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The Antidote

Local Investors Continue Debate on the Posion in the Well

By Local Angel Investors, 12/8/2005 5:15:19 PM MST

Editor�s note: The following is a rebuttal to Josh Coates� October 2005 cover story titled �Poison in the Well.� If you missed the October issue, you can read Josh�s article at (www.connect-utah.com/article.asp?r=1318).

Please take the time to read both articles, the feedback from readers and also my comments in the disconnect section explaining the importance of this debate before forming your own opinion.

It is important to realize the focus of this debate is on seed funding techniques primarily for companies that someday will be candidates for a venture capital Series-A round of equity financing � not all types of startups. The reason these types of companies are so important is that it is some of these companies that someday could become Utah�s next anchor companies needed to help spur economic growth.

I hope that by presenting all sides of this highly controversial topic, it will foster a healthy and productive debate resulting in understanding from both sides and a unified community pushing for the common goal of sustained economic growth in the region. Both sides make some very good points.

You�ll find all footnotes to this article at the bottom of the page.

Please send any comments on this debate to feedback@connect-utah.com to be printed in a future �letters to the editor� section of the magazine.

Venture investing is very risky.

It involves taking real cash and investing it into business ventures that are more likely to fail than succeed (provide a positive return on investment). It entails taking a quantum leap of faith that an equity investment will appreciate or a debt investment will be repaid with interest.

Recent criticisms of "Utah style angel investing" have some merit but are largely unfounded and ignore the efficiencies of the marketplace. Supply and demand is hard at work in Utah's angel investing marketplace. Utah has a relatively high number of startup ventures per capita but less angel investment capital per startup than premiere angel investing markets such as Silicon Valley, Seattle, Raleigh-Durham, Austin and Boston. In addition to high-tech startup deals, the average angel investor in Utah has real estate and other investments beckoning him at much better risk-reward ratios. For instance, it is not hard to get consistent 14 percent annualized returns via real estate debt investments carrying much less risk than any investment in high-tech startup � or indeed in any startup company.

Since there are more deals chasing less money per capita, there is always going to be supply and demand at play. There are so many variables at play in an average angel-investing scenario that it is hard to say what is typical. Entrepreneurs need to mitigate every point of risk best they can in order to attract capital. While there are indeed some "super angels" who will ignore the economic realities and invest large sums of money in deals for seemingly altruistic purposes, more angel investors (not "friends and family" investors) are savvy current or previous entrepreneurs that know both sides of the fence and they will not "do a bad deal" out of the goodness of their heart despite the "angel" moniker. Have you ever wondered about the people who criticize angel investors � have they ever written a check investing in another entrepreneur? Not just deferred salary, but a real check that was meaningful?

We would all love � if we were entrepreneurs � to get $500,000 for our new Web-based startup, pay ourselves a $120,000 annual salary, sell a little bit of equity for it, and go about having fun with other people's money. But, that's just not going to happen in a market where there is less money than qualified deals, as exists with true third-party angel money in Utah (low supply) and Utah startup companies wanting money from angels (high demand). This could change with the economic and entrepreneurial conditions, but right now this is the market.

Instead, to get money an entrepreneur has to make the investment attractive and assume more risk. The notion of having a bridge loan (not really a loan because it is not paid back if the company cannot afford it and if the company cannot afford it the loan defaults) that converts at 20 percent less than a future value was invented by a marketplace where there is more money than good deals. It shifts almost all of the risk to the investor. The risk should be more fairly dispersed.

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Nevertheless, any argument about this is basically moot. There is not some magic group movement that is going to resolve this discussion. This is supply-side economics[1] at its finest. The supply of money needs to increase. We need to find more angel investors! Then, the market will naturally resolve this issue. Therefore, the antidote to any (albeit perceived) "poison in the well" is to let the market dictate the deals and do not ask pioneering angel investors to take substandard deals in the interest of the common good without at least an equal sacrifice on the part of the entrepreneur.

With that said, let's delve deeper into the motivations and reasoning behind why Utah's venture funding has evolved to where it is today. We will also highlight some egregious points from the subject article.

Let's look at some of the more absurd claims and comments from the subject article:

"... individuals that make small $50,000 to $300,000 investments" in startup companies are "messing things up."

Do we want these investors to stop investing? We don't think so. If entrepreneurs have better terms with Investor A than Investor B, then the Entrepreneur will select Investor A. Oops, that's letting the market work things out. Free enterprise, capitalism and all that rubbish!

"Mainstream angel funding (Bridge Funding) ... 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."

The author of the subject article repeated this twice in his article. Our experience is that if the company does not "acquire institutional funding" then the loan does NOT get repaid UNLESS there is a personal guarantee (one of Utah's greatest sins). The casual and cavalier attitude regarding investor payback is symptomatic of a sense of entitlement on the part of the entrepreneur: "I deserve your money to fund me and my ideas and to pay me a salary for operating the business yet I do not need to share in the risk." Regarding personal guarantees, why shouldn't the entrepreneur's credit and personal assets be on the line? The investors' are.

�The investors can call the loan at any time (typically resulting in a forced company bankruptcy)."

We have never seen this provision in any deal in Utah. To have an investor be able to call the loan at any time would indeed be stupid! We need examples of deals where this has been done.

�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.�

It is? Who says? The point is to give the lender a "lower strike-price option" of sorts in exchange for the immense amount of risk. A valuation must be set at the time of the loan for it to have such an option-like quality (same issue with warrants). After all, the investment is being made today, not tomorrow � and why should an investor pay out today's dollars for a future price? That's negative interest and negative return.

�A Utah-style angel arrangement where the note is not convertible, but merely a seed loan in exchange for equity ... is a humorous but sad financial arrangement.�

This funding method was developed by UTFC and has worked for many companies. Angel investors line up to do a side-by-side investment with UTFC because UTFC is so good at due diligence. If the entrepreneur truly believes his business will be worth 10X in a few years from now, then this type of financing is the lowest cost of capital. Do the math? Yes, do the math.

�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.�

Is that what entrepreneurs really want? For the few angel investors Utah has to stop investing? Given the fact that many of us see five to seven deals per week each, it seems to be an important source of capital for the Utah market. Who will pick up the slack?

�I think sincere investors want the Utah technology sector to grow and be successful, but we 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.�

Isn't cold, hard cash "skin in the game?" We have never met any active angel investor in Utah that is apathetic. To us, real arrogance is to judge one without having been in his shoes. That is, how much have the critics invested? Truly? Many people give advice, but don't write checks. The true definers of the marketplace are those who write checks.

�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."

The personal guarantee on debt builds in self-discipline and shows skin in the game. The entrepreneur tries harder to survive and preserve the investor's interests. Most experienced investors will tell you their many horror stories of entrepreneurs with no skin in the game who walk away and leave the investors holding the bag. This is about shifting risk unduly to investors. It should be a partnership in risk, not a one-sided affair where the investor is lucky to get to invest in the entrepreneur's sure thing.

Read the sidebar box at the end of the article (it needs to be read in its entirety) containing quotes from the subject article. The first two of these we have never heard. In fact, we require all entrepreneurs � even the so-called sophisticated ones � to create a thorough financial projection and a capitalization plan, which usually reveals that the entrepreneur was way off on his business plan. We educate and enhance the entrepreneur; we do not prey on idiots. A bad deal is a bad deal. We want to get paid back. Only smart, educated, experienced people pay us back. The third has some merit. Debt is senior to equity. We are always happy to hold debt when things go south compared to being an equity holder. The fourth is accurate. Why would an investor take a worse deal than what the market is doing? Altruism? We all have better recipients for our altruism than funding the lifestyle of a low-risk-taking entrepreneur!

The quotes the subject article shared from "seasoned out-of-state investors" were largely comments from those in the larger markets with more available angel capital. They may be right for their markets.

Quotes are fun. Let's take a quote from Bill Payne, one of the nation's leading angel investors and educators:

�Convertible notes are also a convenience to investors, since they generally remove the risk of equity investments at valuations that prove to be too high. However, in many cases, pricing the conversion at a small discount to the next round can be unfair to the early-stage investor, when closing the next round takes much longer than anticipated, or when the valuation of the company is growing rapidly. One could conclude then that convertible debt limits both the downside risk and upside potential for these investors.�[2]

PriceWaterhouseCoopers adds:

�If the business opportunity you are pursuing is the purchase/ expansion of an existing business, you may want to consider various debt instruments. Advantages include retaining equity, fixed interest payments and flexible payment/payback terms. Convertible debt is useful for companies that have a high degree of risk but do not want to give up a large portion of equity. The conversion feature of convertible debt is attractive to investors or banks who typically make loans but require equity for their added risk.�[3]

Those more "sophisticated" people in Massachusetts say:

�... private debt, in the form of a first-round private investor financing, may be available. Many private investors like the security of debt because it is paid ahead of equity, while insisting on some participation in the "upside" of the business's performance.�

�For these transactions, convertible notes, which are issued for a stated term but are convertible at the holder's option on maturity, might fit the bill. Most of these notes are unsecured, subordinated to future commercial debt, carry an interest rate of prime plus 2 or 3 percent, and are convertible either into common equity at an agreed valuation up front or preferred shares based on the valuation set by the next outside venture or institutional round.�[4]

Apparently, others are doing "Utah-type" convertible debt and find it useful. Maybe Utah is ahead of the curve?!

Our research into the practices in Massachusetts helped us discover something we might want to implement in Utah:

Early-stage companies also may try performance promissory notes, which offer investors above-market coupon rates as well as percentage participation in the company's actual revenues or profits from a division or particular product within a set period of time. The key to offering these investor incentive terms is to build in a mechanism for terminating them or offering a "buy-out" later on if necessary when the company might be sold or hopes to complete a subsequent financing round with venture investors. These transactions often can be done quickly and efficiently and without SEC registration under Section 4(2) or Regulation D under the Securities Act of 1933.[5]

Note that innovative angel techniques generated from outside Utah (and recently introduced during a visit by Bill Payne to Utah)[6] include items the subject article's author might find incredibly outlandish: founder vesting.[7] Read the footnote for details.

One especially useful comment in the subject article centered on the concept of a "dirty cap table." We all hate "messed up" cap tables. And they happen for many reasons �more often from bad terms, not debt v. equity. Almost every major VC fund in the state and even several outside the state have made follow-on investments to Utah-type debt financings[8]. Still, in the end, angel investors with debt have real control. Angels with equity do not. Why would any investor want to give up the little control she might have?

Some of the subject article's criticisms (such as the example where $50,000 results in 25 percent ownership) are really about bad "friends and family" or "fellow founder" situations. That is what messes up cap tables. We also discourage poor F&F or improper founding deals. We preach about messed up cap tables. Convertible debt structures (including some of those criticized) do not create messed up cap tables. Bad terms, whether equity or debt, do.

Many of us moved from the areas sporting the kind of deals the subject article espouses as the "right" way to do startup investing. Unfortunately, calling one market's way wrong when it has developed naturally due to market forces is possibly counterproductive if people believe that a wholesale change could be accomplished overnight. It cannot, because the laws of supply and demand are immutable. Case in point: Utah followed Silicon Valley in the days of the dotcom era and investors plunked down huge amounts of investment capital without even seeing a business plan or meeting all the principals � often sight unseen � why? Because there was so much money in the U.S. economy that everyone in the nation did it. Then, the merry-go-round stopped. The money dried up and things returned to normal, as defined by market forces. Utah's post-dotcom style of funding ventures exists because the combination of quality deals, quality management teams, quality talent, available angel money, follow on capability by institutions and many more factors have fostered the situation as it is today.

One antidote is more angel money in the marketplace. We need competition for the deals. Recently, in the past few months, there have been deals where multiple investment parties have competed for deals and entrepreneurs got better deals and terms. Imagine that! The message is: if you are good, if you are worthy, if you can demand the respect of the marketplace, you will get money and it will be on excellent terms. That's the real secret antidote to so-called poison in the well.

Numerous active investors who have invested individually millions and collectively tens of millions of dollars in deals contributed and/or support this contribution including Rick Farr, Stephen W. Gibson, Kyle Love, Joseph Ollivier, John E. Richards and other un-named individuals.

SIDEBAR:

From the subject article:

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 the market. That's just the way it is."

FOOTNOTES:

1 While all macroeconomics involves both supply and demand, supply-side economics emphasizes the importance of encouraging increases in supply.

2 www.entreworld.com/Content/EntreByline.cfm?ColumnID=595

3 www.pwcglobal.com/Extweb/industry.nsf/docid/0ABEAF6CB88B073985256AC5007E1856

4 www.masshightech.com/fin03_05.asp

5 www.innovationavenue.com/print-finance-fundingnonvc.htm

6 Bill Payne, noted angel investing expert, presented near the University of Utah earlier in 2005 and previously in 2004 at the National Association of Seed and Venture Funds (NASVF; see www.nasvf.org) held in Salt Lake City. In fact, Steve Grizzell of UTFC Financing Solutions in Salt Lake City is the Chairman of the Board of NASVF (see www.nasvf.org/web/nasvfinf.nsf/pages/Board). This type of activity counters the claim that Utah is off in its own world.

7 Founder Vesting. A term imposed on founders of seed and early stage deals in which the founder ownership is subject to a vesting schedule with nothing up front and linear vesting over, typically, four years. The first 12 months ownership is often "cliff" vested after the first year with monthly vesting thereafter. For more mature companies, vesting credit can be applied at the time of investment. The purpose of this term is to protect investors from an early, unplanned exit by the founder and to provide investors with the equity necessary to attract a new management team. (http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=322)

8 List of venture capital firms that have followed angel or UTFC debt deals available from UTFC upon request.