WILMER CUTLER PICKERING
HALE AND DORR LLP

2004 VENTURE CAPITAL REPORT

Table of Contents

2004 Review

The US venture capital financing market—measured by both financing activity and liquidity events—was hardly robust in 2004, especially as compared to the aberrant market conditions of 1999–2000. However, by most measures, the market was noticeably stronger than in 2002 and 2003, fueling optimism that we may see continued improvement in 2005.

The number of venture capital financings in 2004 (2,067) was essentially the same as in 2003 (2,092). The total amount invested in venture capital financings increased from $18.9 billion in 2003 to $20.4 billion in 2004, reversing a three-year decline. However, the number of financings and the amount invested remain well below the levels reached during the 1999–2001 Internet bubble ($94.6 billion was invested in 2000), and the number of financings also remains below the levels of 1997–1998 and 2001–2002.

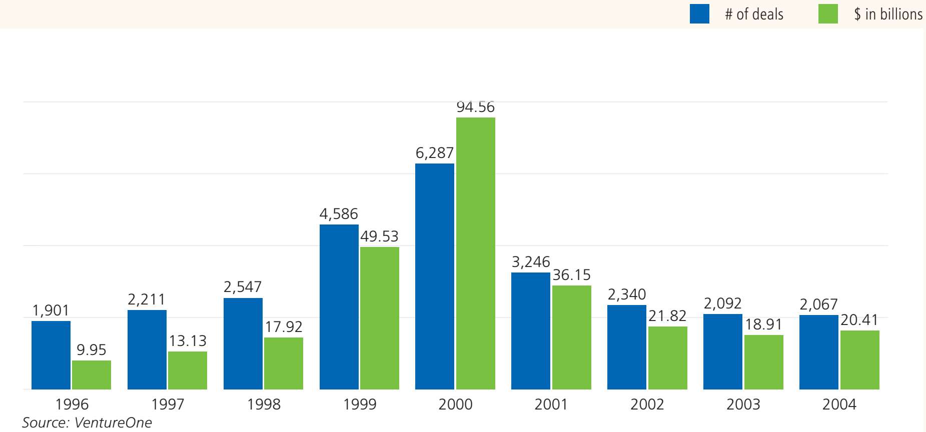
The average size of venture capital financings grew from $9.0 million in 2003 to $9.9 million in 2004. This increase also reverses a three-year decline, and represents the highest average financing amount for any year other than the 1999–2001 period. The average financing size was significantly higher in the life sciences industry ($13.3 million) than in the information technology industry ($9.2 million), although both industries had comparable increases over 2003. The average financing size in the life sciences industry is the largest on record, as the outlandish statistics from 1999–2001 were primarily a phenomenon of the IT sector.

Valuations of venture-backed companies showed a significant uptick in 2004. The median pre-money valuation for venture financings increased from $10.8 million in 2002 and $10.0 million in 2003 to $13.0 million in 2004, reflecting the improved market for liquidity events (discussed below). Despite this increase, however, 2004 valuations were still well below the median pre-money valuations in 1999–2000. For the fourth consecutive year, the median pre-money valuation of life sciences companies ($16.3 million in 2004) exceeded that of information technology companies ($12.0 million in 2004).

Seed and first-round venture capital financings as a percentage of total venture capital financings increased slightly from 30% in 2003 to 33% in 2004. This percentage remains well below those of 1996–2000, when seed and first-round financings represented between 48% and 55% of total venture financings in each year. This decline reflects venture capitalists' adoption of more rigorous investment criteria; their disproportionate expenditure of time on struggling portfolio companies; and the lengthening of the time it takes for companies to achieve liquidity, which keeps more later-stage companies in the pool of venture-backed companies receiving financing.

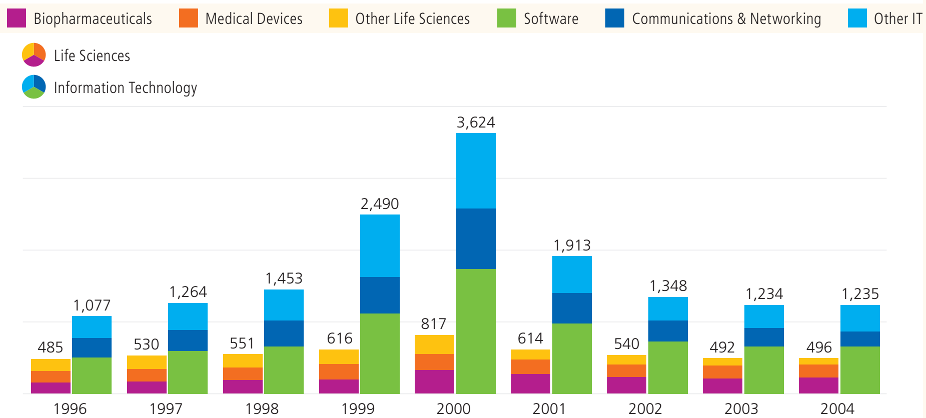
The breakdown of venture capital investments by industry sector has not changed significantly over the past

Venture Capital Financings – 1996 to 2004



Source: VentureOne

Venture Capital Financings by Industry – 1996 to 2004



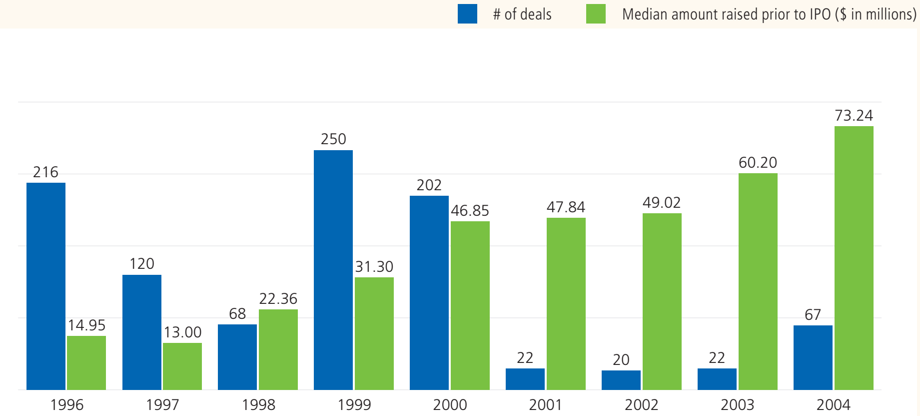
Source: VentureOne

several years. Financings of information technology companies as a percentage of total venture capital financings were between 54% and 60% in each year since 1996. Financings in the life sciences sector dipped to below 20% of all venture capital financings in 1999–2000, but have been between 23% and 24% of total financings in each of the last three years. The percentage of all venture capital investment dollars going to life sciences companies (31% in 2003 and 32% in 2004) is higher than the percentage of life sciences financings overall (24% in both 2003 and 2004), reflecting the greater financing needs of life sciences companies.

The geographic locations of venture-backed companies have changed very little in the past ten years. California-based companies accounted for 42% of all venture financings in 2004, and have led the country in this regard in each year since 1996. Massachusetts was home to the second largest number of companies receiving venture financing in each year since 1996, accounting for 12% of financings in 2004. Texas, New York and Washington rounded out the top five states for venture capital financings in 2004.

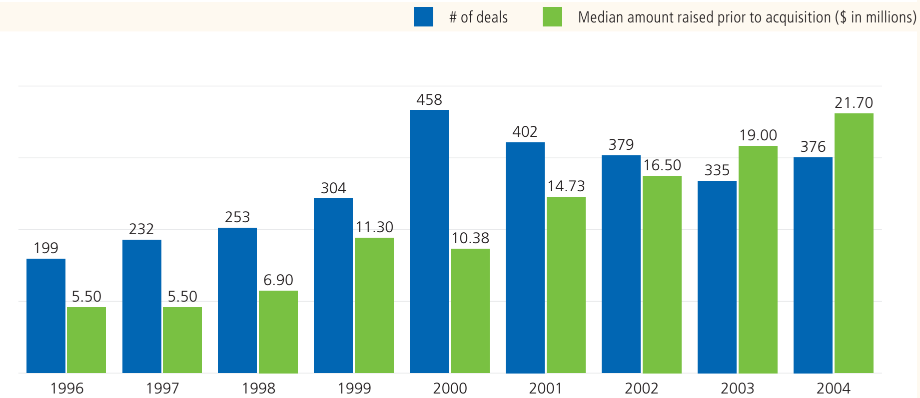
There was significant improvement in the IPO market in 2004 as compared to recent years. There were 67 IPOs by venture capital–backed companies in 2004, a figure that exceeds the total number of venture-backed IPOs in the three-year period from 2001 to 2003. This figure, however, not only remains lower than the IPO numbers during the 1999–2000 bubble, but is also lower than those from 1996 through 1998 (a surprising and often overlooked statistic is that there were more venture-backed IPOs in 1996 than 2000). In 2004, both the median amount raised in venture-backed IPOs ($50 million) and the median pre-money valuation of those companies ($224 million) were lower than in the 2001–2003 period. This is not surprising, as the IPO window was open for much of 2004, allowing more small companies to go public than in recent years. The median time from initial equity funding to an IPO was 5.7 years in 2004, which is equal to the 2003 figure and higher than that of any other year in at least 10 years.

Venture-Backed IPOs – 1996 to 2004



Source: VentureOne

Acquisitions of Venture-Backed Companies – 1996 to 2004



Source: VentureOne

The M&A market for venture-backed companies also improved in 2004. The number of acquisitions of venture-backed companies increased from 335 in 2003 to 376 in 2004. More important, the median acquisition price paid for venture-backed companies increased dramatically, from $18 million in 2002 and $23 million in 2003 to $40 million in 2004. While this figure is well below the median acquisition prices in 1999–2000 (including a staggering $100 million median in 2000), it is higher than the median acquisition prices in the 1997–1998 timeframe. The median time from initial funding to an acquisition was 4.7 years in 2004, the highest figure since 1996.

2005 Outlook

After four full years of a bleak venture capital market—particularly with respect to liquidity events—most industry observers are relatively cautious in their outlook for 2005. However, there are a number of reasons to believe that the market upswing that began in 2004 will continue, and perhaps gather momentum, in 2005.

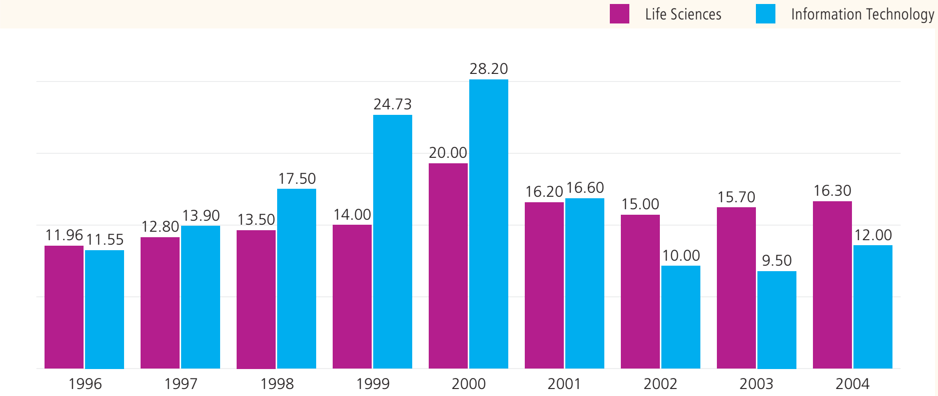
We believe that the number of venture capital financings, and the amount invested, is likely to increase in 2005 as compared to 2004. The increase in investment between 2003 and 2004 indicates some deal momentum as we enter 2005. In addition, the enormous amount of money raised and available for investment by venture capital funds should contribute to a higher level of investing activity.

We expect to see more bootstrapping by startup companies in 2005 than in prior years. Many entrepreneurs, believing that the valuation of their companies will increase (and thus the dilution to their stock holdings will decrease) if they defer venture financing until they have made significant progress in product development or customer validation, are funding their companies for the first six to 18 months from sources other than venture capital. These sources include angel financing, government grants and personal funds (often obtained through prior successes at venture-backed companies).

We also expect company valuations to increase in 2005. This view is supported by an extrapolation of recent trends, as 2004 valuations were up significantly over those of 2003. Under basic principles of supply and demand, the large amount of venture capital money available for investment should result in valuations—particularly those of "hot" companies—being bid up. In addition, the US economy appears to be improving as we enter 2005. More important, there is some statistical evidence, as well as widespread anecdotal evidence, that corporate America is loosening its purse strings on technology spending for the first time in several years, a development that bodes well for many venture-backed technology companies.

The health of the venture capital industry is better measured by statistics on liquidity events than statistics on the level of investments. There are

Median Pre-Money Valuation in VC Financings – 1996 to 2004



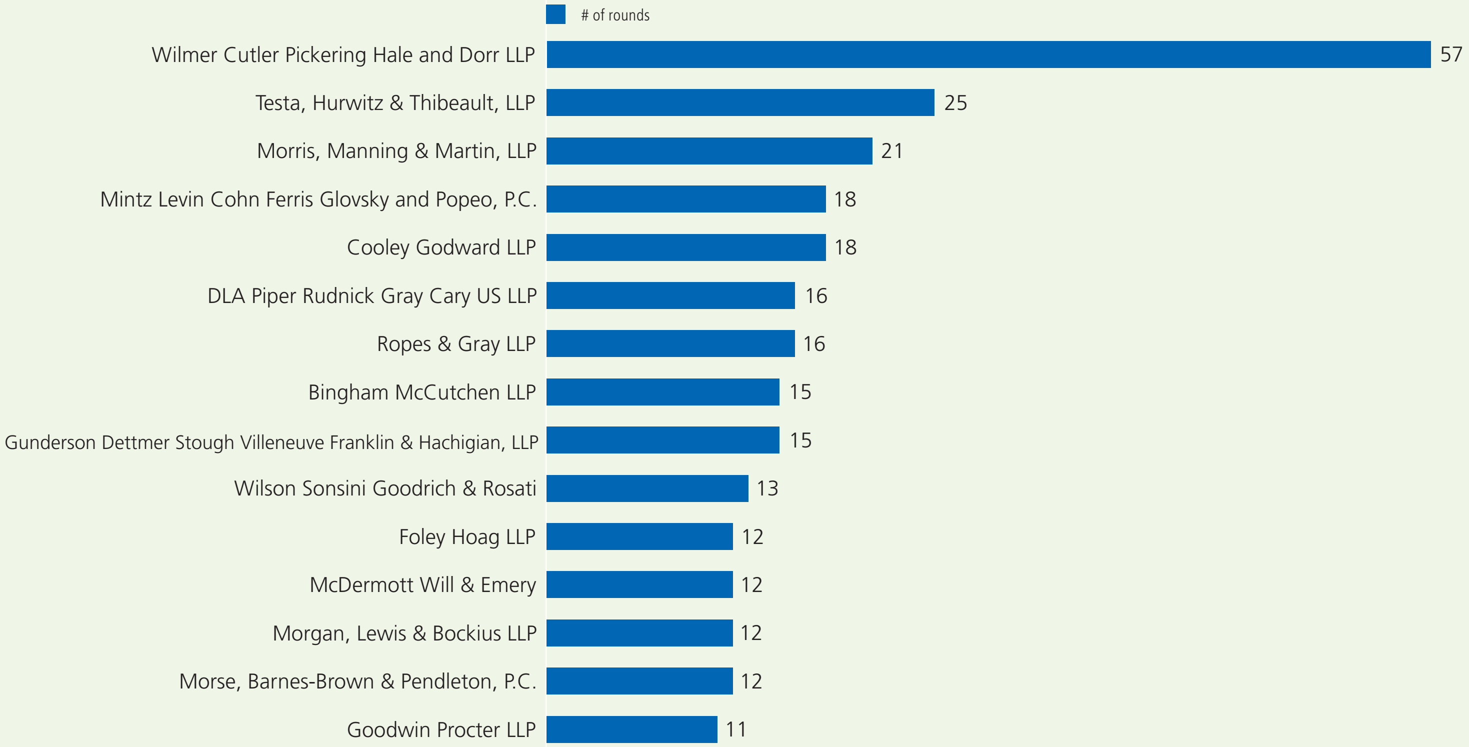
Source: VentureOne

several countervailing factors that will influence the markets for IPOs and acquisitions of venture-backed companies in 2005, although we believe that the net result of these factors will be an improved market for liquidity events.

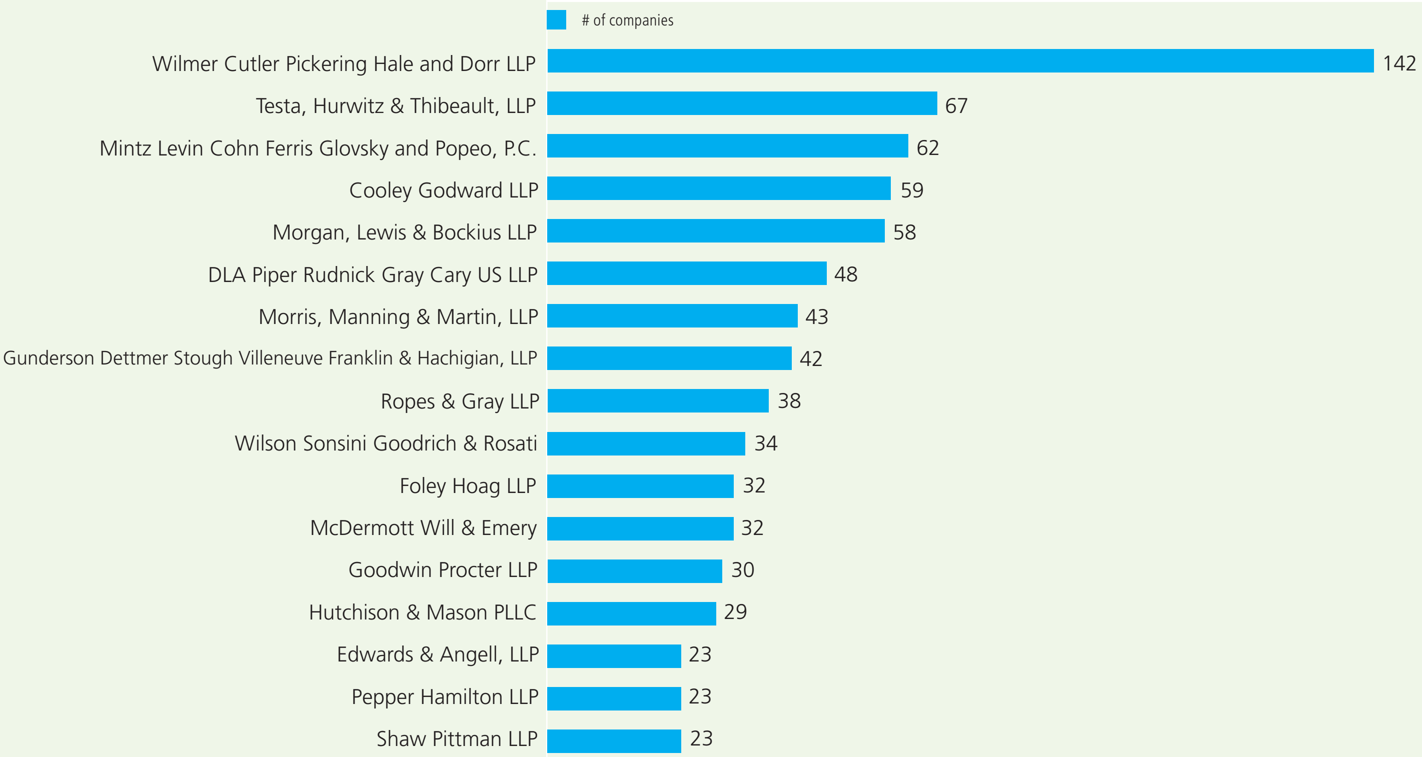
Factors that should positively affect the liquidity market include the expected improvement, noted above, in both the US economy in general and corporate technology spending in particular. In addition, the significant increase in venture-backed IPOs in 2004 and the recent performance of the stock market bode well for IPOs in 2005. The M&A market was also much better during 2004, with the median acquisition price of $40 million representing the highest such figure since 2000. Moreover, if the US dollar remains weak, venture-backed companies may attract significant interest from foreign acquirors.

One factor that continues to dampen the market for liquidity events is the Sarbanes-Oxley Act and the related regulatory environment facing public companies. Some venture-backed companies may be hesitant to go public because of the increased cost—including accounting and legal expenses and director and officer liability insurance premiums—and enhanced scrutiny that go along with being a public company. Similarly, concerns over the internal control environment and the need for personal certifications by CEOs and CFOs in SEC filings are causing many public companies to proceed cautiously, if at all, with respect to acquisitions of venture-backed companies. While these concerns are not likely to dissipate any time soon, there is hope that public companies will have more appetite, and more bandwidth, to pursue such acquisitions after their first internal control report and related auditor attestation have been completed and filed with the SEC (which, for many public companies, will happen by March 15, 2005). ■

Counsel to Eastern US Companies Receiving VC Financing in 2004



Counsel to Eastern US Venture-Backed Companies at Year-End 2004



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

Source: VentureOne

The role of corporate directors has come under increasing scrutiny after Enron, WorldCom and other notable corporate scandals. While attention has been focused principally on directors of public companies, many of the lessons learned also apply to directors of private companies.

Venture capitalists who serve as corporate directors (VC directors) have the same legal duties as directors of public companies. Given the characteristics of the typical venture-backed company, however, these legal duties often translate into a somewhat different set of responsibilities for VC directors.

This article provides an overview of the responsibilities of the VC director, taking into account some of the unique challenges and opportunities the role presents, and offers practical advice on how venture capitalists can be particularly effective directors.

Responsibilities of a Director

The role of a corporate director is to oversee and to monitor the executives' management of a company, rather than to manage the company directly. Paul Brountas, in his book *Boardroom Excellence* (San Francisco: Jossey-Bass, 2004), describes the oversight responsibilities of the board of directors as including:

- Assisting and advising the CEO
- Selecting, evaluating and compensating the CEO and the company's senior executives
- Replacing the CEO or other senior executives, if appropriate, and developing a management succession plan
- Advising management on the company's strategic plan and business objectives
- Overseeing the company's accounting practices and monitoring legal and regulatory compliance
- Resolving specific business, governance or regulatory issues confronting the company
- Reviewing and approving financial plans and material transactions, such as acquisitions and divestitures

VC directors engage in all of these activities and have the same fiduciary duties and responsibilities as the company's other directors, but several factors make their roles as directors somewhat different.

First, a venture-backed company is typically in the early stages of its development, and often guided by founders lacking significant executive experience. Second, a critical factor in the success of the company is its ability to hire talented management, making the VC directors' contacts and networks particularly important. Third, the company will in almost all cases require periodic financings, and the VC directors typically play a critical role in those financing transactions. Fourth, management of venture-backed companies often lack experience in dealing with directors and conducting effective board meetings, and look to their experienced VC directors and legal counsel for guidance in governance matters.

For all of those reasons, VC directors tend to play a considerably more active oversight role than their public company counterparts.

Being an Effective VC Director

Considering the fiduciary duties and responsibilities of a director, and the special role played by a director of a venture-backed company, how can a VC director maximize his or her effectiveness? Here are a few suggestions:

Optimize the Composition of the Board. VC directors should bear in mind several important principles when making decisions affecting the composition of the board of directors. First, a board will function more effectively if the experiences and skills of the directors are broad-based and complementary, rather than largely overlapping. Second, because the board will likely confront a number of decisions in which one or more members has a personal interest (such as management compensation and venture capital financings), there should be at least one truly independent director—that is, someone who is neither a member of management, a significant investor in the company, nor a close friend or business associate of a company executive or significant investor. Third, because the effectiveness of the board of directors depends in large part on the ability of the directors to get along, personal "chemistry" should be considered when making board composition decisions. The candor, creativity and good judgment that is the hallmark of an effective director can be stifled by an environment of adversarial personal relationships. Finally, consider appointing one of the outside directors—rather than the CEO—as chair.

Prepare for Board Meetings. The most important element of effective preparation for a board meeting is receiving the right information in a timely manner. Directors of most companies receive board packages containing extensive information. However, they do not always receive the most important information—and sometimes critical information is lost in an avalanche of less useful information. For example, a two-page memorandum by the CEO on what keeps him or her awake at night will typically engender a more thoughtful and helpful discussion at the board meeting than a thick binder of detailed reports on marketing activities and product schematics. Directors should discuss with management the type and quantity of information they believe they need, and insist that the information be distributed several days in advance of board meetings. It is also critical that all directors take the time to read these materials before the meeting.

Work with Management in Setting Board Meeting Agendas. The agendas for board meetings are often set by the CEO, and typically consist of reports by executives concerning various aspects of the company's operations. Without diminishing the significance of that information, those reports should not dominate the board meeting. Most of the key information about the company's business, operations and finances can be provided to the directors in advance of the meeting. The meeting agenda should instead focus on important issues that call for a thoughtful, interactive discussion among directors—such as key hiring decisions, effective sales strategy, new product development and the company's strategic direction. It may be advisable to designate a VC director to work with the CEO to jointly set the agenda for board meetings.

Pay Attention at Board Meetings—and Force Others to Do the Same. Regardless of how well prepared directors are for a board meeting, the effectiveness of the meeting will be greatly diminished—and the liability of directors potentially increased—if some directors are working on their BlackBerries, talking on their cell phones or surfing the Internet rather than listening and contributing to the discussion. Boards of directors should consider adopting rules for meetings, such as banning the use of electronic devices. In addition, meeting agendas should provide for periodic breaks to allow directors to attend to other important matters without impinging on the board meeting.

Challenge Management Where Appropriate. An essential part of any director's role is that of a "professional skeptic." If directors simply accept and agree with everything management proposes, they will be abdicating a significant part of their duties. Probing the reasons underlying management's positions, and disagreeing with management's conclusions where appropriate, typically inspires a healthy exchange of ideas. While challenging management is healthy, it is important that the challenge be presented in a constructive way. Management should be challenged through a friendly and respectful dialog—without denigration of the views of others or personal antagonism. As Paul Brountas notes in *Boardroom Excellence*, "always remember that you can disagree without being disagreeable."

Set the Right Tone at the Top. VC directors can call upon their considerable experience to impress upon management the importance of tone and culture in the corporate setting. Directors should stress best practices and "getting it right," whether in the context of internal controls, audit and financial matters, corporate governance, disclosure, employee relations or dealings with third parties. The board should lead the effort to adopt and enforce codes of conduct and ethical guidelines that apply equally to senior management and all employees. The board should also ensure that the company monitors compliance with these codes and policies.

Mentor the Management Team. VC directors should use their operating or board experience to provide management with guidance on a variety of aspects of the company's operations, including technical, financial, industry, human resources and corporate governance matters. Most corporate executives welcome constructive feedback and advice. Board members should be proactive and create an atmosphere of open communication with management, particularly with the CEO. It is not always necessary to wait for board meetings—in some situations directors may want to meet with management outside of the boardroom to focus on particular issues.

Tackle Difficult Decisions. Directors must sometimes take the initiative to resolve difficult decisions or take remedial action. Issues such as changing senior management, altering product strategy, terminating a line of business, or selling or shutting down the company are of paramount importance to the company and its stockholders. Directors must recognize when difficult decisions need to be made and not be reluctant to make them.

Seek Expert Advice Where Appropriate. The proper discharge of a director's responsibilities, including the duty of care, will require that the directors occasionally obtain the advice of outside professionals, such as legal counsel, accountants and investment bankers. Matters on which such expert counsel is often needed include accounting issues, transactions such as acquisitions or financings, and litigation. Availing themselves of such advice can not only enable directors to make more informed decisions, but can also provide them with additional legal protection.

Recognize and Address Conflicts of Interest. Conflicts of interest for VC directors are almost inevitable given their dual roles as directors and major investors. Examples of common conflicts include: a financing by the company in which the VC director's fund will be an investor; an M&A transaction with another company in which the VC director's fund is an investor; and management compensation matters where a member of management serves as a board member in another of the VC director's portfolio companies. VC directors should be sensitive to conflicts, or the appearance of conflicts, and be prepared to address them. Appropriate responses to a conflict involving a director may include:

- requiring that the conflicted director make full disclosure to the other directors of his or her conflict of interest;
- appointing a committee of independent directors to address the matter;
- obtaining a fairness opinion, or independent valuation, from outside professionals; and
- having the disinterested stockholders approve the transaction presenting the conflict.

Conclusion

VC directors are often involved with companies that rely heavily on them for strategic input and industry experience. This presents both a challenge and an opportunity for the VC director, and makes his or her role particularly important. A VC director must keep in mind the fundamental duties and responsibilities of a director and basic principles of corporate governance, while actively guiding and training management of the company. A VC director with the ability to perform and balance these roles can be an invaluable resource for management, a knowledgeable advocate and protector of shareholder interests, and a critical player in the company's decision-making process as the company moves along the difficult journey from startup to success. ■

SiCortex	$21,000,000	*First Round*	September 2004
Microbia	$40,000,000	*Fourth Round*	May 2004
veveo.tv	$14,000,000	*First Round*	October 2004
Acopia Networks	$25,000,000	*Third Round*	October 2004
Netezza	$15,000,000	*Fourth Round*	December 2004
A123Systems	$20,000,000	*Third Round*	June 2004
Starent Networks	$25,000,000	*Fourth Round*	February 2004
Endeca	$15,000,000	*Mezzanine Round*	February 2004
Gloucester Pharmaceuticals	$29,000,000	*Second Round*	October 2004
VistaPrint	$52,000,000	*Second Round*	August 2004
surfkitchen extend your reach	$17,500,000	*Third Round*	July 2004
Ounce Labs The Ounce of Prevention	$10,000,000	*Second Round*	December 2004
Momenta	$20,500,000	*Third Round*	February 2004
CoreStreet Real Time Credentials	$8,500,000	*Second Round*	February 2004
IMlogic	$16,000,000	*Third Round*	May 2004
airwide solutions	$16,250,000	*Third Round*	October 2004
Virtual Iron	$12,000,000	*Second Round*	June 2004
evident Software	$10,000,000	*Second Round*	June 2004
Propagate Networks	$8,000,000	*Third Round*	June 2004
NxStage	$20,000,000	*Late Stage*	August 2004
neotropix	$10,000,000	*First Round*	December 2004
Softricity	$7,500,000	*Fourth Round*	April 2004
Authoria	$10,500,000	*Late Stage*	June 2004
Aegis Semiconductor	$10,000,000	*Third Round*	April 2004
PowderMed	£20,000,000	*First Round*	May 2004
icera semiconductor	$22,500,000	*Second Round*	July 2004
Compound Therapeutics	$15,500,000	*Series A Extension*	December 2004
Transitive	$11,500,000	*Third Round*	September 2004
context media	$11,000,000	*Third Round*	June 2004
Polychromix	$8,000,000	*Second Round*	February 2004
Infinity Pharmaceuticals	$25,000,000	*Strategic Investments by Johnson & Johnson and Novartis*	December 2004
Archivas digital archiving	$10,000,000	*Second Round*	December 2004
mobilecohesion	$6,000,000	*Second Round*	January 2004
Kalido	$10,000,000	*Second Round*	June 2004

THE LEADER IN TECHNOLOGY AND LIFE SCIENCES COMPANY VENTURE FINANCINGS.

WILMER CUTLER PICKERING HALE AND DORR LLP

New England

In 2004, there were 297 venture capital financings in New England, representing a decline of 7% from the 318 in 2003, and the total amount invested fell 9% (from $2.96 billion to $2.70 billion). While venture capital investment in the region remains well below the bubble years of 1999 to 2001, the average number of financings over the last three years (320 deals) almost exactly mirrors that of the 1996 to 1998 period (321 deals).

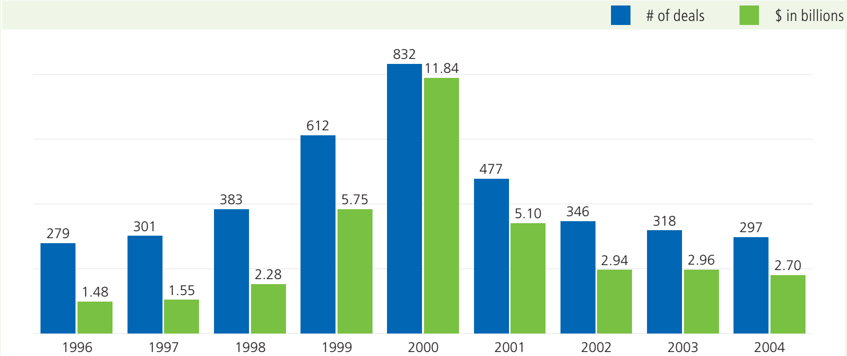
New England continues to be a leading center of activity for technology and life sciences companies. In 2004, information technology companies accounted for 62% of the region's venture capital financings, and life sciences companies made up 25%. New England produced some of the most notable venture capital deals of the year, including SiCortex's $21 million financing—the nation's largest Series A financing for a computer systems company in the past three years—as well as the $40 million financing of biopharmaceutical company Microbia and VistaPrint's $52 million deal.

For 2005, we expect New England—and Massachusetts in particular—to remain a hotbed of venture capital activity. The region's world-renowned universities and research institutions will continue to produce exciting technological innovations and scientific discoveries and a talented employee pool. This steady stream of new talent and ideas, coupled with the area's large number of established technology and life sciences companies—which also continue to spawn ideas and to produce entrepreneurs primed to found new companies—and its extensive network of venture capitalists and other service providers, should maintain New England's status as one of the most appealing environments for emerging companies.

Tri-State

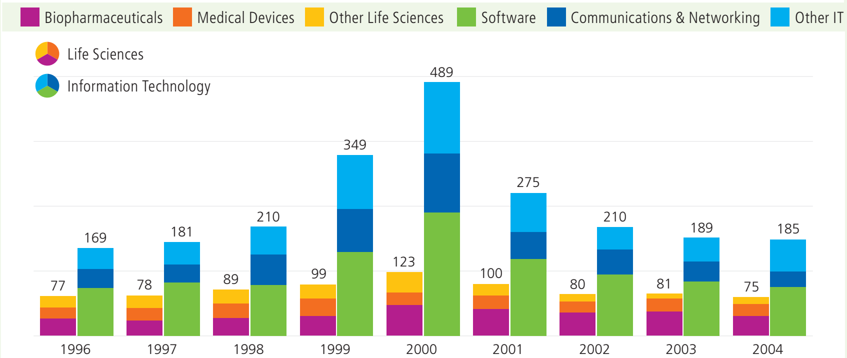
The number of venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania fell 8%, from 236 in 2003 to 218 in 2004. The total amount of venture capital financing invested in the region declined by 17%,

New England Venture Capital Financings – 1996 to 2004



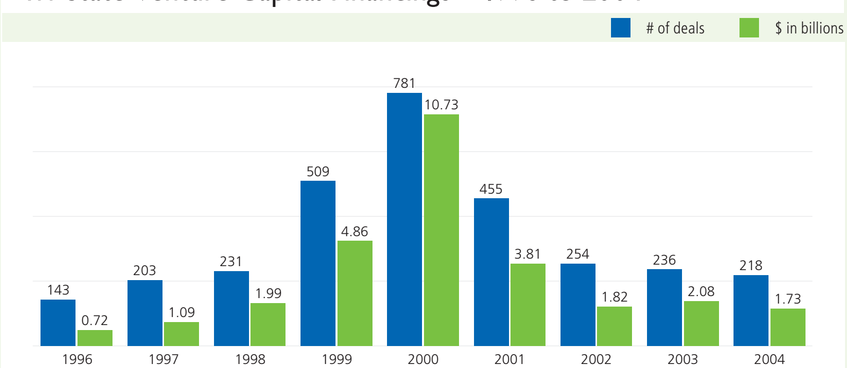
Source: VentureOne

New England Venture Capital Financings by Industry – 1996 to 2004



Source: VentureOne

Tri-State Venture Capital Financings – 1996 to 2004



Source: VentureOne

from $2.08 billion in 2003 to $1.73 billion in 2004. However, venture capital activity in the tri-state region in 2004 exceeded the pre-boom years of 1996 to 1998, which had an annual average of 192 financings raising $1.27 billion.

We believe that the tri-state region's strengths in the pharmaceutical, life sciences, financial services and information technology sectors, coupled with the large volume of Fortune 500 companies in the region, will provide a favorable environment for emerging companies in 2005.

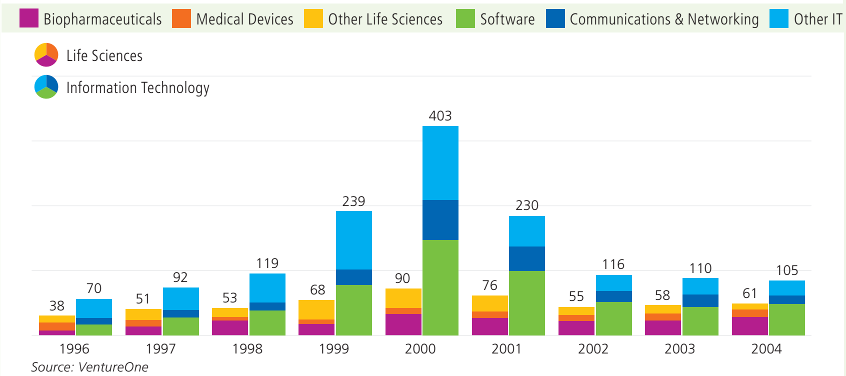
Mid-Atlantic

In 2004, there were 134 venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia, representing a decline of 8% from the 146 in 2003. However, the total amount invested in the region increased 19%, from $989 million in 2003 to $1.17 billion in 2004.

While the number of information technology companies in the region receiving venture capital financing fell for the fourth consecutive year, the number of biopharmaceutical and medical devices companies receiving venture capital financing has remained steady over the past three years—although still lagging behind the peak of 2000.

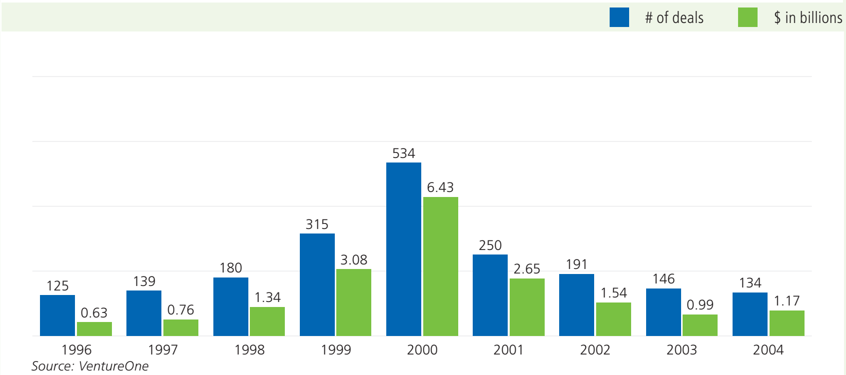
For 2005, we expect that the concentration of companies in the region that focus on national security, government contracting and defense will produce a steady stream of attractive emerging companies. We also expect that the region—and particularly the Research Triangle area—will remain a vibrant hub of life sciences–related investment. ■

Tri-State Venture Capital Financings by Industry – 1996 to 2004



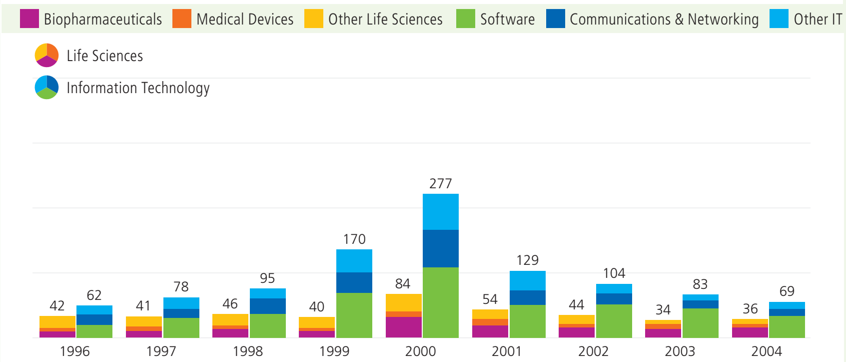
Source: VentureOne

Mid-Atlantic Venture Capital Financings – 1996 to 2004



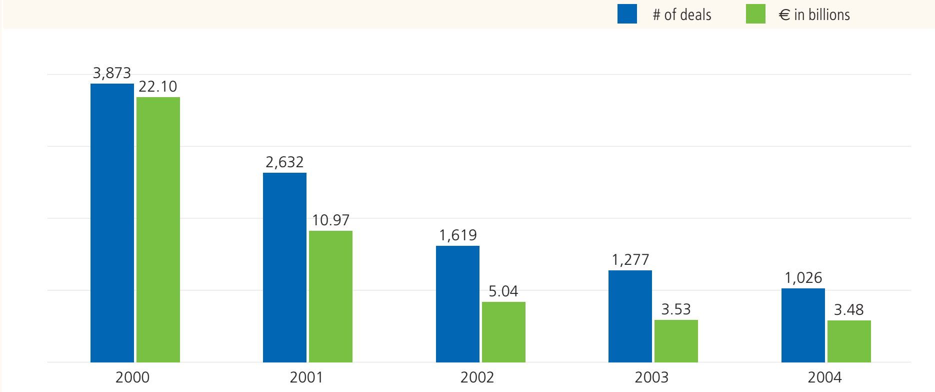
Source: VentureOne

Mid-Atlantic Venture Capital Financings by Industry – 1996 to 2004



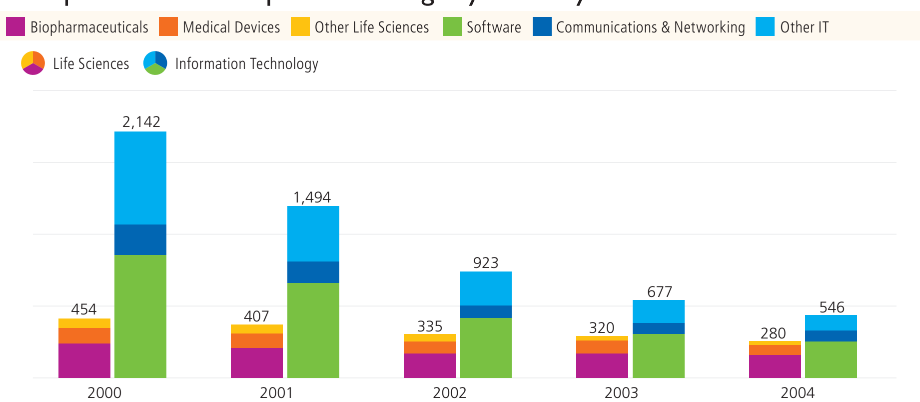
Source: VentureOne

European Venture Capital Financings – 2000 to 2004



Source: VentureOne

European Venture Capital Financings by Industry – 2000 to 2004



Source: VentureOne

Europe

In 2004, there were 1,026 venture capital financings in Europe, representing a decrease of 20% from the 1,277 in 2003. The total amount invested in Europe, however, declined only slightly—falling 1% from €3.53 billion in 2003 to €3.48 billion in 2004.

The average financing size in Europe, although lagging significantly behind the US average, increased from €2.76 million in 2003 to €3.40 million in 2004—the highest level since 2001. In another bright sign, seed and first round financings accounted for 36% of all rounds in 2004 (and 38% in the fourth quarter)—up from 33% in 2003.

With a total of 314 deals, software companies accounted for the largest number of European venture capital financings in 2004, holding steady at 31% of all financings as compared to 30% in 2003.

Biopharmaceutical companies produced 176 financings, or 17% of all deals—up from 15% in 2003. Due to their larger average deal size, biopharmaceutical companies accounted for 35% of the total amount invested—up from 27% in 2003. Several life sciences spinouts logged very large first round financings, including PowderMed's £20 million deal.

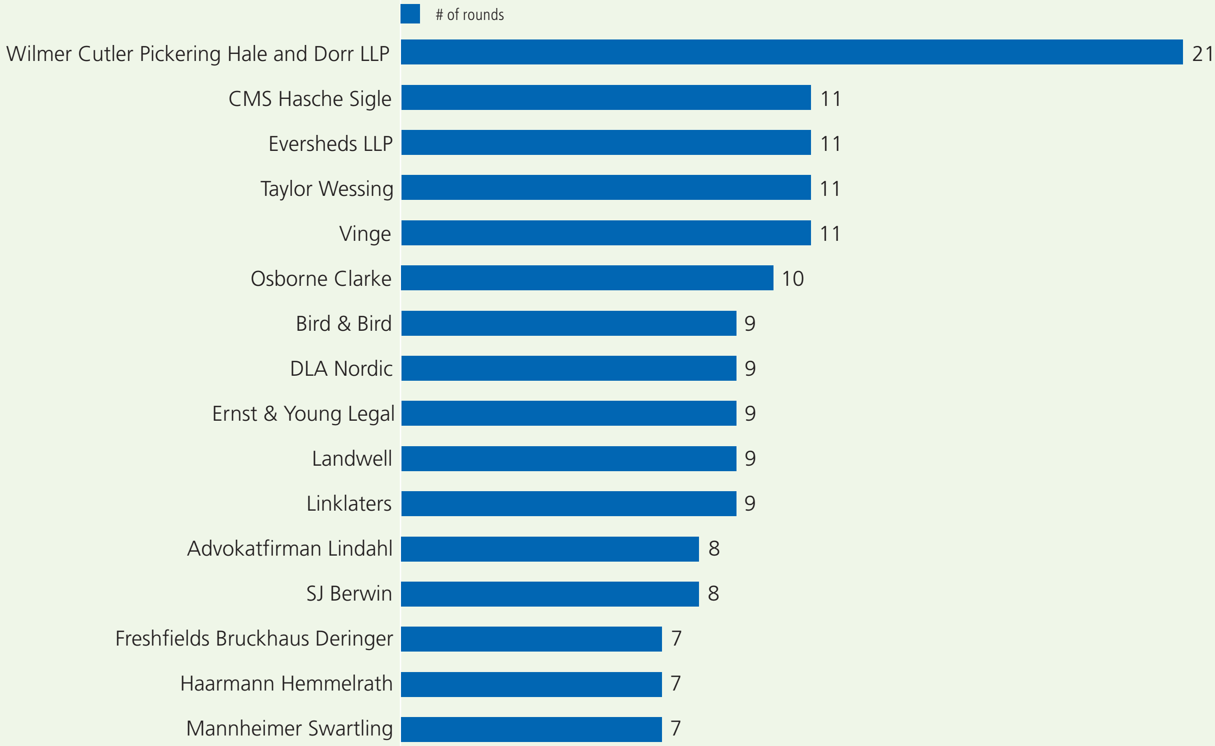
The United Kingdom remains the largest venture capital market in Europe, with 31% of all deals (down slightly from 32% in 2003) in 2004, followed by France with 19% (up from 15% in 2003), Germany with 14% (down from 15% in 2003) and Sweden with 9% (unchanged from 2003).

The number of IPOs by European venture-backed companies increased from nine in 2003 to 34 in 2004—the highest yearly total since the 178 IPOs in 2000. While median IPO proceeds increased only 9%, from €9.5 million in 2003 to €10.4 million in 2004, median pre-IPO valuations increased 47%, from €26.9 million in 2003 to €39.5 million in 2004. The median time from initial equity funding to IPO was 4.3 years in 2004, up from 3.4 years in 2003, but well short of the median time for US venture-backed companies completing IPOs in 2004 (5.7 years).

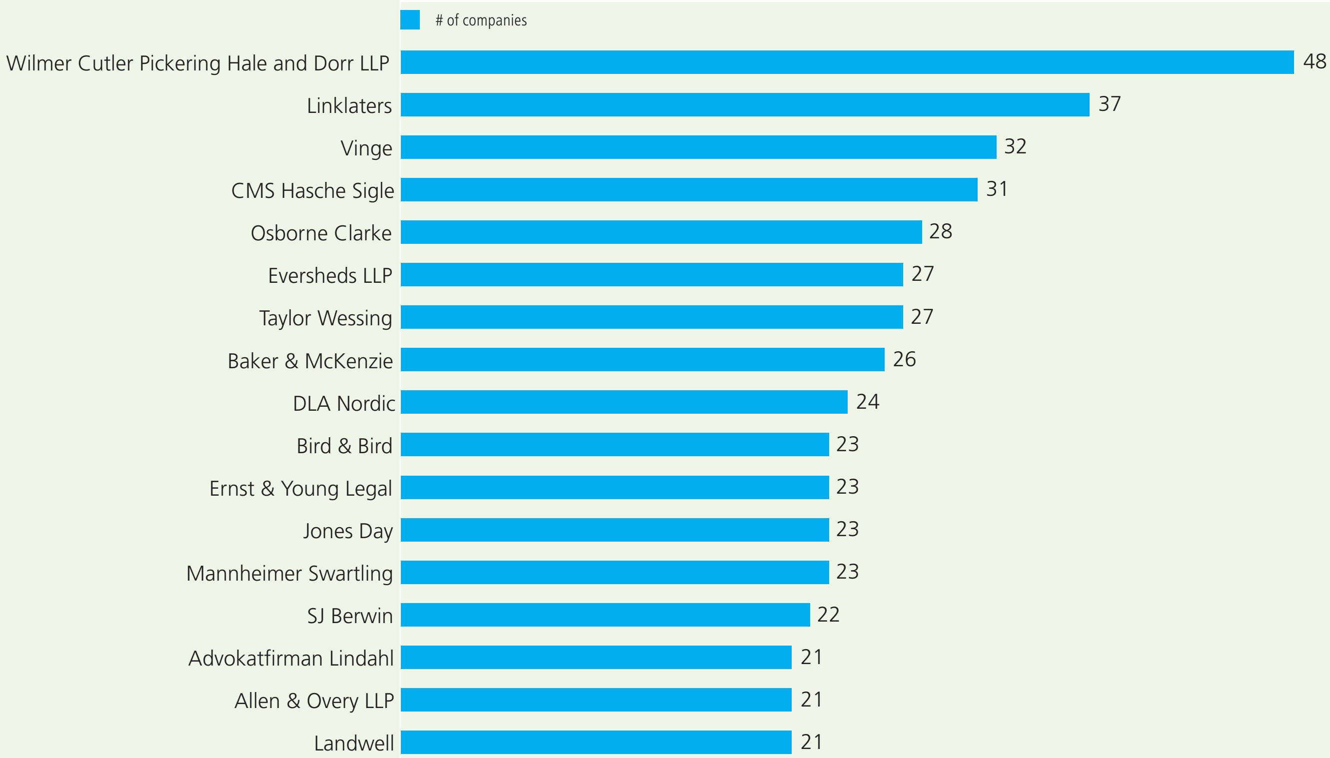
Acquisitions of European venture-backed companies edged up from 147 in 2003 to 163 in 2004—the largest number in at least five years. In an even more encouraging sign, the median acquisition price jumped from €10.6 million in 2003 to €26.0 million in 2004—the highest median acquisition price since the €29.7 million in 2000—reflecting the greater maturity of the acquired companies, whose median time from initial equity funding to acquisition increased from 3.2 years in 2003 to 4.1 years in 2004. The purchases of KVS by Veritas and Alphamosaic by Broadcom were prominent examples of acquisitions of European venture-backed companies by US public companies during the year.

For 2005, we expect European venture capital investment and IPO activity to remain steady. Since 2005 will be an important year for fundraising by venture capital funds, it is likely that there will be an increase in sales of VC-backed companies as funds seek to demonstrate investment returns to their limited partners. ■

Counsel to European Companies Receiving VC Financing in 2004



Counsel to European Venture-Backed Companies at Year-End 2004



Note: The above charts are based on European companies that completed a seed, first, second, later stage, corporate or restart round of venture capital financing.

Source: VentureOne

In 2005, we expect the venture capital industry to experience a continuation of the upswing in fundraising that began in late 2003. We also expect to see the acceleration of two fundamental changes to the industry with roots in the post-bubble environment of the early 2000s—an increased focus on governance standards and the transformation of private equity into a more liquid asset class.

Fundraising

Venture capital funds in the United States raised $17.6 billion in 2004, nearly double the total from 2003. This result makes 2004 the most active year in fundraising since 2001. We believe that 2005 will be even more active, both in terms of the number of VC funds seeking financing and the total amount raised.

Many venture capital firms delayed raising additional funds in 2004 in the hope that a more vibrant M&A and IPO marketplace would add liquidity to funds raised between 1999 and 2001. That liquidity never materialized for many funds and they must now enter the fundraising market without significant distributions to investors from their immediately preceding funds. Emerging managers are entering the marketplace at a faster rate than venture capital firms are shutting their doors. Both of these factors are likely to lead to an increase in the number of funds raising capital in 2005.

Many of the larger venture capital firms are expected to come to market in 2005. Although the larger firms intend to raise funds that are smaller than their previous offerings, we believe that the median fund size of all VC funds raised in 2005 will be higher than that of funds raised in 1999 to 2001. We attribute this phenomenon to the likelihood that less-established firms will raise funds that are larger (in the $150 million to $250 million range) than their previous offerings. As a result, the 2005 fundraising total should exceed that of 2004.

This anticipated increase in the level of VC fundraising activity has many consequences. The most important is that competition among funds for deals will increase, particularly if the total number of firms raising capital increases. Increased competition will ultimately diminish the returns to investors that the industry as a whole will achieve.

Governance

The venture capital industry, like other segments of the alternative asset class, is attracting the attention of regulators and others who wish to impose stricter and more formal governance standards. Even industry-sponsored organizations such as the European Venture Capital Association advocate increased controls on an industry that has historically been lightly regulated and fiercely independent.

A manifestation of this phenomenon has been the ongoing controversy over transparency and disclosure. This issue is likely to remain in the forefront in 2005, as more previously undisclosed information held by VC funds makes its way into the public domain. More demands will be made on funds to publicly disclose information about their portfolio companies, and litigation is likely to result as they attempt to protect that information.

In a move that has drawn the attention of accounting standards boards in the United States and abroad, many industry-sponsored organizations have adopted valuation standards and guidelines designed to harmonize the valuation metrics used for reporting purposes. These standards and guidelines are similar to those historically used in the industry, but there are important differences, the most significant being a provision that allows the value of securities of a private company to increase due to positive operating results even in the absence of a third-party financing of the company at a higher price. We anticipate wide adoption of these newer standards in Europe and increasing pressure on US venture capital firms to adopt similar standards.

The debate over transparency and valuations is the beginning of a reexamination of the industry's traditional ways of doing business. Much of this reexamination is the result of the increased influence of European institutional investors and the large amount of capital they are investing in VC funds. More developments along these lines are expected in 2005 and beyond.

Liquidity

A robust secondary market in limited partnership interests has been established—and some say overfunded—and a nascent secondary market in direct interests in portfolio companies has developed in the last few years. These developments will have many consequences that will not become apparent for a number of years.

The secondary markets, both for limited partnership and direct interests, originally developed out of the need of distressed sellers to unload unwanted portfolios. These markets are likely to grow because more sellers will use them as asset allocation or realignment tools, rather than as a buyer of last resort. Venture fund managers will need to reexamine the nature of their relationships with their limited partners, which traditionally were oriented to the long term, but—in the event of increased liquidity—may become oriented more to short-term results.

The growing secondary market in direct portfolio company investments arms venture fund managers with a new tool for trimming their portfolios. More venture funds may take advantage of this market in 2005 as they deploy capital out of new funds and look for ways to diminish the burden of their older portfolios.

The venture capital industry continues to evolve in unexpected ways as it matures from a cottage industry to a mainstream investment option for institutional investors. We expect this rapid evolution to continue in 2005, with the major developments revolving around the robust fundraising market, governance and the evolution of venture capital investing from an illiquid to a liquid asset class. ■

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

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

Deals with Earn-Out		
With Earn-Out: 24%	**Without Earn-Out:** 76%	
Deals with Indemnification		
With Indemnification By Target's Shareholders: 89% By Buyer[1]: 37%	**Without Indemnification** By Target's Shareholders: 11% By Buyer: 63%	
Survival of Representations and Warranties		
Shortest: 6 Months	**Longest:** 36 Months	**Most Frequent:** 12 Months
Caps on Indemnification Obligations		
With Cap: 85% Limited to Escrow: 72% Limited to Purchase Price: 7% Exceptions to Limits[2]: 74%	**Without Cap:** 15%	

Escrows

With Escrow: 83%

% of Deal Value:	Lowest: 4%	Highest: 23%	Most Common: 10%–20%
Length of Time:	Shortest: 6 Months	Longest: 36 Months	Most Frequent: 12 Months

Exclusive Remedy: 64%

Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[3]: 72%

Baskets for Indemnification	
Deductible: 39%	**Threshold:** 51%
MAE Closing Condition	
Condition in Favor of Buyer: 81%	**Condition in Favor of Target[4]:** 30%

Exceptions to MAE

With Exception: 78%[5]

[1]The buyer provided indemnification in 48% of the identified transactions where buyer stock was used as consideration; in 65% of the transactions where the buyer provided indemnification, buyer stock was used as consideration.
[2]Generally, exceptions were for fraud and willful misrepresentations.
[3]Generally, exceptions were for fraud and criminal activity.
[4]In 50% of these transactions, buyer stock was used as consideration.
[5]Generally, exceptions were for general economic and industry conditions.

Based on hundreds of venture capital financing transactions we handled from 2002 to 2004 for companies and VCs, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2002	2002 Range	2003	2003 Range	2004	2004 Range
A "multiple liquidation preference" is a provision that provides that the holders of preferred stock are entitled to receive more than 1x their money back before the proceeds of the liquidation or sale are distributed to holders of common stock.	Series A	38%	1x – 2x	0%	N/A	22%	1.25x – 5x
	Post–Series A	25%	1.5 – 3x	24%	1.5x – 5x	11%	1.5x – 3x

Deals with Participating Preferred		2002	2002 Range if capped	2003	2003 Range if capped	2004	2004 Range if capped
"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	56%	1.5 – 2x	61%	2x – 4x	56%	2x – 5x
	Post–Series A	64%	2x – 5.5x	76%	2x – 5x	54%	1.75x – 5x

Deals with an Accruing Dividend		2002	2003	2004
"Accruing dividends" are generally payable upon liquidation or redemption of the preferred stock. Because the sale of the company is generally deemed to be a "liquidation," the accrued dividend effectively increases the liquidation preference of the preferred stock.	Series A	81%	30%	47%
	Post–Series A	44%	52%	48%

Anti-Dilution Provisions		2002	2003	2004
A "full ratchet" anti-dilution formula is more favorable to the investors because it provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a "weighted average" anti-dilution formula takes into account the dilutive impact of the dilutive issuance based upon factors such as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	Series A	Full Ratchet: 28% Weighted Average: 72%	Full Ratchet: 3% Weighted Average: 97%	Full Ratchet: 3% Weighted Average: 97%
	Post–Series A	Full Ratchet: 24% Weighted Average: 76%	Full Ratchet: 30% Weighted Average: 70%	Full Ratchet: 7% Weighted Average: 93%

Deals with Pay-to-Play Provisions		2002	2003	2004
"Pay-to-play" provisions provide an incentive to investors to invest in future down rounds of financing. Investors that do not purchase their full pro rata share in a future down round lose certain rights (e.g., their anti-dilution rights are taken away or their shares of preferred stock may be converted into common stock). ■	Total	23%	31%	26%
	% of Total That Convert to Common Stock	30%	50%	67%
	% of Total That Convert to Shadow Preferred Stock	70%	50%	33%

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

See our *2004 IPO Report* for a detailed analysis of the 2004 IPO market and 2005 outlook. The report features regional IPO market breakdowns, a review of the PIPEs and Rule144A markets, a discussion of proposed changes to IPO "quiet period" rules, and tips on 8-K readiness for new public companies.

Our *2004 M&A Report* offers an in-depth review of the global M&A market and discusses the outlook for 2005. Other highlights include advice on deal protection techniques, a survey of the key terms in sales of VC-backed companies, an analysis of the impact of Sarbanes-Oxley on M&A transactions, and practical guidance on Form 8-K filing requirements in M&A deals.

To request a copy of either report, please contact marketing@wilmerhale.com or call 617 526 5600.

Data Source

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

Internet Availability

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

Additional Copies

For additional copies of this report, please contact the Wilmer Cutler Pickering Hale and Dorr Marketing Department at marketing@wilmerhale.com or call 617 526 5600.

04_379 VER 02/05 18500

Baltimore

Beijing

Berlin

Boston

Brussels

London

Munich

New York

Northern Virginia

Oxford

Waltham

Washington

wilmerhale.com