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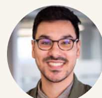
John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis



Max Navas
Analyst, Venture Capital
max.navas@pitchbook.com

Data

Susan Hu
Senior Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Joey Schaffer**

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Challenges for Emerging Managers

How recent headwinds are shaping the proving grounds for US VC fundraising

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

- Despite 2022 setting the US record for annual VC fundraising at $171.0 billion, emerging-manager fundraising peaked the year prior. Waning momentum in the second half of 2022 culminated in an annual figure of $37.0 billion closed by emerging managers, marking a decline of 34.9% YoY. This trend has persisted through 2023 YTD, during which emerging managers secured a meager $2.3 billion. 2023 is poised to be the first year since 2016 to see emerging managers close less than $20 billion in commitments.

- In general, emerging managers pull from a relatively smaller network for commitments than their more established counterparts. LPs in emerging funds, especially smaller funds, are likely to be HNWI or family offices rather than large institutions with an embedded venture capital strategy, which made commitments to their established manager peers at a ratio of 5-to-1 from 2020 to 2022.

- While fund return sample sizes can be small and not necessarily conclusive of the broader market's performance by manager type, they can open the door to conversation regarding why the current market conditions may be giving prospective LPs pause in committing to emerging managers. Across the fund vintages of the GFC from 2007 to 2009, emerging managers underperformed their established peers on pooled TVPI basis by 0.31x to 0.83x.

- More than 1,500 emerging-manager funds have been raised in the US that are of the 2018 vintage or earlier. Fund returns data for these vintage years show DPI figures—a measure of the capital that has been distributed back to LPs as a proportion of the total paid-in capital—below 0.23x. The limited track record of emerging managers, coupled with a general lack of returns due to the young age of funds, adds to the challenges emerging managers face when raising new vehicles.

- Declining commitments to emerging managers could have ramifications for the venture market down the line. 63.7% of the funds raised in the past five years by firms headquartered outside of major markets have been by emerging managers, representing roughly half the capital available from smaller-market investors. Without new funds closing, deal activity in smaller ecosystems may shift back to areas with more substantial bases of capital.

Introduction

The fundraising landscape for emerging managers has undergone significant changes over the past 18 months, presenting a myriad of challenges for these up-and-coming players in VC. While the pandemic initially brought favorable conditions for fundraising, the subsequent market volatility in 2022 has disrupted the flow of capital, impacting the distribution and investment portfolios of limited partners. As a result, emerging managers find it increasingly arduous to secure funds due to their limited investment track records, untested historical performance during recessionary periods, and the challenge of attracting the right type of LPs to contribute capital to their funds.

In the current fundraising climate, even seasoned VC managers are expected to face obstacles, but the hurdles are notably higher for emerging managers. In 2022, the number of funds closed by established managers outpaced those led by emerging managers for the first time. This shift led to established managers commanding a larger share of the capital raised in the US VC market, leaving emerging managers with a mere 21.1% of the total funds secured.

The implications of these fundraising challenges extend beyond the individual struggles of emerging managers. Smaller VC ecosystems in the US could suffer if these emerging managers are unable to secure funding from limited partners. The VC industry thrives on innovation, disruption, and the infusion of capital into budding entrepreneurial ventures. Local capital is imperative to help scout and fund startups that launch outside of traditional capital hubs. A declining presence of emerging-manager-led funds could make it more difficult for startups to raise capital and may force them into larger ecosystems.

This note will explore how the fundraising landscape for emerging managers has changed, the factors that make their fundraising experience more challenging, and the implications for the US VC ecosystem if emerging managers struggle to secure investor dollars.

The evolving fundraising landscape

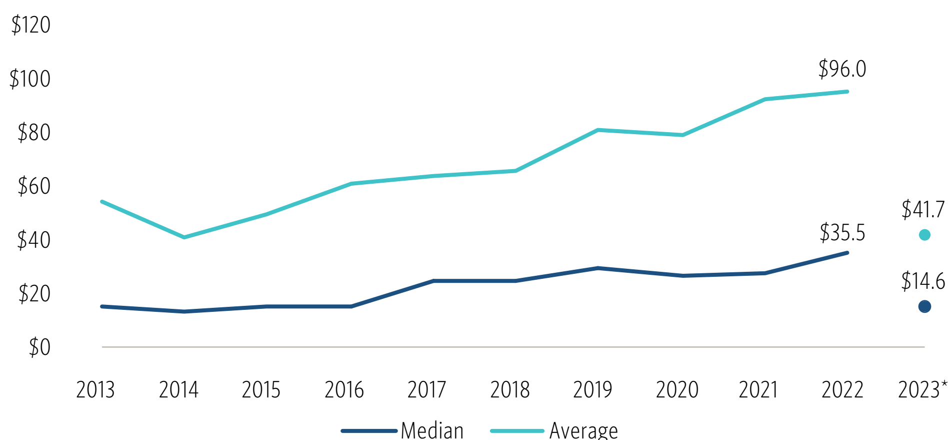
The venture market has significantly matured over the last decade from $22.5 billion raised in 2013 to $171.0 billion raised in 2022. The growth of the seed stage and the expansion of the venture-growth stage at the top end of the market has allowed VCs to flourish with varying risk profiles to attract LPs. In 2013, 852 unique VCs had raised a fund in the prior five years. Fast-forward a decade to 2023, and 2,556 unique VCs have raised a fund in the past five years; tripling the number of firms actively investing in the market and demonstrating the swell in investor appetite for the historically strong returns of this asset class.

Within the expansion of unique VCs participating in the market, managers can be segmented into two categories: emerging and established. We classify emerging managers as those that have raised three or fewer funds, regardless of fund family or asset class. These managers aim to build their reputation, expand their reach, refine their investment strategy, and develop their expertise to be recognized on the level of established industry giants like Sequoia Capital or Andreessen Horowitz.

As VC ages past this period of immense growth, the path for emerging managers, especially those launching their initial fund, is challenging. With the annual growth rate of new fund launches on a decline, it's to be expected that fundraising figures will skew further in favor of established managers as capital concentrates within their larger funds.

Despite 2022 setting the US record for annual VC fundraising at $171.0 billion, emerging-manager fundraising peaked the year prior. Waning momentum in the second half of 2022 culminated in an annual figure of $37.0 billion raised by emerging managers, marking a decline of 34.9% YoY. This trend has persisted through 2023 YTD, during which emerging managers secured a meager $2.3 billion. 2023 is poised to be the first year since 2016 to see emerging managers close less than $20 billion in commitments.

Median and average emerging manager VC fund size ($M)



Source: PitchBook • Geography: US
*As of April 17, 2023

Acknowledging our slower pace in collecting fundraising data on smaller funds and the likeliness of figures to shift over time, 2022 marked the first year the number of closed funds led by emerging managers fell behind the number closed by their established manager peers; despite the much higher number of emerging managers active in the market. For the majority of the past decade, the number of emerging-manager-led funds closed in a given year has outpaced those raised by established managers at a ratio greater than 2-to-1. The dynamic nature of these categories has meant that many VCs previously designated as emerging managers have gone on to raise a fourth fund and be considered established, which does add bias to the dataset. However, 1,840 emerging managers have raised a fund in the past five years, while 718 established manager peers have raised a fund during the same timeframe. Regardless, a larger group by such a wide margin was unable to muster the ability to close a higher number of funds.

The shift of limited partner commitments to more established funds during a market slowdown may not be surprising as it is a perceived departure from risk, but it has created a much more difficult environment for emerging managers raising a fund. A prime example of this shift is first-time fund manager Phenomenal Ventures' $6.0

Annual VC fund count by manager type

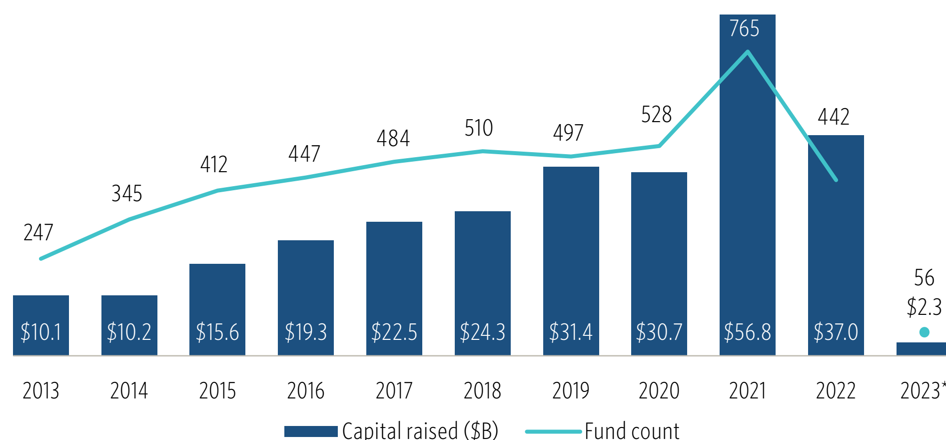
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
Emerging manager	247	345	412	447	484	510	497	528	765	442	56
Experienced manager	93	148	171	198	177	271	256	371	576	459	70

Source: PitchBook • Geography: US
*As of April 17, 2023

million fund that closed in Q1 2023. According to a recent article, the managing partners "expected that their combined 30 years of experience at tech companies would allow them to collect $15 million, a standard first-time fund target."[1] Although these smaller-sized funds provide a substantial amount of capital to work with, managers of such funds encounter limitations when it comes to investing efficiently across the entire venture capital lifecycle and achieving diversification.

The challenging environment has also produced a significant decline in the median fund size of emerging managers, which dipped from the high watermark of $35.5 million in 2022 down to just $14.6 million in Q1 2023. Though one quarter doesn't set a trend, smaller fund sizes can impair the ability of investors to deploy their preferred strategy, especially in a market still awash in capital, even if the investors committing the capital have become more patient. Even though emerging managers may concentrate their efforts on seed- and early-stage opportunities, the market has driven larger, multi-stage investors to increase their focus on earlier deals, adding further challenges for emerging managers raising and deploying their desired strategies with a smaller fund. Despite the market headwinds, seed-stage deal metrics have continued to grow, with the median deal size and valuation reaching new highs in Q1, further highlighting problems that can occur due to small fund sizes.

Emerging-manager VC fundraising activity



Source: PitchBook • Geography: US
*As of April 17, 2023

1: "Cash Dries Up for VC Newcomers," The Information, Kate Clark and Becky Peterson, April 10, 2023.

In a market where the denominator effect has created overexposure to this asset class in LP portfolios, LPs are being more cautious and slower to commit to funds in general, leaving emerging managers at a further disadvantage.

What factors are making fundraising more difficult for emerging managers?

Several factors are creating this more difficult environment for emerging managers: the shift in LP types they traditionally look to for commitments, the lower historical fund performance during periods of market volatility, and the limited time for newer vintage funds to demonstrate returns.

LP targets

Compared with managers that have been able to raise several funds, emerging managers will pull from a relatively smaller network for commitments. LPs in emerging funds, especially smaller funds, are likely to be high-net-worth individuals (HNWIs) or family offices, rather than large institutions with an embedded venture capital strategy. Due to the lower amount this network may be able to commit due to the size of the capital base, emerging managers need to receive commitments from a higher number of LPs relative to their fund size, further complicating fundraises.

HNWIs tend to have more flexible budgets, but can be more acutely pained by fluctuations in various asset class returns and the denominator effect. The extended time horizons, often 10 or more years, and the illiquid nature of VC funds can be worrisome for LPs because their capital is locked up in a volatile market with few liquidity options should conditions worsen. Funds led by emerging managers, typically targeting seed- and early-stage opportunities, have underlying portfolio companies that are further away from exit and unlikely to produce any near-term distributions for LPs; unlike what LPs could expect from funds targeting late-stage and venture-growth opportunities or even other asset classes. Further exacerbating the arduous fundraising journey of emerging managers is their confidence in realizing capital comments. Anecdotally, we've heard of GPs learning that individual investors decided to back out of their fund commitments. While such events may be idiosyncratic in nature rather than a market-wide phenomenon, losing out on commitments can have dramatic repercussions on the total fund size and investment strategy.

Single- and multi-family offices are another LP that emerging managers and smaller funds target for commitments. According to a report from First Republic, "family offices are the most reliable sources of capital in the current market," and 46% of the emerging managers they surveyed considered them to be their primary fundraising target.[2] Family offices have a longer investment horizon than individual investors and can better navigate overexposures to various asset classes due to having a greater amount of assets. However, family offices are not without concern of their own in the current market where public and private valuations have yet to reconcile. Dentons' latest Family Office Direct Investing Survey Report stated

2: "The Current State of Emerging Manager Fundraising in 2023," First Republic, Caroline Hale, February 3, 2023.

that 70% of family offices are "being patient and looking for lower valuations before adding risk" to their portfolios.[3] As a result, family offices are exercising more scrutiny and taking longer to evaluate investment offerings before making commitments. These LPs could temporarily refrain from making new commitments or sever fledgling relationships with emerging managers and prioritize longstanding relationships cultivated with established managers.

Pension and endowment commitments to emerging managers

	2020	2021	2022	2023*
Corporate pension	9	9	3	2
Endowment	15	18	4	0
Public pension fund	19	53	10	1

Source: PitchBook • Geography: US
*As of April 17, 2023

Pension and endowment commitments to established managers

	2020	2021	2022	2023*
Corporate pension	67	49	13	0
Endowment	29	47	38	1
Public pension fund	168	176	163	15

Source: PitchBook • Geography: US
*As of April 17, 2023

Historical returns

Tracking returns data is difficult because many firms keep the performance of their funds confidential to safeguard their investment strategies and maintain a competitive advantage in the market, as well as adhere to Securities and Exchange Commission marketing rules. While low data counts generally make the return divisions between emerging and established managers inconclusive of the broader market's performance, the limited returns data can open the door to conversation as to why the current market conditions may be giving prospective LPs pause in committing to different manager types.

In the last quarter century, emerging managers underperformed against their established peers on a pooled TVPI basis—a multiple that tracks the overall fund value to its cost basis—in 56.0% of the fund vintage years. However, given the recent economic downturn it is important to consider how emerging managers have performed during recessionary periods. Acknowledging the small sample size, across the fund vintages of the global financial crisis (GFC) from 2007 to 2009, emerging managers underperformed their established peers on pooled TVPI basis by 0.31x to 0.83x.

VC success might be tied to just a few winning investments in each fund, and the success of funds led by established managers in these vintage years can be traced back to the manager's ability to access the financing rounds of startups such as Meta Platforms, Bloom Energy, Coursera, Box, and Kayak Software. From a deal-sourcing standpoint, emerging managers could be seen as having a disadvantage because of their nascency, but often the best deals come with a higher price tag, adding further limitations to the ability of smaller funds to outperform.

3: "Family Office Direct Investing Survey Report," Dentons, January 2023.

Fund pooled TVPI multiples by manager type*

Vintage	Emerging managers	Established managers
2013	1.93x	2.73x
2014	2.55x	2.95x
2015	2.57x	2.33x
2016	2.44x	2.47x
2017	2.13x	2.20x
2018	1.50x	2.02x
2019	2.07x	1.58x
2020	1.23x	1.37x
2021	1.06x	1.13x
2022	1.10x	0.86x

Source: PitchBook • Geography: US
*As of September 30, 2022

Several funds led by emerging managers that closed during the GFC found success due to their fund sizes being significantly larger and being able to access and participate in the lucrative exits of DocuSign and Twitter. Of the emerging-manager-led funds from 2007 through 2009 that we have returns data on, the median fund size was $239.5 million, well ahead of the median emerging-manager fund size during the same period, which totaled $35.0 million. The robust networks and larger fund sizes of these firms meant that they could access and participate in DocuSign's $30.1 million Series C in 2010, generating sizable returns following its 2018 IPO at a valuation of $4.4 billion. Similarly, some of these emerging funds invested in Twitter's $35.0 million Series D in 2009 and subsequently reaped strong returns from its IPO in 2013.

The two-pronged approach of utilizing fund size and investment networks that created success for the previously described emerging managers is not widely available to the emerging-manager masses. 60.1% of all emerging-manager funds closed in the past two decades have been below $50.0 million. As a result, many of these managers lack the means to participate in a $30.0 million Series C financing round, capture a desirable equity position, and achieve portfolio diversification. While some emerging managers are sure to have strong networks allowing them to be privy to and source promising deals, insufficient capital can limit their ability to participate. With the decline in median emerging-manager fund size in 2023, accessing financing rounds of promising startups and delivering strong returns is even more challenging.

Limited track record

Another challenge emerging managers must overcome is their limited track record of prior funds coupled with a general lack of realized returns to highlight for prospective LPs. Newer vintage funds closed in the past five years have likely not had enough time to make investments, see exits, and return capital. Especially for managers focused on seed or early-stage deals, exits can generally be years away. The median hold period for companies prior to exit is five years. Across both emerging- and established-manager-led funds closed since 2018, the DPI figures—a measure of the capital that has been distributed back to LPs as a proportion of the total paid-in capital—sit below 0.23x. This lack of performance doesn't exclusively impact emerging firms, but the lesser ability of newer managers to show a record of successful fund returns is an added challenge. More than 1,500 emerging-manager funds have been raised in the US with a vintage of 2018 or earlier, representing a large majority of the funds that have been raised in the past decade.

Because so many emerging funds were raised in recent years, they have also been investing through the market swell that drove valuations to unsustainable highs. While these valuations impact emerging and established funds, it's likely that the smaller fund sizes of emerging managers have left these firms with less dry powder to invest into the corrected market. Moreover, LPs are aware of the continued reconciliation between public and private valuations, as well as the decline in the broader market's median deal sizes and valuations, which leaves them weary of future portfolio markdowns and the challenging prospects for funds that lack dry powder. This has left many hesitant to commit capital to new vehicles, especially those led by emerging managers that will likely raise smaller fund sizes and have more limited access to promising investment opportunities. As a result, we expect to see fewer funds closed by emerging managers, and those that are able to complete fundraising will likely do so on an extended timeline in an effort to get closer to their fundraising targets.

Fund pooled DPI multiples by manager type

Vintage	Emerging managers	Established managers
2013	1.18x	1.26x
2014	1.53x	1.21x
2015	0.72x	0.81x
2016	0.33x	0.60x
2017	0.43x	0.47x
2018	0.03x	0.23x
2019	0.18x	0.11x
2020	0.05x	0.05x
2021	0.00x	0.00x
2022	0.00x	0.00x

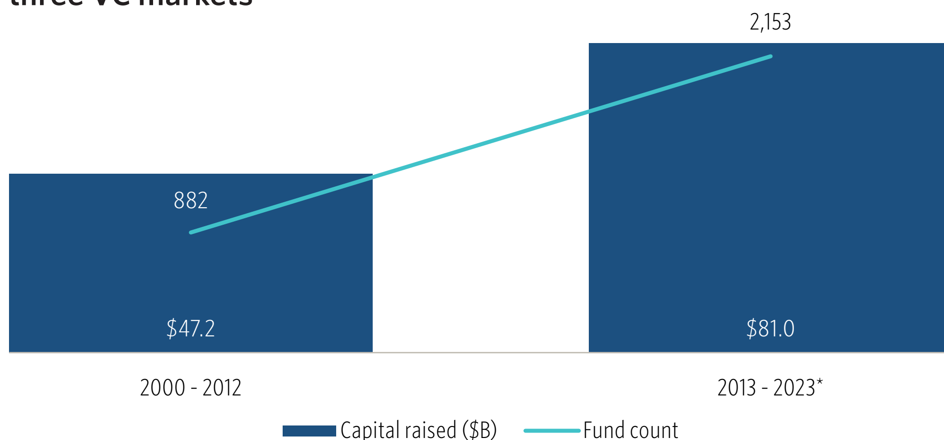
Source: PitchBook • Geography: US
*As of September 30, 2022

What are the implications for the US VC ecosystem if emerging managers struggle to fundraise?

Declining commitments to emerging managers could have ramifications for the venture market down the line. Until recently, the US venture market was concentrated heavily within several key ecosystems, namely the Bay Area, New York, and Boston. However, the growth of the venture market has helped push capital into smaller markets, with a lot of that growth occurring because of the ability of emerging managers to raise capital within those markets. In fact, emerging-manager fund count and fund value in ecosystems outside of the Bay Area, New York, and Boston have dramatically increased in the past decade. During that time period, these markets raised 2,153 emerging funds with commitments totaling $81.0 billion, representing increases of 144.1% and 71.6%, respectively.

This increase in fundraising has coincided with higher deal activity within these markets. From 2013 to 2022, investment in smaller ecosystems grew from just $39.2 billion to more than $250 billion amidst a near doubling in deals. While it's true that some of this investment was due to VCs from major ecosystems expanding their regional investment footprint, first-time and emerging managers raising funds in smaller ecosystems are important for funding local deals. Prior to market changes brought on by the COVID-19 pandemic, the median distance between a seed-stage company and the lead investor on its seed round was less than 100 miles, demonstrating the challenges of raising capital for startups in many areas of the US. Because emerging managers typically invest in seed- and early-stage startups, they are key contributors of capital to smaller ecosystems and help develop startups until larger firms and larger check writers can take them to the next level.

US VC fundraising activity by emerging managers outside of top three VC markets



Source: PitchBook • Geography: US
*As of April 17, 2023

Though the distance between lead investors and target companies has increased since the onset of the pandemic as virtual communication and work-from-home orders helped boost investment in smaller markets as discussed in our Q1 2023 Analyst Note: Capital Concentration and Its Effect on the VC Ecosystem. With more firms and companies prioritizing a return to the office, there is the potential that

we may see VC firms look to do the same, investing closer to their headquarters where they can more easily coach founders and prioritize their support for existing portfolio companies over new investments. With this change, smaller VC ecosystems would receive less outside capital and become more reliant on local investors to continue to support deal activity. 63.7% of the funds raised in the past five years by firms headquartered outside of major markets have been by emerging managers, representing roughly half the capital available from smaller-market firms.

If market conditions worsen and emerging managers continue to struggle to reach their fundraising targets and close new funds, the growth of smaller ecosystems would likely suffer. While there are a high number of active emerging-manager funds in the market today, without new funds closing, deal activity in smaller ecosystems may shift back to areas with more substantial bases of capital. The deterioration of the market's capital base has already begun with the broader slowdown in fundraising, and the depressed exit market doesn't look likely to rebound in the near term. Continued poor fundraising for emerging managers may not show up immediately in deal activity data, but a lengthened slowdown would pressure dealmaking in smaller markets in the future.

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