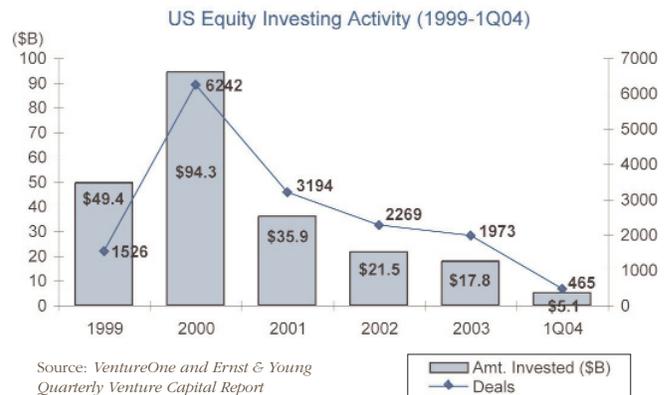
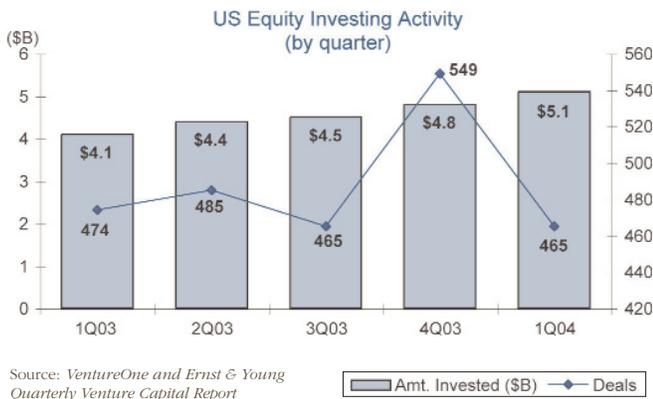


# Venture Capital Update Q1 2004

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 Q1 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 our ongoing dialogue regarding the opportunities ahead of us.



## True Confessions – Notes from the Spring LP Meeting Season

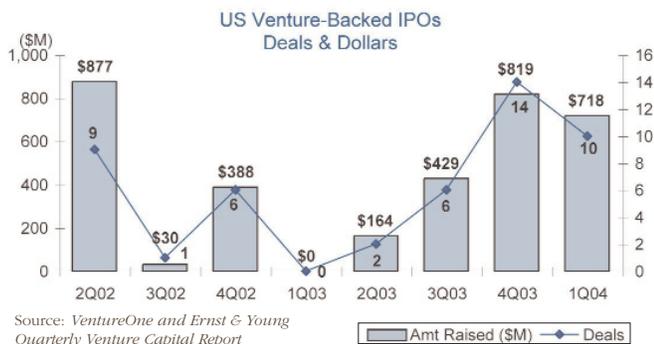
By John Otterson  
 Managing Director SVB Capital

The Spring 2004 LP Meeting Season, the first half of that annual rite of disclosure to Limited Partners by General Partners, has come and gone. This year GPs have been upbeat; some because we are another year further away from April 2000 others because of positive liquidity events that enabled distributions to LPs. One of the more lucid perspectives that most accurately summed up the 2004 LP Meeting season to date was of cautious optimism.

This perspective clearly underscores the widespread concern that good news could trigger increased asset price volatility driven by another round of hype-induced valuation inflation. With the pain and suffering of 2001-2003 still fresh in their minds, GPs are loath to allow good news to rekindle the exuberant expectations of recent years.

### Common Themes

A welcome theme of the LP meetings was the return of public buyers to drive M&A transaction activity. As the recession forced public firms to focus on the bottom line of their core businesses, M&A activity was subjected to exceptionally high internal hurdles. As revenues and earnings have stabilized and recovered in the wake of the recession, management teams are once again turning to M&A for strategic growth and acceleration of R&D



Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### Region Focus All Industries

	# of Deals	# Invest. firms	Avg. Per Deal	Sum Inv. (\$M)	% of Invest.
Bay Area	142	319	12.8	1,736.2	34.1%
Midwest	11	47	15.4	156.2	3.1%
New England	58	159	10.7	610.0	12.0%
New York Metro	31	85	10.5	324.7	6.4%
Texas	23	58	8.5	183.0	3.6%
Potomac	19	74	10.3	196.5	3.9%
Southeast	31	91	10.1	304.2	6.0%
Orange County	6	17	9.8	49.2	1.0%
Los Angeles	18	24	13.0	198.6	3.9%
San Diego	25	21	13.7	341.7	6.7%
Oregon	1	NA	9.0	9.0	0.2%
Philadelphia	13	53	25.9	262.4	5.2%
Colorado	11	24	11.3	96.9	1.9%
Washington State	21	63	12.1	259.9	5.1%
Southwest	8	25	9.3	74.4	1.5%
Research Triangle	4	10	6.3	25.0	0.5%
<b>Total</b>	<b>465</b>	<b>877</b>	<b>11.5</b>	<b>5,086.5</b>	

Source: VentureOne/Ernst & Young

### Post Money Valuation Report (\$M) - 1Q04

Biopharmaceuticals	\$37.0
Healthcare Services	NS
Medical Devices	\$19.3
Medical Information Systems	\$4.0
Communications & Networking	\$23.0
Electronics & Computer Hardware	\$10.0
Information Services	NS
Semiconductors	\$9.6
Software	\$8.3
Consumer & Business Products	51.7
Consumer & Business Services	\$12.0
Retailers	NS

\*Four observations needed for valuation

Source: VentureOne

timelines. This resulted in exits and subsequent distributions by a number of venture firms during 2003, and the expectation for distributions by many more firms in 2004.

The Q1 results supported this theme with 78 M&A exits for venture-backed firms, raising a total of \$5.3 billion, or on average \$67.0 million per transaction. While the transaction volume for Q1 is in line with the trailing twelve-month average, the dollars raised increased significantly. Between Q2 2003 and Q1 2004, M&A exits raised an average of \$3.8 billion per quarter, an increase from \$2.8 billion per quarter over the prior twelve-month period. Similarly, the twelve-months ended March 31, 2004 recorded an average of \$47.8 million per transaction as compared to \$31.2 million in the prior twelve-month period. This increase in exit valuation reflects both the increased strategic importance placed on M&A by public acquirers as well as the general recovery in public market valuations.

### Globalization: India and China

Most remarkable is the prevalence of discussions regarding outsourcing and selling to India and China. The topic is ubiquitous, signaling the perceived importance accorded these two economies. Many commented on the political sensitivity of outsourcing during this election year, but recognized that the comparative advantage, if harnessed adroitly, is too compelling to ignore in an environment that demands absolute capital efficiency.

In commenting on India and China, partners at DCM - Doll Capital Management noted that there is an increasing globalization of portfolio companies on many levels, with entrepreneurs seeking cost advantages from offshoring R&D, manufacturing, and call center activity, as well as generating revenue advantage from foreign sales. DCM also noted that U.S. venture firms are increasing their foreign investment activity, citing SMIC among a number of other syndicated deals. Accel Partners is such a believer in the promise of globalization that they have hired an offshoring expert to lead portfolio companies through the many challenges inherent to conducting business across multiple time zones and cultures.

### Impact of the Internet

Another recurrent theme was the revenge of the Internet. While this sector had outpaced telecom in receiving blame for perpetrating the bubble, it is clear that the Internet has transformed the way we live, although perhaps not exactly as predicted by the many proselytizers of the last decade. The most talked- and written-about IPO of all time, Google, may be upon us this summer and is poised to deliver eye-popping returns

to Sequoia and Kleiner Perkins. A number of other Internet-based enterprises, including Netflix and Expedia, have come into their own with market recognition translating into significant valuation gains for their venture backers in 2003. The transformation is clear in established industries as well, with Sequoia's Mike Moritz noting that airline industry darling and newcomer JetBlue is booking 65 percent of its revenues online, while erstwhile stalwart Delta languishes with only 10 percent of its revenue booked online. It is clear that the Internet is here to stay, and that those enterprises that can leverage its reach and cost advantage to develop new business models that solve customer pain will be rewarded.

### Overcapitalization of Venture Capital

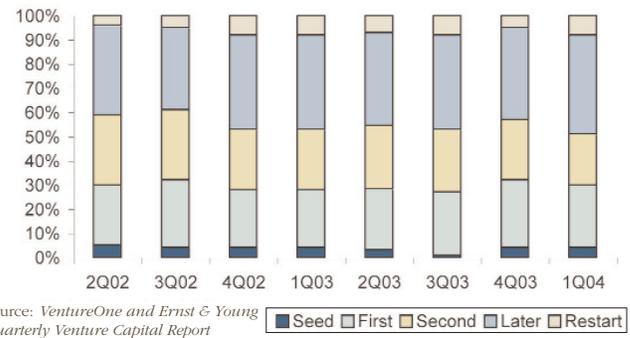
Fundraising for venture capital firms has become problematic. Not in the sense that firms are unable to raise their next fund, but that there is too much money trying to enter venture capital. While many of those leading institutional investors, such as Yale, who fueled the industry's growth over the second half of the last decade have scaled back their allocations to venture capital, a much larger group of institutional investors, including pensions, endowments and foreign institutions who have yet to participate, are clamoring to invest.

Many long-standing venture capitalists are looking for equilibrium of around \$10.0 billion in commitments to venture funds per year. This is in line with last year's \$10.2 billion reported by Venture Economics, roughly half of the \$20.0 billion anticipated for 2004, and but a tenth of the amount committed in 2000. Too much money in venture capital is certain to have a corrosive effect on returns as too many copy-cat business plans will receive funding, creating customer confusion in the marketplace and dilution of entrepreneurs' efforts.

The surge in LP interest comes at a time when many top-tier venture capital firms have decided that smaller funds make more sense, thus restricting the availability of allocations in top-tier venture capital funds. A number of well-known firms tested the fundraising waters in 2003 and were wildly over-subscribed. Many younger firms however have struggled to differentiate themselves and prove that they are among the desirable group of emerging managers who have strong potential to achieve top-tier results.

While most firms were pleased with the relative improvement in the market and economy of the past year, they remain reserved in their outlook over the near-term. This was manifest in market prognostications that M&A and IPO activity would remain highly selective,

US Deal Flow by Round Class



Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### Most Active Investors - 1Q04

Firm Name	Under Mgmt (\$M)	# of Deals
Sequoia Capital	2,153	16
Menlo Ventures	2,710	13
Alta Partners	989	12
Draper Fisher Jurvetson	1,775	12
Intel Capital*	750	12
Noro-Moseley Partners	580	12
New Enterprise Associates	5,000	11
Oxford Bioscience Partners	872	10
JP Morgan Partners	24,000	10
Accel Partners	3,000	9

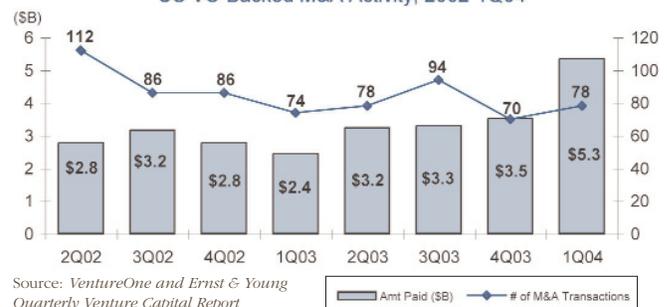
Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

### US VC-Backed Liquidity Events by Industry 2002-1Q04

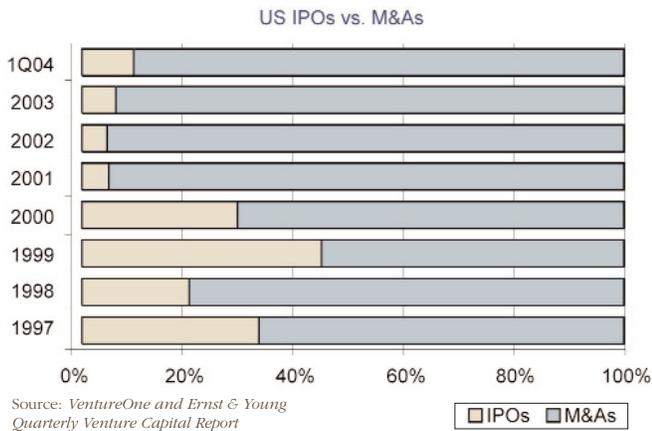
	2002		2003		1Q04	
	IPO	M&A	IPO	M&A	IPO	M&A
Biopharmaceuticals	2	12	7	19	8	6
Healthcare Serv.	2	9	1	4	0	2
Medical Devices	3	15	0	9	1	4
Medical IS	1	10	0	8	0	3
Comm. and Network	1	47	0	551	0	11
Elect. & Computer Hdw	0	11	3	9	1	6
Information Serv.	3	62	3	31	0	5
Semiconductors	0	15	3	23	0	5
Software	1	142	1	140	0	44
Other	7	80	4	38	0	3
<b>Total</b>	<b>20</b>	<b>403</b>	<b>22</b>	<b>332</b>	<b>10</b>	<b>89</b>

Source: VentureOne and Ernst & Young Quarterly Venture Capital Report

US VC-Backed M&A Activity, 2002-1Q04



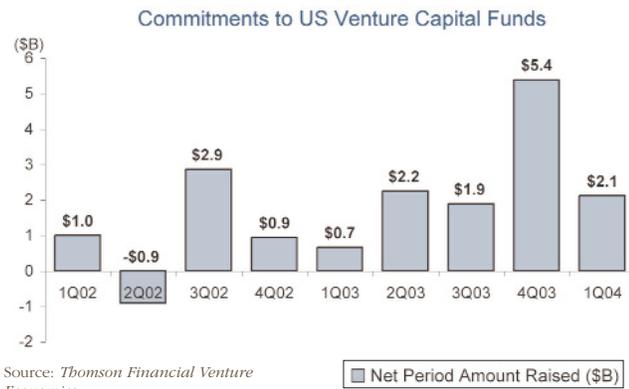
Source: VentureOne and Ernst & Young Quarterly Venture Capital Report



focused on best-of-breed solutions. There was also a tentative stance on the economy in general. In particular, many partners relished the current market buoyancy and cooperative economy, but expressed concerns about the unknown post election environment as well as external threats to market stability.

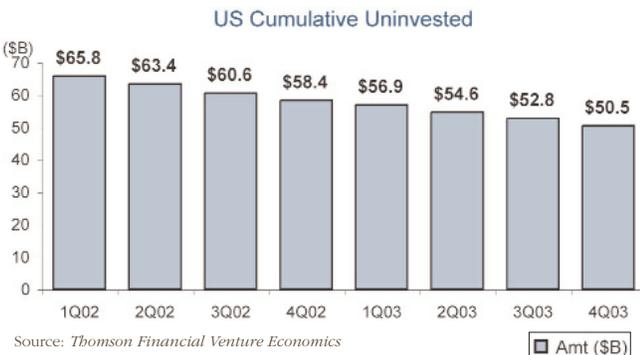
### Fundraising

During the last decade the venture capital fundraising cycle shortened from a historical four- to five-year cycle to a one-year cycle with many firms raising back-to-back funds in 1999 and 2000. These shorter cycles were driven by the rapid increases in public market valuations, which in turn encouraged swift deployment of capital to harness valuation lift in public markets.



Following the uncertainty in public markets in 2001, most venture firms slowed their investment pace, resulting in an elongation of the fund deployment cycle. While a few firms ventured forward in 2003 to raise follow-on funds, 2004 has been widely anticipated as being a banner year for fundraising. The first quarter witnessed \$2.1 billion raised by venture firms. While this figure is below the quarterly average of just over \$2.5 billion logged across 2003, and a steep decline from the \$5.4 billion raised in the fourth quarter of 2003, it is three times the amount raised in the same quarter a year ago.

Most notable in this fundraising cycle is the smaller fund-size being raised by venture firms. Whereas the largest 20 funds of the 1999-2000 vintages were all over \$1.0 billion, only one fund, NEA, has surpassed that mark so far in the current cycle. Most firms seem to favor the \$300.0 - \$500.0 million fund size, citing the renewed mantra of capital efficiency at the portfolio company level in defending their fund size targets.



Also remarkable in the current fundraising cycle is the change in line-up at many ventures firms. With LPs intensely focused on individual track records and succession issues, many firms have been proactive in ensuring that individual partner attributes are in line with stated firm strategy. The GP response has ranged from individual partner departures, to the closure of the entire West Coast practice of one long-standing East Coast firm. To be sure, some departures were firm initiated, while the departing partner initiated others.

A byproduct of these departures is the creation of new venture funds. While these new entities will be challenged to establish proprietary deal-flow and market reputations, and face the unknowns of partnership dynamics, a few are certain to establish themselves as the new guard over the coming decade. The emerging

manager concept has caught on, and many fund-of-funds and advisors are sure to lead their clients to deploy capital in such funds.

This presents the industry's biggest conundrum to LPs: how to fund the promising firms of tomorrow, without funding too many mediocre firms who threaten overall returns? The answer lies in selection and proportion. LPs will be well served to perform smart diligence and deploy their capital in as measured a fashion as they expect from venture funds.

### Focusing On Innovation

It will come as no surprise that venture capitalists are ardent believers that the long-term forces that drive innovation remain intact and that small private companies continue to sustain advantages over large public companies in developing new products and exploiting new markets. Furthermore, venture firms believe that technological innovation, the core of the venture industry, is a prerequisite to satisfying global demands for economic growth.

Within the IT sector, wireless has remained a perennial favorite as the benefits to connected computing are extended beyond the wireline. Specific areas cited by GPs included Ultra-Wideband, or UWB, and mesh networks. The Enterprise Data Center is also looked upon favorably, as design migrates from proprietary systems to clustered computing founded on Linux and Intel-based servers. The cited business drivers for this opportunity are improved systems and applications management, security, uptime, as well as data analytics and data management.

Broadband access is expected to grow from 100 million subscribers to 250 million in the next 24 months. Worldview notes that ubiquitous broadband access is fundamentally changing the world of the carrier, enterprise and consumer by enabling the delivery of next generation services and applications.

Life science has also received favorable attention, particularly in the aftermath of the tech bubble. The increased understanding of the genetic, molecular and cellular mechanisms of disease promises a profound opportunity in the coming decade. While aging global demographics will provide market growth for efficacious compounds and devices, the resulting strain on the healthcare system will remain a challenge. As the cost of healthcare approaches 15 percent of GDP, it will drive a re-prioritization of personal expenditures.

A common refrain from life science investors is drug development, not discovery. This reflects a desire to focus

### Cumulative Fund Type Performance as of 12/31/03

Calculation Type: IRR

Fund Type	Num	Avg	Cap Wtd Avg	Max	Upper Quartile	Min
Early/Seed VC	526	14.1	2.9	721.1	17	-85.9
Seed Stage VC	63	8.4	0.2	258.6	14.6	-61.2
Early Stage VC	463	14.8	3	721.1	17.4	-85.9
Balanced VC	412	8.8	2.6	193.4	15.1	-49.4
Later Stage VC	183	8.9	0.8	209.3	16.4	-100
All Venture	1121	11.3	2.3	721.1	16.3	-100
Small Buyouts	176	20.2	23.4	1588.5	18.1	-61.1
Med Buyouts	106	12.4	12	388.8	19.1	-57.1
Large Buyouts	79	4.5	4.4	91.3	14.2	-72.7
Mega Buyouts	100	3.3	3.9	136.4	11.3	-63.1
All Buyouts	461	12	6.1	1588.5	17.1	-72.7
Mezzanine	63	6.1	5.3	56.1	12.6	-52.2
Buyouts & Other PE	590	11.1	5.8	1588.5	15.6	-72.7
All Priv Equity	1715	11.2	4.7	1588.5	16.2	-100

Source: Thomson Financial Venture Economics/NVCA

### Cumulative Vintage Year Performance as of 12/31/03

Venture Capital Funds (only)

Calculation Type: IRR

Vintage Year	Num	Avg	Cap Wtd Avg	Max	Upper Quartile	Min
1992	27	22.4	25.8	102.3	31.6	-47.2
1993	40	21.	29.1	98.6	34.4	-25
1994	40	724.7	33	113	41.8	-47.9
1995	45	44.3	51.1	247.8	62.1	-30
1996	34	74.6	62.9	463.7	96.9	-24.1
1997	60	46.1	42.5	296.1	59.9	-46.3
1998	74	31.7	29.8	721.1	16.7	-46
1999	104	-15.5	-16.5	141.7	-2.8	-100
2000	105	-17.1	-16.1	26.5	-5.6	-99.6
2001	51	-12.2	-14.2	35	-2.9	-55.6
2002	13	-19.6	-18.6	14.3	-7.2	-68.8
2003	6	-35.2	-27.4	78.2	0	-85.9

Source: Thomson Financial Venture Economics/NVCA

on that section of the pharmaceutical development value-chain where risk-reward is balanced and offers compelling returns to investors. Such VCs are engaging compounds once they have entered the clinic, a much later stage than sought previously. Similarly, many believe that medical devices will present investors with solid returns as investment holding periods may be shorter due to more streamlined clinical development paths and FDA approval processes. LPs who committed to Three Arch Ventures' most recent fund, which was oversubscribed several times, validated this belief.

One of the newer areas of interest is consumer, which is distinct from retail. In combination with the Internet reducing transaction costs and outsourcing decreasing customer service burdens, the latest digital technologies are enabling new consumer-oriented business models. Perhaps the proliferation of the latest generation of cellular phones is the most prolific example of the power of the consumer that venture capitalists seek to harness in ventures focused on the digital home, distribution of entertainment, and massively integrated semiconductor devices. In supporting his thesis of the promise of the digital home, one venture capitalist noted the progression of networks from the enterprise to the Internet, with the home as the logical next frontier for networking applications.

### The Truth Be Told

The venture capital industry has always dealt with challenges set before it, be it too much or too little of any resource, economic or intellectual. For those venture capitalists who can extract and nurture the best opportunities from the competing noise, the promise of fueling the next industry leaders holds compelling potential. They will do so knowing that start-ups have shown their ability to outmaneuver industry titans time and time again when it comes to innovation, a phenomenon that lies at the heart of venture capital. It is this knowledge that gives us a strong sense of cautious optimism as well.

####

### Equity Financings\* for US Venture-Backed Companies, by Industry Group (2002-1Q04)

\*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 Total				2003 Total				1Q04			
	# 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.	231	8.9	3,142	15%	204	12.0	3,474	20%	57	18.0	1,468	29%
Healthcare Serv.	44	7.2	392	2%	29	5.0	250	1%	2	NS	15	0%
Med Devices	166	8.6	1,656	8%	173	7.4	1,639	9%	37	6.6	272	5%
Medical IS	85	4.4	465	2%	60	3.9	286	2%	15	3.7	67	1%
<b>Healthcare Total</b>	<b>526</b>	<b>7.1</b>	<b>5,655</b>	<b>26%</b>	<b>466</b>	<b>7.2</b>	<b>5,648</b>	<b>32%</b>	<b>111</b>	<b>7.6</b>	<b>1,822</b>	<b>36%</b>
Comm. and Network	291	10.0	4,698	22%	240	10.0	2,867	16%	58	9.0	717	14%
Elect. & Computer Hdw	97	7.2	1,130	5%	80	10.0	843	5%	30	10.0	377	7%
Information Serv.	94	4.0	556	3%	86	4.7	586	3%	17	6.0	140	3%
Semiconductors	120	9.1	1,412	7%	127	10.0	1,501	8%	36	8.1	327	6%
Software	708		5,178	24%	620		3,920	22%	142		1,015	20%
Other IT		6.0		0%		5.1		0%		6.7		0%
<b>Info. Tech. Total</b>	<b>1310</b>	<b>7.0</b>	<b>12,974</b>	<b>60%</b>	<b>1153</b>	<b>6.5</b>	<b>9,718</b>	<b>55%</b>	<b>283</b>	<b>7.0</b>	<b>2,574</b>	<b>51%</b>
Consum. & Bus. Prod.	27	1.3	126	1%	28	4.5	236	1%	6	5.1	54	1%
Consum. & Bus. Serv.	332	5.0	2,209	10%	245	5.0	1,723	10%	44	5.4	480	9%
Retailers	23	6.0	159	1%	15	5.0	120	1%	6	5.0	87	2%
<b>Products &amp; Serv. Total</b>	<b>382</b>	<b>4.8</b>	<b>2,494</b>	<b>12%</b>	<b>288</b>	<b>5.0</b>	<b>2,078</b>	<b>12%</b>	<b>56</b>	<b>5.3</b>	<b>621</b>	<b>12%</b>
<b>Other Total</b>	<b>51</b>	<b>3.3</b>	<b>330</b>	<b>2%</b>	<b>66</b>	<b>3.0</b>	<b>311</b>	<b>2%</b>	<b>15</b>	<b>5.5</b>	<b>69</b>	<b>1%</b>
<b>Grand Total</b>	<b>2269</b>	<b>6.4</b>	<b>21,452</b>	<b>100%</b>	<b>1973</b>	<b>6.0</b>	<b>17,755</b>	<b>100%</b>	<b>465</b>	<b>7.0</b>	<b>5,086</b>	<b>100%</b>

Source: VentureOne/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.