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2011 Seed Financing Survey

Internet/Digital Media and Software Industries

Background

Last year we published our first Seed Financing Survey in recognition of the growing importance of seed financing to entrepreneurs and the venture capital environment, especially in the internet/digital media and software industries.

This is our second such survey. In addition to providing information for 2011, this survey also offers comparative information with 2010 to facilitate the identification of trends.

The information contained in this survey is based on 56 transactions in 2011 and 52 in 2010. The vast majority of these transactions were for companies based in Silicon Valley, with some from the Seattle and Los Angeles regions.

Overview of Seed Financing Environment

The seed financing environment for internet/digital media and software companies is expanding and becoming increasingly varied. Although there are no definitive figures of which we are aware on the size of the market, anecdotal evidence and third party data indicates that the market is growing significantly. Third party information includes the following:

- Dow Jones VentureSource ("VentureSource") reported that venture capital investment in seed rounds increased 52% from 2010 to 2011.
- VentureSource has also reported that the three most active U.S. venture investors in 4Q11 were all seed-stage focused investors (500 Startups, SV Angel and First Round Capital).
- The Center for Venture Research at the University of New Hampshire has reported that investing in the U.S. by angels increased 14% from 2009 to 2010, and 4% in the first half of 2011 compared to the first half of 2010.
- peHUB has reported that more than two dozen incubators/accelerators have been founded in the Los Angeles region alone.
- Y Combinator admitted 63 startups to its summer 2011 class, up from 43 in the winter of 2011 and 34 from the summer of 2010.
- Stanford University has announced that they will be opening a new entrepreneurship-themed dorm, the "eDorm", where students will, among other things, form startup teams. The faculty sponsor will be Peter Thiel.

Not only is the amount of seed investing increasing, but the diversity of seed funding sources is also increasing. Seed investments are available from:

- Friends and family.
- Professional angels, who are often previous entrepreneurs or early employees in successful companies.
- Groups of angels investing their own money together.
- Incubators/accelerators that provide formal mentoring and often funding.
- Listing services that help seed investors and entrepreneurs pair up.
- Seed funds that focus on early stage investments.
- Traditional venture capitalists that make seed investments, either directly or through a separate fund.
- And potentially crowd funding, which is currently the subject of pending congressional facilitating legislation.

With this proliferation of seed capital and diversity of sources, the "leverage" in seed transactions seems to be leaning in favor of entrepreneurs, as preferred stock valuations, convertible note usage and convertible note cap amounts are increasing, as described in our survey results below. This trend is consistent with the results of our separate venture capital survey (**www.fenwick.com/vcsurvey),** which shows that internet/digital media and software companies receiving later stage funding are also obtaining increased valuations.

Other anecdotal trends noted in the seed environment are faster investment decision-making by investors and in some cases guaranteed funding of accelerator/incubator participants, which also evidence a good environment for entrepreneurs.

While it is certainly possible that we are seeing some "irrational exuberance" in the market, we believe that there are solid, fundamental reasons for the growth of seed capital investing.

First, the internet, and related new tools and technologies, have fundamentally reduced the time and expense it takes to bring internet/digital media and software products to market, allowing investors to get more "bang" and information for their buck.

Second, the growth of mobile devices and internet usage in general has increased the demand for the products and technologies being developed by these early stage companies. And there is certainly a significant potential payoff for them – with over 30 venture-backed technology companies currently having valuations over $1 billion.

And third, the hurdle for seed funded companies to obtain their next round of financing appears to be significant (note that in our survey less than half of companies receiving seed funding in 2010 had received venture funding within 18 months). This suggests that the increasing number of companies receiving seed funding are being carefully evaluated before they are being provided with more substantial next stage funding.

Update on Companies Included in our 2010 Seed Financing Survey

On average 18 months has passed since the companies included in our 2010 survey raised their seed round of financing. Set forth below is information on what has happened to those companies during that time period.

Raised venture capital financing:	45%
Raised additional seed financing:	12%
Still operating and have not raised additional financing:	21%
Acquired:	12%
Shut down:	4%
No data available:	6%
Total	100%

Overview of 2011 Seed Financing Survey Results

We saw the following notable trends in the 2011 survey:

- The use of convertible notes increased by 10 percentage points, and likewise the use of preferred stock decreased by 10 percentage points.

- The median size of convertible note deals increased from $662,500 to $1 million, while the median size of preferred stock deals remained basically flat around $1 millon.

- The pre-money valuation in preferred stock financings increased from $3.4 million to $4.0 million for internet/digital media deals, and from $2.7 million to $3.5 million for software deals.

- The median valuation cap on convertible notes increased from $4.0 million to $7.5 million.

- The percentage of convertible note deals that convert at a discount to the next equity valuation increased from 67% to 83%.

- The rights of a convertible note investor on an acquisition (before conversion of the note) generally improved.

In general we consider the increased use of convertible notes, the increased cap on convertible notes and the increased valuation of preferred stock transactions to be entrepreneur friendly trends, and the increased use of convertible note discounts and increased note holder rights on an acquisition to be investor friendly trends, but generally less important than the entrepreneur friendly trends.

Detailed Results of 2011 Seed Financing Survey

	2010	2011
Industry breakdown:		
Internet/Digital Media:	71%	75%
Software:	29%	25%
Lead investor background:		
Seed funds:	43%	46%
Professional angels:	31%	28%
Venture capital funds:	26%	27%
Financing Structure:		
Preferred Stock:	69%	59%
Convertible Debt:	31%	41%

Average Size of Investment

Below is the average size of investment for investors who invested at least $100,000, broken down by type of investor and between Preferred Stock financing and Convertible Note financing.

Preferred Stock	2010	2011
Professional angels:	$310,000	$163,000
Seed funds:	$392,000	$423,000
Venture capital funds:	$591,000	$516,000
Convertible Notes		
Professional angels:	$182,000	$244,000
Seed funds:	$140,000	$424,000
Venture capital funds:	$290,000	$501,000

Analysis of Preferred Stock Seed Financings.	2010	2011
• Median pre-amount valuation.		
Internet/Digital media:	$3,400,000	$4,000,000
Software:	$2,700,000	$3,500,000
• Median amount raised:	$1,056,000	$1,000,000
• Percentage using non-participating preferred liquidation preference:	90%	91%
• Percentage using participating preferred liquidation preference:	10%	9%
• Percentage in which investors received a board seat:	72.5%	70%

Analysis of Convertible Note Seed Financings	**2010**	**2011**
• Median amount raised:	$662,500	$1,000,000
• Median size of future financing in which note converts:	$1,000,000	$2,000,000
• Percentage of deals in which valuation on conversion is capped:	83%	82%
• Median valuation cap:	$4,000,000	$7,500,000
• Percentage of deals that convert at a discount to the next equity round valuation:	67%	83%
• Median initial discount:	20%	20%
• Percentage of deals with discount in which discount increases over time:	25%	5%
• Percentage of deals without discount that have a valuation cap:	100%	75%
• Percentage of deals having warrants:	0%	0%
• Treatment of note if company is acquired prior to an equity financing:		
Receive return of investment plus a premium:	50%	61%
Median premium:	0.75x original principal amount	1.0x original principal amount
Right to convert at an agreed upon valuation:	33%	65%
Percentage that have neither conversion right nor premium:	17%	9%
Percentage that have both conversion right and premium:	0%	35%
• Median interest rate:	6.0%	5.5%
• Median term:	18 months	18 months
• Percentage in which notes are secured:	0%	4%
• Percentage in which investors received a board seat:	8.3%	4%

Methodology and Definitions

For purposes of this survey we define a "seed" financing as the first round of financing by a company in which the company raises between $250,000 and $2,500,000, and in which professional investors play a lead role. Please note that this definition excludes financings led by "friends and family", which terms may not be negotiated on an arms-length basis, and smaller financings where parties may not substantially negotiate terms. Due to the foregoing definition of a seed financing, and the fact that all companies surveyed had a connection with our firm, the survey may not be representative of all companies receiving early stage financing, as we are likely over-weighted to more promising companies funded by more established seed investors.

Please note the use of the following additional definitions:

(i) a "Professional Angel" is an individual or group of individuals who regularly invest their own funds in early stage companies.

(ii) a "Seed Fund" is a fund that primarily invests in the first round of professional financing of an early stage company.

(iii) a "Venture Capital Fund" is a fund that invests in various stages of the growth of a private company.

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Disclaimer

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