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VC Funding Slips For Nearly All But The Fortunate Few

By **Tom Zanki**

Law360, New York (July 19, 2016, 8:52 PM ET) -- The number of venture capital deals slid again globally in the second quarter, a report released Tuesday shows, leaving all but a few elite private companies scrambling to adapt to the stingy new landscape.

The report, compiled by venture capital database CB Insights and KPMG International, shows that 1,886 deals raised $27.4 raised billion in capital, marking a 6 percent drop in deals from the prior quarter and the fourth straight decline. Deals lawyers say the report's findings resonate with what they are seeing, at least for most companies.

"The slowdown is here," VLP Law Group partner David Goldenberg said, adding that many venture-backed companies are being advised to conserve cash in anticipation of less generous funding rounds than ones in the past few years.

The study's authors attributed the decline to an uncertain exit environment for investors — a trend that has been building for several quarters amid a cooling market for initial public offerings — compounded by macroeconomic instability and Brexit chaos triggered by the British referendum to leave the European Union. The number of global venture deals peaked at 2,300 in the second quarter of 2015 but has gradually fallen every quarter since.

Total funding for venture-backed companies edged up 3 percent in the second quarter, mostly because of financing rounds of more than $1 billion that benefited a few large private companies like Uber Technologies Inc., Snapchat Inc. and Chinese transportation network Didi Chuxing. Experts say the results reveal a wider pattern in which robust, late-stage private companies can still obtain funding on favorable terms while the majority is finding it harder to please skeptical investors.

"There are a handful of companies that investors have insatiable appetite for, but if you are not one of those companies, you are going to have a tough time," CB Insights research director Marcelo Ballve said.

Whereas prior bullish periods rewarded companies for posting rising revenue and market share, companies that want to continue attracting money will have to demonstrate a viable path toward earnings growth, experts say. That's because hedge funds, mutual funds and other late-stage institutional investors that plant money in venture-backed companies in hopes of a profitable IPO have become more critical of financial performance.

"Expect to see lots of companies talking about profitability and taking on cost-cutting measures in the coming quarters," CB Insights CEO Anand Sanwal said in a statement.

The CB and KPMG report also notes that large mega-round activity, which it defines as deals totaling more than $100 million, slipped to 35 such deals in the second quarter. That's down from 40 in the first quarter and from a recent peak of 73 in the third quarter of last year.

The study authors attribute the trend to decreased appetite for large deals from venture capitalists, as well as so-called crossover investors like mutual funds and hedge funds, that invest in a company just before it goes public.

The birth of so-called unicorns, which are private companies valued at $1 billion or more, continues to be subdued as well, according to the study. Seven new unicorns were created in the second quarter, up from five in the first quarter but still well below the double-digit rates of prior years.

But lawyers who advise emerging companies say deals aren't falling across the board, noting that many startups are still proceeding with seed rounds. Gunderson Dettmer partner Andy Bradley said there remains enthusiasm among investors for innovation, especially regarding companies involved with driverless vehicles, genomics or the so-called Internet of Things.

"We're seeing a healthy amount of deal activity at the early-stage venture level," Bradley said. "When it comes to growth capital, we are seeing investors be more careful especially with the larger, late-stage deals."

Much of that caution reflects a shaky IPO market, which clouds exit strategies for investors. Only 44 companies have completed IPOs this year, marking the slowest pace since the financial crisis, according to researcher Renaissance Capital. Against that backdrop, more private companies face down rounds in which financing occurs at lower valuation than the preceding round.

"The [IPO] market not being as available impacts the terms that are available for those later-stage companies," Cooley LLP partner Craig Jacoby said.

Jacoby added that Cooley's own research shows that venture deals are down, but not steeply. Over the last five quarters, the number of transactions are roughly comparable, though there is increased volatility lately, he said.

"There are definitely signs of weakness in the market compared to where it used to be, but it is not a collapse by any means," Jacoby said.

If the IPO market continues to be soft, and private company valuations remain down from past peaks, there could be a spike in acquisitions in the second half of 2016, lawyers say, providing a more certain exit path for venture capital investors. At the same time, if the stock markets continue to rally, and post Brexit-fears subside as they have in recent weeks, that could also lift the mood in the private space.

"It's not like people aren't willing to invest now," said Fenwick & West LLP partner Barry Kramer, adding that the current downturn is not comparable to the recession era of 2008. "There is no shortage of money. There is just a question of why are the public markets not as receptive."

--Editing by Christine Chun and Catherine Sum.