Venture debt:
An alternative growth financing option

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Introduction

Among the many worries that keep founders and CEOs up at night, raising capital is usually one of the most pressing. That's because capital is essential for driving growth as a company evolves from a great idea into a thriving business. Unfortunately, all of the media hype about venture-backed companies reaching astronomical valuations only adds to the pressure. In fact, it can make founders and CEOs see raising huge rounds as a sign of success, even when it's not always in their best interest.

To be clear, there's no question that equity has a critical role to play in helping founders and CEOs meet their business goals. But it's important to recognize that equity isn't the only source of capital to fund a fast-growing company. Using debt to complement your equity funding can be a smart move for stakeholders in a variety of situations, including when they want to:

Achieve a higher valuation. The higher the valuation you get when you raise equity, the better it is for your business. Companies often use venture debt to extend their runway so that they have more time to grow their business before their next valuation.

Secure greater upside. Dilution is a serious consideration any time you raise equity. By using venture debt to meet a portion of their financing needs, founders and CEOs can minimize the dilution they suffer and ultimately see more upside when the business eventually exits.

Maintain control. Using venture debt results in less dilution, providing founders with greater economic and strategic control over the business they worked so hard to build.

Bridge to equity. Sometimes founders and CEOs find themselves in a position where they want to achieve certain operational or financial milestones before raising equity, or where they could simply use additional funding leading up to an equity raise. Using venture debt can help companies accelerate momentum and maximize liquidity thereby optimizing their negotiating position going into an equity raise.

Common scenarios where you might use venture debt include:

- Achieving a higher valuation
- Securing greater upside
- Maintaining control
- Bridging to equity
- Taking advantage of acquisition opportunities
- Maintaining strategic flexibility

Take advantage of acquisition opportunities. Acquisitions can help companies drive growth, expand into new markets, or secure complementary technologies or solutions. But financing them can be challenging. Venture debt can often be secured more quickly than other forms of financing, enabling companies to take advantage of strategic opportunities.

Maintain strategic flexibility. Bringing on a new investor often means re-setting the clock and committing to a plan (and time horizon) that promises to deliver the investor's target return. Using venture debt can help founders maximize their flexibility when it comes to deciding when and how to exit.

While companies must always plan to be well capitalized, CEOs and founders need to find the right combination of capital sources. The goal should be to optimize the company's cost of capital while enabling them to maintain more control over their business longer. We believe that the key to doing so is by blending equity capital with debt capital. As we'll see, incorporating debt into your overall capital mix is a simple, efficient, and cost-effective way of growing a business without the downsides that come with relying exclusively on equity.

In this white paper, we will take a closer look at venture debt and how it works. We'll then explain how it can be used in conjunction with equity capital to help businesses grow and build enterprise value.

"During our last financing round we tried to strike a balance between raising enough capital to supercharge our growth and not suffering too much dilution. Once we learned about venture debt, adding it into the equation became a no-brainer. With a mix of debt and equity, we were able to raise the full amount we needed to accelerate our product roadmap and invest in our back-end processing capabilities. The result was a broader addressable market and a more valuable business, all while minimizing dilution and retaining more upside."

Eric Green
Co-Founder and CEO, Askuity

So what exactly is venture debt?

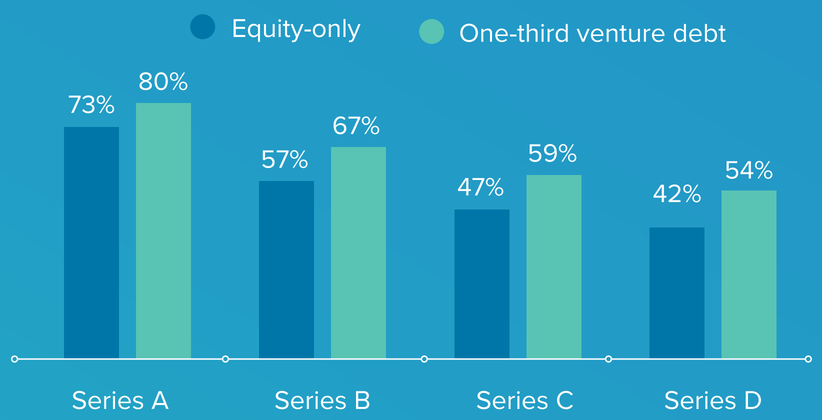
Venture debt is a form of non-dilutive financing that complements equity. More specifically, it typically takes the form of a term loan or line of credit that companies can use to proactively fuel growth by, for example, investing in sales and marketing, accelerating product development, enabling more hires, funding acquisitions, or simply providing basic working capital.

For fast-growing companies that don't have significant assets or positive cash flows and that therefore often don't have access to traditional bank loans or material amounts of bank financing, venture debt can be a powerful debt financing tool.

The implications of raising equity

While the idea of raising a large equity round can be very appealing — not least because of the attention that comes with it — the fact is that using equity alone to grow a business has some important implications. In simple terms, raising equity:

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.



Requires you to give up board seats. That means that you have to obtain your equity investors' consent on important decisions such as the strategic direction of the business, staffing and compensation, and product roadmap, among others.

Forces a valuation of the business now. While not necessarily a bad thing, there are cases, such as when the company is growing quickly or is about to achieve certain key milestones, where it's better to defer a valuation until a later date when the business will likely be worth more.

Eats up precious time. Raising equity generally isn't a fast or simple process. Even in the best scenario it will divert management's attention away from what should be their primary focus: growing the business.

The truth about venture debt

Debt is a common tool that can be used to accelerate the impact of equity. In traditional business sectors such as manufacturing or retail, securing your first loan — typically from a bank — to grow your business is a well-accepted milestone. Indeed, using debt is a very common way for traditional businesses to acquire equipment or machinery, expand production capacity, and finance inventory, among other things.

And yet, founders and CEOs in the technology sector have failed to apply the same logic to their businesses. Instead, the generally held belief was that the only way to raise the capital needed to grow a technology business was to partner with angel investors or a venture capital firm to raise equity. While this approach was historically driven in part by the lack of debt-funding alternatives for technology companies (these days, by contrast, there are many debt-funding options), the allure of being backed by top-tier VCs also plays a role. That's because in many cases founders and CEOs see VC funding as a proxy for success, even when that's not always the case.

The data for debt provided to technology companies is not as well documented as data for equity venture capital, but by some estimates venture debt accounts for at least 10 percent of all venture capital deployed.[1]

"When I was raising capital for Achievers I wanted to be backed by the best VCs in the world because that meant that I was in the same league as Steve Jobs and Larry Page. Unfortunately, that led to a suboptimal outcome for the people that mattered most to me — my family, my management team, my employees, my friends, and my other early investors. Had I used venture debt as part of my long-term funding strategy, this group would have made $30 million more at exit. And that's only part of the picture. Raising all that equity also meant I lost control of the business too early. That meant that we didn't always make the right decisions and that we ultimately sold the business far too soon."

Razor Suleman
Founder, Achievers

Had I used venture debt, this group would have made $30 million more at exit.

1 Connie Loizos, "Yep, more later-stage companies are taking on venture debt." March 28, 2017.

Senior vs. mezzanine venture debt

In this whitepaper, we refer to venture debt as the debt that is used to fund growth. In most cases, it will be the junior or mezzanine layer of the debt portion of the balance sheet. While senior bank facilities are sometimes characterized as venture debt, it's important to understand the differences.

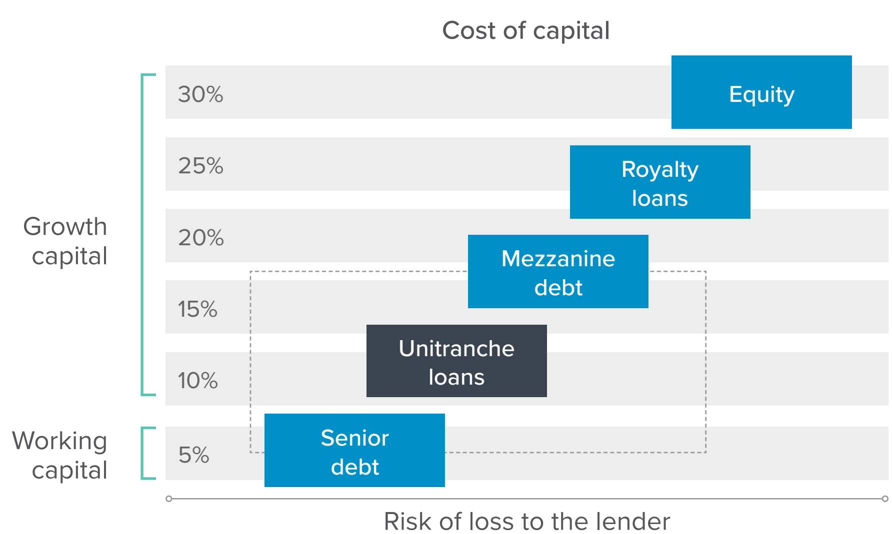
Bank facilities, generally structured to support a company's working capital needs, will carry lower interest rates and offer less lending capacity than venture debt. In many cases, senior bank facilities are put in place concurrent with the company completing an equity raise. They also might be subject to amortization and include other covenants designed to minimize the lender's risk.

Adding venture debt as the junior or mezzanine layer of debt capital ranking behind a senior bank facility can therefore be an attractive option. Combining senior bank facilities with mezzanine venture debt structures enables companies to maximize their debt funding while minimizing their blended cost of debt capital, diversifying funding sources, and avoiding dilution.

Unitranche loans

Unitranche loans combine senior and mezzanine debt into a single loan, with a blended interest rate that sits between senior loan and mezzanine loan rates. Unitranche loans are attractive to borrowers because of a number of key features and benefits. These include:

- The convenience of dealing with a single lender
- One loan agreement and one set of loan covenants, simplifying negotiation and increasing the certainty of closing
- A single reporting obligation, reducing administrative complexity
- No need for intercreditor agreements, allowing for faster closing, reduced legal expenses, and less complexity in managing the loan
- Non-bank lenders offering unitranche solutions will generally have a greater risk appetite, offer less restrictive covenants (on the entire loan), and be able to provide more "patient" capital



Considering venture debt?

Here's what to look for

While there's no shortage of lenders that provide venture debt, it's important to keep in mind that they don't all work the same way. Companies need to do their homework to understand the structure and terms of any potential debt financing to ensure it's the best solution for their business and fits with their longer term capital-raising strategy. Where possible, partner with a lender that:

Offers capital efficiency. Being required to draw down the entire amount of the loan up front can mean the company is paying interest on excess capital it cannot invest effectively, which is inefficient. Instead, consider loan structures that allow the company to draw down capital as required.

Doesn't require amortization. Rather than being strapped with the burden of immediately having to pay back a loan, look for lenders that offer the option of interest-only loans over the entire term, with the principal due in full upon maturity.

Is flexible. You want the ability to increase funding as your business grows and to prepay your loan without penalty. Most venture debt facilities are fixed in their size, leverage ratios, and term. A lender with rigid policies and large prepayment penalties could impede a business's ability to execute on its strategic plan and its ability to raise additional capital in the future.

Has a transparent all-in cost structure. Different venture debt providers take different approaches to pricing deals. In addition to an annual interest rate, that may include upfront fees, administration fees, standby fees, early prepayment fees, and warrants, among other costs. When it comes to venture debt, transparency and simplicity trumps opaqueness and complexity.

Doesn't have excessive or highly restrictive covenants. True venture debt should generally have fewer covenants than traditional senior or working capital loans as it's meant to work as growth capital and bear more risk (and should be priced accordingly). In addition, venture debt covenants should be appropriate for companies that are using capital to fund growth and that are often generating no operating cash flow. Beware of senior loans masquerading as venture debt with excessive covenants that increase the risk of defaults and restrictive covenants that reduce the capital that's actually available to be drawn down.

Understands the venture growth journey and has a proven appetite for risk. The right venture debt provider should have a proven track record of being borrower- and founder-friendly, and of behaving well when things don't go according to plan. While the lender has a fiduciary responsibility to safeguard the capital it has loaned, a seasoned and rational lender will work with the company to overcome challenges and help ensure the optimal outcome for all business stakeholders.

What you need to know about warrants

If you're looking at venture debt that includes warrants, pay attention to:

- ✓ The formula for calculating the number of warrants the lender will get, and the strike or purchase price for the warrants
- ✓ How long the warrants will remain outstanding
- ✓ If the lender has an option to force the borrower to redeem the warrants or the shares purchased by exercising the warrants (known as a put option)
- ✓ Any anti-dilution clauses associated with the warrants or underlying shares

Finding a venture debt partner that's able to provide a loan structure that meets your particular needs and objectives is critical for ensuring a successful financing.

Venture debt demystified

Now that we know what venture debt is and what to look for in a venture debt provider, let's look at how the venture debt process works as well as some of the key benefits of using venture debt.

As a company evolves through different stages of growth, it can access different sources of capital. Early on, founders and CEOs might use their own personal funds, turn to friends and family, or rely on angel investors. As the company grows, develops its product market fit, and establishes a steady track record of growth, other options such as venture debt become viable alternatives.

Securing venture debt should be a quick and straightforward process that can be completed in a matter of weeks. Here's how the process should look:

> **Investment screening.** The process usually begins with an introductory call between the borrower and the lender. If there's a potential fit, the company will be asked to provide financial information so that the lender can conduct a preliminary review and pre-diligence on any items of note.

> **Term sheet.** In step two, it's time to sign a term sheet. Term sheets should clearly outline all material terms of the transaction so that there's no confusion later on in the process. Asking the lender for a term sheet early in the process will also provide you with a better sense of the terms of the financing and help you quickly determine if the offer is right for you before you invest significant time in due diligence.

> **Diligence and investment approval.** Next, the lender's diligence team will examine the borrower's business, financial, operational, and legal situation in detail to determine the borrower's creditworthiness. Upon completion, the file will be submitted to the lender's credit committee for review and approval.

> **Legal and funding.** Following approval of the loan, the lender will provide its legal and funding documentation. Legal documentation, and the associated legal expenses, can vary widely between lenders. Borrowers should confirm expected legal costs in advance and look for streamlined legal and funding documentation to drive speed and cost efficiencies. Once any legal issues that may have been identified during diligence have been addressed, the funds should be ready for release.

Portfolio management. Borrowers should be prepared to remit monthly reporting to facilitate loan monitoring. A good lender will proactively engage with the borrower as needed, provide detailed unit metrics and operational analysis, and leverage its network to help support and accelerate the company's growth.

Investment exits. Finally, at the end of the term, the borrower repays the loan in full via a refinancing, capital raise, or other liquidity event. In some instances, companies will re-engage with their venture debt lender multiple times, initiating new facilities as their capital requirements evolve and grow.

With that understanding of how venture debt works, let's consider the main advantages of using it.

These can be summarized as follows:

- Founders and their teams maintain control over their business longer. Maintaining control enables founders and their teams to drive the strategic direction of the company they are working hard to build. That's important not just because of the impact it can have on morale, but also because it typically leads to better business outcomes. In fact, according to a study by Purdue University, companies where the founder still has a significant role, whether as CEO, chairman, a board member or in some other capacity, tend to perform better longer.[2]
- It's non-dilutive. As part of a long-term financing strategy, venture debt allows companies to create greater economic value for co-founders, employees, friends and family, and other early supporters.
- It's flexible. You can combine venture debt with senior debt from a bank to reduce your overall cost of debt capital, draw it down when it makes sense for your business, and, unlike equity, repay it when you want.

Maintain control

It's non-dilutive

It's flexible

2 Joon Mahn Lee, Jongsoo Kim, and Joonhyung Bae, "Founder CEOs and Innovation: Evidence from S&P 500 Firms," Purdue University, February 17, 2016.

Finding the right mix of venture equity and venture debt

When it comes to developing an overall capital-raising strategy, companies need to give careful thought to their options and find ways to incorporate a balance of debt and equity. That's because it's impossible to build a successful business using debt alone. At the same time, founders and CEOs can quickly get squeezed if they just rely on equity. By combining the two types of capital, however, it's possible to achieve a capital structure that not only optimizes the company's cost of capital but also provides founders and early shareholders with maximum flexibility and control.

Figuring out what the ideal mix of capital should look like depends on the specific business. A company that can predict with confidence how investment will directly drive revenue growth (and how much) or otherwise create value in their business, will generally be better suited to using debt capital than one that struggles to do so. Fundamentally, a company's capital efficiency will determine how much debt it should use.

"When used right, venture debt is an important alternative source of capital for venture-backed growth companies. For founders and CEOs, it's an opportunity to raise money in a way that's fair, unobtrusive, and that doesn't create dilution. Right now, about a quarter of the companies in my portfolio use venture debt. I will continue to encourage more to do so because it's a win-win for everyone."

Rob Antoniades
General Partner and Co-Founder, Information Venture Partners

Venture debt is an important alternative source of capital for venture-backed growth companies.

Is venture debt the right choice?

Venture debt is one of many viable options to consider when raising capital, but it's not necessarily a one-size-fits-all solution that's suited for every company. For example, raising venture debt isn't a good idea if:

The business isn't growing fast or efficiently enough. Venture debt is best suited to fast-growing companies for which the value created through capital investment (e.g., in the form of revenue growth) meaningfully exceeds the cost of that capital. Borrowing at 15 percent makes no sense if you're only growing at 10 percent. Likewise, if customer lifetime value is too low due to high churn or low margins, or customer acquisition costs are too high, then venture debt probably doesn't make sense.

There's no clear plan in place for using the capital. It's critical that any funds borrowed are actively put to use to create value. Having excess debt capital on your balance sheet simply represents another cost with no benefit. The same can be said for raising excess equity capital except that the cost takes the form of unnecessary dilution. In that case, the cost is borne by the founder and early shareholders rather than the company.

The company hasn't figured out its product market fit. This is an essential step in a company's evolution. Companies that haven't reached it are generally too early stage for most forms of venture debt and can likely
be better financed with equity.

Remember

Venture debt is an obligation that involves a fixed interest payment every month as well as capital being repaid at the end of the term. If a business isn't confident that it can meet its obligation, it shouldn't take on venture debt.

The way forward

Although the pressure to raise capital is real, it's important not to fall into the trap of associating raising a big round of equity with success. Founders, CEOs, and boards should take the time to evaluate all of their funding options. As part of that, they should consider the near- and long-term financial and operational consequences for the company and its early investors. In many cases, that will mean finding ways to raise capital from a combination of sources, including equity and debt. The key is to build the necessary foundation for the company to grow, but in a way that minimizes dilution and cost, and enables founders and early investors to retain the greatest control of their business.

By partnering with the right venture debt lender — one that understands the business and offers the flexibility to meet a borrower's individual needs — companies can quickly access the capital they need to proactively grow their business. And they can do it in a way that doesn't come at the cost of dilution or control for them or any of their investors. For fast-growing companies looking to further accelerate their growth, it makes a lot of sense.

To learn more about venture debt, visit www.espressocapital.com.

About Espresso Capital

Espresso empowers companies with innovative venture debt solutions. Since 2009, we've helped more than 270 technology companies and their investors accelerate growth, extend runway, and increase strategic flexibility with non-dilutive capital. Learn more at **www.espressocapital.com.**

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