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Facing the challenge:

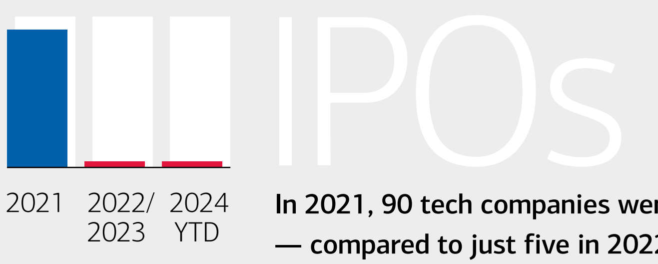
Raising capital in a period of lackluster IPO volumes

VCs ready to cash in on long-term investments have been waiting more than two years for an exit. They may be waiting a while longer. Similarly, many late-stage tech companies are finding it more difficult to raise capital for a much-needed cash infusion to fund operating losses. For players on both sides of the market, the reality is that tech valuations are down. The sheer number of deals is down. There is a dearth of tech IPOs — making investment into late-stage companies challenging.

How did this happen?

It's a circular equation, says Mo Renta, managing director and Transformative Technology Group executive for Bank of America.

Venture capitalists, of course, look for limited partners to fund startups. Those LPs are largely institutional investors who can choose not only VC deals, but a wide range of investments with shorter-term and/or more liquid exit options, like stocks, money market funds and U.S. Treasury bonds. And over the past couple of years, those less risky, more liquid investments have been providing good returns — making them an attractive alternative to locking up money for five or more years in a VC investment.



In 2021, 90 tech companies went public — compared to just five in 2022 and 2023, and five in 2024 year-to-date.

Adding to the problem is the inability to monetize existing deals. Says Renta: "Every year there should be a harvest of monies that were put into tech companies five, or eight or 10 years earlier. But in the last two years, we have not been able to harvest those vintages through the IPO market." In 2021, 90 tech companies went public — compared to just five in 2022 and 2023 combined. So far this year, there have been just five tech IPOs: Astera Labs, Reddit, Ibotta, Rubrik and Silvaco, with four to five more expected this summer. "LPs have not been able to replenish investments and redeploy capital," she says. "Some of those were investors who first came into the tech world during that record 2021 year, when they felt there was nowhere else to invest their money."

Those first-time investors are part of a confluence of events that led us to where we are today, she says. In 2020 and 2021 the venture capital market was flooded with those new investors who often were not the typical venture LPs — and that excess capital drove up valuations. "Then those new investors were spooked by a couple of things: the rapid rise in interest rates and the inability to cash out, with valuations plunging and the IPO market shut," Renta says. "Now with rates well above zero and attractive and more liquid investment alternatives, we are unlikely to see these investors return to venture at least for the remainder of this cycle."

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Key takeaways

- Valuations have come down dramatically from the peak numbers of 2020 and 2021, making late-stage capital difficult to come by.
- With the IPO market effectively frozen, limited partners have not been able to replenish investments and redeploy capital.
- The tech marketplace needed a reset — too many ill-considered startups were funded in the flush of money during 2020 and 2021.

In September 2023, market watchers expected that the Klaviyo and Instacart public debuts would lead a reopening of the tech IPO market. Instead, Renta says, "It was a false start, with disappointing results. So we remain in this vicious cycle, albeit now it is driven by the supply side versus the demand side. There is a standstill in the equity markets: While there is a backlog of strong tech companies qualified to go public and good public market investor appetite, these stronger tech companies don't want to go public right now. Those companies are staying on the sidelines because of lackluster recent IPOs, and also the overall market worries due to uncertainty about inflation, the outlook for interest rates, elevated geopolitical tensions and the upcoming elections. The public company scrutiny and valuation volatility is just not worth it."

For tech companies, she says there is little relief in sight by way of the IPO market for the remainder of 2024 with respect to IPO volumes. LPs looking to replenish and redeploy capital will be limited, and in turn VC fundraising and startups (particularly late-stage) looking to raise fresh capital will continue to be challenged for 2024.

Of course, there is always an exception: A select slice of tech companies — artificial intelligence-related companies — are the hottest commodities in the business world. And there still is strong investor interest in seeding these businesses.

For tech companies, Renta says, it translates to a metaphorical tale of two cities. "If you're working in AI, you've got no issues — all the money is going to you," she says. "If you're not, though, it's harder to raise capital."

Today's exit options

Despite the unfortunate sequence of events, tech companies still need cash — and VC partners are eager to monetize investments. What do the possible exit options look like for the near term? Not particularly attractive, Renta says. "At some point the dam has to break," she says. "But if the IPO market floodgates don't open, bid/ask spreads will continue to compress further, and a flood of M&A activity will occur — which we have already started to see — along with bankruptcies or closures of tech firms. I think we will start seeing some cracks in 2024. How much further can tech companies cut? How many more dollars will VC funds be willing to use to fund single-digit and low double-digit late-stage growth companies that are still burning cash?"

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But tech companies are hesitant to go public now because current valuations have come down dramatically — often 30% to 40% — from the peak numbers of 2020 and 2021. According to PitchBook, the median exit valuation for startups that went public in 2023 declined by nearly half, the lowest number in a decade. Witness Reddit, which launched its IPO on March 21. Its IPO price translated to a valuation of about $6.5 billion, dramatically lower than the $10 billion private market valuation of the company in 2021. But 19-year-old Reddit went public anyway, giving founders and employees, many of them early-stage employees, an opportunity to cash in on years of work.

Reddit went public the day after Astera Labs, which provides semiconductor-based connectivity for cloud and artificial intelligence infrastructure. Astera at least initially benefited from investors' seemingly endless current appetite for any company involved in AI, particularly those related to chip supply.

In the wake of the disappointing tech IPOs in the fall of 2023, everyone is watching to see how the Reddit, Ibotta, Rubrik and Silvaco IPOs in particular fare, for signs that the market is receptive enough for other eager tech companies to go public. Ibotta is a particularly noteworthy barometer, because its IPO proceeds included primary proceeds; other tech companies and investors will want to keep an eye on its performance over the next couple of weeks. And that, in turn, will determine what is going to happen in the VC market over the rest of the year.

"We know that the presidential election will be a damper on activity in the second half of the year, but the response to Reddit and Ibotta will determine if there will be a dribble or a drought in terms of additional IPO activity for 2024," Renta says.

In either case, the 2024 window for IPOs is narrow. “Uncertainty dislocates the markets — and the big looming event is the U.S. presidential election,” she says. Activity will slow down before the presidential campaign begins in earnest, typically around Labor Day, while the markets wait for election results. “But in addition to that, the prevailing wisdom since last year has been that inflation will drop in 2024 — and rates along with it. Clearly, that is all in question once again,” she says. Bank of America economists recently revised its predictions from three cuts to the federal funds rate starting in the summer to just one, likely at the end of 2024.

The big picture

Looking beyond the tech investor markets, macroeconomic conditions remain strong. “Many economists, businesspeople and investors were expecting a recession at this time, but that has not happened — thanks largely to the robust job market and strong consumer spending, which both have proved extremely resilient,” Renta says.

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U.S. GDP during the fourth quarter of 2024 grew 1.6%, with the largest contributor being personal consumption. The unemployment rate has been hovering near the lowest numbers since World War II, at 4.1%, and that tight labor market has contributed to solid wage increases for many Americans, albeit with some signs of labor market softening in the June numbers. Despite persistent inflation in certain categories, consumer spending remains strong.

Still, Renta thinks the potential for inflation to reaccelerate is the most underestimated risk in the U.S. economy. “Usually when you are getting inflation under control, it’s because you have squashed consumer demand, the unemployment rate has increased and demand has decreased,” she says. “But this time around has been different. A lot of the inflation we saw in 2020–22 happened as a byproduct of the pandemic — because consumers couldn’t get goods they wanted.”

She says most of the deflationary activity has been supply-chain-related, as bottlenecks and other pandemic issues waned. “But if there’s a supply chain issue — like a blockade in the Red Sea or Suez Canal — inflation could spike again,” she says. “That’s what bothers me; it can happen very quickly. We feel that we’ve got inflation under control, but the situation is more vulnerable than the market factors in.”

Looking forward

Given all this, what is the capital-raising outlook for the rest of 2024 and into 2025?

Renta expects that late-stage capital will continue to be difficult to come by. Investors — hedge funds and hybrid VC/PE investors — have pulled back, continuing the trend of 2023, when VC deals with private equity investors accounted for just a third of all capital investments. U.S. VC fundraising totaled $53 billion in 2023, down nearly two-thirds from the record totals raised in 2021 and 2022.

The IPO market will also be subdued. “While the equity capital markets are strong, tech IPO volume in 2024 will be disappointing,” Renta says. “Once again we will kick the can to the following year. Now it’s 2025 when we hope activity will pick up.”

Her big-picture perspective, though hard for some individual companies to swallow, is that the tech marketplace needed a reset — that too many ill-considered startups were funded in the flush of money during 2020 and 2021, and a correction or cleanup of the market will be good for the long-term health of the innovation economy.

“For a tech company, especially a startup, the mission has changed from just a few years ago. First it was: Grow your top line, boost revenue — who cares how much it costs? Then two years ago, very abruptly we switched to a very different message: Cut costs, even if it takes down your revenue,” she says.

“Today’s message is that you’ve got to spend more but responsibly; growth matters. You have to invest in the company — those who cut back too far are finding it especially difficult to attract investors,” she says. “It’s time to invest, not like the reckless sailors we were in 2020 and 2021, but investing to grow the business and to demonstrate your company’s unique positioning and competitive advantage in the marketplace.”

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