# Analyzing the IPO Market Outlook

## Examining current market conditions to highlight potential next steps for VC-backed IPOs

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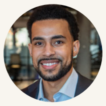

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Contents



## Key takeaways

- Instacart and Klaviyo's recent IPO filings look to end a tech-unicorn-IPO drought that has dragged on for more than 18 months. During that time, just 50 VC-backed companies have completed a public listing, an enormous slowdown that has pressured all aspects of the venture market. Roughly 87% of the record exit value in 2021 was generated through public listings, leaving VC searching for returns in the current environment.

- Several key pressures can be examined to determine why the market for VC-backed IPOs has been so slow. High interest rates, declining valuations, and relatively low performance from tech companies in the public market during 2023 have left many VC-backed companies looking at a difficult IPO market. Now, while profits are at a premium and less-risky investments are delivering high yield, many private companies are left in a bind and likely looking at a lower-valuation exit.

- The low number of IPOs by VC-backed companies has left a large backlog of companies that should have gone public since the market slowdown began in early 2022. By our estimate, roughly 220 companies should have listed over this time. When conditions do promote more filings, there could be a rush to list by companies looking to take advantage of the shifting market.

## Introduction

Cava's IPO in June 2023 was the first high-profile VC-backed IPO since 2021. The company performed well in its debut, opening at $42 per share—priced above its expected range—and closing at just under $44 per share. These details were intriguing to the market, potentially pointing to a shift in market sentiment toward VC-backed companies.

The anticipation of an open IPO window has been palpable over the past couple months. In 2021, roughly 87% of the record $777.2 billion in exit value was generated through public listings (IPOs and deSPACs). There are currently more than 800 unicorns in the US alone, a majority of which will need to go public. IPOs have also been seen as somewhat of a linchpin for VC, whether it is because of the need for returns to be distributed to LPs or because IPOs are indicative of a strong investor sentiment that could move from public markets to private markets.

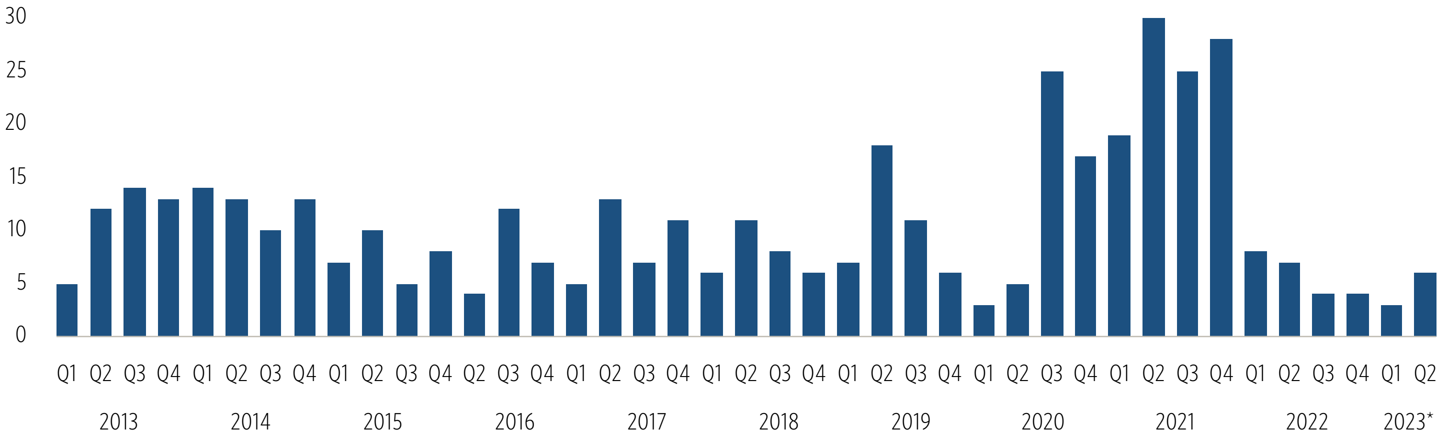
The problem is that Cava is not a traditional VC-backed tech company, at least not one like the majority of the unicorns that are still private. As a restaurant, the company was much less of a tech investment than a brand investment. Other companies with IPOs in 2023 were also not seen as great comparables to the VC-backed tech companies that had raised at high valuations before the market slowdown, as they did not have to raise privately in a capital-starved market.

While a common axiom is that a few companies will test the waters before an IPO window opens, Instacart and Klaviyo may be the two IPOs that give a sense of the market appetite for VC-backed companies. Until those listings are completed and we see how they perform after their debut, the examination of past IPOs and current market conditions can provide a more holistic view of IPO market expectations for the next few quarters.

## VC-backed IPO data and background

The IPO landscape has undergone a notable transformation over the past 10 to 15 years. During this period, the IPO market observed a shift in investor preferences, with companies increasingly choosing to go public despite not immediately demonstrating profitability. This trend has been particularly pronounced within technology-driven sectors, where investors exhibit a growing inclination to prioritize rapid expansion and market dominance over short-term profit generation.

### VC-backed tech IPO count by quarter




Source: PitchBook • Geography: US
*As of June 30, 2023

Examining this trend through the lens of notable tech IPOs reveals insights into changing investor sentiments and market dynamics. Prominent examples include Snap, the parent company of Snapchat, which went public in 2017. Despite initial concerns about profitability, Snap's IPO valuation was characterized by a remarkable price/sales (P/S) ratio of approximately 34x. This ratio underscored investors' willingness to pay a premium for growth prospects, highlighting a distinct focus on long-term potential. Lyft followed suit in 2019 with a P/S ratio of approximately 10x, revealing investor confidence in its growth trajectory despite profitability challenges.

The financial metrics of these IPOs underscore a prevailing investor bias toward growth-centric companies over immediate profitability. The substantial P/S ratios observed in these cases reflect investors' readiness to pay a premium for firms demonstrating strong revenue-growth potential and a belief that this growth will eventually translate into profitability.

However, the post-IPO performance of these companies highlights the intricate nature of balancing growth with profitability. While initial enthusiasm is often driven by growth prospects and market positioning, transitioning from a growth-centric strategy to a sustainable, profitable business model presents multifaceted challenges. These include navigating intense competition, regulatory complexities, and operational intricacies that can significantly impact the trajectory of post-IPO stock prices.

Beyond financial metrics, the transformation of the IPO landscape over the past decade and a half can also be attributed to broader market forces and emerging industries. Technological innovation has propelled sectors such as e-commerce, financial technology, and most recently AI to the forefront, leading to remarkable success stories exemplified by Amazon, Apple, and Tesla. Moreover, historically low interest rates set by the Federal Reserve (the Fed) spurred investors to seek higher returns through equity investments, thereby augmenting the appeal of IPOs as vehicles for potential growth. Now, as the tech IPO landscape continues to evolve, striking a delicate balance between innovation, growth, and profitability remains paramount for both investors and companies alike.

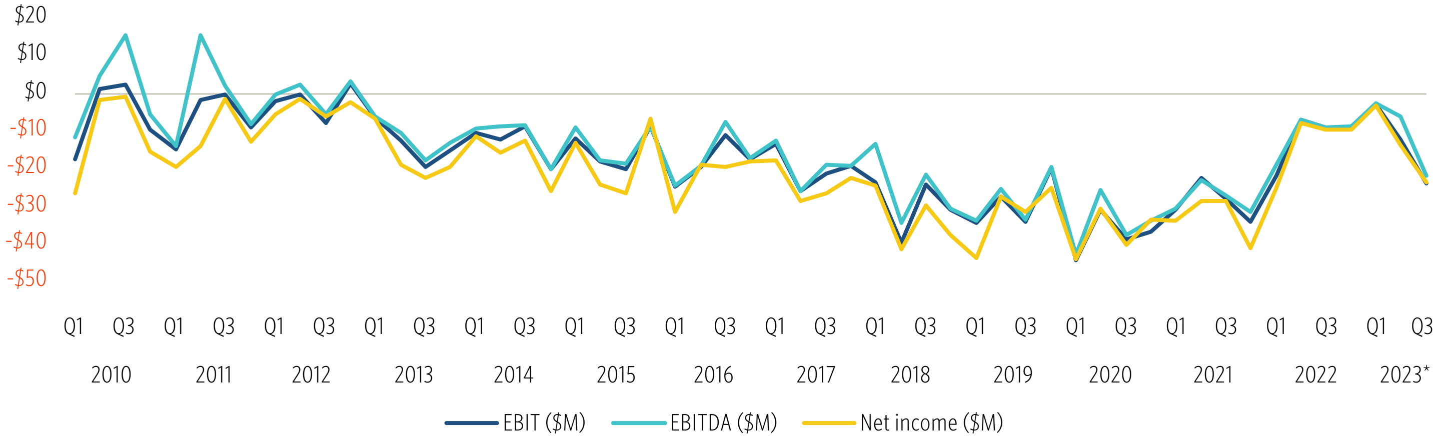
## Current public market challenges

*Profitability and valuation*

Profitability is a term that gets thrown around the VC market often, though it has not been a characteristic of VC-backed companies that listed publicly over the past decade. Now, profitability—or at least a viable path to profitability—matters, influencing how public market investors will value a company moving into their purview. Both Klaviyo and Instacart have only recently generated positive operating incomes, a sign that these companies likely shifted their businesses over the past year to turn profitable.

Up until 2022, the venture market dynamic involved pushing capital into companies to subsidize business models and achieve strong growth. Growth at all costs placed a premium on other metrics besides profitability. In some cases, software enabled viral growth due to its relatively easy distribution. While we do not know the revenue metrics of companies currently waiting to IPO, it is difficult to imagine them being largely different from the VC-backed companies that have gone public over the past few years, except that they have been operating in a more uncertain market that has pressured growth in all sectors. In 2021, when 192 US companies completed an IPO, just 17 had positive net incomes. The median annual net income at IPO has been a loss every quarter since 2009.

### Median financial metrics of VC-backed IPOs by quarter



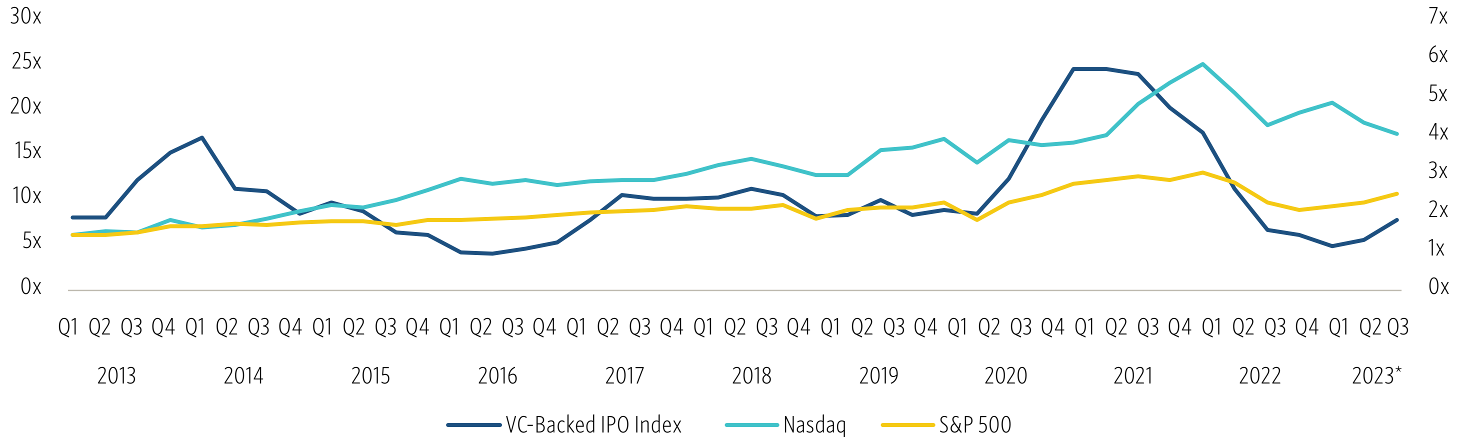

Source: PitchBook • Geography: US
*As of July 31, 2023

In general, true profitability is not the single measure of success for a private company. Revenue growth, total addressable market, and customer acquisition and retention rates are measures that investors often use when valuing a company. VC investment comes with high expectations of growth, so earnings are put back into the company to fuel further growth rather than saved by the company or distributed to investors. Valuations are benchmarked on future projections of growth and cash flows rather than on current figures.

Growth at all costs placed a premium on revenue growth, generally a proxy for market share or a large addressable market to be captured. Uber is a good example. At the time of its IPO, the company posted a net loss of $3.2 billion, yet the growth in revenues and number of trips were expanding quickly. From 2016 to 2018, revenue increased by 162.8%, while rides booked through the rideshare platform increased by 9 billion during that time, a growth of 900%.[1] Uber was expanding into various other costly product lines, such as freight and last-mile delivery, but its financial metrics were not prime for an IPO. However, they were very indicative of VC-backed IPOs at the time, just on a larger scale.

As valuations soared through 2021 for late-stage and venture-growth-stage companies, many pre-IPO companies were left with values that reflected a market much different than the current one. Using our VC-Backed IPO Index as a proxy for valuation movement, the index constituent P/S multiple moved from under 9.0x in Q1 2020 to more than 24.0x by late 2020 and through H1 2021. That multiple has now cratered, suggesting that investors are valuing revenue more conservatively and are expecting pre-IPO companies to face growth challenges. Late-stage VC valuations have followed a very similar pattern to the IPO index P/S ratio, tracking with a correlation of 0.79 over the past decade.

**Quarterly price/sales multiples of VC-Backed IPO Index versus Nasdaq and S&P 500**




Source: PitchBook • Geography: US
*As of July 31, 2023

1: "Uber Common Stock," US Securities and Exchange Commission, May 9, 2019.

If we look at a company like DoorDash, which Instacart will likely have its financials compared against, the P/S multiple has consistently moved lower since its listing. When the company debuted, its P/S multiple came in around 25x; now it is roughly 4x. Instacart raised in 2021, the same year DoorDash made its public debut. Though the true valuation calculation is not known, the pre-money valuation for the round was $38.8 billion, which was a 26.2x multiple on its 2020 revenues. A series of internal valuation cuts and current annual revenues around $3 billion for Instacart would place a basic valuation around $12.0 billion for the company with current market pricing. The situation highlights the challenges that companies face in the current market if they had raised during 2021, when private valuations were at record levels. Even though Instacart's revenue has grown, the company is likely looking at a lower valuation than its last priced investment.

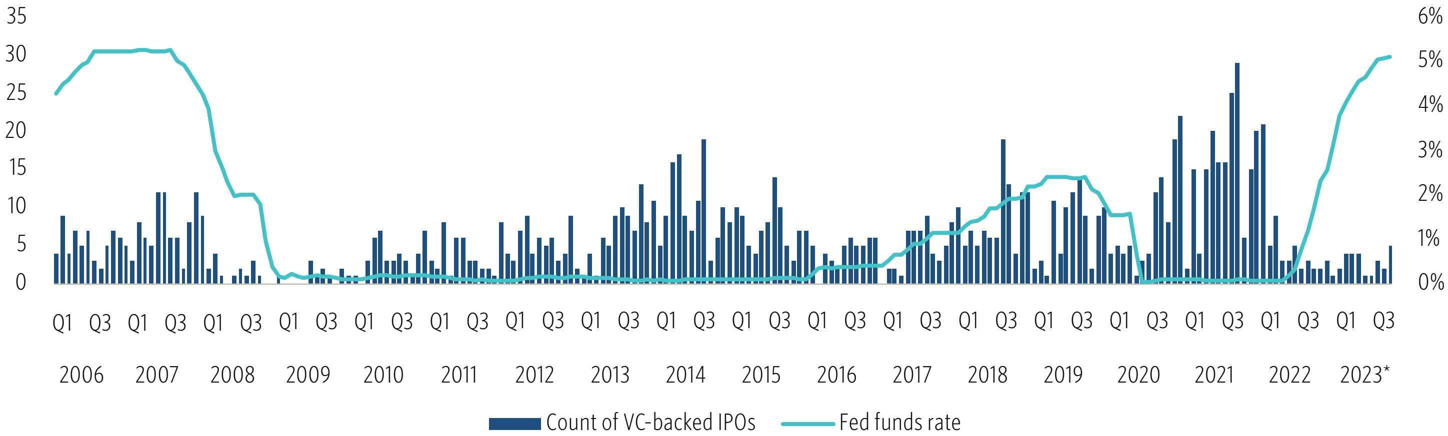
Even if some companies IPO successfully, current VC-backed companies must decide if it is worth an IPO at a much lower valuation or if remaining private is a better option amid the market change. For many enterprises, especially those with lengthy cash runways, the latter choice would be a tough pill to swallow. But the market has shifted, and profitability, at least a strong path to profitability, is now receiving a premium.

### *Interest rates*

In July 2023, the Fed approved a much-anticipated 25-basis-point interest rate hike that takes benchmark borrowing costs to a target range of 5.25% to 5.5%—their highest level in more than 22 years. The increase is the 11th time the rate has been raised since March 2022, and while many Consumer Price Index (CPI) trackers indicate that some areas of inflation remain above the Fed's 2% target, economic growth has been surprisingly resilient despite the rate hikes.

The correlation between the federal funds rate and the number of IPOs is a complex and debated topic and is influenced by a variety of factors. While direct causation is difficult to establish, our data shows that there has been a moderate correlation between the fed funds rate and the number of VC-backed IPOs. Generally, we have

**VC-backed IPO count versus fed funds rate by month**




Source: PitchBook • Geography: US
*As of July 31, 2023

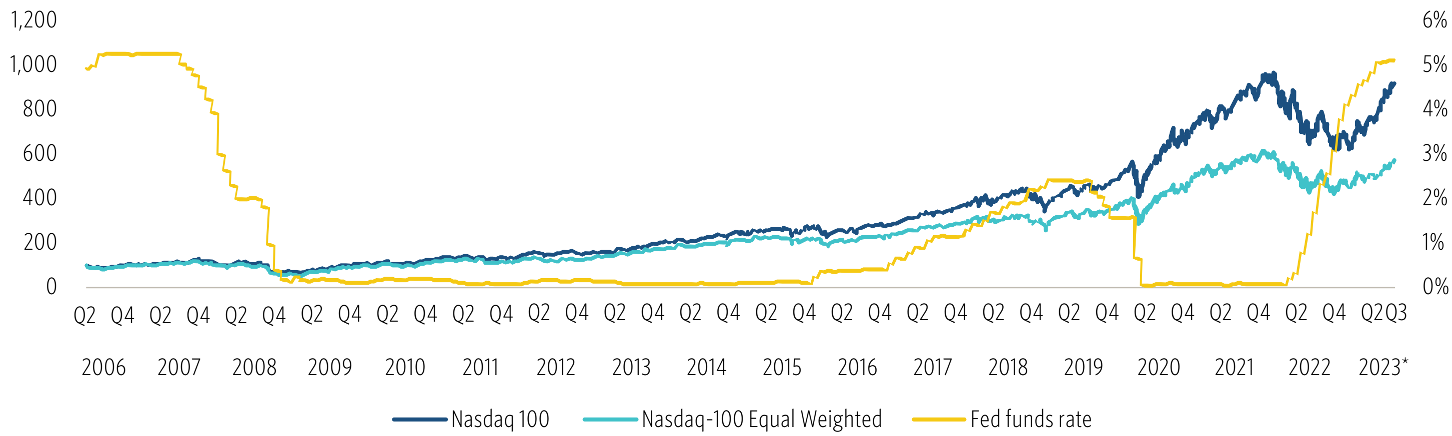
observed that periods characterized by lower federal funds rates have aligned with heightened IPO activity. Notable instances include the post-financial-crisis era from around 2009 to 2014 as well as the COVID-19-pandemic era from the beginning of 2020 to the beginning of 2022.

We observe a noticeable decline in IPO activity in higher-interest-rate environments. This makes sense given a higher federal funds rate leads to higher borrowing costs for companies, which could potentially make it more expensive for them to raise capital through an IPO. Moreover, in a high-interest-rate environment, investor appetite for riskier assets, such as newly issued IPO shares, may decrease, leading to lesser demand for IPOs. This combination of higher financing expenses and decreased investor interest can create an unfavorable environment for startups looking to go public.

Similarly, the correlation between the performance of public tech stocks, exemplified by indexes such as the Nasdaq 100, and the fed funds rate is important to consider when attempting to analyze the near-term IPO landscape. Fundamentally, lower interest rates mean lower bond yields, which dampens the attractiveness of investments perceived as less risky. Meanwhile, tech stocks, often valued for their growth potential rather than immediate profitability, gain prominence as investors seek to optimize their returns when interest rates are lower.

As we can see by the chart below, lower rates correlate to higher tech prices and vice versa; the past year has been volatile for many tech companies, which enjoyed ample attention from investors in an economic climate where low interest rates made them more compelling investments.

**Nasdaq 100 and Nasdaq-100 Equal Weighted (rebased to 100) versus fed funds rate by quarter**




Source: PitchBook • Geography: US
*As of July 31, 2023

It is important to note that the Nasdaq 100 suffers from an imbalance created by overweighting megacap companies, which have had remarkable year-to-date outperformance:

- **Apple:** 11.616%
- **Microsoft:** 9.835%
- **Amazon:** 5.132%
- **Nvidia:** 4.211%
- **Meta Platforms:** 3.511%
- **Tesla:** 3.171%
- **Broadcom:** 3.085%
- **Alphabet**
    - *Class A shares (GOOGL):* 2.744%
    - *Class C shares (GOOG):* 2.719%

Roughly 46% of the Nasdaq 100's weighting comes from just eight megacap growth stocks; viewing the index from the angle of a concentrated megacap growth stock index helps to explain its strong performance YTD despite elevated interest rates. Further, when we juxtapose the year-to-date performance of the equally weighted Nasdaq 100 (NDXE), which has risen by 20%, with the Nasdaq 100 (NDX), which has gained 40%, it becomes evident that the broader tech sector has not achieved a comparable level of success.

Despite this, anticipation of the Fed's decision to halt rate hikes (or even lower rates in 2024) can potentially act as a catalyst for tech companies, propelling them toward outperformance. This scenario, combined with the prospect of declining inflation rates, could provide an advantageous backdrop for the IPO landscape, as a more accommodative monetary environment often bolsters investor confidence and appetite for new market entrants.

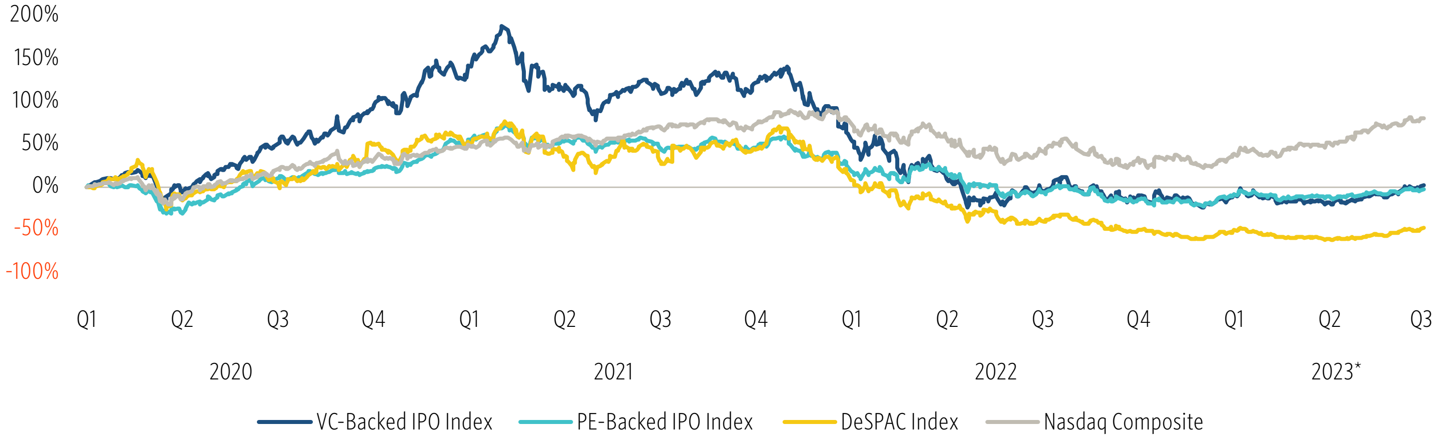
## *Public market performance and the economic backdrop*

Public markets being up YTD is generally a good sign for IPOs and companies moving from private to public. As of the end of July 2023, the S&P 500 was up 19.6%. Our PitchBook indexes, the VC-Backed IPO Index and the DeSPAC Index, were also up for the year, albeit on a slightly smaller scale. If the public market slowdown was a major factor in the poor IPO market of 2022, then these boosts should signal an opportunity for a rebound.

The market has performed well despite the economic headwinds of supply chain strain, a rising-rate environment, and heightened geopolitical tensions. Predictions of an imminent recession have largely gone away, and the Atlanta Fed even estimated US GDP growth in Q3 2023 to be 5.9%.[2] Though a soft landing has yet to be fully engineered, the Fed has signaled a continued hawkish stance on inflation, which could lead to further rate hikes.

2: "GDPNow," Federal Reserve Bank of Atlanta, August 24, 2023.

## Quarterly public listings performance versus Nasdaq Composite

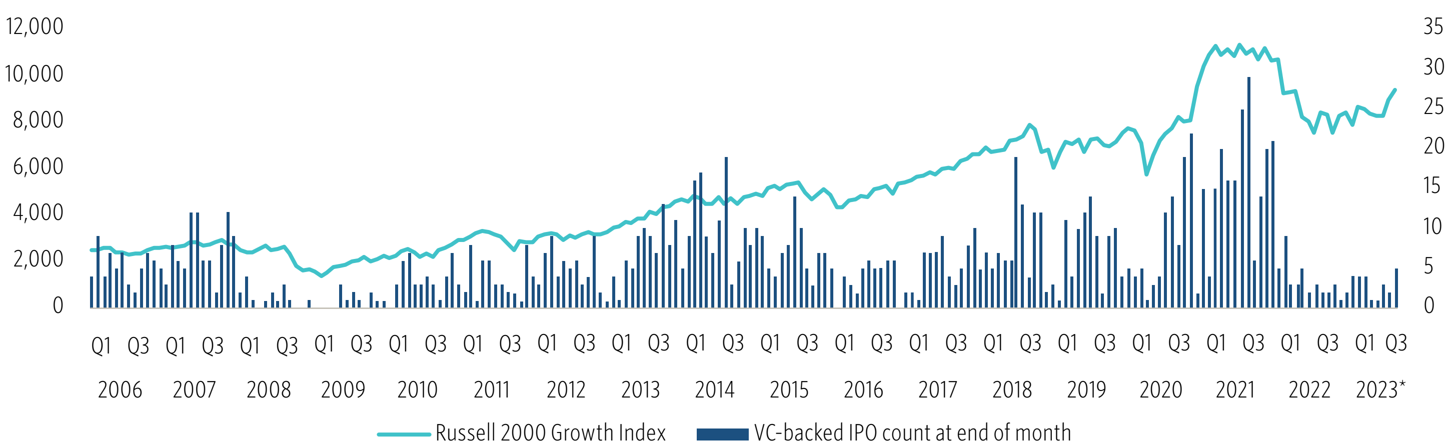



Source: PitchBook • Geography: US
*As of July 31, 2023

These performance figures can be deceiving. As mentioned earlier, public performance has become heavily weighted toward the largest companies. The top 10 companies account for roughly 30% of the weighting within the S&P 500. Microsoft, Apple, Amazon, Nvidia, Alphabet, Meta, and Tesla account for the heaviest weights, and these seven stocks have had a strong 2023. These stocks alone have returned 66.6% as of the end of July. Without them, the S&P 500 has moved just 7.9% higher.

This is positive, but it is not quite the IPO boost of a broad-market 20% return. The Russell 2000 Growth, which can be used as a barometer for smaller, mid-market growth companies, is up just over 6% this year and has fallen over the past couple weeks. During the 2020 and 2021 IPO market, the Russell 2000 Growth was up by more than double following a pandemic-induced fall in early 2000.

## Russell 2000 Growth Index versus VC-backed IPO count by month




Source: PitchBook • Geography: US
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Undoubtedly, perceived public market stability will also be a factor in the increase of VC-backed IPOs moving forward. Lockup periods can be as long as six months, which can bring substantial change to the price of a stock, increasing or decreasing the returns to investors should they look to offload shares to LPs or cash out their stakes.

Much has been said of the 2021 IPOs that are now worth much less than their initial share prices. However, for employees and pre-IPO investors, the first six months may be the most pivotal, as quick erosion in share price can erase expected returns of the event.

For now, the market outlook is much calmer than it has been. CPI figures have come down to almost 3%, just 1% above the Fed's target rate. The VIX has moved to the lowest level since before the pandemic, and although historically there has not been a connection between the VIX and VC-backed IPOs, the more relaxed nature of the market could entice some startups to see 2023 as a more opportune time to list than any year since 2021.

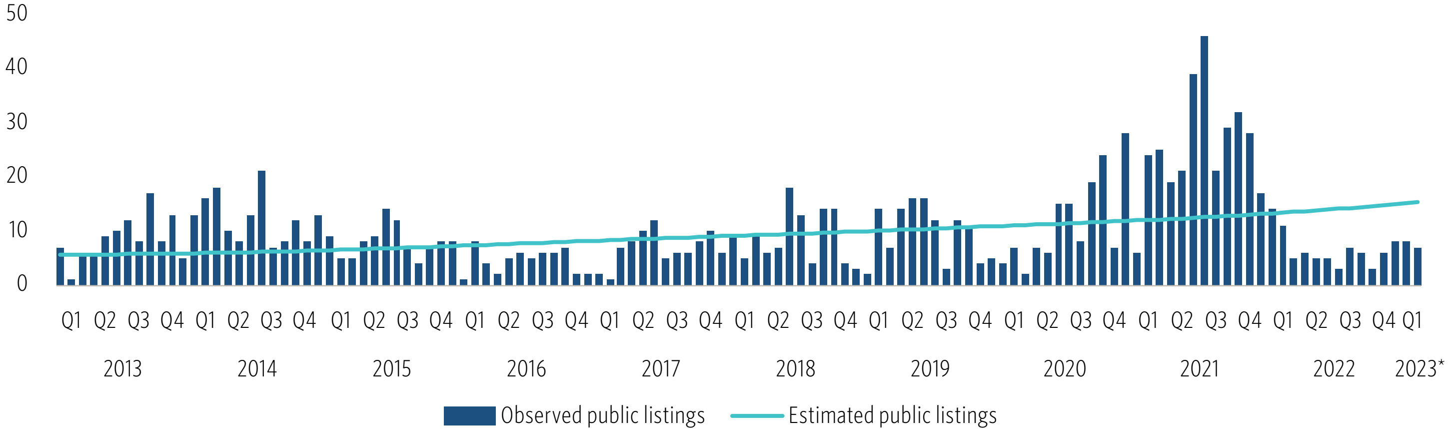
## Where the VC market stands

The venture market is surely in need of an IPO return. More than 800 unicorns operate in the US, and many others globally would look to list on a US exchange. The average unicorn last raised capital 17 months ago, putting the last round of many of these companies squarely in the valuation highs of VC and pushing these companies up to the historical financing timeline—the historical median time between rounds for VC-backed companies has fluctuated between 1.18 and 1.55 years.

Since the beginning of 2022, poor market conditions have created an enormous backlog of companies that should be exiting via IPO. Taking into account the number of VC-backed companies remaining private, roughly 220 companies should have listed publicly during this time. Now, the question becomes how many IPOs the market can support in a timely manner. The number of late-stage and venture-growth-stage companies that are still private has doubled since 2016. Even if the next 12 months showed the same number of IPOs as 2021, there would still be roughly a month's supply left in the backlog.

Beyond the slow exit environment, US startups find themselves with few other great options available. Capital availability has also been at extreme lows, complicating both organic and inorganic growth options. Yet it is unlikely that we have reached a point where companies are forced to pursue a listing. A recent analyst note looked at how the overcapitalization in 2020 and 2021 has likely led to deeper cash reserves for the VC market, particularly for unicorns. The longer the drought continues, however, the more challenging the market will become for companies needing to raise capital for growth.

**Monthly VC-backed public listing count versus estimated IPO backlog**




Source: PitchBook • Geography: US
*As of June 30, 2023

Investors also have an incentive to hope for a return of IPOs. Public listings have been a major driver of returns for VC in recent years. In 2021, $661.7 billion of value was generated through public listings, including deSPAC reverse mergers. The M&A market has also been incredibly slow in 2023, especially for larger transactions, as the Federal Trade Commission has been aggressive in its policing of the market.

Slowing returns in venture have had a deep impact on venture fundraising. This year's $33.3 billion in closed commitments through June 30 is not even 20% of the total closed during last year's record, and investors have needed to shift tactics because of it, lengthening the time between fundraises, either forced or by choice. In turn, investors have been deliberate with remaining dry powder, leading to increasing capital deficiency within the market.

The slow IPO market has become a major stumbling block for the VC-backed community, impacting all areas of the market.

## VC-backed IPO outlook

The prevailing outlook for the IPO market, with a specific focus on the substantial cohort of growth-centric tech unicorns mentioned earlier, is shaped by a confluence of factors. Notably, the prolonged economic downturn and the elevation in interest rates over the past year and a half have catalyzed one of the most languid US IPO environments observed in more than a decade. That said, the impending public debut of Instacart, among others that may file before the end of the year, emerges as a pivotal determinant of what is to come in the near term.

VC-backed tech unicorns, emblematic of their prioritization of growth over immediate profitability, have traditionally garnered investor favor within an environment characterized by suppressed interest rates. However, the ongoing economic conditions, coupled with the Fed's orchestrated interest rate maneuvers in response to burgeoning inflation, are potentially redefining market sentiment. There appears to be a discernible recalibration in investor preferences—favoring solvency and sustainable growth frameworks over the seemingly unrestrained pursuit of expansion. Instacart's journey through the venture ecosystem to its public filing is a noteworthy example. The firm's fiscal performance shows a notable ascent in profitability in the first half of the year, albeit concurrently indicating a deceleration within its foundational grocery-delivery enterprise. This trend, while suggestive of a maturing market, could underscore an emerging preference for enterprises that exhibit financial resilience, even within the dynamic tech landscape.

Now, as the IPO market anticipates impending listings from industry titans like Arm, Instacart, and Klaviyo, their reception will surely provide substantive insight into investor preferences. The VC market's reaction will likely hinge on the companies' initial performance as publicly traded entities. Strong pricing, with support at the debut price, could contribute to a rebound in the IPO market this year, particularly if investors perceive that growth-focused companies can align their expansion strategies with sound financial fundamentals. This may encourage more VC-backed tech startups to begin filing S-1s with targets to debut in public markets before the end of the year.

Lackluster performance of these stocks might reinforce the trend of investor preference for companies that exhibit outsize growth potential and an ability to continue an upward trend in profits. In this case, the IPO market's rebound might be delayed until there is increased confidence in the ability of growth-centric companies to navigate economic uncertainties and deliver on their promises of financial sustainability.

The interest-rate environment, falling multiples, and uneven performance of the tech sector are challenges that VC-backed companies haven not encountered for IPOs in recent memory, and until more S-1s are filed, the ability for private companies to adapt to market conditions since the slowdown began is unknown. While strong companies should be able to IPO in variable market conditions, the dynamics of venture that have given way to such high private valuations have positioned many companies poorly for the current market.