

Hale and Dorr LLP

2003/venturecapitalreport

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2003 Market Review

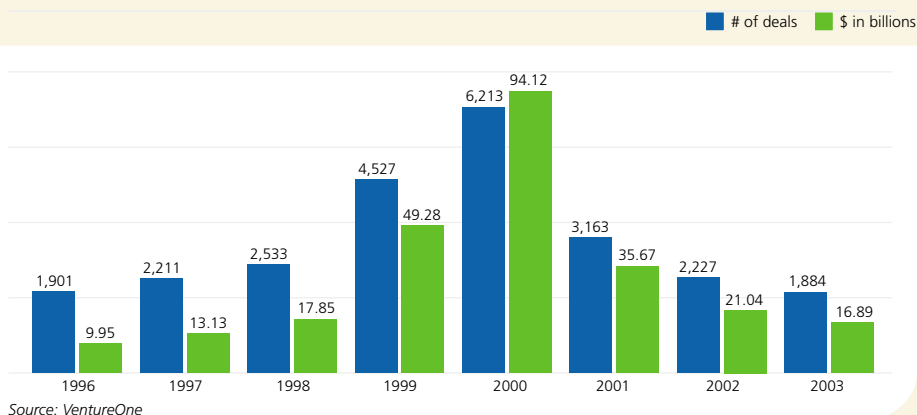
Entering 2003, many industry observers believed that the U.S. venture capital financing market—measured by number of deals and amount invested—would begin to improve as compared to 2002. This optimism was based on both empirical data—such as gradual improvements in leading economic indicators—and the notion that the 2002 venture capital market was so depressed that there was no where to go but up. As it turned out, however, 2003 extended rather than reversed the market downturn that began in the latter part of 2000.

The number of venture capital financings declined for the third straight year. The 1,884 venture financings in 2003 represented a decrease of 15% as compared to 2002, and a decline of 70% as compared to the 2000 peak. 2003 saw the lowest number of venture capital deals since 1995. The amount of venture capital invested also decreased, from \$21.0 billion in 2002 to \$16.9 billion in 2003. The 2003 investment total represented only 18% of the amount invested in 2000. The amount invested in venture capital financings has declined more steeply than the number of deals, reflecting smaller financings.

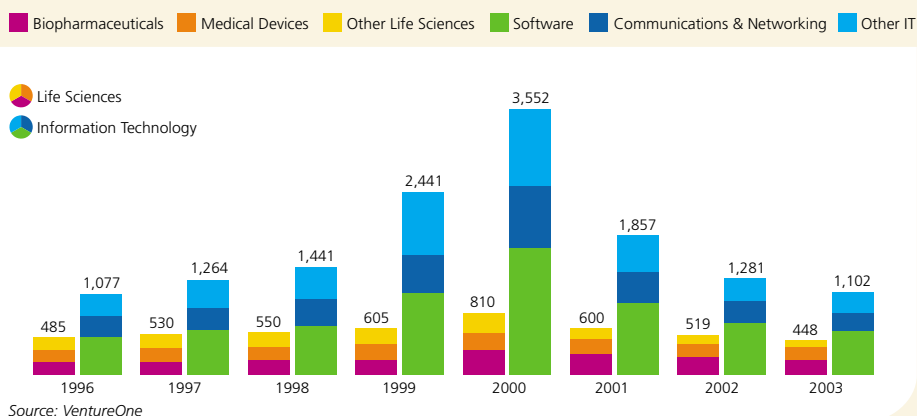
While venture capital deal flow decreased in 2003, valuations of venture-backed companies showed signs of bottoming out and beginning to improve. The median pre-money valuation for venture financings decreased from \$24.0 million in 2000 to \$15.1 million in 2001, and decreased further to \$10.3 million in 2002. For 2003 deals, the median pre-money valuation was \$9.9 million, essentially flat as compared to 2002. Moreover, the trend within the year was positive, as the median pre-money valuation was just under \$9 million for the first half of 2003 and approximately \$11 million for the second half of 2003.

Seed and first-round venture capital financings once again declined in 2003 as a percentage of total venture capital financings. During each year from 1995 to 2000, seed and first-round financings

U.S. Venture Capital Financings – 1996 to 2003



Venture Capital Financings by Industry – 1996 to 2003



were between 48% and 55% of total venture financings. Since then, however, there has been a significant decline, as seed and first-round financings dropped as a percentage of total venture financings to 38% in 2001, 30% in 2002 and 29% in 2003. This trend is likely due to venture capitalists continuing to devote a disproportionate amount of time to struggling portfolio companies, and to a “raising of the bar” for companies seeking funding as venture investors apply more

rigorous criteria to investment decisions than they did during the boom years.

One market metric that has not changed significantly in recent years is investments by industry sector. Financings of information technology companies as a percentage of total venture capital financings ranged from 54% to 59% in each year between 1996 and 2003. The life sciences sector has exhibited a little more volatility over this time period,

with a high of 26% of all venture financings in 1996 and a low of 13% in both 1999 and 2000, the apex of the Internet wave. In 2003, life sciences investments accounted for 24% of the number of venture financings but 32% of the venture funds invested, as the financing sizes have increased slightly in the life sciences sector but decreased in the information technology sector.

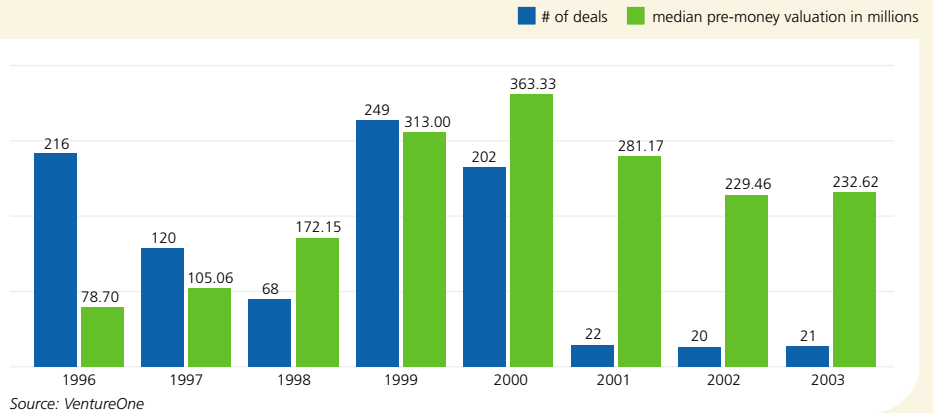
The geographic breakdown of venture financings has also remained quite stable over the last decade. California was home to the largest number of companies receiving venture capital financing in every year from 1996 to 2003, with California companies representing 41% of the venture financings both over this period and in 2003.

Massachusetts was the second-ranked state in each of those years, accounting for 11% of the venture capital investments over this period and 12% in 2003. New York, Texas and Washington were the next most popular states for venture capital financings during this time period.

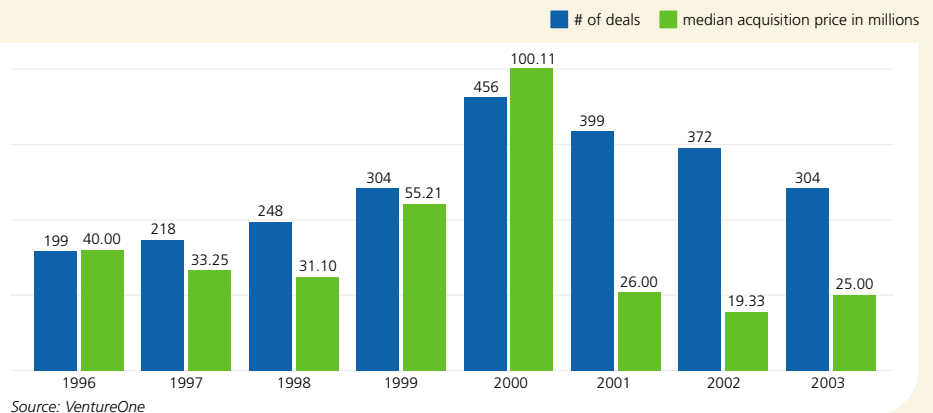
The bleakest aspect of the venture capital market in 2003 continued to be liquidity events for venture-backed companies. The number of IPOs by venture capital-financed companies during the last three years is not only dramatically lower than the IPO numbers during the Internet frenzy of 1999–2000, but is also significantly lower than the numbers in the 1996–1998 period.

There are, however, some sources of optimism in the 2003 IPO statistics. While the overall number of venture-backed IPOs in 2003 was disappointing, the trend line is somewhat more positive, as the breakdown from the first to the fourth quarter was zero, two, six and 13. Moreover, there were 18 venture-backed companies in IPO registration at the end of 2003. In addition, the median pre-money valuation of the venture-backed companies engaging in IPOs in 2003 was \$233 million. This figure represents a slight increase over 2002 (\$229 million) and, while somewhat lower than 1999–2000 (\$336 million), represents a significant increase over 1996–1998 (\$102 million).

Venture Capital Backed IPOs – 1996 to 2003



Acquisitions of Venture Capital Backed Companies – 1996 to 2003



The M&A market was also not an especially fruitful path to liquidity for venture-backed companies in 2003. The number of acquisitions of venture-backed companies continued to decline, dropping to 304 in 2003 from 372 in 2002. The number of acquisitions in 2003 was slightly higher than the number in the 1996–1998 time period. This is deceiving, however, in that the tremendous number of seed and first-round venture financings in 1999–2000 (4,872, as

compared to 2,001 in 1996–1997 and 1,127 in 2002–2003) created a much larger number of “mature” venture-backed companies in 2002 and 2003. Accordingly, if market factors were relatively constant, the number of acquisitions of venture-backed companies in 2003 would have been considerably higher than in past years.

The prices paid to acquire venture-backed companies in 2003 (\$25 million median)

were higher than in 2002 (\$19 million median), but were well below the prices paid not only in 1999–2000, but also in 1996–1998. More disturbingly, the median amount of venture capital money raised by acquired companies has increased as the acquisition prices have decreased, further reducing the return to venture capital investors.

2004 Outlook

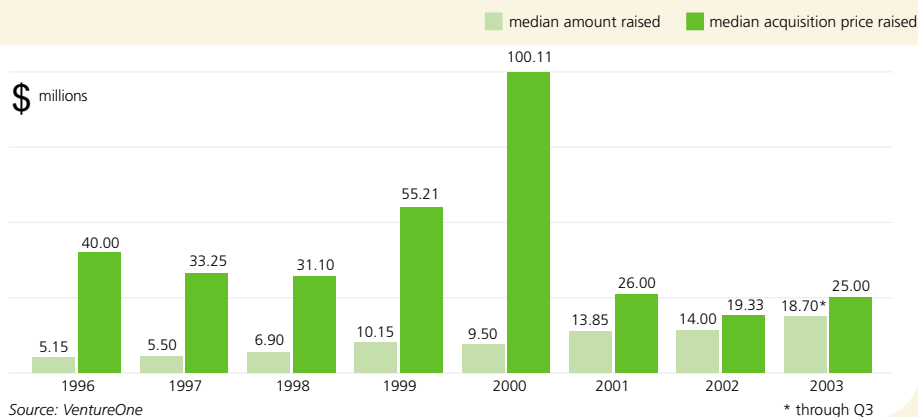
The outlook for 2004 can probably best be characterized as one of guarded optimism. There seems to be a consensus that several important indicia of the health of the venture capital market will improve in 2004. At the same time, however, it is reasonable to expect that some of the fundamental characteristics of today's venture capital market will continue to negatively impact certain metrics by which the market is measured.

We believe that the number of venture capital financings will be greater in 2004 than in 2003, for several reasons. First, the pace of venture investing increased somewhat during the course of 2003, with the 496 financings in the fourth quarter representing the highest number in any quarter during 2003. Second, venture capital firms have a tremendous amount of money to invest. Finally, the number of deals in 2003 is not an especially high hurdle to overcome.

One factor mitigating against a significant increase in the number of venture financings is the fact that many fewer venture-backed companies have been established in the past two years than in the several years prior to that. In 2002–2003, there was a total of 1,127 seed and first-round financings, compared to a total of 4,872 in 1999–2000. Since later-round financings typically comprise more than half of all financings each year, the smaller number of venture-backed companies created in the last two years should have a dampening effect on the total number of financings in the upcoming years.

We expect that the average financing size will decrease in 2004. This is largely a reflection of the fact that the valuations for acquisitions of venture-backed companies—which are a far more frequent source of liquidity than IPOs—have dropped

Median Amount Raised and Acquisition Price – 1996 to 2003



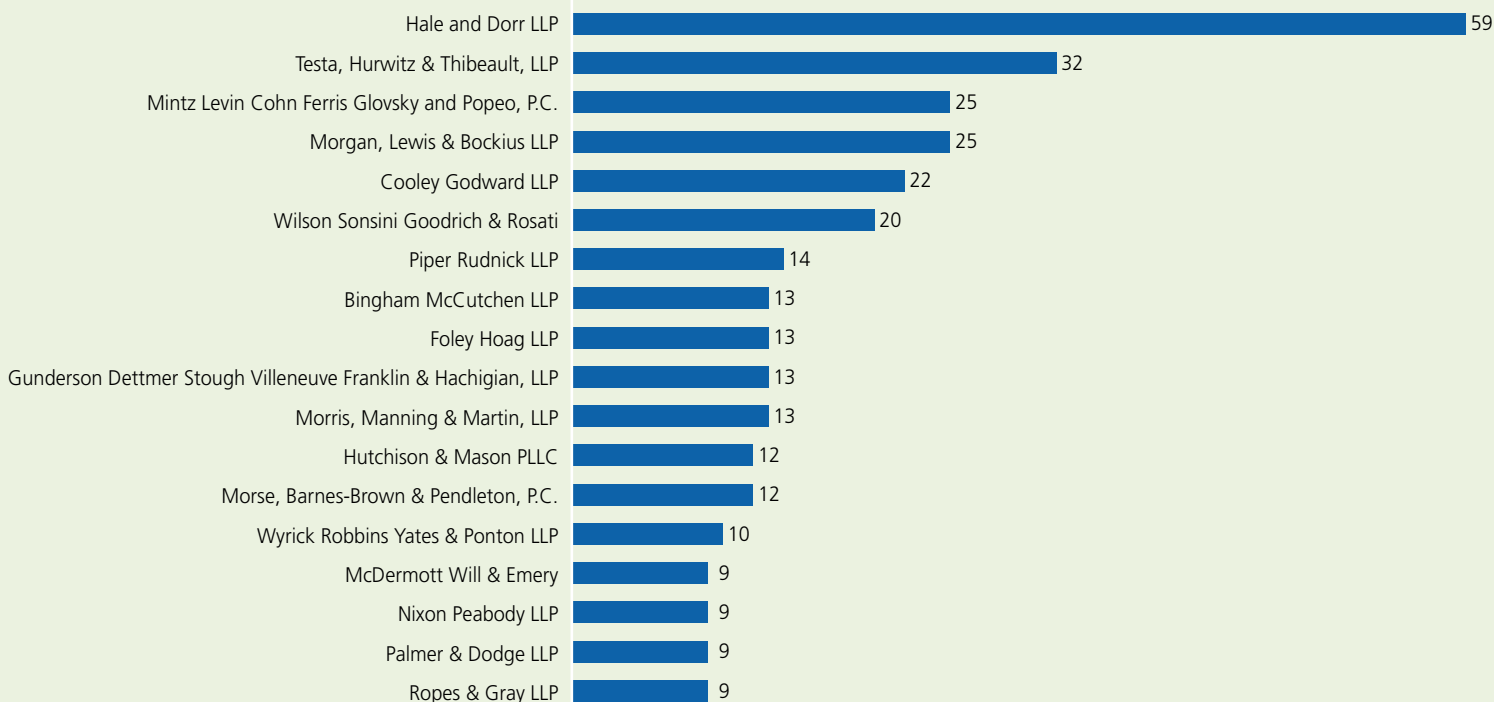
so dramatically in recent years. Today, a “home run” means that the company is sold for \$100–200 million, rather than the billion dollar valuations that top venture-backed companies were commanding several years ago. Given this economic reality, venture capitalists cannot afford to invest more than \$50 million in a company and expect to earn attractive investment returns. As a result, companies will be forced to develop business plans and growth strategies that require much less funding than might have been available to them several years ago.

There is reason for optimism that the market for liquidity events—both IPOs and acquisitions—will improve somewhat in 2004. One factor is the relatively strong IPO market at the end of 2003. The 13 venture-backed IPOs in the fourth quarter of 2003 were the most since the fourth quarter of 2000. A second source of optimism is the recent uptick in acquisition prices for venture-backed companies. The average acquisition price in the fourth quarter was \$33.4 million, the highest since the third quarter of 2001. In addition, several technology companies and industry analysts have recently forecast increased technology spending in 2004, which bodes well for venture-backed companies.

The smaller number of companies receiving venture funding in the last few years should also have a positive impact on the valuations in liquidity events. The decrease in the number of companies being funded presumably is due, at least in part, to the

application of more rigorous screening criteria, which should improve the overall quality and value of the companies that are funded. There is also a widespread view that the tremendous number of companies that were funded in the last several years has resulted in an oversaturation of many of the sectors targeted by venture-backed companies, creating an environment where most of the venture-backed companies in a given sector were destined to fail. Accordingly, the smaller number of venture-backed companies should contribute to a less challenging competitive environment. Some industry observers remain of the view, however, that there are still too many companies being funded, and that equilibrium will not be restored to the market unless the number of venture financings drops even further. ■

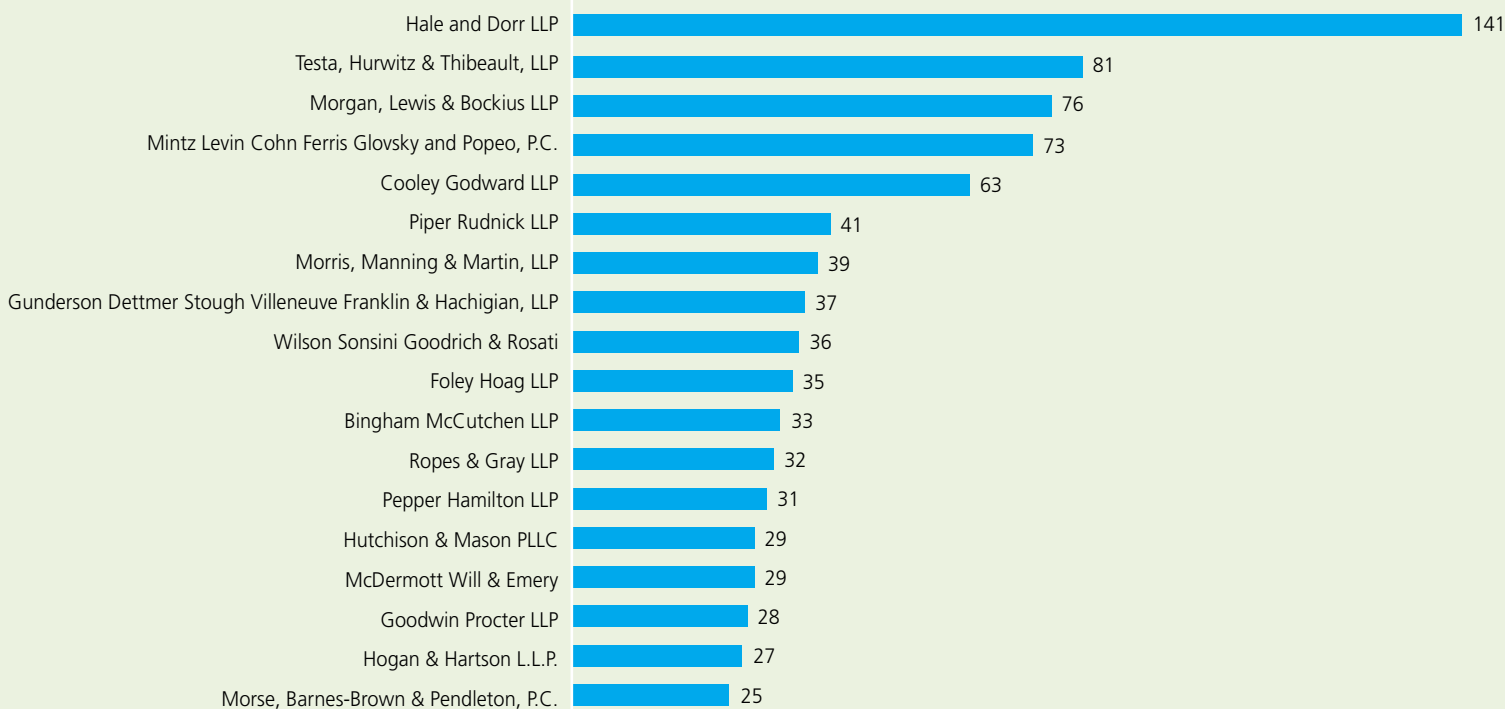
Counsel to Companies Receiving Venture Capital Financing in 2003



Note: The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later stage, corporate or restart round of venture capital financing in 2003.






































Source: VentureOne

Counsel to Venture-Backed Companies at Year-End 2003



Note: The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later stage, corporate or restart round of venture capital financing and were private and independent as of the end of 2003.

Source: VentureOne

 \$42,700,000 Second Round July 2003	 \$20,000,000 Third Round July 2003	 \$8,000,000 First Round July 2003	 \$30,000,000 Second Round August 2003	 \$25,000,000 Second Round August 2003	 \$26,500,000 Second Round March 2003	 \$12,000,000 First Round March 2003	 \$30,000,000 Second Round May 2003	 \$56,000,000 Second Round October 2003	
 \$21,000,000 Second Round January 2003	 \$25,000,000 Strategic Investment by Pfizer February 2003	 \$10,000,000 Second Round April 2003	 \$10,000,000 First Round June 2003	 \$8,000,000 Second Round November 2003	 £17,000,000 Third Round October 2003	 \$24,600,000 Second Round July 2003	 \$18,875,000 Second Round November 2003	 \$10,000,000 Third Round December 2003	 \$23,000,000 Third Round January 2003
 \$13,000,000 Second Round February 2003	 \$22,000,000 Third Round November 2003	 \$13,600,000 Second Round August 2003	 \$8,000,000 Third Round April 2003	 \$15,500,000 Second Round November 2003	 \$6,000,000 Second Round October 2003	 \$13,100,000 Fourth Round March 2003	 \$20,000,000 Third Round January 2003	 \$20,000,000 Late Stage June 2003	
 \$12,000,000 Second Round December 2003	 \$5,500,000 First Round July 2003	 \$45,000,000 Third Round January 2003	 \$10,500,000 Second Round October 2003	 \$12,200,000 First Round November 2003	 \$19,000,000 Second Round May 2003	 \$13,400,000 Third Round February 2003	 \$10,000,000 Second Round March 2003	 \$25,000,000 Strategic Investment by Amgen December 2003	 \$10,500,000 Second Round August 2003

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While the IPO market for venture-backed companies has been limited in the last three years, recent stock market gains have fueled optimism about the IPO market in 2004. Companies contemplating an IPO in 2004 should be aware that the sweeping changes in the regulatory landscape resulting from the Sarbanes-Oxley Act and related SEC, Nasdaq and NYSE rule changes have increased the importance of careful advance preparation. Key matters to be addressed by IPO candidates in the six-to-twelve months before an IPO include:

Building relationships with investment bankers and analysts. The much publicized “global research analyst settlement” has significantly changed the interactions between companies and underwriting firms. Among the changes most relevant to pre-IPO companies are:

- research analysts may not participate in marketing pitches by investment bankers;
- investment bankers may not promise research coverage by their bank’s analysts; and
- a company’s interactions during the IPO process with the investment banking and the research divisions of the underwriters must be largely separate.

It is therefore critical for a company to cultivate relationships with both the investment bankers and the research analysts at potential underwriting firms.

Auditor independence. The Sarbanes-Oxley Act and new SEC rules have significantly tightened the requirements for auditor independence. While the SEC auditor independence rules generally do not apply to private companies, a pre-IPO company’s auditor must be independent with respect to each fiscal period (generally three full fiscal years) covered by the financial statements in the IPO registration statement. Accordingly, a company contemplating an IPO in the future should ensure that its auditor satisfies the SEC auditor independence rules even prior to the IPO. Among the items that would generally

Companies contemplating an IPO in 2004 should be aware that the sweeping changes in the regulatory landscape resulting from the Sarbanes-Oxley Act and related SEC, Nasdaq and NYSE rule changes have increased the importance of careful advance preparation.

prevent an auditor from being considered independent is the provision by the auditor of specified types of non-audit services to the company, including bookkeeping services, financial information systems design and implementation services, appraisal services, management functions and human resources services. Auditor independence would also be tainted if the company hires, in a senior financial role, any person who worked on the company’s audit as an employee of the auditor during the prior year.

Controls and procedures. The SEC has recently adopted a variety of rules relating to both “disclosure controls and procedures” and “internal control over financial reporting.” These rules require public companies to establish and maintain such controls, to evaluate them on a periodic basis and to report on such evaluations in their periodic SEC filings. In addition, a public company’s annual report must include a management report on the company’s internal control over financial reporting, as well as an attestation report from the company’s independent auditors.

These requirements make it critical for a company to establish and document robust controls and procedures prior to its IPO. Those controls and procedures are a necessary underpinning of the disclosures the company must make in its IPO registration statement and its periodic post-IPO filings, including the personal certifications of the CEO and the CFO that must be contained in post-IPO SEC filings. In addition, a company’s controls and procedures will undoubtedly be the focus of due diligence by the IPO underwriters.

Executive loans. One of the more publicized aspects of the Sarbanes-Oxley Act is its prohibition of personal loans to directors and executive officers of a public company. This prohibition becomes applicable to a private company upon the initial filing of its IPO registration statement. A company contemplating an IPO should generally refrain from making loans to its executive officers and directors. While some companies have chosen to make such loans, subject to a requirement to repay the loan prior to the filing of an IPO registration statement, this situation can create difficulties for a director or officer who lacks sufficient liquidity to repay the loan at that time. Moreover, forgiveness of the loan, while not illegal, can create tax, accounting and fiduciary duty issues.

Corporate governance issues. In the wake of the highly publicized corporate scandals of the past several years, the corporate governance standards applicable to public companies have been largely rewritten by the Sarbanes-Oxley Act, the SEC, Nasdaq and the NYSE. The most significant changes affecting pre-IPO companies are:

- Each public company must have a board of directors comprised of a majority of “independent” directors, as defined by Nasdaq or NYSE rules. Although an IPO company has a grace period of one year from its initial listing to fully comply with this rule (as well as the audit committee rule described below), pressure from underwriters and investors may force the company to comply at the time of its IPO. As a result of the increased liability and scrutiny to which directors of public companies are subject, it is often difficult to find well-qualified directors.

In addition, because all directors of an IPO company have personal liability for material misstatements and omissions in the company's IPO registration statement, some individuals are reluctant to join the board of a company shortly prior to its IPO (and thus face liability for a registration statement describing a company with which they are relatively unfamiliar). Accordingly, it is never too early for a company contemplating an IPO at some point in the future to recruit independent directors.

company must carefully develop a code of conduct that, in addition to complying with the applicable legal requirements, takes appropriate account of the company's business and culture.

- Recent changes to Nasdaq and NYSE rules have tightened the stockholder approval requirements such that virtually all new stock plans, as well as material amendments to existing stock plans, must be approved by stockholders of the company. In addition, the recent

In the wake of the highly publicized corporate scandals of the past several years, the corporate governance standards applicable to public companies have been largely rewritten.

- Each public company must have an audit committee comprised of at least three persons, each of whom (i) is independent within the definition of Nasdaq or the NYSE, (ii) satisfies the "super-independence" requirements of the SEC, and (iii) is financially literate. In addition, at least one member of the audit committee must have accounting or financial management experience, and the company must disclose in its SEC filings whether the committee has at least one "audit committee financial expert," as defined by SEC rules. Again, it is advisable for a pre-IPO company to assess whether it needs additional directors for the audit committee, and to begin to recruit them, well in advance of the IPO.
- Each public company must have, and make publicly available, a code of conduct for its directors, officers and employees, addressing matters such as conflicts of interest, accurate and timely public disclosure, compliance with laws and enforcement of the code's provisions. In addition, any waiver of the code for an executive officer or director must be approved by the board of directors and then publicly disclosed. Because of the public disclosure requirements, a pre-IPO

elimination of discretionary voting by brokers on stock plan proposals has made it harder for public companies to obtain stockholder approval for stock plan proposals. Accordingly, if a pre-IPO company wishes to adopt a new stock plan (such as an employee stock purchase plan or a director stock option plan) or amend its employee option plan to increase the number of shares covered by the plan, it should generally obtain stockholder approval of the new plan or plan amendment while it is still a private company and that vote is presumably easier to obtain. ■

New England

In 2003, there were 293 venture capital financings in New England, a decrease of 13% from the 336 in 2002, and the total amount invested fell 8% (from \$2.86 billion to \$2.63 billion). Despite the year-over-year decline, activity picked up as the year progressed, and there were more financings in the second half of 2003 than the second half of 2002.

New England continues to be a leading center of life sciences activity. In 2003, biopharmaceutical companies accounted for 15% of New England's venture capital financings, compared to the national average of 10%, including the largest deal in the nation in the fourth quarter—\$56 million raised by Critical Therapeutics of Cambridge, Massachusetts.

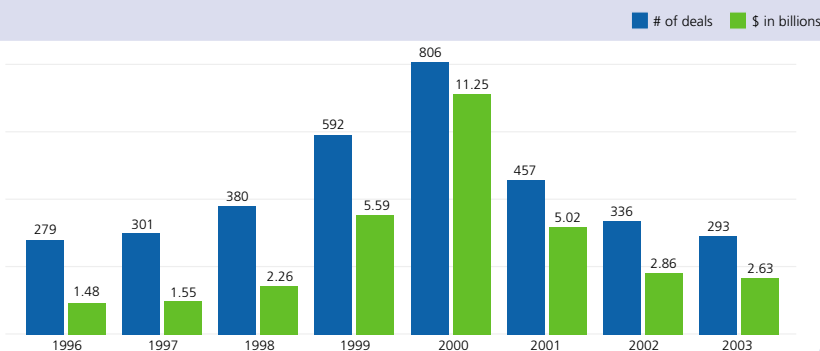
For 2004, we expect New England to remain a hotbed of venture capital activity. The large number of established technology and life sciences companies will continue to spawn ideas and entrepreneurs for founding new companies. Coupled with the large number of world-renowned universities and research institutions—which continue to produce exciting technological innovations and scientific discoveries and a talented employee pool—and an established network of venture capitalists and other service providers focused on serving venture-backed companies, we expect the region to remain one of the most appealing environments for emerging companies in 2004.

Tri-State

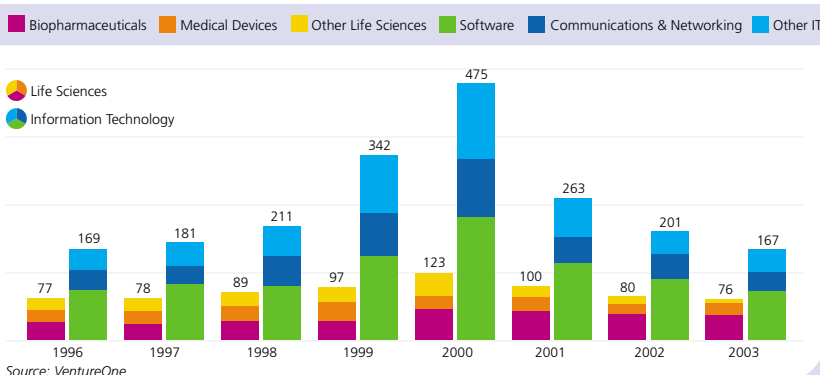
The number of venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania declined 14%, from 246 in 2002 to 212 in 2003. The total amount invested in the region remained relatively steady, declining marginally from \$1.78 billion in 2002 to \$1.72 billion in 2003. However, venture capital activity in the tri-state region in 2003 exceeded the pre-boom years of 1996–1998, which saw an annual average of 192 financings raising \$1.26 billion.

We believe that the tri-state region's strengths in pharmaceuticals, life sciences, financial services, and communications and information technologies, coupled with the large volume of Fortune 500 companies in the region, will provide a conducive environment for emerging companies in 2004 and that venture capital activity should pick up in 2004.

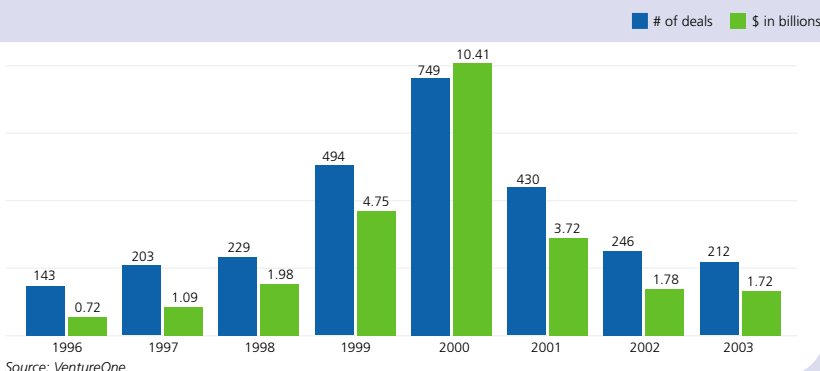
New England Venture Capital Financings – 1996 to 2003



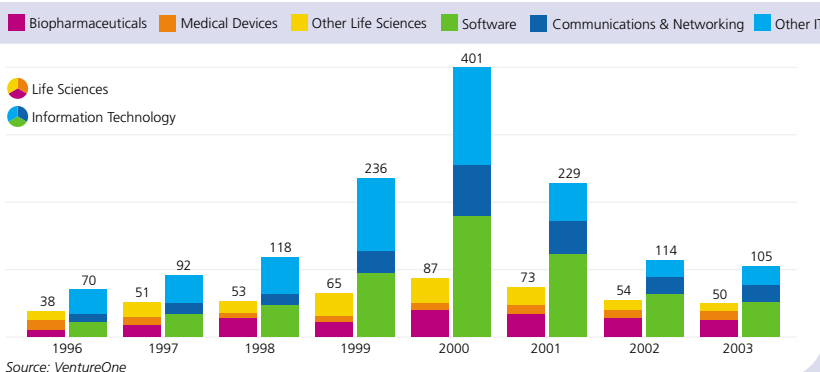
New England Venture Capital Financings by Industry – 1996 to 2003



Tri-State Venture Capital Financings – 1996 to 2003



Tri-State Venture Capital Financings by Industry – 1996 to 2003



Mid-Atlantic

The mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia saw one of the larger decreases in venture capital activity as the number of financings decreased 28%, from 181 in 2002 to 131 in 2003. The total amount of venture capital financing raised by companies in the region fell 42%, from \$1.58 billion in 2002 to \$918 million in 2003.

While investment in software and communications and networking companies has continued to decline, biopharmaceutical and medical devices companies in the region have seen relatively steady levels of investment over the last three years, although still lagging the peak in 2000.

For 2004, we expect the concentration of national security, government contracting and defense-related activity in the region will produce a steady stream of attractive emerging companies. We also believe the region—and particularly the Research Triangle area—will remain a vibrant hub of life sciences-related investment. In addition, we anticipate increased investment in the software and communications sectors—particularly in companies providing enterprise-wide solutions.

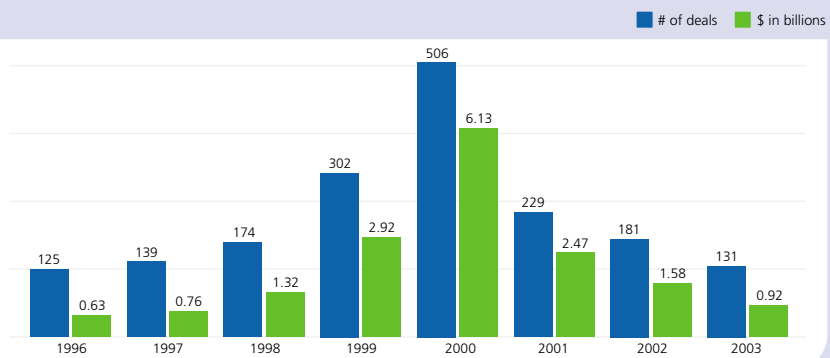
Europe

In 2003, there were 1,039 venture capital financings in Europe, a decrease of 31% from the 1,500 in 2002. The total amount invested in Europe fell 23%, dropping from €4.51 billion in 2002 to €3.47 billion in 2003.

The United Kingdom remains the largest venture capital market in Europe, with 32% of all venture capital financing in 2003, followed by France (15%), Germany (14%) and Sweden (9%). In 2003, biopharmaceuticals was the most popular sector, with 26% of all venture capital financing, followed closely by software with 25%.

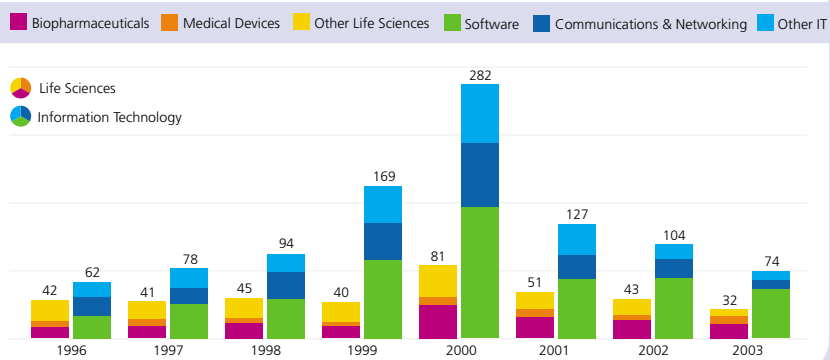
Despite a lack of sustained economic growth, we anticipate European venture capital activity will pick up in 2004. The large number of leading life sciences and other multinational companies and academic and research institutions, combined with a different regulatory environment than the U.S.—particularly for biopharmaceutical companies—should help make the European venture capital market vibrant in 2004. ■

Mid-Atlantic Venture Capital Financings – 1996 to 2003



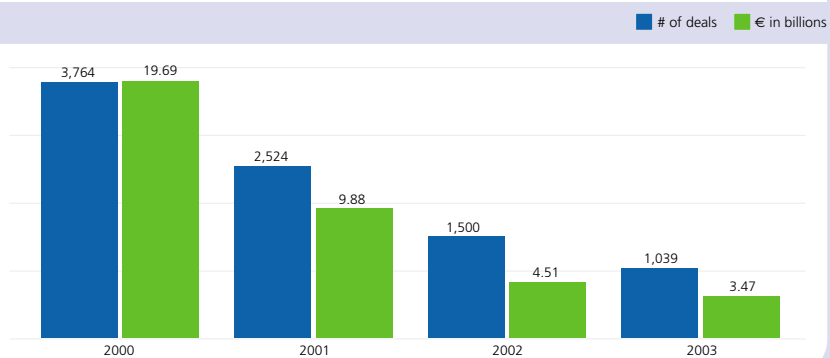
Source: VentureOne

Mid-Atlantic Venture Capital Financings by Industry – 1996 to 2003



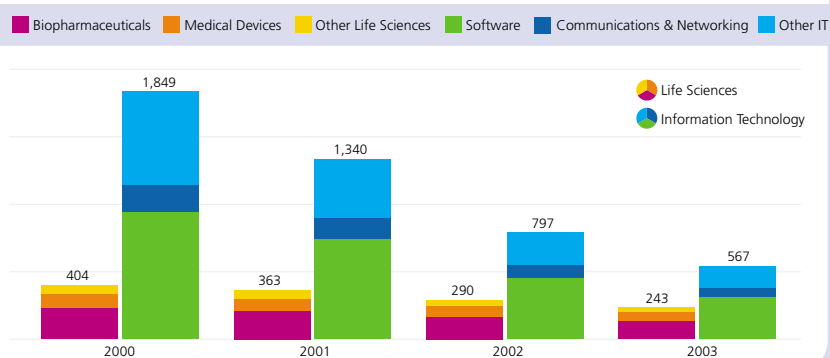
Source: VentureOne

European Venture Capital Financings – 2000 to 2003



Source: VentureOne

European Venture Capital Financings by Industry – 2000 to 2003



Source: VentureOne

Based on hundreds of venture capital financing transactions we handled in 2002 and 2003 for companies and VCs, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2002	2002 Range	2003	2003 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	38%	1x - 2x	0%	N/A
	Post-Series A	25%	1.5x - 3x	31%	1.5x - 5x
Deals with Participating Preferred		2002	2002 Range	2003	2003 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.			if capped		if capped
	Series A	56%	1.5x - 2x	61%	2x - 4x
	Post-Series A	64%	2x - 5.5x	76%	2x - 5x
Deals with an Accruing Dividend		2002		2003	
“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	81%		30%	
	Post-Series A	44%		52%	
Anti-Dilution Provisions		2002		2003	
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: 28% Weighted Average: 72%		Full Ratchet: 3% Weighted Average: 97%	
	Post-Series A	Full Ratchet: 24% Weighted Average: 76%		Full Ratchet: 30% Weighted Average: 70%	
Deals with Pay-to-Play Provisions		2002		2003	
“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	23%		31%	
	% of Total That Convert to Common Stock	30%		50%	
	% of Total That Convert to Shadow Preferred Stock	70%		50%	



Want to know more about the 2003 IPO market and 2004 outlook?

Please see our companion publication, the *2003 IPO Report*, for national and regional analyses and outlooks, recommendations and best practices for issuers affected by the global research analyst settlement, a review of PIPEs and Rule 144A financings in 2003 and an overview of the attributes of outstanding corporate directors.

To request a copy of the *2003 IPO Report*, contact marketing.department@haledorr.com or call 617 526 5600.

Data Source

All data in this report was compiled from the VentureSource database.

Internet Availability

An electronic version of this report can be found at www.vcleader.com.

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