Debt

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Understanding Early-Stage Debt Financing: Why Good Deals Turn Bad

Introduction

At Capital Advisors Group, we have advised hundreds of early-stage companies on billions of dollars of debt transactions over the past 17 years. You might think that we've seen it all—but we haven't, not even close. Every deal is different, and every company's capital structure is unique. However, there are some rules of the road we follow to help our clients to avoid some common and preventable mistakes in negotiating a successful debt financing transaction.

We have compiled countless examples of why and how good deals turn bad, from pursuing too much leverage, to miscalculating the size, scale, and timing of an equity raise, to missing projected revenue numbers in the middle of a deal. This paper aims to educate prospective borrowers of venture bank debt, non-bank venture debt, and/or structured finance debt on how to avoid the common pitfalls that send deals spiraling off in the wrong direction and potentially failing to come to fruition.

Note: We define "early-stage" not by how long the company has been in business, but more by their current financial profile. We define early-stage as any cash-burning company that is either public or venture-backed, including companies that are working toward profitability or those that may be moving toward a definition of "middle market."

Even the Best-Laid Plans Can Go Awry

The credit and underwriting process in early-stage debt financing is generally based on a range of factors. These include the sponsors or investor group backing the company, how much equity has been raised, cash on hand and cash life, revenue ramp, profitability, broad evaluations of specific market or industry sectors, and key performance indicators (KPIs), to name a few. Underwriters do their best to build a framework around certainties of repayment, while early-stage companies oftentimes face significant volatility as the business grows. Obviously, the goals of the underwriters are sometimes inherently conflicted with the realities of the companies to which they're lending.

When advising on early-stage debt financing transactions, Capital Advisors Group works to help companies prepare for the due-diligence and underwriting process while working through a debt financing transaction. However, this paper describes how even the best laid plans can go awry in the middle of a transaction when certain common pitfalls, some avoidable and some not, do occur.

1. An Unpredictable Equity Raise

Oftentimes debt and equity can be raised concurrently. Capital Advisors Group helps companies understand how to optimize capital structure when considering simultaneous equity and debt raises. For instance, sometimes it makes sense to use debt to avoid dilution of equity. One prerequisite that is most important for cash burning companies is to establish a firm equity target before exploring debt financing options.

Those who have raised equity, especially from a syndicate of investors, understand it can be difficult to fully nail down the exact amount coming from each, especially at an early stage of the raise. Any uncertainty about the total equity that will be raised, or about the ultimate mix of investors, can have a big impact on lenders' decision whether to finance a debt deal. Depending on the size of the equity raise, a shift of a few million dollars among tens of millions may not be detrimental to a debt raise. But a material shift of 10%-to-15% or more can crater a debt financing transaction that is already underway, especially if debt term sheets are in hand with contingencies related to the equity raise. In addition, if a shift in an equity raise reduces the funded cash runway of the company to less than 12 months, terms and conditions from debt providers may sour. Of course, these calculations can differ for companies with steadily growing revenues and or profitability.

Key Takeaway: Be confident in the eventual size of an upcoming equity round before pursuing debt financing.

2. Overly Optimistic Financial Projections

Among the most common issues that can derail a debt financing is the ubiquitous "hockey stick" set of financial projections. IMPORTANT NOTE: Entrepreneurs are optimistic, lenders are not. Far too often we see overly optimistic projections which, over the course of a debt financing transaction, begin to falter. This can lead to a crisis of credibility and may result in lenders stepping away from the transaction.

Prior to any transaction we oversee, Capital Advisors Group rigorously reviews financials for red flags. Oftentimes the projected hockey stick performance raises those flags and, without a very solid story for the near future significantly outperforming the near past, we advise clients to be more realistic about what the future may hold. Even if the near-term numbers hold true, optimistic projections can be detrimental to a company if it begins to miss the numbers after the debt is already in place. This can lead to tripped covenants and serious issues for the borrower.

Key Takeaway: When pursuing a debt round, conservative financial/growth projections are best.

3. A Lack of Direction on Size, Structure and Approach

The primary reasoning behind debt financing for early-stage companies is to avoid the dilution that is typically associated with equity financing. While one must repay debt financing, any dilution of equity held by founders and management is often relatively miniscule or, sometimes, nonexistent. However, we often talk with companies that have little understanding of how debt might avoid dilution of equity, how they may quality for debt financing, how lenders view appropriate leverage, or what types of structures might be available.

At Capital Advisors Group, we believe deal rightsizing is key. The answer to "How much do you want to borrow?" should rarely, if ever, be "As much as we can." In the world of debt financing, more is not always better. We believe debt financing should be used strategically to help the company reach a milestone that could not otherwise be attained through a combination of equity and/or revenue. The goal is to materially help the company along its growth path. For most early-stage companies, deal sizing is not a perfect science. But there are several factors, such as an upcoming equity raise, current cash on hand, revenue (including MRR and/or ARR) and positive EBITDA, that can help determine appropriate leverage. In addition, certain structural components of loans can have a significant impact on a company. For example, there are amortizing and non-amortizing term loans, lines of credit based on receivables or recurring revenue, and equipment loans and leases that all may come with their own unique conditions.

Finally, how a company approaches the market will ultimately determine the outcome. Just calling your banker because you know they provide loans may result in the best possible outcome, but it also may not. A broad understanding of the market and the different lenders that may be suitable for your transaction will help you understand if the terms offered by your banker are optimal, or if another lender might provide a better solution.

Key Takeaway: Understand the market. Approach the wrong lender, asking for too much leverage and an inappropriate loan structure can kill a deal before it even begins.

4. Situations Out of Your Control

Of course, the most frustrating situations arise when factors completely out of your control rear their ugly heads in the midst of a transaction. These include external market-moving factors that may be affecting an entire sector or specific technology. Think cleantech/solar and Solyndra. Think blood diagnostics and Theranos.

There are plenty of previously successful legacy technologies that are becoming obsolete and falling out of favor with investors. In life sciences, big Phase III failures and regulatory rejections can affect certain therapeutic targets for a period of time. Lawsuits, fraud, scandal and even equity selloffs of larger public players in the same market can cause issues with deals. In most cases like these, all one can do is forge ahead. However, if a company is running a broad, competitive selection process, it can still get a deal done even if one or two lenders drop out.

Key Takeaway: Competitively source a debt financing transaction in case one or two lenders drop out. Grin and bear it. These things happen.

Conclusion

As noted above, while certain factors that can negatively affect the outcome of a debt financing transaction are completely unavoidable, most are well within your control. Understanding the market, maintaining a thorough set of financials, remaining rational about growth projections, seeking appropriately sized and structured loans, and running a competitive process will lead to the best outcomes every time.

About Us

Capital Advisors Group's debt consulting division has provided early-stage corporate debt solutions to clients since 2003. We also manage customized separate cash accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. We provide FundIQ® money market fund research, and our CounterpartyIQ® service provides aggregation and credit analysis of counterparty exposures and risk assessment on short-term fixed income securities and portfolios.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

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