VALUE FOCUS
Venture Capital

Year-End 2015

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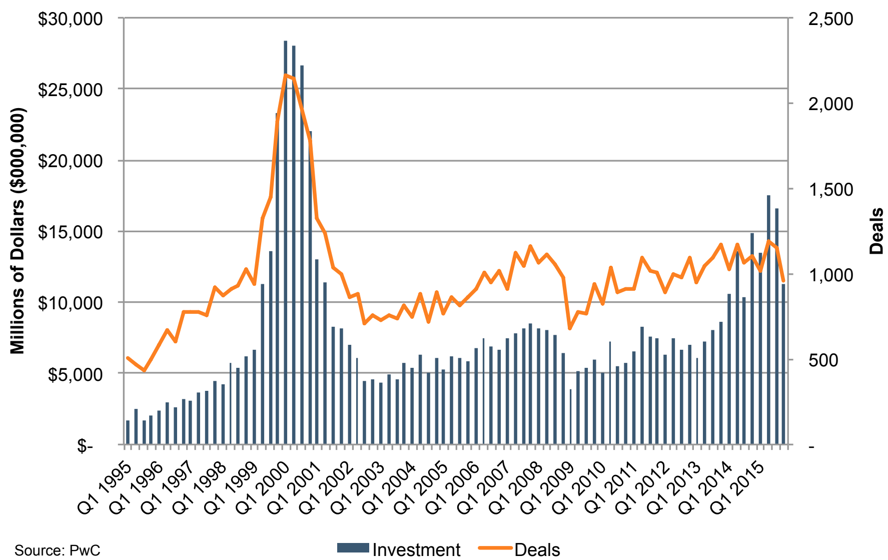
Year-End Market Perspective

Venture Capital Overview

The second half of 2015 has seen a cooling in the venture capital industry, as rising valuations and an increase in investments in the first half of the year gave rise to **concerns over the sustainability** of the market. Whether the industry is in a bubble remains a hotly contested topic, but there is no denying that the backside of 2015 witnessed a correction. Round counts fell 25.8% from the first half of the year to the second half and **were down nearly 14%** from year-end 2014 to year-end 2015. However, the amount of capital invested in the industry continues to grow. Venture financings at year-end 2015 topped out at a staggering $77.3 billion, more than twice the amount of capital seen pre-recession.

The median pre-money valuation at year-end 2015 rose from $44.7 million in 2014 to $59.9 million, even as volatility in the global economy increased and several tech companies, once the golden children of the venture capital industry, **struggled to maintain their private valuations** in the public market. In response, year-end 2015 was marked by growing **investor wariness**, forcing many companies to take a hard look at their expenses and put a brake on their burn rates. Investor exuberance (or at least acquiescence) has come to a halt as the industry prepares for the possibility of a correction to the market that will drive the overly-optimistic valuations common at cycle peaks back to more normal historical levels.

Venture Capital Overview



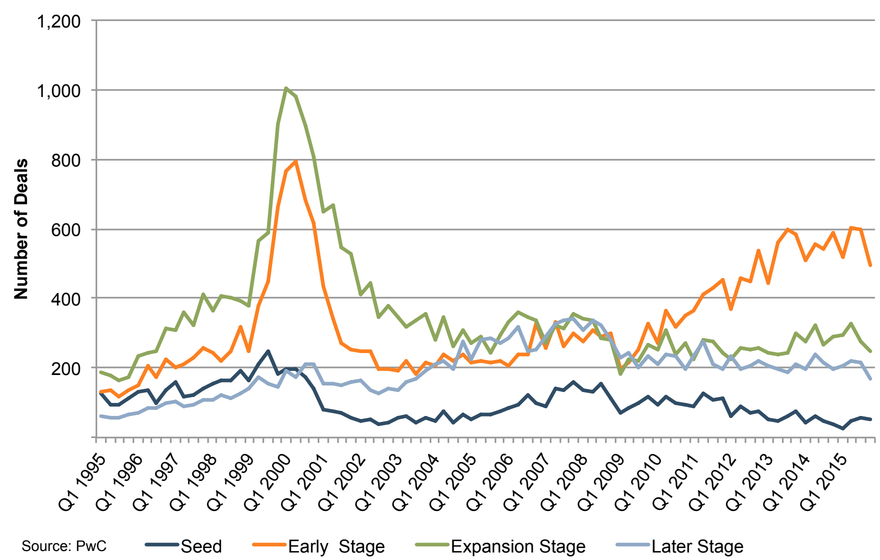
Source: PwC

Venture Capital Activity by Stage & Quarter

During the five years leading up to 2015, the **number of rounds closed** at the angel/seed stage increased at a 22% compound annual growth rate ("CAGR"), far outpacing the 3% and 1% CAGRs in the early-stage and late-stage rounds, respectively. The explosion in the number of seed and angel investments has led to increased competition for investments among the early and expansion rounds, driving down numbers and increasing time between rounds, even while total capital invested remained strong. However, in the second half of 2015, seed and early-stage rounds have seen a precipitous drop in round count and size. As discussed in the following section on seed activity, **investors have become wary** in light of liquidity concerns and market volatility, choosing to throw their money behind safer bets and stronger financial performance. In a flight from risk, investors have shifted towards late-stage financings.

With a proven track record and a greater ability to survive an economic downturn, late-stage financings are a safer bet in a volatile market. Year-end 2015 managed to close out with $44.9 billion in capital invested in the late stage, even as the 321 **deals recorded in the fourth quarter** was well below the 403 deals in the third quarter. Late-stage rounds saw the most capital invested in over a decade due both to concerns in the market, and an increase in the number of nontraditional investors entering the venture capital arena. Venture capital has seen a huge increase in investment from both mutual funds and hedge funds in 2015, driving the current flock to value as economic volatility increased. In 2015, 80% of all capital invested in the late stage was in deals of over $25 million.

Venture Capital Activity By Stage and Quarter

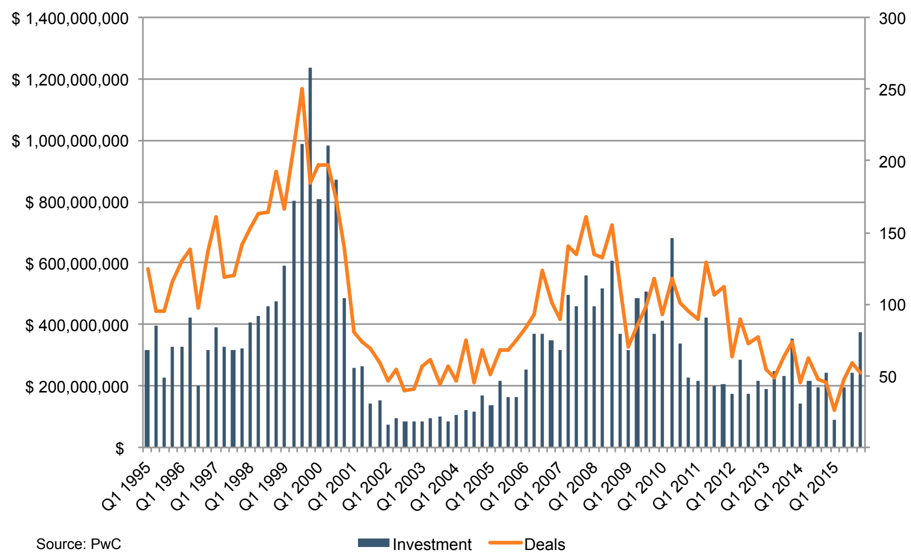


Source: PwC

Seed Activity

Since 2010, the median pre-money valuation of a seed round increased from $3.2 million to $5.5 million, with round sizes more than doubling over the same period. The **steady growth in seed rounds** is attributable to several factors, including the institutionalization of seed investing, an abundance of dry powder, and the growth of angel networks that have reduced input and startup costs. However, as discussed above, the second half of 2015 has seen a downturn in counts that indicates a softening of investor over-confidence. Seed activity fell 32% from the first to the second half of 2015, while capital invested fell from $4.3 billion to $3.2 billion over the same period. In 2014, capital invested totaled $6.2 billion, indicating that the current decline in capital and rounds may be more of a **return to historical norms**, rather than a bottoming out of the market.

Seed Trends



Source: PwC

Exits Overview

Market Imbalance Drives Down IPOs

As 2015 unfolded, so did a growing imbalance between the public and the private markets. With interest running high in the "alternative asset space" and cheap debt for LBOs, the costs of going public made the process not particularly worthwhile. In contrast, a glut of capital in late-stage funding rounds led to an increasing preference for private capital markets. Year-end 2015 topped a five year funding high at $74.2 billion across 4,890 deals, reflecting a 26% year-over-year increase in funding, and a 10% decrease in deals. The third quarter alone saw **IPO activity fall** 34% year-over-year, while the median capital raised in private fundraising rounds hit a staggering $92 million.

In a ***RIA Valuation Insights*** blog **post** back in November, we discussed the potential implications of the rising valuations and their impact on the public market – most notably, the high potential for a rapid devaluation of late finance rounds. Several high profile, third quarter IPOs **fell short of the private valuations**, leading to a correction in the fourth quarter of 2015, as IPOs fell 22% from the third quarter. The number of IPOs that placed below range, on the other hand, **increased from 27%** in the third quarter of 2015 to 60% in the fourth quarter. According to Pitchbook, investor wariness has led to an increase in risk premiums in both the public and the private market, leaving late-stage startups hard pressed to find the cash injections necessary to achieve growth. Compensatory provisions similar to those found in the Square pre-IPO rounds are expected to **become more frequent** as companies in need of funds may be forced into softer debuts, with deleterious effects on investor returns.

The IPO market is also seeing increasing competition from M&A activity, as M&A deals continue to inflate in value while IPO pricings have consistently fallen short of expectations. Through November 2015, there were **over 10,000 announced M&A deals** in the United States with a total deal value over $2 trillion, 679 of which included corporate acquisitions of VC-backed companies, for a total of $68.2 billion. Companies contemplating going public have taken to a two-pronged approach, in which they shop for potential buyers while simultaneously preparing for an IPO. With investors wary of inflated IPO values, M&A has become a more promising exit strategy for venture companies, and the trend is expected to continue into 2016.

Firm Focus

SEQUOIA

Similar to our **mid-year 2015 newsletter**, our firm focus is centered on a collection of 15 of the largest, most active venture capital firms involved in high profile deals across the United States. Most notably, our group of firms underwent a significant decline in the number of investments from year-end 2014 to year-end 2015, while the sum of capital invested remained fairly stable. As discussed above, investor wariness has led firms to cut back on early stage funding, and led many firms to struggle with maintaining private valuations in the public market. In light of investor wariness in the United States, one firm, **Sequoia Capital**, has seen momentum in an unexpected place – India.

Sequoia Capital is a multistage investor that invests in seed stage, early stage, and growth stage investments. The company **focuses on startups** within the energy, enterprise, financial, health care, internet and mobile sectors, with the greatest number of investments in mobile, e-commerce, and enterprise software. Although the company sticks to the United States for seed and early-stage investments, Sequoia Capital does **not limit itself by location** in growth-stage investments, with investments throughout China, India, Israel and Europe.

Founded in 1972, Sequoia Capital has a history of being first. The company strives to be the first investor and business partner in growth companies, as Sequoia Capital operates on a competitive philosophy that often puts them at the inception of a firm. With a track record of early investments that includes WhatsApp, Instagram, YouTube and PayPal, the company has a knack for spotting big winners in the tech field early and often. Sequoia Capital made as much as **50 times its money** when Facebook purchased WhatsApp in February 2014 for $16 billion.

Sequoia Capital has been in the Indian market for nearly ten years now and hopes to make some of the same returns in India as in the United States, pouring over $1.4 billion in Indian startups since they first arrived. In 2015 alone, Sequoia Capital distinguished itself as the most prolific investor in India's venture scene, with **33 startups** in mostly the consumer and health care sectors. However, with technology known to be the Sequoia Capital's sweet spot and India poised to become one of the largest mobile/internet user bases in the world, it looks as though the company has spotted yet another early winner. How the world economy and India's venture scene will pan out in the years to come is yet to be determined, but if Sequoia Capital's past track record says anything, the company is poised to do well.

Regulation on the Horizon

This article, by **Karolina Calhoun, CPA/ABV**, originally appeared on Mercer Capital's **Financial Reporting Blog**.

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The **International Private Equity and Venture Capital Valuation (IPEV) Guidelines** were developed in 2005 to set out recommendations on best practices in the valuation of private equity investments. The IPEV Board is made up of leading industry associations from around the world, including the **National Venture Capital Association (NVCA)** and the **Private Equity Growth Capital Council (PEGCC)** in the United States. **In October 2015**, the IPEV Board published draft amendments to the existing guidelines. After a period of comments and revisions, the guidelines were approved and will go into effect at the beginning of 2016.

The IPEV Valuation Guidelines are intended to be applicable across a range of private equity funds, defined in a broad fashion to encompass seed and start-up venture capital, buyouts, growth/development capital, mezzanine debt, and other types of private investment vehicles. While US GAAP and IFRS financial reporting guidelines do not require that the IPEV Guidelines be followed, the IPEV Guidelines were created with the compliance requirements and implications of these standards in mind.

The stated objective of the IPEV Valuation Guidelines is to set out best practices where private equity investments are reported at "Fair Value" to help investors make better economic decisions. The guidelines are concerned with valuation from a conceptual, practical, and investor reporting standpoint and do not seek to address best practice as it relates to internal processes, controls/procedures, governance, committee oversight, or the experience/capabilities required of the valuation professional.

The **proposed amendments** to the IPEV Guidelines include edits to improve readability and clarity of understanding, as well as technical edits. The technical edits include the following:

1. Update on IASB Unit of Account Progress to conform with international standards.
2. Additional guidance emphasizing that fair value estimates (1) should be developed independently for each reporting entity (or fund) and (2) should be estimated using consistent valuation techniques.
3. Modification of guidelines for the valuation of debt for purposes of determining the value of equity, including the treatment of prepayment penalties in the calculation of the fair value of debt.
4. New guidelines to describe back-testing, including assessing what information was known as of the Measurement Date and whether known information was included in the Fair Value assessment.
5. New guidelines aimed at clarifying certain valuation techniques, including the use of Market Approaches (Price of Recent Investment, Multiples, Industry Valuation Benchmarks, or Available Market Prices), Income Approaches (Discounted Cash Flows), and Replacement Cost Approach (Net Asset Value).
6. Discussion of certain special considerations, including non-control minority positions, guidance on mathematical models, and guidance on the sum-of-the-parts method.

With increasing activity and interest from investors, valuation guidance for private equity and venture capital investments continues to become more clearly defined. For more information on the guidelines, please refer to the **International Private Equity and Venture Capital Valuation Guidelines, Edition December 2015 DRAFT**.

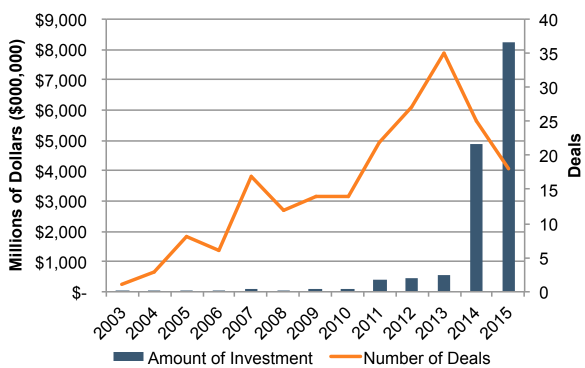
Sector Focus

Travel Tech

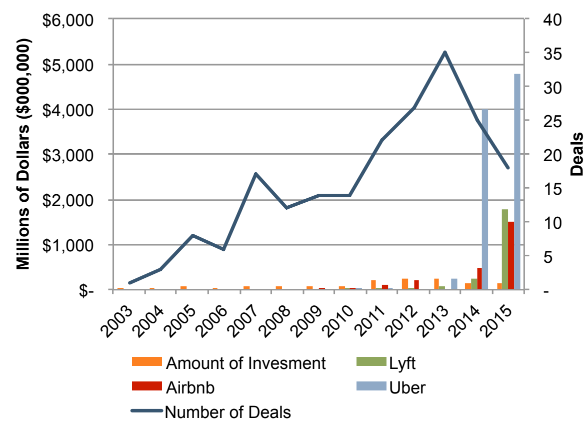
In the venture capital space, travel tech is on the move. The second half of 2015 was marked by a staggering amount of capital flowing into companies that offer app-based lodging and travel services. Over the past five years, the uptick in activity in the travel tech space has been attributed to a growing dependence on the ease and flexibility of mobile devices to plan and schedule travel. What was once a fairly predictable industry dominated by well-established incumbents that demanded consumers plan well ahead or pay the price, is rapidly transforming into one in which consumers can expect immediate results at competitive prices. For example, companies such as **Hotel Tonight** provides customers with last minute deals for unoccupied rooms, while ride-hailing apps like **Uber** and **Lyft** offer competitive fares at the click of a button.

In line with the venture capital industry as a whole, the number of deals in the travel tech space has fallen in 2015. However, the amount of capital has continued to rise, with companies such as Airbnb completing a $1.5 billion round in June of 2015 that valued the company at $25.5 billion. According to **VC Experts**, well over three-quarters of the dollars invested in the travel tech industry were attributed to Airbnb, Uber, and Lyft. In the last two years, Uber has seen rounds topping out at $2.1 billion and $2.8 billion, respectively, dwarfing the other companies in the industry. As shown in the charts below, the surge in investments in 2014 and 2015 are primarily attributable to Uber, Lyft and Airbnb. When removed, the sector's performance is much more conservative.

Travel Investments by Year



Source: VC Experts



Source: VC Experts

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Venture Capital Services

Mercer Capital provides business valuation and financial advisory services to venture capital firms and other financial sponsors.

Our financial advisory services to the venture community include:

- Portfolio Valuation
- Solvency Opinions
- Fairness Opinions
- Purchase Price Allocations
- Goodwill Impairment
- Equity Compensation (409a)
- Personal Goodwill Valuation
- Dispute Resolution
- Buy-Sell Agreement Valuation
- Carried Interest Valuation

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