

## Bridge the Gap

When risks are high and cash needs are immediate, a convertible bridge note provides a solution everyone can live with.

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By David Worrell

Novazone Inc. was not a thriving [business](#) when Paul White joined it in late 2003. In fact, the company had cash-flow problems that threatened to quash the launch of its new ozone-sterilization devices. To buy the business and turn it around, White needed substantial capital resources.

He also needed [investors](#) who could see past the present situation and buy into his vision of Novazone as a world-class supplier of high-end industrial equipment.

"Novazone had customers like Procter & Gamble, Coca Cola, Colgate-Palmolive and Neutrogena," says White, 43, now president and CEO. "But the company was perpetually running out of [money](#)."

The risks were enormous when he offered to buy the struggling company, but so was the upside potential. White bought the company at a relatively low price but had to convince investors that it was worth much more. "What we did was fairly complex," admits White, who jumped into entrepreneurship after several years as a venture capitalist for Fremont Ventures in San Francisco.

To get money in the door quickly, White offered a series of convertible bridge [loans](#) to angel investors. These loans allowed White to purchase the company without giving up any ownership until the company's health improved. In other words, White borrowed money from investors with the promise to convert it into company stock at a later-determined price. The loan arrangement bridged the gap between when White needed the cash and when he could reposition the company with stronger sales and a higher valuation.

### Right on Time

For entrepreneurs, a key benefit of bridge financing is the time it buys between investment and valuation, according to Peter Townshend, a partner at law firm [Allen Matkins Leck Gamble & Mallory LLP](#) in Del Mar Heights, California. Townshend, who specializes in preparing the legal documents companies need when they bring on new investors, says he has been preparing more bridge loans lately.

The purpose of the [loan](#) is to get a little bit of money in when it's needed most. That money typically comes from smaller investors, such as angels. "Entrepreneurs will try to get money in quickly from supportive parties who might not have enough money to make a round," says Townshend.

He also likes the flexibility of convertible bridge loans. "For a company that's not in the position to raise bank debt, there hasn't been much between a bank loan and pure equity capital," Townshend says. In his opinion, the convertible note is the perfect middle ground: "It's quick to close and can be as easy as a single loan document."

The loans are short term--typically six months to two years, according to Townshend, and by definition are meant to be converted into stock rather than repaid.

### Rewarding Investor Risk

If this sounds like the answer to your financing prayers, be warned: Bridge loans make some investors queasy. "For the investor, it's a little like buying a car without knowing how much it costs," Townshend explains. To overcome investors' apprehension, companies typically make it very attractive for investors to take that additional risk. Terms on bridge loans can include not just interest, but also "warrant coverage"--essentially a free grant of stock options that can be exercised later.

"[Investors want to] earn a little interest on their loans--maybe 5 percent--but they'll also earn a discount on the eventual stock purchase. Or they'll get additional warrants--maybe 25 percent warrant coverage," Townshend says. That would give a \$100,000 investor the option to purchase another \$25,000 worth of stock at the same discounted price, but at a later time--perhaps as much as five years later. At Novazone, early investors who entered into convertible notes were treated to interest, warrants and a discount on the eventual stock price. All in all, individual investors lent the company more than \$3 million--enough for White to buy the company, with plenty left over for working capital and new marketing efforts.

Sales started pouring in immediately. By the third quarter, Novazone's sales pipeline had grown 250 percent. By late 2004, Novazone was profitable, with annual sales approaching \$10 million.

## **The Conversion**

As White had hoped, Novazone's rapid growth began to attract the attention of venture firms, which led to a large VC investment and the conversion of the loans into stock within the year.

"That was the tricky part," White recalls. When a VC firm started to negotiate a major investment into Novazone, some of the original terms of the bridge loan were called into question. The firm complained that White had given up too much to the loan holders. Fortunately, those loan holders knew what a great deal they were getting and were willing to compromise. "There was a lot of room for renegotiation," says White. "In the end, everybody took a cut--the note-holders included. But they all bought into the idea that it was the right thing for the company."

On paper, the original investors (that is, lenders) were rewarded with exceptional returns on their money. "It was only on paper--a conversion return," says White, "but it was unanimous that it was a good deal for the angel investors."

## **The Right Fit**

Who should make use of convertible bridge notes? Entrepreneurs who are raising money from less sophisticated investors should certainly consider it, says Townshend. "It's perfect for the rich uncle who has no idea what the right price is for equity. He wants to put money in now and leave the negotiations to a more sophisticated investor."

Although it is rare for institutions to use bridge notes, the process is so straightforward that Townshend expects even professional investors to begin using them more in the future. "Eventually, bridge rounds may replace equity rounds completely," he predicts.

That would certainly be welcome news for entrepreneurs. Convertible bridge loans make very good sense for entrepreneurs who can do a lot with a little: When the initial money can be used, as in Novazone's case, to rapidly improve a company's position or value, the entrepreneur stands to benefit from a higher valuation for the company.

The best part? Bridge loans are relatively simple documents. While you'll still want an attorney involved in drafting the document, taking money through a bridge note is not nearly as complicated as selling stock in the company.

Nonetheless, Townshend warns entrepreneurs not to use convertible notes indiscriminately. Company owners should not mislead bridge investors about the company's plans to raise additional money and convert the loan to stock. Convertible bridges should only be used when a major financial event--like a larger round of equity fund raising--is on the horizon.

As Townshend puts it, "The trick is not to let your bridge turn into a pier."

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