Growth Equity Technology Outlook

Private Capital, Alternatives

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In Brief

- 2023 ended with a more resilient than expected global economy, avoiding a widely anticipated U.S. recession. Inflation fell from record highs as global bond yields rose globally and the Fed ended 2023 by signalling a pivot toward lower rates.
- Within the private markets, Growth Equity Partners views the landscape as a tale of two cities: down rounds are increasingly prevalent as companies are unable to grow into the valuations set in their previous funding rounds. Concurrently, certain subsectors such as Artificial Intelligence (AI) and emerging categories within cybersecurity continue to command premium valuations relative to their fundamentals.
- Unlike other hype cycles that largely underwhelmed relative to investor expectations, AI will continue to be a dominant thematic and area of focus in 2024 and beyond for consumers, businesses, and investors. Virtually all sectors are being transformed by AI but, despite recent advancements in the technology, we are still in the very early innings of seeing its full impact.
- In 2024, IPO markets will continue to open, but the bar for successful IPOs will remain elevated with public markets rewarding high quality, profitable businesses at reasonable valuations. In many instances, founders will be faced with the dilemma of continuing to grow their businesses in the private markets or accept the new reality that their IPO price, in many instances, is below the price set in the most recent round of financing.

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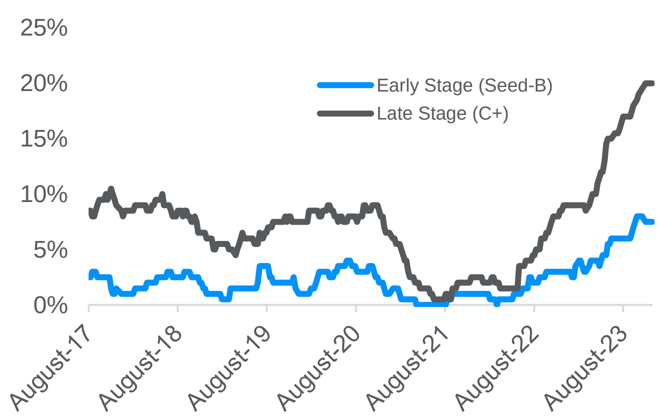
Market Dynamics

Within the private markets, Growth Equity Partners views the landscape as a tale of two cities: down rounds are increasingly prevalent as companies are unable to grow into the valuations set in their most recent funding rounds. Concurrently, certain subsectors such as Artificial Intelligence (AI) and emerging categories within cybersecurity continue to command premium valuations relative to their fundamentals.

Firstly, deal making activity continues to be largely in decline on a year-over-year basis and the rate of down rounds is climbing. Notably, the rolling 200-deal average percentage of down rounds for both early- and late-stage deals are at 5-year highs: nearly ~20% of Series C+ transactions were down rounds while earlier stage financings (Seed-B) reached 8%[1].

Prevalence of Down Rounds



Source: Aumni; data as of November 2023.

One in every five late-stage (Series C+) deals are down rounds while the rate for early-stage down round deals (Series Seed–B) has also climbed to 5-year highs[2].

In parallel, some founders are continuing to seek extensions or bridge rounds from existing investors to preserve valuation and avoid markdowns. This was another recurring theme in 2023 with bridge rounds comprising more than 1 in 3 deals across the late-stage venture and early growth markets[3]. As we near the end of the 2-year mark of the 2022 correction, in which many founders and companies were advised to extend runway for as long as possible, we believe the bridge round trend will gradually dissipate in 2024 and result in more down rounds as these founders seek financing.

Secondly, we continue to observe outliers in high-quality AI and emerging categories within cybersecurity companies which are commanding premium valuations relative to their fundamentals, thus driving up average valuations across the VC ecosystem.

Geopolitical dynamics will continue to have an increased influence on investor outlooks. To this end, 27% of respondents from Pitchbook's VC survey believe that war will significantly impact the technology sector in the coming years, second only to high interest rates, resulting from the backdrop of the Israel-Hamas war, ongoing war in Ukraine and continued tension between the US and China[4].

IPO Market

Growth Equity Partners went against consensus in 2023 with a view that IPO markets would not re-open in the year ahead. While there was a glimmer of hope for the market in September with a few high-profile technology IPOs, performance largely disappointed expectations in the subsequent months and the technology IPO market has since remained quiet. In 2024, IPO markets will likely open, albeit slowly, but the bar for successful IPOs will remain elevated with public markets rewarding high quality, profitable businesses and even those companies will receive must more modest valuation relative to the excesses of 2020 and 2021.

Illustrating the points above, 2023 saw two of the first major VC-backed IPO exits since late 2021, Klaviyo and Instacart. Both companies grew revenue ~40%+ in 2022 and were profitable[5], however, both went public at a discount to their last priced private rounds. Additionally, post-IPO trading performance has been disappointing, with Klaviyo down -15.4% and Instacart down -27.8% from their respective IPO prices[6]. The muted pricing and trading of these deals, despite their strong financial

[1] Aumni. November 2023
[2] Aumni. November 2023
[3] State of Startups 2023. Carta. 2023
[4] H2 2023 VC Tech Survey. Pitchbook. 2023
[5] S-1 filings. 2023
[6] Bloomberg Finance L.P. 2023

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profiles, are signs that a broader IPO market reopening may not come until the market feels the effects of an accommodating monetary policy.

As we think about the backlog of IPOs and potential liquidity events, one must keep in mind that 50% of the global unicorns were created in 2021[7] and these companies collectively raised north of $200B of cash[8]. Further, this translates to companies having years of liquidity while still proving out their business model. In many instances, company valuations from the most recent financing rounds remain high relative to the underlying public market multiples that saw a meaningful correction over the past two years. This valuation disconnect is among the biggest factors in keeping companies from going public. Founders are faced with the dilemma of continuing to grow their businesses in the private markets or accept the new reality that their IPO, in many instances, is well below their most recent round of financing.

Generative Artificial Intelligence (GenAI)

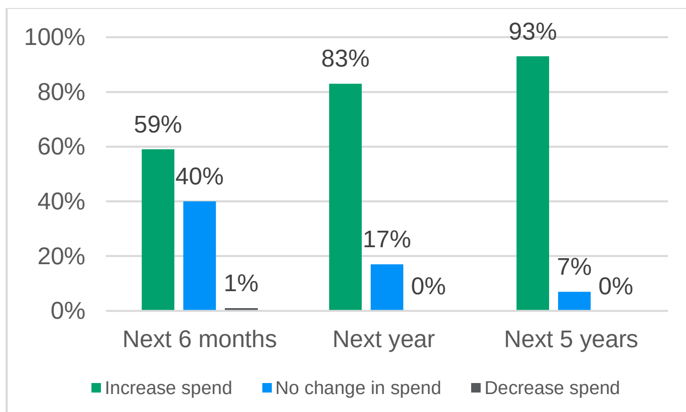
OpenAI's ChatGPT quickly established generative AI as a transformative trend, reaching an estimated 100 million monthly active users in January 2023. Achieving this feat just two months after its launch, ChatGPT is the fastest-growing consumer application in history[9]. Witnessing the power of ChatGPT and similar technology, the world has since considered how generative AI could radically transform economies, companies, and the way we live. Several verticals are transforming with the technology, especially those with redundant and highly manual workflows – the legal, healthcare, and logistics spaces are only a few examples. Despite generative AI's dominance of the news in 2023, its full impact is yet to be seen.

Enterprises cautiously experimented with solutions in 2023, while 2024 will see generative AI products directly affect workflows and boost productivity. Companies' appetite for these solutions presents a massive new area of spend across AI infrastructure and applications, yielding significant investment opportunities.

Generative AI was a rare bright spot in both the VC ecosystem and corporate budgets in 2023. Startups such as OpenAI raised rounds as large as $10B, and several VC firms announced large commitments to invest in the nascent space. Several other startups such as Anthropic raised billions from both VC investors and megacap tech companies.

With investor interest comes spending appetite: while enterprises largely tightened their software spending in 2023 as rate hikes ushered in austerity measures, generative AI defied this trend. Some surveys suggest ~80% of enterprise technology buyers expect to deploy generative AI solutions in the next 12 months, and 59% of buyers are expected to increase AI/ML spending in the next six months[10]. It is rare to see such a tight coupling of investor excitement, consumer interest, and enterprise demand. We attribute this combination to the unique and immediate productivity gains enabled by generative AI, with JPMC estimating a potential 10% ($7-10T) boost to global GDP enabled by GenAI[11].

AI/ML enterprise technology spending trends



Source: Battery Q3 2023 Cloud Software Spending Survey

While Growth Equity Partners acknowledges the sector is still early in adoption and many companies' valuations are ahead of their current scale, we firmly believe that the hype around generative AI is well-justified. In addition to household names such as OpenAI and Anthropic, several startups across the ecosystem will emerge as leading standalone companies and return significant value to their investors.

[7] Gene Teare, "Global Venture Funding and Unicorn Creation in 2021 Shattered All Records." Crunchbase News, January 5, 2022
[8] Pitchbook. 2023
[9] Krystal Hu, "ChatGPT sets record for fastest-growing user base – analyst note." Reuters, February 2, 2023
[10] Q3 2023 Cloud Software Spending Survey. Battery Ventures. 2023
[11] J.P. Morgan Chase & Co. 2023

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Growth Equity Partners continues to prioritize the infrastructure companies building generative AI technology and software companies employing generative AI to differentiate their applications. Our research suggests companies that will stand out in these crowded fields are those with strong engineering teams, solutions that enable enterprises to make the most of their proprietary data, and intelligent automation of painfully manual workflows.

Creative deal structures are in

The bar for successful companies has and will continue to be elevated across public and private markets. High quality, profitable companies (or companies evidencing a path to profitability) will be rewarded yet even in these instances valuations will be muted relative to multiples witnessed in 2020 and 2021.

AI will continue to be a thematic area of focus in 2024 for consumers, businesses, regulators, and investors broadly. Deliberate deployment and investment in companies in less considered AI verticals, with top talent and solutions that enable the use of proprietary data, are the keys to success.

As a result of the current deal making and valuation environment, committed capital across the VC and growth equity ecosystem will likely need to be deployed more creatively in structured equity deals and 'growth buyout' transactions. As the broader growth equity landscape continues to shift, one must remember that the best performing fund vintages have often followed bear markets[12]. The Growth Equity Partners team remains optimistic that investors will find more attractive opportunities as reasonable entry points in the year ahead.

Next steps

For more information, contact your J.P. Morgan representative.

[12] Anonymous, "2022: A Superior Vintage in the Making for VC." Thales, November 1, 2022

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