Venture Investing Outlook in the COVID-19 Economy and Beyond

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While the COVID-19 outbreak continues to wreak havoc on scores of businesses, many venture-stage companies have unique characteristics that we believe will enable them to not only survive the present economic turmoil, but also create compelling value in a post-pandemic world. Venture companies are innovators by definition, and many are propelled by pioneering technologies or processes that should be in high demand as business models in many industries are reinvented for a society emerging from coronavirus quarantines.

In this perspective, we discuss why Adams Street Partners remains a strong proponent of venture investing in the present market.

Near-Term Market Impact

COVID-19 has disrupted nearly every business and end market. The immediate impact of the pandemic has been most severe on companies selling directly into verticals such as real estate, travel, retail, or hospitality. Other companies, however, are benefiting from the present circumstances. Companies in such sectors as grocery and food delivery (e.g., Instacart); remote productivity and collaboration (e.g., Slack); online education (e.g., Coursera); cybersecurity (e.g., PerimeterX); and online gaming (e.g., Roblox), are experiencing positive momentum as they are providing important services and delivering necessary solutions during this unprecedented time.

While the consumer end-markets were impacted immediately by the pandemic, companies selling into enterprises generally experienced less of an impact in Q1 and early Q2 due to longer sales cycles and existing customer engagements put in place pre-pandemic. The impact on enterprise-focused companies will likely manifest in Q2 and into Q3 as their customers rationalize their own businesses.

In terms of fund valuations, we are seeing Q1 2020 venture fund valuations marked down between 10-15% on average relative to year-end 2019 marks. The impact of the pandemic is company and end-market specific, and the severity of the impact varies by manager. By comparison, the S&P 500 was down about 20% in the first quarter though it has rebounded sharply in the second quarter (to date). We believe that the second quarter could be largely flat at the fund level, with potential markups for public companies (and private companies using public comparables) offset by possible markdowns for private companies raising capital and earlier stage companies without a proven business model.

Despite the economic disruption in the near term, we believe several factors position the Adams Street venture portfolio well in the current environment:

- experienced investors drawing upon lessons learned from previous market cycles to act expeditiously and decisively to provide the necessary support to their portfolio companies;
- the recent robust fundraising cycle of underlying managers has capitalized companies better than at the onset of previous recessionary periods providing longer runway for businesses; and
- substantial dry powder in venture capital to invest behind attractive opportunities.

Exits and Liquidity

Given the present uncertainty, companies are struggling to accurately forecast their revenues over the next twelve months. While we are seeing some selective green shoots for the venture-backed IPO market this year, we expect overall the public markets will likely be less receptive to IPOs through 2020 and possibly into 2021.

In contrast, we may see considerably more M&A activity for several reasons:

- the aforementioned receptivity of the public markets may naturally push entrepreneurs to seek alternative routes of liquidity;
- large incumbent companies seeking to address the need for digital transformation will likely look externally for near-term solutions;
- companies may see attractive entry points to expand their product portfolio, target new customer segments, or add a faster growing revenue stream; and
- significant private equity dry powder may continue to look to venture capital-backed businesses for growth opportunities.

Climate for New Venture Investments

What are the implications of this for new venture investments? On a relative basis, we expect venture investing to be muted in the near term while:

- investors and companies continue to process information and evaluate the effects of COVID-19 on their businesses;
- price discovery continues amongst buyers and sellers; and
- travel and social interaction restrictions remain in place.

Notwithstanding, the venture capital industry is open for business and deals involving high-conviction companies, both in early and growth stages, have continued to close (e.g., Stripe);

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some deals are even raising financing rounds at flat or slightly increased valuations. The rebound in public markets in April and May has driven many technology stocks back to near or all-time highs, which could bolster valuations, particularly in the growth stage. Deal velocity and impact on valuations will ultimately be predicated on the end market the company sells into (and the market's appetite for such exposure), the strength of the team, and the underlying fundamentals of the business.

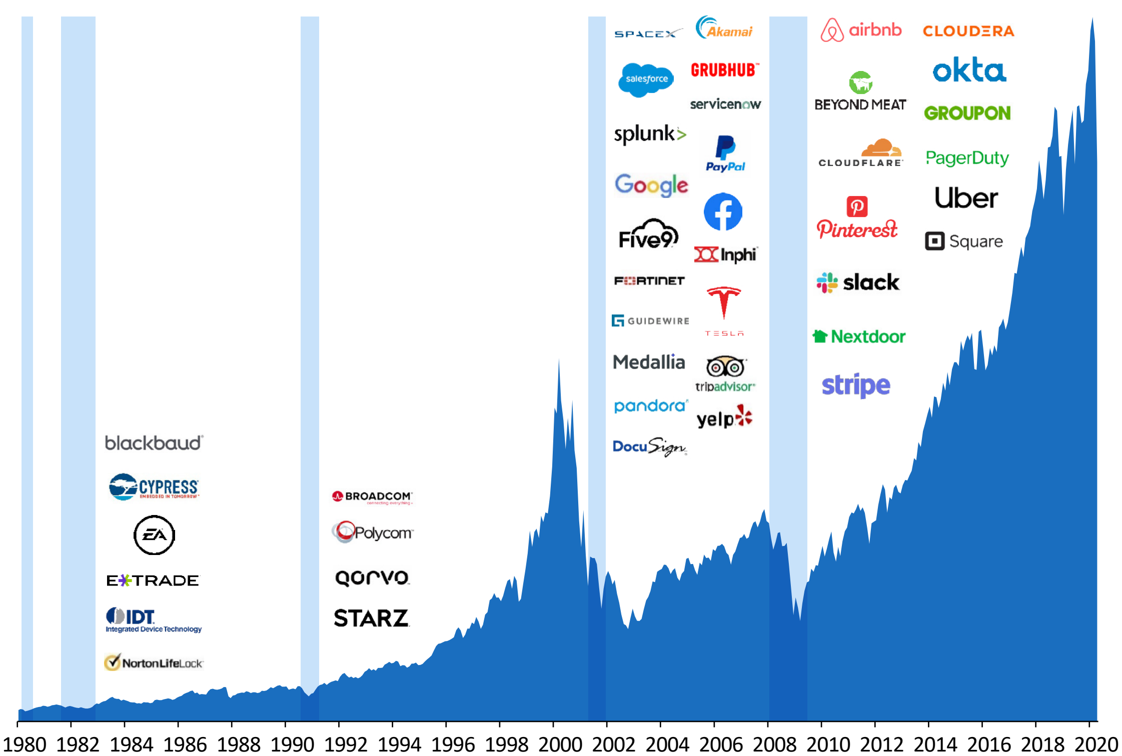
What This Means for VC Investors

Despite the near to medium-term volatility that has resulted from the pandemic, we find it's helpful to look to history as a guide for what to expect for the venture market in the coming months and years. The following chart maps US recessions since 1980 against the NASDAQ index. For each recession band, you can see select venture-backed companies that were created and funded around those tough economic times – including Google, Facebook, Airbnb, Stripe, and Uber.

Constraints Foster Creativity[1]

Select US Companies Founded Around US Recessions (1980-2020)[2]

■ NASDAQ Composite Index (^COMP) - Index Value ■ US Recession Periods



Why are enduring companies often born during times of economic difficulty? Our view is that:

- constraint and hardship oftentimes foster creativity;
- there's a self-selection of great entrepreneurs who are agnostic to economic headwinds;
- the supply of high-quality talent increases as labor markets become less competitive; and
- these companies are typically built with a focus on capital efficiency that serves them well when economic conditions eventually improve.

> **“We have seen two years’ worth of digital transformation in two months.”**
>
> – Microsoft CEO Satya Nadella

Investment Focus: Innovation Themes

The pandemic has caused significant disruptions to wide swaths of businesses, particularly those serving the Main Street economy, but has also highlighted the need for technological solutions for companies to operate efficiently and effectively in the new world order. In other words, the pandemic has slowed down the broader economy but has accelerated technology adoption and the innovation economy. As Microsoft CEO Satya Nadella noted on a recent quarterly earnings call, “We have seen two years’ worth of digital transformation in two months.” Companies in every industry are prioritizing the adoption of technology in order to survive.

Thematic investing is a tenet of Adams Street’s investment philosophy, and enables us to maintain perspective during difficult investment environments. We have identified several innovation themes that we believe will likely become more attractive in the post-pandemic world, including the changing workplace and the continued migration to Cloud and SaaS solutions.

Venture Capital: Innovation Themes

Pandemic Accelerating Technology Adoption / Digital Transformation

ENTERPRISE	CONSUMER	FRONTIER
Migration to Cloud and SaaS	Modern Mobility & Transportation	Blockchain / Distributed Systems
Artificial Intelligence / Machine Learning / Big Data	Neo Financial Services	Quantum Computing
Network / Cybersecurity	Health-Conscious Living	SpaceTech
DevOps Tools	Mobile / Online Retail and Commerce	
Changing Workplace	Transforming Healthcare	
Robotic Process Automation	Sharing Economy	
Manufacturing Renaissance / Industry 4.0	Esports / Gaming	
Disruption of Non-Tech industries		

In Summary

In the short term, we expect the venture environment will get worse before it gets better. It seems likely that fund valuations will decline in the second quarter. Some companies whose growth rates have declined meaningfully, or whose product-market fit is not compelling, will struggle to raise follow-on capital.

On the plus side, however, we expect innovation to continue, and that technology adoption will accelerate not *despite* the pandemic, but *because* of the pandemic. We believe tech will lead us out of this economic cycle and that great companies will be created during the coming 12 to 36 months. If past recessions are a guide, we believe that the years 2020 and 2021 may well be high-performing vintage years for many venture capital and growth equity investors. ■

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1. Source: US Recessions Data from Federal Reserve Bank of St. Louis (Accessed May 2020). NASDAQ Composite Returns from CapitalIQ as of May 2020. Adams Street Analysis.
2. Note: The companies listed reflect US-headquartered, venture-backed companies founded during recession and recovery periods.