Venture Debt: When and Why – A Strategic Guide for CFOs

Published: June 21, 2011

Rich Bowman,
Senior Vice President & Head of Debt Consulting
rbowman@capitaladvisors.com

Stefan Spazek,
Senior Vice President
sspazek@capitaladvisors.com

Main: 617.630.8100
Debt Consulting: 617.630.8110

Note: Capital Advisors Group is a Boston-based institutional investment advisor that has been helping venture-backed companies invest their cash assets for more than 20 years. Debt Advisors Group is the venture debt consulting arm of Capital Advisors Group, which helps venture-backed companies determine their optimum capital structure, identify appropriate lenders, source term sheets and negotiate deals.

What Is Venture Debt?

Definition: Venture debt or venture lending is a type of debt financing provided to venture-backed companies by specialized banks or non-bank lenders to fund working capital or capital expenses, such as purchasing equipment. Unlike traditional bank lending, venture debt is available to startups and growth companies that do not have a track record of positive cash flows or significant assets to use as collateral.

This definition of venture debt appears fairly straightforward in its own right, yet the prospect of this type of financing for a venture-backed company can become one of the most divisive topics at the board level. Some board members may embrace the idea of exploring this type of financing as an option to help extend the company's cash life while, ultimately, posing less dilution to existing investors than would additional outside equity investors. Some, on the other hand, cast a distrustful eye toward the lending community and may feel some venture debt terms place onerous restrictions on the company.

The truth is both impressions may be correct. It is important to understand, first and foremost, that not all lenders are alike. Some lenders truly may be interested in supporting the companies to which they lend and seek to build relationships and long-term partnerships in the process. Conversely, some less-established lenders may view their function as a simple transaction and may seem to be interested in little more than getting their principal and interest out of the deal and moving on to the next deal. Seeking out the best lenders and weeding out the rest is a crucial first step in any venture debt deal.

When It Makes Sense

Venture debt typically makes the most sense when a company can use it strategically to reach an important milestone or inflection point (i.e. clinical trials or a crucial R&D stage) that will help it move forward. IMPORTANT: Debt deals should not be pursued with the sole intention of putting more money on the balance sheet. It is imperative that CFOs review their projections, burn rates and expected milestones and determine exactly how a particular debt deal can help extend the company's cash runway to reach those milestones or the next expected equity round. Typically, venture lenders prefer to see the following conditions met before partnering with a company on a deal:

- At least 12 months of cash
- Strong VC investors
- Strong management team and product

BIO:
Rich Bowman has more than 30 years of experience in consulting, commercial lending and equipment leasing, most notably in the high technology and life science industries. He originally joined Capital Advisors Group more than seven years ago as President of Debt Advisors Group. Currently, Rich is overseeing business development for Capital Advisors Group's west coast region and marketing the firm's investment management and venture debt services to growing companies.

Prior to launching Debt Advisors Group in 2003, Rich held senior positions at GE, Comdisco, Inc. and Equitable Life Leasing Corporation where, for 15 years, he worked in financing products for early stage companies. Rich holds his FINRA Series 65 license.

When It May Not Make Sense

As stated earlier, it is important to pursue venture debt with a particular strategy in mind. Putting more money in the bank in case you need it is not the best approach. Remember…you have to pay it back.

Additionally, if you're uncertain as to whether the company may need the additional cash and sign a deal with no immediate intention of drawing the cash, you may find yourself on shaky ground. To protect themselves against this type of scenario, most lenders put mandatory draw periods in place and they also have Material Adverse Change (MAC) clauses that allow them to pull out of the commitment of the funds if the company's circumstances "adversely" change before the cash is drawn. What does this mean? Make sure you know. It could mean anything from the simple failure to meet projections or milestones to more catastrophic scenarios. Make sure the terms are defined and don't leave it up to the lender to define them for you.

What To Watch For

Onerous covenants – Beware of any covenant that easily can be triggered which could throw the company into default. These covenants may be structured around: quick ratios, cash spending formula caps, lawsuits, senior management departure, abandonment by VCs, etc.

All asset liens that include your intellectual property – On growth capital structures, typically, venture lenders will take a position of a senior all-asset lien with a negative pledge on the intellectual property (i.e. they will carve your IP out of the lien). Don't risk your IP for what ultimately amounts to a minority investment in your company; it's simply not worth it.

Cash-collateralized deals – It is important to understand how deal structures may differ between banks and independent venture lenders. Many may be attracted to bank deals on the surface because they will tend to have lower rates. However, you're often paying for that lower rate by reducing your company's financial flexibility since banks typically require an amount equal to (or sometimes far higher than) the amount of the loan to be held in an operating account at the bank. Then, in final documentation the bank may stipulate the "right to offset" without notice. This gives the bank the ability to recoup the loan by sweeping your operating account should the company begin to struggle. You may also lose the ability to utilize any cash in the operating account that may fall below the limit of the debt repayment since the bank will likely be keeping a very close eye on both. Venture lenders on the other hand tend to have higher initial rates since they're taking on greater risk than banks, but the financial flexibility for the company tends to be far greater.

Vague MAC clauses – As stated above, do not accept vague or open-ended MAC clauses. Work with your attorney during the due diligence process, before signing final loan docs, to define how and when a MAC clause may be triggered. It doesn't happen often, but you don't want to be surprised if it does.

Floating rates – This is an easy one. Some lenders may offer rates that start low but then have the ability to float over the entire repayment period. In this current environment, you can be guaranteed that rates are only going in one direction and that is up. A more favorable rate structure is a float-to-fixed rate that locks in for the entire repayment period upon signing final loan docs.

Current Market Conditions

Debt Advisors Group has collected more than 900 term sheets since its inception in 2003, and provides a value to its clients in knowing exactly how the venture debt market shifts to more or less conservative positions over time. From the recent lows in this market during the credit crisis of 2008 and 2009, lenders were extremely conservative and very few deals were getting done; we've seen a solid rebound. In the past 12 months, we have seen conditions become much more favorable for borrowers as rates have fallen into the low double-digit range and warrants have come down considerably. There is plenty of capital available for the venture lenders to put to work these days so, if it the strategy makes sense, now is a good time to see if a cash runway extension can help get your company over that next big hurdle.

Any projections, forecasts and estimates, including without limitation any statement using "expect" or "believe" or any variation of either term or a similar term, contained herein are forward-looking statements and are based upon certain current assumptions, beliefs and expectations that Capital Advisors Group ("CAG", "we" or "us") considers reasonable or that the applicable third parties have identified as such. Forward-looking statements are necessarily speculative in nature, and it can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes. Some important factors that could cause actual results or outcomes to differ materially from those in any forward-looking statements include, among others, changes in interest rates and general economic conditions in the U.S. and globally, changes in the liquidity available in the market, change and volatility in the value of the U.S. dollar, market volatility and distressed credit markets, and other market, financial or legal uncertainties. Consequently, the inclusion of forward-looking statements herein should not be regarded as a representation by CAG or any other person or entity of the outcomes or results that will be achieved by following any recommendations contained herein. While the forward-looking statements in this report reflect estimates, expectations and beliefs, they are not guarantees of future performance or outcomes. CAG has no obligation to update or otherwise revise any forward-looking statements, including any revisions to reflect changes in economic conditions or other circumstances arising after the date hereof or to reflect the occurrence of events (whether anticipated or unanticipated), even if the underlying assumptions do not come to fruition. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. Further, certain information set forth above is based solely upon one or more third-party sources. No assurance can be given as to the accuracy of such third-party information. CAG assumes no responsibility for investigating, verifying or updating any information reported from any source other than CAG. Photocopying or redistributing this report in any form is strictly prohibited. This report is a confidential document and may not be provided or disclosed to any other parties than the intended recipient(s) without the prior written consent of CAG.