

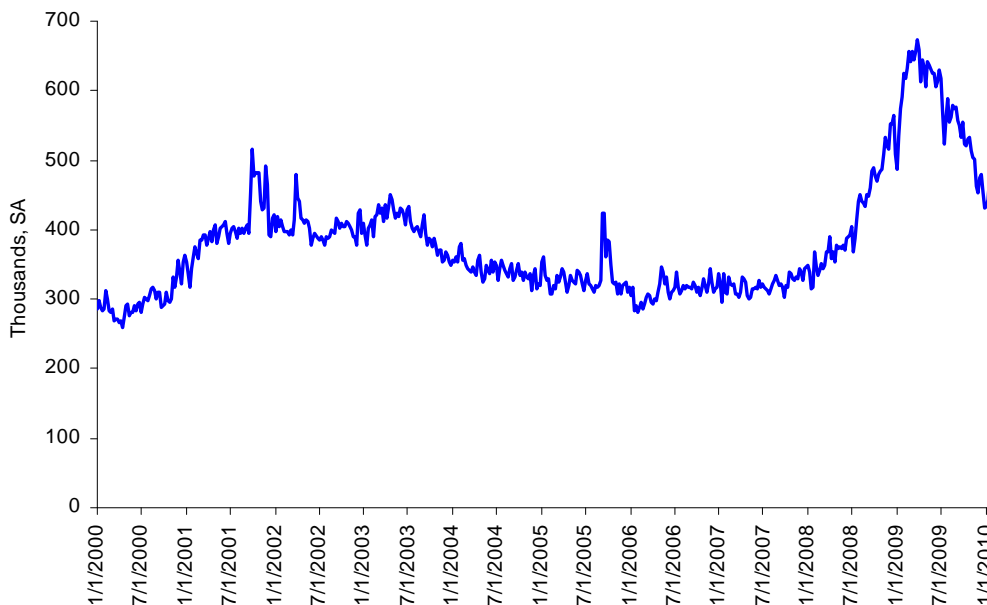
February 22, 2010

Pall in Venture Capital: Economic Sluggishness Likely to Persist

Venture capital activity remains stalled despite the recovery in GDP and purchasing managers indices. Venture capital is a key part of the entrepreneurship and innovation which drives future U.S. economic growth, yet weakness there doesn't register much in macro-indicators (which emphasize activity in bigger companies and the government.)

- Big companies are benefiting from inventory rebuilding, the partial recovery in autos (which collapsed after the Lehman bankruptcy), and the near-zero Fed funds rate. Big companies register heavily in the macro indicators yet haven't traditionally been a big source of job growth. The Atlanta Fed estimates that firms with fewer than 50 employees – few venture-backed startups are bigger – have accounted for 30% of job growth since 1992.
- Jobless claims shows a mixed picture. 473,000 people filed an initial jobless claim in the week ended February 13, an improvement from 2009 but still reflecting the weakness in job creation.

Initial Unemployment Claims (last obs. February 13, 2010)



Source: Department of Labor; Encima Global

Pall in Venture Capital

Investments by venture capital firms fell to \$17.7 billion in 2009, the lowest since 1997, down 37% from 2008. In the fourth quarter of 2009, VC investment totaled only \$5 billion, a 2% decline from the third quarter. VC firms also had trouble building new funds, raising just \$15.2 billion in 2009, a 47% decline from 2008.

This dearth of venture financing is one of several factors arguing against a robust expansion.

- Without an active venture capital market, the labor market recovery will be held back. Some 20% of GDP has been accounted for directly by companies that were venture financed.
- The competitive catalyst that comes from entrepreneurial upstarts challenging their more established competitors contributes further to economic vibrancy.

The exit channel for VC-backed firms through the public markets is all but shut down. In 2008, only six firms came to market raising \$470 million. There was a marginal recovery in 2009 to 13 venture-backed IPOs taking down \$1.9 billion. But that pales against the 86 deals brought to market for \$10.3 billion in 2007, or the 57 new issues garnering \$5.1 billion in 2006. The two year total of venture-backed IPO activity in 2008-09 was the lowest since 1974-75.

- So far in 2010, there have been two venture backed IPOs. QuinStreet, an Internet media and marketing company, raised \$150 million. But the IPO priced at \$15 per share, below its already downwardly revised target range of \$17 to \$19 per share. Ironwood Pharma raised nearly \$190 million at \$11.25 per share. That price was cut from the \$14 to \$16 range that the firm was seeking just a month earlier.
- Even in the cradle of the innovation economy – Silicon Valley – times are tough. The 2010 Silicon Valley Index, published last week, warned that the Valley is in danger of losing its edge. Venture capital investment in Silicon Valley has declined from \$32.3 billion in 2000 to \$10.7 billion in 2008 and just under \$7 billion in 2009. Initial public offerings of valley firms have dropped to the lowest levels since the 1970s.

The obstacles facing venture capital, and the fact that the IPO route has essentially been denied to successful enterprises, leaves much growth-critical risk capital sidelined. This reflects the lackluster economic environment and the obstacles from Washington-driven regulatory and tax uncertainty.

- An outlook for strong growth would translate into rising expected returns and foster a more vibrant VC environment. However, the threat of mammoth federal spending and deficits and the prospect of further tax increases clouds after-tax return expectations.
- The most important tax rate for after-tax returns from VC investments is the capital gains tax rate. It is scheduled to increase by one-third at year-end 2010, to at least 20% from the current 15%.

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