

# Silicon Valley Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: USFSVVICI)

Second Quarter – 2008

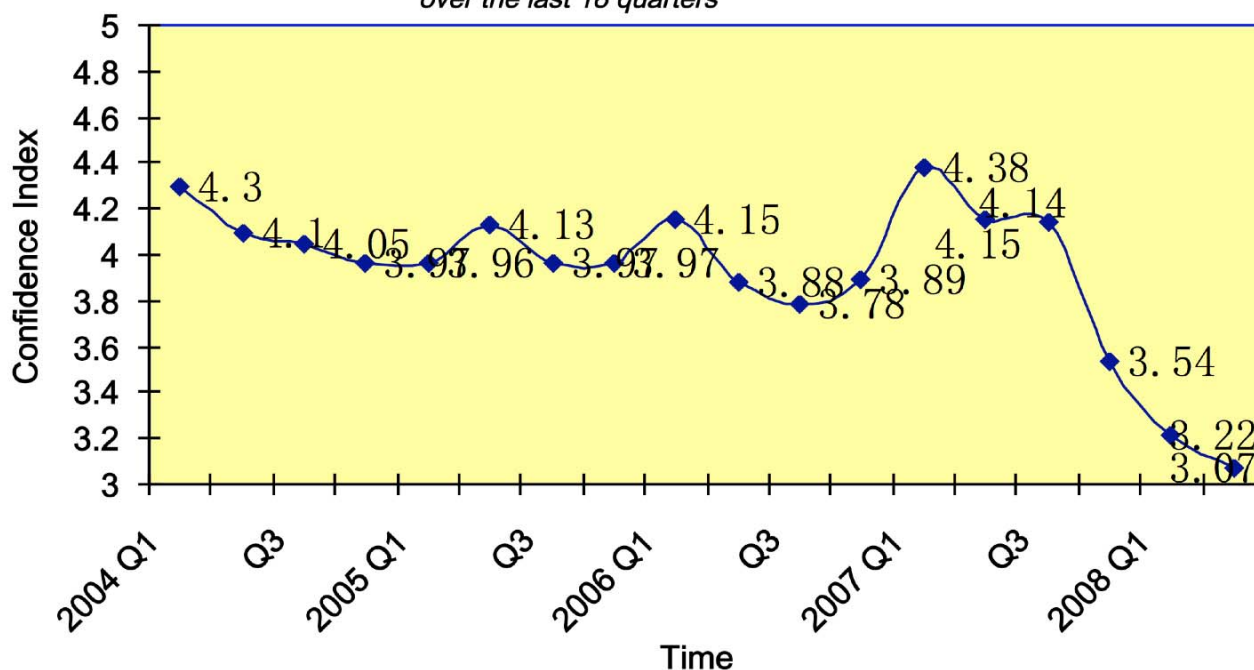
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The quarterly *Silicon Valley Venture Capitalist Confidence Index* (Bloomberg ticker symbol: USFSVVICI) is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index measures and reports the opinions of professional venture capitalists in their estimation of the high-growth venture entrepreneurial environment in the San Francisco Bay Area over the next 6 - 18 months.<sup>1</sup> The *Silicon Valley Venture Capitalist Confidence Index* for the second quarter of 2008, based on a June 2008 survey of 27 San Francisco Bay Area venture capitalists, registered **3.07** on a **5 point scale** (with 5 indicating high confidence and 1 indicating low confidence). This reading fell from the previous quarter's reading of 3.22 to a third consecutive new low since the Index was originated in Q1 2004 and indicates a continuing downtrend in venture capitalists' confidence. Please see Graph 1 for trend data.

Graph 1

Trend line of Venture Capitalists' Confidence  
over the last 18 quarters



<sup>1</sup> 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.

The continuing significant drop in venture capitalists' confidence over the last three quarters is unprecedented in the four and a half year history of this quarterly index and indicates a on-going decline of sentiment among the majority of surveyed venture capitalists regarding the future high-growth venture environment in the Bay Area. It bears noting that the major decline in VC confidence in Q1 of 2008 preceded the worst quarter (Q2) for venture-backed IPOs in 30 years, with no venture-backed firms completing an IPO (according to the NVCA). Therefore, the further decline in confidence in Q2 would appear to signal continuing difficulty for the near term entrepreneurial environment. 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 save those who wished to remain anonymous.

**The deteriorating economic landscape was the most often cited reason for a more difficult venture environment and lower confidence.** For example, Shomit Ghose of Onset Ventures pointed to the decelerating economy which is negatively impacting the public equity markets and potential liquidity events for venture-backed firms. Jim Marshall of Selby Ventures also singled out macro economic concerns. Additionally, Steve Carnevale of Point Cypress Ventures stated "We are headed for a major economic problem worldwide... This will impact revenue generation of portfolio companies, as well as exit strategies and funding sources. There will as always be exceptions where some companies do well in a down market. But these will be the exceptions." Two other respondents, who wished to remain anonymous, also emphasized the declining financial markets for lower optimism.

Linking volatile exchange rates to the problematic venture market, Igor Sill of Geneva Venture Partners reasoned that the weaker U.S. dollar signals a more difficult global environment ahead for venture-backed companies. Concern over the impact of oil and rising inflation was also voiced. Kirk Westbrook of invencor observed that in the "past few months there seems to have been a 'wait and see' attitude impacting business operations. The continued escalation in oil is beginning to dampen this and could potentially cause developed world inflation that grinds any growth to a halt. The economic fissures that are emerging globally will only worsen as oil remains at \$140 or higher per barrel."

**The broader economic downturn is affecting venture valuations as well.** Joe Mandato of De Novo Ventures explained "There is uncertainty in the market. While deal flow remains high, there is not yet an appreciation for the implications of the economy on the exit market and pricing of those exits. This has caused a lengthening of the decision making process for VC's and pricing pressures on the pre-money values of venture investments."

**And venture financing is harder to come by.** Debra Beresini of invencor indicated that "Many venture firms have money to invest in entrepreneurial companies now. Most, however, are holding onto cash – it could be a reaction to the downturn of a few years ago." A derivative to this notion of tighter money was made by an anonymous survey participant who stated that "the follow on financing environment requires that any companies currently in one's portfolio perform at a high level." And Igor Sill of Geneva Venture Partners concurred, saying "Concerns over higher rates will naturally slow growth and the availability of venture capital follow-on funding." David Epstein confirms that the "IPO market is non-existent and larger companies are not willing to pay for smaller companies which would not be accretive day one. This means exits are not plentiful, leading to VC's wanting to conserve cash and move slower in findings which in turn lowers valuations."

**But some areas of the venture environment seemed stronger than others.** Bryant Tong of Nth Power is still very bullish on selected sectors of the clean tech space. An anonymous respondent echoed this view, arguing that while "Overall US economic growth is slowing down, clean tech and biotech may attract more funding due to higher natural resource prices." And Kurt Keilhacker of TechFund shared

“While the market is slowing down exits in IT related investments, interest and demand for solutions in Cleantech is fueling medium term optimism.”

**With exits stalled, financing more difficult to come by, and valuations lower, it appears that a new equilibrium is being established.** Sandy Miller of Institutional Venture Partners explained “Supply and demand in the venture market are coming into a balanced state. Private companies doing new financings are finally adjusting their valuation expectations to reflect the weakened broader financial market reality. As is typical, it took about a six month lag. At the same time there is plenty of venture capital to invest in the large number high-performing companies.”

**Despite and perhaps because of current difficult market conditions, some venture capitalists expressed optimism about the future venture environment.** For instance, Steve Harrick of Institutional Venture Partners contended “Entrepreneurship is persistent and adaptive. This is a good time to be building innovative businesses away from public market scrutiny.” Similarly, Dag Syrrist of Vision Capital offered, “In hard times we generally make better investments, companies make better decisions, cash lasts longer and great companies are formed.” And an anonymous respondent indicated “there are a lot of good ideas and entrepreneurs coming with some very sound technology intensive ideas.” And Igor Sill concluded “The shining light ahead in Silicon Valley are those well positioned software companies offering a disruptive sales model (ala SaaS) Open Source and fraud prevention providers which become more attractive to recession affected corporations.”

And hope for a better liquidity market in the medium term remains. Bart Schachter of Blueprint Ventures expects that “The IPO market will re-open in 2009 as the credit and housing crises ease and the US is headed by a new administration.”

**While the current turmoil in the broader economy and capital markets has made for a difficult venture environment at present, these conditions may also act as the proving ground for a new group of more resilient enterprises.** Venky Ganesan of Globespan Capital Partners summed up this view, stating “To paraphrase Dickens, It’s the best of times and it’s the worst of times. If you consider the cocktail mix of the credit crunch, high commodity prices, deteriorating consumer confidence and the lack of IPO exits for the venture capital community, then it’s the worst of times. Exits are the river Nile of the venture business and I am afraid the river has been dry for too long. However, if you are an incredible entrepreneur with an innovative idea then this is the best of times. Rents are cheap, people are available and the tourists are gone. While its hard to imagine now, some day in the future the economy will boom, consumers will buy, and, gasp, even housing will go up, and if you lay the seeds of growth now, you will reap then. Be greedy when others are fearful.”

**To sum**, the current harsh economic conditions have led to the lowest level of venture capitalists’ confidence in the 4.5 year history of this index. The previous low points in VC confidence in Q4 2007 and Q1 2008 preceded the dramatic slow down and halt to venture backed IPOs in Q1 2008 and Q2 2008, respectively. Therefore, the insight of the responding venture capitalists in this survey appears to be well tuned to the near term functioning of the public capital markets with respect to venture-backed liquidity events. Further, in a recent press release regarding the drought of IPOs of venture-backed firms, the National Venture Capital Association stated that “the situation is concerning enough to be characterized as a capital markets crisis for the start-up community.”<sup>2</sup>

The confluence of poor current economic conditions and lower confidence in the future portends a difficult venture environment in the near term. With the stalled exit market continuing into a third quarter

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<sup>2</sup> “NO VENTURE-BACKED IPO’S ISSUED IN THE SECOND QUARTER OF 2008”, National Venture Capital Association press release, July 1, 2008.

and the resulting strain on the business model of venture firms; financing and valuation metrics are likely to be tightened and portfolio firm oversight increased. The return of a more liquid and welcoming public capital market would, of course, mitigate these hurdles, but, in the near term, entrepreneurs and their venture backers, will necessarily develop new innovative ways to launch, build, and grow ventures in the current economic reality. However, as some responding venture capitalists have pointed out, the current harsh environment may provide the proper catalyst for the formation of new enterprises that will be more resilient to tough market conditions and thus more successful and sustainable in the long term.

**Table 1**

**Participating Venture Capitalists in the 2008 1<sup>st</sup> Quarter Confidence Index Survey**

| <b>Participant</b> | <b>Company</b>                 |
|--------------------|--------------------------------|
| Bart Schachter     | Blueprint Ventures             |
| Bryant Tong        | Nth Power                      |
| Chester Wang       | Acorn Campus Ventures          |
| Christian Cortis   | Advanced Technology Ventures   |
| Colin Wiel         | Keiretsu Forum                 |
| D. Kirk Westbrook  | invencor                       |
| Dag Syrrist        | Vision Capital                 |
| Dave Epstein       | Crosslink Capital              |
| Debra Beresini     | invencor                       |
| Deepak Kamra       | Canaan Partners                |
| Eric Buatois       | Sofinnova Ventures             |
| Igor Sill          | Geneva Venture Partners        |
| Jeb Miller         | The Carlyle Group              |
| Jim Marshall       | Selby Partners                 |
| Joe Mandato        | De Novo Ventures               |
| Kathryn Cavanaugh  | De Novo Ventures               |
| Kurt Keilhacker    | TechFund                       |
| Sandy Miller       | Institutional Venture Partners |
| Shomit Ghose       | Onset Ventures                 |
| Steve Carnevale    | Point Cypress Ventures         |
| Steve Harrick      | Institutional Venture Partners |
| Steve Sullivan     | Skyline Ventures               |
| Tom Fountain       | Mayfield Fund                  |
| Venky Ganaesan     | Globespan Capital Partners     |
| Wende Hutton       | Canaan Partners                |
| Anonymous          | Anonymous                      |
| Anonymous          | Anonymous                      |

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