Best Practices for Sourcing Venture Debt:
How to Create Parity and Foster Competition for your Deal

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Rich Bowman
Senior Vice President & Head of Debt Consulting
rbowman@capitaladvisors.com

Stefan Spazek
Senior Vice President
sspazek@capitaladvisors.com

Main: 617.630.8100

Note: Capital Advisors Group is a Boston-based institutional investment advisor that has been helping clients invest their cash assets for more than 20 years. Debt Advisors Group, the venture debt consulting arm of Capital Advisors Group, helps our clients determine their optimum capital structure, identify appropriate lenders, source term sheets and negotiate deals.

Abstract
The venture lending market occupies a unique niche in the world of venture financing. Because it is less dilutive than equity, venture debt, when used appropriately, may be an attractive solution for a company to extend its cash life. However, there exists a large and disparate group of lenders that vary in quality, service (i.e., how easy they are to work with) and deal preference. Some are specialists that will focus on vertical markets they know well, while others are generalists that will complete deals across industries based primarily on the credit quality of the deal. There are lenders known to slip enhancements into their terms that sweeten the deal for them on the back end, and some that won't even look at a deal that doesn't first meet very strict criteria. This paper intends to lay the groundwork to assist borrowers source venture debt to help them objectively view each deal, compare lenders and create competition for their business.

Introduction – History of Venture Debt
Venture Debt was first introduced in the late 1960s for new technology firms that did not qualify for traditional bank financing. These start-up companies not only lacked a proven track record, but also were burning through cash. Historically, the only way such companies could raise capital was through equity financing. Then, a number of equipment leasing companies that were well prepared to maximize the value of certain types of equipment as collateral, began underwriting equipment leases to these early stage companies. In this emerging form of lending, venture debt was collateral driven and almost never reached the 100% financing level for these cash-strapped firms. Finally, in the late 1980s, Equitec Financial Group developed a leasing product that offered 100% financing. Equitec devised the concept of using an "equity kicker" on each deal to increase yield on a portfolio basis to balance the higher risk profile of the borrowers and to offset the inevitable increased loss ratio when compared to bankable credit portfolios. In these early transactions, the "equity kickers" came in the form of success-based fees or warrants. This 100% financing model,

BIO:
Rich Bowman has more than 30 years of experience in consulting, commercial lending and equipment leasing, most notably in the high technology and life science industries. He originally joined Capital Advisors Group more than seven years ago as President of Debt Advisors Group. Currently, Rich is overseeing business development for Capital Advisors Group's west coast region and marketing the firm's investment management and venture debt services to growing companies.

Prior to launching Debt Advisors Group in 2003, Rich held senior positions at GE, Comdisco, Inc., and Equitable Life Leasing Corporation where, for 15 years, he worked in financing products for early stage companies. Rich holds his FINRA Series 65 license.

which utilized warrants on a short-term basis (typically three years), remains the primary structure used by venture lenders today.

Similar to the significant growth of venture capital investments of the 1990s, the venture debt space grew dramatically. Operating leasing companies that entered the market such as Comdisco, GATX, TransAmerica, Equitable Life Leasing and others fueled growth. Banks specializing in financing early-stage companies also embraced this rapidly growing market. Finally, specialty finance companies were formed to serve and grow within this financing niche. The venture debt market continued its rapid expansion throughout the '90s and reached its height during the "Internet Bubble" of 2000.

In 2001, the market crashed when the "internet bubble burst," producing a meltdown in both the venture capital investment and venture debt markets. Many lenders, such as Comdisco, TransAmerica, GATX, were forced out of the business. The market slowly recovered, however lenders were much more aware of their credit exposure when engaging new clients. To further reduce risk, the banks modified their structures to be fully cash-collateralized (meaning borrowers are required to keep their operating cash at the bank with sweep provisions linked to MAC clauses). Over the years, the executives from the failed lenders created new specialty finance companies to fill the void of lenders that closed down.

Today, the lending community generally falls into three categories, each with their own competitive characteristics:

- *Venture Banks.* Most conservative structures (i.e., cash collateralized, "MAC" clauses, etc.) with lower interest rates and lower warrant coverage.
- *Divisions of Large Corporations or Large Finance Companies.* Less conservative structures. Medium pricing and warrant coverage.
- *Specialty Finance Companies*. Typically formed solely for venture debt lending with private investors seeking healthy returns. Most flexible; least conservative documentation (i.e., default limited to non-payment, true runway extension). Higher interest rates and warrant coverages.

Outside of a temporary shortage of capital during the credit crisis of 2008 - 2009, the venture debt market now is as strong as ever. Unlike the equipment focus of the early days, most transactions today are structured as loans with a general lien against all assets of the firm (carving out the IP via a "negative pledge") and it is a much more mature and predictable financial product. However, there are more than 25 lenders serving this niche today, each with their own unique approach to the lending model. The following is a step-by-step outline for borrowers interested in evaluating and pursuing a venture debt deal.

Step I: How's Your Credit?

The first step in pursuing a venture debt deal requires the borrower to look in the mirror, evaluate his or her own company and determine the optimum deal and objectives. What is the size of the deal and why target that amount? Is it because the company would like to get as much as possible from the lender or is it because that amount will take the company to the next important milestone? Hopefully it's the latter. What is the company's current cash runway? Six months? 12 months? 18 or 24 months? Believe it or not, one of those answers will make the deal palatable for the lender and provide the greatest runway extension. What product/technology/device/drug is the organization working to bring to market? The answer could affect the available terms and conditions from lenders. Finally, who are your investors and how willing are they to continue supporting the company? Unfortunately, in this market there is no Equifax or Experian; there is no magic 740-850 credit score that will guarantee the best deal from lenders. Don't forget the lenders are in it to make money for their shareholders and are working with their own interests in mind; therefore, it's crucial that borrowers take a stark look at their companies to gauge the credit quality and understand if it's possible to attain the best terms lenders have to offer.

Step II: Know the Market

Today's venture lending community is broad and diverse. While most lenders are very capable, many may not be appropriate for certain deals. Some lenders are wary of single indication drugs or medical devices because they would prefer to see a broader array of market applications. As noted above, some lenders are banks that will bring a different set of conditions to the table than will specialty finance entities which are specifically set up to lend to early-stage companies. This is a decentralized market. There is no website or other resource that shows borrowers all of the lenders and their rates on any given day. The terms that the market will bear largely depend on the credit quality of the borrower and the lenders brought in for that specific deal. Mapping the deal's objectives to the proper lenders is paramount. Consider the following illustration:

	Lender A	Lender B
Type	Bank	Specialty Finance
Fund	Not Applicable	Recently Raised
Risk Appetite	Prefers Lower Risk	Will Take Higher Risk
Equity	Fewer Equity Rights	More Equity Rights
Financial Flexibility	Low	High
Reputation	Good	Good
Interest Rate	Lower	Higher

At first glance, Lender A in the above illustration might appear to offer the more attractive deal because Lender A is taking fewer warrants and equity sweeteners and is coming in with a lower rate. However, a closer look reveals that by taking a lower risk, Lender A provides lower financial flexibility. As a bank, Lender A may require its borrowers to maintain all deposits at the bank (i.e., greater security against a venture debt deal going bad). With all of the company's cash at the bank, Lender A can keep a close eye on the cash balances and regularly check those balances against the level of the existing loan. The bank will not want to see the cash level dip below the loan amount. Therefore, the borrower receives very little realized cash runway extension from the deal. Lender A also may include the "right to offset" as part of the loan conditions, which gives the bank the right to sweep that deposit account at its discretion should it deem the deal is going badly.

Conversely, Lender B will not include such a provision in the deal, thus providing the borrower greater financial flexibility and true cash runway extension. The higher risk presented to Lender B also results in a slightly higher interest rate and greater equity options (warrants). However, because Lender B recently raised a fund, this lender will be eager to do a deal and may be more willing to negotiate terms if the company presents itself as a good credit risk.

These scenarios demonstrate why each deal is specific to the individual borrower and that it must be determined early on what is most important to the company when pursuing the deal. This will help to identify which lenders to target and how they can help borrowers achieve their goals. Finally, it is crucial to have a firm grasp of prevailing market terms to be able to identify if and when a lender is offering the most competitive terms.

Step III: Create Competition

When it comes to pursuing a venture debt deal, where might one begin? For most, the process logically begins with approaching someone they trust. However, whether an old friend or former colleague, a long-time banking relationship or a trusted referral, it is always important to remember that the lender sitting across the table has shareholders to please, numbers to meet and supervisors to satisfy. The conversation may be pleasant, but the fact remains that your interests are at odds. Their job is to present the deal that most benefits their organization and your job is to close on a deal that most benefits your company.

Competition is key. Bring in multiple term sheets and compare them on an apples-to-apples basis. Build a simple spreadsheet for the purposes of running a side-by-side analysis and evaluate the criteria most important to the company. What is of greater importance, the lowest rate or the most financial flexibility? (Note: when we evaluate rates, we evaluate what we call "the all-in rate," which is not just the interest rate quoted, but also includes the upfront or facility fee, as well as any back-end balloon payments. Be sure to consider each and tally the sum when evaluating the deals.) Does the board want to push hard for the lowest warrants to avoid dilution? Or, perhaps, prepayment penalties are a concern. Below is an example of how one might use such a tool to evaluate term sheets.

Sample Competitive Evaluation*

	Lender A	Comparative Analysis	Lender B
General Information			
Line Amount	$2,500,000		$2,500,000
Amortization Term (Months)	30	Longer amortization and increased interest-only periods allow for greater runway extension of nine months	36
Interest Only Term (Months)	6		12
Rate Information			
Fees	Prime+ .25% @ 8.25%		Prime+ 1.50% @ 8.25%
Run Rate	8.5%	Back-end payment allows company to take advantage of early cash flows	9.75%
End of Term Payment	2.9%		5.7%
Fees			
Type	Earned	No Facility Fee	Deposit
Amount	$12,500		$10,000
Cost-of-Capital			
All-in Rate/IRR	10.69%	Lower all-in-rate represents cost savings of approximately $159K over the term of the loan	11.95%
Financial Flexibility			
Soft Cost Maximum	N/A		N/A
Lien Coverage	All Asset Lien, including IP	Greater Financial Flexibility	All Asset Lien, Neg. Pledge
Financial Covenants	Maintain Investment & Operating Accts. at Bank	Effectively no runway extension	None
Warrant Coverage			
Warrants	7.5% Series A Preferred	Given a share price of $1.30, Lender A would be granted 144,231 shares as opposed to 96,154 shares for Lender B	5% Series A Preferred
Length of Warrants (yrs.)	x10		x10
Prepayment			
	Not Stated	If the company would need to refinance prior to the end of the term, it is imperative to negotiate prepayment prior to documentation	Year 1: 3% Year 2: 2% Year 3: 1%

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Step IV: Negotiate

At this stage of the deal, all of the legwork to determine the appropriate deal for the company has been completed: the borrower has researched and identified the relevant lenders, executed all of the necessary NDAs, coordinated and participated in the lenders' fact gathering meetings and conference calls, collected the term sheets and built the model to evaluate the lenders' terms. Now, it's time for the negotiation. With a solid grasp of the company's credit profile and prevailing venture debt market conditions, it is possible to competently push back in the right areas to negotiate the deal. Consider the following:

> **<u>Rate</u>**
> **Scenario 1**: 11.5% all-in rate vs. a 10.5% all-in rate over a 42-month term with a 6-month interest only period for a $5 million loan
> **Result**: Negotiating the all-in rate saves the company **more than $115,000** over the term of the loan.
>
> **<u>Warrants</u>**
> **Scenario 2**: 5% warrants vs. 6% warrants, based on previous round valued at $1.50 per share for a $3 million loan
> **Result**: Negotiating the lower warrants makes the board happy. Based on a $3 million loan, the lender gets an additional 20,000 shares in the higher warrant deal. Plus, a 10-year exercise option could result in a significant upside for the lender.

The proof is in the numbers and the hard work can pay off.

Conclusion

Clearly, it takes a significant amount of work to properly run a competitively sourced and evaluated venture debt deal. Anyone charged with exploring venture debt as a financing option understands they are bound by a fiduciary duty to seek the best available deal for the company. As stated earlier in this paper, most CFOs have the experience and relationships in place to pick up the phone, make a call and collect term sheet from a couple of lenders. However, that approach may not result in the best borrowing option for the company. Remember, if the company presents itself as a good credit risk it can benefit from very competitive deal terms – but realize that it will take time and effort to reach the best deal.

About Debt Advisors Group

Debt Advisors Group has the experience necessary to understand the ever-changing debt market. This is best demonstrated by the following statistics from Q1 2003 through Q3 2011:

- Advised **733** different companies with approximately **$2.6B** in debt need.
- Sourced the following debt products: growth capital, equipment loans/leases, A/R, inventory based financing and factoring.
- Reviewed and maintained a library of more than **889** direct lender proposals.
- Worked with **55** different debt funds, finance companies, and banks that specialize in venture capital-backed companies.
- Provided services for the portfolio companies of **327** venture capital firms.
- Aided diverse companies from the following industries: pharmaceutical, biotechnology, medical devices, healthcare services, communications, networking and software.