Funding Imbalance, Thriving Innovation Boost Growth Equity Outlook

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KEY TAKEAWAYS

- After delaying fundraising for 12-18 months following valuation declines in 2022, we believe demand from growth stage companies for additional capital is likely to surge from late 2023.
- Simultaneously, many non-traditional providers of capital have exited the growth stage arena, creating a supply-demand imbalance.
- A strong pipeline of innovative startups means the demand side of the equation will likely be further swollen by a cohort of early stage companies that are now graduating to the growth stage.

For over 50 years, Adams Street has observed the intricacies of the growth stage ecosystem through several market cycles. We have seen great times to invest, and less attractive times to invest. Generally, each period is largely determined by two (mostly) independent factors.

The first is the valuation climate, which is shaped by the demand for capital, its corresponding supply, and public market sentiment. The second is the demand for — and state of — technological innovation. An improving valuation climate and the robustness of underlying innovation trends creates the potential for one of the best growth stage investing environments in years. The current banking crisis is also creating market dislocations that are likely to accelerate the capital supply-demand imbalance.

Potential Record Demand for Growth Capital

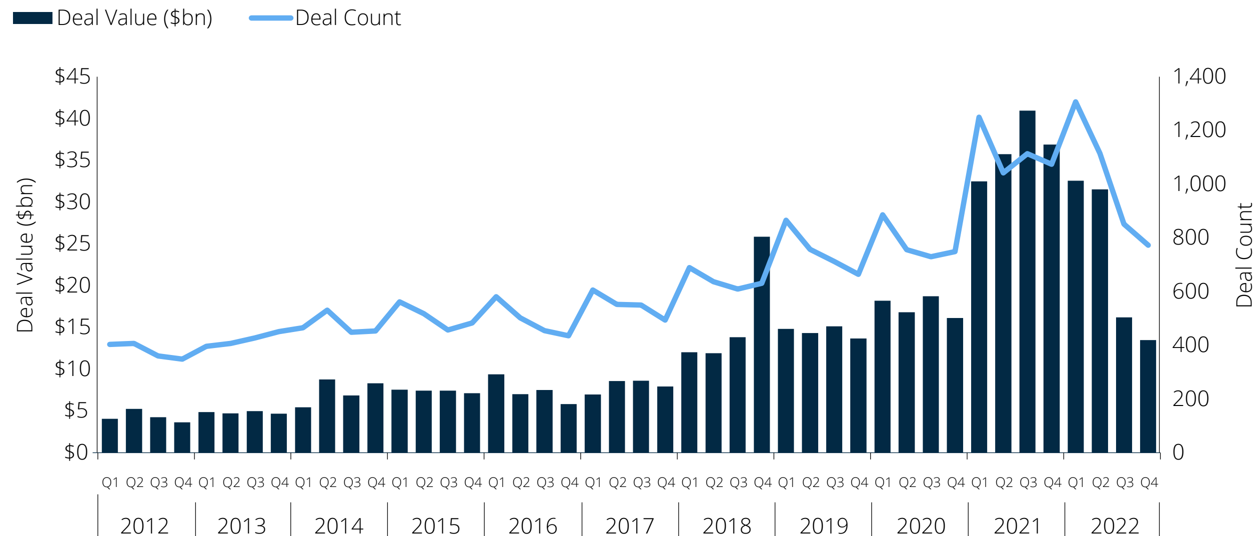
Venture capital (VC) deal activity across all stages, but notably the growth stage, fell dramatically in 2022,[1] especially in comparison with the euphoric activity of the prior year. The drop in growth stage deal volume was partly because many companies avoided raising capital during the recent volatile and uncertain environment.[2] However, we believe this is likely set to change for two reasons.

Many companies delayed fundraising over the last 12-18 months, either by reducing spend and/or by taking out lines of credit that are becoming less attractive due to rising interest rates. They are likely to need to raise capital before the end of 2023 or during 2024 because

they are running low on cash. Alternatively, they may want to take advantage of a friendlier fundraising environment because they have grown into — or past — their last round valuation, they have found their "efficient frontier" on growth vs. profitability, or because they now find themselves in a more favorable competitive position.

Second, an active early stage VC market has funded an enormous pipeline of promising and highly innovative companies over the past few years, many of which will ultimately "graduate" into the growth stage funding landscape. These dynamics lead us to believe that in late 2023 and beyond we will see the proverbial "dam break" in growth stage fundraising demand.

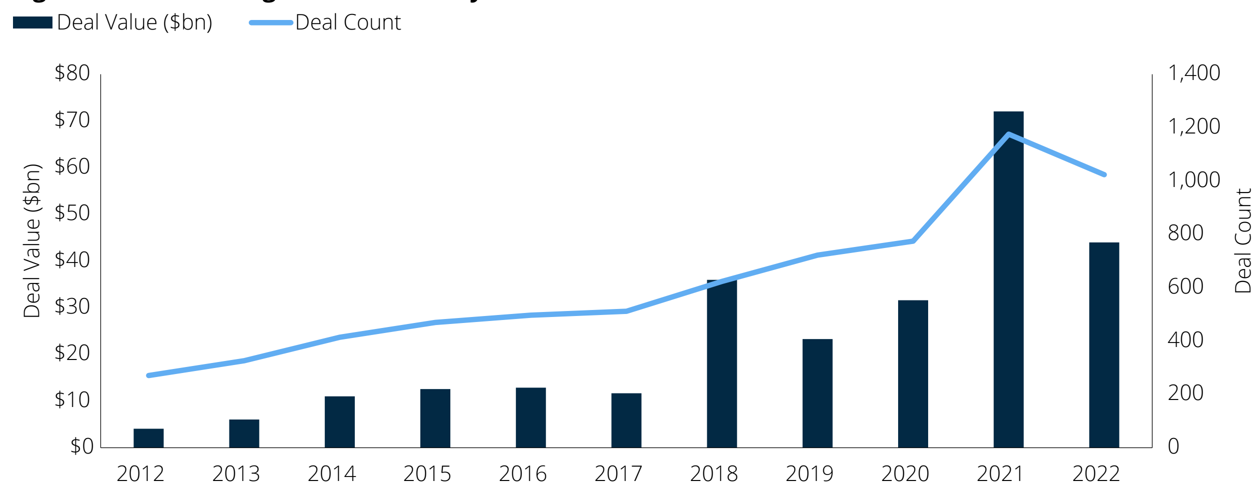
Figure 1: US Late Stage VC Deal Activity by Quarter[3]



Fewer Suppliers of Growth Capital

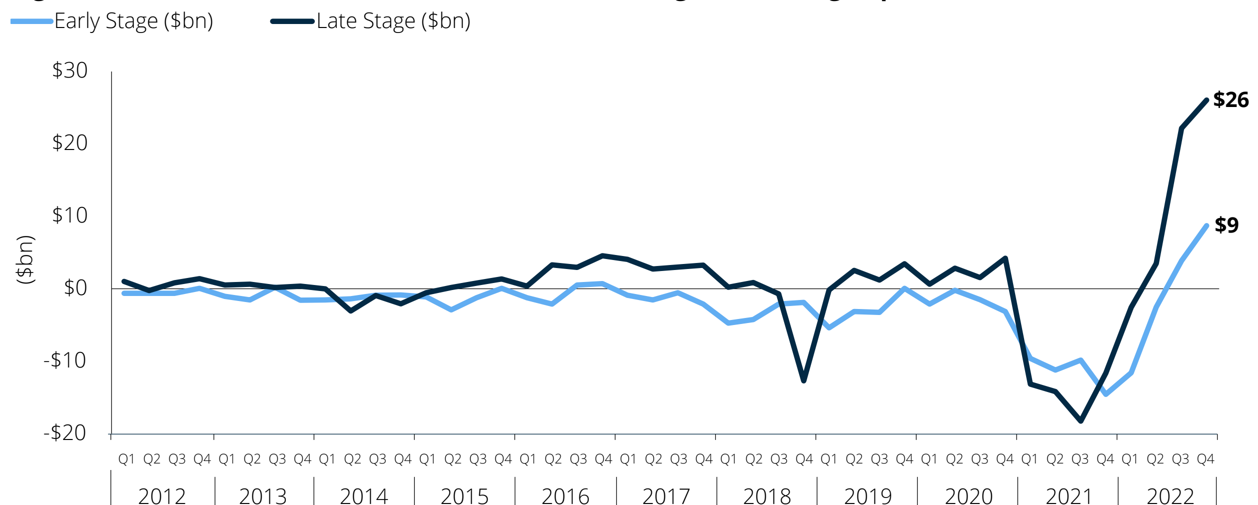
On the supply side, growth stage investing has long held appeal to a wide spectrum of non-traditional investors such as sovereign wealth funds, family offices, and corporate venture capital arms. This cohort took an increasing share of the late stage VC deal volume in recent years, peaking at about 50% in 2021, up from about 24% in 2012.[4]

Figure 2: US Late-Stage VC Deals Led by a Non-Traditional Investors Decline[5]



However, for reasons such as private markets moving toward lengthier exit timelines — in part due to the IPO window being effectively closed — many of these non-traditional investors are leaving the growth stage market. Their share of late stage VC deal volume fell in 2022,[6] a trend we expect to continue in 2023 and beyond. Their withdrawal reduces the pool of available capital to growth stage companies, with PitchBook reporting that demand exceeded supply by about $26 billion in the fourth quarter of 2022.

Figure 3: Excess Demand Creates $26 Billion US Late-Stage VC Funding Gap[7]



The recent banking crisis might exacerbate this imbalance — albeit temporarily — amid heightened concern about the financial resilience of some debt providers, which may lead to additional caution in the supply of capital to the sector.

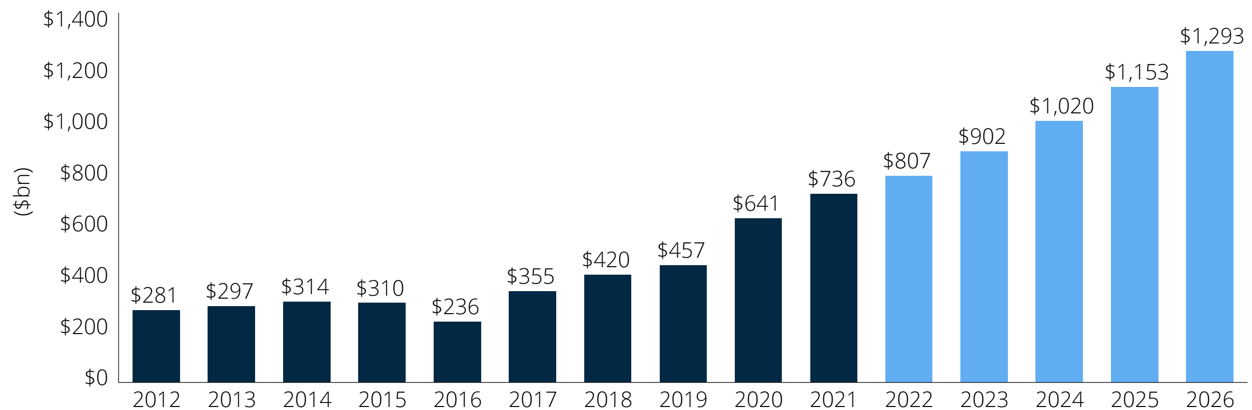
Public Market Correction Creates Attractive Valuations in Private Markets

Then there are valuations, which are becoming more attractive. The growth-at-all-cost mindset that prevailed in 2020 and 2021 led to sky-high valuations across private and public markets. However, rising interest rates compressed multiples in the public markets by as much as 60% in some sectors.[8] When public valuation multiples adjust up or down, it makes sense that private valuation multiples should move in a similar fashion. While private valuations nearly always adjust more slowly and more modestly, we still believe we are entering a valuation climate that is far more palatable than what we have seen since the start of the decade.

Underlying Technology Trends Remain Robust

It is important to note that what we have discussed until now has all been capital markets related (e.g., capital demand, capital supply, valuations). Furthermore, it is crucial to remember that capital markets and technology trends operate mostly independently. More pointedly, despite the valuation reset, underlying technology trends remain healthy, as illustrated by a Gartner forecast that global spend on software will rise to nearly $1.3 trillion in 2026, from $807 billion last year.

Figure 4: Global Software Spend Continues to Advance ($bn)[9]



One reason for optimism is that we are still in the early stages of digital transformation of the global economy. Technology is driving meaningful change across all sectors. About 90% of Domino's pizza sales come from digital channels,[10] modern cars have more than 100 million lines of code,[11] while agricultural machinery maker John Deere has invested about $300 million acquiring robotic and automation technology companies.[12]

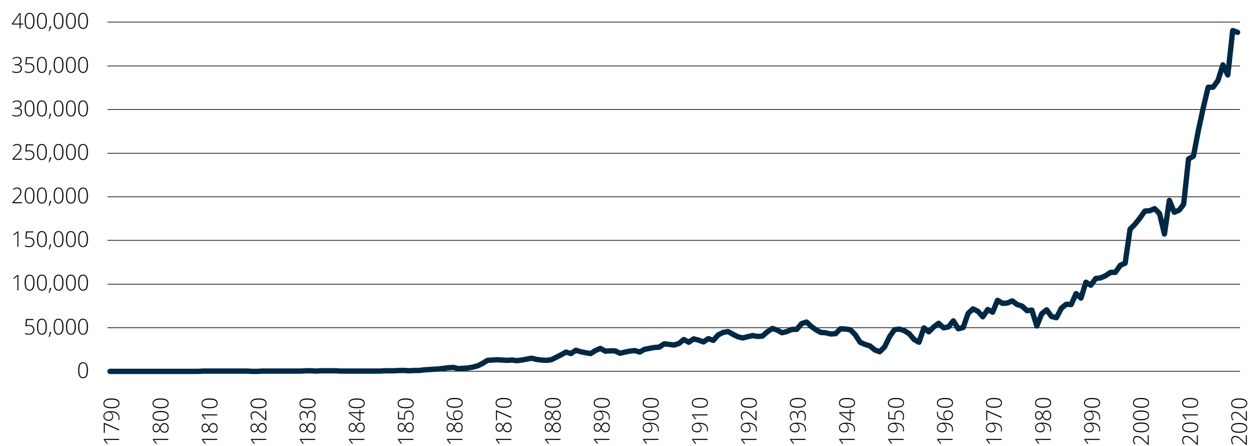
Even within more mature tech industries, there is meaningful runway to continue driving value chain efficiencies — in operations, customer value and engagement, and scalability, among others. In addition, as inflation impacts every industry, demand for software will probably rise. As Microsoft CEO, Satya Nadella, succinctly said in April 2022, "In an inflationary environment, the only deflationary force is software".[13]

Rate of Innovation Continues to Accelerate

A reasonable proxy for innovation is the number of patents granted. In its first 171 years, the US Patent Office issued 3.3 million patents.[14] Following the invention of the semiconductor, it took 38 years to double that number. The era of the internet, smartphones, cloud computing, artificial intelligence, automation, and robotics means the Patent Office has continued to set annual records.

In 1889, Charles H. Duell, the Commissioner of US Patent Office, famously said that the patent office would soon shrink in size, and eventually close, because "everything that can be invented has been invented". However, as Figure 5 shows, the rate of innovation is accelerating. The compounding nature of technology means that each wave of innovation benefits from the prior one, leading to more significant value creation for both consumer and enterprise technology-focused companies, and their investors, over subsequent decades.

Figure 5: US Patents Issuance Acceleration Points to Thriving Innovation[15]



The commercialization engine of innovation — the start-up ecosystem — remains healthy for two reasons. First, the institutionalization of the angel and seed ecosystem over the past decade has facilitated increased company formation. Second, because of the current environment, we believe a new generation of highly innovative, resilient, and determined founders will emerge to lead these new innovative companies.

We are increasingly seeing founders have capital efficiency at the forefront of their minds right from the outset and know that to create an enduring company, they will need to build products that are mission critical; that are "must-haves" and not "nice-to-haves." The supply of innovative new companies is important because we have observed over the past few market cycles that this is a significant determinant of overall longer-term returns.

For all these reasons, we believe that we could be entering an exciting era for growth investing. Longer-term impacts of the recent banking crisis are difficult to predict, but they are likely to exacerbate the supply-demand imbalance for capital. The valuation climate is also more favorable, all while underlying innovation trends remain robust. These dynamics are likely to create opportunities to buy into sector disruptors at more reasonable prices while they renew a focus on fundamentals.

These are ingredients that hold the potential to drive strong returns in growth capital over cycles. ■

1. Source: PitchBook Fourth quarter 2022 NVCA Venture Monitor Summary.
2. Ibid.
3. Ibid.
4. Ibid.
5. Ibid.
6. Ibid.
7. PitchBook. "Q1 2023 Analyst Note: When Dry Powder Stays Dry."
8. Market data per CapitalIQ.
9. Gartner. "Gartner Market Databook, 2Q22 Update."
10. https://internetretailing.net/strategy-and-innovation/more-than-90-of-first-half-dominos-pizza-sales-online-and-44-via-its-app/
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12. https://www.cnbc.com/2017/09/06/deere-is-acquiring-blue-river-technology-for-305-million.html
13. https://www.microsoft.com/en-us/Investor/earnings/FY-2022-Q3/press-release-webcast
14. US Patent and Trademark Office. https://www.uspto.gov/web/offices/ac/ido/oeip/taf/h_counts.htm
15. Ibid.

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