

Israel VC Indicator Survey.

Expectations as of Quarter 3, 2004

Investments on the Rise, Foreign Investors are Back

The purpose of the Israel VC Indicator is to identify trends within the venture capital arena. Its objective is to give a comprehensive picture of the expectations of the Israel VC community for the next six to twelve months. The survey is designed to explore relevant key aspects, such as the economic and market climate, deal activity and investment and managerial focus.

The VC Survey is a Deloitte initiative, which is conducted on a quarterly basis concurrently in the UK, Canada, Israel, Germany, Austria, Spain, Belgium, Switzerland, the Netherlands, Italy, Australia, Hong Kong and China, India, Taiwan and Korea.

The results were collected from August 18th through September 10th, 2004 from 46 VCs in Israel, including all of the largest VCs in the country.

This project is conducted by the Business Development Department within the TMT Group.

Introduction

2004 has been a better year for the high-tech industry around the world and with it for the local industry. The third quarter of 2004 continues to reflect the improved reality along with moderated optimism. VC investment levels continued to rise, a number of VCs have raised new funds and further increase of foreign involvement in the Israeli high-tech industry could be seen. The VC community expects all of the above to continue into next year.

The Israel VC Indicator Survey is a comprehensive picture of VCs expectations for the next six to twelve months and acts as an indicator of changing confidence levels in:

- Economic and market climate
- Deal activity
- Investment and Managerial focus

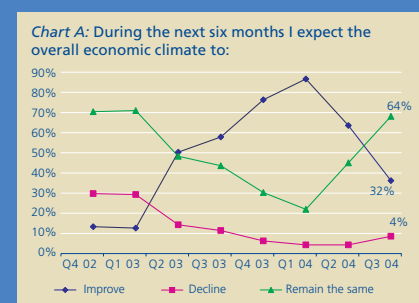
The results produce a forward-looking measure of the overall sentiment in the Israeli venture capital community, which is extremely relevant to immediate deal flow.

The 12th Deloitte Brightman Almagor Israel VC Indicator Survey results for Q3 2004, include a comparison, where relevant, to responses from previous surveys.

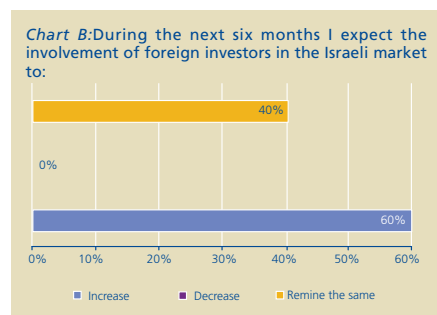
Results

As in the previous quarter, this quarter's results indicate further moderate expectations regarding the next six months. A large decrease can be seen in the number of VC members that expect the overall economic climate to continue improving over the next six months (32% in Q3 2004 compared to 59% in Q2 2004), and 64% expect it to remain the same as opposed to 41% in Q2 2004. Due to the slow but steady improvement in the economic climate that has been witnessed during the past few months around the world and along with it a local improvement as well, these expectations

indicate that the VC community expects a continuing positive atmosphere although without a significant change in the near future. (Chart A)

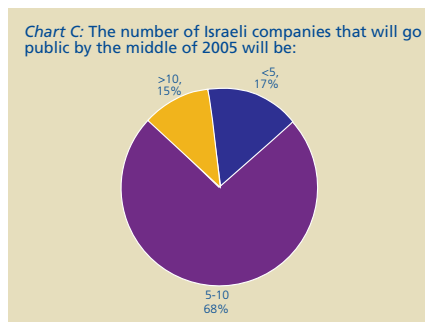


The moderation in the VC community members' expectations can also be seen in their anticipation regarding new funds raised from the VCs by companies. Only 34% of the respondents expect raising new funds by companies from VCs to be less difficult (compared to 51% in the previous quarter), but 64% of the respondents expect it to remain the same as at the present time. Since there has been a large increase in the number of investments made by VCs in Israeli start-up companies since the beginning of the year this indicates that the VCs expect investments to continue at a realistic and steady pace. In addition, foreign involvement in the Israeli high-tech industry and VCs has grown significantly over the past few months and **100%** of the respondents expect it to continue at the present pace or further increase during the next six months (60% of them expect an increase). (chart B)



Further indications to the VC community's intentions to continue a steady investment pace and even increase it slightly, can be seen in the fact that 34% of the respondents in Q3 2004 expect the most important factor leading to an increase in their investment levels to be technology innovation and an increase in corporate IT spending compared to 21% in Q2 2004, and for the first time since Q4 2003 there is a decline in the significance ascribed by the VCs to the recovery of public markets. Only 66% of the respondents compared to 79% in the previous quarter consider the recovery of public markets to be the main factor influencing their investment levels. It seems that the VC community feels more confident in a somewhat steady IPO market during 2005, and even if its return is slightly "delayed", it doesn't feel as dependant on this factor due to many VC members being satisfied with exits by M&As as an appropriate alternative to an IPO, and therefore ready at the present time to continue investing.

Towards the last quarter of 2004, VC expectations are realistic with only 30% of the respondents expecting to see between 5 to 10 Israeli high-tech companies go public by the end of the year (compared to 42% in Q2 2004) and 70% of the respondents expecting an IPO from less than 5 companies. Furthermore, the large majority of the respondents (83%) expect between 5-10 companies to go public by the middle of 2005, with 15% of them expecting more than 10 Israeli high-tech IPOs over that same period. (Chart C)



An increase can be seen in the number of respondents that don't foresee the return of a healthy IPO market for technology companies before 2006 or later (39% in Q3 2004 compared to 17% in Q2 2004) as opposed to the previous quarter where the majority of the respondents (72%) expected it to happen in 2005 (57% in Q3 2004). This expectation will have a direct impact on the number of exits during 2005 with 89% of the VC community members expecting to exit from 5-25% of their portfolio companies during 2005.

Following the recent IPOs and M&As executed over the past six months, many VCs are continuing to lower their acceptable return on potential exit opportunities to more realistic rates. Only 49% of the respondents state that an acceptable return from an exit of an investment exceeds three times the original investment (compared to 54% in Q2 2004, 60% in Q1 2004 and 68% in Q4 2003).

A slight increase can be seen in favor of the Seed and First round stages at the expense of the Second round with only 38% of the respondents expecting the majority of their new investments to be made in the latter as opposed to 48% in Q2 2004. This again reflects a calmer and stable state of mind regarding exits and quick ROIs and allows for more long-term investments. In addition, the fact that a few VCs have raised new funds over the past few months, and the expectation of 60% of the respondents to raise their next fund during 2005, has enhanced many VCs' ability to invest in earlier stages

Following the trend of raising new funds, 93% of the VC community still agrees with the opinion stated a year ago in the parallel quarter by 91% of the respondents, that the optimal size for a fund operating in Israel is no larger than \$250 million. 74% of them (in Q3 2004) state that the optimal size is between \$100-250 million.

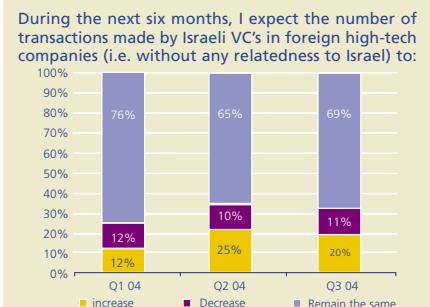
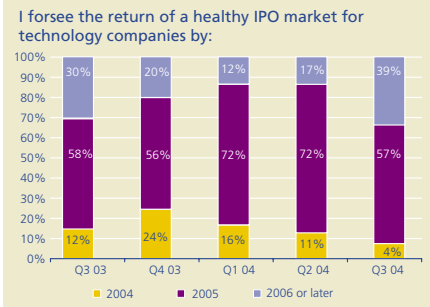
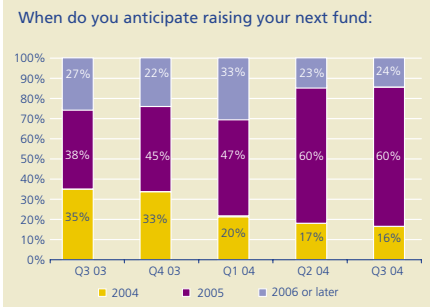
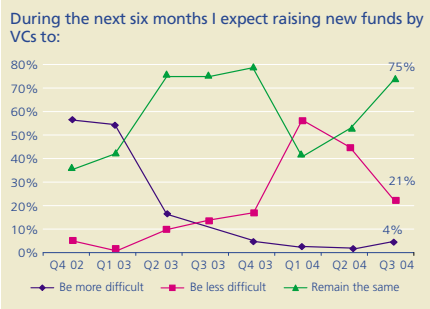
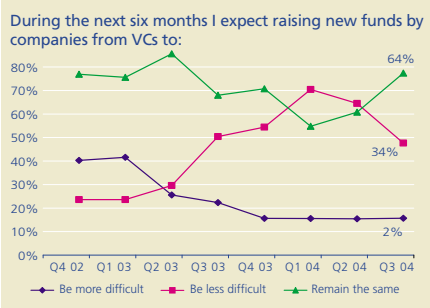
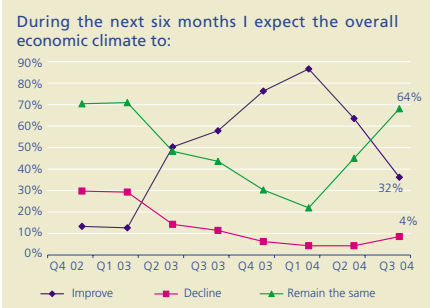
Although still the leading sector, a large decline can be seen in the number of respondents expecting an increase in investments in Internet/E-commerce (only 50% in Q3 2004 compared to 98% in Q3 2004). Homeland security and Wireless and Telecom sectors are also expected to continue increasing. ●

Insights

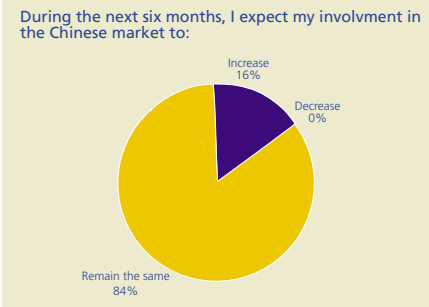
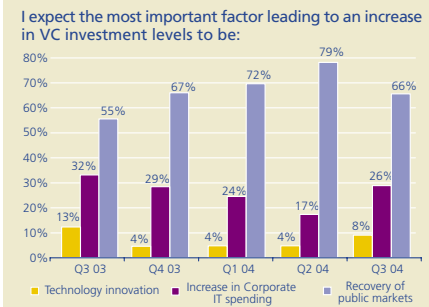
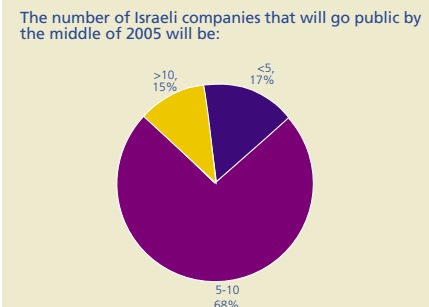
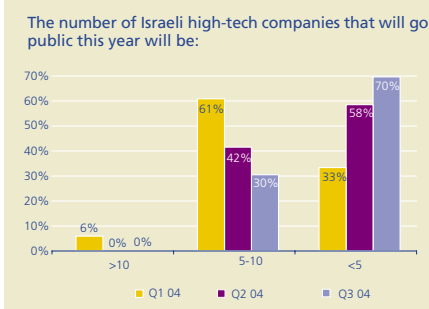
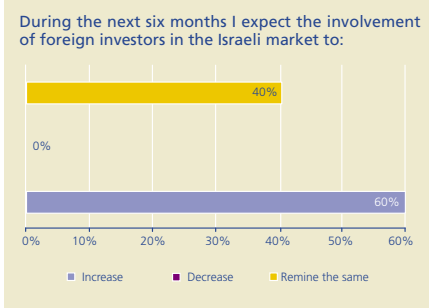
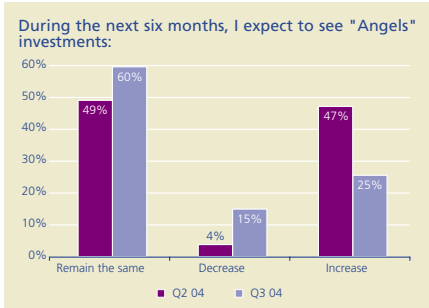
- A reality of a somewhat routine of investments has begun around the world and with it in Israel, in the beginning of 2004 and will continue into 2005. These investments are performed at a reasonable pace and preceding comprehensive due-diligence and examining. Larger rounds with higher valuations can be seen, and therefore VCs must continue to be alert and cautious.
- The return of a steady IPO market and with it exit possibilities will have a large affect on all investment activity, both by VCs and for VCs. Many of the exits witnessed (both IPOs and M&As) since the beginning of the year have not provided the return on investment hoped for by the VCs at the time of the original investment. During the next six months exit valuations are expected to remain at reasonable and low levels. VCs must take this into consideration at the time of new investments in order to achieve acceptable ROIs in the future.
- Due to the current conditions in the stock markets around the world and to the law changes and regulations for public companies, many investors and companies view an M&A as an acceptable and maybe even preferred exit option. Either way (IPO or M&A), Corporate Governance is beginning to play an important role in all of the companies' readiness for the new regulations.
- At present it seems that there is equality between the amount of funds in the local market and the number of companies that are in need for funds. Additional funds raised will once again enlarge the market and enhance the competition between the VCs. Therefore the near future is crucial for some of the local VCs. VCs who won't be successful in raising new funds will have to take additional measures in order to deal with their situation and this reality, such as consolidation, reduction of management activity or maybe approach fund raising from the public. Furthermore, the expected change of ownership in the local institutional investors can provide new opportunities for funds for the VCs.
- Since the beginning of the year the Israeli government has implemented many reductions and cut backs that directly affect the local high-tech industry, and in the long run the Israeli market as a whole. The results of these decisions are already visible. Foreign investors and international companies are reconsidering the feasibility of their investments and local companies are expected to increase their involvement in the Far East markets.
- In order to deal with the challenge presented by the Far East markets, the Israeli government must take immediate measures in order to improve the local market's competitiveness both by re-attracting international companies and by encouraging the employment of local employees.

Detailed Results, 3rd Quarter, 2004

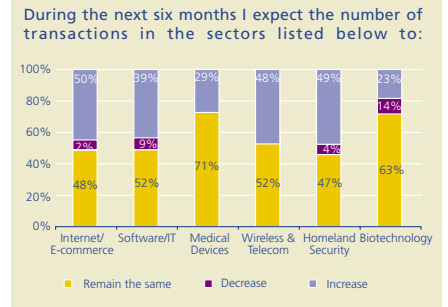
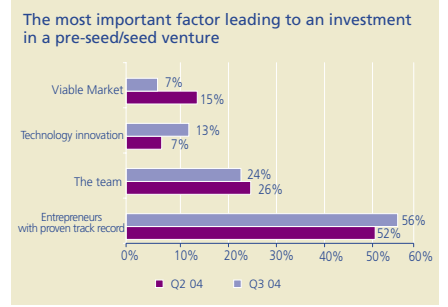
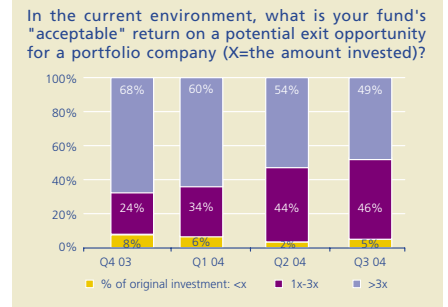
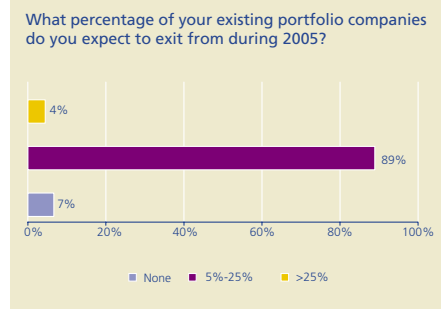
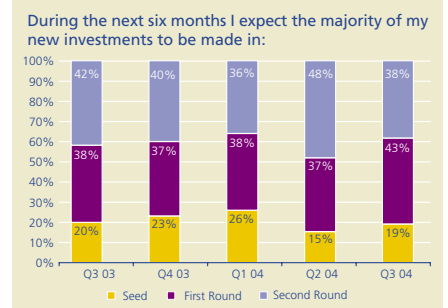
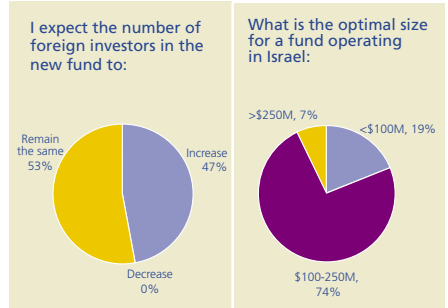
Economic Activity



Deal Activity



Investment & Managerial Focus



For more information...

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