Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

THE ENTREPRENEURS REPORT
Private Company Financing Trends

Q1 2013

Valuations by Industry Segment

By Herb Fockler, Partner, Palo Alto

In the last *Entrepreneurs Report*, we looked at pre-money valuations in typical first-round equity financings. We examined more than 300 angel/seed and venture capital investments of at least $2 million in technology and other emerging growth companies between the beginning of 2008 and the end of 2012, using rolling 25-deal medians. While median pre-money valuations varied over the period, and the median for the entire period was about $7 million, we found a strong move to higher valuations over the last 18 months, during which the median valuation was about $11.5 million and reached a high of $14 million in November 2012.[1]

In this article, we look at pre-money valuations in a different way: examining how they vary across industries. For this analysis, we limited our focus to deals that occurred only during 2011 and 2012 in order to reduce the effects of the lower valuations from 2008 through 2010. We also broadened our sample to include not just financings in which at least $2 million was raised, but also financings below that amount, though we did analyze them separately.

Transactions under $2 Million

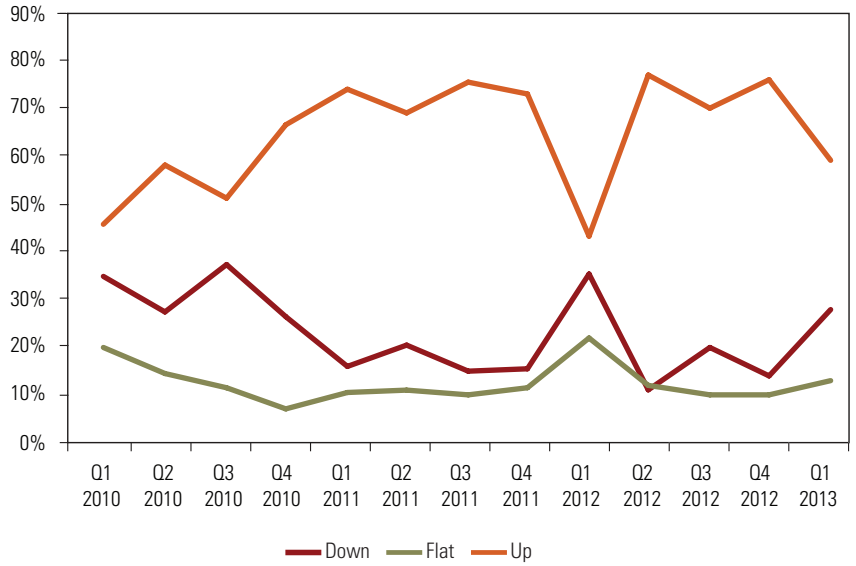
For transactions in which less than $2 million was invested, the industry sector with the highest median pre-money valuation was Retail & Non-technology Products. The median pre-money valuation for the sector was $4.5 million. This was significantly higher than for the sectors with the next

(Continued on page 8)

[1] Given our use of a backward-looking rolling 25-deal sample, the actual peak was likely several months earlier.

From the WSGR Database: Financing Trends for Q1 2013

Up and Down Rounds by Quarter – Equity Financings



The number of deals and the total funds raised in equity venture financings in which Wilson Sonsini Goodrich & Rosati represented one of the principals declined significantly from Q4 2012 to Q1 2013. This decrease was consistent with the declines reported by industry-wide surveys such as PricewaterhouseCoopers' MoneyTree Report.

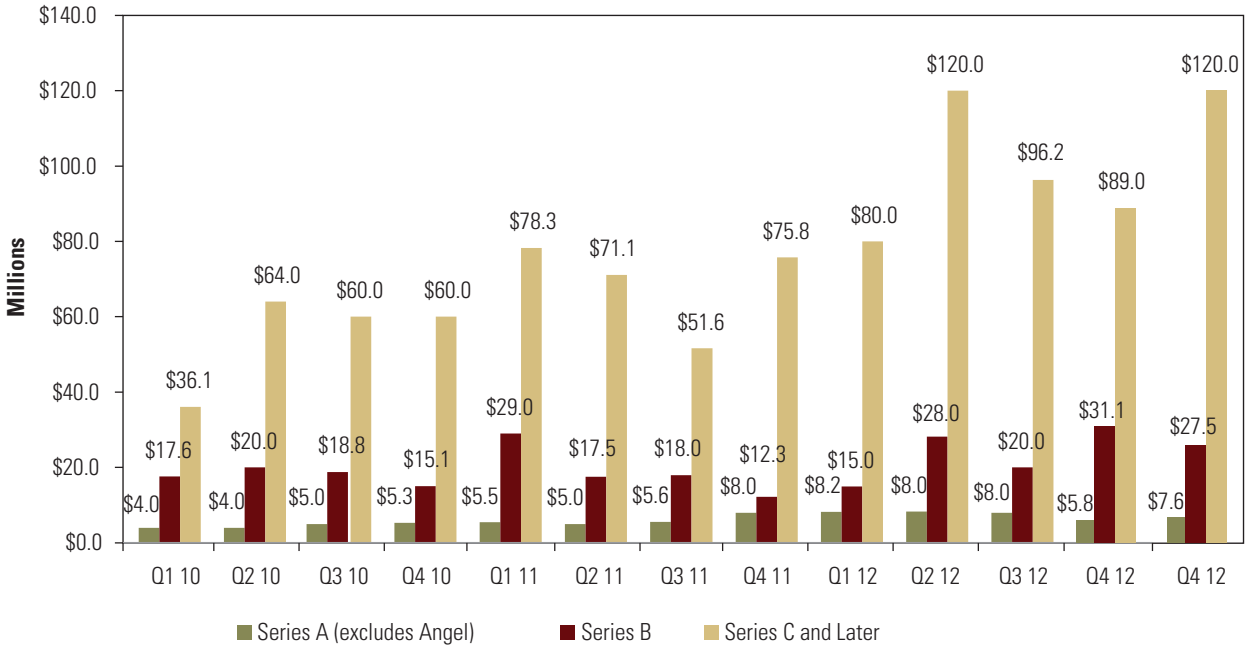
While equity venture activity declined, the dollar amount of bridge loans increased significantly, particularly post-Series A loans, which doubled between Q4 2012 and Q1 2013. The increase in bridge loans reflected both continuing activity by angel investors in early-stage deals and the necessity for existing investors to provide continuing financing to carry portfolio companies through a slowdown in equity investments by new investors. However, even with the increase in debt deals, combined debt and equity financings were still well below 2012 levels.

The decline in the volume of venture financings was accompanied by a small increase in the absolute number of down rounds, which, combined with a decrease in the aggregate number of deals, led to a significant increase in down rounds as a proportion of total deals. Median amounts raised fell for Series B and later rounds, although there was a small increase in the median amounts raised in

For purposes of the statistics and charts in this report, our database includes venture financing transactions in which Wilson Sonsini Goodrich & Rosati represented either the company or one or more of the investors.

(Continued on page 2)

Median Pre-money Valuations – Equity Financings



Series A financings led by venture firms and for bridge financings. Despite the increase in the number of down rounds, pre-money valuations remained strong for both venture-led Series A deals and Series C and later rounds. Series B rounds posted a modest decline in valuations.

Deal terms remained largely unchanged when looking at all rounds in the aggregate. However, there were significant shifts in the terms for down rounds, with a notable decline in the number of deals with senior liquidation preferences and an increase in the percentage of capped participating preferred. This may be a consequence of a smaller number of down rounds in prior quarters.

Up and Down Rounds

Up rounds represented 59% of all financings in Q1 2013, down markedly from the 76% figure for up rounds in Q4 2012. This decrease was not as dramatic as the one a year ago, however, when Q1 2012 up rounds represented only 43% of all financings as opposed to 73% in Q4 2011.

Conversely, down rounds as a percentage of total deals doubled, from 14% in Q4 2012 to 28% in Q1 2013. The percentage of flat rounds grew slightly, from 10% of all deals in Q4 2012 to 13% in Q1 2013.

Valuations

Companies that raised money in non-angel Series A venture financings in Q1 2013 generally did so at higher valuations than in Q4 2012. The median pre-money valuation for Series A deals rose from $5.8M in Q4 2012 to $7.6M in Q1 2013, and was close to the $8.0M median Series A pre-money valuation for full-year 2012. Conversely, the median pre-money valuation for Series B rounds declined from $31.1M for Q4 2012 to $27.5M for Q1 2013, though the latter was still higher than the $21.0M median Series B pre-money valuation for full-year 2012. The median pre-money valuation for C and later rounds rose markedly, from $89.0M in Q4 2012 to $120.0M in Q1 2013, matching Q2 2012 for the highest figure from 2010 to 2012.

Amounts Raised

From Q4 2012 to Q1 2013, median amounts raised in equity financings increased modestly for non-angel Series A financings while declining for later-stage deals. The median amount raised in Series A deals increased from $1.8M in Q4 2012 to $2.4M in Q1 2013, although this latter figure was still lower than the $2.6M median for full-year 2012. Conversely, the median amount raised in Series B financings declined from $7.0M in Q4 2012 to $5.0M in Q1 2013, and the median amount raised in Series C transactions decreased from $11.8M in Q4 2012 to $10.5M in Q1 2013.

The median amounts raised in both pre-Series A and post-Series A bridge loans increased from Q4 2012 to Q1 2013. The median pre-Series A loan amount rose from $200K in Q4 2012 to $300K in Q1 2013, while the median for post-Series A loans more than doubled, from $800K in Q4 2012 to $1.9M in Q1 2013, the highest median amount raised since the $2.0M figure in Q1 2010.

Deal Terms

Liquidation preferences. Deals with senior liquidation preferences increased slightly, from 38% of all rounds in Q4 2012 to 39% in Q1 2013. In up rounds, the use of senior liquidation preferences remained constant at 37% in both Q4 2012 and Q1 2013, while in

down rounds, the use of such preferences declined from 50% in Q4 2012 to 36% in Q1 2013. This decline was mirrored by a large rise in the use of complex preference structures in down rounds, from 0% of all deals in Q4 2012 to 18% in Q1 2013.

Participation rights. The use of participating preferred decreased from 32% of all deals in Q4 2012 to 29% in Q1 2013. The use of such rights in up rounds decreased from 35% of all deals in Q4 2012 to 14% in Q1 2013, while down rounds saw an increase in the use of participating preferred, from 43% of all deals in Q4 2012 to 62% in Q1 2013.

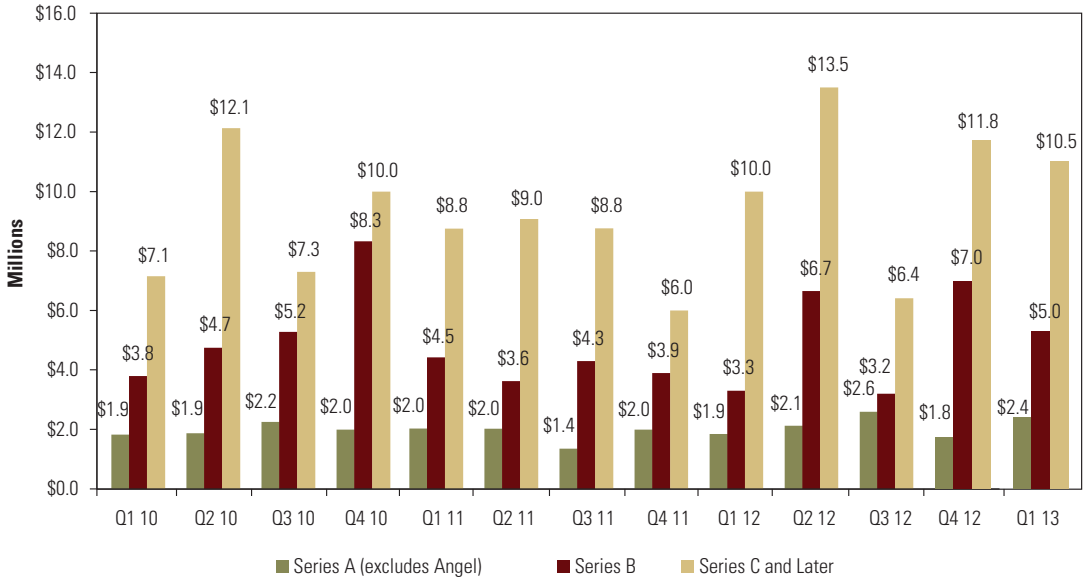
Anti-dilution provisions. There was a general increase in the use of broad-based weighted-average anti-dilution provisions, from 92% of all rounds in Q4 2012 to 96% in Q1 2013. Broad-based weighted-average anti-dilution was used more frequently in up rounds (from 91% of all deals in Q4 2012 to 96% of all deals in Q1 2013) but less frequently in down rounds (from 100% of all deals in Q4 2012 to 92% in Q1 2013).

Pay-to-play provisions. The use of pay-to-play provisions stayed roughly constant in Q1 2013 as compared with Q4 2012. Only 6% of all deals in Q1 2013 used such a provision (compared with 5% of Q4 2012 deals). No up rounds had pay-to-play provisions, and only 15% of down rounds did.

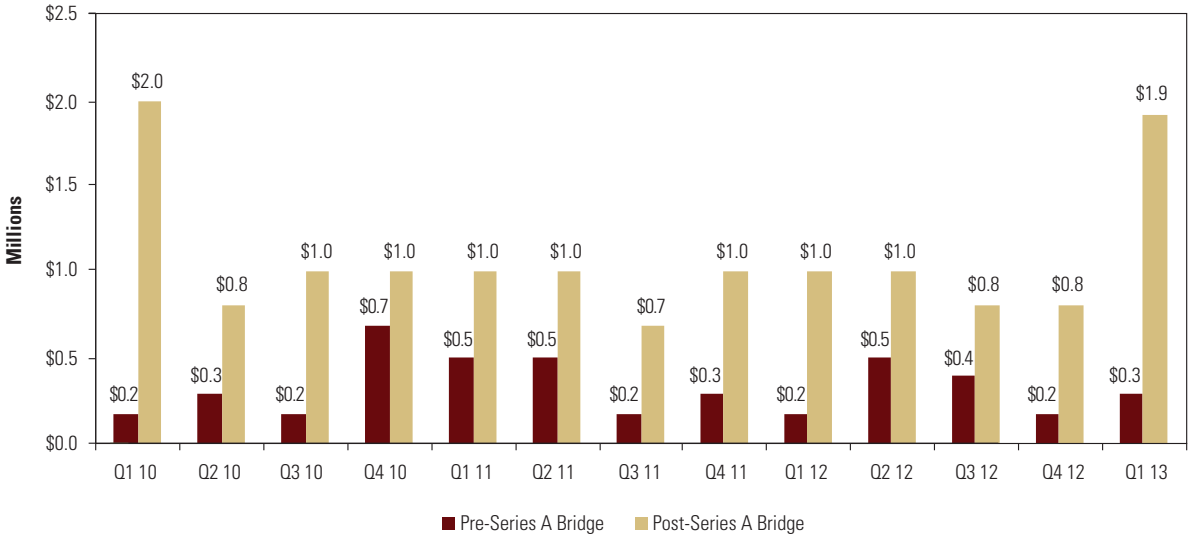
Redemption. The overall use of redemption provisions increased modestly, from 19% of Q4 2012 deals to 21% of Q1 2013 deals. In up rounds, the use of investor-option redemption declined from 27% of Q4 2012 deals to 16% of Q1 2013 deals, while in down rounds, the decline was from 57% to 33%.

To see how the terms tracked in the table below can be used in the context of a financing, we encourage you to draft a term sheet using our automated Term Sheet Generator. You'll find a link in the **Entrepreneurial Services** section of wsgr.com, along with information about the wide variety of services that Wilson Sonsini Goodrich & Rosati offers to entrepreneurs and early-stage companies.

Median Amount Raised – Equity Financings



Median Amount Raised – Bridge Loans



(Continued on page 4)

Private Company Financing Trends (WSGR Deals)[1]

	2011 All Rounds[2]	2012 All Rounds[2]	Q4 2012 All Rounds[2]	Q1 2013 All Rounds[2]	2011 Up Rounds[3]	2012 Up Rounds[3]	Q4 2012 Up Rounds[3]	Q1 2013 Up Rounds[3]	2011 Down Rounds[3]	2012 Down Rounds[3]	Q4 2012 Down Rounds[3]	Q1 2013 Down Rounds[3]
Liquidation Preferences - Series B and Later												
Senior	47%	37%	38%	39%	34%	30%	37%	37%	79%	56%	50%	36%
Pari Passu with Other Preferred	51%	58%	57%	57%	64%	67%	58%	63%	18%	39%	50%	45%
Complex	1%	2%	4%	5%	1%	2%	2%	0%	3%	0%	0%	18%
Not Applicable	1%	3%	2%	0%	1%	1%	2%	0%	0%	5%	0%	0%
Participating vs. Non-participating												
Participating - Cap	16%	14%	11%	16%	17%	13%	13%	7%	22%	17%	14%	31%
Participating - No Cap	26%	19%	21%	13%	24%	20%	22%	7%	46%	41%	29%	31%
Non-participating	58%	67%	68%	71%	59%	67%	64%	85%	32%	41%	57%	38%
Anti-dilution Provisions												
Weighted Average - Broad	91%	92%	92%	96%	91%	92%	91%	96%	80%	85%	100%	92%
Weighted Average - Narrow	4%	3%	5%	1%	7%	3%	2%	0%	6%	5%	0%	0%
Ratchet	3%	3%	1%	1%	2%	2%	2%	0%	6%	8%	0%	8%
Other (Including Blend)	3%	3%	2%	1%	1%	3%	4%	4%	9%	3%	0%	0%
Pay to Play - Series B and Later												
Applicable to This Financing	6%	5%	3%	6%	1%	1%	2%	0%	20%	23%	17%	15%
Applicable to Future Financings	6%	3%	2%	0%	4%	3%	2%	0%	11%	3%	0%	0%
None	88%	92%	95%	94%	94%	96%	96%	100%	69%	74%	83%	85%
Redemption												
Investor Option	22%	22%	19%	20%	25%	23%	27%	16%	32%	35%	57%	33%
Mandatory	2%	1%	0%	1%	2%	1%	0%	0%	3%	3%	0%	0%
None	77%	77%	81%	79%	73%	76%	73%	84%	65%	63%	43%	67%

[1] We based this analysis on deals having an initial closing in the period to ensure that the data clearly reflects current trends. Please note the numbers do not always add up to 100% due to rounding.
[2] Includes flat rounds and, unless otherwise indicated, Series A rounds.
[3] Note that the All Rounds metrics include flat rounds and, in certain cases, Series A financings as well. Consequently, metrics in the All Rounds column may be outside the ranges bounded by the Up Rounds and Down Rounds columns, which will not include such transactions.

(Continued on page 5)

Bridge Loans

Interest Rates. Interest rates for pre-Series A bridge loans generally declined between Q4 2012 and Q1 2013, while rates for post-Series A bridges generally increased. The percentage of pre-Series A bridges with annual rates under 8% increased markedly, from 56% of all deals in Q4 2012 to 82% in Q1 2013. By contrast, the percentage of post-Series A bridge loans with annual interest rates above 8% increased from 14% of all deals in Q4 2012 to 37% in Q1 2013; the percentage of post-Series A bridges with rates of 8% or less declined from 61% to 33%.

Maturities. Maturities for pre-Series A bridge loans continued to lengthen. The percentage of deals with maturities of 12 months increased from 31% in Q4 2012 to 45% in Q1 2013, while loans with maturities of less than 12 months fell from 13% to 0%. Maturities for post-Series A bridge deals in Q1 2013 were evenly split, with roughly a third each under one year, at one year, and over one year.

Subordinated Debt. Fewer pre-Series A loans were subordinated to other debt in Q1 2013 (9% of all deals) than in Q4 2012 (31%), while for post-Series A bridge loans, the use of subordinated debt increased from 43% of all deals in Q4 2012 to 52% in Q1 2013.

Warrants. Only a small number of pre-Series A loans had warrants, so we did not examine trends in warrant coverage for those deals. Approximately 59% of post-Series A loans in Q1 2013 had warrants, up from 31% in Q4 2012. The percentage of the deals that had warrant coverage above 25% grew from 0% in Q4 2012 to 53% in Q1 2013.

Conversion. Nearly all Q1 2013 bridge loans provided that they were convertible into equity, with 100% of pre-Series A deals and 93% of post-Series A deals being convertible. The percentage of pre-Series A bridges subject to an explicit price cap grew from 88% of deals in Q4 2012 to 91% in Q1 2013. For post-Series A deals, the percentage of loans with a price cap declined from 29% of deals in Q4 2012 to 16% in Q1 2013. More pre-Series A loans in Q1 were convertible at a discounted price than previously (92% of all deals in Q1 2013 compared with 88% in Q42012). However, the use of discounted prices declined for post-Series A loans, from 54% of such deals in Q4 2012 to 38% in Q1 2013.

Multiples. Repayment of loans at a multiple in the event of an acquisition declined in popularity for pre-Series A loans, falling from 47% of all deals in Q4 2012 to 20% in Q1 2013. Similarly, post-Series A loans with such a feature declined from 25% of deals in Q4 2012 to 15% in Q1 2013.

Bridge Loans	2012 Pre-Series A (76 Deals)	Q4 2012 Pre-Series A (16 Deals)	Q1 2013 Pre-Series A (12 Deals)	2012 Post-Series A (157 Deals)	Q4 2012 Post-Series A (29 Deals)	Q1 2013 Post-Series A (27 Deals)
Interest rate less than 8%	64%	56%	82%	44%	61%	33%
Interest rate at 8%	30%	44%	18%	41%	25%	30%
Interest rate greater than 8%	5%	0%	0%	15%	14%	37%
Maturity less than 12 months	8%	13%	0%	34%	33%	33%
Maturity at 12 months	30%	31%	45%	36%	41%	33%
Maturity more than 12 months	62%	56%	55%	30%	26%	33%
Debt is subordinated to other debt	13%	31%	9%	39%	43%	52%
Loan includes warrants[1]	8%	6%	8%	32%	31%	59%
Warrant coverage less than 25%	20%	0%	0%	42%	63%	33%
Warrant coverage at 25%	40%	100%	0%	33%	38%	13%
Warrant coverage greater than 25%	20%	0%	100%	14%	0%	53%
Warrant coverage described as variable or "other"	20%	0%	0%	12%	0%	0%
Principal is convertible into equity[2]	99%	100%	100%	97%	97%	93%
Conversion rate subject to price cap	65%	88%	91%	24%	29%	16%
Conversion to equity at discounted price[3]	79%	88%	92%	52%	54%	38%
Discount on conversion less than 20%	17%	14%	30%	15%	14%	11%
Discount on conversion at 20%	54%	57%	40%	46%	79%	33%
Discount on conversion greater than 20%	29%	29%	30%	39%	7%	56%
Conversion to equity at same price as other investors	12%	6%	8%	38%	36%	54%
Repayment at multiple of loan on acquisition	16%	47%	20%	22%	25%	15%

[1] Of the 2012 pre-Series A bridges that have warrants, 40% also have a discount on conversion into equity. Of the 2012 post-Series A bridges with warrants, 17% also have a discount on conversion into equity. Of the 2013 post-Series A bridges with warrants, 19% also have a discount on conversion into equity.

[2] This includes notes that provide for voluntary as well as automatic conversion.

[3] Of the 2012 pre-Series A bridges that have a discount on conversion into equity, 4% also have warrants. Of the 2012 post-Series A bridges that have a discount on conversion into equity, 13% also have warrants. Of the 2013 post-Series A bridges that have a discount on conversion into equity, 40% also have warrants.

Convertible Notes vs. Priced Equity in Seed Round Financings: An Illustration of Capitalization Outcomes

By Sundance Banks, Associate, Palo Alto & SOMA

"*So, have you decided whether you're doing a convertible note round or a priced equity round?*" In recent years, we have seen significant changes to the landscape of early-stage financings, making this one of the first questions that founders of start-ups are likely to face when they begin talking with investors. Convertible note financings have become an increasingly popular method for raising seed financing, and the nature of the terms included in convertible note financings has evolved. Understanding the capitalization impacts of raising funds through the issuance of convertible notes versus preferred stock has become essential knowledge for founders and angel investors.

This is the first in a series of articles comparing the impacts of issuing convertible notes and preferred stock in initial equity financings. In this issue, we'll look at the basics of convertible note discounts and valuation caps, as well as examine various capitalization outcomes in a number of examples comparing seed investments raised through the issuance of convertible notes and preferred stock.

The Basics of Convertible Note Discounts and Valuation Caps

Like traditional loans, convertible notes accrue interest and have a maturity date; however, the fundamental difference from traditional loans is that convertible notes also have the ability to convert into equity upon certain events. Moreover, in the vast majority of cases, the receipt of interest payments is not the investor's primary goal; rather, the structure of convertible notes is based on the assumption that a round of equity financing will follow the convertible note financing, and the convertible note investor expects the note to convert into preferred stock in connection with that equity financing.

In most cases, the convertible notes will convert automatically into preferred stock upon a "qualified financing" of a certain threshold (e.g., a new money Series A investment of $1 million), and, to compensate the note investors for their earlier and riskier investment, the notes typically convert at a discount (e.g., 10-30%) to the price paid by the new Series A investors. This results in the investors converting the principal and interest of their notes at a lower price than the purchase price paid by the other Series A investors, thus receiving additional shares.

In addition to having a right to purchase shares upon conversion at a discount to the per share price paid by the new investors, it has become common for investors to require a "cap" on the pre-money valuation at which the notes will convert. Valuation caps provide a ceiling on the value of the company for the purposes of calculating the conversion price of the notes. Noteholders typically have the right to convert their note at the lower of (a) the conversion price determined by applying the discount to the pre-money valuation or (b) the conversion price determined by applying the valuation cap. For example, on convertible notes with a 20% discount and a $4 million valuation cap, the noteholder would receive a 20% discount on the Series A price up to a valuation of $5 million, and if the Series A investors are paying a price per share based upon a valuation higher than $5 million, the convertible notes will convert at a discounted price per share based upon the $4 million valuation cap.

One rationale for using convertible notes is that they can allow the parties to postpone the difficult decision of setting a valuation on an early-stage company in connection with a seed financing, and instead rely on the Series A financing investors to price the company. While this is true with respect to convertible notes that have only a price discount (and not a valuation cap), many view valuation cap provisions as effectively setting a valuation on the company. However, a valuation cap is not the equivalent of a true valuation of the company; instead it is a quasi-valuation that puts the company's valuation within a certain range. It is important to note that this valuation speaks to the value of the company at the next equity round (i.e., the time when the notes would convert automatically, as opposed to the time at which the notes are issued). When determining the valuation cap, the investor is effectively saying, "*At the time of the company's next preferred equity financing, I'm not willing to pay more than a price based upon a valuation of $X, and if the company is valued at more than $X, I want to be compensated with additional shares, even beyond my negotiated conversion discount shares. I took an early risk, and I shouldn't suffer excessive dilution.*"

Capitalization Examples & Analysis

To illustrate the impact of alternative seed-financing structures on a company's capitalization, assume that a group of angel investors wants to invest $500,000 in a company and proposes a pre-money valuation of $4.5 million. The founders, however, consider that valuation too low and want a valuation of at least $7 million, believing that once they are able to release the beta version of their product and build out their team, they likely could raise a priced equity round with a valuation of least $10 million. Because the parties can't agree upon a valuation for a priced preferred stock round, they decide to proceed with a convertible note financing and put off a true valuation of the company until the Series A financing.

To evaluate the capitalization impact of this decision, it is necessary to compare the different seed-stage financing alternatives that were available to the company and the angel investors and evaluate these alternatives after both a high-valuation Series A financing and a low-valuation Series A financing. The table below compares the following financing alternatives, assuming a seed-stage investment of

$500,000 by the angel investors: (a) a priced Series Seed preferred stock financing at a pre-money valuation of $4.5 million (i.e., the result if the founders had agreed to the angel investors' proposed valuation), (b) a convertible note financing with a 20% discount, and (c) a convertible note financing with a 20% discount and a valuation cap of $8 million. To illustrate the differences among these alternatives on the post-Series A capitalization of the company, we will consider the results in two scenarios: an upside scenario in which the company prospers and obtains a very favorable $20 million pre-money valuation for a Series A preferred priced round with the new investors investing $10 million for a 33.3% stake in the company, as well as a downside scenario in which the company ultimately receives a low $2 million pre-money valuation with the new investors investing $1 million for a 33.3% stake in the company.

Upside Scenario. In the upside scenario, if the founders and the angel investors had proceeded with a Series Seed preferred financing at a $4.5 million pre-money valuation, the angel investors would have fared significantly better than if they had invested in convertible notes, with the angel investors owning 6.2% of the fully diluted capitalization following the Series A financing in the equity scenario (as opposed to 3.9% in the scenario using convertible notes with a valuation cap). This is the scenario that drives many founders to proceed with convertible note financings, as they envision a high-growth company that will escalate in value quickly and don't want to suffer the dilution that occurs when pricing a seed preferred financing too low.

The upside scenario also illustrates why investors favor convertible notes with valuation caps. Without a valuation cap, the notes would convert at an effective pre-money valuation of $16 million (due to the 20% discount), meaning that it would have been better for the angel investors to agree to the founders' desired pre-money valuation of $7 million for a Series Seed preferred financing. However, the near ubiquity of valuation cap provisions in convertible note seed financings has made this largely a moot point. In this example, the valuation cap would provide the angel investors with almost twice as many shares of Series A preferred stock as the investors would have received if the notes only contained the 20% discount provision (3.9% of the fully diluted capitalization with a valuation cap vs. 2.1% without it).

It is important to recognize that pursuant to the terms of most convertible notes, the conversion discounts and valuation caps will result in a company effectively creating more liquidation preference than the amount of money that the noteholders have invested. This results in the converting noteholders effectively having a liquidation preference greater than the standard of 1x the initial investment amount; if this differential gets too large, it may not sit well with the new investors.[1] A solution to

	Terms of Seed Investment		Series A Preferred Terms		Post-Series A Fully Diluted Ownership			
			Pre-money Valuation	New Money Investment	New VC	Option Pool*	Founders	Angel Investors
Upside Scenario	(a)	Series Seed preferred stock round at $4.5 million pre-money valuation; angel investment: $500K	$20,000,000	$10,000,000	33.3%	10.0%	50.4%	**6.2%**
	(b)	Convertible note round with 20% discount; angel investment: $500K	$20,000,000	$10,000,000	33.3%	10.0%	54.6%	**2.1%**
	(c)	Convertible note round with 20% discount and $8 million valuation cap; angel investment: $500K	$20,000,000	$10,000,000	33.3%	10.0%	52.7%	**3.9%**
Downside Scenario	(a)	Series Seed preferred stock round at $4.5 million pre-money valuation; angel investment: $500K	$2,000,000	$1,000,000	33.3%	10.0%	50.4%	**6.2%****
	(b)	Convertible note round with 20% discount; angel investment: $500K	$2,000,000	$1,000,000	33.3%	10.0%	35.9%	**20.8%**
	(c)	Convertible note round with 20% discount and $8 million valuation cap; angel investment: $500K	$2,000,000	$1,000,000	33.3%	10.0%	35.9%	**20.8%**

* Assumes option pool increase prior to Series A round.
** Assumes no anti-dilution adjustment for the Series Seed preferred, as anti-dilution rights are not typically provided for Series Seed preferred stock.

(Continued on page 8)

Convertible Notes vs. Priced Equity in Seed Round Financings . . .

Continued from page 7...

avoid this type of liquidation preference overhang is to use a conversion discount formula in the convertible notes that provides that the "discount shares" are issued in the form of common stock (which would not have a liquidation preference), while the principal and interest on the convertible note will still convert into preferred stock without a discount.

Downside Scenario. In the downside scenario, it clearly would have been better for the founders to have agreed to the investors' proposed Series Seed preferred round at a $4.5 million valuation. Unless the founders had negotiated a conversion price floor (a relatively rare term), in the downside scenario, the convertible notes would convert into Series A shares at the low $2 million pre-money valuation, giving the angel investors a 20.8% stake in the company for the initial $500,000 investment.

Ultimately, the decision of whether to raise funds via convertible notes or preferred stock depends on the actual terms offered by investors, and in many cases, investors may seek to dictate this decision. The next article in this series will explore in detail the pros and cons of raising seed financing via convertible notes versus preferred stock from both the company's and investors' perspectives. Please email sbanks@wsgr.com or another member of the firm's entrepreneurial services practice if you have any specific questions regarding convertible notes and recent market trends.

WSGR Convertible Note Financing Resources: WSGR hosts a free online Convertible Note Term Sheet Generator, which is available at: http://www.wsgr.com/WSGR/Display.aspx?SectionName=practice/termsheet-convertible.htm.

[1] For example, in the upside scenario, for convertible notes with only a 20% conversion discount, the angel investors would have an effective liquidation preference of 1.25x their initial $500,000 investment, and the angel investors would have an effective liquidation preference of 2.35x in the scenario with convertible notes with an $8 million valuation cap.

Valuations by Industry Segment . . .

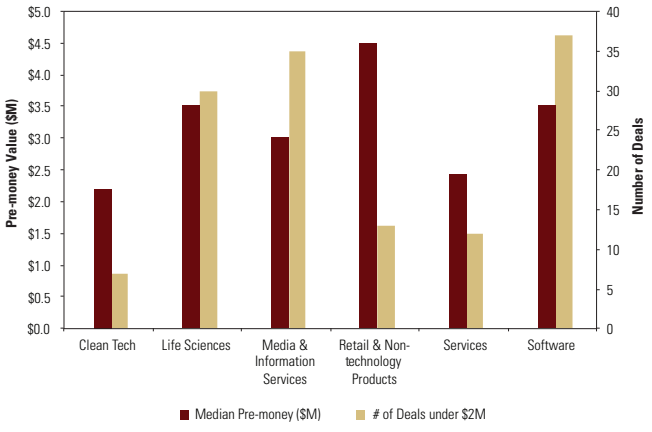
Continued from page 1...

highest median valuations—Life Sciences (predominantly medical devices) and Software—both at $3.5 million. The Media & Information Services sector, which includes social media and similar companies, had a median valuation of $3.0 million, while Services and, not surprisingly given the recent bankruptcies of a number of key players in the solar market, Clean Technology brought up the rear at $2.4 million and $2.2 million, respectively.

By definition, the invested amounts in this category were all less than $2 million, but even then, there were significant variations in invested amounts across industries. The median amounts invested in Life Sciences and Software companies were highest, at $1.0 million and $940,000, respectively, while the smallest median invested amount was in the Services sector, at $600,000.

Also notable is that for the Media & Information Services, Life Sciences, and Clean Technology sectors, there were more financings in the under-$2 million-invested group than in the above-$2 million-invested group. For Clean Technology and Life Sciences, the differences in the number of deals between the groups were relatively minor, but for Media & Information Services, there were more than twice as many deals under $2 million (35) than at $2 million and above (14). On the other hand, because the number of deals under $2 million in each of the Semiconductor, Electronics & Computer Hardware, and Communications & Networking sectors was so small (one, one, and three respectively), we left them out of the under $2 million analysis entirely. Instead, we discuss them in the $2 million and above group. Evidently, some sectors almost always require more than $2 million in invested capital even for their first equity round.

Median Pre-money Valuations for Initial Financings under $2M



Comparing median valuations, it appears that the Retail & Non-technology Products sector was the place to be during the past two years if you needed to raise a relatively small amount of money. This is rather ironic, given the technology-centric focus of our sample. But dollar valuations should not be looked at in isolation. Valuation is the language in which the division of ownership, economics, and control between founders and investors is negotiated, but it only tells half the story. The actual division between founders and

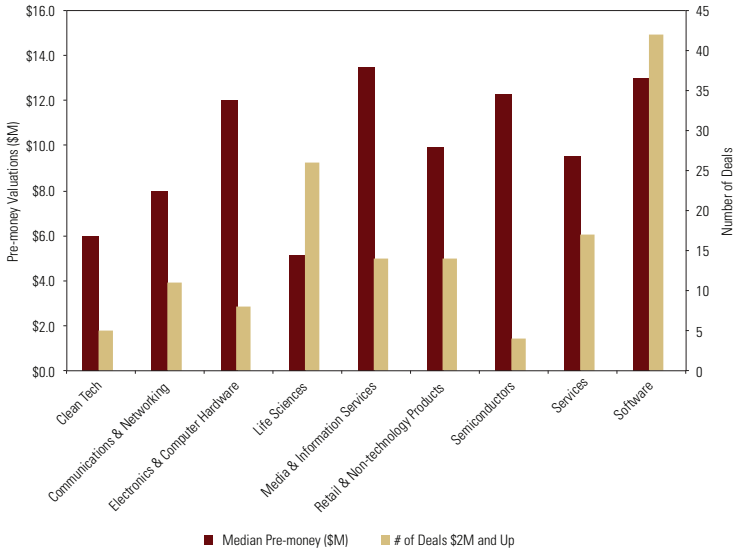
investors also depends on the amount of money invested at that valuation—a very large investment at a somewhat high pre-money valuation could result in the founders owning a lower percentage of the venture than with a small investment at a mid-level valuation. Of course, depending upon the nature of the venture, the small investment may not provide sufficient funding (much as in those sectors with very few deals under $2 million), so this is not a choice available to all founders.

As in our previous articles, in order to reveal the founders-investors split more clearly, we devised an imputed founders' share for each deal. This represents the portion of the company's capitalization that remains in the hands of the founders and early employees post-financing, as opposed to the percentage owned by investors or in the option plan reserve, which we assumed to be 15% in all cases for the sake of convenience and comparability.[2] Once again, Retail & Non-technology Products led, with a median imputed founders' share of 71%, followed by Services at 67%.[3] The combination of significantly higher valuations paired with amounts invested on the low side (in the case of the Retail & Non-technology Products sector) and with bottom-half valuations with the lowest amounts invested (in the case of the Services sector) differentiated these sectors from most others, which had imputed founders' shares in the low 60%s. Clean Technology trailed all other sectors, with an imputed founders' share of 53%.

Transactions Raising $2 Million and Up

For deals in which $2 million or more was invested, not surprisingly, valuations were significantly higher than in the under $2 million group, and the differences in median pre-money valuations among sectors were larger. The Media & Information Services and Software sectors had the highest median pre-money valuations during this period—$13.5 million and $13.0 million, respectively. These valuations likely reflect the high valuations accorded to companies in these sectors in high-profile IPOs and mergers in recent years. Nearly as high were median valuations in the Electronics & Computer Hardware sector ($12.0 million) and in the Semiconductor sector ($12.3 million), traditional areas of larger-scale venture capital investment. Retail & Non-technology Products companies, whose valuations led in the under $2 million group, had a more middling median valuation for deals above $2 million ($9.95 million). Life Sciences showed a similar but even larger divergence, tying for the second-highest median valuation in the under $2 million group, but coming in with the lowest median pre-money valuation of any sector for $2 million and up deals ($5.1 million). Clean Technology, on the other hand, was consistent across both groups—lowest in the under $2 million group, and second lowest in $2 million and above deals, at $6.0 million. The low valuations for both of these sectors are likely reflections of their long cycles for research and scientific development and regulatory approvals, which increase the dilution and risk while prolonging the time until liquidity.

Median Pre-money Valuations for Initial Financings $2M



Median amounts invested for deals of $2 million and above ranged from $3.0 million in the Electronics & Computer Hardware sector to $5.2 million in the Life Sciences sector.

As mentioned above, some sectors are not amenable to small capital raises for their first equity rounds. Over 80% of the initial equity financings in both the Electronics & Computer Hardware and Semiconductor sectors were in the $2 million and above group, as well as a significant majority of deals in the Communications & Networking sector, where many companies' offerings include a substantial hardware component. A majority of initial financings for Software, Services, and Retail & Non-technology Products companies were also in the $2 million and over group.

Imputed founders' shares for the $2 million and over group were generally lower than in the under $2 million group, reflecting the fact that the difference in amounts invested

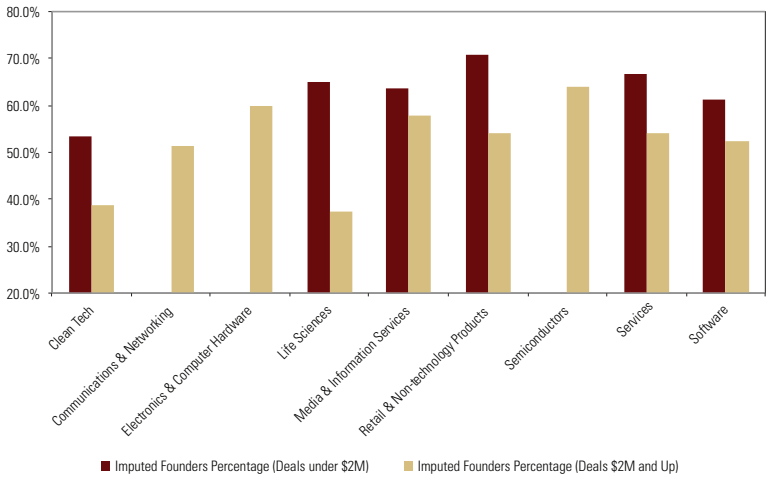
[2] We have ignored the fact that some of the investment in a first equity financing may not be new dollars, but rather may be conversion of debt previously issued to friends and family or angel investors. As a result, any such amounts are included on the investor side of the ledger in our analysis even though the portion of the capitalization held by these persons frequently comes out of the founders' share.
[3] We calculated an imputed founders' share for each deal and then took the median of the results for each sector. Thus, the median imputed founders' share differs from what would be calculated using the median pre-money valuation and the median amount invested, which are likely to be different deals.

(Continued on page 10)

Valuations by Industry Segment . . .

Continued from page 9...

Median Imputed Founders' Share Post-money Valuation by Industry



between the two groups exceeded the differences in valuation. The ranking of the sectors in terms of imputed founders' shares also is shuffled from the ranking in the lower group. The Semiconductor and Electronics & Computer Hardware sectors, which had too few deals to appear in the under $2 million group, led the $2 million and above group with median imputed founders' shares of 64% and 60%, respectively. Even among those sectors that appear in both groups, the ranking differs. Retail & Non-technology Products companies were in the middle of the pack, and Media & Information Services went from third lowest in the lower group to third highest in this group, with a median of 58%. Clean Technology once again lagged the other sectors at 39%, but here the sector with the lowest imputed founders' share was Life Sciences, at 38%. Once again, it appears that first-round Life Sciences deals seem driven by factors different from those affecting the IT sectors.

Admittedly, the sample in a number of these sectors is small, so it may not be warranted to draw fine distinctions among them. But some general observations can be made: It seems difficult to do very small deals in the harder IT sectors of Semiconductors and Electronics & Computer Hardware, but that doesn't prevent founders from doing very well in terms of retaining a greater share of their ventures following their first equity financings. At the same time, it is also clear that Clean Technology ventures and their founders face serious funding challenges by all measures.

Industry Segment	# of Deals under $2M	Median Amount Invested ($M)	Median Pre-money ($M)	Imputed Founders' Percentage of Post-money Valuation	# of Deals $2M and Up	Percent of Deals over $2M	Median Amount Invested ($M)	Median Pre-money ($M)	Imputed Founders' Percentage of Post-money Valuation
Clean Tech	7	$0.78	$2.20	53.3%	5	41.7%	$4.00	$6.00	38.8%
Communications & Networking	N/A	N/A	N/A	N/A	11	78.6%	$3.88	$8.00	51.3%
Electronics & Computer Hardware	N/A	N/A	N/A	N/A	8	88.9%	$3.00	$12.00	59.8%
Life Sciences	30	$1.01	$3.50	64.9%	26	46.4%	$5.23	$5.13	37.5%
Media & Information Services	35	$0.88	$3.00	63.8%	14	28.6%	$4.60	$13.50	57.8%
Retail & Non-technology Products	13	$0.75	$4.48	70.7%	14	51.9%	$4.22	$9.95	54.0%
Semiconductors	N/A	N/A	N/A	N/A	4	80.0%	$3.32	$12.30	64.0%
Services	12	$0.60	$2.43	66.6%	17	58.6%	$4.60	$9.50	54.2%
Software	37	$0.94	$3.50	61.2%	42	53.2%	$5.20	$13.00	52.4%

To Form or Not to Form: Contract Formation in the Real World

By Caitlin Courtney, Associate, Palo Alto

A company that is selling or licensing intangible products such as software or other services to consumers and businesses frequently will wish to use contract law to protect its preexisting rights and limit liability. However, a legally enforceable contract requires acceptance. The consent to be bound by the terms of the contract is often best evidenced by a party's signature to a written agreement. Frequently, though, in commercial transactions involving software and similar products, it may not be feasible to obtain the signatures of both parties. Nevertheless, there are other ways to form a contract. This article explores the risks of some of the different methods of contract formation.

Online Contracts

If the transaction will occur online, there are two primary methods of forming a contract without a signature: browse wrap or click wrap. "Browse wrap" refers to posting a link to terms on a website without requiring the user to affirmatively express acceptance of those terms (i.e., browsing the website allegedly binds the user). "Click wrap" requires the user to click through the terms and accept them, usually by checking a box that indicates that the customer accepts the terms of the agreement prior to purchasing or accessing products or services.

In determining if browse-wrap or click-wrap agreements are enforceable, courts generally look for actual or constructive consent. In the browse-wrap context, the mere act of using a website is generally insufficient to bind a customer to its terms. Courts have reasoned that, without clear notice of the terms, customers cannot be deemed to have agreed to them. Thus, browse wrap is more likely to be enforced when a link to the terms is prominently displayed on the company's website, effectively putting users on notice of the terms prior to using the service. Some courts, however, remain hesitant to enforce browse-wrap agreements because they do not require users to take affirmative action to agree to the terms. By comparison, since click wrap requires users' affirmative acceptance, courts generally find that conspicuous click-wrap terms form a binding, enforceable contract. Thus, browse wrap raises many more risks than click wrap and, accordingly, click wrap is generally preferable.

However, neither method of online contracting is risk free. For example, in a click-wrap scenario, a company employee who clicks and accepts the terms might not have the authority to bind the company. Although the terms of the contract can be written to minimize this risk, it cannot be entirely eliminated. Likewise, the content of the terms may render them unenforceable in certain circumstances, such as if the terms are so unfair that they are deemed substantively "unconscionable" by a court or if the terms allow one party to modify the contract at any time without consent.

Shrink Wrap

Another method of contract formation is shrink wrap. "Shrink wrap" refers to terms that can be read and accepted after a product is delivered to the customer. Merely including contractual terms contemporaneously with the delivery of products or services does not form an enforceable contract, because there is no way to demonstrate actual or constructive consent by the user to be bound by those terms. Generally, the customer must have prior notice of the terms and take an affirmative action, such as clicking and accepting the terms, prior to installing or using the product. Additionally, for a shrink-wrap agreement to be enforceable, courts in some jurisdictions require that the customer be given a right to return the product and receive a full refund if the customer does not agree to the terms. This may raise practical problems for companies that do not want to offer, in effect, an optional return right. Further, there is a risk that the contract may not be enforceable to the extent that the customer already has a contract with the seller or another party, such as an intervening reseller, or if the terms are substantively unconscionable. While a shrink-wrap agreement is better than no agreement at all, it carries a greater risk of unenforceability than a signed agreement or a click-wrap agreement.

Purchase Orders

A common method of forming a contract is through the acceptance of a purchase order. A customer's purchase order usually contains that customer's buyer-friendly standard terms. Accordingly, the seller typically will respond with a confirmation or acknowledgment that contains seller-friendly terms. In this "battle of the forms" between two businesses, a contract is often created under the Uniform Commercial Code (UCC). Depending on the circumstances, a court could either determine that the seller's acknowledgment was an acceptance of the customer's offer, thereby forming a contract, or, if the parties actually performed the sale (by shipping and accepting the product), that a contract was deemed to have been formed. Under the UCC, the resulting contract likely will exclude many of the seller's important terms, particularly as to warranty and liability. The final contract also could incorporate UCC standard "gap filler" terms that are customer friendly. As a result, this method of contracting creates uncertainty regarding the existence and content of the agreement, and therefore poses risks to a seller.

(Continued on page 12)

To Form or Not to Form . . .

Continued from page 11...

Comparing Methods of Formation

The best method for creating an enforceable contract in any given situation depends upon a company's particular business process and willingness to accept risk. For example, where inappropriate use of a particular product may result in significant loss to the user, it is important to have an enforceable disclaimer of warranties as part of an enforceable contract. This may lead a company to favor a more conservative approach, such as a click wrap. However, in other cases, practical constraints may require that a company accept purchase orders and take on additional risk. Therefore, it is important to carefully weigh the benefits of the different methods of creating a contract against the risks that the agreement may be unenforceable or exclude the terms that the company desires.

WSGR

Wilson Sonsini Goodrich & Rosati

PROFESSIONAL CORPORATION

650 Page Mill Road, Palo Alto, California 94304-1050 | Phone 650-493-9300 | Fax 650-493-6811 | www.wsgr.com

Austin Beijing Brussels Georgetown, DE Hong Kong Los Angeles New York Palo Alto San Diego San Francisco Seattle Shanghai Washington, DC

For more information on the current venture capital climate, please contact any member of Wilson Sonsini Goodrich & Rosati's entrepreneurial services team. To learn more about WSGR's full suite of services for entrepreneurs and early-stage companies, please visit the Entrepreneurial Services section of wsgr.com.

For more information about this report or if you wish to be included on the email subscription list, please contact Eric Little (elittle@wsgr.com). There is no subscription fee.