Cravath Emerging Company and Venture Capital Insights

July 2022

2022 Mid-Year Recap

MARKET UPDATE

Venture Capital ("VC") Activity

Global VC funding recorded the largest quarterly drop in a decade during the second quarter of 2022—a 23% decrease on a quarter-over-quarter basis, with a total of $108.5 billion invested compared to $141.6 billion in the first quarter of 2022.[1] VCs invested approximately $250 billion in the first half of 2022, a 12.5% drop compared to the $285.7 billion invested by VCs in the first half of 2021.[2] The number of VC-funded deals dropped by approximately 15%, with a total of 7,651 deals completed in the second quarter of 2022 compared to 8,990 deals completed in the first quarter of 2022.[3] However, the number of VC-funded deals completed in the first half of 2022 outpaced the first half of 2021, with 16,641 and 16,049 VC-funded deals completed in the first half of 2022 and 2021, respectively—a 4% increase.[4] The tightening VC market was the result of a variety of factors, including concerns over declining stock market performance, lingering economic fallout from the COVID pandemic, heightened risk following Russia's invasion of Ukraine and persistent inflation combined with rising interest rates. However, accounting for the fact that 2021 was an exceptional year for VC activity, 2022 funding amounts and deal volume levels remained strong compared to pre-2021.[5] In fact, VC activity—in both invested amount and number of investments—for the full year 2022 is projected to exceed annual pre-2021 levels.[6]

The impact of the market slowdown was felt most strongly in retail tech where new funding dropped by 43% in the second quarter of 2022 on a quarter-over-quarter basis to $13.2 billion (a seven-quarter low for the sector). Other sectors that experienced significant funding declines included fintech and digital health, with decreases of 33% and 32%, respectively, in funding on a quarter-over-quarter basis (an eight-quarter low for the digital health sector).[7]

Companies in the later stages of the VC funding cycle have been most impacted by the market slowdown and have experienced significant declines in average deal size and valuation compared to 2021 levels, though average deal size and valuation remained higher than pre-2021 levels (the late stage median deal size of $14 million to date in 2022 is 40% higher than the late stage median deal size of $10 million of 2020).[8] Seed stage and other early stage companies, on the other hand, approached record deal activity and funding levels in the second quarter of 2022.[9] Median deal size for deals involving angel investors actually increased in the first half of 2022 by $1 million compared to 2021 as a whole—the only investor group to see positive change since last year.[10] The strength of activity for early stage companies can be attributed, at least in part, to their relative distance from the public markets and the number of smaller funds raised over the last few years looking to deploy capital.[11]

Exit Trends

The U.S. IPO market has largely been closed during the first half of 2022: U.S. IPOs of VC-backed companies reached a 13-year quarterly low, with only 22 completed U.S. IPOs of VC-backed companies in the first half of 2022 (compared to 183 and 108 in in the first halves of 2021 and 2020, respectively).[12] Global IPOs were down 73% compared to the same period last year.[13] SPAC business combination transactions also have significantly declined compared to 2020 and 2021 activity levels.[14] There were thirty terminated business combinations in the first half of 2022, representing $32 billion of transaction value.[15] Increasing scrutiny of SPACs by the Securities and Exchange Commission ("SEC"), including proposed rules that would make going public via combination with a SPAC more challenging, and extremely high redemption rates of SPAC shares by SPAC investors (in the first half of 2022, on average more than 80% of SPAC investors opted to redeem their SPAC shares for cash prior to the conclusion of the SPAC's combination with a target[16]), have depressed both sponsor appetite to bring new SPACs to the market and the appeal for companies to go public via a SPAC transaction.

While the public markets are down overall this year, VC-backed companies that recently went public as part of the IPO and SPAC boom of 2020 and 2021 are performing worse than the public markets as a whole, with formerly VC-backed public companies declining in value by approximately 58% so far in 2022, compared to an approximate 25% decline for the S&P 500 and Russell 2000 as of mid-June 2022.[17, 18]

Global M&A activity has provided steady exit opportunities for VC-backed companies and comprised the majority of exits in the first half of 2022, although M&A deals involving VC-backed companies recorded its lowest level since the last quarter of 2020.[19] In the U.S., despite the IPO slowdown, the number of exits in 2022 were trending to remain on par with the annual number of exits seen between 2014 and 2020 (with 2021 as an outlier).[20]

SPECIAL INSIGHTS

Market Response to Market Conditions

In the face of soft market conditions, emerging companies across all growth stages are considering alternative sources of capital and resources, including debt financing, royalty arrangements and milestone payments.[21]

Companies that are unable to access alternative sources and do not have sufficient liquidity to wait until market conditions improve will have to raise funds in an increasingly investor-friendly environment. In the first instance, companies may turn to existing investors for extension rounds before accepting flat or down rounds (and correspondingly lower valuations) from new investors.[22] Companies may be able to preserve strong valuations by providing investors with additional value or structured incentives to invest, such as enhanced liquidation preferences (discussed further below under "Changing Deal Terms").[23]

Notably, companies across the tech sector, both public and private, have announced cost-cutting programs (including significant layoffs), restructurings, and reductions to their product pipelines to proactively extend their cash runways and prepare to sustain businesses until markets improve.[24] While some of these initiatives may be proactive measures, in certain situations, VCs and other investors have applied pressure to company management to show a path to profitability or reduced cash burn.

Changing Deal Terms

As the fundraising environment becomes increasingly investor-friendly, deal terms are beginning to shift.[25] Investors are able to negotiate provisions like enhanced liquidation preferences (guaranteeing investors a set payout, often 100% or a multiple of their original investment, in an exit or liquidation), ratchets (protecting investors from future rounds at lower prices by adjusting the number of common shares an investor's preferred shares will convert into) and strong redemption rights (allowing investors to liquidate their holdings upon the occurrence of certain events).[26] While strong investor protections may be surprising to founders and companies accustomed to the exceptionally founder-friendly markets of 2020 and 2021, the return of strong investor protections represents a market shift to the investor-friendly markets observed a few years ago.

Industry Spotlight—Crypto

Investors, including VCs, have increasingly been interested in cryptoasset-related startups as cryptoassets and other applications of blockchain technology (*e.g.*, web3) develop into more mainstream products and services. For example, Andreessen Horowitz recently announced that it is raising a new $4.5 billion crypto fund—its fourth crypto fund.[27] The announcement stated: "Since the advent of computing in the 1940s, there has been a major computing cycle every 10-15 years, including PCs in the '80s, the internet in the '90s, and mobile computing in the '00s. We believe blockchains will power the next major computing cycle, which we call crypto or web3."[28] In the first quarter of 2022, there were $9.7 billion global VC investments in cryptoasset-related startups, and two-thirds of the way through the second quarter of 2022, there were already $5.3 billion such investments.[29] Cryptoassets have a number of use cases for financial innovation, including as a store of value, for payments, as an investment asset, and to facilitate innovations in financial services infrastructure. Unlike traditional financial assets, however, there are significant regulatory gaps and limited regulatory clarity for cryptoassets and companies, and those active in the cryptoasset space face substantial legal risks and uncertainty.[30]

Other Considerations

As companies position themselves to weather uncertain economic conditions, maintaining relationships with existing investors is critical. VCs are prioritizing existing investments and allocating reserves to support companies with strong performance records and with which they already have relationships.[31] Companies with strong relationships with their investors will continue to be at an advantage when seeking qualitative advice, operational support and liquidity, particularly if a flat or down round becomes necessary.

As companies seek to position themselves in a favorable light for investors, they should consider incorporating environmental, social and governance ("ESG") plans at an early stage. ESG is a growing area of importance among investors, particularly given the SEC's recent proposals to require SEC-regulated companies, as well as certain funds and investment advisors, to provide enhanced disclosures on ESG factors, including climate change. VCs increasingly utilize ESG factors when evaluating investment opportunities and many corporate investors and strategic partners, particularly public companies, require counterparties to meet, evaluate or even satisfy certain ESG criteria,[32] putting startups that have not evaluated or implemented ESG frameworks at a disadvantage.

[1, 2, 3, 4, 5, 6, 7, 10, 19] CB Insights, *State of Venture Q2 2022 Report* (July 12, 2022); available here.

[8, 9, 11, 12, 14, 20, 22, 23, 31] PitchBook *NVCA Venture Monitor Report Q2 2022* (July 13, 2022); available here.

[13] Troy Hooper, Sam Kerr, Cristiano Dalla Bona & Perris Lee, *ECM Highlights 1H22: The worst of times,* Mergermarket (July 5, 2022), https://community.ionanalytics.com/ecm-highlights-1h22-the-worst-of-times.

[15, 16] Troy Hooper, *Spotlight on SPACs: Deal cancellations accelerate,* Mergermarket (July 6, 2022).

[17] James Thorne, *Scores of newly public companies worth less than they raised from VCs*, PitchBook (June 16, 2022), https://pitchbook.com/news/articles/market-cap-vc-raised-tech-sell-off.

[18] Jacob Sonenshine, *Small-Cap stocks have gotten crushed. Watch for them to rebound soon*, Barrons (June 19, 2022), https://www.barrons.com/articles/small-cap-stocks-rebound-51655512167.

[21] Leah Rosenbaum, *The biotech market is melting down. Here are 3 unconventional ways startups can raise money without relying on venture capital,* Business Insider (June 20, 2022), https://www.businessinsider.com/how-biotech-startups-can-raise-money-down-market-debt-royalties-2022-6.

[24] Rob Price, Samantha Stokes and Diamond Naga Siu, *'We're on the precipice': The tech industry heads for a historic slump amid VC pullback, looming layoffs, and plummeting share prices*, Business Insider (May 12, 2022), https://www.businessinsider.com/tech-industry-cost-cutting-job-losses-whos-most-at-risk-2022-5.

[25, 26] Chris Metinko, *As Venture Dollars Slow, Deal Terms Begin Trending Back Toward Investors,* Crunchbase (June 14, 2022), https://news.crunchbase.com/venture/vc-deal-terms-startups-investors/.

[27, 28] Chris Dixon, *Crypto Fund 4*, Andreessen Horowitz (May 25, 2022), https://a16zcrypto.com/crypto-fund-four/.

[29] Hannah Miller, *VCs Are Still Rushing to Back Crypto Startups*, Bloomberg (June 1, 2022), https://www.bloomberg.com/news/newsletters/2022-06-01/in-crypto-downturn-startups-are-still-getting-venture-capital-dollars.

[30] For more detail on cryptoasset regulatory developments, particularly of relevance to banks, please see our *Cravath Financial Institutions Insights*, Mid-Year 2022 Review of Bank Regulation Developments (July 11, 2022), https://www.cravath.com/news/cravath-financial-institutions-insights-midyear-2022-review-of-bank-regulation-developments.html.

[32] Freya Pratty, *What does the ESG reckoning mean for VC,* Sifted (June 23, 2022), https://sifted.eu/articles/esg-reckoning-vc/.