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RISE WITH THE WEST.
Introduction

Valuation growth tapers in 1H 2019. Skyrocketing valuations have been a persistent theme in VC throughout the past decade. However, in the first half of 2019, valuation growth cooled across the board in what we see as a rationalization after the sustained run-up. While a flattening of growth isn’t a cause for alarm, it does signal a potential shift in sentiment around VC or at least a natural ceiling to pervasive optimism among investors.

Step-ups remain elevated. Growth of the absolute valuations may have cooled, but companies are still expanding rapidly. Median early-stage valuation step-up multiples have been on the rise since 2016 and surpassed 2.0x in 2019 for the first time in at least a decade. At the late stage, the median step-up jumped to 1.6x so far in 2019, up from 1.4x last year and marking the third consecutive year of increases in the step-up multiple.

2019 has been characterized by a receptive exit environment. A vast majority of exit value for the year came from a handful of highly valued IPOs, which has assisted in pushing the upper-quartile IPO valuation over $1.0 billion. Despite the lower median price tag for acquisitions, the median valuation step-up for those deals has been consistently higher than the step-up for IPOs since 2011. This discrepancy has widened in 2019, as the acquisition step-up continued its uptrend to 1.9x while the IPO step-up shrank to 1.1x.

Alex Frederick
Senior Analyst, VC

Cameron Stanfill
Analyst II, VC
Angel & seed valuations have risen steadily from a nadir in 2009 following the recession. Growth has slowed slightly, however, gaining 7.1% in the first half of 2019 versus a nearly 13% annual gain in 2017 and 2018. We have observed a gradual decline in deal count at this stage, with capital being concentrated in the most attractive deals. Contributing factors to this trend include the emergence of alternate sources of capital, such as crowdfunding; the maturity of entrepreneurial resources and infrastructure in the form of incubators, accelerators and university support; and lastly, a crystallization of startup maturity expectations at the seed stage. The top quartile of pre-money valuations saw a spike in 1H 2019, demonstrating an increased competitiveness and focus on the highest-performing or most developed startups.

The median age of companies at the angel & seed stage has continued to climb over the past two years, bolstering the theory that startups are waiting longer to raise capital, likely due to investor preference for more business maturity in these initial financing rounds. In 1H 2019, median age landed at 3.1 years, up 10.9% so far from full-year 2018. The average number of rounds raised prior to Series A has been increasing, and discussion surrounding the continued expansion of early-stage VC and the emergence of new funding stages such as “pre-seed” and “pre-A” will likely continue to increase the median age of companies at the angel & seed stage. Despite the continued increase in company age and pre-money valuation at this stage, median deal size has so far in 2019 declined 6.8% from full-year 2018. We believe this is a natural readjustment following the investor exuberance seen across stages in 2018.
Median valuation step-ups at the angel & seed stage have consistently landed near 1.4x throughout the past decade. These step-ups are typically between angel and seed or between seed and follow-on seed. Raising a second (or additional) seed round typically indicates that the company is maturing but continuing to hone in on the business model, product-market fit and other foundational dynamics to prepare for growth. It is therefore logical that a limit exists to the value added in a subsequent seed round.

Select largest seed valuations of 1H 2019

<table>
<thead>
<tr>
<th>Company name</th>
<th>Close date</th>
<th>Deal size ($M)</th>
<th>Pre-money valuation ($M)</th>
<th>Sector</th>
<th>HQ location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wheels</td>
<td>January 23, 2019</td>
<td>$37.0</td>
<td>$80.0</td>
<td>Transportation</td>
<td>West Hollywood, CA</td>
</tr>
<tr>
<td>Reliant Immune Diagnostics</td>
<td>March 20, 2019</td>
<td>$10.9</td>
<td>$43.5</td>
<td>Healthcare devices &amp; supplies</td>
<td>Austin, TX</td>
</tr>
<tr>
<td>The Small Exchange</td>
<td>May 16, 2019</td>
<td>$10.0</td>
<td>$30.0</td>
<td>Capital markets/institutions</td>
<td>Chicago, IL</td>
</tr>
<tr>
<td>Modern Animal</td>
<td>February 22, 2019</td>
<td>$10.5</td>
<td>$26.5</td>
<td>Services (non-financial)</td>
<td>Los Angeles, CA</td>
</tr>
</tbody>
</table>

Source: PitchBook | Geography: US
*As of June 30, 2019
We believe in the risk takers, the game-changers and the disrupters — those committed to leveraging innovation to make the world a better place. And because we ourselves are entrepreneurs, we know firsthand the challenges faced by startups and growth companies alike, allowing us to solve problems other banks may not even see. Bridge Bank offers solutions for both founders and funds, including:

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- Term loans for venture debt and other credit facilities for VC backed companies
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Deals at the early stage saw continued growth in pre-money valuations despite deal sizes plateauing from 2018 activity. This leveling off of deal sizes is likely due, in part, to startups reaching a natural limit to the amount of funding that can effectively be put to work at a given stage. The median deal size landed at $6.3 million in 1H 2019, while the top quartile of deal sizes rose to $14.9 million, up from $14.5 million in 2018 so far. Naturally, there are always examples of companies operating outside of the norm who can put much larger amounts of capital to work, and we see those larger investments reflected in the top quartile of deal size activity.

Pre-money valuations at the top quartile have risen 56.1% from 2017. This fervent activity can be partially attributed to the influx of nontraditional investors at the early stage—including corporations, PE funds, hedge funds and traditional asset managers—willing to invest at elevated rates. We’ve received reports from investors of a decline in attractive investment opportunities, which would explain increased competition and subsequently upward pressures on deal sizes and valuations of the most desirable companies.

Source: PitchBook | Geography: US
*As of June 30, 2019

Range of early-stage VC deal sizes ($M)

Source: PitchBook | Geography: US
*As of June 30, 2019

Range of early-stage VC pre-money valuations ($M)
Median early-stage valuation step-up multiples surpassed 2.0x in 2019 for the first time in at least a decade. Step-ups have been on the rise since 2016 as startups continue to accelerate growth and add value at the early stage. Higher absolute valuations may create a challenge as companies strive to maintain step-up multiples in subsequent rounds. However, strong step-up activity at the late stage negates this concern for the time being.

The median percentage acquired at the early stage held flat at 25.0% through 1H 2019, a level it has hovered around since 2012. Since 2009, the range between the top and bottom quartiles has narrowed from 22.2% to 15.9%, indicating that the percentage acquired at this stage has continued to standardize. We don’t expect this difference to narrow much further due to the wide spectrum of factors affecting business valuation, runway and maturity that can be found at the early stage.
The late stage has been at the forefront of the valuation conversation given its prominence as a proportion of total VC capital invested. Valuation buildup at this stage has been significant across the spectrum but has been steepest at the median, where we recorded a 37.8% YoY expansion in 2018. So far in 2019, this growth trajectory has cooled across the board, with an increase of only 15.7% in the median and 7.8% in the 75th percentile (versus 37.8% and 37.4%, respectively, in 2018). We see this stabilization as a rational reaction from investors; valuation multiples can’t rise unabated forever. The largest companies have significantly extended the gap between the median valuation and top quartile in the past five years. VC investors continue to consolidate funding behind companies with momentum or the anticipated winners in their portfolio, which we expect will prolong top-quartile outperformance.

Following a similar theme of mean reversion, deal sizes at the late stage have declined in 2019. This is another distinct shift from the past decade and is slightly surprising due to the sustained levels of available capital. However, given the magnitude of the growth—especially at the top end of the stage—a tempering of the expansion was somewhat expected. Whether the changes in deal sizes and valuations hold throughout the rest of the year will be key in determining if this was a short-term dip in growth trajectory or a true inflection point.

Valuation step-ups at the late stage tell a slightly different story about the velocity of valuation growth. The median late-stage step-up jumped to 1.6x so far in 2019, up from 1.4x last year and marking the third consecutive year of increases in the step-up multiple. While this does conflict with the data around slowing growth from late-stage valuations, it illustrates how the VC market as a whole is still healthy. Late-stage valuations are still setting new highs, and the pace of dealmaking is still remarkably rapid, both of which elevate step-ups. Growth remains crucial for VC-backed companies; if companies can continue to deliver on investors’ expectations, we expect step-ups to stay high.
The trends in percentage acquired by investors in a given round further illustrate the favorable valuation climate for late-stage startups. Since the financial crisis, we’ve recorded a steady decline in the percentage of ownership sold in late-stage rounds. We principally attribute this to the competition for attractive deals at the stage, exacerbated by the flood of new nontraditional entrants into the market. As mutual funds and SoftBank step in to back the high-growth technology businesses that populate much of the late stage, the scope and scale of this stage has exploded. With this level of demand from investors, companies have had more success raising larger sums while giving up less ownership. If VC exits retain their recent strength and drive attractive returns, we believe this more founder-friendly paradigm will persist.
Moss Adams Q&A:
Surveying the venture landscape

What are the key trends across the late-stage, VC-backed company universe that have evolved the most over the past five years? How has your business conducted with these companies evolved?

Stan: A significant shift from the business vantage point is the growth in sell-side due diligence assistance. Educating our clients around sell-side issues wasn’t as common five to seven years ago. In the last three years, however, the sell-side portion of our business has grown to nearly 40% of the overall quality of earnings (QoE) business. Buyers now expect a sell-side report at hand when they’re initiating transactions. Currently, everyone is always fundraising, so we’ve developed a continuous process of education for our clients. Companies come to us for sell-side QoE assistance in preparing to raise money or for introductions to kickstart the fundraising process. Since investors are more demanding given the sizes of rounds and valuations being asked, we must assist in justifying the quality of revenue, preparing for due diligence and more.

Thomas: The trend that immediately comes to mind is the massive increase in capital flowing into the market, but let’s put that in context. When I started with Moss Adams in 2014, it was already getting easier for companies to raise money from VCs after the difficult period between 2008 and 2011. Since then, it’s not that it’s become substantially easier to raise capital, but given the abundance of capital, there are multiple sources to target when companies are looking to raise. With that said, everyone is aware of this capital-rich environment, and there is consequently a degree of caution. In short, if you’re hurting in any way, it will be harder to raise money. However, some companies do elect to undertake more stringent terms as they strive to move capital to the next investment stage. Interestingly, much if not most of the capital that has flooded into the market is concentrated in a small percentage of the market (i.e. unicorns). There is a segment of the small but growing company population taking longer to raise capital.

Is it more a matter of demand, in that investors are much more cautious, or is it a matter of supply, in that companies that are looking to raise are simply not as alluring? How do companies stand out in this environment?

Stan: Often, companies opt to save on ensuring the fundamentals of clean books, strong corporate structure and clear controllership in the early stages. However, if you can thoroughly prepare in those areas, you demonstrate to investors your capacity for overall growth. Given how much money you can raise in this environment.

Thomas: It’s a nuanced balance between the two. We’ve seen an increase in the number of companies looking for funding, so regardless of an abundance of capital, investors need to be careful. Granted, the number of investors has also increased, given successful exits that generated angel investors or verified a firm’s investment strategy and enabled them to raise another fund. The key dynamic is whether the company can justify the valuation and attract money to help it progress to the next stage beyond capital considerations.
environment, the minute details of your company structure will be scrutinized by anyone outside of your existing investor relationships, so you must be responsive and ensure operations and accounting are squared away. Currently, there are unicorns going public that are impacted by an indefinite path to profitability.

How do you see those dynamics playing out across stages, from the earliest to the latest?

Stan: First off, from an investor’s perspective, everyone has their own interpretation of when a company is in early, late or growth stage. For me, growth stage doesn’t start until you have the fundamentals of traction, and many software businesses aren’t even profitable at that point. At the growth stage, it’s about predictable burn rates, expansion of existing production and sales and research and development (R&D) investment into additional products. Prior to that, companies are seeking traction, acquiring good customers and establishing the marketplace. For example, at the early stage, I once worked as CFO with a software company that was performing decently, trending close to $10 million in recurring revenue. However, they had a legacy services business that was breakeven at best. When I arrived, the company was performing a debt refinancing, which made it clear the services business should be split out from the software business. They sold that legacy services unit, which then went on to be flipped by its acquirer for 3x its initial price. Once that software business was not burdened by its services unit, it was able to take off. Those are the types of decisions early-stage companies often must make, and which enable companies to eventually move into the growth stage.

Thomas: Currently, companies are staying private longer and are continuing to raise significant amounts of money before they choose to go public. The timeline previously ranged between four and five years, but now, we often see timelines stretching upward of seven or eight years. More importantly, the companies we’ve worked with often fall into diverse camps. Some don’t plan on raising again and instead target an acquisition. Others look to keep raising until they are well positioned to go public. Where each company falls is usually determined by where they are in their lifecycle. One unifying factor across all stages is a more dynamic, responsive fundraising strategy on the part of founders. From the investor side, we have seen some examples of significant accommodation—some players are willing to pay preferred prices for common stock ownership of well-positioned companies. Others are not so inclined, especially at the early stage. There simply is a proliferation of diverse responses and strategies in the current landscape at far greater scale than we’ve seen before.

On which issues do you work most closely with companies in this landscape?

Thomas: For companies that are looking to raise, there is an emphasis on revenue recognition, especially given ASC 606 coming into effect early this year. Investors will want clear financials in general; the more sophisticated firms can draw conclusions from even murky figures, but overall, the degree of clarity for which VCs are looking has only intensified. For example, firms want to know aggregate contract value undertaken, duration of recognition periods and sustainability and growth potential of the customer base. At the end of the day, multiples are a function of growth, which must be proven out. Companies must be able to tell a story of growth that is convincing over a potentially long timeframe because, as mentioned previously, timelines are increasingly protracted.

When I began with Moss Adams in 2014, I had multiple clients that were concerned to be early stage (i.e. pre-revenues or minimal revenues). These clients primarily had been founded over the last couple years. Five years later, we are still estimating four years to exit for one client; for another, three years. Most of the companies that we work with are targeting an acquisition. I most often work with early-stage companies to tell a compelling story of their growth as they pursue an acquisition.

Stan: We work with the companies as they prepare for their financing rounds, so I am most experienced in investigating matters from the investor’s side. To allude to an earlier question, what investors focus on tends to lead to frequent disconnect across stages. At the early stage, investors are primarily focused on the efficacy and applicability of the technology at the core of the business, whereas at the late stage, investors want more rigor in the financials (e.g. traction of revenue).
Let’s walk through an example of some metrics we use to analyze. From the investor’s side, I often look at headcount on top of sales in order to get started. Average cost per head should drop as development scales, and maintenance costs are optimized. Then, you target calculations of churn and renewal rates and see how dollars spent on sales versus R&D cost curves eventually intersect. Once they intersect, that means you have a mature product and can focus on going to market and sales. That’s where a company really becomes growth stage. Those signs are what aid investors in justifying different scales of valuations.

In the population of companies with which you work, are the majority in an indefinite status, wherein they’re still private and don’t have a clear path? Which proportion is more prepared to exit?

Thomas: It often depends on the size of the company. Some businesses have been around for close to a decade and aren’t prepared to go public, so M&A is the likelier option. A few are positioned for loss. Many of our smaller companies with the option of going public realize how onerous that shift can be (e.g. undergoing audits and the additional scrutiny of their financials). Those may opt to remain private. Some enterprises will always have an exit on their mind, which is usually the case for the Bay Area-based companies with which we work, especially since they typically raise plenty of VC.

Are there other topics you’d like to address, or any responses you’d wish to expand upon?

Thomas: For those companies that can sustain themselves for longer periods of time without financing, there can be significantly less stress and they can focus on their core business. After all, raising large rounds is complex and has tradeoffs. At what rights and preferences are you going to take on equity, and how will that dilute your current shareholders? If the funding can’t come through at the valuation you want, what is your response going to be? When you’re public, you have ups and downs and your performance is all over the place, but for private companies, they have not yet had that counterpart, public market experience. There are competing interests in and for any company, and you must have a solid plan in place to justify significant fundraises, as well as obtain them in the end.

Stan: Successful companies and investors understand that firms are really backing management, particularly at the early stage. Management teams need to be coachable and able to react and pivot. At the growth stage, you’re investing in the management team’s ability to articulate and execute on a growth plan. You need to be able to answer not only all the questions your existing investors may have, but also what questions new investors coming into a round may have of both the management team and extant investors. New VC firms should also look for these signs, as they are hallmarks of quality management teams.
The current class of VC-backed unicorns remains on the uptrend through the first half of 2019, despite the flurry of outsized exit activity starting off the year. While not quite as headline-grabbing as this year’s prominent IPOs, the unicorns that remain VC-backed have had a successful year so far. During the first six months, 35 new unicorns were minted, pushing aggregate numbers higher and keeping the aggregate valuation almost flat. The amount of value that remains tied up in unicorns is quite impressive given the massive size of the companies that exited in 1H 2019—including Uber, Slack and Lyft—which represented over $100 billion in exit value.

Companies are reaching unicorn status in roughly the same time span as last year, with the average years to achieve unicorn status in the first half of 2019 sitting above the decade average. However, with the strong aggregate valuation performance in replacing the exited unicorns, we recorded a reversal in the trend of slower growth of companies after they reached unicorn status. As companies scale, it is usually more difficult to continue the existing growth trajectory given the larger base. With that said, the median of both the absolute and relative velocity of value creation ratios (VVC and RVVC, respectively) have moved higher in 2019. The VVC increased dramatically in 1H 2019, posting a ratio of 4.5 (meaning the median company created $4.5 million of value per day between rounds), a 247.2% increase over the final 2018 value. Outlier businesses contributed heavily to this growth as RVVC posted a much more measured 31.2% increase over 2018, implying that the median fastest-growing unicorn was increasing its value 41.2% per year. While both ratios remain significantly below the highs from 2014, this data serves as a bellwether for broader sentiment around the unicorn segment, which is currently trending positively.
Median and average time (years) to achieve unicorn status

![Graph showing median and average time to achieve unicorn status from 2009 to 2019.]

**Source:** PitchBook | **Geography:** US

*As of June 30, 2019

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Velocity of VC value creation

\[ VVC = \frac{\text{absolute change in valuation between rounds ($M)}}{\text{days between rounds}} \]

Relative velocity of VC value creation

\[ RVVC = \frac{\% \text{ growth in valuation between rounds}}{\text{years between rounds}} \]

![Graphs showing velocity and relative velocity of VC value creation from 2014 to 2019.]

**Source:** PitchBook | **Geography:** US

*As of June 30, 2019
Median pre-money valuation of early-stage deals with CVC participation rose to $33.0 million in 1H 2019, up from $30.0 million in 2018. That compares with the pre-money valuation of deals without CVC participation, which landed at $28.0 million. The valuation gap between deals with and without CVC participation has narrowed from $9.3 million in 2015 to $5.0 million in 2018. CVCs have become more sophisticated investors, expanding from the most high-profile deals garnering the loftiest valuations to lower-profile deals with strong strategic and financial fit.

Conversely, we’ve observed the median pre-money valuation of late-stage deals with CVC participation skyrocket to $151.1 million so far in 2019, up from $125.0 million in 2018. This stands in contrast to deals without CVC participation, where median pre-money valuation landed at $55.0 million. The wide valuation gap at the late stage can be attributed to CVC participation in mega-deals ($500+ million), including the driving force of SoftBank’s Vision Fund which has been a major contributor to the rising deal sizes and valuations over the past five years. We expect SoftBank to continue as a major player in the market with the announcement of Vision Fund II.

**VC deal activity with CVC participation**

**Median early-stage CVC pre-money valuations ($M)**

Source: PitchBook | Geography: US

*As of June 30, 2019*
Deal sizes with CVC participation have risen steadily across stages, in contrast with deals without CVC participation which were flat or down in 2019. The growth has been greatest at the angel & seed stage, where the median size of deals with CVC participation was up 13.2% over full-year 2018. Although seed deals as a proportion of all deals with CVC participation has largely been flat over the past three years, the strategic value unique to corporates through synergies and innovation gains likely plays a factor in willingness to participate in larger and higher valued deals.

**Median late-stage CVC pre-money valuations ($M)**

Source: PitchBook | Geography: US
*As of June 30, 2019

**Median VC deal sizes ($M) with CVC participation by stage**

Source: PitchBook | Geography: US
*As of June 30, 2019
Valuations by sector

Median pre-money valuations ($M) by stage for VC software companies

Median pre-money valuations ($M) by stage for VC pharma & biotech companies

Median pre-money valuations ($M) by stage for VC healthcare companies

Median pre-money valuations ($M) by stage for VC energy companies

Source: PitchBook | Geography: US

*As of June 30, 2019
Valuation arguably matters the most at a startup’s exit event, as lofty private valuations meet real world expectations from corporate acquirers and public market investors. 2019 has been characterized by a receptive exit environment to say the least, with a new decade-high exit value with only six months of data. A vast majority has come from a handful of highly-valued IPOs, which has assisted in pushing the upper-quartile IPO valuation further above the median and over $1.0 billion. Elsewhere across exit types, acquisition valuations posted strong half-year activity, with some appreciation from the median and bottom quartile and flat movement from the top quartile. While billion-dollar exits drive an outsized portion of total exit value and are more commonly IPOs, acquisitions have remained the most common way for VC investors to find liquidity.

The absolute valuation at which investors can exit is an important datapoint, but perhaps more crucial to consider is how those valuations stack up against the companies’ last private valuation. As the accompanying chart illustrates, despite the lower median price tag for acquisitions, the median valuation step-up for those deals has been consistently higher than the step-up for IPOs since 2011. This discrepancy has widened in 2019, as the acquisition step-up continued its uptrend to 1.9x while the IPO step-up shrank to 1.1x, endangering the decade-long streak of medians surpassing 1.0x. This year in exits has been characterized by some of the highest-valued private companies going public, which has made it more difficult for companies to achieve higher step-ups. There have, of course, been some IPOs pricing significantly higher than their last private valuations, including Zoom Video which debuted at $8.5 billion after being valued at $1.0 billion in its 2017 Series D.
It is crucial to the health of the broader VC landscape that a significant portion of companies continue to achieve valuation step-ups at exit over 1.0x. This ensures a steady flow of distributions back to LPs and is necessary to achieve the expected returns for an investment in VC. So far, 2019 has proven to be more than adequate in this regard, and the pure dollar amount exited has already secured this year’s place as a pivotal moment for the VC strategy.
Deal terms

Through the first half of 2019, trends in aggregate deal terms largely sustained previous trajectories, further solidifying the current entrepreneur-friendly market. The past decade has coincided with a nearly uninterrupted bull market and easier access to capital, which fueled the shift in bargaining power toward founders. We expect this trend to continue until there is a material change in the actively available capital flowing into VC, which would most likely occur in the case of a prolonged recession. The protections provided by the deal terms often come into play only in the instance of a less favorable exit, so when those situations are more top of mind, investors are more likely to demand stringent terms.

Deal size and percentage acquired are the two most important factors in the determination of valuation. However, the terms companies receive in their financings have the potential to move the needle if necessary. Two of the most investor-friendly protections, participation rights and cumulative dividends, are both sitting at or near decade lows of 15.6% and 19.1%, respectively. If down rounds and exits remain near current levels, we expect more investors to forgo these rights. Recent rocky performance from high-profile VC-backed IPOs and signs of weakness in the broader stock market have stoked fears, but we still believe the strength from the exit market and the resulting cash flows will support the VC ecosystem for the near term.

Deals (#) including participation rights as proportion of all VC deals

Percentage of deals by dividend bucket

Source: PitchBook | Geography: US

*As of June 30, 2019