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Published on September 22, 2022

Contents

Key takeaways	1
Introduction	2
Down round data	2
Research	3
Exits post-down round	5
Conclusion	7

Down Rounds, Impacts, and Exit Opportunities

A look at what's in store for companies taking down rounds in the current 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

- The quick retreat of the public markets and dramatic shift in VC investor advice from grow at all costs to conserve cash will leave many companies with extended valuations and revenue metrics unable to reach expectations. These companies will be forced to take a down round, though there has yet to be a major increase in these particular ill-spoken financings. Just 6% of completed rounds in 2022 have been at lower valuations than the company's previous investment.

- A majority of down rounds occur at the late stage. As the market has almost continuously helped valuations grow over the past decade, the median late-stage valuation has stretched to $100 million—double the figure from 2018. Here, there is ample room to readjust valuations and rejigger a business model if needed, whereas younger companies may simply fold rather than be afforded the opportunity of a down round investment.

- Companies taking on a down round often continue growth. Just 13% of companies raising a down round from 2008 to 2014 were unable to raise a new round or exit immediately after the down valuation investment. Nearly 20% of post-down round exits occur via PE buyout, which is a significantly higher proportion than what is seen in the broader venture exit dataset.

Introduction

Down rounds can be detrimental to the equity stakes of founders and early investors and can create barriers for future company growth, including the stigma that the business is floundering and the signaling risk for investors that accompanies that belief, as well as difficulties hiring and retaining talent—perceived or otherwise. However, down rounds are necessary in certain situations if companies want to continue operating. For some companies, down rounds are unavoidable.

As the venture capital (VC) market has grown since the recession years of 2007 and 2008, valuations have almost continuously grown, and the occurrence of down rounds has been inverse. Moreover, valuations have skyrocketed over the past couple years as growth was prioritized over immediate profitability, as the market hoped that first-mover advantage and overfunding growth would lead to profits down the road. This expanded valuation multiples placed on company revenues as public markets grew rapidly and exit events for VC-backed companies were plentiful.

Market sentiment has shifted dramatically in 2022. "Growth at all costs" seems to be a shelved strategy for the time being, and the swift decline of the public market leaves many private, non-profit-generating startups with much higher valuations than their larger, public counterparts. At the same time, the public market exit valve has been shut off, leaving many highly valued companies in need of another private financing round in an inhospitable market.

With the current market showing little to no signs of pricing pressure abating, and as the macroeconomic uncertainty continues, the more likely we are to see a significant increase in down rounds for VC-backed companies. For many reasons, the valuation multiples on forward revenues are reverting to pre-2021 levels. The question becomes: What can the market expect from these companies moving forward?

Down round data

Despite the pressure being exerted on the venture market, the industry has yet to see an increase in down rounds in 2022. This isn't wholly unexpected, as down rounds can lag into a down market as companies find creative ways to lengthen runway and stay out of equity financing markets. Our Q2 2022 US VC Valuations Report noted that fewer than 6% of completed financings in 2022 have been at valuations lower than what the company previously raised. This is the lowest figure in our dataset and is opposite of what many would expect. Before re-entering the equity market, many companies instead look to extend their current runway. One method of runway extension is via layoffs. As of early September, more than 80,000 tech employees have been laid off globally in 2022,[1] a vast majority of those in June, July, and August.

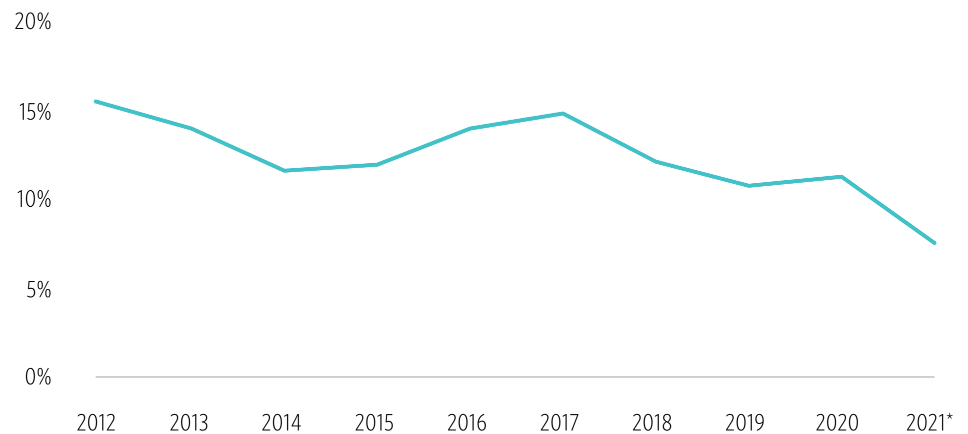
1 "Layoffs.fyi Tracker," Layoffs.fyi, Roger Lee, n.d., accessed September 1, 2022.

We expect more down rounds to occur in the current slowdown, however. Public markets, while somewhat stabilized, are not ready to accommodate a large number of money-losing startups, which will propel companies to raise in private again. There are roughly 1,200 unicorns globally, all yet to realize returns for their investors; their public market comparable companies have also likely seen large drawdowns in their market caps, which will lead to lower private valuations in new raises. An economic recession, even a minor slowdown, can have material impacts on company growth, which will likely filter though the next few quarters into new financings at lower valuations—and that's only if a company has remained viable. In general, down rounds are a lagging data point.

Companies that raised at high valuations in 2021 may not need to raise more capital this year. A general rule is that fundraises, alongside revenues, should enable a company to operate for around 18 months. This would bring companies back to market in Q3 2022 if they had raised in early 2021, though it is possible to extend runway without selling more equity.

Down rounds are not relegated to economic downturns. Each year, companies go through down rounds, restructuring their business or retargeting their growth. In 2021, likely the most exuberant year for US VC, more than 7% of completed VC financings were at valuations lower than the company's previous investment.

Down round deal count as a share of all VC deals

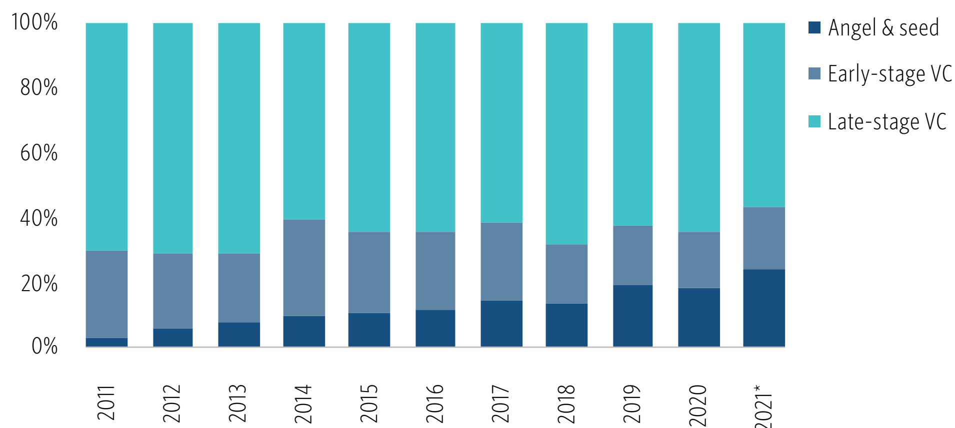


Source: PitchBook | Geography: US
*As of December 31, 2021

Research

Over the past decade, more than 3,000 companies have raised financings at lower valuations than they had raised in the round prior. For all the companies that raised a round during that time, this is a relatively low count. The growth of the venture market during the past decade has helped keep down rounds at bay, but down rounds do increase during times of market stress. Toward the end of 2016 and into 2017, the exit market for VC-backed companies stuttered, especially regarding IPOs. This coincides with an increase in down rounds during those years.

Share of down round deal count by stage

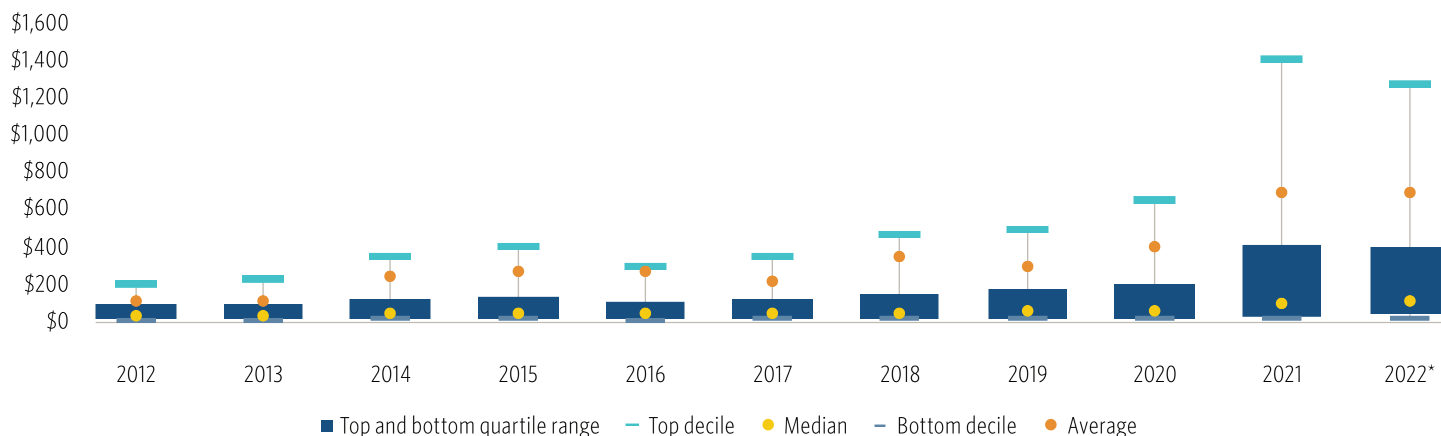


Source: PitchBook | Geography: US
*As of December 31, 2021

Most of the decade's down rounds have come at the late stage. This makes sense on the surface, as companies seeing their valuations balloon over several consecutive rounds have more to cut than early-stage companies, which may be unable to raise a follow-on round if the core business is missing its mark. Late-stage companies taking down rounds also receive more scrutiny because they are generally more well-known in the market. A down round for WeWork is going to receive more attention than a company just off its Series A, for example.

Over the past decade, the late stage has also extended considerably, with its median valuation surging past $100 million since 2021. One decade ago, even the top-decile valuation was around $200 million. Now, that figure has had more than $1 billion added to it, with the 2021 top-decile late-stage valuation notching almost $1.4 billion. This expedient and vast extension has left many companies exposed with underperforming financial metrics that have been unable to keep up with the growing multiples on forward projections.

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

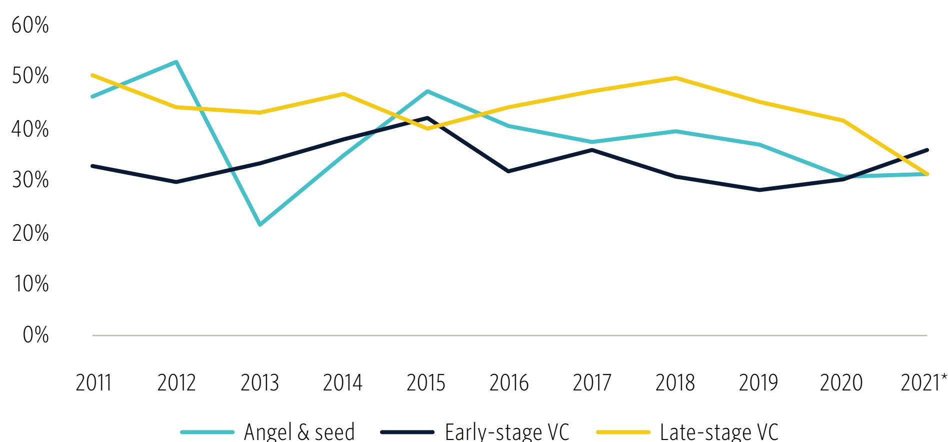


Source: PitchBook | Geography: US
*As of June 30, 2022

Because of this, late-stage companies have also experienced some of the largest drawdowns on their valuations when taking on down rounds, seeing the highest of any stage in five out of the past six years. Late-stage down rounds may look more at repackaging the company for an easier sale to recoup capital for investors. Late-stage companies are more susceptible to public market shifts, even those less systematic than the current situation in 2022. Companies or technologies with few similar public comparables could potentially see strong private market repricing if one of those public companies falters.

Klarna, for example, took a roughly 85% markdown on its valuation during its most recent round. During the market decline, the buy-now, pay-later space has been in rough water. One of Klarna's public comparables, Affirm, was—likely not coincidentally—down more than 80% at the time Klarna closed its financing.

Median down round investment valuation decline by stage



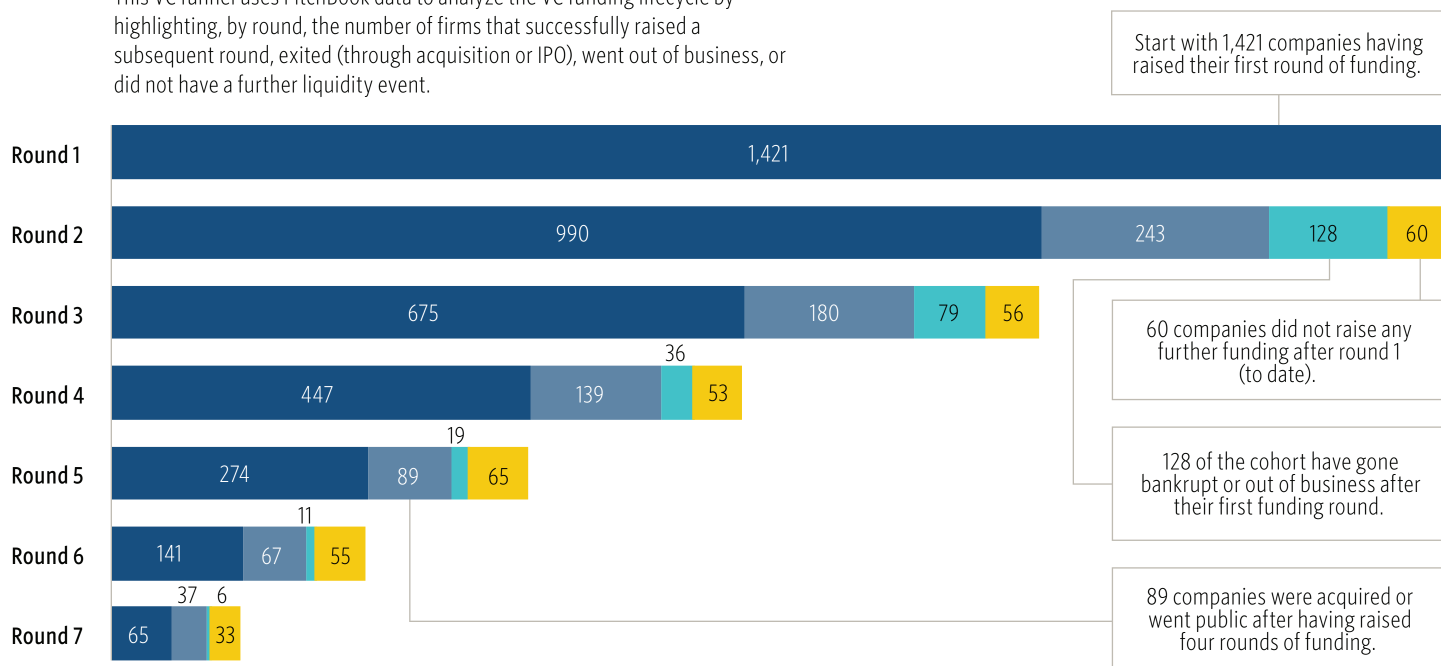
Source: PitchBook | Geography: US
*As of December 31, 2021

Exits post-down round

We must consider if companies taking on down rounds can exit and what those exits may look like. Airbnb showed that it's possible to take on capital through a lower-priced round and then exit successfully. The company's 2020 round was a large debt, so while not necessarily apples-to-apples, warrants were priced at around half of the company's prior financing round to the benefit of those investors to a sizeable stake of the company's equity at IPO.

By using the 1,421 companies raising a down round from 2008 to 2014, we can track the ability for beleaguered companies to continue growth. Just 188 of those companies in the dataset were unable to raise further financing or complete an exit immediately after taking a down round, thus suggesting that down rounds aren't an instant company killer. This dataset does have a unique construction, as all down rounds, regardless of stage, enter the funnel simultaneously. A seed-stage down round, therefore, moves through the funnel the same as a down round raised at Series D, when companies are much more developed and a pivot in business model is less obtainable.

Down round VC funnel*



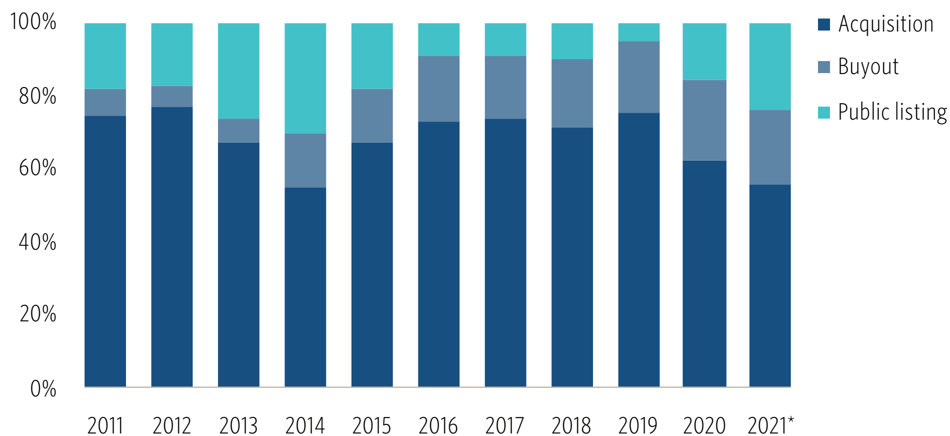
Source: PitchBook | Geography: US
*As of December 31, 2021

The high number of companies able to exit likely also corresponds with the high proportion of down rounds occurring at the late stage. Here, investors are less likely to abandon a company; they instead look to recoup investment where they can, even if it is less than the total invested in the company. We don't characterize these exits as "successful," which we define as exiting at a higher valuation, or unsuccessful, because the expectation of exits has likely changed on the company level.

Of the exits completed after taking a down round, a much higher than normal proportion of this group exited through a buyout from a private equity (PE) firm. Since 2016, 166 buyouts of companies that had previously taken a down round have occurred, constituting 19.4% of the exits for these companies. Within the broader venture ecosystem, just 11.5% of exits occur via buyout. While buyouts have increased as a VC-backed exit route in the past several years, it is still not ideal from a company perspective. Buyouts often lead to corporate-level restructuring and replanning, which can be a departure from the growth-at-all-costs mindset linked to the venture market. Of the buyouts completed, most have been add-ons. VC-backed companies either build upon new technologies or bring technologies into new use cases. Seeing these buyouts made to create new platforms for future add-ons wouldn't make sense either. These companies are being used as add-ons to larger platforms, incorporating the emerging company under an umbrella and a more corporate structure to aid its growth.

All things considered, buyouts of companies that have taken a down round make sense. For one, as shown, many companies that take on a down round are at the late stage. While there can be varying levels of development, these companies have

Share of post-down round exits by type



Source: PitchBook | Geography: US
*As of December 31, 2021

likely raised quite a bit of capital already, thereby leading to a strong understanding of where the product might fit into the market. The benefit is thus that PE firms are able to perform due diligence on true financial performance and addressable market, rather than on an idea of what a technology or market may be.

While we do see a high percentage of these companies that do exit at a higher valuation than that of their down round, thus insinuating that a relative turnaround is possible, the high number of buyouts adds substantial bias to this data. For those exits that we do have information on valuation, 88.1% are at a step-up from the down round.

Public listings for this dataset also show deviations from typical VC exit activity. For one, public listings for 2021 show that the dataset was roughly split between traditional IPOs and de-SPAC transactions. Though SPACs have been a larger exit opportunity for VCs over the past couple years than they were previously, the divide is much lower. During 2021, 38% of public listings were de-SPACs, which likely will be the highest proportion for the foreseeable future.

Last year as well, the traditional IPOs completed by companies that had taken a down round were heavily weighted toward healthcare companies. The mechanical differences of healthcare verus tech business models are apparent in venture financing, but the divide here highlights exit opportunities between the markets.

Conclusion

As a natural mechanism of a market, down rounds remain unavoidable for some companies within VC. Down rounds will likely increase in years after significant market growth, as in 2020 and 2021. Generally, these rounds aren't a contagion and are limited to a few companies within a certain market.

The findings related to down round data showcase that these financings aren't broadly company destroyers—though we didn't dive into more internal factors such

as founder and existing investor dilution, which can, for all intents and purposes, make an investment in the company worthless in extreme cases.

Over the next few years, buyouts will likely continue increasing in the venture market, as well. The longer the current market slowdown continues, and the more down rounds increase, PE funds should find fertile ground in the late-stage VC market. Reiterating that more than 1,200 unicorns operate globally, the inability for the whole of this group to exit in an orderly, successful fashion will lead to a swath of developed companies inviting a turnaround akin to what many buyout shops would look to organize.

The data also shows that investing into a down round could prove to be an investment strategy with decent returns. The fact that 88% of known exit valuations for companies taking a down round were higher than the down round valuation should increase the confidence in down round participants.

Experiencing a dramatic shift in market sentiment is a shock to the system, especially for companies told to grow with abandon one month, only to conserve runway and batten down the hatches the next. Whether the quick drawdown could have been foreseen, it wasn't expected by the venture market to materialize so quickly. The resulting decline in capital availability, especially for companies with lagging financials, is a natural market occurrence. Down rounds are a part of markets, but rather than heralding the end of the company, the data shows they should rather signal a shift in company expectations.

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