Venture Debt: Emerging from the Credit Crisis with New Borrowing and Refinancing Opportunities

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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, the venture debt consulting arm of Capital Advisors Group, 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.

Credit Crisis of 2008 - 09

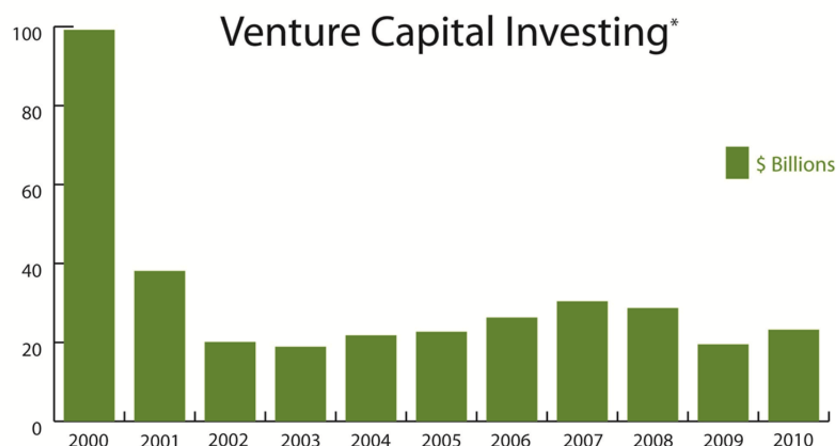
Venture debt, like other forms of borrowing, was negatively impacted during the depths of the financial crisis that was triggered in 2008 by a liquidity shortfall in the US banking system. The lenders in this niche market tend to operate under varying financial structures, which determined how they fared during the crisis. For example, lenders that previously leveraged the capital they raised were unable to find reasonably priced lines of credit and, therefore, had significantly less funds to offer. Additionally, the lenders that were backed by hedge funds, which were facing their own difficulties, had little or no funds to lend and many stopped looking at new deals altogether. Finally, many lenders that were divisions of larger, more diversified lenders found it difficult to compete due to the perceived inherent high credit risk of lending to unproven, early-stage companies and stopped lending or abandoned the market. As a result, most of the lenders in the space had extremely limited capital to lend and the remaining healthy few became much more cautious in their approach to deals and only pursued the very best lending opportunities. This general shortage of funds and lack of competitive pressure allowed the lenders to raise their interest rates and warrant coverage to much higher levels than at any time in the previous seven years.

As much as the credit crisis and other economic factors impacted the venture debt market, historically, it seems that the ability to raise venture capital has an even more direct impact on venture debt cyclicality, as well as its availability and cost. Our experience indicates that venture debt in a stable economic market usually averages between 7%-10% of the overall venture capital invested. Venture debt, which was created in the 1970s, took hold in the 1980s and grew in the 1990s to its pinnacle in 2000, prior to the Internet Bubble. All of this venture debt activity and growth followed a track similar to that of venture capital investing. The first downturn in the venture capital and venture debt markets occurred when the Internet Bubble burst in 2001.

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.

It is useful, therefore, to look at how the venture capital market rebuilt itself following that event and, based on past market trends, we can assume that the venture debt market has similarly followed that rebuilding. The chart below demonstrates the year-over-year total investments in the venture capital market:



In order to predict the resurgence of today's current and future venture debt market, it is important to review more closely how venture debt re-emerged from the last significant downturn:

- **2001:** Internet Bubble bursts. Significant numbers of lenders leave the market while the remaining lenders spend most of their time managing troubled portfolios and cautiously responding to new opportunities.

- **2002-03:** Venture debt lenders slowly and conservatively rebuild market.

- **2004 to mid-2008:** New lenders enter space, joining long-term lenders and driving overall debt funds to their estimated second highest level in 2007. Increased competition among lenders to use their "dry powder" drives pricing to record lows and offers borrowers the most favorable overall terms and conditions in the history of the product.

- **Mid-2008 to mid- 2010:** Credit crisis hits. Venture capital investing drops. Lenders have significantly less capital available. The overall amount of available funds to venture-backed firms shrinks significantly. Lenders raise rates, warrant coverage and structural terms, and conditions tighten. Venture capital backed firms find debt harder to find and significantly more expensive to obtain.

- **Mid-2010 to Present:** Venture Capital investing has bounced back and continues to rise. Lenders have been able to raise new funds and more favorable leverage returns. Competitive pressure forces lenders to lower rates and warrant coverage and, on an overall basis, grant more favorable terms and conditions.

Current Terms and Conditions* Versus Credit Crisis Highs

Currently, interest rates of payments (IRRs) to lenders appear to be more than 400 bps lower than what we saw in 2008. Warrant coverage is being reduced approximately 4%-6% from highs and repayment terms of no longer than 36 months typically are being stretched to 42-48 months. Nearly all financial covenants are being removed in this environment and all asset lien structures often are replaced by structures allowing a negative pledge on intellectual property. Finally, the overall loan amount in each deal tends to be a higher percentage of the borrower's existing equity.

*On competitively sourced non-cash collateralized growth capital loans.

Reviewing Refinancing of Credit Crisis Debt Deals

Given the current, more favorable terms and conditions in the venture debt market, it also may be an opportune time for borrowers with debt facilities in place to re-evaluate their loans and investigate the benefits that refinancing may offer. A cost/benefit analysis should include the following elements:

<u>Potential Benefits</u>

Improved Cash Flow:

- Lower rates
- Longer term creates longer payback
- Larger loan amount due to higher multiple

Better Financial Flexibility:

- Reduction or elimination of restrictive covenants
- Lower lien coverage freeing up IP through negative pledge

<u>Cost of Re-financing</u>

- Additional Warrants Costs
- Breakage fee on initial loan
- Closing costs (facility fee) on new loan

Summary

The venture debt market appears to have rebounded well from the credit crisis. There is an active base of lenders that have raised a significant amount of capital and the healthy competition among these lenders has led to much better terms and conditions for

borrowers. If you are a venture-backed company in need of cash runway extension to reach that next point of inflection or milestone, venture debt may be a viable option. Additionally, you may find that you may benefit from refinancing loans originated in the past two years.

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