TechCrunch+ Fundraising

We need to destigmatize down rounds in 2023

Holden Spaht @hspaht / 7:30 PM GMT+5:30 • January 2, 2023

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A **new year** is upon us, and with it comes uncertain, and uncomfortable, market conditions. Accompanying those conditions are equally uncomfortable decisions. For startup founders, determining which path is right for their business may require fundamentally rethinking the way they measure success.

Holden Spaht
Contributor

Holden Spaht is a managing partner at private equity firm Thoma Bravo.

The business climate in 2023 will be unfamiliar to many who founded a company in the past decade. Until now, a seemingly endless stream of relatively cheap capital has been at the disposal of any startup deemed by the VC world to have high growth potential. Everyone wanted a piece of "the next Facebook." With interest rates near zero, the risks were relatively low and the prospective rewards were astronomical.

Burning money to chase growth became the norm; you'd just raise more money when you ran out. Debt? Who needs it! Existing investors were happy to play along, even if their share in the company was somewhat diluted — growing valuations kept everyone sated.

Over the years, this pattern of rapidly rising valuations and a pie growing fast enough to compensate for any dilution — fueled by "free money" that made almost any investment justifiable — crystallized into a mythology at the core of startup culture. It was a culture that nearly everyone, from founders and investors to the media, fed into.

Climbing valuations made for great headlines, which sent a signal, both to potential employees and the markets, that a company had momentum. High valuations quickly became one of the first things new investors looked to when it was time to raise additional capital, whether that was through a private round of funding or an IPO.

But tough economic conditions tend to dispel complacency with hard realities, and we'll see reality checking in when it comes to funding this year. Amid rising interest rates and a generally negative macroeconomic outlook, the tap will run slowly — or not at all. Equity financing is no longer cheap and plentiful, and as drought

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strikes, a sense of anxiety will grip founders. They can no longer burn cash without seriously contemplating where they'll get more when it's gone.

by ego or driven by media appetites.

When that time comes, founders will be faced with a choice that could make or break their business. Do they turn to alternatives like convertible notes, or do they approach new investors for more equity funding? Tech stocks have been pummeled in the past year, which could mean their company's value has taken a hit since the last time they raised capital, leaving them with the prospect of the dreaded "down round."

It's easy to see why down rounds seem out of the question for many startup founders. For starters, they'd face the flip side of the positive media mania, which risks eroding employee morale and investor confidence. In a culture where growing valuations are worn like a badge of honor, founders may fear that taking a down round would render them Silicon Valley pariahs.

Down rounds don't spell the end of your business

The truth is, there's no one-size-fits-all solution. The funding route you take has enormous consequences for the future of your company, and so it shouldn't be clouded by ego or driven by media appetites.

At Thoma Bravo, we're helping companies cut through that fog. We challenge founders and business leaders to take a step back and reevaluate operational decisions that were made in different market conditions.

It's critical to ask and consider these questions methodically as you raise new capital:

- Where am I winning and losing in the market, and how should that inform my investment plans?
- Does my quota-bearing sales headcount investment plan still make sense, especially if attainment is low and many reps are unproductive?
- Is this the right time to invest in new markets where the competition is more intense, or do I refocus on my core products and services, where I have a greater "right to win" and higher margins?
- Could I bootstrap using the cash on my balance sheet, tighten my belt on operations and self-fund through the next period or even all the way to an exit event?

If these questions all lead to the same conclusion — that new funding is indeed needed — founders should then weigh the pros and cons of each potential path to financing.

The first impulse may be to turn to convertible notes. They can be appealing for a number of reasons: As a combination of debt and equity, they're a faster avenue to money, they're marginally less expensive to issue than pure equity, and because they generate part of their return from a coupon, they generally don't force existing investors and management to adjust the company's equity valuation.

But those benefits come at a steep price. Investors are looking for annual returns of up to 20% on such notes, which makes them very expensive as debt. The capital is likely to be senior to all equity raised to date, and they may come with restrictions on where the company can spend the money. What's more, the financier may not provide any strategic value beyond the capital.

For some startups, those trade-offs are worth it. But for others, particularly those with very high valuations, a down round may be the better choice. Existing investors generally suffer minimal dilution with down rounds, and you have the benefit of resetting expectations of value in a challenging market. That can take pressure off and put you in a position to exceed expectations. If that's the case, it's far better to make that choice while you still have the freedom to do so.

Every financing decision is unique, but every time, it will be one of the most important decisions an entrepreneur makes. I encourage CEOs and investors to weigh the trade-offs with eyes wide open. Whichever financing solution you choose should be grounded in its ability to facilitate flexible support that allows you to build for the long term, regardless of market conditions.

When those conditions inevitably change for the better, I hope we can look back at companies that chose to take a down round not with critical judgment, but respect. Such decisions show prudence, clear-headed assessments of risk and that the founders valued flexibility. Most of all, they show that the founders knew how to navigate tough markets by making tough calls, rather than hanging on to a collective mythology of so-called exponential growth.

For anyone looking for an indicator to invest, those signs — more than hype or headlines — will stand out for all the right reasons.

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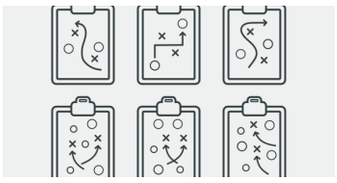

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Ronald Weissman · 1 day ago

Excellent article except for the "de-stigmatize" bit. Some of us warned CEOs that 2020-21 were unsupportable, and when markets turned, they'd suffer. But CEOs and investors co age in and lacking any experience prior to the great bull market of 2010-21 couldn't conc anythin...**See more**

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Remember how this whole working thing works?

Natasha Mascarenhas
1:30 AM GMT+5:30 • January 4, 2023

Welcome back to Equity, the podcast about the business of startups, where we unpack the numbers and nuance behind the headlines. As promised, I'm taking over Equity Monday for the beginning o...

TC+ Market Analysis

How well did Israel's cybersecurity industry do in 2022?

Yuval Krigel
1:13 AM GMT+5:30 • January 4, 2023

The majority of capital that did flow into Israel's cybersecurity industry poured directly into one area: seed rounds of early-stage startups.

Crypto

Former FTX CEO SBF pleads not guilty to U.S. criminal charges

Jacquelyn Melinek
1:07 AM GMT+5:30 • January 4, 2023

FTX founder and former CEO Sam Bankman-Fried plead not guilty to all eight counts of U.S. criminal charges on Tuesday. Bankman-Fried appeared before a judge in the U.S. District Court in New York C...

Gaming

Microsoft now has its first official union in the US

Amanda Silberling
12:36 AM GMT+5:30 • January 4, 2023

At ZeniMax, a Microsoft-owned gaming studio, 300 quality assurance (QA) testers have voted to unionize. This marks Microsoft's first official union in the U.S., as well as the biggest gaming ...

Fintech

Two CEOs is better than one with Henrique Dubugras from Brex

Rebecca Szkutak, Darrell Etherington
12:30 AM GMT+5:30 • January 4, 2023

Welcome back to Found, where we get the stories behind the startups. This week Darrell and Becca are joined by Brex co-founder and co-CEO Henrique Dubugras to chat about his corporate credit card a...

Security

Hackers claim ransomware attack on Los Angeles housing authority

The Housing Authority of the City of Los Angeles, or HACLA, has confirmed it is investigating a cybersecurity incident shortly after the LockBit ransomware gang claimed responsibility for a cyberat...

Carly Page
12:06 AM GMT+5:30 • January 4, 2023

TC+ Fundraising

Here's what USV plans to do in 2023 with its $200M climate fund

Tim De Chant
12:00 AM GMT+5:30 • January 4, 2023

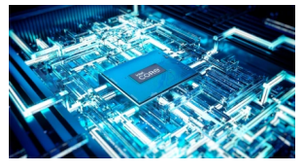
With so much dry powder, what are Union Square Ventures' plans for deployment?

Hardware

Intel unveils high-end 13th-gen 24-core processors plus N-series workhorse to fill the the Pentium and Celeron gap

Ingrid Lunden
11:59 PM GMT+5:30 • January 3, 2023

Intel is taking a more subdued approach to CES these days — forgoing a splashy event staged in a big hotel showroom in the wake of Covid-19, and a wider change in PR strategy after years of m...



Startups

TechCrunch+ roundup: Normalizing down rounds, 2023 climate trends, term sheet basics

Walter Thompson
11:57 PM GMT+5:30 • January 3, 2023

Everyone gets wet when it rains, but accepting a down round allows founders to keep building their businesses.

Startups

Here's how you described the tech industry's 2022 in a headline

Natasha Mascarenhas, Mary Ann Azevedo, Alex Wilhelm
11:24 PM GMT+5:30 • January 3, 2023

As readers know, we have fun with headlines on this site. But clearly, so do all of you. As part of our end of the year coverage, the Equity podcast team asked listeners to write a headline that re...

Gaming

Nvidia upgrades GeForce Now with RTX 4080 performance for premium users

Romain Dillet
10:42 PM GMT+5:30 • January 3, 2023

Nvidia announced some new features for its cloud gaming service during its virtual CES press conference. The company is upgrading its premium plan by adding new servers with better hardware compone...

TC+ Fundraising

3 ways PE firms can ensure relevant due diligence for M&A targets ahead of a

It's critical for due diligence providers to analyze a company's business segments and product lines to identify the range of its exposure to potential issues.

recession

Corey Massella
10:30 PM GMT+5:30 • January 3, 2023

Transportation

Foxconn's EVs will be built with Nvidia's self-driving toolkit

Rebecca Bellan
10:15 PM GMT+5:30 • January 3, 2023

Taiwanese manufacturer Foxconn and Nvidia announced Tuesday ahead of CES 2023 a partnership to develop automated and autonomous vehicle platforms. Under the two-part partnership, Foxconn will becom...

Transportation

Mercedes to use Nvidia's digital twin tech to modernize its factories

Rebecca Bellan
10:15 PM GMT+5:30 • January 3, 2023

Mercedes Benz is joining the metaverse. Or at least its assembly facilities are. The automaker is one of Nvidia's latest customers to use Omniverse Enterprise, a software platform used to bu...

Robotics & AI

Nvidia's robot simulator adds human coworkers

Brian Heater
10:15 PM GMT+5:30 • January 3, 2023

Simulators have been a godsend when it comes to testing robots. Real-world testing is lengthy, expensive and potentially dangerous, so anything you can do to work out as many kinks as possible ahea...

Transportation

Nvidia helps Hyundai, BYD, Polestar join the in-car gaming revolution

Rebecca Bellan
10:15 PM GMT+5:30 • January 3, 2023

Nvidia's on demand cloud gaming service, known as GeForce Now, is headed to select Hyundai, BYD and Polestar electric vehicles, the company said Tuesday ahead of CES 2023 in Las Vegas. The an...

Apps

TikTok begins rolling out the ability for creators to restrict videos to adult viewers

Aisha Malik
9:46 PM GMT+5:30 • January 3, 2023

TikTok has announced that it's expanding its audience controls feature, giving creators the ability to restrict their videos to adult viewers. Prior to this expansion, the adult-only audience...

TC+ Fundraising

5 tips for healthcare startups fundraising in a down market

Dr. Galym Imanbayev
9:30 PM GMT+5:30 • January 3, 2023

In fundraising, a founder's greatest challenge is not selling any particular product or strategy. Instead, it is often unwinding and realigning the investor's biases.

Crypto

Solana price spikes as newly launched dog coin BONK gains community hype

Jacquelyn Melinek
9:08 PM GMT+5:30 • January 3, 2023

Last week, Solana (SOL) fell to its lowest level since February 2021. But its price has risen over 12% in the past 24 hours on Tuesday after almost nine days of consecutive losses that brought its ...

Hardware

Apple is increasing battery replacement service charges for out-of-warranty devices

Ivan Mehta
4:20 PM GMT+5:30 • January 3, 2023

Apple is increasing service charges for battery replacement of out-of-warranty iPhones, iPads, and MacBooks starting March 2023. The price rise ranges from $20 to $50 for different kinds of devices...

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