Silicon Valley Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: USFSVVCI)

Third Quarter – 2009

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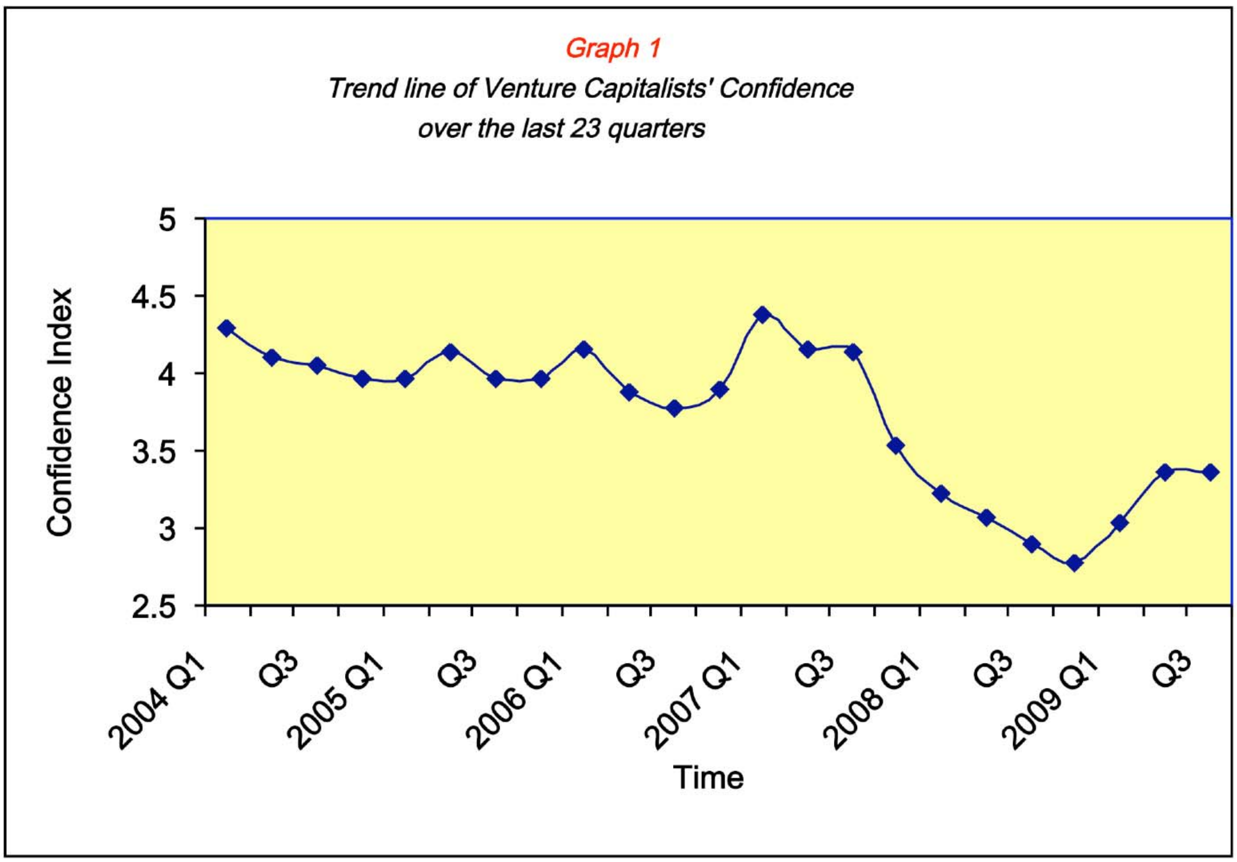
The quarterly *Silicon Valley Venture Capitalist Confidence Index™ (Bloomberg ticker symbol: USFSVVCI)* is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index measures and reports the opinions of professional venture capitalists in their estimation of the 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 2009, based on an October 2009 survey of 35 San Francisco Bay Area venture capitalists, registered **3.37** on a **5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index reading stayed exactly constant from the previous quarter's reading of 3.37 and indicates a leveling off of confidence after rising the previous two consecutive quarters following a five-year low in confidence in Q4 2008. 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 predominant sentiment was cautious optimism that the worst of the financial crisis and economic decline was behind us and it is time to put investment capital to work in at least some of the many attractive new ventures that are seeking funds. While several venture capitalist respondents voiced concern over a coming restructuring of the venture capital industry due to shifting allocations of available capital and lagging returns in recent years, more believed that the economic crisis, which has set a pall over much of the financial landscape, has also created opportunities for investments in potentially disruptive enterprises that can be had at more modest valuations. In the end, return cannot be made by not investing, so a number of those with available funds see now as a good time to look for bargains, believing that the log jam of exit opportunities is beginning to clear and will reward those investors who take advantage of the opportunities now available.

The third quarter did indicate a continued opening, if a small one, of the IPO market for a second consecutive quarter after two quarters without any venture-backed IPOs.[2] This tepid maintenance of the initial public offering market coupled with the expectation that exits through corporate acquirers will accelerate given the increasing value of their stock currencies with the recent run-up of public market valuations brings an expectation that the venture business model is healing. These settling trends helped maintain VC confidence steady over the preceding quarter. 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.

Innovation continues regardless of the economy. Venky Ganesan illuminated this notion, reckoning, "Invention never has a recession. As we slowly recover from this leverage driven global recession, the innovators among us have kept inventing and lots of these innovations are now prime for investment. We see many interesting ideas around the Internet, Mobile and Clean Tech sector. The flowers of the future are the seeds of today and the time to plant them is NOW." Elaborating on this view, is Jeb Miller of JAFCO Ventures who offered "We are seeing promising opportunities to help fund and build sustainable companies in emerging sectors such as green IT and cloud computing and to exploit disruptive models in existing sectors such as gaming and video delivery. An increasing number of quality entrepreneurs are shaking free from larger companies as cost reduction efforts have stifled development efforts and roadmaps at the incumbents…"

And the Silicon Valley venture environment continues to be the leading destination for investment in growth businesses. For example, Igor Sill of Geneva Venture Management reasoned "Investors will always gravitate towards high-growth sustainable businesses and Silicon Valley's innovative information technology breeding ground is at the epicenter of an industry that continues to thrive. Silicon Valley is recovering at a faster pace than the rest of the nation... The two major deterrents, outsourcing and high overhead costs have been well contained, and hopefully, Silicon Valley's higher than average housing cost dilemma has been tempered. Silicon Valley holds all the key economic components for a long run sustainable growth cycle."

New enterprises are gaining traction. Bruce MacNaughton of Crosslink Capital reported high confidence based on "Realistic valuations, realistic business plans, and companies and consumers who are spending for value." And Bill Byun of Samsung Ventures indicated "Our portfolio companies are ramping and I am seeing good signs of new startups on the horizon."

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[2] "Venture-Backed Exit Market Continues to Face Challenges Despite Largest IPO in 2.5 Years," Thomson Reuters and National Venture Capital Association, October 1, 2009.

Capital will need to be put to work. Dag Syrrist of Vision Capital argued that "Institutional investors and, increasingly, even venture investors are reaching the point where doing nothing is no longer OK, and while it seemed rational and responsible during a period of dramatic uncertainty, doing nothing is not going to get a fund, investor or portfolio out of the rut and generate above average returns. This will increase capital allocations and investment rates. In parallel, after a significant run up in public market returns, venture and PE may offer a way for those who did participate in the 2009 to date rally a way to deploy gains, and for those who did not, an opportunity to generate returns. Lastly, while investors with capital to deploy have been excited about low valuations, relatively few transactions are closing, and the bid/ask spread is closing – albeit slowly – which is good for all as well."

And investments are being made. Joe Mandato of De Novo Ventures indicated "From a virtual standstill, we have seen glimmers of light and more deals are getting done." And Richard Yen of Saban Ventures noted "We're finding quality early-stage investment opportunities in the current environment, although most start-ups are still struggling to monetize and build sustainable business models." And an anonymous respondent said "Thawing of the public markets predicts an upturn in venture investing amounts and valuations, historically, though we do always lag." Similarly, Bart Schachter of Blueprint Ventures stated "I believe venture is a lagging indicator by 12 – 18 months so willingness to back start-ups at 2008 levels will resume in late 2010. However, a resurgent IPO environment could accelerate the recovery."

Dan Lankford of Wavepoint Ventures observed "Slow recovery, but some encouraging signs in Clean Tech investing." However, Bryant Tong of Nth Power advised "Even though more money is being invested in Clean Tech, the ability for these early stage companies to grow and become profitable is still very difficult. Until the general economy improves and starts to actually show sustained growth, it will continue to be hard for these companies to thrive."

Exit opportunities are returning. Deepak Kamra of Canaan Partners confirmed "The exit environment has improved for both IPO's and M&A's and the performance of our portfolio companies is steadily improving." An anonymous respondent also noted the "IPO market seems to be thawing and the M&A deals on early stage by Medtech acquirers has gained momentum." And Jeb Miller of JAFCO Ventures confirmed "…the exit environment is showing signs of promise." This sentiment is consistent with the reality of liquidity events which - while still quite modest, especially the IPO market - does at least now exist with eight venture-backed IPOs in the last two quarters – more than for the entirety of 2008 but far below historical averages.[3] Additionally, Robert Ackerman of Allegis Capital offered "Stabilization of the public markets combined with some easing in the path to liquidity for venture investments gives entrepreneurs and investors hope that the train is back on the tracks – albeit moving slowly… It all starts with small moves based upon confidence."

Acquisition ready companies stand to benefit from the increased appetite by corporate acquirers. Sandy Miller of Institutional Venture Parnters detailed "The tone of the market has significantly improved. The big, cash-rich technology companies are moving aggressively to acquire premier private tech companies after a long quiet period. The IPO market has also opened up for high quality companies. There are today more private venture-backed technology companies with more than $50 million in revenues than at any point in history, and by a wide margin. So I think it's an increasingly positive environment for both entrepreneurs and venture investors though, thankfully, not a "bubble" by any means."

[3] "Venture-Backed Exit Market Continues to Face Challenges Despite Largest IPO in 2.5 Years" Thomson Reuters and National Venture Capital Association, October 1, 2009.

But questions on the availability of exits remained. Shomit Ghose of Onset Ventures reasoned “For private equity, the exit market still feels a little like the Eagles’ Hotel California: you can check in any time you like, but you can never leave. But we seem to have avoided Great Depression 2.0, and there’re great start-up opportunities out there leveraging the current disruptions in technology and business models.” And Chester Wang of Acorn Campus Ventures observed “A little improved exit opening in the short run, but questionable in the long run.” Two other venture capitalist respondents who wished to remian anonymous also pointed to a lack of an IPO market as a reason for their caution.

And liquidity remains linked to the tenuous health of the macro economy. Kirk Westbrook of invencor articulated “Although Q3 09 witnessed the best public stock market performance in over a decade, the overall US economy continues to provide mixed signals of the underlying health keeping exuberance in check throughout all the industrialized nations. It appears there is an underlying sense that stabilization has occurred and will be persistent. With this comfort two important factors have improved: the IPO listings and corporate M&A. More than the recent, but still unassuming IPO listings, the announced September merger activity seems to reflect a strategic shift within larger concerns that their base business operations have improved to the point where the risk around strategic acquisitions is outweighed by the potential it will provide competitively. Leverage to facilitate these transactions still seems fleeting and the bar is high for a concern to be an attractive take over candidate. Accordingly, the ability to free some of the long-trapped liquidity will continue to facilitate improving conditions for entrepreneurial growth, but will retard high growth until a more robust and consistent economic environment can be realized.”

Meanwhile, Graham Burnette of Red Planet Capital shared “Venture capital investors have to be optimists, and I am no exception. However, everything that I see in the macro environment, whether on the economy, state and federal government, healthcare, or the financial sector, points towards weakness rather than strength. The only area of strength that I see is innovative entrepreneurship: there is still a very strong flow of brilliant entrepreneurs with great ideas.”

And the lack of interim capital threatens to be an issue. Jay Watkins of De Novo Ventures suggested “With the number of inside rounds and bridge financings climbing steadily, its no secret that venture capitalists are protecting their existing portfolio investments against exposure to a difficult financing environment in 2009. But, the real trouble is likely to be this time next year when insider support has been tapped and these companies are forced to finance in a market where capital remains in short supply. New start-ups will struggle to compete.”

A tenuous economic and exit environment requires flexibility by portfolio firms. Kurt Keilhacker of Tech Fund Capital explained “In this economic environment one can't bet a company on the timing of a "return to the mean" scenario. Consequently, the focus is on growing innovative companies which will thrive across several different economic environments.”

Concern over pressure on the venture capital business model persists. Jim Marshall of Selby Ventures explained “I think while there are pockets of good venture opportunities out there, many markets are maturing and we're operating in a shrinking industry. This does not bode well for early-stage companies looking for their first venture rounds.” And a respondent who wished to remain anonymous said there are “too many VC’s, poor returns for too many years, and VC’s are getting weeded out.”

However, on the whole, cautious optimism is emerging. Debra Beresini of invencor shared, “I am cautiously optimistic that the worst is over - now we have to build confidence. Once confidence is restored, people and companies will look forward rather than inward…”

In sum, while concern over the macro economic fundamentals remains, a realization that the time to invest in promising new ventures is now upon us is taking hold. Innovation has continued during the economic downturn and the pent-up supply of sophisticated high-potential, capital efficient enterprises that have remained private has been growing. As economic conditions improve along with the ability of venture-backed enterprises to sell into recovering industries, revenue growth should accelerate. While liquidity through IPO remains illusive, the IPO market for venture-financed firms has at least been pried open in Q2 and Q3 amid some renewed interest in venture-backed offerings. Further, the Q3 summer time quarter is often a slow one for venture-backed IPOs, so the maintenance of a even a small stream of IPOs is an encouraging sign and may presage widening exit opportunities in the coming quarters.

Additionally, the recent dramatic rise in public market equities has increased the value of the stock currency of many potential acquirers of private tech firms, thus punctuating the hope of attractive technology firms. Indeed, Google CEO, Eric Schmidt, was quoted by Dow Jones on October 15 saying, "We're open for business, making strategic acquisitions, both large and small."[4] This aggressive posture toward acquisitions by an industry leader will likely pull additional corporate acquirers into the market in the coming months for competitive positioning and should increase liquidity opportunities and valuations for venture-backed firms along with the returns of their venture investors. As the exit market improves with a slow but recovering IPO market and, perhaps more importantly, a broadening acquisition market, anticipation of liquidity events for well-prepared portfolio firms will grow.

In the end, it will be the meeting of a rising confidence in macro economic conditions with the ever-present entrepreneur and the drum beat of innovation that will bring momentum back to venture-backed enterprises in the new year.

[4] Scott Morrison, Dow Jones Newswires, "Google CEO: We're Open to Making Strategic Acquisitions", October 15, 2009.

Table 1

Participating Venture Capitalists in the 2009 3rd Quarter Confidence Index Survey

Participant	**Company**
Bart Schachter	Blueprint Ventures
Bill Byun	Samsung Ventures
Bruce MacNaughton	Crosslink Capital
Bryant Tong	Nth Power
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
David Spreng	Crescendo Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Eric Edmondson	Seven Hills Partners
Graham Burnette	Red Planet Capital
Igor Sill	Geneva Venture Management
Jay Watkins	De Novo Ventures
Jeb Miller	JAFCO Ventures
Jim Marshall	Selby Ventures
Joe Mandato	De Novo Ventures
Karan Mehandru	Scale Venture Partners
Kirk Westbrook	invencor
Kurt Keilhacker	TechFund Capital
Pat Kenealy	IDG Ventures
Prashant Shah	Hummer Winblad Venture Partners
Richard Yen	Saban Ventures
Robert Ackerman	Allegis Capital
Sandy Miller	Institutional Venture Partners
Savinay Berry	Granite Ventures
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
T. Chester Wang	Acorn Campus Ventures
Tom Rosch	Interwest Partners
Venky Ganesan	Globespan Capital Partners
Victor Hwang	T2 Venture Capital
Anonymous	Anonymous
Anonymous	Anonymous

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