

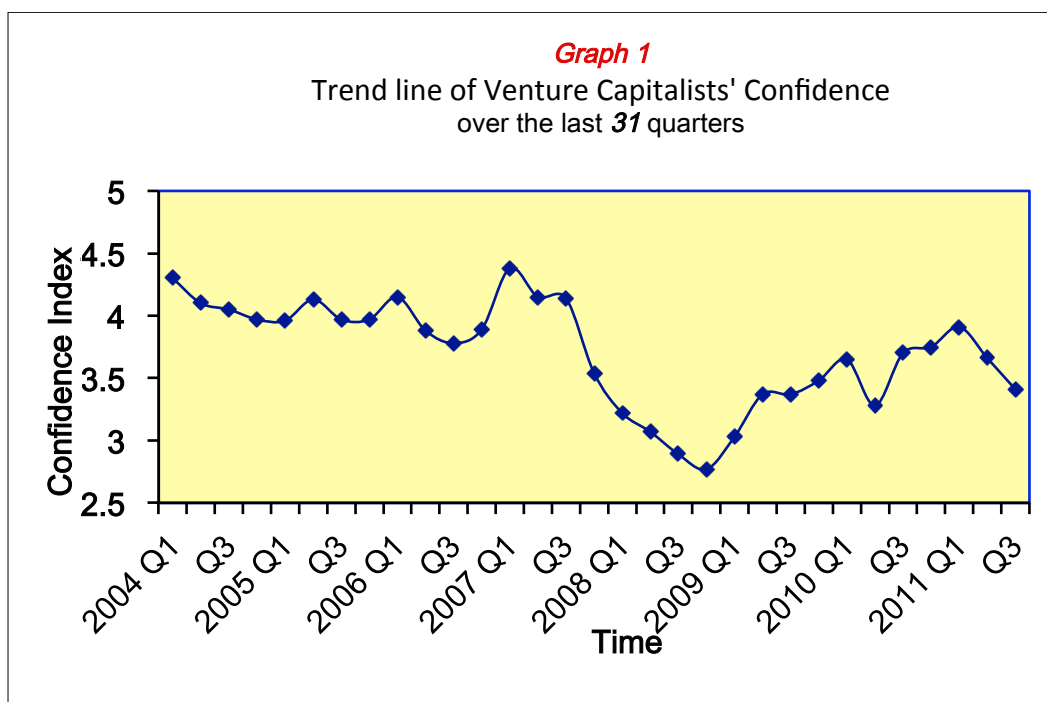
Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: SVVCCI)

Third Quarter – 2011
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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 third quarter of 2011, based on a September 2011 survey of 33 San Francisco Bay Area venture capitalists, registered **3.41** on a **5 point scale** (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index declined significantly from the previous quarter's reading of 3.66 and marks a second consecutive quarter of a substantial overall decline in confidence among the venture capitalist respondents to this on-going research. 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 in the future high-growth venture environment in the Bay Area declined significantly for a second consecutive quarter. As a group, the responding venture capitalists in the Q3 survey pointed to troublesome macro conditions, an uncertain exit environment, high valuations, and regulatory burdens. Some VC respondents pointed to diverging trends among venture-backed firms, depending on the sector of investment, with social media and mobile computing continuing to perform well and life science generally lagging once again. Still, others worried that continued market volatility may have longer-term effects on the venture capital business model itself. Despite the list of concerns, confidence in the resilience of entrepreneurs and faith in the future remained with some survey participants seeing long-term opportunities residing within current short-term uncertainty. 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.

Uncertainty in the macro environment is hamstringing an otherwise healthy venture environment. Brian Panoff of Granite Ventures explained “We continue to see great teams and opportunities. I’ve also been encouraged by the resilience of technology spending during this period of prolonged broader economic and market instability. My main concerns would be the disconnect between private and public valuations (in certain sectors) as well as the possibility that the economy may worsen and impact the start-up world more directly.” And Kirk Westbrook of invencor provided “Though there seems to be a vibrant energy around newly emerging companies, the amorphous economic conditions remain a challenge to execution in the ecosphere. Larger parts of the food chain that are the end customers of the non-consumer facing start-ups exhibit a lack of urgency driven by their own uncertainty. For consumer facing companies, there seems to be a counter-intuitive ability to find revenues that may be driven by an escape from the realities of everything else going on around the consumers. Mixed together, the result is an occluded vision for the future that fosters the cycle of uncertainty and tempers what might be a more robust environment.” Additionally, Chester Wang of Acorn Campus Ventures noted “Uncertainty of the economy and capital market.” And a VC contributor who wished to remain anonymous blamed a “weak macro environment” for his medium confidence.

While entrepreneurs continue to create, the volatile exit market demands endurance. Shomit Ghose of Onset Ventures indicated “It’s still a ‘Tale of Two Cities’ out there: the best of times, the worst of times. Though the exit market remains very challenging, we continue to see a steady flow of scrappy start-up entrepreneurs with nicely disruptive business models.” Sandy Miller of Institutional Venture Partners elaborated “Despite the weakness in the public market I remain optimistic about the private venture capital market. There are an unprecedented number of really high-quality young companies that are growing rapidly, in many cases, on a profitable basis. I think more than I can remember at any time. Yes, many of these companies are commanding valuations that seem high at the time, but they also seem to grow into those valuations quite quickly. As for the IPO market I think it will come back because of the quality level of the companies in registration. The buyers, I think, will return with a better appetite after they have had time to digest the financial market crisis.” And Tom Rodgers of Advanced Technology Ventures indicated that it is a “Good time to be an entrepreneur with a differentiated idea – firms and angels with money aggressively seeking to put money to work and valuations are a bit frothy. However, public market volatility/uncertainty and a general lack of urgent strategic acquirers are challenging near term liquidity prospects. Less money going into the venture class is driving an ongoing shakeout and restructuring.” Two other VC respondents who requested anonymity also noted the uncertain exit market. Concurrent with the aforementioned concerns, the number of venture-backed IPOs plummeted in Q3 to only five, a 77% decline from what was a healthy IPO market in Q2.^{2 3}

² Thomson Reuters and NVCA Press Release, October 3, 2011.

Continuing macro environment and exit uncertainty is beginning to impact other aspects of the venture business model. For example, a VC respondent who requested anonymity stated “Innovation continues but overall market uncertainty and the IPO window closing will likely have a dampening effect on capital availability.” Debra Beresini of Invencor explained “...Investors are investing on a limited basis and with a narrow focus due to the lack of exit opportunities. For an investor to invest in a company, there must be a clear and identified path to an exit – more so than the previous standard. It is not sufficient to know that a company in the XYZ space will acquire the newly funded company; the information that is needed is that ABC company will acquire the newly funded company – and have indicated such by structuring some type of strategic relationship with the newly funded company. Are others, outside of this condition, being funded? Yes, some are, but most of those companies are led by investors who are serial entrepreneurs. With the exit roadblock still in the way the backlog is getting larger. To me, this is a definitive indicator that the funding of new companies will not increase in the next quarter.” In fact, Thomson Reuters and the NVCA reported that total dollar commitments to venture capital funds declined by 53% in Q3 from the year earlier period.⁴ Addressing another element of the venture business model, Bob Ackerman of Allegis Capital noted that “While the innovation economy is alive and well in Silicon Valley, a chronic shortage of experienced engineering talent challenges the growth plans of young companies. The pressures to grow ‘offshore’ continue to be a major consideration in funding and building young companies.”

Within the uncertain market environment, the performance of venture-backed firms varied considerably by sector. Dino Vendetti of Formative Ventures observed these diverging trends, sharing “The tech industry in the Bay Area has been a tale of two cities with certain industry segments struggling and others thriving. Investment capital, especially early stage capital, has been flowing into the high growth web and mobile market segments. I see this trend continuing as the structural conditions remain attractive for entrepreneurs to pursue new start-up ideas with readily available funding.” Similarly, a VC respondent who requested anonymity reported “Lots of excitement around tech companies right now with lots of money getting invested and valuations increasing, less so with cleantech and healthcare. This will definitely continue in the short term but will likely not last beyond two years.”

And Igor Sill of Geneva Venture Management also differentiated venture opportunities by sector and stage of investment, stating “My confidence level is high for late stage, positive EBITDA margin tech companies in high growth sectors, (i.e. cloud computing, SaaS, open source, virtualization, RT financial solutions and BI.) The M&A market activity has risen considerably as publicly traded tech firms are actively expanding via acquisitions to fuel their continued growth. For seed and early stage startups, the outlook is mixed as we prefer investing in the later stage companies with lowered risks, albeit lesser returns, during these prolonged economic conditions.”

Life Science continues to be weighed down by the regulatory environment. Joe Mandato of De Novo Ventures pointed to “Continued uncertainty and concern on the erratic, inconsistent and unduly lengthy regulatory process.” One contributor who provided comments in confidence, emphasized that the “Healthcare venture environment has shifted radically with FDA approval problems in the device world and a difficult life science environment. VCs are scrambling to invest in health care IT companies.”

³ The decline in venture-backed IPOs in Q3 follows a decline in venture capital confidence in Q2. Cannice and Goldberg (JSBE 2009) found that declines in venture-backed IPOs tend to be preceded by declines in venture capitalists’ confidence.

⁴ Thomson Reuters and NVCA Press Release, October 10, 2011.

Questions are arising whether strong companies in hot sectors are still good investments. Bill Reichert of Garage Technology Ventures stated “It looks like some of the air is coming out of the social/local/mobile/gaming bubble. We are still seeing tremendous entrepreneurial and investor exuberance at the start-up level, but the massive crunch of companies chasing the discretionary time and income of consumers is just not sustainable. And the uncertainty around high visibility players like Groupon could have a dampening effect in the coming months, unless a turnaround at the macro level bails everyone out, which is feeling unlikely right now. The venture industry was counting on this sector for liquidity and returns in the near term, so that our investments in cleantech and cloud can play out in the longer term. Limited partners are already generally frustrated with venture as an asset class, and if it turns out that all the returns on Groupon go to the employees that cashed out early — ouch!!” And Jeremy Liew of Lightspeed Venture Partners noted that he “Continues to see high quality, innovative companies and entrepreneurs. (There are) lots of great companies, question is whether the deals for investors are great.”

But in uncertainty resides opportunity for venture investors. Dag Syrrist of Vision Capital asserted “The exceptional lack of political and market certainty is leading most large companies to avoid making decisions, including the longer term investments needed to support their product and service road map, which gives new companies an opportunity and creates ‘white space’ opportunities for innovation and investments by the venture community. With venture investors willing to make a bet and take risk, it could be one of the better times.” Bob Pavey of Morgenthaler Ventures elaborated “I responded last time that I was optimistic but expected many surprises and challenges. The challenges have been at least as great as I feared, but now the pessimism is so great and widespread that we have to be near the bottom.”

And confidence in entrepreneurial firms remains. Jeb Miller of Jafco Ventures emphasized that “Silicon Valley remains the epicenter of a robust market for social media, eCommerce and mobile Internet startups that have the opportunity to scale quickly while the incumbents are bogged down with stagnant growth and macro market challenges.” And Bryant Tong of Nth Power added “We continue to see favorable risk based opportunities for proven technologies with a clear path to profitability.” Doug Pepper of InterWest Partners confirmed “My high confidence in the future environment is based primarily on the quantity and, more importantly, the quality of innovative startups we are seeing right now. This innovation is being driven by the simultaneous mass adoption of two new platforms, namely the Social Internet and Mobile Computing. However, this confidence is tempered slightly by the frothy new investment environment and the weak global macro-economic environment.”

And Venky Ganesan of Globespan Capital Partners assured “The shrieking headlines about Greece and Europe, the childish behavior of our politicians and the volatility of the stock market might give people pause but the three pillars of the new tech revolution - cloud, mobile and social remain extremely strong. People overestimate the short-term impact of technology and vastly underestimate the long-term impact of it. We are in the midst of a fundamental technology shift from PC to mobile, which is going to result in one of the largest legal wealth creation opportunities. So whether you are an investor or an entrepreneur turn off the talking heads on TV, tune out the nattering nabobs of negativity, and go out and build something insanely great!!!”

In summary, confidence declined markedly for the second consecutive quarter – weighed down by macro economic volatility, exit market roadblocks, and regulatory pressures. The uncertainty emanating from the broader economic and political environments has begun to impact the venture business model with clearer roads to liquidity being sought in some cases and a shift toward later stage, less risky investments being taken in others. Prolonged liquidity roadblocks will continue to negatively affect fundraising. If declines in LP funding become more sustained and profound this could lead to a negative cycle for the venture environment. Still, faith remains in the ability of start-up entrepreneurs to

define market opportunities and develop solutions that command value. Whether the patience of these entrepreneurs, their venture backers, and venture fund LPs outlasts the current negative trends in the broader macro environment is the key question that is yet to be answered.

Table 1
Participating Venture Capitalists in the 2011 3rd Quarter Confidence Index Survey

Participant	Company
Bill Reichert	Garage Technology Ventures
Bob Bozeman	Eastlake Ventures
Bob Pavey	Morgenthaler Ventures
Brian Panoff	Granite Ventures
Bryant Tong	Nth Power
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Dino Vendetti	Formative Ventures
Doug Pepper	InterWest Partners
Igor Sill	Geneva Venture Management
In Sik Rhee	Rembrandt Venture Partners
Jeb Miller	Jafco Ventures
Jeremy Liew	Lightspeed Venture Partners
Joe Mandato	De Novo Ventures
John Malloy	BlueRun Ventures
Karan Mehandru	Trinity Ventures
Kirk Westbrook	invencor
Richard Yen	Saban Capital Group
Robert Ackerman	Allegis Capital
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Tim Wilson	Partech International
T. Chester Wang	Acorn Campus Ventures
Tom Baruch	CMEA Capital
Tom McKinley	Cardinal Partners
Tom Rodgers	Advanced Technology Ventures
Venky Ganesan	Globespan Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D. is a Professor of Entrepreneurship and Innovation with the University of San Francisco School of Management. 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 on-going 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.

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