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The Effect of Capital Resources on Dealmaking

Can patterns in VC resources help pinpoint underfunded ecosystems?

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Credits & contact

Analysts

KYLE STANFORD Analyst, VC
kyle.stanford@pitchbook.com
DARREN KLEES Senior Data Analyst

Contact PitchBook

RESEARCH
reports@pitchbook.com

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Key takeaways

- The Bay Area's unparalleled dry powder and wide range of VC fund sizes allows companies across verticals to find local lead investors at every stage. The median distance a Bay Area-based company needs to travel to find a lead investor is just 27 miles, compared to nearly 1,100 miles for companies headquartered in Miami.
- A low amount of local capital availability coupled with increasing deal counts can highlight underfunded ecosystems where local fundraising has not kept up with the demand for VC. There is less than $1 million in Houston-area dry powder for each VC-backed startup located there. Despite this, the area has recorded increases in activity recently due to strong participation from outside investors.
- Late-stage investment relies less on local capital. Just 33% of late-stage deals in the selected combined statistical areas (CSAs) are led or solely funded by investors located in the same CSA as the target company, compared to 43% and 38% for seed and early-stage deals, respectively.

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Introduction

Of the more than 3,000 VC funds raised by US investors since 2006, more than one-third are managed by firms headquartered in the Bay Area. These funds run the gamut of sizes and strategies, allowing startups to find local investors for all their financing needs. No other metro area has raised more than 450 funds, and just five areas have reached triple-digit funds closed since 2006. As a result, raising capital is much different for companies headquartered outside of the Bay Area than it is for those located in the Mecca of VC. Bay Area companies have raised over 13,400 VC rounds since 2006, 25.8% of all fundings in the US, while no other area as reached even 6,000 total deals.

As this disparity in fundraising between the Bay Area and other major hubs has been highlighted over the past few years, novel approaches have been adopted by investors to reach low-funded areas. One such effort is Revolution Ventures' Rise of the Rest Fund, which travels the country to find companies that stationary funds might miss. However, this nomadic model doesn't seem to be a sustainable strategy for the industry as a whole. Rising costs and increased competitiveness in the Bay Area may push some investors based in the area to look elsewhere, and, while many have launched satellite offices to tap new opportunities, the region's dominance continues in all areas of VC. Of the $97.8 billion in dry powder contained in US VC funds at the end of 2018, less than $9.3 billion is held outside of the Bay Area, New York, Boston, Los Angeles or Seattle.

Capital resources is one indicator for the development of venture ecosystems. The Bay Area is undoubtedly the most developed ecosystem in the US—containing an array of seed, early-stage and late-stage investors—but not even the Bay Area can be the sole source for all its own deals. Indeed, the Bay Area is a target for outside VC investment due to its high density of startups and large talent pool. Nontraditional investors such as mutual funds and foreign sovereign wealth funds have gravitated toward investment in Bay Area companies or have even set up operational headquarters in the region, further widening the already apparent resource disparity.

The development of a VC ecosystem goes far beyond the amount of capital in local funds, requiring local talent and a density of investable startups, but it is access to capital that allows ideas to get off the ground. The question isn't whether capital access is important, but how local and outside capital availability interact to develop a VC ecosystem and how we can use the data to determine which ecosystems are growing.

To search for patterns in the relationship between local and outside funding sources, we analyzed the 24 most active CSAs in the US in 2019. The ecosystems used for this research were devised using CSAs mapped out by the US Office of Management and Budget and "can be characterized as representing larger regions that reflect broader social and economic interactions."[1] These groupings help distinguish between multiple ecosystems within single states, though an argument can be made that many states have only a single market for VC or that markets across state lines effectively coexist as a single VC ecosystem. This cohort provides a large enough dataset to view shifts in trends where local dry powder, outside investors and deal counts converge. Only deals that were funded by a sole investor or had lead investors tagged were included in this research.

Most active CSAs*

Ecosystems in study	2019 deals in study	Funds closed (#) since 2015	Funds ($M) raised since 2015	2018 dry powder ($M)**
San Jose-San Francisco-Oakland, CA	1,169	524	$114,362.0	$56,936.2
New York-Newark, NY-NJ-CT-PA	550	201	$25,241.9	$13,039.7
Boston-Worcester-Providence, MA-RI-NH-CT	281	138	$28,949.5	$13,467.8
Los Angeles-Long Beach, CA	257	77	$5,916.7	$2,919.8
Seattle-Tacoma, WA	162	43	$5,076.7	$2,174.8
Denver-Aurora, CO	121	23	$2,127.8	$1,024.3
Washington-Baltimore-Arlington, DC-MD-VA-WV-PA	107	33	$2,905.7	$1,324.0
Philadelphia-Reading-Camden, PA-NJ-DE-MD	102	14	$946.4	$195.5
Chicago-Naperville, IL-IN-WI	87	42	$3,233.9	$1,425.1
Atlanta-Athens-Clarke County-Sandy Springs, GA-AL	56	8	$647.0	$274.2
Salt Lake City-Provo-Orem, UT	44	17	$1,108.0	$439.0
Dallas-Fort Worth, TX-OK	43	10	$237.1	$77.8
Houston-The Woodlands, TX	43	5	$234.1	$180.6
Pittsburgh-New Castle-Weirton, PA-OH-WV	39	4	$5.2	$21.4
Raleigh-Durham-Cary, NC	38	12	$632.4	$281.6
Miami-Port St. Lucie-Fort Lauderdale, FL	35	7	$108.6	$87.5
Minneapolis-St. Paul, MN-WI	32	8	$572.8	$31.2
Portland-Vancouver-Salem, OR-WA	32	9	$94.8	$50.5
Detroit-Warren-Ann Arbor, MI	31	9	$861.2	$291.2
Indianapolis-Carmel-Muncie, IN	27	4	$110.7	$81.3
Nashville-Davidson-Murfreesboro, TN	26	11	$479.7	$220.7
Columbus-Marion-Zanesville, OH	24	10	$768.1	$248.1
Phoenix-Mesa, AZ	24	10	$84.1	$80.8
Madison-Janesville-Beloit, WI	18	6	$54.3	$39.3

Source: PitchBook | **Geography**: North America
*As of September 30, 2019
**As of December 31, 2018

1: US Office of Management and Budget, August 15, 2017

Local capital availability

$$\textit{Local capital per VC-backed startup} = \frac{\textit{dry powder held by CSA VC firms}}{\textit{\# of CSA VC-backed startups}}$$

Local capital per VC-backed startup is a lagging indicator of an ecosystem's development. Funds tend to cluster in areas with investable companies rather than stationing themselves in promising areas with the hope of attracting founders to create new enterprises. However, we contend that local funds are essential for an early-stage environment to grow.

VC is predicated, at least in part, on investors' ability to work with startups to achieve growth. The nature and intensity of that work varies, but many VCs prefer to be hands on, providing operational support, networks and advice when necessary. From an operationally focused investor's standpoint, proximity to a startup helps not only with sourcing and due diligence, but also with monitoring and advising the company once the investment has been made. Continued contact between investors and founders aligns goals and allows each side of the table to share in the future vision of the company.

We calculated local capital per VC-backed startup to compare the immediate access to investment for entrepreneurs in different regions. Large ecosystems lead this ranking, generally by a wide margin. The Bay Area controlled nearly $57 billion in dry powder at the end of 2018. So, despite the CSA having over 4,700 active VC-backed companies, the amount of capital per VC-backed startup in the Bay Area is still a staggering $12.1 million. Just three ecosystems in our research contained more than $5 million in dry powder per VC-backed startup at the end of 2018, while nearly half contained less than $1 million per VC-backed startup. Not surprisingly, the three ecosystems with the highest amount of dry powder per VC-backed startup are the areas with the highest activity within the industry. The Bay Area, Boston and New York have raised 863 VC funds since 2015, giving local companies a wide array of options when fundraising.

VC ecosystems with highest local capital ($M) per startup*

	Dry powder ($M)**	Active VC companies (#)	Dry powder per active VC company ($M)
San Jose-San Francisco-Oakland, CA	$56,936.2	4,711	$12.1
Boston-Worcester-Providence, MA-RI-NH-CT	$13,467.8	1,413	$9.5
New York-Newark, NY-NJ-CT-PA	$13,039.7	2,584	$5.0
Seattle-Tacoma, WA	$2,174.8	656	$3.3
Chicago-Naperville, IL-IN-WI	$1,425.1	539	$2.6

Source: PitchBook | **Geography**: North America
*As of September 30, 2019
**As of December 31, 2018

A higher amount of local dry powder should be able to support a higher density of VC-backed startups. There is an unsurprising positive correlation of 0.94 between local dry powder and the number of active VC-backed startups in the same ecosystem; however, Los Angeles stands out as an outlier in the space. The Los Angeles ecosystem has the third highest number of active VC-backed startups yet falls to eighth highest total for local capital availability. Los Angeles has raised 77 funds since 2015, but 62 of those have been under $250 million, a size typically suited to fund early-stage companies. While the number of late-stage deals in Los Angeles have surged in the past couple years, an average of 85% of those have been led by an investor outside the CSA each year since 2015.

VC ecosystems with lowest local capital ($M) per startup*

	Dry powder ($M)**	Active VC companies	Dry powder per active VC company ($M)
Minneapolis-St. Paul, MN-WI	$31.2	240	$0.1
Pittsburgh-New Castle-Weirton, PA-OH-WV	$21.4	154	$0.1
Portland-Vancouver-Salem, OR-WA	$50.5	236	$0.2
Dallas-Fort Worth, TX-OK	$77.8	272	$0.3
Miami-Port St. Lucie-Fort Lauderdale, FL	$87.5	291	$0.3

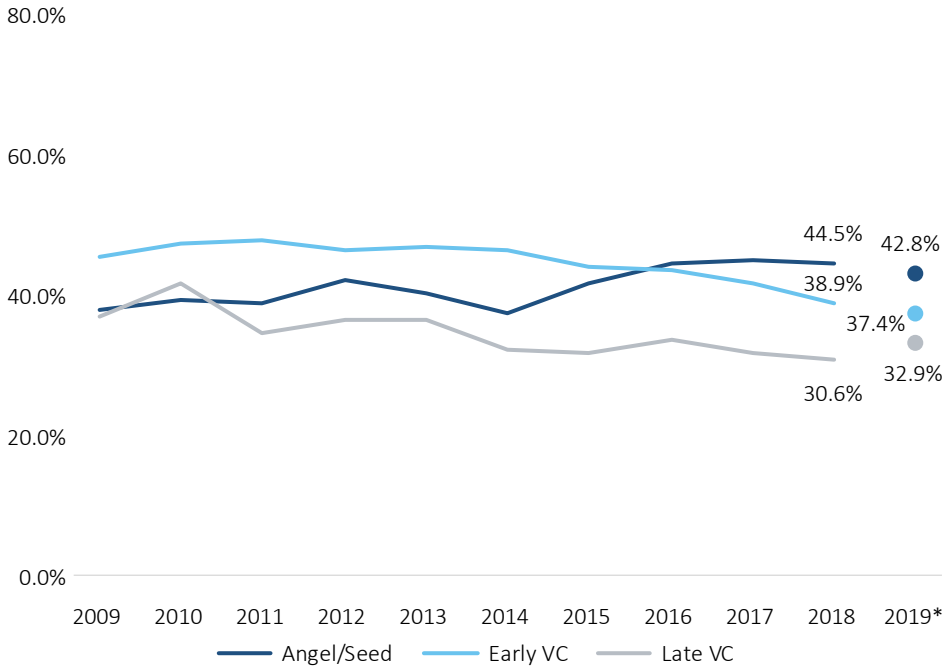
Source: PitchBook | **Geography**: North America
*As of September 30, 2019
**December 31, 2018

Companies headquartered in areas with a low figure in this calculation run into more difficulties when raising capital. Fund counts in these areas may be too low to support the amount of companies raising capital, or the funds may not be large enough to support companies as they move through the venture lifecycle. Minneapolis is an example of a region that has a seen strong investment but is lacking in local capital to support its companies. The area has raised just eight funds since 2015, and the area's $31.2 million in dry powder brings its local capital availability calculation to just $130,000 per VC-backed startup. For an ecosystem that once held more than $1 billion in dry powder, this low total is notable. To compare, Buffalo, New York has the same amount of dry powder per VC-backed startup as Minneapolis, despite the fact that Buffalo has a much smaller VC ecosystem, raised only two VC funds in the past decade and holds less than $5 million in dry powder.

The low amount of local capital and the city's distance from other VC hubs puts pressure on Minneapolis companies looking for funding, especially considering how far the city is located away from a major VC hub. The median distance Minneapolis companies travel to find a lead investor is more than 900 miles.

In addition, the proportion of deal activity with a local lead investor provides insight into how capital availability can affect startups at different stages. Across the ecosystems in our data, the proportion of seed deals led or solely funded by investors located in the same ecosystem is higher than the proportion of late-stage deals. This is intuitive, as we expect to see local investors engaging in companies at the seed and early stage before considering larger funds that can lead to more substantial late-stage financings. Pre-VC startups likely don't have the resources to find investment from non-local investors, as many are pre-revenue and still developing a functional prototype. More importantly, founders may not have the knowhow to seek investment outside their ecosystem.

Proportion of VC deals (#) with local lead investor participation by stage



Source: PitchBook | **Geography**: North America
*As of September 30, 2019

Outside capital availability

$$\textit{Outside VC participation} = \frac{\textit{\# of CSA deals led by outside VC firms}}{\textit{\# of all CSA deals}}$$

Where local capital availability lags in VC ecosystems, outside investment often fills the void, sometimes out of necessity. Increasing outside VC investment can be an indicator that an area contains a growing talent and company pool that is outpacing the means of local investors. Indianapolis is on track to surpass 2018's volume with a new record high for deal count, despite raising just four local VC funds since 2015, including only one above $50 million. The ecosystem has not had local investors lead more than 50% of deals at any stage this year, highlighting its current reliance on outside investment to lead deals.

Looking at other ecosystems light on dry powder, we can see that outside lead investors are more heavily relied upon. So far in 2019, 12 ecosystems in this study have had 75% or more of total deals be led by outside investors. Just three of those ecosystems held more than $300 million in dry powder at the end of 2018, and the average local capital per VC-backed startup in that group was just under $1 million. However, each of these ecosystems have quickly grown in terms

of deal count. 2018 full-year figures illustrate that each of the 12 ecosystems outpaced their average yearly deal count from the past decade by at least 15%, with several reaching deal counts that were 50% higher.

VC ecosystems with lowest dry powder and proportion of deals led by local investors by stage*

	Dry powder ($M)	Seed	Early stage	Late stage
Pittsburgh-New Castle-Weirton, PA-OH-WV	$21.4	95.2%	40.0%	75.0%
Minneapolis-St. Paul, MN-WI	$31.2	14.3%	23.1%	8.3%
Madison-Janesville-Beloit, WI	$39.3	39.3%	33.3%	33.3%
Portland-Vancouver-Salem, OR-WA	$50.5	50.0%	14.3%	16.7%
Dallas-Fort Worth, TX-OK	$77.8	0.0%	20.0%	13.3%
Phoenix-Mesa, AZ	$80.8	14.3%	11.1%	12.5%
Indianapolis-Carmel-Muncie, IN	$81.3	50.0%	46.7%	37.5%
Miami-Port St. Lucie-Fort Lauderdale, FL	$87.5	18.2%	9.1%	23.1%
Houston-The Woodlands, TX	$180.6	0.0%	33.3%	11.1%
Philadelphia-Reading-Camden, PA-NJ-DE-MD	$195.5	23.1%	26.8%	20.0%

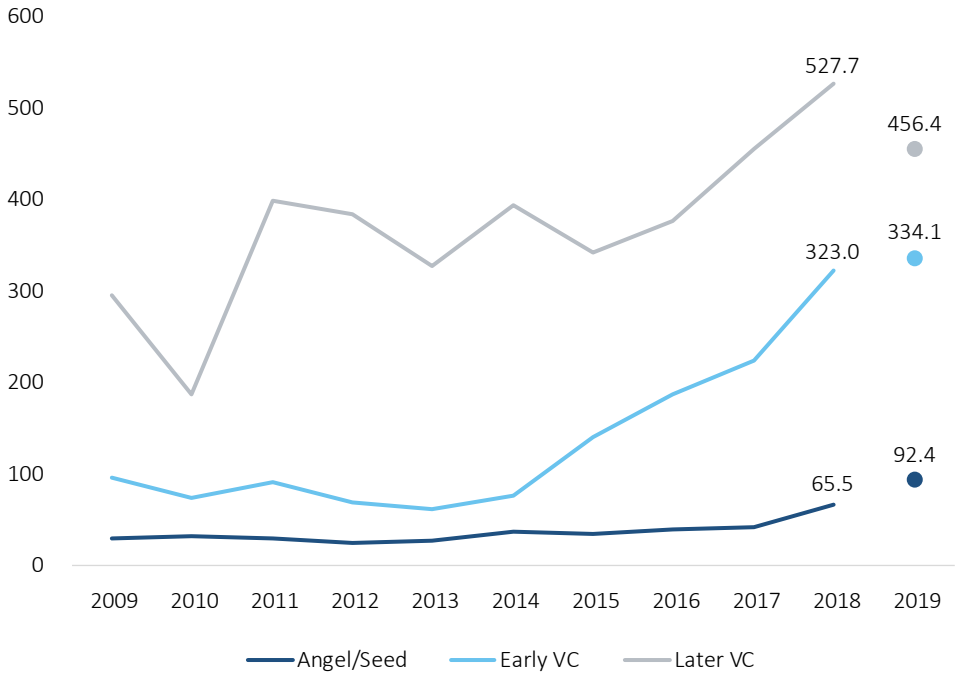
Source: PitchBook | **Geography**: North America
*As of December 31, 2018

Even for well-funded ecosystems, however, late-stage capital is not readily available from local VCs, which means that outside investors play a crucial role in the development of companies as they move through the VC lifecycle. While the Bay Area is as close to self-sufficient as a VC ecosystem can be, near all other ecosystems rely on outside investor participation at the late stage. With the rise of $500 million-plus mega-funds, large VCs are also having to look beyond their own backyard to put large sums to work.

Late-stage investors also have the added benefit of company notoriety when sourcing deals. It's much likelier that late-stage companies are known outside their immediate ecosystem when hitting the fundraising trail, expanding their network of contacts when in search of investors. We expect the distance between target companies and lead investors to grow in response to this trend as the company moves through the venture lifecycle. Companies looking for seed financings generally work through local investor networks first, while later stages generally require large funding vehicles that may not be located nearby. This trend holds distinctly in the data. The median distance between a target company and lead investor

for late-stage deals in the US notched over 400 miles so far in 2019, while the median distance for seed deals is just under 100 miles between the lead investor and target company.

Median distance (miles) between lead investor and target company by stage



Source: PitchBook | **Geography**: North America
*As of September 30, 2019

Seattle is a prime example of an ecosystem that relies on outside investors for its more mature companies. The area has evolved into a major hub of VC activity, but lacks large, late-stage funds that are more prominent in ecosystems such as New York, Boston and the Bay Area. While this doesn't necessarily hinder support or fundraising for late-stage companies in Seattle, it highlights how outside investment in an ecosystem works alongside local fundraising to move companies through their lifecycle, and we expect late-stage deals in this ecosystem to be led at a higher proportion by outside investors. While Seattle-area VCs lead or solely fund 41% of seed deals, they lead only 19% of late-stage deals.

VC ecosystems with highest amount of dry powder in funds closed on $250M+

	Dry powder in funds $250M+**	% 2019 late-stage deals led by outside investor*	Median distance (miles) to late-stage lead investor*
San Jose-San Francisco-Oakland, CA	$15,417.8	51.9%	30.9
New York-Newark, NY-NJ-CT-PA	$5,300.1	71.0%	188.9
Boston-Worcester-Providence, MA-RI-NH-CT	$4,403.6	82.9%	259.4
Seattle-Tacoma, WA	$1,371.7	81.1%	703.5
Los Angeles-Long Beach, CA	$1,041.5	82.5%	582.7
Denver-Aurora, CO	$906.9	74.2%	943.5
Chicago-Naperville, IL-IN-WI	$635.9	81.8%	606.5
Washington-Baltimore-Arlington, DC-MD-VA-WV-PA	$457.9	60.0%	209.3
Detroit-Warren-Ann Arbor, MI	$186.0	66.7%	67.4
Columbus-Marion-Zanesville, OH	$176.5	75.0%	425.9

Source: PitchBook | **Geography**: North America
*As of September 30, 2019
**As of December 31, 2018

Conclusion

Capital availability, whether from local or outside investors, is just one way to gauge the development of investment activity in a given ecosystem. Government and grant programs figure prominently in the beginnings of an ecosystem, but neither appear in this dataset. In addition, even within a focus on fundraising, many factors can cause the data to misrepresent what is happening locally. Lead investors are an important piece of fundraising, but a large portion of capital is provided by other investors.

Regardless, younger companies benefit immensely from growth in local capital availability. VC fundraising has brought unprecedented amounts of capital to the industry in recent years, but that capital has stayed largely isolated to tech hubs around the US. 115 VC funds

were closed through 3Q 2019 in the Bay Area, Boston and New York, while just 58 closed outside those ecosystems. The median distance between the lead investor and target company in those hubs since 2015 is just 32 miles. For other ecosystems it stretches to 323 miles.

VC will continue to be a hands-on investment strategy, and a shorter distance between company and investor benefits each party. It isn't reasonable to expect all ecosystems to provide the lifecycle support that the Bay Area can, but to continue the growth of less prominent ecosystems, local investor networks and support for startups will need to continue to grow as well.

As we move forward with coverage of VC ecosystems, we will continue to expand on how access to capital affects local industries and incorporate these patterns into our broader analysis.