Cravath Emerging Company and Venture Capital Insights

2023 MID-YEAR MARKET UPDATE

Market Update

VENTURE CAPITAL (VC) ACTIVITY

Global VC funding of companies in the first half of 2023 reflected a slowdown, totaling only $144 billion—a 51% drop from $293 billion in the first half of 2022 and a 10% decline from $160 million in the second half of 2022.[1] Despite mounting pressure on venture capital in a difficult economic environment, global VC funding of companies remained broadly on par with corresponding pre-2021 levels and several mega rounds were successfully completed, including Stripe's $6.5 billion Series I raise and Inflection AI's $1.3 billion Series B raise. Investments in AI, in particular generative AI startups and growth companies, continued to expand dramatically and included the largest deal of this period with OpenAI's multi-year, strategic investment from Microsoft, reportedly worth $10 billion.

Later stage companies have continued to experience an outsized impact on their ability to raise funds, with significant declines in deal sizes and valuations. In the second quarter of 2023, in particular, global late-stage funding totaled $31 billion, which represents the lowest quarterly amount since 2018 and a decrease of 54% as compared to the second quarter of 2022.[2] In 2022, companies that were farther away from public markets were more insulated from the increasingly challenging fundraising environment, partly due to their longer-term investment horizons, but in the first half of 2023 the overall trend caught up with these companies, with each funding stage posting a year-over-year decline of more than 30% in terms of deal volume.[3]

The decline in global VC funding during the first half of 2023 can be attributed to a variety of factors, including elevated interest rates, the collapse of Silicon Valley Bank, declining market performance for now-public VC-backed companies, the ongoing war between Russia and Ukraine, recessionary concerns and, to a lesser extent, persistent inflation. In light of these factors, VC investors have been particularly cautious when assessing new investment opportunities and deploying capital to existing portfolio companies, which has led to a heightened level of due diligence and prolonged deal timelines.

Though the macroeconomic headwinds described above are still prevalent, many financial experts and economists are optimistic that some of these conditions could improve in the second half of the year: inflation in the U.S. has fallen each month in 2023 (on a year-over-year basis), the feared systemic banking collapse following the fall of Silicon Valley Bank has not yet materialized, equity markets have recorded lower volatility since late March of 2023, and, despite recently raising the benchmark federal funds rate to the highest level in 22 years, the Federal Reserve has hinted that it may soon stop raising interest rates.

FUNDRAISING

As a result of record fundraising in 2021 and 2022, the relatively low level of recent deal flow and persistent macroeconomic challenges, many VC funds ended 2022 with a surplus of unused capital, which was largely preserved in the first half of 2023. The amount of undeployed capital in the U.S., so-called "dry powder," was estimated to have reached $279.8 billion at the end of the first half of 2023,[4] roughly in line with the $290 billion in dry powder available at the end of the first half of 2022.[5] Consequently, there was little appetite for new fundraising, with U.S. VCs raising only $33.3 billion across 233 funds in the first half of 2023, as compared to $121.5 billion across 415 funds in the same period of the prior year.[6] At this rate, U.S. VC fundraising for 2023 is on pace to reach its lowest level in six years.

EXIT TRENDS

In the first half of 2023, total U.S. exit value amounted to $12 billion from 588 exit events (*i.e.*, through M&A and public listings), as compared to a total U.S. exit value of $51.5 billion from 785 exit events in the first half of 2022.[7] If this pace is maintained, U.S. exit value for 2023 will be at its lowest level in a decade. The decrease in exit value was in large part due to the lackluster global and U.S. IPO markets, which recorded only $64.2 billion worth of global activity in the first half of 2023, reflecting a decrease of 34% from $97 billion in the second half of 2022 when IPO markets were already significantly depressed.[8] Excluding SPACs, there were 17 IPOs on U.S. exchanges that raised $100 million or more in the first half of 2023, as compared to 11 of such transactions in the first half of 2022 and 160 of such transactions in the first half of 2021.[9]

Relatedly, companies that went public since 2022 have been underperforming public markets—Renaissance IPO ETF, an index that tracks companies that recently completed U.S. public offerings, has decreased by over one-third in value from 2022 through the first half of 2023, compared to declines of 7% and 12% in the S&P 500 and Nasdaq Composite, respectively, over the same period.

However, there are some positive developments in the IPO market. The tech-heavy Nasdaq Composite stock index, which is sometimes viewed as a leading indicator for tech IPOs, increased over 30% in the first half of 2023. In addition, the first half of 2023 saw several successful IPOs, including Johnson & Johnson's spinoff of its consumer healthcare business, Kenvue, which raised roughly $3.7 billion (marking the largest IPO since November 2021) and the Mediterranean restaurant chain Cava Group, which completed its IPO at a valuation of $2.5 billion. On its first day of trading, Cava's shares nearly doubled in price, suggesting that there may be more market demand for IPO companies than previously thought. Additionally, the second quarter of 2023 recorded $42.7 billion in follow-on offerings, further suggesting improved demand for equity securities and a potential rebound in the IPO market.[10]

In line with recent trends, mergers and acquisitions have accounted for the majority of exit value, generating roughly 57% of total exit value in the U.S. in the first half of 2023, up from 50% in full year 2022.[11] More VC-backed companies that sought an exit or were under significant pressure to obtain additional capital were deterred by the weak IPO market and instead turned to M&A in the first half of 2023, creating opportunities for strategic and financial acquirers. Strategic buyers, in particular, comprised roughly two-thirds of M&A deal value in the first half of 2023.[12]

NON-TRADITIONAL CAPITAL

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

Bridge rounds—financing rounds that occur between primary financings—have been particularly popular. These bridge rounds typically take the form of preferred equity or convertible notes issued to existing investors or company insiders, and serve the dual purpose of extending a company's cash runway while holding valuations at prior rounds.

In the first half of 2023, total deal value in the U.S. VC market involving non-traditional VC investors (which includes private equity funds, corporate venture capital ("CVC"), sovereign wealth funds and asset managers) amounted to $62.5 billion, or 73% of overall U.S. VC deal value. This reflects a slight pullback from the relative participation rates observed in recent years.[13] Consistent with recent trends, CVCs continued to remain active in VC deals, participating in 24% of all U.S. venture deals in the second quarter of 2023.[14]

Special Insights

INDUSTRY SPOTLIGHT—ARTIFICIAL INTELLIGENCE

Since the public release of ChatGPT at the end of 2022, interest in artificial intelligence ("AI") has grown exponentially among investors, large public companies and consumers alike. AI is top of mind for the largest organizations—a record 110 S&P 500 companies mentioned AI in recent earnings calls.[15]

AI companies raised $25 billion in the first half of 2023, representing 17% of all global VC funding over this period.[16] CVCs and other corporate investors have been particularly active in the AI space—Microsoft has announced a multi-year, strategic investment in OpenAI, reportedly worth $10 billion, Amazon has launched AWS Generative AI Accelerator, an accelerator program for generative AI startups[17] and large public companies, such as Salesforce and Workday, have launched large AI funds looking to invest in promising AI startups.[18] AI startups have also been the target of M&A transactions by large public companies.[19]

AI's emergence has raised significant legal considerations for both AI developers and users. One challenging legal area related to the development of AI is ownership rights—including rights of use issues, uncertainty surrounding ownership of AI-generated works and questions about using open source content in training data. Additionally, as AI is inherently reliant on huge data samples (including potentially personal, sensitive or confidential information), AI companies are exposed to various cybersecurity and privacy laws. Although these areas are generally regulated by existing laws, the laws are now being tested by novel issues and their application may be uncertain. The legal landscape will continue to evolve as AI-related issues are litigated and as specific legislation is adopted. Companies should reinforce their existing software procurement policies with an eye towards AI uses, while investors should evaluate issues related to the development and use of AI in their diligence process.

INDUSTRY SPOTLIGHT—CLIMATE TECH

As discussed in our newsletter published in January 2023, VC investors have continued to focus on the climate tech industry: Since the start of 2020, 2,500 climate tech companies have raised over $117 billion in global venture funding. Although climate tech funding in the first half of 2023 decreased 40% compared to the first half of 2022, it outpaced the total VC funding over the same period, which decreased 51%.[20]

As climate activism continues to spread, consumer appetite for environmentally focused products and technologies continues to grow and governmental and entrepreneurial focus on advancing climate technology continues to increase, VC investor interest in the space is expected to remain for the foreseeable future. Notably, in April 2023, the Venture Climate Alliance, composed of more than 20 leading VC firms across the U.S. and Europe, launched with the goal of building a movement within the VC industry to combat climate change within their respective firms and as investors and advisors to their portfolio companies.[21]

THE COLLAPSE OF SVB AND THE IMPLICATIONS FOR VC COMPANIES AND INVESTORS

In March 2023, Silicon Valley Bank collapsed, sending shockwaves across the VC industry. SVB was the 16th largest U.S. bank and played a critical role in the venture capital and startup ecosystem. By some estimates, SVB had a business relationship with roughly half of the startups in the U.S. and was a leading source of venture debt for these companies.[22] Similarly, VC funds relied heavily on SVB: a large portion of SVB's loan portfolio consisted of loans extended to VC and private equity firms in order to satisfy capital call obligations, which helped facilitate venture deals.

Since being acquired by First Citizens Bank in March, SVB has resumed lending to startups, but more conservatively (and slowly) than before. SVB has also signaled a decrease in lending to venture and private equity funds.[23]

Nevertheless, SVB's future lending strategy remains uncertain and the availability of venture debt and other capital solutions tailored to early stage companies remains challenging. Industry participants are closely monitoring which entities will emerge as new leaders in early stage company financing and whether certain alternative financing solutions will gain traction.

Regulatory Developments

SEC FILES CHARGES AGAINST CRYPTOCURRENCY EXCHANGES

Following the collapse of FTX, the SEC has ramped up its enforcement activity against cryptocurrency ("crypto") companies in the first half of 2023. In June 2023, the SEC filed charges for violations of various federal securities laws against Binance, the world's largest crypto exchange, and Coinbase, the largest U.S. crypto exchange. As the SEC's complaints in these two lawsuits imply—and as SEC Chair Gary Gensler has suggested in the past—the SEC considers most crypto assets (but notably, *not* Bitcoin) to be "securities" under federal securities laws and therefore subject to the SEC's jurisdiction.

The SEC's heightened scrutiny of crypto assets and broader regulatory uncertainty have to some extent chilled investment in the crypto industry, despite the year-over-year rise in many cryptocurrency prices themselves since July 2022. Many crypto investors believe that the SEC has taken a harmful "regulation-by-enforcement" approach, which adds regulatory risks to any investment in a crypto-related company. These investors have long been asking the U.S. government, including the SEC, to provide regulatory clarity around crypto assets through rule making and legislation.

While the SEC has moved in the direction of increased scrutiny, the industry did receive positive news in July in a federal case in the Southern District of New York where the court held that crypto token XRP is—under certain circumstances—not a "security" under federal securities laws. As of the publication of this newsletter, the SEC has signaled it may appeal this ruling.

SUPREME COURT LIMITS SECTION 11 LIABILITY IN SLACK DIRECT LISTING CASE

On June 1, 2023, the Supreme Court vacated a decision by the U.S. Court of Appeals for the Ninth Circuit in *Slack Technologies, LLC v. Pirani*, resolving a circuit split on the question of standing for investors bringing a claim under Section 11 of the Securities Act of 1933, as amended (the "Securities Act"), in connection with a direct listing. The Supreme Court's opinion practically eliminates Section 11 liability for companies going public through a direct listing, requiring plaintiffs to plead and prove that the securities at issue are traceable to the particular registration statement alleged to contain material misstatements or misleading omissions.

Since 2018, the New York Stock Exchange and the Nasdaq Stock Market have allowed companies to go public through a direct listing in lieu of a traditional underwritten IPO. In a traditional underwritten IPO, existing shareholders typically cannot trade their unregistered shares for a period of time after the IPO, and so all publicly traded shares are easily traceable to the registered offering for some period of time after the IPO. In contrast, in a direct listing, selling stockholders (and, in the case of a primary direct listing, the issuer) can sell shares registered as part of the direct listing concurrently with sales by selling stockholders of shares that were previously acquired in private placements and that can be publicly resold pursuant to Rule 144 or another available registration exemption, making tracing securities to a particular registration statement challenging.

In 2019, Slack went public through a direct listing on the NYSE, in which selling stockholders offered 118 million registered shares and 165 million unregistered shares previously acquired in private placements. When Slack's stock price dropped following the direct listing, the plaintiff filed a class-action lawsuit under Sections 11 and 12 of the Securities Act, alleging that the shares he purchased were issued pursuant to a materially misleading registration statement. However, the Supreme Court sided with Slack, holding that Section 11 liability only applies to securities issued pursuant, and traceable, to such alleged defective registration statement. (Notably, the Supreme Court declined to consider the merits of the Section 12 liability claim.)

While the Supreme Court's ruling in *Slack v. Pirani* does not completely rule out the possibility of Section 11 liability for companies going public through a direct listing, this decision implements a very high bar on the question of standing, requiring securities to be traced to a registration statement.

SEC EXPECTED TO ADOPT INCREASED REGULATION OF PRIVATE FUND ADVISERS

An SEC proposal that imposes stricter rules on private fund advisers is in the final rule stage, with final action expected in October 2023. As proposed, the SEC's rule would apply to SEC-registered advisers and, in some cases, non-registered advisers—the latter including most VC fund advisers.

Under the proposed rules, registered private fund advisers would be required to, among other things, (i) provide investors with quarterly statements detailing fund performance, fees and expenses, (ii) obtain and distribute an audit for each fund they advise annually and upon liquidation, (iii) distribute a fairness opinion in connection with certain adviser-led secondary transactions and (iv) document the annual review of their compliance procedures.

In addition, under the proposed rules, private fund advisers, whether registered or non-registered, would be prohibited from (i) engaging in certain enumerated activities and practices that are contrary to the public interest and the protection of investors (*i.e.*, seeking reimbursement or indemnification for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund, charging certain fees and expenses to a private fund or its portfolio investments, or borrowing or receiving an extension of credit from a private fund client) and (ii) providing certain types of preferential treatment to certain investors that would have a material, negative effect on other investors (*i.e.*, side letter provisions regarding special redemption or information rights).

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July 5, 2023

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