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Contents

The Seed Blip

The impact of large investors' flight to the US seed market—and their departure

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

- In contrast with the compression seen at the early stage, where deal metrics have fallen from their record highs during the market slowdown, seed deal sizes and valuations have continued their upward trajectory, influenced by large investors that moved up the venture lifecycle in 2020 and 2021. The median seed deal size reached $2.8 million in July 2023, representing an increase of 260.6% from its 2010 level. In the same period, the median seed pre-money valuation grew 227.9%, landing at $10.4 million.

- The rapid evolution of VC provides several compelling reasons why large investors have increasingly embraced seed-stage investments, including the ability to add opportunistic alpha to their investment strategies, gain larger equity stakes and influence, and access disruptive technologies before they revolutionize an industry. From 2010 to 2022, the number of large investors participating in seed more than doubled, going from 88 investors to 181.

- Large investors have greatly contributed to the rise in seed deal metrics, expanding their influence by leading a greater portion of seed deals. Their involvement in seed reached a peak in 2022 with $8.0 billion invested across 1,080 deals, accounting for 35.9% of the broader-market seed deal value and 19.4% of the deal count.

- Despite the slowdown in large-investor involvement in seed, seed deal metrics have remained elevated due to the growing pre-seed market and the plethora of smaller VC funds closed in recent years. Barring the re-emergence of large-investor involvement, the continued growth of seed deal metrics is unsustainable as it stands, given that smaller funds focused on the seed stage will have trouble supplementing the drawdown of their remaining overhang with new funds amid the increasingly harsh fundraising landscape.

In this note, our definition of large investors includes US VC firms that have raised at least one fund with at least $500.0 million in commitments, as well as a custom list of investor types, including asset managers, sovereign wealth funds, PE buyout, PE growth/expansion, other private equity, mutual funds, and hedge funds participating in the venture asset class.

Introduction

In the ever-evolving landscape of venture capital, the period spanning from 2020 through early 2022 witnessed a remarkable and unprecedented phenomenon: a surge in large-investor participation in seed-stage deals. The COVID-19 pandemic ushered in a hypercompetitive dealmaking environment, driving large investors to dramatically increase their allocation to seed, where they could better obtain target equity stakes and increase their risk/return profile in the low-interest-rate environment. The surge in large-investor involvement in seed contributed to record-high median deal sizes and pre-money valuations, yet the extent of large investors' impact was muffled by the tailwinds pushing the broader market upward.

Beginning in early 2022, the US venture market experienced elevated volatility and a lack of liquidity, resulting in severe deal-metric compression. This macroeconomic shift led to a slowing deployment of capital to the venture asset class and created opportunities for large investors to revisit investment opportunities in other venture stages at discounted valuations. Yet, seed-stage deal metrics remained unfazed against the slowing participation of large investors and the compression across the broader US VC market. The "seed blip" has not only reshaped the dynamics of the seed startup ecosystem but also created new hurdles for investors and founders alike.

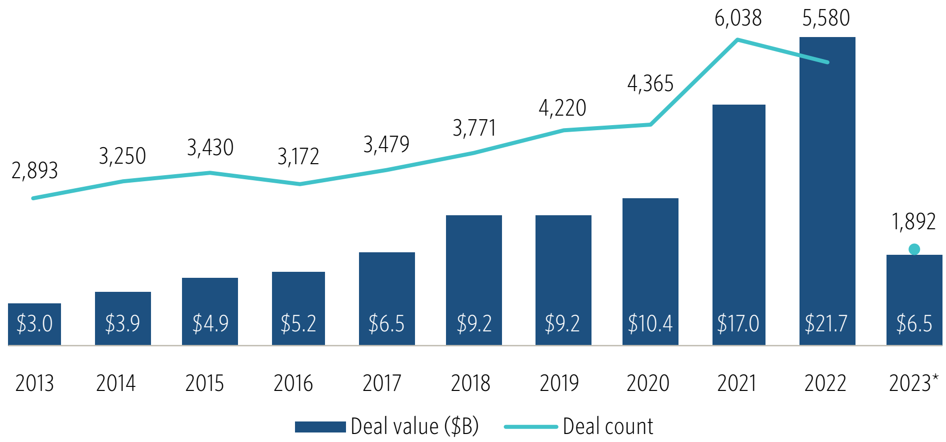
This note delves into this remarkable shift in venture capital dynamics, exploring the factors contributing to the surge in large-investor participation at the seed stage and the resulting effects on startups and the venture capital ecosystem. We will examine the drivers behind this trend; analyze its implications for entrepreneurs, investors, and the overall startup ecosystem; and shed light on how it has transformed the traditional venture capital landscape.

Broader-market seed growth

A little more than a decade ago, the seed market was much smaller than it is today, driving just a few billion dollars in deal value. Now, total invested capital at the seed stage has grown to more than $20 billion annually. Several factors, including the emergence of a pre-seed market, the growing presence of accelerators and incubators, as well as the advent of crowdfunding, have greased the entrepreneurial flywheel and supported the seed stage's growth. As costs to create and run a startup have fallen, the minting of new entrepreneurs and startups has become easier. The increasing number of funding sources and investor interest in backing the most nascent startups further contributed to the seed stage's growth, such that the annual seed deal count grew from 859 deals in 2010 to 5,580 deals in 2022.

Not only has seed deal activity flourished in terms of deal value and count, but seed deal size and valuation metrics have seen substantial gains. The median seed deal size grew from $800,000 in 2010 to $2.8 million in July 2023, representing an increase of 260.6%.

Seed deal activity

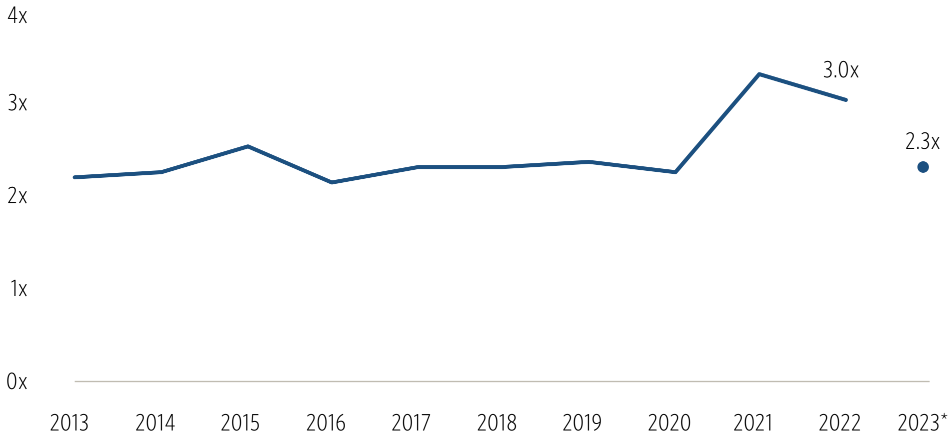


Source: PitchBook • Geography: US
*As of July 11, 2023

In the same period, the median seed pre-money valuation grew 227.9%, landing at $10.4 million. In contrast with the compression seen at other stages, where 2023 YTD median deal sizes and pre-money valuations have fallen from their record highs, seed deal metrics have continued their upward trajectory throughout the market slowdown.

As the seed market evolved, large investors increased their presence at the seed stage, and the symbiotic relationship between the two became increasingly pronounced. The influx of capital not only fueled the growth of startups but also had a profound impact on seed deal metrics. This dynamic interplay between the seed-stage startup ecosystem and deep-pocketed investors has reshaped the landscape of dealmaking, influencing everything from valuation trends to funding strategies. Understanding the intricate dance between the two is pivotal for comprehending the current state of the seed market and its trajectory.

Median step-up from seed to Series A

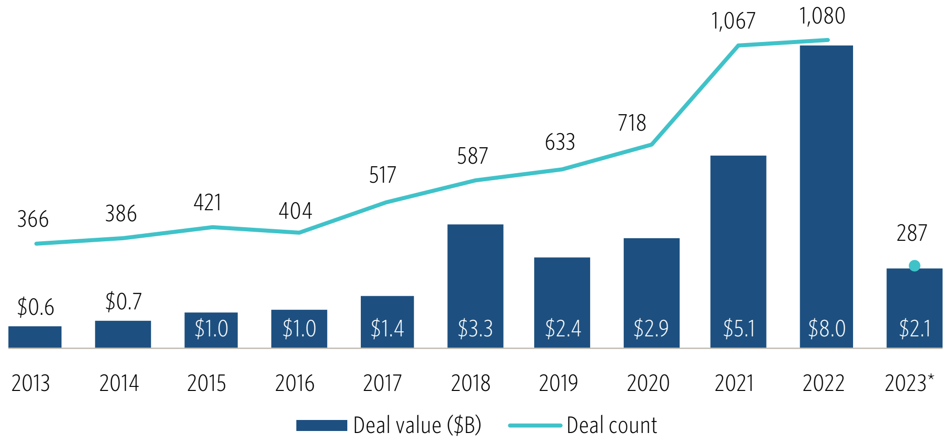


Source: PitchBook • Geography: US
*As of July 11, 2023
Note: Step-ups were calculated using the Series A round date.

The surge of large-investor involvement in seed

The favorable market conditions spurred by the COVID-19 pandemic translated into outsized deal activity involving large investors. From 2020 through 2022, large investors participated in $16.0 billion in seed deal value, exceeding the $11.2 billion in seed deal value from the prior 10 years combined (2010 to 2019). Large-investor involvement in seed reached a peak in 2022 with $8.0 billion invested across 1,080 deals, accounting for 35.9% of the broader-market seed deal value and 19.4% of the deal count. These figures highlight the larger amounts of capital these investors were putting to work and the value they assigned to this stage. Large-investor involvement in seed surged from 2020 to 2022 due to several factors, including heightened competition among investors, an increase in the number of funds closed, and the growth of seed-focused programs.

Seed deal activity with large-investor participation

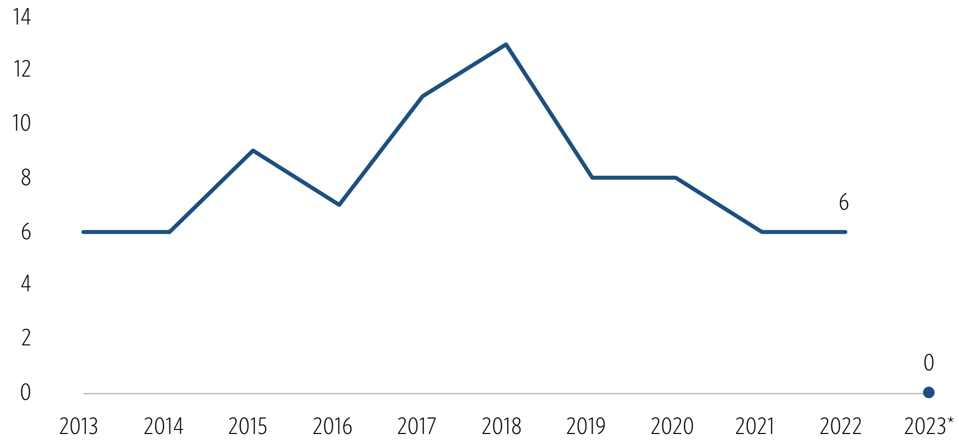


Source: PitchBook • Geography: US
*As of July 11, 2023

In recent years, the venture capital landscape has witnessed a remarkable shift, with nontraditional investors increasingly active at all stages of the venture lifecycle. As the number of unique investors—VC and non-VC alike—increased, so did the competition for deal access. This produced a heavily startup-friendly dealmaking environment where investors found it increasingly difficult to participate at terms reasonably proportional to their fund sizes. At the height of the dealmaking frenzy in 2021 and early 2022, deal metrics saw explosive growth and startups raised more cash without having to give up as much equity. From the investor's perspective, this environment made it costlier to acquire their desired equity stakes at each venture stage.

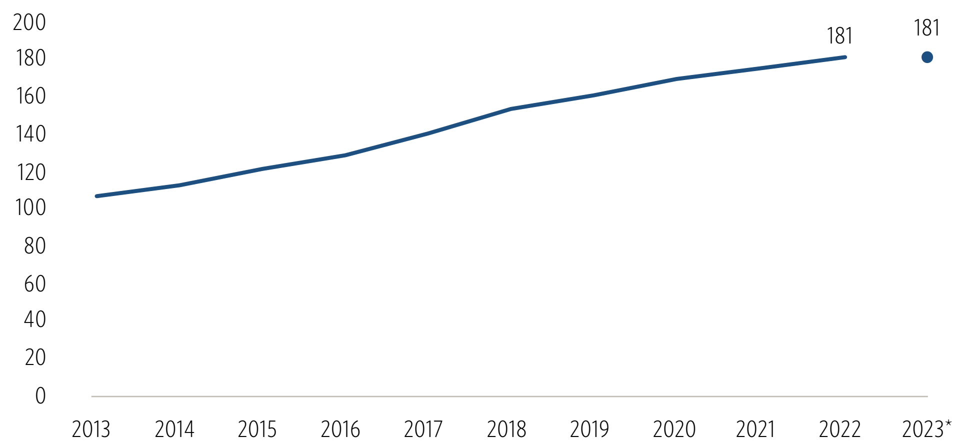
While large-investor participation in seed has grown steadily over the past decade, the heightened dealmaking competition from 2020 through early 2022 caused large investors to increase their focus on the earlier stages of the venture lifecycle, where they could leverage their size and augment their risk/return profiles. By increasing their participation in seed-stage deals, large investors could add opportunistic alpha to their investment strategies. Our 2021 analyst note VC Returns by Series: Part III highlighted Series A investments, which displayed an annualized return of 26.7%, significantly higher than the returns of investments in Series B through F, which hovered between 15.2% and 19.4%. With the seed stage being earlier than Series A investments, we expect annualized returns to be even greater for participating large investors that have the resources to help support the startups through an exit event.

Count of large investors participating in first seed deal



Source: PitchBook • Geography: US
*As of September 23, 2023

Cumulative count of large investors participating in seed deals



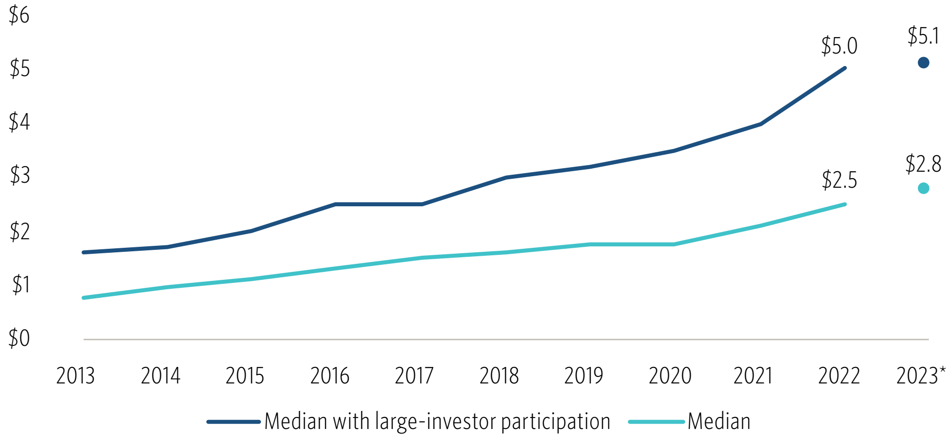
Source: PitchBook • Geography: US
*As of September 23, 2023
Note: Individual large-investor participation in seed of each year is counted once.

Along with the mitigation of dealmaking competition, elevated LP interest enticed large investors to increase their allocation to seed through new funds and programs established to support seed-deal identification and investment. The COVID-19 pandemic created a unique macroeconomic environment where the near-zero interest rates drove LPs to put more capital to work in search of yield. The venture asset class was particularly attractive to LPs due to its history of seeing some of the strongest returns among all private capital strategies. The elevated LP interest prompted large investors to close funds at a faster clip, which increased the need for capital to be put to work, as well as introduce more dedicated seed funds to provide access to new markets and risk profiles for LPs. Investors such as Greylock Partners, Sequoia Capital, Andreessen Horowitz, Khosla Ventures, and Coatue Management launched dedicated seed funds and earmarked substantial amounts of capital alongside or within their flagship funds to take advantage of the seed stage's maturity, broaden their investment strategies, and appeal to a wider audience of LPs.

The impact of large investors on seed deal metrics

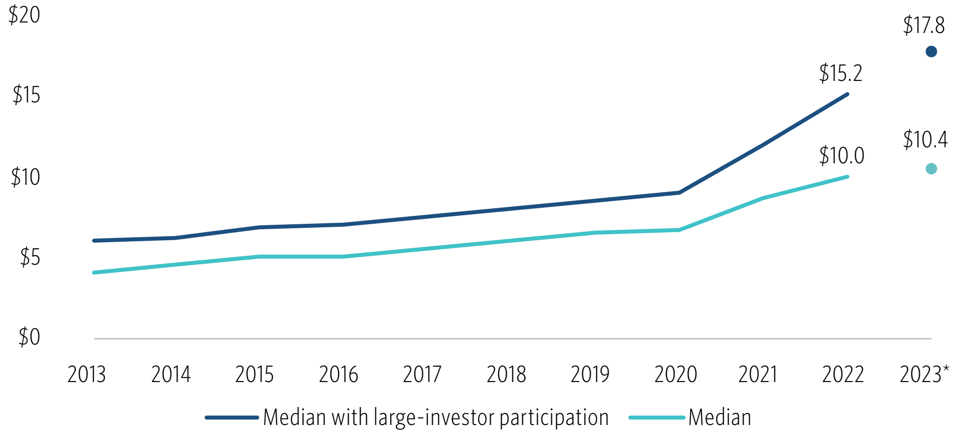
While large investors participate in a minority of US seed deals, they have a significant impact on the deal metrics. The median deal size and median pre-money valuation for seed deals with large-investor involvement have been significantly larger than the broader market's figures. In 2022, the median seed deal size with large-investor involvement reached $5.0 million, while the broader seed median deal size hit only $2.5 million. Concurrently, the median seed pre-money valuation with large-investor involvement hit $15.2 million, while the broader market saw the median seed pre-money valuation hit $10.0 million.

Median seed deal value with large-investor participation ($M) versus median seed deal value ($M)



Source: PitchBook • Geography: US
*As of July 11, 2023

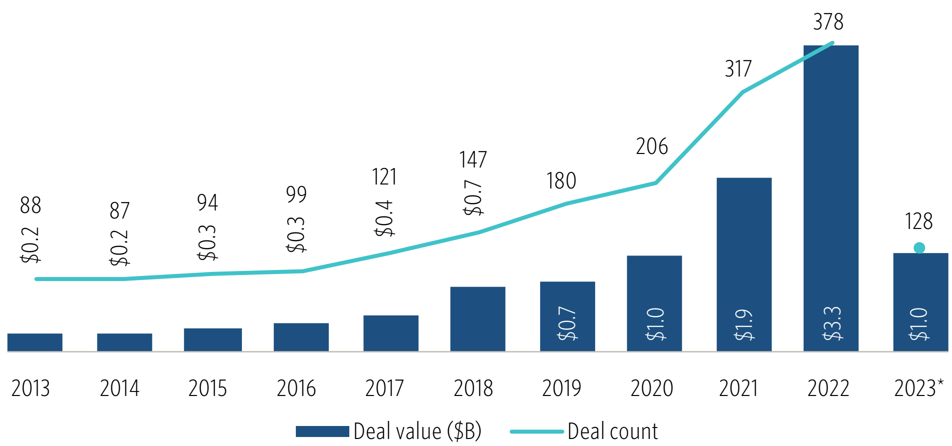
Median seed pre-money valuation with large-investor participation ($M) versus median seed pre-money valuation ($M)



Source: PitchBook • Geography: US
*As of July 11, 2023

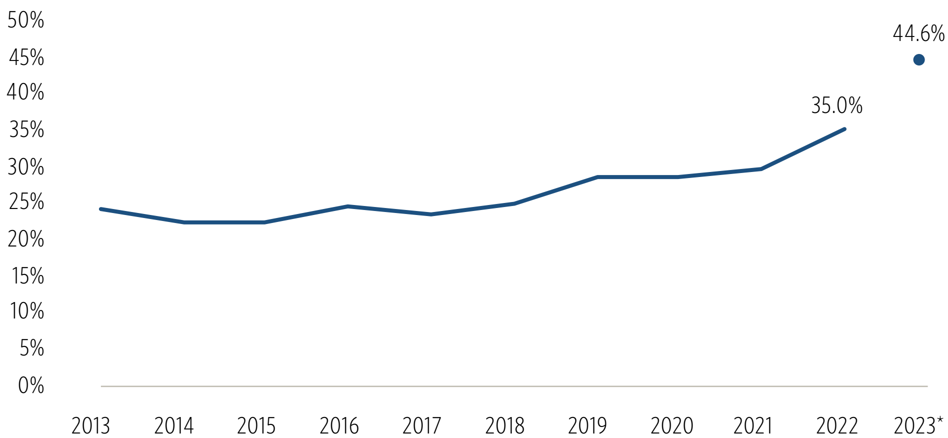
Our data suggests that large investors have flexed their size advantage for increased influence over seed, as they lead nearly one-third of the seed deals they participate in, setting the terms of the round within the company. This figure reached 35.0% in 2022. When large investors are leading financing rounds, they are setting the term sheet and determining the pre-money valuation and round size, thus setting higher figures that make a more effective use of their capital.

Seed deal activity with large investor as lead



Source: PitchBook • Geography: US
*As of July 11, 2023

Deals with large investor as lead as a share of all seed deals with large-investor participation



Source: PitchBook • Geography: US
*As of July 11, 2023

Not only have large investors influenced seed deal metrics, but they are also capturing larger equity stakes. Our data shows that since 2020, large investors participating in seed capture an equity stake between 30.0% and 31.4% on average, more than the average stakes acquired in the broader seed market, which range from 26.1% to 27.9% in the same period. For the amount of money invested into the stage, the increased stakes make sense. This extra couple points of equity translates into more say in voting and helps limit the dilution these large investors will take in subsequent financing rounds. Moreover, their larger equity stake allows them to play a more active role in influencing strategic decisions, recruiting talent, networking with customers, and creating synergies with their existing portfolio companies.

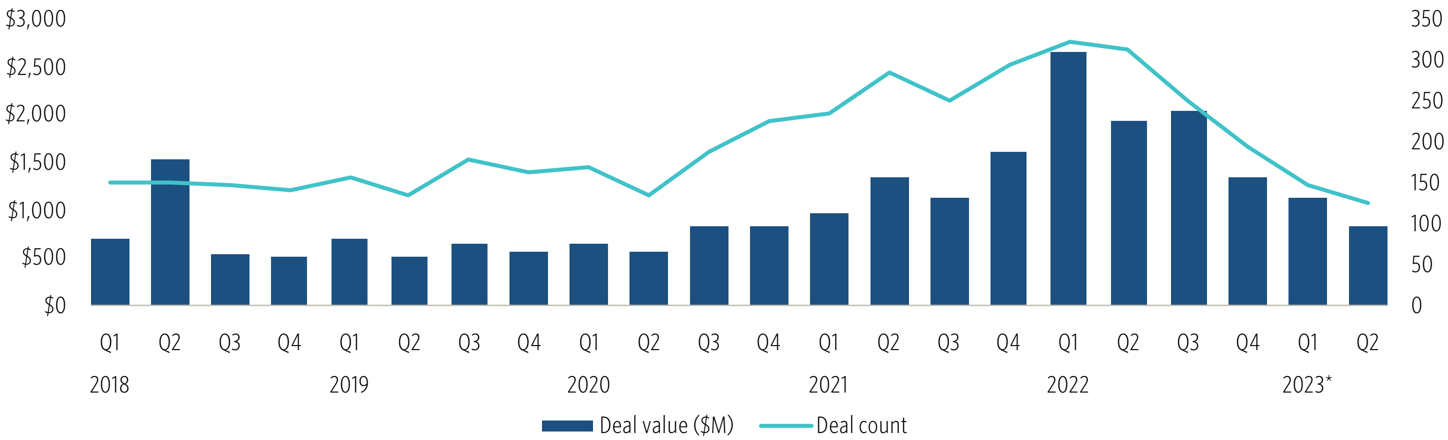
While all this has happened, early-stage metrics have fallen. In 2018, the median early-stage share acquired hit a record high of 26.3%, but by Q4 2021, it hit a decade low of 22.2%. Concurrently, the median early-stage deal size grew from $5.5 million in 2018 to $9.2 million in 2021, highlighting how investors were paying a premium to own a smaller equity stake. The overall convergence of seed and early-stage deal metrics generated through large-investor involvement creates a difficult situation for companies and investors later on, as it erodes the value that can be created between stages. This can be seen in the median valuation step-up from seed to Series A rounds, which has declined from 3.3x in 2021 to 2.3x in July 2023. Valuation step-ups, defined as the difference between the post-money valuation of a company's previous VC round and the pre-money valuation of its new round, play a vital role in the expectations of startups looking to raise a subsequent round and the ability of GPs to demonstrate positive interim fund performance.

Large-investor pullback leaves seed at unsustainable levels

In early 2022, we saw market volatility pick up, the IPO window effectively close, and the US Federal Reserve begin to hike interest rates. Stifled paths to liquidity and an increasing cost of capital caused many investors, VC and non-VC alike, to re-evaluate their venture capital investment strategies, slow their pace of deployment, and in some cases pull back from the VC market in search of more stable yields from other investment products, such as private credit and government bonds. As the number of active participants and the pace of dealmaking declined, so did the competition among investors to access deals and secure favorable terms in more mature stages.

The market slowdown has also shifted the return expectations of seed investments as the downstream market has seen metrics fall and exits paths blocked. Not only are new deals coming to market with more realistic valuations, but strong companies that investors may have passed on in the frothier 2021 market are also returning to raise at more realistic, and in some cases lower, valuations; the Q2 2023 US VC Valuations Report estimated the share of down rounds to be at a four-year high of 15.2%. Deal metrics have fallen back closer to the long-term trend, allowing investors to diversify their fund portfolios more affordably across the venture lifecycle and returning them to previous strategies.

Seed deal activity with large-investor involvement by quarter



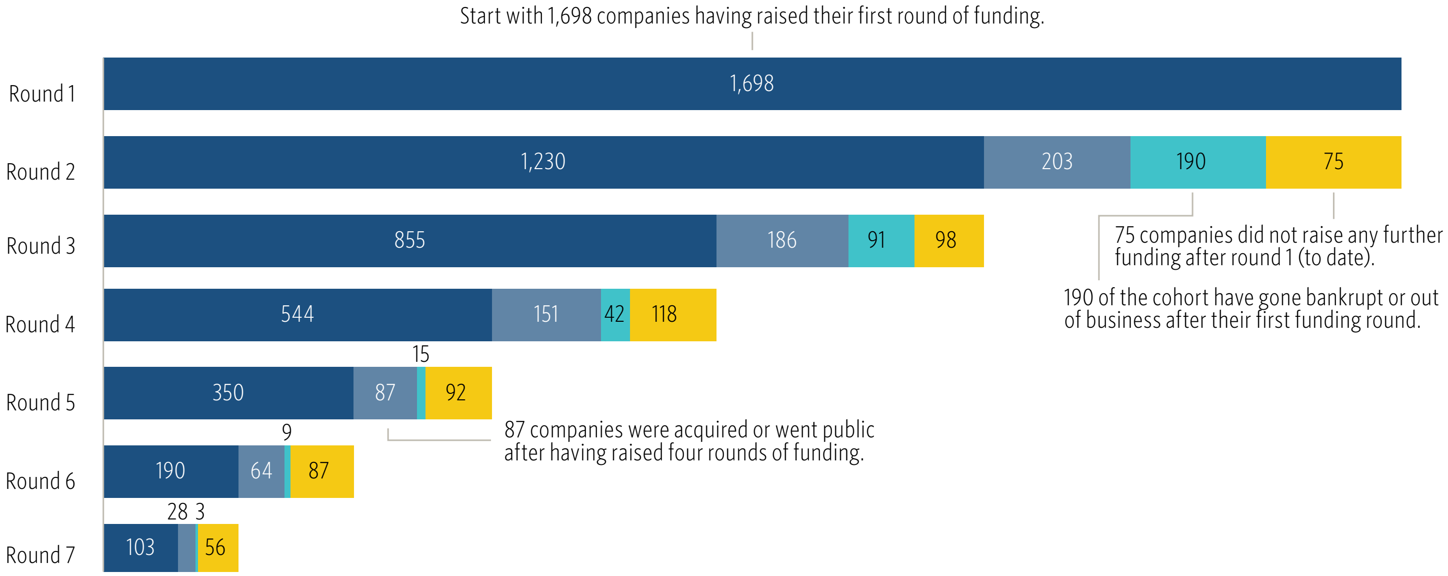
Source: PitchBook • Geography: US
*As of July 11, 2023

Despite the slowing participation of large investors in seed, seed deal metrics have remained high due to the growing pre-seed market and the plethora of smaller VC funds closed in recent years.

The short-lived overexuberance of large-investor involvement in seed has left smaller investors having to pick up the check. Since the start of 2020, $22.9 billion has been committed to 1,854 funds with total commitments of $50 million or less. Many of these funds primarily focus on pre-seed through early-stage investments in order to achieve their targeted diversification and return profiles. As of 2022, $12.3 billion, or 4.4%, of the US VC capital overhang is held within funds with commitments of $50 million or less. While these smaller funds are likely able to meet founders' valuation expectations and steadily deploy capital for the near term, the elevated seed deal metrics can only be sustained so long as these funds maintain dry powder, and the current fundraising landscape is not what it was 18 months ago. LP interest in the venture asset class has sharply declined amid the liquidity drought and valuation corrections, making it much more difficult for GPs to close these funds. In the first three quarters of 2023, $2.0 billion has been committed to 174 funds with less than $50 million in commitments, just 8.8% of the capital raised and 9.4% of the number of funds closed in this size bucket since 2020. As dry powder within these funds diminishes and fewer new funds are raised to supplement the drawdown, seed will likely experience a correction and deal metrics will fall.

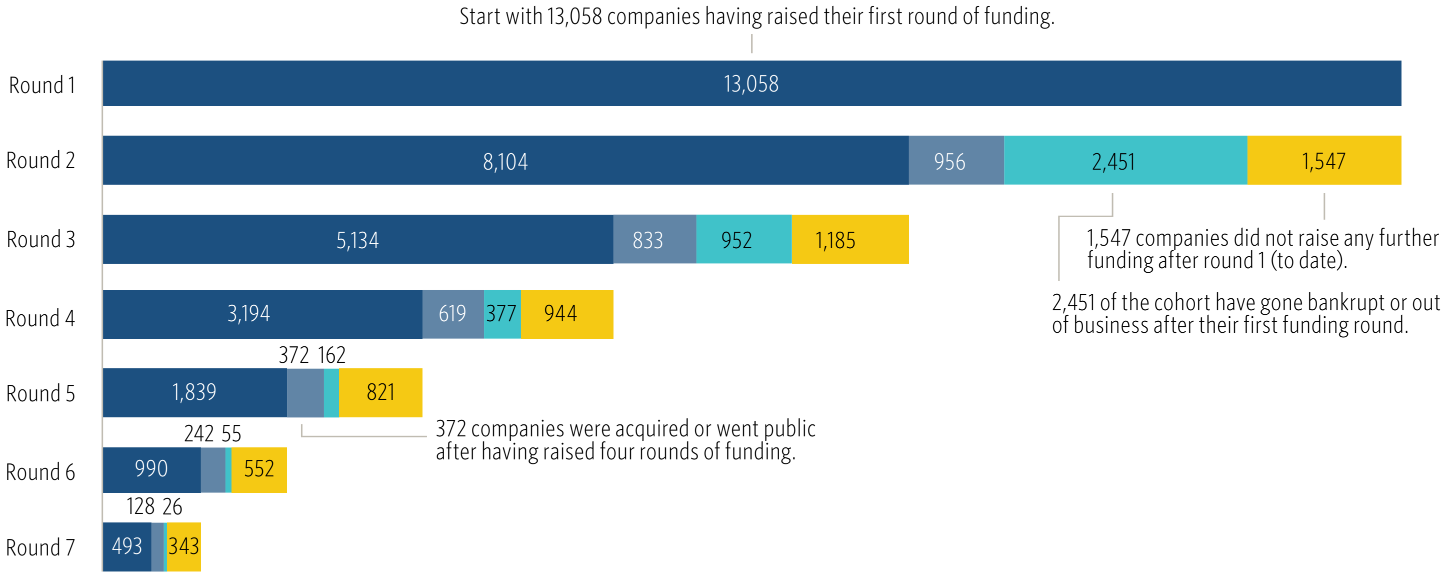
As it stands, the continued growth of seed deal metrics is unsustainable without the re-emergence of large investors at the stage. Smaller investors lack the capital to support record-high seed deal metrics amid the large-investor pullback and depressed fundraising landscape. Moreover, smaller investors' continued participation at these high levels, coupled with lower seed return expectations, could adversely impact their overall fund returns. Analyzing VC funnels of startups that raised a seed round as their first VC deal between 2010 and 2016 shows that 72.4% of startups that had large-investor involvement in their seed round went on to raise a subsequent round, compared with 62.1% of startups in the broader market. Large investors like Sequoia Capital have seen roughly 75% of their seed investments go on to raise Series A financing.[1] Moreover, startups that had large-investor participation in their seed round are roughly twice as likely to reach a successful exit via acquisition, buyout, or public listing than startups in the broader market; 42.3% startups with large-investor involvement in their seed round reached a successful exit, compared with just 24.1% in the broader market.

VC funnel for companies whose first VC deal was a seed deal and had large-investor participation*



Source: PitchBook • Geography: US
*As of July 11, 2023
Note: This funnel includes startups whose first VC deal was between 2010 and 2016.

VC funnel for companies whose first VC deal was a seed deal*



Source: PitchBook • Geography: US
*As of July 11, 2023
Note: This funnel includes startups whose first VC deal was between 2010 and 2016.

1: "Sequoia and Seed Investing," Sequoia Capital, Mike Vernal, January 15, 2018.

If the likelihood of reaching a subsequent financing and a successful exit is lower without large-investor participation, this impacts the risk/return profile for smaller investors deploying capital into seed. In order to achieve their target fund return and generate sufficient LP interest to raise another fund, managers of these smaller VC funds will need to invest at lower deal sizes and valuations such that they achieve greater portfolio diversification and increase their chances of seeing positive returns.

Outlook

The seed investing landscape is on the brink of significant transformation in the years ahead, driven by a confluence of factors that collectively point toward the waning participation of large investors and a decline in seed deal metrics. These shifts are intricately linked to the evolving dynamics of the startup ecosystem.

We expect a continued decrease in the participation of large investors in seed, both in terms of deal value and count through 2024. While we will continue to see the completion of outsized seed deals with large-investor involvement, such occurrences will become increasingly rare. Consequently, the responsibility for sustaining seed deal activity will increasingly fall upon smaller investors, which, until now, have had the necessary capital to support startups at progressively higher deal sizes and valuations. However, as their available dry powder dwindles, raising new funds becomes more challenging, and value creation between seed and Series A startups continues to erode, investors will prompt a recalibration of seed deal metrics to align with their diversification and return objectives. Thus, we can anticipate that seed deal metrics will hit a plateau in the coming quarters and eventually exhibit signs of decline toward the latter part of 2024.

Effectively navigating this shifting landscape will demand flexibility, adaptability, and a keen comprehension of the evolving needs and expectations of both founders and investors. While challenges may arise, this transformation also presents opportunities for startups to thrive within an ever-evolving entrepreneurial ecosystem.