



YOUNG
VENTURE
CAPITAL
SOCIETY

Venture Debt –Another tool of the VC

June 10, 2005

By: Mathew Guliner
Paul J. Marino

In the ever evolving world of venture capital, many venture capital firms (“VCs”) have found it difficult to find investment opportunities that present the promise of higher than market returns with traditional style investing. As a result, many VCs have deviated from typical investing styles and have begun to create new (at least in the VC world) formulas for investment success. One such formula is debt based investing.

Within the last few years, due to a variety of factors including, risk averse behavior, lack of exit strategy (partially due to the poor performing IPO market), and a dearth of investment ready companies, debt based investing has become a viable alternative to traditional investing for many VCs. Venture debt as it is known, is usually structured as a (i) term loan, (ii) generally 2-4 years, (iii) whereby the VC lends money to the company using a promissory note (often collateralized by the company’s equity and assets), and (iv) the VC receives either warrants with the loan, or (v) the note is convertible to equity at the option of the note holder. This structure has become popular with some VCs because it allows the same protection as traditional debentures (bonds, *etc.*) on the downside (by using securitized debt) as well the ability to participate in the upside of a deal by use of a conversion feature or warrants.

Lending venture debt usually comes in one of two forms, venture lending or venture leasing. Lending relates to money needed for operating expenses where venture leasing is more often for purchase of equipment, land, or other tangible assets.

Generally, one thinks of a loan being issued by a traditional lender (such as a bank) and not by a VC. However, as many companies have found, since a VC is not tied to rigid state and federal regulations, a VC often offers more competitive rates and features than a traditional lender and more importantly it can structure a loan in a variety of ways, including as subordinated debt. This is an important element for many VCs and companies because it removes any possible impairment that the funding could have on other lending facilities. Additionally, (again as a direct result of the lack of regulatory oversight) VCs can fund start-up companies with less collateral to pledge, less cash on the books or assets to secure because they do not have to meet governmental structured thresholds.

A company usually seeks venture debt either (i) before participating in a round of preferred financing (as a bridge), (ii) in conjunction with financing (as a means to stave

off further dilution), and/or (iii) following equity financing (again to stave off immediate dilution and to create more free-cash flow). Regarding the first scenario, a bridge loan can prove invaluable to many start-ups because many start-ups need the extra time to improve revenue, ink another deal (contract), and (hopefully) improve their valuation. The same could be true about the second scenario whereby VCs lend money side by side with a private placement. In that scenario, a VCs lender may not be intrigued enough in the company to make an equity placement but is keen enough in the company that it believes in its ability to continue and improve operations. In the third scenario, a company may not wish to further dilute investors (or may be prohibited from doing so) and the prospect of adding debt will not immediately dilute current shareholders.

Another benefit of venture debt is that debt financing is often cheaper than equity financing. For instance, an equity investment of \$1mm at a pre-money valuation of \$1mm will buy the VC 50% of the company. If the company succeeds and the future valuation is \$20mm, the VCs stake is now worth \$10mm; a return that is excellent on a \$1mm investment. Whereas the venture debt holders would receive their preference rate plus warrants. Additionally, venture debt providers are usually less involved than typical VCs and usually are not on the board and only provide (usually) strategic guidance to start-ups (which is not always good and certainly (from the company's perspective not always bad).

However, venture lending is not for every company. Start-ups must be able to pay the monthly interest associated with the loan (unless the loan has a preferred in kind payment structure). Assuming that the debt is structured in a traditional manner, the interest payment from venture debt may not be a perfect fit for some early stage pre-revenue companies. Also, venture lenders want to ensure that the officers of the company realize that the loan is in fact a loan and not an investment and often times make the loan a recourse loan thereby making the company's officers execute a personal guarantee.

However, in general debt is beneficial to both parties. It allows a risk averse VC to engage a start-up all the while avoiding the downside of a crash and burn scenario and share in the upside of a homerun. For a start-up company, venture debt is often a good first experience with VCs because it allows the company to retain ownership (no dilution) and can extend the amount of time, or runway, before needing a new round of financing.

Some providers include:

RBC Centura , Lighthouse Capital Partners, Silicon Valley Bank, CoAmerica Eastward Capital Partners (CommVest), Horizon Technology Finance, and Sand Hill Capital