With IPO Hopes Fading, Square And Box Face Reality Of Commodity Products

Posted 5 hours ago by Danny Crichton (@DannyCrichton)

Square and Box would seem to be the very epitome of every startup founder's dream of reaching the pinnacle of entrepreneurial success. Take a kernel of an idea and turn it into a massive, multi-billion-dollar company that publicly debuts in an IPO. For the founders involved, the exhilaration and elation of that drive to the top must be deeply palpable, and at times it probably seems as though every single molecule in the universe is working in their favor.

Yet, the cruel vagaries of startups are such that those laws of physics can change in mere moments. Square, a favorite with the press with its charismatic founder, Jack Dorsey, seemed to have everything it needed to conquer and crush the physical retail point-of-sale market, an industry that has called out for innovation for years without much progress. Box, the poster child (in a literal sense) of the power of a 20-year-old founder to transform the enterprise into a cloud- and mobile-enabled world, was flying high as one of the top valued startups in America.

Yet, both companies have now delayed their IPOs – perhaps indefinitely – and analysts are seriously questioning the ability of either company to get their roadshows back on track.

This isn't the kind of bubbly they were hoping to pop.

It is the ultimate of Zero-World Problems: what do you do when your billion-dollar company is hemorrhaging cash, yet can't be sold, can't go public, and can't raise funding? For founders facing the Series A crunch, such questions may seem irrelevant, perhaps even a tad obnoxious. Yet, in the tale of Square and Box lies a grave message for all of us about the ability of certain founders to defy gravity, even in the face of overwhelming evidence of the difficulty of building startups targeting commodity technology markets.

Great Technology Companies Start with Monopolies

Businesses want to command entire markets and become monopolies to extract profitable rents from customers. Competitors see the opportunity in these markets and similarly want to get a slice of the profits. Conflict breaks out between these companies, who compete with each other by providing better products and lowering their prices. Consumers win by getting more for less, while companies face diminished profits as their specialized products become commodities.

That's the textbook description of market economics, but the best technology companies rarely follow such a narrative. Instead, they search for ways to create some sort of network or lock-in effect, where they can seize the entire market and hold their competitors at bay, or what Peter Thiel calls becoming the "last mover." From there, the company can expand into other markets, using its economic power and superior technology to leverage its business into other commodity spaces. It's this expansion and defensive capability that venture capitalists seek in funding pitches from startups — a sort of iron law of raising capital.

These two companies didn't start with a highly profitable niche and exploit it with the best possible product on the marketplace, but instead brought to market an evolutionary improvement over existing solutions. That was always going to be a tough sell.

Almost all of the great technology businesses can be described this way. Google built a search engine that has few competitors even today, and the company used its success to move into commodities like email and messaging. Facebook designed a social network that remains the largest and most engaged in the world, but it has also made forays into areas like messaging and news. Microsoft turned its strength in the Windows operating system into a massive platform for enterprise customers. The massive size of these companies comes from their ability to defend their inexorable growth in hugely profitable markets, while leveraging their business to enter into new markets.

None of the technologies that underlie these companies are a commodity, which is why there are so few successful search engines, social networks, and operating systems. When we turn to Box and Square, they have never had the same capability to keep competitors out of their markets.

Square is one of dozens of payment processors and point-of-sale solutions on the market, and Box has dozens of cloud storage competitors. These two companies didn't start with a highly profitable niche and exploit it with the best possible product on the marketplace, but instead brought to market an evolutionary improvement over existing solutions. That was always going to be a tough sell.

The Challenge of Commodity Businesses

When Box started, file syncing was hard, and getting access to files on mobile devices was nearly impossible. Yet, there is no "monopolistic" effect built into such an infrastructure, and consequently, competitors saw the same market opportunity that Box did and began developing their own products, ranging from startups like Dropbox to behemoths like EMC, Microsoft, and Google.

Venture capitalists are hawks for certain signs that a company doesn't have command of its market. One obvious warning is when sales and marketing expenses are very high, particularly compared to the average sales price of the product.

Square faces a similar competitive environment. It's hard to differentiate a product in a space like point of sale systems, since customers of small businesses just want their credit card accepted as fast as possible. Similar comments can be made about MobileIron in mobile device management and Zendesk in customer support management, two companies that are also waiting to enter the public markets.

Aaron Levie

Venture capitalists are hawks for certain signs that a company doesn't have command of its market. One obvious warning is when sales and marketing expenses are very high, particularly compared to the average sales price of the product. When companies lack highly differentiated products, they can't compete on technology, so they compete on marketing to try to build differentiation through mindshare.

Thus, you see initiatives like Square handing out Readers for free and lowering fees as lead generation, or Box offering the vast majority of its customers free services while putting up billboards along major U.S. freeways. According to Box's S–1, the company spent more than $170 million on sales and marketing in the year ending January 31, 2014, a period in which the company made $124 million in revenue. Or, to put it another way, 137 percent of Box's revenue was spent on sales and marketing.

There is, of course, an argument to be made for spending today to invest in the future. One of the major questions for equity analysts about Box's S–1 was whether the long-term sales contracts that the company is presumably signing guarantees it an income stream that will allow it to slow down sales and marketing expenses while continuing to rapidly grow its top line. Similarly, if Square can build sufficient penetration into the SMB space, it might be possible for the company to build additional services on top of its platform to grow its income from merchants. The fact that both companies have delayed their IPOs demonstrates what analysts thought of this line of thought.

Another warning sign of a commodity business is a low average sales price, particularly when compared to expenses. In other words, how well can a company protect its margins. Even today, Box's average sales price is only around $3,600. With Square's business model, it takes a tiny fraction of the transaction fee for each dollar that flows through its payments network. While its profit margins have never been made public, it's generally believed that the company is near break even or slightly unprofitable serving its merchants, a pricing decision designed to quickly expand the company's business.

These high expenses and low revenues lead to obviously high burn rates. Square is believed to have lost more than $100 million in 2013, and Box lost almost $160 million last year, as well. Such rapid evaporation of cash truly limits the options for the founders of these companies, since it puts a very large ticking time bomb around their necks, weakening their negotiating position with potential acquirers.

Finally, a more qualitative sign of a commodity business comes from the culture of the company. In the rush to create differentiation, companies often try to spit out products hoping to find some feature that secures customer sales. Both Square and Box have expanded their product lines dramatically, often without a comprehensive strategy involved.

Levie at Box speaks easily about his vision, but the company's actual array of products is still blurry, with consumer and enterprise options still prominently featured and at times at odds with each other. Square is even more variable, launching a blistering array of products in the last few months including Square Market, Square Wallet, and Square Cash in addition to its core point of sales products. A lack of focus is not a good signal.

A Tale of Two Startups and the VCs Who Backed Them

We know that the iron law of raising capital is to prove expansive power and defensibility, and we have analyzed how Square and Box both appear to be in typical commodity markets given their performance and metrics. It's therefore astonishing that earnest venture capitalists and non-traditional venture investors have driven the valuations of both companies to stratospheric levels during the last three years.

Square raised about $330 million across three separate rounds in 2011–2012, pushing its valuation to $5 billion according to CrunchBase. Box similarly raised about $379 million over the last three years, pushing its valuation to $2 billion.

Jack Dorsey

That's despite clear evidence that Square and Box are getting squeezed by competitors from above and below. Box faces challenges from a number of startups, most prominently its arch-rival Dropbox, for control over the cloud data market. But its real competition comes from larger behemoths like Microsoft and EMC, who already have deep inroads into the enterprise, and are already offering decently comparable cloud services on their existing platforms. Similarly, Square has had to compete with entrenched merchant software companies like Intuit and PayPal, which both offer readers similar to Square, yet already have millions of customers using their products.

Microsoft and Google haven't ignored cloud services any less than PayPal has ignored new modes of payments, and they have enormous advantages due to their scale to overcome any delay in their product offerings.

The obvious economic response to this situation is to try to move up the value chain, and indeed, both companies are repositioning themselves to find higher-value markets. Box is now defining itself as a middleware company, a translation layer between the existing commodity cloud storage companies and application developers. It sees itself as the glue for enterprise collaboration. And it appears Square is trying to be a more full-service commerce provider, adding tools like analytics and online storefronts in the hope of offering better services for small businesses.

In a way, one could argue that this is a classic example of the Innovator's Dilemma, in which a startup disrupts an entrenched company by providing a simpler and cheaper solution and slowly eating the market upwards. Unfortunately, such disruption is rarer today in the technology industry, if only because executives are more attuned to this sort of disruption that they were in the past. Microsoft and Google haven't ignored cloud services any less than PayPal has ignored new modes of payments, and they have enormous advantages due to their scale to overcome any delay in their product offerings.

So what did the venture capitalists see in these two companies to drive their valuations so high so quickly? One half of the answer is obviously metrics, particularly around revenue growth. Few companies in the world have grown as fast as Box or Square, and as McKinsey recently wrote in its recent analysis of 3,000 startups, growth is truly everything in getting to the top.

The other half of the answer is more qualitative, and simply has to do with the founders of both companies matching certain archetypes of success. Box was founded in 2005 and helmed by a 20-year old founder named Aaron Levie, a first-time entrepreneur who dropped out of USC to build the company with his childhood friend Dylan Smith. Square was founded in 2009 by Jack Dorsey, who helped to lead Twitter to one of the most significant Valley exits of all time. The inspiring college dropout and the second-time entrepreneur are hard to turn down for most venture capitalists.

The Valuation Trap at the IPO

A second iron law of startups might be that the higher the valuation of a startup, the fewer options it has for financing and exits. If a startup has only raised a seed round, there are an immense number of options the company can choose, such as a talent acquisition, a strategic investment, a partnership, a bootstrapped approach, a full Series A round, or maybe a controlled shutdown. But once a company has raised mezzanine capital and is valued in the billions, its options are essentially to go public or find a very interested buyer with deep pockets. There are few other options on this side of the startup pipeline.

Technology stocks, particularly among software-as-a-service companies, have declined precipitously over the past two months as investors flee for safer investment options.

Interestingly, VCs have been willing to ignore this law, because the flush times for technology startups meant that the hardest part of investing was simply getting into the best rounds and holding. In an industry where startups have been greatly helped by the rising tide of enthusiastic equities markets, nearly every deal that could get to the markets has been a smash success.

Thus, even companies that were competing ferociously in commodity markets like cloud storage, mobile device management, or human resources have seen tremendous value creation.

Then the markets corrected. Technology stocks, particularly among software-as-a-service companies, have declined precipitously over the past two months as investors flee for safer investment options. The lack of appetite for growth tech stocks means that IPOs in the sector are nearly impossible, putting every company's plan on hold. Square and Box are part of that holding pattern, but they are unlikely to be the ones that encourage investors to wade back into the market. In disrupting such well-known industries as payments and storage, analysts are familiar with the businesses here, and they haven't liked what they have seen.

That doesn't mean there aren't interesting companies that have the potential to reenergize the markets. As a marketplace for bedrooms, Airbnb has a natural monopoly in its business model which will allow it to leverage its profits into a variety of premium services like cleaning, transportation, and tour-guide products. Its balance sheet is highly desirable as well, since it doesn't hold any physical real estate compared to traditional hotel chains. A company with a more neutral outlook might be Uber. The company certainly has a network effect, since users will likely default to a single choice of app when requesting a taxi. But Uber's competition is a tap away, and thus it needs to refine its products to build more defensibility.

But that is small solace for the founders, employees, and investors at Square and Box, who are going to face a period of deep uncertainty. These next few months will be defining for both companies. If Levie and Dorsey can rebuild their products under excruciatingly tough pressure, both companies have a chance to get out from their predicament. Given their burn rates, it is more likely that both startups will sell or begin a process of downsizing to reduce expenses. We'll finally pop the bubbly, but it will be more Box wine than Dom Perignon.

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