

INDUSTRY INSIGHT

FINANCE by David Burton and Bo Sartain



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View from the bridge

Bridge financings offer angel investors and entrepreneurs many benefits including low transaction costs and creditor protection

Bridge financings provide an efficient financing mechanism for start-up companies to raise seed capital (or small amounts of capital between major financing rounds) from friends, family, angel investors and even institutional venture capital investors.

Why efficient? A bridge financing can typically be done in about

one-fourth the time it takes to complete a venture-capital preferred-stock equity financing. This shorter process translates into significant savings to the company for expenses, such as legal fees, necessary to complete the financing. This is particularly important if the amount of money being raised is small, so that a disproportionately high percentage of the capital being raised is not consumed in the transaction negotiations and documentation.

A bridge financing is structured as a convertible promissory note. Typically, the note will provide that the principal and accrued interest will convert into shares of the company's stock upon the closing of its next equity financing. The shares to be received upon conversion will have the same rights and features as the shares purchased by the investors in the next round of financing, and for the same price per share.

Because bridge loans are very high-risk investments, most often the company raising the money will also be required to issue warrants to the bridge-loan investors as an equity sweetener for bearing the extra risk of investing prior to the company's raising more substantial amounts of money (the interest on the note is typically a nominal amount).

The size of the warrant, or "warrant coverage," is a risk premium and is usually expressed as a percentage of the principal amount of the corresponding bridge note. For example, a bridge loan of \$500,000 with 50% warrant coverage means the investor's warrant will be for \$250,000 worth of the company's stock.

The warrant may be exercisable for shares of either common stock or the equity security being issued to the investors in the company's next equity financing (which is typically preferred stock). From the company standpoint, it is generally better to have the warrant be for common stock rather than preferred stock. This is particularly true if the exercise price of

the warrant is for a nominal amount.

The exercise price of the warrant is generally set at either the price per share established in the next financing round (best for the company, as it minimizes dilution from the warrant exercise) or at a nominal price (for example, par value of the stock—a highly dilutive alternative). The exercise price of the warrant is a negotiable point and will vary from deal to deal.

The benefits of bridge financing to the entrepreneur and the company include:

- Lower transaction costs because key negotiating points with the investors are deferred until the next major equity financing.

Specifically, agreeing on a valuation for the company and the special rights and preferences the investors require for preferred-stock terms are postponed because the convertible note will convert into stock in the next financing on the same terms and for the same price as the stock the company issues to investors in the next financing.

- No company valuation is set. This feature of the bridge financing is especially important to companies wanting to use stock or stock option grants as a form of "sweat equity" to attract talent.

For example, if a company issues common stock to friends, family or angel investors in order to raise seed capital at \$1 per share, this price will establish a fair market value for the company's stock. It will affect the company's ability to issue stock or grant stock options below that price without creating unfavorable tax and equity compensation issues, and may cause cheap stock and other financial accounting issues and charges for the company.

Benefits of bridge financing to the investor include:

- Creditor protection. In the event that the company is not able to secure any additional financing and is forced into liquidation or bankruptcy, an investor is better off as a creditor than a stockholder; as a creditor, the investor will be in a superior position in the priority of the liquidation of assets.

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Also, a bridge-note holder can further strengthen its protection by structuring the bridge financing as a secured convertible note, placing the investor ahead of general unsecured creditors such as trade creditors. Secured bridge financings are more complex transactions, however, and they require more time and legal expense to complete.

- Dilution protection. Not setting a value on the company helps the investors in addition to helping the entrepreneur and the company.

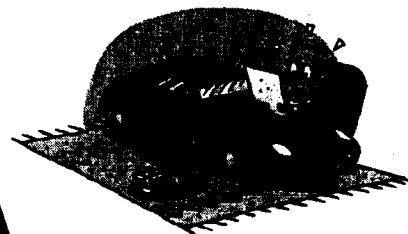
One of the greatest uncertainties in angel financing deals structured as com-

mon stock investments is how much dilutive effect the next equity round of financing will have on the angel investor, both in terms of numbers of shares and a dilution of the angel's rights and protections. Angel investors may agree on a value for the price per share of the company, but that is no guarantee the venture capital investor will share the same view.

With the convertible note, the angel investor secures the same valuation and the same rights and preferences that the venture capital investors will negotiate in the next equity round. **D**

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