

Silicon Valley Venture Capitalist Confidence Index™

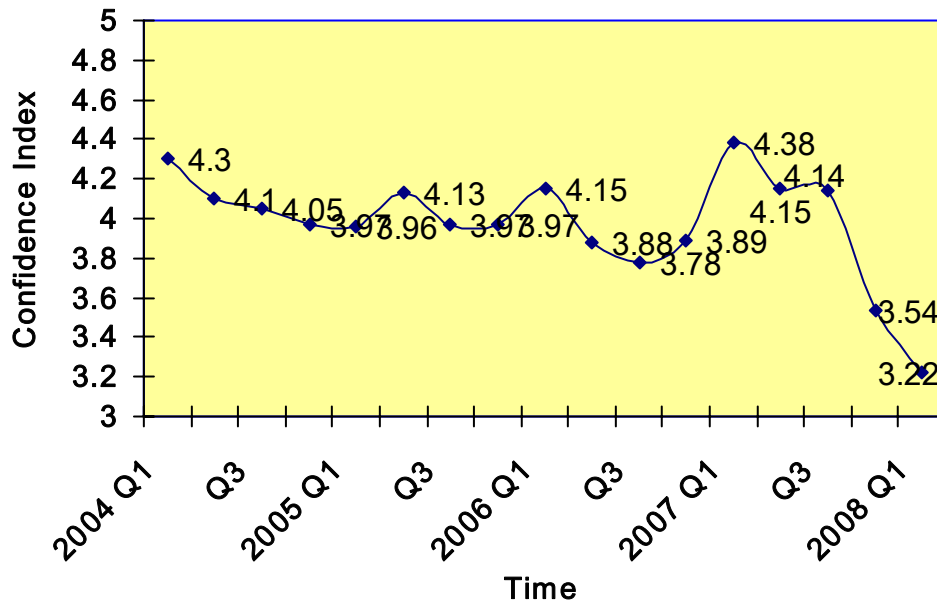
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First Quarter – 2008
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The quarterly *Silicon Valley Venture Capitalist Confidence Index* (Bloomberg ticker symbol: *USFSVVICI*) is based on an on-going survey of San Francisco Bay Area/Silicon Valley 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.¹ *The Silicon Valley Venture Capitalist Confidence Index for the first quarter of 2008, based on an April 2008 survey of 32 San Francisco Bay Area venture capitalists, registered 3.22 on a 5 point scale (with 5 indicating high confidence and 1 indicating low confidence).* This reading fell significantly from the previous quarter's reading of 3.54 to a second consecutive new low since the Index was originated in Q1 2004, and it indicates a continuing steep downtrend in venture capitalists' confidence. Please see Graph 1 for trend data.

Graph 1
Trend line of Venture Capitalists' Confidence
over the last 17 quarters



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. This forward looking indicator of Bay Area high-growth entrepreneurial activity is expected to act as a fair proxy for new venture activity across the United States, as the San Francisco Bay Area is the largest source of venture capital in the nation.

This major fall in venture capitalists' confidence over the last two quarters is unprecedented in the over four year history of this quarterly index and indicates a continuing declining sentiment among the majority of surveyed venture capitalists regarding the high-growth venture environment in the Bay Area over the coming months.

Concerns related to the continuing financial market turmoil and its impact on potential public market offerings of venture-backed firms drove confidence lower. Further, concern about the broadening macro economic decline that began with the mortgage crisis and appears to be spreading through other sectors of the national and global economy was cited as a primary cause for lower confidence. However, some responding venture capitalists were hopeful for an upturn in late 2008 and 2009 while other VCs (primarily early stage investors) were optimistic that this might be a good time to invest in seed stage companies given their longer time horizon for an exit and more attractive (lower) valuations. In the following I provide many of the comments by the participating venture capitalist respondents along with my analysis. Further, all of the Index respondents' names and firms are listed in Table 1.

Declining confidence was linked directly to the growing scarcity of exit opportunities for venture-backed firms. Focusing on declining liquidity event opportunities, Eric Buatois of Sofinnova Ventures, shared "we continue to see good deal flow with innovative entrepreneurs, but the shut down of the IPO window will make investors a bit more cautious." Dan Lankford of Wavepoint Ventures concurred, indicating "While the long term future continues to be bright, the current economic turmoil has created a challenging exit environment." Deepak Kamra of Canaan Partners also noted that the exit scenario is bleak. Graham Burnette of Astrolabe Ventures agreed but qualified his view, stating "Despite the lack of IPO opportunity, we continue to see high quality entrepreneurs with excellent business plans. These entrepreneurs are the life-blood of venture investing."

Focusing on macro economic issues and their effect on money flows within the venture industry, Debra Beresini of invencor stated that "The credit crisis and the current administration's slow response are affecting all areas of the financial markets. Venture capital and the entrepreneurial environment are somewhat immune as a great deal of capital has been raised and needs to be invested. The entrepreneurial market is robust and innovation will continue to advance in spite of the economic malaise. New funds, however, may have a challenge raising money until aggressive steps are taken to repair the damage which has been done in the financial markets." Also basing his caution on an expected decline of flows of venture money, Mukul Singhal of Canaan Partners reasoned that "Institutional funding (Series A and later) will slow down a little but funds will keep investing because most of the funds raised money in 2006-2007. However; I think angel funding will slow down because angels will see risk in their other capital market investments and will save cash."

Extending the macro economic decline argument to expected valuations, Dag Syrrist of Vision Capital calculated "There is significant capital in funds raised over the last several years that needs to be deployed. However, valuations are likely to be reduced, but the investments will be made nonetheless. However, if economic pessimism continues through Q3, it will result in fewer investments made, similar to 2002-03." Extending this logic, Daniel Ciporin of Canaan Partners offered that "Valuations in entrepreneurial activity and venture funding are a lagging indicator to the overall market environment, but we are about to see that lag catch up to us."

More broadly, Joe Mandato of De Novo Ventures indicated that his confidence was linked to the general state of the economy. And several other contributors who wished to remain anonymous attributed current national and worldwide economic conditions for their lower confidence, while one other anonymous respondent pointed out that “Capital market meltdowns always scare people for a while.”

Projecting that the full impact of the credit market crisis may still broaden, Kirk Westbrook, of invencor, reasoned “The continued malaise evident in the credit markets has yet to be fully reflected broadly in industries beyond housing, construction and financials in the United States. As the more restrictive debt and capital requirements are beginning to effect large enterprises, I think the next six months will see a contraction in booked revenues as sales cycles and uncertainty cascade down the food chain. A silver lining to the US economic environment is the weak dollar which is providing a competitive pricing advantage for companies with international opportunities.” And Steve Carnevale of Point Cypress Ventures projected that “..the game has changed as of the Bear collapse.” Carnevale expects a recession and bear market for an extended period, but believes that some technology businesses that focus on B2B business models may still prosper in this environment.

Also emphasizing the negative impact of the current financial market volatility on the local venture market *but offering hope for the future*, Sandy Miller of Institutional Venture Partners commented “Silicon Valley over the last quarter has been "in denial" about the negative impact that the overall financial crisis will have on technology growth companies. However if technology growth companies operate conservatively they should weather what is likely to be a 2 or 3 quarter storm and come out of it strongly in 2009. I think 2009 will be a robust year.”

Expressing industry specific concerns, Skip Fleshman of Asset Management Company Venture Capital pointed out that “The venture industry has over invested in capital intensive clean tech companies that will take forever (in some cases literally) to show returns.” But Dan Lankford of Wavepoint Ventures countered this view, noting “We are particularly optimistic about the venture investing in the clean energy and environmental space. The fundamental infrastructure for these industries is growing, and they are increasingly driven by real market needs rather than government incentives.”

However, not all of the responding venture investors expressed declining sentiment. Pointing to the strength of venture-backed tech firms as a positive indicator, Bill Reichert of Garage Technology Ventures shared, “This recession is very different than the last one. First, it’s not inherently a tech recession, which the last one was, and second, startup companies are structured very differently than they were in 2001; they are much leaner and scrappier, and they are more international out of the box.” And Peter Ziebelman of Palo Alto Venture Partners pointed out that “There is a continued opportunity for start ups whose products help other companies increase revenues. Their market may be larger companies that are pushing that top line in a lackluster economy or small medium businesses that are fighting for their survival.” Further, David Epstein of Crosslink Capital added “Although, as my partner Alain Harrus says "there is a disconnect between public and private valuations." There still seems to be a great deal of activity. Entrepreneurs need to be more patient and lower valuation expectations, but still can get funded. I am expecting financial market strength and therefore deal activity to pick up significantly in the 4th quarter.”

Investors in early stage companies appeared to have a generally higher level of confidence. For example, Bruce MacNaughton of Crosslink Capital advised that a good time to focus on early stage companies is when the economy is not doing well. And Lars Leckie of Hummer Winblad Venture Partners noted, “We continue to see a robust flow of early stage software companies due to the large amount of angel investments in our sector.” Ron Conway of Baseline Ventures attributed his high confidence on the great infrastructure that Silicon Valley provides for entrepreneurs. Colin Wiel of Keiretsu Forum also held high confidence, noting that “hedge funds, real estate funds, and buyout funds are all troubled, largely due to the debt crisis. Venture Capital and angel investing are among the few bright spots in the alternative investing landscape.” However, Richard Yen of Blueprint Ventures countered this view, saying “Even early-stage investors are affected by the turbulent credit markets and tight IPO market. VCs will be investing much more cautiously in the near-term.”

To sum, the responding venture capitalists’ concern emphasized the broadening impact of the credit crisis and general financial market volatility which has caused a drought in venture-backed exits. This perception is confirmed by the National Venture Capital Association which reported that only five venture-backed firms came to an initial public offering in the first quarter of this year. This is the smallest number since the second quarter of 2003. The NVCA also reported that M&As were at one of their quarterly lowest levels in 10 years.² This decline in exits of venture backed firms in Q1 2008 follows on the heels of a plummeting VC confidence in Q4 2007³ and despite a very robust year of venture investments in 2007 which boasted the highest investment total since 2001⁴. The precipitous decrease in exits in Q1 validates the declining VC confidence from last quarter and corresponds to the continuing drop in confidence this quarter. Further troubling is the significant decrease in venture-backed companies that have filed for an initial public offering with the SEC since 2007. The NVCA reports that the number of firms ‘in registration’ has declined from 60 last quarter to 37 this quarter.⁵ Excepting a turnaround in the exit scenario, VC confidence and activity in the near term high-growth entrepreneurial environment may remain challenged.

Caution over deteriorating macro economic conditions that could impact top line growth of some portfolio firms was also raised. However, several responding venture capitalists attempted to look beyond the immediate impact of problematic economic conditions to a potential uptick later this year and in 2009. This view was reinforced by early stage investors who tended to see opportunity in the current downturn to identify high potential ventures at lower valuations. A longer term view of early stage investors justifies this scenario. While most of the commentary focused on macro economic conditions, industry specific comments on clean tech broke both ways – seeing investments in clean tech ventures as a potential long term prize or a risky bubble.

Viewing the venture capital business model in total, available capital to invest is robust due to large investor commitments in recent years, and the supply of able entrepreneurs with innovative market oriented ideas remains ample, however, exit opportunities have become quite limited. A healthy exit market is, of course, crucial to a buoyant venture environment, and the current bottle neck for exits that has emanated from the public financial market crisis cannot help but put a damper on venture investing confidence and the high-growth venture environment for the near term. However, the longer term view in the venture industry – particularly by early stage investors, mitigates the impact of this liquidity event bottleneck somewhat, and hope remains for a return of more welcoming public market for exits by 2009.

² Thompson Financial and the National Venture Capital Association, “Venture-backed Exits Decline Significantly in first Quarter 2008”, April 1, 2008, Emily Mendell, Matthew Toole, Sandy Anglin.

³ Cannice, Mark, “Silicon Valley Venture Capitalist Confidence Index Report Q4 2007”.

⁴ Thompson Financial and the National Venture Capital Association, “2007 Venture Capital Investing Hits Six Year High at \$29.4 Billion”, January 19, 2008, Emily Mendell, Lisa Peterson, Clare Chachere.

⁵ Thompson Financial and the National Venture Capital Association, “Venture-backed Exits Decline Significantly in first Quarter 2008”, April 1, 2008, Emily Mendell, Matthew Toole, Sandy Anglin

Table 1

Participating Venture Capitalists in the 2008 1st Quarter Confidence Index Survey

Participant	Company
Bart Schachter	Blueprint Ventures
Bill Reichert	Garage Technology Ventures
Bruce MacNaughton	Crosslink Capital
Colin Wiel	Keiretsu Forum
D. Kirk Westbrook	invencor
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Daniel Ciporin	Canaan Partners
Dave Epstein	Crosslink Capital
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Eric Buatois	Sofinnova
Graham Burnette	Astrolabe Ventures
Jeb Miller	The Carlyle Group
Joe Mandato	De Novo Ventures
Lars Leckie	Hummer Winblad Venture Partners
Mukul Singhal	Canaan Partners
Pat Kenealy	IDG Ventures
Peter Ziebelman	Palo Alto Venture Partners
Richard Yen	Blueprint Ventures
Ron Conway	Baseline Ventures
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Skip Fleshman	Asset Management Company
Standish O'Grady	Granite Ventures
Steve Carnevale	Point Cypress Ventures
Steve Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
Tim Wilson	Partech International
Tom Fountain	Mayfield Fund
Tom Rosch	Interwest Partners
Wayne Cantwell	Crescendo Ventures

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