

# CONNECT INNOVATION REPORT

EXECUTIVE SUMMARY  
FIRST QUARTER 2011



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SAN DIEGO BUSINESS JOURNAL

CONNECT is a nonprofit organization dedicated to creating and sustaining the growth of innovative technology and life science businesses in San Diego. Since 1985, CONNECT has assisted in the formation and development of over 2,000 companies and is widely regarded as the world's most successful regional program linking inventors and entrepreneurs with the resources they need for success. CONNECT focuses on research institution support, business creation and development, entrepreneurial learning, access to capital, public policy advocacy, awards, recognition and networking. Nearly 40 countries and regions have adopted the CONNECT model, including the U.K, Sweden, Norway, Denmark, and Australia, and most recently, New York City. For more information, please visit [www.connect.org](http://www.connect.org)

INTRODUCTION

The CONNECT Innovation Report (CIR) is the first comprehensive quarterly report in the country to provide an economic indicator of the strength and impact of the innovation economy. Published by CONNECT, San Diego's technology and life sciences accelerator, the Report compares San Diego, California and selected regions, and includes:

- The number of new innovation start-ups in key regions across California;
- Technology start-up new job creation figures across California;
- Technology sector wages and employment in San Diego;
- Public policy brief focused on the innovation economy;
- Venture capital investment across the U.S., California and San Diego;
- Merger and acquisition activity across California and San Diego;
- Private placement investment in California and San Diego;
- Initial and follow-on public equity offerings in California and San Diego;
- Patent activity in San Diego and other regions in California;
- Federal research grants in San Diego and California; and,
- Private research organization employment and wages in San Diego, California and Boston Metro region.

The CONNECT Innovation Report tracks the health of the San Diego innovation economy by comparing data year-on-year and quarter-to-quarter, providing a comparison across tech industry clusters to selected regions and monitoring availability of various types of capital. The data helps policymakers and trade organizations plan and advocate effectively for our innovation economy including availability of visas and workforce training for talent in high growth clusters, building an attractive environment for capital investment, allocation of grant funding, reform of the patent system, and zoning. The Report also highlights San Diego as a world leader in innovation with world-class research, leadership and management talent.

CONNECT Innovation Report Steering Committee

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Kelly Cunningham	Senior Fellow and Economist	National University System Institute for Policy Research
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Kai Lin	Programmer Analyst	San Diego Supercomputer Center
Sundari Baru	Programmer Analyst	San Diego Supercomputer Center
Igor Rozhkov	Analyst	CONNECT Innovation Report Volunteer

July 7, 2011

### Number of San Diego tech start-ups doubles in first quarter 2011, new CONNECT Innovation Report shows

CONNECT's newly released First Quarter 2011 Innovation Report shows the number of San Diego tech start-ups in the first quarter of 2011 doubled to 70 companies over the same quarter last year and was the highest rate for a first quarter in the last four years. The Report also showed that tech employment is on the rise, merger and acquisition activity has tripled and the number of patents granted rose sharply.

"It certainly appears things are starting to percolate again for technology businesses. Perhaps a long sought rebound in technology business activity may become apparent," commented Kelly Cunningham, Economist and Senior Fellow at the National University System Institute for Policy Research (NUSIPR).

Overall, San Diego tech start-ups created more than 130 new jobs in the first quarter of 2011 and more than 930 jobs for the full year 2010. California tech start-ups created almost 1,700 new jobs in the first quarter of 2011. Tech employment was up slightly in the first quarter of 2011 and the overall employment situation in San Diego is gradually improving. "There is a sense that things are improving," commented Chuck Flacks, Research Director at the San Diego Workforce Partnership, "The San Diego Workforce Index is up over 4% from last year while things are still relatively flat around the country. It seems like we may be one of the regions that is leading the nation out of the recession."

In the first quarter of 2011, San Diego research institutions and innovation companies received \$258 million in National Institutes of Health (NIH) research grant funding - the highest first quarter award received over the past three years in San Diego. Overall, federal research grant funding to San Diego research institutions, universities and innovation companies totaled \$300 million in the first quarter of 2011.

Company merger and acquisition activity in San Diego nearly tripled in the first quarter of 2011 over the same quarter last year and was up almost 40% over the fourth quarter of 2010. The value of reported M&A deals closed in the first quarter of 2011 in which a San Diego company was the merger or acquisition target totaled more than \$2.3 billion. Deals in which San Diego companies were the acquirers totaled almost \$1.4 billion in the first quarter of 2011.

After a dip in the fourth quarter of 2010, the number of patents granted rose sharply in San Diego and Orange Counties in the first quarter. San Diego continued to lead the Southern California region in the first quarter of 2011 in terms of patent density measured by the number of patents published and granted per 100,000 residents over the past three years. "This kind of patent density and growth serves as a good indicator of the level and pace of innovation in the region, said Steve Hoey, CONNECT Innovation Report project leader. In San Diego, 1,115 patents were granted in the first quarter of 2011, up 19% from the 940 granted in the previous quarter. Patent applications published in the first quarter were also up (3%) with 1,541 patents published compared to 1,492 in the fourth quarter of 2010.

The Executive Summary and Full Report, including all data, are available at <http://www.connect.org/programs/connect-track/>

# CONNECT INNOVATION REPORT EXECUTIVE SUMMARY

A QUARTERLY EVALUATION OF OUR INNOVATION ECONOMY IN SAN DIEGO AND ACROSS CALIFORNIA

New Start-ups and Employment / Tech Employment and Wages / VC Investment / M&A Activity / New Patents / Research Grants

## VC FUNDING TO START-UPS JUMPS BUT OVERALL VC INVESTMENT DOWN BY HALF; NUMBER OF SAN DIEGO START-UPS DOUBLES IN FIRST QUARTER 2011; SAN DIEGO M&A DEAL VALUE TRIPLES TO MORE THAN \$2 BILLION

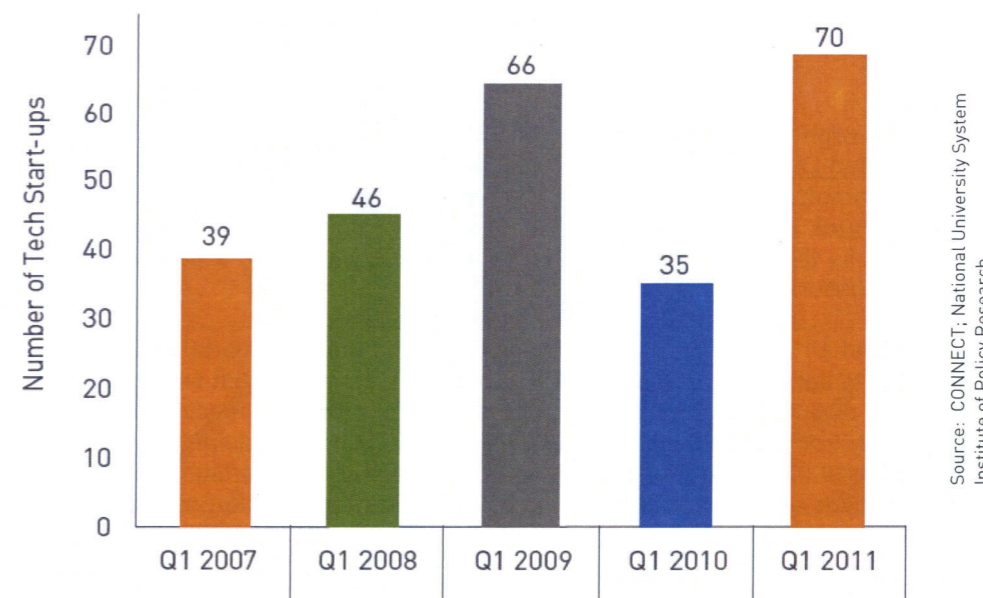
CONNECT's newly released First Quarter 2011 Innovation Report shows almost half the first quarter venture capital (VC) funding went to early stage companies (\$48 million) and 12% went to start-up stage companies (\$12 million), a substantial jump from the previous two quarters when only 1% of VC investment went to start-up deals.

However, VC investment in San Diego companies fell by more than half to \$100 million in the first quarter of 2011 compared to the \$218 million raised in the fourth quarter of 2010. The number of San Diego VC investment deals was also down 23% with 22 companies receiving funding.

In San Diego the number of tech start-ups in the first quarter of 2011 doubled to 70 over the same quarter last year and was the highest rate in the last four years. "It certainly appears things are starting to percolate again for technology businesses. Perhaps a long sought rebound in technology business activity may become apparent," commented **Kelly Cunningham**, Economist and Senior Fellow at the National University System Institute for Policy Research (NUSIPR).



SAN DIEGO INNOVATION START-UPS – COMPARISON BY 1<sup>ST</sup> QUARTER



Source: CONNECT, National University System Institute of Policy Research

CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

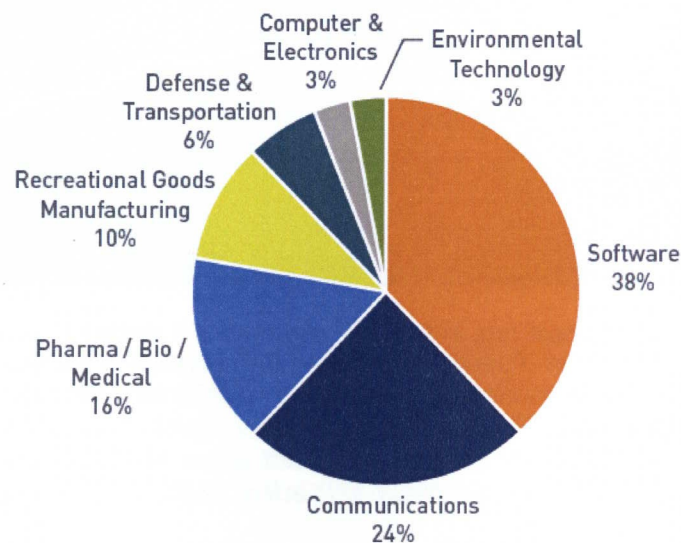
New data in the Report shows the deal value of San Diego companies acquired in the first quarter of 2011 tripled compared to the same quarter last year to more than \$2.3 billion. Federal research grants to San Diego's 80+ local research institutes and innovation companies totaled almost \$300 billion in the first quarter of 2011. San Diego funding received from the National Science Foundation was up 14% in the first quarter.

Statewide, the number of tech start-ups totaled 597 in the first quarter, up almost 70% from the same quarter last year. San Diego accounted for almost 12% of the new technology businesses started in the first quarter of 2011, ranking fourth after Los Angeles (LA), Santa Clara and Orange Counties. In the first quarter, LA had 117 new tech companies and Santa Clara had 95. Orange County ranked third with 75.

The increase in first quarter tech start-ups relative to previous years was also seen across the state. "The state of California had a relatively robust quarter for start-ups in the first quarter of 2011, the largest number by far for any first quarter over the past five years," said Cunningham.

San Diego tech start-ups created more than 130 new jobs in the first quarter of 2011 and more than 930 jobs for the full year 2010. California tech start-ups created almost 1,700 new jobs in the first quarter of 2011.

SAN DIEGO START-UPS BY INDUSTRY – 1<sup>ST</sup> Quarter



"New software businesses had a strong increase, followed by slight gain in communications enterprises," Cunningham commented. San Diego had 27 new software companies established in the first quarter of 2011, up 35% from 20 in the fourth quarter of 2010 and more than double the number formed in the first quarter of 2010. The communications sector saw 17 start-ups in the first quarter of 2011 up from seven formed in the same quarter of the previous year. Life sciences company formation was down more than 25% from the fourth quarter of 2010 with 11 start-ups established in the first quarter of 2011, but up over the same quarter last year when there were only eight start-ups. Computer and electronics start-ups declined the sharpest in the first quarter with only two new companies established compared to 14 in the fourth quarter of 2010 and seven in the first quarter of 2010.

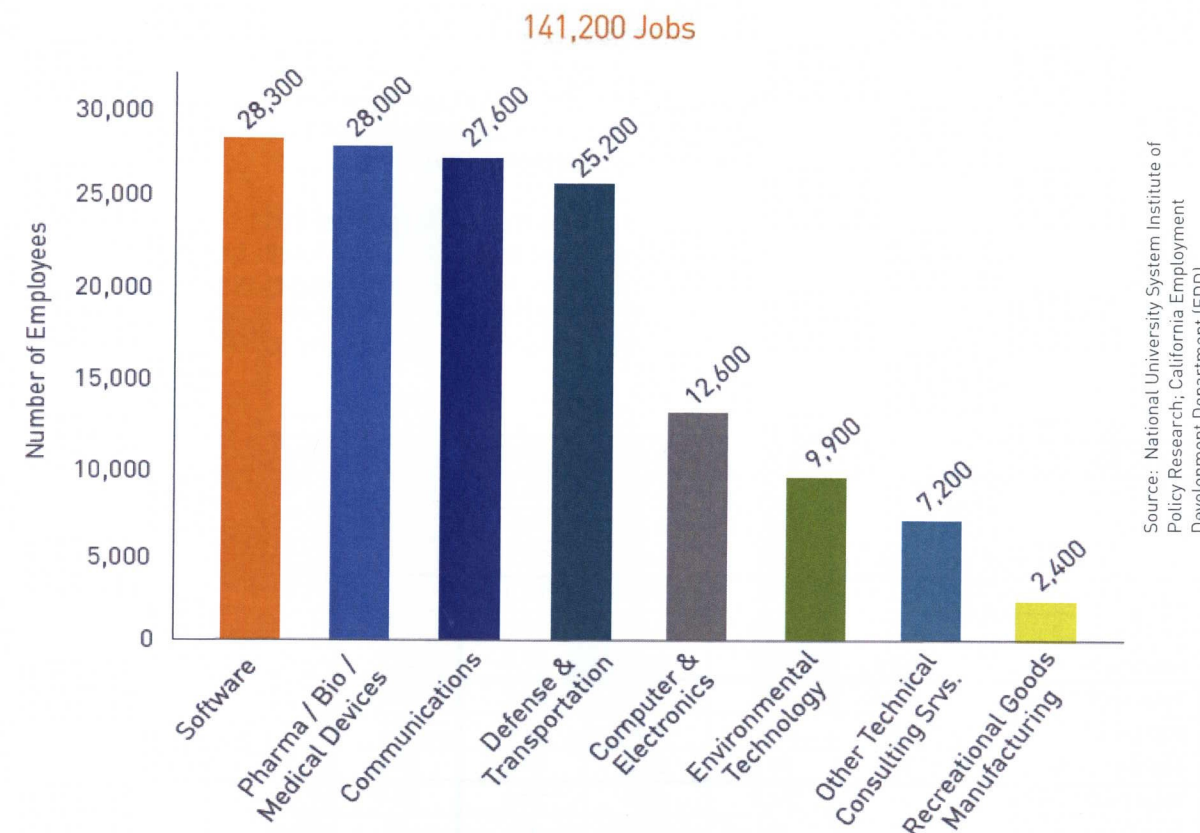
Source: CONNECT; National University System Institute of Policy Research

Tech employment was up slightly in the first quarter of 2011 and the overall employment situation in San Diego is gradually improving. The [San Diego Workforce Index](#) showed a slow and steady increase in the number of non-farm jobs, growth in temporary employment and general overall economic improvement. "There is a sense that things are improving," commented **Chuck Flacks**, Research Director at the [San Diego Workforce Partnership](#). "The index is up over 4% from last year while things are still relatively flat around the country. It seems like we may be one of the regions that is leading the nation out of the recession."

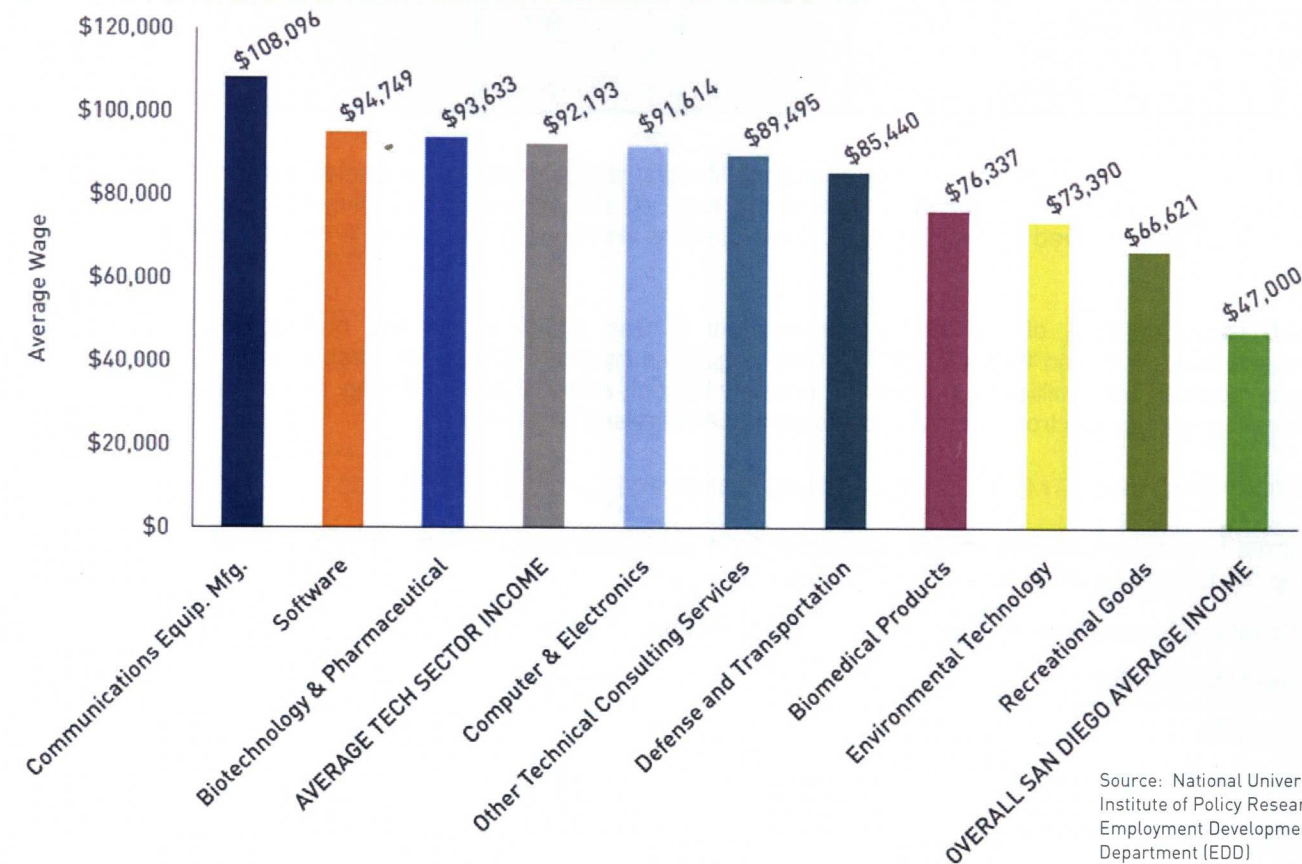
The tech sector represented 11% of all jobs in San Diego County in the first quarter of 2011 with more than 141,000 workers employed based on estimates by the NUSIPR. Software was the largest employment sector with more than 28,000 jobs - an increase of 600 jobs. The life sciences sector (pharma/ bio/medical devices) was a close second with 28,000 jobs, up slightly from the previous quarter. The communications equipment manufacturing sector was up an estimated 200 jobs to total 27,600 in the first quarter. Defense and transportation represented more than 25,000 jobs. The average annual tech sector wage was almost \$90,000—almost double San Diego's overall average annual wage of \$47,000.

CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

SAN DIEGO TECH EMPLOYMENT BY INDUSTRY – 1<sup>ST</sup> Quarter 2011



SAN DIEGO AVERAGE TECH SECTOR WAGES BY INDUSTRY



CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

VC INVESTMENT IN SAN DIEGO START-UPS INCREASES; OVERALL INVESTMENT FALLS BY HALF

VC funding to start-ups was up in the first quarter of 2011. Start-ups received 12% of the total VC investment in San Diego in the first quarter, up from only 1% in the previous two quarters, and early stage companies received 48% of VC investment. "The venture capital funding received by tech sector start-ups is encouraging for expansion in the sector. The VC funding and other private investments can lead to new, high-paying jobs for the local workforce," said Gary Moss, Labor Market Information Specialist at San Diego Workforce Partnership.

VC investment in the San Diego region continued to decline during the first quarter of 2011 to the lowest quarter in two years. Venture investment in the first quarter of 2011 was down by half from the fourth quarter of 2010, with 22 local companies receiving \$100 million, according to the most recent PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ quarterly report. VCs invested \$218 million in 27 deals in San Diego in the fourth quarter of 2010. San Diego ranked ninth in the nation in VC investment in the first quarter of 2011.

SUMMARY OF NATIONAL & REGIONAL VENTURE CAPITAL

Region		2008	2009	2010	2010 Q1	2010 Q4	2011 Q1
United States	Total (in Billions)	\$28.0	\$18.1	\$21.8	\$5.0	\$5.1	\$5.9
	# of Deals	3,985	2,893	3,277	763	765	736
	Average (in Millions)	\$7.0	\$6.2	\$6.7	\$6.5	\$6.7	\$8.0
California	Total (in Billions)	\$14.0	\$9.1	\$11.0	\$2.3	\$2.7	\$3.0
	# of Deals	1,626	1,185	1,289	309	328	266
	Average (in Millions)	\$8.6	\$7.7	\$8.5	\$7.5	\$8.2	\$11.2
Northern CA	Total (in Billions)	\$10.8	\$7.2	\$9.1	\$1.7	\$2.2	\$2.9
	# of Deals	1,251	871	1,027	226	252	212
	Average (in Millions)	\$8.6	\$8.3	\$8.8	\$7.4	\$8.6	\$13.9
Southern CA	Total (in Billions)	\$3.2	\$1.9	\$2.5	\$0.6	\$0.5	\$0.5
	# of Deals	375	266	322	80	49	54
	Average (in Millions)	\$8.5	\$7.0	\$7.6	\$7.7	\$10.8	\$9.1
San Diego	Total (in Billions)	\$1.2	\$0.9	\$0.9	\$0.2	\$0.22	\$0.10
	# of Deals	132	107	118	31	27	22
	Average (in Millions)	\$9.0	\$8.4	\$7.5	\$7.3	\$8.1	\$4.5

Source: The MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Financial

The first quarter saw a substantial shift of investment dollars from later stage companies to financing of start-ups and early stage companies, which received 60% of the total VC investment in San Diego, up from 27% in the fourth quarter. Start-ups received \$12 million in VC funding in the first quarter compared to only \$2 million in the previous quarter.

Biotech made up 76% of the total VC investment in San Diego in the first quarter of 2011 with Conatus Pharmaceuticals, Inc. and Genomatica, Inc. receiving \$25 million and \$24 million, respectively. Genomatica plans to raise as much as \$150 million going forward, possibly through an initial public offering. In the industrial/energy sector, cleantech consumer electronics e-cycle company ecoATM raised \$14 million.

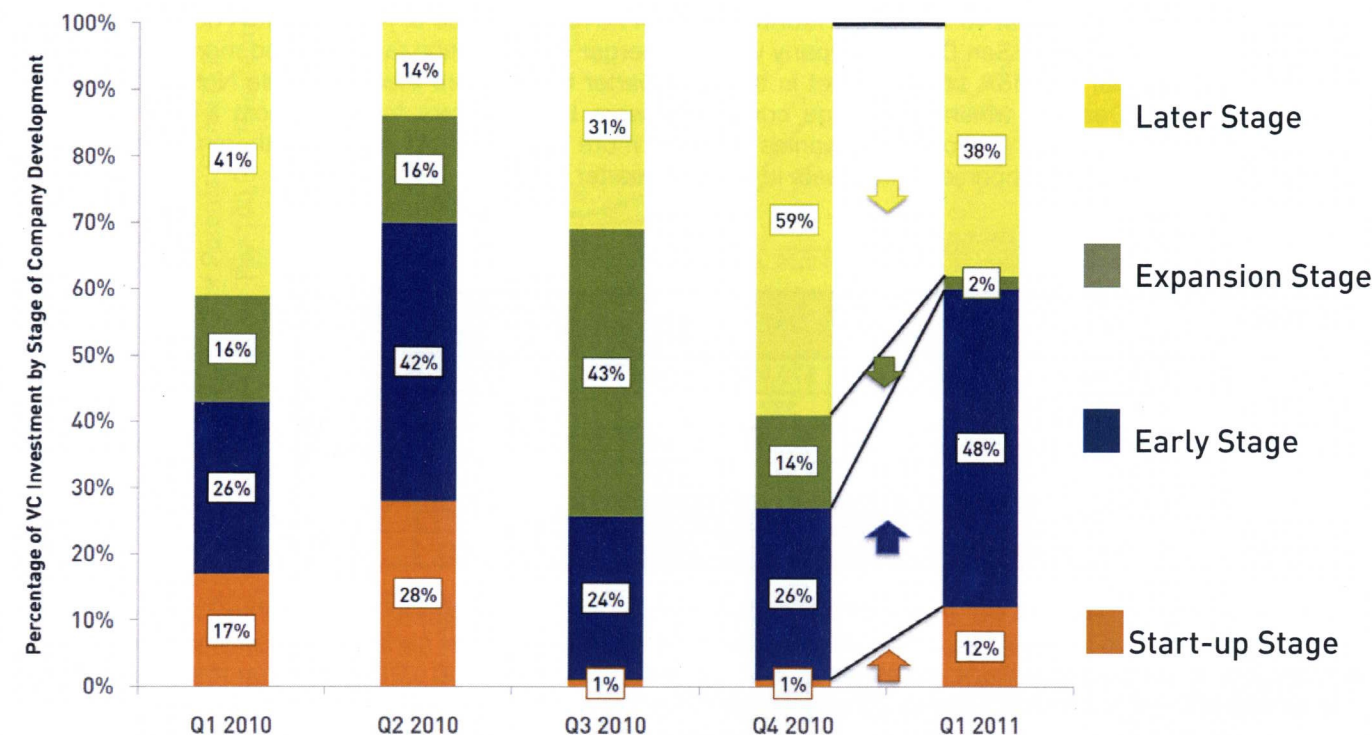
THE TOP 10 VC INVESTMENTS IN SAN DIEGO COMPANIES - 1<sup>ST</sup> QUARTER 2011

The three largest investments the first quarter of 2011 accounted for 64% of the total VC funding in San Diego, with the top 10 deals accounting for 91% of total funding.

Conatus Pharmaceuticals, Inc.	\$25.3 million	Ophthonix, Inc.	\$4.7 million
Genomatica, Inc.	\$23.8 million	Verdezyne, Inc.	\$3.1 million
ecoATM	\$14.4 million	Next Therapeutics, Inc.	\$3.0 million
Elcelyx Therapeutics, Inc.	\$6.1 million	Grid2Home, Inc.	\$2.6 million
Mpex Pharmaceuticals, Inc.	\$5.1 million	Axikin Pharmaceuticals	\$2.5 million

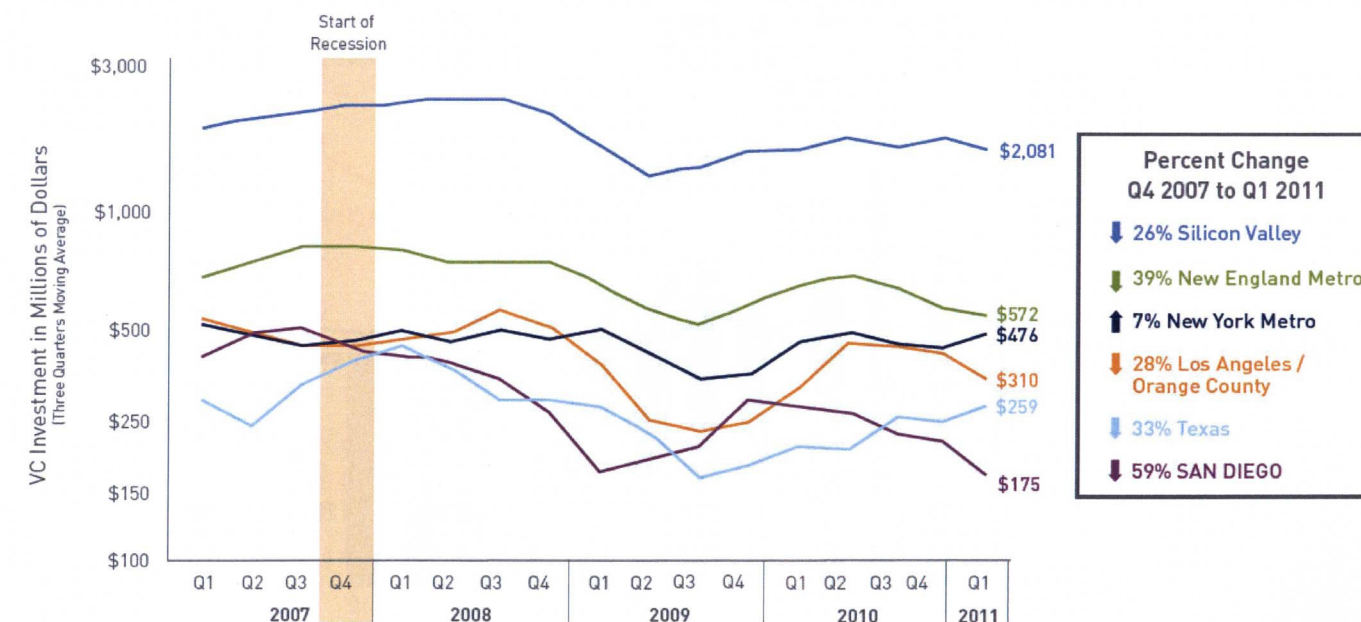
CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

VC INVESTMENT IN SAN DIEGO COMPANIES BY STAGE OF DEVELOPMENT - Q1 2010 to Q1 2011



When using a moving average of three quarters' data, San Diego continues to show a more substantial decline in venture investment relative to the other top five regions over the past three years. [A moving average can smooth quarter-to-quarter fluctuations to better enable trend analysis.] The San Diego first quarter 2011 VC investment moving average was down almost 60% from Q4 2007 — a substantially larger decrease than seen in other key innovation economies such as Silicon Valley and New England Metro. LA/Orange County VC investment has almost returned to pre-recession levels.

VC INVESTMENT MOVING AVERAGE BY REGION - 2007 to 1<sup>ST</sup> QUARTER 2011



CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

VALUE OF SAN DIEGO M&A DEALS JUMPS

Company merger and acquisition activity in San Diego nearly tripled in the first quarter of 2011 over the same quarter last year and was up almost 40% over the fourth quarter of 2010. The value of reported M&A deals closed in the first quarter of 2011 in which a San Diego company was the merger or acquisition target totaled more than \$2.3 billion. In Southern California, the M&A target market in the first quarter fell by more than half while Northern California as a region doubled. Deals in which San Diego companies were the acquirers totaled almost \$1.4 billion in the first quarter of 2011. Southern California companies acquired more than \$9.5 billion and Northern California purchasers acquired \$9.7 billion in companies and assets in the first quarter.

REGIONAL M&A DEALS – 1<sup>ST</sup> QUARTER 2010

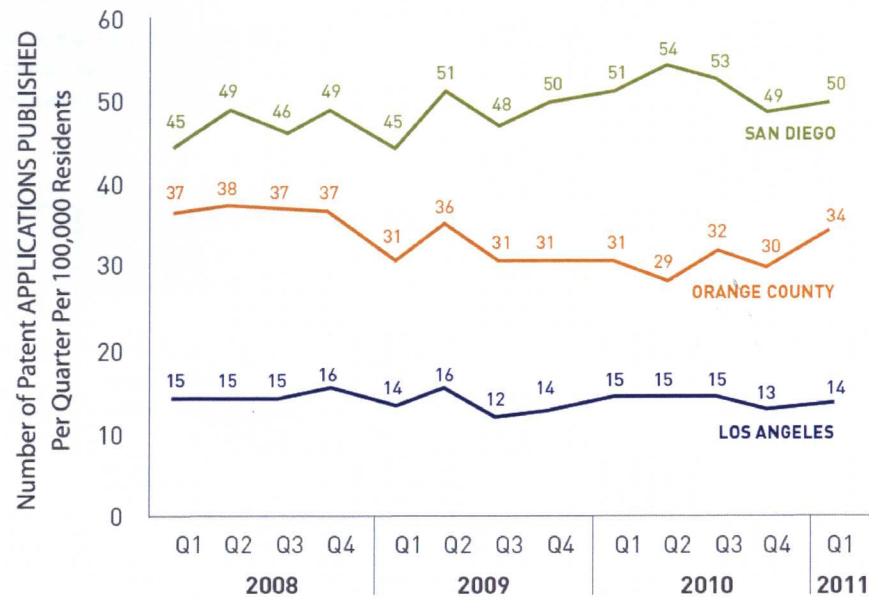
Region		2009	2010	2010 Q1	2010 Q4	2011 Q1
Northern CA	Total Reported Value (in Millions)	\$20,803	\$20,803	\$17,069	\$9,207	\$18,695
	# of Closed Deals	337	337	195	174	179
Southern CA	Total Reported Value (in Millions)	\$6,608	\$6,608	\$19,127	\$13,301	\$5,439
	# of Closed Deals	314	314	153	224	225
San Diego	Total Reported Value (in Millions)	\$1,655	\$1,655	\$845	\$1,680	\$2,319
	# of Closed Deals	79	156	46	41	47

Source: Capital IQ; ROTH Capital Partners; CONNECT

PATENT ACTIVITY UP ACROSS THE STATE; SAN DIEGO LEADS SOCAL REGION

San Diego continued to lead the Southern California region in the first quarter of 2011 in terms of patent density measured by the number of patents published and granted per 100,000 residents over the past three years. After a dip in the fourth quarter of 2010, the number of patents granted rose sharply in San Diego and Orange Counties in the first quarter. "This kind of patent density and growth serves as a good indicator of the level and pace of innovation in the region, said **Steve Hoey**, CONNECT Innovation Report project leader.

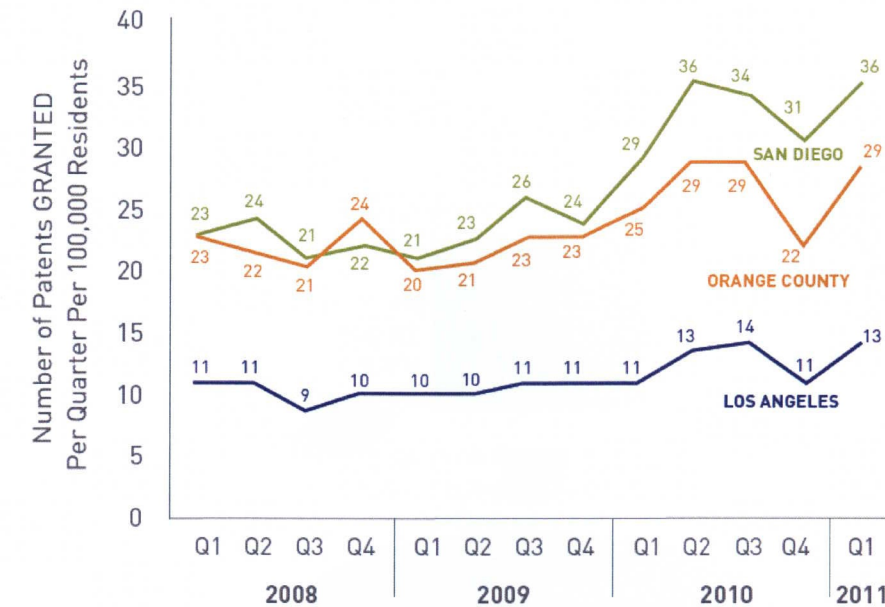
PATENT DENSITY PER QUARTER – PATENT APPLICATIONS PUBLISHED: 2008 TO Q1 2011



Source: United States Patent and Trademark Office; UC San Diego Extension; CONNECT

CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

PATENT DENSITY PER QUARTER – PATENTS GRANTED: 2008 TO Q1 2011



Source: United States Patent and Trademark Office; UC San Diego Extension; CONNECT

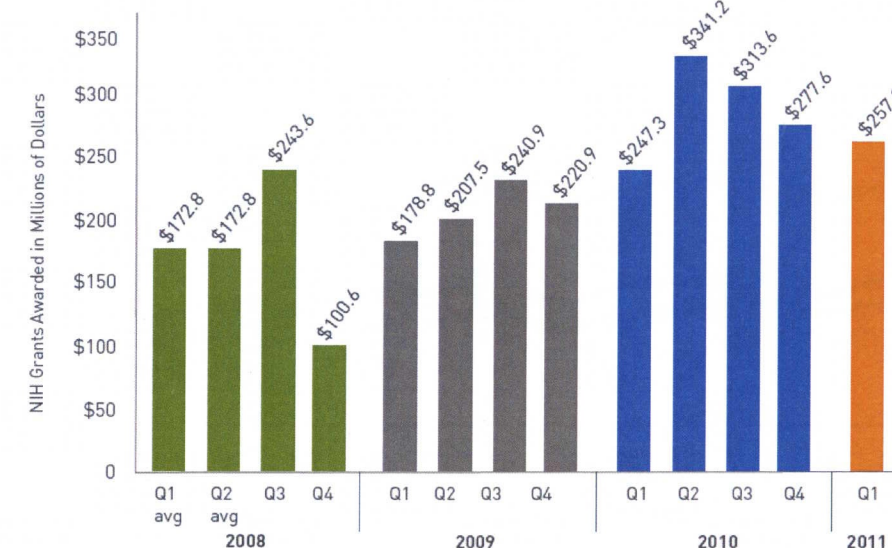
In San Diego, 1,115 patents were granted in the first quarter of 2011, up 19% from the 940 granted in the previous quarter. Patent applications published in the first quarter were also up (3%) with 1,541 patents published compared to 1,492 in the fourth quarter of 2010. San Diego accounted for 17% of the patent applications published in California in the second quarter and 12% of the patents granted. Patent activity was up across California in the first quarter of 2011. Santa Clara led the state in terms of overall patent activity.

SAN DIEGO OVERALL RECEIVES \$300M FEDERAL RESEARCH FUNDING IN 1<sup>ST</sup> QUARTER 2011

San Diego's NIH, NSF, NASA, NOAA and Department of Defense SBIR/STTR funding totaled \$300 million in the first quarter of 2011. Federal grant funding awarded in San Diego from the NIH totaled almost \$1.2 billion in 2010, up 28% from 2009 and more than 70% from 2008. In the first quarter, San Diego research institutions and innovation companies received \$258 million in NIH funding—the highest first quarter award received over the past three years.

NSF grant funding to San Diego totaled \$28 million, up 14% from the previous quarter. San Diego also received more than \$6 million in federal research funding from the National Oceanic and Atmospheric Administration (NOAA) and more than \$1 million from the National Aeronautics and Space Administration (NASA) in the first quarter of 2011.

SAN DIEGO NIH GRANT FUNDING – 2008 TO 1<sup>ST</sup> QUARTER

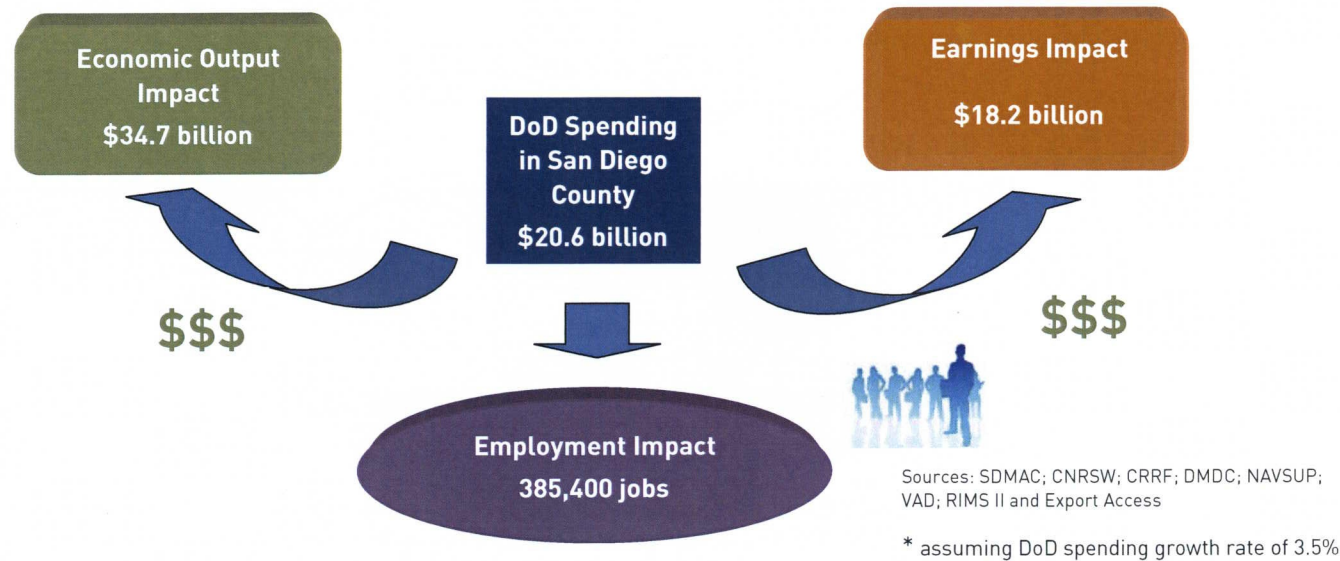


Source: National Institutes of Health, UC San Diego Extension; San Diego Supercomputer Center; CONNECT

CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

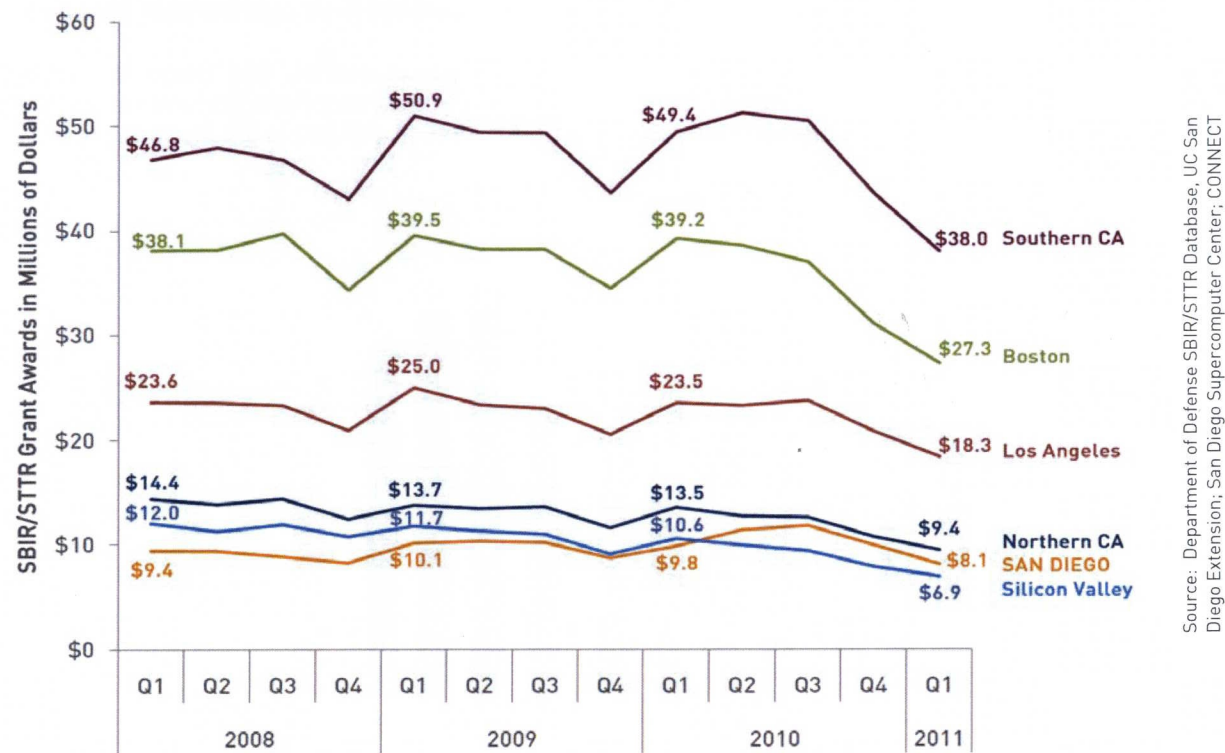
New data from [San Diego Military Economic Impact Study](#) commissioned by San Diego Military Advisory Council (SDMAC) shows that direct spending by the Department of Defense (DoD) in San Diego in 2011 is estimated to total more than \$20 billion and further catalyze almost \$35 billion in economic impact and sustain approximately 385,400 jobs.

PROJECTED ECONOMIC IMPACT OF DOD SPENDING IN SAN DIEGO COUNTY – 2011\*



San Diego innovation companies received more than \$8 million in Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) program grants in the first quarter of 2011. This was down more than 20% from the fourth quarter of 2010. Through these two competitive programs, the U.S. Small Business Administration (SBA) Office of Technology ensures that the nation's small, high-tech, innovative businesses are a significant part of the federal government's defense technology research and development efforts. SBIR/STTR funding is only a small portion of total federal DoD spending in the San Diego region.

REGIONAL DoD SBIR/STTR FUNDING – Q1 2008 TO Q1 2011



CONNECT INNOVATION REPORT EXECUTIVE SUMMARY (CONT'D)

CONNECT PUBLIC POLICY BRIEF – JUNE 2011

Spring and early summer in Washington D.C. has brought a flurry of activity focused on innovation issues both on and off the Hill. Congress has tried to reach an agreement on SBIR reauthorization but has retreated to their respective House and Senate chambers to consider how to renew efforts to broker a deal to renew the SBIR program for the next several years.

Congress has been more successful in advancing long-awaited patent reform legislation. The Senate passed its version in March with the House passing a similar version in June. Although the two bills share much in common, including transitioning the U.S. from a first-to-invent system to a first-to-file system, and changes to the post-grant review system, a significant hurdle still looms. The Senate version of the bill permanently ends fee diversion while the House version does little to change the current United States Patent & Trademark Office (USPTO) funding model that Congress has often raided, leading to a tremendous patent application backlog and innovation-delaying wait times for patent issuance. The fee diversion problem is the cornerstone of the Senate bill and a House-Senate battle might be the last skirmish in the 6-year saga to update the U.S. patent system.

Both on and off the Hill, talk about a repatriation tax holiday, to bring foreign profits back to the U.S., continues to get buzz. The House has even introduced a major repatriation bill that is likely to see floor action this year. The House has also been scrutinizing the practices of the Security and Exchange Commission in relation to its impact on start-up business formation. Such scrutiny has led the House Financial Services Committee to pass a bill that will raise the SEC's Regulation A cap on direct public offerings from \$5 million to \$50 million. Increasing the Reg A cap will lower the cost of raising capital for small businesses which will spur greater investment, start-up growth, and job creation. The Reg A bill has bipartisan support giving it momentum to receive a floor vote this year.

With various innovation issues pending like SBIR reauthorization, patent reform, and start-up/small business access to capital, plus the biggest issue of the budget/debt limit passage, the D.C. summer is likely to produce fireworks far past the celebration of America's birth.

## THE CONNECT INNOVATION REPORT: CONTACT INFORMATION

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To purchase the full 62-page CONNECT Innovation Report with supplemental data and more than 70 charts and tables for First Quarter 2011, contact Steve Hoey at [shoey@connect.org](mailto:shoey@connect.org)

**CONNECT****Catalyzing the creation of innovative technology and life sciences companies in San Diego**

CONNECT has assisted in the formation and development of more than 2,000 companies in the San Diego region and is widely regarded as one of the world's most successful organizations linking inventors and entrepreneurs with the resources they need for commercialization of innovative products in high tech and life sciences. The program has been modeled in more than 50 regions around the world – most recently in New York City, Bogotá, Columbia and Saudi Arabia. Key to our success has been the unique "culture of collaboration" between research organizations, capital sources, professional service providers and the established industries. CONNECT has been recognized by *Time*, *Inc.* and *Entrepreneur* magazines and last year received the 2010 Innovation in Economic Development Award from the U.S. Department of Commerce for creation of Regional Innovation Clusters. CONNECT manages the San Diego Innovation Hub (iHub) designated by the state of California Governor's Office of Economic Development in 2010.

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Accelerating Innovation in San Diego™

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