

VentureEdge

EUROPE

1H'05 | €150

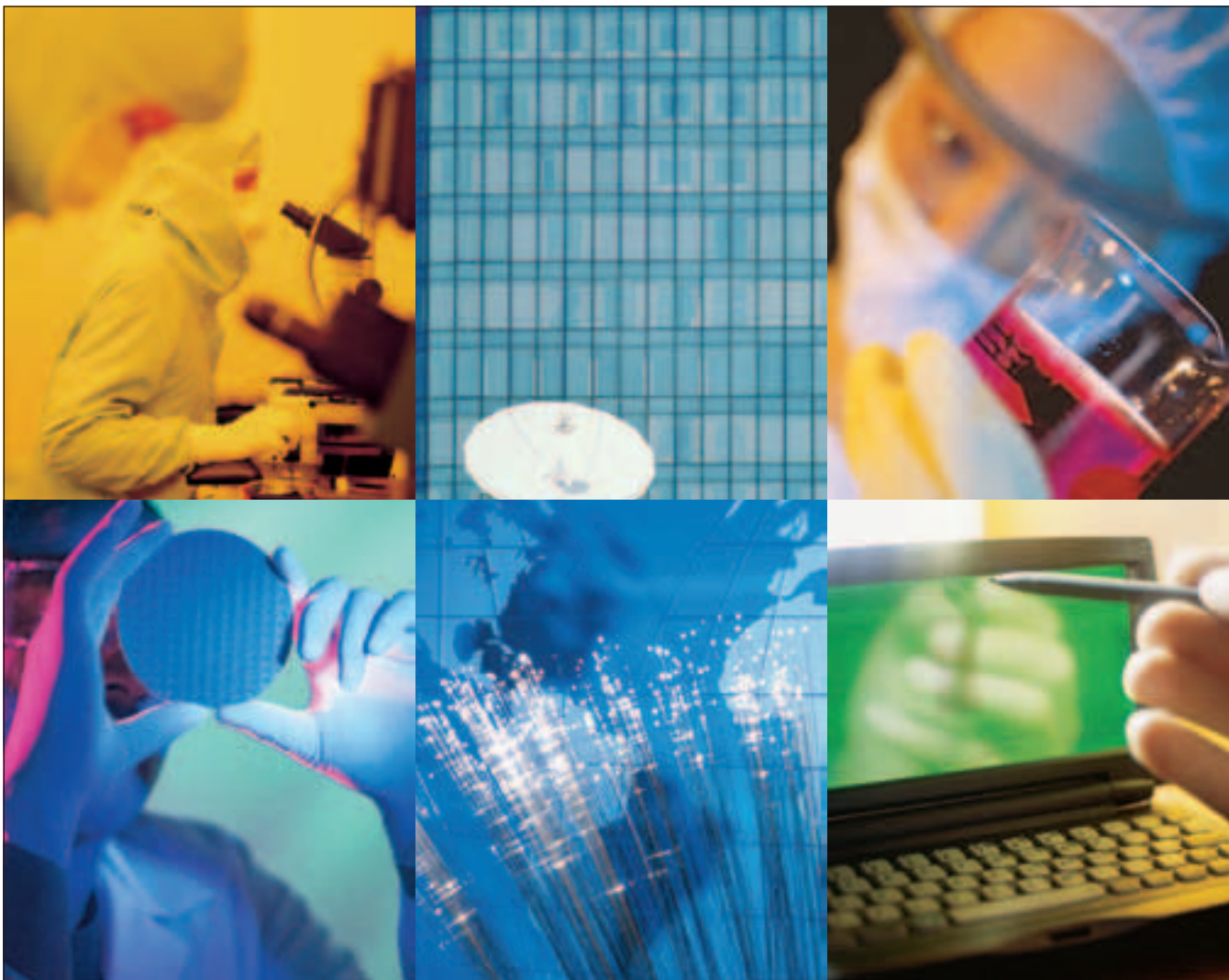


1H'05

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“The way I see it, if you want the rainbow,
you gotta put up with the rain.”

—DOLLY PARTON (1946—)

To date, 2005 has been a mixed bag for the European venture capital industry. With exits, there has been a small but significant IPO window for the most promising European entrepreneurial companies, although these exits are taking longer to achieve. The environment for fund raising has also improved, with more money raised by venture firms in the first half of 2005 than the whole of 2004. However, venture capitalists are deploying less money this year than last, and financing fewer companies. The pace of deals has declined 29 per cent compared to this point last year, and the amount of investment is down 13 per cent.

Neither the U.S. nor Israel have yet seen deal flow levels match the levels set in the first half of 2004. Israeli investments is off by approximately \$84 million from this point last year. U.S. investment is off by about \$1 billion. While 2004 seemed to be a year of rebuilding in the worldwide venture capital industry, investors in 2005 have so far been more circumspect. Early stage investing has fallen off in favor of supporting existing portfolio companies. Later stage investing in the U.S. climbed in the second quarter, reaching its highest level in four years. In Europe, the percentage of the total investment going into later stage deals rose to 50% in the first half of this year, up from 39% at this point last year.

The focus on later stage may be the result of the liquidity climate in Europe, as investors finally see some exit opportuni-

ties for older portfolio companies. New exchanges aimed at smaller entrepreneurial companies in Europe and the maturing of AIM have improved opportunities for companies to seek public market exits. Twenty-one European venture-backed companies completed initial public offerings in the first half of the year, the most that have occurred in the first half of a year since 2001. The median pre-money valuation for these companies at IPO was €57.3 million, the highest level since 2000. The median time from initial equity funding to exit was more than five years (compared to less than one year in 2000). Other than IPOs, however, the exit market slowed in the form of mergers and acquisitions. Only 70 have been completed so far this year, compared to 94 in the first half of 2004. But the median amount paid for these companies has increased to €25.7 million, up from a median €17.8 million in 2004.

Amongst the mixed signals from the statistics on investments, fundraising and exits, the underlying pattern appears to be a flight to those investors or investees with an established track record. While there are fluctuations from quarter to quarter, it appears that the European market has found a new post-bubble equilibrium in terms of the amount invested. Since the start of 2003, only two quarters have had investment outside of the €750 million to €950 million range; this investment continues to be focused on fewer entrepreneurial firms as investors seek the elusive pot of gold.

STEPHEN HARMSTON-GREEN
Director, International Research
Dow Jones VentureOne

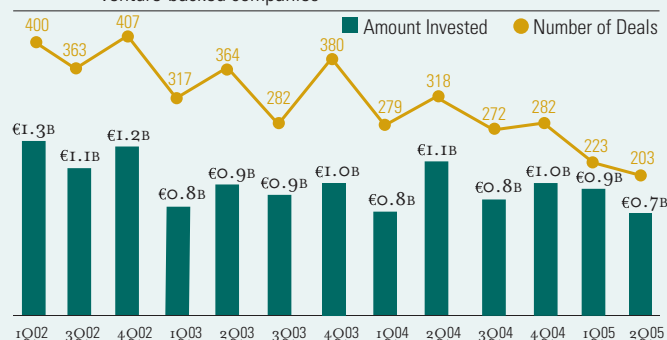
1H'05

The European venture capital market saw signs of improvement in terms of liquidity in the first half of 2005, particularly in the second quarter when 14 venture-backed companies completed initial public offerings, raising a total of €313.5 million, an increase of 139% over the amount raised in the same quarter a year earlier (€130.9 million). This improvement came on top of seven IPOs in the first quarter, which raised €253.9 million.

However it remains to be seen whether the good news about liquidity will be enough to restore investors' confi-

"Without innovation, no entrepreneurs; without entrepreneurial achievement, no capitalist returns..."
—JOSEPH A. SCUMPETER (1183 - 1950)

Figure 1: Number of deals and amount invested in European venture-backed companies



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

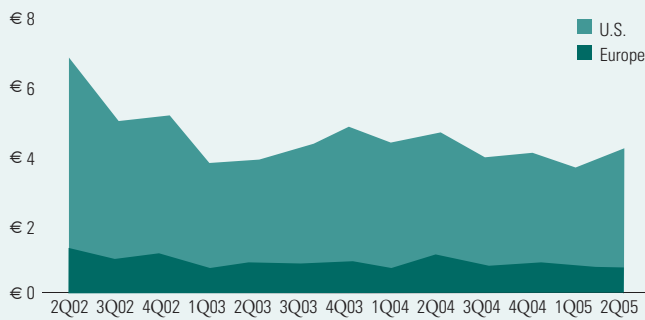
dence for future financing in Europe. Of course, investors only build firms large enough to advance to successful exits. So far for 2005, European venture capital investment has been on a slower pace than last year. At the end of the first half of the year, capital investments reached €1.66 billion, off the pace of the €1.87 billion raised at the half year mark of 2004, and lower even than 2003 levels. Deal flow in 2005 has also decreased, with 426 financing rounds for the first half—a 29% drop in activity from last year.

Despite the declining number of deals, a few important trends are in evidence in 2005. Among them, an increase in later-stage rounds, which represent 40% of all deals occurring in Europe in the first half of 2005. That compares to 32% of the deals in the first half of 2004. The focus on later-stage activity is, of course, coming at the expense of early stage and second round deals. Early stage deals grew steadily during 2004, ultimately making up a third of all deal flow in Europe last year. So far this year, early stage deals are representing about 30% of the completed rounds. Second rounds

Figure 2: Largest venture capital deals in Europe (3Q04-2Q05)

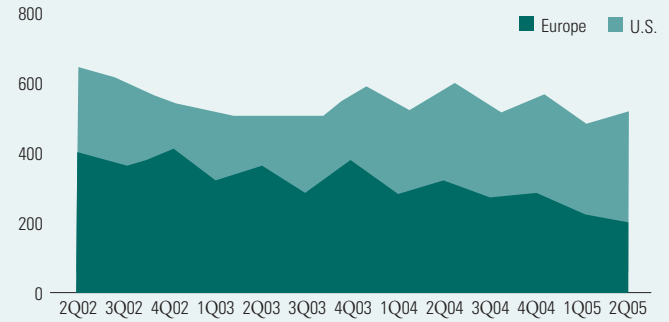
Company Name	Country	Close Date	Raised (€M)	Company Description
Oxagen	United Kingdom	23/05/05	€ 46.20	Provider of advanced genetic analysis.
Arakis	United Kingdom	31/08/04	€ 43.26	Researcher and developer of therapeutics based upon existing drugs and drug templates.
Novoxel	France	01/12/04	€ 40.00	Developer of antibacterial and antifungal agents to treat severe and difficult infections.
ProStrakan Group	United Kingdom	25/10/04	€ 31.80	Provider of prescription medicines for the treatment of unmet needs in major markets.
Neuro3d	France	20/12/04	€ 31.50	Developer of novel psychopharmacologic and neurologic drugs.
Speedel	Switzerland	22/02/05	€ 30.83	Provider of therapies for cardiovascular and metabolic diseases.
Wilex	Germany	10/05/05	€ 30.00	Developer of novel biopharmaceutical therapies for tumors, including renal and breast cancer.
Biolipox	Sweden	21/12/04	€ 30.00	Developer of therapeutic compounds for use in the treatment of respiratory diseases.
Zealand Pharma	Denmark	07/01/05	€ 26.30	Developer of therapeutic drugs which can improve the treatment of severe diseases.
Level 5 Networks	United Kingdom	20/06/05	€ 24.68	Provider of semiconductors and software focused on high performance ethernet connectivity.
CSG Solar	Germany	26/01/05	€ 24.00	Developer of thin-film solar module technologies.
Newron Pharmaceuticals	Italy	21/02/05	€ 23.00	Developer of small molecule drugs for the treatment of central nervous system diseases.
BioXell	Italy	20/10/04	€ 23.00	Developer of therapeutics for urological and chronic inflammatory disorders.
In-Fusio	France	04/08/04	€ 22.50	Provider of mobile games services to wireless operators.
Dansk Bredband	Denmark	03/11/04	€ 22.40	Provider of high-speed broadband connections to private homes and small companies.
Nations Healthcare Limited	United Kingdom	31/12/04	€ 21.60	Operator of independent sector treatment centers (ISTC) in the UK.

Figure 3: Equity into venture-backed companies, Europe vs. U.S. (€B)



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 4: Number of Venture Capital Deals, Europe vs. United States



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

are making up only 24% of the deals.

The median amount of capital invested in later rounds also increased significantly, reaching €3.1 million at the first half of the year, about €1 million higher than it was a year ago. This indicates that investors in Europe are directing substantial sums to those companies considered to have the most promising potential for exit. Larger round medians are apparent for early stage and second rounds. In the first two quarters of 2005, the median amount invested in a first round of financing was €2 million, up from the €1.25 million median for 2004. For second round financings, the median amount invested in a round was €2.3 million, up from €1.6 million last year.

On the other hand, seed and first round deals represent only 32% of the deal flow in the U.S. in 2005, but represented 34% in 2004. In addition, \$1.96 billion was invested in these rounds at this point in 2004, compared to \$1.67 billion through the first half of this year, a 15% decrease.

Interestingly, products and services companies, which includes a number of Internet-related firms, saw the largest percentage of early stage deal flow so far in 2005, with 36% of the rounds made up of seed and first round deals. In fact, there have been 50% more early stage product and services deals than there were in the first half of 2004.

As with last year, the percentage of second round deals continue to decline, representing just 20% of all completed rounds in 2005 so far. This may be a result of fewer initial deals being completed during the last few years, leading to a dearth of companies in line for second round financings.

While liquidity options in the form of initial public offerings and mergers and acquisitions in the U.S. opened up slightly in 2004, they remain slow in 2005 and have yet to return to the levels of the last decade, causing investors to proceed cautiously as they consider their investments' ultimate exit potential.

Within the U.S. venture capital market, information technology still represents the majority of financings, with 59% of the deal flow thus far this year. In total, \$5.63 billion has been invested in 598 rounds through the first half of 2005. However both IT deal flow and investment are off the pace of 2004 levels; \$6.44 billion had been invested in 693 financing rounds at this point last year. Within the IT category, communication deals have held steady with last year, reaching 125 financing rounds and \$1.54 billion invested to date.

U.S. healthcare companies are also trailing investment levels from last year. So far, \$2.50 billion has been invested in 219 deals. In comparison, 259 deals had received \$3.62 billion at the half-year mark in 2004. Within the category, healthcare services companies are holding steady with 16 deals and \$172.4 million invested, approximately the same as last year. So far this year, healthcare financings make up about 22% of the market's deal flow, compared to 24% of the deal flow last year. In terms of capital, healthcare companies have received about 25% of the amount invested thus far this year, compared to 32% last year.

One bright spot for the U.S. venture capital market is products and services companies, which have received \$1.58 billion invested in 146 financing rounds through the first two quarters of the year. This represents an increase of six deals

"The question for VCs remains a fundamental one of risk appetite and global ambition — frankly, fear vs. greed"

—RAPHAEL GRUNSCHLAG, DIRECTOR OF INVESTMENT BANKING, MERRILL LYNCH INTERNATIONAL

Europe vis-à-vis the U.S.

U.S. venture capital investment has also slowed in 2005, although not as dramatically as in Europe. In the U.S., \$10.1 billion has been invested in 1,012 deals through the first half of 2005. Deal count is off about 9% from this point in 2004 and the amount invested is about \$1 billion below the \$11.2 billion invested in the U.S. in the first half of last year. On a quarterly level, investments in the U.S. were slow in the first quarter of 2005, but picked up by the second quarter, although still did not match the investment levels of 2Q'04, which was the highest investment quarter in the past 10 quarters.

As in Europe, U.S. investors have focused on existing portfolio companies with later round deals capturing a considerable portion of activity so far this year, particularly in the second quarter. In fact, the \$5.48 billion invested in later rounds thus far in 2005, is 15% higher than the amount of capital directed toward later rounds at this point last year. Later rounds are currently making up 40% of the deal flow in the U.S., compared to 36% last year.

from the same period last year, and 57% more capital invested. The largest U.S. deal so far this year was in this category—the \$320 million investment in Integro (New York, NY), an insurance provider. This was also the largest venture capital investment since 2001.

Over the past few years the amount invested into European entrepreneurial companies has run at about 20% of the amount invested into U.S. entrepreneurial firms. In 2005 so far, this drifted upward to about 21%. The long-run disparity in terms of amount invested is a function of the relative newness of the European venture capital industry, which has lower visibility amongst institutional investors.

With regard to the number of transactions, Europe hit a historical peak in 2Q'01, when deal volume was 86% of that in the U.S. By the end of the first half of 2005, European companies have completed only 42% as many rounds as their U.S. counterparts. This remains low compared to historical levels, indicating that there is more room for short-term growth in the European market in terms of number of deals completed.

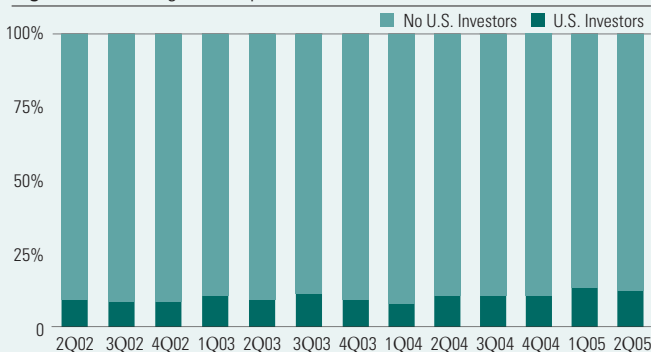
With 42% of the deals but only 21% of the money, European entrepreneurial companies continue to receive, on average, much smaller investments than their U.S. counterparts. This is a function of the relative size of venture capital funds in the two markets. The greater maturity of the U.S. market, and its larger returns to limited partners, has led to wider acceptance among investors such as pension funds and foundations. This has driven up the median venture capital fund size, which, in turn, has pushed up the average deal size. Other aspects being equal, this puts European entrepreneurs at a disadvantage.

Beyond Europe, Israel, and the U.S., investors are also considering their Far East investment strategy. The year 2004 may well be remembered as the "year of the trip", as increasing numbers of investors ventured to China and India to explore the burgeoning investment opportunities there. The investment level in Asia appears poised to increase significantly in the next few years, beyond the estimated 9% of global investment which it currently receives.

"We are likely to witness some consolidators emerging from Europe, and also participation by Indian and mainland Chinese players."

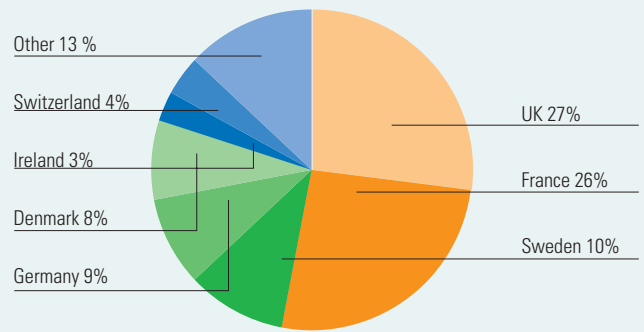
—RORY O'SULLIVAN, MANAGING DIRECTOR,
SARDIS CAPITAL

Figure 5: Percentage of European Deals with U.S. Investors



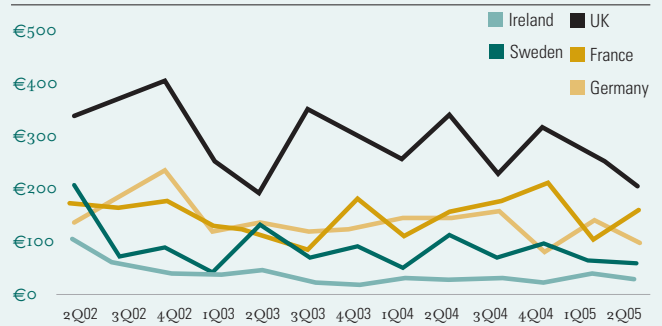
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 6: 1H05 European Venture Capital Deal Flow by Country



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 7: Equity Investment in Europe for Major Countries (€M)



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Individual Country Perspectives

After holding steady in 2004, European venture capital investment faltered slightly in the first half of 2005. For the first two quarters of the year, €1.66 billion has been invested in European companies, an 11% decline from the €1.87 billion invested in the first two quarters of 2004. Deal flow has dropped further: the 426 deals are about 29% fewer than the 597 deals posted in the first half of 2004 in Europe. Both deal flow and investment have steadily declined since the fourth quarter of 2004.

The relative slowdown in the number of deals completed compared to the amount invested is to be expected and is a trend that could well continue. Many European venture firms have been discussing the need to invest more money in fewer companies in order to enable European entrepreneurs to compete with their counterparts in the U.S. Historically, average round size has been much lower in Europe, which has constrained the growth rate of European firms.

The U.K., which often bucks the trend of the rest of Europe, was complicit in declines so far this year. Deal flow dropped off sharply in the first two quarters of the year in the U.K., reaching only 120 at the half-year mark, a 33% decline from last year. The capital invested also faltered in the U.K., particularly in the second quarter of 2005. After holding steady in the first quarter with last year's first quarter investments, the second quarter dropped to a quarterly low of €206.5 million, bringing the half yearly total to €472.4 million, a 20% decline from this point in 2004.

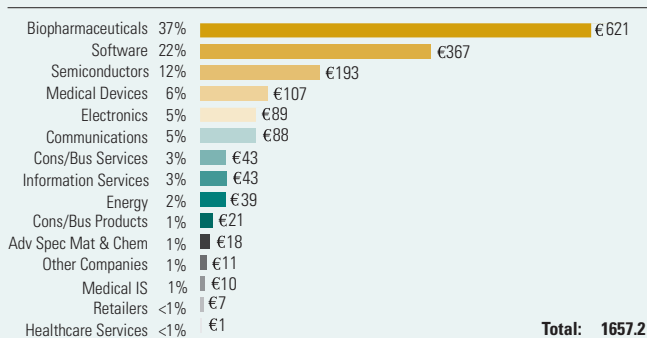
For Europe as a whole, the quarterly investment progression also slowed between the first and second quarter. In the first quarter, investments of €921.6 million actually represented a 23% increase over first quarter 2004. However in the second quarter, total investment fell to €735.6 million, a 34% drop from the same quarter a year earlier.

Part of the reason for the fall in activity in the U.K. and

Figure 8: 2005 European Investment Geographic Analysis (€M)

Countries			
Northern Europe	Denmark	17	€ 64.94
	Finland	4	€ 7.27
	Iceland	1	€ 0.53
	Norway	4	€ 19.98
	Sweden	20	€ 61.95
Northern Europe Total		46	€ 154.67
Western Europe	Austria	1	€ 2.10
	Belgium	6	€ 5.13
	France	53	€ 159.57
	Germany	18	€ 97.63
	Ireland	7	€ 27.37
	Italy	2	€ 22.00
	Netherlands	4	€ 25.24
	Portugal	2	€ 13.94
	Spain	3	€ 1.29
	Switzerland	8	€ 20.11
	United Kingdom	53	€ 206.54
Western Europe Total		157	€ 580.92
Grand Total		203	€ 735.59

Figure 9: 1H05 European Investment by Industry (€M)



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Europe as a whole appears to be a second quarter slowdown. Over the course of the first quarter of 2005 the behaviour of the four largest venture capital markets in Europe was fairly steady. The U.K., France, Germany and Sweden also saw larger investment levels in the first quarter of 2005, compared to the first quarter of 2004. But by the second quarter, only France was holding on to that lead as the three other countries saw investment levels decline.

The French market saw investments increase quarter over quarter throughout 2004, growing from €113 million in the first quarter to €214.5 million by the fourth quarter. In 2005, the pattern may be repeating as investments increased from €120.9 million in the first quarter to €159.6 million by the second quarter. As a result, although the total number of deals in France declined by four between the first half of 2004 and the first half of 2005, the amount invested increased by 4% over that time period.

Although the U.K. still maintains the highest amount invested and market share (29%), France, whose market share increased to 18% in 2004 and is holding fairly steady this year, appears to be well-positioned for entrepreneurial activity in the European venture capital arena.

As for Germany, deal flow declined 36% in the first half of the year with 46 deals. The amount invested has not fallen

as sharply: 15% to €244.5 million. Given the overall downward trend, Germany's market share remains flat at 15%.

Sweden remains the fourth largest venture capital market, with €129.1 million invested in 40 financings thus far this year, declines of 20% and 49%, respectively. Its deal count is almost on par with Germany this year. Among other countries, Denmark has seen a significant increase in investment with €142.4 million, a 21% improvement from the first half of 2004, although there were 10 fewer deals. Ireland also posted investment gains, with €70.9 million invested, an increase of 26% from the same period last year, although with three fewer deals, bringing the half year's total to 15.

The U.K. still accounts for the biggest share of the market both in terms of amount invested and number of deals. Germany's disappointing performances thus far this year, coupled with France's new vigor and the varied investment levels in Ireland, Sweden, Switzerland, Denmark, and Norway point to the possibility of investment being more widely spread across the major venture markets in Europe. However it is important not to read too much into quarterly patterns, and too early to say whether this will mark the beginning of a long-term challenge to the U.K. dominance in favor of a more balanced distribution of investment.

"Because the supply of capital for early stage IT deals in Europe, especially those with significant technology risks, appears to remain relatively constrained, we've continued to target this kind of investment."

—GEORGE POWLICK, MANAGING DIRECTOR,
DOUGHTY HANSON TECHNOLOGY VENTURES

Major Venture-Backed Industries

While investments declined among all major industries in Europe, investment into healthcare companies, bolstered by biopharmaceutical deals, held relatively steady in the first two quarters of the year with €738.2 million directed toward the category thus far. The total number of healthcare deals to date in 2005 stands at 127, down by 25% from the 169 posted in the first half of 2004.

Information technology investment has regained some ground. While the number of amount declined 6% from first half 2004 levels, with €779.5 million invested so far this year, it has once again surpassed healthcare investment after falling behind it in late 2004. Technology deals fell further, however with 231 so far this year, down from 313 at this point last year.

IT regained some of its dominance in terms of total amount invested. In the first half of 2004, IT was responsible for 44% of the total capital invested in Europe, but in 2005 represents 47%. Healthcare's share has also grown proportionately, from 41% in the first half of 2004 to 45% this year. This appears to come at the expense of investment in products and services companies, which represent just 4% of the total investment in 2005, compared to 8% last year.

The products and services category, which includes many Internet-related companies, remains only a small portion of investment activity in Europe. The category was able to attract only €72 million in investment so far this year and deal count was down 40%.

Healthcare Investment

Since 2000, healthcare firms, unlike those in other sectors, have not witnessed as drastic a reduction in financial backing. While venture investments in IT and products and services sectors have declined 88% and 98% respectively from the same period in 2000, healthcare investment has declined only 18%. One reason for this is that venture capitalists investing in healthcare companies recognize these companies require a longer investment cycle and are therefore financially prepared to support them for several years. If healthcare investment requires more patience and arguably more money, investors know that the risks involved can be worth taking. Its intrinsic lure has also been augmented by the active life sciences IPOs in the U.S. last year, and by recent life sciences IPOs in Europe.

Shorter term, the decrease in the number of healthcare financings in the first half of this year was fairly consistent across the industry's segments, which all posted fewer deals. However, larger biopharmaceutical investments pushed the total amount invested in this segment up to €620.7 million in the first half of the year, a slight increase from a year earlier—and the only healthcare segment to post a half yearly increase in investment. The number of biopharmaceutical deals were down by 18. The other major healthcare category—medical devices—posted 37 deals and €106.9 million invested, which is 13 fewer deals than last year's half year count, and 28% less capital invested.

Healthcare was home to the largest deal so far this year, the second quarter's €46.2 million later-round investment in Oxagen (Abingdon, U.K.), a firm that analyses genetics for inflammatory and metabolic diseases.

Information Technology Investment

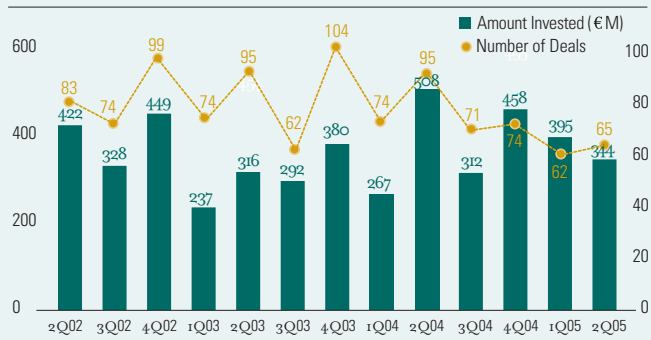
The IT sector saw a decrease in both investment and deal flow. Overall, there were 26% fewer IT deals and 6% less capital invested in the industry. The half-year totals were €779.5 million invested in 231 deals.

Software investment continues to account for the lion's share of IT investment with €367.2 million and 127 deals, or 55% of all IT rounds through the first half of the year. There was a slight rebound in investment in the electronics sector, with 8% more capital invested to reach €88.9 million, while deal flow held steady at 38 deals in the first two quarters. This is the first time that investment in the electronics segment has surpassed the communications segment. The communications segment had 32 deals and investment of €87.8 million, a decline of 49% in deals and 65% in capital.

The information services segment saw two fewer deals, but 70% more investment, bringing the half yearly total to €42.8 million for the segment. While the slight resurgence of interest in information services was noteworthy, long gone are the days when information services accounted for almost one third of the total amount invested in the IT sector.

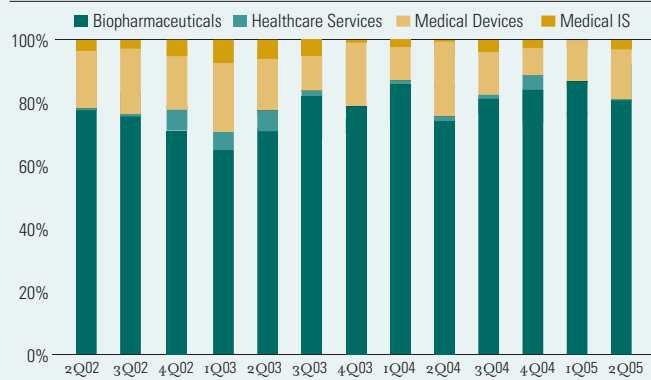
The semiconductor segment was the only IT segment to report an increase in investment in the first half of 2005. In total, €192.8 million was invested in 25 semiconductor companies so far this year. Although that is two fewer deals, the investment level represents a 172% increase from the same period of 2004. Perhaps not surprisingly, the semiconductor segment also registered this year's largest deal in IT: a €24.7 million second round investment in Level 5 Networks (Cambridge, U.K.), a chipmaker focused on high performance ethernet connectivity.

Figure 10: Venture Capital Investment in European Healthcare Companies



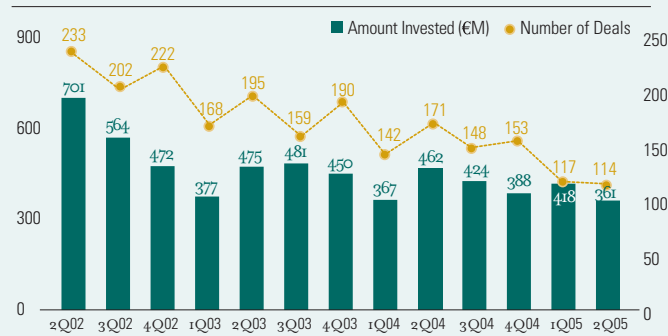
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 11: European Healthcare Investment Allocation by Sector



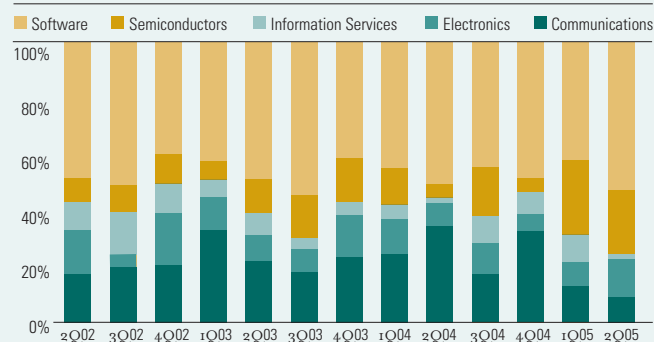
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 12: Venture Capital Investment in European IT Companies



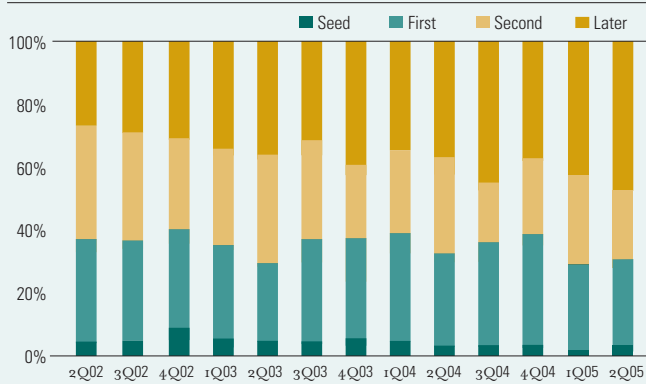
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 13: European IT Investment Allocation by Sector



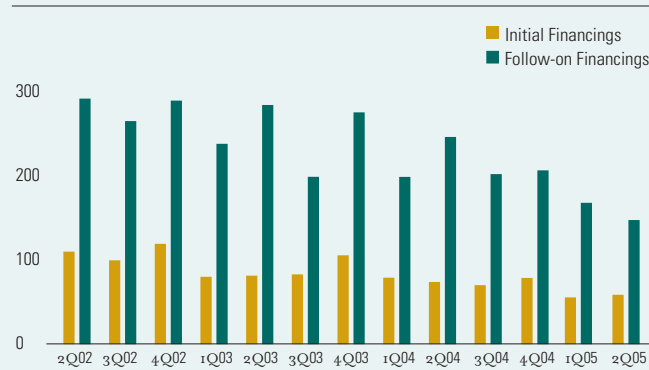
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 14: European Deal Flow Allocation by Round Class



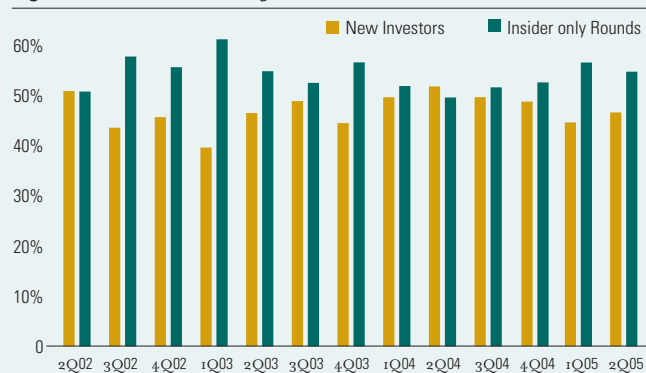
Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 15: Initial vs. Follow-on Financing Rounds



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 16: Follow-on Financing: Insider vs. New Investor Rounds



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Internet Investment

As the Internet is a means of doing business rather than an industry category, VentureOne does not track Internet-related deals as a separate industry grouping but instead assigns a dimension to companies with one of the following Internet components: business services, content, e-commerce, infrastructure, ISP, and software/database.

Currently, as a percentage of overall European venture investment, Internet-related investment is far less significant than in previous years. In 2000 it accounted for 76% of total investment, whereas in 2005 it has fallen to about 28% (or €456.3 million).

In the first half of the year, however, two sub-sectors—online services and software/database related Internet busi-

ness saw modest increases in investment levels. Investment into online services in the first two quarters of the year increased 3% to €72.7 million whilst investment in software/database businesses increased 18% to €383.9 million.

“We are living in Darwinian times: some of the older more established venture funds are failing to achieve fund raising targets.”

—PAUL HARVEY, PARTNER, ATLANTIC BRIDGE VENTURES

Later Stage Activity

The concentration on later stage investments seems to have returned in 2005. Later stage deals made up 40% of the rounds completed in the first half of the year—the largest percentage in the past five years and a considerable shift from the 1999 and 2000 time frame, when later stage deals represented only 10–12% of financing rounds in Europe. For the comparable period for 2004, later stage deals represented 32% of the financing rounds.

In terms of investment, later stage deals are also taking a larger representational percentage of the capital, about 50% of the investment in the first half of the year. In comparison, it was 39% at this point last year. Again the greater focus on later stage investing is historically significant, as it is the largest percentage of venture capital directed to this round class since before 1999.

The overall switch from early stage to later stage investment is a natural part of the venture capital cycle. The success of venture capital in the U.S. in the 1980s was driven by the large flows of money invested in early stage projects in the late 1970s and 1980s. Similarly, the early 1990s saw a concentration on later stage deals as investors picked up on the large flow of previous early-stage investments.

This phenomenon has both positive and negative drivers. In some respects, venture capitalists have little choice but to concentrate on later rounds. The significant spike in investment in the late 1990s and 2000 spawned a huge number of venture-backed companies. Combined with the contraction of the IPO and M&A markets, this means that venture capitalists face stark choices. Although exit markets are beginning to improve, many companies still require a large pool of money to see them through to an exit opportunity. However, because raising new venture capital funds is difficult, venture capitalists must make tough decisions about where their remaining funds are allocated. Each portfolio must have some successes—otherwise the firm will not generate the returns necessary to convince limited partners to re-invest. Thus, venture capitalists must conserve cash to support their most promising portfolio companies through to successful

“Investors are refusing to back inferior performance”

—KEVIN DILLON, PARTNER,
ATLANTIC BRIDGE VENTURES

exits. Investors must also factor in returns. Investing at the early stage may yield potentially higher returns, but investing at the later stage may result in a shorter turnaround for returns – both of which impact IRRs.

In 2004, there were signs that the pendulum was swinging in the direction of early stage investing. But in 2005, for most investors, it appears the risk/reward trade-off is more compelling at later stages. Companies that have already raised multiple funding rounds are likely to have well-developed technologies and may even be at or approaching profitability (although this is more likely in IT than in health care). The risk involved in investing in these companies is much lower than for seed or startup companies. At the same time valuations have been increasing for later stage deals, reducing the long-term potential gains from later stage investment. There is an argument within the industry for investing at earlier stages in a firm's development, as there is currently less competition between investors. Also, some investors argue that company formations allow them to start with a "clean sheet", without the historical baggage of restrictive terms that are often applied to prior rounds in a down market. There are small numbers of specialist early stage investors, but most venture firms in Europe have traditionally moved with the market. This might change going forward as many investors are on the fundraising trail and trying to differentiate themselves

Capital Efficiency

There has been a strong negative correlation between the number of deals completed over time and the median time between financing rounds. Over recent years, the median time between rounds has been creeping up quarter by quarter. In 4Q'00, the average period between financing rounds was a fraction over 10 months. By the second quarter of 2005, the average had doubled to 20 months.

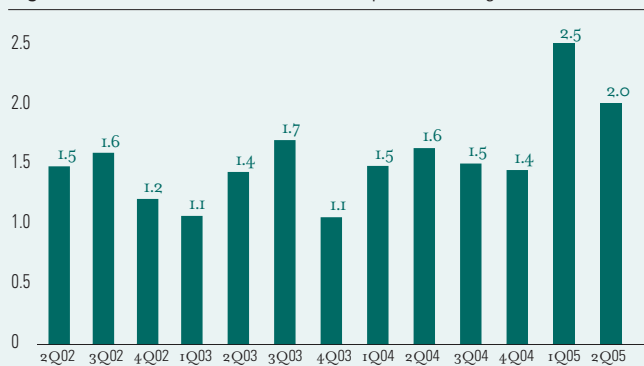
The overall increase in the median time between rounds since 2000 can be seen as a re-adjustment to new market realities. In 2000, the business model for many venture-backed entrepreneurs involved expanding swiftly in a capital-intensive manner (by advertising, building communication infrastructure, or developing products rapidly). The short time between rounds in 2000 was a function of companies' high burn rate, which in hindsight seems often to have been an inefficient use of venture money. In the current environment, the emphasis is on working venture money as hard as possible, with ambitious plans for aggressive growth often curtailed in favour of cutting costs and increasing sales. The increase in time between rounds has hovered between 18 and 20 months since 2003.

As the median time between rounds has increased, the efficiency of venture money has also increased. To attract funding, management teams have had to develop convincing business plans with measurable milestones. Unfortunately, management teams have also had to spend more time securing funding at the cost of running their businesses.

Across Europe, the median amount raised by an entrepreneurial company is increasing upwards in 2005. For the first half of the year, the median round size throughout Europe was €2.3 million, on par with 2000 levels.

Median deal sizes tend to be higher in the U.K. than the rest of Europe, and for both areas they tend to be much lower than in the U.S. So far in 2005, the highest rounds

Figure 17: Median Amount Invested in European Financing Rounds (€M)



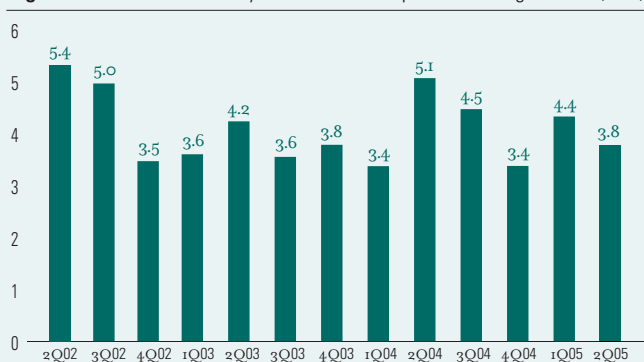
Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 18: Median Time (in months) Between Financing Rounds



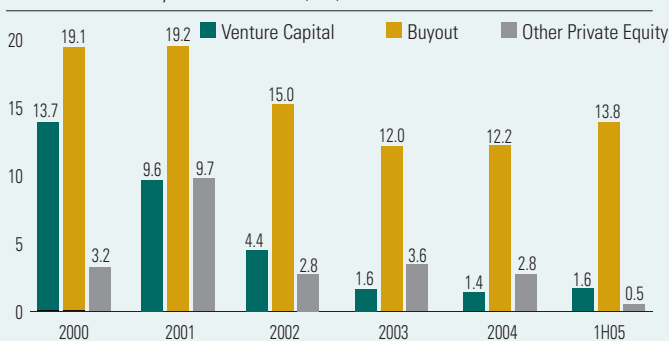
Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 19: Median Pre-money Valuation of European Financing Rounds (€M)



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 20: European Funds Raised for Venture Capital, Private Equity, and Buyout Investment (€B)



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 21: Most Active Investors in Europe in 1H'05

Investing Firm Name	Initial Company Investment	Follow-on Investment	Total Number of Deals
3i Group	10	25	35
SPEF Venture	5	8	13
Atlas Venture	4	8	12
Sofinnova Partners	4	6	10
SEB Foretagsinvest	2	8	10
Siparex Group	3	6	9
Innovacom	3	6	9
Vækstfonden	2	6	8
I-Source Gestion	2	6	8
AGF Private Equity	1	7	8
YFM Group	4	3	7
Societe Generale Asset Management	3	4	7
Scottish Equity Partners	4	3	7
Healthcap Venture Capital	3	4	7
Enterprise Ventures Limited	5	2	7
Auriga Partners	1	6	7

were found in Germany, which posted a median round size of €3.6 million, followed by France, where it was €2.5 million. Germany's higher median round sizes appeared to be particularly bolstered by larger healthcare deals this year. The U.K. had the third largest median, €1.9 million, but had the highest IT round medians at €3.1 million.

Valuations

Valuations are the result of different and potentially conflicting forces: the fund raising environment and the consequent level of capital available for investments; the exit market whereby successful M&As and IPOs help entrepreneurs running similar companies to strike better deals with their investors; the number of companies with a convincing business model; and the type of deals (i.e. seed vs. later, typically with a higher valuation).

In 2005 so far, the overall contraction in venture capital investment and reduced competition for deals outweighed other factors and held valuations steady with 2004 levels. The overall median valuation for the first half of 2005 was €4 million, the same as it was in 2004.

By country, median valuations in Germany increased to €8.5 million from €7 million in 2004. France's median valuations also rose, to €4.9 million from €3 million in 2004. However, median valuations for U.K. companies declined to €3.9 million from €5.7 million.

Investor Spotlight

At the half year mark of 2005, 3i Group undertook 35 deals, maintaining its position as the most active investor in Europe. Of these, 25 were investments in existing portfolio companies. The second most active investor was SPEF Venture with 13 deals, more than half of which (8) were closed by existing portfolio companies.

Unlike in the U.S., where nearly all the most active investors are pure-play venture firms, in Europe there is a

broad mix of generalist private equity firms, investment banks, and government investors, as well as corporate venturing and venture capital firms.

Like 3i, venture capitalists in general have, over recent quarters, been increasingly focused on their existing portfolio companies and less interested in new investments. Therefore, the proportion of follow-on financing rounds that included a new investor declined in 2002 and 2003, reaching a low of about 40%. For the past year and a half, there has been a slight curtailment of this trend and by the second quarter of 2005, 46% of follow-on financings included a new investor.

"Most investors no longer view European Venture as a stand-alone asset class but rather seek the best venture funds globally. Should some of these best funds invest in Europe then investors will invest in Europe."

—DAVID RIMER, OPERATING PARTNER, INDEX VENTURES

Fundraising

The year is showing some signs of recovery in the depressed fundraising market for buyout and venture funds. While the pendulum swing that led to the rapid expansion of the European private equity market from the mid-1990s onward was reversed over the past two years, there is renewed interest for buyout firms, which have raised just over €13.8 billion so far this year, an increase from the €12.1 billion raised in total in 2004.

Venture capital funds have increased as well, with €1.6 billion raised so far in 2005, compared to €1.4 billion in total in 2004. Other private equity funds have lagged, raising €530 million through the year's first half, compared to €1.1 billion in the first half of 2004.

Figure 23: Most Active Investor - Initial Financings

Investing Firm Name	Number
3i Group	10
XAnge Private Equity	6
Kreditanstalt Fur Wiederaufbau	6
SPEF Venture	5
Enterprise Ventures Limited	5
YFM Group	4
Sofinnova Partners	4
Scottish Equity Partners	4
Northzone Ventures	4
Intel Capital	4
INCUBA Venture	4
Emertec Gestion	4
Elaia Partners	4
Benchmark Capital	4
Atlas Venture	4

Figure 24: Most Active Law Firms, 3Q04 - 2Q05

Law Firm Name	Number
Wilmer Cutler Pickering Hale and Dorr	19
Bird & Bird	12
Vinge	11
Linklaters	11
Taylor Wessing	10
Freshfields Bruckhaus Deringer	9
Eversheds	9
Ernst & Young Legal	8
Baker & McKenzie	8
DLA Nordic	8
CMS Hasche Sigle	8
Pinsents	7
Landwell	7
Cederquist	7

Figure 25: Most Active Commercial Banks, 3Q04 -2Q05

Commercial Bank Name	Number
Barclays Bank	50
HSBC Bank	41
Societe Generale	34
Svenska Handelsbanken	33
NatWest	33
BNP Paribas	30
SEB Bank	26
Deutsche Bank	26
Nordea	25
Danske Bank	25
Bank of Scotland	22
Bank Populaire	22
Lloyds TSB Group	19

Figure 26: Most Active Auditors 3Q04-2Q05

Firm Name	Number
Ernst & Young	134
PriceWaterhouseCoopers	109
Deloitte Touche Tohmatsu	65
KPMG	73
Grant Thornton	29
BDO International	15

Figure 27: European M&A activity (Largest M&A Deals) 1H' 2005

Company Name	City	Country	IndustrySegment	CloseDate	Amount Paid (Euro, M)
Sit-up	London	United Kingdom	Communications	12/05/05	€ 283.61
Oxxio	Leusden	Netherlands	Cons/Bus Services	06/06/05	€ 137.00
Inventel	Paris	France	Communications	29/05/05	€ 127.00
Ciao	Munich	Germany	Cons/Bus Services	06/04/05	€ 119.00
Entific Medical Systems	Gothenburg	Sweden	Medical Devices	07/03/05	€ 115.50
Solexa	Little Chesterford	United Kingdom	Biopharmaceuticals	07/03/05	€ 115.05
Cirpack	Suresnes	France	Communications	21/04/05	€ 95.00
Karavel	Paris	France	Cons/Bus Services	02/02/05	€ 60.00
Bankia Bank	Oslo	Norway	Cons/Bus Services	12/04/05	€ 53.20
LEA	92051 Paris	France	Communications	30/06/05	€ 51.00
Zone Vision	London	United Kingdom	Communications	17/07/05	€ 49.62
Native Networks	Maidenhead	United Kingdom	Communications	21/03/05	€ 49.27
Inca Digital Printers	Cambridge	United Kingdom	Electronics	02/06/05	€ 43.86
Vidus	Ipswich	United Kingdom	Software	22/02/05	€ 42.04
Xemics	Neuchatel	Switzerland	Semiconductors	23/06/05	€ 33.88
Impella Cardiosystems	Aachen	Germany	Medical Devices	10/05/05	€ 31.47

“The IPO market is slowly re-opening, allowing larger VC-backed companies again to contemplate an IPO rather than a trade sale.”

—PAUL-NOËL GUÉLY, PARTNER, ARMA PARTNERS

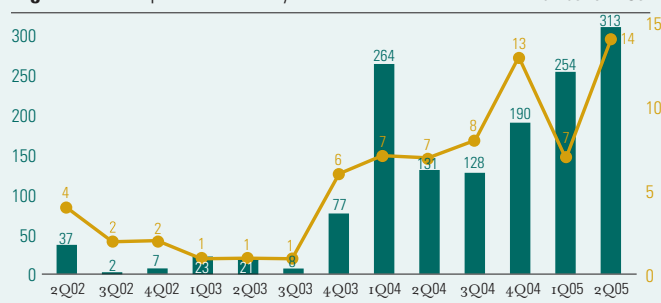
Liquidity

One of the most important factors contributing to the long-term health of the venture capital industry is the state of the exit market: initial public offerings and mergers and acquisitions. A stagnant market forces investors to continue funding existing portfolio companies, depleting their funds and preventing the funding of new venture-backed companies. A robust market introduces liquidity and allows venture investors to distribute returns to their investors, the limited partners.

Current statistics for European venture-backed IPOs and M&As show that the situation is improving. For most of 2002 and 2003, exit markets were firmly shut and the majority of exits that did occur were at a loss or represented only a modest return on committed capital. At the first half of 2005, there have been 21 venture-backed IPOs, which raised €567.4 million, the highest amount raised since the first half of 2001. In particular, in the second quarter of 2005 there were 14 IPOs compared to seven in the same quarter of 2004. This was the strongest second quarter since the heady days of the bubble.

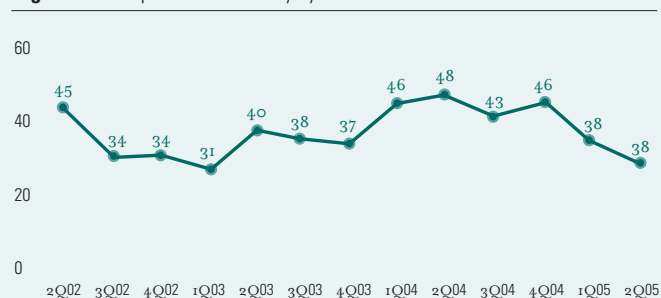
Europe may have seen a resurgence in IPOs over the past 18 months, but caution still reigns and the exit opportunities remain considerably different to those during the bubble. One factor that is improving the exit climate is the maturing of AIM and new exchanges such as Alternext, which are making it easier for smaller companies to achieve exits via the public market.

Figure 28: European IPO Activity



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

Figure 29: European M&A Activity by Transaction



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

As for exits via M&A, there were 70 venture-backed acquisitions in the first two quarters of the year, more than half of them (43) for information technology companies. In comparison, there were 94 M&As in the first half of 2004, and 60 of them were IT companies. The largest M&A in 2005 so far was Sit-up (London, U.K.), a provider of interactive video content, which was acquired by Screenshop, a subsidiary of Telewest Global (Nasdaq: TLWT) for approximately €283.6 million.

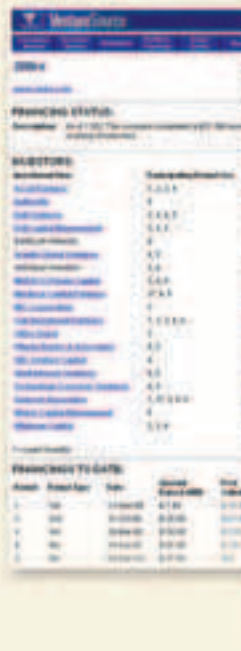
As in the U.S., corporate acquirers are recognizing the value of these venture-backed companies. The median acquisition price for a company acquired this year in Europe is €25.2 million, the highest median amount since 2000.

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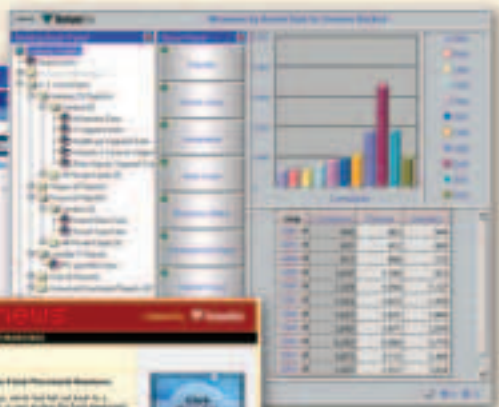
Company Profile



Investor Profile



Cambridge Associates LLC data



Company Analytics

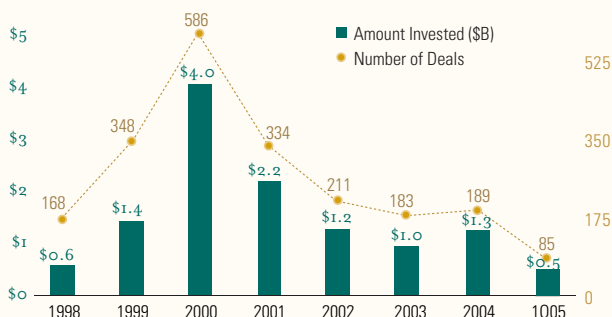


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Figure 30: Annual investment in Israeli venture-backed companies



Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

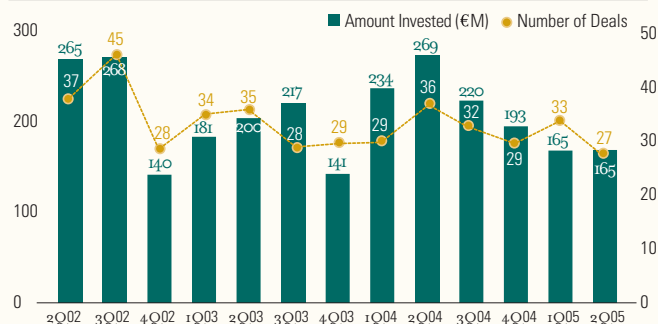
Israel

Venture capital activity in Israel during the first half of 2005 has declined slightly from the level of activity seen in 2004. So far this year, there have been 85 deals involving companies with offices in Israel and \$539.5 million invested. In contrast, in the first half of 2004, 96 deals raised \$623 million. Of those Israeli deals this year, more than half of the financing rounds, or 57, and \$263.3 million of the capital invested went to companies with headquarters in Israel. When compared to venture capital activity among European countries, Israeli financing levels are second only to the United Kingdom in terms of capital invested—an indication that Israel remains a stronghold for entrepreneurial innovation.

Investment by Industry

Technology companies remain the dominant force for Israeli venture capital activity. Of the 85 deals completed in the first half of 2005, 60 of them were for information technology companies, raising \$330 million. Within IT, software is favored, representing half of all IT deals so far this year and \$179.8 million invested. Communication companies have posted 13 deals and \$89.2 million in investment, making the segment the second most active IT investment area in Israel. Electronic companies saw a slight increase in deal flow, with two more deals than this period a year ago, bringing the total to nine. Investment into this segment so far this year reached \$31.1 million. Overall, the median amount invested into an Israeli technology company in the first half of this year has declined to \$5 million, down

Figure 31: Venture Capital Investment in Israeli IT Companies



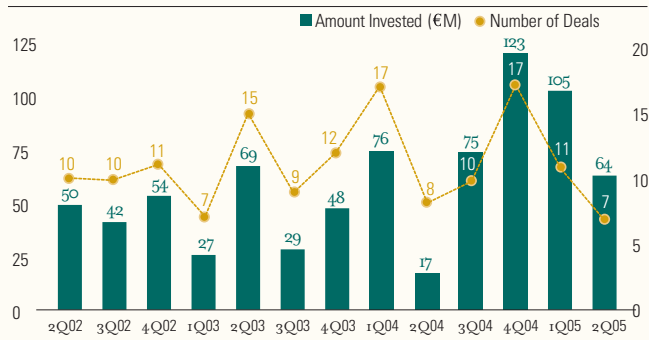
Source: VentureOne/Ernst & Young | Underlying data available in VentureSource

from \$6 million throughout 2004. However, the IT companies are more highly valued so far this year—the median valuation is \$15 million, compared to \$10 million in 2004.

Meanwhile, investment into healthcare companies in Israel has grown considerably in 2005. For example, the median amount invested in a healthcare company is now \$5.3 million at the year's first half, compared to \$3.5 million in 2004. Overall, \$168.8 million was invested in Israeli healthcare companies in the first two quarters, an increase of 85% from the same period in 2004, although there were seven fewer deals this year. The largest healthcare deal of the first half of the year was the \$43 million second round for Predix Pharmaceuticals, a developer of small molecule drugs with an office in Ramat Gan, Israel. Unlike in the U.S. and Europe, where most healthcare investment has been focused on biopharmaceutical companies, Israeli investors have been more focused on medical devices startups. This segment has received 14 deals so far in 2005 and \$85.3 million in investment. The largest medical devices deal was the \$27 million later round for superDimension in Herzliya, Israel, a provider of endoscopic tools. With only a couple of deals, medical information systems companies also received a significant increase in investment in 2005, a total of \$35.2 million being directed to this segment.

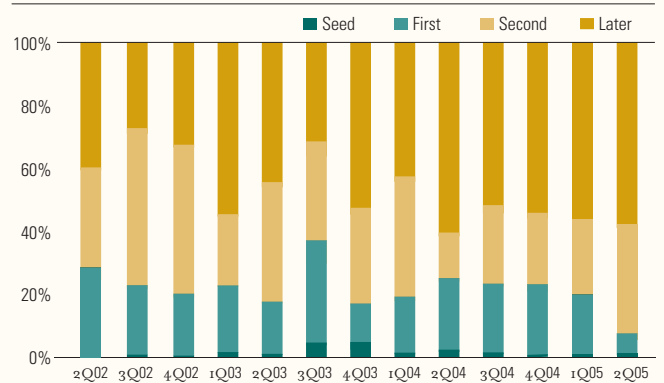
As in the U.S., the products and services category in Israel is also garnering new interest. There were four deals so far in 2005 and \$30.1 million invested which is almost double the investment level in this category in the first half of last year, and one more deal.

Figure 32: Venture Capital Investment in Israeli Health-Care Companies



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Figure 33: Israeli Deal Flow Allocation by Round Class



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Activity by Round Class

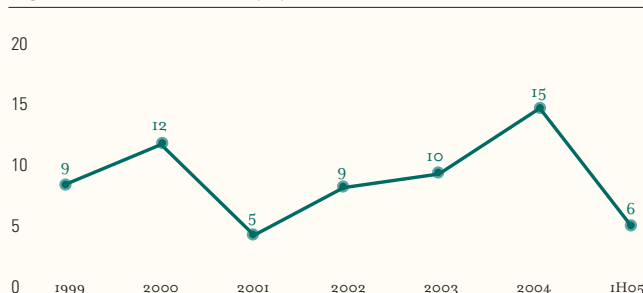
Investors in Israeli companies remain focused on later stage rounds—a trend that has also become apparent this year in the U.S. and Europe as investors see potential liquidity opportunities for existing portfolio companies. In Israel, 46% of the deals in the first two quarters of the year were for later stage financings, an increase from the 40% seen in the first half of 2004. The capital invested is even higher: 56% of the amount invested in 2005 so far has been for later stage rounds, compared to 32% in the same period of 2004. As a result, the percentage of seed and first round deals were reduced slightly. Only 27% of the deals in the first two quarters went to early-stage companies, compared to 29% last year.

Liquidity and Fundraising

In terms of liquidity, only a handful of Israeli companies have succeeded in exiting via the public markets for the past three years. Although, two Israeli companies completed IPOs last year, raising \$118.7 million, there have been no IPOs in the first half of this year. Israeli companies are however reaching liquidity via mergers and acquisitions. Six M&As have been completed so far in 2005; 15 were completed in all of 2004.

It remains to be seen whether fundraising will pick up in Israel in 2005, as it has in the U.S. and Europe. One \$200 million fund has closed so far this year in Israel. Last year, two funds totaling \$500 million closed in Israel, both in the third quarter of the year.

Figure 34: Israeli M&A Activity by Transaction



Source: VentureOne/Ernst & Young | Underlying data available in **VentureSource**

Methodology

The findings in this report are based on aggregate data from VentureOne's proprietary European research. This data was collected by surveying over 1,200 active professional European investment firms, through in-depth interviews with over 7,000 company CEOs and CFOs, and from hundreds of secondary sources. The deals underlying this data can be viewed in VentureSource, the world's leading venture capital research database. • These venture capital statistics are for equity investments into early-stage, innovative companies and do not include companies receiving funding solely from corporate, individual, and/or government investors. • No statement herein is to be construed as a recommendation to buy or sell securities or to provide investment advice.

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