A WORD FROM J.P. MORGAN

Our views on venture

Economic momentum, still-too-hot inflation, and strong labor markets have persisted through the first part of 2024, leaving the Federal Reserve (Fed) in no hurry to cut rates. Even so, there are some signs of spring in exit markets.

Since the beginning of the year, market expectations have recalibrated to a later and shallower path of Fed rate cuts. Although the outlook for terminal real rates that underpin valuations has ticked up only slightly, higher projected Treasury issuance to fund fiscal deficits, combined with declining demand from price-insensitive buyers like central banks, could contribute to greater interest rate volatility over the medium term and a steeper yield curve.

Meanwhile, US election rhetoric is heating up and ongoing military conflicts in Europe and the Middle East keep near-term uncertainty and geopolitical risks elevated.

Interestingly, history tells us that past presidential elections do not appear to coincide with slowdowns in capital markets or M&A activity. We are cautiously optimistic that the recent pickup in issuance and deal volumes from low levels could build throughout the year.

Regarding IPO activity, markets are generally tracking in line with our expectations for a phased reopening. First-quarter volumes mark a notable uptick from 2022 and 2023, even though levels overall remain light relative to historical averages. Additionally, the profile of the recent IPO cohort—scaled, profitable—looks very different than it did in 2021, leaving the sizable backlog of venture-backed companies aiming to IPO largely intact.

The recovery of exit markets over the coming quarters will be key for reigniting and normalizing activity earlier in the venture lifecycle. In the meantime, founders will need to continue to focus on the basics: balance growth with profitability, manage cash burn, and be opportunistic in raising liquidity with realistic valuation expectations.

Amid the macroeconomic crosscurrents and exit market green shoots, the funding environment for late-stage companies remains challenged; the rate of down rounds continues to rise.

The venture ecosystem has experienced a meaningful unwinding since late 2021; we think we could be in the latter innings of this process as funding activity appears to be leveling off around 2019 to 2020 levels and valuations are resetting lower. The prevalence of down rounds and bridge down rounds continued to climb in the first few months of the year. In Q4 2023, more than one in every five late-stage transactions was a down round, according to Aumni.[1, 2] This trend has also persisted in early-stage transactions, where down rounds have climbed to nearly 9% of deals. Aumni data indicates that convertible bridge rounds in early 2024 saw greater than 25% of valuation caps below the last priced round valuation.[3]

Within the tough funding environment, Dave Reich, Head of Innovation Economy Debt Solutions at J.P. Morgan, notes that private credit is more actively providing growth capital for later-stage scaled companies. Reich counsels that companies should consider the risks of this route of funding, or any form of debt, including a clear understanding of the lender's expectations for debt repayment. Further, if leverage is excessive, it could complicate future equity raises when the markets ultimately rebound.

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1: Aumni, a J.P. Morgan company, is a leading provider of investment analytics software to the venture capital industry.
2: "Aumni Venture Beacon: Year End 2023 Report," Aumni, a J.P. Morgan Company, n.d., accessed March 24, 2024.
3: Ibid.

Early-stage activity reflects cautious optimism on the part of investors. Seed valuations have been on an upward trend, though the range has widened, which speaks to greater investor selectivity.

According to Ashraf Hebela, Head of Startup Banking at J.P. Morgan, the pace of seed deals and valuation trends suggests the environment for startup funding continues to lean investor-friendly compared to 2020 and 2021. Given this backdrop, it is critical that founders be able to deliver a well-formed plan that includes a product road map, a financial model, and the level of hiring required to get to break even—all of which can help support a target valuation.

The attribute early-stage investors value most in the current environment is the founder's (and team's) profile in terms of relevant experience. A strong leadership team with a prior startup track record that is pursuing a large market opportunity is a favorable combination. Soft skills, such as resilience and being stubbornly motivated to succeed, are also important amid a turbulent market. Other considerations are the competitive landscape, as well as how much the technology has been de-risked, and how differentiated the startup's offering is in market. Factors that could hinder capital-raising efforts today include a lack of startup and industry experience, an undifferentiated solution, or if the technology is viewed as too early.

As venture markets have been broadly challenged over the past two years, emerging and diverse managers continue to present a compelling and differentiated approach to the ecosystem.

Jamie Kramer, Head of Alternative Solutions at J.P. Morgan Asset Management, chairs the investment committee for Project Spark, an initiative that invests in diverse, emerging venture managers. She notes that from 2020 to 2022, large institutions with embedded VC strategies made commitments to established manager peers versus emerging managers at a ratio of 5:1. This has created an overlooked opportunity for differentiated alpha in emerging managers.

Kramer finds that diverse managers tend to be highly motivated and bring a unique focus to solving problems within their own communities or ecosystems. For example, a veteran manager in Spark's portfolio has firsthand knowledge about intelligence gathering and the need for cybersecurity, especially in today's environment. This manager has backed a cybersecurity startup that utilizes patented AI-powered, deception-based active monitoring to detect, engage, and respond to malicious activity. Further, the manager has leveraged their network to support the company's engagement with large defense firms to build out sales of the product.

Another example in Spark's portfolio is a venture fund managed by two female GPs. The fund focuses on AI to improve healthcare options, while ensuring gender inclusivity and bias elimination. Specifically, one company has developed AI-enabled tools to forecast and monitor health conditions.

Diverse emerging managers can have access to differentiated deal flow that tends to be less crowded and enables them to make meaningful investments with smaller check sizes. They often look to add value beyond capital through networks and industry expertise.

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