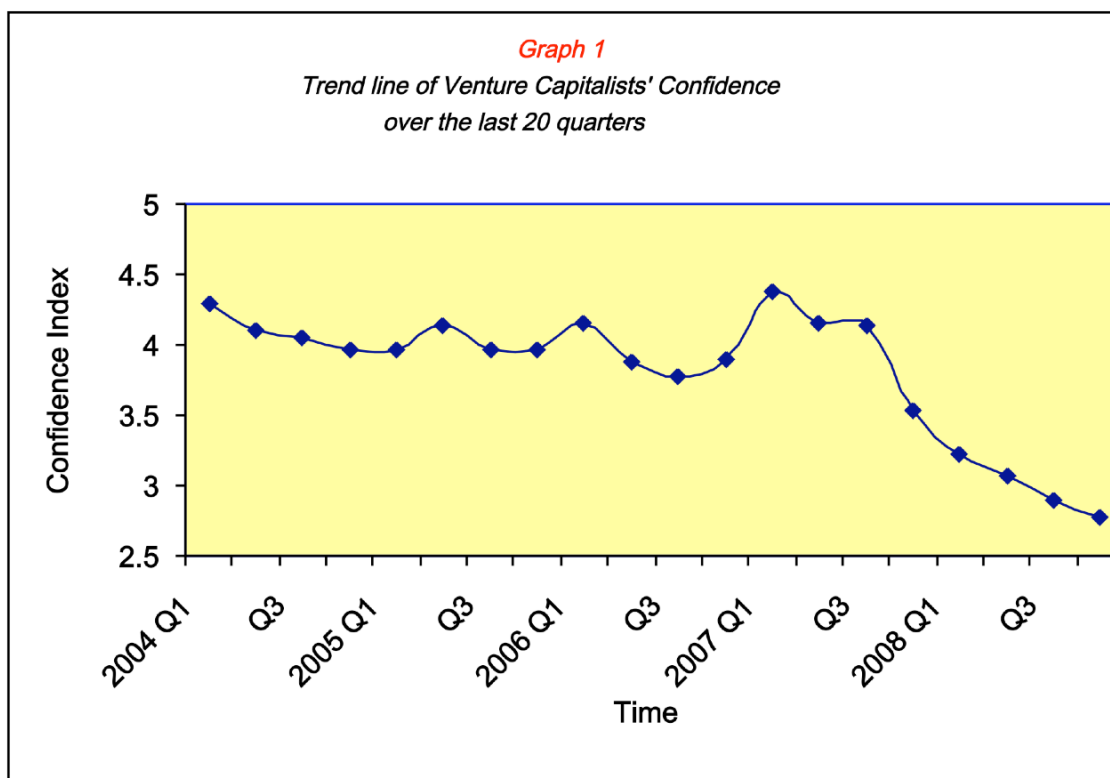


Silicon Valley Venture Capitalist Confidence Index™

Fourth Quarter – 2008
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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 fourth quarter of 2008, based on a January 2009 survey of 33 San Francisco Bay Area venture capitalists, registered 2.77 on a 5 point scale* (with 5 indicating high confidence and 1 indicating low confidence). This quarter's reading fell from the previous quarter's reading of 2.89 to a fifth consecutive new low since the Index was originated in Q1 2004 and indicates a continuing downtrend in venture capitalists' confidence. 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.

The continuing global financial market turmoil and economic decline remained at center stage as a negative influence on venture capitalists' confidence for the recent quarter. In particular, the beaten down financial markets and the resulting negative impact of the liquidity prospects of most venture-backed portfolio firms weighed on confidence. This protracted delay of most liquidity events (both IPO and M&A) has led to significant strain on the venture business model for the near term. While these ongoing concerns did predominate, a fundamental belief in the power of innovation, the prowess of entrepreneurs, and the unique strength of the Silicon Valley eco-system for enterprise creation remained strong. In fact, several venture capitalists saw this harsh economic time as an ideal moment for thoughtful innovation and the creation of new products that would more directly solve customer needs. Timing, though, does appear to be central to sentiment. That is, while most respondents anticipate that 2009 will be another difficult year, the prospect of pent up demand for new entrepreneurial ventures and investment alternatives is expected to surface by 2010. While the exact nature of the reemergence remains to be seen, lower valuations of new ventures, a laser focus on positive cash flow operations, and the long term perspective of patient venture capital bodes well for an eventual recovery in this international center for technology and innovation. Still, with the quarterly confidence index at its lowest point in its 5 year history, the coming months and quarters appear to present a very challenging venture environment. 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.

Caution has grown with the continued unraveling of the broader financial system, but hope for the medium term remains. For example, Debra Beresini of invencor, typically optimistic of the venture environment, gave a rating of 2 and indicated that rating may still be optimistic. And Bruce MacNaughton of Crosslink Capital commented that "The macro-economic conditions are horrible." Also very concerned over the on-going economic environment but impressed by the robust government response was Kirk Westbrook of invencor. He stated "Although I believe the global economy slid to the edge of the precipice during Q4 08, I am encouraged that the atypical and expeditious reactions by governments around the world may have prevented a fall into a much darker 30's era economic crevice. Surely, challenges will remain within the next six months, but the public sector stimulus efforts will also begin to reveal themselves, and the level of massive uncertainty seems to have subsided or has at least been contained. The resulting ability of more established businesses to develop realistic forecasting will slowly help to thaw the opportunity for emerging company solutions that are cost effective and strategic. Disciplined cash focus will be mission critical, but those concerns that are both good at the management and articulation of the value proposition will likely see opportunity in a less cluttered environment as they move toward mid 2009."

A derivative of the public market decline is the decreasing availability of liquidity events for venture-backed firms. TC Wang of Acorn Campus indicated "Uncertainties in the financial market for the next 12 months will clog the M&A and IPO pipe line worldwide." In fact, Thomson Reuters and the National Venture Capital Association reported on January 2 that no venture-backed firms have had an IPO in Q4 and only 37 M&A transactions occurred. For the full year, 2008 brought just 6 venture-backed IPOs. This is the lowest number since 1977. Further, 40 venture-backed firms withdrew their IPO registration in 2008.² To this point, Igor Sill of Geneva Venture Management argued "We have certainly hit the low ebb of a very dry cycle period for venture liquidity as measured by IPOs. ...With this liquidity void, we will see few, if any, new venture firms emerging, and frankly, few fund raising efforts from established firms. Some will even close down. We'll be trying to salvage, sell, merge the promising startups and dispensing with those requiring too much runway and capital to breakeven. As for new

² Thomson Reuters and the National Venture Capital Association (January 2, 2009). "Global Economic Crisis Weighs Heavily on Venture-backed Exits in 2008."

startups getting first round funding, it will be tough going.” A respondent who wished to remain anonymous confirmed “The issue of liquidity will play a big role in the next 18 months.”

As exits for mature portfolio firms remain elusive, new venture financing will become more competitive. One contributor shared “There will be less capital available to finance during this period.” But, Colin Wiel of Keiretsu Forum offered “VC’s have slowed their rate of investing significantly. Angels are still fairly active.”

A concern over a declining number of customers for their portfolio firms was also voiced. Steve Harrick of Institutional Venture Partners noted that “Technological innovation will continue unabated. Revenue growth, however, will be more difficult to come by due to a decline in aggregate spending.”

A number of responding venture capitalists envisioned that a new direction for the venture capital industry may emerge from the macro economic malaise. For example, Joe Mandato of De Novo Ventures shared “Given the uncertainty in the environment, the industry is trying to figure out what its course should be in the face of this environment.” And Dan Lankford of Wavepoint Ventures explained “The entrepreneurial environment is impacted by a long term reduction in exits and exit values and the sharper, more recent meltdown of the financial markets. The future of large venture capital firms with large amounts of money under management doing early stage investing is not bright. These funds require large exits which are increasingly hard to come by. On the other hand, smaller, early stage VC’s are likely to do better. These funds are structured for smaller, M&A exits which, although currently slow, will likely recover over the next few quarters. ... There is a good chance that the venture industry is "de-evolving" toward it's roots of small, early stage funds where the partners made most of their money from capital appreciation.” And an anonymous contributor relayed “The VC investment model does not appear to provide competitive returns relative to other asset classes in this time frame. Most VC firms are practicing triage on their portfolio companies in reaction to the current economic environment.”

Steve Carnevale of Point Cypress Ventures articulated “This continues to be a perfect storm for the economy and the venture capital community. Both demand of product and supply of capital are challenged. Historically, venture-backed firms have always relied on exit strategies from either the public market or acquisitions. When one was weak, the other was strong. Now the public market is non existent and acquisitions are low probability events. At the same time, capital for venture investments is a rounding error for many of the institutional investors. As they continue to be under siege, venture capital will be thrown under the bus.³ The venture community should expect substantial structural changes to occur just like other private and public equity sectors. In fact, it is possible that the entire venture industry is an example of the excesses of the credit bubble (just like housing) that has now burst. It will be substantially reduced and may go back to the levels of funding of the early 1990’s. Expect the venture pool of capital to be reduced by as much as 60% to 80% below current levels of funding. If Obama wants to maintain the US as the innovation engine of the world, he needs to think about a tax stimulus package that will keep the venture capital industry strong.”

³In a related empirical study (forthcoming in the International Journal of TechnoEntrepreneurship) that examined the relationship between VC confidence and industry wide capital commitments to venture-backed firms, I found with my co-author, Dr. Cathy Goldberg, that declines in overall capital commitments preceded increases in VC confidence. This may be due to the supply/demand relationship where fewer dollars were chasing the same number of attractive deals, thus, driving down the price (valuation) of some attractive investments and enabling increasing ROI. If this relationship holds in this unique downturn – individual VC confidence may turn upward in coming quarters as industry wide capital commitments decrease. (On January 19, 2009 Thomson Reuters and NVCA reported a significant drop off in fund raising activity in Q4.)

Timing is everything. Concern over exits but optimism in entrepreneurial opportunities was expressed by Sandy Miller of Institutional Venture Partners who said “2009 will remain a challenging year for exits with little to no IPO activity expected and M&A subject to lowered valuation realities. But it should be a great year for new investments. There are still many private technology companies with real momentum that will need capital to finance their growth.” Deepak Kamra of Canaan Partners also expressed concern for the balance of 2009 but increasing sentiment thereafter. And Bart Schachter of Blueprint Ventures said “View 1st half of 2009 as extremely negative, 2nd half as starting to pick up, and prepare for recovery in 2010.”

Similarly, Bill Reichert of Garage Technology Ventures offered “Although I expect the venture environment to be very soft over the next six to nine months, I expect activity to be very robust coming out of this recession, as investors and entrepreneurs aggressively exploit the pent up demand for innovation across an expanding range of technology sectors, including computing, communications, entertainment, networking, materials science, energy, and biotech.” Another contributor echoed this recovery time-line, expecting the next 6 months to be very tough for VCs and entrepreneurs, but seeing increasing activity in the second half of 2009 and a new investment wave in 2010.

Some venture capitalist respondents took a Darwinian perspective, expecting that the current harsh environment will help identify the strongest firms with sustainable business models that make for good venture investments. For example, Eric Buatois of Sofinnova Ventures said “In these difficult times, only strong and motivated entrepreneurs building companies on very strong foundations will get funding. We are likely to see very strong companies created in the next two years.” An anonymous contributor confirmed that “investing in downtimes can be fruitful.” In a similar vein, Dag Syrrist of Vision Capital explained “Capital can now be deployed in companies with growth plans and expectations consistent with market realities – i.e. it takes a significant amount of time for companies to scale and become valuable, and investors are more accepting of this reality. In hard times companies are forced to create valuable products and become relevant to their customers – and investors – both traits often overlooked in growth periods.”

And David Epstein of Crosslink Capital provided “Although the financial environment is likely to worsen before it starts to recover, many companies have navigated through the downturn by cost cutting, raising bridge financing and have all gotten the Sequoia RIP religion. There will still be many companies trying to raise money as fledgling entities; but early stage, low priced (close to early stage series A valuations) but relatively healthy middle stage companies, will begin to find money flowing again, albeit in smaller chunks. No great liquidity of note is expected in 2009, but a general consolidation during a period of flat growth (ignoring still high volatility) will present a good time for earlier stage companies to make development progress and prepare for company and product launches in the 2nd half of 2010. This, we would hope, will line up well with a modest recovery. The new administration will play a wild card role here.”

Further, Robert Ackerman of Allegis Capital said “While there is turmoil in the venture markets due to the macro economic environment – innovation is alive and well. You can easily argue that now is the time when we most desperately need the creativity and innovation that come from venture-backed companies. That said, it won’t be easy for companies to secure their initial funding in today’s environment – which means that those who do secure capital – must have something special going for them in terms of the quality of their idea and team and market momentum. There is no such thing as “good enough” in this environment.” And Daniel Ciporin of Canaan Partners expects that “Investment opportunities are in some ways the best they have been in years, the real challenge is the compressed timeframe for getting to cashflow breakeven that the current economic circumstances demand.”

Confidence in the ability of entrepreneurs to continue to innovate and in the Silicon Valley eco-system remained strong. For instance, David Spreng of Crescendo Ventures declared “Silicon Valley innovation and entrepreneurial spirit will help America lead the way out of economic crisis beginning in 2009, sooner than most people think.” Further, Standish O’Grady of Granite Ventures contended “Innovation and entrepreneurial activity are continuing, and are RELATIVELY unaffected by the deleveraging of the massively over-leveraged and under-regulated broader financial landscape.” Further, Richard Yen of Saban Ventures noted that “We’re bullish about the investment opportunities in traditional early-stage companies. Talented management teams are still getting financed and the current downturn has focused everyone on near-term revenues and profitability, which we feel is a healthy thing.”

And Shomit Ghose of Onset Ventures reasoned “The macro economy is looking like the '08 Detroit Lions, with no hope of recovery till 2010 at the earliest. But Silicon Valley continues to produce entrepreneurs with the talent and drive of the '72 Dolphins. There are daunting challenges in the next 18 months to be sure, but there's also reason for optimism over the long term.” And Venky Ganesan of Globespan Capital elaborated “Like the phoenix rising from the ashes, our innovation economy will rise from the smoldering ashes of this credit crisis. It is precisely when conventional wisdom and the pundits are at their bleakest, when the future seeds of innovation are sowed. Venture capital and innovation is built on the crucible of change and change, as our new President says, has come to America.”

In summary, the continuing fall-out from the credit crisis and downward economic spiral (lack of exits, squeezed capital commitments, and fewer customers for portfolio firm products) has led to the lowest level of venture capitalists’ confidence in the 5 year history of this quarterly survey and report. Expectations for an ongoing malaise in the public capital markets and a shrinking economy portend a continued difficult operating environment for new growth enterprises and their venture backers. As some respondents have suggested, the intense economic pressures on several aspects of the venture business model may necessitate an eventual adjustment to it. And entrepreneurs, given lower public valuations, a longer holding period to liquidity, and fewer bidders, can expect more modest valuations for their enterprises. However, it is worth recalling that the Silicon Valley venture industry endured the 2000/2001 Internet bubble and bust. And current increasingly stringent financing criteria and lower valuations may mean that many of today’s investments will eventually earn significantly positive returns. Further, a confidence in the resilience of entrepreneurs, and the unique support structure of the Silicon Valley entrepreneurial eco-system remains strong. This underlying confidence coupled with the belief that even stronger enterprises, tried by fire in this harsh environment, will emerge more vibrant and sustainable when the broader economic environment finally recovers, leaves cause for optimism in the long term resilience of the Silicon Valley venture capital and entrepreneurial machine.

Table 1

Participating Venture Capitalists in the 2008 4th Quarter Confidence Index Survey

Participant	Company
Bart Schachter	Blueprint Ventures
Bill Reichert	Garage Technology Ventures
Bruce MacNaughton	Crosslink Capital
Colin Wiel	Keiretsu Forum
D. Kirk Westbrook	invencor
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Daniel Ciporin	Canaan Partners
David Epstein	Crosslink Capital
David Spreng	Crescendo Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Eric Buatois	Sofinnova Ventures
Eric Edmondson	Seven Hills Partners
Igor Sill	Geneva Venture Management
Jeb Miller	The Carlyle Group
Joe Mandato	De Novo Ventures
Pat Kenealy	IDG Ventures
Richard Yen	Saban Ventures
Robert Ackerman	Allegis Capital
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Steve Carnevale	Point Cypress Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
TC Wang	Acorn Campus
Venky Ganesan	Globespan Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

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