*February 15, 2007*

Over the past few years, debt has evolved from a balance sheet burden to a benefit within the venture community. Debt funds, finance companies, banks, and hedge funds have all taken on venture lending positions in order to capitalize on the explosive growth in this industry. Yesterday, an article in the *Wall Street Journal*, titled "Venture Funding Twist," reported on the increasing popularity of debt for venture-backed companies[1]. The venture debt market is still rebounding from the demise of the internet bubble in 2001, but according to research firm, Venture One, it is now roughly a $2 billion industry in the US and in 2006, represented approximately 7% of the money invested in US venture-backed firms.

Now that the venture debt market is established and growing (as well as continuously changing) how can CEOs/CFOs be expected to navigate through the lenders, the terms, the options, etc. to find a deal that properly satisfies the company's financing objectives, while providing a secure and safe relationship with a reputable firm? Debt Advisors Group, Inc. (DAG) has consulted for more than 390 companies* in various stages of development from the life sciences sector to high technology. We have forged relationships with over 40 lenders and maintain a library of roughly 530 proposals, which allows us to aid companies in their pursuit of the best and most suitable debt deal. DAG understands not only our clients' diverse financing needs but also how to match those various objectives with the appropriate lenders based on lenders' risk and loan structure preferences.

This month's case study shows how our knowledge of the lending landscape and debt market allowed us to craft a solution for a specialized debt financing need.

**Profile**
A representative early stage pharmaceutical company, "Drug Corp," with $65MM in venture capital financing was looking to supplement its current equity position in order to extend its cash runway and also enhance its bargaining position between equity rounds.

**Debt Needs**
The company sought debt financing in the form of a $5MM venture loan to be used at the company's option for working capital, equipment purchases, and software needs. As the venture debt market has evolved, lenders' risk appetites have expanded and growth capital lines have become increasingly popular. Lenders who typically needed collateralization are now able to provide venture funding in larger line amounts at competitive rates.

**DAG's Evaluation**
Drug Corp's Chief Financial Officer (CFO) with guidance from the DAG team recognized the benefit of layering a line of debt over an upcoming equity raise for insurance purposes rather than for immediate cash needs. DAG recommended using debt as a complement to equity (and a leverage for expensive money), rather than a substitute.

**Drug Corp's Financing Goals**
The CFO's explicit goals for the new round of financing were:

- Maximize future financial flexibility
- Minimize warrant coverage – Drug Corp's Board of Directors wanted to give away as little equity as possible
- Significantly extend cash runway
- Minimize prepayment penalty

**The DAG Process**
The DAG team solicited proposals on behalf of Drug Corp from six independent lenders with proven expertise in working with venture-backed companies. DAG was able to create a competitive bidding situation which helped to drive the terms and rates of the proposals.

The terms of the new financing included:

- Commitment of $5MM with a drawdown period of 9 months
- All asset lien, negative pledge on intellectual property
- 6 month interest-only period followed by 30 months of amortization
- 4% warrants (tranched 50% at closing, 50% upon usage)
- Prepayment penalty – Year 1: 3%, Year 2: 2%, Year 3: 1%

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[1] Tam, Pui-Wing (2007). "Venture Funding Twist", *The Wall Street Journal*, 14 Feb, p. 2.

**Net Results**

- Extended cash runway by more than 10%
- Leveraged venture funding with minimal dilution
- Potentially strengthened negotiating position for equity raise
- Enhanced flexibility by limiting restrictions and covenants
- Negotiated competitive prepayment terms to give the company the option to refinance or expire the line without experiencing major penalties

*All data as of 12/31/2006.

*The facts contained in this case study are fictional but realistic. Results achieved are based on a variety of factors, including each client's specific debt needs, financial objectives, and risk tolerance. Past performance is not a guarantee or assurance of future performance.*