

COVID-19's Influence on the US VC Market

VC braces for impact of crisis, with pockets of opportunity

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Key takeaways

- The effects of the economic slowdown brought on by COVID-19 will absolutely be seen in VC. Aggregate VC dealmaking has remained strong so far. We expect Q1 deal flow to be largely unaffected, but we do expect a decline in total venture transaction volume over the next few quarters.
- In deals being negotiated, we have already seen a downward shift in valuations, and deal terms have swung back in favor of investors following a prolonged movement toward founder-friendly terms. Startups needing to raise capital in the current environment will increasingly encounter liquidation preferences, dividend rights and other investor protections.
- VC-backed biotech companies have begun to reassess their drug development and clinical trial budgets as they curtail burn rates to extend cash runways. Exit opportunities for biotechs have also become hazier with the current market volatility, as many recent IPO filers might be forced to return to their private backers for capital.
- Economic shocks test how important the venture investment has become to nontraditional investors, but this crisis may also test how important those investors have become to the broader venture market. Many corporate VCs (CVCs) will pull back, but we expect those that have set up dedicated investment teams and raised venture-focused funds to continue investing prudently. We expect the biggest drawback from nontraditional investors with liquid strategies, such as hedge funds, as well as those with large asset bases that view VC as less essential.
- The venture industry has put a premium on providing capital to ecosystems outside of the major investment hubs, but a retraction in venture investment will likely hit these areas harder than regions with high amounts of local capital available. Travel is restricted across the world, and though video conferencing technologies have proved their worth in connecting people and workforces, a flight to safety may push investors to keep capital closer to home.
- M&A retrenchment should occur in tandem with IPOs. The IPO window closed fairly quickly as the extreme volatility returned to public equities. However, on the M&A front, we believe a slowdown is highly probable as well, given that corporations will be heavily focusing on liquidity and maintaining operations rather than investing externally. The math of sourcing capital to complete M&A transactions becomes much more complex when faced with the trifecta of tight cash positions, decreases in equity value and difficulty in raising additional debt.

Published on April 1, 2020

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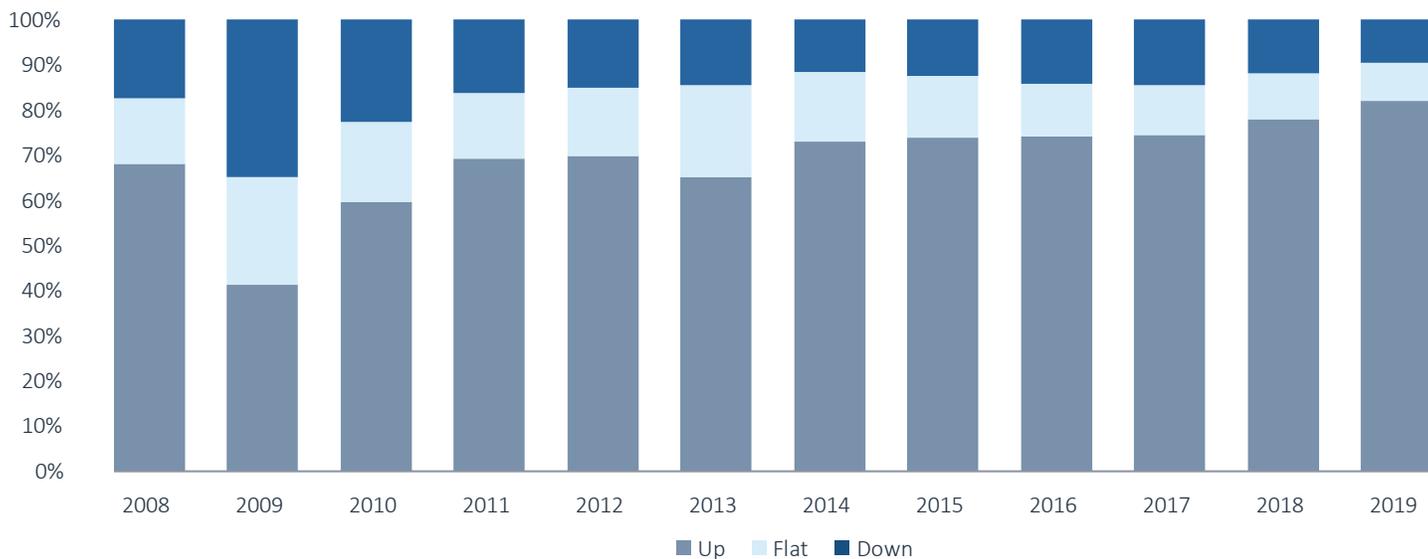
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Overview

The effects of the economic slowdown brought on by COVID-19 will absolutely be seen in VC. Given the differences in liquidity, however, they'll play out in a slightly more delayed and muted fashion than what we're observing in public equities. VC deals, for instance, have a longer lead time than their public counterparts, meaning that many deals announced in March crossed the finish line because the negotiations were already in progress (or consummated) prior to the fallout. In the last two weeks of March, we saw a plethora of mega-deals (VC deals over \$100 million) from a diverse set of companies including Tempus, HashiCorp, Gojek, Scopely, Immunocore, SutroVax, Kallyope and UserTesting. As a result of this momentum, aggregate VC dealmaking has remained strong, and we expect Q1 deal flow to be largely unaffected.

We do expect a decline in total venture transaction volume over the next few quarters. The lack of in-person meetings slows down sourcing and due diligence, even if most VCs still publicly express a desire to execute deals. This decline will likely be accompanied by an overall increase in deal quality, as VCs reserve capital for the most promising portfolio companies and as new deals receive more scrutiny. That said, as investors become more skeptical and stringent in sourcing and diligence, valuations will be challenged. Down rounds are liable to climb from the decade low of 9% that we recorded in 2019.

Valuation change between VC rounds



Source: PitchBook | Geography: US
*As of December 31, 2019

Setting the stage

Startups at different stages are likely to feel the impact differently. Companies early in their lifetime probably lack revenue and may rely solely on bootstrapping and venture dollars for growth, while more mature companies often enjoy access to a wider array of financing options. Late-stage companies moving toward an exit will need to keep revenues stable and find ways to achieve efficiencies while maintaining growth (or limiting declines) across different business segments. At the same time, sector differences will vary the repercussions of the market turbulence on startups as well. Investors are drawing stark contrasts between enterprise- and consumer-focused businesses, both of which will be benchmarked differently than biotech companies, for example. As such, the venture market will adjust in terms of valuations, deal activity and potential exit opportunities.

Angel & seed deals were resilient in the last downturn, but the market has evolved

VC deal activity during global financial crisis

Deal count	2007	2008	2009	2008-2009 YoY delta
Angel & seed	792	930	1,246	34.0%
Early stage	2,130	2,291	1,860	-18.8%
Late stage	1,431	1,566	1,452	-7.3%

Deal value (\$M)	2007	2008	2009	2008-2009 YoY delta
Angel & seed	\$0.94	\$0.92	\$1.25	34.8%
Early stage	\$14.67	\$14.86	\$9.64	-35.1%
Late stage	\$22.45	\$21.15	\$16.59	-21.5%

Source: PitchBook | Geography: US
*As of March 17, 2020

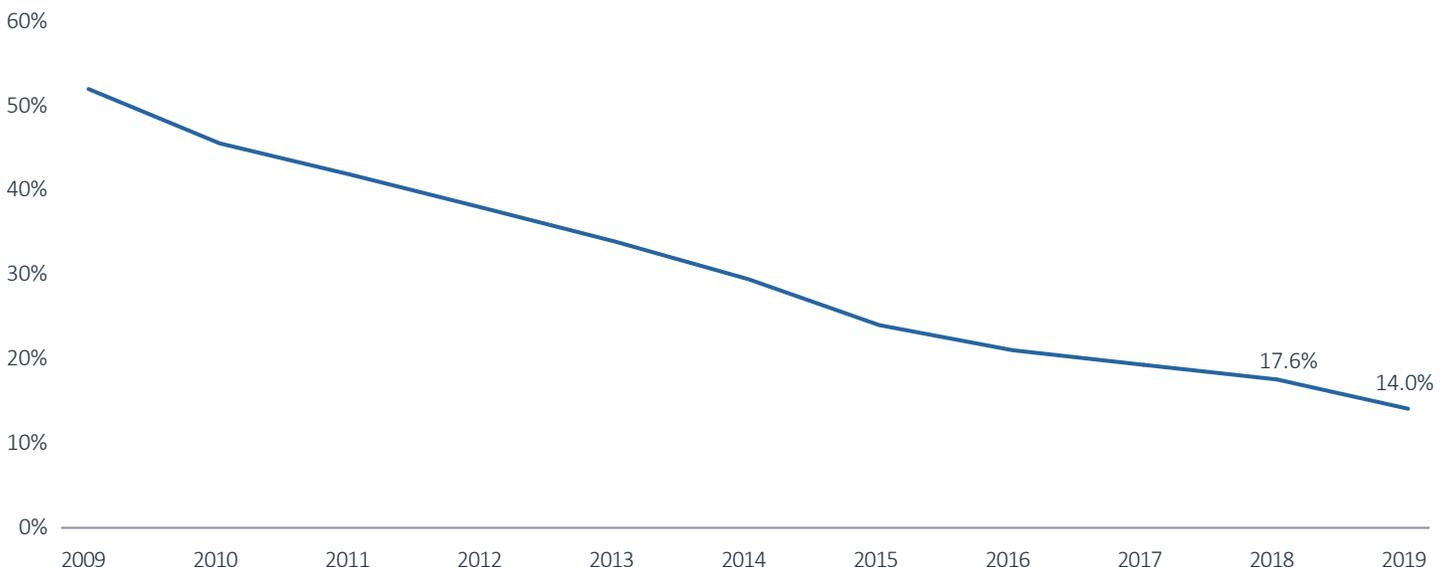
During the last recession, angel & seed activity actually increased as interest in the stage began to boom during a period of prolonged growth. For investors of that time, the illiquidity and risk of early bets on private companies were outweighed by the potential windfalls that could be realized. Angel & seed activity looks much different today; more than 5,000 deals were completed at this stage in 2019, greater than 5x the total prior to the financial crisis. We think that angel & seed dealmaking will largely be resilient, but it is important to note that deal counts have been trending downward in recent years while the amount of capital deployed has risen to record levels. As such, we do not anticipate a strong uptick in activity like we saw in the previous downturn.

One reason we expect sustained investment activity is that it's become a common belief that companies formed during a recession end up being some of the most successful. It is difficult to find an investor who will publicly state that they aren't still pursuing deals. The sentiment is that the confluence of not having any customers to lose and the ability to ride the wave of economic expansion as the companies start to ramp up leads to better outcomes for earlier-stage startups rather than established players. There are countless examples from the great recession in 2008 and 2009, including many of the most highly valued VC-backed businesses, such as WhatsApp, Slack, GitHub, Airbnb, Stripe, Uber, Waymo and Pinterest.

Early-stage fundraising comes at an inflection point for many companies that are looking to justify high valuations despite lack of revenue. Early-stage investment has reached nearly \$45 billion across roughly 4,000 deals each of the past two years. The abundance of Series B and C businesses present particularly difficult decisions for investors. A high volume of struggling companies could leave VCs with tough choices on which portfolio companies or business models their reserve capital stores are able to support through the downturn, which may result in a shrunken startup ecosystem. Having strong cash flow and positive unit economics will be increasingly important for companies at this stage to secure future financing.

In deals being negotiated, we have already seen a downward shift in valuations, and deal terms have swung back in favor of investors following a prolonged movement toward founder-friendly terms. Startups needing to raise capital in the current environment will increasingly encounter liquidation preferences, dividend rights and other investor protections. Many startups may find these terms, or the prospect of a down round, untenable and turn to alternative sources of financing, as we discuss later.

Proportion of VC deals with liquidation participation rights



Source: PitchBook | Geography: US
*As of December 31, 2019

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Late-stage VC

The confluence of factors that merge at the late stage, as well as the breadth of what deals now constitute late-stage VC, mean that the eventual effects of the slowdown related to the current pandemic crisis are likely to be just as broad. Firstly, as mentioned earlier, VC GPs are likely to focus on supporting existing portfolio companies and their capital needs rather than establishing new startup relationships. Global VC dry powder is sitting at \$188.7 billion as of mid-year 2019, which translates to just over two-and-a-half years of capital on hand based on recent fund contribution rates. This suggests that many GPs are set up to weather this turbulence.

At the late stage, however, there is much more involvement from large asset managers that invest across asset classes. This means that many of them are experiencing a swifter hit to the value of their public equity or credit holdings, causing the reverse of the denominator effect that we've seen in the market during the prolonged bull run. As a result, many of these nontraditional investors and LPs find themselves overallocated to alternatives, which could cause some pullback in both direct investing from these participants as well as a lull in VC fundraising further down the line.

However, as noted in the sidebar, we think the risks of the denominator effect are mitigated today relative to the global financial crisis (GFC). Furthermore, the maturation of VC over the past decade has made it a more integral part of many nontraditional portfolios, which may contribute to higher stickiness than we've seen in previous downturns. For instance, many sovereign wealth funds (SWFs) have opened offices in Silicon Valley, suggesting that participation could be more robust throughout this crisis, while CVCs raised a record number of dedicated funds in 2019.

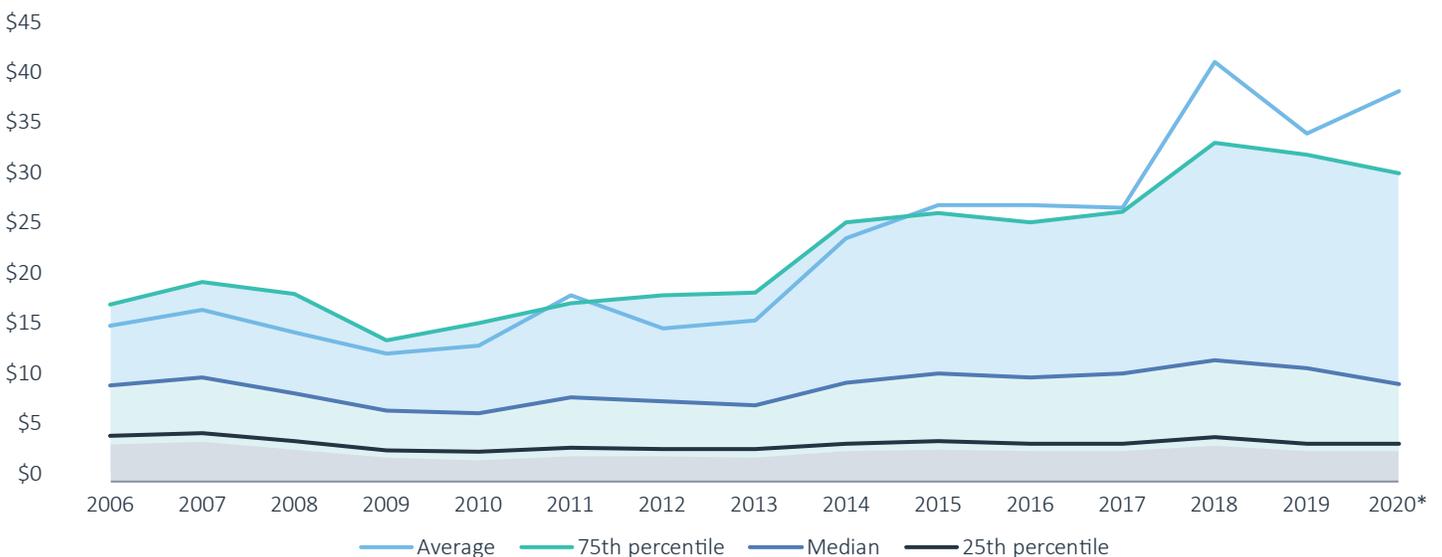
"How is the pullback in public markets going to affect allocations and commitment pacing to private markets?"

For allocators to private funds, sell-offs in public equities reduce the overall asset pool available for investment. Consider an investor with \$100 and target allocations of 60% equities, 20% fixed income and 20% private markets. If equities were to sell off by 20%, the total asset pool would fall to \$88; this would effectively result in the private market allocation target falling from \$20 (20% of \$100) to \$17.6 (20% of \$88). This phenomenon is commonly referred to as the 'denominator effect.'

Many institutional investors were already overallocated to private markets when the GFC ensued, meaning that the denominator effect had outsized consequences. As a result, the drawdown in public equities during the GFC led to liquidity issues as LPs struggled to make capital calls. Overallocations also forced certain institutions to sell LP interests at steep discounts on the secondaries market."

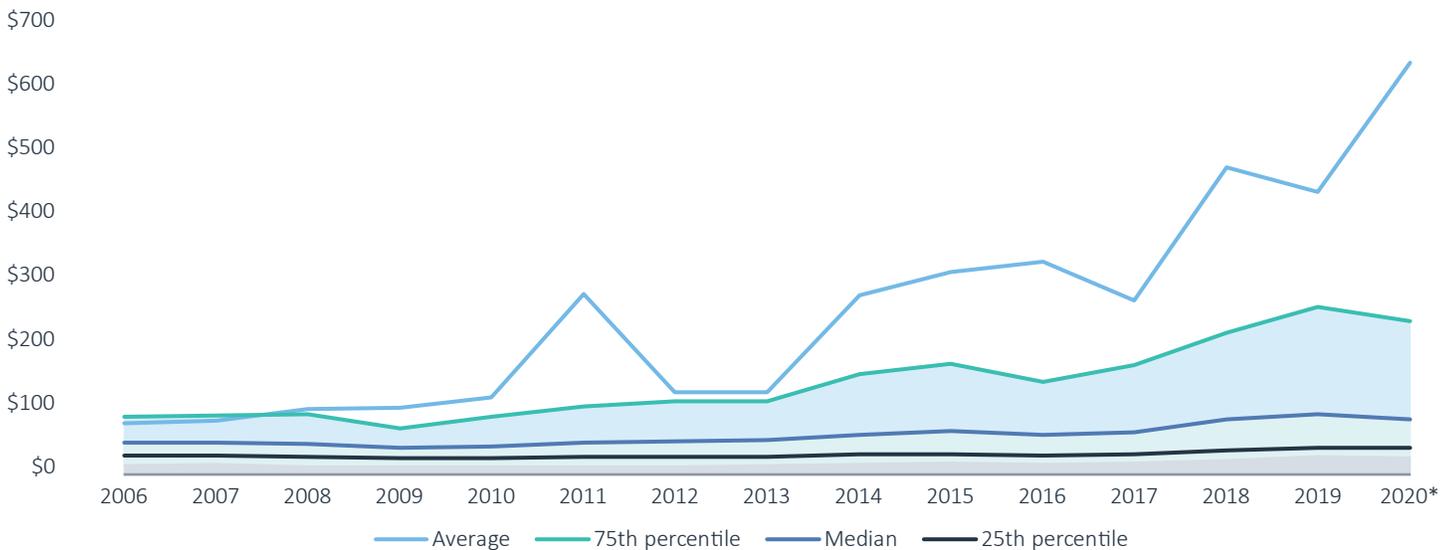
—James Gelfer

Quartile distribution of late-stage VC deal sizes (\$M)



Source: PitchBook | Geography: US
*As of March 17, 2020

Quartile distribution of late-stage VC pre-money valuations (\$M)



Source: PitchBook | Geography: US
*As of March 17, 2020

Given those factors, if this downturn is sustained, it is likely that much of the capital that was setting prices at the margin will dry up, putting additional negative pressure on valuations after deal sizes declined and valuations plateaued in 2019. Furthermore, the prices of companies at this stage are more linked to public markets than at any other point in the cycle. The proposition of reviewing comps and trying to price a new financing in the current climate is daunting, especially with the S&P 500 down nearly 30% at time of writing from one month prior. Raising a priced down equity round is typically not ideal for the business itself nor the investors; not only are the optics poor, but the investor protections begin to kick in and complicate the process. These rounds are generally uncommon but tend to spike in times of economic uncertainty. For example, they made up 35% of deals in 2009, up from 18% in 2008, as compared to 9% in 2019. We expect this percentage to pop up slightly by the end of 2020, especially if the fallout from the economic shutdown caused by COVID-19 lingers for longer than expected.

On one hand, an IPO converts all equity holders to common stock, eliminating the complexity of preferred equity shares that often include terms that convolute down rounds, which could make it easier to weather a downturn as a public company. Some startups may wish they hadn't chosen to stay private for as long as they have. However, the illiquidity that is fundamentally characteristic of operating as a private company allows companies to avoid the second-by-second mark-to-market that public companies endure during volatile times. In the current environment, where investor protections have been increasingly lax in the aggregate, we expect the negative consequences of being a public company to outweigh the simplicity of the equity capital structure.

Feeling the burn rate

In this economic climate, cash flow management has become a crucial focus for companies as they work past the crisis to avoid pricing an equity round into a down market. Companies that have raised capital recently may have the ability to downsize and lengthen runways, but the growth projections that accompanied the price of the previous round will be tougher to reach. These companies do have the advantage of good timing to be able to grow through the subsequent recovery (assuming a quick rebound) if they can lower cash burn and secure another round.

In this past decade, capital was relatively easy to come by for both VC investors and startups, and it became a more common practice for participants to stockpile this capital for a rainy day. Many buzzy VC-backed companies, such as Slack, Postmates and numerous others, were able to build up a war chest of cash by capitalizing on outside demand for their shares, even when they didn't necessarily need the money to fund current operations. If these companies have been prudent with their spending and forward-thinking, this strategy may yet help sustain some of these businesses through this economic slowdown.

Companies that were just on the brink of raising capital or that had a deal revoked are in a much more difficult situation. Some may raise equity on suboptimal terms, while others will seek alternatives to a priced equity round, such as debt financing, to sustain operations. Companies with distinctive business models will likely have very different experiences during this crisis. For example, companies with high contract-based ARR may be able to ride out a downturn on their own; however, those that are pre-revenue (e.g. biotechs) have fewer levers to pull to stay afloat, which could mean pricing down.

It will be a best practice at this time for companies to emphasize lowering cash burn. Investors also must be diligent in monitoring their liquidity and ability to back their portfolio companies. Maintaining adequate reserve capital grows in importance at a time like this, as the difficulty of raising a new fund may increase in tandem. This disproportionately benefits follow-on deals in existing portfolio companies rather than new deals as VCs work to support and consolidate behind the perceived winners in their portfolios. Follow-on deals may be less affected given the desire to keep existing companies afloat, and the familiarity that GPs have with the portfolio company may allow Zoom and videoconferencing to be sufficient for dealmaking purposes.

Enter-prized

We expect tech-enabled, contract-based businesses, such as [SaaS companies](#), to remain relatively resilient, because many contracts are locked in for at least a few more months. In general, customers are not going to be reevaluating long-term enterprise technology contracts, especially if the economy bounces back fairly quickly. Impediments from the virus are likely prolonging sales cycles for new clients or grinding those conversations to a halt as new spending may be put on freeze. That said, we still believe the slowdown will impair these companies less than consumer-focused startups that may be seeing a precipitous fall in the top-line as a demand-driven downturn seems to loom. For a breakdown of the effects on specific sectors, our emerging technology team has released a [complementary note](#) diving into the impact the COVID-19 situation is having on the verticals that we cover.

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Paradigm shift in the healthcare and biotech sectors

Investors and operators alike within the healthcare and biotech sectors will likely shift strategy to avoid being caught flat-footed again. As a direct response to the novel coronavirus, some VC investors—including Y Combinator's Sam Altman and The 1517 Fund—have been eager to finance nascent scientific discoveries that could manifest into groundbreaking vaccine technologies. Tangential startups and large tech companies in Silicon Valley are also leveraging their respective skillsets to better diagnose and treat COVID-19. As such, VC-backed companies with drug R&D activity and clinical trials in vaccines and/or infectious diseases are well positioned to see significant upside as the market continues to determine the timing and duration of the global pandemic.

Despite the blessing of large cash infusions, VC-backed biotech companies are also cursed with high burn rates due to soaring drug R&D costs and increasing capital expenditures. These startups tend to have at least a year or two of runway in cash due to the capital-intensive nature of the biotech business model. However, the potential long-term ramifications of the current market conditions could force startups to trim drug development budgets to maintain long-term sustainability as the instability surrounding future funding continues to grow. Clinical-stage companies are also experiencing delays and disruptions to trial enrollment and data collection due to the burden of COVID-19 on overwhelmed hospitals; this is extending the timeline further and thinning out the runway that companies have put in place.

Previous analysis by PitchBook showed that the time between venture rounds increased during the financial crisis of 2007 and 2008. Our data also indicates that VC deal activity in the life sciences slowed in the years that followed; total early-stage deal value for the sector dropped 24.2% from 2008 to 2009. Pre-revenue private companies like these have well-defined runways that make it difficult to survive without raising additional capital. This could force them to search outside of venture, potentially cutting the high valuations that VC-backed biotechs have enjoyed for the last several years.

Compared to other sectors within biotechnology, the vaccine market is inherently risky. Funding for vaccines and infectious diseases has historically been quite poor. Investors argue that it is difficult to predict a market size for emerging infectious diseases and, given the ambiguous timeline of viral outbreaks, there is no long-term promise of a revenue stream for vaccine manufacturers. Savvy investors will recall that in previous outbreaks—namely, SARS in 2003 and MERS in 2012—companies that began developing and testing vaccines and treatments quickly found themselves out of funding when the outbreaks spontaneously disappeared. Given the impact and pressure that COVID-19 has placed on nearly every industry in the global economy, we believe there will be sustained interest from investors over the next few quarters toward both directly-affected companies (i.e. biotechs focused on prophylactic drugs and preventive healthcare technologies) and indirectly-affected tangential companies (i.e. sub-supplier companies focused on rapid vaccine technology development or manufacturers of ventilators and other medical equipment).

"Companies have begun exploring creative ways to take their existing drug portfolio to formulate a vaccine to COVID-19. Virtually every public biotech company is either repurposing existing antiviral drugs or developing new platforms as experimental COVID-19 treatments, knowing that the current market opportunity for vaccines has never been bigger or more unpredictable. Large amounts of liquid assets such as cash and short-term investments allow companies such as Gilead, Regeneron and Moderna to quickly pivot existing programs and initiate coronavirus-focused clinical trials. Even private VC-backed biotechs such as Greffex are getting in the game; however, they generally lack the capital needed to conduct clinical trials and will rely heavily on venture funding to reach the next steps. From a regulatory point-of-view, the Center for Biologics Evaluation and Research (CBER) at the Food & Drug Administration (FDA) has been developing frameworks to safely accelerate the trial timeline for a potential vaccine in a controlled manner. We anticipate a metaphorical "all hands on deck" for VC-backed biotechs as they look to take advantage of this current regulatory environment on top of what has been several years of favorable FDA drug approval metrics. At time of writing, there are potentially almost 70 existing drugs and experimental compounds that may be effective in treating COVID-19.¹ The potential of this could greatly benefit the healthcare private markets and alter the landscape of the biotech sector as companies consider the multidimensionality of their drug platforms."

—Joshua Chao, Ph.D

1: "A SARS-CoV-2-Human Protein-Protein Interaction Map Reveals Drug Targets and Potential Drug-Repurposing," bioRxiv, David E. Gordon, et. al, March 22, 2020

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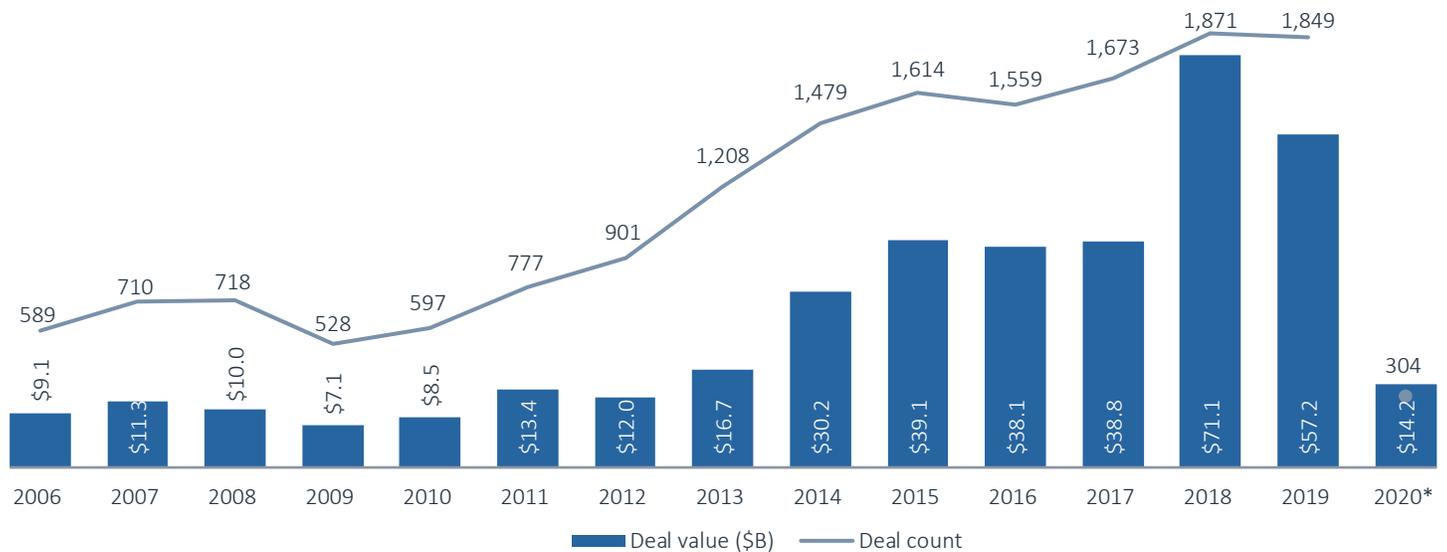
Nontraditional investors: How entrenched are they?

Over the past decade, we have seen high growth in the number of funds and firms adding direct venture to their list of strategies. They've featured prominently in the mega-deals that have exploded in the age of the unicorn. The value of VC deals with participation by nontraditional investors has reached a combined \$200 billion over the past two years. We have argued that nontraditional investors have become more entrenched in VC, building more sophisticated venture operations and realizing the diversification benefits that VC offers their portfolio. But downturns are typically a catalyst for market participants to revert to their tried and true strategies. Over the next few months, the resolution of nontraditional investors will be tested, and only when the industry emerges on the other side will we be able to determine the extent to which VC has become a mainstay strategy for these investors.

We expect VC deal activity with nontraditional investor participation to slow in the near term, largely mirroring any hindrance the turmoil creates in VC firm activity. Though these investors have increased their venture presence, many leave the pricing and sourcing to other firms, acting solely as add-on participants to deals in progress. It will be several months, even quarters, before we see the full impact. But it is difficult to make generalizations about "nontraditional investors," which is a blanket term covering corporate VC, PE firms, SWFs, mutual funds and hedge funds, along with several other investor types. Each has a different profile for risk, return and liquidity, and each employs a different strategy within VC.

Within this group, corporate VC may be the most important to follow. For one, many corporations will need time to assess the damage to their core businesses, stemming from both stock price declines and negative adjustments to revenue streams as exposure to overall economic deterioration is determined. CVC has seen a massive increase over the past few years due to its function as part of external R&D and growth strategies. But another facet of investing that could stall CVC activity is simply the optics of a corporate investment in an outside company if and when that corporation is simultaneously laying off its own employee base. We expect firms investing off their own balance sheets to focus almost exclusively on existing portfolio companies. However, the story may be different for corporations that have used cash returns from the 11-year bull market to create dedicated investment units and funds, which have entrenched them in the venture industry. The emergence of these dedicated funds allows corporations to separate CVC from more internal decision making, and the capital earmarked for startup investment may be somewhat insulated from any deterioration in their parent company's stock.

VC deal activity with CVC participation



Source: PitchBook | Geography: US
*As of March 17, 2020

"The venture industry has seen its peripherals grow during the last decade just as much as its core. Non-VC funding options now vary widely and are accepted as viable funding options for growth. An economic event such as this poses different threats to different sources. Accelerators and incubators will face challenges directly to their business models if in-person programs cannot convert seamlessly to a video-conference format. Individual investments made by family members or angels are primed for a downturn as the broad economic crisis depletes capital reserves and these investors taper their activity. Grant fundings alone aren't enough to sustain startups through a downturn, and the economic impact felt by institutions providing the grants could materially affect their delivery."

—Kyle Stanford

SWFs are a unique investor type within the nontraditional group. The size and lengthened time horizon of these funds enable SWFs to invest in the largest VC deals without needing immediate returns, which is an important characteristic depending on the depth and breadth of any coming recession. Many of these funds are financed through natural resources, and the current market rout of oil could push these funds into further diversification from natural resources. In the past, putting a material amount of capital to work in venture was difficult, making it not worth the effort for many large allocators, including SWFs. In recent years, however, the upward bound limit of venture deal sizes has continued to push even further, offering SWFs more opportunities to finance emerging growth companies.

While a pullback from nontraditional investors seems likely, the extent of the overall decline is difficult to estimate. Many of these investors manage capital pools that are magnitudes larger than classic venture funds. And even with their participation in outsized VC deals, the total exposure to startups is relatively small. The distressed nature in which some startups might find themselves could provide opportunities for large fund managers to consider. As we hear of slides in valuations and terms quickly beginning to favor investors, late-stage startups needing to raise capital on down rounds could become targets for these nontraditional investors.

Venture debt set to play big part in funding scene

While venture is predicated on equity financings, venture lending has seen its part of the market grow up and down the venture lifecycle over the past few years. From large banks lending to the Airbnbs and Ubers of the industry to revenue-based financings offered to young startups, debt has become a way for entrepreneurs to subvert traditional venture funding and for pre-IPO companies to optimize their capital structure before filing. In many cases, debt components have been used in addition to equity financings to provide further growth capital without diluting existing investors.

The deterioration of valuations seems likely to play a major part in the incurrence of debt financings during the near term. For late-stage companies that have ridden the valuation wave, debt could be a lifeline if immediate capital is needed, supplanting more expensive down-round equity financings. Given the current low reference rates for venture debt, existing late-stage borrowers may want to refinance existing facilities and reaffirm their relationship with their lenders. We could also see a large pull back in lending from banks and other institutions that have waded further from their core lending strategies over the past several years. With this, debt funds focused on the venture market could see less competition in the short term, and loan terms should move in favor of lenders.

Early-stage venture debt is set to experience a much different set of obstacles. Low or even lack of revenue makes reliance on venture funding paramount to the success of companies already in the fundraising cycle. As venture firms assess the damage to their portfolios, and potentially trim capital deployment, extending capital on hand is a major challenge that startups will face. VC-backed companies across the industry have begun a series of layoffs that will likely extend for at least a few months. Extra runway can be pivotal to startups, but layoffs are also likely followed by deepening revenue crunch. Revenue hits taken by startups with existing debt may substantially affect their ability to pay down their loan, and existing facilities could make it difficult to raise equity funding during a crisis if a proportion of that funding will simply go toward paying down debt rather than growth.

The proposed government bailout spending contains SBA lending legislation that will apply to many startups, though personal loan guarantees can make these facilities risky for not only the company, but also the founders staking their personal assets on success. Tax credits and emergency SBA grants that may be available to keep employees onboard seems pertinent to the venture industry as companies restructure their workforces. Innovative debt products that have come to market in recent years, such as revenue-based financings, may also help weather the storm as payments fluctuate with incoming revenues. They should lessen the strain on companies with such facilities. We believe companies with enterprise SaaS models and strong recurring revenues will be best suited to wait out a prolonged economic slowdown.

Venture lending has shown to have relatively low default and capital loss rates over the past few years, in large part due to lenders' relationships with VC investors. The current climate is much different than the frothy market to which the VC industry had become accustomed over the past several years, and venture debt will likely take a prominent place in financing companies through the crisis. We do not believe, however, that venture lenders will shift their focus, or expand their range of companies with which they do business. Much like VC firms, a focus on core investment principals will provide venture lenders a playbook for navigating the changes occurring across the industry.

An effect on venture ecosystem growth

Recently, the industry has made a concerted effort to fund companies and entrepreneurs located outside the major hubs of tech. Areas such as Atlanta, Columbus, Raleigh and Austin have benefited from investors realizing that good companies can be created anywhere. While pain will be felt up and down the list of venture ecosystems, the smaller, emerging areas could feel it much more than Silicon Valley, New York and other highly capitalized, top-tier ecosystems.

The continued growth of ecosystems hinges on capital availability in the immediate vicinities. [Our data](#) has shown that the distance between companies and their investors extends as the company progresses through the venture lifecycle, but the youngest startups typically rely on local capital for funding. We expect first checks written by local angels to slow, at least temporarily. Seed-stage investors will reassess their portfolio and may need to slow capital deployment as in-person meetings have come to a halt. Fewer early investors in a local market, coupled with an extended market downturn, could have a profoundly negative effect on the growth of entrepreneurship and innovation outside of traditional venture hubs, essentially resetting the development of smaller ecosystems.

Zoom and other video conference software companies have made deal meetings and diligence sessions possible in a world bereft of in-person contact. However, dealmaking requires a high level of trust between investors and startups, which can be difficult to establish virtually. In many cases during an economic crisis, virtual dealmaking meetings are probably best suited between portfolio companies and their existing investors. For this reason, video conference technology could only in a best-case scenario continue fostering the growth of emerging ecosystems. It has, however, proven its worth during these times of low travel and increased working from home. It's not out of the question to presume that as things normalize on the other side of this crisis, tools such as these will emerge as a benefit for companies outside of VC investment hubs that are seeking funding.

Across the industry, GPs with proven track records may be able to raise funds in a downturn if needed. First-time managers, especially those outside major markets, will have a much more difficult time when looking to raise follow-on vehicles. We haven't seen yet if companies headquartered in emerging VC ecosystems will be able to successfully exit in this environment. Utah is a market that has proven its ability to realize substantial returns and, more importantly, has closed a double-digit number of funds since the beginning of 2018; this should provide fundraising opportunities for companies amid the uncertainty of other small markets.

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Where has the liquidity gone?

The IPO window for private businesses in general is linked very closely to the conditions in the public market. The current conditions give companies considering a public listing a glimpse of the environment into which they will begin trading. The volatility that the market has experienced over the past few months makes going forward with an IPO an extremely uncertain decision for company management and board members. This leads us to believe that there will be a significant pullback in IPO volume over the duration of the crisis, as we have already seen in recent weeks. This slump will also apply to direct listings, which have gained a significant amount of momentum over the past few years. Even though no new capital is raised, the transaction still prices the equity of the business in the currently volatile public markets. For some historical context, only 13 VC-backed IPOs closed in 2008, and only 11 closed in 2009. We expect IPO activity in 2020 to drop drastically after eclipsing 80 listings in both 2018 and 2019.

"Exit opportunities for VC-backed biotech companies have also become hazier with the current market downturn. Public market volatility is at its highest level since 2008, forcing a dozen or so recent IPO filers to await market thaw. A number of these filers are private VC-backed biotech companies looking to raise a significant level of capital to put their products into the hands of clinicians and patients. However, the currently dim IPO market will force these private companies to delay their plans to list. To note, public healthcare companies tend to do well during uncertainty. Out of the 11 sectors that comprise the S&P 500 index, healthcare has traditionally been one of the least volatile to market forces. Alongside consumer staples, the healthcare sector is currently the second least volatile in terms of the rate of downturn in the last 30 days. Given the unique healthcare-directed nature of COVID-19 and its broader implications in the global market, we see the current market conditions as more favorable for large healthcare and biotech incumbents that are looking to reinforce their pipeline through strategic M&A activity of private VC-backed companies at a significantly lower valuation than during the prolonged bull market. This ultimately catalyzes scientific innovation and benefits patients and companies across the industry."

—Joshua Chao, Ph.D

There is plenty of anecdotal evidence to back up this future decline in IPO volume. Airbnb is reportedly looking to raise another private round and likely to further delay an IPO. Social Capital Hedosophia, fresh off of its completed reverse merger of Virgin Galactic, postponed two new blank check vehicles. Even the nearly constant flow of biotech IPOs has seen some pause, with a handful of companies that are fully ready to list still sitting on the sideline. These biotech companies will be important to watch. Given many companies in this space are still pre-revenue, suspending an IPO puts them in a tight spot when it comes to cash flow. Some of these companies may be forced into returning to the private markets or potentially seeking a sale of their business.

On the M&A front, we believe a slowdown is highly likely as well, given that corporations will be heavily focusing on liquidity and maintaining operations rather than investing externally. The math of sourcing capital to complete M&A transactions becomes much more complex when faced with the trifecta of tight cash positions, probably decreases in equity value, and difficulty in raising additional debt. However, given the challenges startups may face in raising capital, there will likely be some struggling companies forced to seek a sale if unable to find another option. This could pose some opportunities for prepared strategics or financial sponsors to make smart acquisitions or acqui-hires at attractive prices if they can find the liquidity to make it happen.

For VC funds that are fully invested or nearing that mark, the prospect of selling portfolio companies into this market may push some GPs to delay exits if possible and utilize the extensions built into the fund. Lengthening holding times of portfolio companies will ratchet up the returns pressure on GPs as both the exit multiple and time to realization move against investors in the short term. The likely deterioration of IRRs over the next couple of quarters will flow back through and increase the difficulty of fundraising for many VC firms. Given this protracted timeline and the aforementioned denominator effect, some LPs may choose to exit on their own terms and try to sell their stakes in funds in the secondaries market. While a flood of this activity would depress the prices that LPs will be able to realize, we don't expect a massive rush of capital allocators to the exits through these means. The light at the end of the tunnel is slightly more clear right now relative to the last two downturns.