TECH FINANCE 101

By George S. Takach

You are the founder of a fast growing tech company in the fintech space. You have a great software product used by banks and other financial institutions, which you make available on a hosted basis to customers in North America, but increasingly in Europe and Asia as well. You are growing fast. You are currently number 4 in your market, but you have your sights firmly on moving up to number two, in terms of total sales and market share. You are scaling quickly internationally. You just opened offices in New York and Charlotte, but you would like to expand with a physical presence in London, Frankfurt and Singapore. Time is of the essence.

So far, you have been able to finance your growth through cash flow – those three early adopter customers in Toronto were a god send; they believed in you, they got a good price for being beta customers, and they helped you scale up the product and the business around the service. But now you could use $10 - $ 15 million to open those foreign offices, hire some senior sales people (selling enterprise software into the financial services sector is hard, and experience is expensive), and enhance the product offering with some additional customer facing features. You also have your eye on two acquisitions in adjacent markets to fill out your product offering.

Venture Capital

One option for you is venture capital. Today, your balance sheet has only one class of shares – so called “common shares”, which is the basic type of equity issued to founders and early seed investors. Common shares have three core attributes: each common share has a vote (primarily to elect the Board of Directors of the company, the Board essentially having oversight for the overall direction of the company, and hiring and firing the senior management team); the common shares are entitled to receive dividends when the Board decides the company will pay them (but most early stage, private tech companies don`t pay dividends); and upon any sale or winding up of the company, the holders of common shares receive the residual value paid by the buyer of the company after creditors are satisfied.

Venture investors usually purchase not common shares, but rather a “preferred share”, typically an instrument such as a so-called “Series A Share”. These are “preferred” shares because they have a preference over the common shares; but they are also convertible into common shares. So, for example, upon a sale of the company, the holder of a Series A Share would receive the greater of either: (1) the money they invested (if the purchase price for the company is fairly low, because the company has not done very well – this essentially gives the venture investor some down side protection); or (2) the percentage of the company they would hold if they converted their shares into common shares (this allows them to participate in the growth of the company’s valuation if the company does very well). Moreover, if the company is not doing well (but is sold) and the preferred shareholders get their money back, they do so before the common shareholders are paid even a penny.

Another preference for the Series A Shares is that if the company is not doing very well, and (instead of being sold) it issues additional shares at a price per share less than what the venture investor paid, then without having to pay more for its original Series A

Shares, the venture investor would receive more of those shares at no additional cost (the actual amount depends on how much money was raised at the lower price per share). Again, this so-called “anti-dilution protection” is a feature not extended to the holders of common shares (the commons would be diluted on a so-called “down round” of subsequent investment).

The holders of Series A Shares will also be given various other preferences over the common shares; for example, there will be certain actions, such as the payment of dividends, that will require the approval of the Series A Shareholders, even if the Board votes in favour of the measure. Moreover, the Series A Shareholders will typically have a seat or two on the Board itself. In short, if you issue shares of your company to a venture investor, they will invariably rank well ahead of you on your balance sheet.

The True Cost of Venture Capital

Before agreeing also to an investment by a venture capital firm, you, as the founder of your company, also need to understand clearly what the “cost” is of this investment. Primarily, this is determined by calculating what percentage of the equity you will be giving up for the investment, and what that dilution represents when it comes time to sell the company or take it public in an initial public offering of shares (“IPO”). This in turn requires you to also model what you think the likely purchase price (or IPO issue price, and subsequent share price in an IPO) will be. None of this can be done with absolute precision (modeling the future in the tech space is an inexact science for sure), but at least you should get a sense of what you are looking at as an order of magnitude.

For example, I have been at more than one closing dinner, celebrating the sale of a tech company, where the founder leans over to me and says, “You know, for my 12 % of the sale proceeds, that was an awful lot of risk and tension”. In other words, the founders regret giving up as much of the equity of the company as they did. Put another way, the cost of the Series A Share investment was actually, in retrospect, quite expensive. (On the other hand, assuming the founder does end up with only 12 % of the final sale price – if the enterprise value of the company is very large, and that was a function of the assistance of the venture capital firm, then the cost of the Series A Shares was much lower). You get the idea.

Venture Debt

For all these reasons, in order to maximize the value derived from your balance sheet, in addition to considering venture equity capital, you should give serious thought to your debt financing alternatives. That is, instead of issuing equity shares of your company to an investor (who thereby becomes a co-owner of the company), you borrow money as debt, and issue a promissory note that requires you to repay the principal of the debt, along with an interest payment on the outstanding principal. We`ll call this “venture debt”, although there are multiple sources for this kind of lending, including banks, so-called mezzanine lenders, and increasingly some companies who specialize in venture debt, such as Espresso Capital.

Venture debt comes in several different “flavours and sizes”, and as with venture capital equity financing, you need to approach a number of prospective lenders to truly understand what alternatives are available to you. For example, some venture debt lenders amortize the repayment of the loan; that is, on a monthly basis you are paying

an amount that includes both interest and a portion of the principal. Other venture debt lenders, such as Espresso Capital, require you to pay only a monthly interest amount, with the principal being repaid in a lump sum at the end of the loan period.

Are Warrants Warranted?

Another difference between various lenders to tech companies is whether they insist on being issued warrants or not. You'll recall it was noted above that one of the big potential benefits of venture debt is that it can be non-dilutive; that is, the debt does not represent an equity ownership in your company – therefore, when you (for example) sell your company, you will repay the principal (and the accrued interest) of the debt, but then the lender will not also participate in the growth in the value of your company – all that growth will accrue to you and the early stage equity investors, such as any co-founders, "first" employees, and friends and family who may have invested upon the incorporation, or in the seed round, of the company.

There is, however, an exception to this result with venture debt, namely, if the lender (in addition to the usual loan arrangement discussed above) also requires that they be issued a warrant by the debtor company. Under the warrant, the company agrees to issue to the lender at a date in the future equity shares at a certain price, typically the fair market value of the shares at the time the warrant is granted. Then, presumably the value of the company (and the value of the shares underlying the warrant) will increase, such that on the ultimate sale of the company, the lender might have to pay the company $1.00 per share for the shares underlying the option (because when the warrant was granted each share of the company was worth $1.00), but then the lender will immediately turn around and sell each share for $5.00 to the buyer of the company. The incremental growth in value of $4.00 per share is pocketed by the lender and represents dilution to the founder and early investors (similar to the situation with the investment in preference shares by the venture capital firm, though usually the warrant is for a smaller percentage of the shares – but nevertheless, if the lender is insisting on being granted warrants, this equity dilution factor has to be taken into account as you cross compare term sheets from the different sources of venture funding).

Be Careful With All Financing

There are a few other risks of some venture debt deals you should be aware of. Some lenders, for example, will require, or at least ask for, a personal guarantee from you (so, that if your company falls on hard times, and cannot repay the interest and principal of the loan, the lender can collect these amounts from you, in which case your other personal assets may be at risk, such as equity you have in your house, or a cottage property, etc.). As a general rule, you`ll will want to avoid a deal where you have to provide a personal guarantee, if at all possible.

In a similar fashion, lenders will typically take security over the legal intellectual property in the assets of your company (such as the software used to power your solution), so that if you fail to pay amounts due under the loan, the lender can seize your assets and cause them to be sold to satisfy the outstanding debt (and you would be paid any excess received from the sale).

In short, while venture debt has some advantages to venture capital, it also has some elements that require close scrutiny and management. Nevertheless, you really should

consider both, so that you can understand what it would take to minimize equity dilution while still having additional working capital to fund the robust growth of your fast growth company.