

## vFinance Entrepreneurial Confidence Index (VECI)

**Third Quarter 2004**  
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### Executive Summary

Entrepreneurial confidence declined 3.6% in the third quarter of 2004 compared to the second quarter, the first quarterly decline in a year. Despite the decline, the vFinance Entrepreneurial Confidence Index (VECI), a measure of the interest in starting new businesses, stood at 197.9 (2002=100), 36.6% above the level of a year ago.

After seeing signs of a second quarter upturn in the entrepreneurial sector, the third quarter was a disappointment. Although there were 64 initial public offerings (IPOs) in the quarter, the highest level in four years, (but still weak compared to the late 1990s), venture capital (VC) investors severely reduced funding of new start ups. VC's funded 601 deals in Q3, down 24% from the second quarter and the lowest quarterly total since the end of 1995.

There appears to still be a high level of caution in the investment community. Even though there is a high and growing level of interest in starting new businesses, as seen in the rising VECI, the support for these businesses in the investment community is spotty at best. As a result, the **innovation gap** between the desire to start a business (measured by the VECI) and the support for new business (venture funding) has never been wider, one reason that the economy continues to underperform. As vFinance continues to study the VECI's relationship to economic and market indicators, we find the quarterly VECI appears to lead the small cap equity market as represented by the Russell 2000 by about 6 months. With the VECI rising in the first half of this year, it suggests small cap stocks will rise in the next second half.



Other important findings include:

- **Technology** continues to dominate entrepreneurial interest, accounting for 19.2% of the total inquiries received in the third quarter, the smallest share technology has ever recorded, down from 35% in 2001. As the preeminence of technology has faded in equity markets, the interests of entrepreneurs have shifted to other sectors as well.
- **Real estate** remains the hottest sector attracting its largest share of inquiries ever, with 11.0% of the total in the third quarter as the red hot housing market has stimulated interest among entrepreneurs.
- This quarter, the true surprises are the strength of interest in **auto parts** and **trucking**. These sub-sectors may be experiencing the early stages of new innovation and they need to be studied more closely. In addition there was a steep decline in interest in the **wireless** sector to the smallest number of inquiries in three years.

The following sectors and sub-sectors experienced the largest changes in interest. These are early indications of major changes in trends that investors should monitor closely.

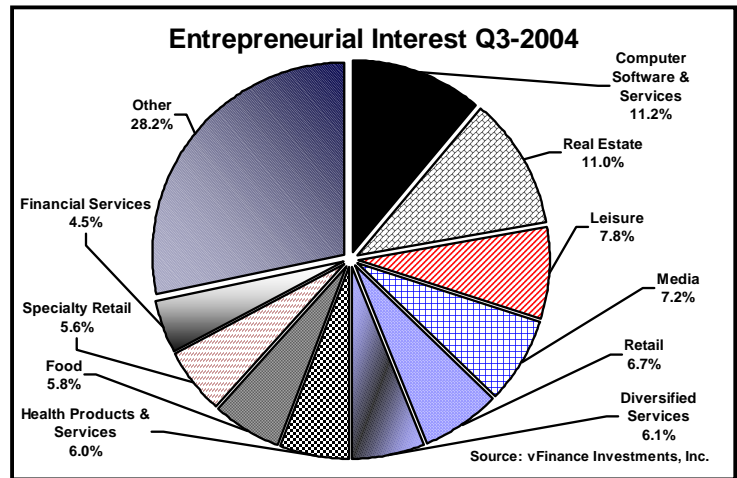
Q3/2004	Rising	Declining
<b>Sectors</b>	<ul style="list-style-type: none"> <li>• Real Estate</li> <li>• Retail</li> <li>• Transportation</li> <li>• Energy</li> </ul>	<ul style="list-style-type: none"> <li>• Telecommunications</li> <li>• Drugs</li> <li>• Diversified Services</li> </ul>
<b>Sub-Sectors</b>	<ul style="list-style-type: none"> <li>• Lodging</li> <li>• Trucking</li> <li>• Auto Parts</li> <li>• Oil &amp; Gas Refining &amp; Marketing</li> </ul>	<ul style="list-style-type: none"> <li>• Drugs</li> <li>• Diversified Utilities</li> <li>• Leasing</li> <li>• Music Retail</li> </ul>

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**Response Shares**

The largest number of responses continues to show up in the **computer software and services** sector, which accounted for 11.2% of all interest. Second on the list is **real estate**, which accounted for 11.0%. **Real estate** has seen a sharp increase in interest over the past year, jumping from 7.9% a year ago, while interest in the **computer software and services** sector has gradually declined from 13.1% a year ago to the current 11.2%, the lowest share we have seen since the survey began three years ago.

Response share is not the same as VEI ranking. Response share is the individual sector's share of all responses, the VEI ranking includes measures of the growth or decline in interest over time, and therefore gives an indication of rising or falling interest as well as the overall level of interest at any given time.



**The VEI monitors 28 major sectors and 289 sub-sectors**

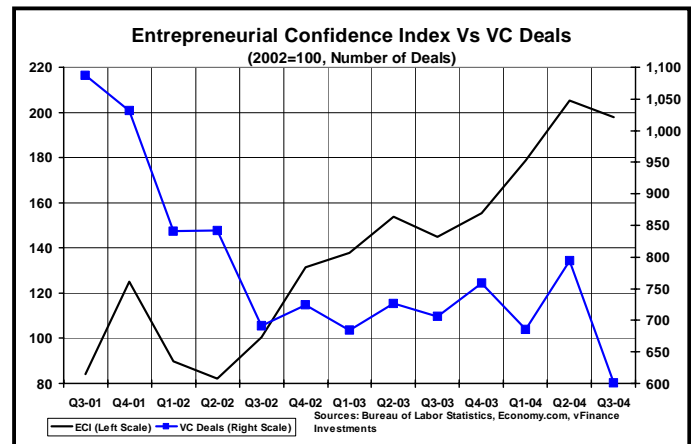
The decline in the **computer software and services** sector appears to be part of a trend in the inquiries that began when the VEI data was first gathered in the third quarter of 2001. The computer-related sectors have seen their shares decline steadily during the past three years while non-technology sectors like **retail**, **real estate** and **media** have seen their shares increase. This may be a reflection of weakness of technology within equity markets. The steep decline in the NASDAQ market index and most Internet-related companies has made technology industries less attractive to entrepreneurs because it has become more difficult to profit in this sector. In addition, as the Internet continues to become more widely adopted, newer users are more likely to be interested in non-technology sectors as opposed to the technology-oriented users who dominated Internet use in its early days.

**The VEI and The Economy: The Innovation Gap Widens**

Although down slightly in the third quarter, the VEI remains in a strong upward trend, suggesting continuing growth in the desire to start a new business among entrepreneurs in the US economy. Unfortunately, that desire is not being turned into actual new businesses. The latest evidence of this Innovation Gap is the sharp decline in venture capital investment in the third quarter of 2004.

The chart shows the clear divergence in the trends between the number of firms receiving venture financing and the interest in starting a new firm since we began collecting this information in 2001. In the third quarter of 2004, the Gap expanded to its widest margin ever. Other data also indicate there is an Innovation Gap in the US economy today. The number of new establishments adding employees in 2003 fell to the lowest level since 1997. This suggests that the new business formations one would expect to see when the desire to start a new business is high is just not happening.

That is the Innovation Gap. In an otherwise healthy economy, when it should be narrowing, it is widening.



The economic consequences of the Innovation Gap can be seen in employment. New businesses are needed to create jobs. The current economy has the worst job-creation record in the post-war era. The average employment increase after three years of recovery has been 6.9 million, while the economy today has added only 700,000 jobs since the recession ended.

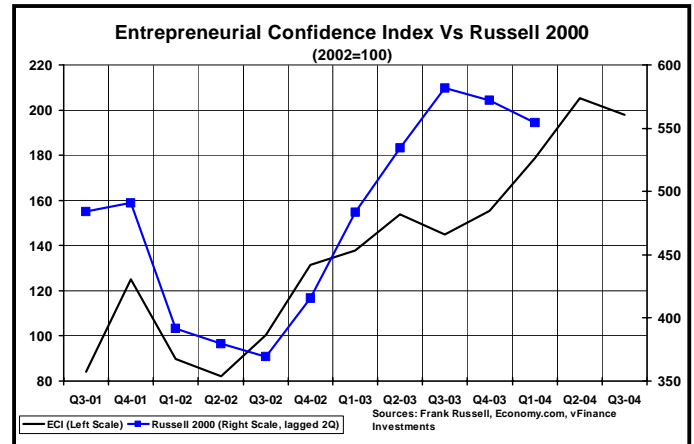
## The VECI and The Equity Markets: The Small Cap Market

With this report, we now have three full years of VECI quarterly data. The more historical data we have, the better able we are to study and understand the relationship of the VECI to the economy and financial markets. As we continue this analysis, we have been impressed by the apparently strong relationship between the VECI and Russell 2000, a stock market index comprised of small cap equities. The correlations are solid, but not compelling. It will take more time and more analysis to see if the relationship holds up, but our preliminary findings are that the VECI leads the Russell 2000 by about half a year. What this means is if the VECI increases in any quarter, the Russell 2000 increases six months later. This has happened about two-thirds of the time according to the correlations.

The reasons for this relationship may be related to conditions in equity markets. With venture capital activity down because venture funds have been unable to sell their portfolio companies, due to the weak IPO market, returns and new investment opportunities in this asset class have been limited over the past several years. Investors who have traditionally paced a portion of their assets in these types of higher risk assets have not had as many options as in the past. There just aren't enough funds willing to take up the risk capital that is available.

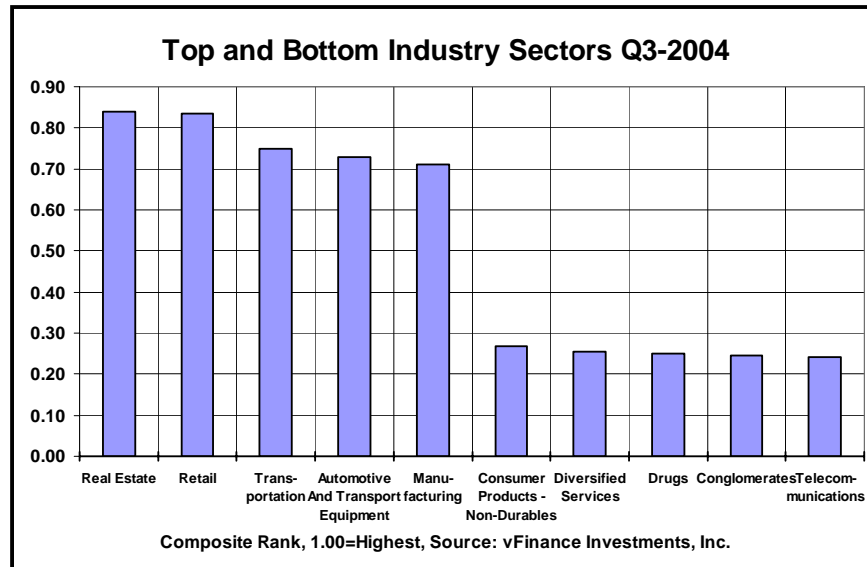
One alternative investment that risk-disposed investors may be turning to is the small capitalization equity market. Small cap equities tend to be lower priced and riskier than large cap and the risk capital that has been shut out of the venture space may be moving here with part of its investments.

The VECI tracks the level of interest in starting new businesses among entrepreneurs. When the index rises it tells us that there are more individuals and businesses seeking funding to start a business. When this index increases, there is more interest, more general innovation, more underlying activity in the entrepreneurial space. It is possible that this increase has an impact on the small cap sector of the economy and through that on investors. We are continuing to study this relationship, which suggests that there is a linkage between small cap investors and entrepreneurs that should be investigated more closely. If this relationship remains strong, today's VECI may be telling us something important about the small cap market in the next six months. The strength of the VECI in the first half of 2004 points to higher prices for small cap stocks in the second half.



## Major Industry Sectors

vFinance ranks the 28 major industry sectors that our respondents are asked to identify by both size and growth. The rankings are from a low of 0.00 to a high of 1.00. A highly ranked industry sector shows a combination of a high level of interest and rapid growth in interest. This composite rank provides an insight into where entrepreneurs are focusing their efforts and can provide investors and policy makers with valuable information on prospective future economic and market trends.



In the third quarter the highest-ranking sector was **real estate** (0.839), followed by **retail** (0.835), **transportation** (0.750), **automotive and transportation equipment** (0.728) and **manufacturing** (0.710). Other sectors that showed a significant improvement in their ranking, indicating significant increases in interest include **financial services** (0.705) and **energy** (0.679).

- ✓ **Real estate** remains the darling of entrepreneurs looking to profit from the upsurge in activity in this important sector of the US economy. We are very cautious on the residential real estate sector because the Federal Reserve has begun to raise interest rates. Although long-term rates in the bond market have yet to increase substantially, they will in the next six months, and when they do, this sector may experience a steep decline. Thus, we are probably seeing a peak in entrepreneurial interest in real estate.
- ✓ Opening a store has always been one of the main forms of entrepreneurship in the US. This explains the growing level of interest in the **retail** sector, which has been in the top 10 ranked sectors consistently since the fourth quarter of 2002. The combination of continuing strength in consumer spending and the low barriers to entry in this sector will likely keep retail among the top ranked sectors in the future.
- ✓ The biggest surprise in this quarter's rankings was the sharp increase in interest in the **transportation** sector with a climb in the **trucking** sub-sector accounting for most of the gain. **Logistics**, another sub-sector in the transportation sector, is an increasingly important function for corporations seeking to better manage their supply chain also saw increased interest as did **air services**. In an economic environment of rising oil prices and bankrupt airlines, an increase in interest in the transportation sector is difficult to understand. However, truck tonnage, the amount of goods moved by truck, has risen to an all time high in the latest six months so the strong activity in this industry may be attracting interest among entrepreneurs.
- ✓ **Automotive and transport equipment** and the **manufacturing** sectors were also surprises. These two sectors do not usually generate much interest from entrepreneurs because they are industry sectors that

have large existing companies and high barriers to entry. One possibility is that the increase in oil prices is triggering entrepreneurs to look into ways to increase auto efficiency or switch to alternative energies. For example, the **alternative energy** sub-sector has seen interest increase in recent quarters. However, in the second quarter, **auto and transport equipment** was the lowest ranked sector as interest dropped sharply. So the increase in the latest quarter needs to be watched carefully to see if it is a one-quarter jump or a more sustained climb.

The lowest ranked major sectors were **telecommunications** (0.241), **conglomerates** (0.246), **drugs** (0.250) and **diversified services** (0.254). Of these, the biggest decline was in **telecommunications**, which had seen a sharp increase in interest in the second quarter. The main reason for this drop was a steep decline in interest in **wireless communications services**, which fell to the lowest level ever recorded. This decline may be a result of consolidation in the wireless industry, which is rapidly becoming dominated by a few large national companies with regional providers being absorbed. The low ratings for **conglomerates** and **drugs** are no surprise given the low levels of interest in these sectors to begin with and the high barriers to entry in these sectors. The drop in **diversified services** indicates that we are seeing fewer individuals seeking to consult. In the past higher layoffs have generated higher interest in starting consulting services leading to an increase in this sector.

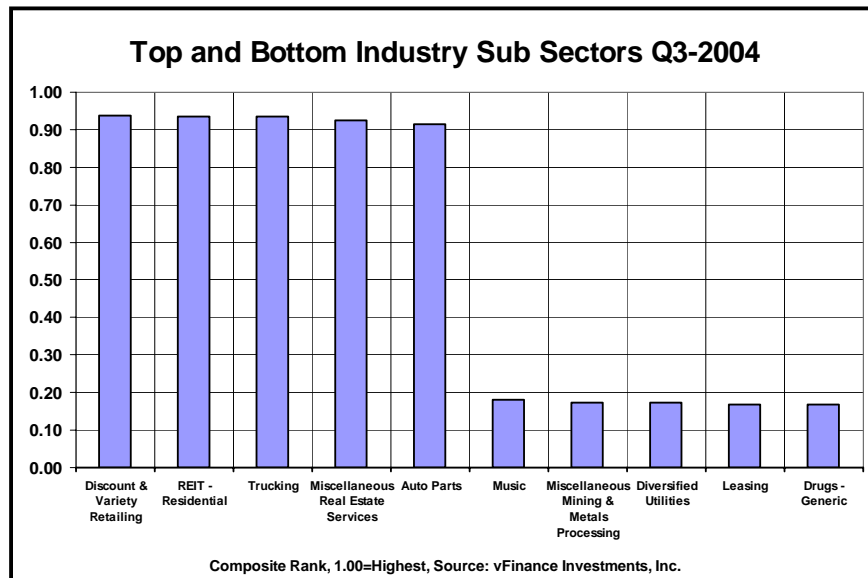
The following table shows the top ten major industry sectors for each of the past three quarters.

Major Industry Sector	Q1-04	Major Industry Sector	Q2-04	Major Industry Sector	Q3-04
Real Estate	0.9330	Diversified Services	0.8304	Real Estate	0.8393
Consumer Products - Non-Durables	0.8036	Media	0.8170	Retail	0.8348
Diversified Services	0.8036	Real Estate	0.8080	Transportation	0.7500
Food	0.7723	Electronics & Miscellaneous Technology	0.7946	Automotive & Transport Equipment	0.7277
Retail	0.7143	Aerospace & Defense	0.6473	Manufacturing	0.7098
Materials & Construction	0.7098	Health Products & Services	0.6339	Media	0.7098
Financial Services	0.6071	Manufacturing	0.5938	Financial Services	0.7054
Leisure	0.6027	Drugs	0.5536	Energy	0.6786
Computer Software & Services	0.5893	Telecommunications	0.5536	Health Products & Services	0.6652
Health Products & Services	0.5848	Retail	0.5491	Metals & Mining	0.6607

- ✓ We are somewhat skeptical of the strength in the **real estate** sector and suspect that it may be a case of entrepreneurs seeking to enter a market that has already seen its best growth and is probably at or near a peak.
- ✓ The increase in **financial services** is much more attractive. There was an increase in interest in the **investment banking and brokerage** sub-sector, suggesting that entrepreneurs see an opportunity in providing financial services to companies that may be too small for the large financial institutions.
- ✓ **Leisure** has seen a substantial decline in interest in the latest two quarters as interest in **sporting activities** and **miscellaneous entertainment** have fallen sharply. These declines have been partially offset by a rise in interest in the **lodging** sub-sector, but overall, this sector has fallen from the 8<sup>th</sup> highest in the first quarter to 18<sup>th</sup> in the third quarter. **Lodging** probably benefited from the strong vacation season during the summer, when this survey was conducted. The overall decline in **leisure** is likely a consequence of continuing concerns about the economy with sluggish employment growth making entrepreneurs more cautious about whether consumers will have enough free time and extra spending money.

## Industry Sub-Sectors

Of the 289 industry sub-sectors tracked by vFinance, only 74 saw the number of entrepreneurs expressing interest increase while 200 saw declining interest in the third quarter compared to the second quarter and 14 remained unchanged. This was a sharp decline from the second quarter when 183 sub-sectors experienced increases in interest and represented the smallest number of increases in interest since the survey began in the third quarter of 2001.



- ✓ Two of the top five sub-sectors are **real estate** related, which is no surprise as this sector has dominated entrepreneur interest throughout the year due to the strong housing sector. As we noted above, entrepreneurial interest in this sector may be at a peak as the increase in interest rates is likely to lead to an expected decline in real estate in the coming year. The largest increases were in **residential REITs** and **miscellaneous real estate services**. The **residential REIT** sub-sector has seen a steady increase in interest over the past several quarters as the housing industry has been one of the best performers in the economy.
- ✓ Two sub-sectors that are surprises are **trucking** and **auto parts**. In both cases there was a sharp increase in interest from the second quarter. These two sub-sectors are in industries that tend to be highly sensitive to oil prices. Higher fuel prices tend to dampen demand for autos, hurting the parts industry, and, it raises the cost of doing business in the trucking industry. The increase in the **auto parts** sub-sector may be a signal of emerging innovation that could reduce fuel consumption or in hybrid vehicles. In **trucking**, the strength of the manufacturing sector, which saw production reach an all time high in the third quarter, is probably behind the increase in truck traffic and in interest. The amount of freight being shipped by truck (as measured by the American Trucking Association) reached a record level in the second quarter and remained at a very high level in the third quarter.
- ✓ The lowest ranked sub-sectors did contain one surprise, as the **outsourcing and other human resources** was ranked number 281 out of 289. This is a sharp drop from the second quarter when it was ranked 23<sup>rd</sup>. It appears that as the attention being paid to outsourcing has diminished, so has interest in this sub-sector from entrepreneurs. Other low ranking sub-sectors included those with high barriers to entry, including **generic drugs**, **diversified utilities** and **metal mining**.

## vFinance Entrepreneurial Confidence Index

The movement in rankings from one quarter to the next is shown in the following table. Because of the large number of sub-sectors, there tends to be significant movement between quarters.

Major Sector	Sub-Sector	Q1-04	Major Sector	Sub-Sector	Q2-04	Major Sector	Sub-Sector	Q3-04
Leisure	Sporting Activities	0.9338	Media	Music Production & Publishing	0.93599	Retail	Discount & Variety Retailing	0.938149
Consumer Products - Non-Durables	Miscellaneous Non-Durable Consumer Goods	0.9299	Real Estate	Property Investment. & Management	0.89879	Automotive & Transport Equipment	Auto Parts	0.91436
Real Estate	Real Estate Development	0.9299	Diversified Services	Personal Services	0.87889	Financial Services	Investment Banking & Brokerage	0.851211
Real Estate	Property Investment & Management	0.9226	Real Estate	R E Dev.	0.87500	Real Estate	REIT - Residential	0.849481
Automotive & Transport Equipment	Buses & Other Vehicles	0.9001	Manufacturing	Miscellaneous General & Special Machinery	0.85813	Real Estate	Miscellaneous Real Estate Services	0.83045
Diversified Services	Personal Services	0.8936	Aerospace & Defense	Aerospace and Defense Products	0.84818	Transportation	Trucking	0.823962
Food	Diversified Foods - Other	0.8932	Diversified Services	Staffing	0.82483	Real Estate	REIT - Hotel/Motel	0.820502
Diversified Services	Consumer Services	0.8919	Real Estate	REIT - Residential	0.81315	Financial Services	Investment Firms	0.819204
Specialty Retail	Toy & Hobby Retailing & Wholesale	0.8867	Electronics & Miscellaneous Technology	Miscellaneous Electronics	0.81012	Metals & Mining	Gold & Silver & Other Precious Metals	0.817474
Real Estate	Residential Construction	0.8737	Leisure	Restaurants	0.80753	Retail	Clothing	0.807526

- ✓ The **music production and publishing** sub-sector soared to the rankings in the second quarter on the back of the rising popularity of music downloading and the iPod. But its ranking fell back to number 73 in the third quarter as interest fell to the lowest level of the year. Nevertheless, this sub-sector still attracts a large number of entrepreneurs ranking as 7<sup>th</sup> in terms of total number of inquiries.
- ✓ Care must be given when interpreting these data. The trends in the general economy tend to be reflected in the movement of entrepreneurial interest, hence the strength in real estate, But this may reflect more popularity than investment opportunity. Nonetheless, some nuggets for investors can appear within this data. Where we look is at the surprises. Which industries or sub-sectors are rising when everything says they shouldn't be? These sub-sectors deserve more scrutiny by investors as the rising interest may indicate a new trend emerging in the industry. This quarter, the true surprises are the strength of interest in **auto parts** and **trucking**. These sub-sectors may be experiencing the early stages of new innovation and they need to be studied more closely to see if there are fundamental changes occurring that investors may be able to profit from.

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