

# THE ENTREPRENEURS' REPORT: Private Company Financing Trends

January 1, 2005 – September 30, 2007

Fall 2007

## Private Company Financing Trends

As the technology sector enters its fourth year of recovery from the dramatic collapse in 2002 and 2003, we are witnessing a number of trends with potential significance to venture-backed companies:

- The IPO has re-emerged as a viable exit for venture-backed companies, notwithstanding the substantially increased compliance costs and challenges that are faced by public companies with the advent of Sarbanes-Oxley and a host of other regulatory requirements. The number of IPOs in the technology sector is up significantly in the first three quarters of 2007, in comparison with the same period of 2006.
- Our data indicate a notable increase in pre-money valuations for venture-backed companies, particularly for the step-up from the Series A round of financing to the Series B round. Median pre-money valuations in Series B rounds included in our database

*continued on page 10 . . .*

### In This Issue

#### The Basics . . . . . Page 5

What to Do After You Have Found Seed Investors

#### Quarterly Deal Highlights . . Page 6

Partial Cash-Out of Founder's Stock

#### Regulatory Developments . . Page 7

Option Pricing for Private Companies – New Rules

#### Insight Corner . . . . . Page 8

What's My Company Worth?

## The Data Set\*

**DISTRIBUTION BY SERIES.** From January 1, 2006, through September 30, 2007, nearly 35% of all Wilson Sonsini Goodrich & Rosati equity financings in the data set consisted of Series A rounds, another 27% consisted of Series B rounds, 31% consisted of Series C rounds or later, and 2% fall into other categories. For the purposes of this report, data relating to Series A rounds of financings predominantly refers to early-stage investments by institutional investors (i.e., both organized angel groups as well as traditional venture capital firms). Angel rounds, where they are identified in the charts, typically include individual seed investors.

Although each successive round of financing may have its own significance in terms of industry trends, the frequency of angel and Series A rounds as a percentage of the overall financings is particularly important as a key indicator of the health of the industry in general. These two categories of financings reflect new companies whose ideas and business plans are funded and provide direct evidence of investment in innovation. In the second half of 2006, for example, angel and Series A rounds combined to represent 48% of all financings; For 2007 year-to-date, angel and Series A rounds comprise 38% of all financings. This data would appear to indicate a continuing recovery of the broadly defined technology sector in comparison with earlier periods.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Angel	7%	6%	4%	7%	1%	1%	7%	7%	3%	7%	11%
Series A	35%	42%	39%	36%	33%	34%	46%	37%	35%	35%	23%
Series B	24%	17%	27%	31%	32%	27%	22%	23%	25%	26%	34%
Series C and later	32%	33%	26%	25%	34%	35%	22%	32%	33%	30%	32%

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\* The data in our report are from seed and venture financings in which WSGR represented either the company or the investor. This data consist of more than 600 financings in each of 2005 and 2006. For 2007 year-to-date, the number of financings included in our database is largely consistent with the same periods for the prior two years. Data are reported on financings throughout the United States, without distinction by geography.

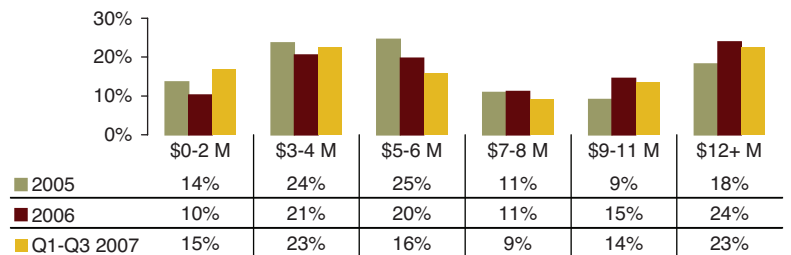
In our descriptions of these data, we refer to the mean and median numbers for certain periods. Median data is that number that separates the top half of the data set from the bottom half. For mean data, we use a truncated average, discarding from the calculation the highest and lowest figures for the period (and in some cases the top and bottom two figures.) This eliminates from the calculation of the mean the effect of financings that in our judgment are unusual and therefore should be excluded.

## The Data Set *(continued from page 1)*

**VALUATION TRENDS.** Although median pre-money valuations may not be useful for pricing individual deals, they are pertinent as an indicator of industry trends. Our data indicate that the median valuations for later-round deals increased substantially from 2005 to 2006. In the first three quarters of 2007, 29% of Series B rounds reflected valuations of \$30 million or more, compared to 31% of Series B rounds in all of 2006 with valuations at this level. In the first three quarters of 2007, 32% of Series C and later rounds reflected valuations of \$61 million or more, down from 37% for all of 2006.

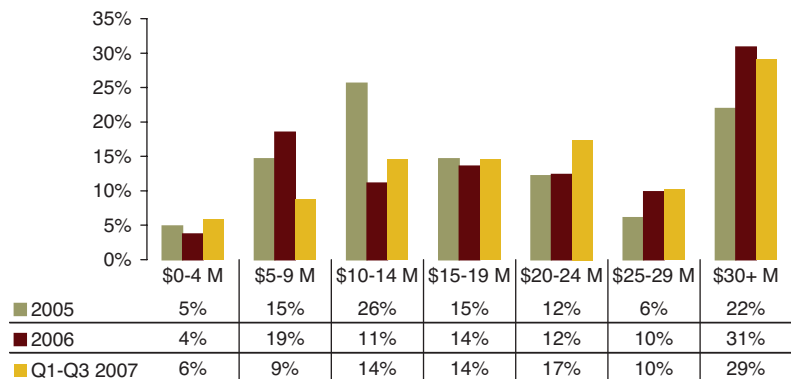
### Series A

In 2005 the median Series A pre-money valuation was \$6.0 million and the mean was \$8.3 million. In 2006, the median pre-money valuation remained the same at \$6.0 million and the mean climbed to \$10 million. For Q1–Q3 2007, the median valuation was \$5.5 million and the mean also decreased to \$7.5 million.



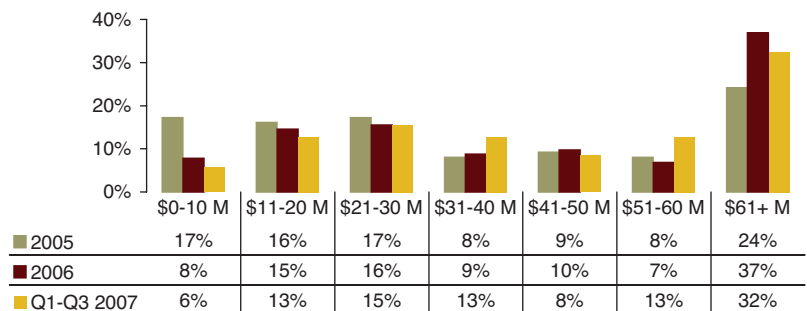
### Series B

The median Series B pre-money valuation was \$16.5 million in 2005 and the mean was \$21.3 million. For 2006, the median Series B pre-money valuation increased to \$20.0 million and the mean rose to \$25.9 million. The median pre-money valuation for Q1–Q3 2007 was \$22 million and the mean fell slightly to \$23.3 million.



### Series C and later

The median pre-money valuation for Series C and later rounds was \$30 million in 2005 and the mean was \$48.2 million. For 2006, these numbers were \$45 million and \$56.8 million respectively. For Q1–Q3 2007, the median pre-money valuation remained at \$45 million and the mean dropped slightly to \$55.9 million.



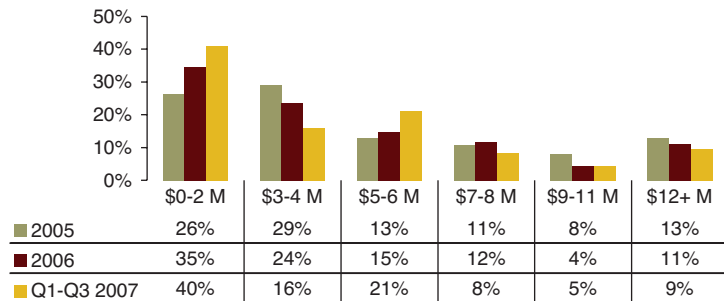
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## The Data Set *(continued from page 2)*

**AMOUNTS RAISED – BY SERIES.** As indicated in the charts, amounts raised have been widely dispersed relative to the medians. However, despite a strong supply of money in the venture sector, the median amounts raised by series did not change substantially during the period covered by this data set.

### Series A

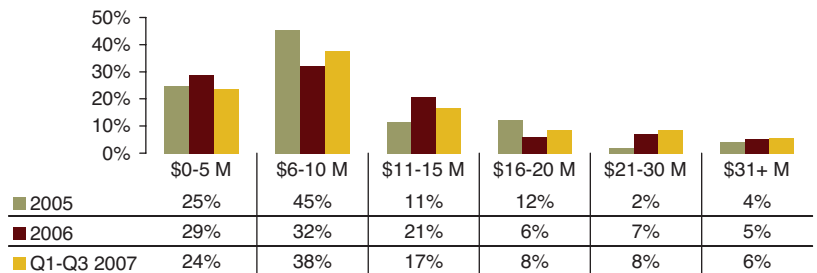
The median amount raised for Series A financings was \$4.0 million in 2005, 2006, and again in Q1–Q3 2007. The mean amount raised for these financings was \$5.7 million in both 2005 and 2006, and \$4.7 million for Q1–Q3 2007. Based on historical pre-money valuations for companies raising their first round of institutional financing (see data on previous page), these data confirm the traditional view that founders should be prepared to allocate a significant percentage of equity capital to VCs even at the first round of investment.



For example, for a company with the 2007 year-to-date median pre-money valuation (for Series A financings) of \$5.5 million that would want to raise 4 million (the 2007 year-to-date median) as its first financing the founders would have to give up 42% of the equity ownership of the company. This is a significant percentage, and explains why many founders choose either to (i) build the pre-money valuation of their company by bootstrapping the business as long as possible before taking on venture capital, or (ii) reduce their operating budget—and the amount of equity capital required for the first financing—to conserve the amount of equity ownership that remains with the founders and early employees during the first stages of operation.

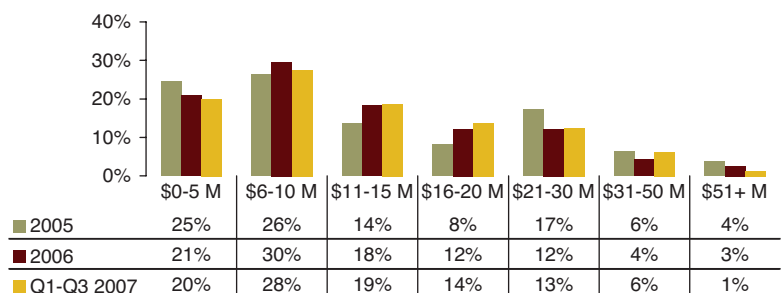
### Series B

The median amount raised for Series B financings was \$8.0 million for 2005 and \$9.0 million in 2006, and increased to \$10.0 million during Q1–Q3 2007. The mean amount raised for Series B financings was \$9.9 million in 2005, \$10.6 million for 2006, and \$11.4 million for Q1–Q3 2007.



### Series C and Later

The median amount raised for Series C and later-round financings was \$10.0 million in both 2005 and 2006, and increased to \$11.5 million during Q1–Q3 2007. The mean amount raised for Series C and later financings was \$15.4 million in 2005 and \$14.4 million in 2006. For Q1–Q3 2007, it was \$13.4 million.



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## The Data Set *(continued from page 3)*

**UP VS. DOWN ROUNDS – BY QUARTER.** Up rounds (that is, financing rounds at a company valuation above the valuation of the preceding round) far exceeded down rounds throughout this period. In both 2005 and 2006, 65% of Series B and subsequent rounds were up rounds, and 21% were down rounds. In Q1–Q3 of 2007, 76% of such financings were up rounds and 11% were down rounds. This trend would appear to underscore the continued recovery and health of the sector when contrasted with the 2001-2003 timeframe.

### % of Total Financings (Post Series A)

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Up	67%	65%	52%	75%	68%	59%	70%	65%	77%	72%	79%
Down	23%	25%	22%	17%	19%	26%	16%	23%	19%	8%	5%

**UP VS. DOWN ROUNDS - BY SERIES.** The proportion of down rounds is naturally lowest in Series B financings, perhaps in part due to the lower valuations that are ascribed to companies during their first phases of operations. As valuations climb during later stages, the data indicate that companies face an increasing likelihood of a down-round financing. This fact could result from either an overly high valuation in a prior round, or failure to execute on the business plan.

### % of Total Series B Deals

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Up	78%	63%	70%	86%	83%	78%	82%	74%	80%	89%	86%
Down	22%	25%	15%	11%	3%	7%	12%	21%	15%	4%	0%

### % of Total Series C Deals

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Up	70%	86%	50%	78%	77%	47%	64%	62%	73%	80%	67%
Down	20%	14%	28%	11%	15%	40%	9%	15%	27%	0%	8%

### % of Total Series D Deals

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Up	50%	60%	0%	60%	44%	50%	33%	58%	67%	44%	75%
Down	33%	20%	50%	20%	44%	36%	33%	25%	0%	33%	13%

### % of Total Series E and Later Deals

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Up	50%	45%	33%	67%	25%	67%	75%	50%	75%	43%	100%
Down	25%	36%	17%	33%	50%	33%	25%	50%	25%	14%	0%

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**The Basics:**

# Startup Companies and Financing Basics

*I have just succeeded in finding investors for a seed financing of my company.*

**What kinds of structures should I think about for a seed-level investment?**

Startup companies typically structure their initial seed or angel round of financing with the use of either convertible notes or Series A preferred stock.

A convertible-note financing generally consists of loans from the investors documented by a promissory note that automatically converts when the first equity financing—typically involving the issuance of Series A preferred stock—is completed. Although there are wide variations in terms, convertible notes usually (i) convert into the same security that is issued in the equity financing (e.g., Series A Preferred) on the same terms as are negotiated in the equity financing; (ii) may or may not be secured by the assets of the company; (iii) have a relatively short maturity date (and sometimes are even payable on demand) to reflect the investor's anticipation that an equity financing will occur in the near future; and (iv) are typically accompanied by an "incentive" to recognize that the investors in the seed financing are taking unusual risk. This incentive can take the form of either a discount from the conversion price of the note (i.e., to allow the investor to convert the note into Series A Preferred at a discount from the price that the Series A investors are paying) or warrants to purchase the equity security into which the note converts at an exercise price equal to the purchase price of the equity security.

An equity financing at the initial seed or angel stage generally consists of the issuance of Series A preferred stock on terms fairly similar to those that would be required by any institutional venture capital investor.

Many early-stage companies may be better off with a convertible-note financing over a Series A financing in a seed or angel round for a few reasons:

- A convertible note avoids the need to establish a valuation for the company at a very early stage of its existence (i.e., before there is any real information or operating data that can be used to establish a meaningful valuation). Because the investors remain creditors of the company until an equity financing occurs, there is no need to establish how the equity ownership of the company will be divided between the founders and these early investors.
- Convertible-note financings typically involve substantially less legal paperwork to complete.

As a result, in most cases, they are simpler, faster, and less costly.

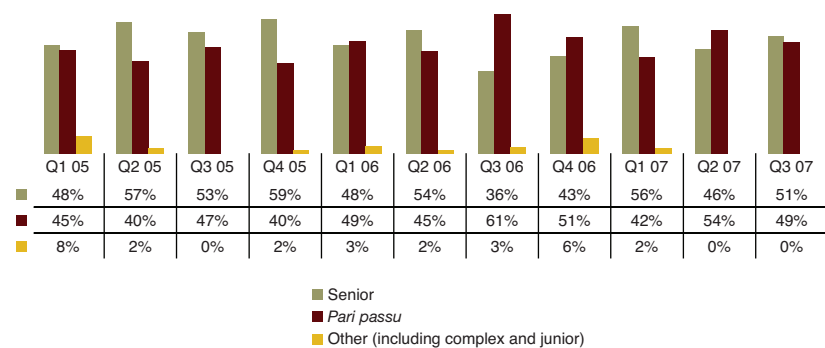
- Convertible-note structures, because they place investors in a creditor position with the company, are usually acceptable to early-stage investors who may be concerned about the risks of investing in early-stage startups.

However, many companies are sufficiently advanced in the execution of their business plans that it makes more sense to structure their first formal financing as equity and not as debt.

*continued on page 10 . . .*

## The Data Set (continued from page 4)

**LIQUIDATION PREFERENCES: SENIOR VS. PARI PASSU.** The liquidation preference represents the right of preferred stockholders, upon a sale or liquidation of a company, to be paid in preference to common stockholders. Liquidation preferences also may establish a priority among series of preferred stock. The table below shows the percentage of financings in which the new series of preferred stock is senior to the prior series of preferred, and the percentage of financings in which the new series is on par (*pari passu*) with prior series. The use of senior liquidation preferences naturally increases in difficult financing environments and declines when the general financing market is strong. Our data show that the use of senior liquidation preferences declined from 2005 to 2006 and then increased modestly in Q1-Q3 2007.



*continued on page 6 . . .*

*Quarterly Deal Highlights:*

## Interesting Approaches to Unique Problems: Partial Cash-Out of Founders' Stock\*

**The Facts.** TechnoCorp, Inc., a VC-backed startup formed in 2001, was about to engage on a Series B Preferred financing round. Isabel and Jonathan, the co-founders and CEO and CTO of the business, had managed to bring the company forward on a shoestring budget. They had completed a modest Series A Preferred round of seed financing for \$300,000 in 2003, consisting principally of friends and family members, and had stretched the company's working capital by paying themselves a salary that was well below market. By 2007, through Isabel's and Jonathan's hard efforts, the company had grown—it had 23 employees, its first revenues, and an expanding customer base. At this point, the two founders began fundraising for an institutional round of financing of approximately \$5 million.

World Ventures, a well-known local venture fund, as well as a number of other VC funds, was intrigued by the business prospects of the startup and began positioning for the right to be the lead investor in TechnoCorp's financing.

Multiple term sheets were submitted to the founders for their consideration.

World Ventures submitted a proposal to invest \$5 million in TechnoCorp for Series B Preferred at a price of \$2.00 per share. Isabel and Jonathan expressed their concern to World Ventures that bootstrapping the company over the last six years, and taking out only a modest salary, had imposed a significant financial hardship for both of them and their families.

Although the founders were aware of the usual wisdom that the purpose of funding from VCs is to provide working capital for the company, not liquidity for the stockholders, they nevertheless made the case that the World Ventures' financing proposal would be more favorably considered if World Ventures would agree to a partial cash-out of the founders stock held by Isabel and Jonathan.

The two founders suggested that \$400,000 of the proposed funding of \$5 million be applied toward the purchase of 200,000 shares of fully

vested common stock held by the two founders (i.e., a purchase of 100,000 shares from each founder at a purchase price of \$2.00 share). The mechanism for accomplishing this would be to complete the financing, expand TechnoCorp's working capital by the \$5 million received in the financing, and then permit the company itself to repurchase the 200,000 shares.

At the time, the common stock of the company was valued at \$0.05 per share, equal to the fair market value of the common stock as determined by the company's board of directors. It was expected that upon completion of the Series B Preferred financing, it would be necessary to re-evaluate the fair market value of the common stock for purposes of future option grants under the company's stock plan.

**The Problem.** Counsel for the company raised the concern that if the company were to repurchase 100,000 shares of common stock from each founder for \$2.00 per share—i.e., the same price as the Series B Preferred—it would

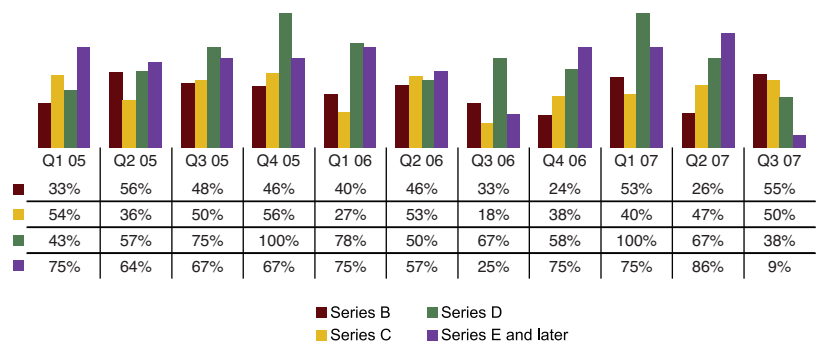
\* This case study is based upon a transaction for a WSGR client. However, names, amounts, and other details have been changed to protect the identity of the client and the confidentiality of the transaction.

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## The Data Set *(continued from page 5)*

### SENIOR LIQUIDATION PREFERENCE – BY SERIES.

The proportion of financings with senior liquidation preferences generally is lowest for Series B rounds and increases for later rounds. The following chart shows the percentage of senior liquidation preferences by round of financing.



Percent of financings that have a senior liquidation preference.

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**Regulatory Developments:**

**New Rules on Option Pricing for Private Companies**

On April 17, 2007, the Internal Revenue Service adopted long-awaited rules on “deferred compensation” that have a significant impact on how private companies should be setting the strike price of options to purchase common stock. The new Section 409A of the Internal Revenue Code changes how nonstatutory options priced below “fair market value” are taxed. If a nonstatutory option is priced below fair market value, Section 409A requires payment of tax on the difference between the exercise price and fair market value as of the date of vesting, which will generally be treated as wages taxable to the optionee as ordinary income, plus the optionee will be assessed a 20% additional federal income tax (plus an additional 20% income tax for California taxpayers), regardless of whether the option is exercised. While not entirely clear, Internal Revenue Service guidance suggests that during each subsequent tax year (until the option is exercised or expires), the optionee will incur additional income taxes (including the additional 20% federal income tax, and, if applicable, the additional 20% California income tax), plus

penalties and interest on any increase in the value of the underlying stock.

As a result of these new rules, boards of directors of private companies need to be more rigorous than in the past in determining the exercise price of options. Although there was no regulatory basis for this practice, boards of early-stage private companies as a general rule would price options to purchase common stock at 10% of the price of the most recent preferred stock round. However, setting the exercise price as a fixed percentage of the preferred stock price is not acceptable methodology under Section 409A. Instead, the board must take into account the new standards in setting the exercise price no less than fair market value on the date of grant.

The final regulations provide guidance regarding acceptable methods for determining the fair market value of private company common stock. A method will not be considered reasonable if it does not take into consideration all available information material to the valuation of the private company’s common stock. The general

valuation factors to be considered under a reasonable valuation method must include the value of tangible and intangible assets, the present value of anticipated future cash-flows, the market value of similar entities engaged in a substantially similar business, recent arm’s length transactions involving the stock to be valued, and other relevant factors (such as control premiums, discounts for lack of marketability and whether the valuation method is used for other purposes).

Section 409A provides three alternatives for determining the fair market value of a private company’s common stock that will result in a valuation that is presumed reasonable, unless the IRS can show that the valuation method or its application was “grossly unreasonable.” The two most commonly used methods are (1) a formal valuation by a qualified independent appraiser as of a date no more than 12 months before the option grant date, or (2) an internal written report prepared in good faith by an individual (often a board member or employee) who has “significant knowledge and experience” and that takes into

*continued on page 11 . . .*

**The Data Set** *(continued from page 6)*

**PARTICIPATING VS. NON-PARTICIPATING LIQUIDATION PREFERENCES.** Since the liquidation event for most venture-backed companies is an acquisition, the details of the liquidation preference may substantially affect the economics for the common stockholders. A participating preferred stock has the right to the return of its original investment and also the right to share in the remaining proceeds pro rata with the common stock. In contrast, a non-participating preferred stockholder must choose between the return of its original investment or converting its preferred stock to common and sharing pro rata with the other common stockholders. By definition, a participating preferred stock is more advantageous to the preferred stockholders and, therefore, more costly to the common stockholders.

Participating preferred stock, including participation rights that are capped (see data below), has become more common in this decade. From 2005 to Q1–Q3 2007, it was used in nearly two-thirds of the financings.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Participating	75%	69%	62%	57%	69%	66%	68%	60%	66%	63%	55%
Non-Participating	25%	31%	38%	43%	31%	34%	32%	40%	34%	37%	45%

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**Insight Corner:**

# What's My Company Worth?

Just as the three most important things in real estate are said to be location, location, location, the three most important things in a venture capital financing are valuation, valuation, valuation. Among the investment terms of the typical Silicon Valley deal, valuation is by far the most important. After all, valuation, along with the amount invested, determines how ownership of the new venture will be split between founders and investors.

Notwithstanding this importance, a startup company's true valuation is very hard to determine. Traditional finance theories offer three common methods to value a company: net present values of discounted cashflows, comparable companies comparisons, and VC target returns. Unfortunately, none of these methods works well for a startup.

The discounted cashflows/net present value method involves predicting the cashflows that a business will generate in future years and discounting those cashflows to the present, using a discount rate that reflects the time-value of money plus the risk whether the returns will be achieved as compared to a risk-free alternative investment. The problems with this method are substantial, and start with the difficulty of predicting with any sort of credibility

the future cashflows of a business that may have just started operations, probably has no current revenues, certainly is not profitable, and is years away from positive cashflow. That would be difficult enough for a new company in an existing industry, but it is almost impossible for a startup that intends to develop a new product for a new industry or a rapidly changing market, as most startups do. Add to this the simple mathematical issue that the discounted cashflow calculation is greatly affected by the selection of the discount rate, and the method becomes even less useful—accurately quantifying the risk of a new venture over a risk-free investment may be even harder than predicting the future cashflows. In short, this method generally requires too many difficult and unreliable assumptions.

The comparisons to comparable companies method works better for startup companies, but still presents issues. This method involves identifying other companies that are similar in terms of industry, markets, products, size, stage of growth, and the like. Ideally, there will be companies that meet all these criteria, so that direct comparisons with their valuations can be used to determine a reasonable valuation for the subject company. Even if there are no directly

comparable companies, adjustments and accommodations can be made to compare the subject company to less directly comparable, but still similar, companies. For example, the ratio of valuation to revenues for a more mature company in the same industry can be used as a multiple to apply to the predicted revenues of the subject company to determine its valuation.

The first problem with this method for a new startup, however, is simply whether there actually are any companies close enough in comparability to make comparisons meaningful. Any new startup that hopes to succeed must intend to do something different from existing companies, whether in terms of product, technology, or market approach. Moreover, even without dramatic differences in business plans, startups are different from established companies, especially publicly traded ones, in so many ways that comparisons between them may be tenuous. This also leads to the second problem with this method: even if comparable companies exist, there may not be information available about them to enable comparisons to be made, especially regarding their valuations. For any company that is not publicly traded, publicly available information is limited. Private companies rarely release their revenues or other

*continued on page 9 . . .*

## The Data Set *(continued from page 7)*

**PARTICIPATING LIQUIDATION PREFERENCES – CAP VS. NO CAP.** When participating preferred stock is used, companies often negotiate to cap the total return (preference plus participation) at a multiple of the original purchase price, often in a range between 1.5x and 4x. If the per share return on a sale of the company exceeds the cap, the preferred stock has the option to convert to common and share pro rata with the other common stockholders. Our data indicate that about one-half of all financings with participating preferred stock includes a cap.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Participating -- cap	47%	48%	51%	52%	50%	34%	52%	52%	48%	42%	56%
Participating -- no cap	53%	52%	49%	48%	50%	66%	48%	48%	52%	58%	44%

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## What's My Company Worth? *(continued from page 8)*

financial numbers, and actual valuations are even more closely guarded (although some of this information may be available for a fee, sometimes substantial, through various third-party data sources). Thus, this second method often fails through lack of data.

The third method is based upon the target returns that VCs generally try to achieve with their investments. The VCs predict an ultimate future value of company in a liquidity event, as well as the timing of that event. They then estimate their likely ownership stake at that time, and therefore the ultimate future value of their investment. The VCs then apply the internal rate of return that they desire to achieve for their fund investments to calculate the size that their initial investment in the company must be in order to grow to the desired future value. Unfortunately, this method also suffers from the problem of having to predict future values in a very uncertain future. In addition, to be rigorous, the method should take into account all the future investments the VC is likely to make in the company. The amount, price and timing of these follow-on investments can significantly affect

the calculation. Moreover, they too are difficult to predict at the time of the first investment.

So, how then are valuations actually determined in startup financings? Each of the above methods includes a substantial amount of arbitrariness; so that that any valuation derived will also be fairly arbitrary. This arbitrariness has led one Silicon Valley observer to claim sarcastically that valuations are really determined through conversations like the following:

Founder: "How much is my company worth?"

VC: "How much money are you trying to raise?"

Founder: "Five million."

VC: "Then I'd say your company is worth . . . oh . . . about five million."

Founder: "No, wait. I need to raise seven million."

VC: "Oh well, then your company is probably worth more like . . . ah . . . seven million."

All joking aside, there is some guidance in the foregoing, in that it focuses the valuation

discussion not on absolute values, but on relative ones. As a simplification of the VC target returns method above, VCs will often seek to obtain 50% of a startup company, on a post-investment basis, regardless of the particular dollar valuation. This leaves the founders with 50%, which they generally have to share with future officers and employees through an option plan reserve of 15% to 25%. Calculation done.

There's not a lot of science in this last method. But given the problems and arbitrary results of ostensibly more rigorous dollar valuation methods, the goal of coming up with any exact dollar valuation that all parties agree upon is probably illusory. Focusing immediately on relative valuations, on the other hand, provides a simpler and more direct alternative for dividing ownership between founders and investors in a startup company, which, after all, is what valuation is all about.

By **Herb Fockler**,  
*Partner*

## The Data Set *(continued from page 8)*

**ANTI-DILUTION PROVISIONS.** In almost all financings, each share of preferred stock on its original issuance is convertible, either at the election of the holder or on a mandatory basis in specified circumstances, into common stock on a one-for-one basis. The use of a price-based anti-dilution clause will adjust this conversion ratio in favor of the investor if the company issues shares in the future at a lower price than the price paid by the investor. The objective of price-based anti-dilution is to provide the investor a measure of compensation for the reduced valuation through a slightly improved ownership position in the company. Formulas range from "broad-based" and "narrow-based" weighted-average formulas to "ratchet-based" anti-dilution. Broad-based weighted average anti-dilution is the least protective to the investor, and ratchet clauses are the most protective. Broad-based weighted-average formulas were used most recently in 88% of the financings in our data set.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Weighted average -- broad	87%	91%	81%	80%	80%	83%	88%	78%	91%	85%	88%
Weighted average -- narrow	4%	6%	7%	7%	2%	5%	3%	2%	4%	3%	9%
Full ratchet	6%	2%	2%	6%	11%	3%	3%	10%	1%	8%	2%
Other (including Blend and None)	3%	1%	10%	8%	8%	10%	7%	10%	4%	3%	2%

*continued on page 10 . . .*

## Private Company Financing . . .

(continued from page 1)

jumped from \$16.5 million in 2005 to \$20 million in 2006 to \$22 million year-to-date in 2007. In correspondence with this trend, the percentage of up financing rounds in our database is at a historical high over the period that includes 2005, 2006, and 2007 year-to-date. In addition, industry data suggest that venture-backed companies experienced valuation increases at all other stages of growth as well, including valuations reflected in acquisitions.

- It appears that an increasing number of companies are funded, due in part to the abundance of cash that is available through traditional venture capital firms, through the active reappearance of corporate venture investors (Intel, Cisco, and Google, to name a few) and, with increasing impact, through private equity

firms that have entered the late-stage mezzanine investment space.

Although these trends would appear to bode well for the emerging growth company, more recently we have seen a decline in 2007 in the number of institutionally backed VC financings at the Series A level. This may be attributable, at least in part, to the increasing role that angel groups appear to play in providing seed funding to startup companies. Our data show that the activity levels of angels and angel groups in seed financings increased in the third quarter of 2007. We believe that the number of Series A financings is an important indicator of the innovation growth rate in the broadly defined technology sector.

Also, at a macro level, it is unclear at this time whether the current turbulence in the financial markets may impact the investment perspectives of the venture capital community as well.

## Startup Companies and Financing Basics

(continued from page 5)

A convertible-note structure is almost always intended to be only a temporary financing arrangement. The financing of emerging growth companies is expected both by founders and investors ultimately to take the form of equity, due to a typical company's inability to service the interest and principal repayment associated with debt as well as the investors' interest in participating in the growth of the company through an equity stake.

By **Yoichiro Taku**,  
*Partner*

## The Data Set (continued from page 9)

**FINANCINGS WITH PAY-TO-PLAY PROVISIONS.** Forward-looking pay-to-play provisions impose a penalty on stockholders who do not participate in future down-round financings. Penalty provisions may include a reduction in the liquidation, conversion, or voting rights of the preferred stockholders who are unwilling or unable to step forward to support the down-round financing, or a forced conversion of all or a portion of their preferred stock into common stock. The purpose of pay-to-play provisions is to help facilitate future financings in the difficult circumstances that are common for down rounds.

	Series A	Later Up Rounds	Later Flat Rounds	Later Down Rounds
% of Financings with Forward-Looking Pay-to-Play	6%	6%	6%	10%

**REDEMPTION RIGHTS.** Redemption rights represent the right of the investors to require the issuer to repurchase preferred stock at a predetermined price, usually the original purchase price in the investment transaction. Although redemption rights are almost never exercised, they continue to be included in about one-third of the venture financings.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Yes, Redemption	42%	32%	35%	32%	39%	36%	35%	30%	36%	42%	31%

continued on page 11 . . .

## Interesting Approaches . . .

*(continued from page 6)*

set a significant benchmark for the fair market value of the common stock, and in all likelihood require the company's board of directors to look to that same benchmark as the minimum exercise price for option grants to employees on a going-forward basis. The founders asked World Ventures to consider alternative structures that would enable the founders to be rewarded with a significant amount of cash, but also permit the company to continue to grant equity incentives to its employees at a competitive price that was more in line with historical pricing of past option grants (i.e., lower than \$2.00 per share).

**A Solution.** The TechnoCorp board of directors completed the Series B Preferred financing with World Ventures for \$5 million, and immediately commissioned an independent valuation consultant to analyze and opine on the post-financing value of the common stock. The valuation consultant, after completing his analysis, determined that the value of the common stock on conclusion of the financing was \$0.40 per share. The TechnoCorp board of directors then authorized the repurchase of 100,000 shares from each of Isabel and

Jonathan at a purchase price of \$40,000 (i.e., \$0.40 per share). Concurrent with this authorization, the board also authorized the grant of a one-time cash bonus to each founder of \$160,000, in recognition of their personal contributions to the business over the course of several years.

**The Analysis:** This structure enabled TechnoCorp to use \$0.40 per share as the exercise price of stock option grants for new and continuing employees during the short span of time following the Series B Preferred financing. Independent valuation of the stock supported the company's accounting objectives in fairly pricing common stock used for compensatory purposes; it also eliminated potential tax risks to the employees receiving option grants at the \$0.40 per share price after the financing. Isabel and Jonathan paid capital-gain tax rates on the 100,000 shares that each sold back to the company, and paid ordinary income tax rates on the \$160,000 cash bonus that each received upon the authorization of the board.

By **Doug Collom**,  
*Partner*

## New Rules . . .

*(continued from page 7)*

account the general valuation factors described above, provided that this method will only be presumed reasonable if the company does not reasonably expect to undergo a change of control within 90 days, or an initial public offering within 180 days, of relying upon the report. The failure to use one of these methods does not result in an automatic determination that the fair market value is not reasonable. However, the failure to do so would result in the company having the burden of proving to the IRS upon audit that the fair market value is reasonable.

Section 409A is highly technical, and each private company should consult carefully with its board of directors, outside counsel, and third-party valuation firms to consider the appropriate approach.

By **Craig Sherman & Scott McCall**  
*Partners*

## The Data Set *(continued from page 10)*

**DIVIDENDS.** In the vast majority of preferred stock financings in the emerging growth sector, declaration and payment of dividends on preferred stock is discretionary at the election of the board of directors. Therefore, in practice dividends are never declared or paid. This reflects the philosophy that cash taken in from investors is for the purpose of building the company. However, in a small minority of financings, some investors seek to augment the return on their equity investment by requiring a cumulative dividend that accrues from year to year, usually at a rate that is approximately 7-10% of the original investment price, and becomes payable upon the occurrence of a sale of the company or an IPO. The requirement of cumulative dividends as part of a financing is, and remains, unusual and outside of market norms.

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Cumulative Dividends	18%	8%	7%	10%	16%	12%	9%	7%	13%	19%	2%



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