

## insights

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# Is venture debt right for your start-up or growth-stage company?

Start-up and growth-stage companies rely heavily on invested capital to fund operations, develop product and scale. However, capital invested by venture capital firms and angel groups can be highly dilutive to founders. Also, subsequent rounds of capital will be dilutive to early investors. As such, founders and venture-backed boards of directors have turned to venture debt as a means to fill the gap between highly dilutive capital events and traditional bank loans that are either not available to young companies or too restrictive on the company's operations.

### What is venture debt?

Venture debt (also known as venture lending) provides non-dilutive working capital for early-stage and growth-stage companies that cannot qualify for traditional commercial loans but that have demonstrated traction and customer adoption, and identified prospects in their markets. Companies that are appropriate for venture debt have developed a strong syndicate of professional investors, secured venture capital financing, and are poised for rapid growth.

Venture loans provide additional runway without causing dilution to existing investors and founders. These loans are typically made in connection with venture equity rounds as a way to provide additional working capital to fund the completion of milestone initiatives that will boost the company's future valuation. This type of debt should not be confused with convertible note indebtedness which is generally short term and provided specifically to bridge companies to anticipated equity rounds. By contrast, venture loans amortize over a multiyear period, are secured by collateral and are provided by lenders, not equity investors.

### Benefits and risks

Generally, venture lenders work closely with boards of directors and equity investors to provide value without creating burdensome operating and compliance requirements in the loan terms. As such, venture loans tend to be free of multiple financial performance covenants and are not limited to specific collateral base formulas (such as typical revolving credit lines). Venture loans often provide flexibility in allowing drawdowns to occur over time and can provide elongated periods of interest-only payments so that a borrower can manage its debt service while preserving as much capital as possible for its operations.

Overall, venture lenders tend to be creative in restructuring underperforming loans. Of course, venture loans are secured by collateral – often including intellectual property – which would be at risk if the loans default. Also, since venture loans tend to be light on traditional financial performance ratios, venture lenders closely track financial statements and other indicators of stability, including cash on hand, customer generation, comparison of budget to performance, and the appetite of the company's equity investors to commit to additional capital infusions.

These soft financial measurements are sometimes expressed through a "material adverse change" provision. This type of provision allows lenders to cease lending, call the loan, or restructure its terms, in the event the lender perceives that the overall prospects of the company are diminished to a degree that threatens the loan repayment or the value of the collateral.

### Typical loan terms and warrant rights

Venture loans range in size, with early-stage borrowings in the \$1 million to \$5 million range, and growth and more mature-stage borrowings up to and exceeding \$20 million. Growth capital loans are often priced at prime plus 5 to 10 basis points, with interest-only payment periods of 6-12 months. Overall, the loans have a 3- to 4-year maturity.

The loans are secured by collateral including intellectual property, or in the alternative a pledge that the intellectual property will not become the subject of a lien in favor of any party other than the lender. In connection with making the loans available, venture lenders receive warrants to purchase preferred equity of the borrower entity. The warrant component provides additional upside reward on the credit risk for the loan.

Overall, venture lenders tend to structure their loan terms based on the needs of the borrower, the borrower's industry and anticipated cash needs, and the input of the borrower's equity investors, as opposed to strict formulas or other criteria that define most commercial loan products.

### Who are venture lenders?

Lenders in the venture debt market tend to fall into two categories: commercial banks that have venture lending groups inside of the bank, and private funds.

Commercial venture banks usually require a depository relationship with the borrower which, if established early, should not be disruptive to a borrower. On the plus side, these banks can provide access to other financial products (merchant accounts, payment processing). Bank loans are usually issued at lower interest rates, given the relatively low cost of capital. But commercial banks are sometimes inhibited by regulatory restrictions on underwriting requirements, making it more difficult for them to offer flexibility on restructure terms. Banks are also subject to changes in ownership or policy, which can affect their lending practices. Nonetheless, banks can provide larger and more complex credit products as borrowers mature including payment processing, hedging and international banking opportunities.

Venture debt funds can provide more flexibility in structuring loans and tend to be aligned with the interests of a borrower's equity investors. Debt funds are typically structured as privately held limited partnerships funded by institutional investors, pension funds, and ultra-high net worth families and individuals. As such, the costs of capital may be higher based on the need to compete for fund investors. However, since private fund managers have the goal of achieving significant returns and are privately managing capital, private fund managers can exercise broad discretion in structuring loan terms, tolerate higher risk, and react quickly to both opportunities and challenges. Private funds can also exercise discretion to convert debt to equity, or to undertake limited equity infusions to support a borrower's capital needs.

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