END OF AN ERA

Eckuity's Take on the State of the VC Market

March 2023

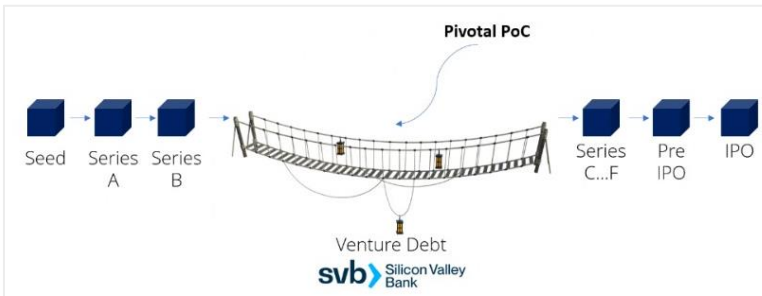
We believe that the venture capital industry that funds technology and healthcare companies has fundamentally shifted over the past few weeks. Going forward, the funding criteria will emphasize commercial viability and efficient capital utilization, i.e., efficiency will trump size.

"*We are* _lending_ *at 5x revenue because the VCs are valuing the company much higher than that*."

- Actual quote from a former SVB employee who worked in their lending department.

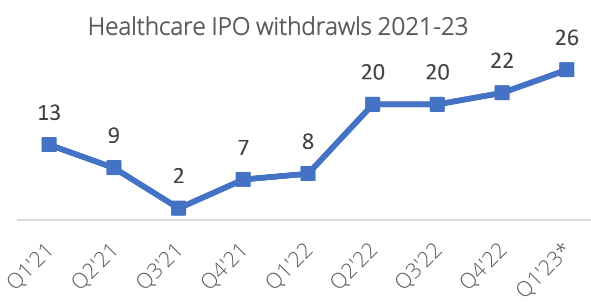
One of the fundamental shifts that we will see in the near-to-medium term is back-to-basics valuation based on profitability and earnings.

We don't think venture investors have fully grasped the gravity of the SVB situation.



It is quite evident that as the biggest lender and the most significant bank for venture funded companies and for the VCs themselves, the demise of SVB will have a profound impact on the VC ecosystem. But even beyond that, with the 2022 downturn, while the VC-backed companies were already facing a tough funding environment, many were still able to keep themselves oxygenated with a SVB backstop as they worked through their critical proof-of-concept milestones before the long-only and crossover investors participated in the last pre-IPO financing round.

With the collapse of that funding bridge, it will be very difficult for many companies to cross this "concept-to-proof" bridge, especially if their business is money losing and relies on inorganic growth through acquisitions. It has been quite commonplace to show 50-60% of total revenue growth coming from ever-increasing customer acquisition cost (CAC) financing, because "*who cares about EBITDA*". Those businesses will have a much tougher time surviving beyond 2024.



*As of 3/24/23. Source: SEC EDGAR

And while First Citizens Bank is acquiring all the deposits and loans of SVB, neither that bank nor any other bank will "pick up the slack" from SVB. Firstly, because other banks were not very prolific lenders to early-stage companies anyways, and with the renewed focus on lending and aversion to risk, most of the other banks will rather decrease than increase their current exposure to this asset class. And while the private loans on SVB's books are not mark-to-market, whether they will retain their 100 cents on the dollar is hard to predict. In summary, we will not have another backstop or placeholder to replace SVB in the foreseeable future.

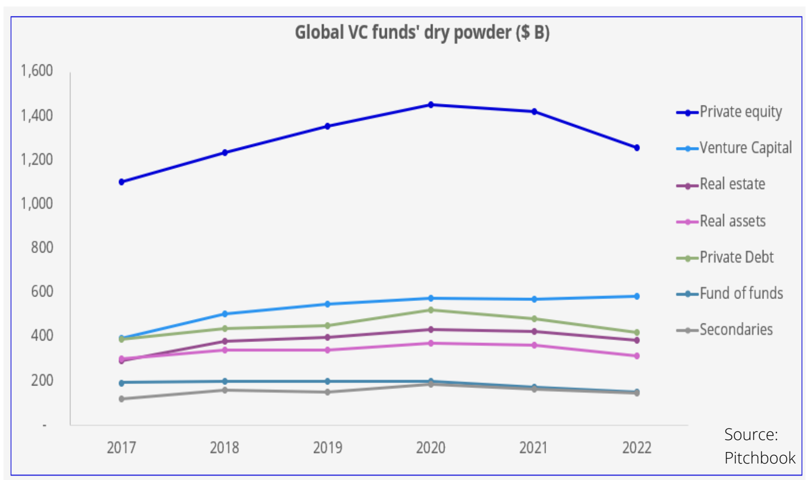
Side Note

While the issues with SVB's shrinking deposit base and concentration in long-dated treasuries is very well documented and analyzed by experts around the world, we should not forget that monoline asset class concentration for any financial institution can have catastrophic impact overnight.

Notwithstanding, sometimes non-monoline is no guarantee for safety, as is reminded by a former highly esteemed Swiss bank's recent collapse; the challenge with monoline is far more acute.

Biotech funding for the deep-pocketed.
Unlike Tech's CAC funding, biotech companies do not have the luxury of inorganic growth through acquisitions, but they still face similar challenges in terms of high funding needs. With the sudden freeze of accessing the public markets, and the new-found wisdom of focus on commercialization by most investors, we believe that for the time-being, many biotech companies will have to rely only on the largest investors in the space. Most other investors will simply be unable to cope up with the intense competition for commercialization and lack of visibility of a potential exit for most biotech companies.

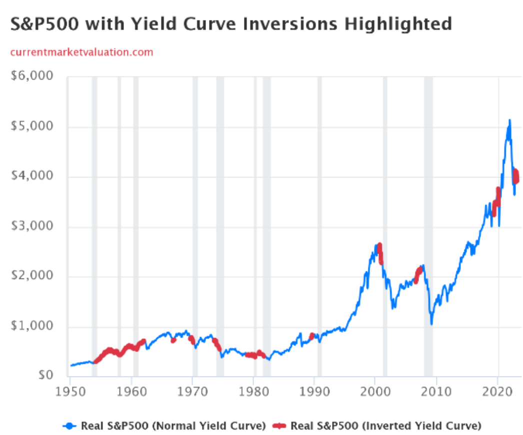
Hope for early-stage companies.
As the capital needs for very early-stage biotech companies is not very large, and the fact that many VCs are still sitting on ample dry powder, smaller capital allocations will continue to be fulfilled. During 2022, valuations noticeably dropped for later-stage companies. However, seed-stage life science companies are not experiencing the same shift. The median seed / Series A pre-money valuation did not significantly decrease in 2022, and actually increased in every sector except biopharma, which was stable. Global venture firms were sitting on $585.5B of capital raised but not allocated as of end of Q3 2022.

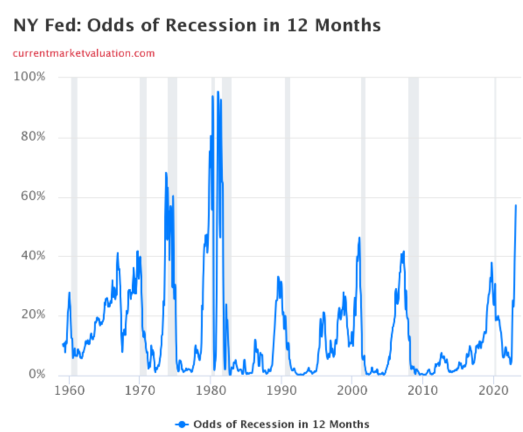


Strong indications that 2023-2024 vintage funds will outperform previous funds.
With the realistic expectations on valuation, we believe that 2023-2024 vintage funds will deploy capital on their own terms as the tables have turned for the proverbial *companies vs. investor dynamic*. The investors now have a significant upper hand (they were already doing better in 2022) and will be able to dictate terms in most term sheets.

The markets will crash and then rebound in the long term for a simple reason – People Forget.
I (Vishal) was fortunate to witness the 2008 crisis up close, but many younger investors had no clue up until 2023. While it is anyone's guess how long the *impending* recession will last, as shown by the graphs below, it is more likely than not that there will be some sort of recession in the near-term. The

below chart illustrates the 10Year – 3Month yield curve spread mapped over S&P500 returns. The data series is the price of the S&P500, with the color of the line highlighted red during periods of yield curve inversion. Clearly, you can see strong correlation where periods of inversion tend to precede stock market devaluations.





Source: US Dept of Treasury and NBER

However, the good news is that despite the banking turmoil and volatile expectations around monetary policy, the markets have held their ground. All this indicates that the level of confidence in the long-term economic outlook is still stable and the investors with a long-term outlook would continue to invest in solid businesses with long-term upside.

We believe that stronger companies with disruptive business model and clear path to commercialization will continue to attract significant capital, and importantly, now at the expense of weaker companies. The delta between the haves and have nots will increase in the near-to-medium term with investors flocking to de-risked, proven technologies.

And then, at some point, investors will forget, as we always do. And we will restart lending at 5x revenue and value companies at 30x revenue. Whether that will happen in 5 years or 10 years is anyone's guess. But until such time, the *venture* part of the VC industry as we know, will no longer conform to its lexicon as venture capitalists will not *risk* as much as they have been used to in the past decade.

The era of investing in unproven bets is gone, for the foreseeable future, and only the truly innovative and commercially minded will survive.