MILESTONE MATTERS

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"There is a cliché among investors that, "cash is king." Nevertheless the cliché is mistaken: Confidence is the real king and cash only its consort." Annual message to shareholders, Mathews Asia Funds, December 2008

Editor's Corner

Dear Friends, Investors and Associates,

I write this note to you during "quiet week" between the frenzy of Christmas and the sometimes forced jollity of New Year's Eve festivities. The mail is sparse and the phone calls few and so one has time to think - a great luxury - particularly amidst the hurly burly that characterized the financial community during 2008.

I was struck by a recent rumination in the New York Times, not so much for what was written but by who wrote it. The thought was penned by the man I have come to think of as the Darth Vader of the Empire of Economic Despair, the columnist and Nobel laureate, Paul Krugman. He wrote in mid-December 2008, "Late next year the economy should begin to stabilize and I am fairly optimistic about 2010." I agree but think there is a much bigger story and opportunity at hand.

As I am sure you have observed, there is a pronounced tendency in the media and among pundits to engage in group thinking as distinct from thinking. The conventional line is that 2008 represented a critical juncture in modern history – a point at which the U.S., through its own folly, surrendered its preeminent place in the community of nations and will slide into an economic and political backwater. This line of thinking is championed by, among others, Nouriel Roubini, Professor of Economics at New York University.

Now I accept that the United States has acted foolishly and deserves retribution for its aversion to saving, its addiction to debt and, seemingly, like a small child, its need for instant consumer gratification. But I am reminded of an observation attributed to Bismarck, the Iron Duke and Prime Minister of early 20th century Germany, who reportedly remarked to Winston Churchill that "the good Lord watches over drunks, children and the United States of America."

After contemplating submission to this tidal wave of negative pronouncements, I came across, in the ever stimulating Financial Times of December 16, 2008, an article which gave me optimistic intellectual grist to feed my mill. In brief, the points made are as follows. It is true that the U.S. has suffered terribly during 2008. But economic performance and power are relative indices. The fact is, that despite the dismal performance of the U.S. securities markets during the year, astonishingly, the U.S. performed better than all other major markets.

Furthermore, the U.S. remains one of the few countries that have access to the international debt markets despite paltry interest rates associated with its issued bonds. The exclusion from these markets includes some quite respectable economies such as those of Brazil, Columbia, Mexico, Peru, South Africa and Turkey.

Analogously, in a world of economic uncertainty and volatility, the U. S. remains, for many, the investment market of last resort.

On the opposite side of the Roubini debate, are those who argue that the U.S. will find itself emerging from the recent global turmoil, more powerfully positioned than prior to the financial crisis. This power has been enhanced by the sharp decline in the price of oil which has had a huge negative impact on the economic fortunes and political power of a number of oil dependent regimes such as Russia, Iran and Venezuela.

As the FT article's author, Ricardo Hausmann, Director of Harvard's Center for International Development, points out, this U.S. position of hegemony can be squandered. It is not a position that the U. S. earned by virtue of wise policies but a position it has inherited because of global dislocations for which it is, in large measure, responsible. But life is unfair. The situation, for the moment, reflects the fact that in the land of the blind, the one-eyed man is king.

The opportunity presents itself to marry this fortuitous U. S. position of strength to wise policy and the use of "soft power" via a global U.S.-led lending program. With the ability to raise money in huge amounts, the U.S. can selectively lend capital to responsible members of the global community, (directly or via the World Bank and the IMF) who, in turn will buy U.S. goods and stimulate global trade. Purposeful refusal to lend to rogue regimes will have a comparable salutary global political impact.

As this letter goes to press in the wake of the signing of the "stimulus" bill, the market experienced a horrendous week. In contrast to a welter of negative assessments, Mr. Bernanke predicted an end to the recession by the beginning of 2010. We don't think that anybody really knows. The challenge for Milestone is to avoid being rattled by the daily vicissitudes and to hew to our long-term strategy. We are involved in marathon investing. We continue to see very interesting opportunities. And, as is characteristic of times of economic distress, entrepreneurs are more malleable and entry-level prices are falling.

We believe commitments made now will prove rewarding when we achieve liquidity within the context of a recovering economy.

Best wishes for a Happy and Prosperous New Year,

Edwin A. Goodman
General Partner

MVP NEWS

F. Morgan Rodd has joined MVP as its fourth General Partner. Morgan is a ten-year veteran of the venture capital industry, having previously served as vice president of new ventures at E*TRADE Group, Inc. where he co-led a six-person team in making investments for a $210 million venture fund. In 2003, the fund spun out of E*TRADE and became ArrowPath Ventures. In his capacity as co-managing partner, Morgan guided a team that made investments in a wide range of opportunities, including enterprise software, infrastructure technology, Internet technology, and technology-enabled businesses. His successful investments include Security Focus, Sanera, Immunix, NetSec and Bridgestream.

MVP PORTFOLIO NEWS

MVP concluded 2008 on a high note with the sale of MVP III's holding in **Premise Corporation** in which we had been investors for 20 months. This was MVP III's first realization. Premise, which provides patient scheduling software to hospitals was sold to Eclipsys (NASDAQ:ECLP) which sells a wide range of software applications to healthcare organizations with the goal of improving clinical, financial and operational outcomes. Premise shareholders received $38.5 million. Having invested $1.59 million in the course of two financing rounds, MVP III realized a return of 2.5X and an IRR of 79%.

In early December of 2008, in order to strengthen the balance sheet of **M5 Networks**, the inside investors invested an additional $2 million. Of that amount, MVP III and MVP III NY each invested $110,000. M5 provides VOIP (Voice Over Internet Protocol) telephone services to small businesses. Despite the difficult environment, revenues for the year increased by more than 50% over 2007.

Here We Go Again

I hear a lot about capital efficiency these days. Given the economic environment, venture capitalists talk a lot about their desire to invest in capital efficient businesses and business models. Entrepreneurs and CEOs are following the trend by talking about how their businesses are capital efficient and should be able to get to cash flow breakeven by achieving modest growth. I am seeing more and more company pitches that highlight capital efficiency as a reason that a particular company should receive funding. Capital is hard to come by these days, much harder today than twelve months ago. Consumers and businesses are not spending, so growth is hard to achieve To survive today, you need to be efficient with your use of cash as you may not be able to get more if you need it.

The mantra of capital efficiency is not new to the VC community. During the last downturn that began during 2000-2001, I heard a similar call from VCs and entrepreneurs regarding the merits of capital efficiency. Similar to today, we had then emerged from a period when access to capital was easy and capital itself was plentiful. Liquidity events unlocking enormous profits became the stuff of legends even though many of the companies getting liquid had little revenue and virtually no profits. Then, the boom turned to bust as access to capital became harder, the basis for valuations returned to more traditional measures of earnings and earnings growth, and accounting scandals created skepticism about the quality of earnings and revenue.

I worked in Silicon Valley during the notorious meltdown, and it was then and there that I first heard the cry of capital efficiency. For a time, VCs acted accordingly. They made smaller investments in companies across all stages of maturity. Companies sought less money with the investment thesis that they could get to profitability with limited capital and incur less dilution.

Somewhere in the 2004-2005 timeframe, the theme of capital efficiency again receded. Suddenly, Web 2.0, clean-tech, India and China came to the fore. Once again, entrepreneurs were raising significant amounts of capital, and most VCs were content to make large investments. Being capital efficient no longer mattered. Then, we experienced the economic downdraft of September 2008. It took a couple of months, and it started slowly in a low voice, but soon the cry of capital efficiency could be heard loud and clear across the venture capital ecosystem. Here we go again.

Market Recovery During Past Nine Rececssions (S&P 500 Returns Depicted)

Recession Date (Beginning - End)	Month/Year When Market Reached Bottom	% Gain In First 12 Months Of Recovery
Jul 1952 — May 1954	Aug 1953	35.0
Aug 1957 — Apr 1958	Dec 1957	43.4
Apr 1960 — Feb 1961	Oct 1960	32.6
Dec 1969 — Nov 1970	Jun 1970	41.9
Nov 1973 — Mar 1975	Dec 1974	37.2
Jan 1980 — Jul 1980	Apr 1980	31.2
Jul 1981 — Nov 1982	Jul 1982	59.4
Jul 1990 — Mar 1991	Oct 1990	33.5
Mar 2001 — Nov 2001	Feb 2003	38.5

Source: Smith Barney, Working Wealth, Winter 2009

So as I ponder the cycle of the last ten years, what strikes me and somewhat confounds me is the notion that capital efficiency is something to focus on only in tough economic times. At least, it is only in tough economic times that the topic of capital efficiency is discussed. This seems odd to me as I believe VCs should always be concerned about capital efficiency. If the definition of capital efficiency is the ratio of capital input to economic output then a VC should seek as big a ratio of output to capital invested as possible. So what does this really mean? In my opinion, it means that VCs should focus on funding businesses that have a chance of a high return relative to the amount of capital invested. Further, we should be disciplined and thorough in our analysis regarding how much capital a company will need in both the near-term and in the long-term.

In the early days of venture capital, capital efficiency was the mantra of venture capitalists and the entrepreneurs they backed. For example, Fairchild Semiconductor was initially funded for $1.5 million in 1957. From that initial investment, a new generation of silicon transistors was developed, and the Silicon Valley that we know today was born. Fast forward a bit more than 10 years to 1968, and Intel was founded with $2.5 million in venture capital. In 1980, Microsoft raised its only venture investment; a grand total of $1.0 million. In 1984, Cisco raised $2.5 million, and the list goes on and on.

The boom of the late 1990s, which was clearly an aberration in the history of venture, distorted the idea of capital efficiency. The increase in the number of funds and the absolute dollars these funds were able to raise contributed to this distortion, causing a lapse in discipline and focus around capital efficiency and what that really means. It is my hope that this downturn cleanses the VC industry once and for all so that it can go back to its roots of always thinking about investing in capital efficient businesses. This will be a healthy outcome for the VC ecosystem, especially those who invest in venture capital funds.

Here at Milestone, investing in capital efficient businesses is a cornerstone of our investment strategy, regardless of where we are in the business cycle. We focus our time and energy on funding investment opportunities that have tremendous upside potential and on finding entrepreneurs who are efficient in their use of capital.

F. Morgan Rodd, General Partner

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IN THE NEW YORK METROPOLITAN AREA

MILESTONE VENTURE PARTNERS
551 MADISON AVENUE - 7TH FLOOR
NEW YORK, NY 10022
V: (212) 223-7400 F: (212) 223-0315
WWW.MILESTONEVP.COM