Debt
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Early-Stage Debt Financing: Stakeholder Perspectives

Contacts

Stefan Spazek
Senior Vice President
Main: 617.630.8100
sspazek@capitaladvisors.com

Jimmy Nguyen
Assistant Vice President, Financial Analyst
Main: 617.630.8100
jnguyen@capitaladvisors.com

Introduction

With relatively abundant availability of private financing, many companies today are choosing to remain private. And in recent years, privately held start-ups and growth stage companies seeking financing have increasingly looked to venture debt and other early-stage debt structures as extensions of their equity investments. Such funding, which tends to be less dilutive than equity financing or convertible debt, has become more available over time. There are venture banks, specialty finance companies and an ever-expanding roster of non-bank debt funds willing to lend across the corporate growth spectrum from early stage cash burning companies to later stage profitable organizations. To qualify for what we define as early stage debt (i.e. companies that may not otherwise qualify for large commercial bank lines), companies typically need to have strong institutional investors, a demonstrated history of customer adoption and year-over-year revenue growth or high growth with a predictable revenue track and/or some profitability. As entrepreneurs, founders and their teams begin their journey with a new company, it's important to have credible plans for if, how and when to use debt financing and to understand its potential effects on all stakeholders. Finally, to complete a successful debt-financing deal, it's essential to make sure all stakeholders' incentives are aligned.

Stakeholder 1: The Company

Management teams of early-stage companies constantly monitor the financial health of their organizations and tend to be in perpetual fundraising mode. According to a CB Insights Research Brief[1] and other research such as the 2015/2016 Global Entrepreneurship Report published by Babson College and other organizations[2], under-capitalization is one of the top reasons new businesses fail. Whether they face unexpectedly high cash burn, are failing to spend cash in the right areas, or are seeking to shorten time-to-market for new products and services, it is important for management teams to understand when it's time to raise capital and to be aware of all the financing options available.

Outside of bootstrapping and/or a friends-and-family investment approach, most companies will need equity financing at some stage to accelerate growth. Some investors and management teams will choose equity as the sole source of financing for growth. At Capital Advisors Group, we believe that debt financing, in addition to equity, can also be beneficial to corporate growth when used strategically and appropriately.

[1] CBINSIGHTS, *The Top 20 Reasons Startups Fail,* https://www.cbinsights.com/research/startup-failure-reasons-top/
[2] GEM, *GEM 2015 / 2016 Global Report,* http://www.gemconsortium.org/report/49480

Generally, the debt market is not suitable for companies during the earliest stages of their lifecycles. Typically, companies in their nascency that are still building out their management teams and business concepts are best served by institutional investors providing equity financing. The risks of securing a debt facility at the earliest stages can outweigh the benefits for all parties involved, including the company, employees, founders, investors and lenders.

However, companies that have bootstrapped to a higher growth stage with a significant revenue ramp, or those that have raised multiple or significant equity rounds (i.e. Series A, B or later), might substantially benefit from debt financing. Companies that are generating predictable revenues, have a high probability of raising future equity if needed and that are roughly 18 to 24 months away from profitability may also be good candidates. Debt financing in these cases can help extend the company's remaining cash life and potentially defer a future equity round until a higher valuation is achieved.

We believe it is critical that companies only consider debt financing when it can be used to achieve a milestone that may not have been possible based on the existing available equity or cash on hand. We use the term "milestone" broadly to include any clinical hurdles or data readouts for healthcare companies, as well as general opex, capex or territory growth that may otherwise not have been possible. Because debt financing is almost always far less dilutive than equity management, founders and employees sometimes see great value in moving a company forward with debt. Diligence work on debt financing can vary widely. In some cases, it may be relatively minor compared to equity financing diligence and sometimes acts as insurance in case it takes longer to hit the next milestone/equity raise. And, in the long run, if a company continues to perform well at each equity funding and meets its milestones, the non-to-minimally dilutive debt financing should return more total value to the founders' stock.

Stakeholder 2: The Lenders

An important note for companies seeking debt is to understand that not all lenders are alike. Capital Advisors Group makes a distinction between venture banks, venture debt (any non-bank entity such as public/private funds or venture arms of BDCs), structured and royalty finance (most often found in healthcare) and middle market/mezzanine finance. Among these different types of lenders, there exists a menagerie of distinct focuses and specific conditions into which each prefer to lend.

The venture banks might be the most generalist lenders across the technology and healthcare industries at the earliest stages. They also have an ability to partner with other lenders and can grow their capacity to lend to their clients through many stages. However, because they are banks, they will have certain limitations due to regulatory oversight. The banks may also require a company's banking services as a condition of any loan.

The next strata of lenders are the non-bank venture debt funds or specialty finance companies. These lenders tend to provide debt at a higher cost of capital than banks because they're not able to lend using relatively inexpensive deposits, they can't offset a lower cost of capital with other services and they are viewed as taking on slightly more risk than the banks because they don't necessarily have ready access to companies' operating cash as do the banks. Fundamentally, the lending model at these funds is somewhat similar to that of the banks; however, they also tend to be able to provide larger loans, sometimes with more flexibility in structure and terms. Some will even lend to companies that are not sponsored by venture capital or private equity firms, or to companies with riskier credit profiles.

Lenders tend to be most comfortable when cash-burning companies have at least 12 months of remaining cash on hand. As additional security, venture banks (and many non-bank funds) generally prefer to lend to companies backed by top-tier institutional investors with deep pockets. This gives lenders confidence that additional capital for the company will likely be available in the future. In addition, to mitigate risk, venture banks and funds will

take a senior lien on all assets of the business (typically carving out intellectual property via a negative pledge) and sometimes may require financial or performance covenants to make sure the company is meeting its projected plans.

When a venture bank or venture debt provider decides the credit profile of a company is suitable for debt financing, the borrower will likely help offset the lender's risk in different forms whether they are financial and/or non-financial covenants and kickers such as warrant coverage, equity participation rights or success fees. In light of these conditions however, it is important to remember that the blended cost of capital and flexibility may still be more attractive than strictly relying on fully dilutive equity financings. In addition, lenders will tend structure contingencies and convenants based upon what the company has provided for its growth plan and milestones. Lastly, the realm of structured or royalty finance in healthcare and middle market or mezzanine debt in broader technology is reserved for those companies that have cleared certain regulatory hurdles (FDA) or reached a consistent level of revenue growth, respectively. This type of financing can be more expensive than traditional venture debt financing, but it can also provide much greater flexibility in terms and far larger financing rounds than can venture debt.

Not covered in this paper is the relatively recent advent of MMR financing which has become more popular in recent years and is reserved, under certain conditions, for SaaS companies experiencing growing annual and monthly recurring revenues.

Stakeholder 3: The Investors (PE or VC)

For an early-stage company that has received institutional support, it goes without saying that the investors and board will have an opinion on the type of financing the company pursues. Some equity investors may have had past experiences with debt financing or even specific lenders and will weigh in heavily on partnering with debt providers. With a meaningful ownership stake in the company, it is obvious investors and founders are working toward the common goal of a highly successful enterprise and exceptional returns on their investments.

Any reputable venture-debt lender will work to understand the company very well and align its goals with those of the founders and investors. Lenders will likely reach out to a company's board of directors and investors to understand their vision for the company (and to assure future financial support if needed). In some cases, investors embrace debt financing and have strong and long-standing relationships banks or other lenders, and those lenders will likely provide debt financing to multiple portfolio companies. However, it is always recommended to run a full process involving multiple lenders whenever a company is pursuing debt financing. In a vacuum and without broader knowledge of the market, it is difficult to tell how or why one lender may pursue a deal with more attractive terms than another. Without running a full process and comparing multiple term sheets, one may never know how much could have been saved over the term of any debt financing.

Conclusion

In short, it is critical for a company considering debt financing to take all stakeholders into account.

Will it make sense for the company to take such financing to help reach new growth or hit milestones?

Is the timing right for the company and are the conditions right to pursue an appropriately sized round?

Who are the proper lenders to contact based on deal size, market focus, company stage, etc.?

Are the investors and company directors on board with the company seeking debt financing?

To align the incentives of all stakeholders, these questions and many others must be answered before pursuing early-stage debt financing.

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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Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com