



Venture Debt Overview

Introduction

- When utilized appropriately, venture debt can reduce dilution, extend a company's runway or accelerate its growth with limited cost to the business
- If utilized poorly or with unfavorable terms, debt can reduce a company's agility or become an obstacle to future equity raises
- Our goal: help entrepreneurs understand how to raise debt in a way that benefits the business and the team

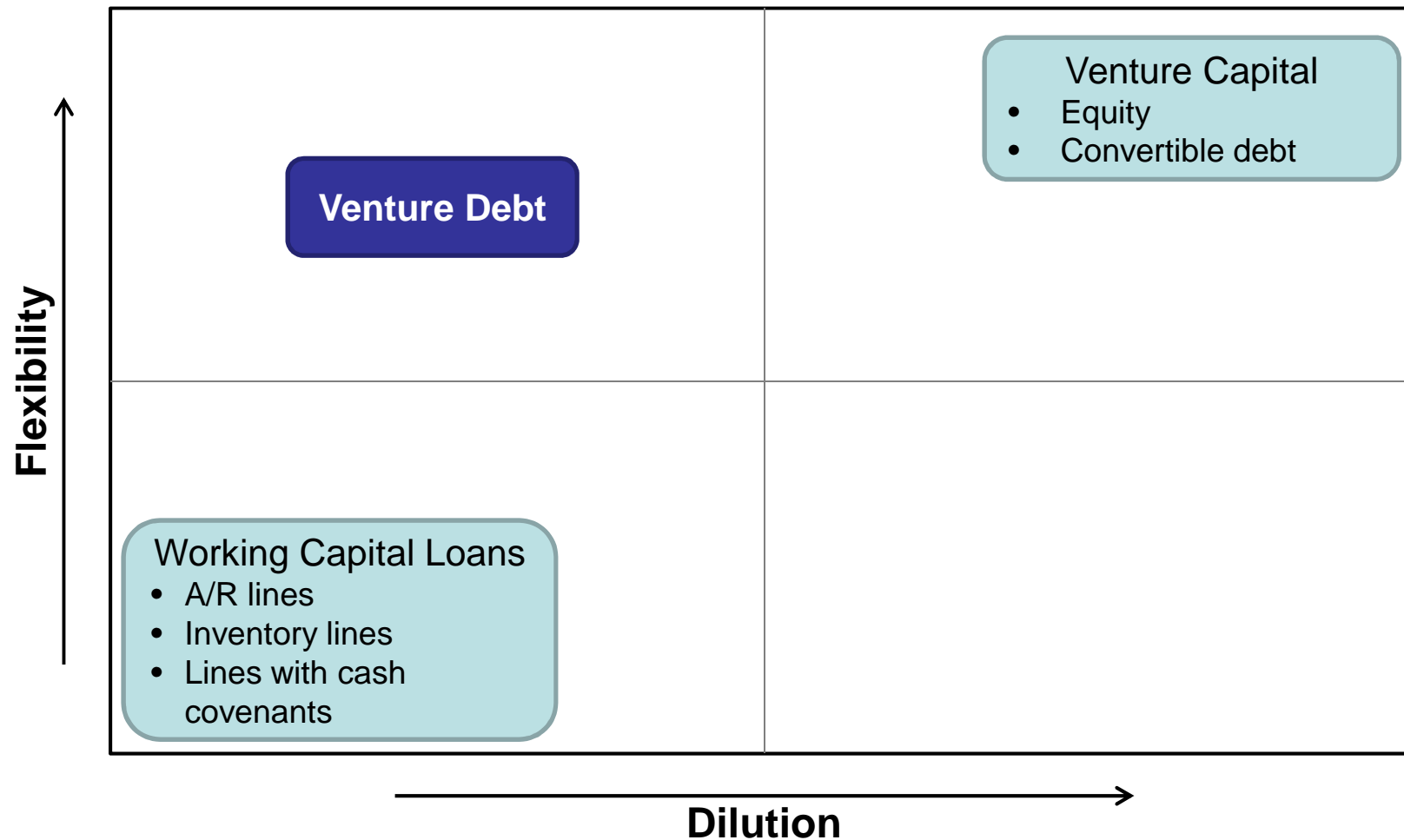
What is venture debt?

- A form of debt financing provided to venture equity-backed companies that **lack the assets or cash flow** for traditional debt financing, or that want **greater flexibility**
- Generally structured as **term loans**, which amortize (pay-down) over time, with **warrants** (purchase rights) for company stock
- Typically, **senior debt** (repaid first in an exit or bankruptcy) and collateralized by a company's assets and/or intellectual property, or by specific equipment
- A **complement to equity financing**



‘Risk capital’ that is less costly than equity when structured appropriately

Venture debt offers a balance between flexibility and dilution



Venture debt vs. other types of loans

	Venture Debt	Convertible Debt	Working Capital Line
Description	<ul style="list-style-type: none"> A non-convertible, senior term loan that can be used like equity, and generally includes warrants 	<ul style="list-style-type: none"> A loan (typically provided by an equity investor) which converts to stock in the company's next equity round 	<ul style="list-style-type: none"> A revolving line of credit which is secured by working capital. May or may not include warrants for purchase of company stock
Repayment of loan principal	<ul style="list-style-type: none"> Generally repaid in monthly payments over the life of the loan 	<ul style="list-style-type: none"> None, converts to equity 	<ul style="list-style-type: none"> Can flex up or down over the life of the loan, depending on the size of the "borrowing base" securing the loan
Interest rate (ballpark)	<ul style="list-style-type: none"> 10-15% 	<ul style="list-style-type: none"> 3-8% 	<ul style="list-style-type: none"> 6-10%
Dilution	<ul style="list-style-type: none"> Generally a small fraction of equity (<1%) , due to warrants 	<ul style="list-style-type: none"> Similar to equity, but can be more or less dilutive depending on valuation in next round and specific terms 	<ul style="list-style-type: none"> Minimal to none, may or may not include warrants
Default clauses	<ul style="list-style-type: none"> Varies, but often limited to failure to repay 	<ul style="list-style-type: none"> Generally none 	<ul style="list-style-type: none"> Often includes MAC catch-all (any "material adverse change"), investor abandonment, etc.
Financial Covenants	<ul style="list-style-type: none"> Generally none 	<ul style="list-style-type: none"> Generally none 	<ul style="list-style-type: none"> Often bound to a minimum amount of cash, A/R, performance vs. plan, etc.

When is venture debt a good idea?

Good idea

- Ex 1* When a company wants incremental capital to **accelerate growth** without taking equity
- Ex 2* In **conjunction with, or following, an equity round** to provide additional capital without increasing dilution
- Ex 3* To add runway and enable the company to **reach additional milestones**, and raise its next equity round at a higher valuation
- For the **purchase of equipment or acquisitions**
 - Most lenders will offer good terms on “equipment loans”, which are secured only by equipment purchased with the loan
- When the amount of capital needed is **too small for an equity round**

Bad idea

- When the company is already at a **low cash balance** or as a financing of **last resort**
 - The weaker the cash position of the company, the worse the terms will be
 - Raising the financing early, and structuring it appropriately (to avoid paying back the loan before it is useful) can put the company in a much stronger position
- When the debt payments will amount to **more than a quarter of the company’s operating expenses**
 - At this point, the financing may discourage future equity investors and can become a burden to company
- When a company has **highly stable revenue streams and receivables**
 - A line tied to accounts receivable could be appropriate and is generally cheaper

*See examples in appendix

How to analyze a venture debt term sheet

- Regardless of the type of financing, the most important question is:
Does the proposal meet your financing goal?
 - If your goal is runway extension, how much further is your cash-out point?
 - If you are managing for variability in your business, is the financing flexible enough to be available when you need it?
 - Will it be recalled if your business stumbles and has a weak quarter?
- Minor differences in interest rates and warrant coverage are not as important as ensuring the financing meets your needs

*See the appendix for specific terms and clauses
common to venture debt term sheets*

What to watch out for

- **Covenants:** Loans tied to a company's cash balance or A/R are common and can add cushion to the balance sheet, but are risky for an early stage company as the cash may be recalled when the company needs it most
 - e.g. A company which is investing to grow its business loses a key customer, temporarily causing a major decrease in A/R and must pay down its loan early
- **Backend loaded deals:** A backend interest payment can help lower the interest paid early on, but loans which require large final (“bullet”) payments can complicate raising additional equity and can place a strain on a young company
- **Default clauses:** Material Adverse Change (MAC) and other “subjective default clauses” can allow a lender to recall their loan due to events which are beyond the company's control
 - e.g. An existing equity investor deciding not to participate in a future round
- **Lenders who won't make good long-term partners**
 - Lender behavior in past deals
 - How often have they called defaults? Have they been willing to restructure?
 - How have they acted when things didn't work out?
 - Availability of funds for follow-on financing or restructuring
- **Deals which require borrower to bear all risk:** A fair deal will be structured such that the lender is putting a portion of their capital at risk of not being repaid in the future

How equity investors think about venture debt

Benefits

- Raising venture debt allows equity investors to **reserve additional capital** for future rounds and to invest across their portfolios
- It also helps equity investors **avoid dilution from new investors** by reducing the size of a new equity round or helping you reach milestones to raise your next round at a higher valuation

Concerns

- Venture debt is **senior to preferred equity**, so if things don't work out, debt is repaid first
- Investors may **worry about interest increasing your burn** or want you to **stay lean**
- Investors may be concerned about **losing control of the company** if a default is called and/or have had **negative experiences in the past**

Keeping the debt to a reasonable amount can help alleviate both of these concerns

Know your potential lenders' **histories and reputations**

See some specific thoughts from VCs in the appendix

Summary

- Venture debt is a strong option for venture-backed companies who want to add capital and minimize dilution
- Though more expensive than traditional working capital lines, venture debt offers far greater flexibility
- However, excessive debt or loans with heavy restrictions can be detrimental to a business, and the terms of any potential loan should be considered carefully

Questions/comments?
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Appendix

Specific terms, examples and other
opinions on venture debt

Evaluating specific terms

Term	Description	Advice
Interest rate	<ul style="list-style-type: none"> The effective interest rate is based on a “stream” or amortizing rate but may be increased by any of the following: <ul style="list-style-type: none"> Up-front fees Final, back-end payments Adjustments for changes in macro interest rates 	<ul style="list-style-type: none"> Modeling all payments and calculating the effective interest rate will help you compare the “true” interest rates from multiple proposals <ul style="list-style-type: none"> Or ask the lender to do this for you
Draw periods	<ul style="list-style-type: none"> If a company is raising venture debt long before it needs the cash, a period over which the company can choose to draw the cash is sometimes included 	<ul style="list-style-type: none"> A long draw period is can help a company with a large cash balance, but is costly to the lender (as they have to reserve capital they can’t invest) and may increase other pricing to compensate <ul style="list-style-type: none"> Pre-conditions to funding, typical after a long draw, can be a problem if the company has any major setbacks Alternatively, a longer interest-only period can help a company avoid paying back principal before it’s needed
Multiple tranches	<ul style="list-style-type: none"> Lenders may also elect to offer the financing in stages, with portions available at different times, sometimes conditioned upon the achievement of milestones 	<ul style="list-style-type: none"> Tranched deals can help a company to raise a larger financing than they might otherwise, but as with draw periods, be very clear on the conditions for future financings
Warrants	<ul style="list-style-type: none"> Similar to options, warrants are the right to buy stock at a certain price Warrants offer lenders equity upside and help align interests in the company’s long-term success 	<ul style="list-style-type: none"> While warrants offer minimal dilution, they often enjoy the same rights as preferred equity which means the terms can be just as complicated
Pre-payment/ restructure	<ul style="list-style-type: none"> If the company decides to pay the loan back early, it may incur additional fees Similarly, restructuring a loan may require additional fees or warrants 	<ul style="list-style-type: none"> Understand exactly what you will be charged if paying the loan back early Inquire about past restructuring agreements the lender has made

Ex 1

Example 1: Financing a later stage company

For a simple introductory example, we'll consider an actual company from our portfolio:

- A late stage company which had raised a modest amount of capital, SoftwareCo, was nearing breakeven, but wanted additional capital to invest in growing its business and expanding its sales team
- However, SoftwareCo was hesitant to raise a new round of equity and only wanted a small amount of incremental capital
- Instead, we provided SoftwareCo with \$1.5M of venture debt

Tradeoffs of raising equity vs. debt

Equity

- Even if SoftwareCo achieved a 100% increase in valuation from last round, raising \$1.5M of equity (at \$20M pre-money) would have caused ~7% dilution
- However, could be difficult raising only \$1.5M and potentially drag on for weeks negotiating between multiple existing investors

Debt

- Company raised \$1.5M of debt at last round valuation of \$10M post-money
- Company granted Leader warrants leading to ~1% dilution
- Term sheet issued within one week of initial meeting

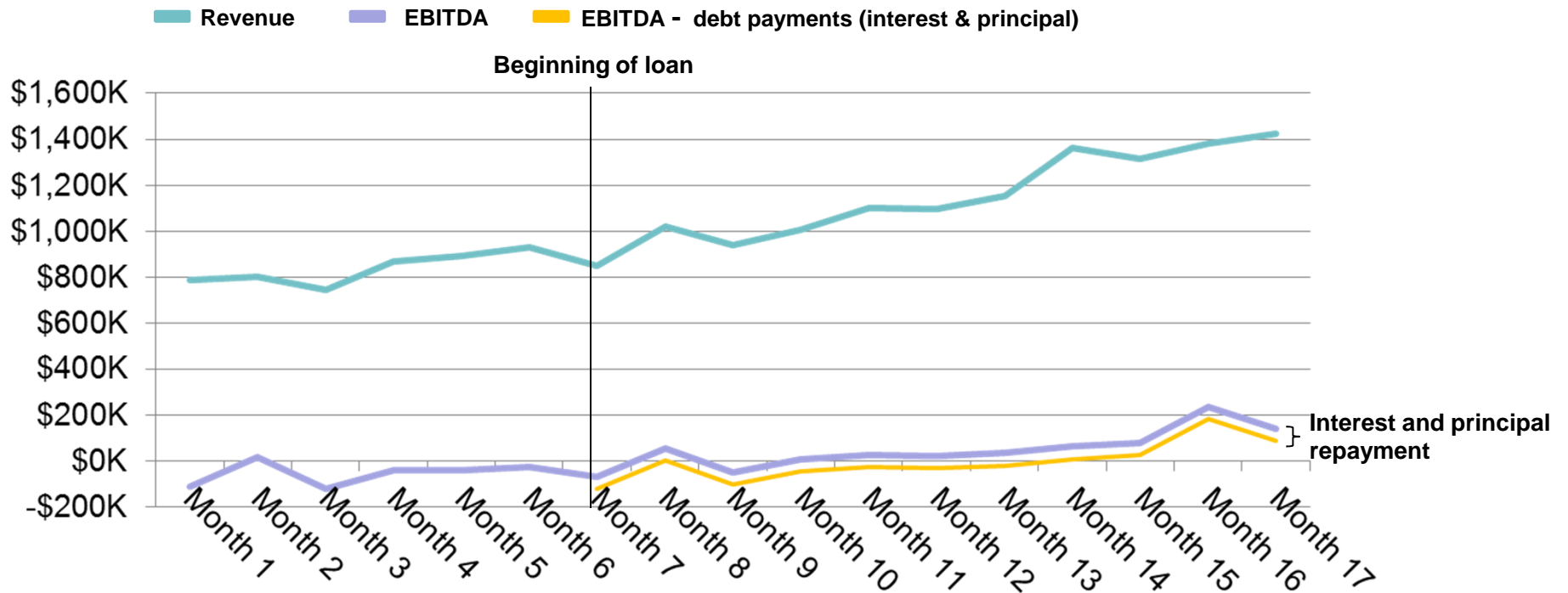
Ex 1

Impact on the company

SoftwareCo was able to expand its sales force and drive strong revenue growth, while marginally increasing expenses, leading to an attractive acquisition by a large software company.

Loan terms:

- 36 months of amortization
- 9.5% interest rate, 4.5% final interest payment, 1% commitment fee (effectively ~12% interest)
- 9% warrant coverage



Ex 2

Example 2: Raising Series B

The second example considers a fictitious early stage company:

A SaaS business, WidgetCloud, raised Series A funding from BigTree Ventures one year ago and is looking to raise Series B with a new lead investor.

However, both WidgetCloud and BigTree want to avoid being heavily diluted by the new capital. WidgetCloud is considering raising a portion of the financing in venture debt.

Amount to raise: \$10M
Pre-money valuation: \$20M
Management ownership: 40%

Scenario A) 100% Equity

- Company raises full \$10M in equity



- Management gives up 13.3% of company

Scenario B) 60% equity, 40% debt

- Company raises \$6M in equity
- Company simultaneously raises \$4M term loan with warrants for 7% of loan value (\$280K)



- Management gives up 9.6% of company

Ex 2

Impact of venture debt on runway

*While paying down the loan will increase the company's burn, raising the entire Series B entirely in equity **only gives WidgetCloud three more months of runway.***

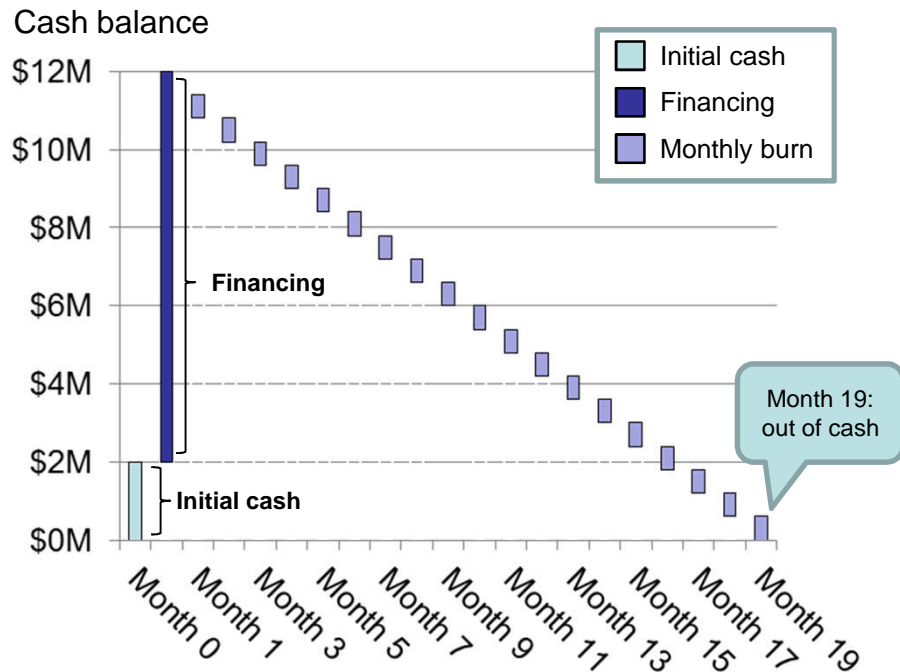
Assumptions:

- Company has \$2M in cash prior to financing
- Company's burn, excluding debt payments, is constant at \$600K
- Loan is drawn immediately

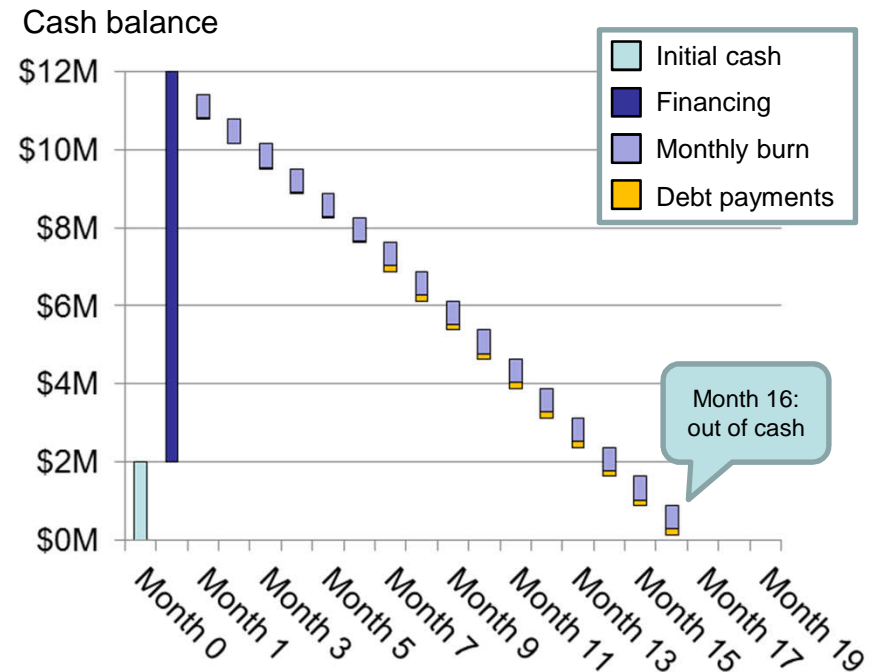
Typical loan terms:

- 6 months of interest-only payments, 30 months of amortization (equal payments of interest and principal)
- 9% interest, 1% fee, 5% back-end payment (12% effective rate)

A) 100% equity



B) 60% equity, 40% debt



Ex 2

Impact of venture debt on management's position: Series C

While the company must repay the loan, management can reduce dilution by having raised less equity in Series B, even if they must raise additional equity in Series C to fully repay the loan.

However, the loan's value depends on how far the company progresses before the next equity round.

The next round: Series C details:

- WidgetCloud wants to raise \$20M to fund the company to profitability
- *In the debt scenario (B) assume the company must raise an additional \$4.7M to compensate for principal and interest payments

	No increase in valuation between rounds		~1x increase in valuation		~2x increase in valuation	
	A) All equity	B) With debt	A) All equity	B) With debt	A) All equity	B) With debt
Series B post-money	\$30M	\$26M	\$30M	\$26M	\$30M	\$26M
Series C pre-money	\$30M	\$26M	\$60M	\$60M	\$90M	\$90M
Series C raise	+\$20M	+\$25M*	+\$20M	+\$25M*	+\$20M	+\$25M*
Series C post-money	\$50M	\$51M	\$80M	\$85M	\$110M	\$115M
Mgmt ownership	16.0%	15.7%	20.0%	21.6%	21.8%	23.9%
Δ in mgmt ownership		-1.9%		+7.8%		+9.5%

Management is better off raising debt if the valuation increases more than \$4.3M

Summary

- For a slight cost to the business, WidgetCloud is able to **substantially reduce the dilution of Series B** by raising part of the financing as venture debt
- However, if the company will need to raise another round, this is only valuable to management (and any preexisting investors not leading the round) **when the company is able to meaningfully increase its valuation before Series C**

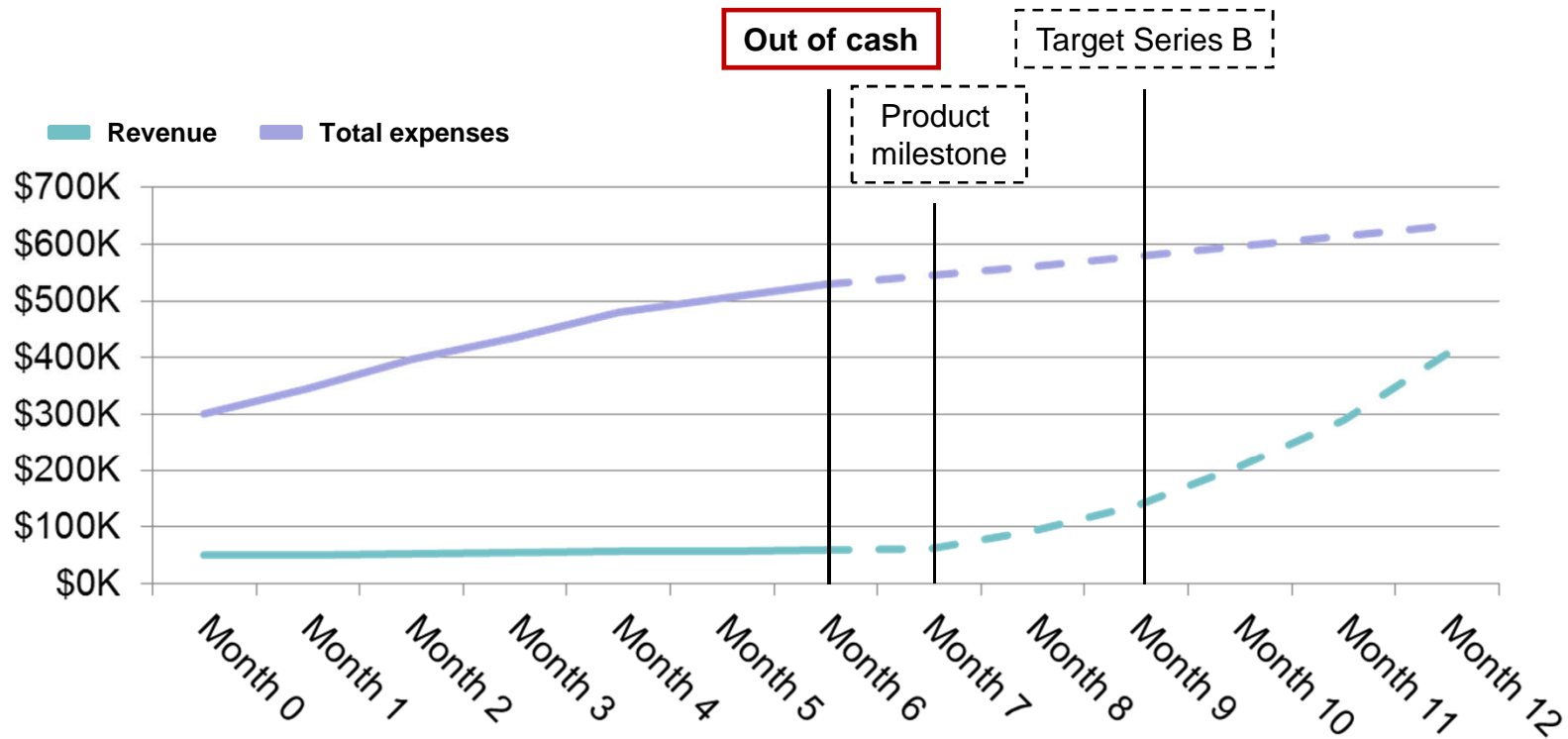
For a slightly more complex example, Example 3 compares runway extension between rounds using equity, venture debt and a working capital loan.

Ex 3

Example 3: Runway extension for an expansion stage company

MedDeviceCo raised Series A funding from High Tech Capital a year ago and has ~6 months of runway remaining. The company has yet to achieve substantial revenue and wants to add runway to achieve milestones and raise its next round at a more attractive valuation.

MedDeviceCo is deciding between raising an internal bridge round, a venture debt loan and an accounts receivable loan.



Ex 3

The cost of each financing depends on whether equity costs are considered...

Proposed terms (at \$12M pre-money valuation, management owns 40%):

Equity	A/R Loan	Venture Debt
<ul style="list-style-type: none"> • \$5M equity round • 2x liquidation preference 	<ul style="list-style-type: none"> • Up to \$3M loan, tied to accounts receivable (assume \$2M is eligible) • 36 month term • 6.25% interest rate (prime rate + 3%) • 1.0 quick ratio covenant* • Warrants for 3% of loan value 	<ul style="list-style-type: none"> • \$5M term loan • 36 month term • 6 months of payments of interest-only • 12% interest-only rate • Warrants for 8% of loan value

Costs of each financing

<u>Total interest</u>	\$0	\$0.1M	\$0.7M
<u>Equity 'cost':</u>			
Dilution to management	12%	0.3%	1.3%

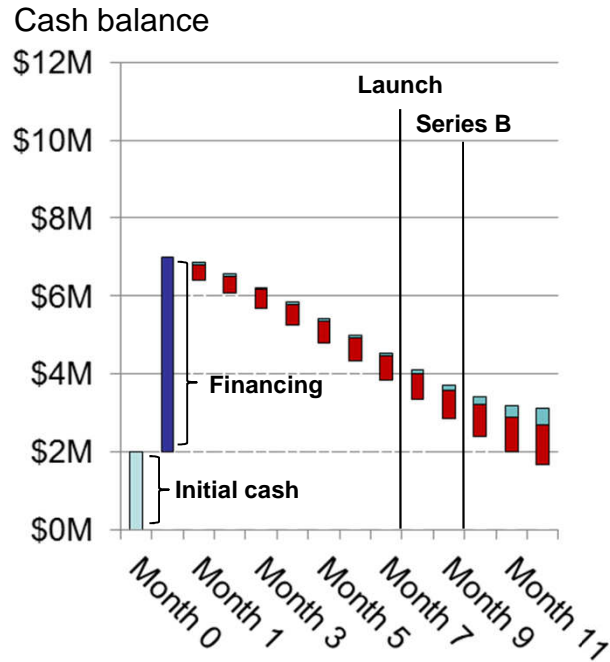
* $(\text{current assets} - \text{inventory}) / \text{current liabilities}$ must stay at least 1.0

Ex 3

...but the financing must also be truly useful

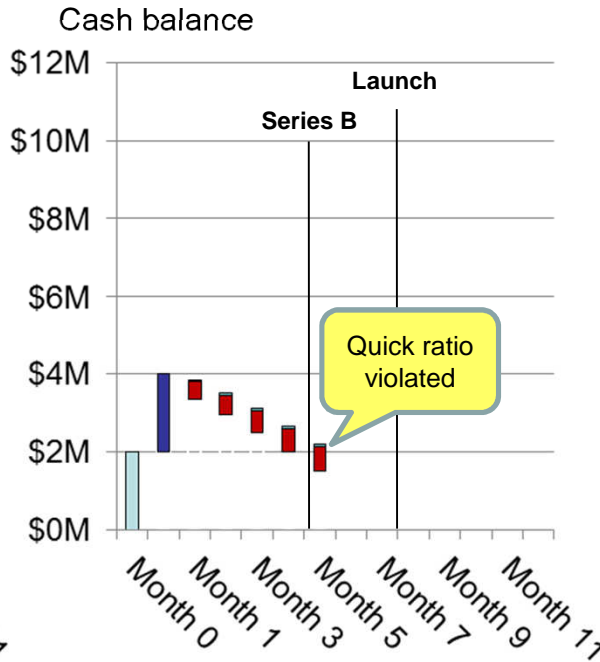
Initial cash Financing Revenue Expenses Debt payments

Equity



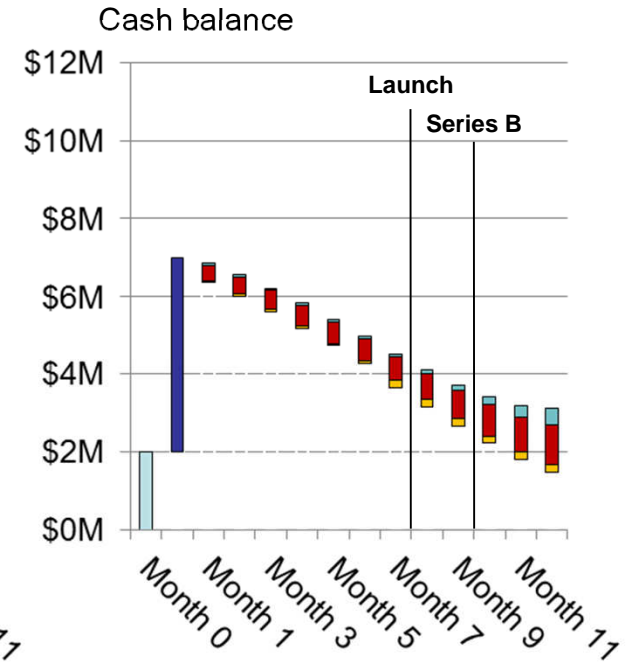
Company receives needed runway extension, but management **sells 12% of ownership stake with a 2x preference**

A/R loan



Company adds runway cheaply, but is only able to raise \$2M and **trips the covenant** in the fifth month, requiring a hurried equity raise

Venture Debt



Company receives needed runway extension and slightly increases burn, but only **sells 1% ownership**

- An equity bridge offers the best runway, but causes the most dilution and may come with terms favoring investors
- Covenant-protected and working capital lines are cheapest, but may not be available when they are most needed
- Venture debt can offer the runway needed at a lower cost than equity, but only if it is structured in a way that is helpful to the company

Other perspectives on venture debt

While we believe venture debt to be an important and beneficial financing tool, there are a wide variety of opinions within the venture community; two are highlighted here.

Source	Summary	Our take
<p>Fred Wilson, Union Square Ventures</p> <p>http://www.avc.com/a_vc/2011/07/financings-options-venture-debt.html</p>	<p>While Fred Wilson has written positively about venture debt for later stage companies and equipment loans, he has been critical of venture debt for early stage companies: <i>“If the startup is getting the money because of the credit worthiness of my firm and the other firms in the deal, then I’d rather be putting more equity in instead and getting paid for my capital at risk.”</i></p>	<p>Fred is right, we can’t expect a startup that isn’t near profitability to repay a loan from operating cash flow, and when things don’t go as planned, it is the existing investors who must support the company (and its debt).</p> <p>However, this is true regardless of whether the company takes debt, and Fred doesn’t mention the benefits to a founder (avoiding dilution) or to an investor (reserving more capital to invest across his portfolio). Additionally, the fundamental bet is not on the credit worthiness of the investors, but rather the ability of an early-stage company and its team to attract additional equity, hopefully from new investors.</p>
<p>Sarah Tavel, Bessemer Venture Partners</p> <p>http://www.adventurista.com/2009/01/true-cost-of-venture-debt.html</p>	<p>Sarah Tavel points out on her blog (see link) and in a presentation for Bessemer that while raising venture debt can extend a company’s runway, a company may be forced to pay both interest and principal before they ever use the debt, leading to a higher than expected cost of capital.</p>	<p>Sarah makes an excellent point, and one that we have tried to touch upon here. If you are financing purely for runway extension, negotiating an interest-only period or a draw period can help you avoid this situation.</p> <p>However, if you are raising debt as a cushion against unexpected changes in your business or to finance a purchase, the additional runway isn’t actually your goal and evaluating the loan only in these terms may ignore the benefit provided.</p>