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EEC Perspectives

AUGUST 2009
Quarterly Review of Series A and First Round Financings and Series B and Later Round Financings

Included in this Issue

Quarterly Review of Series A and First Round Financings and Series B and Later Round Financings

Gazing Into The Crystal Ball

David Pierson

The Landscape

Recent statistical reports indicate that the difficult environment for companies seeking venture capital funding continues unabated:

- The recently released “MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Reuters” reported continued low levels of venture capital financing activity during Q2 2009 and projected that investment levels for 2009 will likely resemble those from 1996 and 1997. Deal volume in Q1 2009 and Q2 2009 declined 42% and 40%, respectively, compared to Q1 2008 and Q2 2008, and dollars invested in Q1 2009 and Q2 2009 declined 58% and 51%, respectively, from the comparable prior year periods.
- The NVCA and Thomson Reuters recently reported that although liquidity event activity for venture-backed companies improved mildly in Q2 2009, it remained far below traditional levels.
- The NVCA and Thomson Reuters also recently reported that the number of venture capital firms involved in fundraising activity during Q2 2009 dropped to the lowest level since Q3 1996 and that the number of dollars committed in Q2 2009 dropped to the lowest level since Q1 2003.

In addition, anecdotal evidence suggests that existing venture funds with money to invest largely are still sitting on the sidelines. In general, it appears that venture funds continue to be focused on triage for their existing portfolio companies and are likely to maintain that focus until the economic outlook improves. Many are periodically bridging funds to their portfolio companies while those companies search for potential new investors or acquirers and struggle to preserve cash, extend their runway and generally do more with less. Moreover, the secondary market for venture investments is more active than in the past, as distressed or disillusioned venture firms look to exit the industry.

The Outlook

As the preceding description of the venture landscape suggests, the short-term outlook is not particularly bright:

- Liquidity events and venture fundraising activity are the backbone that supports venture investing. As long as they remain moribund, venture funding will remain hard to obtain by historical standards. Only the most promising startups are likely to get funded and only the most promising emerging and growth stage companies are likely to find new investors.

- When funding is available, valuations will be on the low side and terms will be on the harsh side. For existing companies, expect to see bridge rounds from existing investors and down rounds and wash out rounds when new money comes in.
- As long as the IPO window stays mostly shut and the short-term economic outlook remains cloudy, deal terms can be expected to be skewed toward maximizing investors' returns in a company sale context (think accruing dividends, participating preferred stock, liquidation preference multiples).

Longer term, however, many see reason for hope. Well before the current economic meltdown, pundits were warning that excess capital had been committed to the venture fund arena, with too many firms with too much money chasing too few good deals. This, it was said, had several adverse effects, the most significant of which was the following: (i) it led to artificially inflated valuations, which made follow-on fundraising more difficult; and (ii) it resulted in too many companies chasing too few opportunities, producing heightened competition, depressed product prices and ultimately slower growth for the relevant product markets and the companies trying to address them. Viewed this way, the current economic downturn, though painful, is simply a right-sizing of the venture world that will bring with it a return to rationality. As fund sizes decrease, there will be a greater willingness to do smaller deals, which will mean that more attention can be paid to startups. With fewer active venture funds and less committed capital, valuations will return to "reasonable" levels. As current investors run out of money and patience for their less successful portfolio companies, M&A activity will pick up. The exits may not be great ones, but they will be exits, and the overgrowth of past mistakes will finally be cleared, leaving room for new investments and new companies to flourish.

Past experience suggests that there is some wisdom in these views. Business cycles are known to occur. Bubbles burst, and recoveries follow. The key question, of course, is how long we will have to wait before there is meaningful improvement.

There are signs that a start has already been made. There were, after all, five IPOs of venture-backed companies in Q2 2009. Although this is not exactly a robust total, it is an improvement and an encouraging sign. Here at the EEC, and at Foley Hoag more generally, we are beginning to see an increase in new company formation and financing and M&A activity. In these circumstances, I prefer to see the glass as half full rather than half empty, and I would urge promising startups and eager entrepreneurs to do the same.

The Numbers

Dave Broadwin

Usually "how are things?" is one of those meaningless introductory phrases that people use when they pick up the phone or run into a neighbor at the grocery store. Since the advent of the great recession, I have the sense that people really want to know — at least how business is going. It is as if they are checking to see if there is a pulse. The normal response to this query — "fine, how are you?" — is a non response and, before the great recession, led off into whatever you really wanted to talk about. Nowadays, people ask follow up questions and, inevitably, agree that things are better than they were last quarter or, at least, that they have not gotten worse. In fact, I would say that anecdotal evidence is that the venture economy is noticeably improved. What is reality and what is the impression people want to leave with each other is hard to know. So, what do the numbers really say?

Exits

The numbers suggest that the venture community is expecting a couple of years of continued sluggish (poor) economic performance and a slow exit market. In the first six months of the year there were approximately 130 M&A exits of which only three reported valuations in excess of $100 million. In addition, there were only five IPOs of venture financed companies reported in the first six months of 2009.

Implied Pre-Money and Post-Money Valuations

Taking out the obvious outliers in the form of very large or otherwise unusual investments and looking back over a year and a half of valuations for Series A transactions, the dollar amounts of the investments, the amounts raised and the implied valuations seem generally consistent over the entire period. This consistency suggests that the base line Series A deal, if one can call it that, between entrepreneurs and venture investors has not really changed with the economy. This result seems counter-intuitive since in a bad economy one would think that entrepreneurs would have to give away more equity to get less money. A couple of things might explain this seeming anomaly. First, deal quality might be higher than during "normal" times. With the result that deals that would command excellent terms in "normal" times are commanding normal terms now and deals that would fetch average terms in normal times are not getting done. Second, Series A deals have a few years to go before investors have to worry about a liquidity event with the result that there is a built in expectation that the bad economy will be behind us before the next round has to be raised or a liquidity event is contemplated.

With respect to the Series B and later rounds there seems to be more variability in the amount raised and the percentage of the company sold to investors in the round. In addition, there were quite a large number of down rounds. This variability seems more in line with expectations for a bad economy than the result for Series A financings.

Also, it is hard to believe that the poor market for exits is not adversely affecting Series B and later rounds since investors are rightly concerned about having to find an exit in today's market.

Terms

The most striking trend in Series A round terms is the continuing prevalence of transactions with a 1x preference and full participation. Full and capped participation were roughly equally present through last year compared to the first half of this year where there were none with capped participation. There is a similar (but not quite the same) pattern in Series B and later stage deals. Since participating preferreds generally protect the investor in low to mid range exit valuation scenarios, this pattern suggests that investors have continuing concern about exit values and timing. Also, a number of Series B and later stage transactions had pay to play provisions. These provisions are designed to incentivize co-investors to participate in future rounds, and the presence of these provisions suggests that investors are concerned about the ability of their co-investors to continue to fund. Again, this trend suggests that venture investors anticipate having to fund more and for a longer time than in the past.

Activity Levels

Series A activity in the most recent quarter was down compared to the prior quarter and down significantly from 2008. Series B and later round activity was flat with the prior quarter and with the last quarter of 2008. In certain ways this data provides a consistent picture with the rest of the data we have gathered. Investors are cautious about making new investments in a climate where they anticipate having a second round any time before the economy gets better, but they continue to fund existing commitments, despite being concerned about exits and the ability and willingness of their co-investors to participate in future rounds.

Conclusion

The seeming weakness in Series B and later round valuations, the prevalence of participating preferred structures, and the decline in transactions all suggest that investors are anticipating at least a couple of years of less than robust exits. Without a turn around in the exit market, these trends are likely to continue. While people may answer the question about how they are doing with something to the effect that things are better, investors seem to be behaving as if things aren't better and won't be for a couple of years.

Selected New England Series A Round Transactions

Second Quarter 2009

Implied Pre-Money and Post-Money Valuation

Company	Original issue price of Series A preferred stock	Number of authorized shares of Series A preferred stock	Value of Series A preferred stock authorized	Number of authorized shares of common stock	Series A preferred stock as a percentage of authorized common stock	Implied pre-money valuation	Implied post-money valuation
NABsys, Inc.	$1.0918	5,025,175	$5,486,486.07	7,500,000	67.00%	$2,702,013.94	$8,188,500.00
ISG Holdings, Inc.	$1.0000	51,600,000	$51,600,000.00	68,400,000	75.44%	$16,800,000.00	$68,400,000.00

Selected New England Series B and Later Round Transactions

Second Quarter 2009

Implied Pre-Money and Post-Money Valuation

Company	Most recent round of preferred stock	Original issue price of most recent round of preferred stock	Number of authorized shares of preferred stock in most recent round	Value of preferred stock authorized in most recent round	Number of authorized shares of common stock	Most recent round of preferred stock as a percentage of authorized common stock	Implied pre-money valuation	Implied post-money valuation	Up or Down Round
Aileron Therapeutics, Inc.	Series D	1.179633	34,036,009	$40,149,999.40	64,275,532	52.95%	$35,671,539.24	$75,821,538.64	EVEN
airwide solutions inc.	Series F	1.015448	7,444,910	$7,559,918.97	65,000,000	11.45%	$58,444,201.03	$66,004,120.00	DOWN
Avedro Inc.	Series B	0.863190	11,584,938	$10,000,002.63	34,755,353	33.33%	$20,000,470.52	$30,000,473.16	UP
ConforMIS, Inc.	Series D	6.000000	12,000,000	$72,000,000.00	37,000,000	32.43%	$150,000,000.00	$222,000,000.00	UP
Cortria Corporation	Series B	0.250000	17,872,000	$4,468,000.00	33,200,000	53.83%	$3,832,000.00	$8,300,000.00	DOWN
Demandware, Inc.	Series D	1.299106	11,546,403	$15,000,001.42	70,000,000	16.49%	$75,937,418.58	$90,937,420.00	EVEN
Gather Inc.	Series II	0.800000	1,875,000	$1,500,000.00	11,000,000	17.05%	$7,300,000.00	$8,800,000.00	EVEN
Interlace Medical	Series C	1.100000	18,700,000	$20,570,000.00	35,000,000	53.43%	$17,930,000.00	$38,500,000.00	UP
LocaModa, Inc.	Series A-2	0.030000	83,358,698	$2,500,760.94	128,396,382	64.92%	$1,351,130.52	$3,851,891.46	DOWN
MedVentive Inc.	Series C	0.200000	46,000,000	$9,200,000.00	100,000,000	46.00%	$10,800,000.00	$20,000,000.00	DOWN
Modiv Media, Inc.	Series A-1	0.140000	34,000,000	$4,760,000.00	103,000,000	33.01%	$9,660,000.00	$14,420,000.00	DOWN
Modiv Media, Inc.	Series B	0.140000	18,000,000	$2,520,000.00	162,000,000	11.11%	$20,160,000.00	$22,680,000.00	EVEN
Normoxys, Inc.	Series B-1	7.770000	450,000	$3,496,500.00	8,000,000	5.63%	$58,663,500.00	$62,160,000.00	DOWN
OurStage, Inc.	Series B	0.252500	40,000,000	$10,100,000.00	130,000,000	30.77%	$22,725,000.00	$32,825,000.00	DOWN
Raindance Technologies, Inc.	Series C	0.214600	59,402,591	$12,747,796.03	152,607,447	38.93%	$20,001,762.10	$32,749,558.13	DOWN
Setpoint Medical Corporation	Series A-1	1.000000	4,000,000	$4,000,000.00	22,500,000	17.78%	$18,500,000.00	$22,500,000.00	EVEN
Verax Biomedical Incoroporated	Series D	1.204500	12,000,000	$14,454,000.00	52,000,000	23.08%	$48,180,000.00	$62,634,000.00	EVEN

This analysis is inherently imprecise and is based on a number of general assumptions which may or may not be accurate. However, in a typical situation we believe it will yield an approximation of the valuation placed on the company at the time of financing, and therefore may be of interest to our readers.

We can prepare a similar analysis across any group of transactions that our clients are interested in. For example, we could prepare analysis for a group of competitive companies so you can see what the implied valuations of your competitors are. If you would like additional information on this service, please contact your lawyer at Foley Hoag or one of our Emerging Enterprise Center lawyers listed at the end of this publication.

Terms of Selected New England Series A Rounds 2009[1]

	Q1		Q2		Q3		Q4	
Based on NVCA Form[2]	Yes 2	No 0	Yes 1	No 1	Yes	No	Yes	No
Dividends								
Cumulative accruing[3]	Yes 2	No 0	Yes 2	No 0	Yes	No	Yes	No
1x Liquidation Preference								
With full participation	2		1					
With capped participation	0		0					
Non-participating	0		1					
Greater than 1x Liquidation Preference								
With full participation	0		0					
With capped participation	0		0					
Non-participating	0		0					
Redemption	1		2					
Antidilution[4]	0		0					
Fully broad-based	0		0					
Broad-based	2		1					
Narrow-based	0		0					
Full ratchet	0		0					
Pay to Play Provision	0		0					

1 Determined from a review of publicly available Certificate of Incorporation filings.

2 Certificate of Incorporation appears to have been based substantially on the NVCA form.

3 Dividend rates ranged from 6% to 8% for the second quarter of 2009.

4 "Fully broad-based", "broad-based" and "narrow-based" all refer to a weighted average conversion rate adjustment formula. "Narrow-based" means that the formula includes outstanding equity on an as-converted basis, but not options or warrants. "Broad-based" adds to the narrow-based formula outstanding options and warrants on an as-exercised basis, but does not include ungranted options. "Fully broad-based" adds to the broad-based formula options that may be issued in the future pursuant to a plan approved by the Board of Directors. "Full ratchet" means that the conversion rate adjusts to the lowest price at which the issuer sells or is deemed to sell (as in the case of a sale of convertible securities) any shares of common stock.

The table above summarizes publicly available information about various terms included in the Certificates of Incorporation for "Series A" financings for companies headquartered in New England. For the purposes of this table we have focused solely on transactions that appeared to us, from the public filings, to be identifiable as "Series A" financings. We have excluded transactions that appeared to us to involve considerations and concerns different from those applicable in a typical "Series A ", such as might occur, for example in the case of a recapitalization. For this reason, the set of transactions described above is somewhat different from the set of transactions described in the later tables. We have selected terms to report on that we believe will be of particular interest to entrepreneurs. Each of these terms is linked to a description of that term in our Web site. Information included in the table above is based on information made publicly available by participants in the relevant transactions and therefore is not comprehensive.

Terms of Selected New England Series B and Later Rounds[5]

	Q1		Q2		Q3		Q4	
Based on NVCA Form[6]	Yes 7	No 9	Yes 4	No 13	Yes	No	Yes	No
Dividends								
Cumulative accruing[7]	Yes 3	No 13	Yes 6	No 11	Yes	No	Yes	No
1x Liquidation Preference								
With full participation	9		6					
With capped participation	3		3					
Non-participating	4		5					
Greater than 1x Liquidation Preference								
With full participation			3					
With capped participation			0					
Non-participating			0					
Redemption	13		8					
Antidilution[8]								
Fully broad-based	3		3					
Broad-based	13		11					
Narrow-based	0		1					
Full ratchet	0		2					
Pay to Play Provision	4		3					

5 Determined from a review of publicly available Certificate of Incorporation filings.
6 Certificate of Incorporation appears to have been based substantially on the NVCA form.
7 Dividend rates ranged from 2% to 10% for the second quarter of 2009.
8 "Fully broad-based", "broad-based" and "narrow-based" all refer to a weighted average conversion rate adjustment formula. "Narrow-based" means that the formula includes outstanding equity on an as-converted basis, but not options or warrants. "Broad-based" adds to the narrow-based formula outstanding options and warrants on an as-exercised basis, but does not include ungranted options. "Fully broad-based" adds to the broad-based formula options that may be issued in the future pursuant to a plan approved by the Board of Directors. "Full ratchet" means that the conversion rate adjusts to the lowest price at which the issuer sells or is deemed to sell (as in the case of a sale of convertible securities) any shares of common stock.

The table above summarizes publicly available information about various terms included in the Certificates of Incorporation for "Series B" and later round financings for companies headquartered in New England. For the purposes of this table we have focused solely on transactions that appeared to us, from the public filings, to be identifiable as "Series B" and later round financings. We have excluded transactions that appeared to us to involve considerations and concerns different from those applicable in a typical "Series B "or later round, such as might occur, for example in the case of a recapitalization. For this reason, the set of transactions described above is somewhat different from the set of transactions described in the later tables. We have selected terms to report on that we believe will be of particular interest to entrepreneurs. Each of these terms is linked to a description of that term in our Web site. Information included in the table above is based on information made publicly available by participants in the relevant transactions and therefore is not comprehensive.

We can prepare a similar analysis across any group of transactions that our clients are interested in. For example we could prepare analysis by industry so you can see what terms are prevalent in your industry. If you would like additional information on this service, please contact your lawyer at Foley Hoag or one of our Emerging Enterprise Center lawyers listed at the end of this publication.

The Activity Level Summary

New England Series A and First Round Transactions by Industry*

	2008				2009					
Industry	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Quarter ended June 30, 2009**	**Quarter ended June 30, 2009**
Biopharma	2	3	3	6	1	**1**			3	**1**
Medical Device	5	0	1	1	0	**0**			0	**0**
Alternative Energy	1	2	0	1	0	**1**			2	**1**
Software	2	1	4	2	2	**2**			1	**2**
Communications	0	0	0	0	0	**0**			0	**0**
Other	3	12	5	3	5	**1**			12	**1**
Total	13	18	13	13	8	**5**			18	**5**

* Source: Dow Jones VentureSource

New England Series B and Later Round Transactions by Industry*

	2008				2009					
Industry	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Quarter ended March 31, 2008**	**Quarter ended March 31, 2009**
Biopharma	5	6	11	6	10	**8**			6	**8**
Medical Device	5	5	6	6	4	**8**			5	**8**
Alternative Energy	1	3	0	2	1	**0**			3	**0**
Software	14	13	10	19	13	**9**			13	**9**
Communications	1	2	2	3	3	**2**			2	**2**
Other	13	11	14	10	8	**14**			11	**14**
Total	39	40	43	46	39	**41**			40	**41**

* Source: Dow Jones VentureSource

The Activity Level Summary

National Series A and First Round Transactions by Industry*

	2008				2009					
Industry	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Quarter ended June 30, 2008**	**Quarter ended June 30, 2009**
Biopharma	24	23	12	17	9	**4**			23	**4**
Medical Device	24	13	12	10	4	**7**			13	**7**
Alternative Energy	8	13	12	8	3	**5**			13	**5**
Software	32	33	35	22	15	**12**			33	**12**
Communications	3	0	8	1	7	**1**			0	**1**
Other	89	106	80	80	45	**16**			106	**16**
Total	180	188	159	138	83	**45**			188	**45**

* Source: Dow Jones VentureSource

National Series B and Later Round Transactions by Industry*

	2008				2009					
Industry	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Quarter ended June 31, 2008**	**Quarter ended June 30, 2009**
Biopharma	33	41	44	43	**39**	**40**			41	**40**
Medical Device	44	44	42	35	**31**	**55**			44	**55**
Alternative Energy	10	16	18	20	**11**	**18**			16	**18**
Software	111	117	89	93	**85**	**76**			117	**76**
Communications	28	25	29	28	**22**	**24**			25	**24**
Other	154	128	129	126	**112**	**125**			128	**125**
Total	380	371	351	345	**300**	**338**			371	**338**

* Source: Dow Jones VentureSource

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Size of New England 2009 Series A and First Round Transactions by Industry*

Industry	$5 million or less	Above $5 million up to $10 million	Above $10 million up to $15 million	Above $15 million up to $20 million	Above $20 million
Biopharma	1	0	0	0	0
Medical Device	0	0	0	0	0
Alternative Energy	1	0	0	0	0
Software	2	0	0	0	0
Communications	0	0	0	0	0
Other	0	0	0	0	1
Total	4	0	0	0	1

* Source: Dow Jones VentureSource

Size of New England 2009 Series B and Later Round Transactions by Industry*

Industry	$5 million or less	Above $5 million up to $10 million	Above $10 million up to $15 million	Above $15 million up to $20 million	Above $20 million
Biopharma	4	0	2	0	2
Medical Device	1	2	2	1	2
Alternative Energy	0	0	0	0	0
Software	3	5	0	1	0
Communications	1	1	0	0	0
Other	8	5	0	0	1
Total	17	13	4	2	5

* Source: Dow Jones VentureSource

The tables above summarize publicly available information about the number and size of first round financings and second round financings for companies headquartered in New England and nationally by industry. The data included in the tables is derived from VentureSource, a publication of Dow Jones VentureOne. VentureSource categorizes transactions as "seed round" "first round," "second round" and so on. Upon examination of each transaction, it is not always clear why a particular transaction was put in a particular category, however, for the purposes of these tables we have used the categories as defined by VentureSource. Information included in the tables above is based on information made publicly available by participants in the relevant transactions and therefore is not comprehensive.

If you have any questions about this publication or about the EEC and how we can help your entrepreneurial venture, please feel free to contact any of the following lawyers:

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The Emerging Enterprise Center at Foley Hoag (EEC), located in the heart of the Route 128 technology corridor, serves the wide-ranging needs of Greater Boston's entrepreneur and venture communities by providing timely and efficient delivery of a full complement of legal services and widening access to business management expertise and professional networks. The EEC focuses on key priorities for any emerging technology company: patent protection and strategy, corporate organization and governance, financing and deals. It also serves as a state-of-the-art venue offering seminars, programs and events to facilitate learning, collaboration and networking among industry organizations, providing a forum where entrepreneurs and industry thought leaders convene to exchange ideas and accelerate the progress of emerging enterprises. Visit the EEC at emergingenterprisecenter.com.

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