Why Debt—More Than Venture Capital—Offers Tech Firms More Financial Freedom

"Freedom" isn't a word we normally associate with debt. But for fast-growing businesses in the technology sector, a loan really can offer more flexibility and freedom than venture capital.Venture capitalists do infuse a business with instant cash, and the investors can also offer a young company financial expertise and industry contacts they may be lacking. But as part of this exchange, companies often have to give up a lot. Investors usually seek some measure of control within the company and some VC firms even demand a majority share of the company and a seat on the board of directors.

However, a business owner with good credit and a strong business plan can borrow money from a bank and retain all the control in the company. That's the path attorney Stephen Lesavich chose when he started his Chicago law firm.

Back in 2002, Lesavich used the equity in his home to get a loan for start-up capital. Today, the Lesavich High-Tech Law Group, P.C. specializes in intellectual property and Internet law. Lesavich says many of his clients have also taken out loans to fuel their growth rather than seek venture capital. They do so, he says, precisely so they can remain in the driver's seat at their companies.

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How much control will you give up?

Maintaining control was what motivated Vladimir Gendelman to turn down an offer of venture capital when his company was poised for growth.

Gendelman is founder and CEO of Company Folders, an 11-year-old online company that prints presentation folders. In 2009, a local VC firm in Michigan offered Gendelman substantial funding to expand. But the investors also wanted to take control of the company's management and put Gendelman on salary. As he researched the terms further, he also realized that not all of the capital investment would be liquid from the start. Half was set aside for operations and reserves, to be controlled by the investors.

In the end, Gendelman realized he would be giving up the parts of the business he liked the best: creating products and interacting with clients. While he considered the offer, Gendelman met at a conference a fellow business owner who was having a crisis with his own VC investors.

"He was in a situation where he was extremely stressed out, and I thought, 'This is my answer. I want nothing to do with this'," Gendelman recalls.

Gendelman's experience isn't uncommon, Lesavich says. Some VCs prefer to have the founder completely out of the picture to run the company as they see fit. Other equity investors keep founders onboard to maintain client relationships, but they allow them little management responsibility.

"They've ended up in situations where they see the venture capitalists trying to drive the company in one direction to maximize profits, but it's outside of the comfort level of the people who founded it," Lesavich says. "That creates conflict."

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The risk of debt has rewards

A common myth of venture capital funding is that is drastically increases a company's chances for success. One study estimated that only 25 percent to 30 percent of businesses backed by venture capital fail. But in 2012, Harvard Business School lecturer Shikhar Ghosh shook up the industry when he told the Wall Street Journal[1] that his research shows the number is much higher. About three out of four companies do not return capital to their investors, Ghosh claimed.

And while a business's risk rests with the borrower with a bank loan, assuming that risk can make a business a better steward of its finances.

"The upside of borrowing money is that the founders are more careful with the money they have," Lesavich says. "Many times, when tech companies get money from venture

capital firms, they burn through the money for things that do not directly relate to the success of the business." Gendelman says his discussions with the venture capital firm were a catalyst for taking his company to the next level. "After I met with the investors, I started thinking of all the things I could do with extra money," he says. "I realized I could work at a much faster pace."

Gendelman took out a bank loan and opened a few credit card accounts with zero percent interest rates. Since then, the company's annual revenues have more than doubled and Company Folders' client list now includes more than a dozen Fortune 500 firms, such as Ford Motor Co., Hilton, ExxonMobil, and Hallmark.

Gendelman says his goal was to pay off all his debt in five years. And he's on track to be debt-free a year early. "If you want to generate more income and the only thing you're missing is money, then my recommendation is to go with the debt," he says.

[1]Wall Street Journal: "The Venture Capital Secret: 3 Out of 4 Start-ups Fail" Sept., 20, 2012; http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190

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