



Equip Ventures L.P. is an early stage venture capital fund currently raising up to a \$75 Million Fund investing in seed and early stage next generation technology companies primarily located in two markets that are currently under-funded by venture capitalists - U.S. companies based on innovative Israeli technology and in San Diego region-based companies. Mark D. Goros and David S. Waxman, the General Partners of the Fund, have over 45 years of combined high-tech operational and venture capital experience and along with a premier advisory team of former CIO's, VC's and startup managers 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 \$700M + in revenues. He was also on the founding team of 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 six years. During the course of their careers, the General Partners have developed a strong track record of early stage venture capital investment decisions with an annual IRR in excess of 200%, which has been driven by an exit ratio of 65%.

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

2004 Preview for Venture Capital Asset Class

Themes Emerging from Recent Private Equity Investment Conferences

LP Summit West – San Francisco – Dec. 2nd & 3rd

Private Equity Analyst – NY - September 23 & 24

E&Y Journey Israel VC '03 – Tel Aviv - September 4

Limited Partner Summit – NY - June 24 & 25

Mid Atlantic Venture Association Conf. - Baltimore - May 27

With 2004 here, we thought it would be a good idea to attend LP Summit West and Private Equity Analyst to get our hands around what LP's and other Venture Capital GP's were expecting for the New Year. Recognizing that not all of you had the opportunity to be at PEA, which is historically the Private Equity kickoff conference that sets the tone for the coming year, and LPSW which is a follow up conference that builds on the themes showcased at PEA, we are happy to compile some of the key observations, themes and benchmarks that we thought might be of interest from some of the panels we found most relevant to the VC asset class. We've also integrated and included some themes from earlier conferences that we think might have interest as well.

Hope you find it helpful in planning for 2004, which should see an increase in VC fundraising and investing.

General Themes

1. The current dynamics in the early stage venture capital market set the stage for more compelling returns for Vintage 2004 & 2005 VC Funds.

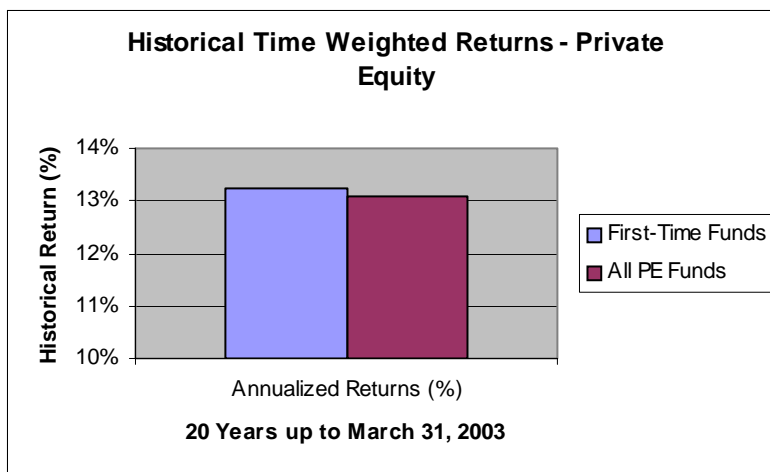
- VC Investment in Q3 2003 nearly matched Q2 2003, despite the summer month's traditional slowdown in activity. Q2 2003 VC investment exceeded VC investment in the 1st half of 2002.
- Most VC's are talking about an upswing in deal flow quality and quantity.

- Low valuations & excellent terms are available for top-tier entrepreneur deal flow.
- While only truly passionate entrepreneurs were starting companies in 2001- mid-2003, we will see a larger pool of entrepreneurs, some of lower quality looking for VC funding in 2004 and 2005.
- Great management talent is available in a very strong recruiting pool – managers with entrepreneurial mindsets are sensing a shift in market and starting to look for new opportunities.
- With few companies still being funded, the competitive landscape down the road 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 the quality of companies will be much higher than in late 90's.
- Many early stage VC's are now quite optimistic regarding the seed and early stage VC investment opportunity, but are having difficulty investing in new companies due to time and bandwidth commitments to current portfolio companies.
- Technology needs are not disappearing –long term IT spending has doubled as a % of Capital Spending every ten years and that trend will continue over long term. Q4 2003 should be a good quarter as budgets are spent due to “use it or lose it” effect and 2004 should start to see a steady improvement in capital spending figures.
- While last year there was a debate regarding VC Capital Overhang, it is now the general consensus that there is little capital available in current VC Funds for new opportunities, as manifested by the number of VC Funds that will return to market by end of 2005 to refill their coffers. 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 80% of the remaining capital is reserved to invest in current portfolio companies or late stage opportunities (leading to late-stage capital overhang), another 10% is reserved for management fees and some excess capital has been, and is being returned to LP's by GP's that raised “Mega VC Funds”. This is cutting down competition for deals and keeping valuations low.
- Additionally, the late stage capital overhang will also have the 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 Vintage 2004-2005 funds that will have a supply of follow-on co-investors for their portfolio company's successive rounds. However, strong intra-VC relationships will be critical for these Fund Managers to succeed.

2. New LP Entrants to VC Asset Class and much smaller size funds of established GP's for forthcoming fund-raising cycle, as well as Succession issues and an LP premium on operating experience, will solidify demand for Emerging Manager GP's with operating experience raising smaller funds in 2004-5.

- With low valuations and investment terms that can only support a capital efficient \$13-18 Million cumulative VC investment before positive cash flow, smaller funds will be the only funds that can put these smaller amounts of capital to work, without overwhelming a startup's capital structure. Emerging GPs can supply the partner bandwidth and operational experience necessary to nurture early stage companies.

- While no general consensus existed in 2002 and 1H 2003, “Back to Basics” style VC Investing (as discussed in detail below in Theme # 7) and Smaller Fund Sizes are now established facts across the industry. There is a consensus that Venture Capital Management is not necessarily a scalable business. All the major established top-tier VC’s (with exception of NEA who announced the closing of a \$1.1B fund in December ‘03) that are coming to market in forthcoming fundraising cycle, are raising sub-\$400M funds and the average fund size for Funds raised to date in 2003 is \$141M, down from \$300M in 2000. Accordingly, fund allocations to re-upping LP’s are being cut back. This dynamic will result in the closing out of new potential LP’s and new LP entrants to top-tier Funds. This excess VC asset class capacity will now be in most instances funneled to the 2004-2005 crop of Emerging Managers (“EM’s).
- EM’s and First Time Funds are now a fact of life on the ground with a much stronger pool of candidates in 2004 raising capital and a much greater supply of capital becoming available to fund them. Demand for EM’s and EM formation is not only being driven by supply-demand dynamics discussed in the 5 bullet points below, but is being driven by generational/succession issues at established VC Funds. This represents a shift among LP’s to a recognition that operational experience and capabilities are of higher value in being a successful VC than financial engineering skills and that newer funds with limited troubled portfolios and LP management issues can be more focused to concentrate on adding value to forthcoming vintage portfolios.
- A clear indication of above dynamic was the placement of the session “Identifying and Evaluating First Time-Fund Managers” on the first day of the Limited Partners Summit West conference on Dec. 2 at 11AM – the peak session attendance time frame. Just six months ago, if such a panel would have even have been put together by the conference organizer; it most likely would have been relegated to the second day during the afternoon. During this session David Turner of West AM presented data that indicated that First Time Funds have higher returns than all PE Funds over a 20 year period as indicated below:



Additionally, Erica Bushner of GKM Generation Fund laid out a First-Time-Fund Due Diligence methodology and Clint Harris of Grove Street gave a very erudite presentation on the critical and dynamic role First Time Funds play over the long term for most private equity portfolios.

- An additional indicator at the LP Summit West Conference that EM's are "here to stay" was consensus expressed during the "The Voice of Experience Panel" with Dick Kramlich of NEA, Hanse Halligan of Fairview, Duke DeGrassi of Hamilton Lane and Dixon Doll of DCM that the Top Tier VC Funds "would look a lot different in 5 years from now".
- State Pension Funds and large public Institutions are leading the way in establishing EM and small fund size mandates being managed by specialized advisors that have experience and track records in working with EM's. In addition to CALSTERS long standing program with Grove Street, major pension Funds including NIB and COPERA have begun investing in Emerging Managers through specialized advisors. Additionally, CALSTERS, MASS PRIM, State of Virginia and several others have initiated Advisor RFP's for \$100M-\$250M Emerging Manager Programs and are in decision-making mode now. Discussions with other major pension funds have indicated that within 6-12 months there will be at least fifteen specialty emerging manager advisor programs actively investing, including the CPP, the major Canadian Pension Fund that announced an EM program at the PEA conference which will allocate 5-10% of a multi-billion dollar portfolio to new teams. If we see more instances in which public institutions are closed out of top-tier funds, similar to Sequoia's closing out of University of California, its long-time LP, due to UCOP's disclosure requirements; we could see this trend accelerate even more over next 3 years. This trend is driving certain Fund of Funds that traditionally had not invested in EM's to allocate portions of their assets under management to Emerging Managers to help with their own fundraising efforts.
- Having been very conservative in VC asset class deployments in 2001 to 2003, LP's are recognizing that if they do not deploy more aggressively to the VC asset class in 2004-2006, they may be compounding their "timing problem" due to over-commitment to the under-performing 1999 and 2000 Vintages which will have a major impact on their long term returns. As they deploy in 2004-2006, a lack of capacity at top-tier established funds and a recognition of the factors driving the increase in high quality Emerging Managers, will drive many LP's to deploy a segment of their VC allocation to Emerging Managers. In some instances, LP's who were closed out of the top-tier funds they were interested in still must deploy to the VC asset class. Some of these LP's will deploy their full VC commitment to EM's.
- Poor public equity returns over the past 3 years are driving overall returns down and raising the specter of under-funded liabilities for corporate, govt. pension funds, endowments and foundations. To make up for the return deficiencies, more capital will be deployed to Alternative Assets. Some of these allocations will filter down to the VC asset class, which offers the highest-risk reward ratio.
- LP's are recognizing that the Generational/Succession issue at established funds will play a much greater role in a lower re-up ratio than they had originally projected. Over the past 6 months, this issue has developed a strong momentum as recognition solidifies that there already has been a fair amount of turnover

among partners at established Funds, as the more senior partners who developed the Firm's track record make 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. There have also been several instances where well-established funds have decided not to continue raising capital or invest in VC deals due to a lack of successors to scaling-down established partners (i.e. Crosspoint) or where high profile partners strongly identified with the success of their fund (i.e. Ted Dintersmith of Charles River, Mike Levinthal of Mayfield) are planning on leaving. Accordingly, LP's now recognize that the 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.

- There is a consensus building that past performance is not necessarily an indication of future performance and that operations experience resident in EM management teams might be more of a critical element in investing in successful GP's moving forward. Phil Cooper of Goldman Sachs, gave a very interesting talk on this with significant data backup at the NY Super-Return Conference in April. A similar consensus emerged at the LP Summit in late June, that from a historical fund performance perspective; generally Fund I and Fund II have offered the best returns, Fund III & IV on the lower half of the curve, with Fund V, when generally there has been a new generation of investing partners, returning to Fund I and II levels.
- Additionally, there is now a strong LP consensus that Emerging Managers are "hungrier" and will be more receptive to negotiating LP-friendly terms and conditions. Due to their smaller fund sizes, GP's by definition cannot enrich themselves based on the management fees of their smaller funds, which leads to the next theme.

3. 2004 will be a much more robust GP Fund-Raising year than 2002-2003 combined, when 200 Funds successfully completed fundraising.

- Consensus is that many GP's in all asset classes are coming to market in 2004-2005 as their draw-down periods for 1999 and 2000 vintage funds come to a close, including many top-tier VC Funds.
- Top-tier VC Funds will drive a bi-furcated market. While re-ups will not be automatic and generational change, successions issues and FOIA issues will add extra variables to the fundraising process for established funds, smaller fund size goals will still enable them to raise capital relatively efficiently. Less established funds will have to demonstrate strong operational skills, differentiable strategies, small fund sizes, commitment to strategy, fundraising stamina and strong relationship management skills over an extended period of time to meet fundraising goals. GP's that can not clearly demonstrate these capabilities were advised by leading LP's to consider holding off on coming to market until late 2005-2006, when teams who already have not put in a significant amount of work building LP relationships in 2002 and 2003, with a goal of peaking and closing in 2004, might be better off waiting for, when the market will be less crowded with top-tier Funds.
- Interestingly, a track record of the GP investing together was emphasized less as being critical for fund-raising than in the past (note that individual track records and

some history of working together are very important), as that it is clearly recognized that Emerging Manager partnerships with strong qualities will emerge that are not “Pure Spinouts” from top-tier funds. Individuals who may have worked together in past, but did not spend time together at same VC funds will often provide a stronger GP investment opportunity.

- With many new LP entrants to the VC asset class shifting from planning mode to deployment mode, (primarily international institutions and US pension funds), they will find that they are not able to access top-tier funds. These funds are less interested in public pension fund capital and will have to cut back current limited partners due to smaller fund sizes. This means opportunity arises for new Emerging Manager partnerships, which recognize these dynamics and are preparing to come to market in 2004-2005. These EM's appeal to LP's that have carved out capital for EM's outside of their top-tier fund commitments as well as the unfulfilled capacity of many LP who could not re-up to their full allocation.
- US Endowments and Foundations in most instances will be the exception to this trend and in most instances will be cautious about committing to the same high allocations they did in past to re-ups. However, as that they have always maintained a higher risk-reward profile than other LP's, and there will be a strong supply of EM's in the market, endowments and foundations will seek to participate as LP's on a selective basis so they don't miss out on the opportunity to establish some ground-floor relationships with a new generation of potential high-performing funds.
- There was some discussion of European Institutions returning to market for a second wave of private equity investment, but they will look for US institutional leads in US Funds before committing.

4. LP VC Return Expectations are lower than they have been in the past, but despite increased discussion surrounding it, LP's do not expect the fundamental economics and structure of LP/GP relationship to change in near or mid term, but there will be changes to non-core terms.

- Consensus on VC Asset Class IRR Projections from major LP's & VC's are as follows:
 - i. Vintage 1999-2000 – recovery of capital unlikely
 - ii. Vintage 2001 – Single digit returns most likely, although selected fund with a small ratio of capital deployed can outperform
 - iii. Vintage 2002 –2003 – 12-15% Return
 - iv. Vintage 2004 – 2006 –14-17% Return

These numbers include all VC stage funds from Seed to Late Stage and everything in between. Early-Stage VC Funds are expected to have 2004-2006 returns comparable to the 30%-35%, ~3X, long term historical VC returns from 1970-1998 over time. Secondary Funds are expected to return 20-25% and outperform other VC investment segments in near-term, but will under-perform rest of VC investment segments as valuations rise. The VC industry as a whole is not expected to return to composite 30% return for 5 years, which is the expected exit period for portfolio companies in vintage 2003-2204 Funds.

- Large Public Institutional LP's often measure Private Equity return performance on a relative basis and are seeking a minimum of Russell 2000 + 300 basis points from their PE portfolios. Large State Pension Fund Managers also noted that if

relative performance was not there for a 5-year time frame, they could lose political support for Private Equity Programs, which could potentially significantly impact on PE capital availability from US pension funds, if the market trough continues for 2-3 more years.

- Private Fund Managers are much more concerned with absolute performance and benchmarking their own performance versus comparable private equity managers with similar strategies.
- Despite lower return expectations, 20% carry and 2% management fee on committed capital not expected to change (with exception of sub-\$100M funds which are allowed a 2.5% management fee), with exception that some outlying 25%-30% carry funds will raise their next fund with a 20% and 25% carry respectively. Despite discussion that the current structure is a holdover from a smaller fund era, and even from 70's Real Estate Partnership era, due to the fractured ownership issue, it is difficult for LP's to unify and drive change as that they typically own at most just 10% of any given LP, major structural change is not likely. If LP's are unhappy with a GP's performance, they will "vote with their feet" during the upcoming fundraising cycle. There is some talk that perhaps by 2006 or 2007 there will be some fundamental changes, perhaps with a move toward a budgeted management fee and variable carry based on performance, but those terms are only put in place very rarely at this point. There is very little LP appetite for a 10% flat carry with a deal-by deal distribution mechanism that some GP's in the UK have experimented with.
- 8% hurdle rates are more prevalent now, but LP's recognize that if a hurdle rate is combined with a back-end carry payout or "full-recovery" distribution clause, GP distributions will potentially not be paid out for up to 8 years, even in a average PE IRR scenario, which will be a major talent recruiting and retention barrier for GP's and potentially hurt performance. This is especially relevant for younger partners who often have to go into personal debt to meet GP capital calls. Accordingly, it is rare that both 100% backend-carry and hurdle rates are combined. Although a hurdle rate, interim carry distribution and an interim clawback provision is a combination that can work for both LP's and GP's, depending on the GP and LP requirements. However, pendulum is moving in the direction of Full Recovery Carries.
- There is a movement toward an annual review of key man provision designees due to succession issues and generational change at established Funds. This is not as much of an issue at Emerging Managers, where LP's know that GP's they are investing in will be major players at Fund for many years to come
- LP's are not necessarily focused on absolute size of GP contribution toward LP, but are more focused on the relative % of net worth that the GP's contribution represents.
- According to some LP's, Due Diligence will be tougher than in the past and in some instances could focus on personal lifestyle issues of the GP, such as rounds of golf played a year, how often a private plane is flown, how many 2nd homes, etc. that may not indicate a full focus on early stage investing, or have an impact on key man insurance issues.

5. FOIA Disclosure Issues are having some broad unforeseen effects.

- Disclosure by major Public Institution LP's ("PILPS") are "puncturing some of the mystique" surrounding some VC Funds as not only are their '99-2000 interim performance numbers being disclosed, but lower than expected returns in strong vintage years for some funds are forcing LP's and entrepreneurs to re-evaluate them.
- As indicated above, some VC Funds are closing out PILPS that either are currently legally bound to disclose GP performance information (i.e. Sequoia closing out UCOP) or not allowing in public pension funds that may at some point in future have GP performance disclosure obligations. This is applying mostly to new LP candidates. This dynamic will drive a lot of pension fund and public university capital towards Emerging Managers, who are willing to develop these LP relationships and create momentum toward the creation of more EM advisory mandates.
- All parties in the PE community are unified in the belief that portfolio company information must not be disclosed to the public, as it can produce a major risk to the industry. As that the possibility exists that courts may decide otherwise at some point in the future, selected GP's are taking the precaution of not disclosing underlying portfolio company information to not only PILPS, but also in certain instances, are limiting disclosure of portfolio company information to Fund of Funds that have PILPS as investors, to limit potential downstream disclosure issues.

6. After a trough period that tracked the VC Investment and Fund raising curve in the US, major institutional LP's commitments in Israeli VC Funds have recently been announced and VC investment activity in Israel is starting to pick up somewhat, but with a major US and European investor component.

- According to the Israel Venture Association (IVA) Q2 survey, 86 private Israeli high-tech companies raised \$271M in Q2 '03, a 28% increase from Q1 '03. New investments accounted for 40% of Israeli VC investments compared to 34% in Q1. Local Israeli VC investments were stable at \$94M, while international investors (primarily US) increased direct Israeli investments by 72% from Q1.
- An additional strong vote of confidence for the Israeli tech market were 2 significant commitments announced in September from major state pension funds, to Israeli GP's. New York State committed \$50M to Pitango and the State of Illinois pension fund, committed \$25M to Evergreen, which represents 25% of its VC allocation for 2003.
- From a stage perspective, according to the IVA survey, seed investments grew to 7% from 3% of total VC investment in Q1; early stage rounds attracted 35% as compared to 31%; initial revenue investments attracted the most capital – 48% - a 38% increase from Q1; while late stage investments declined to 10% of the capital raised, 39% below the amount raised in Q1, indicating a shift in bias toward earlier stage investment which is an indicator of more positive outlook.
- The vote of confidence given to Israel by overseas investors has been foreshadowed by an increase in optimism amongst Israeli VC's and the high tech community. At the Journey '03 conference in Tel Aviv, which is the tone-setter for the Israeli VC community, attendance was up significantly from 2002 and there was a general feeling that the worst of the high tech slump is behind the Israeli

high tech community. Additionally, the Deloitte and Touche - Brightman VC Indicator survey for Q3 2003 that measured the expectations of managing partners in 50 Israeli VC funds reported that 54% of the GP's expected the high tech environment in Israel to improve, compared with 46% in Q1.

7. VC Investing approach is now “back to basics” – 1980’s and early ‘90’s style.

- The average seed valuation for IT startups is generally \$2-\$2.5 Million, the average Series A valuation is \$4-\$5 Million.
- Valuations when viewed from revenue metric perspective currently are: 1X current year realistic revenue projections.
- Unless a company has achieved of, or even surpassed milestones, Series B round will either be flat or a downround.
- Full ratchet anti-dilution terms, participating 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 and be counter-productive. A response to this concern includes management milestone-driven option “give back” carve-outs.
- Capital Efficiency - A survey of early stage VC's elicited responses that if a software 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 as attractive.
- Strong return to Best Practices of 1980's and 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 current seven-year investment cycle; we are in beginning stages of (2001-2008 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 early stage VC's are currently employing 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 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. Some VC's still disagree 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

- b. Complete Management team including CEO with domain expertise – ideally, but not necessarily your recruited 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, although we have seen an improvement in August 2003, when 20 IPO registration statements were filed.
- vi. 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. Ideal investment \$ ratio per partner in early stage VC asset class should not be higher than \$35M per partner with a built-in 125-150% holdback for “pay to play” in future rounds.
- vii. Ideal Series A Board Structure is now 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 wrapping up 2003 and planning for 2004.

David & Mark

For more information or to request a Private Placement Memorandum, visit us at www.equipventures.com, or call us at 1-858-366-4047, 1-858-551-1280 or at our Israel office +972-08-979-1119