Advisory | Venture Capital & Emerging Technology

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2023 Investment Trends and 2024 Outlook

I. Introduction

While a down year compared to all-time highs experienced in 2021 and 2022, 2023 represented another strong year in the U.S. venture community based on deal flow and total investments, even if not shared equally among all venture-backed companies and all stages of companies. High valuations in low interest rate environments during the pandemic contrasted with rising rates and inflation in 2023 resulted in many venture-backed companies seeking additional capital on lesser terms than their prior high-water valuations. Accordingly, many companies facing stalling growth and a liquidity crunch yielded many convertible note rounds, equity down rounds and stronger economic terms and downside and governance protections for investors, in addition to distressed exits. More aggressive regulatory regimes, particularly antitrust enforcers, represented additional hurdles for acquisition targets to obtain exits while the public markets remained tepid. On the other hand, significant government incentives have offered companies in certain high priority industries lucrative opportunities to attract investment. In 2024, we expect that the recent pare-back in start-up valuations will lead to more methodical growth, more meaningful oversight and professional corporate governance, and balanced economics between founders and investors, though companies that raised at pandemic highs will continue to face difficult decisions. Nevertheless, we remain cautiously optimistic that the prospect of reduced interest rates and increasing liquidity demands will present a more favorable climate for private dealmaking and public market opportunities in 2024.

II. Fundraising Climate and Deal Trends

A. 2023 Transaction Statistics

After peaking in 2021, 2023 followed a downward trend in U.S. venture capital investment that began in 2022. According to data published by PitchBook in collaboration with the National Venture Capital Association (NVCA)[1], 2023 saw 15,766 estimated total venture-backed investments with $170.6 billion invested, down from 19,025 and $348.0 billion in 2021 and 17,592 and $242.2 billion in 2022, respectively. No stage in a company's lifecycle was immune from the general aggregate trends across the industry in 2023, with the combined "pre-seed" and "seed" value dropping from $24.2 billion to $14.6 billion,[2] early-stage (i.e., Series A to Series B) dropping from $70.0 billion to $39.5 billion,[3] late-stage (e.g., Series C) experiencing a similar fall from $94.0 billion to $80.4 billion,[4] and venture-growth (e.g., Series D and beyond) dropping from $54.1 billion to $36.1 billion,[5] according to PitchBook. though remaining above pre-pandemic levels. Moreover, valuations remained robust, even if early-stage to late-stage median valuations began to fall from 2021 highs (though "seed" investments ascended to $12.0 million for the first time in 2023).[6] On the other hand, 2023 exit activity reached recent lows with just $61.5 billion in exit values across approximately 1,129 deals, a further decrease from $78.6 billion and 1,401 in 2022, which itself was a steep decline from $796.8 billion and 1,990 in 2021 (largely represented by public listings), respectively.[7]

Regionally, the Bay Area, Los Angeles, New York, and Boston remained the epicenters for venture deals, particularly from a deal size perspective. According to PitchBook, approximately 50% of all venture capital deals (similar across lifecycle) involved companies located in these core markets, while 60% of the capital in pre-seed/seed rounds to over 70% of the capital in later stages, were provided to such businesses. Notwithstanding high-profile venture investors exploring moves to Texas and Miami, the Bay Area continued to set the pace with over 600 more deals than the runner up locale of New York, which itself experienced its highest portion of U.S. deals (15.1%) than ever before, double the next highest market.

B. 2024 Deal Trends

Many companies that raised at ever-increasing valuations during the post-pandemic stimulus boom markets are wrestling with the reality that the market no longer supports their lofty appraisals and now are contending with pivots, layoffs, more challenging fundraising environments, and, worst case, distressed sales or winding up of businesses.

While the market will remain robust for some companies who have stayed on track with their growth and/or revenue models to raise capital on balanced or even favorable terms, for companies who have stalled in their growth trajectory and need to tap the private capital markets, the primary trends we see continuing in 2024 include (i) slower transaction timelines, including more significant and detailed diligence processes, (ii) a greater emphasis and expansion of investor

[1] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 6

[2] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 9

[3] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 13

[4] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 15

[5] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 18

[6] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 10, 14, 16

[7] https://nvca.org/wp-content/uploads/2024/01/Q4-2023-PitchBook-NVCA-Venture-Monitor.pdf, Page 35, 36

governance protections and limitation on founder-favorable governance structures, (iii) down rounds (whether as standard Preferred Stock rounds or convertible financings on convertible notes or Simple Agreements for Future Equity (SAFEs) including valuation caps below the previous valuation), (iii) recapitalizations, including pay-to-plays or "cramdowns" (i.e., existing Preferred Stock equity relegated to a single junior preference below the new money or, worse, converted to Common Stock) and "pull-ups" (i.e., creating new senior series of Preferred Stock to incentivize existing investors to put additional capital into the business and jump the line of those who do not), and (iv) additional downside protection (i.e., greater than 1x liquidation preference multiples) or upside kickers (i.e., warrants to purchase additional shares in the investor's discretion).

C. Transaction Timelines and Approval Challenges

Particularly in light of several high profile venture-backed founder mismanagement and fraud trials, investors are revisiting their diligence processes, particularly as limited partners and other syndicate investors demand more significant diligence reports and legal-prepared memoranda. Moreover, with "market" terms shifting from fairly consistent "middle-of-the-road" terms in financing rounds (i.e., basic 1x liquidation preferences, with or without a seat on the Board of Directors for the lead investor, and a typical selection of investor approval rights), companies and investors face more difficult negotiation processes as terms become more bespoke, especially when founders and existing investors remain anchored to prior higher valuations. Accordingly, term sheets and letters of intent are taking longer to reach agreement and even once companies and lead investors agree on the parameters of a transaction, many capital providers are now requiring considerable commitments from other significant investors and/or existing stockholders in order to have comfort that the businesses will have sufficient runway following their investment. Obtaining approval from the requisite stockholders of the business, who may not be pleased to see their investment seemingly depreciate and experience other investors jumping the line, also presents challenges and heightened sensitivity to managing potential litigious insiders.

D. Governance Matters

In the typical venture-backed early-stage start-up, founders will often retain control with the ability to nominate a majority of the Board of Directors or similar governing body until several rounds of funding introduce independent directors and additional investor-controlled Board seats in subsequent rounds. Investors in such Series Seed and Series A companies (most often purchasing "Preferred Stock," a senior security with certain rights and preferences ahead of the "Common Stock" held by founders, employees, and other service providers) will typically receive certain minimum basic approval rights requiring the approval of a majority or supermajority of the holders of Preferred Stock (i.e., "protective provisions"), e.g., approving future financing transactions and other similar economic protections.

Additionally, certain founders seek super-voting shares when forming their businesses in order to maintain long-term control on stockholder voting matters, including nominating and appointing a plurality or majority of the Board of Directors once a company has gone public, though super-voting shares remain a significant minority with most companies opting for all voting shares to have consistent treatment. Most often, by the time a venture-backed company reaches growth stages (e.g., Series B and beyond), the Board of Directors will generally be balanced with the founders and/or management team controlling one or two seats on the Board (sometimes requiring service requirements as employees or consultants, whether by the persons entitled to nominate and elect the directors and/or the individuals that need to serve in said seats), large institutional investors will negotiate a similar number (or greater number) of Board seats (with certain key Board approval matters requiring their specific approval, in addition to general Board votes), and one or several seats reserved for independent directors not affiliated with major stockholders. As a company nears a public offering, a company will often prepare for going public by shifting more of the Board seats to independents and a relaxing on the list of items requiring approval by the investor-appointed directors or Preferred Stock protective provisions.

Now, companies raising funds from a position of weakness should be prepared for investors to seek enhanced governance and economics rights and protections. For example, super-voting shares for founders likely will be reserved for exceptional circumstances, such as serial entrepreneurs with proven track records of creating immense growth for investors. While founders will still maintain control over matters subject to the approval of all holders of capital stock until they are substantially diluted after several rounds, investors may require a greater list of operational approval rights, whether by any Preferred Stock-appointed directors or through the Preferred Stock protective provisions. Moreover, new investors may request additional approval rights rather than deferring to votes of all holders of Preferred Stock as a single voting bloc (i.e., "majority of the Preferred Stock, which must include a majority" of the new series of Preferred Stock sold to investors in the latest round of funding), particularly if said series has a senior liquidation preference to the other series of Preferred Stock and said protective provisions relate to protecting their core economics. In other words, capital providers are demanding more control over their investment and oversight over the operations of their portfolio companies.

E. Down Rounds, Convertible Financings, and Structured Preferred Financings

Down rounds, i.e., raising funds at a lower valuation than the most recent financing valuation, have become the difficult reality for many start-ups, which present challenges for companies as additional investments from insiders who may have exhausted reserves to support their portfolio companies have dried up and companies reach the end of their cash runway. Accordingly, as was the case in 2023, we expect many companies and investors to negotiate structured equity financings, whether directly as additional Preferred Stock financing rounds or convertible notes or SAFEs or by the incorporation of warrant "kickers," whereby such convertible instruments provide the investors a discount (or effective discount) on their shares based on the price raised in a subsequent valuation, whether based on a flat discount rate, a valuation cap, or the better of the effective discount depending on the valuation in that next financing (or an effective discount by providing warrant coverage to boost ownership in exchange for little to no additional investment dollars).

Early in the post-pandemic investment boom period, companies facing such circumstances often tried to spin convertible financings as avoiding a down round (if they did not have valuation caps lower than the prior financing round), but now many convertible financings have much more favorable terms for investors, including lower valuation caps, higher discount rates, "most favored nations" provisions (providing investors "full ratchet" anti-dilution protection if a company raises convertible instruments on more favorable terms, allowing such earlier investors to elect to receive the same terms), minimum liquidation/exit preferences at greater than one times their investment, seniority to other existing securities, interest accrual at favorable rates, performance milestones to unlock additional capital, and sometimes additional upside kickers in the form of warrants allowing the investor to purchase additional shares at some point in the future in their sole discretion (in the event said shares are "in the money").

Additionally, certain financing opportunities present proposals for pay-to-plays/"cram downs" and "pull-ups," incentivizing existing investors to contribute more capital or experience other parties jumping the line (in the case of a pull-up) or removing all of their preferences and preferential rights and converting to Common

Stock. We anticipate such financing structures to continue. Of course, financing terms that impact the existing liquidation preference stack may be more prone to face resistance from existing investors and companies will need to manage difficult conversations and approval processes with their existing stockholders in order to close on necessary capital to continue the business as a going concern. On the other hand, existing investors may be forced to approve deals that seemingly are not in their interest if the alternative is a distressed sale or winddown of the business.

III. Exit Opportunities

A. Regulatory Headwinds for Mergers and Acquisitions

Both home and abroad, antitrust regulators present greater challenges to successfully close significant mergers and acquisitions. High profile tie-ups, including Adobe's proposed $20 billion acquisition of Figma (called off due to challenging approval paths from the European Commission and the UK Competition and Markets Authority), Illumina's announced plans for divestiture of Grail following a challenge by the Federal Trade Commission (FTC), among others in an array of industries, represented cautionary tales for strategic horizontal acquisitions. Even smaller M&A exits are not immune from antirust risks, even if not necessarily participating in the same traditional market, with several high-profile tech companies facing regulatory hurdles with respect to acquisitions that many would not have expected based on historical regulatory activity. Even as some companies have been able to overcome regulatory hurdles and public challenges, many companies may forgo strategic exits for fear of tying up their businesses for several years under antitrust review, particularly when such tie-ups may prevent the company from raising additional capital in the interim to continue as a going concern.

Additionally, other transactions may experience other challenges even if less ripe for antitrust concerns, such as the Committee of Foreign Investment in the United States (CFIUS), in cross-border exits, particularly in an election year in foreign acquisitions of companies operating in key industries involving core constituencies. Although targets may be able to soften the blow by negotiating break-up fees, the costs and disruption to business posed by forgoing other liquidity opportunities may result in companies seeking alternative exits.

Nevertheless, other businesses, particularly "mom and pop" businesses helmed by those in the "Baby Boomer" generation seeking retirement, or distressed venture-backed companies seeking a face-saving sale, may present unique opportunities for acquirors that may not trigger antitrust and other regulatory scrutiny. Private equity also offers another opportunity for venture-backed exists as funds sit on record levels of "dry powder" and more frequently tread into the earlier private market stages, particularly seeking distressed opportunities.

B. Expect a New Wave of Public Listings

Although the market for initial public offerings (IPOs) in 2023 does not suggest a ripe market for 2024, with numerous growth and late-stage unicorns seeking exit opportunities for their early investors treading lightly in strategic sales, we expect many of these companies to attempt to pursue the public markets in 2024. The spike in the volume of direct listings and special purpose acquisition company (SPAC) in recent years has diminished (in part due to new disclosure rules proposed by the Securities and Exchange Commission (SEC), SPAC investors seeking redemptions of their original SPAC investments, and poor public market performance by many companies who sought liquidity and capital via these avenues in 2020, 2021, and 2022), we expect more growth stage companies to explore the public markets, including exploring dual-track opportunities for public offerings and "de-SPAC" transactions with the backing of meaningful private investment in public equity (PIPE) investment.

C. Secondary Sales Offer Additional Liquidity

A further path for liquidity for early and growth stage investors remains the secondary market. With the advent of online capitalization table management platforms easing record-keeping for start-up companies and providing new opportunities for companies and investors to connect with one another and streamline corporate diligence processes, new secondary market platforms, and the proliferation of secondary deals, may become a reality in 2024. (However, recent reporting on the potential exposure of confidential information on such a platform suggests that the proliferation of new platforms to facilitate secondary dealing may not be without its setbacks.) Over the last few years, secondaries typically have presented themselves in the venture context for founders seeking liquidity in connection with primary financing rounds, whereby a portion of the committed capital from the investors is allocated to the founders and other early employees with the investors still receiving typical Preferred Stock equity in a simultaneous exchange with the company, sometimes through "Founder Preferred Stock" automatic conversion mechanics. However, we expect that private markets will continue to develop for growth and later stage start-ups who remain hesitant to enter the public market yet want to enable liquidity paths both for their employees and early investors.

IV. Policy and Regulatory Hurdles on the Horizon

A. Corporate Transparency Act and Other Disclosure Regimes Present New Investor Requirements

2024's welcoming of the advent of the Corporate Transparency Act of 2019 (CTA) regime represents another attempt by the United States federal government to monitor and prevent illicit activity in U.S. capital markets, joining other policy and geopolitical initiatives such as the wielding of sanctions laws and CFIUS in monitoring U.S. corporate activity.

Effective January 1, 2024, the Corporate Transparency Act requires certain U.S. legal entities and foreign entities registered to do business in the United States (i.e., "Reporting Companies," excluding certain investment funds and other exempted entities) to report certain information about itself, its beneficial owners (i.e., those who directly or indirectly own or control 25% of the ownership interests of a reporting company or those who are deemed to have "substantial control" over said reporting company such as senior officers, those with the ability to appoint such officers or a majority of its board of directors or similar governing body, and other important decision-makers determined by the U.S. Department of Treasury's financial Crimes Enforcement Network (FinCEN)), and company applicants (i.e., those filing entity formation or registration documentation in U.S. jurisdictions). Within 90 days of the formation or registration of a new Reporting Company in 2024 (30 days after 2024), and by the end of calendar year 2024 for existing Reporting Companies, Reporting Companies must file Beneficial Ownership Information (BOI) reports that includes key biographical information about itself and its beneficial owners and company applicants, including the entity's name, address, jurisdiction, Internal Revenue Service (IRS) Taxpayer Identification Number (TIN) or Employer Identification Number (EIN), and the name, date of birth, address, and a passport, state driver's license, or other identification issued by a state, local government, or tribe of beneficial owners and company applicants. The failure to report may result in significant monetary and other penalties. Accordingly, investors who may wish to avoid the CTA reporting regime may be foreclosed from obtaining certain key governance rights that could trigger an argument that they have "substantial control" over a business. Regardless, the CTA represents a new reporting burden not previously experienced by most US-based businesses not otherwise engaged in highly regulated industries subject to similar reporting requirements.

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B. Election Year Presents Uncertainty for Recent Major Federal Spending Legislation and Other Policies

The implementation of large federal spending programs adopted under the Biden Administration, including the Infrastructure and Jobs Act (also known as the Bipartisan Infrastructure Deal), the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act, and the Inflation Reduction Act has created certain incentives for investment in certain industries (e.g., physical infrastructure, climate technologies, advanced semiconductors, and their respective adjacent industries) presenting opportunities for capital providers. Additionally, slowing inflation and strong employment suggest that interest rates may begin to fall and present a more promising market for more aggressive deal-making. In a pivotal election year rife with geopolitical uncertainty, however, investors may tread lightly until voters decide whether these initiatives will remain effective with another Democratic term or whether a Republican White House may have an opportunity interrupt the further administration of federal resources to said policies and invite other changes, including to antitrust enforcement and tax policies, that could impact business decision-making and encourage different investing behaviors.

V. Conclusion

2024 represents another year of uncertainty in the capital markets as geopolitical risks, elections, uncertain inflation and interest rate policies, and heightened regulatory scrutiny present challenges for venture-backed start-up companies seeking additional funding and exits. Still, governmental policy supporting specific industries like climate-focused businesses, the rapid development of potentially transformative technologies like artificial intelligence and machine learning (AIML) coupled with softening valuations offer investors seeking “hockey-stick” returns plenty of opportunities for allocating their capital in 2024, both in the early-stage private markets and with later stage companies on the verge of providing liquidity for their investors.

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