



To: Our Investors, Colleagues and Friends
From: Equip Ventures GP's – David Waxman and Mark Goros

Re: Observations from October 2002 Private Equity Investment Conferences

- **Private Equity Analyst – NY – October 1 & 2**
- **IBF Early Stage Venture Capital Conference – San Francisco Oct. 3 & 4**
- **Global Venture Network Conference – NY – Oct. 17 & 18**

With 2002 coming to a close and 2003 coming up on us in just a few months, we thought it would be a good idea to invest some time at conferences to get our hands around what LP's and other Venture Capital GP's were expecting for 2003. Recognizing that not all of you had the opportunity to hit the conference circuit this month, we are happy to compile some of the key observations, themes and benchmarks that we thought might be of interest to you from some of the panels we found most relevant to the VC asset class.

Here they are:

1. The dynamics in the early stage venture capital market set the stage for very compelling returns for Vintage 2003 VC Funds

- Low valuations & excellent terms are available for top tier entrepreneur deal flow
- Only truly passionate entrepreneurs will start companies in this market
- Great management talent is available in a very strong recruiting pool
- With few companies being funded, the competitive landscape down the road the when the IT spending downturn shifts will be very thin.
- VC's are being much more selective and have set the bar much higher, so quality of companies will be much higher than in late 90's.
- Certain VC's including Tim Draper of DFJ, Brian Jacobs of St. Paul Ventures, Sonja Hoel of Menlo Ventures and Noel Fenton of Trinity are quite bullish on the Seed and early stage VC investment opportunity.
- Technology need is not disappearing – over long term IT spending has doubled as % of Capital Spending every ten years and that trend will continue despite near to medium term gap, due to release of pent-up demand in medium term.
- VC Capital Overhang is not necessarily what it seems on the surface. While there is a significant amount of capital that has been committed to the asset class that has not yet been deployed by VC's, at least 50% of the remaining capital is reserved to invest in current portfolio companies another 15% is reserved for management fees and the excess capital is being returned to LP's by GP's that raised "large Mega VC Funds" driven by the recognition that most of the capital committed by LP's in Vintage '99 and 2000 Funds was misaligned in large VC Funds that are focused on their current portfolios and not positioned and nimble enough to deploy early stage VC investments in capital efficient deals that take advantage of the 2003-2005 investment climate. Most of the excess non-reserved

capital will ultimately be returned to LP's which has an impact on the next theme we observed:

2. More LP Capital Available and increasing capacity and appetite for New and Emerging GP's with operating experience raising smaller funds in 2003

- Very few established brand name VC's are coming to market to raise capital in 2003, the earliest they will enter market is mid 2004.
- When established VC's come to market, LP's will face major succession Due Diligence issues, as there will be a fair amount of turnover among partners as the older partners who developed the Firm's track record will be making way for junior partners who learned their investment lessons during the late 90's, a period that is not representative of the investment climate moving forward. LP's recognize that upcoming investment cycle is an opportunity to cleanse carry allocation inequities and realign GP interests through investments in spinouts and new Funds and entities managing smaller pools of capital
- Similar to development in Hedge Fund market, LP's are starting to talk about Emerging Managers as being a better bet than some established firms as that the Emerging Partnerships are "hungrier" and can not "get rich" on management fees of their smaller funds.
- Having been very conservative in VC asset class deployments in 2001 and 2002, LP's are recognizing that if they do not deploy more aggressively to the VC asset class in 2003, they may be compounding their "timing problem" due to over-commitment to the under-performing 1999 and 2000 Vintages and have a major impact on their long term returns. Accordingly as they deploy in 2003 – they are open to looking at First time and Emerging Partnerships. Dennis McCrary, the head of Investment Partnerships at Adams Street Partners, notably stated that **30% of the Funds they invest in 2003 will be First time Funds or Emerging Partnerships.**
- Poor public equity returns over past 2.5 years are driving overall returns down and raising the specter of under-funded liabilities for corporate and govt. pension funds which will be deploying more capital to Alternative Assets in order to make up for the return deficiencies. Some of these fund will filter down to the VC asset class.
- With low valuations that can only support a capital efficient \$13-18 Million of investment before exit, smaller funds will be the only funds that can put those amounts of capital to work and supply the partner bandwidth necessary to nurture early stage companies through the coming challenging years, when cap spending will still be constrained.
- LP's are placing a premium on GP's prior operating experience which will be critical in imposing operational and financial discipline on portfolio companies during the coming challenging years, when cap spending and capital markets will still be constrained.
- Industry is bifurcating and "barbelling"– small sub-\$250M funds will focus on very active early stage investing and \$1B+ funds will focus on buyouts, very capital intensive hardware deals and mezzanine deals. You will not see \$1 Billion + funds doing early stage investment any more. This will cause some major change and spin-outs among current top tier incumbents who after capital givebacks are still in \$600M + range which is viewed as perhaps too large to deliver top tier returns in prevailing investment climate going forward.

- “Barbelling” dynamic and late stage capital overhang will also have effect of bidding up the few intriguing Series B & Series C deals that will emerge from the shortage of Series A deals being done in 2002 & 2003. This is a very positive dynamic for small, emerging Vintage 2003 funds now being formed. These new funds do not have the baggage of an existing portfolio and will be in a position to invest in these Series A deal opportunities.
3. **LP VC Return Expectations are lower than they have been in the past, but despite a lot of talk about it, LP’s do not expect the fundamental economics and structure of LP/GP relationship to change in near or mid term**
- IRR Projections from major LP’s & VC’s including University of North Carolina, Harbourvest, RBC, Hamilton Lane, Abbot Capital and Carlyle Group ranged from 11%-18% - with the upper quartile from 16-18%. Warburg was outside the box and projected a 40% return.
 - 20% carry and 2-2.5% management fee on committed capital will not change, due to the fractured ownership issue as that it is difficult for LP’s to unify and drive change as that they typically own at most just 10% of any given LP. If LP’s are unhappy with a GP’s performance, they will “vote with their feet” during the upcoming fundraising cycle. Harbourvest mentioned that perhaps by 2006 or 2007 there will be some fundamental changes.
 - Terms such as clawbacks, which were highlighted as potentially major issues for ’95 to ’97 vintage funds could be tightened up in near term. Key man provisions were highlighted for near term tightening as well.
 - LP’s are not necessarily focused on size of GP contribution toward LP, but are more focused on the relative % of net worth that the GP’s contribution represents.
4. **Experienced early stage VC’s are saying that current early stage valuations and terms are so favorable they are “almost too good” leading to potential portfolio company management incentive issues.**
- The average seed valuation is currently \$2.5 Million, the average Series A valuation is \$5 Million.
 - Valuations when viewed from revenue metric perspective currently are: 1X current year realistic revenue projection.
 - Unless a company has made significant achievement of or even surpassed milestones, Series B round will either be flat or a downround.
 - Full ratchet anti-dilution terms, redeemable preferred securities and 2-3X liquidity preferences, are now pretty much standard in term sheets, although more entrepreneur-friendly VC’s recognize that these when combined with low valuations can disincentivize management teams. A response to this concern includes management milestone-driven option “give back” carve-outs.
5. **Investing approach is “back to basics” – early ‘90’s style**
- Capital Efficiency - A survey of West Coast early stage VC’s elicited responses that if a company did not reach positive cash flow with a range of \$13-18M in cumulative total investment, they would pull the plug. Business plans that require more capital are not even being considered. At the East Coast Global Venture Conference in NY, this issue did not even come up.

- West Coast VC's prefer to invest in early stage deals with a strong syndicate of investors, rather than invest in late stage "distressed" purchases at very low valuations, which East Coast investors seem more interested in.
- Strong return to Best Practices of early '90's:
 - i. Lengthy, thorough Due Diligence
 - ii. Disciplined valuations, will not get into bidding wars
 - iii. Fresh Insight peer review from non-investing partners for continued support for Series B investors.
 - iv. Return to syndication for Series A's to spread risk for future round financings.
 - v. Hiring new team members with premium on operating experience.
 - vi. Panelists most likened upcoming seven year investment cycle of 2002-2009 period to the 1991-1998 period, which is viewed as one of the strongest VC return cycles over the 35 year history of VC investing.
- "Rule of Thumb" milestones that West Coast VC's are shooting for are as follows:
 - i. \$500,000 to develop a Business Plan and Founding team (engineering and founding CEO and product development team)
 - ii. \$1.5 Million to get first paying customers. Like to see use of part-time people and bootstrapping approaches.
 - iii. VC's are not looking to bring in a new CEO until revenue is being generated and in some instances only post-series B. Notably, Woodside Ventures disagreed with this approach and look to bring in a new CEO at a very early stage. as they did in during the bubble period.
 - iv. An additional- \$3-4 Million to achieve milestones that are strong enough to attract Series B
 - a. 3-5 high quality paying customers (i.e: no friends of the CEO)
 - b. Complete Management team including CEO with at a minimum domain expertise – ideally, but not necessarily your recruited –in long-term star.
 - c. Very strong technical team
 - d. No debt, simplified cap structure
 - e. Pay to Play for Series A investors if they want to maintain liquidation preferences.
 - f. Release of Series B could be milestone-based.
 - v. Current Expectation is a 5-6 year holding period until exit. General expectation is IPO market returning in '06-'07.
 - vi. A total of \$13-\$18 Million at maximum cumulatively invested in a company until positive cash flow or plug will be pulled. Ideal syndication team should be 2 lead VC's and 2 complementary VC's or strategic investors.
 - vii. Invest at a rate of 1.5 - 2 companies per partner per year with a maximum of 6-8 boards per partner due to increased focus on portfolio companies.
 - viii. Ideal Series A Board Structure: 1 member of management – typically a founder (or new CEO if already recruited), 2 VC's, 2 outside Bd.

Members. It should be noted that in a post-Sarbanes-Oxley environment, recruiting outside board members is much more difficult than it has been in the past. Accordingly if second outside member can not be recruited, there is a window for 2nd management member to stay on board, but only if one of them is an externally recruited CEO.

Hope you find this helpful in planning for 2003.

David & Mark

Equip Ventures L.P, is an early stage venture capital fund currently raising up to a \$75 Million Fund that will be focused on investing in seed and early stage next generation technology companies primarily located in two markets that are currently under-funded by venture capitalists - in U.S. companies based on next generation innovative Israeli technology and in San Diego region based companies. Equip views the next 24 to 36 months as an advantageous time period to invest in early-stage ventures due to a positive convergence of market factors. Mark D. Goros and David S. Waxman, the General Partners of the Fund, have over 43 years of combined high-tech operational and venture capital experience and will play a significant value-added role in nurturing the Fund's portfolio companies. Mr. Goros was one of the early executives at Oracle and was a key member of the team that drove them to \$1 Billion + in revenues and he was on the founding team at BroadVision. Mr. Waxman has co-founded and served as CEO of several startups including an Israel-US technology company and has been a Venture Capitalist for five years. During the course of their careers, the General Partners have developed a track record of early stage venture capital investment decisions strong with an annual IRR in excess of 100%, which has been driven by an exit ratio of 68%.

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