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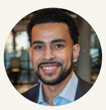

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The Collapse of Silicon Valley Bank

SVB was an integral piece of VC, and its failure will have large impacts on the market

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

Key takeaways

- Over the course of nearly 40 years, SVB has solidified itself as the leading lender and banking partner for many successful venture startups. This brand recognition and trust resulted in SVB amassing more than $175 billion in total deposits by the end of 2022; however, as liquidity options for many startups dried up, these enterprises began to heavily rely on fund withdrawals from their bank accounts to extend runway. To fund these withdrawals, SVB was forced to sell a large amount of US Treasuries and other securities, which had become devalued due to recent interest rate hikes. Fearing for the safety of their capital, depositors began to withdraw their funds en masse. Ultimately, SVB was unable to fulfill withdraw requests, and the bank was seized by the FDIC on March 10; fortunately, the Fed assured all depositors that 100% of their capital would be safe and accessible as of Monday.

- The failure of SVB puts more pressure on a venture market that was already reeling from the slowdown in financing seen over the past year. Quarterly capital invested had fallen more than 60%, and deal count, while high on a relative historical basis, was down nearly 25%. The reallocation of resources and banking that may need to be done will only add to a slowdown in a financing market that was looking set for another soft quarter in Q1 2023. A large portion of the bank's loans were to GPs in both VC and PE. The credit allowed these funds to quickly access capital for deals, creating a more seamless investment market.

- The lightning strike of SVB's collapse led to concerns over a possible contagion effect on other regional banks collectively suffering from the same type of unintended consequences of the Fed's interest rate hikes. Now that the lender of choice for many investors for decades is suddenly gone, we expect to see startups and investors looking to raise funds from nonbank lenders. While it remains unclear what will happen to companies with existing loan contracts with SVB, as an acquisition is yet to be announced, should VC-backed startups rush to raise debt from nonbank entities, competition for loans may push prices higher.

- Even though SVB's venture debt portfolio wasn't the primary cause of the bank's abrupt fall, the critical role the bank has been playing in venture lending sounded alarms to active players in the venture market. For example, Hercules Capital, one of the largest business development companies focused on venture lending, released a business update in response to SVB's collapse on Monday morning. Venture debt lenders will likely receive an intensified number of inquiries and closer scrutiny in the short term.

Silicon Valley Bank is gone

The collapse of Silicon Valley Bank (SVB) was sudden. The full weight of what the failure means for the venture market might not be known for a while, and it is likely that fallout will trickle on for some time as the market unweaves itself.

SVB was not only the bank of nearly 50% of the tech and life sciences startup market in the US, but also a lender to many VC-backed companies, as well as the short-term financing provider to VC and PE funds through capital call lines of credit, among other products. The bank's reach was far beyond the US. SVB UK was shut down last week. Companies and investors across the globe relied on SVB to be their trusted partner within VC. Because of this high number of market touchpoints, the impact of the downfall will cast a wide net.

Looking at the evolution of the collapse, several factors worked in tandem to create the imbalance leading to the bank's downfall. The venture market itself has gone through much tribulation over the past 12 months, but the start of the situation was the massive increase in bank deposits through 2021. More than $750 billion was invested into US-based tech startups alone over the past three years. The rise of this activity led to major inflows that tripled SVB's deposits, which was good for the bank. But these interest-bearing liabilities increased so swiftly that SVB needed to recalibrate its portfolio. This year, the slowing market and shift in interest rate environment combined to work against the bank.

The bank run on Thursday, March 8, was enormous, fueled by fears of exactly what became the eventual product of the situation. The bank was seized by regulators on Friday after $42.0 billion in client withdrawal requests on Thursday left the bank insolvent.[1]

SVB's CEO noted in an analyst call that the continued cash burns of startups banking with the company, alongside the slow financing environment that has prevailed over the past year, led to slowing inflows. There is no indication from the current details of the collapse that companies that had banked with SVB are struggling on a large scale. However, just 2.3% of the deposits were FDIC insured, creating a real, immediate problem for companies that were unable to withdraw their money and needed that cash to fund near-term obligations such as payroll.

The market received a bit of calming news on Sunday night, when the Fed, US Department of the Treasury, and FDIC announced that all cash would be available for SVB depositors on Monday morning. In addition, SVB UK was purchased by HSBC UK, stemming fear of fallout there. As of this writing, a new buyer has not been announced for the US bank, but the backstop financing from the US government will allow companies to operate as normal for the time being. The step seemed to be a necessary crutch to avoid systemic failure. Signature Bank has also been seized by the government, and other regional banks are facing steep selloffs in the public market.

1: "Silicon Valley Bank: Order Taking Possession of Property and Business," Department of Financial Protection and Innovation of the State of California, March 10, 2023.

Because SVB was set up to focus on the startup market, it offered a suite of products to clients at which larger banks had balked. Venture debt, a growing source of financing in VC over the past few years, was a centerpiece of the bank's strategy toward startups. But the bank also held cash from venture funds and offered lines of credit to funds to pace commitments and quickly complete deals without calling down capital. These are just two of the support lines the bank offered the venture market, and the changes that will result from its collapse will likely alter the nature of the venture market.

What happened to Silicon Valley Bank?

Founded in 1983, SVB has been a leading lender in the venture ecosystem and has grown to become the 16th largest bank in the US with $212.0 billion in assets and approximately $170 billion in total deposits.[2] Like other banks and financial institutions, SVB used client deposits to purchase large amounts of securities—including US Treasuries (USTs) and other government-sponsored bonds—to meet minimum fund reserve requirements. According to SVB, 55% of its assets were in "high-quality" fixed income securities, the vast majority of which were in USTs and securities issued by government-sponsored enterprises.[3]

In March 2022, the Fed began raising interest rates from recent near-zero levels in an effort to battle raging inflation. Given the inverse relationship between interest rates and bond prices, this rate hike devalued many outstanding fixed-income instruments such as USTs and agency securities. Additionally, these rate increases put severe pressure on earnings and growth projections for public and private enterprises alike, leading to stark valuation declines and a frozen exit environment for many private startups.

The amalgamation of these two consequences severely affected SVB's balance sheet. As avenues for liquidity began to dry up and the cost of fundraising increased, many of SVB's depositors started to withdraw funds to meet liquidity needs and extend runway. Given current market conditions, this was to be expected, and financial institutions ideally have the necessary reserves and controls in place to fund client redemptions. In SVB's case, however, higher rates have significantly lowered the value of its secondary reserve portfolio—largely comprising USTs and other securities—which meant selling the underlying securities to fund withdrawals would lead to significant losses for the bank.

Indeed, on March 8, in an effort to reposition its balance sheet and fund redemptions, SVB sold a $21.0 billion bond portfolio with an average yield of 1.79%—well below the current 10-year Treasury yield of roughly 3.7%. This resulted in a realized loss of $1.8 billion (after-tax) and prompted many SVB depositors to withdraw funds. Hoping to quell fears and meet growing liquidity needs, SVB's parent company, SVB Financial Group, announced a $2.25 billion share sale on Thursday. Despite best efforts, the threat of additional deposit withdrawals, which necessitated an additional capital raise, kept potential buyers at bay, and SVB's shares traded down 60% by the end of Thursday.

2: "Strategic Actions/Q1'23 Mid-Quarter Update," SVB, March 8, 2023.
3: Ibid.

Ultimately, the sale was called off on Friday, and regulators—unwilling to wait for potential buyers to come along and looking to protect clients—closed the bank and placed it under the control of the FDIC. Now in receivership, SVB's insolvency is the second-largest bank failure in US history, and given 93% of its client's deposits are uninsured, many depositors were unsure how much of their capital they will be able to recover. While no buyer has been announced for the US operations, the Fed, FDIC, and Treasury Department assured depositors their cash would be available, quelling fears of mass startup failures for the time being.

Immediate impact to the VC market

Inaccessible bank accounts would have led to an immediate existential crisis for startups that kept operating funds with SVB. The VC market had already been in a troublesome spot because of a severe lack of available capital resulting from the slow funding environment. The good news from Sunday was that companies would have access to the full amount of their deposits on Monday, ensuring a healthy operation could resume.

Without a backstop financing solution, the inability to access capital immediately would have put enormous strain on a large swath of startups. Within the $152.0 billion of SVB's uninsured deposits is company operating capital for many startups. Regardless of whether all that capital is recovered or not down the road, there was an immediate operating problem for companies that needed to make payroll or pay for the use of services. The impact of losing access to these funds would not have been limited to company shutdowns; investors would have been harshly affected by the loss of portfolio companies. These losses almost assuredly would have led to limited partners losing faith in the venture market, resulting in fewer investing vehicles and a further, steeper drop in near-term venture funding.

The worst-case scenario for individual companies in this situation will be failure. We have noted that investment levels remain high on a deal-count basis relative to any year outside of 2021, and there is a lot of dry powder. But even if those are both true, there has been a significant decline in the market—deal value has declined by around two-thirds over the past four quarters—and investors continue to clutch to dry powder. This event will only increase cautionary activity. The market in 2023 is very different from 2021, and there is no sense that there would have been savior capital waiting for struggling companies needing quick capital for operations. Q1 2023 is looking to be similarly low in terms of dollars invested as Q4 2022, and there is little indication the IPO market will pick up any time soon to relieve pressure building within the market.

Although SVB's venture loans were not the problem, they did carry the need for borrowers to move all banking services onto its platform. Moving funds to a solvent, well-respected bank—as SVB was believed to be—was an easy decision, and the idea that access to those funds would evaporate should have been nonexistent. SVB's lending platform was large, and even though less than 20% of its book value went to startups and VC-backed clients, the number of tech and life sciences startups it brought into its fold was enormous. With so many companies now facing the inability to access funds, SVB's venture lending platform has inadvertently exposed the market.

Again, venture debt from SVB was not a large part of the total venture market. The more than $1 trillion invested into the global venture market over the past few years was mostly equity capital. Yet the added lack of capital to early-stage startups will hurt. Debt was an insurance lever for companies adding fuel to growth, especially in a slowing market where the difficulty in raising a new round has increased substantially.

The current situation poses several new risks for managers as well, including concerns for deposited LP capital, access to capital call lines of credit, and capital committed to funds by SVB Capital. While VCs do not call the entirety of a fund's LP commitments down at one time, they will draw down most of the capital during their investment period, which traditionally spans two-to-three years. By cross referencing the data compiled by Castle Hill Diligence on VC and PE firms storing at least a portion of their assets at SVB with PitchBook's platform, we identified 240 US-based firms with exposure, including some of the largest names, such as Sequoia Capital, General Catalyst, Kleiner Perkins, and TCV. In the last three years the 240 identified firms raised $86.8 billion across 417 funds, leading us to believe a sizeable portion of capital could have been held as deposits with SVB. SVB not only was a choice bank of established managers but also assisted emerging managers as they entered the ecosystem. Over the last three years the 12 emerging managers listed on SVB's website closed 27 funds with commitments totaling $1.3 billion. The largest and most established managers are better positioned to endure the uncertainty that will reign pending acquisition of the SVB's US subsidiary, but emerging managers with limited investment track records as well as fewer and smaller-sized funds could have their relationships with LPs strained, damaging their ability to raise new funds.

Tandem to SVB banking services offered to VCs was its capital call lines of credit afforded to managers to bridge the time between investments and calling down investor capital. In 2022 SVB extended capital call lines of credit to VC and PE firms, referred to as Global Fund Banking Loans, totaling $41.3 billion or 56% of its total loan portfolio.[4] These loans allowed VCs to invest efficiently and achieve a record-breaking amount of deal activity in 2021 and 2022. With SVB in receivership and set to be acquired, fund managers may not be able to secure the same amount of credit—or as frequently—and deal activity could slow even further. Moreover, 55% of the Global Fund Banking Loans were to funds based in California, Massachusetts, and New York, areas widely considered mainstay venture capital markets in the US. The questionable access to future loans could dramatically impact deal making efficiencies in those markets.

Still to be determined is how the collapse will impact SVB's investment arm, SVB Capital, which has roughly $9.5 billion in assets under management, spread through investments and fund commitments. SVB Capital has previously made commitments to 15 major VCs,[5] and while the amount of its current commitment is undisclosed, its situation now poses a risk for these funds and SVB Capital's underlying portfolio companies. It is unlikely SVB's acquirer will be obligated to meet its commitments to VCs as well as provide capital to portfolio companies, which would put further pressure on the market.

4: "Form 10-K: SVB Financial Group," US Securities and Exchange Commission, December 31, 2022.
5: "Opening Doors to Innovation," SVB Capital, 2023, accessed March 13, 2023.

In total, SVB is much more to the venture market than a bank. The problems that will continue to surface from the collapse will impact all participants in the market, with knock-on effects reaching beyond the depositors.

Implications for the venture lending market

SVB has been one of the largest and longest-standing loan providers for tech and healthcare startups in the US. The sudden collapse of a bank that has been vital to the US startup ecosystem for nearly 40 years carries significant implications for venture debt.

Venture debt has been growing in popularity as an alternative form of financing over the past few years. Many lenders reported record loan originations and performance in 2022, a time during which more venture-backed startups looked to raise this nondilutive form of capital amid slashed valuations and diminished capital supply. The abrupt fall of SVB significantly impacts VC-backed startups that currently hold a loan contract with the bank, especially when it is unclear when the bank will be sold and whether existing loan terms and conditions will be honored when an acquirer steps in.

SVB had provided debt solutions to startups across the venture ecosystem, ranging from pre-revenue, early-stage startups to late-stage ones with up to $75 million in recurring revenues. In 2022, SVB issued $6.7 billion of venture debt, making up 9% of its loan portfolio.[6] This type of debt is categorized as "investor-dependent" (ID), meaning that loan origination is contingent upon the existing investors' commitment to a company's future success. The bank's collapse has had a particularly detrimental effect on early-stage startups that have yet to develop strong financial metrics and largely rely on their investor syndicate to secure debt. For years, startups in nascent stages of development had access to term loans from SVB with low interest rates and ample structural flexibility. With its collapse, early-stage startups without a steady revenue stream are likely to encounter severe headwinds seeking alternative means of debt financing. Late-stage companies, on the other hand, face a different set of issues. Not only do these companies require larger size loan packages, which makes borrowing from debt funds even more costly, but the private credit market, which is a major player in debt financing for companies operating at a more developed stage, also faces market uncertainty, adding another layer of challenges.

Percentagewise, the bank has been shrinking the weight of its venture debt portfolio over the past couple years as a risk-hedging mechanism, citing that its early-stage ID loans have historically been its highest risk portfolio.[7] In 2017, investor-dependent loans made up 16.5% of its total loan book.[8] The figure slid to 11.0% in 2020 and landed at 9.0% in 2022.[9] The consistent drop illustrates adjustments the bank made in response to the perceived risks of lending to startups operating in nascent stages—SVB had been growing its loan book well outside of venture debt—but also that venture lending grew at a more tempered pace than the broader venture

6: "Form 10-K: SVB Financial Group," US Securities and Exchange Commission," December 31, 2022.
7: "Q4 2022 Financial Highlights," SVB, January 19, 2023.
8: "Form 10-K: SVB Financial Group," US Securities and Exchange Commission," December 31, 2022.
9: Ibid.

market. Although its venture loan portfolio was not at the heart of SVB's fall (in fact, lenders collectively have become more prudent during the market downturn by only lending to highly liquid companies with the strongest financial prospects, speaking to the overall quality of the loan portfolio), a crowd of venture market participants were severely impacted. Uncertainty remains regarding what will happen to existing venture loan contracts with SVB, and startups may have to either adjust to working with the acquiring bank or apply for credit elsewhere if a smooth transition falls apart.

For the past four decades, SVB has issued loans to VC-backed startups with low interest rates and minimal to no covenants. With a sound reputation and deep knowledge of the startup environment, the bank developed and has been maintaining an extensive network with VC investors, who keep coming back with introductions to their portfolio companies, knowing that SVB had been consistent with debt issuance and loan terms during market highs and lows. With SVB shut down by regulators, startups that had been working with SVB that are now looking to switch lending partners will likely face challenges, as the venture debt market has become more competitive over the past year amid the market downturn. More importantly, even if SVB was to be purchased, it is unlikely that the bank's structure or management will be preserved, meaning the venture debt market has forever lost a critical player with deep insights into the venture capital landscape, vast experience with market shifts, and most importantly, a long history of serving the startup community consistently. With a vacuum left by SVB, venture debt will undoubtedly see broad market changes, and it will take a while before the dust settles.

In addition, SVB's collapse may lead to investors and startups reevaluating risks associated with bank loans and exploring other borrowing options while deciding whether to go to a bank or nonbank lender such as venture debt funds. The lightning strike of SVB's crisis sounded alarms to VCs and startups, shattering the near-absolute faith they previously had in its secureness and reliability. There are concerns that a possible contagion effect on regional banks that hold long-term bond portfolios could cause them to collectively suffer from the Fed's rate hikes, translating into an elevated appeal of nonbank lenders. Now that the go-to lender for many investors is no longer around, we expect to see more companies in solid financial standing exploring debt options from nonbank debt funds. Meanwhile, should many highly liquid startups rush to nonbank lending entities, the increased level of competition will likely raise the bar for obtaining loan packages even higher. Anecdotally, many lenders stopped lending to startups with fewer than 12 months of runway amid the 2022 private market turmoil. The liquidity position requirement would likely be even more stringent when lenders have more high-quality borrowers from which to choose.

In our latest analyst note on venture debt we discussed opportunities and challenges for venture debt amid market turbulence and predicted further expansion of the venture debt market. The SVB crisis does not change our outlook. Instead, it speaks to the current, heightened uncertainties in the private market. We stand by our belief in further expansion of the venture debt landscape and expect to see a shift in venture lending market patterns in the next few quarters.

SVB UK and beyond

SVB expanded internationally, alongside the global growth in VC in the last five years, with 650 employees across five countries in the UK and EMEA, including Germany and Denmark, where offices were opened in 2018 and 2019, respectively. SVB entered the UK market in 2004, and SVB UK became a wholly owned subsidiary of SVB, regulated by the Prudential Regulatory Authority and Financial Conduct Authority on June 20, 2022.

Although the UK arm of SVB was small in comparison to the US, it served as a banking institution for more than 3,300 clients. Several startups and VC investors across the UK and Europe were customers, including Snyk, Wise, Darktrace, and Atomico. The spillover effect on SVB UK triggered concerns that it could lead to the failure of numerous startups and create funding ramifications for VC-backed companies, and VC funds. As a result, joint statements and a petition were signed by more than 200 individuals requesting the UK government to step in.

The Bank of England planned to put SVB UK into insolvency after the collapse of SVB in the US. However, SVB UK was acquired by HSBC for £1 on March 13, 2023. Despite SVB UK's outflows during the past week, HSBC is bullish on the opportunity the acquisition presents. As of March 10, SVB UK had loans of around £5.5 billion and deposits of around £6.7 billion. For the financial year ending December 31, 2022, SVB UK recorded a profit before tax of £88 million. SVB UK's tangible equity is expected to be around £1.4 billion.[10]

Aside from the SVB UK sale, the impact on Europe is expected to be less pronounced than on the US. The Deutsche Bundesbank, the central bank of Germany, reportedly convened its crisis team on Monday to assess the impact on the local market. Despite public market jitters, no further action is expected in Europe. The threat of increased volatility and unease facing smaller banks cannot be ruled out, and the fallout could inform upcoming monetary policy decisions.

The outlook without Silicon Valley Bank

The prevailing sentiment of the market, less than a week after news of the stock sale of SVB broke, remains unease. A sale of the bank seems likely and potentially straightforward. The bank's loan book, especially the portions of venture debt and startup loans, may take time to value. However, because depositors have been backstopped, this should not end up as a mass startup-extinction event.

Immediately speaking, this collapse could not have come at a worse time for the VC market, though. Investor caution had already clouded deal activity. Companies needing more capital already had much more limited options, and the benchmarks for successful financings had already risen significantly. Any impact on the growth rate of companies due to the limits on financing makes the mountain startups must climb that much taller.

Through the past four quarters, startup investment in the US has fallen 25% by count and 61% by deal value. Aggregate deal value will always be influenced heavily by outsized financings, but the market could possibly deflate much further. Early-stage deal count

10: "HSBC Acquires Silicon Valley Bank UK Limited," HSBC, March 13, 2023.

had stemmed the declines over the past couple quarters, even showing a slight uptick in Q4. This area of the market is a concern now, as the macroeconomic climate has taken a major hit from SVB's collapse and its ripple effects.

SVB has grown well beyond the borders of its namesake. Silicon Valley Bank UK was also shuttered last week before being snapped up by HSBC. Thousands of startups across the world have banked with SVB. The idea of contagion within the global venture industry should drive decision makers to strive for a quick resolution. We have seen other players in the startup banking and lending space step up to help stem near-term fallout. Brex, for example, is offering emergency credit lines. But stop-gap financing needs will be in the billions.

The void left in the market will close at some point. The market for early-stage lending will be covered by other lenders. The roughly $5.5 billion in investor-dependent loans (early-stage lending) SVB had is large, but it is a drop in the bucket of the total capital that makes it to VC-backed startups on a yearly basis. Other banks will assume the banking role for the venture market, and the business will be spread across many banks. SVB noted a $1 billion+ gain on the warrants received through its lending program, well outpacing any lost capital from these loans. More broadly, the venture lending market is expected to have very low losses annually, with the unique structure of these deals lessening risk. The bull market of the past decade has also helped lower risk, but the basis of venture loans is often cash runway for the companies. And with these lenders sitting senior to equity investors, venture debt will remain a risk many will take.

Although market confidence has been shaken, this was not a collapse because of VC. The difference, at least in the near term, will be that these banks will not have the suite of startup-focused products that had been available through SVB, and it will take time to develop the level of service that VC received from the bank that had focused its efforts on its market. The failure of SVB will increase the pressure on the market, likely leading to a further slowdown in startup financing.

It should be expected that valuations will steepen their decline. Median venture-growth valuations have already fallen below the levels as far back as 2019. Late stage has seen its median fall more precipitously in recent quarters, and the longer liquidity is low, the further valuation declines will move from public markets. The seed stage had seen its highest quarterly median valuation in Q4 2022, but this market shock could seize up the seed and early-stage market until the banking industry finds more stable footing.

Silicon Valley Bank's collapse will lead to changes in the mechanics of the venture market, hopefully in a long-term benefit. The swift rise of venture in 2020 and early 2021 put more capital to work than the market could handle. With the market's trust collectively being concentrated with Silicon Valley Bank, too much capital became SVBs problem when the outflows began.