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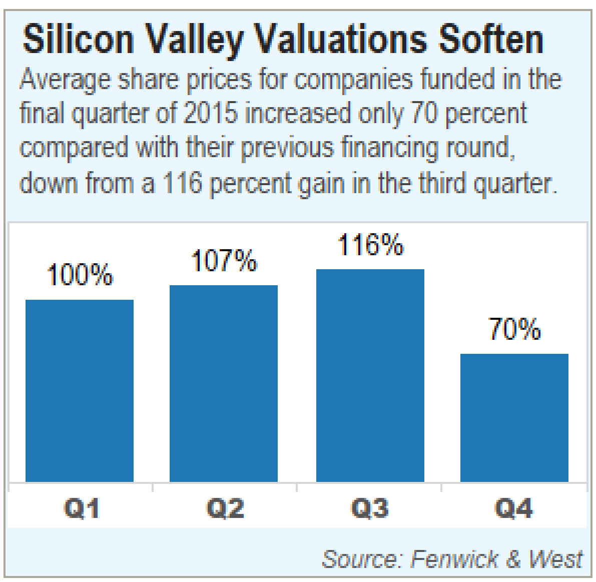
Silicon Valley Startup Valuations Start To Plateau

By **Tom Zanki**

Law360, New York (February 24, 2016, 3:33 PM ET) -- Valuation growth for Silicon Valley's venture-backed companies softened in the fourth quarter, a trend experts say shows that public market volatility is likely rattling investors in late-stage technology and life science companies concerned about a weak outlook for initial public offerings.

Data released this week by technology and life science-focused law firm Fenwick & West LLP shows that private valuations are still rising at a solid clip, though the robust pace seen earlier in 2015 has slowed. Average share prices for companies funded in the fourth quarter increased 70 percent compared with their previous financing round, down from a 116 percent jump in the third quarter and marking the lowest increase since the fourth quarter of 2013, data shows.

Additionally, the number of "up rounds" — in which private companies sell their stock at a higher price than in the prior round — fell from 86 to 82 percent while "down rounds" rose from 4 to 12 percent, according to the study, which focused on 152 venture financings that closed in the fourth quarter by Silicon Valley-based companies.



Survey author and Fenwick & West partner Barry Kramer said those numbers show the overall funding environment remains healthy, though he cautioned that "we are seeing a real softening."

“When the public markets go down it affects the whole range of venture investments," Kramer said, adding that later rounds are more affected because they are closest toward a transition to the public market.

The survey indeed shows that Series E and later funding rounds — the final stages of private investments — reported the most down rounds at 26 percent. Series E and higher rounds also reported the smallest average share-price increase among fourth-quarter financings at 16 percent.

Honigman Miller Schwartz and Cohn LLP partner Phil Torrence said he expects continued trepidation in the so-called crossover rounds, known for attracting institutional investors shortly before a company goes public, unless public markets recover. He noted that investors that buy stakes in those stages do so with an eye toward a public exit.

But public markets haven’t been welcoming as of late, generating only four IPOs year to date and often at disappointing prices amid wider global volatility.

“There is a direct correlation between activity in venture investing and a slowdown in the capital markets,” said Torrence, who works on life science offerings, the only industry to generate IPOs so far in 2016, albeit in modest amounts.

Earlier funding rounds, which typically show more rapid rises since they are starting from a smaller point, fared better than later rounds, though initial rounds also fell from third-quarter levels. Companies that raised funding in Series B, C and D posted average prices increases of 101, 81, and 57 percent respectively, according to the survey.

Viewed from a long-term perspective, Kramer noted valuations across all stages are coming off of multiyear highs reached in the middle of 2015.

“It’s still a very solid result; it’s just not as good as it was,” Kramer said of fourth-quarter totals.

Kramer said his bigger concern is that financing remains ample for private companies — and all indications show that it is — but in a more cautious environment, companies may have to defer initial public offerings until markets are more welcoming or accept a down round if necessary in order to raise money.

“It isn’t the end of the world,” Kramer said. “If you have to take a down round, you have to do it. The key is to do what is right strategically for your company.”

The Fenwick survey follows other reports analyzing private financing trends by firms that advise early-stage companies that showed valuation growth slowing in late 2015.

Recent analysis by Cooley LLP and Wilson Sonsini Goodrich Rosati & PC, which studied deals involving their respective firms, reported signs of weakening valuations toward the end of the year, particularly among later-stage businesses, but noted that funding as a whole is healthy relative to historical levels.

“Although valuations and amounts raised in the fourth quarter of the year showed some market softening, overall metrics for Q4 indicate a market that remained strong compared to prior years,” the Wilson Sonsini report said.

The Fenwick report also notes changes in industries that are drawing investor enthusiasm. For the first time since 2010 when it began tracking data by industry, software companies did not rank among the top two industries from a valuation standpoint, ranking third with a 60 percent average share price increase.

The top two industries in terms of valuation growth were Internet/digital media and hardware, which reported 111 percent and 100 percent average share price increases. Kramer said the growing diversity of aspiring public companies is a healthy sign, representing a far cry from dot-com bubble of the early 2000s.

“This is more than just people creating new apps for the Internet,” Kramer said. “We have companies with robots, drones, and Internet of Things. One of the things to emphasize is we have a number of very promising industries now.”

Life science companies, an industry that generates an outsize percentage of public offerings, didn’t fare as well in the fourth quarter. The segment’s average-share price rose 25 percent, the lowest increase among industries tracked by Fenwick's study, while 25 percent of its financings — or 3 of 12 — resulted in down rounds, the highest percentage of any industry. Torrence said that downward trend likely reflects the chilly IPO market.

--Editing by Jeremy Barker.
