

ByteandSwitch INSIDER

BYTE AND SWITCH'S TECHNOLOGY RESEARCH SERVICE FOR FINANCIAL PROFESSIONALS, INVESTORS, AND LEADERS IN THE STORAGE NETWORKING INDUSTRY.

Venture Capital Survey

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August Highlights

- **A total of \$1.12B** was invested in 87 storage networking firms from 3Q02 to 2Q03
- **Funding has slowed** noticeably compared with the previous 12 months, but in relation to other tech sectors, storage remains fairly healthy
- **Follow-on rounds** represented the vast majority of this past year's funding, with only 6% of VC money going to first-round startups
- **Hardware startups** saw the most action, with 40 firms tallying \$687M in funding
- **Ten companies raised** two rounds during the one-year period, but that isn't necessarily an indicator of their health
- **At least \$670M in VC** funding was flushed down the drain after storage startups shut their doors

I. Introduction: Throw Another Billion on the Fire

By Graeme Thickins

It's a cliché to say that storage networking is a hot sector for venture capital. Let's face it: The billion-dollar-a-year mark has been reached, and even exceeded, so many times now in this business that it seems we all get a bit jaded. But even in the depressed VC funding climate of recent times – combined with what can only be called a dismal period of corporate IT spending – venture funding in the storage and storage networking sector has held its own pretty well, albeit with most dollars going to follow-on rounds in the past 12 months.

“What's been interesting to me,” says Charles Beeler, managing partner at Menlo Park, Calif.-based El Dorado Ventures, “is just the fact that investors continue to fund new and existing startups in the storage space – in spite of the general acknowledgement that the space has been heavily funded, and clearly overfunded in some segments.”

Such is the feeling that comes through time and again in this business: Storage just keeps going, and going, and going. With the growth in the volume of data in enterprises today, and the huge attendant management problems relating to that – both of which are major, strategic IT issues – there remains a demand for new and better solutions from this industry that just won't go away. And despite recent factors, such as an otherwise reduced IT spending climate and a slowing economy (now showing encouraging signs of a pickup), corporations simply have not been able to avoid addressing their ever-present storage management problems.

In this *Byte and Switch Insider* report, we evaluate the total funding that has gone into the storage networking sector for the 12-month period from 3Q02 to 2Q03. The way we define the universe of companies we include in this report is straightforward: All are focused on the storage networking market, which means their primary lines of business are related to storing and/or retrieving data from disk, tape, or other storage media over a network.

The overall intent of this report is to help better illustrate which way the wind is blowing in the world of venture funding in storage networking these days – not just the oft-cited “what's in” and “what's out” routine, but the nuances of what's in between the lines, too. One thing's certain: VCs *do* run in packs and are affected to some degree by the herd mentality. You're not the only one who's ever wondered if VC funding is really just about trend chasing. Even VCs themselves have been known to admit it is.

A. Summary Findings

The highlights of our study this year:

- We identified 97 specific funding rounds from July 1, 2002, through June 30, 2003, for 87 companies that fall into the storage and storage networking universe as defined by *Byte and Switch Insider*. (Ten companies received two financing rounds each in the report period.)
- These funding rounds totaled \$1.12 billion. In addition, we found four funding rounds for which the reporting VCs did not disclose the dollar amount, so the actual number is slightly higher.
- So far in 2003, about 6.1% of total VC investment dollars are going to storage networking companies, according to research conducted by PricewaterhouseCoopers. That compares with 4.6% at the end of last year.
- Storage networking hardware startups saw the most activity, pulling down 61% of the total funding, or \$686.9 million, as well as the highest average funding per company.
- Nevertheless, funding has slowed noticeably: A conservative estimate is that VC funding in storage startups *has dropped by at least 50%*, compared with funding 12 months earlier.
- It's been an especially tough environment for early-stage storage networking firms to secure seed funding. Nearly all the funding in the period was follow-on funding to companies that were already established. Only \$70.1 million, or 6.3%, went to a total of seven first-round startups.
- The most active VCs were Greylock, Lightspeed Venture Partners, and New Enterprise Associates (NEA), each of which contributed to six rounds of funding. However, the only VCs who saw any decent return on their investments were those backing the only two sizeable acquisitions of private companies last year: Bessemer Venture Partners, BlueStream Ventures, and Charles River Ventures (which backed Pirus, acquired last year by Sun), and Sequoia Capital and Accel Partners (which backed Rhapsody, acquired by Brocade).

In the following sections, we'll delve into all the year's VC numbers, slicing and dicing them and providing a healthy amount of stats, commentary, and insight into what they all mean. Specifically, we cover which categories of firms are

getting the most money; who's dishing it out; which technologies are the hottest; and which segments can be considered "overfunded." We'll also give you a feel for how the storage sector fared in relation to other IT categories and provide some predictions and outlook on what the experts say we can expect in the coming year.

To get a feeling of what's changed and what's stayed the same, we compare this year's findings to last year's *Byte and Switch* VC report. Among other things, we wanted to see how many of those same startups raised even more bucks this year. We also look at how many startups were acquired, how many went out of business (or had "fire sales"), and even note a group of startups that appears to be barely clinging to life.

We'll look at which VCs have been the most active in storage networking – ranking them by number of deals, and listing all the deals associated with each. And we take a shot at identifying the winners and losers among the VC firms, based on the year's documented "liquidation events." (Meaning acquisitions, of course, since there were no IPOs... *what are those, again?*) It hasn't been the best year for VC returns in this industry, but don't feel too sorry for these guys – at least one source tells us to hang onto our hats as far as what's coming.

B. Methodology

To conduct our study of venture financing in the storage networking industry over the past 12 months, we compiled funding information from multiple sources, including PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association MoneyTree Survey, *Byte and Switch's* own database of funding-related news and analyses, and other industry sources. (More information about the MoneyTree Survey is available at www.pwcmoneytree.com.)

Because venture investing concerns private capital, we obviously do not attempt to cover publicly owned storage firms in this report, with the exception of our inclusion of private investments made in three firms that are publicly traded (BakBone Software Inc., Dot Hill Systems Corp., and Vixel Corp.).

II. Funding by Category

We divided the past year's universe of 87 storage networking companies into four categories: Hardware, software, silicon, and services. Here's how the numbers shook out:

Table 1: VC Funding by Category (3Q02 - 2Q03)

| Category | No. of Cos. | Total Funding | Avg./Co. | Category Description |
|-----------------|-------------|---------------|----------|--|
| Hardware | 40 | \$686.9M* | \$17.17M | Storage arrays, storage networking switches, storage security appliances, RAID controllers, InfiniBand switches |
| Software | 30 | \$256.3M** | \$8.54M | Backup and recovery, data replication, storage resource management (SRM), virtualization, file caching; archiving; global file systems |
| Silicon | 10 | \$126.5M | \$12.65M | Storage processors, TCP Offload Engines (TOEs), network components |
| Services | 7 | \$53.4M | \$7.63M | Storage service providers (SSPs), storage networking consulting |

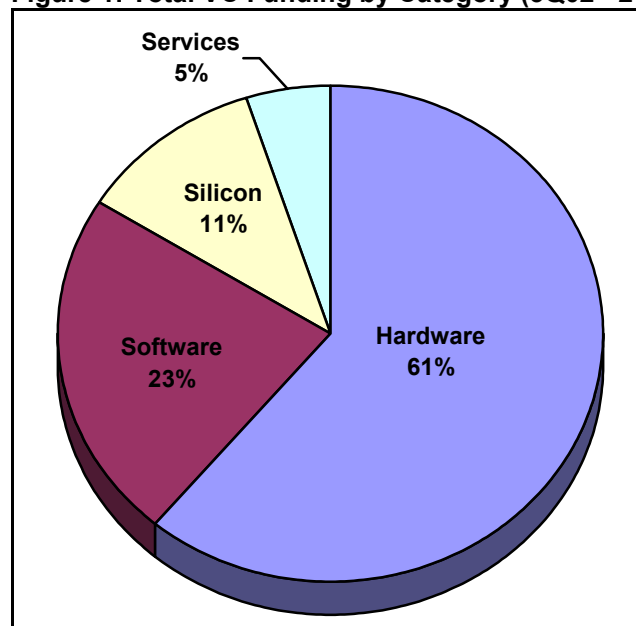
* Excluding one round whose amount was not disclosed.

** Excluding three rounds whose amounts were not disclosed.

The hardware category was clearly the richest recipient of VC bounty over the past 12 months, pulling down 61% of the total amount invested in the storage networking industry and garnering the highest average funding per company (\$17.17 million).

However, as we'll discuss later in this report, there is some concern that segments within the hardware category have been overfunded. Also note that our total for the hardware group assumes that Pillar Data Systems, bankrolled by Oracle CEO Larry Ellison, has received its estimated \$100 million in funding over the period surveyed. Nevertheless, we see that software companies were funded at lower rates than hardware or silicon storage companies – which is reasonable, given the higher development, manufacturing, inventory, and support costs associated with hardware business models.

Figure 1: Total VC Funding by Category (3Q02 - 2Q03)



In the tables on the following pages, we list all funding rounds we identified in the past 12 months, presented in alphabetical order in each of the four categories. Note that in addition to the investors listed here, some startups have received investments from individuals or firms that have not been disclosed. The information was compiled using PwC's MoneyTree Survey data for storage networking startups in conjunction with our own research.

Table 2a: Storage Hardware VC Funding

| Company | Amt. (\$M) | Quarter | Investors | HQ | Description |
|--|------------|---------|---|------------------|---|
| Acopia Networks Inc. | \$30.0 | 2Q03 | St. Paul Venture Capital, Charles River Ventures, Accel Partners, STAR Ventures, Itochu Technology | Chelmsford, MA | Application-intelligent SAN switches |
| BlueArc Corp. | \$1.5 | 1Q03 | Fort Washington Capital Partners | San Jose, CA | High-end NAS system |
| Candera Inc. (formerly Confluence Networks) | \$2.5 | 1Q03 | Hotung International Company, AsiaTech Management | Milpitas, CA | Network storage virtualization appliance |
| Chaparral Network Storage Inc. | \$8.2 | 1Q03 | Athenian Ventures | Longmont, CO | Controllers for storage routers |
| BlueArc Corp. | \$1.5 | 1Q03 | Fort Washington Capital Partners | San Jose, CA | High-end NAS systems |
| Compellent Technologies Inc. | \$9.0 | 3Q02 | Crescendo Venture Management, El Dorado Ventures | Eden Prairie, MN | Midrange SAN storage systems |
| | \$14.3 | 2Q03 | Crescendo Venture Management, Affinity Capital Management | | |
| Data Domain Inc. | \$9.3 | 4Q02 | Greylock, New Enterprise Associates | San Mateo, CA | Disk-based backup appliances |
| Dot Hill Systems Corp. | \$6.0 | 4Q02 | Omicron Partners | Carlsbad, CA | SAN and NAS storage systems |
| | \$17.8 | 1Q03 | Undisclosed | | |
| E2O Communications Inc. | \$17.0 | 2Q03 | SunAmerica Ventures, New Enterprise Associates, Smart Technology Ventures | Calabasas, CA | Fiber-optic couplers |
| EqualLogic Inc. | \$15.0 | 1Q03 | Charles River Ventures, Sigma Partners, TD Capital Technology Ventures | Nashua, NH | IP SAN storage systems |
| Exavio Inc. | \$14.3 | 2Q03 | ComVentures, VantagePoint Venture Partners, Crystal Internet Venture Fund, Enspire Capital | San Jose, CA | Large-scale digital media storage for on-demand video |
| InfiniSwitch Corp. | \$9.045 | 1Q03 | Flagship Ventures, Columbia Capital, TL Ventures, Bessemer Venture Partners, Convergent Ventures, Index Ventures Management, Lightspeed Venture Partners, Austin Ventures, Moore Capital Management | Westborough, MA | InfiniBand switches |
| Inkra Networks Corp. | \$30.1 | 3Q02 | Battery Ventures, Morgenthaler Ventures, Norwest Venture Partners, Storm Ventures, Greenstone Venture Partners | Fremont, CA | Data center virtualization services switch |
| InPhase Technologies Inc. | \$6.3 | 4Q02 | New Venture Partners, Newton Technology Partners | Longmont, CO | High-capacity holographic storage media and systems |

Table 2b: Storage Hardware VC Funding

| Company | Amt. (\$M) | Quarter | Investors | HQ | Description |
|----------------------------------|------------|---------|--|---------------------|---|
| Intransa Inc. | \$6.0 | 4Q02 | 3Com Ventures, Sofinnova Partners, U.S. Venture Partners, Advanced Technology Ventures | San Jose, CA | IP SAN storage systems |
| | \$7.1 | 2Q03 | Advanced Technology Ventures, US Venture Partners, Sofinnova Ventures | | |
| Isilon Systems Inc. | \$15.0 | 3Q02 | Sequoia Capital, Atlas Venture, Madrona Venture Group | Seattle, WA | Distributed storage for media delivery |
| LeftHand Networks Inc. | \$20.0 | 1Q03 | Boulder Ventures, Garage Technology Ventures, Ironside Ventures, New World Ventures, Portage Venture Partners, Sequel Venture Partners, Sprout Group, Vista Ventures, Wasatch Venture Fund | Boulder, CO | IP SAN storage systems |
| NeoScale Systems Inc. | \$12.0 | 2Q03 | Sevin Rosen Funds, Lightspeed Venture Partners, Bay Partners | Milpitas, CA | Storage security appliances |
| Netezza Inc. | \$5.0 | 4Q02 | Orange Ventures, Charles River Ventures | Framingham, MA | Database acceleration appliance |
| NextGig Inc. | \$10.0 | 4Q02 | El Dorado Ventures, ComVentures, Doll Capital Management | San Diego, CA | Database acceleration appliance |
| Panasas Inc. | \$32.0 | 3Q02 | Centennial Ventures, Mohr Davidow Ventures, Intel Capital, Carlyle Group, Evercore Partners, Novak Biddle Venture Partners | Fremont, CA | Distributed NAS systems |
| Persist Technologies Inc. | \$1.5 | 3Q02 | ArrowPath Venture Capital, Athena Ventures, ComVentures, Red Rock Ventures | Pleasanton, CA | Email backup appliance |
| Pillar Data Systems Inc. | \$100.0* | 4Q02 | Larry Ellison (Lawrence Investments LLC) | San Jose, CA | Integrated SAN/NAS systems |
| Platypus Technology Inc. | \$0.5 | 4Q02 | Ecentury Capital Partners | North Billerica, MA | Solid state storage systems |
| | \$3.2 | 1Q03 | Ecentury Capital Partners | | |
| Rackable Systems Inc. | \$22.5 | 1Q03 | Parthenon Capital, PTI Ventures | San Jose, CA | Rack-mounted server and storage systems |
| RASilient Systems | \$4.0 | 1Q03 | Acorn Campus, Intel Capital | Cupertino, CA | Networked storage arrays for small/medium enterprises |
| Redline Networks Inc. | \$12.0 | 2Q03 | Advanced Technology Ventures, Charles River Ventures, Echelon Ventures | Campbell, CA | Data center appliances for Web acceleration |
| Sanera Systems Inc. | \$35.0 | 2Q03 | CMEA Ventures, Goldman Sachs & Co, ArrowPath Venture Capital, Greylock, Enterprise Partners, Storm Ventures | Sunnyvale, CA | Director-class SAN switches |

* Byte and Switch Insider *estimate*

Table 2c: Storage Hardware VC Funding

| Company | Amt. (\$M) | Quarter | Investors | HQ | Description |
|------------------------------------|---------------|---------|---|----------------------|--|
| Snap Appliance Inc. | \$25.0 | 4Q02 | Moore Capital Management, Mellon Ventures | San Jose, CA | Entry-level/ midrange NAS systems |
| | \$25.4 | 2Q03 | Ascend Venture Group, Mellon Ventures | | |
| Solid Data Systems | \$3.25 | 4Q02 | International Capital Partners, Zesiger Capital Group, Ardara | Santa Clara, CA | Solid state storage systems |
| StoneFly Networks Inc. | \$0.7 | 2Q03 | Crescendo Venture Management, El Dorado Ventures, Palomar | San Diego, CA | IP storage switches |
| Tacit Networks Inc. | \$7.3 | 4Q02 | Canaan Partners, RRE Ventures, Silicon Alley Seed Investors | South Plainfield, NJ | Caching appliance for file sharing |
| 3PARdata Inc. | \$0.474 | 1Q03 | Mayfield Fund | Fremont, CA | High-scale SAN storage systems |
| 3ware Inc. | \$24.65 | 4Q02 | U.S. Venture Partners, Selby Venture Partners | Mountain View, CA | Serial ATA RAID controllers |
| | \$1.35 | 1Q03 | Selby Venture Partners, New Enterprise Associates, Pacifica Fund, VantagePoint Venture Partners | | |
| Topspin Communications Inc. | \$30.1 | 3Q02 | Advent International Corporation, Accel Partners, Redpoint Ventures, Duff Ackerman & Goodrich, Presidio Venture Partners | Mountain View, CA | InfiniBand switches |
| Troika Networks Inc. | \$15.2 | 2Q03 | Windward Ventures, DynaFund Ventures, Hamilton Apex Management Partners, Anthem Venture Partners, Draper Fisher Jurvetson, Draper Fisher Jurvetson ePlanet Ventures | Westlake Village, CA | Storage virtualization appliance |
| VIEO Inc. | \$14.365 | 1Q03 | Rho Ventures, Audax Group, Eyes of Texas Partners, TL Ventures, Flagship Ventures | Austin, TX | Application infrastructure/ systems management appliance |
| Vixel Corp. | \$8.0 | 1Q03 | Goldman Sachs | Bothell, WA | Embedded Fibre Channel switches |
| Voltaire Inc. | Not disclosed | 2Q03 | Hitachi Ltd. | Bedford, MA | InfiniBand switches |
| Vormetric Inc. | \$10.0 | 3Q02 | Sigma Partners, Vanguard Ventures | San Jose, CA | Storage encryption appliance |
| XIOtech Corp. | \$45.0* | 4Q02 | Oak Investment Partners | Eden Prairie, MN | SAN storage systems |

* Byte and Switch Insider *estimate*

Table 3a: Storage Software VC Funding

| Company | Amt. (\$M) | Quarter | Investors | HQ | Description |
|---|---------------|---------|--|-------------------|--|
| Actona Technologies Inc. <i>(formerly VersEdge)</i> | \$7.0 | 3Q02 | Evergreen Ventures, Sequoia Capital, The Fantine Group | Los Gatos, CA | WAN file-caching software |
| | \$4.0 | 2Q03 | Sequoia Capital, Evergreen Canada Israel Investments, The Fantine Group | | |
| Allocity Inc. | \$13.25 | 1Q03 | Mohr Davidow Ventures, Redpoint Ventures | Mountain View, CA | Email storage management software |
| AppIQ Corp. | \$12.0 | 1Q03 | Matrix Partners, North Bridge Venture Partners | Burlington, MA | SAN management software |
| Astrum Software Corp. <i>(acquired by EMC 4/03)</i> | \$0.093 | 4Q02 | Ironside Ventures | Boston, MA | Storage resource management (SRM) software |
| | \$0.009 | 1Q03 | Ironside Ventures | | |
| Atempo Inc. | \$6.2 | 1Q03 | Bank of America Equity Partners, KBC Investco | Mountain View, CA | Backup and recovery software |
| Avamar Technologies Inc. | \$13.0 | 2Q03 | Goldman, Sachs & Co., Lightspeed Venture Partners, Benchmark Capital, @Ventures | Irvine, CA | Disk-based backup software and systems |
| BakBone Software Inc. | \$15.0 | 2Q03 | VantagePoint Venture Partners | San Diego, CA | Backup and recovery software |
| CreekPath Systems Inc. | \$16.0 | 4Q02 | New Enterprise Associates, Sequel Venture Partners, TeleSoft Partners, A.G. Edwards & Sons | Longmont, CO | SAN management software |
| Diligent Technologies Corp. | \$19.6 | 4Q02 | EMC, Credo Group | Framingham, MA | Backup and recovery software |
| FilesX Inc. | \$7.5 | 2Q03 | Benchmark Capital, Index Ventures Management, Genesis Partners | Southborough, MA | Data recovery software |
| Incipient Inc. | \$15.0 | 4Q02 | Greylock, Sigma Partners, Globespan Capital Partners | Waltham, MA | Network-based virtualization software |
| Kashya Inc. | \$7.4 | 4Q02 | Battery Ventures, Jerusalem Global Ventures | San Jose, CA | IP data replication |
| Lumigent Technologies Inc. | \$7.0 | 2Q03 | Greylock, North Bridge Venture Partners, Solstice Capital | Acton, MA | Data integrity and security software |
| MonoSphere Inc. | \$7.0 | 3Q02 | Lightspeed Venture Partners, Benchmark Capital | Redwood City, CA | Storage virtualization software |
| Mountain View Data Inc. | Not disclosed | 2Q03 | Hitachi America, Nippon Venture Capital Co., Daiwa International, Kokusai Capital Co. | Mountain View, CA | NAS system software |
| NBT Technology Inc. | \$6.6 | 4Q02 | Accel Partners, Lightspeed Venture Partners, Gunderson Dettmer | San Francisco, CA | File acceleration software |
| Neartek Inc. | Not disclosed | 1Q03 | Doughty Hanson & Co. | Westborough, MA | Tape virtualization software |
| NSI Software | \$15.0 | 4Q02 | ABS Capital Partners, Dell Ventures, J&W Seligman Company | Hoboken, NJ | Data replication software |

Table 3b: Storage Software VC Funding

| Company | Amt. (\$M) | Quarter | Investors | HQ | Description |
|---------------------------------------|---------------|---------|--|-------------------|--|
| Odysys International Ltd. | \$4.0 | 3Q02 | Carlyle Group, JAFCO Investment | Santa Clara, CA | Clustered file system software |
| OuterBay Technologies Inc. | \$9.0 | 3Q02 | BA Venture Partners, Redpoint Ventures, Leapfrog Ventures | Campbell, CA | Database archiving software |
| | \$8.0 | 2Q03 | Mayfield Fund, BA Venture Partners, Redpoint Ventures, Leapfrog Ventures | | |
| PolyServe Inc. | \$19.5 | 4Q02 | Greylock, New Enterprise Associates, The Roda Group | Beaverton, OR | Clustering software |
| Sistina Software Inc. | \$10.0 | 1Q03 | Crescendo Venture Management, Validus Partners, St. Paul Venture Capital | Minneapolis, MN | Global file system and logical volume manager software |
| SteelEye Technology Inc. | \$0.647 | 4Q02 | Venrock Associates, CrossBridge Venture Partners | Mountain View, CA | High availability clustering and data replication software |
| | \$0.490 | 1Q03 | Venrock Associates | | |
| StorAd Inc. (formerly Zambeel) | \$12.0 | 2Q03 | Apex Venture Partners, Kleiner Perkins, New Enterprise Associates | San Jose, CA | Next-gen NAS software |
| Topio Inc. | \$10.0 | 1Q03 | Sequoia Capital, Sigma Partners | Santa Clara, CA | Disaster recovery software |
| Unitrends Software | \$1.0 | 2Q03 | Trelys Funds | Myrtle Beach, SC | Data protection software |
| Vyant Technologies Inc. | \$3.0 | 2Q03 | Undisclosed | Fairfax, VA | Data recovery software |
| Wasabi Systems | Not disclosed | 3Q02 | Intel Capital | New York, NY | Embedded software for storage systems |
| XOsoft Inc. | \$2.5 | 4Q02 | JK&B Capital | Cupertino, CA | Content accelerating software |
| Yosemite Technologies Inc. | \$4.5 | 4Q02 | Hummer Winblad Venture Partners, Altos Ventures | Fresno, CA | Backup and recovery software |

Table 4: Storage Silicon VC Funding

| Company | Amt. (\$M) | Qtr. | Investors | HQ | Description |
|--------------------------------|------------|------|---|--------------------|---|
| Aarohi Communications | \$8.0 | 4Q02 | Intel Capital, Telesoft Partners, Kennet Capital | San Jose, CA | Intelligent network storage processors |
| Aristos Logic Corp. | \$20.0 | 1Q03 | Woodside Fund, JP Morgan Partners, TPG Ventures, QTV Capital | Foothill Ranch, CA | Intelligent network storage processors |
| Dune Networks Inc. | \$24.0 | 3Q02 | Alta Berkeley Venture Partners, Elwin Capital Partners, Jerusalem Venture Partners, Pitango Venture Capital | Agoura Hills, CA | Silicon storage solutions |
| iReady Corp. | \$6.0 | 1Q03 | RWI Group, Crescendo Venture Management | Santa Clara, CA | IP storage acceleration chips |
| iVivity Inc. | \$13.0 | 2Q03 | Kinetic Ventures, HIG Capital Management, LSI Logic Corporation, Commonwealth Capital Ventures, Cordova Ventures | Norcross, GA | ASICs for accelerating storage services |
| NetOctave Inc. | \$0.456 | 3Q02 | Intersouth Partners, Kitty Hawk Capital, Wakefield Group | Morrisville, NC | Security processors and acceleration boards |
| S2io Technologies Corp. | \$18.0 | 4Q02 | Menlo Ventures, VenGrowth Capital Funds, Business Development Bank of Canada | Cupertino, CA | 10-Gig Ethernet network interfaces and software |
| Sierra Logic Inc. | \$12.0 | 3Q02 | InterWest Partners, JP Morgan Partners, TPG Ventures, QTV Capital | Roseville, CA | Serial ATA processors |
| Silverback Systems Inc. | \$15.0 | 1Q03 | US Trust Private Equity, Telegraph Hill Communications Partners, Pitango Venture Capital, China Development Industrial Bank, Gemini Capital Fund Management, Newbury Ventures | Campbell, CA | IP storage acceleration chips |
| Trebia Networks Inc. | \$10.0 | 2Q03 | Kodiak Venture Partners, Raza Foundries, Atlas Venture | Acton, MA | Storage acceleration chips |

Table 5: Storage Services VC Funding

| Company | Amt. (\$M) | Qtr. | Investors | HQ | Description |
|---|------------|------|--|-------------------|---|
| AmeriVault Corp. | \$1.0 | 2Q03 | Alta Communications | North Waltham, MA | Online backup and recovery services |
| Arsenal Digital Solutions Worldwide Inc. | \$10.5 | 1Q03 | Southeast Interactive Technology Funds, Covestco Seteura | Cary, NC | Outsourced storage management services |
| EVault Inc. | \$6.0 | 1Q03 | Individuals, Jemison Investments, Massey Burch Capital Corp., Business Engineering Science & Technology Discoveries, Council Capital Mgmt., River Cities Capital Funds | Walnut Creek, CA | Provides online backup and recovery services |
| GlassHouse Technologies Inc. | \$1.5 | 3Q02 | JAFco Co. Ltd., GrandBanks Capital, Sigma Partners | Framingham, MA | Storage consulting and design services |
| IPR International LLC | \$2.4 | 2Q03 | Murex Investments, Innovation Philadelphia | Conshohocken, PA | Electronic data vaulting and recovery services |
| LiveVault Corp. | \$10.0 | 1Q03 | Sevin Rosen Funds, Atlas Venture, Matrix Partners, Adams Street Partners | Marlborough, MA | Online backup and disaster recovery services |
| ManagedStorage International Inc. (MSI) | \$22.0 | 1Q03 | JP Morgan Partners, Tudor Ventures | Broomfield, CO | Data protection and outsourced storage services |

III. The VC Year That Was

A. Year-Over-Year Comparison

A comparison of this year's results to those in the VC report *Byte and Switch* published about this time last year is difficult to make, because that report did not use the same methodology. But overall, last year's report identified 106 companies receiving funding and calculated total "private investment" in all storage networking categories at \$2.89 billion.

That means funding in the past 12 months has fallen off substantially, and although we would note again that comparisons can be difficult when methodologies vary between studies, the numbers indicate that VC funding of storage networking has dropped by *more than half* in the past year compared with the previous one.

Another interesting data point is the number of companies appearing on last year's list that also raised money this year. The total number is 34, which is 39% of the 87 companies on this year's list. That definitely says something about where a large chunk of VC funds have been going recently – namely, to firms that have gained a foothold in their execution plans or are meeting milestones, as opposed to being lavished on brand-new firms in Series A (first round) fundings.

In fact, we identified only seven early-stage startups receiving first-round funding in the period we examined, bringing in a total of \$70.1 million. Note that the largest amount of funding in this group went to Diligent Technologies, which we've included on this list even though the company is perhaps better characterized as a spinoff from EMC than a true startup.

Table 6: Startups Receiving First-Round Funding (3Q02 - 2Q03)

| Company | Amount | Quarter | Investors |
|-------------------|---------|---------|--|
| Compellent | \$9M | 3Q02 | Crescendo Venture Management, El Dorado Ventures |
| Data Domain | \$9.3M | 4Q02 | Greylock, New Enterprise Associates |
| Diligent | \$19.6M | 4Q02 | EMC, Credo Group |
| Exavio | \$14.3M | 1Q03 | ComVentures, Crystal Internet Venture Fund |
| NBT Technology | \$6.6M | 4Q02 | Accel Partners, Lightspeed Venture Partners, Gunderson Dettmer |
| RASilient Systems | \$4M | 1Q03 | Acorn Campus, Intel Capital |
| Tacit Networks | \$7.3M | 4Q02 | Canaan Partners, RRE Ventures, Silicon Alley Seed Investors |

Jeff Hinck of Crescendo Ventures underscores the dynamic at work in explaining the shakeout after the storage networking market became very crowded in 2000. "Startups today need verifiable customer traction. It's harder for new ideas – most funding today is later-stage stuff," he says. "We look for companies that can get from zero to \$15 to \$25 million in revenues pretty quickly."

Overall, though, the signs are encouraging, says Jay Hare, technology partner at PricewaterhouseCoopers, commenting on the technology venture funding environment in general. "With the rebound of Nasdaq, a leading indicator to next quarter's venture fundings, we've had both a 5% uptick in total dollars for all venture fundings as well as a meaningful uptick in the percentage of venture capital going into early-stage companies." In the second quarter of 2003, the Nasdaq gained 21%.

Continues Hare: "During 2002, early-stage companies attracted approximately 19% of all venture dollars. In Q2 of 2003, a four-quarter trend of continuous declines ended when the early-stage companies attracted 22.3% of all dollars, up from 16.5% in Q1 of 2003."

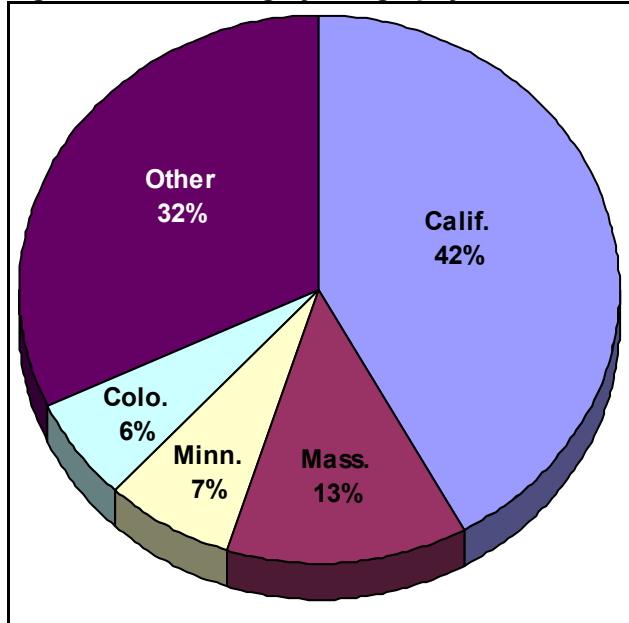
More evidence of positive trends is found when further analyzing the latest MoneyTree survey data. At the end of 2002, storage networking deals attracted approximately 4.6% of the total dollars nationwide. In 2003 so far, the sector is surpassing that figure, with approximately 6.1% of the total dollars nationwide going to storage networking deals, according to Jennifer Hacker Olsen, PwC's Twin Cities office MoneyTree survey coordinator. For the full year studied in this report (3Q02 through 2Q03), storage networking deals attracted 5.3% of total venture dollars nationwide.

B. Geographic Split

The *Byte and Switch Insider* survey data shows that California (not surprisingly) ranks highest in terms of dollars (\$468 million, or 42% of our total) put into storage networking deals. Massachusetts ranks second; Minnesota third; and Colorado fourth.

However, when comparing each state's total dollars in VC funding versus the amount that went into storage networking, Oregon has the highest percentage, at 15.0%, with Minnesota a close second at 13.7%. Colorado is the third highest state in this ranking, with 11.1% of all VC dollars invested in storage networking, while California is fourth at 7.8%.

Figure 2: VC Funding by Geography



C. Which Sectors to Watch

The development to watch in hardware is the gathering momentum behind IP SANs, with such strong startups as EqualLogic, Intransa, LeftHand Networks, and StoneFly squarely in the fray. After several years of hype about iSCSI, the market is starting to gel, and each of these companies will either catch the wave or risk getting sucked under. Ditto for storage acceleration chip startups – iReady, iVivity, Silverback, and Trebia – which had bet the iSCSI market would already be in full swing by now and would need their TCP Offload Engines (TOEs). It's make-or-break time for all these guys.

In software, there's no denying that the data protection/backup/disaster recovery sector was the hottest area of funding in the past year (just by sheer count of fundings alone), followed by storage resource management (SRM), system area management (SAM), and storage virtualization software firms.

More than a few analysts and VCs note, however, that the latter area is overfunded and consolidation is definitely already underway (for example, IBM buying TrellicSoft; EMC acquiring Astrum and striking a deal with BMC on SRM). Mike Karp of Enterprise Management Associates says the trend in software that's most interesting right now is "storage management based on value of the data to the business process."

A noticeable trend developed this past year in services as well: There was a strong showing of support from VCs for online backup services, and for four of the seven companies funded in this category. Interestingly, the largest single amounts of funding in this sector went to two storage service provider (SSP) firms – Arsenal Digital and ManagedStorage International Inc. (MSI). While the SSP sector was an area many had given up for dead, both of these firms are doing well. That's because unlike the SSPs of yesteryear, which expanded their data facilities with the assumption that they were going to host customers' primary data, Arsenal and MSI are handling primarily backup and recovery operations. (In other words, the scut work that the IT staff doesn't particularly like to do.) These are much more palatable offerings.

D. What's the Opposite of Hot?

That would be InfiniBand. InfiniBand was way overfunded – and most firms in that segment will die or already have, says Steve Duplessie of the Enterprise Storage Group. He sees room for only two or three players there at most. As it happens, only three InfiniBand firms got funding in this category this past year, all of which are switch companies (InfiniSwitch Corp., Topspin Communications Inc., and Voltaire Inc.). This compares with 12 very well-funded startups last year, in sub-categories that included IB chips, switches, and software. Specifically, the amount raised this year by IB-focused ventures was only \$39 million (plus one additional undisclosed investment amount), compared to what now seems a mind-blowing \$409 million last year. Ouch, that's about a 90% haircut! Such is life when the trend gods turn against you.

Some other comments on the what's-not-hot front come from Crescendo's Jeff Hinck: "You won't see any big deals anymore like 3PARdata – companies selling million-dollar boxes. Also, we don't think there's much promise in chips and components. Our research shows the returns are rarely there. There are too many of those companies, and they only have about six possible customers. Plus, companies like Cisco and EMC make their own [silicon].... We like networking boxes – we see better returns there."

E. Going Back to the Well

As we noted earlier, there were ten companies that raised two rounds of capital each in the 12 months covered by this report. However, you'll note that for some of these companies, going back to the well looks suspiciously like emergency funding necessary to keep the lights on. For example, Astrum's investors wrote a check for \$90,000 in the third quarter of 2002, then another for \$9,000 a few months later. Mercifully, EMC bought the company not long after. SteelEye looks like it's navigating under similar circumstances.

Here's the list, with amounts and timing for each round. (See main tables in the previous section for investors and company descriptions.)

Table 7: Companies Receiving Two Rounds of VC Funding (3Q02 - 2Q03)

| Company | First Round | Quarter | Second Round | Quarter |
|------------|-------------|---------|--------------|---------|
| Actona | \$7M | 3Q02 | \$4M | 2Q02 |
| Astrum | \$0.09M | 4Q02 | \$0.009M | 1Q02 |
| Compellent | \$9M | 3Q02 | \$14.3M | 2Q02 |
| Dot Hill | \$6M | 4Q02 | \$17.8M | 1Q02 |
| Intransa | \$6M | 4Q02 | \$7.1M | 2Q02 |
| OuterBay | \$9M | 3Q02 | \$8M | 2Q02 |
| Platypus | \$0.5M | 4Q02 | \$3.2M | 1Q02 |
| Snap | \$25M | 4Q02 | \$25.4M | 2Q02 |
| SteelEye | \$0.65M | 4Q02 | \$0.49M | 1Q02 |
| 3ware | \$24.65M | 4Q02 | \$1.35M | 1Q02 |

F. Flameouts

Here are seven notable private companies from the past year that have joined the ranks of the dearly departed, listed in reverse chronological order.

Table 8: Defunct Startups (3Q02 - 2Q03)

| Company | Total Invested | Approx. Date of Closure | Major VCs |
|----------------------|----------------|-------------------------|---|
| TrueSAN | \$30M | June 2003 | Woodside Fund, Merrill Lynch & Co. Inc., QLogic Corp., JT Venture Partners, Credit Suisse First Boston Corp., Spring Creek Partners, and Finisar Corp. |
| Scale Eight | \$55M | May 2003 | Oak Investment Partners, Star Ventures, InterWest Partners, CenterPoint Ventures, and Crown Advisors |
| ProvisionSoft | \$80M (est.) | April 2003 | CMGI, Compaq, Novell, Sun |
| Zambeel* | \$66M | April 2003 | Kleiner Perkins Caufield & Byers, New Enterprise Associates (NEA), Amerindo Investment Advisors, Aurora Technology Fund, Integral Capital, Juniper Networks, Merrill Lynch, and Morgan Keegan |
| Acirro | \$9.5M | Sept. 2002 | Raza Foundries |
| Sanrise | \$232M | Sept. 2002 | ACON Venture Partners, Comdisco Ventures, Crosspoint Venture Partners, Exodus, GATX Ventures, Global Innovation Partners, Greenbridge Partners LLC, The Greenspun Corp., Hitachi, Hitachi Data Systems (HDS), Lighthouse Capital Partners, Morgan Stanley Dean Witter & Co., Morgan Keegan & Company Inc., Oasis Ventures, Texas Pacific Group, Veritas, and Wilson Sonsini Goodrich & Rosati |
| Cereva | \$200M | July 2002 | Matrix Partners, North Bridge Venture Partners, Oak Investment Partners, Goldman Sachs & Co., Intel Capital, WorldView Technology Partners, and Sumitomo Corp. |

* Restarted as *StorAd Inc.* in April 2003.

G. Restarts

One underlying trend in the overall funding of tech ventures this past year is the increased frequency of “restarts.” A survey that tracks VC investments conducted by Ernst & Young and VentureOne found that the number of restart fundings increased seven times this past year, from 1% to 7% of all fundings.

A “restart” goes by many names – including “washout” and “zero-pre-money” (that’s VC talk). Translation: All previous shareholders are vaporized. But the obvious purpose of such a move is for the original VCs to protect their investment, or at least recoup some of it at a later time, rather than take a complete loss.

Not surprisingly, you won’t find the VCs involved in these things too willing to discuss the subject. “Recap” (meaning recapitalization) is another term that’s substantially equivalent. In a recapitalization round, the existing equity structure is wiped out and started over so existing preferred holders are converted to common shareholders and a new structure of preferred shares is started.

After a washout, the new VCs may end up owning up to 95% of a company – which is certainly more like an acquisition, notes PricewaterhouseCoopers’ Hare. He also points out that just because the doors of a company didn’t actually close doesn’t mean that a restart didn’t occur. The implication is that a lot goes on that simply isn’t announced publicly.

With the above background on this touchy subject, we call your attention to one such firm in our data that would qualify as a “restart” – Zambeel, which was a highly touted NAS hardware company before its VCs flushed \$66 million in previous investments and rebirthed the company in April 2003 as *StorAd*, reportedly to market some sort of software related to Zambeel’s technology. That month, Zambeel reportedly received a \$12 million round of funding led by Apex Venture Partners with participation by previous investors Kleiner Perkins and NEA, a condition of which was to restart the company as a new entity called *StorAd* that had just bought certain assets from Zambeel in an auction. Several key employees also moved over to *StorAd*, at least one of which has since moved on.

Some other companies that switched focus or made a significant change in the past year – while they perhaps aren’t each a washout or recap, technically speaking – include:

- **3ware**, which left IP storage behind and is now marketing serial ATA RAID controllers;
- **Scale Eight**, which changed from services, to software, then to hardware before shutting down for good in June 2003;
- **Trebia**, which changed its entire management team after receiving a \$10 million round May 2003, and previously had said it was for sale. At press time for this report in August, Trebia was said to have shut down, with an unnamed third party acquiring its intellectual property assets; and
- **VIEO**, which changed from a supplier of software for InfiniBand servers to a systems management software company.

H. Hot (and Not-So-Hot) Acquisitions

By far the *potentially* largest deal of the year for a privately held company was Cisco's announcement in August 2002 that it would buy internally incubated SAN switch startup Andiamo – but, alas, no VCs were involved, so we won't dwell on it. Cisco said at the time that the maximum price would be about \$2.5 billion in Cisco shares, based on a complicated formula. But industry analysts believe the final transaction will be far less than that. Cisco maintains about a 44% ownership in the company, with employees holding the rest.

The biggest “exits” of the year in the storage industry that did involve VCs were the Pirus acquisition by Sun, announced in September 2002, and the Rhapsody Networks acquisition by Brocade, announced in November 2002. Pirus would appear to have been the larger of the two deals, valued at \$160 million when it closed in November. The value of the Rhapsody acquisition was \$137 million when it closed in January 2003. However, it's possible the final payout could be close to the Pirus number, once what is called the “earn out” portion of the deal is known in November 2003. (An additional sum will be paid then if a product development milestone is reached.)

After these four deals, the list drops off quite a bit. Below is our list of acquisitions announced during the report year (July 2002 through June 2003) in order of deal size. At press time in late August, SAN switch vendor McData announced the biggest deals in storage networking for 2003 so far, buying Nishan Systems for \$82 million in cash and Sanera Systems for \$101 million in cash.

Table 9: Storage Networking Acquisitions (3Q02 – 2Q03)

| Acquirer | Acquiree | Value of Deal | Date Announced |
|---------------------|-------------------------------|---------------|----------------|
| Cisco Systems | Andiamo | Up to \$2.5B* | 08/20/02 |
| Sun Microsystems | Pirus Networks | \$160M | 09/18/02 |
| Brocade | Rhapsody Networks | \$137M | 11/05/02 |
| Quantum | Benchmark Storage Innovations | \$56M | 09/06/02 |
| Sun | Terraspring | \$35M | 11/15/02 |
| EMC | Prisa Software | \$20M | 09/25/02 |
| Network Engines | TidalWire | \$18M | 11/11/02 |
| Quantum | SANlight | \$8.5M | 02/05/03 |
| Overland Storage | Okapi Software | \$5M | 06/26/03 |
| Computer Associates | Netreon | Not disclosed | 02/05/03 |
| EMC | Astrum | Not disclosed | 04/15/03 |
| IBM | TrelliSoft | Not disclosed | 08/29/02 |

* Final price based on a formula including sales of Andiamo switches over a three-month period and Cisco's market cap.

I. Fire Sales

Some of the previous transactions could likely be shifted into this section, if the full details were only known – meaning they were less than breakeven for the investors involved (in some cases, much less). However, our intent with the following list is to identify asset sales only – as in "picking the bones" – that occurred after a company declared bankruptcy, closed its doors, or, in one instance (Storability selling its data center operations to StorageTek), changed its direction and made a divestiture related to its previous business.

The transactions are listed below in reverse chronological order.

Table 10: Transactions Involving Intellectual Property or Other Assets (3Q02 - 2Q03)

| Buyer | Seller | Value of Deal | Date |
|-----------------------------------|------------------------------|---------------|------------|
| Storability | ProvisionSoft | Not disclosed | July 2003 |
| Motorola | Paceline | Not disclosed | May 2003 |
| ManagedStorage International Inc. | Sanrise (services unit) | \$6M | Jan. 2003 |
| EMC | Sanrise (other assets) | \$2.5M | Sept. 2002 |
| Cable & Wireless | StorageWay | \$2M | July 2002 |
| StorageTek | Storability (SSP operations) | Not disclosed | July 2002 |
| EMC | Cereva Networks | \$10M* | July 2002 |

* Byte and Switch Insider *estimate*

J. Sizzlin' in July

Could this be a harbinger of things to come? With summer normally a slow time for VC closings, we were surprised to see a particularly large amount of funding announced in the past month – a total of \$99 million – immediately following the June 30 cutoff for our report data. Here are those July 2003 fundings:

Table 11: Funding Rounds in July 2003

| Company | Amount | Investors |
|------------------------------------|---------|---|
| BlueArc | \$47.0M | Meritech Capital, Crosslink Capital, RWI Group |
| Netezza | \$20.0M | Sequoia Capital, Battery Ventures, Charles River Ventures, Matrix Partners, Orange Ventures |
| Revivio (<i>formerly Mariko</i>) | \$20.7M | Globespan Capital, Bessemer Venture Partners, Charles River Ventures, Flagship Ventures |
| StoneFly | \$11.3M | Rustic Canyon Partners, Crescendo Ventures, El Dorado Ventures, Palomar Ventures |

IV. VC Scorecard

In an attempt to track just who dished out the most cash this past year, we compiled a list of VC firms by number of deals. (Doing it by dollar volume is not possible, since specific investments by each firm are almost never broken out – only totals are generally reported for a given round of financing.) Here's the rundown for July 2002 through June 2003. Note: Two rounds for the same company counts as two deals in this ranking. [Disclosure: Lightspeed is an investor in Light Reading Inc., which publishes *Byte and Switch Insider*.]

Table 12: Storage Networking Funding Rounds per VC Firm

| No. of Deals | VC/Startups Funded |
|--------------|--|
| Six | <p>Greylock: Data Domain, Incipient (x2), Lumigent, PolyServe, Sanera</p> <p>Lightspeed: Avamar, InfiniSwitch, MonoSphere, NBT Technology, NeoScale, Netezza</p> <p>NEA: 3ware, CreekPath, Data Domain, E2O, PolyServe, Zambeel</p> |
| Five | <p>Crescendo: Compellent (x2), iReady, Sistina, StoneFly</p> |
| Four | <p>Charles River: Acopia, EqualLogic, Key Research, Redline Networks</p> <p>ComVentures: Exavio (x2), NextGig, Persist</p> <p>Redpoint: Allocity, OuterBay (x2), Topspin</p> <p>Sequoia: Actona (x2), Isilon, Topio</p> <p>Sigma Partners: EqualLogic, GlassHouse, Topio, Vormetric</p> |
| Three | <p>Accel: Acopia, Topspin, NBT Technology</p> <p>Atlas: Isilon, LiveVault, Trebia</p> <p>Advanced Tech Ventures: Intransa (x2), Redline</p> <p>Benchmark: Avamar, FilesX, MonoSphere</p> <p>El Dorado: Compellent, NextGig, StoneFly</p> <p>Ironside Ventures: Astrum (x2), LeftHand Networks</p> <p>JP Morgan Partners: Aristos Logic, MSI, Sierra Logic</p> <p>VantagePoint: 3ware, Exavio, BakBone Software</p> |

A. Winners & Losers

The number of deals a VC firm does is one thing. But what counts is which firms had the best returns from storage deals, based on the acquisitions of companies they backed. The consensus this year seems to be that five firms performed the best: Sequoia, Accel, Charles River, Bessemer, and BlueStream. The two biggest acquisitions, as mentioned previously, and the main VCs who benefited from each, were Pirus (Bessemer, BlueStream, Charles River), and Rhapsody Networks (Sequoia, Accel).

But even the best return of the five VCs mentioned above may have only been about five to seven times their total investment, sources tell us. It's also interesting – and perhaps quite understandable – that three of these five firms show up on our list of most-active VCs in the world of storage.

There were other investment winners this year, of course, but likely only in the 2x range – and so shall remain nameless. (That's because VCs don't get excited about a number like this, folks – even when you or I might be thoroughly ecstatic about it.) And even more firms only broke even from their acquisitions, which were hardly all huge wins in a year when bargain-hunters had such an upper hand.

So, was it a good year for VCs in storage? Well, for some, yes – but certainly not spectacular. For too many others, it was not pretty. The winners named above still have a long way to go to match the scorecard of Crescendo and El Dorado, which industry insiders say took down as much as a 100x for their investors when Cisco snapped up NuSpeed for \$460 million back in 2000, when the startup was just seven months old. (How does anybody ever beat that?) Did such a payday cause these firms to fold the tent and head for their own personal South Seas islands? Hardly – both are still among the most active VCs out there in storage venturland, as noted in our list above.

On the flip side, who were the VC “losers”? This list gets just a tad longer. There were some spectacular bombs this year, as covered in the previous section under the “Flameout” heading – storage startups that went out of business erased at least \$670 million of total investment (and that’s just based on adding up the numbers we can easily identify). We should note, however, that this number was invested not just in the past year, but over the life of these startups. Nonetheless, remember it the next time you read about all the positive returns VCs manage to nail down.

We don’t want to focus on the negative here, but documenting a complete picture for the past year necessitates us listing the VCs involved in the biggest failures of the period, which were Cereva, Sanrise, Scale Eight, ProvisionSoft, TrueSAN, and Zambeel. The VCs affected in some of these wipeouts include stellar names in the venture capital business: Kleiner Perkins, Oak Investment Partners, New Enterprise Associates, and Goldman Sachs, to name a few.

And many other VC firms made the list of unwinnners as well, including (in no particular order): Matrix Partners, North Bridge Venture Partners, WorldView Technology Partners, Comdisco Ventures, Crosspoint Venture Partners, GATX Ventures, Morgan Stanley Dean Witter & Co., Morgan Keegan & Company, Texas Pacific Group, ACON Venture Partners, Global Innovation Partners, Greenbridge Partners, The Greenspun Corp., Lighthouse Capital Partners, Oasis Ventures, Star Ventures, InterWest Partners, CenterPoint Ventures, Crown Advisors, Woodside Fund, Merrill Lynch, JT Venture Partners, Credit Suisse First Boston, and Spring Creek Partners. (On the other hand, some of the firms mentioned here had modest winnings in some of the announced acquisitions of the year, which could have mitigated their losses somewhat.)

Well, *c’est la vie!* Nothing ventured, nothing gained. And, yes: All true VCs do have that tattooed on their behinds.

B. Corporate VCs: Losing Heat?

Any report on venture capital investing, especially in the storage and storage networking sector, would not be complete without addressing the topic of corporate venture investing. Many established technology firms in this industry maintain a corporate venture department or fund for the purpose of making strategic investments that somehow benefit the mother ship. Many startups have gone on to considerable success with the help of such corporate equity investments, which some label a form of “outsourced R&D” by established firms who often find it less costly and more expeditious to “buy” (invest in) the technology of new startups rather than “build” their own. And many of these mother ship firms have been rewarded greatly financially from these holdings – especially those that went on to IPOs.

But let’s take a look at the current state of affairs in this non-traditional VC sector. First of all, below we list deals we could identify in the past year in which corporate VCs participated. Not all corporate VCs announce their investments publicly, and if they do they often don’t disclose the amount of the investment (as is the case with one investment below, which Hitachi made in Voltaire). As such, it’s entirely possible there have been other investments in this category that we are unable to document.

Here are the corporate VCs we are aware of that participated in funding rounds in the past year, in the startups noted. These fundings are included in our overall list earlier in this report.

- **Intel:** Aarohi, Panasas, Wasabi, RASilient
- **Hitachi:** Mountain View Data, Voltaire
- **Daiwa:** Mountain View Data
- **LSI Logic:** iVivity

Why does the list seem shorter than you might expect it this year? Because corporate venture investing has been a declining business in recent times, for a number of reasons.

“Corporate governance pressures are the main reason,” says Jay Hare, technology partner at PricewaterhouseCoopers. “That’s putting the focus of companies squarely back onto what they do best.” Venture investing is not deemed an essential activity, he notes, and accounting changes have made things tighter, affecting off-balance-sheet items like this. Moreover, poor returns after the dot-com bust certainly caused many firms to exit the business of venture capital investing. “The Johnny-come-latelys are gone – and there were hundreds,” he says.

One of the storage industry stalwarts that did exit the business this past year was Quantum. In August 2002, the company sold the portfolio of its Quantum Technology Ventures unit to Pantheon Ventures, a London-based VC firm, which also has offices in San Francisco. As of that point, according to Barbara Nelson, Quantum’s EVP of corporate marketing and strategy, “We are longer in the ‘venture’ business, as it were.”

But it raises the question, did Quantum sell its portfolio just a bit too soon? As noted below, one of its holdings was Rhapsody Networks, which was one of the biggest takes of the year for VCs. Either that or it got a very good price for the portfolio in anticipation of the deal, one would assume.

CORPORATE VC WINNERS THIS YEAR

- **Oracle, Quantum Technology Ventures:** Investors in Rhapsody (acquired by Brocade)
- **Veritas, StorageNetworks:** Investors in Pirus (acquired by Sun). Unfortunately this wasn't enough to save StorageNetworks, which folded in July.
- **HP, EMC:** Investors in Terraspring (acquired by Sun): Reportedly this deal was not quite breakeven.

CORPORATE VC LOSERS THIS YEAR

The biggest failures of the year, lumped here as a group for convenience, are the companies that funded Cereva, Sanrise, Scale Eight, ProvisionSoft, TrueSAN, and Zambeel: Intel, Sumitomo, Exodus, Veritas, Hitachi, Hitachi Data Systems, Wilson Sonsini Goodrich & Rosati, CMGI, Novell, Sun, Compaq, QLogic, Finisar Corp., and Juniper Networks.

What does the future hold for entrepreneurs looking for corporate VC investment? "I suspect as times get better, we'll see more activity from the corporate VCs," says Arun Taneja, founder of consulting firm Taneja Group. "In thin times, it's hard for a company to spread spare money around, since there is little to spare. And these investments don't show returns for years."

V. Conclusions & Outlook

What's in store for the second half of 2003 and early 2004? We would expect VCs to continue to be cautious, making very selective new investments and nurturing their existing companies. If a startup is showing no traction, the product is late, or the management team is not cutting it, "we will see them slaughtered," predicts Taneja. "The next 12 months is the year of producing results, bearing fruit. Lots of Series B and C."

Here are other observers' forecasts for the storage networking sector:

- *Duncan McCallum, Bessemer Venture Partners: "We expect continued consolidation and more company failures over the coming year – especially in the storage software space, which is overfunded. Now will be the time to watch for those companies that are able to build sales traction and rise above the noise."*
- *Charles Beeler, El Dorado Ventures: "We think there are still significant opportunities to reduce the complexity of implementing and operating storage networks, without reducing the functionality provided. People are talking about this as a midmarket solution, but large companies as well want to reduce the management overhead and complexity of their storage networks."*
- *Scott Sandell, New Enterprise Associates: "While NEA has been an active early-stage investor during the last two years, we are just now seeing increased activity from other firms in the business. We expect this to continue as the economy recovers."*
- *Steve Duplessie, analyst with Enterprise Storage Group: "Yes, customers are buying from startups. In the management space, CreekPath and Storability are nailing big deals at big customers. It's very encouraging, and tells me the big vendors don't have the right stuff."*

But will the sector continue to hold strong promise for growth from an investor perspective? "We believe storage will be a growth sector for the IT industry," Sandell says. "And, given the remaining unsolved problems, we expect it to be a fertile area for innovation. That said, the opportunities to build large new storage companies are fewer than five or six years ago, because the larger vendors have become more aggressive in pursuing new opportunities."

Finally, there's the question of whether the improving economy is loosening up the IT-spending purse strings at all. This is happening – but slowly. Duplessie chalks it up to paranoia: "They know they need it, know they will get screwed if something bad happens, but it's still slow in getting the financial attention it needs. Stupid really, since all the leverage is back in the customer's hands – vendors will kill to be helpful."

In closing, we thought it would be instructive to cite the results of a recent survey. Venator Partners, a Boston-based executive search firm that serves early-stage technology companies, recently surveyed 48 venture capital firms in the U.S., Europe, and Israel – and found the results "both encouraging and surprising," says Randy Bogue, managing partner.

Here's a summary:

- **86%** of VCs said they're more actively looking for new deals now than they were a year ago.
- **78%** say the quality of the deal flow has been trending up over the past year.
- **84%** expect corporations to resume IT spending at levels consistent with historical averages by 2004, with 52% expecting the recovery in the first half of 2004, and 32% in 2H04.
- **69%** say they'll be concentrating on early-stage investments in the coming year (52% Series A; 17% seed round)

How's that for a positive note on which to wrap up this report? If our friendly neighborhood VCs remain as optimistic as they purport to be, next year could hold a slightly brighter picture overall for storage startups looking to land fresh capital.

About the Author

***Graeme Thickins** is an independent technology writer based in the Twin Cities and Southern California who writes often on storage networking topics. This is his first report for Byte and Switch Insider. He has worked in the IT and storage industries for three decades, during which time he's written about hundreds of startups and emerging technologies, the majority of which were fueled by venture capital. He may be reached at graeme@thickins.com.*

Appendix A: MoneyTree Survey Methodology

The MoneyTree™ Survey measures cash-for-equity investments by the professional venture capital community in private emerging companies in the U.S.

General Definition

The survey includes the investment activity of professional venture capital firms with or without a US office, SBICs, venture arms of corporations, institutions, investment banks and similar entities whose primary activity is financial investing. Where there are other participants such as angels, corporations, and governments in a qualified and verified financing round the entire amount of the round is included.

Qualifying transactions include cash investments by these entities either directly or by participation in various forms of private placement. All recipient companies are private, and may have been newly-created or spun-out of existing companies.

The survey excludes debt, buyouts, recapitalizations, secondary purchases, IPOs, investments in public companies such as PIPES (private investments in public entities), investments for which the proceeds are primarily intended for acquisition such as roll-ups, change of ownership, and other forms of private equity that do not involve cash such as services-in-kind and venture leasing.

Investee companies must be domiciled in one of the 50 US states or DC even if substantial portions of their activities are outside the United States.

Specific Methodology

The focus of the survey is on cash received by the company. Therefore, tranches not term sheets are the determining factor. Drawdowns on commitments are recognized at the time the company receives the money rather than recorded as a lump sum amount at the time the term sheet is executed. Convertible debt and bridge loans are recognized only when converted to equity.

Once a company has received a qualifying venture capital financing round, all subsequent equity financing rounds are included regardless of whether the round involved a venture capital firm as long as all other investment criteria are met (e.g. cash-for-equity, not buyout or services in kind).

Angel, incubator and similar investments are considered pre-venture financing if the company has received no prior qualifying venture capital investment and are not included in the MoneyTree results. Angel, incubator and similar investments that are part of a qualifying venture capital round or follow a qualifying venture capital round are included to the extent that such investments can be fully verified as meeting all other criteria (e.g. cash for equity, not buyout or services in kind).

Direct investment by corporations (not through a corporate venture capital arm) is excluded unless (a) the investment is clearly demonstrated to be primarily a financial investment rather than outsourced R&D or market development, (b) it is a co-investment in an otherwise qualifying round, or (c) it follows a qualifying venture round in a company and meets all other criteria (e.g. cash-for-equity, not buyout or services in kind).

Data is primarily obtained from a quarterly survey of venture capital practitioners. Information is augmented by other research techniques including other public and private sources. All data is subject to verification with the venture capital firms and/or the investee companies.

Only professional independent venture capital firms, institutional venture capital groups, and recognized corporate venture capital groups are included in venture capital industry rankings.

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