GEEK-OUT TOPIC: *Unicorns and Venture Capital Investing*

A Unicorn is a privately held company that has a valuation of greater than $1 billion. The term was first coined by seed venture investor Aileen Lee in her article: “Welcome to the Unicorn Club, Learning from Billion Dollar Startups”. In her article Lee looked at venture startups in the 2000’s and found that only 0.07% of them ever achieved a valuation of greater then $1 billion, making them as rare as a Unicorn. The term has since been used, and perhaps overused, by not only the venture community but also traditional Wall Street as banking firms clamor to bring these private behemoths public.

A history of Unicorns

Though Aileen Lee coined the term in a 2013 article, many investors were familiar with the concept of the highly valued tech ventures that most notably entered the scene during the dot-com bubble in the late 1990’s. Though it may seem that valuations during that period were over the top, valuations are actually growing faster more recently than in the years prior. A Harvard Business Review Study showed that valuations in the years 2012 – 2017 grew twice as fast than in the period of 2000 – 2013. In fact, most recently we have witnessed the emergence of the *Decacorn*, which is defined as a private company whose valuation exceeds $10 billion. Most notable amongst those are recently public Lyft and Pinterest. Still waiting in the wings to go public are Uber, WeWork, Airbnb, SpaceX, Epic Games, and Palantir. China has a number of large notables as well which include Ant Financial, Lu.com, Xiaomi, and DiDi. As of 2018 there were 119 companies valued at $1 billion or more.

Where do all of these Unicorns come from?

Most Unicorns are born in the world of Venture Capital in which firms invest in privately held startups with the hopes that their risky investments will pay off in the long run. In order for Venture Capitalists (VCs) to be successful, they must experience a significant growth in valuation over time and ultimately exit the investment. In order to increase their probabilities for success VC-backed companies adapt what is referred to as a Get Big Fast strategy in which companies are highly financed in order to gain maximum market penetration. The high level of financing enables companies to gain market-share by price gauging and lavish marketing budgets. As lower prices and higher spending usually lead to unprofitability, the high level of

Venture Funding enables the startups to continue to operate. As companies begin to gain market share rapidly, valuations increase which is accentuated by the Venture Capital fund raising process (see below for more on how that works).

Over the past decade, more and more venture money has become available as institutional and high-net-worth investors sought higher rates of return than could be achieved in the public markets (stocks and bonds). The higher risks associated with the private investments meant increased potential for higher returns. Another driver of private investment was the JOBS act of 2012, which increased the number of private investors allowed in a privately held company. According to a study by McKinsey and Co., the amount of private investments in software companies increased threefold from 2013 to 2015 alone. With all of that capital chasing around an opportunity to invest in the Next Big Thing, or NBT (an inside VC term), valuations increase. Remember increased demand with limited supply means higher prices and the same applies for the price of ownership in a private company.

Historically, privately held companies would grow too large for private investors and would seek funding by going to the public markets in an IPO. With more and more capital available to fund private companies, IPO's are being put off further. Additionally, with the availability of private capital from commercial banks, private equity firms, and large VC firms, companies can be more strategic with their IPO timings and wait until the public markets can support their lofty valuations.

Venture Capital

Venture Capital, as its name implies, is the investment of capital in ventures, usually private, that are expected to exhibit rapid growth thereby providing significant returns to investors in return for their risk. Venture Capital is part of the larger Private Equity (PE) investment industry. VCs typically focus on fast growing startups, while traditional PE firms focus on taking large public companies private, buyouts, and financing special situations which demand significant amounts of specialized capital. Privately funded startups go through many stages in their growth and VCs typically specialize in various growth stages of companies as well as industry specific investments.

Typical life of a venture funded startup

Most ventures start with what is referred to as Angel or Seed Funding. This initial funding is typically on the smaller side and can range from $50k to $1 million dollars. Companies seek these early investments at a stage when the only thing they have is a dream and perhaps a rudimentary business plan. As a company at this stage is most vulnerable and risky, valuations are very low and early investors demand a higher percentage of ownership to compensate for the risk. Company founders typically give up around 50% ownership at this stage. What they get in return is the capital required to further develop their business plans. Early stage

investors are typically business building experts that have, themselves, been successful in past startups. This is referred to as *smart money*, and the wisdom of former entrepreneurs is critical at the early stage. Once a formal business plan is developed and early market research is conducted, proofs of concept are developed and fund raising begins for what is typically a Series A financing. At this stage companies are expected to have a clearer picture of their business model and perhaps a prototype and demo product. Series A financing is the beginning of commercialization in which a company will begin to develop their actual product. As the risks are somewhat smaller than its earlier seed stage, valuations typically go up. The math works like this:

Seed Investment:

Investment: $500,000
Pre Money Valuation: $600,000
Post Money Valuation: $1,100,000
Founder's own: 600,000 / 1,100,000 = 60%
Seed Investors own: 40%

Series A:

Investment: $2,000,000
Pre Money Valuation: $10,000,000
Post Money Valuation: $10,200,000
Founder's own: (1 - (2,000,000 / 10,000,000)) * 60% = 48%
Seed Investors own: 32%
Series A Investors own: 20%

In this scenario, the company raised $2 million in their second round financing at a higher valuation of $10 million. In order to raise the additional funds both the founders' and the seed investors' ownerships were diluted by the amount of company shares required to raise the new round. The number of required shares is directly related to the agreed upon pre-money valuation. This is important to understand because the amount of dilution goes up with lower valuations and down with higher ones. Thus there is an incentive on the part of both founders and existing investors get higher valuations as they progress. Can you see the Unicorn trend start to emerge?

Ventures typically will go through several more rounds of finance for commercialization, all larger with bigger valuations, assuming things work out as planned. Once a company has revenues and can demonstrate revenue growth, they begin to raise larger specialized financing which are sometimes referred to as mezzanine rounds. These are typically debt-based hybrids which are contingent on an imminent IPO or acquisition. These are most likely very large rounds which count on smaller increases in valuation but typically have a short term time horizon. Based on the above example one can see that at this stage there are plenty of

investors, going back to the original seed investors, who are standing in line waiting to hopefully realize the return on their initial investment - all dependent on valuation growth.

Conclusion

Unicorns, private companies whose valuations typically exceed $1 billion, typically get started with Venture Capital Investment. Venture Capitalists invest in risky startups with the hopes of gaining large returns to compensate them for big risks. Ventures go through many stages of growth and financing to get to the large valuations which are associated with today's Unicorns and Decacorns. Large increases in valuation are necessary for privately held companies to effectively finance their growth and get to a stage where they can get to a successful, and highly touted Initial Public Offering. As many privately held, venture funded companies rely on investments to cover cash flow shortfalls, many venture IPO's go public with little or no earnings. Recent examples include Lyft and Pinterest, both Unicorns. As a result, investing in these Unicorns can be risky and prospective investors need to do lots of diligence and get the advice of investment professionals before investing, all the while bearing in mind that Google, Apple, and Facebook all started out as seed ventures at one time.

Mark Malek
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