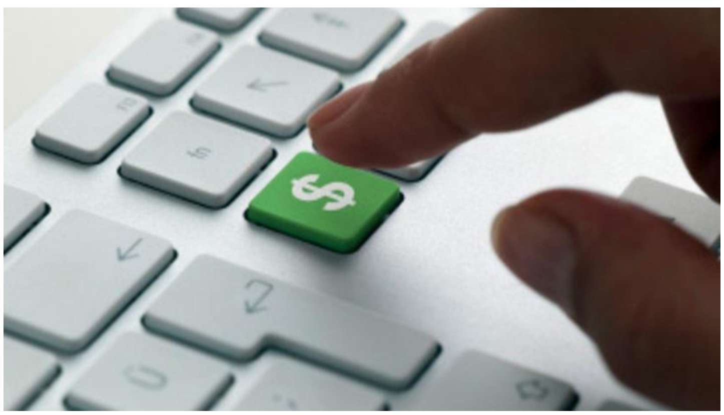
PART 1 OF 2:
NON-TRADITIONAL DEBT FINANCE FOR START-UP COMPANIES

Start-up companies in need of cash to get their business off the ground can look to raise money either through the issuance of equity or debt. Raising money by issuing preferred equity can be costly to the founding equity owners of a start-up, both in terms of the expense of negotiating and documenting the transaction and the eventual dilution of the founding owners' equity interests. Preferred equity investors also typically require



that founding owners relinquish some level of control of the business in exchange for their investment. On the other hand, early and mid-stage start-up companies often find it difficult to obtain traditional debt financing because they lack some or all of the attributes that most lenders require in order to make such financing available, including a proven track record of profitability and management of expenses, steady cash flow and accounts receivable, solid financials and valuable business assets available to serve as collateral.

For these reasons, early and mid-stage start-up companies should consider the various forms of non-traditional debt finance that may be available, depending upon the nature of the company's business and its stage of development, including convertible debt and venture debt. Convertible debt and venture debt can provide much-needed cash to a start-up company in between major equity raises, providing the company with additional time to grow the business, achieve important business milestones and, ultimately, improve the company's valuation before the next equity raise.

WHAT IS CONVERTIBLE DEBT?

Convertible debt is a hybrid of debt and equity financing, typically effectuated by the company issuing one or more convertible promissory notes. Convertible notes are debt instruments that convert into equity (usually preferred equity) at some point in the future, typically a future preferred equity financing event. Convertible notes contain all of the customary features of debt, including a promise to pay, a term, a maturity date, repayment terms and an interest component. Although convertible notes accrue interest, typically interest is not paid currently but is capitalized over the term of the note and added to the principal amount at that point in time when, or event upon which, the debt converts into equity.

CONVERTIBLE NOTES ARE DEBT INSTRUMENTS THAT CONVERT INTO EQUITY (PREFERRED EQUITY) AT SOME POINT IN THE FUTURE, TYPICALLY A FUTURE PREFERRED EQUITY FINANCING EVENT.

The key feature of a convertible note is the fact that, at some predetermined pre-negotiated time or event, the principal amount of the note and, potentially, the accrued interest thereon, will convert into equity in the company at a discount to the "price" paid by new equity investors for their company equity. The discounted price is effectuated through a "conversion discount" or "conversion valuation cap," or some combination of the two (described below), that is negotiated by the convertible note investor and the company at the time the convertible note is issued, along with the other economic aspects of the investment. The conversion discount and conversion valuation cap reward convertible note lenders for advancing money to an emerging company prior to a major equity raise.

Here's how the conversion discount works. If the convertible note investor and the company have agreed that the convertible note will carry a 20% conversion discount, then the principal amount of the note, together with the capitalized interest that accrued from the date of issuance to the date of conversion (depending on the note's terms), will convert into preferred equity in the company at a price that is 20% less than the price paid by investors purchasing equity at the next stage of equity financing. Assuming the subsequent equity investors purchase equity for $1.00 per preferred share, a $100,000 convertible note carrying a 20% conversion discount would convert into 125,000 preferred shares (without factoring in any conversion of accrued interest on the note). This compares to the 100,000 preferred shares that a new equity investor would receive in exchange for a $100,000 investment. Put another way, a 20% conversion discount allows the convertible note to convert into preferred equity at a per share price of $.80 as opposed to $1.00 ($100,000.00 / $.80 = 125,000 preferred shares).

A conversion "valuation cap" is another way to reward a convertible note investor for investing money in a start-up company prior to a major equity raise, particularly in situations in which the parties disagree on the company valuation or an appropriate conversion discount. The investor and the company agree upon a hypothetical maximum valuation of the company as of the time the convertible note is issued, known as the valuation cap. If the actual valuation of the company used by the equity investors as a basis for their investment at the time of the next major equity raise is higher than the valuation cap, then the convertible note will convert into equity at a discounted price determined by dividing the valuation cap number by the actual valuation number upon which the new equity investors base their investment.

For example, if the parties agree to a valuation cap of $2,000,000 and the valuation of the company at the time of the next equity raise is $5,000,000, then the convertible note would convert into equity at a per share price of $0.40 ($2,000,000 / $5,000,000) compared to the $1.00 per share price paid by the equity investors. Accordingly, the holder of our $100,000 convertible note would receive 250,000 preferred shares of the company at the time of conversion (assuming, for purposes of this example, no conversion of accrued interest on the note), whereas an equity investor that invested $100,000 would receive only 100,000 preferred shares. By linking the conversion price

to the valuation of the company at a subsequent equity raise, the valuation cap temporarily solves the issue of uncertainty or disagreement regarding an appropriate company valuation and discount factor at the time of the convertible note investment, postponing the determination until a later time when investors coalesce around an agreed-upon valuation. At the same time, the upside reward that a valuation cap provides to the convertible note holder is proportionate to the progress achieved by the company with the use of the convertible note proceeds.

ADVANTAGES OF CONVERTIBLE DEBT

From the company's perspective, convertible notes offer certain advantages over raising cash through the issuance of preferred equity. First, convertible debt can be issued much quicker and at much less expense than the issuance of preferred equity. The legal documentation is fairly straightforward, typically consisting of the convertible note itself, a note purchase agreement and an investor questionnaire.

Second, convertible notes tend to not be secured by any liens on company assets, as the investor expects to be "repaid" through the conversion of the note into equity, tacitly speculating on a company's future success rather than lending based on the value of its assets.

Third, if handled carefully, convertible notes can offer a company a great deal of flexibility regarding financing terms. In many financing rounds, typically all investors receive the same economic terms. With convertible notes, subject to certain conditions, the company can agree to different economic terms with each separate convertible note investor, including different

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- Offer a company a great deal of flexibility regarding financing terms
- Company can agree to different economic terms with each separate convertible note investor
- Can be issued without the parties agreeing on any hard valuation of the company
- Founding equity owners typically are not required to relinquish a significant degree of corporate control

conversion discounts and valuation caps. Convertible notes also can be issued without the parties agreeing on any hard valuation of the company, which is often difficult in the early stages of the business. Finally, contrary to venture capital equity raises and traditional debt financing, when issuing convertible notes, the founding equity owners typically are not required to relinquish a significant degree of corporate control or agree to adhere to a laundry list of covenants and restrictions, as they would in a traditional debt financing.

NEXT WEEK - PART 2 OF 2:
NON-TRADITIONAL DEBT FINANCE FOR START-UP COMPANIES

In the next installment, we will take a closer look at the different forms of financing known as "venture debt," and compare venture debt to convertible note financing and preferred equity financing.