

Included in this Issue

- The End of Doom and Gloom
Dave Broadwin
- The Numbers
David Pierson
- Selected New England Series "A" Round Transactions: Fourth Quarter 2008
- Selected New England Series "B" and Later Round Transactions: Fourth Quarter 2008
- Terms of Selected New England Series A Rounds 2008
- Terms of Selected New England Series B and Later Rounds
- The Activity Level Summary
 - *New England Series A and First Round Transactions by Industry*
 - *New England Series B and Later Round Transactions by Industry*
 - *National Series A and First Round Transactions by Industry*
 - *National Series B and Later Round Transactions by Industry*
- Size of New England 2008 Series A and First Round Transactions by Industry
- Size of New England 2008 Series B and Later Round Transactions by Industry

Annual Review of Venture Capital Financings

The End of Doom and Gloom

Dave Broadwin

I like my gloom and doom as much as the next guy, but a whole year of unrelenting gloom and doom is overdoing it. Looking back on a year's worth of numbers, it occurs to me that there is a lot to say that is not in the numbers.

Entrepreneurs are like weeds.

If you just look at the national numbers you could come to the conclusion that there are fewer deals than last year, that the VCs are taking longer to invest and are investing at lower and lower valuations, and that all of this just acts as disincentive for entrepreneurs to start new ventures. But, anecdotal evidence is to the contrary. I polled some of my partners, and we all agree there is steady stream of new start-ups in all industries. They are not necessarily getting financing from VCs. In fact, the pattern that I see evolving is that entrepreneurs spend a bunch of time (many months) hiking up and down Winter Street to no avail. After that, they figure out other ways to keep moving forward by self-funding and going to family and friends or others with special affinity, and they make do with less. In a number of cases, they seem to me to be happier and more productive once they accept that there will be no VC money and they figure out something else. Entrepreneurs are like weeds; it will take more than a long dry spell to kill them off.

Smart investors can learn from their own mistakes.

Before writing this paragraph I went back and checked an old closing binder, and, yes there it was, a 5x participating preference. I have been waiting and bracing myself for what I imagined would be inevitable – the return of onerous terms (not to be confused with really really low valuations). The ones I have been expecting are multiple X participations and full ratchet antidilution provisions. The practical effect of a preferred stock with these provisions is, of course, to leave anyone who is not invested in that series (especially the common holders) with little or nothing. My sense is that investors discovered how disheartening and demotivating these provisions were in the last cyclical downturn (and that they left a very bad taste in the mouths of many entrepreneurs). So far, I have not seen them. I have seen bottom fishing valuations, but that is another matter. Investors may not learn from the mistakes of others, but at least they learn from their own.

Rumors of the death of venture capital.

How many times have you heard (or read): the venture model is broken or average venture returns were about 1.5% in the last eight years (or something like that), or there is way too much money invested in venture funds, or the like? There is, of course, some kernel of truth to each of those statements, but they need to be looked at in some context. It would be hard to deny that there are great opportunities to found and build great new companies. These

opportunities seem self-evident in certain sectors such as renewable energy and clean technology, but they will also exist in sectors that don't have as much play in the media as renewable energy and clean tech. Mobile technologies, cloud computing, data storage, industrial efficiency and robotics come to mind. Institutions are going to see the opportunities and they will want to invest. To date I have not heard anyone suggest a more efficient way for large funds to make these investments than through venture funds. Furthermore, venture funds were raised in 2008 (way less than in 2007, but raised nonetheless). If people are putting money in venture funds at this point in the cycle, they will continue to do so in increasing amounts in '09 and '10. Rumors of the death of venture capital are greatly exaggerated.

The darkest hour

As of this writing, it is hard to find any good news. The Dow looks like it could easily drop below 6000, there are no IPOs, acquisition activity is way off and a lot of it seems to be fire sales, and venture funding is very hard to get even at rock bottom valuations. I think Bernanke said that the current recession might be over by year end. That is Fedspeak for "under the most optimistic circumstances it will stop getting worse in the fourth quarter." This is hardly an optimistic statement. I keep searching for a harbinger of better times, but nothing obvious has appeared to me. Having said that, you would not expect to see, touch and feel specific evidence of a rebound until after hitting bottom. Right now visibility is nil, but the darkest hour is just before dawn.

Maybe I have been down so long it looks like up to me, but I am an optimist. All the gloom and doom has given everyone something to talk to complete strangers about, but it is time to move on.

The Numbers

David Pierson

Set forth below are analysis and commentary regarding the information reported in the various tables throughout this issue of *EEC Perspectives*.

Implied Pre-Money and Post-Money Valuations -- New England Q4 2008

Perhaps the most interesting aspect of the reported data regarding implied pre-money and post-money valuations for New England Series A rounds and Series B/later rounds during the fourth quarter of 2008 is that the reported information does not give much hint of the current economic downturn and its impact on venture capital financing and the efforts of emerging companies to raise capital. The reported pre-money and post-money valuations are all within “normal” ranges and to the extent relevant the rounds are all up rounds.

Terms

The matrices of terms for selected New England Series A rounds and Series B/later rounds for 2008 show the following notable trends as the year progressed: (i) with respect to dividends, away from cumulative accruing dividends – a surprising trend in light of the deteriorating economic environment; and (ii) with respect to liquidation preferences, away from non-participation and toward full participation or least full participation with a cap – a trend one would expect in the circumstances. Also, in the case of Series A rounds, as the year went on there was an increasing tendency to include a pay to play provision.

Activity Level

Surprisingly, New England Series A round activity in Q4 2008 was up compared to Q4 2007 and New England Series B/later round activity in Q4 2008 was down only slightly compared to Q4 2007. Nationally, however, the Q4 2008 activity level was down both for Series A rounds and for Series B/later rounds compared to Q4 2007.

New England Series A round activity was down 25% in 2008 compared to 2007, and New England Series B/later round activity was down 9% in 2008 compared to 2007. Nationally, Series A round activity was down 11% in 2008 compared to 2007, and Series B/later round activity was down 1% in 2008 compared to 2007.

For the year, New England saw a rather dramatic decline in software and communication financing transactions. Biopharma financings transactions were down slightly, and medical device and alternative energy financing transactions remained essentially flat. Nationally the picture was roughly comparable, although the decline in software and communication financing transactions was not quite as severe and there was a significant jump in Series B/later round alternative energy transactions.

The information in the size of transaction table for New England Series A rounds in 2008 is about what one would normally expect. Most transactions raised \$10 million or less, and the transactions that raised the most were biopharma deals. The information in the size of transaction table for New England Series B/later rounds in 2008 is somewhat surprising because of the large number of transactions raising \$10 million or less, and particularly the number of transactions raising \$5 million or less.

Conclusion

The reported information suggests that the deals that got done in 2008 got done on relatively conventional terms. This is little solace to those who are now seeking but unable to obtain financing, but it's good news for those fortunate enough to have access to capital. It is also consistent with our experience at Foley Hoag.

From a broader perspective, I think that in the short term we are likely to see continuing pressure on valuations, a relatively slow pace of new deals and some unhappy fire-sale type exits. However, on the other hand, now would seem to be a good time to invest, particularly in start-ups, and accordingly it would seem reasonable to expect that sooner or later nerves will calm, markets will steady and the capital that is now sitting on the sidelines will be put to work.

Selected New England “Series A” Round Transactions

Fourth Quarter 2008

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
NKT Therapeutics	\$1.00	8,000,000	\$8,000,000.00	14,250,000	56.14%	\$6,250,000.00	\$14,250,000.00
Semprus Biosciences Corp.	\$0.4570922	32,766,670	\$14,977,389.28	45,000,000	72.81%	\$5,591,759.72	\$20,569,149.00
Entra Pharmaceuticals, Inc.	\$1.00	10,425,926	\$10,425,926.00	18,000,000	57.92%	\$7,574,074.00	\$18,000,000.00
Alnara Pharmaceuticals	\$0.83	24,096,386	\$20,000,000.38	39,096,386	61.63%	\$12,450,000.00	\$32,450,000.38

Selected New England “Series B” and Later Round Transactions

Fourth Quarter 2008

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
Qteros (formerly Sunethanol)	Series B	\$0.627	40,333,645	\$25,289,195.41	90,000,000	44.82%	\$31,140,804.58	\$56,430,000.00	Up
Xtalic Corporation	Series B	\$3.93	2,563,867	\$10,075,997.31	7,600,000	33.74%	\$19,792,002.69	\$29,868,000.00	Up
Aushon Biosystems	Series B	\$1.40	5,357,144	\$7,500,001.60	23,000,000	23.29%	\$24,699,998.40	\$32,200,000.00	Up
Energetiq Technology, Inc.	Series C	\$5.32	939,850	\$5,000,002.00	8,000,000	11.75%	\$37,559,998.00	\$42,560,000.00	Up
Memento, Inc.	Series D	\$4.60	2,172,781	\$9,994,792.60	11,159,907	19.47%	\$41,340,779.60	\$51,335,572.20	Up
Play Hard Sports, Inc.	Series B	\$0.66616	12,020,000	\$8,007,243.20	35,000,000	34.34%	\$15,308,356.80	\$23,315,600.00	Up
Streambase Systems, Inc.	Series D	\$2.1239	2,938,259	\$6,240,568.29	30,000,000	9.79%	\$57,476,431.71	\$63,717,000.00	Up
RatePoint, Inc.	Series B	\$0.748693	14,705,628	\$11,010,000.74	40,000,000	36.76%	\$18,937,719.26	\$29,947,720.00	Up
Satori Pharmaceuticals, Inc.	Series B	\$0.50	44,500,000	\$22,250,000.00	75,500,000	58.94%	\$15,500,000.00	\$37,750,000.00	Up
Exit41, Inc.	Series C-1	\$18.50	1,100,000	\$20,350,000.00	1,700,000	64.71%	\$11,100,000.00	\$31,450,000.00	Up
Virtual Computer, Inc.	Series B	\$0.5288	28,366,112	\$15,000,000.02	81,000,000	35.02%	\$27,832,799.97	\$42,832,800.00	Up

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 2008¹

	Q1		Q2		Q3		Q4	
Based on NVCA Form ²	Yes 5	No 3	Yes 5	No 0	Yes 2	No 1	Yes 3	No 1
Dividends								
Cumulative accruing ³	Yes 5	No 3	Yes 3	No 2	Yes 1	No 2	Yes 1	No 3
1x Liquidation Preference								
With full participation	2		2		0		2	
With capped participation	0		1		2		2	
Non-participating	6		2		1		0	
Greater than 1x Liquidation Preference								
With full participation	0		0		0		0	
With capped participation	0		0		0		0	
Non-participating	0		0		0		0	
Redemption	8		3		1		2	
Antidilution⁴								
Fully broad-based	0		0		0		0	
Broad-based	6		5		3		4	
Narrow-based	1		0		0		0	
Full ratchet	1		0		0		0	
Pay to Play Provision	1		1		0		2	

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 7% to 10% for 2008.

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 Rounds⁵

	Q1		Q2		Q3		Q4	
Based on NVCA Form ⁶	Yes 6	No 4	Yes 7	No 0	Yes 10	No 5	Yes 10	No 1
Dividends								
Cumulative accruing ⁷	Yes 5	No 5	Yes 3	No 4	Yes 7	No 8	Yes 1	No 10
1x Liquidation Preference⁸								
With full participation	1		2		0		5	
With capped participation	3		3		4		6	
Non-participating	4		8		3		0	
Greater than 1x Liquidation Preference								
With full participation	0		0		0		0	
With capped participation	0		2		0		0	
Non-participating	0		0		0		0	
Redemption	9		11		7		10	
Antidilution⁹								
Fully broad-based	1		3		0		0	
Broad-based	6		10		6		10	
Narrow-based	0		1		0		0	
Full ratchet	3		1		1		1	
Pay to Play Provision	3		3		3		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 6% to 8% for 2008.

⁸ Two of the transactions involved liquidation preferences which are not typical in these type of transactions and therefore were not included in the above chart.

⁹ "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*

Industry	2007				2008				Year ended December 31, 2007	Year ended December 31, 2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Biopharma	7	8	2	3	2	3	3	6	20	14
Medical Device	5	3	2	0	5	0	1	1	10	7
Alternative Energy	0	0	2	0	1	2	0	1	2	4
Software	8	6	5	2	2	1	4	2	21	9
Communications	1	1	0	0	0	0	0	0	2	0
Other	2	5	7	7	3	12	5	3	21	23
Total	23	23	18	12	13	18	13	13	76	57

* Source: Dow Jones VentureOne

New England Series B and Later Round Transactions by Industry*

Industry	2007				2008				Year ended December 31, 2007	Year ended December 31, 2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Biopharma	4	7	9	13	5	6	11	6	33	28
Medical Device	3	10	3	4	5	5	6	6	20	22
Alternative Energy	1	0	3	1	1	3	0	2	5	6
Software	12	24	12	23	14	13	10	19	71	56
Communications	5	5	5	2	1	2	2	3	17	8
Other	9	7	14	9	13	11	14	10	39	48
Total	34	53	46	52	39	40	43	46	185	168

* Source: Dow Jones VentureOne

The Activity Level Summary

National Series A and First Round Transactions by Industry*

Industry	2007				2008				Year ended December 31, 2007	Year ended December 31, 2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Biopharma	28	26	14	19	24	23	12	17	87	76
Medical Device	20	15	11	9	24	13	12	10	55	59
Alternative Energy	12	7	13	9	8	13	12	8	41	41
Software	52	47	39	33	32	33	35	22	171	122
Communications	11	13	10	7	3	0	8	1	41	12
Other	77	92	93	92	89	106	80	80	354	355
Total	200	200	180	169	180	188	159	138	749	665

* Source: Dow Jones VentureOne

National Series B and Later Round Transactions by Industry*

Industry	2007				2008				Year ended December 31, 2007	Year ended December 31, 2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Biopharma	46	50	37	61	33	41	44	43	194	161
Medical Device	41	49	32	39	44	44	42	35	161	165
Alternative Energy	5	18	14	8	10	16	18	20	45	64
Software	91	132	102	111	111	117	89	93	436	410
Communications	36	28	41	28	28	25	29	28	133	110
Other	98	132	127	140	154	128	129	126	497	537
Total	317	409	353	387	380	371	351	345	1466	1447

* Source: Dow Jones VentureOne

Size of New England 2008 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	6	3	0	1	6
Medical Device	5	1	1	0	0
Alternative Energy	0	1	1	0	0
Software	3	6	2	1	0
Communications	0	0	0	0	0
Other	15	7	1	1	1
Total	29	18	5	3	7

* Source: Dow Jones VentureOne

Size of New England 2008 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	5	4	5	3	10
Medical Device	7	6	3	3	3
Alternative Energy	1	1	0	0	4
Software	20	14	11	1	8
Communications	2	4	0	0	2
Other	21	14	8	0	3
Total	56	43	27	7	30

* Source: Dow Jones VentureOne

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 Venture Source, a publication of Dow Jones Venture One. Venture Source 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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