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Foreword

Private financial markets have never played as significant a role in global markets as they do now.

As the unprecedented bull market in equities and low interest rates on government securities combined to encourage massive capital inflows into private funds over the past decade, a new phenomenon emerged: a surge in the population of mature, private companies at varying stages of growth. Fueled by relatively easy access to private capital from fund managers ranging from private equity (PE) to venture capital (VC), the size and scale of this segment of the company universe is shaping market dynamics significantly.

The Road to Next series is an examination of the key trends defining this new segment of the market. Deloitte and PitchBook have collaborated to produce a distinct methodology and array of data sets in order to answer some of the most pressing questions for investors and companies within this space. In each quarter of 2020, a new Road to Next edition will focus on the most critical issues companies and their backers face, covering liquidity concerns, investor strategies, macroeconomic pressures, important regulations, market dynamics, and more.

In this inaugural edition, we introduce the array of data sets and define the methodology employed to capture key trends across this market segment, including:

- Private capital deal activity broken down into PE and VC components
- Deal flow by sector
- Median transaction sizes
- Private-capital-backed exits by type
- Assets under management (AUM)

Deloitte professionals will discuss the critical issues dominating industry discussions in the current environment, especially the hurdles that mature, growing companies are facing as they scale up and seek to obtain a higher degree of sophistication while staying private or begin to prepare for a liquidity event.

Each edition will feature additional themes and new data sets as brand-new, important trends develop throughout the year, as the population of large, late-stage, and maturing companies continue to stay private or begin to prepare for the next phase of their journey.

Jason Menghi
Partner
Audit & Assurance
Deloitte & Touche LLP

With more than 20 years of audit and accounting experience, Jason specializes in serving private equity firms and their portfolio companies.

Heather Gates
National Managing Director
Audit & Assurance
Deloitte & Touche LLP

With more than 25 years of financial services experience, Heather specializes in serving emerging growth companies.
The expansion-stage population

Expansion-stage companies (#) by valuation size at time of financing

Shining a spotlight on any segment of private companies requires clarity around the criteria used to establish that population. Although these criteria are fully detailed in the methodology at the end of the report, it is instructive to lay out in more detail some of the data points defining this brand-new ecosystem of privately held companies.

Enterprise size
Since 2014, the valuations of expansion-stage companies have trended larger. Well over half of all expansion-stage financings resulted in valuations of at least $100 million or more in 2019. Upmarket of that size segment, the growth in multibillion-dollar enterprises has been especially dramatic in the past two years.

Employees & investors
Notably, the median number of employees has roughly held steady across the entire expansion stage over the past several years. This stability is potentially attributable to increasing economies of scale given advances in software development tools and other enabling digital infrastructure. Investors are a different matter; the median number of backers in an expansion-stage company at the time of financing rose to a peak of eight in 2018; the average jumped to exceed 10. Upon IPO, the median number of firms exiting hit a peak of 10 in 2019. More firms are looking to gain exposure to this segment of the market.

Age
The average age of expansion-stage companies at the time of financing (since their founding) has slightly declined in the past few years, but the median is still at or near historical highs depending on deal type. In 2019, PE growth capital infusions hit a record in terms of age of recipient company, at nearly 12.5 years; corporate rounds soared to a record high of 6.2 years. Late-stage VC recipients actually declined in median age, hitting just shy of eight years.

The median employee count for an expansion-stage company was 65 in 2019. Outliers skewed figures considerably at this stage, resulting in an average of nearly 700 employees in the same period.
Executive summary

In the wake of the financial crisis of 2008-2009, financial assets have ballooned in size as markets rallied, thanks in large part to singular monetary policies undertaken by central banks worldwide.

Private financial markets enjoyed a similarly robust expansion, with total AUM in North America rising by over 94 percent between 2007 and Q1 2019 to a mammoth $2.6 trillion.

The vast bulk of private market dry powder—capital commitments pledged to a bevy of private fund types—is concentrated in PE and VC funds. As of March 2019, those funds in North America alone boast nearly $809 billion in dry powder. AUM for US venture and growth funds leapt from $580.4 billion in 2018 to $781.6 billion by the end of Q1 2019.

Given this proliferation of dry powder and the increasing number of active firms in the market, multiple factors have combined to produce a brand-new, fast-growing segment of the private company universe: an expansion-stage population of maturing companies attracting significant infusions of capital from venture, PE, and nontraditional private market investment firms.

Newer entrants such as PE firms, hedge funds, and mutual funds have been attracted to this segment, helping propel the median late-stage VC financing size and pre-money valuation to stratospheric highs.

A significant amount of realized value has helped contribute to the popularity of this growth stage. In 2019, aggregate exit value grew to well over $300 billion, dwarfing any other single year since 2010 handily. Although volume peaked in 2014 and 2018, with each year recording well over 900 exits from companies within this expansion-stage ecosystem, that record tally of value was driven by a somewhat slower rate of liquidity.

As companies have stayed private for longer, their original investors have sought alternative methods of liquidity, as they looked to recoup at least some of their investment without overly straining preplanned fund holding periods. Secondary markets for fund stakes and exchanges for private company shares have grown in popularity to meet this demand.

Step-ups for VC-backed companies that were bought by a corporation or PE firm have steadily risen to slightly higher-than-average levels—from 1.32x in 2016 to 1.78x in 2019. These disparate trends imply that strategic and financial acquirers are more willing to pay premiums in the current inflated environment. However, the key question is how much longer that willingness can persist. Companies coming to market will have to ensure they are fully prepared for additional scrutiny.

As complex and competitive as the expansion-stage arena currently is, and even given the intensifying scrutiny and caution on the part of companies and investors, its growth does not appear likely to slow any time soon.
Background

In the wake of the financial crisis, financial markets have surged to a staggering size over the past decade.

According to the Securities Industry and Financial Markets Association (SIFMA), equity markets approached $75 trillion in size in 2018, while the global bond market neared $103 trillion. Returns have been equally strong—the S&P 500 soared upward by 246 percent in the 2010s, to take one example. Private financial markets enjoyed a similarly robust expansion in size. In North America alone, the total AUM of private fund managers rose by over 94 percent to a mammoth $2.6 trillion between 2007 and the end of Q1 2019. Dry powder hit a record $925 billion by the end of March 2019 (the latest available date for fund returns data), relative to the peak of $612 billion last decade. The vast bulk of that dry powder is concentrated in PE and VC funds, which together tallied just shy of $809 billion in North America.

Multiple factors intertwined throughout the 2010s to produce these elevated figures. Chief among them was the unprecedented monetary stimulus unleashed by central banks worldwide in order to promote economic growth and stave off significant financial market turmoil during the Great Recession.
Regulatory oversight and stricter controls increased demonstrably around the type of lending in which commercial banks could engage, initial public offerings (IPOs), and quarterly reporting requirements. The successive waves of innovation and associated value creation across business process digitization and the shift to cloud-and mobile-based systems also played a prominent role. Not to be ignored, the outperformance of private asset classes relative to public markets in the decades prior to the financial crisis and throughout much of the 2010s helped attract significant inflows of capital from allocators that could no longer rely on sufficiently strong interest rates to boost overall return given central bank rates. A ripple effect was thereby created by these factors in succession, which has only further fostered the growth of private financial markets. In no particular chronological order, they follow:

- As financial markets began a steady recovery and subsequent expansion to record sizes, asset managers encountered a phenomenon dubbed the “reverse denominator effect.” Their allocations to alternative investments such as PE or VC fell below target sizes given the boom in equities, prompting further commitments to alternatives in general to maintain balance. AUM in private capital overall and its growth segment in particular rose steadily.

- PE fund performance bounced back from the recession more swiftly than expected and continued to outperform public market equivalents; meanwhile, in the second half of the 2010s, a handful of venture funds began to post blockbuster returns.

- Given persistently low interest rates and the impetus to diversify portfolios beyond the bull market in equities to hopefully less-correlated but still high-performing asset classes, many investment firms turned to alternatives in an attempt to boost overall portfolio returns over the long term. It is worth noting that hedge funds as a source of alternative returns decidedly fell out of favor as more and more managers had difficulty beating the strong performance of equities. As a result, there has been a huge surge of capital committed instead to PE, venture, and other private fund types.

The interrelation of the steps of the cycle above is clear. More funds poured into PE and VC coffers, enabling them to diversify and execute investment strategies. Given an expanding supply of investment opportunities, this has proved successful enough that limited partners (LPs) have committed even more capital to PE and VC. However, as is also evident from that chain of events, the key hurdles of both performance and supply must be addressed for the cycle to recur.

"As the number of listed companies shrinks further, more asset managers will likely shift allocations to alternative investors, which may further expand the supply of capital available for companies to stay private longer.”

Heather Gates
National Managing Director
Audit & Assurance
Deloitte & Touche LLP
“A widening range of funds and firms are looking to gain liquidity, so they target late-stage investments that are perceived to be closer to an exit.”

Jason Menghi  
Partner  
Audit & Assurance  
Deloitte & Touche LLP
On the supply side, the number of companies in the market for funding or sale has soared because of three key trends: the increase in the number of available investment opportunities as companies have stayed private longer, a surge in startup rates on a worldwide basis in various segments of tech and sector-specific technology solutions, and aging demographics from both the company and investor side, which are leading to increasing ownership transitions. Meanwhile, as more and more fund managers have flocked to alternative assets, the main arenas of PE and VC saw a diversification of investment strategies as firms sought to maintain outperformance or as brand-new firms were established. A unique phenomenon eventually occurred: A new arena of investment opportunities came into being as the lines between late-stage VC and growth equity blurred, spurred by private company maturation, significant supplies of capital, and increasing sophistication in private fund managers’ strategies.

AUM for US venture and growth funds leapt from $580.4 billion in 2018 to $781.6 billion by the end of Q1 2019. As occurs in every fast-paced environment, competition in growth capital dealmaking has been on the rise, reaching a significant pitch of intensity, especially as commitments keep coming. Given how positive net cash flows have been, that’s hardly a surprise. Dry powder is significantly concentrated in the most recent vintages for increasingly larger and wider-ranging venture and growth equity funds, which creates an even greater impetus for fund managers to deploy capital in the expansion-stage environment. In short, signs point to competition increasing even further.
Throughout the 2010s, the expansion-stage investment cycle has mushroomed, rising from over 2,000 transactions in 2010 to eclipse 3,300 in each of the past two years.

Aggregate investment value has also risen, if at a less inexorably inflationary rate, with only the past two years producing standout results. In 2018, nearly $140 billion was invested, while 2019 comfortably eclipsed $117 billion. Interestingly, that decline in deal value occurred simultaneously with a surge in late-stage VC deal volume between those two years, likely due to the sliding count of PE growth deals, which reduces the potential for outlier transactions. Another potential contributor is the sheer size of the investor population within this growth environment—2019 alone saw close to 2,000 unique active firms, relative to 1,331 in 2013, implying newer entrants may tend to close deals on the lower end of the size range.

“Investors are motivated to quickly close a deal in the current environment, as a slight shift in timing could generate vastly different valuations.”

Jason Menghi
Partner
Audit & Assurance
Deloitte & Touche LLP
It’s worth noting that corporate rounds have experienced the largest proportionate increase in volume, yet still are few relative to PE growth and late-stage venture financings. Corporate venture arms generally are the preferred mode for corporations to gain exposure to this space, hence the relative ratios.

Quarterly volume figures reveal that late-stage venture’s highest three-quarter stretch ever recorded was in the past year, suggesting not only investor optimism but also the inflation in median financing sizes and pre-money valuations driven by company maturation and access to capital. Although sample sizes are sparse for corporate rounds, their median size was at an all-time high in 2019, as was that of PE growth/expansion financings. The corresponding figure for late-stage VC slid only slightly from its high of $11.5 million in 2018, indicating the effect of newer entrants into the space.

Among those newer entrants were the nontraditional investors that, coupled with the trend of companies staying private longer, were the primary creators of the expansion-stage ecosystem. Although PE firms were in the clear majority given the

“A generational shift amid the largest, traditional VCs is occurring. Micro-VCs are also rapidly increasing in number as experienced partners leave brand-name firms and start their own. We have yet to see the full ramifications of new funds writing smaller checks at a higher volume.”

Heather Gates
National Managing Director
Audit & Assurance
Deloitte & Touche LLP
surge in growth investing, corporations, hedge funds and mutual funds also played a significant role given their substantially larger AUMs, which allow them to cut massive check sizes that put upward pressure on deal sizes and valuations.

Hedge funds sought to forestall their industrywide challenges by diversifying into private markets; even mutual funds diversified into direct investing to potentially juice their returns, backing the companies that seemed likeliest to exit at huge valuations.

The immense flood of capital had a clear effect on overall valuations, especially for late-stage venture rounds. The median late-stage VC post-money valuation hit an all-time high in 2019, exceeding well over $100 million, while the combined figure for the overall growth capital ecosystem exceeded $110 million. This abundance of capital—both in financing sizes and valuations—intriguingly has occurred in tandem with a marked decline in the median time between venture late-stage rounds.

Even the median time between early-stage rounds has held flat. In short, despite having more capital deployed in a given round than ever before across this space, firms are still raising capital either more quickly or at the same rate.

Taking these trends into consideration, it’s hard not to conclude that this growth environment is primed to tempt companies and investors alike to stray from discipline with regard to capital deployment and due diligence.

Although any correction for any market is difficult to predict, in the wake of any financial crisis, plenty are quick to raise concerns at any signs of overreaxubrance in any investment cycle. There are key concerns for parties on both sides of any financing negotiation, especially in a brand-new ecosystem centered on mature private companies that are still growing and raking in large sums.

Chief among these concerns in the current environment is the proper deployment of capital, both in terms of company spending and the appropriate investment size. As Menghi has noted, the broader PE industry—not just the fast-expanding growth equity stage—has seen increasing scrutiny of valuations across portfolio company investments in general. VCs have experienced likewise. It’s important to note that, although ripple effects of any such revelations or investor trepidation will spread throughout an entire industry eventually, it is the expansion-stage ecosystem that is and will continue to command the most attention given its rapid expansion over the past several years. However, key areas for participants to consider are
increasingly clear, from staying ahead of shifting regulations to clarifying pathways to profitability more swiftly.

**Key areas of focus through 2020**

**Transparency**

Especially as companies scale to a significant size, transparency between investors prospectively investing dozens of millions of dollars and companies has become increasingly emphasized. As Gates states: “The conversations between investors and companies have shifted to center on transparency. Although the company’s sector can play a role in the intensity of scrutiny, there is more of an emphasis on a clear separation between the company, the founder(s), and investor(s).”

**Timing for both companies and investors**

Given the rate of distributions noted earlier, especially for this relatively newer expansion-stage ecosystem, timing may not yet seem to be as pressing a concern. Both PE and VC fundraising still held strong throughout 2019. However, in a heated and increasingly volatile climate, planning ahead never hurts. “Investors and companies alike are much more focused on the time horizon for profitability, as well as the ability of the leadership team to execute on what’s needed to make that happen,” says Gates. Pitch decks for follow-on rounds should address burn rates, usage of additional capital infusions, and pathways to profitability head on.

**Revenue recognition**

When it comes to accounting matters, revenue recognition is always front and center, according to Gates, especially for the hefty population of software companies at the expansion stage. “There have been shifts back and forth over the past 30 years, but the latest shift to ASC 606 has had an impact on software companies.”

“Private investment firms are exploring VC investments as a way to balance their portfolio’s investment composition, particularly focused on capitalizing on the upside associated with late-stage VC investments.”

**Jason Menghi**
Partner
Audit & Assurance
Deloitte & Touche LLP
**Accounting changes**

Another key issue for growing software companies is lease accounting in ASC 842. The Financial Accounting Standards Board will require adoption of a new lease standard by private companies on January 1, 2021 for annual financial statements, that will entail implementation of new systems and processes to not only recognize new leases but also detail changes that may require remeasurement of existing leases. A fair number of companies are going to have more capitalized assets on their balance sheets than in the past, so lenders will need to be prepared for shifts in ratios among other educational efforts regarding these changes.

**Valuation guidance**

In August 2019, the American Institute of Certified Public Accountants released a brand-new, detailed guide that provides guidance and illustrations for valuation of PE and VC funds’ portfolio companies as well as other complex situations. “Ideally, if private investment firms follow this guidance, it could benefit investors of the private market space,” says Menghi. Overall, growing familiarity with the guidance and illustrations as endorsed by the AICPA would be a wise investment on the part of both companies and investors.

**Additional due diligence**

According to Menghi, “Safeguards that could help promote more stability in this particular area include securing independent valuation firms, third-party fund administrators, and employing tax software so that the funds are in line with best practices relating to accounting for all aspects of the investment fund.”

As complex and competitive as the expansion-stage arena currently is, and even given the intensifying scrutiny and caution on the part of companies and investors, its growth does not appear likely to slow any time soon. That said, the overall supply does not necessarily imply quality, so as investors increasingly emphasize key aspects of company preparation, growth projections, and timelines for liquidity, it is reasonable to expect a potential slowing in the rate of investment volume within this expansion-stage space, or at maximum, a plateau much like that observed between 2018 and 2019.
“In this environment, the pressure to deploy capital is considerable.”

Jason Menghi
Partner
Audit & Assurance
Deloitte & Touche LLP
Expansion-stage ecosystem at a glance

Infographic

Three big things

01
Unique firm activity
The number of unique firms active in the expansion-stage ecosystem is nearly at 2,000 as of 2019

02
Nontraditional VC
Nontraditional VC investors still help propel investing—they participated in close to $90B in deal value in 2019

03
Record exit value
Record exit value in 2019 helped drive distributions—close to $320B was exited last year

Setting new records

$185B
$185B in US VC & growth fund capital overhang as of March 31, 2019

75%
a 75% increase from 2014

Growth fund returns

US VC and PE growth funds returned $34.7 billion back to their investors as of the end of Q1 2019

Expansion-stage capital overhang ($B)

$185B in US VC & growth fund capital overhang as of March 31, 2019

Overhang by vintage
Cumulative overhang

Source: PitchBook | Geography: US
*As of December 31, 2019
“At some point, everyone needs a liquidity event. Return on investment is impacted by the length of time to liquidity and is therefore how limited partners often measure their managers’ performance.”

Heather Gates  
National Managing Director  
Deloitte & Touche LLP
The emergence of the expansion-stage ecosystem has led to intriguing consequences for general liquidity trends and resulted in a lofty final exit volume in 2019.

The year saw well over $300 billion in aggregate exit value as well, dwarfing any other single year since 2010 handily. Although volume peaked in 2014 and 2018, with each year recording well over 900 exits from companies within this expansion-stage ecosystem, 2019’s record tally of value was driven by a somewhat slower rate of liquidity. As can be surmised from that trend, median and even mean exit sizes have been on the rise. However, the other two primary exit channels—PE buyouts and corporate acquisitions—have also seen record or near-record highs in terms of median annual exit size.

The historic shift from public listings to more robust M&A activity has been well documented and is still in full swing. That in large part explains the strength of the M&A cycle which has proved so beneficial to companies as well as their investors in this expansion-stage ecosystem.

Source: PitchBook | Geography: US
*As of December 31, 2019
PE investors’ push into technology-focused investing has also provided an increasingly popular exit route for maturing companies that opt to stay private overall rather than tap public markets for additional capital.

The increasing degree of private company sophistication is another simple factor in increasing median exit sizes; as companies have stayed private longer, they have grown to such an extent that their purchase prices are subsequently larger. But prolonged private tenures have additional outcomes.

As companies have stayed private for longer, their original investors have sought alternative methods of liquidity as they looked to recoup at least some of their investment without overly straining preplanned fund holding periods. In addition, long-tenured employees have also required ways to cash out their stock options, while incoming senior hires have usually required either higher compensation or access to equity via some means given the company was still private. In response, innovation in the form of secondary exchanges and secondaries markets in general has increased over the past several years.

With such tools at both investors’ and companies’ disposal, in addition to ongoing maturation and time taken to exit, it’s little surprise that exit sizes have been trending larger and larger across the market. However, with any such inflation in exit sizes, ramifications for the companies new to the space and their would-be acquirers become more consequential. Interestingly, step-ups between venture-backed companies’ last private financing valuation and those achieved following their IPOs have held essentially flat for some years now. The percentage of companies that are profitable at the time they hold their IPO has declined over the past few years to an all-time low in 2019. Although it can be common for companies to declare in their prospectuses that they may never achieve profitability, for especially prominent unicorns debuting in 2019, it became somewhat of a punchline as well as succinct commentary on the potential mismatch in expectations between private and public market players.

Conversely, the step-ups for VC-backed companies that were bought by a corporation or PE firm have steadily risen back to slightly higher-than-average annual levels—from 1.32x in 2016 to 1.78x in 2019. These disparate trends imply that strategic and financial acquirers are more willing to pay premiums in the current environment, even given current deal sizes. However, the key question is how much longer that willingness can persist.
As of now, with private growth capital inflows having retained their momentum through at least the end of 2018 according to PitchBook’s latest fund returns data, there will be plenty of dry powder for PE firms to utilize in buying out larger companies across multiple sectors. Meanwhile, as the cost of borrowing remains low and larger strategic buyers remain comfortable with acquisitive rather than organic growth, demand for these expansion-stage companies looks set to remain intact. On the supply side, moreover, the inventory of unique companies held privately within this space is still nearly 800 as of 2019, well on the higher end of historical tallies. Exit activity may not hit record levels again in 2020 but looks set to remain strong throughout the year. Consequently, companies should take advantage of the favorable exit environment while they can.

A shortlist of areas for focus developed by Deloitte for companies considering going public or entering an auction are as follows:

**Understand the requirements**
Companies should ensure they understand the full gamut and intensity of needed documentation, from the financial reporting required for filing an IPO to the documentation prospective buyers are likely to request. For example, all relevant accounting standards as well as those that are forthcoming—such as the lease hold regulations mentioned above—will likely need to be incorporated, while quarterly financial statements for companies prepping for an IPO are also going to be required.

“If exits and returns slow, investment holding periods could extend, which likely would impact timing of returns to investors. Private investment firms typically have a quarterly valuation cadence, which could help reduce the volatility in valuations if there were a downward trend in equity markets. Investors in private markets should consider this as they are assessing opportunities.”

Jason Menghi
Partner
Audit & Assurance
Deloitte & Touche LLP
Different strategic and financial acquirers will require varying degrees of documentation and disclosures based on the eventual terms determined, but in-depth reporting is highly probable across the entire business, from human resources to accounting.

**Weigh costs and benefits**
Going public typically allows the executive team to retain control but usually comes with increased governance costs, greater need for disclosures, and higher potential liabilities. On the other hand, an aptly chosen financial or strategic buyer can prove a powerful partner in focusing on core business lines, even at the expense of less independence.

**Align buyer and seller incentives**
Strategic versus financial buyers may have significantly differing motives due to their own structure and incentives. Consequently, ensuring open lines of communication and clear objectives established prior to any negotiations is of paramount importance.

**Ensure resources are in place**
Even mature companies with significantly built-out teams could need additional resources in accounting and finance before pursuing an IPO. Those negotiating with potential acquirers may need to invest in these resources as well as in third-party service providers such as legal counsel.

There is much more detail in each of the above arenas to consider. For more information, visit [www.deloitte.com/us/audit](http://www.deloitte.com/us/audit).

“There are far more private investment firms now seeking partners to acquire part of their stake to generate liquidity so that returns can be provided to their investors.”

**Jason Menghi**
Partner
Audit & Assurance
Deloitte & Touche LLP
Methodology

Geographical region: United States

Capital overhang: Calculated as the sum of capital yet to be deployed that is available for investment. This report includes US-based VC and PE growth funds.

Cash flows: Aggregate capital called (known as contributions) by funds and aggregate capital returned (known as distributions) to LPs from funds by year. Only cash flows from US-based VC and PE growth funds are included in this report.

Assets under management (AUM): Aggregate dry powder (uncalled capital), as well as aggregate NAV (net asset value, i.e. the value of underlying fund investments) by year. AUM is restricted to US-headquartered VC and PE growth funds.

Active investors: The number of active investors is calculated by including either investors who have raised a venture or growth fund in the trailing five years, or those who have made four or more VC or PE growth investments in the past three years. There is no exclusion on investor type apart from angel investors.

All investment data is restricted to late-stage VC, PE growth, or corporate financing types as defined by PitchBook.

Tourist investors are defined as hedge, mutual, or sovereign wealth funds. All exits are defined by PitchBook’s primary exit types: buyouts, acquisitions, or IPOs. The underlying companies are those that have at minimum achieved any of the investment data under restrictions.

Company inventory is calculated by tallying the number of companies that achieve either late-stage VC, PE growth, or corporate financing by year and have not recorded an exit event as of the year in question.

This report was written in January and early February 2020.

Data provided by PitchBook.
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