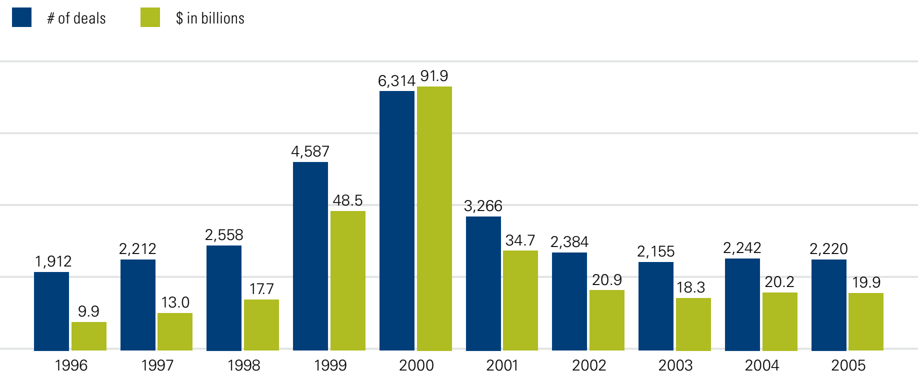
2005 Venture Capital Report

WILMERHALE

WILMER CUTLER PICKERING HALE AND DORR LLP

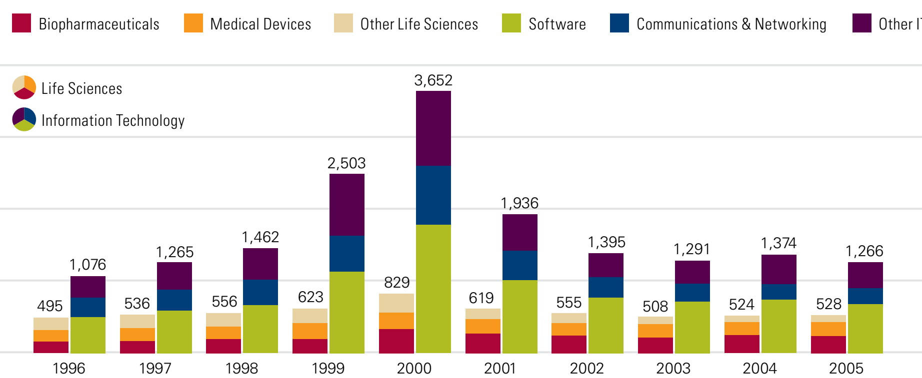
Table of Contents

US Venture Capital Financings – 1996 to 2005



Source: Dow Jones VentureOne

US Venture Capital Financings by Industry – 1996 to 2005



Source: Dow Jones VentureOne

2005 Review

In 2005, the amount and nature of venture capital financing activity in the US market was substantially similar to the levels seen in 2004 and the immediately preceding years. The changes in the markets for liquidity events were more appreciable, with a less robust IPO market but an improved M&A market.

There were 2,220 reported venture capital financings with $19.9 billion in proceeds in 2005, compared to 2,242 financings with proceeds of $20.2 billion in 2004, and we expect the level of 2005 venture capital activity to see a boost once all transactions have been reported. While the 2005 metrics remain well below those of the 1999–2001 Internet bubble, in terms of both the number of financings and the amount invested, they are larger than the levels reached in any year during the 1995–1998 time period.

The median size of venture capital financings dipped from $7.0 million in 2004 to $6.6 million in 2005. The median financing size was once again higher for life sciences companies ($8.0 million) than for information technology companies ($7.0 million). This gap grew in 2005, as the median life sciences financing increased somewhat, while the median IT financing was unchanged.

Valuations of venture-backed companies increased once again from 2004 to 2005. The median pre-money valuation for venture financings was $10.1 million in 2003, $12.9 million in 2004 and $14.3 million in 2005. These increases reflect the gradual improvement in the last several years in the markets for liquidity events, and follow the laws of supply and demand, as the amount of money available for investment by venture funds continues to increase. The $14.3 million median pre-money valuation in 2005 represents the highest such figure for any year other than 1998–2001.

Median pre-money valuations of life sciences companies and IT companies converged at $15.0 million in 2005—due to the fact that IT companies posted a solid increase for the third consecutive year, while life sciences company valuations declined.

Seed and first-round venture capital financings represented 35% of the total number of venture capital financings and 21% of the total amount invested in venture capital financings in 2005—almost exactly the same percentages as in 2004. While the proportion of seed and first-round financing activity has remained relatively consistent since 2001 (between 31% and 37%), these figures are down significantly from 1995–2000, when seed and first-round financings represented between 48% and 54% of the total number of venture financings in each year. The primary reasons for this decline include the application of more rigorous investment criteria by venture capitalists to new investment opportunities and a longer average time between an initial venture funding and a liquidity event—a lag that increases the proportion of later-stage companies in the mix for venture financings.

The breakdown of venture capital financings by industry sector has remained relatively consistent in recent years.

Financings of IT companies represented 57% of all venture capital financings in 2005, and have been between 54% and 60% of venture capital financings in each year since 1996. Life sciences company financings constituted 24% of venture capital financings in 2005. Other than during the 1999–2001 Internet bubble, when they dipped below 20%, financings of life sciences companies have represented between 21% and 26% of venture capital financings in each of the last 10 years. As in recent years, the amount invested in life sciences companies as a percentage of total venture investments in 2005 (31%) was higher than the percentage of life sciences financings, reflecting the greater financing needs of life sciences companies.

The leading locations for venture capital investing have changed little over the past decade. California led the country with 43% of all VC financings in 2005—a position it has held for at least 10 straight years (this data is not available for periods prior to 1996). Massachusetts has been the runner-up throughout this period, and accounted for 11% of venture financings in 2005. Texas, New York and Washington ranked third, fourth and fifth, respectively, in both 2004 and 2005.

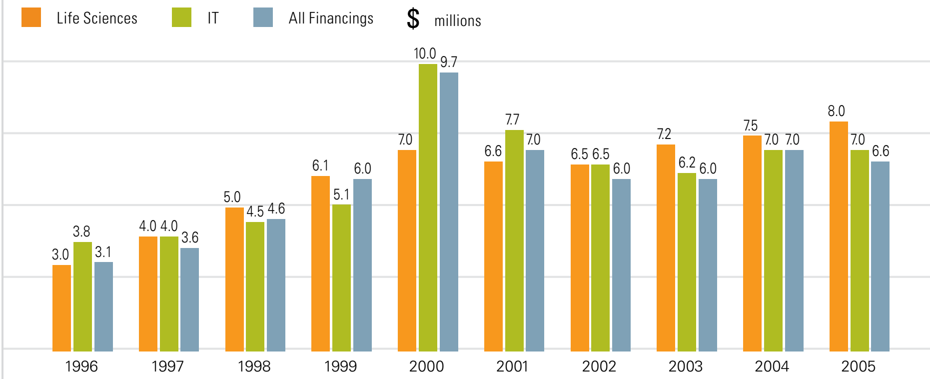
The IPO market for venture-backed companies was not as strong in 2005 as it was in 2004. There were 41 IPOs by venture-backed companies in 2005, compared to 67 in 2004. The 2005 figure significantly exceeds the average number of venture-backed IPOs (21) during the 2001–2003 drought. However, the total of 41 venture-backed IPOs in 2005 was well below the average number of venture-backed IPOs, not only during 1999–2000 (226 per year) but also in the 1996–1998 period (an average of 135 per year).

The median amount raised in venture-backed IPOs in 2005 ($48 million) was below both the 2004 figure ($50 million) and the median figure for the 2001–2004 period ($60 million). The median pre-IPO valuation of venture-backed IPO companies in 2005 ($167 million) was also down from both 2004 ($224 million) and the 2001–2004 period ($240 million). The median time from initial equity funding to IPO inched down to 5.6 years in 2005 from the 2003 and 2004 median of 5.7 years, which had been the longest median time from funding to IPO in the preceding 10 years. The median amount raised prior to IPO by venture-backed companies going public in 2005 was $52 million, which was below the 2004 figure but well above the figures in the mid- to late-1990s, when VC-backed companies routinely completed IPOs after only one or two financing rounds.

A comparison of median pre-IPO valuations to amounts raised prior to IPO indicates that venture-backed company IPOs from 1996–2000 produced significantly greater returns for investors than IPOs in the last several years, even though in recent years there has been a "raising of the bar" for IPO companies and IPO valuations are greater now than during the 1996–1998 period.

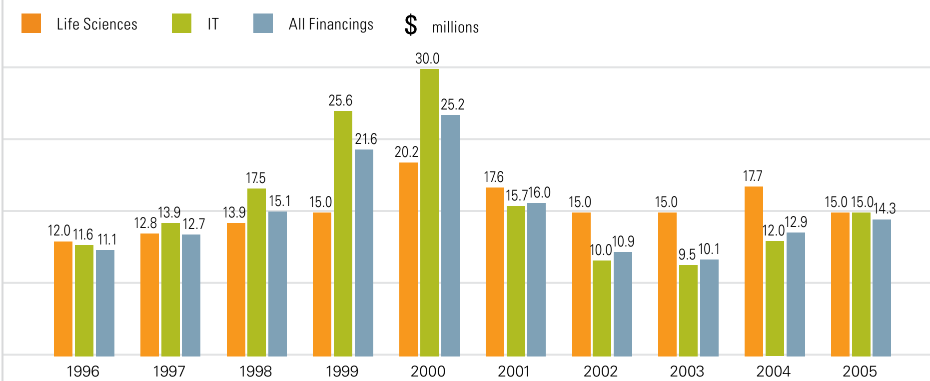
The M&A market for venture-backed companies continued to improve in 2005. There were 356 reported acquisitions of venture-backed companies in 2005, a decrease from the 407 reported in 2004, but more than the 338 in 2003, and we

Median Size of US Venture Capital Financings – 1996 to 2005



Source: Dow Jones VentureOne

Median Pre-Money Valuation in US Venture Capital Financings – 1996 to 2005



Source: Dow Jones VentureOne

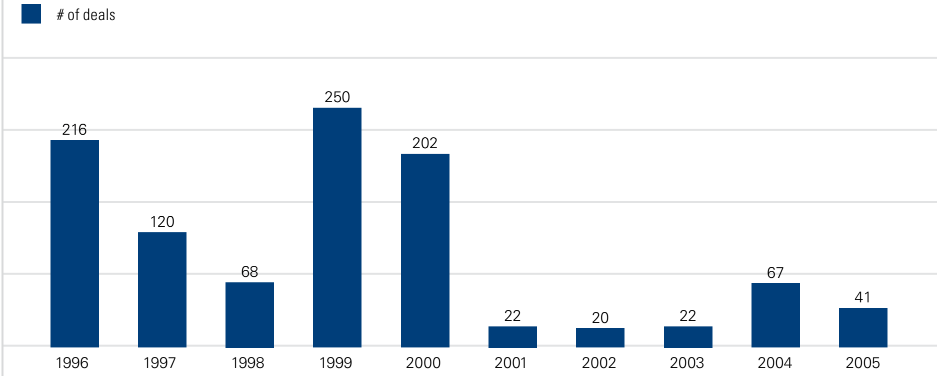
expect the total number of acquisitions in 2005 to approach the 2004 number once all transactions have been reported.

In 2005, M&A transactions accounted for 90% of the liquidity events for venture-backed companies (IPOs contributed the other 10%), marking the fifth consecutive year in which M&A transactions represented 85% or more of venture-backed liquidity events—in sharp contrast to the 1996–2000 period.

The median acquisition price for venture-backed companies in 2005 again increased significantly, growing from $25.0 million in 2003 to $39.3 million in 2004 to $47.5 million in 2005. The 2005 median acquisition price, while substantially lower than the $100.1 million median acquisition price in 2000, was higher than that of any year in the last 10 years other than the period 1999–2000.

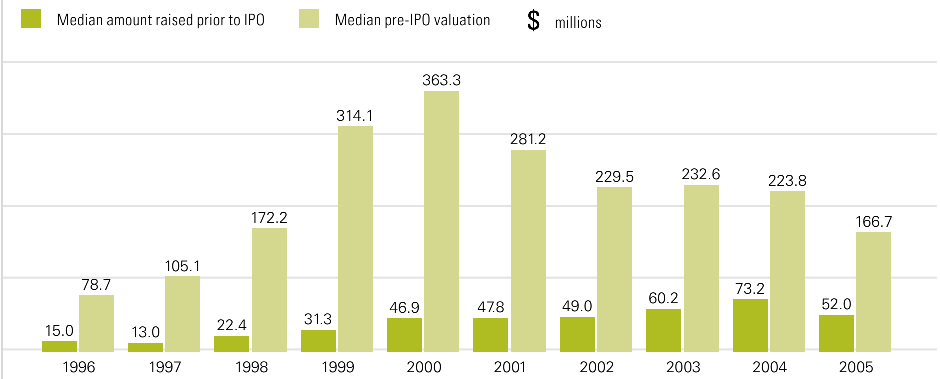
The median time from initial funding to acquisition was 5.4 years in 2005—the highest figure in the last 10 years—and the median amount raised prior to acquisition increased from $20 million in 2004 to $23 million in 2005, indicating that acquirers are focusing on more mature companies.

US Venture-Backed IPOs – 1996 to 2005



Source: Dow Jones VentureOne

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1996 to 2005



Source: Dow Jones VentureOne

2006 Outlook

We do not see any developments or trends likely to result in a significant change in the level of venture capital investments in 2006. We expect that valuations of venture-backed companies will continue to increase in 2006, as a result of the same factors that have driven up valuations over the past two years. However, the rate of increase (median pre-money valuations in 2005 were 42% higher than in 2003) is probably not sustainable.

We expect to see a limited increase—if any—in the average size of venture capital financings, as well as continued downward pressure on the total amount raised by VC-backed companies. Despite the improvements in recent years in acquisition prices paid for venture-backed companies, a very successful sale today generally means an acquisition price of several hundred million dollars (in 2005 only two venture-backed companies were purchased for more than $500 million—and only 15 were purchased for more than $250 million), rather than the billion-dollar deals that were relatively commonplace five to seven years ago. As a result, venture capitalists must limit the amount they invest in companies—forcing companies to develop business plans requiring less funding than might have been available several years ago—in order to earn attractive investment returns.

It is always difficult to predict which industry sectors will be "hot" in a given year. However, we expect that companies developing technology that delivers content to mobile consumers will likely be a focus of increased investment interest. In addition, there will likely be a continued blurring of the lines between IT and life sciences investments, as more investments are made in software, chips and components supporting medical and biotech applications.

The increased globalization of venture capital activity is also expected to continue in 2006. We foresee more venture capital firms investing in overseas companies, sometimes with a local investment partner.

This trend is being driven by greater opportunities to invest in talented management teams or compelling technologies located abroad, as well as increasingly accessible and attractive end-user markets outside of the United States. Another manifestation of this globalization trend is the growing number of investments in companies that have management teams located in the United States and development or other operations located internationally.

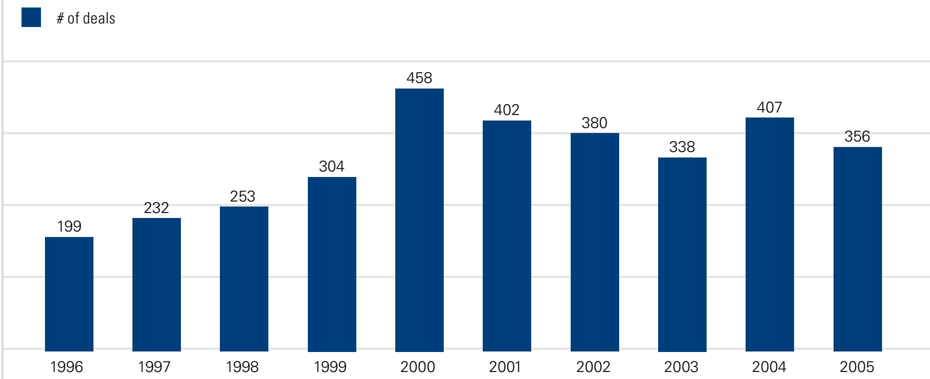
We do not expect drastic changes in the IPO market in 2006. One positive sign is that we enter 2006 with some momentum, as the second half of 2005 produced twice as many venture-backed IPOs as the first half. However, the IPO "bar"—in terms of size and financial performance—remains relatively high. In addition, the regulatory environment—in particular, the expense involved in complying with SEC rules on internal control over financial reporting—is dissuading some companies from embarking on IPOs. We are cautiously optimistic that this situation will become less of a disincentive for IPO candidates, as financial executives and auditors become more familiar with what is still a new process and new regulatory regime, and as the SEC, the Public Company Accounting Oversight Board and/or Congress ease the regulatory burden for smaller companies.

There has been considerable speculation about US venture-backed companies going public on foreign stock exchanges such as AIM (a small-cap exchange affiliated with the London Stock Exchange), or exchanges in Canada and Germany. However, offerings on such exchanges typically do not result in significant liquidity opportunities for shareholders, and we therefore expect the number of offshore IPOs by US venture-backed companies to be limited.

M&A transactions should continue to be the dominant liquidity vehicle for venture-backed companies in 2006. M&A valuations are not likely to continue to increase at the rate experienced in the last two years, but there is little reason to believe they will not hold steady or increase modestly. M&A activity is generally believed to have been dampened in the past two years by the internal control documentation and audit process that larger public companies had to report on for the first time in 2005, as companies were concerned about the impact of introducing a new business enterprise into their internal control environment. Now that larger public companies—the most likely acquirers of venture-backed companies—have completed their first cycle of internal control audits, this impediment to acquisitions should be somewhat alleviated, leading to an increase in M&A transactions in 2006. ■

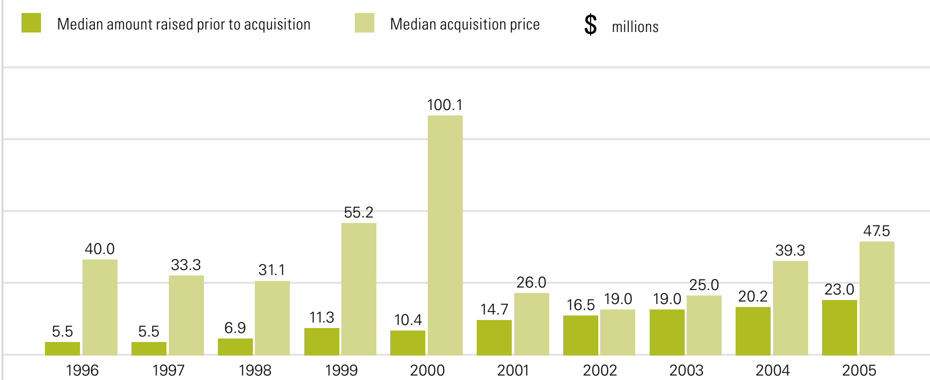
January 2006

Acquisitions of US Venture-Backed Companies – 1996 to 2005



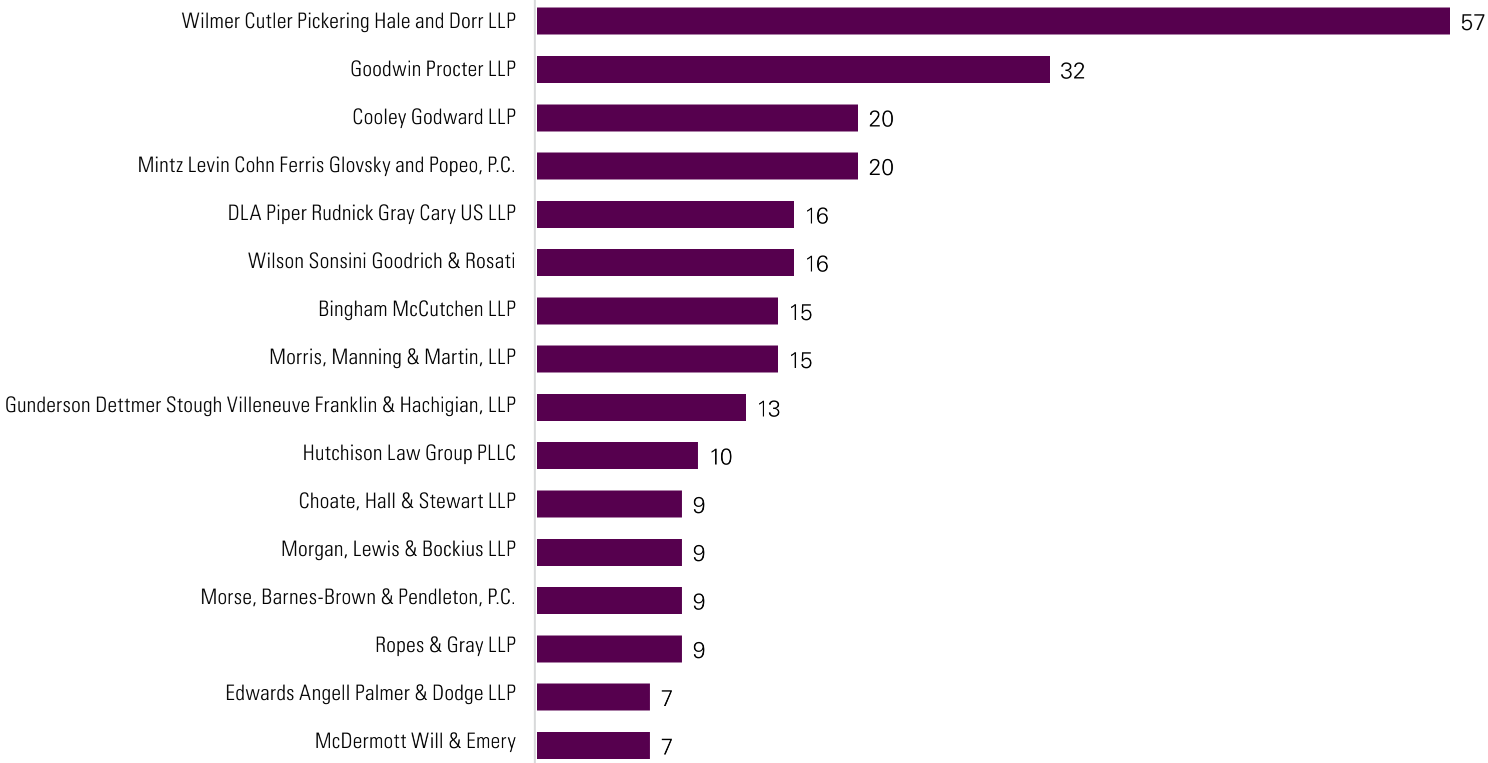
Source: Dow Jones VentureOne

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1996 to 2005



Source: Dow Jones VentureOne

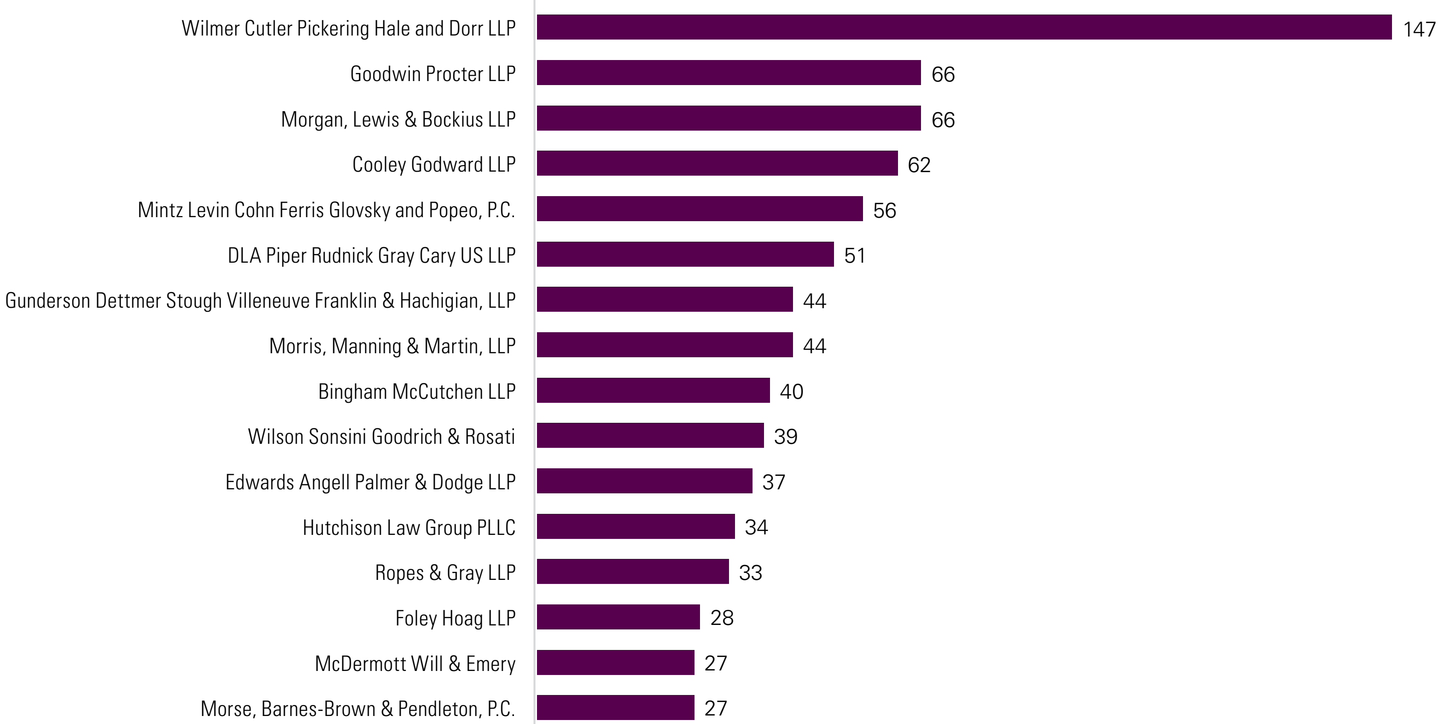
Counsel to Companies Receiving VC Financing in 2005 – Eastern US



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 2005.

Source: Dow Jones VentureOne

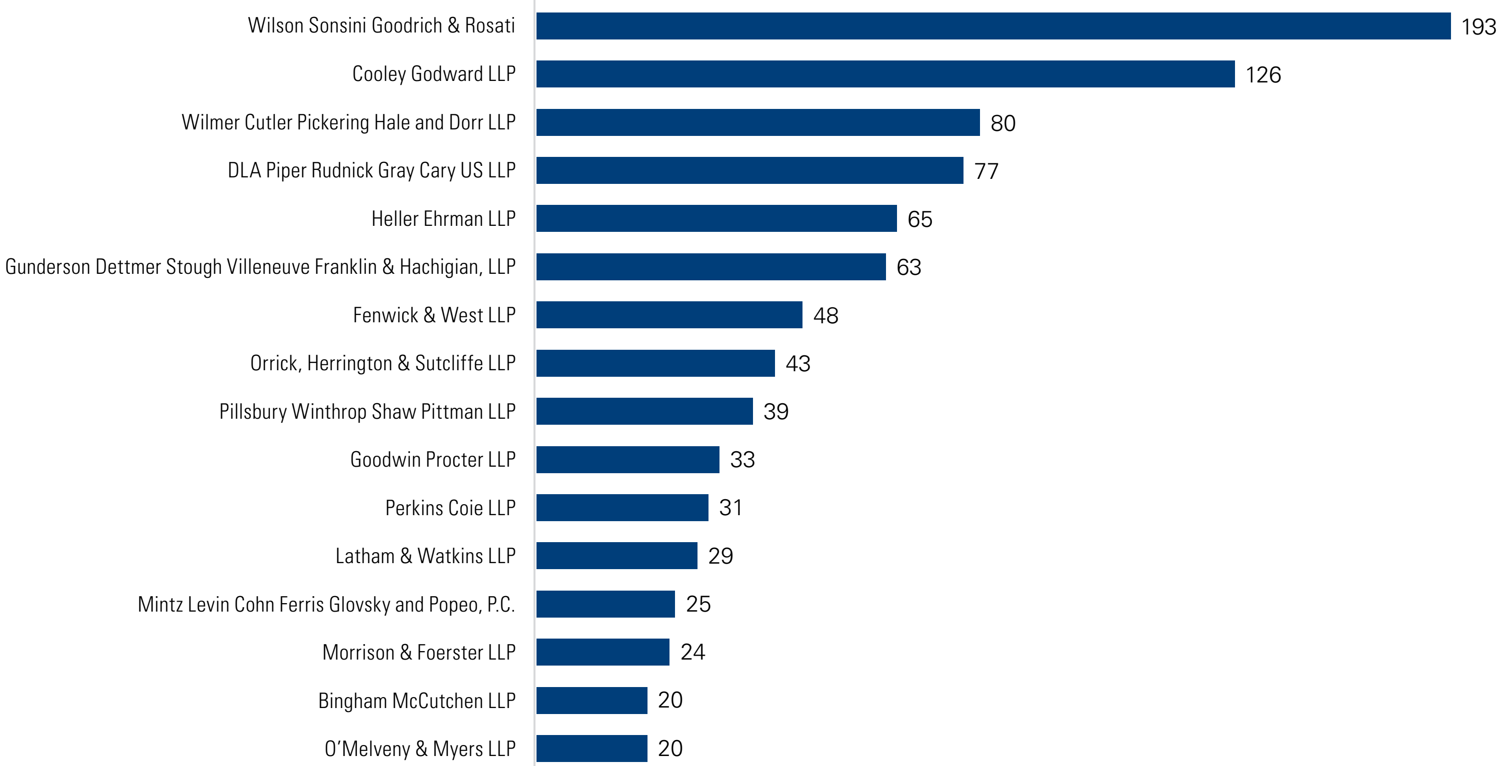
Counsel to VC-Backed Companies at Year-End 2005 – Eastern US



The above chart is based on companies located east of the Mississippi River that have completed a seed, first, second, later stage or restart round of venture capital financing and were private and independent as of the end of 2005.

Source: Dow Jones VentureOne

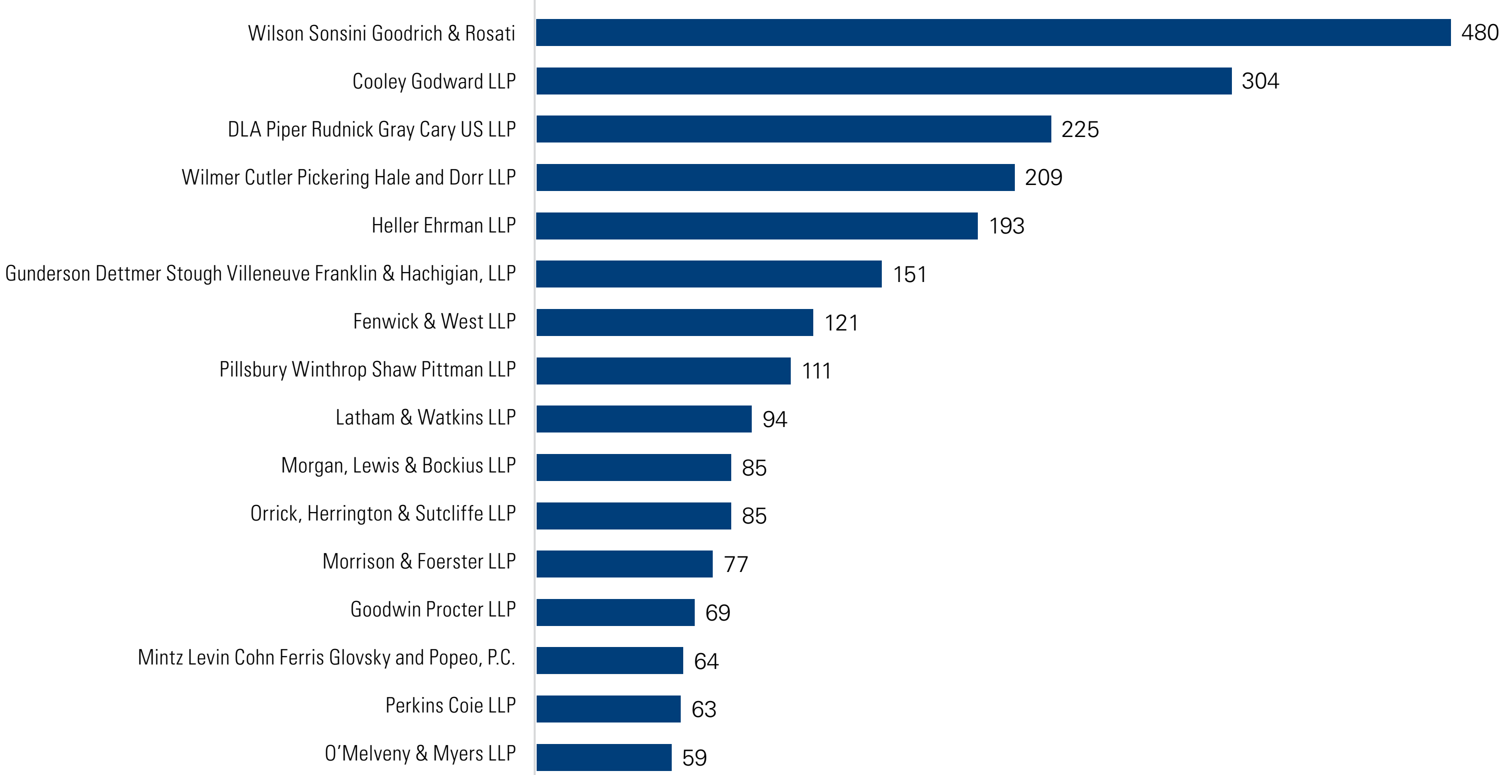
Counsel to Companies Receiving VC Financing in 2005 – Worldwide



The above chart is based on all companies contained in the VentureSource database (covering the United States, Europe and Israel) that completed a seed, first, second, later stage or restart round of venture capital financing in 2005.

Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2005 – Worldwide



The above chart is based on all companies contained in the VentureSource database (covering the United States, Europe and Israel) that have completed a seed, first, second, later stage or restart round of venture capital financing and were private and independent as of the end of 2005.

Source: Dow Jones VentureOne

California

California companies reported 955 financings, with $8.96 billion in proceeds, in 2005, compared to 951 deals and $9.60 billion in 2004. Final 2005 data—after all transactions have been reported—are likely to show growth in deal volume from 2004 to 2005 and comparable proceeds across both years.

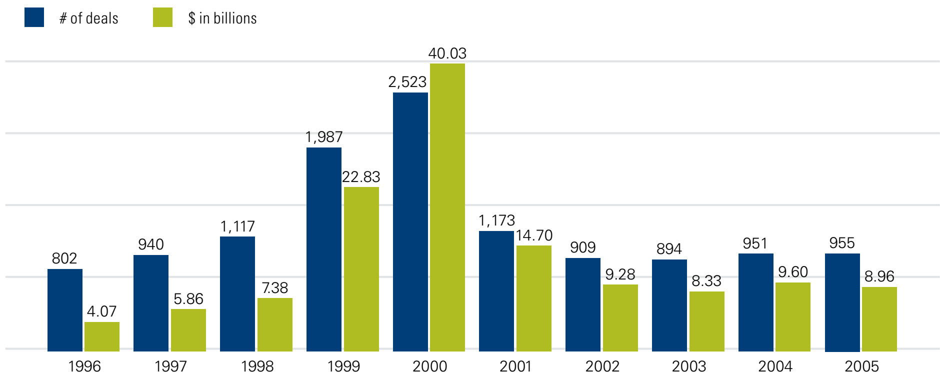
Roughly four times the size of the next largest venture capital market in the United States, California was responsible for 43% of all deals and 41% of all proceeds in the country in 2005. Although 2005 activity was well below the peak year of 2000—when California produced a staggering 2,523 financings with $40.03 billion in proceeds—deal volume and proceeds have largely returned to pre-bubble levels.

California's venture capital market spans all industry sectors, with particular strengths in technology, life sciences, consumer retail and media/entertainment. IT companies dominated the market again in 2005, accounting for 63% of all financings in the state—down from 68% in 2004. Life sciences companies made up 20% of California's deals—the same percentage as in 2004.

California spawned 14 IPOs by venture-backed companies in 2005, down from 38 in 2004, as some IPO candidates opted for M&A liquidity on attractive terms. Although the number of acquisitions of VC-backed companies declined from 161 in 2004 to 127 in 2005, the state produced 10 of the 15 deals in the country over $250 million, and the largest sale of the year (Pfizer's acquisition of Angiosyn for $527 million).

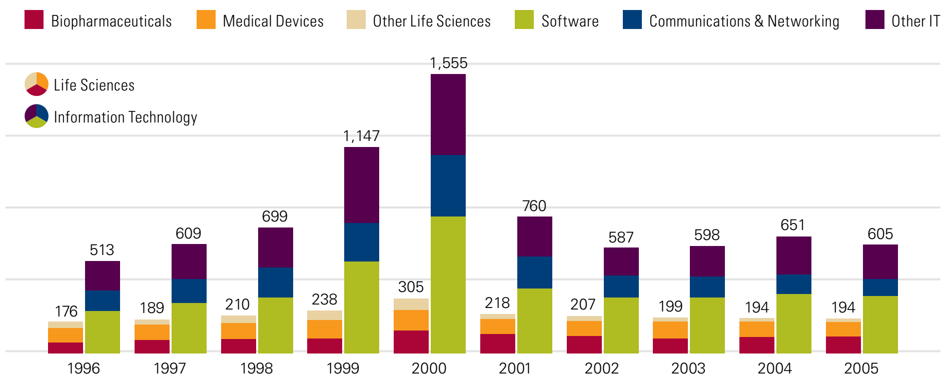
We expect California to maintain its venture capital leadership in 2006, particularly in technology and life sciences. With a heavy concentration of industry leaders, venture capitalists, scientific talent, entrepreneurs, service providers and other startup infrastructure, conditions are ripe for further growth in California in 2006. A significant part of that growth should come from "global startups" that are founded and financed in Silicon Valley, but have major operations in Asia or other foreign jurisdictions.

California Venture Capital Financings – 1996 to 2005



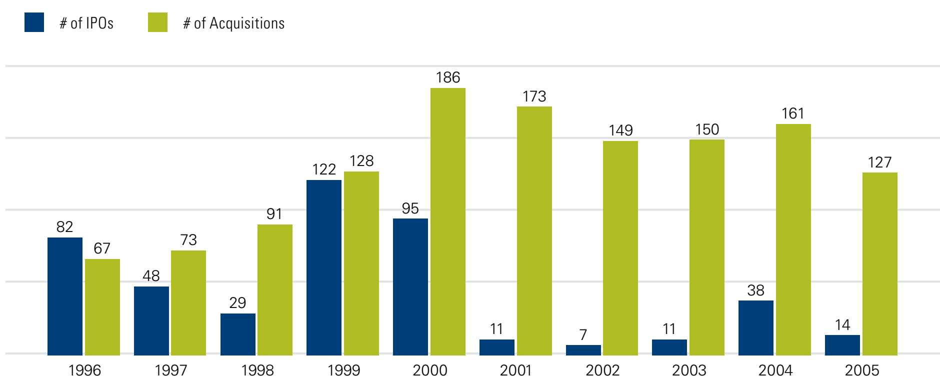
Source: Dow Jones VentureOne

California Venture Capital Financing by Industry – 1996 to 2005



Source: Dow Jones VentureOne

California Venture-Backed IPOs and Acquisitions – 1996 to 2005



Source: Dow Jones VentureOne

Mid-Atlantic

In 2005, there were 152 reported venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia, compared to 151 in 2004, with $1.38 billion in proceeds in each year. Although the reported data suggests 2005 was a flat year in venture capital activity, we expect that the region will show year-over-year growth once all transactions have been reported.

The region produced some notable deals during the year, such as information technology company TARGUSinfo's $60 million financing. IT companies accounted for 52% of all financings in the region—the same percentage as in 2004—and life sciences companies edged up from 28% to 30%.

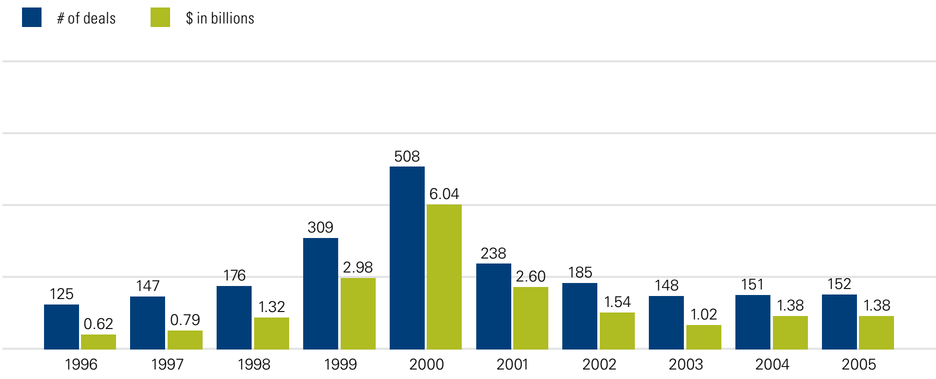
Venture-backed companies in the mid-Atlantic region bucked the national decline in IPO activity in 2005, but mirrored the national trend of fewer acquisitions.

There were four IPOs by mid-Atlantic VC-backed companies in 2005—the largest number since 2000—compared to two in 2004. Three of the 2005 IPOs came from Maryland, including the nation's largest VC-backed IPO of the year (Under Armour's $123.5 million offering).

The number of acquisitions of venture-backed companies in the region fell from 35 in 2004 to 22 in 2005. The region's largest deal of the year was the acquisition of healthcare company Lumenos for $185 million.

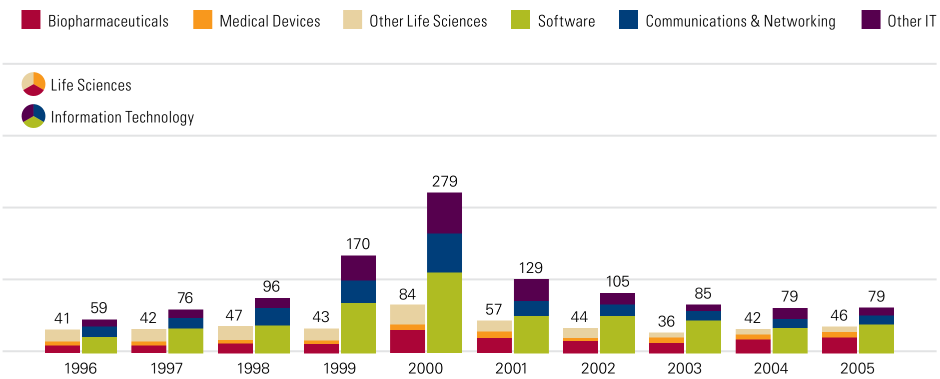
For 2006, we expect that the concentration of companies that focus on information technology, national security, government contracting and defense will produce a steady stream of attractive emerging companies in the region. We also expect that the region—and particularly the Research Triangle area—will remain a leading center of life sciences–related investment.

Mid-Atlantic Venture Capital Financings – 1996 to 2005



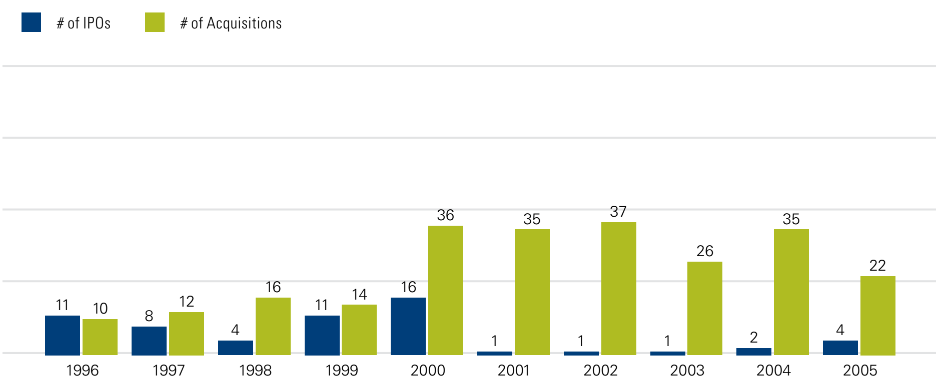
Source: Dow Jones VentureOne

Mid-Atlantic Venture Capital Financing by Industry – 1996 to 2005



Source: Dow Jones VentureOne

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1996 to 2005



Source: Dow Jones VentureOne

New England

New England companies reported 293 financings, with $2.79 billion in proceeds, in 2005 compared to 314 deals and $2.81 billion in 2004. Once all 2005 transactions have been reported, we expect that financing proceeds in 2005 will exceed 2004 proceeds and that the number of 2005 deals will approximate 2004 deal volume.

While venture capital investment in the region remains well below the bubble years of 1999–2001, the average number of New England financings over the last four years (324 deals) closely parallels that of the 1996–1998 period (326 deals).

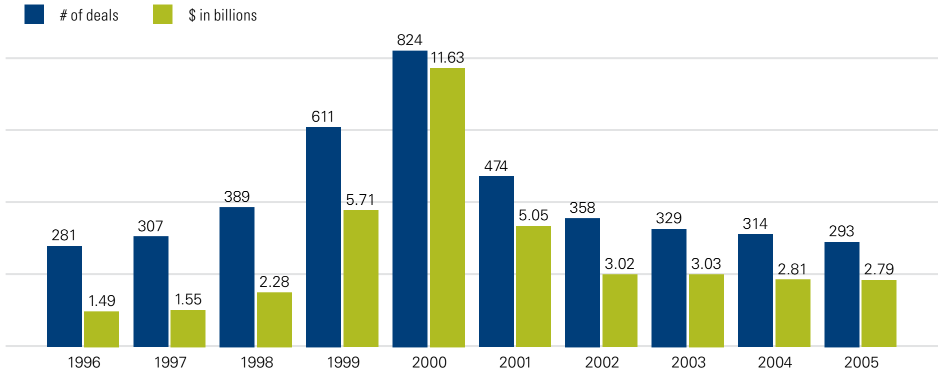
New England continues to be a leading center of activity for technology and life sciences companies—and the only region to report increases in both IPOs and acquisitions of VC-backed companies in 2005. In 2005, information technology companies accounted for 60% of the region's venture capital financings—down from 64% in 2004—and life sciences companies made up 25% of the year's deals, compared to 24% in 2004.

The region produced eight venture-backed IPOs in 2005, compared to seven in 2004—all from Massachusetts in both years. In contrast to 2004, when all seven New England IPOs were in life sciences, the eight IPOs in 2005 spanned the technology and life sciences sectors.

Acquisitions of venture-backed companies in New England increased from 56 in 2004 to 64 in 2005—a figure exceeded only once in the past decade (69 in 2000). The region produced two sales over $200 million—the acquisitions of Imagitas and TransForm Pharmaceuticals for $230 million each.

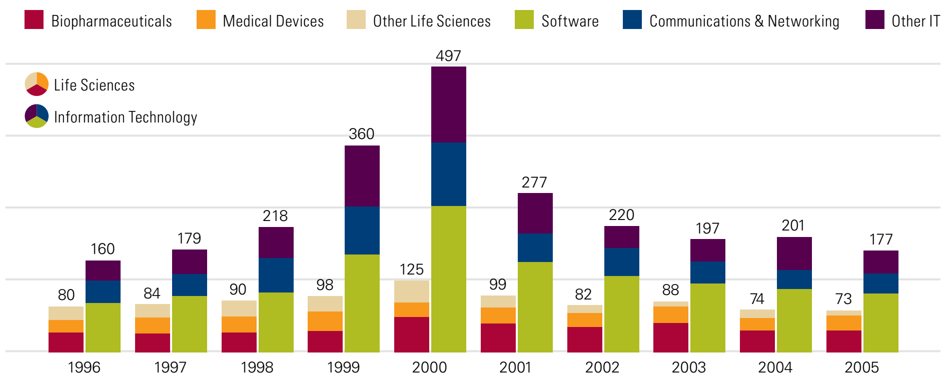
For 2006, we expect New England—and Massachusetts in particular—to remain a hub of venture capital activity. The region's world-renowned universities and research institutions should continue to produce technological innovations, scientific discoveries, talented employees and entrepreneurs, all of which—coupled with the area's extensive network of venture capitalists and other service providers—should maintain New England's status as one of the country's most appealing environments for emerging companies.

New England Venture Capital Financings – 1996 to 2005



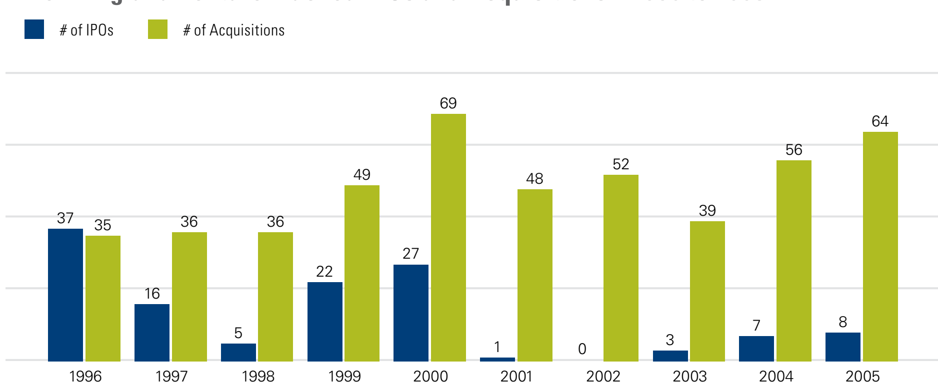
Source: Dow Jones VentureOne

New England Venture Capital Financing by Industry – 1996 to 2005



Source: Dow Jones VentureOne

New England Venture-Backed IPOs and Acquisitions – 1996 to 2005



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 declined modestly, from 239 in 2004 to 207 in 2005, although we expect this gap to close once all 2005 transactions have been reported. Total reported investment proceeds increased by 12%, from $1.99 billion to $2.22 billion.

Venture capital activity in the region again exceeded the pre-boom years of 1996–1998, which produced an annual average of 193 financings raising $1.26 billion.

IT companies continued to dominate the tri-state region's VC financing market, with 52% of all deals in 2005—up from 49% in 2004. Life sciences companies logged 27% of the region's financings, compared to 26% in the prior year.

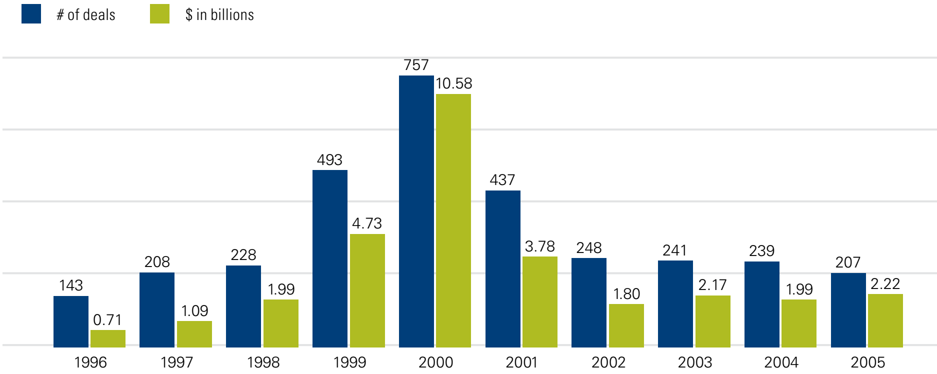
Liquidity events in the tri-state region largely echoed national trends in 2005.

The number of venture-backed IPOs in the region dropped by half, from ten in 2004 to five in 2005, as attractive valuations steered more companies to sales. Of the five IPOs in 2005, two were in information technology (including the nation's second largest VC-backed IPO of the year, DealerTrack's $113.3 million offering), two were in life sciences, and one was in financial services.

The number of acquisitions of venture-backed companies in the region increased from 45 in 2004 to 47 in 2005—a total exceeded only once in the past 10 years (49 in 2001). The tri-state region accounted for five acquisitions of VC-backed companies for more than $250 million each—three in healthcare and two in information technology—the only region outside of California to produce any acquisitions of that size in 2005.

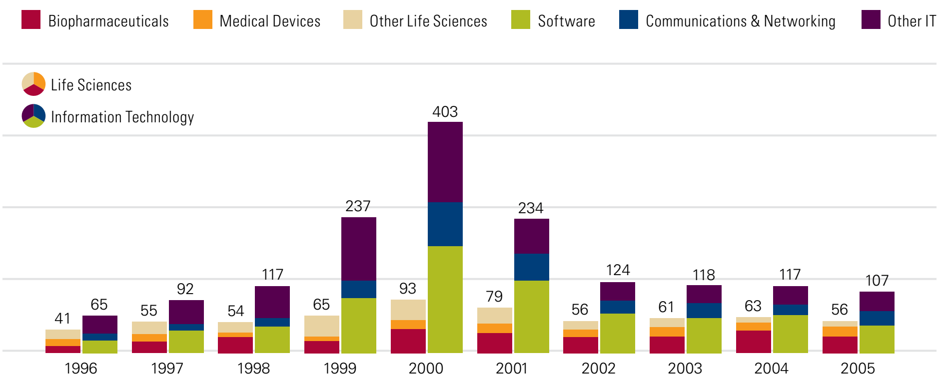
We believe that the tri-state region's strengths in the pharmaceuticals, life sciences, financial services and information technology sectors—combined with its large number of Fortune 500 companies—will provide a favorable environment for VC-backed startup companies in 2006. ■

Tri-State Venture Capital Financings – 1996 to 2005



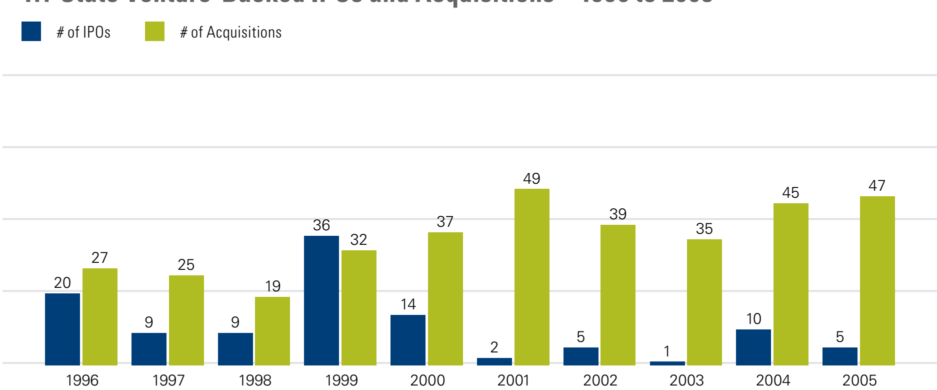
Source: Dow Jones VentureOne

Tri-State Venture Capital Financing by Industry – 1996 to 2005



Source: Dow Jones VentureOne

Tri-State Venture-Backed IPOs and Acquisitions – 1996 to 2005



Source: Dow Jones VentureOne

Counsel of Choice for Venture Capital Financings

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

TARGUSinfo	$60,000,000	*First Round*	August 2005
Surface Logix	$42,000,000	*Third Round*	October 2005
MINTERA	$18,500,000	*Second Round*	April 2005
AYLUS	$10,000,000	*First Round*	January 2005
KALIDO	$13,500,000	*Third Round*	September 2005
ALANTOS Pharmaceuticals	$20,000,000	*Second Round*	March 2005
PTC Therapeutics	$26,600,000	*Late Stage*	September 2005
incipient	$20,000,000	*Third Round*	January 2005
OXAGEN	$59,800,000	*Second Round*	May 2005
AHURA	$10,000,000	*Second Round*	January 2005
NANTERO	$15,000,000	*Third Round*	March 2005
BzzAgent	$13,750,000	*Second Round*	December 2005
zipcar	$10,000,000	*Late Stage*	July 2005
Virtual Iron	$8,500,000	*Third Round*	August 2005
Tribotek Science of Interconnects	$12,500,000	*Second Round*	May 2005
Akorri	$8,400,000	*First Round*	February 2005
SmartBargains	$18,000,000	*Fourth Round*	September 2005
REDSHIFT	$12,000,000	*First Round*	December 2005
BINOPTICS	$10,000,000	*Second Round*	February 2005
GlycoFi	$11,000,000	*Third Round*	September 2005
SpaceClaim	$6,300,000	*First Round*	October 2005
BIONICARE The Non-Drug, Non-Invasive Advantage	$15,000,000	*Third Round*	May 2005
ICERA	$10,000,000	*Second Round*	April 2005
SOFTRICITY	$15,000,000	*Late Stage*	April 2005
SIONEX Corporation	$12,000,000	*Third Round*	November 2005
STARENT NETWORKS	$15,000,000	*Late Stage*	May 2005
cognima	$12,000,000	*Second Round*	June 2005
TIMELAB	$7,500,000	*Second Round*	March 2005
CAMIANT	$8,000,000	*Second Round*	March 2005
axiom legal	$20,000,000	*Second Round*	May 2005
azuro	$9,000,000	*Second Round*	December 2005
CODON DEVICES	$13,000,000	*First Round*	February 2005
egenera	$15,000,000	*Late Stage*	March 2005
TargetRx	$15,000,000	*Fourth Round*	April 2005

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2005 Review

The European venture capital market in 2005 produced a solid level of investment activity and a significant improvement in liquidity events.

In 2005, there were 995 reported venture capital financings with proceeds of €3.77 billion in Europe, compared to 1,093 financings with proceeds of €4.16 billion in 2004. However, we expect the level of venture capital activity in 2005 to equal or exceed 2004 activity once all transactions have been reported.

The median financing size in Europe, although lagging significantly behind the US median, increased from €1.8 million in 2004 to €2.0 million in 2005—the fourth consecutive annual increase, and the highest level since 2000—due to an increase in larger, later-stage rounds. Later stage financings climbed from 38% of all rounds in 2004 to 43% in 2005, while seed and first-round deals declined from 37% to 34%.

With a total of 288 deals, software companies again accounted for the largest sector of the European venture capital market in 2005, representing 29% of all financings, as compared to 30% in 2004. Financings by software companies produced €806 million in reported proceeds in 2005, compared to €896 million the year before.

Biopharmaceutical companies produced 164 financings in 2005, or 16.5% of all deals—down slightly from 17% in 2004. Total proceeds in this sector edged down from €1.42 billion to €1.21 billion. Due to their larger average deal size, biopharmaceutical companies accounted for 32% of the total amount invested in 2005, compared to 34% in 2004. The largest European biopharmaceutical financing of 2005 was Oxagen's $59.8 million deal.

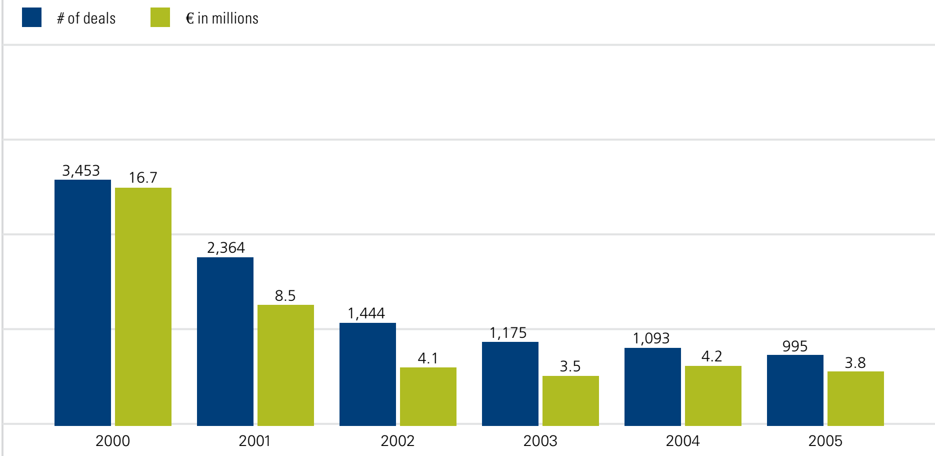
Financings by European medical device companies edged up from 8% of deals in 2004 to 9% in 2005, while reported proceeds in this sector increased 30%, from €245 million in 2004 to €318 million in 2005—the largest amount invested in medical device companies since at least 2000.

The United Kingdom remains the largest venture capital market in Europe, having produced 30% of all deals in 2005 (up from 28% in 2004), followed by France with 21% (up from 18% in 2004), Germany with 10% (down from 12% in 2004), and Sweden with 9% (down from 13% in 2004).

The IPO market for European venture-backed companies enjoyed its best year since 2000. The number of IPOs jumped from 35 in 2004 to 60 in 2005—marking the highest yearly total since the 182 IPOs in 2000 and surpassing the total number of IPOs for the period 2002–2004—and the year ended on a high note, with 23 IPOs in the fourth quarter. For the first time since 2001, the number of IPOs by European VC-backed companies exceeded the number of IPOs by US VC-backed companies.

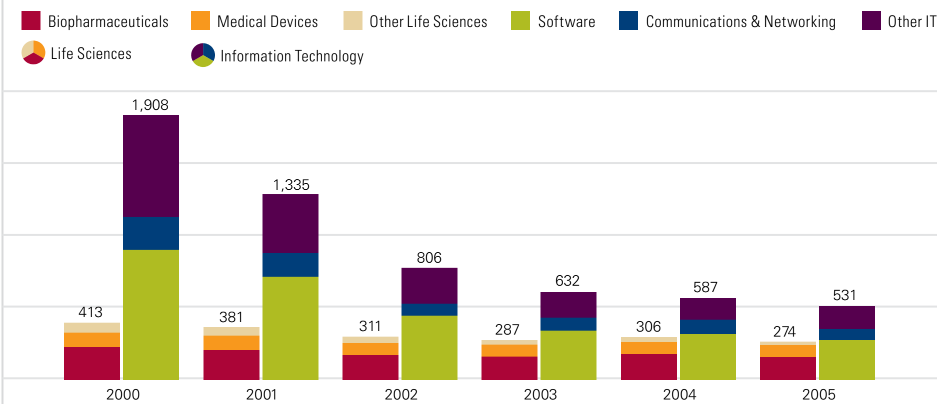
Median IPO proceeds soared 45%, from €10.3 million in 2004 to €14.9 million in 2005, and median pre-IPO valuations climbed 20%, from €34.9 million to €42.0 million. These increases reflect, in part, a more mature base of IPO companies. The median time from initial equity funding to IPO was 5.9 years in 2005, up from 4.3 years in 2004, and longer than the median time for US VC-backed companies completing

European Venture Capital Financings – 2000 to 2005



Source: Dow Jones VentureOne

European Venture Capital Financings by Industry – 2000 to 2005



Source: Dow Jones VentureOne

IPOs in 2005 (5.6 years). The median amount invested prior to IPO declined from €13.3 million in 2004 to €11.1 million in 2005.

The strength of the European VC-backed company IPO market cut across industry lines in 2005, with information technology companies producing 25 IPOs and life sciences companies contributing 22. The United Kingdom was the largest source of IPOs, with 21, followed by France with 13 and Germany with eight.

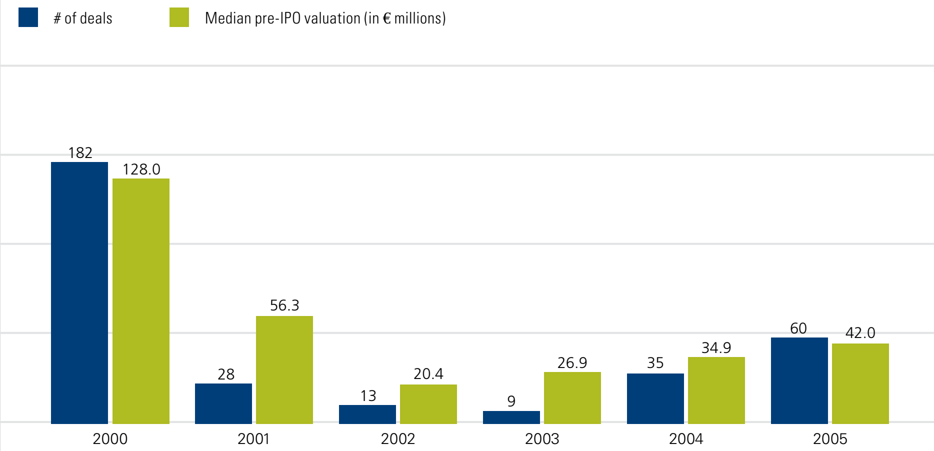
Despite the strong IPO results of 2005, the lack of a public market where high-growth companies can raise substantial sums of money and provide sufficient liquidity to investors, like Nasdaq, remains an issue for European VC-backed companies seeking exits.

The number of reported acquisitions of European venture-backed companies declined from 194 in 2004 to 163 in 2005. However, the reported 2005 figure already exceeds the number of acquisitions in every other year since 2000, and we expect the total number of acquisitions in 2005 to approach the number in 2004 once all transactions have been reported. More than half of the year's reported deals (86) were for information technology companies, and 47 were for life sciences companies. UK-based companies accounted for 47 deals, followed by France with 27 and Germany with 26.

In an encouraging sign, the median acquisition price increased from €17.8 million in 2004 to €22.5 million in 2005—even though the median amount raised prior to acquisition remained at €6 million. The higher acquisition prices reflected the greater maturity of the acquired companies, whose median time from initial equity funding to acquisition increased from 4.2 years in 2004 to 4.9 years in 2005—still less than the median time of 5.4 years for acquired VC-backed companies in the United States in 2005.

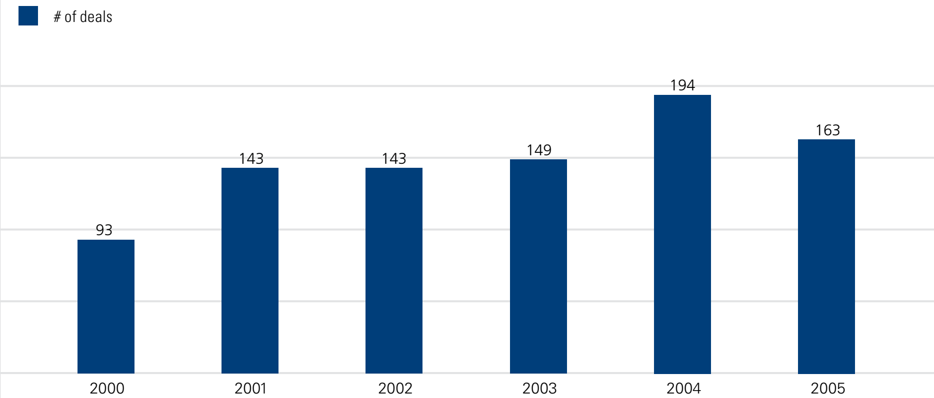
The €2.08 billion purchase of Skype Technologies by eBay was the largest European VC-backed company acquisition of the year—and more than four times the size of the largest US deal in 2005. In terms of prominence, size and return on investment, it is likely that Skype Technologies will be considered a landmark investment to which all other European VC investments are compared for the foreseeable future.

European Venture-Backed IPOs – 2000 to 2005



Source: Dow Jones VentureOne

Acquisitions of European Venture-Backed Companies – 2000 to 2005



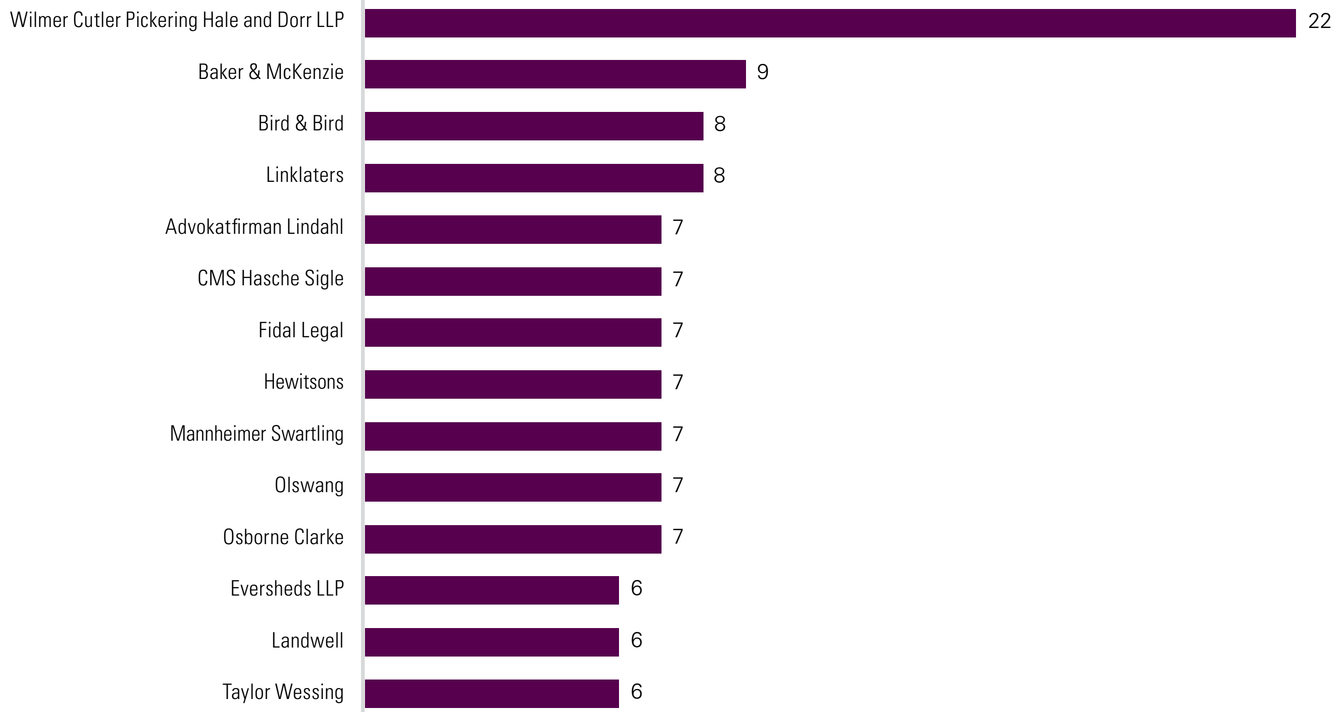
Source: Dow Jones VentureOne

2006 Outlook

For 2006, we expect European venture capital investment to remain steady or to increase modestly. We also expect the median financing size of VC deals in Europe to continue to increase as improved liquidity conditions enable more larger, later-stage rounds—particularly deals led by private equity firms—to be completed.

On the heels of the best year for liquidity events by European VC-backed companies since 2000, conditions appear conducive to continued strength in the IPO and acquisition markets. Since 2006 will be an important year for fundraising by European venture capital funds, funds will be seeking trade sales and IPOs of VC-backed companies to demonstrate investment returns to their limited partners. Also, the IPOs of Optos and Qinetiq on the London Stock Exchange in January 2006 may herald an increasing receptiveness in the public markets to venture-backed technology companies. ■

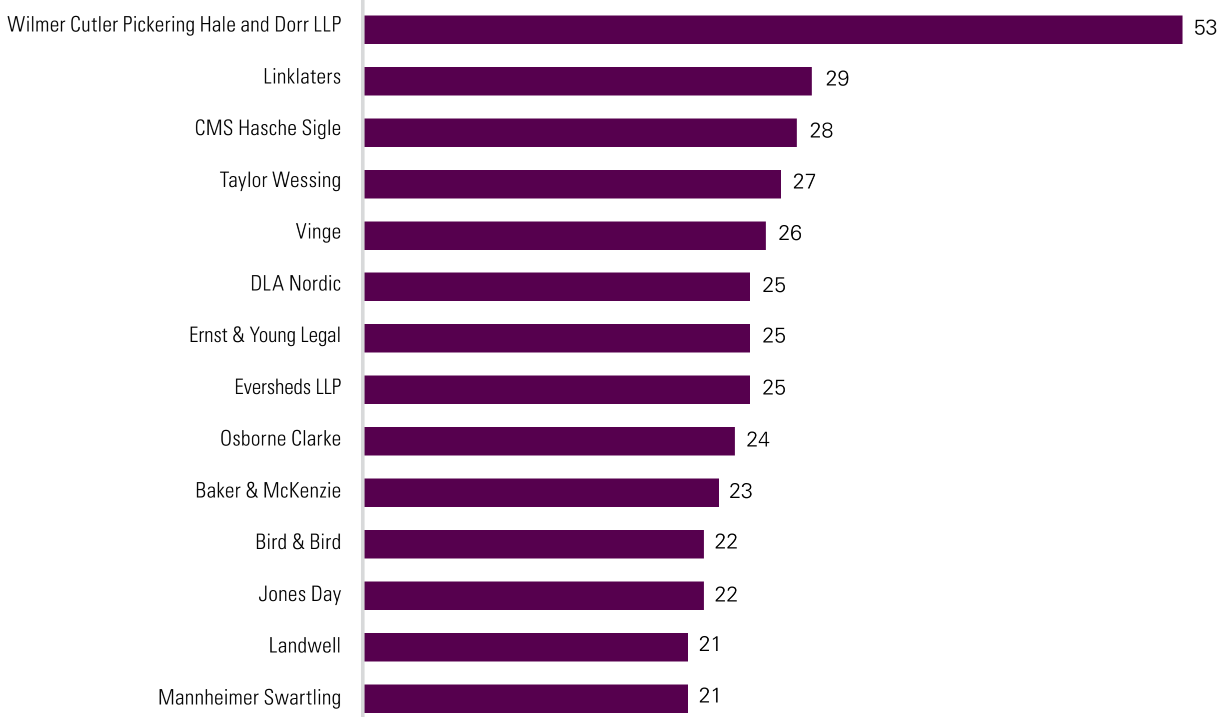
Counsel to Companies Receiving VC Financing in 2005 – Europe



The above chart is based on European companies that completed a seed, first, second, later stage or restart round of venture capital financing in 2005.

Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2005 – Europe



The above chart is based on European companies that have completed a seed, first, second, later stage or restart round of venture capital financing and were private and independent as of the end of 2005.

Source: Dow Jones VentureOne

Based on hundreds of venture capital financing transactions we handled from 2002 to 2005 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences

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.

	2002	2002 Range	2003	2003 Range	2004	2004 Range	2005	2005 Range
Series A	38%	1x – 2x	0%	N/A	22%	1.25x – 5x	3%	1.5x
Post–Series A	25%	1.5x – 3x	24%	1.5x – 5x	11%	1.5x – 3x	110%	1.5x – 2x

Deals with Participating Preferred

"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.

	2002	2002 Range	2003	2003 Range	2004	2004 Range	2005	2005 Range
		if capped		if capped		if capped		if capped
Series A	56%	1.5x – 2x	61%	2x – 4x	56%	2x – 5x	58%	2x – 5x
Post–Series A	64%	2x – 5.5x	76%	2x – 5x	54%	1.75x – 5x	71%	2x – 5x

Deals with an Accruing Dividend

"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.

	2002	2003	2004	2005
Series A	81%	30%	47%	78%
Post–Series A	44%	52%	48%	87%

Anti-Dilution Provisions

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.

	2002	2003	2004	2005
Series A				
Full Ratchet	28%	3%	3%	0%
Weighted Average	72%	97%	97%	100%
Post–Series A				
Full Ratchet	24%	30%	7%	16%
Weighted Average	76%	70%	93%	84%

Deals with Pay-to-Play Provisions

"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).

	2002	2003	2004	2005
Total	23%	31%	26%	25%
% of Total That Convert to Common Stock	30%	50%	67%	55%
% of Total That Convert to Shadow Preferred Stock	70%	50%	33%	45%

Most venture-backed companies do not have deferred salary or bonus plans and understandably expected the new tax rules on deferred compensation to be of little relevance to their day-to-day operations. However, new Section 409A of the Internal Revenue Code reaches many arrangements not historically considered deferred compensation, including stock options and severance payments.

As a result, management and directors of venture-backed companies must understand the impact of Section 409A on compensation arrangements. Following a brief overview of Section 409A, we offer practical advice for VC-backed companies on how to implement stock option programs and severance payment arrangements in light of Section 409A.

Overview

Section 409A applies to all deferred compensation plans and agreements entered into, or vesting after, January 1, 2005. The provision:

- establishes timing rules specifying when an election to defer compensation must be made; and
- dictates the permissible distribution events for deferred compensation.

If a compensation arrangement is not compliant with, or exempt from, Section 409A, the recipient will be required to pay income tax when the arrangement vests, and possibly interest and a 20% penalty tax. In addition, the company may have reporting and withholding obligations.

Deferred compensation includes any agreement, plan or arrangement that provides for a deferral of compensation, with very limited exceptions. A deferral of compensation exists when there is a legally binding right in a tax year to compensation that is payable in a later year. A legally binding right can exist even if payment of the compensation is subject to contingencies, such as continued service or termination of service. Deferred compensation:

- *Includes:* salary and bonus deferrals (including accrued salary not paid); options and stock appreciation rights with below-market exercise prices; some employment, severance and change-in-control agreements; and SERPs or excess benefit plans; but
- *Excludes:* retirement plans; vacation, sick, death and disability benefits; most options and stock appreciation rights with fair market value exercise prices; ESPPs; restricted stock; short-term deferrals, and certain foreign plans.

Stock Options

Stock options with an exercise price that is at least equal to the fair market value of the common stock on the date of grant, and that do not otherwise have a deferral feature, are exempt from Section 409A. Thus, the most significant issue for venture-backed companies under Section 409A is whether the board's process for determining fair market value will be sufficient to exempt stock option grants from the new law. The IRS has provided the following guidance for determining fair market value:

- For stock options granted before January 1, 2005, a good faith attempt to establish a fair market value exercise price for stock options (that is, the same standard historically used for incentive stock option purposes) is sufficient.
- For stock options granted on or after January 1, 2005, the more exacting standard of "any reasonable valuation method" must be used.

In addition, the IRS has issued proposed valuation regulations that may be relied on immediately even though they are not scheduled to become effective before January 1, 2007. The proposed regulations provide that the fair market value of private company stock must be determined by the reasonable and consistent application of a reasonable valuation method that considers all relevant facts and circumstances. A valuation performed by an independent third party no more than 12 months before the option grant date will be presumed to result in a reasonable valuation. If such independent valuation is not obtained, the proposed regulations provide that the following factors should be considered:

- the value of tangible and intangible assets;
- the present value of future cash flows;
- the market value of stock or other equity interests in similar companies;
- control premiums and discounts for lack of marketability; and
- whether the valuation is consistent with valuations used for other corporate purposes.

What does the IRS guidance mean from a practical perspective? Our thoughts and recommendations are as follows:

Pre-2005 Grants. Stock options granted before January 1, 2005 should be exempt from Section 409A, provided the board made a good faith attempt to establish a fair market value exercise price for the options and the options do not otherwise include a deferral feature. A company that can satisfy this standard only needs to consider the application of Section 409A to those pre-2005 stock options that were intentionally issued at a discount or that included a deferral feature.

Post-January 1, 2005 Grants. For options granted on or after January 1, 2005, the standard of "any reasonable valuation method" for determining fair market value under Section 409A is applicable until final regulations are issued. It is clear, however, that this standard is higher than the incentive stock option standard. Moreover, while the regulations are not yet effective, and may be revised before issued in final form, they are indicative of the approach and level of scrutiny that the IRS expects with respect to valuation. As a result, the common practice of valuing private company stock based on rule-of-thumb discounts and cursory board resolutions stating that "the Board has determined that the fair market value of the common stock is $X" will not be sufficient for purposes of Section 409A.

Therefore, for stock options granted by VC-backed companies on or after January 1, 2005, boards should carefully scrutinize their valuation process and confirm that the valuation would satisfy the "any reasonable valuation" standard. For future stock option grants:

- At a minimum, the board should undertake a rigorous assessment of the qualitative and quantitative facts and circumstances related to the value of the company's stock in order to establish the fair market value. This analysis should be fully documented in corporate records, including board minutes.
- The safest approach is to have an independent third-party valuation of the company's stock contemporaneous with option grants. For practical reasons, this may require a company to limit the number of times that options are granted each year.
- If recurring third-party valuations would be prohibitively expensive, the board might engage a third party to value the company's stock as of a specific date and to provide the methodology used to determine that value. The board could then use that methodology each time it subsequently grants stock options. The methodology should be updated periodically as the company matures.

Recent SEC guidance on cheap stock is another reason for later-stage companies that may be IPO candidates to seek an independent appraisal.

It is too soon to tell if any one valuation method will emerge as the standard practice for venture-backed companies and, in any case, we expect that the method used by such companies will change as they mature. A very early stage company may rely on its board to make the determination of fair market value because the relevant facts and circumstances may be limited during the company's infancy. Conversely, a more mature company may turn to a valuation firm as the facts relating to valuation become more numerous and complex—and more subject to second-guessing by the IRS.

Severance Payments

In another surprise to many venture-backed companies, Section 409A applies to severance payments, or "separation pay" in 409A parlance, unless the plan or agreement is exempt from the new rules. The proposed regulations include several potential exemptions for separation pay arrangements for involuntarily terminated employees. However, the proposed exemptions are available only for involuntary terminations, and no specific exemption has been provided for separation payments upon voluntary terminations, including "good reason" terminations. Thus, separation payments made upon a voluntary termination will more likely be subject to Section 409A if paid pursuant to an agreement in place prior to the termination, rather than one negotiated at the time of termination.

Exemptions. The following exemptions to Section 409A for separation pay are the most likely to be used by VC-backed companies:

- Payments made upon an involuntary termination will be exempt from Section 409A, provided that the payments do not exceed the lesser of (i) two times the employee's annual compensation for the calendar year preceding the year in which the termination occurs, and (ii) two times the maximum amount that can be taken into account under a retirement plan for the year (for 2006, this limit is $220,000). In order to fall within this exemption, all payments must be made no later than December 31 of the second calendar year following the calendar year in which the termination occurs.
- An agreement that provides for payments to be made solely upon an involuntary termination will be exempt from Section 409A, regardless of the amount of the payments, provided that the payments are made within the "short-term deferral" period. A short-term deferral exists if the payments are made by the later of (i) the 15th day of the third month following the employee's tax year in which the involuntary termination occurs, and (ii) the 15th day of the third month following the end of the company's tax year in which the involuntary termination occurs.
- Payments negotiated at the time of termination, whether as a result of an involuntary termination or a voluntary resignation, and regardless of the amount, will be exempt from Section 409A, provided that the payments are made in a lump sum or within the short-term deferral period described above.

Non-Exempt Arrangements. It is also possible to structure non-exempt separation pay arrangements in a manner that complies with Section 409A. For example, separation pay arrangements with multiple-year payouts or those that include pro-employee "good reason" triggers could be structured to comply with the new rules. In any case, whenever a separation payment is contemplated, whether at the time an employment agreement is negotiated or at the time of a termination, companies need to consider the application of Section 409A.

Conclusion

Venture-backed companies have, to a large extent, avoided the direct impact of the far-reaching regulatory changes in the last few years that have significantly affected public company compensation practices. In light of Section 409A, however, venture-backed companies should examine and, if necessary, alter their compensation practices to ensure that the employees and advisors who are helping to build the business are not adversely affected by the new tax law. ■

When a company seeks to go public, the SEC routinely scrutinizes the company's pre-IPO grants of options and other compensatory equity awards to assess whether they were properly valued. A company that underestimated the fair value of its common stock in accounting for stock and option grants—commonly referred to as having issued "cheap stock"—is required to recognize compensation expense.

In the past, the SEC typically allowed a company to estimate the fair value of its stock by using a rule-of-thumb discount from the IPO estimated price range. Starting last year, however, the SEC has adopted a new approach to cheap stock which, when coupled with new tax rules governing deferred compensation, makes cheap stock issues more complicated for pre-IPO companies.

The Practice Aid

In 2005, the SEC modified its practice for reviewing cheap stock issues, and began to apply the recommendations contained in an AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, initially issued in mid-2004. The Practice Aid identifies three acceptable valuation methodologies—market-based, income-based (such as discounted cash flow) and asset-based—and establishes a hierarchy of valuation methodologies:

- The preferred method is a valuation at the time of issuance by an unrelated valuation specialist.
- If a contemporaneous valuation is not possible, the Practice Aid recommends a retrospective valuation by an unrelated valuation specialist.
- The final, and least favored, alternative is a valuation established by a so-called "related-party valuation specialist," such as the IPO company's board of directors.

The Practice Aid goes into significant detail as to best practices for valuation of equity-based compensation by private companies, and the SEC requires relatively extensive prospectus disclosure of the process by which IPO companies complied with the Practice Aid.

To date, the best practices contained in the Practice Aid have been implemented primarily in the context of IPOs and applied to the 12-month period prior to the initial filing of a company's registration statement. Thus, application of the Practice Aid to pre-IPO grants should now be part of IPO planning.

In the future, private companies may begin to apply the Practice Aid earlier in their life cycle as a result of:

- GAAP – in connection with all compensatory equity grants, regardless of whether an IPO is pending; or
- Section 409A – the new deferred compensation tax provisions.

Section 409A

New Section 409A of the Internal Revenue Code, which imposes a 20% penalty tax on non-exempt deferred compensation arrangements, also applies to stock options with exercise prices below the fair market value of the underlying stock. The IRS has provided the following guidance for determining fair market value:

- For stock options granted before January 1, 2005, a "good faith attempt" to establish a fair market value exercise price for stock options (that is, the same standard historically used for incentive stock option purposes) is sufficient.
- For stock options granted after January 1, 2005, the more exacting standard of "any reasonable valuation method" must be used.

Proposed IRS regulations provide that the fair market value of private company stock must be determined by the reasonable and consistent application of a reasonable valuation method that considers all relevant facts and circumstances. A valuation performed by an independent third party no more than 12 months before the option grant date will be presumed to result in a reasonable valuation. Otherwise, the following factors should be considered:

- the value of tangible and intangible assets;
- the present value of future cash flows;
- the market value of stock or other equity interests in similar companies;
- control premiums and discounts for lack of marketability; and
- whether the valuation is consistent with valuations used for other corporate purposes.

Recommendations for Pre-IPO Companies

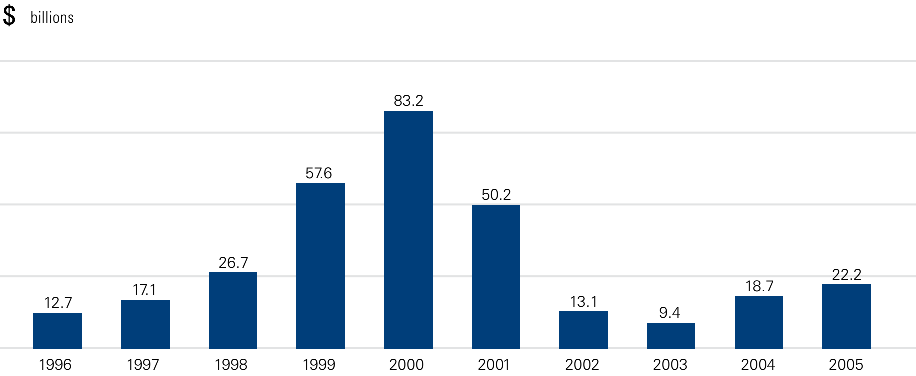
- The safest approach is to have an independent third-party valuation of the company's stock contemporaneous with option grants. For practical reasons, this may require a company to limit the number of times that options are granted each year.
- At a minimum, the board should undertake a rigorous assessment of the qualitative and quantitative facts and circumstances related to the value of the company's stock in order to establish the fair market value. This analysis should consider the applicability of the methods contemplated by the Practice Aid, as well as the Section 409A factors listed above, and should be fully documented in corporate records, including board minutes.
- If recurring third-party valuations would be prohibitively expensive, the board might engage a third party to value the company's stock as of a specific date and to provide the methodology used to determine that value. The board could then use that methodology each time it subsequently grants stock options. The methodology will need to be updated periodically as the company matures. ■

Fundraising

The vigorous pace of 2004 US venture fund formation activity continued in 2005. Total committed capital in 2005 was $22.2 billion, an increase of 19% from the $18.7 billion in 2004. For the second consecutive year, total commitments were up from the preceding year, although total fundraising was substantially smaller than the record-breaking amounts seen in 1999–2001.

We expect that the venture fund formation market will remain robust in 2006. Numerous funds are currently in the market and planning first- and second-quarter closings, and demand from institutional investors appears to be strong. We expect that general partners will continue to seek to avoid capital overhang by raising funds of moderate size.

Commitments to US Venture Capital Funds – 1996 to 2005



Source: Dow Jones VentureOne

Increased Accountability?

In recent years, the corporate world has seen an increased emphasis on accountability and financial and other controls, which has affected both public and privately held corporations. To date, venture capital funds have been largely unaffected by this trend—at least with respect to their own internal governance. Notorious for their desire to maintain the confidentiality of their performance and other information, and generally free from any type of periodic disclosure requirements or government regulation, venture capital funds have largely flown under the radar on accounting and financial controls issues. However, recent trends in venture fund formation and funds' investment activities suggest that venture capital funds will enhance their accounting and financial controls in several arenas.

Fundraising Activities. As institutional investors have become increasingly subject to scrutiny, they have in turn begun to conduct more thorough and methodical evaluations of the funds in which they invest. Institutional investors now routinely seek a broad array of performance, background and other data. The failure of a fund to provide the requested information promptly and professionally hurts its fundraising efforts. Any misleading or incorrect data—even if based on a genuine mistake under the pressure of a deadline—could result in potential liability. Funds are well served by cultivating increased discipline in gathering, organizing and updating all such data on a regular basis, with a view toward providing and presenting the information promptly and effectively.

Reporting Activities. Venture funds provide data to their investors on an annual and quarterly basis, and fund investors' appetite for information seems insatiable. Over the past few years, as quarterly and annual fund performance data has become publicly available, the data disclosed by funds has become subject to review and verification by outsiders. Accordingly, funds are gradually becoming publicly accountable for the accuracy of the data they disclose to their investors.

Investing Activities. Fund diligence on prospective portfolio companies must be thorough and defensible. Recent lawsuits involving write-offs of portfolio company securities by buyout funds have resulted in intense examination of fund investing activities—and underscore the need to document investment decisions carefully and to maintain records that can survive the withering scrutiny of litigation.

Litigation Environment. For decades, investors in venture capital funds generally displayed their dissatisfaction with fund management by declining to invest in new funds sponsored by the same managers. Similarly, general partners hesitated to take action against limited partners for even the most egregious behavior. But those rules are changing. Fund investors have brought lawsuits against funds for mismanagement, and funds have sued their investors for capital contribution defaults and to enforce confidentiality provisions. Likewise, funds have litigated against co-investors in connection with portfolio company investing activities, and have sued portfolio companies for misrepresentation and fraud. Disgruntled employees and departing general partners have also sued fund sponsors. These proceedings have resulted in disclosure of the internal workings of funds in all aspects of their activities—fundraising, investing and diligence.

Conclusions. Given the heightened emphasis on investor due diligence in funds, the increasing transparency of fund data and the greater likelihood of litigation, venture funds need to recognize that the way they conduct their internal activities is more likely than ever to become a matter of public record. Although they may not be legally required to report such activities on a periodic basis, venture funds should stand ready to disclose documentation of material decisions and reveal the levels of care and diligence they have applied to decision-making. Funds need to be prepared to read about their internal activities in the business section of the local newspaper or in an Internet newsletter. If they would be uncomfortable with that type of disclosure, they should reevaluate the way they make and document their important decisions. ■

We reviewed all merger transactions involving venture-backed targets signed up or consummated in 2004 and 2005 (as reported in VentureSource)—a total of 54 transactions in 2004 and 39 transactions for 2005—where the merger documentation was publicly available and the deal value was $25 million or more. Of the 2004 merger transactions, 23 (or 43%) were for cash, 22 (or 41%) were for stock and nine (or 17%) were for a mixture of cash and stock. Of the 2005 transactions, 27 (or 69%) were for cash, four (or 10%) were for stock and eight (or 21%) were for a mixture of cash and stock.

Based on this review, we have compiled the following deal data:

Deals with Earn-Out		2004	2005
Deals that provided contingent consideration based upon post-closing performance of the target (other than balance sheet adjustments)	With Earn-Out	24%	15%
	Without Earn-Out	76%	85%

Deals with Indemnification		2004	2005
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification		
	By Target's Shareholders	89%	100%
	By Buyer[1]	37%	46%

Survival of Representations and Warranties		2004	2005
Length of time that representations and warranties survived the closing for indemnification purposes[2]	Shortest	6 Months	9 Months
	Longest	36 Months	24 Months
	Most Frequent	12 Months	12 Months

Caps on Indemnification Obligations		2004	2005
Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	85%	100%
	Limited to Escrow	72%	79%
	Limited to Purchase Price	7%	5%
	Exceptions to Limits[3]	74%	73%
	Without Cap	15%	0%

[1] *The buyer provided indemnification in 48% of the 2004 transactions and 25% of the 2005 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions and 17% of the 2005 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] *Generally, exceptions were for fraud and willful misrepresentations.*

Escrows		2004	2005
Deals having escrows securing indemnification obligations of the target's shareholders	With Escrow	83%	97%
	% of Deal Value		
	Lowest	4%	2%
	Highest	23%	20%
	Most Frequent	10%–20%	10%
	Length of Time		
	Shortest	6 Months	6 Months
	Longest	36 Months	24 Months
	Most Frequent	12 Months	12 Months
	Exclusive Remedy	64%	84%
	Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[4]	72%	66%

Baskets for Indemnification		2004	2005
Deals with indemnification where a specified "first dollar" amount did not count towards indemnification, expressed either as a "deductible" (where such amount can never be recovered) or as a "threshold" (where such dollar amount cannot be recovered below the threshold but once the threshold is met all such amounts may be recovered)	Deductible	39%	38%
	Threshold	51%	62%

MAE Closing Condition		2004	2005
Deals where the buyer or the target had as a condition to its obligation to close the absence of a "material adverse effect" with respect to the other party or its business	Condition in Favor of Buyer	81%	82%
	Condition in Favor of Target[5]	30%	13%

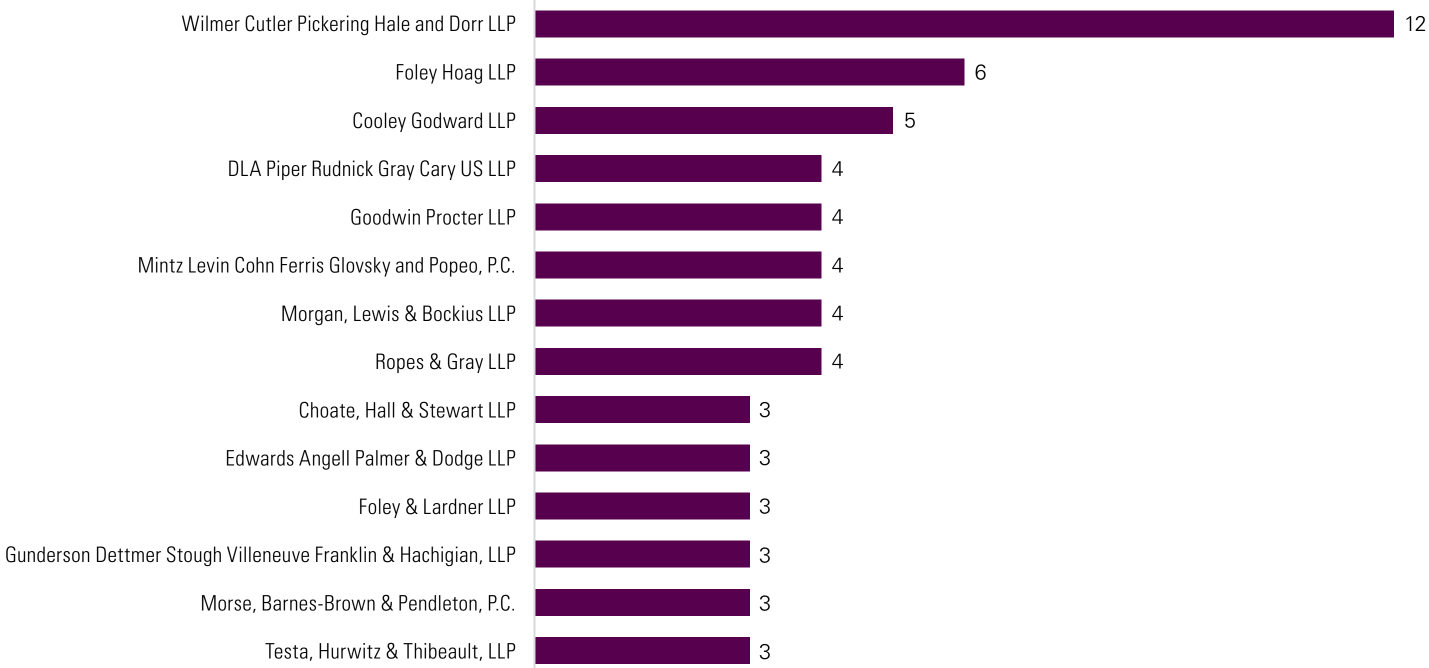
Exceptions to MAE		2004	2005
Deals where definition of "material adverse effect" for the target contained specified exceptions	With Exception[6]	78%	79%

[4] *Generally, exceptions were for fraud and criminal activity.*

[5] *In 50% of these transactions in 2004 and in 80% of these transactions in 2005, buyer stock was used as consideration.*

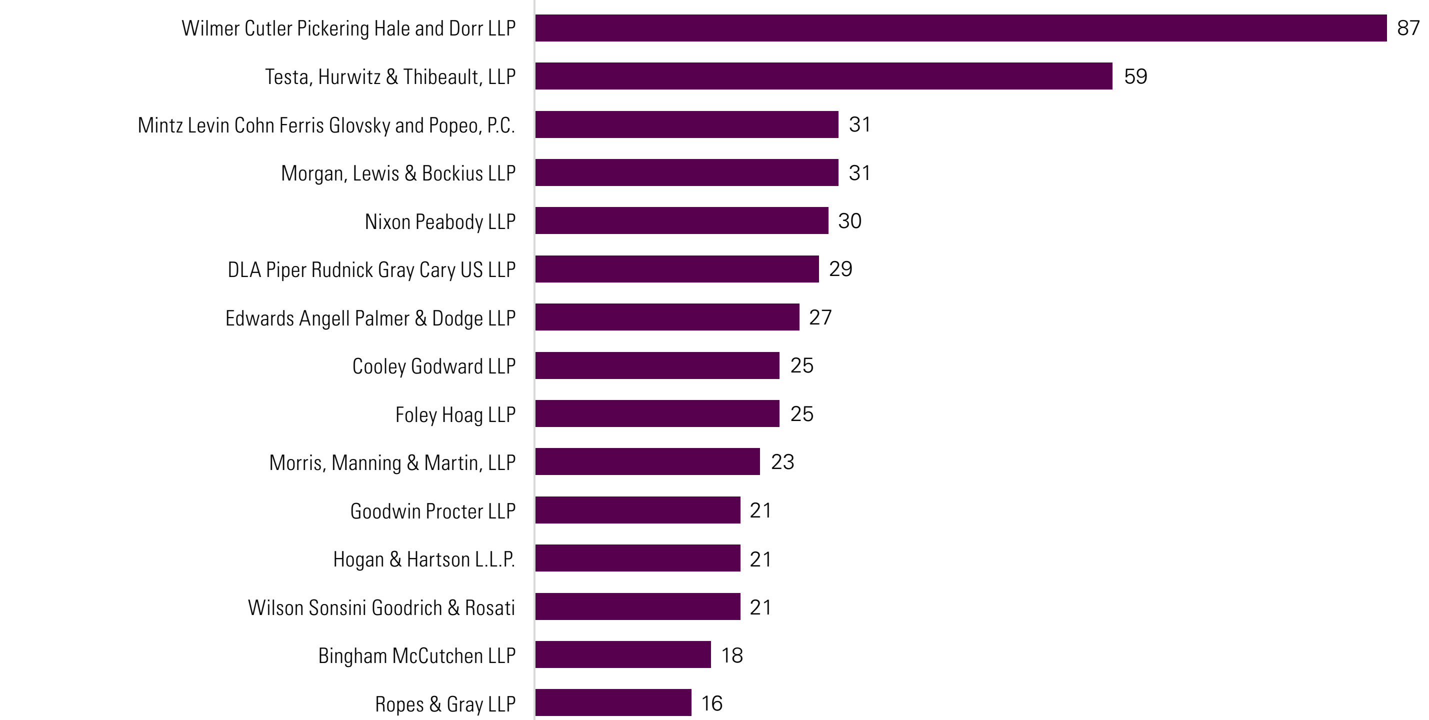
[6] *Generally, exceptions were for general economic and industry conditions.*

Counsel in Sales of Eastern US VC-Backed Companies in 2005



Source: Dow Jones VentureOne

Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2005



The above charts are based on companies located east of the Mississippi River.
Source: Dow Jones VentureOne

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Data Sources

All data in this report was compiled from the VentureSource database from Dow Jones VentureOne, except as otherwise described.

***Special note on data:** All venture capital financing and M&A data discussed in this report is based on currently available information. Due to delayed reporting of some transactions, the 2005 data that is presently available 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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