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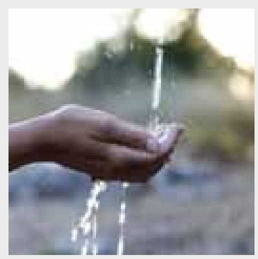


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Venture Debt: A Capital Idea for Startups

Patrick Gordan
Strategic Partner

Access to capital is the paramount concern of emerging growth companies. First and foremost, a startup must secure the proper amount of capital; too little and it may fail to thrive, too much and it may become bloated and unable to grow efficiently. Cost is critical as well—many an entrepreneur and investor have built successful companies only to find that the fruits of their labor have been diluted significantly along the way.

These concerns have led to demand for supplemental forms of financing that provide startups with the capital they need, at a cost that makes sense. To meet this need, venture debt has emerged as an integral part of the entrepreneur's toolkit. *Venture debt* is a form of debt financing for venture equity-backed companies that lack the assets or cash flow for traditional debt financing, or that want greater flexibility. A complement to equity financing, venture debt is generally structured as a three-year term loan (or series of loans), with warrants for company stock. Typically, venture debt is senior debt that is secured by a company's assets or by specific equipment. Overall, venture debt is a form of "risk capital" that is less costly than equity when structured appropriately.

As a partner at a leading venture lending firm, I have seen firsthand the benefits of venture debt. My partners and I have committed nearly $500 million in capital to emerging growth companies since 2000, and have witnessed instances where the use of venture debt has increased shareholder value over $1 billion for a startup.[1] Yet despite the growth of the venture debt industry, for many it remains an unfamiliar form of financing. In this article, I explain how venture debt arose, explore its value for the entrepreneur and investor, and describe how it can be used.

The Genesis of Venture Debt

In many ways, the 1970s and 1980s witnessed the coming-of-age of the modern venture industry, as pioneering venture firms such as Sequoia Capital and Kleiner Perkins established track records and experience over multiple funds, and successful startups like Apple, Genentech, and Sun Microsystems demonstrated the potential of venture investing. Yet for all the promise of venture, startups—and indeed the entire venture industry—were capital-constrained. While limited partner (LP) commitments to venture funds would later grow dramatically (peaking at $104 billion in 2000), in 1985 limited partner commitments were only $3.8 billion.[2]

In this environment entrepreneurs and investors sought alternative forms of financing, and looked to the high-tech equipment leasing industry as a form of financing that could help

[1] e.g., Art Janik, "Google's Debt of Gratitude," *Private Equity International* (May 2005), 63, available from http://www.privateequityinternational.com/Pages.aspx?pageID=3349&aID=15068.

[2] National Venture Capital Association, *2012 National Venture Capital Association Yearbook* (Arlington, VA: Thomson Reuters, 2012), 22, http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=876.

satisfy the needs of startups at a time when substantial capital investment was required. Leasing, they felt, would augment equity capital and result in a more efficient capital structure. Just as more-established firms financed valuable equipment with debt rather than equity, entrepreneurs and investors sought to do the same to preserve scarce investment capital and lower the overall cost of financing.[3]

Unfortunately, however, the high-tech equipment leasing business looked not only at the value of leased equipment, but also at the creditworthiness of the borrower. Without financials demonstrating three years of profitability, leasing companies and banks would only provide financing for half the value of the equipment. While this was helpful, substantial capital needs still had to be satisfied with equity. To cover the other half, the company's equity investors could provide the banks with a guarantee, but this approach created a new set of problems; the equity investors required warrants in exchange for the guarantee and still had to set aside capital to cover their obligations to the banks.

The reluctance of banks and leasing companies to fully finance equipment for startups was based on the widely accepted notion that startups failed at an alarmingly high rate. Indeed, Dun & Bradstreet reported at the time that 80% of all startups failed.[4] The idea of venture debt emerged from those familiar enough with venture to question this perspective.

For example, Mike Lee of Equitec Financial Group, a firm active in equipment leasing, observed that the failure rate for venture-backed startups was much lower than commonly accepted, and critically, virtually all of the failures occurred four years or more after inception. Therefore, providing financing to startups on a three-year basis would have a lower default risk than commonly believed. As the available lease financing forced companies to utilize 50% equity for equipment purchases, it would be more advantageous to offer the startup 100% financing, repaid over three years and combined with a warrant to purchase preferred stock. This approach would have a reasonable risk profile, with the warrant compensating for any incremental risk.[5]

Equitec, Western Technology Investment, and other firms were pioneers in the venture-leasing space. Their initial deals were financed with a combination of investor capital driven by investment tax credits and bank borrowings. In this era, venture lessors were often looking for clients and investors at the same time; many venture debt firms active today can trace their roots to one of these companies. About the time that the investment tax credit ended, new firms were created that began to use a fund structure to finance transactions. Eventually, traditional leasing companies such as Comdisco and GATX entered (and subsequently exited) the space, followed by technology-focused banks such as Silicon Valley Bank.[6]

Benefits for Entrepreneurs and Investors

The value of venture debt is often described in a number of ways—the phrases "bonus round" and "insurance policy" are common—but fundamentally, it exists because it makes venture more efficient. Capital is invested in startups to achieve milestones critical for the development of the firms and integral to increasing value, as reflected either in the value accorded in future rounds of financing, or in the value captured at the sale or initial public offering (IPO). As shown in figure 1, the valuation of startups proceeds in a stair-step fashion. The incremental capital afforded by a venture loan allows startups to achieve more progress ahead of the next valuation event, or to increase the certainty of reaching such milestones, while minimizing the dilution that would occur by securing additional capital at an earlier round.

The value provided by venture debt can be further understood as the incremental ownership

[3] Mike Lee, Equitec Financial Group, interview, August 2012.
[4] Ibid.

[5] Ibid.
[6] Ron Swenson, interview, August 2012.

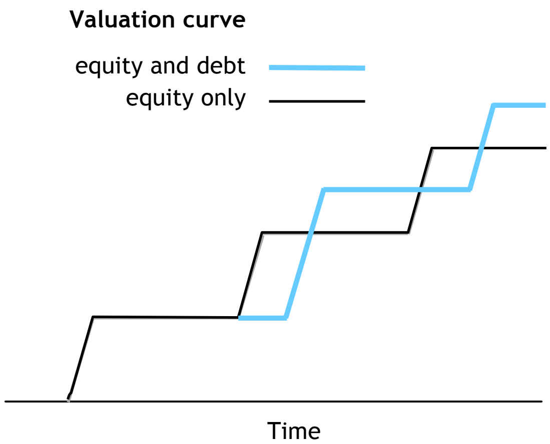

Figure 1. Shareholder Value Over Time: Venture Debt Makes Venture More Efficient. Author's image and analysis.

retained by raising debt, reduced for early-stage companies by the additional equity raised at later rounds to repay the debt. Specifically, consider $1 of venture debt with 8% warrant coverage, and interest and principal repayment terms such that 20 cents will be paid prior to the next round. The company has gained the use of 80 cents of capital for roughly 6 cents of dilution, reducing dilution by over 90%.[7] To the extent that the company will raise additional capital in the future to repay the debt, based on common repayment terms and taking into account the average increase from round to round, dilution is reduced by 45% as compared to raising more equity at the outset.[8]

Case Example: Late-Stage, On-Demand Software Company

To a certain late-stage, on-demand software company, Leader Ventures provided $1.25 million of venture debt financing for sales force expansion. The cost of the financing was $250,000 in interest and warrants representing 0.79% ownership of the company. Issuing new equity at the last round would have resulted in 10.7% ownership of the company, so using venture debt resulted in a dilution savings of nearly 10 points. This dilution savings produced significant value: 22 months after the financing, the company was purchased at a significant multiple to the last valuation. By retaining greater ownership of the company, proceeds to management and shareholders were increased by $5.2 million.

Additional Benefits

The value of venture debt extends to other areas as well. Venture loans can generally be arranged much more quickly than equity financings, saving valuable management time or meeting unforeseen needs (e.g., an acquisition). At Leader Ventures, we have closed financings in as little as two weeks from initial contact to funding. A venture-debt financing does not establish a valuation for the company, which can be helpful ahead of a new round of equity financing, before a potential sale, or in avoiding an inside round, where management and existing investors would otherwise need to negotiate a price. Finally, venture lending firms do not generally require board seats or observation rights, removing questions of board dynamics. Figure 2 shows the distinctions between venture debt and other types of loans.

Overview of the Venture Lending Industry

The venture lending industry has evolved significantly from the early days of venture leasing. As tax laws changed and equipment financing became a smaller part of startup capital needs, leases changed to loans, and financing broadened to encompass a multitude of purposes, leading to what is now called venture lending or venture debt. Venture investors as well as company management teams became much more sophisticated in how they use venture debt, and today's providers have learned much from past downturns.[9]

[7] The dilution inherent in a warrant has to take into account the exercise value of the warrant, especially as most warrants contain a net exercise provision where the number of shares delivered is net of the shares needed to satisfy the exercise price. Assuming that the warrants are exercised at a time when the company's value has grown 4x, the dilution is 3/4 of the warrant amount.

[8] Increase in valuation from Series A to Series B, and Series B to Series C, for 2011 based on Fenwick & West, "Silicon Valley Venture Survey: Second Quarter 2012," 23 August 2012, http://www.fenwick.com/publications/pages/silicon-valley-venture-survey-second-quarter-2012.aspx.

[9] This synopsis is based on my experience working in the industry for many years and discussing trends with many colleagues.

	Venture Debt	Convertible Debt	Working Capital Line
Description	A *non*-convertible, senior term loan that can be used like equity, and includes warrants	A loan that converts to stock in the next equity round, usually at a discount or with warrants	A revolving line of credit that is secured by working capital; may or may not include warrants
Repayment	Generally repaid in monthly payments over the life of the loan	None, converts to equity	Can flex up or down over the life of the loan, depending on the "borrowing base" securing the loan
Approximate Interest Rate	10-15%	3-8%	6-10%
Dilution	Generally a small fraction of equity (< 1%), due to warrants	Similar to equity, but can be more or less dilutive depending on valuation in the next round and specific terms	Minimal to none; may or may not include warrants
Default Clauses	Varies, but often limited to failure to repay	Generally none	Often includes MAC catch-all (any "material adverse change"), investor abandonment, etc.
Financial Covenants	Generally none	Generally none	Often bound to a minimum amount of cash, A/R, performance vs. plan, etc.

Figure 2. Types of Debt Financing for Startups. Author's image.

Growth in Use—and in Thoughtfulness

In the early days of venture leasing, companies that secured venture leases were mostly capital-intensive hardware businesses, such as semiconductor firms or computer manufacturers, followed soon thereafter by biotech companies that faced significant capital requirements to build out research laboratories. Other industries such as software were not seen as attractive to the early venture lessors, due to concerns about the inability to patent software.

In the early 1990s, however, companies started to see value in using a modest amount of term debt to extend their cash runway and delay their next equity round. Many venture lessors were slow to adopt this new structure because it did not offer them the "hard" collateral they expected. With time, many providers began to realize that they could increase their warrant coverage with this new type of loan and that the level of enterprise value within the companies could be sufficient to support the value of their loans. With this realization, the transition from venture leasing to venture lending was under way. Many of the downsides of being a lessor (e.g., collecting personal property taxes or double sales taxation) were eliminated by using a secured loan structure.

As widespread adoption of venture loans coincided with the dot-com boom, both borrowers and some lenders in the space began to stray from the fundamentals that built venture debt into a valuable part of the venture ecosystem. With the dot-com downturn several players were forced out of business, although the teams who ran them quickly re-entered the space with new organizations.

Both companies and investors learned quite a bit from this time, and are more prudent about their use of debt and about considering what the debt will mean to their companies if they encounter difficult times. The mindset that debt is just a cheap form of equity does not work, because if things do not work out, the company is still on the hook to pay back the debt.

Today's venture lenders and management are far more thoughtful about how they utilize debt and consider whether it is (or is not) a good fit for them. Companies now consider intangibles when choosing a lender, and ask important questions such as, "Am I dealing with a decision-maker?", "What is their history working with companies that hit hard times?", and "Will they take a long term perspective?".

Market Size

Only limited statistics are available on the annual volume of venture loans, as most providers are private funds or divisions of larger businesses that do not report separately on their venture debt activities. Most estimates place the market size as $2-4 billion per year.[10] The market for venture loans is often considered a function of the amount of venture capital equity invested in a given year, and thus downturns in venture equity generally reduce the available market for venture debt transactions.

Participants

As the venture lending industry bounced back from the dot-com collapse, more providers entered the scene. The new money came from different sources and was attracted to different aspects of the space. Hedge funds liked the uncorrelated nature of venture debt's returns, traditional leasing companies saw growth potential, new banks saw value in securing client relationships with high growth businesses. When combined with existing players, these new entrants significantly added to the industry's funding capacity. While many of the mainstream players are industry generalists, there are now specialists in life sciences, software-as-a-service businesses, and regional firms.

Many participants segment today's venture debt providers into three groups, based on how they are funded. A firm's funding source often dictates its behavior, and therefore influences how it approaches risk-reward tradeoffs in financing.

Banks

At one end of the spectrum are banks that provide venture debt. Subject to federal banking regulator oversight, which may look critically at term loans to cash-flow-negative businesses, banks are nevertheless very attracted to the space because venture-backed companies generally carry significant cash balances (especially after they close a new equity round).

Banks can utilize their position as a lender to require companies to maintain their cash with the bank. While the bank is primarily interested in the revenue opportunity, it also gets security from holding cash if the company hits a bump in the road. Banks are considered to have the lowest cost of capital, and thus they often provide very attractive terms; however, they are the most likely to limit the size of their loans and mitigate risk through financial covenants. In addition, they often require "material adverse change" or "investor support" clauses, which permit a default to be called by the lender if—in the lender's judgment—a material adverse event has occurred or investors are unlikely to finance a company sufficiently to repay its outstanding debt.

Finance Companies

Finance companies may be independent businesses focused on venture lending, or they may be divisions of larger finance companies. Like banks, finance companies often use a business model with salespeople marketing to clients and centralized decision-making by credit committees. Finance companies are often comfortable with larger loan sizes, but they have a higher cost of capital than banks. In addition, they are frequently publicly-traded and are therefore sensitive to near-term earnings, which can make them more risk-averse when there is the prospect of an unexpected loss.

Funds

Funds are generally higher-cost providers but are usually willing to take more risk in exchange for higher return. Most funds more closely resemble

[10] Timo Fischer and Gaétan de Rassenfosse, "Venture Debt Financing: Determinants of the Lending Decision" (working paper, 24 January 2012), 3, http://dx.doi.org/10.2139/ssrn.1909602; Darian M. Ibrahim, "Debt as Venture Capital," *University of Illinois Law Review* (2010): 1169, University of Wisconsin Law School Legal Research Paper Series Paper No. 1081, http://dx.doi.org/10.2139/ssrn.1418148.

venture capital firms in that their partners are both identifying opportunities and making investment decisions, which can be helpful from the company perspective as decision-making is more transparent. It is uncommon for most funds to use financial or subjective default covenants, and frequently funds will lend more to a given company than other types of lenders would.

Types of Venture Debt

In today's market there are two general types of venture debt available. *Equipment financing* is used specifically for the purchase of equipment, and is secured by that equipment alone. The availability of equipment financing is tied to the actual purchase of equipment, and therefore if less equipment is purchased than initially planned, less financing can be utilized. As a result, this type of financing is often less costly, though not all venture lending firms offer equipment financing.

Growth capital has come to refer to term loans that can be used for any corporate purpose. Growth capital term loans are secured by a blanket lien on a company's assets, which may nor may not include a lien on intellectual property.

Using Venture Debt

When utilized appropriately, venture debt can reduce dilution, extend a company's runway, or accelerate its growth with limited cost to the business. If utilized poorly or with unfavorable terms, debt can reduce a company's flexibility or become an obstacle to future equity raises.

Venture debt can be useful in the following instances:

- when a company wants incremental capital to accelerate growth without taking equity;
- in conjunction with, or following, an equity round to provide additional capital without increasing dilution;
- for the purchase of equipment;
- for acquisitions; or
- when the amount of capital needed is too small for an equity round.

Venture debt is less suited to the following three situations. First, it does not suit a company that is already at a low cash balance or when used as a financing of last resort. The weaker the cash position of the company, the worse the terms will be. Raising the financing early and structuring it appropriately (to avoid paying back the loan before it is useful) can put the company in a much stronger position. Second, venture debt is not suitable when the debt payments will amount to more than 20 percent of the company's operating expenses. At this point, the financing may discourage future equity investors and can become a burden to the company. Finally, venture debt is less useful when a company has highly stable revenue streams and receivables, in which case a line of credit tied to accounts receivables is likely to be more appropriate and cheaper.

Analyzing Venture Debt

Regardless of the type of financing, the most important question is whether the proposal meets the company's financing goal. If the goal is runway extension, venture debt should be evaluated based on how much it extends the company's cash-out point. If the objective is managing variability in the business, then the proposal must be flexible enough to be available when needed, rather than recalled if the business stumbles and has a weak quarter. In this context, minor differences in interest rates and warrant coverage are not as important as ensuring that the financing meets the needs of the company. This section describes some of the key pitfalls in a considering venture debt.

Covenants

Loans tied to a company's cash balance or accounts receivable are common and can add cushion to the balance sheet, but are risky for an early-stage company as the cash may be recalled when the company needs it most.

Benefits	Concerns	
• Allows equity investors to **reserve additional capital** for future rounds and to invest across their portfolios	• May have to repay debt first if things don't work out, because venture debt is **senior to preferred equity**	**Keep debt to a reasonable amount** to alleviate these concerns
• Helps **avoid dilution from new investors** by reducing the size of a new equity round or helping reach milestones to raise valuation	• May **worry about interest increasing burn** or want the company to **stay lean**	
	• May be concerned about **losing control of the company** if a default is called and/or have had **negative experiences in the past**	Know lenders' **histories and reputations**

Figure 3. How Equity Investors Think About Venture Debt. Author's image.

Default Clauses

"Material adverse change" and other "subjective default clauses" can allow a lender to recall their loan due to events beyond the company's control (e.g., an existing equity investor deciding not to participate in a future round).

Back-End Loaded Deals

A back-end interest payment can help lower the interest paid early on, but loans requiring large final principal payments (i.e., a "bullet") can place a strain on a young company and complicate raising equity.

Lender Reputation

It is important to consider how the lender has behaved in past deals. How long does it take to get a response for a waiver or other ordinary approvals? How often has the lender called defaults? Have they been willing to restructure?

Proposals Burdening the Company

Proposals should not require the company to bear all the risk: a fair deal will be structured such that the lender is putting a portion of its own capital at risk of not being repaid in the future.

Venture debt is a strong option for venture-backed companies who want to add capital and minimize dilution. Though more expensive than traditional working capital lines, venture debt offers far greater flexibility. However, excessive debt or loans with heavy restrictions can be detrimental to a business, and the terms of any potential financing should be considered carefully. Figure 3 summarizes the benefits and concerns of this approach to financing.

The Future of Venture Debt

Looking forward, two trends suggest that venture debt will find continued usefulness as a financing option for startups. Since 1999, the time for startups to reach liquidity through acquisition or initial public offering has increased by almost three and a half years.[11] The increasing time frame has amplified the need for alternative financing sources, including venture debt. In addition, the recent rise of capital-efficient, angel-backed companies is also likely to represent increased interest in alternate financing approaches. Such companies are increasingly reaching scale ahead of raising institutional equity financing, and alternative sources of capital are increasingly of interest to such companies so they can continue to grow without the dilution or control issues of formal rounds.

From the inception of venture leasing in the 1980s, to the growth of venture lending and growth capital loans in the 1990s, to adjustments to the changed venture environment after the dot-com bubble and financial crisis, the venture debt market has continued to evolve and grow.

[11] NVCA, *Yearbook 2012*, 52.

As new venture models evolve in the coming years, venture debt will continue to represent a way for entrepreneurs and investors to support the success of their companies.

Patrick Gordan

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Patrick holds an MBA from Stanford Business School, where he was an Arjay Miller scholar, and an A.B. in social studies *magna cum laude* from Harvard College, where he was elected to Phi Beta Kappa.

Leader Ventures

Leader Ventures is a pre-eminent venture lending firm, established in 2005 by experienced professionals from Dominion Ventures, one of the pioneers of the venture lending industry. With the motto, “Venture lenders supporting great entrepreneurs,” Leader shares with the Society of Kauffman Fellows the mission of understanding and supporting innovation, and fostering an ecosystem built on familiarity and trust. In support of this mission, Leader is proud to be an exclusive partner with SKF.

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