PitchBook

2018 Venture Capital Outlook: 1Q Follow-Up

Assessing our VC predictions

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As 2018 kicked off, PitchBook's venture capital research analysts provided our outlook for development in the year. Here we take a look at how our themes have played out early in 2018.

Predictions

- Continued bifurcation of VC valuations, with late-stage pricing remaining elevated, while angel & seed sees a pullback
- Alternative exits become less alternative
- The median fund size will continue to grow
- Venture activity will increase in entrepreneurial hubs outside California
- Unicorns will hit the exits, with haircuts coming to several
- Net cashflows to LPs will stay positive as exit values get a boost
- Initial coin offerings (ICOs) will become more institutionalized
- Fintech consolidation will accelerate

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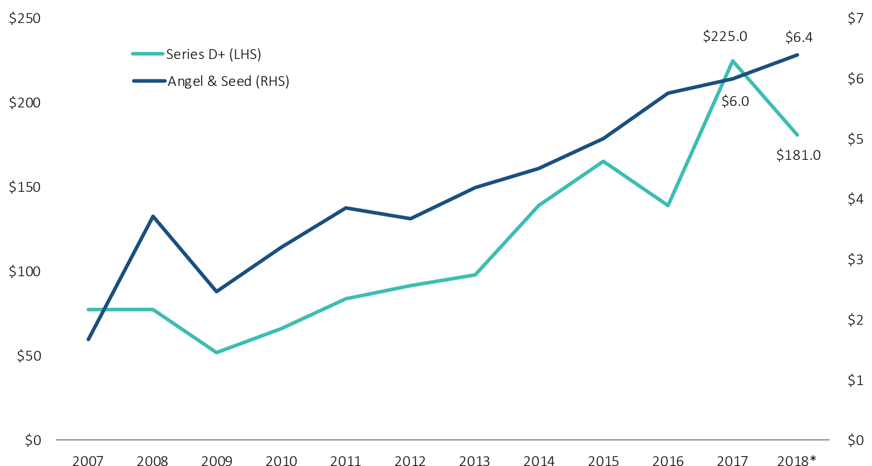
Prediction: Continued bifurcation of VC valuations, with late-stage pricing remaining elevated while angel & seed sees a pullback

Rationale: *Following a period of exponential expansion, deal activity in the angel & seed market has pulled back from its peak, which should start to alleviate the upward pressure on valuations. Concurrently, the large pool of capital available—including funds recently raised for late-stage deals—should translate to continued strong competition for deals.*

Caveat: *Companies receiving angel & seed funding may continue to raise their initial institutional capital later in their lifecycle and command higher valuations as a result. Late-stage companies are more susceptible to broad market or economic shocks, which would reverse the trend in late-stage valuations. At the current stage of the business cycle, we think the risk of these types of shocks has increased.*

Update: Progress toward this theme is trending slightly negative through the first quarter, as angel & seed valuations have maintained their median 2017 levels of approximately $6.4 million. One contributing factor is that the median age of companies raising an angel or seed round has increased to 3.0 years, from 2.4 years in 2017—in line with our caveat to the original theme. Angel & seed deal volume in 1Q 2018 remained relatively consistent with lower levels observed over the last eight quarters—which, contrary to our thesis, has not precipitated a decline in valuations. While angel & seed valuations still have the potential to trend downward in 1Q, once more data points are backfilled, the current market forces look to be pushing that timeline out further.

Median pre-money valuation ($M) by series



Source: PitchBook
*As of 4/2/18

Regarding late-stage valuations, first-quarter data has also moved against our hypothesis. The median series D+ valuation fell from $225 million at the end of 2017 to $181 million in 1Q 2018, a 19.6% decline. Valuations will undoubtedly fluctuate through the remainder of the year, and we anticipate these figures to rebound as the late-stage capital availability thesis has only strengthened in 2018. Despite the significant sequential decrease, 2018's median late-stage pre-money valuation of $181 million is still a historically high value—greater than any year aside from of 2017. We haven't seen any broader market challenges to the large, late-stage venture environment that would prevent further increases in valuations, strengthening our view of an increase over last year's tally.

Prediction: Alternative exits become less alternative

Rationale: *Lengthening exit timelines have driven investors to seek out more creative ways to find liquidity besides strategic acquisitions—traditionally the most prevalent exit route. To that end, alternative ways of accessing the public markets, such as SPACs and direct listings, should continue to gain popularity. Furthermore, the access ramps (e.g., exchanges and brokerages) to the direct secondary markets have increased as of late, which will help both investors and employees achieve liquidity even without a full exit.*

Caveat: *Strategic acquirers could resume a more acquisitive attitude toward VC-backed companies, resulting in a return toward the heightened acquisition volumes that we saw from 2012-2016. Additionally, the new and relatively uncertain alternative IPO options currently being tested could prove unsuccessful and discourage others to follow suit. Finally, stock market performance could weaken, putting pressure on the IPO window and further delaying companies poised to go public.*

Update: In just the first few months of 2018, we've already seen new SPAC activity, direct secondaries picking up and the Spotify direct listing—all of which support our alternative exits theme. The alternative IPO options have gained momentum, with True Wind Capital (a technology-focused middle-market PE firm) launching a new $287.5 million SPAC named Nebula Acquisition, and FanDuel reportedly nearing a reverse merger with Platinum Eagle Acquisition Corp. However, we still haven't seen any activity or merger rumors from Social Capital Hedosophia, which holds weight in the venture ecosystem given its size and stated ambitions. Spotify completed its direct listing on April 3, successfully pricing far above its last private valuation. While the process wasn't completely smooth and the stock did trade steadily down from the opening price, existing investors are

still sitting on gains over private secondary market valuations. Price volatility over the next few weeks will be key in determining if any other large well-established VC-backed companies will be persuaded to follow suit.

Additionally, secondary sales of Spotify's shares have drastically increased in the past few quarters leading up to the direct listing on the NYSE. With the less-coordinated nature of a direct listing, this secondary market activity has provided a degree of price discovery and a more accurate market valuation than the stereotypical private company obtains. Trading before the public listing may also calm some of the potential volatility common for early trading in the public markets, as existing shareholders with short-term liquidity needs have already had the opportunity to sell. We expect direct secondary activity to become a more common practice for companies approaching a public listing, either by traditional methods or the alternatives.

To that end, direct secondary activity accelerated more broadly in the first quarter of the year. The most notable deal is the SoftBank consortium that purchased $8 billion of Uber secondary shares from early investors and employees (including Travis Kalanick) at a substantial discount to the company's last private valuation. This was undoubtedly the largest-ever secondary sale of a VC-backed company, as well as probably the most widely publicized. However, anecdotally it seems that many of the SoftBank Vision Fund's other investments have included a significant secondary portion to provide some liquidity for investors or employees, as these huge funding rounds can further delay exits. This ability to scale and grow effectively in the venture markets and subsequent extension of hold periods is a clear driver of increased alternative liquidity options.

Spotify sale price history of ordinary shares

	Per Share Sale Price (in US Dollars)		Number of Ordinary Shares sold in the period
	High	Low	
1Q 2017	$56.25	$37.50	1,265,360
2Q 2017	$85.00	$46.25	2,067,600
3Q 2017	$95.00	$65.50	2,482,040
4Q 2017	$125.00	$81.50	6,980,440
1Q 2018 (through March 14)	$132.50	$48.93	7,898,280

Source: Spotify F-1

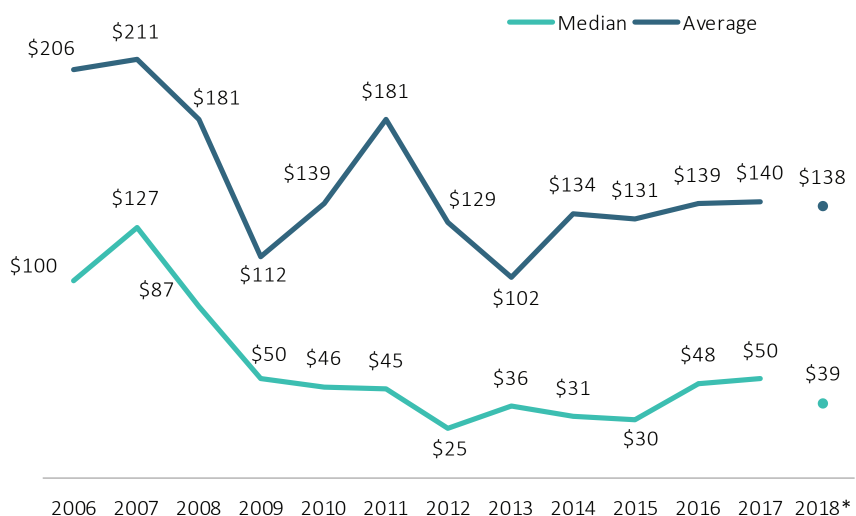
Prediction: Median fund size will continue to grow

Rationale: *VC fund sizes continued to climb in 2017, but the number of closed funds fell to the lowest level since 2013. The 20% increase in median fund size, coupled with a 26% decrease in fund count, suggests that LPs are making larger commitments to fewer managers, consolidating their allocations with proven managers. Committing to fewer general partners helps to streamline the investment process and minimize administrative costs for LPs, many of whom have limited resources dedicated to alternative investments. In parallel, GPs have been targeting larger funds to keep up with growing round sizes and to maintain sufficient follow-on funding reserves. We expect these trends to persist in 2018 and exert further upward pressure on median fund size.*

Caveat: *Instead of consolidating, LPs could choose to further diversify with more allocations to first-time or emerging managers that often offer more flexible fund terms, as well as innovative and differentiated strategies that provide portfolio diversification benefits.*

Update: In the US, the median size of funds closed in the first quarter sits at $38 million, a 23% decrease from 2017's median. Although three mega-funds (vehicles larger than $500 million) closed in 1Q, a strong showing of smaller funds has pushed the median lower. Amongst returning heavyweights are General Catalyst with a $1.37 billion fund, Norwest Venture Partners with its ninth flagship fund closed at $1.5 billion, and Battery Ventures with an $800 million fund and $450 million side-car vehicle. US micro-funds (funds smaller than $50 million) have more than kept pace, however, and constitute over

Median & average US VC fund size ($M) by year



Source: PitchBook
*As of 4/2/18

50% of US fund count for the first time in two years. These vehicles include several niche strategies like female-founder-focused True Wealth Ventures Fund I ($19 million), and regional university-focused Illinois Ventures Emerging Technologies Fund III ($15.15 million).

When we expand our view globally, the median fund size has also decreased from last year but sits at a high value in the US at $55 million in 1Q 2018, further underscored by several large European fundraises from the likes of Edmond de Rothschild Investment Partners, Eight Roads Ventures and HV Holtzbrinck Ventures. That last fund manager notes its seventh flagship fund, which closed on more than €300 million in January, was well oversubscribed and raised in record time, exhibiting continued LP preference for larger allocations to experienced fund managers.

Examining the pipeline of funds expected to close this year, we still expect to see median fund size grow both in the US and globally. Fundraises of over $1 billion announced from Sequoia, Lightspeed Venture Partners, Khosla Ventures and Social Capital, as well as the venture capital arm of China's largest insurer, Ping An, lead us to believe traction in 1Q is only an inkling of what the year holds. However, as we mentioned in our original caveat, an outsized number of funds on the smaller end of the spectrum may still add downward pressure on the median.

Prediction: Venture activity will increase in entrepreneurial hubs outside California

Rationale: *The median VC deal size and pre-money valuation for California-based startups have grown substantially in the last few years. With it becoming more expensive than ever to finance startups in the region, 2017 saw a growing proportion of deals and capital flow to developing VC hubs in mid-America. Geographically diverse investments tend to be less expensive for VCs while still offering competitive performance. We expect to see greater investment in entrepreneurial hubs outside California in 2018.*

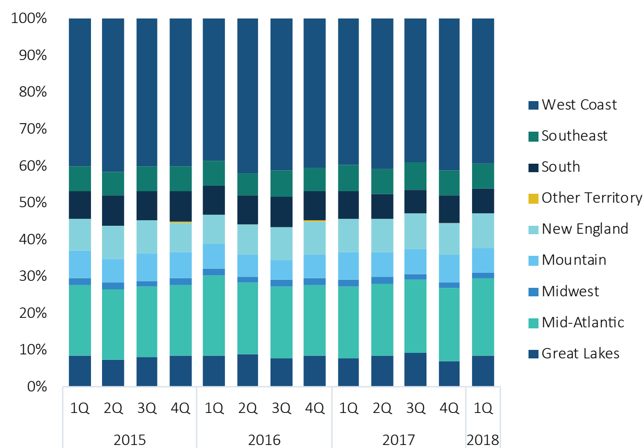
Caveat: *Time is money, and many VCs may see sourcing investments from external hubs as not worth the cost. It takes time for ecosystems to develop, and some may be too undercapitalized or under-resourced to offer a substantial enough pipeline for investors to commit. Also, startups outside Silicon Valley and its closest neighbors may find it challenging to attract the same level of talent when in competition with salaries, lifestyle and venture ecosystem found in the home of the venture industry.*

Update: Though we can only draw limited conclusions from first-quarter data, we see this theme gaining some positive traction. New England, the Mid-Atlantic and the Great Lakes regions have all seen marginal increases in their proportion of deal activity for 2018, while the West Coast has seen a slight decline. When it comes to capital invested, however, the West Coast (predominated by California) continues its dominance thanks to several highly valued late-stage rounds.

The proportion of all venture deals completed in the Mid-Atlantic has increased about 1.5 percentage points YoY, driven by activity in New York, Pennsylvania and Virginia. New England has also seen a slight increase as a percentage of all deal activity, driven by a healthy quantity of angel & seed deals in Massachusetts, while increased activity in the Great Lakes region can be attributed in large part to the growth of Chicago's venture ecosystem.

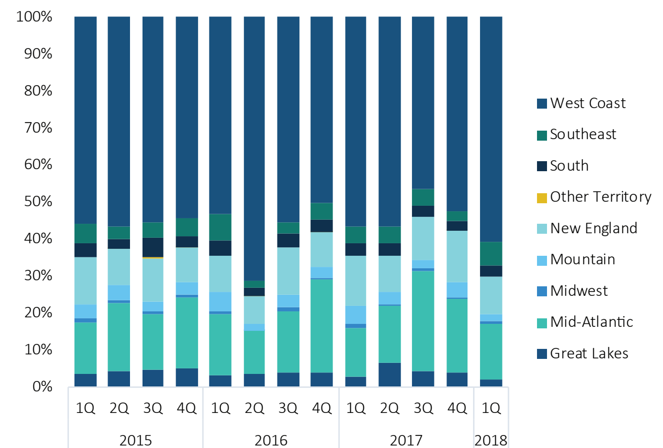
Even with these developments, the West Coast continues to lead in the proportion of capital investment by a wide margin. With over $15.5 million invested already in 2018, the West Coast is the only geographic region to see its proportion of capital invested in the US increase YoY (aside from the Southeast region, which harbors Florida's heavily capitalized Magic Leap). This speaks to the maturity of the West Coast ecosystem, particularly in California. While California is home to a substantial pipeline of mature companies, it also historically has more VC-backed exits than any other state, which has encouraged further entrepreneurship and early-stage investing.

Deal flow (#) by region



Source: PitchBook
*As of 3/21/18

Capital invested ($) by region



Source: PitchBook
*As of 3/21/18

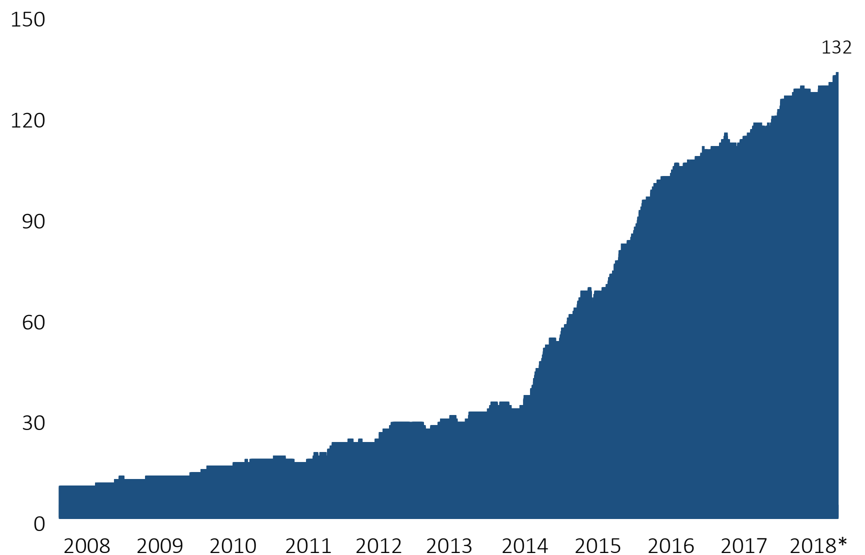
Prediction: Unicorns will hit the exits, with haircuts coming to several

Rationale: *As more companies achieve the highly coveted status of unicorn, questions are beginning to arise as these companies stay private longer and the amount of capital locked up in them grows incessantly. With public equity valuations elevated after nearly a decade-long bull run and M&A multiples at all-time highs, 2018 may be the best chance for many to exit before the market and business cycle turn.*

Caveat: *The global buildup of dry powder, which shows no sign of reversing in 2018, has facilitated large late-stage financings that have afforded companies the opportunity to stay private and forgo an exit. Additionally, many companies achieved unicorn status during a period of rampant valuation growth, so it's also possible that some of these businesses encounter challenges and are forced to raise a new round below a billion-dollar valuation in lieu of an exit.*

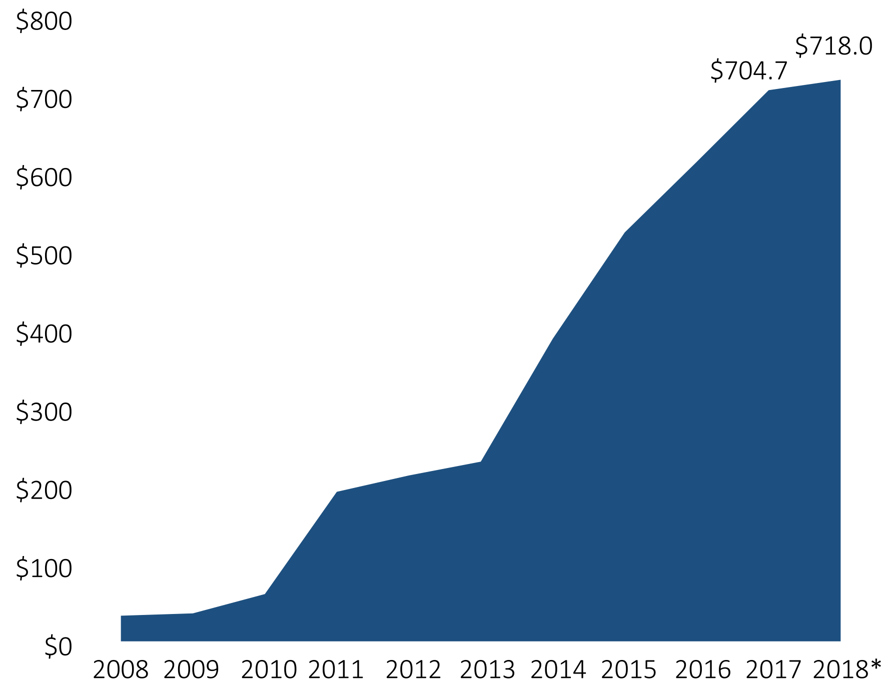
Update: In an underwhelming showing, just one unicorn made its way to the exit in 1Q 2018—and it technically was a down round, as Dropbox completed an IPO at a valuation of around $8.2 billion, roughly $1.8 billion lower than its last private valuation. The company did, however, quickly see its market cap rise above the $10 billion threshold and has maintained the momentum from that first-day pop, currently trading with a market cap over $12 billion.

Aggregate count of US-based unicorns



Source: PitchBook
*As of 3/1/2018. Note: the number of unicorns for this chart is calculated on a daily basis

Total valuation ($B) of US unicorns in a calendar year



Source: PitchBook
*As of 3/1/2018

The second quarter will likely show us more in terms of unicorn exits. Spotify recently listed and DocuSign—along with several other tech companies—have filed for IPOs, pointing toward high company interest in the public markets right now. Though there has been some turbulence in public equities recently, with tech stocks getting especially hammered, the markets are still trading near all-time highs, and the oversubscription of Dropbox's IPO shows that public investors are still ready and willing to invest in these highly valued unicorns.

Recently enacted corporate tax breaks in the US also represent a new dynamic in the M&A market that could lead to more VC-backed exits. It has been estimated that Amazon, for example, may save as much as $2 billion in taxes over the next two years. The abundance of extra cash may allow corporations to resume their buying sprees, even folding in the highest-valued private companies.

Still, the outlook on unicorns remains murky due to the overall lack of data for the year to date, but valuations remain robust in both public and private markets. Altogether, unicorns hold roughly $715 billion in illiquid value, and troubled waters could loom if trade wars break out or if the business cycle begins to turn.

Prediction: Net cashflows to LPs will stay positive as exit values get a boost

Rationale: *While a lackluster exit environment in 2017 will weigh on distributions, we expect a rebound in overall exit value in 2018 fueled by several $500 million+ exits. This should help to keep net cashflows to LPs in positive territory.*

Caveat: *Any hiccup in the exit environment will make it difficult for distributions to keep pace with contributions, as deal sizes continue to grow.*

Update: For the first time since 2011, cashflows back to LPs turned negative in 2017 (data through 2Q), highlighting the lackluster exit environment from last year. Interestingly, distributions have been relatively strong for more recent vintages, suggesting that waning net cashflows may be a symptom of older funds holding on to their winners. Exits only continued to slacken during the back half of last year while deal value continued to stay at heightened levels, suggesting that the downtick in net cashflows could last for a few more quarters.

The first quarter didn't yield the exit value that will get cashflows back positive; however, the Dropbox IPO, coupled with a number of large companies that entered registration over the final month of the quarter, has provided optimism that exits will in fact have a very solid year in 2018.

The main caveat to this outlook remains the prospect of a correction in public markets, which could have a major effect on VC-backed exits. That being said, the IPO market seemed unfazed by the volatility and negative returns from public equities in 1Q. For unicorns, which will need to see a high number of exits to get VC cashflows back positive, IPOs will likely be the easiest—or only—route for an exit. Current investor sentiment in VC-backed tech IPOs seems high as long as the companies coming to market can show solid business metrics, but that can quickly change.

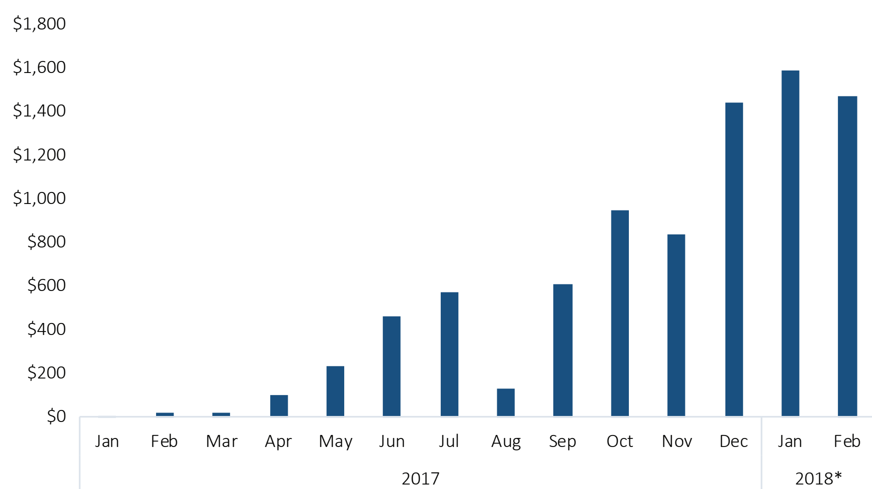
Prediction: ICOs will become more institutionalized as more sophisticated investors are enticed by the relative bargains available via ICOs relative to the stretched valuations of listed crypto assets.

Rationale: *Investors seek out "the next big thing," as exchange-listed crypto assets continue to exhibit strong tailwinds from retail capital flows. Furthermore, we expect to see a strong pipeline of projects in 2018 as many of the ICOs we've seen to date were rushed to market preproduct.*

Caveat: *Increased ICO regulatory enforcement could create additional administrative and compliance costs, which could encourage credible projects to instead seek out pre-ICO early stage capital from accredited investors.*

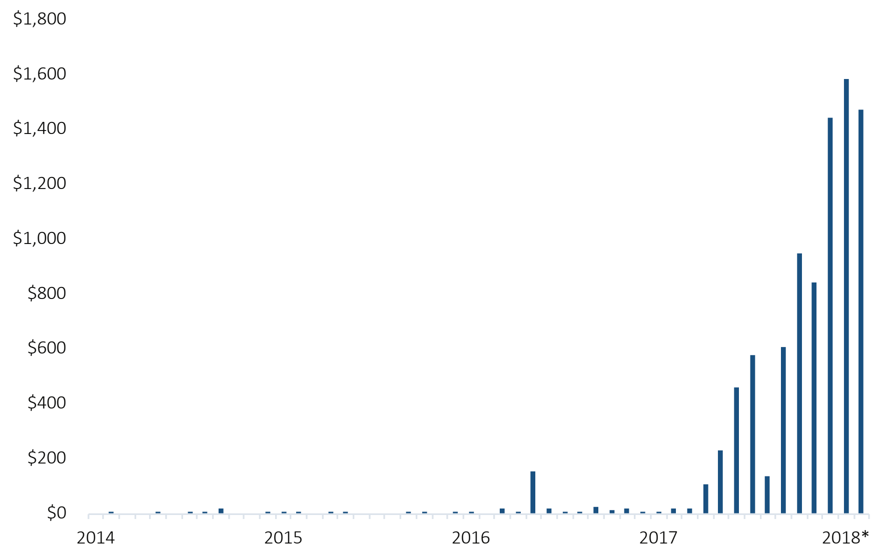
Update: In spite of the fear, uncertainty and doubt that has crept into the crypto asset space in 2018, ICO totals have remained robust. January and February—the most recent months for which we have data—saw total ICO fundraising figures of $1.58 billion and $1.47 billion, respectively. These totals are in line with the $1.44 billion raised in December, which at the time was the largest month on record by a long shot. While Telegram's token sale has certainly buoyed these

ICO capital raised ($M) by month



Source: CoinDesk ICO Tracker
*As of 2/28/2018

ICO capital raised ($M) by month



Source: CoinDesk ICO Tracker
*As of 2/28/2018

totals, ICO capital is being dispersed across a range of projects. Neuromation (crowdsourced AI training data), Elastos (decentralized OS), and Odyssey (p2p marketplace) are among a number of projects currently raising in the $50-100 million range. If we annualize the pace of ICOs over the course of 2018, total capital raised this year will total 3x all prior cumulative funding.

Furthermore, traditional investors have poured capital into the crypto vertical in the recent quarter. Private investments totaled $1.4 billion in 1Q 2018—the first billion-dollar quarter on record. The figures were supported not just by early stage seed deals for fledgling projects, but also late stage venture and M&A of established businesses in areas like mining infrastructure. Raising traditional equity capital is still a common practice for US-based projects that are hesitant to wade into the ICO space.

Prediction: Fintech consolidation will accelerate as business models mature and publicly traded tech giants move into financial services.

Rationale: *Technology giants have a huge opportunity to leverage and add to datasets by offering financial services.*

Caveat: *Any entrance into financial services will be bring new regulatory considerations, which technology companies tend to avoid. The track record has been mixed when traditional corporations branch into lending; most recently, GE—perhaps the most high-profile marriage of commerce and finance—divested itself from many of these businesses.*

Update: There has already been considerable big tech activity in fintech so far in 2018. Amazon has been in talks with banks, including JP Morgan, to launch Amazon-branded checking accounts. The move would save the retailer $250 million in interchange fees if 15% of customer dollars move through this service according to Bain. On a similar front, Amazon's Alexa Fund venture arm recently announced participation in the Series A of Greenlight Financial Technology, which offers a debit card for kids that allows parents to monitor usage and filter certain types of retailers. The crucial technology is the AI filtering algorithm that can determine transaction types, a critical weak spot of other personal finance applications and a valuable dataset as the world's largest retailer enters new markets.

Some of the more notable fintech M&A has been focused on improving datasets for AI. Goldman Sachs in February announced the acquisition of personal finance startup Clarity Money. The bank plans to add the product to its Marcus unit, a strategic priority for the bank. Clarity helps consumers improve their credit and cancel recurring payments by using AI to monitor transaction history. Entrenched incumbents aren't the only ones trying to acquire their way to innovation: Credit-monitoring startup Credit Karma, which has raised more than $300 million in venture backing, bolstered its presence in 1Q 2018 via its acquisition of personal finance chatbot Penny.