East Coast vs. West Coast - Seed and Early Stage Investing Supremacy: Has the West Won?

by Paul J. Marino, 4/24/2007

What is the reason for the tremendous disconnect between geographic regions when it comes to seed and earlier stage investments[1]; this divergent development per regions (specifically, NY Metro and Silicon Valley) has to be more than just the obvious maxim, "money attracts more money" (the more money that is deployed the more companies come to the marketplace seeking money, the more money is deployed, etc.) or does it?

This article intends to conduct a cursory examination of the foregoing and attempt to answer the question, has the West won.

Having practiced exclusively on the east coast (New York metro area) and dealing mostly with companies looking for cash, my outlook may be tainted by the "grass is always greener" effect. Nonetheless, after yet another round of "beat-up-due-diligence" negotiations with a nameless venture firm, and a venture seminar showing the disparity of funding between east and west coast A & B round closing, I began to think that perhaps the grass is greener out west (heck forget about the grass there is just a lot more green).

To start, the east coast is certainly growing in terms of venture dollars (since the 2000 there has been 13.22bn deployed for NY Metro and NE). Boston has been a hub for venture investment since General Doriot founded American Research and Development Corporation in 1946; New York (and the metropolitan area) is well flush with private equity and hedge fund cash; and metro-Washington, D.C. has seen significant growth before AOL became a part of Time Warner (or was it the other way around). Anyway, the point is that there is life outside Silicon Valley but there must be a reason (beyond the great weather) that Silicon Valley is the heart of venture capital in the US. Clearly, one could write a treatise on trying to answer this question; however, due to spatial limitations of this article, we will concentrate on the earlier stage deals and juxtapose Silicon Valley against (primarily) NY Metro.

In order to compare the regions we must first try to create a common denominator. Currently, most publications focus on four stages of venture capital deals which are:

- Startup or seed deals ("Friends and Family");
- Early stage deals (typically "A Round" deals);
- Later stage (typically later stage "B or C" rounds of financing); and
- Expansion capital (typically the do or die round for management, the company or both).

Taking a snapshot of the third quarter of 2006 from the MoneyTree Survey^{tm} as published by Pricewaterhouse Coopers/Thomson/NVCA[2] (hereinafter "**MoneyTree**"), the greatest dollar and frequency of deals occurred in the expansion capital round with $2.854 billion deployed and a total amount of deals equaling 300, and in last place was early stage investments followed by startup/seed investments (visit www.yvcs.org for a 10 year snapshot of NY Metro, Silicon Valley and New England).[3] For investors who lived through the Internet bubble, this is not "ground breaking" information because (i) investors learned their lesson when it comes to investing substantial amounts of capital in an unproven startup company and (ii) later stage companies seeking expansion capital usually require more cash flow to push their proven concept into the marketplace. Further, institutional investors find it difficult to rationalize an investment in seed/early stage companies (usually comprised of two guys, a white board and a dog) because the risk/reward rationalization vaporizes without a viable exit strategy, which was previously the public market (and could be trending to the AIM). Further and as a result of the evaporation of the public IPO market early stage exists have increased from 5 to 7 years for investors; which could be a reason why so many companies are started to be sold rather than to go the distance to the IPO end zone. The good news, however, for startup/seed and early stages companies is that they represented a combined 278 total deals totaling $1.178bn deployed (a 10% increase year-over-year).

Further, according to the MoneyTree at the end of the third quarter in 2006, there is almost four times the money deployed (invested) in Silicon Valley than the next closest geographic area—New England. To state the obvious, Silicon Valley is far and away the venture capital headquarters of the United States. However, that's only the partial story; the intriguing part is the chasm between early/seed and later/expansion stage deals between the three top regions (NY Metro, New England, and Silicon Valley).

Without being overly analytical let's assume that the standard ratio of money deployed in Silicon Valley is approximately 3-to-1. Hence, for every three dollars deployed in Silicon Valley one dollar was deployed elsewhere. For this reason, since 1995 Silicon Valley is number one in every stage of development (this is true taking a ten year snapshot too) with New England and NY Metro finishing (interchangeably) in second and/or third place respectively.[4] However, the ratio changes when you get down to the seed stage round to a little more than 4:1.

Interestingly, while the following charts are just a snapshot of funding occurrences (3rd quarter of 2006), they are consistent with the ten year funding pattern and thus indicative of deal flow/closings.

The first two charts deal with expansion stage and later stage rounds and are fairly consistent with historical regional differences. However, in recent years, especially in the New York Metro area, what makes these stages interesting is the presence of private equity shops and hedge funds. The presence of these non-traditional venture investors is one of the factors (together with the lack of "pure" venture shops in both New York Metro and New England area compared to Silicon Valley) contributing to the dramatic difference in the number of deals per dollars displayed.

- Expansion Stage[5]

Region	Money Deployed	Percentage of Total	No. Deals	Dollars Per Deal
Silicon Valley	$735MM	32.00%	76	$9.67MM
New England	$316MM	13.77%	30	$10.53MM
NY Metro	$245MM	10.69%	17	$14.41MM
LA/Orange County	$241MM	10.48%	27	$8.925MM
San Diego	$178MM	7.76%	15	$11.86MM

- Later Stage[6]

Region	Money Deployed	Percentage of Total	No. Deals	Dollars Per Deal
Silicon Valley	$780MM	40.88%	71	$10.98MM
New England	$210MM	10.98%	29	$7.24MM
NY Metro	$155MM	8.13%	7	$22.14MM
LA/Orange County	$130MM	6.83%	10	$3.25MM
San Diego	$103MM	5.39%	13	$7.92MM

- Early Stage[7]

Region	Money Deployed	Percentage of Total	No. Deals	Dollars Per Deal
Silicon Valley	$494MM	40.13%	93	$5.31MM
NY Metro	$168MM	13.67%	25	$6.72MM
New England	$130MM	10.58%	30	$4.33MM
Midwest	$96MM	7.83%	14	$6.85MM
Southeast	$77MM	6.229%	13	$5.92MM

- Seed Stage[8]

Region	Money Deployed	Percentage of Total	No. Deals	Dollars Per Deal
Silicon Valley	$150MM	52.45%	20	$7.5MM
New England	$39MM	13.66%	7	$5.57MM
North Central	$15MM	5.24%	1	$15MM
Philadelphia Metro	$15MM	5.11%	2	$7.5MM
Northwest	$12MM	40.5%	3	$4.0MM

First, as one would expect Silicon Valley leads the way in each stage of development. For example, in the Expansion Stage there were: (i) 17 total deals in the NY Metro area totaling approximately $245mm deployed; (ii) 27 total deals in the LA/Orange County area with $241mm deployed; (iii) 30 total deals in New England with $316mm deployed; and (iv) 76 total deals in Silicon Valley with $735mm deployed.[9] Thus, there were two-thirds less investment activity in NY than there was Silicon Valley. However, looking at the seed stage (the other end of the investment continuum) NY Metro does not even show up and the second place finisher, New England deployed about $111mm less.

The same numbers hold true for the early stage investments phase (although, when tracking institutional investment in the seed stage one must take into consideration that many of the seed deals are financed by private individuals [a/k/a "Angels"]. During the early stage investment phase, NY Metro finished (a distant) second with $168mm deployed for 25 total deals with Silicon Valley deploying $494mm for 93 total deals.

Before drawing a conclusion too quickly let's take a look at historical data. Since we are concentrating on the first two stages of development, let's take a snap shot of historical data (again relying on the MoneyTree survey) for the "seed stage" round of NY Metro, New England and Silicon Valley from the year 1995 to 2006. Silicon Valley led the way with a total of $5.22BN followed by New England with a total of $1.77 BN and lastly NY Metro with $1.52BN. That's about a five to one ratio for dollars deployed between Silicon Valley and New England/NY Metro.[10]

So what the closer analysis uncovers is the simple truth that Silicon Valley attracts more early stage companies. It would seem to reason that investors in Silicon Valley are willing to take more of a risk on pre-revenue companies because so many more early stage companies are located there; hence more opportunity to invest (or is that the same thing?).

Early stage companies are the life blood of any venture ecosystem—which said ecosystem attracts entrepreneurs to create early state companies which in turn attract more investors, who in turn attract more service providers, which create more early stage deal flow, creating more turnover in early stage companies which in turn creates more unemployed entrepreneurs who in turn create more companies. This venture ecosystem seems to have found a symbiotic developmental cycle in Silicon Valley—why has it not thrived in other areas?

1. The history of innovation behind Silicon Valley—Hewlett Packard, Intel, Apple, enough said.
2. The network effect (giants Cisco, 3Com, Bay Networks, etc. are located in the area)—in other words, with so many entrepreneurs and venture folk in one area it creates a giant network of folks who in fact "network".
3. The "buzz" factor. Clearly, there is more buzz in Silicon Valley than there is anywhere else. The fact is that when you think of an investment bank you generally think of New York City, when you think of start up companies you think of Silicon Valley.
4. Money, see the charts above. The sheer volume of deals creates a cyclonic effect which affects both investors and issuers.
5. Successful operators who have "cashed-out" often seed former colleagues and other "in-industry" entrepreneurs.

With everything accounted for however, the venture outlook in the Northeast (NY Metro in particular) is far from bleak. First, the hedge fund effect is starting to take hold. Greenwich, CT is the hedge fund capital of the United States and more and more hedge funds are allocating capital to invest in early stage deals. Second, the stockpiling of dry powder by private equity funds is creating a deal scarcity effect leading to some private equity firms to start looking at venture style deals. However, thus far it's been my experience (both anecdotal and empirical) that these groups are still looking for developed cash flow positive businesses—which fits more of a merchant banking approach than a venture approach.

The argument against investing in early stage deals is, among others, (i) the time frame for return on investment (if any) is too far out, (ii) management team is too inexperienced (following the old venture axiom "bet on the jockey not the horse"), (iii) the cost of lost cash is too high to gamble on an unproven investment (in other words—for institutional investors they cannot take the risk to have a portfolio investing in pre-revenue companies in that they are a crap shoot at best—usually with unproven management, and if they want to have multiple series of funds, then the risk of a dud in the portfolio is too high), and (iv) there is no reason to take the risk because there are not that many investors competing for early stage deals and as a result, the investor can pick only the most mature companies in the marketplace.

In any event, unless more venture funds focusing on early stage development enter the New York metro area it is doubtful that any significant gain in early stage investments will occur.[11] However, if hedge and private equity creation continues at the pace it is on now and assets begin to become scarce, gains could be made—but even then there is still a long way to go.

---

[1] For example, from 1995 through Q4 2006 Silicon Valley deployed $29bn for early and seed stage investments compared to $8.7bn for NY Metro and $11.1b.

[2] The PWC MoneyTree Survey encompasses Q3, 4 2005 and Q1, 2, 3 2006. The PWC MoneyTree survey can be found at www.pwcmoneytree.com.

[3] In second place is the later stage round with $2.21 billion and 219 deals with the order of finish following in reverse stage order (i.e., later stage to early stage); for more information see, www.pwcmoneytree.com.

[4] The MoneyTree survey (at least the online version) only tracks as far back as 1995.

[5] PWC MoneyTree (see, www.pwcmoneytree.com/expansionstage), (visited, 2/17/2007).

[6] PWC MoneyTree (see, www.pwcmoneytree.com/laterstage), (visited, 2/17/2007).

[7] PWC MoneyTree (see, www.pwcmoneytree.com/early), (visited, 2/17/2007).

[8] PWC MoneyTree Survey (see, www.pwcmoneytree.com/seedstage), (visited, 2/17/2007).

[9] PWC MoneyTree Survey (see, www.pwcmoneytree.com) (2/17/2007)

[10] PWC MoneyTree Survey (see, www.pwcmoneytree.com), (visited, 2/17/2007).

[11] This is particularly true considering the amount of limited partner activism (*e.g.*, demanding significant returns in a shorter period of time), the institutionalization of venture capital (*e.g*., there are scores of folks leaving sell side investment banking firms, going into or creating venture funds and taking with the staid processes, procedures and methods that work in investment banking but don't necessary translate into venture (hence the term venture), and the hedge fund mentality—*i.e*., the demand for faster returns)