

DEBT FINANCING

Professor Karl T. Ulrich



@ktulrich



Key Idea

- Equity makes the investor an owner of the business – for better or worse.
- Debt is an obligation to return principal and interest.
- Debt is usually *senior* to equity – it is paid back before equity.
- Debt is often secured by assets – the collateral.
- *Examples:*
 - Trade debt (i.e., payables due suppliers).
 - Credit card balance.
 - Equipment financing (e.g., leases for machines).
 - Bank line of credit.
 - Government loans.
 - (Convertible notes from investors.)

Issues with Debt

- If things go well, generally less costly to founders than equity.
- Typically have to pay interest from cash flow, which will be difficult for most start-ups.
- Typically requires personal guarantees of management team, so unattractive to those with significant personal assets.
- If genuinely secured by valuable assets (e.g., receivables, inventory, equipment) then may be a good alternative to equity financing during growth phase.



Source: Aerocardal

Financing Working Capital with Debt

- Working capital is the cash you need to operate the business, even when it is profitable.
 - Cash tied up in inventory.
 - Receivables you are waiting for customers to pay.
- Banks will often provide a line of credit collateralized by receivables and inventory.
 - Loan covenants specify the ratio of debt to collateral. For instance, the bank may be willing to lend up to 70 percent of the value of your receivables and inventory.
 - Often still requires a personal guarantee.
- Specialized financial institutions may *factor* receivables from your financially solid customers.
 - Expensive! Sometimes as high as 24% annual interest.



Government Loan Programs (e.g., SBA in U.S.)



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A special kind of debt – the *convertible note*

- Used as a quick, inexpensive way to raise a (relatively) small amount of capital without setting a valuation. In most respects more like equity financing than typical debt financing.
- Investor puts in seed capital as a loan – e.g., 100,000 USD.
- Loan converts to equity when and if an institutional investor (e.g., a VC) provides more capital – e.g., 1 million USD.
- Usually converts at a discount (e.g., 20 percent) and usually has a “cap” of some amount (e.g., 4 million USD pre-money valuation).



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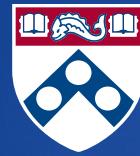
Contact Us



Mark Gallagher
Senior Market Manager,
Silicon Valley Bank
Regions: New England,
New York, Canada



Jim Parsons
Managing Director,
Silicon Valley Bank
Regions: Northern
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