SEED CAPITAL reVIEW

SEMI-ANNUAL REPORT | SECOND HALF, 2014

PUBLISHED BY: MEMBERS OF THE ENTREPRENEURIAL SERVICES GROUP AT GRAY PLANT MOOTY

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Welcome to the third edition of Seed Capital reVIEW, written by members of the Entrepreneurial Services Group at Gray Plant Mooty. This report, like our prior reports, analyzes results of our survey regarding seed and angel capital financings by early-stage companies in Minnesota (typically financings of between $100,000 and $2 million).

In this edition of Seed Capital reVIEW, we summarize the survey responses we received regarding financing transactions completed during the second half of 2014. Our prior editions of this report summarized similar data covering the first half of 2014 and the second half of 2013.

In addition to analyzing the specific data of the financings closed during the second half of 2014, we were also able to compare that data to the responses we received to our prior surveys. With having three sets of data, we are now able to start identifying some trends in the terms of seed and angel capital financings. We hope this information will continue to be useful to reviewers of this report as they structure future financings.

For this period, our response rate was not as robust as it had been in the prior two surveys, a trend we hope to reverse when we survey the first half of 2015 over the next few weeks. While the actual reasons for the lower response rate are not known, we believe that it may be the result of the following:

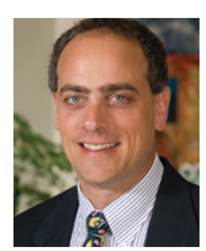
- Less angel and seed deal activity during the second half of 2014 (a period during which there was no Minnesota angel tax credit funding available).
- A smaller email distribution of the call for responses, in part due to the ceasing of operations by the Minnesota Angel Network, an organization that had supported and helped to distribute the message to potential respondents.
- The timing of the call for responses, which was in late January and early February, a time period that may be particularly busy for those handling year-end financial reporting, the same individuals who might often be responding to our survey.
- Our initial articulation of the incentive to respond to the survey, something we had more clearly articulated during the first two survey cycles.

This Seed Capital reVIEW represents responses from individuals and companies involved in 41 reported financings. While smaller than previous surveys, we still think this data set provides a meaningful lens on the terms on which seed and angel capital financings are being completed in Minnesota.

In July we plan to circulate our survey for deals completed in the first half of 2015 and expect to publish our next Seed Capital reVIEW later this fall. In the meantime, we hope this information is useful to you and helps facilitate more successful seed and angel capital raising transactions for Minnesota's emerging growth businesses.

Thank you for your continued support of the Seed Capital reVIEW.

Max Bremer



Dan Tenenbaum

EXECUTIVE SUMMARY

For this third edition of the Seed Capital reVIEW, we analyzed survey responses relating to seed and angel financings raised by companies in Minnesota during the second half of 2014.

Key metrics and findings during the period include:

- Nearly 45% of survey respondents were from the medical/healthcare industry. This represents a substantial increase in medical/healthcare respondents in comparison to our past surveys.
- Only 24% of respondents utilized the Minnesota Angel Tax Credit – a significant reduction from our prior surveys and likely the result of limited to no available credits during the second half of 2014.
- Pre-revenue companies comprised a smaller share of total financings than in previous surveys (26%). This share is down nearly 20% from our previous report.
- Consistent with prior surveys, approximately 67% of respondents reported offerings structured using equity securities. Of those equity securities, 60% were common equity, with the remainder being preferred equity. Debt securities comprised the remaining 33% of total offerings.
- The most frequent benefits received by equity investors were:
  - Participation rights in future investment rounds.
  - A board seat or observation rights.
  - Some form of liquidation preference.
    - The overwhelming majority of respondents—more than 80%—have received a 1x liquidation preference in preferred equity financings. We saw a significant increase in the percentage of respondents reporting a participating liquidation preference.
- For debt-structured offerings:
  - Similar to past survey results, almost all respondents reported debt with an initial term equal to or greater than one year.
  - A majority of respondents reported receiving rights to participate in future financings. Since releasing our initial report for the second half of 2013, we've seen steady increases in the prevalence of these preemptive rights.
  - Almost 82% of debt-structured offerings were convertible to company equity.

Read on for a more comprehensive breakdown of the survey's findings.

Before delving into the specific details of the survey results, we think a few overall comments may help with your review.

As with our prior surveys, the most active industries for raising start-up capital in the Twin Cities continue to be medical/healthcare, technology and cleantech/biotech. Medical/healthcare companies had an especially strong representation in this survey, and in particular companies that identified as being in the healthcare IT space were numerous. We've noticed a growing number of companies in the Twin Cities that are developing businesses that use technology to facilitate, streamline, update and improve health care services, and expect that this will continue to emerge as an important sector.

Now that we have three sets of surveys, representing capital-raising transactions from an 18-month period, some common terms and features are beginning to emerge from the data. For example, the prevalence of rights to participate in future rounds of financing ("preemptive rights") has been prominent and increasing over each survey. Also, for preferred stock, it appears common for an investor to receive a liquidation preference, most often a "participating" 1x preference. Other similar trends are starting to emerge, which we think will be valuable information for entrepreneurs seeking to raise capital, and investors seeking to support them.

Finally, the utilization of the Minnesota Angel Tax Credit, at least based on this survey, was not as important to early-stage capital raising as it had been for prior periods. Some of that can no doubt be attributed to the fact that this survey reflects a time period (the last 6 months of 2014), when no new allocation of credits was available because funding had been exhausted. Of course, some of the financings still may have involved the Minnesota Angel Tax Credit because they overlapped periods when funding was available. Of those who reported that they used the tax credit during this survey period, most indicated that it was still important for their offering. Even though several companies were able to raise capital without the tax credits, we still think the program is a valuable tool for Minnesota to remain competitive in attracting and keeping start-up businesses (at least relative to its neighbors, such as Wisconsin and North Dakota, which have their own tax credit programs).

CHARACTERISTICS OF COMPANIES RAISING EARLY-STAGE CAPITAL

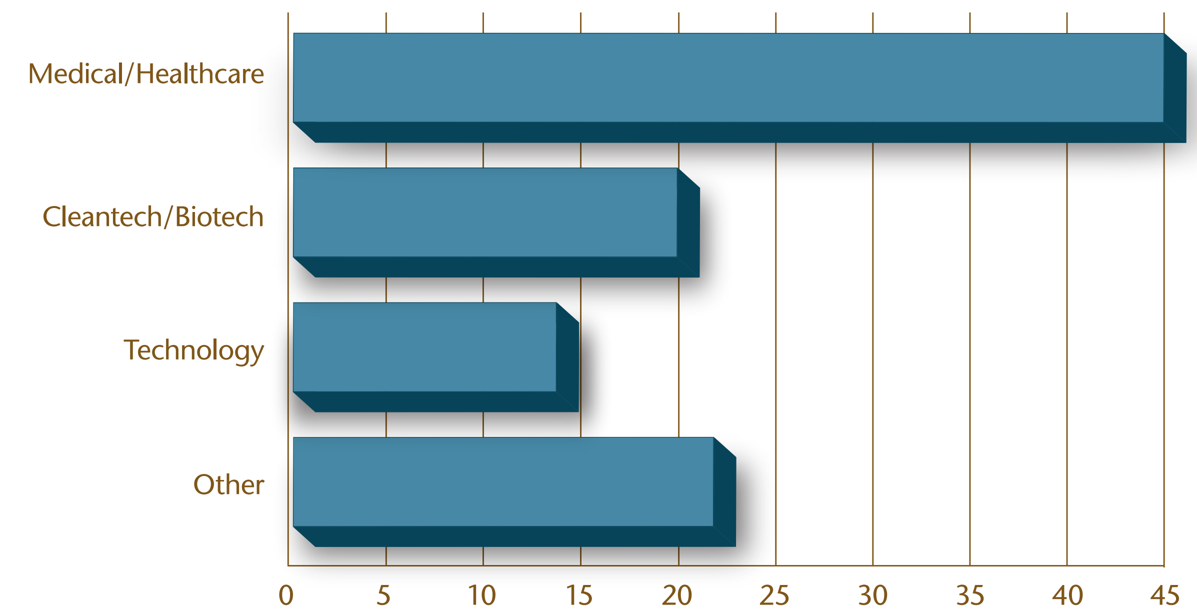
Industry

The responses to this question were somewhat surprising to us. The primary industry of a company raising capital skewed heavily in favor of medical/healthcare companies, at approximately 45%. Almost 20% of respondents identified their company as being in the cleantech/biotechnology industry, and only 13% identified their company as being in the technology industry, all of which were software companies (i.e. no companies identified as being in the e-commerce, storage, nanotech or semiconductor space). In our prior survey, 28% of respondents identified their company as being in the medical/healthcare industry and 26% identified as being in the technology industry, so this is a substantial increase for medical/healthcare companies and a substantial decrease for other technology companies.

We think that this may be an anomaly impacted by the smaller response rate, rather than a larger trend away from financing of technology-based companies. Our own experience suggests that, while there is still plenty of activity in the medical/healthcare space in Minnesota, there also is plenty of activity in the technology space.

Interestingly, of the companies that identified being in the medical/healthcare industry, the largest single sub-space was for healthcare IT companies, at 30%. This would seem to confirm some of our own recent experience, where, at least in Minnesota, the healthcare IT space seems to be quite active. We expect that the ongoing implementation of the Affordable Care Act, continuing cost pressures related to healthcare and further development of mobile technologies will only drive additional activity in the healthcare IT space.

Respondents noted the following with respect to the industry of the companies raising capital:



Pre- or Post-Revenue?

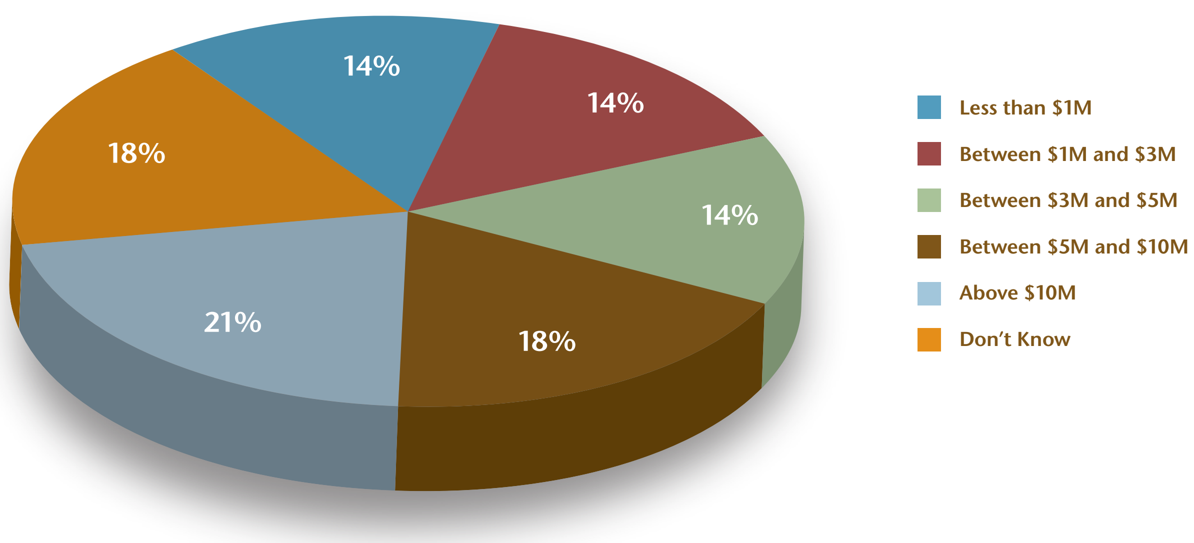
The responses to this question were also surprising. Approximately 26% of survey respondents indicated that they have not yet generated revenues, with the remaining 74% indicating that they have already generated revenues. This is a substantial change from our prior report, when nearly 43% of respondents indicated that they were pre-revenue. In our first survey, 47% of respondents indicated that they were pre-revenue.

So, one way to interpret the data is that there is a strong trend in favor of post-revenue companies for seed and angel financings. It also could be that technology companies are more quickly able to generate revenues than in the past. Based on experience with our clients, we think that the trend is not quite as pronounced as the data suggests. It is certainly easier for companies with revenues to raise capital, although we think that interesting companies with unique technology and a strong team can still raise early stage capital in Minnesota, despite being pre-revenue.

Of the three most prominent industries reflected in this survey–cleantech/biotech, medical/healthcare, and technology–both cleantech/biotech and technology were heavily weighted toward post-revenue, at nearly 80%. In contrast, only 58% of medical/healthcare companies indicated that they were generating revenues. This is consistent with our prior surveys, and is likely reflective of the long lead times needed in the medical/healthcare space, especially in medical device, to generate revenues.

Pre-Money Valuation

Responses to the question regarding pre-money valuation were as follows:



Responses to this question have been largely unchanged from prior surveys. On the whole, it seems, this survey attracts relatively equal responses from companies within each of the above categories of valuation.

Also, we note that only one respondent indicated that the price for this offering was less than a prior offering (i.e., a "down round"). The remainder indicated that the price was higher (40%), flat (32%), or that they didn't know. This is similar to our prior surveys, which indicates that we remain in a decent environment for early stage capital raising transactions in Minnesota. Obviously, there are a number of different factors that go into determining the valuation for a company in its earlier stages of capital raising, but our own experience suggests that there is a lot of momentum and support in the Twin Cities start-up scene, and lots of talented entrepreneurs. As such, the continued paucity of down-round transactions is not a surprise to us.

BROKERS AND GENERAL SOLICITATION

Use of Placement Agents or Brokers

As with prior survey results, the vast majority of respondents indicated that they did not use a placement agent or broker to assist with raising capital. Only 12% reported using a placement agent or broker, while 88% reported that they did not use a placement agent or broker. This continues to be consistent with our experience and with the general limited availability of such type of assistance for small and early-stage financings.

Use of General Solicitation under Rule 506(c) to help promote the financing

We are continuing to track the use of Rule 506(c) of the Securities Act of 1933 in early stage offerings. For those who do not already know, Rule 506(c), which was finalized just under two years ago, permits issuers to use general solicitation as part of an offering, provided that all investors in the offering are accredited and that the issuer "takes reasonable steps" to verify that all investors are accredited.

15% of respondents in this survey reported using general solicitation under Rule 506(c) as part of their offering. This is mostly consistent with prior surveys, where 20% (second half of 2013 survey) and 10% (first half of 2014 survey) of respondents indicated that they used general solicitation. In addition, we were able to separately pull data from all SEC filings made by companies in the five-state area during the second half of 2014. These filings showed that approximately 86% of offerings did not involve an exemption which permits general solicitation, with half of the remainder (7%) using Rule 506(c).

The survey results continue to indicate a higher level of utilization of general solicitation than we have seen in our client base. The 7% indicated in SEC filings is closer to our anecdotal experience. In any event, Rule 506(c) offerings, while still in the vast minority, appear to be gaining some acceptance.

We will continue to monitor this particular question closely for future surveys to determine whether these first three surveys were anomalous, or if the use of general solicitation is becoming a viable way for early stage companies to raise capital.

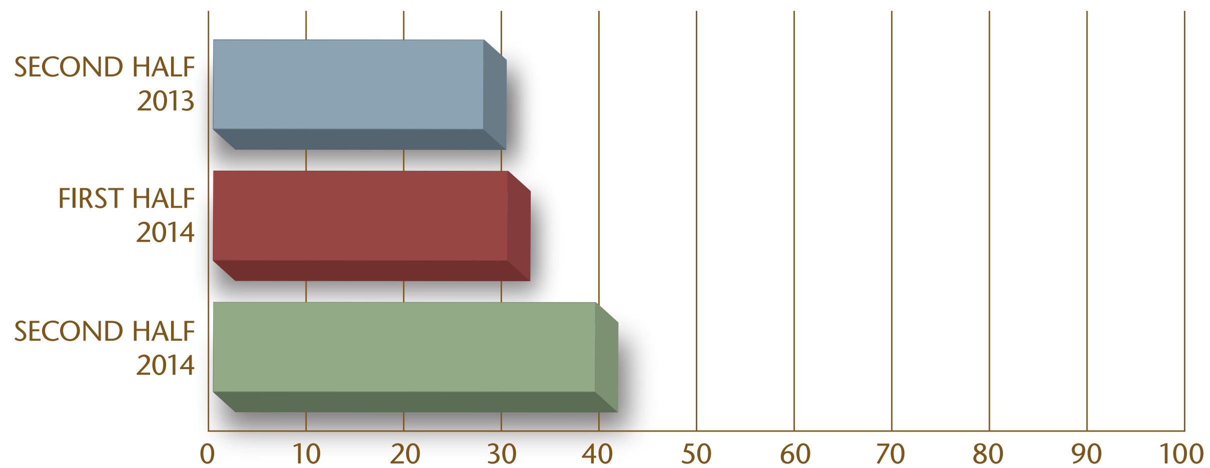
EQUITY V. DEBT

Of the respondents to our survey, approximately 67% identified the securities in the offering as being equity securities, while the remaining 33% identified the securities as debt securities. These relative percentages are consistent with prior surveys.

Characteristics of Equity Securities

As with our prior surveys, most respondents indicated that the equity securities sold were common equity (60%) as opposed to preferred equity (40%). The relative percentage for preferred equity has increased in each of our surveys though, from a low of 29% for our last half of 2013 survey, to 40% for this survey. We'll continue to monitor this trend and assess whether investors are insisting that their investments be for preferred equity. This is an important issue for both companies and investors.

Percentage of respondents indicating preferred equity:



Of those identified as involving equity securities, the respondents reported receiving the following "preferred-like" features:

Right to participate in future rounds of financing:	64%
Redemption right:	18%
One board seat:	18%
More than one board seat:	9%
Observation rights:	9%
Anti-dilution protection (weighted average):	9%
Anti-dilution protection (full-ratchet):	0%
Registration rights:	0%
None:	18%

As with our prior surveys, the right to participate in future rounds of financing (also known as a "preemptive right" or "right of first offer") was by far the most common feature given to investors in equity offerings. In our first survey, 33% of respondents indicated they received preemptive rights, and in our last survey 50% of respondents indicated the same. The increasing prevalence of preemptive rights shouldn't be surprising. It is usually the case that companies raising capital want prior investors to participate in subsequent rounds. The primary downside to granting preemptive rights is the logistical burdens they impose. We remain a bit surprised that preemptive rights are so much more prevalent than other types of rights we see investors requesting, such as board seats or observation rights. Based on these responses (and the response to our question regarding debt offerings – see the next section), it appears preemptive rights are becoming increasingly popular in early-stage equity offerings.

Liquidation Preference

Of the reported preferred equity financings, 80% involved some form of liquidation preference. The vast majority of respondents who reported receiving a liquidation preference noted a 1x preference. This is identical to our prior survey, and similar to our first survey. In addition, only one respondent reported a 2x preference, and none were greater than that.

Also, 80% of the respondents indicated that the liquidation preference is participating (that is, in addition to the preference, they have a right to share proportionally, on an as-converted basis, with other holders on a liquidating distribution after payment of the preference). This is an increase from our prior surveys, when the percentages of respondents indicating a participating preference were 60% and 50%, respectively. We'll continue to track this response to see if a trend is developing toward an even larger preponderance of participating preferred stock.

Characteristics of Debt Securities

For those who indicated that the investment was structured as a debt security, rights to participate in future rounds of financing, board representation (one or more seats), redemption rights or observation rights were the most common types of "preferred-like" features granted to investors/lenders. The detail on such features relating to debt is as follows:

Right to participate in future rounds of financing:	63%
One board seat:	38%
More than one board seat:	38%
Redemption right:	38%
Observation rights:	25%
None:	13%

As with equity offerings, the most common feature provided to investors in debt was a preemptive right, and the prevalence of this right has been increasing over time (50% in our initial survey and 57% in our last survey).

Almost all categories of "preferred-like" features were up in this survey for debt offerings, and in particular redemption rights increased significantly (from 7% to 38%). The data on this point doesn't necessarily indicate a trend in favor of redemption rights, and indeed we still think (as the data suggests) that redemption rights aren't standard for early-stage debt offerings. Further, the ability to redeem debt instruments would make them ineligible for Minnesota Angel Tax Credit. Perhaps the lack of availability of the credit during the survey period led to an increase in the use of redemption rights. We'll continue to track this item to see if a trend develops in debt offerings and, if so, whether it is linked to the availability of the tax credit.

Interest Rate

Interest rates may be rising. 25% of debt respondents reported that the interest rate on their debt security was less than 5%; 37.5% of respondents reported that the interest rate was between 5% and 10%; and 37.5% of respondents reported that the interest rate was greater than 10%. In our prior survey, only 13% responded that the interest rate was greater than 10%. We'll continue monitoring this to see if the market is moving toward higher interest rates on early stage debt instruments.

Security Interest in Assets

Consistent with our prior surveys, the respondents were nearly split on whether repayment of the debt was secured by the company's assets. Exactly 50% of respondents in this survey reported that repayment of the debt was secured by some company assets, while the remaining 50% reported that the debt was unsecured.

Warrant Coverage

44% of respondents involved in a debt financing reported receiving some warrant coverage, which was up from our prior survey in which only 33% of respondents reported receiving any warrant coverage. 33% of all respondents reported receiving less than 10% warrant coverage, with the remaining 11% reporting receiving between 10% and 20% warrant coverage. It is unclear if this uptick indicates an actual trend toward warrant coverage for investors, or if these numbers are just an anomaly skewed by these results and a lower response rate. We'll continue to track this as warrant coverage can be an attractive equity spiff for investors in early-stage debt offerings.

Term of the Debt

As with our prior surveys, most respondents (75%) reported that their debt instrument had an initial term of more than 1 year. 25% reported that the debt had a maturity of exactly 1 year, and no respondents indicated that the debt had a term of less than 1 year. These results have remained largely unchanged across our surveys.

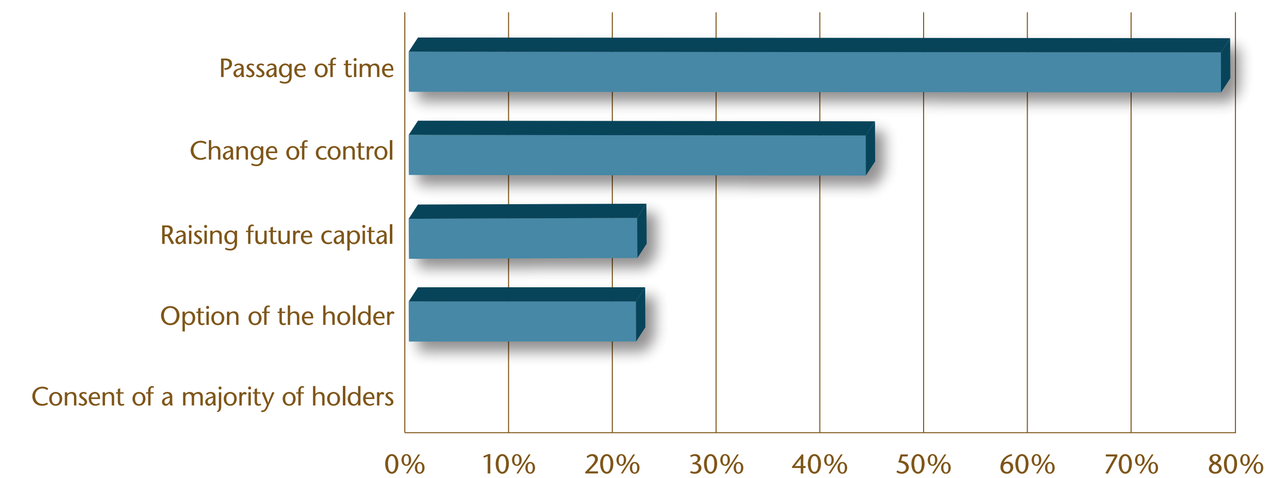
Convertible Debt

Almost 82% of respondents reported that their debt is convertible into equity, with the remainder being not convertible. This is consistent with our prior surveys, where at least 70% of respondents reported receiving convertible debt. Given that much of this seed stage debt financing has the risk profile of equity, it isn't surprising (or different from our experience) that most investors will want the ability to participate in the equity "upside" for the equity-like risk they are taking.

As noted in our prior surveys, for a debt offering to qualify for the Minnesota Angel Tax Credit, the debt must mandatorily convert into equity (and it cannot convert into equity within the first 180 days following its issuance).

Of those who received convertible debt, only 43% reported that the debt converts into the next round at a discount to the next round's price. This is consistent with our last survey's response, when only 40% indicated that their debt converted into the next round at a discount. Based on our experience, we think that the norm would be for convertible debt to convert into the next round at a discounted price. Of those reporting a discount, the discounts ranged from 15% to 25%, which is consistent with our recent experience.

The events that would trigger a conversion were reported as follows:



These percentages indicate that (consistent with our experience) most convertible debt can be automatically converted upon the occurrence of more than one triggering event.

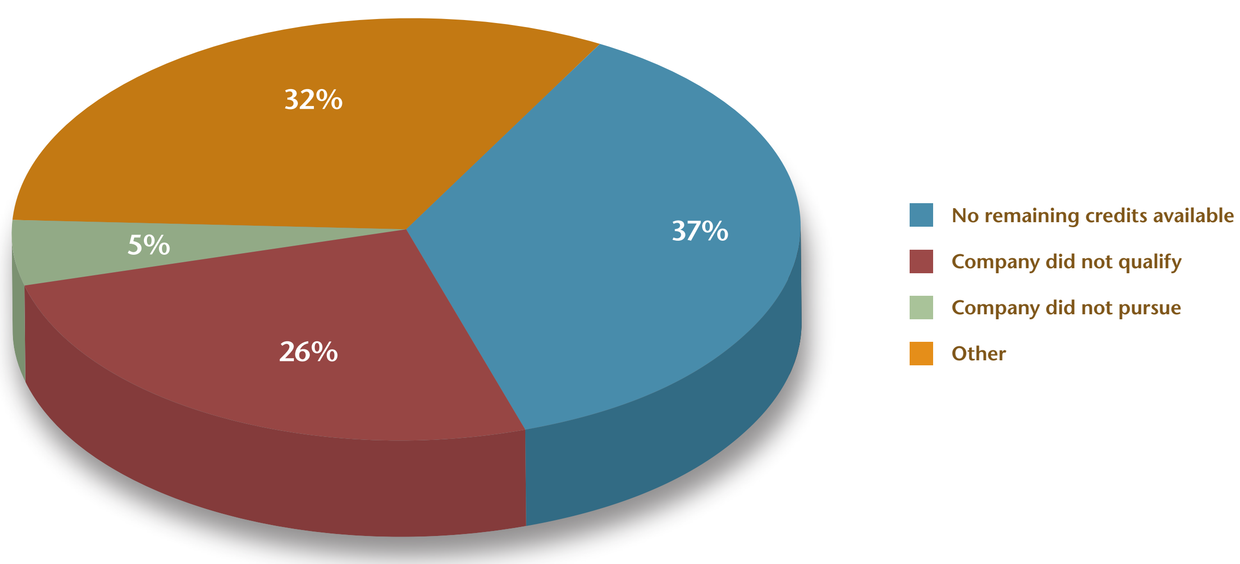
One thing that was surprising about these numbers is that only 22% of respondents indicated that their debt would convert in connection with a future capital raise. We think it is quite common for early-stage debt to automatically convert in connection with a future round of financing, as well as a change of control transaction and after some pre-defined period of time.

For a triggering event based on the raising of future capital, 50% of respondents reported that the threshold amount was $1 million, and the other 50% reported that the amount was more than $2 million. No respondents indicated that the threshold amount was less than $1 million or between $1 million and $2 million. Given the low response to this particular question, and that only 22% in total indicated that their debt converted in connection with a future round of financing, we don't think any broad generalizations can be drawn from this data. In our experience though, the amount of future capital that must be raised in order to trigger a conversion of debt is generally negotiated, and usually represents some amount of capital that the company needs to reach its next set of milestones (that is, it is a number that is not just picked out of the air, but is based on the company's actual business needs).

MINNESOTA ANGEL TAX CREDIT

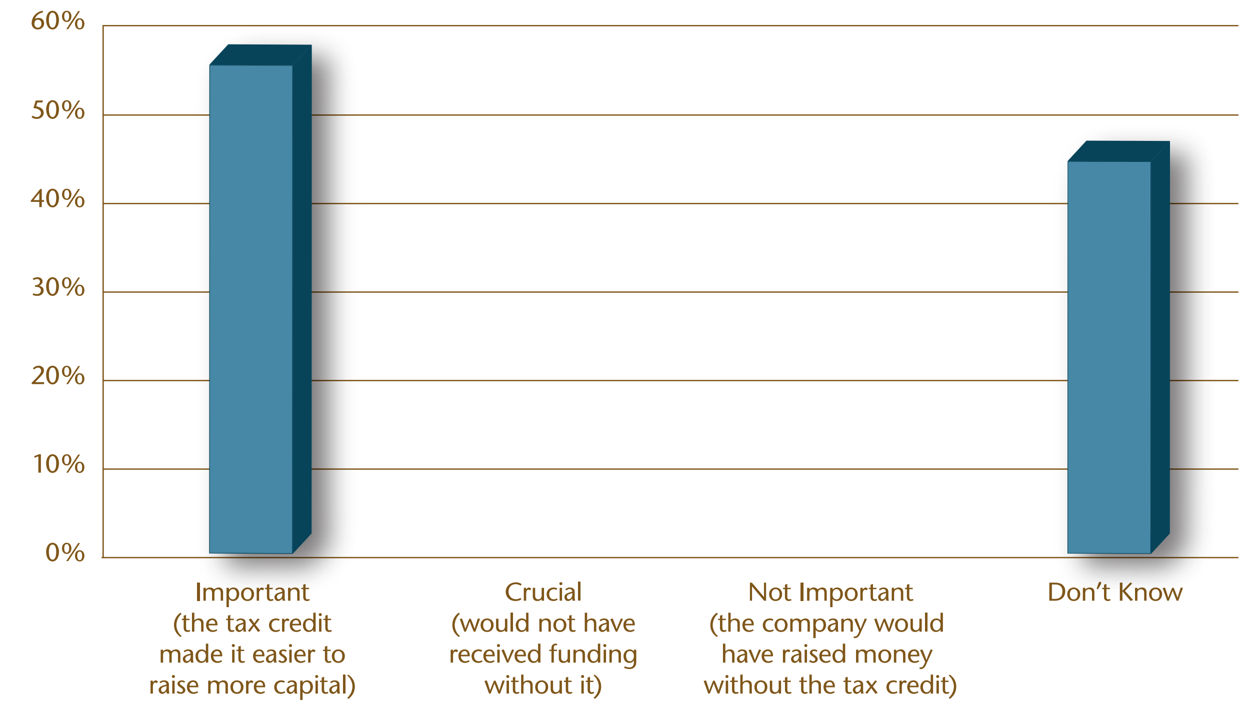
The responses to our questions about the Minnesota Angel Tax Credit were significantly different from those in our prior surveys. In this survey, 50% of respondents reported that the Minnesota Angel Tax Credit was not utilized in the financing, while only 24% responded that the Minnesota Angel Tax Credit was utilized. The other 26% responded that they did not know. In our prior survey, nearly 71% reported that they utilized the Minnesota Angel Tax Credit, and in our initial survey over half reported that they utilized the Minnesota Angel Tax Credit.

A big reason for this shift was likely that, for many companies, the available credits in the program had already been allocated by the second half of last year. So, nearly 37% of respondents indicated that the reason for not using the Minnesota Angel Tax Credit was that no credits remained. The actual breakdown of responses for those indicating that they did not use the Minnesota Angel Tax Credit was as follows:



We suspect that the response to these questions in our next survey will probably be different because we know that as of June 15, 2015, there were still tax credits available. One change to the tax credit program that could be decreasing demand is a new restriction that prohibits officers, principals, 20% owners and their family members from receiving the tax credit. We will plan to parse this question a little more carefully in our next survey to determine why demand appears to be decreasing. For the second half of 2014, though, we expect that a big factor was lack of available credits.

Of those who responded that they used the Minnesota Angel Tax Credit as part of the financing, over 50% indicated it was important, but none indicated that it was crucial. This again was a change from our prior results, when 30% indicated that it was crucial. The following was the breakdown with respect to the importance of the Minnesota Angel Tax Credit in completing the financing:



Summary

Now that we have three sets of surveys, some trends are beginning to emerge. In all of our surveys, medical/healthcare, technology and cleantech/biotech have been the most active industries for early-stage capital raising, and we suspect that will continue to be the case, at least for the near term.

In addition, some terms are beginning to appear as common or well-accepted in early-stage financings, such as preemptive rights (for both equity and debt offerings), liquidation preferences for preferred stock offerings (typically 1x participating), and board or observation rights for both equity and debt offerings. Of course, all terms are subject to negotiation for each specific deal, but the data are starting to show terms that are commonly present in a variety of deals.

We plan to modify (and add) questions to our survey to dig deeper on particular data and evolving trends and regulatory activity. Who knows, by late next year we may be seeing companies reporting successful use of the recently enacted MNVest legislation authorizing (subject to additional regulatory activity) intra-state crowdfunding. Stay tuned for that in future survey results.

We have enjoyed talking with entrepreneurs who have contacted us about financing activity and prior survey results. Please contact us with any thoughts or questions. Happy Summer!

Max Bremer   Dan Tenenbaum

MINNEAPOLIS
500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402
612.632.3000

ST. CLOUD
Suite 500
1010 West St Germain Street
St. Cloud, MN 56301
320.252.4414

WASHINGTON, DC
The Watergate - Suite 700
600 New Hampshire Avenue, NW
Washington, DC 20037
202.295.2200

GRAY
PLANT
MOOTY