A WORD FROM J.P. MORGAN

Our views on venture

"The resetting of venture valuations is progressing in a relatively orderly fashion thus far. Whether this can continue amid persistent macro and micro headwinds remains to be seen. If liquidity pressures intensify in the coming quarters as we expect, the pace of reset could accelerate."
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The venture ecosystem is managing through a combination of macro and micro challenges

With short-term interest rates up a sharp 400 to 500 basis points over the past 15 months, there are signs that US economic growth is losing some steam. This is the intended effect by the Federal Reserve Open Market Committee (FOMC), which is tasked with a dual mandate of maximum employment and price stability—for example, inflation averaging 2% over the long term. With the latter well off the mark since mid-2021, tighter monetary policy is meant to slow spending and investment by raising borrowing costs and generally reducing liquidity in the markets and economy. Slower economic activity should cool price-setting expectations over time and bring inflation back down toward its targeted level.

For the startup community, this likely means reduced growth potential in the near to medium term. Until there is greater clarity in the macro outlook, many potential customers are likely to tighten budgets and dial back spending plans. While the US economic expansion has lost some momentum in recent quarters, resilient consumer spending has pushed out the potential onset of recession to later this year or early next. With elevated recession risks on the horizon, business sentiment has turned increasingly cautious, leading to lower corporate IT spending than previously expected and reduced M&A activity. Even the best-performing startups are not immune to the environment, having to revise forecasts lower.

Meanwhile, as the dust continues to settle following the regional banking disruption in March, the outlook for venture lending is emerging as a key area of uncertainty. Silicon Valley Bank was a lender to numerous startups in the venture ecosystem, and the void created by its collapse will take time to fill. We expect moves to diversify deposits and banking relationships by startups and VCs will lead to less venture lending activity over the intermediate term.

Recalibration to the new valuation environment is underway, with a focus on profitability

Over the past 18 months, founders have had to meaningfully shift their focus from a growth-at-all-costs mentality to one of balance between growth, profitability, and durability. This is in response to reduced risk appetite among investors, given the more volatile market backdrop, macroeconomic uncertainty, and slowdown in exit market activity. The Rule of 40 has been increasingly referenced in valuation discussions, with best-in-class companies calibrating profitability to sustainable growth.

According to Carly Roddy, Head of West Coast Private Capital Markets, this dynamic has also extended into transaction terms, with a notable shift from founder-friendly to increasingly investor-friendly terms. Structured solutions continue to offer a creative path toward narrowing the gap on valuation expectations. Structured features can include contractual returns, downside protection, and governance rights.

In this environment, fewer companies are announcing valuations with financing rounds, and we estimate up to half of Series A and Series B raises this year have been bridge rounds, predominately insider-led. These bridge rounds serve a dual purpose of holding valuation at the prior round level, while also extending cash runway. Secondary transactions for late-stage companies have also become more prevalent as an avenue to provide liquidity for insiders and employees. These have taken the form of company-organized tender offers or synthetic secondaries, where the company issues a new class of shares and uses the proceeds to buy back equity from insiders.

Effusion around generative artificial intelligence speaks to elemental optimism in venture

Despite the most challenging set of circumstances facing the venture ecosystem in over 20 years, the hype around generative AI in recent months speaks to the optimism and resiliency of the venture mindset. While most segments of venture investing have slowed sharply and valuations are in the process of resetting lower, activity and valuations for generative AI startups remain at all-time high levels. AI's share of venture investment had been steadily rising from 5% in 2012 to over 20% in 2022, but AI has received nearly 50% of all Series B funding year-to-date.

Similarly, seed-stage deals for founders with established track records are active and competitive. As late stages are challenged by prior round valuations and quiet exit markets, more venture investment is funneling toward seed and earlier stages, where investment horizons are longer and commitment sizes smaller.

Some green shoots, but broader reopening of the IPO market unlikely until 2024

According to Alice Takhtajan, TMT US Equity Capital Markets, there have been some encouraging developments in the IPO market in recent months, though a few more pieces need to fall into place to see a broader reopening. Positive signs include a sustained pickup in secondary volumes, lower equity market volatility since late March, and a handful of successful IPOs across the healthcare and consumer sectors.

Other criteria needed to fully open the IPO markets include improved macro clarity with regards to interest rates, inflation, and potential recession. Takhtajan believes this would give investors greater confidence around 2024 and 2025 financial forecasts, and therefore valuations.

Notably, only four tech IPOs have priced in the past 12 months, versus 112 in 2021 at the peak. This is the longest hiatus for tech IPO activity since the 2008 to 2009 global financial crisis, when the window was closed for 14 months.

Normalized markets might see 35 to 40 tech IPOs per year, representing one-third of the overall IPO market.

The good news is that once the IPO market does reopen, the pipeline of companies preparing to go public is quite strong, according to Takhtajan. There are several scaled, profitable, and growing companies that will be well positioned to test the market later this year or early next. This could create a competitive rush for the exits, leaving VCs with portfolio companies that do not get out to have some tough LP conversations.

Given the uncertain and competitive landscape, choosing the right investors is a vital decision for founders

Having investors that can bring value to startups beyond capital is critical in today's environment, according to Luke Sikora, Partner of J.P. Morgan Growth Equity Partners. This group recently closed a $1 billion technology focused late stage venture and growth equity fund. Partnering with investors that can provide insights, data capabilities, and access to global networks can be a key differentiator for founders looking to scale and position their businesses for long-term success.

Sikora also believes that young companies benefit from a hands-on approach from investors. Many founders in today's ecosystem lack the perspective of prior downturns and can gain a competitive edge from the experience and expertise investors bring to the table. This is especially impactful when investors come prepared to leverage their own core competencies and networks, adding strategic value to their portfolio companies.

While there has been a retreat of nontraditional venture capitalists since 2021, significant dry powder, coupled with resetting valuations, provides an opportunity for disciplined investors to prudently deploy capital over the next few years.