Fenwick
FENWICK & WEST LLP

Angel/Seed Financing Survey

Internet/Digital Media and Software Industries

Silicon Valley and Seattle

2010

Background

In 2002, Fenwick & West began publishing its Silicon Valley Venture Capital Survey. The survey was published in response to dramatic changes in the venture capital financing environment resulting from the bursting of the "dot-com bubble", and our belief that there was a need for an objective analysis of how the venture capital environment had changed. The survey was well received and we have continued to publish it – a copy of the most recent survey is available here.

We believe that in recent years there has been a significant change in the angel/seed financing environment primarily in the internet/digital media and software industries. We believe these changes are due to the following factors:

- The nature of these industries is such that products can be developed and introduced to the market quicker and with less resources than other industries.

- The development of new technologies has further accelerated the speed, and reduced the resources needed, to introduce new products in these industries.

- These industries have now been around for at least a decade, if not longer, and as such a generation of successful entrepreneurs having the expertise, financial resources and interest is now available to assist and finance the current generation of entrepreneurs.

- Venture capital has become harder to obtain, with venture capital investment in the U.S. overall declining from $29.9 billion in 2007 to $26.2 billion in 2010, and with investment in venture funds by limited partners declining even more precipitously, with $11.6 billion invested in 2010, the lowest amount since 2003, according to Dow Jones VentureSource.

As a result of these factors we believe that there have been the following changes in the angel/seed financing environment:

- There has been a shift in the composition of investors, from largely friends and family, wealthy individuals and a few organized groups, to a larger percentage of professional angels, seed funds and venture capital funds willing to invest smaller amounts of capital.

- The amounts raised in angel/seed financings have increased, and can exceed $1 million. Investors in these financings also have deeper pockets with the ability to participate in later rounds.

- The terms of these financings have become more sophisticated and arms length, as investors are more likely to be true third parties investing larger sums, with an interest in being more active in the oversight of their investment.

In light of the increasing importance of angel/seed financings, and a desire to make objective information about such financings available to the community at large, we undertook a survey of 52 internet/digital media and software industry companies that obtained angel/seed financing[1] in 2010 in the Silicon Valley and Seattle markets.

The results of our survey are set forth below.

Results of Angel/Seed Survey

Industry breakdown:

Internet/Digital Media:	71%
Software:	29%

Lead investor background:

Seed funds[2]:	43%
Professional angels[3]:	31%
Venture capital funds[4]:	26%

Financing Structure

Preferred Stock:	69%
Convertible Debt:	31%

Comment: Convertible notes were used more frequently in smaller financings, while preferred stock was more prevalent in larger financings.

[1] For purposes of this survey we defined an angel/seed financing as the first round of financing by a company in which the company raised between $250,000 and $2,000,000, and in which professional investors played a lead role. Please note that this definition excludes financings led by "friends and family," where terms may not be negotiated on an arms-length basis, and smaller financings where parties may not substantially negotiate terms.

[2] Funds that primarily invest in the first round of professional financing raised by start-up companies.

[3] Individuals or groups of individuals that primarily invest their own funds.

[4] Venture capital funds investing not more than $1 million in the seed/angel financing.

Convertible notes have the advantages of not requiring that a company valuation and other terms be negotiated, and do not create a series of preferred stock that may have separate voting rights under some circumstances. However, convertible notes may have to be repaid if the company does not raise financing before the notes become due, and are disadvantageous to the investor if the company's valuation increases significantly before the next financing. Many investors in convertible notes address this last issue by requiring valuation caps, as set forth below.

In recognition of the trends in the financing environment described above, our firm has created "Series Seed" preferred stock financing documents that we have made available to the entrepreneurial community at large in an effort to reduce legal costs for early stage equity financings. The documents are available here.

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

Seed funds:	$392,000
Professional angels:	$310,000
Venture capital funds:	$591,000

Convertible Notes

Seed funds:	$140,000
Professional angels:	$182,000
Venture capital funds:	$290,000

Analysis of Preferred Stock Angel/Seed Financings.

- Median pre-money valuation.

Internet/Digital media:	$3,400,000
Software:	$2,700,000

- Median amount raised: $1,056,000
- Percentage using non-participating preferred liquidation preference: 90%**.**
- Percentage using participating preferred liquidation preference: 10%
- Percentage in which investors received a board seat: 72.5%

Analysis of Convertible Note Angel/Seed Financings

- Median amount raised $662,500
- Median size of future financing in which note converts: $1,000,000
- Percentage of deals in which valuation on conversion is capped: 83%
- Percentage of deals that convert at a discount to the next equity round valuation: 67%
- Median initial discount: 20%
- Percentage of deals with discount in which discount increases over time: 25%
- Percentage of deals without discount that have a valuation cap: 100%
- Percentage of deals having warrants: 0%
- Treatment of note if company is acquired prior to an equity financing:

  Receive return of investment plus a premium: 50%

    Median premium: 0.75x original principal amount

  Right to convert at an agreed upon valuation: 33%

  Percentage that have neither conversion right nor premium: 17%
- Median interest rate: 6.0%
- Median term: 18 months
- Percentage in which notes are secured: 0%
- Percentage in which investors received a board seat: 8.3%

Conclusion

We believe the results of this survey reflect the evolving financing environment for start-up companies in the internet/digital media and software industries. These trends are also evident in the growth of professional angels, seed-stage funds and traditional venture capital firms participating in angel and seed-stage investments.

For additional information about this report please contact Barry Kramer at 650-335-7278; bkramer@fenwick.com, or Steven Levine at 650-335-7847; slevine@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 Angel/Seed Survey sign up page.