# Micro-Funding Opportunity

## Micro-funds proliferate in a market where everything is getting larger

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Contents



## Key takeaways

- **Though 2021 saw a record number of fund closings and more than $129 billion raised, which was highlighted by 63 funds of $500 million or larger, micro-funds continue to proliferate the market.** Funds this size run contrary to the narrative of larger deals, larger valuations, and larger firms investing early in the venture lifecycle, but they provide benefits across the market that larger funds cannot.

- **As the median seed deal size in the US has reached $2.9 million, micro-funds have become more stretched in their ability to diversify portfolios—the median micro-fund continues to hover around $10 million.** However, as more micro-funds are raised in smaller markets, strong opportunities exist for these funds to invest in less-expensive deals than those seen in the Bay Area and New York.

- **Though returns data on micro-funds is thin, the sample data shows a strong return profile for micro-funds, which alone promotes confidence in their strategy.** Coupled with the continued growth of these smaller vehicles and the growing proportion of micro-funds raised by established managers, micro-funds will likely perform well against benchmarks.

## Introduction

2021 was a record year for US venture capital (VC) fundraising, with more than $129 billion raised. That figure, which was nearly 50% higher than 2020's total, came largely on the back of the record number of mega-funds closed. 63 funds received commitments of $500 million or more, pulling the average fund size for the year up to $188 million.

A record
**339 micro-funds**
closed in 2021

For several years, a major trend within the venture industry has revolved around larger and larger funds, which is abundantly clear in the median and average fund size data. But micro-funds, those raising $50 million or under, have also thrived. In 2021, 339 vehicles of this size closed—a new record—with those funds receiving nearly $5 billion in commitments, also a new record. This figure undercounts the total raised, and as more data is collected over the next few quarters, the number of micro-funds closed in 2021 will likely approach 400. The proliferation of micro-funds is a true contrast to the narrative in nearly all areas of venture. Not only are funds larger in the aggregate, but deal sizes and valuations have continued to increase aggressively; crossover investors and private equity (PE) funds have also multiplied throughout the VC ecosystem, bringing along excess capital. With these data points, micro-funds should be priced out of the market, their purchasing power in VC minimalized.

As the top quartile of the market has become more ostentatious, micro-funds have adapted to the changing landscape, offering opportunities for LPs, companies, and new investment firms to access the venture market like never before. Despite the growing divide between micro-funds and the vehicles that drive the majority of venture fundraising in the US, these smaller vehicles have continued to drive trends from the beginnings of venture, and we believe they will continue to do so. Not only do they provide capital to the youngest companies, but they also offer benefits to the industry that larger funds cannot.

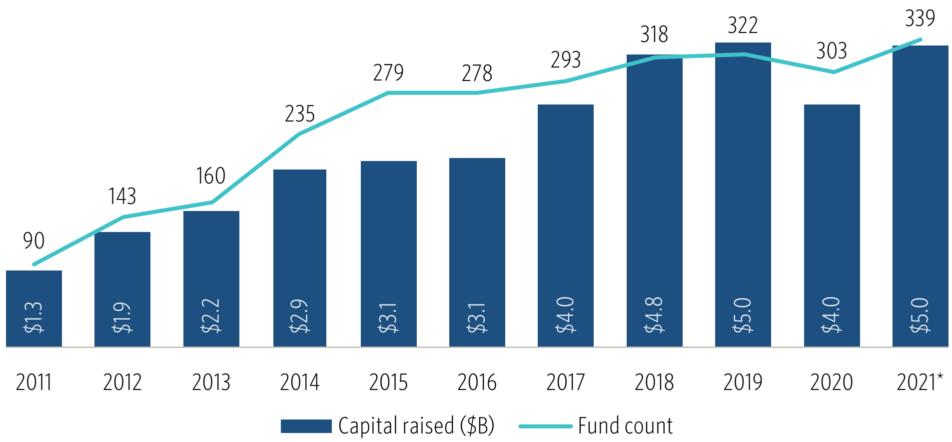
## Micro-funds data

Just $5.0 billion was raised by funds closed on $50 million or less in 2021. That figure represents a paltry 4% of the total capital raised by US VC funds during the year. However, such a simple comparison lacks the nuance to assess micro-funds' true impact on the market.

Over the past decade, the number of micro-funds closed annually has grown from an average of 75 each year between 2006 and 2011, to an average of 320 each year between 2018 and 2021. Last year's record of 339 micro-funds closed did not quite set a new high for total commitments and instead fell just below 2019's record.

Micro-funds have made their most obvious impact on US venture at the seed stage. Over the past decade, seed has grown from a small market to one with nearly 4,000

### VC micro-fund activity

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*As of December 31, 2021

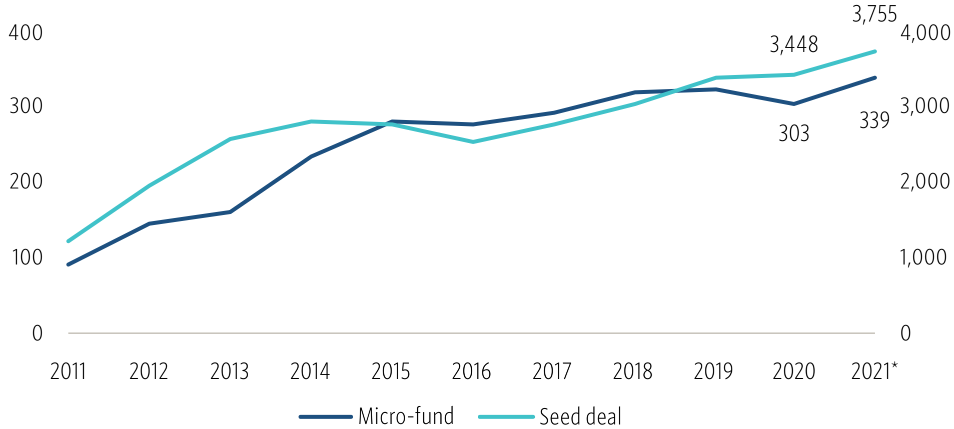
deals per year. Pre-seed has also spawned over the past few years. With companies at this level likely operating pre-product, micro-funds are able to take on the risk while also putting to work a material amount of capital from their funds.

It would not be proper to discuss the rise of micro-funds without discussing the rise in US market seed deals. Today, large multi-stage funds are propagating seed more often than ever before. Andreessen Horowitz raised a $400.0 million fund for seed; Greylock Partners allocated $500.0 million out of its billions of dollars in dry powder for seed deals, offering up to $20 million for each financing. Additionally, many nontraditional institutions have invested in seed deals. These larger firms' participation in seed is more the exception than the rule. For micro-funds, on the other hand, seed is a core investment stage. The companies raising seed capital offer a high enough reward for the risks being taken, all while offering deal sizes in which micro-funds can participate, also diversifying their portfolio. In 2021, the median seed deal size was just $2.9 million. Though this figure showed strong growth over the prior decade, the size still enables micro-funds to participate and even lead these financings when desired.

In fact, the rise of seed deals and micro-funds is very much correlated, sporting a correlation coefficient of 0.95. Though there is likely some messiness with sorting—the lagging indicator within this pairing—charting the rise of micro-funds by count and the growth of seed-stage deals shows the undeniably positive relationship.

Because micro-funds are tied to the earliest stages of venture, the industry receives benefits from these vehicles that cannot be replicated by larger funds. These

### VC micro-fund and seed deal count

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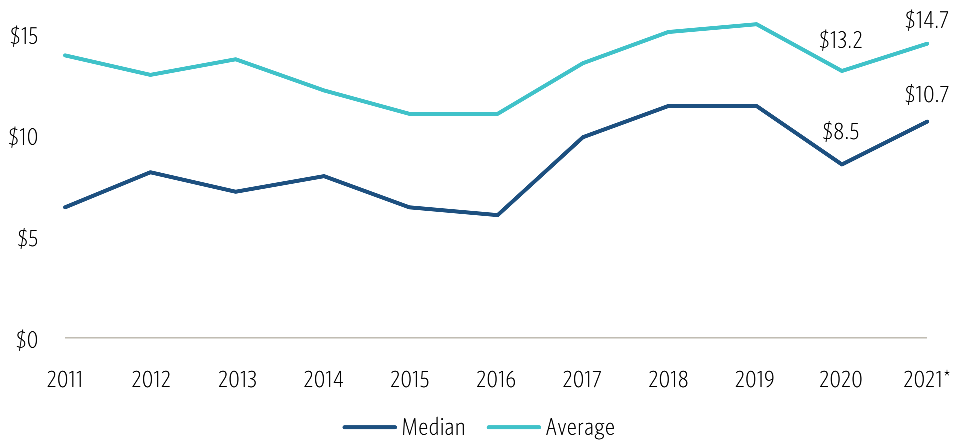
benefits flow not only to companies but also to LPs and new managers, and data shows that the spread of VC outside areas of the main venture markets, on both a geographical and sector basis, is influenced by micro-funds.

At the median, micro-funds are just over $10 million in size—at the average, just under $15 million. Spreading that amount across a significant number of portfolio companies can be difficult. The median size of a company's first institutional round has grown to $2.0 million, doubling in the past five years. If an investor hopes to continue participating in future company rounds, the fund needs to enter financing early in order to save enough capital for later.

### Median and average micro-fund size ($M)

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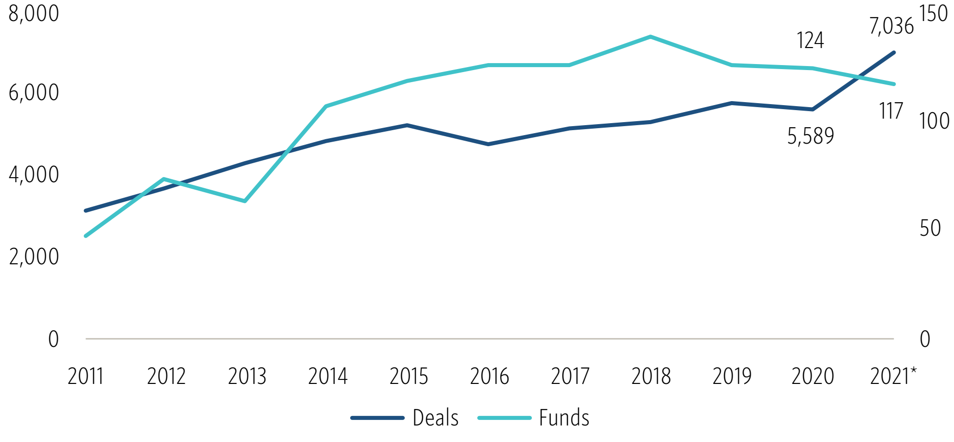
## Benefits for VC ecosystems

Over the past few years, we have seen the emergence of pre-seed. This earliest stage of venture has allowed many of these micro-funds to invest without jeopardizing their strategies because of any capital constraints. It is important to remember, however, that when medians and averages are referenced in research, those figures are largely impacted by the Bay Area, New York, Boston, and Los Angeles ecosystems. Those four areas alone account for more than half of all venture activity in the US, and their high capital availability and large cohort of local investors increase prices and valuations much more than in smaller regions. That is to say, micro-funds outside those areas are not competing against the same headwinds, even if the prices today are higher than they have ever been before. We explored these differences in deal sizes and valuations between ecosystems in past research.

Capital has moved to smaller ecosystems, increasing the number of investors and micro-funds in those areas. The development of ecosystems is relies heavily on smaller funds, not simply because of the capital but because it is imperative for local capital to help fund startups, no matter the market. The median distance between a company and the lead investors of the seed stage round is just 94 miles, and many small ecosystems lie even farther from a major capital center, where most of the VC is located.

### VC deals and micro-funds closed outside major hubs

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The number of micro-funds raised outside the major four markets each year has outpaced the closing of larger funds every year since 2013. This is completely opposite of fundraising trends within the four largest markets. In 2021, 277 funds larger than $50 million were raised in the Bay Area, New York, Los Angeles, and Boston, while just 215 micro-funds were closed during the year. In fact, the number of micro-funds closed per year has never outpaced vehicles of larger size in any year when those four markets were aggregated.

Although the total raised by micro-funds since 2006 does not even add up to half of a Vision Fund, the investment power of these small funds is multiplied by the networks they bring into new ecosystems. As more companies receive local investment, the growing cohort of companies will be able to draw capital from larger funds located in other areas. This itself is a major reason for needing local capital, as those firms will have a larger network and reach than many of the founders needing to raise capital.

## Benefits for LPs

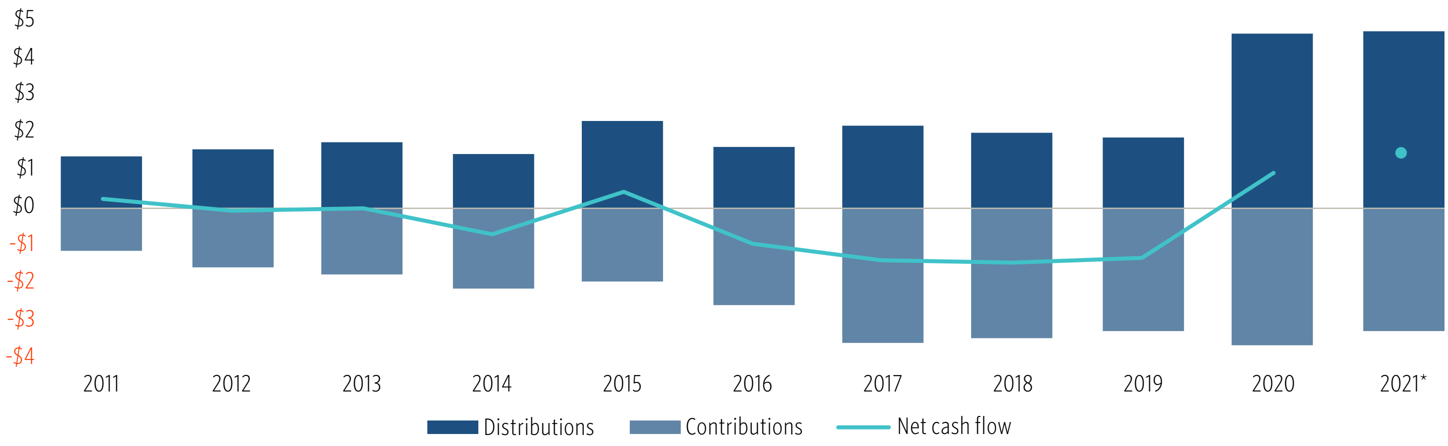
LPs have upped their commitments to venture in a big way over the past several years. This allocation has been generated by the VC market's recent strong performance. According to our recent Benchmarks report, the VC strategy has produced the highest returns of any private capital strategy over both the three- and five-year horizons. This is not surprising given the high exit values created at the top end of the market and the ever-increasing inventory of unicorns (companies valued at $1 billion or more).

However, VC can be difficult for LPs to enter. Many of the largest VC funds are raised through the same LPs that were involved with the VC firm's previous funds. Access to the largest managers also can require a large check—too large for some smaller LPs to cut.

At the opposite end of the spectrum, micro-funds may be too small for large LPs to write a commitment material to without allowing a single LP to make up too large a portion of the fund—for example, checks may be limited to $1 million. An LP managing upwards of $1 billion-plus may see this as too small to provide the returns needed.

Cash flows from micro-funds back to LPs have been positive over the past few years. Through the first half of 2021, distributions to LPs from micro-funds totaled $4.7 billion, with just $3.3 billion being called down for investments.

### VC cash flows from micro-funds ($B)




Source: PitchBook | Geography: US
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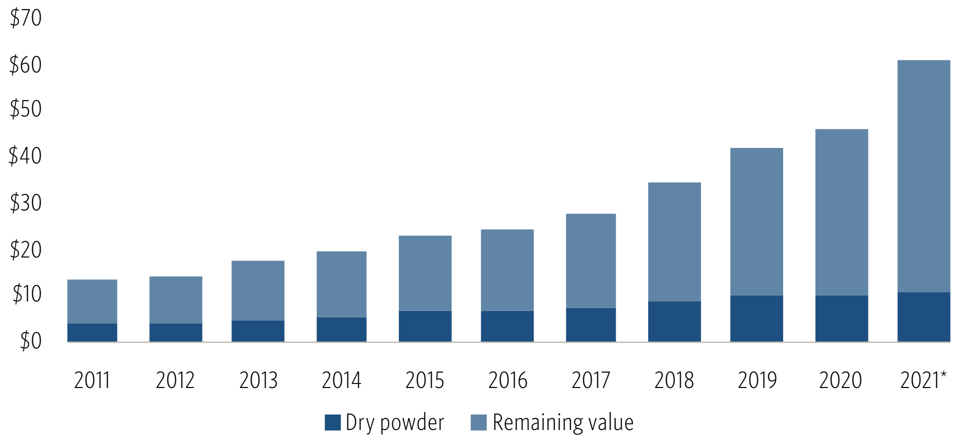
We expect micro-funds to continue strong distributions over the next several years. As AUMs of these funds have grown, the remaining value locked in investments has grown much faster than the dry powder. This makes sense on a basic level, as many early investors have recently seen their valuations grow multiples times over, yet completing an exit can prove more difficult—globally, more than 1,000 companies remain private with valuations above $1 billion. As of June 30, 2021, roughly the same amount of value remained locked in investments as had been raised by micro-funds since 2006—in theory, the remaining value was set to return capital equal to all the micro-funds raised during that time. Though return performance data coverage for micro-funds is low, the sample data shows strong performance figures, boosting confidence in the true returns from the micro-fund market.

**Micro-funds AUM ($B)**

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As we have seen micro-funds grow in number over the past few years, LPs' increased interest in the strategy has boosted funds across size ranges. For LPs that are either too small to access large funds or are looking to simply get a foot in the door of venture and test out the strategy alongside other investment theses, micro-funds have provided that opportunity. Family offices and high-net-worth individuals, as well as foundations and smaller endowments, are major targets for micro-funds.

## Benefits for investors

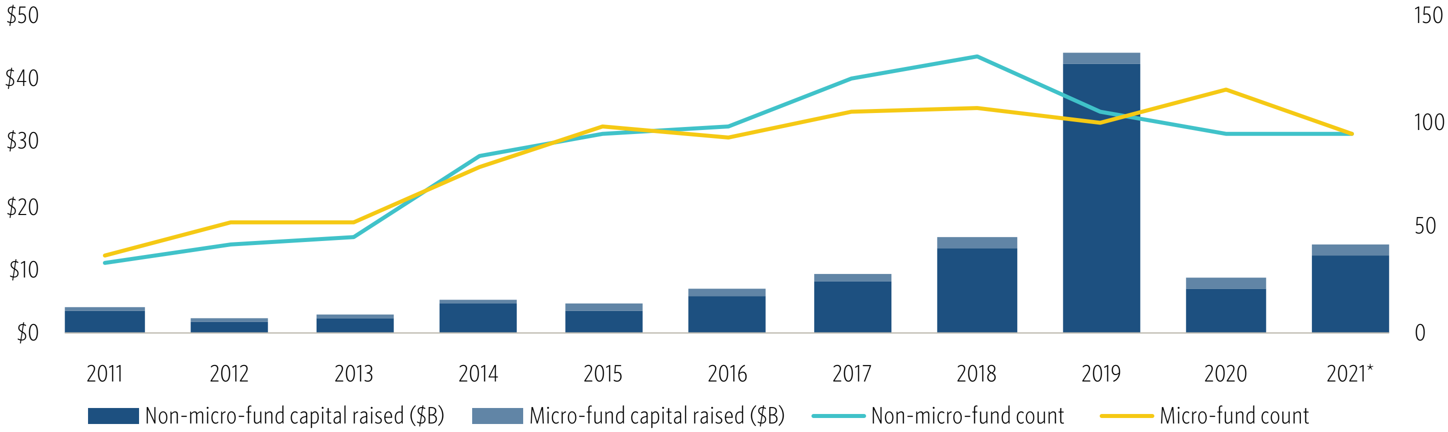
For investors, the benefits of a small fund are more difficult to address. Smaller funds draw fewer fees, making them relatively more expensive to operate on a cost-to-fund size basis, or at least increasing the need for the fund to run leaner than its larger counterparts. Fewer total commitments also increases the strain on micro-funds looking to diversify their holdings throughout venture, especially over the past few years as deal sizes and valuations have increased steadily. The seed deal value growth from $1.0 million to $2.9 million over the past seven years will hurt smaller funds relatively more than larger, multi-stage funds active in the same range.

Over the past seven years, seed deal value grew from

**$1.0M to $2.9M**

Along the same vein as LPs gaining access to venture, micro-funds have also been a vehicle for new managers to begin investing in VC. Over the past decade, more than half the micro-funds raised each year, on average, were the first fund raised by the GP. Since 2015, an average of 100 first-time funds raised suscribed to the micro-fund methodology.

## VC first-time fundraising activity by type

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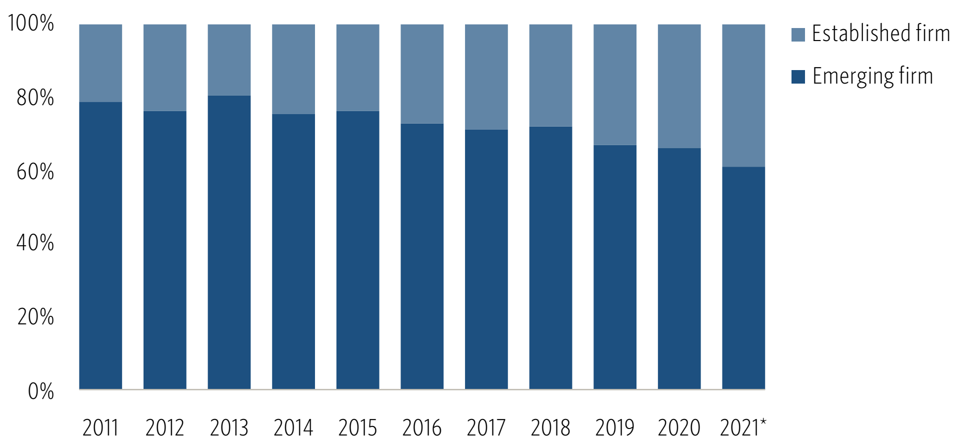
Each year,
**over 60%**
of micro-funds are raised by emerging managers

This is not to say that micro-funds are merely a start to a career in VC before moving on to larger funds. Many managers deploy a strategy that simply calls for less capital, with no intention of growing the team or exploring outside the niche. Each year, more than 60% of micro-funds—and in several years, more than 75%—are raised by emerging managers (those with fewer than four total funds). But more interestingly, the proportion of micro-funds raised by established managers has grown steadily over the past decade. This points not only to strong returns being realized by micro-funds, and managers' ability to continue raising subsequent funds, but also to the value these vehicles add to the market.

## Share of VC micro-fund count by manager type

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In 2021, many new micro-funds were also raised by investors in smaller markets. Though the Bay Area, New York, and Boston still led the way in terms of funds closed and dollars raised, a record number of micro-funds closed in smaller markets. 117 closed outside of the four major markets for the first time in 2021, adding more than $1.9 billion to deployable cash piles for those areas.

While opportunities still exist for micro-funds in the main ecosystems—illustrated by the strong number of these funds closed within those regions—smaller markets may provide even more opportunities. When we mention the rise in median deal sizes, it is important to remember that the deal sizes outside of the four major markets do not resemble those being completed within them. For instance, the median seed deal size in Atlanta is just $2.0 million, while in the Bay Area it has risen above $3.5 million. These smaller deal sizes enable micro-funds to diversify their portfolios without putting a strain on resources, while also potentially taking larger stakes in the companies they invest in.

## Moving forward

The growth of micro-funds is, at the very least, indicative of how much the demand for venture exposure has grown over the past decade. Despite growth in deal sizes and valuations over that time, the large number of these small funds continues to fuel the VC pipeline. Platforms that help facilitate the administration and raising of these funds have played a large part, but without interest from LPs, raising a VC fund is impossible.

As the venture market continues its growth, facing stronger headwinds than it has over the past decade, micro-funds may begin to feel higher pressures. Smaller LPs could be impacted the most by rising interest rates, and the public market volatility may cause a redistribution of portfolios away from illiquid vehicles, capping the amount of LP capital available for these funds. During the onset of the COVID-19 pandemic, there was some industry talk that emerging managers had difficulty securing LPs. This resulted in a wait-and-see approach regarding the impact the pandemic would have on these managers' ability to raise new funds. Of course, that approach flipped, leading to record fundraising by both established and emerging managers—with $41.3 billion raised by emerging managers during 2021. VC has been the highest-performing private capital strategy over the past few years. As these returns generate more investor interest, the fundraising opportunities will continue to grow.

Should headwinds subside without major economic disruption, we expect micro-funds to continue growing as well. The continual development of ecosystems around the US and the world will lead to more funds within those markets. Though larger funds will be needed eventually to complete the development of a market, it should be noted that the Bay Area is still the largest market of micro-funds, despite it being the original VC hub.

In the end, micro-funds continue to proliferate in venture because, in many ways, they help democratize VC. Whether it be through increased opportunities to access the investment strategy, raise capital, or grow an investment firm or VC ecosystem, micro-funds offer keys to many.

Maybe more than ever before, the past couple years have brought about a major shift in the global economy. As remote work and comfortability with video conference business software—especially in regard to venture investing—bring change to the venture industry, we expect capital to increasingly flow to smaller markets, nascent technologies, and underserved areas. With this spread, the opportunities for micro-funds themselves will be plentiful.