Cravath Emerging Company and Venture Capital Insights

2023 RECAP AND 2024 OUTLOOK

Market Update

VENTURE CAPITAL (VC) ACTIVITY

Global venture capital activity underwent a challenging period in 2023, with both deal value and deal count falling to their lowest levels since 2018. Global VC funding in 2023 amounted to $248.8 billion, representing a 42% decrease from $426.2 billion in 2022 and a 62% decrease from the record $648.6 billion in 2021.[1] Similarly, global VC deal count in 2023 recorded a 30% decrease from the levels seen in the two prior years.[*] [2]

Late-stage companies have continued to experience an outsized impact on their ability to raise funds compared to early- and mid-stage companies.[**] In line with 2022, late-stage companies comprised just 8% of VC deals in 2023.[3] Further, there were just 394 global mega-rounds (*i.e.*, deals worth $100 million or more) in 2023, continuing the downward trend seen in 2022 (there were 933 mega-rounds in 2022 as compared to 1,608 mega-rounds in 2021).[4] Despite this trend, there were a number of notable mega-rounds in 2023, particularly in the artificial intelligence sector.

The challenging VC environment in 2023 can be attributed to a variety of factors, including persistent inflation, supply chain disruptions, heightened geopolitical tensions (such as the conflict in the Middle East, growing tensions between the U.S. and China and the Russia-Ukraine war), the collapse of Silicon Valley Bank and elevated interest rates.

2024 is poised to be a critical year for many private companies that raised capital at high valuations in 2020 and 2021. Since then, companies have been pursuing a wide range of financial and operational measures in order to extend their runways and avoid down rounds (*i.e.*, an equity financing where a company sells equity at a valuation that is lower than a valuation achieved in the immediately preceding raise). However, as such measures are not designed to serve as long-term solutions, many of these companies will face significant pressure in the coming year to consider fundraises or, in the case of late-stage companies, exits, at terms well below their peak valuations.

* The number of global VC deals in 2023, 2022 and 2021 amounted to 29,303, 42,069 and 41,736, respectively.

** Median deal value in 2023 across all stages fell to $2.8 million from $3.0 million and $3.6 million in 2022 and 2021, respectively. For late-stage companies, median deal value in 2023 fell to $21.0 million from $26.4 million and $50.0 million in 2022 and 2021, respectively.

FUNDRAISING

U.S. VC fundraising in 2023 fell to its lowest level since 2017: only $66.0 billion of new capital was raised by VCs in 2023, reflecting a 61% and 60% decrease from the record levels raised in 2022 and 2021, respectively.[5] Similarly, the number of funds that raised capital in 2023 recorded a steep decline, reaching the lowest mark since 2013.*** [6] The record levels of fundraising in 2022 and 2021 combined with the low investment activity in 2023 continue to result in a record amount of undeployed capital, so-called "dry powder." The level of dry powder in the U.S. was estimated to have reached $302.8 billion at the end of 2023.[7]

Geographically, the Bay Area remains dominant, with 46% of U.S. VC fundraising occurring in the Bay Area in 2023.[8] However, since the COVID-19 pandemic, VC fundraising has become more geographically dispersed, with cities such as New York, Boston and Washington, D.C. establishing themselves as robust VC hubs and collectively accounting for 35% of U.S. VC fundraising in 2023 (compared to just 24% in 2019).[9]

Recently, a number of investment firms have raised new funds in order to purchase equity in VC-backed companies directly from existing investors and employees in the private secondary markets. These markets have traditionally seen depressed volumes but are steadily maturing as the size and age of private companies continue to increase. As a result of the weak exit market, VC funds (and, to a lesser extent, employees) are turning to secondary markets in order to unload their investments and investors are focusing on this opportunity, with several large investment firms having raised, or being in the process of raising, multi-billion dollar funds that would target the private secondaries market.

EXIT TRENDS

In 2023, total U.S. exit value amounted to $61.5 billion—the lowest amount in over a decade—representing a relatively modest 22% decrease from 2022 compared to the steep 92% decrease from the record-setting 2021.[10] The decrease in exit value was in large part due to the lackluster global and U.S. IPO markets. In 2023, public listings globally raised just $123.2 billion,[11] while U.S. public listings raised just $22.6 billion,[12] each representing the lowest levels since 2016.

In line with recent trends, in 2023 mergers and acquisitions (M&A) continued to provide a relatively strong exit avenue compared to IPOs. For the second consecutive year, M&A provided over 50% of U.S. exit value (contrasted with 28% and 18% in 2020 and 2021, respectively).[13] In 2024, M&A activity involving VC-backed companies is likely to remain robust as it is expected to benefit from the potential interest rate cuts previewed by central banks, which would lower the cost of acquisition capital for acquirors.

IPO activity remained relatively low despite being predicted to increase in the second half of 2023, particularly as notable IPOs were set to launch. This was in part due to a number of companies that went public in 2023 seeing their share price drop below the listing prices in the weeks following their IPOs. More broadly, the trading performance of companies that debuted in the U.S. public markets in 2023 trailed the broader market, recording an increase of just 14%, compared to increases of 24% and 43% of the S&P and Nasdaq, respectively, for the same period.[14] Further, performance of companies that had recently gone public via SPAC mergers remained very poor, with more than twenty such companies filing for bankruptcy in 2023.[15]

*** Only 474 funds raised capital in the U.S. in 2023, compared to 1,340 and 1,543 in 2022 and 2021, respectively.

However, there are reasons to believe that the global and U.S. IPO markets may rebound in 2024. Public equity markets ended 2023 on strong footing: as discussed above, the S&P and Nasdaq recorded increases of 24% and 43%, respectively (compared to decreases of 19% and 33%, respectively, in 2022). Although newly listed companies trailed the broader market, they picked up significant momentum in the last few months of 2023, with the Renaissance IPO ETF—an index that tracks companies that recently completed U.S. public listings—increasing 27% over November and December. Another indicator that may help foreshadow a more robust IPO environment in 2024 is the significant number of valuable private companies in the IPO pipeline, with the global market recording 1,233 unicorns (*i.e.*, private companies valued at over $1 billion) at the end of 2023.[16]

NON-TRADITIONAL CAPITAL

In light of the challenging funding environment and exit conditions, growth companies continued to explore alternative sources of capital, including venture debt, asset-based lending, 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 from an external partner.

In particular, asset-based lending has emerged as a viable funding option in asset-rich industries, such as manufacturing and distribution. Asset-based loans are directly correlated to the value of a borrower's assets, which serve as collateral for the loan. Companies with healthy assets and strong relationships with lenders have turned to asset-based lending as a way to secure working capital without necessarily agreeing to the burdensome financial covenants typical of traditional debt financing.

In 2023, there was a significant increase in down rounds. The percentage of equity financings that were down rounds in the U.S. increased to 20% in 2023 from only 8% in 2022.[17] Because down rounds tend to elicit negative sentiment (both internally and externally), many companies have chosen to raise capital through convertible debt or SAFE rounds in order to avoid priced rounds that would revalue the company's shares downward. In addition, VC funds have been increasingly putting more money into their portfolio companies—so-called "insider rounds"—allowing VCs to deploy some of their dry powder, support existing investments and extend a company's runway without a share repricing. In situations involving financial distress or near-term liquidity shortfalls, existing VCs have provided "recapitalizations," which more significantly alter the capital structure and allocation of rights in exchange for new capital.

Special Insights

INDUSTRY SPOTLIGHT—ARTIFICIAL INTELLIGENCE (AI)

AI and machine learning firms continue to build momentum as companies and individuals adopt AI tools in their activities. While overall VC funding declined in 2023, AI investment was up 9% from the previous year, reaching nearly $50 billion in global VC funding. Moreover, more than $23 billion of this funding was committed to generative AI startups. For example, Anthropic, a competitor to OpenAI (the company behind ChatGPT), raised nearly $7 billion in funding in 2023 alone, including rounds from Amazon, Google and Spark Capital.[18] Other notable AI-related raises in 2023 included Inflection AI raising $1.3 billion, Metropolis raising $1.1 billion, Databricks raising $685 million, and Aleph Alpha and SandboxAQ each raising $500 million.[19]

Strong support and funding of AI companies have provided founders with negotiating leverage that was otherwise lacking during the poor funding conditions of 2023. Corporate control has been a key theme, particularly in light of the brief shakeup in OpenAI leadership in the latter half of 2023, with the firing of Sam Altman from his role as CEO by OpenAI's board of directors, followed by over 95% of OpenAI employees threatening resignation and the ultimate reinstatement of Sam Altman as CEO less than one week later with a new board of directors. Founders with negotiating leverage have started to reconsider the amount of corporate control they wish to retain (*i.e.*, in the form of dual-class voting) in order to protect the company's mission and management.[20]

On the legal and regulatory front, in October 2023, President Biden signed an executive order calling for AI regulation by more than 20 federal agencies and emphasizing the importance of "promoting responsible innovation, competition, and collaboration."[21] In the EU, policymakers have agreed on the terms of the A.I. Act, a framework for regulating AI and its implications for health, safety and human rights.

Meanwhile, a number of high-profile lawsuits have been initiated concerning the generative AI platforms of numerous companies, including OpenAI, Microsoft, Anthropic, Google and Stability AI, among others. The allegations in these complaints range from copyright infringement of authors' books, articles and song lyrics, to unlawful collection and use of personally identifiable information. These cases are ongoing, and the copyright and privacy claims related to the associated AI applications have not been dismissed. Given the scarcity of policy guidance in the AI field, the legal landscape will continue to evolve as AI-related issues are litigated and as regulation and legislation are adopted. Companies should proactively reinforce their software procurement policies to account for risks pertinent to AI tools and examine the terms of vendor agreements to ensure confidential and proprietary information is protected. Similarly, investors should evaluate issues related to the development and use of AI in their diligence processes and include agreement terms that mitigate AI risk where applicable.

THE COLLAPSE OF SILICON VALLEY BANK AND THE IMPLICATION FOR VC COMPANIES

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 business relationships with roughly half of the startups in the U.S. and was the leading source of venture debt for these companies. Since being acquired by First Citizens Bank in March, SVB has resumed lending to startups, but more conservatively (and slowly) than before, allowing other industry participants to gain significant market share. Large traditional lenders, as well as startup-focused fintech companies, have started to offer or expanded existing venture debt financing platforms. Several of them have hired notable former SVB bankers.

UPDATES TO THE NATIONAL VENTURE CAPITAL ASSOCIATION (NVCA) MODEL LEGAL DOCUMENTS

Since publishing its first model legal documents in 2003, the NVCA form financing documents have become widely adopted as the industry standard in the VC industry. In October 2023, the NVCA announced significant updates to five of its key documents: the Certificate of Incorporation, the Stock Purchase Agreement, the Voting Agreement, the Right of First Refusal and Co-Sale Agreement and the Investors' Rights Agreement. The updates reflect current market terms and address recent changes in Delaware law and other relevant case law. In addition, the updated forms include new guidance on emergent topics, such as diversity policies and trade and economic sanctions.[22]

PUBLICATION OF THE EMERGING BUSINESS CREDIT AGREEMENT (EBCA) BY THE LOAN SYNDICATIONS AND TRADING ASSOCIATION (LSTA)

The LSTA, an industry leader in the syndicated loan market, published in November 2023 its first-ever form of Emerging Business Credit Agreement. The EBCA is intended to serve as a loan agreement for businesses that are "no longer a new venture but [are] not yet established middle market companies" and are seeking to borrow between $25 million and $100 million. Companies negotiating comparable credit agreements should consider referencing to the EBCA for key market terms.[23]

Regulatory Developments

BENEFICIAL OWNERSHIP REPORTING UNDER THE CORPORATE TRANSPARENCY ACT (CTA)

As of January 1, 2024, new beneficial ownership reporting rules under the CTA have gone into effect. These rules authorize the Financial Crimes Enforcement Network (FinCEN) to establish and maintain a national registry of beneficial owners of entities that are deemed "reporting companies," which includes a broad range of companies formed in the U.S. as well as foreign companies registered to do business in the U.S., which may include smaller private growth companies. At first glance, the rules might be confusing because FinCEN "reporting companies" are not the same as SEC "reporting companies." The rules list 23 categories of entities that are exempt from reporting, which can be categorized into four areas: (i) large operating entities (*i.e.*, companies employing more than 20 full-time employees); (ii) subsidiaries of exempt entities; (iii) regulated entities; and (iv) other exempt entities. Given the breadth of exemptions, most sizable operating companies are exempt from the reporting rules; however, smaller private growth companies are likely not exempt and ought to analyze the exemptions closely.

Reporting companies are required to file reports with FinCEN that disclose certain basic company information and personally identifying information for two categories of individuals: (1) the reporting company's beneficial owners—which include any individual who exercises substantial control over such company or owns or controls at least 25% of such company and (2) the reporting company's applicants (*i.e.*, those forming or qualifying the company).

Any reporting company created in 2024 will have 90 days from the date on which it receives notice of its creation (if a domestic company) or qualification to do business (if a foreign company) to file an initial report with FinCEN. Any domestic reporting company created before 2024 and any entity that becomes a foreign reporting company before 2024 must file an initial report no later than January 1, 2025.

DEVELOPMENTS IN ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) AND CLIMATE-RELATED REGULATIONS

While ESG has been at the forefront of public markets for several years, private markets have been seen as lagging behind in developing ESG practices, strategies and investment criteria. However, increased pressure from regulators and institutional investors is causing many VC funds to establish ESG-focused investment criteria, which is in turn resulting in startup companies more widely adopting ESG principles across their activities.

Recently, regulators in the U.S. and in Europe have been cracking down on "greenwashing"—the practice of exaggerating or overstating a fund's focus on environmental and sustainability practices or factors in their investment criteria. For instance, in September 2023, the SEC adopted changes to the so-called "Names Rule," which now requires funds whose name suggests a particular focus on a certain investment type to invest at least 80% of their assets consistent with such name.

Similarly, the UK has passed a new regulatory regime that will require asset managers who market their funds as sustainable to choose one of four specific fund labels and demonstrate that they apply at least 70% of their assets according to such label. These rules are in addition to existing rules that generally require correct, clear, complete and fair marketing of financial products, which have recently been applied in the context of greenwashing.

Late-stage private companies that are considering IPOs in the U.S. should also be aware of the pending SEC climate disclosure rules, which, if adopted as proposed, would require public companies to include substantial climate-related disclosures in periodic reports and registration statements. These include significant and detailed line-item disclosures in a number of climate-related areas, such as climate risk identification, management and governance, and requirements to report Scope 1 and Scope 2 Greenhouse Gas (GHG) emissions and, if material or if included in an emissions target, Scope 3 emissions. Assuming the rules are adopted substantially as proposed, companies considering IPOs should plan accordingly to ensure they put in place compliance systems and avoid any unwanted delays.

In addition, several states have undertaken measures that require climate-related disclosure and encourage ESG investment. In September and October 2023, California passed three seminal climate-related bills: (1) the Climate Corporate Data Accountability Act, (2) Greenhouse Gases: Climate-Related Financial Risk and (3) the Voluntary Carbon Market Disclosures Act, which collectively make up the most extensive set of mandatory climate disclosure rules in the U.S., and will require disclosure as soon as 2026. These requirements generally apply to companies "doing business in California" that satisfy certain financial thresholds, including private companies. Notably, there is a bill pending in the New York legislature that would mandate some of the same disclosures, including disclosure of GHG emissions, and would similarly apply to certain private companies that do business in New York.

The EU has also adopted a broad framework for ESG disclosure: the Corporate Sustainability Reporting Directive (CSRD), and its requirements apply to some private companies. Adopted in 2022 and now in effect for the first cohort of companies, the CSRD requires that subject companies report on a wide range of topics, including the effect of sustainability challenges on their operations as well as their own impact on the environment. Importantly, the CSRD introduced reporting requirements for non-EU companies that have a nexus to the EU and meet certain criteria which include financial thresholds, and may capture private companies.

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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