2011 Venture Capital Report

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Review

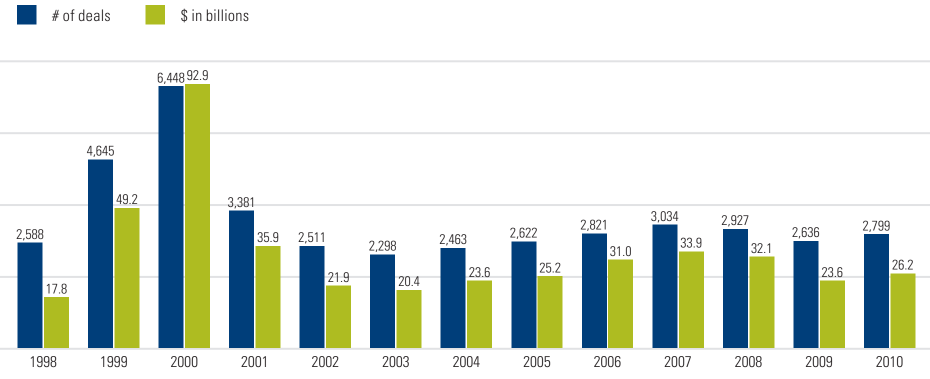
After a seesaw year in which quarterly deal volumes were relatively stable but quarterly proceeds varied widely, the venture capital market ended 2010 on a high note, topping 2009's results by a comfortable margin. Liquidity performance was even more impressive in 2010, with the number of VC-backed IPOs soaring and M&A transaction activity posting solid gains.

In 2010, 2,799 reported venture capital financings raised total proceeds of $26.2 billion, compared to the 2,636 financings that raised $23.6 billion in 2009. Financing activity in 2010 reflected the robust capital market and economic conditions that generally prevailed throughout the year. Deal volumes were fairly level in 2010, producing quarterly totals of 629, 762, 673 and 735 transactions. Quarterly proceeds were uneven, however, jumping from $4.7 billion in the first quarter to $8.1 billion in the second quarter, and slumping to $5.9 billion in the third quarter before rebounding to $7.6 billion in the fourth quarter. Some of the variability in quarterly proceeds may reflect reporting delays.

The median size of all venture capital financings dipped from $5.0 million in 2009 to $4.5 million in 2010, representing the third consecutive annual decline and the lowest figure since 1998. The median financing size for life sciences companies decreased from $5.6 million in 2009 to $4.6 million in 2010, while information technology companies saw their median financing size hold steady at $5.0 million.

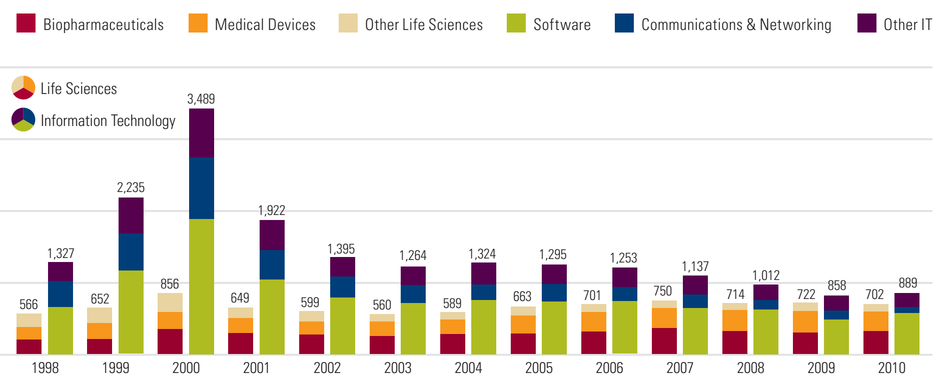
Overall, valuations of venture-backed companies declined from 2009 to 2010. The median pre-money valuation for all venture financings was $13.5 million in 2010—the lowest figure since 2004—compared to $20.8 million in 2009. Among life sciences companies, the median pre-money valuation decreased from $21.5 million in 2009 to $13.1 million in 2010. Information technology companies saw a similar drop in median pre-money valuation, from $19.8 million to $12.8 million.

US Venture Capital Financings – 1998 to 2010



Source: Dow Jones VentureOne

US Venture Capital Financings by Industry – 1998 to 2010



Source: Dow Jones VentureOne

Seed and first-round venture capital financings represented 35% of the total number of venture financings in 2010 (compared to 33% in 2009) and 17% of the total amount of venture capital investment (compared to 18% in 2009). Seed and first-round financings have constituted between 29% and 41% of the total number of all venture financings in each year since 2001. The proportion of seed and first-round investing activity over the past decade, however, is significantly lower than the proportion prior to 2001. This relative decline in early-stage investing activity is due, in part, to the fact that more rigorous investment criteria are being applied by investors, and in part to the longer average time from initial funding to a liquidity event, which increases the relative amount of money needed for investment in later-stage companies.

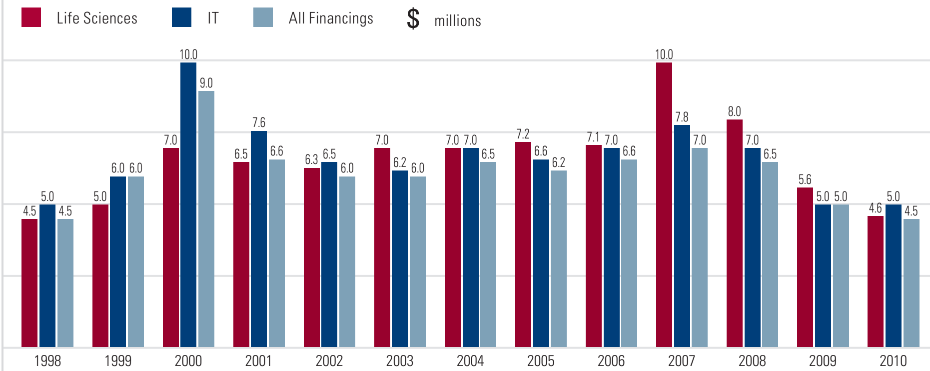
The breakdown of venture capital financings by industry sector in 2010 exhibits a continuation of longer-term trends. The gap in the number of financings between life sciences companies and information technology companies has been narrowing for a decade. In 2010, IT companies represented 32% of all venture capital financings, while life sciences companies constituted 25%. In 2010, for the second consecutive year, the amount invested in life sciences companies exceeded the amount invested in information technology companies.

The geographic breakdown for venture capital investing has remained fairly constant since 1996 (the first year for which this data is available). California-based companies accounted for 40% of all venture financings in 2010, and have led the country in this regard in each year since 1996. Massachusetts, home to 10% of the companies receiving venture financing in 2010, again finished second in this category, as it has in each year since 1996. New York, Texas and Pennsylvania rounded out the top five positions for 2010.

After all but disappearing in 2008 and the first half of 2009, due to the global economic crisis and declines in the capital markets, the IPO market for VC-backed companies bounced back in 2010. A total of 46 venture-backed companies went public, up from just eight in 2009. The largest VC-backed IPO of 2010 belonged to FXCM, an online provider of foreign exchange trading and services. The median amount of time from initial funding to an IPO was 8.1 years in 2010, up from 2009's median of 7.9 years but below the record 8.7-year median recorded in 2008.

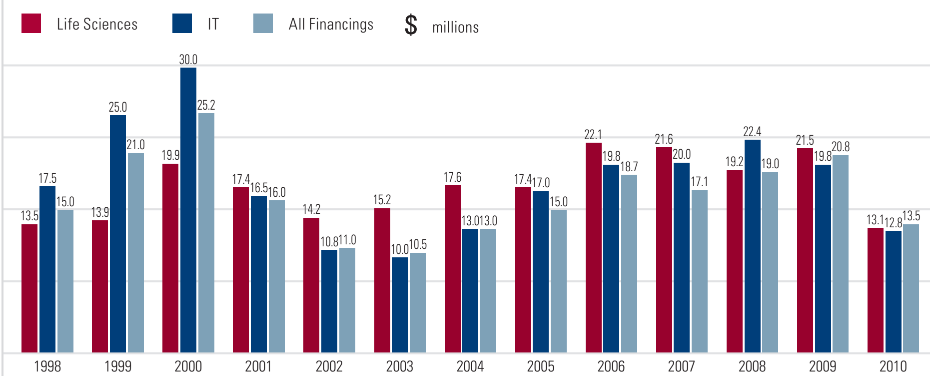
The ratio of pre-IPO valuations to the median amount raised prior to IPO by venture-backed companies going public dropped from 8.9:1 in 2009—the highest since at least 1996—to 4.1:1 in 2010. (A higher ratio means higher returns to pre-IPO investors.) The ratio for 2009 reflected higher IPO valuations coupled with the lowest level of pre-IPO financing of venture-backed IPO companies in 10 years, while the ratio for 2010 was consistent with recent historical levels. This ratio was between 3.1:1 and 5.3:1 for each year from 2001 to 2008. In contrast, this ratio ranged from 7.7:1 to 10.0:1 from 1997 to 2000, due to outsized pre-IPO valuations by younger companies.

Median Size of US Venture Capital Financings – 1998 to 2010



Source: Dow Jones VentureOne

Median Pre-Money Valuation in US Venture Capital Financings – 1998 to 2010



Source: Dow Jones VentureOne

The M&A market for venture-backed companies was stronger in 2010 than in 2009, reflecting the availability of large cash balances by strategic buyers and positive economic conditions. There were 531 reported acquisitions of venture-backed companies in 2010, compared to 408 in 2009. Purchase prices also jumped, with the median acquisition price for venture-backed companies increasing to $40.0 million in 2010 from $27.0 million in 2009, which had been the lowest figure since 2003. The median amount of time from initial funding to acquisition was 5.2 years in 2010, down from 5.5 years in 2009.

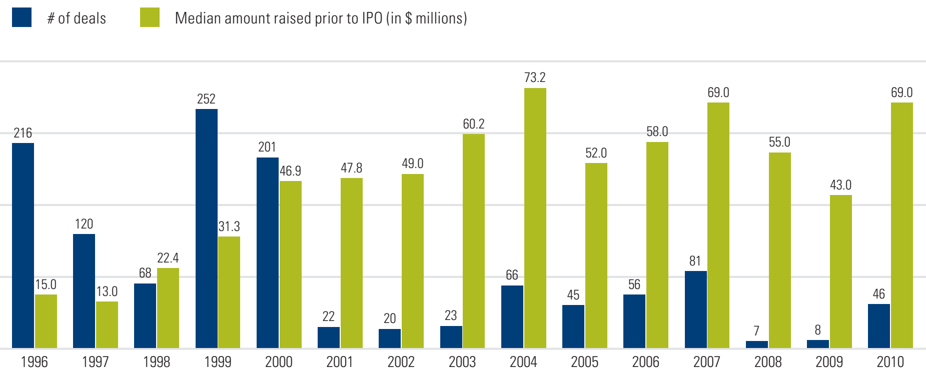
The largest VC-backed company acquisition of 2010 was Ascent Media's purchase of Monitronics International for $1.2 billion. This was the first billion-dollar transaction since 2008, when EqualLogic was acquired by Dell for $1.4 billion and MySQL was acquired by Sun for $1.0 billion. There were a total of eight VC-backed company acquisitions of more than $500 million in 2010, compared to four in the prior year.

The ratio of median acquisition price to median amount raised prior to acquisition was 2.0:1 in 2010, compared to 1.3:1 in 2009 and 1.6:1 in 2008. (A higher ratio means higher returns to pre-IPO investors.) The 2008 and 2009 ratios were in line with the ratios of between 1.1:1 and 1.8:1 that prevailed each year between 2001 and 2005. In 2006 and 2007, strong acquisition prospects propelled the ratios to 2.4:1 and 2.9:1, respectively. At the peak of the dot-com craze, the ratio was a staggering 10.0:1.

The above comparison of the ratios of valuations to the financing amounts required to achieve liquidity events indicates that returns to venture capital investors are higher on IPOs than on M&A transactions. This is hardly surprising, since few underperforming companies are able to go public. The higher valuations ascribed to IPO companies are offset in part, however, by the fact that the median amount raised prior to liquidity event for M&A companies is generally less than half the amount for IPO companies, and the reality that venture investors generally achieve liquidity more quickly in an M&A transaction (which frequently yields the bulk of the purchase price in cash at closing) than in an IPO (which generally involves a post-IPO lockup period of 180 days and market uncertainty on the timing and prices of subsequent sales).

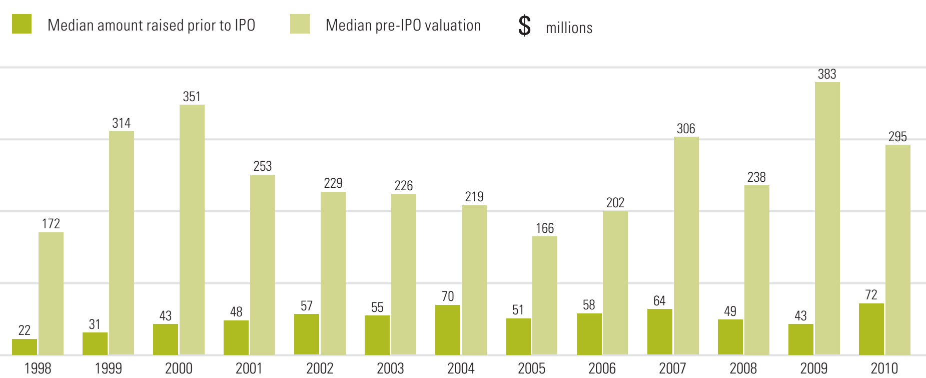
The 11:5 ratio of M&A transactions to IPOs for venture-backed companies in 2010 reflected dramatic improvement from the ratio of 51:1 in 2009 (and the even worse ratio of 54:1 in 2008) and the return to a level close to historical norms. This ratio was 8:1 during the period 2004–2007, 19:1 during the period 2001–2003, and a remarkable 2.1:1 during the Internet boom of 1998–2000.

US Venture Capital–Backed IPOs – 1996 to 2010



Source: Dow Jones VentureOne

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1998 to 2010



Source: Dow Jones VentureOne

Outlook

Venture capital investing and liquidity activity in the first half of 2011 was largely consistent with the comparable period of 2010. Growing concern over economic conditions, however, is tempering optimism for the balance of the year.

Nearly $15.0 billion was invested in approximately 1,500 venture capital financings in the first half of 2011, representing a 10% increase in proceeds compared to the first half of 2010. The number of deals increased only slightly during this period; the increase in total proceeds was primarily attributable to an increase in median financing size. These results are likely to be revised upward as additional data becomes available, but full-year 2011 activity could fall short of 2010 results if economic conditions worsen.

The year-to-date liquidity picture is similar to the financing landscape. The number of IPOs by venture-backed companies increased from 23 in the first half of 2010 to 25 in the first half of 2011, including prominent IPOs by LinkedIn ($352.8 million) and HomeAway ($216.0 million). Reported acquisition activity edged downward during this period, from 236 to 215 deals, although delayed reporting probably explains much or all of the decline in volume. The first half of 2011 has already produced five VC-backed company acquisitions of more than $500 million, underscoring the willingness of strategic buyers to pay large amounts for attractive targets.

The level of venture capital financing activity over the next year will be significantly affected by general economic conditions, investor confidence and the health of the IPO market for VC-backed companies. Entering 2011, the outlook for the year was generally positive, but more recent developments—including the looming sovereign debt and banking crisis in Europe—have clouded the prognosis.

Investor interest in the consumer Internet sectors should remain strong, although valuations may undergo a correction from the recent levels that at times have seemed reminiscent of the dot-com era. Valuations in other sectors will also be under pressure over the coming year if conditions in the economy at large and in the capital markets worsen.

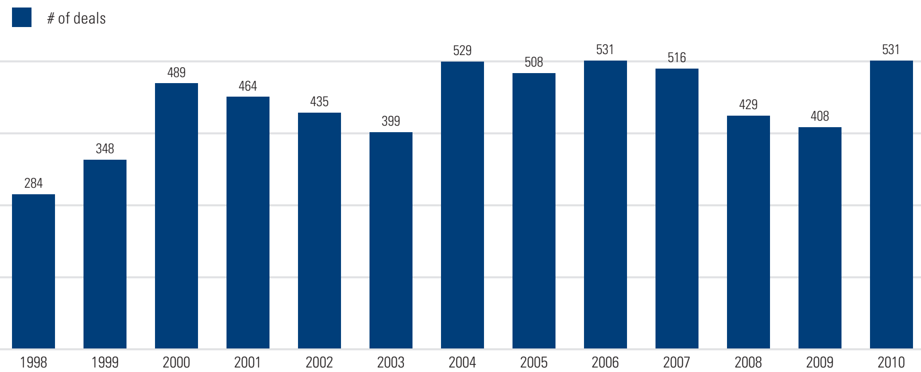
The clean technology and renewable energy sector should benefit from heightened environmental awareness, the availability of government funding, and the long-term trend in rising energy prices. Problems with distribution, larger numbers of competing technologies, and the need in many cases for significantly larger investment amounts than in traditional venture-backed industries may cause some investors to approach this market cautiously.

Ongoing globalization in venture investing is likely to continue. International markets such as China, India and parts of Southeast Asia, as well as portions of Eastern Europe and South America, are spawning increased entrepreneurial activity and innovation, and the regulatory environments in those countries are also becoming more hospitable to foreign investment. These factors are partially offset, however, by concerns about the political and economic environments in these regions and the somewhat undeveloped "ecosystems" in which these companies will have to develop. As a result, while investments in international-based companies should continue to increase, they are likely to do so at a measured pace.

The outlook for the IPO market for VC-backed companies is unclear at the moment, particularly for the smaller, emerging-growth companies that exemplify VC-backed company IPO candidates. The number of VC-backed IPOs surged from 2009 to 2010, and increased further in the first half of 2011, reflecting economic growth and relatively stable market conditions. However, extreme volatility in the capital markets—fueled by the downgrade of the US credit rating that followed the political brinkmanship of this past summer's debt cap increase debate and concerns about a "double dip" recession—is threatening to derail the IPO market. A large pipeline of pending IPOs, including widely anticipated offerings by high-profile Internet companies, should test the market this fall.

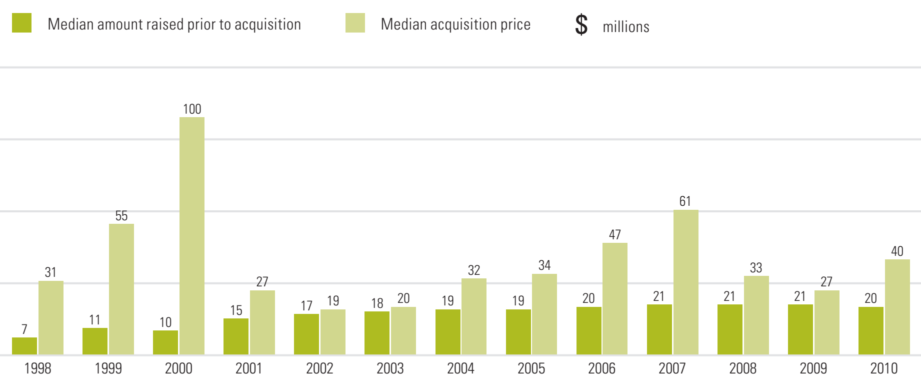
Deal activity and valuations in the M&A market also present a mixed outlook over the coming year. Strategic acquirers have large cash balances to deploy, but may pull back if the economy stagnates. Moreover, any softening of the venture-backed IPO market would negatively affect the M&A market because limitations on the IPO market as a credible alternative diminish the leverage of venture-backed companies in negotiating acquisition prices, and because any general economic concerns that dampen the IPO market will also adversely affect the valuations of target companies. ■

Acquisitions of US Venture-Backed Companies – 1998 to 2010



Source: Dow Jones VentureOne

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1998 to 2010



Source: Dow Jones VentureOne

California

California companies reported 1,190 financings in 2010, up from 1,127 financings in 2009. In a dramatic reversal of fortune from the prior year, proceeds soared from $10.83 billion to $18.53 billion in 2010. Liquidity outcomes for California VC-backed companies also improved substantially, with a nearly tenfold increase in IPOs and a year-over-year increase of more than 50% in the number of acquisitions.

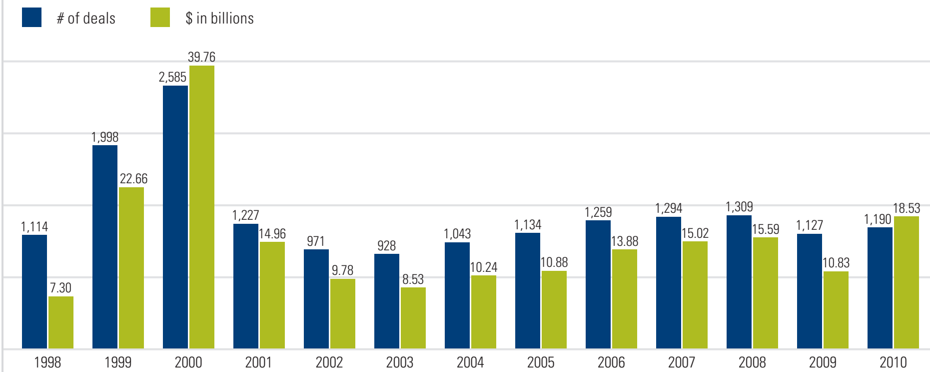
Nearly four times the size of the next-largest venture capital market in the United States, California was responsible for 40% of the nation's financing transactions in 2010. The year's tallies for both deals and proceeds were the largest ever achieved in California other than during the peak of the dot-com boom—in 2000, California produced a staggering 2,585 financings with nearly $40 billion in proceeds.

California's venture capital market spans all industry sectors, with particular strengths in consumer Internet, information technology, life sciences, cleantech, consumer retail and media/entertainment. With a 40% market share, information technology was the largest sector in the state in 2010, followed by life sciences at 18%. California's best-known VC-backed companies are, of course, in social media.

The state generated 19 IPOs by VC-backed companies in 2010, compared to just two in 2009. The number of reported acquisitions of VC-backed companies increased from 168 to 262—the highest total since at least 1996. California produced half of the eight venture-backed company acquisitions nationwide in 2010 that exceeded $500 million, including Acclarent's acquisition by Ethicon for $785 million and AdMob's acquisition by Google for $750 million.

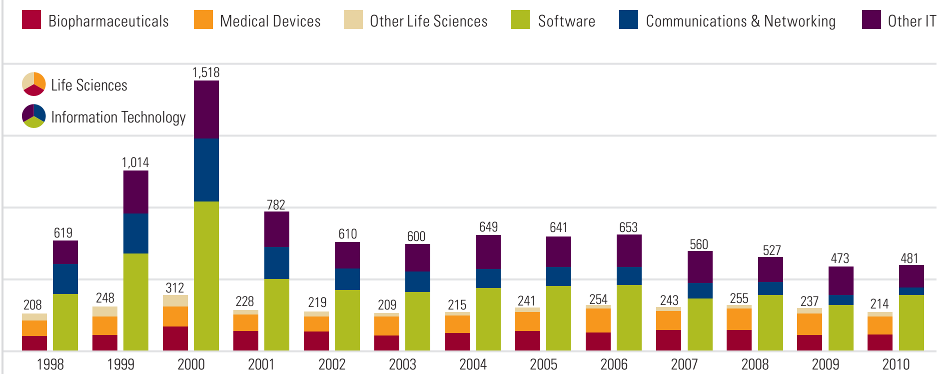
We expect California to maintain its venture capital leadership in the coming year. Future growth in financing activity and continued strength in liquidity will depend, in part, on general economic conditions, the willingness of strategic buyers to pay attractive premiums and the overall health of the capital markets. Liquidity highlights from the first half of 2011 include LinkedIn's $352.8 million IPO and Plexxikon's $805 million acquisition by Daiichi Sankyo.

California Venture Capital Financings – 1998 to 2010



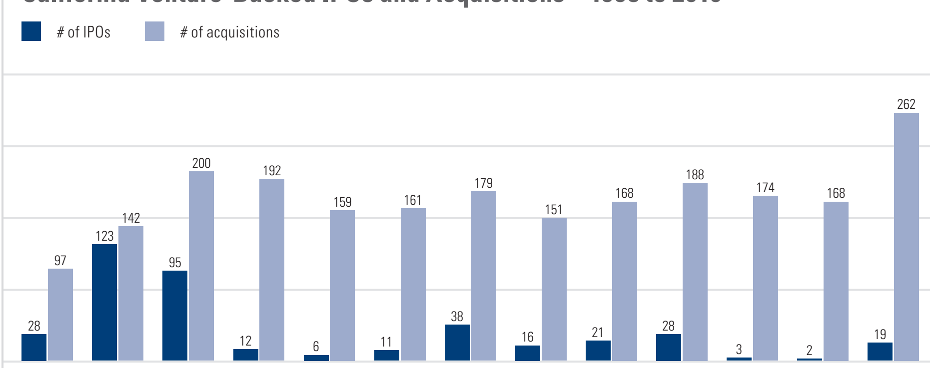
Source: Dow Jones VentureOne

California Venture Capital Financings by Industry – 1998 to 2010



Source: Dow Jones VentureOne

California Venture-Backed IPOs and Acquisitions – 1998 to 2010



Source: Dow Jones VentureOne

Mid-Atlantic

The number of reported venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia increased from 145 in 2009 to 161 in 2010, while proceeds jumped from $1.08 billion to $1.53 billion. Although they do not rival the deal activity that prevailed between 1999 and 2001, annual tallies for venture capital financings and proceeds in the mid-Atlantic region remain above the levels seen in the pre-bubble years.

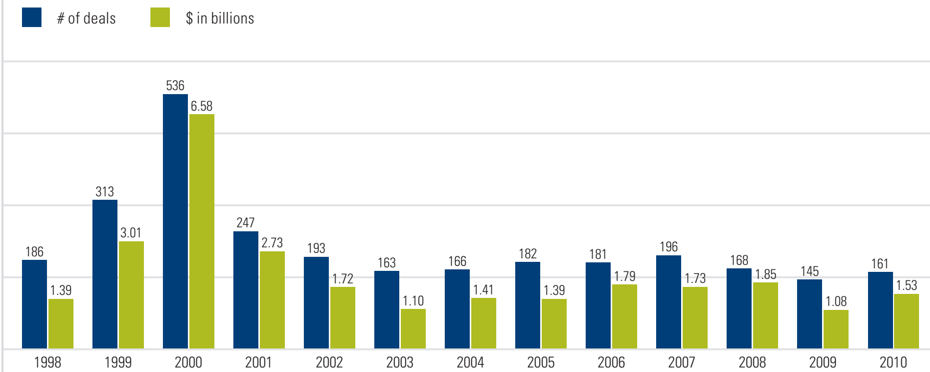
The percentage of all mid-Atlantic financings completed by information technology companies increased from 32% in 2009 to 35% in 2010. The region's life sciences sector—which outpaced the information technology sector for the first time in 2009—saw its market share drop from 37% to 29%.

After being shut out of the VC-backed IPO market in 2009 for the second consecutive year, the mid-Atlantic region rebounded with three IPOs in 2010: BroadSoft ($67.5 million), Primo Water ($100.0 million) and SciQuest ($57.0 million).

The number of reported acquisitions of venture-backed companies in the mid-Atlantic region increased from 33 in 2009 to 35 in 2010, and this gap should widen once all transactions are reported. Virginia continued to lead the region in VC-backed M&A transactions in 2010, with 18 deals, followed by Maryland with 11. The region's largest deal of the year was the $545 million acquisition of Bravo Health by HealthSpring, followed in size by PAETEC Holding's acquisition of Cavalier Telephone for $460 million.

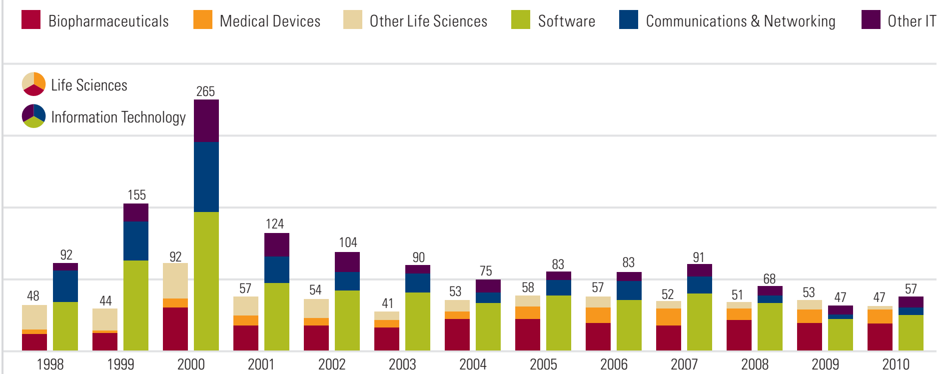
In the coming year, we expect that the mid-Atlantic region will remain a leading investment center for technology and life sciences companies and will spawn additional candidates to pursue IPOs as market conditions permit. We also expect that the information technology and defense industries will produce a steady stream of attractive emerging companies in the region.

Mid-Atlantic Venture Capital Financings – 1998 to 2010



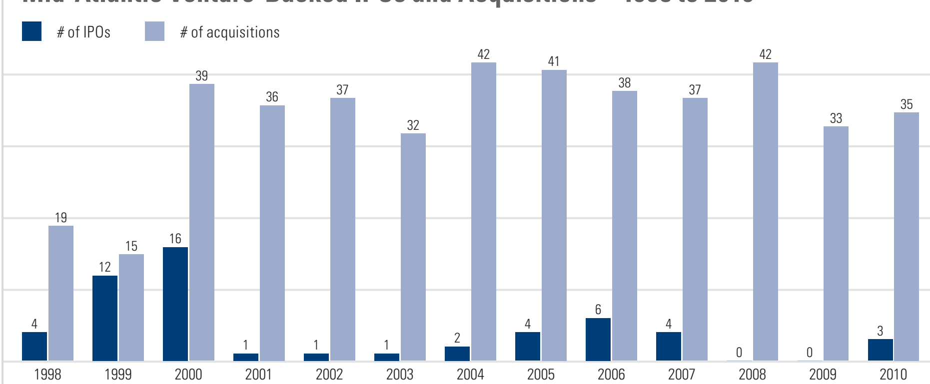
Source: Dow Jones VentureOne

Mid-Atlantic Venture Capital Financings by Industry – 1998 to 2010



Source: Dow Jones VentureOne

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1998 to 2010



Source: Dow Jones VentureOne

New England

New England companies reported 370 financings in 2010, up from 344 in 2009, but proceeds dropped to $2.77 billion from $3.13 billion—the third consecutive year in which proceeds have declined. Once all transactions have been reported, the year-over-year decline in financing proceeds should narrow, and the number of financings in 2010 should approach the largest number achieved since 2001.

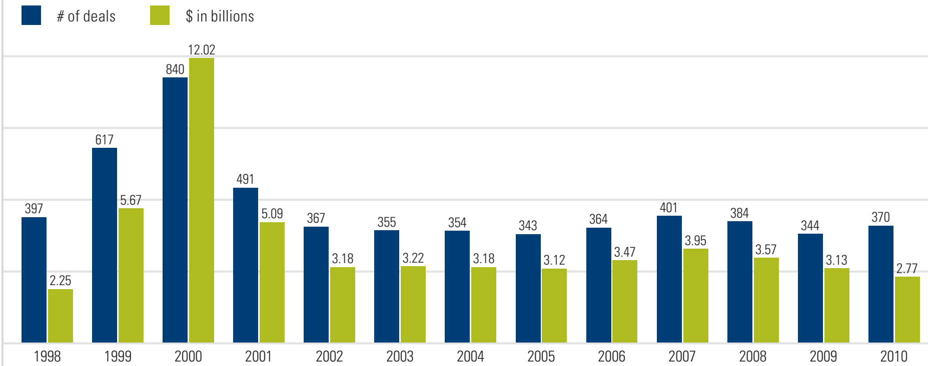
New England continues to be a leading center of activity for technology and life sciences companies. In 2010, the number of financings by information technology companies narrowly edged out the number of financings by life sciences companies, as the two sectors swapped places in the rankings again. Information technology companies accounted for 37% of New England's venture capital financings in 2010 (up from 31% in 2009) and life sciences companies contributed 36% of the region's financings (down from 40%).

New England generated three venture-backed IPOs in 2010—the $81.0 million IPO of AVEO Pharmaceuticals, the $108.0 million IPO of Higher One Holdings and the $187.5 million IPO of Ironwood Pharmaceuticals—compared to two IPOs in 2009. The region's year-to-date highlights for 2011 include IPOs by Tangoe ($87.7 million) and Zipcar ($174.3 million).

The number of reported acquisitions of VC-backed companies in New England surged from 54 in 2009 to 81 in 2010. The region's largest deal of the year was the acquisition of Alnara Pharmaceuticals by Eli Lilly for $380 million (including potential milestone payments). In the first half of 2011, BioVex Group was acquired by Amgen for $1 billion (including potential milestone payments), Advanced BioHealing was acquired by Shire for $750 million and ITA Software was acquired by Google for $700 million.

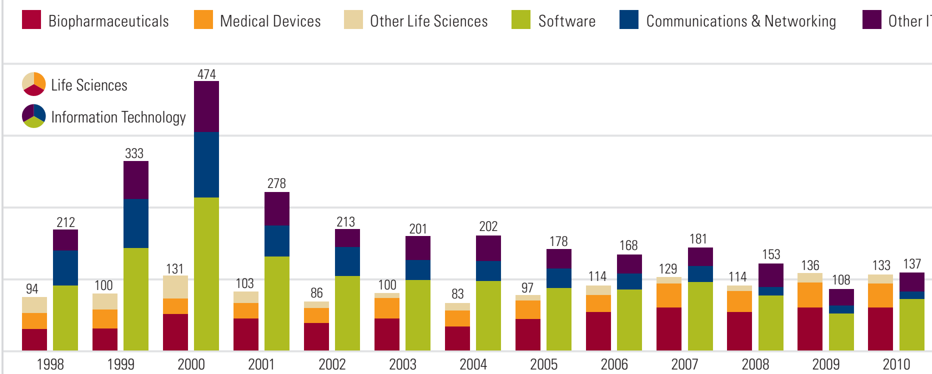
We expect New England—and Massachusetts in particular—to remain one of the country's most appealing environments for emerging companies and a hub of venture capital and IPO activity during the coming year.

New England Venture Capital Financings – 1998 to 2010



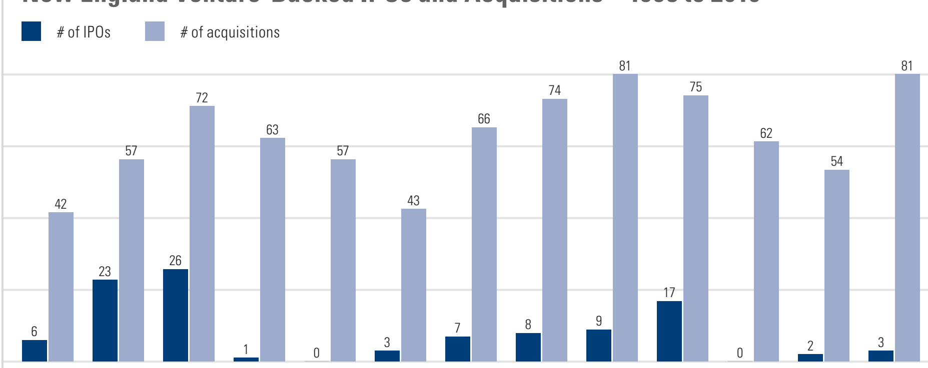
Source: Dow Jones VentureOne

New England Venture Capital Financings by Industry – 1998 to 2010



Source: Dow Jones VentureOne

New England Venture-Backed IPOs and Acquisitions – 1998 to 2010



Source: Dow Jones VentureOne

Tri-State

The number of reported venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania increased from 368 in 2009 to 467 in 2010, while proceeds rose from $2.39 billion to $3.23 billion. These increases were primarily attributable to financing activity in New York, which saw the number of deals shoot up from 190 to 278—just behind Massachusetts in the state rankings—and proceeds jump from $1.24 billion to $2.12 billion.

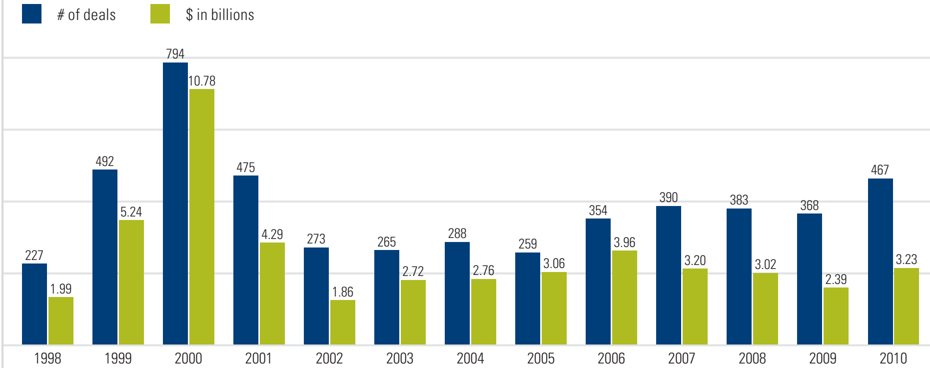
Information technology companies garnered the largest share of the tri-state region's VC financing market in 2010, with 26% of the region's financings, the same percentage as in 2009. Life sciences companies, which had led the tri-state region's rankings for the first time in 2009, accounted for 24% of the region's financings in 2010, down from 28% in the prior year.

The tri-state region produced eight venture-backed IPOs in 2010, compared to only one in 2009. The region's largest VC-backed IPOs of 2010 were by FXCM ($210.8 million), IntraLinks Holdings ($143.0 million) and Qlik Technologies ($112.0 million).

Reported acquisitions of venture-backed companies in the tri-state region more than doubled, from 40 in 2009 to 88 in 2010. The region's largest deals of 2010 were Eli Lilly's acquisition of Avid Radiopharmaceuticals for $300 million and Cephalon's acquisition of Ception Therapeutics for $250 million. In the first half of 2011, the region produced three deals in excess of $250 million, with the acquisitions of Quidsi by Amazon for $545 million, Admeld by Google for $400 million and The Huffington Post by AOL for $315 million.

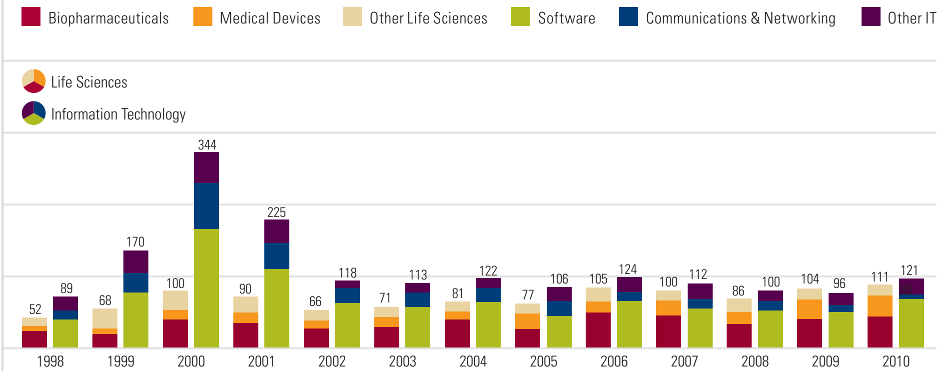
Over the coming year, we believe that the tri-state region's strengths in the pharmaceuticals, life sciences, financial services and information technology sectors—particularly in the consumer Internet space—will continue to foster a favorable environment for VC-backed startup companies and produce viable IPO candidates. ■

Tri-State Venture Capital Financings – 1998 to 2010



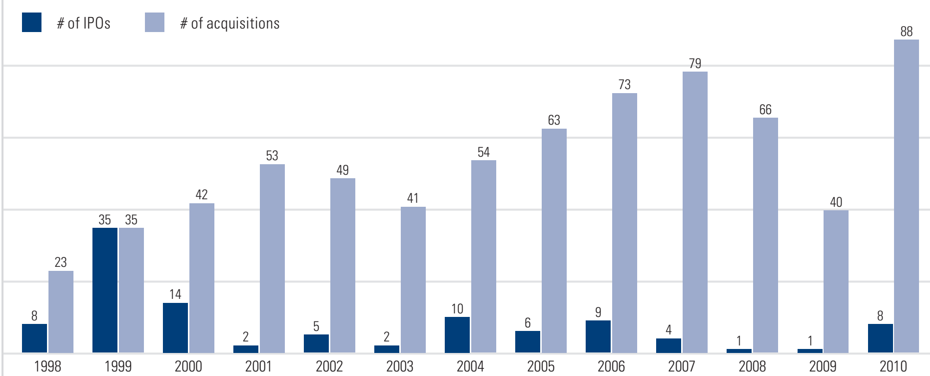
Source: Dow Jones VentureOne

Tri-State Venture Capital Financings by Industry – 1998 to 2010



Source: Dow Jones VentureOne

Tri-State Venture-Backed IPOs and Acquisitions – 1998 to 2010



Source: Dow Jones VentureOne

Counsel of Choice for Venture Capital Financings

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, CLEANTECH, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

KiOR	$55,000,000	*Third Round*	April 2011
1366 Technologies	$28,400,000	*Second Round*	October 2010
Merrimack Pharmaceuticals	$77,000,000	*Late Stage*	April 2011
Petra Solar	$40,000,000	*Second Round*	January 2010
CASA	$96,000,000	*Late Stage*	April 2010
tōkai pharmaceuticals	$23,000,000	*Fourth Round*	September 2011
Constellation Pharmaceuticals	$15,000,000	*Second Round*	June 2011
Rhythmia Medical	$7,000,000	*Third Round*	September 2010
Cerulean	$24,000,000	*Third Round*	November 2010
Metamark Genetics, Inc.	$22,000,000	*Second Round*	July 2010
BioScale	$25,000,000	*Fourth Round*	May 2010
Aylus Networks	$16,000,000	*Fourth Round*	June 2011
TransMedics	$36,000,000	*Late Stage*	February 2010
Semprus	$18,000,000	*Second Round*	December 2010
Virdante Pharmaceuticals	$47,750,000	*First Round*	October 2009
nanoterra	$17,200,000	*First Round*	December 2010
workmarket	$6,000,000	*First Round*	June 2010
Tetraphase Pharmaceuticals	$45,000,000	*Third Round*	May 2010
Xanodyne pharmaceuticals, Inc.	$88,000,000	*Late Stage*	May and October 2009
mc10	$15,000,000	*Second Round*	August 2011
Alnara Pharmaceuticals	$35,000,000	*Second Round*	January 2010
Laser Light Engines	$13,000,000	*Second Round*	September 2010
RatePoint	$7,000,000	*Third Round*	August 2010
Veracode	$12,000,000	*Fourth Round*	January 2010
Link medicine	$45,000,000	*Third Round*	April 2010
SiliconBlue Technologies	$18,000,000	*Fourth Round*	May 2011
PTC Therapeutics	$50,000,000	*Late Stage*	December 2009
catabasis	$40,000,000	*First Round*	April 2010

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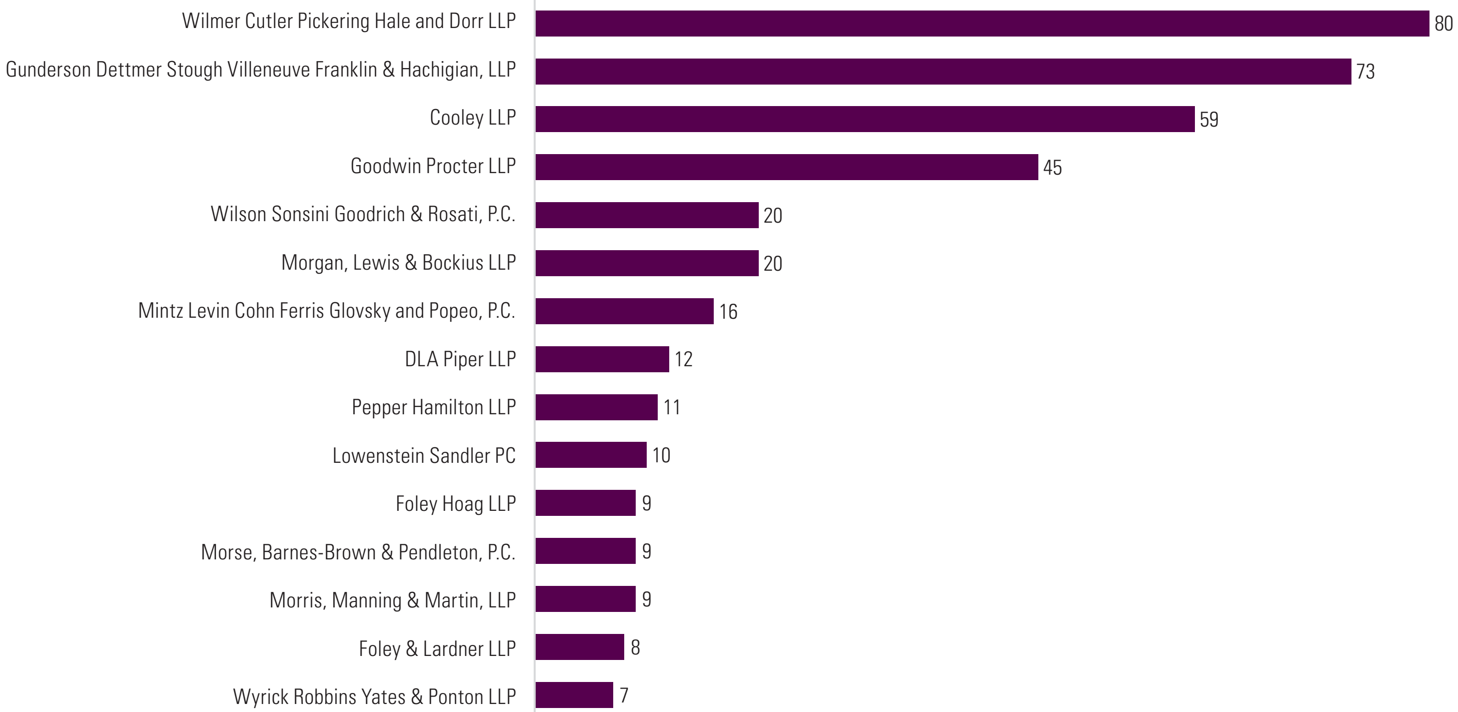
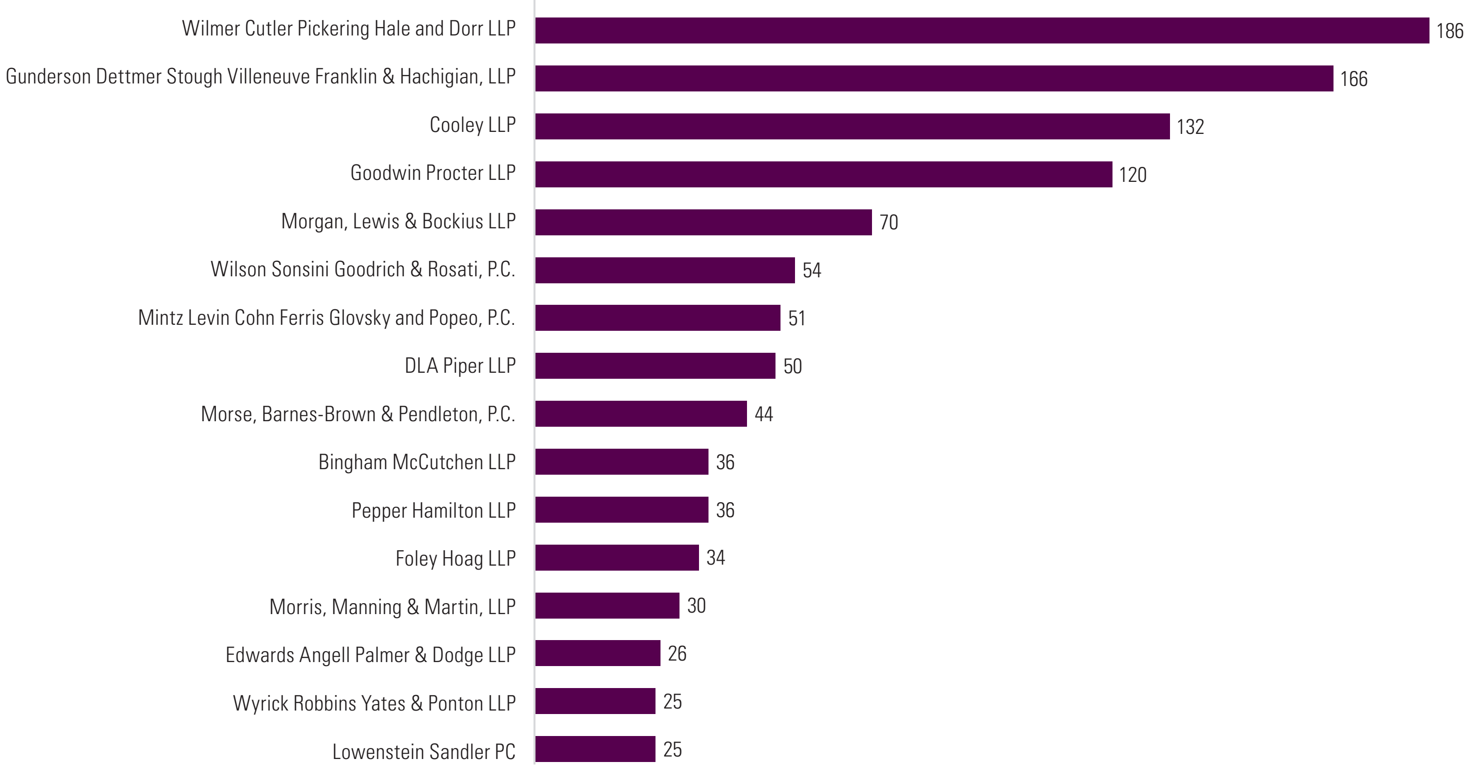
Counsel to Companies Receiving VC Financing in 2010 – Eastern US



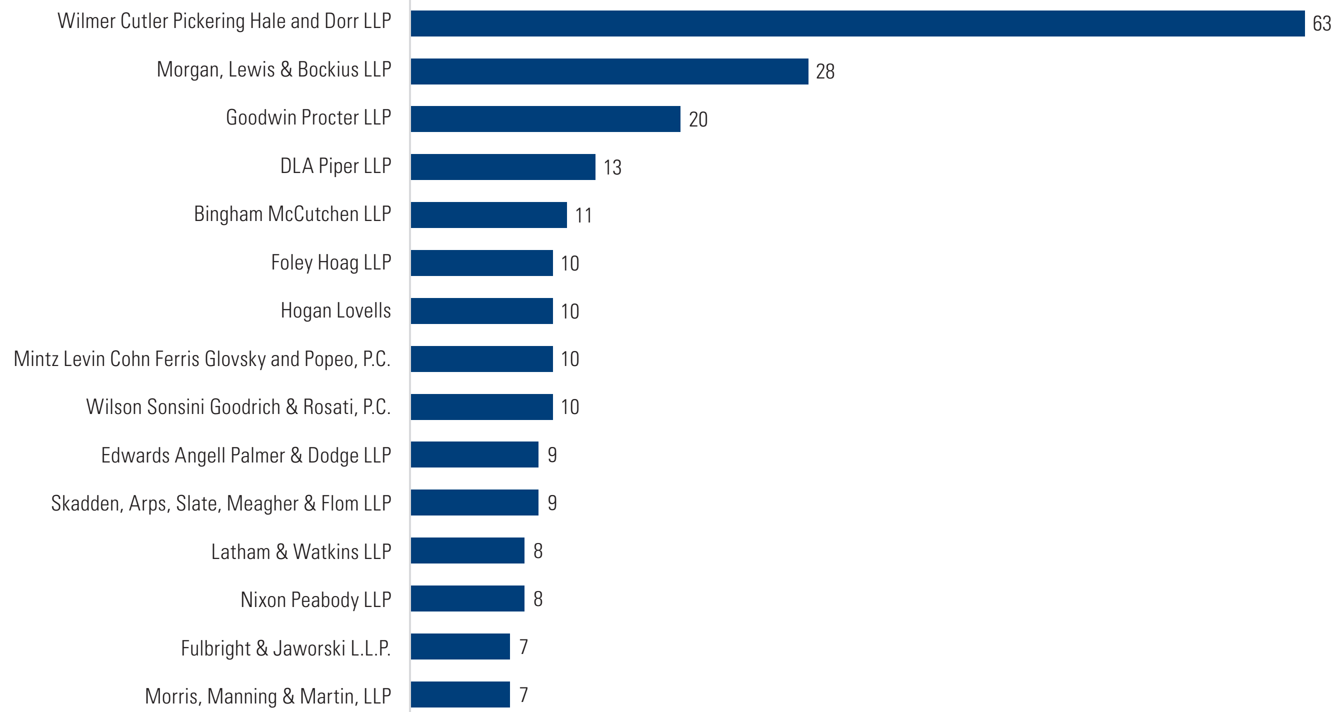
The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later-stage or restart round of venture capital financing in 2010.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2010 – Eastern US



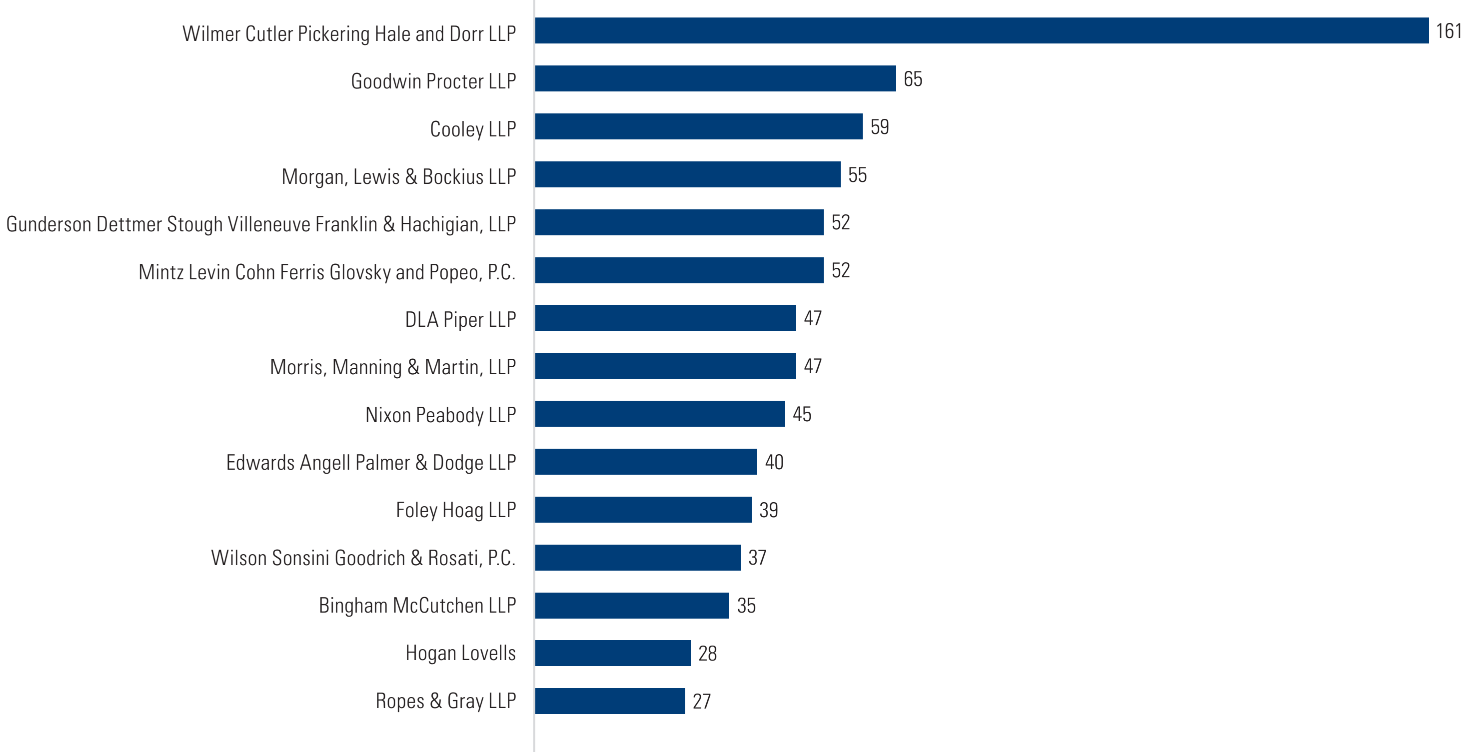
The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2010.
Source: Dow Jones VentureOne

Company Counsel in IPOs of Eastern US VC-Backed Companies – 1996 to 2010



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne and SEC filings

Company Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2010



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne

Review

In 2010, European venture capital financing activity picked up from the prior year, as evidenced by increases in proceeds and median financing size. Liquidity outcomes for European venture-backed companies also improved in 2010, with a fivefold increase in IPOs.

Venture capital financing proceeds in Europe increased to €4.2 billion in 2010 from €3.6 billion in 2009, while the number of financings was essentially flat—1,125 in 2010 compared to 1,138 in 2009. Once all 2010 transactions have been reported, the year's deal total should top 2009's tally, giving 2010 the first year-over-year increases in both deal flow and financing proceeds since 2007. The median financing size in Europe increased from €1.6 million in 2009 to €2.0 million in 2010.

The software sector again accounted for the largest portion of the European venture capital market in 2010, representing 19% of all financings, followed by biopharmaceuticals (14%) and consumer information services (12%).

The United Kingdom remained the largest venture capital market in Europe, generating 27% of all financings in 2010, followed by France (22%), Germany (14%) and Sweden (8%).

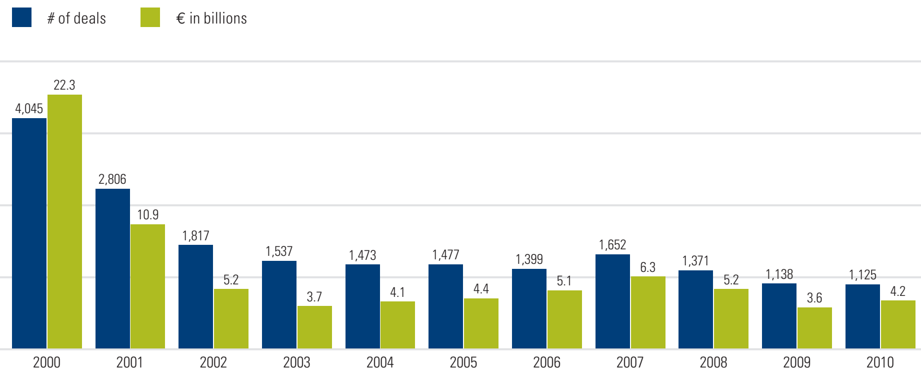
The number of IPOs by European venture-backed companies soared from three in 2009 to 15 in 2010, although this total is still well below the levels of 2004 to 2007. The number of acquisitions edged down from 155 to 139—delayed reporting suggests the actual gap in M&A activity was smaller.

Outlook

To date, the 2011 European venture capital market has shown mixed results, consistent with its uncertain outlook in light of economic concerns.

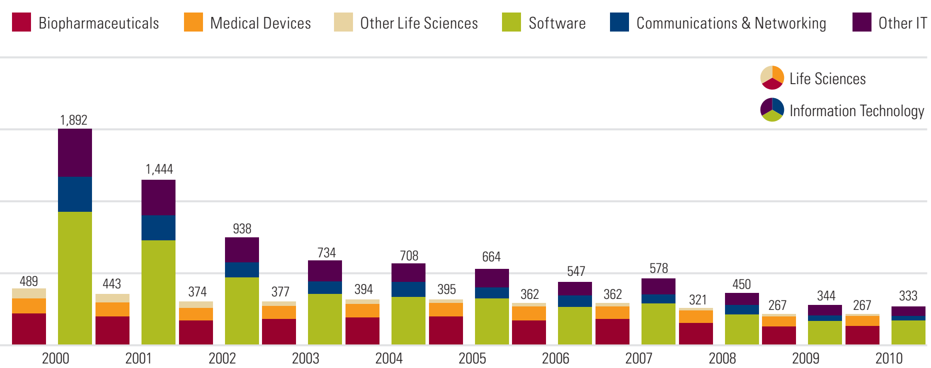
Financing activity picked up in the second quarter but is still trending below the prior year's levels. In the first half of 2011, the number of IPOs by European VC-backed companies was higher than in the first half of 2010. Meanwhile, reported acquisition activity declined from the second half of 2010, but was comparable to the first half of the year. ■

European Venture Capital Financings – 2000 to 2010



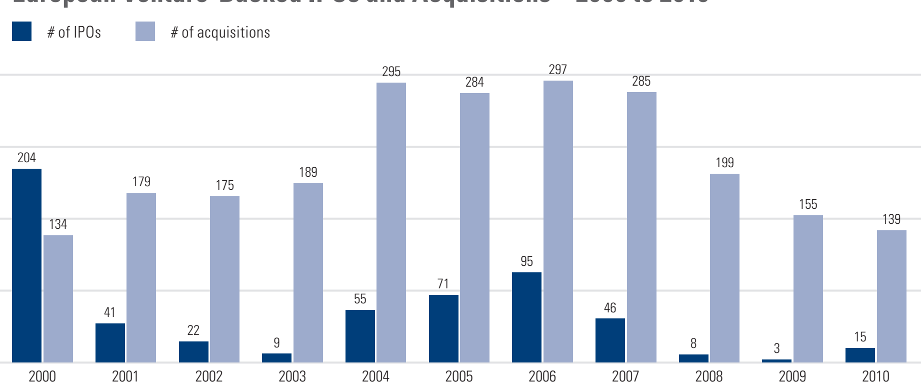
Source: Dow Jones VentureOne

European Venture Capital Financings by Industry – 2000 to 2010



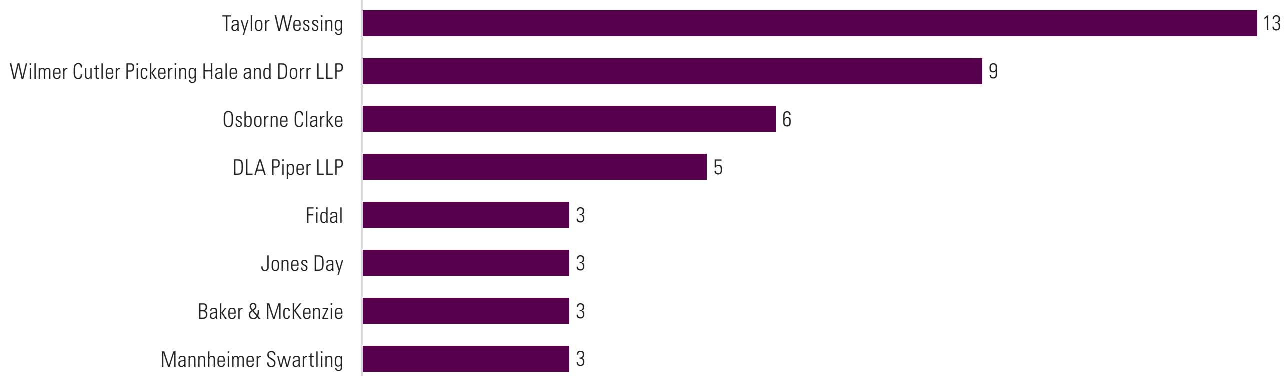
Source: Dow Jones VentureOne

European Venture-Backed IPOs and Acquisitions – 2000 to 2010



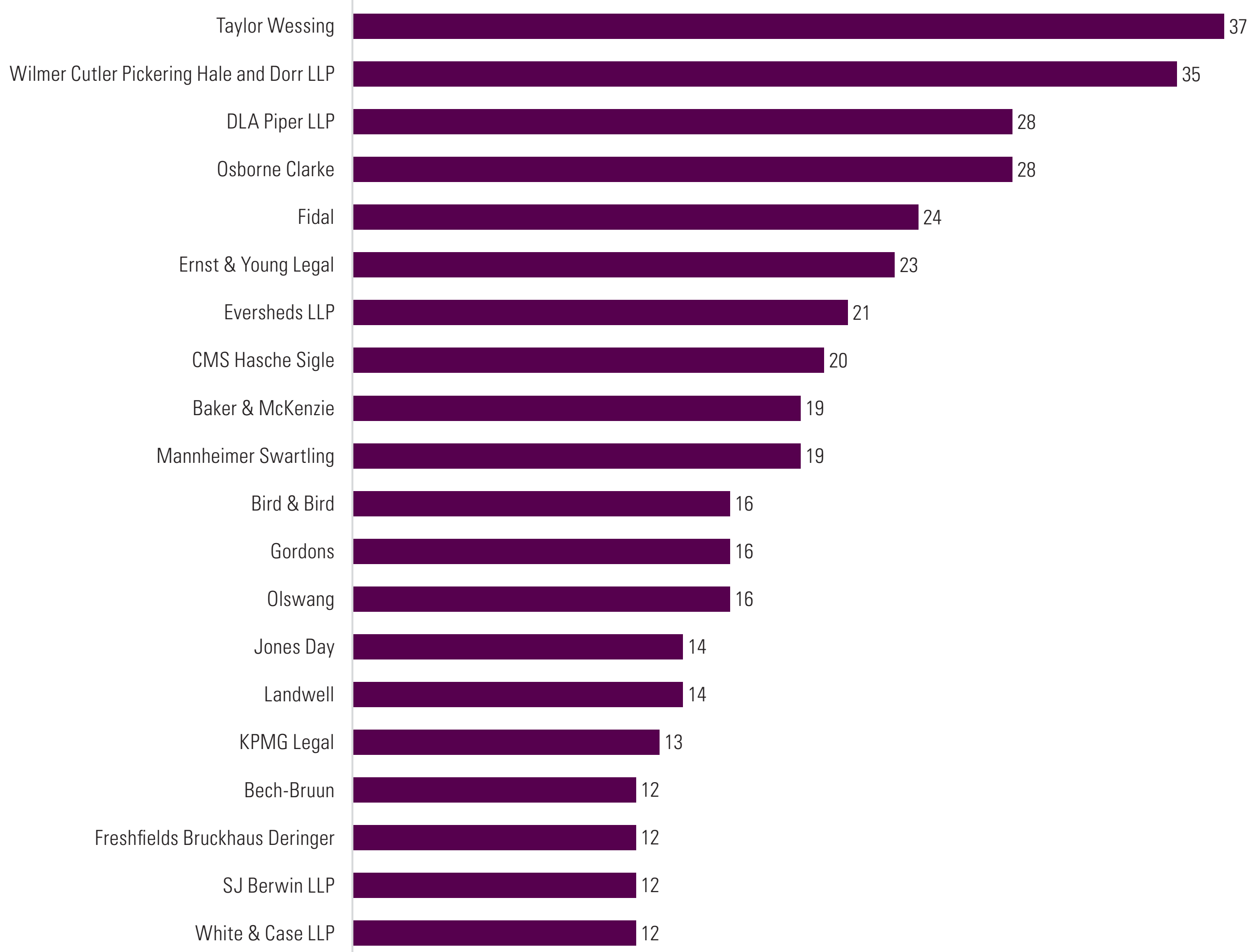
Source: Dow Jones VentureOne

Counsel to Companies Receiving VC Financing in 2010 – Europe



The above chart is based on European companies that completed a seed, first, second, later-stage or restart round of venture capital financing in 2010.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2010 – Europe



The above chart is based on European VC-backed companies that were private and independent as of the end of 2010.
Source: Dow Jones VentureOne

Since its enactment in 1993, Section 1202 of the Internal Revenue Code has provided non-corporate investors with the ability to exclude from federal taxable income up to 50% of the gain realized from the sale of "qualified small business stock" (QSB Stock) held for more than five years. Although venture capital financings and other investments in small businesses are often structured with this in mind, the strict and somewhat complex requirements and limitations of Section 1202 often made the exclusion elusive.

Legislation passed in 2009 and 2010, however, made the exclusion (and the ability to roll over gain to other QSB Stock under Section 1045) much more attractive for 2011. Capital financings and investments made (or gain from the sale of QSB Stock rolled over and invested in new QSB Stock) before the end of this year will reap significant tax benefits. Here we provide you with a brief overview of Section 1202 and the tax benefits available under the current exclusion rates, which expire on December 31, 2011.

Now and Then: Exclusion Rates Under Section 1202

Prior to 2009, Section 1202 provided an exclusion from federal taxable income for 50% of any gain realized from the sale of QSB Stock, but the seemingly generous 50% exclusion was limited in several ways:

- The amount of gain eligible for the exclusion was limited to the greater of (1) $10,000,000, reduced by the amount of gain attributable to the issuer's stock already excluded by the investor in prior tax years, and (2) 10 times the aggregate adjusted basis of all of the issuer's QSB Stock disposed of by the investor during the current tax year.
- Long-term gain from the sale of QSB Stock ineligible for the exclusion was subject to taxation at a maximum rate of 28% (and not the lower rate of 15% currently in effect for most other types of assets).
- A portion of the gain excluded under Section 1202 was required to be included in income for alternative minimum tax (AMT) purposes.

Example 1: Investment in QSB Stock Acquired Prior to 2009

Investor acquires QSB Stock on October 1, 2006, and sells it on November 1, 2011, realizing a gain of $100,000. Provided all the requirements of Section 1202 are met, Investor can exclude $50,000 from federal taxable income but is taxed at a rate of 28% on the remaining $50,000 and pays $14,000 in taxes. Investor's effective tax rate is 14%. If Investor is also subject to the AMT, 7% of the excluded $50,000 is treated as an item of tax preference, and Investor's effective tax rate climbs to over 14.9%.

Although the cap on the gain eligible for the exclusion remains in effect, legislation passed in the last two years provides for exclusion rates of 50%, 75% or 100%, depending on when the QSB Stock is acquired. In addition, for QSB Stock acquired between September 28, 2010, and December 31, 2011, no portion of the excluded gain is includable in income for AMT purposes.

Example 2: Investment in QSB Stock Acquired in 2011

Investor acquires QSB Stock on February 1, 2011, and sells it on March 1, 2016, realizing a gain of $100,000. Provided all the requirements of Section 1202 are met, Investor can exclude all $100,000 from federal taxable income and no portion of the excluded gain is includable in income for AMT purposes.

The recent legislative amendments to Section 1202 expire at the end of this year, at which point the pre-2009 rules will once again apply. Therefore, investment in QSB Stock is only tax-exempt (up to the amount of gain eligible for the exclusion) in 2011. The following table summarizes the rules and the periods during which they are applicable:

QSB Stock Acquired	Exclusion Available	Cap on Eligible Gain	Item of AMT Preference
On or before February 17, 2009	50%	Yes	Yes
On or between February 18, 2009 and September 27, 2010	75%	Yes	Yes
On or between September 28, 2010 and December 31, 2011	100%	Yes	No
On or after January 1, 2012	50%	Yes	Yes

Practice Tip

Investors routinely require representations in stock purchase agreements that assist them in determining whether the issuer's stock will in fact qualify as QSB Stock at the time of investment, as well as covenants in investor rights agreements to ensure the issuer's continuing commitment to complying with the requirements of Section 1202. The content of those representations and covenants often needs to be negotiated due to the uncertain nature of some of the Section 1202 requirements, as described below.

What is QSB Stock?

Generally, stock will be treated as QSB Stock only if all of the following requirements are satisfied:

- *The QSB Requirement.* The issuer is required to have been a "qualified small business" (QSB) as of the date of issuance. That is, the issuer was a domestic C corporation and neither it nor any predecessor corporation had aggregate gross assets in excess of $50 million at any time prior to or immediately after the issuance of the stock in question. For purposes of Section 1202, gross assets generally include the corporation's cash and the aggregate adjusted tax basis of any other property (including intellectual property) held by the corporation.
- *The Active Business Requirement.* The most onerous of the QSB Stock

requirements stipulates that, during substantially all of the investor's holding period, the issuer must have used at least 80% (by value) of its assets in the active conduct of one or more "qualified trades or businesses." For this purpose:

– A "qualified trade or business" is any trade or business except those explicitly identified by the statute. Businesses that are not considered qualified trades or businesses include consulting, health or legal services; financial and brokerage services (or any other business where the issuer's principal asset is the reputation or skill of one or more of its employees); banking, insurance, farming and certain mining businesses; and any business operating a hotel, motel, restaurant or similar business.

Practice Tip

The natural evolution of a startup company's business from, for example, the development, production and sale of a product to the provision of customized products or consulting services can make this requirement difficult to satisfy for "substantially all of the investor's holding period."

– Special tax-advantaged entities (such as domestic international sales corporations, regulated investment companies and real estate investment trusts) cannot satisfy the active business requirement.

– Generally, assets used in certain startup activities, research and experimental activities or in-house research activities may be treated as used in the active conduct of a qualified trade or business.

– For corporations that have been in existence for less than two years, any assets that are held to meet the reasonable working capital needs of a qualified trade or business, or that are held for investment and are reasonably expected to be used within two years to finance research and experimentation or increase a qualified trade or business's working capital, are treated as used in the active conduct of such business. For corporations that have been in existence for two years or more, only 50% of those assets will qualify to be counted as used in the active conduct of a trade or business.

Practice Tip

Given the limitation on the amount of working capital (or assets held to meet future working capital or research and experimentation needs) that can be counted toward satisfaction of the active business requirement, QSB Stock representations and covenants required by investors may be more difficult for a company to provide once it has been in existence for two years or more.

– A corporation does not meet the active trade or business test for any period during which (1) more than 10% of the total value of its assets consists of real property not used in the active conduct of a trade or business, or (2) more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations (excluding stock of the corporation's subsidiaries and stock held for investment and reasonably expected to be used to finance research or experimentation, or to increase the corporation's working capital needs within two years).

- *The Original Issuance Requirement.* Stock is required to have been acquired by the investor at its original issuance (directly or through an underwriter) in exchange for cash or property (other than stock), or as compensation for services (other than as an underwriter of the stock). To this end, and subject to limited exceptions, stock acquired by an investor will generally not be treated as QSB Stock if either (1) at any time during the four-year period beginning two years before the issuance of the stock, the issuer redeems any of its stock from the investor or a related person, or (2) at any time during the two-year period beginning one year before the issuance of the stock, the issuer redeems stock with an aggregate value exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period.

Rolling Over QSB Stock Gain

Section 1045 of the Internal Revenue Code allows non-corporate investors to defer gain from the sale of QSB Stock held for more than six months if other QSB Stock is purchased within 60 days of the date of sale. Provided Section 1045's requirements are met, gain on the sale of the original QSB Stock is recognized only to the extent that the amount realized exceeds the replacement stock's purchase price. To the extent gain is not recognized, that amount is applied to reduce the investor's basis in the replacement stock. In addition, the holding period of the original QSB Stock is tacked to the holding period of the replacement stock.

Example 3: Rolling Over Gain from the Sale of QSB Stock in 2011

Investor acquires QSB Stock on October 1, 2006, for $100,000 and sells it on March 1, 2011, for $200,000. On April 15, 2011, Investor acquires new QSB Stock for $200,000. Provided the Section 1045 requirements are met, Investor does not recognize any gain on the sale of the original QSB Stock but takes a basis in the replacement QSB Stock of $100,000. The appreciation in the replacement QSB Stock is now subject to the 100% exclusion rate, rather than the 50% exclusion rate applicable to the QSB Stock purchased in 2006. In addition, because the holding periods are tacked, Investor could sell the replacement QSB Stock as soon as six months later and take advantage of the 100% exclusion rate at that time. (Contrast this with the treatment of the same Investor who did not roll over gain from the sale of previously held QSB Stock, in Example 1 above.)

The recent legislative changes to Section 1202 offer particularly significant tax benefits to investors who choose—*by the end of 2011*—to invest in QSB Stock or roll over gain from QSB Stock previously held. Due to the complexity of the provision, investors and issuers should consult with their tax advisors regarding their specific circumstances prior to seeking the benefits of Section 1202. ■

Based on hundreds of venture capital financing transactions we handled from 2006 to 2010 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2006	2006 Range	2007	2007 Range	2008	2008 Range	2009	2009 Range	2010	2010 Range
A "multiple liquidation preference" is a provision that provides that the holders of preferred stock are entitled to receive more than 1x their money back before the proceeds of the liquidation or sale are distributed to holders of common stock.	Series A	5%	2x	4%	1.5x – 2x	3%	3x	0%	N/A	4%	2x
	Post–Series A	9%	1.25x – 3x	7%	1.5x – 2x	14%	1.3x – 3x	19%	1.5x – 5x	10%	1.5x – 2x

Deals with Participating Preferred		2006	2006 Range	2007	2007 Range	2008	2008 Range	2009	2009 Range	2010	2010 Range
"Participating preferred" stock entitles the holder not only to receive its stated liquidation preference, but also to receive a pro-rata share (assuming conversion of the preferred stock into common stock) of any remaining proceeds available for distribution to holders of common stock.	Series A										
	Total	59%		57%		53%		30%		33%	
	Capped	22%	2x – 5x	42%	2x – 6x	35%	2x – 5x	25%	2x – 3x	18%	2x – 3x
	Post–Series A										
	Total	62%		62%		56%		57%		44%	
	Capped	24%	2x – 5x	37%	2x – 5x	41%	2x – 5x	35%	2x – 6x	45%	1.6x – 5.5x

Deals with an Accruing Dividend		2006	2007	2008	2009	2010
"Accruing dividends" are generally payable upon liquidation or redemption of the preferred stock. Because the sale of the company is generally deemed to be a "liquidation," the accrued dividend effectively increases the liquidation preference of the preferred stock.	Series A	53%	43%	53%	41%	23%
	Post–Series A	55%	38%	36%	41%	30%

Anti-Dilution Provisions		2006	2007	2008	2009	2010
A "full ratchet" anti-dilution formula is more favorable to the investors because it provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a "weighted average" anti-dilution formula takes into account the dilutive impact of the dilutive issuance based upon factors such as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	Series A					
	Full Ratchet	7%	9%	6%	0%	0%
	Weighted Average	93%	91%	94%	100%	100%
	Post–Series A					
	Full Ratchet	7%	5%	5%	9%	4%
	Weighted Average	93%	95%	95%	91%	96%

Deals with Pay-to-Play Provisions		2006	2007	2008	2009	2010
"Pay-to-play" provisions provide an incentive to investors to invest in future down rounds of financing. Investors that do not purchase their full pro-rata share in a future down round lose certain rights (e.g., their anti-dilution rights are taken away or their shares of preferred stock may be converted into common stock).	Total	22%	28%	23%	35%	20%
	% of Total That Convert to Common Stock	65%	79%	92%	87%	100%
	% of Total That Convert to Shadow Preferred Stock	35%	21%	8%	13%	0%

We reviewed all merger transactions between 2004 and 2010 involving venture-backed targets (as reported in Dow Jones VentureOne) in which the merger documentation was publicly available and the deal value was $25 million or more. Based on this review, we have compiled the following deal data:

Characteristics of Deals Reviewed	2004	2005	2006	2007	2008	2009	2010
Sample Size	54	39	53	33	25	15	17
Cash	43%	69%	68%	48%	76%	60%	71%
Stock	41%	10%	8%	0%	4%	0%	6%
Cash and Stock	17%	21%	24%	52%	20%	40%	23%
Deals with Earnout	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
With Earnout	24%	15%	17%	39%	12%	27%	29%
Without Earnout	76%	85%	83%	61%	88%	73%	71%
Deals with Indemnification	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
With Indemnification							
By Target's Shareholders	89%	100%	94%	100%	96%	100%	100%
By Buyer[1]	37%	46%	38%	48%	48%	36%	17%
Survival of Representations and Warranties[2]	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Shortest	6 Months	9 Months	12 Months	6 Months[3]	12 Months	6 Months	9 Months
Longest	36 Months	24 Months	36 Months	36 Months	24 Months	18 Months	21 Months
Most Frequent	12 Months	12 Months	12 Months	12 and 18 Months (tie)	12 Months	18 Months	18 Months
Caps on Indemnification Obligations	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
With Cap	85%	100%	100%	97%	95%	100%	100%
Limited to Escrow	72%	79%	84%	78%	81%	71%	71%
Limited to Purchase Price	7%	5%	2%	9%	14%	0%	6%
Exceptions to Limits[4]	74%	73%	84%	97%	62%	71%	94%
Without Cap	15%	0%	0%	3%	5%	0%	0%
Escrows	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
With Escrow	83%	97%	96%	94%	96%	93%	100%
% of Deal Value							
Lowest	4%	2%	3%	3%	3%	10%	2%
Highest	23%	20%	20%	43%	15%	15%	25%
Most Frequent	10%–20%	10%	10%	10%	10%	10%	10%
Length of Time							
Shortest	6 Months	6 Months	12 Months	6 Months	12 Months	12 Months	9 Months
Longest	36 Months	24 Months	36 Months	60 Months	36 Months	18 Months	36 Months
Most Frequent	12 Months	12 Months	12 Months	12 and 18 Months (tie)	12 Months	12 and 18 Months (tie)	18 Months
Exclusive Remedy	64%	84%	90%	73%	83%	46%	53%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[4]	72%	66%	86%	100%	85%	83%	80%
Baskets for Indemnification	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Deductible	39%	38%	48%	48%[5]	43%[6]	43%	56%
Threshold	51%	62%	52%	39%[5]	48%[6]	57%	44%
MAE Closing Condition	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Condition in Favor of Buyer	81%	82%	98%	97%	88%	100%	100%
Condition in Favor of Target[7]	30%	13%	23%	44%	21%	20%	19%
Exceptions to MAE	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
With Exception[8]	78%	79%	85%	91%	92%	93%	94%

1 The buyer provided indemnification in 48% of the 2004 transactions, 25% of the 2005 transactions, 41% of the 2006 transactions, 53% of the 2007 transactions, 50% of the 2008 transactions, 40% of the 2009 transactions and 80% of the 2010 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions, 17% of the 2005 transactions, 35% of the 2006 transactions, 56% of the 2007 transactions, 25% of the 2008 transactions, 40% of the 2009 transactions and 33% of the 2010 transactions where the buyer provided indemnification, buyer stock was used as consideration.

2 Measured for representations and warranties generally; specified representations and warranties may survive longer.

3 In two cases representations and warranties did not survive, but in one such case there was indemnity for specified litigation, tax matters and appraisal claims.

4 Generally, exceptions were for fraud, willful misrepresentation and certain "fundamental" representations commonly including capitalization, authority and validity.

5 Another 13% of these transactions used a "hybrid" approach with both a deductible and a threshold.

6 Another 4% of these transactions used a "hybrid" approach with both a deductible and a threshold and another 4% had no deductible or threshold.

7 In 50% of these transactions in 2004, in 80% of these transactions in 2005, in 83% of these transactions in 2006, in 86% of these transactions in 2007, in 60% of these transactions in 2008, in 100% of these transactions in 2009 and in 67% of these transactions in 2010, buyer stock was used as consideration.

8 Generally, exceptions were for general economic and industry conditions.

Want to know more about the IPO and M&A markets?

Our *2011 IPO Report* offers a detailed analysis of, and outlook for, the IPO market. The report features regional breakdowns, a review of the special issues faced by companies that go public using unconventional structures, and a discussion of post-IPO financing techniques. We also discuss the typical attributes of successful IPO candidates, and present useful IPO market metrics that are ordinarily unavailable elsewhere.

See our *2011 M&A Report* for a detailed review of, and outlook for, the global M&A market. Other highlights include an overview of the new Dodd-Frank requirement for a non-binding shareholder advisory vote on golden parachute arrangements, a look at special considerations in California M&A transactions, and a survey of key terms in sales of VC-backed companies.

To request a copy of any of the reports described above, or to obtain additional copies of the *2011 VC Report*, please contact the WilmerHale Marketing Department at marketing@wilmerhale.com or call +1 617 526 5600. An electronic copy of this report can be found at www.wilmerhale.com/2011VCreport.

Data Sources

All data in this report was compiled from the VentureSource database from Dow Jones VentureOne, except as otherwise described. For law firm rankings, IPOs by VC-backed companies and sales of VC-backed companies are included under the current name of each law firm.

***Special note on data:** Due to delayed reporting of some transactions, the venture capital financing and M&A data discussed in this report is likely to be adjusted upward over time as additional deals are reported. Based on historical experience, the adjustments in US data are likely to be in the range of 5–10% in the first year following the initial release of data and in smaller amounts in succeeding years, and the adjustments in European data are likely to be more pronounced.*

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