Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: SVVCCI)

Third Quarter – 2015

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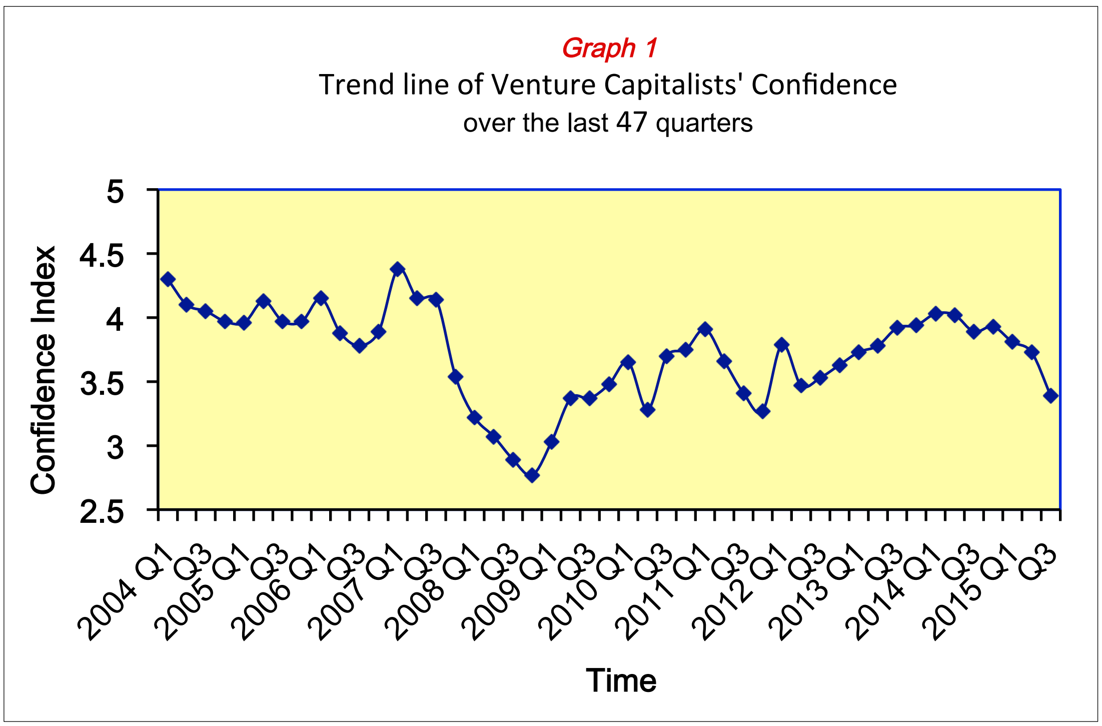
The *Silicon Valley Venture Capitalist Confidence Index® (Bloomberg ticker symbol: SVVCCI)* is based on a recurring quarterly survey of San Francisco Bay Area/Silicon Valley venture capitalists. The *Index* measures and reports the opinions of professional venture capitalists on their estimations of 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 2015, based on a September 2015 survey of 31 San Francisco Bay Area venture capitalists, registered 3.39* ***on a 5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence). This quarter's index measurement declined sharply from the previous quarter's index reading of 3.73. Please see Graph 1 for trend data.



[1]Questions about this ongoing research study or related topics should be sent to Professor Mark Cannice at **Cannice@usfca.edu**.

Confidence in the future entrepreneurial environment of the San Francisco Bay Area fell in the third quarter as a rising tide of concern over inflated valuations of venture capital backed firms weighed on sentiment. Concurrently, volatility in the public financial markets appears to be slowing the exit market with only 13 venture-backed firms achieving an IPO in Q3. This is down sequentially from Q2 2015 and year over year from Q3 2014.[2] The growing sense of inflated valuations for some venture-backed firms along with a lackluster IPO market makes for a challenging business model for the venture industry. Still, confidence in determined and talented entrepreneurs persists, as confirmed by continued strong flows of investment capital[3] into firms crafting potentially disruptive innovations in technology applications and business models that may in time form the foundations of future industries.

In all, though, the *Silicon Valley Venture Capitalist Confidence Index* dropped significantly in Q3 to 3.39, well below its previous quarterly reading of 3.73 and its nearly 12-year average of 3.72, and to its lowest point since Q4 2011. As the index is designed to gain venture capitalists' insights into future conditions[4], a measure of caution in the near term future of the high growth entrepreneurial environment may be warranted. 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 provided their comments confidentially.

A growing consensus emerged that valuations of venture-backed firms, in at least some sectors, no longer reflect market fundamentals. For example, Paul Holland of Foundation Capital observed that "persistent high prices for private financings have failed to synch up with significant softness in the public and exit markets." Mr. Holland determined that it appears to be an imbalance that will have to be sorted by prices softening for private financings. Similarly, Mohanjit Jolly of DFJ expects a "general cooling off, especially around valuation expectations which will have some trickle down effect, especially for those firms that may have paid up in recent rounds of financing. Public market adjustment is also going to have some impact on private company valuations, albeit with some lag."

This distortion in valuations is most apparent among firms in later stages of development. Cindy Padnos of Illuminate Ventures indicated "The recent high valuations of many later stage venture-backed companies is based less on performance than on market demand for growth investments. This makes them susceptible to overall market volatility, which is something they cannot really influence, let alone control." Gerard van Hamel Platerink of Redmile Group suggested "Late stage deal valuations and asymmetric deal terms are increasingly out of synch with what will likely be realized upon an exit, in our view." And Bill Reichert of Garage Technology Ventures affirmed "The public markets cannot possibly absorb the current batch of unicorns at their current valuations, not to mention the thundering herd of unicorn wannabes. There will be more disappointment than celebration over the next 18 months. Still, there is plenty of room for creating real value and building great companies. We just need to adjust expectations."

Jon Soberg of Expansive Ventures noted "The concerns being voiced in the market about late stage valuations, especially relative to public markets, are very valid and will likely be self-fulfilling in terms of lowering valuations and making fundraising more challenging." In fact, fundraising by venture capitalists declined in Q3 by about one-third in terms of capital raised from the year earlier quarter and over half as compared to Q2 of this year.[5] Of course, fewer IPOs coupled with higher private valuations limits exit

[2] NVCA and Thomson Reuters press release dated October 1, 2015.

[3] NVCA press release dated October 16, 2015 (based on MoneyTree™ Report from PWC and NVCA, Data: Thomson Reuters).

[4] Cannice, Mark V., and Cathy Goldberg (2009). "Venture Capitalists' Confidence, Asymmetric Information, and Liquidity Events", *Journal of Small Business and Entrepreneurship* (Routledge) 22 (2), pp. 141-164.

[5] NVCA and Thomson Reuters press release dated October 7, 2015.

and ROI potential. For example, Dixon Doll of DCM Ventures pointed to a "sharp falloff in VC-backed IPOs and angel funding plus soaring late stage valuations and companies staying private longer; summarized, simply getting liquid has gotten more challenging."

As indicated in recent quarterly reports, the impact of non-traditional investors in venture-backed firms may be exacerbating the inflated valuation problem. Karan Mehandru of Trinity Ventures explained "The gap between public and private technology company valuations is massive. Furthermore, the level of risk that late stage private investors are underwriting is unprecedented and, arguably, unwarranted in many cases. With many investments being led by oversees and public market investors dabbling in private markets, and with the public market correction in process, many of those investors will be over-weighted on private assets, which would result in a pullback of capital causing many high burn/high growth companies to reach the end of the cash runway with few liquidity options in sight." Additionally, Robert Ackerman of Allegis Capital argued "The broader innovation economy in the Silicon Valley has entered a phase of growth that is unsustainable. The massive influx of capital from outside of the traditional venture investment environment has inflated valuations and the costs of doing business for start-ups – expectations in some technology sectors are clearly running ahead of reality. A selective recalibration is inevitable and will ultimately be proven to be healthy."

Finally, Dag Syrrist of Vision Capital relayed "As we're entering the period where we don't even try to justify valuations, we're also boxing ourselves in with pricing that can't be supported by actual transactions. The public market will require both growth rates *and* profitability to support the multiples bestowed by the venture community, and of course accretive acquisitions are not possible so there's few exits and *none* at these valuations. So the party will last as long as there are funds willing to use equity to support the burn rate of companies launching services that feel a lot like they are mimicking what parents sometimes do for 22 year olds before they move out. I for one fear we're now somewhere in the beginning of the end period, especially when you look at the private / public ratios, both in terms of number of transactions and valuations of the deals, both of which are upside down."

High valuations at other stages and elements of global uncertainty may also be impacting confidence. For instance, a VC respondent who provided comment off the record, stated "Too much angel capital is pushing Series A valuations to unrealistically-high levels, and overcrowding too many product segments." Another responding VC also blamed high valuations for low confidence, and another mentioned "fear popping the 'unicorn' bubble in tech, and the biotech public market sliding, as well as market volatility given world events." More broadly John Malloy of BlueRun Ventures offered that "a noisy environment does not typically help the innovation process."

Despite broad concern over valuations, confidence that the potential of Silicon Valley-built technology firms will again be embraced by the public markets endured. For instance, Sandy Miller of Institutional Venture Partners detailed "There is a backlog of terrific venture-backed technology companies on file with the SEC to go public. As a few test the waters, I think they will meet with a good reception which will encourage others. The next 12 months should see more tech IPO activity. While there are warning signs, the U.S. equity markets should remain relatively strong, simply because there is no alternative for investors given the bleak conditions in Europe and China."

And technology trends continue to create opportunities for enterprising firms. Jeb Miller of Icon Ventures reported that "startups are continuing to thrive in the Bay Area as they capitalize on the massive disruption enabled by the platform shifts to cloud, mobile and big data enabled solutions." Eric Buatois of Benhamou Global Ventures concluded "The digital transformation of the enterprise is impacting every industry on a global basis. All the large corporations are working hard on connecting to Silicon Valley to identify new products and new business models to adapt to this new world. It will certainly create very large partnering opportunities for young companies both at the business development and merger and acquisition level."

High quality ventures continue to attract investment. Roy Thiele-Sardina of HighBar Partners shared "We continue to see high quality ideas and companies looking for funding. Many have initial traction before looking for funding." Bob Bozeman of Eastlake Ventures added "The opportunities being funded are increasingly worthwhile. However, local costs of living, talent required for growth, and overall capital requirements to breakeven continue to stress challenges for high investment returns. Overall SV is still advantaged because of ability to deploy capital behind aggressive talent, and disruptive ideas are getting solid backing."

Looking to the trend of increased capital availability as a boon to new venture creation and innovation, Igor Sill of Geneva Venture Management explained "My confidence level remains high as a result of venture capital's accelerated investment flow in 2015, due mostly to the many 'unicorns' with larger capitalization deals and higher valuations than anytime I can remember--greater than our dot.com 2000 era. As the public markets continue their bearish trends, capital has turned to the private, alternatives markets, specifically venture investing. There's an ample supply of capital and a slew of new investors. Venture investments are attracting Corporate Venture arms, Private Equity firms, Mutual funds, Family Offices, and Institutions by-passing the traditional Venture Capital investors. Competition for quality deals is higher than I've ever seen, fueling those higher valuations. The number of new quality startups, the increased amount of investment and the rate of disruptive startups are absolutely amazing. I believe this trend will continue well into 2016." Reinforcing Mr. Sill's point, one VC commented anonymously, attributing high confidence to the amount of money pouring into the venture space at "crazy high valuations."

In summary, average confidence among venture capitalists who responded to the Q3 survey fell sharply as a growing majority of venture capitalists expressed concern over valuations of later stage firms. The risks presented by these high valuations are compounded by the current slow down of the IPO market. However, despite a decline in IPO exits of venture-backed firms and a slow down in fundraising by VC firms, investments into portfolio companies remained high[6], nearly equaling the previous quarter's amount. While the venture business model is long term by nature, a rebalancing of fundraising, exits, and investments must at some point occur. Still, some see the abundance of capital as an opportunity to fund new innovation and new ventures that will in time help again transform and create new industries.

Patience, discipline, and vision will be needed to navigate what appears to be a current mismatch in private valuations, public market receptivity, fundraising and investment. Despite what may be near term challenges in financial metrics and cash flows, the powerful Silicon Valley ecosystem for new venture creation and innovation remains intact.

[6] NVCA press release dated October 16, 2015 (based on MoneyTree™ Report from PWC and NVCA, Data: Thomson Reuters).

Table 1

Participating Venture Capitalists in the 2015 3rd Quarter Confidence Index Survey

Participant	Company
Alain Harrus	Crosslink Capital
Andreessen Horowitz (firm)	Andreessen Horowitz
Bill Byun	7 Capital
Bill Reichert	Garage Technology Ventures
Bob Bozeman	Eastlake Ventures
Cindy Padnos	Illuminate Ventures
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Deepak Kamra	Canaan Partners
Dixon Doll	DCM
Eric Buatois	Benhamou Global Ventures
Gerard van Hamel Platerink	Redmile Group
Igor M. Sill	Geneva Venture Management
Jeb Miller	Icon Ventures
Jeremy Liew	Lightspeed Venture Partners
John Malloy	BlueRun Ventures
Jon Soberg	Expansive Ventures
Karan Mehandru	Trinity Ventures
Mohanjit Jolly	DFJ
Paul Holland	Foundation Capital
Robert R. Ackerman, Jr.	Allegis Capital
Ross Jaffe	Versant Ventures
Roy Thiele-Sardina	HighBar Partners
Saban Ventures (firm)	Saban Ventures
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Stephen J. Harrick	Institutional Venture Partners
Tom McKinley	Cardinal Partners
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D. is Department Chair and 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 Jack Cannice and Joe 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.