

Israel VC Indicator Survey.

Expectations as of Quarter 2, 2009

Have we reached safe ground?



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 29th Deloitte Brightman Almagor Zohar Israel VC Indicator Survey results for Quarter 2, 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 2, 2009 were collected from June 11th, 2009 through June 21st, 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.

2nd Quarter, 2009

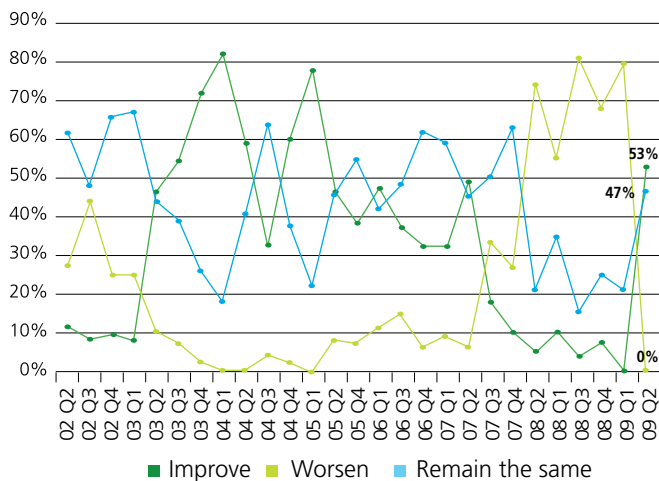
Highlights

- Positive sentiment in the high tech industry
- The Israeli government should take action
- Public debate regarding the business model of venture capital firms

Results

The general perception is changing regarding market conditions. After five consecutive quarters of pessimistic expectations regarding the overall economic climate, we can see a major change in this trend. None of the respondents to our survey think that the economic climate is going to get worse than what we have just experienced (compared to 79% and 68% in Q1 2009 and Q4 2008, respectively). The optimism that faded for almost two years is back with 53% of respondents thinking that the economic climate will improve (compared to an average of 8% in the last seven surveys).

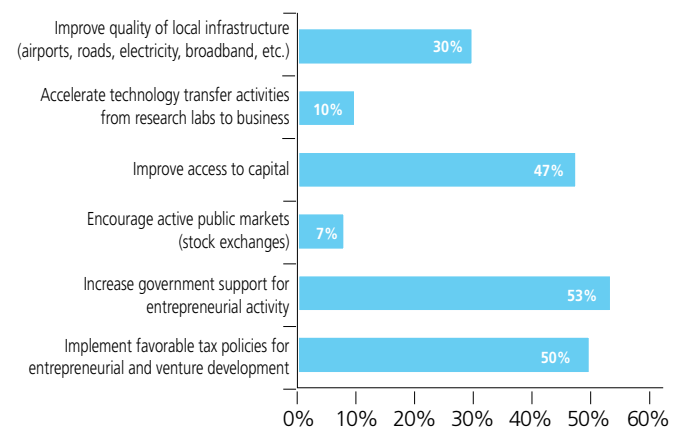
Chart 1: During the next six months, I expect the overall economic climate to:



Recognizing the fact that innovation is vital to economic recovery, governments can take several actions to foster innovation. More than half of the respondents think that government should increase support for entrepreneurial activity (53%) and implement favorable tax policies for entrepreneurial and venture development (50%). Forty seven percent think government should improve access to capital. Thirty percent believe improvement in the quality of local infrastructure (airports, roads, electricity, broadband, etc.) is essential, 10% think government

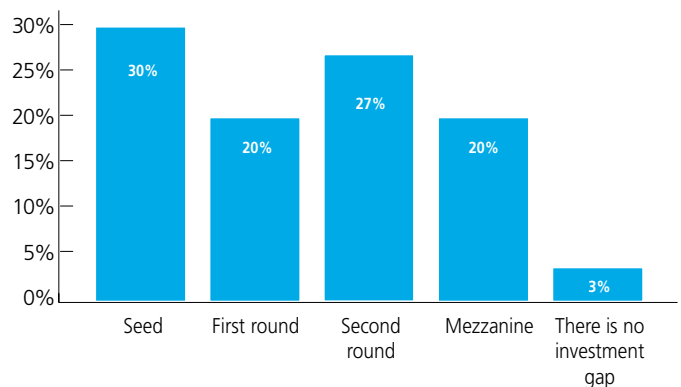
should accelerate technology transfer activities from research labs to business, and 7% encourage active public markets (stock exchanges).

Chart 2: Over the next 12 months, which two of the following actions are most important:



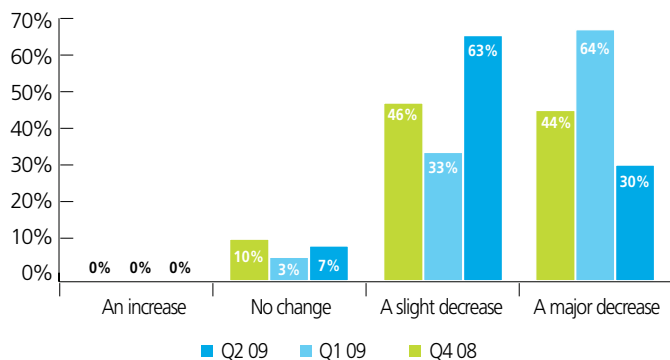
The difficulties in raising new venture capital have continued into the 2nd quarter of 2009. With the lack of angel investors, seed stage companies are seeking alternative routes for funding. It is no surprise that the biggest investment gap in the Israeli start-up industry is said to be in the seed stage, with 30% of respondents echoing this belief. Second round stage investment gap was found to be the next main investment gap in Israel by 27% of venture capitalists. Approximately 20% of venture capitalists believe the hardest hit area to be either the first round or the mezzanine funding round. Only a minority of 3% of respondents found no investment gap.

Chart 3: What is the main investment gap in the Israeli start-up industry?



The forecast for a slowdown in the revenues of high tech companies is still dominating the thoughts of our survey respondents. Review of the forecast in the last three quarters indicates that companies were and still are facing difficulties such as a slowing revenue stream and cash flow generation. The current venture capitalists' forecast in regards to revenues is discomfoting. Sixty three percent think we will see a slight decrease in the Israeli high tech companies' revenues in comparison to 33% at the last survey. Thirty percent think we will see a major decrease in the Israeli high tech companies' revenues. A fraction of the respondents estimate that current levels of revenues will be maintained. None of the respondents believe we will see an increase in revenues.

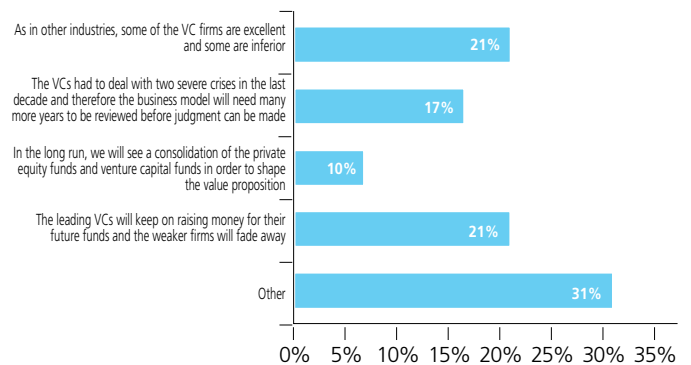
Chart 4: Due to the turmoil in the global economy, the Israeli high tech companies' revenues are likely to show:



As part of the public debate regarding the global economic crisis and the business models of financial institutions in general and funds in specific, recent publications indicate that the business model of venture capitals around the world does not provide the expected results. The polled Israeli venture capitalists do not have a unified voice as to why the business model is not working. Twenty one percent think that as in other industries, some of the VC firms are excellent and some are inferior. Another 21% think that the leading VCs will keep on raising money for their future funds and the weaker firms will fade away. Seventeen percent think the venture capitalists had to deal with two severe crises in the last decade and therefore the business model will need many more years to be reviewed before judgment can be made, and 10% think that in the long run, we will see a consolidation of the private equity funds and venture capital funds in order to shape the value proposition. Thirty one percent could not agree with the suggested reasons and provide alternative explanations such as, the

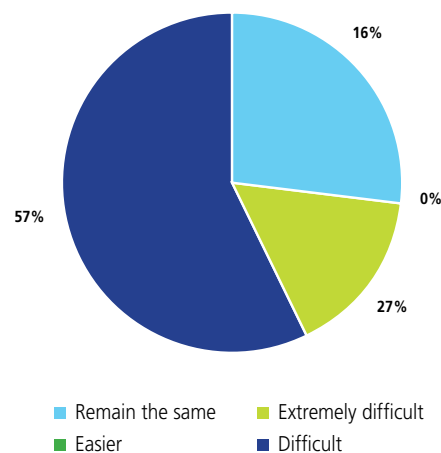
maturing of the high tech industry affecting the return, there is too much capital chasing and too few quality deals, etc.

Chart 5: Recent publications indicates that the business model of VCs around the world doesn't provide the expected results. The main reason for that is:



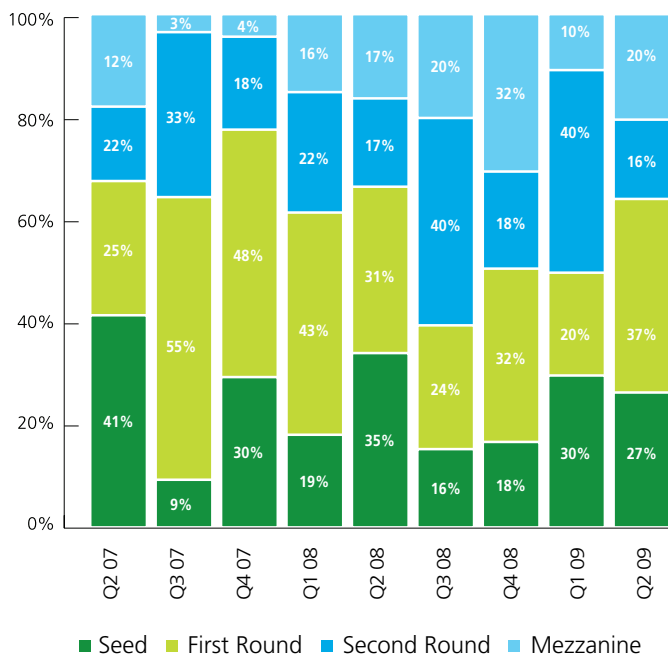
As in previous surveys, the impact of the current financial crisis on the fundraising activities of the venture capital community is crucial. A vast majority (84%) believe that fund raising will become more difficult than before (57% difficult and 27% extremely difficult). Sixty percent believe it will remain the same as before and none of the respondents think that it will become easier in the near future.

Chart 6: VC fundraising activity will become:



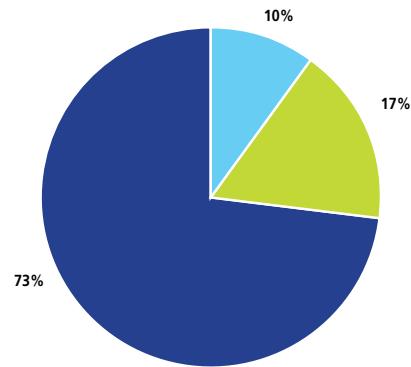
One of the indicators giving evidence that we are in the end of the crisis is the segmentation of the new investments. In the previous four quarters the majority of the new investments were in the second round and mezzanine rounds. In the current survey, 64% of venture capitalists surveyed expect that their new investments will be made in relatively early stage (Seed and First Round). Only sixteen 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 40% on the last survey.

Chart 7: During the next six months, I expect the majority of my new investments to be made in:



The majority of venture capitalists are maintaining their investments strategies despite the crisis. Seventy three percent will maintain current focus of investment strategy, in terms of stage of development. Seventeen percent will shift focus to later stage companies and existing portfolio companies and 10% will shift focus to early stage companies.

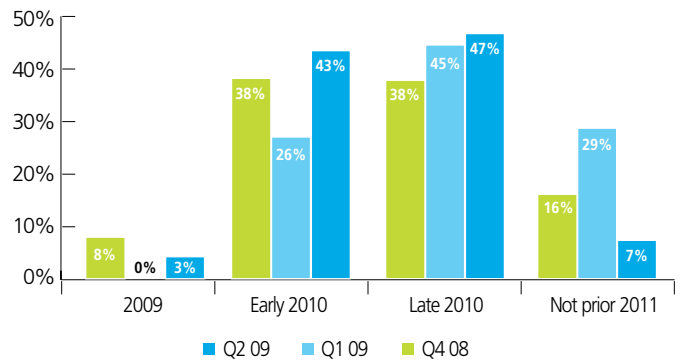
Chart 8: Is the global recession affecting the focus of your venture investment strategy in terms of stage of development of investee companies?



- 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

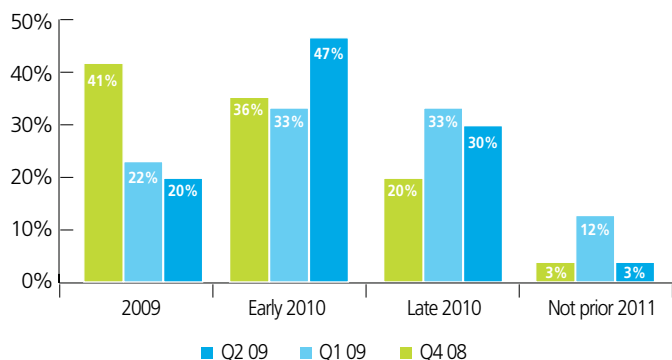
As we are nearing the third quarter, the venture capitalists assume that the IPO market is not going to fully re-open until the end of the year. The majority think that during 2010 the IPO market will re-open with 43% of respondents think it will be on early 2010 and 47% on late 2010. Only 7% of respondents think the re-opening will be delayed until 2011 (compared to 29% in Q1 2009 and 16% on Q4 2008).

Chart 9: When do you think the NASDAQ IPO market will re-open?



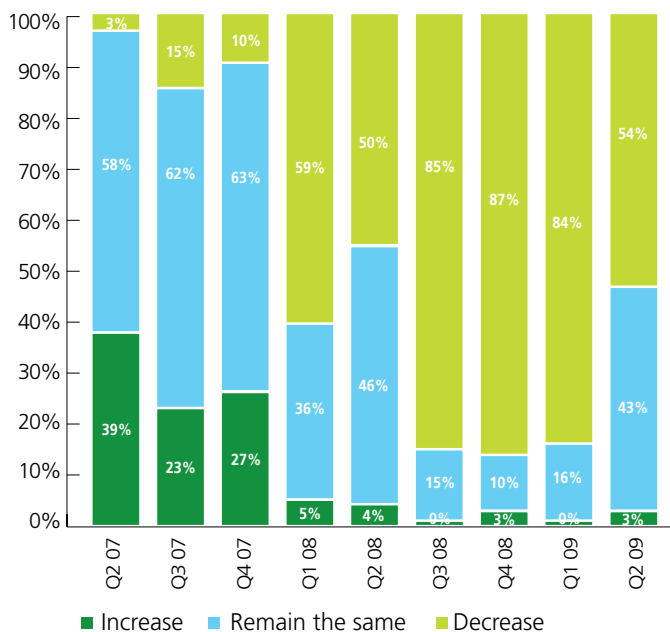
The outlook for M&A transactions is quite optimistic. The forecast for this market is much more positive than the NASDAQ IPO market, with 41% of the venture capitalists surveyed seeing a ramp up in M&A transactions during 2009 (compared to 22% in Q1 2009 and 20% on Q4 2008). The rest of the respondents believe it will gain momentum during 2010 and only 3% believe it will stagnate until 2011.

Chart 10: When do you think M&A transactions will ramp up?



The respondents' outlook regarding investment valuations is less pessimistic than it was during the last three quarters. Fifty four percent of respondents expect that investment valuations will decrease (compared to 84% in Q1 2009, 87% on Q4 2008 and 85% on Q3 2008).

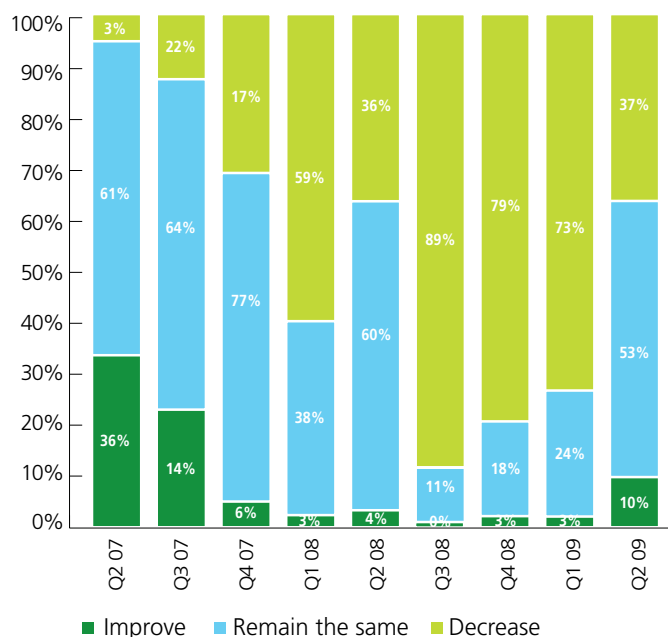
Chart 11: During the next six months, I expect investment valuations to:



The respondents of this survey are not yet presenting a positive trend (3% think it will increase) but the percentage of the respondents that think the valuation is going to remain the same is much higher (43%).

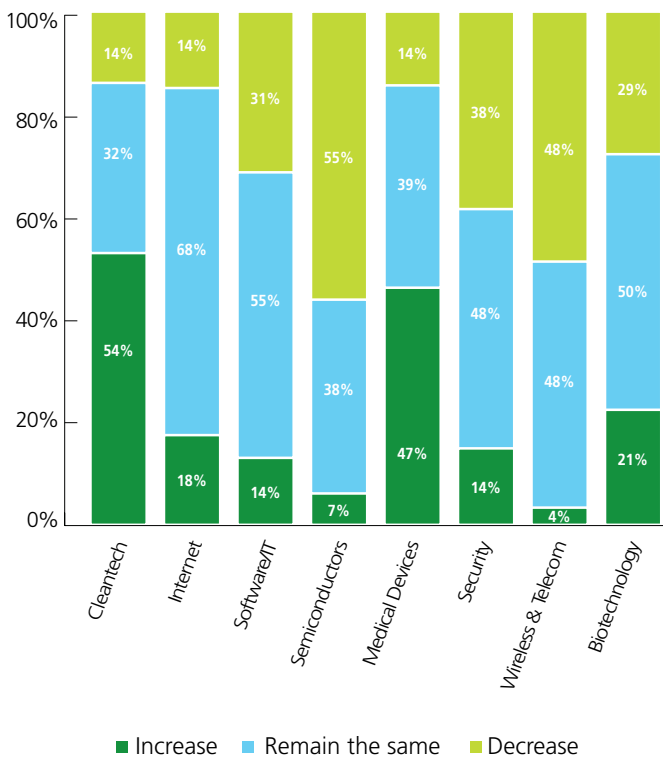
The trend of the investment valuations is much the same with respect to exit valuations. For the first time, after three quarters, the majority of the respondents expect exit valuations to remain the same, with 53% (compared to 73% in Q1 2009, 79% on Q4 2008 and 89% on Q3 2008). The expectation for improvement in exit valuations is being felt by 10% of respondents. This compares favorably to the outlook of respondents last quarter and has not been at this level for almost two years - Q3 2007, with 14%.

Chart 12: During the next six months, I expect exit valuations to:



Reviewing the expectations for the number of transactions in all sectors, we can conclude that, in general, the trend is for a decreasing number of transactions over the near term. The sectors holding the greatest interest are the cleantech (54% expect to increase in the number of transactions) and the medical devices (47% expect to increase in the number of transactions) sectors.

Chart 13: During the next six months, I expect the number of transactions in the sectors listed below to:



Insights

For the first time in the last year and a half, this survey is presenting a sense of optimism. The expectations from the overall economic climate and from the market conditions are for an unchanged scenario or even improvement in some cases. The capital markets are stabilizing but a full recovery is yet to be seen. High tech companies made the necessary adjustments for the crisis and hope to see an improvement in the near future – but the expected revenues forecasts are still gloomy. Looking forward, we can expect an interesting change in the market sentiment which will influence the recovery of the early stage companies, late stage companies and investors in the high tech industry.

Venture capitalists expect government to take actions in order to help in the recovery process of the industry. For example: increased support for entrepreneurial activity, implementation of favorable tax policies for entrepreneurial and venture development, and improved access to capital. Such actions not just necessary for the maintaining of the high tech industry in Israel in the long run but crucial in order to make sure Israel will still be relevant and competitive in the global technology industry at the end of the crisis.

The venture capital firms are capitalizing on opportunities during these difficult times as well. It seems that it is a buyers market and that the venture capitalists can bargain with very good companies on fantastic valuations. However, we have to remember that the whole ecosystem of the economic market weakened and therefore the business model of the venture capitals is currently being re-examined. There are various reasons for the problems that venture capital firms are facing, such as, some of the venture capital firms are excellent and some are inferior; the weaker venture capital firms will fade away; too much capital chasing a limited number of deals, etc. The current debate has an immediate impact on the ability to raise new funds. In the long run, we estimate that the number of venture capital firms in Israel and in the world will be reduced.

Sentiment related to the number and value of high tech transactions is much less pessimistic than it was in previous years. The outlook for the IPO market is still uncertain for the coming six months – however, expectations are high for a ramp up in M&A transactions in the near future. Regarding investment valuations, both entrance and exits valuations are expected to remain the same or even to increase in the near future as compared to the last year and a half. With respect to industry or sector preference, the cleantech and medical devices sectors are still dominant and most attractive for the venture capitalists.

