PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Senior Director, Institutional Research & Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis

Cameron Stanfill, CFA
Senior Analyst, Venture Team Lead
cameron.stanfill@pitchbook.com

Data

Alex Warfel
Quantitative Research Analyst
Susan Hu
Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Julia Midkiff**

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IPOs Stall and Valuations May Fall as Bullish Decade Closes

Investigating the VC valuation and liquidity climate in the face of shifting market conditions

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

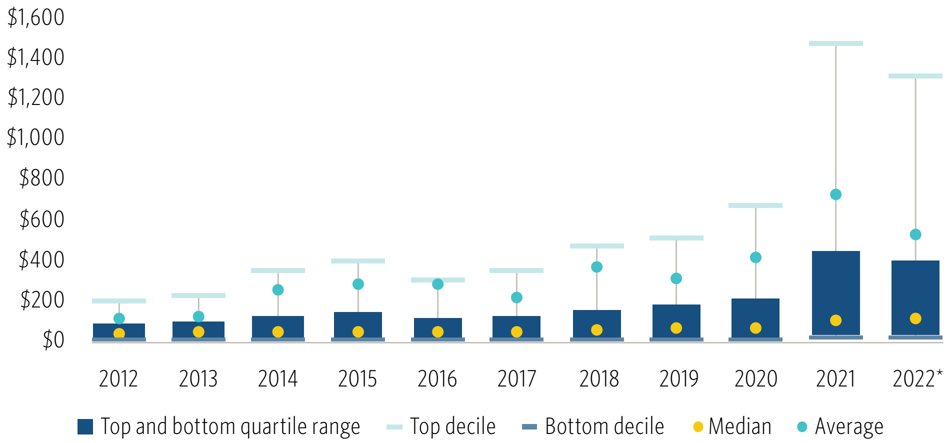
Will valuations ever fall?

Valuations are again the trending topic within the venture capital (VC) market; however, the narrative has gone from gawking at the rapid growth toward fearing for an imminent collapse. The rout in public equity prices, which has been especially concentrated and vigorous within the technology sector, has brought intense scrutiny to the valuation multiples of growth assets that have swelled during the post-pandemic recovery. This valuation climate of 2020 and 2021 implied perfect adherence to long-term growth targets, but the onset of significant inflation and subsequent increase in interest rates have challenged the feasibility of those future revenues and cash flows, causing the repricing we're seeing now in public markets.

A sharp, unexpected rise in interest rates is not favorable for companies that rely on cash flows far into the future to justify their current market capitalization. But this phenomenon became the norm over the past couple of years as the Federal Reserve's aggressive asset purchasing policies and near-zero-reference interest rate incentivized risk-on investing to find investment returns. This phenomenon was a key driver in the massive expansion of dollars flowing into the VC strategy, pushing annual capital investment from $88.4 billion to $342.2 billion in a matter of five years. This influx of investor demand with a relatively steady level of companies seeking to raise capital has fostered the consistent growth in VC valuations from 2017-2021. As the cycle seems to finally inflect away from that low-inflation, low-rate reality from the period following the global financial crisis, we expect a reduction in marginal demand for VC assets, allowing for some mean reversion of valuations.

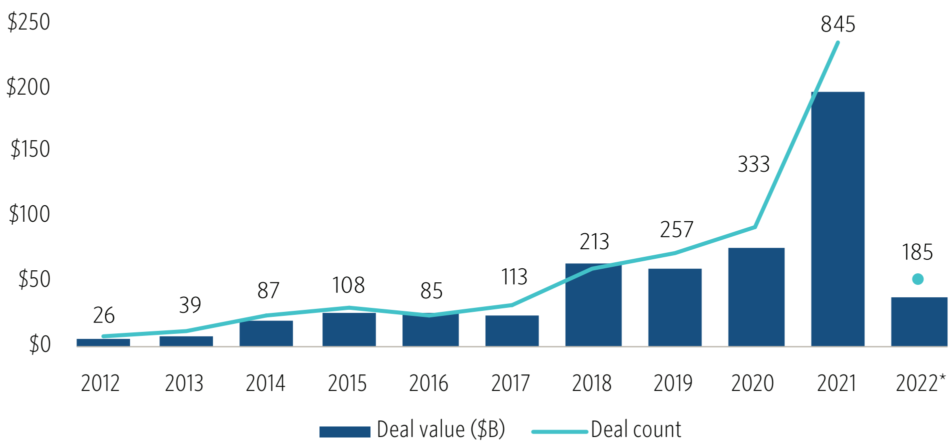
Late-stage VC, as the target of much of the new capital available to VC as well as being the group of businesses with the closest proximity to public comps, is in the crosshairs of many of these changes. With most of the VC space, we still seem to be in a wait-and-see pattern at least as of the end of Q1. Our just released US VC Valuation Report has yet to show any significant declines because of the illiquidity private ownership affords these companies as well as the slight lag in data collection. For example, median pre-money valuations in Q1 2022 are broadly flat relative to 2021 for most segments, except for late-stage VC, which has already started to display some signs of valuation decreases at the median. This cooling is even more clear when looking at the average valuation since this figure is affected more by outlier transactions such as unicorn ($1 billion+) creations and mega-deals ($100 million+), which have started to slow significantly.

Late-stage VC pre-money valuation ($M) dispersion



PitchBook US VC Valuations Report | *As of March 31, 2022

US VC mega-deal activity



PitchBook-NVCA Venture Monitor
*As of March 31, 2022

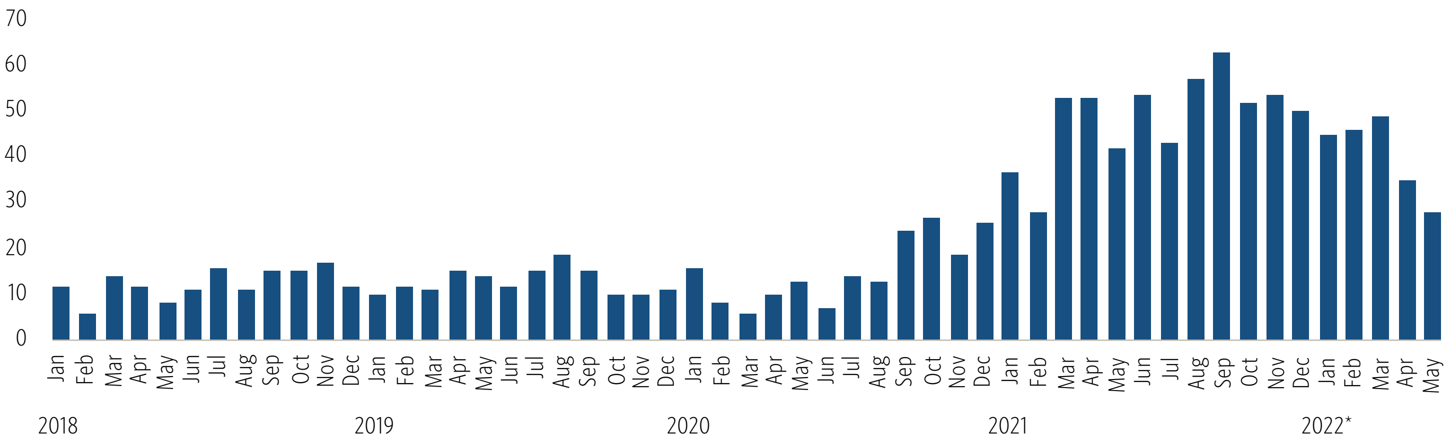
For the rest of the VC ecosystem, that represents companies earlier in their maturity. There are multiple levers that can smooth some of the volatility experienced by broader markets. This is one of the key benefits of illiquid private equity strategies. Given that valuations are typically only set with new fundraises, startups can find creative ways to extend runways, perhaps opening previous rounds to raise capital on similar terms and valuations or taking on non-dilutive financing such as venture debt. Outside of internal controls, startups are also able to control valuations by the deal terms included in their capital raises, specifically by adding greater investor protection. We believe that more of these protectionist deal terms will emerge in the coming quarters, especially if the downturn extends or deepens over the next six months. VC investors are the other party involved in these fundraising negotiations, and many of these GPs may see a downturn as an opportunity to gain back some control over deal terms that were ceded to companies during the easy money times of the last few years. These protectionist term sheets and concessionary behavior, which serve a short-term function to save face and avoid down rounds, can quickly turn into a slippery slope for startups. These terms can muddy the cap table, causing knock-on effects such as increasing the difficulty to attract new investors to join in on future fundraises or in the worst cases, forcing liquidity decisions that aren't ideal for all insiders, including LPs, GPs, and especially equity-holding founders and employees.

Despite the tendency of VC's illiquid nature to smooth market troughs and blips, the seeming duration of this valuation reset and Fed action makes the effect likely to eventually trickle through to VC-backed businesses even at the seed and early stages. It may appear in next quarter's data or possibly later, given the pace of dealmaking and data collection.

The reality that public valuation multiples have dropped to their current levels cannot be ignored or dodged forever by private investors and startups. There will not be a complete lack of funding for startups, as the stores of dry powder will continue to support fundraising. However, new conversations around capital raises are undoubtedly being negotiated within the context of this new normal, as exit-multiple assumptions are necessary even at the earliest investment stages.

For startups that are nearing an exit or facing pressures from early investors and employees, the realities of the valuation environment are even more top of mind. The issue here is that institutional investors are leaning away from the full risk-on mode we experienced in 2021, which makes finding providers of liquidity much more difficult—especially if the multiple contraction remains the new normal over the next six to 12 months. For instance, exit opportunities such as IPOs have already seen a serious pullback since the end of 2021, and massive crossover VC rounds that could provide secondary liquidity are beginning to decline in volume as asset managers retrench in the face of the current volatility. These liquidity transactions can also be complicated if the deal is anchored to a price or multiple that is no longer the market rate, but insiders want to avoid a negative revaluation.

Global unicorn creation by month



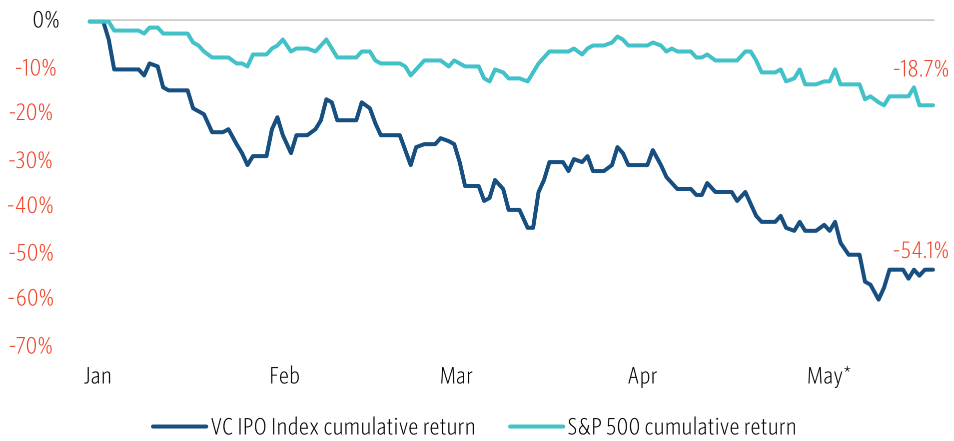
Source: PitchBook | Geography: Global
*As of May 20, 2022

Will liquidity come back?

While VC dealmaking and fundraising activity are more insulated from short-term fluctuations, the exit markets experience a much more direct and swift effect from a correction in public markets. This is especially true for public listings, as we've seen new IPO issuance slow to a trickle, especially for any listings of over $1 billion, and even deSPAC (special purpose acquisition company) activity of VC-backed businesses has retracted relative to the pace of 2021. After the frenzy of public listings in 2021 it was likely that 2022 would display a slowdown on a YoY basis, especially in terms of exit value. The onset of negative pressure on public equities has undoubtedly steepened this decline with just 14 IPOs closing in Q1—only one of which was over $1 billion in value at the time of listing.

This slowdown has mirrored the performance of broader equity markets, but particularly performance of young, growing businesses, which is shown in our PitchBook VC IPO Index. The year-to-date performance of our VC-backed IPO index has retrenched 54.1% since the beginning of 2022 relative to the 18.7% decline of the S&P 500. This illustrates the bifurcation of the market into growth and non-growth assets, where those assets receiving the growth demand were priced at historically high valuation multiples, which has led to a disproportionate effect on pricing amid a climate of rising interest rates.

PitchBook VC IPO index vs. S&P 500

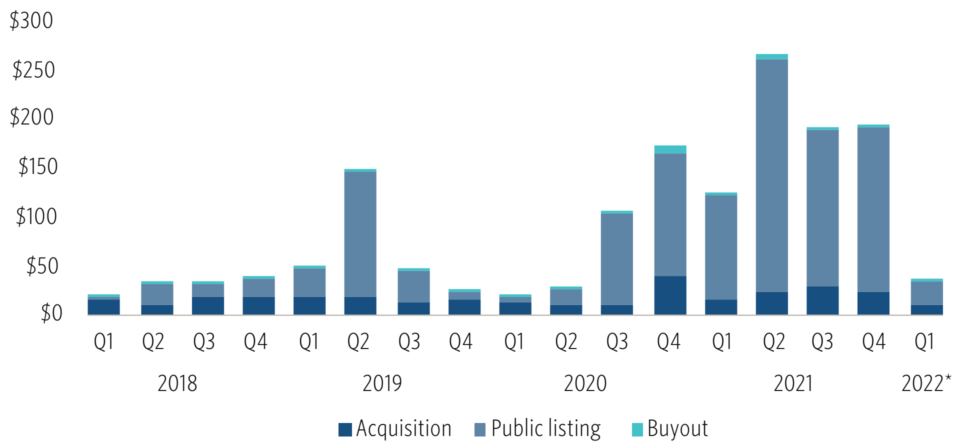


Source: PitchBook | Geography: Global
*As of May 20, 2022

SPACs have also fallen on tough times from an aftermarket performance standpoint as well as from a multitude of indications that SEC regulation of the SPAC vehicle will be approved shortly. From the VC perspective, a key piece of that regulation has to do with safe harbor protections that currently cover deSPAC transactions and allow for future projections to be used in those filing documents without legal liability. Losing those protections would remove a key benefit for private companies considering a deal with a SPAC, especially for the cohort of VC-backed businesses that are lower on the maturity spectrum or operate in a deep tech industry that requires longer research and development processes and large capital expenditures. Furthermore, Goldman Sachs and others have announced their plans to pull out of the SPAC underwriting market in another blow to the struggling market.

But there is some light in the darkness, specifically around those SPACs still without a deal. Since the capital has already been raised in the SPAC IPO, the sponsors of these vehicles don't need to price a new issuance into the market. They just have to convince the current SPAC shareholders to approve the announced deal. Shareholder buy-in is key given the elevated redemption rates that many recently announced deSPAC transactions have encountered, which could potentially endanger the deal closing. The good news is some of these SPACs may be able to get a deal done with a private company over the next few months at a more favorable entry valuation for shareholders—compared to what we saw during 2020 and 2021—as long as there are companies willing to accept these lower valuations. However, we still expect a significant portion of SPACs in market will not find a deal and end up returning capital to IPO buyers.

Quarterly US VC exit value ($B) by type



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Not to leave out strategic acquisitions, but this is the most stable group of the bunch. The acquisition count through Q1 2022 set a healthy pace, with just a slightly tempered acquisition value closer to the levels we saw in Q2 and Q3 of 2020 during the onset of pandemic uncertainty. Most strategic acquisitions in the US occur after the company has raised seed through Series B rounds, so this activity typically tracks the early-stage markets, which are better insulated from drastic valuation haircuts than companies that pursue a public listing.

What's next?

Timing the ebb and flow of exits will be crucial to the overall health of the VC market over the next few years. Funds have fixed lives, and LPs expect to get a return on their investment—a business reality that can discourage backers from holding stakes in great companies in perpetuity and reaping the rewards of patience and compounding growth. Sequoia is trying to circumvent this pain point with its new permanent fund structure.[1] But for the rest of the market, exits are the beginning of the return cycle on the VC market wheel of capital—meaning an extended period

1: "The Sequoia Capital Fund: Patient Capital for Building Enduring Companies," Sequoia, Roelof Botha, October 26, 2021.

with few to no exits of the scale to which the market has become accustomed could have some very detrimental ripple effects on VCs' ability to fundraise and in a worst-case scenario, decrease capital availability to startups years down the line.

The drastic decrease in purchaser demand for new listings is perhaps the crux of this argument and is specifically concerning for VC relative to other private market strategies given that around 90% of all dollars exiting VC since 2019 have come from the IPO market. These exits were a key part of the elevated VC fund returns we saw over those same years, which drove a significant amount of capital into the space from nontraditional investors as well as LPs increasing commitments. In the bear case, 12 months or longer without a material amount of liquidity for the swelling number of unicorns sitting in VC portfolios would likely result in some fairly serious valuation haircuts. A handful could find themselves priced back below $1 billion. Exit markets provide a third-party validation of private company valuations, and if that function pauses for more than a year, we would anticipate an uptick in down exits and rounds, as delays or repricing of comparable transactions could force some private companies' hands.

In practice, the health of VC exit markets over the next few years will land somewhere between the best- and worst-case scenarios. A multitude of high-performing, innovative, and transformative businesses operating under VC backing will find financing partners and continue to flourish even in the face of a recession. These types of investments, as usual, are the home runs that drive VC returns in all stages of the business cycle. Longer hold times could put some pressure on returns, but we believe VC investments will be able to weather the storm in the medium term. We also believe M&A activity from mega-cap tech companies may accelerate over the next 12 months as those public businesses use war chest cash to pick up key strategic add-ons at attractive entry points.

We've essentially reverted to pre-pandemic levels or onto what is probably a more sustainable growth trajectory for VC as an investment strategy. There was a mismatch of capital supply and demand in the venture market that was exacerbated during the last two years; however, it is normalizing back to what we see as a steady-state growth rate. There is certainly the possibility that liquidity crunch in other asset classes could pull VC activity below this steady-state growth rate over the next few years, but we believe the strategy has reached a size and maturity that help insulate VC investments from completely drying up regardless of the macroeconomic climate.

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