

TITAN CAPITAL PARTNERS

The VC Market Cycle

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INTRODUCTION

Unlike the stock exchange that represents the aggregate performance of publicly traded companies, contains leading macro economic indicators, and reflects the overall performance of the economy, the venture capital industry operates differently. The cadence, momentum and overall market shifts in the industry are affected by additional sets of factors, such as technology-driven shifts that drive market demand. The rhythm and oscillations represent a distinct cycle – the VC cycle.

In the dynamic landscape of venture capital investments, understanding the nuanced patterns of market behavior is crucial for both founders and investors seeking sustainable success. In this report, I delve into the intricate mechanisms that underpin these market dynamics which drive the shifts in the oscillating cycle. Understanding the cycle helps us investors navigate seeming uncertainties amidst changes in investor appetite in relation to broader macroeconomic conditions.

VC MARKET CYCLE

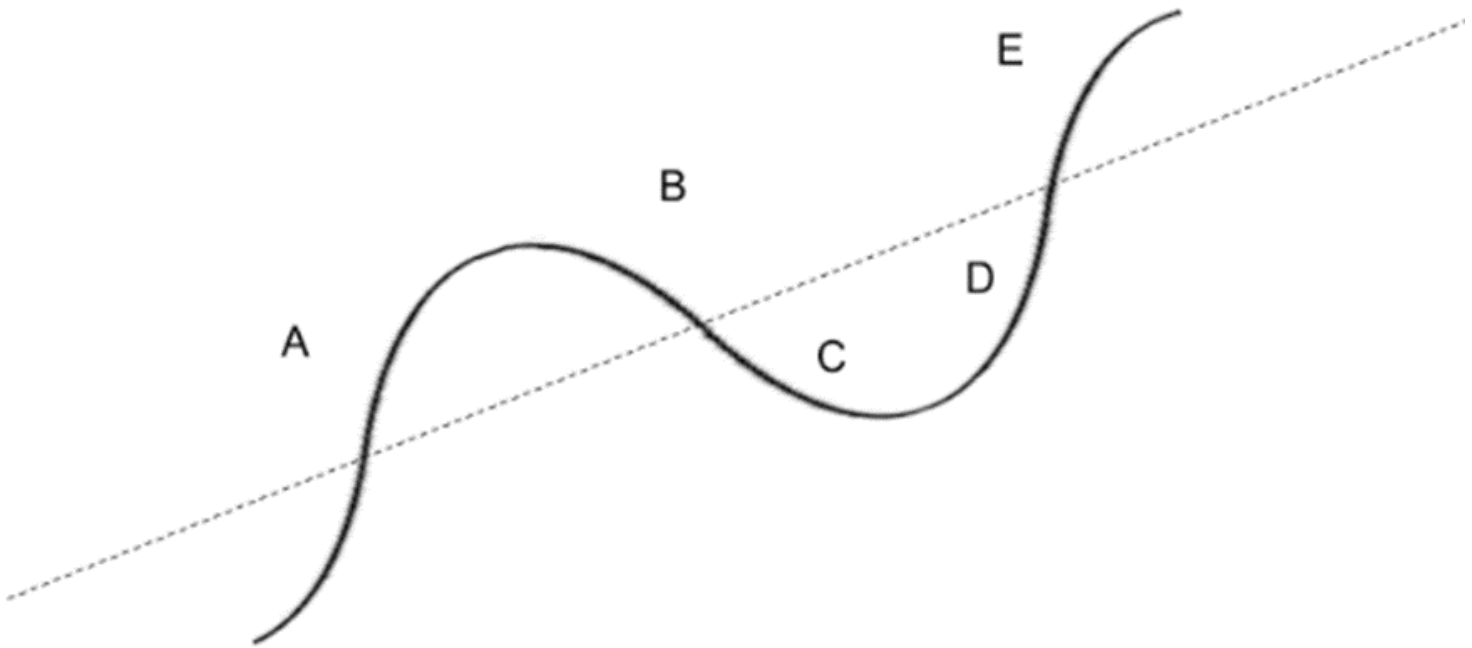
Shifting Investment Preferences throughout the Cycle

The VC cycle doesn't fluctuate in a pronounced manner like public markets, but it behaves in a similar sinusoidal fashion, consisting of four distinct periods of time. The rises and falls in the waves extend from peak to trough and represent the changes from expansion to contraction periods. These changes are driven by broader macroeconomic conditions such as interest rates, fundamental economic growth, stock market performance and others, which all ultimately impact the amount of commitments to risky assets, particularly to PE/VC funds.

To successfully see through these changes, market participants such as founders and investors aim to adjust their strategy from upside seeking or downside mitigation (from greed to fear), both to take advantage of current opportunities and to protect themselves from extreme scenarios. For a VC investor, the key amendments are conducted to selection criterion of the type of value proposition offered by the startup, business models, target customers, and ultimately the technology sectors of interest. These in turn, have an impact on decision criteria and the key KPIs VCs look for, valuation benchmarks and the market realities such as the due diligence time available.

Successful VC investors know how to position their portfolios to take advantage of times of peak valuations to increase their investment velocity, divestment activity and total ROI per each dollar. At the same time, they strategically build positions in companies resilient enough to withstand long periods of illiquidity that result from dramatic shifts in investors risk appetite.

THE SINUSOIDAL WAVE



A

Period A

B

Period B

C

Period C

D

Period D

E

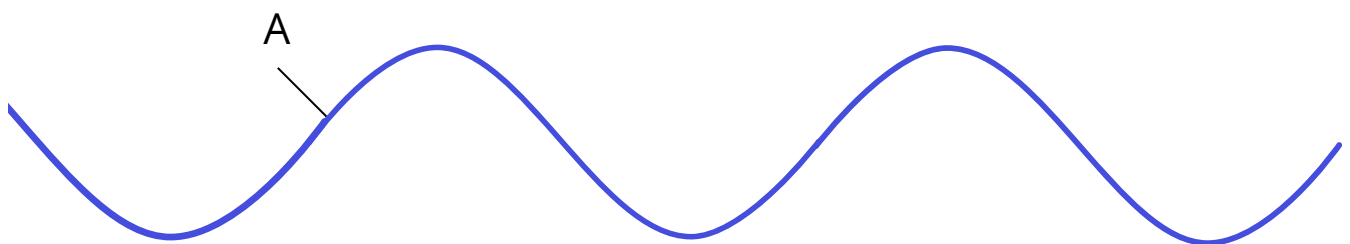
Period E

PERIOD A

Period A represents an environment that encourages risk taking. Interest rates are low, and investors are likely to exit the bond market and seek other classes that provide higher returns such as PE and VC. During this period, the technology sector is traded well on the stock exchange and software multiples are at an all-time high. These circumstances were prevalent in the years 1996-1999 and pre-2019-2021. In the immediate years just before the burst of the bubble, tech markets can grow by 2-3x in a single year with companies shortening their fundraising cadence to several different rounds a year.

Tech companies that benefit the most are those that provide a “growth supporting product”, in many cases sharing with their client’s success, which resonates with clients that wish to capitalize on current market sentiment and beat their competition.

This gives rise to VC investment strategies that focus on sectors that are able to grow quickly in their “top-line” by raising more money “revenue return”, with no regard to actual expenses incurred and gross and profit margins. Thus, the prevailing KPI is optimist seeking projection based “Next Twelve Months (NTM) ARR Multiple”. Prior to the burst of the dot.com bubble, certain companies were judged by EV / Number of Eyeballs.



PERIOD A CONT'

Although not offering much of a downside protection, transactional business models are increasingly presented as “recurring & predictable”, and the “Pay-As-You-Go” frictionless business model becomes more attractive as it allows for scale and bigger upside.

Sectors that rise are fintech and its payment derivatives such as HR tech and proptech which benefit from volume of transactions. Other startup sectors that flourish during this period are semiconductors, agtech, climate tech, construction tech and other segments which typically require large development periods and require heavy investor financing but, they address large TAMs that captures investors' imaginations.

Companies that typically serve enterprise clients decide to go “down market” and begin to serve mid market S&Bs to keep up with their competition growth rates. PLG companies that emphasize the “low touch” marketing approach.

During this time, VCs exercise limited due diligence to the competitiveness of the environment. Additionally, some companies' valuations make no sense, for example, when valuations are set to reach amounts that are bigger than their TAM's.

In this climate, a few unusual phenomena start to emerge such as the emergence of blank check companies, SPACs and crowdfunding investment structures that charge high fees (in some cases 50% and more) “all in”. Due to lack of quality dealflow, some VCs look for regular businesses with large revenue turnover that can implement digitization and define the business as “tech-enabled” and therefore, command software-like multiples. This party continues until Period B.

PERIOD B

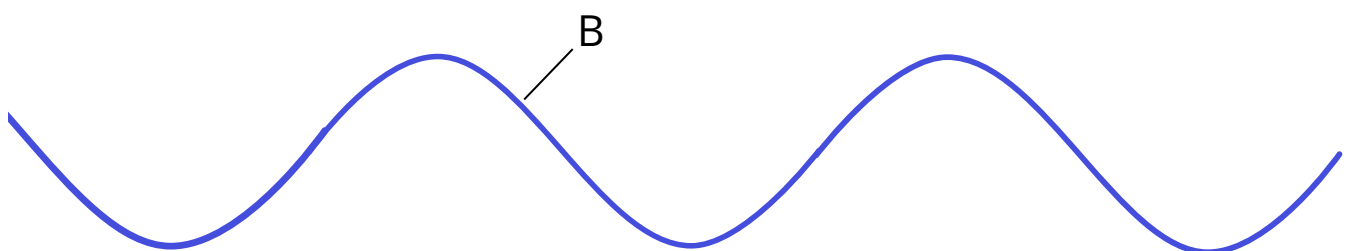
Tech companies with unsustainable business models begin to “blow up” causing a snowball effect of fear in the market. Persistent inflation begins to emerge, and central bankers decide to increase interest rates to battle inflation (as was the case in Q1 2022). As a result, software public stocks drop sharply by 60–90% and multiples stand at a median of ~5x.

Despite the turmoil in the public market, private companies are not yet affected. Private companies’ valuations are still high. Additionally, these companies are still well capitalized and do not feel an acute need for cash.

Although many start to discuss a potential recession, there is no confirmed concrete data about reduction in customer appetite. CEOs find themselves in quite a flux. Some experienced founders begin to implement cost cutting initiatives in order to align their companies’ cost structures to the new and reduced sales projections.

Overall, investors and founders prefer to delay financial raises as they try their best to grow into their valuations, however, in many cases, this is nearly impossible.

Period B typically about a 24-months and is mainly characterized by investment standstill until private companies run out of cash. To recover, private companies need to readjust their private valuations to attract financing. Investors and LPs are sitting on the fence and are only completing transactions they have already started.



PERIOD B CONT'

LPs halt their investment in new VCs altogether as they experience a “dominator effect” whereby their current allocation to private equity exceeds its target (due to fall of public stocks).

VCs shift their strategy to preserving the “winners” in their portfolios and in some cases, they may buy shares at high valuations in their own portfolio (“internal rounds”) to avoid short term down rounds. These actions reinforce the mismatch between their fund’s reported valuation and real value.

Sectors of companies that are hurt first relate to upside creation such as marketing automation and lead generation which is reflected by major layoffs across sales and marketing teams.

Due to the liquidity crunch, other sectors that experience harm are the long-term projects that are not as critical such as AI analytics which have a 3–5 years horizon and “deep tech” startups.

The business models that are hurt first are the ones that have no minimum floor to revenues such as Pay-As-You-Go and transactional business models.

Companies that excel in this climate are companies that position themselves as “cost-cutters” and/or optimizers. They reduce risk by reducing revenue and client churn. The software clients that do not churn are the ones that serve as a source of truth for the organizations’ platform rather than point solutions, and that assist mainly the back office such as R&D. Companies that serve S&B’s experience significant churn and try to move up market.

During this time, VC book value is impaired and is not reflective of its intrinsic value as VC’s are obligated to update their valuations only when a transaction happens.

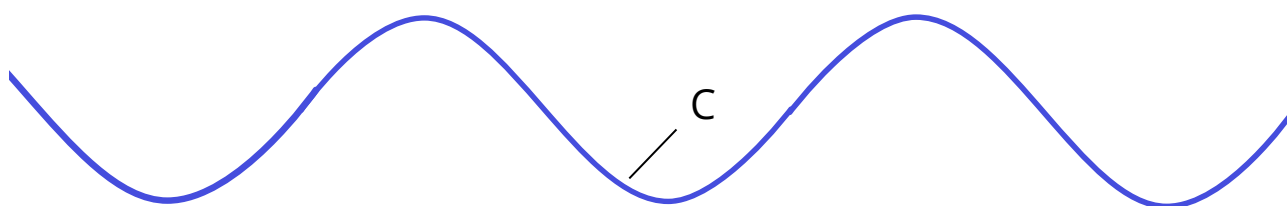
PERIOD C

In period C, LP commitments are renewed but overall allocation to VC is still trending down. During this period, interest rates are high, and LPs are more likely to increase their exposure in other asset classes such as bonds, credit, or real estate. As a result of reduced commitments to venture, VCs and founders are forced to make down rounds (or flat rounds with significant liquidation preference) to finance their operations at lower valuations, resulting in big losses and further contractions.

Early-stage startups are most affected during this period, as many companies will need to reach higher bars to raise financing. The time between their fundraising rounds is extended, and “early adopter” customers (typically SMBs), reduce costs and software spend in key categories. Due diligence takes more time, as VCs struggle to reach convictions without proper “new world” historical performance.

Companies that contain government organizations as clients with long term agreements and sectors that are perceived to be “mission critical”, such as cybersecurity and infrastructure software receive more attention. These companies have business models that are recurring, predictable and typically enjoy high NDR levels. Company expenses tend to be attributed to COGS, or the operating system of record for organizations. Other value propositions that are being valued by the market are companies whose solution relates to shortening time and value.

Funds focus on downside mitigation although bargains may be found as software multiples are at 5x-10x and are calculated based on Last Twelve Months (LTM ARR). This situation continues until Period D.

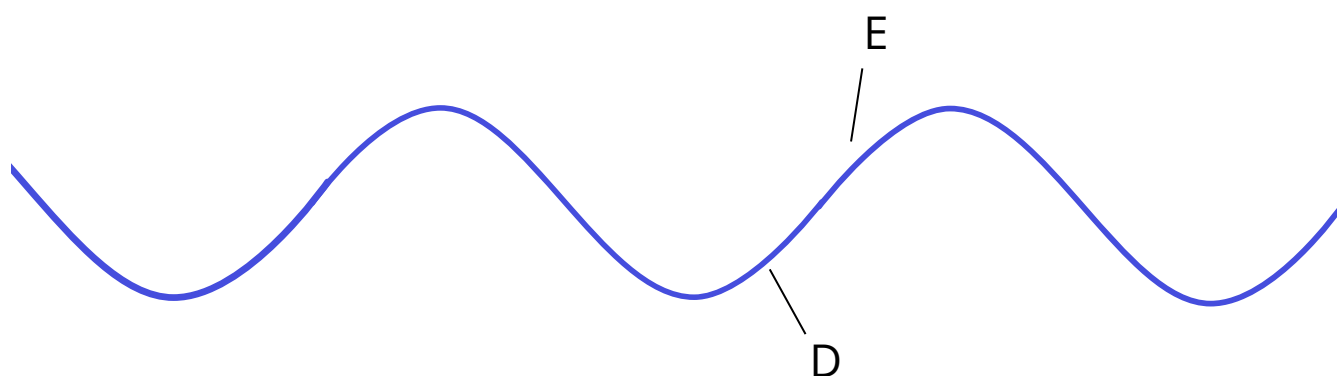


PERIOD D

Recent positive track records generated by VCs is the new “normal world” valuation and interest rates are in the process of decline. In this period, LP commitments remain low but are trending upward. VCs can conduct more rigorous deal selection as they are more likely to adhere to their investment guidelines. Unsustainable companies and business models have either gone bankrupt or exited the market. Many companies focus on “real-world metrics” such as profitability and cash flows.

In addition, interest rates are lowered, and companies start to decrease their debt burdens. The valuations of tech companies start to rise, making portfolios of VC firms that invested in period C look compelling, which attracts LP commitments. Investors shift their focus from profitability alone to a mix of profitability and growth to allow for upside. Software multiples for top companies are beginning to climb to > 10x current ARR.

VCs are more open to finance point solutions that can grow faster.



PERIOD E

Completing the cycle brings us to period E which is identical to period A. The stock exchange is performing well, and investors feel they have more disposable income and are more willing to take on risk. The level of LP commitments and risk appetite are once again high. Software multiples for select mediocre companies are likely > 20x ARR. Investors focus on growth at all costs.

CLOSING REMARKS

It is important to bear in mind that overall, the market is trending upwards and it is important for VCs to capture the fundamental growth of companies and markets. Understanding this cycle is critical, and identifying where we stand at different points in time allows us to try our best to time our entry to the market at opportune points of lower valuations and greater quality businesses.

ACKNOWLEDGEMENTS

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