

Venture Debt: Device Financing Lifeline or Anchor?

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Summary: Venture debt has become an increasingly popular financing option particularly among device companies. But, if not used properly, it can help sink rather than save a start-up.

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Venture Debt: Device Financing Lifeline or Anchor?

Venture debt has become an increasingly popular financing option particularly among device companies. But, if not used properly, it can help sink rather than save a start-up.

by Stephen Levin

Once largely the province of equipment leasing companies, venture debt has become an increasingly popular financing tool with life science start-ups.

Venture debt is particularly well-suited to device start-ups because they are milestone-driven, a fact that lenders like.

Debt can be used successfully both by start-ups that are doing well and those who are encountering difficulties, but the rules of the game are different than with equity financing. Failing to know the difference can be disastrous.

In the fall of 2004, veteran device executive Allan May, then President and CEO of peripheral device start-up Vascular Architects Inc. (VA), was chairing a board meeting discussing possible financing options for the struggling company when two of his venture investors suggested that VA consider using venture debt. May was no stranger to a variety of financing options—he had been CEO or chairman of more than a half-dozen medical device start-ups. But by his own admission, he wasn't familiar with venture debt, nor were several of the company's other investors. Based on his investors' suggestion, May contacted Maurice Werdegar, a partner with San Jose-based Western Technology Investment (WTI), a pioneer in providing venture debt, particularly to life science companies, and the two struck a deal that enabled May to finance the company toward a target of profitability. Things did not go as planned, however, and the two ultimately worked closely together to keep the company afloat long enough to negotiate a successful trade sale of the failing company's assets—avoiding what otherwise looked to be likely bankruptcy.

Vascular Architects represents an extreme example of how young companies have turned to venture debt to help either stay afloat—in the case of VA—or extend their current funding to achieve milestones that put them in a better position for their next financing round, IPO or sale of the company. Venture debt has become an increasingly popular financing tool for venture-backed life science start-ups, particularly device companies, who seem to be especially well-suited to using this type of financing because their development paths typically are marked by a clearly-defined series of milestones—technological, clinical and regulatory. Such milestones are important in venture debt because they serve as the basis for a relationship that lenders ideally look for as providing identifiable targets that can be achieved using debt. Indeed, long-time device executive and investor Rich Ferrari of DeNovo Ventures, who has relied on venture debt to help fund a number of his portfolio companies, estimates that 40% of device start-ups today use this tool at some point to help finance the company.

While useful in the right instance for companies undergoing tough times, it's incorrect to assume that venture debt is used mostly in the kinds of distressed situations that Vascular Architects, for example, found itself in. In fact, venture debt is most commonly used by successful start-ups to extend their financial runways in order to hit the next milestone and improve the company's standing for their next round of funding. Percutaneous valve leader **Evalve Inc.** is an example of a market leader that has gone that route twice in the course of its very successful financing history—having raised a total of \$117 million to date through its most recent Series D round. (See *"Evalve and Mitralign Deals: Heart Valves Draw New Device Investors,"* IN VIVO, December 2007 [A#2007800190].)

One point on which company executives, venture investors and lenders all agree: venture debt can be a helpful tool for companies if used in the proper situation, but if misunderstood and improperly used, it can trigger serious problems. "It's called venture debt for a reason, because at the end of the day, it has to be repaid," Allan May points out, only somewhat facetiously. In May's view, the most important factor executives need

to consider in deciding whether to use venture debt is choosing the right lender. "You need to be careful how you use debt and make sure you're working with a [lender] who understands your company's situation and will work with you so that you both achieve your goals," he says.

Venture Debt Follows Venture Capital

Talk to device start-up executives and venture capitalists about who they use as a source of venture debt, particularly in the Silicon Valley area, and the name that comes up most frequently is Western Technology Investment, which is among the pioneers in this type of lending. WTI pre-dates the rise of venture-backed life science start-ups, having been founded in 1980 by Ron Swenson, who remains the company's CEO. From the outset, the company differed from traditional venture debt lenders, most of whom got into the business as an off-shoot of the equipment-leasing industry (WTI was never a leasing company).

Maurice Werdegar, who joined WTI in 2001 and handles many of the firm's device deals, explains that the growth of venture debt can be directly tied to the growth of the venture capital industry, particularly in life sciences. "The big step in the growth of venture debt was the initiation of lenders providing growth capital," he explains. Unlike conventional debt, which is asset-based lending, venture debt provides a working-capital line for companies to use for whatever they want. "There are no earmarked purposes," he goes on. "You use it in the same way a company would use equity, with no strings attached."

With the growth of the life science and information technology businesses, first in the Silicon Valley and then elsewhere around the country, companies that had previously been in the traditional equipment-leasing industry, as well as new entrants like WTI, saw these new industries as emerging business opportunities. The problem was that these companies didn't fit the equipment leasing profile because they lacked the assets traditionally used to collateralize the loans, i.e., the equipment.

Andy Hirsch, a partner in the corporate finance group at Wilson Sonsini Goodrich & Rosati, who specializes in capital markets-secured lending and has been doing venture lending deals since the late 1980s, recalls the transition from equipment leasing to life science and IT lending occurring in the early 1990s. "Life science and technology start-ups began approaching lenders not for loans to buy equipment but just because they needed more cash on their balance sheets, often to show prospective acquirers or strategic partners that they had some staying power," Hirsch explains. "This resulted in lenders providing loans to these companies that were basically cash-collateralized."

While the idea of a company borrowing against its own cash may seem counter-intuitive, it proved useful for young companies in providing what Hirsch calls "balance-sheet window dressing." "Potential acquiring companies or strategic partners were largely interested in how much cash a start-up had on hand; they were not as interested in looking at their liabilities," he adds.

Over time, lenders began to recognize that the real credit in these deals was not the start-up *per se*; rather, it was the likelihood that there would be a follow-on round of financing or a reasonably-near exit. That led to the shift away from traditional equipment leasing in favor of what were initially called growth capital loans. With this developed what has become almost a symbiotic relationship between venture debt lenders and venture capitalists. The lenders essentially follow the VCs, pretty much relying on the venture investors' track records and due diligence to determine the *bona fides* of a particular deal, especially for early-stage companies. "With those seed-stage and Series A companies, lenders look at the track records of the VCs and assess the company's trajectory as to the likelihood that there's going to be a Series B; that's really what they are lending against in those cases," Hirsch says.

Balancing the Three-Legged Stool

In Maurice Werdegar's view, when done properly, venture lending deals resemble a balanced three-legged stool, benefiting each of the three parties involved—the company, the venture investors, and the lender. The

entrepreneur and the company's management avoid additional dilution because, in the end, they own a larger share of the company, says Werdegar, while the VC gets higher returns because they've put less capital to work and can see further company development before making the next funding decision. "And as the lender, we get our returns from interest and warrants earned on these deals, offset, of course, by losses on deals that don't work out," he explains.

Over the past few years, the growth of venture capital and venture-backed start-ups resulted in a proliferation of venture debt lenders—Werdegar estimates that just last year there were as many as a dozen firms competing for these deals. He groups them into three categories: banks, diversified financial institutions (often hedge funds and private equity groups, who have been the most recent entrants into this field), and institutionally-backed funds like WTI that focus exclusively on lending to venture-backed companies. Werdegar notes that recent economic events, particularly the tightening of the credit markets, have resulted in many of these most recent venture debt lenders re-assessing their commitment to the market, and he predicts that several will ultimately choose to exit, leaving the field once again dominated by banks and pure venture debt firms.

The different types of lenders have widely varying business goals and are comfortable with different levels of risk, and they structure their deals accordingly. Banks, for example, often use venture lending as a means of attracting new customers for their other banking services and therefore frequently include in their deals a covenant requiring the start-up to keep all of its cash with the lending institution. That can become a problem because banks, as well as some non-bank venture lenders, also often include what are called material adverse change (MAC) clauses in venture debt deals. These are provisions that kick in, as the clause's title reflects, when there is a significant negative change in a company's business, giving the lender certain rights, the most important of which typically is the ability to freeze a company's bank accounts. If the company is able to meet its obligations, such a clause does not present any problems, and even if a company does run into problems, a lender is not required to invoke such a clause. Indeed, Andy Hirsch, whose group has done more than 1,500 venture debt deals, points out that most of the time the parties resolve the situation without the lender triggering this provision. But the concern from the company's perspective is that, because most start-ups are likely to miss a milestone from time to time or run into some other unforeseen problem, the existence of a MAC clause can leave a cloud hanging over the company's future.

Werdegar says that including MAC clauses and other potentially punitive type of covenants run contrary to venture lending's goal of furthering a start-up's financial runway under both good circumstances and bad, and for that reason, WTI does not include those types of restrictions in its agreements. Indeed, Western Technology does not include those covenants in its agreements, due, says Werdegar, to the company's having a higher risk tolerance than traditional lenders, a fact that the firm promotes as a competitive advantage. "Venture debt really serves only one purpose: to create runway extensions for companies to have extra capital in time to hit key milestones or to accelerate their growth," says Werdegar. "It doesn't serve the company well to take on a venture debt deal with covenants that actually prevent the company from using the money in certain circumstances where it may be needed most."

WTI's higher risk tolerance is, says Werdegar, something that differentiates it from other venture debt companies and influences how its venture debt deals are structured. Dedicated venture lending firms like WTI, which tend to be more comfortable with higher risk levels, often structure their deals with fewer covenants, offset by higher pricing, than bank loans.

Of WTI's risk profile, Werdegar says: "It may sound odd, but we are proud to say we've lost money in several deals because we're often willing to fund companies that may have fallen short of a milestone, and we never employ subjective defaults." He argues that, when a company has done many venture debt deals (over a thousand in the case of WTI), losing money occasionally on a deal means a lender is carrying out its end of the bargain. "We're not proud that we've lost money; we're proud of what that means—which is that our deal structures do what we say they will, which is they allow companies to actually use all of our capital. It's like buying an insurance policy," he suggests. Indeed, Werdegar claims that WTI is the most active player in the

venture debt industry, having done more than 400 deals in the last three years alone, divided among five partners. Roughly one-third of those deals have been in life sciences, with the vast majority of those being in medical devices.

Another distinction between the different categories of venture lenders is that they tend to lend at different rates of interest. Banks typically do deals at lower rates but, as noted, include additional terms such as deposit requirements and subjective default covenants.

Venture lending funds like WTI currently are doing deals at low double-digit interest rates with warrant coverage ranging from 5%–12%, depending on a variety of factors including the type of debt and the stage of the company; in some cases, the lender may also invest equity as part of the deal. Typically this debt is repaid in 36 months from when it is drawn, although some deals have draw periods of up to one year, while others may require that the money be drawn immediately. For WTI, deal size ranges from \$500,000 for a seed-stage company, all the way up to \$20+ million for a late-stage company. The firm's average deal size is about \$3 million.

With that average deal size, WTI's lending sweet spot is ideally suited to the needs of device companies, who typically are raising funding in much smaller tranches than their biotech counterparts. It is no coincidence, therefore, that, with one-third of WTI's portfolio in life sciences, the bulk of that is in medtech companies (although on a dollar-weighted basis, biotech and medtech may be of roughly equal value because the biotech deals are bigger).

Deal size is only one factor why device companies are strong candidates for venture debt financing. More important is that the typical development path of medtech companies, comprised as it is of a series of identifiable milestones, lends itself well to the predictable, target-driven approach that these lenders prefer. "There are very clearly defined milestones in medical device companies that are value-creating and well understood," says Werdegar. "Because those milestones are known to create value, the big risks with a device company typically are that timing problems will occur resulting from issues that are out of a company's control, such as clinical trial problems or regulatory issues." And it is precisely those kinds of problems that venture debt can help with. "Having a buffer of additional time, which venture debt can provide, is a pretty well-accepted concept in terms of giving a company an insurance policy against the unforeseen timing risks that are out of their control," he says.

The similarity between venture lending firms such as WTI and venture capital funds goes beyond a common customer base. The firms are structured similarly, with each getting their funding from limited partners. Also, venture capitalists and venture lenders are unregulated, unlike banks. WTI is currently on its 12th fund, the first seven of which were comprised of consortiums of individual investors; the firm raised its first institutional fund in 1994 and just closed its fifth institutional fund in 2007.

The venture debt model differs from venture capital when talking about the size of a fund and the amount of money available to invest since funds are essentially recycled as debt is repaid. WTI currently is investing at a rate of around \$400 million a year and has over \$1 billion of untapped investment capacity to put to work over time.

And while venture lenders' portfolios' performance are often compared with that of venture capital investments, such comparisons aren't really apt because the expectations of venture debt deals are lower with a steady but not spectacular return considered acceptable. Werdegar calls venture debt "a game of strikeouts, singles, and doubles, rather than home runs." "The trick," he says, "is not to strikeout too often."

Using Debt During Good Times....

Evalve is an example of a successful venture-backed company that has used venture debt twice to provide the type of runway extension Werdegar describes. Evalve was looking to gain additional time because enrolling

patients for its percutaneous heart valve clinical studies was taking longer than expected. The company worked with WTI and obtained debt financing both after their Series B and Series C funding rounds.

Most start-up CEOs try to avoid using debt, having been schooled on the "cash-is-king" mantra. But Ferolyn Powell, Evalve's president and CEO, believes that, while preserving cash is generally sound advice for emerging companies, in her company's case, the debt financing more than paid for itself by enabling Evalve to delay its next funding event until it achieved its next milestone. "By allowing us to hit a critical milestone with that extra run time, even though drawing down the debt costs warrants and interest, our experience was that it paid for itself by increasing valuation and avoiding dilution," she says.

Having used venture debt successfully twice (\$4 million and \$10 million, respectively), Powell believes there is a role for this type of financing for start-ups, though she cautions that debt funding should be used in a limited way, largely because it is expensive money. "If a company is confident they are going to hit their next milestone and will do their next financing without drawing on the debt, then I wouldn't use it because, while the warrants are reasonable, the interest rates are very high, meaning it could be money spent unnecessarily," she explains. Powell also points out that debt can raise questions with new investors in the next funding round, who may object to paying not only for the then-current valuation but also for the debt spent to reach the milestones that produced that valuation.

Ultimately for start-ups, however, the valuation proposition is generally more important than the cost of capital. If the debt can bring a higher valuation, then most companies consider it to be a worthwhile investment. In Andy Hirsch's view, "For early-stage companies, being able to extend their runway so they get a higher valuation with less dilution in their next financing round is more important than the expense of the capital."

Debt can also prove valuable for later-stage companies, according to Hirsch. "After a number of rounds, raising additional equity is often politically difficult among several series of investors, so venture debt can perform a service by not forcing these investors to go through a difficult negotiation; someone else just comes in and provides the capital and does so at lower cost than raising more equity," he explains.

In the current device start-up climate, where additional clinical and regulatory burdens have extended the time that investors need to stay with companies prior to exits, debt financing can play an increasingly important role. Even if a company does multiple debt deals over the course of time, if they are raising money at a better valuation by having used the debt to achieve key milestones, the result is that the company can be built with less equity and less dilution, as Evalve's experience shows.

Venture debt, however, is not the solution to every company's financing woes. An over-reliance on debt can severely burden a young company. And Maurice Werdegar notes that, "Debt can become like a drug: used the right way, it can really help a company, but used improperly, it can cause problems. That's because debt has this unique aspect to it: it has to be repaid monthly, and you never want debt to become the major topic at a board meeting."

....And When Good Deals Go Bad

Given the likelihood that start-ups are going to encounter at least some unanticipated growing pains, venture lenders like WTI typically maintain a glass half-full philosophy and are prepared to help these companies work through any number of potential problems in order to enable the company to repay the debt. "Our bet is always that a company, even if it experiences a number of setbacks, can still raise money, and if that fails, that there's enough residual value in the company that can be sold to generate a return," says Werdegar.

Vascular Architects is an example of a device company that appeared to have everything going for it, yet ran into unexpected problems and had to use venture debt to salvage a difficult situation. The San Jose-based company looked to have all the makings of a successful device start-up. Its technology for performing

peripheral angioplasty through a minimally-invasive procedure called remote endarterectomy, which consisted of VA's proprietary ePTFE-covered *aSpire* stent and delivery system, was developed by noted surgeon/entrepreneur, Thomas Fogarty, MD. The company's investors read like a "who's who" of venture and corporate backers, including Arch Venture Partners, Three Arch Partners, Domain Associates, and the Vertical Group on the venture side, and **Medtronic Inc.**, Johnson & Johnson Development Corp., and **Edwards Lifesciences Corp.** on the corporate side. Vascular Architects' system was designed to treat a significant unmet clinical need in what is acknowledged to be a huge market—peripheral vascular disease. And the company had an approved product that was on the market in the US. (See "*Vascular Architects: Going Against the Peripheral Flow*," IN VIVO, December 2004 [A#2004800239].)

The problem was that Vascular Architects discovered a defect in the product, after it was already on the market, that would require the device be redesigned. That redesign also had potential regulatory implications that would need to be resolved, and in order to do that, the company would need to demonstrate clinically that they had corrected the design flaw. To correct the problem, Allan May recalls, VA company officials established a series of specific milestones that the company needed to achieve across the product development spectrum—R&D, regulatory, and clinical. "These were very clear 'reach/don't reach' type of goals that we needed to hit in order to keep the company on track," May says. "We knew what we had to do; we just didn't know if it was possible to do it."

To finance the product redesign, Vascular Architects needed to raise additional funding through what was the company's Series E round. "We were able to budget reasonably accurately what this process would cost," May explains. "But the issue was ramp—something's always going to go wrong or take longer or cost more, and you don't know in advance what it is, and at this point for us, this was fairly painful, dilutive financing."

Vascular Architects made the decision to supplement its Series E financing with venture debt from WTI. This strategy enabled the company to raise less of the dilutive venture funding, yet still have access to additional financing should the redesign process take longer than planned. May says his decision to work with WTI was based on the lender's history of working with companies that had run into problems and coming up with creative solutions. "Maurice Werdegar convinced me that, in the event something did go wrong and we needed some flexibility on the debt, they would be a good partner," he says.

Werdegar's pledge proved prophetic, as Vascular Architects turned out to lack the resources needed to launch the new design and to complete the acquisition negotiations that had been ongoing with multiple parties. "Ultimately, the syndicate ran dry—investors were unable or unwilling to put more money into the company and they ran out of runway," Maurice Werdegar recalls.

Allan May was left with limited funds with which to try to arrange the sale of the company and those funds came primarily from the debt. At a time when venture equity was unavailable to the company, WTI stuck with VA, highlighting an important difference between the two. "We make venture debt decisions, not venture capital decisions," Werdegar explains. "Although it's very important for us to understand what drives venture capital, we have very different matrices for how we make decisions."

A venture debt lender's first bet is that a company, even if it experiences a number of setbacks, can still raise additional venture capital. But in those cases where it can't, the lender's second bet is that there is enough residual value in the company that it can be sold to cover the amount of the debt, as was the case with Vascular Architects. "As a lender, while I need to understand the nuance of what drives venture capital decisions, I don't need to replicate their due diligence in deciding whether to invest in a company," Werdegar explains. "What I need to understand is how to keep a management team together, even if their VCs have abandoned them, in order to structure deals that are win-wins for us and for the company. Those are very different skills than a VC needs."

In Werdegar's view, "There are a lot of good venture debt bets that are not good venture capital bets, and vice versa." If a venture debt lender were to invest alongside a venture capitalist on 20 deals, and let's say there

were 12 winners and eight losers: for the VC, these deals are basically binary bets—either a home run or a strikeout—with the VC backing the winners and abandoning the losers, and probably making a lot of money in the process. For venture debt lenders, however, that scenario is most likely to be a disaster. "Those kind of binary bets can kill a venture debt player because we can't hit home runs; the best we can do are singles and doubles, and they aren't enough to make up for the strikeouts," he explains.

Changing the Rules of the Game

Another important difference between venture debt and venture capital is that debt, by its very nature, can impose different obligations on a start-up company. This is most likely to occur when the company has had problems and is running out of funding, in which case debt can cause the rules of the game to change significantly. Allan May ran into this situation as he was trying to position Vascular Architects to be acquired. Armed with only limited resources, May's priority was to execute an M&A transaction, which would typically involve things like flying the company's engineers out to meet with potential acquirers and other similar expenses aimed at getting the company sold. He quickly found out, however, that because the company was being funded with debt, his fiduciary obligations as CEO had shifted. "If the time comes when you are using that money, the company can be viewed as legally insolvent, in which case the CEO's responsibilities shift to protecting assets to pay debtors, which can limit your ability to make the kind of decisions in running the company that you otherwise would have," May says. "That's why it's important to have a partner that will work with you to optimize the value for all creditors and all investors, to the extent possible."

Andy Hirsch points out that, from a legal perspective, identifying when a company has entered what in legal parlance is called the zone of insolvency, which essentially means the company is approaching insolvency but may or may not be there yet, is particularly difficult with start-up companies. That is because one of the tests of insolvency is a company's ability to pay its debts as they become due, and, by their very nature, start-ups usually don't raise enough money to pay all of the obligations they incur, knowing they are going to raise additional funding. "Viewed in terms of a classic test of insolvency, these companies may be insolvent from the start," Hirsch points out. In his view, a better measure of determining when a start-up company is reaching the zone of insolvency—and hence when management's obligations begin to shift—is when the chances of obtaining additional venture financing or an early sale of the company begin to diminish.

Once a company reaches that point, Hirsch agrees with Allan May that the interests of the creditors and investors may start to diverge, and the board of director's fiduciary responsibilities begin to shift toward the creditors. Having guided many companies through these rocky times, Hirsch emphasizes the need for boards of directors—often dominated by investors—to take actions to best preserve enterprise value for all stakeholders. "In a situation where a company is going badly, the investors and the lender need to recognize that neither will gain anything if the company is shut down," he advises. Hirsch's experience is that, in most such situations, the lender recognizes that it's in their best interest to allow the company's existing management to remain in place because they can almost always sell the company for more than could a new, inexperienced group. "In my 20 years of handling these deals, I have almost never seen one end up in court," he says.

Indeed, the endgame at Vascular Architects played out in exactly the manner Hirsch describes. Allan May was forced to downsize the company significantly, going from 50 employees down to five. May wanted to use nearly \$1 million—roughly 25% of VA's debt—to pay severance to these employees. "The company's problems weren't the result of having the wrong people or having people who weren't working hard," he says. "Ultimately, we ran into a series of technical and regulatory issues, and I didn't think our employees should bear that entire burden." He approached Werdegar with this proposal, and WTI agreed, with the understanding that May and his senior management team remain in place and use their best efforts to sell the company and repay all debt.

Typically, WTI will first look to restructure its deals when companies get into trouble, reducing their debt payments and extending them into the future. If the company is still unable to obtain additional funding, rather than impose a hostile foreclosure, Werdegar says WTI often enters into what he calls "friendly foreclosure." "This is where, with the consent of the board and management, we act as a heat shield against other creditors by technically foreclosing on the company, but we do it purely for the reason of keeping them out of bankruptcy court to best preserve the chances of the company either finding additional funding or being sold," he explains. In that situation, the company can limit its expenses by paying only its priority creditors, and typically WTI will negotiate an arrangement to keep the current management team in place.

Allan May sold Vascular Architects for an undisclosed amount to Wallace Enterprise, a Nashville-based investor group, which last year re-sold the business to **Lemaitre Vascular Inc.** for \$2.8 million. Looking back on WTI's decision to work with VA, Maurice Werdegar acknowledges that the company was backed by a "tired syndicate," but thought that with a product on the market and a promising next-generation device, the worst case scenario would be that other investors would provide the company with additional funding. "It turned out that we were wrong," he admits. "Things went far worse than we could have anticipated on every level. But we still ended up ok; we got out whole."

Timing is Everything

The real question for start-up companies, given the potential strings attached to venture debt, then becomes when is the best time to employ this type of financing? Ross Jaffe of Versant Ventures, who has used venture debt in a number of his portfolio companies, takes the view that companies should only use venture debt when they need a runway extension to either reach a significant milestone or enhance the company's ability to do its next financing round. In Jaffe's experience, taking debt just to make a company's cash last a little longer usually does not prove to be valuable.

Jaffe also stresses the need for companies to accurately model how much runway extension the debt will actually provide. "Most debt holders want you to pay it down relatively early, so in many cases, by the time you have paid the debt back, companies may find they get less than three months runway extension from it, which generally does not add much value," he says. Jaffe advises companies to look for debt to provide an additional six-to-nine months of time, during which ideally they would be able to hit a milestone and leave themselves plenty of time to raise their next round of venture funding, presumably at a better valuation due to the extra time afforded by having access to the debt. "If you're running out of debt right as you are getting to your next milestone, that is often not helpful because then the company is out of cash before you can raise your next venture round," he explains.

In Jaffe's view, venture debt makes the most sense for device companies as they mature and have commercially viable products. "The settings where I have found debt is best used in venture-backed start-ups is in the phase where you are starting to commercialize a company and are growing revenues. At that point, the debt enables the company to buy an additional six-to-twelve months of time so that they are able to get a much better valuation in their next financing round," he says. Jaffe suggests that venture debt is riskier in early-stage companies where a hiccup in R&D or clinical trials can wind up with a company running short of cash. "In that case, debt just adds complexity to the situation because now the CEO not only has to run the company and deal with investors, but also get involved with debt holders who are demanding payment," he says.

Allan May takes a different view, arguing that early-stage financing rounds and rounds in which a company is looking for a ramp extender are actually the best stages at which companies should employ venture debt. "Those are relatively safe rounds where there is minimal financing risk because the company can be fairly confident that their venture investors will step up and fund the next round," he says.

From a lender's perspective, Maurice Werdegar says WTI has no preference in terms of what stage of development a company has reached in order to be an appropriate venture debt candidate. Rather, it is simply

a matter of assessing the risk/reward factor, which varies both by individual company and by stage of development. In Werdegar's view, Series A/early-stage companies carry less funding risk because of the likelihood that venture capitalists will stick with them for at least one more round even if they stumble a bit. However, early-stage companies carry a greater technological or clinical risk that the product will fail, and at that stage there is little or no residual value in the company, which could prove a greater risk for a venture debt lender. On the other hand, Series C/later-stage companies have spent more capital so they run an increased funding risk, and if they stumble at that point, the venture syndicate may no longer want to keep supporting the company. But there probably will be more residual value in the company, in terms of technology and IP, which would be to the advantage of a lender.

Indeed, WTI has done several recent deals with companies that were looking to add venture debt either in conjunction with or just before or after filing their S-1s in preparation for IPOs. In those later-stage deals, the equity investors don't want to put more money into the company largely because they want to avoid the pricing issue so they don't set a pre-IPO price that could in any way result in a lower public offering price. Companies also don't want to look under-funded on their road show, so debt can serve the purpose of providing a balance sheet cushion both for companies about to go public, and for later-stage companies who are in negotiations with potential strategic partners. WTI has also done debt deals with companies after they've gone public, most often those who are delaying an eventual secondary public offering and using the debt to improve the company's position for the subsequent financing.

The only type of company that WTI would not consider to be a venture debt candidate is one that is struggling along and for which additional capital would not help it achieve any important milestones. "We don't want to be a bridge to nowhere," Werdegar says. Also, as noted, WTI is also not interested in working with companies that it thinks are taking on too much debt. Until the recent shift in the economic climate resulted in a tightening of debt sources, some companies were taking advantage of the increased availability of debt, often to their detriment. "We see companies asking for more debt than we think is healthy," he explains. When is debt unhealthy? "If things don't work out as planned, will the company's board and investors be willing to support our debt payments, or is the debt going to be the noose that kills the company?" he explains.

In the end, to be successful, venture debt has to be a classic win-win situation with both the company and the lender getting value out of the relationship. Maurice Werdegar summarizes venture debt for life science companies when he says, "It's all about measuring out capital in limited dosages to achieve maximum effect." "The venture debt message," he says, "is to complement each small round of equity with an appropriate amount of debt to maximize what the company is trying to achieve so that the next financing round's valuation is as high as possible."