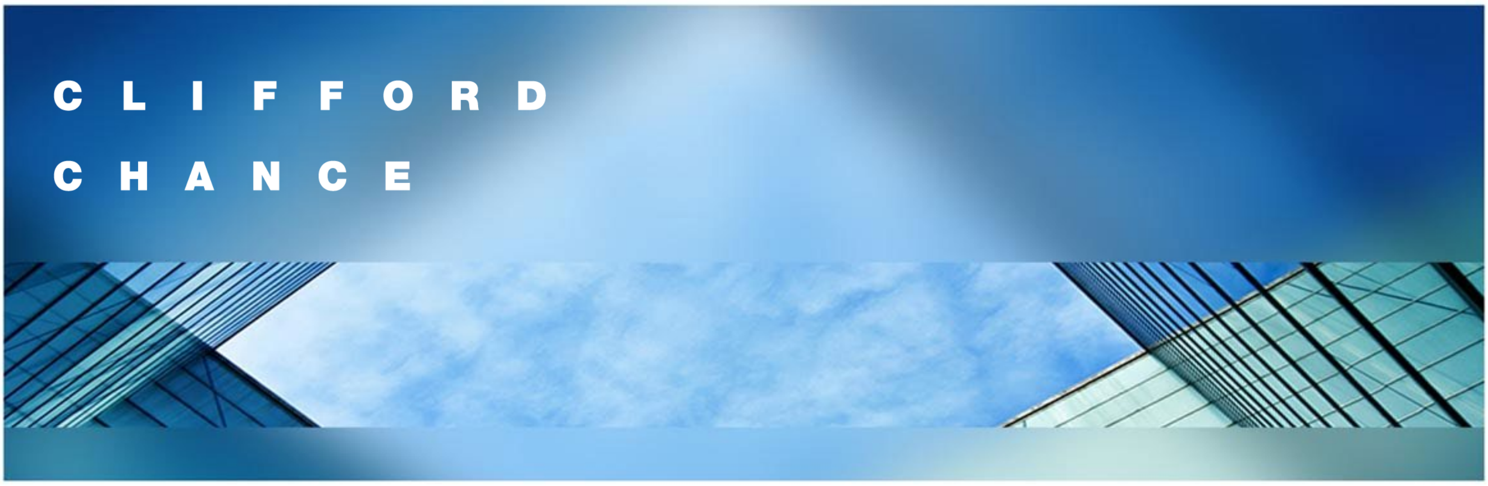

VENTURE DEBT: A LIFELINE FOR GROWTH COMPANIES

When raising equity becomes difficult or more expensive for growth companies, venture debt can come to the rescue. In inflationary times and economic distress, it might be the lifeline a growth company needs. Growth companies are increasingly contemplating the use of venture debt as a supplementary source of non-dilutive financing. Given the uncertain economic outlook, venture debt can also be considered as a buffer against running out of cash, extending the runway to the next milestone. We expect the current economic climate to act as an accelerator for an exponential rise in popularity.

Key takeaways

- Venture debt is a supplementary source of non-dilutive financing for growth companies
- Allows to bridge the gap between two equity rounds, prolong a runway period, finance working capital assets and validate the business(model)
- Can be structured in different ways depending on growth company's needs and lifecycle; in most cases venture debt is combined with warrants which give lender right to subscribe to equity of the growth company at certain price within a specific period of time
- Amount of venture debt raised in a single transaction is usually 25-50% of the most recent VC fund raise
- Mainly suited for growth companies with an already robust business model and capability to repay interest in the short term to avoid default and dilution

WHAT IS VENTURE DEBT?

A financing tool

Venture capital financing has been around for quite some time. It is widely adopted as a financing method for early-stage companies and growth companies with a higher risk profile than more mature established businesses. However, early-stage companies with at least some track record and a viable revenue model can also finance themselves through debt. Venture debt is used as an alternative to equity(-like) financing instruments such as convertible debt or preferred equity. Venture debt facilities are usually, though not exclusively, raised shortly after an equity increase to extend a company's cash runway with a view to minimising dilution and maximising shareholder value. Specialist dedicated funds or banks provide these lending facilities to venture capital backed entities with high growth potential, especially in the technology and life science sectors. Since such companies have only little assets to secure and are often burning cash, they are less apt for conventional debt financing. Venture debt lenders tend to look over longer horizons and service loans based on future revenue streams.

Structure and characteristics

Venture debt tends to take the form of a non-convertible senior loan that can be either secured or unsecured. Its maturity is short to medium term (one to four years), but there is no standardised structure. A typical form of collateral that is granted in the case of secured transactions, are intellectual property rights.

Typically venture debt financing packages offer an equity upside exposure to the lender, which can compensate the lender for the lack of security. Generally, that equity upside consists of a package of warrants – the amount of which is expressed as representing a slice of the total loan amount. The warrants are exercisable against a predetermined strike price, which is generally linked to the growth company's valuation at its most recent equity raise or to its valuation at a future capital round with a discount. We have seen the subscription price being expressed as the lower valuation of a previous financing round and a future financing round, economically 'capping' the subscription price without the warranty holder risking a downturn. This allows the lender to acquire shares in target entity as compensation for the unsecured character of the loan with a high(er) default risk. Alternatively, the debt might be directly convertible. Apart from these equity kickers, other forms of earn-outs are possible.

Most venture debt facilities consist of amortising loans, which start with an "interest-only ("I/O") period" of six to twelve months. After the interest-only period, the borrower also starts servicing the principal amount. Other pricing structures might be possible, such as all interest being payable at maturity only, equity kickers (e.g., the abovementioned warrants) and other forms of earn-outs. The facilities will be accompanied by agreed fees.

WHY ARE GROWTH COMPANIES CONTEMPLATING VENTURE DEBT?

Why now?

The current economic turmoil and uncertainty due to unusually high inflation have important consequences for growth companies, which typically have large upward growth potential but negative cash flows. The uncertain economic climate is putting pressure on valuations and we have seen raising equity becoming more difficult as investors show decreased risk appetite. In order to avoid so-called "down rounds" (i.e., raising equity at a lower valuation than the previous equity raise) that can be highly dilutive to founders, debt financing – now more than ever – has appeared as an attractive alternative for growth companies to bridge the gap to the next equity round and extend their cash runway. Using venture debt can as such serve as a supplementary source of non-dilutive financing. Venture debt is in particular attractive to growth companies with liquidity problems, such as tech scale-ups that experience delays in meeting milestones. Venture debt can fund the gap until the company is back on track to achieve the valuation milestone and such work as cash insurance in harsh times.

Why is it useful?

If a growth company has a proven business model, venture debt liquidity facilitates further growth during times of economic distress and attracting equity later – when the tide has turned – at a higher valuation. Growth companies can further execute their business plan, establish a decent credit track record and safeguard their capacity to raise future equity and (bank) debt without incurring damage from a cash shortage. Typically, in the venture debt market, borrowers are able to tap around 25 to 50% of the amount raised during their most recent capital round. The exact slice is determined by the specific circumstances of the transaction, such as the company's size and the intended use of the proceeds. To repay the loan, the company can raise new equity, opt for refinancing, or – if it becomes cash flow positive in the meantime – use its revenue streams.

As mentioned above, venture debt also has the benefit of avoiding shareholder dilution. The company does not issue additional shares at the time of incurring the debt, but research moreover has suggested that the extended runway period also results in the ability to raise equity less expensively at the next capital round, which reduces the dilution for existing shareholders even further.[1] Although, companies that deploy newly raised equity to service outstanding debt instead of for growth purposes, risk attracting that equity at a slightly discounted valuation (reflecting the need for debt repayment) compared to if it could use its operational resources for repayment. This will merely be the case for companies that are still in an earlier stage and yet to prove their business model.

Another advantage to growth companies is that venture debt facilities typically contain no or limited operational and cash covenants.

Other considerations when using Venture Debt

Using venture debt as a supplementary finance source should be carefully assessed, both by potential investors and growth companies. At least the following key considerations should be taken into account:

- **Pricing**: venture debt can be more expensive than traditional sources of financing such a senior secured debt; growth companies should take this into account in their business plan and investors in their investment decision. Interest and principal payments can be burdensome for a growth company if it burns cash in the meantime.
- **Timing**: growth companies will typically elect to use venture debt only – and investors will accept to provide such debt – if the borrower has achieved a certain maturity (e.g., full marketing and product launch) to avoid interest and principal payments being overly burdensome.
- **Security**: if venture debt providers require collateral, this is often structured as a pledge over the growth company's IP.
- **Still potential dilutive effect**: the lender of venture debt can exercise its warrants which might still dilute the existing shareholders; a careful assessment should this be made by existing investors before taking on venture debt that contains equity kickers.
- **Debt implies creditors**: contrary to venture capital, venture debt does not come with investors that acquire stakes in a company and advise it in becoming a better and bigger business. The lender merely becomes a creditor and does not intervene in the management, allowing the founders and investors to remain in control. Management needs to consider that creditors have a mere contractual claim and might not hold back from assertive handling to ensure recovery of their claim. This might involve invoking events of default to accelerate the loan or even pushing a company towards insolvency proceedings in case of servicing failure

[1] Jesse Davis & Adair Morse & Xinxin Wang, 2020. "The Leveraging of Silicon Valley," NBER Working Papers 27591, National Bureau of Economic Research, Inc.

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