Market Analysis
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State of the Venture Capital Industry

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Executive Summary

As a general premise, we adhere to the "endowment model" of investing and believe venture capital has a place within every diversified portfolio. We think it is difficult to "time" the market as well as access the best managers intermittently, and that it therefore makes sense to invest consistently in the asset class. It is also our belief that investors that have done so over long periods of time have been richly rewarded. While speaking from an admittedly biased perspective and perhaps offering more tactical guidance than normal, we hope this piece offers our perspectives on the current state of the market, given the profound impact that extraneous factors continue to have on the venture capital industry. It is based on experience, empirical research, and ongoing discussions with our managers.

First, the macroeconomic turmoil of the past 12 months – declared by many as the worst financial crisis since the Great Depression – hastened the consolidation in the number of venture capital firms, which we had viewed as an inevitable and positive process for the industry. At the height of the Internet bubble, the number of truly active[1] firms approached 1,200. Today, that number is closer to 400 and trending downward toward what we perceive as a far more "right-sized" industry with 300-400 U.S.-based firms.

Second, in addition to hastening the venture capital industry's rationalization, the general market environment is positively influencing competition, investment pace, valuations, and recruiting, while negatively impacting managers' legacy portfolios. Regarding competition, fewer active funds leads to less look-alike companies, with only the best of the best able to secure capital. Second-order effects include slowed pace and lower valuations; remaining managers are able to commit more time to due diligence and thus make better investment decisions, as well as complete financings at reduced valuations, evidenced by a dramatic decline in early stage pre-money valuations through the fourth quarter of 2008. Further, slack in employment creates a "buyer's market" to recruit top-tier talent to portfolio company management teams. And most established managers have large existing portfolios, comprised primarily of company stakes acquired pre-crash and therefore at higher relative valuations. They are focused on triaging these portfolios by cutting burn rates and shutting-down poor performing companies.

The net result of all of the above factors is an attractive environment for new dollars committed to venture capital. Issues certainly remain, including constraints on General Partners' time due to legacy board positions and a still lackluster exit window. However, an attractively structured industry comprised primarily of proven General Partners should lead to attractive absolute returns (and we would argue that 3-, 5-, and 10-year venture capital data suggests that strong returns relative to public market indices never fled) over the next cycle.

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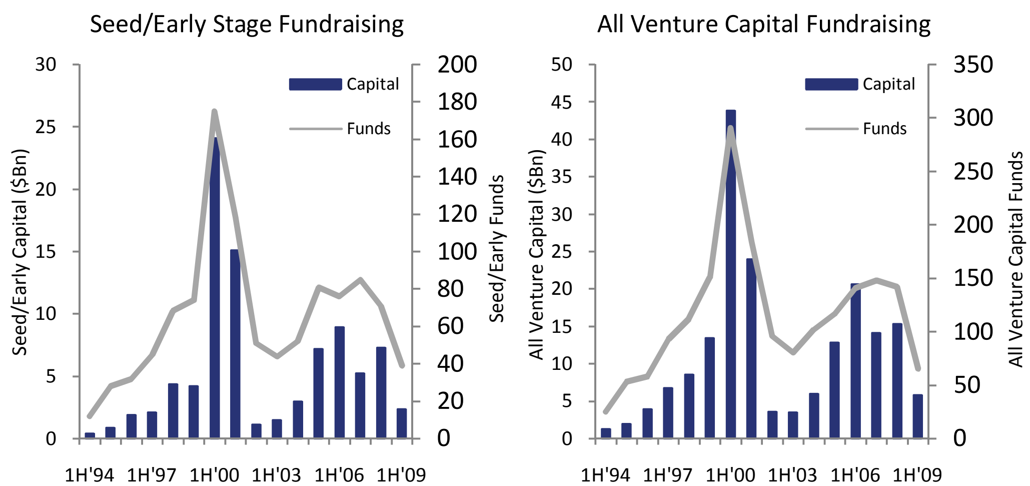
(1) Includes those that had a close in the current and previous four vintage years.

Fundraising

Venture capital fundraising fell significantly in the first half of 2009 from 2008 and 2007 levels. $2.4 billion of seed and early stage capital was raised in the first half of 2009, which is 67% less than the $7.3 billion raised in the first half of 2008 and 55% less than the $5.3 billion raised in the first half of 2007. To quantify fundraising by number of firms raising capital, which affects the structure of the market, 39 firms closed on seed and early stage capital in the first half of 2009, 45% less than the 71 firms that did so in the first half of 2008, and 54% less than the 85 firms that did so in the first half of 2007.

Fundraising data including expansion and later stage financings, in addition to the seed and early stage data, tells a similar story. $5.9 billion of total venture capital was raised in the first half of 2009, which is 61% less than the $15.3 billion raised in the first half of 2008 and 58% less than the $14.1 billion raised in the first half of 2007. Sixty-six firms closed on venture capital in the first half of 2009, 54% less than the 142 firms that did so in the first half of 2008, and 55% less than the 148 firms that did so in the first half of 2007. The following 15-year charts indicate that per half-year statistics for capital and number of funds, the industry is approaching pre-bubble levels.

Exhibit 1 – Venture Capital fundraising has fallen significantly since the "bubble"

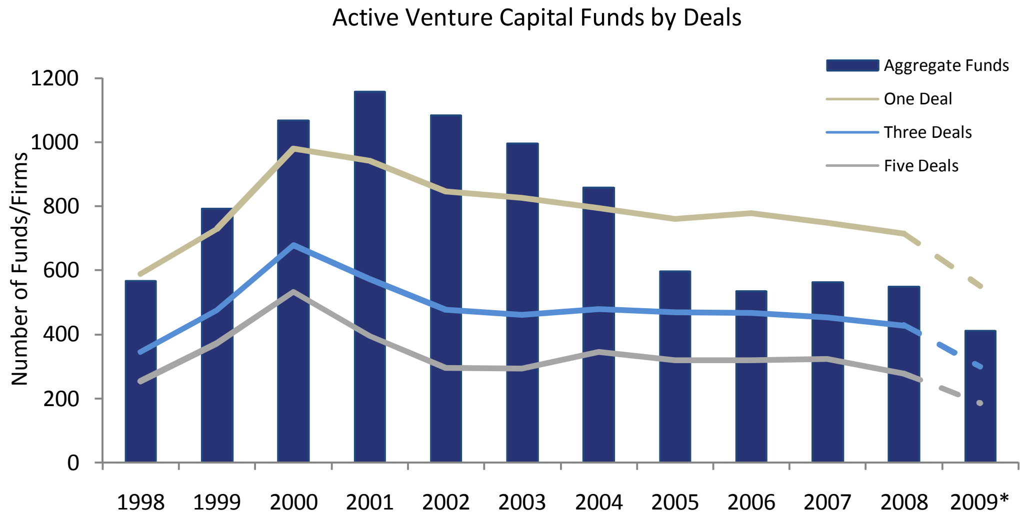


Source: Venture Economics
U.S.-only independent private partnerships

To determine the number of active firms in the market over time, a somewhat difficult measure due to the long-tailed nature of venture capital funds, we analyzed both the number of firms that raised capital in the current and previous four vintage years, as well as the number of firms that have done one, three, or five deals each year. The first method acts as a proxy for investable capital, as venture capital investment periods typically span five years, after which uninvested capital is rarely used for seed and early stage deals, and therefore does not drive early stage pre-money pricing. Per this method, the chart below indicates that there are roughly 400 active firms today, or 66% fewer than in 2001, the height of the Internet bubble. To pare this back to what we perceive as *truly active* firms, we determined that only 300 firms completed at least three financings in 2008, the last time period for which we have full-year statistics. This is 56%

fewer firms than the 678 that completed at least three deals in 2000. While some "overhang," or uninvested capital certainly persists, we are trending toward what we and our managers perceive as a "right-sized" industry.

Exhibit 2 – Proxy for "truly active" firms: trending toward "right-sized" industry



Source: Venture Economics (funds) and VentureSource (deals)
U.S.-only independent private partnerships
*TrueBridge Capital Partners estimates of full-year 2009 statistics using 1H 2009 data

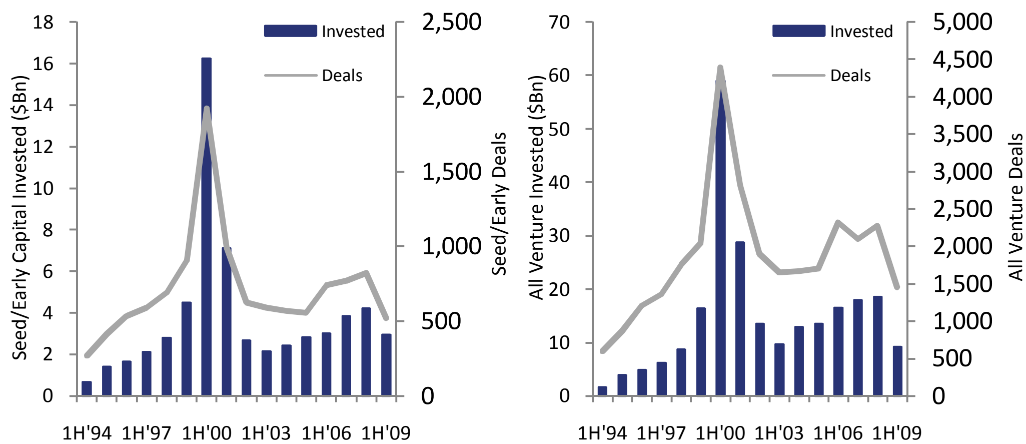
A significant portion of the most recent fundraising decline is directly attributable to general market turmoil; as institutional investors faced liquidity constraints and/or became over-allocated to private asset classes due to disproportionate decreases in public market valuations relative to private market valuations, they could not commit to new funds. However, it is our belief that the economic crisis simply hastened a process of market consolidation that had already begun. Venture returns by all but the very best firms in the industry have been depressed in absolute terms during the past eight to ten years due to a glut of both capital and market participants. Low returns would have naturally eased the industry's overcapitalization, albeit more slowly. We believe that the contraction of the venture market is a very positive event for the investors that remain committed to the asset class. There are fewer firms making new investments, which should reduce competition and drive down pricing, thus paving the way for strong absolute and relative returns.

Investments

In the first half of 2009, $3.0 billion was invested in seed and early stage portfolio companies, which is 30% less than the $4.2 billion invested in the first half of 2008, and 23% less than the $3.8 billion invested in the first half of 2007. Five-hundred twenty-four seed and early stage deals closed in the first half of 2009, 36% less than the 823 deals that closed in the first half of 2008, and 32% less than the 772 deals that closed in the first half of 2007.

Once again, investments data including of expansion and later stage financings, in addition to the seed and early stage data, tells a similar story. $9.2 billion was invested in portfolio companies in the first half of 2009, which is 50% less than the $18.6 billion invested in the first half of 2008, and 49% less than the $18.0 billion invested in the first half of 2007. One thousand four-hundred fifty-four venture capital deals closed in the first half of 2009, 36% less than the 2,278 deals that closed in the first half of 2008, and 31% less than the 2,100 deals that closed in the first half of 2007. In parallel with the fundraising analysis above, the following 15-year charts indicate venture capital investment activity to have decreased to near pre-bubble levels, a trend we foresee leveling-out in the near-future.

Exhibit 3 – Venture Capital investing activity has also fallen considerably



Source: Venture Economics
U.S.-only independent private partnerships

It naturally follows that as venture capital firms find it difficult to raise new pools of capital, they make fewer investments. The lack of capital and general market uncertainty has led managers to take a more cautious and measured approach. As capital flowed more freely into the asset class during the past 10 years, managers used less discretion when pursuing deals. Whereas previously, even marginal and lookalike portfolio companies could find funding, only best-of-breed companies are able to secure venture financing in the current environment. Anecdotally, there may have been seven to ten firms circling the waters of a "hot" deal during the bubble and most of the past six years, whereas now only one to four competitive bidders generally exist, thus easing pricing for each round. Our managers' recent feedback has been that the current environment allows more time to diligence each deal, which in turn fosters better decisions. We believe that proven firms – and particularly the top 20-25 caliber managers which we feel comprise CVE-Kauffman Fellows Endowment Fund I – will emerge from the downturn stronger and more disciplined, and therefore better positioned to earn attractive returns and money multiples.

Valuations

Median early stage pre-money valuations reached their second lowest point of the past 15 years in the fourth quarter of 2008, the last time period for which we have data available. Using a one standard deviation band on either side of the mean over the past

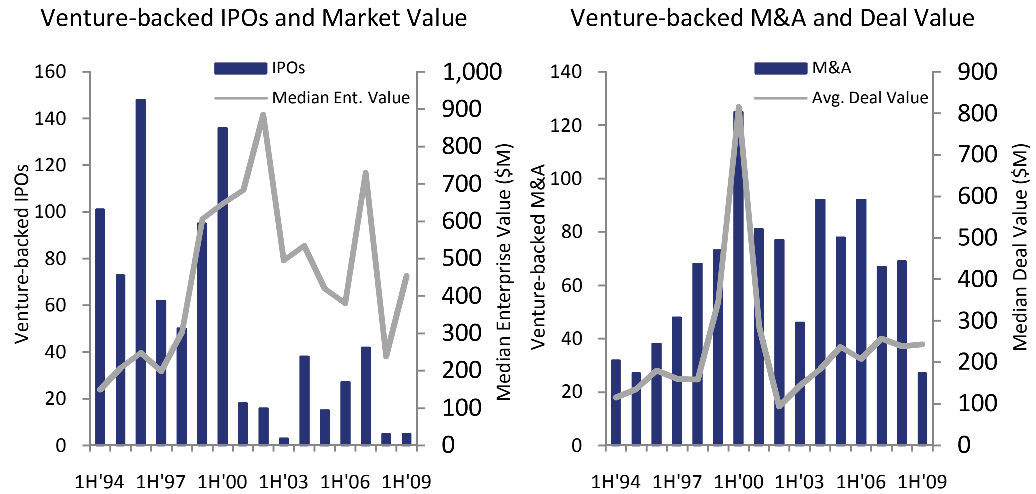
15 years, we determined that historical seed and early stage pre-money valuations typically traded in a fairly tight range from approximately $5.0 million to $9.0 million. The median pre-money valuation in the fourth quarter of 2008 was $4.2 million, well below the low end of this range. The two highest median valuations over the 15-year time period were $12.8 million in the first quarter of 2007, and $12.4 million in the first quarter of 2000, the height of the Internet bubble. The 2000 vintage is turning out to be among the worst in the venture capital industry's history, which is likely correlated to the period's high valuations, while it is still too early to determine the relative performance of vintage 2007. The midpoint of the $5.0 million to $9.0 million range is $7.0 million; market turmoil and other factors have thus driven pricing down 48% to the fourth quarter of 2008. Anecdotally, downward pressure remained through the first and second quarters of 2009.

Questions regarding valuations are often met by our managers with comments that pricing rarely changes dramatically at the early stage. Our analysis of the data suggests that this is the case in an absolute sense; given the recent "normal range" of seed and early stage pre-money valuations, variations within a $4.0 million span do not seem dramatic. However, that valuations are currently down 54% from the top of this range is significant, and represents as steep or steeper a valuation decline as in other major asset classes in the past year. Managers' are thus able to "buy low," thereby achieving half of the sound investment philosophy equation, which should positively influence returns on new dollars invested.

Exits

The first half of 2009 persisted as one of the poorest periods in history for venture-backed liquidity. Just five venture-backed companies achieved initial public offerings ("IPOs") during the period, squarely in-line with the first half of 2008 but down nearly 90% from 2007. Mergers and acquisitions ("M&A") fared worse than IPOs relative to the first half of 2008, with the number of venture-backed acquisitions falling nearly 60%, although M&A activity was roughly flat from 2007 to 2008. Evidenced in the charts below, the recent lack of liquidity for venture-backed companies is nearly unprecedented over the past-15 years, with the first half of 2003 serving as the only comparable period, although M&A activity remained fairly robust during this time. Also apparent is that the bar to achieve public liquidity is higher today than in the early-1990s, as the median enterprise value of a newly public venture-backed company is approaching $500 million, compared to approximately $200 million then (without inflation-adjustments, so the magnitude is overstated yet the trend remains the same). Sarbanes Oxley is partly to blame, but perhaps more so is the diminished risk appetite among public equity investors for small and largely unproven companies.

Exhibit 5 – Exit market showing some signs of life but still unprecedentedly weak



Source: Venture Economics
U.S.-only, venture-backed companies

The IPO window has recently shown some signs of life, particularly through the recent offerings and subsequent appreciation for A123 Systems, OpenTable, and SolarWinds. However, current market uncertainty with regard to general economic and stock market conditions continues to apply pressure to venture-backed liquidity and exit sentiment. We cannot predict when the window will open, nor whether a large scale exit for a company like Facebook or Twitter can act as a fullback clearing the way for a flurry of small and nimble venture-backed "running back" IPOs. However, we do know that the average time to liquidity for venture-backed companies over the past 20 years has been seven years, that it takes significant time and effort to build great businesses, and that some of the brightest companies today – including Cisco, Dell, Oracle, Apple, and Skype – were formed during the darkest periods of the past. Therefore, we think there is a high probability that a rosier picture will exist down the road for dollars invested into seed and early stage companies now.

Conclusion

In addition to the hard data above, our managers and their entrepreneurs, while also biased like us, believe that their next investment cycle will be far more compelling than their last. They are able to round-out portfolio company management teams by adding experienced and driven executives in a "buyer's market." Deal activity has slowed due to competitors' focus on their current portfolios and/or inability to raise capital, thus providing more time for due diligence, which should foster better decisions. On the valuation front, several managers have discussed doing later stage deals at Series A or Series B prices, confirming our analysis above. Several entrepreneurs told us that downturns are their favorite times to start companies, because there is less "noise" in the system (which we interpret as passer-by, impassionate entrepreneurs and companies muddying the competitive landscape). Venture capital managers and their entrepreneurs should emerge from the downturn more conservative and focused, and thus better able to generate attractive returns for their investors.

As noted in the Executive Summary, we think it is difficult to “time” the venture capital market as well as access the best managers intermittently, and that it therefore makes sense to invest consistently in the asset class. It is also our belief that investors that have done so over long periods of time have been richly rewarded. While speaking from an admittedly biased perspective and perhaps departing a bit from our non-tactical approach, we conclude that the net result of the above is that now is an attractive time to invest in venture capital, particularly relative to the past ten years.