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Venture Debt: An Attractive Tool for Startup Companies

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Startup and growth-stage companies typically rely on venture capital equity financing for their fundraising needs. Although venture capital is necessary to grow a business, it may not be the best tool available if the objective is a cash infusion to meet developmental and other milestone goals. Rather, taking on debt in the form of a venture loan (which, by conservative measures, is a $4 billion per year industry), may best serve companies' cash needs, while avoiding unnecessary dilution.

What, Why, and Who Will Provide?

Venture debt is a loan that provides working capital for early-stage and growth-stage companies without the dilutive effect of a full-fledged equity investment. Venture loans are also used to finance purchases of equipment, but the most popular use is to fund milestone initiatives that can boost a company's future valuation. This is because with a cash infusion in the form of venture debt, a company can achieve its next milestone (attracting future equity investors) without diluting the current equity holders. Venture loans differ from traditional loans in several respects. Lenders will often piggyback on the due diligence conducted by venture capital firms, which is why venture loans are usually made in conjunction with venture capital financings (this also reduces transaction costs). Venture loans often have more flexible terms and lenders are considered more incentivized to restructure debt than traditional lenders in the event of underperformance, since the lender often holds warrants.

Why Not Take Out a Normal Loan? Companies that take out venture loans usually do not qualify for traditional bank loans, because most early-stage companies are cash-flow negative and have little collateral. Companies best suited for venture debt are those with past and/or concurrent venture capital equity investments and intellectual property that can serve as collateral and confidence in future growth.

Who Provides Venture Loans? Broadly speaking, there are two types of lenders that provide venture loans: traditional banks and venture debt lenders ("VDLs"). Some traditional commercial banks have venture debt arms, but they are not a central business focus. VDLs are often structured as private limited liability partnerships funded by pension funds, institutional investors, and private investors. Since private fund managers need to attract their investors with healthy returns, they can exercise broad discretion and flexibly structure venture loans. VDLs are far more likely than traditional banks to tolerate the risk inherent to lending to startup and early-stage companies and frequently specialize by industry. Meanwhile, traditional banks may require borrowers to keep significant cash on hand, which defeats the purpose of borrowing to lengthen a company's cash runway. Banks are also limited in the amount they can loan such companies, and require other strict covenants due to regulatory burdens. Covenants can be a good thing since borrowing may be cheaper and there is less ambiguity as to what constitutes default, but if the goal is freer cash flow, covenants can stifle growth. Sometimes, a company can simultaneously receive loans from a traditional bank and a VDL, which enables it to obtain a larger commitment than one institution may be willing to underwrite. This, however, requires a heavily negotiated inter-creditor agreement on topics such as collateral and enforcement rights upon default, which increases the complexity (and therefore the transaction costs) of this approach.

How Will My Startup Be Evaluated? Unlike traditional loans, which are judged using traditional financial performance measures, venture lenders typically track and analyze financial statements and cash on hand, but also customer generation, budget comparisons, and past investors' appetites to commit additional equity. VDLs are adept at measuring the potential of cash-flow negative companies and relying on non-traditional and more subjective performance measures to weigh the risks of underwriting venture loans.

What Do Venture Loans Look Like?

Usually venture loans are specially structured to stimulate growth and achieve milestones. Loan amounts vary from $1mm to $20mm, have a longer maturity than traditional loans (3–4 years), accrue interest from 10–15% and are secured by collateral in the form of intellectual property. Venture loans are different from convertible notes because unlike convertible notes, they do not serve as a bridge between equity rounds, are not financed by current equity investors and are not short-term loans. Typically, venture loans are not burdened by operating or compliance requirements, such as mandatory cash reserves, and often VDLs will provide for longer periods of interest-only payments in order to allow the company freer cash flow to meet its milestone goals.

Warrants. Many venture loans come with warrants, exercisable by the lender upon a liquidity event (such as an IPO). Warrants both give additional upside to lenders and allow them to hedge the risk of lending to an early-stage company with no positive cash flow.

MAC Clauses. In an effort to protect lenders, venture loans may include a material adverse change ("MAC") provision. The MAC clause allows lenders to cease lending, call the balance of the loan or restructure the loan should the lender believe the overall prospects of the company have worsened. The inclusion of a MAC clause underlies the notion that venture loans are designed for companies that have some track record of venture capital investment, a strong customer base and confidence in future growth.

Board Observer Rights. Lenders typically require board observer status, in order to track the non-traditional performance measures discussed above. Typically, however, venture lenders will not require a seat on the board of directors, which is standard for venture capital investors.

What's the Catch?

Venture loans are not without risk. Although they provide needed cash without the dilutive effects of a full-fledged equity financing (which thus makes venture loans less costly in the long-run), there are risks to consider.

Venture Loans May Not Add Runway. The primary goal of venture debt is to add runway, but this goal is only served if the company remains attractive to equity investors (or if a liquidity event is near). Without some certainty as to that next step, lenders will insist on financial and cash-on-hand covenants, which can simply maintain or even shorten the runway.

It's Debt! Venture loans are collateralized debt, commonly secured by intellectual property which is at risk in the event of default. A company must be careful that it is not hindering its ability to license intellectual property to outside parties. Lenders may require venture loans to be senior to all other company debt, which would require strategic planning. In addition, too much debt, or debt that is structured poorly, can make a company unattractive to equity investors or a potential acquirer. Some analysts recommend that the amount required to service the debt be no more than 10% of a company's cash burn. It is important to remember that venture debt is not "cheap equity" but a loan that must be repaid. Debt must be repaid before equity holders (the preferred and common stockholders) get their investments back. Although immediate foreclosure is not usually the first step venture lenders take, a lien on a company's assets (particularly on intellectual property of a startup) gives lenders enormous leverage in case of default. New investors may be weary they will get their money back at all if the company is saddled with onerous debt. Similarly, some loans may preclude a company from future working capital financing. A company must be vigilant that it is not foreclosing tomorrow's possibilities by taking out oppressive debt today.

Beware of the MAC. The material adverse change provisions in these loans must be clearly understood, and there is a risk that the lender can call the balance of the loan if a company's outlook dims. The risk is heightened if the lender can make this decision unilaterally. Debt adds an administrative burden in general, and in particular, MAC clauses require rigorous analysis.

Know Your Lender. If the lender is a traditional bank, there can be obstacles to a successful venture lending relationship. The bank will often require a depositary relationship with the borrower (although this risk can be alleviated with a little planning). State and federal regulators are intensely focused on banks' performance, which hampers flexibility. In addition, banks will consult with a company's equity investors to measure the company's prospects and the probability that the debt will be repaid. Depending on the outcome of these conversations, a bank's probing can poison the well between the company and its investors.

Watch Out for Fees. Some venture loans have closing fees, maturity fees, and prepayment fees, which can negatively impact cash holdings. All loans require interest payments, and with warrant coverage for the lender, venture debt is not a cheap alternative to traditional debt in terms of payment obligations. Keeping transaction costs down is an important consideration, especially if dealing with an economical board of directors.

Lots of Flavors. Borrowers must be careful to take out the right kind of venture debt. Different kinds of venture debt (such as equipment loans, growth capital, working capital, and refinancing existing debt) have different bells and whistles. Although all types of venture debt are at their core, loans, a borrower must be careful that its goals are best served by taking out the right type of loan for its particular needs.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings New York lawyers:

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