2009 Venture Capital Report

Attorney Advertising

WILMER CUTLER PICKERING HALE AND DORR LLP ®

Table of Contents

2 US Venture Capital Market Review and Outlook

6 US Regional Review and Outlook
- California
- Mid-Atlantic
- New England
- Tri-State

10 Selected WilmerHale Venture Capital Financings

12 Law Firm Rankings – Eastern US

14 European Review and Outlook

15 Law Firm Rankings – Europe

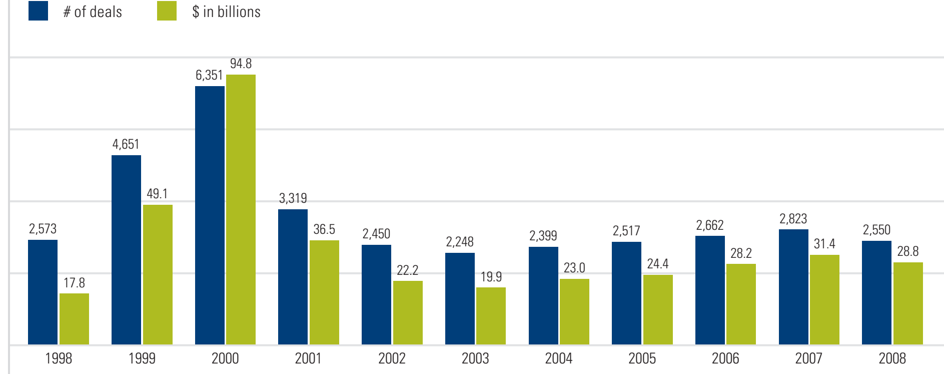
16 VC Fund Formation Review and Outlook

17 Stock Option Repricing in Private Companies

18 Trends in Venture Capital Financing Terms

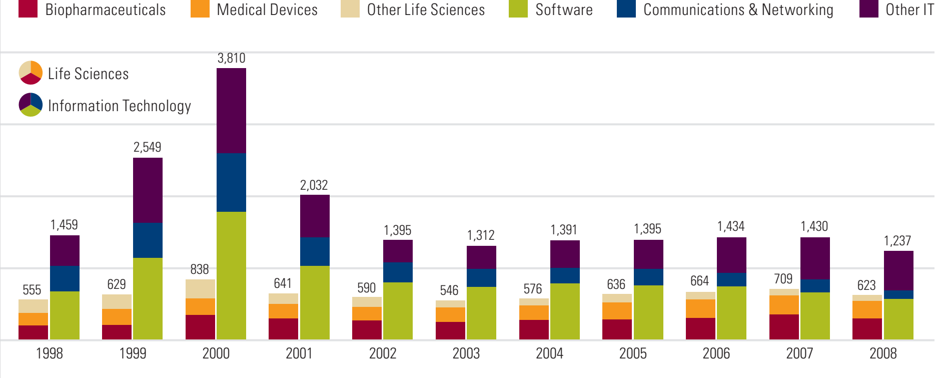
19 Trends in VC-Backed Company M&A Deal Terms

20 *Initial Public Offerings: A Practical Guide to Going Public*



Source: Dow Jones VentureOne

US Venture Capital Financings by Industry – 1998 to 2008



Source: Dow Jones VentureOne

2008 Review

The gradual but steady increase in venture investing activity that had characterized the venture capital market over the past several years was reversed in 2008, especially during the second half of the year. More significantly, there was a staggering drop-off in the IPO and M&A markets for venture-backed companies during the year.

In 2008, 2,550 reported venture capital financings raised total proceeds of $28.8 billion, compared to the 2,823 financings that raised $31.4 billion in 2007. While 2008 financing activity was higher than that during any year in the period 2002–2005, the decline in the number of deals and amount raised in the second half of 2008, compared to the second half of 2007, was significant, as the industry wrestled with the impact of the global economic recession.

The first half of 2008 saw financing activity that was consistent with the first half of 2007. In the second half of 2008, however, deal flow and proceeds dropped by about 15% compared to financing activity in the second half of 2007. The timing of the global economic crisis meant that the fourth quarter produced the biggest period-to-period declines, as the number of deals and total proceeds declined by 18% and 26%, respectively, from 2007 to 2008.

The median size of venture capital financings decreased from $7.4 million in 2007 to $7.0 million in 2008, a figure that is consistent with 2006 levels. The full-year figures were driven down by fourth-quarter performance, as the median size of venture financings in the second and third quarters of 2008—$8.0 million and $7.0 million, respectively—was still relatively strong compared to 2007. By the fourth quarter, however, the median financing size had dropped to $5.5 million. The median financing size for life sciences companies decreased from $10.0 million in 2007 to $9.0 million in 2008, while the median financing size for information technology companies decreased from $7.0 million to $6.5 million in this period.

Despite the decline in the economy in the second half of the year, valuations of venture-backed companies increased between 2007 and 2008. The median pre-money valuation for venture financings was $20.5 million in 2008, compared to $15.0 million in 2007. Even on a quarterly basis, 2008 valuations were relatively strong, reaching a low point of $20.3 million in the third quarter before rebounding to $22.5 million in the fourth quarter. Other than in 2007, when pre-money valuations decreased from 2006 levels, pre-money valuations have increased every year since 2003. This upswing is somewhat surprising in light of the difficulties that venture-backed companies experienced in the IPO and M&A arenas in 2008.

In 2008, seed and first-round venture capital financings represented 38% of the total number of venture financings and 20% of the total amount of venture capital investment. Seed and first-round financings have constituted between 31% and 40% of the total number of all venture financings in each year since 2001. The proportion of new investing activity during the last seven years, however, is significantly lower than that during the period 1999–2000 (54%) as well as the period 1996–1998 (49%). This

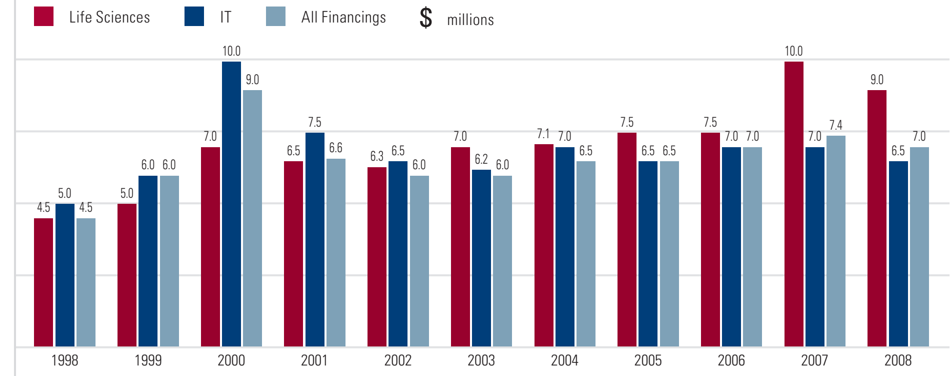
relative decline in new investing activity is due, in part, to the fact that more rigorous investment criteria are being applied by investors, and in part to the longer average time from initial funding to a liquidity event, which increases the relative amount of money needed for investment in later-stage companies.

The breakdown of venture capital financings by industry sector in 2008 was similar to that of prior years. In 2008, IT companies represented 49% of all venture capital financings, and life sciences companies constituted 24%. This split is generally consistent with the breakdowns over the last 12 years, other than during the 1999–2001 Internet bubble, when life sciences financings dipped below 20%. As has been the case in recent years, the amount invested in life sciences companies in 2008 as a percentage of total venture investments was higher than the percentage of life sciences financings (28% as compared to 24%), due to the greater capital needs of life sciences companies.

The geographic breakdown for venture capital investing has remained fairly constant since 1996. California-based companies accounted for 45% of all venture financings in 2008, and have led the country in this regard in each year since 1996 (the first year for which this data is available). Massachusetts, home to 11% of the companies receiving venture financing in 2008, again finished second in this category, as it has in each year since 1996. New York, Pennsylvania and Texas rounded out the top five positions for 2008.

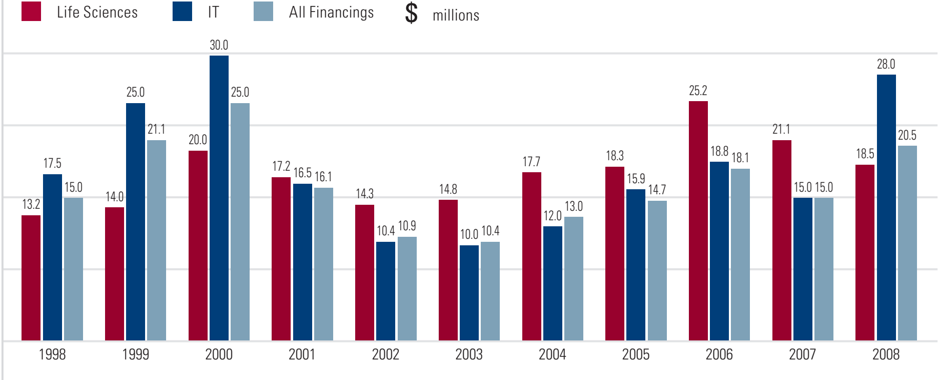
After sharply declining on the heels of the dot-com collapse of 2000, the IPO market for VC-backed companies had been gradually regaining strength until last year. In 2008, the IPO market for venture-backed companies all but disappeared due to the global economic crisis and overall declines in the capital markets. A mere seven venture-backed companies went public last year, compared to 76 in 2007. During the period 2004–2007, the number of IPOs by life sciences companies outpaced that of IT companies. This trend held true in 2008, which saw four life sciences IPOs and three IT IPOs, although the sample size for 2008 was very small.

Median Size of US Venture Capital Financings – 1998 to 2008



Source: Dow Jones VentureOne

Median Pre-Money Valuation in US Venture Capital Financings – 1998 to 2008



Source: Dow Jones VentureOne

It is illuminating (and perhaps sobering) to compare pre-IPO valuations to the median amount raised prior to IPO by venture-backed companies going public. In 2008, the ratio of median pre-IPO valuation to median amount raised prior to IPO was 5:1. This ratio was between 3.0:1 and 4.7:1 for each year from 2002 to 2007. In contrast, this ratio ranged from 7.7:1 to 10.0:1 from 1997 to 2000. The fact that the ratio has been lower over the last several years than in the period 1997–1998 is attributable to the significantly lower amount invested in companies prior to their IPOs a decade ago, while the decrease as compared to 1999–2000 is attributable to the significantly higher IPO valuations in 1999–2000. Thus, not only have there been fewer venture-backed IPOs in the last several years than during the latter half of the 1990s, but the venture-backed companies that are going public are also producing lower returns for their investors.

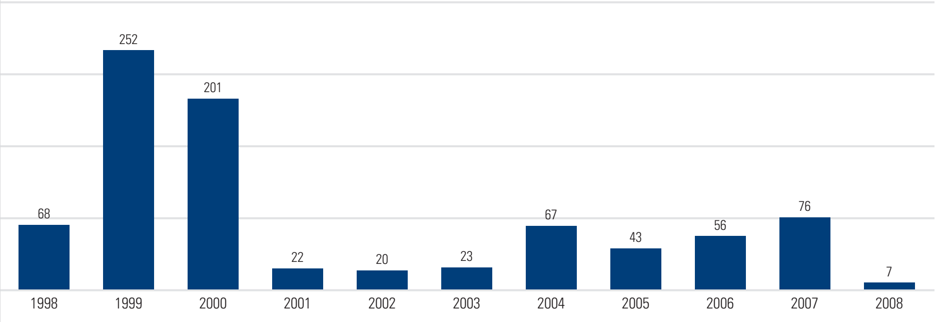
As was the case with the IPO market, the M&A market for venture-backed companies was significantly weaker in 2008 than in 2007. There were 325 reported acquisitions of venture-backed companies in 2008, compared to 457 in 2007. In addition to the significant

decline in the number of acquisitions in 2008, there was also a marked decline in purchase prices. The median acquisition price for venture-backed companies tumbled from $97 million in 2007 to $45 million in 2008. This drop represents the first annual decrease after five consecutive annual increases in the median acquisition price, and the 2008 median acquisition price represents the lowest figure since 2005. There were only two billion-dollar acquisitions of VC-backed companies in 2008: EqualLogic's acquisition by Dell for $1.4 billion, and Sun's acquisition of MySQL for $1 billion.

The ratio of median acquisition price to median amount raised prior to acquisition was 2:1 in 2008, down from 4.8:1 in 2007. The 2008 ratio, however, was in line with the ratios of between 1.2:1 and 2.5:1 for each year from 2001 to 2006. These figures underscore that, like the IPO market, the M&A market for venture-backed companies worsened in 2008. Not surprisingly, the overall returns are somewhat higher on IPOs than on M&A transactions, since few underperforming companies are able to go public. The higher valuations ascribed to IPO companies are offset in part, however, by the fact that the median amount raised prior to liquidity event for M&A companies is generally less than half the amount for IPO companies.

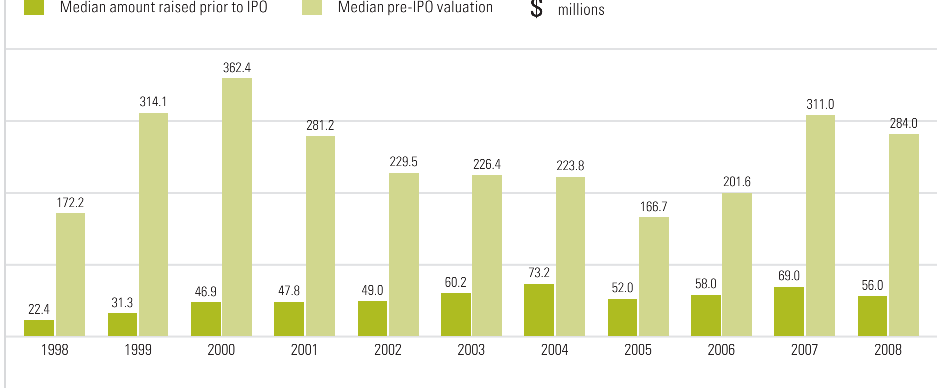
The 46:1 ratio of M&A transactions to IPOs for venture-backed companies was an aberration that can be attributed to the fact that the IPO window was effectively closed for most of the year. This ratio was at least 7:1 in every year from 2001 to 2006, and was 6:1 in 2007. Over the five-year period from 1996 to 2000, the ratio of M&A transactions to IPOs for venture-backed companies was less than 4:1.

US Venture-Backed IPOs – 1998 to 2008



Source: Dow Jones VentureOne

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1998 to 2008



Source: Dow Jones VentureOne

2009 Outlook

Some industries are likely to fare better than others, but we believe that the overall level of venture capital financing activity will decline in 2009, continuing the trend of the past year. The likely decrease will be attributable in large part to a continuation of the market factors seen throughout 2008, including the decrease in the amount of venture capital available for investment and the weak IPO and M&A markets.

Preliminary year-to-date financing data bear out this prediction. According to Dow Jones VentureSource, the first quarter of 2009 produced the lowest quarterly level of venture capital financing in 11 years. Reported deal flow rebounded in the second quarter of 2009, but was well below activity in the second quarter of the prior year. Although these results are likely to be revised upward as additional data becomes available, 2009 appears headed toward a full-year decline from 2008 levels.

We also expect that venture capital valuations will decline in 2009. The unfavorable valuations for liquidity events in 2008 have been compounded in 2009 by continued concerns about the health of the economy and the capital markets. Moreover, as limited partners in venture funds have less money to put to work or are looking to rebalance their own portfolios, there are fewer venture dollars available. Investors also remain concerned that too much invested in a particular company or sector will prevent a suitable rate of return.

On a brighter note, investments in clean technology and renewable energy sources should increase in 2009. The sector is

likely to benefit from rising fuel prices, heightened environmental awareness and the availability of significant amounts of government funding. Problems with distribution, the prevalence of competing technologies and the need in many cases for significantly larger investment amounts than in traditional venture-backed industries, however, may cause some investors to steer clear of this market.

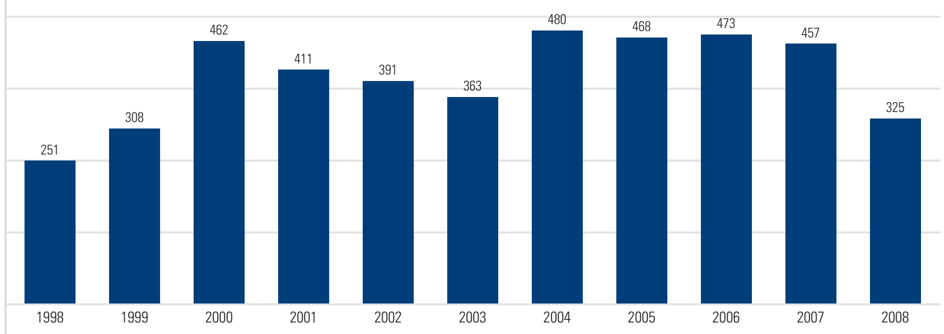
Recent globalization trends in venture investing are likely to continue in 2009. International markets such as China, India and other parts of Southeast Asia are spawning increased entrepreneurial activity and innovation, and the regulatory environments in those countries are also becoming more hospitable to foreign investment. These factors are tempered, however, by concerns about the political and economic environments in these regions and the somewhat undeveloped "ecosystems" in which these companies will have to develop. As a result, while investments in international-based companies should continue to increase, we believe they will do so at a measured pace.

The venture-backed IPO market was terrible in 2008, and its weakness continued into the first quarter of 2009, reflecting overall trends in the capital markets. The Dow Jones Industrial Average dropped 23% in the second half of 2008 and another 13% in the first quarter of 2009, and the Nasdaq Composite plummeted 31% in the second half of 2008 before beginning to stabilize, with a decline of only 3% in the first quarter of 2009.

More recently, the IPO outlook has begun to brighten amid a modest rebound in the capital markets—the Dow Jones Industrial Average and Nasdaq Composite increased by 11% and 20%, respectively, in the second quarter of 2009—and some signs that the recession is beginning to abate. After no venture-backed IPOs in the fourth quarter of 2008 or the first quarter of 2009, six VC-backed companies went public in the second quarter of 2009. Five of these priced at or above the top of their ranges, and all six were trading above their offering price on July 1. This uptick is likely to encourage other VC-backed companies to begin the IPO registration process or to resuscitate dormant filings over the balance of the year. Still, it is too soon to say whether the nascent recovery in the VC-backed IPO market will continue throughout 2009.

Any significant weakness in the venture-backed IPO market is likely to have a negative impact on the M&A market, for several reasons. First, any general economic concerns that dampen the IPO market should also adversely affect the valuations of target companies. Second, limitations on the IPO market as a credible alternative for venture-backed companies diminish the leverage of those companies in negotiating acquisition prices. Finally, problems in the world's credit markets will make it more difficult for many buyers to fund otherwise attractive acquisitions. As a result, we believe that the number and valuation of acquisitions are likely to decrease in 2009. Preliminary year-to-date M&A data support this assessment. Dow Jones VentureSource reports that the number of acquisitions of VC-backed companies in the first half of 2009 was 29% below the number in the first half of 2008, while proceeds from these deals fell even further—by a whopping 61%. ■

Acquisitions of US Venture-Backed Companies – 1998 to 2008



Source: Dow Jones VentureOne

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1998 to 2008

Source: Dow Jones VentureOne

California

California companies reported 1,146 financings in 2008—down slightly from 1,200 in 2007—while reported proceeds edged up to $13.87 billion from $13.82 billion in the prior year. Final 2008 data—after all transactions have been reported—is likely to show modest growth for the year.

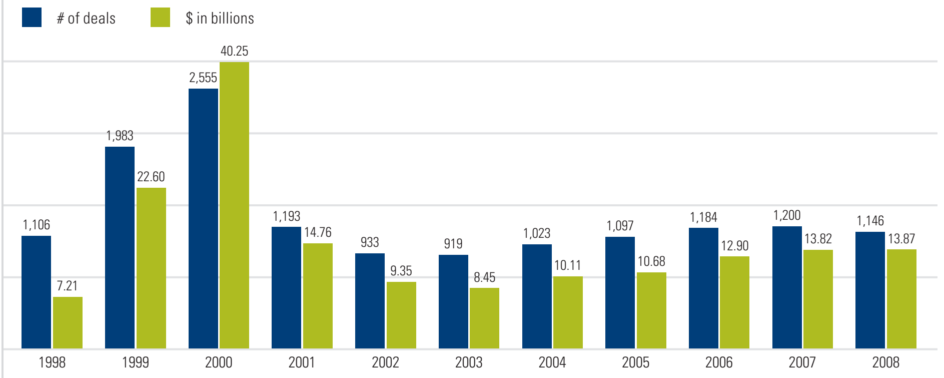
Roughly three times the size of the next-largest venture capital market in the United States, California was responsible for 45% of all deals and 48% of all proceeds in the country in 2008. Although California's venture capital activity remains well below the peak year of 2000—when it produced a staggering 2,555 financings with $40.25 billion in proceeds—deal volume continues to exceed pre-bubble levels by a modest amount, while annual proceeds are substantially higher.

California's venture capital market spans all industry sectors, with particular strengths in technology, life sciences, cleantech, consumer retail and media/entertainment. IT was the largest sector in 2008, but its market share in the state slipped to 41% of all financings in 2008 from 44% in the prior year. Life sciences companies made up 20% of California's deals in 2008, unchanged from the prior year.

The liquidity picture for California venture-backed companies was considerably bleaker. The state generated only three IPOs by VC-backed companies in 2008, compared to 28 in 2007. M&A activity was more stable in 2008. The number of acquisitions of VC-backed companies dropped from 151 in 2007 to 146 in 2008, but remained at the annual level that has generally prevailed since 2002. California produced two of the four company sales nationwide that fetched at least $500 million in 2008, and five of the 13 deals that topped $250 million.

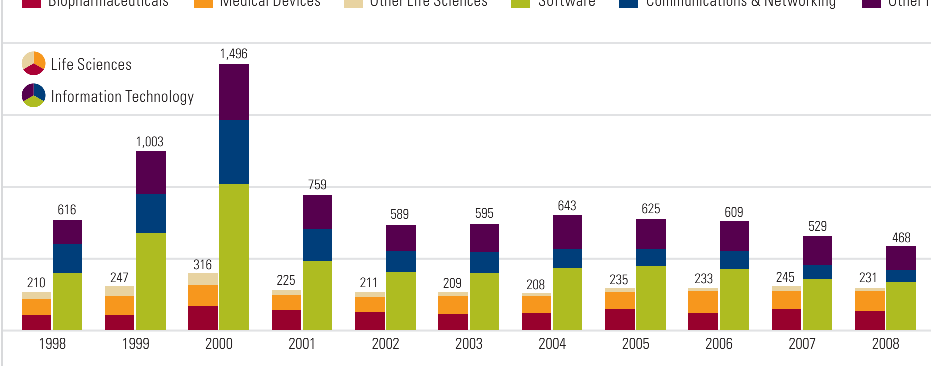
We expect California to maintain its venture capital leadership in 2009, particularly in information technology, cleantech and life sciences, and conditions appear ripe for future growth in financing activity.

California Venture Capital Financings – 1998 to 2008



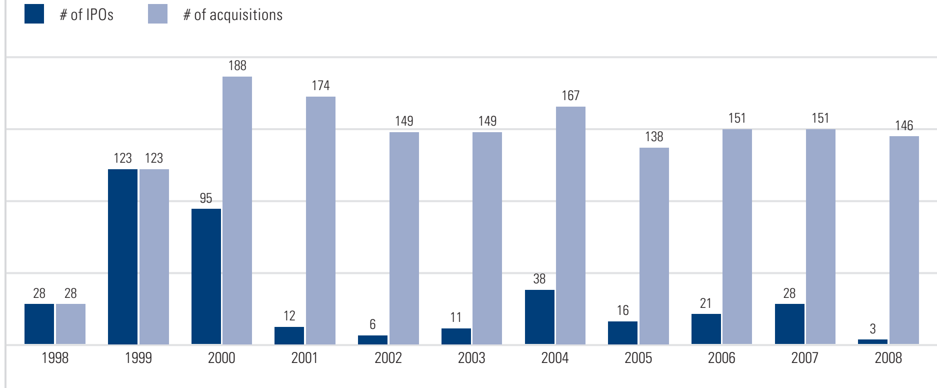
Source: Dow Jones VentureOne

California Venture Capital Financings by Industry – 1998 to 2008



Source: Dow Jones VentureOne

California Venture-Backed IPOs and Acquisitions – 1998 to 2008



Source: Dow Jones VentureOne

Mid-Atlantic

The number of reported venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia dropped from 192 in 2007 to 143 in 2008, while proceeds fell from $1.93 billion to $1.62 billion. Once all 2008 transactions have been reported, we expect deal volume and proceeds in the region to narrow the gap, but to remain behind 2007's totals.

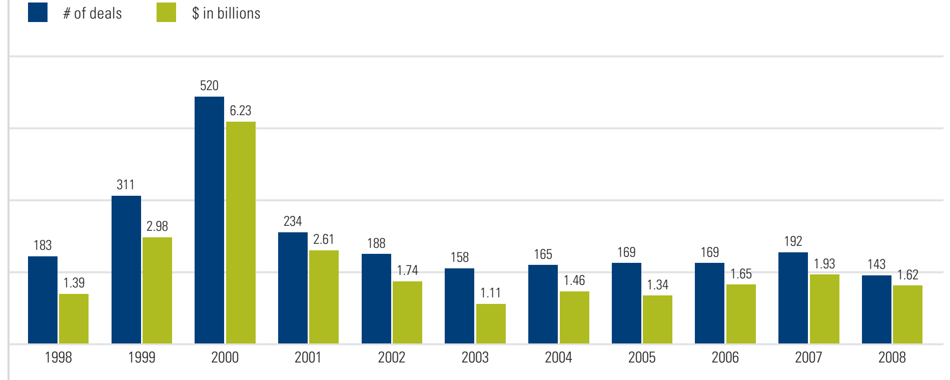
Despite the slowdown in 2008 compared to 2007, financing activity in the mid-Atlantic region over the past seven years has yielded an annual average of 169 venture capital financings with proceeds of $1.55 billion. These figures continue to top the levels seen in the pre-bubble years of 1996–1998.

The percentage of all financings in the region completed by IT companies dropped from 52% in 2007 to 48% in 2008, while the portion attributable to life sciences companies was unchanged at 27%.

There were no IPOs by mid-Atlantic VC-backed companies in 2008, compared to four in 2007, but M&A liquidity improved during the year. The number of acquisitions of venture-backed companies in the region jumped to 39 from 27 the prior year. Virginia continued to lead the region in deal volume by a healthy margin, once again contributing 15 deals. Maryland and North Carolina each contributed nine VC-backed M&A transactions.

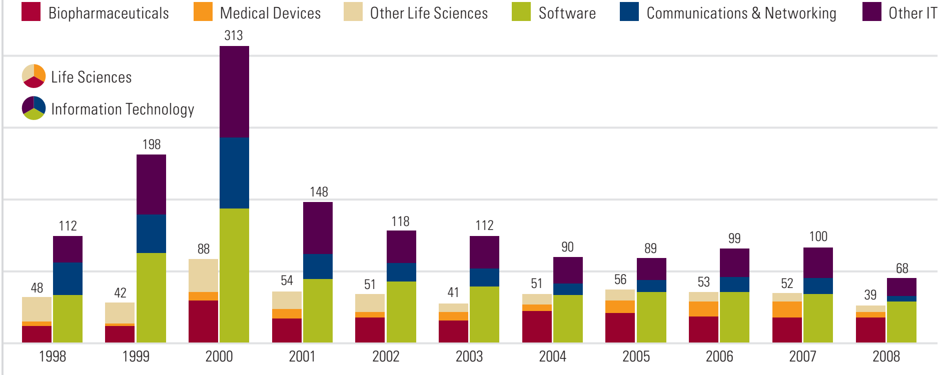
Maryland's deal tally included two of the country's 13 acquisitions in 2008 that were valued in excess of $250 million: the purchase of Bill Me Later by eBay for $945 million, and the sale of CoGenesys to Teva Pharmaceutical Industries for $400 million.

For 2009, we expect that the information technology, government-related IT services and defense industries 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.



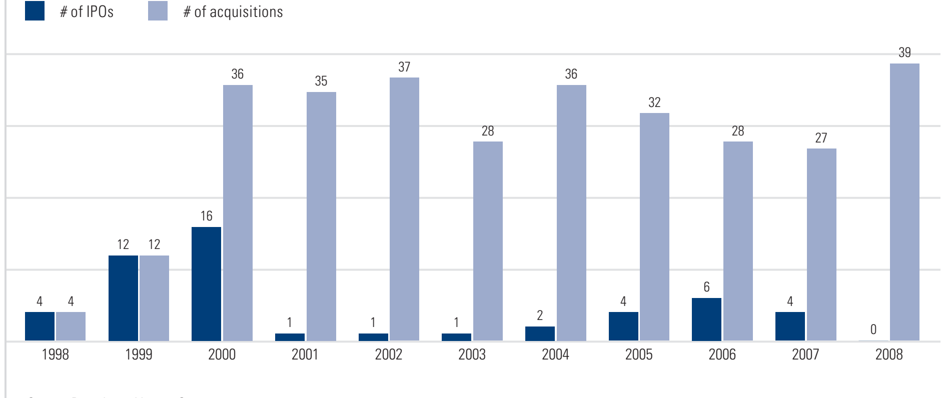
Source: Dow Jones VentureOne

Mid-Atlantic Venture Capital Financings by Industry – 1998 to 2008



Source: Dow Jones VentureOne

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1998 to 2008



Source: Dow Jones VentureOne

New England

New England companies reported 339 financings in 2008, down from 381 in 2007, while proceeds dipped to $3.24 billion from $3.83 billion in the prior year. We expect that the year's results will be essentially level with 2007, once all transactions have been reported.

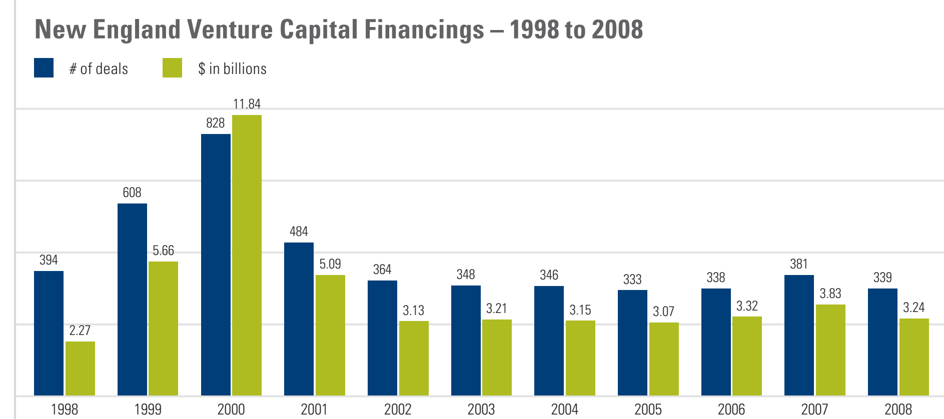
While venture capital investment in the region remains well below the bubble years of 1999–2001, the average number of New England financings over the last seven years (350 deals per year) rivals the prevailing deal volumes of 1996–1998, and average annual proceeds have increased by two-thirds between these periods.

New England continues to be a leading center of activity for technology and life sciences companies. In 2008, information technology companies accounted for 40% of the region's venture capital financings, down from 47% in 2007, while the market share for life sciences companies held steady at 32%.

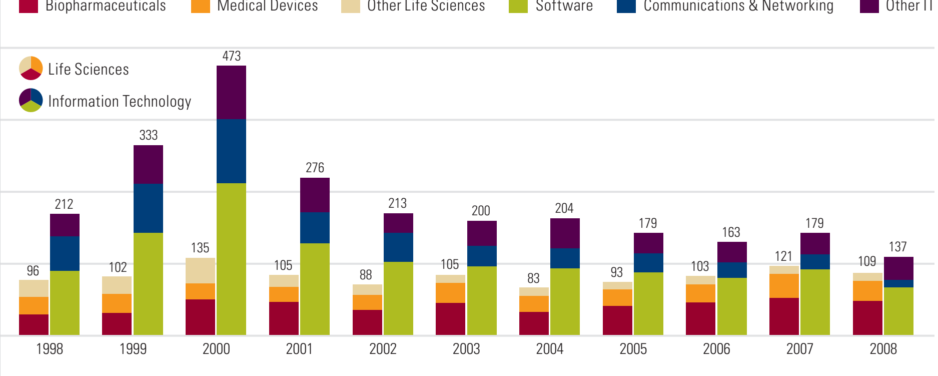
After generating 17 venture-backed IPOs in 2007, New England had none in 2008. Even with the poor IPO market conditions that prevailed throughout 2008, this was a surprising result for a region that historically has produced a large number of IPOs. The drought ended with the very successful IPO of Massachusetts-based LogMeIn in the second quarter of 2009.

The number of acquisitions of VC-backed companies edged down to 54 in 2008 from 55 in the prior year. On a high note, the region produced the largest deal in the country in 2008—the sale of New Hampshire–based EqualLogic to Dell for $1.4 billion in cash. Upon its announcement, the EqualLogic acquisition represented the largest all-cash purchase price in history for a private VC-backed company.

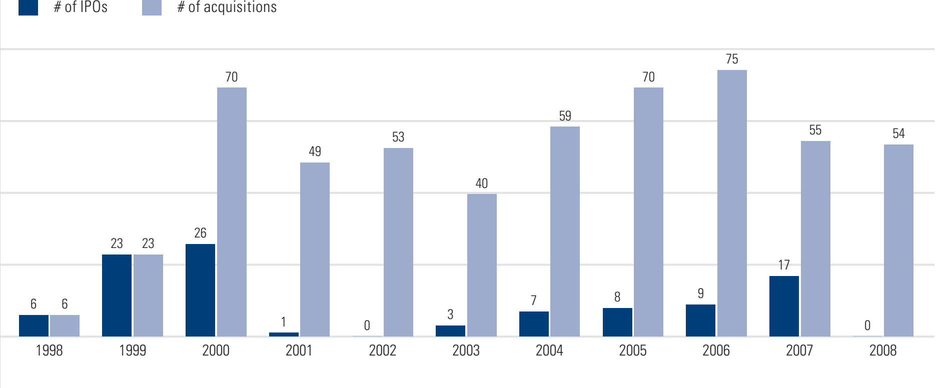
For 2009, we expect New England—and Massachusetts in particular—to remain one of the country's most appealing environments for emerging companies and a hub of venture capital activity.



Source: Dow Jones VentureOne



Source: Dow Jones VentureOne



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 slightly, from 339 in 2007 to 330 in 2008, while proceeds decreased from $2.74 billion to $2.50 billion. Once all 2008 transactions have been reported, we expect the region to show modest growth over 2007 and the highest totals since the dot-com peak of 1999–2001.

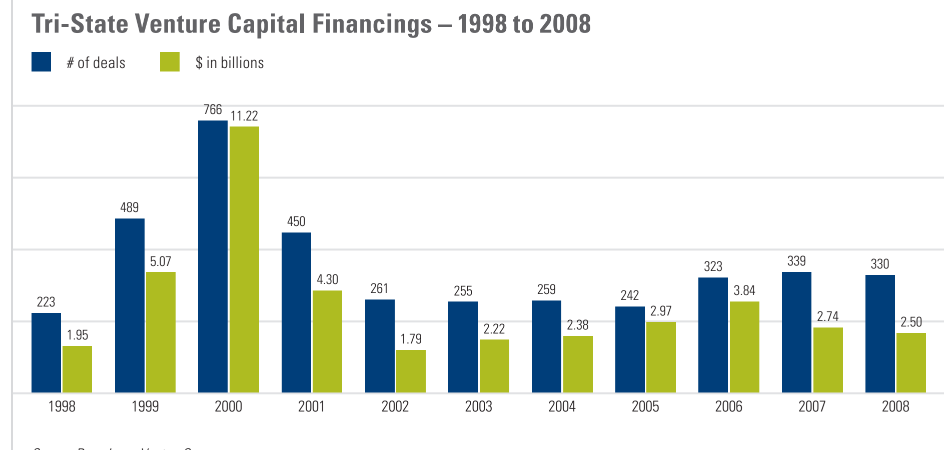
Venture capital activity in the region continues to exceed, by a significant margin, the volume of deals and proceeds during the pre-boom years of 1996–1998. Over the past seven years, the tri-state region has produced an annual average of 287 financings with proceeds of $2.63 billion, compared to an average of 191 financings raising $1.26 billion per year for the period 1996–1998.

IT companies garnered the largest share of the tri-state region's VC financing market in 2008, at 30%, down from 34% in 2007. Life sciences companies followed, with 26% of the region's financings in 2008, down slightly from 27% in the prior year.

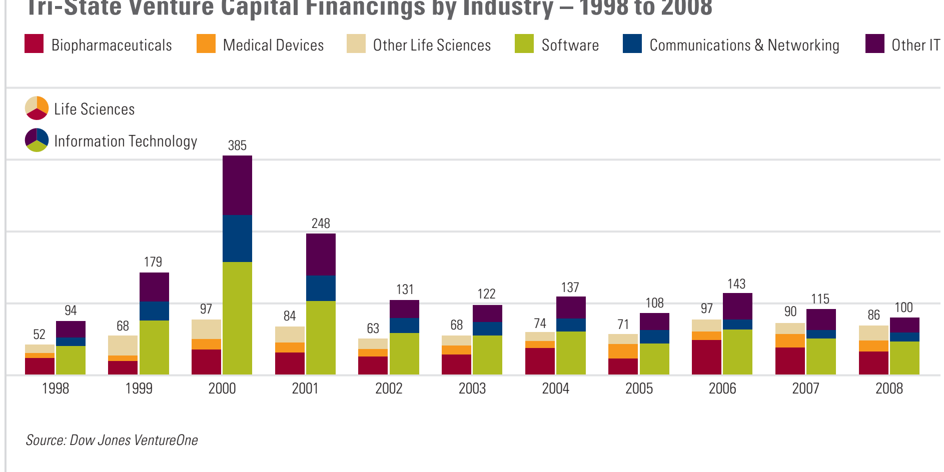
The tri-state region produced only one venture-backed IPO in 2008, compared to four in 2007. The region's only VC-backed IPO in 2008, however, was the nation's largest, as New York–based RiskMetrics Group completed a $245 million offering.

Acquisitions of venture-backed companies declined from 57 in 2007 to 54 in 2008—still the second-highest total in more than a decade. Unlike in 2007, during which the tri-state region was home to the largest sale of the year, the region did not produce any VC-backed company acquisitions priced above $250 million in 2008.

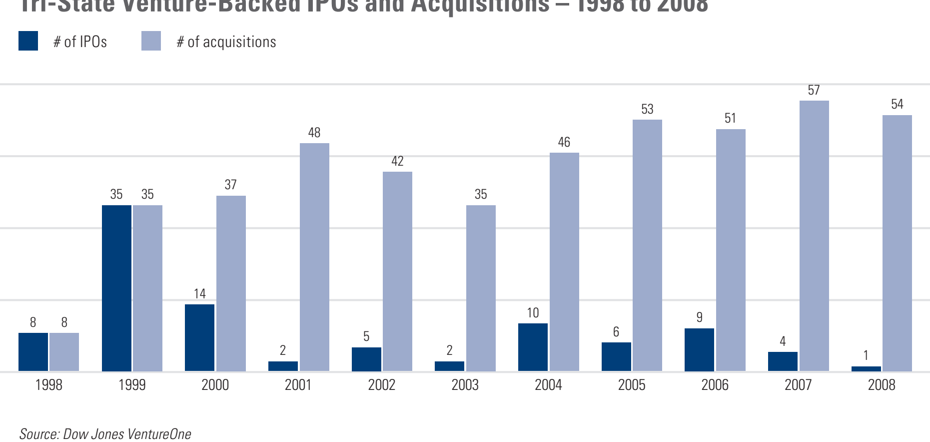
We believe that the tri-state region's strengths in the pharmaceuticals, life sciences, financial services and information technology sectors—combined with its large number of Fortune 500 companies—will continue to provide a favorable environment for VC-backed start-up companies in 2009. ■



Source: Dow Jones VentureOne



Source: Dow Jones VentureOne



Source: Dow Jones VentureOne

Counsel of Choice to Ventur

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, CLE

Finan

$100,000,000
Late Stage
April 2009

$40,000,000
Second Round
July 2008

$40,000,000
Fourth Round
May 2009

$22,000,000
Third Round
May 2009

Initial Publi

Initial Public Offering of Common Stock
$135,204,000
Counsel to Issuer
June 2007

Initial Public Offering of Common Stock
$124,200,000
Counsel to Issuer
July 2007

Initial Public Offering of Common Stock
$107,200,000
Counsel to Issuer
October 2007

M&A Tra

Acquisition by
Bristol-Myers Squibb
$430,000,000
October 2007

ALANTOS Pharmaceuticals

Acquisition by
Amgen
$300,000,000
July 2007

Acquisition by
NXP Semiconductors
$85,000,000
January 2008

Acquis
Or
Undis
June

e Capital-Backed Companies

EANTECH, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

cings

$33,000,000
First Round
June 2008

$32,000,000
First Round
April 2008

$38,000,000
Late Stage
May 2009

$134,500,000
Second Round
March 2008

c Offerings

Initial Public Offering of Common Stock
$100,000,000
Counsel to Issuer
April 2007

Initial Public Offering of Common Stock
$122,667,000
Counsel to Issuer
July 2009

Initial Public Offering of Common Stock
$58,100,000
Counsel to Issuer
July 2007

nsactions

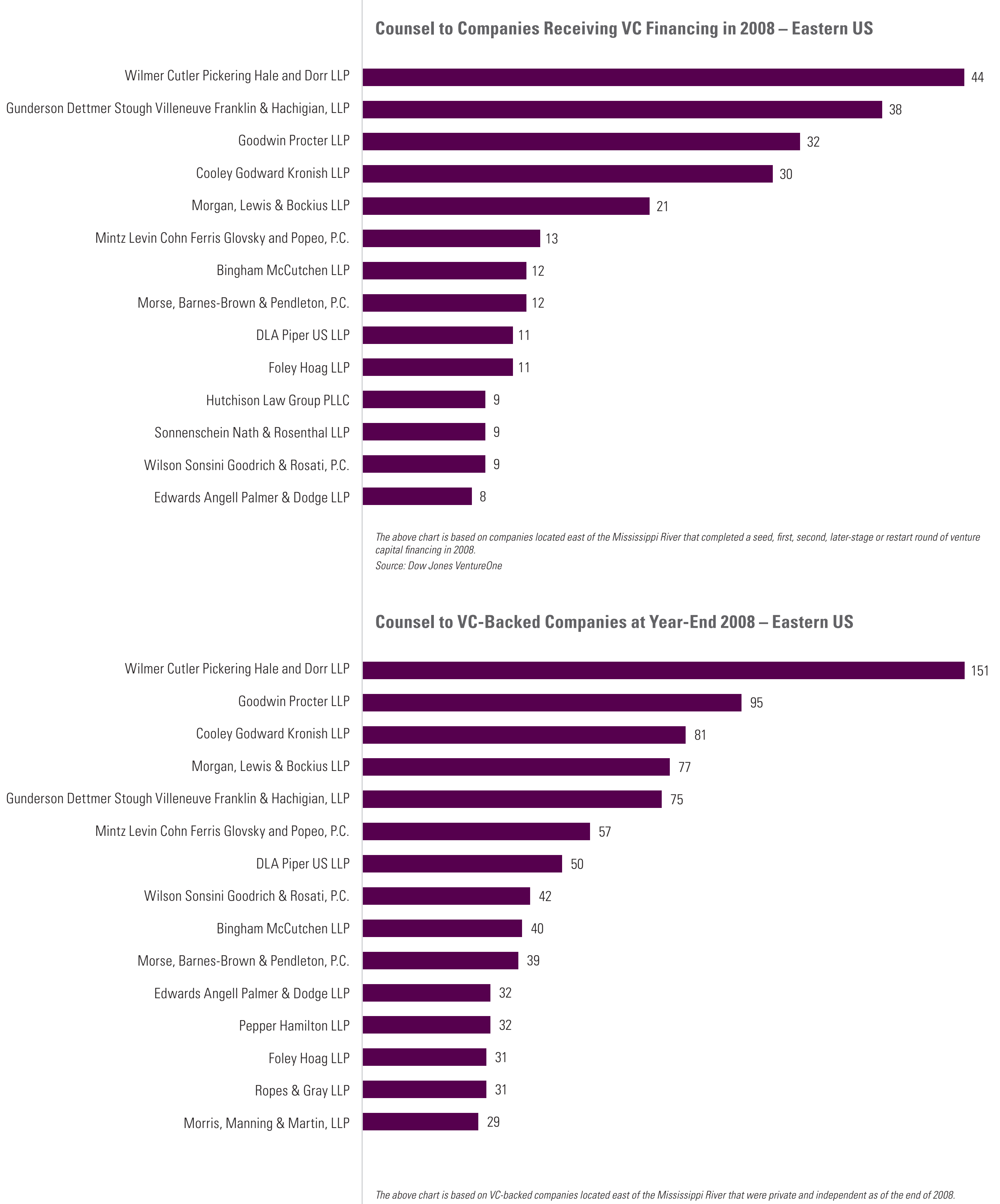
ition by
acle
sclosed
2009

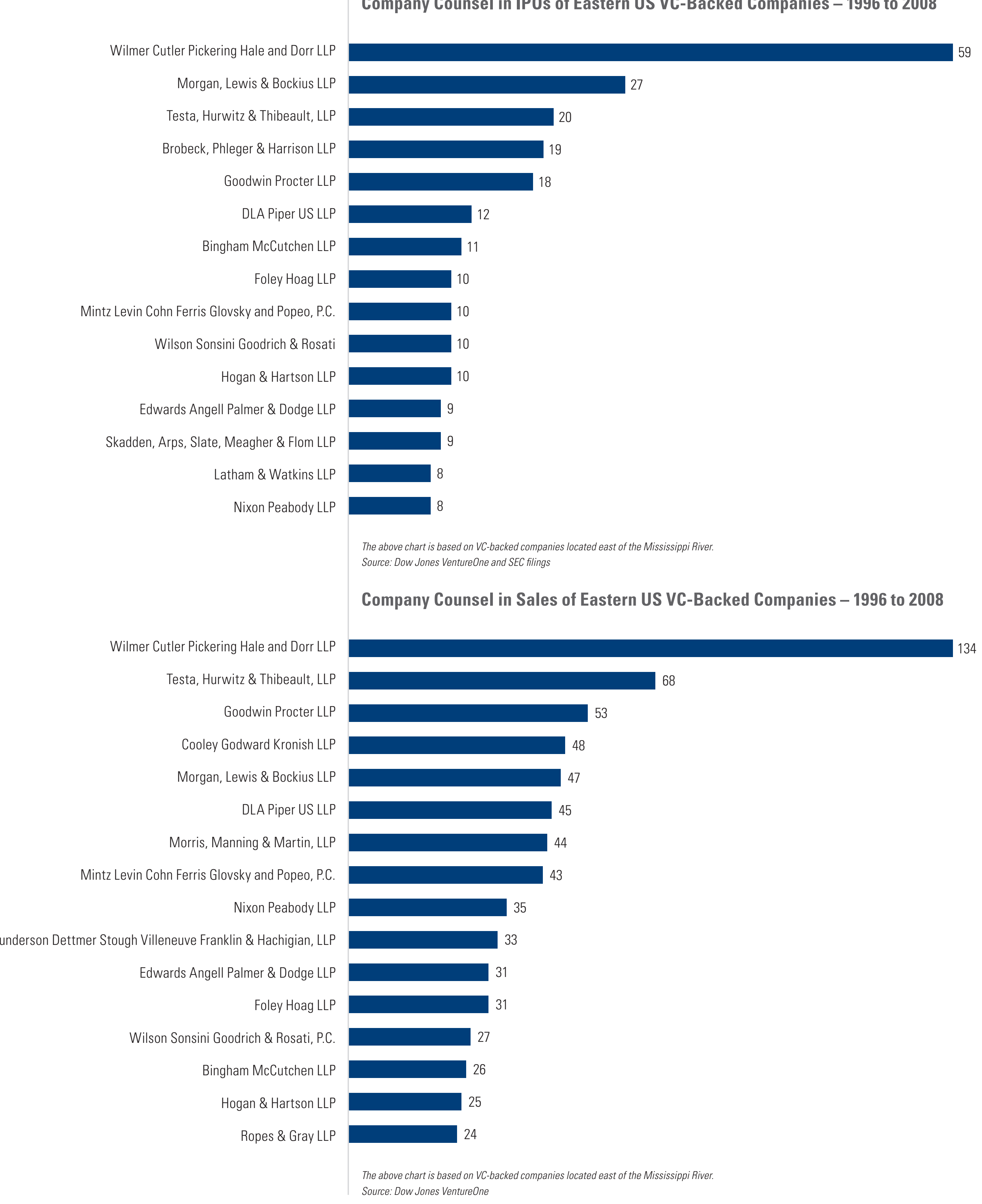
Acquisition by
Bedford Funding
$63,100,000
September 2008

XANTHUS PHARMACEUTICALS

Acquisition by
Antisoma
$52,200,000
June 2008

Acquisition by
Dell
$1,400,000,000
January 2008


Counsel to Companies Receiving VC Financing in 2008 – Eastern US
Wilmer Cutler Pickering Hale and Dorr LLP 44
Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP 38
Goodwin Procter LLP 32
Cooley Godward Kronish LLP 30
Morgan, Lewis & Bockius LLP 21
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C. 13
Bingham McCutchen LLP 12
Morse, Barnes-Brown & Pendleton, P.C. 12
DLA Piper US LLP 11
Foley Hoag LLP 11
Hutchison Law Group PLLC 9
Sonnenschein Nath & Rosenthal LLP 9
Wilson Sonsini Goodrich & Rosati, P.C. 9
Edwards Angell Palmer & Dodge LLP 8
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 2008.
Source: Dow Jones VentureOne
Counsel to VC-Backed Companies at Year-End 2008 – Eastern US
Wilmer Cutler Pickering Hale and Dorr LLP 151
Goodwin Procter LLP 95
Cooley Godward Kronish LLP 81
Morgan, Lewis & Bockius LLP 77
Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP 75
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C. 57
DLA Piper US LLP 50
Wilson Sonsini Goodrich & Rosati, P.C. 42
Bingham McCutchen LLP 40
Morse, Barnes-Brown & Pendleton, P.C. 39
Edwards Angell Palmer & Dodge LLP 32
Pepper Hamilton LLP 32
Foley Hoag LLP 31
Ropes & Gray LLP 31
Morris, Manning & Martin, LLP 29
The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2008.
Source: Dow Jones VentureOne


Company Counsel in IPOs of Eastern US VC-Backed Companies – 1996 to 2008
Wilmer Cutler Pickering Hale and Dorr LLP 59
Morgan, Lewis & Bockius LLP 27
Testa, Hurwitz & Thibeault, LLP 20
Brobeck, Phleger & Harrison LLP 19
Goodwin Procter LLP 18
DLA Piper US LLP 12
Bingham McCutchen LLP 11
Foley Hoag LLP 10
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C. 10
Wilson Sonsini Goodrich & Rosati 10
Hogan & Hartson LLP 10
Edwards Angell Palmer & Dodge LLP 9
Skadden, Arps, Slate, Meagher & Flom LLP 9
Latham & Watkins LLP 8
Nixon Peabody LLP 8
The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne and SEC filings
Company Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2008
Wilmer Cutler Pickering Hale and Dorr LLP 134
Testa, Hurwitz & Thibeault, LLP 68
Goodwin Procter LLP 53
Cooley Godward Kronish LLP 48
Morgan, Lewis & Bockius LLP 47
DLA Piper US LLP 45
Morris, Manning & Martin, LLP 44
Mintz Levin Cohn Ferris Glovsky and Popeo, P.C. 43
Nixon Peabody LLP 35
Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP 33
Edwards Angell Palmer & Dodge LLP 31
Foley Hoag LLP 31
Wilson Sonsini Goodrich & Rosati, P.C. 27
Bingham McCutchen LLP 26
Hogan & Hartson LLP 25
Ropes & Gray LLP 24
The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne

2008 Review

The level of European venture capital financing activity dropped in 2008, although reported proceeds remained above the average level of the post-boom era. Liquidity events declined much more sharply, mirroring trends in the United States.

Venture capital financing proceeds in Europe dipped to €5.0 billion in 2008 from €6.0 billion in 2007, while the number of reported venture capital financings fell from 1,471 to 1,122. Once all 2008 transactions have been reported, we expect the year's deal total to narrow this gap. On a brighter note, the median financing size in Europe reached a record €2.7 million in 2008.

The software sector again accounted for the largest portion of the European venture capital market, representing 20% of all financings, followed by biopharmaceuticals (13%) and information services (12%).

The United Kingdom remained the largest venture capital market in Europe, generating 29% of all deals in 2008, followed by Germany and France, each with 19%, and Sweden with 7%.

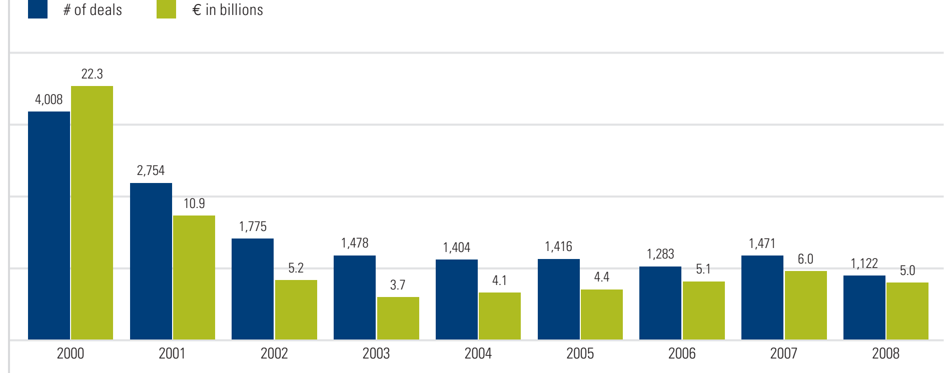
The number of IPOs by European venture-backed companies plunged from 45 in 2007 to just 5 in 2008. M&A activity fared somewhat better, with the number of reported acquisitions dropping from 333 to 234.

2009 Outlook

For 2009, we expect European venture capital investment to remain steady or increase modestly. Recent growth in median financing sizes is likely to moderate, as later-stage deals led by private equity firms continue to be hampered by broader economic issues.

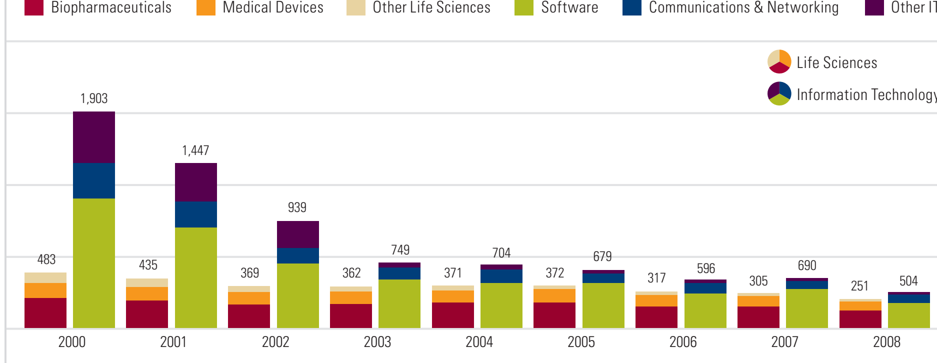
The liquidity outlook for European VC-backed companies appears clouded. Weakened economic and capital market conditions do not bode well for IPO flow in 2009. On the M&A front, deal activity seems likely to remain below the levels of 2005–2007, although there is continuing demand for strategically important acquisitions.

European Venture Capital Financings – 2000 to 2008



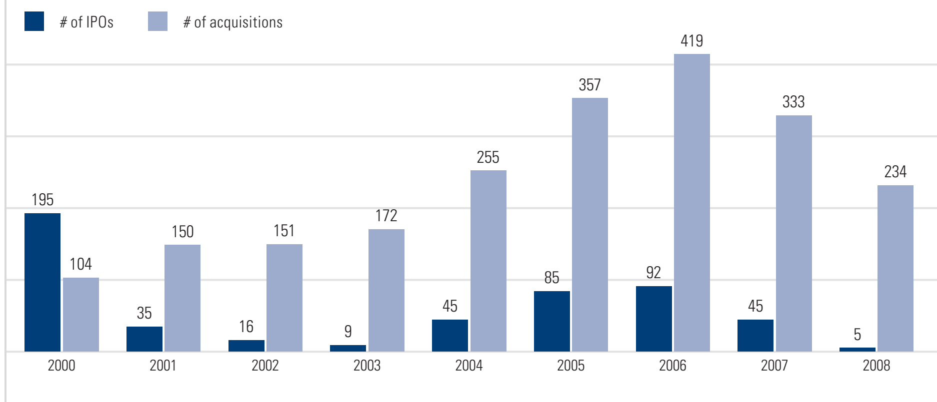
Source: Dow Jones VentureOne

European Venture Capital Financing by Industry – 2000 to 2008



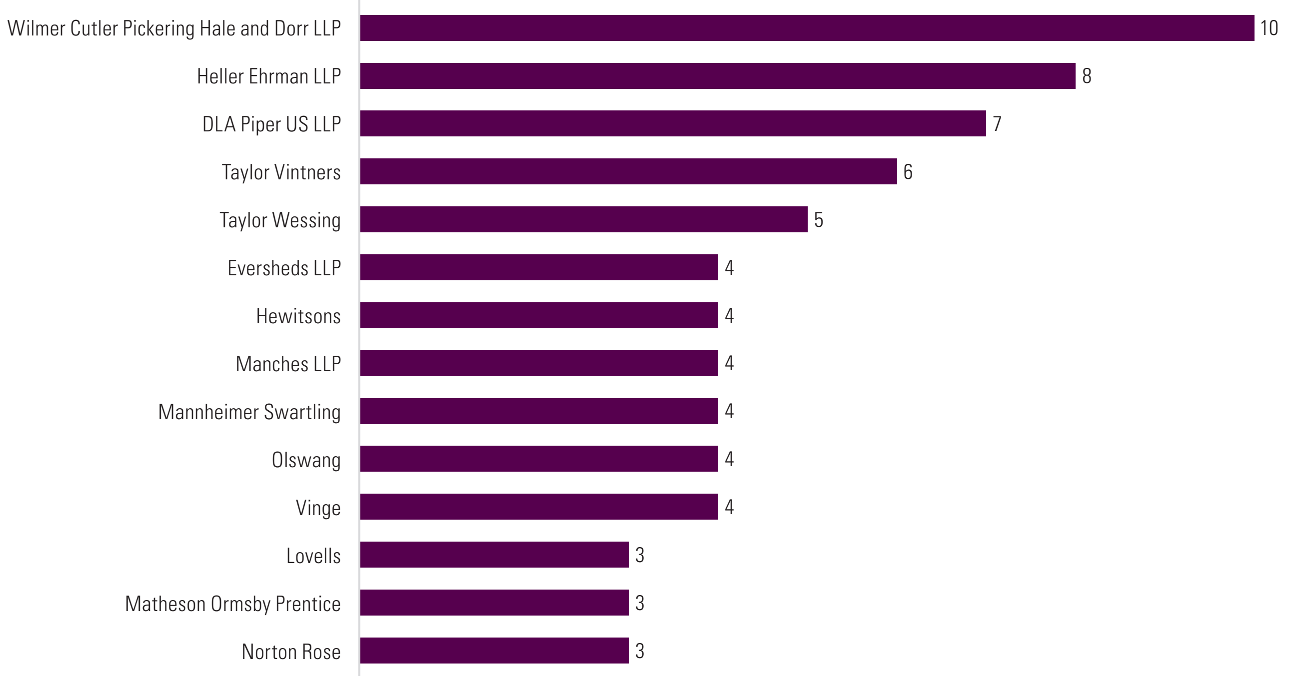
Source: Dow Jones VentureOne

European Venture-Backed IPOs and Acquisitions – 2000 to 2008



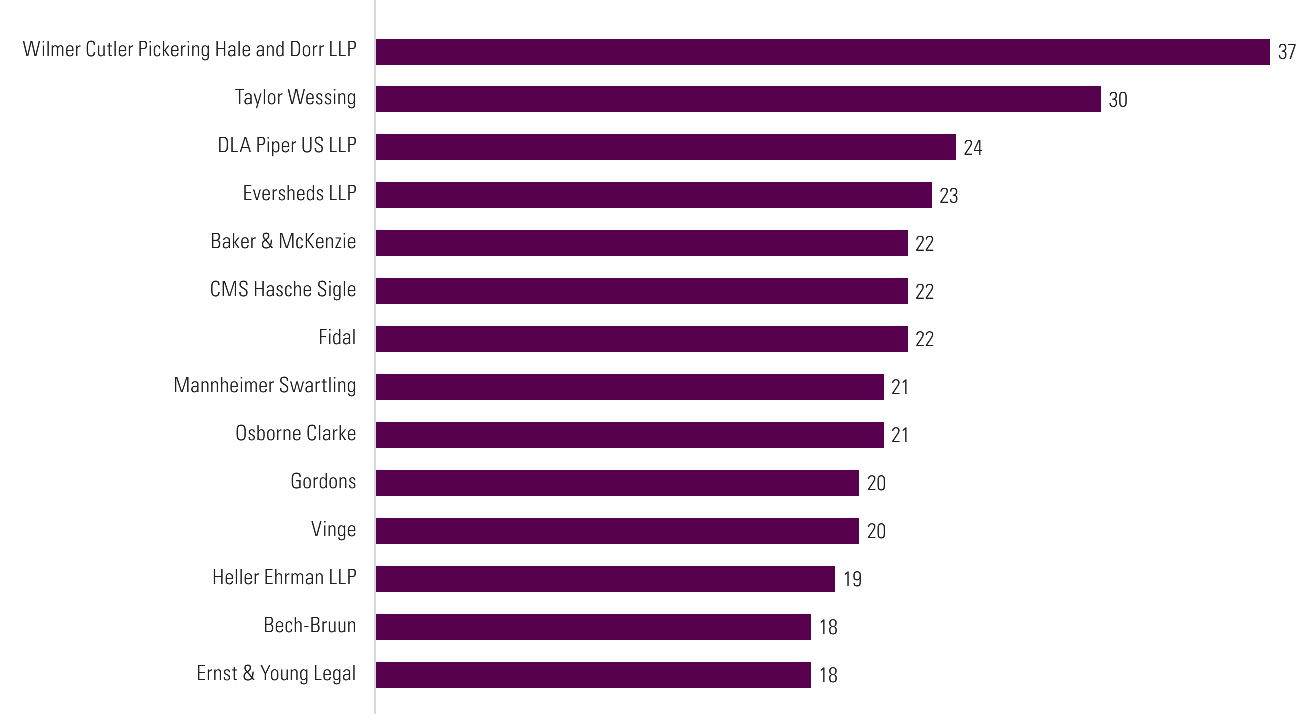
Source: Dow Jones VentureOne

Counsel to Companies Receiving VC Financing in 2008 – 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 2008.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2008 – Europe



The above chart is based on European VC-backed companies that were private and independent as of the end of 2008.
Source: Dow Jones VentureOne

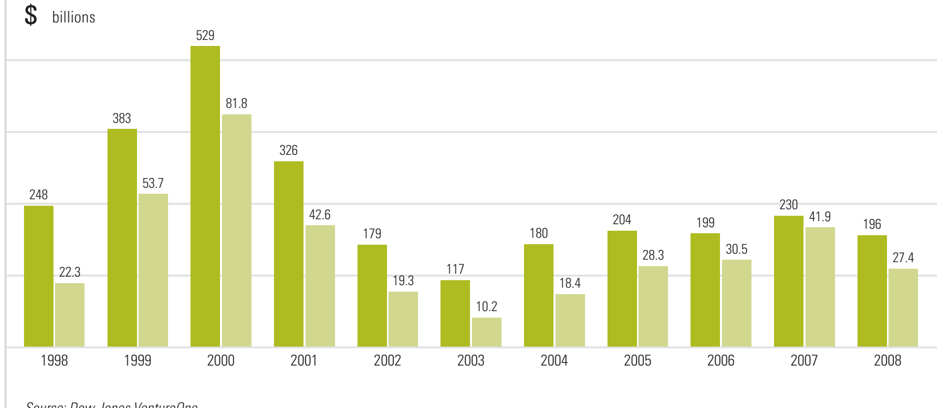
Fundraising

Venture capital fund formation activity declined substantially in 2008, with a total of 196 funds raising $27.4 billion, down 35% from the $41.9 billion raised by 230 funds in 2007.

We expect that venture capital fundraising will fall further during 2009, as institutional and individual investors regroup after the turmoil that hit the financial markets in 2008. Many institutional investors are "overallocated" to private equity after suffering substantial losses in their public equity portfolios, and may be struggling to satisfy existing funding commitments to private equity. They are likely to proceed cautiously before making commitments to new funds. Venture funds can assume the fundraising process will take longer than usual. Fund sizes are likely to remain moderate, to provide flexibility to both fund managers and investors.

Preliminary year-to-date data supports these predictions. According to Dow Jones VentureSource, just 52 funds raised a total of $5.1 billion in the first half of 2009. Although these results are likely to be revised upward as additional data becomes available, it seems clear that the level of venture capital fundraising is still undergoing corrections to reflect general economic conditions and venture capital returns in recent years.

Commitments to US Venture Capital Funds – 1998 to 2008



Source: Dow Jones VentureOne

Secondary Transactions in Fund Interests

Investments in venture funds are generally illiquid. State and federal securities laws and the funds' governing agreements typically impose significant restrictions on transfer. The life of a fund is usually at least 10 years, and investors do not have withdrawal or other rights to cash out of their investments. Investors have capital contribution obligations that extend over the life of the fund, with significant penalties for default. Thus, an investment in a fund represents a long-term commitment. Secondary buyers, however, can offer liquidity for investors looking to sell an individual interest in a fund, or a portfolio of fund interests.

The cash position of many private equity investors has been impaired by the decline in the public securities markets, as well as a reduction in cash distributions from their fund investments, due to minimal IPO and merger and acquisition activity. These investors are looking to decrease unfunded capital commitment liabilities on their balance sheets. Because the buyer in a secondary transaction generally assumes the obligations of the seller under the fund's partnership agreement (including obligations to make capital contributions), they can provide relief from these problems. Some investors may find that selling interests in some funds to provide cash for upcoming capital calls in other funds is the only viable option to avoid defaulting on commitments.

Buyers of private equity interests are motivated by the opportunity to purchase fund interests at low valuations. The purchase price paid for a private equity interest in a secondary transaction is typically based on the fund's net asset value (NAV). Private equity funds determine their NAVs on a periodic basis (annually, semi-annually or quarterly). Markdowns in NAV, based in part on reductions in the values of the underlying portfolio companies associated with the market downturn, are expected to be reflected on year-end financial statements. Secondary buyers are likely to be excited at the prospect of purchasing fund interests at these low values. This desire to purchase may be enhanced by the fact that many secondary buyers may feel they overpaid for interests purchased in the last two years and will seek to "average down" the cost of their portfolios.

For these reasons, many observers expected to see a robust secondary market for private equity interests in 2009. In the first half of the year, however, price has proven to be an obstacle in getting deals done, as sellers have been unwilling to accept deep discounts from NAV. Since financial statements of private equity funds have not reflected anticipated levels of markdowns and there has been limited visibility as to future values as a result of the volatility in the equity markets, buyers fear overpaying and are unwilling to close the pricing gap that has developed.

There has also been a more fundamental, unforeseen shift in the secondary market: a disconnect between the motivations of buyers and sellers. Sellers are looking to off-load unfunded commitments, while buyers are still seeking more fully funded interests that can be more accurately valued and have traditionally formed the bulk of secondary transactions. In addition, since private equity funds are not expected to generate distributions in the next few years, buyers cannot hit their target internal rates of return, which are the primary metric buyers use to evaluate their investments. Structured deals designed to address these differing motivations have not been readily accepted by sellers, as legal structures cannot work magic on the numbers and are complicated for sellers to understand.

As the equity market settles down and both buyers and sellers regain confidence in their ability to value private equity assets, the pricing spread should narrow and the anticipated boom in secondary transactions should occur—just later than originally predicted. ■

Option repricing has received widespread attention in the wake of the broad market declines that began in 2008 and have continued into 2009. The market collapse of the past year has spared few sectors or issuers, prompting companies across many industries to reexamine their equity incentive programs and consider various techniques, including option repricing, to restore the intended benefits of those programs.

For public companies, option repricing can be a controversial topic, and often encounters resistance from stockholders. Private companies generally enjoy greater latitude in implementing an option repricing program because they are not subject to stock exchange rules or most SEC rules. The principal differences between option repricing in public and private companies are summarized below.

- ***Employee Incentives:*** Stock options are intended to provide incentives to motivate and retain employees who are expected to contribute to the success of the company. This is true in both public and private companies, but may take on a heightened importance in a private company. Many private companies grant stock options more broadly than public companies, and cash compensation in private companies is often lower than in public companies because of the perceived value of stock options.

- ***Stockholder Approval:*** Nasdaq and the NYSE require listed companies to obtain stockholder approval of option repricings unless the underlying plan specifically permits options to be repriced. Private company stock plans usually do not require stockholder approval of an option repricing, and Nasdaq and NYSE listing requirements do not apply. If stockholder approval in a private company is needed, it is usually readily available from a small group of investors and founders and can be obtained quickly, pursuant to a written consent of stockholders.

- ***Program Design:*** Private companies usually opt for a simple structure in which the option exercise price is reduced, whereas public companies often design more complex programs involving cash payments or the issuance of restricted stock in exchange for underwater options. Moreover, public company repricings are typically structured as "value-for-value" exchanges in which the value of the surrendered (underwater) options equals the value of the new (repriced) options received in exchange—meaning the repriced option must cover a smaller number of shares than the surrendered option. In contrast, private companies often demand little or no "giveback" from participants in terms of a reduced number of option shares or revesting requirements.

- ***Proxy Statement Rules and Public Disclosures:*** If stockholder approval of an option repricing program is sought, a public company must comply with the SEC's proxy statement rules and make various other public disclosures. A private company need not comply with the SEC's proxy rules or make any SEC filings with respect to an option repricing.

- ***Tender Offer Compliance:*** If the repricing program consists solely of a reduction in the exercise price of outstanding options without optionholder consent, or is limited to a small number of executive officers, a private company need not comply with the SEC's tender offer rules. Otherwise, a private company must give option holders 20 business days to make a decision (and must not make any inaccurate or misleading statements in connection with the repricing).

- ***Investor Relations:*** Investor relations considerations apply equally to public and private companies, but a private company will be much closer to its principal investors and able to gauge their reactions more easily. In addition, venture capital investors are likely to be more sympathetic to an option repricing in a private company than institutional investors in a public company.

- ***Accounting Treatment:*** The accounting treatment for equity incentives is the same for public and private companies. When an option is repriced, FAS 123R requires the fair value of the new options minus the current fair value of the surrendered options to be recorded as compensation expense over the remaining vesting period of the repriced options.

- ***Tax Consequences:*** The tax consequences applicable to the grant of stock options and option repricings are generally the same in public and private companies, with several practical differences. In order to comply with ISO rules and the rules under Section 409A, most private companies obtain independent stock valuations to support the exercise price of new option grants and to establish the new exercise price in repricings. Section 162(m) does not apply to private companies.

- ***Treatment of Foreign Employees:*** In both public and private companies, local law compliance will be necessary if foreign employees participate in a repricing program. This may be particularly burdensome in a private company with a small number of foreign employees, and may result in the exclusion of foreign employees from a repricing program.

- ***Securities Law Compliance:*** Shares subject to public company options—original or repriced—are usually registered on a Form S-8 registration statement. A private company must make sure that the grant of new options in an option repricing program is exempt from registration under the Securities Act of 1933, typically pursuant to the exemption provided by Rule 701 (and sometimes supplemented by Section 4(2), Regulation D and/or Regulation S).

- ***Investor Covenants and Charter Provisions:*** A private company must consider the restrictions and covenants contained in its investor agreements and corporate charter when developing and implementing a repricing program. For example, investor anti-dilution protections, rights of first refusal and mandatory employee vesting provisions may need to be waived.

- ***Approval and Implementation Process:*** The approval and implementation process is more streamlined in private than in public companies. Because of the simpler structure, smaller number of participants, absence of tender offer filing requirements, less extensive employee communications materials and close coordination with the company's principal stockholders, a private company typically can develop and implement an option repricing program much more quickly than a public company—often in a few weeks or less. ■

Based on hundreds of venture capital financing transactions we handled from 2004 to 2008 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2004	2004 Range	2005	2005 Range	2006	2006 Range	2007	2007 Range	2008	2008 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	22%	1.25x – 5x	3%	1.5x	5%	2x	4%	1.5x – 2x	3%	3x
	Post–Series A	11%	1.5x – 3x	10%	1.5x – 2x	9%	1.25x – 3x	7%	1.5x – 2x	14%	1.3x – 3x

Deals with Participating Preferred		2004	2004 Range	2005	2005 Range	2006	2006 Range	2007	2007 Range	2008	2008 Range
"Participating preferred" stock entitles the holder not only to receive its stated liquidation preference, but also to receive a pro rata share (assuming conversion of the preferred stock into common stock) of any remaining proceeds available for distribution to holders of common stock.	Series A										
	Total	56%		58%		59%		57%		53%	
	Capped	N/A	2x – 5x	48%	2x – 5x	22%	2x – 5x	42%	2x – 6x	35%	2x – 5x
	Post–Series A										
	Total	54%		71%		62%		62%		56%	
	Capped	N/A	1.75x – 5x	39%	2x – 5x	24%	2x – 5x	37%	2x – 5x	41%	2x – 5x

Deals with an Accruing Dividend		2004	2005	2006	2007	2008
"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	47%	78%	53%	43%	53%
	Post–Series A	48%	87%	55%	38%	36%

Anti-Dilution Provisions		2004	2005	2006	2007	2008
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	3%	0%	7%	9%	6%
	Weighted Average	97%	100%	93%	91%	94%
	Post–Series A					
	Full Ratchet	7%	16%	7%	5%	5%
	Weighted Average	93%	84%	93%	95%	95%

Deals with Pay-to-Play Provisions		2004	2005	2006	2007	2008
"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	26%	25%	22%	28%	23%
	% of Total That Convert to Common Stock	67%	55%	65%	79%	92%
	% of Total That Convert to Shadow Preferred Stock	33%	45%	35%	21%	8%

We reviewed all merger transactions between 2004 and 2008 involving venture-backed targets (as reported in Dow Jones VentureOne) in which the merger documentation was publicly available and the deal value was $25 million or more. Based on this review, we have compiled the following deal data:

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

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

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

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

[4] Generally, exceptions were for fraud and willful misrepresentation.

[5] Generally, exceptions were for fraud, intentional misrepresentation and criminal activity.

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

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

[8] In 50% of these transactions in 2004, in 80% of these transactions in 2005, in 83% of these transactions in 2006, in 86% of these transactions in 2007 and in 60% of these transactions in 2008, buyer stock was used as consideration.

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

Announcing

Initial Public Offerings: A Practical Guide to Going Public

Drawing on WilmerHale's decades of IPO leadership, this book presents a comprehensive yet practical guide to the going-public process.

Preparation, planning and crisp execution have never been more vital to your chances of IPO success. Now there's a guide that charts every twist and turn on the path to a winning IPO. Hailed by executives, entrepreneurs, general counsel, investment bankers, venture capitalists and accountants alike as the first comprehensive IPO resource, *Initial Public Offerings: A Practical Guide to Going Public* demystifies the IPO process with real-world advice straight from the IPO trenches. Packed with practical guidance, planning tips, best practices and empirical data, this readable guide will help you avoid roadblocks, frame smart questions and make better decisions on every step of the IPO journey.

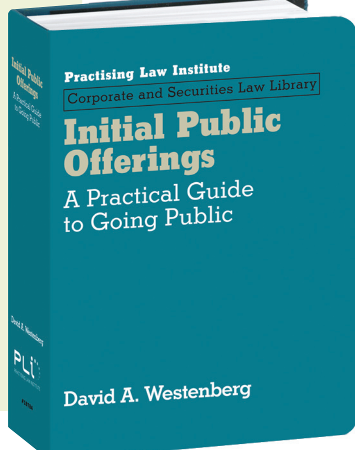
"CEOs should keep this book at their side from the moment they first seriously consider an IPO… and will soon find it dog-eared with sections that inspire clarity and confidence."
— Don Bulens, CEO of EqualLogic at the time it pursued a dual-track IPO

"There's nothing I like more than practical guidance. And this book sure fits the bill as a detailed step-by-step guide that every practitioner should have. A perfect starter's kit."
— Broc Romanek, Editor of TheCorporateCounsel.net

"This book sets the standard against which any future IPO guide will be measured, and should be required reading for management and boards of any company contemplating a public offering."
— David B. Elsbree, public company director and retired audit partner

"This book demystifies the entire IPO process, from A to Z. It is incredibly easy to find what you are looking for and, most importantly, to quickly understand the subject matter. Whether you are a C-level executive, a seasoned practitioner or Joe the Plumber, you will benefit greatly from having so much pulled together in one organized spot."
— Greg Beecher, CFO, Teradyne

"The most complete book about going public ever written—almost everything a company's management needs to know."
— Jay R. Ritter, Cordell Professor of Finance, University of Florida



How to Order:

The book will be published in October 2009 and may be purchased from the publisher at www.pli.edu or by calling (800) 260-4754. A 20% discount is available to WilmerHale clients and friends by specifying the code KAD9-8WEB1.

For more information, visit **www.IPOguidebook.com**.

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

Our *2009 IPO Report* offers a detailed analysis of, and outlook for, the IPO market. The report features regional breakdowns, a review of the PIPE and Rule 144A markets, and an analysis of the most common takeover defenses implemented by companies going public. We also discuss the typical attributes of successful IPO candidates, and present useful IPO market metrics that are ordinarily unavailable.

See our *2009 M&A Report* for a detailed review of, and outlook for, the global M&A market. In other highlights, we discuss the likely course of antitrust enforcement in the Obama administration and present a survey of key terms in sales of VC-backed companies.

To request a copy of any of the reports described above, or to obtain additional copies of the *2009 Venture Capital Report*, please contact the WilmerHale Marketing Department at marketing@wilmerhale.com or call +1 617 526 5600. An electronic copy of this report can be found at www.wilmerhale.com/2009VCreport.

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 2008 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.*

© 2009 Wilmer Cutler Pickering Hale and Dorr LLP

WilmerHale recognizes its corporate responsibility to environmental stewardship.

09_025 RPI 09/09 11,000

wilmerhale.com

Wilmer Cutler Pickering Hale and Dorr LLP is a Delaware limited liability partnership. Our United Kingdom offices are operated under a separate Delaware limited liability partnership of solicitors and registered foreign lawyers regulated by the Solicitors' Regulation Authority (SRA No. 287488). In Beijing, we are registered to operate as a Foreign Law Firm Representative Office. Wilmer Cutler Pickering Hale and Dorr LLP principal law offices: 60 State Street, Boston, Massachusetts 02109, +1 617 526 6000; 1875 Pennsylvania Avenue, NW, Washington, DC 20006, +1 202 663 6000. This material is for general informational purposes only and does not represent our legal advice as to any particular set of facts; nor does it represent any undertaking to keep recipients advised of all relevant legal developments. Prior results do not guarantee a similar outcome. © 2004–2009 Wilmer Cutler Pickering Hale and Dorr LLP