Venture Capital: Turning Today's Dreams into Tomorrow's Write-Downs

KCR believes that many of the most speculative, loss-making, hype-driven, low-quality tech companies are actually in private hands today. Many of them held by venture capital funds. Why does this matter?

Tech bulls today have ignored our warnings around vendor financing highlighted in our piece *Accounting Gimmicks on a Grand Scale*. In the dot.com bubble the explosion in loss-making startups created wholly unsustainable demand from more established hardware and software vendors. The "best" of these speculative baubles showed up in the great IPO boom of the late 1990s. You could see these startups – and their dubious business models – in plain sight.

Today, we believe much of this nonsense is hiding in portfolios of pensions, endowments, and other unfortunate investors paying absurd fees to venture capitalists. The data suggests we are, at worst, on to something.

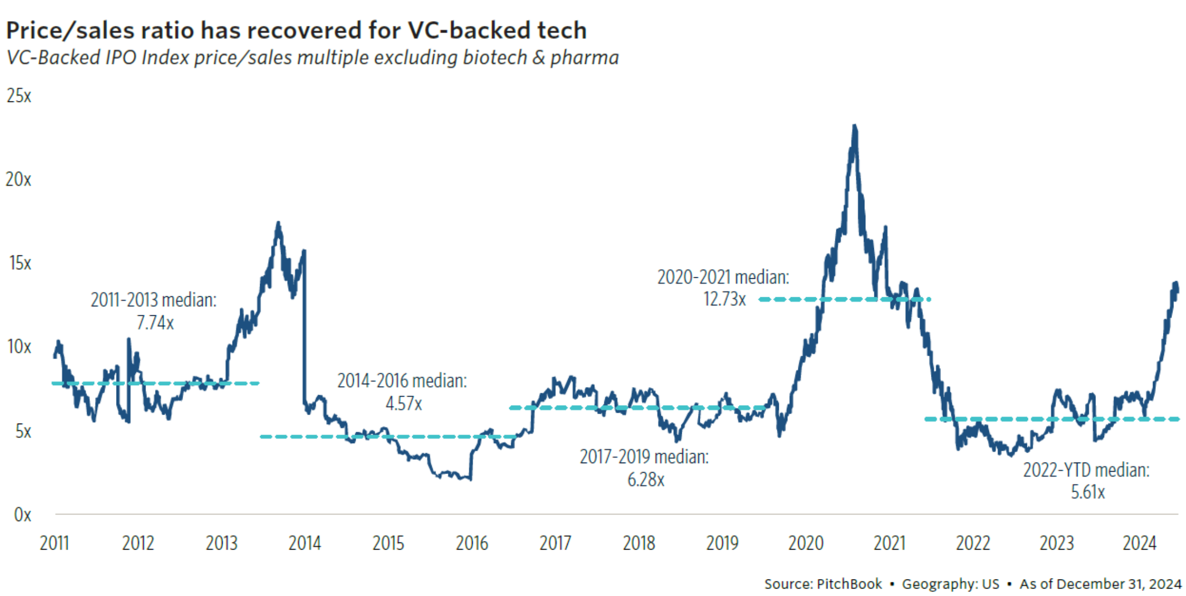
Let's start by highlighting some key takeaways from a fantastic article from Pitchbook.[i] Key notes:

- The backlog of companies in the Venture space has risen from $1.7 trillion in 2020 to $4 trillion today, a $2.3 trillion increase
- Warren Buffet took over Berkshire Hathaway in 1965 and today the company is valued at $1 trillion – a lifetime of work from the world's greatest investor
- **Do we really think the great minds of Silicon Valley have conjured up new companies worth 2.3x the value of Berkshire Hathaway in just the last four years?**
- If so, would that not be the greatest innovation miracle of all time? **Or is it overpriced bullsh*t?**
- Remember, Berkshire is so big it owns more of America than anyone other than the Federal Government

The reason there are not more IPOs, according to Pitch Book themselves, is that **the private valuations are higher than what the market will pay.**

Pitch Book's recent comprehensive coverage of VC[ii] suggests that companies are starting to take down their valuations because they desperately need money. Yet look at the chart below.

This shows the price to sales ratio of VC-backed IPOs, **excluding biotech and pharma,** has hit nearly 15x. An indefensibly stupid multiple that defies even cursory intellectual review. Something we have discussed *ad nauseum,* most recently in our piece *The Cheap, Expensive and Unfortunate (Stocks > 10x P/S)*.



Consider a chart we recently updated for a client showing that **in public markets** there's over **$5 trillion** worth of equity in **software stocks alone trading over 10x price to sales**.

And this market is too cheap to buy these VC companies? Where are they valued? If you owned those companies in a VC wrapper, what fees are you paying? What will happen if this deluge of growthy VC companies tries to go public? When supply increases what does price do again?

Software: Total Market Cap > 10x P/S ($ Trillions)

Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 12/31/2024

How could this get worse? What else could go wrong? Add debt. Lots of it.

Remember our summary of legendary billionaire investor Seth Klarman's out-of-print book *A Margin of Safety*? Here is how Mr. Klarman described the junk bond mania of the 1980s that would subsequently implode, wiping many investors out:

"Junk bonds appeared to perform a sort of financial alchemy…. owners of the junk bonds issued by the many companies whose interest expenses were greater than their pretax profits were able to claim to have earned interest income in excess of the profits earned by the underlying businesses. … And as long as the yield illusion was perpetuated, investors kept buying the bonds." -A Margin of Safety, p. 60

Below is an excerpt from another recent Pitchbook piece describing the unusual lending boom to loss-making venture capital firms today **(emphasis ours)**[iii]**:**

There are two things in this down cycle that I haven't seen in previous cycles that standout. The first is that tech deal sizes on average have become much larger than in prior downturns, when lenders tend to pull back. That has not been the case in this downturn.

The other difference in this cycle that we've not really seen in prior downturns is instances of venture debt being provided without accompanying equity support from the venture capital backers.

We're seeing pre-profitable [companies that lose money] companies raising unprecedented loan sizes without accompanying equity support, and that is very different. *We've been very disciplined during this downturn.*

I marvel at some of these deal sizes and, candidly, do not know how these massive, unprecedented deals without equity will pan out. Maybe they'll be fine, but time will tell.

KCR will be the first to tell you: we cannot time markets. Yet what we can do is follow the facts. And the facts here are as simple as they are unfortunate.

- Venture Capital funds have a massive quantity of companies – many that lose money – valued such that they cannot list them in the most expensive markets in American history
- Worse, these loss-making venture companies are saddled with massive amounts of debt that is unlikely to ever be repaid and…
- All the debt and equity funds raised by these venture capital firms for these companies is showing up in the sales and profits of big tech companies like Nvidia, Google, Amazon, Microsoft and countless others

Our team is not in the forecasting business, we are in the Moneyball business.™ Similar to the dot.com bubble, when these speculative venture firms begin failing in mass, much of the $4 trillion in VC holdings will be written off as worthless. How can a group of listed equity investors like us make such a possibly controversial statement? **Because the data is very clear: between 75% - 90% of such startups fail.[1]**

And what will happen when 75%+ of these VC firms fail? The currently booming demand for compute, storage, and ever-faster AI chips, will suddenly turn into a glut. And this will, at best, dent the profits of big tech companies. At worst, it could lead to a negative cycle where the sector suddenly swings from record profits to deep losses, just like in the dot.com bust.

Our team believes machine learning and artificial intelligence will likely bring tremendous advances for humanity. But like the many other wonderful technological breakthroughs that have characterized human history – from trains, planes, automobiles, and the internet – purchased in their novel moments of euphoria, they will prove to be terrible investments.

[1] Startup Failure Rates, Why Most Venture-Back Companies Fail, Harvard Business School & Fast-Company

Disclaimer

[i] *Pitchbook, Valuation expectations still holding back IPO market*
[ii] Pitchbook, *2024 Annual US VC Valuations Report*
[iii] Pitchbook, *"Venture lending evolving amid larger deals, equity investor pullback"*