LYTICAL VENTURES

# WHAT TO DO NOW

An Opportunity in Early-Stage Venture Capital in the Current Environment

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The premise of a venture-backable company is that it is going to grow fast and create a lot of value. Investors will indulge paying a seemingly high price for a newish company because the company is expected to grow so quickly that it justifies the price paid today and more.

Appreciating the above, if you read no further, the most important thing to remember is that an economic downturn can create attractive entry points into companies which manifest into long-term value for investors.

Given the current state of the world, punctuated by inflation, rising rates, a public markets correction, and political discord, the mere suggestion of additional investment in venture capital might seem tantamount to asking someone to run into a burning building. However, upon further review of the circumstances, such suggestion might otherwise be regarded as disciplined advantage-taking of others' misperceptions and overreactions.

Of course, recessions can slow the growth of a venture-backed company, causing it to take longer to grow into a coveted value and may even require more capital to get to the same point. Recessions can heighten risk and lower the present value that can and should be assigned to any enterprise, whether in an interim round or ultimately. Similarly, inflation reduces the purchasing power of both a startup and its customers. Lower purchasing power typically constrains the startup's revenue, which, in turn, increases a startup's burn rate and lengthens the path to profitability. So, with inflation, as with recession, a startup may need more capital amid customer uncertainty and related longer sales cycles.

In more exuberant times, startup founders are conditioned to spend any available capital to maximize growth. The faster a startup grows, the greater the access to and the lower the cost of capital. Yet, once a credible hint of a recessionary and/or inflationary period presents, startup founders are often advised by their investors to maximize capital preservation and increase runway until better times. A frugality in noteworthy contrast with founders' earlier conditioning. This advice—or, perhaps, this order, depending on the relationship—brings the added, unavoidable consequence of slowing growth and reducing the startup's value, an ironically self-fulfilling eventuality.

At Lytical Ventures, we contend change creates opportunity. For venture investors with available capital and a propensity to lean in, akin to well-prepared firefighters, an abundance of quality companies, with good products and strong teams, in a protected market, will present themselves.

## How Lytical Ventures is Appraising the Current Environment

- Since World War II, there have been twelve recessions, lasting 10.3 months on average. The 'Great Recession' of 2008, allegedly the perfect storm of recessions, lasted eighteen months. The most recent recession, in February 2020, lasted only two months. Data suggests that the average length of recessions is shortening. By implication, if a well-managed startup has eighteen months of cash runway, it should reasonably be able to weather a normal-and-even-worse-than-normal recession.
- On the one hand, the average inflationary cycle is 27 months, a bit over two years. Current historically low rates afford the government with at least one useful, combative tool, the ability to raise interest rates, which may slow the overall economy and counter inflation. Money supply stood at an all-time high in January of 2022, so, similarly, a moderation in money...

...supply can likewise stem inflationary pressures. Microsoft's Satya Nadella recently identified an additional force to counter inflation, observing that "digital technology is a deflationary force in an inflationary economy because of productivity increases it yields." Here, again by reasonable implication, we posit that the possibility of a shorter inflationary cycle credibly exists.

- The target lifecycle for an early-stage venture capital fund is about 10 years. Companies will likely be exposed to an economic downturn in that period. The companies that can weather the downturns are often well-positioned to grow quickly during the recovery period. When venture investing is done right, managers spread the investments over three to five years, spreading the risk across economic cycles. Moreover, if VC's are well-positioned to capitalize on attractive deals during the downcycles they have the wind at their back in their effort to deliver outsized returns.
- Today, many high-quality companies are low on cash, a function not of their position or prospects, but rather of the timing of their last capital raise. This creates an opportunity for venture investment. Furthermore, the balance of power with regard to deal terms has shifted in favor of the investor. This combination translates into improved valuations and superior corporate governance. Finally, behavioral psychology also enhances the prospects for current venture investment, as, in the face of 2022 losses, recency biases have reduced the pace of broad capital allocation. Plainly, there are good opportunities for those that can filter signal from noise.
- Importantly, in our bailiwick, cybersecurity spending tends to be impacted quite modestly by economic cycles. First, while corporate spending generally might have slowed, it has not abated. And, some spending is mission-critical. Hackers do not pause their nefarious activities in the wake of an economic downturn; if anything, they increase them. Corporate spending on cybersecurity and corporate intelligence is rising secularly, and strong governance demands increasingly sophisticated protection of tangible assets and data. Cybersecurity startups, particularly those with differentiated technology, should be buffered and bolstered by the disparity between the broader market and the secular growth in the corporate intelligence market (a growth some 9x the growth in the economy broadly).

## What to do?

Upon reflection and examination, Lytical Ventures did not allocate capital faster when the market was roaring and valuations were soaring. We exercised price and other disciplines, stuck to our proverbial knitting, and found a plethora of great, growing businesses with reasonable venture valuations and prospects. We were skeptical of the froth we saw at times and kept the bat on our shoulder, even when some aspects of expensive deals were enticing. Warren Buffett, in the realm of value investing, famously proclaimed one should be "fearful when others are greedy, and greedy when others are fearful." Today, we see the opportunity to capitalize on the fears in the marketplace. We do not intend to allocate capital slower in an environment where there are high-quality opportunities presenting themselves. Consistency and process have always won in venture capital. It will help our long-term returns when others temporarily forget this.



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