Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: SVVCCI)

Second Quarter – 2010

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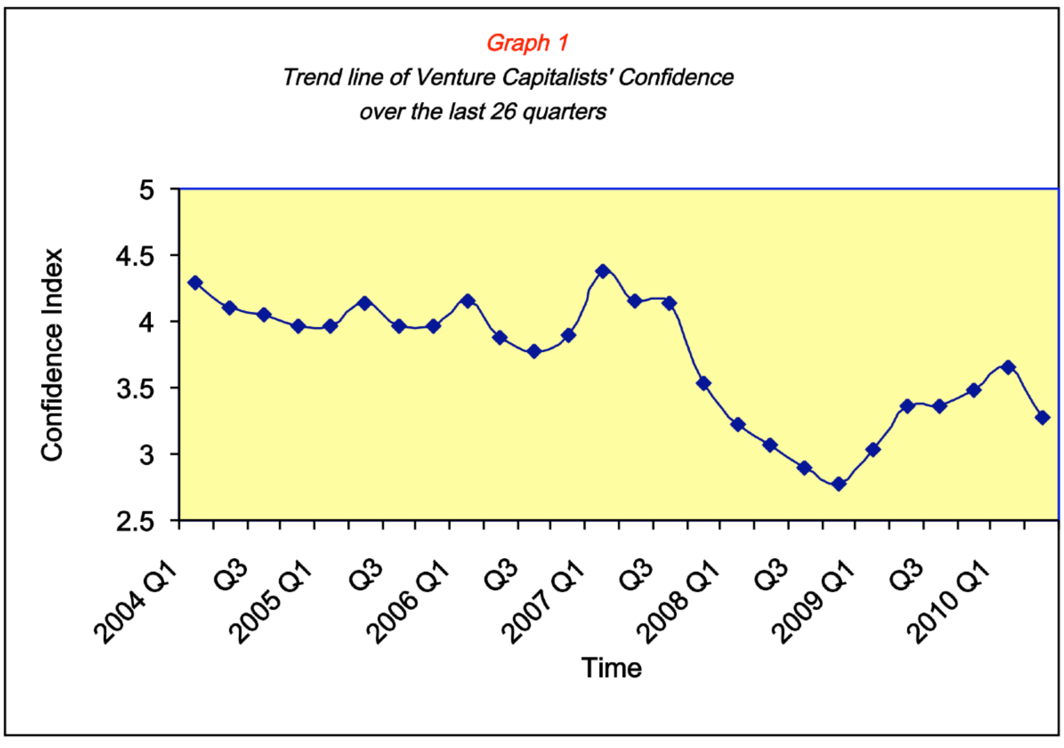
The quarterly *Silicon Valley Venture Capitalist Confidence Index® (Bloomberg ticker symbol: SVVCCI)* is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index measures and reports the opinions of professional venture capitalists in their estimation of the 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 second quarter of 2010, based on a June 2010 survey of 32 San Francisco Bay Area venture capitalists, registered* ***3.28*** *on a* ***5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index reading dropped significantly from the previous quarter's reading of 3.65 and ends a five-quarter 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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Confidence among Silicon Valley venture capitalists in the future high-growth entrepreneurial environment in the Bay Area declined markedly in the second quarter. This is a reversal of a modest upward trend in confidence over the previous five quarters. The drop in confidence appears to be primarily linked to concerns over macroeconomic trends in the U.S. and internationally and to regulatory uncertainty specific to the venture industry. This downturn in confidence predominated despite a strengthening IPO market for venture-backed firms in Q2[2] as some respondents noted the lack of clarity for future exit opportunities. These growing general and specific pressures on the venture capital business model create a difficult operating environment for venture firms and their portfolio companies. However, confidence in the resiliency and innovative nature of entrepreneurs in the Silicon Valley gave a number of the responding VCs cause for optimism that opportunities and enterprising companies will emerge from the continuing tumultuous environment. 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.

Rising uncertainty in the macro economy drove confidence lower in Q2. Dag Syrrist of Vision Capital stated "Collective fear of sluggish growth in the overall economy will drive down investors' perceived need to deploy capital (why invest now, if it's going to be cheaper in the future)…" He continued "It's troublesome how long-term investments are now almost completely driven by short to medium term market worries…" Kirk Westbrook of invencor observed "Globally, the Eurozone and the cooling China market will need to be monitored to evaluate the impact they may have on business opportunities within the next 12 months…The exuberance enjoyed during the past couple quarters was tempered in Q2 and will likely be subdued through the remainder of 2010…" And Graham Burnette of Red Planet Capital noted that "Microeconomic drivers are generally positive… (but) macroeconomic drivers are generally negative: the world and US recovery are still very fragile and concerns are growing about Europe and China dragging the US back into recession…"

Macro shocks to the venture industry itself also weighed on confidence. A survey respondent who wished to remain anonymous explained "Structural shifts in the venture business will constrain the availability of capital at a time when funds need cash. Several firms will collapse in the next 18 months. Add a bit of carry tax and corporate income tax rate increases and a soft Euro and US economy and you have a more difficult situation developing." Another respondent who asked to remain unnamed asserted "Congress' proposed carried interest tax increases are a disaster for the U.S. venture capital industry, and for U.S. innovation and economic growth."

Liquidity opportunities are unpredictable. While the second quarter was a good quarter for IPOs of venture-backed firms, venture capitalists focused on the inconsistent nature of exit opportunities. Robert Ackerman of Allegis Capital detailed "While entrepreneurial activity continues apace, uncertainty around the broader funding and exit environments continue to place an on-going damper on new investment activity…Until either or both of these factors are addressed, capital investment in new ventures is likely to be moderate." Igor Sill of Geneva Venture Management elaborated "Key to investment timing in start-ups is visibility in public market liquidity, and though we've seen a few IPOs, there appears to be little appetite for IPOs over the next 6-9 month period. Having said that, there are several outstanding, profitable and high growth private companies well prepared to go public when the public market window prevails. Optimistic employment metrics will go a long way in opening up the public markets for new tech offerings." And Dag Syrrist of Vision Capital pointed to "…sluggish corporate pricing in M&As…(and corporate acquirers) desire to preserve cash." Kirk Westbrook of invencor also emphasized that liquidity remains challenged, but Deepak Kamra of Canaan Partners viewed the exit environment as relatively stable for acquisitions. Finally, Bob Bozeman of Eastlake Ventures provided that "Early stage

[2] Dow Jones VentureSource reported that 15 U.S. venture-backed IPOs occurred in the second quarter of 2010. This figure is five times the number of venture-backed IPOs for the same period a year ago (July 1, 2010).

outside flips are challenging," expressing concern about the trend of investing in firms that aim to be acquired rather than investing with patience to build enduring businesses.

And unique challenges are building for life science ventures in particular. Joe Mandato of De Novo Ventures shared "The market continues to be challenging. Few medical device financings are being done; the process continues to be very slow putting additional pressures on management to preserve cash." He continued "In the medical device sector, investors are now looking for later stage opportunities where regulatory and re-imbursement risk have been mitigated and there is visibility for product launch and revenues."[3] Another VC respondent pointed to the "Overall regulatory environment (FDA) which has led to lack of clarity on the regulatory hurdles with ever moving targets, lack of public market exits for life sciences companies, and this administration's general anti-business sentiment and policies that are non-conducive to venture risk taking" for his concerns. And Tom McKinley of Cardinal Partners shared "I see much more activity in company creation; the exception is the medical device arena given the negative impact of the FDA on innovative companies..."

Some venture capitalist respondents see new opportunities in this challenging environment. For example, Chester Wang of Acorn Campus Ventures drew attention to new medical applications of IT ventures saying "A lot of mature IT technologies that were created a few years ago but had little market are now trying to solve some of the medical field problems. This will create ample revenue generating opportunities and give a second life to some of the IT segment." Tom Rodgers of ATV Capital stated, "The venture entrepreneurial environment is undergoing some significant changes but both VCs and entrepreneurs are nimble, and there is no shortage of compelling, impactful ideas and innovations. There will likely be fewer of us but we will adapt." Furthermore, Bill Reichert of Garage Technology Ventures asserted "The opportunities available for entrepreneurs continue to improve, in spite of a highly constrained funding environment." But others signaled cautious optimism. Brian Panoff of Granite Ventures offered "I think the fundamental value of innovative technology companies remains strong. In this type of economic environment, productivity gains through technology are more important than ever. My optimism is only tempered by instability in the capital markets and regulatory environments."

Deal flow continues to be robust. Sandy Miller of Institutional Venture Partners reasoned "We are seeing more exciting young technology companies than in past years. The ability to scale rapidly today is unprecedented as today's companies stand on the shoulders of those who came before, benefiting from web-based marketing, social media platforms and open source. Entrepreneurial innovation is robust." Sharing this view was Alain Harrus of Crosslink Capital who indicated "We see an increased level of early stage startup ideas and a proportionally higher number of quality teams/ideas." And Bryant Tong of Nth Power concluded "Plenty of attractive deals are out there when you consider the low valuations."

However, Bill Byun of Samsung Ventures cautioned "General deal flow is strong but the next few quarters will determine the enthusiasm, based mainly on market performance." And Dan Lankford of Wavepoint Ventures added "The large tech companies have cash and are looking to fill their product pipelines, so we are starting to see some acquisitions. It would be helpful if the public equity markets could show some positive movement."

Confidence in the versatility of Silicon Valley entrepreneurs stays strong. Bruce MacNaughton of Crosslink Capital reasoned "The innovation engine in Silicon Valley is driven by a culture of entrepreneurs. In times like today, when many changes are taking place and things are in great flux, new opportunities are uncovered by entrepreneurs thinking deeply in this unique geography…" Jeb Miller of

[3] Dow Jones VentureSource reported on July 17, 2010 that, indeed, venture firms are focusing investment on drug development firms that are near commercialization.

Jafco Ventures proclaimed "Bay Area start-ups continue to be best positioned to capitalize on the disruptive market opportunities created by cloud computing, social media and clean-tech." And Eric Buatois of Sofinnova Ventures recounted "Since February, we have seen a new set of companies looking for funding driven by well proven management teams, with very differentiated and innovative products and business plans. This deal flow combined with a good exit market (both M&A and IPO) will definitively continue to fuel the entrepreneurial environment."

Financing is coming in more bite-sized pieces. While the total amount of investment into venture-backed portfolio firms increased in Q2 from the year-ago level[4] during the financial crisis, a larger proportion of that financing went to later stage firms, leaving less for investments in new enterprises. This trend is consistent with commentary from some respondents of the Q2 survey. For instance, Bob Pavey of Morgenthaler Ventures mentioned that "Good entrepreneurs are still active, but they can only find money for capital-efficient plans."

And Dino Vendetti of Formative Ventures detailed "My confidence is somewhat based on the particular industry sector we're talking about. Industry segments that require lots of capital for up front development are definitely out of favor with the possible exception of clean tech, which is still attracting a lot of investment. The web and mobile eco-systems are actually quite exciting right now with a number of key market trends continuing to shift dollars away from traditional media to the internet. Also, the explosion of mobile app's and location-based services on the iPhone, iPad, and Android products is creating an anywhere/anytime web that is growing by leaps and bounds every month. The capital efficiency of these start-ups is allowing entrepreneurs to generate revenue very quickly and minimize the amount of external financing they require. While there has been a contraction in the size of new venture funds raised (thereby reducing the pool of money that can be invested in start-ups by VC firms), there has simultaneously been an increase in angel investors and small early stage venture funds which have filled the gap for these type of companies. Because they don't need a lot of capital, the angel investors coupled with the small VC funds are a good source of capital for these entrepreneurs."

In sum, confidence in the future high-growth entrepreneurial environment dropped in Q2 on concerns of general macroeconomic weakness, unpredictable liquidity opportunities, and regulatory uncertainty specific to venture capital firms, with each factor negatively impacting the business model of the venture industry. It is noteworthy that confidence declined in Q2 despite a concurrent spike in venture-backed IPOs. However, this observation is not inconsistent with previous research[5] that demonstrated that venture-backed IPOs tend to rise the quarter after an increase in VC confidence, as was the case in Q1.[6] As venture capitalists look to the future for potential exits, their confidence is tied to expectations of future liquidity rather than exits in the recent past.[7] Thus, the decline in confidence in Q2 provides a potential *tell* for a slower IPO market for venture-backed firms in Q3.

Dow Jones VentureSource noted that the time to liquidity by IPO reached a record 9.4 years in Q2. As the time to liquidity and the amount of venture capital financing needed to achieve an exit reach new highs, the ROI of venture investments is curtailed further and additional pressure is placed on the VC business model. As good ROI exit opportunities (e.g. timely and capital efficient) become scarce, and the threat of increased taxation on any remaining profits increases, fund-raising becomes more difficult for venture capitalists and, therefore, financing is harder to come by for those enterprises that need it. Still,

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[4] Dow Jones VentureSource Press Release, July 17, 2010.

[5] Cannice, Mark V., and Cathy Goldberg (2009). "Venture Capitalists' Confidence, Asymmetric Information, and Liquidity Events," *Journal of Small Business and Entrepreneurship*, 22 (2), pp. 141-164.

[6] The Q1 2010 Silicon Valley Venture Capitalist Confidence Report correctly forecast an increase in venture-backed IPOs in Q2.

[7] In this sense a confidence indicator is akin to guidance provided by chief executives about future quarters that accompanies the results of the just completed quarter.

confidence remains strong in the ability of entrepreneurs to develop capital-efficient businesses that thrive in uncertain environments. This faith in the entrepreneur and the innovative eco-system of Silicon Valley kept confidence from falling further in Q2 and provides hope for the balance of 2010. However, less risk capital to support new enterprise development among the nation's entrepreneurs and technologists could, over time, limit innovation and the break-through solutions that have defined the U.S. economy for generations. It remains to be seen if alternative sources of capital will fill the funding gap to support the next generation of world-class technology firms.

Table 1

Participating Venture Capitalists in the 2010 2nd Quarter Confidence Index Survey

Participant	Company
Alain Harrus	Crosslink Capital
Bill Byun	Samsung Ventures
Bill Reichert	Garage Technology Ventures
Bob Bozeman	Eastlake Ventures
Bob Pavey	Morgenthaler Ventures
Brian Panoff	Granite Ventures
Bruce MacNaughton	Crosslink Capital
Bryant Tong	Nth Power
Christian Cortis	ATV Capital
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Deepak Kamra	Canaan Partners
Dino Vendetti	Formative Ventures
Eric Buatois	Sofinnova Ventures
Graham Burnette	Red Planet Capital
Igor Sill	Geneva Venture Management
Jeb Miller	Jafco Ventures
Joe Mandato	De Novo Ventures
Kirk Westbrook	invencor
Mudit Jain	Synergy Life Science Partners
Prashant Shah	Hummer Winblad Venture Partners
Robert Ackerman	Allegis Capital
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
T. Chester Wang	Acorn Campus Ventures
Tim Wilson	Partech International
Tom McKinley	Cardinal Partners
Tom Rodgers	ATV Capital
IDG Ventures	IDG Ventures
Anonymous	Anonymous

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