PitchBook

Pursuit of Growth Turns Outward

An analysis of buy-side investment activity by US VC-backed companies

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Key takeaways

- As companies remain private for longer and as investors increase emphasis on growth, startups are taking a strategic approach more commonly taken by public companies and looking externally to fuel expansion. M&A counts by VC-backed companies have plateaued since 2015, but VC deal volume with participation from startups is on a sharp trend upward.

- Completing one or two acquisitions between rounds corresponded to slightly higher median valuation step-up multiples against the non-acquisitive startups. However, the more active dealmakers with three or four deals in a year start to see some deterioration in multiples. Integration risk certainly increases with more acquisitions, and many of the possible reasons a startup may feel compelled to engage in M&A, such as stalling growth or operating in an extremely competitive market, also double as factors that would drive valuation step-ups lower.

- With the top-quartile VC-backed company in 2018 raising $72.7 million before making an acquisition and with a median of $78.2 million in capital raised before making a VC investment, companies that complete a $100 million deal are likely candidates to start making these external investments. Deals of this size used to fall in the domain of the public markets, but now that these mega-deals are becoming more common within VC, it's logical that we've recorded elevated dealmaking activity by VC-backed companies.

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Introduction

The last decade has constituted a fundamental shift in what it means to be a VC-backed company. A surge of capital from both existing VCs and nontraditional participants has enabled companies to reach unprecedented sizes. Many of these companies have remained private for more than a decade. With investors clamoring to back rapidly growing startups, some VC-backed companies are now opportunistically raising rounds even when their balance sheet is strong, amassing war chests of cash rather than using the capital to fund operations. While most startups are still spending VC financing to grow organically, some companies are using their stockpiles to supplement their growth with external investments.

External investments by VC-backed companies come in a variety of structures, with startups dramatically increasing both acquisition activity and their own dealmaking into other startups. This elevated focus on external growth is further evidence of the broader changes in VC, principally at the late stage where companies are beginning to operate in a manner more typical of public companies. This evolution has ramifications for how investors approach the space.

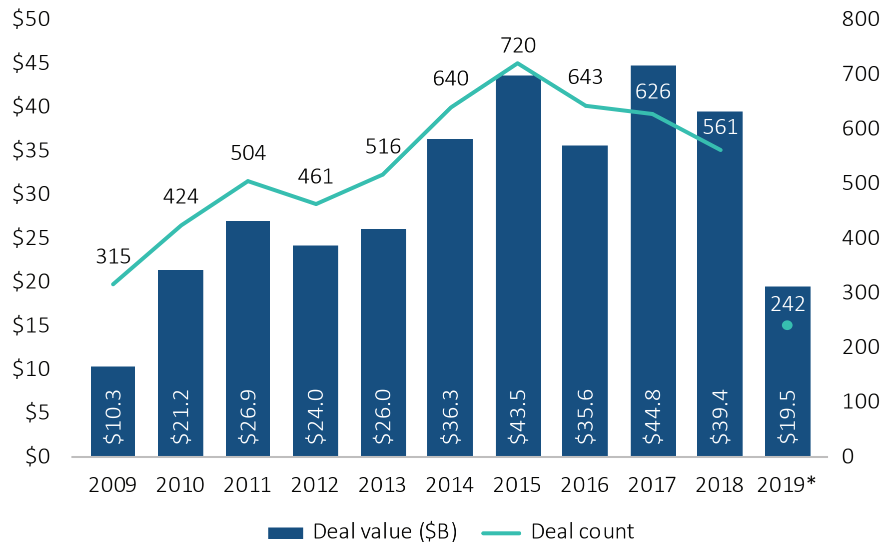
From an investor's perspective, owning equity in a VC-backed company that is an active dealmaker can add complexity, requiring the consideration of minority positions and the risks of properly integrating acquired businesses. The strategy considerations are particularly important, as the buy-and-build approach is not part of the traditional VC playbook and will have implications for the risk/return profile of the investment.

The prevalence of unprofitability in VC-backed companies also adds another layer to the analysis, with many of these external investments funded purely by VC raised by the acquirer, as opposed to internally generated funds, meaning the cost of capital is relatively high. In a sense, this is akin to the GPs sponsoring the acquisition or minority investment, similar to how a buyout firm would support an add-on for one of its portfolio companies. The difference is that while VC backers have some input in strategic decisions via board seats or general advisory relationships, they traditionally have less sway in specific strategic decisions than a PE backer or majority owners. Furthermore, the popularization of the "founder-friendly" approach weakens this link more by giving the founders broader latitude with respect to strategic decision making. In this note, we will examine how dealmaking by VC-backed companies has developed over time and the outlook going forward.

Acquisitions

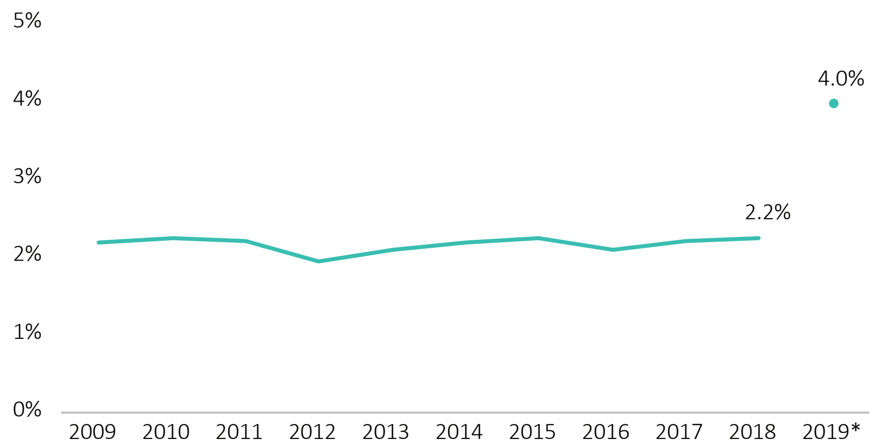
Although typically associated with more mature businesses, acquisitions are by no means a new strategy for relatively young companies. However, the explosion of capital in the venture space has made it easier for startups to begin acquiring. While not pacing for a sequential increase in M&A volume, VC-backed companies' share of total M&A activity by count has seen an uptick so far in 2019.

M&A activity by US VC-backed companies



Source: PitchBook | **Geography:** Global
*As of June 4, 2019

Proportion of M&A activity with US VC-backed investor participation



Source: PitchBook | **Geography:** Global
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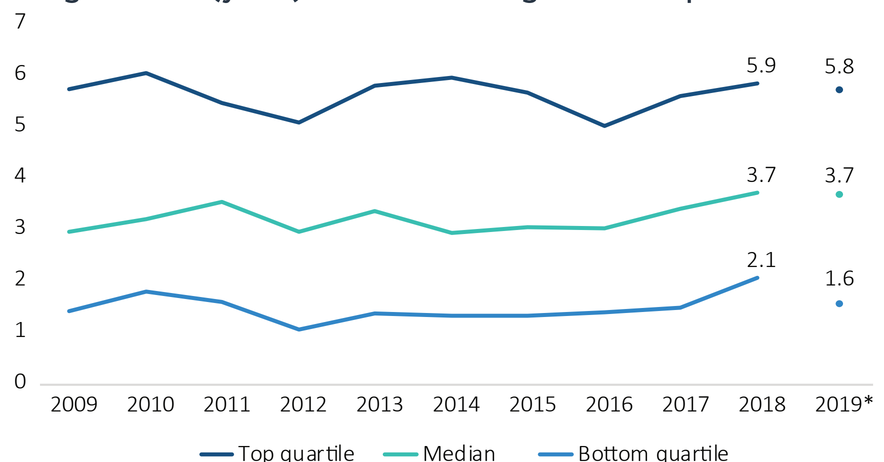
M&A activity by VC-backed companies accelerated quickly in the several years leading up to 2015, coinciding with a surge in VC investment. Investors seeking growth opportunities were driven to VC during the last decade as returns from traditional asset classes floundered. With this emphasis on growth from investors, valuation expansion for startups is primarily driven by the growth prospects, and companies sometimes must look externally to continue fueling expansion.

As a vehicle to achieve this rapid growth, acquisitions can represent an immediate boost to company scale by augmenting teams such as the salesforce or operations such as manufacturing capabilities, as well as achieving synergies to accelerate growth. These deals likely need to clear a high hurdle of potential value creation given the risk of this approach for a growing company, but in the case of a stagnating company, the deal may be critical to the future of the business and easier to rationalize. Furthermore, VC, which is relatively expensive on a cost of capital basis, is the principal source of financing for these transactions, which adds difficulty to reconciling the economics of the deals.

The median time between a VC-backed company's first financing and its first acquisition has remained relatively flat over the past decade. Despite the ability to raise more capital more quickly, companies aren't buying external businesses until three or four years after their first financing, representing a reasonable level of maturity. The data around average and median capital raised before first acquisition also suggests this maturity.

Range of time (years) since VC funding to first acquisition



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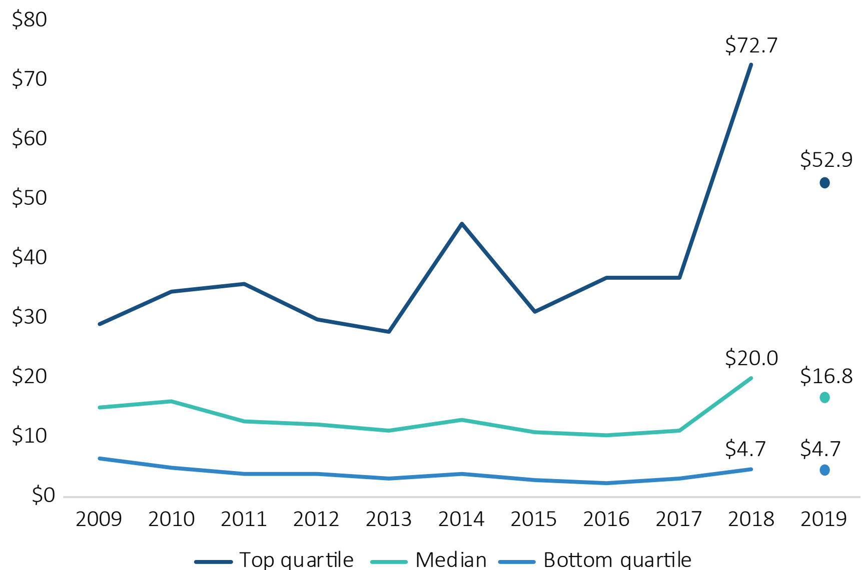

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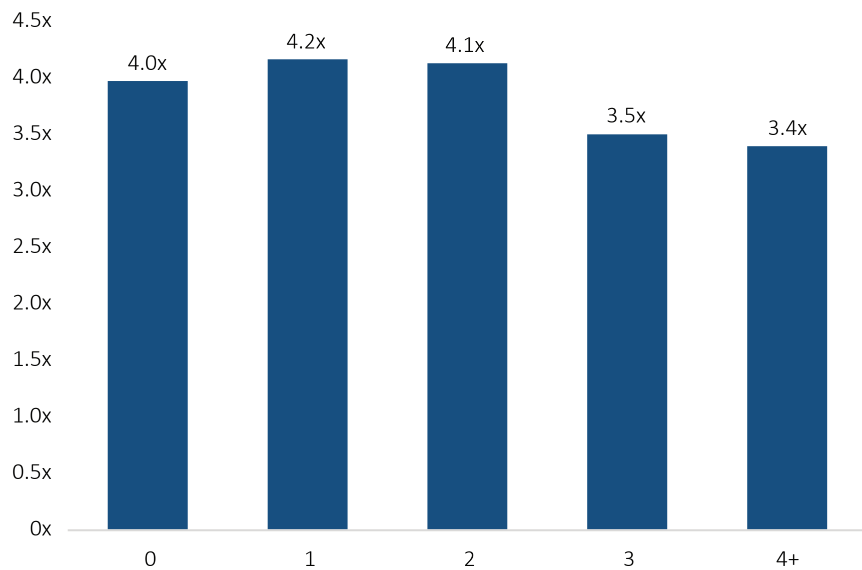
The amount of capital raised before a company makes an acquisition at the top quartile has more than doubled over the past decade to $72.7 million in 2018, mirroring the trend of larger deal sizes especially for late-stage businesses. While the age of companies and number of rounds raised by acquirers remained fairly constant, the scale and maturity of the most acquisitive companies in the last few years has dramatically increased. On the other hand, the median acquirer is raising slightly less capital than it has historically. We believe this dichotomy stems from acqui-hires and very early-stage acquisitions making up a significant portion of tracked acquisitions by VC-backed companies.

Acquisitions are without a doubt an avenue for growth, but they also invite plenty of complexity in valuing the combined business. To examine if acquisitive startups are treated differently, we looked at valuation step-ups bucketed by number of acquisitions between rounds. Completing one or two acquisitions corresponded to slightly higher median and average valuation step-ups compared to the non-acquisitive startups, suggesting some boost in scale or growth prospects from the dealmaking. However, moving toward the more active side of the spectrum, we start to see some deterioration in multiples. As a company makes more acquisitions, the risks to integration and financial success of these deals increase drastically, which can put pressure on the subsequent valuations. Questions also arise around why high-growth startups would choose to enact M&A at this pace. Typically, these companies should be growing

quickly enough to keep the focus on organic growth and improving the business model. To be sure, many of the possible reasons that a startup may feel compelled to engage in M&A—such as jumpstarting stalled growth, pivoting business models, or operating in an extremely competitive market—also double as factors that would drive valuation step-ups lower.

Average valuation step-up multiple by number of acquisitions made since previous VC round (annualized)



Source: PitchBook | **Geography:** Global
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Moving beyond the data, there are myriad reasons a startup would choose to pursue acquisitions. Predominately, motivations include boosting scale or growth within the main business line, making an acqui-hire, purchasing IP, adding a new business line and expanding into new geographies. While these are effective ways to scale a business, they don't come without risks. Overpaying for the asset is one of the main pitfalls, but more often we see anecdotes centered on the difficulty of integration. Mixing company cultures, retaining employees and realizing the synergies assumed in the reasoning behind an acquisition are exceedingly difficult endeavors, all of which can derail the best laid plans, especially when both companies involved are relatively young.

A whole host of the most recognizable startups are among the top all-time VC-backed acquirers, with Twitter, Facebook and Dropbox leading the way. These companies all share a few characteristics, including early fundraising success and a consumer-facing platform that can benefit from network effects, consistent new features

or operational improvements. For instance, before their first acquisitions, Facebook had raised more than $360 million, and Dropbox had secured $257.0 million. Twitter started acquiring earlier in its life with only $23.0 million in venture funding; however, this was followed up by a $102.0 million round a year later which began the company's accelerated pace of dealmaking.

Airbnb and The We Company are the two most active currently VC-backed acquirers, and they possess many of the same characteristics as their actively acquisitive predecessors. Both businesses have built a brand and a customer base around a core platform or product, and to achieve growth, the companies must increase the value of the network or expand the customer base, which happen to be key benefits of acquisitions.

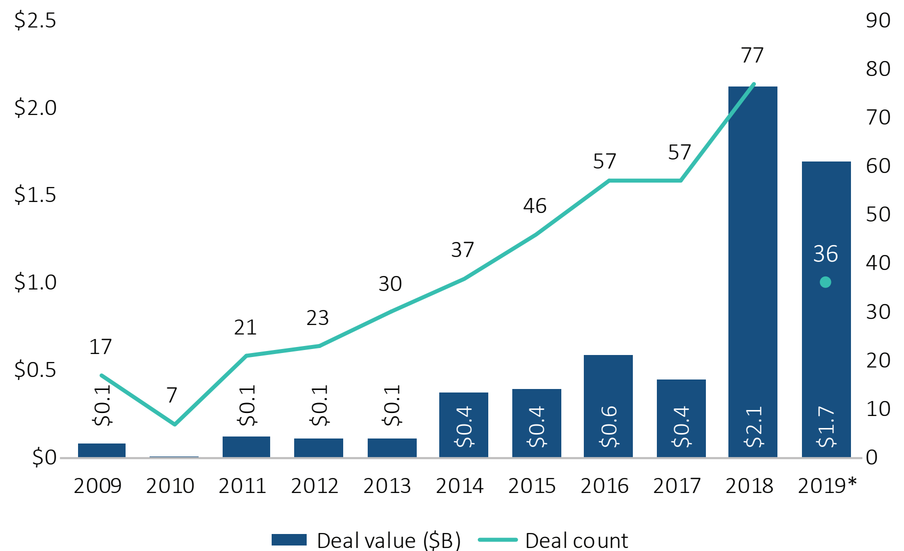
For these two companies, we've estimated the split of acquisitions related to the core business versus noncore to be about 60/40. This gives us a notable look at the trade-off these larger unicorns are considering when it comes to making acquisitions. While gaining scale and improving the core product is still a strategic focus, expanding into new adjacent businesses is a key portion of M&A activity for both Airbnb and The We Company. Buying technology or new capabilities via an acquisition is often timelier and more cost effective than building the same thing in-house. We see this in the data, as many of the large VC-backed technology companies utilize this buy instead of build strategy.

These high-flying unicorns also match the mold when it comes to capital raising. Airbnb began acquisition activity almost concurrently with a $112.0 million Series B, and the We Company raised nearly $1 billion before beginning its spree of deals.

Venture investments

A more nascent and smaller piece of this landscape involves VC-backed companies participating in VC investment into other startups. Corporate venture capital (CVC) has been an active strategy since the 1990s but has more commonly been utilized by established public companies to outsource innovation and supplement internal R&D. However, due to the aforementioned shifts in the VC ecosystem, companies are able to raise large sums of capital and grow larger in the private markets. Although VC-backed companies are still much more likely to acquire a peer than participate in a VC financing, activity has been on a steady uptrend since 2010, with 2019 on pace to set a new high for deal count.

VC deal activity with US VC-backed investor participation



Source: PitchBook | **Geography:** Global
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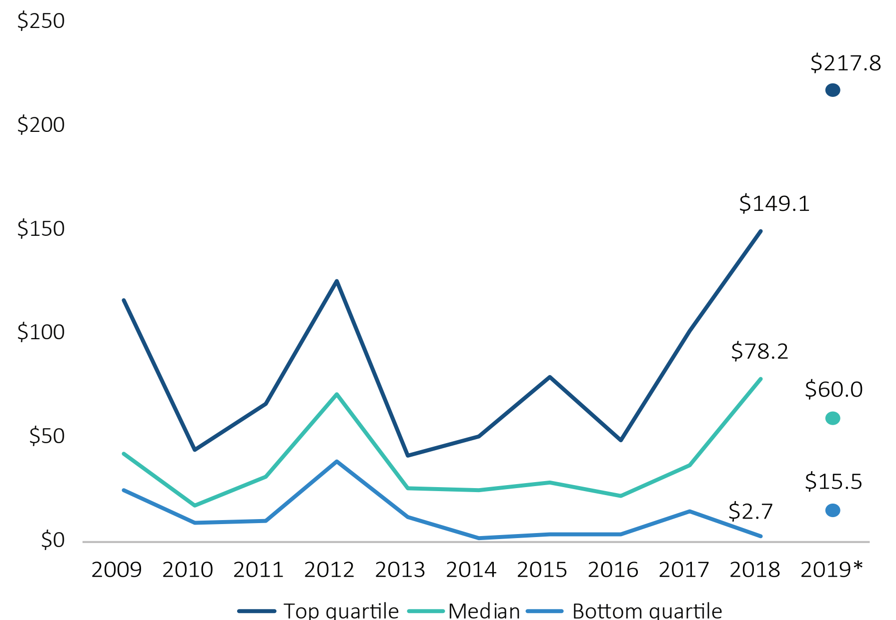
VC-backed companies have tended to make VC investments in seed and early-stage startups given the typically smaller check sizes, but capital investment has skewed to the late stage, which comprised 68.4% of deal value with VC-backed company participation in 2018. This trend matches what we see in the broader venture market with a small group of investors at the top of the market driving an outsized portion of capital investment.

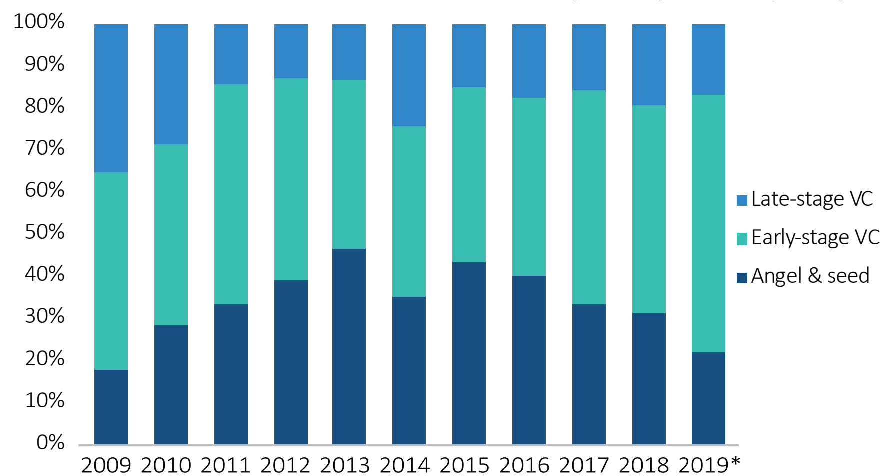
Range of VC raised ($M) prior to first VC investment



Source: PitchBook | **Geography:** Global
*As of June 4, 2019

Relative to acquisitions, minority deals are a lower commitment option in terms of time, capital and resources, enabling some economic interest in the outside business without the full integration timeline or cost that acquisition entails. With this level of involvement, many strategic benefits such as partnerships, product integrations and innovation can still be realized with less financial risk. We see this as a major tailwind for increasing volume of VC deals with private company participation, especially when coupled with the increased age and maturity of companies that remain under VC backing.

VC deals (#) with US VC-backed investor participation by stage



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The only two VC-backed companies that have participated in more than 10 VC deals are Slack and Coinbase, each of which takes a decidedly different approach. Slack is far and away the most active with participation in 51 deals, mostly tied to the company's dedicated investment fund, known as the Slack Fund. The Slack Fund's stated strategic angle is to invest in businesses that are making Slack integrations a core part of their product. Most of Slack's deals have gone into seed and early-stage rounds, as the fund is relatively small compared to both the broader venture space and to the over $1 billion in capital that Slack has raised since founding. This strategy is extremely similar to what Salesforce has fostered with Salesforce Ventures, emphasizing investments in companies building integrations or apps on the Salesforce platform.

A large portion of the Slack Fund's capital comes from external LPs, which differentiates the strategy from the traditional CVC model that invests capital from the parent company. The fund was filled out only by existing investors in Slack (Accel, Andreessen Horowitz, Index Ventures, Kleiner Perkins, Social Capital and Spark Capital). Slack's unprofitability adds an interesting dynamic, given Slack's

commitment to the fund is comprised of capital those investors had invested earlier into the business. Making these external investments alongside existing backers can help the company to mitigate some of the potential conflicts around common ownership of both companies involved in one of these transactions.

Coinbase's 10 VC investments have been very closely linked to the company's operation in the cryptocurrency and blockchain space. As one of the early consumer cryptocurrency companies to achieve scale, the company has used that position as a platform to invest in related and tangential companies in the blockchain ecosystem. This position in the industry makes Coinbase uniquely qualified to evaluate other entrants in the ecosystem, potentially an edge enabling the company to compete against traditional VCs in the space for financial returns. Given the nascence of this technology and the general trends we see with these investments, Coinbase's VC investments have been nearly all at the seed and Series A level.

The speed at which the company made these deals is also notable, with this flurry of dealmaking all taking place in the last eight months of 2018. Interestingly, this corresponds with the period directly after the sharp decline of the prices of bitcoin and other major cryptocurrencies, when sentiment surrounding the space was turning distinctly negative. By investing in businesses during a downturn, Coinbase was able to offer some support for the ecosystem and potentially invest in compelling businesses at attractive valuations.

The circular aspect of a company using VC dollars to invest in VC deals brings up some questions about the efficiency for GPs that suddenly have minority interests in startups in which they didn't directly invest. While this will usually represent an exceedingly small position in the context of a GP's larger portfolio, conflicts may begin to arise as this activity becomes more commonplace. The investments by portfolio companies could serve to further concentrate an existing position, initiate a position in a company competing or conflicting with existing investments, or just generally add unwanted exposure.

For instance, Sequoia and Kleiner Perkins have both invested in Airbnb as well as female-focused co-working and social club startup The Wing, which just added Airbnb as an investor in December 2018. In this case, Sequoia and Airbnb both participated in the Series C, suggesting Sequoia was aware of the extent of its exposure and potentially consulted with Airbnb about the investment given Sequoia's seat on Airbnb's board. But the potential for conflicts in similar situations is evident.

Conclusion

With no immediate catalysts to disrupt the VC funding environment, we believe the focus for VC-backed companies will continue to be heavily weighted toward growth. Given the availability of capital, companies can invest beyond internal sales & marketing or R&D to achieve scale, exploring strategic investments outside of the company. With much of the low-hanging fruit secured, finding new innovations, niches and geographies through M&A or VC investment becomes more attractive.

With the top-quartile VC-backed company in 2018 raising $72.7 million before making an acquisition and with a median of $78.2 million in capital raised before making a VC investment, companies that complete a $100 million deal are likely candidates to start making these external investments. Deals of this size used to mainly fall in the domain of the public markets. However, now that these transactions are becoming more common within VC, it's logical that we've recorded elevated dealmaking activity by VC-backed companies. At the level of maturity and scale that companies completing these deals have achieved, it also makes sense for them to look externally to drive continued growth. Due to the confluence of these factors, we expect external dealmaking activity by VC-backed companies to increase in volume over the short term as these companies fully realize the opportunities.