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The Relationship Between Venture Capital and Open Source

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The logic behind backing a company that does not charge anything for their product is sometimes hard to understand. Fenton explains the unique relationships between a venture capital firm and an open source company they fund.

Transcript

One of the things being a venture capitalist starting in 1999 is that you discover there's a quite fine line between genius and insanity and it's probably even more the case in open source software where the fundamental premise is that the software doesn't cost anything to get started with it. That played out in the late 90's where I would describe as an open source gold rush. The term was coined in '98 before people called it free software. Red Hat went public in 1999, we were all really excited back then and the theory was well Red Hat is just a beginning of something huge and the venture industry went back and looked at this back over 40 "open source companies", many of them is just ideas and slides. Red Hat achieved a peak market cap of over 25 billion dollars via Linux which is another venture back company was an 8 billion dollar market cap and by 2002, by the way we had a couple in that 40. I will claim credit for two that didn't make it. Open source was a dirty word and you couldn't even think about raising money for an open source business plan and those that did were sort of ashamed of it and it was sort of a dot com effect where you want to run away from the fact that you even got near one of them. Red Hat had collapsed over to 120th of the prior market cap but it turns out it had a business and as we see now lately its gone up nicely and built a much more substantial business but that process of early failure forced us to say "Well if we really believe, should our convictions be shaken about open source or is there something deeper at work that we can identify as a framework to invest" and pulled back, the course of really this are our mistakes that thought us these lessons. First and foremost if you're going to back an open source company the market has to be of significant size. Going after open source for a developer tool doesn't make a lot of sense.

The math has to work. Secondly and I think this is probably the most humbling thing for a venture capitalist and something we've had a really internalize is that critical mass is defined as the communities declared a victor has to occur before we invest. And in almost every case, every case if you really look at the data, when venture capital went in prior to critical mass, the enabling powers of venture led to a bunch of bad behaviors not unlike a spoiled kid that destroyed the opportunity for open source. And it's really humbling when you go back to the Linux cares, the Covalent Sendmail, there's a long list of venture back companies that might have been successful if they didn't get what I would argue, "doped up" on venture capital before it made sense. Thirdly, the companies that have a chance we've discovered can't just be any product. They have to be products that go in to production that requires support offering and that's especially true for enterprise grade open source and it creates as you'll see in Mars case, the oxygen supply for a very interesting business model where the value equation shifted in the customer's favor but you can still build a profitable business. An example of it I mentioned Sendmail. If you guys are familiar with Sendmail is sort of the industry standard gateway for email. All attempts to make that into an interesting business or Apache for that matter have failed because the products are really buttoned down. They don't migrate that much and they don't require the kind of support let's say an application server does.

And finally and fourthly, there needs to be in our view a new frontier of adoption. A lot of companies today are trying to save their businesses by saying, "Well let's just make it open source." And all of a sudden we're going to get a lot of uptakes and developers love us and we'll have this free distribution but it's really not worth it succeeded in the past. Its' typically around new data center build outs, new application architectures and that degree of newness is really central to and minding for most startups you're creating a new experience, a new form of adoption which allows the products to get into market.