



FENWICK & WEST LLP
Trends in Terms of Venture Financings
In the San Francisco Bay Area
(Third Quarter 2008)

- **Background** – We analyzed the terms of venture financings for 101 companies headquartered in the San Francisco Bay Area that reported raising money in the third quarter of 2008.
- **Overview**

There has recently been substantial distress and volatility in world financial markets. A brief overview of this situation as it relates to our venture survey follows:

- The vast majority of the recent financial market distress has taken place in the fourth quarter of 2008. For example, during the first two months of the third quarter of 2008, the Nasdaq was actually up 3%, and even with an 11% loss in September 2008, the Nasdaq loss for the third quarter was (only) 8%. However, in the fourth quarter to date, the Nasdaq is down approximately 33%.
- As this survey only covers the third quarter of 2008, the vast majority of the financial distress we are currently seeing is not reflected in the results of this report.
- That said, there is significant anecdotal evidence that the venture financing environment has experienced significant distress in the fourth quarter to date. This evidence includes the now well known Sequoia Capital briefing in October. Additionally, the quarterly Silicon Valley Venture Capitalists Confidence Index™ produced by Mark Cannice at the University of San Francisco reports that the confidence level of venture capitalists in Silicon Valley is 2.89 on a 5 point scale, which is the lowest confidence level since the index was originated in 1Q 2004. This index can be accessed at: <http://www.usfca.edu/sobam/nvc/pub/svvcindex.html>
- Although we will not have extensive statistical information on how the venture environment has changed as a result of recent financial market distress until our fourth quarter report is published, we have taken the opportunity to republish an article that we wrote in 2003 during the dotcom crash. This article explains the various ways venture terms changed during those difficult times, and the reason for such changes. While we hope that history is not repeating itself, and we see significant differences between the dotcom bust (which was centered on venture-backed technology companies) and the current financial difficulties (which have a much broader focus), we thought that a republication of this article might be useful to our readers. This article is available at http://www.fenwick.com/docstore/VCSurvey/Recent_Developments_VC_Terms_w.pdf

So with that introduction, set forth below are the results of the 3Q08 survey. Such results show that companies raising venture capital in 3Q08 continued to receive somewhat higher valuations than in their prior round. However, the results are far less positive when we divide third quarter results into July/August 2008 (when the stock market was still strong) and September 2008 (when the significant

stock market weakness became evident), as described in further detailed below. The highlights of the quarter are as follows:

- Up rounds exceeded down rounds for the 19th consecutive quarter (73% up vs. 12% down, with 15% flat). However, up rounds were only 64% in September, which was the lowest amount of up rounds since 3Q05.
- The Fenwick & West Venture Capital Barometer™ showed a an average price increase of 55% for companies receiving venture capital in 3Q08 compared to such companies' prior financing round. The amount of such increase is generally flat with the amount of increase we have seen over the past three quarters. However, when the third quarter results are analyzed by month, the Fenwick & West Venture Capital Barometer™ showed a 67% increase in July/August, and only a 19% increase in September.
- Although the overall use of senior liquidation preferences for 3Q08 was 45%, which is consistent with recent quarters, it was a far higher 73% in the month of September.

Other U.S. industry-related results for the third quarter include the following:

- The amount invested in U.S. venture-backed companies in 3Q08 was approximately \$7.4 billion in 583 transactions, compared to \$7.5 billion invested in 660 transactions in 2Q08, and \$7.9 billion invested in 673 transactions in 3Q07. In other words, we are seeing a slow but noticeable decline in the amount of venture investment.¹
- That said, venture investment in Silicon Valley in 3Q08 actually saw an increase from the prior quarter (in dollar terms), with 195 transactions receiving \$3.2 billion, compared to 219 transactions receiving \$2.7 billion in 2Q08.¹
- An industry sector analysis shows that the energy and utility sectors saw the largest growth in 3Q08, as such sector comprised 17% of total U.S. venture investment (in dollars) in 3Q08. However, significant changes appear on the horizon for the energy environment, with more government support expected from the new administration, which is likely to be a positive factor for the venture-backed energy industry, but oil prices have decreased dramatically so far in the fourth quarter, which is likely to be a negative factor for the industry. In a change from recent quarters, investments in information services (which includes Web 2.0) was down, and IT investment in general was down, while health care investment was flat.¹
- Acquisitions of venture-backed companies in 3Q08 continued to decline noticeably, with 66 transactions totaling \$4.4 billion in 3Q08, compared to 80 transactions totaling \$6.1 billion in 2Q08. M&A activity in 3Q08 was the lowest since 4Q03.¹
- There was only one venture-backed IPO in 3Q08, compared to no venture-backed IPOs in 2Q08. In general, the venture-backed IPO business is non-existent.

- **Financing Round** – The financings broke down according to the following rounds:

Series	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
A	16%	15%	17%	16%	13%	14%	18%	22%
B	26%	31%	29%	26%	38%	34%	38%	31%
C	28%	20%	22%	27%	28%	25%	20%	23%
D	17%	19%	13%	16%	12%	18%	12%	11%
E and higher	13%	15%	19%	15%	9%	9%	12%	13%

- **Price Change** – The direction of price changes for companies receiving financing this quarter, compared to their previous round, were as follows:

Price Change	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
Down	12%	13%	19%	22%	14%	11%	9%	22%
Flat	15%	19%	9%	9%	7%	8%	12%	11%
Up	73%	68%	72%	69%	79%	81%	79%	67%

The percentage of down rounds by series were as follows:

Series	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
B	7%	3%	16%	11%	13%	5%	7%	6%
C	14%	23%	25%	11%	14%	10%	4%	15%
D	12%	14%	29%	47%	8%	17%	0%	42%
E and higher	15%	19%	10%	33%	33%	27%	36%	53%

- **The Fenwick & West Venture Capital Barometer™ (Magnitude of Price Change)** –Set forth below is (i) for up rounds, the average per share percentage increase over the previous round, (ii) for down rounds, the average per share percentage decrease over the previous round, and (iii) the overall average per share percentage change from the previous round for all rounds taken together. Such information is broken down by series for Q3'08 and is provided on an aggregate basis for comparison purposes for the prior four quarters. In calculating the “net result” for all rounds, “flat rounds” are included. For purposes of these calculations, all financings are considered equal, and accordingly the results are not weighted for the amount raised in a financing.

Percent Change	Series B	Series C	Series D	Series E and higher	Combined total for all Series for Q3'08	Combined total for all Series for Q2'08	Combined total for all Series for Q1'08	Combined total for all Series for Q4'07	Combined total for all Series for Q3'07
Up rounds	+84%	+114%	+48%	+45%	+83%	+91%	+78%	+91%	+108%
Down rounds	-53%	-31%	-74%	-57%	-49%	-56%	-36%	-36%	-46%
Net result	+67%	+78%	+28%	+12%	+55%	+53%	+49%	+55%	+79%

- **Liquidation Preference** – Senior liquidation preferences were used in the following percentages of financings:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
45%	38%	47%	39%	42%	51%	36%	40%

The percentage of senior liquidation preference by series was as follows:

Series	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
B	35%	21%	38%	26%	23%	47%	30%	23%
C	48%	32%	46%	43%	48%	39%	25%	38%
D	59%	62%	36%	53%	69%	65%	50%	58%
E and higher	38%	50%	70%	40%	67%	74%	64%	67%

- **Multiple Liquidation Preferences** - The percentage of senior liquidation preferences that were multiple preferences were as follows:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
16%	11%	17%	15%	21%	15%	14%	14%

Of the senior liquidation preferences, the ranges of the multiples broke down as follows:

Range of multiples	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
>1x- 2x	50%	75%	100%	80%	100%	75%	100%	40%
>2x – 3x	50%	25%	0%	20%	0%	25%	0%	60%
> 3x	0%	0%	0%	0%	0%	0%	0%	0%

- **Participation in Liquidation** - The percentages of financings that provided for participation were as follows:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
62%	57%	60%	59%	54%	48%	59%	73%

Of the financings that had participation, the percentages that were not capped were as follows:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
51%	55%	56%	41%	39%	54%	52%	64%

- **Cumulative Dividends** – Cumulative dividends were provided for in the following percentages of financings:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
4%	6%	5%	4%	4%	6%	8%	4%

- **Antidilution Provisions** - The uses of antidilution provisions in the financings were as follows:

Type of Provision	Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
Ratchet	7%	1%	2%	3%	6%	5%	5%	4%
Weighted Average	93%	99%	98%	97%	94%	93%	94%	95%
None	0%	0%	0%	0%	0%	2%	0%	1%

- **Pay-to-Play Provisions** - The use of pay-to-play provisions in the financings was as follows:

Percentages of financings having pay-to-play provisions.

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
12%	7%	6%	9%	13%	10%	8%	10%

The pay-to-play provisions provided for conversion of non-participating investors' preferred stock

into common stock or shadow preferred stock, in the percentages set forth below:

- Common Stock.

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
60%	87%	67%	89%	57%	77%	89%	73%

- Shadow Preferred Stock.

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
40%	13%	33%	11%	43%	23%	11%	27%

- **Redemption** – The percentages of financings providing for mandatory redemption or redemption at the option of the venture capitalist were as follows:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
23%	29%	20%	21%	26%	22%	26%	22%

- **Corporate Reorganizations** - The percentages of post-Series A financings involving a corporate reorganization were as follows:

Q3'08	Q2'08	Q1'08	Q4'07	Q3'07	Q2'07	Q1'07	Q4'06
4%	4%	5%	5%	9%	3%	9%	6%

For additional information about this report please contact Barry Kramer at 650-335-7278; bkramer@fenwick.com or Michael Patrick at 650-335-7273; mpatrick@fenwick.com at Fenwick & West. The contents of this report are not intended, and should not be considered, as legal advice or opinion.

To be placed on an email list for future editions of this survey please go to our [VC Survey sign-up page](#).

¹ Information in this paragraph obtained from Dow Jones VentureSource.