THE CAPITAL NETWORK

CAPITAL UPDATE

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The Race is on as Investor's Funds Swell

by Emily Sopensky

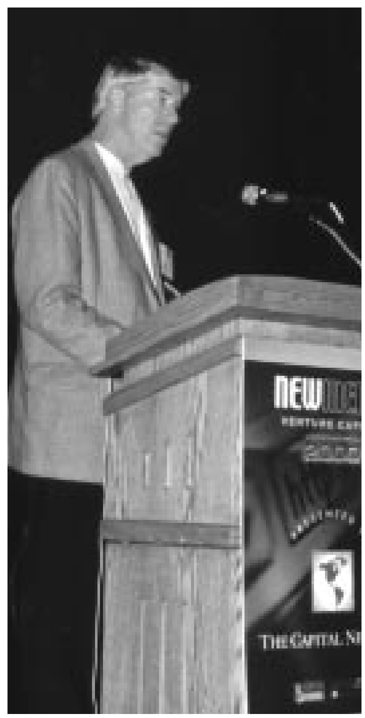
Recent reports show VC investments doubling during the year with Internet companies receiving two-thirds of such investments made in 1999. According to the PricewaterhouseCoopers' 4Q99 MoneyTree report on venture capital, almost $15 billion was invested in entrepreneurial ventures in the fourth quarter, a 300% increase over the same quarter in 1998. "Technology-based companies, including Internet-related businesses, accounted for more than 90 percent of all investments in 1999," the report concludes.

"This is great for The Capital Networks services" says George Watson, TCN's Chairman. Our focus is on helping early stage technology companies understand the process of raising capital and then helping those companies find investors. There are more investors and they are running larger funds and that's why last year the number of dollars raised was a big stair step up."

TL Ventures and Austin Ventures, firms with a strong Texas presence, are among the most active venture capitalist firms in the nation, according to the report.

"There is an abundance of dollars and an abundance of entrepreneurs," echoes Stan Tims, TL Ventures. "We've added a VC partner for Dallas because of the activity—our first in Texas outside of Austin."

As a sizeable player, TL Ventures' investments in Austin are 70-80% in the Internet and IT, according to Tims. In Texas, they also have significant interests in communications and life sciences companies. Having invested in life sciences for some time, Tims says they are finally paying off handsomely. "[With them], there's a long time to invention—quite a hockey stick," he explains.



Stu Penny, Viewon.com CEO, pitches investors at the NewMedia conference.

In November 1999, part of Austin Ventures' strategy was to spin out AV Labs a company test focused on early stage companies. With $60 million to invest, AV Labs CEO Rob Adams concurs that it is "a great time to be an entrepreneur. However, the challenge is still not significantly easy to raise the initial money."

"Money is not a scarce resource, but people are," he adds. "We're very aggressive in recruiting for our Venture Fellows program." Fellows attracted to AV Labs become interim operating executives of portfolio companies. AV Labs contributes one-third of the management team for each of its companies.

"That's our secret sauce. We have a half dozen Fellows now and expect to have a total of 12 by the end of the year. In part, we anticipate some will go work for a company they are helping. Since they've already had 90 to 120 days to experience the company, they should know whether they want to stay with them."

With so much money available, the question becomes how to invest it responsibly and expediently. "My impression is that a lot of attorneys are helping steer their companies to investors and groups

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Message from the President

As the year flies by, entrepreneurial activity continues to expand at an incredible pace. The funding pond keeps getting bigger as a number of new venture funds come online and many established funds get larger.

It's a great time to be involved with entrepreneurial ventures.

The Capital Network had a very busy first half of the year. The NewMedia Venture Conference, which we partnered with South by Southwest's Interactive Festival, saw more than 300 attendees and featured 12 Internet related companies. The Golden State Venture Capital Conference, held in northern California, featured 24 companies presenting to an audience of more than 400. The monthly Texas Angel Investors program continues to bring together angel investors and quality tech entrepreneurs. These programs are considered some of the best gatherings of investors and early stage tech deals in the country, and recently TCN successes have been featured in *Forbes ASAP, dbusiness.com, Reuters, the Dallas Morning News, the Austin American-Statesman* and the *Houston Chronicle.*

TCN's goal is to assist tech entrepreneurs in raising capital. We spend time with entrepreneurs helping them understand the process of raising capital and reviewing their deals, helping "groom" them by advising on their business models, business plans and business pitches. TCN then helps entrepreneurs find the right investors for their venture, whether its angels, venture capitalists or corporate investors.

TCN is proud to play a role in helping bring together investors and entrepreneurial ventures. We appreciate the support from our vast network of partners including investors, entrepreneurs and professional service providers in making TCN the entrepreneurs' choice in raising early stage capital.

For the latest information on The Capital Network's activities and how we can help you, please check our website at www.thecapitalnetwork.com

—David Gerhardt

Outsource Finance and Accounting to Help Entrepreneurial Companies Grow

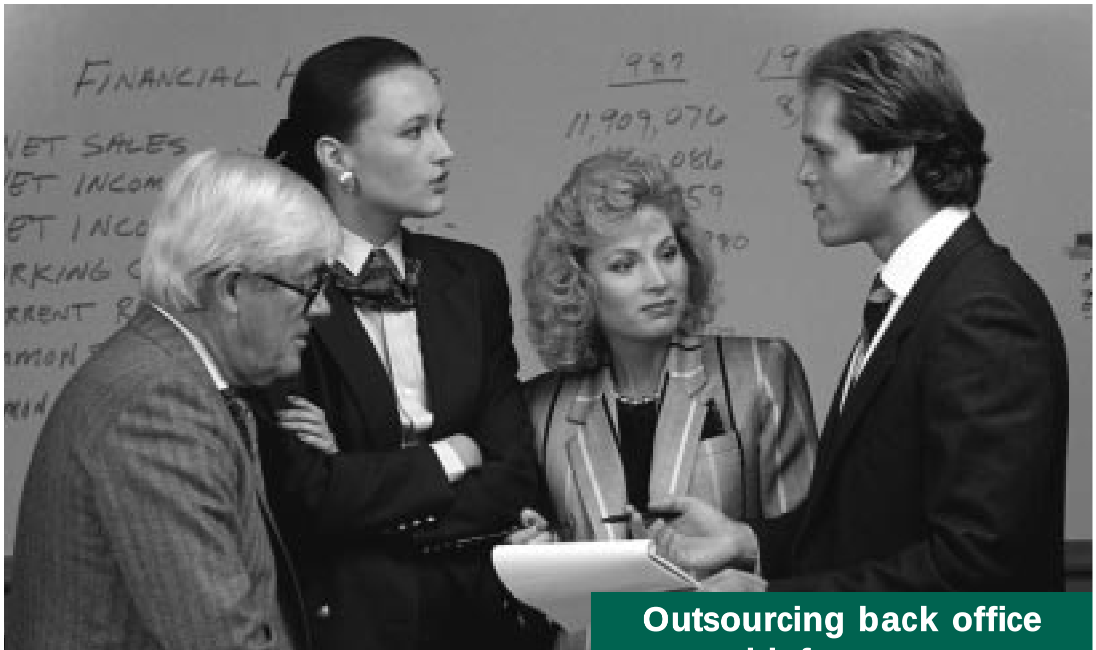
by Boyd Mulkey, Outsourcing, Arthur Andersen Austin

To succeed in the new economy, companies need to be nimble, adaptable and efficient simultaneously. Companies need great thinking, the right people and the best technology to get, and stay, ahead of the competition. Most important, companies must keep their focus on the things that create wealth and success.

Dot-com or high-growth companies often lack management "bandwidth" to tackle the details of essential but non-strategic financial operations. Investors expect senior management to focus on products and services that create wealth, while they also demand a solid, highly effective infrastructure. Outsourcing back office and infrastructure jobs is a smart move for fast-growth technology companies because it frees them to focus on creating their products and services.

As a company grows, its management team may consider going public. It makes good sense to partner with an outsourcing provider before going public. This partner will build quality assurance into key business processes and follow a methodology squarely focused on risks and controls.

Outsourcing basic transaction processing generally includes general ledger maintenance. billing and accounts receivable, cash collections and application, accounts payable cash disbursements, closing monthly books, and preparation of monthly financial statements.



Companies can also benefit from outsourcing direction of strategic functions such as: management reporting, budgeting/forecasting, financial analysis and treasury. This strategic help allows fast-growth companies to get on with their real mission. These companies benefit from greater accuracy and speed of information while reducing the cost of these functions.

Strategic tax planning should also be an integral part of an organization's initial structuring. Companies need to establish a tax strategy that effectively supports business objectives and informs early-stage decision-making. With e-commerce activity projected to increase ten-fold over the next five years, Internet taxation is a critical issue that businesses need to understand today. A company's ability to capitalize on the lowest effective tax rates across multiple jurisdictions can directly impact its overall market valuation.

Outsourcing back office and infrastructure jobs is a smart move for fast-growth technology companies because it frees them to focus on creating their products and services.

Arthur Andersen's vision is to be the partner for success in the new economy. The company help entrepreneurial companies grow and provide objective insight to fast-growing companies and their owners through nine core market offerings: Assurance, Business Consulting, Corporate Finance, eBusiness, Human Capital, Legal Services, Outsourcing, Risk Consulting and Tax Services.*

Arthur Andersen has more than 75,000 people in over 85 countries that are united by a single worldwide operating structure that fosters inventiveness, knowledge sharing and a focus on client success. Since its beginning in 1913, Arthur Andersen has realized 86 years of uninterrupted growth, with 1999 revenues over U.S. $7 billion. Arthur Andersen is a business unit of Andersen Worldwide.

For information regarding outsourcing for high-tech and high growth companies contact Michelle Parchman in the Arthur Andersen Austin office at 512-391-3200, or visit our website at www.arthurandersen.com.

**Note The services offered in particular areas may depend on local regulations. In some locations, legal and/or tax services are provided by Andersen Legal, the international network of law firms that is associated with Andersen Worldwide SC.*

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like The Capital Network that can help them," observes Reena Richtermeyer, an attorney with Jackson Walker LLP's Austin office.

Richtermeyer, who specializes in software licensing, finds that her firm is inundated with new prospects. "We're getting way too many business plans; sifting through to find the golden nugget is increasingly a problem," she says.

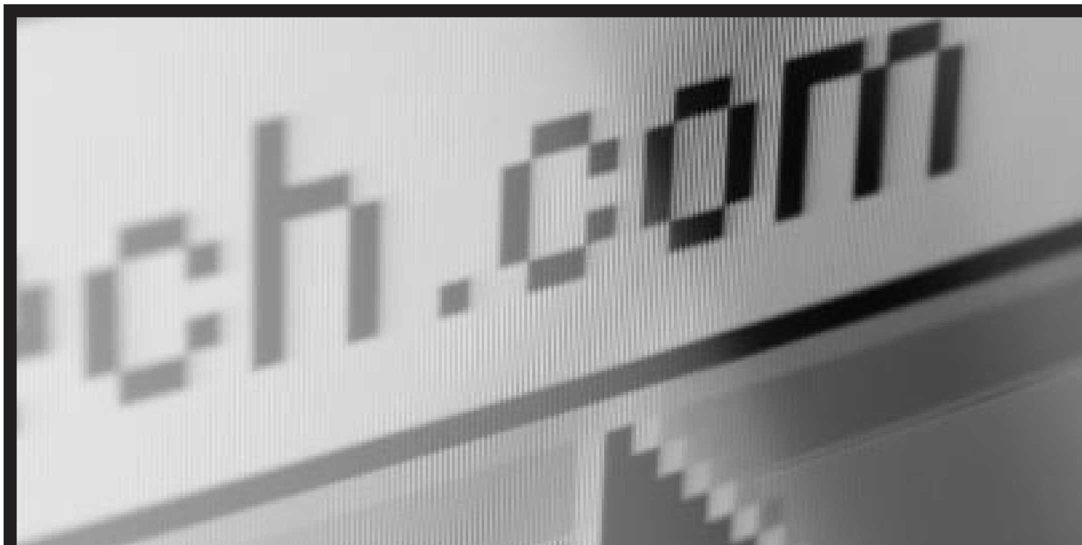
"There are more that you have to look at; it's exhausting because of the sheer volume," agrees Gene Lowenthal of Sanchez Capital Partners. "There are a lot more deals, and the deals are actually pulling down more," he says, confirming the MoneyTree Report findings that formative stage companies received funding that was on average 60% more in 1999 than in 1998. Further, the study reports that "deal size for Internet-related formative stage companies is even larger, rising to $8.9 million for the year."

Lowenthal notes that while most investors seem to be looking for a better proof of concept before putting money in, he still sees worthwhile companies going wanting. Because of heavy competition, Lowenthal's general approach is to have the inside track and get them "while they are young."

The Silicon Labs IPO was CenterPoint Ventures' most recent company to go public. According to Kent Fuqua, general partner, there are three more in their portfolio that are queued to go public. "It's easier than ever to raise new funds. But the pendulum may swing," Fuqua cautions. "For example, [mutual fund giant] Fidelity Magellan got so bloated that it couldn't reproduce the results that it did when it was smaller and nimbler. Similarly, the quality of VC deals can't keep up with the quantity of dollars coming in. High quality management teams are a scarce resource. New funds are not going to be able to produce the returns."

Consequently, CenterPoint continues to look for business with real revenue models, especially in early stage IT, semiconductors, telecom equipment, and Internet-based services for B2B commerce. "We invest in what we know and when we think we can add value."

Also part of CenterPoint's strategy is to house in offices with four other funds, such as Triton Ventures, Sanchez Capital, Arch Ventures, and Sevin Rosen in Austin. "We've worked together for years, have gained mutual trust, and combine our list of contacts. For early stage investments, we can share the risk," explains Fuqua.



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MoneyTree Report

The Capital Network's Role

Tims believes that often fledging companies are intimidated about the process of raising capital. The Capital Network provides an opportunity for companies to understand the issues and get connected to investors. "We get leads from TCN," Tims says.

"The Capital Network continues to be a preferred resource for tech-entrepreneurs to learn about how to raise capital and then get introduced to appropriate venture capitalists, angel investors and corporate investors. It's a very important role we play," adds David Gerhardt, President of TCN. "And its becoming even more critical as the venture funds get larger and can't devote as much time to the early stage deals. Demand for our services are increasing — and we're making a real difference as the list of entrepreneurs that we've helped prepare and find money continues to grow."

Top 5 Texas VC deals in 1999

ConnectSouth $100 million
PointOne $55 million
Allied Riser $51 million
Chorum $42 million
Agillion.com $38 million

Source: PricewaterhouseCoopers

The Pre-IPO Cheap Stock Issue: Sources and Solutions

by Adam Mandel and Matt Morris, Business Valuation Services www.bvs-inc.com

As the government-appointed guardian of the gate for the American capital markets, it is the duty of the Securities and Exchange Commission (SEC) to ensure that public companies and companies desiring access to public markets adequately disclose material information about financial position and performance — both historical and prospective. The level of disclosure required by this U.S. regulator is among the most comprehensive in the world, and is aimed at protecting the financial investors in public companies.

Pre-IPO Stock Option Grants

This charge to protect investors, however, has historically been filled with various conflicts. One such issue involves stock options granted to management, investors and other key employees by companies contemplating an initial public offering (IPO). The SEC routinely scrutinizes these stock option grants in order to ensure that pre-IPO companies have appropriately accounted for such options in their investment prospectuses. In an effort to attract and retain key employees, many pre-IPO companies, particularly high tech companies, knowingly or not, issue options at a steep discount to the eventual IPO price. While these options may vest over a period of years, they substantially guarantee a sizable profit for their employee recipients, thereby preserving employees' loyalty and their continued best efforts. "Cheap stock" is the SEC moniker given to these under-priced options.

Consequences of a Cheap Stock Issue

The issuance of cheap stock is certainly not illegal. Companies are free to practice this technique as long as they properly account for the value of these options as a compensation expense rather than as incentive options when presenting financial statements to public market investors. There are, however, negative consequences to a cheap stock issue, the most tangible of these being the cash expense associated with restating historical, audited financial statements. Pro forma financial statements to be filed in a registration statement would likely need to be revised as well, and for companies that are only marginally profitable, the resulting compensation charges that are amortized over the subsequent vesting periods can reduce or even eliminate earnings in the near term, perhaps adversely affecting the company's IPO valuation in the process. In addition, some companies have lowered their IPO price to appease the SEC thus leaving significant dollars on the table.

A less tangible, but certainly no less important, consequence of a cheap stock issue is the timing effect on the IPO itself. There have been numerous instances in the last few years when companies' conflicts with the SEC extended past the ideal IPO window suggested by their underwriters. The effects of this delay can result in the company going public in a softer market or even the company missing its opportunity to go public altogether.

SEC's Response

While the SEC has not published hard and fast guidelines on cheap stock issues, its typical response is to request a detailed list of all options granted and all shares bought and sold, sorted by date and price, for a period of 12 to 18 months prior to the filing of the registration statement. The SEC has, however, infrequently requested information going back even further. Again, while no official standard exists, anecdotal evidence suggests that the SEC is willing to entertain a 10% to 20% discount to the expected IPO price as an "illiquidity" discount or discount for lack of marketability for stock options granted no more than about three months prior to the filing of the registration statement.

Valuation Procedures

The difficulty for pre-IPO companies remains that, without an active public market for its stock, it must rely on other sources to determine the fair market value of its stock at the time of stock option grants. The three commonly used valuation procedures are (1) internal valuations by management, (2) reliance on funding valuations by venture capitalists (VCs) and (3) appraisals by independent valuation experts.

The first two procedures have sufficient pitfalls to warrant extreme caution. While management may understand the dynamics of their company's operation very well, effectively quantifying it may prove difficult while maintaining sufficient employee incentive. The use of VC funding rounds also tends to create cheap stock issues because VC rates of return are, for a variety of reasons, much higher than those required by the public investors the SEC was designed to protect. Both the described valuation procedures have a tendency to increase the difference between the eventual IPO price and the price at which stock options are granted.

By all accounts, a well-documented, thorough analysis of a company's stock price by a qualified appraiser before stock options are granted remains the best defense to an SEC challenge involving cheap stock. While this valuation process may require periodic updates leading up to the IPO, the time and money savings are usually quite substantial if the SEC is satisfied that a company's board of directors has exercised sufficient due diligence in granting its pre-IPO options.

BVS is a nationally recognized financial and valuation advisory services firm. If you have any questions please contact BVS at 972-620-0400 or amandel@bvs-inc.com.

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Selecting the right people—the greatest single problem young companies face

by Sam Gassett, Primus Associates

The leadership team is the most critical component of an early stage venture. The greatest challenge facing technology companies is finding those key leaders.

To many investors and venture capitalists, the key leadership's the capabilities weigh heavily in valuing a new venture. The strength and growth potential of the company depends on investors' belief in the leaders. Will they be able to grow the business? Do they have the right industry expertise? Is their knowledge of the marketplace and rolodex significant and current? How well do they do in a crisis, during tough negotiations, or battling new competition and market shifts? How well do they do in public; In giving presentations; closing sales; or speaking with the press? Most importantly, is the leadership team the right one for that venture?

What might seem to be an easy decision--that is, the team has great résumés, industry experience, and good management skills--is much more complex when evaluated thoroughly. A great leader at an early stage venture is not necessarily the same person who can lead a multinational, established corporation and vice versa. Add to that the essential need for a strong cultural fit and you have a complex task in a time when demand greatly exceeds supply. Each company must establish its own unique culture that will create the right momentum for a home-run. That culture is built, executed and re-built by the high-impact leaders driving the company.

What makes a good leader for a high tech startup?

Again, every company is unique in its need for a successful venture. However, some traits do stand out as general qualifiers.

- A proven leadership track record with industry expertise in the startup's marketplace
- Leadership at an early stage company
- The ability to manage multiple tasks, work well under great stress, handle crisis well and be the lead salesperson for the company
- Excellent presentation and net working skills
- Experience launching a new product, exceptional marketing knowledge
- Strength assessing and managing competition
- Desire to work long hours, willingness to travel heavily, and ability to communicate within the financial community
- The ability and rolodex to bring like individuals to the team either directly or as advisors

The stronger each of these traits are the better the chances a new company will have in achieving critical goals such as funding, sales and product development.

Success is not guaranteed with the right leadership, but the chances of failure with the wrong leaders increase dramatically.

What are the top leaders looking for to join a startup?

Many of the same things valued by founders, employees, and investors are Excitement in the idea and business model; belief that there is a chance for enormous success and that they will play a key role in making the success happen

- A salary that covers the lifestyle they are accustomed to
- Excellent options to create significant personal wealth when the company succeeds
- A capable and creative team with a burning desire to make the business succeed; that are willing to stick out through difficult times

How do you find those best-of-the-best leaders?

Utilizing your existing resources combined with hiring professionals who specialize in executive recruiting for high tech executives is the best route. Relying on one's own network will get the company to a certain level. You should leverage that to the best of your ability. In addition, build upon the relationships the startup has with investors and venture capital firms as well as service providers, such as law, accounting, banking and consulting. It is in everyone's best interest for the new venture to succeed. When it comes time to take the company forward, a professional firm specializing in executive recruiting is the best option.

How do I decide when it is time to get outside recruiting assistance?

The sooner the better. If you had chest pains you would not delay seeing a doctor; the management of any company is the heart of that organization and you want it to be healthy and strong. Since company's have a variety of options for outside search, you want to weigh all of the factors carefully. Choosing what appears to be the least expensive route often winds up being the most costly versus selecting a firm with a proven track record in your industry from the beginning.

Ask yourself these questions:

- What kind of guarantee does the firm offer?
- Have they worked with similar companies and similar positions?
- Do they have a "hands-off" policy where they will not recruit from the company they are working for?
- How many clients do they already have? Do they have so many with a hands-off policy that they can not recruit from the greatest pool of potential candidates possible?
- What is their track record of success and how long does it take them compared to the national average to complete a search (the national average to complete a leadership level search is 14 weeks)?
- Do they know the city they are recruiting a leader to and can they sell that city to a potential recruit?
- Will they stay with you for the long run if the search takes longer than planned?
- How often will they up date you on their progress?

If you weigh all of the factors carefully and place the right emphasis to this critical part of any business your chances of success will improve. You can have the best idea ever imagined, but without the right team, the idea will not develop into reality.

Sam Gassett is the founder and president of Primus Associates. He has over 20 years of recruiting and human resource expertise and has been involved in recruiting over 10,000 positions. Primus Associates is a national executive recruiting firm headquartered in Austin, Texas that works solely with high tech companies. Sam can be reached at sam@primusnet.com

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Please fax this form to 512.305.0836, or clip and mail. See also our website www.thecapitalnetwork.com

☑ YES! I would like more information about The Capital Network.

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My interest in TCN (Please Describe) ____________

____

Throughout the year, TCN events bring entrepreneurs and investors together.

Neil Webber, Vignette co-founder and AV Labs master entrepreneur with Joel Wiggins, executive director, the Austin Technology Incubator.

Austin Mayor Kirk Watson welcomes attendees to NewMedia Ventures Conference.

Nancy O'Brien, chief evangelical officer, ExperienceArt.com.

David Gerhardt, TCN president; Jeff Blanchard, investor and TCN board member; Monica Summers, Reuters reporter.

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Calendar of Events

Texas Venture Capital Conference and Financing Entrepreneurial Ventures Workshop
May 3-4, 2000
The Four Seasons, Austin

Invest Midwest
May 23-24
Ritz Carlton, Clayton, Missouri

Southwest Venture Capital Conference and Corporate Investment Workshop
October 25-26, 2000
The Westin Park Central, Dallas

Texas Angel Investors -- Call for dates

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