

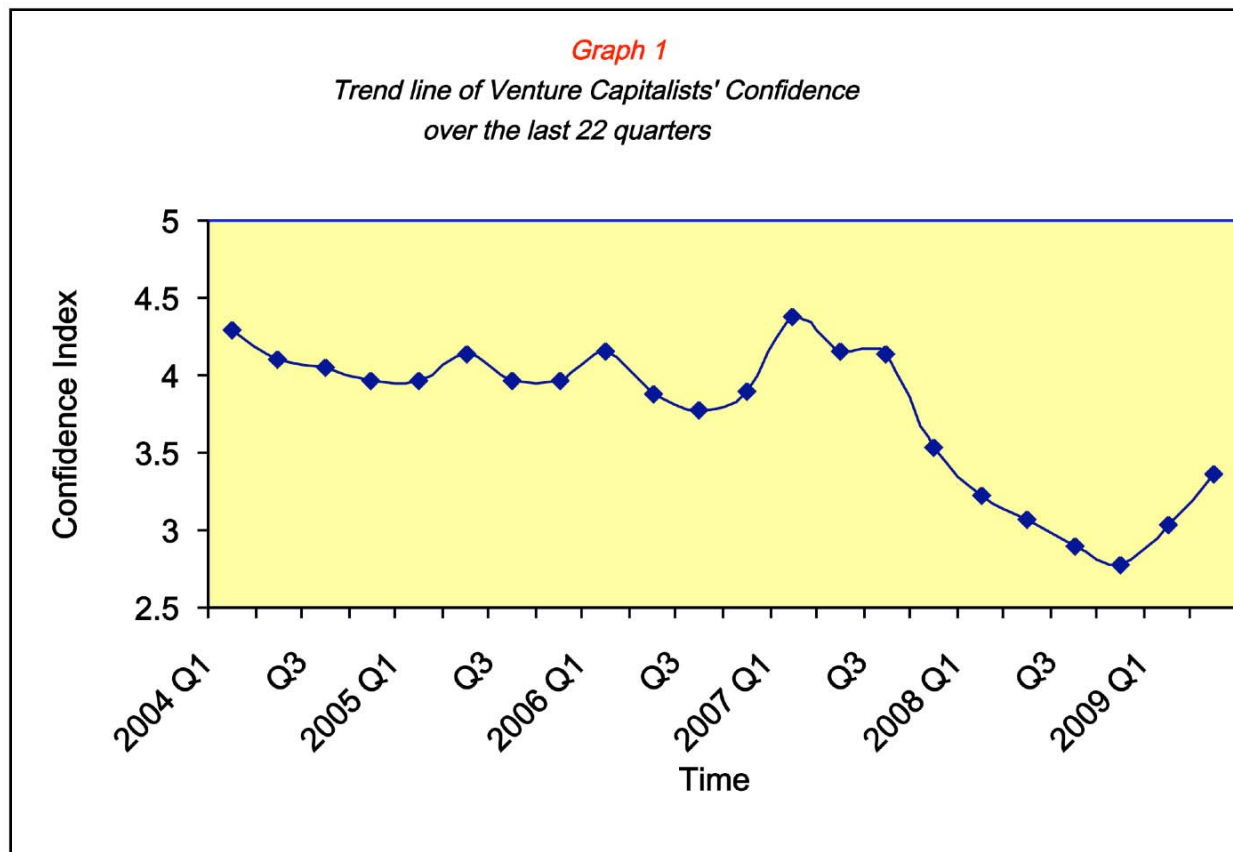
Silicon Valley Venture Capitalist Confidence Index™ (Bloomberg ticker symbol: USFSVVICI)

Second Quarter – 2009

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*Mark V. Cannice, Ph.D.
University of San Francisco*

The quarterly *Silicon Valley Venture Capitalist Confidence Index™* (Bloomberg ticker symbol: *USFSVVICI*) is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index measures and reports the opinions of professional venture capitalists in their estimation of the high-growth venture entrepreneurial environment in the San Francisco Bay Area over the next 6 - 18 months.¹ *The Silicon Valley Venture Capitalist Confidence Index for the second quarter of 2009, based on a June 2009 survey of 42 San Francisco Bay Area venture capitalists, registered 3.37 on a 5 point scale* (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index reading rose from the previous quarter's reading of 3.03 and is the second consecutive uptick in VC confidence since the index indicated a five-year low in confidence in Q4 2008. Please see Graph 1.



¹ Publishing a recurring confidence index of professional venture capital investors is intended to provide an on-going leading indicator of the overall health of the high-growth new venture environment. Questions about this study or related issues should be addressed to the author at Cannice@usfca.edu.

While caution over the functioning of the capital markets and the broader economy remains, confidence increased on average among a majority of the venture capitalists who responded to the June survey. Venture capitalists expect that the worst of the financial crisis is behind us. While the effects of the financial market disruption on the venture industry will linger for some time, most VCs observed an increasingly determined and talented pool of entrepreneurs and a continuing march of innovation. The responding VCs also noted that the harsh economic environment has helped them identify the most resilient and creative entrepreneurs, and these entrepreneurs have necessarily become more capital efficient. VCs expect that this heightened capital discipline on the part of the managers of their portfolio firms will aid in the long-term sustainability of these new enterprises.

Still, concern remains over the continuing dearth of liquidity events and the limited availability of new capital for financing innovative companies. In particular, financing has become scarcer for early stage businesses as fewer new funds have been established and some venture firms have focused on funding later stage portfolio companies that are awaiting limited exit opportunities. However, Q2 did see the reopening of the IPO market for venture-backed firms after two consecutive quarters with no venture-backed offerings. And the second consecutive quarterly uptick in sentiment among the responding venture capitalists suggests increasing confidence that the underlying elements of the VC business model are recovering. In the following, I provide many of the comments of the participating venture capitalist respondents along with my analysis. Further, all of the Index respondents' names and firms are listed in Table 1 save those who wished to remain anonymous.

Many of the responding VCs see the financial crisis abating along with an improving entrepreneurial environment. For example, Venky Ganesan of Globespan Capital Partners stated "They say if you wait for the robins, spring will be over. While there is much to repair in our financial and credit markets, the worst is over and its time to sow the seeds for the future." And Sandy Miller of Institutional Venture Partners indicated "There has been a stabilization in the environment generally in the last two months... While we are by no means out of the woods, the tone for both entrepreneurs and investors has improved." Further, Dag Syrrist of Vision Capital offered "With fear of absolute and imminent economic collapse easing, attention is shifting to deploying capital and building value."

Kirk Westbrook of invencor detailed "As Q2 09 progressed it seems apparent that the unprecedented de-leveraging that occurred in the preceding several quarters began to cease...I believe that with each passing week the 1920's worse case scenario continues to fade..." Taking a more sanguine view, Deepak Kamra of Canaan Partners observed "irrational optimism coupled with the ultimate tendency of markets to revert to the mean."

As fears of a banking system collapse have eased, the public equity markets have begun to stabilize along with the prospects for venture-backed firms and their investors. Alain Harrus of Crosslink Capital explained "In the public markets, fear has switched over to greed. The flow of capital has restarted. The entrepreneurs have always been active and present, even in the darkest moments. So, matching the flow of capital with innovative ideas will result in growth over the next 28 months." And David Spreng of Crescendo Ventures noted "Optimism and activity are picking-up. The early-stage investment environment is attractive despite the fact that exits for more mature companies are few and far between." An anonymous respondent shared this view, stating "The markets seem to be coming around on the public side for quality companies--this drives our confidence to invest." And Joe Mandato of De Novo Ventures held moderate confidence saying "Now that some time has passed and there is a bit less uncertainty; investments are being made, albeit with aggressive pricing and very selectively."

The pent up supply of capital will need to find a home. Sandy Miller of Institutional Venture Partners indicated "...We are seeing demand by small cap money managers for venture-backed IPOs...Merger activity is also picking up as the larger tech companies become less defensive and look to make strategic acquisitions while prices are still relatively low." And Dag Syrrist of Vision Capital noted that "Corporate cash hoarding and increasing M&A is making investors start to think of how to exploit the market opportunities...Pressure to be active will overcome fear of not knowing what the future will hold." Similarly, a survey respondent who requested to remain unnamed, said there exists the "...expectation that venture money sitting on the sidelines will start to be deployed in the next 6-12 months." And Dan Lankford of Wavepoint Ventures pointed out that "Deal flow remains reasonably good, and some smaller, more capital efficient deal are getting funded." Igor Sill of Geneva Venture Management added "Clean, green power/energy technologies, life sciences, along with government-applicable technologies (Biometrics, Biodefense, ...) are ... getting funded these days."

VCs noted that during the downturn and nascent stabilization, the pace of innovation has continued. Bill Reichert of Garage Technology Ventures indicated "We do not see any slowdown in the pace of innovation or in the creation of high quality new ventures. And now with the nuclear winter seemingly behind us, entrepreneurs and investors are looking for opportunities to take advantage of several emerging waves of technology." Jim Marshall of Selby Ventures confirmed "Despite the difficult funding environment, there is still an incredible amount of innovation going on through the entrepreneurial ecosystem." And Shomit Ghose of Onset Ventures, shared "I'm cautiously optimistic. While it's not yet clear to me that we've reached bottom on The Great Recession, the entrepreneurship and innovation factory that is Silicon Valley is running at full capacity."

Venky Ganesan of Globespan Capital Partners added "Future economic growth of the US and the world will be driven by technological innovation and the time to sow the seeds is NOW..." Similarly, Kurt Keilhacker of TechFund Capital provided "There are definite signs of stabilization and hints of increased activity - especially in clean energy sectors. Innovation is not dependent on a certain unemployment rate or stock index. Rather, innovation is often catalyzed by times of uncertainty."

A number of responding venture capitalists concluded that the successful entrepreneurs in today's difficult funding environment are adapting and finding ways to develop world class firms in a more capital efficient manner. Chris Rust of U.S. Venture Partners held high confidence because "...Silicon Valley entrepreneurs adapted quickly to market realities, building more profitable companies quicker without later stage follow on financings." And Jeb Miller of JAFCO Ventures indicated "We're seeing a promising new crop of startups taking advantage of the strong available talent and with a premium on capital efficient business models." Further, Richard Yen of Saban Ventures noted "Early-stage start-ups are focusing on monetization now more than ever, and that's a very healthy thing."

Karan Mehandru of Scale Venture Partners reasoned "... Companies that come out the other end after 18 months will have shown the ability to weather slower sales cycles, manage cash and maintain a clear focus on execution in the face of competition, lack of liquidity and a consolidated customer base. Those will be the companies that fuel innovation and sustainable growth." Steve Harrick of Institutional Venture Partners elaborated "Good businesses have the potential to become great companies in climates like this one. Well managed businesses are hiring selectively, controlling costs and capturing share from weakened competitors."

New ventures that build creative and efficient solutions which that leverage their core competencies and Silicon Valley location are well positioned for the eventual recovery. Bruce MacNaughton of Crosslink Capital stated "Creative entrepreneurs are founding and operating disciplined companies that focus on their core competencies;...solving a real crisis and providing a real value don't require good economic

times to be successful.” Also confident in the entrepreneurial talent of Silicon Valley and more efficient venture operations was Savinay Berry of Granite Ventures who shared “Good talent continues to be available in the market. Combined with tight operating budgets and a less negative trend for enterprise and consumer spending, new companies are positioned well to increase their efficiency and burn less capital before getting to breakeven.” And Bill Reichert of Garage Technology Ventures added “The fact that the funding environment is much tougher actually gives entrepreneurs and investors in Silicon Valley an advantage over other parts of the country.”

VCs also pointed out that the harsh economic realities have helped to reveal the best and most determined entrepreneurial talent. Bill Byun of Samsung Ventures shared “...In today’s environment, when I meet a team of startups with compelling business ideas, I witness more than passion. I hear hunger to succeed and solve real problems versus testing out a business concept with an investor. What we are seeing in today’s economic downfall is that we are once again reminded that our employers will not save us during very difficult times. Hence, entrepreneurs are formulating their business ideas into real business plan and are executing with vengeance...” A corollary view of the build up of entrepreneurial talent was provided by an anonymous respondent who reported a “Migration of several IT executives to cleantech (semiconductor execs to solar/LEDs, software execs to smart grid.)” And Jim Marshall of Selby Ventures confirmed “Times like these truly separate the real entrepreneurs from the ‘get rich quick’ folks.”

Holding high confidence in entrepreneurial talent but concerned about the availability of funding was Victor Hwang of T2 Venture Capital who stated “...On one hand, there is a huge amount of entrepreneurial energy right now, due to the large numbers of very talented people who have been ‘liberated’ from other jobs and the sense that there are great companies to be built in several sectors. However, the amount of risk capital available in the system has shrunk rapidly... the forces are trending towards a very large number of interesting startups at the early stages but with little capital available for them to expand at the same pace as we have gotten accustomed to.” From the early stage perspective, Colin Wiel of Keiretsu Forum calculated that “VC dollars are still quite limited, but it is a great time to be an angel investor, and if you can raise startup capital, it is a great time to be an entrepreneur.”

In fact, a number of venture capitalists still see a problematic financial market with limited exit opportunities for mature portfolio firms. This liquidity constraint will tend to push available capital toward maintaining the operations of promising late stage firms and make raising capital difficult for seed stage firms. T. Chester Wang of Acorn Campus Ventures projected there will be “... very limited exits in the next 12-18 months, whether it is IPO or M&A...” And Christian Cortis of Advanced Technology Ventures explained “The slow pace of exits for investors in venture-backed companies will likely add to the demand for any available capital, diverting some of it away from early stage opportunities. The backlog in maturing companies will need to clear before start-up activity returns to the pace seen in recent years.” Bart Schachter of Blueprint Ventures made a similar point, stating “Disruptions in the equity markets and their impact on early stage venture capital allocations will continue to plague limited partners of venture capital funds. This will lead to constrained investments by VCs in early stage deals...”

And Bob Ackerman of Allegis Capital suggested “The venture environment continues to be challenged by a lack of capital for commitment to new start-up companies. This is due to a combination of venture firms primarily focused on their existing portfolios and the general conservatism around committing capital to new investment opportunities...” A respondent who wished to remain anonymous extended this view, stating “...Due to the state of the public markets, most venture need to triage their portfolios and from what we see they are not making the hard choices.” And Igor Sill of Geneva Venture Management explained “The 2008/2009 recession, along with a sputtering IPO market has placed inordinate pressures

on venture-backed portfolio companies to tighten their belts and minimize capital requirements. We are clearly experiencing a significant slowdown on new startup financing, as available funds are being deployed to support existing portfolio investments. There is considerable evidence that the current financial crisis will have a prolonged adverse effect greater than the 2000 dot com bubble burst. Preserving portfolio valuations is the near term venture capital strategy...”

Regulatory changes in the financial markets have also increased the underlying uncertainty of investing in new ventures. Graham Burnette of Red Planet Capital indicated that “...the proposed regulatory reform for the financial system envisions bringing the venture capital industry under the regulatory umbrella of the SEC. I believe that this significant new regulation, if enacted, will create a large chilling effect on venture investing...” An anonymous survey respondent noted that “the criteria for companies to become public is unclear and are certainly much more stringent than before...If the opportunities of VC backed companies to become public is limited, the exit price for M&A will be depressed. It will, as a consequence, compress the return of the venture capital industry.” Focusing on the healthcare space of the venture market, Tom McKinley of Cardinal Partners explained there are several factors that will make the environment more difficult this year, including the FDA and how the agency will deal with new administration, and the cash needs of medical firms *vis a vis* the constrained supply of available capital.

While uncertainty remains, most of the venture capitalists who responded to the June survey believe that opportunity rests within the mix. For example Tom Rogers of Advanced Technology Ventures reasoned “I think the funding market has somewhat stabilized as investors are no longer paranoid that they are catching a falling knife. Valuations and more importantly entrepreneur expectations in the private sector have been rationalized to some extent relative to the public market counterparts. However many of the strongest companies were bridged by existing investors through the past 6-9 months and will now be coming back to the market over second half of ‘09 and early part of ‘10. It will be interesting to see what their reception is...”

In sum, with VC confidence rising for the second consecutive quarter, there appears to be a growing consensus that while uncertainty in the capital markets remains, the worst of the financial crisis is likely past, and it is time to plan for a recovery. So while liquidity events remain illusive, the IPO market for venture-financed firms has at least been pried open in Q2 amid some renewed interest in venture-backed offerings. Thomson Reuters and the National Venture Capital Association reported on July 1, 2009 that “there were five venture-backed IPOs for the (2nd) quarter, the highest number since the first quarter of 2008.”² The modest but significant rise in IPOs of venture-backed firms in Q2 (there were no IPOs of venture-backed firms during the previous two quarters) followed an uptick in VC confidence in Q1. This relationship (increasing venture-backed IPOs the quarter following an uptick in VC confidence) is consistent with the finding of a related empirical study that demonstrated that increases in VC confidence tended to precede increases in the dollar amount of venture-backed IPOs by one quarter.³ Therefore, a further increase in confidence in Q2 suggests the possibility of additional venture-backed IPO activity in Q3, albeit the Q3 summer time quarter is often a slow one for venture-backed IPOs.

² “Venture-backed Exit Market Shows Signs of Life in Second Quarter”, July 1, 2009, Thomson Reuters and the National Venture Capital Association.

³ In a related empirical study (forthcoming in the Journal of Small Business and Entrepreneurship) that examined the relationship between VC confidence and liquidity events, I found, with my co-author, Cathy Goldberg, that increases in VC confidence tended to precede an increase in the dollar volume of IPOs of venture-backed firms. We posit this relationship is based on the informational advantage that venture capitalist have as they operate at the intersection of the private and public equity markets. Thus, VC confidence tends to rise as liquidity opportunities begin to present themselves in the near term.

And while fundraising by venture capitalists has slowed significantly in 2009⁴, signs of life in the market for liquidity events of venture-backed firms should reinvigorate capital flows to venture funds over time. While capital for seed stage firms remains limited, this constraint will help ensure that those early investments that are made now at lower valuations will be more likely to generate positive returns. Further, the discipline brought on by tighter markets and investment hurdles will foster the development of entrepreneurs who bring laser focus on sustainable business models and a more expedient time to positive cash flow. When the public capital markets right themselves fully, there will exist a healthy supply of innovative and efficient venture-backed enterprises ready to refresh their ranks.

Table 1

Participating Venture Capitalists in the 2009 2nd Quarter Confidence Index Survey

Participant	Company
Alain Harrus	Crosslink Capital
Bart Schachter	Blueprint Ventures
Bill Byun	Samsung Ventures
Bill Reichert	Garage Technology Ventures
Bob Ackerman	Allegis Capital
Bruce MacNaughton	Crosslink Capital
Chris Rust	U.S. Venture Partners
Christian Cortis	Advanced Technology Ventures
Colin Wiel	Keiretsu Forum
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Daniel Ciporin	Canaan Partners
David Spreng	Crescendo Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Graham Burnette	Red Planet Capital
Igor Sill	Geneva Venture Management
Jeb Miller	JAFCO Ventures
Jim Marshall	Selby Ventures
Joe Mandato	De Novo Ventures
Karan Mehandru	Scale Venture Partners
Kirk Westbrook	invencor
Kurt Keilhacker	TechFund Capital
Prashant Shah	Hummer Winblad Venture Partners
Richard Yen	Saban Ventures
Sandy Miller	Institutional Venture Partners
Savinay Berry	Granite Ventures
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
T. Chester Wang	Acorn Campus Ventures

⁴ "Venture Capital Fundraising Slows Considerably in the First Quarter of 2009," April 13, 2009, Thomson Reuters and the National Venture Capital Association.

Thomas McKinley	Cardinal Partners
Tom Rogers	Advanced Technology Ventures
Venky Ganesan	Globespan Capital Partners
Victor Hwang	T2 Venture Capital
Wayne Cantwell	Crescendo Ventures
	Partech International
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D.* is an Associate Professor of Entrepreneurship with the University of San Francisco School of Business and Professional Studies and the Executive Director and Founder of the USF Entrepreneurship Program (recognized among the leading entrepreneurship programs in the US).

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