InsurQuote Systems, Inc.

David Whetten, founder of Insurquote, looked over his pro forma financials and wondered what value he could convince Wasatch Venture Capital to place on his company. InsurQuote, a computer software company based in Provo, Utah, created products designed to automate the flow of rating information in the insurance industry. Wasatch Venture had only been licensed as a Small Business Investment Company for a month and was eager to make his first venture capital investment.

Dave had been introduced to Todd Stevens, Managing Director of the Wasatch Venture Fund through the Wayne Brown Institute, one of the largest organizers of venture capital conferences in the country. InsurQuote was selected by the Institute to present their business plan at the Investors Choice West venture capital conference in Utah during February 1993. This conference brought together emerging high technology companies with venture, corporate, and private investors. In addition to meeting Stevens, Whetten also secured an initial loan of $50,000 from the Utah Technology Finance Corporation. A year had passed since then and InsurQuote was seeking $300,000 in equity financing from Wasatch Venture to launch its products into a new market.

Venture Capital Industry

The formal venture capital industry in the United States was fairly young. The first venture fund, American Research and Development, was created in 1946. VC funds typically invested in start-up companies that could not secure traditional sources of funding, either because they lacked substantial tangible assets or expected negative earnings in the near future.

The venture capital industry remained fairly small throughout the 1960's and 1970's, with the amount of money raised by venture capitalists limited to several hundred million dollars per year at most. The flow of money into the venture capital industry increased significant in the early 1980's, due to several changes in the industry. One of the most important of these changes was a 1979 amendment to the ERISA "prudent man" rule, which regulated pension fund investments. The amendment allowed for pension managers to invest in venture capital and other high-risk assets. With this new capital resource available, investment advisors entered the industry to advise pension managers and other institutional investors about investing in venture funds.

Returns to venture capital decreased in the late 80's however, because of over investment in several industries and the entrance of many inexperienced fund managers. The lower returns led to less capital invested in the VC industry. Returns increased in the early 90's as the inexperienced managers exited the industry and the IPO market heated up. Not only did venture fundraising start to increase dramatically, but the average amount invested in a single company also increased. The average deal size was $5.3 million in 1994.

InsurQuote Systems, Inc. *was written by Jonathan Jones under the direction of Hal Heaton.*

The strength of the IPO market was an important factor in determining venture capital commitments. Particularly, historical data showed that changes in IPO market activity preceded changes in venture capital fundraising *(Exhibit 1)*. Venture capitalists needed to liquidate their interest in a company to realize a return on their investment. The most profitable way to do that was through an IPO. As a result, when the IPO market was strong, the venture capitalist was able to realize a higher return, and subsequently led to strong venture capital fundraising.

Several trends were apparent in the industry during the first half of 1994. The funds were larger in size, they were run by more experienced managers, and the average deal size was typically larger. Thirty-five venture capital funds raised $1.88 billion[1] during the first half of 1994. In comparison, $1.29 billion was raised by nearly twice than number of funds during the first half of 1993. Firms in the early 90's were also investing in later-stage companies. Early-stage investing was generally out of favor with venture capitalists, unlike the 80's, when many funds were investing in start-up and early-stage companies. A robust VC industry during the early part of 1994 saw a partial reversal of this trend with nearly one-third of venture capital being invested in early-stage companies.

Small Business Investment Companies

The Small Business Investment Company (SBIC) Program played an important niche in capital markets by providing venture capital to many small businesses in the United States. Don Christensen, Associate Administrator for Investments at the Small Business Administration (SBA), referred to the SBIC Program as "an entry-level way into the VC industry."[2] The program allowed for VC firms to obtain government backed leverage, which could enhance private capital and make a new fund "an economic reality."

Congress created the SBIC Program in 1958. A study conducted at the time by the Federal Reserve determined that growing small businesses and start-up companies did not have adequate access to the capital markets. Banks were generally unwilling to approve long term loans needed by small businesses. Similarly, equity financing in the size desired by many small companies was difficult to obtain from existing venture capital firms. The SBIC Program was created to meet this need, becoming the Investment Division of the SBA.

SBICs were privately owned and managed venture capital firms, although they were licensed and regulated by the SBA. The criteria to form an SBIC company included a qualified management team and private capital of at least $5 million. Regulatory restrictions mandated the operating rules of an SBIC and the types of companies that were approved for investment. SBICs determined their own investment objectives however, ranging from early-stage financing to acquisition/buyout financing. SBICs

[1] Richard Gourlay, "Survey of Venture and Development Capital," Financial Times (September 23, 1994).
[2] Alistair Christopher, "SBICs See Revival After Early 90s Slump," *Venture Capital Journal* (May 1, 2000).

typically invested in industries ranging from technology to manufacturing and retail. Although the program required an SBIC to provide equity capital, each SBIC and small business negotiated their own financing agreements, which varied from simple equity capital to long-term loans, debt securities, or convertible debt.

The advantage of the SBIC program was that companies could leverage their investments by borrowing up to 300 percent of its initial private capital from the government. Until 1995, loans to SBICs were made strictly through the Debenture Program. SBICs obtained money from the government by issuing SBA guaranteed debentures. The SBA then pooled these debentures and sold an SBA guaranteed security, representing an undivided interest in the debentures, through a quarterly public offering. The 10-year SBA guaranteed participation certificate paid interest equal to the current 10-year Treasury bond plus an average of about 70 basis points. SBICs could use this program several times up to a total of $108.8 million.

The Debenture Program ran into problems during the early 1990s. Lax regulations, multimillion dollar loses, fraud, political bribes, and other abuses threatened to shut the SBIC Program down. More than a dozen SBICs filed for bankruptcy, owing the government over $70 million. Several others were forced into liquidation, owing the government approximately $645 million. Mike Stamler, an SBA spokesman, said that the high SBIC failure and liquidation rates were due to "an inappropriate match between the sources and uses of the funds."[3]

The Debenture Program required an SBIC to immediately begin making semi-annual interest payments with a lump sum principal repayment at the maturity of the 10-year debenture. The problem resulted from the fact that many SBICs invested in early-stage and start-up companies that did not produce returns for several years. Christensen argued that many "SBICs found this burdensome because they had to make interest payments before they realized any profits."[4] The mismatch between interest payments and returns on investment put SBICs in a cash-flow squeeze. The recession during the early 1990s made matters worse for many SBICs. Companies that SBICs had invested in did not mature or distribute their profits.

In 1992, Congress made important changes that revitalized the SBIC Program and allowed for the creation of stronger and more successful SBICs. One of the most important changes was the creation of the Participating Securities Program. Participating securities were similar to a redeemable preferred stock. The SBA made the interest payments for the SBIC until it started to realize a profit from its investment. The SBIC then repaid those interest payments with interest. While eliminating the cash-squeeze on SBICs investing in early-stage companies, an SBIC needed $10 million in private equity to qualify under this program and could then only borrow up to two times the amount of its capital. The participating program allowed the government to share in a SBICs' upside

[3] Max Jarman, "Investment Format Changes Designed to Aid Small Firms," *Arizona Business Gazette* (April 7, 1994).
[4] Christopher, *Venture Capital Journal*.

potential. The government received 10 percent of the profits an SBIC made on its investments.

SBIC funding has been an important source of capital for many companies. America Online, Apple Computer, Federal Express, Cray Research, Intel, Staples and Sun Microsystems all received financing from an SBIC firm. From the program's beginning through March 31, 1994, $11,641.9 million had been invested in 104,146 small businesses *(Exhibit 2).* The approval of the participating securities program lead many in the industry to believe that nearly $9 billion in new capital would become available to small businesses through the creation of 150 to 200 new SBICs.[5]

There were significant incentives for banks to invest in an SBIC. The Small Business Investment Act authorized banks to invest in SBICs. Banking regulations normally prohibited banks from making equity investments in non-bank businesses. This act specifically allowed banks to participate in venture capital through the SBIC program. SBICs were also a "qualified investment" under the Community Reinvestment Act so banks got credit for investing in their local communities through investments in an SBIC. Banks were allowed to invest up to 5% of their capital and surplus in partially or wholly owned SBICs.

Wasatch Venture Fund

Through the SBIC Program, Zions Bank formed Wasatch Venture Fund in April 1994. Zions Bank saw the fund as a good investment and wanted to participate in the upside potential of venture capital.

Wasatch Venture invested in early stage technology companies, including information, communication, Internet, software, and medical product companies in Utah, Arizona, California, Colorado and Washington. A typical investment provided either startup or first-stage development financing. Wasatch looked for companies where the management team was in place, the business plan was being used as a working document for long-term planning, and they had either a product or technology that was ready to be deployed. Usually these small businesses needed capital to either market a product launch or to expand the marketing and sales activity in an effort to increase revenue.

Zions Bank brought in Todd Stevens to manage the fund. Todd Stevens got his MBA from the Harvard Business School. Prior to becoming the managing partner at Wasatch Venture, Stevens worked for 10 years as a finance executive at several Utah companies, raising nearly $450 million in debt and equity financing. He also worked as a consultant for the Simmons Media Group, which owns radio stations in Salt Lake City, Utah; Albuquerque, New Mexico; and Austin, Texas. During this time he became acquainted with Roy and Harris Simmons, founders of the Simmons Media Group and Chairman of the Board and President of Zions Bank, respectively. Todd Stevens' prior work experience with Roy and Harris Simmons put him in the right position to become the managing partner of the Wasatch Venture Fund.

[5] Jarman, *Arizona Business Gazette*.

Stevens and the management team he selected had no venture capital experience when Zions Bank started the fund. Tim Draper, founder and Managing Director of Draper Fisher Jurvetson, who also got his MBA from Harvard, was brought in as an investment advisor to help the Wasatch management team "learn the ropes." Stevens was introduced to Draper through a mutual friend from Harvard who was also working in the VC industry for the Pacific Mezzanine Fund, a later-stage fund.

Draper earned a BS in Electrical Engineering from Stanford University before going to the Harvard Business School. He worked for Hewlett-Packard, Apollo Computer, and in high technology corporate finance for Alex Brown & Sons, before founding Draper Fisher Jurvetson. Draper Fisher Jurvetson is an early stage venture capital firm based in Redwood City, California. With an impressive track record investing in technology companies, Draper Fisher Jurvetson is a highly regarded VC firm. Tim Draper was actively involved in the day-to-day operations as Wasatch Venture's investment advisor.

There were several important reasons why Zions Bank licensed Wasatch Venture as an SBIC. The most important reason was that the SBIC structure was the only way for the bank to participate in venture capital. Additionally, an SBIC license would allow for other banks to invest in future funds.

The second benefit to licensing the Wasatch Venture Fund as an SBIC was that its investments could be leveraged. The creation of participating securities would have limited the leverage Wasatch Venture could obtain to only this program. Stevens felt that the fund benefited because it was approved under the debenture program before the participating securities program was finalized later that year:

> "A lot of funds used the participating securities program. We stayed away from that because our investor base felt like they had enough capital to deploy and they didn't want to share the upside with the SBA. After the participating securities program was approved, the SBA only let latter stage SBIC funds that invest in the companies with cash flows and could pay a current yield on the investment, get debenture leverage. We licensed our fund in 1994 before the participating program was in effect. We got the debenture leverage even though we were early stage investors."

Wasatch raised $9.5 million in private equity and used debenture leverage to increase the fund total to $22.5 million. The debenture program required semi-annual interest payments as soon as the leverage was obtained, in contrast to the less rigid payment schedule of the participating securities program. Managing cash flows from the fund's investments to make these interest payments was a challenge for Wasatch Venture. Stevens noted in hindsight that Wasatch was fortunate to "have a few deals where we did convertible debt, that had current interest, so we had some money coming in."

A significant benefit of bank affiliation was that it increased Wasatch's deal flow, or the number of business plans that they got each year. Zions Bank talked with many

entrepreneurs that had interesting ideas or had started a company, but did not have company assets or profitability that the bank could loan on. If promising, these people were referred to Wasatch Venture. Wasatch also had close working relationships with other funds, particularly with Draper Fisher Jurvetson. Any deals that Draper Fisher Jurvetson received from the Rocky Mountain area were sent to Wasatch Venture. This allowed Wasatch Venture to see many more deals than if they would have simply started the company on their own.

The Wasatch Venture management team looked at nearly 1,000 business plans each year and invested in about half to one percent of those companies. When evaluating a business plan, the two key issues that Stevens looked at were the management team and the industry.

> "We really spent a lot of time making sure that the management team had the right kind of background, the right kind of perspective, and the right kind of vision of where there going with the business. When they had a 'fire in the belly' and a vision of where they were going to go, some industry experience, and knowledge of how it could happen, then those were the kind of deals that we loved to back. Even though it was risky, if the management could pull it off, the upside and potential return was huge. We liked the entrepreneur with experience, with industry knowledge and contacts, and a vision or a technology that was going to totally leap frog or revolutionize a market. That was what we liked to see."

The business secondly needed to be in a market that was large and growing. With every plan that they read, the management team asked, "can this company be a billion dollar company?" The business should ideally have been in a billion-dollar market that was growing in the double digits. Stevens wanted to see huge growth because it gave a company significant opportunity in a large market:

> "Just by keeping its market share, a company could grow rapidly, as opposed to a shrinking market where fighting for market share was like a death struggle for everyone. You wanted to be in a market where you could ride the wave of market growth as well as try to increase market share. You got a double benefit for investing in a company in that type of market."

With the creation of the Wasatch Venture Fund, Stevens planned to invest in about 30 companies over the next three to five years. Each investment, usually between $250,000 and $1 million, would always have an equity component to the deal. Stevens hoped to make 20, 50, or 100 times their money on each investment with a liquidity event five to seven years after the investment. He knew he would lose on some investments however, based on the risk profile of the companies. Between a quarter and a third of the businesses would go bankrupt or out of business. In another quarter to a third of the deals, Wasatch would probably just break even. The last third to a half really made the difference for a fund, with a couple of the deals returning 50 to 100 times the initial investment.

InsurQuote Business Plan

InsurQuote Systems, Inc. created sophisticated computer software solutions that automated the process used by insurance companies and agencies to develop, distribute, and access insurance rating information. Competition in the insurance industry was based on using this information to provide competitive insurance quotes and write unique customer policies. After observing the industry's inefficient, inaccurate, and uncontrolled systems for handling insurance rating information, David Whetten knew that there was a significant business opportunity in the automation of this process.

Background: Dave Whetten had been in the insurance industry for over 10 years by May of 1994. At the invitation of his brother-in law in 1981, he left Brigham Young University without finishing his degree in computer science to help form an insurance agency in Arizona. At that point, his brother-in-law had been in the industry for nearly 20 years. With his strong computer background, Whetten took over the IT equipment side of the business and began to look at the software that was required to run the agency. He was appalled and amazed by the lack of quality software. He enjoyed rewriting much of their software and soon began to write custom software programs for other agencies.

Whetten quickly realized that good automation software was needed in the insurance industry. He decided to return to BYU to complete his degree and develop this business idea. With the help of his younger brother and the inexpensive talent pool available at BYU, Whetten built his first software-quoting program. This product was an automated comparative rating system to be used by insurance agents in Utah. An agent typically represented 8 to 10 insurance companies. Insurance premiums and rates could take an experienced agent seven minutes to calculate by hand and hours to calculate all 8 to 10 companies. To complicate the manual quoting process, each company asked similar but different questions about a client used to calculate a rate. It simply was not feasible for an agent to prepare comparative rates of all the different companies he represented.

Whetten's comparative rating software created a superset of all of the questions needed to quote a group of companies. By inputting this information into the program, an agent could quote all 8 to 10 companies within minutes and show the rates displayed on a computer screen for comparative purposes. Whetten was encouraged by his initial success. Within seven months of releasing this product, he had put the competition in Utah out of business. Whetten said that for an agent, "It very quickly became a business tool that you simply couldn't function without."

It became clear to Whetten that they were dealing with a fairly small part of an extremely large problem. Agencies were not the only groups struggling to manage this information. As Whetten developed relationships with insurance companies, he learned that they too were having similar difficulties maintaining, updating and distributing their rating information.

Manual Rating Process and IQPL: Managing and updating rating information in the insurance industry was a manual process that involved insurance companies, rating

vendors, and insurance agencies. *(Exhibit 3)* Whetten had spent years researching how rating information was created, managed, distributed, and used in the industry. He worked closely with insurance companies and agencies to map out the entire process. *(Exhibit 4)* Whetten's experience and research supported his conclusion that the manual process was inefficient and allowed for inaccurate rating information to be perpetuated throughout the process:

> "The same information got handled over and over, and reprogrammed and reprogrammed and mistakes were made all along the way. We realized that there was a huge need here to develop a core underlying technology that could meet all of those needs, whether it was doing rate analysis for an insurance carrier or an agent needing to do a comparative quote. There were dozens of steps in this process. This information was used in many different ways, but it was the same core underlying information. We realized that if we could develop a technology that could get its arms around all of those needs – encompass all of those needs and requirements with the same set of data – we were dealing with something really big. It had the potential, in our opinion, of changing the entire way the industry worked. It would change the face of the whole industry."

Automating the rating information process from the carrier to the agency was the vision that drove Whetten's business forward. Whetten wanted InsurQuote to be more than a comparative rating vendor in traditional terms, acting as a link in the manual flow of information in the insurance industry. He wanted to create products that would automate the management and distribution of rating information. Whetten believed that automation was possible only by creating a new programming language to handle this specific problem. Whetten and his team began writing the InsurQuote Programming Language (IQPL) as a proprietary, 4^{th}-generation programming language designed to model the complex structures and policies used in creating an insurance quote. IQPL took nearly 30,000 hours for Whetten and his team to complete.

The importance of IQPL was seen in the benefits it brought to both insurance companies and agencies. InsurQuote planned to use IQPL to create a processing engine that would merge the complex and diverse data of many different insurance companies into a single system. Individual insurance companies could independently create, maintain, and update their own unique rating structures within this program and distribute them directly to the agencies. An insurance agency using a comparative rating program based on IQPL could develop a rate for single company or compare an unlimited number of companies at once (over 100,000 comparisons per hour).

Whetten believed they would be successful because the insurance industry was fragmented and efforts to standardize rating information would fail to emerge. Each state had different requirements and laws that left even the same company looking differently from state to state. The sheer volume of data required to program a single state kept most rating vendors to doing business in only a couple of states and prevented the emergence of a nationwide program. Most importantly, the insurance carriers wanted to differentiate themselves by doing things differently than their competitors.

"We looked at this and really bet the farm, if you will, on a fundamental principle, and that was that the standardization efforts that were going on in the industry were doomed to fail because the companies simply did not want to be forced into a single standard. They wanted to do things their own way. In fact, they intentionally did things differently just to confuse the competition and try to carve out a niche for themselves.

The only way to do this was to develop a technology that was robust and complex enough, that would allow different companies to do things very differently from one another. We simply had to have tools that were flexible enough, that whatever the insurance companies wanted to do, we could do it and we could model it. Even though the models were very different from one carrier to the next, we had to somehow tie those together into a common underlying system. It was an incredibly complex challenge, but we felt that if we could do that, we would be in a position to win in a big way.

Now, had a standardization effort really taken hold and simplified much of the problem we were trying to solve, we would have been blown out of the water because all of this complex technology that we were developing suddenly was no longer needed. We knew this industry wasn't going to get simple, that we had to do this the hard way, and we were going to win because it was the only way it was going to work!"

Market Size: The InsurQuote business strategy focused on providing software solutions for insurance companies, insurance agencies, and the consumer. InsurQuote intended to use its proprietary technology to develop products for these three groups that would improve the efficiency, accuracy, and lower the costs of rating information systems.

Insurance Company: InsurQuote planned to develop products for insurance companies that would provide them with the tools to manage and update their own rating policies. *(Exhibit 5)* These tools would be accessed through the Visual Development Environment, a graphics-based interface that would provide pre-programmed templates, on-line help, and other tools to use IQPL effectively. Companies could quickly analyze their competitive position in the market and complete rate revisions efficiently and accurately to avoid a time-consuming, labor-intensive, error-prone, and costly manual update process. Revised rating information could easily and accurately be sent to update an agency's systems that was using the same automated technology.

Insurance Agency: InsurQuote's core product for agencies was a comparative rating engine, allowing agents to compare policies from several companies at the same time. After inputting the potential client's data, the system would compare coverage options, print customized letters and insurance applications, store and retrieve quote information, and share data with agency management systems. One of the critical needs in the existing rating system was the ability to automate the exchange of information, including applications, policy manuals and rate updates, between insurance companies and agencies. InsurQuote's system would be able to complete an automated distribution of this information in less than 30 seconds over a modem.

Consumer: The consumer market was a large opportunity for InsurQuote. InsurQuote had entered into an alliance with Automated Call Processing Corporation and Consumer's Union. The alliance brought together InsurQuote's comparative rating system, ACP's voice-response technology, and the marketing expertise of Consumer's

Union to let consumers call an 800 number to get quotes from the most competitive companies. This concept was currently in the test phase in Florida and, if successful, would be expanded to the largest 10 states first and then rolled out nationwide.

InsurQuote believed they were the first ever to estimate the market size of the business they were targeting. The market segment that made the effort and investment worthwhile was the insurance company segment. As the largest vertical market in the world with trillions of dollars in assets, InsurQuote worked with insurance companies to figure out how much was being spent on the rating process as a percentage of their total revenue.

> "Although this had never been done before, we had some pretty solid numbers that suggested that there was an incredible amount of money being spent on this process. It was an extremely cumbersome, antiquated, inefficient process and if we could bring even fairly minimal amounts of efficiency to the process then the payoff was big! It was quite simple to justify markets for a single product in the six to eight hundred million-dollar range. The total easily went into a multi-billion dollar opportunity on an annual basis."

The insurance company, agency, and consumer segments of this market were conservatively estimated in InsurQuote's business plan to be $628 million, $99 million, and $1.5 billion respectively. *(Exhibit 6)*

Whetten hired Bill Woahn and Frank Weinrauch to join his management team and to help complete industry research. Woahn had significant management experience in both finance and operations for technology-related companies. Weinrauch worked for the last sixteen years in the marketing and sales of new software products.

Marketing and Strategic Plan: In contemplating market penetration, the InsurQuote management felt that IQPL gave them a significant technological advantage over their competitors. Competition in the company segment was minimal for most of InsurQuote's proposed products. The technological advantage came in InsurQuote's ability to integrate its tools into a single operating environment that first, allowed insurance companies to manage their own rating information, and second, facilitated the free flow of data between markets and products.

Competition in the agency segment was fragmented because no single vendor had the technology to create a national comparative rating program as previously discussed. IQPL was believed to overcome this obstacle. As insurance companies began to manage and distribute their own rating information using InsurQuote products, InsurQuote believed that the benefits agencies recognized by using its products would be augmented.

In 1994, InsurQuote's strategic plan focused on increasing its market share in the agency segment while it continued to develop the company tools. The management team believed that the best way do this was through strategic partners. Understanding their lack of sales and marketing expertise, key strategic relationships would give InsurQuote an installed base in new geographic areas, a mature distribution channel with established

marketing contacts in those markets, and a strong reputation and image. Strategic partnerships could be formed with other rating vendors, agency management system vendors, premium finance companies, insurance companies, consumer groups, and other industry related relationships.

By focusing its competition on the agency segment, InsurQuote hoped to complete the company toolset with little competition or disclosure. InsurQuote management believed that the completed company toolset would give it a powerful competitive advantage by guaranteeing accuracy, efficiency, cost savings and the flexibility to respond to market changes then unrealized in the insurance industry.

Financial Forecasts: InsurQuote 's management believed that over the next five years, the company's revenues would increase from $.75 million to $52.5 million, and net income would be positive, increasing to $18.4 million by the fifth year. *(Exhibit 5)* InsurQuote's products created a powerful financial model for the company. Information in the industry changed rapidly and could be outdated within several months. Similar to an annuity, each product sale resulted in ongoing maintenance payments to keep the product information current. As long as a product was being used, InsurQuote would be able to maintain an ongoing revenue stream.

By 1993, after five years of work, the fundamental technology was coming together. Whetten could now create insurance quotes using IQPL:

> "What some people said could never be done, we were doing. We felt that we now had a model we could demonstrate and could be scaled to go after the larger market. We didn't have all of the products we needed, but the underlying fundamental technology could now be demonstrated. We could talk about how complex the industry was, what was need to solve the problem, and show the fundamental technology that could make it happen."

In May of 1994, Whetten asked for $300,000 from Wasatch Venture. This first round of equity capital was intended for three purposes: first, to open a new market in Texas by launching an agency comparative rating system; second, to complete the company toolset; third, to repay some of the personal debt that had been incurred to start implementing the business plan.

Funding Growth and Expansion

Tim Draper and Todd Stevens had made a prior investment offer to InsurQuote during November 1993. Wasatch Venture wasn't officially licensed as an SBIC at this point. However, Draper and Stevens had been looking at potential deals so that when Wasatch Venture was approved, they could hit the ground running and make several immediate investments. Negotiations fell apart after Draper and Stevens could not agree with Whetten on a valuation of InsurQuote.

The first investment offer was for $300,000 and one-third of the company. Whetten remembered Draper saying that he generally valued a company at 1 times

revenues or 10 times net income and that he wanted to make an average of 25 times return over multiple rounds of investment. InsurQuote would need to be valued at $50 million in 5 years to get the return Draper wanted, giving a 55 times return on the first round. Draper's initial valuation of InsurQuote was at $1,000,000 – a $700,000 pre-money valuation plus the $300,000 investment by Wasatch.

After thinking over Wasatch Venture's offer, Whetten met again with Draper and Steven on December 1, 1993. Their valuation of InsurQuote did not come close to what he had expected. Whetten felt that although InsurQuote's financials looked like an early stage company, in terms of risk, they more closely resembled a later stage company. While no one disputed the potential market opportunity, assessing InsurQuote's risk level was the primary issue that both parties disagreed on. Whetten felt that their operational risk was lower than an early stage company because they had been in business for nearly 10 years, the technology could be demonstrated, and an established management team was in place.

Draper and Stevens considered the level of risk associated with "a small group in Provo, Utah that wanted to change the world." How successful would a company that no one had every heard of actually succeed in capturing a piece of such a large market? Evaluating the risk vs. reward was where the discussion would turn when they started talking about valuations. Would the InsurQuote technology really be superior to its competitors? Would it create barriers to entry that would keep other large players in the industry out of this market? Although they were unable to agree on a valuation, they mutually agreed to discuss an investment at a later time.

The management team at InsurQuote funded the company through to the next level. They took cash advances on every available credit card they could get and had liens put against their home mortgages. They raised $115,000 to complete the development and market launch of additional products. In looking back at this stage of the company, Whetten could not "believe the risk his business partners took in doing this. We believed in what we were doing and believed there was an opportunity here and so they really pitched in."

By May 1994, Whetten meet again with Wasatch and showed them the progress that InsurQuote had made over the previous five months. Whetten felt that it was important to show Wasatch that they had put some of the risks behind them as they continued to execute on their business plan. He demonstrated the development of InsurQuote's products and tried to educate Draper and Stevens on the complexity of the insurance industry and the unique solution that they were providing.

Investment Decision

After setting aside the InsurQuote business plan for the second time, Stevens contemplated whether fund's first deal should be with InsurQuote. If he decided that Wasatch should make a second investment offer, Stevens knew that he would need to reevaluate InsurQuote's valuation. Successfully completing the deal would hinge on

coming to an agreement with Whetten on a valuation of the company. Additionally, Stevens needed to decide how the deal should be structured and how much equity Wasatch would require to make the investment worthwhile. Stevens knew that there would be an equity component to the deal, but he wanted to consider the benefits of each investment alternative: straight equity, convertible preferred stock, or convertible debt.

Straight Equity: Common stock would allow Wasatch to share in the upside potential of InsurQuote. As shareholders, the deal would include standard terms including the right to vote and to receive dividends. Stevens wondered if investing as a common stockholder would give Wasatch enough protection if InsurQuote went bankrupt or out of business.

Convertible Preferred Stock: Convertible preferred stock was commonly used in the industry when structuring a deal. It gave a VC firm preferential treatment over common stockholders to dividend payments and the distribution of assets in the event of a liquidation or sale of the company.

Stevens considered several items that had been included on a sample term sheet typical of convertible preferred deals. The preferred stock would pay annual non-cumulative dividends between 8 and 10 percent. The investor would receive preferential treatment if the company was sold or liquidated. Preferred shareholders would be entitled to receive their original purchase price. The remaining assets would be divided on a pro-rata basis to all shareholders until the investor received 5 times their original investment. After that, the preferred shares would not get any additional proceeds until the other shareholders had received an amount per share equal to the preferred shares.

The investor would have the right to convert the preferred shares at any time into common shares at a one-to-one ratio. Preferred stock usually included an anti-dilution clause that would protect the investment against stock splits, stock dividends, combinations, or recapitalization by adjusting the conversion price on a ratchet basis. The preferred stock would also have voting rights and would give the investor the right to appoint one of the five members of the Board of Directors. Typical preferred stock deals also included provisions for the right of first offer on any new equity offering, rights of registration, and restrictions on issuing any equity senior to the preferred stock.

Convertible Debt with Warrants: Stevens would only consider providing debt financing if it had an equity component. He realized that the risk was too great to only be compensated by an interest rate. Convertible debt or debt with warrants provided the upside potential Stevens required and would give Wasatch some cash flow to pay the interest on its debenture leverage.

Stevens remembered the confidence Whetten had in his ability to implement InsurQuote's business plan. "I know our competitors. We have many years of a lead on them. I know the industry and I understand the problem. I have been in this industry for almost 10 years and I have spent years and years developing this software. I have talked to countless insurance carriers and we have had thousands of agencies as customers. I

know how hard this is to do and our technology can do it." As Stevens considered all of the issues related to this investment decision, in the end, he had to determine if a deal with InsurQuote would be a profitable first investment for Wasatch Venture.

Exhibit 1a: Venture Capital Fundraising and IPOs[6]

	Fundraising[7]	Number of venture-backed IPOs	Amount raised in venture-backed IPOs	Total Number of IPOs	Total Amount Raised in all IPOs	Venture-backed IPOs as percent of all IPOs (#)	Venture-backed IPOs as percent of all IPOs ($)
1978	$411	6	$137	42	$495	14.3%	27.3%
1979	$465	4	$63	103	$794	3.9%	7.9%
1980	$1,200	24	$684	259	$2,378	9.3%	28.8%
1981	$1,648	50	$799	438	$4,953	11.4%	16.1%
1982	$2,011	21	$754	198	$1,942	10.6%	38.8%
1983	$5,250	101	$3,526	848	$18,388	11.9%	19.2%
1984	$4,660	44	$746	516	$5,291	8.5%	14.1%
1985	$4,035	35	$836	507	$13,595	6.9%	6.1%
1986	$4,262	79	$2,046	953	$24,418	8.3%	8.4%
1987	$5,179	69	$1,637	630	$20,147	11.0%	8.1%
1988	$3,581	36	$935	435	$6,823	8.3%	13.7%
1989	$3,329	39	$1,134	371	$6,909	10.5%	16.4%
1990	$2,414	43	$1,296	276	$4,932	15.6%	26.3%
1991	$1,472	119	$3,918	367	$17,237	32.4%	22.7%
1992	$1,937	157	$4,411	509	$24,508	30.8%	18.0%
1993	$2,451	193	$5,011	707	$41,330	27.3%	12.1%

[6] Based on Paul A. Gompers and Josh Lerner, *The Venture Capital Cycle* (Cambridge: The MIT Press, 1999): 8-9, 15.
[7] All dollar figures are in millions of 1993 dollars.

Exhibit 1b: Venture Capital Fundraising and IPOs

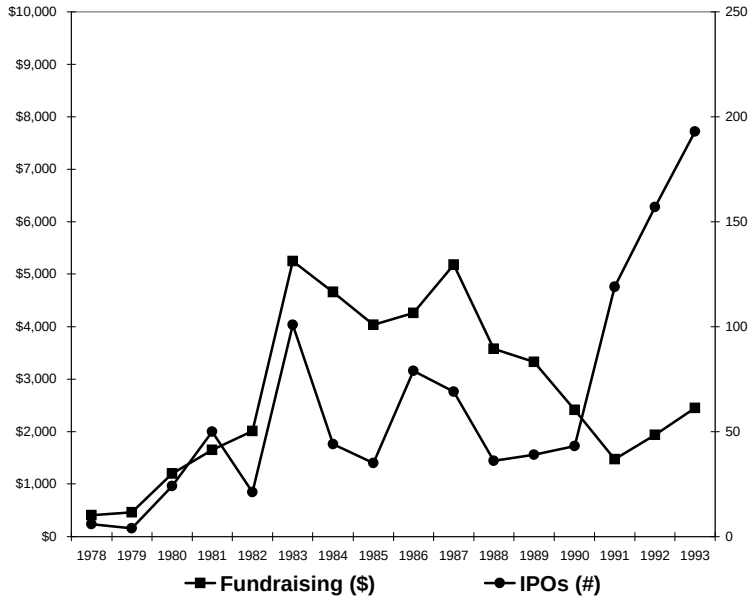


Exhibit 2: Venture Capital Disbursements[8]

	1965-1969	**1970-1974**	**1975-1979**	**1980-1984**	**1985-1989**	**1990-1994**
Food	1	9	6	23	80	93
Textile and Apparel	4	12	9	19	27	70
Lumber and Furniture	2	8	6	24	62	37
Paper	2	2	2	2	12	14
Industrial Chemicals	1	1	1	6	18	23
Drugs	1	12	34	245	554	746
Other Chemicals	1	7	8	10	52	46
Petroleum Refinancing & Extraction	3	3	26	92	27	14
Rubber Products	1	5	6	19	11	7
Stone, Clay, and Glass Products	0	1	3	14	48	31
Primary Metals	0	3	5	20	44	33
Fabricated Metal Products	0	0	0	2	1	2
Office and Computing Machines	39	84	108	744	641	442
Other Nonelectrical Machinery	12	12	32	254	280	162
Communication and Electronic	23	65	60	497	736	709
Other Electrical Equipment	0	6	16	36	52	50
Transportation Equipment	1	7	5	6	24	25
Aircraft and Missiles	0	0	0	12	20	4
Professional & Scientific Instruments	13	37	70	383	549	544
Other Machinery	7	14	16	62	89	98
Total	**111**	**288**	**413**	**2,470**	**3,327**	**3,150**

[8] Gompers and Lerner, *The Venture Capital Cycle:* 12.

Exhibit 2: SBIC Financing to Small Businesses[9]

Fiscal	SBICs		SSBICs[10]		Total	
Year	# Fin.	$ Amount	# Fin.	$ Amount	# Fin.	$ Amount
1960	196	$9.9	0	$0.0	196	$9.9
1961	1,376	$69.5	0	$0.0	1,376	$69.5
1962	3,056	$154.3	0	$0.0	3,056	$154.3
1963	3,034	$153.2	0	$0.0	3,034	$153.2
1964	5,638	$220.0	0	$0.0	5,638	$220.0
1965	4,763	$186.8	0	$0.0	4,763	$186.8
1966	4,960	$221.1	0	$0.0	4,960	$221.1
1967	3,728	$164.2	0	$0.0	3,728	$164.2
1968	2,816	$143.2	0	$0.0	2,816	$143.2
1969	3,090	$182.4	0	$0.0	3,090	$182.4
1970	2,920	$187.0	0	$0.0	2,920	$187.0
1971	2,536	$156.0	157	$1.9	2,693	$157.9
1972	2,733	$168.2	247	$3.5	2,980	$171.7
1973	2,405	$175.2	285	$5.2	2,690	$180.4
1974	2,000	$197.6	367	$12.4	2,367	$210.0
1975	1,516	$125.4	306	$10.9	1,822	$136.3
1976	1,708	$120.1	326	$11.8	2,034	$131.9
1977	1,801	$143.9	378	$17.1	2,179	$161.0
1978	2,106	$214.0	424	$24.8	2,530	$238.8
1979	2,099	$246.3	462	$30.7	2,561	$277.0
1980	2,182	$286.2	470	$37.9	2,652	$324.1
1981	2,225	$299.7	600	$46.2	2,825	$345.9
1982	2,407	$363.5	725	$50.0	3,132	$413.5
1983	2,204	$293.5	799	$51.0	3,003	$344.5
1984	2,492	$422.2	850	$61.5	3,342	$483.7
1985	2,708	$401.8	1,318	$94.1	4,026	$495.9
1986	2,934	$474.0	1,585	$121.4	4,519	$595.4
1987	2,483	$477.2	1,598	$147.3	4,081	$624.5
1988	2,472	$547.0	1,583	$141.5	4,055	$688.5
1989	2,295	$638.4	1,482	$139.8	3,777	$778.2
1990	1,674	$516.3	1,320	$132.5	2,994	$648.8
1991	1,206	$500.3	1,088	$104.1	2,294	$604.4
1992	1,006	$360.4	936	$88.7	1,942	$449.1
1993	694	$450.7	890	$90.3	1,584	$541.0
1994	1,063	$791.4	1,424	$156.4	2,487	$947.8
Cumulative	**84,526**	**$10,060.9**	**19,620**	**$1,581.0**	**104,146**	**$11,641.9**

**Fiscal year ends March 31*

***($ millions)*

[9] http://www.sba.gov/INV/stat/table1.doc

[10] SSBICs were specifically targeted toward the needs of entrepreneurs who had been denied the opportunity to own and operate a business because of social or economic disadvantage.

Exhibit 3. Terms and description of the Insurance Industry[11]

Property and Casualty Insurance: Property insurance provided protection against financial loss arising from the destruction of, or damage to, real property caused by such perils as fire, thrift, accident, etc. Casualty insurance is concerned with the insured's legal liability for injuries or damage the insured may have caused or for which the insured may have responsibility.

Life and Health Insurance: Life insurance provided benefits to beneficiaries in the event of the policyholder's death. Health coverage provided benefits as a result of sickness or injury. Policies included insurance for losses from accident, medical expense, disability, or accidental death and dismemberment.

Personal Lines: Insurance, such as auto or home insurance, for individuals or families.

Commercial Lines: Insurance for businesses, organizations, institutions, and other commercial establishments.

Independent: Independent companies distributed their insurance products by agencies that represented more than one company (referred to as *independent* agents).

Captive: Captive companies (such as State Farm and Allstate, also referred to as direct writers) had a dedicated agency sales force; agencies that represented a single company were referred to as *captive* agents.

Rating Information: The tables, factors, rules, formulas, and methods from which the insurance buyer's premium was calculated.

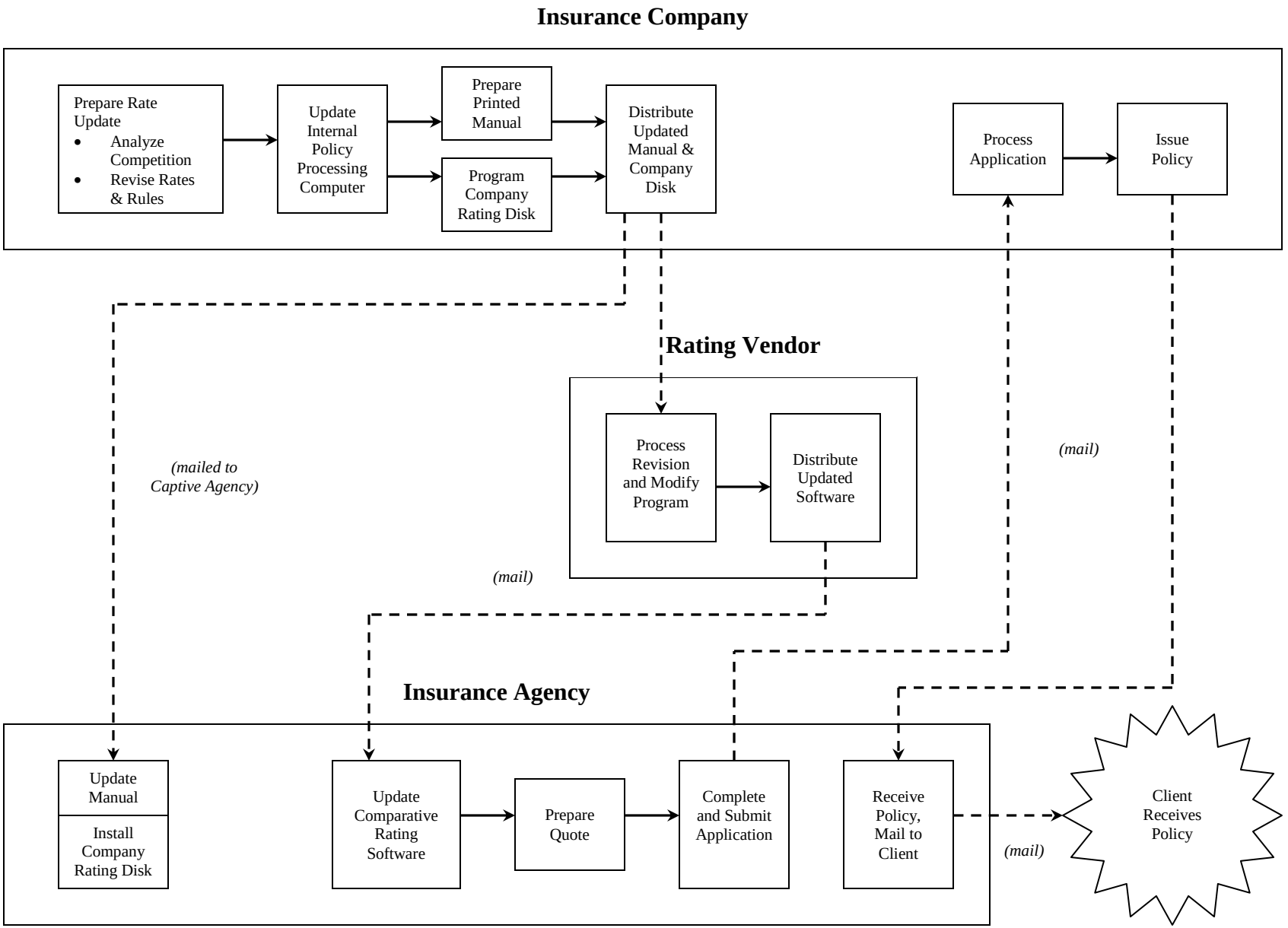
Company Rating Program: A computer program that embodied the rating information for a single insurance company, and was provided by that company to its agents.

Comparative Rating System: A computer program that combined the rating information from various companies into a single system, allowing the user (normally an agent) to compare premiums for multiple companies at the same time.

Comparative Rating Vendors: Third-party companies who developed, maintained, and marketed comparative rating systems to agents.

[5] InsurQuote Systems, Inc., *Business Plan* (May 1995): 2-3.

Exhibit 4a. Rating Information Flow[12]



[12] *Business Plan*: 4.

Exhibit 4b: Rating Information Flow

Description of Flow of Information in the Insurance Industry

The flow of information in the insurance industry between carriers, agencies, comparative rating vendors, and consumers was a manual process that was time-consuming, inefficient, and frequently inaccurate. The problems associated with this manual system could be seen in two examples: as insurance companies updated their rating information and as a customer purchased a new policy.

Updates in rating information began with the insurance company. Rate structure changes were outlined in written documents and then manually entered into a computer mainframe. Printed manuals and software updates were then mailed to agencies and comparative rating vendors. Vendors programmed their systems and sent a comparative rating program to agencies that contained data from several other insurance companies. Agencies used the rating software to prepare quotes for their clients. This complex and time-consuming process could take an insurance company anywhere from two to six months to complete.

There was a significant potential for inaccuracies to be perpetuated throughout this process as information was passed along from one group to another. Errors could first occur when the company converted data from written documents to its mainframe and then from the mainframe to software updates and printed manuals used by vendors and agencies. Secondly, inaccuracies could arise as rating vendors received rating updates and attempted to compile the different formats and unique rating methods of several different insurance companies into one common program. Errors occurred either through an oversimplification of the different rating methods or through the vendor's computer systems' inability to create one comparative rating program.

When a customer decided to purchase a new policy, applications were handwritten and all official communication between the agency, insurance company, and the customer occurred through the mail. The flow of rating information as described in these examples can be seen in the above diagram.

In 1994, there were 3,900 independent insurance companies and 55,000 independent agencies in the property and casualty market segment. Each insurance company used different agencies and each agency represented different groups of insurance companies. In an industry that was highly fragmented and companies competed by differentiating themselves from each other, no single vendor was able to automate this process. The comparative rating program that Whetten sold in the early 80's was typical of how information manually flowed from different groups in the insurance industry.

Exhibit 5. Products for the Insurance Company Segment[13]

Product	*Description*	*Development Schedule*
VIN Decoder	Used the Vehicle Identification Number to retrieve the appropriate vehicle, attributes, symbol, and applicable surcharges or discounts to correctly issue a policy.	4-6 months
Rate Analysis	Allowed an insurance company to evaluate its competitive position in the market by generating thousands of comparative quotes.	8-10 months
Symbol Management	Symbols were based on many factors, including the type of vehicle, original price, relative cost of repair, claims history, etc. A symbol was assigned to each vehicle and was then used to calculate a desired quote.	10-12 months
Territory Mapping	Allowed insurance companies to graphically define desired territories used to calculate an insured person's level of risk.	10-12 months
Forms and Applications	Created custom applications and other printed forms that were linked to the rating program.	10-12 months
Complete Electronic Data Transmission	Transmitted data between insurance companies and agencies including updated rating information and application and policy information.	14-18 months
Electronic Manual	Created and distributed a manual electronically.	14-18 months
Visual Development Environment	A graphics based programming environment using IQPL that provided links to all of InsurQuote's products including: Symbol Management, Territory Mapping, and Forms & Applications	14-18 months

[13] *Business Plan:* 20

Exhibit 6. Projected Market Size

The InsurQuote business plan[14] described the market opportunity and size in terms of its products for the insurance company, agency, and consumer segments ($ millions):

	Market Size
Insurance Company Segment: The initial target market was the property and casualty insurance companies, particularly the personal lines. Of the 3,900 property and casualty companies in the U.S., the largest 900 wrote the majority of the business. The remaining 3000 companies were very regionalized, often writing business in only a single state.	
Visual Development Environment: For the 900 major companies, the average initial setup fee was expected to be $100,000 with annual maintenance charges of $180,000. For the remaining 3000 companies, the initial setup fee was $25,000 on average with annual maintenance charges of $50,000.	$312
Single Company Program: Insurance companies spent an average of $40 annually per agent to provide a single company program. There were approximately 55,000 agents in the U.S., each representing an average of 9 companies	$19
Rate Analysis: Rate analysis was done on a state-by-state basis, so rate analysis tools were also sold on a per state basis, with 5,566 companies doing business in the U.S. The average per state cost was $5000.	$27
VIN Decoder: The typical annual fee for providing the VIN decoder database was expected to be $6,000.	$23
Electronic Data Transmission: The number of applications submitted and policies issued annually was estimated to be 141 million. The average fee was estimated to be $1.75.	$247
Total Insurance Company Segment	**$628**
Agency Segment: There were approximately 55,000 independent insurance agencies in the U.S. This number was expected to decrease over the next five years, while the total number of agents would remain approximately the same. The average monthly fee for the comparative rating program was $150 for both personal and commercial uses	**$99**
Consumer Segment: The initial cost for using the insurance pricing service was $11 per vehicle. There were 139 million vehicles in service in 1994 and it is assumed that the service will be used annually.	**$1500**

[14] *Business Plan*: 21-26

Exhibit 7. Projected Income Statement[15]

	1994	1995	1996	1997	1998	1999
Revenues *(by segment)*:*						
Agency		1.7	3.7	6.3	9.5	13.3
Company		0.1	2.7	7.3	18.4	38.4
Consumer		0.1	0.4	0.5	0.7	0.7
Other		0.1	0.1	0.1	0.1	0.1
Total Revenues	**$.75**	**$2.0**	**$6.9**	**$14.2**	**$28.7**	**$52.5**
Cost of Sales:						
Personnel						
Client Services		0.3	1.3	2.1	3.1	4.4
Programming		0.8	1.1	1.4	1.6	1.6
R&D		1.2	1.9	2.0	2.2	2.5
Operating		0.3	0.8	2.0	4.4	8.9
Total Cost of Sales		2.6	5.1	7.5	11.3	17.4
Gross Income		(0.6)	1.8	6.7	17.4	35.1
SG&A		1.2	1.7	2.2	3.2	5.4
Operating Income		(1.8)	0.1	4.5	14.2	29.7
Income Taxes		0.0	0.0	1.1	6.5	11.3
Net Income	**($.5)**	**($1.8)**	**$0.1**	**$3.4**	**$7.7**	**$18.4**

***($ millions)*

1993 Financial Data: *($000's)*

Assets	$454	Total Revenues	$538
Liabilities	$257	Net Income	($94)
Equity	$197		
		Employees	47

[15] *Business Plan*: 56.

Exhibit 8. Comparable Companies in the Computer Software & Services Industry

(million $)	Crawford & Co.	Delphi Information Systems	Policy Management Systems	Warner Insurance Services
Balance Sheet Data				
Assets	$317.0	$31.9	$660.0	$42.1
Long-Term Debt	$0.7	$6.6	$6.0	Nil
Book Equity	$208.0	$6.2	$477.0	$20.5
Income Data				
Revenue	$576.0	$53.6	$453.0	$69.7
EBITDA	$96.4	(2.1)	$94.5	$9.7
Net Income	$38.1	(8.9)	$(56.1)	$3.7
Market Data				
Price	$16 1/8	$3 1/2	$33 7/8	$4 1/4
EPS	$1.06	$1.64	$(2.46)	$0.4
PE Ratio	15	NM	NM	11
Shares Outstanding	36,076,667	7,036,410	22,637,021	8,869,025
Beta	1.06	N/A	1.29	1.49
Employees	7,390	461	4,786	510

Business Summary

Crawford & Co. (CRD.B)[16]

Crawford & Co., a diversified service company, provided claims and risk management services, health care management, and risk control services to insurance companies, corporations and self-insured entities. In 1993, 72% of revenue came from Claims Services, 24% from Health Care Management Services, and 4% from other Risk Management Services. The percentage of consolidated revenues derived from outside the United States totaled 7.4% for the year ending December 31, 1993.

Insurance companies, which represented the major source of revenue, customarily managed their own claims administration functions, but required various services provided by Claims Services, including the management, coordination and supervision of all parties involved in the claims settlement process. Crawford & Co. developed automated receiving, distributing and reporting claims systems. Health Care Management Services played an integral part in the resolution of many medical related claims.

Other Risk Management Services included the Risk Science Group, which provided customized computer-based information systems and software, analytical forecasting services, and systems consulting expertise in the risk management and insurance industry.

Delphi Information Systems (DLPH)[17]

Delphi Information Systems provided automation systems and services for independent property and casualty insurance agencies and brokerages in North America. The company developed, marketed and supported UNIX based computer software systems designed to automate and integrate the business functions at independent agencies, including the areas of sales management, policy and claims administration, accounting, financial reporting, rating, and electronic interface with the computers of

[16] Crawford & Company 10-K (December 31, 1993)
"Crawford & Co.," *S&P Standard NYSE Stock Reports*, Vol. 61, No. 133, Sec. 6 (July 12, 1994): 681M.
[17] Delphi Information Systems 10-K (March 31, 1994).

insurance carriers. The company also marketed and supported the hardware necessary to operate its proprietary software systems.

Delphi also provided proprietary software and services to insurance carriers, which helped them rate and quote insurance products and distributed such rating data to independent agencies. The company's software also electronically linked the computers of insurance carriers to independent agencies, which allowed for the decreased cost and errors associated with entering new policies, renewals, endorsements and inquiry information. This also enhanced the response time between agencies and carriers by eliminating the transfer of information by mail, telephone, or dedicated terminals supplied by carriers. Forty-three insurance carriers interfaced with the Company's agency management systems.

The company pursued an acquisition strategy beginning late in fiscal 1991 to strengthen its market position and increase its growth opportunities, acquiring competitors that provided proprietary software and automation systems to independent insurance agencies and brokerages. Delphi's customer list included over 90% of the largest 100 brokerages in North America with its software operating on approximately two-thirds of all workstations and terminals installed in independent agencies.

Policy Management Systems (PMS)[18]

Policy Management Systems provided standardized insurance software systems and related automation, administration and information services to the entire insurance industry. PMS offered more than 135 major products and services, including over 90 applications software products.

The company's software products automated virtually every insurance processing function, including risk analysis, policy rating, premium calculation, policy issuance and claims management, as well as various accounting, financial reporting, and cash management functions. Systems had been designed to permit ease of use and adaptability to a particular customer's requirements. The company also offered certain processing and professional services to insurance companies.

Products were marketed to several thousand property and casualty insurance companies, life and health providers, and independent agents and adjusters in the U.S. and Canada. Software products and related automation support services were also offered in 24 foreign countries. As of December 31, 1993, the company provided information services to more than 9,000 insurance companies, agents and adjusters and had over 3,000 software systems licenses in force. A large loss was recorded in 1993, reflecting a decline in revenues as well as various large nonrecurring charges.

Warner Insurance Services (WCP)[19]

Warner Insurance Services was a full service provider of automobile policy processing and administrative services to the insurance industry. Policy processing services were rendered through WCP's Automobile Insurance Processing System, which provided customers with processing features including rating, underwriting rules, policy quotation and issuance, forms production, billing and collections, endorsements, cancellations and reinstatements, and management and statistical reporting.

Policy administration services consisted of all services required in connection with the issuance and maintenance of an automobile insurance policy, including policy issuance, rating, underwriting, renewal issuance, endorsements/policy changes, ID cards, records management, management reports, and rate pursuit.

Claims administration services consisted of all services necessary to adjust and settle automobile insurance claims. These services included reporting a claim, establishing and maintaining a claim file, determining reserves, appraising and settling claims, and investigating possible fraud. Cover-All Systems, a wholly owned subsidiary, provided a software package that provided complete insurance policy processing for personal, commercial and specialty lines.

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[18] Policy Management Systems 10-K, December 31, 1993.
"Policy Management Systems," *S&P Standard NYSE Stock Reports*, Vol. 61, No. 114, Sec. 23 (June 14, 1994): 1861B.

[19] Warner Insurance Services 10-K, October 31, 1993.
"Warner Insurance Services," *S&P Standard NYSE Stock Reports*, Vol. 61, No. 67, Sec. 46 (April 7, 1994): 2419.