Silicon Valley Venture Capitalist Confidence Index™

(Bloomberg ticker symbol: USFSVVCI)

Third Quarter – 2008

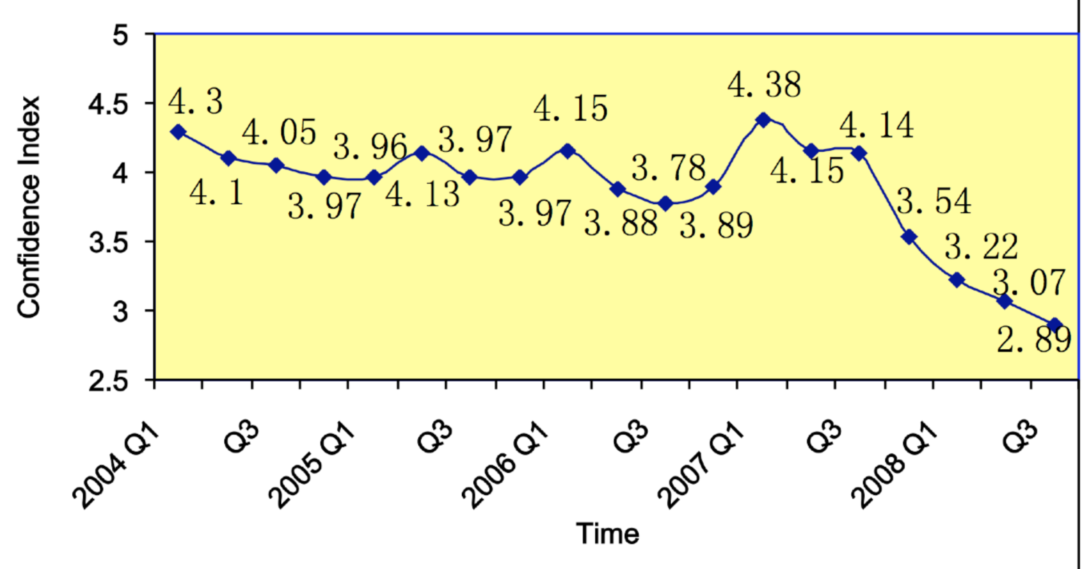
(Release date: October 15, 2008)

Mark V. Cannice, Ph.D.
University of San Francisco

The quarterly *Silicon Valley Venture Capitalist Confidence Index™ (Bloomberg ticker symbol: USFSVVCI)* 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 third quarter of 2008, based on a September 2008 survey of 33 San Francisco Bay Area venture capitalists, registered* ***2.89*** *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 3.07 to a *fourth consecutive* **new low** since the Index was originated in Q1 2004 and indicates a continuing downtrend in venture capitalists' confidence. Please see Graph 1.

Graph 1

Trend line of Venture Capitalists' Confidence over the last 19 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.

The unprecedented deterioration of macro economic conditions and the resulting impact on the venture capital business model were cited most often by this study's responding venture capitalists as the factors that negatively impacted their confidence in the near term environment for growth ventures. The expanding credit crisis that began in residential real estate and infected the banking and financial system now also weighs heavily on key elements of the VC business model. Specifically, the volatile public financial market has dashed the IPO hopes of most venture-backed firms for now. Thomson Reuters and the National Venture Capital Association reported on October 1 that only six venture-backed firms have had an IPO in 2008; this is the lowest number since 1977.[2] While the lack of IPO exits has adversely impacted the sales side (liquidity events) of the VC business model this year, the precipitous decline in the value of stock portfolios of some limited partners (e.g. pension fund asset managers) will likely limit the amount of capital committed to venture funds in the near term. Further, the disposition of venture firms such as Lehman Brothers Venture Partners[3] brings additional uncertainty[4]. However, despite the upheaval in the financial markets and the growing concern among many of this study's participants, some responding venture capitalists expect this might be a good time to launch a firm, noting that history points to the establishment of successful new ventures during difficult economic times. This counter cyclical sentiment may be based on the lower capital needs of seed stage firms and the longer-term time horizon of the venture industry.

While the Index has hit its lowest point to date, this quarter's respondents had the widest range of confidence since I began this survey nearly 5 years ago with responses ranging from very confident (5) to quite cautious (1). This breadth of opinion to some degree reflects the wild swings of sentiment and direction in the public financial markets. Still, the coming quarters appear to present a difficult environment. In the following I provide many of the comments of 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 accelerating economic decline continued to weigh on venture capitalists' confidence. For example, Bryant Tong of Nth Power shared that his confidence is lower than last quarter due to the uncertainty of the financial markets. An anonymous contributor also pointed to the "overall financial meltdown" for his lower confidence. Expecting a long-term negative impact of the financial market crisis, Kirk Westbrook of invencor offered that "There are so many unknown variables in the world economy at the moment that I think the near term will be a challenging time. ….The underlying psychological sentiment targeting the financial sector may be hard to turn optimistic in a short period of time. I am concerned this will continue to creep more broadly beyond financials into the world markets. Much like the late 80's and early 90's, I believe that growth will be challenged by market and psychological forces for the next 9-12 months in the best case scenario." And, predicting that the financial market contagion will broaden further, Bart Schachter of Blueprint Ventures argued that "National and international economic developments will eventually reach into all asset classes including venture."

Dag Syrrist of Vision Capital explained how the deepening economic crisis will directly and negatively impact the venture business model stating "*Venture funds are frozen with uncertainty*. Until some pro-longed data showing the economy and markets stabilizing appears, funding will not increase again. While venture has the capacity to be counter cycle, the majority of funds follow others in their investment activity and, therefore, will wait a significant period of time before increasing the deployment of capital. The combination of no exits and companies not meeting plan, forces funds to focus on existing portfolio companies rather than new opportunities. The funds who have a critical mass of capital and long term LP

[2] Thomson Reuters and the National Venture Capital Association (October 1, 2008). Venture-backed IPO drought continues in the third quarter of 2008".
[3] Miller, Claire Cain (September 30, 2008). "Lehman to spin off venture capital arm?" New York Times.
[4] Schonfeld, Erick (October 2, 2008). "What will happen to Lehman's Start-up Orphans?" TechCrunch.

relations, and the experience of deploying capital ahead of improved market conditions, will do just fine, but they will be in the minority."

Numerous responding venture capitalists linked the worsening economic environment and sparse liquidity opportunities to their cautious outlook. TC Wang of Acorn Campus noted "The current financial market mess will essentially block the IPO and most of the M&A deals for quite a while. Without a clear exit strategy in sight, it is hard to finance new deals." Joe Mandato of De Novo Ventures elaborated "At this time I would continue to rate the environment a 3.5, not for lack of venture money, nor a lack of credible deals, but because of the uncertainty surrounding the timing and form of exit options." Similarly, Dan Lankford of Wavepoint Ventures indicated "Deal flow and investment continue to be reasonably strong. The biggest issue is the lack of exits." And Standish O'Grady of Granite Ventures indicated that "Innovation and interesting new companies continue to flow, but the broader capital markets (and no IPO market) are obvious concerns."

David Epstein of Crosslink Capital extended the liquidity problem discussion to other aspects the venture business model, explaining "With the volatile markets, and little hope of an IPO market for at least the next 6 months, we will be continuing this adjustment period which realigns the entrepreneur's valuation expectations with those that allow for a reasonable ROI to the VC's given longer holding periods and reduced public valuations. This, along with the short term reduced prospects of institutional fund raising for the asset class, will further slow the deployment of capital." In a similar vein, Graham Burnette of SBV Venture Partners said "While entrepreneurial activity continues to be strong, exits from investments require strong and trustworthy capital markets. I think that the issues in the capital markets are going to take quite some time to work out, which means a very poor environment for exits. Without exits, venture investing will be weak." And an anonymous contributor confirmed "General concern about the financial market as well as the lack of the next big investment thing will reduce venture funding by investors (the amount of capital flowing to the asset class)."

Pointing to the direct impact of the financial markets on the management of start-up enterprises, Kurt Keilhacker of TechFund Capital indicated that "Clearly the markets are in a state of unparalleled volatility. Such volatility makes intermediate planning challenging for start-ups and makes cash management especially key. Start-ups that are able to build or maintain technological beachheads while managing cash carefully will find themselves in a future terrain with a lot fewer competitors." And Daniel Ciporin of Canaan Partners reasoned that "given the current environment the bets on early stage companies will need to be larger than usual, with higher risks."

Explaining how recent government action and the disposition of Lehman's venture fund could further impact the venture industry, Igor Sill of Geneva Venture Partners offered "… The recent US economic bailout plan for Wall Street will certainly impact Silicon Valley in a negative fashion. Primarily, the valuation of portfolio holdings by venture funds will undoubtedly drop significantly. The impact will surely be felt in the 2nd Quarter of 2009 as venture firms issue K1s and revised financial statements to LPs. Lehman Brothers Venture arm is in the process of selling its $1.1B venture portfolio for an as yet undisclosed amount, though most in the know project it is 35-40% below valuation book metrics. Silicon Valley follow-on portfolio investments will be very tight and few, with numerous shutdowns of poor performing investments. Fund raise closings for new venture funds will drop significantly as appetite for the asset class diminishes. A "wait and see attitude" will prevail for the next 6-9 months." David Epstein also noted that portfolio firms' values would need to be adjusted based on public comparables projected at the time of an exit.

A comprehensive analysis of the future prospects of the venture industry within the context of the harsh macro environment was provided by Steve Carnevale of Point Cyprus Ventures who concluded that "This is forming to be a perfect storm for the venture capital industry that may result in a significant contraction of firms and capital. This storm has two fronts. The US economy and the long investment cycle associated with life sciences and clean tech. First, the economy as a whole. The US is bankrupt as a country as a result of massive borrowing that has grown over 30 years. This borrowing created an inflated investment portfolio that made available capital to tertiary alternative investments like venture capital. We are at the beginning of a massive deleveraging that has unprecedented consequences for the economy and the venture capital industry. …The industry will contract not only because of overall economic weakness, but because the fundamental investment cycle will be dramatically longer. …Now the majority of venture capital is going into life sciences and increasingly clean tech. These types of investments will take longer to produce returns then in the traditional VC investments in the computer industry. When institutional investors figure that out, they will reduce their capital availability for this kind of alternative asset. …Therefore, the VC industry will get sandwiched between the economy and it own fundamentals."

While the majority of responding venture capitalists expressed a sobering view on the near term future, a number of venture capitalists had notably higher optimism in the high-growth venture environment. David Pidwell of Alloy Ventures contended that the venture market is still working, observing "The high tech entrepreneurial market seems to be immune from the financial crisis that has reached epidemic levels on Wall Street." And some VCs focused on emerging market opportunities and the declining costs of launching a new firm. Bruce MacNaughton of Crosslink Capital forecasted "many opportunities for valuable company creation as buyers focus on increased productivity as well as saving money and energy." And Colin Wiel of Keiretsu Forum noted that "Capital is harder to come by, which is a challenge. Conversely, resources are cheaper and easier to come by, including talent, office space, legal help, etc."

The venture capital investment cycle extends beyond the public market volatility, and some study participants emphasized this fact in supporting their more optimistic outlook. For example, Eric Edmondson of Seven Hills Partners stated "Despite current market turmoil, we remain very optimistic about the resilience in the entrepreneurial environment in California. One has to take a longer-term view. We have a unique environment which provides entrepreneurs with a support structure in terms talented individuals, and availability of capital." And Debra Beresini of invencor shared that "There is no doubt that this is a difficult market for everyone. Venture firms which are actively investing will slow down their investment rate, but these firms will still be active. The exits for new investments are four to six years into the future, and thus, not necessarily impacted by today's market. Venture funds which are trying to exit have the most difficult task. There have been few choices in exit activities over the last few years, but now there are no choices. With that being said, biotech is still a good bet, and for those firms which invest in specialty commodity companies especially in food and beverage or "green" technologies, there are many opportunities available. The world will survive this economic crisis, as it has in the past; we need to find a strategy that prevents the economy from derailing in the future."

Voicing serious concern but holding out hope for the entrepreneurial spirit, Venky Ganesan of Globespan Capital Partners related "We are in the midst of a perfect storm - declining housing market, credit crunch, massive deleveraging of the economy and an IPO market that is closed. However the entrepreneurial spirit that has driven America remains strong and we will innovate our way out of this situation. In 232 years of history it has never made economic sense to bet against America and that has not changed. Right now as we navigate through this terrible financial morass, somewhere in a garage two young intrepid founders are creating the next Google. They are the future."

Also focusing on the resilience of entrepreneurs, Eric Buatois of Sofinnova Ventures suggested that "Good entrepreneurs push their ideas independently of the financial market cycle. The potential lay off from large companies will incite good entrepreneurs to take a shot at creating their own companies." And Bill Reichert of Garage Technology Ventures reasoned that "I continue to be bullish on entrepreneurship; it's the best part of the economy to be in during times like this. Over the near term, some investors and some entrepreneurs will give up, but that will only clear the forest floor for the next wave of entrepreneurs and innovation. If you are lean and scrappy, you've got a tremendous advantage over competitors big and small in times like these."

Relying on the lessons of the past Robert Ackerman, of Allegis Capital reasoned that "History has repeatedly shown that many of the most successful start-ups have their origins in particularly challenging markets. In order to be successful, you need to have a clearly better idea with a laser like focus and a tremendous amount of discipline around cash. These are all good things. There may be less start-up activity over the next 12 to 18 months but what there is will be of a materially higher quality. This is good for entrepreneurs as well as venture investors." In a similar theme, Chris Rust of US Venture Partners suggested, "Downturns are historically the best time to start new businesses." He continued, "The Bay Area has adopted a strong export mentality, and the weakened dollar is helping exports." Mr. Rust concluded that the tech community has quickly moved to the forefront of high-growth emerging market areas such as cleantech, biotech, mobile internet, internet advertising, massive multi-player online games, virtual worlds, and cloud computing; and, highly skilled company builders are continuing to launch new VC-backed companies at a healthy pace.

To sum, the worsening economic conditions have led to the lowest level of venture capitalists' confidence in the nearly five year history of this index. The quarter's decline followed the three consecutive previous low points in VC confidence dating back to Q4 2007. Worth noting is that VC confidence in the future environment began to decline markedly in Q4 2007 which was a good quarter for venture-backed IPOs. Therefore, it appears the insight of the responding venture capitalists in this survey is well tuned to the near term future functioning of the public capital markets with respect to venture-backed liquidity events. In a related empirical study that examined the relationship between VC confidence and IPOs of venture-backed firms[5], I found with my co-author, Cathy Goldberg[6], that declines in VC confidence preceded declines in the dollar volume of IPOs of venture-backed firms. Therefore, the current downward trend in VC confidence appears to portend fewer IPO exits in the near term.

With the stalled exit market continuing into the fourth quarter 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. Further, the appetite for capital commitments to venture funds by LPs may diminish. This negative spiral of two key components of the venture business model seem likely to somewhat constrain new investment in the medium term. The confluence of significant stress on the venture business model, lower VC confidence, and poor macro economic conditions suggests a continuing difficult venture environment. 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.

---

[5] Cannice, Mark V., and Cathy Goldberg (forthcoming). "Venture Capitalists' Confidence, Asymmetric Information, and Liquidity Events", (forthcoming), *Journal of Small Business and Entrepreneurship* (Journal of the Canadian Council of Small Business and Entrepreneurship).

[6] Cathy S. Goldberg, Ph.D. is an associate professor of finance with the University of San Francisco School of Business

Table 1

Participating Venture Capitalists in the 2008 3rd Quarter Confidence Index Survey

Participant	Company
Bart Schachter	Blueprint Ventures
Bill Reichert	Garage Technology Ventures
Bruce MacNaughton	Crosslink Capital
Bryant Tong	Nth Power
Chris Rust	U.S. Venture Partners
Colin Wiel	Keiretsu Forum
D. Kirk Westbrook	invencor
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Daniel Ciporin	Canaan Partners
Dave Epstein	Crosslink Capital
David Pidwell	Alloy Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Eric Buatois	Sofinnova Ventures
Eric Edmondson	Seven Hills Partners
Graham Burnette	SBV Venture Partners
Igor Sill	Geneva Venture Partners
Jeb Miller	The Carlyle Group
Joe Mandato	De Novo Ventures
Kurt Keilhacker	TechFund Capital
Robert Ackerman	Allegis Capital
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Steve Carnevale	Point Cypress Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
TC Wang	Acorn Campus
Tom Fountain	Mayfield Fund
Venky Ganaesan	Globespan Capital Partners
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D.* is an Associate Professor of Entrepreneurship and the Executive Director and Founder of the University of San Francisco Entrepreneurship Program (recognized among the leading entrepreneurship programs in the US).

*The author wishes to thank the participating venture capitalists who generously provided their expert commentary and analysis as well as Tomosue Den, USF MBA Candidate, for his extensive survey and technology support. Webmasters are welcome to link to this page with courtesy notification to Cannice@usfca.edu. To post this report on your website, please request permission by email to Cannice@usfca.edu. 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 full name of the author. Reports for previous quarters may be found at www.Cannice.net**.**