May 2002

Dear Friends of Valhalla Partners,

Our Quest

We are a team of venture investors who have participated in the business for many years. Lately, we have stepped back from the business to reflect on how it has changed – and how it must be changed. Our objective is to craft a new strategy and new operating practices for a venture firm that will be more effective in this, and any future, environment. We have taken a hard look at the issues facing the business, we have analyzed the latest data and we have spoken with experts.

The purpose of this letter is to share our findings with other interested industry participants and to participate in a dialog that we hope will improve our insights, our business practices and our returns. It is no secret that our industry is in the midst of a transformation that confronts each of us with an unprecedented set of challenges. Any effort to overcome those challenges must be based on a thorough understanding of what has occurred and why.

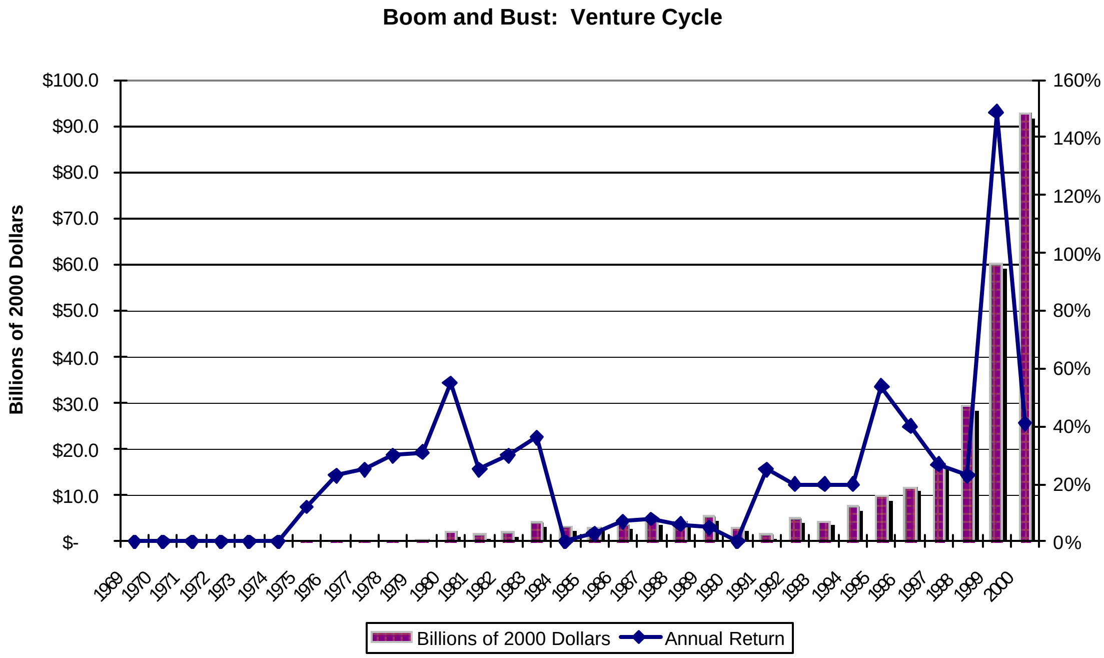
Our Central Conclusion: The sheer size of the most recent boom-and-bust venture cycle has forced structural changes in how we conduct our business, creating a serious imbalance between capacity and capital. The recent flood of capital into our industry has produced a disparity between the amount of capital deployed and the ability of partnerships to effectively manage it.

Venture capital results have historically been based on a series of time-intensive, inter-related capabilities directed toward selecting and building new companies. The specific approach used for each investment and for each partnership will vary significantly. Yet the key activities and the core principles remain constant. Unfortunately, our industry's ability to deliver on these capabilities has been severely eroded because the time available to devote to each opportunity has been sharply reduced. The reason -- *The amount of capital deployed by each experienced partner has increased ten fold during the last twenty years*. Our belief is that the industry can and should find its way back – and reap the rewards for doing so.

The Boom and Bust Cycle

The cyclical nature of the venture business is so pronounced that Limited Partners measure relative performance by matching funds based on vintage year or the year a fund began investing. The cycle has been fairly called "the boom and bust cycle." When returns increase, the industry attracts more capital. More capital typically elicits lower returns. We are now about eighteen months past the high point of the most dramatic boom cycle the industry has ever experienced and the implications are significant.

One of the best illustrations of the cycle appears in the book, The Money of Invention, by Paul Gompers and Josh Lerner of the Harvard Business School. Their chart, which overlays both returns achieved and capital raised per year, is illustrative.



<u>The Seeds of Crisis</u>

One of the first to call attention to the recent changes in our industry was Professor William Sahlman of the Harvard Business School. In his article "Observations on the Venture Capital Industry," Sahlman notes the rapid growth in entrepreneurs and entrepreneurial experiments. He draws attention to the sheer size of the changes: for the six years ending in 2000, $216 billion was invested in technology compared to $14 billion in the prior six year period -- an increase of 1400%. Professor Sahlman also observes "… the seeds of self-destruction were being sewn during this period. Valuations in the capital market were undiscriminating, unsustainable and dangerous, even for good companies."

<u>The Loss of Core Values</u>

Sahlman is among a number of industry observers who believe that the venture industry inadvertently lost its way during this period. "The biggest change," he writes, "was the abandonment of some of the fundamental rules of venture capital with respect to structuring sensible experiments. First, the quality of due diligence and pricing discipline deteriorated as competition among venture firms to get into the 'best' deals increased . . . the community backed dozens of competitors in the same industry . . . venture capitalists were so busy that their ability to add value during the process of company building was weakened . . . [venture capitalists] did not anticipate having to support companies in the event capital markets turned sour" and finally, "the challenge going forward is daunting."

The "Perfect Economic Storm"

The boom that has enabled our industry to raise record levels of funds has also caused us to drift from our core principles. The years of "boom" results have led to an almost imperceptible yet steady erosion of our abilities to execute these principles. Dick Testa's letter to clients and friends is perceptive on this point. First, he notes how "… the venture capital industry is in the midst of an unprecedented crisis" and that … "Over the past eighteen months, we have seen the collapse of the Internet bubble, followed by a broad and deep public market reversal associated in part with excessive investment in the telecommunications sector, and we now face a likely recession of unknown depth and duration." He concludes, "… the ground under our feet has shifted significantly during the past two years."

Yet Dick is optimistic. Why? Because success, he believes, will be achieved by venture firms that once again "battle-harden their organizations for the long haul, and when experienced partners maximize the time devoted to value-added, company-building."

The Capital to Capacity Imbalance

We believe that the root cause for what ails our industry is the imbalance that has arisen between the industry's capacity and the capital entrusted to it. It is not just the size of funds, it is the amount of capital each experienced partner must deploy and manage that lies at the heart of nearly all of our industry's problems. The ten-fold increase in capital per partner is responsible not for just a transient economic phenomena but for re-shaping industry practices and organizations. This time, the boom-and-bust cycle has transformed the very structure of the industry.

Empirical Data

To test our hypothesis, we relied heavily on data available through Venture Economics, but we invite others, who may have access to more detail or other data sources, to do their own analysis.

- Mid-sized funds: We found that mid-sized funds out-performed the larger and smaller funds by 50 to 200%. Funds larger than $1 billion performed the worst. In fact, very large funds have produced either negative returns or very modest gains to date. We would have preferred to compare returns by capital per partner, but size of fund should be a good surrogate. Most venture funds have not changed the number of general partners as dramatically as they have changed the capital under management.

- Fundraising: Annual fund raising in the last three years represents 60% of the money raised over the last 30 years. It is sobering to reflect that during this boom, the industry raised 50% more than it raised in the prior 27 years. Prolific annual fund-raising has increased capital under management from $3 billion only twenty years ago to $240 billion today -- an 80-fold increase.

- Venture professionals: The number of venture professionals (not the number of experienced partners), over the same twenty year period, has increased from 890 to 8300 or a 9-fold increase.

- Capital per partner: The capital per partner has increased just under ten times, and that number includes professionals who are new, young and unproven. The growth in venture partners has not kept pace with the growth in capital and there is some data (as evidenced by the performance of the funds larger than $1 billion) to show that returns have and will suffer as a consequence.

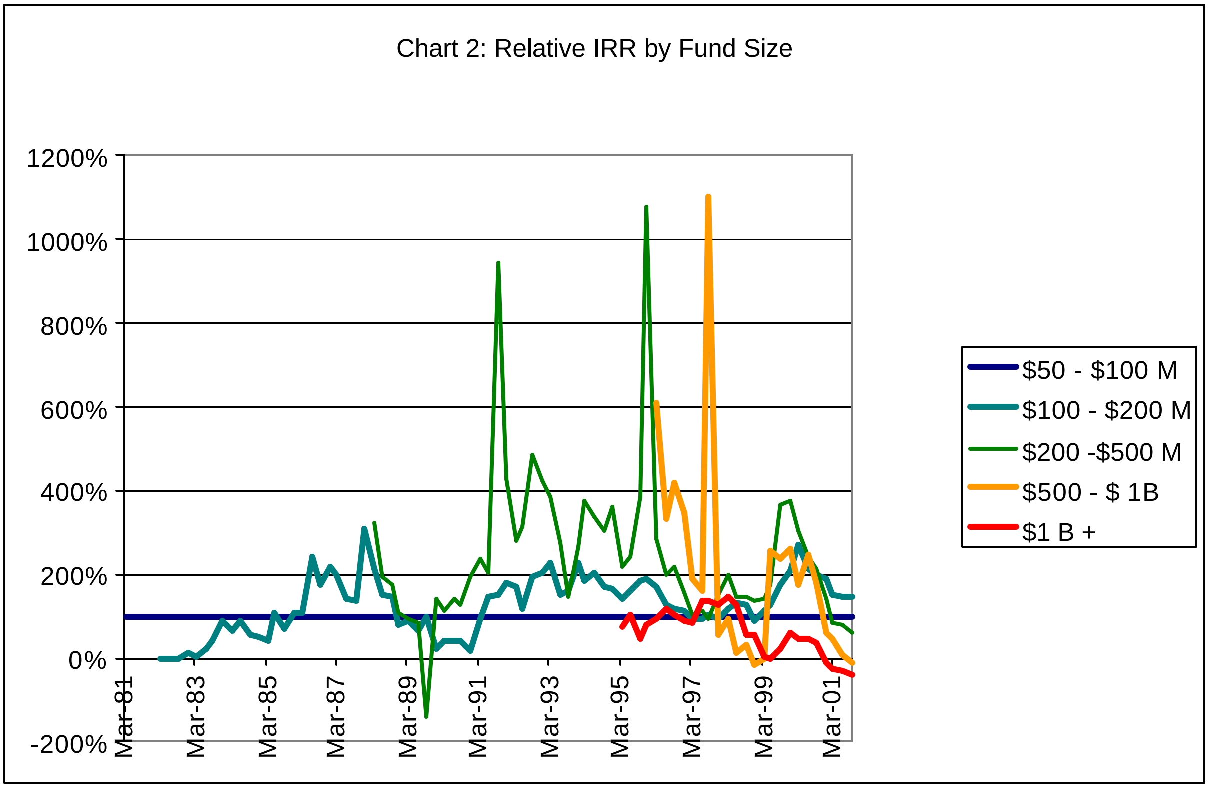


Chart Two (above) shows the performance of all funds as a ratio to the benchmark performance of the $50 to $100 million funds (shown as the dark blue line equal to 100%).

Our conclusion is that better performing partnerships are able to raise more capital and thereby attain a level of critical mass (they attract key personnel and better investment opportunities). The middle size funds reflect a combination of talent, critical mass and appropriate capacity. The largest funds may reflect willingness to aggregate capital, but without the ongoing discipline necessary to maintain an appropriate ratio of intellectual capacity to capital. Clearly, some large funds have developed strategies or will develop strategies to effectively deploy larger amounts of capital. But, for now, this data raises important questions that require continuing scrutiny.

While other classes of funds produced some extraordinary returns during this period, the largest funds did not. We think the reason the industry has arrived at this point is the prevalent, but understandable, philosophy among limited partners to invest more and more money with those teams that have produced results. The data we have seen to date identifies the risk of giving too much money even to proven teams and may be the basis for some of the limited partner dissatisfaction that we speak to in the following section.

Strategies for Deploying Large Pools of Capital

Venture firms have three basic strategies available to deploy large pools of capital.

- Increase the number of investments per partner
- Increase the amount invested in each company
- Change the nature of their business

Most venture firms have responded with a combination of all of these strategies. There are limits and risks to each of these strategies. By increasing the number of investments, the venture partner can deploy more assets, but has less time for each company – less time to be informed, less time to give advice, less time to recruit. Managing too many portfolio companies also leaves less time for the effective evaluation of new opportunities.

Increasing the average investment in each company can be the result of overpaying, but most often is a purposeful attempt to increase ownership percentage and reduce the level of syndication. The limits to this strategy are: (1) Firms can only increase percentage ownership by two or three times. (2) This strategy limits the number of other venture partners involved with the investment. The partnership must undertake an even greater level of support to replace that lost by the lack of syndication. (3) This direction drives a firm towards a higher level of crossover investments (cross fund investments) and the attendant conflicts. (4) Most importantly, the need to invest relatively large amounts in each new project may move investment "targets" into sectors which are more capital intensive, less capital efficient, and less likely to produce top quartile returns.

Changing the nature of the business is risky, but this strategy will likely produce both the best and the worst outcomes. Some firms have shifted to more capital-intensive portfolio sectors. Some have elected complex affiliations and alliances making their businesses more complex. Some firms here morphed into broader private equity investors using a combination of venture skills and financial engineering.

What Limited Partners Tell Us

Limited partners indicate to us that while some individual pension funds and endowments are over allocated to venture capital, most are not. In fact, there are a number of institutions that have just initiated venture investment programs at a time when few venture funds are out raising capital. Limited partners also indicate that while the level of available capital is down, it is still significant. A few pointed out that returns on debt and public equities will be low and the alternative investment class still looks relatively attractive. In fact, Commonfund Institute reported that its members plan to increase alternative investments from 23% in 2001 to 26% in 2002.

Many limited partners are realistic and sanguine about the economic cycle suggesting no systemic dissatisfaction with venture investing. However, there are select areas of near-universal concern. Those concerns stem from a view that during the last few years, our industry raised too much money, on terms that were far too favorable to the general partner. In addition, there is concern that large funds raised during the boom period are unlikely to deliver great returns. A number of limited partners are advocating adjustments in fees or in capital commitments, but the basis for pursuing these aims is moral suasion rather than contractual remedies. While adjustments in fees, fund size and other terms will certainly be worked out when venture funds return to the market to raise new funds, there are clear indications that some adjustments are being actively considered today.

Since we expect and advocate care in new investment rates, we would not be surprised to see some adjustments in fees and fund size, although the politics and socialization of any changes will depend on individual partnerships and the nature of their situation. We sense that the slow down in investment pace gives rise to a new question for LP's -- The loss of the option to reinvest at the end of the "normal" three year period. In any case, this is a particularly important time for open and direct communication with limited partners. It is critical they be encouraged to air their issues and for venture partnerships to address those that can be addressed. We cannot tell how the individual firms and their limited partners will address these issues, but it may be a matter of contention for several years to come.

We think the focus of any discussion should not be just on fund size, but on fund strategy. If a firm is able to stay "on-strategy" with larger amounts of capital, fund size should not be an issue. If the firm's strategy is distorted by the capital under-management, a re-examination of fund size will be in everyone's interest.

Why Some Large Funds Will Resist Changes

Some large funds may find it difficult to release investors from these commitments. They will be concerned about appearances, complexity, financial incentives, and the need to support fund management infrastructure.

We spoke to one well-regarded group that raised a fund of about one billion dollars in late 1999. They have laudably invested at a much slower pace than they anticipated and have taken down only $350 million to date. However, they have used $60 million in fees, written off and written down $96 million in investments. If they were to cut the fund size to $500 million, as some of their investors have proposed, they will be 31% in the hole. It is a very steep hole from which to climb and the general partners are understandably reluctant to change.

Coping with Portfolios Built During the Boom Years

The number one issue facing existing venture partnerships is the uncertain future of existing portfolio companies built during the boom period and the expanded need to support these over-hanging portfolio investments in the years to come. It is critical that these portfolios not be abandoned, because most firm track records were built on returns achieved while managing much smaller funds. Venture partnerships still need to prove that their strategies, models and personnel can deliver returns while deploying significantly larger amounts of capital. Since the current investing environment is much more attractive than in recent years, there is a temptation to return to a rapid new investment path. However, abandoning the current portfolio too rapidly and without sufficient effort will create high failure rates and dramatically lower returns.

Certainly, everyone has already experienced various degrees of write-offs and write-downs, but there are more adjustments to come. More importantly, support for the existing portfolio will be exceedingly time-consuming during the next few years. Portfolio companies need a greater level of support because lead times to liquidity events are longer, capital is scarce, and frankly, the bad habits that our industry has helped to create must be changed.

We expect that almost all venture funds have addressed the need for portfolio companies to resize their expenses and, if possible, find a strategy for survival based on their current cash or, preferably, cash coming from customers and other stakeholders. This probably includes reducing salaries and perks as well as headcount. While many corrections to portfolio companies have already taken place, vigilance is required to retrain management at some companies.

We recommend setting portfolio values as close to the current reality as possible. This action implies not waiting for a new transaction to set values. General partner write-downs and judgment must replace historical valuation methodologies. There is a temptation to hold with the last transaction and to maintain that price through several bridge loans, but failure to make adjustments now will lead to confusion about fund progress in the future.

Our next recommendation will take quite a bit of work, but we think it will be extremely worthwhile. We would call it a projection of ultimate value for the portfolio. Each fund needs to project how much additional capital each portfolio company needs and what kind of value each company may have at liquidation. This exercise leads to better decisions about the allocation of scarce capital and people resources and moves the partnership away from sequential decisions and towards a portfolio management strategy. In effect – an operating plan for the fund. The exercise should yield a strategy to optimize returns, manage scarce cash and people resources and provide some insight into the potential returns that the fund will produce. We would be happy to provide an example approach to any one who is interested.

<u>Guidelines for New Venture Investments</u>

We would make three recommendations with regard to new investments.

First, invest at a prudent rate and utilize your capacity carefully. The full extent of demands from existing portfolios is not fully known and the demands of new investments are greater than what the industry has assumed in the last few years. In addition, investing at a more measured pace extends the investment period and helps provide cyclic diversity.

Second, we would suggest that new deals be divided between industry sectors with which you are familiar and investments in new, emerging sectors. Because of the collapse of the on-line and telecom sectors (the two sectors composed 60% of investments in 2000), we anticipate a rotation by venture partnerships into the software and medical sectors. Business models in those sectors are well understood and many partnerships have expertise in the sectors. However, we fear these sectors will quickly become overvalued. For this reason, we believe searching for new sectors should be a priority for venture partners interested in above average returns.

Third, we would be very price sensitive to new deals. In the last few years the combination of competitive pressures and inflating markets drove prices up and reduced the importance of price in the investment equation. Stating the obvious, pricing will be critical to investment performance. Basing technology company valuations on an expectation of anything more than three or four times future sales is counting on the return of market euphoria.

Self-Evaluation and Addressing the Challenges

Every venture firm needs to take a particularly careful look at itself and consider both how it has changed during this most recent boom and how it must change today. This is an opportunity to become stronger, but the process of change will be tough. Venture results are produced over very long cycles and it is difficult to know how an individual fund will do. There is no agreed upon industry scorecard, but there are both objective and subjective measures that can be helpful.

Some objective measures should be collected as a prelude to a self-evaluation. In particular, a firm should measure trend lines (at least by year) of the critical factors relative to the capacity of the firm and the capital it manages. Capacity should be measured in full-time experienced partners.

A number of firms have attempted to free up general partner time by experimenting with new resources such as part-time venture partners, executives in residence and analysts. While we applaud the use of these resources, we think firms should not be seduced into thinking they represent equivalent capacity.

Venture firms also need to look at capacity relative to their objectives. In which sectors has the firm invested over the last ten years? Where is the firm planning to invest in the next five years? How do the capabilities of the firm (the talent and expertise) line up with the expected level of effort? We also think venture partnerships need to assess how they spend their time. How much partnership time is devoted to each activity? How has the amount of time devoted to each portfolio company changed over time? What kind of claim on capacity does a new investment create? In fact, what company building activities does the partnership undertake?

Forward Looking, New Strategies, Opportunities

Venture firms need to be particularly articulate about their strategy during these times. Often the strategy of firms in our industry was the sum of what individual partners chose to do. We now face a situation where shared strategies are needed.

What is the plan for delivering the best results from the existing portfolios? Besides a triage of the best and worst, what can and should a firm do to secure the best outcome for its investors? How long will it take to deliver these results?

What kind of capacity remains for new investments? What strategy does the firm have to deploy new money effectively? Does the firm have target sectors and unique expertise? Are they looking for new sectors or geographical niches? What has been the trend on pre-money valuations? How well has your fund performed at different levels of capital per partner?

Every firm is different and there are many successful strategies and approaches, but in this environment, every firm needs to challenge its methods and assumptions. This is a much better time to invest than during the boom years. Management teams, service organizations, real estate and capital equipment are all more available and less costly. Valuations are lower, but liquidity timing is uncertain and public valuations are lower, as well.

Our industry has reached a singular turning point in its history. Some firms will address the challenges and build competitive advantage. Some will not. We welcome continued dialog, new information and criticism. We are on a search for the right answers.

The Team at Valhalla Partners, L.P.