The University of San Francisco
Silicon Valley Venture Capitalist Confidence Index

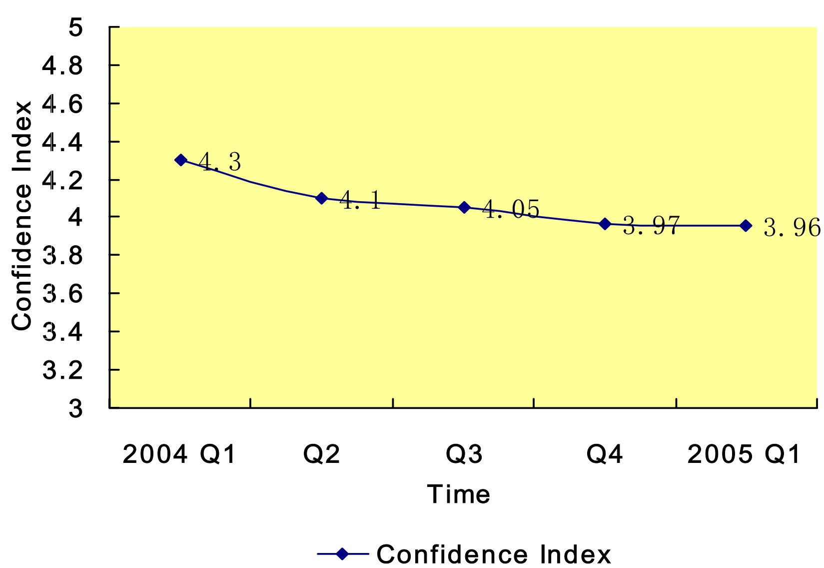
First Quarter – 2005
(Release date – April 21 – 2005)

The *Quarterly University of San Francisco Silicon Valley Venture Capitalist Confidence Index* is based on a survey of San Francisco Bay Area/Silicon Valley venture capitalists. Created and authored by Professor Mark Cannice and Professor Roger Chen of the University of San Francisco School of Business and Management, the USF Index (Bloomberg ticker: USFSVVCI) 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.

In publishing a recurring confidence index of professional venture capital investors, the USF Entrepreneurship Program intends to provide an on-going leading indicator of investment in new high growth businesses in the San Francisco Bay Area. We expect that this forward looking indicator of Bay Area new venture investment and high growth entrepreneurial activity will also act as a fair proxy for new venture investment across the U.S., as the San Francisco Bay Area is the largest source of venture capital in the nation.

The USF Silicon Valley Venture Capitalist Confidence Index for the first quarter of 2005, based on an April 2005 survey of 40 San Francisco Bay Area venture capitalists, came in at 3.96 on a 5 point scale *(with 5 indicating high confidence and 1 indicating low confidence),* ***and <u>suggests a healthy level of Bay Area venture financings and entrepreneurial activity in the coming months.</u> The 4th Quarter Index Level <u>is essentially unchanged</u>*** *<u>from the previous quarter's level</u> of 3.97 on a 5 point scale.*

Table 1
Trend line of Venture Capitalists Confidence over recent 5 quarters



We see a leveling off of venture investor confidence from what was a modest down trend in confidence over the previous three quarters of 2004. The very strong confidence level in the first quarter of 2004 appears to have stemmed mainly from high expectations of an impending recovery which would include the opening up of IPO markets, better macro economic numbers, and increased corporate spending. Confidence in the last 3 quarters of 2004 trended down somewhat as the reality of business conditions and investment opportunities, while good, may have not quite met the high expectations voiced earlier in the year.

This quarter's survey reveals a blend of optimism and caution. A good overall economic environment is a key factor for the overall high confidence among the responding venture capitalists. However, certain economic issues such as high energy prices, rising interest rates and spotty corporate spending caused some uncertainty. Further, the respondents do not see a dramatic increase in exit opportunities through IPOs or M&As. Similarly, while the growing supply of venture capital in the Bay Area provides reason for high confidence in venture investment in the near term, some venture capitalists worried that this growing supply of funds may lead to a situation where too much money is chasing too few deals, thus driving up valuations and resulting in a possible bubble. Finally, the confidence of venture capitalists also varied by sector. In general, high confidence mostly focused on consumer related technologies and energy rather than biotech or IT for now. Overall, the absolute Index level of 3.96 in this latest quarter is favorable and projects continued health in the Bay Area entrepreneurial environment.

All of the Index respondents' names and firms are listed below, save those who wished to remain anonymous. Many of the responding venture capitalists also went on the record with commentary that supported their degree of confidence in the upcoming venture investment environment. In the following analysis, we provide many of their comments.

General optimism was indicated by many of the responding venture capitalists. Venky Ganesan, Globespan Capital Partners, provided a refreshing analysis, stating, "We are witnessing an inflection point in the tech funding cycle and are now hitting an upward slope in the funding environment. *Silicon Valley has its mojo back* – parking lots at Buck's and Il Fornaio are full, traffic is backing up on 280 and startups are getting multiple term sheets". Supporting Venky's assertion, Bart Schachter of Blueprint Ventures offered that "The Bay Area is resuming levels of 93-94…the next up-cycle is 3-4 years away". Bolstering this view, J. Sanford Miller of 3i, confirmed that, "We are at a nice balance between the interests of the entrepreneurs and the venture investors". Similarly, Arno Penzias of New Enterprise Associates said, "While the outlook varies by sector, I'm seeing overall growth in the number and quality of new investment opportunities, as well as in the business prospects of companies in our portfolio". Similarly, Bob Marshall of Selby Ventures pointed out that, "The environment for startups continues to improve, VCs are funding more companies, etc..". Further, Raj Atluru of Draper Fisher Jurvetson noted "..optimism on internet 2.0 applications, wireless adoption, digital consumer applications", while Tzu-Hwa Hsu of Walden International sees, "An improving and growing US economy; an active Stock market and more IPO opportunities, and a more dynamic and aggressive investment environment".

Scott Sandell of New Enterprise Associates indicated, "There are very talented entrepreneurs starting companies for us to fund, a reasonably healthy economy into which they can sell their products, and ample capital to fund them after our initial funding. Importantly, there is also a very robust appetite for acquisitions of companies with new products that can increase the growth rate of more mature tech companies. And for those that are really successful, the public markets are waiting". Supporting this view, Deepak Kamra of Canaan Partners sees, "Strong deal flow activity in most sectors", while Peter Wolken with Diamondhead Ventures agreed that, "Things are picking up with the economy back on track, lots of deal flow, and high quality entrepreneurs with good business models".

Caution was voiced by some. For example, Dag Syrrist of Vision Capital remarked that, "Significant uncertainty faced by corporate capex and opex spending in face of continued and weakening market issues (dollar, energy prices, interest rate increase, government deficit spending), will continue to make it difficult for small companies to sell to large companies. In my view, this is off set somewhat by the need of larger companies to replenish R&D pipeline sacrificed in effort to reduce cost over last 36-48 months". Striking a different note of concern, Robert Ackerman of Allegis Capital observed that, "While there has been a healthy return to the fundamentals that drive a healthy venture capital environment, I continue to be concerned by the specter of too much capital being directed by venture capitalists that are relatively new to the industry. This is a recipe for over capitalization of perceived “hot sectors” and over-valuation of young companies". Kirk B. Westbrook, International Venture Fund, maintained that, "Overall, there appears to be a sustained moderate growth in the business climate. However, it still appears that some segments, especially infrastructure/IT and those not directly serving consumers, are experiencing pockets that continue to be a challenge in relation". That position seemed to be supported by another anonymous contributor who believed that the new investment cycle would be driven more by "..digital media, flat screens, HDTV...web 2...etc.".

Cautious optimism was offered by others. For example, Sergi Martorell of 3i contended that, "Even though a new cycle in the US VC industry is well underway (many Silicon Valley VCs have raised new funds) and investment recovery in the tech/venture industry will continue, uncertainties remain, especially on the exit markets for tech companies. This might affect the amount of capital VCs deploy into very early-stage ventures as well as the confidence amongst entrepreneurs. In general, GDP forecasts are up, economic growth to the Bay Area is returning and consumer confidence is stable. The Bay Area ecosystem will continue to foster entrepreneurialism, however, it is unlikely that we return to boom levels anytime soon. My prediction is cautious optimism and a gradual recovery in the venture entrepreneurial environment".

Similarly, Randolph L. Tom of Dynasty Capital Services confirmed that, "Dynasty has witnessed a great amount of deal flow of some very viable business opportunities in the mobile entertainment and software sectors. The deal size has been smaller than expected, ranging in the $5M or less, as many companies are leery of giving up too much equity at this stage of their development. Perhaps the rain that has engulfed the Bay Area in the last several months has kept the entrepreneurs inside, so their business plans are more advanced as they spend more time inside, perfecting their ideas and their pitch. We have also seen a great deal of interest in media metrics, home land security and communications systems used for tracking and identification purposes sought out by defense contractors. Those private companies have been increasingly attractive to investors, particularly with the rise in the interest of private equity investors and to a certain degree, in the case of public companies, to hedge fund investors. Finally, there is still a great deal of M&A activities; the age old adage of too much money chasing too few deals is still applicable. I expect that it will still be a hot market for consolidating industries seeking once again economies of scale".

A blend of short term optimism and long term caution was expressed by Brendan Richardson of Vision Capital, who stated that, "..from every corner – entrepreneurs, VC’s, LPs, Lawyers, etc – there is a positive outlook. There is money being invested in all stages of companies and there are funds that are out raising money with less difficulty in years. At a networking function earlier this week, a well-known venture attorney ... mentioned that his firm was working with VCs raising funds and had almost $3B in fund closings scheduled for the next 6-9 months. That’s a lot of fuel which will need to be invested in the next 3-4 years - a typical investment period for a venture fund. So I think the next 6-18 months are going to be busy for entrepreneurs, lawyers and VCs in the Valley. The question, however, remains as to whether this LP enthusiasm for US venture will create another wall of money that drives up valuations and results in another bubble. I’d say, ultimately, yes. So while the near term looks rosy, the long term looks cloudy".

Focusing on the unique characteristics of Silicon Valley, Chris McKay of Granite Ventures asserted that, "We've had a consistent view that the Bay Area continues and will continue to be a great area to invest". Striking a somewhat different note, Linus Lundberg, Vision Capital, concluded, "The cost of building a business in the Bay Area is high compared to the likely exit value potential. With IPO only being possible for only a very few great companies and M&A valuations being moderate, it is now critical to limit the total capital required to build a business". Supporting this view point, Tom Cole of Trinity Ventures finds that "..An active M&A environment is providing liquidity for startups, though the size of many deals is modest. Entrepreneurs who are capital efficient have an opportunity to generate good returns for themselves". Similarly, Peter Ziebelman of Palo Alto Venture Partners notes that, "More newly formed companies understand the realties of the harsh economic environment".

With regards to the biotech sector, Ben Chen of Burrill & Company, finds that, "..despite some set back with the COX-2 related drugs, we are seeing a good selection of technology and company with solid management teams". Another venture capitalist in the biotech sector who wished to remain anonymous, offered that, "Things still look good in the life sciences world, assuming the IPO market is sensible". Another anonymous contributor asserted, "The IPO window for healthcare opened up in 2004 but seems to be closing at the start of Q2 of 2005. With rare exception, biotech IPO's over the last 18 months saw little value recognition over the amount of private equity raised. Private investors will need to evaluate their biotech investments carefully as the public markets seem pretty unforgiving". While for medical devices, Joe Mandato, De Novo Ventures, confirmed, "We are continuing to see a steady flow of high quality opportunities".

With regards to business IT, Curtis Lee of Advanced Technology Ventures suggested that, "The technology boom from a few years ago helped solve a lot of problems that companies faced, however, it has also led to the creation of additional problems (i.e. integration, proliferation of data, etc.). This scenario has created an opportunity for current start-ups and entrepreneurs in solving some of these issues". Meanwhile, David G. Arscott of Compass Technology Partners, pointed out that, "We are seeing a continuing recovery after the difficulties of dealing with the over-heated venture environment in 2000. Companies need new solutions to logistic and security problems, among others. We are also going to find new opportunities that take advantage of the accelerating broadband-based communications infrastructure. Better and inexpensive communications allow us to take a global approach to business requirements. Silicon Valley can take a leadership role, leveraging its own infrastructure to build new companies taking advantage of theses enhanced communications capabilities".

With regard to the energy sector, Bryant Tong, Nth Power, indicated that, "The whole energy technology space which Nth Power invests in, is getting much attention and as a result, investment dollars are following this sector. It’s hard to read the morning paper without seeing an energy related story. Most of these stories discuss the problems we face as we continue to demand greater amounts of power and energy sources. This has created commercial opportunities for many of the companies that we invest in".

However, most focus appears to be on consumer technology applications. For example, Sharon Wienbar, BA Venture Partners, stated, "People's appetite for fun and handy new technology continues unabated. Even if large enterprise purchasing continues to be slow, consumer and smaller businesses have unprecedented access to innovative technology". Supporting this view, Randolph L. Tom of Dynasty Capital Services said, "We see the mobile entertainment market as a substantial opportunity, particularly outside the US and would expect that the companies in the States who have always been behind in this area will follow suit after the Telco merger activities calms down".

Cautious optimism seems the trend with a focus on consumer related technologies rather than business IT for now. Bio-tech and medical device companies while attractive appear to be at the mercy of the appetite of public markets and potential acquirers. While money is available and may tend to drive up valuations, a deliberate caution and avoidance of excessive risk on the part of the responding venture capitalists will tend to prevent another period of extravagant valuations and poor investment decisions.

To sum, the overall VC Confidence Index level appears to be leveling off at a healthy mark after trending down somewhat over the last 3 quarters. A sober optimism appears to be the generally held view in the venture capital industry. The steadying of the relative index level and the primarily positive comments from the venture capitalists surveyed indicate a continued upbeat sentiment for venture capital investment in the coming months, and bode well for ***continued health in entrepreneurial activity and new company formation in the San Francisco Bay Area for 2005.***

Table 2

Participating Venture Capitalists in the 2005 1st Quarter Confidence Index Survey

Arno Penzias	New Enterprise Associates
Bart Schachter	Blueprint Ventures
Ben Chen	Burrill & Company
Brendan Richardson	Vision Capital
Bryant Tong	Nth Power
Casper deClercq	U.S. Venture Partners
Chris McKay	Granite Ventures
D. Kirk B. Westbrook	International Venture Fund
Curtis Lee	Advanced Technology Ventures
Dag Syrrist	Vision Capital
David G. Arscott	Compass Technology Partners
Deepak Kamra	Canaan Partners
Henry Wong	Novus Ventures
Joe Mandato	De Novo Ventures
Linus Lundberg	Vision Capital
Mike Rocke	Rocke Capital Ventures
Peter Wolken	Diamondhead Ventures
Peter Ziebelman	Palo Alto Venture Partners
Raj Atluru	Draper Fisher Jurvetson
Randolph L. Tom	Dynasty Capital Services
Robert C. Marshall	Selby Venture Partners
Robert R. Ackerman, Jr.	Allegis Capital
Robert Troy	Geneva Venture Partners
Sanford Miller	3i
Sanjay Subhedar	Storm Ventures
Scott Sandell	New Enterprise Associates
Sergi Martorell	3i
Sharon Wienbar	BA Venture Partners
Shomit Ghose	Onset Ventures
Steve Sullivan	Skyline Ventures
Tom Cole	Trinity Ventures
Tom Fountain	Mayfield
Tzu-Hwa Hsu	Walden International
Venky Ganesan	Globespan Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Please see the report for the previous quarter at: http://www.usfca.edu/sobam/nvc/cindex_4_2004.htm.

Look for the 2nd Quarter 2005 USF Silicon Valley Venture Capitalist Confidence Index in July 2005. Venture capitalists who wish to participate in next quarter's Index survey or become involved with the USF Entrepreneurship Program are asked to contact Professor Mark Cannice at **Cannice@usfca.edu**. Please find additional information about the University of San Francisco School of Business and Management Entrepreneurship Program (rated *Top Tier by Entrepreneur Magazine* – 2004 & 2005) and it's International Business Plan Competition at: **http://www.EntrepreneurshipProgram.org**.

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