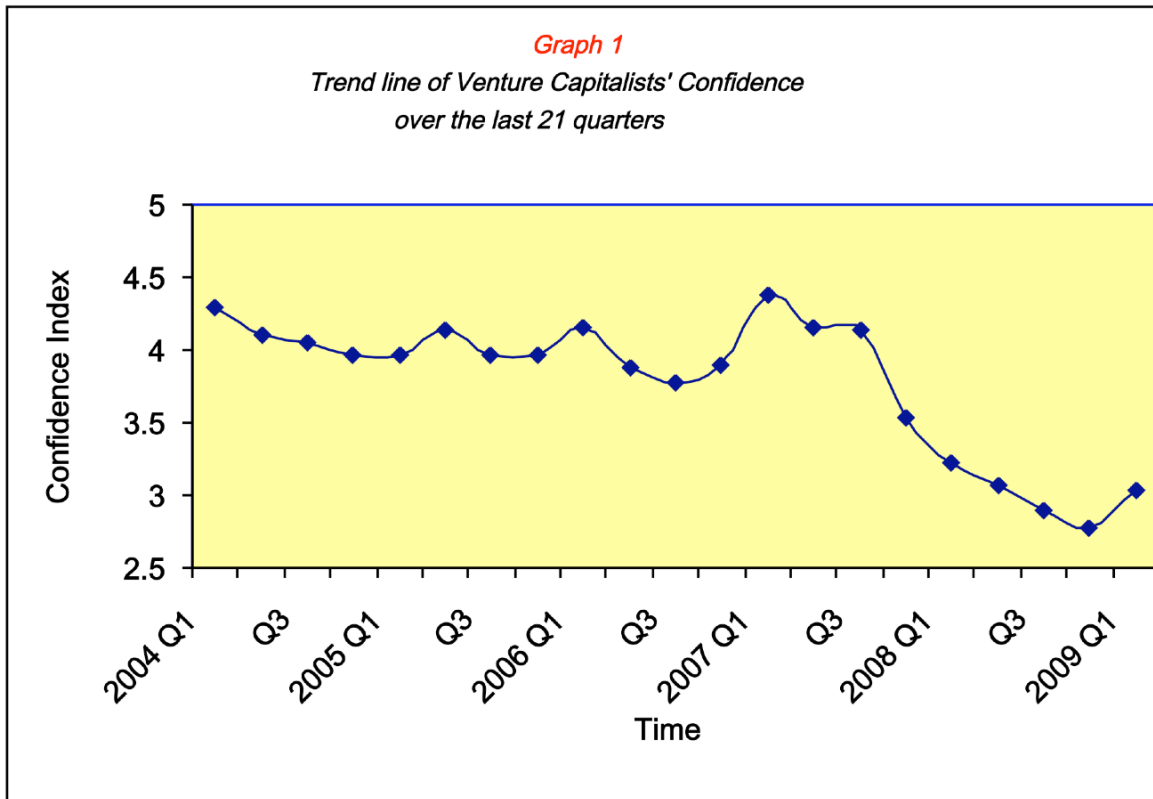


# Silicon Valley Venture Capitalist Confidence Index™ (Bloomberg ticker symbol: USFSVVICI)

**First Quarter – 2009**  
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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.<sup>1</sup> *The Silicon Valley Venture Capitalist Confidence Index for the first quarter of 2009, based on a March 2009 survey of 30 San Francisco Bay Area venture capitalists, registered 3.03 on a 5 point scale* (with 5 indicating high confidence and 1 indicating low confidence). This quarter's reading rose from the previous quarter's reading of 2.77 (a 5 year low) and ended a five-quarter trend of new lows in confidence. This breaking of the downward trend in VC confidence provides hope for an eventual recovery in the high-growth venture environment. Please see Graph 1.



<sup>1</sup> 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](mailto:Cannice@usfca.edu).

**While concern over the state of the national and global economy and financial system remains, a sense of foreboding appears to be giving way to an expectation of eventual, if slow, recovery in the high-growth venture environment.** This *mustard seed*<sup>2</sup> of hope appears to be taking sprout among a majority of the venture capitalist respondents who provided their insight to the March 2009 survey. And it is nurtured by venture capitalists' faith in the resilience of entrepreneurs to build efficient enterprises with disruptive solutions, more modest expectations for growth and valuations, and the early stages of a stabilization in the financial system. Most importantly, this hope is leading to a more optimistic climate and new investments, with numerous VCs believing that great companies tend to be launched in difficult economic environments. As venture capitalists take a long term perspective in shepherding their portfolio firms over years rather than quarters, investments made today are expected to grow and blossom on the other side of the current economic malaise. The modest but measurable uptick in confidence in Q1 breaks the extended decline and provides an important step toward new entrepreneurial growth opportunities. 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.

**Venture capitalists' concern over the continuing global economic crisis remains, but signs of stabilization have been noted by some of this study's respondents.** For example, Debra Beresini of invencor stated, "I see signs... (Hopefully, this is not the same as seeing 'dead people'). There are signs the economy is trying to overcome uncertainty. There are signs that the stock market is trying to avoid its recent roller coaster ride. There are signs that house sales have increased given lower interest rates, reduced prices and economic incentives, and there are signs that venture firms are beginning to invest again. These firms, however, are focused on investing into very narrow and specific niche markets; but they are looking and investing. There are no guarantees, however, that the economy has hit bottom and will continue to rise, but I see signs..." Ms. Beresini continued, "I was in Washington DC a few weeks ago and there is a positive energy in the air; there was a feeling of hope. We might not like all the stimulus incentive packages, but if they work, we will look back and wonder why these incentives weren't implemented sooner."

**However, the macro economy is still seen as negatively impacting several aspects of the venture capital business model.** Chester Wang of Acorn Campus Ventures detailed several issues that remain problematic. Mr. Wang maintained that the public market is cheap as an alternative investment to venture capital, and capital calls to limited partners and access to exit markets are tight. Also linking the macro economic environment to the venture business model, Joe Mandato of De Novo Ventures stated, "There is so much concern about the economy and uncertainty in the investor base that deals are becoming much more difficult to finance and funds are needing more time raising money."

*The continuing lack of exit opportunities are especially worrisome.* Jim Marshall of Selby Ventures emphasized, "Raising follow-on rounds of financing from new investors continues to be a challenge and existing investors are having to allocate more capital to support their portfolio companies. This, combined with the lack of liquidity (IPO or M&A) in the market makes for a challenging time in our industry." In fact, Thomson Reuters and the National Venture Capital Association reported on April 1 that no venture-backed firms had an IPO in Q1. This makes for two consecutive quarters without a venture-backed IPO, the first time on record that this has occurred. They also reported that registrations for IPOs are down and M&A volume was light.<sup>3</sup>

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<sup>2</sup> Borrowing the oft used phrase of optimism by Mr. Lawrence Kudlow of CNBC.

<sup>3</sup> "Venture-backed exit market remains a concern in the first quarter", Thomson Reuters and the National Venture Capital Association, April 1, 2009.

Also tying the macro economy to the lack of liquidity events, a respondent who wished to remain anonymous said, “The deteriorating economic climate will likely extend exit periods for VC-backed companies by 2-4 years beyond the forecasts of Q3 and Q4 2008. This means that even profitable start-ups will take a longer time to exit than previously forecast.” Two other respondents who wished to remain anonymous also pointed to the lack of exit opportunities (e.g. IPOs). Clearly, the lack of liquidity events for this extended period puts a significant strain on the venture capital business model. Dan Lankford of Wavepoint Ventures also noted the lack of exits but indicated, “Deal flow remains reasonably good,” while another respondent reasoned that “economic conditions make it very difficult for start up companies to build their business,” and another expects inflation to be a rising problem later this year.

**Some respondents envisioned the current economic adjustment as a necessary cycle to ensure the long-term health of the venture environment.** For example, Venky Ganesan of Globespan Capital argued, “The era of liquidity driven growth powered by easy money and leverage is over. We went from a game in which we had a large number of players (entrepreneurs and workers) with a small number of people making bets on them (financiers) to a situation where we had very small number players and large amounts of people making bets on them, and, worse, we had people making bets on the people making bets. The good news is that this madness is over. The hangover is going to be painful but recovery is already on the way. We are back to growth driven by creating unique and innovative products and services that power productivity increases. This is what Silicon Valley does best and I have no doubt that in the next few months/quarters we are going to see the bloom of innovation in the Valley.”

*And commenting on venture capitalists’ response to the on-going economic malaise,* Tom Rogers of Advanced Technology Ventures indicated, “Given the uncertainty, most VC firms are in cash preservation mode to some extent. While this means that capital for private companies is certainly harder to come by, the most attractive companies will continue to get funded. While this means pain for some, particularly those that offer incremental as opposed to disruptive solutions or those that got caught in between milestones and needing cash, overall this will improve the long term health of the entrepreneurial environment.”

**And some responding VCs see the downturn in the economy as an opportunity to build great companies.** Prashant Shah of Hummer Winblad Venture Partners shared, “In a struggling economy, the real innovators emerge. And for firms like ours who have capital, there is no better time to invest in new startups.” And Sandy Miller of Institutional Venture Partners reasoned, “While the environment seems gloomy with no end in sight we need to remember that some of the best companies have been founded and built during bleak times. True entrepreneurs will continue to find ways of moving their ideas forward. From a venture investor standpoint 2009 and 2010 should be an attractive environment for new investments though there will be little liquidity for existing investments.”

And Jeb Miller of JAFCO offered, “We view this as a very promising time to start a new company. Big companies have cut back on product roadmaps and compensation and there is plenty of capital and strong talent available for new ventures. There is a premium on capital efficiency, but new startups have the opportunity to develop disruptive technologies and business models that will intersect the market as we come out of the current financial malaise.” Echoing this sentiment is Igor Sill of Geneva Venture Partners who offered, “As bad as things seem today, I anticipate a recovery back to the norm in 2010, for both venture investing and the IPO market. I expect a very difficult 2009, but recognize that a down market cycle is the best time to invest in promising startups when valuations are reasonable and market testing of solutions tend to provide a true ‘litmus test’. We know that there is no recession on innovation, and great companies and ideas have always emerged from troubled times.”

*The passage of time itself will tend to bring new investments.* Dag Syrrist of Vision Capital provided, “As doing nothing will be harder and harder and the realization that no return can be generated by not investing, firms will start deploying capital again especially as cost of funding business is low compared to historical standards. The effect of a slower growth cycle may possibly also contribute to higher quality companies being built. While exits may be further in the future, a slowing economy forces companies (and their investors) to actually provide something of value to customers...” Also looking on the bright side, Shomit Ghose of Onset Ventures declared, “On the one hand it’s like a Roach Motel: there’s no exit market, so money comes in but can’t get out. On the other hand, innovation and entrepreneurship continue to barrel along in sixth gear: there’re a lot of disruptive investing opportunities out there.” And Dan Lankford of Wavepoint Ventures noted, “Some portfolio companies are thriving during the downturn. Particularly encouraging is the likelihood that larger technology companies will be looking to acquire technologies or products as the economy recovers.”

**Others expect the current economic upheaval will lead to an unleashing of sophisticated talent into the entrepreneurial economy.** This additional talent coupled with the necessity of efficient execution will tend to produce successful new firms. For instance, Bruce MacNaughton of Crosslink Capital calculated, “The combination of the poor economy combined with little innovation at big companies leads many bright entrepreneurs to follow their passions, and the best companies get built by following passion.” In a similar vein, Savinay Berry of Granite Ventures indicated, “Historically, some of the most successful companies have been started in the middle of a recession. This is due to the availability of talent, a focus on a lean operating structure, and a self-selection process for raising capital. This time is no different. Companies started during this recession would have a good chance of being successful if they can adopt and adapt to the attributes described earlier.” And Graham Burnette of SBV Partners added, “Our firm invests at the early stage - when companies are unlikely to have products to sell. Thus, an economic downturn is a good time for us to invest. There are more skilled people to recruit, scarce resources are less scarce, and the eventual customers are more open to ideas for solving problems in newer, innovative and less costly ways. We think this is a good time to invest, and valuations are low.”

**And some see the economic downturn ending or at least a transition to a new normal.** For example, Kirk Westbrook of Invencor said, “It appears the US may be emerging from an unprecedented economic winter, as is evidenced by the very recently emerged buds on the branches of the now stark economic tree. What remains to be seen is if this is a false spring or if, in fact, the recent Washington programs will have the effects that were targeted, with success in dealing with the financial institutions bearing the greatest impact. Regardless of the improvement, I believe that the US economy has experienced somewhat of a social reset. I do not think we will return to the voracious consumption patterns that were made available by the lax credit environment. As a consequence, I believe revenue assumptions for consumer facing high-growth ventures must realistically consider the resulting spending pattern shift likely to occur as the more fiscally constrained environment emerges within the next 12 months.”

*As the economy bottoms out, investment should resume over time.* Richard Yen of Saban Ventures offered, “There’s some hope that the worst economic times are behind us, though it’ll take time for VCs to pick up the pace and resume making new investments.” And David Epstein of Crosslink Capital explained, “The environment is improving in sentiment, if not in dollars. Although the available dollars do not immediately increase on the improved outlook in the public markets, the talk is now a little more of “when” than if. The weaker VC’s are likely to fold, but there are many others that are planning their next raise (still 12-24 months out). This is allowing a little more seriousness in new non-portfolio investments. Although the portfolio companies are still taking the majority of the time and funding dollars, Series A and recap deals are getting done as well. It will take at least 2 years for things to stabilize, but at least we’re talking about that recovery.”

**Meanwhile, certain sectors of investment were viewed more optimistically.** Bryant Tong of Nth Power stated, “The Clean Tech sector continues to be one of the few bright spots in venture capital for early stage investors. With billions of government money targeted in this area, R&D will be robust and new and promising technologies will be the result.” And Dan Lankford of Wavepoint Ventures added, “...We are seeing particular growth in the number of capital efficient clean tech deals.” The new administration has strongly signaled its support for the development of clean energy alternatives. Most recently, on March 23, President Obama met with representatives of the venture capital industry and reiterated his support for innovation in this area. Strong political and social focus on clean tech development does bode well for the long term opportunity in this sector.

**But, not every respondent was convinced that the economic path was clear as concern over the impact of US government policy on entrepreneurial innovation was emphasized.** For example, Joe Mandato of De Novo Ventures specified that, “Contributing to the overall industry concern is the talk about taxing carried interest as ordinary income, which makes little sense.” And Bob Ackerman of Allegis Capital argued, “While entrepreneurs continue to innovate – it is increasingly difficult for these young companies to secure the capital they require to grow and prosper. At the same time – government - on all levels – is taking actions that make it more difficult for capital to form to support these entrepreneurs and for these entrepreneurs to build their companies. Capital and talent are highly portable and are attracted to environments where they can be profitably deployed. It is becoming increasingly clear that the US in general – and California in particular – are not as attractive as they once were. Thousands of entrepreneurs have returned to India and China over the last couple of years and billions of dollars of investment capital have followed. The new industries and jobs they are creating – would have been the exclusive domain of the US economy just a few short years ago.”

*And concern over the long term impact on the VC business model was expressed.* Steve Carnevale of Point Cypress Ventures stated, “The venture capital industry is in crisis and risks systemic collapse like other segments of the financial industry. The current returns are low, near term future prospects remain dismal, fund investors are canceling commitments and raising future funds is doubtful for all but a few of the best firms. There are not enough high return deals to support a \$20+ Billion a year size of the venture industry as it is currently structured. The vast majority of the venture firms will go back to smaller early stage deals. ...Rather than investing tens of millions of dollars to create a billion dollar company, venture firms will invest a few million dollars to create a hundred million dollar business. This venture bubble of the last decade has proven that the venture business is not scalable because it depends on the hard work of professionals to help grow small innovative businesses. There are not that many billion dollar business opportunities. ....This is bad news for the venture industry, but good news for entrepreneurs. The next successful companies will be started during this downturn. But it will not be from a huge investment...”

**To sum, while concern about the global economic and financial environment and its impact on capital availability continues among the respondents in this quarterly report, a rising confidence in an eventual recovery is emerging.** Further, the articulation that economic turmoil tends to propel innovative and operationally efficient new enterprises forward became a rising theme. And the emergence of these new ventures is expected to be fueled by a wave of entrepreneurial talent unlocked from larger corporations. This evolutionary process of *forced entrepreneurship* – while very painful – will in time – with the support of patient venture capital help ensure the broader local and national economic recovery. And, importantly, confidence did turn upward in Q1 after 5 consecutive quarters of declining sentiment. Drivers of this increase in confidence appear to range from the expectation of a stabilizing financial system, but also from the observance of more efficient execution of existing and new portfolio firms.

Further, as VC fund-raising has declined, less capital is available to chase the same number of attractive deals. This adjustment to the supply/demand relationship for venture capital/venture deals is driving down

valuations and creating the pretext for better long term investments for the venture community and their limited partners<sup>4</sup>. This notion is consistent with findings of a recent empirical study that saw venture capitalists' confidence rise after declines in total fund-raising.<sup>5</sup> And while liquidity events have remained elusive over the last 5 quarters, the recent nascent recovery in the public capital markets, if it can be sustained, will tend to increase the likelihood of new venture-backed IPOs, especially given the presumed pent-up demand for such offerings.<sup>6</sup> Interesting to note is that the significant decline in VC confidence in Q4 2007 (a quarter that featured a strong exit market) preceded the major decline in IPOs over the next 5 quarters. It remains to be seen if this modest uptick in confidence in Q1 2009 presages the opening up of the IPO market. However, the rise in confidence among Silicon Venture Capitalists in Q1 after 5 quarterly declines provides a sign of hope that recovery is a matter of 'when' rather than 'if'. As the rise in confidence translates to further investment, the emergence of new world class firms is bound to follow. Recovery will come, and it will start with entrepreneurial endeavor, and it will be guided and accelerated by venture capitalists' support. See the *signs*.

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<sup>4</sup> On January 19, 2009 Thomson Reuters and NVCA reported a significant drop off in fund raising activity in Q4.

<sup>5</sup> In 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. This relationship appeared to hold from Q4 2008 (a decline in fund-raising) and Q1 2009 (an increase in confidence).

<sup>6</sup> 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 IPOs of venture-backed firms.

**Table 1**

**Participating Venture Capitalists in the 2009 1<sup>st</sup> Quarter Confidence Index Survey**

<b>Participant</b>	<b>Company</b>
Bob Ackerman	Allegis Capital
Bruce MacNaughton	Crosslink Capital
Bryant Tong	Nth Power
Chester Wang	Acorn Campus
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Daniel Ciporin	Canaan Partners
David Epstein	Crosslink Capital
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Graham Burnette	SBV Venture Partners
Igor Sill	Geneva Venture Partners
Jeb Miller	JAFCO
Jim Marshall	Selby Ventures
Joe Mandato	De Novo Ventures
Kirk Westbrook	invencor
Mudit Jain	Synergy Life Science Partners
Prashant Shah	Hummer Winblad Venture Partners
Richard Yen	Saban Ventures
Sandy Miller	Institutional Venture Partners
Savinay Berry	Granite Ventures
Shomit Ghose	Onset Ventures
Stephen Harrick	Institutional Venture Partners
Steve Carnevale	Point Cypress Ventures
Tom Rogers	Advanced Technology Ventures
Venky Ganesan	Globespan Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

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