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#VCs and #startups are dealing with the reality that today's environment is brutal compared to what it's been like over the past few years.

The reason for the abrupt shift is that Darwin went on vacation for a few years but has finally returned.

This changes EVERYTHING! 🧵 👇

It's undeniable that the VC and startups ecosystems feel different in 2022 than they did in 2020 and 2021.

For years, money was flowing freely from LPs to VCs and from VCs to startups. Many startups went public or were sold and the returned liquidity added fuel to the fire.

But today's markets aren't behaving like they did in recent years.

Worsening macro conditions short circuited a long bull run and Investors are shifting from risk-on to risk-off mode. Public stocks adjusted first but the ripple effect is starting to impact the private markets.

What follows is a narrative about the Acceleration Phase (2020 + 2021), the Correction Phase (2022) and the New Normal Phase (Now and Beyond) in the private markets.

The narrative focuses on the three main participants: Startups, VCs and LPs.

And the narrative is dizzying.

Acceleration Phase (2020 + 2021)

VCs deployed capital at a breakneck pace and raised bigger and bigger funds to feed their machines.

VCs found it easy to raise from LPs because they were flush with capital given the performance of the markets for more than a decade.

Capital was cheap and abundant which led to a universal “grow as fast as you can” mentality.

Founders and Boards suffered from mono-variable-itis.

All they cared about was top line growth which led to “bigger and faster” at the expense of “capital efficient and sustainable”.

Outcomes were multiples of historical norms which changed the calculus of investing. This “truth” rippled from late to early stage quickly.

Valuations collapsed to simple division. A startup would want $X and was willing to accept dilution of Y% which implied a valuation of X/Y.

Since Founders only give up when they run out of cash, the abundant capital had a second order effect of preventing failures and fueling good, marginal and bad businesses alike.

As long as a business found a way to grow it was able to attract funding.

VCs were underwriting to the false signal of the next round being an up round vs. the de-risking of a startup’s business model.

Back-to-back rounds were happening at increased valuations and increased speed with very little having been proven in-between.

And it was working.

The number and size of IPOs eclipsed anything seen in recent history.

Acquisitions happened at multiples that defied gravity.

And half-baked businesses SPACed to ensure that Founders and Investors didn’t miss out on the gravy train.

Darwin was on vacation.

The Correction Phase (2022)

The first half of 2022 was marred by a worsening macro environment.

Inflation concerns drove aggressive tightening by the Fed and the effects of the Russia/Ukraine war were felt globally.

The economy struggled and the S&P 500 was down 20%+.

In the public markets, the darlings of the past few years were in complete free fall.

High growth tech stocks were down more than 50% and many as much as 85%.

Recent IPOs suffered the same fate and companies that SPACed performed even worse.

The days of cheap and abundant money were gone.

The days of unprofitable high growth tech stocks being well received by the public markets were gone.

The days of all asset allocation strategies producing solid returns were gone.

Darwin had returned from vacation.

The impact in the private markets was sudden and dramatic. There was plenty of dry powder in the system but much of it was frozen.

Exit valuations were no longer solely based on revenue. Most startups were overvalued and misconfigured to be attractive in this new environment.

Investors quickly modified the formulas that governed what a company was "worth". Capital efficiency and profitability were suddenly very important.

With capital availability no longer a certainty, Founders had no choice but to refactor how their businesses were configured.

It was as-if a global playbook had been issued to the entire startup ecosystem that consisted of RIFs to lower burn, reduced marketing spend and growth rates to improve paybacks, and holistic operating plans that made current cash last twice as long.

VCs ranked their companies and prioritized follow-ons in their "great" companies to prevent them from being in-market anytime soon.

Raising in 2022 was considered a fool's errand and raising in 2023 was to be avoided. Insider-led rounds made this possible.

Insider rounds went from being a historical signal of weakness to a real signal of strength.

Flat rounds and extensions went from the exception to the rule.

Convertible notes became a popular way to avoid pricing companies.

And structure started returning to term sheets.

But some startups had to raise from new investors in 2022.

They were companies that couldn't find ways to make their cash last much longer AND weren't in the top 25% of their existing Investors' portfolios.

The result was a tangible reduction in quality for in-market deals.

VCs reacted accordingly and slowed their pace of investing.

Funding in Q3 2022 was $81B, down over 50% from Q3 2021 and Q4 could be worse.

This dramatic pullback was market driven but also a second order effect of the LP community dealing with "The Denominator Effect".

The Denominator Effect occurs when the value of one portion of a LP's portfolio decreases drastically and pulls down its overall value.

Definitionally, any segments which did not decrease in value at the same rate end up representing a larger percent of the overall pie.

LPs develop strategies that bucket investment opportunities into asset classes and then allocate a certain percentage of their portfolio to each bucket.

The historical and projected performance of each asset class impacts allocations but balance matters to LPs more.

With public equities down massively in 2022, LPs definitionally have less money to deploy and they need to re-balance their portfolios.

This will come by reducing VC exposure which in turn will directly impact the startup ecosystem.

Which brings us to today:

The New Normal Phase (Now and Beyond)

Since the VC asset class is illiquid, LPs can only reduce exposure through new allocation decisions.

Rationalizing which VCs to shed will be painful but necessary for LPs in 2023 because there's more demand from VCs than supply from LPs.

The Cambrian explosion of new VCs in recent years was fueled by a relaxing of LPs' historical criteria but LPs are returning to their roots given the uncertain environment.

The truth is that Darwin favors results over promises and newer VCs might struggle to raise capital.

Darwin favors VC firms with differentiated strategies, long histories of realized top quartile returns and experienced investors who have worked together through cycles.

Darwin makes survival difficult for VC firms with generic strategies, unrealized returns or unproven teams.

If step one of Darwin undoing the damage created while he was on vacation is to preferentially make new capital available to proven VCs, step two is for VCs to internalize that their dry powder is a precious commodity.

VCs are in the business of investing capital, but given the “New Normal”, VCs will aim to deploy their dry powder very thoughtfully.

The bar will be raised on the quality and progress of startups being funded. VCs will value results more and narrative less. Proof will matter.

Step three of Darwin’s return is for Founders to internalize that how startups were built in the recent bull market has to be contextualized.

Simply put, the fundamentals of how to fund, build and scale startups efficiently needs to be relearned.

Disciplined Founders will procure and allocate assets efficiently.

Disciplined Founders will maximize learnings and scale costs carefully.

Disciplined Founders will be ambitious while de-risking their businesses in stages.

Disciplined Founders will thrive in this new world.

The final step of Darwin’s return is for marginal businesses to be starved of capital.

Without new capital, marginal businesses will have to improve their current operating plans (if they can), sell to a bigger player (if they can), or shut their doors for good.

The New Normal should prove to be a perfectly good environment for LPs, VCs and Startups to thrive as long as they acquire the taste for disciplined investing behaviors.

But not everyone will learn to acquire the taste which will force Natural Selection to do what it does best.

I hope you've found this thread informative and interesting.

If so, a like and a re-tweet of the initial post in the thread would be appreciated!


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