Morgan Lewis

Q2 2024

CORPORATE VENTURE CAPITAL SURVEY

OVERVIEW

Corporate Venture Capital (CVC) slowed to its lowest share of total VC deals since 2014 in the second quarter of 2024. Only 23.3% of deals that were completed include a CVC investor in Q2. Pitchbook data shows that just over 978 corporates have made a VC deal in the United States so far in 2024. Nearly 62% of CVC deals through the first half of 2024 were made at seed or Series A.

In this survey, we track investment trends as the market slowed for CVC financings. We also analyze a survey of key economic terms of the largest Q2 2024 venture capital investments in which CVC programs either led the round or participated as significant or anchor investors.

KEY TERMS

Our survey focuses on the following deal terms typically negotiated between companies and investors:

Valuation

Liquidation Preference

Participating Preferred

Cumulative Dividend

Redemption Rights

Protective Provisions

"Pay-to-Play" Provisions

VALUATION

The survey covers a wide range of financing transactions during Q2 2024, from early to late-stage financings. Of the Morgan Lewis transactions we reviewed that disclosed prior valuations, we noted that approximately 50% of the transactions involved higher valuations from the prior round, while the other 50% had lower valuations from the prior round. Compared to Q1, this represented an overall decrease in the number of deals with higher valuations, reflecting a slower fundraising environment and an increase in down rounds. The exception continues to be for artificial intelligence (AI) financings, which continued to outpace the market.

LIQUIDATION PREFERENCE

While preferred stockholders receive preferential treatment on distribution over common stockholders in the event of liquidation, the liquidation preference among different series of preferred stock is often a negotiated term. The later-round preferred stockholders may request a senior ranking over prior-round preferred stockholders, while earlier investors may insist on equal (or pari passu) treatment with new investors.

Based on our review, 100% of the transactions included a 1x liquidation preference which was pari passu with the prior preferred round, meaning that the new round investors do not include a senior preference to the prior preferred round. These results were the same as from the Q1 survey, indicating that in terms of liquidation preference, companies have been able to continue to hold the line on providing seniority to new investors in the liquidation stack.

PARTICIPATING PREFERRED

With "non-participating" preferred stock, the preferred stockholders are entitled to receive only the amount of their preference (typically the amount paid for the stock). With "participating" preferred stock, preferred stockholders are entitled to receive their preference amount first in a liquidation event (plus accrued and unpaid dividends), with any remaining proceeds being divided among holders of common stock and preferred stock on an as-converted basis.

Based on our review, 100% of the transactions involved "non-participating" preferred stock. These results were the same as with Q1, indicating that "non-participating" preferred stock remains the market standard even as the market has been more investor-favorable.

CUMULATIVE DIVIDEND

If dividends are cumulative, dividends accrue and accumulate at a specified rate whether or not declared by the board. Upon conversion of the preferred stock, cumulative dividends would convert into additional common stock, which would increase the investors' percentage ownership interest in the company above their original investment.

Based on our review, approximately 67% of the transactions did not provide for cumulative dividend provisions, while the remaining 33% included cumulative dividends. Compared to Q1, this represented a slight increase in cumulative dividends. Later stage financings and mezzanine rounds tend to include cumulative dividends, as private equity investors often prefer to fix a baseline rate of return. In Q2, there was a higher concentration of later stage financings, which would explain the increase in cumulative dividend provisions.

REDEMPTION RIGHTS

Redemption rights allow investors to force the company, in specified circumstances, to redeem their shares at cost and in some cases cost plus a small guaranteed rate of return.

Based on our review, only a small minority, roughly 14%, of the transactions included some form of redemption rights.

PROTECTIVE PROVISIONS

Protective provisions provide preferred stockholders with special approval rights with respect to certain matters of particular significance to their investment in addition to class or series voting rights that may exist under relevant state corporate laws. These matters may include liquidation and sale of the company, amendment of charter or bylaws, changes in board size, and authorization of issuance of other preferred stock. An often-negotiated point is whether a specific series of preferred stockholders should have the right to vote together as a single class with other series of preferred stock and/or separately without the participation from other preferred stockholders.

Based on our review, approximately 29% of the transactions included voting rights only as a single class together with other series of preferred stock, 57% included voting rights both as a single class with other preferred stockholders and a separate vote by series for certain matters, and 14% did not disclose.

'PAY-TO-PLAY' PROVISIONS

A "pay-to-play" provision requires that investors participate in a later financing in order to retain their anti-dilution or other special rights. A pay-to-play is not a standard term in most VC financings and typically will come into play only in down-rounds. **We did not observe any pay-to-play provisions in the transactions we reviewed.**

SPOTLIGHT ON AI AND ENERGY

AI's projected growth and energy-intensive nature leads to increased demand for energy and opportunities for CVC investments/partnerships:

- A generative AI chatbot query needs nearly 10x as much electricity to process as a search from a traditional internet search engine.
- Sources considered to power AI: renewables and nuclear.
- Traditional sources of funding such as venture capital will need to be supplemented by strategic investment by corporate partners/utilities and Inflation Reduction Act funding.

AI is also being increasingly used as a tool by energy companies:

- Utilities are relying on it to improve system reliability, grid resilience, and operations.
- There is interest in the nuclear industry to use AI to improve operational performance and mitigate risk.
- This will create opportunities for CVCs to invest and partner with the startups addressing AI and energy management tech.

Electric infrastructure build-out faces regulatory issues and other constraints:

- Regulation at the state level (transmission and generation siting, distribution system build-out and rates) and federal level (transmission planning and generator interconnection).
- Constraints: Sufficient generation and ability to transport from generation to location.

SUMMARY

While the economic terms of each investment are unique based on the facts and circumstances of the companies and investors participating, our Q2 2024 analysis indicates that the environment for venture financing transactions continued to be soft, as the volume of deals and valuations decreased. However, the deals terms have not shifted significantly for those companies that were able to close financings during Q2.

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