The University of San Francisco
Silicon Valley Venture Capitalist Confidence Index

Second Quarter – 2006
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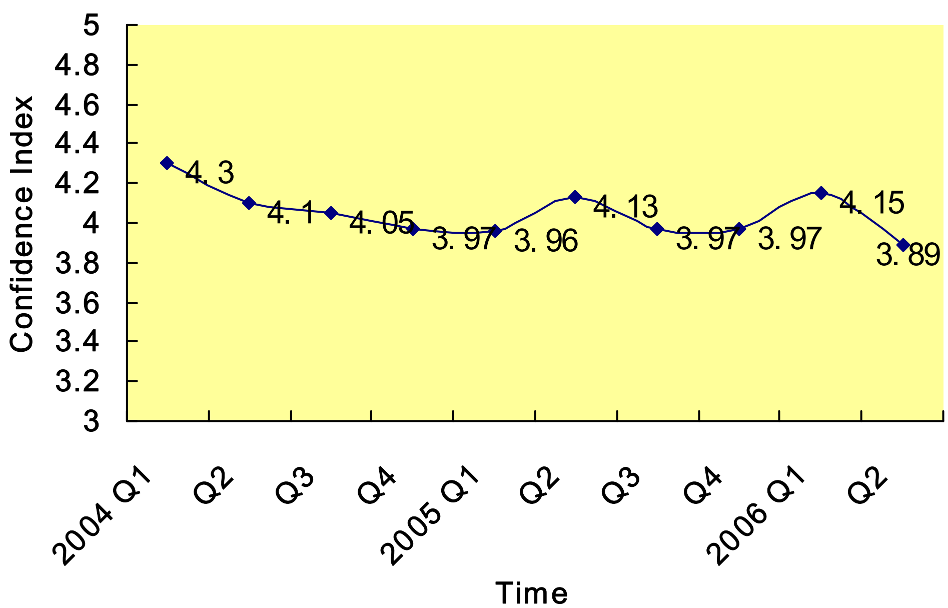
The *Quarterly University of San Francisco Silicon Valley Venture Capitalist Confidence Index* is based on a survey of San Francisco Bay Area/Silicon Valley venture capitalists. Created and authored by Professor Mark Cannice and Professor Roger Chen of the University of San Francisco School of Business and Management, the USF Index *(Bloomberg ticker symbol: 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 (www.EntrepreneurshipProgram.org) 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 second quarter of 2006, based on a July 2006 survey of 37 San Francisco Bay Area venture capitalists, came in at 3.89 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 activities in the coming months.*</u>

Table 1

Trend line of Venture Capitalists Confidence over recent 10 quarters



However, the 2nd quarter Index level <u>declined significantly from the previous quarter's level</u> of 4.15 on a 5 point scale, to <u>its lowest reading since this Index was originated more than 2 years ago in April 2004.</u> While this reading is not dramatically lower than some readings over the previous 9 quarters, it does signal a shift from broad confidence to increasing caution among a growing number of Silicon Valley Venture Capitalists.

Some of the responding venture capitalists pointed out potential problems in the high-growth environment, such as inflated valuations and difficulties getting an investment to an exit alternative. Still, many of the responding venture capitalists held upbeat assessments of the near term environment for high-growth ventures. We review and discuss many of the responding venture capitalists' insights in the following. Further, all of the Index respondents' names and firms are listed below, save those who wished to remain anonymous.

An overall friendly operating environment for growth ventures in the Bay Area was observed by Rob McIntosh of Arrow Path Venture Partners who stated, "This is the best environment I have seen in the last 5 years. Buyers have renewed confidence in buying from start-ups. We are having an increasingly difficult time retaining and recruiting new employees at our portfolio companies. Large companies are increasingly acquisitive and actually paying decent multiples for businesses. In fact, we are seeing more and more pre-emptive M&A efforts by large companies looking to thwart/harness new innovations. Terms on financings are much more company friendly with increasing valuations. Additionally, there is still excess VC money throughout the Valley searching for good ideas. Finally, the traffic on 101 (my leading indicator of the economy) is terrible once again!"

Providing another cogent argument for continued optimism in the high-growth venture environment, Debra R. Guerin of invencor, Inc. offered that, **"**As the real estate market flattens, private investors will want to invest their dollars elsewhere. As angel investors invest in a number of early stage companies, venture investors will provide follow on funding for the best of the best; the more seed capital, the more possibilities. Further, the general climate is positive for growing new companies. The entrepreneurs to whom I have spoken are very optimistic and full of energy – both good signs."

Good deal flow is also bolstering optimism in the Bay Area venture industry. For example, Bob Marshall of Selby Venture Partners notes that "Corporate profits remain healthy, strong M&A activity continues and there continues to be good deal flow in the Valley." Further, Dave Epstein of Crosslink Capital is seeing a, "great amount of deal flow – good ideas, (and) good people…" Gilman Louie of Alsop Louie Partners, added that "Venture investing is on the increase and there has not been a slowdown in the number of new startups." Similarly, Colin Wiel of the Keiretsu Forum San Francisco noted that "New startups are making more progress in bootstrap mode before seeking funding, allowing angels and VC's to make more well-informed seed-stage investments." Additionally, Claas Heise of T-Venture of America stated, "In early stage (Seed and A) the climate is now very positive - valuations are still reasonable, and more VCs than in the past years are looking into early-stage financings. However, if the overall investment climate would turn sour in the next 12 months, this would very much impact the sentiment towards doing early-stage deals - not necessarily warranted from my point of view."

On the life science side – Joe Mandato of De Novo Ventures pointed out that, "Deal flow is robust, but there exists a bit of uncertainty regarding the economy and the likelihood of a public exit market or dilutive acquisitions. While Steve Sullivan of Skyline Ventures notes, "quality projects continue to surface here, both early and mid stage".

Several venture partners attributed their confidence to the **strong pace of innovation in the Bay Area.** For example, Jim Marshall of Selby Venture Partners, noted that the, "Pace of innovation is improving and many entrepreneurs are starting new companies again." Raj Atluru of Draper Fisher Jurvetson pointed to "extraordinary entrepreneurial activity". Jim Watson of CMEA Ventures added that, "Innovation is being fueled by large private equity investments in the valley and experienced entrepreneurs are in the game again."

For the basis of his confidence, John Kohler of Redleaf Venture Management argued that, "Innovation moves in cycles… there has been significant development in a number of technical fields that will present new capital formation opportunities in the Bay Area. There is reduced risk in the market today and investor confidence is growing. Finally, there is a new wave of capital spending that is forming on the back of aging technology that was purchased in '98 – 2000." Supporting this point of view is Igor Sill of Hambrecht Geneva Ventures, who stated, "In terms of the overall US economy as of June 2006, the real capital goods imported into the US rose 12.9% year to date from a year ago figures, while real consumer goods imports increased 3.8% from year ago figures. As it affects the Silicon Valley economy, we are witnessing strong corporate purchasing of leading edge technologies within the software sector, equivalent to 1995-1996 buying trends, supporting the notion that the beginning of the ten year software cycle is in play. We believe the outlook for software technology is growing rapidly as corporate IT departments gear up with advancements in on-demand software applications, security software, communications and enterprise software, especially those "disruptive" software technologies, Salesforce.com and Pleasanton, CA based, ZANTAZ." Echoing this theme, Deepak Kamra of Caanan Partners emphasized the "fundamental growth in tech opportunities on a global basis."

Robert Troy of Geneva Venture Capital, also focusing on Bay Area entrepreneurial talent, offered, "The stage is set for the expected maturity boom in the high-tech industry: sophisticated entrepreneurs who have obviously learned from the mistakes of the recent past, next paradigms in place, to better serve the consumers and customers with great value added and interesting business models, giant progress of the infrastructure and more and more money to support innovation. The Bay Area is more than ever the high-tech Mecca thanks to an extraordinary pool of talents." But, Kirk Westbrook of invencor, Inc. suggested that caution was growing in business spending, stating, "Much like the machinations of the public markets, the spending decisions being made by the larger organizations that are the customers of most venture backed companies appear to have a similar path. While many appear to be comfortable with the present business climate, I sense an increasingly cautious optimism about the near term."

Strong Consumer demand for new technology applications also was given as a reason for an upbeat assessment. Richard Yen of BluePrint Ventures observed, "Rapid consumer adoption of Internet, mobile, and digital media products is generating a lot of excitement in the venture and entrepreneurial communities." Eric Buatois of Sofinnova Ventures offered that, "Large companies are starting to upgrade again their overall IT infrastructure. New semiconductor products are needed to create new consumer appliances. Every thing is becoming mobile. Consumers are more and more buying services through the web." While an anonymous contributor added, "The global ad market is $280bn with only 4% on line. There is a massive secular shift in ad spend allocation away from traditional media and towards the Internet – companies that help facilitate that transition will benefit."

A focus on renewable energy resources was identified by Mike Rocke of Rocke Capital Ventures. He indicated, "Interactions to syndicate early stage investments for future energy supply relief is also a hot topic, with top innovative ideas being funded that will stretch our existing energy resources, and make renewable energy resources more cost competitive."

However, concerns over valuations and another bubble have begun to emerge more broadly. Claas Heise of T-Venture of America pointed out that, "The financing climate has become quite heated recently, especially for mid-and late-stage deals, with valuations for financing rounds that require a very good outcome to make a decent return on the investment." Mohanjit Jolly of Garage Technology Ventures also noted, "There seems to be a lot of frothiness in the venture market currently, especially in certain sectors like consumer internet. When valuations get to relative high double digits with revenue still 18-24 months away, you know it's 'bubble 2.0'. I think there will be some correction in the early stage as these companies come back for their series B without any meaningful revenues."

Bart Schachter of BluePrint Ventures also emphasized caution, noting, "I believe 2006 is exhibiting some 'mini-bubble' characteristics." It may be that these high valuations are due to the increasing amounts of available capital to local entrepreneurs. For example, Mike Rocke of Rocke Capital Ventures indicated, "We are seeing both new VC funds in the Bay Area, and record breaking amounts of private capital being raised by existing firms." Countering the potential 'bubble notion' is Dave Epstein of Crosslink Capital who notes that, "Valuations should stay in check given a weak stock market. Talent availability is good due to both fewer options by public companies because of option expensing and the backdating scandals and somewhat less perceived value in the weak market." Noting the same public market issues but with an alternative conclusion, Graham Burnette of SBV Venture Partners reasoned, "I believe that the current scandal regarding stock option back-dating is likely to distract many in the entrepreneurial culture, and is also likely to lead to a new level of government regulation, much like the Enron and WorldCom scandals led to SOX. This will make the difficult job of growing young companies even more difficult while reducing the ability of those companies to provide strong incentive compensation."

Confidence in entrepreneurial management teams remains, but doubt in potential exits is dampening overall confidence. For example, Charles Beeler of El Dorado Ventures stated, "We have continued to see a number of very compelling investment opportunities led by strong early-stage management teams. These are the type of people who can turn good opportunities into great outcomes and will adjust to the market as needed in order to succeed. Given this, and what we expect the long-term results of these companies will be, we are fairly positive about the investment climate. The reason I gave a four instead of a five is that we have not seen a healthy market for exits, in particular for IPOs in quite some time. This is always a challenge for venture investors and the companies they back, and I have no doubt it will continue to cast a shadow over the market for some time, although given the pace of new investments the current shadow is being ignored by many." Dixon Doll of Doll Capital Management also sees "..generally strong economic conditions, plenty of capital availability, prosperous customers for products and services of tech startups; the only negative is a relatively poor environment for private venture backed companies to go public."

Tom Baruch of CMEA Ventures also noted, "If pessimism in the public market for small technology and life sciences companies remains for the period it will start to constrain activity". Additionally, Sharon Wienbar of BA Venture Partners shared, "I am concerned that expectations of "pops" are too high, while the public stock markets are in a real funk, and interest rates are going up". Echoing this theme, an anonymous contributor emphasized that the, " NASDAQ is goings sideways, and interest rates are up. When the exit is clogged, then entrance to the pipeline will be reduced." Providing one explanation to the exit problem, Jeb Miller of Com Ventures pointed to a difficult regulatory environment as a drag on liquidity, stating, "Regulatory requirements that are stifling the tech IPO market and industry consolidation are reducing the number of attractive exit opportunities." But Dag Syrrist of Vision Capital counters that, "A less robust growth rate of the economy will lead the Fed to stop raising interest rates which will help the stock market and give investors an improved sense of liquidity for private companies."

In sum, the sentiment among our responding venture capitalists was mixed. Concerns about bubble like valuations and limited exit alternatives put a damper on confidence in the high-growth venture environment. However, an underlying belief in the strength of the entrepreneurial talent pool and the pace of innovation in the Bay Area helped buoy expectations. This belief, combined with the increasing demand in consumer and mobile applications and the sense of the beginning of a new business IT cycle kept the confidence index from declining more sharply. Again, while the overall index declined significantly from the previous quarter – the majority of VCs were generally upbeat about the overall entrepreneurial environment but aware of the potential dangers of excessive valuations and limited exit alternatives. This tempered optimism should help support a *healthy Bay Area entrepreneurial environment for the balance of 2006.*

Table 2

Participating Venture Capitalists in the 2006 2nd Quarter Confidence Index Survey

Bart Schachter	BluePrint Ventures
Charles Beeler	El Dorado Ventures
Chester Wang	Acorn Campus
Claas Heise	T-Venture of America
Colin Wiel	Keiretsu Forum San Francisco
D. Kirk B. Westbrook	invencor, inc.
Dag Syrrist	Vision Capital
David Epstein	Crosslink Capital
David Pidwell	Alloy Ventures
Debra Guerin-Beresini	invencor, inc.
Deepak Kamra	Canaan Partners
Dixon Doll	Doll Capital Management
Eric Buatois	Sofinnova Ventures
Gilman Louie	Alsop Louie Partners
Graham Burnette	SBV Venture Partners
Igor Sill	Hambrecht Geneva Ventures
Jeb Miller	ComVentures
Jim Marshall	Selby Venture Partners
Jim Watson	CMEA Ventures
Joe Mandato	De Novo Ventures
John Kohler	Redleaf Venture Management
Mike Rocke	Rocke Capital Ventures
Mohanjit Jolly	Garage Technology Ventures
Raj Atluru	Draper Fisher Jurvetson
Richard Yen	BluePrint Ventures
Rob McIntosh	Arrow Path VC
Robert C. Marshall	Selby Venture Partners
Robert Troy	Geneva Venture Partners
Sharon Wienbar	BA Venture Partners
Steve Sullivan	Skyline Ventures
Tim Wilson	Partech International
Tom Baruch	CMEA Ventures
Tom Fountain	Mayfield
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Please see the report for the previous quarters at: www.EntrepreneurshipProgram.org under the publications tab. Look for the 3rd Quarter 2006 USF Silicon Valley Venture Capitalist Confidence Index in October 2006. 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 its International Business Plan Competition at: www.EntrepreneurshipProgram.org.

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