Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: SVVCCI)

Fourth Quarter – 2010

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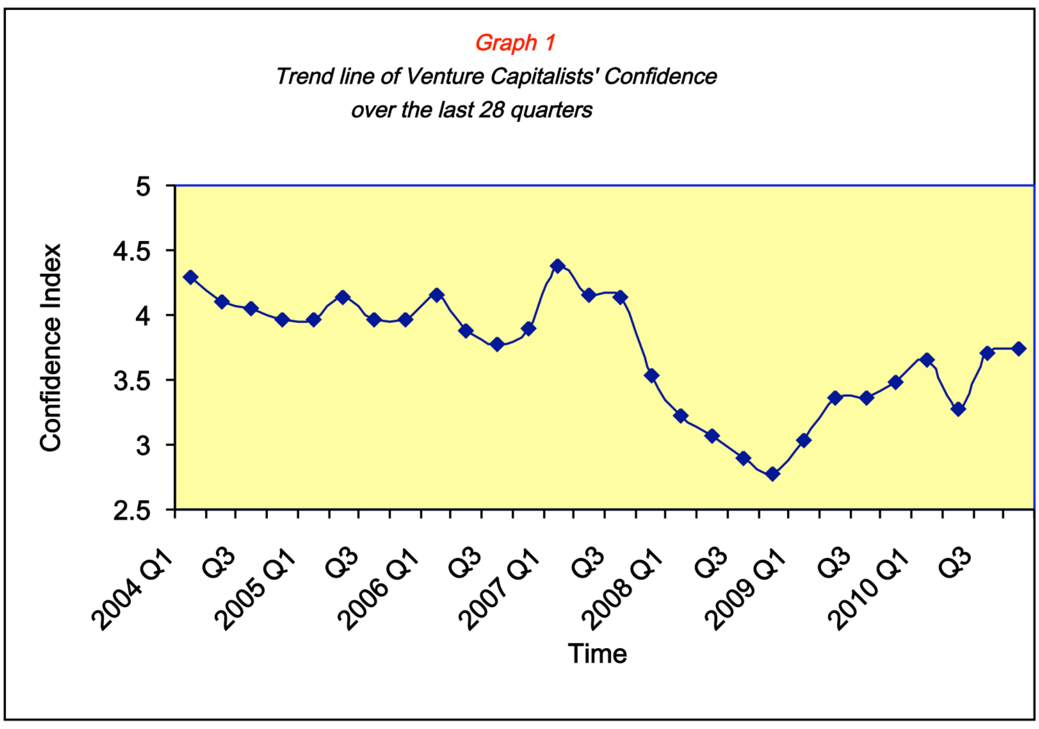
The quarterly *Silicon Valley Venture Capitalist Confidence Index® (Bloomberg ticker symbol: SVVCCI)* is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index, measures and reports the opinions of professional venture capitalists in their estimation of the 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 2010, based on a December 2010 survey of 35 San Francisco Bay Area venture capitalists, registered **3.75** on a **5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index edged up from the previous quarter's reading of 3.70 confirming the resumption of an upward trend in VC confidence since its low point in Q4 2008. Please see Graph 1 for trend data.



[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 its author at **Cannice@usfca.edu**.

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Evidence of an improving exit environment supported a slight rise in confidence among the venture capitalists that participated in the Q4 survey. The steadily rising public capital markets along with a burgeoning market for acquisitions appear to be supporting an increasing number of IPO exits for venture-backed firms. Furthermore, the expectation that the rise of new disruptive technologies is creating major new market segments gave confidence to a number of VCs that significant opportunities are becoming available for their portfolio firms. Increasing market opportunities and recovering exit channels should, over time, drive greater limited partner interest and more venture investments, creating a virtuous circle for the venture business model after several years of a challenging environment. While concern over excessive valuations in some sectors along with a continuing regulatory drag on the life science sector was raised, overall sentiment in the future growth environment firmed up somewhat and reaffirmed an upward trend in confidence, coming on the heels of a major increase last quarter. In the following, I provide many of the comments of the participating venture capitalist respondents along with my analysis. Additionally, all of the Index respondents' names and firms are listed in Table 1 save those who wished to remain anonymous.

The growing momentum in acquisitions of venture-backed firms along with improving IPO opportunities is creating a generally more robust exit environment for 2011. For example, Roy Thiele-Sardina of HighBAR Partners indicated "We are seeing an increased number of M&A transactions which increases the confidence to fund companies that can be acquired." Bob Ackerman of Allegis Capital confirmed that "The exit environment for venture-backed companies continues to improve with growing strength in the M&A markets and IPO activity running ahead of last year's projections." He continued "We expect to see growing strength in these areas in 2011…" And Tim Wilson of Partech International reasoned that the rise in the public market is helping drive more confidence in M&A transactions and, hopefully, a stronger IPO market." Similarly, Bob Pavey of Morgenthaler Ventures stated "Public markets are getting better and a few good IPOs will increase optimism." In fact, Dow Jones VentureSource reported that "514 companies achieved liquidity in 2010…that represents a 25% increase in exits from 2009…" In addition they reported a more than five-fold increase in the number of IPOs of venture-backed firms from 2009.[2]

The strength in M&A exits is being driven by growing corporate cash balances that are chasing venture-backed innovation. Kurt Keilhacker of Techfund Capital noted that "With cash building again on large tech company balance sheets a number of CEOs are writing checks to acquire that future billion dollar market." Brian Panoff of Granite Ventures agreed, stating that "The need for technology (and the productivity gains it provides) from start-ups remains undiminished and the broader economy, while still fragile, seems to be slowly recovering. Additionally, large companies have historically high levels of cash and seem poised for investment during a recovery, whether by technology purchases or through acquisition." Eric Buatois of Sofinnova Ventures explained further that "Large technology corporations are actively complementing their product portfolio with acquisition to address the explosion of mobility and the need to massively increase the capacity of networks. The combination of cloud computing and mobile computing such as the tablet is creating innovative business models. Consumers are paying for the content given a very rich experience combined with a pay per usage model. Large corporations will deploy these technologies as it increases the workforce productivity. The IPO market which was moderately active in 2010 is going to be more robust in 2011."

Exit opportunities are expanding internationally as well, particularly in China. Chester Wang of Acorn Campus Ventures reiterated "There are more M&A activities and trans-pacific exit activities happening. This has created some liquidity events." And Tim Chang of Norwest Venture Partners noted "I'm personally more bullish on opportunities and exits coming out of China right now than the US: there, we

[2] Dow Jones Venture Source, January 3, 2011.

will see $1B+ category leaders created across the board. In the Valley, we'll have a few blockbuster companies, but mostly 'flipmeat' style feature-oriented startups better suited for super angels at smaller M&A outcomes, instead of venture-scale $1B+ standalone industry leaders…"

New technology developments and social trends are creating new market opportunities for entrepreneurs and their venture backers. Venky Ganesan of Globespan Capital Partners declared that "Venture capital backed start-ups and financings are seeing a new renaissance and the reason is 'Clomosol'. No, it's not a new drug but rather my coined term for the four major trends powering technology: Cloud, Mobile, Social, and Local. The wealth creation driven by Clomosol will dramatically impact both the local Bay Area economy as well as the overall technology sector. However, Clomosol is not for everybody and side effects might include increased traffic, a shortage of engineers, and high valuations. Please talk to an experienced VC before embarking on this trend." In a similar vein, Deepak Kamra of Canaan Partners pointed to "A recovering business and consumer market for technology, led by certain sectors like social commerce, Saas, and mobile innovation." And John Malloy of BlueRun Ventures noted the "Converged service innovation of mobile and web in this market versus the rest of the world."

New technology sector opportunities combined with viable exits are creating a strong environment for new venture creation. Jeb Miller of Jafco Ventures observed a "Robust environment for starting new ventures in the mobile Internet and cloud computing ecosystem with an ample supply of angel and venture capital and an improving climate for strategic exits." And Dan Lankford of Wavepoint Ventures noted that "We are seeing a definite ramp up in start-up activity and are encouraged by the likely continuing growth in M&A activity by large tech firms." Additionally, Graham Burnette of Red Planet Capital indicated "Entrepreneurial activity has never slowed through the economic downturn, and as the recovery seems to be getting established, the products and technologies of young entrepreneurial companies will grow quickly."

Confirming this positive trend in the venture environment was Igor Sill of Geneva Venture Management who reasoned that "…the venture industry is poised for a healthy resurgence after significant contraction over these last three years. Those firms with mediocre, lack luster returns and short track-records are gone or significantly reshuffled. There's more deal flow, better value, much more LP distributions, and as a result a lot of fund raising campaigns being launched. Start-up valuations have been rising for four successive quarters and the initial public offerings markets are now opening up. Great days lie ahead." For example, Steve Harrick of Institutional Venture Partners noted "Conditions are improving and more of our companies are beating plan and raising targets. Execution is paramount, but revenue dollars are there for the taking for innovative businesses." And Bill Byun of 7 Capital shared that "A majority of my portfolio companies are on a ramp and have very positive outlook for 2011."

But, caution remains. Kirk Westbrook of invencor reflected "While I believe there is finally reason for optimism, it remains a relative scenario. I do not believe that normalcy can return to the economic ecosphere until the underlying problems that persist in the still damaged capital markets are resolved. The 2010 IPO market is a present gauge of the capital liquidity issues and those similar kinds of capital challenges are present through the other capital pools throughout different segments of the economy. I am cautiously optimistic that the healing is underway, but hard pressed to find a wealth of tangible events to support the fledgling hope yet." Similarly, a respondent who wished to remain anonymous noted the "Lack of exits and lack of LP commitment to venture funds and as a result a shrinking pool of venture dollars." In fact, Thomson Reuters and the NVCA reported that fundraising declined for the fourth consecutive year.[3]

Commenting on the broader economic and political environment, Dag Syrrist of Vision Capital elaborated "On the positive side, broad based economic indicators are aligning in a manner which should encourage corporations to spend some of their $2T, and banks lend some of their (our?) $1T. Countering this is the complete inability of Congress to deliver any sense of predictable rules and goal posts on anything from taxes to healthcare – which effects venture activity indirectly, and with the sad reality that the country is not able to reach optimal solutions and decisions we're being side lined – and worse the populist banter is indifferent. So I'm left in a 'middle of the road' view, with a slow deterioration over time."

On the life science side Joe Mandato of De Novo Ventures was concerned that "the market for early stage life science investments remains soft due to continued concerns on regulatory uncertainty and long term capital needs relative to potential exits timelines." Another responding VC indicated "The regulatory environments for medical innovation in the US and EU are troubling, with no improvement in site." However, Tom McKinley of Cardinal Partners shared "I am seeing much more angel activity in the healthcare space, especially in healthcare IT…"

And concern over bubble like valuations is growing as the venture finance structure morphs. Bob Ackerman of Allegis Capital observed that "…frothiness in the Social Media space creates some concern around a secular bubble/bust cycle in this sub-market." A VC respondent who commented on condition of anonymity explained "Seed stage valuations are reaching bubble proportions. Super angels, microfunds and organized and semi-organized angel groups have funded more than 1000 U.S. companies in 2010, of which less than a third would have attracted classical early-stage venture capital even three years ago. Mortality rates for these companies could reach 80%, overall. Further, the 'interface' valuations and terms between surviving angel companies and the established VC ecosystem are already problematic and will become more so."

In sum, confidence in the high growth entrepreneurial environment edged higher among the responding venture capitalists in the last quarter of 2010 along with steadily improving public financial markets, increasing exit channels, and growing market opportunities. This Q4 reading confirms an upward trend in confidence since its low point two years prior. The strength in confidence is clearly related to increasing exit opportunities through both acquisition and the long awaited return of the IPO market. Acquisitions are likely being driven by both opportunistic behavior (e.g. excessive corporate cash being applied to new technologies and market opportunities) and competitive necessity (e.g. defending current markets through pre-emptive acquisitions). And the increase in acquisitions provides a context of competitive bidders to drive demand for IPO exits. Summarizing these current trends is Sandy Miller of Institutional Venture Partners who stated "The venture environment looks strong for 2011. While there are signs of speculation in some parts of internet/digital media, overall there is a good balance of supply and demand for venture capital. Some of the best performing technology IPOs have been in sectors that venture firms have treaded lightly in. This should bolster interest in a broader perspective on tech sectors. The 2011 exit environment should be very strong with both an active IPO market and intense M&A activity driven by the unprecedented cash hoards at the big public tech companies."

While concern remains, the steady rise of the public financial markets, a slowly healing economic landscape, and a more conciliatory regulatory environment[4] may re-energize the innovative engine of the

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[3] Thomson Reuters and NVCA press release, January 17, 2011.
[4] Obama, Barack, "Toward a 21st-Centure Regulatory System," Wall Street Journal, A17, January 18, 2011.

Silicon Valley entrepreneurial ecosystem. As President Obama recently wrote, "…That vibrant entrepreneurialism is key to our continued global leadership and the success of our people."[5] It is this entrepreneurial passion guided by creative capital and supportive government policy which will help ensure that the New Year will be brighter than it predecessors.

Table 1

Participating Venture Capitalists in the 2010 4th Quarter Confidence Index Survey

Participant	Company
Alain Harrus	Crosslink Capital
Bill Byun	7 Capital
Bob Bozeman	Eastlake Ventures
Bob Pavey	Morgenthaler Ventures
Brian Panoff	Granite Ventures
Bryant Tong	Nth Power
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
David Spreng	Crescendo Ventures
Deepak Kamra	Canaan Partners
Eric Buatois	Sofinnova Ventures
Graham Burnette	Red Planet Capital
Igor Sill	Geneva Venture Management
Jeb Miller	Jafco Ventures
Joe Mandato	De Novo Ventures
John Malloy	BlueRun Ventures
Karan Mehandru	Trinity Ventures
Kirk Westbrook	invencor
Kurt Keilhacker	Techfund Capital
Mudit Jain	
Pat Kenealy	IDG Ventures
Richard Yen	Saban Capital Group
Robert Ackerman	Allegis Capital
Roy Thiele-Sardina	HighBAR Partners
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
T. Chester Wang	Acorn Campus Ventures
Tim Chang	Norwest Venture Partners
Tim Wilson	Partech International
Tom McKinley	Cardinal Partners
Venky Ganesan	Globespan Capital Partners
Anonymous	Anonymous

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[5] Obama, Barack, "Toward a 21st-Centure Regulatory System," Wall Street Journal, A17, January 18, 2011.

among the leading entrepreneurship programs in the U.S.) The author wishes to thank the participating venture capitalists who generously provided their expert commentary. Thanks also to the attorneys of Greenberg Traurig for their support of this research, as well as to Catherine Lydon and Jack Cannice for their copy-edit assistance. When citing the index, please refer to it as: *The Silicon Valley Venture Capitalist Confidence Index®*, and include the associated Quarter/Year, as well as the name and title of the author.