

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.)



Starting & Managing

Loans & Grants

Contracting

Learning Center

Local Assistance

About SBA



1 2 3

Loans & Grants

Video: SBA Loans
Explained ►

Connect with SBA
Lenders ►

Blogs on
Financing ►

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).



Silicon Valley Bank

Investor Relations / News / Locations

Account Login

Search SVB



Clients We Serve Banking Solutions Global Offices Research & Insights About Us Contact Us

Credit Solutions

In bull markets and bear markets, SVB has stayed at our clients' side with financing solutions that support their strategic goals.

Achieving your company's strategic goals takes resources — and resources require capital. In an environment where risk is difficult to assess, Silicon Valley Bank has the industry expertise to manage credit risk while supporting our technology, life science, premium wine and venture capital clients.

With nearly 30 years consistently focused on companies in the industries we serve, we have an unparalleled understanding of business cycles of companies like yours. We've stood by our clients through dramatic market cycles and transformational technology eras.

SVB Credit Solutions

SVB's deep experience allows us to design the right financing solutions for our diverse base of clients, including emerging and established private and public companies. We can support a multitude of needs throughout a company's lifecycle, including:

- **Business as usual**, when you need working capital or financing for new equipment.
- **New markets**, with credit solutions for financing new lines of business or expansion into new geographies, including global growth
- **Ownership restructuring**, with financial support for mergers and acquisitions, buyouts and IPOs, joint ventures, and founder liquidity.

WHAT

Related Solutions

- ▶ [International Banking Solutions](#)
- ▶ [Trade Finance Solutions](#)
- ▶ [Cards and Merchant Services Overview](#)

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
California



Wharton
UNIVERSITY *of* PENNSYLVANIA

ONLINE