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Global Trends in Venture Capital 2006 Survey

U.S. Report Sponsored by Deloitte & Touche USA LLP in association with

NVCA National Venture Capital Association

CVCA 中华创业投资协会 China Venture Capital Association

CVCA Canada's Venture Capital & Private Equity Association
Association Canadienne du Capital de Risque et d'Investissement

evca European Private Equity & Venture Capital Association

tvca

IVCA Indian Venture Capital Association

VCA

BVCA investing in enterprise

IVA Israel Venture Association

SVCA Singapore Venture Capital & Private Equity Association

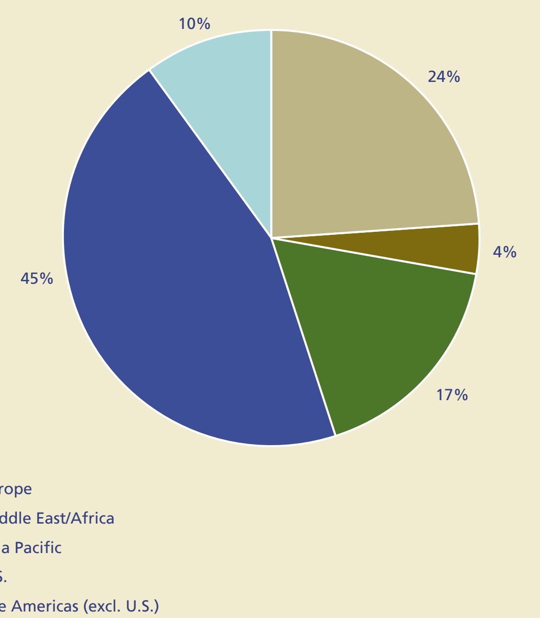
ABVCAP Associação Brasileira de Private Equity & Venture Capital

Audit.Tax.Consulting.Financial Advisory.

About the Survey:

The 2006 Global Venture Capital Survey, sponsored by Deloitte & Touche LLP in conjunction with the National Venture Capital Association and other venture capital associations,* throughout the world was administered to venture capitalists (VCs) in the Americas, Asia Pacific (APAC), Europe, the Middle East, and Africa. There were 505 responses from general partners with assets under management ranging from less than $100 million to greater than $1 billion. The survey was conducted in April and May 2006. The breakdown of respondents was as follows:

Figure 1a. Location of Respondents



The survey questions were aimed at discovering the degree to which venture capitalists are expanding their worldwide investment focus, identifying the territories they are targeting for expansion and how their business practices are changing in order to accommodate a more global approach to investing. Likewise, questions explored the impediments they see associated with establishing footholds in various geographic markets as well as the ongoing challenges they encounter doing business in the United States (U.S.).

The format for the 2006 survey closely matched that of the prior year so that key attitude changes about global investing among venture capitalists could be tracked from year to year. However, new questions were added relating to the impact of regulation on the investment climate and the degree to which venture-backed companies are locating primary operations outside their domicile.

* The participating venture capital associations include:
- Brazilian Association of Private Equity & Venture Capital (ABVCAP)
- British Venture Capital Association (BVCA)
- Canada's Venture Capital & Private Equity Association (CVCA)
- China Venture Capital Association (CVCA)
- European Private Equity & Venture Capital Association (EVCA)
- Indian Venture Capital Association (IVCA)
- Israel Venture Association (IVA)
- Malaysian Venture Capital and Private Equity Association (MVCA)
- Singapore Venture Capital & Private Equity Association (SCVA)
- Taiwan Venture Capital Association (TVCA)

While the survey is primarily focused on the venture capital (VC) industry, some respondents are buyout firms and firms that invest in all private equity. The types of firms responding were as follows:

Figure 1b. U.S. Firm Type

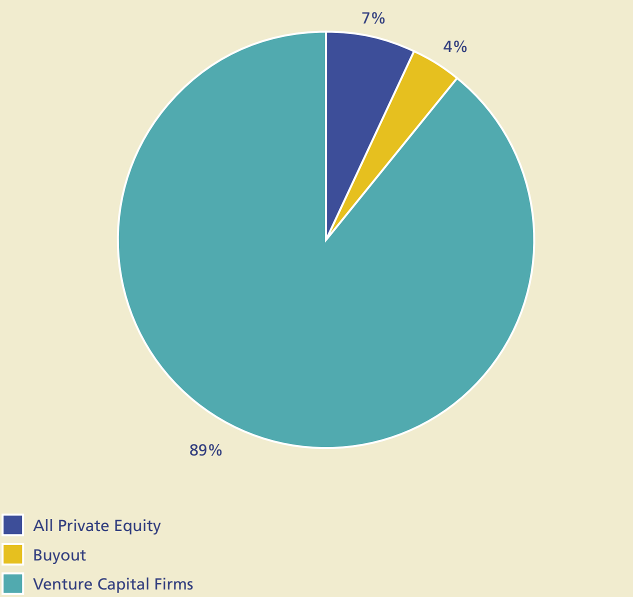
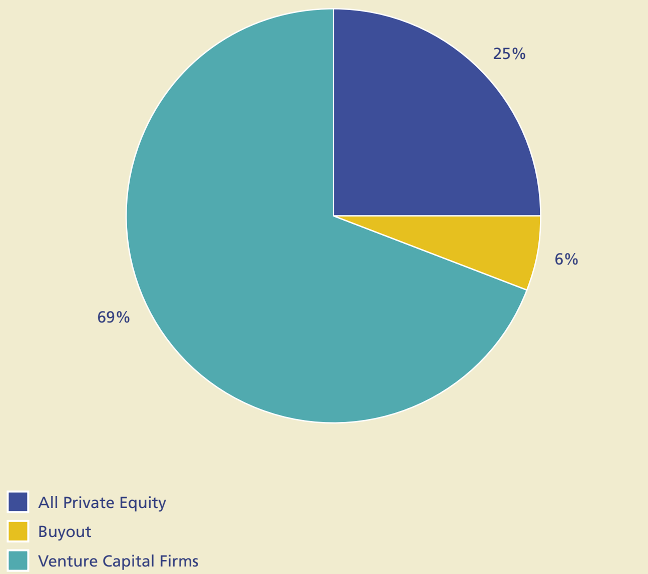


Figure 1c. Non-U.S. Firm Type



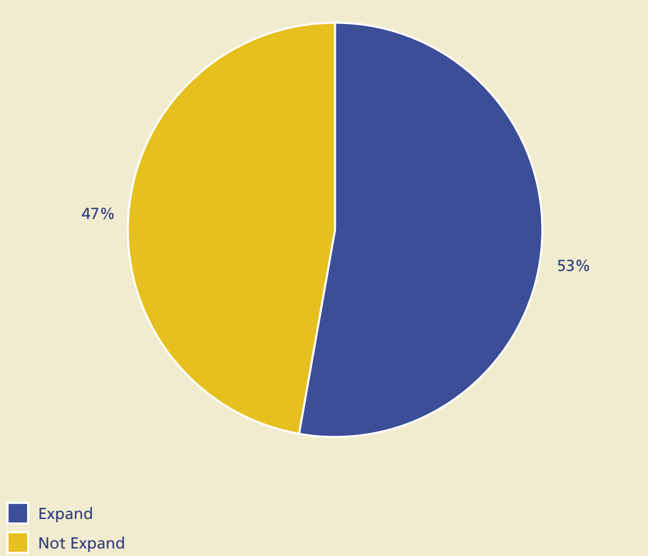
Taiwan and China are analyzed separately within this report. References to Taiwan are in respect of the related territory which is part of the Peoples' Republic of China, and references to China do not include the territory of Taiwan.

The Great Divide — A Narrow Majority of VCs Go Global While the Rest Stay Focused Stateside — United States Still is the Top Destination of Choice

Inevitable as globalization may be for the U.S. venture capital community, the trend is still fledgling. This year's survey data clearly suggests, a cautious approach is being taken on the part of the venture industry as it moves to identify opportunities outside of the United States.

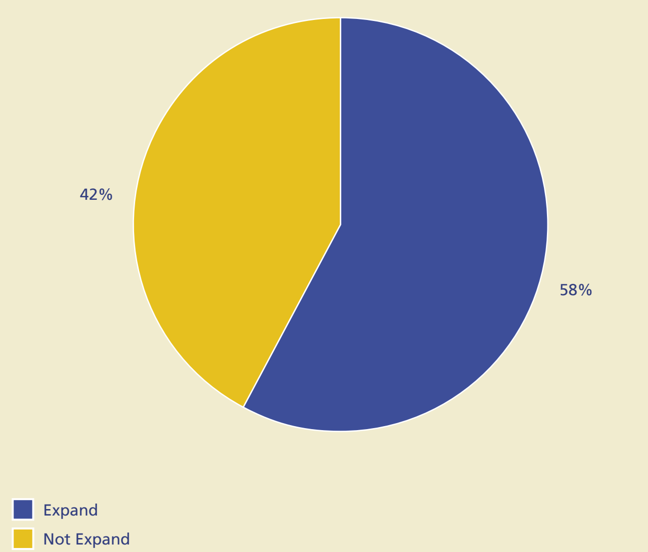
U.S. venture capitalists, as survey responses from this year's *Global Trends in Venture Capital* show, remain closely divided among those who expect to expand their international investment focus and those who expect to maintain their U.S. focus.

Figure 2a. Percentage of venture capitalists indicating an increase in expanding global investment focus (U.S. respondents)



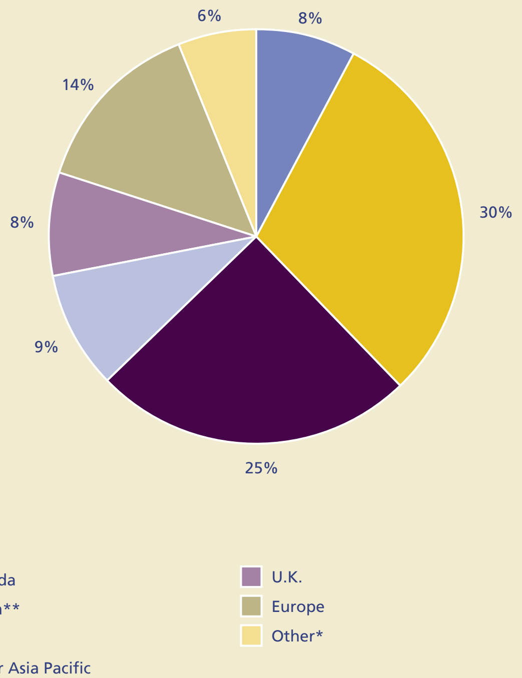
Until recently, venture capital investment was a local activity with most venture capitalists never considering investments that were not within driving distance (or at least a short plane ride) from their offices so that they could keep in close contact with their portfolio companies. The fact that more than half of all U.S. respondents stated that they were planning on expanding internationally (albeit cautiously) signals a sea change in the venture industry.

Figure 2b. Percentage of venture capitalists indicating an increase in expanding global investment focus (Non-U.S. respondents)



U.S. respondents remained consistent about the markets they expect to target in the coming five years. Interest in China** and India, which were the top two destinations for U.S. respondents last year, showed an annual increase of 10 and 7 percent, respectively. After the two Asian markets, U.S. respondents fragmented across a number of geographies, including stalwart markets such as the United Kingdom and Canada.

Figure 3. All locations where investors would like to expand investment focus (U.S. respondents)



* Includes Japan, South America/Mexico, and Taiwan**

Still, one cannot ignore that 47 percent of U.S. respondents expressed no interest in pursuing global expansion over the next five years. Underlying the schism is a variety of reasons, not least of which is the continued robustness of the U.S. venture capital market (see Figure 7). Also noteworthy is that of the 53 percent of U.S. respondents who indicated they intend to expand globally, only 19 percent indicated that they expect to decrease their investment focus in the United States. These results increased modestly from the prior year survey in which slightly more than 50 percent of U.S. respondents indicated they intended to increase their global focus, and only 19 percent indicated they intended to decrease their U.S. focus.

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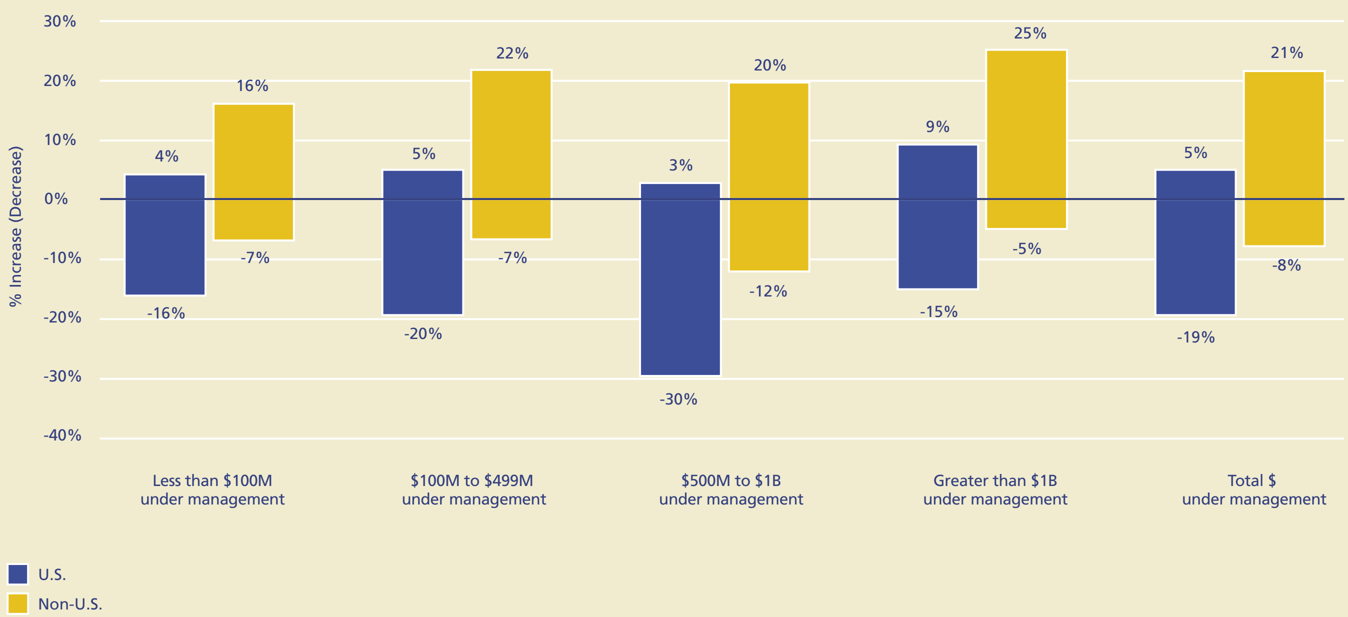
Further compelling data showed that non-U.S. firms also indicated that they intend to increase their investment focus in the United States over the next five years.

Figure 4. Change in investment focus in the U.S. in the next 5 years by firm size (all respondents)



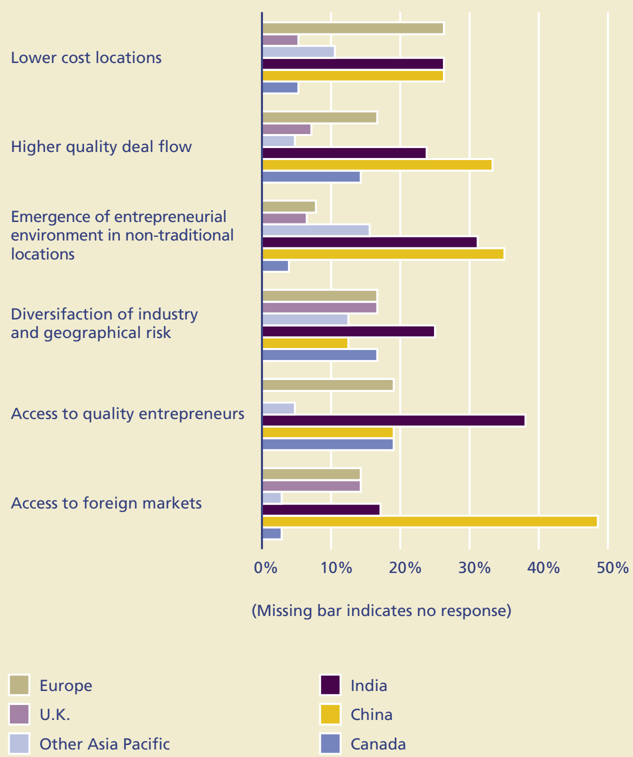
While over half of U.S. VCs are planning to expand globally, only 19 percent indicate they plan to reduce their U.S. investment focus. The fact that U.S. VCs are maintaining their U.S. focus and that non-U.S. firms are expecting to increase their U.S. focus indicates the United States will continue to enjoy a healthy and robust venture capital market for the foreseeable future.

Key Reasons Why More U.S. VCs Will Go Global

Self-sustaining as the U.S venture capital market may appear today, this year's survey data strongly suggests there is a growing interdependence between U.S. and foreign venture capital concerns, resulting in unprecedented numbers of strategic alliances.

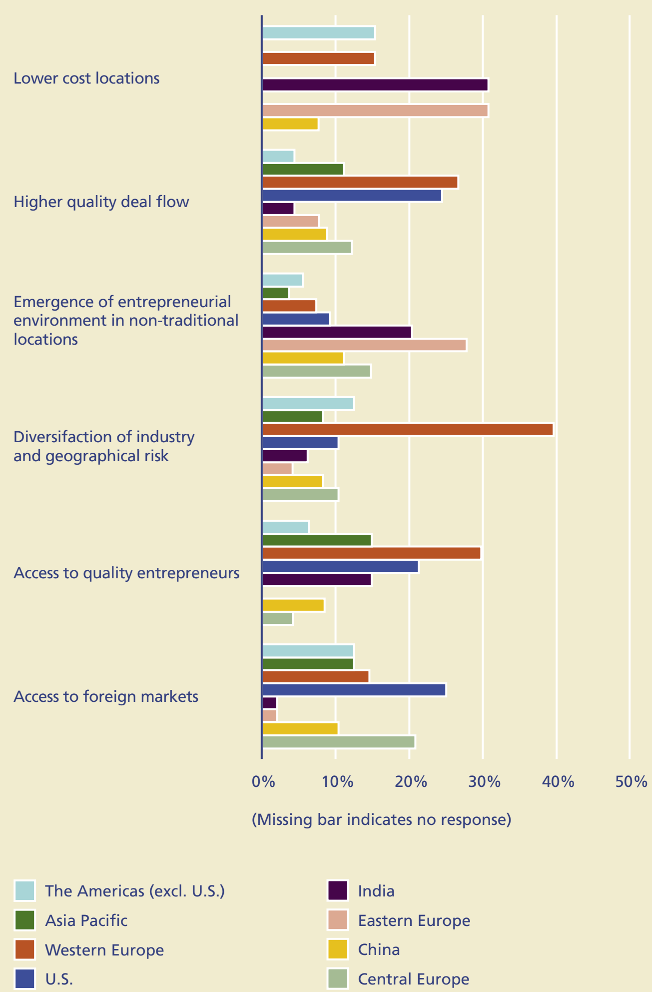
Respondents from the United States acknowledged that their interest in investing globally is being driven by a number of practical reasons as can be seen in the following chart.

Figure 5. Top locations where investors would like to expand investment focus and why (U.S. respondents)



Interestingly, when comparing the U.S. and non-U.S. responses, it becomes clear that the primary drivers for investing outside of the home market are the same. Although, U.S. venture capitalists and non-U.S. venture capitalists don't necessarily have the same view about where those opportunities exist. All respondents (U.S. and non-U.S.) are interested in India and China for lower cost locations. U.S. venture capitalists are highly interested in China for access to foreign markets and India for access to quality entrepreneurs. Alternatively, non-U.S. venture capitalists are highly interested in India and Eastern Europe for access to emerging entrepreneurial markets; the U.S. for access to foreign markets, quality deal flow, and quality entrepreneurs; and Western Europe for diversification, quality deal flow and quality entrepreneurs.

Figure 6. Top locations where investors would like to expand investment focus and why (Non-U.S. respondents)



Venture capital communities are springing up all over the world. The Global Entrepreneurship Monitor research project recently reported that venture capital "plays a central role in facilitating high growth entrepreneurship" in 21 nations[1]. In the same way that they helped export technology around the globe, so too have U.S. venture capitalists inspired an entrepreneurial ideal that is spreading at a steady clip. Though the bulk of venture investment still resides in the United States, the growing pool of entrepreneurial talent is percolating beyond its border and represents both future competition and collaborative opportunities.

For example, Skype, the European Voice-Over-Internet phone company funded by Luxembourg-based Mangrove Capital and co-founded by Mark Tluszcz, garnered attention in Silicon Valley when it was acquired by eBay in 2005 for $2.5 billion[2]. Buoyed by Skype's success, and that of other non-U.S. tech concerns, governments around the globe have begun investing public funds alongside of private dollars to help with the incubation of start-up firms and innovating technologies expressly for global competition. In July 2005, the French government set aside €1.5 billion in seed capital to be used for research and development and infrastructure support at universities and private sector companies for projects deemed internationally competitive.

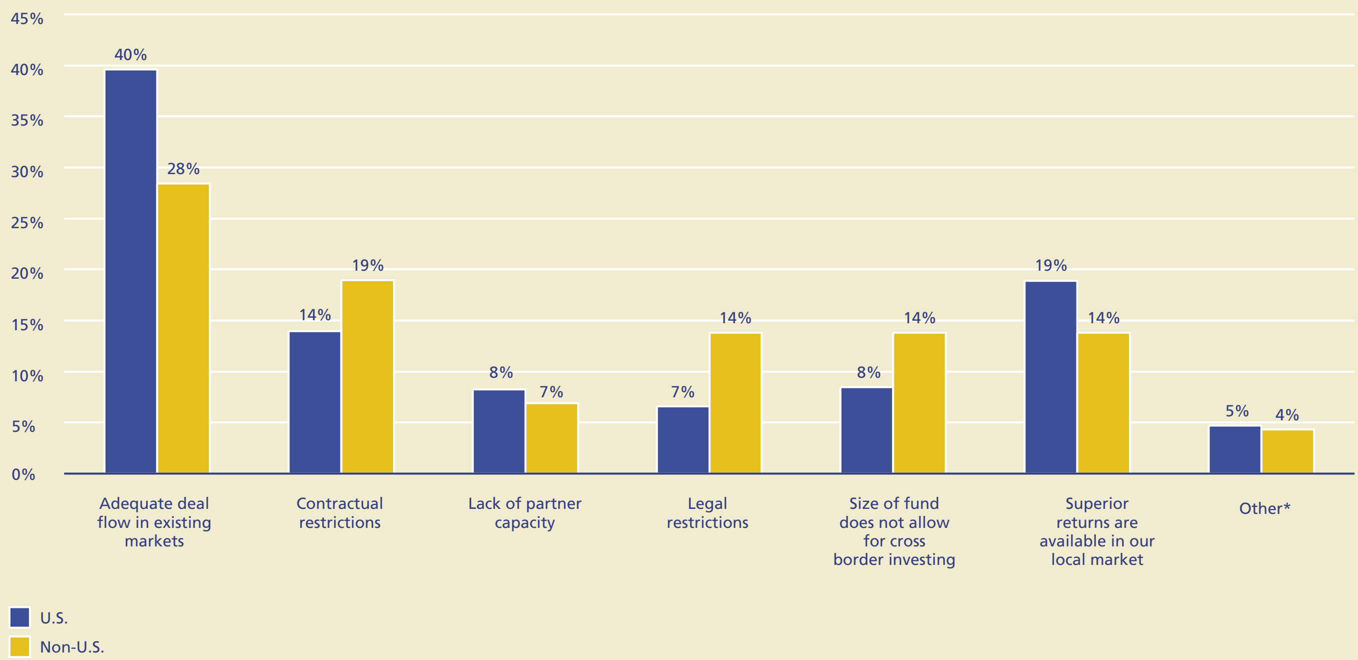
The data also suggests that the global investment focus is not necessarily being driven by venture firms identifying opportunities in far-away lands and then acting alone in making the investment. Rather it suggests that networks of relationships among venture firms around the world are beginning to develop. These relationships indicate that foreign firms are interested in identifying the best opportunities wherever they may be and then creating an investor group with partners on the ground that can help the local company succeed in a global marketplace. In many ways, this evolution is simply the modern day equivalent of the U.S. venture capital industry of 40 years ago. At that time, a small collection of firms would operate through well established networks of general partners to structure and manage deals, albeit on a more local or regional basis.

Key Reasons Identified for Not Globalizing — There is No Place Like Home

Despite an ever-expanding universe of opportunities, the United States continues to dominate the global landscape on a variety of fronts in the eyes of both U.S. and non-U.S. based respondents.

When asked to identify the main reasons they were not pursuing international expansion, almost 60 percent of U.S respondents pointed to higher quality deal flow and superior returns in the United States as the primary reason they were not interested in expanding globally.

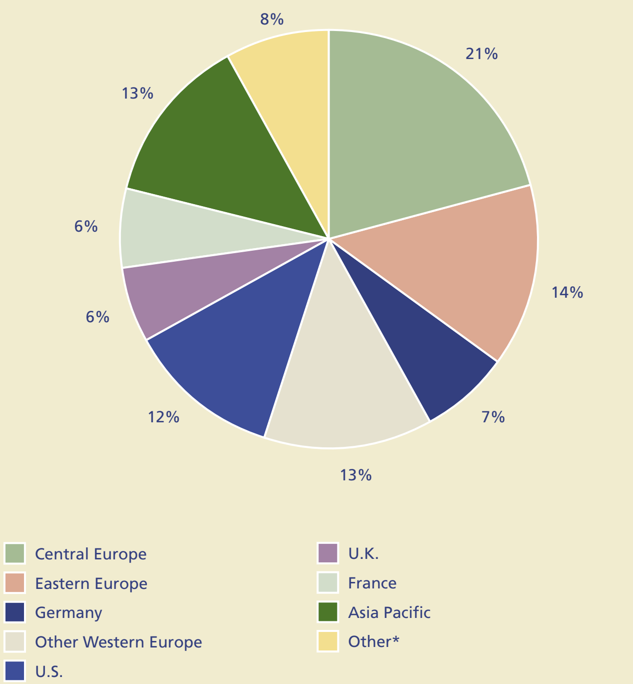
Figure 7. Primary reason venture capitalists are not expanding their international investment focus, in the next 5 years (all respondents)



* Primarily consisted of not expannding internationally as firm was already 100% invested internationally

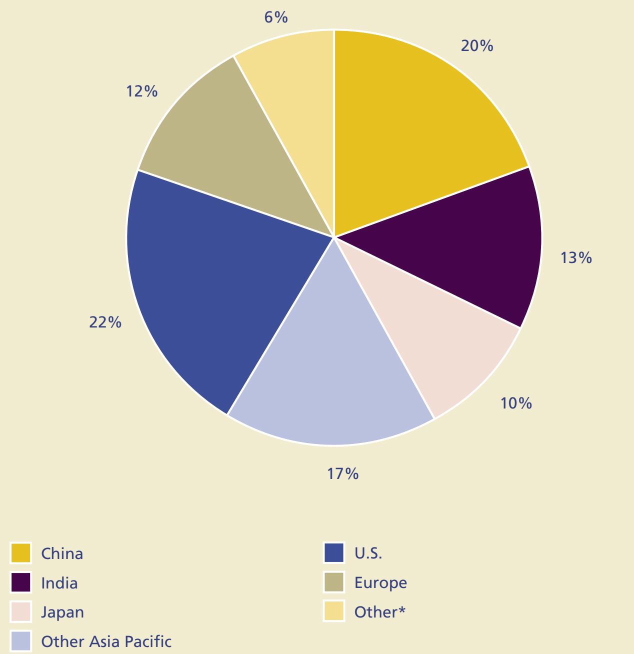
Two-thirds of European respondents identified an interest in expanding their global investment focus, of which 12 percent indicated the United States is their primary focus. Over half of the Asia Pacific respondents intend to expand globally, of which 22 percent indicated the United States is their primary focus.

Figure 8. All locations where investors would like to expand investment focus (Europe respondents)



*Includes Canada, Denmark, South America/Mexico, and Sweden

Figure 9. All locations where investors would like to expand investment focus (APAC respondents)



* Includes Canada, South America/Mexico, and Taiwan

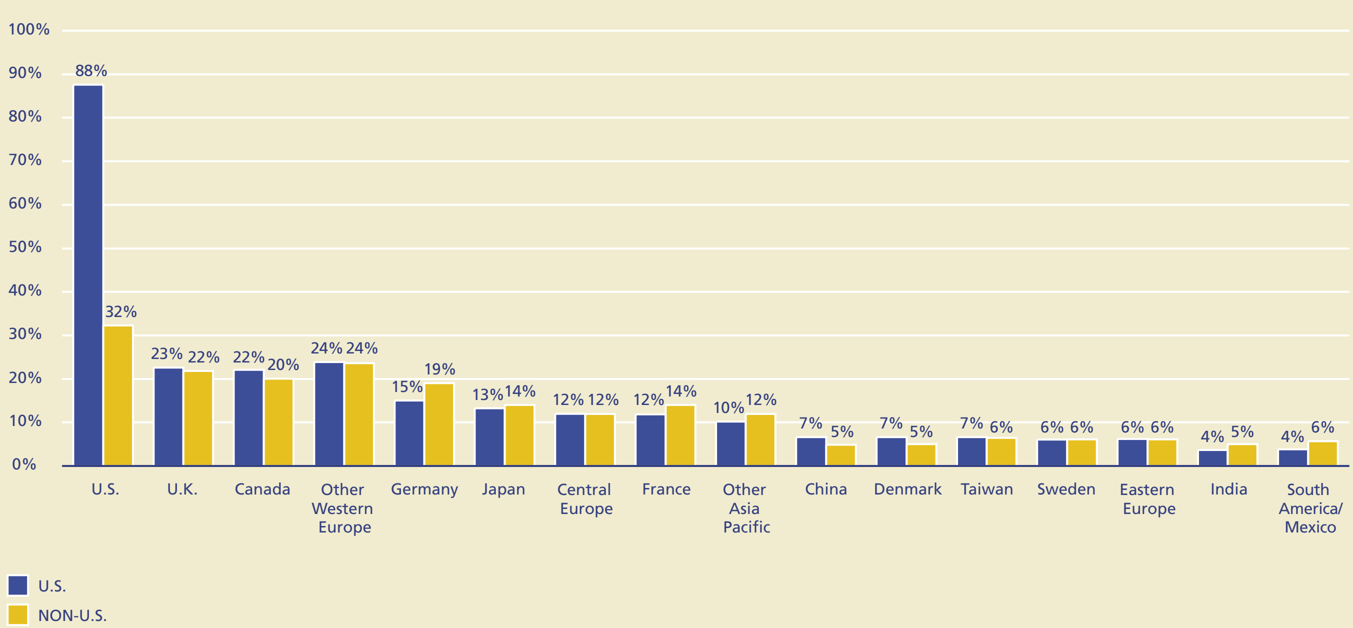
Adequate Deal Flow Is Not a Phenomenon in the United States Only

Readers should be careful not to infer that non-U.S. respondents were necessarily displeased with deal flow in their own markets. As survey data showed, some 42 percent of non-U.S. respondents did not have plans for international expansion within the next five years. Like their U.S. counterparts, they too identified adequate deal flow in their home market as the primary reason for their lack of movement. (see Figure 2b and 7).

Underlying this bullishness on the part of non-U.S. VCs is a broad-based rebound in primary and secondary capital markets around the globe. The resurgence of initial public offerings (IPOs) in places like Germany, London, and India is further evidence of this trend. The AIM market in London, in addition to attracting European companies to float their shares, is also actively recruiting U.S. companies to list on the exchange. As representatives in the German office of Deloitte Touche Tohmatsu (DTT) reported, local companies raised €3.5 billion on the Frankfurt exchange last year. This year is expected to be even better, attracting attention from exchanges and investors around Europe. The attention has fueled the DAX, the benchmark German index, to levels not seen since 1998. The Indian capital market has also been on an upswing over the last two years, fueled in part by substantial participation from foreign institutional investors. Reflecting the secondary market trends, there has been an appreciable increase in the primary market, too. The IPO market in India, which stood at 18 newly public companies in 2004, turned out more than 45 companies in 2005. In the first five months of 2005, 28 companies went public and another 78 are believed to be waiting in the wings. Data published earlier in the year by Venture Intelligence India showed that between January and March of 2006, local venture capitalists and private equity firms collectively invested some $1.4 billion in 69 companies.

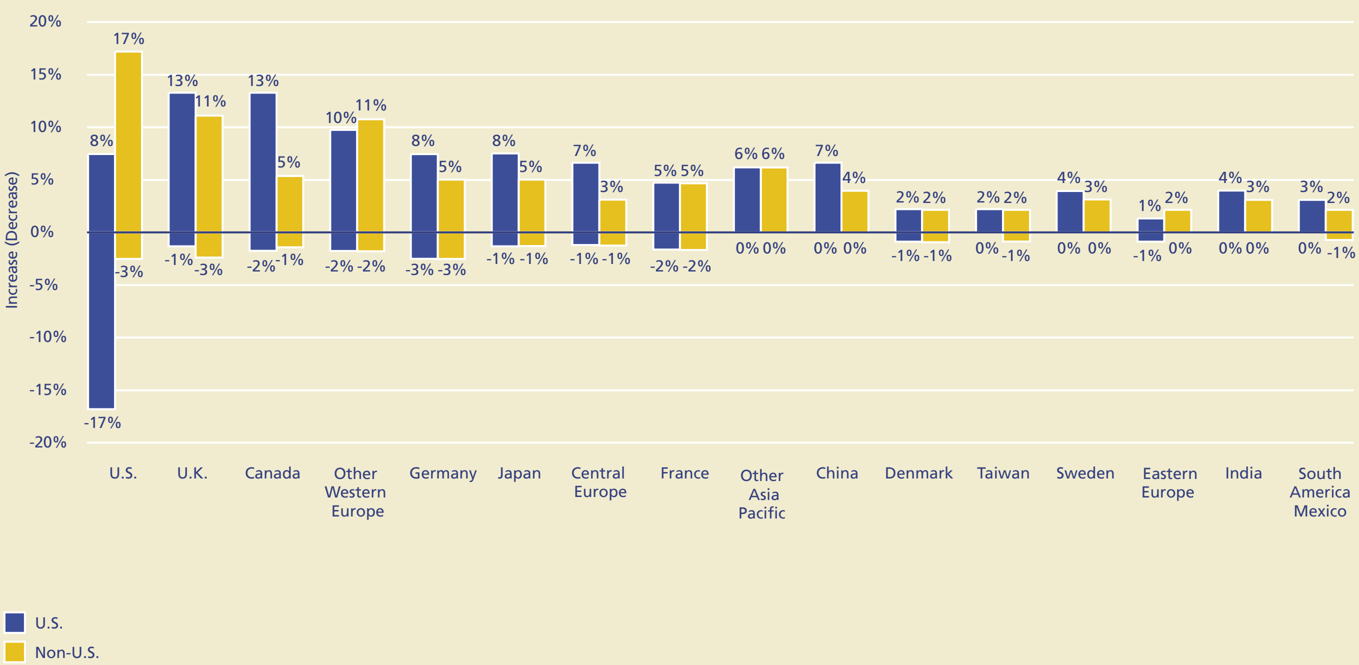
The survey results also indicate an increase in global focus on the part of limited partners (investors in venture capital funds). Currently, 57 percent of total survey respondents identified the United States as a source of investors; for U.S. respondents the number was around 88 percent. The next largest investor pool collectively identified by all respondents was Other Western Europe, followed by the United Kingdom and Canada. China and India, interestingly enough, accounted for seven and four percent, respectively, of the total investor pool.

Figure 10. Current location of venture capital firms' investors as a percentage of respondents (all respondents)



When asked if the location of the fund's investor base was expected to change in the next five years, 17 percent of the U.S. general partners surveyed believed they would experience a decline in U.S. investors (and an increase in investors from other locations) while all other territories surveyed indicated they expected to see an increase in interest from U.S. investors. This data clearly suggests that limited partners are looking beyond their current borders and will also be part of the global trend.

Figure 11. Anticipated location of venture capital firms' investors, in the next 5 years, by country, as a percentage of respondents (all respondents)



Outsourcing — Some U.S. Investors Taking Advantage of Resources in Foreign Markets — U.S. Has Not Lost Its Edge According to VCs Outside the U.S.

A new question in this year's survey related to the number of portfolio companies that, while domiciled in one country, have a majority of operations in a foreign location. Over half of the U.S. respondents indicated that at least 10 percent of their portfolios have a majority of operations overseas. While U.S. respondents identified China, India, Israel, Taiwan** and the United Kingdom as their top five locations for manufacturing, research and development and engineering operations, non-U.S. respondents responded in the reverse. Confounding the widely held belief that the United States is losing its edge for innovation, non-U.S. respondents identified the United States as the top location for all three categories, even outranking China as a top hub for manufacturing.

Figure 12. Top 5 locations where the majority of the Manufacturing, Research and Development, and Engineering operations are outside the investees' home country (U.S. respondents)

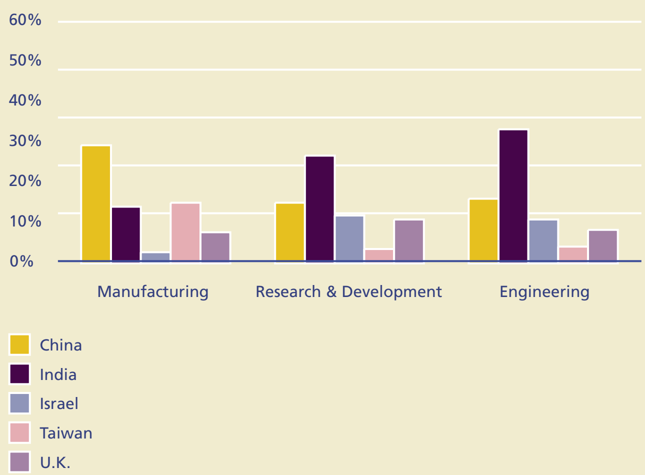
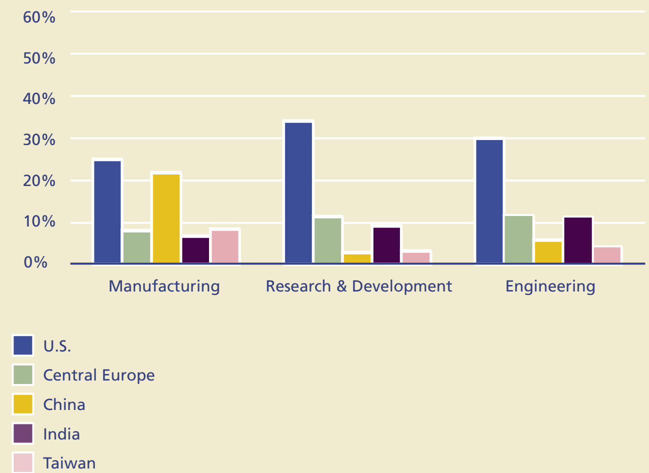


Figure 13. Top 5 locations where the majority of the Manufacturing, Research and Development, and Engineering operations are outside the investees' home country (non-U.S. respondents)



Following the Flow — Top Markets Where U.S. VCs Want to Be

After China and India, geographic focus among U.S. respondents fragmented into much smaller pieces of the pie. The United Kingdom and Canada (see Figure 3) were the only other two single geographic locations to capture significant interest from U.S. survey respondents.

The United Kingdom, long considered to be the second most mature venture capital market outside the United States, continues to experience a private equity boom not seen in years. According to recent data from the British Venture Capital Association, U.K. private equity activity increased to its highest ever levels in 2005 in terms of funds raised, private equity investments made and also divestments. Funds raised from investors reached £27.3 billion (compared to £3.3 billion in 2004). Overseas investors accounted for 79 percent of the total funds raised in 2005 compared to 66 percent in 2004, a BVCA report said[3].

Canada, like the United Kingdom, is also attracting increasing numbers of U.S. and other foreign investors. In Q1 2006, DTT representatives in Canada reported that foreign investment in Canadian companies totaled $122 million, representing 31 percent of all venture capital activity in Canada, compared to a 25 percent share in all of 2005.

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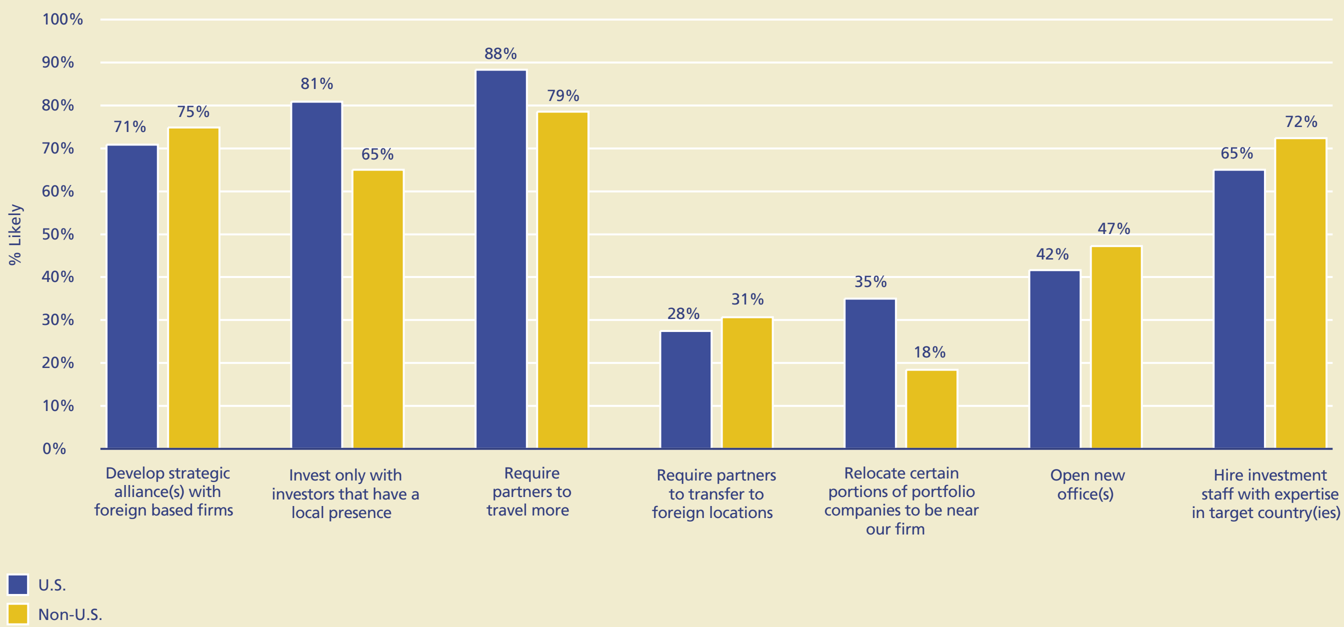
U.S. VC Strategies for Global Investment

Respondents made it clear that the key to successful international investing is to develop strategic alliances with foreign-based firms or to invest only with investors with a local presence in the market. Most notably, relocating partners or relocating portfolio companies was the least favored response to increasing their global presence. The survey responses indicate a strong preference to operating in foreign markets through locally based investors with experience operating in that market.

Figure 14. Expected business practices to be deployed to expand globally (all respondents)



Impediments to Global Investing

Venture firms are expanding outside their home location to take advantage of lower cost structures and new opportunities in emerging markets, and for diversification. Nevertheless, expanding internationally does present additional risks and challenges.

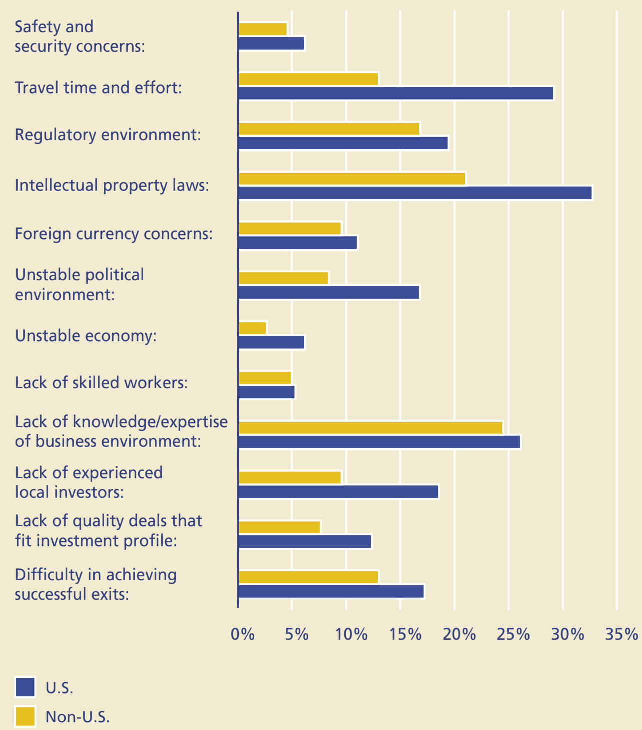
A lack of knowledge or of expertise in the local business environment was a universal concern among all respondents. It was an issue for U.S. firms contemplating expansion into all regions, particularly China and Canada. Beyond a lack of market savvy, U.S. respondents identified a number of other impediments that varied from market to market. Among the top locations targeted for U.S. VC expansion, impediments were as follows:

For China, U.S. respondents expressed the most concern about:

- The lack of strictly enforced intellectual property laws
- The relative distance from the United States
- Regulatory issues (the government's approval process regarding domestic companies that want to expand overseas)
- Lack of experienced local investors
- Difficulty in achieving exits

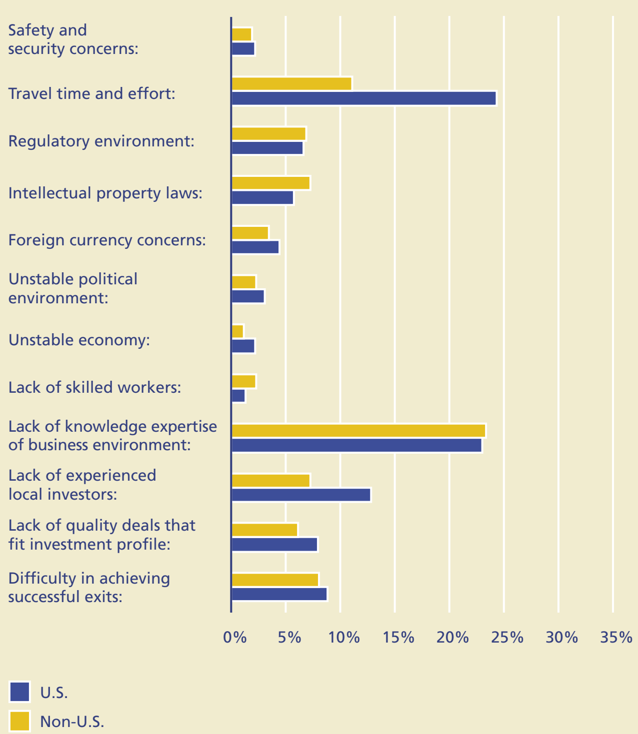
Though IPO exit strategies continue to be fraught with challenges in China, key government bodies including the Ministry of Commerce (MOC) and the State Administration of Foreign Exchange (SAFE) are working to streamline the approval process for domestic companies that want to go overseas, a fact that should appeal to U.S. VCs looking for Chinese portfolio companies. U.S. and non-U.S. respondents are concerned about a number of the same issues where China is concerned, but interestingly, there are significant differences in terms of their relative importance as well, which reflect a unique perspective of the local marketplace.

Figure 15. Impediments to investing in China (all respondents)



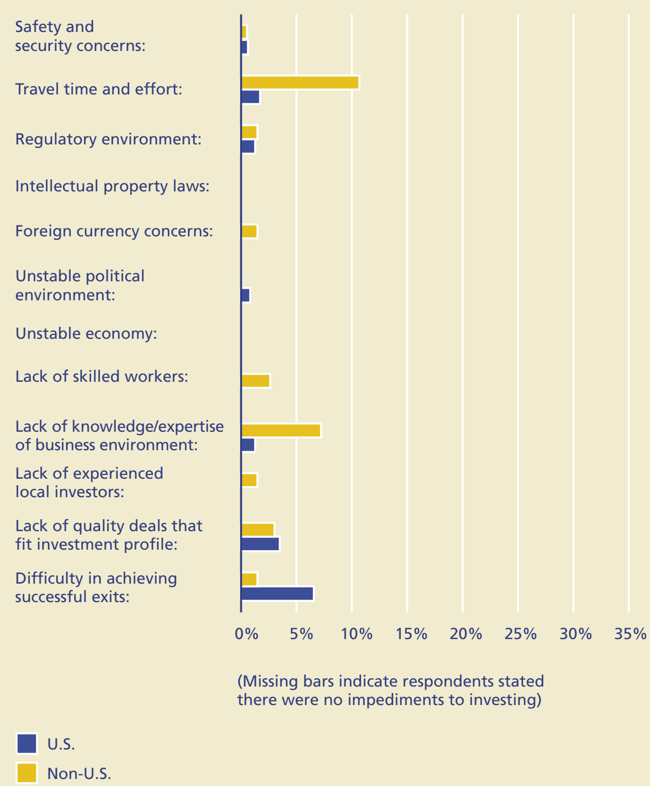
In the case of India, barriers to entry were fewer than those identified in China. The biggest concern expressed by U.S. respondents, other than travel time and lack of knowledge, is the market's perceived lack of experienced investors. This is likely to change over time. Representatives of the DTT member firm in Mumbai offered, the number of start-ups being launched in India is on the rise. Meanwhile, high liquidity in the equity markets is providing a good exit outlet. As a result, private equity is beginning to rush into India. Private equity and venture capital firms invested about $2.3 billion in Indian companies across 147 deals during 2005, according to a study by Venture Intelligence India[4]. During 2005, private equity and venture capital firms obtained exit routes for their investments in 42 Indian companies, while 17 private equity and VC-backed companies raised about $950 million via IPOs during 2005[5]. Approximately $2.5 billion is reported to have poured into India in the first quarter of 2006 alone, roughly the same amount of funding raised for all of 2005[6].

Figure 16. Impediments to investing in India (all respondents)



The U.S. continues to present very few impediments to investing. The following chart demonstrates how positively both U.S. and non-U.S. investors view investing in the United States.

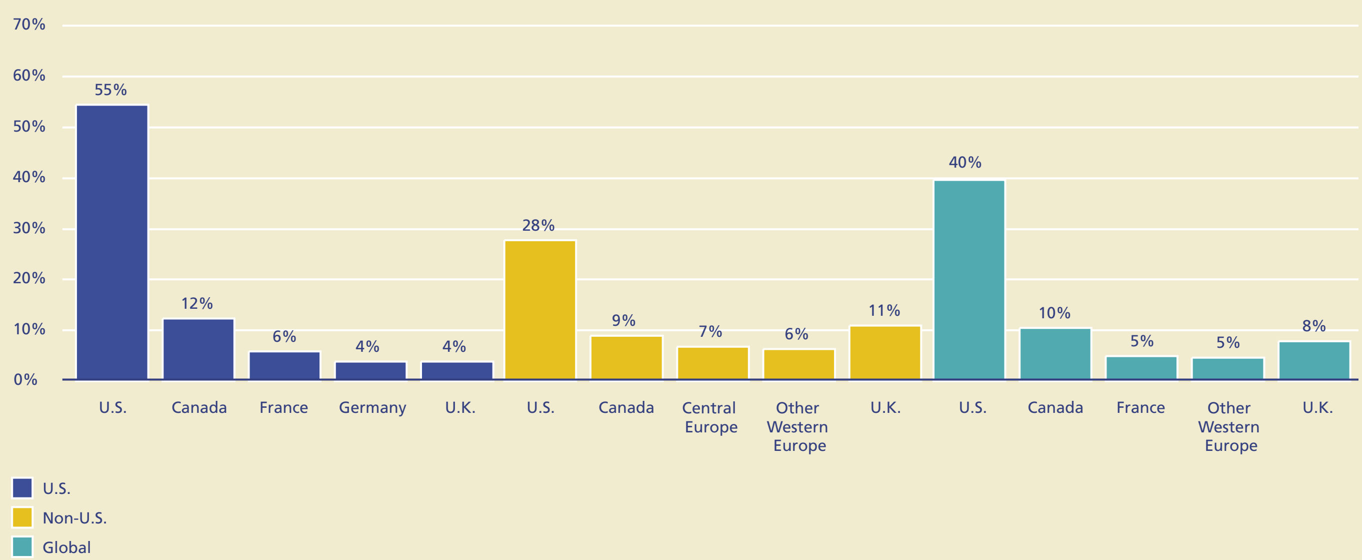
Figure 17. Impediments to investing in the U.S. (all respondents)



Respondents were asked to rank the most expensive five markets on the basis of a variety of cost-related benchmarks covering line items from employment and environmental regulation to corporate governance compliance, taxation and litigation. The U.S., in nearly every case except for taxation and intellectual property laws, dominated the top spot for U.S. and non-U.S. responses, alike.

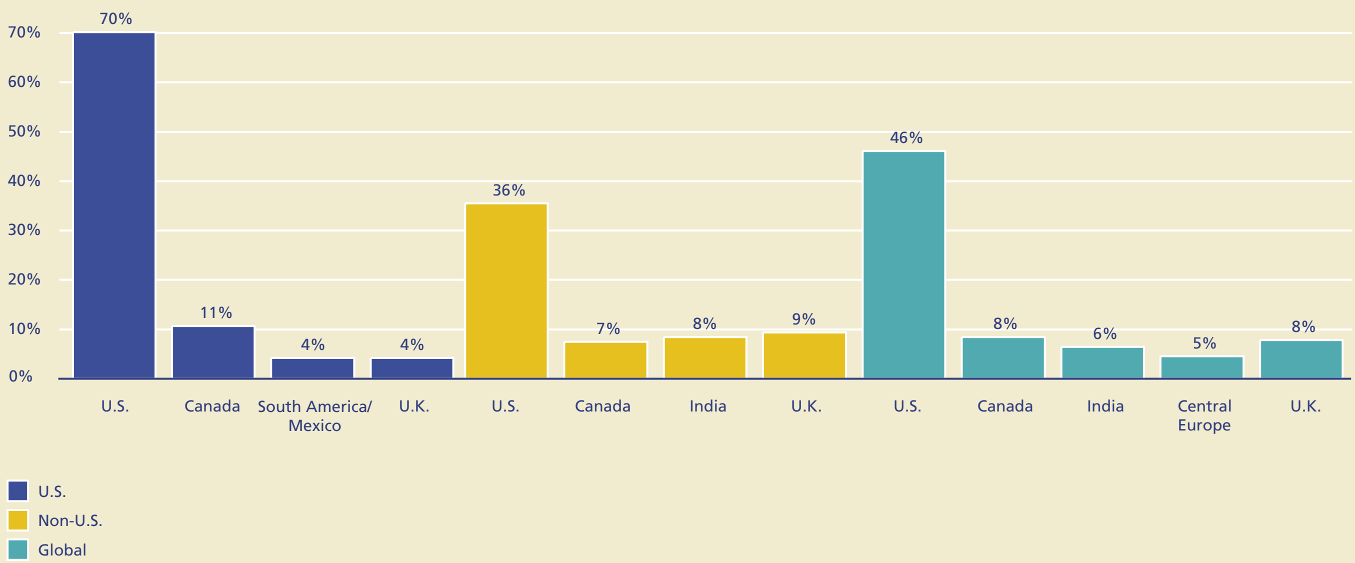
On the compliance front, 55 percent of U.S. respondents felt that the cost of complying with corporate governance was too high. Interestingly, non-U.S. residents seemed slightly less concerned with only 28 percent of respondents saying they thought that the cost of U.S. corporate governance was too high.

Figure 18. Top markets where the cost of complying with corporate governance regulation is too high (by respondents)



Even more of a concern than corporate governance compliance was litigation. Some 70 percent of U.S. respondents versus 36 percent of non-U.S. respondents saw the threat of legal action as an additional financial risk associated with doing business in the United States. Though it is difficult to pinpoint an exact figure regarding the number of cases involving U.S. venture capitalists, the fact that increasing numbers of firms now employ in-house counsel suggests the number is not insignificant.

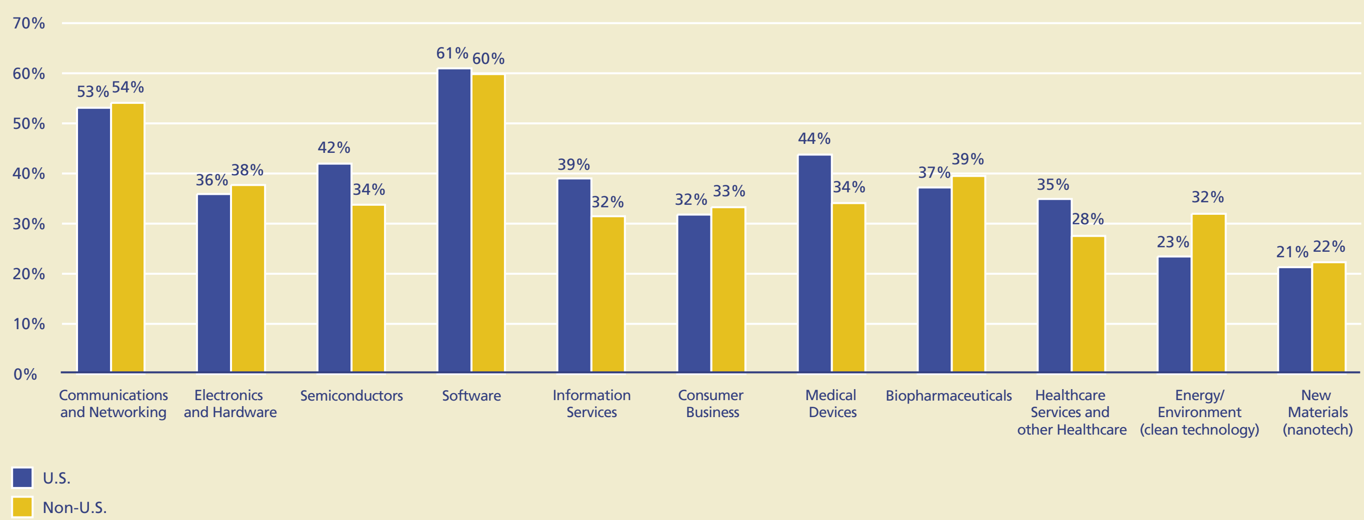
Figure 19. Top markets where the litigation environment creates additional financial risk (by respondents)



Avenues to Growth — Clean Technology, Medical Devices and New Materials on the Rise

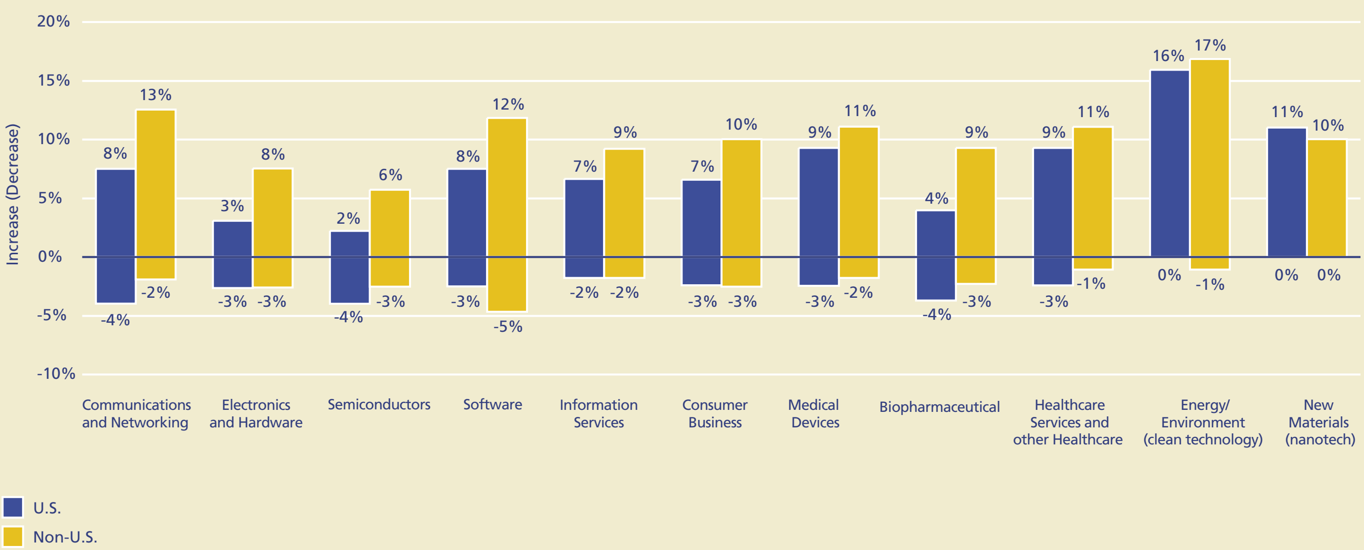
This year's survey did not show that increased globalization of the U.S. venture capital industry would result in a sea change of investment practices by industry sector. For the time being, it appears that the majority of U.S. respondents like their foreign counterparts, plan to stay the course, focusing mostly on software investments followed by communications and networking technologies.

Figure 20. Current industry investment (all respondents)



However, for a second year in a row, U.S. respondents selected energy/environment as the sector most likely to see the highest increase in investment focus. Some 16 percent of U.S. respondents said they planned to boost their investment focus in clean technology businesses. This compares with 17 percent of non-U.S. respondents.

Figure 21. Increase (Decrease) in industry investment, in the next 5 years (all respondents)

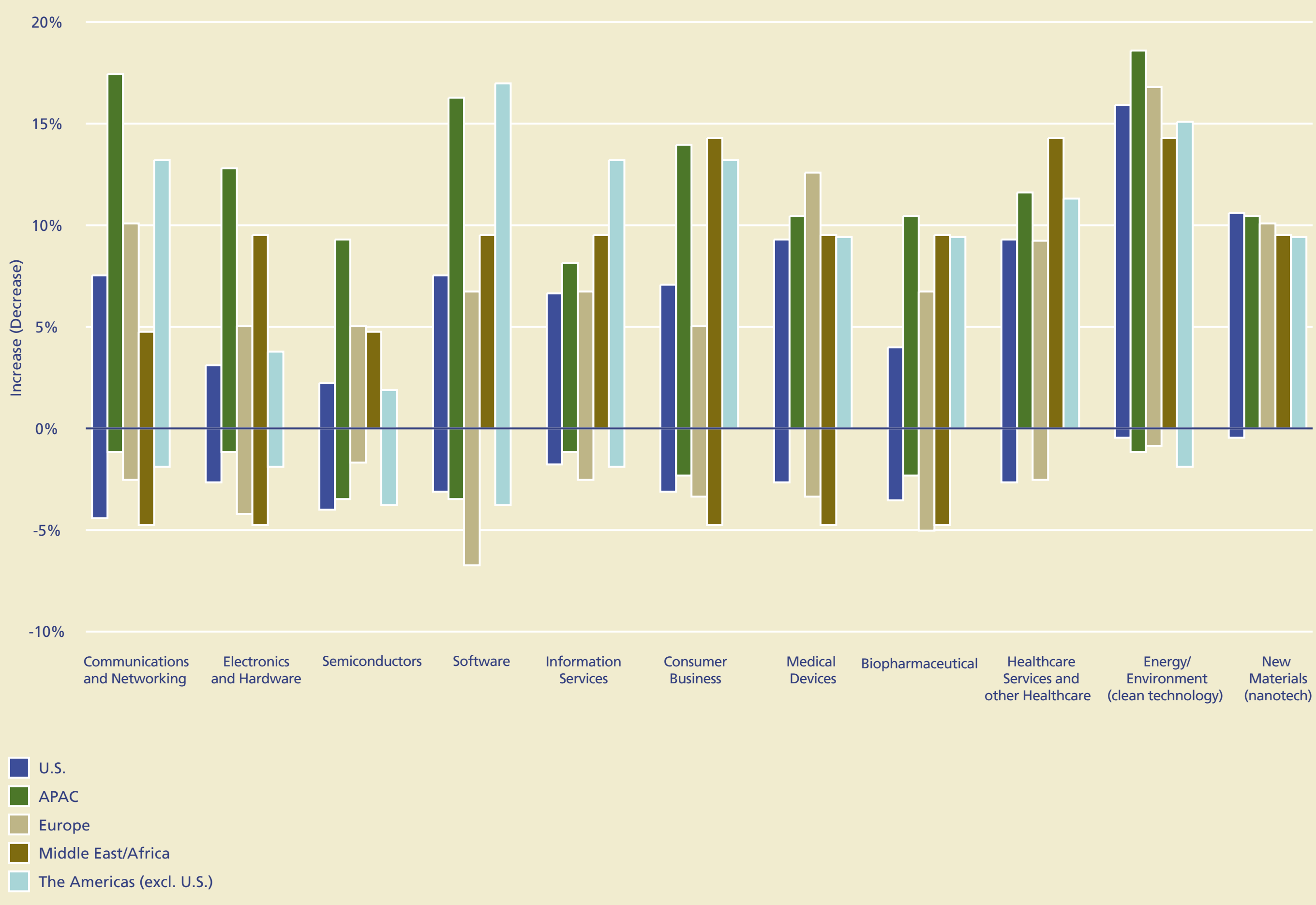


The Cleantech Venture Monitor, a U.S.-based source for quarterly clean technology deal information, has tracked more than $8.8 billion in clean technology deals since 1999. Its latest analysis, released in June of 2006, showed that investment in the sector may soon surpass the record $797 million made during Q1 2000. During the first quarter of 2006, clean technology investment accounted for 8.5 percent of all North American venture capital investment, according to the firm[7]. In terms of investment focus, it was the fifth largest investment category in North American venture capital, ahead of semiconductors and behind only biotechnology, software, medical and telecommunications.

What remains to be seen is the degree to which U.S. VCs may find they have to play catch–up with their counterparts in Europe and even Asia where stricter environmental regulations, including those focused around the Kyoto Protocol, have served to focus private equity more quickly on the clean technology sector.

After clean technology, the sectors expected to see the largest increase in U.S. VC investment focus include new materials (nanotechnology) followed by healthcare services and other healthcare and medical devices. (see Figure 20)

Figure 22. Increase (Decrease) in industry investment, in the next 5 years by region (all respondents)



(missing bars indicate no decrease)

Conclusion

In total, the survey presents a very positive story for U.S. venture capital. The data reflects a maturing industry that is expanding to seek opportunities around the globe and also suggests that the intersection of mature and emerging venture capital markets is imminent but not impulsive. The survey did not track actual investment activity on a global basis; therefore it is not clear how much actual cross-border activity is occurring currently. Many industry observers believe that global investment activity is expanding slowly and VCs are moving cautiously as they explore the right business model for a more global approach to finding opportunities and generating better returns for their investors. The data collected on impediments to investing on a broader international basis would seem to indicate that this is the case.

The survey also shows that in the eyes of both U.S. and non-U.S. VCs, the United States remains the most enticing source of quality entrepreneurs. However, the data shows that the entrepreneurial spirit is growing everywhere in the world, and there will continue to be opportunities for venture capitalists to invest in start-ups across the globe. While there is no immediate danger of the U.S. venture capital industry losing its significant lead, it is clearly under pressure to adapt to an increasingly global market. To this end, firms will have no choice but to further develop global networks vis-à-vis strategic alliances and investor outreach. These facts present unique challenges and opportunities for both VCs and the entrepreneurs in whom they invest.

Exactly how globalization of the U.S. venture capital industry will play out in the years ahead will continue to be the subject of much speculation. Given the profile of the U.S. industry, mostly small to medium-sized firms that have tended to prefer companies within driving distance, the shift toward long-distance alliances seems evolutionary in nature. Still, the fact that more than half of this year's U.S. survey respondents say they are planning to expand their business internationally suggests the community may be on its way to giving up its long-standing predilection toward the parochial.

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For More Information

Deloitte & Touche USA LLP

Phillip Asmundson
Vice Chairman and
National Managing Partner
Technology, Media & Telecommunications
USA, Deloitte & Touche USA LLP
203 708 4860
pasmundson@deloitte.com

Mark E. Jensen
Partner and National Director
Venture Capital Services
USA, Deloitte & Touche USA LLP
408 704 4790
mejensen@deloitte.com