

Venture Capital Report

2018

WILMERHALE® 

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REVIEW

The venture capital market rebounded in 2017, with an uptick in deal flow, an increase in financing sizes, soaring proceeds and a record high median pre-money valuation. The \$73.2 billion invested into the US venture capital ecosystem in 2017 represents the second-highest annual total since 2000, and the number of 2017 venture capital financings—once all deals are accounted for—should rival the highest annual tally since the dot-com era.

VC-backed company liquidity activity was also strong in 2017. The IPO market produced a 28% increase year-over-year and attractive valuations, while the number of acquisitions of VC-backed companies in 2017 should top the 2016 tally—and reach a record high—once all acquisitions are reported.

Equity Financing Activity

The number of reported venture capital financings increased by 3%, from 4,129 in 2016 to 4,259 in 2017. Once all financings are counted, the total for 2017 should approach the 4,561 deals in 2016—the highest level since 2000.

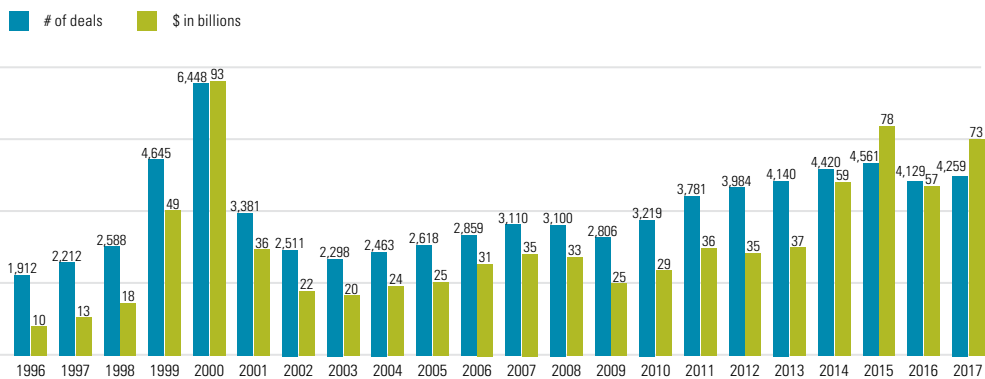
Total reported venture capital financing proceeds increased by 27%, from \$57.4 billion in 2016 to \$73.2 billion in 2017.

Adjusting for the normal lag in deal reporting, deal value increased each successive quarter in 2017, and is likely to surpass the \$77.7 billion total for 2015 once all 2017 financings are accounted for.

Overall, the median size of venture capital financings increased by 13%, from \$5.0 million in 2016 to \$5.7 million in 2017—the highest level since 2008. The median size of first-round financings increased by 52%, from \$3.0 million in 2016 to \$4.6 million in 2017. The median size of second-round financings increased by 15%, from \$5.9 million in 2016 to \$7.5 million in 2017. Later-stage financings saw the largest dollar increase in median financing size, increasing by \$5.8 million, or 48%, from \$12.0 million in 2016 to \$17.8 million in 2017—the highest annual figure since 2000.

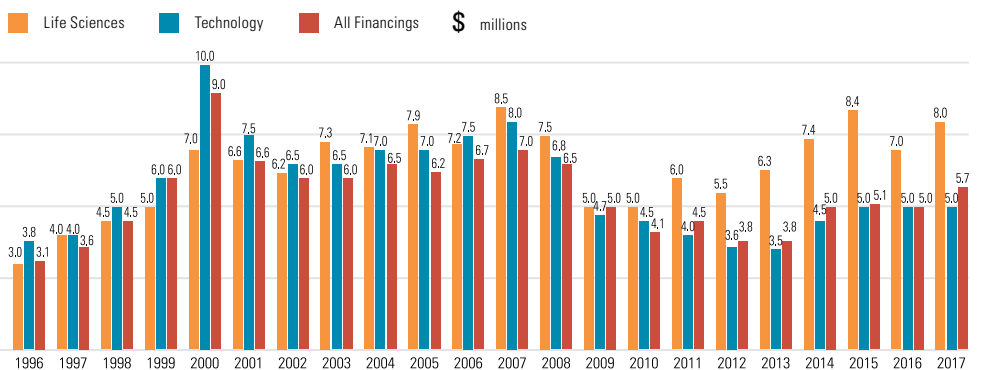
The median financing size for life sciences companies increased by 14%, from \$7.0 million in 2016 to \$8.0 million in 2017.

US Venture Capital Financings – 1996 to 2017



Source: Dow Jones VentureSource

Median Size of US Venture Capital Financings – 1996 to 2017



Source: Dow Jones VentureSource

Among technology companies, the median financing size was \$5.0 million for the third consecutive year, remaining significantly below the typical financing size prior to 2009. The general decline in the median financing size for technology companies in recent years is at least partly attributable to technological advances—such as cloud computing and open-source software—that have enabled startups to commence and grow their operations with less funding than historically required.

Between 2012 and 2015, the number of very large financings increased dramatically, as venture-backed companies increasingly relied on IPO-sized later-stage rounds of financing, sometimes with the intention of eschewing the public markets entirely. The number of financing rounds of at least

\$50 million increased from 81 in 2012 to 283 in 2015. Following a sharp decline to 184 rounds in 2016, the number of financing rounds of at least \$50 million rebounded in 2017 to 279—just shy of the 2015 tally. Similarly, the number of financing rounds of at least \$100 million—which increased from 19 in 2012 to 103 in 2015 and then declined by almost one half, to 52, in 2016—recovered to end 2017 only one short of the 2015 total.

The increases in super-sized rounds have been driven largely by private equity, crossover and hedge funds, which are attracted to pre-IPO companies that can offer the potential for sizeable valuation increases and investment returns, especially when investors are able to negotiate ratchet provisions

guaranteeing them a minimum return at the time of an IPO, typically in the form of additional shares if the offering prices below a specified price.

There were four billion-dollar financing rounds in 2017, equal to the number in 2016. This elite club was led by WeWork, with a \$3.1 billion financing from SoftBank, topping WeWork's \$430 million round in 2016 and its \$434 million round in 2015.

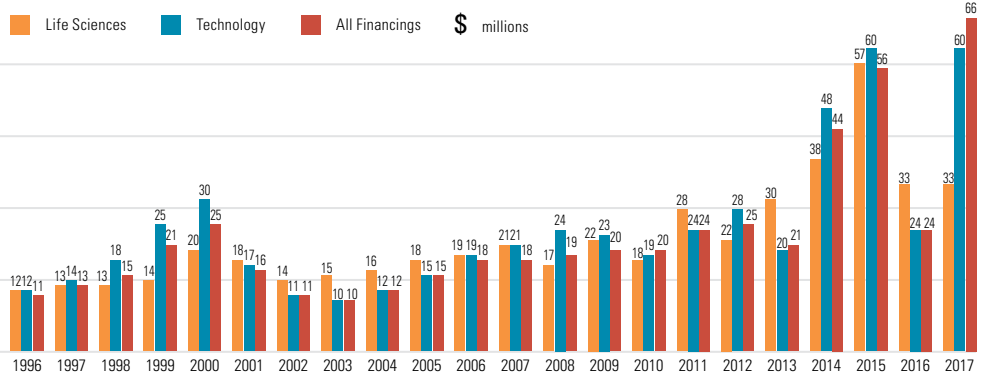
The other billion-dollar financings in 2017 came from Lyft (with a \$1.5 billion round led by CapitalG, the venture investment arm of Google's corporate parent, Alphabet), Grail (with a \$1.2 billion round primarily from undisclosed private and strategic investors) and NextEV (with a \$1.0 billion round led by Chinese search engine giant Baidu).

The median pre-money valuation for all venture financings more than doubled from \$24.0 million in 2016 to a record \$66.0 million in 2017—surpassing the prior high of \$56.3 million in 2015—primarily because of higher valuations in the consumer products and services sector. The median pre-money valuation in the technology sector jumped from \$23.5 million in 2016 to \$60.0 million in 2017. Among life sciences companies, the median pre-money valuation inched down from \$33.0 million in 2016 to \$32.7 million in 2017—well below the sector's record high of \$56.9 million in 2015.

Although the reported 2017 figures are likely understated, the number of seed venture capital equity financings increased 60% from 2016 to 2017, while the number of first-round financings dropped by 31%. The combined number of seed and first-round financings declined for the fifth consecutive year, accounting for 39% of all venture financings in 2017—compared to 48% in 2012. The number of second-round financings decreased by 19% from 2016 to 2017, and the number of later-stage financings declined by 21%.

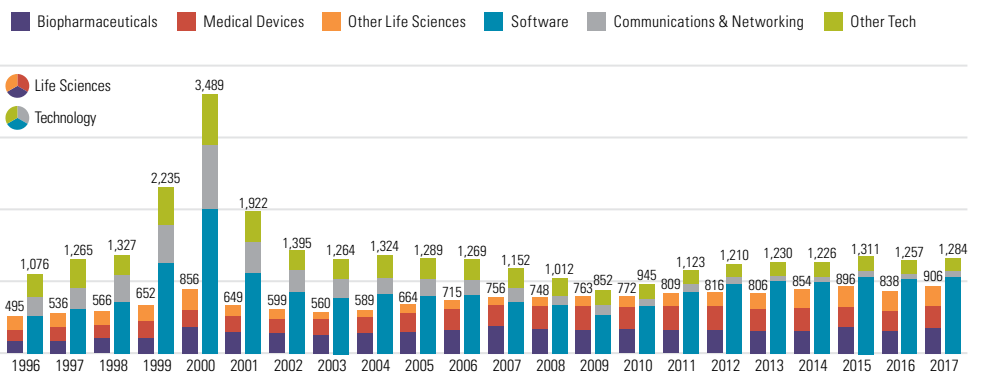
Proceeds from seed and first-round equity financings represented 17% of all venture capital financing proceeds in 2017, down from 19% in 2016. Proceeds from second-round equity financings accounted for 18%

Median Pre-Money Valuation in US Venture Capital Financings – 1996 to 2017



Source: Dow Jones VentureSource

US Venture Capital Financings by Industry – 1996 to 2017



Source: Dow Jones VentureSource

of all venture capital financing proceeds in 2017, while 53% of the year's proceeds were attributable to later-stage equity financings.

The technology sector accounted for 30% of the year's transactions in 2017, equal to the sector's market share in 2016. The business and financial services sector saw its market share decline for the second consecutive year, from 24% in 2016 to 22% in 2017. The market share for life sciences companies increased for the fourth year in a row, from 20% to 21%.

California—which has led the country in financing activity in each year since 1996—produced 42% of all venture financing transactions in 2017 (1,772 financings) and 53% of the year's proceeds (\$38.9 billion). New York, home to companies with 589 financings raising \$10.8 billion

in 2017, finished second in the state rankings, followed by Massachusetts (with 345 financings raising \$7.3 billion), Texas (with 181 financings raising \$1.57 billion) and Washington (with 179 financings raising \$1.72 billion).

Liquidity Activity

The number of venture-backed US issuer IPOs increased by 28%, from 39 in 2016 to 50 in 2017. The largest VC-backed US issuer IPO of 2017 was the \$3.4 billion offering of Snap—the largest VC-backed IPO since Facebook's epic \$16.0 billion offering in 2012—followed by the IPOs of Blue Apron Holdings (\$300 million), Denali Therapeutics (\$250 million) and Cloudera (\$225 million).

In 2017, 56% of all VC-backed IPOs were by life sciences companies, down from 60% in

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2016 and 68% in 2015. The VC-backed IPO market share for technology companies increased for the second consecutive year—growing from 30% in 2015 to 36% in 2016, and to 42% in 2017—but remained well short of the sector’s 60% market share over the five-year period from 2010 to 2014.

The median amount of time from initial funding to an IPO increased from 7.2 years in 2016 to 7.5 years in 2017—the highest annual level since the 8.1 years in 2010.

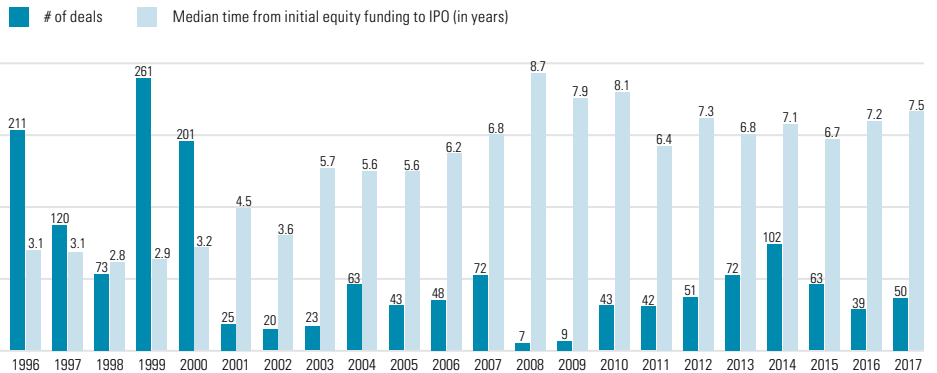
The median amount raised prior to an IPO increased by 7%, from \$92.0 million in 2016 to \$98.4 million in 2017, and the median pre-IPO valuation increased by 49%, from \$232.2 million to \$347.0 million. As a result, the ratio of pre-IPO valuations to the median amount raised prior to an IPO by venture-backed companies going public increased to 3.5:1, its highest level in the last five years, up from 2.5:1 in 2016 (a higher ratio means better returns to pre-IPO investors). The ratio was between 3.2:1 and 5.6:1 for each year from 2001 to 2012, other than a spike to 9.0:1 in 2009 based on a very small sample size of VC-backed IPOs that year. In contrast, this ratio ranged from 7.5:1 to 10.0:1 from 1997 to 2000, due to very large pre-IPO valuations by younger companies.

The number of reported acquisitions of VC-backed companies dipped by 2%, from 613 in 2016 to 600 in 2017. Once all acquisitions are accounted for, however, the 2017 tally is likely to surpass the number in 2016 and set a new record. Total reported proceeds declined by 13%, from \$88.0 billion in 2016 to \$76.4 billion in 2017—still the fourth-highest annual level, behind the \$97.8 billion figure in 2000 at the height of the dot com boom, the \$86.6 billion in 2014, and the 2016 total.

The median acquisition price for venture-backed companies increased by 8%, from \$92.4 million in 2016 to \$100.0 million in 2017—equaling the record set in 2000.

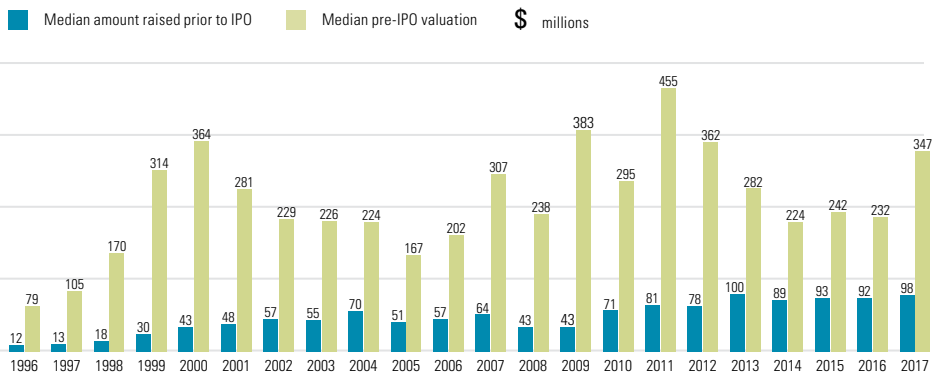
The median amount of time from initial funding to acquisition declined from 5.2 years in 2016 to 4.9 years in 2017, representing the second-shortest median since 2005.

Venture Capital–Backed IPOs and Median Time to IPO – 1996 to 2017



Source: Dow Jones VentureSource and SEC filings
The above chart is based on US IPOs by VC-backed US issuers.

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1996 to 2017



Source: Dow Jones VentureSource

The median amount raised prior to acquisition declined by 3%, from \$12.6 million in 2016 to \$12.2 million in 2017. The ratio of median acquisition price to median amount raised prior to acquisition increased from 7.3:1 in 2016 to 8.2:1 in 2017 (a higher ratio means higher returns to pre-acquisition investors). In 2017, this ratio represented the highest annual figure since the ratio of 10.0:1 in 2000, at the apex of the dot-com delirium. The increase in this ratio stemmed from significantly higher acquisition prices, coupled with historically low investment levels prior to acquisition.

There were 19 VC-backed company acquisitions for at least \$500 million in 2017, up from 17 in 2016 and equal to the 2015 count. The largest deal of 2017 was Cisco Systems’ \$3.70 billion

acquisition of AppDynamics, signed on the cusp of its IPO. There have been eight billion-dollar acquisitions of VC-backed companies each year since 2015.

The above comparison of the ratios of valuations to the financing amounts required to achieve liquidity events indicates that—for the fifth consecutive year—returns to venture capital investors in 2017 were higher in M&A transactions than in IPOs. Furthermore, venture investors generally achieve liquidity more rapidly in an M&A transaction (which frequently yields the bulk of the purchase price in cash at closing) than in an IPO (which generally involves a post-IPO lockup period of 180 days and market uncertainty on the timing and prices of subsequent stock sales).

When combined with the typically shorter timeline from initial funding to liquidity for M&A transactions (4.9 years in 2017) than for IPOs (7.5 years in 2017), these data points underscore why venture capitalists often prefer a company sale to an IPO. For example, although the ratio of M&A transactions to IPOs for venture-backed companies declined from 15.7:1 in 2016 to 12.0:1 in 2017, it still represented the second-highest ratio in the last five years.

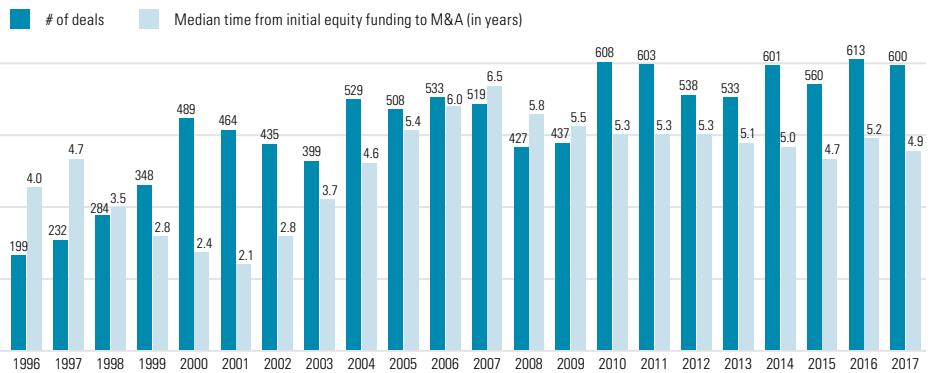
Although company sales far outpace IPOs as liquidity events, the average 2017 VC-backed IPO gained 35% during the year, with 64% of IPO companies trading above their offering price at year-end—illustrating that investor gains from a liquidity event do not end with an IPO.

OUTLOOK

The venture capital market began the year on a strong note, building on the momentum from the end of 2017. Results for the balance of 2018 will depend on a variety of factors, including the following:

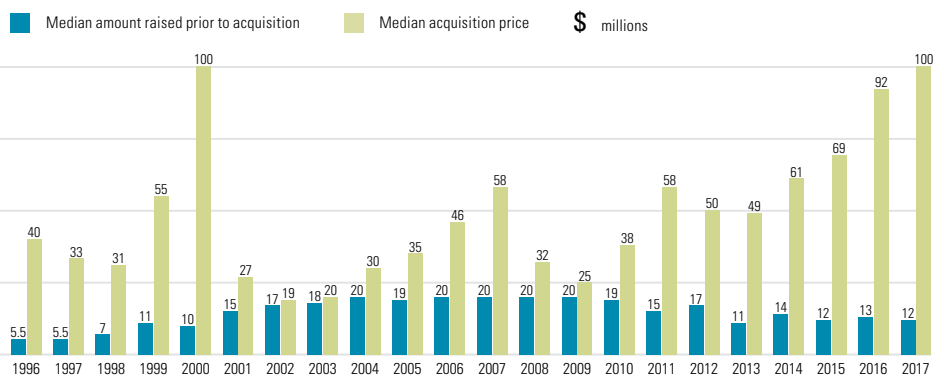
- *Financing Activity:* Deal flow in the coming year should benefit from several tailwinds, including favorable macroeconomic conditions; ample amounts of venture capital; expansion of corporate and strategic venture investing; and the willingness of buyers to pay attractive prices in acquisitions. However, financing activity could slow if 2017’s decline in venture capital fundraising persists, if economic growth stalls, or if investors are deterred by the sharp increases in valuations across most sectors last year. Despite potential headwinds, early results are encouraging, with the first quarter of 2018 seeing higher levels of financings, proceeds and venture capital fundraising than the fourth quarter of 2017.
- *IPOs:* Although it was intended to encourage emerging growth companies (EGCs) to go public, the JOBS Act—combined with other changes in regulatory requirements and the availability of large amounts of private investment capital—has made it easier for “unicorns” and other EGCs to stay private longer. As a result, many EGCs—particularly in the technology industry—have opted to delay their

Acquisitions of US Venture-Backed Companies and Median Time to M&A – 1996 to 2017



Source: Dow Jones VentureSource

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1996 to 2017



Source: Dow Jones VentureSource

public debuts, often relying on private “IPO-sized” rounds to meet their financing needs. Nonetheless, investor needs for cash returns, coupled with the attractive valuations and solid aftermarket performance of VC-backed IPOs in 2017, should prompt additional VC-backed IPOs in 2018. The number of VC-backed IPOs declined from the fourth quarter of 2017 to the first quarter of 2018, but still represented the third-highest quarterly tally since the beginning of 2016.

- *Acquisitions:* Public company balance sheets remain flush with cash, helping strategic acquirers supplement organic growth through acquisitions. Debt-financed acquisitions may, however, become more expensive due to a combination of rising interest rates and limitations on the deductibility of business interest under the new tax

law. M&A activity in the coming year will also depend in part on valuation trends. Preliminary data suggests that the number and value of VC-backed company acquisitions may have declined modestly from the fourth quarter of 2017 to the first quarter of 2018.

- *Attractive Sectors:* Companies offering products that leverage blockchain technology, AI, machine learning and voice technology, especially in the enterprise environment, should continue to attract funding in 2018. Other industries that should receive significant investment include security, robotics, consumer product e-commerce, agtech, fintech, and healthcare IT. Life sciences companies with compelling market opportunities—such as those in immunology and gene therapy—should also continue to appeal to investors. ■

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CALIFORNIA

California companies reported 1,772 financings in 2017, up 2% from the 1,739 financings in 2016. Total proceeds increased by 27%, from \$30.7 billion in 2016 to \$38.9 billion in 2017.

The growth in proceeds was largely attributable to an increase in very large financing rounds. The number of rounds raising \$50 million or more increased by 50%, from 103 in 2016 to 154 in 2017, while the number of rounds raising \$100 million or more soared from 28 to 57. The state's—and the country's—largest financing in 2017 was Lyft's \$1.5 billion round.

California-based companies accounted for 55% of all financing rounds in the country raising \$50 million or more in 2017, down slightly from 56% in 2016. Overall, California was responsible for 42% of all financing transactions in the country in 2017, equal to the 2016 figure.

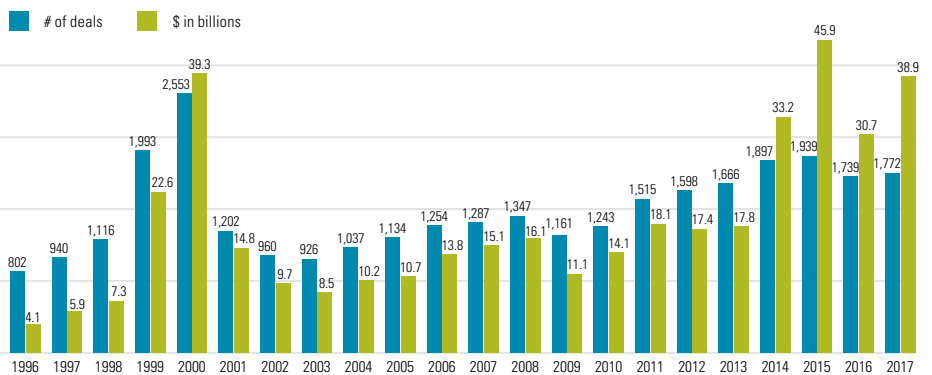
Technology was the largest sector in the state, producing 34% of all California financings in 2017, followed by consumer goods and services (26%), business and financial services (19%) and life sciences (17%).

The number of IPOs by California-based VC-backed companies increased from 12 in 2016 to 18 in 2017. California was home to all but one of the six largest VC-backed IPOs by US issuers in 2017, the largest being the \$3.4 billion IPO from Snap, followed by Denali Therapeutics (\$250 million) and Cloudera (\$225 million).

The number of reported acquisitions of California VC-backed companies dipped 3%, from 267 in 2016 to 259 in 2017. The state's largest deals were the \$3.70 billion acquisition of AppDynamics by Cisco Systems—also the nation's largest in 2017—and the \$1.4 billion acquisition of SquareTrade by Allstate.

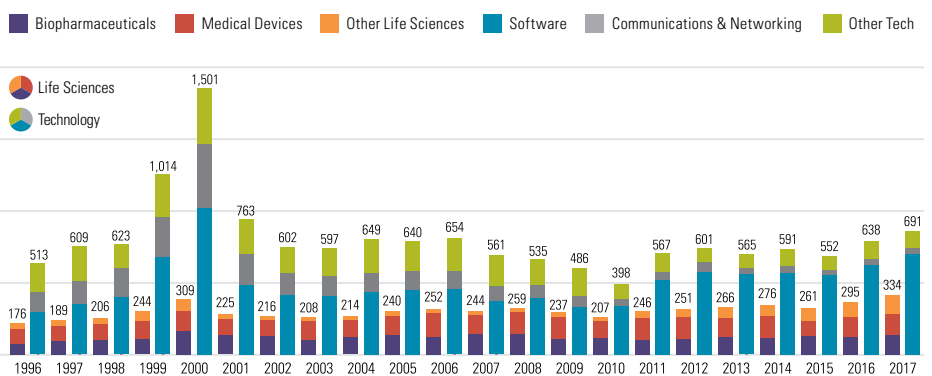
California will undoubtedly maintain its venture capital leadership in the coming year. Financing and liquidity activity in 2018 will largely depend on the level of venture capital fundraising, the willingness of strategic buyers to continue to pay attractive prices, and overall IPO market conditions.

California Venture Capital Financings – 1996 to 2017



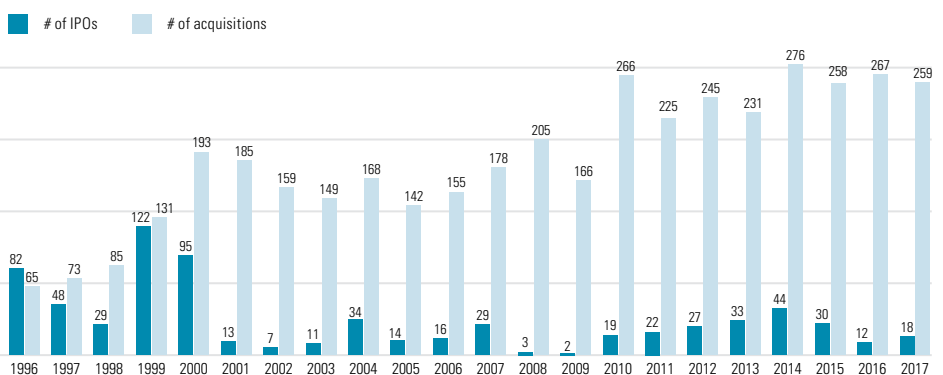
Source: Dow Jones VentureSource

California Venture Capital Financings by Selected Industry – 1996 to 2017



Source: Dow Jones VentureSource

California Venture-Backed IPOs and Acquisitions – 1996 to 2017



Source: Dow Jones VentureSource

MID-ATLANTIC

With 291 rounds, the number of reported 2017 venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia represented a 46% increase from the 200 financings in 2016. Total proceeds jumped by 73%, from \$1.76 billion in 2016 to \$3.04 billion in 2017.

The number of financings and amount of proceeds in 2017 represented the highest levels in the region since 2000.

North Carolina led the mid-Atlantic region with 87 financings and \$968.5 million in proceeds in 2017, supplanting last year's leader, Virginia, in both categories.

The number of mid-Atlantic financing rounds raising \$50 million or more increased from five in 2016 to eight in 2017, led by AvidXchange (\$300 million), Precision Medicine Group (\$275 million) and EverFi (\$190 million).

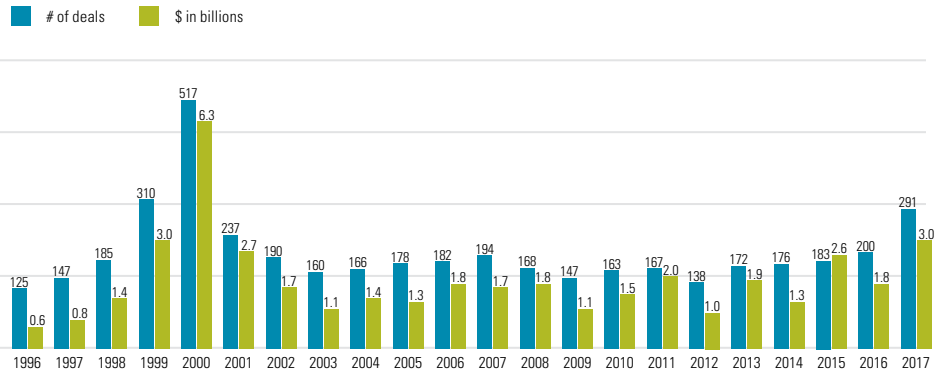
Technology companies accounted for 34% of all mid-Atlantic financings in 2017—extending the tech sector's longstanding leadership in the region—followed by life sciences companies (26%) and business and financial services companies (23%).

The region produced four VC-backed IPOs in 2017—three from North Carolina and one from Virginia—to double the prior year's tally. The largest VC-backed IPOs in the region, each hailing from North Carolina, were by G1 Therapeutics (\$105 million) and Bandwidth (\$80 million).

The number of reported acquisitions of mid-Atlantic VC-backed companies declined by 13%, from 38 in 2016 to 33 in 2017, of which Virginia contributed 13. The region's largest M&A transaction of the year was the \$200 million acquisition of Vtesse by Sucampo Pharmaceuticals, followed by the \$170 million acquisition of Greensmith Energy Management Systems by Wärtsilä.

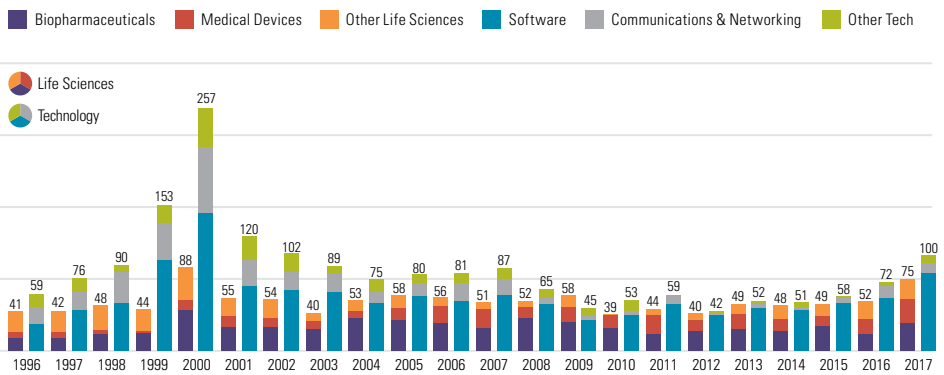
Assuming market conditions are conducive, the mid-Atlantic region should enjoy continued growth in financing and IPO activity in 2018, led by the region's continuing strength in technology and life sciences.

Mid-Atlantic Venture Capital Financings – 1996 to 2017



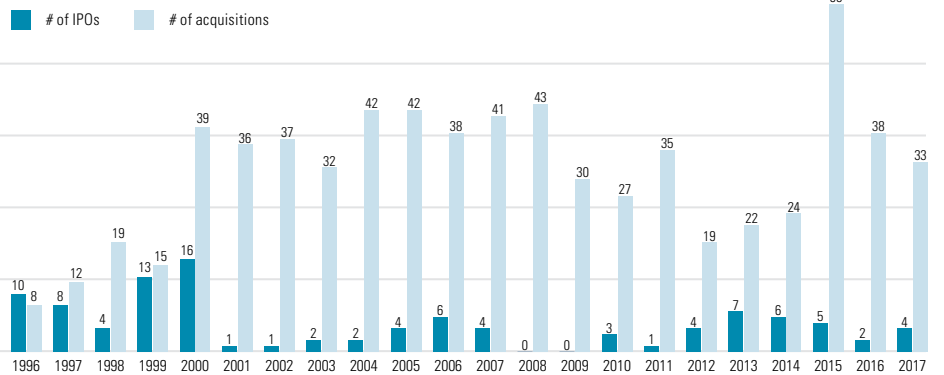
Source: Dow Jones VentureSource

Mid-Atlantic Venture Capital Financings by Selected Industry – 1996 to 2017



Source: Dow Jones VentureSource

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1996 to 2017



Source: Dow Jones VentureSource

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NEW ENGLAND

New England companies reported 413 venture capital financings in 2017—the highest annual tally for the region since the dot-com boom years—up 15% from 358 financings in 2016. Total proceeds increased by 27%, from \$5.69 billion in 2016 to \$7.21 billion in 2017—the second-highest annual figure for the region since 2000.

Massachusetts, the perennial leader in New England and the nation's third-largest source of VC financings, led the region in 2017 with 345 financings and \$6.62 billion in proceeds.

The number of financing rounds in New England raising \$50 million or more jumped from 25 in 2016 to 40 in 2017. The region's largest financing in 2017 came from Ginkgo Bioworks (\$275 million).

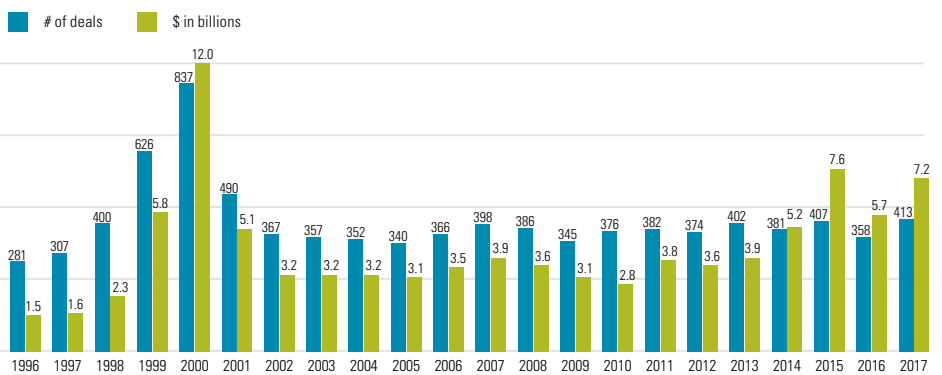
For the ninth consecutive year, the number of financings by life sciences companies outpaced the number of financings by technology companies. The life sciences sector represented 40% of New England's venture capital financings, followed by technology (27%) and consumer goods and services (17%).

The number of venture-backed IPOs by New England-based companies increased from nine in 2016 to 14 in 2017—13 from Massachusetts and one from Connecticut. All but two of the year's IPOs were by life sciences companies, including the largest, by Biohaven Pharmaceutical (\$168 million), followed by tech company CarGurus (\$150 million).

The number of reported acquisitions of VC-backed companies in New England increased from 64 in 2016 to 69 in 2017, of which 53 were contributed by Massachusetts. The region's largest M&A transaction of the year was the \$705 million acquisition of Vention Medical's Advanced Technologies business by Nordson.

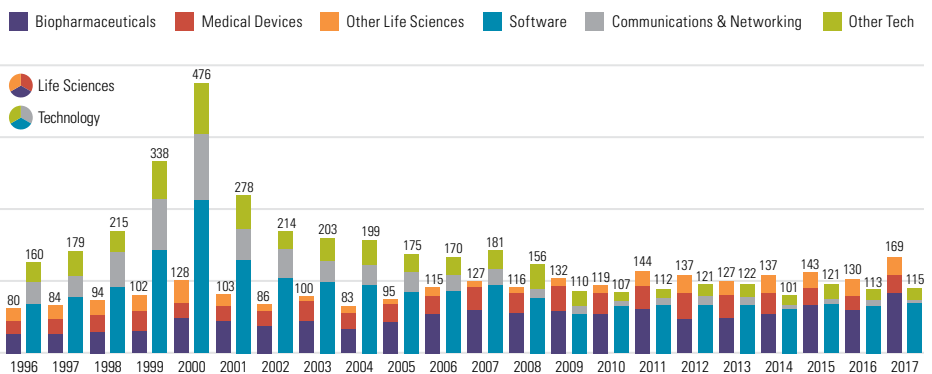
With its concentration of world-renowned universities and research institutions, New England—and Massachusetts in particular—should remain one of the country's most appealing environments for emerging companies and a hub of venture capital and IPO activity during 2018, particularly in the life sciences and technology sectors.

New England Venture Capital Financings – 1996 to 2017



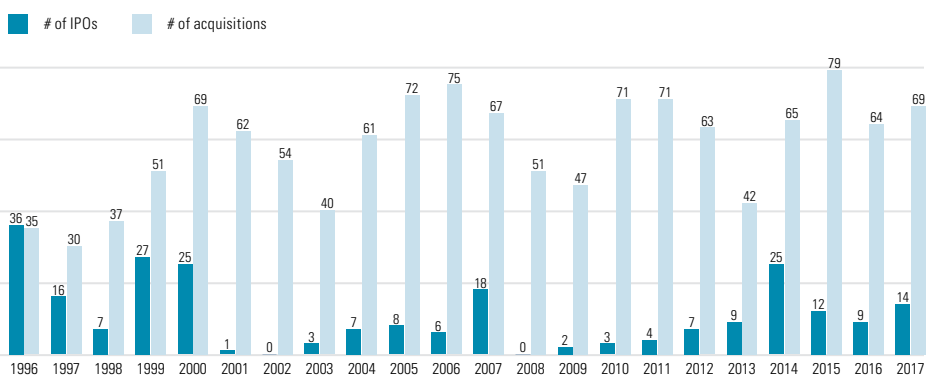
Source: Dow Jones VentureSource

New England Venture Capital Financings by Selected Industry – 1996 to 2017



Source: Dow Jones VentureSource

New England Venture-Backed IPOs and Acquisitions – 1996 to 2017



Source: Dow Jones VentureSource

TRI-STATE

The number of reported venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania increased by 19%, from 641 in 2016 to 745 in 2017. Total proceeds in the region increased 57%, from \$7.83 billion in 2016 to \$12.26 billion in 2017.

New York, the nation’s second-largest source of VC financings, led the tri-state region in 2017 with 589 financings and proceeds of \$10.78 billion.

The number of financing rounds in the tri-state region raising \$50 million or more increased from 28 in 2016 to 40 in 2017. The region’s largest financing for the third year in a row came from WeWork (\$3.1 billion), followed by Urban Compass (\$550 million), Peloton Interactive (\$325 million) and Harmony Biosciences (\$270 million).

Consumer goods and services companies accounted for the largest share of the tri-state region’s VC financing activity in 2017, with 32% of all financings, followed by technology companies with 28% and life sciences companies with 18%.

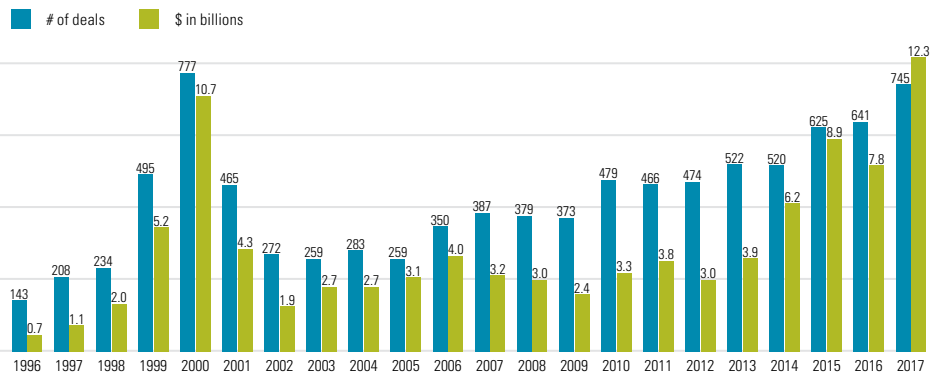
The number of VC-backed IPOs in the tri-state region increased from three in 2016 to eight in 2017. New York produced six of the region’s VC-backed IPOs—the highest annual figure for the state since 1999. The region’s largest VC-backed IPO was from New York-based Blue Apron Holdings (\$300 million), followed by New York-based MongoDB (\$192 million) and Pennsylvania-based OptiNose (\$120 million).

Reported acquisitions of venture-backed companies in the tri-state region decreased by 15%, from 119 in 2016 to 101 in 2017. New York generated a record 74 deals, followed by Pennsylvania (16) and New Jersey (11).

The region’s largest deal of 2017 was the \$3.75 billion acquisition of BAMTech by The Walt Disney Company, followed by the \$1.7 billion acquisition of Bai Brands by Dr Pepper Snapple Group.

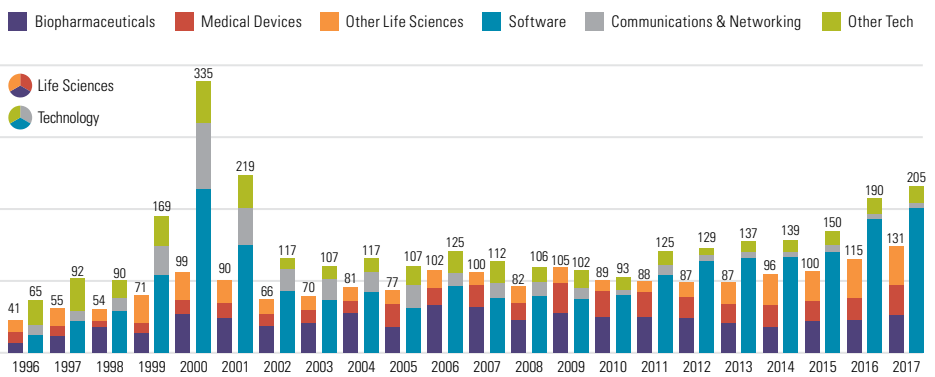
With strength across a broad array of industry sectors, including consumer, technology and life sciences, financing and liquidity activity in the tri-state region should continue to flourish in 2018. ■

Tri-State Venture Capital Financings – 1996 to 2017



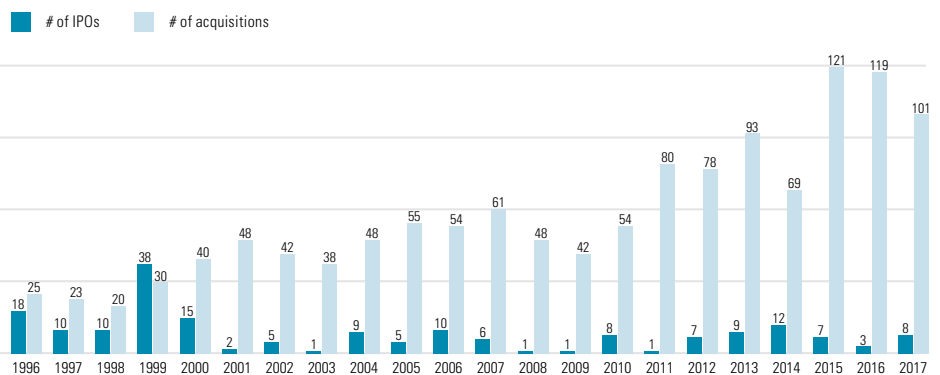
Source: Dow Jones VentureSource

Tri-State Venture Capital Financings by Selected Industry – 1996 to 2017



Source: Dow Jones VentureSource

Tri-State Venture-Backed IPOs and Acquisitions – 1996 to 2017



Source: Dow Jones VentureSource

10 Pre-IPO Crossover Financings

Private companies routinely rely on exemptions from the registration requirements of the Securities Act to complete private placements of securities. In recent years, the pre-IPO financing toolkit has been significantly expanded due to both legal changes (such as the creation of new exemptions from registration) and market changes (such as the emergence of new markets and investors for private financings).

An increasingly common financing strategy for pre-IPO companies is to conduct a “crossover” financing shortly before an IPO. Crossover financings are capital raises from investors that historically invest primarily in public companies, rather than from venture capital funds and other more traditional private company investors. Crossover financings provide unique benefits to both the company and the crossover investors beyond the cash infusion for the company and investment opportunity for the investors.

Crossover financings benefit companies looking to go public in the near future by expanding their stockholder base prior to the IPO to include institutional public company investors—the type of investors that often buy shares in IPOs. The presence of these investors in the company significantly increases the likelihood that they will purchase a meaningful portion of the company’s IPO, providing a strong foundation for the offering. In addition, other potential investors often view the decision of recognizable public company investors to invest in a private company as a form of validation of the company and its business, further increasing the chances of a successful IPO.

At the same time, crossover financings benefit participating investors. By investing in a company prior to its IPO, crossover investors obtain a stake in the company at what is expected to be a lower valuation than the IPO price, place themselves in a better position to receive their desired allocations in the IPO, and have an opportunity to conduct the kind of in-depth diligence that is not possible for an investor in the IPO process.

While late-stage crossover financings come with significant potential benefits to both the company and the investors, these financings must be structured and implemented carefully to avoid potential securities law violations and to ensure that the company and investors are able to realize the anticipated benefits.

TIMING CONSIDERATIONS

Section 5 of the Securities Act provides that every offer or sale of securities, including in crossover rounds, must either be registered or made pursuant to an exemption from registration. When crossover rounds occur close in time to the IPO, care needs to be taken so that activities related to the IPO do not invalidate the exemption for the crossover round.

The use of “general solicitation” in a private financing can, with certain exceptions, invalidate an exemption, and the filing of a Form S-1 can itself be viewed as a general solicitation. However, as a result of the JOBS Act and subsequent changes in SEC staff review procedures, every company is now allowed to submit a Form S-1 for confidential or nonpublic review and delay public disclosure of its IPO plans until much later in the process. By doing so, companies may conduct a crossover round much closer to the time of the IPO without the risk that the Form S-1 itself will constitute an improper general solicitation.

Even after publicly filing a Form S-1, companies may still conduct a private financing under a valid exemption. If the company is looking to conduct a crossover round after publicly filing a Form S-1, the company should limit participation in the private financing to those investors with whom it had a meaningful relationship prior to the filing of the Form S-1.

As the private financing transaction and the IPO get closer together, there is a risk that the two offerings could be “integrated” for securities law purposes, whereby the private offering could be deemed to be part of the public offering in violation of Section 5 of the Securities Act. When two offerings occur within six months of each other, they must come within a regulatory safe harbor or otherwise comply with SEC

guidance to avoid integration. In a crossover financing, with the same investors expected to participate in both the private financing and the IPO, the integration risk is heightened. Moreover, when “test-the-waters” (TTW) meetings are held concurrently with or prior to a crossover financing, the risk of integration between the two offerings is increased. (Under the JOBS Act, “emerging growth companies” may hold TTW meetings with eligible institutional investors to gauge their interest in a proposed securities offering.)

Due to the risk of invalidating an exemption from registration when a crossover financing and IPO occur close in time, the company should keep good records regarding how and when investors were solicited, and meetings with investors should be carefully planned and vetted by counsel in advance.

IPO PARTICIPATION RIGHTS

In traditional private financings, investors are granted the contractual right to participate in future private financings, usually on a pro rata basis. In late-stage financing rounds, investors may also request the right to purchase shares in the IPO, which can be particularly attractive to crossover investors and are often sought in crossover rounds. However, the grant of IPO participation rights may, particularly if granted less than 12 months prior to the IPO, be deemed to be an “offer” of the IPO securities in violation of Section 5 of the Securities Act. As crossover financings are often conducted with an expectation that an IPO will occur within 12 months, companies need to carefully structure IPO participation rights to avoid a Section 5 violation.

A common solution is to grant investors the right to participate in the IPO only “if permissible under the securities laws” or, if not, the right to invest in a concurrent private placement on terms substantially similar to the IPO. From the standpoint of crossover investors, purchasing shares through a concurrent private placement may be less attractive because the shares received will be unregistered and subject

to minimum holding periods before any public resale, whereas shares purchased in the IPO would be registered and immediately transferrable (subject to any applicable post-IPO lockup agreement). In addition, any potential marketing benefits of naming the crossover investors in the roadshow may be decreased by stating that they will be participating in a concurrent private placement.

INVESTOR DILIGENCE PRIOR TO IPO

A key benefit to investing in a private round, as compared to a public offering, is an investor's ability to conduct its own diligence. This is especially important if the company's technology is difficult to understand or its intellectual property positions are complicated. In an IPO, while the underwriters will conduct in-depth diligence, the company generally can provide investors only with information that is described or contained in the Form S-1. And, although crossover investors are likely to be invited to attend IPO roadshow meetings, company responses to investor questions at those meetings will not stray materially beyond the substance of the disclosures in the Form S-1.

As a crossover round gets closer to the IPO time frame, and in particular if there is a possibility that the crossover round will not occur and the company will proceed directly with the IPO, the company must be careful with exactly how much information it provides, and when it provides such information, to crossover investors. If the company provides access to written diligence materials to an investor, but no crossover round materializes and the company instead moves directly into the IPO process, there will be a risk that those written materials constitute a written offer of the IPO securities prior to the public filing of the Form S-1 in violation of Section 5. To mitigate this risk, the company should keep the diligence process for the private financing separate from the diligence process for the IPO, take steps to make clear that any written diligence materials are used solely for the crossover financing, and cut off investor access to the diligence

materials once the crossover round ends or the company determines not to proceed with the private financing. If the company is in the process of drafting its Form S-1 at the same time it is meeting with potential crossover investors, the company should also make sure that any offering materials or presentations to investors are generally consistent with what the Form S-1 will ultimately say.

DISCLOSURE OF IPO PLANS TO CROSSOVER INVESTORS

In crossover rounds, investors take the risk that they will not have immediate liquidity for their shares. As a result, crossover investors have a strong interest in making sure the company's IPO occurs on a relatively short timeline, and may press for rights that keep them informed about the status of the company's financing decisions and expectations through board representation, board observer rights or other contractual rights. In addition, as part of the IPO process, the company will likely need to obtain stockholder consents and lockups and obtain required information from its large pre-IPO stockholders prior to any public disclosure of the IPO.

The company needs to structure its investor communications to satisfy these obligations without violating the "quiet period" restrictions that are intended to prevent a company from soliciting offers for an IPO prior to publicly filing a registration statement. The company should also ensure that crossover investors are required, and informed of their obligation, to maintain the confidentiality of the information they receive as investors.

DISCLOSURE OF CROSSOVER INVESTORS IN IPO

An important benefit of a crossover round for a company is the validation of the company that the investments can convey to the market in the IPO process. To reap this benefit, the company will often want to identify the crossover investors in its TTW meetings, Form S-1 and roadshow. While there is an obligation to disclose certain information in the Form S-1

about 5% stockholders, this obligation generally will not extend to smaller crossover investors, so the company will need to obtain consent from those investors prior to identifying them in the Form S-1 or roadshow. Ideally a company will obtain consent up front as part of the crossover financing process. When seeking consent for any IPO disclosure, the company will need to be careful in how and what it communicates, in order to avoid quiet period violations and keep information about the IPO confidential.



































Another company benefit from a crossover round is the ability to show, prior to TTW meetings or the roadshow, that a significant portion of the IPO is likely to be taken by existing stockholders, which can establish momentum for the roadshow. This is usually done by obtaining indications of interest from stockholders prior to the roadshow and disclosing these indications of interest in the Form S-1. While these indications of interest cannot be binding obligations to purchase, the market generally understands the significance of indications of interest. Given the prominent disclosure of these indications of interest and the market expectations they create, the company needs to be confident that the identified stockholders will honor their indications of interest and be careful, in discussing with stockholders their potential investments, not to cross the line into an impermissible offer or sale.

CONCLUSION

Crossover financings are an increasingly common and important step for many companies preparing for an IPO. When planned for and executed correctly, a crossover financing can be a significant boon to a company, both from a valuation and a fundraising perspective. At the same time, there are multiple potential legal traps for the unprepared company or investor, particularly as transaction timing and process change. Any company considering a crossover financing in advance of an IPO should work with counsel to ensure that both transactions are structured to achieve the company's desired goals and avoid legal pitfalls along the way. ■

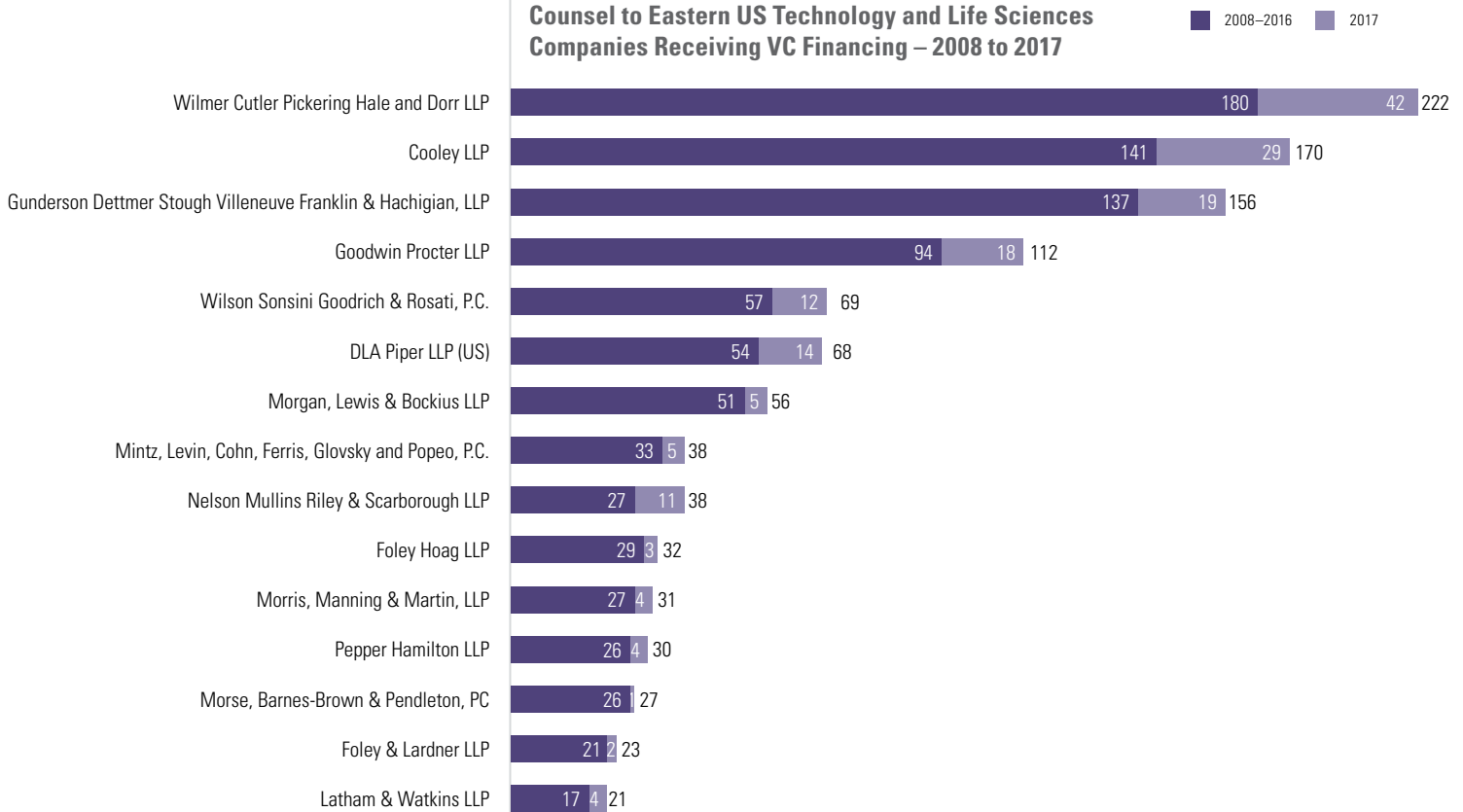
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 <p>generation bio</p> <p>\$100,000,000 Second Round February 2018</p>	 <p>UNIFY ID</p> <p>\$20,000,000 First Round May 2017</p>	 <p>ZAIUS</p> <p>\$30,000,000 Second Round March 2018</p>	 <p>ConsumerPhysics</p> <p>\$4,950,000 Third Round October 2017</p>	 <p>jebbit</p> <p>\$6,800,000 First Round July 2017</p>	 <p>ALCRESTA</p> <p>\$35,000,000 Third Round September 2017</p>	 <p>IMMUTA</p> <p>\$8,000,000 First Round February 2017</p>	 <p>PANDION</p> <p>\$58,000,000 First Round January 2018</p>	
 <p>SOFT ROBOTICS</p> <p>\$20,000,000 Second Round February 2018</p>	 <p>NANTERO</p> <p>\$29,700,000 Late Stage April 2018</p>	 <p>dirarm</p> <p>\$30,000,000 First Round August 2017</p>	 <p>Dedrone</p> <p>\$15,000,000 Second Round February 2017</p>	 <p>Cydan</p> <p>\$34,000,000 First Round September 2017</p>	 <p>nyansa</p> <p>\$15,000,000 Second Round December 2017</p>	 <p>mabl</p> <p>\$10,000,000 First Round February 2018</p>	 <p>skyword</p> <p>\$25,000,000 Late Stage December 2017</p>	 <p>ALTIOSTAR</p> <p>\$32,000,000 Late Stage January 2018</p>
 <p>embark</p> <p>\$6,700,000 First Round June 2017</p>	 <p>Capella Space</p> <p>\$14,900,000 First Round May 2017</p>	 <p>HYALEX</p> <p>\$16,000,000 First Round May 2017</p>	 <p>ThinkCerca</p> <p>\$10,100,000 Second Round May 2017</p>	 <p>STASH</p> <p>\$37,500,000 Fourth Round January 2018</p>	 <p>RIGHTHAND</p> <p>\$8,000,000 First Round March 2017</p>	 <p>DriveWealth</p> <p>\$21,000,000 Second Round November 2017</p>	 <p>trevi</p> <p>\$50,500,000 Third Round July 2017</p>	
 <p>KINDRED</p> <p>\$28,000,000 Second Round September 2017</p>	 <p>SnapApp</p> <p>\$10,200,000 Second Round June 2017</p>	 <p>ExecOnline</p> <p>\$16,000,000 Second Round July 2017</p>	 <p>coverwallet</p> <p>\$18,500,000 Second Round September 2017</p>	 <p>Apellis</p> <p>\$60,000,000 Late Stage August 2017</p>	 <p>YOSHI</p> <p>\$13,700,000 First Round December 2017</p>	 <p>Andela</p> <p>\$40,000,000 Third Round September 2017</p>	 <p>Visterra</p> <p>\$46,700,000 Third Round October 2017</p>	 <p>UNTUCKit</p> <p>\$30,000,000 First Round June 2017</p>

14 Law Firm Rankings – Eastern US

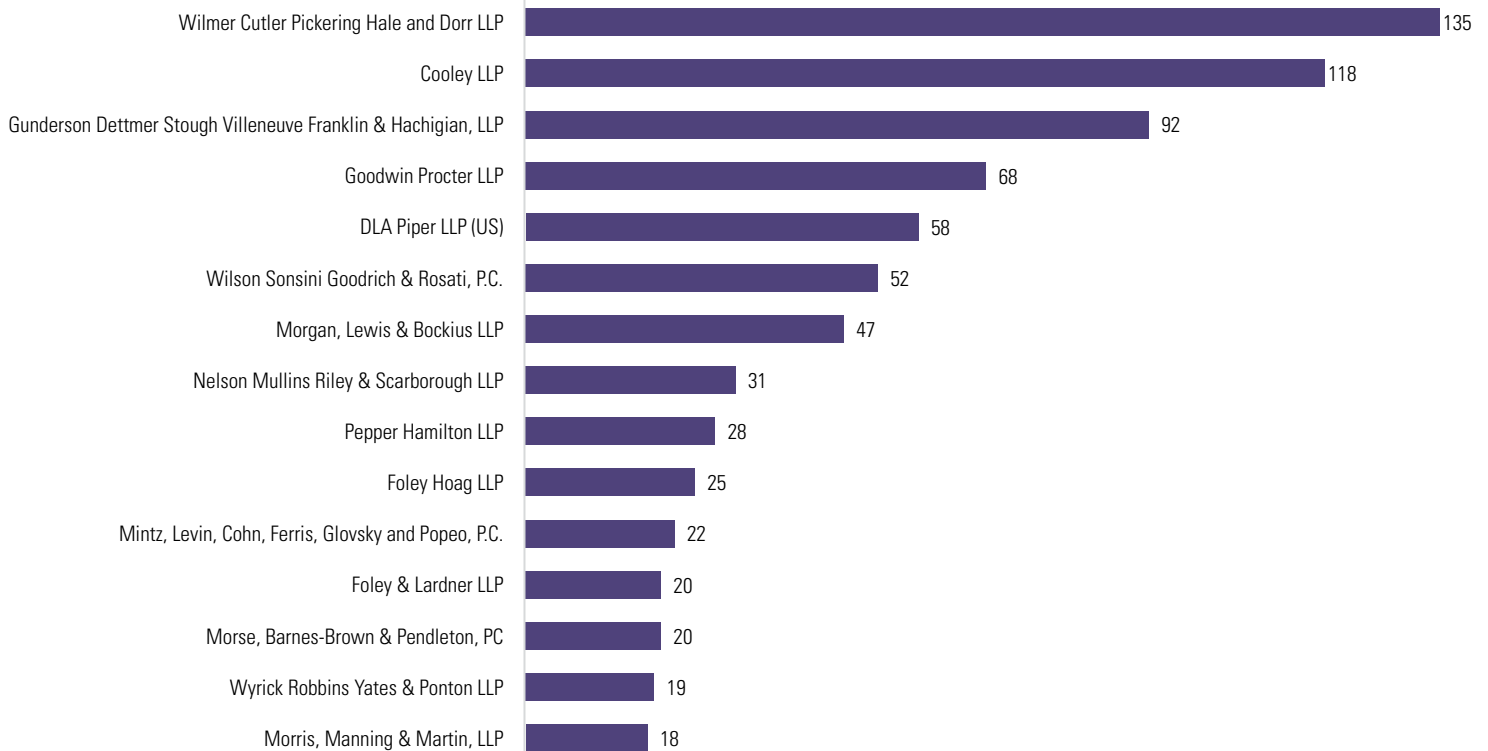
Counsel to Eastern US Technology and Life Sciences Companies Receiving VC Financing – 2008 to 2017



The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later-stage or restart round of venture capital financing between 2008 and 2017.

Source: Dow Jones VentureSource

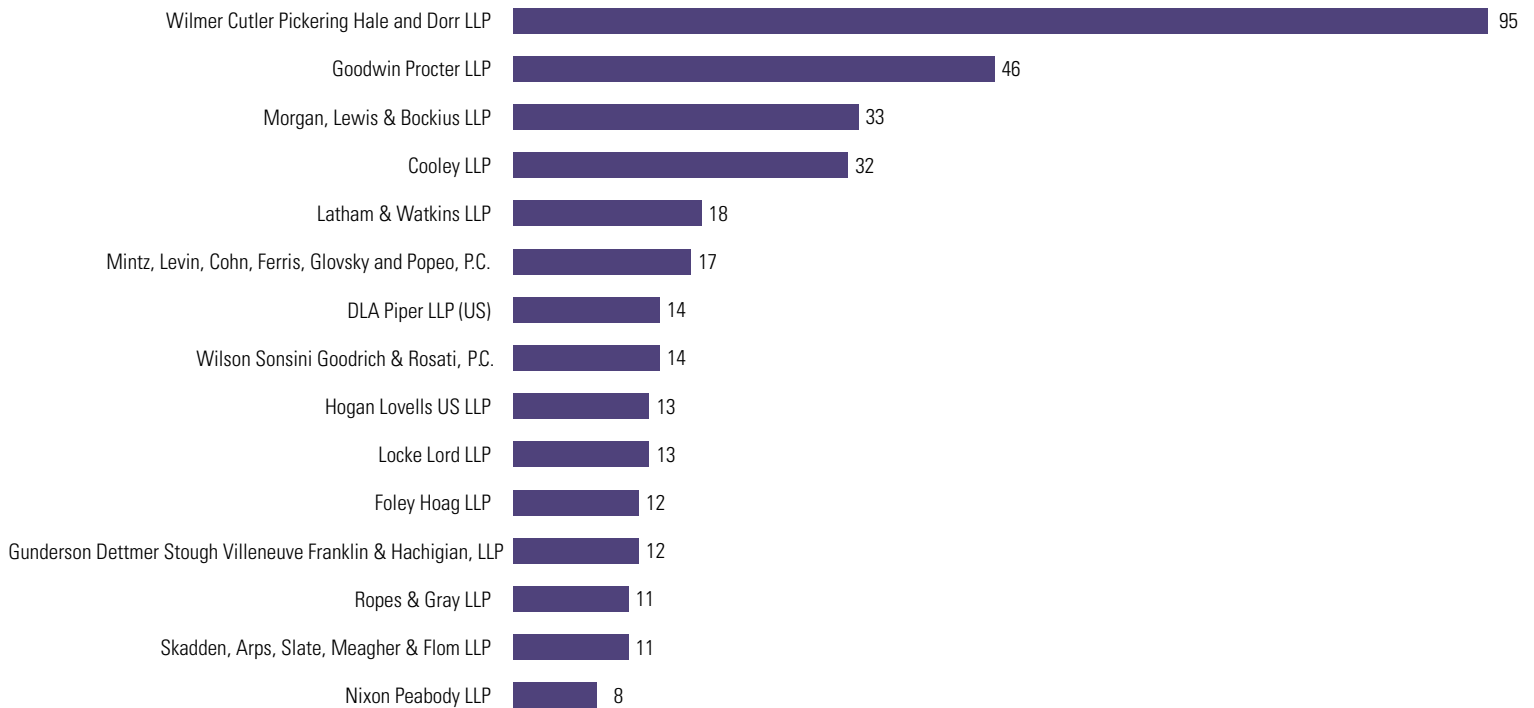
Counsel to Eastern US VC-Backed Technology and Life Sciences Companies at Year-End 2017



The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2017.

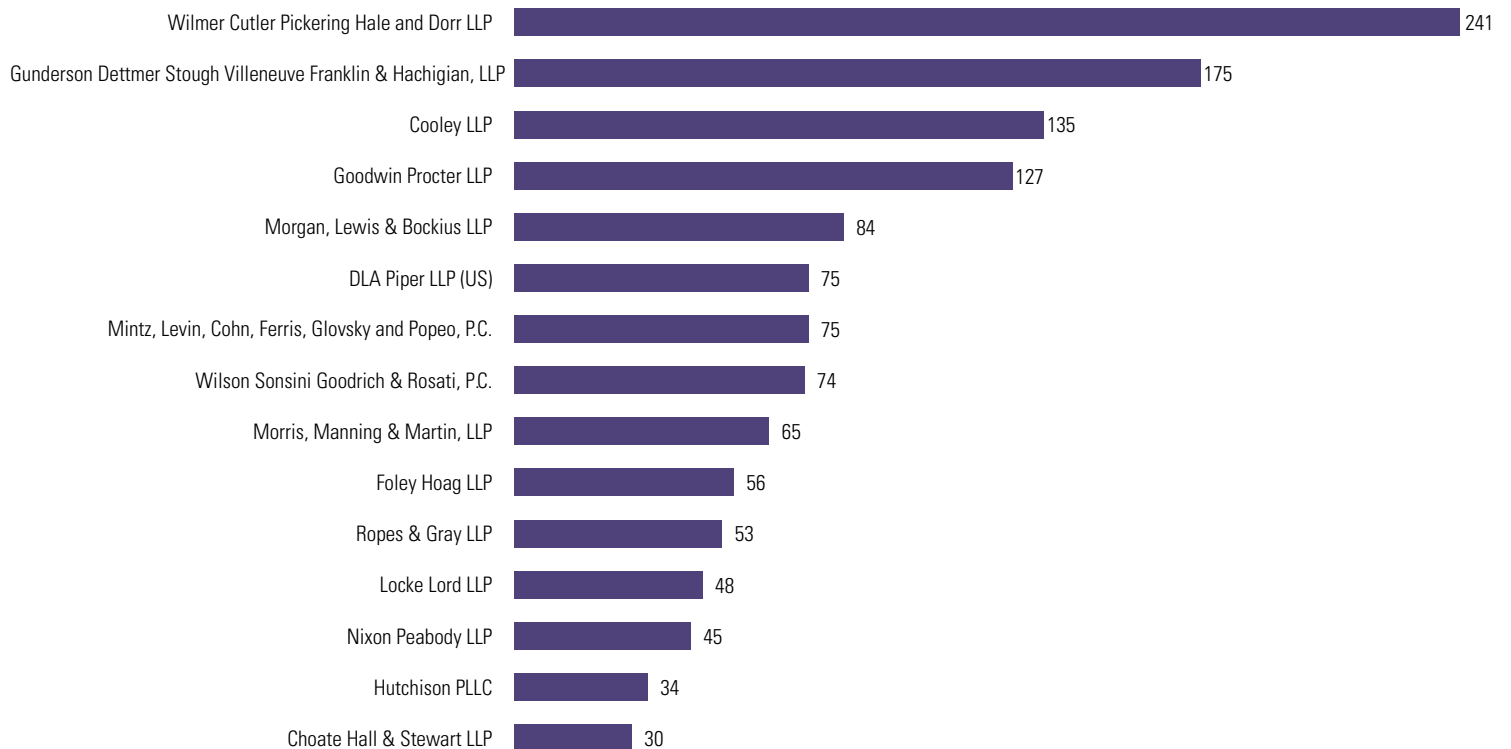
Source: Dow Jones VentureSource

Company Counsel in Eastern US VC-Backed IPOs – 1996 to 2017



*The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureSource and SEC filings*

Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2017



*The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureSource*

16 New Opportunity to Defer Income From Private Company Equity Grants

Last year's sweeping tax reform legislation made significant changes to the Internal Revenue Code with respect to taxation of executive compensation. One of those changes—new Section 83(i) of the tax code—may prove attractive to startup companies and their eligible employees, although the exact benefit of the provision will not be known until the IRS issues interpretive guidance and other uncertainties are resolved.

Section 83(b) of the tax code has long permitted recipients of *restricted stock* to elect to be taxed, immediately upon receipt of the shares, on the difference between the purchase price and the fair market value of the shares at that time rather than to be taxed on the (potentially larger) difference between value and purchase price as the shares vest. New Section 83(i) provides a similar opportunity with respect to *stock options* and *restricted stock units* (RSUs)—the ability of certain private company employees to elect to defer, solely for income tax purposes and for a period of up to five years, the income attributable to stock received upon the exercise of compensatory options or the issuance of shares in settlement of RSUs on or after January 1, 2018.

The potential tax deferral afforded by a Section 83(i) election could significantly benefit eligible holders of stock options and RSUs of private companies. However, the benefits may ultimately prove illusory and the section troublesome, depending upon future IRS guidance. And, importantly, most of a company's senior officers and its significant stockholders are not eligible to make a Section 83(i) election.

GENERAL REQUIREMENTS

Under the new provision, a “qualified employee” may make an election under Section 83(i) with respect to “qualified stock” within the 30-day period following the first date on which the employee's rights in the stock are transferable or are no longer subject to a substantial risk of forfeiture (i.e., are vested), whichever occurs earlier. Not all private company stock is “qualified stock” for purposes of Section 83(i), and not all employees are eligible to make a Section 83(i) election.

The statute provides that a Section 83(i) election will be made in a manner similar to the method under Section 83(b). If a Section 83(i) election is timely made, the amount that would have been included in income upon exercise or vesting of the award, as applicable, is deferred for income (but not payroll) tax purposes until the first to occur of the following:

- the qualified stock becomes transferable (including, for this purpose, to the employer itself);
- the employee becomes an excluded employee (described below);
- any of the corporation's stock becomes readily tradeable on an established securities market;
- the fifth anniversary of the employee's right to the stock becoming substantially vested; or
- the employee revokes the election.

When the deferral period ends, the amount deferred (disregarding any appreciation or depreciation in the value of the stock) will be treated as ordinary compensation income (i.e., not capital gain or loss) for purposes of income tax withholding and reporting.

QUALIFIED STOCK

In order for the stock issued upon exercise of an option or vesting of an RSU to be “qualified stock,” the equity award must have been granted to the employee by the employer-corporation in connection with the performance of services by such person as an employee in a year in which the employer-corporation was an “eligible corporation.” An eligible corporation is any corporation:

- the stock of which (including the stock of any predecessor corporation) has never been readily tradable on an established securities market; and
- that has a written plan under which, during the calendar year in which the award was granted, at least 80% of all of the corporation's US-based employees (excluding persons customarily employed for fewer than 30 hours a week) are

granted stock options, or are granted RSUs, with the same “rights and privileges,” as described in Section 83(i), to receive qualified stock (the 80% test).

As with many issues under Section 83(i), it is not clear what having the same “rights and privileges” means other than that it does not require equal-sized grants to all employees (although each must receive more than a *de minimis* amount). It could mean, for example, that the vesting conditions must be the same. Also, qualified stock will not include any stock issued upon exercise of an option or settlement of an RSU that may be sold to, or replaced with cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture.

QUALIFIED EMPLOYEES

Only employees who are not “excluded employees” may make a Section 83(i) election. For purposes of Section 83(i), an “excluded employee” is any individual:

OTHER TAX REFORM PROVISIONS OF NOTE

The new tax act contains a variety of other provisions of potential interest to private companies, including:

- **Tax Rates:** The maximum corporate tax rate is reduced from 35% to 21% and the alternative minimum tax for corporations is repealed.
- **Net Operating Losses:** For losses arising in taxable years beginning after December 31, 2017, the amount of net operating loss (NOL) a company may deduct in a taxable year is limited to 80% of the company's taxable income for such year (computed without regard to the NOL deduction). Any such NOLs are no longer permitted to be carried back but may be carried forward indefinitely.
- **Interest Deductions:** The amount of business interest a company may deduct in any taxable year after December 31, 2017, is generally limited to the amount of business interest income of the company for such taxable year plus 30% of the adjusted taxable income of the company for such taxable year.

- who is a 1% owner of the corporation at any time during the calendar year or who was a 1% owner of the corporation at any time during the ten preceding calendar years (or who is a family member of such a person), taking into account for ownership the individual's and family member's outstanding options and RSUs;
- who is, or has been at any time, the chief executive officer or chief financial officer (or someone acting in either capacity) of the corporation (or who is a family member of any such person); or
- who has been one of the four highest-compensated officers of the corporation for the taxable year or was one of the four highest-compensated officers of the corporation for any of the ten preceding taxable years (determined as if the disclosure rules under the Exchange Act applied to the corporation).

A qualified employee must also agree in the Section 83(i) election to meet any requirements necessary to ensure that the corporation's withholding requirements with respect to the qualified stock are met. (Note that because the deferred amount is fixed up front, the tax could become due at a point at which the stock remains illiquid and/or has declined in value.)

OTHER LIMITATIONS

A Section 83(i) election may not be made if:

- the qualified employee has made an election under Section 83(b) with respect to the qualified stock (i.e., a Section 83(i) election cannot be made for restricted stock that is subject to a Section 83(b) election, such as if the stock issued upon option exercise is subject to further vesting); or
- the corporation purchases any of its outstanding stock in the calendar year preceding the calendar year that includes the first date the rights of the employee in the qualified stock are transferable or are not subject to a substantial risk of forfeiture.

Company repurchases will not disqualify a qualified employee from making a Section 83(i) election if at

least 25% of the total value of the stock repurchased in the preceding calendar year was stock with respect to which an election under Section 83(i) was in effect and the company determines the individuals from whom such stock is purchased on a "reasonable basis."

NOTICE AND REPORTING REQUIREMENTS

Any corporation that transfers qualified stock to a qualified employee must, at the time that (or a reasonable period before) any amount attributable to the stock would first be includible in the employee's income:

- certify to the employee that the stock is qualified stock; and
- notify the employee that the employee may be eligible to elect to defer income on the stock under Section 83(i) and that, if the employee makes a Section 83(i) election:
 - the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in the stock first became transferable or not subject to a substantial risk of forfeiture (regardless of any decline in value of the stock during the deferral period);
 - the amount included in income at the end of the deferral period will be treated as ordinary compensation income subject to income tax withholding; and
 - the employee must comply with his or her responsibilities with respect to such withholding.

Failure to provide the required notice may result in the imposition of a penalty of \$100 for each failure, subject to a maximum penalty of \$50,000 for all failures during any calendar year. Corporations that happen to have equity grant patterns that satisfy the Section 83(i) rules may find themselves unexpectedly being required to provide notices or being penalized for not having done so.

In addition, any corporation that has outstanding stock subject to a Section

83(i) election at the beginning of any calendar year and that purchases any of its outstanding stock during such calendar year must include on its tax return for the taxable year in which (or with which) the calendar year ends the total amount of its outstanding stock repurchased during such calendar year and any other information that may be required.

EFFECTIVE DATE

While Section 83(i) generally applies with respect to stock attributable to options exercised or RSUs settled in stock after December 31, 2017, until transition guidance is issued, a corporation will be treated as being in compliance with the 80% test described above and the employee notice requirements if the corporation complies with a reasonable good faith interpretation of them. ■

IMPACT OF TAX REFORM ON SECTION 409A VALUATIONS

In order to avoid a violation of Section 409A of the tax code, an option must be granted with an exercise price that is at least equal to the fair market value of the underlying stock on the option grant date. Private companies typically retain independent valuation firms to determine fair market value in a manner consistent with one of the safe harbor methods provided under Section 409A.

The new tax act contains various provisions that could affect the value of a company's stock—both positively and negatively. Valuation firms need to consider these factors in determining fair market value. For example, to the extent that the valuation includes a discounted cash flow analysis, the reduction in the maximum corporate tax rate from 35% to 21% is likely to lead to increases in value. Other provisions of the tax act, such as new limitations on the use of net operating losses and the deductibility of business interest, could have a dampening effect on value.

Tax reform will not affect all companies in the same manner, and may have little or no effect on some companies. Private companies should continue to review their valuation reports carefully, and should not be surprised if they show changes in methodology and resulting valuations as a result of the new tax act.

You've got the vision, the core team, and even a little money. You're prepared to devote enormous time and energy to your new startup. You're unsure what the future will bring but you want to preserve the possibility of going public someday. A full slate of IPO preparations is daunting and unnecessary for a newly founded company, but here are 10 things a startup should do to groom itself for an eventual IPO.

- *Protect Your IP:* In some sectors, intellectual property is the heart of the company, but even low-tech or no-tech startups routinely rely on confidential information, trademarks, domain names and copyrights. You should fashion an IP protection program that matches your needs and budget. Basic IP protection includes corporate name and trademark searches; non disclosure and invention assignment agreements with employees; confidentiality and IP ownership agreements with consultants and third parties; limitation of internal access to confidential information to persons with a need to know; proper use of confidentiality legends, trademark symbols and copyright notices; and domain name registration. Advanced IP protection typically includes US and foreign patent applications.
- *Respect Former Employers and Uncle Sam:* You've got a great idea and maybe some technology to get you started, but be certain your nascent technology isn't owned by a former employer, since a lawsuit can stop your new company in its tracks. Similarly, make sure you retain the rights in any inventions under government contracts. Also, be mindful of any non competition or non-solicitation agreements you or your employees may have—these obligations can affect both the nature of your business and your ability to recruit talent from former employers.
- *Bootstrap to Avoid Dilution:* A founder's sweat equity is a crucial part of the startup package, and by granting equity incentives a startup can pay less cash compensation to employees (although minimum wage laws still apply). "Bootstrapping" can help delay substantial outside investment until significant milestones justify a higher valuation—and protect that equity from

dilution. Bootstrapping might include founder resources, loans from friends and family, or cash flow from operations. Friends-and-family investments present both benefits (it is money) and disadvantages (it can be awkward to ask Mom for a loan), but may be the best funding alternative at inception.

- *Stay Out of the Woodwork:* An IPO can be "out of the woodwork" time. Former employees and other people you've long since forgotten might show up on the cusp of your IPO looking for a piece of the company. Preempt these surprises by making sure your IP rights are properly documented and all equity commitments have been honored.
- *Employ At Will and Take Vacations:* Your employment policies will evolve with the growth of your business. An essential one is an employment-at-will policy—stating that the employment of any employee can be terminated at any time and for any reason, or for no reason. The policy's purpose is to negate any inference that an employee is entitled to continued employment or severance upon termination. Limits on vacation carryover should also be adopted early on, to avoid the buildup of accrued vacation on your books. Besides, annual vacations will keep key employees fresh and productive.
- *Pre-Wire the Company:* Financing arrangements should contemplate the possibility of going public. Set up your capital structure to become streamlined in an IPO, with preferred stock automatically converting into common stock. Make sure your investor agreements (other than registration rights) and investor board rights terminate in an IPO. These kinds of steps can minimize the need for amendments or waivers in the IPO process and facilitate the transition to public company life. As you add outside directors over time, seek candidates that can form the nucleus of a public company board.
- *Lock Up the Future:* In every IPO the underwriters require lockup agreements that prohibit pre-IPO stockholders from selling shares for a specified period of time—typically 180 days—following the IPO. Lockup agreements help maintain an orderly market while the distribution

of shares is completed and initial trading develops. All pre-IPO stockholders and option holders are ordinarily asked to sign lockup agreements. IPO preparations will be easier if you include lockup provisions in your stock plans and agreements and financing documents from the beginning.

- *Remember the Securities Laws:* Many securities laws apply to startups long before they go public. Issuances of stock and options—whether to founders, employees or investors—must comply with these laws. Although new exemptions (such as crowdfunding) have been introduced in recent years, violations can result in liability to the company, make it difficult to attract investors, and even jeopardize an IPO. Securities law compliance is usually not particularly burdensome, but it must not be overlooked.
 - *Discover Delaware:* If you hope to go public, incorporate in Delaware. More than 90% of all IPO companies call Delaware home, and for good reason. Delaware offers nationwide familiarity; a permissive and flexible corporation statute; a well-developed body of case law; and a judiciary experienced at interpreting its statute. Reincorporation in Delaware prior to an IPO is possible, but this step can be skipped by starting off in Delaware—and your financings and other corporate transactions will be facilitated in the meantime.
 - *Keep Good House:* IPO preparations will proceed more smoothly if you attend to "corporate housekeeping" on a regular basis. This includes minute books, stock and option records, employee agreements, IP documentation, contracts and other corporate records and formalities, as well as legal compliance. Many defects can be fixed as an IPO draws nearer, but the process will be helped if you start with a solid foundation of good housekeeping.
- Finally, don't despair if the IPO market is not ready when you are. In recent years, far more start ups have been acquired than gone public. Both possibilities can even be combined in a "dual track" strategy, in which you simultaneously pursue an IPO while entertaining—or even courting—acquisition offers. The above preparation will serve both paths well. ■

OVERVIEW

IPOs and company sales are the lifeblood of the venture capital industry. Venture capitalists fund, groom, encourage and sometimes prod their portfolio companies to go public, since the venture capital business model depends on IPOs as one of the two principal means to provide liquidity to investors (the other being acquisitions). When John or Jane Q. Public thinks of an IPO company today, he or she probably envisions a venture capital-backed company, since it possesses at least three of the characteristics that epitomize an IPO to the general public: innovation, entrepreneurship and potential wealth.

In many ways, the IPO process for VC-backed companies is easier than for other IPOs. A VC-backed company is usually “pre-wired” to go public and, with the proper business and financial profile, is generally well-suited for an IPO:

- Although often complex, the company’s pre-IPO capital structure is set up to become streamlined in an IPO—for example, through the automatic conversion of preferred stock into common stock upon the completion of the IPO.
- The company’s investor agreements and covenants ordinarily terminate in an IPO, except that registration rights customarily survive.
- The company often has in place a board that meets the initial standards for Nasdaq or NYSE listing or, if not, venture capital investors with a network of qualified candidates. In many cases, the company’s board is already operating with audit and compensation committees, easing the transition to public company governance requirements.
- The company typically has had high-quality law and accounting firms since initial funding, making the need for an IPO upgrade less likely and increasing the likelihood that critical early missteps were avoided.
- Due diligence in prior venture capital financings should have helped the company to identify and remediate

issues and prepare it for the rigors of underwriter diligence in an IPO.

- The company likely qualifies as an emerging growth company (EGC) under the JOBS Act, and can benefit from the disclosure and accounting relief available to an EGC to ease its path to an IPO and public ownership.

Despite the IPO readiness of most VC-backed companies, the IPO process for a VC-backed company frequently presents several issues that do not arise as frequently in other IPOs.

HEIGHTENED URGENCY

A VC-backed company often feels a heightened urgency to pursue an IPO, partly because of the existence of demand registration rights—although no company can really be forced to go public if it is unprepared or the market is unreceptive. This is not necessarily a bad thing, since the interests of management and the investors are generally aligned when evaluating a public offering, but it does mean a VC-backed company mulling an IPO is likely to proceed briskly as soon as there is a market opportunity.

INVESTOR INVOLVEMENT

Venture capitalists often control the board and the stockholder votes that are required to complete an IPO. They generally also have the most to gain from a successful offering and the most to lose if it is fumbled. As a result, the investors in VC-backed companies tend to be closely involved with the IPO process, from the initial decision to go public to the selection of the managing underwriters to the pricing of the offering. If investors are selling shares in the IPO, they will also take a keen interest in the underwriting agreement, especially the representations and indemnities to be provided by the selling stockholders.

SELLING STOCKHOLDERS

VC-backed companies are very likely to have registration rights and to encounter strong interest from investors in selling a portion of their holdings in the IPO,

subject to factors such as valuation and the views of the managing underwriters as to whether the inclusion of selling stockholders will adversely affect the marketing of the IPO. VC-backed companies often file resale registration statements six to twelve months after the IPO, enabling pre-IPO investors to achieve additional liquidity.

COMMITTEE MEMBERSHIP

Under the Sarbanes-Oxley Act and corresponding SEC rules, all audit committee members must be independent and an “affiliate” of the company cannot qualify as independent. The SEC defines an affiliate as a person “who, directly or indirectly, controls, is controlled by, or is under common control with, the company.” There is a safe harbor for a person who does not beneficially own more than 10% of any class of voting

PE-BACKED IPOs

Not surprisingly, IPOs by companies that are controlled by private equity firms have some similarities to IPOs by VC-backed companies, along with several differences:

- PE-backed companies typically are larger and more mature than VC-backed companies, and drawn from a wide spectrum of industries.
- Many PE-backed companies were publicly held before being acquired, and their prior public company experience can facilitate the IPO process.
- PE-backed companies often incur substantial debt in their buyout transactions, and this leverage can affect the company’s operations, profitability and even viability, and repayment of indebtedness may be a motivation for the IPO.
- In many instances, a PE-backed company has a majority owner and qualifies as a “controlled company” under stock exchange rules, entitling it to exemptions from some corporate governance requirements.
- PE-backed companies tend to have large IPOs and sometimes pursue placements or registered public offerings of debt concurrently with IPOs.

20 Special Considerations in IPOs of VC-Backed Companies

equity security of the company and is not an executive officer of the company.

If a person's beneficial ownership exceeds 10%, all relevant facts and circumstances need to be considered to determine whether that ownership results in affiliate status, with beneficial ownership of 20% generally viewed as the upper bound (although counter examples exist). In most cases, a director affiliated with a venture capital investor whose beneficial ownership of the company's stock exceeds 20% upon completion of the IPO will not qualify as independent for audit committee membership. Since audit committees in VC-backed companies often include venture capitalists—who typically have more financial experience than other pre-IPO company directors—the composition of the company's audit committee may need to be modified in conjunction with the IPO, either immediately or over time in compliance with stock exchange phase-in rules.

Membership on the company's compensation committee also must be carefully evaluated. Nasdaq and NYSE both require all members of the compensation committee to satisfy enhanced independence requirements under rules mandated by the Dodd-Frank Act. Each exchange has indicated that stock ownership by itself, even if it represents a controlling interest in the company, does not preclude independence, but is a factor that must be taken into consideration in assessing independence. Application of other elements of the enhanced independence requirements may result in a director affiliated with a venture capital investor being ineligible to serve on the compensation committee, or require elimination of relationships between the director and the company that the parties prefer to leave in place.

TRANSITION IN BOARD MEMBERSHIP

Investor agreements permitting venture capital investors to appoint board members almost always terminate in an IPO. Venture capital directors usually have substantial knowledge about the company and its industry, however, and are often invited to remain on the board following

the IPO. Some may be willing to continue, but more frequently venture capital directors will depart upon completion of their board terms after the lockup agreement expires and their fund's shares are distributed to their limited partner investors. Consequently, VC-backed companies need to ensure that their board and board committees meet all SEC and exchange requirements at the time of the IPO, while also planning for the likelihood of changes within the first few years as a public company. If the company knows that a director affiliated with a venture capital investor plans to resign—perhaps under a policy of his or her fund—that fact should be disclosed in the prospectus.

SECTION 16 CONSIDERATIONS

Pursuant to Section 16 of the Exchange Act, a non-exempt, pre-IPO purchase by a director or officer less than six months before the IPO can be matched with a sale by that director or officer in the company's IPO. Although pre-IPO transactions by 10% stockholders ordinarily cannot be matched with sales in the IPO, transactions by a director affiliated with a 10% stockholder might, in some circumstances, be attributed to the 10% stockholder and subject it to Section 16 liability under the “director by deputization” theory. Moreover, plaintiffs have sometimes sought to bring claims premised on an argument that the issuance of additional shares of common stock upon conversion of outstanding preferred stock held by 10% stockholders in the IPO—for example, in exchange for reducing the minimum price threshold for automatic conversion—results in purchases under Section 16 that can be matched with sales in the IPO by those 10% stockholders. Since venture capital funds usually have board representation and are often 10% stockholders, Section 16 issues merit close attention in VC-backed IPOs.

POTENTIAL CONFLICTS OF INTEREST

Representatives of venture capital firms that remain on the company's board following its IPO may have conflicting fiduciary duties if business opportunities come to their attention that are of interest

to both the company and the firms with which those directors are affiliated.

A common solution is for the company to renounce, in its corporate charter or pursuant to a board resolution, all interest and expectancy in any business opportunity pursued by venture capital firms with representatives serving on the company's board unless the opportunity was presented to a firm's representative on the board in his or her capacity as a director of the company. This issue also exists prior to the company's IPO but is often addressed less formally, or not at all, while the company is private. ■

OUTLOOK

VC-backed IPOs ebb and flow with overall market conditions and tend to enjoy their greatest prosperity when the IPO market is most receptive to smaller, higher-growth companies, particularly the technology and life sciences companies that dominate venture capital investing. Other than general market conditions that affect all IPO candidates, the most important factor affecting the flow of VC-backed companies into the IPO market is the availability of attractive sale opportunities in lieu of an IPO. Venture capital investors are generally indifferent between liquidity from an IPO or company sale, but may prefer a sale because it usually can be completed faster and with greater certainty than an IPO. If the valuations of a prospective IPO and sale are comparable and the sale permits the investors to cash out immediately, other than for normal post-closing escrow arrangements, the choice is probably a no-brainer.

VC-backed companies tend to be smaller and less likely to be profitable than other IPO candidates, particularly PE-backed companies. Market expectations for the financial profiles of IPO companies can steer venture capital exits from IPOs to company sales, particularly when overall market conditions are most demanding. Partly due to these metrics, the ratio of M&A transactions to IPOs for VC-backed companies has fluctuated widely over the past two decades. In recent years, the disclosure and accounting relief available to EGCs appears to be tipping the balance in favor of an IPO for many VC-backed companies. VC backed IPOs are likely to remain a fixture in the market as long as venture capital exists.

Trends in VC-Backed Company M&A Deal Terms 21

We reviewed all merger transactions between 2010 and 2017 involving venture-backed targets (as reported in Dow Jones VentureSource) in which the merger documentation was publicly available and the deal value was \$25 million or more. Based on this review, we have compiled the following deal data:

Characteristics of Deals Reviewed	2010	2011	2012	2013	2014	2015	2016	2017
Sample Size	17	51	26	27	37	27	19	18
Cash	71%	73%	73%	59%	59%	67%	47%	56%
Stock	6%	4%	8%	8%	3%	4%	0%	0%
Cash and Stock	23%	23%	19%	33%	38%	29%	53%	44%
Deals with Earnout	2010	2011	2012	2013	2014	2015	2016	2017
With Earnout	29%	29%	31%	33%	30%	26%	37%	22%
Without Earnout	71%	71%	69%	67%	70%	74%	63%	78%
Deals with Indemnification	2010	2011	2012	2013	2014	2015	2016	2017
With Indemnification								
By Target's Shareholders	100%	98%	100%	100%	97%	100%	100% ¹	94% ²
By Buyer	17%	43%	62%	44%	49%	69%	37%	61%
Survival of Representations and Warranties³	2010	2011	2012	2013	2014	2015	2016	2017
Shortest	9 Mos.	12 Mos.	10 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.	9 Mos.
Longest	21 Mos.	24 Mos.	24 Mos.	30 Mos.	24 Mos.	24 Mos.	18 Mos.	24 Mos.
Most Frequent	18 Mos.	18 Mos.	18 Mos.	18 Mos.	12 & 18 Mos. (tie)	18 Mos.	18 Mos.	12 Mos.
Caps on Indemnification Obligations	2010	2011	2012	2013	2014	2015	2016	2017
With Cap	100%	100%	100%	100%	100%	100%	100%	100%
Limited to Escrow	71%	77%	81%	88%	89%	79%	83%	94% ⁵
Limited to Purchase Price	6%	2%	0%	0%	0%	0%	0%	0%
Exceptions to Limits ⁴	94%	96%	96%	100%	100%	100%	95%	94%
Without Cap	0%	0%	0%	0%	0%	0%	0%	0%
Escrows	2010	2011	2012	2013	2014	2015	2016	2017
With Escrow	100%	94%	100%	93% ⁶	97%	93%	89%	94%
% of Deal Value								
Lowest ⁷	2%	5%	5%	5%	2%	4%	5%	4%
Highest	25%	31%	16%	20%	16%	16%	15%	13%
Most Frequent	10%	10%	10%	10%	10%	10%	10%	5%
Length of Time								
Shortest	9 Mos.	12 Mos.	10 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.	9 Mos.
Longest	36 Mos.	36 Mos.	48 Mos.	30 Mos.	24 Mos.	36 Mos.	24 Mos.	24 Mos.
Most Frequent	18 Mos.	18 Mos.	12 Mos.	18 Mos.	12 Mos.	12 & 18 Mos. (tie)	18 Mos.	12 & 18 Mos. (tie)
Exclusive Remedy	53%	78%	73%	60%	86%	63%	88%	71%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy ⁴	80%	97%	100%	100%	100%	100%	93%	92%
Baskets for Indemnification	2010	2011	2012	2013	2014	2015	2016	2017
Deductible ⁸	56%	38%	27%	50%	44%	31%	47%	63%
Threshold ⁹	44%	60%	65%	42%	56%	61%	53%	37%
MAE Closing Condition	2010	2011	2012	2013	2014	2015	2016	2017
Condition in Favor of Buyer	100%	98%	95%	100%	97%	100%	100%	94%
Condition in Favor of Target	19%	15%	9%	17%	19%	12%	39%	22%
Exceptions to MAE	2010	2011	2012	2013	2014	2015	2016	2017
With Exception ⁹	94%	94% ¹⁰	84% ¹¹	96% ¹²	100%	100%	100%	100%

¹ Includes one transaction where the only representations that survive for purposes of indemnification are certain "fundamental" representations and representations concerning material contracts and intellectual property.

² Includes one transaction where the only representations that survive for purposes of indemnification are those concerning capitalization, financial statements and undisclosed liabilities, but excludes one transaction where indemnification was provided for breaches of covenants prior to the closing but representations did not survive for purposes of indemnification.

³ Measured for representations and warranties generally; specified representations and warranties may survive longer. Excludes one transaction in each of 2011 and 2014 where general representations and warranties did not survive.

⁴ Generally, exceptions were for fraud, willful misrepresentation and certain "fundamental" representations commonly including capitalization, authority and validity. In a limited number of transactions, exceptions also included intellectual property representations.

⁵ Includes two transactions where the limit was below the escrow amount.

⁶ One of two transactions not including an escrow at closing did require funding of escrow with proceeds of earnout payments.

⁷ Excludes transactions which also specifically referred to representation and warranty insurance as recourse for the buyer.

⁸ A "hybrid" approach with both a deductible and a threshold was used in another 2% of these transactions in 2011, 8% of these transactions in 2012, 8% of these transactions in 2013, and 8% of these transactions in 2015.

⁹ Generally, exceptions were for general economic and industry conditions.

¹⁰ Excludes one transaction where the specified exceptions do not apply for purposes of a standalone "material adverse effect" closing condition.

¹¹ Includes one transaction where the specified exceptions apply for purposes of a standalone "material adverse effect" closing condition and certain representations, but do not apply for purposes of other representations.

¹² The only transaction not including such exceptions provided for a closing on the same day the definitive agreement was signed.

22 Trends in Convertible Debt Terms

Based on hundreds of convertible debt financing transactions we handled from 2014 to 2017 for companies and investors throughout the United States, we have compiled the following deal data:

Deals with Note Purchase Agreement		2014	2015	2016	2017
Convertible note financings often include a note purchase agreement containing representations and warranties from the company (and possibly the founders).	% of Deals	64%	74%	67%	57%
Term		2014	2015	2016	2017
The term of the convertible note before it becomes due and payable.	Median Range	18 mos. 1–72 mos.	18 mos. 4–60 mos.	18 mos. 2–60 mos.	18 mos. 1–60 mos.
Interest Rate		2014	2015	2016	2017
The rate at which interest accrues during the term of the convertible note.	Median Range	6% 0.33%–15%	5% 2%–14%	5% 0.64%–10%	6% 2%–10%
Deals with Security Interest		2014	2015	2016	2017
Convertible note investors sometimes require the company to provide a security interest in company assets. If the note is not repaid or converted into capital stock, the pledged assets become available to satisfy the note.	% Secured	20%	15%	13%	16%
	% Unsecured	80%	85%	87%	84%
Deals with Conversion Discount		2014	2015	2016	2017
Convertible note investors often require that the notes convert in connection with a financing at a discount from the price paid by new investors in the financing to reward the convertible note investors for the risk of investing before the new investors. A conversion discount is often coupled with a cap on the valuation at which the notes convert.	% of Deals	72%	89%	72%	72%
	Range of Discounts	10%–50%	10%–50%	10%–50%	8%–30%
	% with 20% or Less Discount	76%	74%	69%	98%
	% with Greater Than 20% Discount	24%	26%	31%	2%
	% with Valuation Cap	74%	55%	64%	82%
Deals with Conversion upon Maturity		2014	2015	2016	2017
If a convertible note is not converted or otherwise paid upon maturity, it often converts into shares of the company's capital stock (common or preferred stock). This conversion is most often at the election of the investor but may be mandatory.	% of Deals	57%	60%	50%	39%
	% with Optional Conversion	90%	89%	89%	91%
	% with Mandatory Conversion	10%	11%	11%	9%
	% that Convert into:				
	Common	54%	32%	41%	42%
	Preferred	46%	68%	59%	58%
Deals with Conversion upon Company Sale		2014	2015	2016	2017
If a convertible note is not converted or otherwise paid at the time of a sale of the company, it often converts into shares of the company's capital stock (common or preferred stock). This conversion is most often at the election of the investor but may be mandatory.	% of Deals	66%	74%	46%	61%
	% with Optional Conversion	86%	91%	92%	93%
	% with Mandatory Conversion	14%	9%	8%	7%
	% that Convert into:				
	Common	60%	49%	56%	71%
	Preferred	40%	51%	44%	29%
Deals with Conversion Premium upon Company Sale		2014	2015	2016	2017
Convertible note investors may require that they receive a multiple of the outstanding principal of the convertible note upon a sale of the company.	% of Deals	52%	53%	57%	59%
	Median Premium	2x	2x	2x	2x
	Range of Premiums	1.5x–3x	1.5x–4x	0.5x–3x	1.5x–4.1x
Deals with Warrant Coverage		2014	2015	2016	2017
Convertible note investors sometimes receive a warrant in addition to a note. The amount of company stock covered by the warrant is usually proportional to the principal amount of the note, referred to as the warrant coverage.	% of Deals	11%	4%	17%	8%
	Coverage Range	1%–50%	Insufficient data	5%–50%	5%–100%
	% that Cover Common	20%	50%	0%	20%
	% that Cover Preferred	80%	50%	100%	80%

Based on hundreds of venture capital financing transactions we handled from 2012 to 2017 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2012	2012 Range	2013	2013 Range	2014	2014 Range	2015	2015 Range	2016	2016 Range	2017	2017 Range
A “multiple liquidation preference” is a provision that provides that the holders of preferred stock are entitled to receive more than 1x their money back before the proceeds of the liquidation or sale are distributed to holders of common stock.	Series A	0%	N/A	5%	2x–3x	0%	N/A	2%	1.5x (all)	0%	N/A	3%	1.08x–2x
	Post-Series A	7%	2x–2.4x	9%	1.5x–2.17x	3%	1.5x (all)	4%	1.5x–2x	4%	1.12x–1.25x	8%	1.32x–3x
Deals with Participating Preferred Stock		2012	2012 Range	2013	2013 Range	2014	2014 Range	2015	2015 Range	2016	2016 Range	2017	2017 Range
“Participating preferred” stock entitles the holder not only to receive its stated liquidation preference, but also to receive a pro-rata share (assuming conversion of the preferred stock into common stock) of any remaining proceeds available for distribution to holders of common stock.	Series A												
	Total	15%		8%		12%		6%		13%		10%	
	Capped	43%	2x–10x	50%	2x–3x	40%	3x–5x	100%	2x–3x	Insufficient data		14%	2x (one deal)
	Post-Series A												
Total	27%		24%		19%		19%		28%		16%		
Capped	44%	2x–3x	41%	2x–5x	45%	2x–5x	50%	2x–5x	34%	2x–5x	56%	2x–2.5x	
Deals with an Accruing Dividend		2012	2013	2014	2015	2016	2017						
“Accruing dividends” are generally payable upon liquidation or redemption of the preferred stock. Because the sale of the company is generally deemed to be a “liquidation,” the accrued dividend effectively increases the liquidation preference of the preferred stock.	Series A	29%	9%	11%	12%	23%	8%						
	Post-Series A	28%	11%	22%	25%	30%	26%						
Anti-Dilution Provisions		2012	2013	2014	2015	2016	2017						
A “full ratchet” anti-dilution formula is more favorable to the investors because it provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a “weighted average” anti-dilution formula takes into account the dilutive impact of the dilutive issuance based upon factors such as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	Series A												
	Full Ratchet	0%	0%	0%	0%	0%	0%						
	Weighted Average	100%	100%	100%	100%	100%	100%						
	Post-Series A												
Full Ratchet	3%	1%	1%	0%	1%	0%							
Weighted Average	97%	99%	99%	100%	99%	100%							
Deals with Pay-to-Play Provisions		2012	2013	2014	2015	2016	2017						
“Pay-to-play” provisions provide an incentive to investors to invest in future down rounds of financing. Investors that do not purchase their full pro-rata share in a future down round lose certain rights (e.g., their anti-dilution rights are taken away or their shares of preferred stock may be converted into common stock).	Total	7%	7%	8%	5%	10%	7%						
	% of Total that Convert into Common Stock	100%	100%	53%	71%	94%	83%						
	% of Total that Convert into Shadow Preferred Stock	0%	0%	47%	29%	6%	17%						

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See our *2018 M&A Report* for a detailed global M&A market review and outlook. The report offers an update on takeover defenses, looks at factors companies should consider in M&A transactions that could be subject to "entire fairness" review, and discusses strategies to combat frivolous M&A lawsuits. We also examine the challenges specific to cross-border deals; assess the current CFIUS and FCPA climate; compare deal terms in public and private acquisitions; and survey key terms and issues in sales of VC-backed companies.

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An electronic copy of this report can be found at wilmerhale.com/2018VCreport.

Data Sources: WilmerHale compiled all data in this report from Dow Jones VentureSource, except as otherwise indicated. For law firm rankings, IPOs by VC-backed companies and sales of VC-backed companies are included under the current name of each law firm.

Special Note on Data: Due to delayed reporting of some transactions, the venture capital financing and M&A data discussed in this report is likely to be adjusted upward over time as additional deals are reported. Based on historical experience, the adjustments in US data are likely to be in the range of 5–10% in the first year following the initial release of data and in smaller amounts in succeeding years.

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