GRADUATE SCHOOL OF BUSINESS
STANFORD UNIVERSITY

E-64
April 1999

HOTMAIL CORPORATION

Sabeer Bhatia, co-founder and chief executive officer of Hotmail Corporation, had to decide quickly how he wanted to proceed with the company's fifth round of financing. Sabeer and his partner, Jack Smith, had created and grown one of the most successful companies in the short history of the Internet by offering customers free and universally accessible e-mail on the Web. They had signed up nine million users in less than two years, a rate of growth faster than any company in history. In that time, they had led the company through many financial crises and four rounds of financing. Each round had been successful, but each had been difficult and contentious. This fifth round was proving to be the most difficult of them all, but not for lack of options. Hotmail had received strong indications of interest in investing from General Electric, Excite, and Kleiner Perkins, as well as an acquisition offer from Microsoft. Each deal had its own advantages and disadvantages, and each had its supporters among the Hotmail board, but there was limited time to develop, analyze, and negotiate the deals because the company was almost out of money. If he didn't decide soon, he would default on loan payments and miss making payroll. It would be devastating to see his company - with perhaps more potential than any in the industry - die because he had been forced by lack of capital into making a wrong decision.

This case was prepared by Pratap Mukherjee under the supervision of Charles A. Holloway, Kleiner Perkins, Caufield, and Byers Professor of Management, Stanford University Graduate School of Business, and Rafiq Dossani, Consulting Professor, Asia/Pacific Research Center, Stanford University, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

This case was made possible by the support of the Robert E. and Dorothy M. Morris Fund.

ROUND ONE

Sabeer Bhatia arrived in Los Angeles in September 1988 from Bangalore, India. He was nineteen years old and starting at the California Institute of Technology (Caltech) on a transfer scholarship. He didn't know anyone in the United States, or even how to get from the airport to the school. After three years of hard work, he graduated with an engineering degree and moved to Palo Alto to get a master's degree at Stanford University. Like many others at Stanford's Terman Engineering Center, he caught the entrepreneurial fever and went to see as many speaker presentations as he could. Steve Jobs, Scott McNealy, and many other successful entrepreneurs repeated the message, "You can do it too!" The message was not lost on Sabeer.

After graduation, Sabeer went to work for Apple briefly and then for a start-up called FirePower Systems, where he worked on teams designing Power PCs. He became close friends with Jack Smith, a fellow hardware engineer, and the two grew restless hearing the stories of more companies that had been sold for millions of dollars. "Jack, what are we doing here, wasting our lives?" Sabeer would complain.

In August 1995, at the age of 26, Sabeer, along with partner Jack Smith, began shopping around a business plan for an Internet tools company. The company, named JavaSoft, would provide a personal database, like FileMaker, over the Web. They shopped the deal to many venture capitalists without any success. The concerns of most potential investors were that it would be too hard for this company to attract users in the already crowded Internet marketplace, that the company was in too early a stage, and that the founders were too young and inexperienced. While they were canvassing investors, Jack came up with an idea to attract users to the site so that they would use the tools: free Web-based e-mail. The two partners loved the idea and pursued their capital search with renewed energy. However, they decided to take a cautious strategy in revealing their new concept. If a potential investor dismissed them for their youth and inexperience, they never mentioned free e-mail. They didn't want a less-than-ethical person to copy their idea with another management team. If the venture capitalist got past their youth and focused on the database idea itself, Sabeer and Jack brought up the free e-mail ploy as a way of building traffic. Unfortunately, this strategy did not develop any better results at first. In total, JavaSoft was rejected by more than twenty venture capitalists.

All that changed in February 1996 when the two entrepreneurs met with Steve Jurvetson, a managing director with the venture capital firm of Draper Fisher Jurvetson (DFJ), formerly known as Draper Fisher Associates. DFJ focuses on information technology businesses in the very early stages, often needing seed investments. Steve had graduated from the Stanford Graduate School of Business in 1995 and had been named as a managing director at DFJ within six months of his hire. He was actively looking for new investment possibilities in the Internet arena when Sabeer and Jack were referred to him by another venture capitalist who felt that this investment was in too early a stage for his firm. Their conversation started out just like all the others had. Steve was dismissing them because he couldn't see how they could get good distribution and market visibility in a crowded field. Sabeer noted that Steve was not concerned with his youth, so he decided to share the free e-mail concept. Steve's interest was piqued. He recalled, "The idea immediately clicked with me. We believe that e-mail is the killer app for the Internet." The meeting continued for the next few hours as the group became enthusiastic about building a business entirely around the concept of free Web-based e-mail. The group decided

that advertising was the most promising source of revenue to support the free service. By the time the meeting was over, DFJ was interested in investing in JavaSoft.

Sabeer and Jack began the valuation negotiations by asking DFJ to invest $3 million for 30% of the company's equity. Steve recalled, "They brought in these revenue estimates showing that they were going to grow the company faster than any in history. We dismissed the projections outright, but Sabeer insisted, 'You don't believe we're going to do that?'" Steve thought the offered valuation was unreasonably high, but he was used to getting such aggressive offers from entrepreneurs. He responded by asking how much they needed to develop a prototype product and prove that it was doable. Steve was concerned that the product might be too slow, not have a professional look and feel, not have the right features, or not be scalable. After quick consideration, the entrepreneurs responded with a $500,000 figure.

Steve returned with a term sheet that called for DFJ to invest $300,000 for 30% of the company. This valuation, he told Sabeer and Jack, was in line with its other comparable seed investments. Sabeer made a counteroffer of $300,000 for 15% of the company. Steve was unhappy with that because he was uncomfortable having such a small ownership position in the company. DFJ's philosophy was that it was important to have between 25% and 40% of a company's equity to justify the time that the investors were spending and because they expected their share to remain constant or be reduced with future funding. Steve offered $600,000 for 30%, which would allow DFJ to be comfortable with its ownership stake and provide an adequate amount of money for JavaSoft to ready the product for launch, which he estimated would take three months. Sabeer rejected this offer because he did not want to take so much money or give away so much of the company. He felt that this was the most expensive money he would ever have to raise. He insisted on $300,000 for 15%, a $2 million post-money valuation. If DFJ did not accept this offer by midnight the next night, he would finance the company with some willing angel investors. Sabeer did not mention that these wealthy individuals were willing to invest a total of $100,000, and did not have any relevant operating experience to add to the venture. Steve was unsure whether Sabeer was merely posturing to get a better deal or if he was serious. Right before the deadline, Steve accepted the valuation with the condition that Rex Smith, Jack's father and one of the "angels", also invest in the round. Steve recalled, "I was convinced that I got fleeced. I thought I definitely could have gotten a better deal, and I had a gut-wrenching feeling that the potential angel round was a paper tiger. Sabeer was the most interesting negotiator I've ever met." In fact, the investment was more expensive than similar deals that DFJ had done. The most comparable companies, Four11, Release Software, and iTv, all had lower pre-money valuations.

The final deal was done at 16 cents per share. DFJ invested $300,000 for 1,867,704 shares (15%); Rex Smith invested $15,000 for 93,386 shares (0.75%); Sabeer and Jack each received 4,000,000 shares (32.125%) valued at $642,500; and 2,490,272 shares (20%) valued at $400,000 were reserved for future employees.

For the negotiations on the terms of the deal, JavaSoft hired Mark White of the law firm of White & Lee. Mark was inexperienced with venture negotiations, but JavaSoft had no money and Mark was the only lawyer who offered to work without any cash upfront. Steve told Sabeer that DFJ had a policy of not hiring its own lawyers in order to keep the total legal expenses low.

Furthermore, DFJ would be using a standard term sheet and did not expect much contention over the terms. Steve asked if it would be acceptable for Mark to represent DFJ as well as JavaSoft during the legal implementation after the terms sheet had been signed and the details agreed to. By representing both sides, the law firm could not sneak any changes into the deal without full disclosure. Sabeer and Mark agreed to Steve's request.

With the lawyer on board, the negotiations started. True to its word, DFJ presented Sabeer with the same term sheet that it had presented the entrepreneurs in most of its previous deals. Sabeer and Jack were comfortable with the terms overall, but wanted to change a few provisions. First, they were concerned that the investors were receiving participating preferred stock. They felt this was unfair because the investors "double-dipped," meaning that they got back their original investment and then shared in the remaining equity pool. Steve countered that the clause was important to create a disincentive for the entrepreneurs to sell the company early in life at a low price. Second, the entrepreneurs worried about the right of first offer clause, which allowed DFJ to "purchase all or any portion of shares" in the next round of financing. Finally, they were fearful that they were missing something that could come back to haunt them. They needed to decide what their priorities and negotiating strategy should be. See Exhibit 1 for the proposed term sheet.

DEVELOPING THE PRODUCT

The logical first step for Hotmail Corporation (which had been renamed two weeks after the first round closed) was to decide what business it was in. Sabeer, Jack, and Steve had discussed focusing on free Web-based e-mail, but they thought there might be other, more attractive options which they had not considered. After much discussion, Sabeer and Jack narrowed their options to the following four strategies.

- Web-based e-mail: Hotmail could provide its own Web site where consumers could sign up for free e-mail services in exchange for viewing highly targeted advertising. The other main consumer advantages were that the e-mail could be accessible from anywhere in the world and could be kept separate from work e-mails. Hotmail's revenues would be mainly from advertising revenue and, perhaps in the future, from subscriber purchases of additional services.
- Outsource e-mail for other Web companies: Yahoo! approached Hotmail and asked it to develop and maintain a free e-mail service for its users. Thus, users would get an e-mail address @yahoo.com courtesy of Hotmail's efforts. Hotmail would get payment for its services and users would be notified that the free e-mail service was "Powered by Hotmail."
- Outsource corporate e-mail: Almost from its outset, Hotmail had received requests from major companies to install servers and software at the company locations and provide the maintenance of their corporate e-mail.
- Create a dial-in service: Hotmail could mimic the strategy of the emerging Juno Online Services. Juno was in the process of creating a consumer Internet access company where users could dial-in (like America Online) and get free e-mail service. For a fee, customers could get additional functionality, like attaching files or photographs, and/or Web access. Juno designed the service to derive its revenues primarily through the sale of highly targeted interactive advertising and through direct sale of products and services (on a strictly optional basis) to its subscribers. Juno was scheduled to launch in April of 1996.

Sabeer and Jack decided to focus their efforts on the first option. Outsourcing corporate e-mail was a potentially very attractive, high-margin business but Hotmail simply didn't have the resources to pursue this market. The customers were large, multinational companies and would expect their vendor to be able to provide services continuously in many locations. Furthermore, the long sales cycles typical in similar businesses would quickly exhaust Hotmail's resources. Copying Juno's strategy could also be attractive, but Juno had at least a six-month head start and $25 million in the bank. Also, Sabeer felt that dial-in access was not nearly as attractive to customers as a Web-based service. Hotmail's hardest decision was turning down Yahoo!'s offer. Hotmail could instantly reach millions of Internet users and capitalize on the marketing resources of the clear leader in Web businesses. However, Sabeer felt it was essential to control the brand and have subscribers' e-mail addresses be @hotmail.com. Yahoo! would not agree to this and insisted that having a sub-brand on a Yahoo! service was better than trying to build an independent brand. Nevertheless, Sabeer and Jack declined Yahoo!'s offer and set about creating a free Web-based e-mail service through their own Web site.

Sabeer, Jack, and their small team succeeded in developing a high-quality product in about four months. When Steve saw the completed product for the first time, he was impressed with what he saw. He recalled, "Seeing the product was a huge milestone. When they showed it to us, we knew the product risk was gone. It was fast enough, had the right features, and it even had the ability to attach files, which was quite a technological achievement." After some additional tests and upgrades, everyone agreed that the product was ready for launch. In addition, the team had developed an innovative marketing scheme. Tim Draper, the founder of DFJ, suggested that the company attach a line at the end of each e-mail sent by a Hotmail user that said, "P.S. Get your free e-mail at http://www.hotmail.com." The founders thought that there might be a public backlash against such tampering with private messages, but Tim was insistent. The group adopted the tactic, but with a line clearly delineating the tagline from the e-mail message.

As importantly, Sabeer and Jack had positioned the company so that it would be able to successfully launch the product. The company had learned the important technical and marketing aspects of the business. For example, Sabeer and Jack figured out how much server capacity they needed for each user, and how many and what type of machines would be required. They also developed relationships with key service providers, such as Best Internet Service, which provided data warehousing and monitoring services. Also, they developed a relationship with the aggressive Cupertino National Bank. Sabeer had negotiated a $100,000 loan, which he used to buy the company's first computers. Finally, Hotmail had put together the beginnings of a management team. Sabeer was president and chief executive officer. Jack was the chief technology officer and the head development engineer. The two founders brought in Richard Burright as their first outside hire. Richard was an outstanding programmer and contributed significantly to the product's development. Finally, they hired a young advertising salesperson. With the meager funds available from the first financing round, Sabeer did not feel that he could afford a more seasoned salesperson, who would have cost over $200,000 per year plus commissions. In addition to the full-time employees, Sabeer contracted with outsiders to provide key services. The most important of these functions were system administration (keeping the site up and running all the time) and accounting. He enlisted the help of friends who were

working full-time at other companies. He thought it would have been more effective and time-efficient to have hired them, but he was constrained by the available capital. Steve noted that, with the product and company infrastructure in place, Hotmail was poised for the launch. He remarked, "[Sabeer and Jack] knew they had a tiger by the tail."

ROUND TWO

However, before unleashing Hotmail on the world, Sabeer and Jack needed to raise more money to keep it alive. By June 1996, Hotmail had spent almost all of its initial $315,000 and started raising a new round of financing. The company was desperately short on cash. It was in danger of missing payroll in early August and certainly had nothing to spare to promote its launch. In preparation for what it knew would be difficult negotiations, Hotmail hired Robert Zipp, a senior partner at Venture Law Group. DFJ again requested that the lawyer represent it as well when it came time to implement the term sheet, but this time Robert refused. DFJ, keeping to its policy of not hiring lawyers, went into negotiations without outside representation.

Both sides were uncomfortable since the company was negotiating against one of its own directors. Sabeer said, "It was strange working together at a board meeting one minute and then flipping to the other side of the table for the negotiations. We knew the potential for hostility was high." Sabeer was concerned that Steve knew every detail of the company, including its weaknesses and its precarious financial situation. Sabeer's main goal, like most entrepreneurs, was to minimize the founders' dilution by getting the best possible valuation. Also, he wanted the new capital quickly. DFJ's main interest was increasing its ownership of the business to its standard 25%. It knew that this was absolutely the last chance it would have to increase its stake. Also, since the company would not have to prepare a business plan or spend weeks in VC meetings, DFJ expected a premium for the time savings involved in having an insider already familiar with the company's operations lead a financing round.

From the beginning, the negotiations were tense. While the two parties did agree that the company needed $750,000 of new capital, their valuations differed dramatically. Hotmail's first offer was for a post-money valuation of $20 million, while DFJ's first offer was for $4 million. Both sides were reluctant to adjust their offers significantly and tempers flared on both sides. After weeks of negotiations, it did not seem like the two parties would reach an agreement.

While still negotiating with DFJ, Sabeer was actively seeking other funding sources in the venture capital community. His initial meetings with a number of potential investors seemed to go well, but each one dropped out before offering a term sheet. Sabeer did, however, get a statement of interest from Doug Carlisle at Menlo Ventures. Doug had not offered a term sheet but sounded like he might be willing to lead an investment round at a valuation of $15 million.

However, time was running out for Hotmail, so Sabeer returned to negotiations with DFJ. His fundraising frustrations only increased tensions around the negotiating table. The group had a marathon session in DFJ's office where the contentious discussions continued. At the end of the day, however, they finally reached an agreement. DFJ would invest $750,000 for approximately 10% of the company. DFJ was pleased that it had raised its position in the company to almost 25%. The parties agreed to change DFJ's right of first offer to be limited to the amount necessary to retain its share. Sabeer, however, was unhappy with the valuation and

felt that DFJ had taken advantage of him with its inside knowledge of the company. Nonetheless, Sabeer, Jack, and Steve signed the term sheet on July 2, 1996, two days before product launch.

Shortly after the term sheet was signed, Menlo Ventures presented Sabeer with another term sheet for an investment of $1 million at a post-money valuation of $15 million, double DFJ's offer. Steve recalled his reaction on hearing of the offer: "I thought Menlo was out of their minds. I have lots of respect for them, but they were crazy to offer so much. I encouraged Sabeer to consider the offer as a quick Series C." Sabeer was ecstatic to receive the offer, but was dejected that he couldn't accept it in lieu of his deal with DFJ. He felt he had an ethical obligation to uphold the terms of his deal with DFJ and he honored it. DFJ was issued 1,436,782 Series B preferred shares at $0.522 per share. The second round of financing officially closed on August 8, 1996, with one week's payroll in Hotmail's bank account.

ROUND THREE

Shortly after the second round of negotiations was closed, Hotmail launched its service to the public. To symbolize the freedom that Hotmail was providing by giving its users universal access, the company's Web site went live on July 4th. That day, Sabeer and Jack wore beepers to flash the number of subscribers every hour. In the first month, with minimal marketing resources, the company was signing up hundreds of users per day. With less than $50,000 spent on advertising and public relations, the user base was nevertheless growing exponentially as each outbound message promoted the service to the recipient.

With the money from the second round, Hotmail expanded its management team. Most importantly, it hired Rex Smith, Jack's father, as chief operating officer. Rex was a veteran of many Silicon Valley start-ups and lent some much-needed experience to the team. DFJ introduced Steve Douty to Hotmail, and he became the vice president of marketing. Also, Hotmail hired full-time the people who were previously doing contract work. This included a bookkeeper and a system administrator. Finally, the company hired more software engineers and customer service representatives to keep pace with the increasing growth.

After signing the second financing with DFJ, Sabeer decided not to reject the deal from Doug Carlisle at Menlo Ventures, and in mid-August, he began negotiations with Menlo over the terms of its offer. Doug offered to commit $3 million in two stages: $1 million immediately at a $15 million post-money valuation ($1.00 per share for 1,000,000 Series C preferred shares) and $2 million in six months at a price subject to the company's performance. Sabeer felt that Doug was being generous with his valuation, so he didn't negotiate the $15 million any further. He was quite pleased with the venture capitalist's relaxed negotiating style. Also, DFJ was happy to contribute another $500,000 at the $15 million valuation to maintain its stake and support the round.

Sabeer wanted to better understand the term sheet's contingency clause. Doug explained that Menlo Ventures often used such techniques with large financings to tie the valuation to performance. The contingency clause was in two parts as shown in these term sheet excerpts:

> Warrants: Menlo Ventures VI shall purchase, for a consideration of $1.02 in total, warrants to invest $2.0 million in a Series D Preferred Stock at $2.00 per share upon terms substantially similar to the Series C Preferred Stock terms. These warrants expire 120 days after the closing of the Series C Preferred Stock financing. Menlo agrees to exercise the warrants before expiration if the Company has 500,000 or more registered users of this mail package prior to December 31, 1996.
>
> Put Option: Company shall have an option to put shares of Series D Preferred Stock to Menlo Ventures VI in the amount of $2.0 million at $1.50 per share upon terms substantially similar to the Series C Preferred Stock terms. Such put option shall expire 120 days after closing the Series C Preferred Stock financing. However, Company shall have no right to exercise its put option unless it shall have at least 300,000 or more registered users of its mail package prior to December 31, 1996.

Furthermore, Sabeer and Doug agreed that if Hotmail missed both targets (i.e., had fewer than 300,000 subscribers) by the end of the year, the $2 million would be invested at the Series C price of $1.00 per share.

Sabeer was quite pleased with this offer. In fact, the Hotmail employees had a small party to celebrate, since they knew that, with current growth rates, they would have no trouble getting a total of 500,000 users by the end of the year. In the course of discussions, however, Menlo asked Hotmail's young salesperson how much revenue the company could generate in the fourth quarter of 1996. He estimated that there would be at least $1 million of advertising revenue in that period. Doug decided that revenue, in addition to number of subscribers, was an important performance criterion that should be included in the contingency clause. Doug felt that the $1 million estimate was high and offered to make the target $800,000. Thus, he added to the end of the Warrants paragraph the phrase "and has fourth quarter 1996 revenues of at least $800,000," and to the Put Option section, he added the phrase "and has fourth quarter 1996 revenues of at least $500,000". Sabeer knew that even the lower revenue target would be difficult to achieve and if he missed it, the large investment at $1.00 per share would cause tremendous dilution for the founders. However, his salesperson had already promised those results, so Sabeer reluctantly agreed to the terms.

ROUND FOUR

Sabeer's fears were realized as fourth quarter 1996 revenues were only $350,000. The number of subscribers, however, had reached close to one million by the end of the quarter. Although he had the right to invest at $1.00 per share, Doug decided to reward Hotmail for its incredible membership growth by renegotiating the valuation. In March 1997, the parties agreed on a new price per share of $1.25. Menlo purchased $2 million of Series D Preferred Stock and DFJ kept its equity stake constant by investing $1 million.

ROUND FIVE

By November 1997, Hotmail was a success of unprecedented proportions. Consumers flocked to the site and subscribed to the service in record numbers. The team attributed much of the company's success to its "viral marketing" campaign of adding the advertisement at the bottom of every e-mail. The free site had nine million subscribers and was increasing that base at the rate of 35,000 a day. The company expected to reach 10 million subscribers by the end of 1997. Steve said, "Sabeer did what he said he would do. He grew the subscriber base faster than any company in the history of the world." The financial situation, however, was a different story. In October, the company generated a total of just under $400,000 in revenue, of which $200,000 was from advertising. Monthly net cash outflow totaled over $300,000. With the lack of adequate revenue and an increasingly high burn rate, Hotmail was projected to run out of cash by the end of November. See Exhibit 3 for Hotmail's financial statements.

Through its meteoric rise, Hotmail was continuously upgrading its product offering to increase revenue from customers and build customer loyalty. In April 1997, Hotmail had launched WebCourier, which is a series of partnerships with leading Web sites to deliver user-requested content to the mailbox on a regular (usually daily) basis. Hotmail had signed up c|net's news.com, NetGuide Live, Slate, Mercury Mail, Quote.com, Golf Web, and USA Today as partners to provide content for the service. These partners shared revenue with Hotmail when recipients of their content click on links and transfer to the provider's Web site. In addition, Hotmail had launched Hotmail Gold in July of 1997. This premium service, which cost subscribers $10 per month, allowed subscribers to scan incoming mail for viruses, use enhanced security, and download e-mail to their PC. Finally, the company was working on developing a number of additional services to incrementally improve usage and customer loyalty. Examples of such services were instant messaging, member directories, personal storage areas, and provision of local content, such as weather, news, and sports.

From a user's perspective, Hotmail was doing a good operations job. While there were instances when the site was slow or inaccessible due to volume, customers were generally pleased with Hotmail's performance. However, growth was causing chaos internally. Engineers were working around the clock to solve scalability bottlenecks. System administrators were struggling to add new computers and more bandwidth to cope with the usage increases. Customer service, which accounted for one-third of the company's employees, was flooded with e-mailed questions, requests, and feedback from users. Software engineers were constantly updating and improving the site. Senior management was challenged by trying to hire people fast enough to cope with the troubles. Especially in customer service, management was finding it difficult to attract enough qualified people.

In September 1997, Sabeer had set out to raise another round of funding. This time, Hotmail was looking for between $10 and $15 million to "maintain its market-leadership position, build its brand, expand internationally, and forge media and content distribution relationships." See Exhibit 4 for the executive summary of Hotmail's business plan. Sabeer thought that the post-money valuation of the company should be $125 million for this round. In a month, Sabeer and his investors had generated a number of attractive alternatives. They were:

- Strategic financing: General Electric offered to lead the round of investment offering a series of partnership arrangements that would boost Hotmail's visibility and revenues

tremendously. It promised to link Hotmail with its industry-leading back-end credit card processing business, which could partner with Hotmail to present customers with credit card bills through the Internet. It offered connections with NBC and MSNBC, which could provide content and visibility for Hotmail's planned strategy of providing users with news and other useful information. With GE's backing, Hotmail thought it would be ready for an IPO within the next year. GE had initially agreed to invest $15 million at $125 million post-money valuation, but then changed its mind and offered a $105 million valuation.

- Kleiner Perkins: John Doerr, a general partner at the venture capital firm of Kleiner Perkins Caufield and Byers, expressed interest in leading the financing round and taking a board seat. With this backing, Hotmail felt it would be ready to go public sometime in 1998. John offered to raise the $15 million at a $75 million post-money valuation, which he said was the highest valuation Kleiner Perkins had ever paid to any company. Sabeer and the board tried to get him to agree to a $95 million valuation, but he refused to change his offer.
- Excite: Vinod Khosla, another general partner at Kleiner Perkins, approached Sabeer about the possibility of merging Hotmail with Excite. The popular Web portal was valued by the public stock markets at $400 million. Vinod offered to broker a deal in which Hotmail would receive 33% of Excite's shares. See Exhibit 5 for Excite stock history. Hotmail could see obvious synergies with Excite. Most importantly, Hotmail could provide free e-mail and other related services to the portal's many visitors.
- Microsoft: The software giant had originally wanted to invest along with GE, but Sabeer was wary of having it as an investor because he thought it would put Hotmail in a precarious position if Microsoft decided to replicate the free e-mail service itself. Microsoft responded by offering to buy the entire company for $125 million of company stock. Microsoft was building its MSN brand and thought that Hotmail could be a central offering. The Hotmail board was taken offguard by the acquisition offer and realized that Microsoft knew too much about the company's financial situation from the due diligence it had done when it had been interested in merely investing. Nonetheless, Sabeer told Microsoft that it could have the company for $700 million. The subsequent negotiations were heated. Each side walked out on the negotiations multiple times. In small increments over the course of two months, Microsoft raised its offer to $300 million in stock. See Exhibit 5 for Microsoft stock history.

Two stories weighed in Sabeer's mind as he considered the decision. The first was the story of AOL, which had spurned a Microsoft offer in its early days and was now a multibillion dollar company. The other was that of Pointcast, which had declined an acquisition offer from Rupert Murdoch's News Corporation, and had failed to make its product successful on its own. Sabeer was optimistic enough to think he could replicate AOL's success, but what if he turned down the sure thing and was wrong?

The Hotmail board was torn. Steve Jurvetson wanted Sabeer to reject the Microsoft offer and consider the options that would allow it to go public. If public demand for Internet stocks remained strong and Hotmail continued its rapid growth, the company could be worth more than $1 billion. Steve worked the phones to drum up new investors and put together a financing at a valuation that would be acceptable to Sabeer. Ideally, he wanted an external financing that included John Doerr and GE. This would give Hotmail the best chance of being ready for the public markets. Doug Carlisle advocated selling to Microsoft. He could not believe the $300 million offer and thought it was too good to pass up. In fact, when negotiations with Microsoft

had started, Doug had told Sabeer if the valuation reached a $200 million valuation, he was going to commission a life-size bronze sculpture of him and put it in Menlo Ventures' front lobby. Hotmail's employees also wanted Sabeer to take Microsoft's offer. They had been working for so long being paid so little that they wanted Sabeer to take the sure thing. Even the most recent Microsoft offer would make them all very wealthy.

While contemplating the offers and stringing out negotiations with Microsoft, Sabeer knew that he needed to act quickly because the company was, once again, almost out of money. With the current situation, he could only survive a few more weeks in his negotiation with the software giant. Then, Steve made Sabeer a financing offer to enable him to extend the negotiations and consider other offers from a position of strength. Sabeer was determined to get a $125 million valuation, but the outside investors seemed unwilling to pay that price. DFJ's fund, having participated in every previous round, was near its limit for the total investment in any one company. So, DFJ offered a bridge loan of $3.5 million, most of which was cobbled together from the personal accounts of the DFJ partners. Tim Draper personally put in $1 million and the other partners contributed everything they could. If Hotmail were acquired, the loan would convert into the pre-authorized shares from the preceding round. These shares had the participating preferred clause that enabled investors to get their money back first and then share in the equity pool. If the company chose instead to close another round of financing with external investors, the full-ratchet antidilution protection meant that the shares would automatically be priced at the closing price for that new round. Sabeer was upset with the participating nature of the shares in the offer and the antidilution clause. He felt that, once again, DFJ was trying to get more than its fair share. But how much was it worth to buy some more time?

Exhibit 1
Series A term sheet proposal

Sale of Series A Preferred Stock

of

JavaSoft, Inc.

SUMMARY OF TERMS (2/9/96)

THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF A PROPOSED PRIVATE PLACEMENT OF EQUITY SECURITIES OF Javasoft, Inc. (the "Company"). THIS TERM SHEET IS FOR DISCUSSION PURPOSES ONLY; THERE IS NO OBLIGATION ON THE PART OF ANY NEGOTIATING PARTY UNTIL A DEFINITIVE STOCK PURCHASE AGREEMENT IS SIGNED BY ALL PARTIES. THIS TERM SHEET IS SUBJECT TO SATISFACTORY COMPLETION OF DUE DILIGENCE

A. AMOUNT AND INVESTORS:

Draper Fisher Associates Fund III, LP	$281,700
Draper Fisher Partners, LLC	$18,300
Rex Smith	$15,000
	=======
SUB-TOTAL	$315,000

B. TYPE OF SECURITY: Series A Preferred Stock.

C. PRICE PER SHARE: $0.1606 ["Series A Original Purchase Price"].

D. CAPITALIZATION: 10,490,272 total pre-financing fully-diluted Common shares issued, including:

Sabeer Bhatia	4,000,000
Jack Smith	4,000,000
Reserved for Employee Pool	2,490,272
	=======
SUB-TOTAL	10,490,272

This financing: 1,961,090 shares of Series A Preferred Stock issued as follows:

Draper Fisher Associates Fund III, LP	1,753,774
Draper Fisher Partners, LLC	113,930
Rex Smith	93,386
	=======
SUB-TOTAL	1,961,090
	========
GRAND TOTAL	12,451,362

Exhibit 1 (cont.)

E. VESTING SCHEDULE:

Unless the board determines otherwise, employees' Common stock shall vest 25% at the end of the first year of full-time employment, and at a rate of 1/36th per month thereafter, with respect to stock granted prior to an IPO.

Sabeer Bhatia and Jack Smith are the "Founders" of the Company. Founders' Common stock is owned by Founders.

If a Founder leaves the Company or chooses not to remain a full-time employee, the Company shall have the right to repurchase a portion of that Founder's shares according to the following schedule: 75% upon completion of this financing declining at a rate of 1/36 per month thereafter. After 36 months, the Company will no longer have a right to repurchase. The Company's repurchase right will also terminate if the Company completes an IPO. In the event of a repurchase, the repurchase price for the Company is $0.005 per share.

F. COMPENSATION:

No Company employee shall receive annual compensation in excess of $65,000 (except those receiving commissions from approved comp plans) without consent of all of the directors until the company is merged, is sold, or completes an IPO. Any and all accruals shall be forgiven by the founders prior to this financing.

G. DIVIDENDS:

The holders of Preferred shall be entitled to receive dividends at a rate of 8% per annum in preference to any dividend on Common Stock, whenever funds are legally available, when, if and as declared by the Board of Directors. Dividends shall be non-cumulative.

H. LIQUIDATION PREFERENCE:

In the event of any liquidation or winding up of the Company, the holders of Preferred will be entitled to receive in preference to the holders of Common Stock an amount equal to their Original Purchase Price plus all declared but unpaid dividends (if any).

Preferred A will be participating so that after payment of the Original Purchase Price to the holders of Preferred A, the remaining assets shall be distributed pro-rata to all shareholders on a common equivalent basis.

Exhibit 1 (cont.)

A merger, acquisition or sale of substantially all of the assets of the Company in which the share-holders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed a liquidation.

I. CONVERSION:

1. The holders of Preferred will have the right to convert Preferred shares at the option of the holder, at any time, into shares of Common Stock at an initial conversion rate of 1-to-1. The conversion rate shall be subject from time to time to anti-dilution adjustments as described below.

2. Automatic Conversion: All Preferred shares will be automatically converted into Common upon the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price per share (prior to underwriting commissions and expenses) that values the Company at at least $30 million in an offering of not less than $6 million, before deduction of underwriting discounts and registration expenses.

J. ANTIDILUTION:

Proportional antidilution protection for stock splits, stock dividends, combinations, recapitalizations, etc. The conversion price of the Preferred shall be subject to adjustment to prevent dilution, on a "weighted average" basis, in the event that the Company issues additional shares of Common or Common equivalents (other than reserved employee shares) at a purchase price less than the applicable conversion price.

K. VOTING RIGHTS:

The holders of a share of Preferred will have a right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of Preferred.

L. REGISTRATION RIGHTS:

(1.) Demand Rights: If investors holding at least 20% of Preferred (or Common issued upon conversion of the Preferred or a combination of such Common and Preferred) request that the Company file a Registration Statement for at least 20% of their shares (or any lesser percentage if the anticipated gross receipts from the offering exceed $2,000,000) the Company will use its best efforts to cause such shares to be registered; provided, however, that the Company shall not be obligated to effect any such registration prior to the earlier of (i) July 15, 1998, or (ii) within one year following the effective date of the company's

Exhibit 1 (cont.)

initial public offering. The Company shall not be obligated to effect more than two registrations under these demand right provisions.

(2.) Company Registration: The Investors shall be entitled to "piggy-back" registration rights on registrations of the company or on demand registrations of any later round investor subject to the right, however, of the Company and its under-writers to reduce the number of shares proposed to be registered pro rata in view of market conditions. No shareholder of the Company shall be granted piggyback registration rights superior to those of the Preferred without the consent of the holders of at least 50% of the Series A Preferred (or Common issued upon conversion of the Series A Preferred or a combination of such Common and Preferred).

(3.) S-3 Rights: Investors shall be entitled to an unlimited number of demand registrations on form S-3 (if available to the Company) so long as such registration offerings are in excess of $500,000; provided, however, that the Company shall only be required to file two Form S-3 Registration Statements on demand of the Preferred every 12 months.

(4.) Expenses: The Company shall bear registration expenses (exclusive of underwriting discounts and commissions and special counsel of the selling shareholders) of all demands, piggy-backs, and S-3 registrations. The expenses in excess of $15,000 of any special audit required in connection with a demand registration shall be borne pro rata by the selling shareholders.

(5.) Transfer of Rights: The registration rights may be transferred provided that the Company is given written notice thereof and provided that the transfer a) is in connection with a transfer of all securities of the transferor, b) involves a transfer of at least 100,000 shares, or c) is to constituent partners or shareholders who agree to act through a single representative.

Exhibit 1 (cont.)

(6.) Other Provisions: Other provisions shall be contained in the Purchase Agreement with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, standard standoff provisions, underwriting arrangements and the ability of the Company to delay demand registrations for up to 90 days (S-3 Registrations for up to 60 days).

M. BOARD OF DIRECTORS:

The Board of Directors will consist of three seats. The Board will include one seat for Draper Fisher Associates III to be filled by Steve Jurvetson. Draper Fisher Associates will also have board visitation rights for its other partners. Original directors shall be Sabeer Bhatia, Jack Smith, Rex Smith, Steve Jurvetson, and one outside Board member to be elected unanimously by the Board.

N. RIGHT OF FIRST OFFER:

The Preferred Investors shall have the right in the event the Company proposes an equity offering of any amount to any person or entity (other than for a strategic corporate partner, employee stock grant, equipment financing, acquisition of another company, shares offered to the public pursuant to an underwritten public offering, or other conventional exclusion) to purchase all or any portion of such shares.

The Company has an obligation to notify all Preferred Investors of any proposed equity offering of any amount.

If the affiliated groups of Preferred Investors do not respond within 15 days of being notified of such an offering or decline to purchase all of such securities, then that portion which is not purchased may be offered to other parties on terms no less favorable to the Company for a period of 120 days. Such right of first offer will terminate upon an under written public offering of shares of the Company.

In addition, the Company will grant the Preferred shareholders any rights of first refusal or registration rights granted to subsequent purchasers of the Company's equity securities to the extent that such subsequent rights are superior, in good faith judgment of the Company's Board of Directors, to those granted in connection with this transaction.

Exhibit 1 (cont.)

O. CO-SALE:

The Company, the Series A Investors and the Founders will enter into a co-sale agreement pursuant to which any Founder who proposes to sell all or a portion of his shares to a third party, will offer the Series A Investors the right to participate in such sale on a pro rata basis or to exercise a right of first refusal on the same basis (subject to customary exclusions for up to 15% of the stock, gifts, pledges, etc.). The agreement will terminate on the earlier of July 31, 2000 or an IPO.

P. RESTRICTIONS AND LIMITATIONS:

So long as Preferred Stock remains outstanding, the Company shall not, without the vote or written consent of at least a majority of the Preferred shareholders, authorize or issue any equity security senior to the Series A Preferred as to dividend rights or redemption rights or liquidation preferences. Furthermore, the Company shall not amend its Articles of Incorporation or By-laws in a manner that would alter or change the rights, preferences or privileges of any Preferred Stock without the approval of at least a majority of the Preferred shareholders. Written consent of a majority of the Series A shareholders shall be required for (a) any merger, consolidation, or other corporate reorganization, or (b) any transaction or series of transactions in which in excess of 50% of the Company's voting power is transferred or in which all or substantially all of the assets of the Company are sold.

Q. PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT:

Each officer, director, and employee of the Company shall have entered into a proprietary information and inventions agreement in a form reasonably acceptable to the Company and the Investors. Each Founder and other key technical employee shall have executed an assignment of inventions acceptable to the Company and Investors.

R. PURCHASE AGREEMENT:

The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, with respect to patents, litigation, previous employment, and outside activities, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of closing, including an opinion of the counsel for the Company.

Exhibit 1 (cont.)

S. LEGAL FEES & EXPENSES: The Company shall pay the reasonable fees (not to exceed $5,000) and expenses of counsel to the investors and the Company.

The foregoing Summary of Terms sets forth the good faith agreement of the parties set forth below. By accepting this term sheet, the Company agrees to refrain from solicitation, consideration, or acceptance of alternative proposals to finance, recapitalize or sell the Company for a period of twenty-one (21) days from the date of the Company's signature below. This offer expires on Wednesday, February 14, at 9am.

Draper Fisher Associates Fund III, L.P.

By:_____
Tim Draper

By:_____
Steve Jurvetson

Date:_____

JavaSoft, Inc.

By:_____
Sabeer Bhatia

By:_____
Jack Smith

Date:_____

Exhibit 2
Hotmail Timeline

Year	Month	Subs	Company Milestone	Financing Event
1995	Aug		Sabeer & Jack start shopping JavaSoft	
	Sep			
	Oct			
	Nov			
	Dec			
1996	Jan			
	Feb		First meeting with Steve Jurvetson	1st round term sheet signed
	Mar			
	Apr			
	May			
	Jun			2nd round negotiations begin
	Jul		Product launch	
	Aug			2nd round closed 3rd round negotiations begin
	Sep			3rd round closed
	Oct			
	Nov	0.5 MM		
	Dec			
1997	Jan	1 MM		
	Feb			4th round negotiations begin
	Mar	2 MM		4th round closed
	Apr		Launched WebCourier	
	May			
	Jun			
	Jul	5 MM	Launched Hotmail Gold	
	Aug			
	Sep			Search for 5th round begins
	Oct			
	Nov	9 MM		

Exhibit 3
Financial Statements, October 1997

	Actual Oct-97	Projected Oct-97	Variance Positive (Negative)
Revenue			
Core Sales	195,490	275,000	(79,510)
Swap Sales	-	-	-
Commerce	50,000	-	50,000
Premium Services	2,736	114,507	(111,771)
Web Courier	150,302	80,683	69,619
Total Revenue	398,528	470,190	(71,662)
Expenses			
Salaries	237,391	262,640	25,249
Commissions	28,612	49,500	20,888
Payroll Taxes	15,325	25,908	10,583
Employee Benefits	14,669	21,011	6,342
Consultants	39,434	45,000	5,566
Recruiting Fees	33,750	-	(33,750)
Advertising	136,003	40,000	(96,003)
Promotion	14,387	18,000	3,613
Dues & Subscriptions	5,232	200	(5,032)
Entertainment	700	3,705	3,005
Freight	312	1,000	688
Travel	5,581	8,513	2,932
Insurance	4,249	2,500	(1,749)
Internet Expenses	106,764	60,000	(46,764)
Interest - Equip Loan	19,582	25,000	5,418
IPRO	2,900	5,000	2,100
ABVS	-	3,000	3,000
Legal & Accounting	11,025	7,000	(4,025)
Loan Fees	500	800	300
Office Supplies	5,838	3,000	(2,838)
Small Equipment	1,139	-	(1,139)
Miscellaneous	199	1,000	801
Postage	-	100	100
Rent - office	18,376	23,700	5,324
Rent - equipment	280	300	20
Telephone	7,729	7,969	240
Total G&A Expenses	709,977	614,846	(95,131)
TOTAL REVENUE	398,528	470,190	(71,662)
TOTAL EXPENSES	709,977	614,846	(95,131)
INTEREST INCOME	2,772	-	2,772
DEPRECIATION	103,378	54,000	(49,378)
NET INCOME (LOSS)	(412,055)	(198,656)	(213,399)
CASH FLOW (OUTFLOW)	(308,677)	(144,656)	(262,777)

Exhibit 4
Excerpt from Business Plan, November 1997

1. Executive Summary

"Hotmail makes so much sense; it's the way e-mail, especially personal e-mail, should be. Hotmail upgrades e-mail from a legacy application to the full power of the World Wide Web, including rich content and independence from client software and platforms."
J. Neil Weintraut, Twenty-First Century Internet Partners

The Company

Hotmail is an innovative new company that has translated the cost and complexity of installing and operating legacy e-mail systems into the simplicity and universality of the Internet. Hotmail offers personal, fully functional e-mail on the WWW for free. Internet users pay nothing for Hotmail because, like other prominent Web sites, it is advertising-supported.

Hotmail, launched on Independence Day, 1996, has a compelling vision – to make e-mail, the number one Internet application, accessible from any computer with a web browser from anywhere in the world – and in the process change the way people communicate. Hotmail has created technology that integrates the functionality of text-based e-mail messaging with the multimedia and global access capabilities of the Web.

The Opportunity

One of the most powerful and frequently used means of communications today is electronic mail. In fact, the single most important use of the Internet is the exchange of e-mail. Some studies estimate that nearly 70 percent of users use the Internet for e-mail. This year, in the US alone, 2.6 trillion e-mail messages will be transmitted over the Internet. E-mail messages can be delivered almost immediately anywhere in the world, can be stored and retrieved for later use, can be broadcast to more than one recipient, and can deliver attached files that can be shared by multiple users.

E-mail is commonly recognized as the fastest growing application on the Internet. The Electronic Mail and Messaging Systems (EMMS) Society predicts that e-mail will grow from 125 million users in 1996 to 200 million by the end of 1998. Hotmail has confirmed this hypothesis through phenomenal subscription growth – within one year of its launch, Hotmail will have registered close to 5.0 million subscribers, and currently adds more than 27,000 new subscribers per day.

Online advertising revenue is also projected to grow at high rates over the next five years. CyberAtlas predicts Web advertising to grow from $200 million in 1996 to $4.5 billion in 2000 – an over twenty-fold increase. In addition, it is widely held that the top 20 Web sites will garner the majority of this revenue. Hotmail currently generates over 4.5 million ad impressions daily, which will grow to well over 10 million by 4Q97, putting the Company easily into this category.

The Product

Hotmail delivers all the features and benefits of e-mail, but without the limitations or costs of legacy e-mail solutions. Hotmail is a fully featured, Web-based electronic mail service that is highly scalable, and is implemented and managed entirely at the server.

Because Hotmail is completely server-side, users can access their personal e-mail from any Web access location and from any device that supports a browser. Hotmail is also well positioned for the emergence of new markets made possible by devices like the network computer (NC) and home-based set-top boxes (STBs) that do not have the large computing "real estate" required to host legacy e-mail packages.

Hotmail has recently launched a new content delivery service called WebCourier. Users can subscribe to the service via a checkbox and have content from one or more sites delivered to them on a regular – usually daily – basis. Nine partners have signed with the Company to deliver content for WebCourier: CNET's news.com, NetGuide Live, Quote.com, Slate, Mercury Mail, GolfWeb, iVillage, Thrive and

Exhibit 4 (cont.)

USA TODAY. Besides offering Hotmail users a valuable service, the Company has created revenue- and/or traffic-sharing arrangements with each of the WebCourier partners.

E-mail is just the beginning. Over the course of the next 6-12 months, Hotmail will offer its users products and services such as virus scan of attached files, e-greeting cards, secure e-mail, local and global content, chat and member directories -- all of which enhance the usefulness of and loyalty to the service. These services will generate subscription-based revenue streams for Hotmail and create additional value for the advertiser on the Hotmail service.

Competitive Advantages

First mover advantage: Hotmail has at least a four million-subscriber lead over its nearest Web-based competitor. In addition, Hotmail's systems have handled extreme subscriber growth without a major interruption of service.

Low cost: Hotmail's systems are custom-designed to deliver scalability up to one hundred times greater than commercially available mail products. In addition, Hotmail's cost of subscriber acquisition is extremely low -- less than $1.00 per subscriber, compared to more than $200 per subscriber for AOL and about $18 per subscriber for Juno.

Popularity of the service: The number of registered subscribers has grown twice as fast as expected.

Switching costs. The nature of the e-mail application is such that as messages accumulate, and as people disseminate their address to friends and contacts, it is difficult to switch providers. Hotmail will continue to add functions that incorporate more of an individual's personal information and increase this switching cost.

Brand. Hotmail has gained widespread reputation as one of the fastest growing Web sites, and can attribute much of its growth to grass roots support and word-of-mouth marketing.

Revenue Model

Hotmail expects to generate revenue from three sources.

Advertising: Hotmail's large subscriber base generates a substantial critical mass of impressions that can be demographically targeted, and is capable of summoning premium CPM rates.

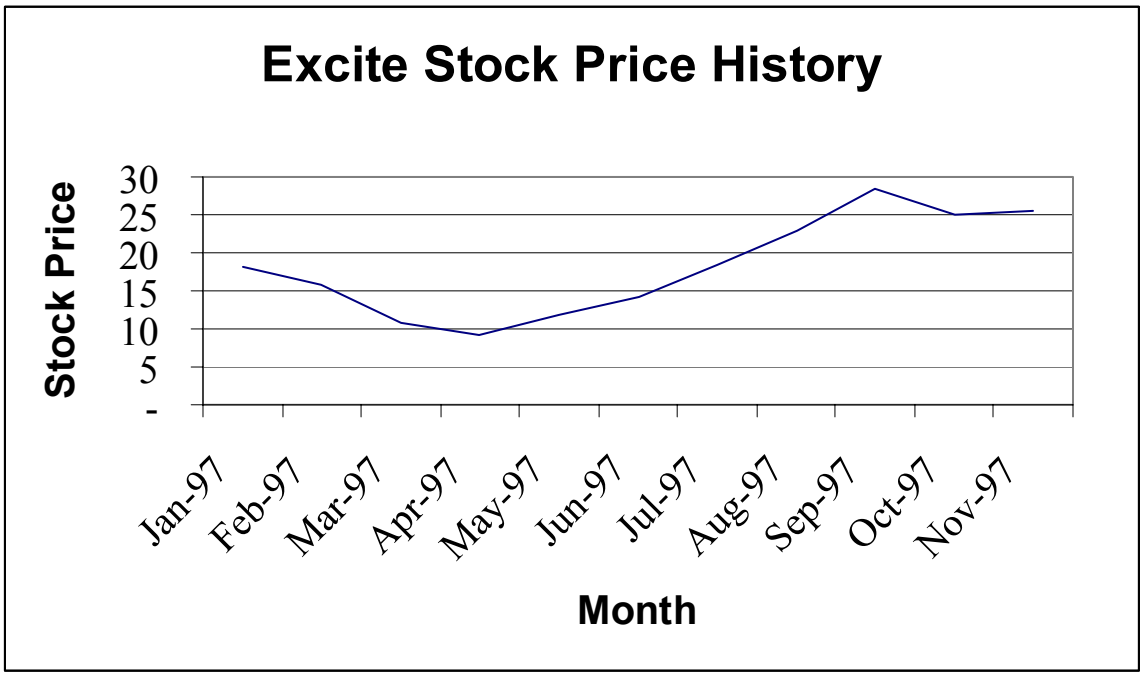
Traffic: Many of the Company's partnerships involve revenue or traffic sharing when Hotmail subscribers are sent to a partner's site and generate advertising revenue while there. Other partnerships, such as the ones with Mercury Mail and Thrive generate revenue for Hotmail based on a per-subscriber "bounty". This "bounty" ranges from $ 1.00 to $ 1.50 per subscriber to these content sources.

Subscriptions to enhanced features: Hotmail will soon be introducing subscription-based services to its user population. These have been carefully determined from results obtained from user surveys. Services that rank high on users' responses include the ability to scan attachments for Viruses and the provision of enhanced security while sending and receiving e-mail.

The Offering

Hotmail seeks an additional $10 to $15 million in a preferred equity round to provide the working capital needed to maintain its **market-leadership position, build its brand, expand internationally and forge media and content distribution relationships** in this very attractive and growing market. The objective is to position the company for an IPO in the upcoming year. Hotmail has received funding to date of $5.6 million from Draper Fisher Jurvetson Associates and Menlo Ventures.

Exhibit 5
Stock Price History for Excite, Microsoft



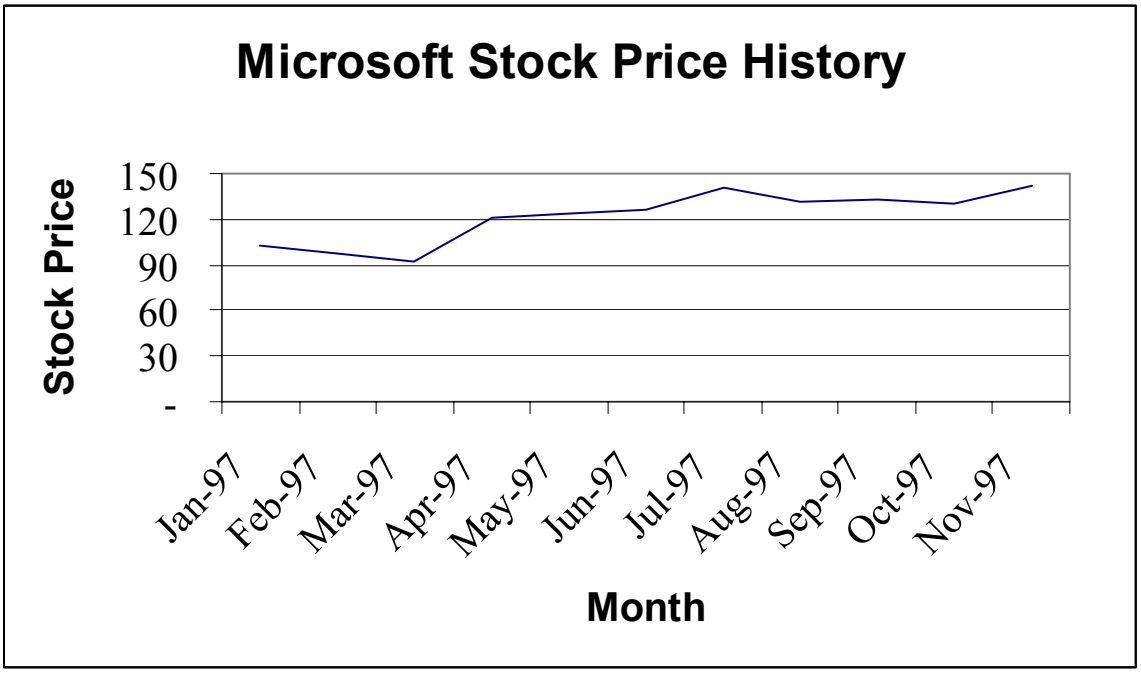


Exhibit 6
Public Internet Company Valuations, November 1997

Company	Primary Business	Market Cap (millions)	3Q97* Revenue (millions)	3Q97* Oper Income (millions)	Unique Visitors per Month/ Subscribers
Yahoo!	Portal	$2,600	$17.3	$0.2	14,800,000
Excite	Portal	$400	$14.4	($5.9)	7,600,000
Lycos	Portal	$450	$9.3	($0.4)	4,900,000
Infoseek	Portal	$300	$8.3	($4.8)	7,900,000
Earthlink	Internet Access	$215	$20.6	($6.8)	362,000
AOL	Internet Access	$8,900	$521.6	$26.3	10,000,000
Netscape	Internet Software	$2,700	$150.0	$16.1	N/A
Amazon	Electronic Commerce	$1,200	$37.9	($9.2)	N/A

* 3rd Quarter (July - September), 1997