



# Venture Debt – Maximizing Its Value In The Current Environment

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**Nothing we'd rather be doing**

# Agenda

- **Definition – What It Is & What It Is Used For**
- **Ascertaining Its Value – Is Debt Worth It?**
- **Types of Financing, Typical Terms, & Availability**
- **Current Trends & The VC Perspective**
- **Separating Myth From Reality**
- **The “Gotchas” & How To Avoid Them**
- **Choosing a Provider & Managing the Relationship**

# What Is Venture Debt?

- **Historical Definition – Venture Leasing**
- **Today's Definition: Any form of debt financing provided to a company that is still dependent on venture capital financing to fund its operations**
- **Not just term debt anymore; revolving working capital financing is an essential part of any financing strategy that includes a venture debt component**

# Typical Uses of Venture Debt

- **Literally speaking:**
  - Financing Equipment
  - General Corporate Purposes (Financing Anything)
  - Financing Revenue Growth
  - Bridge Between Equity Rounds
  - Refinancing Existing Debt
- **The Real Value Proposition:** Leveraging equity capital in order to increase valuations between equity rounds, reduce dilution, and enhance investor return
- **Tangential Benefits:**
  - Enhances appearance of financial stability and “staying power” for prospective/existing customers
  - Unlock restricted cash (landlord security deposits, etc.)
  - Barrier against hostile unsecured creditors

## Ascertaining its Value – Is Debt Worth It?

- **For companies at all stages of development, the answer is yes – but conflicting viewpoints abound!**
- **Current Attitudes About Debt:**
  - We're borrowing our own cash
  - It doesn't add runway
  - It costs too much and/or warrants are too high
  - Gets repaid too quickly to help with dilution/investor IRR
  - Doesn't make sense for pre-revenue companies
  - Makes sense for pre-revenue companies, but only in modest amounts
  - Makes sense for pre-revenue companies, but only in gigantic amounts (more than 6 months cash burn)
  - Makes sense for revenue-stage companies that need to finance sales growth
  - Enhances credibility for prospective customers concerned about the company's financial wherewithal/longevity

# Defining the Value Proposition for Venture Debt

- How much debt and for what purpose?
- What is the potential impact on dilution?
  - What are current assumptions regarding timing, amount, and expected valuation to be obtained in future equity financings?
  - How does timing/amount/purpose of venture debt impact the above assumptions?
  - Can larger valuations be obtained by using venture debt to “add runway”?
- Other considerations
  - Reputation/Financial Condition of debt provider
  - Cost, in terms of interest/fees, warrants, impact on cash burn, effort, and future administrative burden
  - Collateral pledged and sources of repayment
  - Impact on latitude/control over future decision making
  - Limitations associated with type of financing at particular stage of development
  - Tangible/Intangible costs and benefits
  - The board’s perspective

# Defining the Value Proposition for Venture Debt

- Finally, Are We Being Realistic?
  - It is not cheap equity!
  - However, certain types of debt can, and do, “add runway” and take equity-like risks from time to time
  - Type/amount vary based upon capitalization, stage of development, and other factors

**The Bottom Line: If the amount, purpose, and cost/benefit analysis are making sense to you and your board, and so long as your expectations regarding the above are realistic, it's time to proceed!**

## Types of Financing – Equipment Term

- Advances for new and used equipment purchases, to include some portion for “soft costs”
- Draw periods of 0-12 months, followed by repayment periods of 24-36 months (may be longer for biotech)
  - May sometimes include an “interest-only” period
  - May sometimes include a lower stream rate w/final payment
- May be specific lien on equipment financed or first priority blanket lien on all assets (latter may exclude IP)
- May or may not be governed by financial covenants
- Pricing a function of debt terms and risk profile of company
- Available to companies that have raised Series A and later, from both bank and non-bank providers
- Loans v. Leases – proceed with caution on the latter

## Types of Financing – Growth Capital

- **Advances for anything; no invoices required**
- **Draw periods, repayment periods, interest-only periods, etc. are similar to equipment loans**
- **First priority blanket lien on all assets (may exclude IP, but less frequently than equipment loans)**
- **Typically no financial covenants**
- **Pricing a function of debt terms and risk profile of company – but generally higher than equipment loans**
- **Available to Series A and B companies, from select bank and non-bank providers; availability declines for companies at later stages of development**

## Types of Financing – Working Capital

- **Advances against eligible A/R; other formula options can include advances against inventory, purchase orders, recurring revenue, contractual payments, etc.**
- **Generally revolving for a term of 12 months; payments of interest only with principal upon maturity (renewable annually); may include other costs like collateral handling fees, etc.**
- **First priority blanket lien on all assets (may exclude IP depending upon nature of IP)**
- **May or may not be governed by financial covenants, with pricing and degree of control over collateral proceeds as the typical trade-offs**
- **Pricing a function of debt terms and risk profile of company**
- **Available to revenue-stage companies, from select bank and non-bank providers (i.e., asset-based lenders)**

## Types of Financing – Bridge Loans

- Used to “bridge” companies between equity rounds or, in select instances, to the sale of the company
- Advances are typically non-formula “airball” (“uncovered”) or characterized as an advance against eligible A/R (“covered”); typically interest-only, with principal due upon the earlier of (a) date certain, or (b) close of round/sale
- First priority blanket lien on all assets (may exclude IP)
- Typically requires financial covenants
- Pricing a function of debt terms and risk profile of company
- With the exception of those provided by existing VC investors, “uncovered” bridge loans have all but vanished since the late 1990s – but appear to be making a careful comeback in recent months

## Types of Financing – Refinancing Existing Debt

- Used to refinance existing venture term debt so as to reduce impact of debt service on cash burn, eliminate a “hostile” lender, or some combination of the above
- Term financing, working capital financing, or some combination of the two represent the typical approach
- First priority blanket lien on all assets, including IP
- No financial covenants
- Pricing a function of debt terms and repayment risk
- Can be a wonderful thing for a company with a bright future, but where the cash burn related to existing debt service is hampering growth and/or will cause the company to run out of cash prematurely or at an inopportune time

# Separating Myth From Reality

- **Myth #1: It is possible to separate the debt from the cash**
  - Only with regard to specific-lien equipment financing
  - For blanket lien deals, Revised Article 9 and related Account Control Agreements have leveled the playing field for bank and non-bank lenders
  - Bank “right of offset” easily thwarted for specific lien deals
- **Myth #2: Eliminating covenants and/or the MAC clause will result in “cheap equity”**
  - Debt is always debt, and can exit under certain circumstances
  - Covenants can be a good thing; usually less expensive, results in less ambiguity over what constitutes an Event of Default

# Separating Myth From Reality

- **Myth #3: Growth Capital is the most valuable form of venture debt**
  - Only if it doesn't block access to cheaper, interest-only forms of working capital financing upon reaching revenue stage
  - Working capital finance solutions can represent most valuable form of debt financing in certain instances
- **Myth #4: Venture debt doesn't "add runway"; I'm really borrowing my own cash**
  - Venture debt can, and often does, add runway and permit "net borrowing" so long as company continues to be attractive to VCs
  - Watch out for financial covenants; cheap deals w/liquidity covenants are least likely to "add runway"

# Separating Myth From Reality

- **Myth #5: Venture Debt is not worth the hassle**
  - At today's valuations, even modest amounts of debt can have a dramatic impact on dilution
  - Smaller amounts of interest-only debt may help more than larger amounts of amortizing term debt
- **Myth #6: Pledging the IP is Inappropriate**
  - As the borrower's most valuable asset and/or the only asset with real value, the pledge can be key to obtaining the greatest amount of debt on the most favorable terms
  - May be essential in order for lender to perfect its lien on A/R and inventory
  - Will not get in the way of maximizing the value of the IP; broad latitude with regard to non-exclusive and exclusive licensing to third parties often permissible
  - Is not "a sign of weakness" to the outside world
  - With or without a negative pledge, borrower is typically prohibited from pledging to a third party later

# The “Gotchas” & How To Avoid Them

- **Gotcha #1: All Deals of a Certain Type Are Created Equal**
  - Amount and factors that determine availability
  - All-in cost and timing of expenses
  - Interest calculations and prepayment penalties
  - Collateral and sacrifice of future decision-making flexibility
  - Ongoing administrative burden
  - Subjective factors
  - Key Tip: In order to ensure an apples-to-apples comparison, ask your friendly SVBer for help!
- **Gotcha #2: The Contingency Clause**
  - Allows lender to decline advance request if MAC has occurred
  - Key Tip: Draw early, or negotiate a funding covenant (often milestone-based) to replace the contingency clause

# The “Gotchas” & How To Avoid Them

- **Gotcha #3: Term Debt v. Working Capital Debt**
  - With one exception, a big slug of term debt may preclude you from obtaining the cheaper, interest-only working capital financing revenue-stage companies will need to finance revenue growth
  - Key Tip: Choose a debt provider that offers the whole spectrum of debt financing solutions for companies at all stages of development, or negotiate a real carve-out for future working capital financing
- **Gotcha #4: Big Debt is Better**
  - Large amounts of debt can be an impediment to future equity rounds, while smaller amounts of debt, to the extent that debt service places a lower burden on cash burn, may add more value than larger amounts of debt
  - Key Tip: Ensure that debt service is no more than 10% of cash burn in the early stages; the larger the amount, the more the choice of debt provider matters

# The “Gotchas” & How To Avoid Them

- **Gotcha #5: Understanding Financial Covenants**
  - Deals with covenants are often cheaper, but may not “add runway” in certain instances
  - Liquidity covenants generally less appropriate for pre-revenue companies if goal is to “add runway”
  - Covenants, if structured correctly, are appropriate for revenue-stage companies and can mean the difference between obtaining financing and/or obtaining financing on better terms
  - Covenants can largely eliminate the ambiguity associated with the MAC clause, at terms that are often more favorable than those offered for no-covenant deals
  - **Key Tip:** Where appropriate, ask your lender for covenant and no-covenant options so as to better understand the trade-offs relative to the intended purpose

# The “Gotchas” & How To Avoid Them

- **Gotcha #6: Understanding What Your Board Wants**
  - Your board members have a perspective on debt – and “hot buttons” abound
  - **Key Tip:** Understand what the board is thinking and be sure to reach a clear agreement as to the type of debt, who should provide it, what the terms should look like, and how the value proposition will be defined prior to soliciting proposals
- **Gotcha #7: Keeping the Transaction Costs in Check**
  - Negotiating the documents to death rarely results in a more valuable deal; diminishing returns set in quickly when the meter is running at \$500/hr.
  - **Key Tip:** Get the legal review, then negotiate the deal yourself; focus on the big issues, avoid re-drafting the boilerplate if possible

# Choosing a Debt Provider

- **Non-Bank Providers**

- **Pros:** Often willing to lend in larger amounts; no-MAC alternatives more prevalent; unregulated; perceived flexibility
- **Cons:** Generally cost more; lenders generally lose interest as companies progress beyond the Series B round; classic venture lending funds do not offer revolving working capital financing; not always more flexible

- **Bank Providers**

- **Pros:** May cost less, particularly if you are willing to give them deposits and fee-based services; willing to lend at all stages of development; provide a wider array of debt financing solutions
- **Cons:** May be constrained as to deal size for early-stage companies; unless such lending is a dominant part of their business, may be more likely to exit in tough times

- **Hybrid Providers**

- **Best of Both Worlds!**

# Choosing a Debt Provider

- **Things to Consider**
  - How are credit decisions made?
  - What is their typical deal size/type?
  - How much do they have available to lend?
  - Transactional or relationship oriented?
  - How is their reputation?
  - Are they in trouble?
- **Do Your Due Diligence**
  - Get references, and actually call them!
  - Check with your board, other service providers, and former/current borrowers
  - Review financials, press releases, etc. if applicable

## Managing the Relationship

- **Meet with your lender regularly; provide updates as to how the company is doing, what the board is thinking, etc.**
- **Provide all required financial and collateral reporting in a timely manner**
- **Avoid surprises**
- **Communicate, Communicate, Communicate!**

# Questions?

