



Steve Hatfield, PricewaterhouseCoopers, Victor O'Dryna, Maia Heyman, BankBoston Ventures, and TL Stebbins, Adams Harkness & Hill discuss the money market outlook for 2003.

***This Issue:***

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*Money Market Outlook 2003*

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**MAY:** Patricia Russo, CEO & President, **Lucent**

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# Forum

# Reporter

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**FEBRUARY 2003**

**VOL. 21 NO. 6**

**10-250 Re-Cap**  
**Miss The Last 10-250?**  
**Let's Review!**

**Money Market Outlook**  
**2003**

By Martha Mangelsdorf

**Next 10-250: BIOTECH: Innovative Financing Strategies, Past & Present**  
**Wednesday, February 12, 2003**

**Location: Room 10-250 @ MIT**

**NEW Keynote: Dr. Gunther Winkler,**  
Vice President of Strategic Initiatives,  
**BIOGEN**

**Case:** [Paratek Pharmaceuticals](#)

**Panel:** Ted T. Ashburn, M.D., Ph.D.,  
Associate, Oxford Biosciences, Eileen  
Coveney, Partner, LEK Consulting., Stu  
Barish, Managing Director, Leerink Swann

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**What does 2003 hold for the world of venture capital and IPOs?**

The predictions weren't overly rosy at the MIT Enterprise Forum of Cambridge's January 10-250 panel discussion about trends in the capital markets. In fact, moderator Bob Crowley, president of the Massachusetts Technology Development Corporation, joked that the new theme song for many people in the money business is a song from "Saturday Night Fever"-- "Staying Alive."

"It's a tough, tough time," explained Stephen Hatfield, a partner with Ernst & Young. Nonetheless, Hatfield noted that 2002 was shaping up to be the fourth largest year in venture investments - but it didn't feel that way. (Final numbers for 2002 weren't in yet at the time of the event.) And, he said, "overall, we think that it is going to start to come back." In particular, Hatfield had good news about the medical device space, although, even there, in later rounds, "the market realities I think are setting in."

In software, both entrepreneurs and first-round investors have been seeing significant dilution when companies raise money, Hatfield explained. Because the return on the risk of investing in first-round deals is pretty poor, venture capitalists are eyeing investments very carefully. However, on the plus side, Hatfield suggested that the worst period in early-stage investing may be behind us. "At the early stage, most of the bloodletting has happened," he said.

After Hatfield spoke, Victor Odryna, an experienced entrepreneur who is president of Mirecho Labs, shared some of his insights into raising venture capital today. The kind of information technology company venture capitalists want to invest in, he said, has a completed management team; a developed product, in field trials; at least two major

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customers; a leadership position in a market that could be huge; significant barriers to entry; and a clear path to profitability in 12 months or so. "What are they really saying? I might be interested, but only if it's a no-brainer," Odryna explained.

According to Odryna, limited partners are not rewarding venture capitalists for making new investments, because the venture capitalists' "existing portfolios are full of problems." He estimated that 75% of companies that received venture capital funding between 1995 and 2000 are still in the venture capitalists' portfolios. What's more, he said, because valuations have plummeted, venture capitalists say they can do a C or D round at roughly an A valuation.

Odryna suggested that there will be a lot of opportunity for profitable \$10 to \$50 million companies - but we have to find a way to invest in them. While too much time is spent looking for the next big thing, "niche-focused companies really are going to be the strongest," Odryna argued. And, with valuations lower, Odryna argued, "the math doesn't work any longer," for larger venture capital investments. "The economics of deal investing just has to change" for venture capitalists, he said.

Maia Heymann, director of BancBoston Ventures, said that, in the venture capital community, "everyone's moving later-stage." Because early-stage investors have been crammed down, the early-stage financing risk is too high, she said. "It's problem, in terms of how are the new technologies going to be funded," she said. "And I don't think there are any simple answers."

Heymann observed that there's too much money in the system. Most new checks being written are for additional financing to existing portfolio companies, she said. However, she observed that there's been increased venture capital investment in healthcare, genomics, bioinformatics and wireless.

After Heymann spoke, T.L. Stebbins, managing director at Adams, Harkness & Hill, assessed the state of the IPO and public markets. In 2002, Stebbins said, the U.S. capital markets were actually not that bad, but the IPO market is down substantially. What's more the average IPO size in 2002 was \$296 million, and 58% of all U.S. IPO dollar volume in 2002 came from spin-outs, he said. Stebbins added that there were only 20 venture-backed IPOs in 2002. The bar has been raised to go public, Stebbins said. Companies should have \$6.5 million in after-tax profits and absolutely predictable earnings over the next six quarters, he said. The IPO window "is not closed," Stebbins explained. "It's just not a very wide opening."

Things aren't well with NASDAQ, according to Stebbins. "The NASDAQ market is broken" from a trading point of view, he said, noting that, during 2002, 610 companies were delisted from NASDAQ. He said that the cost of being public remains very high - with annual expenses relating to being public a minimum of \$250,000. And he predicted that there will be more companies going out of the public markets than coming into them for the foreseeable future.

Stebbins said he thinks that markets may have established a bottom in early October. "The bleeding has stopped," he said. "But it's going to be a long-term recovery."

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## Sponsor Insight

**Creative Use of Milestones Can Unlock Venture Capital**

By: **Jeffrey L. Quillen**  
[Foley Hoag LLP](#)

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From Cambridge to Silicon Valley, venture capitalists are giving entrepreneurs the same advice: solve real problems of real customers and make sure your solutions save the customers money. Many entrepreneurs have heard this advice and have developed ingenious technologies and sound business plans, but are still unable to attract critical equity financing. In response to this situation, perceptive entrepreneurs are recognizing that prospective investors, like customers, are currently working through their own problems and might be receptive to creative solutions that could benefit entrepreneurs and investors alike. One such creative solution is the use of milestones in venture capital financing. This device can help entrepreneurs attract financing by reducing risks for investors while simultaneously delivering savings for both parties in terms of time and money.

According to the most recent MoneyTree Survey, venture capital firms invested approximately 50% fewer dollars in 2002 than in 2001. The number of companies that received first-time financing decreased by 35% during the past year. There are several reasons for this. Private equity investors, with their fingers on the pulses of the IPO and merger and acquisition markets, are reluctant to make new investments while there are no exit opportunities in sight. Also, venture capitalists are spending much of their time doing triage on their existing portfolios, selecting the companies with the best chances of survival and then, in many cases, transforming those companies' business models to adapt to a radically different business environment.

A less discussed reason for the decreased level of venture capital financing is the credibility crisis in the capital markets generally. Investors of all kinds, including the limited partners that invest in venture capital funds, have been badly burned by corporate scandals during the last two years. Their faith in auditors, analysts and senior management has been badly shaken by the charges brought against Arthur Andersen, blue chip investment banks and the likes of Enron, Worldcom and Adelphia. More than a few investors feel they were duped by promoters of e-commerce and genomics companies. One result is that investors in venture funds are pressuring venture capitalists to cast an especially critical eye over new opportunities.

A small but growing minority of venture capitalists are responding to this heightened skepticism by expressly conditioning their investments upon the achievement of specified milestones. For example, investors will agree to a \$6 million Series A round and divide the round into two tranches of \$3 million. The first tranche will be invested at the initial closing and the second tranche will be invested upon achievement of a specified milestone by a specified deadline. Typical milestones that one might expect to see in a venture capital financing include: the hiring of a qualified CEO; the signing of a collaboration agreement with a major pharmaceutical company; or FDA acceptance of an investigational new drug application. Generally, any significant, objectively verifiable event in the development of a company can be used as a milestone in a financing contract. This structure significantly reduces risks for the investors and rewards the company if it is able to meet or exceed its projections. Effectively, the investors are telling the company "prove it or lose it."

The use of milestones in venture capital financing is not novel but it is rare and under-appreciated. Experienced venture capitalists will tell you that follow-on rounds of financing have always been based on the achievement of milestones, albeit implicit and evolving ones. Within the last few years, the use of express milestones in venture capital financing contracts has been limited mostly to investments in less attractive, riskier companies. The time is right now, however, for all start-up companies to embrace milestones, shake off any stigma associated with them, and explore new ways to utilize them to the advantage of companies and investors alike.

Entrepreneurs should not be concerned with any supposed stigma of milestone requirements in venture capital financing. Milestones are used effectively and without any negative connotation in other business contexts. Premier biotechnology companies make milestone payments to universities in connection with exclusive license agreements and they receive milestone payments from their pharmaceutical partners in connection with their drug discovery and development efforts. In the merger and acquisition market, which is confronted with the same credibility crisis that has

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affected the venture capital market, buyers of businesses are making greater use of contingent deferred consideration, or "earn-outs." In an earn-out, the buyer holds back a portion of the purchase price until some point after the closing and will pay it to the seller only if the acquired company actually achieves one or more specified milestones. In the context of bank financing, even the most stable and successful companies are required to satisfy milestones before they can obtain advances on their lines of credit. Finally, the bubble has burst, mature companies are capitulating to lower valuations in "down rounds," and companies have more important things to worry about than flawed perceptions from a bygone era.

Milestones can be used creatively to benefit weak companies, strong companies and investors. Potential uses of milestones in venture capital financing are limited only by the imagination of the participants.

From the perspective of a company struggling to attract attention from investors, a financing round subject to milestones is certainly better than no financing at all. It might enable such a company to get its foot in the door and a venture capitalist on its board of directors. Aside from commitments for additional tranches of financing, companies also can use milestones to escape from draconian deal terms. For example, a struggling start-up that does not have the leverage to avoid a 3X liquidation preference or a full ratchet anti-dilution provision might be able to lessen their impact by persuading the investor to agree to the expiration of those terms if the company achieves specified milestones. As described in more detail below, milestone-based financing also can enable founders to avoid extreme dilution at today's low valuation if the deal is structured to step up the stock price with the achievement of each milestone.

Companies that are being courted by multiple investors can also benefit from creative uses of milestones. These companies can use milestones to negotiate two significant financing rounds for the time and expense of one. For example, investors could agree to invest \$5 million to purchase Series A stock at an initial closing and an additional \$15 million to purchase Series B stock (at a higher specified price) at a second closing, which will only occur if the company achieves a specified milestone by a certain date. If the company has enough leverage (and some of them do), it can structure the Series B round as an option of the company to "put" its Series B stock to its investors. In that case, if the company timely achieves the milestone, it can decide whether to sell its Series B stock to its investors at the agreed upon price or to go back into the venture capital market and see if it can get a better price. That arrangement is cheaper and more efficient than the traditional model of achieving a goal with one round of funding and then having to start all over again negotiating the next round. If the company fails to achieve the milestone, it can explain the reasons to its investors and hope to find a sympathetic audience or it can go back into the venture capital market to raise its Series B round at a lower price.

Milestone-based financing can benefit investors, and make them more willing to take a chance funding a new venture, by reducing many risks. Investors can invest their funds in smaller increments and withhold additional funds if the company does not perform as expected. One benefit of this strategy is that fewer venture capital dollars will be exposed to the claims of venture lenders who have security interests in the accounts of their borrowers. Another benefit is that it should improve the venture capital funds' cash-on-cash rates of return as the money they invest will go to work faster and not sit idle for long in the money market accounts of their portfolio companies. A venture capitalist also may find it easier to get approval from his or her investment committee for a commitment that is staged and contingent on the company's performance.

Aside from using milestones to hedge funding risks, investors can use milestones to trigger additional rights. For example, financing documents can be drafted to accelerate redemption rights or grant control of the board to the investors if the company fails to achieve specified milestones.

To conclude, recent corporate scandals have created a credibility crisis that is choking the flow of funds to new ventures. Milestone-based financing can reduce risks for investors, reward companies that actually achieve negotiated goals, and reduce transaction costs. That may be just the right combination to unlock venture capital for

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Discarded computers, even those with "erased" disk drives, may harbor confidential information such as credit card numbers and medical records, two MIT graduate students found. [MORE](#)

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Tamika and Brendan had identical backgrounds and credentials. Yet when their resumes were submitted in response to help wanted ads in Boston and Chicago, many more prospective employers were interested in Brendan. Tamika and Brendan were two names selected by researchers at MIT and the University of Chicago School of

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**Forum Entrepreneur to Watch**

**Paula Singer, Windstar Technologies, Inc.**

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**MEMBER BIO:**

CEO and co-founder of Windstar Technologies, Inc. and attorney/partner in the tax law firm, Vacovec, Mayotte & Singer, Newton, MA. Ms. Singer has combined her career experiences - over 20 years advising individuals, employers and payers on international tax matters, 2) over 5 years processing immigration applications while employed by Arthur D. Little, Inc. and 3) over 10 years designing sophisticated computer applications - to develop and implement with her husband, Gary Singer, the International Tax Navigator®, a patented, content-laden, "smart tax system". Ms. Singer, with over 15 years of experience writing and speaking on international tax topics, has authored 6 books under the collective title, U.S. Tax Guides for Foreign Persons and Those Who Pay Them.

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**COMPANY DESCRIPTION**

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**FUNDING TO DATE** : No outside funding.

**Q: What do you see as the biggest challenge for your company in the New Year?**

Expanding our market to include other industries, which must comply with these complex tax rules, such as casinos, agents for foreign artists and athletes, insurance companies, pension administrators, etc.

**Q: What one piece of advice would you give an entrepreneur starting up a company right now?**

Don't be afraid of doing something different. That is what makes a successful entrepreneur in the long run. I have always operated outside of the box. For example, I began building an international tax practice in 1985 at a time when few in Boston understood how international the economy was becoming. In the mid-1990s, when many potential clients wanted products not services, I incorporated my international tax expertise into computer software and began providing tax advice to clients through processing logs, a listserv, software Helps, FAQs, articles, books, and newsletters included in the cost of the software.

And stick to basics when hiring people - experience, skills, and potential - and be less impressed with high-priced credentials. I found my best employee at home. My husband, Gary, who was then in charge of DP at a Boston insurance company, had just the right combination of technical and management skills and experience to design our products and run the company. I couldn't have done this without him.

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If you're interested in being the next "Entrepreneur to Watch" please fill out this form [HERE!](#) or If you know someone who fits the profile fill out the form for them! We'll contact those interested.

**Editor's Article**

**Tales of the Techie Founder**

By James L. Woodward, Editor  
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A techie with little management experience has an idea for a new product. He or she works on the idea for a while and then founds a company to exploit the idea. Then what?

**Scenario 1:** Techie runs the company successfully as it grows and everyone gets rich together. Hewlett and Packard, Olsen, Wang, are good examples of technical founders who built large companies. It's possible, but it doesn't happen very often.

**Scenario 2:** Techie realizes that running a company is a full time job, one that would require him or her to be CEO and let someone else do the technical work. He or she decides at the beginning not to run the company and hires a CEO. Sometimes this works. Often it fails because the founder doesn't really acknowledge the necessity of giving up control, that the new CEO is the boss.

**Scenario 3:** Techie tries to be both CEO and CTO. This rarely works as they really are two jobs. Often something happens which leaves the techie with neither role. This is the scenario that leads to the complaint, "They're taking my company away from me!"

**War Story #1** - I was hired to be COO of a company that was founded and run by a brilliant PhD physicist. He thought he didn't want to run the company, so he tried to hand it off to someone else. The problem he had was that when the COO made a choice, there were three possibilities - that the COO would make the same choice as the founder, that the COO would make a wrong choice, and that the COO would make a perfectly good choice different from one the founder would have made. The first -- no problem. The second - a different kind of problem - every COO makes a few mistakes - hopefully a very few. The third, however, drove the founder crazy - he had to have things done his way, and if they weren't, he just countermanded the decision, often without telling the COO. I was his third attempt at finding a COO. We both thought we could deal with the problem. Wrong! It wasn't until the seventh COO that the VCs got tired of the revolving door and said to the two of them, "Founder, you're not in charge any more, the COO is." They had the votes to force it, and from that time the company was modestly successful. No magic here - just a hard slog dealing with a founder who wanted to have his cake and to eat it, too.

**War Story #2** - Technical founder, with solid experience with a product developed for another market, knew he wanted scenario #2. He sought and found a very solid, experienced CEO to run the company. They also brought in one of the best sales and marketing people I've ever known. In the initial stock split, the technical founder and the CEO had equal shares, larger than the S&M person. The company raised a round of VC money and brought out a first product that was OK, but not really what the world wanted. They raised a second round and needed to bring out a better product. It was time for the CEO to kick ass in product development, but he couldn't - the technical founder still thought of it as his company and didn't, in his heart of hearts, acknowledge that the CEO was his boss. The VCs on the Board fired the CEO and replaced him with a serious ass-kicker, who laid it on the line to the technical founder. The new product was finished and the company grew to around \$100 million in revenue. Again, it took an outside influence really sort out "who's in charge here?"

**War Story #3** - Technical founder with interesting product. She had a reasonable market sense as well as strong technical skills. Decided on scenario #2, but hired badly. The company failed to produce a product that the world would buy, so it changed industry and tried again. Same story, and the CEO was little help. Finally it changed to a third industry. The founder fired the CEO and shortly thereafter sold the company to a major player in the third industry. This is a case where scenario #1 might have worked, and certainly would have served the company better. Choose your scenario carefully.

Remember, too, that these three were successful - they made a profit (modest in one case) for their stakeholders. It doesn't have to work that way and investors know it. If you're a techie founder, you must be prepared to discuss the issue crisply and clearly - "We'll deal with that if it becomes a problem", won't do it.

In scenario #2, a strong outside Board is very helpful. Before funding, this can be as simple as a three person Board - the founder, the CEO, and an outsider who is known and respected by both of them. Be sure you deal with it early - once there's tension, then it's too late.

## Upcoming Events

## [Calendar Details](#)

- **Wednesday, February 12th - [10-250 Case Presentation](#)**  
**BIOTECH: Innovative Financing Strategies, Past & Present**  
  
**UPDATED KEYNOTE:** Dr. Gunther Winkler, Vice President of Strategic Initiatives, BIOGEN  
  
**Case:** [Paratek Pharmaceuticals](#)  
**Panel:** Ted T. Ashburn, M.D., Ph.D., Associate, Oxford Biosciences, Eileen Coveney, Partner, LEK Consulting., Stu Barish, Managing Director, Leerink Swann **Moderator:** William T. Whelan, Esq. Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.  
  
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**Co- Hosted by:** [Mass BioTech Council](#)
- **Wednesday, February 19th - [NEW Concept Coaching Clinic](#)**  
There are hundreds of labs in and around MIT producing and improving some of the most complex and intriguing technologies in the world. Some of the research and technology will spawn successful companies while others will just always be looked at as "kind of cool." **So what's the differentiator?**  
  
At the new concept clinic program we will meet the technologists developing this "stuff" and help them brainstorm their prospects for business applications -- which markets might want this technology, who, if anyone, has a problem that this technology might solve and what else will they need to get this off the ground.
- **Wednesday, March 5th - [Start Up Clinic](#)**  
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- **Wednesday, March 12th - [10-250 Case Presentation](#)**  
**HOMELAND SECURITY: New Opportunities for Business**  
  
**Keynote:** Al Martinez-Fonts, Special Assistant to Tom Ridge for the Private Sector at the Department of Homeland Security  
  
**Case:** [AssureTec](#)  
**Panel:** Suresh Shanmugham, Boston Millennium Partners, John Skinner, Adams, Harkness & Hill., Steven Davis, CXO Management, and Mike Hogan, MassDevelopment  
  
**Sponsored By:** [Wolf Greenfield](#)  
**Co-Hosted By:** [MassDevelopment](#)

- **Wednesday, May 21st - [10-250 Case Presentation](#)**  
**TELECOMMUNICATIONS: The Keys to Recovery**

**Keynote:** Patricia Russo, CEO & President, Lucent.

**Panel:** Steve Levy, Lehman Brothers, Pierre Villeneuve, Ph.D., Clarendon Photonics. **Moderator:** Peter Howe, Business Reporter, the Boston Globe.

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