

## Venture Leasing: The Other Venture Capital

By Jay Hollander

**Summary:** "Venture leasing" is a creative vehicle that allows start-up companies to finance certain infrastructure and equipment needs. The practice has financial advantages, but it also carries some risks. This article explains what venture leasing is and how it works.

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### Introduction

It's no secret that the lifeblood of any early stage company is venture-capital financing. Without it, there is no cash to burn and no financial muscle to grow a company to profit or IPO.

Historically less well-known, however, has been an additional vehicle for financing certain infrastructure and equipment needs that has allowed venture-stage companies to simultaneously cut down on their cash burn rates, focus their equity capital on their core business needs and often increase their valuations for IPO purposes.

This vehicle, known as venture leasing, is a financing device for early stage companies that had been used relatively rarely in years past, but has picked up considerable popularity in the last couple of years, coinciding with the explosion in IPOs in the late '90s.

Still, as we shall see, the use of this device is not for everyone. There are requirements that companies contemplating this type of financing should be prepared to meet and there are decisions to be made concerning the terms of such financing that early stage companies need to be aware of before electing to use it.

### What Exactly is Venture Leasing?

So, what exactly is venture leasing? Simply, it is a hybrid of traditional leasing and venture capital meant specifically to address a certain market segment: the early stage company that has gotten a first round of venture capital financing, has its eye on an eventual IPO and wants to conserve as much equity-based venture capital as it can without diverting it to costs for equipment and infrastructure and without having to further dilute equity positions by seeking additional venture capital.

In a typical venture-leasing transaction, the lessor will lease equipment such as computers and software to early stage companies at a certain interest rate for three to four years. The lessors will also customarily seek warrants for stock in addition to the lease payments, a back-end compensation intended to compensate the lessor for the additional risk in lending to a new company that would otherwise find it impossible to qualify for conventional bank or leasing firm financing.

For the early stage company, there are many benefits to such an arrangement. First, as noted above, if the lease is properly structured, there is a substantial savings in cash that the company might otherwise have to spend to purchase the leased assets. This helps in several ways. Not only does it allow the company to use previously obtained venture-capital money for core purposes such as research and development, sales and marketing, it also can prevent company founders from having to give up substantially more equity if further resort to venture capital would otherwise be required to fund these purchases.

Second, venture leasing provides a source of financing when a company doesn't qualify for bank or traditional leasing financing or when additional venture capital may either be unavailable or trigger unwanted penalties in the original venture-capital agreement.

Third, venture leases typically only require the leased asset as the sole or primary collateral for the lease, as opposed to a commitment of all of a company's assets.

Another benefit of venture leasing is in flexibility, if the entrepreneur chooses wisely. In negotiations with a venture lessor, the giving of company warrants with a suitable exercise price as part of the compensation for the lease can result not only in a lower interest rate overall but also lower payments at the outset, when cash might be shortest.

For early stage companies that have already acquired assets and are looking to obtain some more cash without going back for more venture capital rounds, venture leasing can also accommodate "sale/leaseback" arrangements, giving a start-up a way of drawing working capital out of assets it already owns by selling them in exchange for a cash infusion and a lease of the same assets.

### **"Off the Balance Sheet"**

Perhaps most importantly, if properly structured, the entire venture lease obligation can be done "off the balance sheet," an accounting technique in which lease obligations to acquire assets do not show up as assets or liabilities on a firm's balance sheet.

This method of structuring venture leases can be a very valuable tool for companies, especially those contemplating an IPO. The simple reason is that, for financial reporting purposes, off-balance-sheet financing does not require the company getting the equipment to list the equipment as an asset or to list payment obligations to the lessor as liabilities on the company balance sheet. This avoids dilution of a company's key financial ratios such as the often-consulted debt-to-equity and return-on-equity ratios.

Especially in today's more stringent market for IPOs, a company's valuation will largely be based on the strength of its balance sheet. In this analysis, higher multiples are given to companies whose balance sheets show significant free cash, unencumbered by corresponding liabilities.

Care must be taken here, however, since accounting regulations have limited this off-balance-sheet structure to certain types of cases where the lease can be structured to meet the accounting requirements for an "operating lease," considered a long-term rental as opposed to a method of financing the purchase of the assets.

To qualify as an operating lease under the pertinent Financial Accounting Standards Board (FASB) rules, the transaction must avoid meeting any of the following tests:

- Automatic transfer of ownership at lease end
- A guaranteed/fixed price option for asset purchase
- A term greater than or equal to 75% of the unit's useful life
- The present value of the minimum lease payments are greater than or equal to 90% of the asset's fair market value

### **The Prime Candidates for Venture Leasing**

Obviously, there are substantial benefits to venture leasing. Still, it's not for everybody and companies interested in the possibility of using this vehicle should think about it when they first sit down with their lawyers, even before seeking out venture capitalists for their first round of financing.

The reason for this has to do with how venture-leasing companies evaluate the risks of early stage companies with whom they consider doing business. Since, by definition, the clients for such leasing deals are risky start-up companies, venture-leasing firms also do their due diligence, just like venture capital firms. Understandably, venture-leasing firms want to have some comfort that the company will have secure cash flow for most of the lease term and that the company has a decent shot at profitability and/or an IPO.

Nevertheless, such leasing firms are not in a position to undertake the costs of a full-blown due-diligence procedure, so they normally also look at the strength of the venture-capital firm that first funded the company. Specifically, they'll be interested in the venture-capital firm's reputation, its financial commitment to follow-on financing of the start-up company, as well as the valuations it placed on the company, whose warrants will likely make up part of the leasing compensation. Like traditional venture capitalists, venture leasing firms will also carefully evaluate the start-up company's management team and available cash, to give them confidence in the prospects of success of the venture.

So, prime candidates for venture leasing are start-ups with strong management teams, substantial cash on hand from a completed first round of venture capital, with either commitments or good prospects for follow-on financing, and a reasonable path to profitability and/or an IPO.

### **The Basic Terms and Conditions**

Since venture leasing is a flexible creature, the specific terms of the deal will vary from case to case, in terms of the length of the lease, the structuring of the lease payments, the amount of warrants to be given and whether the transaction will be on or off the balance sheet.

There are, however, certain basics.

Generally, title to the assets will remain in the lessor with significant buy-out cost at the end to avoid accounting interpretations of the transaction as a purchase to be

amortized, rather than an operating lease allowing payments to be treated as an expense.

As a result, depreciation of the equipment will remain with the lessor, a tax benefit to the lessor that would not be as valuable to the presumably unprofitable start-up, and a benefit that can be shared with the lessee through reduced interest rate on the lease.

The lessee should expect that the lease obligations will be fully or primarily collateralized by the equipment, as opposed to all of the company's assets.

Depending upon payment schedule and other terms, warrants equal to 10 percent to 20 percent of the lease amount may be negotiated. Here, care must be taken with respect to valuation of the company so that warrants can be priced appropriately, and consultation with legal counsel and venture capital advisors is important.

The term for such leases may vary but will typically be for three to four years on average, with warrants exercisable once the stock is valued above a pre-defined exercise price.

Often, such leases are structured to be taken as operating leases, which do not obligate the lessee to purchase the equipment at lease end and which work to minimize the monthly payments to the lessee, freeing up more cash for other purposes or to remain with the company as a means of increasing its ultimate valuation.

### **The Risks**

Of course, nothing's perfect, and venture leases are no exception. The first and most important risk is cash flow. If some unanticipated event or condition causes the company to rupture cash that it cannot replace, it runs the risk of defaulting on its lease payments and having the equipment taken back, something which would not happen if the assets were purchased outright in the first place.

Then there is the risk of dilution of existing percentage equity ownership based upon the number of warrants given in exchange for the lease. While this is a valid concern, in reality, the value of warrants given -- typically equal to five or 10 percent of the original cost of the equipment being leased -- will often not materially affect percentage ownership overall.

Also, if the transaction does not qualify for off-balance-sheet treatment, then the assets and corresponding liability will affect the company's valuations going forward until the transaction is completed.

Care should also be taken to ensure that the issuance of warrants does not violate any provisions of any pre-existing venture-capital agreements. Nevertheless, it's worth noting that, in the main, venture capitalists strongly favor venture-leasing arrangements because of the economic advantages they give the start-up company.

There is also a risk of how widely available these leases will continue to be under current stock-market conditions. Since warrants for stock in anticipated IPOs play an important role in venture-leasing transactions, there has been much concern about the continued availability of the venture-leasing method since the value and

frequency of IPOs has diminished so severely with the fall in the stock market. Unfortunately, the probability and extent of this risk is one that only time will tell. If venture capital deals continue to increase from their recent nadir, and IPOs gain in frequency and success in coming months, then the odds are that venture leasing will come back right along with it. Of course, the opposite is also true.