Deloitte.
Brightman Almagor Zohar

Israel VC Indicator Survey.

Expectations as of Quarter 3, 2008

It's belt tightening time

Technology, Media & Telecommunications, October 2008

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 26th Deloitte Brightman Almagor Zohar Israel VC Indicator Survey results for Q3, 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 3, 2008 were collected from September 24th, 2008 through to October 5th, 2008. The responses were collected from venture capitalists in Israel, including replies from the major VCs in the country.

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

3rd Quarter, 2008

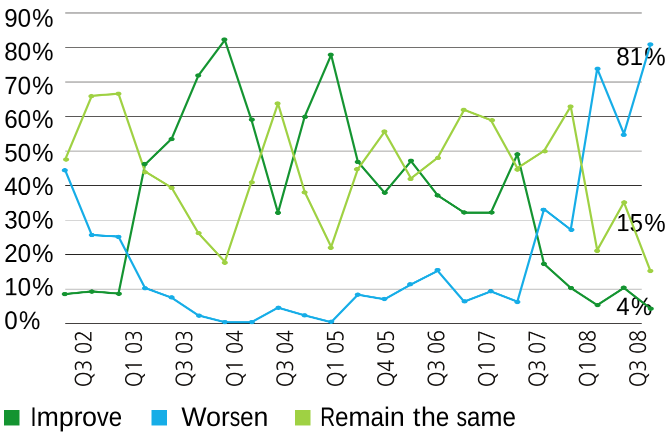
Highlights

- Expectation for the economic climate to worsen hit highest levels since 2001.
- Full ramifications of the Wall Street crisis to be felt in Israel within three to six months.
- Employee layoffs, salary cut downs and decrease in revenues are expected.
- Venture capital investments to slowdown, seed and first round investments to decrease to 2003 levels.

Results

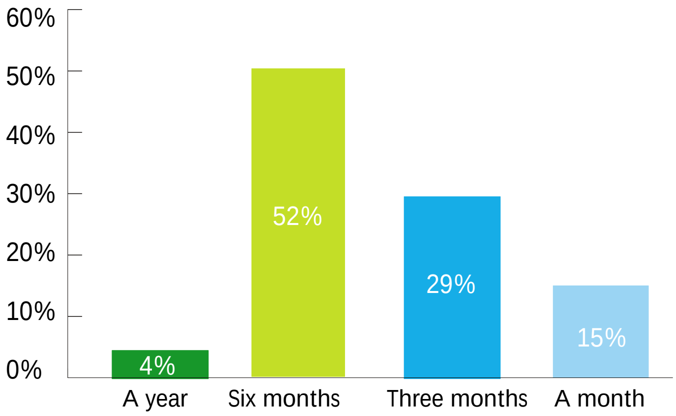
As the turmoil of US and European banking continues to spread into other markets and sectors, Israeli high tech and venture capital industries gear up for some rough times. The downward shift in economic expectations that begun in Q3, 2007 continues into Q3, 2008. This view has now become significantly predominant with 81% believing that the overall economic climate will worsen over the next six months (compared to 55% in Q2, 2008). This is the highest expectation level for the economic climate to worsen since Q4, 2001 when Deloitte's first Israel VC Indicator Survey was launched. At the same time, a mere 4% of respondents believe that the economic climate will improve over the next six months - again, the lowest expectation level for economic improvement since Q4, 2001.

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



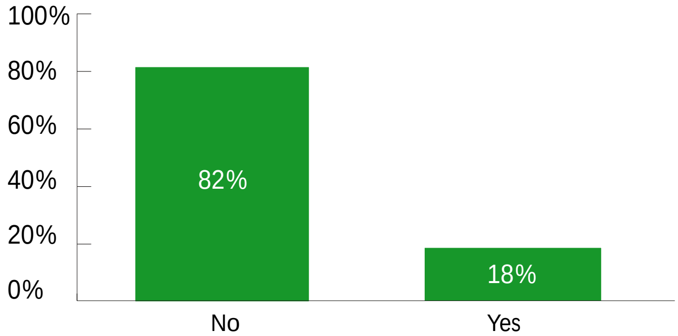
According to more than half of venture capitalists surveyed (52%) the full ramifications of the Wall Street crisis will only be felt in Israel within six months. 29% of respondents estimate it would take just three months and 15% estimate the Wall Street crisis will take full effect in Israel within one month.

The full ramifications of the Wall Street crisis will be felt in Israel within:



The majority of venture capitalists believe that the ramifications of the crisis are not yet fully known. Nonetheless 82% of respondents say that the high tech industry is not headed for a crisis as severe as the crisis that followed the dot.com bubble collapse of 2001. 18% are less optimistic fearing the upcoming crisis will be equal in magnitude to the crisis that followed the dot.com bubble collapse.

Is the high tech industry headed for a crisis as severe as the crisis that followed the dot.com bubble collapse of 2001?

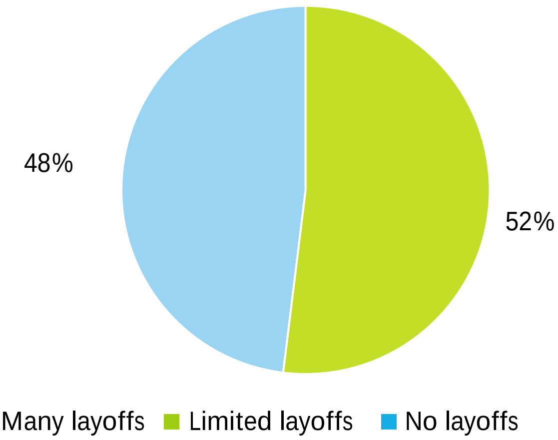


The impact of the financial services sector crisis is imminent but its results are not yet clear. The Deloitte VC Indicator Survey asked the venture capitalists how will the turmoil in the financial services sector and the global economic downturn affect the Israeli high tech industry.

All respondents (100%) predict that the Israeli high tech industry will lay off staff. Respondents are split on whether there will be many layoffs (48%) or limited layoffs (52%) compared with a clear majority in Q2 who thought layoffs will be limited (75%).

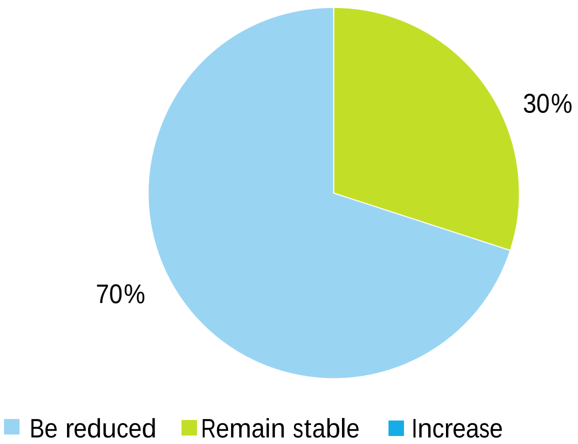
How will the turmoil in the financial services sector and the global economic downturn affect the Israeli high tech industry?

Regarding employment the industry will see:



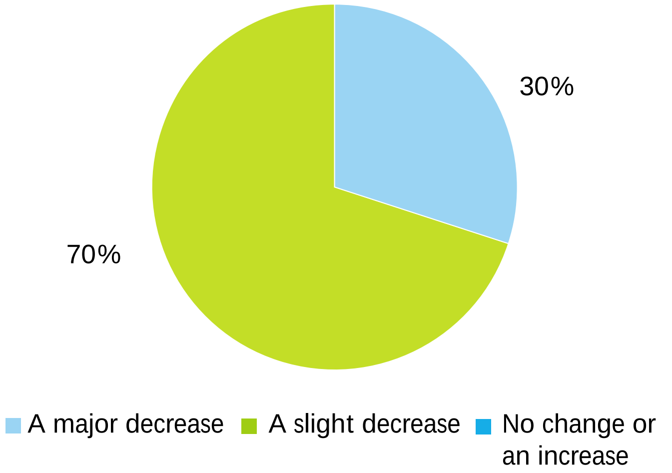
High tech employees that will not be fired are likely to see their salaries cut according to 70% of venture capitalists. 30% think that high tech sector salaries will remain stable.

High tech employees' salaries will:



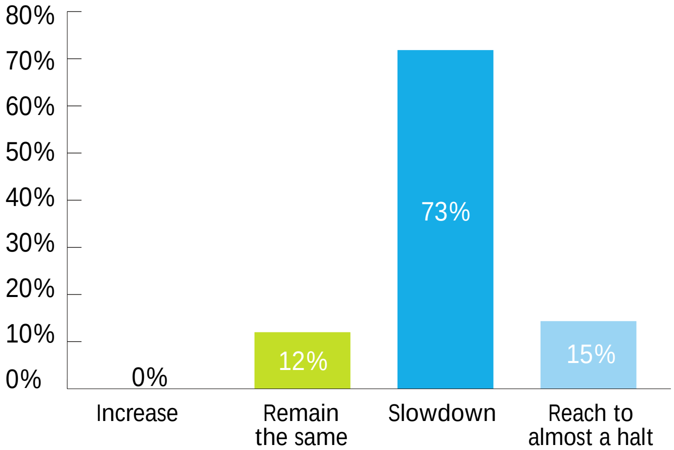
As for high tech companies' revenues, most venture capitalists (70%) say that most companies will see a slight decrease in revenues. 30% of respondents foresee a major decline in revenues for most high tech companies.

Regarding revenues, most tech companies are likely to see:



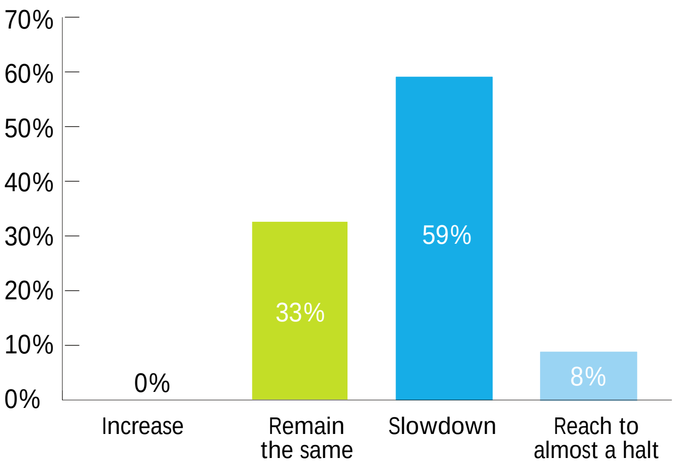
Venture Capital seed investments are headed for a slowdown according to almost three quarters (73%) of respondents. 15% say seed investments will come close to a standstill.

VC seed investments will:



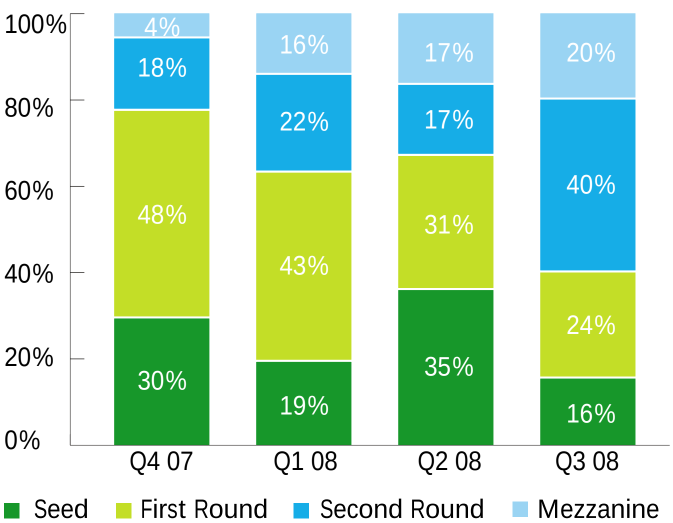
Venture capital second round and third round investments will also decrease but to a lesser extent. 59% of respondents believe second and third round investments will slow while 8% say it will come close to a standstill. 33% of respondents say it will remain the same.

VC second and third round investments will:



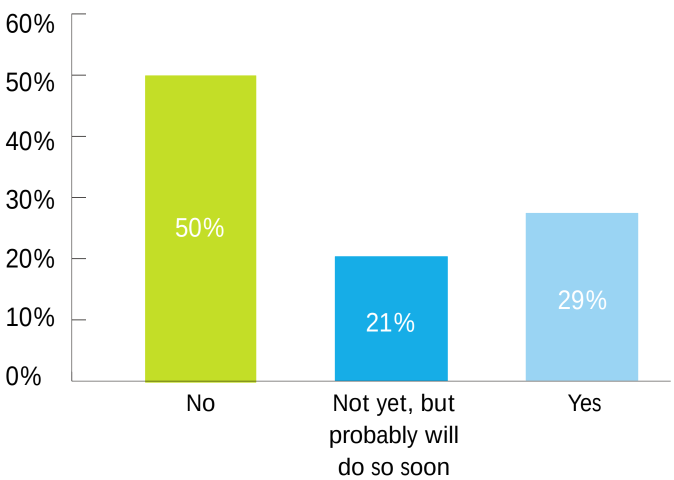
Only 16% of respondents expect that the majority of their new investments to be made in seed stage (compared with 35% in Q2). Only 24% expect to invest mainly in first round stage. 40% of respondents plan to invest in second round stage. Another 20% plan to invest mainly in mezzanine stage, the highest percentage planning to invest in mezzanine since first posting this question on The Deloitte Israel VC Indicator Survey in Q4, 2005. In total, 60% intend to invest in late rounds and only 40% intend to invest in early rounds, the lowest levels measured of investing in early rounds since first posting this question on The Deloitte Israel VC Indicator Survey in Q1, 2003.
This notable shift in investment strategy is evident when compared with investment segmentation a year ago in Q4, 2007 when 78% chose to invest in early rounds and only 22% invested in late rounds.

During the next six months, I expect the majority of my new investments to be made in:



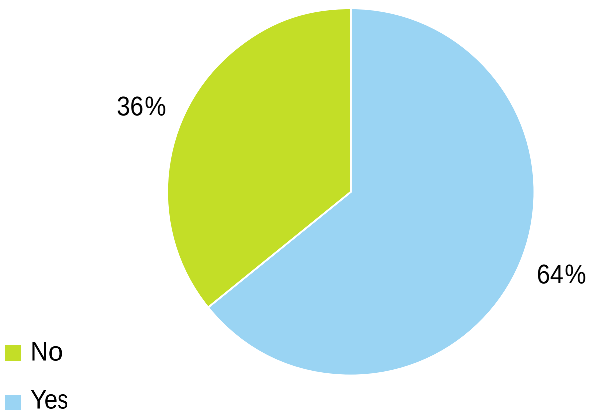
29% of venture capitalists say that their fund started prioritizing which of its portfolio companies it might abandon and write down as losses if the situation deteriorates. 21% of respondents say that their fund has not done so yet but probably will do so soon.

Has your VC fund started prioritizing which of its portfolio companies it might abandon and write down as losses if the situation deteriorates?



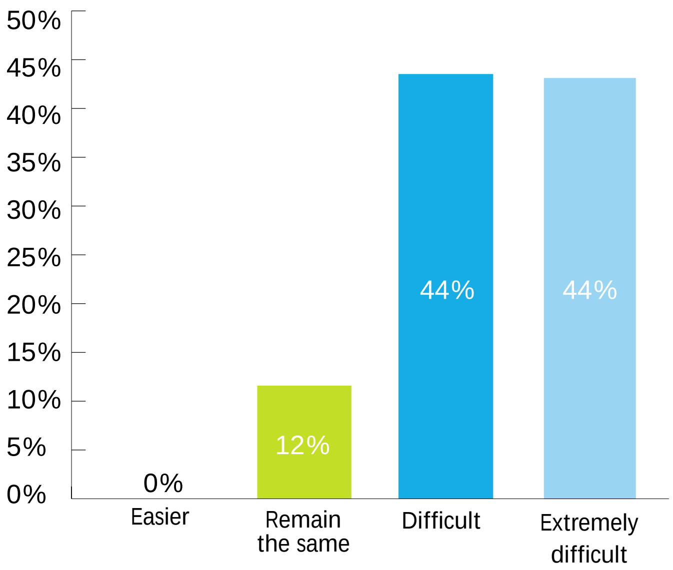
Two thirds of venture capitalists (64%) say that their funds have already advised their portfolio companies to cut expenses, whilst 36% have not done so.

Has your VC fund advised its portfolio companies to cut expenses?



The large majority (88%) of respondents foresee harsh times for VCs raising new funds. Only 12% of respondents say there will not be any significant change in fundraising

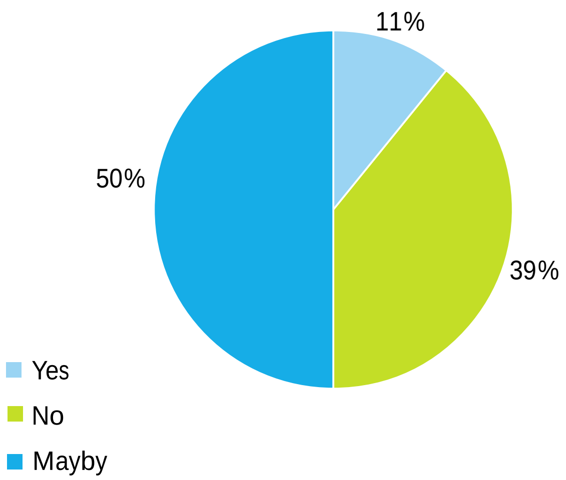
VC fundraising activity will become:



difficulties.

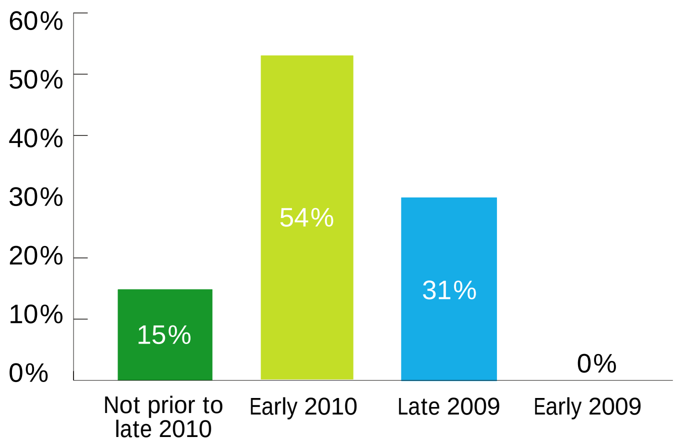
Half of all venture capitalists surveyed (50%) fear that the Wall Street crisis might prompt limited partners to try and withdraw their VC commitments. 11% of respondents are certain that some limited partners will withdraw their commitments.

Will the Wall Street crisis cause prompt partners to try and withdraw their VC commitments?



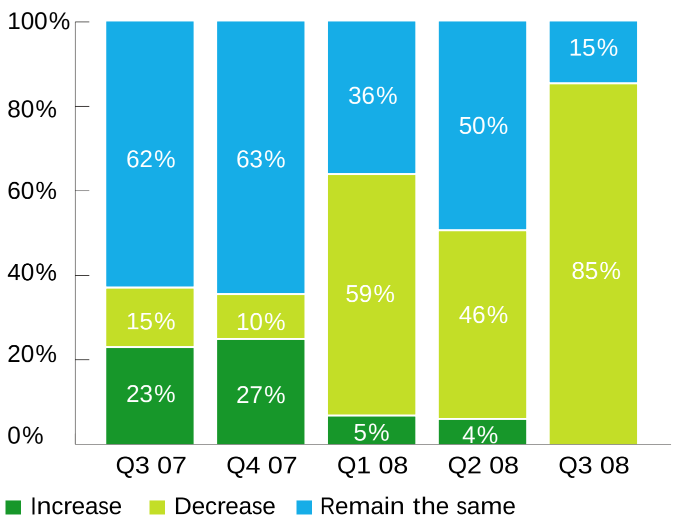
According to venture capitalists we are looking at a minimum of 8 months before the NASDAQ IPO market will re-open with 31% of respondents pointing to late 2009 and 54% point to early 2010.

When do you think the NASDAQ IPO market will re-open?



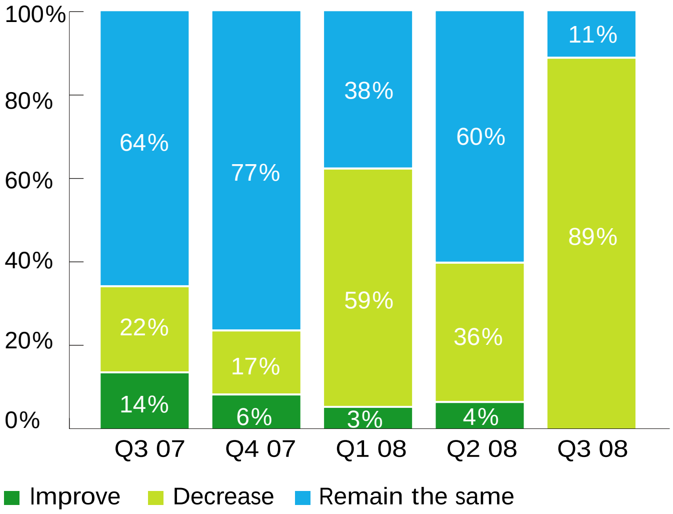
The trend of pessimistic sentiment which has begun a year ago in Q3, 2007 in both investment and exit valuations has reached a new height. 85% of respondents expect investment valuations to decrease compared to 46% in Q2, 2008 and the highest expectations for decrease since first posting this question on The Deloitte Israel VC Indicator Survey in Q4, 2004. No respondent thinks that investment valuations will increase during the next six months, the lowest expectations for increase since first posting this question on The Deloitte Israel VC Indicator Survey in Q4, 2004.

During the next six months, I expect investment valuations to:



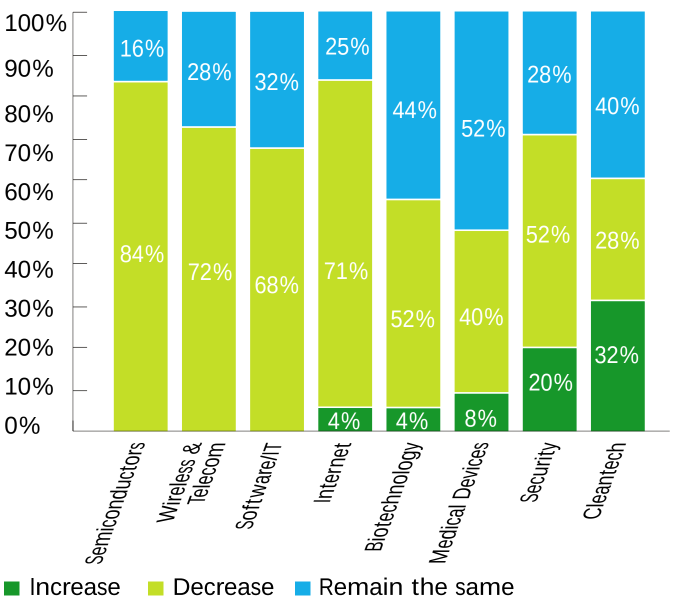
89% of venture capitalists expect exit valuations to decrease compared to 36% in Q2, 2008. This is the highest expectations for decrease since first posting this question on the Deloitte Israel VC Indicator Survey in Q4, 2004. No respondent thinks that exit valuations will increase during the next six months, the lowest expectations for increase since first posting this question.

During the next six months, I expect exit valuations to:



For the seventh quarter in a row, Cleantech remains the favored sector for increased investment, yet it is at its lowest level since first posting this question on The Deloitte Israel VC Indicator Survey in Q3, 2006. Expectations of Cleantech transactions to increase take a plunge to 32% (compared with 74% in Q2, 2008). Expectations of Internet transactions fall to their lowest level since first posting this question on the Deloitte Israel VC Indicator Survey in Q3, 2006. Only 4% foresee an increase in Internet transactions. all other sectors are also expected to show a decrease of transactions during the next six months, according to the venture capital community. Expectation for an increase in transaction in the Semiconductors, Wireless and Telecom and Software/IT sectors all fall to 0%.

During the next six months, I expect the number of transactions in the sectors listed below to:



Insights

The Wall Street crisis rages on and the Israeli high tech industry will not evade its impact, including salary cuts, employee layoffs, decreases in revenues and company closures. VCs are getting more and more cautious and have started urging their portfolio companies to do some major belt tightening. Start ups need to cut expenses and try to be cash positive. Updating projections and rechecking the business model are also advised. Start ups can survive, and even thrive, during volatile economic times by building business models that are more responsive, adaptable, and efficient with resources.

VCs are changing their investment strategy, reducing early stage investments in favor of late stage rounds. VCs will continue to invest in new start ups but will pay more attention to their exiting portfolio companies and allocate fewer dollars for seed investments. Less money available means lower investment valuations for some start ups and for other start ups it might mean failing to raise capital and ceasing to exist. Late stage round valuations will decrease as well as investment options dwindle and VCs gain more bargaining power. On the bright side, the new decreased valuations will allow agile VCs to close excellent investment deals.

Exit valuations are bound to decrease as well. The financial turmoil in the markets makes the IPO exit route practically non existent. Mergers & acquisition uncertainty grows as large corporations take a more cautious approach to M&A, driving valuations down.

VCs are facing major difficulties raising new funds as investors bleed in the stock markets. Finding new limited partners these days can be especially challenging. VCs who are in the process of raising money will find it hard to reach the target that it has set for its fund. But even VCs who have completed their fundraising might encounter difficulties when making capital calls to get the money the limited partners have pledged to the fund. Limited partners exposed to the financial markets might decide they are going to cut back on their commitments regardless of the subsequent fines. All players in the high tech arena must hold on tight as the financial crisis intensifies and prepare for a new reality.

Contacts

We welcome suggestions for issues to be addressed in future **Israel VC Indicator Surveys**. You are welcome 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.

Deloitte's TMT group:

Igal Brightman
TMT Global Managing Partner
+972 (3) 608 5500
ibrightman@deloitte.co.il

Asher Mechlovich
Leader of Israel TMT Industry
+972 (3) 608 5524
amechlovich@deloitte.co.il

Services:

Assurance & Advisory
Asher Mechlovich
+972 (3) 608 5524
amechlovich@deloitte.co.il

Due Diligence & VC Tools
Shlomi Anfang
+972 (3) 608 5550
sanfang@deloitte.co.il

Business Development
Omri Barnes
+972 (3) 608 5408
obarnes@deloitte.co.il

Tax
Yitzchak Chikorel
+972 (3) 608 5511
ychikorel@deloitte.co.il

Incentives
Danny Younisian
+972 (3) 608 5501
dyounisian@deloitte.co.il

Business Development - Deal Flow
Gil Shterzer
+972 (3) 608 5515
gshterzer@deloitte.co.il

www.deloitte.co.il

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