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The Problem With Profitless Start-ups

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Yesterday, I ordered lunch from a gourmet meal-delivery start-up called SpoonRocket – a takeout container of sirloin au poivre and roasted cauliflower that was shuttled to my door in exactly 11 minutes, costing me $8. I then took an UberX car to a meeting across town, paying roughly $10 for a 15-minute ride. On my way, I pulled out my phone to see about getting my broken dryer fixed through Handybook, which provides on-demand repairs in the Bay Area for less than a local handyman would charge.

There are dozens more services like these operating in and around San Francisco – Homejoy for cleaning, BloomThat for flowers, Postmates for courier service, and on and on. Most of them provide cheap, convenient amenities at the tap of a smartphone app. Few of them are profitable on a corporate level. And together, they've formed the backbone of a strange urban economy: one in which massive venture-capital injections allow money-losing start-ups to flourish, while providing services that no traditional, unsubsidized business can match. It's an economy built on patience, and the hope that someday, after the land grab is over and the dust has settled, a better business model will emerge.

It's hard to know which of today's new start-ups are unprofitable. But in some cases, losing money is kind of the point. I have no inside information on SpoonRocket's financials, for example, but I imagine that the company books a loss of a few cents every time I click the order button. (There's just no way, short of a supply-chain miracle, that my $8 covers the cost of preparing a gourmet lunch, driving it to my house, and paying all the drivers and cooks and engineers and assorted other costs associated with running their business.) But SpoonRocket doesn't have to make money, because it's just raised $10 million in venture capital expressly so it can keep its prices low. The metric its investors care about right now is user growth, not profits. And if, indeed, the company is selling meals for less than they cost to make, those investors are willing to fill the gap.

This business model is great for consumers. As a result of start-ups' willingness to lose money for months or years at a time, I get cheap, fast services that come with an effective subsidy that can add up to thousands of dollars a year. But they're problematic for the businesses themselves. Unlike Amazon or Google (which have profitable core operations that subsidize the money-losing services elsewhere in their business), or Uber (which uses the profits from its high-margin Uber Black and Uber SUV lines to subsidize its low-margin UberX service), many of today's start-ups have no profitable parent company pouring in money. They're simply taking millions of dollars in venture capital with the hope of keeping prices low, pushing rivals out of the market, and eventually finding a way to turn a profit.

There are several worrying things about this new, profitless-on-purpose way of doing business. First is that the while some of the money used to fund money-losing start-ups comes from rich Silicon Valley investors, some large amount of it comes from public pensions, college endowments, and other, more modest sources. Lyft backer Andreessen Horowitz, for example, has gotten investments from the Imperial County, California, Employee Retirement System and the University of Michigan; the Tennessee Consolidated Retirement System invests money with SpoonRocket backer General Catalyst. If you asked them, I'm sure that firefighters in Memphis and public schoolteachers in El Centro would have no idea that their retirement funds are being used to lower the price of my delivery lunches and rides across town.

But that’s exactly what’s happening. And when these venture-backed price wars happen in dozens of high-end service sectors all at once, you have a strange cultural phenomenon in which Main Street dollars are being used to finance the lifestyles of cosmopolitan yuppies.

The second issue with the venture-backed service economy is the Amazon problem – specifically, the practice of selling goods at or near a loss creates a deeply unfair competitive terrain for regular businesses. A start-up can sell a $10 lunch for $8 because it has money in the bank and investors who will rush in with more when the supply runs low. But if my local sandwich shop tries to do the same thing, it won’t make next month’s rent. The same goes with non-retail service businesses. Taxi companies had a decent chance of competing with UberX in its early days. But now that UberX and Lyft are both slashing prices to the bone with the assistance of millions of dollars in venture capital, the fight simply isn’t fair.

In the context of international trade, this kind of predatory pricing (selling goods at or below cost in order to drive out rivals) is often illegal. There’s a reason why it should trouble us domestically, too – trying to compete in the VC-backed economy as a profit-conscious business is like running a triathlon with ankle weights.

The third problem is that, as companies like Kozmo and Webvan learned in the first dot-com crash, the music stops eventually. At some point, investor patience wears thin, and the businesses that are still losing money on a per-unit basis tend to shrivel and die. When that happens, what’s left? A hole in the local economy where the local sandwich shop used to be, and nothing to fill the void. Given enough time and enough venture-backed land grabs, we could end up with an oddly configured service sector that contains a fraction of the jobs and utility it did before the subsidized prospectors moved in.

Cushions for emerging business models aren't all bad – not every company should be forced to make a pretty P&L right out of the gate, and without patient investors and other forms of subsidy, we wouldn't have companies like Twitter or Amazon, or things like electric cars and solar panels. And, as I said, the venture-backed economy is amazing for the people who live in it. In the history of the world, there’s never been a better time to be a consumer in San Francisco or New York than today, what with our cornucopia of cheap, on-demand services. I would miss my cut-rate sirloin and cheap Ubers to the airport if a regulatory authority or a market crash took them away.

But you can see how, on a grand scale, the existing model could become problematic. The only way the loss-making venture-backed economy can keep chugging along is if there is a constant supply of new money coming in at ever-higher valuations, subsidizing low prices and making earlier investors whole. Eventually, as in Amazon's case, the public markets may have to bear some of the subsidy. It’s a kind of benevolent Ponzi scheme, one that results in a lot of very cool services being provided at or below cost to a select group of urban consumers, and a lot of traditional businesses being forced to paddle hard to stay afloat. The profitless start-up model should worry us about the future of commerce and competition, even as we take advantage of its gifts.