Growth Equity Update

September 2022 – Edition 6

- In this edition we focus on ESG (Environmental, Social and Governance) and private companies. ESG is inextricably linked to the value and long-term prospects of a business.
- Companies with a strong ESG mission and high growth are clearly well positioned to compete for the growing abundance of ESG labelled capital in the global financial services community. Companies with a less obvious ESG message but with a good handle on key issues like diversity and inclusion, training and development, health and safety, pay practices and risk management, can capitalise on these strong points to attract ESG capital.
- Meanwhile, the August market rally crumpled after hawkish remarks over interest rates by Fed chairman Jay Powell at the Jackson Hole Economic Symposium. Markets fear the tightrope walk of controlling inflation while avoiding recession will be too tough to maintain.
- Nevertheless, the S&P 500 by mid-August had retraced 50% of its fall. Post-War the S&P 500 has never returned to its previous lows after such a move. The average performance in the ensuing 12 months is +19%. There are signs that listed company investors are trimming cash positions and are once again beginning to favour growth over value.
- A Preqin survey on private markets conducted at the end of June and recently released, found that 50% of private equity and 55% of venture capital investors expect worse performance over the next 12 months with 80% of surveyed investors believing venture capital is overvalued.
- We look at the growth of venture debt as an alternative to venture capital fundraising.

Venture backed companies and ESG

Irrespective of the stage of development of a privately owned business, ESG is a vital component in the achievement of full value during the fund-raising process. We interviewed Camilla Hughes, the director responsible for ESG advice in Rothschild and Co's Equity Advisory business, and asked her why ESG is important for privately owned growth companies and how these businesses should approach ESG.

Q: What is ESG and why is it important for private companies?

A. Having a strong Environmental, Social and Governance (ESG) proposition is synonymous with a well-run 'future-fit' business. Businesses which have high growth potential, and by definition are on the point of expansion, typically have a strong investment case of a 'greener' nature. In many cases they are already addressing the gaps in climate solutions and the demands of a better-informed consumer. However, they increasingly need to 'evidence' their approach to E, S and G to demonstrate their long-term viable prospects and to attract capital.

'ESG', to keep it simple, is made up of two aspects; a core ESG proposition and ESG credentials. Together we call this an ESG strategy which, in practice, should mirror the business' core strategy. ESG should not only be at the heart of what a company does but also how it goes about its business. It could be a company with a piece of 'smart' technology which facilitates a value chain or innovates recycled products, it could produce sustainable plant-based foods, or low carbon enablers for construction, transport or agribusiness, for example. Regardless of what the company does or produces, this is still only one part of what ESG means. The other part is the responsibility of a company to measure and improve its impact (positive and negative) on its stakeholders – employees, suppliers, customers, communities, lenders, investors, and broadly the planet – because society has to share energy and natural resources, be mindful of waste disposal and so on. From an investor perspective, understanding how the business manages 'risk' which impacts the top and bottom line of the financial statements, is vital and, in an increasingly volatile world, critical to an investment decision and valuation.

Why is that important? It is, because a fundamentally well-run business will remain competitive, absorb greater volatility, become more efficient and productive, all of which sums to being more profitable in the future. So ESG is important, not just because it is the right thing to do, but because it is inextricably linked to the value and the long-term prospects of a business.

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> Camilla Hughes, Rothschild & Co

Q. Is it important for venture backed companies – do investors care enough at this stage?

A. Investors absolutely do care about the future and financial success of a business (find me one who doesn't!) although many companies and investors do not immediately see the link with ESG and would rather avoid its apparently burdensome reporting aspects. On the contrary, I would encourage a young business to collect its data and embrace reporting against the ESG aspects and be transparent across all its communications, and in doing so capitalise on the many operational and commercial benefits and a pathway to investment capital at the best possible valuation. This is a much more tangible target than a net zero ambition which should also be in the mix.

When investors look at the fundamentals of a company, they look for the delta in the underlying market growth rate, what's driving consumer preferences, the speed of regulatory change and capital investment requirements. They also look at the organisational structure, labour and supply chain management and all the environmental considerations, including energy costs and the transition strategy to alternative energy sources. In doing so they are assessing the broad factors which could disrupt either the revenues or cost base of the business. ESG is the lens through which an investor views the operational risk of a business model and any opaqueness in the model represents unmanaged risk which will likely carry a cost in an investment decision process.

Q. As a founder, what if I feel my company doesn't have a particular environmental or social mission?

A. Founders, who are busy multi-tasking, might think they haven't tackled ESG because they haven't wrapped it up as a dedicated work stream and stuck a label on it. There's often a belief the business falls under the ESG radar, they don't have the resource or time and/or the business doesn't fit neatly under any 'sustainability' pillars.

In practice, all businesses with a client base generating sustainable revenues can create a work stream around ESG considerations and a roadmap to improving energy consumption, thermal count of buildings, employee policies, code of conduct, participation in the community, and a recycling policy for waste and technology hardware and so on. Start by defining a corporate purpose with a set of objectives which align pecuniary factors with a set of non-financial targets. All businesses have a lot of data on themselves, and founders should see the value in this information in the context of customer acquisition, employee retention, supplier relations and capital markets - this information is relevant for ESG – the company may just not realise it, or how to use it. The prolific development of ESG data software and AI means a company can measure its carbon footprint today for as little as around $10k and in house devise an ESG framework with limited resource.

Q. The most recent EU rules on the Corporate Sustainability Reporting Directive appear very demanding – do these extend to smaller companies as well?

A. The CSRD is still currently in consultation, and it is the EU's common reporting framework for non-financial data which will cover over some 75% of total EU companies' turnover. FY 2023(4) is the first set of Sustainability reporting standards and 2024(5) is the second sector specific set of standards currently in development. These are certainly already on the agenda for larger companies but will cascade down to smaller companies in due course. Even if the reporting requirement is not quite on the horizon for some businesses, it is still worth formulating a strategy around the scope of disclosure requirements: business model and strategy; principal risks and opportunities; targets; policies and to anticipate a provision for qualitative and quantitative information both forward-looking and retrospective.

A company with a strong ESG mission and high growth is clearly suitably positioned to attract the abundance of ESG labelled capital in the global financial services community. It is also likely to be able to do this with a data set which addresses a common set of standards and a number of the independent frameworks.

A company with a less obvious ESG message but which has a good handle on external developments and a focus on topics such as climate change, resource use and circular economy, diversity and inclusion, training and development, health and safety, working conditions, community impacts; pay practices, anti-competitive behaviour, and general risk management, should capitalise on these strong points and find a place in the ESG capital deployment race.

Q. What are the pitfalls of ignoring ESG considerations?

A. There is an opportunity cost in the potential impact on founders and corporate profile and value leakage for a start. Bigger gaps in the information set provide an opportunity for potential investors to argue a lower valuation owing to the unidentified ESG risk in the business. Whilst this sounds rather dramatic, investors are increasingly having to report against their own approach to ESG and the ESG risk inherent in portfolio companies. As the risk profile of a prospective portfolio business grows, the less enthusiastic will be the potential investors around a situation - to the extent it may be hard to raise capital at all.

In the same vein as global taxonomy is driving corporates to transition, regulation in the financial services industry is driving a reclassification of funds' investment criteria and putting pressure on companies to think and take action around matters concerning ESG. Younger generational preferences are rapidly shifting consumer demand and investment strategies.

Q. ESG is a big subject – what should a company prioritise?

A. It IS a big subject and we've touched on various topics here already. Prioritise a plan first, map out what ESG means to the business (for the majority this is energy) and the people involved in its operational activities and identify a baseline on as many ESG metrics as relevant. Define the business strategy, its groups of stakeholders and identify where the business has full control and where it has influence. At this point a company can implement initiatives and create policies relating to E and S. This is your ESG strategy. In parallel a company should think about the external developments in reporting and regulation surrounding the business and its clients, and industry accreditations.

The key is to make a plan and build on the layers. Incomplete data is fine and the direction of travel towards basic social targets and net zero will resonate with investors.

Q. How can I tell as a company whether what I am trying to do from an ESG standpoint is working – is there a gold standard to measure the progress?

A. There are a number of ESG reporting, scoring and rating systems and a growing industry in that space. Young companies should do some homework and choose which ones are most achievable and relevant for the business. Some will be commercially beneficial, and others will be helpful to investors in assessing ESG strategy and credentials. However, there are cost implications and hence companies need to think about value, budget and factor in the cost of signatories and data analytics services. When we are advising companies on ESG ratings, it is common to look at the Sustainalytics and MSCI ESG rankings of quoted companies and use this as a benchmark. Whilst aspiring to be a AAA rating score, it's important to keep within the scope of the company's developmental stage, what the business does and where it is on its growth journey.

Q. What about the risks of greenwashing?

A. You do have to be really careful of the issue of purpose/green washing. Founders and companies are naturally in sales mode all the time, but mission statements and claims of being the best/ greenest company/product without substance or supporting evidence can undermine a good ESG story. Starting with a plan and working on the data in the first-place leads to the discipline and measured approach required to provide customers and the financial markets with accurate information. This is not to confuse however ambition and specific goals and targets, there is a place for both, and an inevitable uncertainty in achieving both. Clearly it is good to have plenty of PR and positive language about a company, but it is very important in terms of ESG to be able to have full support, as much quantitative information as possible, to justify your ESG narrative.

Q. If I get the ESG message right am I going to get a higher valuation and more investor interest?

A. Absolutely. I would hope so and there is growing evidence which links ESG and valuation. We are often asked, what's the delta? What's my premium, my return on the effort? As we've touched on, there is long term benefit to creating your ESG narrative and documenting ESG credentials, linked to the ability to attract capital and to underpin the investment case. The more attractive you are as a company, and the less unidentified risk and better run you are proven to be, the more pricing power should remain with the founders. Growth remains a key driver of value, but the world is shifting towards a better-informed process of analysis of risk and the impact on long term viable prospects. The key is to be attractive to as many people as possible and drive value from that source. Anecdotes from the listed markets are interesting because AAA rated companies in both the S&P and the Stoxx 600 can trade at a 30-40% premium to companies with low scores.

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> Camilla Hughes, Rothschild & Co

Q. What capabilities does Rothschild have in this area – how can we help?

A. We are very fortunate at Rothschild & Co. We have a leading Investor Advisory business which includes a leading ESG advisory business, constantly evolving to offer clients and our bankers the support they need, and which fits the capital markets context. We advise on ESG from an investor perspective in M&A, capital raising, debt financing, ESG strategy, attracting ESG capital and advice around ESG ratings and messaging. We incorporate expertise in Governance and activism which includes climate activism and AGM vote support. We partner with our sector and product bankers but most of all we offer independent long-term advice focused on maximising long term shareholder value creation.

Providing ESG advice in the context of Investor Advisory is synonymous with providing best in class advice as analysis and assessment is based on the financial and non-financial profile of a business. ESG might seem complex but with the right support a company can quickly get going and not look back.

September - Pivotal for market direction

After a rally from mid-June to mid-August NASDAQ has rolled off the top and by September 9th was down 5% in the last month and down c25% ytd. The S&P 500 is down 3% in the last month and 16% ytd.

In Europe the Euro Stoxx 50 is down 4% on a month and down 17% ytd.

The outlook for further rises in interest rates. NASDAQ is particularly sensitive to this dynamic. Hopes were raised post the July US inflation numbers (reported in early August) that a drop in the annual rate of inflation to 8.5% from 9.1% in June might induce a more doveish stance by the Fed towards higher interest rates.   Lower gas prices were a key factor. Core inflation was steady at 5.9%, beating expectations of 6.1%.

Market hopes of a lessening need for further rate increases were then dashed by Fed chairman Jay Powell's remarks at the Jackson Hole gathering in late August. At its July meeting the Fed had raised interest rates by 75bps to 2.25%-

2.5% with Jay Powell indicating that the Fed would raise rates as far as required to stunt inflation. This was very firmly reiterated at Jackson Hole where Jay Powell reiterated his intention to tame inflation through raising interest rates. He said the Federal Reserve *'must keep at it until the job is done'* and '*the historical record cautions strongly against prematurely loosening policy.'* He observed *'a single month's improvement [in inflation] falls far short of what the committee will need to see before we are confident that inflation is moving down.'*

Market expectations are now of a further 75bps rate increase in September, of rates at 3.75%-4% in H1 2023 and for such higher rates to persist longer than previously expected.

The prospect of recession: Jay Powell accepts that his robust interest rate message means the successful reduction of inflation will probably mean lower economic growth *'for a sustained period'* as well as *'very likely some softening of labour market conditions'* and *'some pain'* for businesses.

The S&P 500 fell 3.4% and NASDAQ almost 4% in immediate response to these remarks. The market is highly sensitive to the tightrope the Fed is walking between curbing inflation through higher interest rates on the one hand and trying to avoid recession on the other.

Where are we on economic growth? The indications are that the US economy grew in H1 2022 and again in July. Most leading indicators of activity are, though, signalling that growth will weaken. The US banking system is tightening up on the availability and cost of credit and the housing market is deteriorating, down 12.6% month on month in July versus expectations of a c2.5% drop. The S&P service sector purchasing managers index was at 44.1 in August, a fall from 47.3 in July and is now at its lowest level for 27 months.

Labour costs are up c10% yoy which will impact on corporate profitability. CEO confidence has slumped with the Conference Board's quarterly measure of CEO business confidence at a reading of 34, close to its record lows since inception in 1976. This bodes negatively for hiring and capex.

Sporadically there are some more optimistic indicators. The latest quarterly Survey of Professional Forecasters produced by the Philadelphia Fed painted a relatively reassuring picture of the year-ahead outlook. Expectations for quarterly GDP growth have become more muted but remain positive throughout. The risk of a negative quarter over the course of the next twelve months is assessed as no higher than 30-40%. Indeed, the quarterly inflation forecasts, while higher than previously, envisage core consumer price inflation falling to almost 2 ½% in Q3 2023 from last month's near-6% level.

Left field events risk: Inflationary pressures in Europe are higher than those in the United States given the reliance on natural gas supplies from Russia which are disrupted. In the UK peak rates of inflation are seen as potentially hitting as much as 22% in the first part of 2023.

There is the possibility of a re-escalation of perceived geopolitical risks, which would be regarded negatively for markets. These include the threat from nearby hostilities to the Zaporizhzhia nuclear plant in Ukraine. Tension between China and Taiwan remains high in the wake of the visit to Taiwan of Nancy Pelosi, the speaker of the US House of Representatives.

Thus, as we move through September market confidence looks fragile with the US walking a tightrope, successfully thus far, between raising interest rates but avoiding recession. Given the falls in the market we have already seen, a Q3 results season pitted with profits warnings should not be a shock. There is cash on the side-lines which asset managers in the summer months started gently to redeploy and the incentive to keep investing in equities is there given the impact of inflation in eroding the value of cash.

What about the outlook for equity markets?

We observed earlier this year that post war **the average duration of a bear market is 9.5 months. This time around the market peaked in January 2022.** If this bear market performed in average style, then it should emerge by mid-October.

NASDAQ peaked at 16,212 in mid-November 2021, fell to a low of 10,565 in mid-June 2022 and rallied to 13,128 by late August. Effectively the index fell by 35% peak to trough and then rallied by 24% from the trough. By 9th September it was at 11,862, down 25% ytd and still in bear market territory.

Looking at the S&P 500 it peaked at 4,818 in early January 2022, fell to a low of 3,666 in mid-June and rallied in August to 4,305. Having fallen by 24%, it rose from its lows by 17%. Effectively it retraced half its losses, albeit that rise was relatively narrowly based with four stocks, Amazon, Apple, Microsoft and Tesla - contributing 30% of the S&P 500's gain in the rally. By September 9 it was at back at 4,006, down 16% ytd.

> *Post-war, when the S&P 500 retraces half of its bear market losses (as it did this time by mid-August 2022), then the market does not return to its previous lows. Indeed, the average performance of the Index in the ensuing 12 months is +19%.*

This sort of performance presents a conundrum for fund managers. A lot of the commentary coming out of investment firms highlights the precarious state of the global economy and the risks of being sucked into a bear market rally. For individual fund managers though at least three factors are at play:

- **The market has rallied and yet investors are long of cash.** In May the widely followed Bank of America survey (BoA surveyed 288 investors running assets of $833bn) found that investors' cash balances had reached 6.1% on average. Fund managers who stayed long of cash underperformed in the rally.
- **Inflation is eating into the value of that cash.** Core inflation in the US is 5.9% in July and 6.2% in the UK. Real interest rates are negative. Sitting on cash is a recipe for losing money slowly.
- **Investors know that bear markets don't last for ever:**

For instance, in June the S&P 500 dropped by 7.7%. In July it rose by 8%. This is historically a positive signal for continued performance. Post-World War II war there have been only five other occasions in which the S&P dropped 7.5% in one calendar month and regained at least that much in the following month. The others came in October 1974, October 2002, March 2009, January 2019 and April 2020. The S&P 500's average return 12 months after these turnarounds was 30%.

Similarly, the Post-war record shows that, when the S&P 500 retraces half of its bear market losses (as it did this time by mid-August 2022), then the market does not return to its previous lows. Indeed, the average performance of the Index in the ensuing six months is +10.8% (73% of instances show positive returns) and after 12 months the average performance is +19% (100% of cases).

S&P 500 performance after 50% of a bear market is recovered –stocks don't revert to the lows – the average subsequent 12-month performance is +19%

Bear (And Near Bear) Markets					S&P 500 Index FutureReturns			
Peak Date	Trough Date	S&P 500 Change	Date To Recover 50% Of The Bear	Make New Lows After 50% Recovered?	1 Month	3 Month	6 Month	12 Month
8/2/1956	10/22/1957	(21.6%)	6/4/1958	No	2.2%	8.3%	18.0%	29.5%
12/12/1961	6/26/1962	(28.0%)	12/4/1962	No	2.4%	3.5%	12.6%	18.6%
2/9/1966	10/7/1966	(22.2%)	1/12/1967	No	4.3%	6.6%	10.1%	15.3%
11/29/1968	5/26/1970	(36.1%)	12/3/1970	No	3.2%	11.3%	13.8%	7.8%
1/11/1973	10/3/1974	(48.2%)	5/13/1975	No	(1.6%)	(4.9%)	(2.4%)	12.4%
9/21/1976	3/6/1978	(19.4%)	5/1/1978	No	(0.4%)	3.1%	(3.2%)	4.2%
11/28/1980	8/12/1982	(27.1%)	9/3/1982	No	(0.6%)	13.1%	25.3%	33.9%
8/25/1987	12/4/1987	(33.5%)	10/20/1988	No	(5.8%)	1.3%	9.4%	22.7%
7/16/1990	10/11/1990	(19.9%)	1/18/1991	No	11.2%	15.6%	15.6%	26.1%
7/17/1998	8/31/1998	(19.3%)	10/22/1998	No	7.9%	14.4%	26.1%	20.7%
3/24/2000	10/9/2002	(49.1%)	1/26/2004	No	(1.0%)	(1.7%)	(5.2%)	1.1%
10/9/2007	3/9/2009	(56.8%)	12/24/2009	No	(2.6%)	4.2%	(4.6%)	11.6%
4/29/2011	10/3/2011	(19.4%)	10/21/2011	No	(3.7%)	6.2%	10.8%	15.8%
9/20/2018	12/24/2018	(19.8%)	1/18/2019	No	4.3%	8.9%	11.8%	24.3%
2/19/2020	3/23/2020	(33.9%)	4/14/2020	No	(0.9%)	12.3%	24.2%	44.9%
1/3/2022	6/16/2022	(23.6%)	8/12/2022	?	?	?	?	?
Average		(30.3%)			1.3%	6.8%	10.8%	19.3%
Median		(27.1%)			(0.4%)	6.6%	11.8%	18.6%
% Positive					46.7%	86.7%	73.3%	100.0%

Source: Carson, FactSet 8/18/22

Underweight positions trimmed but cash still high. The most recent BoA poll (August 5-11) noted investors had cut back a net underweight position in equities to minus 26%, versus the low of minus 44% in July, a level last seen in the 2008 global financial crisis. The portion of uninvested cash in portfolios dropped to 5.7% from 6.1% in July but remained *"very high"* by historic standards.

Generally, earnings held up in Q2, helped in Europe by currency weakness. While the outlook for earnings may be deteriorating and Q3 is like to see a raft of profits warnings as companies run out of road in the year to make up shortfalls, the effect appears largely anticipated.

Earnings deterioration anticipated and in the price? A net 66% of fund managers in the May BoA survey said they expected global profits to weaken. This type of bearishness has been seen only in the low confidence periods of the 2008 Global Financial crisis and the dotcom bubble crash of 2000. The August 2022 survey also had 58% of investors expecting a recession in the next 12 months up from 47% in July and the highest percentage since May 2020.

Growth again favoured over value: Despite that the net percentage of investors who think *'growth'* will outperform '*value'* over the next 12 months turned positive for the first time since August 2020.

What about private assets?

An interesting source of information into investor attitudes towards private company valuations comes from a recent survey by Preqin. ***Preqin's Investor Outlook: Alternative Assets H2 2022 report*** was released on August 23. More than 300 LPs were interviewed in June 2022. We should recall that markets hit their 2022 lows around June 16.

Preqin found that 50% of private equity and 55% of venture capital investors expect worse performance over the next 12 months

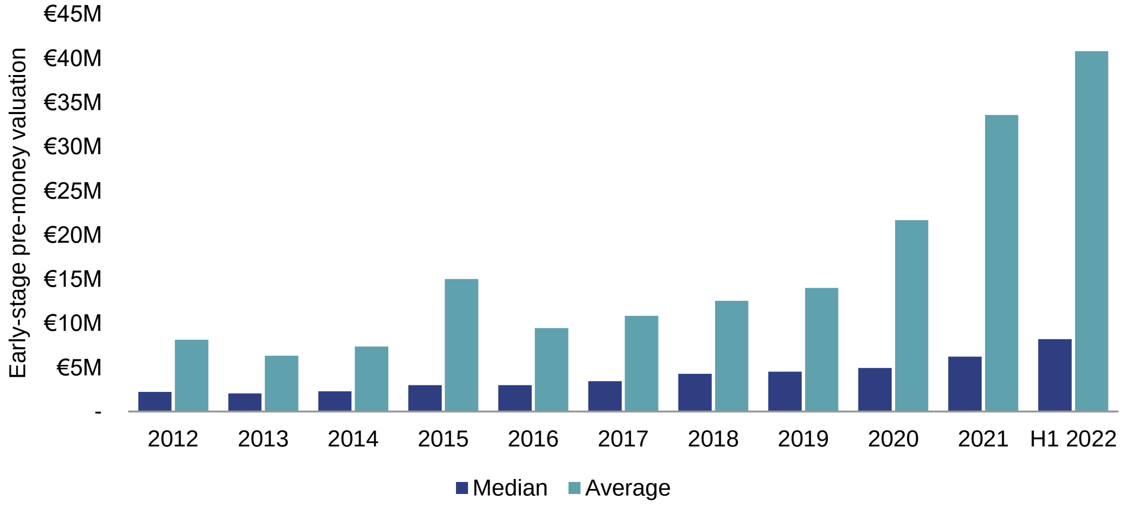
- 80% of surveyed investors believe that venture capital is overvalued, with either considerable room or some room for price reduction.
- 68% of VCs surveyed said they had concerns over the exit environment compared to 33% that expressed exit-related concerns in the prior survey one year ago.
- 26% of venture capital investors intend to increase their pace of capital deployment over the next 12 months, down from 43% one year ago. 33% plan to deploy less during the period, compared to only 13% in 2021.
- For private equity, 30% of investors plan to increase their pace of capital deployment over the next year, down from 43% a year ago.
- 67% of private equity investors said the exit environment is a concern that may lead to lower returns, compared with 28% that said it was a concern a year ago.
- 55% of survey respondents believe that we may be approaching the bottom of the current equity market cycle, whereas 63% still expect a continued deterioration of the macroeconomic environment

Source: H2 2022 Investor Outlook press release (preqin.com)

Perhaps some of this perceived over-valuation in venture capital reflects the experience of VCs in recent rounds. Despite the sharp falls in public market valuations in 2022 the private market data is yet to show much of an acceleration in the number of down rounds. VCs may be feeling that, when it comes to fresh investment, the lower valuations they might expect in such an environment have not yet come to pass. Pitchbook data suggests that European venture capital valuations in the first half of 2022 rose yoy across all stages.

The median early-stage valuation for H1 2022 in Europe was €8.4m, up from €6.3m for the whole of 2021.

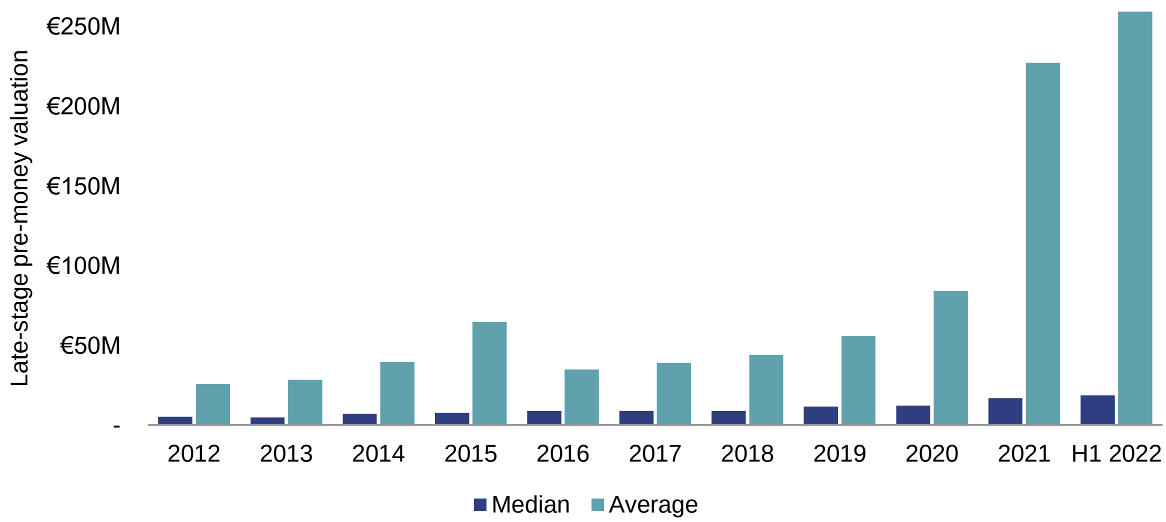
Early-stage deals - Media valuations rise yoy in H1 2022



Source: Pitchbook

The median late-stage valuation in Europe in H1 2022 was €18.7m up from €16.1m in 2021.

Later stage deal valuations



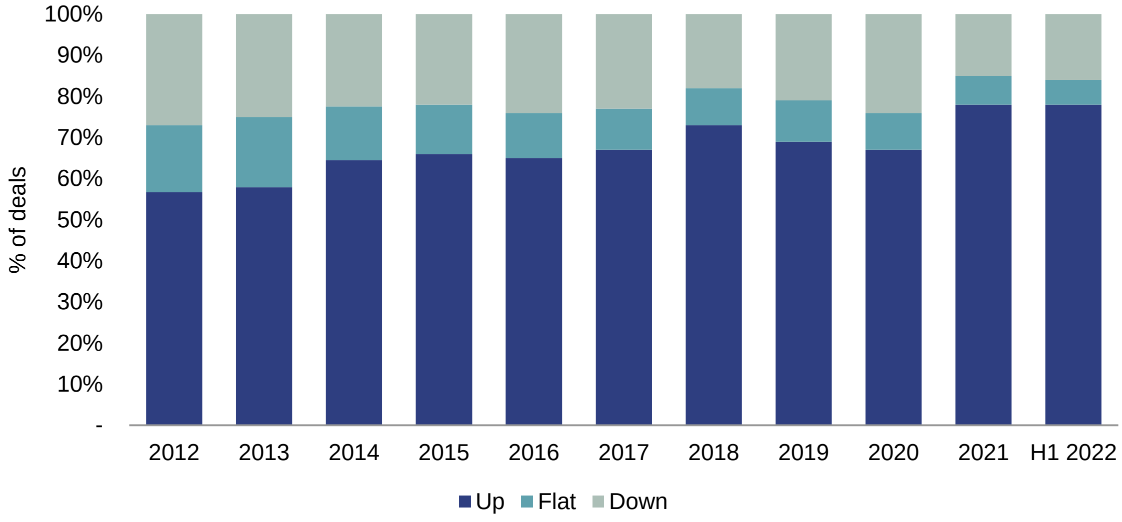
Source: PitchBook data

Geography: Europe

Further reading: [PitchBook's Q2 2022 European VC Valuations Report]

The percentage of down rounds in H1 was 15.4%, close to the figure for 2021 of 14.8%. In fact, the percentage of up rounds actually increased slightly, from 78.5% in 2021 to 79.1% in H1 2022.

Down rounds – barely moved as a % of deals yoy



Source: PitchBook data

Geography: Europe

Further reading: [PitchBook's Q2 2022 European VC Valuations Report]

Investor Feedback

We monitor feedback from venture capital investors 0n the state of the market. The key themes we are seeing are

(i) Investors are seeing activity and value in seed and early-stage rounds

(ii) Attractive opportunities in later stage rounds are fewer and investors report a lot of internal rounds.

(iii) There is a sense that well placed companies are deferring raises in 2022.

(iv) Many investors we speak to observe they are *looking at opportunities and [are] open for business right now.*

(v) The sense remains that valuation expectations are too high and that founders' expectations have not fully adjusted.

Investor comments:

Deal Activity

Significantly less activity

Portfolio companies are pushing for extensions of rounds when they see traction and are reducing burn

Deal flow: looking at a few things but haven't seen too much they are very excited to do

Seeing a lot of internal rounds

Seeing very few sizable rounds at the moment but expect to accelerate back end of the year / next year

Dealflow: looking at a few things but haven't seen too much we are very excited to do

Seed and Series A still very active

Investor appetite

Focused on companies that are moving towards profitability

Open for business and active but not the same level of activity as last year

Very much open for business and expect to have an active period into the end of this year / H1 2023.

Still open for business and active

Looking at a few things but haven't seen too much we are very excited to do

Plenty of dry powder

Very much looking at opportunities and open for business right now

Business models

Very weary of consumer exposure / anything where customer acquisition costs are quite high.

FCF is more important than before but not a prerequisite; unit economics important

Software key focus area but would also look at consumer digital businesses but the hurdle likely to be higher

Digital transformation, B2B SaaS the main focus

Loss-making is fine but need to see best-in-class unit economics being delivered

Prefer capital-light

Valuation

Saw a lot of VC activity in early part of the year but didn't make sense on the basis of crystallising December valuations for businesses where public comps were down 30-40% at the time.

Quality adjusted multiples have not really come in a great deal

Willingness from the buy side to invest is higher but founders' expectations are still too high.

Feeling more of a push to deploy and find value in current environment

Founders remain in denial on valuation. Many looking for debt and other instruments to avoid crystallising a valuation at a lower level.

Private markets – not yet adjusted on valuation.

The growth of venture debt

Recent months have seen the environment for venture capital fundraising become more difficult. Valuations are under scrutiny in fundraising and many companies are wary of raising new equity in such an environment. Frequently companies are looking to defer a funding round and extend the current runway while awaiting more favourable market conditions or, in late stage, a revival of the IPO market. Some capital hungry business models do not have the luxury of being able to defer fund raising.

One option in this context is the use of venture debt. In context the use of venture debt has recently been a fraction of the venture financing market. According to Pitchbook US VC-backed companies raised debt financings of $33.1bn in 2021, less than 10% of the $342bn amount raised in VC equity fund raising.

Venture debt financing provides loans that are typically targeted for specific uses such as capex or acquisitions. It sits alongside equity funding. The basis of the lending is different from that of regular lenders. Security does not rely on asset backing or cash flow and instead is based on overall company performance and momentum and the likelihood of it being able to raise additional equity in new rounds in the future.

The capacity of the venture debt market has been limited. Given lending is typically based around a company's enterprise value rather than being on assets and cash flow there is a relatively high risk involved which in turn means that interest rates are relatively high. Thus Ed Testerman, a partner at King Street which has made around $1.5bn in venture loans since 2019,is quoted in Institutional Investor saying,

'There's a higher risk that these companies won't become cash-flow generative to ultimately repay your loan from cash flow generated by the company itself.'

Capacity in the venture debt market now expanding: The benefits of the venture debt market and its potential growth has attracted some new players into the market which may expand the lending capacity. Lending to technology companies is a major focus.

The Information reports that Blackstone, the private equity business is planning to invest $2bn in technology debt deals over the next few years. This will include venture debt, deals with pre-IPO businesses and deals with companies that have recently gone public.

The Information also states that KKR intends to expand its lending to venture-backed startups and has considered buying a venture-focused lender.

Specialized venture lenders include Hercules Capital. It commented in its recent Q2 figures to end June that

"After delivering record new commitments and fundings for Q1 2022, Hercules continued its momentum in Q2 with record gross new debt and equity commitments of over $1 billion, bringing the total for the 1H 2022 to a record $1.66 billion. Fundings for Q2 totalled over $439 million which brought 1H 2022 fundings to a record of over $790 million. We expect the originations environment to remain attractive and drive strong growth of our portfolio of interest generating assets.'

Other new players are moving into this market. Bloomberg reports that Coatue Management is raising a structured equity fund, targeting c$2bn for its planned Tactical Solutions Fund. It is said already to have raised $1.2 billion. Viking Global is said to be raising a similar fund at around $1bn as is JP Morgan.

Our views on the state of the venture capital markets

Since the start of 2022 we have seen sharp falls in the public markets on the back of a combination of rising global inflation, rising interest rates, and increased geopolitical risk. The Refinitiv Venture Capital Index, which seeks to monitor the real time performance of the venture capital industry is down 50% ytd having been as much as 58% down in mid-June. September will be the real test of the market's new-found direction. High inflation is inducing substantial negative real interest rates yet there is substantial cash on the sidelines.

Our summary of the outlook is:

- The deteriorating interest rate, inflation and macro-economic environment has had a sharp impact on valuations in private markets. The scale of the fall in the Refinitiv VC index is much more substantial ytd even than the fall on NASDAQ. This has been reflected in some big valuation falls on some high-profile VC rounds.
- There is substantial dry powder in the VC industry at close to $500bn.This may now be prioritised to supporting existing rather than new investments.
- Best-in-class companies, addressing critical rather than nice-to-have requirements, continue to attract support. There are still hotspots for investment notably in fintech, cleantech and software. Certain investors remain very active in the space with substantial funds to deploy.
- There will be a growing number of down rounds, albeit the substantial fund raising of 2021 and the ability of companies to eke out existing resources may limit the immediate number of these
- The speed of the investment process appears to have slowed considerably. The volume of new deals has reduced. The level of diligence on new deals has stepped back up.
- Funding for the VCs themselves remains strong which is a positive indicator for H2 2022 and into 2023.
- Valuation priorities have shifted with investors moving away from a growth and revenue multiple emphasis. There is a sharper focus on the path to profitability and positive free cash flow and an emphasis on DCF and comparative based multiples.
- An interesting paradigm is that earnings forecasts for public companies have not fallen much as yet. The fall in the market indices indicates the buy side anticipating earnings deterioration. This in turn means that multiples for public companies are low by recent standards. As earnings forecasts start to fall (the crunch time is usually Q3 when companies begin to run out of road to make up shortfalls) multiples should naturally inflate. At that point, as multiples for public companies recover, the prospect of fundraising for growth oriented private companies becomes more attractive.

Rothschild & Co: Selected 2022 deals in Growth Equity and Private Capital

A selection of the deals on which we have advised thus far in 2022.

Skyroot $51m Series B

- Sole adviser on its Series B raise of INR 4,030m (US$51m) from GIC Private Limited and LK Advisers
- Looking to 'uberize' space for small satellite operators, Skyroot will use its differentiated solid propulsion technology to offer on-demand, affordable launch vehicles. It plans its first orbital launch by early 2023

Castore £50mn RCFn

- Sole debt adviser to Castore on its new multibank £50m Revolving Credit Facility
- Castore is a global premium performance sportswear retailer. Castore also partners with global sports teams, supplying products and managing their retail operations

Carsome: US$290m Series E

- US$290m Series E fundraise led by SeaTown Holdings International and 65 Equity Partners Holdings
- The funding round brought Carsome's valuation to US$1.69bn, cementing its position as Malaysia's first and largest tech unicorn
- Follows US$170m Series D2 round in Sept 2021, on which we also advised

Marwyn Acquisition Company II: £500m equity raise

- Advised Marwyn Acquisition Company II on the launch of its equity raise, by way of a 12-month placing programme
- The company will seek to raise up to £500m during the next twelve months from equity investors in a structure which is distinct from the typical 'SPAC' structure

FL Entertainment: €7.2bn combination with Pegasus Entrepreneurs and simultaneous c€550m equity raising

- FL Entertainment is composed of Banijay, largest independent content producer globally, and Betclic Everest Group, Europe's fastest-growing sports betting platform. Pegasus is an Amsterdam-listed SPAC
- Largest ever European SPAC business combination and PIPE raising

Insight Partners: strategic investment in Precisely

- Led investment in a recap of Precisely Software Incorporated, in an investor group that will also include Partners Group, Clearlake Capital, TA Associates, and Centerbridge Partners
- Precisely is a leading data integrity and infrastructure software company

Kpler: Minority stake Acquisition

- Adviser to Five Arrows Growth Capital and Insight Partners on joint acquisition of a minority stake in Kpler Holding S.A. from its founders
- Consisted of acquisition of c.30% of secondary share capital of Kpler plus primary investment of €20m
- Kpler is a leading SaaS provider of data and analytics to energy markets

Harmay: US$90m Series D

- Advised Harmay on its US$90m Series D equity financing from a group of leading Chinese and global growth equity /venture capital funds
- Harmay is a premium beauty retailer
- Raise was led by QY Capital (an entity related to Alibaba New Retail Fund) plus existing investors

SEBA Bank: CHF110m raise

- Advised on fundraising co-led by a consortium of new investors specialised in blockchain and fintech including Altive, Ordway Selections and Summer Capital
- DeFi Technologies, leader in decentralized finance, and Alameda Research, a global cryptocurrency quantitative trading firm, also participated

First Digital Bank: US$120m capital raise

- Advised on capital raise through a syndicate of investors including Tencent, SBI Investment Co, Julius Baer, and West Coast Equity Partners
- First bank to receive a banking license in Israel for over 42 years and first neobank in Israel

Fibrus: £270m seven-year debt package

- Advised on package comprising a £200m capex facility, £20m revolving facility and up to £50m uncommitted accordion facility
- Fibrus is an alternative provider of full fibre network infrastructure and broadband in rural UK
- Highly active in European fibre infrastructure: our 7th debt financing mandate in UK fibre in last 3 years

Neuberger: US$4.8bn valuation Getty Images combination

- Advised on business combination valuing Getty at an enterprise value of US $4.8bn, equivalent to 15.2x enterprise value to 2022E Adj. EBITDA of US $315m
- CC Neuberger Principal Holdings II is a special purpose acquisition company that completed its IPO in July 2020, raising US $828m in proceeds

Azerion: €1,300m enterprise value combination with EFIC1

- Advised on combination with European FinTeach IPO Company 1 B.V - a SPAC that raised c.€382m through IPO on Euronext Amsterdam in 2021
- Azerion provides solutions to automate purchase and sale of digital advertising inventory
- Landmark transaction - one of the largest de-SPAC transactions across Europe to date

Gousto: £240m primary and secondary rounds

- £70m primary financing for food delivery company Gousto with Softbank Vision Fund 2 in Jan '22
- In Feb '22 secondary component of £170m from institutional investors including SoftBank, Grosvenor Food & AgTech, Railpen and Fidelity
- Valued Gousto at £1.2bn on a pre-money basis

GreenWay: €85m Series C

- Advised Greenway Infrastructure on its €85m Series C fundraise
- Led by a consortium of infrastructure funds including Generation Capital and Helios Energy Investments. The transaction is the first known investment by an infrastructure fund in an EV charging network in Central and Eastern Europe

Diabeloop: €37m Series C

- Advised on its €37m Series C capital raise
- Following extensive investor outreach, LBO France was chosen to lead the raise jointly with existing investors including Supernova Invest, AGIR à dom., CEMAG INVEST and Odyssée VenturesA
- Diabeloop provides automated insulin delivery system and handset facilitating diabetes management

For more information, or advice, contact our Growth Equity team:

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