



Will Work for Equity

Why Arizona Bay started taking stock from its customers instead of cash.

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It should have been a cause for celebration. Last spring, Dave Graham, founder of software consulting firm Arizona Bay, learned that a major client, Jumpstart Automotive Media, had been acquired for more than \$80 million. Jumpstart was one of Graham's first clients; it signed on shortly after he founded Arizona Bay, in 2000. Jumpstart wasn't much at the time, just four employees working from home offices. But with the help of Graham's company, which specializes in creating tech systems for start-ups, Jumpstart grew to more than \$50 million in revenue--enough to make it an attractive acquisition for media conglomerate Hachette Filipacchi.

Graham was happy for his client. But he wished he had been able to share in some of the upside. Arizona Bay, after all, had built the IT infrastructure and Web applications that Jumpstart needed to hit it big. The two companies had worked together closely for years. "They went on to do great things," says Graham. "And we're still their outsourced IT department." Determined not to miss another opportunity, Graham has begun waiving fees and instead taking equity in clients he thinks have a good shot at success. Like a venture capitalist reviewing business plans, he now weighs the potential of every company Arizona Bay works with. "There's a huge opportunity cost in not taking equity," he says.

It's easy to see where Graham is coming from. In the past few years, hundreds of small companies have been snatched up by private equity firms willing to agree to ever-rising valuations. Even with the turmoil in the capital markets in the second half of 2007, it was another record year for merger and acquisition activity. One of the ways vendors and partners--whose behind-the-scenes assistance often is crucial to a start-up's success--can get a piece of the action is to exchange services for equity.

Such an arrangement is hardly unprecedented. During the first Internet boom, companies that provided services to tech start-ups were all too happy to work for stock. A lot of them, alas, ended up with nothing but a stack of worthless paper. But that hasn't deterred outfits like Arizona Bay. "Service companies are increasingly looking to get into work-for-equity relationships," says Peter Wendell, managing director of the Menlo Park, California-based venture capital firm Sierra Ventures and a faculty member at Stanford Business School. "But they're approaching them with more caution than they did during the '90s."

In the 1990s, Graham was one of those entrepreneurs giving away equity in exchange for crucial services. And his vendors ended up with nothing when his company, OpenAuto.com, went out of business, in 2000. So when Graham launched Arizona Bay, he was more interested in cash-in-hand than the promise of a big payday down the road. Indeed, he regularly turned away would-be clients who couldn't afford his fees, even if they offered him equity instead.

But as Arizona Bay grew--it now has 40 employees and more than a dozen clients--Graham began to worry that he was missing out. In 2002, he stepped gingerly into the work-for-equity arena, with a modest investment in one start-up. By 2006, he was still only dabbling in the occasional work-for-equity

deal. But in 2007, after Jumpstart's success, he decided to get serious. Over the past year or so, work-for-equity arrangements have become an integral part of Arizona Bay's business model. Last year, three of Arizona Bay's 12 consulting contracts involved equity. In total, the company invested more than \$1.1 million of consulting work in start-ups in 2007.

Graham is careful about whom he chooses to partner with. He prefers to work with companies that are building Web-based applications and have relatively low start-up costs. Because many of these businesses don't yet have revenue, valuation discussions aren't very scientific, and the process requires some haggling. In most cases, Arizona Bay's management team asks for a stake of at least 20 percent. Graham also pushes for common stock, the right to participate in future funding rounds to preserve the size of the stake, and a guaranteed seat on the board. Equity payments are structured as common stock or as warrants, which give Arizona Bay the right to purchase equity in a client's company at an agreed-upon price at some point in the future. Arizona Bay has also blended equity payments with revenue-sharing deals.

In one recent deal, Arizona Bay agreed to invest \$140,000 worth of website development work in a company called Pro Player Connect. The company's founder and CEO, Jason Kyle, a 13-year NFL linebacker who currently plays for the Carolina Panthers, came to Arizona Bay with just a few business contacts and an idea: an online hub that would connect professional athletes with local sponsorship deals, promotional contracts, and free and discounted promotional gear. Graham liked the idea. In the course of a few conversations, the two men agreed upon a valuation and drafted an arrangement in which Graham would convert fees into an undisclosed amount of equity in Pro Player Connect. Arizona Bay would also get one of three board seats. Kyle retained the right to name the third board member. The site was set to launch just before the Super Bowl.

Graham believes the deal's upside could be significant. The sports endorsement industry is worth nearly \$1 billion and has only recently begun migrating to the Web. Pro Player Connect has attracted some high-profile investors--football veterans Vinny Testaverde and Christian Fauria, as well as NASCAR driver Michael Waltrip. Kyle, for his part, says Arizona Bay's dual role as investor and vendor has been a bonus. "My official title is CEO," says Kyle. "But I've definitely had to lean on Dave. He's definitely steering the ship at times."

Of course, Arizona Bay is a consulting company, not a venture capital firm, and doing the work of both simultaneously can be time consuming. In addition to his legal and fiduciary responsibilities as an investor and board member, Graham spends about 10 to 20 hours per week dealing with start-ups his company has invested in. Investing in start-ups, even at a small level, means opening yourself up to many of the same headaches you're experiencing with your own company. If Graham bets on the wrong entrepreneur, he could lose money--and get swamped with managerial problems at the same time. "My inbox is filled with e-mails from CEOs who have questions every 15 minutes," Graham says. "And they're all pressing."

That's a lot of pressure, given that such deals won't pay off for several years, if ever. But there are ways to tailor equity deals to make them more comfortable for the risk-averse. Take GlobalLogic, a \$100 million software research and development company based in Vienna, Virginia. GlobalLogic takes on about 80 new clients a year, and about 10 percent of the deals now involve a work-for-equity structure. To be safe, GlobalLogic will put only its profit margin at risk: Customers have to pay enough of the fee to cover costs. Also, GlobalLogic takes small stakes, typically from 1 percent to 5 percent. That way, the investments are big enough to be profitable but small enough that GlobalLogic won't be tempted to--or able to--take a hands-on role in running its clients' companies.

The low-risk system limits the upside but still allows GlobalLogic to make a tidy sum if a client does well. Last year, Internet Transaction Services, a GlobalLogic client, was sold to Online Resources Corporation, a Web-based financial services firm, for \$45 million in stock and cash. Peter Harrison, GlobalLogic's CEO, says the company made significantly more on the deal than it would have if it had charged only a fee. Still, he plans to keep the investments small. "We're not getting confused about our business," he says. "We're not a venture capital firm."

Graham has a different view on the matter. Last fall, Arizona Bay launched its own venture capital firm,

Arizona Bay Technology Ventures, which will invest from \$50,000 to \$750,000 in early-stage start-ups. Some of the VC firm's investments will also be Arizona Bay clients. It's too early to say how well the strategy has worked; none of Graham's investments has gone bust, but he hasn't cashed out yet, either. Graham thinks the potential payouts are worth the risk. "We're willing to invest heavily in clients we think will become cash cows," he says.

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