Torin Rittenberg

Since I started writing my newsletter, I've always wanted another way to write more longer-form content. It only took me a few years–but here it is, the first of hopefully many posts that will focus on technology, investing, economics, growth tactics, maybe design, possibly food, and more. You'll receive these posts (which will be published here) directly in your inbox, along with my weekly newsletter. Hope you enjoy, and let me know your thoughts!

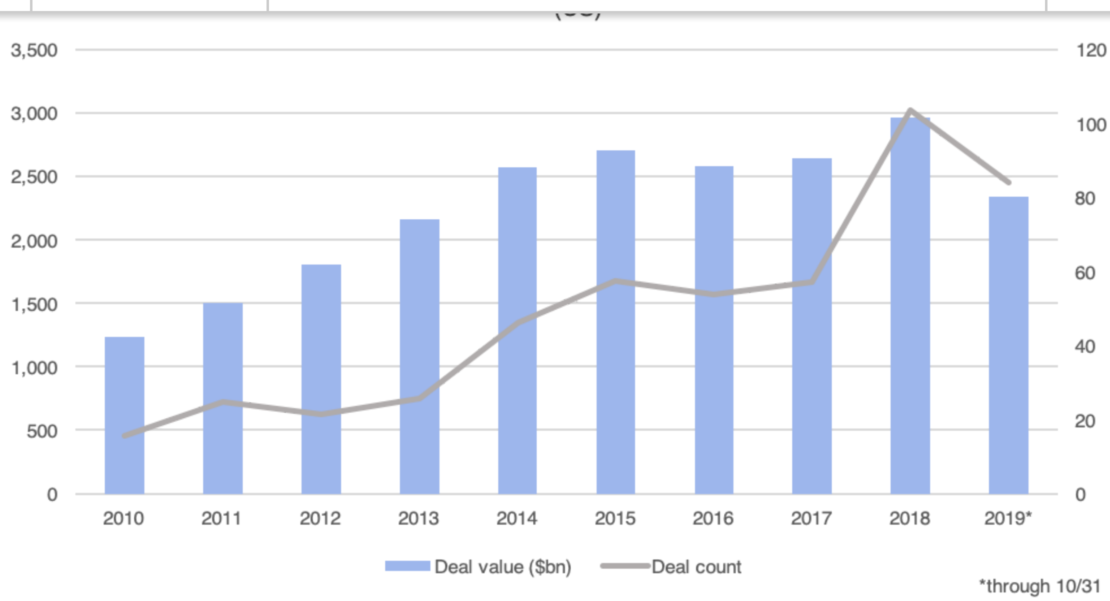
Looking back (and ahead) on the VC funding landscape

Torin Rittenberg - Dec 31, 2019

I thought I'd sum up a few notes from the past year on venture capital, and the funding landscape at large, as both a past participant and now avid observer of the industry. These aren't predictions, per say, but things to merely look out for in the new year/decade.

1. Nontraditional investor activity in VC deals plateaued, but is here to stay.

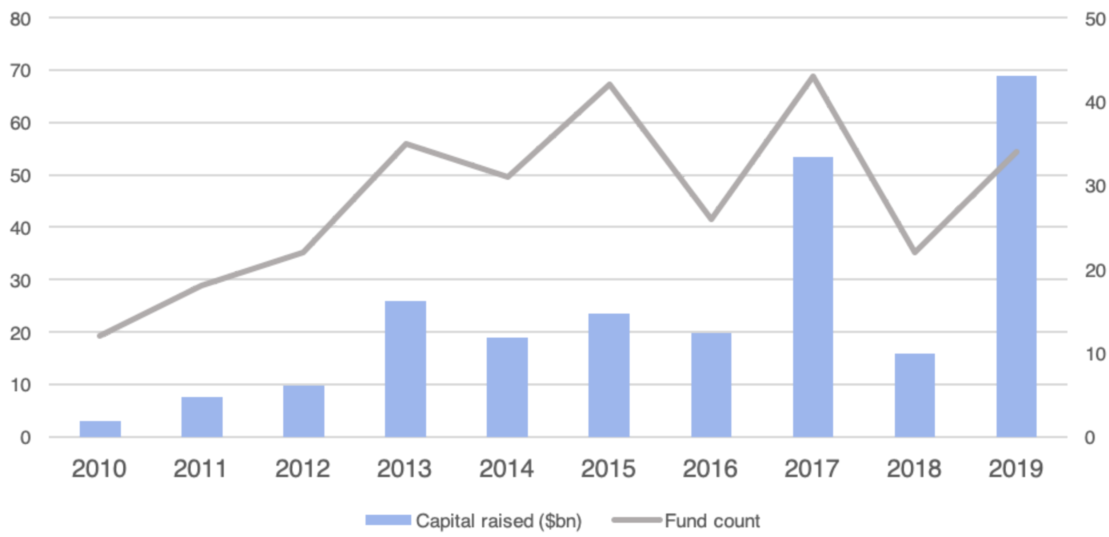
Hedge funds, mutual funds, corporations, sovereign wealth funds, etc. are all classified as so-called "tourists" in VC—nontraditional investors that have now planted their stake in early-stage deals, typically looking for diversification or outsized returns. Their presence in VC deal activity—in both deal value and deal count—took shape around 2014, and then grew again significantly in 2018. The proportion of VC deal activity in the US with nontraditional investor participation this year will end at ~80%, leveling out somewhat from last year's all-time-high of 82%. Additionally, such investors will have participated in ~40% of VC deals in the US this past year.



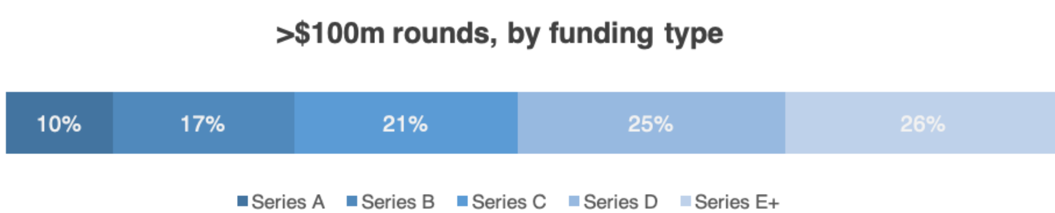
These nontraditional investors are not, I believe, a fleeting part of the venture landscape, but rather an increasingly critical piece to it. Well over 2,000 unique nontraditional investors participated in US VC deals in 2019. Most of this capital is going into late-stage megadeals ($100m+), where the capital can be used more aggressively to (hopefully) affect returns. The median deal size with nontraditional investor participation is more than 4x the deal size without it. It's also interesting to note that, in 2019, nontraditional investors on average participated in three rounds of funding with a company before it went public. This means they are investing a lot earlier than usual to curate startups before hitting the public markets. So, maybe they're not tourists after all—they're the new kids on the block.

2. Tech-focused PE got huge, with tech-focused debt following suit.

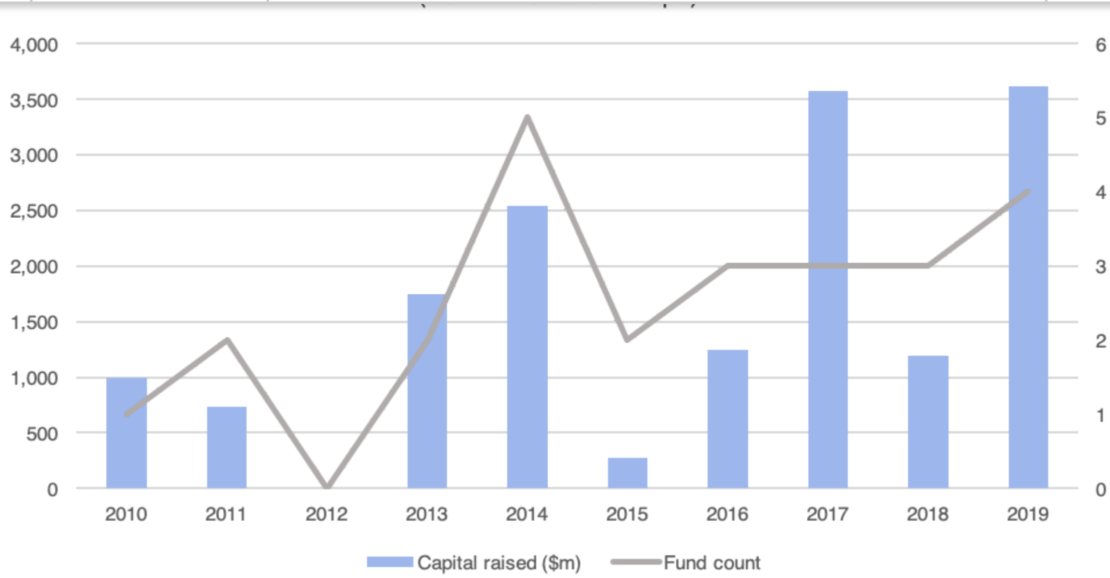
Narrowing in a bit, tech-focused PE firms amongst nontraditional investors has become massive. There's a heap of dry powder in the market for tech companies; for funds in the West, it has reached an all-time high YTD. More tech PE money (>$100bn) has been raised in the past three years than between 2008-2016 altogether. Cash flows have thus both grown exponentially and have been positive. And the money keeps flowing because thus far tech-focused funds are outperforming other comparable funds in 10-year IRRs and fund multiples.



To be fair, it was only a massive year in tech PE fundraising because of Thoma Bravo and Vista Equity Partners both closing flagships funds, driving up the average tech-focused PE fund size to ~$2bn, a record high. These firms are helping the case that, nowadays, startups are certainly not limited to raising a supergiant round because of their age. In 2019, 27% of rounds that were >$100m were Series A and Series B.

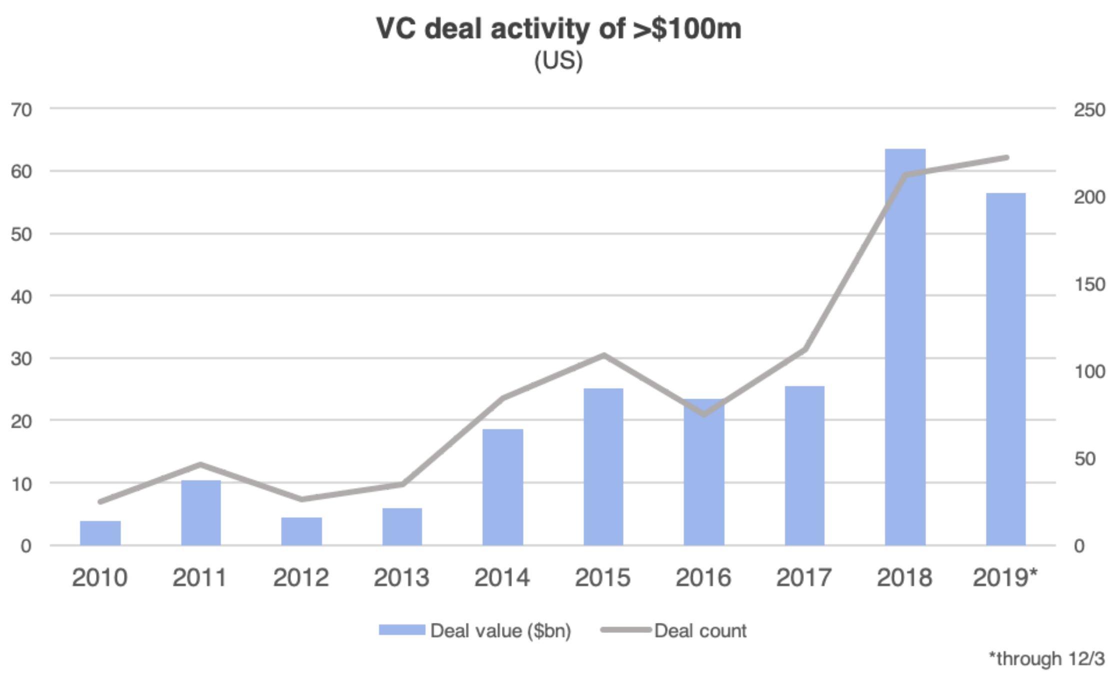


Debt has been another more frequent player in the venture landscape, perhaps because the loss rate has remained relatively low for VC-backed startups at just 2%. It has served as an attractive option as founders try and maintain greater ownership, especially if equity is growing at a much greater rate than revenue and the business has healthy cashflow. It's additionally played a role in the funding wars between industry competitors, where founders chase pools of cash as a lever for growth. Tech-focused debt fundraising hit $3.5bn+ in 2019, another all-time high and area to keep eyes on in the new decade.



3. Megadeals and valuations are up, with an uncertain path forward.

It was another year of strong cumulative deal value in VC due to the participation of larger investors and a record number of rounds that were $100m+.



This isn't anything new. But we did see from WeWork-Softbank that perhaps investors are now going to approach such high-flying deals with more caution, more focus on profitability and stronger oversight, and more realism with deal prices. Many seem to think WeWork hammered these reminders into every investor out there—that the days of piling up capital as a pure growth strategy, or particularly as a moat strategy, are gone.

Perhaps. But I don't think it will do much to lower deal valuations in 2020. People are quick to forget, and given how much dry powder and unique investors there are, it now only takes one or two big fish to kick off another spending spree. And such investors are the best company CEOs. Adam Neumann was a highly public and very expensive example of that. But I still feel skeptical that, indeed, *this time is different*.

The overarching trend of companies operating in private markets for longer will likely continue the megadeal and pricey valuation cycle in 2020.

4. The seed market is as strong as ever; expect more funds to become brand names.

There's evidence and anecdotal stories that the seed market was the busiest it has been in 2019. And I certainly expect seed funds and GPs to turn into more household names in the coming years.

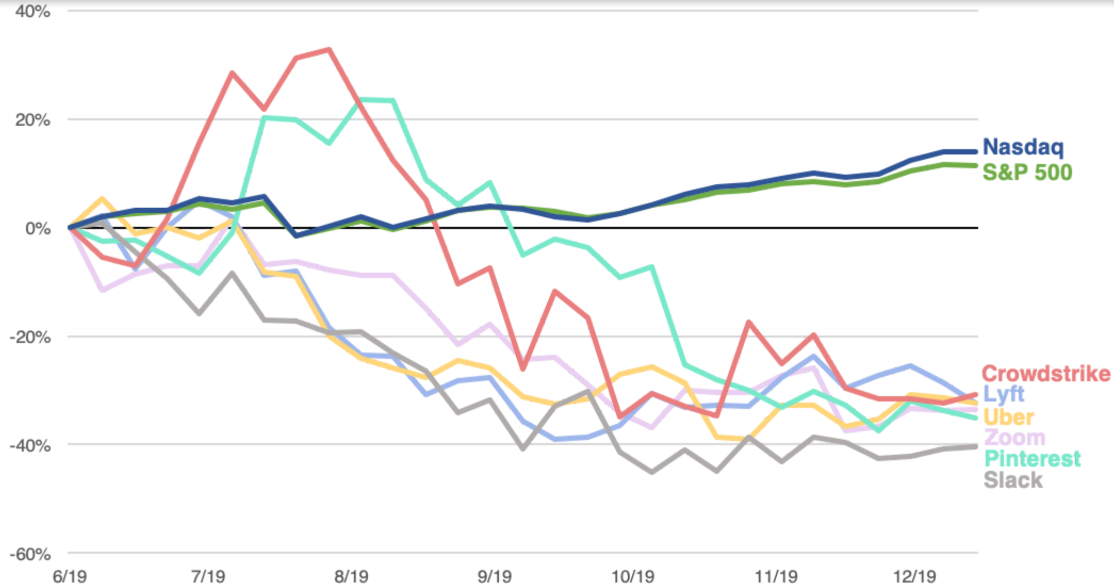
Consider this: The median seed deal now raises somewhere around $2m, compared to just $500k a decade ago. And median pre-money valuations have grown from $2-3m to ~$8m today over the same period.

As seed becomes more institutional, pre-seed will replace what seed effectively used to be. The best way to think about the seed ecosystem nowadays is a take-your-pick format for founders. Your first funding round could be $1m or $5m; you might be pre-product and pre-cofounder or already have an MVP working in market; and you could really call it whatever you wanted, be that an angel or friends & family round, a pre-seed or a seed round.

Many seed investors have been successful because they themselves either started off investing as an angel, or were previously in roles at successful startups. They are therefore more likely to identity with a founder, and offer expertise in a very specific domain that a larger, more generalist fund might lack. The biggest hurdle will be seeing how seed investors can keep up with pricey follow-on rounds. If done right, this is how certain seed funds will turn into brand names.

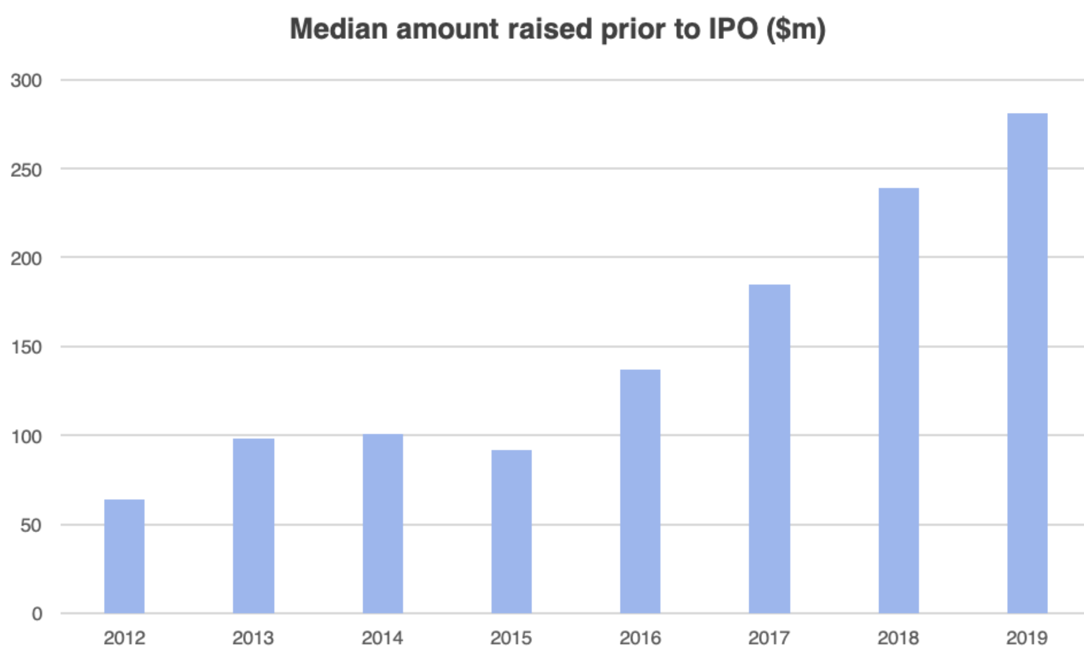
5. Large tech IPOs disappointed; expect direct listings to formalize soon.

We all know just how well the public markets have performed this year. But the much-anticipated tech IPOs of 2019 have left many investors underwater. Shares of all newly-listed companies this year are up an average 23% above their IPO price; yet, tech IPOs are ending the year up an average of just 8% (with many of the largest names still in the red). Both these numbers are below the 30% gain in the S&P 500, and the 35% gain in the Nasdaq Composite.



The returns, for example, of Andreessen Horwitz's three of its past four flagship funds have reportedly ranked pretty low compared to relative benchmarks due to the poor performance of companies like Lyft, Pinterest, Slack, and PagerDuty–startups that it took major bets on but have yet to show real promise in the public markets.

What's more, IPO levels this year remained pretty stagnant compared to prior years. Companies staying private longer means that by the time they go public, they've had much more funding than the historical norm. Many thus go public nowadays not to raise fresh capital but to enable employee and shareholder liquidity. In 2012, the median amount raised before a company went public was $64m. Now it's $281m.



I suspect direct listings will gain stronger force in 2020 as the need to raise from public markets dwindles. They are further attractive for founders because they lower the cost of float.

Of course, much of this rests on if the SEC works with the NYSE and Nasdaq to pass new regulations for such listings. As companies like Airbnb express heavy interest in the new method, it seems likely rules should be changing soon.

I've certainly left out many trends and changes in the funding landscape, but these have been some that have been increasingly on my mind. Feel free to share your thoughts with me on any of the above, or anything I've missed. And expect more longer-form content in the coming year!

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