Navigating the Evolving Venture Capital Landscape for Edge AI Start-Ups

Todd H. Poole
Director, Venture Investments
Pathfinder

Introduction

Introduction: Who Am I?

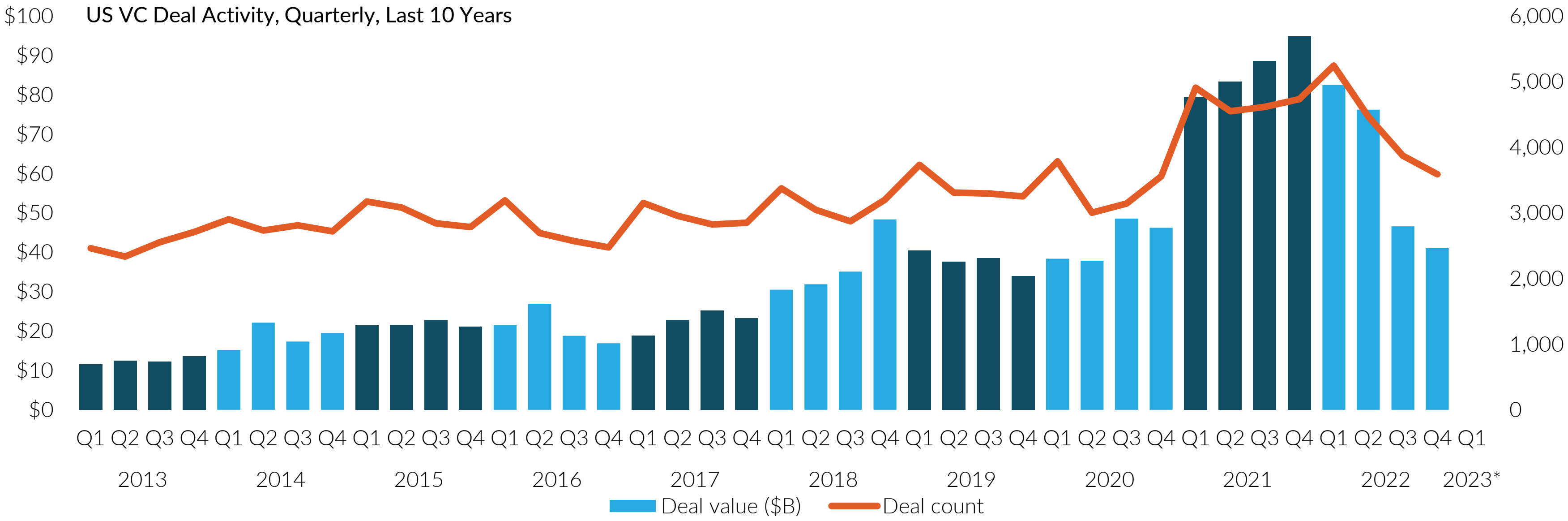
- **Pathfinder** is a ~$500M, enterprise technology-focused, stage-agnostic (Series A to pre-IPO) fund.
- We invest in the **tools**, **teams**, and **technologies** that will be relevant to the enterprise tech sector in 3, 5, 7 years.
- I lead investment activities across a number of deep-, frontier-, and hard-tech categories, including AI, ML, and silicon.
- ~121 investments across 41 portfolio companies.

Alation Data Mgmt	Ayar Labs Systems	BigID Data Mgmt	Classiq Systems	Cohesity Data Mgmt	D2IQ PaaS & Fleet Mgmt	DataRobot App-AI/Analytics	Dragos Security
Flywheel App-AI/Analytics	Kadence Edge	Lightmatter Systems	Mythic Systems	Platform 9 PaaS & Fleet Mgmt	PubNub Edge	SafeBreach Security	Scality Data Mgmt
SingleStore Data Mgmt	Synack Security	Tamr App-AI/Analytics	ThoughtSpot App-AI/Analytics	TruEra App-AI/Analytics	Unqork App-Dev/Ops	vFunction App-Dev/Ops	WekaIO Data Mgmt
Stealth (Data Mgmt) Data Mgmt	OpsRamp (Acquired by HPE) PaaS & Fleet Mgmt	Pachyderm (Acquired by HPE) App-AI/Analytics	Fungible (Acquired by Microsoft) Systems	Cellwize (Acquired by Qualcomm) Edge	Agile Stacks (Acquired by EPAM) App-Dev/Ops	IonQ (Exited: NYSE) Systems	StackRox (Acquired by Red Hat) Security
Portworx (Acquired by Pure Storage) App-AI/Analytics	Chef (Acquired by Progress) App-Dev/Ops	Shape Security (Acquired by F5) Security	Hedvig (Acquired by Commvault) Data Mgmt	Barefoot Networks (Acquired by Intel) Systems	Hexadite (Acquired by Microsoft) Security	Adallom (Acquired by Microsoft) Security	

Background & Context

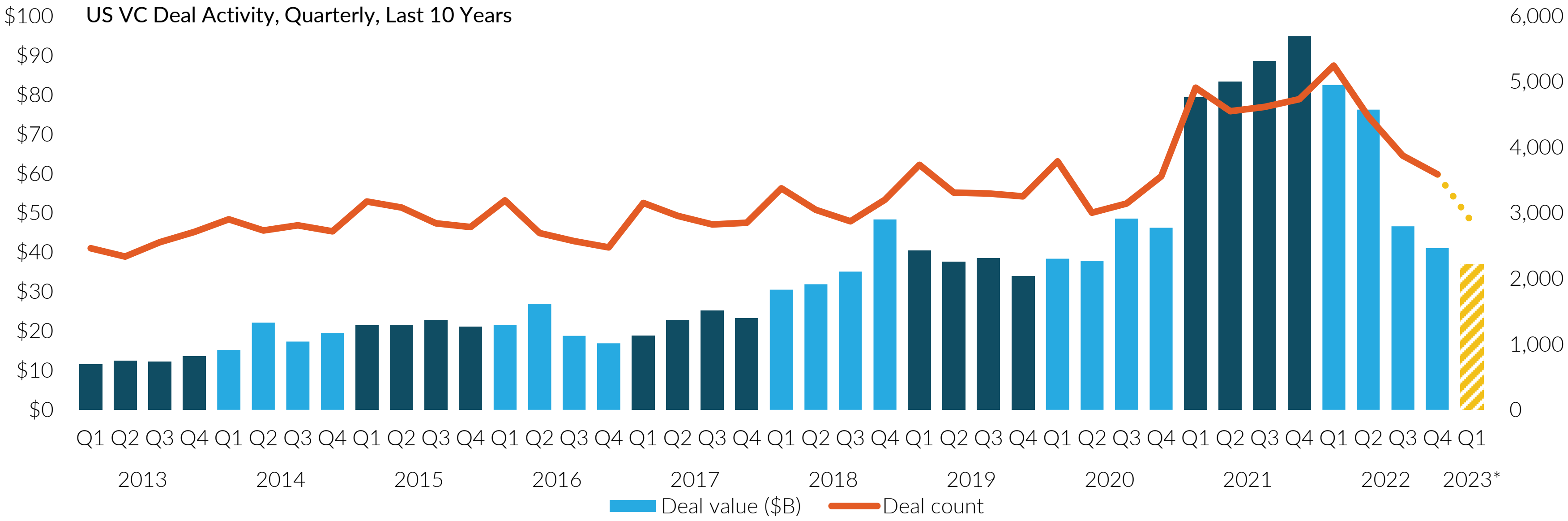
2022 was a tumultuous year…

- Founders raised **29% less capital** in 2022 vs. 2021 ($246B vs. $346B).
- VCs closed **33% fewer funds** in 2022 vs. 2021 (892 vs. 1336).
- Startups realized **91% less exit value** in 2022 vs. 2021 ($73B vs. $786B).



...and Q1 2023 has been even worse.

- Founders raised **only 10%** of the capital they raised in 2021 ($37B vs. $346B).
- VCs closed **only 7%** of the funds they closed in 2021 (99 vs. 1336).
- Startups realized **less than 1%** of the exit value they realized in 2021 ($5.8B vs. $786B).



…and Q1 2023 has been even worse.

- SVB's collapse was a major, unexpected event. They were a key partner to founders and firms with specialized accounts, credit lines, favorable terms on venture debt.
- More than 50% of all startups and VC firms banked with SVB.

Silicon Valley Bank's Collapse Causes Start-Up Chaos

The FDIC has taken over Silicon Valley Bank

SVB Panic Sets in Among Startups and VCs

Silicon Valley Bank shoots self in foot

Silicon Valley Bank seized by FDIC after largest failure since the Great Recession

Silicon Valley Bank shut by California regulator

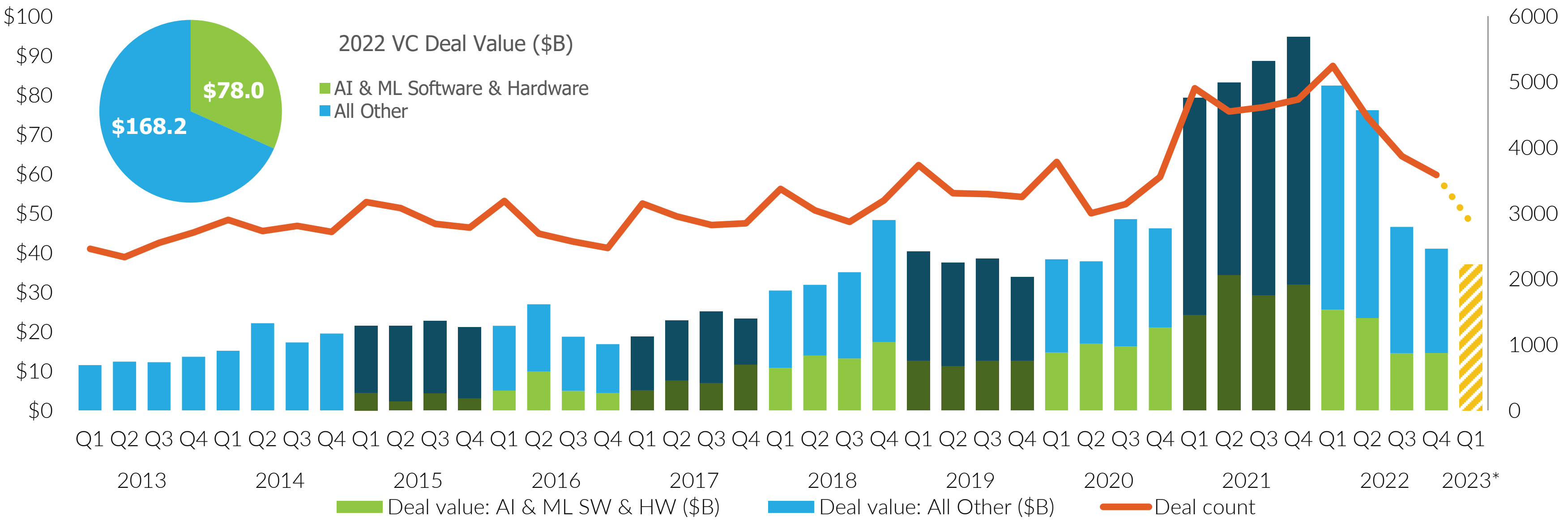
Silicon Valley Bank Closed by Regulators, FDIC Takes Control

Silicon Valley Bank Fails After Run on Deposits

Silicon Valley Bank is shut down by regulators in biggest bank failure since global financial crisis

AI & ML has also been affected.

- AI & ML startups as a group have **fared better** than many of their peers in other sectors.
- Software out-raised hardware and silicon (**$61B** vs. **$17B**), thanks to the LLMs.
- Regardless, overall metrics are still **lower**, in line with the rest of the startup ecosystem.



Main takeaways

- The entire VC ecosystem threw a hell of a party from 2017/18 to 2021.
- Funding was almost universally accessible across all stages, especially in 2021.
- The music started to slow in H1 2022, and had stopped altogether by H2 2022.
- For many, 2023 will be spent nursing the hangover and getting back to fundamentals.
- But for some (including many in the AI & ML spaces), there's still the after party…

Moving into 2023

What to expect moving into 2023.

- AI & ML startups are still faring better than their other startup peers.
- Software AI & ML startups are least impacted, especially anything Generative AI. Hardware and silicon AI & ML startups are having a tougher time.
- We’ve started to see a stratification of startups into 3 groups:
  - **Winners:** Fundamentally strong startups with solid metrics. Will have access to capital, but not at the heady multiples of yesteryear. **Reasonable up rounds likely.**
  - **Survivors:** Structurally weaker startups that acted swiftly to conserve cash, extend runway, and focus on fixing the core of their business. **Flat or down rounds likely.**
  - **Failures:** Startups who were slow to act, or who had fundamental flaws in their business models. Stronger peers will outcompete for customers and investors. **Failure likely.**

What to expect moving into 2023.

- The VCs are facing similar woes: impaired investments, lower returns, lower IRRs.
- Just like startups, VC funds have started to stratify:
  - Some firms have scaled back capital deployments or paused investment activity altogether. **Minimal appetite for new deals; focus is on helping current portfolio.**
  - Some firms are still deploying capital, but much more judiciously. Strong emphasis on "right deal, right terms." **They're immune to FOMO and are willing to walk.**
- A lot of VC chatter lately about returning to good venture investing principles: investing in solid teams; setting realistic expectations; greater accountability; reasonable terms.

What to expect moving into 2023.

- **Founders** seeking term sheets from leading VCs should expect:
  - To **pitch 2x-3x more VCs** than in prior years. Early: 150-100; Mid: 50-75; Late: 30.
  - Far **greater scrutiny** during due diligence. There will be many questions. Have patience.
  - **Lower valuation multiples**. 35x-50x is now closer to 15x-25x in many spaces.

What to expect moving into 2023.

- **Founders** seeking term sheets from leading VCs should also expect to encounter more term sheets with stronger downside protection for investors:
  - Higher **liquidation preferences.** Ex: How much the Preferred get paid from an exit event before the Common. The norm of 1x still exists, but 2x-10x(!) terms are out there.
  - **Preference stack stratification.** Ex: A new Series C lead may no longer accept being *pari passu* – or "treated equally" – to earlier Series A and B investors. May insist they get paid first before the A or B Preferred. A risk to other Preferred, not Founders or Common.
  - **Participation rights.** Ex: The Preferred take their cut of any returns, then if there's anything left for the Common, they get a cut of that too. Double dipping during an exit.

What to expect moving into 2023.

- **Founders** seeking term sheets from leading VCs should also expect to encounter more term sheets with stronger downside protection for investors:
  - **Full-ratchet anti-dilution clauses.** Ex: The Preferred are protected from the dilutive effects of a down round by redefining (i.e., increasing) the number of Common Shares their Preferred Shares will convert into. A risk for Founders and other Common.
  - **Changes to board composition.** Expect to yield existing seats or create new seats.
  - **Milestone-based warrants.** Ex: A Founder assures an investor that ARR will grow from $5M to $15M over the next 18 months. An investor may ask for warrants that will give him a right to buy additional shares at a steep discount (often a penny) if that $15M-ARR-in-18-months milestone is not met. Ensures Founders deliver on promises.

What to expect moving into 2023.

- **Startup employees** should:
  - **Expect greater uncertainty** than in prior years. RIFs (Reduction in Force) spiked in Q4 2022 and are expected to continue in 2023.
  - **Talk to Founders** about your startup's health. Ask about growth, ask about runway.
  - **Look for signals** to confirm. Are customer counts increasing? Has your startup paused hiring? Has it been more than 18-24 months since the last raise?
  - **Have a backup plan.** Go to conferences and networking events. Talk to colleagues at other startups. Polish your resume. Shore up your personal emergency fund.
  - **Remain rational** if things go sideways. Run the numbers for your personal situation. Make sure you understand the math and the risks. Think clearly and stay level-headed.

Q&A

Resources

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- National Venture Capital Association
- List of Law Firms specialized in serving Founders and startup employees