

July 30, 2007

Venture Loan Gives Software Firm Needed Funding with Fewer Strings

By SIMONA COVEL
July 30, 2007

Matt Glickman didn't want his software company to take on debt.

As he watched one debt-laden company in Silicon Valley after another sink around him back in 2001, Mr. Glickman was convinced that paying back a loan "can force a company into bankruptcy that could otherwise do well."



Merced Systems Inc.

Matt Glickman

And the co-founder and chief executive of Merced Systems Inc. didn't want to sell any more equity. In return for \$2.5 million in venture capital, the company had turned over to investors about a third of the company, which is now six years old. That money was used to develop a product that was being installed at corporate call centers.

But the Redwood Shores, Calif., company needed more money to improve the product and grow the business.

So at the urging of an old business-school friend who had gone into technology investing, Mr. Glickman became a somewhat wary participant in the market for venture debt.

More Risk, Higher Rate

Venture-capital firms are known for giving money to young companies, particularly in high-tech industries, in exchange for a piece of the business. Venture debt, however, generally functions like a bank loan—but the lenders are willing to take on much more risk than traditional bankers in exchange for a higher interest rate and the right to buy shares.

If a young company can convince a venture-debt firm that management is strong and cash-flow prospects are healthy, it may be able to hang onto a bigger chunk of its business. "The longer they can put off [selling] equity," the more money founders are likely to end up with in their pockets, says John Richards, associate director of the Center for Entrepreneurship at the Marriott School of Management at Brigham Young University in Provo, Utah.

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With some hesitation, Mr. Glickman says he met with Maurice Werdegar, a partner at venture-debt firm Western Technology Investment and former Stanford Graduate Business School

raising money for a small business and talk with Matt Glickman and WSJ readers.

classmate.

Mr. Glickman also looked into bank loans, but quickly found that "banks are set up to loan to companies with assets," not to risky young software companies, he says. "I needed someone who understood the dynamics of the business."

After crunching numbers and some cajoling from Mr. Werdegar, Mr. Glickman says he and the board "came to the conclusion that debt used appropriately... is a perfectly good vehicle" because unlike the bankers he talked to, Western Technology wouldn't demand that the company cross certain earnings hurdles at certain times.

Fewer Hurdles

In December 2001, Western Technology lent \$1.25 million to Merced Systems, leaving the company with \$2 in equity for every \$1 in debt—a ratio Mr. Glickman was comfortable with.

The annual interest rate on the loan was around 10%, higher than a low-risk loan but lower than rates on some unsecured loans given to young and unproven companies. In addition to the interest, Western Technology received warrants, or the right to buy Merced stock at a certain price. While that means possibly giving up some shares, it's a far smaller chunk than an equity investor would take—and Western Technology doesn't have a say in how the business is run.

Unlike a bank, which might demand that a company meet earnings or cash-flow requirements, Western Technology would allow Merced to use the money as long as the company was still in business. Venture-debt firms are willing to waive those kinds of requirements because the lenders believe they know the patterns of growth a young technology company goes through.

Merced paid back the debt over 2 1/2 years, making monthly payments from its growing operating cash flow. The company, which now has 100 employees, posted more than \$20 million in revenues last year and hasn't needed to take on more venture debt or more venture capital.

In the end, Mr. Glickman says, taking on debt "was a great way" to hold onto more of the business.

Not every business grows so quickly, however. Mr. Werdegar notes that many companies turn to a venture-debt firm looking for a line of credit to hold them until they're able to secure another round of venture-capital funding. "People look at it as six months of extra time," he says. As a debt investor, "the bet we're making is that a company can raise additional capital."

FACT BOX

Company: Merced Systems Inc.

Founded: 2001

2006 Annual revenues: More than \$20 million

Employees: 100

Executive: Matt Glickman

Title: Co-founder and chief executive officer

Age: 41

Years in position: six

Biggest hurdle overcome: Leapfrogging competitors to become market leader.

Biggest success: Becoming the enterprise standard for operations-performance management for many Fortune 500 companies.

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