Diary Jon Moulton

As the venture capital bubble deflates, expect sharp falls in returns and real damage to valuations

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

We are clearly emerging slowly from a venture capital bubble. We went into a world where if it cost a business £5 to generate £1 of Annual Recurring Revenue (ARR) then investors piled into the company because of the rapid sales growth that pouring money in had generated. High annual revenue growth then meant the company was "worth" 10 times ARR.

So, the first guy in got a big write up and returns were high. Of course, revenues are not free cashflow or profits and this absurd game eventually results in a significant drop in VC returns, following a bubble period where being an early player in the game made you look good and, if you were really lucky, someone would buy your stake using the same deeply flawed methodology before the valuation went "Pop". Unrealised VC valuations are due for substantial damage.

It is odd how humans need simple calculations to feel comfortable in a valuation. Revenues are always available whereas in loss making early-stage companies not much else is. It is worth pointing out that Ebitda (especially adjusted Ebitda) multiples are also only a very rough measure of business value. Ultimately cash flows drive value, but the visibility is more of an art than a science. However, trying to ascertain cashflow potential remains a good long-term approach to valuation.

But whether it be VC or crypto assets you can get excellent returns from being early into the bubble!

The weaker economic background with rising inflation and a rise in interest rates make for "interesting" times in the LBO world.

After the last financial collapse in 2008 I confidently expected carnage in the highly leveraged portfolio LBOs. I was quite wrong as I had not expected interest rates to stay so low so long. Central bank largesse fished out some very ropey deals. Largesse and low interest rates may not be the route to "normality" this time.

As long as the rate of inflation stays above interest rates then inflation is on average good for LBO structures. As yet we have seen a step-back in the willingness of lenders to fund LBOs. Volumes of new deals have dropped – especially in the USA. However, US pricing (as measured by the flawed, and often adjusted, Ebitda multiple!) has ticked up to 12.2 times with leverage only at 6x. Absent good growth, returns seem likely to be coming down.

'Rising inflation and a rise in interest rates make for interesting times in the LBO world'

Finally (for this edition) something I have disliked for years. The use of preferred ordinary shares in VC deals will be a significant pain in the coming downrounds.

The difficulty of getting these rounds through a syndicate where VCs and management have different interests can be very difficult. Someone sitting on shares that get their money back at a £20m value will doubtless flinch at being asked to give this up to enable the company to raise money at a more realistic £10m value. There will be complex legals protecting the preferred investors. Whilst there are ways to bribe the preferred investors to move out of the way it is never easy. Companies have failed because of this type of structure. The other joy of downrounds, is watching people trying to grapple with ingenious, even fiendish, anti-dilution terms which issue shares to earlier investors if capital is raised at a lower price than previously – the dilution from this can materially reduce the pricing of the downround, making things even harder.

It is entirely feasible to have multiple rounds of investment with just ordinary shares. The issue is everyone being realistic about valuations. Legal bills plummet (very high nowadays in VC deals) and you get less time wasted in barely functional debate with all too often the optics of a higher price with preferences as a driver.

Over 35 years ago 3i (ICFC as it was then) used CRPOS (Convertible Redeemable Preferred Ordinary Shares). Recent term sheets from some of the larger UK VCs are pretty well identical to CRPOS' terms with lots of "bells and whistles". ICFC used them to very tightly control its usually solo investments without bothering to even take a board seat. VC funds with simpler structures rapidly obsoleted ICFC's weaponry – I wonder what will happen this time.

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Those who got into the VC bubble early would have made significant gains, but those who entered later could be facing substantial losses