The real reasons why you should consider venture debt

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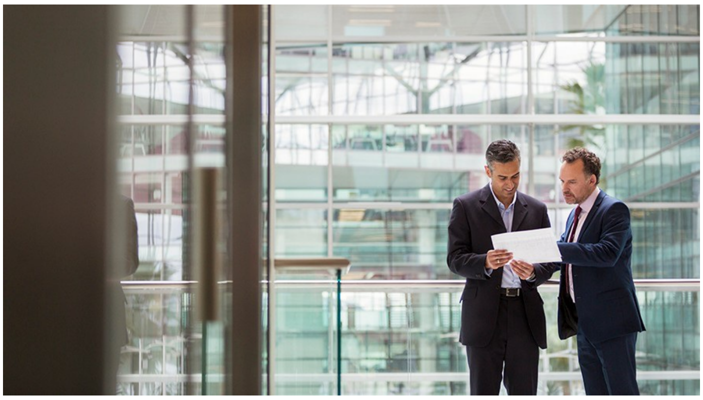

There are many reasons to finance growth for your startup: to realise financial targets in your business plan, to extend the cash runway, to hit the next milestone, to bridge a funding or timing gap, to avoid a down-round, to fund an acquisition or other capital expenses or sometimes just as an insurance measure.

Venture debt can be an attractive way to finance these goals in an earlier stage venture-backed business, particularly around the Series A and Series B markers, with less dilution for existing shareholders than an equity financing.

According to a 2017 article in Pitchbook, the total number of deals completed annually by US-based startups that were partially made up of debt, increased year-on-year from 2008 to 2015 taking a small dip in 2016. The article also said that the cumulative size of those deals rose dramatically from $4.3 billion in 2013 to nearly $14 billion in 2017

Kreos Capital's V Growth Debt fund is the most significant growth debt fund in Europe and Israel. With €400 million of equity commitments, the firm is also one of the more considerable overall growth capital funds dedicated to the region. Companies like Barclays are also backing venture debt, and in 2016, they announced their first £200m venture debt fund.

Venture debt

Typically, venture debt loans are provided by dedicated venture debt funds and sometimes banks, and often complement existing equity funding solutions following a seed or institutional VC investment. Sometimes a venture loan can also form a proportion of a more substantial equity funding round.

Unlike traditional commercial lenders, venture debt lenders normally don't require a valuation of the business or any financial covenants or leveraging ratios. They're also usually prepared to lend to venture-backed early stage companies, even where their revenue profile is significantly lower than a bank would require for lending, because of a company's existing affiliation with a well-known venture capital firm or another institutional investor.

However, in return, these lenders will expect as a minimum, regular access to all financials, external reporting and compliance requirements, a robust and first ranking security package over all the assets including Intellectual Property (IP), bank accounts and receivables and specific protection via representations, warranties, and ongoing positive and restrictive covenants (which sometimes include financial covenants and milestones).

Venture lenders will also require that a Warrant is issued to them typically in respect of the most senior class of shares in the borrower and often at a pre-determined price. However, the expected warrant coverage (usually around 5-12% of the value of the loan) in a venture debt round is a fraction of the equity dilution in an equity funding round. If you don't intend to draw down the entire amount of the loan the venture debt lender has committed to fund, you may still be required to issue a Warrant over the whole loan value, so this should be looked at carefully.

Remember, a venture debt loan creates a cash expense and needs to be repaid monthly (although there may be an interest-only grace period available) or refinanced on maturity (pre-payments unless in full are typically not permitted and will be subject to prepayment penalties). The creation of security will also be apparent on public records and, ultimately, if repayments can't be met the lender can enforce its security and take possession of the collateral and the business. So, it's vital at the term sheet stage to ensure that you approach a range of dedicated venture debt banks and funds to try and negotiate the most appropriate and affordable deal for you.

You should also consider the different types of borrowing models available for the loan facility. Traditionally, venture debt loans are structured as term loans but in certain circumstances, a lender may consider a revolving line or combining term and revolving facilities where receivables or other revenue lines from the business can be used directly to support repayments under the facility and enhance the collateral profile.

You should try to ensure that the size of the loan is commensurate with the needs of the business, that the availability period is sufficiently long with flexible drawdown options and that the amortisation schedule is realistic and achievable.

It's also essential that the covenant and control package sought by the lender is not overly restrictive on the borrower's business and that the structure of the loan gives the most appropriate financing for your business. However, it's important to bear in mind that lenders are not that flexible and rarely relinquish standard covenants, controls, and security requirements.

Venture debt lenders have to be able to offer competitive interest rates and operational fees, although these will still be at the higher end of the scale given the lender's potential risk exposure on a venture debt deal. It's also important to note that the borrower will always have to cover legal and transaction costs for both itself and the lender, which can be quite significant given the complexity of documentation required.

Tips for taking on venture debt

Here are some bitesize tips for taking on venture debt as an alternative financing option for your startup.

- Be selective about which venture debt lenders to target for your business and think carefully about the best timing window to maximise your chances of securing a venture debt deal.
- Remember, you will need to be able to demonstrate liquidity reserves coming from serious investor backing, as a result of a recent VC or institutional funding in your start-up.
- Make sure your existing investors are included in the thought process and support the proposed venture debt round and warrant issue.
- Do your homework on what to expect regarding warrant coverage, security package, ongoing obligations and deliverables to ensure you are sufficiently prepared for the level of control a venture debt lender will want over the business.
- Shop around on fees, interest rates, and warrant coverage and look out in particular for interest-only options, flexible drawdowns, and early prepayment opportunities.