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Venture Dip Has Experts Pondering How Long Slump Will Last

By **Tom Zanki**

Law360, New York (August 9, 2016, 8:53 PM ET) -- A new report shows venture financing further cooled in the second quarter — the third straight quarterly decline — leaving experts wondering whether private markets are in a sustained slump or whether cash-rich investors are ready to pounce on falling prices.

In a report that analyzed 195 second-quarter deals involving companies based in Silicon Valley, Fenwick & West LLP revealed several signs indicating a softening market. The decline follows several valuation markdowns of late-stage private companies by institutional investors and coincides with chillier public markets that complicate exit strategies for investors.

According to Fenwick & West, the number of “up rounds,” where the share price at which a company sells its stock has increased from the prior round, fell to 74 percent, compared with 78 percent in the first quarter. That marked the third straight quarterly drop and lowest level since 2013. At the same time, “down rounds” rose from 11 percent to 13 percent.

Also, data show the average price increase of second-quarter financings rose 40 percent compared with the prior round, down from a 53 percent increase in the first quarter. The reduction marked the third straight decline and smallest increase since 2010.

Fenwick & West partner and survey author Barry Kramer said the sobering climate marks a stark contrast from one year ago, when valuations were at record highs since the firm began tracking such information in 2004.

“It’s been certainly a noticeable decline,” Kramer said, quickly adding that most valuation metrics are in line with 12-year averages, and funding activity remains far ahead of notorious crashes like those seen in 2002 or 2008. “At the same time, we’re not in a horrible situation.”

Fenwick & West’s Silicon Valley survey follows other second-quarter data showing similar trends, including a global report by venture capital database CB Insights and a firm-specific study by Cooley LLP.

Additionally, institutions like Fidelity Investments, which are increasingly investing in late-stage companies in the hopes of spotting a good deal before an initial public offering, have begun marking down their investments, further raising questions about the true value of private companies.

The reductions reinforce widespread belief that valuations are correcting after soaring to unsustainable levels. But attorneys also note that many venture capital firms have been busy raising money the past few years and stand ready to pounce on deals when things settle.

“Anytime there is uncertainty as to valuations and value, it slows down deals getting closed,” said K&L Gates LLP partner Charlie Carter, who focuses on venture capital deals from the firm’s Seattle office. “That’s where we are now — the uncertainty period. As pricing begins to stabilize, you’ll see deals uptick.”

For the time being, experts expect most companies to be much more conservative in how they spend cash. For years, fast-rising companies could plausibly count on ever-rising funding rounds to keep their operations afloat while management focused on devising strategies to increase market share.

But Kramer notes that most private companies conduct funding rounds every 15 to 18 months, meaning that many firms that went to market in bullish 2015 now face more skeptical investors. Companies that can afford to hold out until market conditions improve can choose that route but will eventually have to decide on some exit strategy whether through a sale or a public offering.

“Either companies raise money or they have to do other things, like significantly cut back on spending or get acquired,” Kramer said.

Burgeoning e-commerce company Jet.com chose to be acquired, selling itself for $3.3 billion on Monday to Wal-Mart, which scooped up the Hoboken, New Jersey-based startup to better compete against Amazon.com. The other exit option is an IPO, but that market is chilly to high-flying startups.

Cloud communications firm Twilio Inc. bucked the trend in June with a smash $150 million IPO that marked the only venture-backed "unicorn" — a term for private companies valued at $1 billion or more — to go public this year. But otherwise, the IPO market is cold for companies across the board. Only 56 issues have priced IPOs year to date, the slowest pace since the financial crisis.

Considering the environment, Honigman Miller Schwartz and Cohn LLP partner Phil Torrence said companies should be sure to keep nine to 12 months' worth of cash on hand, certainly no less than six months' worth. Otherwise, if they go out to market in a cash-needy position, companies could “potentially be hit with a buzz saw and be subject to either a flat or down round,” he said.

“Keep as much runway as you can,” Torrence said, referring to how many months a company can fund its operating expenses based on current cash.

--Editing by Christine Chun and Philip Shea.
