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VENTURE DEBT AVAILABLE AT A PRICE

by Paul Springer

While many borrowers are finding themselves shut out of bank and hedge fund financing, venture lenders are still actively lending.

Inclement credit markets have driven some venture lenders into portfolio management mode and others have fallen off the map, but many are disbursing liquid capital, albeit more cautiously than ever.

While equity venture capital investments may have a horizon of 10 years or more and are generally made without much expectation of interim cash flow, venture loans feature terms as short as one year or less and flexible payment structures that often lack the stringent covenants of bank debt.

California Capital Partners (CalCap) managing director John Nelson told *The Distressed Debt Report* that venture lending is accounting for an increasingly larger portion of venture capital investment.

"We're evangelists for venture debt," Nelson said. "This is a growing segment that's risen from 1% or 2% in 2002, to 7% in 2006, and 10% in 2007 of the total venture dollars. With economic conditions as they are now, it's even a better option than before, and when a bounce back occurs we'll be one of the healthiest recoveries."

Wellington Financial, a Toronto-based venture lender, publicly announced in January that it was ready to lend with capital from two new institutional limited partners. The new partners brought $24.1 million to the table, increasing the size of **Wellington Fund III** to $150 million. While traditionally focused on Canada, Wellington plans on investing in the U.S. with its new capital.

Mark McQueen, Wellington's CEO, told *The Distressed Debt Report* that venture loans can offer borrowers an advantageous alternative to equity financing, while his funds' structure is beneficial to investors. The funds have an eight-year recycling period, which means that capital from one loan can be reused for another after a repayment.

This timeframe frees Wellington from pressure to meet redemption requests and enhances returns, McQueen said.

"The benefits to the limited partners are clear—the J-curve is a lot shorter because the fund is invariably kept smaller, lower management fees, and it invariably means a higher net return for investors," he said.

Venture lending pioneer **Hercules Technology Growth** is continuing to make venture loans, but not at last year's pace. "We are actively originating new deals," Hercules CEO Manuel Henriquez said. "But we are dramatically lesser in term of dollars originated than we did a year ago. We're picking our shots very closely."

Venture lenders who source capital from commercial banks rather than limited partners are feeling the broader credit crunch. Henriquez said bank capital is still sparse. "It doesn't exist," he said. "Even we can't get bank financing now. We actually secured a $50 million line with **Wells Fargo** in August. But right now the banks are all trying to figure out their own participation in the TARP program."

Henriquez said Hercules is also using a federal line of credit obtained through the company's small business lending unit. "We have about $127 million drawn on our SBIC line, which is 10-year capital from the U.S. government." (Under the SBIC, or Small Business Investment Company program, the U.S. Small Business Administration guarantees some loans to small companies.)

Borrowers who do obtain venture debt are not going to find rates in line with what banks might have offered in the past, but venture debt is still cheaper than equity. "There are some pretty sophisticated people out there who understand the cost of equity is always going to be 35 or 40%," Wellington's McQueen said. "If you can't get a bank loan and you don't want to raise any more equity, venture debt is substantially cheaper by more than half and is tax deductible as well."

Other venture lenders agreed that rates are on the rise. Mike Selfridge, western division manager for **Silicon Valley Bank**, said venture lending rates are correcting upwards from a time when pricing was too low. "You saw more entrants into the market in 2005 and 2006," he said. "It started getting fairly frothy in the venture lending market."

"So the price has gone up," Selfridge says. "Even double-A-rated corporations are borrowing in the 7-11% range, so the stream rates have gone up on venture debt. Bellwethers are in the 10%-plus range, and the warrant coverage has gone up, generally in the 8% and up range."

Ron Swenson, investment partner and founder of **Western Technology Investment**, said that unrealistically low rates last year reduced his firm's participation in the market. "We didn't feel like we were getting paid for our risk in the second half of 2008," he said.

"You still had some of the banks out there that are pretty aggressive in our space, and I think they've finally woken up and are smelling the coffee now and are bringing their pricing up," Swenson said. "As a result we probably lost a lot of deals in the second half of the year after we bid them because we moved our pricing up."

Swenson said Western Technology has most of a $250 million fund's capital available to invest, but he's being very cautious about using it.

Rob Winkelmann, CEO and managing partner of **DiBari Group**, an advisory that works with borrower management, also noted ramped-up pricing, especially for creditors who are not securing loans. "Pricing has clearly changed," Winkelmann said.

"The asset-based loan pricing hasn't changed that drastically, but the growth capital and term loan pricing has gone up about 600 basis points over the last six months," he said. "**Pfizer** is borrowing at 9%. So venture lending growth and term interest rates are in that 13-15% range. I think historically there was too much venture debt in the markets, and I don't think lenders were paid for the risk they were taking."

Fred Wang, general partner with traditional venture capital firm **Trinity Ventures**, said that unreasonably low rates may have facilitated the funding of some weak companies.

"The venture lending business went through a period in 2006 through 2008 where there was just too much capital on the table," Wang said. "Lenders were beating themselves up with the terms. Now the bottom portion of the borrowers is having trouble, but the other well-run start-ups backed by good VCs are still active in venture debt."

Venture lenders have traditionally enhanced their investments with warrants attached to loans, and warrant coverage is going up with rates. **Agility Capital** Chief Operating Officer Jeff Carmody said that warrants are increasingly on the table. "On a current interest basis we'll get a 1 to 2% loan fee, and double-digit warrant coverage, 15 to 20% coverage, maybe more. We've even gone beyond warrant coverage and what we're looking at is percentage ownership of the company, though not at the level of an equity VC investor."

Trident Capital, a venture investor with $1.6 billion under management, offered one example of current pricing in bridge financing it provided to **ECO2 Plastics**, a recycling company operating out of San Francisco. Trident provided the company with bridge financing twice last year. The second investment, which took place in September, priced convertible bridge notes at 15%. The conversion price reflected a 40% discount to the company's stock price at the close of the deal, which also featured 50% warrant coverage.

Investors' increased focus on pricing risk means that potential venture borrowers face more scrutiny and due diligence than ever, while lenders intent on spreading risk may put less into any given deal. "We're looking for more granularity in our portfolio," said Eric Speer, managing director at **Vencore Capital**. "We're looking for smaller deals.

"And we've raised the bar on credit status," Speer said. "We no longer fund to projected positive cash flow. We're not bridging to rounds unless there is some really imminent investment reason. But our pipeline is full."

Aside from pricing that adequately reflects risk, venture lenders are also looking for potential debtors who have recently received equity backing or who offer an exit strategy that does not depend on an IPO.

CalCap focuses primarily on investments with foreseeable acquisition exits. The firm makes equity and debt investments in small and medium-sized technology companies. "You have to kiss a lot of frogs" to find desirable investments, managing director Nelson said.

He also asks questions about the effect the economy may have on the price a potential acquirer could pay. "What are the most recession- and depression-resistant businesses, and who are the most likely acquirers, because we don't even consider IPOs," CalCap asks, according to Nelson. "What kind of multiples have they paid in the past? And we divide that in three."

While venture lending continues, most market participants agree that in absolute dollars there will be less investing than last year. Still, venture lending capital is available, and some venture lenders believe hard times will weed out shaky businesses and leave fertile ground for more innovative companies.

"Some of the best companies in the world have been funded during difficult economic cycles," SVB's Selfridge said. "The message from a lot of VCs is that in terms of time diversification, this could be a very good time to start investing in great companies."

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