THE CAPITAL NETWORK

CAPITAL UPDATE

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Normalcy Returns to Funding Strategies

By Emily Sopensky

For a year now, the pace of initial public offerings for technology companies has been slower and mergers more frequent than in the boom of 1999.

While most venture capitalists are not lacking funds to invest, they are being more deliberate in making investments. Now, to many entrepreneurs – with their heads and hearts deep into their technology – sealing the deal may seem to be an artform comprehended only by the ancient ones – or those whose memories go back four or five years.

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That's right. Investors are reverting to tried and tested practices commonly used just a few years ago. For instance, not long ago, some emerging companies were successful in their IPOs despite not yet being profitable. But no longer.

"I would say [we look for] at least several quarters of profitability," says Robert Fabbio managing director of TL Ventures Austin. Concurring, Stephen Straus, a general partner with Austin Ventures, says: "We're back to normal. As an example, you can't go public without two to five quarters of profitability.

"There is still venture and angel money available for companies," says David Gerhardt, president of The Capital Network. "Investors are doing more due diligence now. We at TCN continue to help companies raise money, but more than ever before it's important to ensure they have realistic business plans that show a path to profitability."

Most agree that the money is there, but it is going out slower and more carefully. Austin Ventures, for example, filled a $750 million fund last year and closed on a new $1.5 billion investment fund this year. Earlier this year, TL Ventures closed on a new $675 million fund. Some in the VC community are reminded of the early Nineties, when finding good companies to fund involved many, many partner meetings, spending time vetting companies and looking for good prospects.

The use of "new" old practices means, too, that the definition of intellectual property is not quite as facile as it has been recently. "Entrepreneurs that are developing protectable patents are clearly attracting the attention of the venture funds," says Doug Mangum, manager of Silicon Valley Bank's Southwest Division in Austin. Less attractive are companies without any IP or with only business process patents.

"An entrepreneur introducing a new trend really catches my attention," says Straus. "If you have a product, you only need to build a company." While that might sound like simplistic advice, Straus and other experienced investors know that building a business that lasts takes a lot of unglamorous, day-to-day hard work. Laying the foundation is important.

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WHAT A DIFFERENCE A YEAR MAKES

by Mark Hughes, Thompson & Knight, LLP

As everyone has heard ad nauseum, the environment for raising venture capital has changed dramatically in the past year. Still, venture capitalists are continuing to make investments, albeit much more cautiously and at much lower valuations. In addition to the increased scrutiny of investments, investors are also frequently insisting on terms that are more onerous than the terms common to deals of the past two years.

In the current environment, many investors are insisting on "full ratchet" antidilution protection, which adjusts the conversion price of the preferred stock all the way down to the price of the lower-priced sale of shares, regardless of whether that sale was only a small block of shares and therefore not significantly dilutive from an economic perspective.

Not surprisingly, as a result of the economic slowdown, entrepreneurs are often faced with a "take it or leave it" offer and don't have significant leverage to negotiate the terms of the investment. With the exception of some truly rare deals, entrepreneurs are no longer in the position of trying to decide which venture capitalist they prefer. They are now seeking any deal that lets them pursue their vision, while still providing a realistic possibility of a financial reward.

Some would say that the world has finally returned to normal and that money invested in highly risky ventures should have terms which reflect the level of risk. Others might say that the terms which were common in the heyday of venture investment already reflected this high risk and that the terms being offered by venture capitalists today are too burdensome. Nevertheless, the golden rule seems to be back in fashion - "He who has the gold makes the rules."

The Good Old Days

In what entrepreneurs will refer to as "the good old days", a company that had most of the right characteristics (a changing formula), could expect to receive a term sheet that provided for a cash investment in preferred stock. These deals often provided that, in the event of a sale of the company, the investors received their money back and then were entitled to share with all of the other stockholders in the remaining funds. Because everyone knew that these companies would operate at a loss, these deals almost never required the payment of a quarterly or yearly dividend. Investors generally insisted that if the company later sold more stock at a lower price, the conversion price of the preferred stock held by the investor would be adjusted to make up for the economic effect of this lower priced issuance. Notably, because most of these deals provided for an automatic conversion of the preferred stock into common stock in the event of an IPO, short-sighted entrepreneurs were often less concerned with the intricate details because, after all, they planned to do an IPO.

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Back to Reality

With the changing private equity markets, investors are frequently insisting on more aggressive provisions to protect their investments and ensure adequate returns. Below are a few examples of some of the terms that investors are requesting and that entrepreneurs should be prepared to see.

Deal terms common to the current economic environment

1. Higher liquidation preference. In the event of an acquisition, investors are now seeking more than simply a right to receive their money back plus a pro rata portion of the proceeds. More and more, investors are requiring a return equal to two or three times their initial investment, plus a pro rata share of the remaining proceeds. Entrepreneurs should be prepared to negotiate alternatives such as eliminating the preferential payback assuming the purchase price of the acquisition yields a certain minimum return on the investor's investment.

2. Required dividend. Before venture capital became common in businesses that were not expected to generate cash in the near or mid-term, venture investments often required the payment of a dividend. In recent years, this dividend provision has been nothing more than a requirement that if a dividend was ever paid, then it must first be paid to the investors. These provisions operated as nothing more than a deterrent from any dividend payment. Currently, investors are sometimes requiring the payment of a dividend even from companies that are not yet profitable. Often, the company will be permitted to pay the dividend in additional shares

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of preferred or common stock. However, this action will have a further dilutive effect on the existing stockholders.

3. "Full-ratchet" anti-dilution protection. In the past, investors usually insisted on a provision called "weighted-average" antidilution, which protected them from the economic effects of a sale of shares at a price less than the price that the investors paid by calculating the actual economic effect of the lower-priced issuance and adjusting the conversion price of the preferred stock accordingly. In the current environment, many investors are insisting on "full ratchet" antidilution protection, which adjusts the conversion price of the preferred stock all the way down to the price of the lower-priced sale of shares, regardless of whether that sale was only a small block of shares and therefore not significantly dilutive from an economic perspective.

4. Staged investments. Instead of putting all of the committed funds into a company at the initial closing, investors are often staging their investments. While the agreement is generally a binding commitment, the funds do not have to be contributed unless and until the company meets certain defined milestones. Milestones usually relate to internal development goals, but could include financial performance goals such as sales or profitability levels.

Of course, these provisions are only tendencies and trends. Demand for the particular deal in question will ultimately drive the negotiations. Nevertheless, one fact is clear - the golden rule is back in fashion.

Mark Hughess is a partner in the corporate and securities section of Thompson & Knight, LLP in Austin, specializing in mergers and acquisitions, venture capital and other private financing and general business advice to emerging companies.

Message from the President

Many studies of small business report what most entrepreneurs put in the "back of their heads" -- fully 80% of small businesses fail. Two of the primary needs for entrepreneurial businesses are the need for experienced business guidance and the need for growth capital.

Technology-based businesses are one of the fastest growing segments of entrepreneurial ventures and the primary types of businesses seeking and receiving angel and venture capital. At The Capital Network, we work with early-stage technology companies. These fledgling ventures frequently have:

- Minimal or no product or revenue
- Uncertain market
- Incomplete management team
- Smart, driven, inexperienced entrepreneurs

These companies need advisors who provide "business smarts" to guide their ventures, and they need capital to fuel their growth.

And what do the investors need in order for them to invest in these technology-based companies? They need quality opportunities screened to their interests. They want to co-invest with partners. They want to be involved with the venture, so most want to invest close to home.

In addition to investment capital, business angels, venture capitalists and corporate investors also bring a lot of business guidance and expertise to the table.

The key to growing a new technology business is often access to smart money. Investors bring the value-add of industry experience and contacts. In addition, they recognize the complexities of managing a fast-growing venture.

The Capital Network's mission is to help prepare and mentor entrepreneurs. Simultaneously, we introduce investors and entrepreneurs and provide access to expertise. In short, we at TCN help technology entrepreneurs prepare for and find access to "smart" funding resources.

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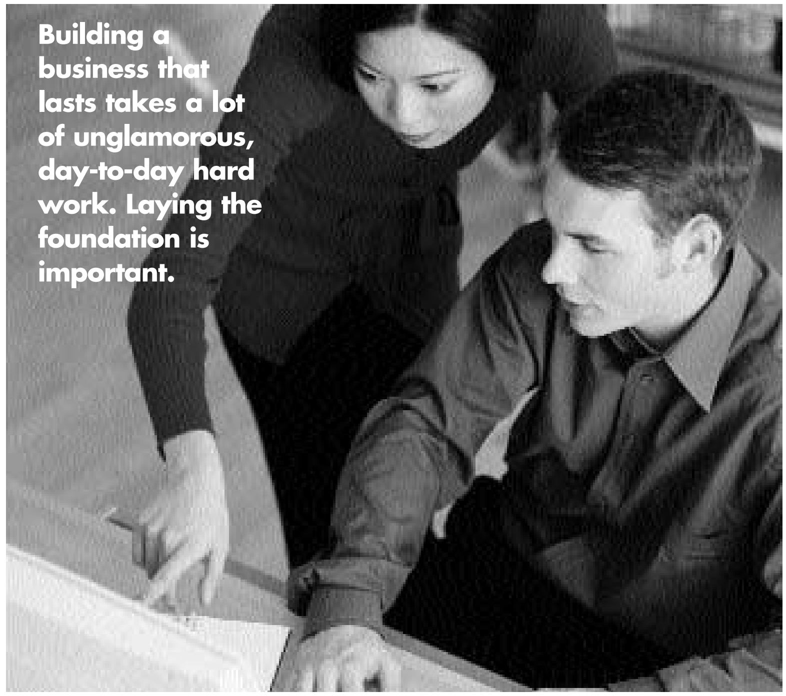
"My belief is to get advice from folks who know what they're talking about – like from The Capital Network on how to run a startup," says Straus.

Under the current climate, decisions are made a lot more rapidly to pull the plug on an ailing startup. But the strong companies that are seeking refunding are getting it faster. "We're seeing a little bit less [requests for continued funding] but the quality is very, very good," says Mangum.

"It is no longer acceptable to fund a company and to expect the next round. Mediocre companies will be separated," he cautions, meaning that there are fewer givens now that the over-exuberance of the investment climate has been quelled. Straus, too, believes the second round of financing is much more difficult. "You have to prove a lot more now."

"Investors are doing more due diligence now. We at TCN continue to help companies raise money, but more than ever before it's important to ensure they have realistic business plans that show a path to profitability."

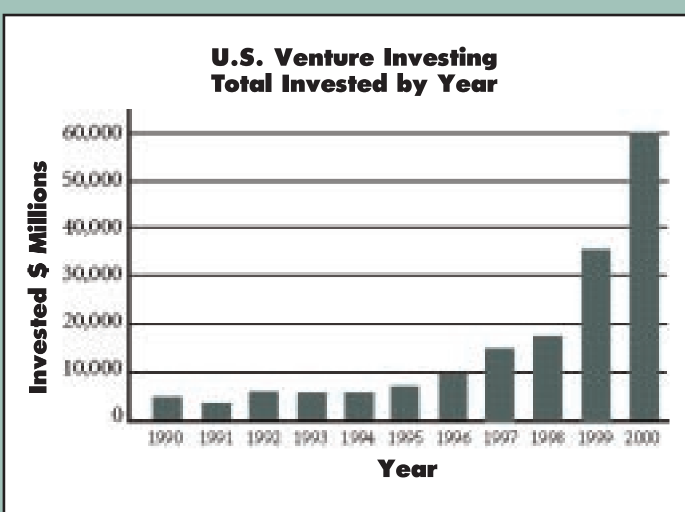
David Gerhardt



While the rules of economics prevail for angel investors, too, history is not as relevant. Instead, learning the practices, likes and dislikes of the individual investor are more important to an entrepreneur seeking early stage funding. Many, angel investors refuse to look at a proposal " over the transom," preferring those that have been referred by trusted colleagues.

Just like a gardner likes to till the soil and nurture tiny plants to big healthy ones, an angel investor likes to invest time and or money with the same avocational motivation – to have fun. Some generally relish spending hours upon hours with chosen acolytes. Some veer away from companies with distant headquarters. Ultimately, learning the ropes of how to raise funds is a life-long process with lots of help along the way for those who ask for it.

FAST FACTS



Investor's Expected Returns for Early-Stage Equity	
Company's Age in Years	**Returns in 3 to 5 yrs**
Start-up	10x
Less than 1	6x
1 to 5	5x
5+	3x

U.S. Angel and Venture Capital Investing in 2000		
	Venture Capital	**Business Angels**
Amount	$60 billion	$35+ billion
Number of Deals	5000	50,000
Ave. Investment	$ 12 million	$700,000

Financing, e-Logistics Part of United Parcel Service's Solutions for Small Businesses

Access to the latest technology as well as the expertise to optimize a supply chain are critical issues for many businesses, but are often perceived as too expensive. To provide startup and small companies with affordable options for equipment and supply chain capabilities, United Parcel Service recently announced partnerships with several well-known vendors.

In April, UPS announced a new computer purchase/lease program that provides small businesses fast, cost-effective options for either leasing or purchasing new personal computers. In an industry first, UPS has partnered with four major computer manufacturers – Compaq, Dell, Gateway and IBM – to create the **UPS OnLine Advantage** program.

This innovative program is available as a value-added service to UPS customers and provides a variety of computer hardware configurations pre-loaded with UPS OnLine WorldShip software and Microsoft Small Business software. The objective is to provide UPS customers the hardware they need to enjoy the benefits of UPS automated shipping software and those that Microsoft Small Business brings to their other business operations.

UPS Capital Corp. recently announced another financing program called **UPS Next Day Leasing,** which provides small businesses with financing solutions for leasing all types of equipment, such as copiers, office furniture and warehouse equipment as well as computers. UPS Capital finances business equipment purchases up to $250,000.

Both the UPS OnLine Advantage and UPS Next Day Leasing address the needs of small business for flexible financing options.

To make crucial supply chain expertise available to emerging e-businesses, **UPS e-Logistics** has teamed with technology powerhouses Oracle Corp., PricewaterhouseCoopers and EXE Technologies, Inc. to provide integrated, end-to-end supply chain management services for the quick and cost effective launch of e-businesses.

UPS e-Logistics, a wholly owned UPS subsidiary, has combined leading solutions from PricewaterhouseCoopers, Oracle and EXE Technologies with the strength of UPS's global fulfillment and distribution network, IT infrastructure and the logistics expertise of the UPS Logistics Group. The result is a complete range of services available to manage the back end of the e-business supply chain, starting when an order is placed on a client's Web site.

The UPS e-Logistics service offering includes warehousing and inventory management, order fulfillment (pick, pack and ship), inbound and outbound transportation, returns management, customer call center and management reporting. The standardized, pre-built services can be bundled and configured, and are scalable for future growth.

UPS e-Logistics will serve both business-to-business and business-to-consumer e-commerce clients, ranging from e-business startups to the dot-com divisions of established corporations. It is the first business to be launched by the **UPS e-Ventures** incubator.

Nearly a year in the making, UPS e-Logistics draws on the respective strengths of its powerful technology team.

This innovative program is available as a value-added service to UPS customers and provides a variety of computer hardware configurations pre-loaded with UPS OnLine WorldShip software and Microsoft Small Business software.

Specifically:

- **PricewaterhouseCoopers,** a leading e-business consulting organization, provides overall systems integration consulting and project management services to support an innovative, reliable and scalable solution for the UPS e-Logistics offering.
- **Oracle Corp,** the first software company to develop and deploy 100 percent Internet-enabled enterprise software, provides full enterprise resource planning (ERP) with integral order management and advanced planning and scheduling (APS) functionality.
- **EXE Technologies, Inc.,** a leading provider of multi-channel fulfillment, ware house and distribution soft ware, provides warehouse management systems at all UPS e-Logistics distribution centers. EXE will bring its EXceed(tm) eFulfillment System (eFS) to the partnership along with its expertise in third party logistics and capability to rapidly deploy solutions on a global basis.

Businesses that want more information about the UPS OnLine Advantage program should call 1-800-PICK-UPS or visit www.capital.ups.com. More information regarding UPS e-Logistics is available at www.e-logistics.ups.com.

In the Company of Peers

Sandford Rothe, Deloitte & Touche, LLP

If there's anything the Internet was made for, it's collaboration and communication across disparate networks. And, in its simplest form, that's what P2P networking is all about. Napster brought the term to our attention, but new P2P applications that eschew a central server, such as universal file sharing, distributed computing, collaborative computing and intelligent agents, have the potential to efficiently and affordably maximize computer resources and improve communications.

One of the earliest P2P users was Intel. It developed NetBatch, an application that handles storage and extra CPUs. "We were able to raise our internal compute efficiency from 30 percent to about 80 percent within the company," says Patrick Gelsinger, vice president and chief technology officer of Intel's Architecture Group. "We now want to take P2P resource sharing and generalize it for more applications across the corporate fabric."

Not long ago, Intel announced an initiative to encourage the growth of new P2P companies and technologies. Companies like Mangosoft, Groove Networks and Distributed Science are identifying possible applications for business, although it remains to be seen what the "killer app" will be.

Why Now?

Gelsinger attributes current interest in P2P to a convergence of three developments: increased bandwidth, a ubiquitous communications capability that's enabled a common language across networks combined with the connectivity and power of the Internet.

"Napster and Gnutella were a spontaneous combustion of those three things," he says. "Look at what's now possible: an organic, end-point driven peer-to-peer capability with a geometric growth base. This spark has shifted the entirety of our thinking so that with all these peer resources on the Net, we are re-architecting how we think about the network and applications."

Where's the Money?

One of the more intriguing and creative uses of the distributed-computing application of P2P is the SETI@home project, an ongoing search for extraterrestrial life by the Search for Extraterrestrial Intelligence (SETI) Institute. SETI@home analyzes radio waves picked up by the Arecibo radio telescope in Puerto Rico. Distributed computing creates resource allocation in which companies rent network bandwidth or CPU cycles on personal and corporate computers, essentially "borrowing" a computer's unused brainpower.

"When you get down to the base level of P2P or even distributed computing, where is the money to be made? It's in the processing power," says Naresh Lakhanpal, national practice director of products and services for Deloitte & Touche's Technology & Communications Group.

Eytan Adar, a research scientist at Xerox's Palo Alto Research Center (PARC), explains that it's no surprise Intel is involved in the initiative. "It's in Intel's interest to figure out how to get people to use their CPUs and leverage idle CPU cycles," he says.

And, in fact, what could be better for Intel than for PC owners to want more powerful desktop machines? Observers mention that Intel's Pentium 4 with NetBurst will stoke P2P, and, even though Gelsinger says the company didn't design the chip with P2P in mind, he believes "It was good luck for Intel. Now we'll take conscious engineering efforts to make it more meaningful."

But other observers say that the microprocessor is irrelevant with the advent of interconnectivity, pointing out that the processing power of the Pentium 4 isn't significantly greater than that of previous Pentium products.

For some companies, the P2P connection has been tenuous. "If anything is holding back a technology company, it's fear," says Cheryl Currid, president of research firm Currid & Company. "Since P2P offers a lot of promise to change things, companies have to think through their positions."

While Currid notes that coming down the pike in the near future will be bigger and better search engines based on P2P as well as small ad hoc collaboration groups, she sees selling the raw service as the business model for P2P. "It's in pulling together the horsepower and taking charge of the application," she says. "Integration services can also give companies a profitable model or just sell an application that happens to be P2P."

That's what Mangosoft is doing. "We are involved in peer-to-peer clustering," says CEO Dale Vincent. The company has two products: Mangomind, which allows Internet users to collaborate as if they were on the same local area network in the same secure manner, and Cachelink, which links together browser caches for improved Internet performance.

But, Adar notes the benefit of file sharing is unclear.. "We haven't seen too many applications that are tremendous improvements over server-based document repositories," he says.

P2P Usage Models Under Development

Type	Description
Universal File Sharing	Protected content distribution
Active distributed Storage Sharing	Reduces need for files servers; migrates files to area of use
Collaboration	Secure file sharing in ad hoc groups
Distributed Computing	New usages models enabled by 10X reduction in computation costs
Intelligent Agents	Cooperative search engine; computer virus quarantine

Source: Intel Corporation

Too Much Togetherness?

While P2P is a very attractive proposition, it does present potential problems. The most obvious is copyright infringement.

"Some people will take content and use it without compensating the entity that created it," says Lakhanpal with Deloitte & Touche. "Others may be able to harness the power of multiple computers to generate a huge level of power that may be used in a devious way, like hacking a system or countering a system to make it useless."

While intellectual property management is essential, Currid notes content distribution doesn't have to be unregulated. "A simple Java applet is all that's needed to keep the right people in and the wrong people out of copyrighted or proprietary content," she says.

Other key issues are security, data integrity and interoperability-all concerns that the P2P Working Group is addressing. Gelsinger sees P2P operating beyond internal corporate boundaries, but he recognizes that before corporations are willing to do that, a secure, reliable infrastructure must be established.

If these challenges are overcome, P2P stands to become a value proposition. "Think about the amount of processor power that comes with a PC today. Look at the size of the hard drives," says Lakhanpal. "Look at the capacity of fiber and broadband. All those combined can make up a very powerful system."

Sandy Rothe, Deloitte & Touche Managing Partner, leads D&T's Technology and Communications Practice in Austin. He is responsible for D&T's service delivery to technology and communications clients and maintaining relationships with the high tech community, law firms, venture capital firms and other civic and professional groups in the Austin area. Sandy has extensive experience serving software, telecommunications, cable, Internet service providers, and other high technology companies and is active in several community organizations.

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"We're involved in a number of VC conferences around the country and TCN consistently puts on some of the best regional events. They continue to deliver."

–Bill Tilghman, Managing Director, Nasdaq

David Gerhardt and Dr. George Kozmetsky

The Capital Network recently launched Venture Watch, an independently produced television news series profiling entrepreneurs and emerging technology business ventures in Austin. For more information, contact René Michaels, Producer, Venture Watch, (512) 305-0846 email - info@venturewatchonline.com

Calendar of Events

May 16: Texas Venture Capital Conference (Austin)

May 17: Financing Entrepreneurial Ventures Workshop (Austin)

October 10: Financing Entrepreneurial Ventures Workshop (Dallas)

October 11: Southwest Venture Capital Conference (Dallas)

December: Southwest BIO Venture Conference (Galveston)

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