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Estimating US VC First-Time Manager Dropouts

Examining past trends and projecting potential implications of future first-time manager attrition from the US VC market

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- Since 2017, $58.5 billion has been committed to 1,381 first-time funds managed by VC investors, representing a 110.8% increase in capital raised and a 67.8% increase in fund count from the preceding decade (2006 to 2016).

- As a result of the harsh fundraising environment and declining LP appetite for venture, the time between first-time and sophomore funds increased to a near-record 2.6 years during 2023.

- Using the follow-on rates of first-time managers by size bucket from 2006 to 2018 (63.0%) as a baseline for the success of first-time managers in our target period of 2019 to 2021, we estimate more than 247 of the 667 first-time managers that closed funds will be unable to raise a sophomore fund.

- The follow-on rates for different sizes of these first-time funds are not necessarily the same, as certain factors that likely led to the varying sizes play out when firms go to raise their second fund. During the period from 2006 to 2018, 76.7% of first-time managers that raised more than $50 million in commitments for their debut fund went on to close a sophomore fund, as compared with 73.1% for managers that raised funds sized between $10 million and $50 million, 64.6% for managers that closed their first fund with less than $10 million in commitments, and just 42.3% for managers with undisclosed fund sizes. This could be due to the LP set, or the manager's prior experience that led to the larger fund sizes to begin with.

- We expect states with smaller, less developed VC ecosystems and more sparse populations of HWNIs will see a larger proportion of first-time managers unable to raise a second fund. Historically, just 56.7% of first-time managers outside of California, New York, and Massachusetts have gone on to raise a second VC fund.

Introduction

As US market volatility has picked up, the VC fundraising environment has become increasingly harsh, resulting in just under $67 billion raised in 2023, roughly $100 billion less than the amount raised by VC managers during both 2021 and 2022. First-time fundraising by new venture capitalists reached a zenith in 2021 of $14.7 billion and has experienced a dramatic decline since, in large part due to the precarious position new managers have been in during the fundraising drought. The prolonged liquidity crunch has made LPs more cautious of deploying—or outright unable to deploy—capital to VC managers without a strong track record or a strong, pre-existing relationship. As a result, investor capital that has flown into the ecosystem has increasingly clustered within funds led by established managers, which has starved their emerging-manager peers.

First-time managers looking to raise their sophomore VC fund face a high hurdle to attract LP capital because they have minimal track records, as they are not likely to have realized significant, if any, exits within their portfolio. Not only that, but new managers that recently raised their first fund invested through the valuation swell and are now tasked with tackling the issues of portfolio company down rounds, shrinking cash runways, and a lack of liquidity to maximize interim fund returns and continue to capture LP commitments.

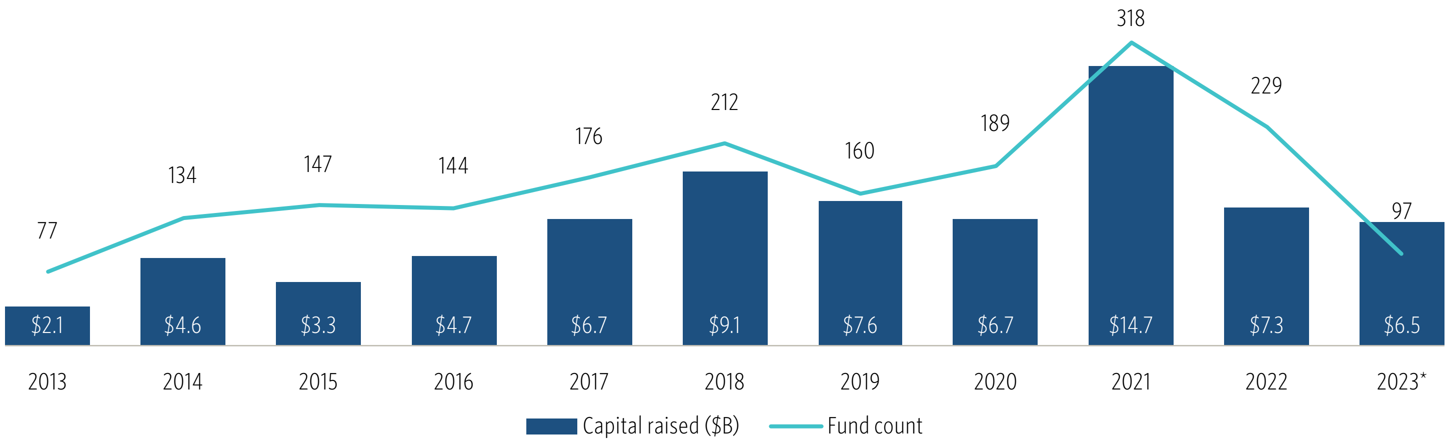
This note will only consider managers that have their primary investor type listed as venture capital, as managers with non-VC primary investor types are less dependent on the success of raising a second VC fund to stay in business.

The increase in new managers over the past few years was a product of the strong interest in VC from LPs and contributed to a diversification of funds across the US market, bolstering smaller markets and non-hub capital availability. Because of poor market returns over the past couple years and the downsized appetite of LPs for emerging managers, we anticipate a sizeable portion of these first-time fund managers will be unable to raise a second fund and will exit the VC market, adding to the already falling supply of capital to the market. This note will use historical data to estimate the baseline portion of first-time managers that will be incapable of raising a second VC fund and highlight the implications of this fallout on the US VC ecosystem.

First-time fundraising activity

Near-zero interest rates and historically strong returns produced by the venture asset class drove LPs to deploy significant amounts of capital into the market and allowed a surplus number of managers to close their first fund in recent years. Since 2017, $58.5 billion has been committed to 1,381 first-time funds managed by venture capital investors, representing a 110.8% increase in capital raised and a 67.8% increase in fund count from the preceding decade (2006 to 2016). The growth of first-time funds has helped decentralize VC dealmaking activity away from coastal epicenters as well as provide more asset class and geographical exposure to LPs across the US.

VC first-time fundraising activity



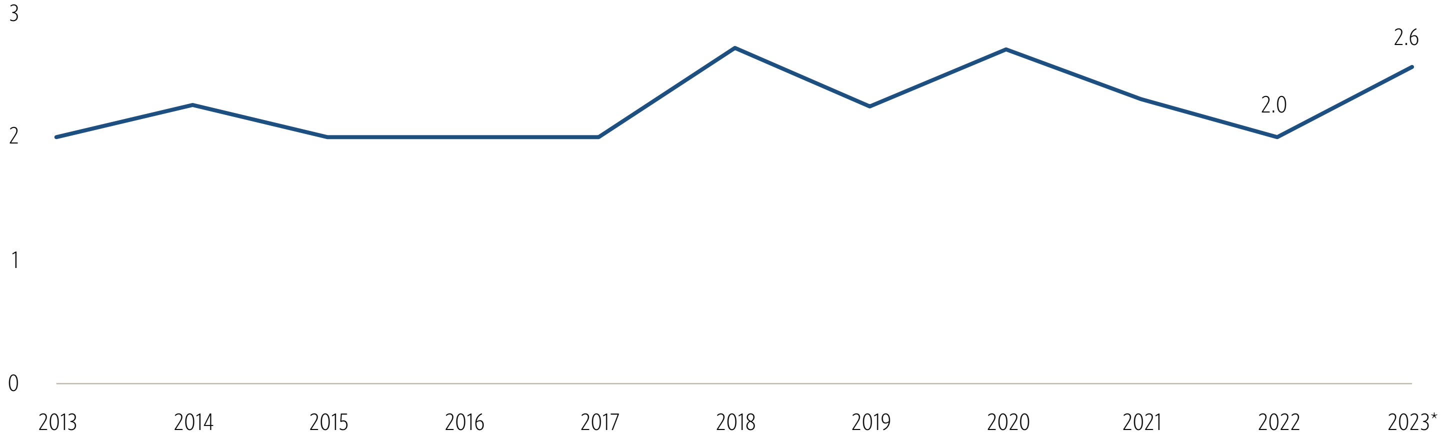
Source: PitchBook • Geography: US • *As of December 31, 2023

First-time fund managers that closed funds during the recent market exuberance are likely looking at raising a follow-on fund, either now or in the near future. Historically, the time between first and second funds has hovered around two years. Facing LPs without the history or track record that established managers can provide has proven to be a high hurdle. At the end of 2023, a total of just 474 VC funds were being tracked as closed, with 75.3% of that capital going to established managers (defined as managers that have opened four or more funds). This marked the second consecutive year established managers captured more than 70% of total committed capital.

Many VC funds follow a common formula of investing their committed capital over three to five years and actively managing the underlying portfolio companies through the fund's lifespan, which typically lasts 10 years, to generate returns for GPs and LPs alike. Commonly, fund managers will opt to raise a second fund before fully liquidating or exiting their first fund to increase their assets under management, capitalize on the interim performance of prior funds, and continue to invest in new startups. Under this assumption, managers of first-time funds closed between 2019 and 2021 are likely hitting the fundraising market if they have not already done so. Yet, the lack of liquidity for the venture market over the last eight quarters has led many LPs to reconsider their allocations to venture, even within existing manager relationships.

As a result of the declining LP appetite for venture, the time between first-time and sophomore funds increased to a near-record 2.6 years in 2023. This suggests both the self-imposed delays in raising sophomore funds because of elevated market volatility as well as the waning LP appetite and confidence in this asset class, especially for young managers. As a possible consequence of the high number of first-time managers that raised funds over the past few years, the capital provided to their local ecosystems could come under pressure, especially affecting those markets that had realized growth during the COVID-19 pandemic and may be relying on local capital to invest in young companies.

Median time (years) between first and second VC funds

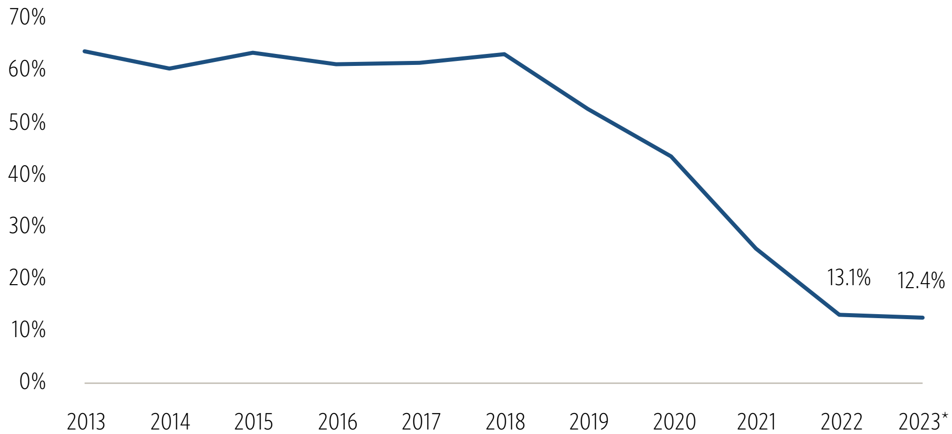


Source: PitchBook • Geography: US • *As of December 31, 2023

Estimating dropouts

Historically, 63.0% of first-time managers were able to raise a second fund. However, a blend of factors, including the surplus number of first-time funds closed, the swell and expeditious freefall of valuations, and the difficult fundraising environment, will likely diminish the success of managers raising their sophomore funds. Even assuming managers of recent vintage funds can close second funds at the historical level, the high volume of first-time funds closed in recent years would put a high number of managers back on the streets.

First-time VC managers that raised a second VC fund as a share of all first-time VC managers



Source: PitchBook • Geography: US • *As of December 31, 2023

Analyzing follow-on fundraising success of managers by close year shows that the 2018 vintage fund cohort and earlier funds have effectively reached the historical success rates, although we will likely see a few more funds raised within more recent vintages. Because of that, we will look at funds with vintages between 2019 and 2021, which account for 667 first-time funds, as we examine the impacts of the poor fundraising environment on first-time managers from those years. These vintages are important for US fundraising because of the enormous amounts of capital raised, the high number of new managers, and the impact they have on the growing markets across the US that need more local capital.

Between 2006 and the end of 2018, 63.0% of US VC first-time managers raised a second fund. All else held equal, translating the historical success rate to first-time funds closed during 2019, 2020, and 2021 would result in 247 of the 667 first-time managers failing to raise a subsequent fund. Although the proportion is no different from the historical data, 247 is already more than the number of new VC managers launched in the US during any year other than 2021. The average number of new managers entering US VC annually over the past decade is just 181 firms. Effectively, the fundraising slowdown could wipe out nearly a year and a half of new VC managers.

However, there are a variety of factors that could limit the ability of first-time managers yet to secure a second fund from reaching the historical success rate. For example, much of the past 12 years has been driven by a wide economic expansion, and venture has benefited significantly from that growth. Given the poor fundraising market today, we should anticipate a lower success rate from more recent vintages, which should lead to an increased portion of fund managers that are unable to raise a follow-on.

Let us assume three basic scenarios where the success rate of first-time managers in our target period is 5%, 10%, and 15% lower than the historical figure. In the first scenario, the success rate falls to 58.0%, and the number of managers that fail to raise a subsequent fund increases to 280. In the second, the success rate falls to 53.0%, and the expected number of dropouts increases to 313. Finally, if the success rate declines to 48.0%—an unprecedented figure but one that could materialize from the US venture market's unprecedented bull run and subsequent liquidity drought—we would expect 347 managers to exit the market after failing to raise a sophomore fund. LPs and startups that invested in or received capital from first-time managers in the period between 2019 and 2021 should be concerned about the future continuity of their investments should 247 or more first-time managers exit the market.

Differentiating success rates by size bucket

While there are a variety of factors that play a role in the fundraising success of managers, many of these factors are subjectively evaluated by LPs. One of the differentiating factors in the ability to raise a follow-on fund that we can see in the data is the link between success and fund size. While fund size in itself is not the reason for success, the ability of a first-time manager to raise an outsized fund likely hinges on that manager's past experience and network among larger LPs that may increase their ability to add commitments to a fund in a slow market.

Under the assumption that larger funds may have stronger networks and connections to larger LPs able to cut larger checks to firms, the higher success rate becomes a little clearer. Evaluating first-time managers is particularly difficult because they have little to no historical fund data or deal performance history on which to conduct due diligence—challenges that could sever a weak LP-GP relationship. A VC firm's respective strengths and differentiation from the crowd will influence how quickly managers can close a fund, but more importantly, the size of the funds they can close.

Historical success rate of first-time managers by size bucket
$50 million or greater: 76.7%
$10 million to $50 million: 73.1%
Under $10 million: 64.6%
Undisclosed: 42.3%

Historically, 76.7% of first-time managers that raised more than $50 million in commitments for their debut fund went on to close a sophomore fund. That figure falls further as fund size decreases, totaling 73.1% for managers that raised first-time funds sized between $10 million and $50 million and just 64.6% for managers that closed their first fund with less than $10 million in commitments. It should be noted that the success rate of managers within each size bucket exceeds the 63.0% overall success rate of first-time fund managers discussed in the previous section. This is because a fourth bucket, which tracks managers of undisclosed fund sizes, accounts for roughly one quarter of all first-time funds closed. This cohort exhibited a substantially lower success rate of 42.3%, bringing down the collective success rate discussed previously.

Within our target period (2019 to 2021), 147 first-time funds were closed with $50.0 million or more in commitments, representing a 44.1% increase in funds of this size compared with the preceding three years. The steeper increase in the number of funds sized $50.0 million or larger, compared with that of smaller size buckets and undisclosed funds, suggests former bull-market conditions are stoking LP risk appetite for venture and prompting eager deployment of capital into more managers and geographies. In tandem with the increased LP risk appetite in recent years was the dramatic growth of VC valuations, which required funds to invest larger checks to achieve their desired equity stake. As such, funds with commitments between $10 million and $50 million, as well as those under $10.0 million, saw increases in fund count over the preceding three years of 31.3% and 28.8%, respectively, albeit smaller on a three-year growth basis.

VC first-time fund count by size bucket

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
<$10M	23	32	44	38	40	40	29	51	72	59	24
$10M-$50M	21	34	40	39	48	60	51	55	87	69	31
$50M+	9	23	24	19	38	45	44	33	70	47	31
Undisclosed	24	45	39	48	50	67	36	50	89	54	11

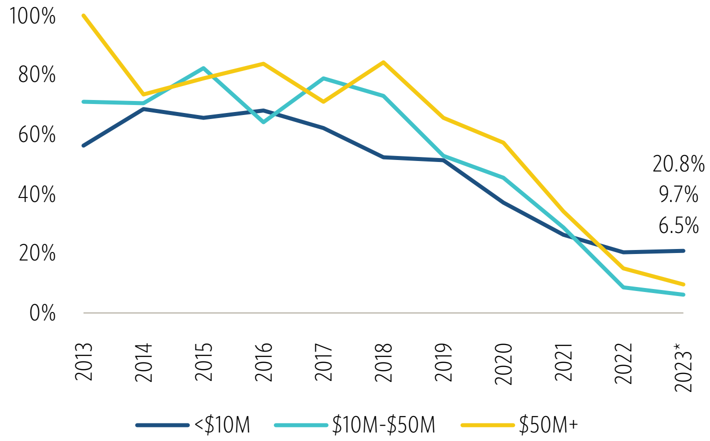
Source: PitchBook • Geography: US • *As of December 31, 2023

Count of VC managers to raise a second VC fund by size bucket

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
<$10M	13	22	29	26	25	21	15	19	19	12	5
$10M-$50M	15	24	33	25	38	44	27	25	25	6	2
$50M+	9	17	19	16	27	38	29	19	24	7	3
Undisclosed	12	18	12	21	18	31	13	19	14	5	2

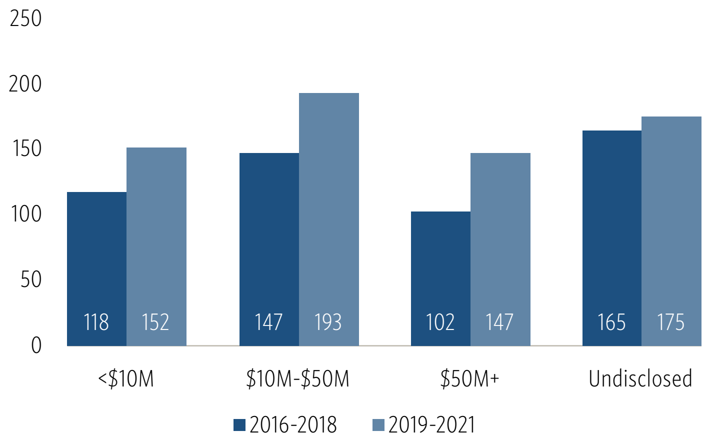
Source: PitchBook • Geography: US • *As of December 31, 2023

VC managers to raise a second VC fund as a share of all VC managers by fund size bucket



Source: PitchBook • Geography: US • *As of December 31, 2023

VC first-time fund count by size bucket and select time frame*



Source: PitchBook • Geography: US • *As of December 31, 2023

The increases seen in larger first-time funds should be an overall benefit to the follow-on rates for these vintages, although several factors could depress the follow-on rates from historical trends. First, the sheer number of first-time managers returning to market increases competition to secure capital from LPs still committing to the strategy. Second, managers across all size buckets likely deployed most of their capital during the valuation swell, and the subsequent challenges and declining deal-to-deal markups bring further challenges to demonstrating positive interim fund performance. While it may hold true that managers of funds with $50.0 million in commitments will prove more successful than their peers managing smaller funds by leveraging the qualities, experience, and networks that permitted them to raise a larger fund in the first place, we may not see these funds continue to close follow-on vehicles at the same rates as before.

Previously we considered a scenario where the overall success rate of first-time managers fell by 15%. Evenly distributing this decrease across size buckets lowers the success rates of the $50.0-million-and-larger bucket to 61.7%, the $10-million-to-$50-million bucket to 58.1%, the under-$10.0 million bucket to 49.6%, and undisclosed funds to 27.3%.

Impact of first-time fund manager dropouts

The impact of first-time managers that are not able to raise a second fund will always be nuanced, but if we look at trends over the past few years, we can develop ideas of what the broad impact might be. For one, the record fundraising in smaller markets likely enabled greater dealmaking within those ecosystems. The rise of new funds was a boost for these markets, which historically have had a lower capital base but saw a distinct increase in deal activity with the increased LP focus on the VC strategy and the market mechanics that came along with the COVID-19 pandemic.

Historically, however, these markets already have had much lower follow-on rates for first-time managers. Just 56.7% of first-time managers outside of California, New

York, and Massachusetts have been able to raise a second VC fund. Managers in the three specified states had success rates that were between 5.8% and 16.9% higher than their peers in other states, demonstrating the local wealth of resources and longer-term commitments to this strategy.

In states with smaller VC ecosystems, the increased fallout of first-time managers could prove problematic. While deal syndication is an important practice across all ecosystems to decrease investor-portfolio concentration risk, in smaller ecosystems where there are fewer VC firms and funds, syndicate networks play a much more crucial role.

Between 2019 and 2021, 232 first-time funds were raised outside the three states with large VC markets—California, New York, and Massachusetts—representing a 26.8% increase in fund count from the preceding three years. This growth helped deal count increase significantly as companies moved during the pandemic. The sustained growth of these smaller markets is likely predicated on the continued fundraising of new firms. If roughly 57% of the first-time managers in those markets are unable to continue, then markets such as Columbus, Ohio; Minneapolis, Minnesota; and Raleigh, North Carolina, which saw large increases over that period, would be in a more challenging capital position to sustain the recent growth.

Count of managers to raise a second VC fund by select states*

	2006-2018
California	522
New York	160
Massachusetts	72
Rest of US	457

Source: PitchBook • Geography: US
*As of December 31, 2023

VC first-time fund count by states with the most VC activity

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
California	35	53	72	68	86	85	76	83	126	100	38
New York	10	20	15	18	24	31	27	36	66	44	20
Massachusetts	5	5	7	9	15	13	6	7	8	9	4
Rest of US	27	56	53	49	51	83	51	63	118	76	35

Source: PitchBook • Geography: US • *As of December 31, 2023

Count of VC managers to raise a second VC fund by states with the most VC activity

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
California	25	37	47	41	51	59	41	40	35	11	6
New York	7	12	8	13	17	17	12	18	14	8	3
Massachusetts	2	3	7	9	11	8	3	3	3	1	0
Rest of US	15	29	31	25	29	50	28	21	30	10	3

Source: PitchBook • Geography: US • *As of December 31, 2023

While it is true that managers in larger ecosystems have increasingly supported deal activity in smaller markets, that increase has come along with the help of local managers that source and develop nascent startups to the point they can effectively deploy capital. Our Q1 2023 Analyst Note: Capital Concentration and Its Effect on the VC Ecosystem showed that the median distance between lead/sole US investors and US target companies has increased dramatically in recent years. During the COVID-19 pandemic, the increasing participation of nontraditional investors and widespread adoption of virtual meetings helped fuel the geographic expansion of dealmaking by investors based in VC epicenters. The stronger presence of local managers, fueled by the larger number of first-time managers, helped support the expansion of VC investor footprints in smaller ecosystems through introductions and referrals. However, rising interest rates and a lack of liquidity via public markets have since led nontraditional investors to dramatically pull back from the venture asset class. This pullback has led to a decrease in investor competition in major VC hubs, such that firms may not be incentivized to seek out deals in other ecosystems. Should a larger share of first-time managers in smaller ecosystems fail to raise a follow-on fund, their diminishing presence coupled with the waning participation of major-market investors could negatively impact the growth of local ecosystems.

VC first-time fund count by region

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
West Coast	38	57	76	73	88	92	79	90	136	107	39
Mid-Atlantic	13	29	21	26	30	45	37	47	84	53	25
Great Lakes	5	13	11	7	8	20	13	13	20	11	4
South	3	11	10	9	9	15	8	13	20	14	9
New England	5	9	9	11	15	14	8	11	12	12	5
Southeast	7	4	9	7	8	17	10	6	24	12	6
Mountain	5	9	8	8	12	7	2	6	18	18	5
Midwest	1	2	3	3	6	1	2	2	4	2	2
Other	0	0	0	0	0	1	0	1	0	0	0

Source: PitchBook • Geography: US • *As of December 31, 2023

States with VC epicenters in cities such as San Francisco, New York, Los Angeles, and Boston rank in the top-six global VC ecosystems using our internal development score methodology as covered in our Q4 2023 Analyst Note: Global VC Ecosystem Rankings. Because the majority of first-time funds are closed in these three states (California, New York, and Massachusetts) we would expect the majority of first-time fund managers unable to raise a second fund to occur there as well. Yet, their inability to raise capital will likely have a negligible impact on those VC ecosystems because they are home to many established managers with strong reserves of capital that continue to capture the majority of the annual total US VC capital raised. Moreover, the large number of high-net-worth individuals funneling capital into venture in these three states has increased the frequency that first-time managers in those states find success in raising a second VC fund.

Conclusion

The US VC fundraising market is in poor shape. 2023 closed with VC fundraising falling to its lowest point since 2017. LPs have become increasingly cautious regarding where they deploy capital and have retreated to the safe harbors of established managers. The continued concentration of capital within established manager-led funds has meant first-time fund managers face the harsh reality that there is less LP demand for their investment products.

The fundraising market is not likely to become any more accommodating for emerging managers in the near future. If recent first-time managers are able to reach historical follow-on rates, the best-case scenario still sees nearly 250 first-time managers that closed funds between 2019 and 2021 unable to raise a second fund. Not only do first-time managers seeking to raise their sophomore fund face more hurdles than their established peers, but those from recent vintages deployed their capital at the height of VC, at a time of high deal sizes and valuations. Poor interim fund performance due to the market shifts will assuredly handicap the fundraising success of many first-time fund managers looking to raise capital.

Smaller markets have always borne the brunt of low capital availability, although the market has become more democratized over the past few years. An unfortunate impact of the current fundraising environment will be the falling capital availability within these markets, dragging back the growth these ecosystems had realized in the form of new, local venture firms. Another side effect could be founders determining that the cost-effective standards of living, wages, and other incentives typical of smaller markets do not outweigh the value of being based in flourishing tech hubs with enduring capital sources. This could cause US innovation to retreat to these major hubs, depriving smaller ecosystems of budding unicorns and the jobs and wealth they can bring.

In recent years, LPs that have committed capital to these managers, as well as startups that have received investments and the ecosystems in which these managers reside, have supported the decentralization and democratization of venture investing. The threatened recession of capital availability and risk appetite in smaller VC ecosystems is concerning because it has the potential to undo progress and stunt future growth.