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Five Cs to watch in Silicon Valley's emerging venture capital ecosystem in 2018

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It's fun to make predictions for a new year and, based on what we at Morrison & Foerster are seeing in the marketplace, here are five areas for startup businesses and their investors to watch in 2018.

Connections. We have long believed that what continues to separate the startup sector in Silicon Valley from other parts of the country and the world is human capital choosing to live and work here, notwithstanding the high cost of living and traffic jams. One understated critical driver in recent years is that people in the Bay Area startup ecosystem voluntarily offer to connect with others.

Momentum should accelerate this year; it is palpable in coffee shops from the San Francisco financial district to Palo Alto. Every unicorn success story, upon digging, seems to lead back to valued introductions made by third parties, often unsolicited.

Cash. Building on a trend that is almost a decade old now, we expect exciting and disruptive startups to continue to attract funding at angel and seed rounds consistent with 2017. The best incubators and accelerator firms continue to receive strikingly strong applications to join their programs, and so-called "Demo Days" continue to be oversubscribed with investor interest.

We see funders across the spectrum – from high-net worth individuals to large corporate, pension, sovereign wealth funds and other investors – choosing to invest directly and also allocating capital to venture funds or fund of funds. At the macro level, we do not think it matters if valuations are extended. Good companies will get funded initially and later-funding rounds will be based on traditional metrics such as revenue, growth, business moats, quality of a business team, being in a hot sector and so on.

Relatedly, on the funding side, venture capital firms remain flush with cash and continue to be open to funding startup businesses early in the cycle. Investment teams continue to form new funds at a rapid clip with impressive IRRs to attract investors.

Cannabis. 2018 will be the first year with legalized marijuana in California for recreational use. Estimates from those in the know suggest that the regulated market will be in the billions of dollars. The new legal framework remains to be fully established – local governments determine what commercial activity can take place in their areas, and the federal government has opened the door to taking action in pro-cannabis states – but, as in other nascent industries, there will be significant opportunities to create and fund businesses as well as significant regulatory hoops to jump through.

Federal law must be watched carefully, especially given Attorney General Jeff Sessions' move early this month to reverse Obama-era guidelines that largely kept the federal government out of state marijuana regulation. And local governments will have much to say over what commercial activity to allow in their jurisdictions.

Unsurprisingly, the uncertainty in law and its application has already led to an advance rush with creative businesses being formed. Companies are also exploring ways to monetize this opportunity through their existing strengths or by adding new verticals to their platforms, including groundbreaking intellectual property work.

Cryptocurrencies. A new vocabulary started to go mainstream last year in the startup world under the cryptocurrency umbrella, headlined perhaps by the acronym "ICOs." Broadly speaking, ICOs (also referred to as initial coin offerings, initial token sales and token generation events) are sales of digital tokens.

Digital token sales provide an exciting, flexible new mechanism by which certain businesses may raise capital that otherwise typically would be provided by venture capitalists, without necessarily requiring dilution of founders' equity or economic interests. Depending on the characteristics of a particular digital token and its manner of sale, certain token sales may be sales of securities, while others may not be and may instead be sales of software. While token sales may present potential funding alternatives for emerging companies, they are not without significant risks, and would-be token sellers should exercise caution when structuring or launching a token sale.

In 2017, the SEC periodically reminded investors of some of the risks and brought enforcement actions against some of the most blatant offenders. This year, we expect that the token sale landscape will continue to evolve as additional regulatory clarity is provided. Given 2017's exponential returns for some bitcoin purchasers (as well as market volatility and fraud), it is likely that cryptocurrencies and token sales will continue to draw regulatory attention for operating businesses and funders alike.

Culture. The culture for startups in the Bay Area needs to continue to change in 2018, and not at a glacial pace. The daily allegations and revelations last year of sexual harassment and hostile work environments shocked many in the ecosystem. The massive problems that were revealed should be fixed as quickly as possible.

Serious companies, and serious investors, will lead by example. They will hire and retain the best, diverse work force, overseen by extraordinary management teams, boards of directors and advisory boards. We hope to see at least the same level of attention to culture and "tone at the top" that has been brought to "risk" areas like cybersecurity in recent years.

At Morrison & Foerster, we are very excited to pen a monthly column in 2018 addressing some of these and other key questions for startup companies and venture capital. Our next column will look at key changes made by the new tax law (another "C" – carried interest). Future issues will flesh out the headline topics covered above and many other subjects that are of current interest to the community, including China.

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