PitchBook

2020 Venture Capital Outlook

Forecasting the primary trends that will shape VC in years to come

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Published on December 17, 2019

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Prediction: The median pre-money valuation for seed-stage companies will eclipse $8.5 million.

> ***Rationale:*** Median pre-money valuations for seed-stage companies have been on the rise over the past decade. Despite the emergence of alternative sources of capital for venture-backed companies and predictions of a VC slowdown, we expect that pre-money valuations will continue to climb in 2020, with the median reaching a decade, if not all-time, high. A mix of increased investor competition, larger funds and a shift toward more mature startups are contributing to upward pressures on seed-stage valuations.
>
> ***Caveat:*** In the event of a downturn, certain seed investors—especially larger players that have moved upstream—may feel compelled to instead seek out late-stage opportunities with lower risk profiles, which would alleviate upward pressures on seed-stage valuations.

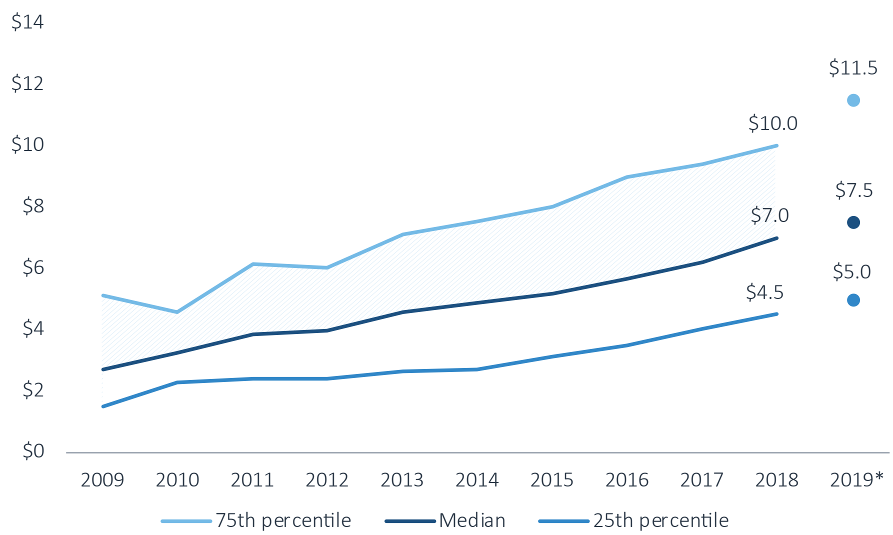
The median age of startups at each fundraising stage has matured over the past decade as startups have gained access to alternative sources of capital (and other resources) and as investors continue to opt for financing the most mature companies at each stage. As of September 30, 2019, the median company age of angel & seed companies is 3.0 years. This is in stark contrast to the median age of 1.9 years in 2014, just five years earlier. As we covered in a previous analyst note, one reason for the climb is that the costs to establish a software startup can run as low as $1,000 or less due to innovations in cloud computing and SaaS sales models. By the time many startups are ready to fundraise a seed round, they are vastly more mature than would have otherwise been possible without access to these resources. These levels of maturity and progress naturally tend to command a much higher valuation. Additionally, startups today have a variety of resources to bootstrap through the earliest entrepreneurial milestones, including incubators and accelerators, crowdfunding and venture debt.

The popularity of VC as an asset class has also attracted nontraditional investors such as asset managers and hedge funds. These “tourist” investors have tended to invest in late-stage companies that are easier to evaluate financially, have clearer growth trajectories and paths to profitability and pose fewer risks than new ventures. Recently, however, these nontraditional VC investors have expanded their scope as early as seed-stage financings in pursuit of returns in an environment of sustained low interest rates and heightened competition. The elevated access to capital for seed-stage companies due to competition from institutionalized angels and nontraditional investors has shifted power to startups, elevating pre-money valuations and deal sizes.

Larger VC funds and blitzscaling—an investment strategy of giant round sizes spurring rapid growth—have changed the game in many (primarily consumer-focused) sectors in which companies use VC to secure a critical mass of market share. The surfeit of capital committed to funds with well-defined investment periods is placing pressure on investors to put that capital to work. This means many startups end up securing more capital than needed or than would otherwise be available in a less frothy investment environment.

While valuations have been on the rise, seed-stage deal activity has declined steadily over the past five years. This could be indicative of a diminishing opportunity set and investor appetite at the earliest stages. Just as Founders Fund has shifted to the late stage with its latest vehicle, other seed investors may be finding that as firms stay private longer, their seed-stage investments have become too diluted. Any reduction in investor competition at the seed stage would likely alleviate upward pressure on valuations.

Range of VC seed pre-money valuations ($M)



Source: PitchBook | **Geography:** US
*As of December 3, 2019

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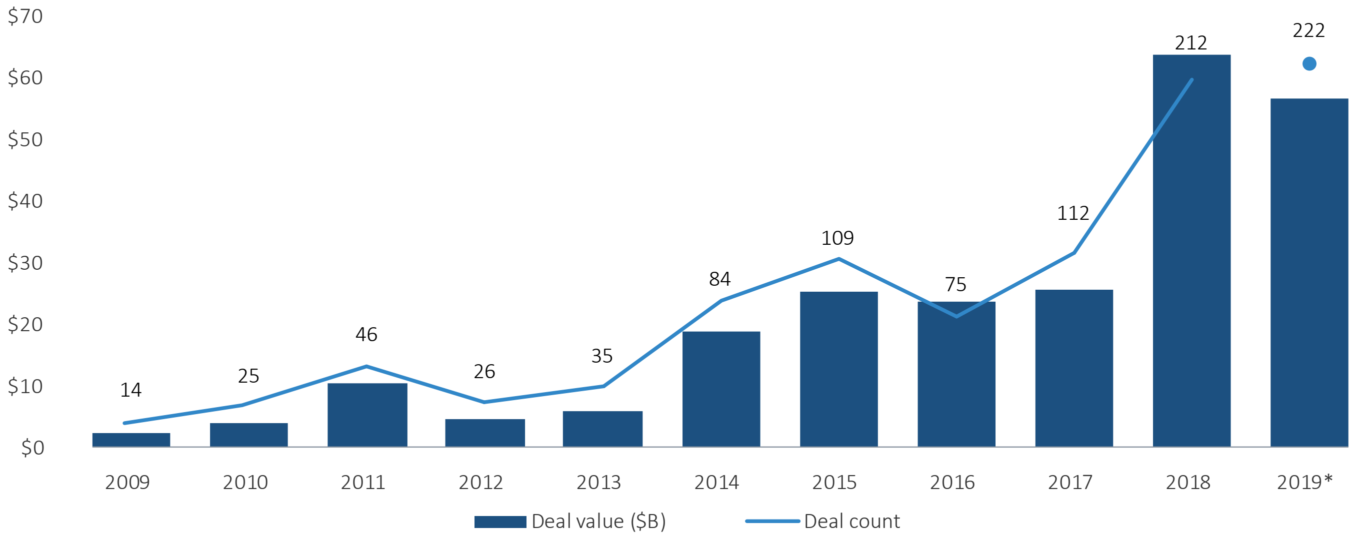
Prediction: 2020 will mark a new annual record for US mega-deals.

> ***Rationale:*** VC remains an alternative investment strategy wherein investors have successfully sought high growth on both an absolute and relative basis, which has led to rising allocations. Additionally, the positive momentum of returns over the past few years has led to strong distributions from VC funds back to LPs. With these large sums recycling back into new VC funds, as well as rising VC allocations from LPs, fundraising totals were pushed to historically elevated levels in 2019. The flood of committed capital and increased participation from nontraditional investors provide a compelling backdrop for late-stage dealmaking. While there have been some hiccups for large VC-backed exits toward the end of 2019, we believe that the long-term factors driving this historic shift of capital to the late stage remain in place and can continue to support elevated mega-deal activity.
>
> ***Caveat:*** Materially negative shifts in the broader economic landscape or tangential asset classes would have a significant effect on the number of startups that can successfully raise outsized financings. A likely substantial decrease in the capital availability for large private companies—especially from non-fund investors (e.g. mutual funds, corporations, LP direct investment) that are highly active in the mega-deal arena—would be detrimental to overall mega-deal volume. If large VC funds or new vehicles such as SoftBank's Vision Fund 2 have difficulty fundraising due to economic shifts or other exogenous factors, this could also hinder sustained levels of mega-deal activity over the next few years.

Over the past decade, two major changes in the financial regime made the current unicorn mega-deal trend possible. First is the great recession, which drove central banks to drastically reduce interest rates in an effort to spur investment and economic growth. However, even as the economy has recovered, interest rates remained low or zero (or negative in some cases outside of the US), keeping returns low, especially for fixed income. Even for public equity allocations, many institutional investors have skewed more toward a passive approach, making PE strategies one of the only areas in which investors see an opportunity for alpha generation. This new reality has driven LPs to investment strategies that can offer a chance to meet their return requirements, which for many has meant increasing or adding allocations to VC.

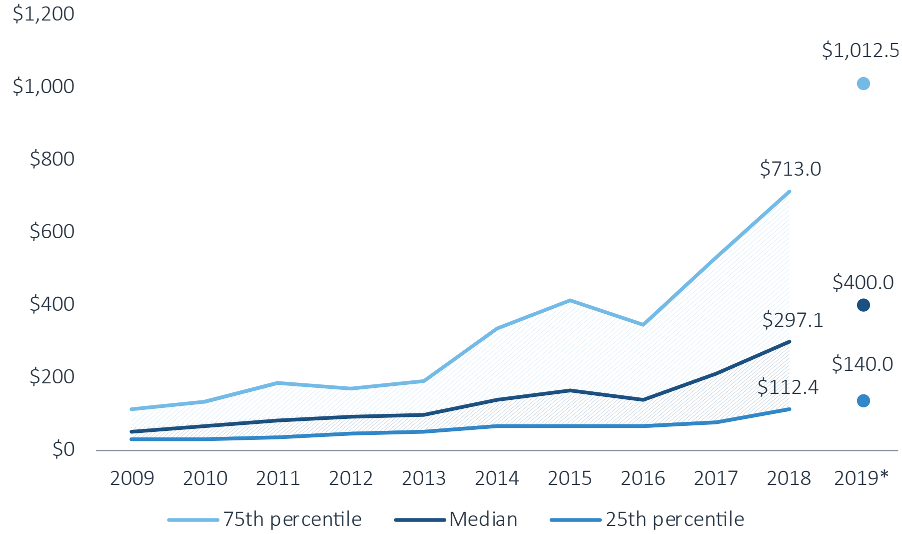
VC mega-deal activity



Source: PitchBook | **Geography:** US
*As of December 3, 2019

Returns and net cash flows to VC investors have been especially positive over the past two years, paralleling the improvement in the exit environment. This has helped to catalyze the massive fundraising totals that traditional VCs have closed (such as Andreessen Horowitz and Norwest raising funds of $2.2 billion and $2.0 billion, respectively), as well as encourage participation from sources beyond VC firms, such as mutual funds, corporations and SWFs. These outside investors have been critical to the swelling number of mega-deals, and while these investor groups have the reputation of being the first money out when the market sours, we believe that trend has shifted given the aforementioned market dynamics. For most of these nontraditional investors, such as T. Rowe Price or the Qatar Investment Authority, the percentage of their portfolio devoted to VC deals is relatively small, which has historically made it easier for this group to cut exposure to venture as a non-core strategy. However, we argue that the ongoing growth in the size and maturity of companies operating in the private markets has made investing at the late stage a more integral part of the strategies for many of these firms.

Range of VC Series D+ pre-money valuations ($M)



Source: PitchBook | **Geography:** US
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Second, Congress passed the JOBS Act in 2012 in an effort to increase the number of IPOs. This legislation also included a provision to raise the maximum number of investors in a private company from 500 to 2,000. The prior limit had effectively forced a few large companies into the public market to continue to raise capital, so a change to the threshold opened the door for companies such as Uber (NYSE: UBER) and Airbnb to proliferate and reach valuations over $10 billion as private companies. It's important to note that the JOBS Act has already been amended multiple times since its original passage to finetune the intended outcomes. Future amendments could force companies to go public earlier than they have been since the original legislation took effect.

While these are prolonged trends, the fact that both are still true today leads us to believe the trend of VC mega-deals will persist. Given these rules enable companies of larger and larger sizes to operate as private businesses, we think the group of investors that have recently been deploying capital at the late stage will continue to compete for access to companies that match their investment preferences.

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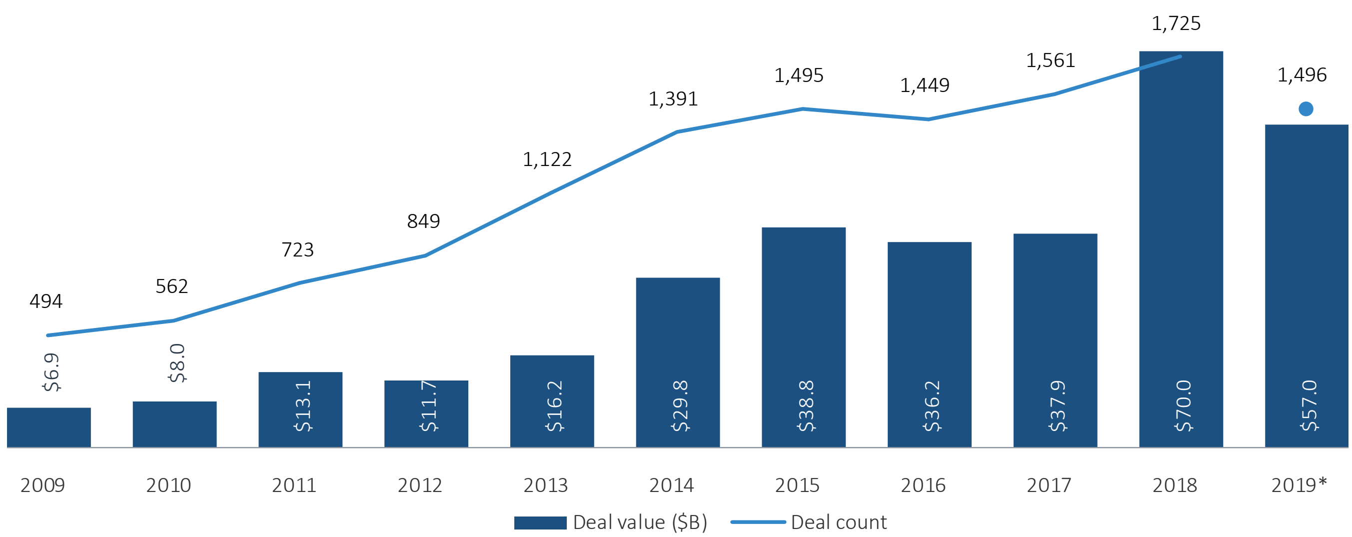
Prediction: CVC activity will reach a new record in 2020.

> ***Rationale:*** Deal activity with CVC participation has increased sharply in recent years, with many large incumbents utilizing the strategy to identify emerging trends and access innovative technologies. CVC arms are becoming more entrenched within the VC industry, having raised more funds dedicated to venture pursuits in 2019 than in any previous year in our dataset, which should underpin activity in the years ahead.
>
> ***Caveat:*** If deal activity falls across the VC industry—whether due to an economic downturn or other developments—deal activity with CVC participation will inevitably follow suit. While some CVC teams can source and lead their own deals, many corporations opt instead to invest in venture-backed companies on an ad hoc basis and participate only in rounds that are already in process. Falling corporate revenues in a broad downturn would also deter corporations that see startup partnerships as nonessential to their businesses' growth.

VC deal activity with CVC participation set a new record in 2018 with 1,725 deals worth a combined $70.0 billion. A large proportion of the year's total deal value derived from a $13.0 billion investment in JUUL. If we exclude that deal from the dataset, 2019 would have outpaced 2018's deal value at the same point YTD. The count of deals with CVC participation in 2019 is on pace to rival 2018's total, with 1,496 closed through December 3. This increase has occurred despite a YoY drop in the number of unique corporations participating in venture, indicating that a select set of companies views this strategy as essential to future growth.

VC activity with CVC investor participation



Source: PitchBook | **Geography:** US
*As of December 3, 2019

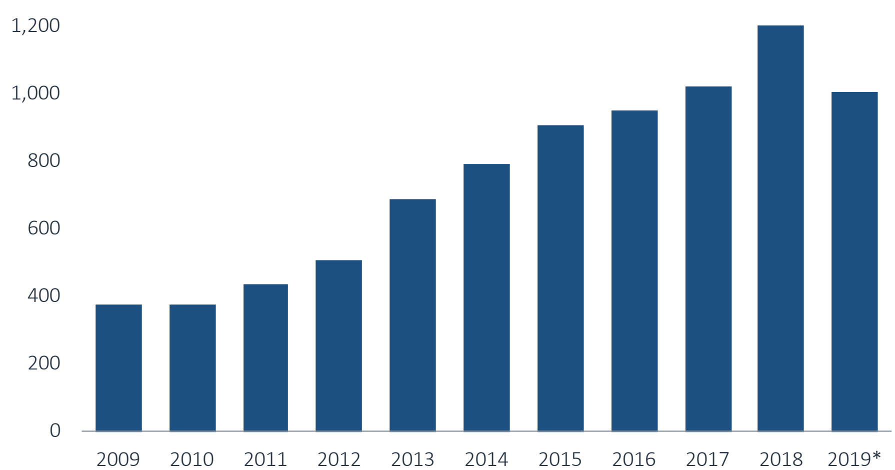
Established incumbents are continuing to look externally for innovation as startups deliver new technologies and build industries at rapid paces. Corporate R&D spend has increased dramatically in recent years, but many companies have realized that investment into internal research efforts alone isn't efficient enough to stave off all competition. After building their balance sheets during the prolonged economic expansion, corporations have used cash reserves to invest in external research and inorganic growth opportunities, including CVC. Investment in VC-backed companies provides corporations the opportunity to learn about emerging spaces before plunging large expenditures into organic development projects. For this reason, CVC can be a useful tool when implemented alongside internal R&D programs.

Economic headwinds appear likely to deter large corporations from pursuing outside investment if they view it as nonessential to core business operations. Because of the strategic motivations for many CVC efforts, corporations can see positive returns on a non-financial basis from VC investment. Continuing to budget capital for these investments alongside internal R&D programs will help corporates weather the storm and be ready for growth once the economy turns. Though deal activity with CVC participation declined during the financial crisis, research showed that R&D spending patterns were largely unchanged throughout the downturn.[1] We believe that this prior

1: "Corporate R&D Spend Up Despite Global Recession," New Atlas, Jude Garvey, November 22, 2009 resilience, combined with the fact that corporations have much more aggressively targeted venture investments over the past decade, suggests that they will continue to see VC as an avenue for innovation even in a downturn.

Rather than viewing VC as a side project or taking a casual approach to investment, corporations are explicitly using startup investment to diversify their products and expand the technologies they incorporate into their offerings. They are increasingly investing in VC through dedicated investment teams and operating specialized funds, rather than financing deals directly off their balance sheet. Corporates have raised 17 VC-focused funds in 2019, the highest annual total tracked by PitchBook. Together these vehicles have more than $1.3 billion in investable capital. Because these funds have cash already earmarked for the strategy, they will likely continue to invest during any economic climate so long as target companies can be found.

Unique global CVCs (#) making investments into US-based, VC-backed companies



Source: PitchBook
*As of December 3, 2019

1: "Corporate R&D Spend Up Despite Global Recession," New Atlas, Jude Garvey, November 22, 2009

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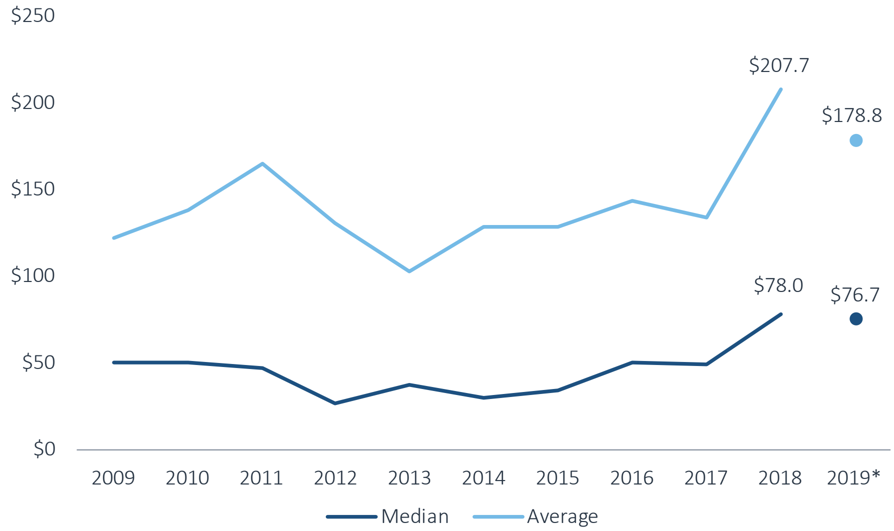
Prediction: The median US VC fund size will top $110 million, reaching a decade high.

> ***Rationale:*** Although the median US VC fund size in 2019 has leveled off, we expect to see a significant increase in 2020 for a variety of reasons, including rising allocations to the strategy and decade-high VC fund distributions back to LPs. This has enabled GPs to raise ever-larger funds as they fuel blitzscaling strategies and strive to keep pace with rising deal sizes.
>
> ***Caveat:*** The recent WeWork calamity and the poor post-IPO performance of multiple prominent tech companies have renewed skepticism around investment into unprofitable startups, which could temper the strong venture fundraising environment of recent years. Furthermore, the healthy exit environment over the past several years is likely to contribute to a rise in first-time funds, a byproduct of the success of early team members. Historically, over half of first-time funds have been micro-funds (sized under $50 million), so naturally a surge in first-time funds would drive down the median fund size. Lastly, if fundraising activity continues to dip from 2018's stellar posting, it could signal investor reticence about the VC asset class, perhaps related to uncertainty regarding global public equities.

Fundraising activity has been operating at elevated levels over the past six years, with a record $70.0 billion raised in 2018. Although capital raised in 2019 has dipped below this epic total, it still sits near the highs seen over the past five years. VC net cash flows have been positive since 2012, which means capital is returning to LPs faster than it can be invested back into new funds. Annual exit values have reached unprecedented levels, soaring to $252.0 billion YTD, which has continued to fuel distributions. The spike in positive cash flows in 2018 will likely lead to a glut of reinvestment into new funds throughout 2020 as LPs look to put capital to work in an attractive asset class. In response to this capital availability and LP appetite, GPs have raised larger and larger funds. In 2018, 23 mega-funds closed, up from eight in 2013.

Median and average VC fund sizes ($M)



Source: PitchBook | **Geography:** US
*As of December 3, 2019

Another factor spurring the rise of fund sizes is investors looking to keep pace with surging deal sizes and ownership targets. Across stages, we have observed deal sizes quickly climb to new highs as startups scale faster between rounds. Overcrowding in the investor landscape has led to unprecedented capital availability and founder-favorable terms, allowing startups to secure as much capital as needed or even more than needed. VC investors are raising ever-larger funds to copy or compete against SoftBank and its blitzscaling investing strategy, which aims to help businesses grow as rapidly as possible through copious VC funding. VCs such as Kleiner Perkins, Sequoia Capital and Andreessen Horowitz have all normalized the phenomenon of $1 billion+ venture funds.

As mentioned earlier, companies have been able to stay private longer given elevated levels of capital availability and new legislation allowing broad shareholder bases for private companies. This has created a challenge for VCs focused on seed- and early-stage companies looking to maintain their equity stake and not have it diluted in follow-on financings. In response, some early-stage investors have shifted their focus to later in the investment lifecycle, as evidenced by Founders Fund's latest $1.5 billion fund focused on growth-stage startups.

As one of SoftBank's most visible investments, WeWork filed to go public in August of 2019, leading to intense scrutiny over its finances, leadership activity and venture funding. The fallout that followed included a discussion on VC funding strategies and a call to switch to a more conservative investment approach emphasizing profitability over growth potential. Although unlikely, adoption of this strategy would likely curtail valuations and deal sizes.

At the other end of the spectrum, as fund sizes have increased, we have observed a steady decline in the absolute count of micro-funds and their proportion of total VC fund count; 76 US micro-funds have closed YTD compared with 2014's peak of 154. With deal sizes growing even at the earliest stages, it is likely difficult for many investors to justify raising micro-funds. However, exit activity over the past decade has created a scenario in which we are likely to see an uptick in first-time funds. Given the majority of first-time funds run under $50 million, A rise in first-time funds would likely counter the factors fueling the increase in median fund size.

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Prediction: SoftBank's second Vision Fund will not close at its target of $108.0 billion.

> ***Rationale:*** The failure of the WeWork IPO—and the subsequent handling of its fallout—has called into question SoftBank's Vision Fund strategy, with skepticism coming both from LPs and the firm's public shareholders. Besides WeWork, several other mega-investments in the Vision Fund's portfolio have suffered significant write-downs in recent months.
>
> ***Caveat:*** The broader industry of LPs is awash with capital and often has trouble obtaining sufficient allocations to VC. Specifically SWFs, which were big backers in the first Vision Fund, are continuing to diversify their holdings away from natural resources and seek alternative strategies for growth. If even a handful of large LPs are willing to look past SoftBank's recent losses and double down on their commitments to the GP's strategy, it could push Vision Fund 2 to its target.

In May 2017, SoftBank's first Vision Fund held an initial close of $93.0 billion, nearly hitting its unprecedented target of $100.0 billion. To help secure the massive commitments needed, the fund offered a dual-class share structure with 40% of the shares paying a 7% coupon annually.

In November 2019, Vision Fund 2 held a first close on just $2.0 billion, less than 2% of its stated target size, and no details of the fund's share structure have been disclosed. This substantially lower first close raised eyebrows given SoftBank had announced in July that the fund's capital had approximated $108 billion so far based on its memorandums of understanding (MOUs) with 12 major entities. Though not legally binding, MOUs are in essence an agreement to partner at a later date. Vision Fund 2's first close came four months after the initial announcement and a litany of snafus for its predecessor, including WeWork's failed IPO, car leasing platform Fair's announcement that it was laying off 40% of its employees, and OYO's announcement that it expects to be in the red until 2023. On top of this, Uber and Slack (NYSE: WORK) are both trading below their IPO prices as of time of publication, and Vision Fund 1 sold back its Wag stack at a valuation reportedly "well below" where they invested. Even if Vision Fund 2 misses its target, it will still likely be the second-largest tech fund ever raised—already a mega-fund by VC standards—but LPs committed to the predecessor fund have called into question how their capital has been deployed in Masayoshi Son's strategy.

Whether or not the fund closes on its target size largely hinges on enormous participation from SWFs. The Public Investment Fund (PIF) of Saudi Arabia wrote a check of $45.0 billion to the first Vision Fund, contributing nearly half of the vehicle's total capital raised. The early announcement of the second Vision Fund highlighted agreements from investors such as Apple (NASDAQ: APPL), Microsoft (NASDAQ: MSFT) and Foxconn (TAI: 2317), but none of those corporate behemoths would be willing to finance such a large proportion, and even together their commitments will likely comprise just a small fraction of the fund's total capital raised. PIF has AUM of $320.0 billion, according to current estimates, and therefore plenty of capital to participate in Vision Fund 2 at the same level it had before, but the LP may make the prudent decision to downsize its investment this time around. It was reported after SoftBank's recent missteps that the Saudi Crown Prince was working with the GP to negotiate a reduced fee structure for its next investment. Kazakhstan's SWF is also reported to be an investor in Vision Fund 2, but its total AUM of roughly $60.0 billion would not allow it to contribute a large proportion of the fund's total target.

PIF's recent IPO is the most high-profile display of SWFs diversifying their holdings, but many are actively looking to expand beyond oil and other natural resources. While diversifying their holdings, SWFs have also shown interest in direct investments, which could provide a way for these investors to put capital to work in the venture asset class without relying entirely on SoftBank's new fund. For example, PIF recently disclosed a $400.0 million investment into ex-Uber CEO Travis Kalanick's new startup; and in 2018, SWFs completed a record 58 deals with US VC-backed startups that totaled more than $9 billion.

SoftBank itself has also planned to contribute $38.0 billion into its new fund, along with a possible $20.0 billion through loans to Masayoshi Son and other executives and employees. Some executives were reportedly encouraged to take loans on the fund that are several times larger than their base salaries. When the new vehicle was announced in July it was assumed that all eligible employees would take out the largest loan available to them, but that assumption seems to be at risk four months later. Such a large amount of loans is not only risky, but if SoftBank and its employees account for more than half of the total fund, a moral hazard situation could manifest to protect the company, against the other half of invested capital in the fund. Investors have reportedly cited the size of the loans and possible conflicts of interest in criticisms of the company and the Vision Fund strategy. Many believe Masayoshi Son shouldn't participate in the loan program.

Masayoshi Son has stated recently that the fund will focus on profits and take a more cautious investment strategy. While this may simply be what the industry wants to hear, a $108.0 billion fund is not a cautious pool of money. Indeed, it seems that the fund's potential LPs may be the ones ultimately exercising caution by forgoing commitments, particularly given the recent scrutiny of Vision Fund 1 and its strategy. Because of these factors, we believe Vision Fund 2 will fail to reach its target size of $108.0 billion.

SoftBank Vision Fund 1's largest VC investments*

Company	Close date	Deal size ($M)	Post-money valuation ($B)	Sector
The We Company	October 31, 2019	$6,550.0	--	Commercial services
The We Company	January 8, 2019	$5,000.0	$47.0	Commercial services
The We Company	August 24, 2017	$1,700.0	$21.2	Commercial services
Uber	December 28, 2018	$1,250.0	$69.6	Transportation
Flexport	April 22, 2019	$1,000.0	$3.2	Commercial services
Fanatics	September 6, 2017	$1,000.0	$4.5	Retail
Katerra	September 20, 2018	$998.9	--	Commercial services
Nuro	February 11, 2019	$940.0	$2.7	Transportation
REEF Technology	March 1, 2019	$900.0	$1.0	Software
Opendoor	September 27, 2018	$725.0	$2.5	Services (non-financial)
DoorDash	November 13, 2019	$700.0	$13.0	Restaurants, hotels & leisure
Compass	December 7, 2017	$550.0	$2.2	Services (non-financial)

Source: PitchBook | **Geography:** US
*As of December 3, 2019

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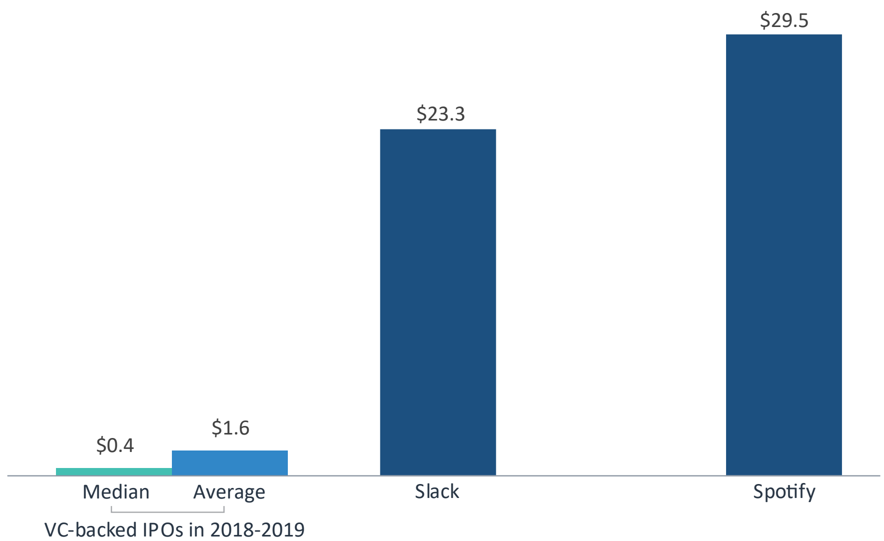
Prediction: At least three direct listings of companies valued over $1 billion will close in 2020.

> ***Rationale:*** Momentum behind direct listings has continued to accumulate following Slack's public debut in April 2019. In October 2019, investment bankers, VC investors and entrepreneurs held an invitation-only meeting to discuss alternatives to the traditional IPO process, which reportedly featured extensive discussion on direct listings. With its seeming emergence as the preferred alternative IPO for technology startups, and with Airbnb announcing that it might opt for this route in its reported 2020 offering, we see direct listings becoming a standard consideration for companies pursuing a transition to the public markets.
>
> ***Caveat:*** Given recent IPO struggles from many of the high-profile public listings in 2019, continued negative receptions to new listings or poor broad stock market performance would materially reduce the number of companies that choose to pursue a public listing of any kind. In the event that investor sentiment around public equities or new listings becomes significantly negative, smaller unicorns may elect to delay any type of offering or instead proceed down the well-worn traditional IPO path to avoid any unwanted volatility or raise money to insulate from the uncertainty.

Sentiment around direct listings as a realistic option for large companies has improved considerably since Spotify's (NYSE: SPOT) debut in 2018. Despite predictions that the listing would face volatility during the first few trading days, it proved to be a success due to its price stability. Even so, industry experts suspected that a direct listing would work only for massive consumer-facing companies with global name recognition. This concern also subsided when Slack followed suit with its successful direct listing one year after Spotify. Slack is well known in certain circles but is a less familiar brand to the average investor compared to Spotify or Airbnb. We believe these factors, along with the company's relatively straightforward focus on technology, opened direct listings as a pathway to the public markets for a much wider swath of private companies.

Comparison of pre-IPO pre-money valuations ($B)



Source: PitchBook | **Geography:** US
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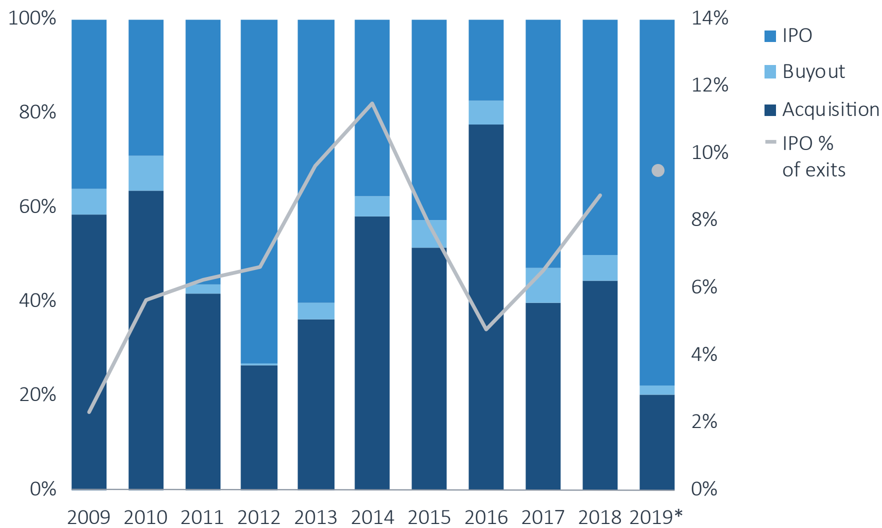
The concepts of direct listings and other alternatives to traditional IPOs (e.g. SPACs, reverse mergers, etc.) have gained popularity in the same environment that has fomented "founder-friendly" terms in VC fundraises. Bargaining power increasingly lies with startups and their founders, who oftentimes retain outsized control thanks to multi-class share structures. As innovative ideas and companies have dethroned capital as the scarcest resource in the private investment landscape, companies have found greater leeway to fight for more favorable terms. Direct listings appeal to startups because they lower the cost of going public via explicit means such as smaller advisor fees as well as implicit costs by reducing the time executives have to spend on a traditional road show. These listings also offer a more transparent process, eliminating investor lockups and providing what is arguably a more accurate market price given the unrestricted float.

VC exits ($) by type



Source: PitchBook | **Geography:** US
*As of December 3, 2019

Critical to the proliferation of direct listings will be the continuation of plentiful capital availability in late-stage VC since direct listings don't raise any fresh capital. Previously, we hypothesized this would make it an attractive option mainly for companies with positive operating cash flows. However, in the current environment, companies have been able to raise enough private capital to amass a long cash runway, even completing a VC deal in the few months immediately preceding a public listing. For instance, Postmates confidentially filed IPO paperwork on February 7, 2019 and announced a $100.0 million Series F the next day, which was then followed up by a $225.0 million growth round in September. If this kind of activity remains feasible, we see an even broader universe of companies that would be able to pursue a direct listing. On a related note, there have been some initial discussions by market participants with the SEC around the possibility of raising capital in a direct listing. We view this continued innovation as an important feature of this process to find a more optimal path to the public markets for large technology businesses.

2019 predictions scorecard

Below we summarize our predictions for 2019 and how they fared.

IPOs as a proportion of total VC exit value will hit another decade high.	PASS	Despite a fairly tepid IPO market at the end of 2019, IPOs as a proportion of total exit value sits at 82.0%, still well above the next highest mark set in 2012.
New participants in VC will continue to proliferate.	PASS	Nontraditional investors have sustained the rapid dealmaking pace, participating in deals totaling $71.4 billion as of September 30, 2019. On a capital basis, PE firms and asset managers have increased relative participation YoY.
The growth in median fund size will decelerate.	PASS	The median US VC fund size has dipped slightly in 2019 to $76.7 million as of December 3. That figure is still the second-highest in our dataset, however.
The median early-stage valuation step-ups will hit 2.0x in 2019.	PASS	Early-stage valuation step-ups grew 5.0% in 2019 to reach 2.0x as of September 30, 2019.
The median angel & seed deal size will continue to climb.	SPLIT	The aggregate median deal size was essentially flat between 2018 and 2019. Although seed deal sizes saw a sizable increase, aggregate deal sizes plateaued due to a rise in the proportion of angel deals.
Banks will back more institutional blockchain solutions.	SPLIT	Although banks continue to join the blockchain consortiums to explore this technology, participation has been limited to pilot tests rather than direct strategic investments.