Q1 VC investment rises, with headwinds increasing for 2023

EY US VC Trends 2023 – Q1 report

EY

Building a better working world

Two large deals fueled total VC dollars invested in Q1, while deal count dipped amid continued economic uncertainty and recent bank shakeups.

In brief:

01 VC-backed companies raised $44.1b in Q1 2023, a 37% increase from the $32.3b raised in Q4 2022, highlighted by two large deals that accounted for $16.5b.

02 Recent bank failures dimmed the overall outlook for venture investment, forcing VCs and start-ups to reassess options.

03 Entrepreneurs need to plan long-term and focus on fundamentals, including profitability, cash flows and finance, to prepare for when conditions improve.

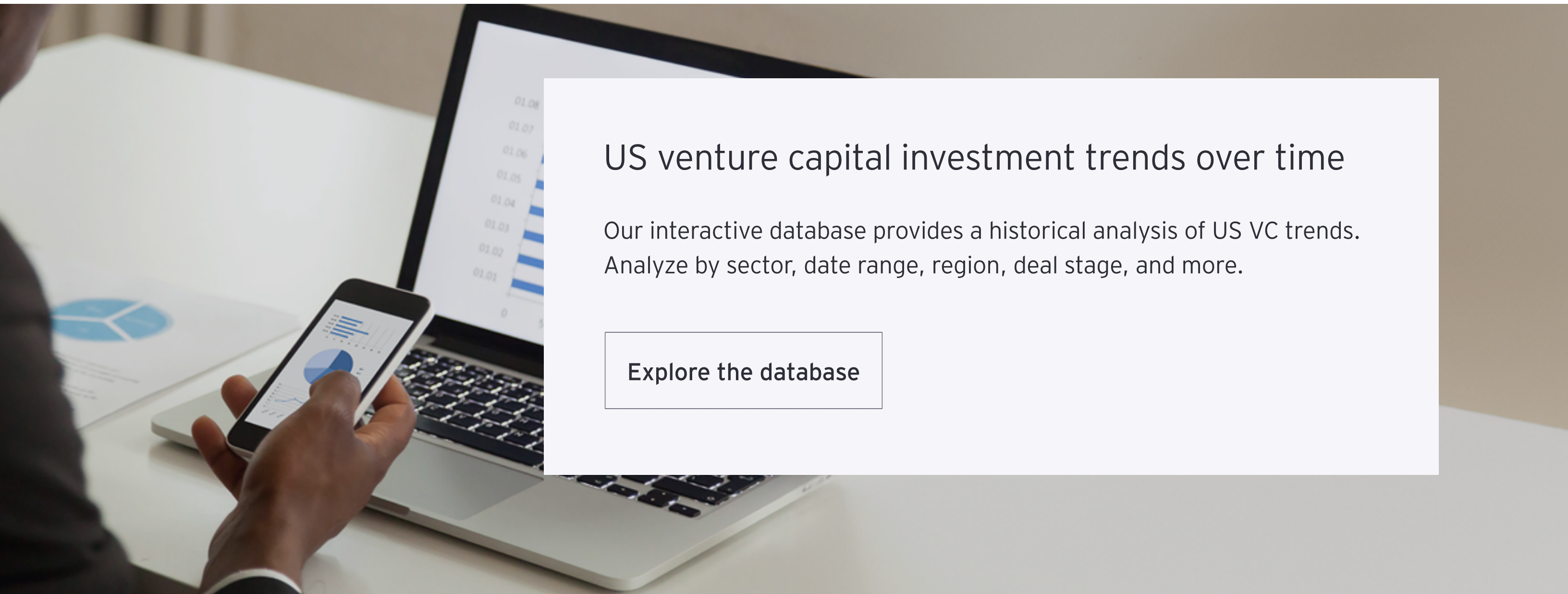
Author

Jeffrey Grabow

EY US Venture Capital Leader
Ernst & Young LLP

While VC investment in Q1 2023 improved by 37% over Q4 2022 – rising to $44.1 billion compared to $32.3 billion for Q4 2022 – recent bank failures and a weaker economic environment have dampened the overall outlook for the remainder of 2023.

For the immediate future, VCs likely will become even more selective about how they deploy capital, and we anticipate that VC investment will continue to drop off from the levels of 2021 and 2022. We may continue to see large fund flows occur, but they're likely to be undertaken from a defensive position to shore up companies in situations where investors are doubling down. Seed and Series A rounds may become more challenging as VCs will likely prioritize existing portfolio companies.



US venture capital investment trends over time

Our interactive database provides a historical analysis of US VC trends. Analyze by sector, date range, region, deal stage, and more.

Explore the database

Given continued economic uncertainty and the fallout from recent bank failures, we expect that many start-ups will continue to struggle to seek new capital. Investors will likely focus on extending the runway for their existing portfolio companies, and we anticipate that new deals will take even longer to be completed. That said, new companies will continue to emerge in this environment, especially those that are able to leverage game-changing technology like generative artificial intelligence.

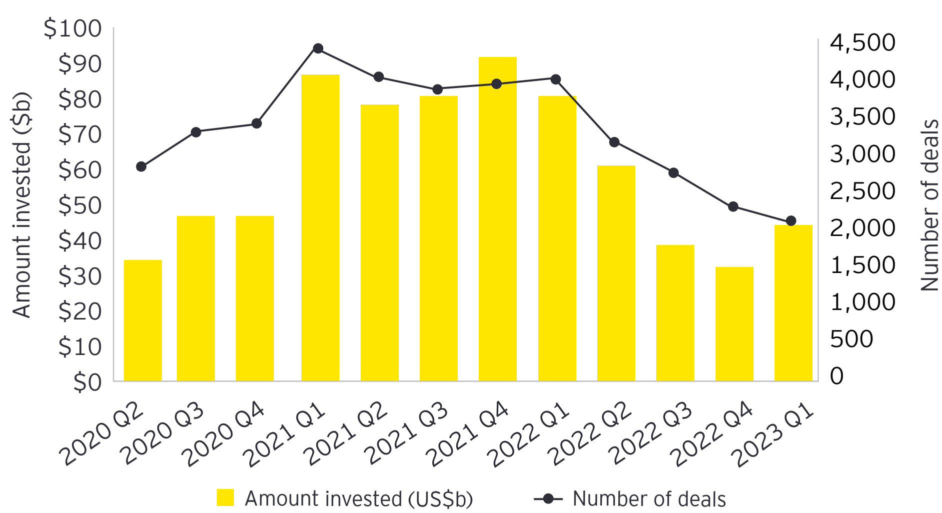
Fund formation continues to slow, dropping to $13.0 billion in Q1 2023 from $13.7 billion in Q4 2022 and from $78.1 billion a year ago in Q1 2022.[1]

Like what we saw in the post-dot.com era, recession concerns could impact the dry powder equation. While the current capital on the sidelines won't disappear, we might see fund restructurings, with existing dry powder going to support current investments and investors exercising more caution before deploying capital.

In this environment, entrepreneurs will need to reevaluate their options and examine all their financial operations, from cash balance and run rates to venture debt. VCs will continue to deploy capital, but deals will be more investor-friendly. Entrepreneurs will need to sharpen their business models and demonstrate a clear path to cash breakeven/profitability. Entrepreneurs with solid unit economics and realistic growth projections will be best positioned to compete for VC dollars.

Deals and dollars invested

Equity financings in US VC-backed companies, Q1 2023



Source: Crunchbase as of April 4, 2023, Ernst & Young LLP. We include equity financings into VC-backed companies headquartered in the US. Sources of cash investments include, but are not limited to, VC firms, corporate investors, other private equity firms and individuals.

Mega-round financing

The number of mega-round deals dropped 18% from Q4 2022, barely reaching the 50-deal threshold for those of $100 million and over, the lowest since before the pandemic. Year over year, the deal count is off by 75%. By this time last year, the market had already recorded 203 mega deals. For the third straight quarter, healthcare had the most mega-rounds by number of deals. In the current environment, we don't expect to see a return to the days of rampant deal and dollar volume in mega-rounds, as we've seen in recent history. However, despite the chill in venture investment more broadly, large deals continue to get done, especially for companies with large addressable markets and disruptive innovation.

Mega-round financing

Investments totaling $100m+, Q1 2023

Source: Crunchbase as of April 4, 2023, Ernst & Young LLP. We include equity financings into VC-backed companies headquartered in the US. Sources of cash investments include, but are not limited to, VC firms, corporate investors, other private equity firms and individuals.

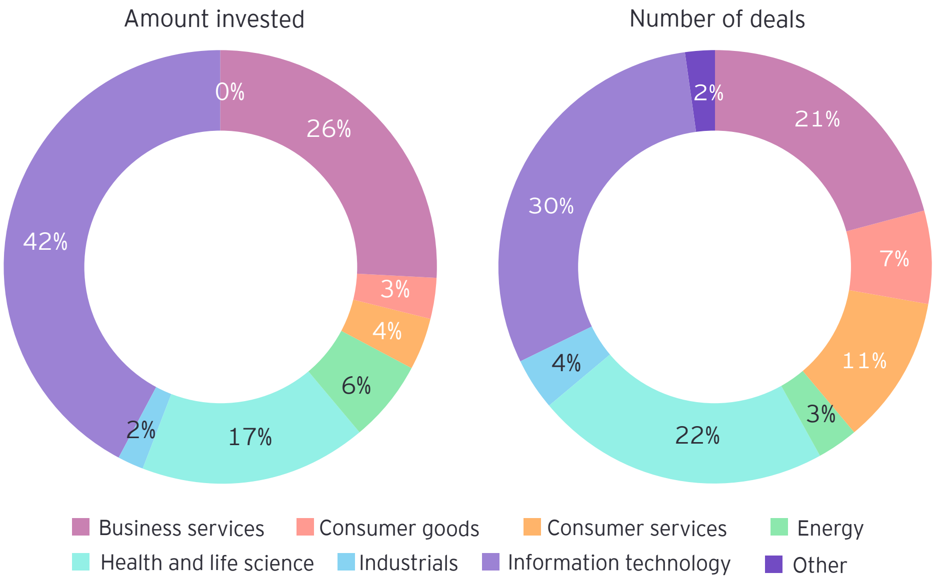
Sectors

Information technology continued to lead in terms of sector activity, followed by business and financial services and healthcare. Business and financial services would have ranked third without one of the two large deals that bolstered this quarter (a FinTech deal). Health care continued its strong recent showing.

We continue to see a decline in consumer goods, which was off 32%. Until inflation and interest rates stabilize, we expect this trend to continue. The energy sector continued to show strength, particularly in renewable energy. However, the bank failures could have an impact on climate tech companies. We will be watching closely to see how those companies interact with the banks and financial institutions that fill the gap.

Investment by sector

US VC investment across industries, Q1 2023



Source: Crunchbase as of April 4, 2023, Ernst & Young LLP. We include equity financings into VC-backed companies headquartered in the US. Sources of cash investments include, but are not limited to, VC firms, corporate investors, other private equity firms and individuals.

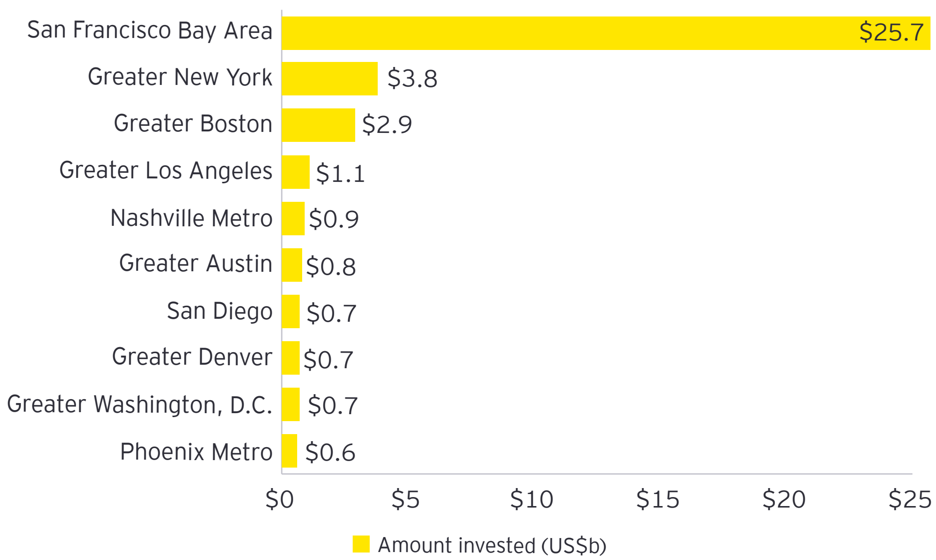
Regions

VC activity in most regions, except the San Francisco Bay area and Austin, experienced a significant drop-off over last year. The San Francisco Bay area continued to hold onto its lead as the top region, accounting for more than half of all VC activity in Q1. That share would have fallen to around 33% of the total without the two large mega deals, however.

New York and Boston finished second and third. Los Angeles came in fourth, while Nashville entered the top five on the strength of a solar energy deal and a specialty health care deal that pushed them ahead of Austin. Los Angeles recorded fewer than 150 deals, the second straight quarter it failed to reach that mark.

Investment by region

US venture capital investment in top 10 markets, Q1 2023



Source: Crunchbase as of April 4, 2023, Ernst & Young LLP. We include equity financings into VC-backed companies headquartered in the US. Sources of cash investments include, but are not limited to, VC firms, corporate investors, other private equity firms and individuals.

Overall outlook

It's too soon to know the long-term implications of the recent shakeup in banks that served the tech ecosystem. It's fortunate that existing venture debt facilities are being honored; otherwise, start-ups would be faced with a credit crunch. The banking fallout, paired with high interest rates and slowing venture investment, means that entrepreneurs need to be deliberate about how they raise and manage capital in this environment.

This could be a painful period for many entrepreneurs. We are likely going to see more layoffs as companies review their operating expenses and try to find ways to survive until the market improves. But companies need to be careful and cut cautiously without impairing their ability to rebound when conditions turn for the better. Given current banking volatility, start-ups should take steps to strengthen their financial teams. In the current environment, companies should diversify their banking relationships, which may require more operating expertise and infrastructure.

We've said it before, but good companies often emerge during tough times. There are no shortage of challenges and distracting headlines in this environment. Entrepreneurs who can stay heads-down focused on executing on fundamentals will be better positioned to weather the storm.

Source: Unless otherwise noted, statistics are from Crunchbase as of April 4, 2023, Ernst & Young LLP.

Disclaimer: The views reflected in this article are the views of the author(s) and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization. Numbers included are from EY analysis and based on Crunchbase data unless noted otherwise.

*We include equity financings into VC-backed companies headquartered in the US. Sources of cash investments include but are not limited to, VC firms, corporate investors, other private equity firms and individuals.

[1] Source: PitchBook, as of April 12, 2023.

Summary

Higher interest rates, a weaker economic outlook and recent bank failures will continue to fuel strong headwinds for VC investment in 2023. As VCs become more selective in how they deploy capital, founders will need to reevaluate their options, focus on their business model and show real growth potential as they compete for VC dollars.

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2024 Ernst & Young LLP.
All Rights Reserved.

2404-4520994
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com