LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

Growing Pains: Growth Capital Sources and Considerations

By Kathryn Hickey

At a certain point in a company's life cycle, founders are likely to be faced with the financial pinch of requiring outside sources of funding to finance further growth and expansion of the business. Once bootstrapping ceases to be an option, there are two main avenues to pursue for growth capital: traditional bank debt or private equity investment. Both options present pros and cons, and they are not mutually exclusive. Ultimately, the route founders decide upon will depend on the objectives, limitations, and concerns specific to their organization. This article will map out a high-level overview of the characteristics and considerations of different growth capital financing options.

Debt Financing

One of the most attractive features of debt financing is its familiarity. Unlike the often unfamiliar complexity of venture capital investments, the basic outlines of a bank loan or line of credit are familiar to the average commercial consumer. Beyond this comfort level, the strongest argument in favor of traditional lending is the ability to avoid giving up ownership of the company and maintaining (nearly) absolute executive control. In most bank loan transactions, the lender will not require a board position or a role in company management. The debt will also be carried on the books of the company as a financial liability only and will not dilute the equity holders' ownership in the company. This can be attractive from a capitalization table perspective because it keeps the number of owners low and the ownership structure relatively simple (although beware of over-leveraging, which could diminish the interest of future investors). Typically, when taking on debt financing, the founders will retain the ability to direct and control decision-making for day-to-day operational decisions. Keep in mind, however, that banks often will require certain limited negative controls or negative covenants that limit the company's ability to engage in certain extraordinary transactions without triggering an event of default under the loan documents unless the lender's prior consent is obtained.

The primary drawback associated with traditional lending is that the debt will always have to be repaid. Unlike in venture capital deals, where return on investment is significantly contingent upon the success of the company, bank debt is an absolute liability with a maturity date. Collateralization requirements will put company assets at risk if payments on the loan are not made in a timely manner. Another key feature that can deter founders from seeking traditional debt financing is the potential that an institutional lender will require personal guarantees, which is especially common when the borrower is a relatively young company. Unless founders can successfully negotiate out of personally guaranteeing loans to the company, debt financings can be risky endeavors for those engaged in early-stage ventures.

Finally, while some lenders have more appetite for risk than others, the terms of traditional bank debt are likely to be more conservative that those that may be available from some private investment funds.

Equity Financing

Private equity investments can be intimidating for many founders because it is a relatively foreign landscape. It is worth it, however, for founders to educate themselves

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on the basic principals involved in venture capital deals, as these can be valuable sources of financing to fund a company's leap to the next level. Minority investment venture capital deals can be employed at various stages of company growth. Typically angel round financing or seed round financings will come in without a fixed price. At this stage, an investor will likely take a convertible note or a SAFE (simple agreement for future equity). These instruments are similar in that they both involve the investment of funds with an agreement to roll that investment into the next round of equity financing of the company, often at some discount or capped purchase price for that future round. The primary difference between convertible notes and SAFEs is that convertible notes are true debt instruments that carry interest and will require repayment upon maturity if they do not convert according to their terms. SAFEs, on the other hand, are not debt instruments and reflect the simple agreement between the company and the investor to convert the investment into future equity if and when another financing round occurs. SAFEs are generally considered more company-friendly, and it may be difficult to persuade a sophisticated investor to invest at an early stage via a SAFE rather than a convertible note, which offers more investor protections.

Once a company is considering a financing round beyond the seed funding stage (typically taking the form of an issuance of "series A" equity interests), there will be a pre-money valuation agreed upon between the investors and the company, which will set the price for the round and dictate the amount of dilution that the round will generate for the founders. Series A and later rounds typically feature various investor protections, which can include a liquidation preference and/or an accruing dividend on the initial investment amount, board seats and/or board observer rights, negative control protections, preemptive rights with respect to future rounds, rights of first refusal on transfers of equity, and anti-dilution protection. Private investors may also require the company to set an increased employee equity incentive pool pre-investment (to avoid dilutive grants post-investment) and/or impose restrictions or vesting requirements on existing founders' equity. At the end of the day, however, the right private investors can provide meaningful contributions as strategic partners with valuable management and executive leadership experience. And because private investor returns are primarily tied to company success, they are attractive in that repayment depends largely upon performance.

A Word of Caution for Small Business Contractors

It is important to note that many of the features typical of standard venture capital investments may be prohibited for companies that rely upon their status as small businesses because these investment deals, if not carefully structured, can result in undesired deemed affiliation with larger investment funds. Structuring concerns are of even greater importance for companies in the 8(a) program or other state-level set-aside programs, for which many standard venture capital investor control/voting rights are considered impermissible. Note that if your company fits into any of these categories, it is vitally important to consult with your legal advisors to determine what structuring options are available prior to seeking private financing.

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