

VENTURE CAPITAL

Meet the Invendor

By Marc H. Morgenstern

Editor's note: Do you owe key vendors money you don't have? Ever wonder what kind of expert advice they're getting on how to handle the debt? Attorney Marc Morgenstern takes you inside that world in this week's guest column. His insights should help you at the negotiating table. --Lawrence Aragon

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As the capital markets keep squeezing tightly, companies are strained for cash, particularly new-economy companies. Equity financings have all but disappeared. Every board is directing management to conserve cash. As a result, many fast-growth companies seeking cash flow are turning to an old standby -- their vendors. Willingly or unwillingly, vendors are finding that their receivables are being stretched. Customers are either deferring payment to suppliers or seeking to convert some or all of these receivables to equity, creating a new class of inadvertent investor. I call this the "Invendor."

Vendors are supposed to supply goods or services and be paid as short-term debt holders. They typically expect to take debt risks and get paid as scheduled, on debt-type terms. But stretched payments can become an equity-type risk, making the vendor more than a debt holder. If the risk/reward ratio has changed because the customer's financial weakness has increased the supplier's risk, then the supplier's reward should increase to balance the risk/reward ratio. They are more than vendors but less than investors.

If you're an Invendor, how do you negotiate with overdue or financially distressed customers? Ask these reality-check questions.

WHO'LL WIN SURVIVOR?

First of all, ask yourself if the customer is going to survive. If they aren't, there's no purpose to negotiation. If they will be around, you'll need to ask yourself a raft of questions, not the least of which is, do you want an ongoing relationship with them? Have they been honest and aboveboard in advising you about their

they been honest and aboveboard in advising you about their financial circumstances and in their dealings with you? Generally, you learn nothing about people's character in good times, and everything in bad times.

Also, is their business model sustainable? If the answer to any of these questions is no, cut your losses. Don't convert your receivables to equity, and, above all, don't extend more credit or supply more services.

If your answer is yes, evaluate your value to the customer. How important are you to them? Do you supply unique goods or services that can't be obtained elsewhere? The harder the vendor is to replace, the greater the vendor's leverage. A major service supplier that is halfway through a mission-critical project has more leverage than a small supplier of office furniture. For effective negotiation, threats to cease being a supplier must have impact. If a vendor can pull the plug and put the customer out of business, leverage is plentiful.

IS THE CUSTOMER KING?

How important is the customer? Today's small customer could be tomorrow's large customer -- or not. Will concessions today reap commensurate rewards tomorrow? Non-equity rewards for cooperation could include entering into long-term exclusive supply contracts or minimum purchase commitments for a fixed period of time. The customer could also agree to pay increased prices for future sales or provide additional marketing or advertising support. Certainty and exclusivity each have value.

WHEN'S PAYDAY?

Does the customer have a near-term liquidity event that will allow you to be paid? The longer the time before liquidity, and the lower the visibility on the amount and source of new cash, the greater the risk. If you're thinking of converting your receivable to equity, try to convert it to preferred stock. Generally, don't convert unless all major vendors are also simultaneously converting.

Develop an understanding of terms for providing new goods or services. Will it be cash up front? Ten-day terms? Are there agreed-upon credit limits? Will you extend more credit only if you receive full payment for all new debt as incurred, plus repayment of some percentage of old debt every month? What happens if there is a default on the new payment terms? It's bad enough to deal with the old debt; don't make the problem worse.

INTERESTED IN A BRIDGE?

How can you level the playing field as a bridge lender? As an Invendor, the supplier has in effect become an unwilling and accidental participant in a customer's bridge financing. Bridge financings frequently reflect a sudden and unanticipated problem: usually an immediate, life-threatening dearth of cash or liquidity. The Invendor has taken a bridge investor's risk, without the rewards.

Virtually all bridge financings provide the debt-holder with interest. A strong Invendor with sufficient leverage should seek the same protection. Have the customer confirm that the debt is due and owed. Leave nothing open for further negotiation about the amount owed, the collectibility of the receivable, or any credits or offsets. Document the debt with an interest-bearing note.

Create upside flexibility. Ask the company for the option to convert some, or all, of the receivable (principal and interest) into equity. Seek the right to invest funds in addition to the amount of the receivable on favorable investment terms. Additionally, even if the receivable is fully paid, the Invendor can still receive equity-type rewards by receiving warrants on the same terms as the bridge financing, or at a discount. Typical warrants would permit the holder to acquire equity in the company, at a fixed price and at any time during a fixed period. The Invendor should push hard to negotiate to get the lowest exercise price and the longest period of time to exercise (five to seven years would be typical). Because of tax issues, usually the warrant holder will exercise the warrant only in connection with a sale or an IPO.

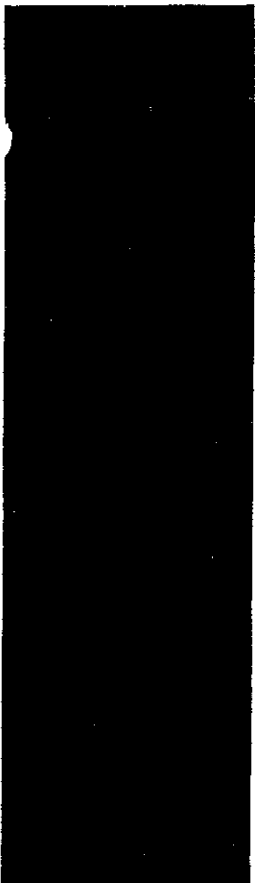
READY FOR EMOTIONAL RESCUE?

Ask yourself honestly whether your negotiating goal is economic or emotional. Suppliers recognize that everyone's future is best served by helping the customer grow. Growing companies purchase more goods and services, benefiting their stockholders as well as vendors. Sometimes what the vendor wants, however, is simply recognition for the role they're playing. Acknowledgement by the customer that the Invendor's forbearance from getting paid is permitting the customer to maintain its existence goes a long way.

Some psychological rewards for the vendor cost the customer nothing. The vendor may simply want to be acknowledged and greeted as a "strategic partner." The formal status acknowledges that the vendor's importance exceeds that of a normal supplier-customer relationship. Bonds form by living through troubled times together. On the institutional level, it may benefit the vendor to be listed as a strategic partner on the customer's Web site or to issue a joint press release acknowledging the strategic partner relationship.

TILL DEATH?

Finally, how can you develop a negotiating environment that recognizes that the desired outcome is a long-term positive relationship with the customer? If the Invendor's goal includes an equity relationship, then the vendor and management will be economic partners for an extended time. Acrimony needs to be limited, and words should be measured carefully. Angry words of personal recrimination reverberate long after the negotiation has ended. The Invendor's speech should be, "I'm here to help, I'd like to help, but I'd like you to acknowledge that I'm playing a broader and riskier role than we envisioned." And in return, the customer should say, in effect, "We find ourselves in an unintended set of circumstances. I'm sorry for your pain. Let's find a way to acknowledge that your capital has been invested in my business,



to my benefit, and find ways to increase your reward and recognize that risk."

As an Invendor, make certain that your value is recognized.

NEXT TIME: Mr. Morgenstern answers your questions. Send them to me at laracon@redherring.com.

Marc Morgenstern, 50, is the managing partner of Kahn, Kleinman, Yanowitz & Arnson and a nationally recognized expert and author on securities and corporate legal matters. He focuses on entrepreneurs and emerging growth companies, with an emphasis on private placements, venture capital, and IPOs. Among his many positions, Mr. Morgenstern is the secretary of Olympic Steel, Mazel Stores, and CT Access Ventures, a venture fund started by national search firm Christian & Timbers. He is also secretary and a member of the board of advisors for Offroad Capital, Signet Assurance, Healthsync.com, Cardinal Commerce, the Dotcommery technology incubator, and Signcast. He also sits on the board of the Rock and Roll Hall of Fame. A Yale alum, Mr. Morgenstern received his law degree from Boston University in 1972. He is a native of Cleveland.

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