A WORD FROM J.P. MORGAN

Our views on venture

We expect the venture market environment to remain challenged in 2024 as excesses of years past continue to work through the system. Whether this is a muddling through or more defined reset event could depend on whether the economy stays resilient and exit markets improve.

The venture ecosystem endured significant turbulence in 2023, including a challenging fundraising environment, the failure of Silicon Valley Bank, and limited exit market activity. Many startups navigated the choppy waters by extending runway via reduced cash burn, raising bridge rounds or other opportunistic financings. An uptick in down rounds from roughly 8% in 2022 to 20% in 2023 suggests valuations are resetting for late-stage companies, albeit on light deal volumes. Meanwhile, seed through Series A investment activity levels and valuations have been relatively stable.

Looking forward, we anticipate most venture-backed startups will need to raise capital in 2024. Unless there is a material shift in sentiment or IPO market activity—which we do not expect—many will face taking a significant down round to raise new equity, end up in M&A discussions, or worst of all, closing their doors. This trend is already picking up, with the number of startups winding down due to bankruptcy or liquidation doubling in 2023 from 2022.

Despite a healthy degree of innovation happening and significant dry powder with VCs, appetite to deploy incremental capital is limited as valuations continue to find their footing and market exposure is already high. For vintage years 2013 to 2019, over 50% of the total value in venture funds relies on existing positions.

A potentially phased reopening of IPO markets in 2024 could set the stage for "normal" IPO markets by 2025.

Glimmers of optimism for an IPO market reopening post-Labor Day were fleeting as market volatility ticked up and the war in the Middle East dampened sentiment. While performance of recent IPOs has been better than the 2021 cohort, the profile of companies coming to market has also shifted. According to Eugene Sohn, Co-Head of Tech Equity Capital Markets at J.P. Morgan, IPO markets are demonstrating receptivity for companies of significant revenue scale, durable business models, and profitability. Although it is estimated there are over 1,000 private unicorns, few meet this profile. The next tech IPO cohort will likely need to exhibit meaningful scale at time of IPO along with growth and profitability. The Rule of 40 is a key barometer. An ideal candidate in the current market environment might have a 20% to 30% top-line growth rate and 15% to 20% EBITDA margins.

The first few months of the year could be an important moment when several mid- to large-cap companies that are durable, scalable, and turning the corner on profitability test the market. If the macroeconomic and market backdrop remain supportive, we could see smaller, higher-growth companies at earlier stages of profitability look to IPO by midyear. Importantly, the Federal Reserve's (Fed's) pivot to a more dovish tone at the December meeting could help pave the way for tech issuance as rate stabilization has been a key consideration for investors in that sector. Companies will likely want to steer clear of coming to market around the time of the presidential election in November—somewhat limiting the windows of opportunity in 2024.

Sohn also notes that as founders evaluate future exit strategies, it is important to consider the process of going public could take up to 24 months. Founders looking to IPO can prepare by establishing and executing on key performance indicators, while concurrently cultivating relationships with institutional investors. Preparing for the public markets is like training for a marathon. Founders need to be ready for standard practices such as quarterly earnings calls, engaging with sell-side analysts, and participating in nondeal roadshows.

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All the while, private capital dialogue remains elevated. Olga Polunina, Head of Private Capital Markets Execution for Capital Connect, J.P. Morgan's digital solution to help raise and invest capital in the private markets, notes that venture and growth investors continue to put capital to work, albeit with lower velocity – and crossovers have become more active.

The outlook for M&A is mixed as valuation expectation gaps remain wide, geopolitical uncertainties high, and conviction elusive.

According to Haidee Lee, Global Co-Head of Strategic Investor Group M&A at J.P. Morgan, a lack of both conviction and visibility required to underwrite growth remain key challenges for M&A activity regaining momentum. Even though near-term recession risks have come down, mismatched valuation expectations between buyers and sellers, heightened geopolitical concerns, and higher interest rates continue to be headwinds. In the meantime, the deals getting done are taking longer, are involving more structure, and are relationship driven. Transactions getting to the finish line today have been nurtured over several quarters or longer and are oftentimes bilateral and bespoke.

The volatile equity markets in 2022 and 2023 still have some sellers anchored on 2021 highs, while buyers are looking to de-risk the current set of uncertainties in the transaction price. Increasing use of structure, such as earnouts and seller paper, has been effective in some cases to bridge the valuation gap. Minority stake sales and continuation funds are also increasingly active transactions, which allow GPs to deliver liquidity to their LPs. We are also seeing elevated control premiums and preference for cash as acquisition currency given higher interest rates and reduced leverage tolerance in debt markets.

While there is never total clarity in forecasting the future, geopolitical uncertainties due to the ongoing land wars in Europe and the Middle East, coupled with a heavy 2024 election calendar in countries representing approximately 50% of global GDP, are unusually high hurdles for boards to overcome.

Additionally, the rapid rise in generative AI over the past year is yet another dynamic element of uncertainty. While there is a strong desire to be at the forefront of this emerging technology, there is still much to learn as to the value of its application and/or potential to disrupt business models or industries.

Among M&A constituents, the tone from strategic buyers remains cautious amid the challenging antitrust regulatory environment. Sponsors have potential for increased activity given record levels of dry powder (18 tech-focused PE funds with more than $10 billion of dry powder), as well as increased private-to-private transactions given public market reratings and fewer IPO opportunities.

The lending landscape for venture continues to evolve in the wake of market disruption.

Amid ongoing challenging conditions for venture, Dave Reich, Head of Innovation Economy Debt Solutions at J.P. Morgan, has seen some evolution across the venture lending landscape in recent months. While many companies have adjusted burn rates over the past year amid the slowdown in venture fundings, startups that last raised over two years ago are nearing the end of their runways, prompting discussions on all forms of capital raising. In today's market, startups need at least 12 months of runway to start discussions around venture debt from a lender, and 18 months is recommended to give time for diligence and to close prospective financings.

When contemplating debt as a part of a thoughtful capital structure, companies with predictable revenue and operational track records are best poised to access the market. Conversely, the use of debt to refinance other lenders to avoid amortization, bridge to an unknown future event, or finance a portfolio company due to a valuation overhang may ultimately lead to more difficult conversations down the road.

Clouding the outlook for venture lending are potential changes to the regulatory framework. The Office of the Comptroller of the Currency recently published Commercial Lending: Venture Loans to Companies in an Early, Expansion, or Late Stage of Corporate Development.[1] This guidance to venture lending institutions could result in changes with respect to both access to and cost of capital.

It is important to consider that venture debt is only one part of the equation. Like equity raises, partnering with a lender or investor that provides strategic dialogue and advisory can be fruitful. Understanding the latest market trends, capital structures, and regulatory environment offers a competitive advantage and increases the likelihood of a successful outcome for both founders and VCs.

1: "Commercial Lending: Venture Loans to Companies in an Early, Expansion, or Late Stage of Corporate Development," Office of the Comptroller of the Currency, November 1, 2023.