



Newsletter

535 Middlefield Road, Suite 190 Menlo Park, CA 94025
T: 650.321.0854 F: 650.321.1968
www.bandangels.com

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Coordinator

Ian Patrick Sobieski

Full Screening Committee

Steve Herrick

Wally Buch

David Deacon

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Art Reidel

Stephen Taylor

Dinner Details

Date: Wed., Oct 17, 2007

Place: Los Altos Golf and Country Club

Time: 6:15 - 9:00 pm

RSVP: 650.321.0854
rsvp@bandangels.com

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Introduction

A quick administrative note, we sent you a Save the Date card three weeks ago for our annual holiday party, and we asked you to save the WRONG date! The date of the holiday party is Tuesday, December 4th, NOT what is printed on that card. The date is correct in the invitations we'll send out shortly and we'll highlight this again but please make a note!

Last month, I summarized part of the Fenwick and West Q207 survey, which showed two important things: that Seed Round valuations have been stable over the past year while Series B and later valuations continue to increase; making the seed stage where the Band usually invests all the more attractive. And that most pay-to-play downrounds are not between Series A and Series B, but around the Series D, E, and F; suggesting that as angels, if we must triage funding, we should consider passing on a Series B prorata participation to save resources to protect ourselves in a possible "late stage" pay-to-play washout round.

This month I'd like to highlight a piece of data from the Fenwick and West report relating to a sometimes controversial deal term. There is often a debate amongst us angels about whether we should ask for "participating preferred" from the companies we finance. By participating preferred we mean that in the event of a liquidation, holders of preferred stock get their initial investment capital back and then participate on an "as converted basis" in additional proceeds. For example, imagine we angels invest \$1M for 25% of a company which is later sold for \$9M. With participating preferred we'd receive our initial \$1M back first, and then split the remaining \$8M with common at a ratio of 1:3. In total we'd receive \$3M and common would get \$6M. Sometimes the liquidation preference is "capped" at some level. In our example, with a 2x cap on the liquidation preference, we'd receive our original \$1M, then split remaining proceeds at the ratio of 1:3 until we had received another \$1M and then all remaining proceeds would go to common. In this example, we'd receive \$2M in total and common would receive \$7M (note, that in this case we'd be better off converting to common and taking 25% of \$9M). That is how it works, but the question is whether uncapped participating preferred is "market" or an egregious and rare term?

Well, the data is this: in Q207 48% of deals had participating preferred. Of these, 54% had UNCAPPED participating preferred. For the four quarters previous to this one the percentage that was uncapped was 52%, 64%, 58%, 64%. Every deal structuring and negotiation is company specific but this data suggests that the answer to the question is even uncapped participating preferred is a common term.

Interestingly, the Fenwick survey reports that 22% of financings provide for mandatory redemption or redemption at the option of the venture capitalist! Redemption gives the investor the right to "put" stock back to the company after some period of time at a specified price. This term is advertised as a way to exit from a company whose growth has stalled and become a "lifestyle" for the founder. This is not a term we usually ask for under the notion since it is very rare, but in light of this data perhaps we should?

- Ian