For Silicon Valley, the Hangover Begins

With venture-capital investors increasingly nervous, once-hot tech startups are retrenching

Money-losing initiatives drained cash at Practice Fusion, a San Francisco electronic medical-records company, which has replaced its CEO, laid off a quarter of its staff and cut other costs. ENLARGE

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Not long ago, employees at Practice Fusion Inc. reveled in the technology boom, munching daily on free healthy food, enjoying “Phenomenal Friday” gatherings and racing around the office on tricycles.

Today, the Silicon Valley extravaganza is waning. The San Francisco electronic medical-records company has booted its founding CEO, laid off a quarter of its staff and cut back on projects to save costs.

“A lot of the reason I was there was because I believed the vision and loved the people I was working with,” said Lauren Burris, the company’s director of programs and engagement until September, when she was laid off. “That’s what shook me a little bit—I didn’t know what the vision was anymore.”

A year ago, startups with nascent business models were scoring billion-dollar valuations as investors raced each other to write checks. Today, venture capital is drying up for less successful startups. Investors, eyeing collapsing tech stocks and economic sloth, are culling their portfolios and forcing cash-starved companies to retrench or shut down.

These changes are eroding the idea that drives Silicon Valley’s economy: Work hard, secure venture capital and get rich. With valuations falling, the other side of the equation is reappearing: Failure is often just around the corner.

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Rory O'Driscoll, a partner with venture firm Scale Venture Partners, likens the mood today to the moment after the Titanic hit an iceberg. "No one wanted to jump into the lifeboats right away," he said. Some hesitated. The smart companies are cutting expenses and raising capital if they can. "You've got to make a quick decision now."

Investors funded fewer U.S. startups in the fourth quarter than any period in more than four years. Since November, at least a dozen tech companies, which combined raised well over $2 billion in venture funding, have announced layoffs, letting go hundreds of people that in most cases represented at least 15% of their staffs. Other companies are closing money-losing projects and raising debt to tide them over.

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Of the 48 venture-funded U.S. tech companies that went public since 2014, 35 now trade below their initial public offering prices, according to a Wall Street Journal analysis.

It isn't as if venture funding has totally dried up. In the fourth quarter, financing for U.S. startups fell 6.6% to $17.13 billion, the lowest in five quarters but still approaching dotcom-boom levels.

This month, Magic Leap Inc., which has yet to release its "mixed reality" glasses—which overlay virtual images on the real world—raised $794 million in funding at a valuation of $4.5 billion. Car-hailing service Uber Technologies Inc. continues to reach new heights, raising funding in December that valued it at over $60 billion, a record for a private venture-backed company.

Venture capitalists say the pace of these huge deals is rapidly slowing, especially after tech stocks declined drastically on Feb. 5. That exacerbated the already wide valuation gap between high-price private tech shares and their public peers.

Some companies are raising funding by selling shares at lower prices than they had in earlier rounds. Such "down rounds" can hurt a startup's chances at recruiting and discourage employees who are often paid with stock options.

Location-sharing mobile-app company Foursquare Labs Inc. raised cash in January selling shares at a 69% discount from the previous price, according to corporate documents provided by research firm VC Experts. Delivery startup DoorDash this week sold shares at a 16% discount. A DoorDash spokesman declined to comment.

Janrain Inc., which facilitates website logins for companies, raised $27 million in December at a 50% valuation markdown from its January 2013 fundraising, said a person familiar with the matter. Martin Day, Janrain's financial chief, said he is pleased the company is on the "backside of that funding."

Foursquare founder Dennis Crowley called its down round "great for employees," declining to go into detail. A person familiar with the matter said the company gave employees new shares, making up for the lower valuation.

Turning to debt

Some startups are turning to debt, which lets them raise money without setting a lower price for their equity—ducking for the moment a potential reckoning with investors.

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Daily fantasy-sports operator DraftKings Inc. raised nearly $100 million in December by selling notes to existing investors that could convert to discounted shares, according to a person familiar with the matter. The notes pay a 5% interest rate, according to filings by mutual funds that hold the DraftKings notes.

The notes helped avoid a big drop in the $2.1 billion valuation the firm received last July. Funds advised by Wellington Management marked down their DraftKings shares by more than 70% in the fourth quarter.

DraftKings insiders also provided cash to help the company absorb legal costs stemming from its battle with regulators, who allege its service constitutes illegal gambling.

A DraftKings spokeswoman declined to comment.

Some startups are also looking to sublease unused office space, and tech layoffs suddenly are commonplace. Last week, Eric Setton, co-founder and chief executive of messaging app maker TangoMe Inc., said he was cutting 20% of its staff to "create a sustainable business." Less than two years earlier, the Mountain View, Calif., company raised $280 million in financing led by Alibaba Group Holding Ltd. at a $1 billion valuation.

Online dating startup Zoosk Inc., which withdrew its IPO filing last May, made a second round of cuts in January, this time 40 people. Its Chief Executive, Kelly Steckelberg, also said the company needs to build a “sustainable” business.

At some point, tech companies may pull back on the employee perks—the free food, stylish workplaces and on-site gyms. Most companies view these perks as vital to retain morale and recruit the brightest in a competitive industry.

Instead, some are nipping around the edges, like job-recruiting site Glassdoor Inc., which took away a dessert table. On a recent afternoon, workers mobbed the cookie-filled table when the company announced its demise.

A Glassdoor spokeswoman said in an email that the move to end dessert was “about overall efficiency and simplifying the offerings to feed more than 500 people…The added benefit was lowering costs.”

Half of the U.S. companies that raised money at valuations over $1 billion in the fourth quarter did so after agreeing to special IPO protections, according to a study by law firm Fenwick & West. These terms either allow investors to block a public offering below a certain share price, or granted them additional shares in the company if the IPO price is too low. A quarter of companies agreed to such terms in last year’s second quarter and 35% in the third quarter.

In October, software firm AppDynamics Inc. promised new investors additional shares in the event of an IPO below its current valuation. This week, DoorDash gave investors the right to block an IPO below $71.82, giving them the ability to renegotiate for more shares if the company can’t triple their money in a public offering. An AppDynamics spokesman declined to comment.

Practice Fusion, banking on the growth of doctors using electronic health records, looked poised for its own IPO when it raised $85 million in a 2013 funding round led by Kleiner Perkins Caufield & Byers at a $635 million valuation.

Daily fantasy-sports operator DraftKings Inc. raised funds in December in a bid to hold off a drop in its valuation. ENLARGE

Daily fantasy-sports operator DraftKings Inc. raised funds in December in a bid to hold off a drop in its valuation. PHOTO: OSKAR GARCIA/ASSOCIATED PRESS

Founder Ryan Howard's hopes were so high he guaranteed new investors double their money in a liquidation or sale, according to people familiar with the matter.

Physicians took to the free software and Practice Fusion earned money by showing pharmaceutical ads and offering lab orders. Revenue rose 75% to $47 million in 2015, people familiar with the matter said.

Practice Fusion offered free food with no starches like pasta, unless it was "cheat day" when they might get white rice. Photos posted under its Instagram account showed employees filling the CEO's office with balloons to celebrate his birthday last May, engineers dressing up in animal onesies, and races around the office on hot pink tricycles for the company's annual olympics.

By summer 2015, Practice Fusion was burning through $4 million of cash a month as it chased money-losing initiatives such as telemedicine, which intended to connect patients with doctors for appointments by phone, people familiar with the matter said. At the same time, revenue was about 10% short of targets.

Somber meeting

With cash running out, Kleiner Perkins partner Beth Seidenberg and other board members decided to remove Mr. Howard as CEO and replace him with an executive who would curb costs. Kleiner said the company needed a "more commercially oriented leader for its next phase."

On Aug. 14, the company announced Mr. Howard had stepped down. It was a Friday. Employees gathered for a somber all-hands meeting, instead of the Phenomenal Friday gathering that had been scheduled.

The situation was dire when Tom Langan, the chief commercial officer, took over as CEO. By October, the company was nearly out of cash, and the volatile market had scared many venture-capital investors away from high-price deals.

To keep the business afloat, investors that month gave Practice Fusion a $20 million bridge loan.

Since then Mr. Langan has laid off a quarter of the workforce. The firm cut free meals to three times a week. No photos have been posted to the Instagram account since August, when Mr. Howard was replaced and became chairman.

Practice Fusion tried to raise new cash, but those efforts have fallen short. Mr. Howard, meanwhile, has sought buyers for his shares, according to people familiar with the matter.

Rebecca Lynn, who led an early investment in Practice Fusion for Morgenthaler Ventures, says making cuts is hard but necessary, given the rough funding landscape.

Said Ms. Lynn: “The companies that make these moves now are the ones that are going to make it out to the other side.”

—Telis Demos, Susan Pulliam and Deepa Seetharaman contributed to this article.

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