The Center for Innovative Entrepreneurship

vFinance Entrepreneurial Confidence Index (VECI)

Fourth Quarter 2004
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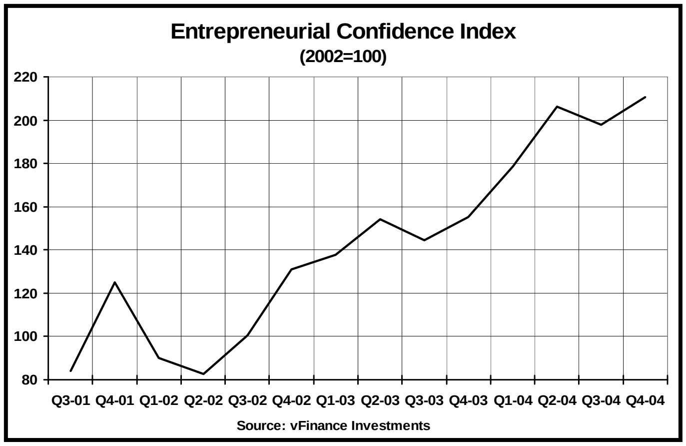
Executive Summary

Entrepreneurial confidence rose 6.3% in the fourth quarter of 2004 compared to the third quarter, the fourth increase in the past five quarters. The increase brought the vFinance Entrepreneurial Confidence Index (VECI) to a new all time high as it stood 36.0% above the level of a year ago. In the fourth quarter, the VECI, a measure of the interest in starting new businesses, stood at 210.5 (2002=100), indicating that interest has more than doubled in the past two years.



The fourth quarter VECI increase coincides with improvement in the innovation economy. Throughout most of 2004, we identified the **innovation gap**, the divergent trends between the rising desire to start new businesses, as seen in the VECI, and a declining trend in the financing of new businesses as seen in falling levels of venture capital (VC) funding and a weak IPO market, as one of the critical weaknesses in the US economy. *In the fourth quarter the innovation gap began to narrow* as VC investment and IPO activity grew more rapidly than the VECI*.* In the fourth quarter VC firms funded 747 deals, a 15.8% increase over the third quarter, but still below the level of the second quarter. More significantly, the number of IPOs jumped to 82, its highest level in more than four years, suggesting an increasing investor willingness to support new firms. All in all, the rising VECI and improvement in the financing climate indicate that the fourth quarter was the best environment for new businesses in several years setting the stage for a healthy innovation economy in 2005.

Other important findings include:

- **Real estate** is strong. Interest in starting a business in real estate accounted for 10.3% of all inquiries in the fourth quarter, down slightly from the third quarter, but the second highest on record. The second half of 2004 represented the highest interest in real estate we have recorded since the survey began in Q3 of 2001.

- **Computer software and services** showed a sharp increase in interest during the quarter with the **games and entertainment** sub-sector recording a steep jump. Overall, this sector saw its share of all responses increase to the highest level in more than a year.

- The **Drugs** sector saw a significant pick up in interest during the quarter largely as a result of higher inquiries in the biotechnology sub-sector, both **biotechnology medicine** and **biotechnology research** experienced a significant increase in their shares of all responses.

These sectors and sub-sectors experienced large changes in interest, early indications that investors should monitor.

Q4/2004	Rising	Declining
Sectors	• Computer Software & Services • Non-Durable Consumer Products • Drugs • Telecommunications	• Retail • Health Products & Services • Transportation
Sub-Sectors	• Entertainment & Games Software • Miscellaneous Financial Services • Miscellaneous Entertainment • Oil & Gas Exploration & Production	• Personal Services • Clothing Retail • Personal Services • Specialized Health Services

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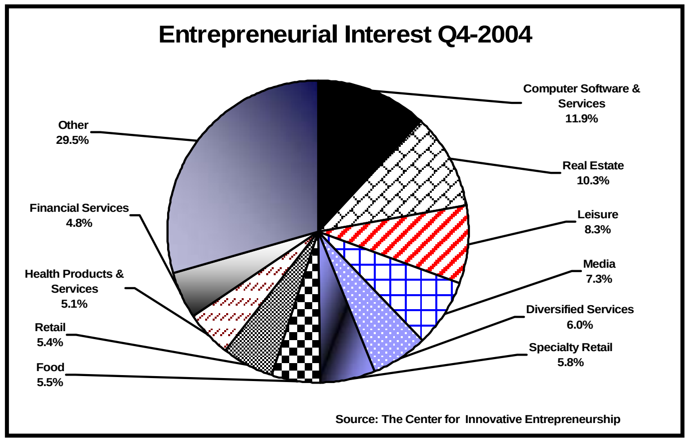
Response Shares



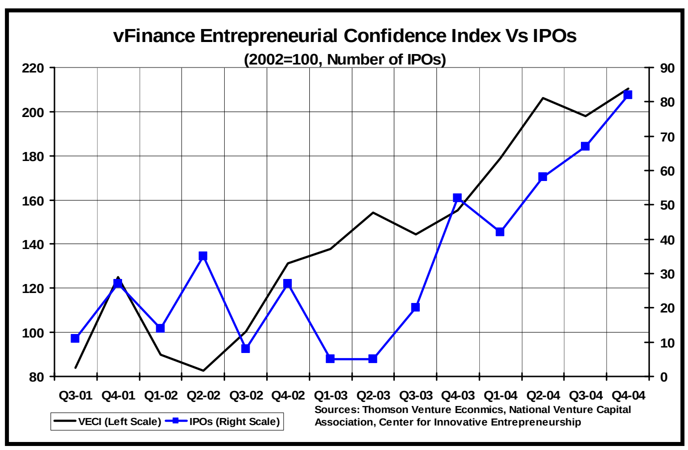
The VECI monitors 28 major sectors and 289 sub-sectors

The **computer software and services** sector garnered the largest number of responses in the fourth quarter survey (11.9% of all responses), as it has in every survey since we began in the third quarter of 2001. **Real estate**, remained second in interest level with 10.3% of all responses. This is down from the 11.0% level of interest recorded in the third quarter, but up from 8.9% a year ago. **Leisure** (8.3%) and **media** (7.3%) held down the third and fourth spots as they did in the third quarter. **Retail** is also a dominant sector in terms of interest level. In the fourth quarter, interest in **retail** and **specialty retail** taken together accounted for 11.2% of all responses, down from 12.3% in the third quarter and the lowest reading for these two sectors combined since the first quarter of 2003.

The fourth quarter decline in **retail** is surprising. Since the survey began in Q3 2001, **retail** and **specialty retail** combined gained share steadily until leveling off at around 12.0% of all responses in 2003 and most of 2004. The decline in the fourth quarter was caused by a sharp decline in interest in **discount and variety** retailing and **clothing**. Interest in retail may have been influenced by the increase in oil prices in the third and fourth quarter as this was widely expected to lead to a slowdown in consumer spending growth.

Response share is not the same as VECI ranking. Response share is the individual sector's share of all responses; the VECI 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 VECI and The Economy: The Innovation Economy Improves

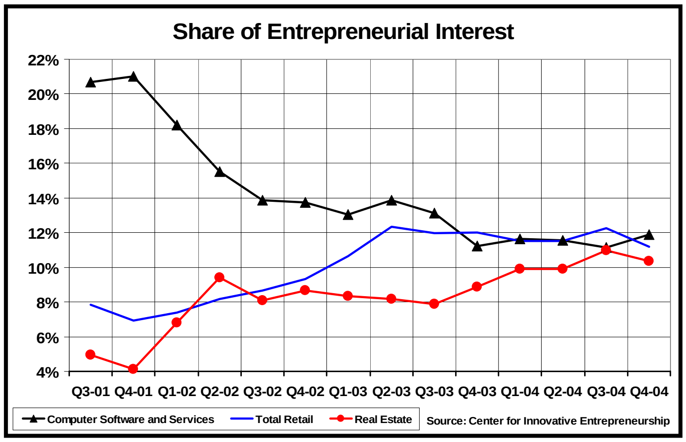


The fourth quarter saw a shift in conditions in the innovation economy, the dynamic core of the economy where new ideas become new businesses, creating opportunity, wealth and jobs. One key aspect of the innovation economy is activity in the financial markets, where capital is allocated. When the innovation economy is strong, investors are more confident in new, emerging companies and are more willing to allocate funds to emerging companies. The result is a robust and dynamic market for new companies and their shares. From 1995 through 2000, the number of initial public offerings (IPOs) averaged more than 550 per year or roughly 140 per quarter, according to data complied by Thomson Venture Economics, and the National Venture Capital Association. However, from late 2000 through the end of 2003, investor appetite for new business was weak, the number of new businesses that became publicly traded companies via IPO, fell to 5 in the second quarter of 2003. Since then, the number of IPOs has gradually increased, reaching 82 in the fourth quarter of 2004, the largest number of IPOs since the third quarter of 2000. In addition, the number of deals funded by the venture capital community increased in the fourth quarter to 747, an improvement over the third quarter, but still nowhere near the average of more than 1,375 deals per quarter from 1998 through 2001.

The innovation economy needs capital to thrive. The strong increase in the VECI since the middle of 2002 indicates that there is no shortage of ideas in search of funding. The recent increases in VC funding and the IPO market suggest that capital markets are starting to provide more financial support to young companies, a development that, if sustained, will support further improvement in the innovation economy in 2005.

VECI Trends: Technology rises, retail falls, and real estate reaches a plateau.

As we monitor the trends in the VECI over time, we can see how entrepreneurs react to changes in the economic climate. The three largest sectors in the fourth quarter were **Computer software and services, real estate and total retail** (the sum of **retail** and **specialty retail**), accounting for slightly more than one-third of all responses with each at roughly 11%.

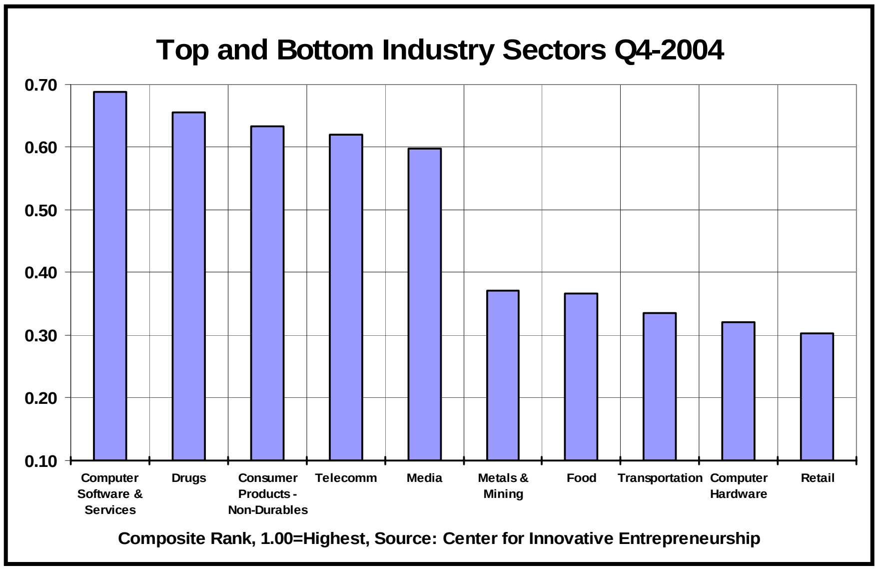


But each sector has traveled a different trajectory to get to its current position, reflecting the shifts in the economy. The software sector dominated entrepreneurial interest in 2001 and early 2002. But as the tech sector faltered and the NASDAQ market fell, this sector dropped from over 20% of all inquiries to about 11%, where it has stabilized. The total retail combination rose gradually to a peak in late 2003 as consumer spending remained robust stimulated by low interest rates and tax cuts. But as the effects of the tax cuts waned and employment growth was sluggish, the retail sector flattened out and has declined slightly over the past year. Meanwhile, as home sales have set records for three consecutive years and show no signs of faltering despite the shift to a higher interest rate environment, there has been a healthy increase in interest in the real estate sector among entrepreneurs. From 4.0% in late 2001 the share of all inquiries has surged to 10.3% in the fourth quarter of 2004.

This performance indicates that the interest of entrepreneurs is partially a reflection of underlying economic and financial market developments. When conditions in the economy shift, they create opportunities, or the perception of opportunity and entrepreneurs are there seeking to take advantage. This suggests that the economy today is providing opportunities in several sectors, rather than highly concentrated in technology as we saw several years ago.

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.



The fourth quarter saw an unusual bunching of rankings with little of the usual dispersion that we have seen in the past. The top ranked sector was **computer software and services** (0.687), followed by **drugs** (0.656), **consumer non-durables** (0.634), **telecommunications** (0.627) and **media** (0.698). Not one of these sectors had a ranking above 0.700, the lowest peak ranking we have ever recorded. In the third quarter, the top five sectors all had rankings above 0.700. The gap between the highest and lowest is the smallest it has ever been with all industries falling in a range of 0.392 points.

- ✓ **Computer software and services** saw a sharp increase in overall interest particularly in the **entertainment and games** sub-sector, where interest surged by the largest amount of any sub-sector. In addition there were increases in interest in the **corporate software** and **communications software.**

- ✓ The biggest surprise of the quarter was the sudden increase in interest in biotechnology, which boosted the **drug** sector to its highest ranking ever. But it wasn't just **biotechnology research** and **biotechnology medicine.** Of the 10 sub-sectors of the **drug** sector, 8 saw their share on all inquiries increase in the fourth quarter. It wasn't a surge, as the overall ranking of only 0.656 indicates, but at a time when levels of interest weren't shifting for any major sector, the increase in interest in the drug sector was enough to boost its ranking.

- ✓ In the **consumer non-durables** sector two sub-sectors showed particularly strong increases in interest in the quarter: **clothing** and **personal care** products. Both sub-sectors saw interest levels return to near the level of the first half of the year after a one-quarter decline. It appears the concern about the strength of consumer spending triggered by higher oil prices in the third quarter dissipated in the fourth quarter leading to higher interest in this sector.

- ✓ The **telecommunications** sector has seen a modest revival in interest over the past year as the effects of the tech bubble hangover have worn off. The level of interest in this sector is still well below the norm of

2001 and 2002, but it appears that efforts to accelerate deregulation in the industry may be leading to a higher interest level in this sector.

The lowest ranked major sectors were **computer hardware** (0.321)**, retail** (0.304), and **health products and services** (0.295). The largest decline was in **retail** which has had a highly erratic performance over the past year, surging one quarter only to drop sharply the next. In the fourth quarter both the **discount and variety** and **clothing** sub-sectors saw a significant decline in interest after experiencing a sharp increase in the third quarter. **Computer hardware**, never a very highly ranked sector saw interest in several sub-sectors decline, causing the entire sector to decline. As hardware has become more of a commodity, the opportunity for innovative new products has faded and overall interest in this sector has fallen from over 2.5% of all inquiries in 2001 to 1.0% in the fourth quarter of 2004. The **health products and services** sector saw interest levels drop to the lowest level since mid-2002 with the **specialized health services** sub-sector showing a steep drop in interest.

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

Major Industry Sector	Q2-04	Major Industry Sector	Q3-04	Major Industry Sector	Q4-04
Diversified Services	0.8304	Real Estate	0.8393	Computer Software & Services	0.6875
Media	0.8170	Retail	0.8348	Drugs	0.6563
Real Estate	0.8080	Transportation	0.7500	Consumer Products: Non-Durables	0.6339
Electronics & Miscellaneous Technology	0.7946	Automotive & Transport Equipment	0.7277	Telecommunications	0.6205
Aerospace & Defense	0.6473	Manufacturing	0.7098	Media	0.5982
Health Products & Services	0.6339	Media	0.7098	Banking	0.5848
Manufacturing	0.5938	Financial Services	0.7054	Financial Services	0.5804
Drugs	0.5536	Energy	0.6786	Leisure	0.5714
Telecommunications	0.5536	Health Products & Services	0.6652	Real Estate	0.5268
Retail	0.5491	Metals & Mining	0.6607	Automotive & Transport Equipment	0.5223

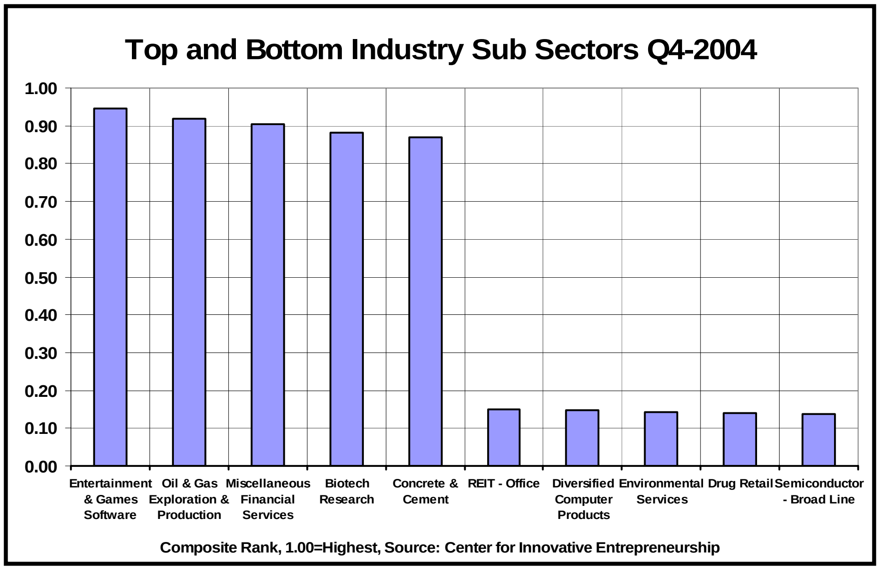
- ✓ The biggest surprise in the fourth quarter is the **banking** sector showing up at number six. This is partially a result of the low rankings of other sectors (with a 0.584 ranking banking would not have been in the top 10 in the second quarter) and partly a result of increasing interest in several regions, led by Latin America and the Midwest. But this has never been a highly ranked category or one generating much interest. It remains a minor sector and not one that should be monitored closely.

- ✓ **Real estate** is the only sector to show up in the top 10 in all three of the latest quarters, a testament to the powerful growth in this sector in the economy at large. The decline in the sector's ranking in the fourth quarter could signal a peaking in interest in this sector**.**

- ✓ **Leisure** returned to the top 10, and remains the third highest sector in terms of number of inquiries. The **tour operators and travel services** sub-sector recorded the strongest performance in this sector, which could reflect increasing confidence in the travel sector as the effects of the September 11 attacks finally dissipate completely. The travel industry has indicated an expectation that air travel will return to pre 9-11 levels this year.

Industry Sub-Sectors

Of the 289 industry sub-sectors tracked by vFinance, only 81 saw the number of entrepreneurs expressing interest increase while 183 saw declining interest in the fourth quarter compared to the third quarter and 25 remained unchanged. This was a slight improvement from the second quarter when 74 sub-sectors experienced increases in interest.



- ✓ Higher oil prices of the third quarter had the expected impact as interest in **oil and gas exploration** showed a sharp increase in the fourth quarter both in the number of inquiries and the share of all inquiries. It was the second fastest growing sub-sector after **entertainment and games software**.

- ✓ The **concrete and cement** sub-sector showed a sharp increase in interest and its share of all inquiries, leading to a jump in its ranking into the top 5. The cement industry is booming as manufacturers are running flat out to meet the demand from the equally strong construction sector. The price of cement has increased almost 12% in the latest 12 months reflecting the tight market. In the fourth quarter, production of cement and concrete products reached a new record high, yet output cold not keep pace with demand and prices surged. These market conditions have probably attracted entrepreneurs to this industry.

- ✓ The lowest ranked sub-sectors tend to be in industries that are either large and not easily penetrated (**semiconductor-broad line)** or have high barriers to entry, like the **REIT** sub-sector. Although **drug retail** may seem an unusual sub-sector to find among the lowest ranked, it has never attracted a high level of interest, probably because this retail segment has become dominated by large, full-service providers making it more difficult for small local stores to compete.

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	Q2-04	Major Sector	Sub-Sector	Q3-04	Major Sector	Sub-Sector	Q4-04
Media	Music Prod. & Pub.	0.9360	Retail	Discount & Variety Retailing	0.9381	Computer Software & Services	Entertainment & Games Software	0.9468
Real Estate	Property Invest. & Mgt	0.8988	Automotive & Transport Equipment	Auto Parts	0.9144	Energy	Oil & Gas Exploration & Production	0.9187
Diversified Services	Personal Svcs	0.8789	Financial Services	Investment Banking & Brokerage	0.8512	Financial Services	Miscellaneous Financial Services	0.9048
Real Estate	R E Dev.	0.8750	Real Estate	REIT - Residential	0.8495	Drugs	Biotechnology - Research	0.8815
Manufacturing	Misc.Gen. & Spec. Mach.	0.8581	Real Estate	Miscellaneous Real Estate Services	0.8304	Materials & Construction	Concrete & Cement	0.8707
Aerospace & Defense	Aerospc/Def Prod.	0.8482	Transportation	Trucking	0.8240	Electronics & Miscellaneous Technology	Scientific & Technical Instruments	0.8521
Diversified Services	Staffing	0.8248	Real Estate	REIT - Hotel/Motel	0.8205	Specialty Retail	Miscellaneous Wholesale	0.8218
Real Estate	REIT - Residential	0.8131	Financial Services	Investment Firms	0.8192	Specialty Retail	Auto Dealers & Distributors	0.8188
Electronics & Miscellaneous Technology	Miscellaneous Electronics	0.8101	Metals & Mining	Gold & Silver & Other Precious Metals	0.8175	Diversified Services	Management Consulting Services	0.8157
Leisure	Restaurants	0.8075	Retail	Clothing	0.8075	Media	Television Production	0.8058

- ✓ The surge in the **entertainment and games software** sub-sector was partially a consequence of the weakness recorded in the third quarter, when this industry ranked 258th. The increase in interest brought it back to the level of the first quarter. But even with this volatility, interest in games software has been growing over the past three years. At the end of 2001, this sub-sector accounted for 0.83% of all inquiries. In the latest quarter it was at 0.98%.

- ✓ 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, one surprise is the strength of interest in **biotechnology** both research and medicine. This sub-sector 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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DISCLOSURE INFORMATION

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