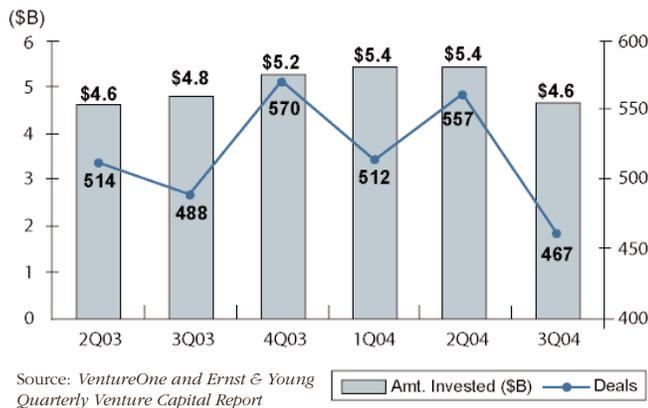


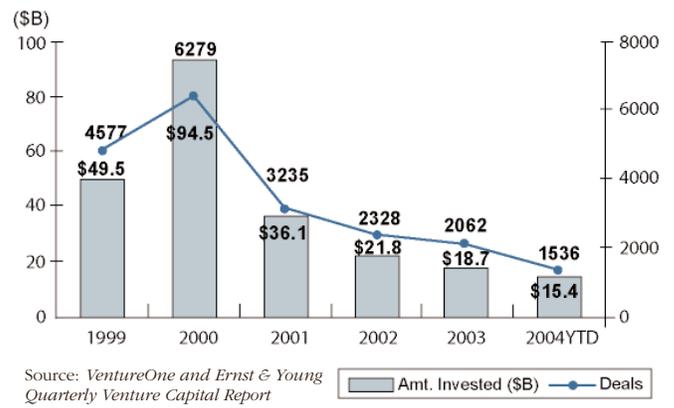
# Venture Capital Update Q3 2004

At Silicon Valley Bank, understanding the industries we serve is fundamental. Like you, we track, study and analyze the activity in our markets and, as your partner, we want to share our findings. This report chronicles venture capital activity in Q3 2004 and includes commentary from our vantage point in the industry regarding what it all means. We seek out and consolidate the most compelling data, pointing to the trends in the technology and life science industries. We invite your opinions and encourage ongoing dialogue regarding the opportunities ahead of us.

**US Equity Investing Activity  
(by quarter)**



**US Equity Investing Activity  
(1999-3Q04)**



## Feeding the Beast?

By Jim Maynard & Adam Tweedy, SVB Capital, Boston

As we transition toward a new investment vintage year, we've noticed several trends shaping up that lead us to believe the industry is maintaining a healthy, stable growth trajectory. But despite the appearance of stability, we have to ask, is the growth really all it's cracked up to be?

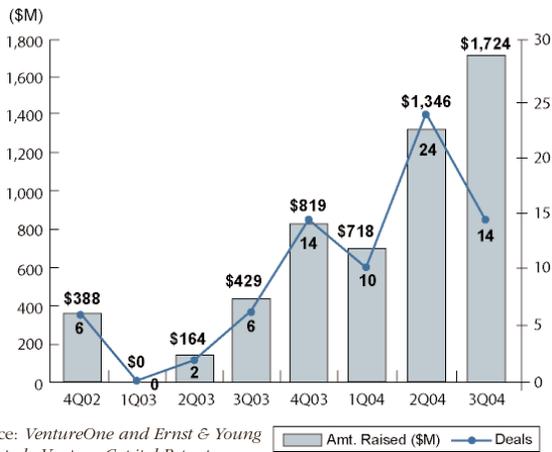
In 2003, we saw \$18 billion invested in early stage companies, but by the close of Q3 '04, the industry had already invested \$15 billion. Generally speaking, the venture industry's Q3 '04 activity and results were solid and signaled a continued resurgence, but the question persists: is this level of increased investment healthy? Some VCs are bullish, but some are wary as a result of past lessons from the misadventure of over-exuberance. There are some industry insiders and key observers who feel the industry should be investing only \$10 billion

per year. To them, \$20 billion of direct annual VC investment represents an over-fed beast, with LPs as the most conspicuous of the beast's keepers.

At a recent Charles River Ventures' annual LP meeting attendees heard a cautionary tale regarding venture fund size and activity levels. It was sobering to hear from a firm considered to be a cornerstone of the venture business that fund sizes are too large and that firms cannot reasonably invest these large funds. Sky-high series-A pre-money valuations resulting from "hyper competition for anything that looks remotely interesting" have lately caused Charles River to take distinct steps toward "a careful assessment of each deal's parameters" (read: price and structure). If an abundance of caution and judicious execution are the keys to success in 2005, clearly CRV's LP commitments are in good hands.

At the same meeting, Bill Sahlman, professor of business administration at Harvard Business School, renowned for his acute knowledge of venture capital,

## US Venture-Backed IPOs Deals & Dollars



Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

## Region Focus All Industries

	# of Deals	Number of Investing firms	Average Per Deal (\$M)	Sum Inv. (\$M)	% of Investment
Bay Area	148	316	11.3	1,539.4	33.7%
Midwest	11	37	11.5	126.5	2.8%
New England	33	82	10.1	330.7	7.3%
New York Metro	29	90	14.0	387.5	8.5%
Texas	26	65	12.5	318.2	7.0%
Potomac	25	56	4.8	119.6	2.6%
Southeast	39	85	11.0	412.8	9.1%
Orange County	11	33	11.2	110.2	2.4%
Los Angeles	8	19	17.5	119.8	2.6%
San Diego	18	74	15.8	272.2	6.0%
Oregon	2	8	15.2	30.4	0.7%
Philadelphia	15	0	6.9	96.5	2.1%
Colorado	13	33	7.7	96.7	2.1%
Washington State	24	61	7.9	179.4	3.9%
Southwest	10	20	12.8	125.8	2.8%
Research Triangle	10	30	8.8	96.8	2.1%
Total	467	795	10.35	4,561.14	

Source: VentureOne and Ernst & Young

## Post Money Valuation Report (\$M) - 3Q04

Biopharmaceuticals	\$28.0
Healthcare Services	NS
Medical Devices	\$22.0
Medical Information Systems	\$26.3
Communications & Networking	\$25.0
Electronics & Computer Hardware	\$30.0
Information Services	\$7.8
Semiconductors	\$36.0
Software	\$17.0
Consumer & Business Products	NS
Consumer & Business Services	\$13.6
Retailers	NS

Source: VentureOne

presented kernels of macro-VC wisdom. Sahlman reiterated the \$10-billion-industry-size mantra and pleaded with LPs “to retreat, not attack.” In analyzing the VC industry today, specifically deal flow as addressed by the GPs themselves, he asked, “is there too much money chasing too few deals, or is there too much money funding too many deals in the same industry,” such as WiFi and RFID?

## Hot Sector or Hot Flash?

To be more specific, is there room in the market for the 141 financings, valued at \$1.2 billion, of the connectivity/communications tools sector that took place in the first nine months of 2004; this on top of the 1,062 financings, worth \$10.3 billion that took place in the four years prior. And should we be asking the same question about the business applications software space, with 124 investments totaling \$0.8 billion in 2004? Think back to as recently as 2000, when 288 companies in the photonics sector raised \$7.1 billion before the industry imploded.

## Mixing It Up

Looking at prior quarters, and prognosticating for future periods, we echo Sahlman’s concerns, but with some qualifications. Recent investment and lending deal flow represent a decent cross-section of early stage venture deals in a variety of industries, such as contract management software for the enterprise, RF chip scale modules for the mobile market, next-gen non-volatile memory and heavy materials bonding. There are no specific patterns among industries and therefore we cannot easily identify one space as over-funded. Furthermore, the opportunities span a variety of software and hardware-related industries and are diversified by stage with a relatively even split between early-, mid- and later-stage companies. This is consistent with our general observation of and experience with early stage venture activity across the nation.

Many established VC firms and funds, especially some of the larger ones, are entertaining multi-stage investments, particularly on the Eastern seaboard. The interest in portfolios diversified by stage, among investors who have historically succeeded in the early stage VC game, is driven by those looking for the elusive \$40-million-revenue software company that has not yet raised outside capital.

In our estimation you can add about six or eight names of established VC or private equity firms to that list of companies looking for late stage investments. Historically, these firms may not have invested in such models and currently have larger, older vintage-year funds that need to be deployed. Others have committed to this strategy by mixing in heavy doses of later-stage investing for their new \$300 - \$500 million vintage '03 - '04 funds. This appears to be a healthy way to build a venture portfolio as the investment cycle turns but, of course, time will tell. Efficient execution and a vision compelling enough to convince

entrepreneurs of the value of this approach will be the keys.

### The Entrepreneurs' Perspective

Turning to the other side of the investment flow, let's look at what entrepreneurs want from VCs these days. Easy answer —“Show me the money.” They're not just talking capital. Scores of entrepreneurs and company builders are looking for more leverage from their investors' networks, specifically, access to sales channels and strategic alliances. In a clear indication that venture professionals have heard the calls of their companies, teams at existing firms are being augmented by former CEOs, CIOs and CTOs who have particular expertise in a given investment space. North Bridge Venture Partners and Polaris Ventures are prime examples of venture firms employing this approach. Many companies are forming new teams composed entirely of GPs with operating backgrounds, and their new funds are attracting significant attention from the LP community and entrepreneurs alike.

Today's portfolio companies require professional board members to have contacts, the knowledge to be a catalyst for business development and the ability to convince large corporations that buying proven technology from start-ups makes sense. They also need channels to help the company grow in other geographies. An investor's relevant experience overseas or even in specific domestic geographies can be invaluable. A recent PWC study (“Paths-to-Value” 2003) found that introductions to customers and assistance with strategic alliances are first and foremost on the minds of start-ups when choosing VC partners. Predictably, the ability to assist with strategy development and recruiting management talent were also noted as important criteria.

As VC firms take an increasingly pragmatic approach to portfolio management, we anticipate company building will remain a high priority. It will become more important than ever for GPs to allow for the time and capacity (how many board seats can one person handle?) to help nurture a company effectively. Most industry insiders believe that six to eight board seats is the maximum that each partner should hold at any given time, well below the 10 to 14 seen in the heyday of three years ago. It would appear that a healthy correction has occurred over the last 18 months as venture professionals have heeded their own advice and are returning to practices best suited to proactive company building.

### What Exits Look Like

While Q3 '04 saw an increase in venture-backed IPOs in aggregate dollars, the number of transactions declined from 24 to 14. Both Q2 and Q3 '04 illustrate the continued slow comeback of public market acceptance for VC-backed deals; however, in a period where IPO multiples continue to be modest M&A often becomes the exit path

### Most Active Investors - 3Q04

Firm Name	Under Mgmt (\$M)	# of Deals in 3Q04
New Enterprise Associates	6,000	17
Intel Capital*	750	14
U.S. Venture Partners	3,200	12
Austin Ventures	3,101	11
Alta Partners	1,500	11
Oxford Bioscience Partners	872	11
Benchmark Capital	2,830	10
Mayfield	2,400	10
Atlas Ventures	2,100	10
Polaris Venture Partners	2,003	10

\* Corporate VC

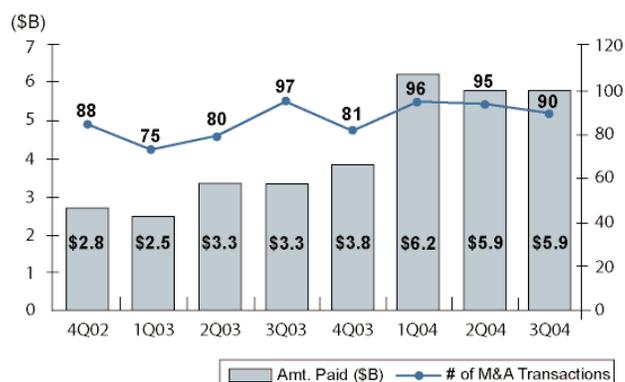
Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### US VC-Backed Liquidity Events by Industry 2002-2004YTD

	2002		2003		2004 YTD	
	IPO	M&A	IPO	M&A	IPO	M&A
Biopharmaceuticals	2	12	7	19	21	24
Healthcare Serv.	2	11	1	5	0	6
Medical Devices	3	15	0	9	4	14
Medical IS	1	10	0	9	0	9
Comm. and Network	0	46	3	51	0	40
Elect. & Computer Hdw	1	11	1	9	0	11
Information Services	1	65	0	37	0	31
Semiconductors	0	16	3	23	3	20
Software	3	145	3	143	3	115
Other	7	84	4	45	3	26
Total	20	415	22	350	34	296

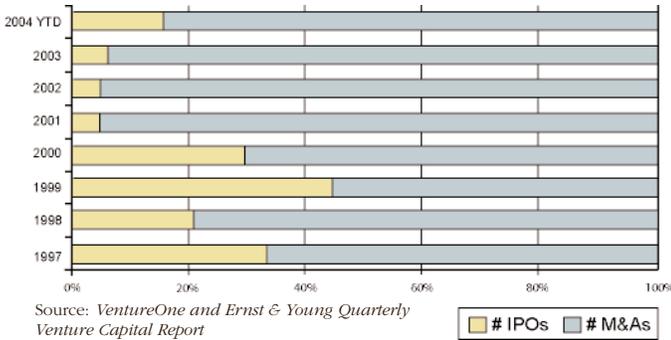
Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### US VC-Backed M&A Activity, 2002-2004 YTD

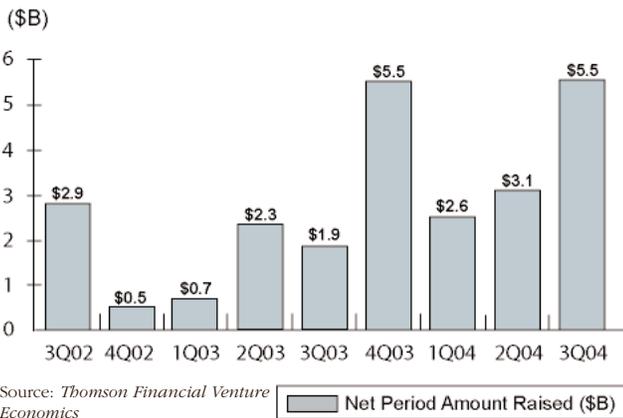


Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### US IPOs vs. M&As



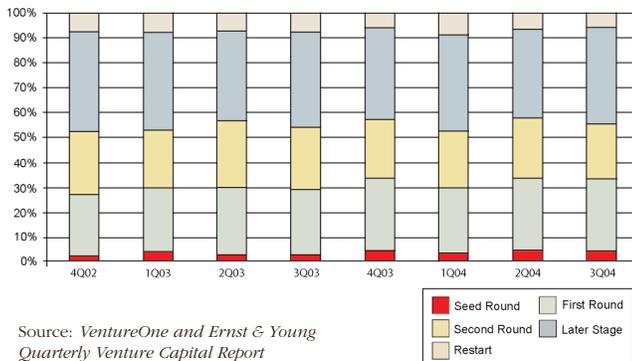
### Commitments to US Venture Capital Funds



### US Cumulative Uninvested



### US Deal Flow by Round Class



of choice. Some 84 percent of exits in 2004 were M&A transactions; the split was more or less even in 1996. The IPO process generally requires VC investors to take another one to two years of risk due to stock lock-ups, and then there is a little piece of legislation from Senators Sarbanes and Oxley that has significantly complicated the responsibilities of a public company director, and added an average \$2 to \$3 million in additional costs to the IPO process. Venture-backed M&A may get a boost in the short term, but we expect that the cost and processes for companies and their investors will begin to ease, once the lawyers and accountants get a handle on the SARBOX issues in the first wave.

### Batting Average

Reflecting on Professor Sahlman's view of the VC world and our first-hand experience in the market, we'd like to offer some conclusions for 2004. If less money in venture capital will drive company development and sustain stronger returns for investors, then we envision investments requiring less capital per deal, a distinct change from prior trends. The need for efficient business models and board members experienced in processes and operations is at the forefront of entrepreneurs' minds. Moreover, the thoughtful deliberation that began in the days after the industry's nadir in 2001 has created a growing and persistent emphasis on effective due diligence. Professor Sahlman pointed out that measuring how many Mondays (Monday being GP meeting day) it takes to get a deal done will be important to a firm's success. The more deals with multiple Mondays – the better.

Finally, employing a baseball metaphor in honor of the Red Sox world championship, which we expect to warm us at least through spring training, ("YES!!" screamed the *Boston Globe's* front page) Professor Sahlman emphasized a need for a continued focus on batting average as opposed to slugging percentage. While the venture business requires an element of swinging for the fences in finding and funding companies, we have seen that sound portfolio management begins with excellent due diligence and results in more positive outcomes. A portfolio chock-full of doubles and triples is a venture professional's friend and the best way to remain in the game in 2005 and beyond.

## Cumulative Fund Type Performance as of 06/30/04

Calculation Type: IRR

Fund Type	Num	Avg	Cap Wtd Avg	Max	Upper Quartile	Min
Early/Seed VC	540	15.1	5.0	721.1	16.8	-72.2
Seed Stage VC	65	8.2	-3.3	258.8	13.3	-49.4
Early Stage VC	475	16.0	5.4	721.1	17.4	-72.2
Balanced VC	421	8.8	4.0	195.2	15.1	-67.8
Later Stage VC	185	9.6	3.7	209.2	14.9	-58.5
All Venture	1146	11.9	4.4	721.1	16.0	-72.2
Small Buyouts	177	12.0	9.5	255.4	18.0	-44.4
Med Buyouts	106	9.5	9.0	81.6	18.5	-47.8
Large Buyouts	81	6.7	6.3	91.3	16.3	-96.6
Mega Buyouts	102	4.6	5.0	60.2	14.9	-81.4
All Buyouts	466	8.9	6.0	255.4	17.1	-96.6
Mezzanine	63	6.9	6.1	55.0	12.6	-45.9
Buyouts and Other PE	602	8.3	5.7	255.4	15.6	-96.6
All Priv Equity	1752	10.6	5.3	721.1	15.8	-96.6

Source: Thomson Financial Venture Economics/NVCA

## Cumulative Vintage Year Performance as of 06/30/04

Venture Capital Funds (only)

Calculation Type: IRR

Vintage Year	Num	Avg	Cap Wtd Avg	Max	Upper Quartile	Min
1992	27	22.3	25.8	102.3	31.6	-47.2
1993	40	21.6	29.1	98.6	34.2	-25.0
1994	41	24.7	32.3	113.0	39.8	-47.9
1995	44	43.6	50.5	247.8	55.6	-29.2
1996	35	73.8	62.5	454.9	95.4	-24.9
1997	59	47.3	45.2	296.0	59.5	-64.1
1998	77	30	29.5	721.1	13.7	-45.0
1999	107	-12.9	-13.7	141.1	-1.1	-59.4
2000	114	-12	-10.4	45.4	-2.8	-42.9
2001	56	-8.5	-11.5	40.4	0.0	-40.9
2002	15	-12	-12.1	97.8	-6.8	-66.3
2003	9	-14.5	-28.6	209.7	-22.8	-72.2

Source: Thomson Financial Venture Economics/NVCA

## Equity Financing\* for U.S. Venture-Backed Companies, by Industry Group (2002-2004 YTD)

\*Equity financings include cash investments by professional venture capital firms, corporations, other private equity firms, and individuals into companies that have received at least one round of venture funding

Industry Segment	2002 Totals				2003 Total				2004 YTD Total			
	# of Deals	Median (\$M)	Amt Invested (\$M)	% of Total	# of Deals	Median (\$M)	Amt Invested (\$M)	% of Total	# of Deals	Median (\$M)	Amt Invested (\$M)	% of Total
Biopharm.	233	8.6	3,174	15%	209	11.0	3,529	19%	167	11.3	3,267	21%
Healthcare Serv.	46	7.3	399	2%	30	6.0	279	1%	21	7.8	226	1%
Med Devices	167	8.4	1,662	8%	177	7.5	1,731	9%	136	6.0	1,156	8%
Medical IS	88	4.4	468	2%	68	3.9	318	2%	44	5.0	269	2%
Healthcare Total	534	7.0	5,704	26%	484	7.2	5,857	31%	368	7.5	4,918	32%
Comm. And Network	291	10.1	4,736	22%	249	10.0	3,051	16%	162	9.5	2,000	13%
Elect. & Computer Hdw	101	7.0	1,146	5%	88	9.2	923	5%	83	9.0	991	6%
Information Serv.	103	3.3	583	3%	89	4.2	588	3%	70	5.2	582	4%
Semiconductors	128	8.0	1,431	7%	142	10.0	1,683	9%	122	10.3	1,346	9%
Software	722	5.6	5,232	24%	648	5.0	4,096	22%	479	6.6	3,649	24%
Other IT				0%				0%				0%
Info. Tech. Total	1,345	6.7	13,129	60%	1,216	6.3	10,340	55%	916	7.4	8,568	56%
Consum. & Bus. Prod.	28	2.5	139	1%	29	4.0	242	1%	17	5.1	105	1%
Consum. & Bus. Serv.	342	4.8	2,208	10%	253	5.0	1,837	10%	169	5.0	1,442	9%
Retailers	24	5.5	170	1%	16	4.6	123	1%	18	3.7	149	1%
Products & Serv. Total	394	4.6	2,518	12%	298	5.0	2,202	12%	204	5.0	1,697	11%
Other Total	55	4.1	400	2%	64	3.3	339	2%	48	4.3	213	1%
Grand Total	2,328	6.2	21,751	100%	2,062	6.0	18,738	100%	1,536	7.0	15,395	100%

Source: VentureOne and Ernst & Young

This update is for informational purposes only and is not a solicitation or recommendation that any particular investor should invest in any particular industry, security, or fund.