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RPM Ep 23 transcript

MY: [00:00:00.09] Welcome to RPM, the podcast that explores the world of private markets. I'm your host Maribel Yoo. Many investors are wondering about the potential effects on their portfolios because of the current economic environment deeply impacted by rising inflation, interest rates and geopolitical instability. In this episode, we're going to talk specifically about the venture capital ecosystem as we navigate this challenging economic environment. Here with me to discuss the current VC landscape from fundraising to liquidity is John Avirett, a partner on our venture capital and growth equity team at StepStone. John, thanks so much for joining me. Welcome to RPM.

JA: [00:00:34.41] Thanks for having me. I'm excited for the conversation today.

MY: [00:00:37.89] Absolutely. Now let's get started with the venture fundraising environment. According to Pitchbook, VC funds raised over $138 Billion in 2021. What venture fundraising trends do you see for the remainder of this year? In 2023?

JA: [00:00:50.91] Yeah, absolutely. Last year was an epic year from a fundraising perspective in venture capital, also from a deployment in terms of investments as well. The first nine months or so of this year, were actually pretty busy as well. A lot of fund managers were coming back to market despite the macro. We are seeing slowness now kind of towards the tail end here of Q3 into Q4 and we'd expect additional slowness in 2023. A lot of folks have raised, again, meaningful sums of capital either this year or last year. The deployment paces have slowed down in terms of net new deals, follow-ons, etc. We'd expect because of those dynamics in terms of investments, that the pace of fund managers coming back to market will slow down. That being said, there's just been a lot of funds that have been raised over the last decade plus. I mean our estimation is there's probably close to 2,000 net new funds. There are going to be a lot of funds that that do have to raise, for better or for worse, even in a more challenging macro. But the dollars when you start reading Pitchbook data or other data sources out there is always skewed by the larger venture funds or growth equity funds or others that raise billion, multibillion-dollar dollars. So it will be interesting to look at statistics both in terms of dollars, but also number of funds raising and then net new funds being created, which again, we're seeing on the net new funds being created that that dramatically falling off already.

MY: [00:02:30.66] For sure. Now, the last time fundraising significantly dropped was during and immediately after the global financial crisis. Now, while the underlying economic conditions are very different now compared to 2009, do you think this gives us any insight into what may lie ahead?

JA: [00:02:44.73] It's a great question and I've been chatting with a variety of constituents about this. You know, I started in the venture asset class in '05, so I had a number of years kind of leading up to this and then seeing all of what happened during the financial crisis. And the interesting thing now is that the asset class has grown significantly in size because a broader subset of allocators are interested in investing in the asset class because of the very strong performance of venture historically and in its future prospects as well. And so, I think as you look forward, you have certain allocators who've been longtime believers in the asset class that with the things that are happening in macro may be overallocated or have less dollars to deploy because they've just been significant participants and that's worked very well. You have others that are kind of steady as you go and maybe allocating very similarly, and then you have newer allocators that maybe hadn't been aggressively investing in venture capital. And look at sort of the downturn here is potentially a top to an opportunity to go heavier. And so in ‘09, 2010 and kind of similarly in ‘01, 2002, etc., it was like all the water moved in one direction, which in those cases was away from the asset class. In this situation it's a bit different, where there's some that are leaning in and some that are status quo and others that are leaning out. So, I think that's going to create sort of just more unpredictability around the fundraising environment in the future. But I think the one thing you can probably predict within sort of what I just described is likely, you know, in these time periods there tends to be a flight towards quality. So, the folks that are allocating will likely again focus more on the established organizations with more proven track records, teams and platforms and emerging managers will have more struggles relative to that.

MY: [00:04:49.08] Absolutely. Now, let's switch gears a bit. Last year we saw historic levels invested in the US VC ecosystem with over $340 billion invested. Can you talk about how the current economic environment has impacted investments?

JA: [00:05:02.47] Sure. I think it's worthy to kind of quickly unpack last year's numbers as well. You know, last year's number was a historic number. It was the highest in venture history. But if you unpack it a little bit more, roughly half those dollars that you described, according to Pitchbook, came from non-traditional venture capitalists. These could be hedge funds or mutual funds or sovereign wealth funds and the like. And so, as you look forward, I think one of the big questions out there for the industry is are these sources going to continue to be committed to the asset class? Or have some of those sources which, again, many of their roots may be a bit more tied to public market investing, have they retreated and gone back to areas where they historically had focused more? So, I think there are, again, more variables as you think about the dollars potentially coming into the system in the years to come, because the dollars raised and the dollars deployed, unlike prior, you know, time periods where there is tighter correlation, there's a lot of pools that are actually not captured in the dollars raised because it's sort of the nature of them. So I think again, that's worth noting. And then if you think about the investment pace out there, what we've seen because of the meaningful reduction in value that's happened in the public markets, the capital markets slowdown and the macro, where in many cases companies’ growth has become less predictable than it once was, because again, some of those macro, the investors have been more patient and cautious to deploy capital because the bid ask spread between where they might want to invest, which again might be tied more to public market multiples that have come down significantly.

JA: [00:07:12.37] The inability in some cases to have as strong a grip around what 2022 or 2023 financials could look like, have given investors pause or creates a disconnect between investors and entrepreneurs to have this sort of bid ask for it to come together. The other dynamic that's really different here than in prior go arounds, what I just described actually tends to happen in prior go arounds, downturns, is that the balance sheets of these businesses are stronger today than in any other sort of downturn out there so they have more significant cash on their balance sheets where those entrepreneurs and the syndicate members of those companies can decide to not raise. And they're oftentimes taking additional steps to extend runway in this environment where they're moving from maybe hyper growth and in some cases less efficient growth to more efficient growth focused on unit economics, which imply in many cases doing RIFs where they're extending runway and therefore not having to raise for even greater times.

JA: [00:08:20.89] And so because of that, some of those high-profile great companies aren't raising capital. And therefore, again, that naturally slows down the pace of investment. You know, the area where kind of pulling bid ask spread together and need for capital versus availability of capital and the like that does come together more quickly is obviously at the at the pure early stage and company formation is those companies don't have balance sheets to get going. And so, I think that's where you'll see and have seen movements from a valuation perspective maybe more briskly than what you'd see at sort of the growth stage. But these things take time to play out. And venture capitalists and entrepreneurs again are doing a lot of internal work around their portfolios. The companies, in order to optimize or retain current or future value. And so because of all those dynamics, you just see a meaningful slowdown and particular in Q2 and Q3, Q3 numbers aren't out yet, but we would expect that to be pretty meaningful in terms of drop off in Q3 and in 2023 and 2024, I think you're going to see more activity as some of those pieces that I described kind of better align.

MY: [00:09:46.81] So speaking of historic levels, last year was one of the largest liquidity years for the venture capital asset class. How has this market affected liquidity?

JA: [00:09:54.91] Yeah, so the capital markets for initial public offerings, direct listings, SPACs and the like have significantly slowed and it's been one of the slowest years in history. And in all of those activities, clearly when valuations have sort of dropped off a cliff from the public markets, public market investors are more interested in profitable businesses. That's created sort of the venture class with companies less interested in testing what are very volatile public markets. And so, there is a very strong class of high caliber growth stage companies that are choosing not to go public. Many of them could go public, but they would likely be at valuations or with kind of shareholder bases potentially buying at IPO that might not be as ideal. So, I think those companies will eventually tap the markets and we'll have to see when the public markets open again for these businesses. It could be later in 2023, it could be 2024. You know, the important thing for those businesses is to continue to do things that that create kind of future value. Where you are seeing kind of more activity and I think a bit more of the story of 2022 into 2023 is financial sponsors, them going after private companies and or venture-backed companies that may have gone public, may still have significant ownership by venture capital firms. So, you've seen groups like Thoma Bravo or Vista and others kind of become active in that space where again, these companies in some cases publicly are trading below historical mean and median, revenue multiples and those private equity firms are going for take privates and the like. Now getting bid asks spreads and all those things the line is definitely easier said than done.

JA: [00:11:57.37] But private equity has become a much more active player and liquidity. And that's not just a 2022 phenomenon that had really been happening in the last 3 to 4 years where a whole host of private equity firms were coming down in venture and acquiring or investing in minority stakes into technology and growth businesses. So, I think that's going to be a really important piece of the equation. And strategics have been less active. The industry definitely needs them to be more active. It can be challenging when you've got publicly traded companies who are your typical acquirers and with their stock fluctuations and investors may be looking for them to do a creative meaning profitable deals, buying something unprofitable can ultimately get dinged. But you've seen some mega transactions happen out there. I mean, Figma being bought by Adobe is one to note for sure. And there's been sort of a number of things in the gaming space that have happened. So yeah, I think what people forget about venture capital is that while IPOs are incredibly important and have driven a lot of returns in the industry, you know, M&A is the largest source of liquidity historically within the asset class, whether it's again looking at venture capitalists, outsourced R&D for large organizations who increasingly all are becoming tech companies or now financial buyers who either have assets where they might want to buy another company and put them together and or to build platforms. So, you know, M&A is definitely going to be an important part of the liquidity cycle for venture capitalists. And I know a lot of venture capitalists and the like are kind of focusing on how to how do they monetize their businesses utilizing this path.

MY: [00:13:47.09] Yeah, I can definitely see M&A activity as one to pick up as well as improving secondary market opportunity. Now, the current market correction appears to be a healthy recalibration for the venture ecosystem and a compelling opportunity for VC investors. Why do you believe now is an opportune time to be investing in venture capital?

JA: [00:14:03.94] Yeah, there's a number of really interesting things that are happening that have the ability for these future vintages to be high performing ones. And I think some of what you have to look at is some of the micro dynamics that are happening on the playing field from a company creation perspective. So when you think about company creation, there's a lot of inputs that go into that in terms of that company building and then capital formation and the like that do have ramifications on exits and outcomes and returns down the road. So let's just talk about a few of those I think that are relevant. So one is, is Labor is becoming more available for startup companies, variety of factors in that, right, whether it's big tech doing RIFs, unicorns, decacorns doing RIFs. And so talent is sort of becoming more available for younger start-up companies. Talents are also becoming cheaper, which is again been one of the issues for these younger companies to compete against a variety of folks that have much bigger balance sheets. So that is a positive factor. I also think that COVID has had a positive factor in terms of hybrid work where companies are able to build teams and notably executive teams on a more distributed basis, which again historically have been an issue of pulling together C-suite teams or executive teams and having them all in one location or a variety of them in a location. So, I think the ability to go build those teams and leverage hybrid is actually a really positive thing from a company building perspective.

JA: [00:15:55.78] Now there's cultural ramifications that one needs to navigate, but I think that is an aggregate, a positive. You know real estate in many cases has become cheaper for companies to get and acquire versus in other periods in the market when your competitors or peer groups that are starting companies or even in your comp set are raising less money, that actually also tends to be a good thing. Where there is an aspect where you've seen a more recent times where a variety of companies are kind of quote unquote keeping up with the Joneses, where a competitor raises 1,500 Million. Thus, you feel compelled to do that, to compete with them. So that ultimately creates businesses that tend to be more capital efficient. They have to do more with less, which again, is typically a positive in terms of the DNA of the company and some of the unit economics and efficacy of how they spend and use and build their businesses. Valuations are clearly coming down, so investors are able to buy more with less mathematically as part of that. And that has ramifications down the road in terms of ownership and what those terminal outcomes look like years and years down the road. And then importantly, forget about all those little micro things that are kind of tied into kind of like company specific. You know, the macro in terms of tech trends is still incredibly strong. We are in a cloud computing super cycle, just picking one, right? And so many of the things that folks got euphoric about over the last 3 to 5 years, they haven't gone anywhere.

JA: [00:17:39.40] Many of them are growing at similar clips. You know, there's some that are growing a bit slower, but they're still growing at relatively hyper rates compared to other segments of the economy. And so, you know, those all tend to be favorable things from a company creation perspective. And, you know, the other piece I think people have to again, zoom out is like, you can't get too cute in this asset class. You know, great companies will be built and the best of times and the worst of times. Clearly there's a lot of great examples of even the most recent downturn of companies that that were built, the Twitters or Zoom Informations or Shopifys or Bill.coms or Airbnbs of the world. And so, yeah, I think we're quite optimistic that these handful of vintage years in front of us have a number of dynamics that should be quite favorable at the early stage for venture capitalists and for entrepreneurs to build durable businesses. Clearly, it'll be harder for those entrepreneurs to raise capital relative to their peers. You might see an even hardened, an even deeper hardened group of entrepreneurs that want to go build businesses because it'll clearly be harder in any case is more challenging and difficult. But those are going to be really positive DNA, I think, to build really good businesses over the long run.

MY: [00:19:01.84] Very much looking forward to seeing what these companies do. Now, John, looks like we've run out of time. Thanks again for joining me today. Take care and looking forward to seeing you again soon.

JA: [00:19:11.11] Thanks for having me.

MY: [00:19:12.31] That does it for this episode of RPM. For more information on all things StepStone venture, follow us on Twitter @stepstoneVC or visit us at stepstonegroup.com. RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.