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ANOTHER TOOL FOR CLEANTECH

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Venture Debt – Another Tool for Cleantech

By Meryl Epstein, Brady Berg and Tavis Morello[1]

The proposition that clean technology is a hot area for investment is hardly debatable any longer. Venture capital investment in clean technology grew from just under $1 billion in 2002 to nearly $8.5 billion in 2008.[2] While 2009 was a down year for cleantech in absolute dollars, it was a particularly bad year for venture capital generally and cleantech performed relatively well compared to other investment classes. In fact, the third quarter of 2009 marked the first time cleantech as an investment category led all other categories of venture investing.[3] As markets begin to thaw in 2010, scores of cleantech companies have secured almost $2 billion worth of venture investments in the first quarter of 2010 alone.[4]

Venture debt typically follows venture capital's enthusiasm, and the venture lenders we have recently spoken with are eager to do more deals with cleantech companies. With the cleantech industry maturing and diversifying, it is increasingly difficult to paint the industry with a broad brush. That said, many cleantech companies are capital intensive and have relatively long time horizons before exits for equity investors are realistic. Those traits make venture debt particularly well suited to help finance the cleantech revolution.

Companies seeking financing often turn to both the equity and debt markets. Equity-based venture capital can be a viable source of funding for early stage companies but may not always be available on desirable terms and can have dilutive effects. Loan financing is more difficult for early stage companies to attract, as traditional commercial banks are typically unwilling to lend to companies who have not yet generated revenues and do not yet have substantial assets to pledge as collateral. Because of their capital-intensive nature and lengthy project timelines, cleantech companies may be more likely than other emerging technology companies to experience a funding gap. In light of these realities, cleantech companies in many cases will find venture debt—a financing structure containing both debt and equity features—to be a viable option. For some cleantech companies, venture debt can strike a desirable balance among risk, reward, and flexibility for companies, investors, and lenders alike.

Over the past few years, Mintz Levin has represented companies and borrowers in numerous venture debt transactions including cleantech companies in the wind, solar, coal, and other clean energy sectors. In this article, we begin by reviewing some venture debt basics and we conclude by answering some of the questions companies most frequently pose to us when considering venture loans.

How Does Venture Debt Work?

In a venture debt transaction, a lender provides capital in the form of loan financing to a venture capital backed company. In addition to interest and principal payments, lenders usually receive warrants as an "equity kicker," which gives them an upside opportunity to participate in the success of the company. In exchange, the borrower taps into another source

of capital to fund its operations until the next round of equity financing while minimizing dilution, as the warrant is generally less dilutive than another round of equity financing.

Venture capitalists (VCs) and venture lenders can mutually benefit from each other's investment in a company. Although venture capitalists take on the most risk by purchasing ownership interests in an early stage company, they also stand to reap greater financial rewards than venture lenders. Venture capitalists face the prospect of possibly never seeing a lucrative liquidation but can also hit the jackpot on a successful exit scenario. Venture capital investment also provides the groundwork for venture debt to be possible. The involvement of well-established VCs in a company signals to the lender that the VC has done sufficient due diligence and research and is confident enough to have skin in the game. Most venture lenders only lend to companies that have completed at least an initial round of venture capital funding and have procured intellectual property protection.

Venture lenders face a different risk-reward profile than equity investors. Rather than acquiring interests in a company, lenders make loans, which entitle them to a stream of present payments of interest and principal. If a company is successful, its lender will be repaid in full including interest at a favorable rate. Its warrant may also provide the lender with additional value based upon the future success of the company. If, however, a company is unsuccessful, the lender is first in line in a liquidation scenario; as a creditor, it holds priority over equityholders when staking claim to a company's assets.

Venture loans are available in several different forms. Equipment loans finance a company's acquisition of equipment and typically cover a percentage of associated soft costs. Growth capital loans may generally be used for any purpose. Revolving credit loans are advanced against a company's eligible accounts and therefore are only accessible to companies that have begun to sell product or services to generate receivables. Bridge loans are short-term mechanisms designed to get the company to the next financing or liquidity event. Depending on the form of loan, maturity dates can range from 6 to 42 months. Loan payments may feature an interest only period and certain loan fees may be back-ended.

Who Is the Best Lender for My Company?

A company's relationship with its lender is a critical component of successful venture debt lending. We encourage clients to be prudent in choosing a lender and to seek someone with whom they expect to have a long-term relationship. Venture lenders typically have strong relationships with established VCs and many board members have experience with particular lenders and loan officers. Investor and board input based on experiences with other companies can help inform the decision-making process. A lender should understand a company's business and goals, including its technology. When choosing a lender, a strong relationship may be more valuable in the long run than subtle differences in deal terms among lenders.

Good communication on both sides is paramount. Companies should use the initial term sheet and loan document negotiation as a courtship phase to really get to know the lender. While all parties are optimistic at the outset of a transaction, it's helpful to know how a particular lender will address the inevitable problems that many emerging companies face. Accordingly, we recommend asking careful questions to determine a prospective lender's philosophy and long-

term approach and to assess its willingness to continue to fund companies through rough stints, as well as its propensity for suing borrowers or otherwise exercising its remedies should a default arise. It is also useful to understand a venture lender's financial condition, its sources of capital, and whether such capital sources may impose restrictions on the lender's decision-making.

What are Market Terms?

Companies are always asking for input on "what is market" in terms of interest rates, warrant coverage, and deal structures. While it's not difficult to discuss the key terms of deals we've been involved with over the past few months (subject to confidentiality requirements, of course), "market" rates and terms always vary within a range. One smart method to gauge the market for your company is to solicit term sheets from several appropriate lenders.

Warrant term ranges are more predictable. The warrant strike price is typically the per share price from the most recent round of financing that has just closed or is imminent and the survival period of the warrant is typically from 6 to 10 years. Warrant coverage generally ranges from 3% to 15% of the amount of the loan. In addition to warrant coverage, the most frequently negotiated issues in venture debt pertaining to the warrant relate to registration rights, antidilution protection, and the relationship between the amount of warrants granted relative to the amount of monies advanced.

Must IP Be Included as Collateral?

Companies are often concerned that a venture loan will require a pledge of intellectual property as collateral. Determining which company assets will serve as collateral for a financing is a threshold question. Lenders naturally want their loans to be adequately secured and seek as much collateral as possible. For many pre-revenue cleantech borrowers, key assets are cash from venture capital raises and intellectual property. The most prevalent collateral structure is a blanket lien on substantially all assets, except that collateral for equipment financing is often only the financed equipment. Intellectual property such as patents, patent applications, and trade secrets (IP) are viewed as the company's crown jewels; investors and board members have strong views on IP as collateral and often regard a security interest in IP as tantamount to giving away the company. Equity finance documents sometimes prohibit a company from granting IP liens without the express consent of the shareholders.

Whether IP will serve as collateral continues to be a hotly negotiated issue in venture loans. While some transactions do include IP as collateral, the prevailing approach is that IP continues to be excluded from collateral, but subject to a "negative pledge." The negative pledge prohibits the company from granting an IP security interest to another party. If IP is included as collateral, the loan documents should be carefully drafted to permit the company to engage in licensing transactions.

Can the MAC Clause Be Eliminated?

Many borrowers loathe material adverse change clauses. A material adverse change (MAC) is defined to include changes in the business, operations, or conditions of the company that are, yes, both material and adverse. In loan documents, the absence of a MAC may be required as a funding condition, particularly for loans that are disbursed in several stages, permitting the lender to decline funding if a MAC has occurred. The MAC provision also frequently appears as a standard event of default. Borrowers worry that MAC clauses are too subjective and discretionary and question why a MAC clause is needed if the company is otherwise satisfying its obligations under the loan documents.

We have found that venture lenders' approaches to MAC clauses vary. On the one hand, many lenders favor MAC clauses as an additional metric of borrower troubles and potentially a catch-all event of default. For these venture lenders, the MAC is part of their standard documentation. While lenders are generally reluctant to invoke an event of default triggered by a MAC, and case law is not well developed in interpreting MAC clauses in the loan context, the credit crisis did create some imprudent lender action relating to MAC provisions. On the other hand, some venture lenders distinguish themselves by offering loan financing without MAC provisions. This flexibility, appealing to some companies, can come with less attractive pricing. Whether a venture loan will include a MAC clause should not be the sole factor in choosing a lender; while some companies and investors have felt burned by the actions of some lenders over the past few years, the MAC clause is not an insurmountable obstacle to a successful venture debt transaction.

At What Stage of the Process Should My Company Involve Legal Counsel?

Many of our clients have found that involving experienced legal counsel at the outset of negotiations with lenders helps to produce an initial term sheet that is more responsive to a borrower's needs. This ultimately facilitates a smoother deal by providing for a more efficient loan document negotiation phase and resulting in lower legal costs for the borrower who generally is responsible for the legal fees of both sets of counsel. Knowledgable counsel can help borrowers identify threshold issues that are best addressed at the term sheet stage before loan deposits are paid and significant lender fees and counsel expenses are incurred. The goal is to incorporate into the term sheet key deal terms from the borrower's perspective. Because the term sheet must be approved by the lender's credit committee, addressing key terms in the term sheet can hopefully obviate the need for the lender to return to credit committee for approval of changed terms. Because the warrant component is a smaller part of the transaction which is usually viewed primarily as a debt deal, warrant terms are sometimes overlooked; counsel knowledgeable about a company's overall capital structure particularly can add value by guiding the borrower to approach the warrant in a manner consistent with the company's overall equity structure.

Does Venture Debt Make Business Sense?

Despite its advantages, venture debt is not a one-size-fits-all proposition. Venture lenders generally seek out companies with strong prospects for subsequent rounds of funding and an experienced management team. Debt is more appropriate for companies that have attained

some financial stability. Unlike companies relying solely on equity funding, a company seeking venture debt must have a source of cash available over the course of the loan to make scheduled interest and principal payments.

Venture debt can be particularly strategic for cleantech companies that are capital intensive, have relatively long horizons to profitability and liquidity, and have a series of discrete milestones over the course of their development. For cleantech borrowers, the growth cycle from concept development to intellectual property protection, proof of concept, and the commercial release of a revenue-generating product will generally take years and will require significant capital. Depending on one's perspective, this long timeline can weigh in favor of or against obtaining debt financing. Loan financing is accompanied by negative covenants, and some companies are not willing to sacrifice their independence by being burdened by common lender restrictions. Other companies are prepared to accept the negative covenants as part of the price of capital.

A major advantage of venture debt is that it can help increase a company's valuations for subsequent rounds of equity financing or a liquidity event. Although debt can reduce a company's valuation, if the company leverages a loan towards hitting the next planned target—for example, securing IP rights on new technology or developing a prototype—the company's increased appeal to potential investors may well be worth that liability. Venture debt may also be suited for companies that have developed a regular client base but are relatively low on cash; a loan can both help finance operations while awaiting customer payments and also indicate market confidence in the company's staying power to future investors.

Venture debt can be a particularly useful financing vehicle for cleantech companies seeking additional financing options. Cleantech companies and their boards must judge whether incurring debt is appropriate in light of the company's particular needs, strategies, and other available sources of capital.

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[1] Meryl Epstein and Brady Berg are members and Tavis Morello is an associate of the Corporate Section at Mintz Levin.

[2] Press Release, Cleantech Group LLC, Record Number of Clean Technology Venture Deals in 1Q 2010 Finds Cleantech Group and Deloitte (Mar. 31, 2010), http://cleantech.com/about/pressreleases/Q1-2010-release.cfm.

[3] Press Release, Cleantech Group LLC, Clean Technology Venture Investment Continued Recovering in 3Q09 Spurred by Economic Stimulus Investment (Oct. 1, 2009), http://cleantech.com/about/pressreleases/20090930.cfm.

[4] Press Release, Cleantech Group LLC, Clean technology venture investment totaled $5.6 billion in 2009 despite non-binding climate change accord in Copenhagen, finds the Cleantech Group and Deloitte (Jan. 6, 2010), http://cleantech.com/about/pressreleases/20090106.cfm.