought process. The best companies are made during the difficult times when there's a much higher bar."

Brion closed its first inÃ‚Âvestment round for less than $10m. "That was the low point for investment," says Mr Chen. "We had a very strong team and we focused on a problem that many people knew was a real challenge for the industry."

"If you look at the overall picture of venture investment you would say it was constrained. However, if you were successful, if you were one of the few to get funded, you were not constrained. It was a hard hurdle, but if you cleared it then you were fine."

Some entrepreneurs say they are concerned that the sense of discipline and business focus that has taken hold in Silicon Valley may not last. The frenzy around social networking websites, boosted by the popularity of blogging and a handful of high-profile acquisitions, such as Rupert Murdoch's $580m acquisition of MySpace, has begun to hint at a return to the exorbitant practices of the bubble era.

But even if this most recent bout of web frenzy ends in another bust, few in the Valley doubt that a new generation of disciplined entrepreneurs will be waiting to pick up where the class of 2002 left off.