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Late-Stage Venture Pessimism May Give Way to Investment Opportunities

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2021 and 2022 saw a record volume of late-stage venture capital (VC) financings completed with healthy valuations (a "frothy" late-stage market). Since the start of 2023, only six Series D offerings have been completed. In this piece we identify some of the factors contributing to the pullback in late-stage funding rounds and note that history indicates there could be some room for optimism.

Late-stage venture capital investing is a broad category, but typically includes companies that are in their Series D, E, and F rounds of funding.[1] Companies raising late-stage venture funding are typically start-ups that have blossomed into commercial enterprises that are five years old or more, have found their optimal product-market fit, are typically close to an IPO or M&A exit.

While the late-stage VC financing space is broadly defined, the market environment for companies raising Series D fundraising rounds can serve as a proxy when measuring late-stage VC activity. After hitting an annual peak of $330 billion in 2021,[2] late-stage deal value has been declining for seven straight quarters,[3] and the environment for exits has continued to degrade with both the IPO market "closed" and M&A activity slowed substantially.[4] In 2021 and 2022, "crossover investors"[5] such as SoftBank and Tiger Global led 43 series D financings together with Andreessen Horowitz and InSight Partners leading another 22 series D in the same period, but it is noteworthy that Andreessen Horowitz and Insight have not led a series D in over a year.[6] (Figure 1)

[1] Some investors also wonder about the line between late-stage venture and growth investing. While there is no clear cut answer, late-stage venture companies are typically still growing faster than growth stage businesses and tend to be in traditional VC categories (e.g. consumer, technology or life sciences businesses). Late-stage VCs also tend to be a bit more hands off than their growth-stage counterparts.

[2] Source: CrunchBase - FinTech, J. Glasner, "The Biggest Start-Up IPOs of the Past 10 Years Are All Below Their First Day Price," May 9, 2023.

[3] Source: Ibid.

[4] Source: CrunchBase, H. Zhang, "The Late-Stage VC Market Has Already Slowed," April 2023. See also CrunchBase - FinTech, J. Glasner "Series D Hits Lowest Point in Years. What Does That Mean?" May 4, 2023 Seventy percent of deals in the first quarter of 2023 involved non-traditional investors.

[5] A "crossover" investor is typically a hedge fund or other non-VC investor that has chased deals in the VC space.

[6] Source: Ibid.

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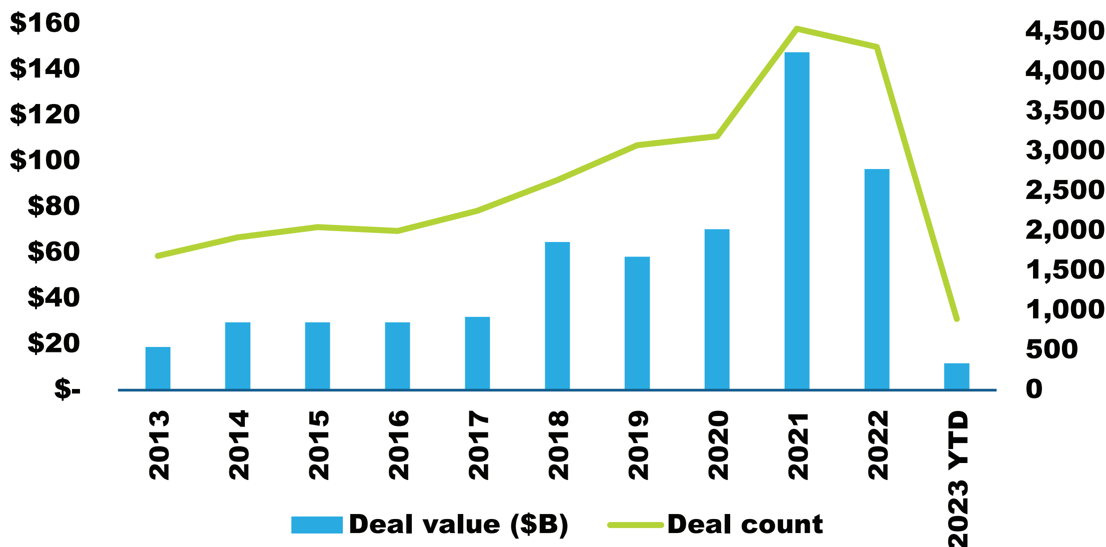

FIGURE 1

Series D Fund Raising (Count & Value)

Source: PitchBook-NVCA Venture Report 1Q2023. Additional deals not included in chart are estimated deal count for 2022 was 214 and for 2023 was 211.

The lack of an IPO market and slowing M&A activity may explain some of the absence of Series D investment activity. For several years the IPO market boomed with new listings and Special Purpose Acquisition Companies (SPAC) activity, but the 2023 IPO market has been nearly dead, with only two VC-backed companies listed above $1 billion on the public markets (both SPACs).[7] In addition, many of the biggest IPOs of the past few years are now trading well below their market valuation on their first day of trading.[8] For example, in 2021 Rivian (RIVN) was perhaps the biggest start-up IPO and enjoyed a similar valuation to the likes of General Motors. Since its IPO however, the company has lost about $54 billion in market cap.[9]

Another factor contributing to pessimism in the late-stage venture space is that even the venture investors who had companies go public in 2021 and 2022 may not have been able to achieve liquidity due to lock ups and/or declining prices. A recent analysis conducted by CrunchBase stated only three of the 20 largest companies to go public over the past fifteen years are trading above their initial offering prices.[10]

Despite a rough 2023 to date, there may be room for some optimism. Lower valuations and less demand from VCs may provide both an attractive entry point, stronger negotiating leverage for late-stage VC investors, and fewer VCs seeking deals. These conditions could satisfy the long-held truism of buying low. And if history is any indication, many great venture-backed companies will be founded and invested in during this challenging environment.[11] Investors willing to conduct extra due diligence to put money to work may find terms to be more advantageous than in previous years. In 2023 Venture Capital firms have advised their portfolio companies to conserve cash in an effort to avoid raising funds in a tough environment – particularly one that could lead to a "flat" or "down" round of financing. At some point in the next 12 months many of the venture-backed companies that raised rounds in the "frothy" markets of 2021 and 2022 are going to have to raise additional capital, and there may be attractive valuations for companies that have fewer options as some of the "tourist" and "crossover" investors have stepped back from backing growth-stage companies (e.g. the hedge funds and corporate VCs).

[7] Source: Analysis of The Crunchbase Billion-Dollar Exits Board, a list of US venture-backed companies' with first exits valued at $1 billion or more. See also, Institutional Investor, M. Celarier, "The IPO Market is on Track for Its Worst Performance in 30 Years," September 30, 2022. See also CrunchBase - FinTech, J. Glasner "Series D Hits Lowest Point in Years. What Does That Mean?" May 4, 2023.

[8] Source: CrunchBase - FinTech, J. Glasner, "The Biggest Start-Up IPOs of the Past 10 Years Are All Below Their First Day Price," May 9, 2023. CrunchBase analysis discussed here argues that all of the IPOs of the past 10 years are below IPO first day close valuation.

[9] Source: CrunchBase - FinTech, J. Glasner, "The Biggest Start-Up IPOs of the Past 10 Years Are All Below Their First Day Price," May 9, 2023.

[10] Source: Ibid.

[11] Source: Prequin Fourth Quarter 2015 Private Equity Performance Report, January 2016. The 2009 and 2010 venture capital vintages had an average annual IRR over 13% by the end of 2015. According to Pitchbook the top quartile of 2009 venture capital funds had an average annual IRR over 27%.

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Finally, the IPO window is not likely to stay closed for an extended period. Looking at the last 42 years of IPO activity, levels tend to be down for 1-3 years before returning to normal (See Figure 2 below). Based on both the historical averages and recent SEC filings, we expect IPO activity to pick up late this year and start returning towards normal in 2024. Recent news of Cava's IPO in the US may be an indication of a thaw in investor sentiment and a positive sign of the return to normalcy.[12]

[12] Source: Financial Times, "US IPO market: Cava shows the benefits of a Mediterranean diet" June 16, 2023.

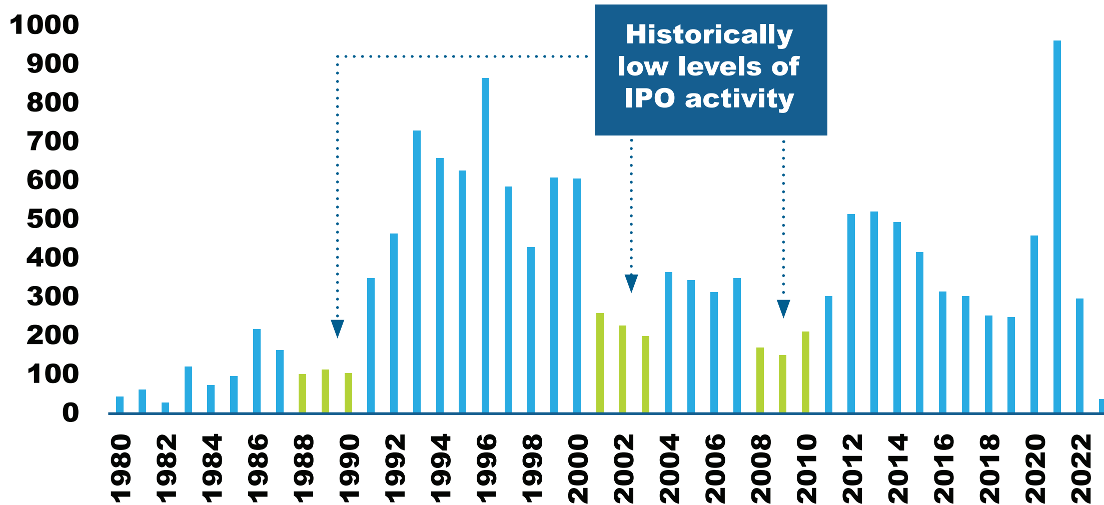

FIGURE 2
US-Exchange Listed IPOs by Calendar Year

Source: Bloomberg as of June 12, 2023.

Varying market and economic cycles will continue to pose unique challenges to investors as they seek to increase their assets or mitigate risks. If hindsight is any indication of what may lie ahead in terms of the investment landscape, a long-term view on prudent due diligence and attaining vintage year diversification through consistent capital deployment may prove to be the best strategy for tackling the venture market.

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