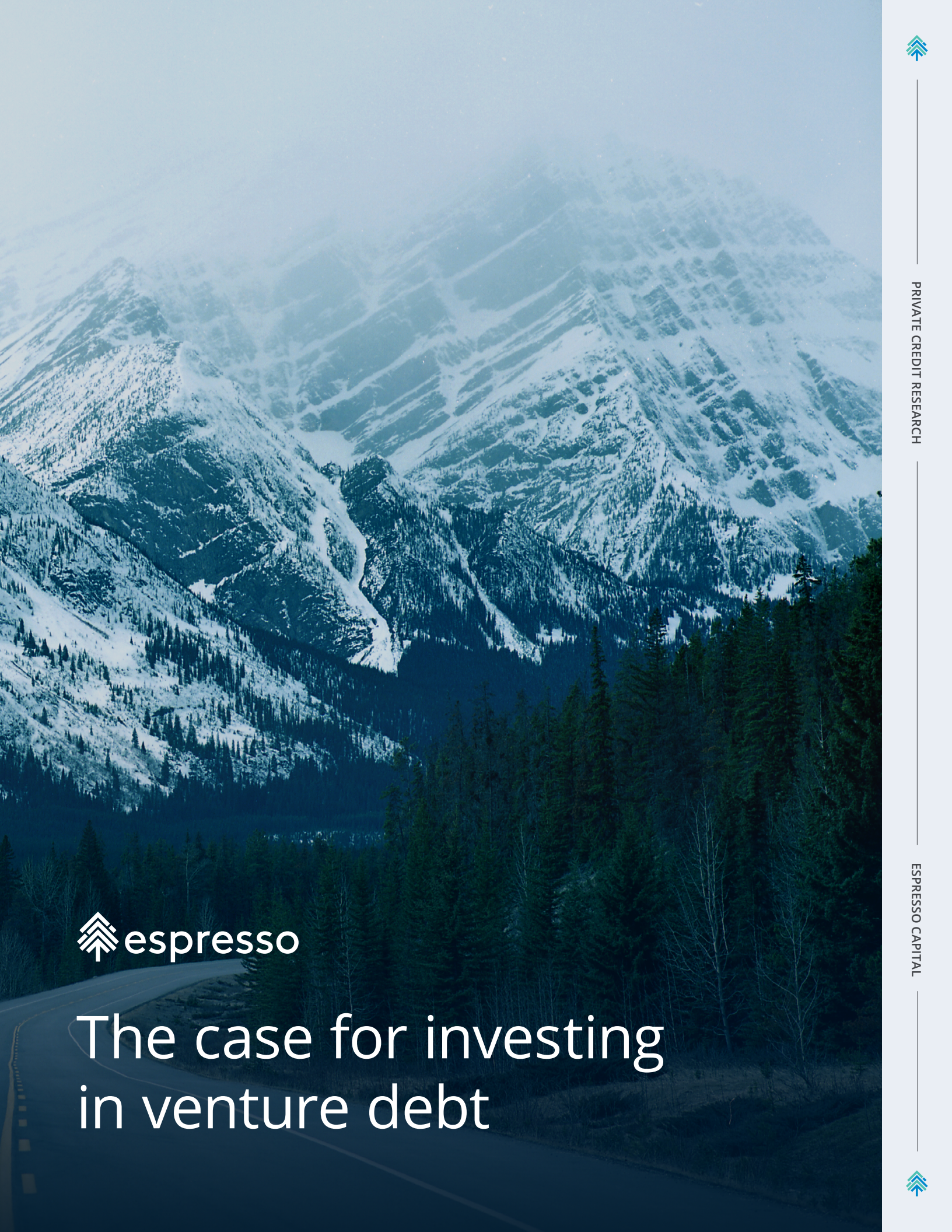




The case for investing in venture debt



PRIVATE CREDIT RESEARCH

ESPRESSO CAPITAL





This publication is part of Espresso Capital's Private Credit Research white paper series, developed to support institutional investors' understanding of evolving themes in private credit, technology lending, and capital markets.

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Introduction

Investors of all stripes—insurance companies, pension funds, sovereign wealth funds, foundations and endowments, family offices, high-net-worth investors, and investment advisors—are increasing their allocations to private debt. This trend reflects the higher returns and enhanced portfolio diversification private debt offers compared to traditional fixed income.

Among private debt strategies, venture debt stands out for its ability to deliver higher risk-adjusted returns with lower correlation than its much larger counterpart, middle-market direct lending. Venture debt has also evidenced lower volatility and correlation compared to traditional and alternative asset classes, enhancing portfolio diversification—a key objective for most investors.

Finally, venture lending is broadly bucketed into two categories: recurring revenue lending to growth-stage software companies and enterprise value lending to pre-revenue and early-stage technology and life sciences companies. Importantly, recurring revenue lending, which is Espresso's focus, has a risk-return profile that looks much more like middle-market direct lending than early-stage or life sciences venture lending.

In our opinion, this combination of characteristics makes venture debt a compelling substitute for fixed income compared to other forms of private debt or public market equivalents like leveraged loans and high-yield debt.

This white paper explains how venture debt works and how it differs from middle-market direct lending, highlighting how these distinctions can positively impact portfolio returns. It also explores the characteristics that make software companies attractive venture debt borrowers, and why venture debt is in such high demand despite its relatively high cost.

Ultimately, this paper makes the case for venture debt as a proven and appealing form of alternative fixed-income investing.

Venture debt is an attractive investment opportunity

Higher returns but similar credit risk

Venture debt offers higher returns relative to middle-market direct lending. While higher yields often correlate with higher risk, there are structural reasons why that isn't completely true of venture debt, which we explain below.

Venture debt is a highly specialized private debt strategy, requiring specialized credit, portfolio management, and loan workout skills, further limiting competitive intensity. Additionally, bank participation in venture lending is limited due to regulatory disincentives. Strategy complexity also plays a role in higher returns, as the category is underfunded relative to the market opportunity.

Despite its higher yields, venture debt's credit risk—measured in realized losses—remains similar to private debt more broadly, resulting in higher risk-adjusted returns.

This imbalance between supply and demand means that the yield on loans isn't just a linear function of the borrowers' risk, thus creating an arbitrage for lenders and investors. In most cases, the antidote to this kind of imbalance between supply and demand is having more lenders enter the market. But in venture lending, the supply/demand imbalance is resolved in the lender's favor—through better pricing and terms—as the need for specialist skills and track record of success provides a meaningful barrier for new entrants.

2017 to Q4, 2024	Gross yield ¹	Realized losses	Net return	Volatility
Cliffwater: venture debt index ²	13.3%	1.2%	11.7%	3.7%
Cliffwater: private debt index ²	10.3%	1.1%	8.3%	5.4%
Differential	+3.0%	+0.1%	+3.4%	-1.7%

Lower portfolio risk without compromising overall returns

Of course, venture debt isn't just about higher returns. One of its greatest features is the diversification it brings to portfolios. Because venture debt returns are relatively uncorrelated with those from other asset classes, investing can help reduce overall portfolio risk.

In an ideal world, your portfolio should be made up of an array of investments that don't all move together. That simple fact helps make the case for investing in venture debt because there is substantial evidence suggesting that the returns from private credit and venture debt aren't particularly correlated with returns from other asset classes.³

If venture debt returns aren't correlated to other holdings in your portfolio, then adding that exposure can lower your portfolio's overall risk.

Venture capital sponsorship and low loan-to-value and provide a high margin of safety

Venture debt borrowers have a very different financial profile than traditional borrowers. They benefit from high growth, high margins, and high enterprise values, but they also consume cash for growth, meaning they are subject to financing risk. As a result, venture loans typically have much lower loan-to-enterprise values than middle-market

1. Gross income yield is the sum of interest, fee, and dividend income divided by average assets.

2. Sourced from Cliffwater Direct Lending Indices, CDLI-V and CDLI respectively, for the period 2017 to Q4, 2024. The CDLI-V and CDLI are asset-weighted by reported fair value.

3. "Private debt funds returns are stable throughout market cycles relative to equity indices with a standard deviation over the period of 0.017 vs 0.71 over the sample period." Professor Amin Rajan, "The Rise of Private Debt as an Institutional Asset Class," 2015.

direct lending, providing much higher loan coverage. That low loan-to-value (LTV) ratio represents a margin of safety for venture debt investors that you won't find in many other strategies with comparable yields. Moreover, this margin of safety is further augmented with venture capital sponsorship, which aligns equity holders' interests with debt repayment.

Managers with specialized skills

Venture lending requires specialist skills due to its need for more complex underwriting and active portfolio management compared to traditional private debt. Specialists use unique underwriting models and tools to assess risk, combining both quantitative financial analysis and qualitative insights, such as industry trends, management team capabilities, and the quality of their equity sponsors.

This expertise allows venture debt lenders to accurately evaluate the value of young, high-growth companies and make informed credit decisions. Additionally, strong relationships with venture capital sponsors provide both better underwriting insights and deal flow, further enhancing the lender's advantage.

Venture debt lenders don't just back managers, they partner with sponsors

Understanding the scale, quality, and depth of an equity sponsor's commitment to a company is an explicit consideration when underwriting a venture loan. Similarly, a sponsor's decision to accept a loan from a venture lender is not based on pricing alone

(though that is an important consideration), but also depends on the scale, quality, and depth of expertise of the lender.

Unsurprisingly, venture lending is very much a relationship-based business, whereby sponsors refer loans to lenders with whom they've had positive experiences. This means that they are more likely to be forthright in identifying any unique risks inherent in a specific company, aiding the lender's due diligence, and are more inclined to proactively reach out to the lender at the first sign of trouble. Sponsors also want to partner with firms that have the capacity to help their portfolio companies, and to partner with people they like and trust. That trust is earned over multiple iterations of a process and can't be replicated.

Venture debt loans tend to be relatively short term

Unlike venture capitalists, venture debt lenders generally aren't trying to guess what the world will look like in a decade's time, and they're certainly not investing on the basis of those views. Instead, they're trying to gauge what's most likely to happen in the next two to four years and lend on terms that will see them paid back in that timeframe.

With that understanding of why venture debt appeals to investors, let's now turn our attention to the companies venture debt providers lend to.

Software companies make attractive borrowers

Recurring revenue business model

Software companies generate high-margin subscription revenues, allowing for greater predictability in borrower performance and therefore lower credit risk. Software companies serving enterprise and mid-market customers, who represent the largest segment of venture debt borrowers, also demonstrate exceptional customer retention rates, further enhancing their predictability and durability. These same attributes make software

companies attractive acquisition candidates too, allowing lenders to maximize recoveries on defaulted loans.

Secular growth

Software companies benefit from secular growth as computing increasingly shifts to the cloud and buyers migrate to modern technology platforms. This adds further resiliency to software companies, as they continue to demonstrate growth even in

difficult macroeconomic environments. Secular growth also contributes to high valuations for software companies, providing an important safety net for lenders.

High customer retention rates

Software is critical to most companies' operations, resulting in high retention rates. Replacing existing software vendors also exposes customers to high switching costs in terms of time, money, and operational risk, keeping them tied to existing vendors, even if they are not entirely happy with their vendors. Software providers often capitalize on this reality by continuously improving the product, thereby ensuring that switching costs remain higher than customers' dissatisfaction threshold.

Operating leverage and ability to extend runway via cost reductions

Since the bulk of a software company's expenditure is allocated to new client acquisition activity, temporarily reducing customer acquisition expenses can extend funding runway during adverse fundraising environments without impacting existing

customer revenues or relationships. This cost management lever can also be augmented by sponsor support, providing software companies with greater capacity to withstand challenging markets compared to the average middle-market company earning transactional revenues.

Ability to exit troubled loans via a sale of the borrower

The large universe of software consolidators looking for upsell and cross-sell opportunities means most software companies have multiple exit options, even in distressed scenarios.

While default and loss rates vary across venture lenders, Espresso has averaged 80% recovery on defaulted loans, resulting in sub-1% average loss rates over the past 8 years.

The attributes above not only reduce the likelihood of a borrower default but also minimize the risk of loan losses in the event of default.

Venture debt **benefits borrowers and sponsors**

While venture debt offers significant advantages to investors, it also provides valuable benefits to borrowers and their sponsors. By leveraging venture debt, these companies can access capital in ways that provide distinct advantages over traditional equity financing. Key advantages include:

Venture debt is materially cheaper than venture capital

Venture capital leads to dilution. Too much dilution too early results in a loss of control over the direction of the business. Meanwhile, founders, CEOs, and other investors all stand to see a smaller payout if and when the business is acquired or goes public.

Extending funding runway

Venture debt can also be a highly valuable funding solution in situations where waiting six or twelve

months to raise a follow-on financing round will yield a material lift in valuation, resulting in less dilution. Similarly, venture debt is an excellent complement to insider financing rounds, which typically have lower valuations than a round led by new investors.

Thanks to the flexibility that can be built into debt agreements, venture debt has numerous other applications. Companies might use it to fund working capital, finance an acquisition, buy out a partner, or simply reduce the time and effort involved in raising capital compared to an equity deal.

However, it's important to note that debt isn't a cure-all. If a company's struggles stem from a flawed business model, borrowing more money won't solve the underlying issues. Still, for companies that need time or can pivot to adjust their growth trajectory, venture debt offers valuable flexibility at a relatively low cost.

A **compelling** private debt strategy

Venture debt stands out as a compelling private debt strategy, offering higher risk-adjusted returns with lower correlation compared to traditional fixed income and other forms of private debt.

The requirement for specialized skills, combined with limited competition, is part of the reason for venture debt's superior performance profile, while low loan-to-value ratios and sponsor-backing provide effective downside protection.

Software companies benefit from predictable recurring revenues, high customer retention, operating leverage, and strong exit opportunities, making them ideal candidates for venture debt financing. Venture debt also provides a flexible and cost-effective alternative to equity financing, helping companies extend funding runway, minimize dilution, and achieve strategic goals.

Overall, venture debt's unique combination of attributes make it an attractive option for investors, borrowers, and sponsors alike, offering stability, growth potential, and versatility in today's rapidly evolving financial landscape.

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