SEED CAPITAL ReVIEW

SEMI-ANNUAL REPORT | SECOND HALF, 2013

PUBLISHED BY: MEMBERS OF THE ENTREPRENEURIAL SERVICES GROUP AT GRAY PLANT MOOTY

GRAY PLANT MOOTY

Welcome to the first installment of Seed Capital reVIEW, written by members of the Entrepreneurial Services Group at Gray Plant Mooty. This is our first periodic report analyzing seed capital being raised by companies in Minnesota (typically financings of between $100,000 and $2 million).

Seed Capital reVIEW is a response to inquiries we frequently get from clients. As advisors to companies and investors involved in early stage financings, we are regularly asked to assess whether proposed deal terms are standard or typical or, more colloquially, "market." Our clients want to know whether early stage investments are typically structured as debt or equity; if equity, whether the investors typically receive preferred or common stock; if preferred stock, they want to know typical terms like liquidation preference (one times or two times the invested amount; participating or non-participating), governance rights, and other similar things. We have our own experience and anecdotal evidence that we think is useful to our clients, but we've always thought it would be helpful to have objective data to support our experience, shape our advice to clients, and guide negotiations. We are hopeful that this survey will provide that objective data.

The results that follow are reflective of seed financings completed during the second half of 2013. In early 2014, we sent out a survey to investors and companies that we believed may have been involved in financings during that time. We identified some of the companies raising capital through Form D's filed with the SEC and from various news reports. The investors were identified through our own research efforts, our contact lists, and those of others active in the entrepreneurial community (e.g., Minnesota Department of Economic Development and the now phased out Minnesota Angel Network).

When we circulated the survey, we were unsure as to how robust the response would be. We know how hard it is to get a high participation rate in surveys (we ourselves are not always so eager to participate in surveys), especially from a group as time constrained as entrepreneurs and seed investors. Given that, we were more than a little surprised, and quite happy, to receive responses from parties involved in 126 separate early-stage capital financings. This level of participation suggests that there is great demand for the information contained in this report. It also provides us with great insight into the types of early-stage financings being consummated and the terms on which they are closing.

In late July we will circulate our survey for the first half of 2014 and expect to publish the corresponding Seed Capital reVIEW this fall.

Thank you for your participation. We hope this information becomes a useful tool for Minnesota's entrepreneurs and seed investors. We welcome any comments or feedback you may have.

Dan Tenenbaum

Max Bremer

Justina Roberts

EXECUTIVE SUMMARY

For this report we analyzed survey responses submitted by 126 separate respondents, the majority of whom were individual angel investors or represented angel groups.

Some key metrics and findings for the second half of 2013, most of which were consistent with the experience of members of our Entrepreneurial Services Group, were:

- The survey's sample encompassed a broad range of industries, with particular concentrations in the medical/healthcare and technology industries.
- A majority of the deals utilized the Minnesota Angel Tax Credit.
- Pre-revenue companies comprised slightly less than half of the total financings.
- Revenue-generating companies were more likely to report pre-money valuations in excess of $5 million.
- Approximately 68% of respondents reported offerings structured using equity securities (and just over 70% of those were common equity, with the remainder being preferred equity), with debt securities comprising the remainder.
- The most frequent rights received by equity investors were:
  - Participation rights in future investment rounds.
  - Investors in preferred equity, over 85% reported some form of liquidation preference, with 1x liquidation preference predominating.
  - Weighted average price-based anti-dilution was also common for preferred investors.
- For debt-structured offerings:
  - Almost all respondents reported debt with an initial term greater than 1 year.
  - A significant majority of respondents reported receiving a seat on the company's board of directors (or Board observation rights) as a term of the deal.
  - More than 75% of debt-structured offerings were convertible to company equity.

We plan to release our survey for the first half of 2014 in July and expect to publish our next report this fall.

About the Firm

Gray Plant Mooty is the oldest continuing law practice in Minneapolis. With more than 160 attorneys, and additional offices in St. Cloud and Washington, DC, the firm's uncompromising client service and practical legal advice have earned it the trust of clients around the world.

About the Entrepreneurial Services Group

The Entrepreneurial Services Group at Gray Plant Mooty brings together legal expertise and business acumen that entrepreneurs can depend upon at every stage of their emerging or growth business. The group builds a deep, personalized understanding of each client's needs, and its attorneys develop legal solutions that help best accomplish their clients' long-term goals. By moving as quickly as its clients do, the group provides responsive service that mitigates the present and potential challenges facing any new business.

Before diving deep into the actual data, we have a few comments on the responses received and the summary data that follows.

First, it appears that the Minnesota Angel Tax Credit is an important factor in raising seed capital. Of the reported deals in our survey, over 51% were accomplished with the help of the Minnesota Angel Tax Credit. Of those reporting that the Minnesota Angel Tax Credit was utilized as part of the financing, 80% reported that the tax credit was either crucial (22%) or important (58%) to the transaction. Only 7% reported that the tax credit was not important to the financing transaction. Of those who responded that the tax credit was not utilized as part of the financing, almost 80% reported that the reasons were either that the company did not qualify (39%) or that there were no remaining credits available (39%). About 21% reported that they did not pursue the tax credit.

These responses seem to verify what we have seen anecdotally. From our experience, the Minnesota Angel Tax Credit has not been determinative in securing an investment in a deal that is not otherwise investable. However, when an investor is otherwise attracted to a particular investment, they are often willing to dig deeper into their pockets because of the Minnesota Angel Tax Credit. And, all other things being equal, the Minnesota Angel Tax Credit helps keep investment dollars in Minnesota, as our neighboring states (Wisconsin and North Dakota, in particular) have their own incentives that make investments in companies in those states attractive. If anything, we think the data from this survey suggests that the Minnesota Angel Tax Credit could be expanded even beyond the recently enacted legislation to extend and increase the credit.

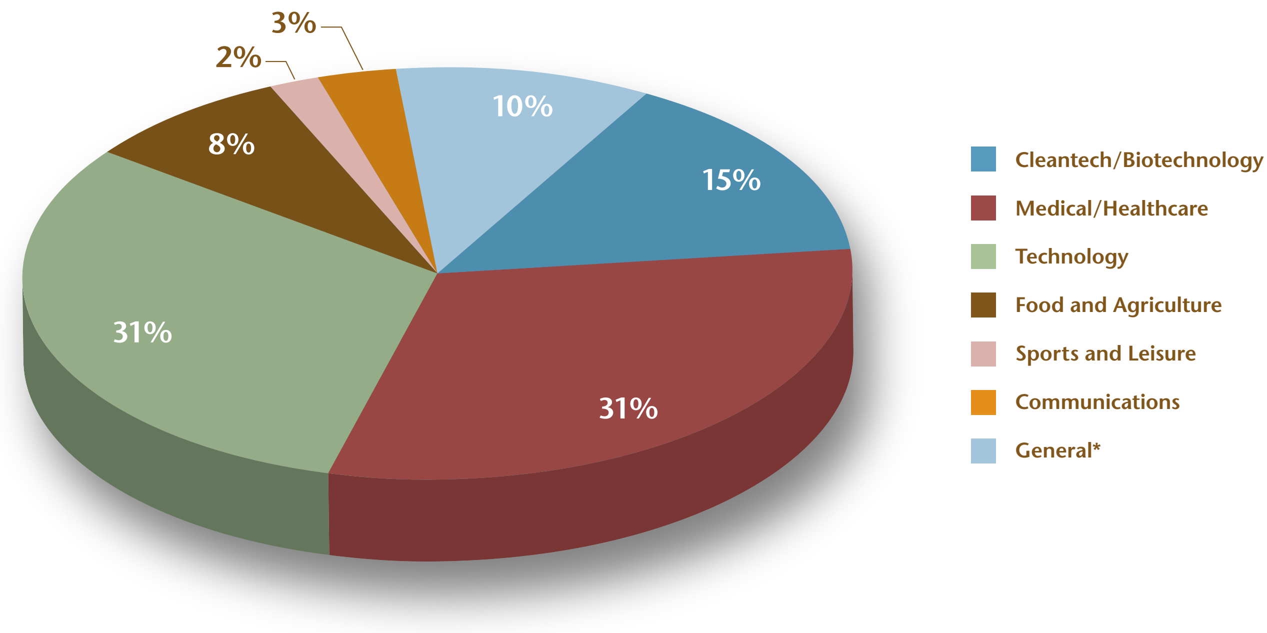
Second, it appears that this survey really resonated with individual angel investors. 54% of respondents overall reported that they were investors, as opposed to managers, officers, or board members of the company (about 31%) or advisors (6%). Of those who identified themselves as investors, over 88% further identified themselves as individual angel investors. This is substantially higher than the number of angel funds or groups (6%) or seed funds (4%). Nobody participating in the survey identified themselves as a venture capitalist. We assume this is largely a function of the types of deals solicited by this survey (capital financing transactions of between $100,000 to $2 million). In our experience, individual angels and angel groups are much more likely to be playing in that space than are more traditional venture capital funds.

CHARACTERISTICS OF COMPANIES RAISING EARLY-STAGE CAPITAL

Industry

For a survey based on Minnesota early-stage companies, it is probably no surprise that the industry focus of companies raising capital was concentrated in the medical/healthcare and technology industries. Medical/healthcare companies have long dominated the start-up landscape in the Twin Cities, given the presence of local medical device giants like Medtronic, Boston Scientific, and St. Jude Medical. For a variety of reasons (including low capital investment requirements, speed to market, scalability, and potential market size), we have also noticed a recent surge of companies that are in the technology space (e.g., software, internet/e-commerce, electronics/instruments, and nanotechnology).

Respondents noted the following with respect to the industry of the companies raising capital:



* business and consumer products and services, industrial/energy, etc.

Pre– or Post-Revenue?

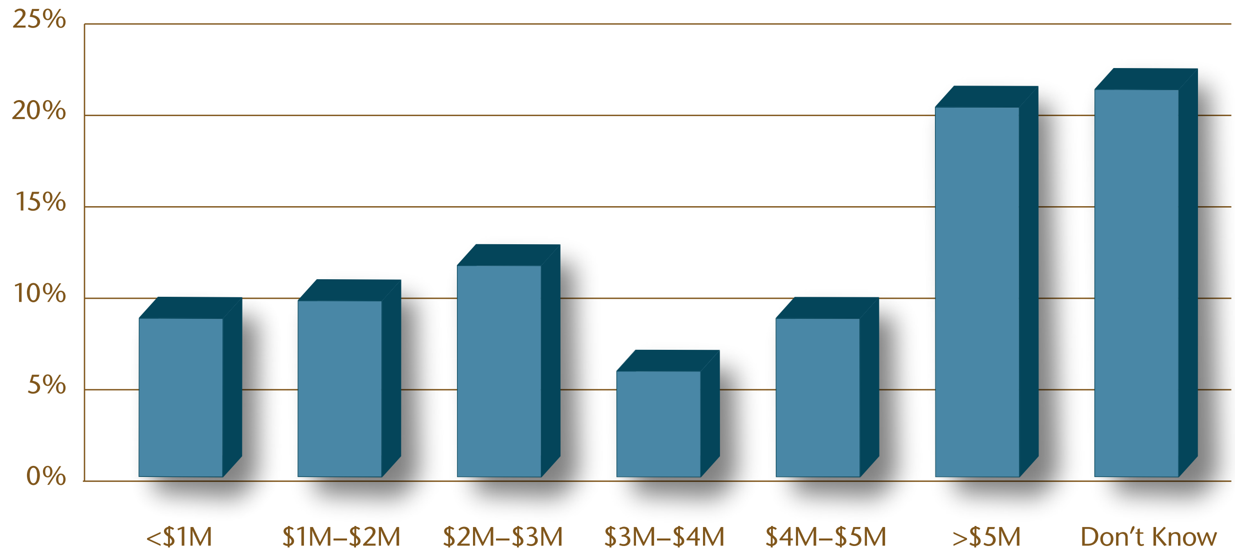
Slightly fewer respondents (about 44%) reported that the company raising capital was still at the pre-revenue stage with the balance (56%) having at least begun to generate revenues. One lesson from this is that a company doesn't necessarily have to have revenue to be investable. This is particularly true in the medical device space, where it can take years of testing and clinical trials to clear the necessary regulatory hurdles to even begin marketing a product.

Note though that when we analyzed the responses to the pre- or post-revenue question and compared that to the data from the pre-money valuation question (see below), we saw that having revenues appeared to correlate to a higher pre-money valuation. Of the responses we received identifying the company as pre-revenue, only 17% reported having a pre-money valuation of above $5 million. For those who responded that the company was already generating revenue, approximately 42% reported having a pre-money valuation of above $5 million.

Interestingly, revenues didn't seem to impact valuation at the lowest end of the valuation range. 7% of pre-revenue companies and 10% of post-revenue companies reported having pre-money valuations of less than $1 million.

Pre-Money Valuation

We received 67 responses to the question of the company's pre-money valuation, approximately as follows:



We were a little surprised that the largest response to the pre-money valuation question was above $5 million. Perhaps for future surveys, we will revise these numbers upward to gauge how much above $5 million the companies in this survey were valued.

It is also worth noting that, in response to the question regarding whether the pre-money valuation of the financing was higher or lower than prior financings, just over half (52%) identified the valuation for the current financing as being higher than the valuation used in previous financings. Only 3% indicated that the valuation used was lower than prior valuations. Given the early stage nature of these companies, these numbers are probably not surprising. Down rounds (where the valuation in a subsequent financing is lower than that used in prior financings) are more typical with start-ups in later stages of development that are experiencing less success than was anticipated.

Use of Placement Agents or Brokers

Consistent with our recent experience, only about 10% of respondents reported the use of a placement agent or broker to help raise capital. There just are not a lot of brokers who focus on raising capital for seed stage financing transactions.

Use of General Solicitation under Rule 506(c) to help promote the financing

The recently finalized regulations under Rule 506(c) of the Securities Act of 1933 permit issuers to use general solicitation as part of their offering, provided that all investors in the offering are accredited and that the issuer "takes reasonable steps" to verify that all investors are accredited. Rule 506(c) only became available last fall, so Rule 506(c) would only have been available for one-half of the 6-month period covered by the survey. Interestingly, almost 20% of participants reported using general solicitation under Rule 506(c) to help promote their financing. This is a category we'll be tracking in future surveys to determine whether general solicitation becomes more popular and useful in helping early-stage companies raise capital.

Equity v. Debt

Of the respondents to our survey, approximately 68% identified the securities acquired as being equity securities, while the remaining 32% identified the securities as debt securities.

We found these responses to be mostly consistent with our experience. At the early stages of raising capital, it is probably more typical that a company will issue equity than debt, and use debt mostly when the company and investor are having a difficult time arriving at an acceptable valuation for the company's equity. That situation is well suited for convertible debt (usually a bridge loan) that is convertible into the company's equity upon the occurrence of a pre-determined event (usually raising additional capital). As is noted below, more than three-fourths of the respondents who indicated that the offering was structured with debt securities responded that the debt was convertible into the company's equity.

Characteristics of Equity Securities

For those who indicated that the offerings were structured using equity securities, approximately 71% responded that the securities were common equity, and the balance (29%) responded that the securities were preferred equity. In our experience, we find that preferred securities are more commonly used in financings involving venture capital firms and later stage angel investors, which is not a group that was heavily represented in this survey.

Of those financings identified as involving equity securities, the respondents most commonly reported receiving participation rights in future rounds and weighted average anti-dilution protection. With respect to the entire list of "preferred-like" features, here were the reported results:

One board seat:	3%
More than one board seat:	9%
Observation rights:	9%
Registration rights:	0%
Right to participate in future rounds of financing:	33%
Redemption right:	9%
Anti-dilution protection (weighted average):	15%
Anti-dilution protection (full-ratchet):	0%
None:	39%
Warrant coverage:	6%

We found it interesting and consistent with our recent experience that no respondents identified receiving registration rights (the right to have the securities registered in a subsequent public offering) or full-ratchet anti-dilution protection. With respect to registration rights, because so few companies seem to go public now, investors presumably view registration rights as less valuable and not worth expending negotiating leverage.

Full-ratchet anti-dilution (which effectively gives the investor the lower purchase price if the company sells equity in the future at a lower per share price) is a very investor favorable feature. More commonly, we see weighted average anti-dilution, which takes into account the dilutive impact of a subsequent issuance of equity at a lower per share price (both in terms of the number of shares issued and the effect of the lower price). If we were to have conducted this survey a decade ago, it is likely that the percentage of respondents reporting full-ratchet anti-dilution protection would have been much higher. But the landscape on this item has shifted somewhat over time.

Liquidation preference

Of the reported preferred equity financings, greater than 85% reported receiving some form of liquidation preference. Of those, 61% reported the preference as being one times the amount invested. 15% reported a 1.5x liquidation preference, and another 15% reported receiving more than a 2x liquidation preference. Notably, no preferred respondents reported receiving a 2x liquidation preference. These results seem to be consistent with our recent experience. Perhaps this is a reflection that the fund raising climate has improved slightly for early-stage companies, but if we had conducted this survey a few years earlier, we think the liquidation preferences would have skewed slightly higher. In recent years, a 1x liquidation preference has been more common.

Also worth noting is that approximately one-half of the respondents who reported receiving a liquidation preference noted that the preference was participating (the other half, of course, reported that the preference was non-participating).

Characteristics of Debt Securities

For those who indicated that the investment was structured as a debt security, Board representation (one seat) or observation rights, rights to participate in future rounds of financing, anti-dilution protection (weighted average), and preferred dividends were the most common types of preferred-rights granted to investors/lenders. The detail on "preferred-like" features relating to debt is as follows:

One board seat:	57%
More than one board seat:	7%
Observation rights:	36%
Registration rights:	14%
Right to participate in future rounds of financing:	50%
Redemption right:	14%
Anti-dilution protection (weighted average):	36%
Anti-dilution protection (full-ratchet):	0%
Preferred dividends:	29%
None:	14%

Interest Rate

5 out of 20 debt respondents (25%) involved in a debt financing reported that the interest rate on their debt security was less than 5%. The other 15 out of the 20 respondents (75%) reported that the interest rate was between 5% and 10%. Notably, no respondents reported an interest rate greater than 10%.

Security Interest in Assets

8 of the 20 respondents (40%) involved in a debt financing reported that repayment of the debt was secured by the company's assets, while the remaining 60% reported that the debt was unsecured.

Warrant Coverage

13 out of the 20 respondents (65%) involved in a debt financing reported receiving no warrant coverage at all. Of those receiving warrant coverage, 15% (3 out of 20) reported receiving less than 10% warrant coverage and 15% also reported receiving more than 20% warrant coverage. Surprisingly to us, only 1 respondent reported receiving warrant coverage in the range of 10% to 20%, which we have seen as a common range for warrant coverage in the past.

Term of the Debt

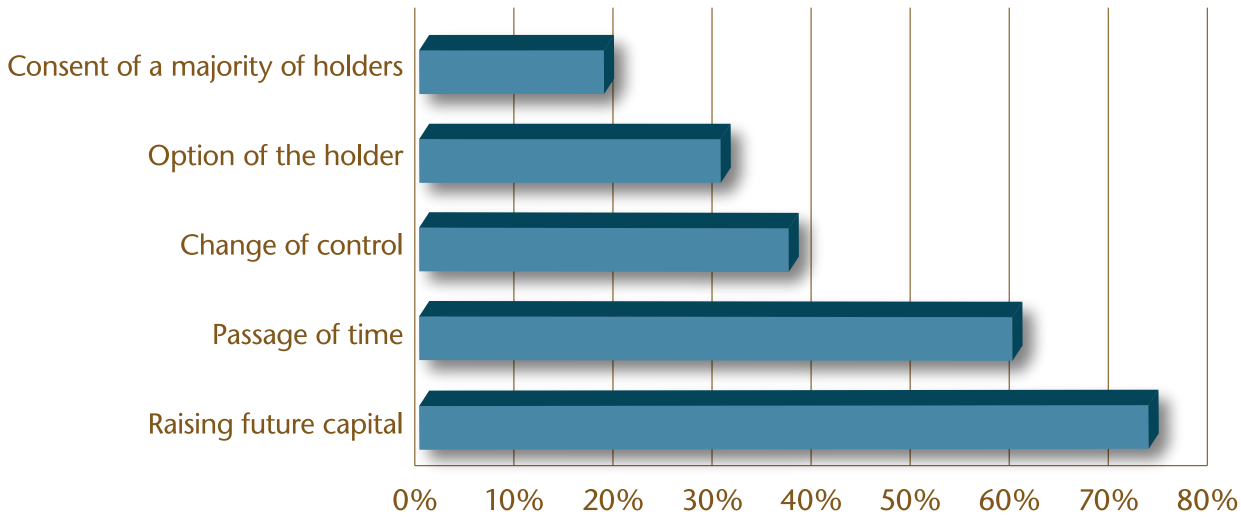
Regarding the term of the debt (that is, the duration of the company's obligation to repay the debt), almost all respondents (19 out of 21) reported debt that had an initial term of more than 1 year. One respondent reported debt that had a maturity of less than 1 year and another respondent reported debt that had a maturity equal to 1 year.

Convertible Debt

More than three-fourths (16 out of 21) reported debt that is convertible into equity, with the remainder being not convertible. Of course, to qualify for the Minnesota Angel Tax Credit, the debt must mandatorily convert into equity (and it cannot convert into equity within the first 180 days following its issuance). It would have been interesting to know whether the Minnesota Angel Tax Credit program has resulted in an increase in convertible debt offerings. As noted above though, even in financings that don't involve the Minnesota Angel Tax Credit, we find convertible debt used frequently when the company and investor cannot arrive at a mutually acceptable valuation for the equity (and prefer to wait for a subsequent equity financing to set the company's valuation).

Of those who received convertible debt, 60% reported that the debt converts into the next round of financing at a discount to the next round's price. The reported discounts ranged between 10% and 25% of the next offering's price, with some variable discounts reported based on the next round's price.

The events that would trigger a conversion were reported as follows:



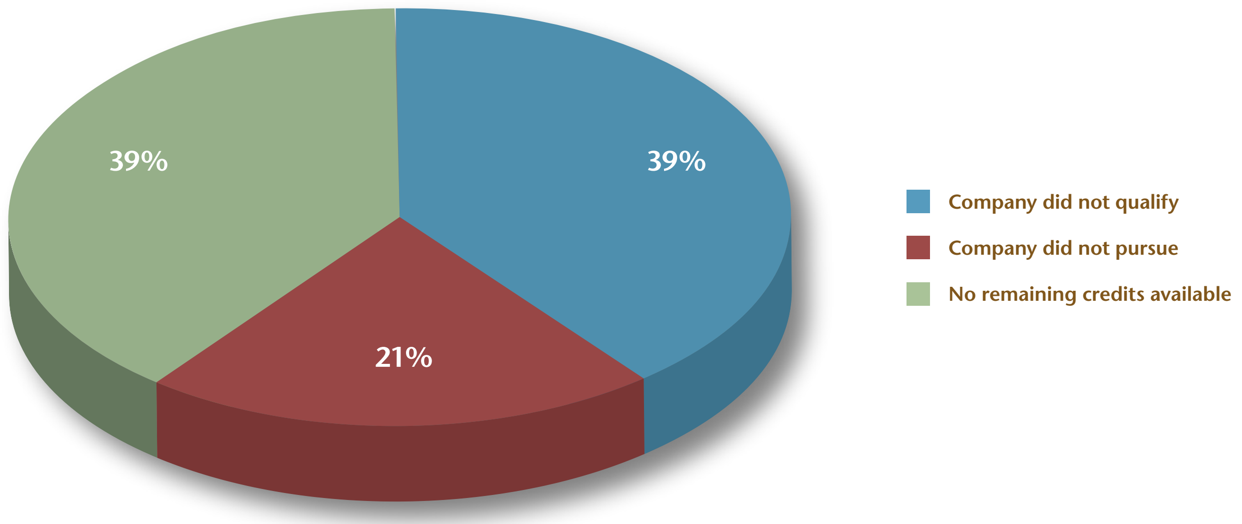
These numbers indicate that (consistent with our experience) most convertible debt can be automatically converted upon the occurrence of more than one triggering event.

For a triggering event based on the raising of future capital, 50% of respondents reported that the threshold amount was less than $1 million. 25% of respondents indicated that the threshold amount was $1 million, and the remaining 25% reported that the threshold amount was greater than $2 million. No respondents reported that the threshold amount was between $1 million and $2 million.

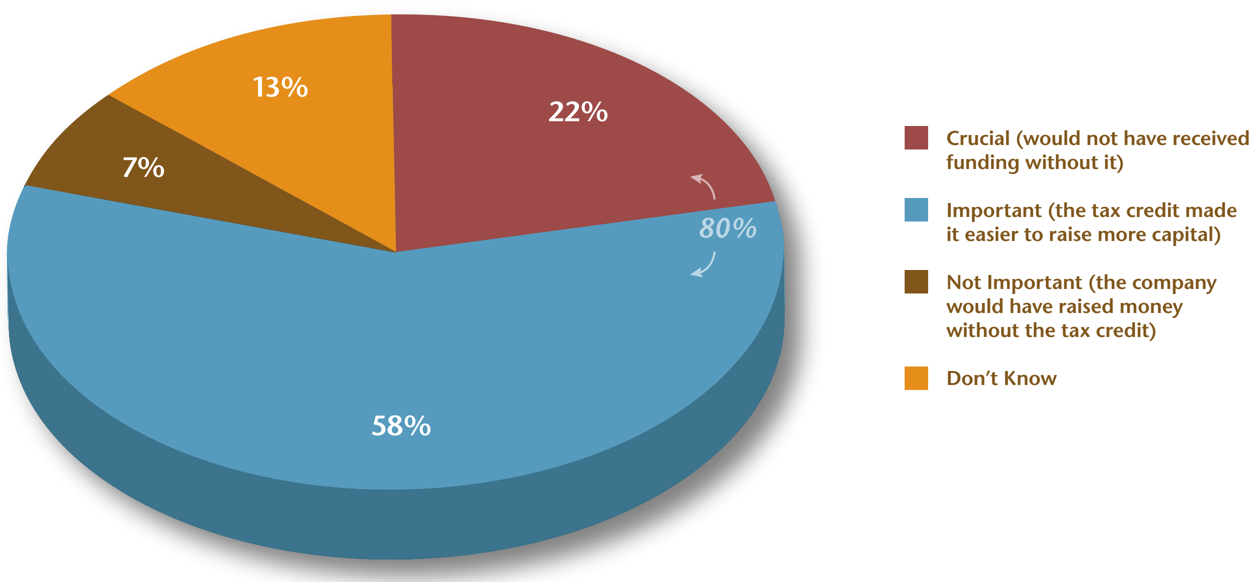
Minnesota Angel Tax Credit

Our questions regarding the Minnesota Angel Tax Credit had a high response rate. 107 of the 126 respondents (85%) answered these questions. Of those responding, over half noted that they utilized the Minnesota Angel Tax Credit as part of the financing. 35% responded that they did not use the Minnesota Angel Tax Credit with the remaining respondents indicating they were unsure of whether the Minnesota Angel Tax Credit was used.

Of those who responded that they did not use the Minnesota Angel Tax Credit as part of the financing, the following were identified as the reasons:



Of those who responded that they used the Minnesota Angel Tax Credit as part of the financing, the respondents noted the following with respect to the importance of the Minnesota Angel Tax Credit in completing the financing:



Summary

For the most part, we found the data in this survey to be consistent with our recent experience in early-stage capital financing transactions. We hope you find this data useful and that ultimately it can be used to help simplify and streamline negotiations for such transactions.

We appreciate the time all of the respondents took to complete the survey and provide us with this very useful information. Having such a strong response really makes this data meaningful.

We plan to circulate another survey in July for transactions that occurred during the first half of 2014. We look forward to comparing those surveys with this survey's results, and identifying any emerging trends in early-stage capital financings. If you have any comments or suggestions for the next survey, please let us know.

In the meantime, we'd be glad to answer any questions you may have about the survey or, more generally, about raising seed capital.

Dan Tenenbaum   Max Bremer   Justina Roberts

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entreviewblog.com

MINNEAPOLIS
500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402
612.632.3000

ST. CLOUD
Suite 500
1010 West St Germain Street
St. Cloud, MN 56301
320.252.4414

WASHINGTON, DC
The Watergate - Suite 700
600 New Hampshire Avenue, NW
Washington, DC 20037
202.295.2200

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