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Unit Economics

Commentators are looking hard for what's wrong with startups in Silicon Valley. First they talked about valuations being too high. Then they talked about valuations not really meaning anything. Then they talked about companies staying private too long. Then they talked about burn rates.

But something does feel off, though it's been hard to precisely identify.

I think the answer is unit economics. One of the jokes that came out of the 2000 bubble was "we lose a little money on every customer, but we make it up on volume". This was then out of fashion for a long time as Google and Facebook hit their stride.

There are now more businesses than I ever remember before that struggle to explain how their unit economics are ever going to make sense. It usually requires an explanation on the order of infinite retention ("yes, our sales and marketing costs are really high and our annual profit margins per user are thin, but we're going to keep the customer forever"), a massive reduction in costs ("we're going to replace all our human labor with robots"), a claim that eventually the company can stop buying users ("we acquire users for more than they're worth for now just to get the flywheel spinning"), or something even less plausible.

This is particularly common in startups that don't pass the Peter Thiel monopoly test—these startups seem to have to spend every available dollar on user acquisition, and if they raise prices, customers defect to a similar service.

Most great companies historically have had good unit economics soon after they began monetizing, even if the company as a whole lost money for a long period of time.

Silicon Valley has always been willing to invest in money-losing companies that may eventually make lots of money. That's great. I have never seen Silicon Valley so willing to invest in companies that have well-understood financials showing they will probably always lose money. Low-margin businesses have never been more fashionable here than they are right now.

Companies that have raised lots of money are at particular risk. It's so tempting to paper over a problem with the business by spending more money instead of fixing the product or service.

Burn rates by themselves are not scary. Burn rates are scary when you scale the business up and the model doesn't look any better. Burn rates are also scary when runway is short (i.e., burning $2M a month with $100M in the bank is fine; burning $1M a month with $3M in the bank is really bad) even if the unit economics look great.

The good news is that if you're aware of this you can avoid the trap. If there's no other way to operate in your space, maybe it's a bad business. The low-margin, hyper-competitive world is not the only place to be. Companies always have an explanation about how they're going to fix unit economics, so you really have to go out of your way not to delude yourself.

If you hold yourself to the standard of making a product that is so good people spontaneously recommend it to their friends, and you have an easy-to-understand business model where you make more than you spend on each user, and it gets better not worse as you get bigger, you may not look like some of hottest companies of today, but you'll look a lot like Google and Facebook.