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When Capital Gets Tight, Savvy Founders Get Creative

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We've all seen the headlines; uncertainty seems to be the only thing that is certain in 2023. On the one hand, geopolitical risks and macroeconomic indicators seem to point toward a likely recession, but on the other hand, the labor market remains tight, U.S. inflation *may* be stabilizing, and 2022 deal volume (financings and M&A exits), while dropping from record highs, is generally aligned with pre-pandemic trends. Still, many businesses are bracing for a slower first half of 2023. All of these factors lead to a tightening venture market, particularly as nontraditional market participants that flooded the industry with capital over the last few years sit on the sidelines. So, what's a venture-backed company to do? In the paragraphs that follow, we lay out a few practical guideposts to help navigate that important question.

Prioritize Liquidity

To grow, you have to survive. If capital gets tight, successful founders may need to shift their thinking to prioritize liquidity over growth, at least in the short term. Deals will likely take longer in 2023, and in response, founders should take steps now to tighten their budgets and stretch their runway as long as possible in case they cannot secure financing within their desired timelines.

Brace for Diligence

Uncertainty begets caution, and caution begets greater diligence. Most company founders should expect that investors will conduct real diligence in 2023, not the "diligence lite" approach of the last few years. Founders can prepare for this by working with counsel and their tax and financial advisors to pre-diligence their own companies, and by setting up a well-organized data room before receiving a term sheet from an investor or prospective acquiror.

Prepare for Flat or Even Lower Valuations

In keeping with the trends of the second half of 2022, founders should expect flat or even lower valuations, especially for later stage venture-backed companies with public comparables that suffered valuation markdowns. When faced with a down round, companies should consider other alternative financing options that don't trigger antidilution, such as venture debt, convertible notes, or flat rounds with limited warranty coverage.

Understand the Economics

Cumulative dividends and liquidation preferences in excess of 1x invested capital are slowly rising. These

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concepts eat into founder returns but may be necessary to attract capital and survive. While investor-friendly economic terms may be necessary in the short run, founders should be careful with them because they will set a precedent for later rounds that will be difficult to back away from when the market outlook improves.

The sky is not falling. We may be coming down from record activity levels in the private capital markets, but we are gliding back to historical norms. Savvy founders will welcome this as an opportunity to refocus on the basic blocking and tackling that leads to sustained growth. In fact, as we saw with the dotcom bust and the Great Recession, the winners that emerge from a market downturn are many times left with less competition, which allows such companies to dominate in the years that follow.

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