Silicon Valley Venture Capitalist Confidence Index®

(Bloomberg ticker symbol: SVVCCI)

Fourth Quarter – 2016

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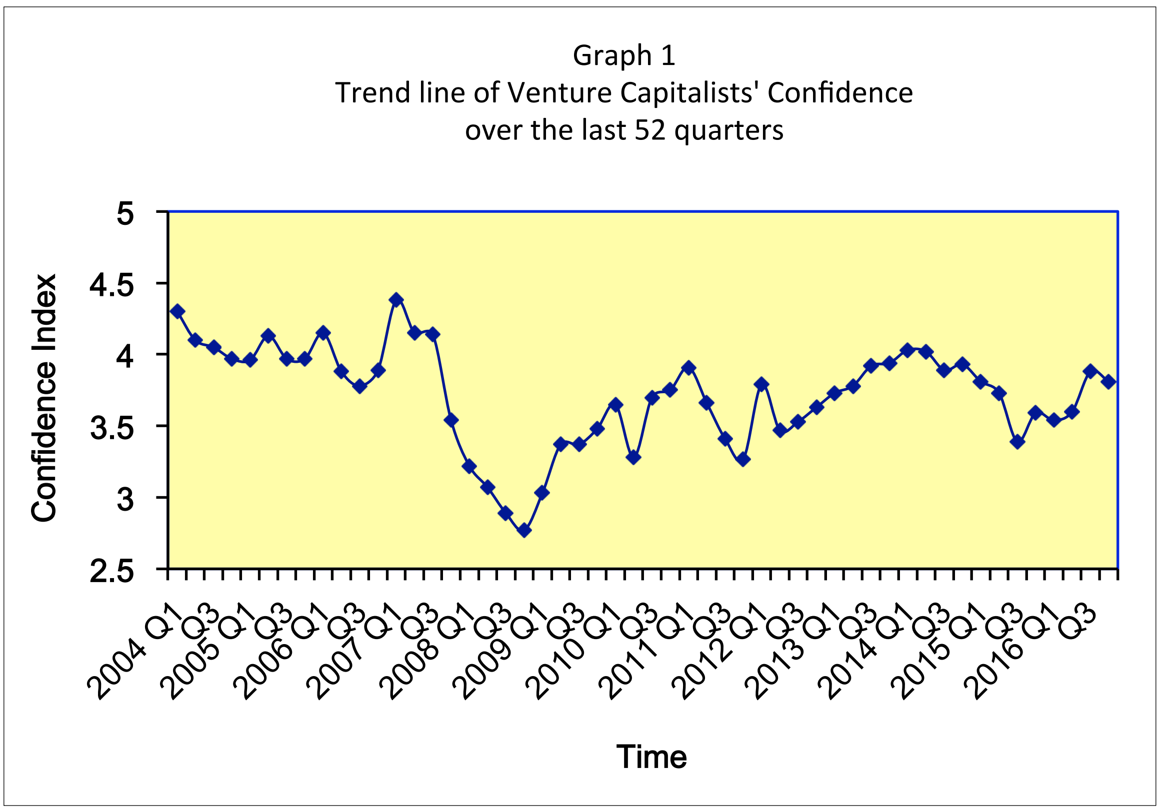
The *Silicon Valley Venture Capitalist Confidence Index® (Bloomberg ticker symbol: SVVCCI)* is based on a recurring quarterly survey of San Francisco Bay Area/Silicon Valley venture capitalists. The *Index* measures and reports the opinions of professional venture capitalists on their estimations of 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 fourth quarter of 2016, based on a December 2016 survey of 29 San Francisco Bay Area venture capitalists, registered 3.81* ***on a 5 point scale*** (with 5 indicating high confidence and 1 indicating low confidence). This quarter's index measurement fell from the previous quarter's index reading of 3.88, but stayed above the 13-year average of 3.71. Please see Graph 1 for trend data.



[1]Questions about this ongoing research study or related topics should be sent to Professor Mark Cannice at **Cannice@usfca.edu**.

Confidence in the future Bay Area entrepreneurial environment edged lower among Silicon Valley Venture Capitalists in the final quarter of 2016. Continuing concerns over political uncertainty restrained sentiment despite an outlook for rapid innovation and a more welcoming exit environment in 2017. The expectation for more liquidity opportunities came during what was a very weak Q4 where the total amount of venture-backed exits, measured in terms of number of exits and total capital value, declined significantly from the previous and year-earlier quarters.[2] Meanwhile, fundraising by VC firms, while very strong in 2016 overall, also declined in Q4 from the previous and year-earlier quarters.[3] As the business model for venture firms is driven by exit opportunities, it follows that fund-raising trends would trail liquidity trends. Still, innovation continues to flourish and expectations for the coming quarters remained strong overall. However, the push-pull of increasing political uncertainty accompanying the new administration with the expectation of more business accommodation in tax treatment, regulatory adjustments, and capital repatriation initiatives, suggests a dynamic environment that may well be best managed with venture investments and corporate acquisitions that serve as call and put options on business opportunities under varying macro realities.

In the following, I provide many of the comments of the participating venture capitalist respondents along with my analysis. Additionally, all of the Index respondents' names and firms are listed in Table 1, save those who provided their comments confidentially.

Innovation continues to drive new market opportunities. For example, Jeb Miller of Icon Ventures stated "We're seeing a growing opportunity for entrepreneurs to build vertical market and functional applications in a disruptive fashion while leveraging mobile, cloud and modern data technologies in a capital efficient manner which benefits the entire ecosystem." Jon Soberg of Expansive Ventures confirmed "The pace of innovation continues to increase and generate great companies and investment opportunities. I don't see that changing." Specifically, Ajay Chopra of Trinity Ventures advised "We are at the start of a massive innovation cycle driven by AI that will have as broad an impact on multiple industries as mobile and cloud computing have." John Malloy of BlueRun Ventures added "Some of the largest sectors of the U.S. economy, such as transportation and healthcare are in the early stages of what promises to be decades long transformations that will drive almost insatiable demand for innovation in AI, ML, robotics, computer vision and will require significant shifts in fundamental network architectures." And Eric Buatois of Benhamou Global Ventures reported "continuous very strong deal flow."

However, Bob Ackerman of Allegis Capital reasoned "Not all innovation is equal: 'technology-enabled innovation', tied to disruptive business models, often does not generate the level of profitability of returns of technology innovators. All too often, investors don't know the difference and pay the price…"

Entrepreneurial opportunities remain as political winds change. Venky Ganesan of Menlo Ventures indicated "Regardless of how one feels about Mr. Trump's politics, his administration is going to be business friendly. We are entering a regime of lower taxes and reduced regulations – this is great news for businesses. The core trends driving venture remain intact (mobile and cloud) and new frontier areas are emerging such as drones and synthetic biology. Never been a better time to be an entrepreneur." Bob Bozeman of Eastlake Ventures and Northern California Investment Funds expects "domino effects of Trump: tax simplifications and improvements, re-orientation of focus on internal U.S. needs (infrastructure, jobs, reduced regulations, etc.) creating business balance." One other venture capitalist respondent suggested "…Peter Thiel's influence in the Trump administration for venture capital and venture investing will be an unknown but positive factor in the fashioning of any tax reform. Accordingly, longer term I have high confidence that the entire entrepreneur/venture ecosystem will thrive promptly

[2] PitchBook-NVCA Venture Monitor Report Q4 2016
[3] PitchBook-NVCA Venture Monitor Report Q4 2016

after tax reform is passed in 2017."

Another responding VC predicted "meaningful tax reform will be enacted into law by June or July of 2017, and I believe that it is going to substantially affect the entire economy in the U.S., and will provide a healthy tailwind to the venture market. In particular, the reduction in the corporate tax rate will alone be a major positive for starting and running companies; add to that some kind of lowering or even elimination of certain capital gains taxes, and investment will be spurred into early-stage companies, and then there is a further possible stimulus from some kind of low or zero rate for bringing back to the U.S. overseas cash (this will be a very modest effect, however, because a lot of that cash is already invested in the U.S. from those foreign subsidiaries)…" Another venture capitalist respondent added "Thanks to high expectations of Trumponomics, the markets will be exuberant for the next 6-18 months, which is a great time to get some exits. However, with all sugar highs come….you know what."

Alternatively, Dag Syrrist of Vision Capital wrote a "combination of political and international instability in the U.S. and abroad will likely cause market volatility, with great uncertainty before the new administration's actual policies get unveiled. Investors will hold back and wait and see rather than over invest and hope for the best. Raising interest rates will make equities less appealing relatively and fundamentally venture is tied to public equity markets and M&A, both of which has had a long run with even public valuations relatively high. For sure certain pockets and niches will do well, but overall trends will depress new capital deployment." And two other VCs highlighted "political uncertainty" and "strong economic growth but uncertainty around Trump", respectively, and one other reflected, "I am still waiting to see the impact of the new administration, and all the related policy and personnel (cabinet) changes that go with it. The way I think about it is that we most likely continue on a steady trajectory, but the new administration creates a significantly higher risk of a major disaster (political, military, economic) that will appear as a one off event, but for which the foundation is currently being laid."

Other macro issues also are impacting the venture environment. For example, Bill Reichert of Garage Technology Ventures detailed "The exuberance of the equity markets is clearly excessive, given the broader macro realities of global debt, demographics, populism and geopolitics. We hope the markets can sustain enough enthusiasm to clear out some of the IPO backlog, but if you are asking for our perspective 18 months out, it seems most likely that the markets have more downside than upside. More important, in the long run, it looks like the chief beneficiary of the globalization of innovation is Silicon Valley. The strengthening of venture ecosystems in the rest of the world is actually strengthening, not weakening, Silicon Valley. This is a cause for great optimism, even as we run the gauntlet of risk and volatility over the next several quarters." Additionally, Dan Lankford of Wavepoint Ventures emphasized "some uncertainty about the investing climate in 2017."

Investor metrics for valuations and venture milestones may be tightening. Bob Ackerman of Allegis Capital noted "An excess of capital, chasing alpha, flooding into the Silicon Valley venture ecosystem has pushed valuations and costs to unsustainable levels in the Bay Area. Some returns will suffer and expect to see satellite innovation centers with lower cost structures benefit…" And Gerard van Hamel Platerink of Redmile Group shared "We are finally seeing companies come back to raise capital with realigned valuation expectations, setting investors up for robust venture returns for the near future." In fact, investment in VC-backed startups declined in Q4, from the previous and year-earlier quarters, both in terms of number of deals as well as total dollars invested. The decline in investment in Q4 was particularly steep in Silicon Valley except for AI-focused ventures.[4]

Furthermore, one VC respondent who provided comment in confidence forecast "In the immediate near

[4] PwC/CB Insights MoneyTree™ Report Q4 and Full-year 2016

term (next 3-6 months), I see some caution in venture financings with venture investors looking for greater traction in the marketplace before investing. 500 Startups announced that it would make market entry a condition to financing its early stage deals, and I think a lot of early stage financing parties wish to see something ready to take to market before investing…"

Hopes for improved exit opportunities remained. Dixon Doll, co-founder of Impact VC and DCM Ventures, explained "a big challenge in the next year or year and a half is getting exits back to traditional levels. While IPO's are projected to improve (from very low levels recently), M&A is still the primary method for liquidity to be obtained, and it has been helped recently by significant acquisition activity from well funded PE/buyout shops, looking to grow their existing PE portfolio companies." And Sandy Miller of Institutional Venture Partners estimated "2017 should be a great year for IPOs for venture-backed tech companies. Likely the best since the dot com bubble. With the election behind us, a great crop of companies poised to go public, recent successes in tech IPOs and strong investor appetite, this year will be very healthy for the whole venture ecosystem after a long IPO drought."

In the current challenging exit environment, new liquidity alternatives are emerging. For example, Howard Lee, of Founders Equity Partners, specified "The decrease in the number of venture-backed exits have contributed to significant illiquidity in the venture investment ecosystem. This in turn has resulted in pressure in the system that requires relief which has historically been in the form of IPOs and M&A exits. Increasingly, direct secondary sales by employees and early investors for partial liquidity are becoming an integral element of the overall liquidity landscape in venture. The growing interest in direct secondary transactions have highlighted the importance of the alignment of interests among the venture-backed companies, the employees, and the buyers of their shares through these transactions." Cole Sirucek also of Founders Equity Partners suggested "Direct secondaries are increasingly becoming an important part of the funding landscape to alleviate this illiquidity issue. However, this segment still suffers from relative immaturity. Until direct secondaries become a more institutionalized segment of venture, we can expect significant inefficiency in the system."

In summary, average confidence edged lower among the 29 responding venture capitalists in the Q4 survey. As has been the trend for several quarters, a focus and recognition of macro factors – particularly political uncertainty and the impact it may have on the overall economy and entrepreneurial ecosystem tempered general enthusiasm on the high level of innovation and entrepreneurial determination and potential new markets they may create. Still, acknowledgement of political uncertainty in the context of a potentially more supportive business environment and a sense of increasing exit opportunities on the horizon have confidence at a higher than average level in Q4.

However, increased political uncertainty should be accounted for in any discount factor for potential future cash flows of new ventures. Therefore, the political upheaval that the nation and its industries are currently experiencing would at first appear to deflate the present value of going concerns and new ventures. Concurrently, the greater macro uncertainty will also tend to increase the value of any options that can be created whether they be in the form of larger numbers of portfolio firms or a broader mix of portfolio companies held by venture firms or more corporate acquisitions that position enterprises for alternative scenarios that play out in the political sphere. Whether the expectation of a more business-accommodative administration outweighs broader macro uncertainty the new administration appears to be creating is difficult to predict. More narrowly, venture capitalists' confidence is often closely aligned with the expectation of a vibrant exit market, so the entrepreneurial proof will most likely be found in the public market pudding over the next months and quarters as to investors' ability to achieve liquidity and attractive returns.

Table 1
Participating Venture Capitalists in the 2016 4th Quarter Confidence Index Survey

Participant	Company
Ajay Chopra	Trinity Ventures
Bill Byun	7 Capital
Bill Reichert	Garage Technology Ventures
Bob Bozeman	Eastlake Ventures and NCIF I&II
Cole Sirucek	Founders Equity Partners
Dag Syrrist	Vision Capital
Dan Lankford	Wavepoint Ventures
Deepak Kamra	Canaan Partners
Dixon Doll	Impact VC and DCM Ventures
Eric Buatois	Benhamou Global Ventures
Gerard van Hamel Platerink	Redmile Group
Howard Lee	Founders Equity Partners
Jeb Miller	Icon Ventures
John Malloy	BlueRun Ventures
Jon Soberg	Expansive Ventures
Karan Mehandru	Trinity Ventures
Mohanjit Jolly	Iron Pillar
Richard Yen	Saban Capital Group
Robert R. Ackerman, Jr.	Allegis Capital
Sandy Miller	Institutional Venture Partners
Shomit Ghose	Onset Ventures
Standish O'Grady	Granite Ventures
Stephen J. Harrick	Institutional Venture Partners
Thomas Klein	Persistent Ventures
Venky Ganesan	Menlo Ventures
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous
Anonymous	Anonymous

Mark V. Cannice, Ph.D. is Department Chair and Professor of Entrepreneurship and Innovation with the University of San Francisco School of Management. The author wishes to thank the participating venture capitalists who generously provided their expert commentary. Thanks also to Jack Cannice for his copy-edit assistance. 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 name and title of the author.