

Israel VC Indicator Survey.

Expectations as of Quarter 1, 2009

Challenging times



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 28th Deloitte Brightman Almagor Zohar Israel VC Indicator Survey results for Quarter 1, 2009 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 1, 2009 were collected from March 9th, 2009 through to March 19th, 2009. The responses were collected from venture capitalists in Israel, including replies from the major VCs in the country.

Deloitte TMT Business Development Team uses 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.

1th Quarter, 2009

Highlights

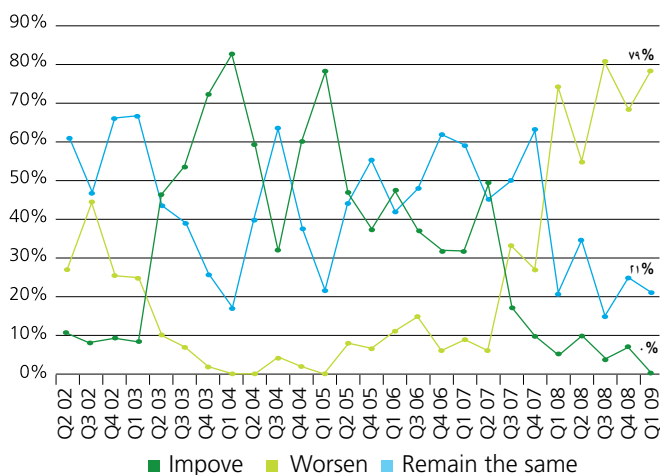
- The global financial crisis is nearing its nadir.
- Entrepreneurs at the gate – the potential of fired professionals.
- An opportunity to shift to early stage.
- Focus on Cleantech and Medical Devices.

Results

The global financial crisis is reaching its nadir while venture capitalists gear up for continued rough times. For the first time, none of the respondents think that the overall economic climate will improve during the next six months (compared to 7% in Q4 2008). This is the lowest expectation level for improvement in the economic climate since Q4 2001 when Deloitte's first Israel VC Indicator Survey was launched. The general outlook for the coming months is pessimistic with 79% of respondents think that the overall economic climate will worsen (compared to 68% in Q4 2008) and 21% think that it will remain the same.

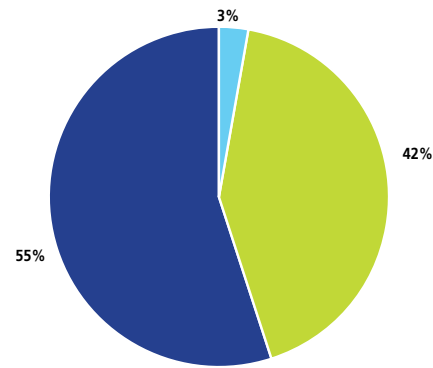
The technology capital markets expectations reflect the same essence of pessimism with 42% of respondents

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



think that the global technology - sector based equity indexes (such as the NASDAQ index) will continue to lose ground in the coming year and 55% think that the indexes will show idle in the coming year. A minority of 3% of the respondents think that the indexes will recover in the coming year.

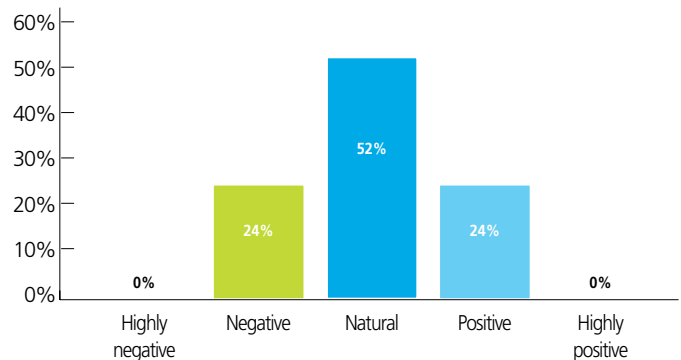
Chart 2: The global technology - sector based equity indexes (such as the NASDAQ index) will:



- Continue to lose ground in the coming year
- Recover in the coming year
- Show stagnation in the coming year

Furthermore, the new Israeli government is not anticipated to bring winds of change. The general election in Israel aroused public debate regarding the economic recovery program but the perspective of venture capitalists is quite indifferent. None of the respondents think the new government will have a highly positive or a highly negative impact on the Israeli high tech industry. Twenty four percent think that the new government will have a positive impact on the Israeli high tech industry and twenty four percent think it will be negative. Over half of the respondents in our survey (52%) think we will see natural impact.

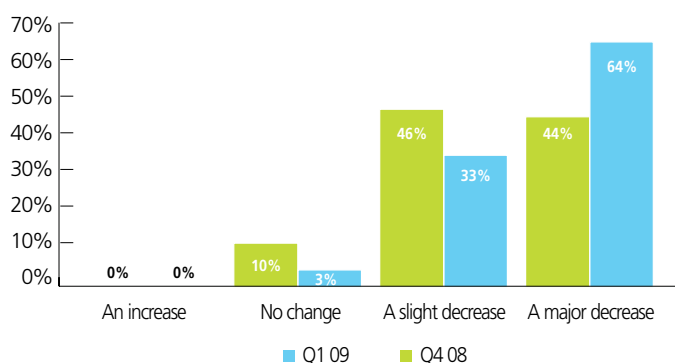
Chart 3: Do you believe that the impact of the new Israeli government on the Israeli high tech industry will be:



The majority of the technology companies in Israel are facing difficulties such as a slowing revenue stream, cash flow generation, difficulty accessing capital and pressure to contain expenses. The venture capitalists' forecast in regards to revenues is unfortunate. Sixty four percent think we will see a major decrease in the Israeli high tech companies' revenues. Thirty three percent think we will see a slight decrease and

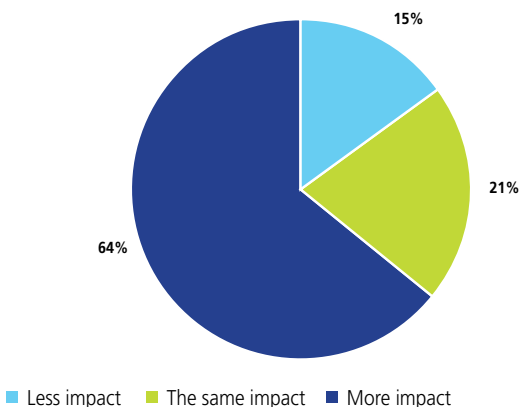
3% think there will be no change in revenues (compared to 46% and 10%, respectively, in Q4 2008). Revenue growth is out of the question, with none of respondents forecasting an increase in Q1 2009 and in Q4 2008.

Chart 4: Due to the turmoil in the global economy, the Israeli high tech companies' revenues are likely to show:



The current extent of the crisis is leading to an unavoidable comparison to previous crises in general and to the "Internet Bubble" bursting in 2000, specifically. The majority of respondents (64%) think that the current financial crisis has more impact on the high tech industry than the impact of the "Internet Bubble" bursting had on the high tech industry. Twenty one percent think the two crises have the same impact and a minority think that the current crisis has less impact than the "Internet Bubble" bursting.

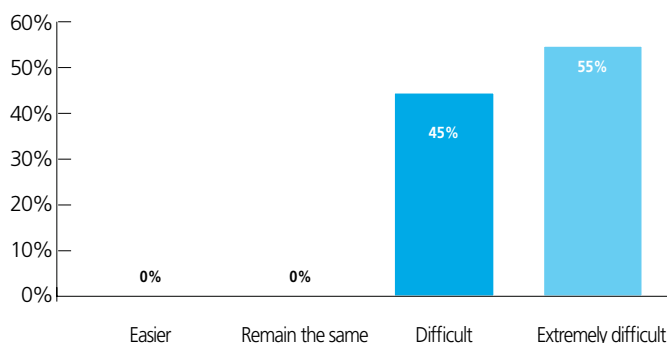
Chart 5: The current financial crisis has _____ on the high tech industry than the "Internet Bubble" bursting in 2000:



This quarter's VC Indicator Survey saw similar responses to those of the Q4 2008 survey results regarding the impact of the current financial crisis on the fundraising activity of the venture capital.

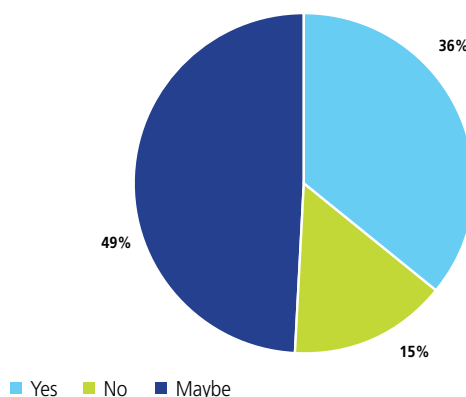
Unanimously, 100% of respondents foresee harsh times for venture capitals raising funds (55% VC fundraising activity will become extremely difficult and 45% difficult). None of the respondents think that VC fundraising activity will become easier in the near future.

Chart 6: VC fundraising activity will become:



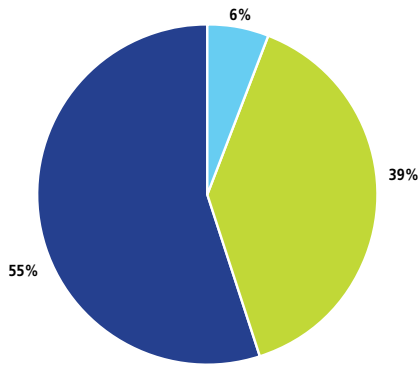
In spite of the fact that venture capitalists fundraising activity is expected to remain laborious, only thirty six percent of the respondents think that the crisis will cause Limited Partners to try and withdraw their commitments. Almost half of the respondents (49%), think it might happen and fifteen percent think it will not happen.

Chart 7: Will the crisis cause Limited Partners to try and withdraw their VC commitments?



The crisis urges companies to push the envelope and reinvent themselves and their business models. The venture capital industry however, is much more conservative. Fifty five percent of respondents report that the global recession does not affect the focus of their venture investment strategy in terms of stage of development of investee companies. Thirty nine percent of respondents report they are shifting focus to later stage companies and existing portfolio companies and only 6% see the current situation as an opportunity to shift focus to early stage companies.

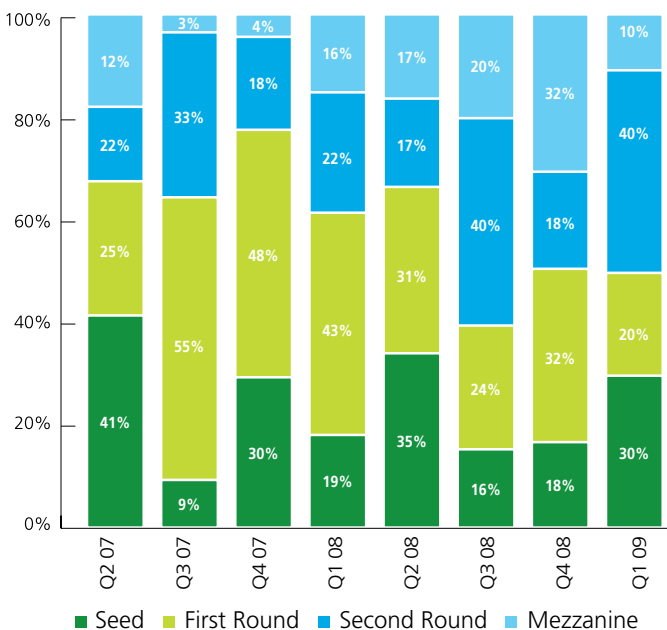
Chart 8: Is the global recession affecting the focus of your venture investment strategy in terms of stage of development of investee companies?



- Yes, shifting focus to early stage companies
- Yes, shifting focus to later stage companies and existing portfolio companies
- No, maintaining current focus of investment strategy in terms of stage of development

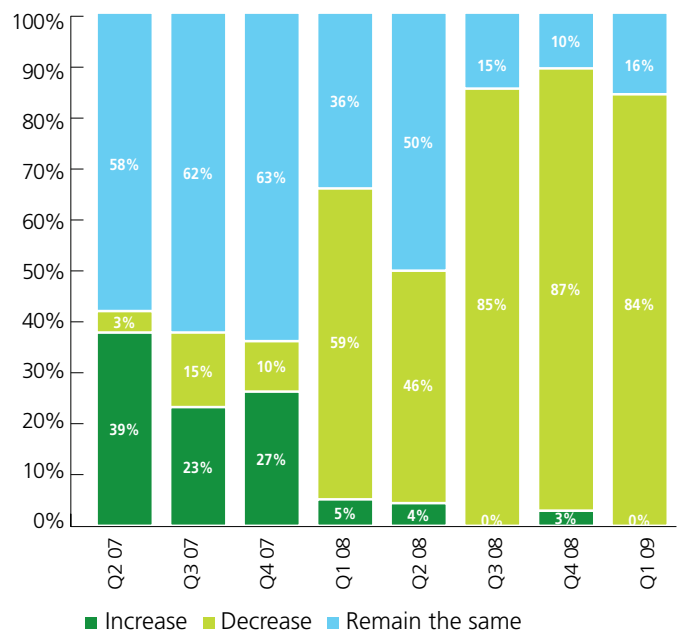
As a consequence of this change in focus, investment priorities are changing. Half of the respondents (50%) report that they will invest in relatively early stages (Seed and First Round) in comparison to seventy eight percent in Q4 2007 and sixty two percent in Q1 2008. Forty percent of respondents expect that during the next six months, the majority of their new investments will be made in the Second Round compared to an average of twenty five percent of respondents from Q1 2007 to Q4 2008 indicating that their new investments would be in the Second Round.

Chart 9: During the next six months, I expect the majority of my new investments to be made in:



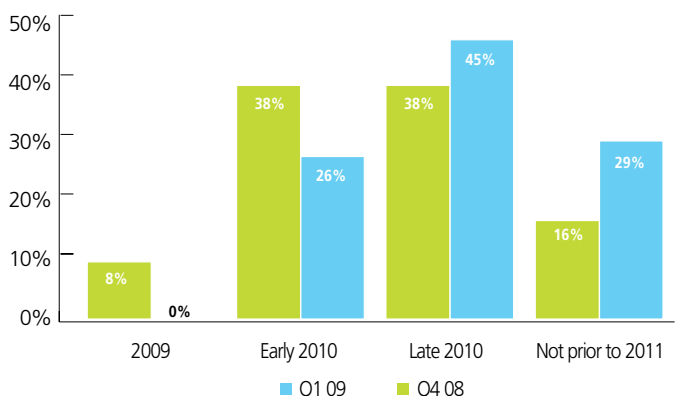
The respondents outlook regarding investment valuations is bleak. The respondents of this survey are hitting the bottom once again. None of them expect investment valuations to increase during the next six months. The picture is crystal clear, the vast majority expects to see a decrease in investment valuations during the next six months with the remaining respondents expecting investment valuations to remain unchanged.

Chart 10: During the next six months, I expect investment valuations to:



As in the previous survey, the NASDAQ IPO market outlook is gloomy. According to one hundred percent of the venture capitalist respondents the market will not re-open prior to the year 2010 (compared to 92% in Q4 2008). Forty five percent of respondents think the IPO market will re-open in late 2010 and twenty nine percent foresee the IPO market remaining closed until 2011 (compared to 16% in Q4 2008).

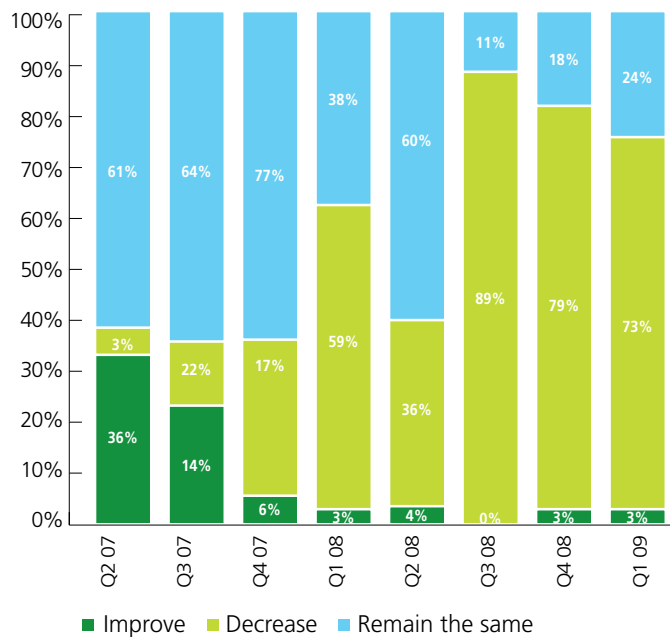
Chart 11: When do you think the NASDAQ IPO market will re-open?



The outlook for M&A transactions is cautiously optimistic. The forecast for this market is relatively more positive than the NASDAQ IPO market, with twenty two percent of the venture capitalists surveyed seeing a ramp up in M&A transactions during 2009. This compares to almost half of the respondents (41%) in the Q4 2008 survey forecasting an uptick in M&A activity in 2009. Sixty six percent think it will ramp up during 2010 and twelve percent think activity will increase during 2011 (compared to 56% and 12% respectively, in Q4 2008).

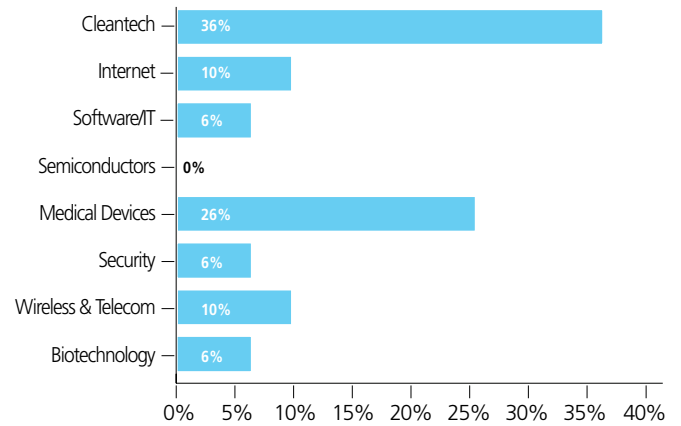
The responses relating to the IPO and M&A markets lead directly to obvious conclusions that we should expect a declining in the exit valuations during the next six months. Therefore, seventy three percent think that exit valuations will decrease, twenty four percent think exit valuations will remain the same and only a minority of 3% think exit valuations will improve (compared to 79%, 18% and 3% respectively, in Q4 2008).

Chart 13: During the next six months, I expect exit valuations to:



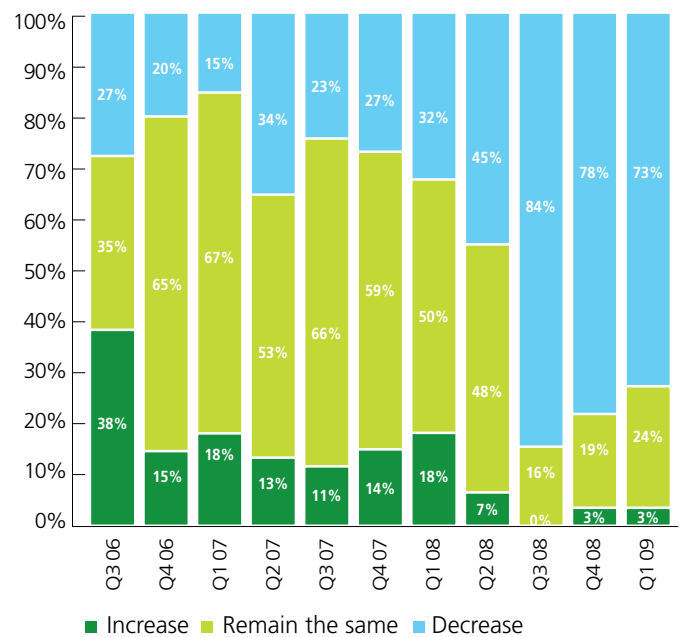
The crisis is leading to polarization of the sectors between the ones which are highly sensitive to volatile markets and the ones which are not. Amongst venture capitalists, thirty six percent think that the first major sector which will recover from the downturn in the economy will be the Cleantech sector, followed by the medical devices sector with twenty six percent responding with a favorable outlook.

Chart 14: I believe that the first major sector which will recover from the downturn in the economy will be the _____ sector:



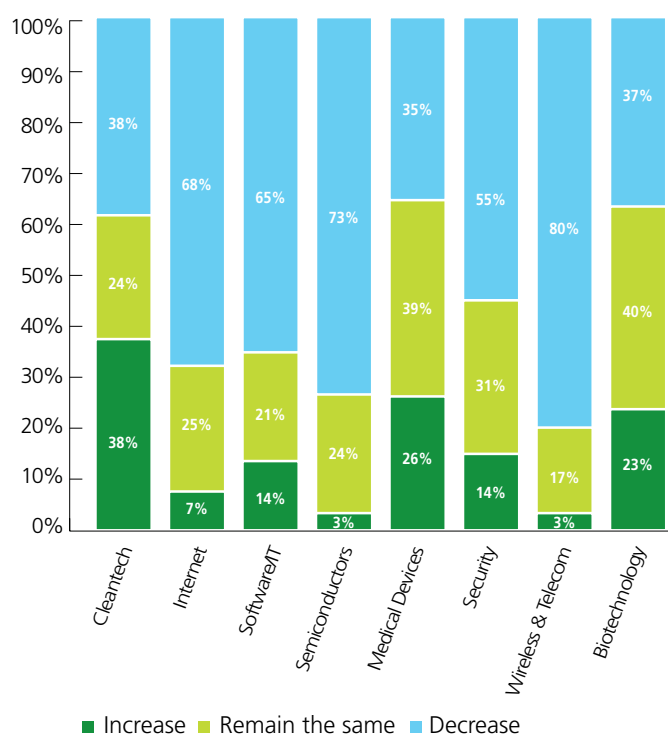
Furthermore, reviewing the trend in expectations for transactions in the semiconductor sector explains the abandonment of venture capitalists the sector. The sector is highly affected from volatile markets and in the last three quarters we can see misgiving from investing in it.

Chart 15: During the next six months, I expect the number of transactions in semiconductors to:



Reviewing the expectations of the number of transactions by all sectors, we can conclude that, in general, the trend is for a reduction in transactions across all sectors. The outlook for a decrease in transactions averages fifty six percent compared to sixteen percent of respondents expecting an increase (compared to an average of 25% forecasting a decrease and 32% anticipating an increase from Q1 2008). The main sectors which are affected are the 'Wireless & Telecom' and 'Semiconductors' sectors with eighty and seventy three percent of respondents, respectively, expecting a decrease in the number of transactions in those sectors.

Chart 16: During the next six months, I expect the number of transactions in the sectors listed below to:



Insights

We are facing challenging times. The capital markets are now in a state of paralysis and the outlook of the overall economic climate is reaching its lowest point. Moreover, the current crisis seems to have more impact than the 2000 "bubble" bursting. It is already clear that the coming era is going to be formidable. The expectations for the new Israeli government are mediocre with no lift in expectations. The expected revenues forecasts paint a dim picture. Changing the mode of the industry will have to be led by decisive and bold actions of venture capitalists, companies' management and governmental authorities.

The anticipated major layoffs are going to flood the market with talented R&D professionals. Some of them have the potential to be entrepreneurs and to establish the next generation of start-ups. The only main obstacle is the lack of investment funding sources. The fading IPO market, the poor M&A activity, the credit crunch and the absence of private investors are leading to a competitive environment with low investment valuations. The venture capitalists should take advantage of the situation by focusing on cherry picking opportunities in the market.

Only a small minority of the venture capitalists surveyed (6%) see the crisis as an opportunity which affects the focus of their venture investment strategy and shifts to early stage companies. Yet, the decrease in both the number of new investments and the valuations of these investments upon exit should urge them to invest in early stage rounds today more than ever. Taking the risk in times of crisis by investing fairly small amounts of money in early stage companies can smartly position the venture capitalist for the end of the downturn. Those prepared to take equally profound action in their investments will emerge as leaders in the medium and long term.

The picture presented in the transactions preferences and from the exits in the last year can easily lead to the conclusion that venture capitalists in Israel should focus on specific sectors. As for now, it appears as if the Cleantech and the Medical Devices sectors should be the accelerator to pull out the industry of this crisis. The pattern of changing economic cycles is part of the environment in which we live and conduct business, therefore the entrepreneurs and the investors should dedicate their resources to industry sectors that might be less influenced by the economic downturn which we are currently experiencing.

