



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

Re: 2003 Mid-Year Perspective on the Venture Capital Asset Class

As mid-year approaches, we thought we would take the opportunity to share with you a compilation of some of our observations regarding the 2003 Outlook for the Venture Capital Asset Class based on our conversations with startups, venture capitalists, LP's and Advisors over the past few months. Hope you find it helpful in planning for the second half of 2003, which should see an increase in VC activity.

1. The dynamics in the early stage venture capital market set the stage for very compelling returns for Vintage 2003 and 2004 VC Funds which is driving an increase in VC investment over 2002.

- VC Investment in Q1 2003 exceeded VC investment in the **1st half** of 2002.
- Low valuations & excellent terms are available for top tier entrepreneur deal flow
- Only truly passionate entrepreneurs are starting 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 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 % 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". This phenomenon is 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 have 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

- 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 necessary to nurture early stage companies through the coming challenging years, when capital spending will still be constrained.
- 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 has announced a tender for a \$100M Emerging Manager advisor. Discussions with other major pension funds have indicated that within 6-12 months there will be at least a dozen specialty emerging manager advisor programs actively investing.
- 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 and 2004, 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 and 2004 – they are open to looking at First time and Emerging Partnerships. Notably, the head of Investment Partnerships at a major advisor and Fund of Funds has told us that 30% of the Funds they invest in 2003 will be First time Funds or Emerging Partnerships.
- Poor public equity returns over past 3 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 funds will filter down to the VC asset class.
- 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 capital spending and capital markets will still be constrained.
- Industry is bifurcating and "barbelling"– small \$50M-\$150M 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.
- Very few established brand name VC's are coming to market to raise capital in 2003, the earliest they will enter market is late 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 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.
 - Similar to developments in the 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 enrich themselves based on the management fees of their smaller funds.
- 3. LP VC Return Expectations are lower than they have been in the past, but despite a lot of discussion surrounding 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 range from 11%-18% - with the upper quartile from 16-18%.
 - 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. There is some talk that perhaps by 2006 or 2007 there will be some fundamental changes.
 - Terms such as clawbacks and even the possibility of interim clawbacks in certain instances, have been highlighted as potentially major issues for '95 to '97 vintage funds could be tightened up in near term. Key man provisions have been 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. VC Investing approach is now “back to basics” – early ‘90’s style

- Capital Efficiency - A survey of West Coast 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 even being considered.
- 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 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.
 - 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. Ideal investment \$ ratio per partner should not be higher than \$35M per partner with a built-in 125-150% holdback for “pay to play” in future rounds.
- viii. 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 planning for the second half of 2003.

David & Mark

Equip Ventures L.P., is a 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 co-founded 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 200%, which has been driven by an exit ratio of 68%.

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