YCP Solidiance

Navigating the Funding Challenges of SEA Startups

MAY 2024

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Executive Summary

Southeast Asia's startup landscape, once fueled by heavy investment, is now adjusting to a new reality. The pandemic and the global economic headwinds that followed have forced a recalibration, where startups now face a funding crunch as investors demand a shift in strategies and a focus on profitability. From competition for limited resources to pressure on growth, the stakes are high for all players.

Venture capitalists struggle to exit older investments, leading to discounted sales in secondary markets. This shift in focus from growth to profitability forces startups to prioritize sustainable business models, forcing them to adapt to survive. This complex landscape presents challenges and opportunities, demanding a keen eye for adaptable, strategic startups with an eye on future recovery.

Profitable startups in Southeast Asia in the growth phase are holding back from further capital injections. It is primarily unprofitable startups that are pursuing new private funding opportunities in the prevailing market conditions. These reductions and valuation adjustments show investors' reluctance to sustain funding deficits unless startups demonstrate a clear pathway to profitability. SEA startups must change their strategies to regain interest from investors and demonstrate a credible trajectory toward profitability.

Balancing rapid growth and profitability presents a formidable challenge for fledgling startups. Consequently, venture capitalists and angel investors specializing in early-stage ventures must weigh multiple factors beyond immediate profitability when assessing investment prospects. The decreased availability of private funding in the region will lead to diminished investments and prompt investors to seek higher returns or accept discounted valuations, intensifying competition among startups at similar stages of development.

2022 saw a peak in exit proceeds in Southeast Asia, coinciding with a surge in deals, indicating a decrease in the average deal value. Similar trends are expected in the near term. While certain macroeconomic factors may stabilize and industry insiders may anticipate a reversal in the short run, some founders remain cautious, foreseeing a potentially challenging fundraising environment for the next 2-3 years before recovery.

The current funding environment in Southeast Asia offers a chance for new investors to strategically acquire startups at discounted valuations, albeit with caution, by thoroughly scrutinizing the robustness of business plan assumptions. However, navigating through cap tables crowded with various financial investors poses a challenge.

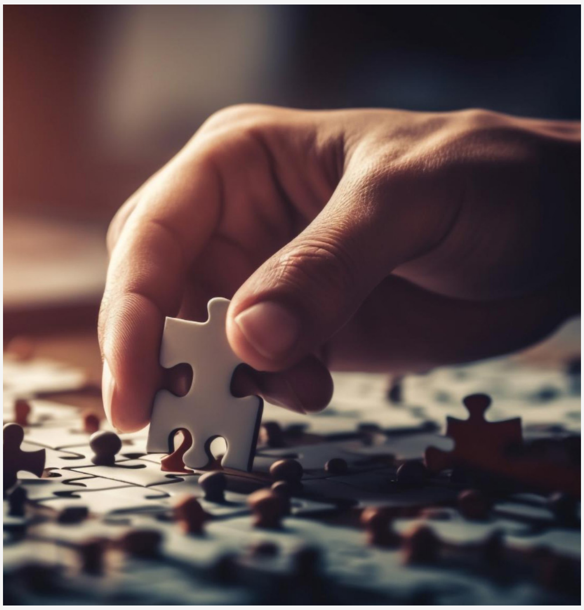
Navigating the Funding Challenges of SEA Startups

In the dynamic landscape of Southeast Asia's (SEA) startup ecosystem, a transformative journey unfolds, marked by a trajectory from unprecedented growth to a recalibration prompted by global economic shifts and the disruptive forces of a pandemic. Once thriving on abundant capital injections, the region now grapples with the aftermath of inflation and rising interest rates.

This change has ushered in a new era, where startups face challenges in securing funding, compelling them to reimagine their strategies and navigate a landscape where caution governs investment decisions. From early-stage ventures grappling with heightened competition for limited resources to growth-stage startups feeling the squeeze for profitability, the stakes are high.

Venture capitalists, under pressure to exit investments made a decade ago, are forging a path through a secondary market characterized by significant discounts. Against this backdrop, a strategic shift from growth to profitability emerges, reshaping valuation dynamics and compelling startups to demonstrate a sustainable business model.

As the industry navigates these complexities, a crucial question arises: which startups are poised to weather this storm and emerge resilient? Delving into the intricacies of differential pricing strategies and negotiation tactics, this report unfolds a narrative where challenges and opportunities converge, inviting investors to explore the nuanced terrain of Southeast Asia's startup ecosystem with a lens focused on adaptability, strategic acumen, and the anticipation of a future recovery.

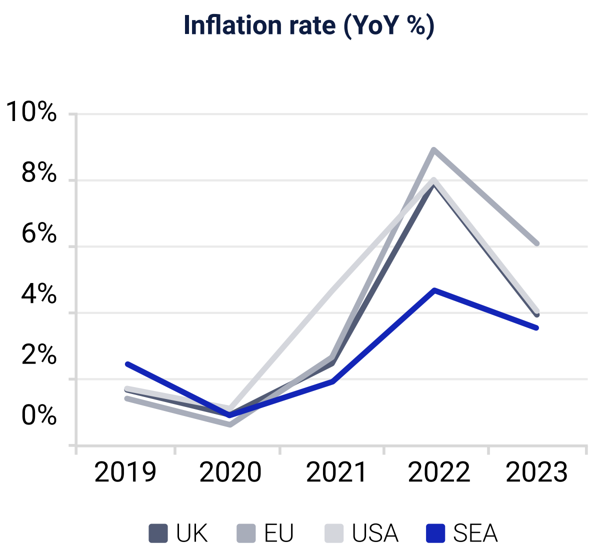


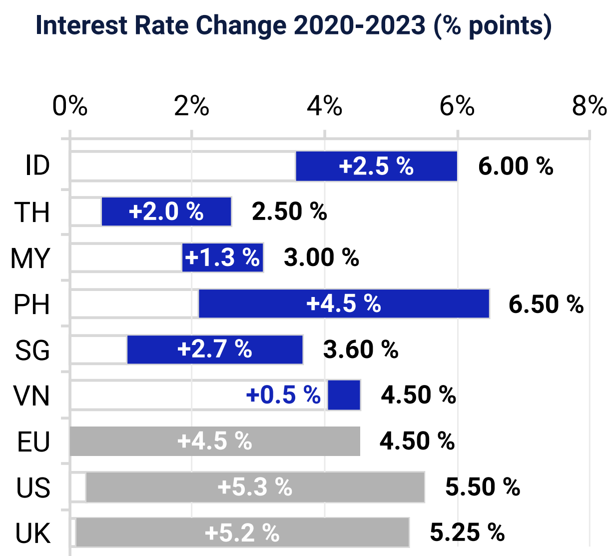
This report's conclusions are substantiated by the personal insights and perspectives of venture capitalists, corporate-linked venture capitalists, and startup founders in SEA, who preferred to remain anonymous, given that their opinions may not represent their respective employers' official views.

Deciphering the Underlying Roadblocks

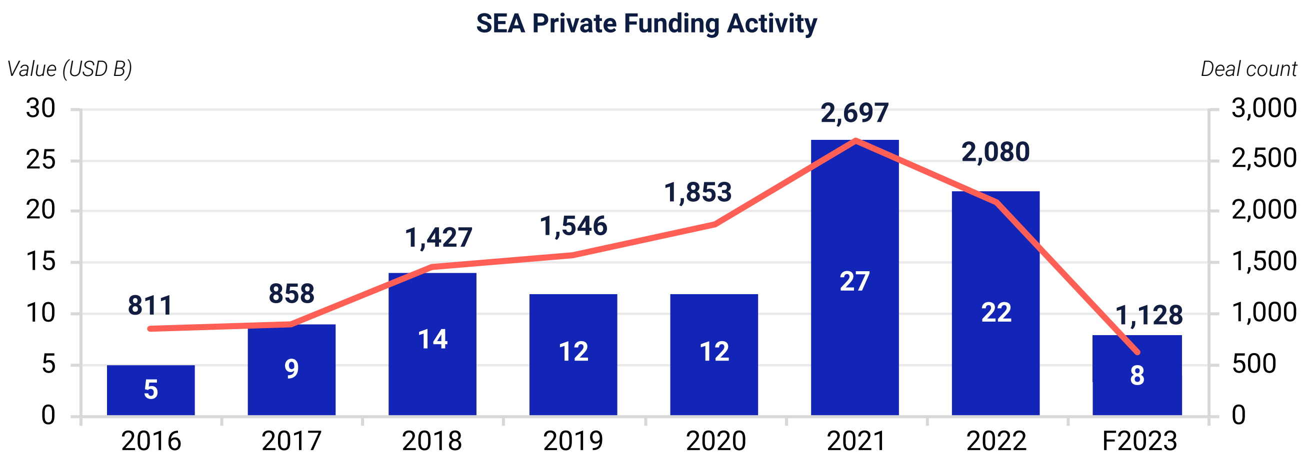
A few years ago, the startup ecosystem in SEA enjoyed a positive investment climate, prompting the ideal environment for startups to experience unprecedented growth usually thanks to substantial capital injections with less emphasis on immediate profitability. This trend mirrored the global scenario, with speculative investors armed with dry powder eager to yield results within fund timelines.

While the world grappled with a pandemic, new expansionary fiscal policies, including SEA, were adopted worldwide to aid citizens and companies battled with the impact. This widespread support contributed to an unusual surge in inflation. As a result, the natural response from central banks was to enforce contractionary monetary policies, by implementing rate hikes and, hence the end of the cheap capital era.





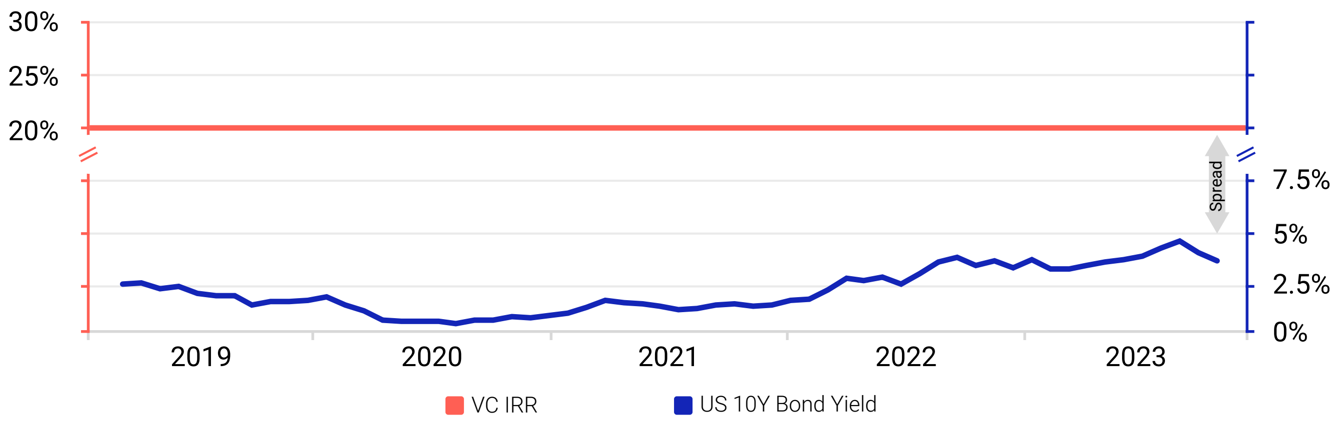
In SEA, despite relatively contained inflation compared to other regions and consequently more moderate interest rate hikes, private funding experienced a decline to its lowest level in six years, in line with global shifts towards higher costs of capital.



The expected impact of the new rising-rate environment on venture capital (VC) and startups is to slow down the exceptional growth seen before.

Nowadays, it is uncommon to observe growth rates of 100% or above seen in the past, as explained by a venture capitalist principal interviewed. The higher interest rates have led to a change in investors' appetite, as the spread between bond yields (which increased due to the interest rate hike) and the 20% target venture capital returns has narrowed.

Spread US 10Y Bond Yield vs 20% VC Target IRR



This has resulted in decreased investments (demand) in startups, while startups (supply) still require funding to sustain their growth plans. Furthermore, capital-raising processes have been prolonged, as investors exercise greater caution in their decision-making, as mentioned by a startup founder from a Vietnamese startup aiming to raise a Series C in 2024. This, in turn, drags startups' growth opportunities, appealing to them to take special care of their runaways and further anticipate their capital raise plans.

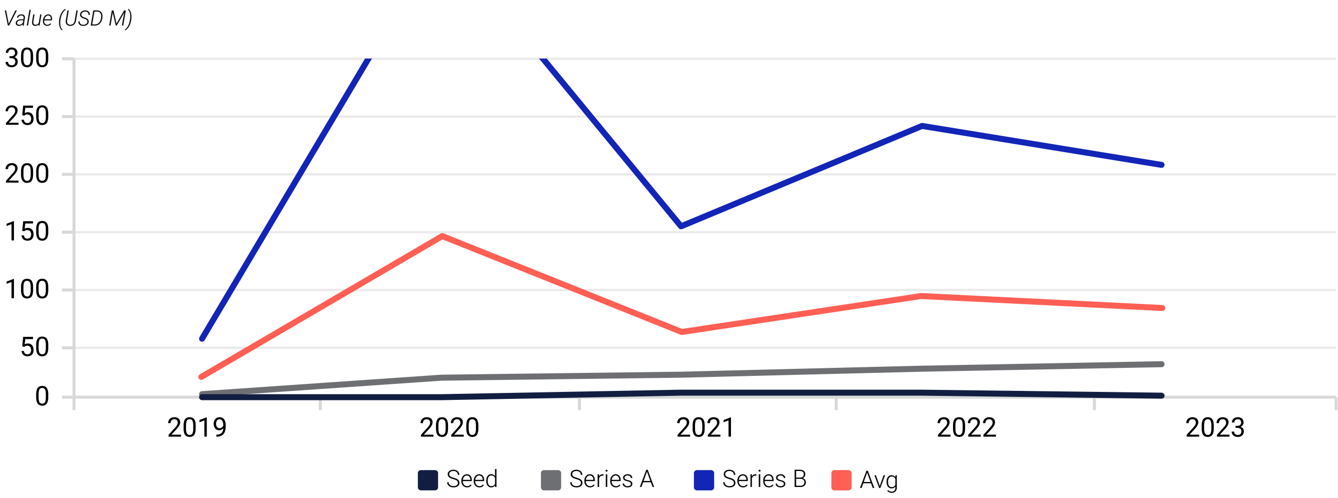
As a result, fiercer competition for funding among startups has arisen, leading to an expected decline in equilibrium prices, or in VC case, valuations.

Therefore, a crucial question arises: which startups are more prone to survive under heightened competition?

To answer this question, it is pertinent to differentiate between early-stage (Seed, Series A, Series B) and growth-stage (Series C, Series D, Series E) startups.

For early-stage start-ups, achieving both high growth and profitability simultaneously is challenging. Therefore, VC and angel investors focused on the early stage will continue to consider various factors beyond profitability when deciding on investment opportunities. However, due to the reduced private funding in SEA, it's anticipated that there will be fewer investments in this category, with either higher expected returns or discounted valuations, thus increasing competition among similar-stage startups.

SEA Median Valuations of Early-stage Startups



The valuation of companies in Seed and Series A stages in SEA has not been significantly impacted by the recent shortage of private funding. However, Series B startups suffered a sharp decrease in valuation post-COVID (2021) and have since maintained at a lower range.

For growth-stage startups, the distinction between profitable and unprofitable companies becomes crucial. The challenging fundraising environment prompts startups to face increased pressure for profitability amid cautious investors with plenty of choices.

Venture capitalists are now prioritizing startups with a successful track record of top-line growth and either profitability-proved or path to profitability, with the ability to scale the business but showing enough fat to be able to grow at a sustainable rate, as shared by an interviewed startup founder. These high-quality deals will only suffer from competition among themselves.

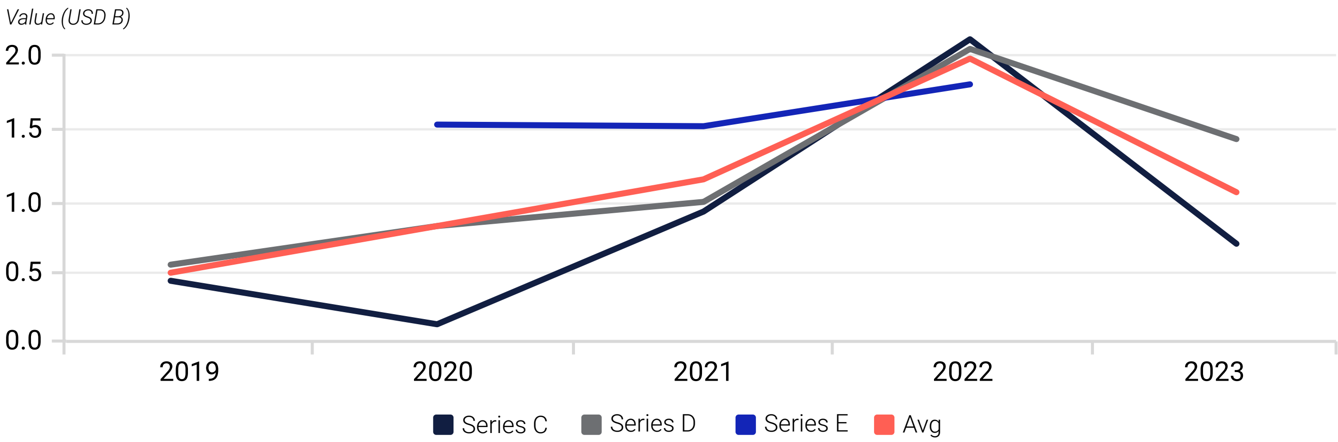
Additionally, self-sufficient companies will be able to strategically defer their capital raise plans considering more favorable conditions in the future by looking to expand their funding runaways through more efficient spending in favor of healthier long-term growth.

The shift in interest from growth to profitability has already manifested in the VC industry through an earlier-stage adoption of EBITDA multiple valuations rather than revenue multiples used in the past.

On the flip side, growth-stage companies that have prioritized revenue (market share) over profitability for an extended period and still require funding to sustain their operations will face loss of interest from venture capitalists, being such companies, whose growth was merely supported by funding, particularly vulnerable to fluctuations in the fundraising environment.

Moreover, their limited cash reserves and short runways will force these companies to either accept lower valuations, undergo significant restructuring, or ultimately shut down—in this exact order.

SEA Median Valuation of Growth-stage Startups



Focusing on the impact on valuation in SEA, we observe that the current fundraising landscape has impacted growth-stage valuations across various stages. This suggests that profitable startups in the growth stage in SEA are refraining from additional capital raises, and it is mainly unprofitable startups that are seeking new private capital amid the current environment.

These cuts and valuation adjustments underscore the unwillingness of investors to continue funding losses unless the management of these startups shows a path to profitability. Consequently, SEA startups have had to reimagine their businesses in order to regain interest from investors and show a viable track to profitability. This has involved revising their estimations of customer lifetime value, which turned out to be overestimated, while high customer acquisition costs ended up with most clients being unprofitable.

This has been particularly accurate in SEA, where the middle class has proven to be smaller than initially forecasted, leading to a reduction of the addressable market of some of these startups and, hence, resulting in lower purchasing power than other benchmarked East Asian markets.

In cases where the revision of prior business plans with aggressive growth did not yield substantial improvements in profitability, additional operational cost-cutting measures have been implemented, leading to leaner organizations, as seen in Grab or Lazada layoff cases, but at the same time, enlarging their runaways to weather the storm.

After understanding why founders are keen to lower their valuation expectations, it is crucial to understand why existing financial investors would accept these lower valuations.

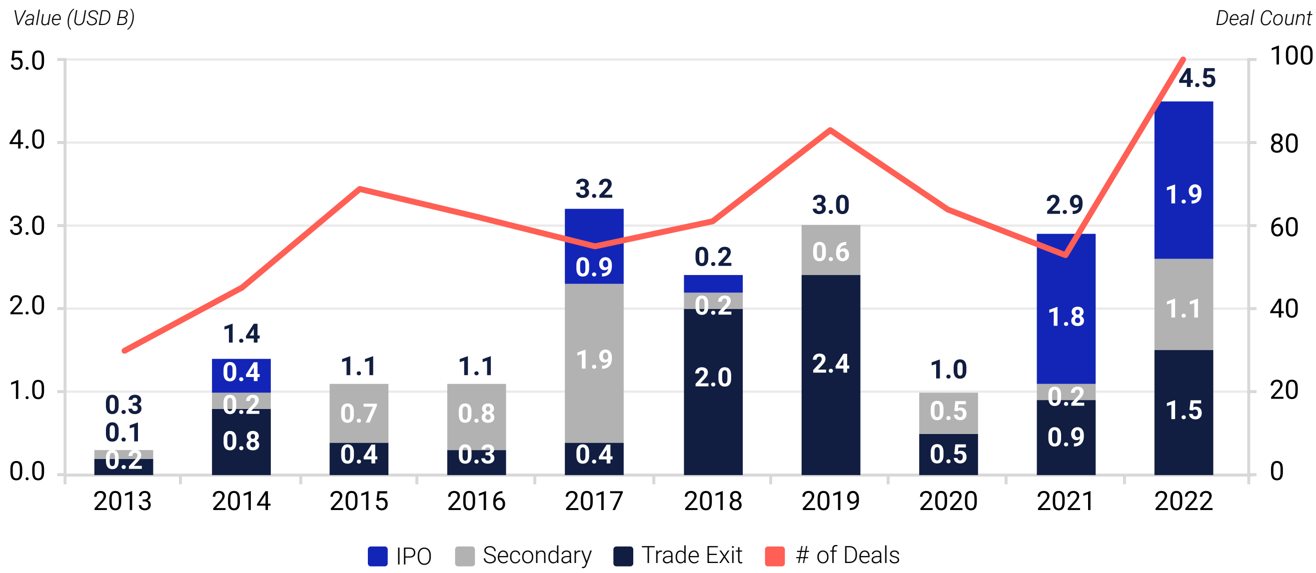
To answer this question, we need to delve deeper into the realm of venture capital. VCs typically aim to exit their investments within a 5-7 year timeline through an upcoming merger and acquisition (M&A) or an initial public offering (IPO). However, the current global landscape shows that both are at unseen levels in 10 years.

VCs in SEA are facing growing pressure to exit, given that investments made in mid-2010 are currently reaching the harvest phase, prompting them to seek exit opportunities.

This has led to a surge in the secondaries market, where venture capitalists seek to sell their minority investments to fresh investors. While previously, the secondary market only allowed flat prices or discounts of up to 10%, the new norm in SEA has shifted towards significant discounts of 30-40%. This trend is particularly notable among distressed limited partners (LPs) looking to divest parts of their ventures, presenting new opportunities for investors to acquire companies at low valuations.

Subsequently, amid the widespread awareness of the ongoing situation and to protect themselves from potential down rounds, these new investors are requesting more stringent ratchet provisions for anti-dilution in their investment term sheets.

Exit proceeds in SEA by year



2022 marked a peak year in exit proceeds, accompanied by a surge in deals. This suggests a lower average value per deal. Similar expectations are anticipated in the near future.

Even though some macroeconomic factors might be stabilizing and some industry insiders might suggest the situation could revert in the short run, the sentiment of some founders is still that the fundraising environment might get more challenging before getting better and might take an additional 2-3 years to recover.

Investors’ opportunity to leverage the situation

As shown previously, the present funding landscape in SEA presents an opportunity for new investors to acquire startups at discounted valuations opportunistically (although with prudence, carefully revising robustness of business plan assumptions) but may need to navigate cap tables filled with numerous financial investors. Finding a common agreement to a down round from all these financial investors may be challenging due to different investment situations.

Early-stage investors may be open to accepting a lower-than-current valuation since they invested at a lower valuation than the latest round. For these investors, a down round could serve as a feasible exit opportunity, provided the offer is in-the-money and ensures a decent Internal Rate of Return (IRR).

On the opposite side, latest-round investors, having invested at the highest Enterprise Value (EV), are less likely to accept a down round unless they face a distressed situation and are willing to cash back at-the-money or out-of-the-money but at a minimal loss, allowing them to reinvest in a higher yield investment elsewhere. Additionally, these investors, having invested more recently, may not be in a rush to exit and could opt to wait for a more favorable offer, aiming to harvest at a later phase.

Hence, negotiation becomes crucial in such scenarios, and getting rid of these investors will be a priority to succeed. An effective approach in negotiating in such cases is to offer differential pricing tailored to each investor rather than offering a ballpark valuation for all shareholders.

To accomplish such a strategy, it is detrimental to determine the minimum price at which each investor is willing to exit through backward calculation considering a fixed IRR, the invested amount, and the investment tenor. This approach enables the new investor to meet the exit expectations of the existing investors individually while still securing a low valuation.

(USD K)	Investment Amount				Acquired Stake	Post Money EV	Pre Money EV	Fully Diluted (FD) Stake
Investor	Seed 2015	Series A 2018	Series B 2020	Series C 2022				
Investor A	250				25.0%	1,000	750	18.23%
Investor B		500			10.0%	5,000	4,500	8.10%
Investor C			1,500		10.0%	15,000	13,500	9.00%
Investor D				5,000	10.0%	50,000	45,000	10.00%
Total	**250**	**500**	**1,500**	**5,000**				**45.33%**

In the given cap table example, this startup has experienced four investment rounds with valuations reaching up to USD 50M. Unlike the current private funding environment, in a normal funding environment, to successfully acquire the startup, an investor must offer at least USD 50M (Flat Round) or more. Failing to meet this valuation would likely result in the last investor (Investor D) waiting until the end of the expected investment tenor, aiming for a better offer.

(USD K)	Invested Amount	FD Stake	EV = USD 50M			EV = USD 60M		
Investor			Exit Value	IRR	MOIC	Exit Value	IRR	MOIC
Investor A	250	18.23%	9,113	56.8%	36.5x	10,935	60.4%	43.7x
Investor B	500	8.10%	4,050	51.9%	8.1x	4,860	57.6%	9.7x
Investor C	1,500	9.00%	4,500	44.2%	3.0x	5,400	53.3%	3.6x
Investor D	5,000	10.00%	5,000	0.0%	1.0x	6,000	20.0%	1.2x
Total	**7,250**	**45.33%**	**22,663**	**49.8%**	**3.1x**	**27,195**	**56.4%**	**3.8x**

In the provided examples, we observe the cost of acquiring the 45.33% stake from the four investors at two different EVs and the associated returns. In a Flat round scenario (USD 50M), the purchase price for 45.33% of shares would be USD 22.7M, with no profit for Investor D. Alternatively, the USD 60M scenario yields Investor D an IRR of 20%, making it a more feasible case. However, the new investor would need to offer USD 27.2M for the same stake in this case.

(USD K)	Invested Amount	FD Stake	Differential pricing			
Investor			Exit Value	IRR	MOIC	Implied EV
Investor A	250	18.23%	1,075	20.0%	4.3x	5,898
Investor B	500	8.10%	1,244	20.0%	2.5x	15,360
Investor C	1,500	9.00%	2,592	20.0%	1.7x	28,800
Investor D	5,000	10.00%	6,000	20.0%	1.2x	60,000
Total	**7,250**	**45.33%**	**10,911**	**20.0%**	**1.5x**	**24,073**

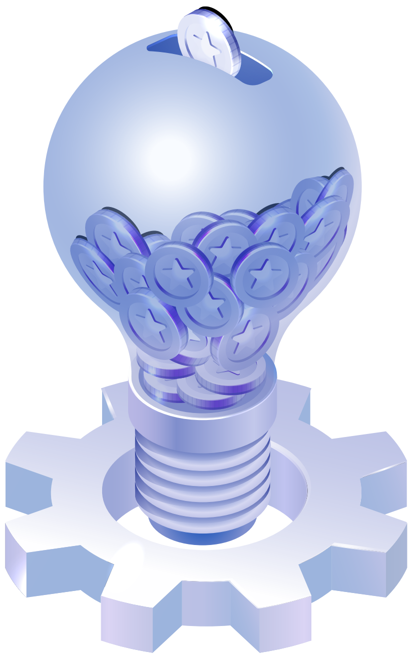
Considering the current private funding landscape, differential pricing can be employed to acquire the startup at a reduced valuation. By reverse engineering from a fixed 20% IRR for all investors, we derive the Returns for each investor, with an implied Enterprise Value ranging from USD 6M to USD 60M. This is contingent on the invested amount, fully diluted stake, and time of investment. Offering a 20% IRR to all investors, which is deemed a decent return in the prevailing environment, results in an Implied Total Enterprise Value of USD 24M instead of USD 60M. The total purchase price for acquiring 45.33% of shares would consequently be USD 10.9M only, instead of USD 27.2M.

A Strategic Approach to Down Rounds in Southeast Asia

The current funding landscape in Southeast Asia presents both challenges and opportunities for investors navigating the startup ecosystem. While the prospect of acquiring startups at discounted valuations can be enticing, a nuanced approach is crucial. Early-stage investors may view down rounds as viable exit opportunities, whereas later-stage investors with larger stakes may be more hesitant if faced with significant business challenges. Negotiating differential pricing tailored to each investor class emerges as a strategic approach. This allows new investors to secure lower valuations while meeting the exit requirements of existing investors.

However, navigating down rounds requires careful consideration beyond pricing. Investors must thoroughly assess the underlying reasons for the down round and the long-term viability of the startup. Collaborating with existing investors to develop a turnaround plan can mitigate risk and ensure alignment toward shared goals.

By understanding the dynamics of cap tables, employing innovative negotiation strategies, and conducting thorough due diligence, investors can capitalize on the evolving SEA startup ecosystem. This strategic approach not only facilitates securing attractive entry points but also fosters sustainable growth and value creation for startups in the long term. As the SEA startup ecosystem matures, a focus on collaboration and innovative financing solutions will be paramount for investors to thrive in this dynamic and exciting market.



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Gary is our Partner based in Thailand, and the Head of Mergers and Acquisitions (M&A) Advisory for Southeast Asia. At YCP, he has supported 100+ clients, from multinational companies to family-owned SMEs in 10 countries across Asia. He has supported various topics under M&A, including commercial due diligence, financial advisory, post-merger integration, CFO service, and under management consulting, including market entry strategy, business process improvement, organization optimization, competitor benchmarking, industry research, and market forecasting.

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Alex is our Manager based in Thailand. At YCP, he has project management experience in SEA cross-border transactions in buy-side financial advisory, such as the acquisition of an Indonesian multi-finance company, a Malaysian non-bank financial institution, an Indonesian SaaS company, a Singapore-based restaurant chain, and a Vietnamese marketing IT startup. He also has experience in the financial valuation of a Malaysian fintech firm and a Malaysian-based non-performing loan portfolio, as well as the financial valuation and negotiation strategy of a Vietnam-based automotive parts manufacturer.

About Us

What We Do

YCP Solidiance is an Asia-focused strategy consulting firm with offices across 20 key locations globally. Asia-focused with global presence, we define new business models and help clients drive their business growth through strategic solutions. We deliver high-impact advisory services by tailoring our services to suit different business needs. To learn more about our services visit: **https://ycpsolidiance.com**

What We Focus On

We focus on advising our large client base across a wide spectrum of strategic consultancy areas, identify breakthrough growth opportunities and develop execution-ready strategies and roadmaps. Our Asia-focused market entry and growth strategy services provide the required insights to capture a profitable market share in the region.

Our Locations

We are present in Singapore (global headquarters), Japan, China, Hong Kong, Taiwan, Indonesia, Malaysia, the Philippines, Thailand, Vietnam, India, United Arab Emirates, Canada, the United States, and the Netherlands.

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