FENWICK & WEST LLP

2012 Seed Financing Survey

Internet/Digital Media and Software Industries

Background

In early 2011 we published our first Seed Financing Survey (for 2010) 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 the third such survey. In addition to providing information for 2012, this survey also offers comparative information with 2011 and 2010 to facilitate the identification of trends.

The information contained in this survey is based on 61 transactions in 2012, 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, Los Angeles and New York regions. Most of these transactions are those in which our firm was involved, and we believe is representative of transactions handled by large Silicon Valley law firms, but may not be representative of the larger, geographically dispersed, seed financing environment.

Overview of 2012 Seed Financing Survey Results

We saw the following trends in our 2012 survey:

- Of the companies funded in 2011, 27% had raised a Series A financing by the end of the following year (2012), while 45% of the companies funded in 2010 had raised a Series A financing by the end of the following year (2011).

- Conversely, 23% of the companies funded in 2011 raised follow-on seed financing by the end of the following year, while 12% of the companies funded in 2010 had raised a follow on seed by the end of the following year.

- The percentage of companies in our survey receiving seed funding that were software companies increased from 25% in 2011 to 34% in 2012, while the percentage of such companies that were internet/digital media companies declined from 75% to 66%.

- The percentage of seed financings led by venture capital investors increased from 27% in 2011 to 34% in 2012.

- The use of a preferred stock structure increased from 59% in 2011 to 67% in 2012.

- The average investment size increased for preferred stock deals from 2011 to 2012, and declined for convertible note deals over the same period.

- The median pre-money valuation in preferred stock financings increased from $3.8 million in 2011 to $4.6 million in 2012.

- The median size of preferred stock deals increased from $1.0 million in 2011 to $1.36 million in 2012, while the median size of convertible note deals decreased from $1.0 million to $0.9 million.

- The median valuation cap on convertible notes decreased from $7.5 million in 2011 to $6.0 million in 2012.

The more detailed results of our survey are set forth below, after the "Overview of Seed Financing Environment" section.

Overview of Seed Financing Environment

The seed financing environment has become very dynamic, and has undergone significant changes, in the past few years. Some of the trends that we are seeing are:

- The Increasing Institutionalization of Seed Financing.

  This is evidenced by the increasing participation of venture capitalists in seed financings, the growth of accelerators and "matchmaker" platforms, and the use of venture capital-like structures in seed financings.

  (1) The increased involvement of venture capital funds in seed investing. Dow Jones VentureSource reported that U.S. seed financings by venture capital firms increased from 173 in 2009 to 388 in 2012, and the amounts invested in such financings increased from $119 million to $287 million during that period. Similarly, CB Insights reported that venture capital investment in seed deals increased from 143 deals in 2009 to 617 deals in 2012, and that the percentage of all seed deals in which venture capitalists invested increased from 30% in 2009 to 35% in 2012. This trend is supported by the results of our Survey, which found that the percentage of seed deals that were led by venture capitalists increased from 26% in 2010 to 27% in 2011 to 34% in 2012.

  (2) The growth of accelerators. Accelerators provide structure to the formation of seed companies by providing formalized mentoring, a network of contacts and in some cases small amounts of financing. This is unlike the prior generations of early stage companies that were more likely to have less formal guidance and structure during their pre-seed and seed period. Since Y Combinator, the first of the current generation of accelerators, was founded in 2005, the number of accelerators has grown to over 130 in 33 countries, per research by Jed Christiansen, founder of Seed-DB, as reported in AllThingsDigital. And accelerators tracked by Seed-DB that provide funding to their companies have increased the number of companies they have funded from 243 in 2010 to 1137 in 2012.

(3) The growth of platforms that match entrepreneurs and investors. Matchmaking platforms are becomingly increasingly important in seed financing, and with the passage of the JOBS Act are likely to continue to grow in importance. These platforms have provided further structure to the seed financing process that did not exist even a few years ago. For example, accelerators like 500 Startups and Rock Health now require all their applicants to submit their applications through AngelList (which was only founded in 2010). And AngelList has recently teamed with Second Market to permit (accredited) investors to easily invest small amounts in some of the companies listed on AngelList.

(4) The use of more traditional deal structures in seed financings. As venture capitalists and professional seed funds become more involved in seed financings, we are seeing indications of the increased use of traditional venture capital deal structures in seed financings. This is supported by our Survey, which shows that the use of preferred stock structures (versus convertible note structures) increased from 2011 to 2012, and that of those financings that used a convertible note structure, there was an increase in the use of valuation caps. However, note that seed round preferred stock valuations increased overall from 2011 to 2012, so the increased use of preferred stock is not necessarily a trend that favors investors at the expense of entrepreneurs, but rather reflects the more traditional preference of venture capitalists to set valuations at the time an investment is made.

- Increase in Seed Financings and the Series A Crunch.

(1) Rapid growth in seed financings compared to Series A. The number of seed financings increased from 472 in 2009 to 1749 in 2012, while the number of Series A rounds only increased from 418 to 692 during the same period, as reported by CB Insights. Additionally, Xconomy reported that the number of seed investments has grown from 15% to 31% of the total number of venture capital deals. This has caused many to question whether too many seed deals are being funded, and opine that many of the seed funded companies will be unable to raise a Series A financing. CB Insights estimates that only approximately 40% of seed funded companies will raise follow-on financings, and that as a result it projects that over 1000 companies that received seed funding in the past year will be unable to raise Series A funding. This is consistent with our Survey data which found that while 45% of companies receiving seed funding in 2010 had received venture financing by the end of 2011, only 27% of companies receiving seed funding in 2011 had received venture financing by the end of 2012.

(2) Follow-on seed financings. Further evidence of this trend is what appears to be a growth in follow-on seed financings, which provide a company with a longer runway to hopefully demonstrate the traction necessary to obtain Series A financing. This is supported by our survey results which found that while only 12% of our 2010 class of seed funded companies received a follow-on seed financing by the end of 2011, 23% of our 2011 class have already received such financing. Anecdotally, the growth of “acqui-hires” also seems to be increasing, supporting the idea that while many seed-funded companies have had difficulty in raising Series A financing, their ability to put together talented teams has led to acquisitions of these companies due to the value of their personnel.

- The Seed Financing Universe is Expanding Geographically and by Industry.

  The current accelerator concept started in Silicon Valley, and was initially focused on mentoring internet-focused companies. This has changed.

  (1) Geographically. Of the approximately 140 accelerators tracked by Seed-DB**,** 45% are based outside of the United States and even for those based in the U.S., many attract foreign entrepreneurs. While it is unlikely to be representative of all incubators, we note that of the 33 companies in the most recent 500 Startups class, 57% are based outside of the United States, as reported in VentureBeat**.** Additionally, the Wall Street Journal reported that a significant number of accelerators being formed in Silicon Valley focus on nationals of specific countries, e.g. Australia, China, Denmark, Germany, Israel, Japan and Russia. Their goal is to provide entrepreneurs from those countries access to Silicon Valley investors, and to provide those investors access to the markets of those countries. And geographic growth is of course occurring in the US as well, with accelerators forming throughout the US, and with some accelerators, like Science in Los Angeles, explicitly focused on connecting their companies with Silicon Valley investors.

  (2) Industry Diversification. While the internet/digital media industry seems especially well suited for seed/accelerator financing, due to being less capital intensive and having a quicker time to market, accelerators are diversifying into other industries. Examples are Lemnos Labs, Bolt and Haxlr8r (hardware), Rock Health, Blueprint Health and Healthbox (life science), Greenstart and Surge (energy/greentech) and Plug and Play (B2B).

Detailed Results of 2012 Financing Survey

- Update on Companies Included in our Prior Seed Financing Surveys:

  On average 30 months has passed since the companies funded in 2010 and included in our 2011 survey raised their seed round of financing, and on average 18 months has passed since the companies funded in 2011 and included in our 2012 survey raised their seed round of financing. Set forth below is information on what has happened to those companies during that time period.

Status of companies that raised their seed round of financing in 2010:

	As of 12/31/2011	As of 12/31/2012
Raised venture capital financing:	45%	45%
Raised additional seed financing:	12%	14%
Still operating and have not raised additional financing:	21%	12%
Acquired:	12%	19%
Shut down:	4%	6%
No data available:	6%	4%
Total	100%	100%

Status of companies that raised their seed round of financing in 2010 versus those that raised their seed round in 2011, 18 months (average) after the seed round:

	Status of 2010 companies as of 12/31/2011	Status of 2011 companies as of 12/31/2012
Raised venture capital financing:	45%	27%
Raised additional seed financing:	12%	23%
Still operating and have not raised additional financing:	21%	32%
Acquired:	12%	7%
Shut down:	4%	5.5%
No data available:	6%	5.5%
Total	100%	100%

- Other Survey Results

	2010	**2011**	**2012**
Industry breakdown:			
Internet/Digital Media:	71%	75%	66%
Software:	29%	25%	34%

Lead investor background:

Seed funds:	43%	46%	46%
Professional angels:	31%	28%	20%
Venture capital funds:	26%	27%	34%

Financing Structure:

Preferred Stock:	69%	59%	67%
Convertible Debt:	31%	41%	33%

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**	**2012**
Professional angels:	$310,000	$163,000	$185,000
Seed funds:	$392,000	$423,000	$458,000
Venture capital funds:	$591,000	$516,000	$624,000
Convertible Notes			
Professional angels:	$182,000	$244,000	$165,000
Seed funds:	$140,000	$424,000	$277,000
Venture capital funds:	$290,000	$501,000	$391,000

Analysis of Preferred Stock Seed Financings.	**2010**	**2011**	**2012**
• Median pre-money valuation.			
Internet/Digital media:	$3,400,000	$4,000,000	$4,400,000
Software:	$2,700,000	$3,500,000	$5,000,000
• Median amount raised:	$1,056,000	$1,000,000	$1,360,000
• Percentage using non-participating preferred liquidation preference:	90%	91%	85%
• Percentage using participating preferred liquidation preference:	10%	9%	15%
• Percentage in which investors received a board seat:	72.5%	70%	73%

Analysis of Convertible Note Seed Financings	**2010**	**2011**	**2012**
• Median amount raised	$662,500	$1,000,000	$918,000
• Median size of future financing in which note converts:	$1,000,000	$2,000,000	$1,750,000
• Percentage of deals in which valuation on conversion is capped:	83%	82%	90%
• Median valuation cap:	$4,000,000	$7,500,000	$6,000,000
• Percentage of deals that convert at a discount to the next equity round valuation:	67%	83%	90%
• Median initial discount:	20%	20%	20%
• Percentage of deals with discount in which discount increases over time:	25%	5%	0%
• Percentage of deals without discount that have a valuation cap:	100%	75%	100%
• Percentage of deals having warrants:	0%	0%	0%
• Treatment of note if company is acquired prior to an equity financing:			
Receive return of investment plus a premium:	50%	61%	50%
Median premium:	0.75x original principal amount	1.0x original principal amount	1.0x original principal amount
Right to convert at an agreed upon valuation:	33%	65%	65%
Percentage that have neither conversion right nor premium:	17%	9%	5%
Percentage that have both conversion right and premium:	0%	35%	20%
• Median interest rate:	6.0%	5.5%	5.5%
• Median term:	18 months	18 months	18 months
• Percentage in which notes are secured:	0%	4%	0%
• Percentage in which investors received a board seat:	8.3%	4%	0%

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 our firm had a connection with the transactions included in the survey, 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.

Disclaimer

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