DOWJONES

Dow Jones Venture Capital
Deal Terms Report

Fifth Edition

VENTURE CAPITAL

Dow Jones

Venture Capital Deal Terms Report

Fifth Edition

Russ Garland
Editor

DOWJONES www.djnewsletters.com

ISBN# 1-893648-93-1/978-1-893648-93-7 | Venture Capital Deal Terms Report published October 2007 by Dow Jones & Company, Inc.,

Table *of* Contents

Advisers

Steven E. Bochner, Partner, Wilson Sonsini Goodrich & Rosati

Michael A. Conza, Partner, Bingham McCutchen LLP

Josh Lerner, Jacob H. Schiff Professor of Investment Banking, Harvard Business School

Sarah Reed, General Counsel, Charles River Ventures

Leonard Q. Slap, Partner, Edwards Angell Palmer Dodge LLP

Introduction

Our fifth annual deal terms survey of U.S. and European venture-backed companies finds the industry in a steady state, with most start-ups facing relatively straightforward term sheets.

Excesses such as liquidation preferences far in excess of what VCs invested were rarely seen. The majority of companies, even those closing later rounds, saw their valuations climb.

This report covers a 12-month period, from July 2006 through June 2007. We sent the survey to companies in the Dow Jones VentureOne database that closed venture rounds during this time. Executives at 375 companies in the U.S. and Europe responded. The aim was to examine key features of venture rounds that are indicative of the overall investment climate.

Here are some highlights of the report:

• The median share of U.S. companies sold to investors in first, or Series A, rounds continued to decline, falling to 38%. The drop wasn't as big as last year, when the median fell from 50% to 40%, but still indicates a strong market for start-ups.

• Three-quarters of U.S. companies closing second rounds saw an increase in their pre-money valuation. This was slightly below last year's 80% but well above the rate reported in our second deal terms survey, covering April 2003 through March 2004, when only 61% of companies closing a second round financing said it was done at a higher valuation than their first.

• The rate of U.S. companies reporting liquidation preferences equal to one times the capital invested plus any accrued interest was 80%, only a bit below last year's 82%. Although later-stage companies closing third or later rounds encountered multiple liquidation preferences somewhat more often than last year, nearly 67% said their investors demanded only a 1x return. No later-stage company reported a multiple higher than 3x.

• Company-unfriendly full-ratchet dilution protection remained rare, appearing in 16% of financings surveyed, about the same rate as last year. Dilution-protection provisions are designed to protect investors if a company closes a subsequent round at a lower valuation. Most investors prefer the weighted-average method, which is friendlier to companies, over full-ratchet.

• Pay-to-play provisions, aimed at keeping venture syndicates together through down rounds, were also not common. These punish prior investors who fail to participate in a down round by converting their preferred stock to common stock or stripping it of certain rights, such as anti-dilution protection. Only 21% of U.S. respondents reported a pay-to-play provision, down from a high of 37% in our survey covering April 2003 through March 2004.

• Most founders and prior investors were not selling shares as part of venture rounds. Overall, founders and/or prior investors sold shares in just fewer than 10% of U.S. financings. Founders sold shares in 16% of first rounds, perhaps because entrepreneurs who bootstrapped their companies sought some liquidity.

• Most U.S. companies – 80% – said they received at least one term sheet from a potential new investor, but few received more than three. Comparing companies that closed up rounds versus those that closed down or flat rounds, a far higher percentage of the former received term sheets from at least one new investor.

• Location matters. Companies based in the San Francisco Bay area saw significant differences in deal terms when compared with companies based in New York and New England, a trend also seen in our prior studies. Investors in New York- or New England-based companies were more likely to get full-ratchet anti-dilution, dividend accruals and exit rights.

• European investors were more than twice as likely as U.S. VCs to pay capital to portfolio companies in stages. In the U.S., health-care start-ups were much more likely to have staged payments than information technology companies.

We hope you find this report useful. Please let me know if you have questions, comments or suggestions.

Russ Garland, Editor

I. Company Valuations

The median value that venture firms placed on U.S. companies when they invested declined in the first half of 2007 after rising for three consecutive years.

Anecdotal evidence, however, indicates that there was still plenty of competition for deals, especially later-stage ones, so it's unclear whether the median for the full year will be down as well. In any case, overall valuations appear to be stabilizing.

The median pre-money valuation, or price placed on a company before a venture financing round, was $16.3 million for the first half of 2007, down from $18 million for all of 2006, according to Dow Jones VentureOne data. (See Exhibit 1.1.) But the median was still well above a low of $10 million for 2003, during a venture industry downturn. Median valuations for health-care as well as for information technology companies were lower in the first half than in 2006.

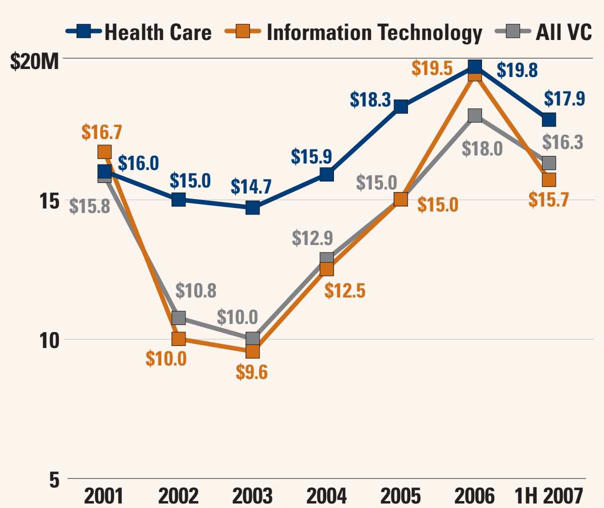
Valuations in the IT and health-care sectors were volatile during the four quarters covered by our deal terms survey. (See Exhibit 1.2.) While quarterly valuation swings are not unusual, they are interesting from a deal terms perspective because they indicate an uncertain market. Placing a value on a company is the most critical element of negotiating a venture financing, and if investors think they are paying too much for their shares, they may seek to mitigate their risk when negotiating other provisions, such as liquidation preferences.

First-round valuations climbed, with the median for all venture-backed companies north of $8 million twice in the last four quarters, at $8.7 million in the second quarter of 2007 and $8 million in the fourth quarter of 2006. (See Exhibit 1.3.) They haven't been that high since 2001. This could be a sign that VCs are tending to make their initial investments in companies that are more mature.

1.1

Median Pre-Money Valuation

*By Industry Group ($M) 2001-2H 2007**

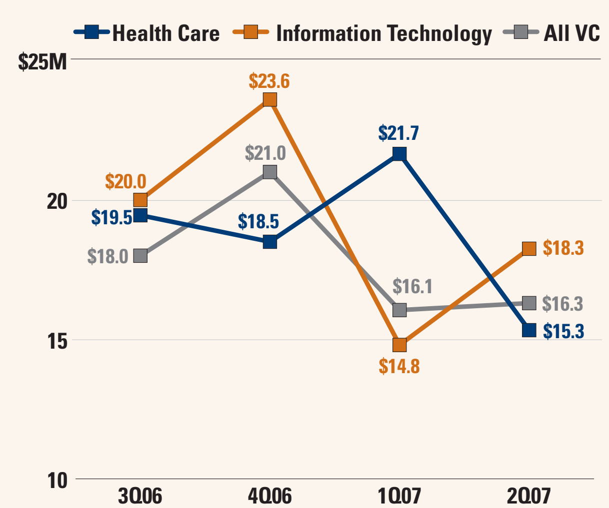


*U.S. venture-backed companies only. Source: Dow Jones VentureOne

1.2

Median Pre-Money Valuation

*By Industry Group ($M) 3Q06-2Q07**

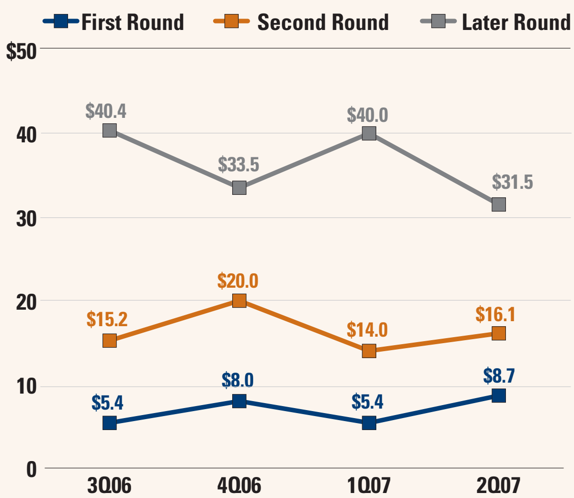


*U.S. venture-backed companies only. Source: Dow Jones VentureOne

1.3

Median Pre-Money Valuation

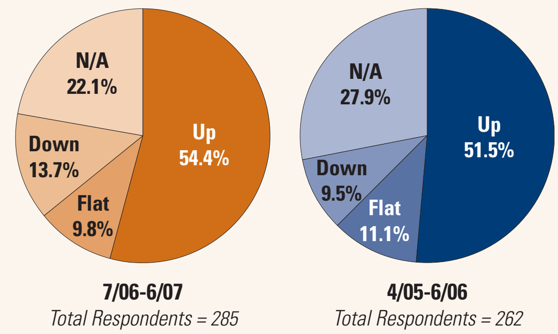
*By Round Class ($M) 3Q06-2Q07**



*U.S. venture-backed companies only. Source: Dow Jones VentureOne

1.4

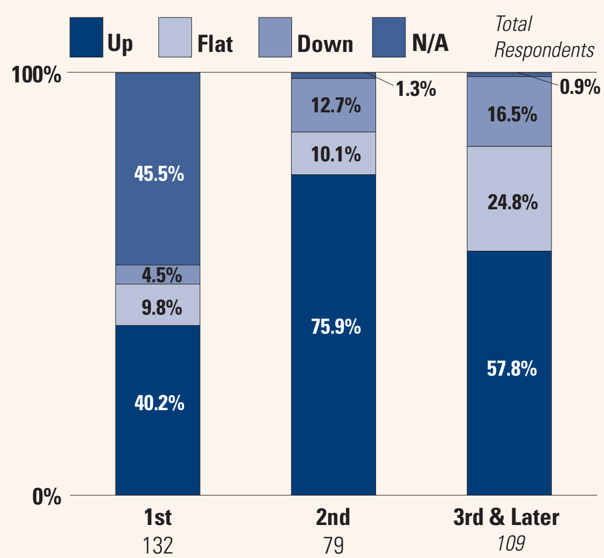
Round Valuation For U.S. Companies



1.5

Round Valuation For U.S. Companies

By Series



Second rounds continued to show a healthy premium over first rounds, but the difference narrowed a bit during the four quarters encompassed by the deal terms survey. Later rounds, which are drawing heavy interest from venture firms, were pricey, with median pre-money valuation twice hitting $40 million or more, a level rarely seen since the tech bubble ended in 2001.

In our survey, we asked companies whether their pre-money valuation rose, fell or stayed the same compared with the post-money valuation of their prior financing. A higher percentage reported receiving an up round this year than last. (See Exhibit 1.4.) Nearly all the companies that said this question was not applicable closed first rounds in which investors priced the business for the first time. (See Exhibit 1.5.) Percentages of higher-valuation financings for companies closing second and later rounds were virtually identical to last year.

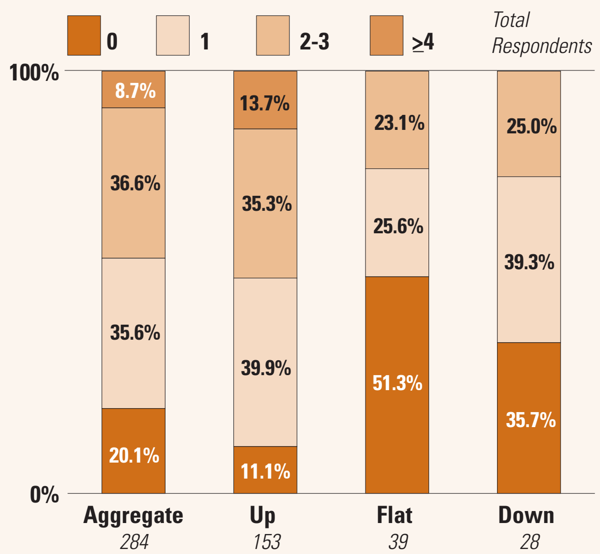
Nor was there much change in the mix of flat and down rounds. By the time a company raises a later-stage financing, there are plenty of ways to measure its performance, and many could not clear the hurdles, as about 41% closed flat or down rounds. Founders and early investors suffer more dilution when their company's valuation stays the same or falls.

For the first time this year, we asked about the number of potential new investors who submitted term sheets. Multiple term sheets indicate competition for the financing, which should translate into a better deal for the company. And lawyers generally advise companies to get at least one outside investor to price the round. Indeed, most companies – 80% of respondents – received at least one term sheet from a potential new investor. (See Exhibit 1.6.) It was rare for a company to get them from four or more potential investors. Flat rounds, which are often done by insiders, generated the lowest percentage of term sheets from new investors. The majority of companies closing down rounds could interest at least one new investor, but no company in this category reported receiving more than three term sheets. ☒

1.6

NUMBER OF POTENTIAL NEW INVESTORS THAT SUBMITTED TERM SHEETS

By Round



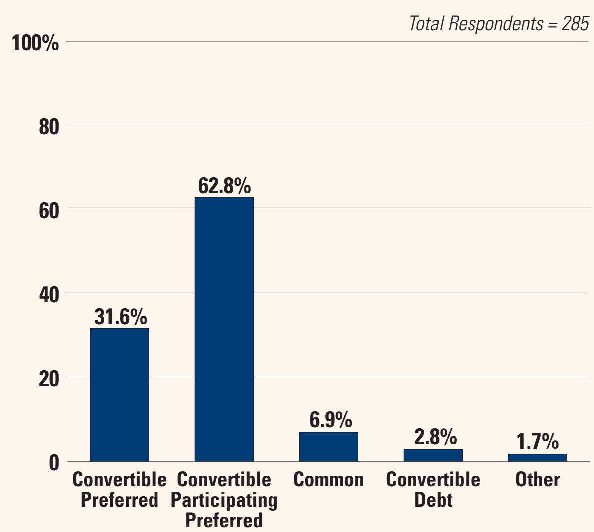
II. Securities

Participating preferred stock, as in previous studies, is the security of choice for venture investors. Just under two-thirds of the U.S. companies responding to our survey said they issued this type of stock to investors in their latest financing. (See Exhibit 2.1.) Convertible participating preferred stock is the formal name for this type of security. "Convertible" because it is convertible to common stock at the option of the shareholder under a formula spelled out in the stock purchase agreement. "Preferred" because its owners have rights not enjoyed by holders of common stock, such as a liquidation preference, which is why it is worth more. "Participating" because investors get the right to share proceeds from liquidation of the company even after recouping the money they invested, and perhaps more, through their liquidation preference. Preferred stock is issued in series, with Series A usually but not always denoting the first round of institutional financing. The second venture round is thus a Series B financing, and so on down the alphabet. A fairly large number of companies – 31.6% of our respondents – issued convertible preferred securities, which lack the participation feature. This type of stock is more entrepreneur-friendly because it theoretically leaves more of the assets of a liquidated company in the hands of common shareholders, who are usually the founders and employees. This could be significant if a company is sold for a price that is too low for all stockholders to see their expected gains.

Companies raising second venture rounds were most likely to issue participating preferred stock – 72.5% did so. (See Exhibit 2.2.) This is a significant change from last year's results, in which only 54.5% of respondents closing second rounds said they issued participating preferred stock. The latest results, however, correspond to earlier deal terms

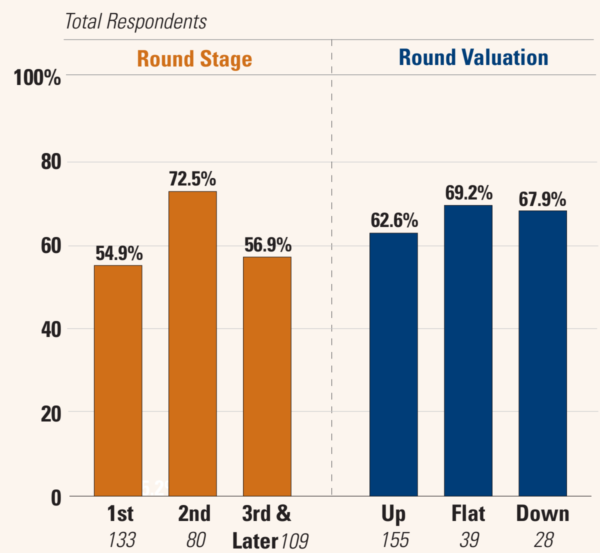
2.1

Types Of Securities Issued To Investors



2.2

Convertible Participating Preferred Securities Issued To Investors



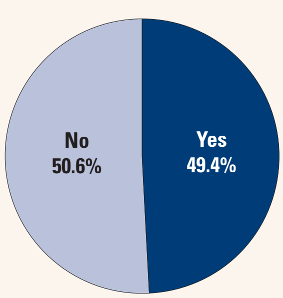
surveys. Because companies raising second rounds are often just beginning to acquire customers, they can be tricky to evaluate, perhaps leading investors to seek the added protection of participating preferred stock.

The percentage of companies closing later rounds that issued participating preferred stock declined from 65.4% last year to 56.9% in our latest survey. This could reflect the large group of companies raising later rounds based on strong revenue and the prospect of an initial public offering or acquisition in the not-so-distant future.

One way for companies to mitigate the effect of the participation feature is to cap the amount investors can collect at some multiple of their investment. Nearly half of respondents did. (See Exhibit 2.3.) The ability of companies to negotiate caps was highly dependent on what happened to their valuation. Those closing down rounds – financings done at a lower valuation than the last round – were far less likely to have the participation provision capped than those closing up or flat rounds. (See Exhibit 2.4.) Overall, caps of two times the amount invested were most common. (See Exhibit 2.5.) However, slightly more than half the companies reported a higher cap, a bit more than in last year's study.

2.3

Participation Capped When Convertible Participating Preferred Securities Issued



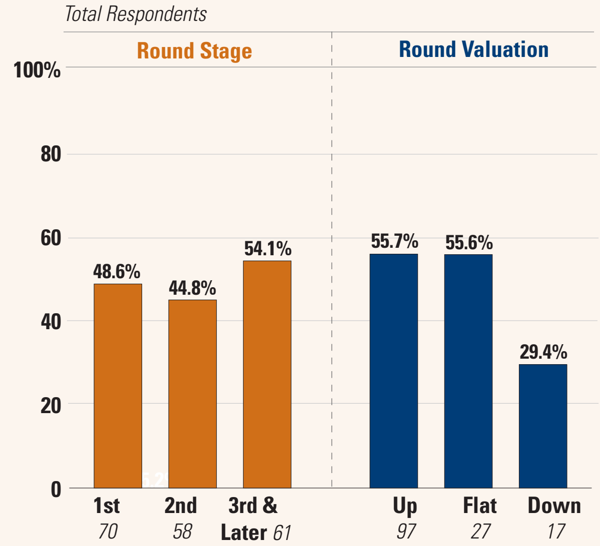
Total Respondents = 178

Caps on returns include the liquidation preference. Most of the time, the liquidation preference equaled the amount invested. (See Chapter V: Liquidation Preference.)

2.4

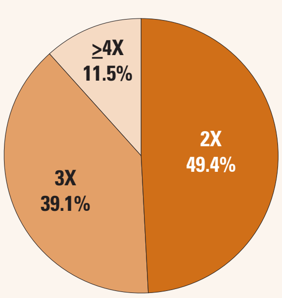
Participation Capped When Convertible Participating Preferred Securities Issued

By Round Stage, Valuation



2.5

Cap On Preferred Investors' Total Return When Convertible Participating Preferred Securities Participation Is Capped



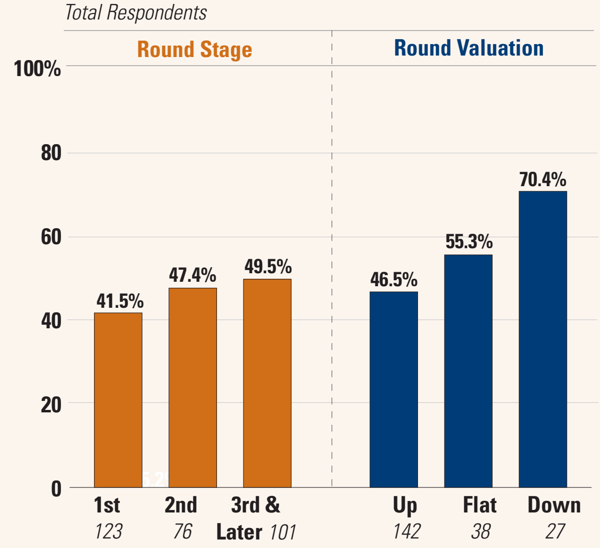
Total Respondents = 87

Only a handful of companies responding to the survey issued common stock, convertible debt or some other type of security as part of their financing. (See Exhibit 2.1.) Preferred stock can pay a dividend, either automatically or when declared by the company. The former, known as a cumulative dividend, generally is not paid to investors unless the company is liquidated. It thereby provides investors with a potential higher return. About half of the respondents said they issued preferred stock with a cumulative dividend, similar to our prior surveys. (See Exhibit 2.6.) Cumulative dividends are more common on the East Coast than on the West. (See Chapter XI: Bay Area Vs. The East.) There wasn't much variation by round stage, but companies closing down or flat rounds were more likely to have this provision in their term sheets. (See Exhibit 2.7.) Most deals paid a dividend in the range of 8% to 10%. (See Exhibit 2.8.) ⊠

2.7

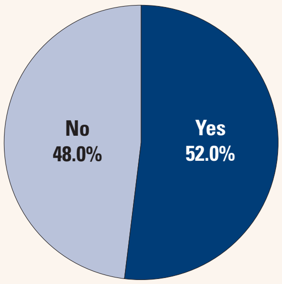
Preferred Stock Carries An Annual Cumulative Dividend

By Round Stage, Valuation



2.6

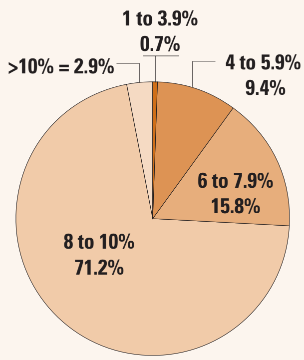
Preferred Stock Carries An Annual Cumulative Dividend



Total Respondents = 271

2.8

Rate At Which Annual Cumulative Dividends Are Payable



Total Respondents = 139

III. Staged Financings

Although most U.S. companies get all of their venture money when the deal closes, investors sometimes pay in stages. Health-care companies, which have to meet clear milestones such as successful clinical trials, are the most apt to face this provision. (See Chapter X: Health Care Vs. IT.)

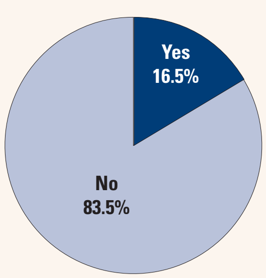
Among all companies in our survey, 16.5% reported staged payments. (See Exhibit 3.1.) The rate seems to fluctuate from survey to survey; it was 21.3% in our prior survey and 11.8% in the one before that.

First rounds, the riskiest for institutional investors, had the highest incidence of staged payments. (See Exhibit 3.2.) A staged payment in a first round can be an alternative to a full-scale second round, thereby allowing management to concentrate on company development rather than fundraising. The valuation of a company seems to affect how quickly it gets its money, with those closing down rounds most likely to have staged payments. Last year's results were similar.

Last year, completion of product development was the chief trigger of a staged round, but in our latest results it was eclipsed by "passage of a set amount of time" and "other." (See Exhibit 3.3.) ⊠

3.1

Capital Raised Is Paid To Company In Stages

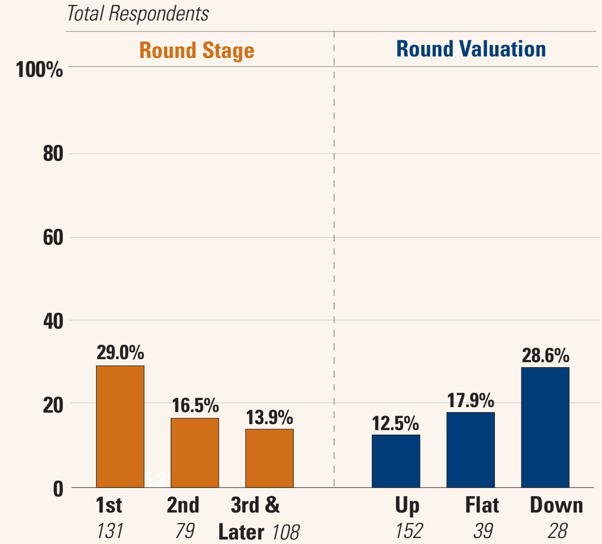


Total Respondents = 285

3.2

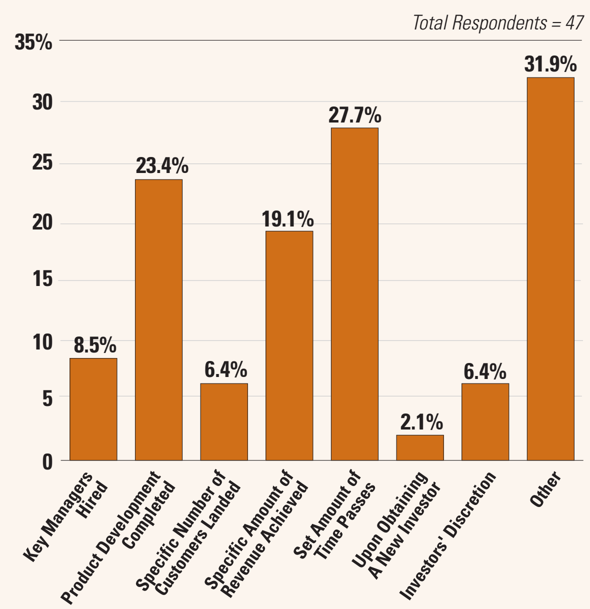
Capital Raised Paid In Stages

By Round, Valuation



3.3

Factors That Trigger Payment When Payment Is Made In Stages



IV. Company Control

The median percentage of U.S. companies sold in first rounds dipped under 40% in our latest survey, another sign that start-ups still have a much stronger position when negotiating with venture investors than they had a few years ago.

The median amount of a company sold in a first venture round was 38%, according to respondents, which closed their financings from July 2006 through June 2007. (See Exhibit 4.1.) In last year's study, which covered rounds closed from April 2005 through June 2006, the median was 40%. First-round medians were 50% in our studies of companies closing venture rounds from April 2004 through March 2005 and from April 2003 through March 2004. These ownership percentages are on a fully diluted basis, which takes into account outstanding stock options and stock set aside for employee incentives.

As noted earlier, first-round valuations have been trending upward, which means entrepreneurs can sell less of their companies to raise the necessary capital. (See Chapter I: Company Valuations.) The median amount raised in first rounds held steady at $5 million in 2005, 2006 and in the first half of 2007, according to VentureOne.

The median percentage of companies sold in second and later rounds also fell slightly from last year's study.

On the flip side of the trend, founders owned more of their companies after a first round. The median founder stake was 35.5% in our latest survey, compared with 31.5% in our prior study and 26.5% the year before. As a company raises additional rounds, founders suffer considerable dilution. Their median ownership after third and later rounds was 10%. (See Exhibit 4.2.)

Exhibits 4.1 and 4.2 also depict the maximum and minimum percentages reported, as well as 25th and 75th percentiles. In first rounds, for example, the 25th percentile amount sold to investors was 24.5%, which means a quarter of the companies responding sold that much ownership or less. In last year's study the 25th percentile was higher – 30%.

Venture firms generally take minority stakes in the companies they back, although an investment syndicate of two or three firms might own more than half a company after a round. To protect their investments, VCs often obtain veto rights over significant

4.1
Benchmark Percentages Of Company Sold On A Fully Diluted Basis

	1st	2nd	3rd & Later
Mean	39.9	31.2	23.6
Median	38	30	21.7
Minimum	3	5	0.4
Maximum	86	75	65
25th Percentile	24.5	20	13.2
75th Percentile	50.5	40	31
Total Respondents	*129*	*77*	*108*

4.2
Benchmark Percentages Of Founders' Ownership After Round

	1st	2nd	3rd & Later
Mean	37.3	18.9	14.9
Median	35.5	15	10
Minimum	0	0	0
Maximum	84	60	84.5
25th Percentile	21	10	5
75th Percentile	52	25.8	20
Total Respondents	*128*	*76*	*109*

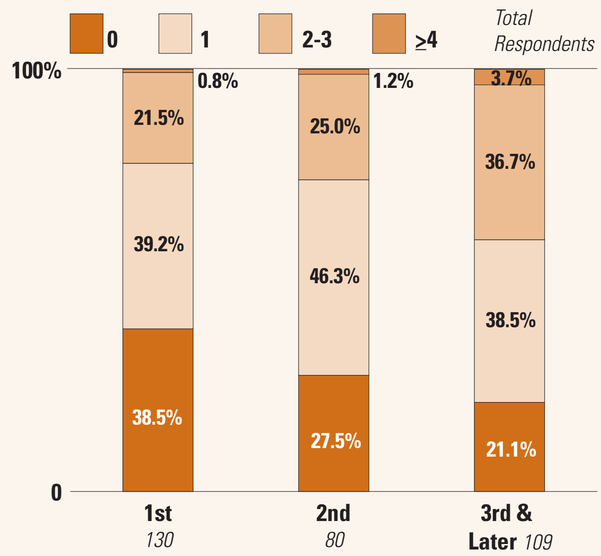
company transactions. These were found in 62.5% of all rounds and were most common in first rounds. (See Exhibit 4.3.) Last year's results were similar.

These rights can require that some or all stockholders agree on certain company actions. They could, for example, give investors in a first, or Series A, round the right to block a subsequent financing.

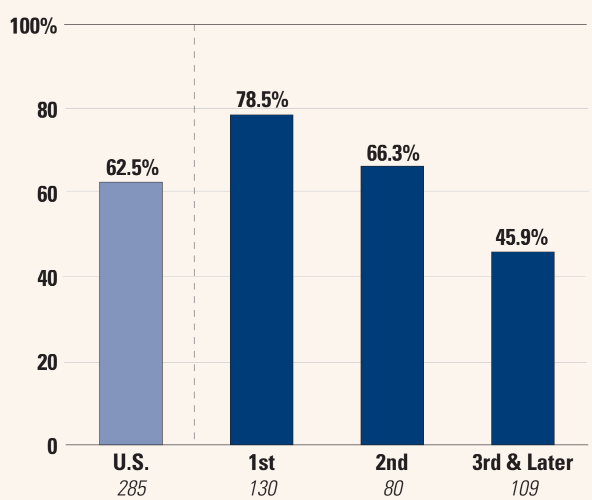
With public company boards under scrutiny, venture-backed companies have been paying more attention to governance issues. Adding independent directors is one way to keep a check on investors and management, but there is a limit because small-company boards of more than seven people are seen as unwieldy. More than half of our survey respondents closing first rounds had at least one independent director, but only about a fifth had more than one. (See Exhibit 4.4.) Companies tended to add independent directors as they raised second and later rounds. Still, about 21% of companies closing third and later rounds had no independent directors. The results didn't change much from the prior survey, although slightly higher percentages of companies closing second and later rounds had at least one independent director.

Balanced boards, where management and founders share control with investors, were the most favored structure after first rounds. (See Exhibit 4.5.) In second and later rounds, investors

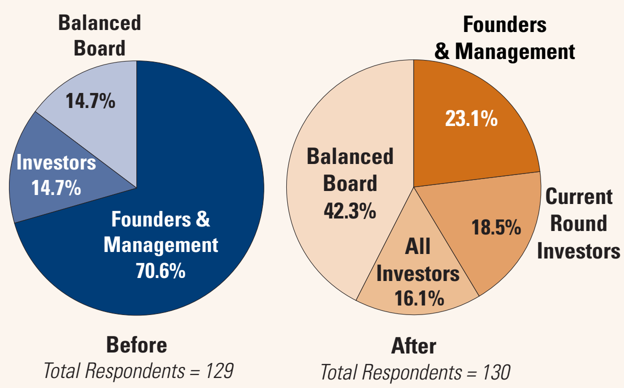
4.4
Number Of Independent Directors On Board



4.3
Investors Who Obtained Affirmative Voting Control Or Veto Rights Over Significant Corporate Transactions



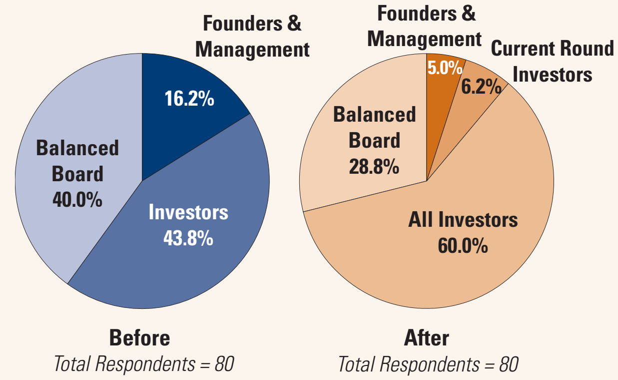
4.5
First Round: Who Controlled The Board?



generally took control. (See Exhibits 4.6-7.) But investors in the current round usually did not push aside earlier backers. This is another sign of better relations in the venture business. In 2002 and early 2003, as many companies raised down rounds and prior investors were washed out, current round investors often took control of boards, our first deal terms report found. ☒

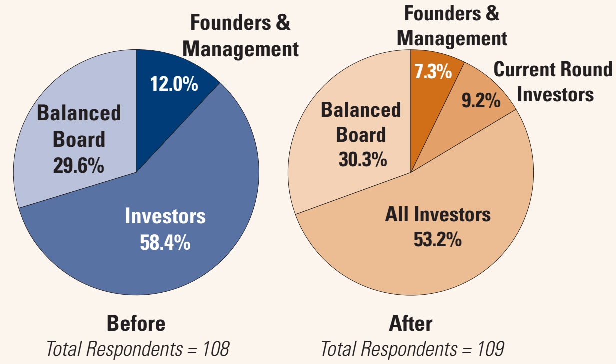
4.6

SECOND ROUND: WHO CONTROLLED THE BOARD?



4.7

THIRD & LATER ROUNDS: WHO CONTROLLED THE BOARD?



V. Liquidation Preference

The multiple liquidation preference, which allows investors to get back more than the amount they invested in certain exit events, remains unpopular.

The vast majority of U.S. companies responding to our latest survey – 80% – said the liquidation preference associated with their latest financing provided investors with a return equal to the amount they invested, plus any accrued dividends.

This was slightly below last year's study, in which 82.4% of companies reported a 1x preference. (See Exhibit 5.1.) Compare this with our first survey during the economic doldrums of 2002 and early 2003, when half the respondents reported liquidation preferences were higher than the amount invested, and 60% of those said the rate was 2x or more.

Unlike last year, when no company reported signing a term sheet that gave investors more than three times their money back after liquidation, two respondents to our latest survey said they did so.

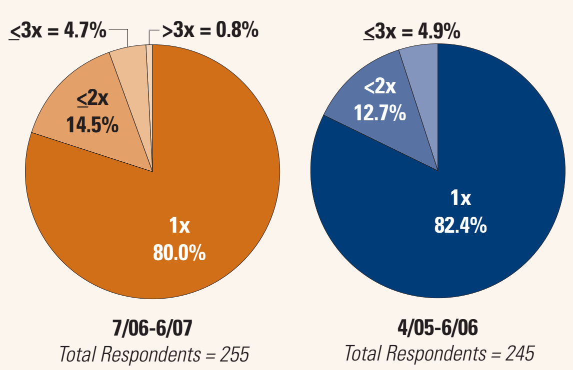
The liquidation preference is a standard feature of preferred stock. It gives holders the right to get their money out of a company before other common stockholders if the company is sold under circumstances that do not trigger conversion of the preferred stock to common. But multiples of 2x, 3x or higher, plus provisions giving priority to the most recent investors, can create nightmarish capital structures for companies and can make it difficult to engineer an acquisition of the company that makes everyone happy.

A multiple liquidation preference, however, can give the investors in a company's last round a positive outcome in an acquisition while most other shareholders walk away empty-handed. For this reason, later-stage rounds had a higher percentage of multiple liquidation preferences. (See Exhibit 5.2.) But even in third and later rounds, more than two-thirds of companies were able to negotiate a 1x preference.

Companies that had flat or down rounds reported higher incidences of the multiple liquidation preference. ⊠

5.1

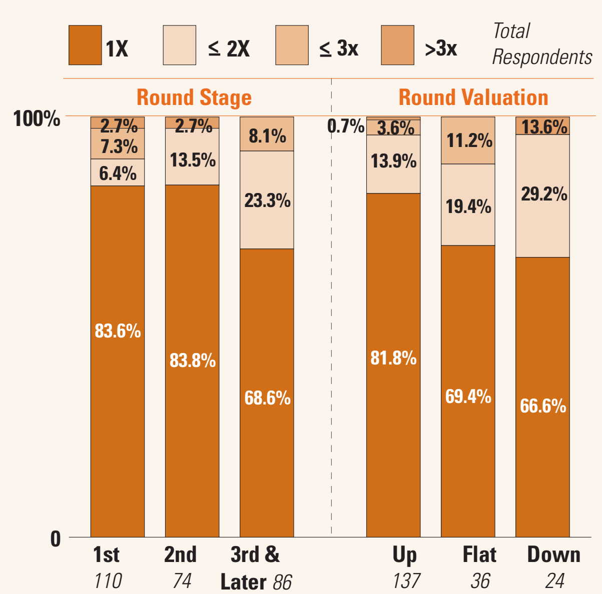
LIQUIDATION PREFERENCE ASSOCIATED WITH PREFERRED STOCK



5.2

LIQUIDATION PREFERENCE ASSOCIATED WITH PREFERRED STOCK

By Round Stage, Valuation



VI. Dilution Protection

Full-ratchet dilution protection got a bad name early in the decade, just like the multiple liquidation preference. The full-ratchet provision continues to be largely absent from term sheets in comparison with the more company-friendly weighted-average method.

Venture deals generally include language designed to compensate investors if the company closes a subsequent round at a reduced valuation. In our latest survey, dilution-protection provisions were found in 76.6% of U.S. deals, a rate similar to our prior studies. When a company sells preferred shares at a lower price than in a prior financing, these anti-dilution provisions set the rate at which earlier preferred shares are converted to common stock. The weighted-average method takes into account the relative number of shares sold as well as the price. Full ratchet, as the name implies, simply drops the conversion price to the price of the securities sold in the new round. Common stock holders suffer more dilution under this formula.

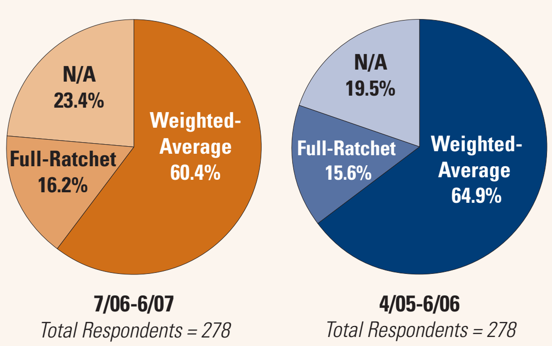
Only 16.2% of the U.S. companies responding to our survey said investors insisted on full-ratchet protection. (See Exhibit 6.1.) Few companies closing up rounds agreed to the full-ratchet formula. (See Exhibit 6.2.) But companies raising later rounds whose performance is subpar can expect investor pressure to accept this term.

The weighted-average provision has two flavors, broad-based and narrow-based. The narrow-based formula, which is less friendly to companies, is rarely used.

Although no venture-backed company expects to raise a down round, dilution-protection provisions can have a serious effect on the holdings of founders and employees if they come into play. They can make a stock-incentive plan worthless by devaluing the common stock. As a result, investors often settle for something less than their full anti-dilution rights in order to help a company get back on its feet. ☒

6.1

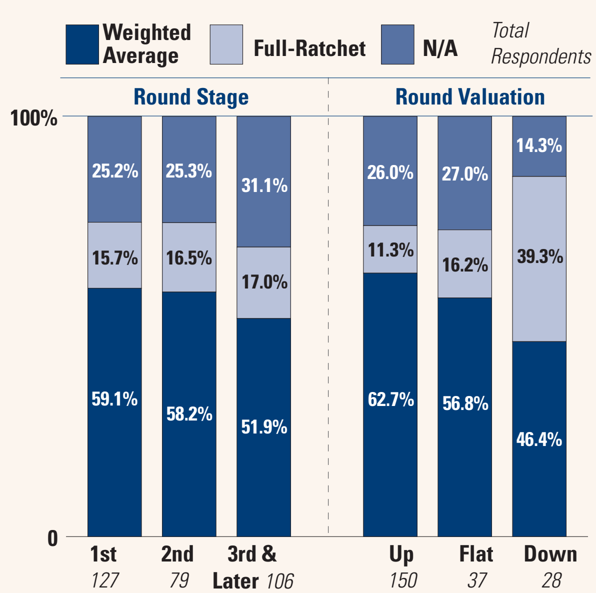
Dilution-Protection Provisions In Down Round



6.2

Dilution-Protection Provisions In Down Round

By Round Stage, Valuation



VII. Pay-To-Play

As memories of the technology investing meltdown faded, venture firms were less intent on including pay-to-play provisions, which punish investors who decide not to finance subsequent rounds if a company's valuation falls.

Only 21.1% of the U.S. companies responding to our survey said their term sheets included pay-to-play provisions that would convert the preferred shares of nonreturning investors to common stock or strip those shares of certain rights. (See Exhibit 7.1.) Our survey covering April 2003 through March 2004 pegged that figure at 37%, and it has declined steadily since.

The pay-to-play provision was a feature of post-bubble investing as venture firms looked to build stronger investment syndicates than the ones that fell apart when struggling companies faced down rounds. Absent pay-to-play provisions, investors who chose not to return often stood to maintain their investment stakes through anti-dilution provisions, or could keep their board seats without coughing up fresh capital.

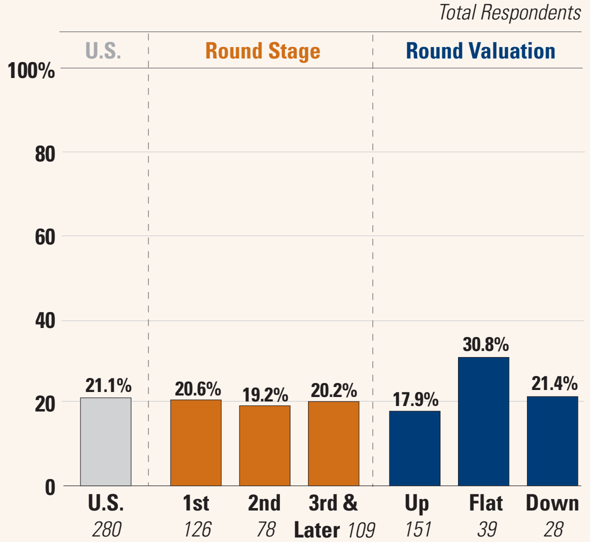
Converting the preferred securities of non-returning investors in a down round to common stock is the most straightforward way to execute a pay-to-play provision. The other option is to convert their stock to what lawyers call "shadow preferred." When this happens, the investors lose certain rights, commonly their board seats or their dilution protection.

But having too many types of preferred stock with different rights gets messy. Of the companies with a pay-to-play provision, 60.7% opted for the conversion-to-common-stock sanction.

At least some prior investors holding preferred securities failed to participate in slightly more than one-third of financings in our survey, similar to last year's results. (See Exhibit 7.2.) ☒

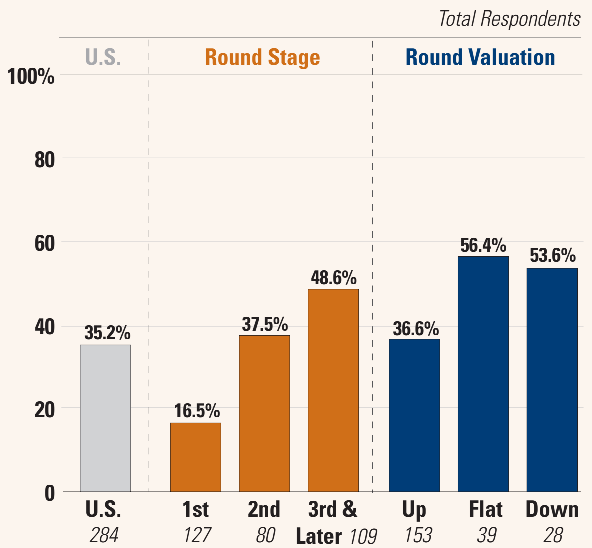
7.1

Existence Of Pay-to-Play Provision Affecting Investors Who Do Not Participate In Future Down Round



7.2

Financings Where Investors Holding Preferred Securities From Prior Rounds Did Not Participate



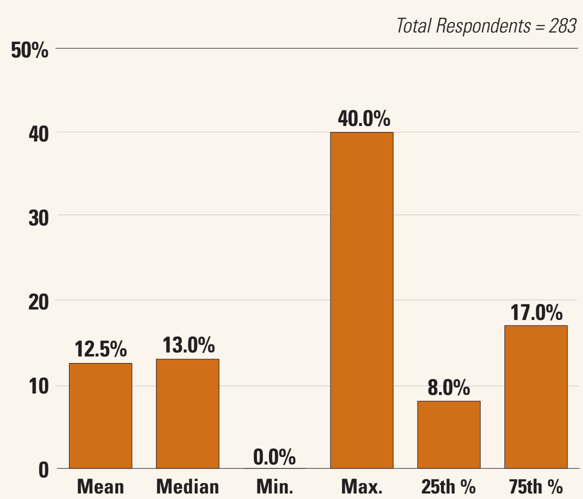
VIII. Founders And Employees

The median percentage of company ownership allocated to stock incentive pools fell below 15% for the first time in our most recent survey, which can be interpreted as a sign that entrepreneurs are suffering less dilution in venture rounds and that start-ups are becoming more conservative in awarding stock options.

Grants of common stock or options to buy the stock are central to attracting and retaining managers and technical experts to cash-starved start-ups. Our prior three surveys had pegged at 15% the median amount of fully diluted ownership allocated for these incentives at U.S.-based, venture-backed companies. But this year the median was 13%, a small but intriguing drop. (See Exhibit 8.1.) The 25th and 75th percentiles were slightly lower as well.

The median fell uniformly across first, second, third and later rounds. In last year's survey, the medians were 15%. In this survey they were 12% for all the round classes. (See Exhibit 8.2.)

8.1
% Fully Diluted Ownership Allocated To Stock Incentive Pool



8.2
% Fully Diluted Ownership Allocated To Stock Incentive Pool
By Round Stage

	1st	2nd	3rd & Later
Mean	12.5	11.8	12.5
Median	12	12	12
Minimum	0	0	0
Maximum	80	26	84
25th Percentile	7	8	5.3
75th Percentile	16.3	16	17
Total Respondents	*130*	*78*	*108*

As noted earlier, founders are maintaining somewhat larger ownership stakes, which could be having an effect on stock incentive pools. (See Chapter IV: Company Control.) Also, public companies face governance and accounting requirements that are changing how they treat stock options. These worries could be affecting private companies as well, curbing the use of options.

Stock incentive pools see dilution as companies raise more capital. Thus there is generally an effort to refresh them in conjunction with new financing. For companies whose valuations dropped, the additional equity for employees is carved out at the expense of founders and prior investors who did not participate in the new financing. Equity granted to founders is not included in the pools.

In later rounds, it's possible that incentive pools are being trimmed to cover only key managers or that they are being replaced or supplemented by cash carve-outs intended to protect managers from the adverse effects of layers of liquidation preferences held by investors.

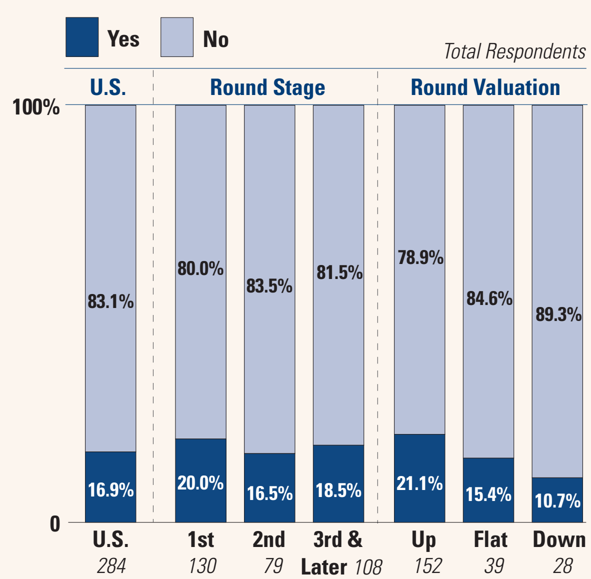
For the first time this year, we also asked about incentives that increase management and founder equity stakes if the companies meet specific milestones. These are not common, being found at only 16.9% of U.S. companies. (See Exhibit 8.3.) They were least common in down rounds.

Founders get equity in companies for the time and expertise they devote to start-ups as well as for any personal money they invest. The amount of equity is decided during negotiations with early investors over a given company's value. To discourage founders from bolting or selling their stock for a fast return, investors often insist that it vest over a period of years – four or more is the norm. At the time of a new round, investors might also insist on a new vesting timetable, or regime, for previously vested founders' stock.

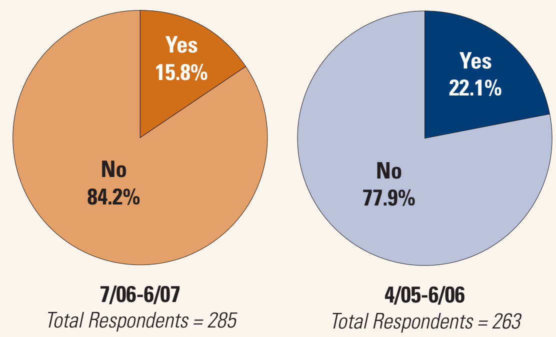
New vesting regimes were found in 15.8% of the financings in our survey, a drop from last year. (See Exhibit 8.4.) This is yet another sign of a highly favorable financing climate for entrepreneurs.

As with most deal provisions, vesting regimes varied by round. New regimes were by far most common in first rounds, when preventing founders from making a quick exit is critical. (See Exhibit 8.5.) There was less variation by round than we've seen in the past, but down rounds still had the highest

8.3
Provisions Exist To Increase Management Or Founder Equity Stakes If Milestones Are Met

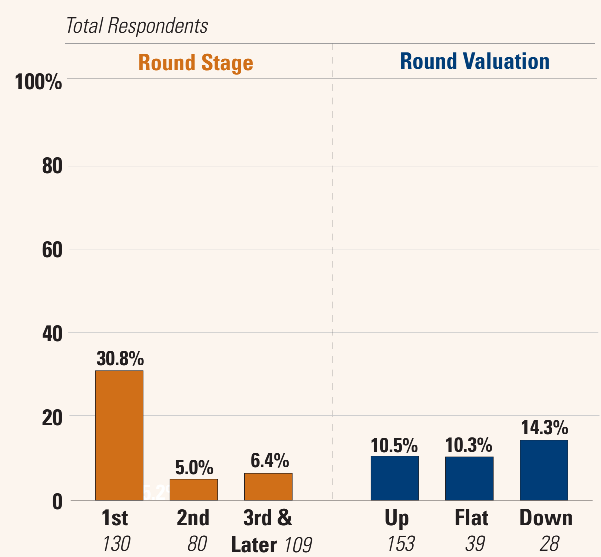


8.4
Previously Vested Founder Or Employee Equity Subject To New Vesting Regime



8.5
Previously Vested Founder Or Employee Equity Subject To New Vesting Regime

By Round Stage, Valuation

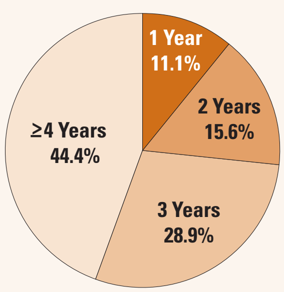


percentage. Because such financings often involve a restructuring of a company's equity, it's not surprising that they place new restrictions on founders' stock. Four or more years was the most common vesting period overall. (See Exhibit 8.6.) Shorter vesting periods are becoming more common, though, judging by responses to this question over the last five years.

We asked for the first time this year if founders or prior investors sold shares in the latest financing. It's taking longer to get companies to liquidity these days, and this can put pressure on the personal finances of founders as well as on investors, whose limited partners want to see returns. The median time from an initial equity financing to an acquisition in the first nine months of 2007 was 6.6 years; to an IPO, 6.8 years, according to Dow Jones VentureOne.

8.6

Vesting Period Length

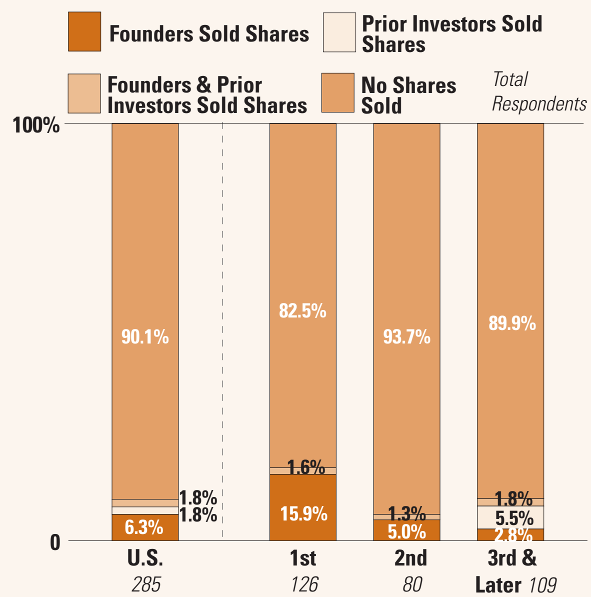


Total Respondents = 45

In most financings, investors did not buy any shares from founders or prior investors. (See Exhibit 8.7.) Founders, who are now more likely to bootstrap their companies for a while before taking venture capital, sold shares in nearly 16% of first rounds. Only a few prior investors sold shares in later rounds, but this could become more common as venture funds raised during the bubble near the end of their 10-year investment cycles. ☒

8.7

Founders Or Prior Investors Sold Shares To Investors In This Round



IX. Exiting The Investment

Investors in nearly half of U.S.-based companies surveyed, even those closing later rounds, continued to aim for a five times or better return in an initial public offering.

Although more venture-backed companies end up getting acquired than going public, term sheets generally contain triggers for automatic conversion of preferred shares to common stock to facilitate the public sale of company stock.

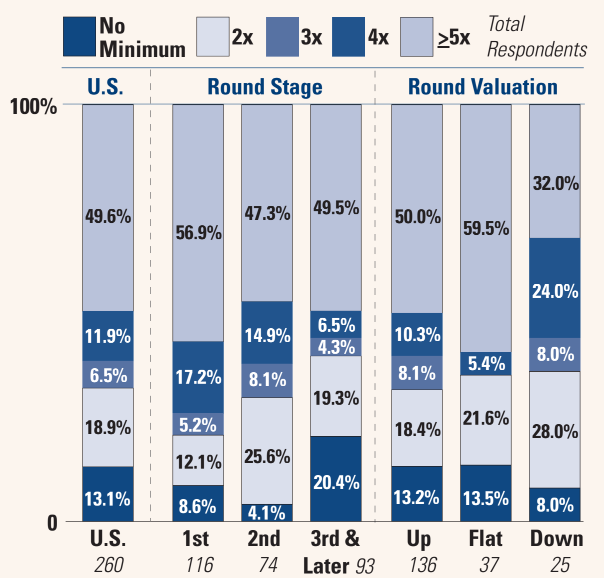
One of these is a share-price multiple, which sets a base valuation that a company must achieve in going public. Our survey found that venture investors in first rounds are most likely to set the bar high, but that multiples of 5x or more are very common in subsequent rounds as well. (See Exhibit 9.1.) Investors in down rounds tended to aim lower, but that result is based on responses from relatively few companies.

The other common trigger, for which we no longer survey, is the minimum amount that a company must raise in an IPO. These multiples and minimums are all up for negotiation when a company is ready to go public in order to achieve a smooth conversion of the preferred shares to common stock.

Many term sheets also contain a provision giving investors the right to redeem their shares after a set amount of time. Investors in 42.4% of the U.S. companies responding to our survey had the right to redeem their shares. (See Exhibit 9.2.) This exit right usually becomes effective five years from the investment date, but it's typically reset with each new investment. Venture investors' main concern is that exit rights apply to all preferred shareholders or none at all. Because a redemption of preferred shares probably would force liquidation of the company, exit rights are hardly ever used. But they can give investors leverage in persuading company management to take action, such as working toward an acquisition. ☒

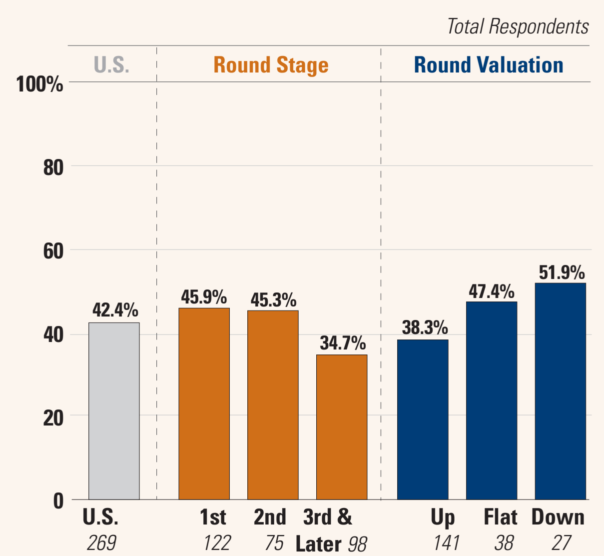
9.1

Share-Price Multiple That Would Trigger Mandatory Conversion Of Preferred Stock To Common In An IPO



9.2

Preferred Shareholders Have Right To Exit After A Set Time



X. Health Care Vs. IT

Health-care and information technology deals – the two main industries in which venture firms invest – continued to show different patterns in how frequently certain deal terms are applied.

During the 12 months covered by our latest survey – July 2006 through June 2007 – 1,471 IT companies collected $13.9 billion in venture capital, while 651 health-care companies raised $9.6 billion.

Health-care companies, especially those developing new drugs, generally require more capital and take longer to mature than IT companies because of federal licensing requirements. An IPO often is just another way to secure more financing for product development rather than an exit for venture investors. Because of these capital requirements, health-care valuations in later rounds tend to be higher than those of IT companies. (See Exhibits 10.1 and 10.2.)

During the first six months covered by our survey, there was a broad spread between the median pre-money valuations for first and second IT rounds, but it narrowed in the second six months. The gap opened in the fourth quarter of 2005, marking the start of a highly favorable climate for IT companies raising second rounds. Such companies are usually more mature than their health-care counterparts, having generally completed product development and begun to acquire customers.

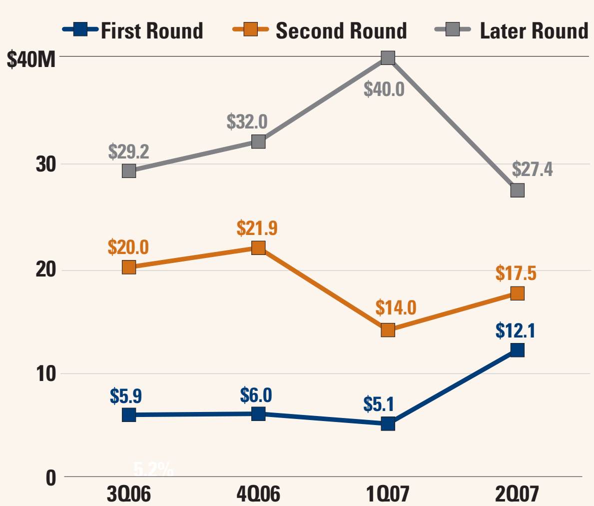
Our survey found little change in the percentage of IT companies closing third or later rounds at higher valuation than in their prior financing and a lower percentage of down rounds. (See Exhibit 10.3.) The picture was less positive for health-care companies, with a higher percentage of down rounds and lower rate of up rounds.

To generate large enough sample sizes, we combined first and second rounds for IT and health-care companies into an "early" category. In this category, health-care and IT companies fared about

10.1

IT Median Pre-Money Valuation

*By Round Class ($M) 3Q06-2Q07**

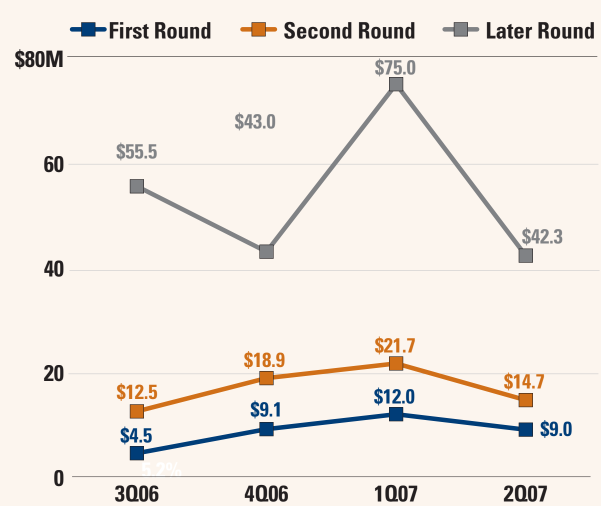


*U.S. venture-backed companies only. Source: Dow Jones VentureOne

10.2

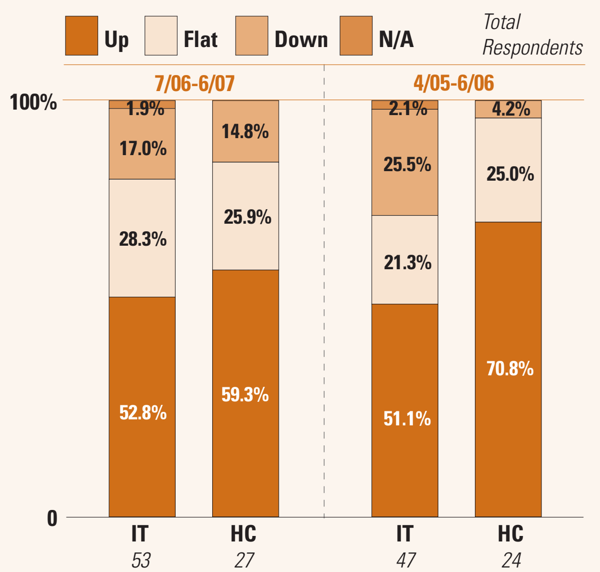
Health Care Median Pre-Money Valuation

*By Round Class ($M) 3Q06-2Q07**



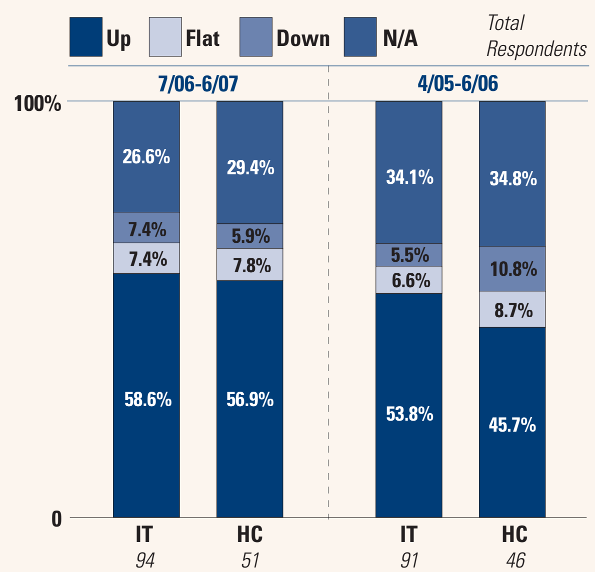
*U.S. venture-backed companies only. Source: Dow Jones VentureOne

10.3
Company Valuation: IT & HC Later Rounds*



*Third or later

10.4
Company Valuation: IT & HC Early Rounds*



*First or second

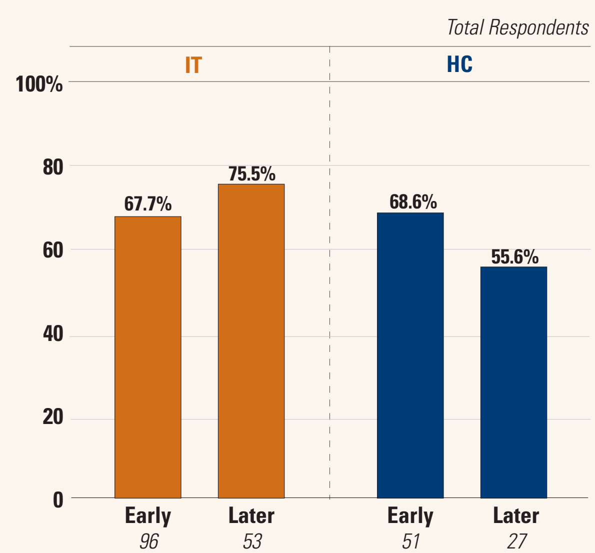
equally. (See Exhibit 10.4.) Health care even showed an improvement from our prior survey. A number of companies in this group closed first rounds where there was no prior valuation, placing them in the "not applicable" (N/A) category.

The remaining exhibits look at how deal terms discussed earlier in this report apply to health-care and information technology company financings. Some highlights:

• IT companies closing later rounds were more likely to issue participating preferred stock to investors, giving them the opportunity to share in the proceeds from the sales even after collecting their liquidation preference. (See Exhibit 10.5.) This finding is similar to our prior study, but back then, IT companies were closing a much lower percentage of up rounds than health-care companies, which is not the case now. It could be that use of the participation feature is more related to differences in how IT and health-care companies develop, but given the small sample of later-stage health-care companies, the results could be misleading.

• Health-care companies were more likely than IT companies to have their capital paid to them in stages. (Exhibit 10.7.) A key reason for this is the ability of health-care investors to peg payments to the progress

10.5
Convertible Participating Preferred Securities Issued To Investors



of clinical trials for drugs and devices. The percentage of staged payments for early-stage IT companies – 10.8% – was less than half the rate in our prior study.

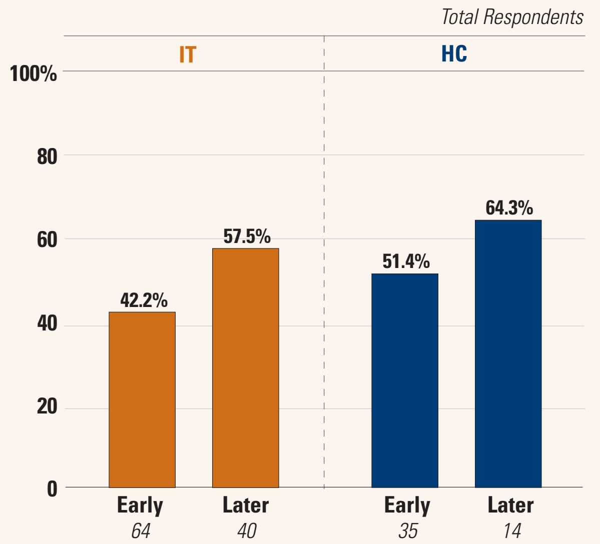
• Investors in later-stage health-care companies were once again more likely than IT investors to obtain full-ratchet, anti-dilution protection, including it in 24% of their deals. (See Exhibit 10.9.) Our prior study showed a similar pattern, with the provision present in 33% of later-stage health-care financings. This provision is less company-friendly than the weighted-average formula.

• Later-stage health-care companies were most likely to have two or more independent directors, perhaps because of the regulatory hurdles they face in getting products to market. (See Exhibit 10.12.) The percentage of later-stage IT companies with no independent directors was 15.1%, less than half that seen last year.

• The median percentage of company ownership allocated to employee stock incentive pools was lower for health-care companies. (See Exhibit 10.17.) The median allocation for later-stage IT companies fell to 15% this year from 17% in last year's study. For early-stage health-care companies the median allocation fell to 11% from 13%. As we noted earlier, the median allocation for U.S.-based companies overall declined to 12% from 15%. (See Chapter VIII: Founders And Employees.) ☒

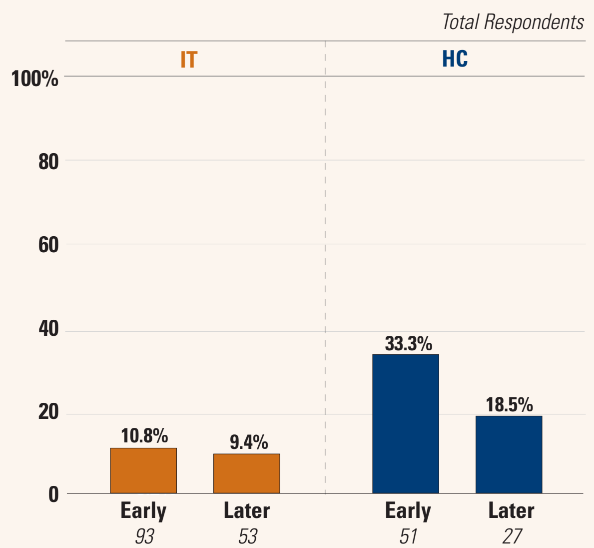
10.6

Participation In Convertible Participating Preferred Capped



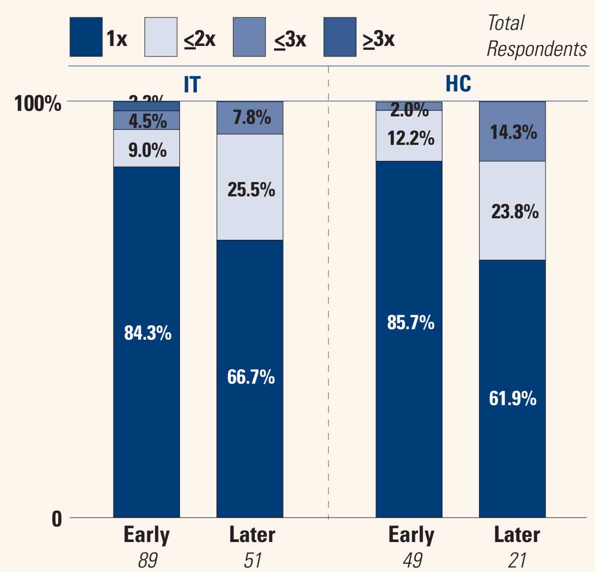
10.7

Capital Raised Paid To The Company In Stages

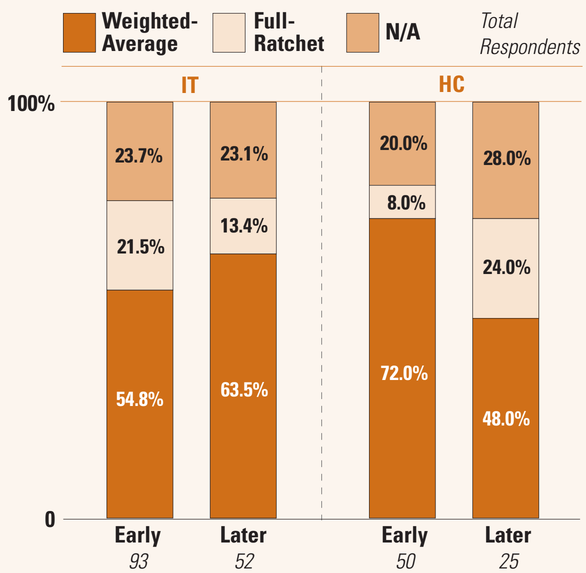


10.8

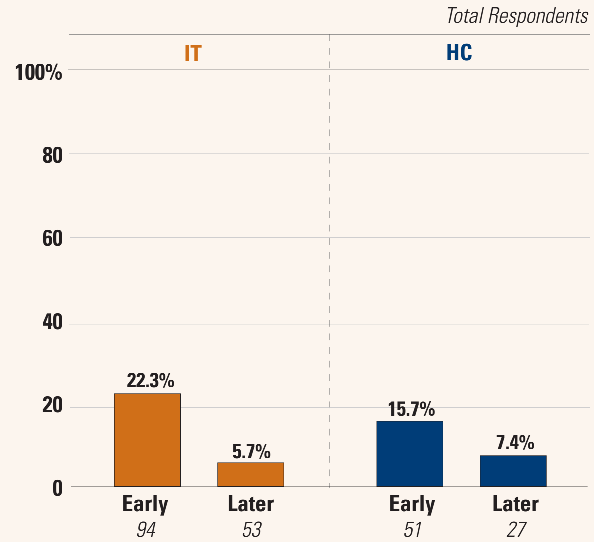
Liquidation Preference Associated With Preferred Stock



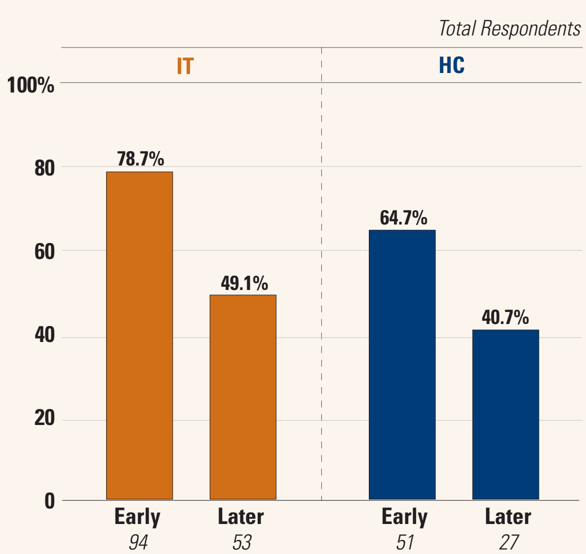
10.9
Dilution-Protection Provisions Based On Weighted-Average Or Full-Ratchet



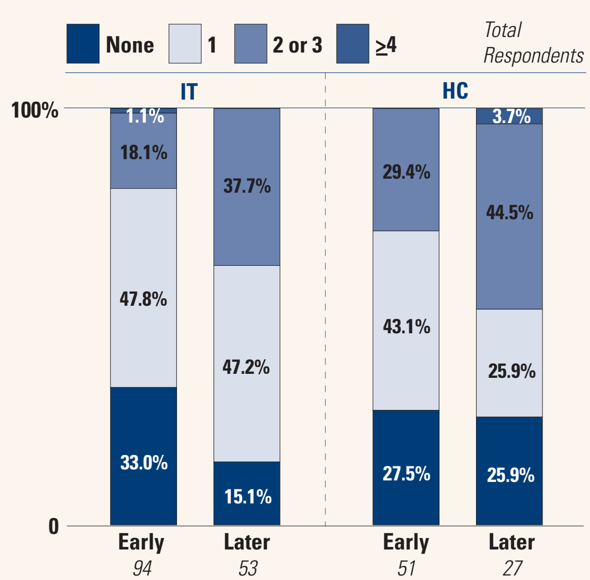
10.11
Previously Invested Founder Or Employee Equity Subject To A New Vesting Regime



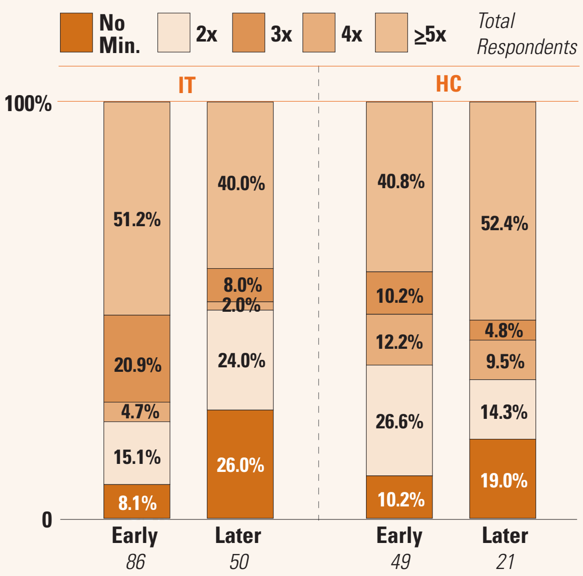
10.10
% Investors Who Received Affirmative Voting Control Or Veto Rights Over Significant Corporate Transactions



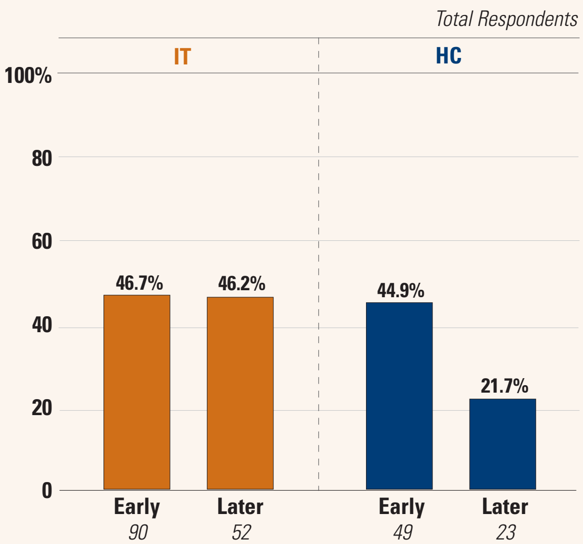
10.12
Number Of Independent Directors On The Board



10.13
In An IPO, Minimum Share-Price Multiple That Triggers Conversion Of Preferred Stock To Common



10.14
% Preferred Shareholders Who Have Right To Exit Investment After A Set Time



10.15
% Company Sold On A Fully Diluted Basis

	IT		HC	
	Early	Later	Early	Later
Mean	34.1	21.6	43	26.7
Median	33	20	45	25
Minimum	10	3	5	0.4
Maximum	80	51	86	65
25th Percentile	21	11.5	24.8	15
75th Percentile	42	28.5	59.3	37
Total Respondents	*91*	*53*	*50*	*27*

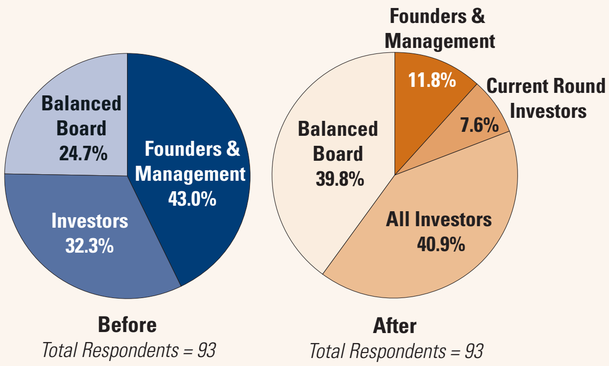
10.16
% Founders Own After Round

	IT		HC	
	Early	Later	Early	Later
Mean	29.4	10.3	22.8	16.6
Median	26	9	20.5	8
Minimum	2	0	0	0
Maximum	80	42	60	84.5
25th Percentile	12	4	11	5.4
75th Percentile	44.3	14	30.3	24
Total Respondents	*90*	*53*	*50*	*27*

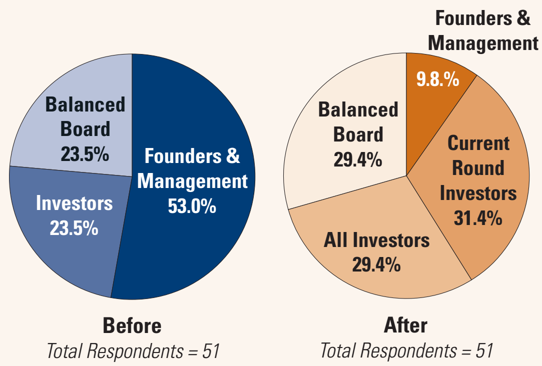
10.17
% Fully Diluted Ownership Allocated To A Stock Incentive Pool After Round

	IT		HC	
	Early	Later	Early	Later
Mean	13.5	12.8	11.4	12.8
Median	15	15	11	12.5
Minimum	0.1	0.2	0	0.1
Maximum	33	28	40	22
25th Percentile	10	5.5	7	10
75th Percentile	19	19	15	15
Total Respondents	*93*	*53*	*51*	*27*

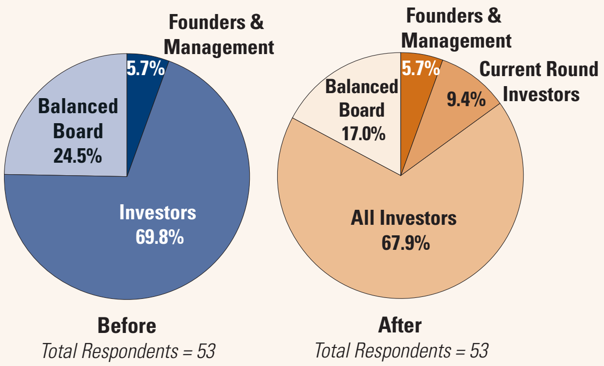
10.18
IT Early Stage: Who Controlled The Board Before & After Round



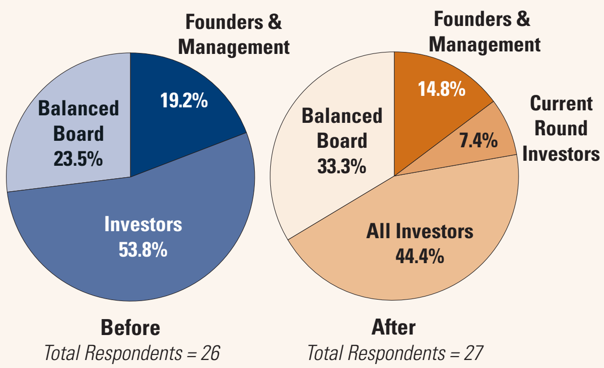
10.20
HC Early Stage: Who Controlled The Board Before & After Round



10.19
IT Late Stage: Who Controlled The Board Before & After Round



10.21
HC Late Stage: Who Controlled The Board Before & After Round



XI. Bay Area Vs. The East

As our prior studies have found, deal terms in the San Francisco Bay Area tend to be more company-friendly than on the East Coast.

The venture industry is clustered around San Francisco, chiefly in Silicon Valley, and in the Boston area. During the survey period – July 2006 through June 2007 – the Bay Area accounted for 32% of total U.S. venture deals; New England for 12%.

We grouped New York with New England to generate enough deals for comparing with the Bay Area. New York and New England had more first rounds, but even though deal terms can vary significantly by round, the mix doesn't seem to have had much effect on these results.

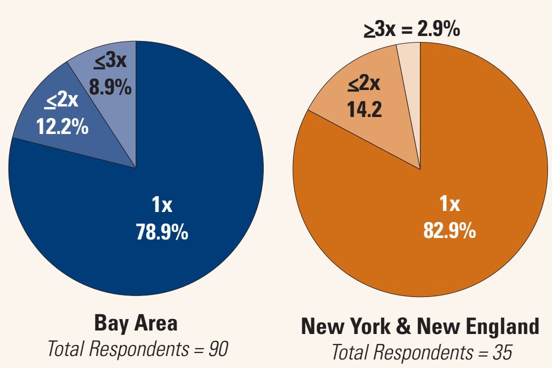
Last year's survey found that companies based in the Bay Area were slightly less likely to grant investors a multiple liquidation preference. This year they were more likely to do so than companies based in New York-New England, but again the difference was not major. (See Exhibit 11.1.)

But New York and New England remained the leader in including the full-ratchet anti-dilution provision, which gained a nasty reputation when, after the Internet bubble, venture firms sought to fully protect their prior investment if a company's valuation declined in a subsequent round. (See Exhibit 11.2.)

The Bay Area was somewhat more aggressive in the use of participating preferred securities, which give investors another crack at the assets of companies even after collecting their liquidation preference. (See Exhibit 11.3.) But those companies were much more likely to have the participation capped. (See Exhibit 11.4.)

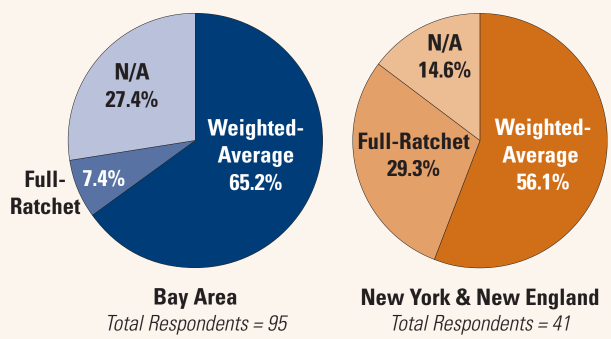
11.1

Liquidation Preference Associated With Preferred Stock



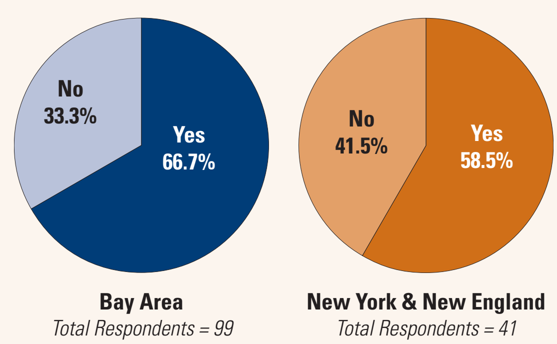
11.2

Dilution-Protection Provisions Based On Weighted-Average Or Full-Ratchet



11.3

Convertible Participating Preferred Securities Issued To Investors

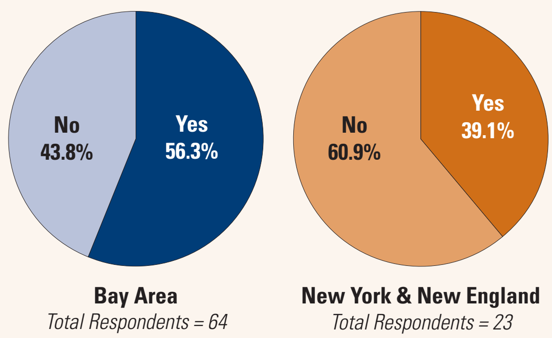


New York and New England tended to be tougher on companies when it came to veto rights that give investors in the current round outsized power over key company decisions, such as a sale of the business. (See Exhibit 11.5.)

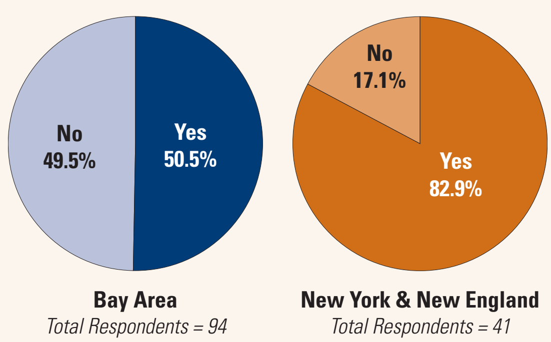
New York and New England companies were also more likely to have a dividend accrual in their term sheets, which can give investors an added boost if a company runs into trouble and has to be sold at a price that is not favorable to all investors. (See Exhibit 11.6.) These dividends, typically 8% annually, are usually paid only in the event of liquidation.

One deal term that companies were far less likely to see in the Bay Area was the exit right, under which investors can force a company to redeem their shares, usually after five years, for the price paid plus any accrued dividends. (See Exhibit 11.7.) Exit rights are rarely used but give investors leverage. ☒

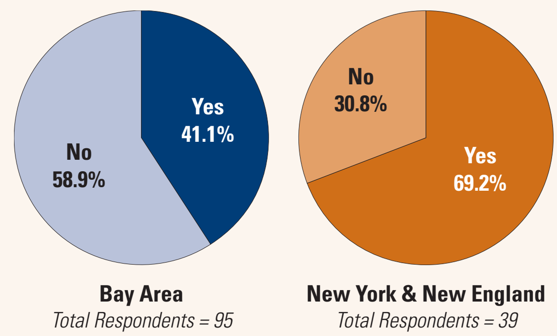
11.4
Participation In Convertible Participating Preferred Capped



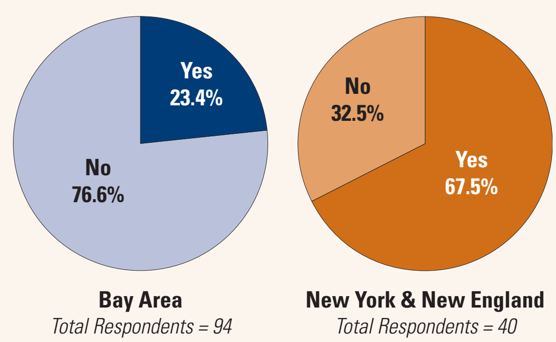
11.5
% Investors Who Received Affirmative Voting Control Or Veto Rights Over Significant Corporate Transactions



11.6
Preferred Stock Carries An Annual Cumulative Dividend



11.7
% Preferred Shareholders Who Have Right To Exit Investment After A Set Time



XII. Europe

Although securities laws and practices vary from nation to nation, and European companies are more likely to issue common stock in a venture financing than U.S. ones, many provisions associated with U.S. term sheets are also found in European ones.

We compared U.S. and European data to see how closely practices on the Continent reflect those in the U.S. We also compared first and second European rounds with third and later ones to see how deal terms varied with the stage of the company. We received responses from more than a dozen countries. (See Exhibit 12.1.) The largest portion by far – 26% – came from the U.K.

The percentage of seed and first rounds was much higher in the European sample, while the U.S. had a higher percentage of second and later rounds. (See Exhibit 12.2.) This could skew comparisons because deal terms can vary by round. But the investment climate in Europe, which took longer to recover than in the U.S., was very similar in terms of percentages of companies closing up, down and flat rounds. (See Exhibit 12.3.)

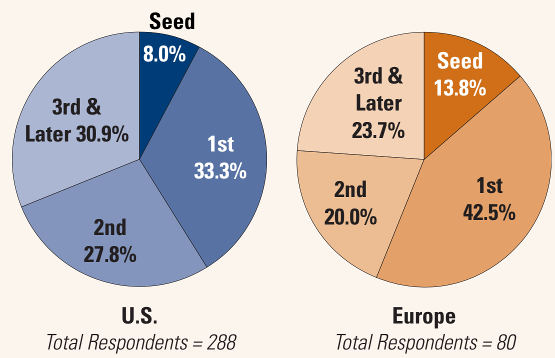
One big difference continued to be a greater reliance on common stock in Europe. (See Exhibit 12.4.) The sample is not large enough to permit a country-by-country analysis of this.

While preferred stock was used in a significant percentage of financings, rates have fluctuated significantly from survey to survey. The latest results show that preferred securities were more often used in early rounds in Europe. (See Exhibit 12.5.)

A majority of European investors in early and later rounds did not get a liquidation preference in excess of the amount invested. (See Exhibit 12.6.) But multiples of two times or more were more common than in the U.S. (See Chapter V: Liquidation Preference.)

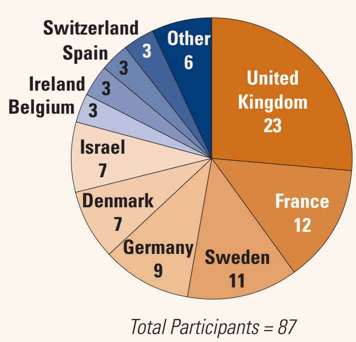
12.2

U.S. & Europe: Current Financing Round



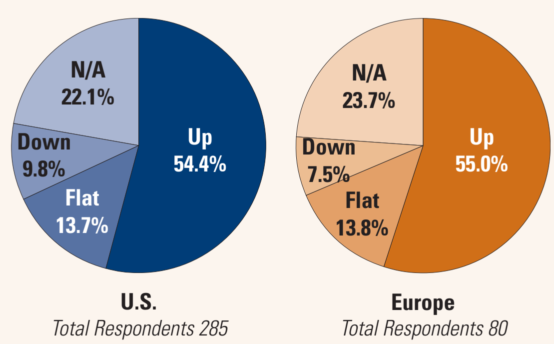
12.1

European Participants By Country



12.3

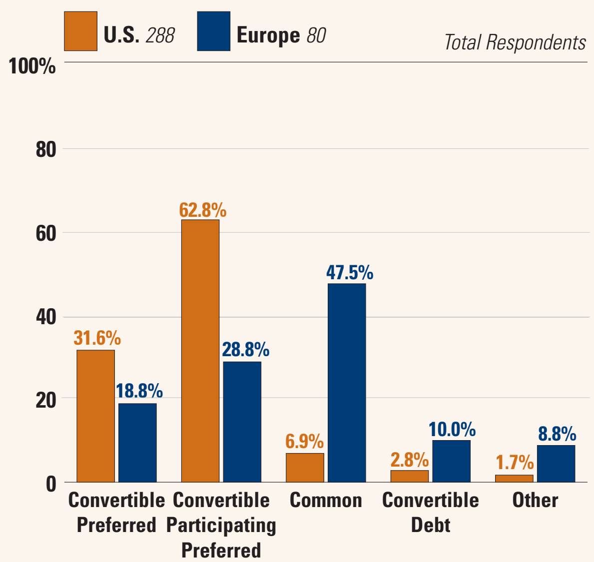
U.S. & Europe: Company Valuation



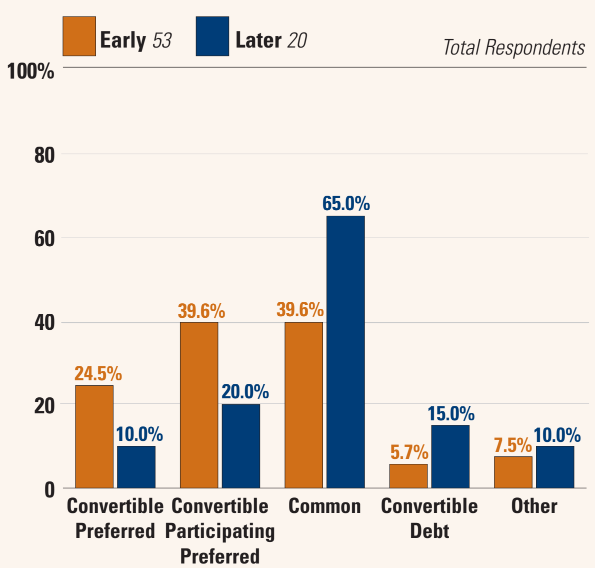
Anti-dilution provisions were less common in Europe, probably because there was less preferred stock. (See Exhibit 12.7.) But nearly one out of every three European deals with anti-dilution provisions involved the more onerous full-ratchet variety. In a down round, full-ratchet restores prior investors' shares to their full value at the expense of founders, management and other investors who lack this protection.

One U.S. deal term that has yet to really catch on

12.4
U.S. & Europe: Securities Types Issued To Investors

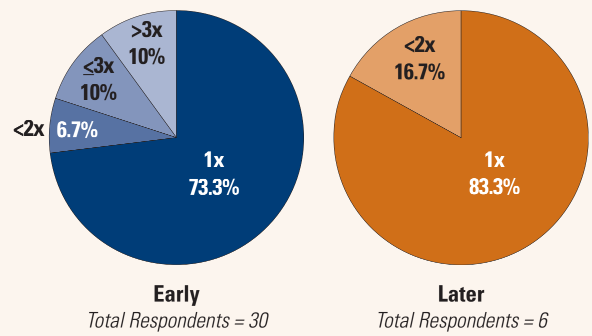


12.5
Europe: Securities Types Issued To Investors

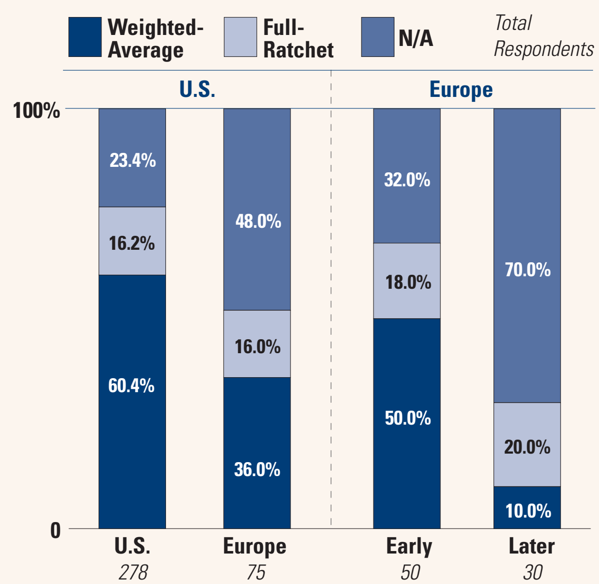


12.6
Europe: Liquidation Preference Associated With Preferred Securities

By Round Stage



12.7
U.S. & Europe: Dilution-Protection Provisions Based On Weighted-Average Or Full-Ratchet

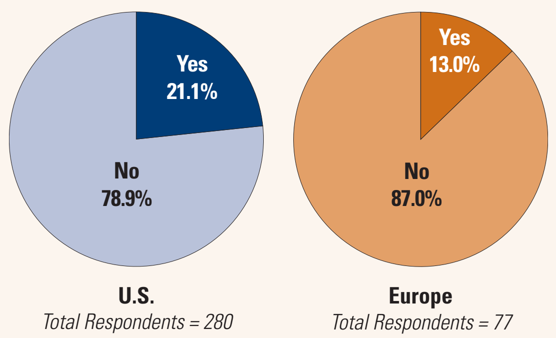


in Europe is the pay-to-play provision, which reduces the value of the stock held by investors who decline to participate in a subsequent down round. It does so by converting their securities to common stock or to preferred stock with lesser rights. Pay-to-play was found in 13% of European financings. (See Exhibit 12.8.) This was a slightly higher rate than last year.

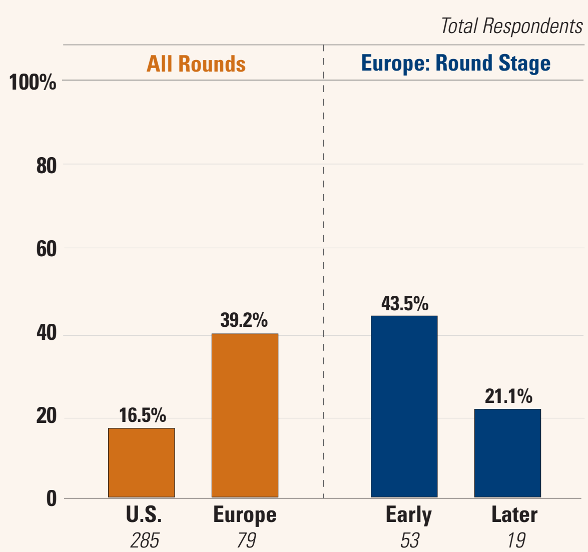
European investors were fond of paying capital to portfolio companies in stages. The practice was more than twice as common as in the U.S. (See Exhibit 12.9.) Nearly 44% of early rounds involved staged payments. For these companies, payments were most often triggered by completion of product development, although passage of a set amount of time and "other" were almost as common.

The remaining exhibits show the results for other significant deal terms as well as benchmark data for the amount of companies sold to investors, the amount held by founders and the ownership share allocated to stock incentive pools. Use of stock incentives in Europe is less common in the U.S., with the median for a pool at 8% versus 13%. ☒

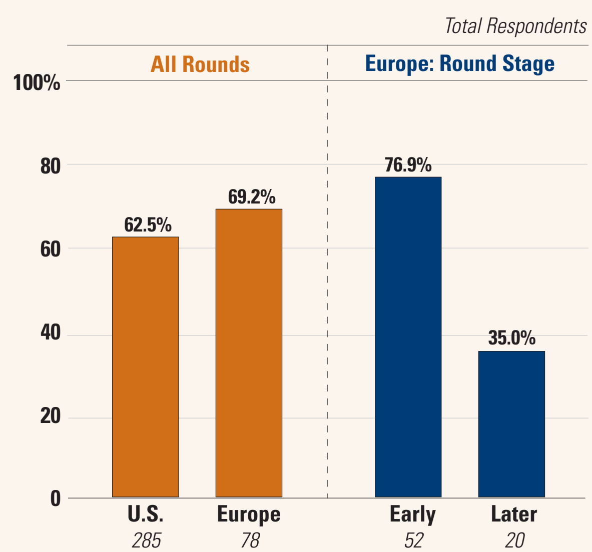
12.8
U.S. & Europe: Pay-To-Play Provision Effecting Investors Who Do Not Participate In Subsequent Down Rounds



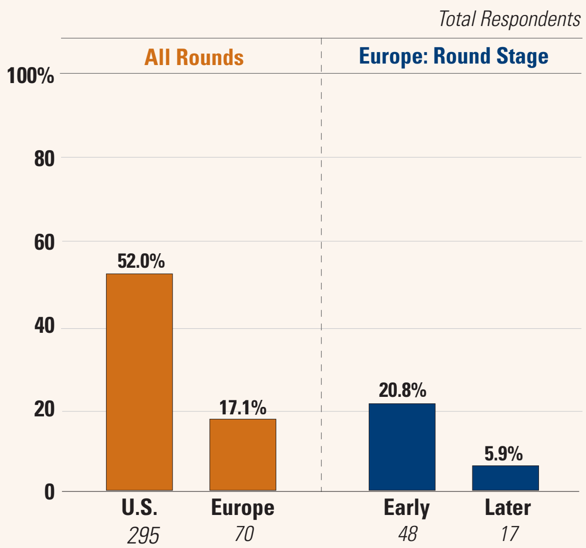
12.9
U.S. & Europe: Capital Raised Paid To Company In Stages



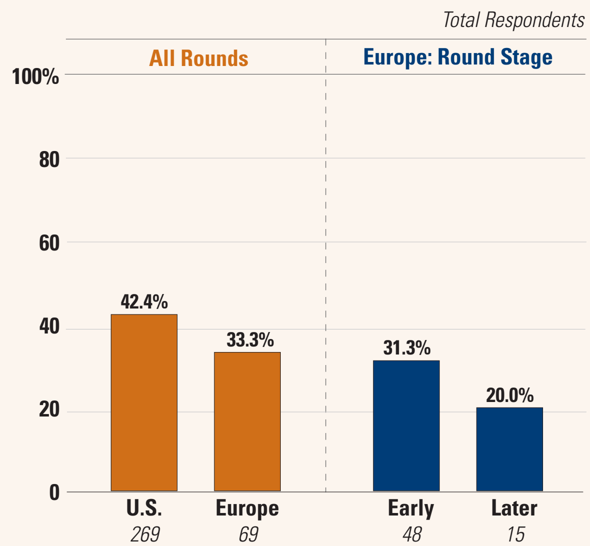
12.10
U.S. & Europe: % Investors Who Received Affirmative Voting Control Or Veto Rights Over Significant Corporate Transactions



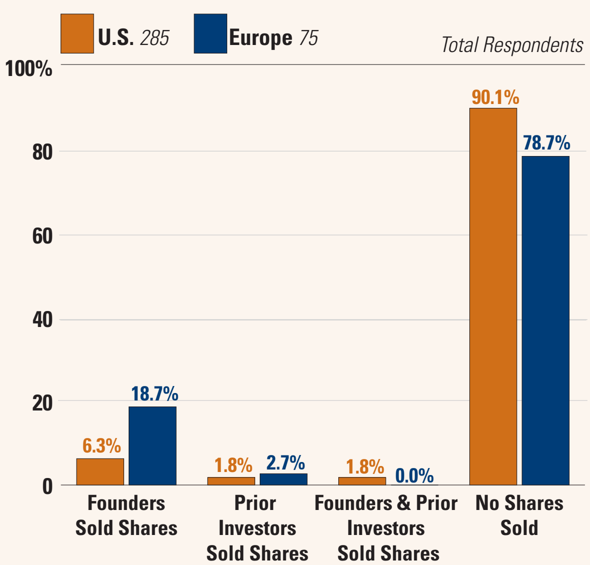
12.11
U.S. & Europe: Preferred Stock Carries An Annual Cumulative Dividend



12.12
U.S. & Europe: % Preferred Shareholders Who Have Right To Exit From Their Investment After A Set Time



12.13
U.S & Europe: Founders Or Prior Investors Sold Shares To Investors In This Round



12.14
Europe: % Of Company Sold On A Fully Diluted Basis

	Early	Later
Mean	34.1	24
Median	30	28
Minimum	67	42
Maximum	3	4
25th Percentile	70	46
75th Percentile	22.25	11
Total Respondents	*52*	*19*
Europe: % Founders Own After Round		
Mean	40.0	26.7
Median	35	21.5
Minimum	2	4
Maximum	84	54
25th Percentile	25	15.5
75th Percentile	60	42.5
Total Respondents	*51*	*20*
Europe: % Fully Diluted Ownership Allocated To A Stock Incentive Pool After Round		
Mean	9.9	11.1
Median	10	6
Minimum	0	0
Maximum	80	84
25th Percentile	4	3
75th Percentile	13	10
Total Respondents	*51*	*19*

DOWJONES
CompensationPro

Good people
are the foundation of a great company—and its single largest expense.

The best companies don't spend more,

they spend wisely.

Compensation is a double-edged sword:

PAY TOO MUCH > and you'll lose both money and credibility.

PAY TOO LITTLE > and you'll lose your best employees and your ability to hire top talent.

It's a fine line. Fortunately, you've got **CompensationPro** to help you walk it, no matter what industry you're in. CompensationPro is your key to competitive **salary, bonus,** and **equity allocations**.

CompensationPro features streamlined navigation tools, enhanced search capabilities and more specific job title categories so you spend less time worrying about personnel and more time building a profitable business.

Why CompensationPro?

» Because you'll *recoup your investment in just one hire!*

» Because CompensationPro helps you allocate your stock options.

» Because CompensationPro offers data for 140 job titles at over 730 private companies, all across the U.S.

» Because it's from the world's most trusted source of information on private companies.

» Because you can't afford not to know what your competitors are paying.

DOWJONES

Appendix

Sample Characteristics & Methodology

This report is based on an electronic survey of companies that raised venture capital from July 2006 through June 2007. The survey was sent via email to Dow Jones VentureOne's contact at the company, usually the chief executive or chief financial officer.

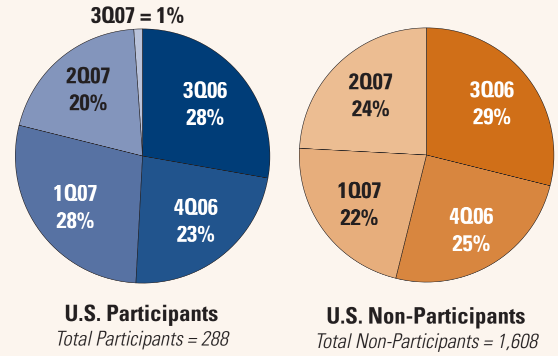
To develop the survey questions, we examined actual term sheets and consulted industry experts. Because venture deals are complex transactions, we could not survey for every nuance. Our goal was to concentrate on those provisions and issues that are most important to investors and entrepreneurs.

We sent surveys to 1,896 U.S. companies and received valid responses from 288 – a response rate of 15.2%. We also surveyed 832 European and Israeli companies and received valid responses from 87 of them, for a response rate of 10.5%.

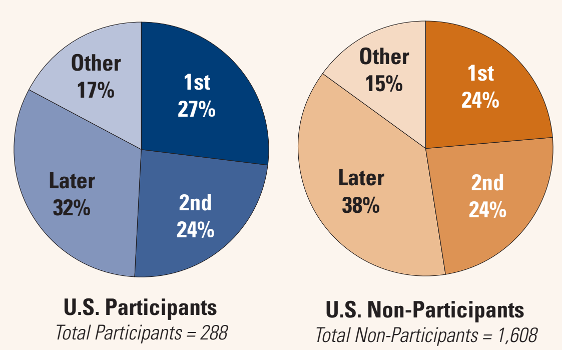
The type of round is a key determinant of deal terms. Our U.S. sample is a bit overweighted in first rounds and underweighted in later rounds based on VentureOne's data. (See Exhibit 13.1.) Because of this, it is important to look at the data analysis by round type and not just at the aggregate results. As part of the survey, we asked each company what type of round it raised – seed, Series A (first round), Series B (second round) and Series C or later (third or later). The round analyses in the report are based on those responses. There were too few respondents closing seed rounds for us to analyze those separately.

Exhibits 13.2 to 13.6 show how our sample compares with nonresponding companies by when the

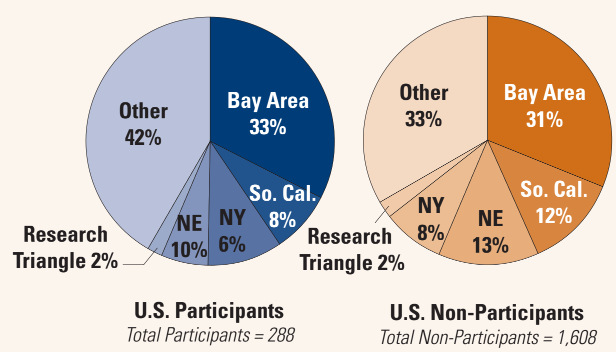
13.2
U.S. Participants By Quarter



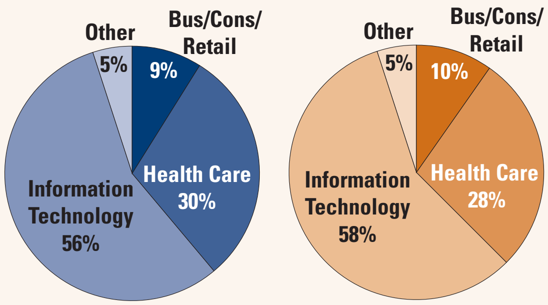
13.1
U.S. Participants By Round Stage



13.3
U.S. Participants By Location



13.4
U.S. Participants Industry Group



U.S. Participants
Total Participants = 288

U.S. Non-Participants
Total Non-Participants = 1,608

13.5
U.S. Participants By Industry Group And Industry Segment

Industry Group/Segment	Total	Percent
Business/Consumer/Retail		
Cons/Bus Products	6	2%
Cons/Bus Services	17	6%
Media/Content/Info	2	1%
Retailers	2	1%
Health Care		
Biopharmaceuticals	33	11%
Health-care Services	3	1%
Medical Devices/Equipment	40	14%
Medical Software & IS	9	3%
Information Technology		
Communications & Networks	22	8%
Electronics & Computers	15	5%
Information Services	32	11%
Semiconductors	21	7%
Software	71	25%
Other		
Adv Spec Mat & Chem	**6**	**2%**
Energy	8	3%
Other Companies	1	0%
Grand Total	**288**	**100%**

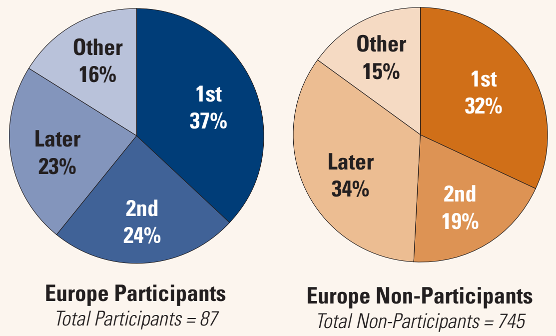
round closed, company location and industry. Although the survey was intended to end with the second quarter of 2007, surveys were sent to a few companies that closed financings early in the third quarter. Three U.S. companies responded.

The European results are slightly overweighted for first and second rounds and underweighted for later. (See Exhibit 13.7.) The remaining exhibits show how participants and nonparticipants compare according to when the financing closed, country and industry. ☒

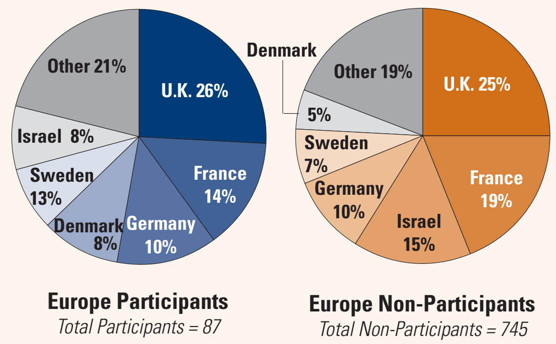
13.6
U.S. Non-Participants By Industry Group And Industry Segment

Industry Group/Segment	Total	Percent
Business/Consumer/Retail		
Cons/Bus Products	24	1%
Cons/Bus Services	98	6%
Media/Content/Info	15	1%
Other Bus/Con & Retail	1	0%
Retailers	15	1%
Health Care		
Biopharmaceuticals	209	13%
Health-care Services	29	2%
Medical Devices/Equipment	170	11%
Medical Software & IS	39	2%
Information Technology		
Communications & Networks	109	7%
Electronics & Computers	79	5%
Information Services	245	15%
Semiconductors	81	5%
Software	420	26%
Other		
Adv Spec Mat & Chem	21	1%
Agriculture	4	0%
Energy	37	2%
Other Companies	12	1%
Grand Total	**1608**	**100%**

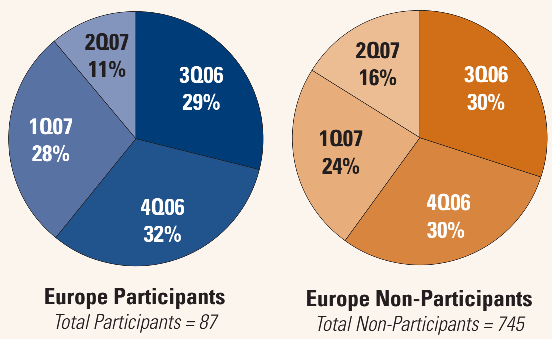
13.7
European Participants By Round Stage



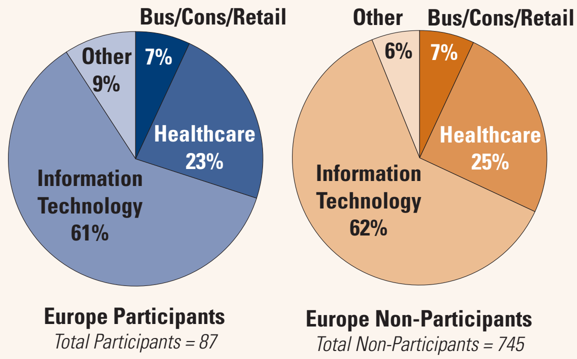
13.9
European Participants By Location



13.8
European Participants By Quarter



13.10
European Participants By Industry Group



13.11
European Participants – By Industry Group And Industry Segment

Industry Group/Segment	Total	Percent
Business/Consumer/Retail		
Cons/Bus Products	4	5%
Cons/Bus Services	1	1%
Media/Content/Info	1	1%
Health Care		
Biopharmaceuticals	15	17%
Medical Devices/Equipment	4	5%
Medical Software & IS	1	1%
Information Technology		
Communications & Networks	6	7%
Electronics & Computers	10	11%
Information Services	12	14%
Semiconductors	7	8%
Software	18	21%
Other		
Adv Spec Mat & Chem	2	2%
Agriculture	1	1%
Energy	4	5%
Other Companies	1	1%
Grand Total	**87**	**100%**

13.12
European Non-Participants – By Industry Group And Industry Segment

Industry Group/Segment	Total	Percent
Business/Consumer/Retail		
Cons/Bus Products	11	1%
Cons/Bus Services	29	4%
Media/Content/Info	3	0%
Retailers	6	1%
Health Care		
Biopharmaceuticals	101	14%
Health-care Services	3	0%
Medical Devices/Equipment	72	10%
Medical Software & IS	8	1%
Information Technology		
Communications & Networks	66	9%
Electronics & Computers	49	7%
Information Services	88	12%
Other IT	1	0%
Semiconductors	39	5%
Software	221	30%
Other		
Adv Spec Mat & Chem	13	2%
Agriculture	1	0%
Energy	21	3%
Other Companies	13	2%
Grand Total	**745**	**100%**

15.391 Early Stage Capital
Fall 2010