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Brightman Almagor Zohar

July 2008

Technology, Media & Telecommunications

Israel VC Indicator Survey.

Expectations as of Quarter 2, 2008

*IPO Market Closed,
Mezzanine funding needed*

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About

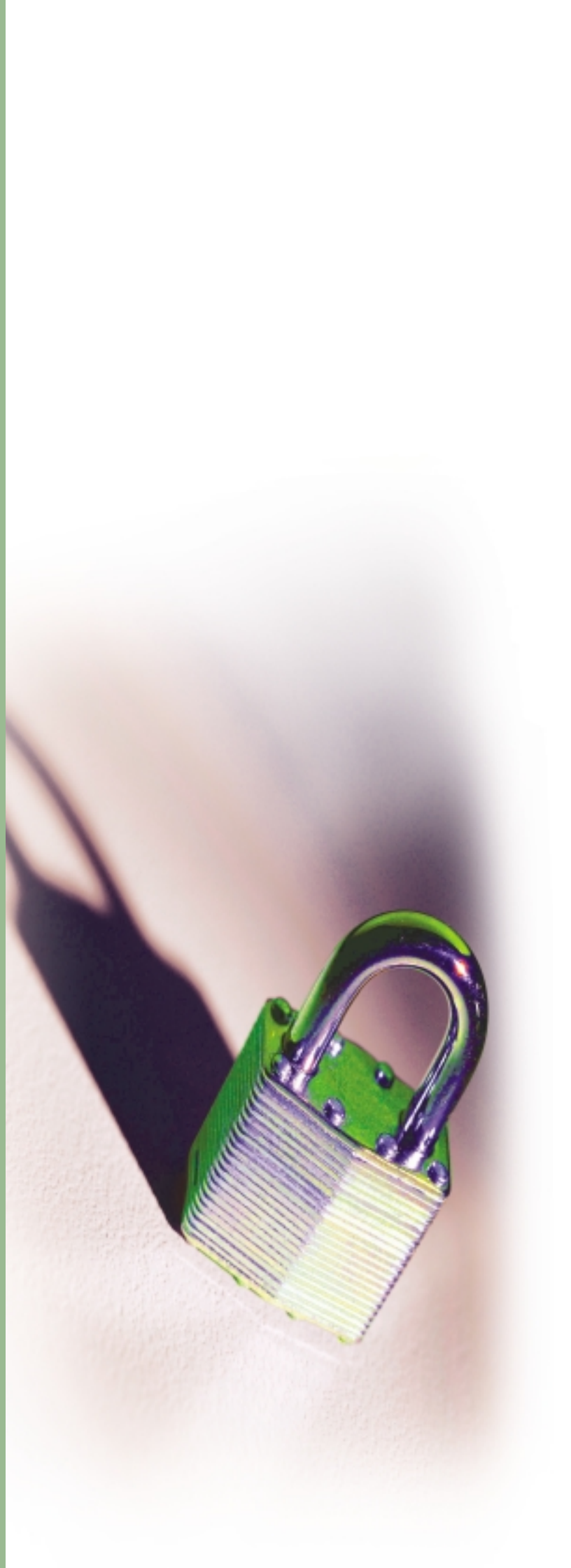
The purpose of the **Israel VC Indicator Survey** is to identify trends within the venture capital arena. Its objective is to give a comprehensive picture of the expectations of the Israeli VC community for the next six to twelve months. The survey is designed to explore relevant key aspects, such as economic and market conditions, deal activity and investment and managerial focus. The results produce a forward-looking measure of the overall sentiment in the Israeli venture capital community, which is extremely relevant to immediate deal flow.

The 25th Deloitte Brightman Almagor Zohar Israel VC Indicator Survey results for Q2, 2008 include a comparison, where relevant, to responses from previous surveys.

The VC Survey and Private Equity Surveys are a Deloitte initiative. The surveys have been conducted for some years, running concurrently in Israel, the United Kingdom, Germany, Spain, Portugal, Central Europe, Mexico, South Africa and India, to name but a few. Moreover, once a year, Deloitte also releases a Global VC Survey. The Global Survey purpose is to identify attitudes of venture capitalists and private equity investors regarding investing on a global basis and tracking long-term trends about the attitudes of international investing.

Responses for Israel VC Indicator Survey Quarter 2, 2008 were collected from June 17th, 2008 through to June 25th, 2008. The responses were collected from venture capitalists in Israel, including replies from the major VCs in the country.

Deloitte TMT Business Development Team used a variety of research and statistical tools to provide extensive analysis of the survey results. If respondents did not answer a question, the count for the question was adjusted accordingly. All charts within this report are sourced from the survey results.



2nd Quarter, 2008 - Detailed Results



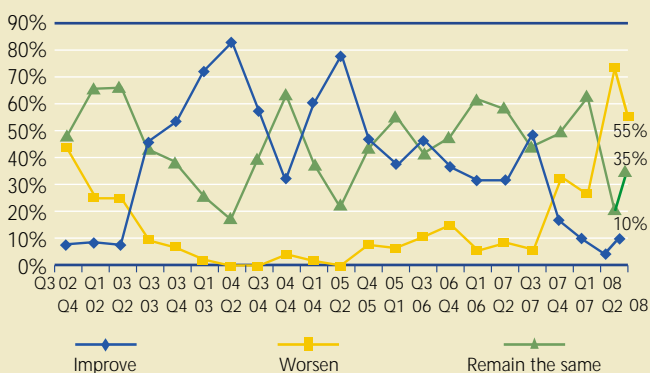
Highlights

- 72% of venture capitalists: Israel is already undergoing an economic slowdown
- Expectations for the overall economic climate to worsen remain strong
- 96% of respondents predict that the Israeli high-tech industry will lay off staff
- 62% of venture capitalists believe that the NASDAQ IPO market will not re-open before late 2009
- Two thirds of respondents think Cleantech is over-hyped, yet Cleantech transaction expectations remain strong

Results

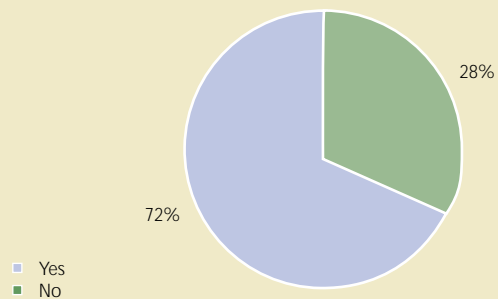
Turbulent economic conditions in global markets and recent uncertainties in the domestic market lead venture capitalists' outlook of the overall economic climate in Israel to remain grim. The downwards shift in economic expectations that begun in Quarter 3, 2007 continues into Quarter 2, 2008, although venture capitalists are slightly less pessimistic. More than half of all respondents (55%) expect that the overall economic climate will worsen over the next six months (compared with 74% in Q1, 2008). A much smaller percentage (10%) of respondents predict that the economic climate will improve over the next six months (up from 5% in Q1, 2008). 35% of respondents predict no change in the overall economic climate.

Chart 1:
During the next six months, I expect the overall economic climate to:



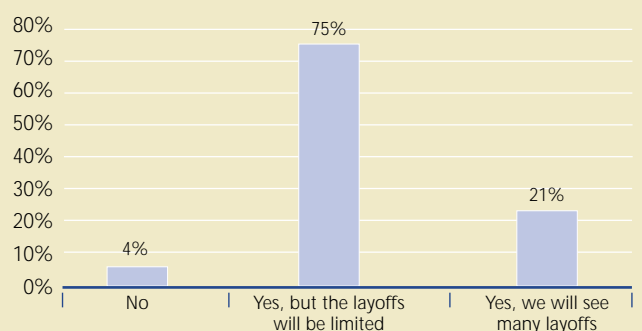
Whilst an economic slowdown has not yet been fully reflected in the official economical indicators, according to nearly three quarters (72%) of venture capitalists surveyed, Israel is already undergoing an economic slowdown. At the same time a notable proportion of respondents (28%) think that Israel is not undergoing an economical slowdown.

Chart 2:
Is Israel undergoing an economic slowdown?



The U.S. economic slowdown combined with the weakness of the U.S. Dollar lead nearly all respondents (96%) to predict that the Israeli high-tech industry will lay off staff. Yet, most (75%) of those foreseeing layoffs say that layoffs will be limited. 21% of respondents believe that we will see many layoffs.

Chart 3:
In light of the U.S slowdown and the weakness of the U.S Dollar, the Israeli high-tech industry is likely to lay off staff?

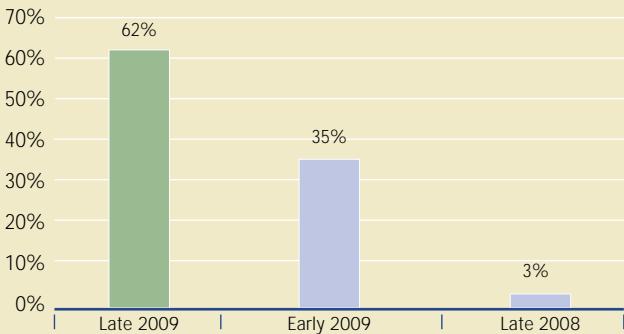


Six months into 2008 and not even one Israeli company went public on NASDAQ and IPOs of American venture backed companies have been few and far between. A mere 3% of venture capitalists expect the NASDAQ IPO market to re-open by the end of 2008.



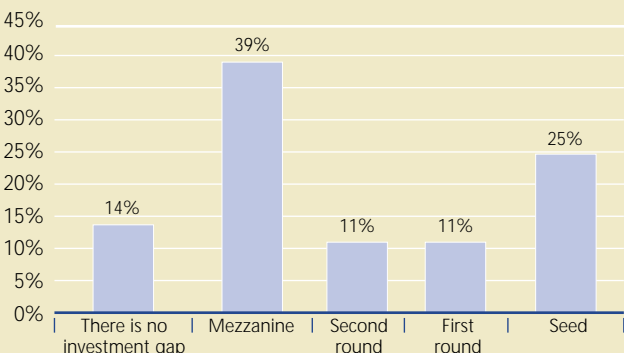
Nearly a third (35%) of venture capitalists thinks that the IPO market will re-open in early 2009. The majority (62%) of respondents believe that the NASDAQ IPO market will not re-open before late 2009.

Chart 4:
When do you think the NASDAQ IPO will re-open?



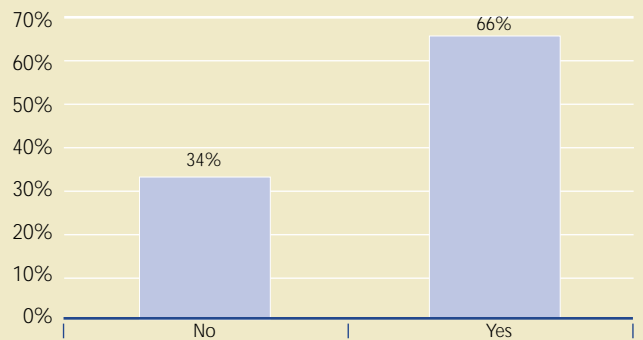
With the IPO market virtually closed, late stage companies are seeking alternative routes for further funding. It is no surprise that the single biggest investment gap in the Israeli startup industry is said to be in the mezzanine stage, with 39% of respondents stating so. Seed stage investment gap was pointed as the main investment gap in Israel by a quarter of venture capitalists. 11% of respondents think the main investment gap is in first round, another 11% say second round and the remaining 14% of respondents say there is no investment gap.

Chart 5:
What is the main investment gap in Israeli start-up industry?



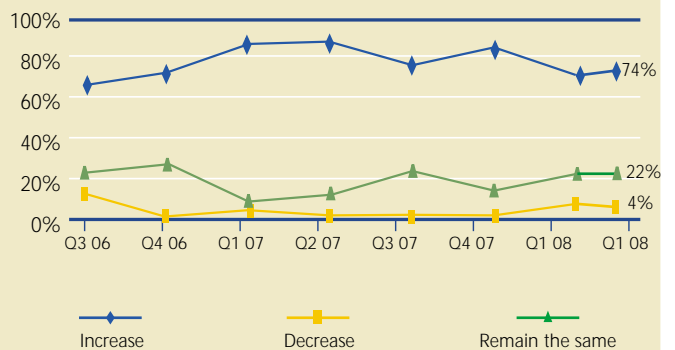
Cleantech is an exciting industry set to experience significant growth and technological developments in the near future. Yet, according to nearly two thirds (66%) of venture capitalists surveyed Cleantech is over-hyped. 34% of respondents think otherwise that Cleantech is not over-hyped.

Chart 6:
Do you believe cleantech is over-hyped?



Perhaps in line with the previous question it is no surprise that for the sixth quarter in a row, Cleantech remains the favored sector for increased investment. Expectations of Cleantech transactions to increase continue to be high and steady at 74% (compared with 72% in Q1, 2008). Only 4% of respondents expect Cleantech transactions to decrease in the next six months (compared with 6% in Q1, 2008).

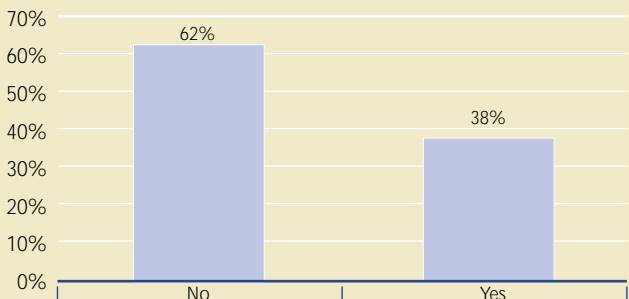
Chart 7:
Expectations of cleantech transactions:



Most respondents (62%) think that the global rise in corn, and other staple prices (which have been partially been driven by the demand for bio-fuels), will not have a negative kick-back on the Cleantech sector. 38% of respondents think it will have a negative kick-back on the Cleantech sector.

Chart 8:

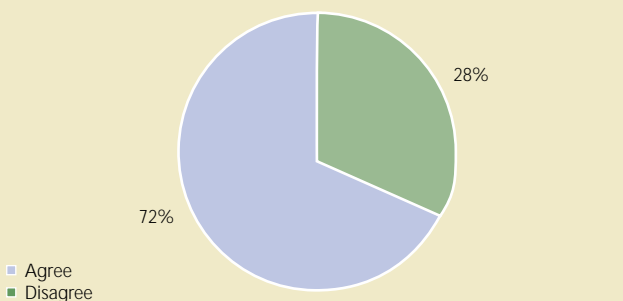
Do you think that the global rise in corn, and other staple prices (which have been partially driven by demand for biofuels), will have a negative kick-back of the cleantech sector?



Nearly three quarters (72%) of venture capitalists agree that the continuing significant global fuel and food inflation should have a significant impact on Cleantech deal flow, 28% of respondents disagree.

Chart 9:

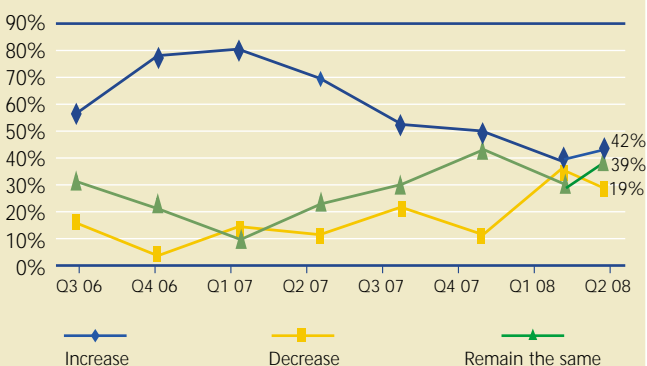
The continuing significant global fuel and food inflation could have a significant impact on cleantech deal flow. Do you:



After four consecutive quarters of downtrend in expectations of Internet transactions this quarter's expectations for an increase in Internet transactions (42%) are slightly higher than those noted in Q1, 2008 (37%). The number of respondents who foresee a decline in Internet transactions has mellowed to 19% (compared with 34% in Q1, 2008).

Chart 10:

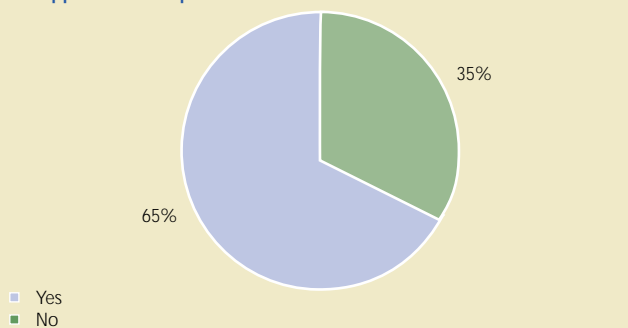
Expectations of internet transactions:



Nearly two thirds (65%) of venture capitalists surveyed believe that Israel can build world leading content companies, gaming titles or web 2.0 application companies.

Chart 11:

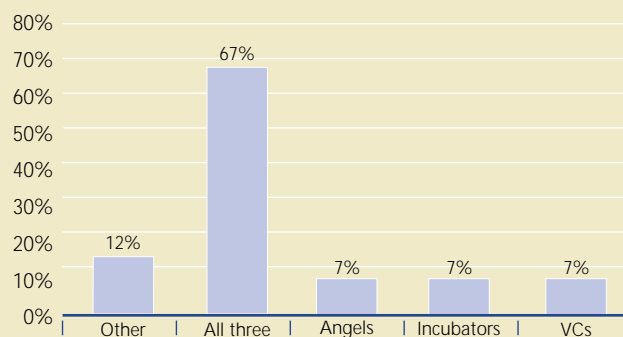
Can Israel build world leading content companies, gaming titles or web 2.0 application companies?



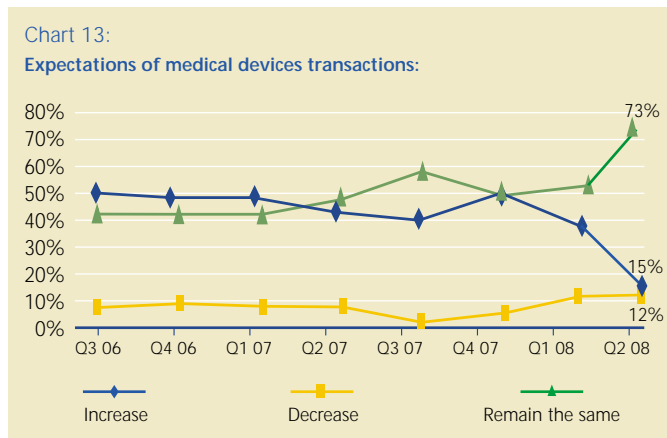
There has been a significant downturn in the last couple of years of venture capital funds investing in early stage Medical Devices startups. Two thirds of venture capitalists say that funding for seed Medical Devices startups should come from angel investors, technological incubators and venture capital funds.

Chart 12:

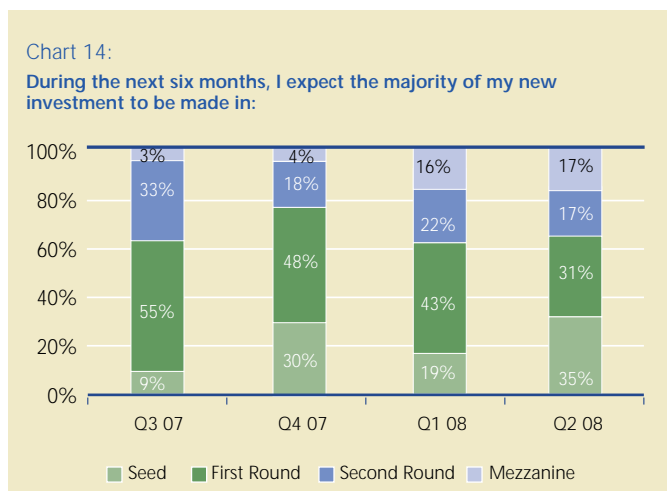
There has been a significant down turn in the last couple of years of VCs investing in early stage medical devices start-ups. Where should funding for seed medical devices start-ups come from?



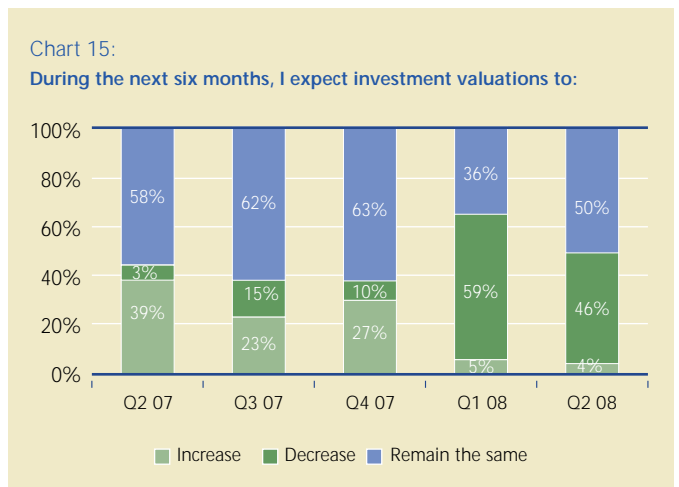
Expectations of an increase in Medical Devices transactions have plunged from an average of 45% in the previous six quarters to only 15% in Q2, 2008. 12% of respondents expect Medical Devices transactions to decrease in the next six months.



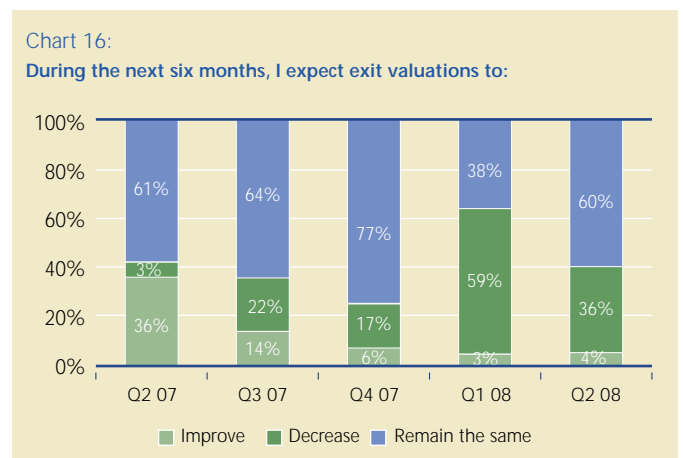
Over a third (35%) of venture capitalists expect that during the next six months, the majority of their new investments will be made in seed round funding. 31% of respondents expect to invest mainly in first round, 17% expect to do so in second round and the remaining 17% expect to do so in mezzanine round.



For the second consecutive quarter both investment and exit valuations are expected to decrease during the next six months, according to the venture capital community. Nearly half (46%) of respondents expect investment valuations to decrease (compared with 59% in Q1, 2008). Only 4% of venture capitalists surveyed foresee that investment valuations will increase during the next six months, the lowest expectations for an increase since first posting this question on Deloitte's Israel VC Indicator Survey in Q4, 2004.



Low expectations are also noted for exit valuations during the next six months. 36% of venture capitalists expect exit valuations to decrease (compared with 59% in Q1, 2008). Only 4% of respondents foresee that exit valuations will increase during the next six months.



In the recent Deloitte Global VC Survey foreign venture capitalists were asked how challenging it is to do business in Israel. In this edition of the Israel VC Indicator Survey we asked the local venture capital community how challenging it is to do business in Israel, as perceived by foreign venture capitalists. Responses of foreign venture capitalists and Israeli venture capitalists were almost identical, with most of them say or estimate that it is somewhat challenging to do business in Israel.

Insights

The Economic slowdown is here.

There is no doubt that the slowdown in the U.S. and the weakness of the Dollar have had an impact on the Israeli economy. This impact is yet to be fully reflected in the official economical indicators, but venture capitalists believe that the impact is severe enough to say that Israel is already undergoing an economic slowdown. In the export reliant high tech industry the strengthening Shekel increases costs and decreases profits. Some Israeli high tech companies have already had to cut jobs and venture capitalists almost unanimously agree that we will see more layoffs in the near future. At the same time Israel is well placed to meet the economic global crisis after its economy has grown by 5% or more in each of the past four years and with high tech exports which not only rely on price but also on competitive edge and innovation. So the slowdown is here and might yet strengthen but it will probably not be dramatic, just a relative lull compared to the past few years. There will be limited layoffs, exports will slightly shrink and growth will decrease, but not substantially.

IPO Market Closed, Mezzanine funding needed

The U.S. market faces the longest venture backed IPO drought in 5 years. Only six American venture backed companies IPOed in the first half of 2008 and the last time an Israeli company went public on NASDAQ was on July 2007. Weak market conditions make the NASDAQ practically closed for IPOs and this has significant implications on late stage companies. No IPOs mean delayed exits, more M&As and potentially lower valuations. Companies waiting for the IPO market to re-open will need additional financing (mezzanine rounds) as it seems that it will take the IPO market at least one year to re-open.

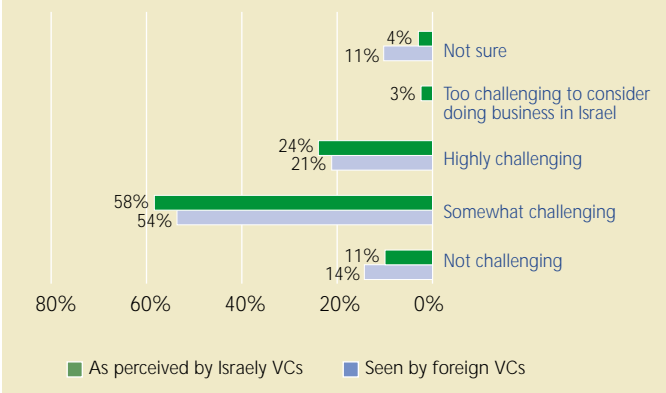
Cleantech is over-hyped

Two thirds of respondents believe that the Cleantech sector is over-hyped. Nonetheless, an even greater percentage of respondents believe that investments and deal flow in this sector will increase. Investors believe that while this is a hot sector which will grow in the coming years, market expectations are currently exaggerated. Whilst we have not seen any mega-exits, Investors should still be wary of over-inflated valuations.

The Interlinked Food and Cleantech Markets

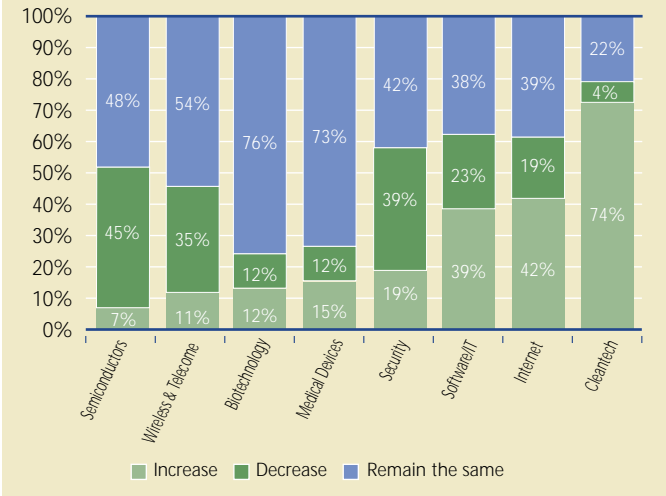
The last half year has seen extremely aggressive global food inflation. This has been partially driven by the use of corn and other staples for the production of bio-diesel. The market is beginning to learn the complexities of the globes interlinked markets, and whilst investment in bio-fuels may decrease due to the kickback on food prices, overall cleantech deal flow will not decrease. The market is beginning to learn where the shrewdest Cleantech investments will be.

Chart 17:
How challenging is it to do business in Israel, as perceived by foreign VCs :



The highest expectations of transactions increase are, once again, in Cleantech. 74% of respondents expect an increase of transactions in this sector. Internet sector is second in expectations of transactions increase with 42%. The Software/IT sector is third with 39%. The weakest expectations are for the Semiconductors sector, only 7% of respondents expect an increase in transactions in that sector, while 45% expect a decrease.

Chart 18:
During the next six month, I expect the number of transactions in the sector listed below to:



Contacts

We welcome suggestions for issues to be addressed in future **Israel VC Indicator Surveys**. You are welcomed to send your suggestions to Gil Shterzer at gshterzer@deloitte.co.il.

Please contact us for further information about: the results of this survey, the special services offered by Deloitte Brightman Almagor Zohar and its affiliates to VCs and assistance with deal initiation and the execution process.

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