Quarterly Report – Oct 2023

The State of Venture and CVCs:

Taking stock of the past 18 months

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Introduction

The Fed's near-zero interest rates and capital influx, which had propelled venture fundraising and investing, is now over. Given the market's rollercoaster of a ride for investors over the past 18 months, **it might be time to stop and take stock of what's happened and what we can learn from the experience**.

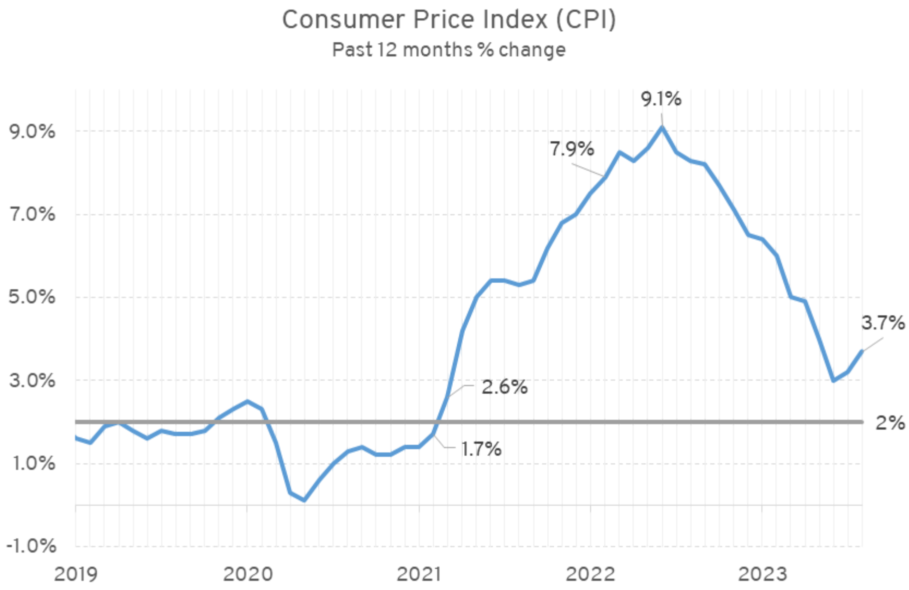
In our view, the role of a venture investor is to provide value to entrepreneurs – in the form of financial capital, credibility, expertise, relationship networks, and accelerating commercialization. **Our intuition is that, in times when the tide is going out, the investors that survive will be the ones that keep that mission in their line of sight.**

This report is the first in a series, developed as a collaboration between TDK Ventures and 6Pages. As such, we are particularly interested in how corporate venture capital (CVC) has behaved and performed differently than venture capital (VC) in general. This first report is intended to lay a foundation for our later perspectives.

A quick review of the macroeconomic drivers

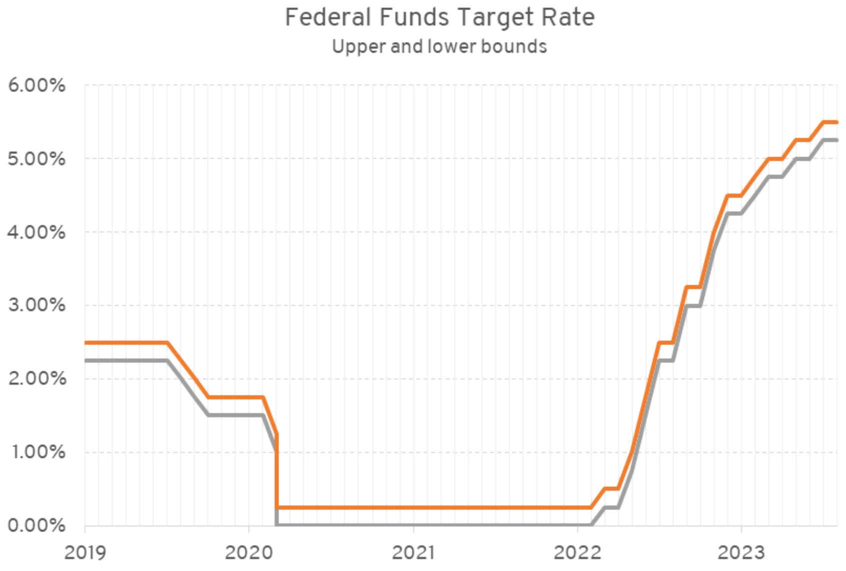
A confluence of factors contributed to **the tumultuous investing environment for venture capital firms over the past 18 months**. Probably the most direct causal factors were persistent rising inflation and the series of rate hikes by the Federal Reserve in response.

Inflation, based on the "all items" Consumer Price Index (CPI), first overtook the Fed's 2% target in Mar 2021. **It continued rising at an alarming pace, reaching 7.9% in the Feb 2022 report** – the last report before the Fed finally pulled the trigger on its first rate hike of this cycle. (Inflation eventually peaked at 9.1% before descending to 3.7% as of the most recent report.)



US Bureau of Labor Statistics

Since Mar 2022, **the Fed has raised the federal-funds target rate range a total of 11 times to now 5.25-5.50%** (as of Sep 2023) – its highest levels in 22 years. The Fed also began unwinding its nearly $9T balance sheet in Jun 2022, pulling substantial volumes of money out of the financial system.



Federal Reserve

Technology and growth stocks tend to be more sensitive to inflation than value investments, in large part because inflation and higher interest rates can erode the value of future earnings – the driver of once high-flying valuations. In times of downturn, investors also tend to flee risk.

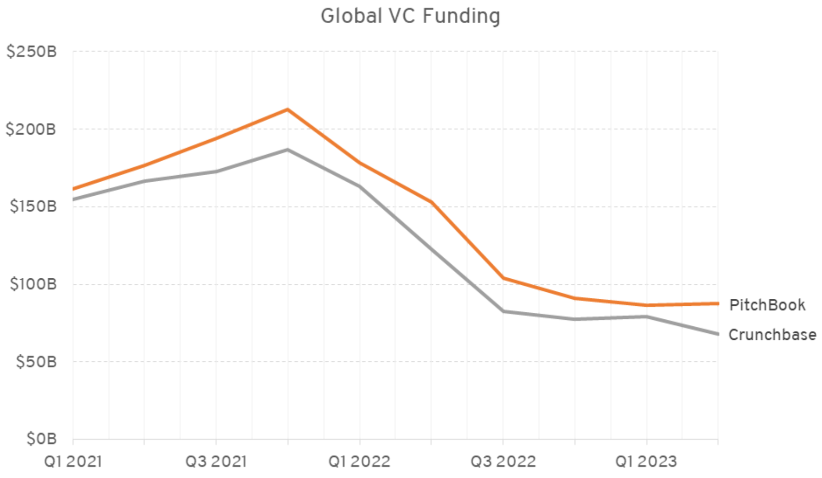
The tech-heavy Nasdaq Composite – amid market jitters and the Fed actions – fell more than 35% from its Nov 2021 peak to reach a low in Oct 2022 it has yet to fully recover from, despite a strong run in H1 2023. **Not too surprisingly, venture capital has faced similar headwinds.**

The Fed is projecting one more rate hike this year and rates are expected to stay high into 2024. While hopes of a soft landing abound, a recession could still be in the cards.

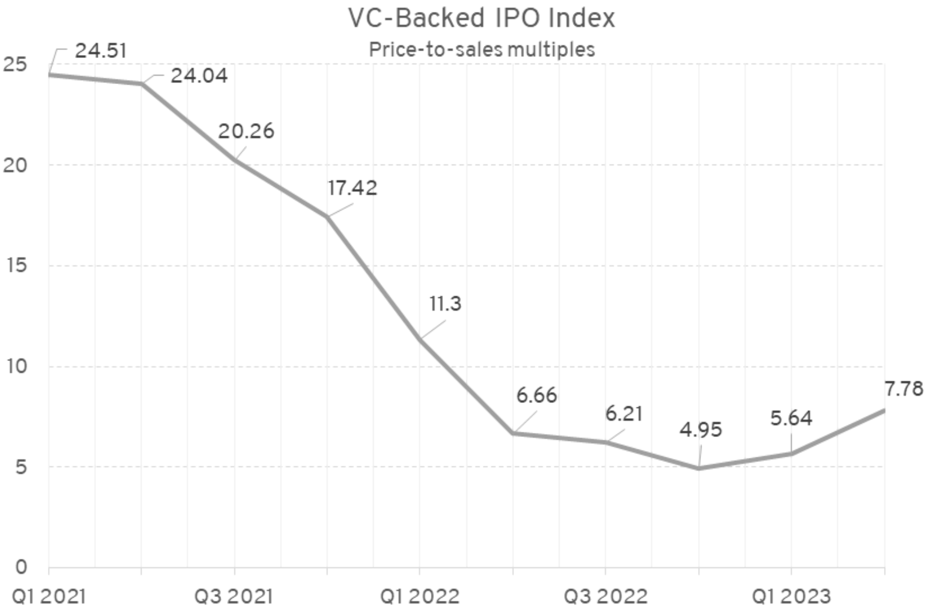
Venture capital over the past 18 months

Under these uncertain macroeconomic conditions, as one investor put it, **"The fear of f**king up (FOFU) has replaced the fear of missing out (FOMO)."** Investors became more conservative, resulting in smaller transaction sizes and some deals shelved altogether.

After a blockbuster year for venture capital in 2021, global VC investment slid 30-35% in 2022. **2023 hasn't been much better, with total VC deal value staying in the doldrums and down 46% year-over-year as of Aug 2023.** In H1 2023, about 20% of startup financing rounds were down rounds, which was twice the pre-pandemic rate.



Enterprise value-to-sales multiples fell precipitously. In 2020-2021, multiples of 40-50x or even 100x against annual recurring revenue (ARR) weren't unusual for a fast-growing startup. As deal volume sank, so did the valuation comps. Multiples for VC-backed IPOs fell from 24.5x (Dec 2020) to 7.8x (Jun 2023), on a TTM (trailing 12 months) basis. Similarly, multiples for publicly traded software companies went from 18.3x (2021) to 6.6x (Jul 2023), on a NTM (next 12 months) basis.



PitchBook

Private-startup valuations are still playing catch-up with public-company comps. Traditionally, private companies see a valuation discount to public companies because of factors such as reduced liquidity, less transparency, and greater risk. Multiples for high-growth private startups, however, saw growing premiums from 2019-2022 that reached as high as 560% of public-company multiples.

The reset has been drawn out because many startups that raised in 2021 entered 2022 with 18-24 months of liquidity. As a result, **many valuation marks have stayed at lofty levels on the books of VC firms until the next financing round or exit**. In a recent survey, 68% of institutional investors believed their venture holdings were overvalued.

VC firms' incentives are generally not aligned with taking writedowns, though a growing number have taken their medicine in recent months – in part because of pressure by limited partners and regulatory scrutiny. Lately, with the possible reopening of the IPO window, investors – some of whom are struggling with their own liquidity – are encouraging once-hot startups to go public even at lower valuations.

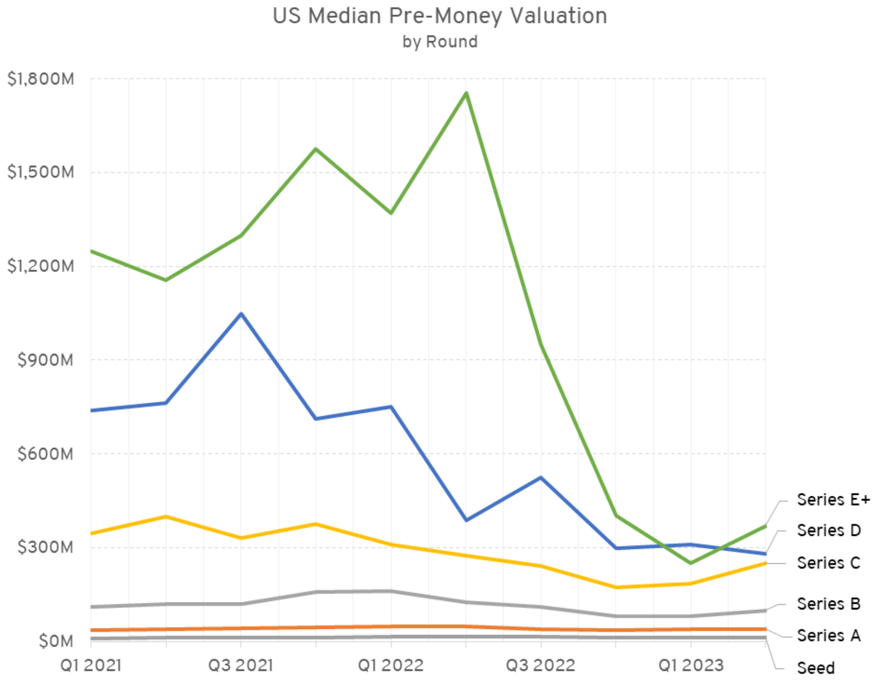
The extended reset has given rise to a swath of **"zombie VCs" who survive managing their existing portfolio but might not be able to invest new checks or raise another fund**. Some have speculated that the number of zombie VCs could reach into the hundreds – **as many as half of all VC firms**. Newer, unproven firms that were part of this past decade's growth from 850 VC firms to 2,500 VC firms in 2023 will be particularly at risk. It could take up to 3-4 years for all of the zombie VCs to unwind.

Even the VCs that are likely to survive are struggling to raise funds anywhere close to the size of their prior campaigns. In the US, VCs raised just $33B in H1 2023, suggesting a substantial decline from the $160B+ raised by venture funds in each of the prior two years (2021 and 2022). TCV, Insight Partners and Tiger Global – all well-known veteran firms – pared back expectations earlier this year, signaling plans to reduce fundraising targets by 25-75%. First-time VC fund managers are even worse off.

The evidence is mounting that much of the painful slide over the past couple years has essentially been a reversion to the norm. For instance, if we compare Q2 2023 VC investment to pre-pandemic Q4 2019, global deal value was essentially on par. Looking at valuations, median valuations for seed-stage, Series A, and Series B startups at their lowest recent levels were similar to or even higher than valuations in pre-pandemic Q4 2019.

What it all meant for startups

From the perspective of a startup seeking investment, **the degree of fundraising pain over the past 18 months was heavily dependent on whether it was an early-stage or late-stage startup**. Valuation dives were generally steeper for later-stage startups – **plummeting 70-85% from peaks for Series D and E+ startups** vs. 50-60% for Series B and C startups, 24% for Series A startups, and just 13% for seed-stage startups.



Carta

In part, the dives were deeper for later-stage startups because they saw some of the biggest gains in the period running up to 2022. **Best-in-class performers held up better but even they have seen significant declines** in their valuations since their 2021 peak. Stripe had a down round earlier this year at a 47% discount to its prior $95B valuation.

Deals also became harder to come by, with deal counts down across every stage from their peaks. Even among early-stage seed and Series A startups, which saw shallower valuation declines, deal counts fell 40-45% after 4 straight consecutive quarters of decline (as of Q2 2023). In the US, the venture capital demand-to-supply ratio reached a high of 2.9x in Q2 2023.

VCs are becoming more conservative and tough-nosed about follow-on rounds, especially for startups still clinging to previously lofty valuations. In some cases, startups have had to resort to disadvantageous debt deals or even cram-down rounds that massively dilute prior investors who opt out of a follow-on.

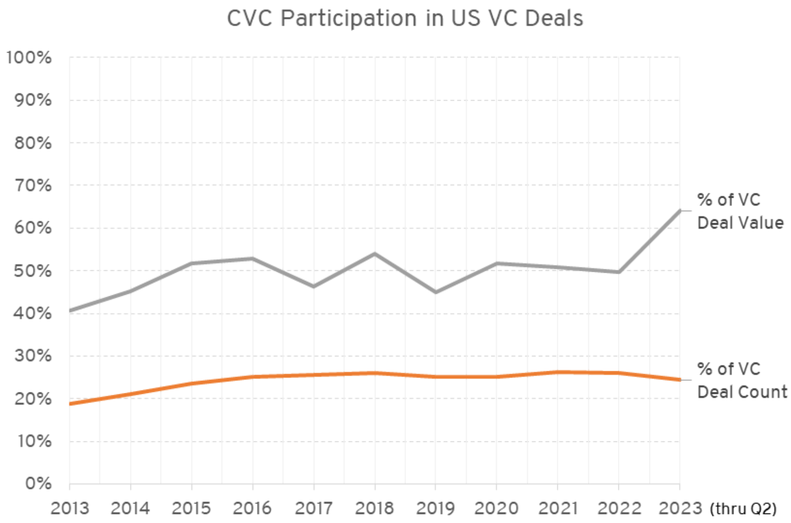
With the environment becoming more of a buyer's market, some investors are taking the opportunity to negotiate more investor-friendly terms. For instance, the proportion of deals with a liquidation multiplier went from a pre-pandemic 2.6% in Q4 2019 to 6-8% in H1 2023. For Series D+ startups, over 60% of deals came with senior or tiered liquidation structures. Some of these terms were taken in lieu of an explicit down round.

Without support, a steady stream of venture-backed startups are making dramatic cuts or shutting down. Some VCs are suggesting to founders of struggling startups that they take the "graceful way out" by shutting down and returning funding to VCs.

Corporate venture capital stayed active

Corporate venture capital has remained relatively active over the past 18 months. In 2022, the proportion of US VC deals that had CVC participation stayed stable near a record high of 26%, even as participation by other nontraditional investors fell. (The US represents over 80% of all CVCs.) Even more notable, **US deals with CVCs as the lead investor increased 27% in deal value** and 6% in number of deals. This year, as **of Q2 2023, CVCs have participated in 24.4% of all US VC deals**, holding reasonably steady.

CVCs' share was even higher in 2023 in terms of deal value – **CVCs participated in 64% of US VC deal value in H1 2023**. This was up from the 49% average from 2013-2022. (There is relatively limited data on CVCs' specific dollar investment in deals; much of the available data is imprecise and uses "deals with CVC participation" as a proxy.)



PitchBook-New Venture Capital Association

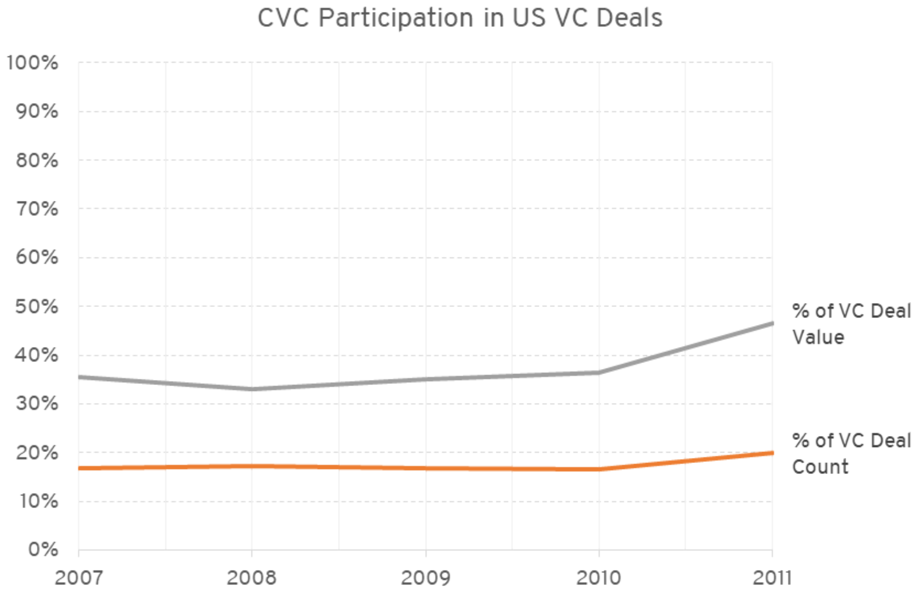
This is not to say that CVCs didn't pull back. They stayed active in deals but often took smaller bites. The median CVC deal size fell from $12.5M-14.5M in 2021 to $10.5M in 2022, in part driven by **growing CVC investment in smaller early-stage startups**. While the number of global deals with CVC participation stayed about flat in 2022 (vs. 2021), in absolute dollar terms they were down more than 40% – in large part because valuations were down.

So far in 2023, some of these trends have continued. **CVC deal size continues to tick down**, with the median CVC deal at $8.4M-$10M in H1 2023 (vs. $10.5M in 2022) and the average CVC deal at $22M (vs. $27M in 2022). **In Q2 2023, global deals with CVC participation were down 46% year-over-year in dollar terms – which was roughly on par with global VC in general.**

The evolution of CVCs since the 2008 financial crisis

As an industry, CVCs have evolved since the 2008 financial crisis. In the US, the value of deals with CVC participation dropped 37% from $11.3B in 2007 to $7.1B in 2009, although it had rebounded by 2011. The pullback brought about the notion that corporate investors were "VC tourists" that bolted at the first sign of a market correction.

It should be noted, however, that **US CVC-backed deals as a proportion of the broader US VC market were actually fairly stable throughout the 2007-2010 period, in both number and dollar terms**. It suggests that CVCs pulled back roughly in line with the rest of the market and weren't running for the exits in an unduly hasty manner.



New Venture Capital Association

Moreover, **a number of marquee corporate venture arms were launched during the 2008-2011 period**. These include Google Ventures (now called GV), Salesforce Ventures, Tencent Investment, BMW i Ventures, Merck's M Ventures, and STMicroelectronics' ST New Ventures. GV and Salesforce Ventures have since become two of the most prolific CVC investors in the industry.

This period kicked off a long run of steady CVC growth, in which the number of global active CVCs grew rapidly from a few hundred to 1,800-2,000+ active CVCs today. By one account, 101 new CVC units were launched in 2022 alone – a record high – and another 23 new CVC units were launched in H1 2023. Nearly 3/4 of the Fortune 100 have corporate venture arms. In the US, CVCs went from participating in 17% of VC deals and 33% of deal value in 2008, to recently 24% of deals and 64% of deal value.

CVCs, and investors in general, now recognize that the **2007-2011 VC vintages tended to outperform the earlier vintages** (1999-2006), with the peak in 2010. Corporate decision-makers began treating startup investing **less like a hobby and more like a long-term commitment** (although many CVCs still assess their objectives horizon as being "short term"). The industry today generally views CVC as a core source of venture capital rather than "tourism" capital, with elite CVCs deploying $100M+ in capital per year.

What exactly is different about CVCs?

While there's variance in how CVCs are organized, **most of them are generally funded through capital allocations from their corporate parent**. These allocations are frequently evergreen or involve a multi-year commitment (but not always). In essence, most CVCs have just one limited partner – their corporate parent.

CVCs typically have a broader set of investment motivations than traditional, financially-driven VCs. In one 2021 study of CVCs, 66% had "mostly" or "purely" strategic motivations, while only 12% had mostly or purely financial goals. Only 22% – including TDK Ventures – had a "balanced" approach. Investments are typically governed by a small investment committee that includes parent company executives, keeping them accountable for their objectives.

CVCs are becoming more hybrid over time. A study from 2022 indicated that 49% of CVCs view themselves as "hybrid." When asked the direction they were moving in, overall responses were tilted very slightly in favor of becoming more strategic and aligned with their corporate parent. For instance, Microsoft's M12 Ventures – historically a hybrid CVC with heavy financial emphasis – is now taking a new direction that cleaves more closely to the mothership. In some cases, **CVCs like M12 Ventures are divesting some minority stakes to focus on areas closer to their core**.

While CVCs are not fully insulated from the macro environment, they are far more protected from becoming "zombies" than traditional VC firms. Because most invest from the balance sheets of their parent company, **CVCs can be less reactive to the macroeconomic environment** – especially given cash on corporate balance sheets is still at robust levels. This could change, however, if there's a recession or consumer pullback that results in corporate parents tightening belts.

In summary

The next year or two may be good years for investment but not necessarily for exits. In an environment of low capital availability, **CVCs that remain active can have an outsized and stabilizing influence over a venture market in disarray**.

There's an **opportunity for CVCs to capitalize by offering distinctive value to startups**. Startups are looking to corporate investors for **help with commercialization**, such as support on distribution or accessing the corporate parent's networks. Lately, there's momentum behind CVCs that can offer **unique assets such as at-scale cloud computing** (e.g. Microsoft) **or GPU chips** (e.g. Nvidia).

It may also be a good time for CVCs to take a close look at their structure and organization, and consider whether they are built to last. This could include talent retention mechanisms, budget allocations, the ability to rapidly conduct high-quality due diligence, and the agility to make high-conviction investment decisions with speed (topics we'll cover in future reports).

Many corporate investors are still relatively new to the game. While not all of them will make it, **the current environment represents an opportunity for them to establish their reputation for being decisive and startup-friendly – even when the broader market is not**.

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