VENTURE CAPITAL: IT'S A GREAT TIME TO BE INVESTING

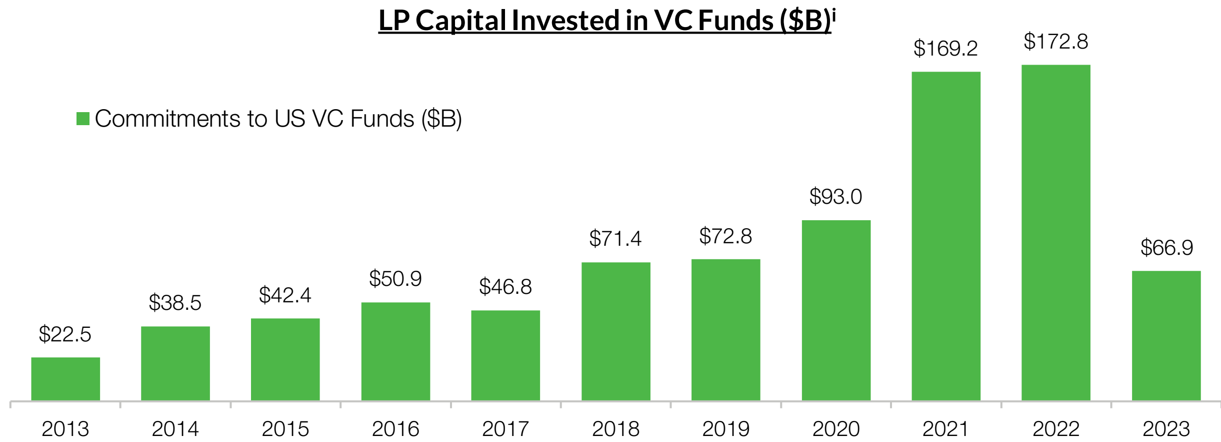
By Jonathan Roosevelt and Evan Gancedo

It is well understood that a critical determinant of a successful venture fund is timing – being in a great vintage. A great vintage is determined by the ability to buy at reasonable valuations as well as the ability to exit when M&A and IPO markets are strong.

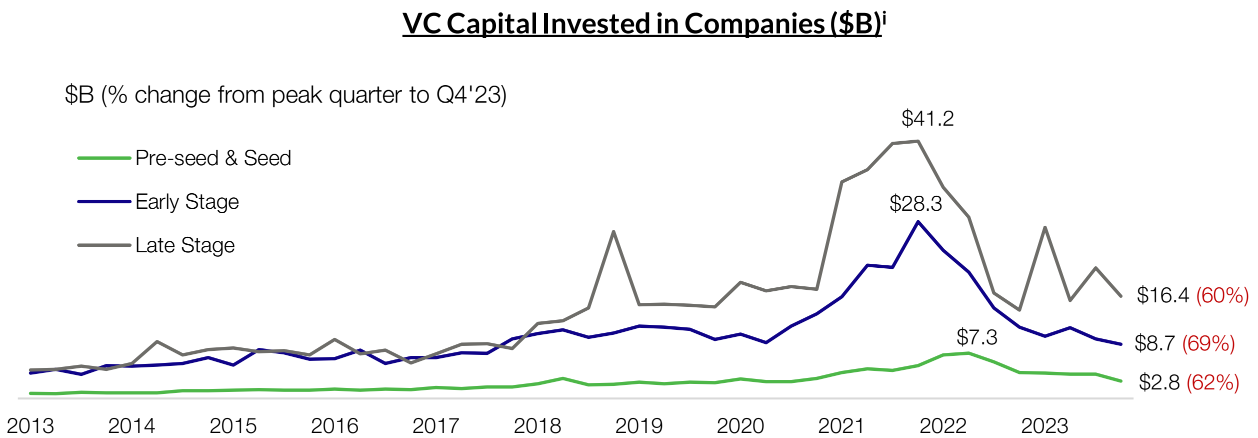
ARE VALUATIONS REASONABLE NOW?

Bolstered in large part by low interest rates and economic stimulus packages, public and private valuations began to spike in Q2 2020, and private market valuations peaked for all stages between Q3 2021 and Q1 2022. As interest rates began rising in March 2022, the VC ecosystem has grappled with public market revaluations, the lowest amount of exit activity in a decade, a dramatic drop in LP capital into VC funds, and a corresponding drop in VC capital into companies.

LP Capital Invested in VC Funds ($B)[i]

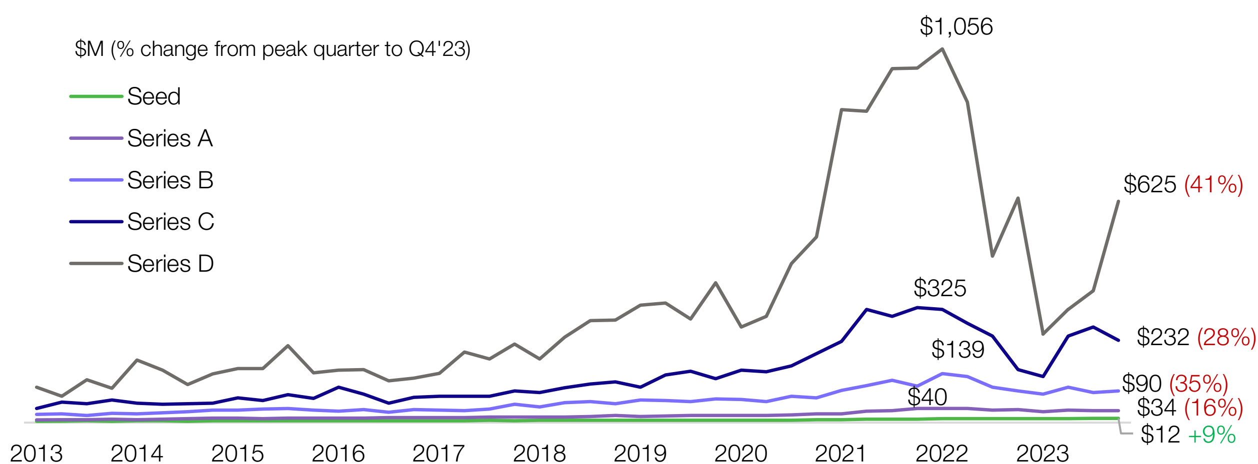


VC Capital Invested in Companies ($B)[i]



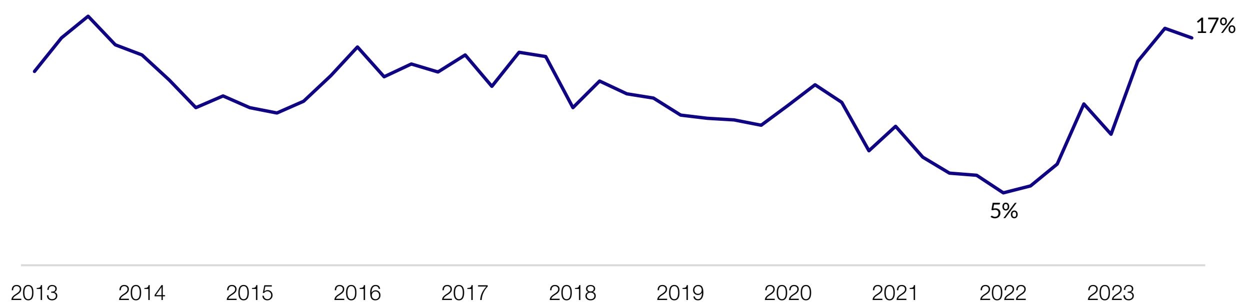
These factors led to declining valuations, most immediately and significantly for later-stage companies, which suffered from their temporal proximity to public companies. However, the public market rebound over the past year has led to a valuation lift for private companies.

Median US VC Pre-Money Valuations by Stage[ii]



On the surface, it appears that valuations, especially among Seed, Series A and Series B companies, remain near froth levels, which suggests that the expectation of almost guaranteed (and inexpensive) follow-on capital remains. But a different story is playing out in most private company board meetings and fundraising conversations. Many private companies' ending cash runways and limited exit options have forced them to face the reality of a capital-constrained and exit-concerned private market. This has led to a significant increase in down and/or structured rounds, layoff announcements and company shutdowns.

Down Rounds as % of Total Follow-Ons[ii]

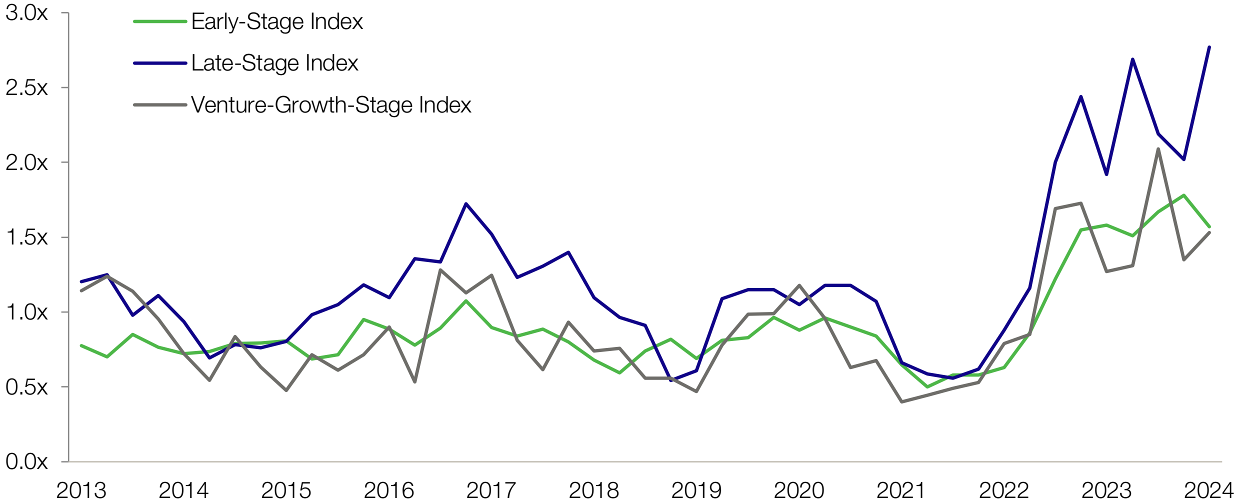


How can it be that valuations are above pre-froth levels and not far from froth levels, but companies are experiencing a decade-high level of down rounds? The answer is that ***median valuation data is hiding the significant flight to quality that VCs have been implementing***.

While a detailed explanation as to why there has been a flight to quality is outside the scope of this short paper, the simple explanation is not that VCs have gotten smarter, but rather that the law of supply and demand has not been suspended. The slump in LP capital into the VC ecosystem – without a corresponding change in startup demand for capital – has shifted the power from entrepreneur to VC. VCs can spend more time on due diligence and can select better, more proven teams with demonstrable traction. According to Eric Rosenblum, founding partner at Silicon

Valley-based, seed-stage-focused Foothill Ventures, "In 2021, our average diligence time for a competitive deal was one to two weeks. Today, the amount of time we have to complete diligence has extended into the four-plus weeks range."[iii]

Venture Capital Demand-to-Supply Ratio[iv]



For the sake of brevity, we will focus on Series A to demonstrate the flight to quality since the early froth period of Q2 2021 to Q4 2021 (shifted about one quarter earlier than peak froth, but a period for which we have data). Data from Tech Crunch, SaaStr and Kruze Consulting in the table below indicates that Series A investors have been dramatically increasing requirements for maturity and growth.

Series A Flight to Quality

	Froth (Q2 2021 – Q4 2021)	**Q3 2023**
Series A ARR Avg.	$1.2M[v]	$2.3M[v]
Median Age (years) of Company Raising Series A	4.1[vi]	4.9[vi]

When the Series A ARR data is combined with the Series A valuation data, a significant reduction in ARR multiples for Series A companies is revealed: from 33.3x to less than 15x.

Series A ARR Multiples

	Q4 2021	**Q3 2023**
Median Valuation	$40M	$34M
ARR	$1.2M	$2.3M
ARR multiple	**33.3x**	**14.8x**

Given the flight to quality, reduced average ARR multiples, and sustained median valuations, we think that the significant reduction in Series A capital has led to a lack of capital for low quality companies seeking Series A financing.

We have made a few assumptions to reveal the sort of impact that this could have on Series A valuations. As we showed above, there has been a reduction of approximately 69% in early-stage (Series A and B) capital from peak of Q3 2021 to Q4 2023. Since the most recent ARR multiple data we have is for Q3 2023, we will use the 66% reduction in early-stage capital between peak and Q3 2023. Let's assume that this reduction applied equally to Series A and B stage companies. For simplicity, let's also assume that 100% of this reduction applied to the lower quality companies that would have raised capital when venture valuations peaked. Finally, let's rank the companies in order of quality and conservatively assume that the bottom 66% were valued at a healthy 20x revenue multiple. Comparing the valuation of the top 34% between Q4 2021 and Q3 2023 we see a 400% variance in this hypothetical analysis.

Series A Valuations: By Quality

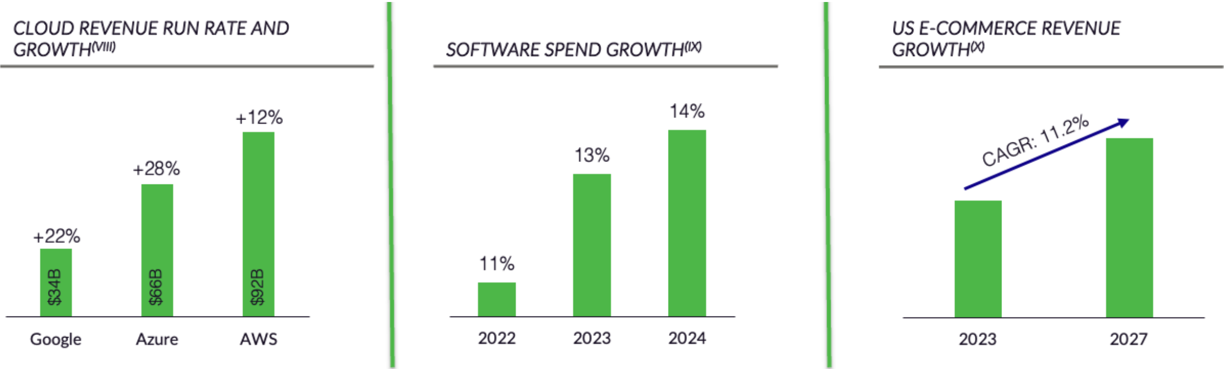
	Bottom 66% ARR Multiple	Top 34% ARR Multiple	Average ARR Multiple
Q4'21	20x	**59.1x**	33.3x
Q3'23	Not funded	**14.8x**	14.8x

WILL THE NEXT DECADE BE A GOOD TIME TO SELL?

The best companies are built on strong foundations. Today's capital market values efficiency and cash discipline. As Brett Wilson, seasoned entrepreneur and co-founder of AI-focused Swift Ventures said, "Today's venture market is a great time to build pillar companies. There are very few stupid startup competitors, glamour entrepreneurs who want to grow at all costs and who think the prize is unicorn status. Companies are being forced to develop healthy habits that will create a valuable crop of exit candidates over the next decade. It's also a great time to pay lower rents and to recruit quality talent experiencing tech's widespread layoffs."[vii]

Furthermore, as evidenced in the visual below, we are experiencing increased demand for technology.

Demand for Technology is Strong



We believe demand for technology is about to experience a dramatic stimulus from AI, this decade's prevalent platform innovation. From PCs (1980s) to the world wide web (1990s) to the cloud (2000s) and smart phones (2000s), disruptive platform innovations have sprouted entirely new products and services. These technological waves have dramatically – and quickly – shaped

the world in which we live. Imagine the world before these platforms and the many services they spawned, including email, online search, e-commerce, streaming entertainment, camera phones, food delivery, digital banking, social media, and ridesharing.

Goldman Sachs predicts that AI will drive a massive 7% (or almost $7T) increase in global GDP in the next decade.[xi] According to Battery Ventures, this growth will require expansion of annual spend in AI-infused software from approximately $600B to potentially more than $1.8T in the next five to seven years.[xii] This does not include anticipated acceleration of annual hardware spend, which is currently over $700B for IT devices and $600B for semiconductors, which are foundational to training and querying AI data sets.[xiii]

While AI has been here for many years under different names, it has recently been brought center stage by breakthroughs driven by the scaffolding of dramatic increases in digital data and computing power. Its promise is to create enormous efficiency and productivity by automating many human tasks and judgements. Like the internet, AI is a fabric that will be woven into virtually every technology … and technology will continue to find its way into virtually every product and service.

We are already watching companies increase their growth rates while decreasing costs by applying generative AI to sales and marketing, product development, recruiting and other areas of their businesses. SEO consultants are being supplanted by auto-generated content that is driving inbound prospects. Sales team members are being replaced by automated email outreach and response. Software engineers are experiencing 20%+ productivity using AI copilots. Recruiters are being easily outperformed by AI-powered algorithms that quickly collect, analyze, and screen a vast number of resumes. Doctors are able to redirect approximately 20% of their time by using AI-powered software to take notes on patients, enter them into EMRs, and automatically generate summaries and recommendations. Smaller insurance teams are processing claims with much greater speed and accuracy. A company as large as JPMorgan Chase has already started "applying AI in every single process, every app and every database."[xiv] While the impact on existing jobs goes on, it may be small compared to Morgan Stanley's point that AI has "the power to create new economic activity and entirely new professions."[xv]

While we do not know exactly what the future holds, AI-powered software will undoubtedly be a large part of a very different future. This, combined with lower, quality-adjusted valuations, makes 2024 an incredibly exciting time to deploy capital.

[i] "Q4 2023 PitchBook-NVCA Venture Monitor Summary," PitchBook, January 2024.
[ii] Data provided by PitchBook as of December 31, 2023.
[iii] Eric Rosenblum, discussion with Jonathan Roosevelt, March 25, 2024.
[iv] "PitchBook VC Dealmaking Indicator," PitchBook, March 12, 2024. *Note: The y-axis shows the ratio of venture capital dollars requested by companies vs. venture capital dollars supplied by funds.*
[v] "Raising Capital in H2 2023: What You Really Need to Know with Creandum Partner Peter Specht," SaaStr, July 2023. *Note: Instead of providing an exact Series A ARR multiple, the quote is that "[Series A rounds] are more mature and have >$2M ARR… with many good funds investing [at Series A in companies with] between $2.5M and $4M ARR."*
[vi] "2023 Annual US VC Valuations Report," PitchBook, February 2024.
[vii] Brett Wilson, discussion with Jonathan Roosevelt, March 25, 2024.
[viii] Jamin Ball, "Clouded Judgement 10.27.23 – Cloud Giants Report Q3 '23," October 27, 2023. *Note: Data as of 9/30/2023, growth rates shown are Year Over Year.*
[ix] "Gartner Forecasts Worldwide IT Spending to Grow 8% in 2024," Gartner, October 18, 2023.
[x] "eCommerce: Market Data & Analysis," Statista, 2023.
[xi] "Generative AI Could Raise Global GDP by 7%," Goldman Sachs Research, 2022.
[xii] "Battery Ventures Sees AI's Massive Impact on Tech, And It's Here Already," Crunchbase News, March 6, 2024.
[xiii] "Industry Insights: Hardware," Statista, 2023.
[xiv] Jamie Dimon, "Jamie Dimon Says AI May let people work 3 ½ days a week," *Bloomberg Television*, October 2023.
[xv] "How Generative AI Could Reshape Work," Morgan Stanley Research, November 8, 2023.