PitchBook

The Bay Area Still Holds the Keys to VC

Why claims that Silicon Valley is in decline are premature

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Key takeaways

- The venture industry in the US has undergone dynamic shifts that will help propel capital outside of the Bay Area, including the industry's adoption of video conferencing software to source, conduct diligence, and invest in companies. However, this shift is not because of any decline in the region but due to the enormous growth of VC over the past decade—deal counts have increased by more than 120% while deal value has grown nearly 400% during that time. It should also be noted that growth in one area does not preclude growth in another, and we believe the further distribution of capital in the US will be a net positive for venture.

- The Bay Area has kept a tight hold on fundraising in the US, closing on commitments exceeding $151 billion over the past five years, more than the rest of the US ecosystems combined. LPs have continued to funnel capital to area VCs because of the region's track record of success, which includes 17 of the 22 US companies to ever receive a private valuation of $10 billion or more.

- Over the past couple of years, smaller ecosystems have shown the ability to build and grow companies to billion-dollar exits, although just 20 companies have completed a $1 billion+ exit outside of the four largest ecosystems over the past three years. Successes such as these will not only increase the interest in these areas to pull capital away from VC hubs, but the realization of returns by the executives and employees of these companies will add further local angel capital to support young startups within the ecosystem.

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References in this research note include Silicon Valley, the Bay Area, and San Francisco, used interchangeably. PitchBook generally recognizes these areas using the San Jose-San Francisco-Oakland combined statistical area (CSA).

Introduction

The COVID-19 pandemic has brought drastic changes to the Bay Area. Without discounting the actual human harm and difficulties it has caused, the venture community in the Bay Area has come under an increasing onslaught of challenges: namely, high market rents have driven tech talent to move away as companies have adopted prolonged work-from-home policies, investors tired of local government policies and perceived oversteps have relocated, and several area tech giants (both VC-backed and public entities) have shuffled their headquarters. For several years, there have been concerted efforts by investors and industry bodies to provide communities and entrepreneurs outside of Silicon Valley with access to venture capital, and the pandemic seemed to be the catalyst needed for a major industry shift. Indeed, our 2021 Venture Capital Outlook predicts that Bay Area deal activity will fall under 20% of the total US dealmaking activity.

Although interest in areas outside of Silicon Valley (and other tech hubs such as New York and Boston) has increased recently, pulling capital away from major hubs has proven easier said than done. Over the past five years, 23.6% of completed VC deals in the US, and 40.9% of the capital invested, have gone to Bay Area-based companies. A major reason is that, despite notions that Silicon Valley is no longer the contrarian mecca of disruption it once was, the area and its VCs continue to draw the majority of venture dollars raised from LPs. Since the beginning of 2016, 53% of capital raised in the US has been drawn by Bay Area-based managers—more than $151 billion. This makes sense because the San Francisco-Silicon Valley area has been a long-time tech hub, and investors and entrepreneurs have flocked to its cities to raise capital and develop companies near like-minded individuals.

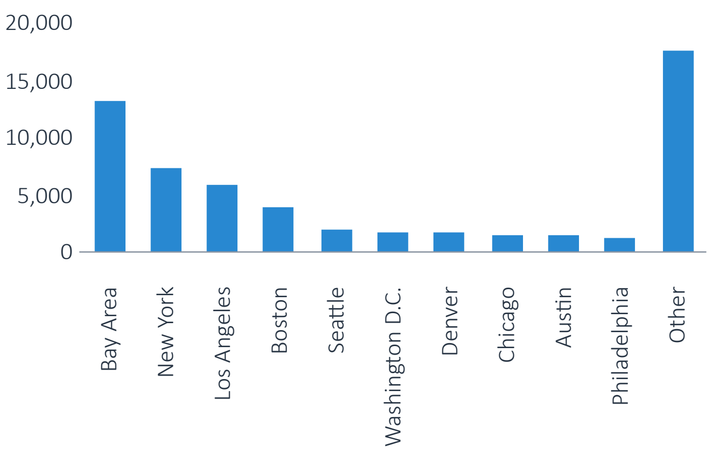
As work from home became prevalent, high rents and home prices in San Francisco and surrounding areas pushed local tech workforces to think about moving to other areas. The opportunity to live and work in a less expensive city while cashing in on the Bay Area's premium salaries was undoubtedly a tantalizing idea for many workers who had tired of the Bay Area's high cost of living.

But moving companies and talent or hoping to develop tech communities and venture hubs is easier said than done and surely will take years to show up in the data. One major obstacle the industry will encounter in developing new venture ecosystems is that dry powder is still heavily centered on the Bay Area. VCs headquartered in San Francisco and Silicon Valley have averaged $34.0 billion in capital raised during each of the past three years, a decidedly enormous amount considering no other ecosystem has raised even $34.0 billion over that time. For comparison, Boston-area and NY-based VCs have each received roughly $31 billion in total commitments since the beginning of 2018. Although no venture ecosystem receives investments solely from local firms, Silicon Valley will continue to operate as the gate keeper of capital for the US VC industry.

Bay Area deal activity will remain second to none

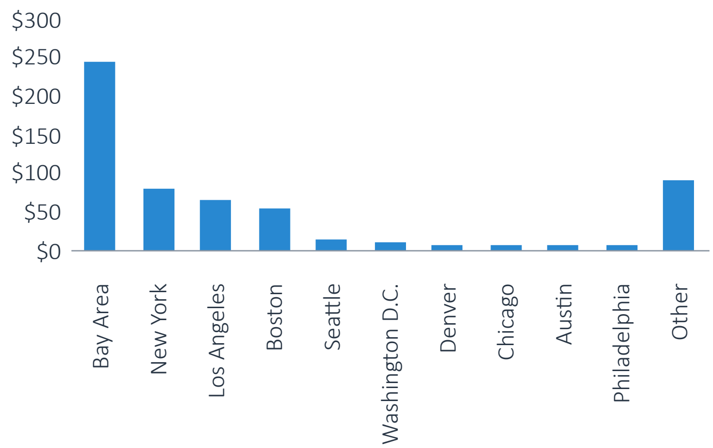
The Bay Area is the main hub of VC worldwide, containing both the largest sets of investors and target companies to go along with its stack of capital. It's hard to argue with the production of the area's VC market, either. Of the 22 US-based companies that have been privately valued at $10 billion or more, 17 have been in the Bay Area (Palantir was headquartered in San Francisco as a private company). The others were in Los Angeles (3), New York (1), or North Carolina (1). And of the 235 exits that have generated a valuation of at least $1.0 billion since 2006, 117 of those companies have been headquartered in the Bay Area, including 57 in the past three years. Just three other ecosystems have had more than four $1 billion+ exits in the past three years: Boston (13), Los Angeles (11), and New York (11).

US VC deal activity (#) from 2016-2020 by CSA



Source: PitchBook | **Geography:** US

US VC deal activity ($B) from 2016-2020 by CSA



Source: PitchBook | **Geography:** US

Silicon Valley was the original tech region, and its local culture has developed in a way that draws young entrepreneurs and tech talent from all corners of the world—in large part due to its venture scene. At the beginning of 2020, two of the five largest employers in San Francisco were formerly VC-backed companies (Salesforce and Uber), and the average tech salary in the Bay Area has reached more than $150,000.[1]

The Bay Area produces the largest cohort of entrepreneurs of any area within the US. Together, Stanford University and the University of California, Berkeley, have graduated nearly 2,900 students who have gone on to found roughly 2,500 companies. Having two internationally recognized universities nearby is not unique to the Bay Area, yet it is no coincidence that the world's largest tech hub blossomed in the shadow of these schools, which have nurtured a culture of tech growth and entrepreneurship. These world-renowned universities continue to add fuel to the Bay Area fire by bringing in the best and brightest minds from around the globe. In some ways, the Bay Area, with its access to local capital and the network generated by graduates of its nearby universities, has operated as an almost self-sufficient VC entity.

1: "Salaries in SF Bay Area," Hired, 2020.

Top 10 universities by VC-backed company founder

University	Founder count
Stanford University *(Bay Area)*	1,448
University of California, Berkeley *(Bay Area)*	1,365
Massachusetts Institute of Technology	1,125
Harvard University	1,100
University of Pennsylvania	1,021
Cornell University	888
University of Michigan	835
University of Texas	749
University of Illinois	621
Yale University	616

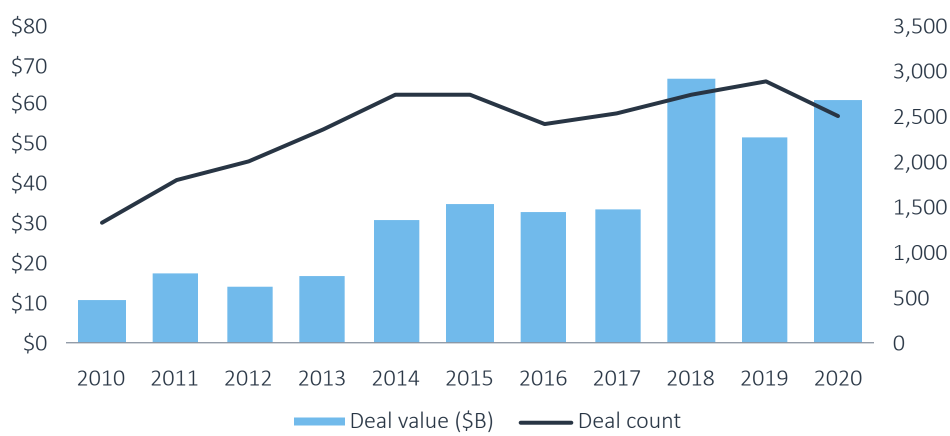
Source: PitchBook | **Geography:** US
Note: Included companies that raised their first round of funding between January 1, 2006 and August 31, 2020

Silicon Valley has an incredibly strong track record for helping company growth, but recent years have shown that unicorns and billion-dollar exits can originate in other regions—even in small markets. Root Insurance (Columbus, OH), for example, completed its IPO with an over $6 billion valuation in 2020. Nonetheless, the development of unicorns and billion-dollar exits has continued to be a California-linked phenomenon for the most part. Of the 734 rounds completed at a valuation of $1 billion or more, 494 (67.3%) have been in California.

Claims of the Bay Area's demise grew loud as the pandemic took hold and as California was accused of mishandling the response. Migration out of the area did start quickly as company-wide work-from-home policies allowed employees to relocate to less expensive locales—whether for a planned short-term hiatus from the city or as a full-blown move. There have also been some high-profile moves out of the Bay Area: Oracle[2] and Hewlett Packard[3] moved their headquarters from the Bay Area to Austin, and Palantir relocated to Denver shortly before its IPO.[4]

Despite the media hype of its decline, San Francisco's VC activity remained relatively steady in 2020, likely even seeing overall growth in deal count for the fifth consecutive year. Although the area's percentage of total US deal activity has declined steadily over the past decade, deal interest in the Bay Area has never been higher. End of year data showed that more than 2,500 VC deals had been completed in the Bay Area alone, a figure that will undoubtedly grow as more data is collected, and one that is higher than the amount collected at the same time a year ago.

Bay Area VC deal activity

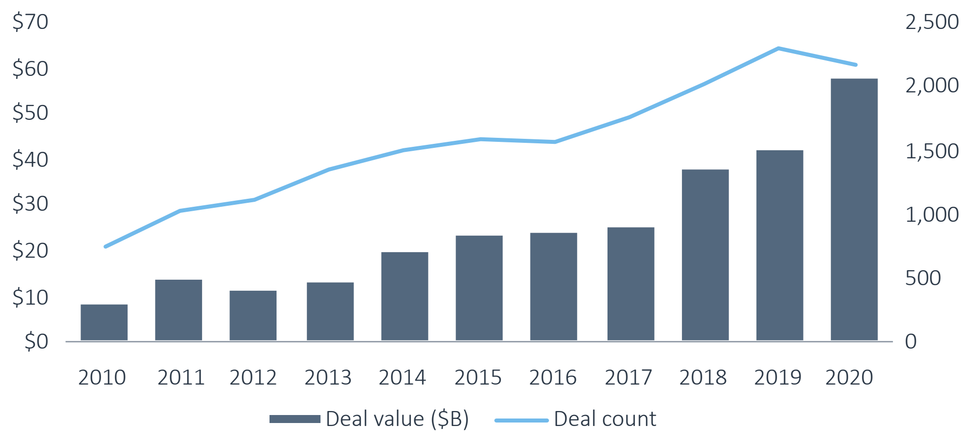


Source: PitchBook | **Geography:** US

Because of the entrenchment of Silicon Valley as the center of venture, deal and capital activity for the US venture industry has largely flowed through the region. Many deals outside of Silicon Valley include participation by Bay

2: Oracle Moves Headquarters to Texas, Joining Valley Exodus," Bloomberg, Nico Grant and Scott Deveau, December 11, 2020.
3: "The Company that Literally Started Silicon Valley Is Moving to Texas," CNN Business, Alexis Benveniste, December 2, 2020.
4: "Palantir Moves Its HQ from Palo Alto to Denver as Plans to Go Public Percolate," TechCrunch, Taylor Hatmaker, August 20, 2020.

Deal activity by Bay Area investors investing outside of the Bay Area



Source: PitchBook | **Geography:** US

Area investors, especially as companies move through the venture lifecycle and require larger funds to provide capital. In fact, investment activity outside of the Bay Area by Bay Area-based VCs has more than doubled over the past decade, with these firms completing more deals outside of the region than locally in 2020.

This is surely a positive sign for future VC investment outside of the Bay Area, but it also highlights the impact the Bay Area has had on the entire venture industry. In essence, investment outside of the Bay Area relies more on Silicon Valley investors than it does on other local ecosystems. Building a network with Silicon Valley investors is almost a necessary factor in the growth and development of other regions.

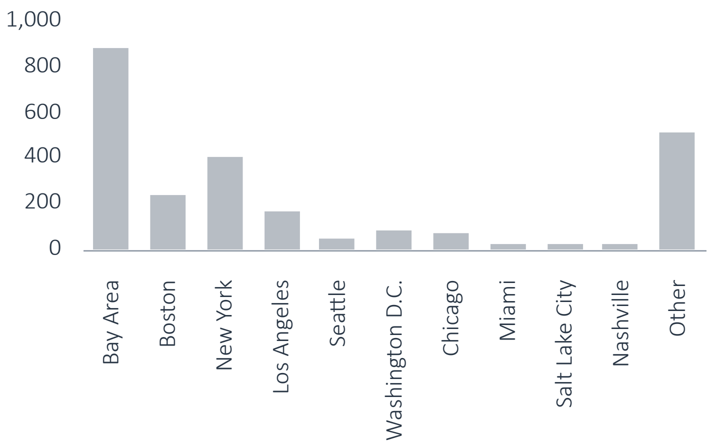
Although the full effect of any migration from the Bay Area will take time to show in the data, one of the first places we can look for changing trends is in the earliest dealmaking data. First-financing data shows where companies are being formed or receiving their first investment and, therefore, where they are likely to continue growth and fundraising. In 2020, 20% of the first financings completed in the US were for Bay Area-based companies, in line with the average proportions seen in recent years, and even a slight increase over 2019. This is one area of data we will be watching in 2021, as first-financing data can act as a leading indicator of where ecosystem growth may be occurring over the next several years.

Our past ecosystem research highlighted the need for local investors to build local activity. We have often spoken of the need for early-stage investors to meet with founders and entrepreneurial teams before making an investment. This has certainly changed over the past year, although we do believe that with vaccines being rolled out in earnest and a return toward pre-2020 normalcy on the horizon, many investors will resume seeking in-person meetings with founders. Undoubtedly, what the pandemic and video communication platforms have created, however, is a wider network for VCs around the globe. Over the next few years, the effects of the relationships developed on Zoom during the pandemic will help spread capital across the VC industry.

The Bay Area will retain its hold on fundraising

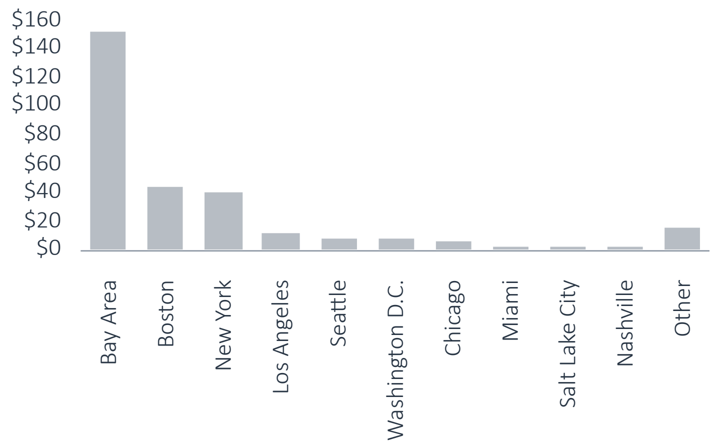
The strength in deal activity across the venture lifecycle comes from the deep bench of venture investors within the Bay Area. From large to small, local VC firms can source and build companies simply by choosing from opportunities in their own back yard. Complementing the number of entrepreneurs churned out by Stanford and UC Berkeley are entrepreneurs from other areas of the country, who are drawn to the Bay Area because of the availability of capital there. It is worth noting that 875 Bay Area VC funds have closed in the past five years, totaling more than $151 billion.

VC fundraising activity (#) from 2016-2020 by CSA



Source: PitchBook | **Geography:** US

VC fundraising activity ($B) from 2016-2020 by CSA



Source: PitchBook | **Geography:** US

More importantly, these funds are of all sizes, targeting all different sectors and stages of investment. While $500 million+ funds have garnered the majority of media coverage, smaller funds are a major piece of the industry and bring opportunities into the venture cycle. Since 2016, the Bay Area has seen an average of 83 new funds under $250 million raised each year and an average of 51 sized under $50 million. While the sizes may be somewhat arbitrary, these funds provide capital to companies working through product development and business ideation. A sub-$50 million fund is as much a cog in the venture machine as a $3.5 billion late-stage vehicle. It should also be noted that while many large funds operate out of multiple offices, those offices are largely constrained to major hubs. Andreessen Horowitz operates out of San Francisco and New York; Sequoia Capital has offices around the world, although its lone office in the US is in Menlo Park. In many cases it is more cost effective to distribute capital beyond hubs through the employment of scout programs and use networks to source deals rather than open an office.

As we have mentioned, several things need to occur for venture ecosystems to develop and grow. There must be a group of talent—or drivers of talent immigration—but there must also be access to capital. Access to capital for young companies almost always comes from local investors and small funds. A budding company in the Midwest is less likely to raise seed capital from a San Francisco-based VC than is a business located within earshot of multiple VCs on Sand Hill Road.

Looking at new fund formation—that is, first funds from new managers—the Bay Area has seen 145 first-time funds raised within its borders since 2016, 33% of the total first-time funds raised in the US during that time—and that despite already being the largest and most competitive venture ecosystem. Coupled with New York and Boston (two other major markets that wouldn't fall under emerging hotspots of VC), 60% of the new managers minted in the past five years call one of these three VC hubs home, highlighting a disincentive GPs have to reach beyond the major hubs.

We have noticed another trend exacerbated by the pandemic that will also likely keep much of the VC power centered on Silicon Valley. In 2020, more than 70% of the capital raised by venture funds in the US went to managers that had raised at least four funds. As of December 31, these "established" managers had raised nearly the same number of funds as emerging managers while at the same time raising at a median size that is $77 million (154%) larger than that of their emerging counterparts.

The assumption is that by the time of raising a fourth fund, a manager has been able to show significant realized returns from previous funds, rather than only being able to highlight paper gains on investments.

Perceived added risk during market turmoil pushes participants to known and trusted areas. In this case, the COVID-19 pandemic largely pushed LPs to return to established relationships with venture funds that have shown a track record of success. This movement further consolidates power over the major hubs. Established managers in the Bay Area raised $29.0 billion in 2020, more than was raised by the entire US VC industry in any year from 2009 through 2013. When including New York and Boston, 90% ($53.8 billion) of the established-manager capital raised in 2020 went to firms in these major tech hubs. Even in a record year for VC fundraising, 73% of the capital went to VC firms headquartered in Bay Area, New York and Boston.

Launching a new VC firm—and eventually becoming an "established" firm—does take years. In many cases, a decade may pass before a new firm raises a fourth fund or is even able to show a strong track record of realized returns. Despite the large investment of time to become established, over the past decade, the VC industry has gone through a grand transformation from a relatively small industry to a worldwide financial market engine.

It is true that some large VC firms headquartered in Silicon Valley may have offices around the country and in smaller ecosystems. However, adding offices is a less cost-effective route toward expanding investment networks. Scout programs and angel networks also support non-Silicon Valley deal flow to these investors. But sustained investment activity into smaller networks from Bay Area investors will be decided on the quality of the deal flow out of those regions, and shifting investment activity toward the highest quality deals will continue to be at the behest of those Bay Area investors for some time.

Emerging venture ecosystems will continue to grow

The growth of venture ecosystems due to the migration out of Silicon Valley likely won't show up in the data for several years, as networks are developed to bring a significant increase in outside capital to the emerging region, or until local VCs are able to raise more capital.

We have, however, observed growth as certain areas of the VC industry have gained more traction over the past decade. Even without a pandemic-induced movement, Los Angeles, for example, has seen its yearly deal counts more than double from 2010 through 2020, hitting a high of 1,257 deals in 2019. Similarly, Denver increased its deal count by an even higher margin than Los Angeles, growing from a count of just 150 completed deals in 2010 to 373 in 2019. Where these two ecosystems differ from the Bay Area is in the availability of local capital.

Over the past decade, Los Angeles has grown into a very strong venture market, receiving the third-highest number of deals of any ecosystem in the US over the past few years. While deal count has always flowed strongly for the market, its proximity to Silicon Valley (at just under 400 miles LA is still the closest major city to San Francisco), as well as its volume of high-net-worth individuals, have been boons for venture firms in the area. In the past five years, 162 venture funds have been raised in LA, 25% more than the total number of funds raised in the preceding decade. Of that total, 37 have been first-time funds, and 129 were emerging manager funds. Just once prior to 2012 had LA raised more than nine VC funds in any given year; since, the average number raised each year has topped 28, and never once has the total fallen below 15.

Denver is a different story. While the area's deal count has grown significantly over the past decade, the access to local capital has seen significantly less growth. In the past five years, Denver has only raised 46 VC funds, with the median fund size raised each year struggling to make it out of single digits. Boulder-based Foundry Group has made several splashes in the ecosystem by raising large funds—the firm has raised $1.25 billion over its past two funds—but outside capital is still needed for late-stage companies. Of the 99 late-stage deals completed during 2020 in Denver (a new highwater mark for the area), Foundry Group participated in just two.

Over the past decade, we have seen growth of investment outside of the Bay Area, New York, and Boston, along with a concerted effort by the industry to get funding to areas not traditionally served by venture capital. But that hasn't translated into as significant an increase in fundraising in those same areas. Up until 2018, an average of 42.7% of the VC vehicles raised in the US were by firms headquartered outside of those three hubs. Over the past three years, just 35.4% of the vehicles have been raised outside of those areas.

Returns may be the most important factor in driving venture dollars to smaller markets. Massive exits by companies in smaller markets have been limited for several reasons. One is simply that fewer companies have been founded in those regions, but another reason is that many companies have relocated to Silicon Valley or New York to continue their growth close to their investors and position themselves near high concentrations of tech talent. However, as work-from-home continues to gain a foothold during the pandemic, it seems likely that the industry's shift to teleconferencing and adoption of a more distributed workforce could lead to changes in this trend.

Even without the pandemic's effects, there had been an increase in large exits beyond the Bay Area in recent years. In 2020, 38 companies exited at valuations of $500 million or more, 35.7% higher than any year prior. These exits will not only increase attention to certain areas but also have the potential to inject more capital into local ecosystems. At the time of Root Insurance's (Columbus, OH) IPO, CEO Alex Timm owned roughly 9.3% of the company, which translated to around $626 million. Utah-based Qualtrics is another example, recently completing an IPO at a valuation of more than $13 billion, just years removed from being acquired for $8.0 billion. It is likely that some capital distributed through exits such as these will reach the local venture ecosystems in the form of angel investment or through reinvestment by investors that have developed networks within the local venture communities.

Exit count by CSA

CSA	Exits (#)
Los Angeles-Long Beach, CA	43
Chicago-Naperville, IL-IN-WI	15
Washington-Baltimore-Arlington, DC-MD-VA-WV-PA	14
Seattle-Tacoma, WA	12
Philadelphia-Reading-Camden, PA-NJ-DE-MD	11
Denver-Aurora, CO	8
Salt Lake City-Provo-Orem, UT	8
Raleigh-Durham-Cary, NC	7
Atlanta-Athens-Clarke County-Sandy Springs, GA-AL	4
Dallas-Fort Worth, TX-OK	4
Other	52

Source: PitchBook | **Geography:** US

Moving Forward

According to an outlook from Zillow, the hottest housing markets in the US during 2021 aren't expected to be San Francisco, New York, Boston, or LA, but Austin, Phoenix, and Nashville.[5] Data such as this does not necessarily predict a movement of people away from major coastal cities in the US, although it does portend that relocation around the US is currently trending toward smaller cities with lower cost-of-living expenses.

When it first erupted in March of 2020, the pandemic delivered an immediate shock to the venture industry. As the year moved along, many of the barriers and challenges first faced by investors and companies alike slowly receded and gave way to activity levels reminiscent of normal times; in fact, Q3 and Q4 turned into two of the most active quarters since the global financial crisis. The venture industry has been known to be a very model-driven and habitual industry, despite its "contrarian" nature. As the world gradually returns to normal with the end of the pandemic in sight, the VC market could fall back into previous patterns—and those patterns center on Silicon Valley.

Bearish-ness on Silicon Valley has been palpable in the media and in Twitter proclamations by those moving to supposedly brighter pastures. Just as the current VC environment could not have been predicted a decade ago, the next 10 years could hold similar transformation, and potentially more movement of capital and deals outside of the Bay Area. Today, though, and for the near future, the keys to VC still reside in Silicon Valley.

5: "Austin Expected to be Nation's Hottest Housing Market in 2021, Leading a Sunbelt Surge," Zillow, Jeff Tucker, January 19, 2021.