2010 Venture Capital Report

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Table of Contents

Review

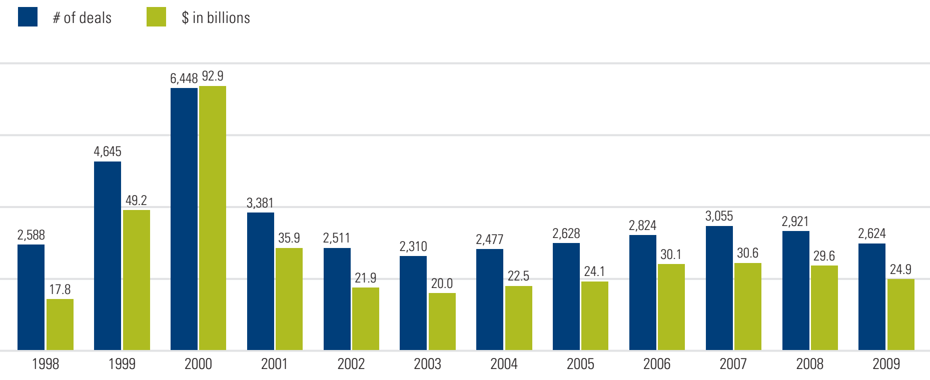
The venture capital market retrenched in the first half of 2009, in the face of sluggish economic conditions, but rebounded nicely to end the year on the upswing. Liquidity events presented a mixed message in 2009, with IPOs up slightly from the prior year and M&A transactions down. Financing and liquidity activity have improved in 2010, sounding an optimistic note for the year ahead.

In 2009, 2,624 reported venture capital financings raised total proceeds of $24.9 billion, compared to the 2,921 financings that raised $29.6 billion in 2008. Financing activity in 2009 largely mirrored capital market and economic conditions. In the first quarter of the year, as the lingering effects of the global economic recession continued to be felt, financing activity reached its lowest quarterly total since 1996. Compared to the fourth quarter of 2008, the number of financings dropped 18% to 541 deals, and proceeds plummeted 33% to $4.0 billion. The second and third quarters of 2009 saw significant upticks in deal flow and proceeds. Then, in the fourth quarter, proceeds jumped to $9.3 billion, one of the highest quarterly totals in years.

The median size of all venture capital financings decreased from $6.0 million in 2008 to $4.7 million in 2009, the lowest figure since 1998. The median financing size for life sciences companies in the same period decreased from $8.9 million to $5.9 million, while information technology companies saw their median financing size decrease from $7.0 million to $5.0 million. These declines reflected a less favorable funding environment and, in the case of many technology companies, the ability to commence operations with lower levels of funding than historically required, due to various technological advances.

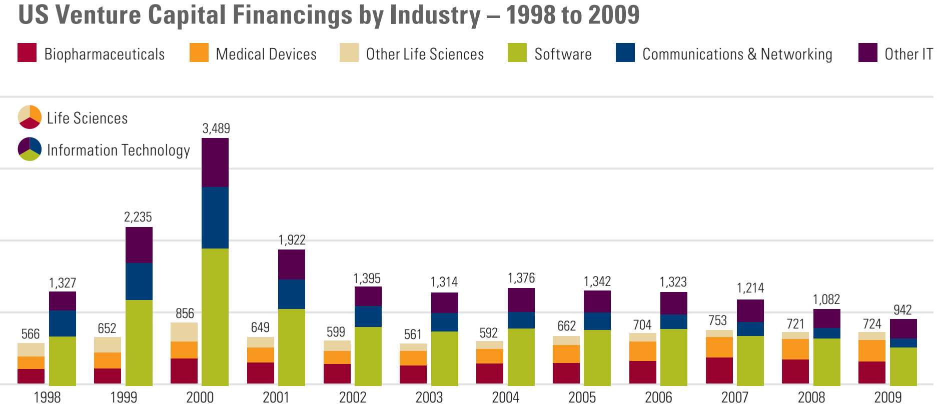
Overall, valuations of venture-backed companies increased between 2008 and 2009, but life sciences companies fared better than information technology companies. The median pre-money valuation for all venture financings was $20.0 million in 2009, compared to $18.0 million in 2008. Among life sciences companies, the median pre-money

US Venture Capital Financings – 1998 to 2009



Source: Dow Jones VentureOne

US Venture Capital Financings by Industry – 1998 to 2009



Source: Dow Jones VentureOne

valuation increased from $18.2 million in 2008 to $20.0 million in 2009, while information technology companies saw a drop in median pre-money valuation from $22.8 million to $19.4 million.

In 2009, seed and first-round venture capital financings represented 33% of the total number of venture financings and 15% of the total amount of venture capital investment. Seed and first-round financings have constituted between 29% and 41% of the total number of all venture financings in each year since 2001. The proportion of seed and first-round investing activity during the last nine years, however, is significantly lower than the proportion prior to 2001. This relative decline in early-stage investing activity is due, in part, to the fact that more rigorous investment criteria are being applied by investors, and in part to the longer average time from initial funding to a liquidity event, which increases the relative amount of money needed for investment in later-stage companies.

The breakdown of venture capital financings by industry sector in 2009 exhibits a continuation of longer-term trends. The gap in the number of financings between life sciences companies and information technology companies has been narrowing for a decade. In 2009, IT companies represented 36% of all venture capital financings, while life sciences companies constituted 28%—the closest these figures have ever been. In 2009, for the first time, the amount invested in life sciences companies exceeded the amount invested in information technology companies.

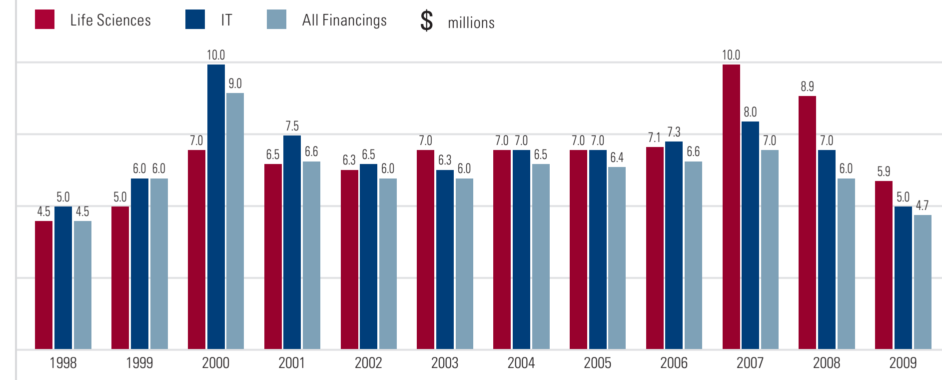
The geographic breakdown for venture capital investing has remained fairly constant since 1996 (the first year for which this data is available). California-based companies accounted for 42% of all venture financings in 2009, and have led the country in this regard in each year since 1996. Massachusetts, home to 11% of the companies receiving venture financing in 2009, again finished second in this category, as it has in each year since 1996. New York, Texas and Pennsylvania rounded out the top five positions for 2009.

After all but disappearing in 2008 and early 2009, due to the global economic crisis and overall declines in the capital markets, the IPO market for VC-backed companies began to return in the middle of 2009. A total of eight venture-backed companies went public last year, up from seven in 2008, setting the tone for strong recovery in 2010. The largest VC-backed IPO of 2009 belonged to A123 Systems, which raised $437.5 million in its September IPO. The median amount of time from initial funding to an IPO was 7.9 years in 2009, down from the record 8.7 years in 2008.

During the period 2004–2007, the number of IPOs by life sciences companies outpaced that of information technology companies. This trend reversed in 2009, with more information technology IPOs than life sciences IPOs, although the sample size was small.

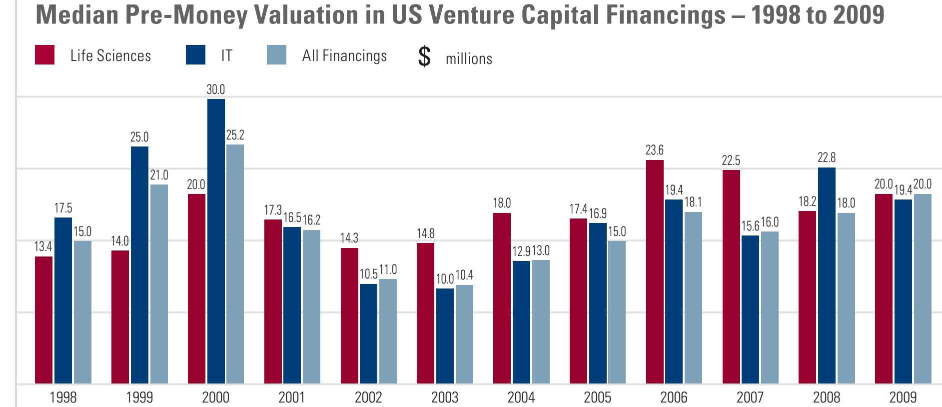
The ratio of pre-IPO valuations to the median amount raised prior to IPO by venture-backed companies going public jumped to 12.0:1 in 2009 from 6.6:1 in 2008. (A higher ratio means higher returns to pre-IPO investors.) This ratio

Median Size of US Venture Capital Financings – 1998 to 2009



Source: Dow Jones VentureOne

Median Pre-Money Valuation in US Venture Capital Financings – 1998 to 2009



Source: Dow Jones VentureOne

was between 3.1:1 and 5.7:1 for each year from 2001 to 2007. In contrast, this ratio ranged from 7.7:1 to 10.0:1 from 1997 to 2000. Although based on relatively few IPOs, the ratio for 2009 was the highest since at least 1996 and reflected higher IPO valuations coupled with the lowest level of pre-IPO financing of venture-backed IPO companies in 10 years. With a significantly larger number of VC-backed company IPOs occurring in 2010, this ratio can be expected to decline, although probably not to the levels that prevailed in the period 2001–2007.

The M&A market for venture-backed companies was moderately weaker in 2009 than in 2008. There were 344 reported acquisitions of venture-backed companies in 2009, compared to 381 in 2008. Purchase prices also dropped, with the median acquisition price for venture-backed companies dipping to $26.0 million in 2009 from $34.0 million in 2008 (a figure which itself was down sharply from the median of $72.0 million in 2007). The 2009 median acquisition price represented the lowest figure since 2003 and the second consecutive annual decrease after five consecutive annual increases. The median amount of time from initial funding to acquisition was five years in 2009, compared to six years in 2008.

There were no billion-dollar acquisitions of VC-backed companies in 2009. The largest deal of 2009 was Amazon's purchase of Zappos for $847 million. In contrast, the largest deals of 2008 were 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 1.3:1 in 2009, down from 1.5:1 in 2008. The 2008 and 2009 ratios were in line with the ratios of between 1.1:1 and 1.9:1 that prevailed each year between 2001 and 2005. In 2006 and 2007, strong acquisition prospects propelled the ratios to 2.4:1 and 3.6:1, respectively. At the peak of the dot-com craze, the ratio was a staggering 10.0:1.

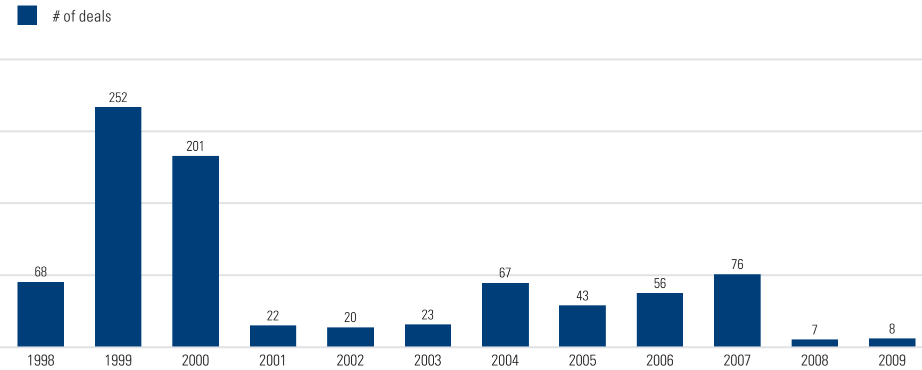
The above comparison of the ratios of valuations to the financing amounts required to achieve liquidity events indicates that returns to venture capital investors are higher on IPOs than on M&A transactions. This is hardly surprising, since few underperforming companies are able to go public. The higher valuations ascribed to IPO companies are offset in part, however, by the fact that the median amount raised prior to liquidity event for M&A companies is generally less than half the amount for IPO companies.

The 43:1 ratio of M&A transactions to IPOs for venture-backed companies in 2009 reflected improvement from 2008's ratio of 54:1, but remained an aberration in historical terms. This ratio was 8:1 during the period 2004–2007, 19:1 during the period 2001–2003, and a remarkable 2.1:1 during the Internet boom of 1998–2000.

Outlook

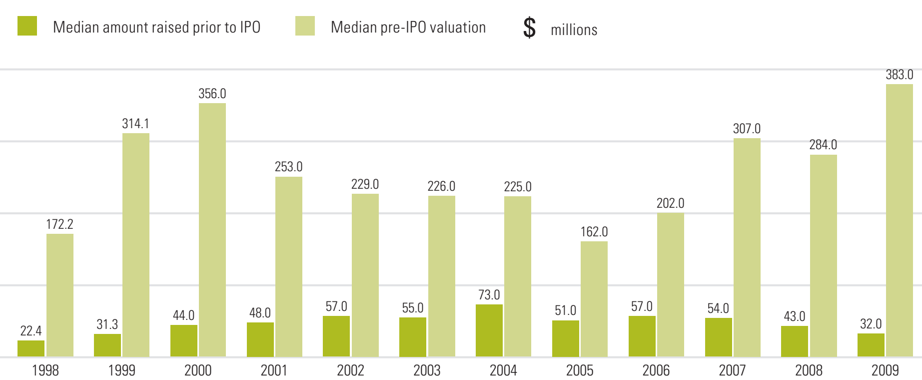
Venture capital investing activity has continued to improve in 2010. Liquidity has also improved, with a substantial increase in the number of IPOs by venture-backed companies and a modest uptick in acquisition activity and valuations.

US Venture-Backed IPOs – 1998 to 2009



Source: Dow Jones VentureOne

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1998 to 2009



Source: Dow Jones VentureOne

More than $18.0 billion was invested in 2,016 venture capital financings in the first three quarters of 2010, a 10% increase over the number of deals and the amount of gross proceeds in the first three quarters of 2009. These results are likely to be revised upward as additional data becomes available, suggesting that full-year 2010 activity will top the totals of 2009 by a significant margin.

The liquidity picture has also brightened. In the first three quarters of 2010, there were 284 acquisitions of venture-backed companies, compared to 259 in the same period of 2009, and 33 IPOs by venture-backed companies—more IPOs than in 2008 and 2009 combined.

We believe that the overall level of venture capital financing activity will continue to increase over the next year, reflecting continued improvements in economic conditions and the substantially improved outlook for IPOs by VC-backed companies, offset in part by a decrease in the amount of venture capital available for investment due to reduced levels of fundraising in recent years.

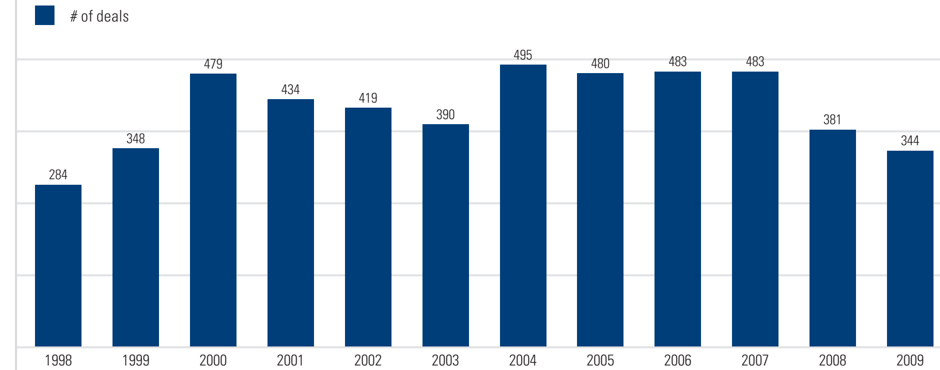
We also expect that venture capital valuations will recover, at least modestly, over the coming year as the impact of improved valuations for liquidity events is felt. Investors will, however, remain careful not to invest so much in a particular company or sector that a suitable rate of return cannot be achieved.

Investments in clean technology and renewable energy sources should increase over the coming year. This sector is likely to continue to benefit from heightened environmental awareness, the availability of significant amounts of government funding, and a long-term trend of rising energy prices. Problems with distribution, larger numbers of competing technologies, and the need in many cases for significantly larger investment amounts than in traditional venture-backed industries may, however, cause some investors to approach this market cautiously.

Ongoing globalization in venture investing is likely to continue. International markets such as China, India and parts of Southeast Asia, as well as Brazil and portions of South America, are spawning increased entrepreneurial activity and innovation, and the regulatory environments in those countries are also becoming more hospitable to foreign investment. These factors are 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.

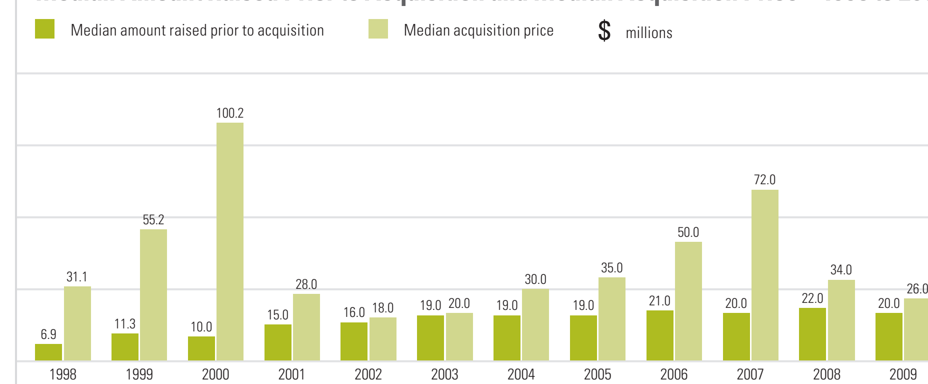
We believe the IPO market for VC-backed companies will continue to improve over the coming year, fueled by economic recovery and the rebound in the capital markets—the Dow Jones Industrial Average and Nasdaq Composite increased by 14% and 19%, respectively, from June 30 through November 1, 2010. After just eight venture-backed IPOs in all of 2009, the first three quarters of 2010 have already produced 33 IPOs by VC-backed companies. This surge in IPOs is encouraging other VC-backed companies

Acquisitions of US Venture-Backed Companies – 1998 to 2009



Source: Dow Jones VentureOne

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1998 to 2009



Source: Dow Jones VentureOne

to begin the IPO registration process, or to resuscitate dormant filings. These companies should form the pipeline for a strong VC-backed IPO market over the next year, absent a reversal in capital market conditions.

Deal activity and valuations in the M&A market should also improve over the coming year as strategic acquirers look to deploy their large cash balances. Further improvements in economic conditions and easing credit conditions would also boost M&A activity for VC-backed companies.

Despite recent improvements, the IPO market remains relatively fragile, particularly for the smaller, emerging-growth companies that exemplify VC-backed company IPO candidates. Any softening of the venture-backed IPO market would negatively affect the M&A market because limitations on the IPO market as a credible alternative diminish the leverage of venture-backed companies in negotiating acquisition prices, and because any general economic concerns that dampen the IPO market would also adversely affect the valuations of target companies. ■

California

California companies reported 1,089 financings in 2009, compared to 1,282 financings in 2008. Reported proceeds plummeted from $15.01 billion to $10.53 billion. These gaps should narrow after all 2009 transactions have been reported, but the year's proceeds are still likely to top out at their lowest level since 2005.

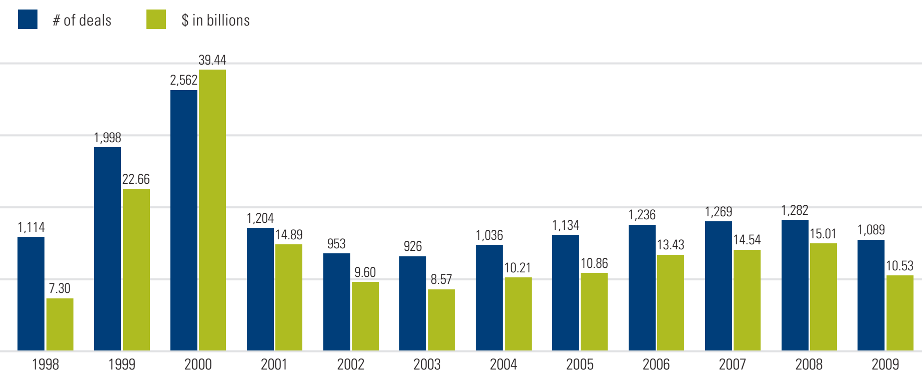
Nearly four times the size of the next-largest venture capital market in the United States, California was responsible for 42% of the nation's financing transactions and proceeds in 2009. Although California's venture capital activity remains well below the peak year of 2000—when it produced a staggering 2,562 financings with nearly $40 billion in proceeds—transaction volumes now exceed pre-bubble levels by a modest amount and 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. With a 43% market share, information technology was the largest sector in the state in 2009, followed by life sciences at 21%.

The state generated two IPOs by VC-backed companies in 2009, down from three in the prior year. The number of reported acquisitions of VC-backed companies edged up from 163 to 168. This tally should increase after all 2009 acquisitions have been reported, and the total may even approach the levels of 2007 and the peak years of 2000–2001. California produced the second- and third-largest venture-backed company sales nationwide in 2009: Medtronic's acquisition of CoreValve for $700 million and Cisco's acquisition of Pure Digital Technologies for $590 million.

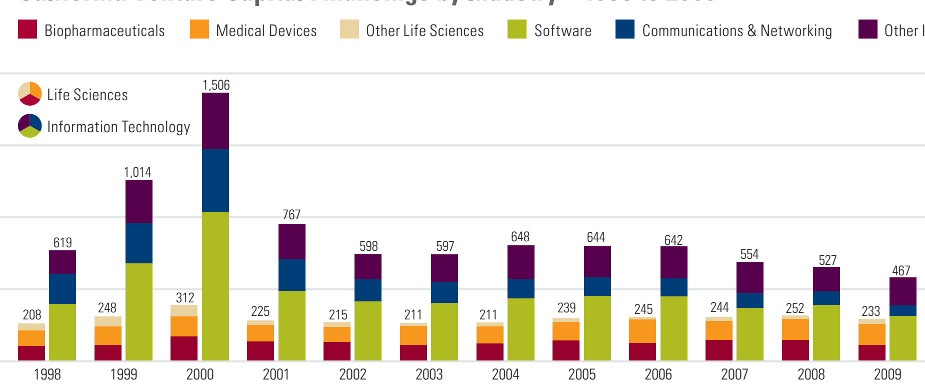
We expect California to maintain its venture capital leadership in the coming year, and conditions appear ripe for future growth in financing activity and significant improvements in liquidity. In the first three quarters of 2010, for example, there were 16 IPOs by California venture-backed companies.

California Venture Capital Financings – 1998 to 2009



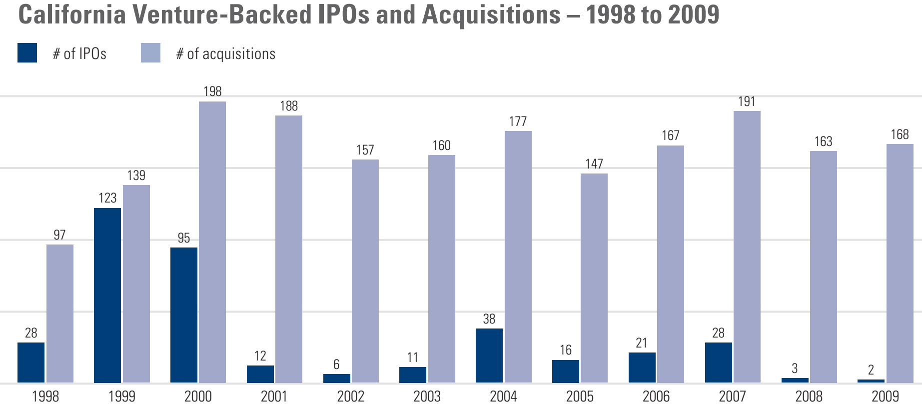
Source: Dow Jones VentureOne

California Venture Capital Financings by Industry – 1998 to 2009



Source: Dow Jones VentureOne

California Venture-Backed IPOs and Acquisitions – 1998 to 2009



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 159 in 2008 to 143 in 2009, while proceeds plunged from $1.83 billion to $1.03 billion. Once all transactions have been reported, the total number of financings in the region in 2009 should approach 2008's level, but proceeds for 2009 are likely to remain well behind 2008's total.

Despite the slowdown in financing activity in 2009 compared to 2008, the past eight years have yielded an annual average of 174 mid-Atlantic venture capital financings, with proceeds of $1.50 billion—figures that top the levels seen in the pre-bubble years of 1996–1998.

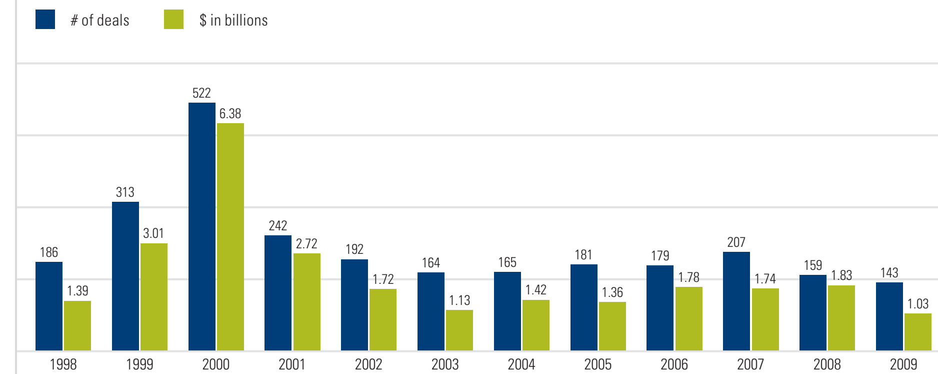
The percentage of all mid-Atlantic financings completed by information technology companies declined from 43% in 2008 to 32% in 2009, while the portion attributable to life sciences companies soared from 29% to 38% to lead the region for the first time.

In 2009, the mid-Atlantic region was shut out of the VC-backed IPO market for the second consecutive year. With improving market conditions, there were two IPOs by mid-Atlantic VC-backed companies in the first three quarters of 2010.

The number of reported acquisitions of venture-backed companies in the region decreased to 31 in 2009 from 42 the prior year, but this gap should narrow once all transactions are reported. Virginia continued to lead the region in VC-backed M&A transactions, with 12 deals in 2009. The region's largest deal of the year was the $400 million acquisition of Athenix by Bayer CropScience.

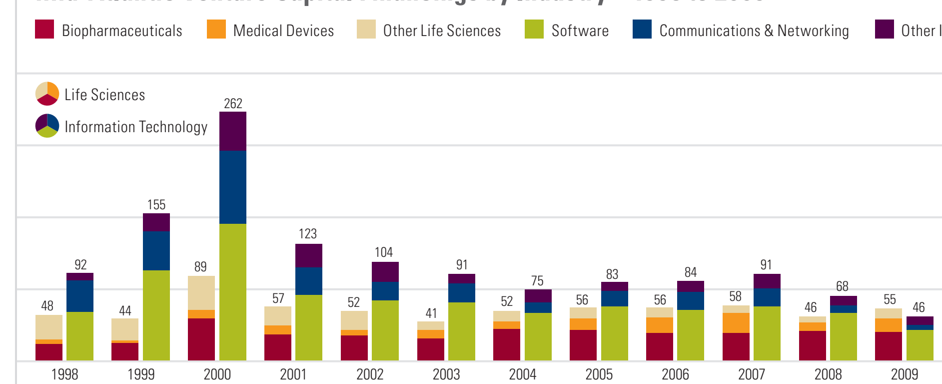
In the coming year, we expect that the mid-Atlantic region will remain a leading center of life sciences–related investment and spawn additional IPO candidates. We also expect that the information technology, government-related IT services, and defense industries will produce a steady stream of attractive emerging companies in the region.

Mid-Atlantic Venture Capital Financings – 1998 to 2009



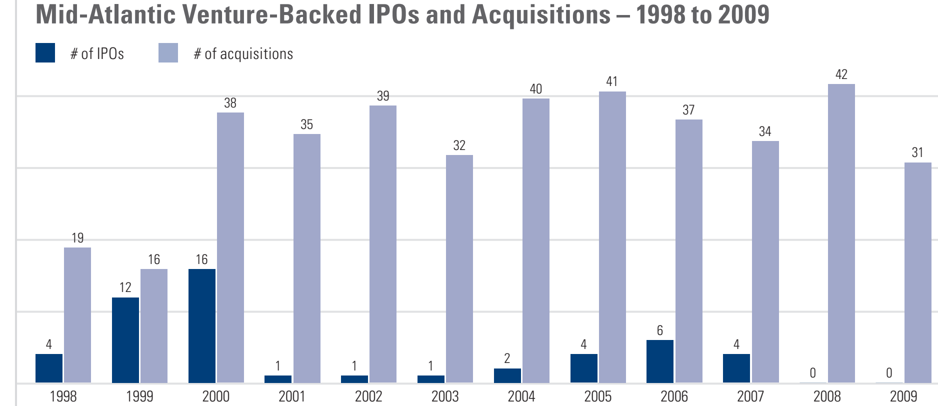
Source: Dow Jones VentureOne

Mid-Atlantic Venture Capital Financings by Industry – 1998 to 2009



Source: Dow Jones VentureOne

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1998 to 2009



Source: Dow Jones VentureOne

New England

New England companies reported 342 financings in 2009, down from 374 in 2008, while proceeds dropped to $3.05 billion from $3.48 billion. The year's results should approximate the totals of 2008, once all transactions have been reported.

While venture capital investment in the region remains well below the bubble years of 1999–2001, New England has maintained an average of 360 financings per year over the last eight years, rivaling the prevailing deal volumes of 1996–1998, and average annual proceeds have increased by two-thirds between these periods.

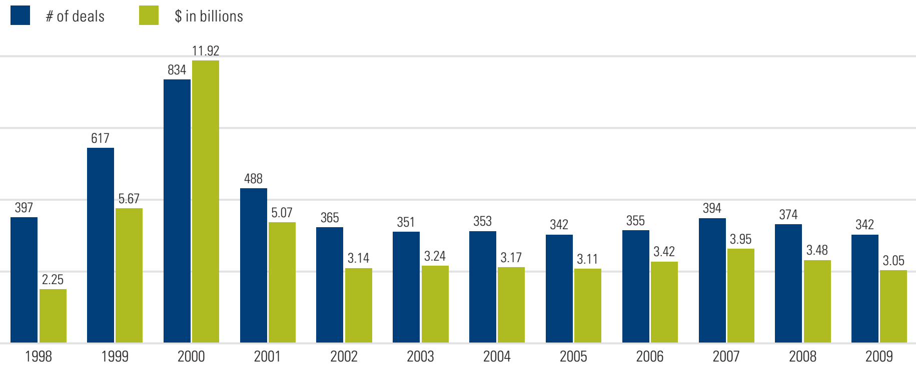
New England continues to be a leading center of activity for technology and life sciences companies. In 2009, these sectors swapped places in the rankings. Information technology companies accounted for 33% of New England's venture capital financings in 2009 (down from 40% in 2008) and life sciences companies contributed 39% of the region's financings (up from 30%).

New England generated two venture-backed IPOs in 2009—the $437.5 million IPO of A123 Systems and the $122.7 million IPO of LogMeIn—after producing none in 2008. Recovery of the VC-backed IPO market has continued into 2010, with three IPOs (by AVEO Pharmaceuticals, Higher One Holdings and Ironwood Pharmaceuticals) through September 30.

The number of acquisitions of VC-backed companies edged down to 49 in 2009 from 56 in the prior year. The region's largest deals of the year were the acquisition of Gloucester Pharmaceuticals by Celgene for $640 million (including milestone payments) and Compuware's $295 million acquisition of Gomez.

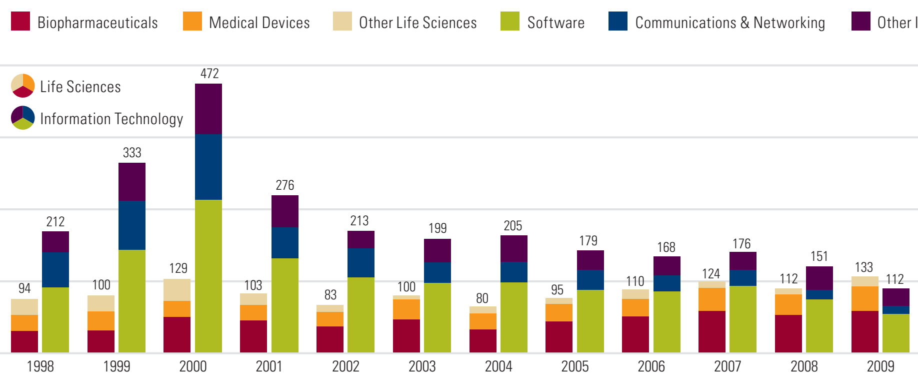
We expect New England—and Massachusetts in particular—to remain one of the country's most appealing environments for emerging companies and a hub of venture capital and IPO activity during the coming year.

New England Venture Capital Financings – 1998 to 2009



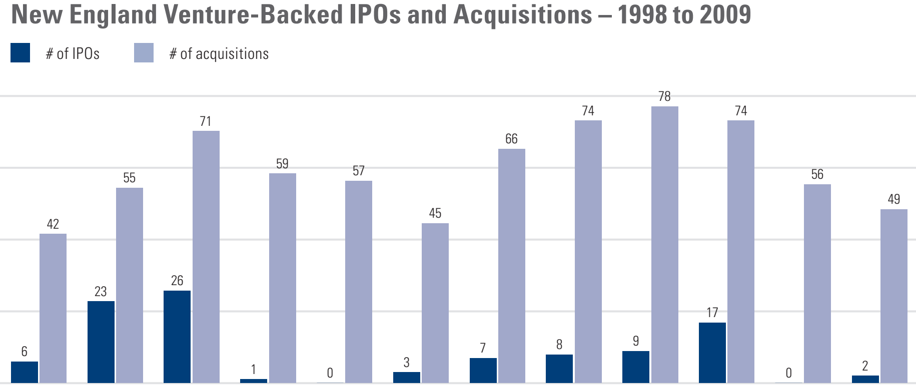
Source: Dow Jones VentureOne

New England Venture Capital Financings by Industry – 1998 to 2009



Source: Dow Jones VentureOne

New England Venture-Backed IPOs and Acquisitions – 1998 to 2009



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 dipped from 375 in 2008 to 350 in 2009, while proceeds decreased from $3.03 billion to $2.32 billion. Once all transactions have been reported, the transaction total for 2009 should be close to last year's total, while proceeds are likely to continue to trail 2008's results.

Venture capital activity in the region presently exceeds, by a significant margin, the volume of financing transactions and proceeds seen in the pre-boom years of 1996–1998. Over the past eight years, the tri-state region has produced an annual average of 313 financings with proceeds of $2.75 billion, compared to an average of 193 financings raising $1.26 billion per year for the period 1996–1998.

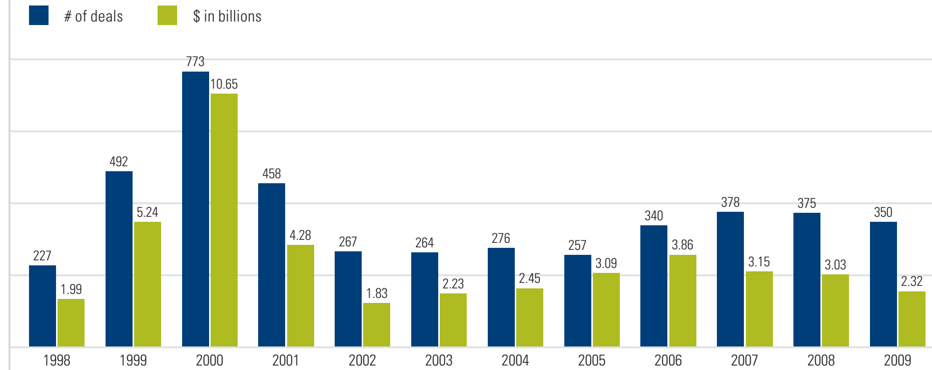
For the first time, life sciences companies garnered the largest share of the tri-state region's VC financing market in 2009, with 29% of the region's financings, compared to 23% in 2008. Information technology companies accounted for 25% of the region's financings in 2009, down from 27% in the prior year.

The tri-state region produced only one venture-backed IPO in 2009—the $88.2 million IPO of Medidata Solutions—to match the region's total from 2008. In the first three quarters of 2010, however, six venture-backed IPOs have come out of the tri-state region.

Reported acquisitions of venture-backed companies in the tri-state region plunged from 61 in 2008 to 35 in 2009. The region's largest deal of 2009 was SunEdison's $200 million acquisition by MEMC Electronic Materials.

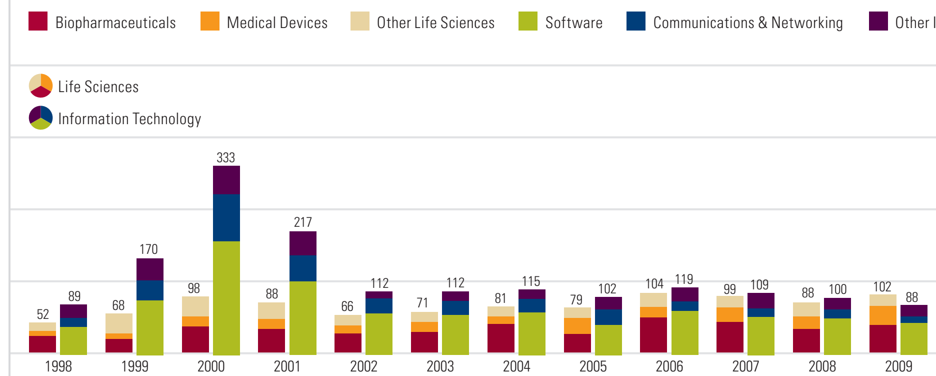
Over the coming year, we believe that the tri-state region's strengths in the pharmaceuticals, life sciences, financial services and information technology sectors—combined with its large number of Fortune 500 companies—will continue to foster a favorable environment for VC-backed start-up companies and produce viable IPO candidates. ■

Tri-State Venture Capital Financings – 1998 to 2009



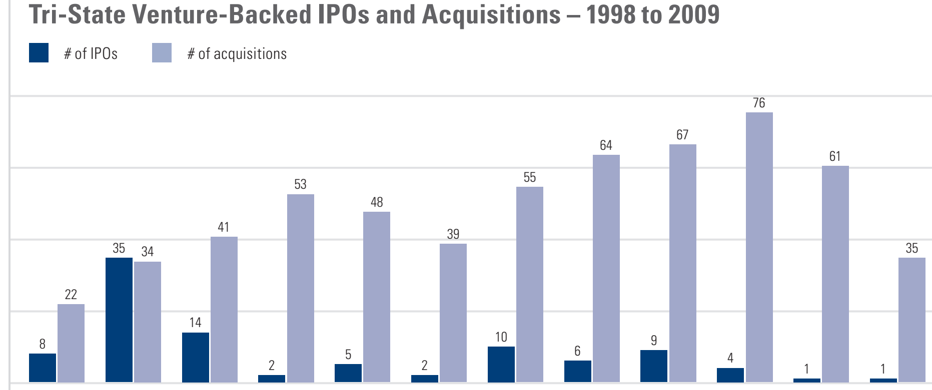
Source: Dow Jones VentureOne

Tri-State Venture Capital Financings by Industry – 1998 to 2009



Source: Dow Jones VentureOne

Tri-State Venture-Backed IPOs and Acquisitions – 1998 to 2009



Source: Dow Jones VentureOne

Counsel of Choice to Venture Capital-Backed Companies

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

catabasis	$40,000,000	*First Round*	April 2010
ALNARA Pharmaceuticals	$35,000,000	*Second Round*	January 2010
On-Q-ity	$26,000,000	*First Round*	October 2009
KiOR	$110,000,000	*Second Round*	April 2010
Virdante Pharmaceuticals	$47,750,000	*First Round*	October 2009
CASA	$96,000,000	*Late Stage*	April 2010
Petra Solar	$40,000,000	*Second Round*	January 2010
RentTheRunway love. wear. return.	$15,000,000	*First Round*	February 2010
Ophthotech	$30,000,000	*Second Round*	December 2009
Oxagen	£16,000,000	*Third Round*	November 2009
A123 Systems	$100,000,000	*Late Stage*	April 2009
Laser Light Engines	$13,000,000	*Second Round*	September 2010
Aileron Therapeutics	$40,000,000	*Fourth Round*	May 2009
copanion	$10,200,000	*Second Round*	October 2009
BioVex advanced vaccines	$70,000,000	*Late Stage*	November 2009
CambridgeSoft www.cambridgesoft.com	$31,300,000	*Late Stage*	November 2009
Veracode	$12,000,000	*Fourth Round*	January 2010
Verivue	$20,000,000	*Third Round*	August 2009
Xanodyne pharmaceuticals, inc.	$88,000,000	*Late Stage*	May and October 2009
actifio	$16,000,000	*Second Round*	September 2010
Novomer	$14,000,000	*Second Round*	August 2009
demandware eCommerce Freedom	$15,000,000	*Fourth Round*	April 2009
Metamark Genetics, Inc.	$22,000,000	*Second Round*	July 2010
SiliconBlue Technologies	$15,000,000	*Third Round*	May 2010
Cerulean	$24,000,000	*Third Round*	November 2010
1366 technologies	$20,000,000	*Second Round*	October 2010
tōkai pharmaceuticals	$22,000,000	*Third Round*	May 2009
kolltan Pharmaceuticals, Inc.	$10,000,000	*Second Round*	December 2009
Constellation Pharmaceuticals	$22,000,000	*Second Round*	May 2010
PTC Therapeutics	$50,000,000	*Late Stage*	December 2009
BioScale	$25,000,000	*Fourth Round*	May 2010
Tetraphase Pharmaceuticals	$45,000,000	*Third Round*	May 2010

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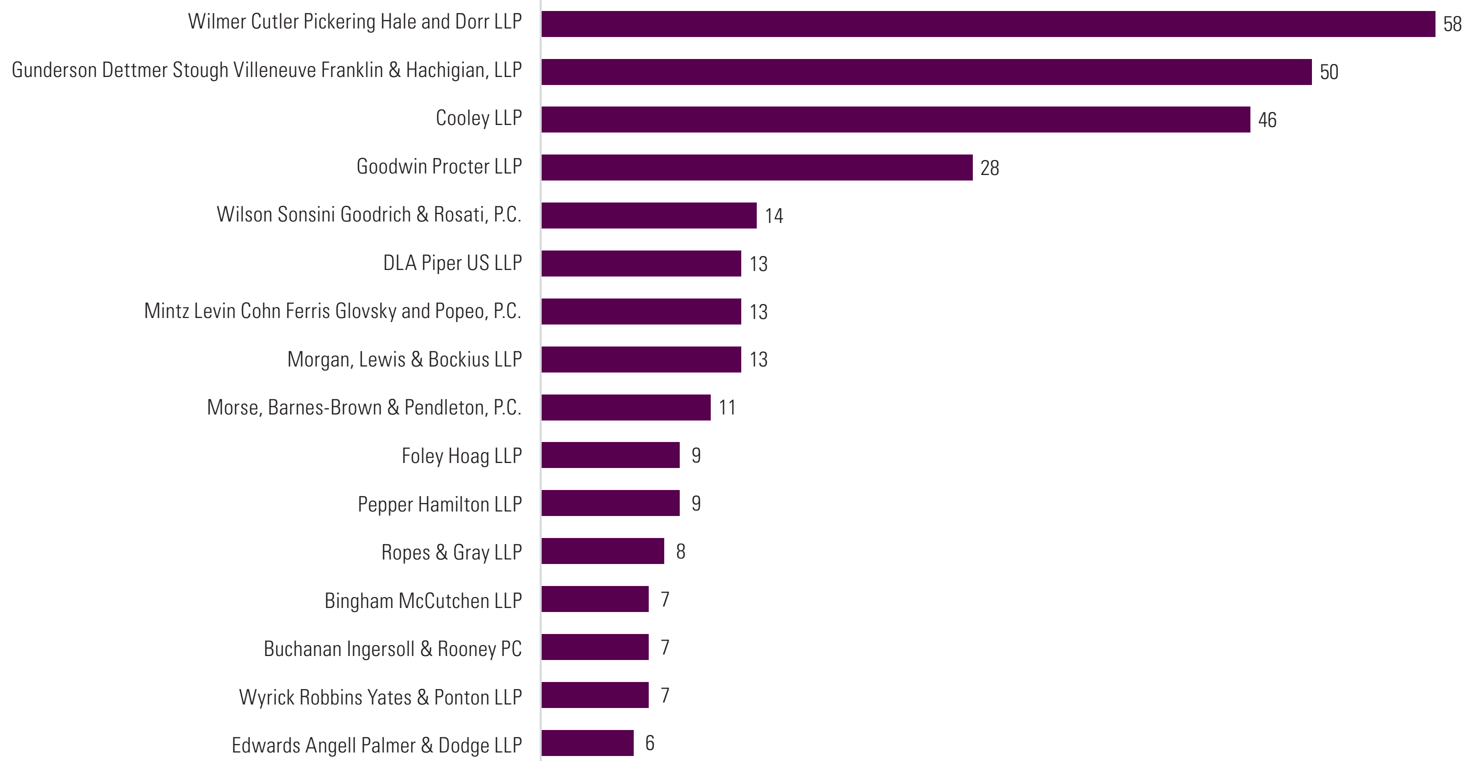
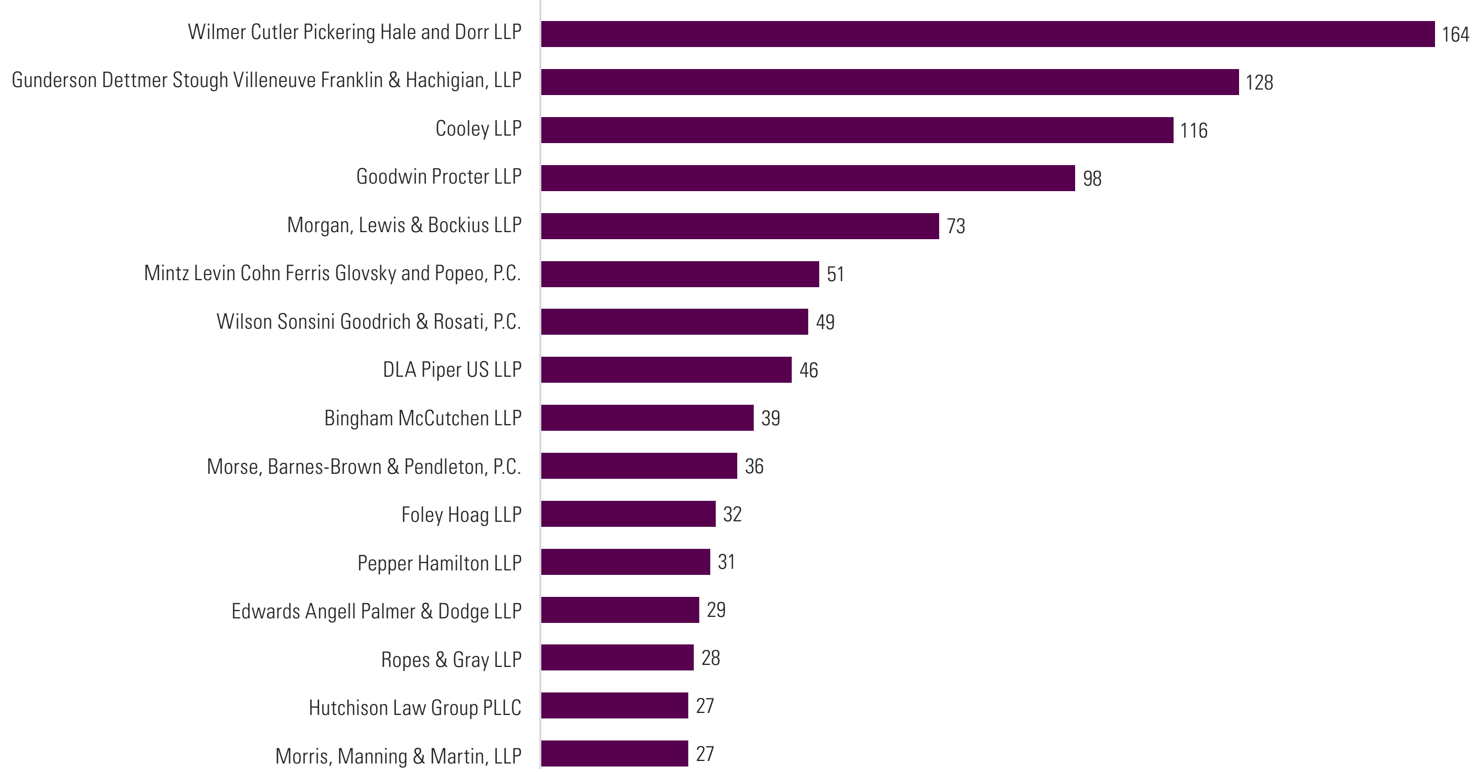
Counsel to Companies Receiving VC Financing in 2009 – Eastern US



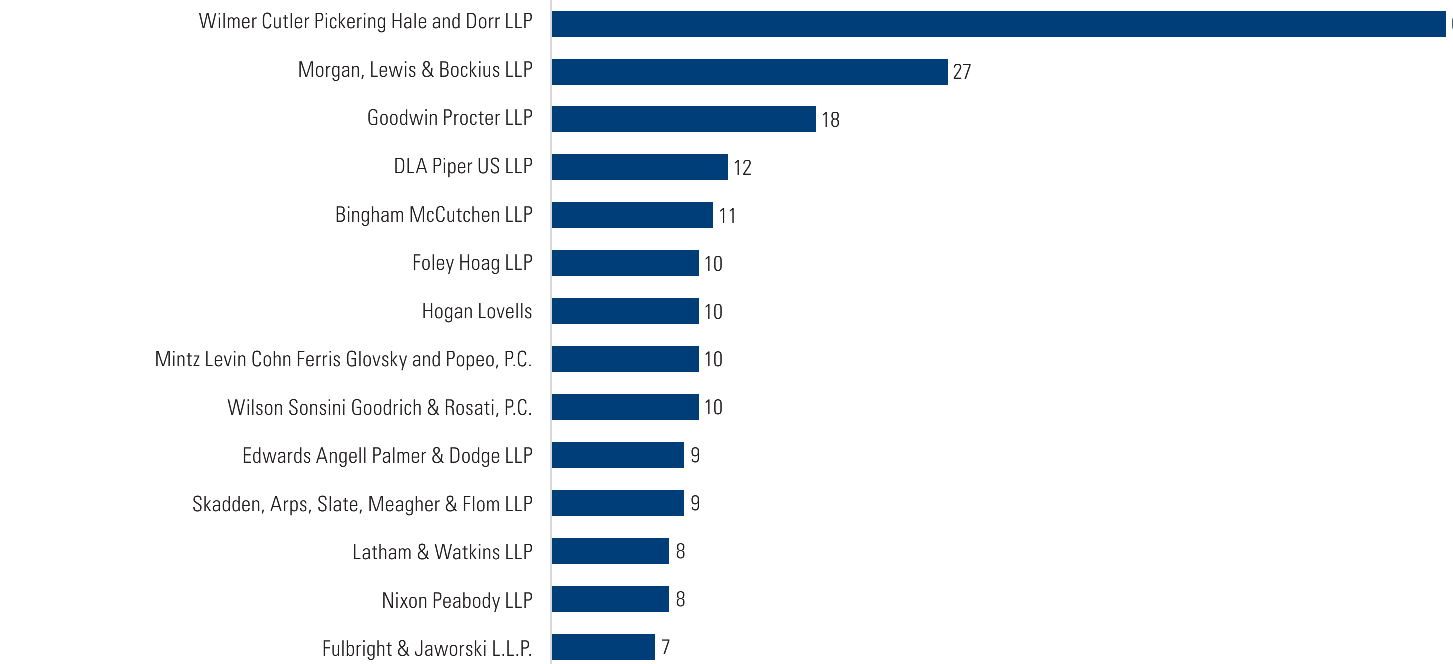
The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later-stage or restart round of venture capital financing in 2009.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2009 – Eastern US



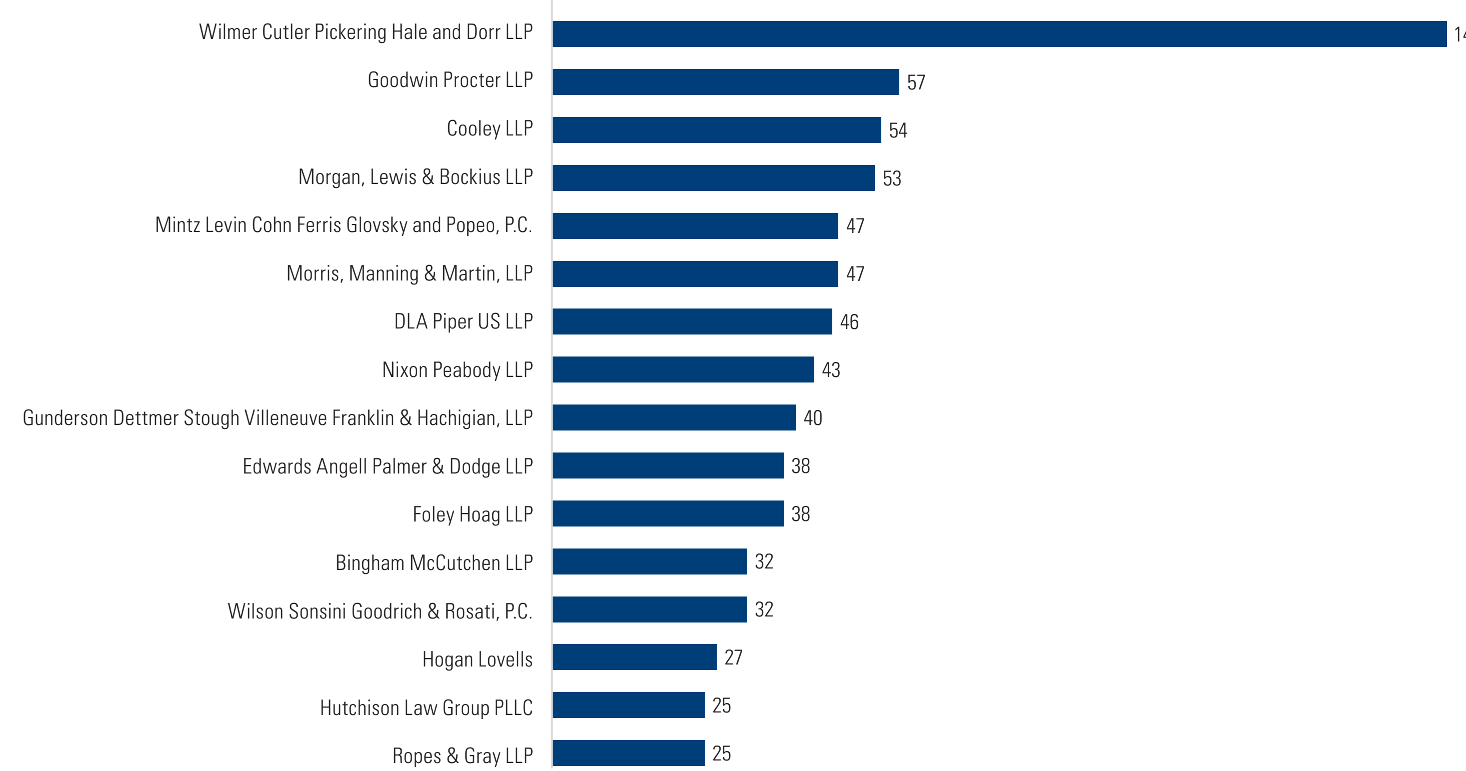
The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2009.
Source: Dow Jones VentureOne

Company Counsel in IPOs of Eastern US VC-Backed Companies – 1996 to 2009



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 2009



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

Review

In 2009, European venture capital financing activity dropped to its lowest level since at least 2000, but ended the year with a strong quarter to set the stage for recovery in 2010.

Venture capital financing proceeds in Europe plunged to €3.4 billion in 2009 from €5.2 billion in 2008, while the number of financings fell from 1,311 to 1,076. Once all 2009 transactions have been reported, the year's deal total should narrow this gap, but proceeds are likely to continue to trail last year's results by a substantial margin. Mirroring worldwide trends, the median financing size in Europe dropped to €1.6 million in 2009 from €2.0 million in the prior year.

The software sector again accounted for the largest portion of the European venture capital market, representing 18% of all financings, followed by consumer information services (12%) and biopharmaceuticals (11%).

The United Kingdom remained the largest venture capital market in Europe, generating 29% of all financings in 2009, followed by France (25%), Germany (16%) and Sweden (6%).

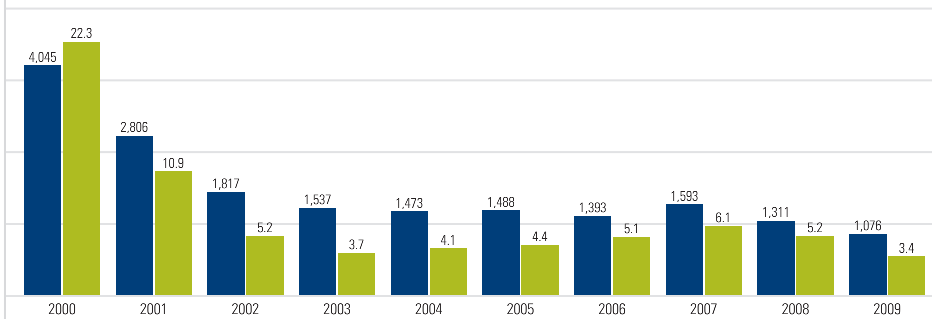
The number of IPOs by European venture-backed companies dropped from 12 in 2008 to just 4 in 2009. The number of reported acquisitions declined from 312 to 237—delayed reporting suggests the actual gap in M&A activity was smaller, but it is unlikely to be closed.

Outlook

To date, the 2010 European venture capital market has shown improvement. In the first half of the year, financings, proceeds and median deal size all increased from 2009 levels. Continued economic recovery should support further growth over the coming year.

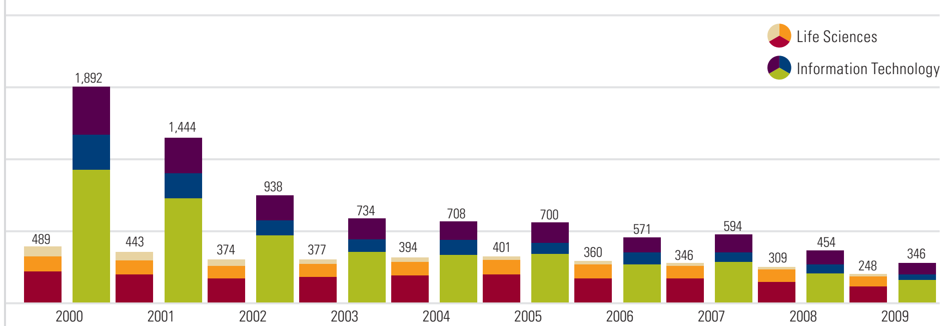
The liquidity outlook for European VC-backed companies also appears to be improving. In the first three quarters of 2010, there have been 12 IPOs by European venture-backed companies. Year to date, M&A activity is tracking at higher levels than in the corresponding quarters of 2009.

European Venture Capital Financings – 2000 to 2009



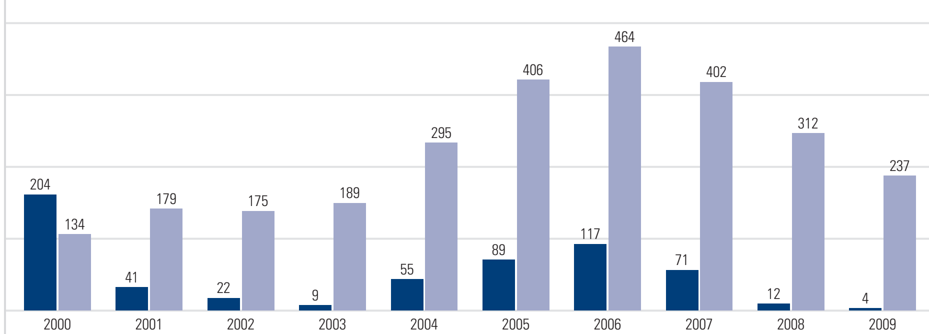
Source: Dow Jones VentureOne

European Venture Capital Financings by Industry – 2000 to 2009



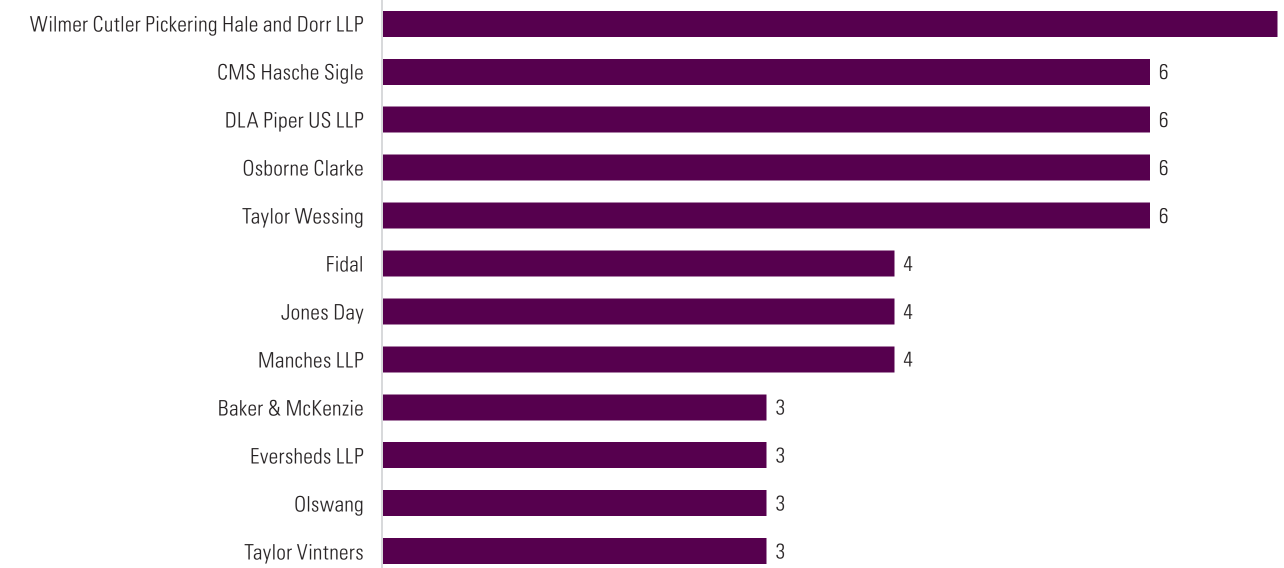
Source: Dow Jones VentureOne

European Venture-Backed IPOs and Acquisitions – 2000 to 2009



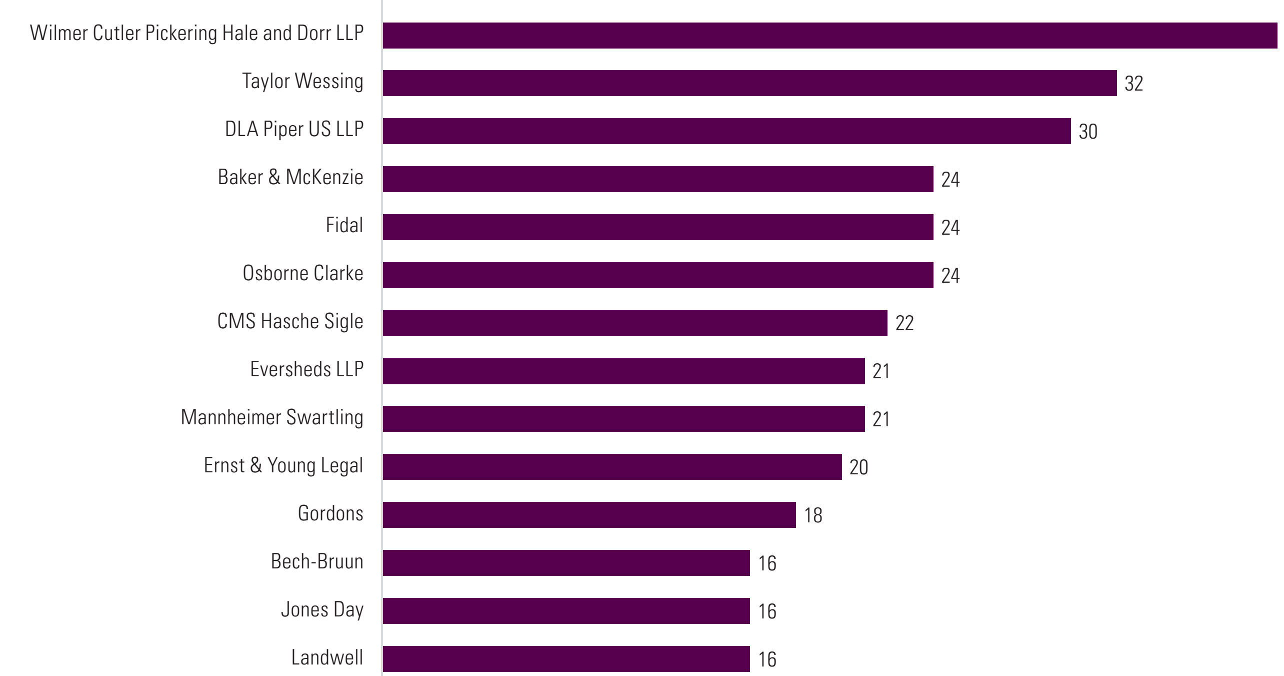
Source: Dow Jones VentureOne

Counsel to Companies Receiving VC Financing in 2009 – 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 2009.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2009 – Europe



The above chart is based on European VC-backed companies that were private and independent as of the end of 2009.
Source: Dow Jones VentureOne

Fundraising

Venture capital fund formation activity declined substantially in 2009, with a total of 134 funds raising $13.5 billion, down 54% from the $29.1 billion raised by 205 funds in 2008. Venture capital fundraising has begun to improve during 2010, however, as institutional investors are cautiously returning to the market following the turmoil that hit the financial markets in 2008 and 2009. During the first half of 2010, 72 funds raised $7.5 billion, up 13% from the $6.6 billion raised by 68 funds during the first half of 2009.

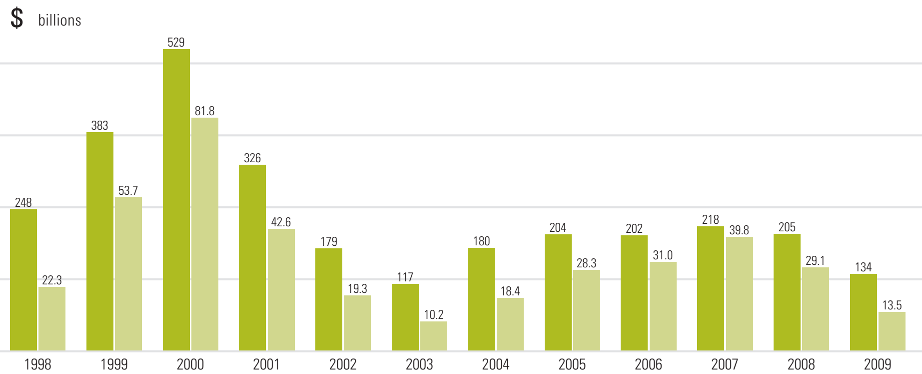
We expect continued improvement during 2010 and 2011, although most venture funds can anticipate a lengthy fundraising process. Formation of funds by new sponsors is likely to remain depressed as institutional investors look to prune the number of their relationships with portfolio managers. Many investors and fund groups are also predicting that venture fund sizes will be smaller, to provide flexibility to both fund managers and investors.

Expansion Capital

Many venture firms are looking for ways to fund existing portfolio investments that now require more time and more money to achieve liquidity. Funds are exploring a number of different strategies to obtain additional capital, as they tap out the capital commitments of their equity investors:

- Funds with the ability to do so are "recycling" investment proceeds, but not all funds are permitted to follow this course, and this approach requires proceeds to recycle.
- Some fund sponsors have agreed to waive and defer management fees, in order to increase the capital commitments available for investment, but this strategy has tax and other risks which make it somewhat unattractive.
- Funds with the ability to do so may borrow money, but there are often limitations on the amount of permitted borrowing and adverse tax consequences from the use of leverage.

Commitments to US Venture Capital Funds – 1998 to 2009



Source: Dow Jones VentureOne

Based on these and other factors, many funds consider forming an annex fund or expanding the existing fund's offering.

Annex Funds. Annex funds are typically formed as separate entities to invest solely in the portfolio companies of an existing "primary" fund. In most cases, interests in annex funds are offered solely to participants in the primary fund (or affiliated entities), with each primary fund investor being offered the opportunity to purchase a share of the annex fund that is proportionate to its share of the primary fund (with overallotment options on unsubscribed amounts).

Annex fund documents are substantially similar to the documents for the respective primary funds, except that management fees and carried interests are often smaller, and they include rules to address conflicts presented by cross-investing arrangements with the primary fund. Fund sponsors must review carefully primary fund agreements to be certain that forming an annex fund does not trigger "key person" events, defaults or management fee rampdowns. In some cases, amendments to primary fund documents are required. Some investors insist on a "blending" of the carried interest from the annex fund and the primary fund. This approach adds significant complexity to the documents, absent unusual circumstances.

Expansion Capital. Other funds have sought to reopen the offering of interests in the existing fund to increased participation by existing investors or participation by new investors.

The expansion of a fund can pose numerous tax and accounting issues, and often is a practical alternative only in those situations in which the fund's portfolio is carried at cost or at a loss, and no liquidity events have yet occurred. As with annex funds, investors are typically offered the opportunity to maintain their existing percentage interest in the expanded fund, with overallotment options on unsubscribed amounts.

Depending on the facts, an expansion offering can be accomplished with fairly simple documentation—an additional subscription agreement and amendments of the existing partnership agreement. In some cases, special management fee arrangements are established for the new commitments, with any fee increase attributable to the new commitments to be effective on a prospective basis only. If there is existing value in the portfolio, the fund sponsors will often make tax and accounting elections in connection with the expansion, with any unrealized appreciation or depreciation through the date of the expansion "booked into" the capital accounts of the investors based on their pre-expansion ownership interests.

Unfortunately, most of the alternatives available to cash-starved funds involve some complexity, and require cooperation from existing investors. However, there are compelling business and economic reasons for both general and limited partners to increase the funding available to shepherd existing portfolio investments through to realization events. ■

You've got the vision, the core team, and even a little money. You're prepared to devote enormous time and energy to your new start-up. You're unsure what the future will bring but you want to preserve the possibility of going public someday. A full slate of IPO preparations is daunting and unnecessary for a newly founded company, but here are 10 things a start-up should do to groom itself for an eventual IPO.

- *Protect Your IP:* In some sectors, intellectual property is the heart of the company, but even low-tech or no-tech start-ups routinely rely on confidential information, trademarks, domain names and copyrights. You should fashion an IP protection program that matches your needs and budget. Basic IP protection includes corporate name and trademark searches; non-disclosure and invention assignment agreements with employees; confidentiality and IP ownership agreements with consultants and third parties; limitation of internal access to confidential information to persons with a need to know; proper use of confidentiality legends, trademark symbols and copyright notices; and domain name registration. Advanced IP protection typically includes US and foreign patent applications.
- *Respect Former Employers and Uncle Sam:* You've got a great idea and maybe some technology to get you started, but be certain your nascent technology isn't owned by a former employer, since a lawsuit can stop your new company in its tracks. Similarly, make sure you retain the rights in any inventions under government contracts. Also, be mindful of any non-competition or non-solicitation agreements you or your employees may have—these obligations can affect both the nature of your business and your ability to recruit talent from former employers.
- *Bootstrap to Avoid Dilution:* A founder's sweat equity is a crucial part of the start-up package, and by granting equity incentives a start-up can pay less cash compensation to employees (although minimum wage laws still apply). "Bootstrapping" can help delay substantial outside investment until significant milestones justify a higher valuation—and protect that equity from dilution. Bootstrapping might include founder resources, loans from friends and family, or cash flow from operations. Friends-and-family investments present both benefits (it is money) and disadvantages (it can be awkward to ask Mom for a loan), but may be the best funding alternative at inception.
- *Stay Out of the Woodwork:* An IPO can be "out of the woodwork" time. Former employees and other people you've long since forgotten might show up on the cusp of your IPO looking for a piece of the company. Preempt these surprises by making sure your IP rights are properly documented and all equity arrangements are in writing.
- *Employ At-Will and Take Vacations:* Your employment policies will evolve with the growth of your business. An essential one is an employment at-will policy—stating that the employment of any employee can be terminated at any time and for any reason, or for no reason. The policy's purpose is to negate any inference that an employee is entitled to continued employment or severance upon termination. Limits on vacation carryover should also be adopted early on, to avoid the buildup of accrued vacation on your books. Besides, annual vacations will keep key employees fresh and productive.
- *Pre-Wire the Company:* Financing arrangements should contemplate the possibility of going public. Set up your capital structure to become streamlined in an IPO, with preferred stock automatically converting into common stock. Make sure your investor agreements (other than registration rights) and investor board rights terminate in an IPO. These kinds of steps can minimize the need for amendments or waivers in the IPO process and facilitate the transition to public company life. As you add outside directors over time, seek candidates that can form the nucleus of a public company board.
- *Lockup the Future:* In every IPO the underwriters require lockup agreements that prohibit pre-IPO stockholders from selling shares for a specified period of time—typically 180 days—following the IPO. Lockup agreements help maintain an orderly market while the distribution of shares is completed and initial trading develops. All pre-IPO stockholders and option holders are ordinarily asked to sign lockup agreements. IPO preparations will be easier if you include lockup provisions in your stock plans and agreements and financing documents from the beginning.
- *Remember the Securities Laws:* Many securities laws apply to start-ups long before they go public. Issuances of stock and options—whether to founders, employees or investors—must comply with these laws. Violations can result in liability to the company, make it difficult to attract investors, and even jeopardize an IPO. Securities law compliance is usually not particularly burdensome, but it must not be overlooked.
- *Discover Delaware:* If you hope to go public, incorporate in Delaware. More than 90% of all IPO companies call Delaware home, and for good reason: Delaware offers nationwide familiarity; a permissive and flexible corporation statute; a well-developed body of case law; and a judiciary experienced at interpreting its statute. Reincorporation in Delaware prior to an IPO is possible, but this step can be skipped by starting off in Delaware—and your financings and other corporate transactions will be facilitated in the meantime.
- *Keep Good House:* IPO preparations will proceed more smoothly if you attend to "corporate housekeeping" on a regular basis. This includes minute books, stock and option records, employee agreements, IP documentation, contracts and other corporate records and formalities, as well as legal compliance. Many defects can be fixed as an IPO draws nearer, but the process will be helped if you start with a solid foundation of good housekeeping.

Finally, don't despair if the IPO market is not ready when you are. In recent years, far more start-ups have been acquired than gone public. Both possibilities can even be combined in a "dual track" strategy, in which you simultaneously pursue an IPO while entertaining—or even courting—acquisition offers. The above preparation will serve both paths well. ■

Based on hundreds of venture capital financing transactions we handled from 2005 to 2009 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2005	2005 Range	2006	2006 Range	2007	2007 Range	2008	2008 Range	2009	2009 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	3%	1.5x	5%	2x	4%	1.5x – 2x	3%	3x	0%	N/A
	Post–Series A	10%	1.5x – 2x	9%	1.25x – 3x	7%	1.5x – 2x	14%	1.3x – 3x	19%	1.5x – 5x

Deals with Participating Preferred		2005	2005 Range	2006	2006 Range	2007	2007 Range	2008	2008 Range	2009	2009 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	58%		59%		57%		53%		30%	
	Capped	48%	2x – 5x	22%	2x – 5x	42%	2x – 6x	35%	2x – 5x	25%	2x – 3x
	Post–Series A										
	Total	71%		62%		62%		56%		57%	
	Capped	39%	2x – 5x	24%	2x – 5x	37%	2x – 5x	41%	2x – 5x	35%	2x – 6x

Deals with an Accruing Dividend		2005	2006	2007	2008	2009
"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	78%	53%	43%	53%	41%
	Post–Series A	87%	55%	38%	36%	41%

Anti-Dilution Provisions		2005	2006	2007	2008	2009
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	0%	7%	9%	6%	0%
	Weighted Average	100%	93%	91%	94%	100%
	Post–Series A					
	Full Ratchet	16%	7%	5%	5%	9%
	Weighted Average	84%	93%	95%	95%	91%

Deals with Pay-to-Play Provisions		2005	2006	2007	2008	2009
"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	25%	22%	28%	23%	35%
	% of Total That Convert to Common Stock	55%	65%	79%	92%	87%
	% of Total That Convert to Shadow Preferred Stock	45%	35%	21%	8%	13%

We reviewed all merger transactions between 2004 and 2009 involving venture-backed targets (as reported in Dow Jones VentureOne) in which the merger documentation was publicly available and the deal value was $25 million or more. Based on this review, we have compiled the following deal data:

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

1 The buyer provided indemnification in 48% of the 2004 transactions, 25% of the 2005 transactions, 41% of the 2006 transactions, 53% of the 2007 transactions, 50% of the 2008 transactions and 40% of the 2009 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions, 17% of the 2005 transactions, 35% of the 2006 transactions, 56% of the 2007 transactions, 25% of the 2008 transactions and 40% of the 2009 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, in 60% of these transactions in 2008, and in 100% of these transactions in 2009, buyer stock was used as consideration.

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

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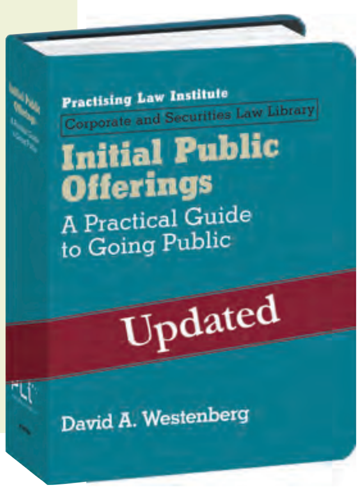

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Data Sources

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 2009 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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