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2005 Compensation & Entrepreneurship Report in Information Technology

2005

((ABRIDGED VERSION))

WILMER CUTLER PICKERING HALE AND DORR LLP

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Quality In Everything We Do

J. ROBERT SCOTT

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Contained within this document are summary level results of our proprietary study of executive equity and cash compensation. This report provides authoritative pay data for ten senior management positions and is based on data collected from 170 private Information Technology companies. The report also provides a window into compensation for outside Board Members. The results are arranged by financing stage, founder/non-founder status, number of employees, company location and business segment within the Information Technology market.

This study was produced by professionals at Wilmer Cutler Pickering Hale and Dorr, Ernst & Young and J. Robert Scott. We were assisted in our work by academics from the Harvard Business School.

You may also access these summary level results from our website at www.compstudy.com for no fee. We appreciate your professional courtesy in providing proper attribution when citing study results.

Participants have been provided detailed unabridged data results at no charge. You may secure a copy of the detailed report for $500 plus a commitment to participate in our next survey. Contact Mike DiPierro of J. Robert Scott at 617-563-2770 or mdipierro@j-robert-scott.com to obtain the unabridged results.

LETTER TO THE INDUSTRY

We are pleased to present our 6th annual Compensation and Entrepreneurship Report in Information Technology. This survey represents our largest sample size to date including data from more than 260 private companies from across the country in five industry segments: Software; Communications; Hardware, Semiconductors and Electronics; Services, Consulting and Integration; and Content and Information Providers.

This survey was conducted between January and April of 2005. As the broader U. S. economy continues to demonstrate signs of recovery, and the market for early stage IT companies appears to have emerged from the doldrums, companies and investors are struggling to understand the affect on compensation and the ability to attract and retain key executives.

Our inspiration for creating this survey of Information and Technology company executive compensation emerged from a desire to respond to our clients need for tools to assist them in critical decision making for attracting, rewarding and retaining key executives. There is very little compensation data available on private companies. Our survey continues to grow and represents one of the few reliable sources for executive pay information in the industry. The overall objective has been to provide fundamental information in a useful, analytic framework to evaluate and respond to the compensation dynamics of the senior executive team.

Our sample size has increased, allowing us to present the correlation between executive compensation and a number of variables, including: financing stage; company size, both in terms of revenue and headcount; founder/non-founder status; industry segment; and geography.

We wanted to understand the impact on private companies after the new accounting rules that require the expensing of stock options; accordingly, we have added a more granular look at the equity compensation vehicles private companies are using in their compensation packages.

This survey has evolved over the years as a result of the input we have received directly from the industry. This year we have correlated executive compensation to company revenue and have provided additional analysis of the data compared to financing rounds. Founders are often compensated using different criteria; therefore we have pulled founder compensation data out of the core analysis and have included a separate section that analyzes founder compensation.

Our hope is to continuously improve our data in an effort to more closely serve the needs of the industry and we encourage readers of this publication to submit comments and suggestions to help ensure the changes we make accurately reflect the requirements of the market. Suggestions and comments should be directed to Mike DiPierro of **J. Robert Scott**, mdipierro@j-robert-scott.com.

Lastly we'd like to express our gratitude to two individuals who contributed greatly to the 2005 addition: Professor Brian Hall and Associate Professor Noam Wasserman of the **Harvard Business School**. Additional thanks go to Ann Winblad, Partner of **Hummer Winblad Venture Partners** and Paul Chisholm, Chief Executive Officer of **mindSHIFT Technologies**. Each took time out of their crowded schedules to discuss their experiences as an investor and entrepreneur in this dynamic industry.

KEY: 2003 2004

DEMOGRAPHICS OF RESPONDENT POPULATION

Demographics of Respondent Population

- This survey of executive compensation in privately held Information Technology companies was conducted between January 2005 and April 2005. The questionnaire resulted in 263 complete responses with data from over 1,200 executives.
- The 2005 report provides aggregated results of the data as well as a deeper examination of the population by a number of perspectives, including: financing stage, founder status, geography, headcount, business segment and company revenue.

Financing Rounds

- Companies are divided between those that have received one or fewer financing rounds, two or three rounds of financing, and those that have raised four or more rounds. The detailed breakdown by financing round shows a concentration of respondent companies that raised one, two or three rounds of financing.

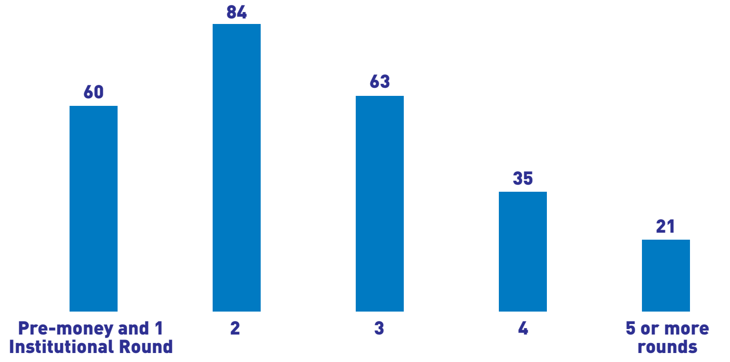
Founder Status

- 28% of the executive population this year were founders of their company, down slightly from our 2004 edition with 31%.
- CTOs were frequent founders of their companies with 62%, though in total number, the CEO was again the most frequent founder with 117.

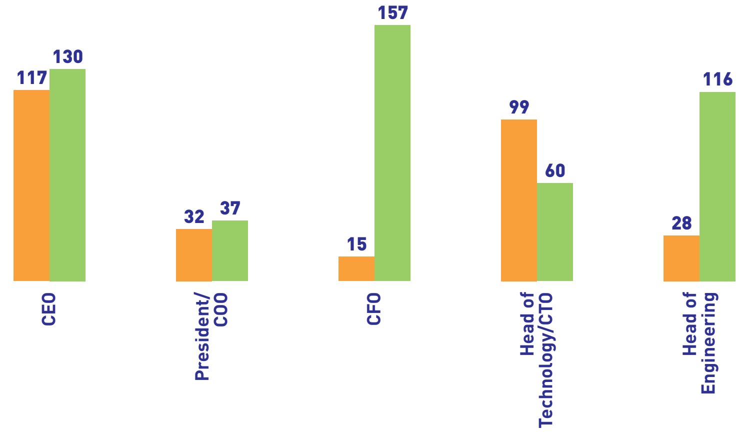
Headcount by Number of Full Time Employees (FTEs)

- The smallest companies, those with fewer than 20 FTEs, represent 33% of the total population.

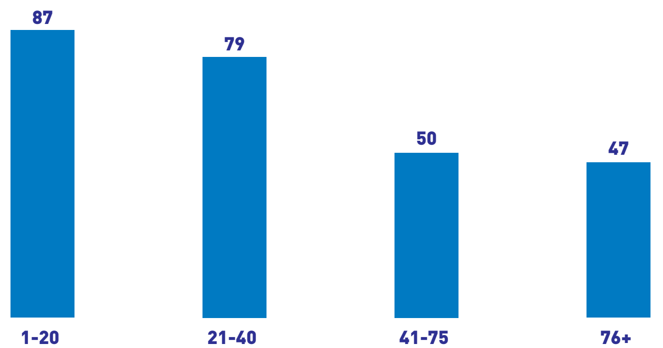
Financing Rounds



Founder/Non-



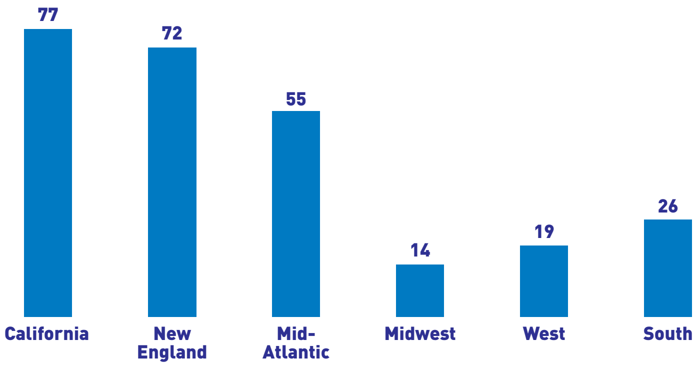
Headcount by Number of Full Time Employees (FTEs)



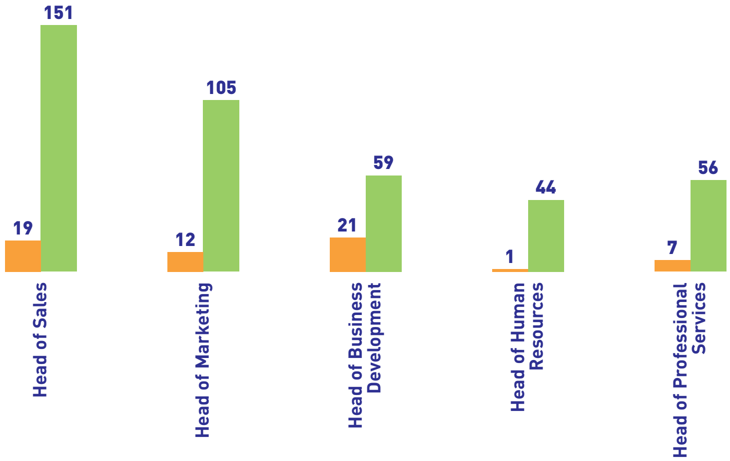
KEY: Founder | Non-Founder

SUMMARY OF RESULTS

Geography



Founder Status



Geography

- As with prior editions, California, New England and the Mid-Atlantic dominated the response population.

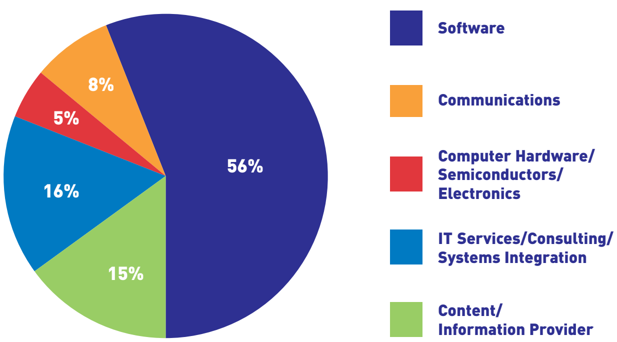
Business Segment

- Software companies again were the most common segment comprising 56% of the respondents. Communications and Hardware, Semiconductor, Electronics companies were next largest with 15% and 16% of the response, respectively.

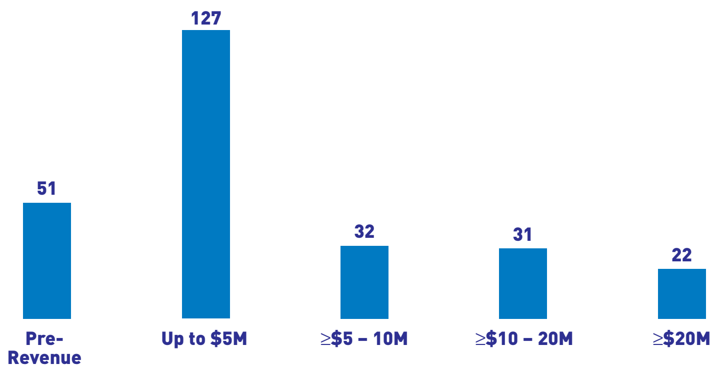
Company Revenue

- In this 2005 edition we began to examine executive compensation as it relates to company revenue. The respondent population leans heavily toward smaller revenue companies with 68% of participating companies generating less than $5 Million.

Business Segment



Company Revenue



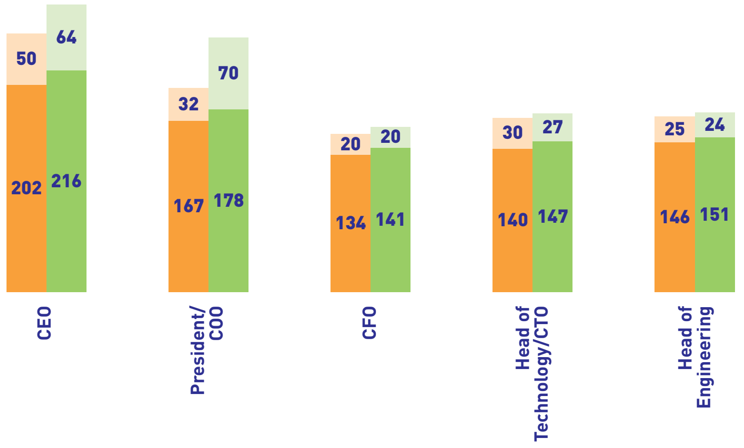
KEY: 2003 2004 Bonus
2003 2004 Base

Total Cash Compensation – 2003 and 2004

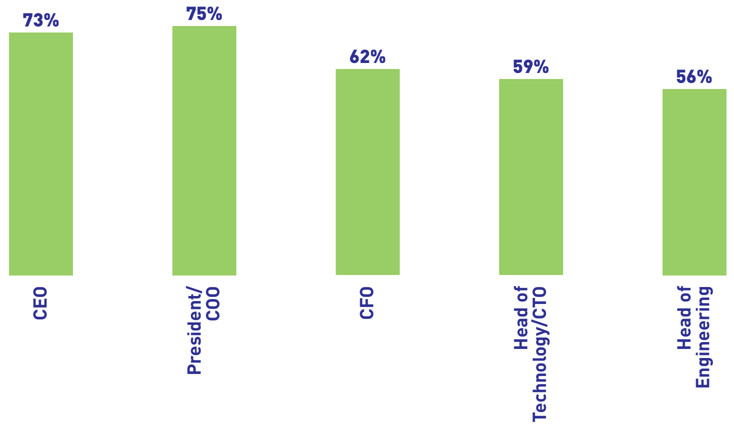
This data represents 2003 and 2004 compensation for non-founding executives.

- Average base salary across all positions increased from 2003 to 2004, by 4.3% overall. This is an increase from last year's report, when base salary increased just 1.9% (from 2002 to 2003).
- All positions except the Head of Human Resources saw a rise in base salary. The largest increases were seen for the Chief Executive Officer and Head of Business Development, each with a 7% rise in average base salary.
- Average bonus also increased in 2004 by 29% across all surveyed positions.
- Bonus as a percentage of base salary rose across every executive position except the CFO and CTO. On an aggregate level, bonus as a percentage of base salary across the executive positions rose from 18% in 2003 to 22% in 2004.
- The most dramatic rise in total cash compensation was for the President/COO, up 24% from 2003 to $248,000.

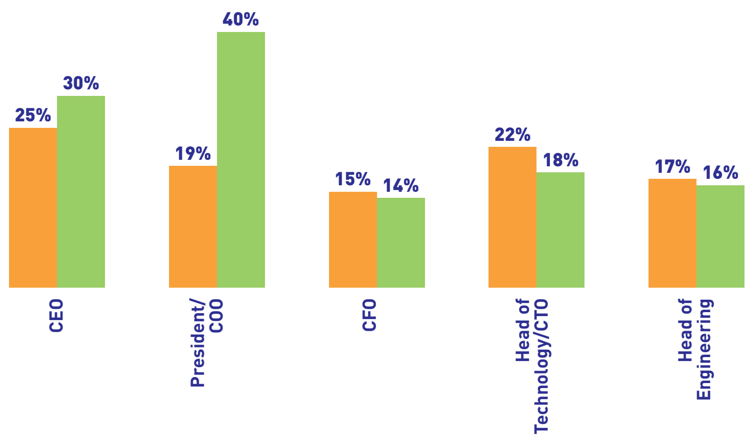
Total Cash Compensation



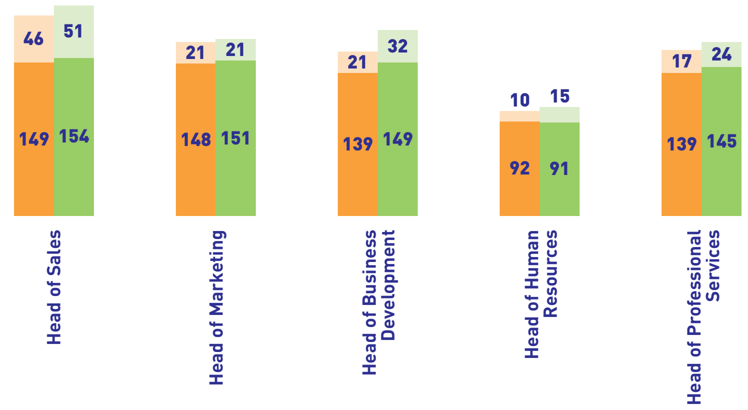
Executives Eligible



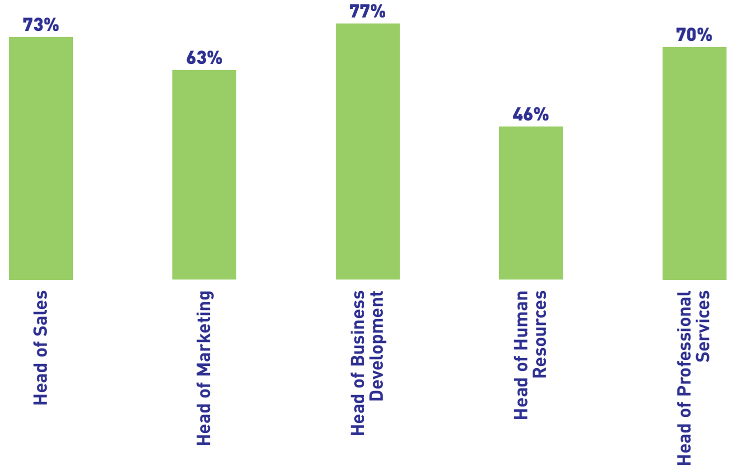
Bonus as a Percentage of



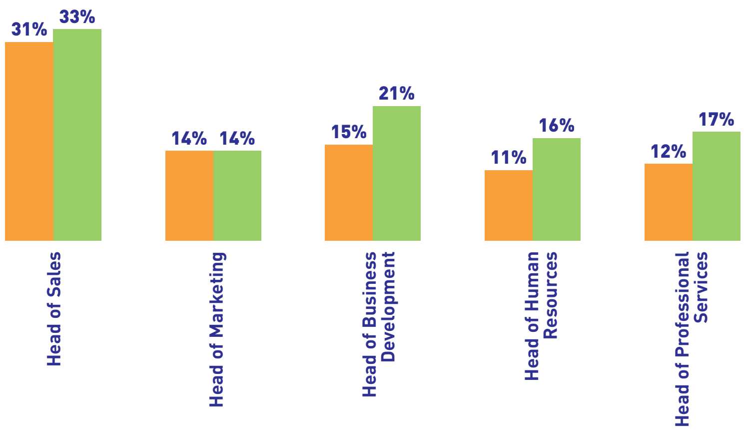
– 2003 and 2004



for Bonus 2004



Base Salary – 2003 and 2004

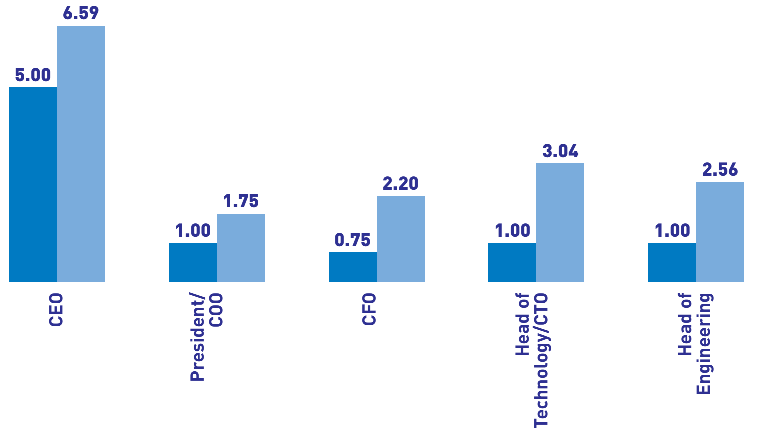


KEY: Median Average

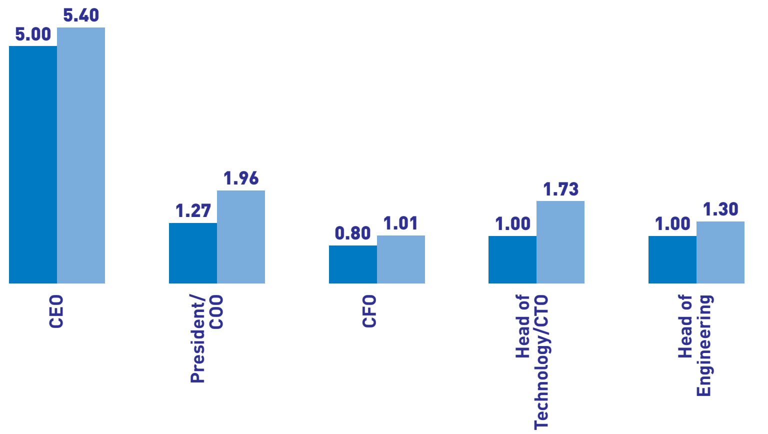
Severance Packages

- 35% of all non-founding executives receive a severance package.
- Of those executives receiving a severance, the CEO sees the highest average duration with 9.16 months. The CEO is also most likely to have a severance package as 59% of non-founding CEOs have a severance package in place.

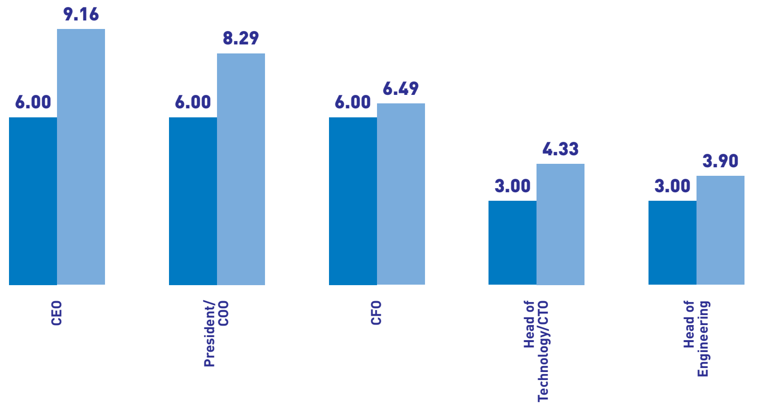
Equity/Option Grants at Time



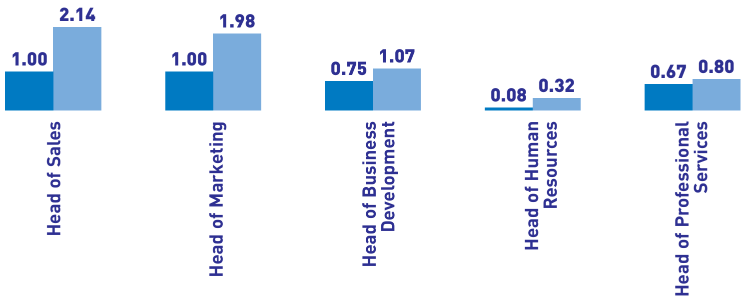
Equity Holdings



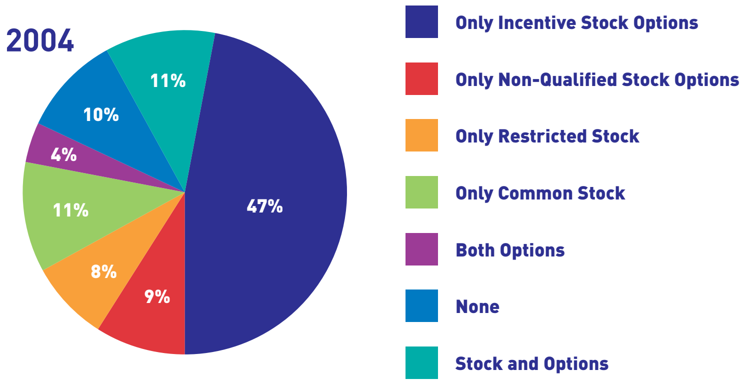
Severance Packages (Median

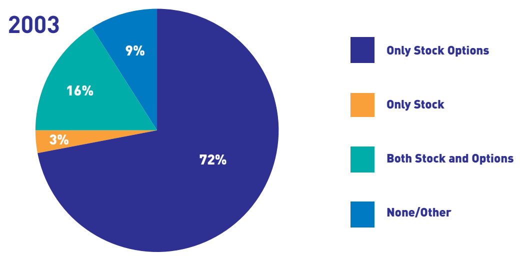


of Hire Median Vs. Average (%)

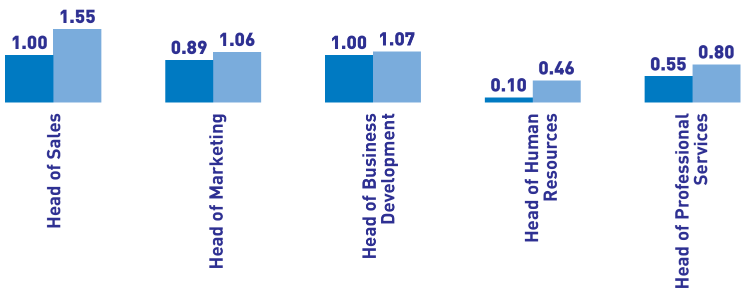


Equity Vehicles Used

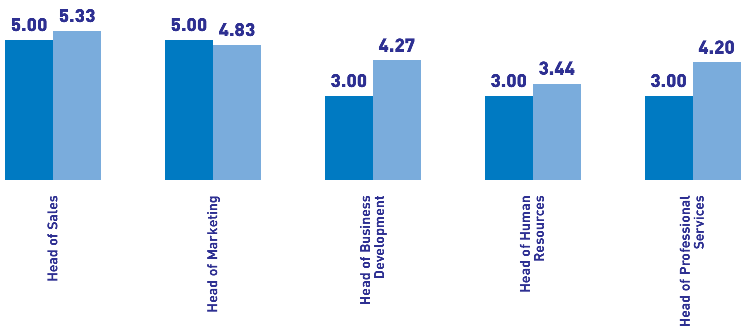




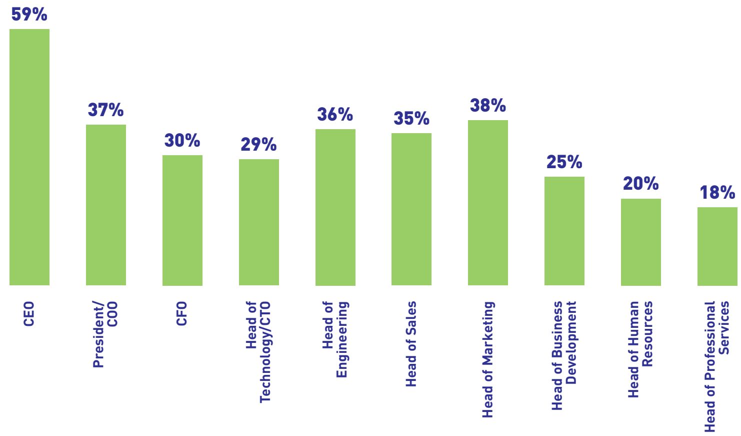
Median Vs. Average (%)

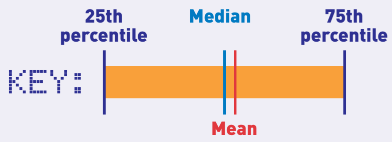


and Average in # of months)



Executives with Severance Package





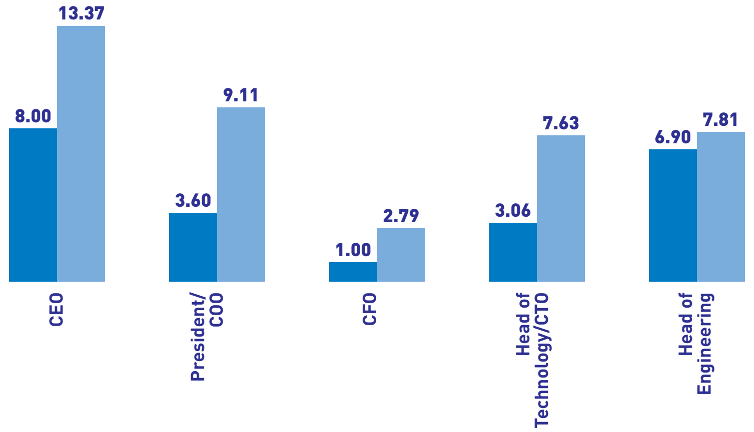
Equity Holdings

- As expected, founders hold a considerably larger equity stake in their companies than any non-founding executive. For the founding CEO, the average equity holding is 13.37% while the median amount is 8.00%. This difference is attributable to a small number of CEOs holding a relatively large amount of equity in comparison with other founding CEOs.

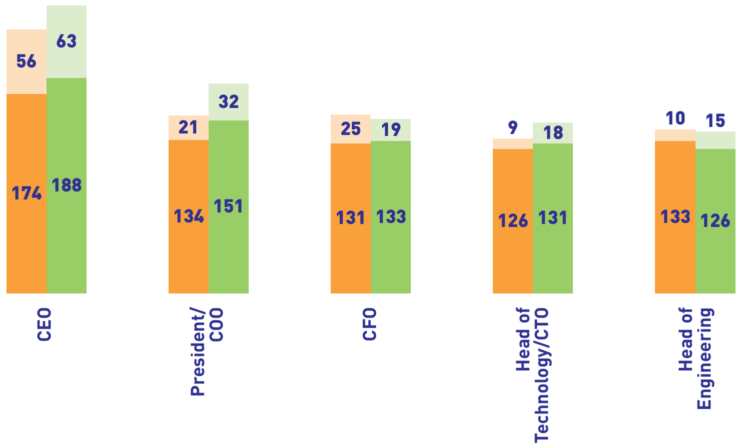
Total Cash Compensation

- In general, founding executives earn less than their non-founder counterparts, particularly in terms of average base salary.
- Founder CEOs earn an average of 13% less in base salary than non-founders.

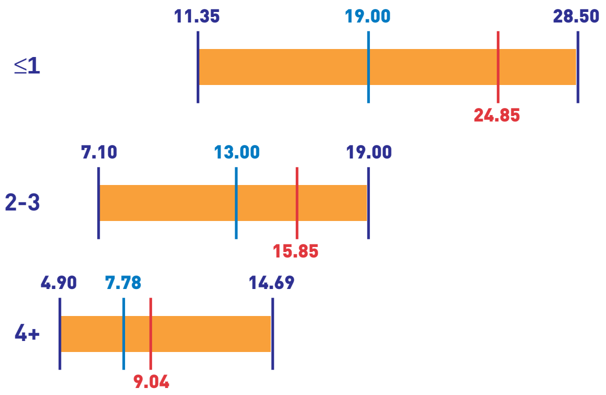
Equity Holdings



Founder Total

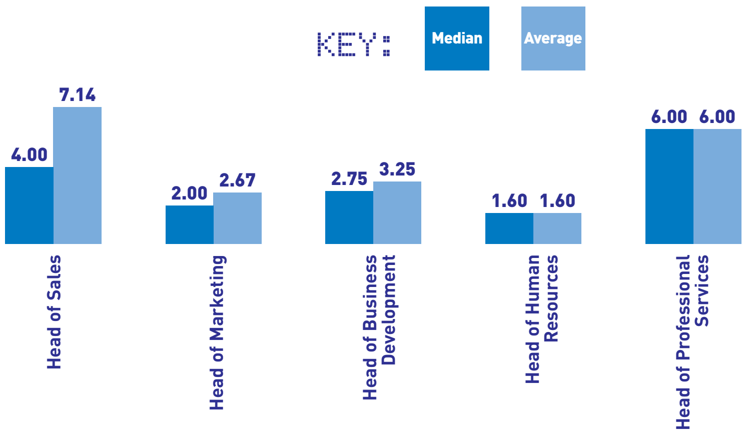


Founder CEO – Equity by Financing Round

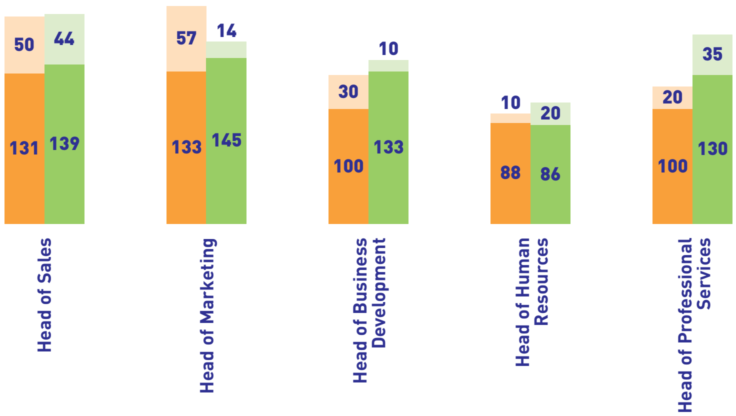


KEY: 2003 2004 Bonus; 2003 2004 Base

– Founders



Cash Compensation



CEO Equity Holdings by Financing Round

- Dilution of equity for the founding CEO is consistent across financing stages, moving from an average of 24.85% equity at companies with one or fewer rounds raised to 9.04% at companies with four or more rounds of financing.

PAUL W. CHISHOLM

Chairman and Chief Executive Officer

MINDSHIFT TECHNOLOGIES

Mr. Chisholm is currently the Chairman and Chief Executive Officer of Mindshift Technologies, Fairfax, Virginia. From 2001-2003 he was President of Paul Chisholm Inc., providing business and telecom consulting to various venture capital firms. From 1996-2001 Mr. Chisholm was the President and Chief Executive Officer of COLT Telecom Group plc headquartered in London, England. Prior to that Mr. Chisholm served as the President of COLT from 1995 and was the company's first Managing Director from its inception as City of London Telecommunications in 1992. From 1988 until 1992, he was the Vice President and General Manager of Teleport Communications Boston, Inc. Mr. Chisholm also held positions at Shawmut Bank, AT&T and New England Telephone.

Mr. Chisholm received a Bachelor of Arts degree from Boston College in 1971 and a Masters in Business Administration from Babson College in 1982.

In addition to COLT Telecom Group plc Mr. Chisholm is on the Board of Directors of Sycamore Networks, Netifice Communications Inc. and Mindshift Technologies.

Aaron: Could you provide a little personal history?

Paul: I began my career with New England Telephone/AT&T, where I spent twelve years. It's funny that I ended up in Telecommunications and Technology, since I was a liberal arts major at Boston College, and never thought I had a technology bent. I was initially trained as a Data Specialist, which really set me up for my future career as the leader of a technology company. The good part of working for a big company, which you never appreciate until you leave, is how much you learn, not only in terms of technical knowledge but also in terms of how to work within a large organization to get things done. That's helped me throughout my career.

As for my entrepreneurial instincts, my father owned a supermarket when I was young, so that may have formed my desire to own my own business. Those instincts were a bit stifled at AT&T, so eventually I decided I'd make my own opportunity. And that's how starting and running my own company came into being.

Actually, there was an interim step. I left AT&T and became Vice President of Technology at Shawmut Bank here in Boston. In that job, I ran Telecommunications and the PC networks, and became a customer of AT&T and other telcos. This was the first time I was on the customer side of the desk and I quickly learned about the business impact of technology issues.

I finally ventured out as an entrepreneur for Fidelity and Merrill Lynch, who recruited me from Shawmut to start Teleport Communications here in Boston, which was my first venture starting from scratch. Teleport was originally started by Merrill Lynch and the Port Authority of New York to build a satellite-based telecommunications network in New York City to keep large financial institutions from moving out of New York to New Jersey. Once they did that, they realized that they had no way of getting telecom information from the satellite fields in Staten Island into the city. So, they developed a fiber optic network to bring it there, and that really spawned the fiber optic network and the CLEC business in the United States. Teleport-Boston was the second CLEC in the United States and the first one in a mid-tier city in terms of size, really to prove the concept that you could build such a network and operate it profitably.

Teleport-Boston became profitable in three years. Fidelity then asked me to leave the venture to develop a company called COLT Telecom. I started to develop COLT in 1992 in Europe. After roughly ten years with COLT, it had become about a billion dollar company, with some 5,000 employees and operations in

32 cities. I left COLT about three years ago and came back to the U.S., where I did some consulting for venture capital firms on start-ups. One of these VCs got me interested in a company called Mindshift, which is an IT outsourcing company for small and medium-sized business. I have been the Chairman and CEO of Mindshift since roughly September of 2003.

Aaron: What was the history of COLT?

Paul: Fidelity saw the potential of creating an analogous business to Teleport in Europe, and I was recruited to leave Teleport to go to Europe to start COLT. Doing telecom in Europe was very different. In the United States there was a distinction between long distance and local companies, and Teleport was a local company. In Europe, there was no such distinction. Secondly, in Europe they had never seen anything like this, so it was totally foreign to them. Lastly, no one thought it was physically possible to build this type of infrastructure through old European cities and a lot of different cultures and disparate regulatory issues.

Aaron: Why did COLT start in London?

Paul: It started in London because that was the only place from a regulatory point of view where you could do this. I have a funny story. In my first week at COLT, Fidelity people suggested that I visit Fidelity's operation in London to tell them what I was planning on doing. The Telecom manager for Fidelity in London at that time came to me and said, "Do you mind if I ask you a question?" And I said, "What?" He said, "If this doesn't work, do you have a job to go back to at Fidelity?" I said, "No." And he said, "Then I suggest you renegotiate your contract, because this will never work in Europe." So the skeptics were internal, too, not just external.

Aaron: As you were thinking about team building at Teleport and COLT, was there a particular functional area that you felt was most critical to build early on?

Paul: I think it was the combination of establishing a solid Operations group that would collaborate with the Sales organization as a single team. As you probably know, there's a natural tendency for Sales and Operations teams to clash. Sales will sell anything and Operations is left to do all the dirty work. That is a fundamental flaw that I saw in a lot of companies. Therefore, I worked early at Teleport and COLT to create a unified Sales and Operations team. It didn't matter if you called it Sales or Operations, the customer was all that mattered.

Aaron: How did the telecom bubble affect COLT?

Paul: We were early. We started long before the bubble, which meant we could do it right, and build the company in stages, which is what you really have to do to build any company. I think the bubble forced people to rush ahead to do too many things too fast. I also think the bubble caused us to lose a generation of managers, because young people were often put into roles they were not ready for. We were fortunate that we could build COLT correctly, and get the culture correct, before we had to move into overdrive. I think a lot of companies that were started in the '96, '97, '98 time frame were placed in overdrive before they had the fundamentals of the business mastered.

Aaron: Can you talk a bit about that lost generation of managers?

Paul: You see it when you work with a young business today. You can't assume that that a young manager knows how to manage people, deal with complex issues, or knows how to react to certain situations. You can't take it for granted that they will know what to do; you have to go back and teach them. If someone's critical developmental years were in the nineties, they likely missed the reality of how to build a company economically. The lesson of most of the nineties was go, go, go, and business will come. That's not really the way to build a business. I think the second thing it did was create expectations of grandeur in terms of wealth accumulation. I think we are now back to reality in terms of what reasonable salary/bonus expectations are and what option grants should look like.

Aaron: Can you discuss the history of Mindshift?

Paul: Mindshift was started in 1999 by a group of people out of EDS who took the concept of outsourcing that they had used with the Government by managing desktops remotely to build a new business. The concept was designed for large organizations. They knew that the mid-tier market, that being companies with thirty to roughly three hundred people, was under-served. So, they saw this as a ripe marketplace for these services. Because the company was started in 1999, they were able to raise a fair amount of money, and they went through that money relatively quickly. They built everything on the concept that people would come, and they found that the selling process was quite different from what they expected. I was initially brought in as a consultant in the summer of 2003 to help the management team reposition the company. They had cut the business down but weren't sure how to rebuild it.

AARON D. LAPAT

Managing Director

J. ROBERT SCOTT

Aaron has been with J. Robert Scott for twelve years. J. Robert Scott is a retainer-based executive search firm and wholly owned subsidiary of Fidelity Investments. Aaron's practice focuses on recruiting Chief Executive Officers, General Managers and functional leaders for high-growth, venture-backed high-tech companies.

Prior to joining J. Robert Scott, Aaron spent four years with a retainer-based executive search firm that serviced the High Technology industry.

Aaron holds a BA in Anthropology as well as an MBA from Boston University. He serves on the Board of Advisors of Stax, Inc., a privately held market research and strategic analytics firm with offices in Cambridge, Chicago and New York. In his spare time, Aaron plays tennis and is a runner. On the off days, he can be found stoking the embers of his VW sized Texas BBQ or mixing up a homemade hot sauce.

Eventually, the VCs asked me if I would become CEO, because they knew I had the experience to scale the business. My job was to take an organization that had a good foundation and improve the sales and marketing model as well as the operations of the business.

Aaron: What stage was the business when you took it over?

Paul: We had about $6 million in revenue, probably about 75 customers, and approximately 50 people on the team. The company had burned through all but about $1 million in terms of investment left in the company. One of the first things I had to do was improve the financial strength of the business. It was my choice to bring in a new VC and we re-capitalized the business as part of my deal to enter the company. Columbia Capital, the remaining existing investor, and Fidelity, the new investor, came in to fund the company to a level I felt necessary to build it. It was fortunate we at had a solid customer base to build upon because attracting customers for a start-up is difficult, especially in poor economic times. The industry was very fragmented, so I saw an opportunity to build a company relatively quickly, through several carefully executed acquisitions.

Aaron: Is there an on-going consolidation opportunity for the company?

Paul: Absolutely. In fact, part of the deal when I came in was that they were acquiring a company in Boston. At the time, Mindshift was primarily based in the Washington, D.C./Virginia area. We acquired a company in Boston as part of the initial funding. We are now in the process of buying a company in New York and probably one in Philadelphia, and that will give us the Boston, New York, Philly, and D.C. markets. Our immediate goal is to reach $50 million in revenue, which will give us the leverage we will need to really do something major.

Aaron: What inspired you to get back involved in running a company day to day?

Paul: You're not the first person to ask me that. I like to be involved. I found that as a consultant to VCs, I could only get so involved with small businesses. I would work with CEOs to explain why Marketing, Sales and/or Operations were not working right, yet you can only go so far as a consultant. You can recommend, you can't take action, and that was frustrating to me. I would make recommendations and then go back two or three weeks later to find that nothing was done. You can only talk to the wall so many times before you want to jump in and get involved.

Aaron: What have the differences been in building Mindshift vs. your experiences with Teleport and COLT?

Paul: One of the most important differences is coming in with an existing team, vs. starting brand new. Changing cultures within an existing organization is always difficult. Some people would argue to do it fast and just get rid of the people and build a whole new team. But by the same token, a lot of new companies don't document what they have or how they do things, so you need experienced people to maintain the customer base plus in any company there are many good employees who just need better direction and management. My belief is that you need to assimilate the existing people to a new culture by example and leadership from the front. It's taken us about a year to get the culture to where it needs to be. We did it by changing some people and by setting the right example.

The second distinguishing feature is when you go into an existing company, you assume they have a customer base and they have an operation, and that the processes in the organization work. However, one important ingredient is to make sure the processes scale with volume. Last year we went from about $9 million to about $16 million in Sales and you learn quickly where the holes are in the processes and you make changes. If I had to do it all over again, I'd probably make sure the processes were better on Day One before I started increasing the Sales.

Aaron: Has your approach to team building changed at Mindshift vs. your previous two entrepreneurial experiences?

Paul: Yes, only in one sense, in that on Day One we acquired the Newton, MA organization. In Europe, I built COLT in London for four years before we went into other countries and cultures, like Germany and France. Mindshift had two organizations that were 100% different; one was started by a bunch of guys from EDS, one was started by a young entrepreneur. The cultures were totally different, and therefore the integration was different.

Aaron: Did one culture win out over the other, or was there some blending that has occurred?

Paul: Actually, there was good blending. The culture that the EDS guys in the Virginia part of the organization brought was oriented strongly toward process and documentation. In the entrepreneurial company in Boston, documentation was relatively non-existent. Structure and process wasn't something they did. They had always done everything unique for each customer, thinking, "I'll do what it takes to win that customer." You can't scale a business doing that all the time. I think we taught them how to scale a business. By the same token, I think they taught the Virginia people about flexibility and how to run a solid Account Management program. So I think we got the best of both worlds.

Aaron: Has your interaction with and management of your Board changed over your career?

Paul: Absolutely. As a young manager, you're unsure of how to do some things, so you make sure you have Board buy-in before you do many things. I probably overdid that. At COLT, I was more confident and independent. When COLT became a public company, things obviously changed. You have to run a public company differently than you do an independent, private company Board. At Mindshift, I have two investors who know me well, who know my history, who know I don't want a babysitter, so to some degree there's less contact in one sense. The contact we do have is much more strategic and is focused on where we go and how we grow the business, vs. what we're doing day to day.

Aaron: How have you changed as a manager over your career?

Paul: My first thought is that my temperament is quite different, particularly in how I react to problems. I have now seen all the issues two or three different times in different situations. I think where I may have overreacted at times as a young manager, I don't overreact anymore. With maturity, you gain a longer term vision. When you're young, you feel like everything has to get done immediately. As a more mature manager, you can see patterns developing, you can see trends, you take more advantage of them, and you have a longer term perspective and don't feel a crushing need to react to every situation.

ANN WINBLAD

Partner

HUMMER WINBLAD VENTURE PARTNERS

Ann Winblad is the co-founding Partner of Hummer Winblad Venture Partners. She is a well-known and respected software industry entrepreneur and technology leader. Her background and experience have been chronicled in many national business and trade publications.

Ann has over 25 years of experience in the software industry. She began her career as a systems programmer at the Federal Reserve Bank. In 1976 Ann co-founded Open Systems, Inc., a top selling accounting software company, with a $500 investment. She operated Open Systems profitably for six years and then sold it for over $15 million. Prior to co-founding Hummer Winblad Venture Partners, Ann served as a strategy consultant for prestigious clients such as IBM, Microsoft, Price Waterhouse, and numerous start-ups. In addition, Ann has co-authored the book Object-Oriented Software and has written articles for numerous publications. Ann received a BA in mathematics and in business administration, as well as an MA in education and international economics from the University of St. Thomas, St. Paul, Minnesota.

Ann has served as a Director of start-up and public companies and currently serves as a director of Dean & Deluca, Intacct, Market Wire, The Knot and Voltage Security. She is also a member of the Board of Trustees of the University of St. Thomas and is an advisor to numerous entrepreneur groups.

Aaron: Could you walk me through the story of Hummer Winblad and how you got into the VC business?

Ann: We started Hummer Winblad in 1989. Today, Hummer Winblad is on our fifth fund, which is a $420 million fund that we raised in 2001. We're about halfway through investing that fund. We have funded eleven new start-ups in the last fifteen months. I started my software company, Open Systems, the same year Microsoft started. John Hummer has been a career venture capitalist. John graduated from Stanford with an MBA and after graduating in 1980, joined a small venture fund called Glenwood Capital. I was toiling away building a software company from scratch through the late seventies and early eighties. Back then there was very limited venture capital to be obtained for the class of investments called software. Most of us starting software companies then didn't start them with much money, including Microsoft. Hummer Winblad became the first fund focused exclusively on software. We started our fund in 1989 and our first full year of investing was 1990. That year, there was less than $400 million invested in software in the entire United States. The attitude of investors at the time was that they did not want the assets of the business walking out the door at night. Unless there was a plant or inventory or some sustainable competitive advantage you could actually own as hard goods, investors weren't interested. Software was the Rodney Dangerfield class of investments. For me, the only choice was to do software investing, because that's where I'd spent my entire career. Today, we have seven partners and a Principal, so we have eight investing members in our firm. Most of our partners have actually run one or multiple software companies.

Aaron: What made you decide to come off the playing field and become an investor?

Ann: Well, actually I was very negative about the venture capital industry when John first approached me about raising a fund. Remember, the software industry didn't have much experience with venture capital. My software company, Open Systems in Minneapolis, had just been acquired by a Dallas based company. So I had just learned that winter was optional having recently moved to California. I did some consulting for Microsoft, Price Waterhouse and IBM. I wrote a book called Object-Oriented Software and John kept hounding me. Actually, I would say that John stalked me for about a year, and finally he hooked me. I became convinced that if I didn't do this with him, then he would do it with someone else, and I would forfeit my opportunity to be a pioneer in the venture capital industry. John understood what buttons of mine to push and he tapped my entrepreneurial orientation of wanting to be the first one into new markets. John neglected to tell me that when we went out to raise our fund, there had not been a new venture capital firm created for five years. So, we actually had 130 meetings to raise our first fund, which was a small $35 million fund. We fortunately invested in 16 wonderful companies, which included companies like Powersoft, Wind River and Hyperion, who were then called Arbor. We returned over 10 times that fund to our limited partners. We started out in a very difficult time in the software industry. I was very concerned that when we first started we had hit the innovation cycle at the wrong time. While we were raising our first fund it was a time very similar to the current bust cycle. Some venture capitalists concluded that economic forces had crushed innovation. They were wrong then as they were these last few years, which have actually been ripe for innovators to seize opportunities. When incumbents are encumbered, it's easier to get customers' attention. We were fortunate that while many early stage investors were licking their wounds, we were out there helping to create some strong software companies and helping to call attention to the entire venture capital industry that software was a robust investment category.

Aaron: How would you categorize the major changes that have occurred in the industry over your fifteen years in the business?

Ann: When we got into the business, it was at a time when it was really hard for people to find "A" round investors. There were very few angels out there, especially in our category, software. Most of the software companies were still quite young, so there was not much individual wealth to spread around to other software companies. All the wealthy individuals came out of other industries, like hardware or semiconductors, and they weren't sprinkling dollars on software.

If you leap ahead to 2000, things had gone completely out of control. People were walking into investors' offices with Powerpoint presentations and getting "A" rounds. "A" rounds were getting aggressively priced up as everybody was jumping into the pool as an early stage investor. You not only had an enormous number of angel investors, but you had a significant number of corporations doing direct investing for the first time. Money had become a commodity. It was very challenging for investors to add value with the pace of investment and the number of competitors at the starting line. The number of companies being funded significantly inflated the cost of talent, and not just the cost of people, but the cost of benefits for the people, the cost of real estate for the people. And, the natural economic efficiency of software companies was destroyed. We were all operating at an extreme competitive disadvantage.

If we then march ahead to 2001, the world stood still. Venture investing in all sectors went from $94 billion invested in 2000 to $36 billion in 2001, and that was not the end of the slide. 2002 was $21 billion, 2003, $19 billion and 2004, $20 billion. With that decline, there were fewer "A" round investors, which is good news. You want the selection criteria to be the toughest at the starting gate. The "B" and "C" round investors depend on us to spend time honing operating plans and opening doors to potential customers who can help these companies perfect their products as they fit technology to meet market needs. We are now back to a core group of early stage venture capitalists doing their job right. We can give fast no's, and slow yes's – meaning we can do an extraordinary amount of due diligence with companies before we give them their first capital. Today, there are fewer numbers of "A" rounds. If you look at the number in the Seed and "A" round categories, it only made up 21% of the $20 billion invested last year. But that number has been constant over the last three years. If you go back to 1998 and 1999, 40% of the deals were new deals. A lot of them went out of business because they had fast yes's vs. slow yes's. Over the last three years we have had the opportunity to exercise great discipline.

It still is very challenging to find the right ensembles, the right combinations of mature, seasoned executives and first-timers to build great companies, but there are not a ton of jobs at start-ups anymore, so those are now desired jobs. We are also seeing more and more start-ups go the distance, meaning they might get acquired, but they have had a chance to say yes or no to that acquisition. They are being bought, not sold. If I look at when we started our firm in 1990, we were serving a PC and server marketplace. Today, look at all the form factors that are computing devices. Additionally, with the newer software platforms that are able to deliver software on demand, we can now address not only the broader enterprise market, but also small and medium sized businesses.

Aaron: Changing themes slightly to talk about the management teams of emerging software companies, which executive positions do you regard as the most critical to bolster early in a business's evolution?

Ann: Well, in 80% of the cases in the early stage and seed stage deals, the team does not come with a CEO. That has not changed. The core position is of course the CEO. The primary job of the Board of Directors is to hire and judge the performance of the CEO. If he/she is not performing, you have to fire the CEO. If you walk around "Venture Land," and someone is feeling bad about a deal, it is usually because they have the wrong CEO. Getting the right CEO into these young companies makes an extraordinary difference, and that CEO does not necessarily have to be one who's done it before. One of our great CEOs is a young guy named Sathvik Krishnamurthy, who runs a company called Voltage. This was a start-up that we funded with Morgenthaler in 2003. They have done extremely well. Sathvik is a first-time CEO. When we picked that first timer, we also recruited an experienced CEO, Srivats Sampath, to be on the Board. Srivats was at Netscape and was the Founder and CEO of McAfee. So we have helped Sathvik build a team, but we helped find someone who is a few years ahead in their career to serve on the Board of Directors so he can have someone to turn to for advice.

Aaron: Looking beyond the CEO, what other positions are most critical?

Ann: The Vice President of Marketing is certainly one of the critical roles. Whenever the sales guy says, "We can't sell it without these features," or the engineering guy says, "We want to build this other feature," the VP of Marketing needs to say, "Wait a second, let's listen to the customer." The Marketing guy keeps the strategy on course, creates the climate for Sales, which means he or she weathers the storm between Sales and Engineering. Strong marketing people are extremely hard to find. In fact, at Voltage we brought the Marketing person on before the CEO because we found the right guy. In the Silicon Valley, we are getting more and more people who have had classic strategy training; who have climbed the product management ranks in larger companies. It's a fact that you don't position yourself as a company, the market positions you. But it is also extremely challenging if you don't have a clue how the market perceives your product, and you are not driving the company strategically. It's been a myth in Silicon Valley that the

Marketing guy is a PR guy. The Marketing person as a PR or advertising person has traditionally been the entrepreneurial view of the Marketing position. But that is not a strategic view of Marketing.

I don't worry as much about Engineering because the quality of the Engineering leadership in the valley is high, and many of us at some point in our career have run Engineering. So we not only know who to hire, but we know how to fail.

The other job that is overlooked is the senior Finance role. Often the pennywise but pound-foolish decision is made. Every partnership says, "You know, we can put off hiring a Finance person. We don't need one of those people yet." It is true that numbers aren't strategy, but they tell you whether your strategy is working, and we push very hard to get a Finance person at least at the VP Finance level into companies earlier vs. later. In today's world, you cannot wait until the eleventh hour. You have to be building the foundations for operating in today's new public market reality earlier vs. later. It used to be that companies would fire the VP of Finance and go out and hire a top gun CFO when they were ready to go public. Well, those top gun CFOs don't want those jobs anymore. They want to have lived at that company for years, because they're going to have to file a piece of paper every quarter saying that they know everything that's going on in that company. We have an obligation now more than ever to get it right at the starting line, especially if we're looking toward a potential IPO.

Aaron: From what you've seen, which of these positions tend to produce the highest yield in terms of cultivating future CEOs?

Ann: I'll use Sathvik Krishnamurthy, the CEO of Voltage, as an example, again. He started in the Engineering function. He has a Computer Science degree, so he really understands the science of what the company is building. Over his career, he moved into Product Management, and then Marketing. He ran Marketing at a company before we recruited him to be the CEO of Voltage. So he has had the natural progression of being a product builder, then having the responsibility of bringing a product to market, and then having to work under a CEO to help guide the product strategy, the strategy of pricing the product, the strategy of launching the product, the requirement to stand in the middle of a hard-charging Sales organization that has one set of demands and an Engineering team that has another. So we do see moving from Engineering through the Product Marketing ranks as one route. The other is the revenue route. There are another set of folks who have touched Engineering, so they know what the products are. They may not have a Ph.D., and they may not have been the best engineer, but they know how products are built. They, however, chose to come up through the revenue route in Sales.

Aaron: We hear lots of talk about there being differences between East Coast and West Coast, from both an investment perspective as well as an operating perspective. Do you see these differences?

Ann: Well, I'm on a couple of East Coast boards now and over our history, we have been on a number of great East Coast Boards. Everybody likes to find likeminded investors at the early stage. That does not mean you operate the same way. It's actually great to have different lenses on a company, so you don't accidentally lead the company into the wrong areas. By likeminded, I mean, you know what work has to be done, you know how important the CEO is, you know how to work through trouble spots for the company, which may even mean replacing or bringing in talent, you know to work together each time a company has to raise capital, and you have a long term view on companies. You have patience in building companies the right way, and impatience in other areas.

We syndicate about 80% of our "A" round deals because it takes a lot of work to get a company started. We tend to work more with West Coast venture capital firms because we're here. Most of our deals are within driving distance, some within walking distance. That's why you tend to have co-investors that are geographically close. I don't see so much the difference in styles at all. We have tremendous respect for companies like Greylock which is a great firm on the West Coast as well as on the East Coast. Atlas is great everywhere, Battery is great everywhere. Oak is a tremendously good East Coast venture firm, and we love doing deals with them. The list of great East Coast firms is quite substantial. So I do think it is more about the individual people you work with on early stage deals and knowing that you'll have a Board that will work well together. We carefully choose the partners that are going to be on the deals based on who will work best with the entrepreneur and with the co-investor. You want to maximize success, and that requires you to put your ego aside. Even if you're a Partner that brings in a deal, you have to look very carefully and ask, "Am I the right Partner to be on that Board? Am I the right Partner to work with the Co-Investor, to work with the CEO, to open the most doors, to recruit the best team, to really bring the experiential surround sound to this company in the best way?" All good investors think that way. I think this East/West thing shows up more in computer bowl games than it does in reality.

Aaron: What role do large companies play in fueling entrepreneurship? Is it as investor, is it as developers of talent, is it as potential acquirer, purchaser or customer?

Ann: The large company role is not as investor, although some of the big companies do have investment arms. Most of the large companies out here do have groups that actually work closely with selected venture capital firms. IBM has a large group of people out here that doesn't make investments, but they work very closely with the venture capital industry. They bring their executives around to meet select venture backed early stage companies. Microsoft has a large group out here that does the same thing. Cisco sends their CIO out quarterly to meet with venture capital firms. They keep track of our companies and when they see an interesting company, they actually work with that company to help guide the product to market. SAP has just established a group to be their outreach to the venture community. Siemens also has a very active venture and partnership outreach program with early stage companies. These companies want to make sure, especially with the early stage venture capital firms, that innovation doesn't get away from them. Most of the businesses that these companies end up acquiring are ones they have known for a long time. The VC world serves, in many ways, as R&D for the entire technology industry. It becomes very competitive amongst the big companies to get the attention of the small number of "A" round investments on the starting line. It is interesting to watch the competitive nature of the large companies as they seek the attention of the smaller companies.

Aaron: What about from a talent perspective? Are there large companies that historically do a better job of producing entrepreneurial talent than others?

Ann: Well, there's a bunch of myths out there. There are some companies that have such strong cultures that you usually want to see the entrepreneur to have had one job somewhere else before you hire them in a start-up. Those strong cultures are pretty well known. We have Microsoft alumni, we have HP alumni, we now have a lot of BEA alumni. If a large company fatigues, and they start under-achieving, and they've hired over-achievers, those over-achievers start looking around and we pounce on them. This has been a challenge for a number of companies out there, like BEA. Some extraordinary people came out of BEA as that business is moving toward a more mature phase in its cycle. That was a company that hired over-achievers and nobody waited for them to take their second job. The first time BEA missed their numbers, we were all over those over-achievers. We have to hire for high performance, but we also have to hire for adaptability. BEA was a company that was formed through a lot of acquisitions; therefore most of the people there were high achievers who were also adaptable. Microsoft also hires high achievers. If Microsoft's culture, which is a great culture, is the same culture as your start-up, you're going to have a perfect fit. But just like HP, which has "the HP way," we usually wait for those HP and Microsoft alumni to have a little time out of that saddle so they learn what the rest of the world is like. Most of us can't operate like Microsoft. It's a unique culture, a unique business model, with unique high performance returns. The reality of learning what it's like to work with fewer resources in a smaller company takes some time. We love recruiting out of the Oracle sales organization. It is a high performance sales organization, has been from day one and still is today. Any time an Oracle high performance salesperson leaves, the venture industry is on them. In fact, many of the leaders in the industry have come out of that Oracle Sales organization. Right now, it's a very distributed industry, and there are many great companies and it's really hard to dislodge great people out of great companies.

Aaron: What about the global market for talent?

Ann: We are still dependent, here in the U.S., our own economy, on home growing great engineers, however, we're not graduating as many engineers. In fact, China graduated five times more engineers than the U.S., the U.K., and Germany combined. We have a problem with visas. If you look at people who are running our companies, many of them came here on visas. Now we can't get these people into the country, into our universities. The student visa situation is grim, and getting grimmer. So many of our MBA program slots and engineering program slots are going unfilled because they used to be filled by people coming from around the world for our great education. Now we don't let them in. We have other systemic issues. Our eighth grade education in math and science, out of the top 40 countries, ranks below number 35. So we are facing a big problem heading into the future. We're at a time where we're competing in a very robust global economy. As a result, many of our companies are globally distributed from the start, because that's where the talent is. We have companies that have engineers in Vietnam, Jordan, India, and China, and they do from the start. We have had to learn as venture capitalists how to manage globally dispersed companies, how to judge the quality of their talent, and how to manage globally dispersed talent. More than ever, we are looking for those skills in our CEOs and in our Engineering leadership as well. It's less about how to squeeze talent out of the local incumbents, as it is finding where talent going to come from in the long term and how we look at how we want to construct these companies. How early must they be globally dispersed, and what does that mean for our leadership skills?

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