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A WORD FROM J.P. MORGAN

Our views on venture

"While there are a few pockets of optimism within venture, the dust has not totally settled for much of the ecosystem. Given the more discerning environment, many startups that were backed in 2021 are unlikely to get the same warm reception when they next need to raise. Of course, it is encouraging to see the green shoots, but a little premature to say we are through the worst of it."
—John China, Co-Head of Innovation Economy, Commercial Banking

The US economy has performed better than expected in 2023, but risks are elevated heading into 2024

Macroeconomic conditions have developed more favorably than we thought three to six months ago. Resilient consumer spending, stabilizing business sentiment, and ongoing fiscal support have all contributed. Recession forecasts have been pushed out, and inflation continues to moderate while labor markets remain tight. Within the venture ecosystem, we have seen labor markets settle after turbulence earlier this year. Although the technology sector leads all industries in layoffs over the past nine months, the pace of monthly job cuts has declined nearly 90% from the spring.

Looking ahead, economic and financial market risks are elevated given the significant amount of monetary tightening that has occurred over the past 18 months. Even if the Federal Reserve is done hiking rates this cycle, we do not expect to see rate cuts until the latter part of 2024. Meanwhile, the Fed's balance sheet runoff program—also known as quantitative tightening—is ongoing at around $1 trillion per year, effectively removing that amount of liquidity from the economy.

The effects of higher interest rates and tighter credit are still playing out. While the volatile conditions of March have faded, regional banks are slowing loan growth, which will subdue economic activity in certain sectors over the coming quarters. Plus, consumers' dwindling excess savings and the resumption of student loan payments are headwinds to spending.

The outlook is also clouded by a greater-than-normal degree of unpredictability around global trade, commodities markets, and national security stemming from the ongoing Russia-Ukraine war and US-China trade tensions.

Given elevated uncertainties around the macro economy and financial markets, it remains crucial for founders to plan ahead and be ready to raise capital when a window of opportunity presents itself. If a company's cash runway is within 18-24 months, the time to start thinking about a private raise is now. While it might be tempting for founders to wait for a better deal down the road, taking decisive action sooner is often the better path.

With the recent uptick in IPO activity, there are glimmers of optimism for venture markets

Although a broader reopening of IPO markets could still be months away, recent activity is encouraging if you are a late-stage company or VC with portfolio companies in the pipeline. Aside from the general pick-up in volumes, there will be a lot of focus on pricing outcomes and subsequent trading performance for this cohort, as well as the ability to deliver on earnings expectations out of the gate. If all goes well, and the broader macro and markets backdrop remains supportive, we expect a bigger reopening in 2024.

Even though the window may open wider in 2024, we expect the bar to remain high. Investors are likely to maintain discipline around IPO participation, focusing on high-quality, profitable companies with proven business models and reasonable valuations. Historically speaking, a vibrant IPO market has seen 90 to 100 venture-backed listings in a year.

Ginger Chambless
Head of Research, Commercial Banking

Ginger Chambless is a Managing Director and Head of Research for JPMorgan Chase Commercial Banking. In this role, she produces curated thought leadership content for commercial banking clients and internal teams. Her content focuses on economic and market insights, industry trends, and the capital markets.

Additional contributors:

Pamela Aldsworth
Head of Venture Capital Coverage

Andy Kelly
Managing Director, Venture Capital Coverage

It is hard to say whether we will see those numbers in the next year or if listings will build more gradually. Regardless, with the IPO backlog sitting at unprecedented levels, there could be a competitive rush for the exits.

In the meantime, my colleague Carly Roddy, Head of West Coast Private Capital Markets, notes that we have seen active markets for secondary transactions and priced equity rounds for late-stage companies. On the back of green shoots in the IPO markets, there is an increased dialogue for issuers going to market with pre-IPO capital raises, which can serve as a branding event ahead of an IPO, to transition the cap table to long-term holders and provide liquidity to shareholders and employees. The market tone has improved, supporting more opportunistic issuances by companies as opposed to the "need to raise" mentality that has prevailed over the past 18 months. Crossover and public-style investors are beginning to return to the private markets, while growth equity and private equity investors remain engaged, with record dry powder to put to work.

Some early-stage companies still see the convertible note as a helpful tool to bridge to the next financing round. According to Aumni, a J.P. Morgan company that pulls anonymized data from tens of thousands of closing documents to provide market insights, valuation caps have trended up recently. A higher valuation cap is generally considered more favorable to founders because when the note converts into equity, there is less dilution to existing shareholders. Following a steep drop from Q2 2022 to Q4 2022, valuation caps appear to be stabilizing in line with historical ranges.

Startups are looking to banking partners for treasury management, venture lending, and networks

According to Ashraf Hebela, Head of Startup Banking, it seems as if founders have spent more time on treasury and cash management best practices in the six months following Silicon Valley Bank's collapse than in the prior 10 years combined. While decisive actions taken by the Fed, Treasury, and FDIC have tempered the pace of deposit flight in recent months, the lens through which startups and VCs evaluate banking partners may have permanently shifted. Access to and safety of funds are no longer taken for granted, while earning a competitive yield on excess cash and a simplified onboarding experience remain important. More consideration is being given to longer-term treasury management because as a company grows and scales, treasury needs become more complex.

Venture lending is another area in which startups and VCs are seeking clarity given the shifting lender landscape. While activity in venture lending has slowed due to subdued venture activity overall, the top end of the market is starting to pick up.

Startups are increasingly looking to their banking partners for insights and networks. It is important for founders to leverage data analytics and sector insights to navigate dynamic market conditions and make informed decisions about how much capital to raise and at what valuation and terms. Access to investor networks such as those we have available through J.P. Morgan's Capital Connect platform can create opportunities for capital raising, while introductions to much larger companies that could become customers or offer operating expertise can provide a competitive edge.
