

**CAPITAL SOLUTIONS NEWSLETTER...**

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The detail behind 2Q Venture Capital investments is out, and the majority of media coverage is a reminder that instead of trying to estimate half empty or full, sometimes it is better to just drink up and move on. In addition, some good term sheet advice from a Venture professional.

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**2Q Venture Investments: Is this the new normal?**

Most media coverage of Venture Capital investments in the second quarter split the baby: the \$3.7 billion invested in 612 companies was either way down (from the \$7.6B raised by 1,048 companies in 2Q 2008) or heading up (from the \$3.2 billion invested in 601 companies in 1Q 2009). Neither half takes the long view.

Looking back at the last decade of venture financing, if one discards the bubble years from 1999-2001 and assumes a slight exuberance from the recent credit binge, the remaining (and admittedly narrow) historical pattern from 2002 - 2005 show annual investments of about \$20B, with roughly 3,000 companies funded. Within this context, the recent 2Q results seem neither the precipitous drop nor a sign that the industry will soon soar again at its previous heights. Instead, the current status could most likely be pretty close to the new normal.

Most reports noted the industry shifts, with investments in IT dropping hard, healthcare rising fast, and cleantech looking like a wave that crested a year ago (cleantech funding to date in 2009 is running at about 25% of the same point last year). However, almost entirely overlooked in most summaries was the significant increase in the percentage of investments at the initial stages of a company's growth. For deals reported by stage, combined seed and early stage investments captured over 40% (expansion was 28% and later stage was 31%). That is the highest percentage for seed and early stage deals since 4Q of 1998, and roughly twice the recent average ([full data here](#)).

There is no doubt that, like much of the financial world, the Venture Capital industry is in flux and will take some time to sort itself out. Several articles anticipate consolidation of venture firms of [up to 50%](#). While such predictions are extreme, it remains unclear if the industry is undergoing a healthy return to more modest historical norms, or a fundamental paradigm shift.

Like the economists who have predicted 11 of the last 4 recessions, most anticipated industry paradigm shifts simply don't happen. This one may still succumb, but the relatively mild exuberance in venture activity over the past three years (see chart above) mean a far smaller hangover than private equity or hedge funds, and the adjustments in the credit markets may yet see venture capital dust off its little black book and start carefully courting suitors once more. If the 2Q data favoring earlier deals is a trend and not an outlier, there is still likely to be up to 40% of \$20 billion in investments looking for an emerging company to call home.

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## The "Promote"

Flybridge's Jeff Bussgang has [a nice blog piece](#) where he coins a new word in the venture lexicon: the "promote" (not the [Prestige](#)). Entrepreneurs too often fixate on their pre-money valuation (the "pre"), instead of focusing on what their equity is worth after the venture check has hit the bank account. For Jeff, the "promote" is where an entrepreneur should focus: the founding team's equity ownership percentage multiplied by the post-money valuation. In other words: after you've received a venture capital investment, what is your share of the company worth?

Two factors are important: the amount of capital raised, and the size of the option pool. Let's look at both using some simple math (and assuming all other terms are equal).

*Term Sheet 1:* Company raises \$4M on a \$6M pre (so \$10M post-money valuation). However, the terms include a unallocated option pool of 25%. So the VC owns 40%; the Option Pool has 25%, and the Founders own 35%. The founder's share is worth \$3.5M (35% of \$10M post-money).

*Term Sheet 2:* Company raises \$3M on a \$5M pre (so \$8M post-money valuation). The terms include an unallocated option pool of 12%. So the VC owns 38%; the Option Pool gets 12%, and the Founders own 50%. Their share is worth \$4.0M (50% of \$8M post-money).

Too many entrepreneurs prefer the first term sheet: they raise more money at a higher pre. But after the dust settles, under the first term sheet they own barely more than one-third of their company and their shares are worth less than the investment. In the second term sheet, the founders own 50% of their company, and even if its valuation is lower, their share is worth almost 15% more.

The sheer complexity of term sheets can be difficult to unravel, but the most savvy negotiators are almost never about the pre, and always about the terms.

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