Cravath Emerging Company and Venture Capital Insights

2022 RECAP AND 2023 OUTLOOK

Market Update

VENTURE CAPITAL (VC) ACTIVITY

Global VC funding in 2022 amounted to $415.1 billion, reflecting a 35% decrease from the record $638.4 billion funded in 2021.[1] The second half of 2022 represented the most significant decline, with global VC funding totaling only $147.3 billion—a 58% drop from $346.6 billion in the second half of 2021.[2] Despite the considerable decrease in global VC funding, deal volume fell by only 4% in 2022 compared to the record set in 2021, suggesting a reasonably robust level of activity albeit with more modest deal sizes.[3] Further, global VC funding remained considerably higher than pre-2021 levels.[*, 4]

Later state companies experienced an outsized impact on their ability to raise funds, with significant declines in deal sizes and valuations compared to 2021 levels. The median deal size for late-stage companies dropped by 45% from $50 million in 2021 to $27.3 million in 2022,[5] while the median deal size for mid-stage companies decreased by 12% from $30 million to $26.3 million during the same period.[6] Companies that were farther away from the public markets or other exit faced a less challenging fundraising environment in part due to their longer-term investment horizons. In 2022, the median deal size for early-stage companies increased modestly to $2.6 million from $2.5 million in 2021.[7]

The digital health, retail tech and fintech sectors were most impacted by the market slowdown, with global VC funding in these sectors decreasing by 57%, 50% and 46%, respectively, compared to 2021.[8] For each of these sectors, the fourth quarter of 2022 represented the lowest quarterly funding amount in over four years.[9] However, sectors such as media and energy proved more resilient in 2022, with U.S. funding levels remaining on par with, or slightly exceeding, 2021 levels.[10]

The decline in VC funding can be attributed to a variety of factors, including declining market performance for now-public VC-backed companies (and across the public markets more generally), lingering impact of the COVID-19 pandemic, supply chain disruptions, the ongoing war between Russia and Ukraine, sustained inflation, increased interest rates and caution around VC companies' financial projections in light of all these factors.

2022 marked a shift in certain deal terms as VC companies began to seek much needed capital from cautious investors. As a result of the weakened market conditions, relative to 2021 investors were better positioned to negotiate for favorable deal terms. Such deal terms commonly provided investors certain control rights (*i.e.*, board seats and consent rights) and occasionally enhanced downside protections (*i.e.*, enhanced liquidation preferences or anti-dilution mechanisms); however, founders and companies strongly sought to hold the line on valuation in

* Global VC funding in 2020, 2019 and 2018 was $297.6 billion, $259.3 billion and $290.5 billion, respectively.

order to avoid down rounds. The more investor-friendly market environment is expected to continue in 2023, particularly as many companies that were able to avoid a funding round in 2022 will need to raise capital in 2023.

FUNDRAISING

U.S. VC fundraising reached an all-time high of $162.6 billion across 769 funds in 2022, as compared to $154.1 billion in 2021 across 1,270 funds.[11] As described above, VCs were cautious in making investments given the weakening economic environment, so the amount of undeployed capital, so-called "dry powder," was estimated to have reached a record $585.5 billion as of September 30, 2022, the most recently available measurement date as of the publication of this newsletter.[12]

In 2021, VC fundraising was more geographically dispersed than in prior years, largely as a result of remote work and the effects of the COVID-19 pandemic. However, as hybrid work emerged and the social effects of the pandemic began to diminish in 2022, there was a return to the traditional VC epicenters: approximately 73% of U.S. VC fundraising in 2022 took place in the Bay Area and New York.[13] However, certain smaller and middle-market cities, such as Denver, Nashville and Philadelphia—which had experienced significant increases in VC activity in 2021—continued to see the same or increased levels of capital raising in 2022.[14]

EXIT TRENDS

In 2022, the total U.S. exit value amounted to $71.4 billion, reflecting the lowest level since 2016 and a decline of 90.5% compared to $753.2 billion in 2021.[15] The fourth quarter of 2022 recorded only $5.2 billion in U.S. exit capital, the lowest quarterly value observed in over a decade.[16] The decrease in exit value was in large part due to the near complete closure of the U.S. IPO market during 2022, with a total of only 133 companies (excluding SPACs) completing IPOs in the U.S., a 72% year-over-year decline.[17] Global IPOs experienced a less dramatic (but still significant) decline in 2022, decreasing 31% year-over-year.[18]

There were 86 SPAC IPOs in the U.S. in 2022, a roughly 86% decrease from 2021.[19] Over 100 SPACs liquidated in 2022, with approximately 85 of these occurring in December 2022.[20] Roughly 380 U.S.-listed SPACs are currently searching for targets, and it is estimated that SPACs with roughly $75 billion in value will need to find targets, obtain an extension of the applicable outside date or liquidate by May 2023.[21]

VC-backed companies that went public through an IPO or SPAC combination in 2020 or 2021 have been underperforming the public markets as a whole. More specifically, VC-backed companies that underwent U.S. IPOs in 2020 or 2021 have collectively decreased 61% in value from 2021 to 2022, compared to declines of approximately 19% and 33% in the S&P 500 and Nasdaq, respectively, over the same period.[22]

Partially counterbalancing the weak public market, M&A provided relatively steady exit opportunities for VC-backed companies and comprised the majority of exits in 2022.[23] However, the number of M&A exits declined slightly with each successive quarter of 2022. Companies that may have otherwise focused on an IPO are now more likely to consider a dual-track process.

Significant U.S. IPO activity seems unlikely to be seen before mid-Q2 2023, when 2022 year-end audited financials and Q1 2023 results become available, and may trail until the second half of 2023 or later.[24] Market indicators that may help foreshadow a more robust IPO environment include successful follow-on equity offerings by existing growth-oriented public companies and successful trading in the secondary market of first movers to the IPO market.

NON-TRADITIONAL CAPITAL

Growth companies are considering alternative sources of capital and resources, including debt financing (venture debt and other forms) and, where applicable to the business, financing on the basis of annualized recurring revenue (ARR), royalty arrangements, licensing and collaboration agreements or other partnerships that involve an infusion of capital.

Technology companies with rich intellectual property (IP) portfolios may consider IP-focused financings, such as IP-backed secured loans, IP royalty securitizations (where a company sells an IP-related income stream) and IP sale-leasebacks (where a company sells its IP to an investor-controlled vehicle with an immediate lease back to the company of the rights to use the IP).[25] Over time, we expect that valuation methods used to value IP will improve. Consequently, we expect that IP-based financings will become even more attractive—for both companies and investors.

For the first time in over a decade, in 2022, non-traditional VC investors, which includes private equity funds and asset managers, collectively reduced investment levels in new VC deals.** U.S. deal count for non-traditional investors in 2022 declined 13.4% year-over-year.[26]

Special Insights

DOWN ROUNDS

Despite the drop in global VC financing, "down rounds"—equity financings where a company sells equity at a valuation that is lower than a valuation achieved in the immediately preceding raise—made up only roughly 6.1% of completed U.S. financing rounds in 2022.[27] However, this modest decline is consistent with the timing of down rounds which generally lag worsening market conditions as companies pursue other liquidity solutions, such as convertible debt financings, and operational restructuring, including reductions in workforce or R&D allocations, before resorting to a down round. More down rounds are expected in 2023 as companies exhaust such alternative capital and resource conservation solutions.

INDUSTRY SPOTLIGHT—CLIMATE TECH

Investors, including VCs, have increasingly expressed interest in companies with environmentally focused products and technologies, such as electric vehicles and renewable energy. So-called "climate tech" investments represented a large share of VC investments in 2022, with more than a quarter of global VC investments over the first three quarters of 2022 being made into climate tech companies.[28] As of the end of 2022, there were an estimated 83 climate tech "unicorns."[29]

Historically, investments in the climate tech space may not have been widely attractive for VCs, in large part because of their relatively long time horizons. However, technological advancements have created clearer growth plans and paths to profitability. In addition, increased climate activism has also led many investors to seek climate-conscious investments. Lastly, recent actions by the U.S. federal government have also spurred interest in the climate tech space, with three major pieces of legislation that were passed in 2022—the Bipartisan Infrastructure Law, the Inflation Reduction Act and the CHIPS and Science Act—introducing trillions of dollars in new federal funding for climate tech in the form of tax incentives, grants and loan guarantees.

** In contrast to other non-traditional VC investors, corporate venture capital investors participated in a greater percentage of U.S. VC deals in 2022 as compared to 2021.

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Cravath, Swaine & Moore LLP

NEW YORK

Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
T+1-212-474-1000
F+1-212-474-3700

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
T+44-20-7453-1000
F+44-20-7860-1150

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
T+1-202-869-7700
F+1-202-869-7600