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Outside the Box

Opinion: Inside SVB's bankruptcy: startup company losses have threatened the financial system for years

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Stock market weakness is squeezing unprofitable startups, forcing them to use bank lines of credit and draw down bank deposits.

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Referenced Symbols
SIVB AMZN -2.53% BTCUSD -0.97% 9984 -0.82%

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The bankruptcy of Silicon Valley Bank **SIVB,** , the nation's 16th largest bank, has rattled global markets. SVB used short-term deposits to finance investments in long-term bonds, stocks, and mortgages — a wager that interest rates wouldn't rise.

Once the Federal Reserve started raising interest rates aggressively to slow inflation about a year ago, the market value of SVB's long-term investments collapsed, but management was able to maintain an illusion of solvency by valuing most of the bank's bonds at par rather than market value.

Depositor withdrawals forced SVB to reveal this accounting discrepancy by selling some of their bonds for a $1.8 billion loss. The next domino was nervous investors fleeing SVB stock, which fell 60% on March 9, and another 65% by the time markets opened on March 10. Before the day was over, the FDIC had closed SVB.

SVB had been focused on Silicon Valley startups since its inception and had helped many succeed. However, most startups have been losing money — lots of money — which presented a unique set of challenges that did not become apparent until rising interest rates crushed SVB's balance sheet.

We have been writing about startup struggles for years (for example, here, here, and here). These startup losses, which have been cumulating for years, are a problem for venture capitalists, stockholders and lenders like SVB.

SVB might have gone bankrupt even if it had not made a foolish bet that interest rates wouldn't increase. The weak stock market since December 2021 has made fundraising challenging for unprofitable startups, forcing them to use their bank lines of credit and draw down their bank deposits. SVB's investments in long-term Treasurys merely caused the festering problems to be exposed sooner rather than later.

Amazon had losses, but nothing like this

Some venture capitalists publicly laugh off startup losses (though they fret privately), pointing to Amazon.com **AMZN, -2.49%**, which had losses for years before it became the giant it is today. But in fact, few startups have been as successful as Amazon, and its losses, which seemed large at the time, are dwarfed by many of today's startups.

Amazon became profitable in its 10th year, when it had $3 billion in cumulative losses. At least 18 publicly traded American "unicorns" — companies valued at $1 billion or greater — have more than $3 billion in cumulative losses, of which three have more than $10 billion.

Moreover, most are far older than 10 years. The average age of America's 144 publicly traded unicorns is 14 years. While Amazon's $3 billion in cumulative losses were about equal to its revenues in year 10, almost 60% of publicly traded American unicorns have cumulative losses greater than their 2021 revenues, meaning that even if they become profitable — a big if — it will be difficult for them to overcome their cumulative losses.

> *Some venture capitalists say that things are turning around, with startups on the cusp of profitability. The facts say otherwise.*

Some venture capitalists say that things are turning around, with startups on the cusp of profitability. The facts say otherwise. The percentage of publicly traded American unicorns that are profitable rose to 19% in 2021 from 16% in 2020 and 12% in 2019, but fell back to 12% during first three quarters of 2022. The end of the lockdowns not only meant the end of easy money; it also meant the end of high revenue growth for startups that provided services to people stuck in their homes.

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Delusions die hard. CBI Insights reports that there are 1,207 privately held unicorns and that their total valuation in March 2023 is $3.79 trillion — that's right, trillion. Few believe these self-valuations since the market capitalizations of publicly traded unicorns has been declining since late 2021. Almost every publicly traded American unicorn saw its market cap fall at least 50% from the peak in late 2021, and most by more than 80%.

Privately held startups also massage their profits, partly because they don't have to release audited statements. For instance, Revolut, one of Europe's top fintech startups, recently announced that it was profitable in 2021, apparently only the second European fintech to achieve profitability. But then it was revealed that it was only profitable because of lucky investments in crypto.

Moreover, Revolut's auditor said it couldn't verify those investments. It doesn't take a PhD in rocket science to know that the value of bitcoin **BTCUSD, -0.95%** and other cryptpo have fallen more than half from their peak in 2021, and so Revolut likely lost money in 2022.

> *Too many venture capitalists, banks and stockholders have invested too much in startups that are little more than compelling stories and persuasive pitches.*

Most of the media have yawned over these fibs, and sometimes even reported them as facts. The reality is that the best startups are the first to go public. Those that remain private are, on average, undoubtedly in worse shape than are those that have gone public. Their true market value is surely far less than their $3.79 trillion self-valuation. Our guess is south of $500 billion.

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These realities are impacting companies with investments in privately held startups. We have written elsewhere about SoftBank's **9984, -0.82%** struggles. Softbank's share price has fallen more than 50% from its peak in early 2021 and a March 16, 2023, Wall Street Journal article entitled "The SVB Tremors Will Shake SoftBank" warns of further losses from its startup portfolio.

Another Wall Street Journal article published on the same day describes the "$23 billion in value erased from Tiger Global's giant holdings of startups around the globe," including TikTok parent ByteDance and payments company Stripe . This article also noted that Harvard University endowment chief N.P. "Narv" Narvekar had warned in his annual letter in October 2022 that venture managers were not trimming the value of their private investments sufficiently.

We will not refrain from saying, "Told you so." The SVB bankruptcy should be a wakeup call for the global startup system. Too many venture capitalists, banks and stockholders have invested too much in startups that are little more than compelling stories and persuasive pitches.

We should all demand more, starting with audited financial statements from all private startups. If they refuse, their market value should be reported as zero.

Jeffrey Funk is a retired professor and now an independent technology consultant. He is completing a book tentatively entitled "Big Promises, Small Results: How Rising Hype and Misleading Narratives are Hiding Startup Losses and Slow Progress in New Science and Technology."

Gary Smith, Fletcher Jones Professor of Economics at Pomona College, is the author of dozens of research articles and 16 books, most recently, "Distrust: Big Data, Data-Torturing, and the Assault on Science" (Oxford University Press, 2023).

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