Turning the corner

Global venture capital insights and trends 2013

Ernst & Young
Quality In Everything We Do

Welcome

2012 was a challenging year for venture capital (VC) investment. Both the amounts raised and the number of rounds declined to their lowest point since 2009. At every level, the market came under pressure from the ongoing tough exit environment. This was reflected in a drop in the number of VC-backed initial public offerings (IPOs) and mergers and acquisitions (M&A) exits, and VC funds again reduced activity in early-stage investment.

However, it was not all bad news. Angel investors and crowdfunding platforms continued to step up their involvement to fill the gap at the start-up stages left by VCs, which moved toward later-stage, high-growth ventures. In 2012, corporates cemented their important role in the VC market. Where they chose to make an investment, typically in the later-stage in the US, the valuation of the business in that round was usually greater than in companies at a similar stage with no corporate investor.

Although there were fewer VC-backed IPOs, in countries other than the US the time taken to exit via IPO was down; those companies that did make it public were characterized by their quality. IPOs remain the most lucrative exit vehicle for VC-backed companies, although the ability to fully exit via a public listing is becoming increasingly remote. More VCs are continuing to hold their investments post-IPO and retain a vested interest as shareholders in a company's performance as a public entity.

In the current market, institutional investors are responding favorably to well positioned deals. This is evidenced in Ernst & Young's *Right team, right story, right price* study, which found that 82% of institutional investors had invested in pre-IPO or IPO stocks in the past 12 months. Those that have done so, strongly favor companies that come to market well prepared, are priced right, run by the right team and have a compelling equity story to tell.

It is worth remembering that over 50% of today's Fortune 500 companies were created in a time of economic downturn so it is unsurprising that competition for high-quality deals remains fierce, with VCs competing against each other and alternative sources of capital. The challenge for VCs is to prove their worth as an accretive and value-added investor offering good terms and post-investment support. As funds continue to build this capability, the cost of investment rises, which will hopefully be offset by attractive returns. Establishing a robust VC value proposition for investee companies is a must-do strategy.

Looking forward, we expect 2013 to be a better year for VC. Steadying economic conditions will bolster investor confidence and point towards increased risk appetite. Early signs for 2013 suggest better exit prospects, a pre-condition for increased fund-raising.

In this, our 10th annual report on VC, we explore the key trends impacting the global VC industry and analyze the key VC hotbeds of the US, China, Europe, India and Israel. Our title, *Turning the corner*, sums up our view of this market as we move into 2013.

We hope you find this report to be a source of valuable insight and look forward to working together with you on the global challenges and opportunities that lie ahead.

Maria Pinelli

Global Vice Chair, Strategic Growth Markets
Ernst & Young

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Executive summary

VC funds are investing fewer dollars, at a later stage and on tougher terms

Improving trend in activity reverses in 2012

Widespread global economic uncertainty weighed heavily on VC investment in 2012, which fell to its lowest level since 2009. Global VC investments declined by 20% year-on-year to US$41.5b, while the number of VC investment rounds declined 8% to 4,970. Average round size decreased to US$8.4m in 2012 from US$9.6m in 2011.

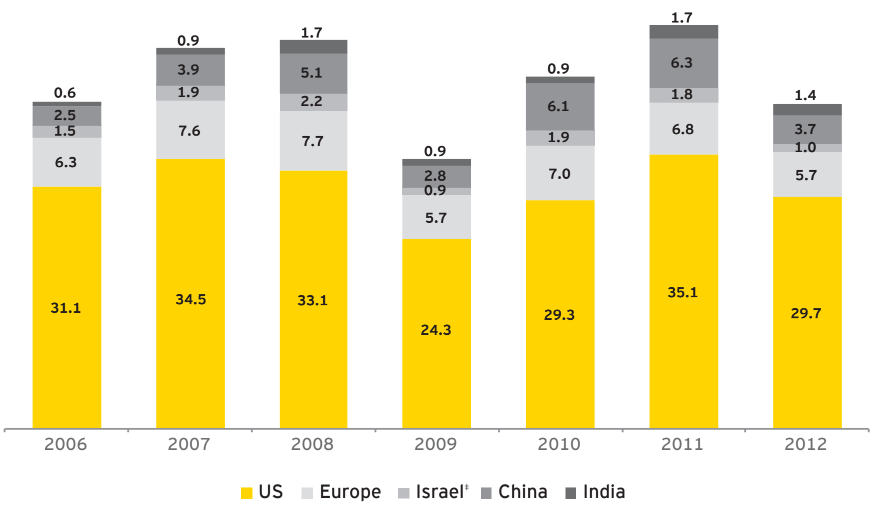
VC investments were down in all markets, and the amount of financing in the seed and first-round stages dropped across all regions. However, even in the volatile equities markets of the past five years, the average one-day, post-IPO return of VC-backed entities in the US was 19%[1], and a recent Ernst & Young report published in February 2013, *Right team, right story, right price*, confirmed that 41% of institutional investors believe rapid-growth markets offer the highest valuations.

The US and Europe accounted for almost 85% of global VC investment, although overall market sentiment was inevitably affected by the continuing slow pace of global economic growth. The slowdown in China's GDP growth rate led to a decline in VC investment of more than 40% in both the number of deals and total value. However, recent improvements in forward-looking indicators of Chinese economic activity point to a more optimistic outlook for 2013.

Mirroring the trends in investment, the number of total VC funds closed, as well as the dollar amounts closed, had been recovering in 2010 and 2011. In 2012, the trend reversed sharply, with the number of fund closings declining by 13% year-on-year to 280 in 2012 from 323 in 2011 and the amount closed falling from US$42.2b to US$29b, a year-on-year decline of 31%. Limited partnership (LP) investors are showing a preference for the most successful "brand name" funds, seeking out depth of experience and track record.

Global annual VC investment 2006–12*

	2006	2007	2008	2009	2010	2011	2012
Totals**: (Rounds)	4,870	5,584	5,245	4,588	5,112	5,403	4,970
Totals: (US$b)	42.0	48.8	49.8	34.6	45.2	51.7	41.5



* Global numbers include US, Europe, Israel, China, India
** Total number of rounds includes restart
‡ All-site Israeli companies

Source: Dow Jones VentureSource, 2013

[1] Dealogic, 2012

The decline in VC funds closed was most pronounced in the Asia-Pacific region, where there had also been a trend towards a greater number of funds closed for early-stage investment rather than multi-stage funds. It is interesting to note the continued decline in the number of active investors in the US, Europe and China — the shift to fewer, stronger players reflecting consolidation in the market.

Lack of exits hampering investment cycle

The decline in activity partly represents an understandable pause in the face of uncertainty following two strong years of growth. There is also, however, the constraining factor of a tough exit environment. With general partners finding it harder to exit their portfolio company investments, the flow of capital being returned to LP investors is slowing, which in turn restricts those investors' ability and willingness to reinvest in new funds. Poor performance of many VC funds relative to benchmark indices, such as the S&P 500, also does not help the reinvestment case.

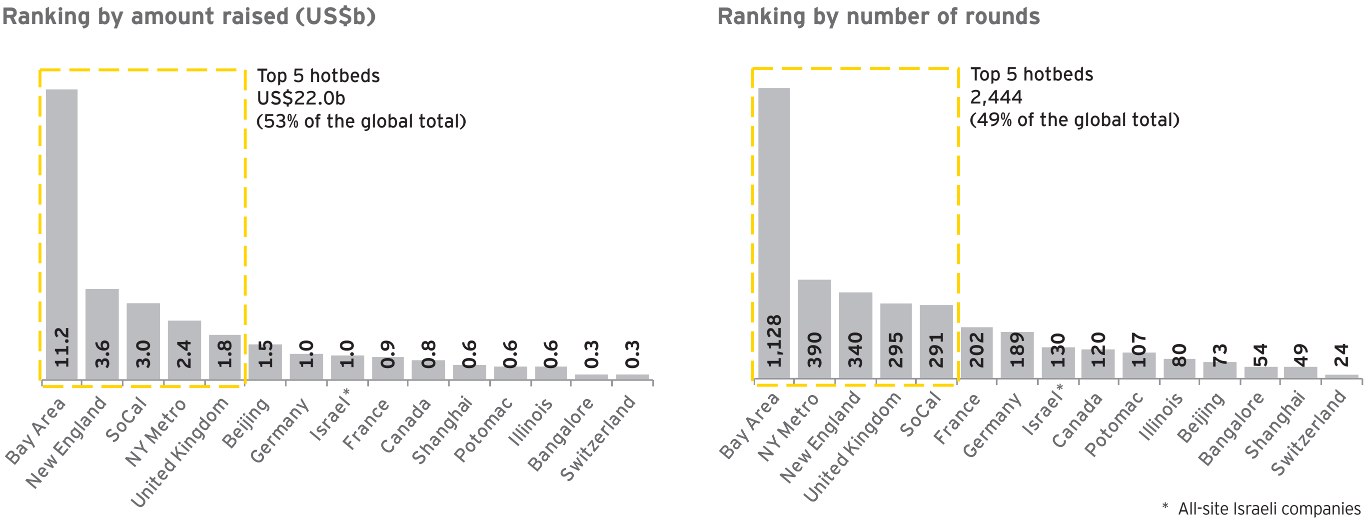
For much of the past 10 years, exits have been challenging for VC-backed companies. First, there was the dotcom bubble that started in June 2001 and lasted until 2004, when Google went public. Then the financial crisis struck, which means the IPO markets have been difficult to access for approximately half of the past 10 years.

Last year proved to be yet another challenging year. The amount raised via IPO declined globally by 27% from US$22.1b in 2011 to US$16.1b in 2012. While there was a large fall in IPO proceeds in all other parts of the world, it appeared that the US bucked the trend. In terms of deal count globally, IPOs declined by more than 30% from 165 in 2011 to 115 in 2012, led by China, where there was a decline of more than 50% in the number of IPOs.

Similarly, VC-backed M&A activity declined by more than 20% from 787 deals in 2011 to 618 deals in 2012, continuing the decline from the 2010 post-financial crisis peak of 856 deals. Activity in the US and Europe, which comprise over 90% of VC-backed M&A deals, fell by about 24%, offsetting an increase in M&A in India.

The median years from initial financing to exit in 2012 across all regions reflect the lack of momentum in the capital markets.

Amount raised and number of rounds by hotbed in 2012



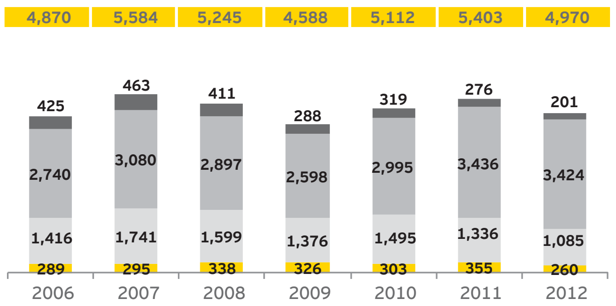
* All-site Israeli companies

Source: Dow Jones VentureSource, 2013

VC investments by development stage 2006–12*

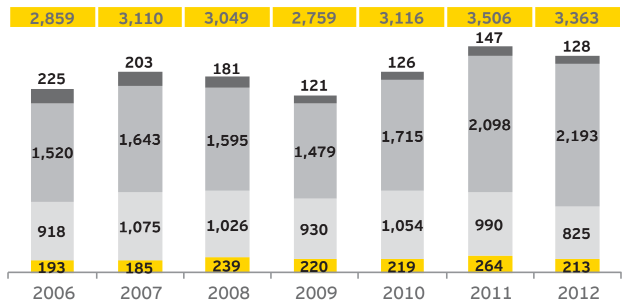
Global**

Total number of rounds



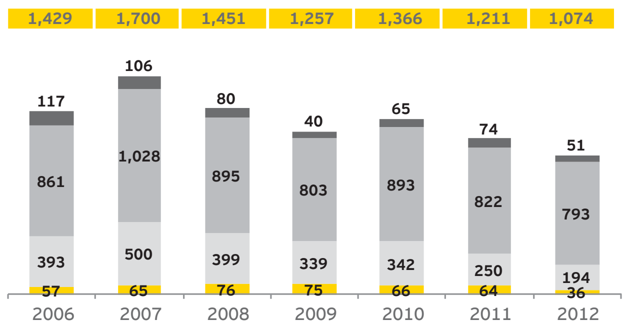
United States

Total number of rounds



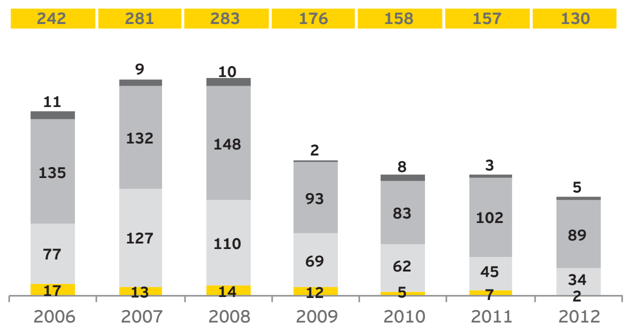
Europe

Total number of rounds



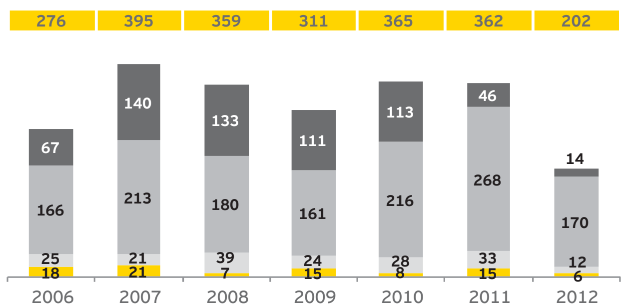
Israel‡

Total number of rounds



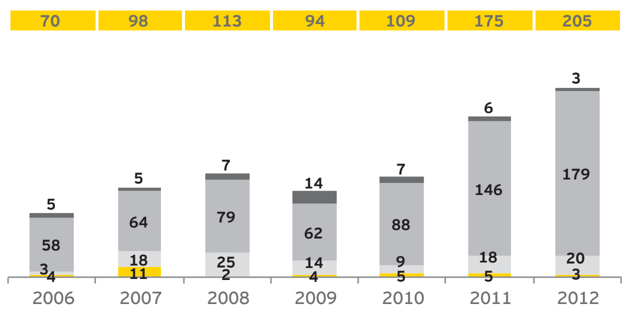
China

Total number of rounds



India

Total number of rounds



Start-up   Product development   Generating revenue   Profitable

* Total number of rounds includes restart
** Global numbers include US, Europe, Israel, China, India
‡ All-site Israeli companies

Source: Dow Jones VentureSource, 2013

Speeding the time to exit will help VC funds return capital to their investors, show a track record of success and, thus, start the process of opening, raising and closing a new fund. It has also helped liquidate the older companies in their portfolios, allowing them to focus on companies that have a better option of exiting, either via IPO or M&A, and repatriating those investment returns back to the fund.

Realignment of the VC model to later-stage

VC funds are adjusting their investing strategies, preferring to invest in companies that are generating revenue and focusing less on product development, pre-revenue businesses. Globally, the share of investment directed to the generating revenue stage has increased from 56% prior to the crisis in 2006 to 69% in 2012 in terms of number of deals and has risen from 55% to 74% in value terms. Conversely, the share of investment directed to the product development stage has declined from 29% to 22% in deal numbers and from 32% to 17% in deal value.

We see evidence of money flowing into companies that are perceived as less high risk. For example, there is a shift away from social media towards enterprise — the companies that are attracting greater VC interest are those that provide a service and are getting paid for it, rather than those that have a good idea but the idea is difficult to monetize.

Portfolio companies are also being encouraged to leverage the cloud and other types of back-office technology, which allows them to focus the use of their funds on growing the company instead of developing their back-office infrastructure.

Median round size declining in the US and China

As investment shifts to later-stage, median round size typically increases as the quantum of risk decreases.

In the US however, VC funds are deploying smaller amounts of capital in later-stage investments. Over the last year, US median round size in the profitable stage has dropped significantly from US$9m to US$6.4m, reflecting VC investment being used to supplement operating cash flows as a bridge until an exit. Median size increased from US$4m to US$6m in Europe. Across all geographical regions, round size during the profitable stage is highest in China, but it also is on a declining trend between 2011 and 2012, dropping from US$20m to US$17.9m.

This trend towards later and smaller investment in less risky companies is also being accompanied by a move towards tougher terms. LPs are demanding better terms from VC funds, while in turn the funds are requiring portfolio companies to meet stricter milestones and tighter time frames.

The increasing role of corporate venture and M&A

Helping offset the weaker IPO market to some extent, corporate venture investment is rising and in 2012 surpassed pre-dotcom levels. Corporates such as Google Ventures are now an important part of the VC market. Between 2003 and 2012, Google was the most acquisitive company in the US venture market, with 60 venture-backed company acquisitions across all industry verticals.[2]

Information technology (IT) has witnessed both the largest number of corporate venture investments and the highest number of acquisitions. Activity in the IT sector is being driven by a combination of healthy corporate cash balances and the rapid pace of technological change as the rise of mobile, big data and cloud computing creates a disruptive business environment.

Corporates are keen to invest in and acquire venture-backed companies to fill in the gaps in their strategy and innovation capability.

When corporate investors make an investment, historically in the "later-stage" in the US, the valuation of the business in that round is typically greater than in companies at a similar stage with no corporate investor. The median valuation premium over the last decade has been 54% in the US.

The link between corporate investment and ultimate acquisition, however, is weak. In all sectors in the US, only 2% to 3% of companies were acquired by an existing corporate investor in 2012. Also the valuation premium evident at later-stage investment by a corporate does not consistently translate into a similar premium at acquisition.

[2] Dow Jones VentureSource, 2013

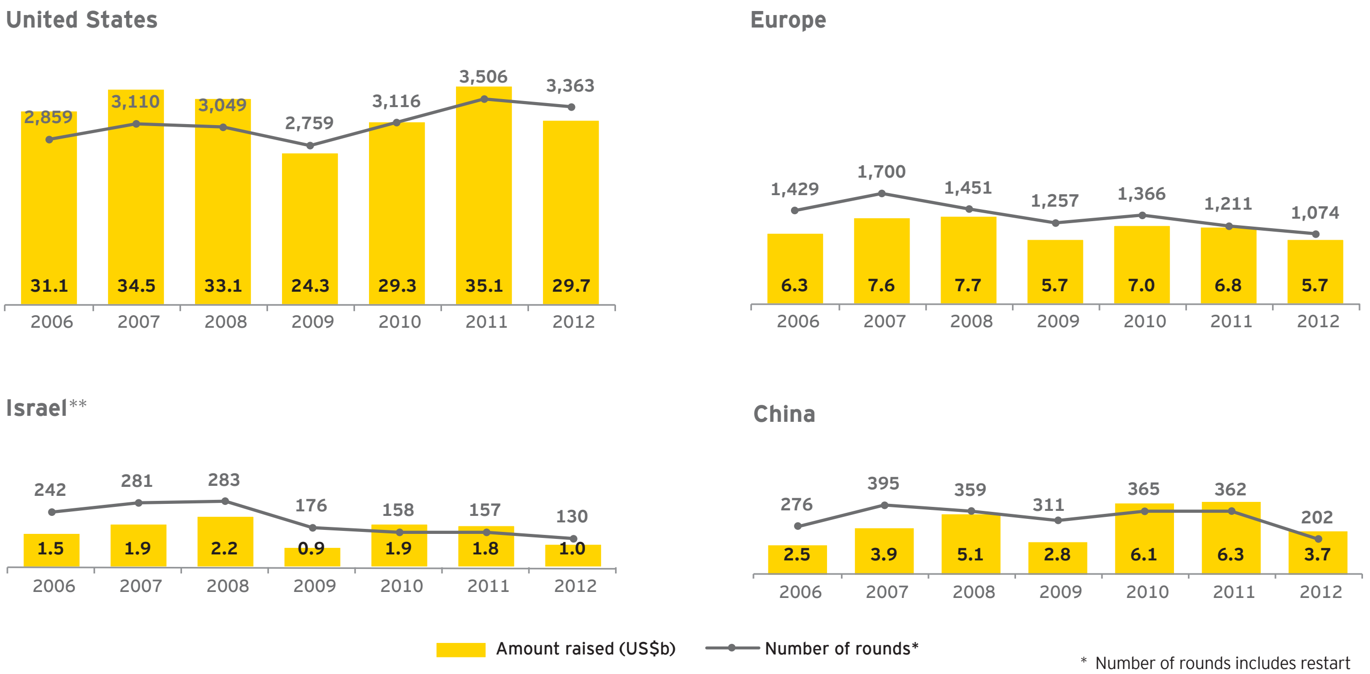
Key global venture insights

1 VC investment strongest in US and Europe

2012 saw a considerable fall in the dollar value of VC investments. VC investments dropped by 15% in both the US and Europe while Israel and China reported drops of more than 40% in the value of investments.

In 2012, the number of deals and average deal size fell significantly across all countries, excluding China (where although the number of deals decreased by 44%, average deal size increased by 5%).

VC investment by region 2006–12*



* Number of rounds includes restart
** All-site Israeli companies

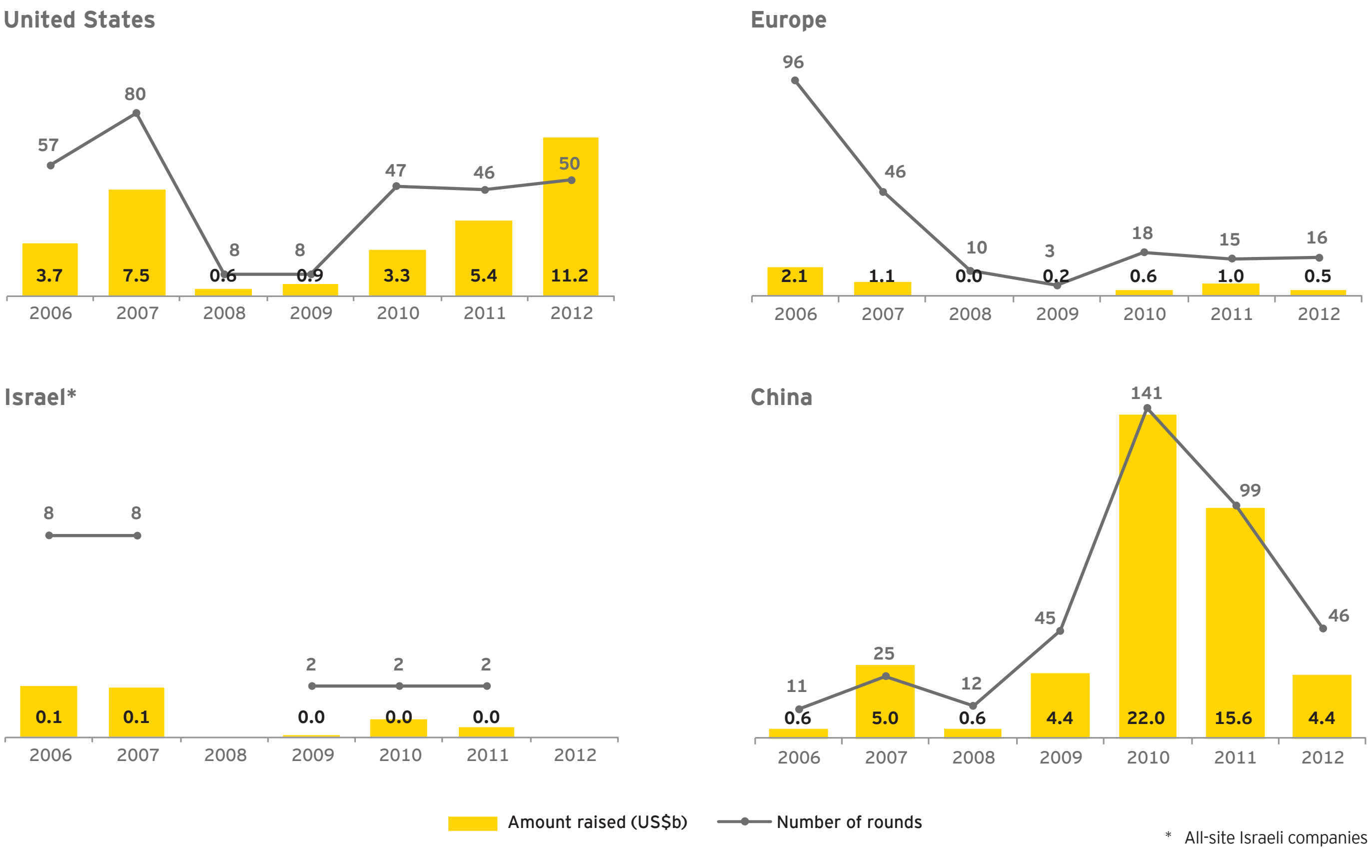
Source: Dow Jones VentureSource, 2013

2 Global VC-backed IPOs down

The amount raised through IPO fell globally by 27% from US$22.1b in 2011 to US$16.1b in 2012. The US bucked the global downtrend and saw a doubling of proceeds on 2011, albeit largely due to the US$6.8b raised by the Facebook IPO.

In terms of deal count, globally IPOs declined by more than 30% from 165 in 2011 to 115 in 2012. This decline was led by China, which saw a drop of more than 50% in the number of IPOs.

Global VC-backed IPOs by region 2006–12



* All-site Israeli companies

Source: Dow Jones VentureSource, 2013

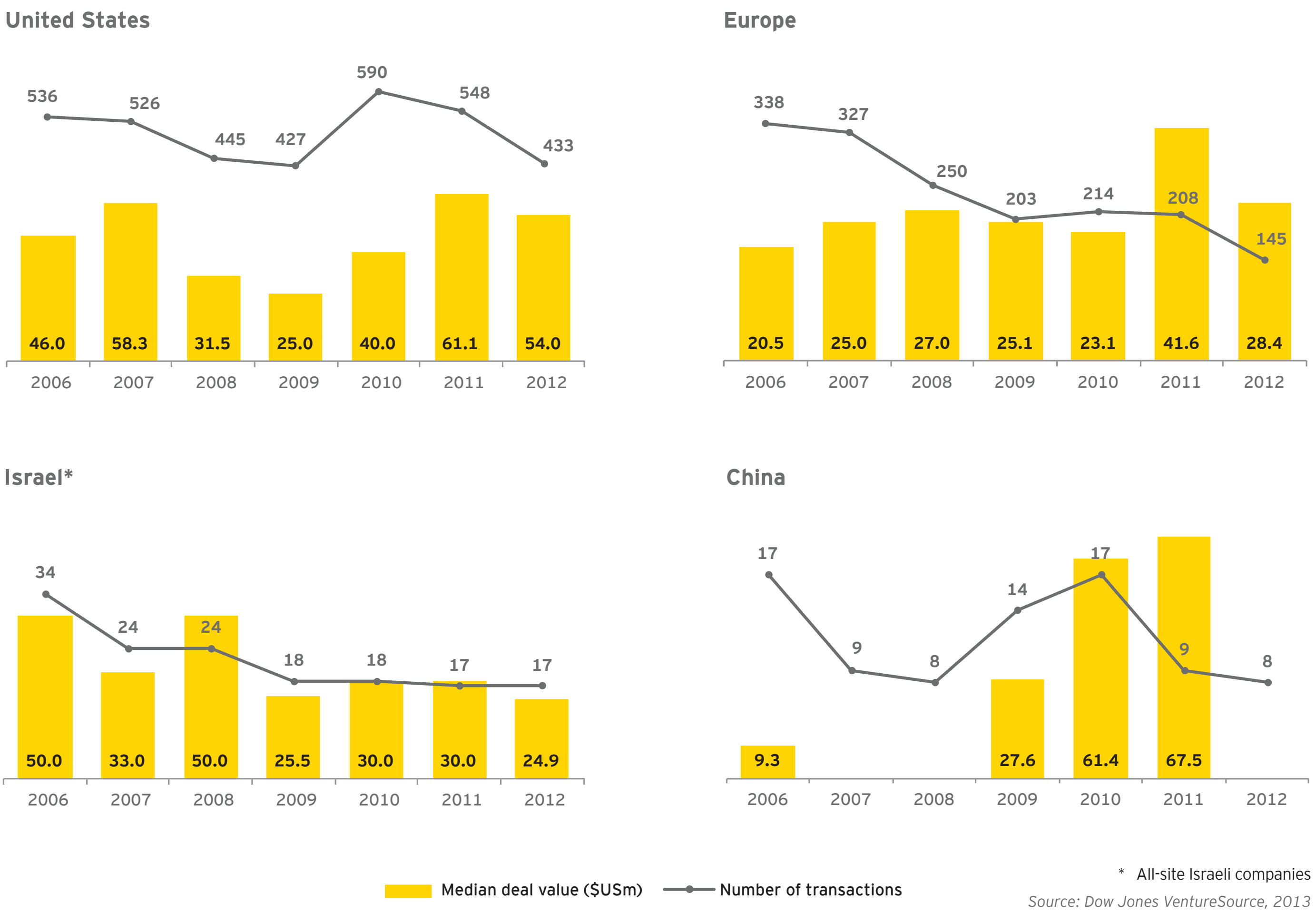
3 Global VC-backed M&A declining despite recovery in some markets

VC-backed M&A activity saw deal counts decline by more than 20% from 787 deals in 2011 to 618 deals in 2012. After reaching a peak of 856 deals in 2010, during the post-2008 recovery, the number of VC-backed M&As has been declining in the last two years.

With deal numbers now lower than pre-2008 levels, 2012 saw a reversal of the recovery that had been under way since 2009.

The US and Europe, which comprise over 90% of VC-backed M&As, collectively witnessed approximately a 24% year-on-year decline in deal count, which brought global numbers down despite an increase in India.

VC-backed M&A by region 2006–12



* All-site Israeli companies

Source: Dow Jones VentureSource, 2013

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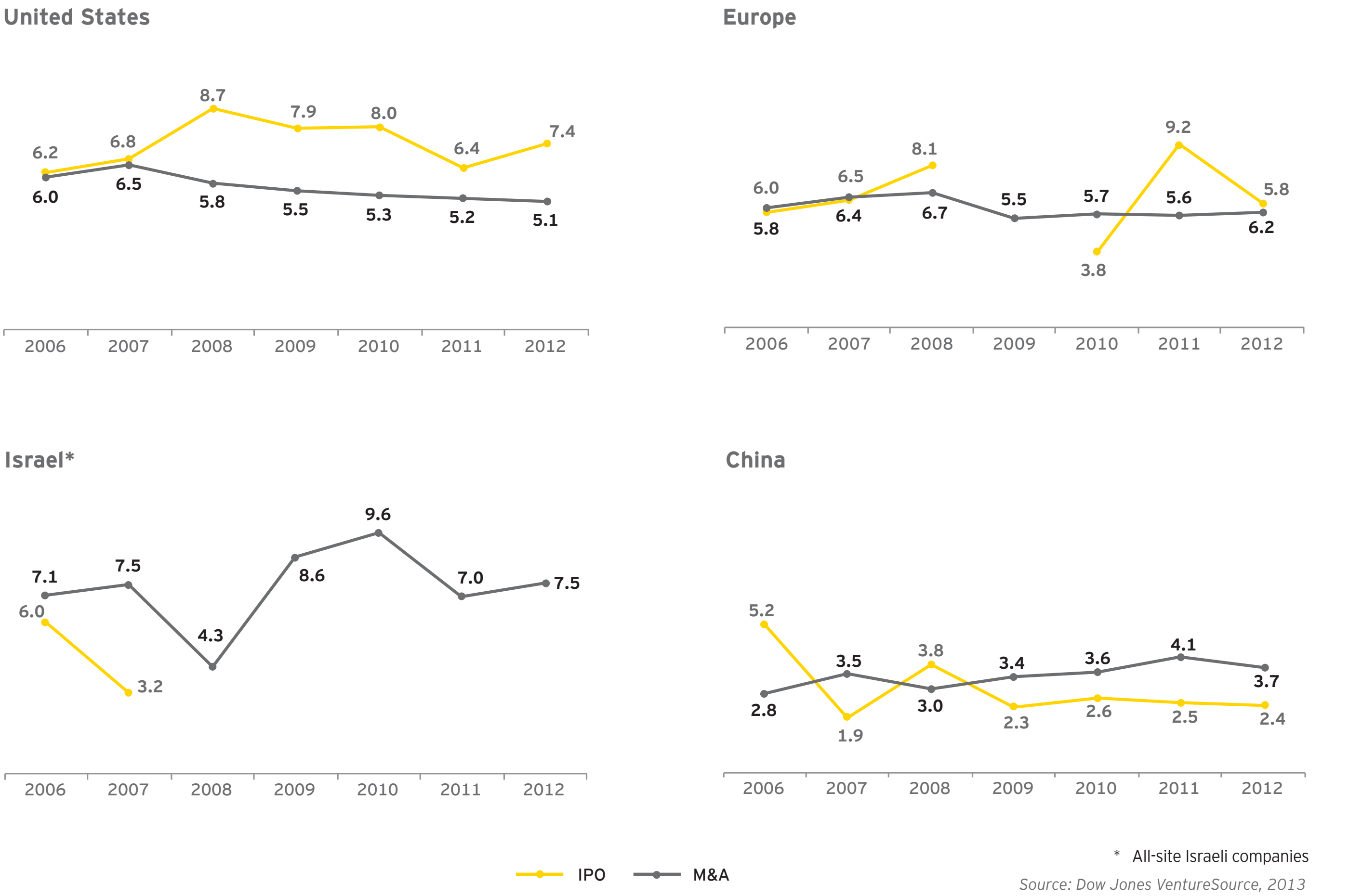
Median years from initial VC financing to IPO and M&A exit falling

Overall, the number of years it takes to exit from initial financing to an IPO or M&A is much higher in the US and Europe than in China.

Through 2012, the time to exit in median years from initial financing through IPO and M&A across regions reflects signs that the IPO market still lacks significant momentum. The longer time to IPO in the US typically results in more mature companies that ultimately command a higher valuation than those that exit in a shorter period of time via M&A.

It is interesting to consider whether changes need to be made to the existing typical VC fund structure of a 10-year term if the time to IPO is now around seven years. A longer fund term may encourage greater levels of early-stage investment.

Time to M&A or IPO by region 2006–12



* All-site Israeli companies

Source: Dow Jones VentureSource, 2013

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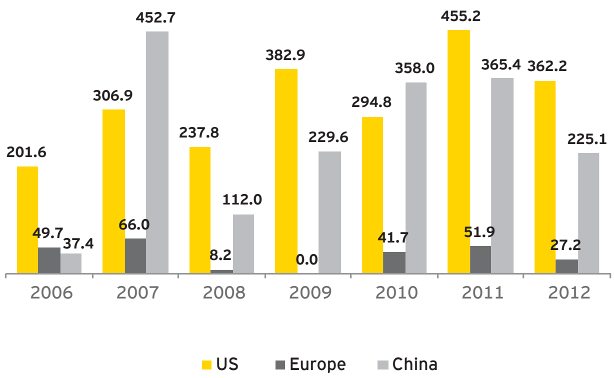
Global median pre-money valuations

Over the past few years the US has led in terms of median pre-money valuations across regions, followed by China. While the US, China and Europe witnessed an increase in pre-money valuations through 2011, valuations declined significantly in 2012.

Median valuations dropped by 20% in the US, by nearly 50% in Europe and almost 40% in China. China's pre-money valuations are very high when compared to the amount of VC investment, because most Chinese companies are still majority-held by the original owner or other non-VC investors. That differs substantially from the other geographies.

Median pre-money valuations — IPO (US$m)



Source: Dow Jones VentureSource, 2013

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Dry powder

While there are varying opinions on the amount of "overhang" or "dry powder" in the global VC industry, data prepared by PREQIN suggests that as of the end of 2012, there was in excess of US$110b of capital committed to VC firms but not yet invested globally. PREQIN data is based on 1,400 firms that offer a VC strategy, either exclusively or as part of a wider focus. This amount is down about 4.5% from 2011.

This includes funds raised for investment in all stages, from early to expansion stage, and includes venture debt. Of this amount, approximately 57% was attributable to North America-focused funds, while 29% was for investment in Asia and rest of world other than Europe.

At levels of global VC investment activity in 2012 of US$41.5b, this represents about 2.7 years' worth of investment capital.

Global VC hotbeds

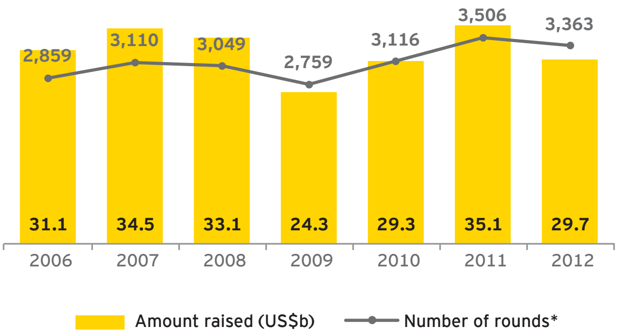
United States

VC trends

Key United States VC statistics

	2010	2011	2012
Invested capital (US$b)	29.3	35.1	29.7
Invested rounds*	3,116	3,506	3,363
Median round size (US$m)	4.20	5.00	4.24
Number of VC-backed IPOs	47	46	50
IPO capital raised (US$b)	3.3	5.4	11.2
Median time to IPO (years)	8.0	6.4	7.4
Number of VC-backed M&As	590	548	433
Median M&A valuation (US$m)	40.0	61.1	54.0
Median time to M&A (years)	5.3	5.2	5.1

United States VC investment 2006–12



Source: Dow Jones VentureSource, 2013

Activity declines, Silicon Valley still dominant

- US VC investment activity declined by 15% to US$29.7b in 2012 compared with 2011. The number of investment rounds also fell, but the drop was not as pronounced, declining by 4% to 3,363.
- On a cumulative basis, the US VC-backed industry remains very substantial. As of January 2013 US$167.9b was invested in 8,288 companies and is still heavily weighted towards Silicon Valley. Since 2000, cumulative equity raised in the Bay Area of US$62.2b exceeds the total raised in all other US VC hotbeds combined.

Shift towards later-stage investment

- Start-up VC funding declined from 264 rounds in 2011 to 213 in 2012. There has also been a decline in product development funding rounds over the last three years, counterbalanced by a three-year increase in funding for companies at the revenue generating stage.
- The shift towards later-stage investing reflects two trends:
  - Substitution for VC fund money in early-stage companies by angel investors, incubators/accelerators and corporate initiatives
  - VC firms' needing to demonstrate more exits to investors in order to persuade LPs to reinvest

Start-up funding size squeezed

- Median round sizes fell in the product development stage from US$5m in 2011 to US$3m in 2012, reflecting VC funds' efforts to more carefully meter out the lower amount of capital being invested in this stage.
- Lower round sizes also partly reflect lower capital requirements, particularly in the early-stage, as companies increase their proportion of variable relative to fixed costs, for example through SaaS and more flexible real estate and staffing options.

Historically low overhang of uninvested capital

- In 2006 the amount of capital raised but not yet invested by North America-focused funds – the overhang – totalled US$77b and peaked in 2007 at US$84b.[3]
- The low overhang underscores the need for a successful exit environment for VC funds to be able to persuade LP investors to reinvest.

The long road to an IPO

- The number of VC-backed IPO exits and the median capital raised were relatively stable, while, if Facebook is excluded, the total amount raised declined by US$1b in 2012.
- Companies exiting via IPO are typically more advanced than those exiting via M&A. The median amount raised prior to IPO of US$78.4m and time to exit of 7.4 years far exceed the respective figures of US$16.7m and 5.1 years for M&A exits.
- Patience is rewarded, as top quartile exit ratios for IPO exits (10.4) are significantly higher than for M&A (7.0).

Longer-term trends

- Consolidation in the number of funds in the VC industry is continuing. LP investors are showing a preference for the most successful "brand name" funds, which suggests consolidation will continue.
- US VC investment is expected to continue to become more international, with the growing realization that the US does not have a monopoly on innovative ideas. US firms are showing an interest in investing in rapid-growth markets, often preferring the relative proximity of South America to Asia.

Outlook finely poised

- The exit environment will be crucial for the US VC industry outlook in 2013. Equity markets have started the year positively, but considerable uncertainty remains regarding the resolution of the US budget, which could have an adverse impact on sentiment.

* Number of rounds includes restart
[3] PREQIN, 2013

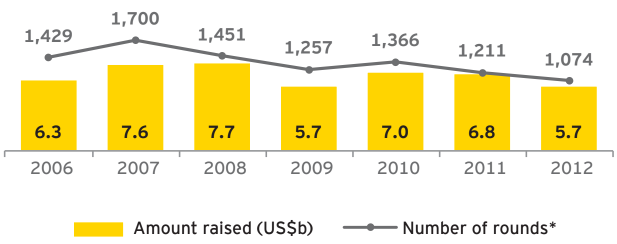
Europe

VC trends

Key Europe VC statistics

	2010	2011	2012
Invested capital (US$b)	7.0	6.8	5.7
Invested rounds*	1,366	1,211	1,074
Median round size (US$m)	2.50	2.37	2.45
Number of VC-backed IPOs	18	15	16
IPO capital raised (US$b)	0.6	1.0	0.5
Median time to IPO (years)	3.8	9.2	6.2
Number of VC-backed M&As	214	208	145
Median M&A valuation (US$m)	23.1	41.6	28.4
Median time to M&A (years)	5.7	5.6	5.8

Europe VC investment 2006–12



Source: Dow Jones VentureSource, 2013

Shift towards later-stage investment

- Reflecting the global trend, European VC investments declined by 16% year-on-year to US$5.7b, while the number of VC investment rounds declined by 11% to 1,074.
- Within the overall total there was also a shift towards later-stage investment, with the proportion of deals in the generating revenue stage rising from 68% in 2011 to 74% in 2012, while product development deals fell from 21% to 18%.
- However, across all stages, investors are still demanding to see a proof of concept or business – in terms of turnover and clients – before committing to an investment.

Regulation and economic uncertainty squeezing VC

- The principal reason for the decline in activity was the ongoing economic uncertainty produced by the Eurozone sovereign debt crisis and its negative impact on investor sentiment.
- However, the continuing trend towards tighter regulation of the European financial services industry, through legislation such as Solvency II and Basel III, has contributed to the decline as tougher regulation and higher capital requirements have reduced appetite, or ability, to invest in VC funds.
- In specific instances, changes in tax regulations have also played a part. For example, in France a reduction in the tax advantages individuals enjoy from investing in VC vehicles has weighed on investor inflows and hence, ultimately, on investment in portfolio companies.

VC-backed IPOs hold steady

- The number of VC-backed IPOs in Europe was stable, albeit at a low level (16 in 2012 compared with 15 in 2011). However, capital raised halved, falling from US$1b in 2011 to US$0.5b in 2012.
- Within the total, the vast majority of IPOs were in the life sciences sector.
- For technology companies, we anticipate companies will increasingly look to the developed VC ecosystem in the US and a possible US listing – a trend that will be facilitated by the reduced compliance burdens on SMEs introduced in the US JOBS Act.

US investors to fill the gap in Europe

- We expect increased US investment in European-based businesses, particularly for companies requiring more than US$10m in capital, which the European VC market struggles to provide.
- A recent example is Access Industries' US$130m investment in music streaming business Deezer in October 2012.

Corporate and family venturing set to rise

- Increased US investment is one of the ways we expect the gap left by the lower number of European institutional investors in the VC market to be filled. Two other types of investor are also likely to help fill the gap.
- Firstly, with less competition from bancassurers, family offices are expected to look at opportunities in the VC market.
- Secondly, corporates, which need to drive growth through innovation, but face a reduced pipeline of VC-backed candidates, are expected to increase their direct participation through corporate venturing.

Outlook for 2013 to remain subdued

- Overall, looking ahead to the coming year, with European growth expected to remain very subdued and the trend towards tighter regulation firmly in place, the contraction in VC investment activity in the region is likely to continue.

* Number of rounds includes restart

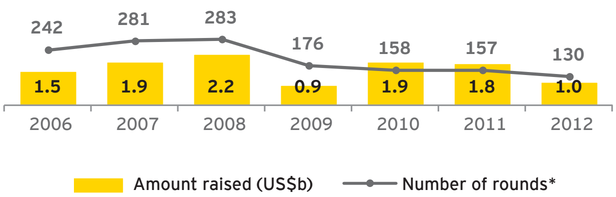
Israel

VC trends

Key Israel VC statistics*

	2010	2011	2012
Invested capital (US$b)	1.9	1.8	1.0
Invested rounds**	158	157	130
Median round size (US$m)	4.60	5.70	4.00
Number of VC-backed IPOs	2	2	0
IPO capital raised (US$b)	42.4	24.2	N/S
Median time to IPO (years)	N/S	N/S	N/S
Number of VC-backed M&As	18	17	17
Median M&A valuation (US$m)	30.0	30.0	24.9
Median time to M&A (years)	9.6	6.9	7.5

Israel VC investment 2006–12*



Source: Dow Jones VentureSource, 2013

Innovation continues to drive VC activity

- 2012 showed a year-on-year decline in VC investments in Israeli companies, in line with the trend in the US.
- The ability of Israeli VCs to raise follow-on funds endures and market fundamentals remain solid, based on the continued determination of Israeli companies to innovate.
- This has been bolstered by the implementation of the government's "comparative advantage" program for technology companies, which is already showing signs of success.
- Micro VCs were also increasingly evident over the past year and continue to fund with available cash, mainly to companies in the seed stage.

Foreign investment on the rise

- The current vintage of Israeli VCs has not yet raised the same amounts as previous ones, notably in the period of 2005 to 2008. As a result, there are not enough funds currently available to support both the existing portfolio and new investments to the levels seen in the run-up to 2009.
- However, the decline in overall VC investment has been to some degree offset by the continuing upward trend of foreign VCs investing in Israeli companies, which accounted for approximately 75% of total VC investment in 2012, compared to 60% in previous years.
- Foreign VCs used to be predominantly from the US, but in 2012 we also saw the entrance of funds from other countries.

Strong showing in M&A exits

- Acquisitions remain the most viable exit option for Israeli companies and their investors, who remain attracted to the innovative nature of many Israeli businesses.
- Although median valuations dipped, 2012 saw VC-backed M&A exits similar to the levels of recent years.
- In 2012 there were no IPOs, and M&A remained on par with the past 2 years. Although we expect the market for IPOs to pick up in 2013, exit via M&A will remain the preferred route with valuations expected to return to levels of previous years.

Cybersecurity the sector to watch

- 2012 saw significant VC interest in cybersecurity, which is shaping out as a renewed Israeli trend.
- In line with global trends, there was also an increase in investment last year in big-data analysis and cloud/SaaS companies, as well as health care.
- We see continued investment in these sectors – along with a rise in VC interest in smart mobility – as part of a long-term trend focusing on technology.

VC investment to rise in 2013

- There is anticipation, and the market suggests, that in 2013 more Israeli VCs will raise follow-on funds and we expect a moderate increase in investments.
- We also anticipate a good year for new start-ups, with the continuation of a clear "going back to seed" trend by Israeli funds raising money in 2012 to 2013.
- First round investments will become more significant as VCs and micro VCs step in to fill the gap left by decreasing levels of angel activity. Angel investment will drop as they focus on existing portfolio companies and as the popularity of social networks and applications companies falls, sectors in which they have historically been key investors.

* All-site Israeli companies
** Number of rounds includes restart

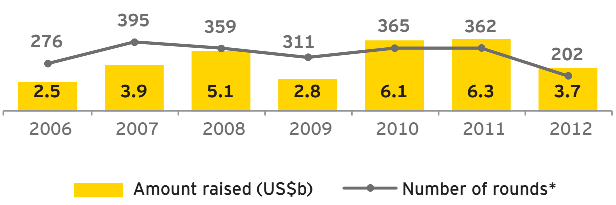
China

VC trends

Key China VC statistics

	2010	2011	2012
Invested capital (US$b)	6.1	6.3	3.7
Invested rounds*	365	362	202
Median round size (US$m)	7.69	11.14	10.00
Number of VC-backed IPOs	141	99	46
IPO capital raised (US$b)	22.0	15.6	4.4
Median time to IPO (years)	2.6	2.5	2.4
Number of VC-backed M&As	17	9	8
Median M&A valuation (US$m)	61.4	67.5	N/S
Median time to M&A (years)	3.6	4.1	3.7

China VC investment 2006–12



Source: Dow Jones VentureSource, 2013

VC activity slows from record high

- VC activity dropped from the record levels of 2011. In 2012, US$3.7b was invested in 202 rounds, a year-on-year decrease of around 40% for both figures.
- Despite this, the median deal value, at US$10m, was significantly higher than that in other parts of the world, due to substantial investments in profitable companies.
- Beijing, one of the emerging VC hotbeds, attracted a significant amount of VC investment through relatively fewer deals. At US$19.9m, average round size in Beijing is the highest and well above the global average of US$8.4m.

Economic and political factors impacting VC

- To some extent, the drop in VC activity reflects a broader slowdown in the Chinese economy, which has seen a drop in domestic consumption and a drop in GDP growth rates.
- External factors such as the US fiscal cliff and ongoing uncertainty in the Eurozone contributed to a decrease in global demand, and this weighed heavily on China's manufacturing activity, as evidenced by declining numbers of the country's monthly HSBC PMI (purchasing managers' index) in 2012. However, the market sentiment is improving: the index rose to 51.9 in early 2013, pointing to a promising scenario for VC investments for the remainder of the year.
- With 2012 the last year of the current Chinese administration, investors were in "wait-and-see" mode as they await the announcement of the next five-year plan and the industry sectors that will benefit from government policy.

IPOs set to rebound

- Since 2010, although the number of VC-backed IPOs in the country has been dropping, China has been the global leader in terms of amount raised and number of exits, with investors attracted by the rapid time to exit and the high returns on offer.
- However, in 2012, China saw over a 50% decline from 2011 in the number of IPOs and over 70% in the amount of capital raised, pushing the country into second place behind the US.
- In part this was due to domestic exchanges such as ChiNext stopping the approval of IPO registrations in the second half of 2012, in an effort to reduce the pressure to the China stock markets caused by the drainage of funds to the IPOs.
- Despite this, in 2012 China still had two of the top 10 largest IPOs by funds raised.
- IPO exits are likely to pick up again from the second quarter of 2013 as government economic policy is confirmed. There are more than 800 companies in the pipeline ready to list when the market opens.

Consumer industries continue to attract VC

- Unlike in most other geographic regions, consumer services remains the most prominent VC sector in China and will remain so, despite the recent economic slowdown.
- E-commerce is one sub-sector that does continue to struggle, with many businesses still in consolidation phase and yet to turn a profit.
- Other industries that are attracting interest from VCs include education-related resources and health care.

Positive VC outlook

- We expect the VC market to rebound in 2013. Although growth will be steady, we do not anticipate a return to the heights of recent years.

* Number of rounds includes restart

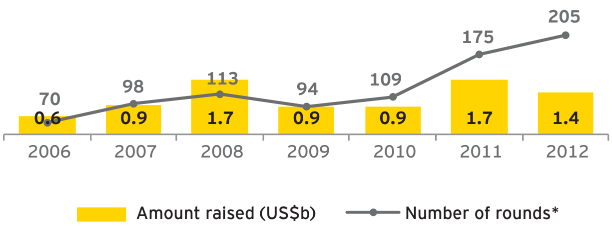
India

VC trends

Key India VC statistics

	2010	2011	2012
Invested capital (US$b)	0.9	1.7	1.4
Invested rounds*	109	175	205
Median round size (US$m)	7.25	5.45	3.61
Number of VC-backed IPOs	6	2	2
IPO capital raised (US$b)	0.5	0.05	0.02
Median time to IPO (years)	4.3	N/S	N/S
Number of VC-backed M&As	17	5	15
Median M&A valuation (US$m)	63.0	N/S	18.4
Median time to M&A (years)	3.5	4.0	3.8

India VC investment 2006–12



* Number of rounds includes restart

Source: Dow Jones VentureSource, 2013

Investment rounds increase in India

- India bucked the declining global trend in VC investment activity in 2012. The number of investment rounds increased by 17% to 205, the third successive year of increasing activity.
- Total capital invested declined from US$1.7b in 2011 to US$1.4b in 2012. The figures for 2011, however, contained a few large investments with a combined value of between US$400m to US$500m, and if these are excluded, the year-on-year comparison looks far healthier.
- Levels of reported VC investment also probably understate the true level of activity because of unreported deals not captured in the data.

Economic development is supporting VC industry growth

- The growing wealth of the Indian economy and the accompanying increase in consumerization is underpinning the growth of the VC industry.
- The two predominant themes from a demand perspective are:
  - Companies addressing changing consumer behavior patterns – the largest proportion of the total pool of VC-backed companies is in consumer services (170 companies out of a pool of 528)
  - The introduction of new technology, particularly internet-based applications such as cloud and mobile
- From a supply perspective, rising economic prosperity has increased the pool of entrepreneurs willing to take a risk on VC investment. Some of these high-net-worth individuals have already made money as successful entrepreneurs prior to becoming VC or angel investors.
- The entrepreneurial ecosystem is becoming more developed as the availability of higher education has spread to third and fourth tier cities, with a corresponding increase in the number of engineering and medical schools.

Late-stage investment dominates

- The Indian VC industry is heavily weighted towards later-stage investment. The proportion of deals in the revenue generating stage was 87% in 2012, up from 83% in 2011 and 81% in 2010.
- The reason for the predominance of late-stage investment is that, compared with Silicon Valley, Indian companies are focused less on innovation and more on application development and efficient delivery models, which take less time to develop into the revenue generating phase.

More deals, but smaller in size

- Median round size decreased from US$5.5m in 2011 to US$3.6m in 2012.
- The decrease in part reflects the influence of the growing network of angel investors on the VC market, with a preference for lower investment sizes.

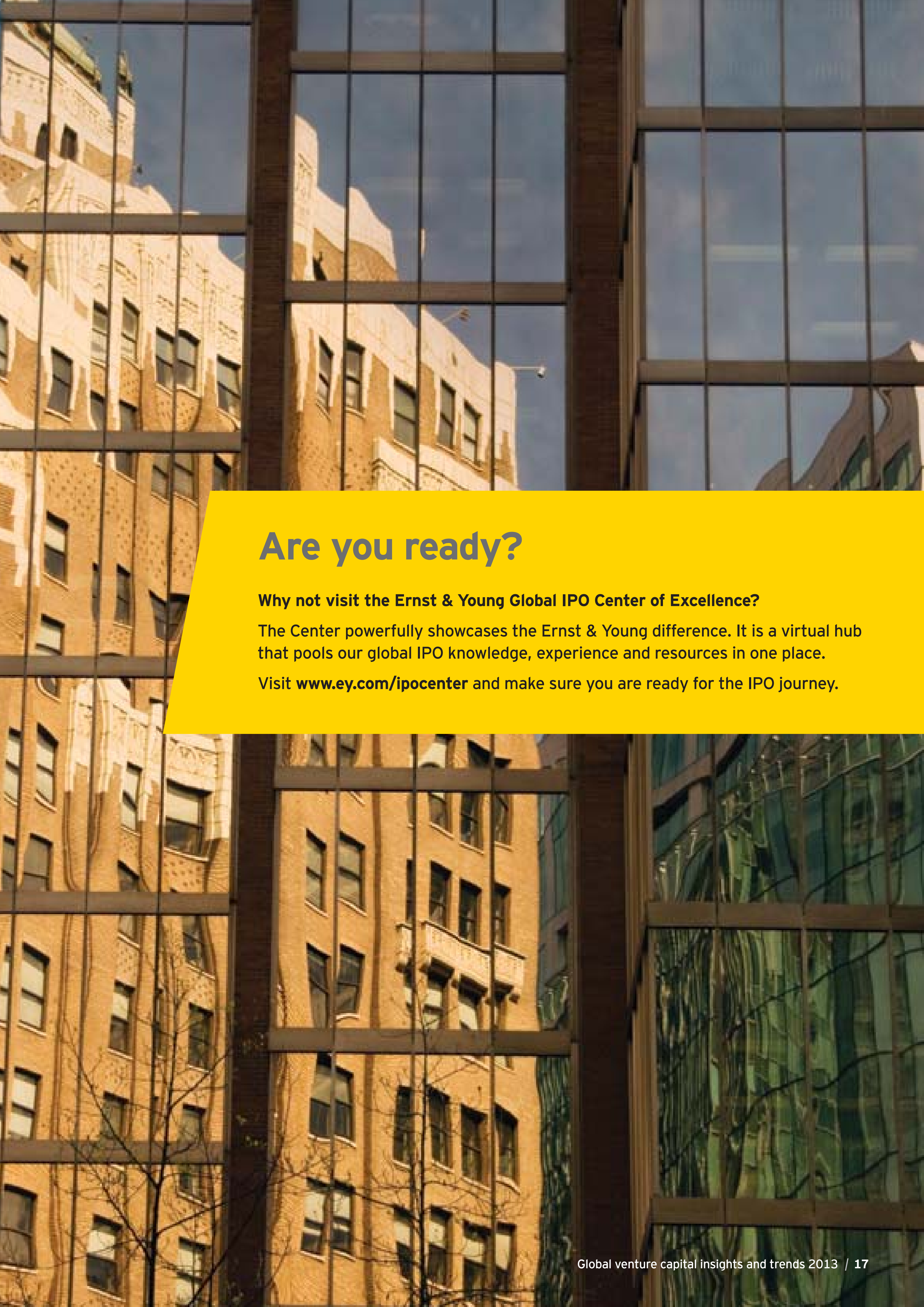
M&A is more likely than IPO at exit

- Strategic buyers are a more likely exit route for Indian VC-backed companies than IPOs. The very low level of IPO exits (two in both 2011 and 2012) reflects the absence of a junior stock market, such as London's AIM.
- Exits are a combination of fresh investment by new VC funds and strategic M&A, with a bias towards the latter because strategic deals tend to command higher valuations.

Positive outlook for 2013

- The growth of India's investor community and the resulting increase in the amount of capital being invested in purely domestic opportunities provides India's VC industry with a degree of insulation from global shocks, and the outlook for the coming year is therefore relatively positive.

* Number of rounds includes restart



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EYG no. CY0463

ED None

VC contacts

Global

Maria Pinelli
+44 20 7980 0960
maria.pinelli@ey.com

Americas

Bryan Pearce
+1 617 585 0499
bryan.pearce@ey.com

Israel

Oren Bar-On
+97 2 3568 7102
oren.bar-on@il.ey.com

EMEIA

Andrea Vogel
+31 8 8407 4070
andrea.vogel@nl.ey.com

France and Luxembourg

Franck Sebag
+33 1 4693 7374
franck.sebag@fr.ey.com

India

Mayank Rastogi
+91 22 6192 0850
mayank.rastogi@in.ey.com

Asia-Pacific

Ringo Choi
+86 755 2502 8298
ringo.choi@cn.ey.com

Greater China

Lawrence Lau
+86 21 2228 2816
lawrence.lau@cn.ey.com