Litera Industry Report

Spotlight on Proptech

LITERA

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Source: PitchBook | Geography: Global | As of June 30, 2022

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Executive Summary

It's often said that real estate is the biggest asset class in the world—and one of the least efficient. Whether applied to commercial or residential real estate, the phrase "cost overruns" is both common and tolerated. Beyond the construction of buildings, homes, and other projects, real estate envelops several subsectors, including property management, real estate brokerages, mortgage financing, and security services. As technology continues to improve, new real estate verticals are maturing as well: smart home technology, smart buildings, and collaborative workplaces, to name just a few.

In conjunction with PitchBook, this report focuses on property technology, or proptech. The numbers in the report reflect a wide constellation of technologies and applications related to the business of real estate. In aggregate, they include venture financings for home remodeling software companies, phone-driven mortgage applications, fixer-upper investment platforms, and package-tracking services for apartment complexes.

A commonality to many is artificial intelligence (AI), which helps sort through thousands or millions of pieces of information to help property owners optimize their plans and upgrade accordingly. For new construction, those data points can help minimize or avoid cost overruns and delays, and for rental properties, they can help improve the relationships between landlords (reducing costs) and tenants (a better living experience). And those data points can help the entire real estate industry repair its reputation as being inefficient, labor-intensive, and time-consuming. Technology has revitalized other cumbrous markets such as music and publishing. Proptech is now aiming to do the same to the largest market in the world, with hundreds of inefficiencies to tackle.

Before we dive into the numbers, a quick note on sector definitions: real estate technology companies develop and leverage technologies to facilitate the purchase, management, maintenance, and investment into both residential and commercial real estate. This includes subsectors such as property management software, Internet of Things (IoT) home devices, property listing and rental services, mortgage and lending applications, data analysis tools, virtual reality modeling software, augmented reality design applications, marketplaces, mortgage technology, and crowdfunding websites. PitchBook's definition of real estate technology significantly overlaps with, and is largely synonymous with, property technology, which is the focus of this report.

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Dealmaking Trends

PitchBook data confirms that proptech has come into its own in recent years. Last year and for the first time, more than 1,000 venture capital (VC) deals were made in the space, worth a combined $22.7 billion. In Q4 2021, $7.4 billion was invested in proptech, more than the industry had seen in any year before 2018. However, the mood began to change in Q2 2022, when only 210 proptech rounds were recorded, a 32.4% slide quarter-over-quarter. Macroeconomic factors such as interest rate hikes, inflation, and the prospect of a recession have cast a cloud over the sector.

Industry advocates point out that commercial real estate performs relatively well in inflationary environments. The sector is also able to pivot its focus between positive and negative environments. Upward cycles motivate property owners to upgrade their buildings, while downturns spur efforts to maximize building security and maintain acceptable tenant rates.

That said, proptech promises to revolutionize the real estate sector, and its fortunes depend on building client rolls and proving its technology is worth the cost. It's a new industry, which opens the door to skepticism in downward markets such as today's. Deal flow slowed in the second quarter, hinting at softer quarters ahead. Certain applications have tailwinds to combat those fears, however. The shift to a work-from-home/hybrid working model presents an opportunity for proptech startups that can add value to commercial clients. Not only can proptech improve efficiencies for both management and current employees, but it can also give companies a boost in a tight labor market, where job seekers often demand hybrid schedules before accepting a role. Other proptech applications can help reduce energy usage in commercial and residential buildings, minimizing one of the biggest costs in the current economy.

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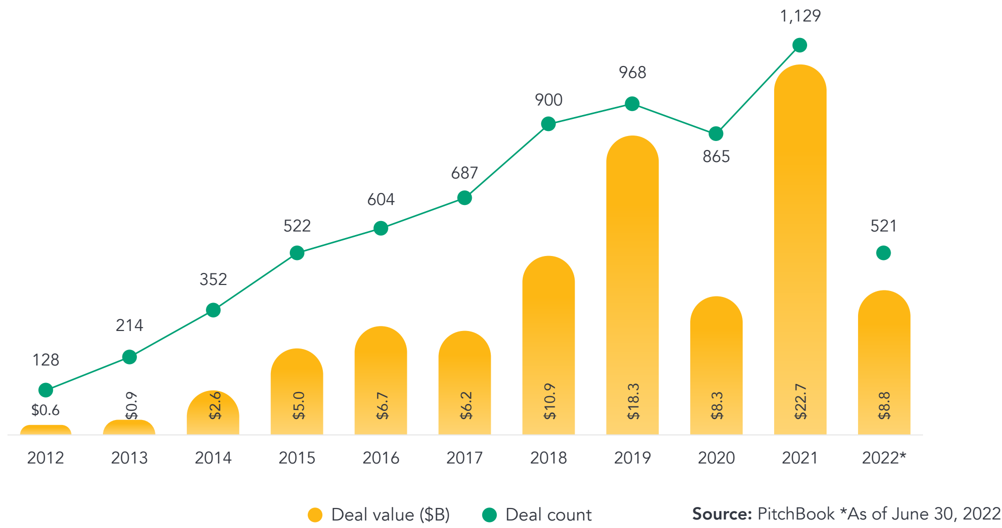
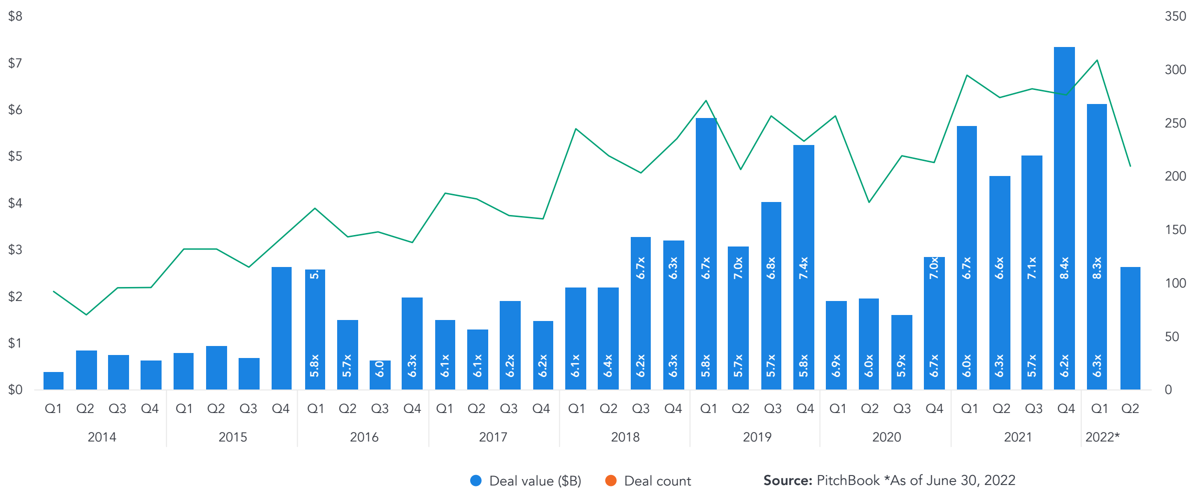
Global real estate technology VC deal activity



Global real estate technology VC deal activity by quarter



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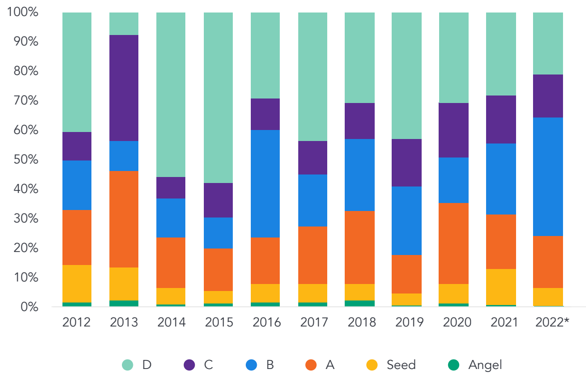
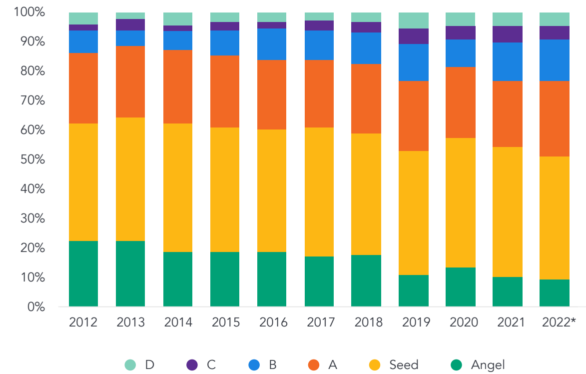
As proptech has matured, investment focus has shifted toward more early-round financings. In past years, it was common to see Series C and later rounds account for half or more of aggregate capital invested. While those rounds have grown over the past two years, they are accounting for a smaller proportion of VC dollars. That reflects health at the seed and Series A and B stages, where newer companies are raising larger rounds than their predecessors. Last year there were 317 seed rounds in proptech, up from 248 in 2020. Deal flow in Series A and Series B was near or beat record highs. Importantly, early-stage deal flow this year compares well to 2021 levels, while late-stage deal flow is on pace to decline significantly. Overall, there is less pessimism at the early stage compared to older startups. That relative optimism is also apparent in early-stage valuations, which are discussed on page 8.

Share of global real estate technology VC deal value by series



Share of global real estate technology VC deal count by series



Source: PitchBook *As of June 30, 2022

There is reason to believe the proptech correction will be limited in scope. Ample funds were raised over the past two years, and the market now has dedicated investors such as MetaProp VC that will invest through the downturn. Companies looking to raise money going forward will have to demonstrate differentiated technologies that meaningfully reduce inefficiencies. The two-year investment wave benefited some startups that are better described as real estate companies, not proptech. Those companies are likely to struggle as investors narrow their attention to proof-of-concept breakthroughs that can win customers in a recession.

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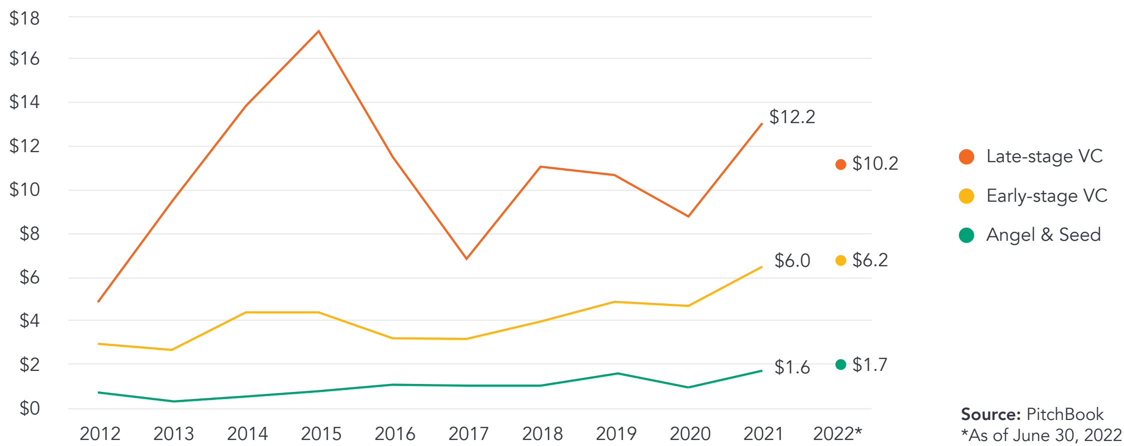
As with startups in other sectors, proptech startups are seeing smaller check sizes this year. The median deal size for late-stage rounds is down to $10.2 million from $12.2 million last year. Angel, seed, and early-stage rounds are treading water so far. More telling is the distribution by check size. Most glaring is the $25 million+ range, which saw 177 mega-rounds in 2021. Halfway through 2022 there have been only 77, which included a strong first quarter. If conditions continue to deteriorate, we'll likely see meaningful declines in the third and fourth quarters as companies adjust their expectations and raise fewer dollars. Across the board, check size distribution appears to be slowing, with only the $10 million-$25 million range on pace to eclipse 2021 levels. However, venture investors raised plenty of capital over the past two years, buoying the chances of capital deployment for better-performing companies.

Median global real estate technology VC deal size by stage



Source: PitchBook
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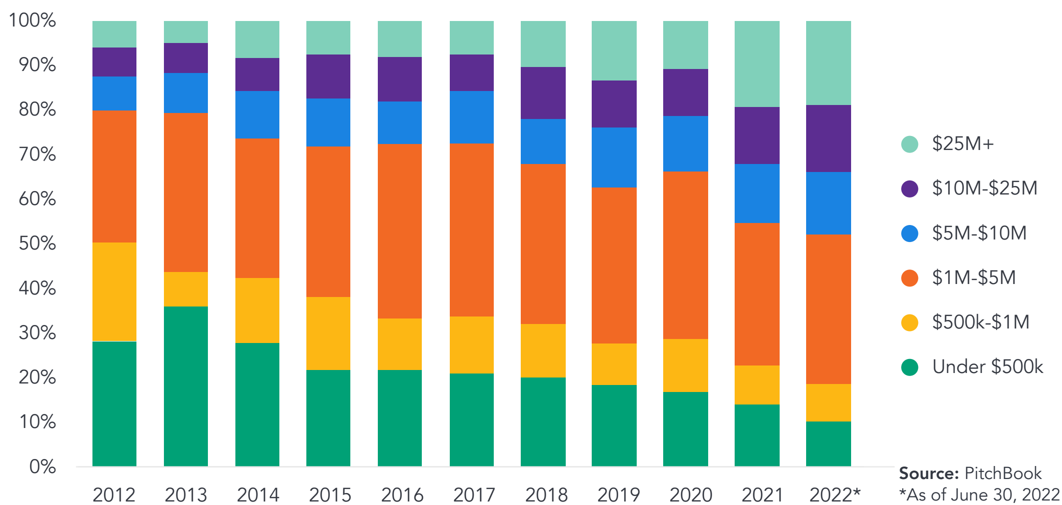
Share of median global real estate technology VC deal count by size



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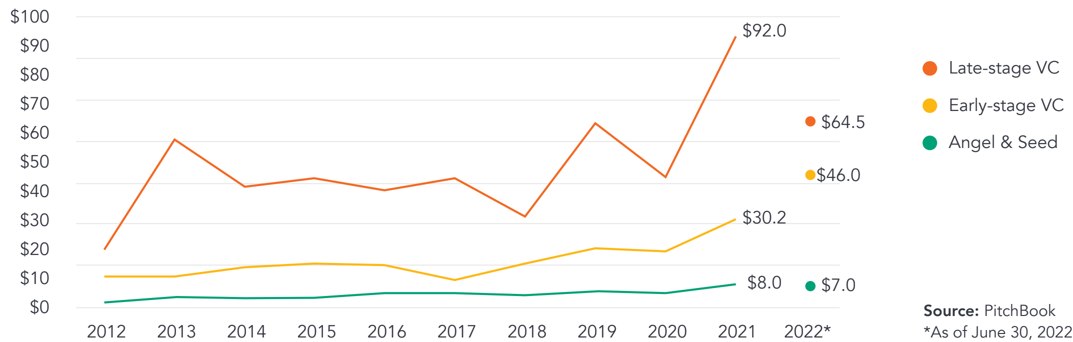
Valuations

After reaching historic heights in 2021, late-stage valuations in proptech have been humbled halfway through 2022. The median pre-money valuation fell from $92.0 million last year to $64.5 million through June 30, 2022, a 30.0% decline. That could change as the year progresses, but 2022 will likely record a significant haircut. Late-stage valuations are often influenced by public market comparables, alongside expectations of a successful exit in the near term. Proptech isn't exempt from the tech market correction, even if it is modestly buttressed by the sturdier commercial real estate segment. It faces the added headwind of being a new and vulnerable vertical just starting to hit its stride.

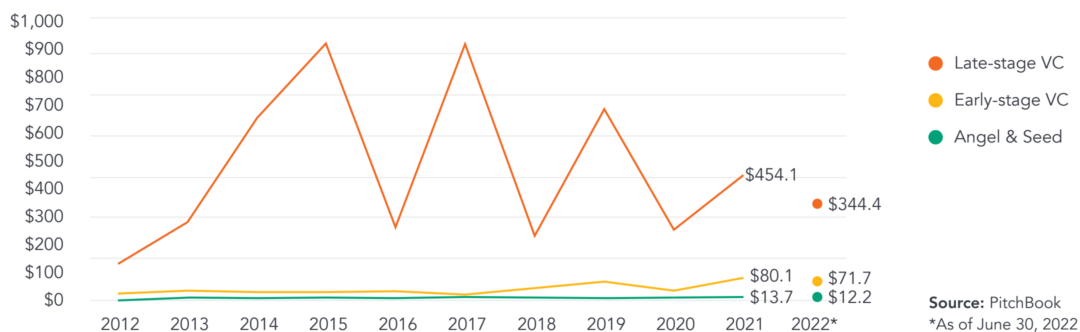
Median global real estate technology VC pre-money valuations



Source: PitchBook
*As of June 30, 2022

Early-stage valuations are, for now, moving in the opposite direction. The median early-stage valuation through mid-2022 is $46.0 million, 52.3% higher than the 2021 median ($30.2 million). With longer timelines to exit, early-stage proptech companies can concentrate on differentiating their technology and waiting for the next exit cycle.

Average global real estate technology VC pre-money valuations



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Exits

The past two years have been a watershed moment for proptech. For new verticals, the first wave of successful exits has provided confidence to the broader investment community of the sector's potential. Between 2020 and 2021, about $101.9 billion worth of exits were made across 145 transactions. For perspective, the prior eight years (2012-2019) saw only $17.5 billion worth of sales across 171 exits.

While IPOs and special purpose acquisition companies (SPACs) dominate the conversation in terms of exit value, M&As are the more popular exit route. Globally, 56 proptech startups were acquired last year, a record. Twenty-three have been acquired so far this year. By comparison, 17 proptech startups went public in some form last year, representing about 19.3% of exit flow. But the $33.3 billion exited by those companies represented some 97.5% of all disclosed exits.

Exits of $1 billion or more helped fuel the recent rush. Among others, Airbnb, Compass, and Opendoor Technologies became public companies over the past two years via traditional IPOs or trendy SPACs. Due to macroeconomic factors, their share prices have been turbulent in recent weeks. Compass, for example, went public in April 2021 at a $7.0 billion valuation, pricing its shares at $18. As of June 2022, its share price had plummeted below $5, shrinking its market cap below $2 billion. While its $450.0 million IPO contributed to last year's exit total, Compass's slide is contributing to IPO hesitation this year. Proptech's IPO window is likely closed for the foreseeable future, and the companies that went public over the last 24 months need to recover if proptech's IPO fortunes are to be revived.

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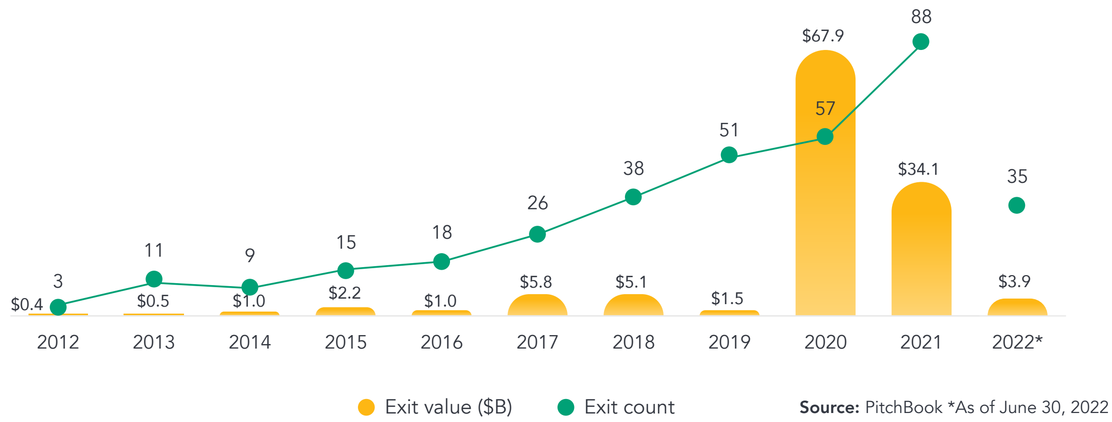
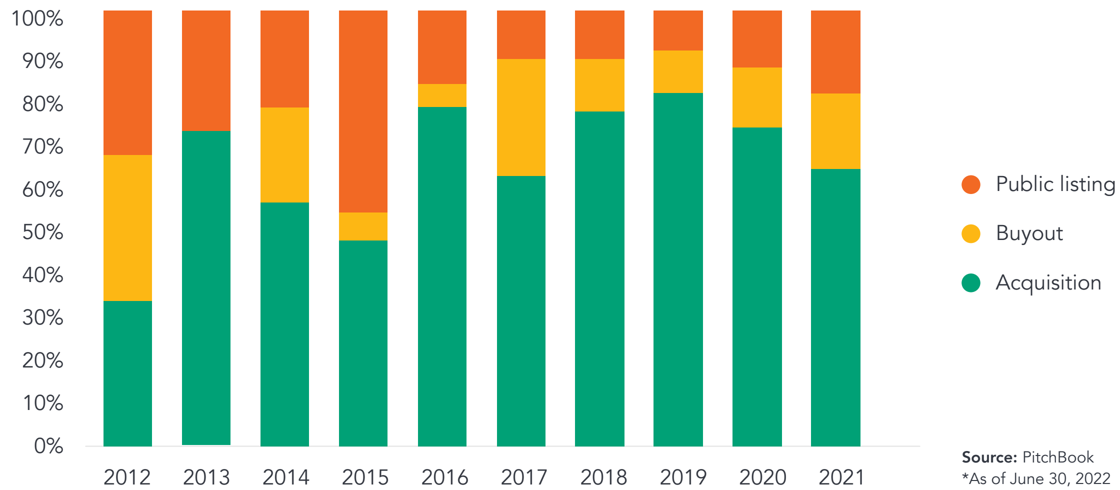
Global real estate technology VC exit activity



Source: PitchBook *As of June 30, 2022

Share of global real estate technology VC exit count by type



Source: PitchBook
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Q&A

Minta Kay
Partner, Goodwin Procter LLP

David Richardson
Partner, DLA Piper

Before we look ahead, let's talk about 2021, which saw more than 1,000 VC deals in the proptech space. What were the main factors that made investors so optimistic? Has that optimism waned this year?

Optimism is not waning. New and material technologies continue to be developed to solve problems that impact the built environment in all respects. As real estate owners, investors, and developers have started to live with and experience the advantages that can be achieved through more sophisticated technology, the adoption rate continues to rise. Proptech companies are playing an integral role in reducing construction and other waste, in moving to net zero and better, in driving down emissions and promoting capture in other ways, and in creating communities that include wellness and social systems that promote the mental and physical health of their constituents. The core drivers of the space, such as operational efficiencies and better buildings, remain. However, there is far more widespread recognition now that technology can have a very positive impact on the environments in which people live.

There were a number of factors contributing to the strong investment activity in 2021. Deal flow for tech financings in general was hot, which led a number of sectors to hit records for valuations. The commercial real estate and construction markets had strong tail winds coming out of 2020 and the slowdowns due to COVID-19. There was a lot of pent-up demand for technology and efficiency solutions in both sectors. There was speculation that the Infrastructure Investment and Jobs Act would pass Congress in 2021 and lead to a substantial increase in public funding for construction, which would lead to increased demand for proptech and construction tech solutions among contractors. Labor shortages helped facilitate rapid adoption of automation and virtualization technologies in both the real estate and construction sectors. And M&A and public market activity in both sectors in 2021 was robust.

2022 has thrown cold water on some of these factors. A number of high-flying proptech and construction companies have crashed this year. Increases in interest rates have cooled the M&A market, and market volatility and increased regulatory scrutiny of the SPAC market has impacted public market activity. However, we are still seeing a number of deals still being done. Valuations may have come down in several instances, but both sectors still appear to be primed for growth.

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With two quarters' worth of data, it's clear that late-stage valuations in proptech have dropped significantly while early-stage valuations still look healthy. What's behind the late-stage pullback?

Late-stage valuations have moderated as investors evaluate cash flow and revenue projections more carefully. The very high levels of activity in the SPAC space, which drove some of the valuations, have slowed, with shares in many proptech companies that went public trading at levels below their offering price. Regulators are looking at disclosure more carefully, contributing to a general sense of greater caution.

With the volatility in M&A and the public markets during the first half of 2022, exits for late-stage companies have delayed or derailed, leading to investors being more judicious with late-stage valuations and follow-on activity. Certain segments of the proptech market have been impacted by the correction in the housing market. Labor shortages, and a legacy issue with technology adoption, have continued to plague the construction market, which impacts the late-stage companies' ability to sustain year-over-year growth multiples.

Should proptech companies be nervous about VC financing in the quarters ahead?

VC interest in proptech companies remains strong. Certain VCs focus on technologies that advance certain sectors related to real estate, while others take a more generalized approach evaluating a broader range of platforms. Additionally, strategic and other institutional investors with large real estate portfolios are investing in proptech-focused funds and in some cases directly into the companies themselves. This reflects a shift in the real estate industry mindset that is recognizing the impact technology can have on the quality and productivity of real estate assets and on addressing important social issues.

Companies that have proven product-market fit, good growth metrics, and solid financial hygiene should be fine. There are a number of value investors who are looking for these sorts of metrics to help balance out risker investments in their portfolios. Valuations will be more tempered than what we saw in 2021, but deals will continue to be made. There are also a number of proptech and construction-tech focused funds that have dry-powder and a commitment to funding new technologies that show a lot of promise. So early-stage companies should still have ample opportunity for funding.

How has proptech been affected by the surge in working from home, or the hybrid work model that's gaining in popularity? Or, conversely, has proptech helped to fuel those trends (instead of being a bystander)?

The hybrid work model has provided an opportunity for many proptech companies to develop solutions that support employees and companies with changing work scapes. Community based working solutions are proving quite successful at meeting a need for professional gathering places or focused workspaces in locations closer to residences.

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The impact of WFH on proptech and construction tech depends on the sector. It hasn't had much impact on construction tech, because construction companies by definition cannot have a WFH workforce. Virtualization and WFH have caused employers to reconsider their real estate needs, both on short-and long-term bases, which has impacted and will continue to impact commercial real estate for months and years to come.

What do you see for the proptech sector over the next year or two? Will it be able to keep growing at its current pace alongside a recession, rent increases, or interest rate hikes?

Proptech will continue to grow without being tied to larger global economic factors. It creates opportunities to address economic inefficiencies in the financial system and may be looked to more continuously to support revenue growth.

Commercial leases that were entered into prior to the pandemic will start coming up for renewal over the next few years, and it will be interesting to see how the commercial real estate market responds. Proptech companies that are more reliant on physical assets (such as asset management platforms and sales and leasing platforms) may be more negatively impacted. But as with most industry disruptions, there will also likely be a number of new opportunities and needs for proptech companies to fill. Growth in many segments of proptech may be tempered for the next few years, as the market corrects itself. On the other hand, as long as the labor market can stabilize, the construction tech market should continue to see strong tailwinds for the next several years.

With those headwinds in mind, where are investors most optimistic going forward?

As noted, the headwinds are not presently strong against the sector. The sector is in many respects countercyclical, and its breadth and potential impact are so significant that they provide value—and results—that lead to change that is overridingly meaningful irrespective of short-term economic challenges. Areas of continued investment include contech (construction, technology solutions that include 3D printing, digital twinning, real time input and risk assessment and up-front improved design and decision making), medtail (the combination of improved access to medical care over one's life with accessibility to accessory retail needs), and all things related to reduction in carbon emissions and improved sustainability. The sector is so broad that there are far too many solutions to name in one short answer. People should be following the space to stay abreast of its fast-moving nature and the benefits it can afford clients.

Adoption of technology in construction tech has been historically slow, but we have been seeing a tipping point where adoption has accelerated over the past few years. Investors seem to be gravitating towards automation technologies, construction finance and spend management platforms, and vertical platforms that facilitate networks effects. On the proptech side, as the housing market cools, we can expect investors to gravitate toward platforms that facilitate or automate asset maintenance (as home improvement and maintenance increases with more people staying put and not moving to new homes). We can also expect technologies focused on energy and cost efficiencies to flourish.

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Methodology

PitchBook's venture capital datasets include minority equity investments, as well as investments combined of both equity and debt, into startup companies from an outside source. Investment does not necessarily have to be taken from an institutional investor. This can include investment from individual angel investors, angel groups, seed funds, VC firms, corporate venture firms, and corporate investors, as well as from nontraditional investors such as hedge funds, mutual funds, or PE funds. Investments received as part of an accelerator program are not included; however, if the accelerator continues to invest in follow-on rounds, those further financings are included.

- **Angel:** PitchBook defines financings as angel rounds if there are no PE or VC firms involved in the company to date and we cannot determine if any PE or VC firms are participating. In addition, if there is a press release that states the round is an angel round, it is classified as such. Finally, if a news story or press release only mentions individuals making investments in a financing, it is also classified as angel.
- **Seed:** As for seed, when the investors and/or press release state that a round is a seed financing, or it is for less than $500,000 and is the first round as reported by a government filing, it is classified as such. If angels are the only investors, then a round is only marked as seed if it is explicitly stated.
- **Early stage:** Rounds are generally classified as Series A or B (which we typically aggregate together as early stage) either by the series of stock issued in the financing or, if that information is unavailable, by a series of factors including the age of the company, prior financing history, company status, participating investors and more.
- **Late stage:** Rounds are generally classified as Series C or D or later (which PitchBook typically aggregates together as late stage) either by the series of stock issued in the financing or, if that information is unavailable, by a series of factors including the age of the company, prior financing history, company status, participating investors, and more.
- **Growth equity:** Rounds must include at least one investor tagged as growth/expansion, while deal size must either be $15 million or more (although rounds of undisclosed size that meet all other criteria are included). In addition, the deal must be classified as growth/expansion or later-stage VC in the PitchBook Platform. If the financing is tagged as late-stage VC, it is included regardless of industry. Also, if a company is tagged with any PitchBook vertical, excepting manufacturing and infrastructure, it is kept. Otherwise, the following industries are excluded from growth equity financing calculations: thrifts and mortgage finance, real estate investment trusts, and oil & gas equipment, utilities, exploration, production, and refining. Lastly, the company in question must not have had an M&A event, buyout, or IPO completed prior to the round in question.

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- **Nontraditional investors:** Any investors besides a VC firm participating in a VC round. "PE" includes VC deals by investors whose primary classification is PE/buyout, growth, mezzanine, or other PE.
- **Corporate VC:** Financings classified as corporate VC include rounds that saw both firms investing via established CVC arms or corporations making equity investments off balance sheets or whatever other non-CVC method is employed.
- **Venture debt:** Debt financings, including convertible notes, term loans, revenue-based loans, and equipment financings, among others, provided to companies that are VC-backed at the time of the round are included in venture debt. When investment rounds are a hybrid of debt and equity, if possible, the equity portion will be extracted when calculating venture debt values.

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