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Liquidity and Growth in the Venture Debt Market

As the stock market continues its volatile trend and media highlight stories of institutional investors and banks taking heavy losses from subprime fallout, the venture debt market has, thus far, weathered the storm and remains largely unaffected. This healthy market in fact, is enjoying positive growth as companies continue to leverage their expensive equity funding with less dilutive debt financing. The current abundance of liquidity in VC (venture capital) funds, a resilient IPO market, and strong Merger and Acquisition (M&A) activity (which is at its highest level since the dot-com era), has enabled greater availability of venture debt.

The recent success of IPOs and M&As has increased liquidity in the capital markets, thus creating a robust venture debt market that enables VC-backed companies to increase their leverage and extend their cash runways. M&A activity has raised $28.4 billion year-to-date and $10.5 billion in the last quarter alone, marking a 31% increase from the same quarter last year[1]. VC financing continues to increase as firms invest and support companies in areas such as life sciences, technology and energy. With close to $23 billion invested through Q3 2007, compared to $20 billion through this time last year, VC funding is on pace to be at the highest level in the past six years[2]. In fact, VC funding reached over $8 billion in the last quarter, which marks the highest level of funding since the first quarter of 2001.

VC backed companies are also enjoying an abundance of liquidity due to the growing IPO market that has raised $4.7 billion already this year. The IPO market raised $2.7 billion in the second quarter of 2007 alone compared to $1.3 billion in Q2 2006, representing a 107% increase in just one year[3]. A director of global research at DowJones VentureOne referred to the amount raised by the M&A and IPO as, "[virtually guaranteeing] that 2007 will be the largest year for venture-backed liquidity - both in terms of IPOs and M&As - in the U.S. since the dot-com boom[4]." The venture debt market benefits from this increase in liquidity because more VC money translates to more financing options for these firms in the debt markets.

VC funding continues to increase per round as investors exhibit increased confidence in their portfolio companies. The median deal size of money invested per round reached $8 million by the end of Q2 2007, the highest level in over three years, which shows the willingness of investors to infuse more funds into the market[5]. An Ernst and Young director reports, "The overall level of investment and larger deal sizes are suggestive of a continued bullish view of these companies' prospects and liquidity options[6]." With the median deal size for each round increasing, companies are leveraging their cash positions with debt financing in order to reach important milestones and inflection points. The current market conditions make

[1] Wade, Adam. "M&A activity for U.S. VC-backed companies jumps to $10.5 Billion in third quarter, highest since dot-com era" *DowJones VentureOne* www.ventureone.com 1 October 2007

[2] PWC MoneyTree Report. www.pwcmoneytreereport.com 22 October 2007

[3] Wade, Adam. "M&A activity for U.S. VC-backed companies jumps to $10.5 Billion in third quarter, highest since dot-com era" *DowJones VentureOne* www.ventureone.com 1 October 2007

[4] Wade, Adam. "M&A activity for U.S. VC-backed companies jumps to $10.5 Billion in third quarter, highest since dot-com era" *DowJones VentureOne* www.ventureone.com 1 October 2007

[5] Wade, Adam and Katie Johnston. "U.S. Venture Capital investment reaches highest level since Q1 2001, rises 8% to $8.07 Billion in third quarter 2007" *DowJones VentureOne* www.ventureone.com 20 October 2007

[6] Wade, Adam and Katie Johnston. "U.S. Venture Capital investment reaches highest level since Q1 2001, rises 8% to $8.07 Billion in third quarter 2007" *DowJones VentureOne* www.ventureone.com 20 October 2007

it an opportune time for VC-backed firms to layer debt into their capital structures and strengthen their cash position to enhance growth strategies. With larger average equity deal sizes, companies are obtaining more funds in the venture debt market and growing their business more cost effectively than by utilizing the more expensive alternative: additional equity. With the availability of debt, companies that need to raise funds are looking for an optimum combination of venture debt and equity. Supplementing an equity round with venture debt can help to preserve ownership, as the equity kickers used in debt financing are far less dilutive than in equity raises.

Although activity levels have increased, "the time between initial equity financing and M&A also reached its highest level ever in the third quarter at seven years[7]." VC-backed firms require more capital to reach a successful exit, which provides an excellent opportunity to leverage these higher investments. Companies can take advantage of additional equity by supplementing these funds with debt financing in order to extend their cash runway. The most appropriate and advantageous time for a VC-backed company to incorporate debt is in conjuction with an equity raise when the company is at its peak liquidity position. The emergence of new lenders into the venture debt market has increased the amount of funds available for these companies looking to use venture debt as a way to buy time.

It's an exciting time for venture-backed companies as liquidity continues to flow into the market through increasing levels of IPO's and M&A's. VC investment level continues to increase which bodes well for an already thriving venture debt market. The outlook remains very positive for the venture debt markets as the subprime credit crisis has, so far, exhibited a minimal negative pressure.

[7] Wade, Adam. "M&A activity for U.S. VC-backed companies jumps to $10.5 Billion in third quarter, highest since dot-com era" *DowJones VentureOne* www.ventureone.com 1 October 2007