FOLEY
FOLEY & LARDNER LLP

The Business Environment Facing Emerging Companies Today

A Report Presented By:

Foley & Lardner LLP

December 10, 2008

EXECUTIVE SUMMARY

Overall, emerging companies today are facing the most challenging economic and business environment in the four-year history of our survey.

It is more difficult than ever for emerging companies to launch in this economic environment and perhaps even harder to formulate an exit strategy.

- 61% of all respondents told us that it is more difficult to start a company today versus 10 years ago, our highest response ever in this category during the four-year history of our survey. By comparison, only 38% of respondents agreed with this sentiment in 2007.
- 53% of emerging company executives said that their likely exit strategy is a merger or sale, our lowest response ever in this category. Additionally, 17% told us they have no intention to sell, our highest response ever in that category. A mere 3% are planning an IPO.
- Emerging company executives have also extended their timeframe for an exit as 81% told us they are 3 or more years away from an exit and only 1% expect to exit within 12 months.

Investors are taking advantage of the general lack of capital availability and the overall challenging economic environment to require more favorable deal terms.

- 62% of investors told us they are seeking more favorable deal terms in light of current economic conditions while 33% are initiating a change in value of their portfolio companies.
- 67% of investors and 75% of emerging company executives responding to our survey told us that they are seeing increase in investments being phased in over time rather than being made at one time.
- 88% of investors and 70% of emerging company executives said they are seeing an increase in the use of operational or strategic milestones by investors designed to influence valuations.

Available capital is becoming increasingly scarce and emerging companies need to be prepared to survive on less of it.

- 36% of investors said they have raised capital within the past 12 months and 63% expect to raise capital again within the next 24 months. However, 38% of investors told us they are cutting back on new investments overall.
- Additionally, 71% of all respondents told us they expect access to capital to remain flat or decline over the next two years. This is the most bearish view on access to capital respondents have had in the four-year history of our survey.
- 74% of all respondents told us that companies today need to be prepared to survive on less capital than they did a decade ago.

Despite this finding, a large number of emerging companies are applying capital at an aggressive rate and plan to seek more capital within the next year.

- 61% of emerging companies responding to our survey told us they have sought capital within the past year and 65% plan to do it again within the next 12 months.
- Additionally, 29% of emerging company executives told us that current economic conditions are forcing them to seek capital from alternative sources than originally planned. This result explains the trend of investors seeking more favorable deal terms.

Executives, investors and advisors expect the IPO market to continue to stall.

- In addition to the mere 3% of emerging company executives planning an IPO as their exit strategy, 99% of respondents view the IPO market as either “stagnant” or “declining.”

Early stage emerging companies face unprecedented challenges including the trend of investors moving “up the ladder” to focus on larger deals.

- 76% of respondents to our survey agreed with the notion that VCs are focusing on larger deals, making $5 to $10 million deals scarce.
- Additionally, 24% of investors responding to our survey told us they are moving from early- to later-stage companies as they refocus their investment strategies.

Emerging company executives and investors are not entirely aligned on the industries poised for growth and success over the next 24 months. Investors are much less bullish on alternative energy.

- Investors identified software/IT (59%), medical devices (50%) and biotech (41%) as the sectors poised for success over the next two years.
- By contrast, emerging company executives identified alternative energy (60%) as the top industry poised for success compared to only 36% of investors. Executives were generally lukewarm in regard to software/IT (38%), medical devices (20%) and biotech (29%).
- Both emerging company executives and investors agree that retail, manufacturing and telecommunications represent the industries with the worst outlook for success over the next 24 months.

VERBATIMS

What is your perception of alternative (non-VC or non-strategic VC investing) sources of equity that are currently active in the market today?

- *There needs to be more---as this would offer alternatives for funding sources.*
- *They are confused and very leery of taking on risk that they cannot adequately evaluate.*
- *There are more sources of equity available today. Examples are bank "growth capital" and hedge fund alternatives. They too are looking for quality investments with a minimum of risk. Such investments are rare in the alternative market.*
- *I think ANY source of equity in today's market is fantastic, whether it's traditional or alternative. Things are a little different today (obviously) than they were a couple of years ago, and I think creative financing and clever strategizing are the keys to remaining competitive.*
- *Relative to VC investing, there are little alternative sources of equity for emerging companies. Moreover, the amount of alternative sources of equity are often not sufficient to fund development of a technology to the next "value inflection point" that could attract VC funding. Thus, while I believe every company should do all it can to secure alternative sources of equity, these sources will typically not be sufficient to drive growth of the business.*
- *They are unpredictable as motivations to invest are based less in quantified expectations of returns and more on interest in a specific area or comfort with a management team. Often these investors do not have a staff of analysts that can generate financial models required for valuation.*
- *They are typically not long-term investors - they come and go with the economic tide. I expect that several strategic investors will exit during this downturn.*
- *It is fragmented and unsophisticated; neither the investors nor the founders understand the inherent increased risks of early stage investing and fail to price the equities accordingly.*
- *They are being "watchfully aggressive" -- i.e., more careful than in the past as to how they place their bets, but aggressively looking for opportunities to get better values and, by so doing, to get proportionally higher returns when the market turns around and values rise.*

VERBATIMS (CONTINUED)

How do you think the economic bailout act of 2008 is going to impact your business moving forward?

- *We've changed plans such that we're not planning on raising capital in 2009. We're expecting availability of credit and funding to be low, though hopefully the bailout will reduce a catastrophe to a "simple" recession.*

- *Allows competition that should have failed.*

- *We are in a niche than is relatively immune to liquidity problems. However, for so long as liquidity and bad management from government and financial institutions roils the markets, this is bad for everyone and is a real brake on growth everywhere. So the issue for us is simply emerging from these serious dislocations and executing our plan.*

- *Will cause fundraising process to take longer and be more difficult to obtain.*

- *I think that the Wall St. meltdown is good in the fact that maybe people will start investing in innovative companies in green-tech and bio-tech rather than real estate and commodities. It is tough to base economic growth on refinancing real estate deals and trading natural resources, which is basically what we've been doing in this country for 5 years.*

- *Once the dust settles -- I think investors and managers will do a "hard reset" and go back to business as usual, albeit with a jaded view of future financing and debt restructuring.*

- *Investment in startups depends on VCs, who depend on their Limited's to have capital to put to work, which depends on healthy capital markets. Preserve the capital markets in order to preserve startup access to capital. The real problem is that the instability of the capital markets leads to press speculation about an economic disaster, which influences consumer spending, which causes an economic slowdown. The press is the unchecked 4th branch of the government; the 24x7 news bubble magnifies things into problems that might not otherwise have been problems.*

- *Commercial bankers are likely to play a more significant role in capital formation and availability than in any period since the mid-eighties.*

- *Short term benefit, long term recession.*

- *I work for a bank, so bailout is having an effect...although not as big as some might like.*

- *No impact directly, but if it helps the economy from depressing further, then I think sources of equity will be more likely to start widening their portfolios.*

- *Still not sure what the bailout is....*

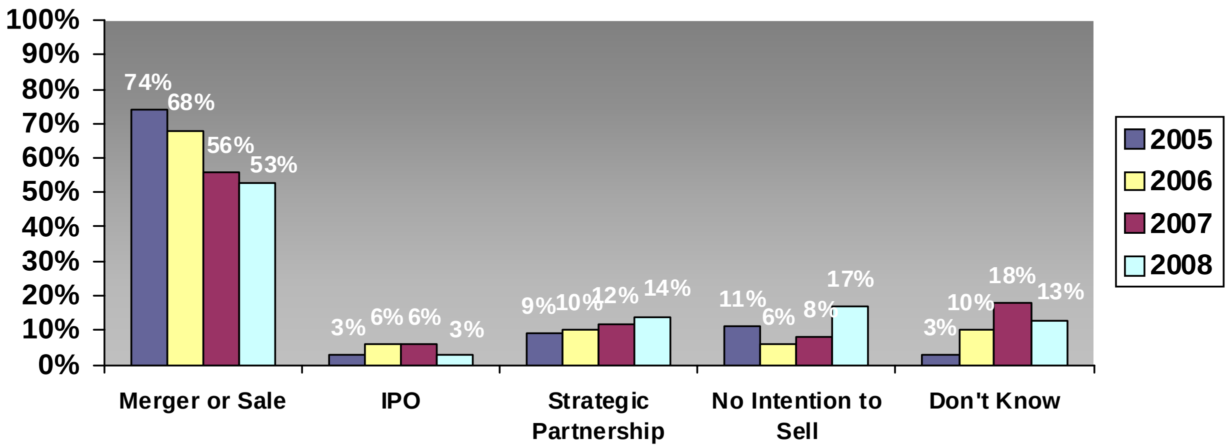
<u>**ANALYSIS OF EMERGING COMPANY SURVEY**</u>

Perspective From Executives of Emerging Companies

The following questions reflect input received from respondents who currently serve as executives of emerging companies.

What is your likely exit strategy?

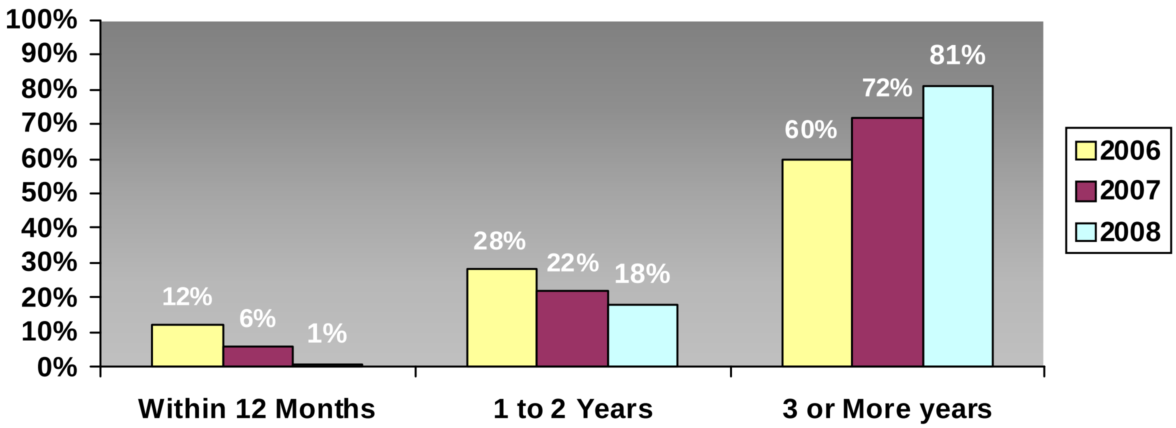
(Note that this question was only addressed to those respondents who identified themselves as a "founder or executive of an emerging company.")



- ➢ The number of emerging company executives citing a merger or sale as their likely exit strategy has decreased consistently from 2005 (74%) to 2008 (53%).
- ➢ Further, in 2008 we witnessed the largest number of respondents in the four year history of our survey who have no intention to sell (17%).
- ➢ A significant number of respondents to this year's survey (13%) also did not know their exit strategy. This actually represents a slight decrease over the previous year.
- ➢ As expected, virtually no respondents (3%) plan to test the IPO market.

What is your likely timeframe for an exit?

(Note that this question was only addressed to those respondents who identified themselves as a "founder or executive of an emerging company.")

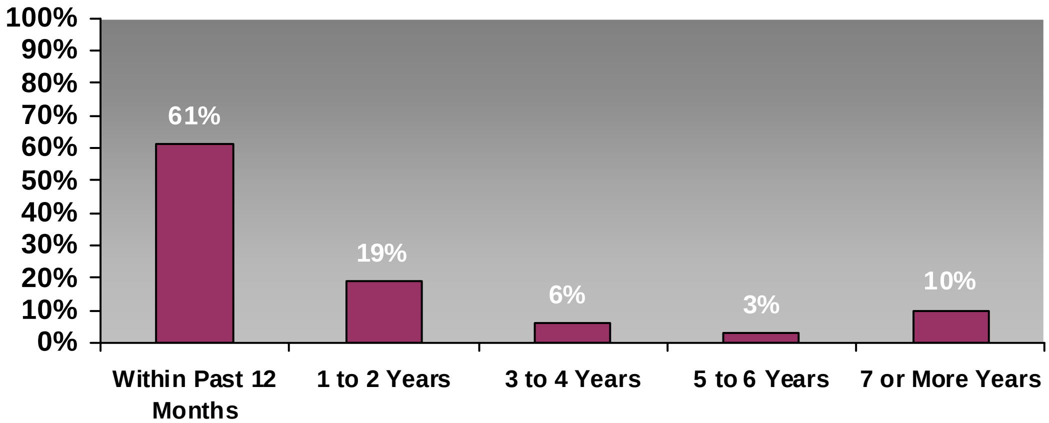


- Emerging companies' timeframe for an exit continues to increase steadily and consistently year-over-year.

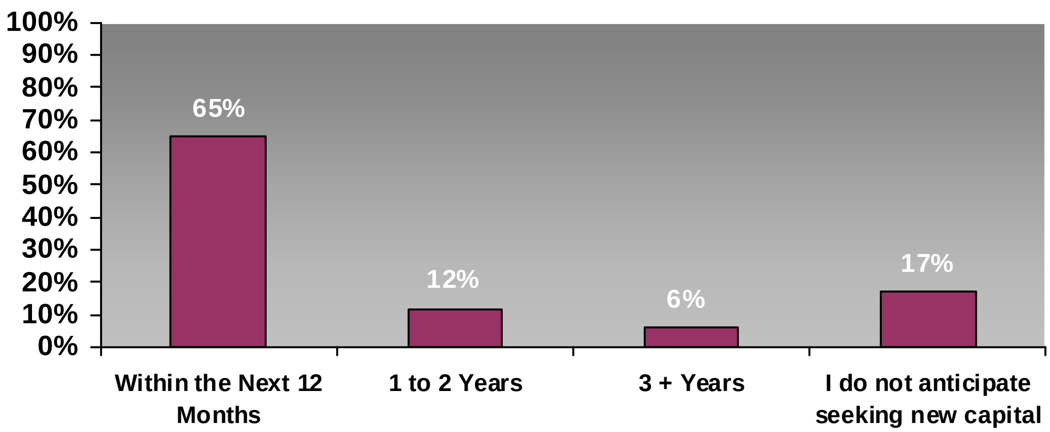
- A large percentage (81%) of emerging company executives responding to our survey are at least three or more years away from a planned exit. This represents a steady increase from the already high percentage of respondents that indicated this extended timeframe in 2007 (72%).

When did you last seek or obtain a capital infusion for your business?

(Note that these questions were only addressed to those respondents who identified themselves as a "founder or executive of an emerging company.")



When do you next expect to seek a capital infusion for your business?

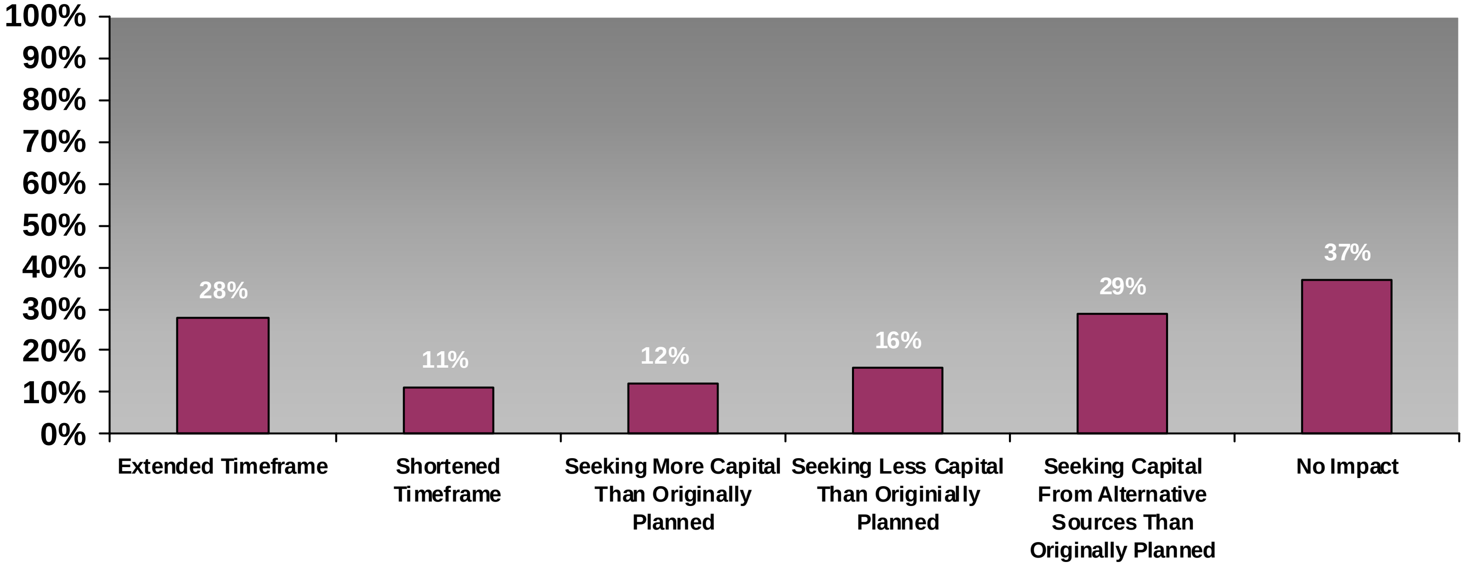


- A significant number of respondents (61%) have sought capital within the past year and plan to do it again within the next year (65%).

- In our view, the real question is whether or not the capital will be available for emerging companies who seem to be using their available capital at an accelerated pace. We believe that these companies have either been forced to use capital faster than they had originally planned or did not raise enough capital to begin with.

How have current economic conditions impacted your plans to raise capital?

(Note that this question was only addressed to those respondents who identified themselves as a "founder or executive of an emerging company.")



- In reaction to current economic conditions, emerging companies responding to our survey have extended their timeframe in their effort to raise capital (28%) or are seeking capital from alternative sources (29%).

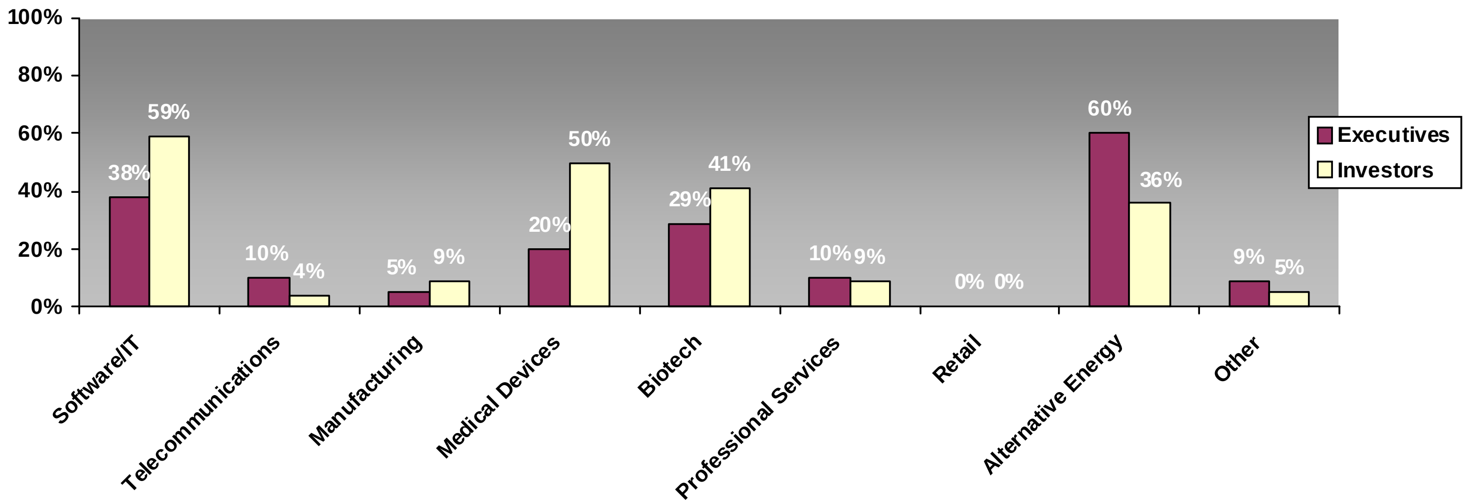
- We believe the 37% of emerging companies who told us that current economic conditions have had no impact on their ability to raise capital is surprising. We expected that figure to be higher.

- The 29% of respondents who are seeking capital from alternative sources than originally planned may reflect a belief that the venture capital segment is relatively unaffected by current economic conditions.

Emerging Company Executives: Which industries do you believe present the *best opportunity for success* for emerging companies over the next two years?

Investors: In which industries do you expect to focus most of your investment dollars in 2009 and 2010?

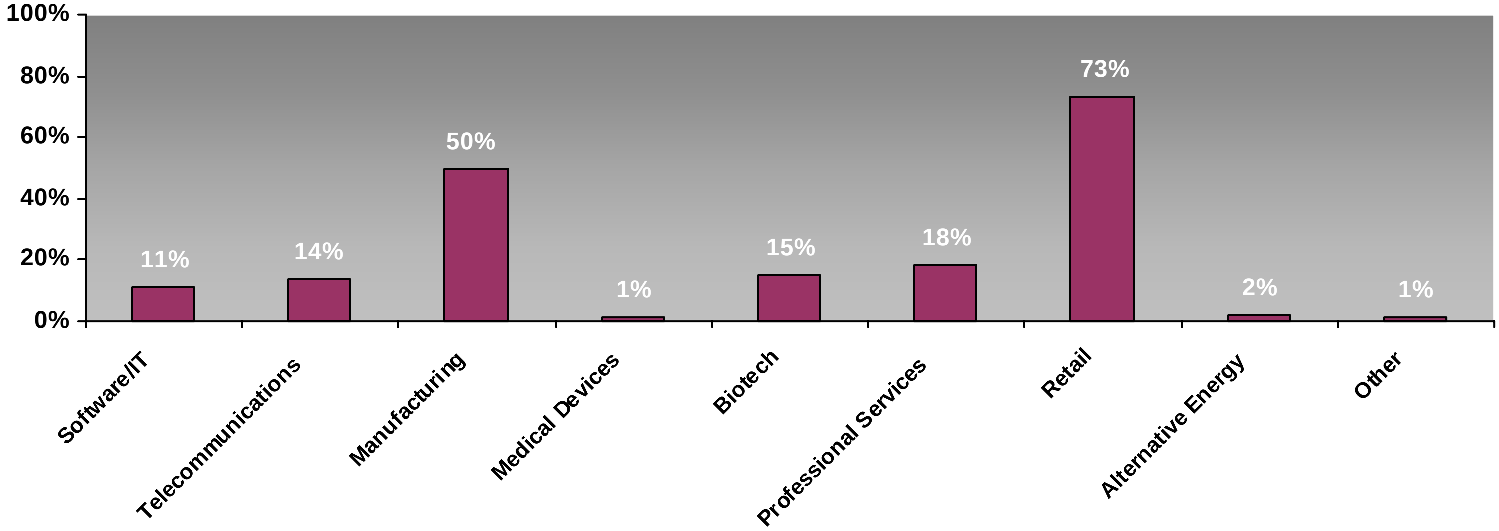
(The following chart represents feedback from both emerging company executives and investors based on the questions above posed to each group.)



- Emerging company executives and investors are not aligned on the industry sectors that they each believe present the greatest opportunity over the next two years.
- Emerging company executives are bullish in regard to alternative energy (60%) but their enthusiasm for the segment was not matched by investors responding to our survey (36%).
- Investors responding to our survey see great opportunity in the areas of software/IT (59%), medical devices (50%) and biotech (41%).

Which industries do you believe present the *__worst outlook__*
for emerging companies over the next two years?

(Note that this question was only addressed to those respondents who identified themselves as a "founder or executive of an emerging company.")



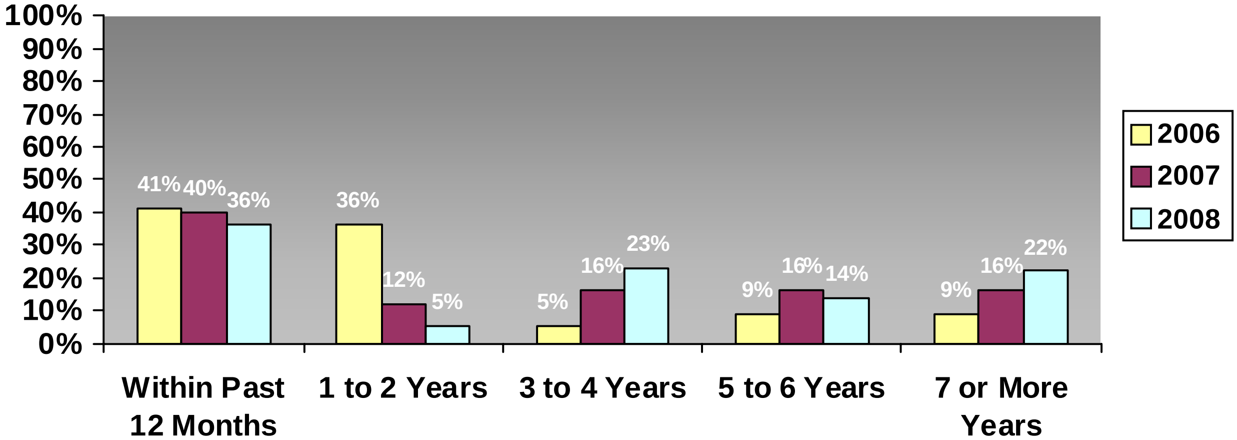
- Emerging company executives responding to our survey clearly identified retail (73%) and manufacturing (50%) as among the areas with the worst outlook over the next two years. These results are consistent with the areas investors told us they are least likely to invest their capital.

Perspective From Investors in Emerging Companies

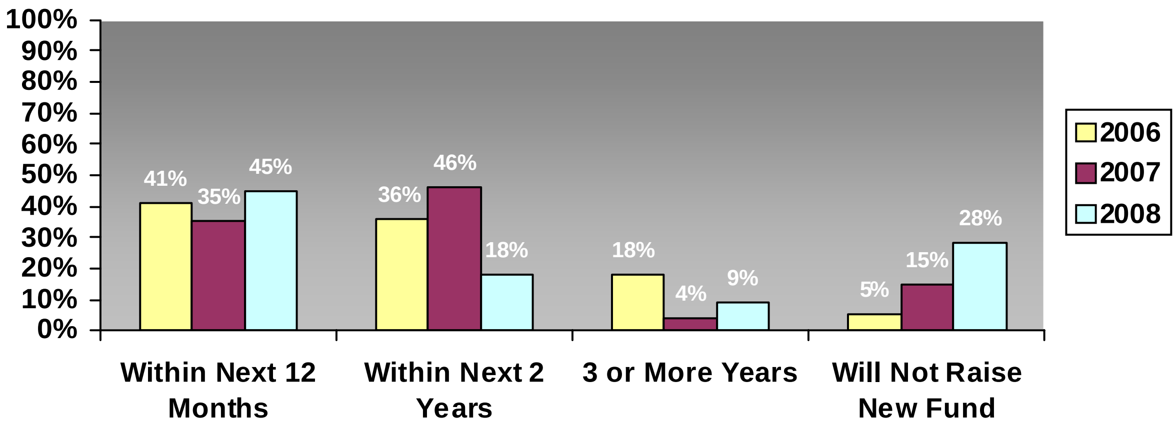
The following questions reflect input received from respondents who actively invest in emerging companies.

When was the last time you raised capital as a new fund?

(Note that these questions were only addressed to those respondents who identified themselves as an "investor.")



When do you expect to raise your next fund?

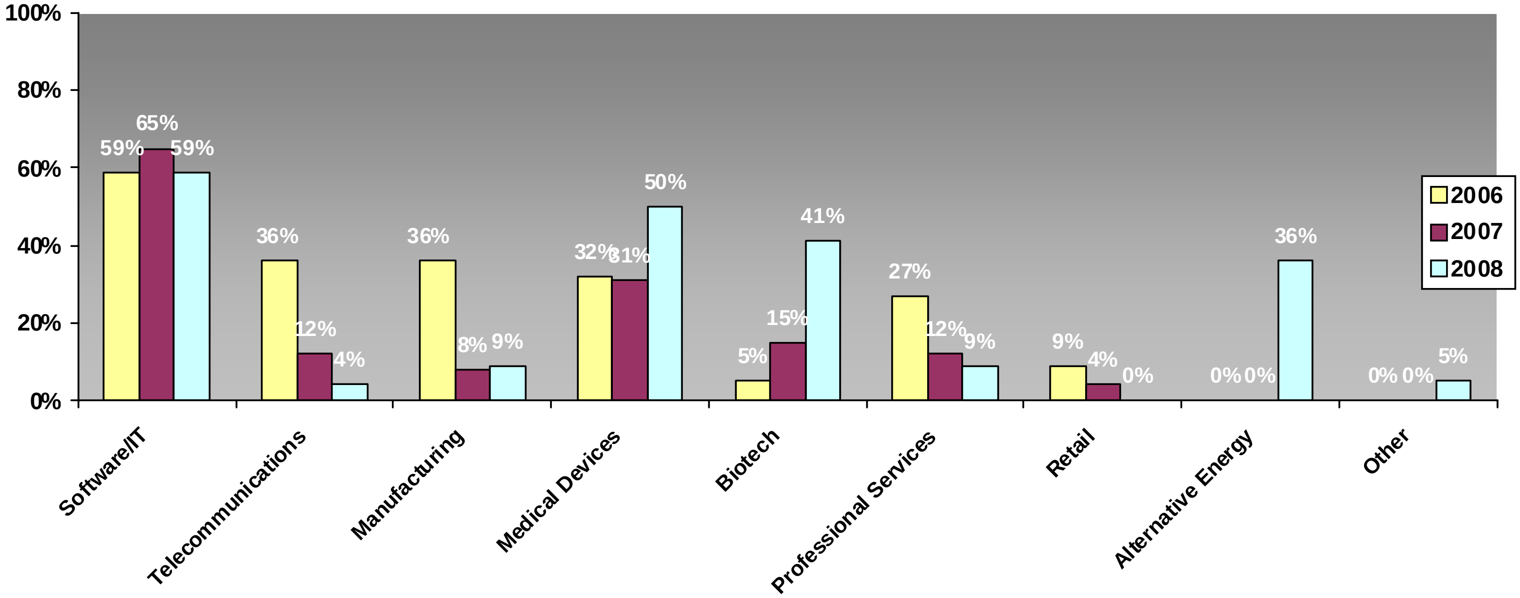


- A large number of respondents (36%) have raised capital within the past year. However, this year's survey saw the highest number of respondents ever who said it has been 3 to 4 years (23%) and 7 or more years (22%) since they last raised capital.

- Additionally, the number of respondents who plan to raise their next fund within the next 12 months has increased significantly over 2007 (45%). In contrast with this data, our 2008 survey witnessed the largest number of respondents ever who said they will not raise a new fund (28%).

In which industries do you expect to focus most of your investment dollars in 2009 and 2010?

(Note that this question was only addressed to those respondents who identified themselves as an "investor.")

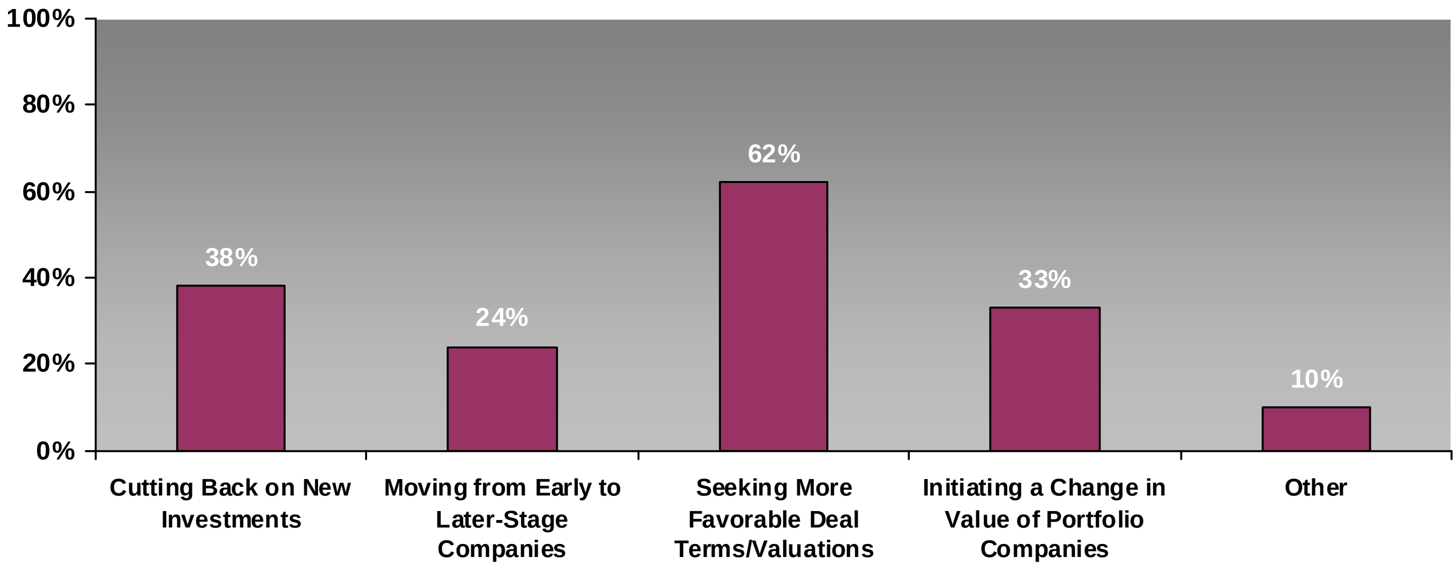


- The above chart presents historical data from the three years in which this question was asked of investors as part of our survey.

- Investor interest in software/IT has remained relatively consistent year over year. Interest in telecommunications and manufacturing has waned while there is renewed interest in medical devices and biotech. (Note that "alternative energy" is a new entry to this year's survey and thus historical data on this segment is not available).

In light of current economic conditions, are you conducting any of the following activities?

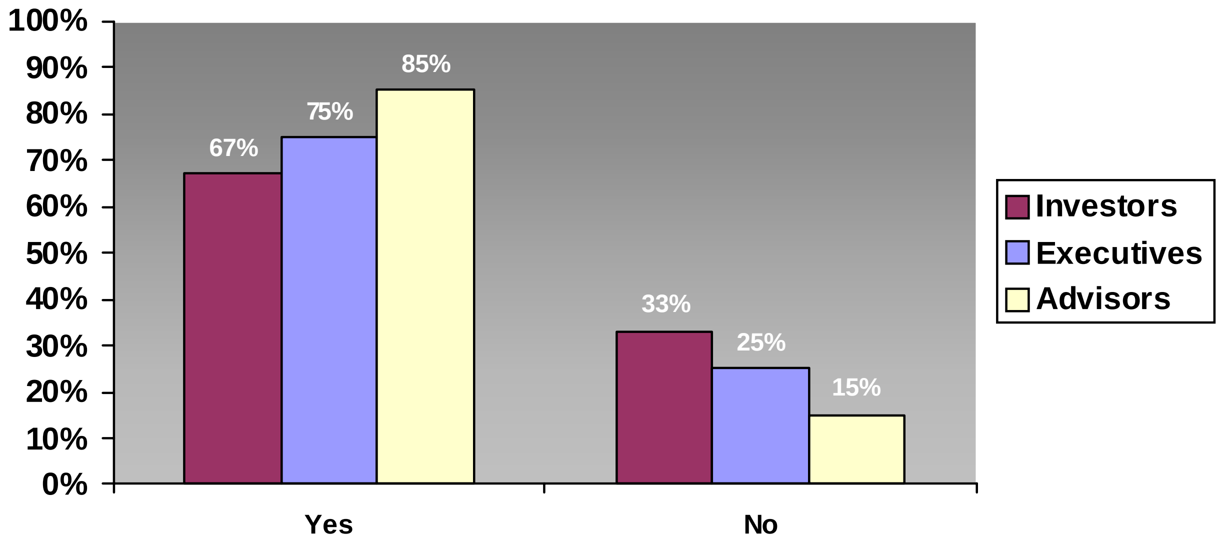
(Note that this question was only addressed to those respondents who identified themselves as an "investor.")



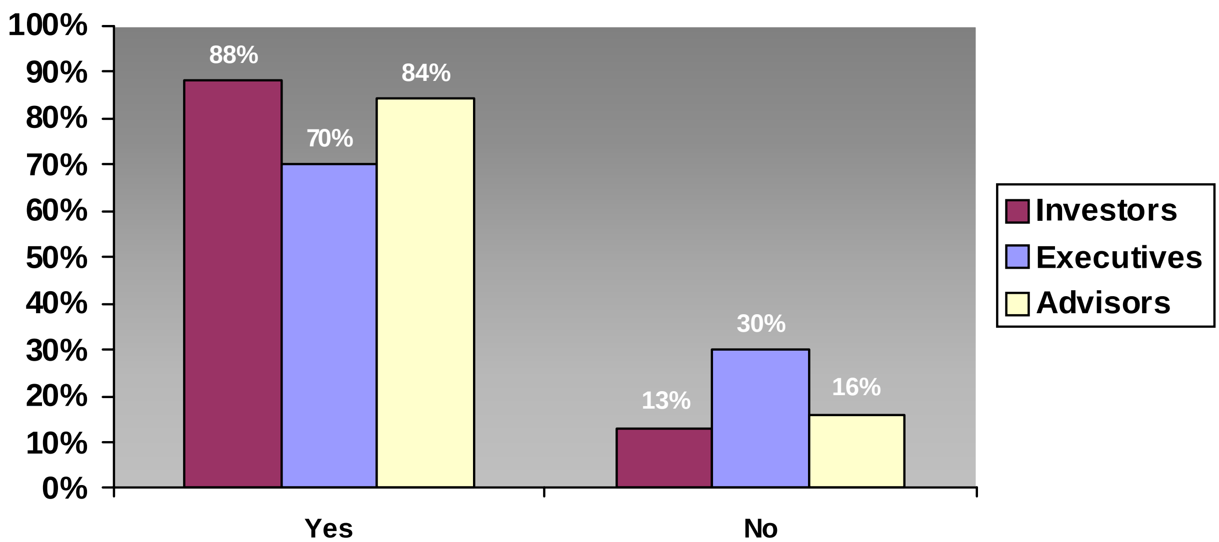
- Investors are clearly seeking more favorable deal terms and valuations in response current economic conditions as they take advantage of tightening credit markets and the relative scarcity of capital. A smaller number (38%) said they are cutting back overall on new investments, which we view as a significant trend to continue monitoring.

- Overall, this data seems to signal that, for early stage companies, there is less capital available and executives should expect less favorable deal terms.

Are you seeing an increase in investments that are being phased over time rather than being made available at once?



Are you currently seeing an increase in the use of operational or strategic milestones by investors designed to influence valuations?

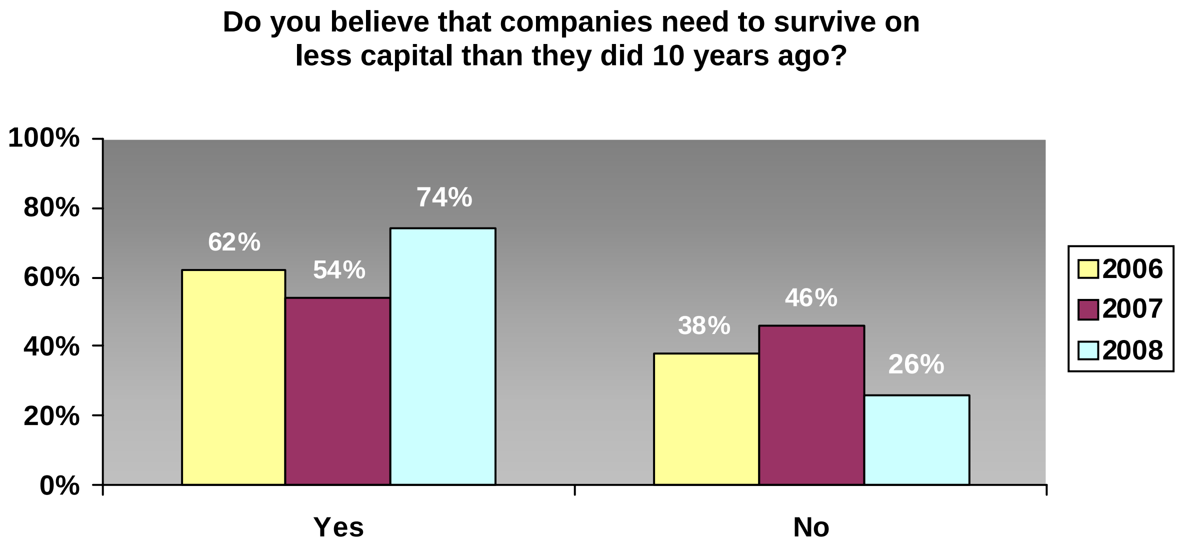


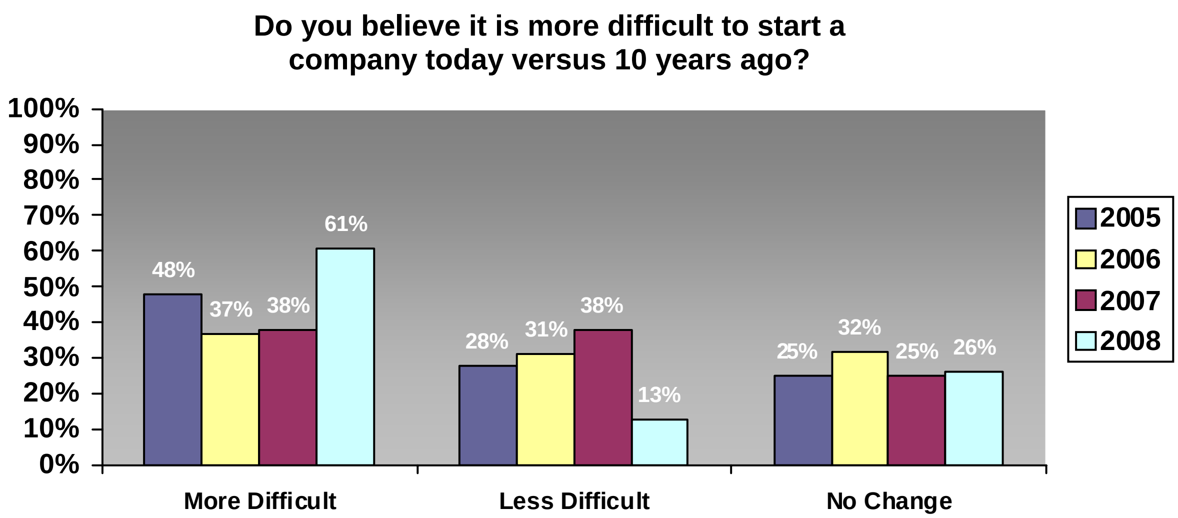
- The questions above, which were posed to all respondents, provide additional detail behind what specific terms are being required of emerging companies seeking capital. Respondents in all categories overwhelmingly agreed that they are seeing an increased in investments being phased in over time as well as the use of strategic milestones to influence valuations.

- It is interesting to note the disparity in executives who agreed that they are seeing the use of strategic milestones to influence valuations. While a significant number agreed with this notion, the response was not as large in the “yes” category as investors and advisors. Further, a large number of executives of emerging companies disagreed with this notion (30%).

Perspective From All Respondents

The following questions reflect input received from all 221 respondents. The demographic make-up of respondents includes 46% outside consultants/advisors, 43% emerging company executives and 11% investors.

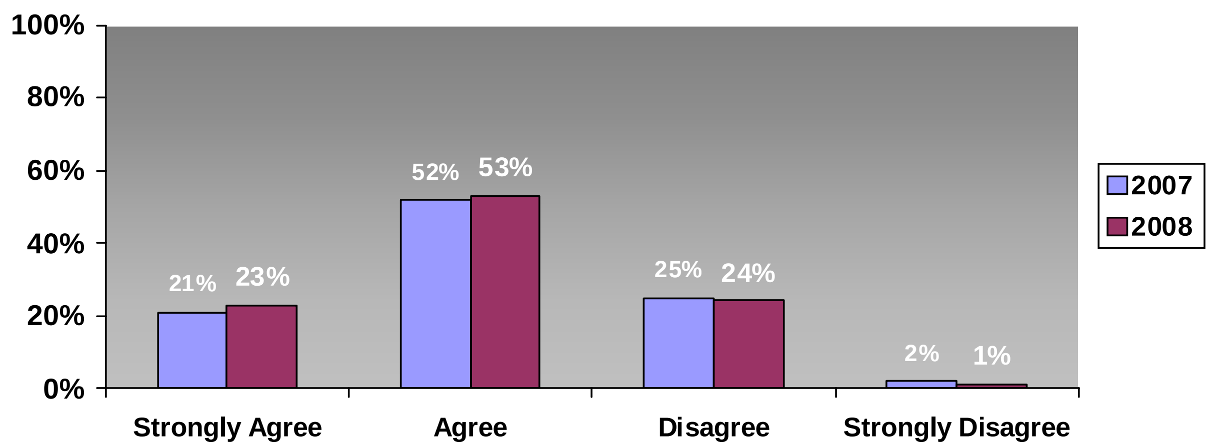




- It is clearly a challenging environment for emerging companies as respondents to our survey overwhelming feel that companies need to survive on less capital than they did 10 years ago (74%).

- Additionally, the highest percentage of respondents in the history of our survey (61%) said they believe it is more difficult to start a company today compared to 10 years ago.

To what extent do you agree that the current trend of VCs focusing on larger deals has resulted in a funding gap, making $5 million to $10 million deals scarce?

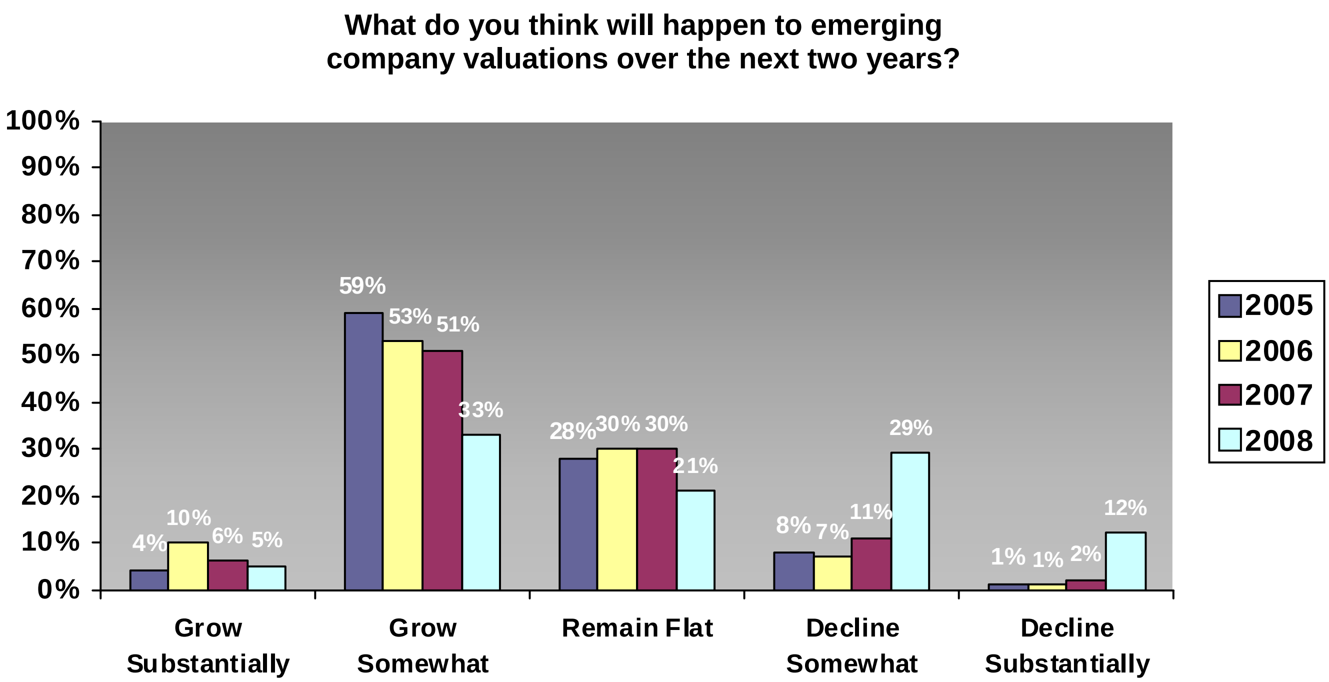


- A large percentage of respondents to our 2008 survey (76%) agreed that the current trend of VCs focusing on larger deals has resulted in a funding gap and made $5 million to $10 million deals scarce.

- We once again believe the strong agreement to this statement is due to the fact that as funds have raised more money, they need to focus on larger deals and put out larger amounts of money at once.

- We invited verbatim responses to this question, which included:

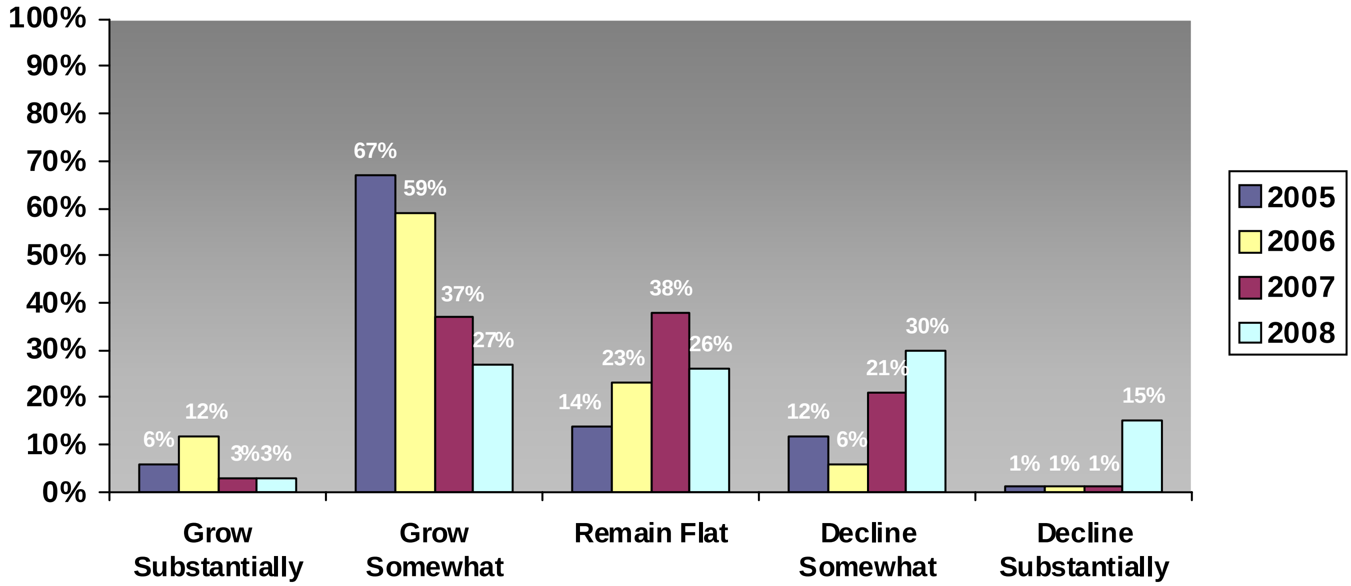
  - *This makes survival of early to mid-stage start ups much more difficult.*
  - *VCs will need to invest in 'smaller' deals in order to ensure a satisfactory level of deal flow. Early stage companies are finding it harder to close Angel Rounds, and those that do, find the Angels now carrying their investment companies further so as not to be diluted, ensure their companies are adequately funded, etc*
  - *VC's are acting more like PEC's. They need to start investing in the riskier investments to truly be Venture Capitalists.*
  - *Short term implications, entrepreneurs will get more creative, long term implications - VC's may find out they are not needed any more.*
  - *… savvy investors with cash to spend remain favorably disposed to, say, four 5MM deals than one 20MM deal. The diversity of investment risk has not changed with the diminution of investment capital.*
  - *I do not think the gap will last long. Many hedge funds are being expected to invest any liquid funds to take advantage of the markets.*
  - *I'm not sure the gap is the VCs "fault." The ability to go public with a market cap of < $250M is too small due to public market conditions. So the only investments VCs can make money on are ones where there's an obvious exit via acquisition, or by creating a company that can have a VERY large market cap (which is rare.)*
  - *Short-term, funding has dried up for new ventures as the VC community focuses more on support existing portfolio companies. Long-term, this new situation will change only after exit options have been fully and solidly restored.*



- For the first time in the history of our survey, respondents who expect emerging company valuations to grow (38%) were in the minority as a significant number of respondents expect valuations to decline (41%) or remain flat (21%).

- This data ties directly into the 62% of investors who told us they are seeking more favorable deal terms as a result of current economic conditions.

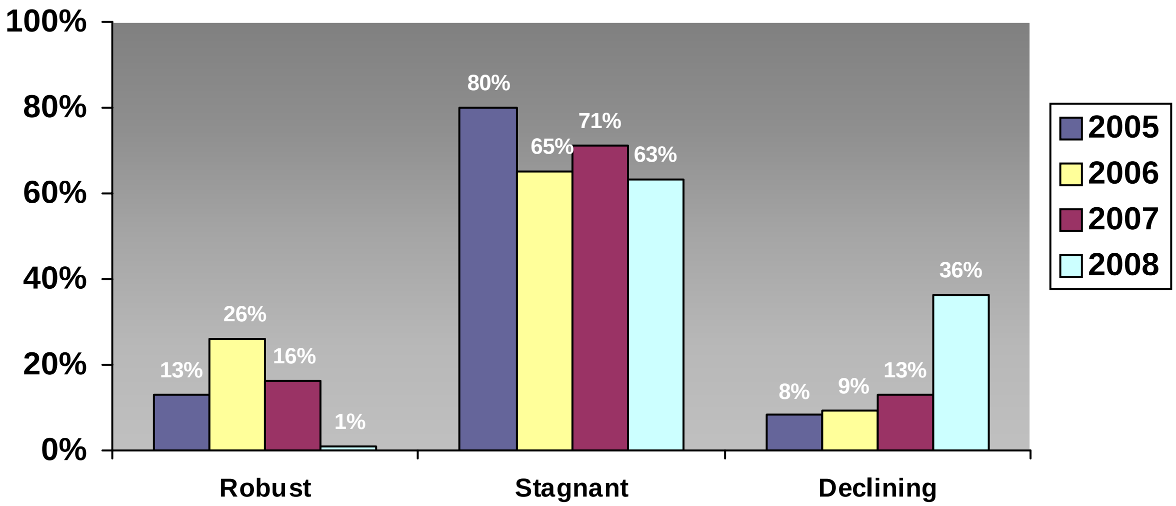
Access to capital over the next two years will…



- Pessimism also pervades perspectives on access to capital as respondents who expect access to capital to grow (30%) were also in the minority as a significant number of respondents expect access to capital to decline (45%) or remain flat (26%).

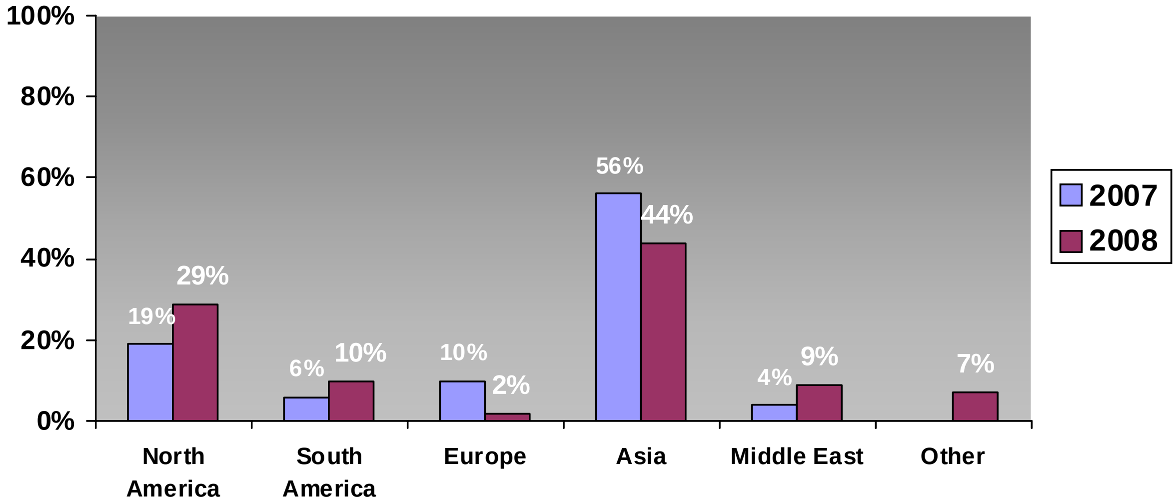
- Since we started collecting our data, the number of respondents who expect access to capital to grow has declined from 73% down to a mere 30% in only four years. Additionally, the number of respondents who expect access to capital to decline has moved from 13% in 2005 to 45% in 2008. This data demonstrates the volatility that has occurred over the past four years.

What is your view of the IPO market over the next two years?



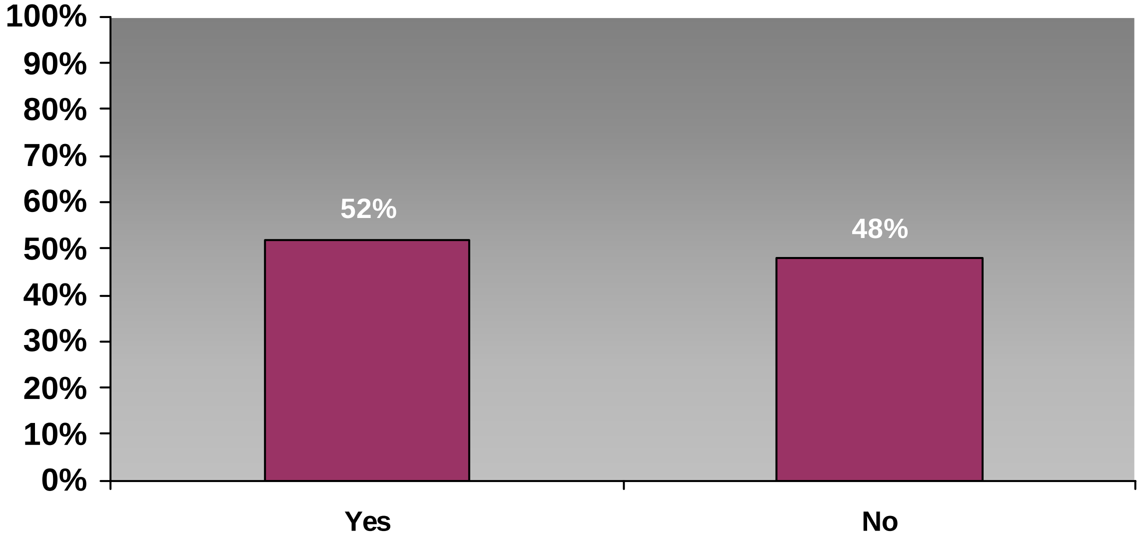
- While it comes as no surprise that respondents overwhelmingly feel that the IPO market is largely stagnant, we witnessed our largest number of respondents in the history of our survey within the “declining” category (36%).

What regions are best poised for economic growth to benefit emerging companies?

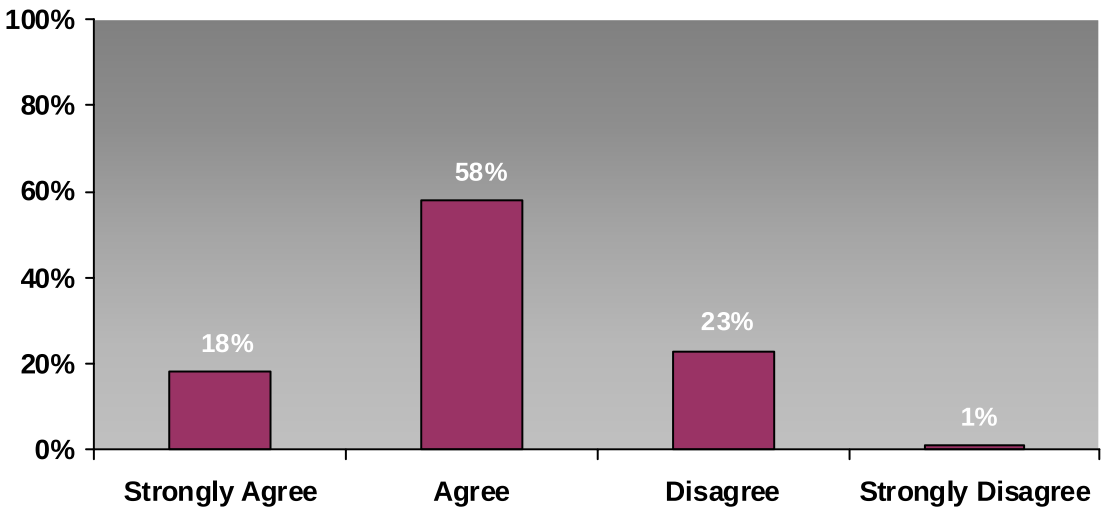


- The decreased interest in Asia and continued lack of interest in the Middle East surprised us. We expected both regions to carry a larger level of interest.

Have you witnessed an increase in the prevalence of foreign investors within the last 12 months?



To what extent do you agree with this statement: I expect foreign investment to increase in the coming year as current economic conditions persist in the U.S.



- Respondents were largely split on the question of whether foreign investors are increasing in prevalence yet a majority (76%) of respondents agree with the notion that foreign investment is likely to increase in the U.S. throughout 2009.

METHODOLOGY

In November of 2008, Foley & Lardner LLP distributed a survey to a group of founders, executives, advisors, outside consultants, investors and potential investors in the emerging technology industry. The survey was completed by 226 respondents.

The demographic make-up of respondents includes 46% outside consultants/advisors, 43% emerging company executives and 11% investors.

The survey coincides with Foley's 2008 Emerging Technologies Conference held in Boston on December 10, 2008 and is attended by many of the respondents completing the survey.

Due to rounding, all percentages used in all questions may not add up to 100 percent.