Weighing the costs and benefits **of equity and royalty agreements**

by Bridget Lair

This information originally appeared in the *NBIA Review*, Volume 28, No. 4, August/September 2012

Taking equity in client companies or making royalty arrangements with them can be risky business for an incubator – and determining if the risk is worth the return depends on the incubator's client base, economic standing and available expertise. It can make sense for some incubators, but not all.

The majority of incubation programs in North America don't take equity in their clients. According to the soon-to-be-released, *2012 State of the Business Incubation Industry* report, a survey of 235 North American incubation programs, 4 percent of respondents take equity in all their clients, 14 percent take equity in selected clients and 82 percent take no equity position in client companies. Yet interest in the subject never flags.

Regardless of an incubator's position on equity investment, incubation programs still need advisors who understand start-up finance so they can effectively assist clients who are ready for outside investment.

What is equity, and how does it differ from other financial tools?

Taking equity in a client company usually involves obtaining part ownership of the company or the option for part ownership in the future (through a stock warrant agreement). Either way, equity is a deferred payment; the incubator provides rent and/or services to clients in return for the potential of a significant cash payment when the company goes public or is acquired by a third party.

A warrant agreement is very similar to a stock option – it provides the right, but not the obligation, to purchase shares at a fixed price for a certain period of time (often 10 years). Another common equity-finance tool, a convertible note (or convertible debt), is typically structured as an interest-bearing loan, which a company can repay with cash or a predetermined amount of equity. It is a hybrid-security with both debt- and equity-like features and often includes an equity "kicker" structured as a warrant to provide investors extra compensation for their risk for investing in early-stage companies (see Resources sidebar on page 6 for sources of more information).

Equity stakes are appropriate for high-growth companies with a clear exit strategy. As a rule of thumb, this means companies with potential to reach $50 million in annual revenue by their fifth birthday, although the figure varies by sector and market.

In contrast, a royalty agreement provides an incubator with a percentage of company sales rather than stock options. With royalty agreements, incubators earn income sooner – as soon as a company generates sales – but the payout may be less. Still, for companies without clear exit mechanisms, namely services or moderate-growth firms, royalties may be a better approach.

Cash up front over credit borrowed against the future

When the Sid Martin Biotechnology Incubator in Alachua, Fla., opened in 1995, companies could pay their incubator space license fee (i.e., rent and service fee) with all cash or cover a portion (a little less than half) through warrant, stock options or a royalty, says Patti Breedlove, associate director of the program. After several years, the incubator changed the arrangement and simplified the options so clients could pay with cash or a convertible note. A few years later, she says, they moved to all cash payments. The University of Florida, which sponsors the Sid Martin incubator, maintains technology license agreements with companies, so it still receives payments for the incubator's investment in its clients, but that equity is separate from the incubation program.

Breedlove says she is happy to be out of the equity business and that incubator/client relations have never been healthier. "There is always stress between the university and the companies, and those stresses do not occur between the companies and the incubator team," she says. That repose helps maintain a strong positive relationship with companies, which is important to encourage reporting and positive feedback for the incubator.

Although Breedlove believes taking equity in companies is an option worth considering for incubators, Sid Martin management ultimately decided it would rather have cash in hand. "We charge for space in real time, so it's a clean slate for our companies, and it's easier for our companies to manage," she says. "The terms of such agreements are complicated, and often start-ups don't have that knowledge or expertise until later. Straight cash they can understand."

The real costs of client equity

Incubators that take client equity or royalties face additional resource constraints and financial costs from those investments. Taking equity may result in lost incubator income, increased costs in terms of staff time or legal consultations, challenged relationships with clients and stakeholders, or loss of potential new clients. Managers experienced in equity investment describe the major considerations about incubator equity investments in the following sections.

Direct and indirect financial costs

If a company fails, not only is the incubation program out the deferred payment for services and rent, management must decide if it will go after the company assets – if there are any – and that takes time, expertise and money. "Just making that decision requires incubator staff time and funds that you will likely never recoup," Breedlove says.

Even companies that do grow often stay small, so there is no opportunity to repay the entire amount they owe, she says. Then, the incubator and the company must reach an arrangement for partial payment – which also requires time, expertise and attorney fees.

Breedlove cautions, "In both of these scenarios, the relationship with the company is at stake, and it may create an adversarial situation between the incubator and the company."

In many cases, companies that will never reach the level of success necessary to make a large payout are the ones that are most open to providing the incubator with an equity stake. "So the incubator never receives payment for the services provided to those client companies – it's equity that you don't want," says Joel Wiggins, executive director of the Enterprise Center of Johnson County in Lenexa, Kan.

And of course, the payout is not always as substantial as people expect. Breedlove says usually when companies are procured young, the acquiring company wants to grab assets and staff while they are a good price. She says Sid Martin clients have had a few large acquisitions, but they are not the norm.

You may discourage good clients

Savvy clients, who may be the most highly likely to attain multimillion-dollar initial public offerings or acquisitions, may shy away from incubation programs that require an equity stake. "Serial, successful entrepreneurs won't sign an agreement like that," Wiggins says. "They are unwilling to give up 1 percent ownership of their company they think will be worth $50 million or more someday."

Sandra Cochrane, technology business consultant at the Michigan Small Business and Technology Development Center and former acting CEO of the Southwest Michigan Innovation Center in Kalamazoo, Mich., says SMIC clients were not interested in giving up ownership. "We asked in a feasibility study, and potential clients said they would rather pay higher rates and keep the company to themselves."

Even if you have signed agreements, discord is highly likely, Breedlove says. "A company may be modestly – or very – successful and may be able to pay out the royalty, but there may be some misunderstanding over whether new products and services are derived from the data stream developed while at the incubator." She warns, "You may need to undergo a royalty audit [a review of the license agreement to ensure all terms have been met] – which, of course, incurs expense and relationship challenges."

Managing equity requires time and money

Financial agreements are long-term legal documents, so the incubator needs to have continuity if management or staff changes. "Someone has to manage, maintain and enforce these agreements, which requires time and management expertise, and there may be no monetary return to the manager," Wiggins says.

Breedlove cautions, "Warrants expire in the drawer because incubators have limited staff or because of staff turnover." If a warrant is nearing expiration, the incubator needs to determine if it is worthwhile to execute it. "Does the company have assets at that point that make executing the warrant worthwhile?" Breedlove asks. "Did you create the warrant with the correct timeframe for that particular company?" She says the opposite may be true, too. "You fail to execute the warrant and shortly thereafter, the company becomes wildly successful. There may be finger pointing."

Equity doesn't count against your bottom line

Most incubator mangers don't view equity or royalty agreements as a source of core operating funds. Instead, those who use them ensure they have sustainable program support such as public funding and client rents and service fees.

Equity stakes are long-term investments, and to date, few incubators have realized a return on an equity stake in a client company. "The execution is too far out in the future for present management to appreciate the results," Breedlove says. "It should be considered as a special pot of money for special projects or programs – not part of the annual income. The agreements are too chancy."

Client equity may create a conflict of interest

Nonprofit organizations need to carefully structure equity agreements to align with their mission. Theoretically, an incubator's nonprofit tax status could be at risk if there is too much equity exposure in clients, or it could pose a conflict of interest if there is too much individual profit from client success – known as private inurement.

Nonprofit incubators often set up a separate limited liability company or corporation to hold equity and execute the deal, then funnel any profits back into the incubator to support facilities and operations. Incubators should hire expert legal counsel to ensure they create a proper framework to make this happen.

The incubator's governing instrument and/or bylaws should state that income from equity interests and royalty arrangements will be used to further the incubator's tax-exempt purposes exclusively and not benefit individuals involved in the incubator's management or oversight. Also, nonprofits need to make sure that taking equity and royalties cannot be construed to be a substantial activity of the incubator.

Aligning the incubator mission of serving client companies with incubator sustainability adds a layer of complexity to incubator/client and incubator/stakeholder relations. Managers have to balance ethics with practicality. The role of an investor is different from that of a coach and/or mentor. Investors typically want what will make the most money, and that may not be what is best for the survival of the company. Incubator managers need to plan in advance how to balance the two competing goals.

Also complicating the balancing act is the potential to jeopardize follow-on funding for the client. "Future investors will look at the cap table [which describes ownership, equity dilution and equity value in each investment round], and a clean cap table is better than one with many previous investors," says Wiggins. He adds, "Future investors may hit the 'pause' button when they see a quasi-public incubator having an ownership stake in a company. They may question the judgment of the entrepreneur for agreeing to the terms of an investment if it is too favorable to the incubator. They may also worry about how the incubator will vote its shares or units in the company – will they represent the investors or the entrepreneurs?"

The upside of equity and royalties

When Wiggins managed the Austin Technology Incubator in Texas several years ago, the program negotiated equity, warrants and convertible notes with client companies. When he made the move to ECJC in 2005, however, Wiggins made the decision not to do so. Still, he says, there are compelling reasons for managers to consider the opportunity.

Taking equity demonstrates commitment

Wiggins says investing in clients shows the incubator is committed to the company's long-term survival and success. Because the incubator earns a return when the client grows and succeeds, the program will want to maximize the return from that company. "It sends a serious message to the client that the incubator is invested in them," he says.

Ellen Hemmerly, executive director at bwtech@UMBC in Baltimore, agrees. "Philosophically, I think it is important to take equity to create alignment of interest for the company and the incubator."

bwtech@UMBC takes equity in 25 companies, about two-thirds of its life science clients. Hemmerly says a few clients already had professional investment and preferred not to give the incubator equity, so the incubator charges them higher rent. "We look at companies and evaluate if they have real potential for high value – for those that we see great potential, we negotiate hard to have an equity stake," she says. "We take 1 percent per year for three or four years [when clients graduate from the incubator]. If companies need concessions for rent, we may negotiate for greater equity percentages of 3 percent or 4 percent per year."

Equity helps incubators provide low-cost services

Equity and royalty arrangements offer incubators flexible tools to work with companies that might not have a lot of capital, Wiggins says. A company can exchange an ownership stake for incubator services in lieu of cash. There are multiple ways to structure agreements – royalties, warrants, convertible notes, etc. "It is a flexible tool that can be used a lot of different ways," Wiggins says. "If someone wants to pay cash and fees for services rather than a percentage of ownership or sales, most incubation programs would allow for that."

In Baltimore, Hemmerly negotiates equity deals on a case-by-case basis. "For companies that do not have the capital they need to operate, and there is a question if they will attract outside investment, incubator equity allows them to preserve their capital and get the services they need to grow."

For smaller companies that will never go public, bwtech@UMBC may or may not take equity; however, the incubator negotiates a fair buy-out for the services clients receive if they have an equity stake and the company leaves the program. "We do an analysis of the company to make sure we get reimbursed appropriately for incubator services," she says. Hemmerly comes from a venture capital background so she handles company valuations and equity negotiations.

Equity may be a source of bonus funds

When equity investments pay off, they can provide a potential windfall for the incubator. "You cannot budget for it, but you may receive a $10,000 or $30,000 lump sum that can be used to build new programs or to bolster the general fund" Wiggins says.

So far, bwtech@UMBC has earned more than the cost of the services provided to clients from the seven or eight companies that have liquidated to date. "We either break-even or a lot better," Hemmerly says. "If it seems we would take a loss on the company, we hold the stock until the company can grow."

"A lot better" is a bit modest. The Baltimore incubator has received $2 million over the last 10 to 15 years through liquidations of companies it has assisted. Hemmerly says roughly half of that came from one successful graduate of their accelerator program, which serves graduates of the bwtech@UMBC incubator and technology companies beyond the start-up phase.

Deals can demonstrate incubator expertise

Finally, taking equity can indicate incubator sophistication. "If the incubator staff has the knowledge and expertise to structure a convertible note, an equity stake, or royalty agreement that will benefit the client company, it demonstrates to the client that the incubator staff understands how early-stage finance works," Wiggins says. "It also means they can help clients later with other follow-on funding opportunities."

Structuring winning agreements

There are as many deal structures in start-up finance as there are lawyers. Most incubator deals are limited in scope (minimal equity stakes and royalty agreements capped at a specific amount), and can be modified to accommodate clients' changing circumstances.

The level of equity share taken by an incubator varies, but typically, it is between 1 percent and 5 percent, says Carol Lauffer, partner at Business Cluster Development in Menlo Park, Calif., who frequently consults for incubators about sustainability. "It is sensitive to the local market, how much capital is available." Many of the incubator managers interviewed use warrants as their finance tool of choice. Warrants can be flexible, allow for convertible notes and are relatively straightforward.

The Los Angeles County Community Development Commission Business Technology Center uses warrants set up on a 10-year term rather than straight equity. An attorney familiar with equity kickers drew up the documents: a letter of agreement and a warrant form. "We take 1 percent of the company for each year they are in the incubator. The warrants are signed at the time of annual renewal," says Mark Lieberman, manager of regional economic development for the Los Angeles County Community Development Commission in Altadena, Calif. The program is flexible about the structure of the terms and will negotiate with clients. Most clients don't mind the 1 percent. "For some clients, we have taken a royalty or an additional rent payment or reduced the amount to less than 1 percent when the company was funded by professional investors," Lieberman says.

The CDC formed an investment committee to help manage the incubator's equity deals. "Incubators need to decide at the outset what their guidelines will be for the equity program," Lieberman says. "Our committee is composed of angels and venture capitalists from the community with expertise in similar financial decisions."

To avoid any conflicts of interest, Lieberman's investment advisory committee recommended that the incubator sell at any liquidity opportunity, noting that the county is not meant to speculate in shares and should be a passive investor. "Their recommendation surprised me at first, but that is not our job," Lieberman says. "The incubator should take cash at the first opportunity and not hold onto company shares."

"Because we are a passive investor with warrants, if there is a change in ownership, we sign off on the change caused by a large investment. We do not want to get in the way of follow-on investment," Lieberman says.

The equity stake supports the incubator's economic development mission because any return stays with the project – to keep the incubation program sustainable. "We need funds for capital improvements or expanded programming," Lieberman says. "Budgets can be tight or loose, and vary from year to year. So a large cash infusion can help balance the incubator's needs."

The CDC warrant program has been in place for six years – "You are not going to see a return for 10 years on that type of portfolio. If managers are looking for a cash miracle saver, this is not it," Lieberman says. "Warrants serve long-term needs."

Proceed with caution

Equity agreements cannot be part of a base operating budget, and expectations must be tempered by the reality that returns are not guaranteed. "When you take equity, you have to understand that it may be worthless," Lauffer says. "The return for the incubator is part a long-term strategy. You don't put it in your budget, but if it pays off, it could really pay off big."

Whether or not an incubator takes equity in its clients, it's important for incubator managers to establish connections with capital-intensive individuals even if they don't invest in companies themselves. "It is important that incubators have people associated with equity and venture, who know the language of the finance model, and who are interested in incubator deal flow," says Randy Goldsmith, president and CEO of the Texas Technology Development Center in San Antonio, who has worked with investment-stage businesses for 20 years. "Every incubator could have a client that is potentially an equity company, and the incubator needs to have the resources – whether internal or external – to connect those clients with investment financing."

Advice for setting up equity and royalty agreements

Every incubator manager who advocates taking equity in clients includes three caveats: consider any potential profit outside your operating budget, seek advice from a seasoned associate and have a trusted legal expert draw up documents specific to the program. Here are some other general tips about structuring equity deals.

- Evaluate how equity and/or royalties support the incubator's mission.
- Determine the goal in holding equity or options. Is your goal cash generation or strategic investment? The answer will guide how you create and manage agreements.
- Evaluate internal knowledge and ability to manage a high-risk portfolio among board or staff members.
- Find expert VCs or angels in your community to help manage your portfolio.
- Set parameters for ethics and practicality.
- Establish an investment committee to guide both your investment policy and decision-making on liquidity and other events.
- Determine if you plan to take equity in current clients, graduates or both. It will change how you set up the agreements and the governing policies.
- Define how you plan to determine valuation. Valuation for a start-up can be difficult because emerging businesses have no profit, no assets and often no product. Elaborate equations to calculate valuation won't work if all the variables are zero.
- Design deals to benefit both the client and the incubator.
- Create clear and reasonable agreements.
- Evaluate clients at entry and make an equity determination after due diligence.
- Consider how much risk the founder is shouldering before investing in a company. If the client is not invested, the incubator shouldn't be either.
- Have legal documents ready when clients enter the program so all the paperwork is organized and executed together.
- For nonprofit incubators, make sure that equity- and royalty-taking cannot be construed as a substantial activity of the incubator and that the program's bylaws clearly state that income from equity and royalty arrangements will be used to further the incubator's tax-exempt purposes exclusively.
- Create contingency plans for equity or royalties in the event that the incubator closes its doors, as well as policies for the disposal of equity or royalty interests when the success of clients is reasonably assured.
- Set reasonable time limits – especially for royalty agreements. The time limit for royalties depends largely on the product. Software is short (five years); pharmaceutical is longer (for the term of the patent, which is 20 years).

Deciding if equity is right for your incubator

Pros:

- Creates potential for substantial return from client companies
- Demonstrates incubator commitment to clients
- Can be a flexible financing tool to work with client companies
- Indicates the sophistication of the incubator

Cons:

- Returns are at least 10 years out
- Requires staff expertise and time
- Requires extensive legal documents and consultation
- May be viewed as a conflict of interest for nonprofit organizations
- Can cause a negative perception from client companies

Resources

- *www.venturecapitaltools.com*: NBIA member Randy Goldsmith has developed a Web site of venture tools and tutorials to help start-ups become venture ready.
- *www.venturedocs.com:* NBIA member VentureDocs offers online tools to help incubators manage financial agreements. The site includes help tabs that describe terms and contexts for investment contracts.
- *www.avc.com*: Fred Wilson, a venture capitalist and principal of Union Square Ventures in New York City, discusses finance topics relevant to start-up capital.
- *www.startupcompanylawyer.com*: Yoichiro Taku, a corporate and securities partner at Wilson Sonsini Goodrich & Rosati in Palo Alto, Calif., discusses start-up capital and legal issues.
- *Put It in Writing II: A Guide to Incubator Policies, Procedures, and Agreements* by Mark Long features a discussion of why written policies and procedures are paramount for efficient incubator operations and provides you with electronic sample documents to help guide your efforts. Available through the NBIA Bookstore at *www.nbia.org/store.*

Featured sources

Patti Breedlove, associate director, Sid Martin Biotechnology Incubator, Alachua, Fla.

Sandra Cochrane, technology business consultant, Michigan Small Business and Technology Development Center, Kalamazoo, Mich.

Randy Goldsmith, president and CEO, Texas Technology Development Center, San Antonio

Ellen Hemmerly, executive director, bwtech@UMBC, Baltimore

Carol Lauffer, partner, Business Cluster Development, Menlo Park, Calif.

Mark Lieberman, manager, regional economic development, Los Angeles County Community Development Commission, Altadena, Calif.

Joel Wiggins, executive director, Enterprise Center of Johnson County, Lenexa, Kan.