Riverside

RIVERSIDE ACCELERATION CAPITAL

MARKET DYNAMICS LEADING TO A NEW STRATEGY

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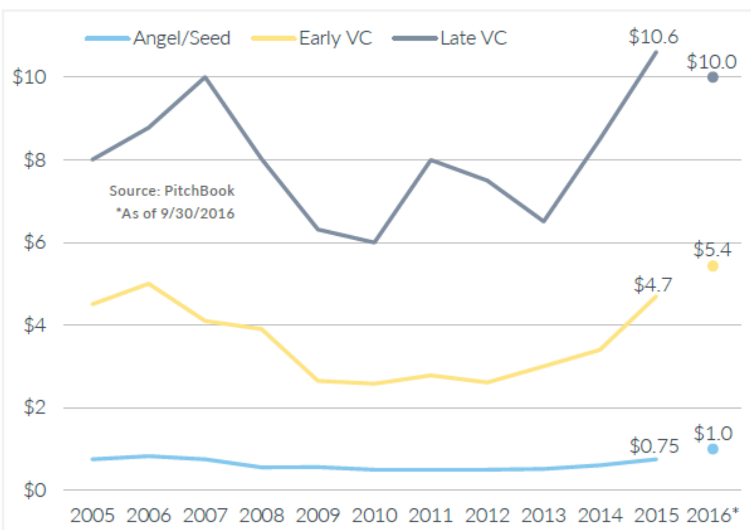
A few weeks ago, just before Thanksgiving, our fund launched our new website, riverside.ac. The launch followed a string of news for the fund, including final close / announcement back in the early fall, and closing of our fourth and latest investment, also just before the holiday. Overall it's been fast-paced and exciting since I joined, and I thought I'd take some time to outline why I'm excited for 2017 and beyond. The mission page of our website briefly outlines the market dynamics that have opened an opportunity for our new investment style, but this post will give me an opportunity to expand upon that. It'll also give me a chance to explain why I jumped at the chance to help build Riverside Acceleration Capital last spring.

For anyone who hasn't yet heard our story, we're investing $500K to $4M into early-growth enterprise software companies, although in a rather unique way. Our model is predicated on growing trends in the software market that have opened opportunity for new forms of investment capital. The broad opportunity is driven by the Internet and the (widely stated) idea that it's fundamentally changed "everything." More specifically, the opportunity is that the Cloud had fundamentally shifted the way that software platforms are built and the way that software companies are scaled. Many of the key themes here are directly related to my 2015 post about building "whole products" and the reduced cost of delivering products to market. In short though, through APIs, existing software building blocks and cloud services it's become cheaper and faster to build and scale software products than ever before.

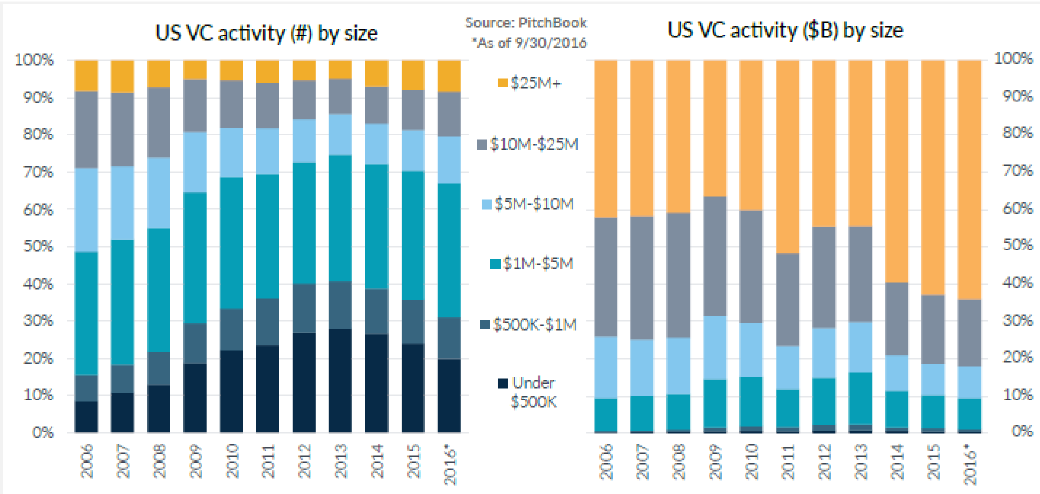
This dynamic manifests itself in several ways. First, it simply costs significantly less to get to market and then to scale the technology side of a growing business. Second, it reduces technology risk of development, further reducing capital required to hit product/market fit. Third, it opens opportunity for entrepreneurs to reach new markets and for experts in non-technology markets to build software and revolutionize those markets. However, despite these changes to business building, the financing options for companies have remained somewhat stagnant. Once a company moves past the seed-stage and has proven product market fit, traditionally large venture and growth capital rounds remain the primary financing options. Further, not only have the forms of financing not truly expanded, but we continue to see these traditional financings trend larger. If a company is looking for a more limited amount of capital, it's become quite difficult to find.

To expand on this, I've included below some charts that demonstrate recent trends in venture/growth financing. Thank you to Pitchbook for this data and please note that leaned heavily on this recent report for these charts.

MEDIAN VC ROUND SIZE ($M) BY STAGE

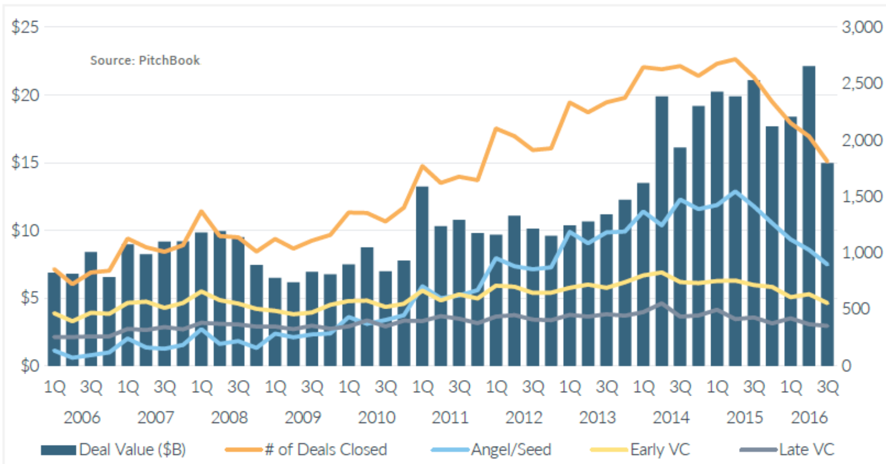


US VENTURE CAPITAL ACTIVITY BY SIZE

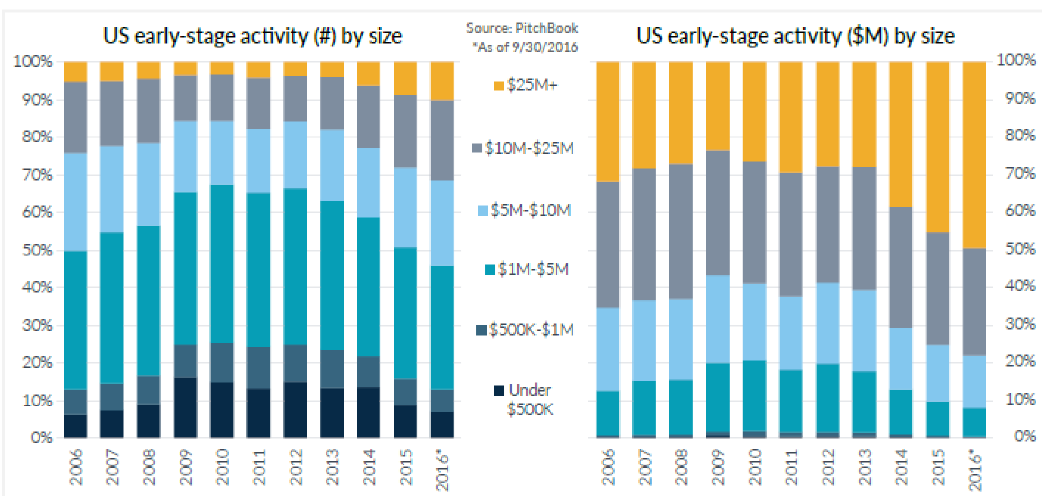


What we can see here is a clear trend towards larger venture financings (even with a slight downturn in Q3 on the late stage it's still quite high). Below, we can see reduced volume, indicating an increasing concentration of that capital into a smaller number of companies (again Q3 seems a bit lighter on capital, but still quite a bit higher than prior years and likely under-reported as recent deals are yet to be announced). Pitchbook points out this trend, and if we look at early stage distribution, it's quite clear that even at that stage, round sizes are growing.

US VENTURE CAPITAL ACTIVITY BY QUARTER



US EARLY-STAGE VC ACTIVITY BY SIZE



A recent post by [@ttunguz]() contained some data that further highlights this trend. Tom's [post]() was focused on the differences in fund-raising for horizontal versus verticalized SaaS but in doing so, he also revealed the enormously large round sizes through the first 9 months of 2016. With SaaS-specific data this is even more relevant to our fund than the numbers above. Tom broke down rounds between Horizontal and Vertical solutions, but across both the round sizes have gotten incredibly large. A $7-10M average for a Series A and $20M Series B is probably 1.5-2x what we've thought of for those rounds in the past and even what we see for overall venture financing "early" and "late" stage financings in the charts above. It's clear that financings for SaaS-based business are rather large these days.

Category	Series	Median	Mean	Total
Horizontal	A	7.3	8.8	149
Vertical	A	9.1	9.8	59
Horizontal	B	21.0	21.2	423
Vertical	B	18.0	19.8	297

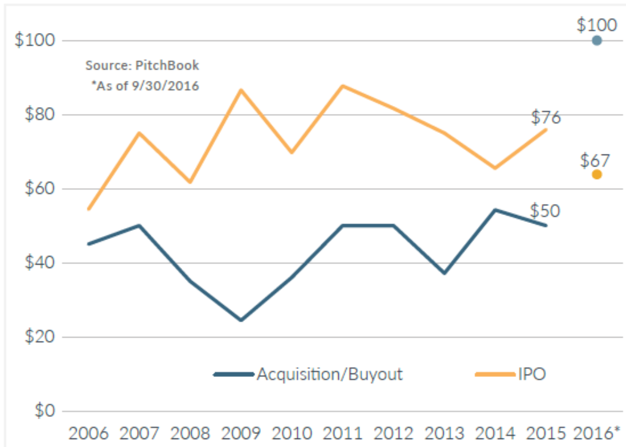
When we consider this fund-raising dynamic set against the market dynamics I've discussed above: cheaper to build, cheaper to scale, and greater number of market opportunities, one likely wonders why the rounds are so big. We believe the answer lies in the use of that capital, set against market opportunity. For a revenue-generating company, with meaningful product/market fit, any future financing is more growth than venture. Once a company has proven market momentum, these growth rounds add "fuel-to-the-fire," powering the company to reach their potential against a large market opportunity. As burn rates rise, companies need this additional capital and accordingly, growth capital firms are built for this dynamic. They're designed to invest in $5M+ rounds and most often in $10M+ rounds, but struggle to invest less. If a company isn't on a path requires this high burn-rate or prefers to raise fewer dollars to progress further before a big growth-round, it can be difficult to raise the capital, even if the business fundamentals are solid.

The other critical element to the venture and growth-capital world is the is the M&A/exit-side of equation. To deliver return to investors, a venture or growth fund must realize an exit at multiples of their original investment (to deliver overall portfolio return while covering losses). With large round-sizes typically accompanying large-valuations, once a company raises a growth round, exit expectations rise commensurately. However, while the big exits typically dominate the news cycle, the truth is that that exit ranges are broad and that they are dominated by sub-$100M exits. Looking at a bit of data from Pitchbook, there were 739 venture-backed exits in the US through the end of Q3 this year. Of those, only 89, or 12% of exits were over $100M. Beyond that, only 10, or 1.35% of all exits, we're over $1B in exit value. Of the exits with announced valuations, the majority were $100M or less. When combined with those exits without a valuation announced, and therefore likely to be relatively small (typically sub-$100M), the vast majority (88%) were in this bucket. Of course, these numbers also only consider those companies that exit - there are a much broader universe that never exit!

When we look at median exit values, as detailed in the chart below, we can see that the most common exit values have remained relatively constant between $40-50M (apart from the deepest part of the recession). There is a jump in that median value this year, and as the second chart shows, there is indeed a concentration of dollars into fewer deals. However, it's likely that some smaller Q3 deals have yet to be recognized and recorded (as they don't come with big announcements) and overall it's hard to believe that trend won't fall back in line with the long-standing median exit range. And so, it appears that the most likely exit for a start-up is in the $50M range, definitely sub-$100M, with some outliers commanding exit valuations over $250M and some major outliers commanding enormous exit valuations over $1B. Indeed, while most companies will indicate an acquisition opportunity by a company like Salesforce, Google, Oracle or a similar tech giant, a quick look at their historical acquisitions shows a broad range of outcomes. Among those acquisitions are a few of those outsized $1B+

acquisitions, a handful more acquisitions with $100M+ values and the preponderance of deals either below that or not announced at all.

MEDIAN US VENTURE-BACKED EXIT SIZE ($M) BY TYPE



US VENTURE-BACKED EXIT ACTIVITY BY QUARTER

If there are a few big breakouts each year, it certainly makes sense that a company with a clearly huge exit opportunity would raise big rounds to meet that opportunity. Similarly, if most acquisitions happen with a median of $50M, it makes sense that the vast majority of companies should aim to be as capital efficient as possible - at least until they see that big opportunity crystallize. A company headed for a billion-dollar breakout would likely want to raise as much as fast as possible, but a company yet to prove that opportunity would want to keep optionality open and the future flexible so that all win at a $25-100M exit.

With this backdrop, you can start to see the challenges for companies looking to raise smaller rounds within the traditional venture market. If a company is clearly breaking-out against a defined and massive market, it makes sense to throw as much behind it as is effective, to reach those larger exit opportunities. But not every company in this broadening set of market opportunities is a fit for traditional growth financing and not at every stage beyond seed. Sometimes a company needs some capital to further prove its market opportunity, or to build and prove sales, market, or product extensibility before committing to a larger raise. That's where we come in.

Riverside Acceleration Capital is designed to give a company additional capital for growth, to help "accelerate" into the next phase of its life-cycle, but without significant dilution of equity, control and optionality. With the backing of The Riverside Company, we can also add significant strategic value to aid in growth. If a company invests our capital as it's last round of financing, it offers tremendous optionality going forward. If a company leverages the capital to grow revenue and prove milestones ahead of a larger growth round, it should better position a company for that raise. Additionally, we can participate in that round and can help formulate the approach to the fundraising market.

If you're interested in learning more, please reach out. You can find us at contact@riverside.ac or connect through our network on LinkedIn.