A WORD FROM J.P. MORGAN

What lies ahead for venture

"While the macroeconomic and market backdrop could remain challenging in the near term, J. P. Morgan continues to invest in ways to holistically serve the startup community through the cycle. Our recent acquisition of Global Shares, a digital cap table solution, and launch of Capital Connect, a digital capital-raising platform we built for early-stage private companies, are just two examples of how we are investing and innovating to meet the varied needs of the venture ecosystem."
— Melissa Smith, Head of Specialized Industries - Middle Market Banking & Specialized Industries, Commercial Banking

Venture players will have to balance near-term macro challenges with longer-term opportunities

With expectations for a deteriorating macro environment in the U.S. in 2023, venture markets are likely to remain challenged in the near term. Founders will need to continue to dial back cash burn where possible to extend runway. This is especially true in Series B or later, where the gap between valuations at the last raise and current market realities is the largest. Reduced growth forecasts and elevated uncertainty continue to challenge valuation assumptions.

We expect the next six months to be telling in terms of how VCs are triaging their portfolios. Many companies that last raised in the heady days of 2021 will be needing additional capital in the coming quarters and are hopefully well down the path to raising their next round. We do not think founders should wait for market conditions to improve to raise capital if it is available sooner. Valuations are likely to be down regardless, and we expect a crowded field of companies looking to raise later this spring to early summer. As VCs remain selective in using reserves to support existing investments, we could see a pickup in strategic merger activity and/or other partnership transactions solely for the purposes of pooling liquidity resources.

The tone in public markets could also be important and a leading indicator for private markets, where trends tend to lag by two to three quarters. Given the deteriorating fundamentals and tight financial conditions, we expect elevated volatility and lower valuations for equities in the first half of the year, when 2022 lows could be retested. This sell-off, combined with disinflation, rising unemployment and declining corporate sentiment, could be enough for the Federal Reserve to start signaling a pivot. This would likely drive an asset recovery and push equities higher into the second half of the year.

In this environment, where the cost of capital is higher and the economy is slowing, some areas of business investment, such as physical plants and buildings, could be cut back over the coming year. At the same time, we expect expenditures for equipment and technology, including software, to remain resilient. Solutions to enhance efficiencies, modernize supply chains and safeguard infrastructures are increasingly viewed as nondiscretionary outlays for commercial customers. The rise in geopolitical tensions and incidences of cyberaggression over the past couple of years reinforces this view.

U.S. consumers appear to be entering 2023 on solid financial footing, albeit with a depleted buffer of savings relative to the beginning of 2022. Despite stiff inflation for much of the year, consumer spending maintained a positive pace in 2022, fueled by reduced savings rates and rising credit card balances. While we are not seeing widespread signals of financial strain as delinquencies hover near historic lows, it is possible that consumer spending could slow in 2023 if labor markets soften. Regardless, shifting consumer priorities from goods toward experiences (i.e., services) are underway and likely to persist in the medium term.

While the tech sector, along with some areas of housing, such as mortgage originators, have started to announce workforce reductions, it is still early days. Across the U.S. economy, labor market conditions have remained strong as businesses added jobs at an elevated pace in recent months and the number of open jobs remained high compared with historical levels. We do expect the effects of higher interest rates and the slowing economy to cause some loosening in labor market conditions by the second half of the year. For startups with capital, this type of environment could present opportunities for founders to fill certain roles in a less competitive backdrop.

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Private capital markets have been resilient amid a slowdown in IPOs

Private capital markets have served as a critical source of funding for later-stage private companies given the pause in IPO markets this year. Carly Roddy, Head of J. P. Morgan's West Coast Capital Markets team, notes that although this capital has become more expensive and structured—and is coming from different investor bases than in the past—private capital is available. Roddy credits this to the flexibility of private capital markets,

where there is additional room for negotiation between issuers and investors on transaction terms. While deals continue to be completed on clean terms, many deals in today's market now include structural downside protection for investors.

Meanwhile, for emerging founders without access to private capital markets or large established investor networks, the capital-raising process can be time-consuming and challenging to navigate. J.P. Morgan's new digital platform, Capital Connect, aims to simplify and facilitate the process for startups by addressing key pain points, according to Michael Elanjian, Head of Digital Investment Banking and Digital Private Markets. Some founders tell us that they spend too much time hunting for warm introductions to the right investors, taking valuable time and focus away from getting their business started with critical pre-money funding. Having access to a self-service platform to network with other founders and VCs, raise capital and analyze market trends can be a way to save time and resources in the capital-raising process.

Another challenge we have observed is that overlooked founders are unable to concentrate on growing their young businesses when they are too busy looking for Impact-focused investors. It is important for the longer-term health of the ecosystem to be inclusive of a diverse set of founders, not just the well-connected. Venture capital going into businesses founded by women and people of color remains a stubbornly low percentage of all venture capital investment activity, underscoring the importance of democratizing access to investor networks.

Emerging founders can understandably find the lack of transparency in the capital-raising process daunting. Gaining analytical insights into market trends, including valuation metrics and deal terms, is very important for founders to make informed decisions when raising capital. A robust database of recent transaction terms can help founders evaluate the market environment and benchmark deal terms.

With the slowdown in the exit markets, and in the IPO market in particular, in 2022, private companies have increasingly evaluated secondary liquidity solutions for insiders. Transparent management of employee ownership and liquidity via a digital cap table can help with employee retention.

On the investor side, emerging fund managers can easily get stretched between spending time with portfolio companies while searching for the right LPs to raise their next fund. Access to a broad network of high-net-worth individuals and family offices with aligned investment objectives could help solve fundraising and capital allocation needs simultaneously.

Founders should be prepared for a turn in the exit environment

While history tells us we could still be several quarters away from a broad reopening in the IPO market, active follow-on issuance after Labor Day is an encouraging sign and is often seen as a precursor to more activity in the primary market. According to Mike Millman, Global Chair of Equity Capital Markets, other important factors for IPOs to make a comeback would be a less volatile market, greater multiple stability, increased confidence on growth and margin outlooks, and improved trading performance from recent IPOs.

In the meantime, a clearer backdrop for growth and inflation, slower pace of Fed tightening, and less rate and yield volatility in 2023 should improve credit market conditions enough to bring more strategics and investors off the sidelines to transact M&A.

In preparation for a pick-up in exit environment activity, whether it is months or quarters away, there are best practices for private companies to consider.

First, stress-test the business model and forecasting ability across a range of economic scenarios over the outward quarters and years. Investors are increasingly focused on how a business may fare through an economic cycle and path to profitability. Expect due-diligence periods to take place over weeks and months, not the hours and days that were the norm in 2020 and 2021.

Second, it is important to analyze both the balance sheet needs of your business as well as insider or employee monetization needs. This should be done ahead of any potential transaction discussions so investor expectations are aligned from the start.

And lastly, founders should continuously be fostering relationships across venture capital, PE, sovereign wealth funds and family offices. It is critical to have a robust relationship network on which to capitalize for a primary capital raise or to help facilitate secondary sales.

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