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This is the second edition of *EEC Perspectives* to focus on "Series A" and first round financings. This EEC Perspective presents data and analysis on the number and size of Series A transactions in the New England region and, with respect to numbers of transactions, nationally for the first six months of 2008. It also reports and provides analysis on certain key terms of the New England transactions.

For this issue of *EEC Perspectives*, we have asked **Maria Cirino** of **.406 Ventures**, an early-stage venture capital firm, to comment on Series A financings. Maria points out, among other things, that, picking the right people for your team is the most important determinate of success once the venture has been funded. We plan to bring you other points of view in future issues of *EEC Perspectives*.

We hope you will find this information useful in your financing efforts. In addition, we would like to hear from you if you have transactions or comments that might be interesting to others. Do not hesitate to send one of us at the EEC an email at info@foleyhoag.com. Also, please visit our Web site emergingenterprisecenter.com and plan on attending some of the many networking and educational events we hold at the EEC. We hope you will find the EEC a valuable resource as you start and grow your company



David A. Broadwin

A Market Perspective

Maria Cirino, Co-Founder and Managing Director, .406 Ventures

With the current crisis in the financial markets and the dearth of exit opportunities, more than ever entrepreneurs need to be focused on building long-term sustainable businesses. Picking the right people for your team, including employees, advisors, counsel, partners, initial customers and investors is the most important determinate of success once the venture has been funded. As an entrepreneur for the last 20 years prior to becoming a venture capitalist, I've experienced firsthand the value that the right set of advisors and investors can bring to an early stage venture.

It's important to keep in mind that raising capital is first and foremost a sales process. As an entrepreneur you have to be prepared to tell your story again and again in a convincing and compelling way that inspires confidence and is backed up with meaningful data and external validation. Who you choose to tell that story to is equally important. While characteristics such as integrity, chemistry and shared vision of the company are essential in your VC partner, it is also important that you find an investor and VC fund that understands early stage investing and has the experience to roll-up their sleeves and contribute as a board member.

- How do their current and former CEOs rate them? Ask current CEOs and more importantly CEOs from companies they worked with previously (successful companies as well as those that didn't have the fairytale ending) how the Partner and fund compared to others on the board in terms of ability to understand the issues at hand, constructively problem solve and add value.
- What is their track record as an operator? One of the primary rolls of the board is to help you avoid pitfalls. VCs with significant experience as senior operators can help you emulate best practices and avoid the mistakes that they've made.
- Does the VC have experience in your space? A VC's network and ability to hit the ground running are directly related to their exposure to and understanding of your market.

There are also many VC fund dynamics that could misalign the fund and company that are often overlooked:

- Do they demonstrate that they have the company's best interests at heart? Throughout the pre-investment engagement with the fund and in particular in negotiations, there will be many opportunities for them to demonstrate that they have the company's best interests at heart. For example, did they try to force more money on the company than it truly needs?
- Do they invest in competitors to their existing portfolio companies? Some funds invest in more than one company in an industry, which can obviously create perverse incentives and conflict within the fund.
- Where are they in the life of their current fund? Funds typically have a 10 years investment horizon, the average time to liquidity for a company has been more than seven years but the recession and recent events in financial markets are likely to drive that even higher.
- What is their reserve policy? If funds don't reserve enough to participate in future rounds, it can be problematic at the time of follow-on rounds.

Syndication is an added layer of complexity, and while it can make the investment process slightly slower, it often has significant advantages post-investment. Most importantly, you will have more than one firm's resources at your disposal including networks, people and points of view. As you evaluate possible combinations of funds for syndication, pay attention to the dynamics that could create a misalignment among the investors. It is generally best to have a syndicate of similar/complementary funds from a size, stage and investment strategy perspective.

Strategic investors can often provide advantages to later stage companies, but should be viewed with caution in an A round. Companies at this early stage generally have not yet developed a broad identity within their customer base and the affiliation of a strategic can often cloud external perceptions of the company.

There are hundreds of venture capital firms out there and you will likely hear similar stories. To find the best fit for your company, do your homework and choose wisely. You only have one opportunity to pick your initial investors. It's a good investment of your time to pick the fund and board member that's right for your business.

Selected New England "Series A" Round Transactions

Second 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 |
|-------------------------------------|--|---|--|---|---|-----------------------------|------------------------------|
| Constellation Pharmaceuticals, Inc. | \$1.00 | 32,150,000 | \$32,150,000.00 | 71,300,000 | 45.09% | \$39,150,000.00 | \$71,300,000.00 |
| Play Hard Sports, Inc. | \$0.50 | 10,000,000 | \$5,000,000.00 | 20,000,000 | 50% | \$5,000,000.00 | \$10,000,000.00 |
| Laser Light Engines, Inc. | \$0.2667 | 16,872,890 | \$4,499,999.76 | 34,000,000 | 49.63% | \$4,567,800.24 | \$9,067,800.00 |
| North End Technologies, Inc. | \$0.817 | 5,209,221 | \$4,255,933.56 | 10,299,044 | 50.58% | \$4,158,385.39 | \$8,414,318.95 |
| Optiwind Corp | \$1.44 | 3,724,802 | \$5,363,714.88 | 15,000,000 | 24.83% | \$16,236,285.12 | \$21,600,000.00 |

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 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.

COMMENTARY:

Bruce Kinn, Foley Hoag Partner

Yes, Series A rounds are getting done despite the general economic climate; and yes, they are getting done at a more modest level because of it. The resulting trend in pricing is certainly not upward, as wary investors attempt to build more cushion into their models to offset negative economic and market conditions. But perhaps due to investors' somewhat heightened level of selectivity and the long-term perspective required of a typical early stage round, the valuations of those early stage companies that are being financed appear to be holding up reasonably well under the circumstances. (Contrast this with later stage financings, where poor near-term visibility for exits impacts pricing more directly.) Our first-hand experience suggests that these trends persist into the third quarter, with Series A deals getting closed even as the roller coaster ride in the public markets continues to encourage caution in both deal selection and deal pricing.

Terms of Selected New England Series A Rounds 2008¹

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

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 8% to 10% during the first quarter of 2008. Dividend rates ranged from 7% to 8% during the second quarter of 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.

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.

COMMENTARY:

Mark Haddad, Foley Hoag Lawyer

It's difficult to generalize with a small sample set, but it is interesting to note that 60% of the Series A deals we reported on in the second quarter had a participation preference, compared to only 25% in the first quarter. We are starting to see the funding environment get more difficult, as a result of economic conditions generally and, more specifically, the slowdown in exits for VC backed companies, as the IPO window is closed and M&A activity has decreased significantly. Of course, Series A deals will still happen in this environment—there is plenty of VC money available for investment and the time horizon to exit a Series A deal is 5-7 years out. However, it would not be surprising to see a trickle down effect to Series A deals—lowering valuations and producing terms that are more favorable to the VCs. Many Series A VCs prefer not to insist on participation, preferring instead to be better aligned with the founders. But when the funding environment is more difficult and the potential exits look less promising, its not surprising to see some VCs gravitating towards the extra return that a participation preference adds to their potential return when evaluating investments (and trying to persuade their investment committee to go along with the transaction).

The Activity Level Summary

New England Series A and First Round Transactions by Industry*

| Industry | 2007 | | | | 2008 | | | | 6 Months ended June 30, 2007 | 6 Months ended June 30, 2008 |
|--------------------|-----------|-----------|-----------|----------|-----------|-----------|----|----|---------------------------------|---------------------------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | |
| Biopharma | 7 | 8 | 2 | 3 | 2 | 3 | | | 15 | 5 |
| Medical Device | 5 | 3 | 2 | 0 | 5 | 0 | | | 8 | 5 |
| Alternative Energy | 0 | 0 | 2 | 0 | 1 | 2 | | | 0 | 3 |
| Software | 8 | 6 | 5 | 2 | 2 | 1 | | | 14 | 3 |
| Communications | 1 | 1 | 0 | 0 | 0 | 0 | | | 2 | 0 |
| Other | 2 | 5 | 7 | 7 | 3 | 12 | | | 7 | 15 |
| Total | 21 | 23 | 18 | 9 | 13 | 18 | | | 44 | 31 |

* Source: Dow Jones VentureOne

National Series A and First Round Transactions By Industry*

| Industry | 2007 | | | | 2008 | | | | 6 Months ended June 30, 2007 | 6 Months ended June 30, 2008 |
|--------------------|------------|------------|------------|------------|------------|------------|----|----|---------------------------------|---------------------------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | |
| Biopharma | 28 | 26 | 14 | 19 | 24 | 23 | | | 54 | 47 |
| Medical Device | 20 | 15 | 11 | 9 | 24 | 13 | | | 35 | 37 |
| Alternative Energy | 12 | 7 | 13 | 9 | 8 | 13 | | | 19 | 21 |
| Software | 52 | 47 | 39 | 33 | 32 | 33 | | | 99 | 65 |
| Communications | 11 | 13 | 10 | 7 | 3 | 0 | | | 24 | 3 |
| Other | 77 | 92 | 93 | 92 | 89 | 106 | | | 169 | 195 |
| Total | 200 | 200 | 180 | 169 | 180 | 188 | | | 400 | 368 |

* Source: Dow Jones VentureOne

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Size of New England 2008 Year to Date 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 | 4 | 0 | 0 | 0 | 0 |
| Medical Device | 5 | 0 | 0 | 0 | 0 |
| Alternative Energy | 3 | 0 | 0 | 0 | 0 |
| Software | 3 | 0 | 0 | 1 | 0 |
| Communications | 0 | 0 | 0 | 0 | 0 |
| Other | 15 | 0 | 0 | 0 | 0 |
| Total | 30 | 0 | 0 | 1 | 0 |

* Source: Dow Jones VentureOne

COMMENTARY: Paul Sweeney, Foley Hoag Partner

The first two quarters in 2008 saw a general decline nationally in Series A transactions (down 8% from the same period in 2007), with a more marked downturn felt in New England (down almost 30% from 2007). Both nationally and in New England, a few industries saw a slight increase in activity, most notably the Medical Devices and Alternative Energy sectors. Other industries were flat or showed decreases in activity, with Software and Communications taking the brunt of the downturn. With only a single New England transaction out of 31 breaking the \$5 million size barrier, the regional picture looked fairly anemic in Q1 and Q2 even before the onset of the severe credit crisis currently working its way through the financial markets. These trends, coupled with the general malaise in the marketplace, should be a wakeup call for entrepreneurs seeking initial capital to fine tune their business plans to show leaner operations and a clear path to achieving profitability as quickly as possible. Raising capital is likely to continue to be difficult for seed and startup enterprises through the remainder of 2008, and entrepreneurs should recognize now more than ever how important it is to partner with well regarded (and well capitalized) venture firms, or even better, with a syndicate of such firms. Based on historical benchmarks, we should expect to see venture firms spending more of their capital and attention on existing portfolio companies and less on funding new startups, at least until we work through the current downturn.

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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