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2023 Mid-Year Venture Assessment: Strong Crosscurrents with a Chance of Riptides

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Limited Partners (LPs) who have long invested in venture capital (VC) can be forgiven for viewing the prevailing market conditions as more than a bit uncertain. This is not to say that VC is *not* investable, but it is undeniably a more complicated moment for allocators when compared with periods like 2009 when all arrows pointed in one direction for experienced, attentive investors.

Strong Crosscurrents

Q1 2023 began as a welcome, albeit slow, reset for LPs and many of the VC managers in their portfolios.

- After public market comps dropped ~30% from peak to Q4 2022, companies started the year recalibrating cash, burn rates, growth targets and fundraising plans to avoid fully adjusting valuations and hoping to grow into the overly optimistic valuations set in 2020-2021. Others simply sat tight, hoping to wait for a rebound in tech valuations. The best companies, however, continued growing at a robust pace, driving home the lesson that tech cycles must be viewed separately from VC financing cycles.
- When the 12/31/22 marks came in, LPs observed that VCs were now carrying the *same* companies at *notably different* valuations. Regardless of emerging divergence, the overall trend was clear. Companies should be valued more in line with the realities of their business fundamentals, not the exuberant prices of 2021. The market began the long, slow (and some would say overdue) processes of implementing disciplined cash management practices, rationalizing labor and implementing stable, sustainable pricing structures.
- General expectations were that by late 2023 or 1H 2024, companies would begin to seek financing again, forcing a reckoning with realistic valuations. The wave of hoped-for price resets was not to be seen, though there were a few notable exceptions like Stripe; which had no choice but to confront the new market realities.

- Distributions to LPs ebbed to a trickle in 2023. Seasoned LPs understood and took some solace in acknowledging that a portion of the bountiful distributions of 2020 and 2021 were in effect 2022 and 2023 distributions pulled forward, locking in very attractive IRRs on funds from ~2008-2013. LPs now wait and watch for the re-opening of the IPO window.
- As the muddled year-end valuation signals dissipate, LPs are just now beginning to understand the “true” current value of their portfolios and trying to calibrate expectations for performance.
- GPs once again speak of the core tenets of ‘discipline’ --- careful attention to unit economics, a shifting focus from momentum to fundamentals (e.g., crypto is out, blockchain is in) and 2.5 to 3-year fund deployment paces. Most are trying to stay out of the treacherous fundraising market.

While these crosscurrents might concern casual observers, experienced LPs have begun to see a more attractive market for new fund commitments compared with a few years ago because GPs are increasingly more thoughtful, aligned, transparent, and methodical in their deployment plans.

A Chance of Rip Tides

But hold on. Just as the crosscurrents of valuations and capital deployment seem to be slowly moving toward alignment, a new set of forces impacting the investment landscape is emerging:

- OpenAI arrived with a giant splash this spring, stunning everyone from seasoned VCs to retirees in gym shoes as well as unprepared governments in the US and Europe.
- The US economy seems to be tracking to a soft landing, contrary to views strongly proclaimed by many that a recession was imminent and inevitable just a few months prior.
- The stock market and tech valuations are rebounding, satisfied that even if interest rates have not peaked, the end of rate hikes may be in sight.

Transformative Technology

2023, which started off as a sober after-party for the VC industry, is now flaunting a whole new era of transformative technology that could fundamentally alter a host of industries and deliver the long-awaited productivity gains long promised by technology. Some LPs are finding seed and early-stage AI gems at attractive prices sprinkled throughout their portfolios, quietly invested in over the last few years when late-stage investors were looking elsewhere. How could any tech observer not be thrilled by the technological potential and be hopeful about the return potential? While the tech cycle and the financing cycles are separate, the former can certainly drive the latter.

Will There Be a Whole New Era in VC before the Last One Ends?

Record levels of fundraising from the most recent VC cycle turned the industry into an investable class, almost comparable to buyouts in institutional portfolios. To some extent, this made sense. VC investments in technology no longer just chase traditional enterprise software total addressable market (TAM) – software TAM itself is literally consuming value from segments of enormous markets like defense, space, transportation, insurance and banking. Notwithstanding these burgeoning opportunities, too much capital was pumped into the market by an expanding roster of LPs from across the globe. Just as LPs are re-calibrating reality, the excitement of AI and bounce back in public markets could distract from a necessary re-set in VC allocations in institutional portfolios.

Meanwhile, what it means to be a VC keeps evolving and performance from the last cycle may have little bearing on performance for the next cycle:

- Many VCs are organized for the 'last war' with models put up in the naughts that may be less relevant to the market for the next 15 years. New models have begun to emerge --- nimble VCs that look like angels; venture funds using buyout and M&A strategies to build beachheads in traditional industries and transform them with tech from the inside out; financing companies with a range of tools rather than just traditional seed to late-stage venture to expand the risk/return spectrum for various categories of investors.
- Investments that alter society mean that VCs must manage their impact amidst their explosive growth if they are to experience successful exits in a decade rather than the ire of angry regulators.

Investing in Turbulent Waters

AI is breathtaking and the favorable economic signs are leading investors around the globe to set their sights on the potential for profit. Just as LPs were hoping they could return to a quiet, thoughtful investment environment with less capital flooding in, the market could easily shift back into overdrive. Simple navigation tools like carrying values and prior performance have little meaning. Successful VC selection will depend on combing through portfolio company details to separate those VCs who are positioned to capture profit in the next cycle from those that are simply re-writing their pitch decks to trumpet AI. It is indeed an exciting market, but perhaps not one for novice swimmers.

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