Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: USFSVVCI)

First Quarter – 2010

(Release date: April 29, 2010)

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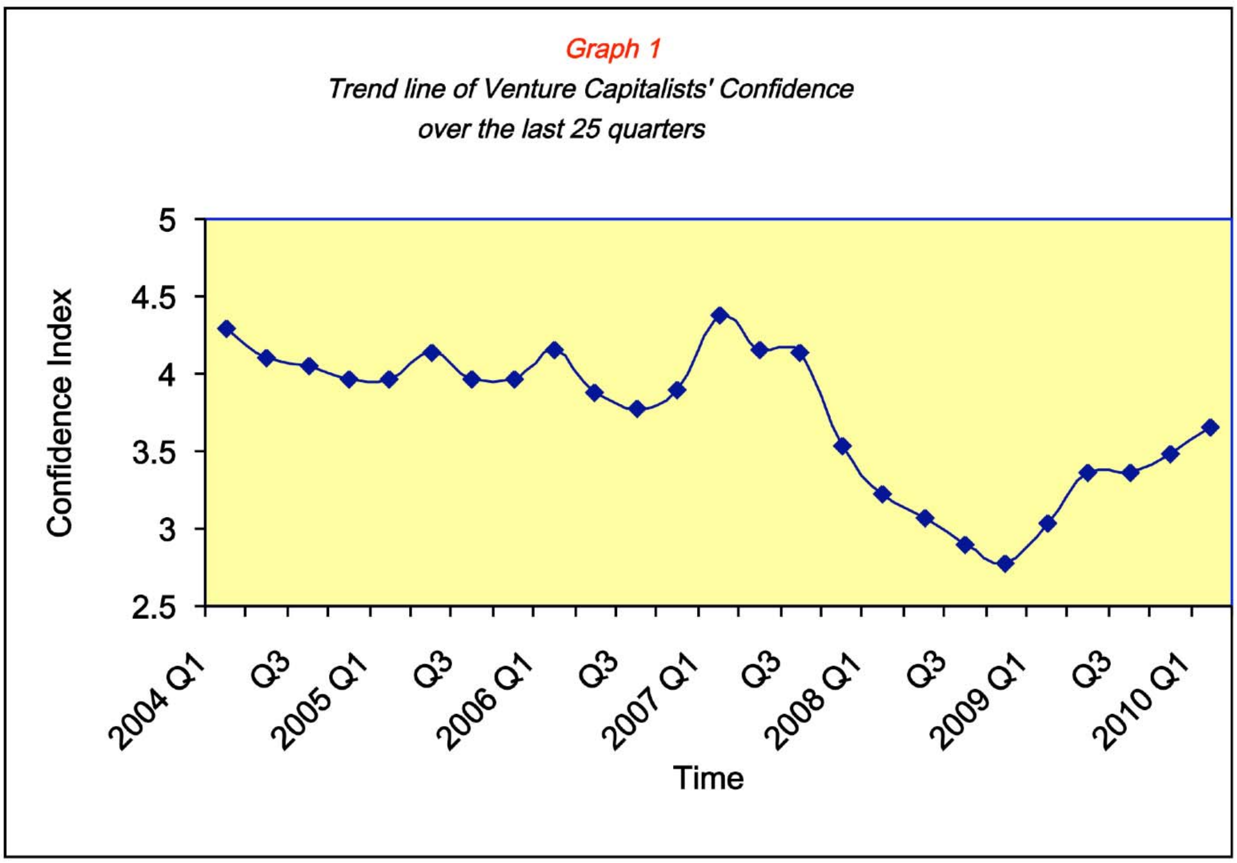
The quarterly *Silicon Valley Venture Capitalist Confidence Index® (Bloomberg ticker symbol: USFSVVCI)* is based on an on-going survey of San Francisco Bay Area/Silicon Valley venture capitalists. The Index measures and reports the opinions of professional venture capitalists in their estimation of the 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 first quarter of 2010, based on an April 2010 survey of 36 San Francisco Bay Area venture capitalists, registered **3.65** on a **5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence.) This quarter's index reading rose significantly from the previous quarter's reading of 3.48 and confirms a continuing upward trend in VC confidence since its five-year low in Q4 2008. Please see Graph 1.



[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. Questions about this study or related issues should be addressed to the author at Cannice@usfca.edu.

Confidence in the high-growth entrepreneurial environment continued to climb among Silicon Valley Venture Capitalists in the first quarter of 2010. An improving exit environment[2] supported by a recovering macro economy and surging public financial markets pointed to growing opportunities for entrepreneurial firms and their venture backers. Heightened focus on disruptive product solutions and learned operating efficiencies made necessary by the last two years of economic trauma has also helped position many venture-backed firms for a potential public debut. Further, corporate acquirers, flush with cash and appreciated stock, stand ready to make acquisitions that are motivated by technology and competitive necessity.

Still, caution remained over the long-term health of the venture industry itself. Concern emerged that limited partners' patience over the recent returns from private equity is near an end, and will result in a compression of investment among fewer venture funds. This growing aversion to risk may then make venture financing more conservative and less accessible to promising but less experienced entrepreneurs. However, while caution remains, sentiment is notably up among the majority of VC respondents in this quarter's survey. 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.

Optimism in the high-growth venture environment was expressed by a growing number of venture capitalists that responded to the Q1 2010 survey. For example, Venky Ganesan of Globespan Capital Partners offered that "As we transition from our winter of despair to the spring of hope, technology companies are leading our economy out of its recession. We are seeing numerous venture-backed companies (some in our own portfolio) that are experiencing strong growth due to their innovative products. These leading companies will both create excellent returns for their investors as well as much needed jobs for our economy. I remain very bullish about the high-growth venture environment in the Bay Area." And Bill Reichert of Garage Technology Ventures indicated "Startups will always emerge in surprising, high-growth sectors, and the environment supporting the start-up ecosystem has definitely improved."

Sandy Miller of Institutional Venture Partners explained "I am optimistic looking out for the next 12 months. There is a nice balance of demand and supply in venture capital. Tech industry fundamentals are much stronger. Innovation in technology is accelerating. The exit environment has obviously improved with tech IPOs working well as big tech acquirers are flush with unprecedented levels of cash. The improved environment has actually encouraged more private companies to finance. So the next year should be an active year." Further, Joe Mandato of De Novo Ventures asserted "The industry is back from the precipice and for those funds with money, there is great opportunity." And Igor Sill of Geneva Venture Partners detailed "Having survived these last eight quarters of cost-cutting and layoffs, there are finally signs of a solid recovery in the venture industry. LPs are finally receiving draw down notices, venture capital is actively being deployed, portfolio holdings are gradually starting to hire, funding expansions and restoring employee benefits…"

New disruptive markets appear to be emerging. Bruce MacNaughton of Crosslink Capital observed that "There is a lot of change in mobile, consumer online behavior, secure computing needs, financing, and energy. Anytime there is change, there is opportunity for innovative companies to capitalize by moving more quickly than the established players. We like what we're seeing." Jeb Miller of JAFCO Ventures attributed his confidence to an "improving exit climate, availability of quality entrepreneurs and management team members, disruptive market opportunities and ability to compete against incumbents

[2] Dow Jones VentureSource reported that eight U.S. venture-backed companies IPOs occurred in the first quarter of 2010. This number matches the number of venture-backed IPOs for all of 2009 (April 1, 2010).

with stagnant product development." And Tom McKinley of Cardinal Partners added "…Healthcare IT is one area where there is increased interest by venture capitalists."

And the overall economic environment continues to improve. Bob Pavey of Morgenthaler Ventures shared "There is a pretty good chance that we have seen the bottom and things are getting better – in fits and starts." Kirk Westbrook of invencor reasoned "It seems to be the growing consensus that the overall death of the US economy has been avoided. Clearly issues remain, but relative to other developed countries those problems seem solvable. Further, some major emerging markets that had recently shown signs of stumble also seem to be getting their bearings. I believe that the emergence of optimism can been seen in the recent public offerings, M&A activity and overall liquidity in the system. It may not be the heyday, but certainly the economy is demonstrating indications of an improved condition." Daniel Ciporin of Canaan Partners elaborated "The continuing attraction of an entrepreneurial lifestyle and business with what increasingly looks to be a V-shaped recovery will prove powerful over the next two years for high-growth technology focused companies."

And Shomit Ghose of Onset Ventures opined "Like a baseball fan during spring training, I'm cautiously optimistic for what the year will bring. The macro-economy continues to slowly improve and this will increase exit opportunities for the strong tech start-ups that are out there today."

In fact, growing exit opportunities are increasing VC confidence and encouraging more investment. Richard Yen of Saban Ventures observed "Steady improvement in the IPO and M&A markets have provided encouragement to both investors and entrepreneurs." Likewise, Eric Buatois of Sofinnova Ventures stated the "IPO market is slowly opening, and large tech firms are buying a lot of new products creating a good liquidity window for venture capitalists. With a better grip on liquidity events, venture capitalists are going to invest in more companies."

Chester Wang of Acorn Campus Ventures also noted "Some opening of the IPO window now and more opportunity in the US/Asia market development." Graham Burnette of Red Planet Capital confirmed "The IPO window is open, with the result that venture investment money is flowing again." He added "True entrepreneurship does not ebb and flow on business cycles, and we continued to see good ideas through the downturn, but it is obvious that word spread very quickly as investments picked up. We are seeing a sharp increase in the number of unsolicited business plans coming in the door." And Bryant Tong of Nth Power commented that "…the Cleantech space continues to be promising, but the real validator of this sector will be the success of the potential exit opportunities over the next year."

I*ndustry demand for next generation innovations may spur further acquisitions.* Kurt Keilhacker of TechFund Capital noted "After underinvesting for several years in R&D, large tech companies are sending more signals that they need to acquire next generation technologies in high growth areas."

However, some respondents indicated that a fundamental change in the VC industry is underway. Dan Lankford of Wavepoint Ventures explained "There is clearly a thawing in the VC funding environment, and, even more obvious, in the exit environment for existing portfolio companies. I think we are also seeing a fundamental re-alignment of the VC world. As the costs of starting many kinds of companies continues to fall, smaller amounts of capital are required, and seed stage investing is increasingly the world of angels and small funds. While some types of deals (supply side energy, pharma, etc.) still require deep pockets, the availability of cloud computing, outsourcing, virtual teams, etc. makes many types of deals increasingly economical. Many companies require less than $10m to get to CFBE, which means that attractive exits can be had at relatively low valuations. While the returns on seed stage investing continue to be attractive, it can be difficult for that asset class to absorb a lot of capital."

And limited partners may be accelerating this transition. Dag Syrrist of Vision Capital observed that "Institutional investors are continuing to reduce their allocations to venture and re-evaluating their need for the asset class given poor historic performance…" He added that (institutional investors) are "…reducing the number of GPs they want to support, and expanding capital commitment to fewer firms rather than supporting emerging managers." He concluded that "These trends will concentrate capital in larger, more established firms, who in turn become more like broad based asset managers which in turn will reduce the amount of capital deployed to new funds. Returns from highly innovative and ground breaking new ventures are limited by investor's willingness to take longer term risk, reflecting LPs reduced ability and support of risk." Similarly, a venture capitalist respondent who wished to remain anonymous, shared "…the current LP fundraising environment and the recent (5-10 years) return profile for venture as an asset class, will lead to a significant culling of the venture capital world over this time period."

Tom Rodgers of ATV Capital explicated further, stating that the "Venture industry is in the process of adjusting to the new normal. There is less money going into funds from LPs. Firms are more parsimonious about how they deploy the capital that they have. Although the exit climate is showing signs of warming up, it hasn't changed the fact that even the good companies are taking more time and more money. And, as a the result, the bar has been raised on the companies that will receive funding. Entrepreneurs and the VCs that fund them are resilient. This will work itself out over time, but not without some further pain and anxiety."

Thus, the road may be tougher for new entrepreneurs. Christian Cortis also of ATV Capital explained "We are seeing capital continue to concentrate around the highest quality teams and technologies, thereby increasing the gap between "have" and "have not" companies. While the trend may lead to a healthier next generation of venture-backed companies, it is raising the bar for first-time entrepreneurs and may lead to a decline in start-up formation."

This lack of capital for seed stage firms may drive new more capital efficient and unique business models. Victor Hwang of T2 Venture Capital noted "The macro-economic climate has created an uneasy tension between high levels of entrepreneurial energy and the ongoing lack of capital for the launch of new companies. Gobs of entrepreneurs + drop-off in Series A capital = more bootstrapping, good ideas stuck in neutral, and more dependence on federal dollars." Meanwhile, Debra Beresini of invencor emphasized the need for focus by entrepreneurs, stating, "…The key to growth in this environment is how to differentiate the company in the market and with the business model while not crossing that thin line into an area that is unproven - this is definitely not an environment for those who like to follow the rules or are timid. Differentiation is the key."

FDA regulatory uncertainty was also raised as an issue of concern. Tom McKinley of Cardinal Partners emphasized "I am very concerned about the FDA and 510K process and changes in the regulatory environment that will cause major issues with respect to small companies and human clinical trials for new products. The life science and medical device areas are more difficult to raise money for from existing companies and new money is very difficult too..." Tom Rodgers of ATV Capital added "The most important thing we are struggling with is uncertainty caused by FDA reform, healthcare reform, the overall economy, etc." And one respondent who wished to remain anonymous confirmed "Significant uncertainty related to FDA timelines and unexpected FDA behavior in general that will impact investment in the healthcare entrepreneurial environment for the next 6-18 months."

In sum, the prevailing sentiment among the respondents of the Q1 survey is that of increasing optimism based on improved VC business model metrics. That is, an improved exit environment is increasing liquidity opportunities for venture firms and providing better returns to limited partners. It follows that more liquidity events will free venture firms from needing to continue to finance some senior firms in their portfolios, thus, allowing investments in more new ventures[3], and increasing returns will encourage continued LP participation in venture funds[4]. Further, disruptive market opportunities are being exploited by venture-backed firms, making them attractive acquisition targets by corporations who may have cut back their R&D budgets during the *Great Recession* and are now flush with cash. Still, a discernable shift in the VC industry may be underway with capital being concentrated among fewer high visibility venture capital firms. This trend may lead to less risky investments, a higher hurdle for less experienced entrepreneurs, and fewer game-changing technologies in the long term. Countering this trend is the availability of more low investment enterprises made possible by technologies developed by previous generations of VC-backed firms.

For now though, better exit opportunities and an improving macro economy are supporting higher confidence among venture investors and point to a stronger high-growth entrepreneurial environment for the medium term. In fact, some research has shown that an increase in VC confidence in one quarter has tended to presage an increase in venture-backed IPOs in the ensuing quarter[5]. If this relationship continues to hold, Q2 could witness the entry of an increasing number of venture-backed firms to the public markets, further supporting the high-growth venture entrepreneurial environment.

Table 1

Participating Venture Capitalists in the 2010 1st Quarter Confidence Index Survey

Participant	Company
Alain Harrus	Crosslink Capital
Bill Byun	Samsung Ventures
Bill Reichert	Garage Technology Ventures
Bob Pavey	Morgenthaler Ventures
Bruce MacNaughton	Crosslink Capital
Bryant Tong	Nth Power
Christian Cortis	ATV Capital
Dag Syrrist	Vision Capital
Daniel Ciporin	Canaan Partners
Dan Lankford	Wavepoint Ventures
David Spreng	Crescendo Ventures
Debra Beresini	invencor
Deepak Kamra	Canaan Partners
Eric Buatois	Sofinnova Ventures
Graham Burnette	Red Planet Capital
Igor Sill	Geneva Venture Management
Jeb Miller	JAFCO Ventures
Joe Mandato	De Novo Ventures

[3] Dow Jones VentureSource reported that VC financings in the first quarter of 2010 increased 12% over the same period last year (April 17, 2010).
[4] Dow Jones LP Source reported that VC fund raising in the first quarter of 2010 increased 41% over the same period last year (April 6, 2010).
[5] Cannice, Mark V. and Cathy Goldberg (2009). "Venture Capitalists Confidence, Asymmetric Information, and Liquidity Events," *Journal of Small Business and Entrepreneurship.*

Karan Mehandru	Scale Venture Partners
Kirk Westbrook	invencor
Kurt Keilhacker	TechFund Capital
Prashant Shah	Hummer Winblad Venture Partners
Richard Yen	Saban Ventures
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Stephen Harrick	Institutional Venture Partners
Steve Sullivan	Skyline Ventures
T. Chester Wang	Acorn Campus Ventures
Tim Wilson	Partech International
Tom McKinley	Cardinal Partners
Tom Rodgers	ATV Capital
Venky Ganesan	Globespan Capital Partners
Victor Hwang	T2 Venture Capital
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

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