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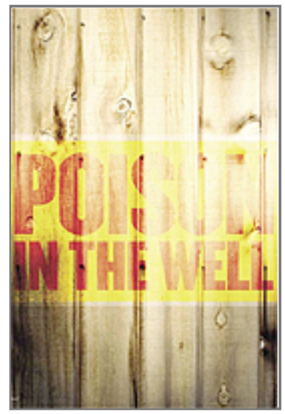
Poison in the Well

Could Utah's Unorthodox Debt-Funding Term Sheet Tactics Be Hurting Economic Growth?

By Josh Coates, 10/18/2005 4:30:04 PM MST



I just passed my one-year anniversary of living in Utah. It's a lot different than where I'm from. In some ways the differences are great - in some ways, the differences are not so great. Over the last year, I've had a keen interest in understanding the dynamics of the Utah technology sector and contemplating how to make things even better here.

Silicon Valley is an amazingly fertile environment. It has the elements where a technology-driven economy can thrive - excellent academic institutions, mature technology corporations, a culture of invention and ambition and a healthy supply of risk-taking venture capitalists, among others. Utah has very similar ingredients (albeit proportionally less) and in theory, we should be able to grow and harvest similar technological and economic success.

Allow me to torture a metaphor: We've got good soil, adequate light and certainly we've got plenty of seeds raring to get out there and grow. So why isn't Utah bearing the same fruit? One problem is in the water.

The Poison

Who is poisoning the well here in Utah? Simply put, it's some of our investors. Now I'm not talking about the tired "vulture capitalist" rant that we've all heard before - from my brief experience here in Utah, the VC firms are largely mainstream in how they do business. Kudos to them!

I'm talking about individuals that make small $50,000 to $300,000 investments in the form of debt, while insisting on unreasonably huge proportions of equity in the company and/or that the founder should personally guarantee the debt. This is the poison I'm talking about. It's a weird, unique-to-Utah kind of poison, and it's messing things up.

Let's put things out on the table and compare Utah deals with typical deals in other parts of the country:

>> Mainstream venture debt (WTI, Comerica, Silicon Valley Bank, GE Capital, etc.): typically follows a Series-A funding, used for equipment and/or operating capital, backed by assets and/or intellectual property. The amount is often $500,000 to $25 million, depending on the firm. Occasionally these deals include some type of warrant coverage, typically 2 to 10 percent. Note that this is 2 to 10 percent warrant coverage on the amount of the debt commitment, not 2 to 10 percent of the outstanding shares of the company.

>> Mainstream angel funding (high net-worth individuals) (this is what I'm going to call "Bridge Funding" later): small $25,000 to $500,000 loans with deferred interest (interest is payable on maturity of the loan, but usually converted at the time the loan converts into stock), option to convert to preferred shares upon Series-A financing and 20 to 30 percent warrant coverage (essentially a discount on the Series-A Preferred.) This is important: the price at which the debt converts is determined by the price of the Series-A financing, which won't be known until it happens. Although the exact "valuation" at the time the loan is made is not known, it is known that the loan will convert at a discount to the Series-A round (based on warrant coverage, i.e., 25 percent warrant coverage has the economic effect of making the loan on a valuation that is 25 percent less than the Series-A round, whatever valuation that turns out to be). On occasion, the loan matures before the company is able to acquire institutional funding. In this case, the 'bridge' leads nowhere and so the loan is simply repaid.

>> Utah-style venture debt and/or angel funding (various local institutions, individuals and groups): I have seen numerous Utah-style venture debt and angel investing practices that are very similar: typically offered as seed funding or growth capital in the form of a loan amount from $50,000 to $500,000. Various provisions can include high monthly interest payments, personal guarantees (i.e. the founder's personal credit and personal assets are on the line), an option to convert the debt to stock at a pre-determined percentage (implied valuation) and the investors can call the loan at any time (typically resulting in a forced company bankruptcy). Other provisions do not involve a conversion of the debt because significant equity (up to 10 to 25 percent) is simply given to the lender as a requirement for the loan.

Now let me concede that not all Utah angels and venture debt firms follow all these unusual practices - but enough of them do that it puts Utah out of the mainstream. In my opinion, two of the most detrimental provisions I have found are the callable loan (forced bankruptcy prior to note maturity) and the practice of setting a valuation. The callable loan is a brutal lever over the entrepreneur to coerce them to do whatever, whenever the lender pleases, and setting the valuation for a convertible loan is nonsensical - the whole point of a convertible loan is to avoid setting a valuation by allowing it to "convert" in the future at some valuation determined by institutional investors. More on these later.

A Utah-style angel arrangement where the note is not convertible, but merely a seed loan in exchange for equity, is not much better. Technically speaking, it is a humorous but sad financial arrangement. For example, if a lender loaned you $50,000 at 8.5 percent interest for one year and received 25 percent of your company, then technically you are paying the lender $4,250 (the interest on the loan) to take 25 percent of your company. The quantitative implication is that the value of your company would be negative $13,000 (go ahead, do the math).

The subjective implication is that the investor not only doesn't believe in you or your company, but he is so doubtful about your success he is asking that you pay him to take some of your equity. Very strange.

Now compare this arrangement with the way the rest of the country does business: an investor believes in you and your company so much that he wants to give you money in exchange for equity. Since you are in the seed stage, you both decide that setting a valuation is premature and so you set up a Bridge Loan. That is, a bridge to a formal Series-A financing. The bridge is in the form of a loan, but the idea here is not that the loan gets paid back in cash, but that it gets paid back in equity. Since the investor is in early, and taking a bigger risk than the Series-A investors who will follow him, a discount on this eventual 'purchase' is agreed upon (this is called warrant coverage). If the seed money is used wisely, then the company will be prepared for a Series-A financing, and everything will fall into place with a nice, clean capitalization table and a well-rewarded seed investor lined up alongside a deep-pocketed, experienced venture capitalist ready to take the company to the next level.

But what if things don't go so well? If the bridge goes "nowhere" (i.e. Series-A financing is not obtained) then the loan is simply repaid - interest and all. And if things really go south, then the only recourse is to exercise their lien on the company's assets (physical and intellectual property). Remember, anyone who invests in a technology startup is by definition, a speculative, venture investor. They don't require a personal guarantee, they can't force a premature payback at their whim and they won't threaten to take your house away if your startup fails.

If that's too hot, then get out of the kitchen. The message here to investors in Utah is that if you can't take a risk on venture seed funding, then please, don't do it. If you want to do secured, high-interest loans then go open a payday check cashing store, automotive title loan business or a pawn shop. Do the Utah technology industry a favor, and stay out of the venture startup business because you are messing things up for Utah's high-tech economy in a very subtle, but critical way.

So why do these Utah investors do things the way they do? Well, I've had extensive dialogues with several of them, and here are some of the typical answers I've received:
* "There is also a golden rule that states, 'he who has the gold makes the rules'."
* "Sure, sophisticated entrepreneurs won't do deals with us, but there aren't many of those in Utah, so we get plenty of people taking us up on our terms."
* "The fact we have this kind of debt allows us as investors to control the company and have it go the way we think it should."

* "Hey, that's market. That's just the way it is."

Compare the above statements with those of some seasoned out-of-state investors with regard to the topic of seed funding and venture debt.

Ifty Ahmed is vice president of Oak Investment Partners, a prestigious Sand Hill Road venture firm, and cautions new entrepreneurs against taking seed money under the wrong terms. "When you are just starting out, it is tempting to take the first bit of money under any terms. The worst thing you can do is take angel/seed money at some set or implied valuation," he says. "One of the questions we ask ourselves when evaluating a startup is if we can turn their dirty cap table into a clean one, and if it will be worth the trouble in the end."

Matt Hemington is a partner in the Cooley Godward Palo Alto office. He has closed dozens of initial public offerings and many hundreds of venture financings. "Entrepreneurs and investors need to be careful with how they structure their initial seed funding," says Hemington. "In my experience, the Bridge Loan structure is often the most flexible, easiest and cheapest method to seed a startup for both the investor and the founder."

Western Technology Investment (WTI) is a firm that specializes in venture debt. They funded the big boys when they were little, including Google's very first data center. Brian Best, an investment partner at the firm explains, "We never set valuations or use personal guarantees with our venture debt loans." Best continues, "and generally speaking, if you do take a loan for seed capital - make sure it's just a simple conversion of the debt upon the next institutional round of funding at the price set by the new investors."

I think sincere investors want the Utah technology sector to grow and be successful, but I have also encountered a sense of arrogance and apathy with some investors in Utah, and an unwillingness to step up and put some real skin in the game.

The Harvest

I'm not quite sure how to put this, but let me give it a try: if an individual or institution suggests to you that they can "fund" your startup with a loan, and then asks you to give them equity for that loan, then politely thank them for their time and never call them back. By doing this, they are implying some level of valuation they have conjured up for your company, and as a seed stage investor putting in a few hundred thousand, they don't really have any business doing this. Setting a valuation based on that level of funding can drastically influence the company's ownership structure and make it extremely difficult for a founder to get later stage funding that is critical to the growth of an emerging company.

I believe the locals here refer to this arrangement as "convertible" or "venture" debt and they are telling people "This is all very typical, this is how things are done." But it's not. It's messed up, and as best as I can tell, it's a "Utah thing." Here are some examples of what can go wrong with this type of funding structure:

>> Fouled-up Capitalization Tables

When it comes time to raise a true Series-A round and your capitalization table lists an individual or company that owns 25 percent of the company's equity, the new investors will ask you, "Who the heck is this guy that owns a chunk of your company?"

If you reply, "Oh, that's so-and-so who gave me a $50,000 loan last summer," the investors will look at you and say, "What? We're negotiating the purchase of 40 to 50 percent of your company for $2 to $4 million, and you already gave away 25 percent of your company to some guy that loaned you a measly $50,000 last year? What were you thinking?"

At best, the new investors try to think about this previous lender as your co-founder, and lump you two together when they crush your ownership down to half of the company in a typical Series-A financing. The only problem for you as the founder is that instead of you and your team getting to own 50 percent of the company, it's you, your team and your previous lender splitting that 50 percent - with you and your team stuck with 25 percent at best. When you consider that any equity your team and future hires are going to get comes out of your chunk, you might be left with somewhere around 10 percent after the Series-A round (with potentially several more rounds to go through the life of the company). Little equity is now available for future funding rounds needed to grow.

This is a "best case" scenario. The "worst case" is that you simply can't get funding because your poorly structured seed loan has made your capitalization table "dirty." The solution is doing a 'recap' (recapitalization), which is a messy process that was perfected during those recent bad economic years. All things being equal, investors will avoid funding companies with fouled-up cap tables.

>> Stunted Company Growth

Another way these terms mess up the local economy is that it stunts the growth potential of the Utah startup. Putting a startup together is stressful enough, but a founder with personal debt on his back with the risk of personal foreclosure and/or having to declare personal bankruptcy if things don't go well will not take the risks necessary to succeed. And of course the callable loan provision is the fast and loose equivalent for the startup itself. These provisions morph entrepreneurs into risk-averse, short-term-thinking business operators that are always looking over their shoulder to make sure their investors don't decide to suddenly pull the plug and put them out of business. I believe one of the harmful side effects is that this stunted growth behavior results in a plateau at the "ma and pa shop" level business.

Think about how many "ma and pa shops" there are in Utah. How many could have been real venture-backed startups if they would have reached for the stars? How different would our local economy be if just 10 percent of these small businesses took the venture startup path instead of the small business path? What if 10 percent of those "made it" by going public, getting bought for millions of dollars or growing into a healthy standalone cash cow? We would see a lot of wealth created in Utah for employees and founders. That wealth would be spent here and flow to the people who live here. As the saying goes, "A rising tide floats all boats."

>> Credibility Problems for Utah

There is sort of an insiders' joke in Silicon Valley. The punch line is "We're the Silicon Valley of the [fill in the blank]." Whenever you travel and people find out that you are from the SF Bay Area, they often say, "Oh, well, then you probably know all about us; we're the Silicon Valley of the South" or "of the Northwest" or "of the Midwest" and you just sort of have to smile, nod your head and say, "Oh, yes, of course. Things are really growing out here." And then you proceed with your business, wondering if these people really know what they are doing.

Of course, the proof is in the pudding. The only way to know if they know what they are doing is if they start to show some results. Results are being obtained every day in the mainstream world outside of Utah.

What is the mainstream doing that is getting results? One of the things they are doing is following mainstream practices. If Utah wants to continue taking strides to become a high-tech hotbed, one good way to do this is by speaking the lingua franca of venture seed financing terms.

The standard Bridge Loan arrangement is the "right" way to get seed money from an angel - no personal guarantees, no call provisions and no implied negative valuations. There is a reason Silicon Valley investors do seed loans a certain way, and it's not because they are nice guys - it's because it's a proven model that makes them money. This formula is tried and true, and these kinds of deals are closed every day, all over the country by experienced people who know how this game works. Silicon Valley has had venture funds on Sand Hill Road since the 1950s. These are not new concepts, and it's not rocket science. There is no need to re-invent the wheel.

The Inoculation

I almost hate to say it, but in our industry, lawyers are our invaluable friends. Something I've noticed here in Utah is that there is an aversion to using good, experienced counsel in funding deals (using your brother-in-law the tax attorney does not count). When I've asked why this is, the typical response is, "They are too expensive," or "I think we know what we are doing." You may think you are saving money, but this is a classic case of being penny-wise, pound-foolish. Investors aren't doing themselves any favors when they use "borrowed" term sheets from a Wilson Sonsini template that they've butchered into a weird custom-tailored deal, complete with spelling errors. (If you think I just made that up to prove a point, think again.)

There are many firms that specialize in venture startups in Silicon Valley, Boston, New York and yes, there are even some in Salt Lake City. They see a broad spectrum of deals - the good, the bad and the ugly, and they take care of both entrepreneurs and investors. If you aren't working with one of these firms, and the deal actually gets done, then it will likely be done incorrectly and the dire consequences won't be made known until long down the road. If you are serious about investing in a hot deal, or raising money for your startup, these lawyers can work with you and make sure you aren't drawing poison from the well.

Josh Coates spent seven years in the technology industry in the San Francisco Bay Area before moving to Utah. In that time he has founded two software companies, raised over $30 million in venture and angel funding, and done consulting for both startups and venture capital firms.

He holds a software engineering degree from UC Berkeley where he did research in large-scale parallel systems. He was listed as one of MIT Technology Review's Top 100 Young Innovators in 2002 and made Red Herring's Top Ten Innovators list in 2001. Coates is currently the founder and CEO of Berkeley Data Systems, a small software company in American Fork, Utah.