Approaching the private capital markets: reviewing recent activity and looking ahead

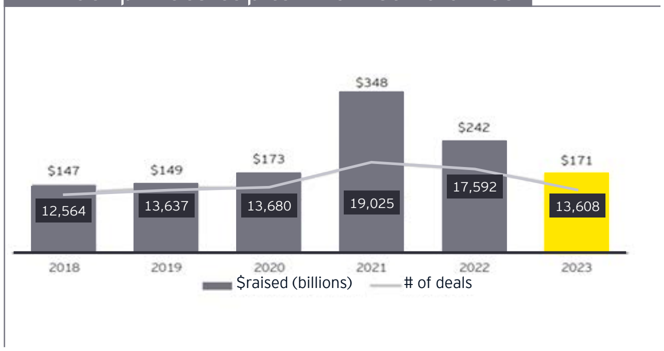
Building a better working world

As we reflect on the recent challenges in the capital markets generally, it is critical to assess the factors and trends driving lower levels of private capital deployment to understand how these dynamics can impact private companies in 2024 and beyond. While some recent transaction activity, trends and macroeconomic conditions provide some optimism, it is important for companies to objectively consider the current state of their operations and the reality of today's private capital markets as they contemplate their strategic alternatives going forward.

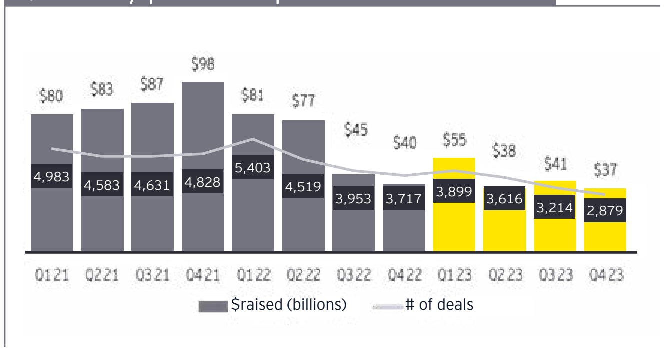
The capital raising environment has been challenging

Aside from 2021 and early 2022, recent years have been less-than-hospitable for private companies raising capital.

Annual private capital market volumes



Quarterly private capital market volumes



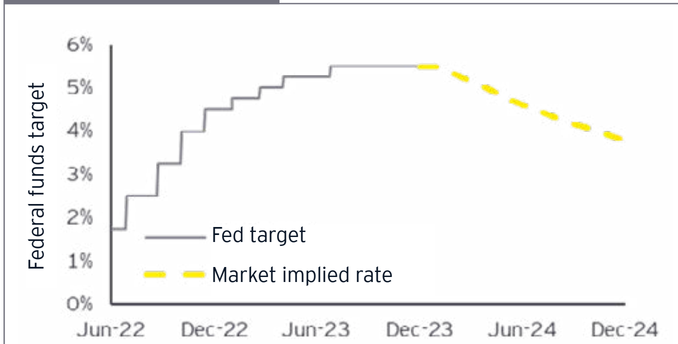
Source: Pitchbook

We saw an uptick in activity levels in the beginning of 2023 following a few subdued quarters. But, the optimism was short-lived as a number of challenges persisted, including (1) increased cost of capital and (2) constrained exit activity, particularly as IPO and M&A activity levels trailed historical averages considerably.

01
Increased cost of capital

The 2023 calendar year was a tale of two halves in terms of Federal Reserve (the Fed) policy and the resulting effects on cost of capital. The year began with the Fed continuing to tackle troubling inflation readings, culminating in a series of interest rate hikes that pushed the benchmark rate to a 20-year high of 5.6% by September 2023. This had significant ripple effects throughout the entirety of financial markets, but particularly for high-growth private companies. As rates moved up, discounting future cash flows had a greater impact on valuations for companies with profit projections focused further into the future.

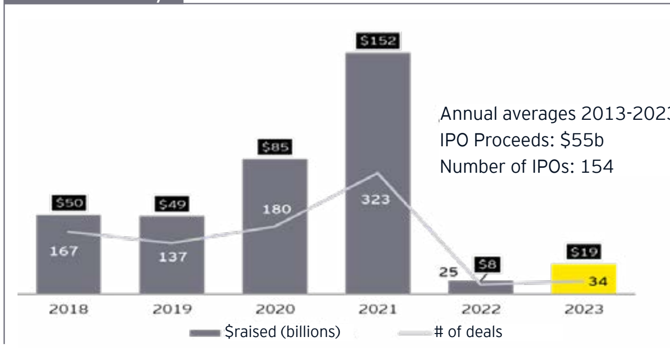
Federal funds rate



02
Constrained exit activity

Private capital deployment in 2023 was also significantly impacted by the inability of private equity and venture capital firms to monetize portfolio companies in the public markets and through M&A, which has in turn impacted their ability to raise new funds from limited partner investors. After hitting lows in 2022 not seen since the financial crisis, IPO activity rebounded modestly in 2023. However, IPO deal volume in 2023 was still more than 75% below the 10-year average. M&A volumes were also constrained in 2022 and 2023, dropping by 24% and 36%, respectively, from 2021 levels, according to Pitchbook.

IPO activity



Source: Bloomberg. Data as of December 31, 2023, except for market implied rate which is as of January 31, 2024.

As 2023 progressed, inflation began to cool as supply chains improved and energy prices eased. This shift prompted the Fed to "pivot" toward a more accommodating stance, ultimately pausing rate hikes by the end of 2023. Although this pause has signaled potential rate cuts ahead, some market observers have warned of a "higher-for-longer" rate environment, particularly as some recent inflation readings have come in hotter than expected, which has continued to negatively impact capital formation in the private capital markets.

These dynamics have contributed to significantly longer and slower recycling of capital trends, resulting in diminished capacity for investments in private companies. But perhaps even more noteworthy than the reduced activity levels in recent periods was the growth in and prevalence of (1) insider-led rounds and (2) "down" rounds.

Recent transaction dynamics have constrained private company fundraising activity

01
More insider-led rounds

The tightening economic climate in 2023 made fresh, external capital elusive, pushing private companies toward support from existing investors. According to Pitchbook, nearly 13% of capital raised came from insiders in 2023, the highest level in over a decade. Viewed optimistically this trend could be attributed to existing investors doubling down on promising portfolio companies, but more typically this is seen as a "temporary fix" to allow companies to "live another day" when investors would ordinarily be inclined to diversify their holdings and invest in new opportunities.

02
More down rounds

Consistent with the turbulent market dynamics that emerged in 2022, last year saw a persistently wide disconnect between private company valuation expectations and investors' view of fundamental value. According to Pitchbook, down rounds increased from roughly 8% in 2022 to 20% in 2023. Many companies were forced to extend their cash runway through a combination of workforce reductions and non-equity financings, which could signal even more down rounds and dilution in the future.

Outlook: significant opportunities and challenges for private companies

In today's rapidly evolving capital markets, companies are continually presented with new opportunities and challenges that require thoughtful, ongoing strategic evaluation. We recognize that the realities of funding needs often necessitate accepting "less-than-ideal" terms and conditions, and striking a deal requires compromise. With that in mind, we recommend that companies considering the private markets should focus on:

01 **Profitability:** Crisp messaging around the development of an attractive margin structure and a credible path to profitability is imperative.

02 **Use of proceeds:** Develop a well-thought-out plan regarding how you will utilize the new money as today's investors want to underwrite growth much more than liquidity.

03 **Structure:** Keep financing terms as plain as possible; later stage investors are often reluctant to engage in complex capital stacks and strive to avoid serving as the impetus for a capital structure reset.

04 **Sizing:** Carefully weigh impact of the capital raised; it is always important to avoid unnecessary dilution, but the "perpetual" capital raise treadmill can be even more damaging in the longer term.

05 **Investors:** Thoughtfully consider strategic investors that could make sense for your round as they may be more valuable to the business or constructive on valuation than financial investors. Engaging with strategic investors can unlock new opportunities for the business and add sector connectivity, in addition to satisfying capital needs. But, the timeline for these investors can be particularly elongated so companies would be well advised to start early.

Despite the prevailing headwinds in the private markets, there are some valid reasons for optimism as we look forward. There is heightened enthusiasm in the market for companies developing disruptive products and service offerings across sectors like AI, biotech, cybersecurity and ClimateTech, but other well-run companies with strong growth prospects outside of these sectors are also getting traction from investors. Companies have been operating under leaner budgets, the talent pool has become more accessible for promising companies, the interest rate environment is expected to improve, and there are green shoots in the IPO and M&A markets that could kick-start the funding flywheel. If the prior successes of today's market leaders are seen as a guide, pressure can brew creativity and foster innovation, and difficult times can catalyze the next industry champions.

Please reach out to our EY FAAS Americas IPO, SPAC and Private Advisory team if a conversation about the private capital markets or process would be helpful.

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