

I N S I D E T H E M I N D S

Health Care Venture Capital Investments

*Leading VCs on Establishing Valuations,
Structuring Deal Terms, and Capitalizing on Trends
in the Industry*



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Investing in the Health Care Economy

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A Vision for Venture Capital

In approaching health care venture capital, we believe our focus on the underlying economic model as the primary entry point of interest differentiates us from others in the industry. We are very interested in science, but only to the extent that a product derived from the science will lower cost, increase quality, and be supported by payers, providers, and patients. Thus, we strive to invest at a point in time when we are comfortable with the business model *and* we know the product will work from a science and technology standpoint. We will not invest in science or technology in search of a business model, or in companies that cannot demonstrate their ability to meet our two key investment criteria.

In late 2006, health care costs in the U.S. are inflating at an annual rate of approximately 8 percent, or depending on the historical reference year, between two and four times the inflation rate of the overall economy. Thus, health care expenditure is becoming an ever-larger percentage of household, corporate, and government budgets. The cause of this potentially insoluble crisis seems to be a complex combination of socioeconomic trends and structural inefficiencies.

We know that the age of the average American is increasing as a result of the dominant size of the baby boomer generation and the advancement of life-saving medical procedures, and of course, older people consume more health care. We know that the “American lifestyle” imposes neglect on the body, leading to an increase in the prevalence of many chronic diseases like diabetes, the growth of which has been declared an epidemic by health care agencies. We know that the health care system as a whole is rife with clinical errors and redundant treatments. And we know there is no direct consumer acting within the health care economy to regulate the relationships among cost, quality, and necessity.

Further, the economic incentives among the major constituents in the health care system are often out of alignment. Payers—i.e., insurers, corporations, and the government—seek to avoid expense, often by limiting access to care. Providers, on the other hand, are paid to provide health care, and thus have underlying economic incentives to encourage

access. Patients, or “members” or “beneficiaries” as they are often referred to, want to get well, thus they seek quality care. However, patients are not direct payers, and generally they lack the information necessary to make comparative judgments. As such, they are often guided through the health care system by the inherent conflict between payers and providers. Broadly speaking, the resulting system is chaotic, inefficient, and extremely expensive, and yet it maintains an insatiable appetite for scientific advancement, particularly in the areas of new medicines and medical procedures.

Creating Value in the Health Care Economy

To be a successful health care venture capitalist, you must believe that where there is trouble, there is opportunity for profit, for there is plenty of trouble in the health care system and lots of need for innovation. Unfortunately, innovation alone may not be enough, unless you are talking about engineering the next great lifesaving medicine. And it is here that we have the first dividing line in health care venture capital investing—namely, the difference between biotech investing and all other forms of health care investing.

The bottom line is the “system” will pay for great new lifesaving medicines. So biotech investing, or the investment in the development of truly novel compounds, stands out as a very long-term science and diversification play. Its nuances are vast, and we will leave their description to others. For the sake of this discussion, we are interested in the other side of the dividing line of investing, namely, investing in the health care economy. This area of investing includes the following sectors: health care services (services), information technology (IT), surgical and diagnostic devices (devices), and reformulation of existing drugs and new drug delivery mechanisms (drug reformulation and delivery). Generally, new businesses in each of these investment areas will look to replace or change an existing service or medical procedure.

It is our view that for a health care business to create long-term value, its product or services must offer the following two benefits: 1) It must simultaneously lower cost and increase quality; and 2) It must work to the

advantage of, or at a minimum, align the economic incentives of the three main players in the health care system: payers, providers, and patients.

These criteria may seem obvious, yet many a health care business today fails to meet them. Take, for example, the “long in the tooth” traditional Health Maintenance Organization. For a period of time in the mid-1990s, HMOs appeared to be lowering costs, for we saw a meaningful period of limited premium increases. This is not the case anymore; according to Hewitt Associates, a national HR consultancy, between 2004 and 2006 HMO premiums increased on average 14.5 percent per year, underscoring the health care inflation issue noted earlier. Of course the public record is full of disputes among HMOs, their corporate clients, providers, and patients. In short, the current model of the HMO does not simultaneously lower cost, increase quality, and align the incentives of payers, providers, and patients. As such, we see it as subject to replacement by a suite of new insurance products that do—just one opportunity in contemporary investing in the health care economy.

It is our view that the lowering of cost, while a key objective in health care delivery, is not enough. Improved quality represents an investment in the future, as quality health care tends to reduce future expense. While challenging, providing the two together is far from impossible, and is most responsive to the needs of a system that is both costing too much today and expected to cost even more in the future.

It is also our view that to get any product or service adopted by the health care system, it must work well for payers, providers, and patients, without exception. For example, a new medical device that lowers the cost of the procedure and improves quality, but reduces profit on the procedure to either doctors or hospitals, will face significant obstacles in the product adoption process.

Challenges

Access to health care information and data is a major challenge to health care venture capital. The U.S. health care system is ten years behind most other industries in its adoption and progressive use of information

technology. Ideas that seek to improve clinical quality, particularly in the areas of consumer-driven health care and care management, will rely on the ability to capture, analyze, and act on data. Broad, comprehensive approaches to data management and capture, like the idea of the universal electronic medical record (EMR)—an idea that has been around since the advent of the ubiquitous personal computer, but has not been successfully deployed in the industry—have been resisted because their direct economic benefit to any payer, provider or patient has never been demonstrated, and thus the willingness of any one or all of the key constituents to pay for such a comprehensive approach to IT in health care does not exist.

Instead, contemporary service companies have to create specific strategies to capture the data they need to deliver the product or services. Most often we see the trial and error necessary to create a data environment that works for payers, providers, and patients as the most significant adversary to the creation of a successful services business.

Adoption of any product or service in health care depends on the forces of payers, providers, and patients. Creating a business model and value proposition that works for each of these constituencies can be very difficult, since generally their economic incentives are not always in line.

Investment Opportunities in the Health Care Economy

Opportunity lies within the micro and macro economic trends that are driving health care inflation. These include:

Care management for the elderly, the disabled, and the chronically ill. These three segments are expected to grow health care expenditures at a rate of 8 to 10 percent per year for the foreseeable future. The implications of chronic illness and disease are staggering and account for over \$400 billion in U.S. expenditures. Individuals with chronic illnesses are the most frequent consumers of our \$1.3 trillion health care system with more than 90 million Americans living with chronic illness, and seven of every ten Americans that die each year having a chronic disease. Of these, cardiovascular disease (heart and stroke), asthma, and diabetes are among the most prevalent, costly, and preventable.

Opportunities to reduce the rate of re-hospitalization, one major source of the ongoing high cost of medical procedures. This is caused by either poor procedure execution or poor compliance by the patient post-procedure. Investment opportunities to overcome these issues include: (i) next generation medical devices that improve physician productivity, reduce procedure time, and reduce the probability of re-hospitalization after the procedure; and (ii) services/IT companies that monitor patients at post-hospital discharge to aid in rehabilitational compliance, including approaches to remote monitoring using the Internet and user-friendly communication devices and protocols.

One of the major costs in treating diseases relates to *late detection*, especially in cardiovascular diseases and cancer. This creates investment opportunities in next generation diagnostic tools that improve physician productivity and diagnose disease more accurately and earlier in the disease cycle. Making calculated investments in innovations that target prevention, predictive modeling, new clinical diagnostics and treatments, along with personalized care management, can bring significant improvements and reductions in the complications associated with chronic illness and disease. One example of a recent investment in this area is a medical device company that focuses on identifying individuals with pre-diabetes who are undiagnosed and untreated, which in the U.S. represents 6.2 million people—a growing epidemic crisis and a huge investment opportunity.

Medical error and waste are primary contributors to accelerating medical costs. Thus, opportunities will continue to emerge in next generation information-based care management programs that focus on reducing medical errors across the entire covered population and enable the delivery of evidence-based medicine as the standard of care.

There is no *consumer force in health care*, and as a result, no direct regulator of expense and quality. Many people believe next generation health plans that enable the patient to become a consumer by encouraging personal financial responsibility and offering the necessary clinical, financial, and comparative quality and cost information, will enable consumer-oriented decision making in health care.

Next generation “special needs plans” and Medicare and Medicaid health plans combine medical best practices, care management, and patient incentives to improve the health care of the chronically ill and lower the overall inflation trend in government funded health care *without* reducing access or benefits.

Goals and Risks

For the risks of VC investing to be worth it, each deal in a portfolio of venture companies must have the potential to deliver a minimum of four to five times the gross cash-on-cash investment returns, and if everything goes well, up to ten times. In this context, a company must grow at a compounded rate of over 40 percent over a five-year period. This is a general statement, but it drives interest in a deal and its negotiated post-money valuation. Market size is clearly the key factor that drives growth potential. While a VC will make every effort to create a set of logical financial projections for a start-up, the exact trajectory to success is very rarely predicted. But if the product and business model make sense for the market, and the market itself is large, the potential to create a very large business in the future exists.

The management team currently involved or to be involved in an investment opportunity is a critical factor in evaluating that opportunity. An important quality for a management team is that they perceive their relationship with their VC converting from a source of capital to an operating and investing partnership after the initial investment is made. We need to feel as though we can trust them. We need to believe that they will keep us informed of any difficulties they are experiencing in meeting their business plan. We need to believe that they will be open to our advice and help. We also need to believe that they respect the urgency that surrounds the process of company building.

We are looking for demonstrated competency and expertise in all of our management teams. This is a value judgment that is established through ongoing diligence meetings, the listed and off-listed reference checks and background checks. It is preferred that most of the management team have past start-up experience, however, major industry players that have left health care companies to run start-ups have also proven to be successful,

provided they had P&L and marketing/sales responsibility in their corporate positions.

Unfortunately management teams often fail to keep their investors and board of directors up to speed on the difficulties the company is facing. The management team that suddenly springs bad news on a board of VC investors is likely to be in jeopardy. Experienced VCs have institutional experience with one hundred or more start-ups. Thus, they will more than likely have encountered a similar marketing, operational, finance or human resources problem at least once in their experience. Good VC boards are truly a wealth of knowledge and start-up experience, and it is important that management teams inform them early and completely on business problems they are experiencing. Late information, especially if it results in a serious setback, will be viewed with suspicion and disapproval. Early indications of difficulties are met with enthusiasm and understanding, and most often the board can set a collective action early to mitigate and often solve the issue, especially if it is financial or personnel-oriented.

In contrast, VCs frequently rely too much on management to inform them of the challenges of their businesses. A mature VC firm is generally monitoring twenty or more companies, in addition to sourcing new investments, and often raising a new fund. An unfortunate truth about the VC business is we spend most of our time with our problem investments, usually at a time after major problems have surfaced. VCs need to be proactive about catching problems in their portfolio companies early, and this constant communication and monitoring needs to go hand-in-hand with a management team's commitment to discuss difficult business issues with their VCs before they evolve into major setbacks. Apart from mistakes in investment selection, this is the most frequent mistake we see VCs making.

On the investment selection front, we believe a frequent mistake is to provide too much weighting to technology in the investment evaluation process. This issue can go two ways. First, being enamored with a new technology that seems groundbreaking and "cool," but for which the development of a practical business model may be highly uncertain. Second, rejecting a business based on a technological enhancement because it lacks

“unique science,” when in fact the science is patentable and the business model is sound. As we have discussed, to us, business model and value proposition is most important. If it is based on a new science or scientific enhancement, that is great, and the most important thing in that instance is that some key portion of the science needs to be able to receive patent or copyright protection.

Due Diligence: Understanding and Mitigating Risk

The essence of VC investing is risk mitigation. The first risk we worry about is whether a new company can overcome resistance to change in the market. That is why our primary business model or economic test is so important. Once we feel like we should have a business, we then focus on the nuts and bolts of the investment due diligence, which for us includes a detailed review of:

The market for the product or service, e.g., size, growth rate, concentration, barriers to entry, business model economics (pricing, margins, manufacturing costs, ongoing software maintenance costs), the customers, and market segmentation.

Competitive issues, e.g., value proposition, return on investment for the customer, distribution strategy, competitive differentiation, growth strategy, and uniqueness and longevity.

Management, e.g., integrity, on and off sheet reference calls, background checks, vision, experience (and relevancy) and track record, education and completeness (are there major hires yet to come?).

Financial, e.g. use of proceeds, long-term capital requirements, valuation, expected time to a liquidity event, possibility of an IPO, detailed review of the company’s twenty-four month budget and long-term (five year) financial model.

The process of due diligence usually consists of: several management presentations, site visits, reference checking, competitive analysis, pricing

analysis, corporate review, and the negotiation of the deal structure and valuation.

Near the conclusion of every due diligence process, whether for a deal you are going to invest in or not, you will be disappointed because certain areas will not be as pristine as you would have hoped. These are your investment risks. Deciding whether to invest requires thinking through these disappointments and deciding whether they will be overcome soon enough for the company to execute effectively. There are only a few rules here; the rest is gut instinct and the collective experience of the VC partnership.

Here are the rules (the instinct is up to you):

- 1) If you cannot quantify the value proposition, i.e., the lowering of cost and improvement of quality, move on.
- 2) If you are unsure that the product or service works for payers, providers and patients, move on.
- 3) If you have major doubts about the CEO, move on. You have to almost LOVE the CEO, because when things go wrong, you are going to have to work with them a lot. You need to believe the CEO can make the adjustments to get through a rough time.
- 4) If you are unsure how much capital the company will need, move on, because it will probably need more than you are expecting. Step aside and wait for the next round when the capital question is clearer. This is especially true if you are a small fund that cannot carry the day by taking a substantial portion of an unplanned round.

Success

For VCs that invest in the services, IT, and devices, long-term success and a good track record need to be based on two factors: (i) superior long-term net returns; and (ii) a high portion of successful portfolio investments versus failures. The former being a measure of investment and monitoring

skill, with the later being a measure of relative safety or potential for a large loss.

We believe it is the responsibility of a VC to make investments in companies that have a high likelihood of success and that can survive tough economies. It is our objective in building a portfolio to invest in companies with a sound business model and large market opportunity. We work to see that these companies have management teams that are highly competent and open to working with their VC partners.

If this is the case, we know the company is likely to succeed and the challenge converts to maximizing returns. Our objective is to have complete write downs of less than 20 percent of committed capital (with an inherent goal of zero write downs). This is the first step to success, i.e., mitigating the risk of big losses in the portfolio. The second step to success is creating huge returns out of at least 20 to 30 percent of the successful companies. We view returns that exceed our benchmark cash-on-cash gross returns of four to five times over four to five years as “huge.”

A good track record in health care services, IT, and devices will have a large number of successful companies (i.e., minimal write downs) and a handful (or maybe more than a handful) of big return investments. To us, having both of these attributes demonstrates to investors that the VC is prudent in its investment selection, works to mitigate risk, and has an eye for and the deal flow to generate big hits. Thus, the VC has the potential to generate net returns that outpace the public financial markets without exposing its investors to the possibility of a significant capital loss.

Investing at the Value Creation Inflection Point

We are looking to invest at a point in time immediately prior to a significant value creation event. This timing is different, depending upon the industry sector. For services, we want to invest approximately eighteen months prior to the company going cash flow positive. For IT, we want to invest for the deployment of a successful beta customer within eighteen months, and production software immediately thereafter. For medical devices and specialty pharmaceuticals, we want to invest at a point in time after some

human testing has been done, but prior to FDA approval and market launch. These moments in the development of the companies correspond to the time where we can add the most value as advisors and board members and when we believe the company positions itself for a great future.

We will also do a small portion of pre-IPO rounds (about 10 to 20 percent of our portfolio) if the valuations make sense and if the company is open to adding our group as an active board member and advisor.

Deal Structuring

Generally we will structure our deals as senior convertible preferred stock with rights similar to the following: dividends; anti-dilution protection in the case of a future down round; as converted voting rights; protective covenants for the senior convertible preferred regarding mergers, amendments to corporate documents, borrowing and making loans, structuring any preferred stock senior or *pari passu*; rights to at least one board seat; rights of first refusal on insider stock sales; preemptive rights on future financings; registration rights; bring-along rights; and tag-along rights.

The stage of a prospective investment has an effect on how we structure the deal. Earlier stage preferred stocks, such as Series A rounds, are generally less structured because there are fewer investors and thus fewer potential conflicts of interest. In later rounds, where the valuation of the company is higher, more structure is required to balance the return incentives of the new money versus the existing investors and management who may already be significantly “in the money” on their investment.

The more investors that are in a deal, the more highly structured the deal will become, because all institutions will want a series of minority investor protections to help them ensure that they get their investment return and that they are protected from being “squeezed out” of an investment.

When we first look at a deal, we try to determine whether we are interested in investing at all, regardless of the valuation. We have noted throughout

the various economic and business model tests we deploy to determine if we are interested in the company. The next step after that is valuation (see the section on valuation for our valuation process). Assuming we can reach agreement on valuation, then we subject the company to detailed due diligence. The result of our due diligence defines the risks of the deal and their magnitude. We will not invest if we determine the risks to be too vast and the likelihood of their mitigation to be too uncertain. That can only be determined after a complete due diligence review.

From the company's standpoint, entrepreneurs need to remember that due diligence is a confirmatory process. The VC is confirming what you have represented. Therefore, at some level, you will be able to know whether a firm will get through the due diligence process and to a close. Expect an established firm to catch every nuance and disclose the big issues up front, so there are no surprises. The worst experience a company can have is for a VC to pull out of a deal because the due diligence did not pan out—especially if it occurs after the signing of a comprehensive term sheet that includes valuation and structure. Starting the process over after such an event can be devastating. Our experience is that more times than not, it is because certain claims made by management turn out to be either dubious or exaggerated, or, frankly, certain members fail to disclose certain difficult aspects of their background up front (e.g., past lawsuits and the like).

Structuring Example

As a tool for exploring some of the more interesting elements of deal structuring we offer up Exhibit A below, a sample deal term sheet. This is a term sheet from an actual transaction that has been modified slightly to remove anything specifically identifiable (we don't want anyone guessing which portfolio company this is) and simplified a little bit to make it a better explanatory tool. What we propose to do in the following paragraphs is walk through several of the essential elements of the term sheet to illuminate their purpose in this deal.

First, some background on the company. This is a very good company in the medical device field. It has a very strong management team. The global market size for the product or service is \$4 to 6 billion for chronic illness.

The product lowers overall cost of delivery, improves patient health and quality of life, and improves profit margins for the providers, thereby meeting our health care economic criteria. The company is at a mid-late stage. It requires one more clinical trial before the product can go to market. The company's cash plan shows a need of \$10 to 20 million to achieve break-even and if the company hits its operational targets it could go public within twenty-four to thirty-six months after the closing of this financing. The \$12.5MM round of financing is expected to last more than twenty-four months. Twenty million has been invested in the company to date in two previous rounds of financing, a Series B (most recent) and a Series A (the first). Each is a convertible preferred stock. The company did miss certain key operational milestones along the way, and thus its capital needs are greater than it originally estimated. Nonetheless, the technology now works and has obtained patent protection in the U.S. and Europe, the market demand is established, and a seemingly well-qualified management team is in place to take the product to the market once this last final clinical trial is complete.

So, with these general facts in mind, let's walk through the term sheet.

Exhibit A: Sample Deal Term Sheet

NEW INVESTMENT, INC.

SERIES C CONVERTIBLE PREFERRED STOCK

[DATE]

This Term Sheet summarizes the terms and conditions of a proposed equity investment by Venture Fund in NEW INVESTMENT, Inc. (the "Company").

A. SUMMARY

PURCHASER: Venture Fund

SECURITIES TO BE PURCHASED: Series C Convertible Preferred Stock (the “Series C”)

AMOUNT: \$12,500,000

INVESTORS: Venture Fund and new investors introduced by Venture Fund will invest \$7,500,000 (the “New Investors”) and existing investors will invest \$5,000,000.

USES OF FUNDS: Working capital and general corporate purposes, subject to approval by Venture Fund prior to closing.

CLOSING DATE: Within 60 days of the signing of this term sheet.

B. GENERAL TERMS OF THE SERIES C

SERIES C CONVERSION PRICE: C Initially the same as the Series C Purchase Price per Share (see below), subject to the anti-dilution protection.

SERIES C PURCHASE PRICE PER SHARE: 1.1x the current Series B Conversion Price, or \$0.43973 per share.

DIVIDENDS: 10% per annum, accruing quarterly.

EMPLOYEE OPTION POOL: Post closing shares shall be added to the employee option pool to maintain the pool’s percent of the diluted shares outstanding equal to 12.48%. The strike price of the options shall be determined by the Board of Directors.

**APPROXIMATE
PRO FORMA
DILUTED
SHARES
OUTSTANDING:**

Security	Diluted Shares	% Diluted Shares
-----------------	---------------------------	---------------------------------

Series C	28,430,000	28.43%
Series B	21,420,000	21.42%
Series A	29,340,000	29.34%
Common/Warrants	8,330,000	8.33%
Existing Options	8,430,000	8.43%
New Options	4,050,000	4.05%
Total Diluted Shares	100,000,000	100.00%

ANTI-DILUTION:

Weighted-average adjustment (same as Series B) on issuances below the Series C Conversion Price. In addition, the number of shares of Common Stock into which shares of the Series C are convertible shall be appropriately adjusted to reflect stock splits, stock dividends, reorganizations, reclassifications, consolidations, mergers or sales and similar events.

**LIQUIDATION
PREFERENCE:**

The Series C Liquidation Preference shall equal 1x the Series C Purchase Price per Share plus any accrued and unpaid dividends and shall rank senior in preference to the Series B Convertible Preferred Stock (“Series B”) and the Series A Convertible Preferred Stock (“Series A”), with the Series B and Series A being referred to herein as the “Junior Preferred.”

**OPTIONAL
CONVERSION:**

Holders of the Series C shall have the option to convert their shares of Series C into common stock at any time at the then applicable Series C Conversion Price.

**AUTOMATIC
CONVERSION:**

Holders of the Series C shall automatically convert their shares into Common Stock at the Series C Conversion Price in the event of (i) a Qualified IPO (as defined herein); or (ii) upon the affirmative vote of a majority of the New Investors (as defined above).

A Qualified IPO shall mean an initial public offering of the Company's common stock wherein at least \$25,000,000 of new capital, exclusive of proceeds of selling shareholders, is raised at a per share price greater than or equal to 3x the then applicable Series C Conversion Price.

**DISTRIBUTION OF
PROCEEDS UPON A
LIQUIDITY EVENT
(PARTICIPATION):**

Upon a Liquidity Event (as defined below), the holders of the Series C shall be entitled to receive cash proceeds equal to (i) the Liquidation Preference and (ii) after the payment of the liquidation preferences to the Junior Preferred, the assets and funds of the corporation remaining available for distribution shall be distributed ratably among the holders of the Series C, the Junior Preferred and the Common Stock on an as-converted basis.

LIQUIDITY EVENT:

A Liquidity Event shall be: (i) a sale, liquidation, dissolution or winding up of the Company; (ii) the merger of the Company wherein the then current shareholders of the Company will own less than 50% of the

combined company on a pro forma basis; or
(iii) a sale of all or substantially all of the
Company's assets.

VOTING RIGHTS:

On all matters submitted to a Common
Stockholders' vote, holders of the Series C
shall vote on an as-if-converted basis.

**PROTECTIVE
COVENANTS:**

Protective covenants for the Series C shall
mirror those for the Series B as described in
Section D.4 of the Company's Articles of
Incorporation, except that only a majority
vote of the owners of the Series C shall be
required.

REDEMPTION:

The Series C shall have the right to be
redeemed at any time after five (5) years from
the closing date at a value equal to the
Liquidation Preference. The Series B shall
have the right to be redeemed one year after
the redemption of the Series C and the Series
A shall have the right to be redeemed one
year after the redemption of the Series B.

**FINANCIAL
STATEMENTS
AND INFORMATION
RIGHTS:**

The Company will submit unaudited financial statements to holders of the Series C not later than 45 days after the close of each fiscal quarter and not later than 30 days after the end of each month, including income statements, balance sheets, cash flow statements, summaries of bookings and backlogs, and comparisons to forecasts and to corresponding periods in prior years. Audited annual financial statements shall be provided not later than 90 days after the end of each year.

REPRESENTATIONS:

The Company will make representations and warranties in the Stock Purchase Agreement customary in transactions of this kind.

INSPECTION RIGHTS:

The holders of the Series C, or their designated agents, shall have the right, at their own expense, to inspect the books, records and premises of the Company, and to discuss the Company's affairs with officers, directors, employees, and accountants, at any time.

C. GENERAL CORPORATE GOVERNANCE AND RIGHTS OF THE HOLDERS OF THE SERIES C:

BOARD OF DIRECTORS: The Series C shall have the right to appoint 2 directors to the board, one of which shall be a representative of Venture Fund. Venture Fund shall also have the right to bring one observer to each board meeting.

RIGHTS OF FIRST REFUSAL AND CO-SALE: The Company shall have the right of first refusal to acquire from any holder of shares of Common Stock or Series C (collectively any “Stockholder”) all shares of capital stock of the Company which such Stockholder wishes to transfer on the same terms and conditions as such Stockholder would transfer such shares to any third party.

In the event that the Company does not exercise this right in any case, each holder of the Series C shall have the right to purchase its pro rated portion (based on their ownership of the outstanding shares of Series C) from such Stockholder.

In the event of any actual sale to a third party, each selling Stockholder shall provide the holders of the Series C the right to sell, on the same terms and conditions, shares of Series C or Common Stock to such third party on a pro rata basis.

**PREEMPTIVE
RIGHTS:**

If additional shares of capital stock are sold by the Company, the holders of the Series C and Common Stock will have the right to maintain their percentage ownership through the purchase of their pro rata share of such securities on the same terms as such securities are offered to other purchasers.

**REGISTRATION
RIGHTS:**

The Series C Investors shall be entitled to two demand registrations on Form S-1 or S-2, or any successor forms, at the Company's expense and the Series C Investors shall have unlimited piggyback and Form S-3 registration rights at the Company's expense, with priority over all other selling stockholders. The Company shall not grant registration rights to any other party without the consent of a majority of the Series C Investors.

**BRING-ALONG
RIGHTS:**

The holders of the Series C, Series B, Series A and the Common Stock holders (together the "Stockholders") shall agree to sell their stock in a sale or merger transaction of the Company wherein a majority of the voting stock of the Company and a majority of the Series C approve such transaction.

D. OTHER MATTERS

**DEAL CLOSING
EXPENSES:**

The Company will bear its own legal fees and expenses with respect to the transaction(s) contemplated in this Term Sheet. At and subject to Closing, out-of-pocket legal fees incurred by Venture Fund and due diligence expenses reasonably incurred by Venture Fund up to a total of \$100,000 will be reimbursed by the Company.

**INVESTMENT
DOCUMENTATION:**

The Company's counsel will draft the documents.

**CLOSING
CONDITIONS:**

Completion of financial, legal and business due diligence. Due diligence will focus primarily on the following matters: management references and employment terms; potential customer references; the science and intellectual property rights; and the company's marketing plan and financing strategy.

**STATE OF
INCORPORATION:**

Delaware

CONFIDENTIALITY:

Insert your lawyer's preferred confidentiality form.

NO SHOP:

Insert your lawyer's preferred form of No Shop.

**NON-BINDING
COMMITMENT:**

While this Term Sheet sets forth the general terms and conditions upon which the parties expect to proceed in good faith, it is a statement of intent only and does not constitute a firm, binding commitment of either party. Such commitment will be made only with the negotiation, preparation and execution of the final definitive agreements. The foregoing not withstanding, as a condition to Venture Fund's going forward with its due diligence and the preparation and review of transaction documentation with a view to closing its investment, Venture Fund and the Company agree that the following provisions of this Term Sheet will be legally binding on the parties: Confidentiality, No Shop and this sentence and the next sentence. This Term Sheet, and any and all binding obligations of the parties (as described in the previous sentence) shall expire within 60 days unless such date is extended by mutual written agreement of the parties.

Acknowledged and Executed By:
NEW INVESTMENT, INC.

Acknowledged and Executed
By:
Venture Fund

[Name]
Chairman and CEO

[Name]
Managing Member

Date

Date

This term sheet, like most, is not legally binding. It is a road map and summary business agreement that enables the drafting of the deal documentation for the deal, which usually takes place simultaneous with confirmatory due diligence. As you review this term sheet you'll note that there are a couple of separately binding provisions, namely the no-shop provision and the confidentiality provision (see "non-binding commitment" near the end of the term sheet). For us to devote significant resources to due diligence we like to have some assurances that the company does not plan to shop our offer to the market while we are moving to a close. This is the purpose of these two "binding" provisions, and they are generally not a problem if the company and its investors are supportive of the valuation offered in the deal. An alternative to a no-shop provision can be a unilateral "right to invest," which essentially states that if the company chooses to close on another proposal that we would have the right to invest in that deal. This right to invest provision is often appropriate for "down rounds" (rounds at a lower valuation than the prior round) or restructuring rounds wherein the existing investors are ultra-sensitive to price and reluctant to enter into a no shop. The no shop is clearly the preferred binding provision, however, and not one to be given up lightly. If your proposal is fair you should be given the time to finish the due diligence and close. Since these are the only strictly binding provisions of the term sheets they should be drafted by your attorney and tailored to the specific set of circumstances.

The summary section of the term sheet is fairly self explanatory. As noted above, this is a \$12.5 million raise. We're proposing to put up \$7.5 million and we are expecting the existing investors (namely the Series A and B) to put up \$5 million. It is very important to us that existing investors participate significantly in later stage rounds. The amount existing investors are willing to put up relative to their fund size and prior investment in the company contains a lot of subtle information about the company and management. Generally, existing investors taking 40 percent of a round, as we are proposing they do here, is a positive sign. It tells us they still like the company and management. Reluctance by existing investors to continue to invest meaningfully (and by meaningfully we mean relative to their fund size—small funds can make "meaningful" small investments) tells us there could be current or past problems, and that perhaps there is more to learn about technical, management or valuation issues.

The next section outlines the general terms of the security we will be buying in the transaction, which in this case is a Series C convertible preferred stock, or a Series C. As we stated above, this is a good company, and as such, this round will be priced at a slight per share premium to the Series B, namely 10 percent. As a way of understanding this section of the term sheet we should run through some valuation calculations, particularly given that the pro forma capital structure is provided as part of the term sheet. Can you calculate: (i) the prior round Series B conversion price? (ii) the post-money value of this deal? (iii) the pre-money value? (iv) the post-money value of the Series B round? (v) the implied percent “step-up” in value of the company from the Series B to the Series C round?

Let’s go through the answers starting with an easy one, the Series B conversion price.

Series B Conversion Price = $\$0.43973/1.1 = \0.39975 (rounded).

What about the post-money value of this deal (after the Series C)? Before doing this calculation, note that in venture finance we usually use simplified definitions of pre-money value and post-money value in that we disregard the cash value of option proceeds. Technically, this approach is not correct from a theoretical accounting or corporate finance perspective as it differs from methods such as the treasury stock method or the enterprise valuation method often deployed by public company analysts and in merger transactions. The reason we disregard the option proceeds is that it simplifies our analysis of pre-money and post-money value in our evaluation of the dilution cost of a financing. Our simplifying assumption is to assume that the option proceeds will be zero, and thus as investors we will always do slightly better on our returns when the option proceeds actually get collected upon exercise. Keep in mind, however, that we are deploying capital that requires a 40 percent compounded annual rate of return, yielding four times or more on our money over a four-year holding period, so on the upside the option proceeds do little to offset the inherent dilution of issuing the options in the first place. On the downside, options rarely get exercised and VCs are generally looking for capital recovery. Using this simplifying assumption, post-money value of this deal turns out to be a pretty simple calculation, namely the Series C conversion price multiplied by the fully diluted shares outstanding or:

Post Money Value = $\$0.43973 \times 100,000,000 = \43.973 million.

The pre-money value follows from the post-money value by simply subtracting the amount of money raised in the Series C:

Pre Money Value = $\$(43.973-12.5)$ million = $\$31.47$ million.

To calculate the post-money value of the Series B round we have to consider the change in the employee option pool (which is generally reserved for management). You'll note that as part of this transaction we are maintaining the size of the option pool at 12.48 percent of the diluted shares outstanding on a post-money basis. So in order to do this, we're increasing the size of the pool by 4.05 million shares. Why? Well, one of the fundamental truths about venture finance is that so long as a company continues to succeed, the option pool needs to grow to maintain management's financial incentives. This is often an overlooked cost of dilution, but sure enough on every new financing round management is going to want to be "made whole" on their option pool. Now these options will be priced higher than the options issued at the time of the company's founding, but as we noted earlier, given the expected returns the option pricing is not as worrisome as the dilution management would have received were the option pool not increased. Generally you can count on option pools being between 7.5 percent to up to 20 percent of a company's capital structure depending on the stage of the investment. Generally these pools do get diluted over various financing rounds, but rarely to the same extent as the dilution experienced by the initial investors and founders.

To compute the Series B post-money value we first need to compute the number of shares outstanding at the closing of the Series B round as follows:

Shares Outstanding at the Closing of Series B = $100,000,000 - \text{Series C}$
 $(28,430,000) - \text{New Options } (4,050,000) = 67,520,000$

and

Series B Post Money = 67,520,000 shares x \$0.39975 per share = \$26,883,187.

And the implied step-up from the Series B to the Series C round equals the Series C pre-money value divided by the Series B post-money value or:

Series C Step-up = $\$31.47 / 26.883 = 1.17$ or 17%.

So note that the percentage Series C step-up in value is 17 percent over the Series B post-money value, but, because of the increase in the option pool that was part of the Series C financing, the Series C price per share is only 10 percent higher than the Series B conversion price per share.

The above calculations are key to understanding the economics of this deal as it relates to the new investors (the Series C), the most recent investors (the Series B), and management.

A few more quantitative questions: I told you that the total amount of capital raised for this company was \$20 million. If I also told you that all of that capital was raised in either the Series B or the Series A round, can you calculate the following?: (i) the size of the Series B round, (ii) the size of the Series A round, and (iii) the Series A price per share? Here are the answers but give the calculation a try on your own. The size of the Series B round is \$8.56 million, making the size of the Series A round \$11.43 million and the Series A price per share equal to \$0.39 (rounded).

From these calculations we learn something very interesting. Basically the Series A and B were priced at almost the same value per share, meaning the Series B round was a near “flat-round.” Does this inspire some potential due diligence issues? It should because on a retrospective basis the Series A and to some extent the Series B rounds look “miss-priced.” We usually take for granted that VCs are price disciplined (although sometimes they are not), so as part of our due diligence, we’ll want to understand how and why the company missed on its Series A and Series B projections (And note, as an aside, how the CEO answers this question will tell you a lot about him, and frankly, how you ask it will tell the CEO a lot about you).

From our standpoint, since we are investing at a \$44 million post-money value, we believe the company could become worth around \$176 million and has upside near \$400 to \$500 million, if the company successfully introduces their great new product to the market and gains meaningful share (for more on these ideas please see the valuation section).

What are the other components to this deal's structure? Well, we have the dreaded downside protection issues, the stuff that matters when things go wrong. In this case, we've asked for a weighted-average price adjustment if the company is forced to raise money in the future at an implied value per share that is less than \$0.43973. Weighted average means that not only will the price per share be taken into account when making the adjustment, but also the amount of money raised relative to the amount of money already invested in the company. This allows the company to raise small amounts of money in case of emergency without the result being complete dilution of the rest of the owners. Oftentimes this provision will come with a "play or pay" provision which requires an investor to purchase its pro rata share of the new round being raised in order to get the benefit of the price adjustment on its prior investment. This provision is normally negotiated during final documentation.

The other significant downside protection provision is the right to, and the seniority of, a liquidation preference upon the sale of the company. As you read through the term sheet you'll note two things: first, these preferences work in an order of priority of last money in, first money out, and that the Series C is a "participating preferred." By participating preferred we mean that on a sale of the company the Series C gets liquidation preference (in this case, its investment plus its dividends), and after the Series A and B get their liquidation preferences if there is any money left over the Series C will share in that on an as-converted basis. Generally, this is an aggressive term, but it is very common in later stage deals. In this case, we asked for it because the Series B had gotten it in its round. This illustrates another key issue to structuring: be prepared to give whatever aggressive terms you are asking for to future investors. As discussed earlier, future rounds usually get more structured, not less. The concept of seniority for the Series C is also captured under the redemption provision.

The optional and automatic conversion terms are fairly standard, as are the information and inspection rights and the registration rights. You'll also note that we are asking for one seat on the company's board and one observer right. Given the magnitude of our investment, this should not present an issue to the company or its investors. Three provisions in this term sheet warrant additional commentary, namely the protective provisions, the preemptive rights, and the bring-along rights.

With respect to the protective provisions you'll note that this term sheet simply refers to the protective provisions that were granted to the Series B and asks that the Series C have a separate vote to approve them. What are they? Well, they are pretty intense, and I will tell you that they will ultimately get renegotiated during the deal documentation round because as a practical matter the company could not give these protective provisions to both classes on stock. Before getting into what they are, though, let's talk about what they are for.

As new rounds of capital come into a company, conflicts of interest begin to emerge, particularly when earlier investors are getting meaningful increases in valuation over time. If this is the case, the early investors would be more inclined to sell at lower prices, and potentially at a point in time when the ideal return has yet to be achieved for the later round investors. This conflict is mitigated first by the liquidation preference (and its participation feature) and the seniority provisions of the convertible preferred stock addressed earlier. Second, this conflict, and other potential conflicts among the late round investors, the early round investors, management, and board are mitigated through practical protective provisions, or rights, that the senior preferred have over or along with the other investors. These protective provisions usually break down into two types: (1) Protecting the existing and ongoing rights of the specific class of preferred and (2) Protecting against the misappropriation or mishandling of corporate assets to the detriment of the specific class of preferred. So, for edification, here are the Series B protective provisions mentioned in the term sheet. I have labeled class protections as "Class" and corporate asset protections as "Corporate." When negotiating these provisions in an environment where there are multiple classes of preferred stock, it is often

settled that the “Corporate” protections get shared among all the classes with each class maintaining their class specific protections. Quoting:

“...[The Company shall not] without the prior consent of at least seventy percent (70%) of the then outstanding shares of [Series B], consenting or voting as the case may be, separately as a class:

- (i) amend, alter or repeal the preferences, rights or privileges of the Series B, by merger or otherwise; or (“Class”);
- (ii) amend or waive any provision of the [Company’s] Amended and Restated Articles of Incorporation or Bylaws (“Corporate”);
- (iii) authorize or obligate itself to issue any new series of stock... being on parity with or having preference over the Series B (“Class”);
- (iv) increase or decrease the number of authorized shares of Common or Preferred Stock (“Corporate”/“Class”);
- (v) dissolve, liquidate or wind up the [Company] (“Corporate”)
- (vi) declare or pay any dividends on any class of capital stock (“Corporate”)
- (vii) engage in a Change of Control transaction (“Corporate”)
- (viii) [change the size of the Board of Directors] (“Corporate”)
- (ix) [redeem a class of capital stock, either completely or in part] (“Corporate”)
- (x) [amend employee benefit plans] (“Corporate”)
- (xi) [enter into any licensing or other transaction for the Company’s intellectual property] (“Corporate”)
- (xii) incur bank debt... (“Corporate”)
- (xiii) issue any equity securities or rights to purchase equity securities (other than shares of common stock...) to employees, directors and consultants for the primary purpose of soliciting or retaining their services (“Corporate”);
- (xiv) change or revise the [Company}’s business strategy (“Corporate”);
- (xv) use proceeds from the sale of the Series B for any purpose other than the working capital... needs of the [Company] (“Corporate”/“Class”)
- (xvi) enter into any affiliate transactions (“Corporate”)

(xvii) [acquire all or part of another company] (“Corporate”)

Rights of first refusal and preemptive rights seek to protect the preferred from being excluded from sales of company stock and from sales of company stock in private transaction to parties that may not be acceptable to the holders of the preferred. Bring-along rights enable the company to be sold in the future by the investors without the ability of the minority investors to block such a transaction—a key issue in certain sales, usually when expectations have not been met.

Valuations for Health Care Companies

The goal, when establishing valuation, is to arrive at a fair deal. Something that offers incentives to management and results in a price that gets the VC the required return. Unfortunately, you will not often know if you did a good job until after you either close the next round or you exit the company at a profit. If due diligence works out, valuation is the next likely showstopper. The rules of thumb listed below are rarely violated.

The main areas considered when trying to create a valuation include market size, business model, comparable rates of adoption, and the anticipated time to exit.

Rules of Thumb

First and foremost, there are some rules of thumb that all VCs use, generally as a guideline to cap valuations depending on the “stage” of the company. Stage can be defined as early, mid or late, together with pre-revenue, revenue, or profitable. Late stage can also be referred to as one to three years prior to an expected IPO or sale. You combine these three definitions to describe the risk of the investment, which at some level tells you the potential quantitative accuracy that can be derived from a detailed valuation exercise.

All VCs develop internal financial projections as part of our valuation exercise. The reality is, though, that creating an accurate long-term projection for an early stage/pre-revenue investment is, well, interesting but

very difficult. In the end, it will only tell you the potential “home run” value of the deal. By definition your projections will be optimistic because you are only looking at the potential for success. During this process you may find yourself effusive with the prospect of owning a \$500 million business that obtains a 10 percent market share within a seven-year time horizon. Certainly such a projection would imply that you could pay \$47 million post-money value and achieve your 40 percent IRR target, achieving a 10 times cash-on-cash return in the process! Well, these kinds of outcomes are fun to think about, but they will lead to a lot of valuation mistakes because they will not quantify all that will go wrong along the way, issues the company will face that will delay its product development and sales, and cause it to use up more capital. As a result, early stage VC rounds tend to be valued using rules of thumb, with the long-term optimistic projection model providing the inspiration to go forward with the investment.

Valuations need to be derived based on the way ventures get financed, which ideally should be through staged equity rounds that are raised subsequent to a company passing through a set of major operational or developmental milestones. Early rounds are done at very low valuations with minimal amounts of capital. For example, \$1 to \$5 million pre-money values with \$1 to \$5 million of capital raised. (Note to entrepreneurs: a key to your outcome will be to manage through the early stage of a company’s development with as little money as possible, because this is where most of your dilution occurs.)

Mid-stage rounds are done at moderate valuations, anywhere between \$5 to \$20 million pre-money values with \$5 to \$20 million of capital raised. Generally, it is only in the later stage rounds—those very near an IPO or sale—where conceptual “caps” on value get less weight than future financial projections. The later stage round is normally the last conceptual round before an IPO or a sale, and the company seeks to raise enough money to sustain the business through the window of time it will take to achieve either of these key milestones. Generally, a company will raise at least \$20 million in a later stage round, but here again the financial model drives the process. A later stage deal should provide enough capital to sustain the company for at least three years on the premise that an IPO or

sale always occurs opportunistically (i.e., when the IPO “window” is open and/or the M&A market is attractive and vibrant).

Regardless of the stage of the investment, the VC is going to work with management during the valuation stage and due diligence phase and build a set of financial projections. The purpose of this exercise is manifold. First, you have to project the future capital requirements of the business. As we have noted, start-ups raise money in stages. The financial model serves first and foremost as a plan to get to the next stage. So the first twenty-four months of this model needs to be extremely detailed, especially on the cost side, and it needs to be extremely conservative on the revenue side. This allows the company to raise the right amount of money in the round, with some “cushion” to make sure they can achieve key milestones before going to the market again. We like our companies that are at the pre-revenue or revenue stage to be adequately capitalized for more than twenty-four months based on a very conservative view of sales traction.

Second, you develop an overall five-year view of the business. We are generally mid-stage investors, with a preferred average holding period of five years. The five-year view tells us where the company could be from a financial point of view at the time we intend to exit. This five-year model will have an expected case, a downside case, and an optimistic case, and will assume the company achieves our conservative twenty-four month post-investment model. Using reasonable exit multiples of revenue, EBITDA and net income, we then estimate the range of potential exit values and our investment return under the assumption that we maintain our ownership percentage in the company in any future expected financings. We then develop a cash-on-cash return calculation for all money we expect to invest in the company. If we are comfortable that we can earn four to five times on our initial investment in the conservative or base case, then we use those cases to establish our valuation proposal, taking into account the rules of thumb noted above.

Third, the process of building the detailed long-term model requires a detailed look at the business model and its inherent risks, and is part and parcel to the due diligence process. Here you look at pricing strategies, costs, and revenue ramps. The earlier stage the deal, the more difficult this

model is to create, but that does not make it less important. Being able to create a financial projection that seems possible is an important part of evaluating a venture stage company, and can often prove to be a very difficult and frustrating exercise. If you doubt the financial model, chances are you are either overpaying or making a poor investment decision.

Advice

Entrepreneurs must understand that you have to give capital its “required return” and in an early stage deal, that is going to happen through valuations that are fairly low. That is why VC deals get staged at ever-increasing valuation rounds. The early rounds should be low valuations and small amounts of capital.

Vcs will get their returns one way or another. It is best to negotiate a fair price and a structure up front. This sets the stage for a productive working relationship with your VC.. I always encourage management teams to look at the potential for a great working relationship first—most valuations will be close—and the party with the higher valuation, especially if an outlier, will be looking for an adjustment later in the ownership process, especially if things slip, which they always do a little.

Finally, venture-backed health care companies often struggle with calibrating their business model and marketing approach in key sectors, e.g., large public payers of health care, Medicare, and Medicaid. The use of traditional commercial sales and marketing tactics are often less effective in the government space and visa-versa. Thus, entrepreneurs should seek VC’s that are experienced enough in their market to offer assistance designed to best position a niche innovation for the biggest impact. This could include advice related to tailoring sales and marketing strategies for a specific market segment (elderly or disabled) as well as a specific disease focused strategy, e.g., diabetes. Additionally, the company may need to establish key strategic and corporate alliances in order to achieve scale—all of which calls upon the venture capitalists to leverage a wide bandwidth of skills and industry relationships in an activist role to ensure success.

Supporting Documents

Following are listed some of the most common financial documents, contracts, charts, term sheets, and other materials used in the due diligence process for venture capital financings:

Company

- Initial due diligence request list
- Organizational information
- The certificate of incorporation, as amended, and bylaws, as amended, of the company and each of its subsidiaries, and a good standing certificate for the company from the respective state of its incorporation and from all jurisdictions where each such corporation is qualified to do business
- A list of all jurisdictions in which the company and its subsidiaries are qualified to do business; a list of all jurisdictions or applications for licenses which were denied and why
- All minutes of meetings of the board of directors and each committee thereof of the company and each subsidiary
- All minutes of meetings and copies of all written consents in lieu of meetings of the stockholders of the company and each subsidiary
- All agreements or plans for reorganizations, mergers, consolidations, acquisitions or the purchase or sale of assets involving the company
- A capitalization schedule for the company, together with a list showing the names and addresses of the security holders of the company and each subsidiary, and the number of shares or other securities held by each security holder
- Documents relating to any conversion, recapitalization, reorganization or significant restructuring
- All agreements, memoranda or offering circulars relating to sales of securities of the company and each of its subsidiaries, copies of correspondence with investors, and copies of any written proposals

or memoranda of oral proposals for the acquisition of securities of each/any of the companies

- All registration statements, reports, and other documents, if any, of the company and each subsidiary filed during the past three years with the Securities and Exchange Commission, any state securities commission and any other federal or state commission, agency or department having jurisdiction over the company and each of its subsidiaries
- Stock option or purchase plans and forms of option or purchase agreements that have been or may be used thereunder
- Lists of outstanding options and warrants including date of grant, exercise price, number of shares subject to option, names and addresses of option holders and vesting schedule (including amounts currently vested and the schedule for any unvested portion)
- All agreements containing registration rights or assigning such rights
- All agreements containing preemptive rights or assigning such rights
- All annual reports and quarterly reports and other communications from the company and each subsidiary to its stockholders during the past three years
- All agreements, contracts, or commitments of each company not entered into in the ordinary course of business, including any joint venture agreements, proposals or understandings where there could be a real or perceived conflict of interest
- A schedule of transactions involving the company and/or its subsidiaries and any (1) officer or director of any of the companies, or (2) any other affiliate of any of the companies, at any time during the last five years
- All brochures, catalogs, and printed forms (e.g., invoices, acknowledgments, statement policy forms, printed contract forms, etc.) used by the company and each subsidiary during the past two years

- A description of all life insurance policies of which the company and each subsidiary is a beneficiary and all liability insurance policies maintained by the company and each subsidiary
- All joint venture and partnership agreements to which the company is a party

Management & Employee Information

- A list of the officers and directors of the company and each subsidiary, including title, address, and the date of election for each officer and director
- A detailed organizational chart
- A list of all management and board positions held by the company officers in companies or organizations outside of the company and its subsidiaries
- A list of professional and personal references for all key company executives
- The legal name, address, date of birth, social security number and a list (with identifying information) of all professional or occupational licenses held by each of the above individuals
- A complete resume for all individuals listed above
- All agreements, contracts or commitments limiting the freedom of any of the companies or any of their respective employees, officers or directors to engage in any line of business or to compete with any other person, including non-competition agreements in customer contracts
- Copies of any employment, severance, bonus or pension plans and a list of individuals eligible for these plans
- Copies of any employment agreements with current and past employees
- A summary of all current and prior employee benefit, health, and welfare plans, and copies of all plan documents, such as trusts, summary plan descriptions, and annual reports
- Copies of any consulting agreements with independent contractors

Acquisition Plan Information

- A list of key acquisition targets in progress by size, product, and geographic coverage area and associated letters of intent as available
- A list of key acquisitions planned but not yet in progress
- A list of past acquisitions, including all related documents and due diligence reports prepared pursuant to those acquisitions

Legal Information

- All material contracts to which the company and each subsidiary is a party or by which the company and each subsidiary is bound
- Copies of all consent decrees, orders, ruling judgments and injunctions relating to the company and/or its subsidiaries
- A summary description of all legal or administrative actions and claims, pending or threatened against, by or involving the company and any of its subsidiaries in any court or before any arbitrator, alternative dispute resolution system or governmental agency
- The pleadings relating to all material litigation to which the company and each subsidiary is a party or was a party during the past three years
- Form of employee confidentiality and invention assignment agreement
- Copies of all certificates, licenses, permits and other authorization of governmental bodies and regulatory authorities that are necessary to permit the operation of the business of the company and each subsidiary
- All material correspondence, memoranda, orders, and other communications from governmental and regulatory authorities relating to the company and each subsidiary during the past three years with regard to equal employment opportunity, occupational safety, and health and environmental protection, and any other matter

- List of all foreign and domestic patents and patent applications held by the company
- List of trademarks, trade names, service marks or copyrights
- List of proprietary processes controlled by the company and other trade secrets
- List of licensing agreements under which the company is the licensor, including schedule of fees thereunder
- List of licensing agreements under which the company is the licensee, including schedule of fees thereunder
- Any correspondence from third parties regarding potential infringement of intellectual property rights of others

Financial & Insurance Information

- A schedule of all insurance covering the company and any of its employees, including general liability, professional liability, errors and omissions, and/or malpractice insurance (if applicable), coverage limits, annual premiums, claims filed and paid (past three years for the foregoing), and copies of all such policies
- To the extent of any self-insurance coverage, details of claims paid for the last five years and claims outstanding, by company
- Bank line of credit agreements, including any amendments, renewal letters, notices, waivers, etc
- All agreements relating to lease financing of real property, personal property or equipment
- All other agreements evidencing outstanding loans to or guarantees by the company
- A list of any contingent or other liabilities not reflected on the audited financial statements of any of the companies referred to herein
- Monthly balance sheets, cash flow statements, and income statements for the past two years and estimated for the current year. Please provide by product, by month and consolidated, as applicable

- A detailed breakdown of cost of services, operating expenses, selling, general, and administrative expenses for the past two years and estimated for the current year for the company and each of its subsidiaries
- Provide an analysis of transactions, charges, and balances existing between any related parties during the last five years
- Provide a list of services provided to or by the company for which amounts are not billed (shared employees, shared properties, etc.)
- Provide a description of and associated stand-alone cost for any services provided by related parties or services provided under agreements/arrangements made by related entities (shared purchasing, distribution contracts, etc.)
- A schedule of all accounts receivable and accounts payable reflected on the most recent balance sheet, specifying the name of each debtor or creditor, the amount owing, and aging schedule for the company and each of its subsidiaries
- All documents pertaining to any receivable from or payable to directors, officers or owners of the stock of the company and/or its subsidiaries
- The latest set of financial projections by product, by month for the current year, and annually through the next four years, including a complete description of sales backlog and pipeline for this period; also annual projections of GAAP financial statements (income statement, cash flow statement, and balance sheet) for the next five years
- Provide auditor contact information; audit reports for the relevant years; management representation letters furnished to the auditors of the company and/or each subsidiary during the past three years; all auditors' letters furnished to the management of the company and/or each subsidiary during the past three years; and all lawyers' responses from the auditors of the company and/or each subsidiary during the past three years
- All other opinions of counsel who have represented the company and each subsidiary during the past three years in connection with litigation, regulatory matters, and proceedings and acquisitions

- All tax returns filed by the company and each subsidiary during the past three years
- Copies of all documents evidencing the indebtedness of the company and each subsidiary, and a UCC, tax and judgment lien search of all locations where the company and each subsidiary has done business or has owned property during the past three years
- Copies of all appraisals, surveys, and environmental reports with respect to any of the assets owned or leased by the company or any of its subsidiaries

Marketing, Sales and Customer Information

A schedule of all active customers, which includes:

- The start date of each contract
- The term of each contract
- Renewal terms of each contract
- The specific products/services purchased by each customer
- The annual dollar value of each contract by product/service and the type of reimbursement to the company (e.g., case rate, capitation, risk sharing, fee-for-service, etc.)
- A customer contact name for each contract

A schedule of all terminated customers, which includes:

- The start date of each contract
- The term of each contract
- The specific products/services purchased by each customer
- The annual dollar value of each contract by product/service
- The reason for termination
- A contact name for each contract
- A breakdown by payer market of current customers and the expected future customer breakdown by product line
- A list of active sales prospects and marketing plans that support these efforts for the next three years, including the current year;

also include the status of each prospect and the percent likelihood of close

- Descriptions of any joint ventures or co-marketing arrangements the company has with any other companies or organizations
- A description of the sales organization, including detailed information about sales incentive programs
- Any marketing and/or strategic plans developed by the company
- Financial savings studies performed by the company and/or financial savings results generated for customers
- A description of the pricing and actuarial process, including company participants, information collected from customers and/or other organizations, risk models, etc.
- Results of any customer satisfaction surveys and provider satisfaction surveys performed by the company or by its customers

A list of key competitors, which includes:

- Name
- Product description
- Geographic market
- Key customers, if known
- Financial status, if known
- Comparison to the company
- An estimate of total market size for each product area and company market share estimates by product area for the past two years, current year, and next two years
- Any press releases, articles or brochures issued by the company or its subsidiaries relating to the company, or any of its products, services, or material events, or any news articles written about the company or its subsidiaries
- A schedule of all memberships held by or on behalf of the company in any trade, professional, or industry-related organization or association

Operational Issues

- Detailed summary of hardware and software in place at the company
- Summary of the age and exposure to technical obsolescence of the systems
- Summary of the capacity of the systems versus amount currently in use
- Summary of historical MIS capital expenditures for the historical period and projected for five fiscal years, starting with the current fiscal period
- Any documented plans for systems integration across subsidiaries and as new acquisitions are made
- A list of all physical locations where business is performed and a corresponding listing of where various parts of the operational process are performed

Other/Miscellaneous

- To the extent not listed above, all of the following documents to which the company and each subsidiary is a party or by which it is bound, such as: (i) deeds relating to real property, (ii) union contracts, (iii) agreements relating to dealerships, licenses or franchises, (iv) supply contracts, (v) agreements relating to the acquisition or sale of assets or businesses involving the company or any subsidiary, (viii) agreements relating to any mergers or consolidations involving the company or any subsidiary.

***Stephen Krupa** founded Psilos with Dr. Albert S. Waxman and Lisa Suennen in 1998 and heads Psilos' East Coast Office. Mr. Krupa focuses primarily on identifying investment opportunities in next generation health care services and health care information technology companies. In addition, he advises many of Psilos' portfolio companies in the areas of capital formation and merger and acquisition strategy and structure. Mr. Krupa has served on several Psilos portfolio company boards, including Active Health Management (excited), HealthScribe (excited), Comprehensive*

NeuroScience and HealthEdge Software. Mr Krupa is currently chairman of the Board of Caregiver Services.

Prior to Psilos, Mr. Krupa was a vice president of Wasserstein Perella & Co. ("Wasserstein"), a leading international investment bank. During his time at Wasserstein, Mr. Krupa specialized in public and private mergers and acquisitions advisory work, much of which was focused in the health care industry. Mr. Krupa's work at Wasserstein resulted in the consummation of strategic transactions with an aggregate market value of over \$11.0 billion. Previously, Mr. Krupa was an associate in the investment banking department of Kidder Peabody & Co. From 1987 to 1992, Mr. Krupa worked first as a mechanical engineer and software applications developer and then as a manager of new business development for Johnson Controls, Inc. ("JCI"), a leading manufacturer of process controls systems. Mr. Krupa holds an M.B.A. with Distinction from the Wharton School of the University of Pennsylvania, where he graduated a Palmer Scholar, and a B.S. in mechanical engineering from the University of South Florida where he was elected to Tau Beta Pi.

Darlene Collins *joined Psilos Group Managers LLC in October 2005. Ms. Collins leverages over twenty years health care experience and a national network of government and industry relationships in support of Psilos' investment activities. Ms. Collins focuses on deal sourcing and evaluation and she serves as a strategic advisor to many portfolio companies on market development and growth opportunities in the public sector. She also plays a key role in Psilos' public policy initiatives on behalf of our portfolio companies. Her areas of expertise include government and employer-sponsored health benefit programs, information-driven technology, pharmaceutical/health benefit management strategies, disease management initiatives, and medical device technology.*

Prior to joining Psilos, Ms. Collins was an accomplished executive and business management consultant in the areas of best practice evaluation and research, business and market intelligence, customer relationship management and government relations, project management, policy and program technical assistance, and business planning. Managing her own firm, her clients included the World Congress (Strategic Leadership for the Healthcare Industry), the National Governors Association's Center for Best Practices, the United States Department of Health and Human Services, PAREXEL International Medical Marketing Services, private companies and organizations (HMOs, outsource vendors, medical groups, industry associations, pharmaceutical firms,

PBMs), and the media. Ms. Collins speaks on a variety of topics and often moderates business roundtables and health care leadership summits. Ms. Collins received her M.P.H. and Credential of Advanced Studies in health services administration from the University of Minnesota and a Masters in education from Clarion State University.

Acknowledgements: We wish to acknowledge Psilos' Senior Managing Member Albert S. Waxman, Ph.D., health care activist, serial entrepreneur, and primary instigator of our investment philosophy. Dr Waxman is a true visionary in health care and a value-add venture capitalist who continues along with his partners at Psilos Group to guide the development of many young companies to success.



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