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- **The Players:** Start-up companies, venture-debt providers and traditional venture capitalists.
- **The Game:** Start-ups need cash. Venture capitalists provide it, in return for stakes. Venture-debt firms provide it, in return for interest payments and, often, the potential for future stakes.
- **The Outcome:** Venture debt is growing fast, accounting for a growing portion of venture funding. But it's not right for all start-ups.

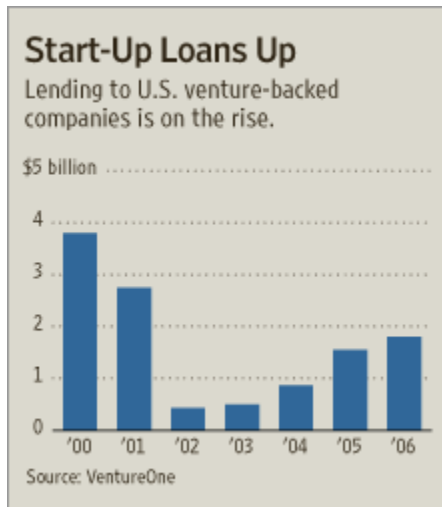
## Venture Funding Twist

### Start-Ups Increasingly Take On Debt To Keep Businesses Chugging Along

By PUI-WING TAM  
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When Web search start-up Retrevo Inc. went looking for financing in December, it landed three \$500,000 offers from interested parties in just four days. But they didn't want to buy stakes. They were offering loans.

"Suddenly I was getting phone calls from debt lenders who all wanted to talk to me," says Vipin Jain, Retrevo's chief executive. He says the Sunnyvale, Calif., company, which runs a search Web site for consumer-electronic gadgets, ended up taking on \$500,000 in debt rather than selling a piece of itself to a venture-capital



firm, the traditional funding route for high-tech start-ups.

Venture lenders are playing a growing role in bankrolling Silicon Valley's latest boom. They include **SVB Financial Group**, Lighthouse Capital Partners, Hercules Technology Growth Capital Inc. and Pinnacle Ventures. Such firms typically provide loans of \$500,000 to \$10 million and sometimes more to fund start-up operations or equipment purchases.

These lenders generally charge double-digit interest rates on par with the interest payments on high-risk corporate bonds, known as junk bonds. Lenders typically also get potential future stakes in the companies, via warrants that can be converted into equity. The warrants convert to equity if the start-up eventually gets bought or goes public.

In contrast, the venture capitalists who typically invest in such companies pay cash for an immediate stake in hopes of a payout later when the company is sold.

Venture debt can be a risky path for early-stage start-ups. The loans need to be repaid over time, which can burden a start-up if it has trouble generating revenue. As creditors, venture lenders also have the first right to demand payback, before other investors.

Though they remain largely out of the spotlight, venture-debt providers are growing fast, becoming some of Silicon Valley's biggest stakeholders. They loaned nearly \$2 billion to U.S. venture-backed companies last year, up from \$434 million in 2002, according to research firm VentureOne. In total, debt formed 7% of the money invested in U.S. venture-backed companies in 2006, up from 2% in 2002. (VentureOne is a unit of Dow Jones & Co., publisher of The Wall Street Journal.)

While venture debt isn't new, it is becoming more important because it is taking longer for start-ups to go public. In 1999, the median start-up took three years to go public from the time it first got financing. That wait has now doubled to more than six years, according to VentureOne. Many companies thus need more money to stay private longer, creating more opportunities for venture lenders.

The trend has contributed to the creation of a slew of venture-debt lenders that have popped up in recent years, including Hercules Technology Growth Capital and TriplePoint Capital. It is unclear how much venture lenders are profiting from the current boom -- many are closely held and don't disclose data. Hercules, however, is publicly traded and over the past year its stock is up about 30%, closing yesterday up 16 cents, or 1.2%, at \$14 on Nasdaq. It recently reported that its

fourth-quarter revenue doubled from a year ago and reported a net profit compared with a year-earlier net loss.

There has "been kind of a frenzy around venture debt," says Kate Mitchell, a venture capitalist at Scale Venture Partners in Foster City, Calif. Ms. Mitchell estimates that about 50% of the companies that Scale has invested in use venture debt, up from 25% in 2002.

For entrepreneurs, venture debt has its benefits. While taking money from a venture capitalist often requires giving away a big chunk of a firm in exchange for the cash, venture debt doesn't dilute an entrepreneur's stake as much. The loans are good for helping start-ups keep going a few more months, says Kenneth Pelowski, a managing partner at venture-debt firm Pinnacle Ventures.

Mr. Pelowski notes that the size of Pinnacle's venture-debt deals have grown in the past few years, with the firm now loaning out an average \$4 million to \$5 million each time, up from \$3 million previously. Pinnacle, Palo Alto, Calif., is reaping an average interest rate in the low double-digits, he says.

Venture lenders sometimes have uneasy relationships with venture capitalists, at times competing for a chance to invest in a hot start-up. Venture lenders also have different, often shorter-term objectives. If a start-up begins failing, the lenders have the first right as a creditor to demand their money back, putting pressure on the company and its venture-capital backers as they try to keep the firm afloat.

Bryan Roberts, a venture capitalist at Venrock Associates in Menlo Park, Calif., says it is particularly dangerous for start-ups with no revenue to take on debt. Because the start-up has no cash flow to pay down the debt, the company may end up paying off the loan's high interest rates with the cash that a venture capitalist has invested in the firm.

Gibu Thomas, a start-up entrepreneur, opted not to take venture debt early last year. The chief executive of Sharpcast Inc., Palo Alto, Calif., already had \$3 million in venture-capital funding last year when he was approached by several venture lenders.

He was spooked by their terms. Some wanted to be able to put liens on Sharpcast's intellectual property and call a default if a founder left the firm. "I didn't feel comfortable signing up," Mr. Thomas recalls.

So he raised an additional \$13.5 million in cash from venture capitalists last February. Late last year, Mr. Thomas borrowed \$1.5 million from venture lenders to buy equipment after the terms were eased.

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