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Square Peg Investor Letter Half Year Report 31 December 2023

Dear Investor,

Without a doubt, 2023 was the year of AI. "AI" was named the most notable word of 2023 by the dictionary publisher Collins, and AI-related terms were recognised in "Word of the Year" lists from Oxford, Cambridge, and Merriam-Webster. Few would disagree this was a reflection of the topic dominating the mainstream tech conversation in 2023. We believe we are at the early stages of the AI era, and that there is a strong likelihood that the AI era may be the most fundamental tech era since the invention of the transistor in 1947.

As we enter the new year we are highly energised and excited for the year ahead.

Reflections on 2023: a steady return to normal

Before turning to 2024, let's take a moment to reflect on 2023. Across all of our funds, we had a slightly slower investing cadence in 2023, however, we made several new investments, and a number of follow-on investments in existing portfolio companies across our Venture and Opportunities funds. Our investing activity in new companies is an entirely bottom-up exercise and we do not target a given level of activity in a year. The number of opportunities gathered pace towards the end of last year, and we enter 2024 with a high level of enthusiasm and excitement.

In 2023, valuations and level of deal activity continued to drift lower for both early-stage and later-stage opportunities but markets continued to function in an orderly manner. The cumulative fall in valuations from their peak in early 2022 is now fairly substantial, especially for later-stage companies. As a reflection of the uncertain market, in June 2022, we proactively introduced general provisions across a number of our funds. Over the past year, we have begun to unwind these provisions following the completion of priced rounds by a number of our portfolio companies. In some instances, portfolio companies have completed priced rounds at a valuation uplift and in other instances, portfolio companies have completed priced rounds that are either flat or down relative to their last round. However, at an overall fund level, the impact of such movements has been largely offset by an unwind in that fund's respective general provision, and we are comfortable with the holding value of our portfolio.

We also saw a rebound in public market tech valuations in 2023 and that will support private market valuations. We don't have a clear view on whether valuations will move higher or lower in 2024 and they sit within a fairly normal range. The major exception remains in the area of AI-first businesses, where valuations continue to be understandably elevated, and we expect this trend to continue for some time.

As a reminder, we are cognisant of valuations but entering companies at low valuations is not the key driver of success in VC investing. In an asset class where a small number of companies generate remarkable returns, and many companies go to zero, having access to and selecting the best companies, is what really matters. To add some colour to that point, our first investment in Carva in 2012 was at a valuation of \$8m. We are elated to have had that opportunity to invest at that price given Carva was recently valued at \$25.5bn, yet, even if the investment was made at a 20x higher price, we would still be incredibly excited about that investment. By contrast, our first investment in Airwallex was at a valuation of \$150m. That reflects the company being at a later stage when we invested (Series A1 rather than Seed) as well as a very high valuation for what was regarded as a "hot" company at the time. The company is today valued at \$5.6bn, and we are equally thrilled to have had the opportunity to invest.

As noted above, our level of follow-on activity was also a little lower than in previous years, reflecting a well capitalised portfolio as well as less enthusiasm by companies to raise rounds in a tougher market environment. This was in contrast to the 2020-2021 period, where many companies raised opportunistic rounds given the large amount of capital available and high valuations. Notwithstanding a slightly lower volume of activity, we were excited by the follow-on opportunity set in our portfolio. We were able to make a significant number of follow-on investments in many of our best-performing portfolio companies from both our core Venture funds and our Opportunities funds.

Overall we are pleased with the performance of our portfolio. We continue to see strong growth (even though in some cases growth was slower in 2023 than in 2022), attractive unit economics, and strong balance sheets. We now have companies with annualised revenues of \$2bn (Carva), companies with annualised revenues in the range of \$500m (Rokt), and a number of other companies with revenues in the range of \$100-\$500m (e.g. Kredivo and Airwallex). In each case these companies are either profitable or on a clear path to profitability, they are growing strongly, and have excellent unit economics. Equally important, we have a strong "next generation" of companies in the revenue range of \$20-\$100m. As you would expect these companies are typically growing faster and are further from profitability than their more mature peers. However, they are well capitalised and generating significant value, leaving them well positioned to evolve into substantial companies over the next few years.

Across the startup universe, we are seeing failure rates continue to increase off a historically low base (see Figure 1). This is both to be expected and in itself is not a concern. From the perspective of creating value for you, our primary focus continues to be on our best-performing portfolio companies, and our portfolio remains high quality and resilient, an outcome of our high-conviction investment approach. From the perspective of individual founders, the failure of their startup can be a traumatic and humbling experience, and as partners on the journey, we will support them as best as possible.

Figure 1: Startups shutting down. Highest number of US startups shutdowns yet in Q3 2023

The failure rates across our portfolio continue to be lower than we anticipated, and while we do expect this to potentially increase in 2024, we believe this will have a marginal impact on the total value of our portfolio. At the start of this downturn two years ago, we committed to do everything in our power to avoid the failure of a company that deserves to endure, and to date, we have been able to keep that commitment.

In regards to exit activity, two criteria need to be present for substantial exits to occur; 1) the company needs to be appropriately ripe, and 2) markets need to be accommodative. Both of those criteria were in place for a number of our portfolio companies in the 2019-2021 period and we took advantage of that to return substantial capital. Over the last two years, market conditions have not been receptive to exits and we have seen very low levels of exit activity. We expect that to pick up somewhat in 2024, but from both a portfolio and market perspective, we anticipate that 2025 and 2026 will be much more active years for exits.

Looking forward to 2024: the year ahead

We will continue to pursue the same investment strategy in 2024 as we have in the last few years - to identify the best early-stage opportunities across Australia, Israel, and Southeast Asia, with a particular emphasis on founders building businesses in the areas of SaaS, Fintech, and AI. We have a high level of confidence that our current strategy and team can deliver incredible outcomes if executed well. These three thematic focus areas will typically represent about three quarters of our investing activity, with the balance looking at emerging themes such as climate tech.

Our multi-geo approach provides us with a greater set of opportunities compared to a fund focused on a single geography. The greater number and breadth of opportunities in turn enables us to be far more thematic in our approach, compounding the depth of knowledge, networks, and reputation we gain over time. As we know, the magic of compounding is not fully realised over a single year but instead plays out when you compound each year and for a sustained period. We see that as our flywheel in action. Our goal has always been to combine the best of a global investor (a large opportunity set, global mindset, global networks), with the best of a local investor that has deep local knowledge and meaningful relationships. This compounding of thematic knowledge and expertise has also helped us identify longevity and defensibility in our Global Tech Fund (listed equities strategy) where we combine our long-term, private capital mindset with our deep focus on tech themes and founder-led teams to understand which companies will continue to create value over a sustained period of time.

Much has been written about AI over the last year and we very much subscribe to the view that something incredibly profound is transpiring that will change our society in fundamental ways. The rate of progress over the last few years has exceeded the expectations of even the most optimistic experts. We expect that in 2024 we'll see a rise in founders with domain-specific knowledge found AI companies to solve age-old problems. Of course, there are no guarantees that this pace of progress will continue at the frenetic pace of the last few years. However, we are very much in the early stages of the AI era and while the pace and direction of progress are somewhat uncertain, there is little doubt that we will see profound progress and the compounding benefits of that progress.

In the earliest days of a new technology, the companies that accrue the most value are those that facilitate its unlocking and use by other players, typically through investment in R&D. They build the rails that others will build on top of. Then come the businesses that distribute this new technology and make it dramatically more accessible. In AI, due to the pace of development, we are building on top of these rails while we are still engineering the rails themselves - the modern-day equivalent of building the kite while flying it. This could mean a lack of durability for much of what is being built today as we are still in a deep state of flux.

We believe there's durability to be found in businesses that are solving vertical or domain-specific problems. Solving long-experienced problems in industries that require specific expertise helps protect from large generalist players (for example, Google and Amazon), and enables a business to be technology-agnostic as their business is not tied to any particular AI. We've already invested in many companies using AI to solve specific problems; some examples include, medical imaging company, Aidoc, transaction marketing platform, Rokt, digital mapping providers, Exodigo and Nears, and global auto parts matching platform, Partly. We're excited to continue investing in AI-first companies in 2024.

The changes brought by AI will have both positive and negative consequences. Our policymakers and leaders in the tech community have a responsibility to mitigate the negative implications as much as humanly possible. However, in our view, taking premature or knee-jerk steps to slow down the pace of progress in AI is an unwise approach. We are living in a world where there are deep divisions and conflicts between liberal democracies and illiberal societies. Technological dominance has always been a key factor in determining the course of history and it is a vital imperative that liberal societies prevail in the AI race.

An update on Israel

We have previously shared our thoughts on the ongoing conflict in Israel and Gaza. We continue to remain in awe of the resilience and resolve demonstrated by our team and our founders in Israel. Each of our Israeli portfolio companies, and the Square Peg team, has been impacted, and in some cases, up to half of the team members of individual companies have been mobilised continually since October 7. In this context, we are impressed by the strong company performance of our portfolio in Israel over the last half. We are also seeing an increasing number of new Israeli companies come to market to raise capital and are encouraged by the early signs of a surprising sense of normality returning to the Israeli startup ecosystem.

Expanding the Square Peg Team

In the last half, we welcomed three new team members, all in newly created roles, to Square Peg. Jess Firth has joined us as an Analyst in the Distribution and Investor Relations team, to support Leila Lee and Matt Linklater. Before Square Peg, Jess spent a few years at Ernst & Young working across audit, consulting and transactions due diligence for a range of financial transformation projects. David Maher has also recently joined us as an Investor in the Global Tech Fund, having previously worked at McKinsey & Company advising clients in their private equity and digital transformation practices. He also brings global experience in roles at growth-stage companies including Southeast Asia's ecommerce leader, Lazada, Swiss crypto innovator, Valour, and most recently London-based electric vehicle player, EV Technology Group. And finally, Dimity Kemp joined the team as Head of People, having previously worked alongside founders in the high-growth stages of Afterpay and Shippit. We're thrilled to have Jess, David, and Dimity on the team as we continue to grow and support our portfolio.

Thank you for your support

We are grateful to our investors for all of your continued support throughout 2023, and we were delighted so many of you were able to join us in person at our Investor Summit last year. As always, we remain cognisant of the need to be responsible stewards of your capital.

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