

An overview of technology financing in Vermont and a primer on “Venture Debt”

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During the past decade there has been a fairly significant increase in technology company financing in Vermont from a wide variety of sources.

- 1) FreshTracks has five Vermont technology companies presently in its portfolio (GroupZoom, Draker, BuySideFX, Patient Engagement Systems and Kohort) In late 2012 we sold our interest in another technology company, NEHP to CPS which is a Vermont headquartered technology company. Our new third fund has issued commitments to finance two additional Vermont technology companies. Of the opportunities in diligence approximately 80% are technology companies. We typically invest in preferred stock which depending on structure is a hybrid of equity and debt. We have invested in approximately half of the venture capital financings in Vermont during the past decade. It’s also important to note that venture capital financings doubled (by number) from the 1990s to the first decade of the new century.
- 2) The Vermont Center for Emerging Technologies Seed Capital Fund has made a number of investments in technology companies.
- 3) There have been notable private equity investments made by non-Vermont financial firms in prominent Vermont technology companies including Dealer Dot Com (prior to the recently announced transaction), MyWebGrocer, and CPA Site Solutions.
- 4) VEDA ran a technology lending program which made loans to many Vermont technology companies. The lender managing this program has subsequently left VEDA and I am not sure what the status of the program is at present.

Technology companies generally take many years to build balance sheets strong enough to support traditional bank financing. Technology companies are best backed by equity capital as they are building their balance sheet, however, there are some specialty lenders which finance certain types of technology companies using debt capital or provide certain types of non-equity financing to technology companies. In general this type of financing falls into the following buckets:

- 1) Mezzanine Debt. Mezzanine or “junior secured” debt typically is secured by assets although the mezzanine debt position is junior to a senior creditor and in liquidation even a secured mezzanine loan may have a significant collateral shortfall. To compensate for risk mezzanine lenders typically charge higher interest rates than senior creditors (in today’s market these rates range from 12% to 18%) and typically receive an equity “kicker” in the form of warrants to purchase stock in a company at a favorable price. From 1993 to roughly 2000 Vermont had an active Mezzanine lender in the form of Green Mountain Capital, although it did not finance many Vermont technology companies. In 2007/2008, VEDA invested in Brooke Ventures a Massachusetts based mezzanine debt fund. This investment was contingent upon Brooke investing the Vermont investment dollars in Vermont companies. Brooke made two investments. One a software company has ceased operations. The second was in Mobile Medical located in St. Johnsbury. Mezzanine lenders such as the old Green Mountain Capital and Brooke Ventures are usually chartered as Small Business Investment Companies or SBICs which are regulated by the SBA and can borrow money from the US Treasury. Green Mountain

Capital was a Vermont licensed lender while Brooke Ventures was not. Brooke was exempt from licensure as long as its Vermont loans were each greater than \$1,000,000.

- 2) Venture Debt or Venture Leasing. This type of lending is also typically secured lending and is performed by the specialty lending arms of chartered banks or by specialty finance companies. Banks that perform this type of lending include East/West Bank, Square 1 Bank, Silicon Valley Bank, Comerica Bank and others. Note that chartered banks are automatically exempt from Vermont's licensed lender laws. Venture lenders do not typically finance start-up ventures and instead they finance companies that have been already backed by significant venture capital firms. For instance Draker which is one of our portfolio companies has a large loan from Silicon Valley Bank. I suspect that there is not a Vermont bank that would finance Draker today. However, Silicon Valley Bank is completely comfortable making this type of loan because it has considerable experience in evaluating and underwriting venture backed technology companies. Draker is not a startup company and will achieve approximately \$10 million in revenue this year. I have always found it fascinating that Vermont bankers will swear that they can't make loans to companies like Draker because of "regulation" yet SVB and other banks which are regulated by the same national regulators make a robust market in these loans. Again though I note that Venture Debt is not granted to start-up companies and is typically only granted to companies that have significant venture capital financing already. The easiest way to increase the amount of venture lending in the state is to increase the amount of Venture Capital backed companies in the state.
- 3) Non-Banks such as the Vermont Community Loan Fund and VEDA. I note that the Vermont Community Loan fund made a loan to Draker in its early years although it used real estate owned by the founder as a source of collateral.

It remains my opinion that one of the biggest impediments to lending activities in Vermont is the Vermont licensed lender law. To refresh your memory secured lending in Vermont is governed by regulations that require licensure. Exemptions are granted to chartered banks, to lending entities that only make secured loans more than \$1 million in size each and to lenders whose entire secured lending portfolio is less than \$100,000. Unsecured business lending is exempt also. I suspect that many business constituents you hear from who are complaining about access to credit are complaining about not being able to find credit of more than \$100,000 but less than \$1,000,000. This is the exact range of credit that is squarely governed by the law and where there are limited exemptions to licensure. In practice though the existence of the licensed lender law tends to confuse lenders and stop even those who might technically be exempt. I recently had a conversation with a representative from a lender called FundBox based in New York City that has an innovative unsecured lending program in which the credit underwriting is primarily performed by an algorithm that analyzes business pay pal account activity and grants credit based on certain characteristics in the pay pal account. Fundbox's attorney had told them not to do business in Vermont because of the licensed lender law. I pointed out to them that since they only made unsecured loans I suspected they were exempt from the law. However, their lawyer disagreed. The mere existence of the law spooked them. When you combine the small market size and limited market opportunity in Vermont with a complicated law it's no wonder we do not have innovative lenders flocking to the state. It's important to note that U.S. business lending activity at the smaller end of the spectrum (\$500,000 and lower) is undergoing a rapid change. Banks realize that it is simply too costly to underwrite small business loans using traditional underwriting methods. However rather than modernizing underwriting processes to become more efficient and less costly banks have simply focused on making larger loans. Non-bank small business finance companies have seized on this and developed efficient low overhead technology driven underwriting solutions to serve this market. These technology driven modern business finance companies are exactly the kinds of entities that require licensure in

Vermont. So while there is a revolution in business lending in the United States, the revolution has yet to cross the Vermont border.

You might find the following links interesting and a good primer on “venture debt.” As I stated before, venture debt is primarily granted to later stage companies who have already received significant venture capital financing.

<http://www.svb.com/blogs/ojzdowski/Understanding-Venture-Debt/>

<http://www.square1financial.com/understanding-venture-debt>

http://www.avc.com/a_vc/2011/07/financings-options-venture-debt.html

<http://www.businessinsider.com/raise-more-debt-before-you-raise-more-venture-capital-2012-1>

<http://www.businessweek.com/stories/2008-09-19/how-venture-debt-financing-works-and-how-to-get-itbusinessweek-business-news-stock-market-and-financial-advice>

http://en.wikipedia.org/wiki/Venture_debt