GETTING

DEBT

GIVEN IT PROVIDES A VALUABLE OPTION FOR STARTUPS THAT WANT TO RAISE FUNDS WITHOUT UNNECESSARILY DILUTING THEIR EQUITY, IT'S WORTH ENTREPRENEURS WRAPPING THEIR HEADS AROUND VENTURE DEBT

BY JOSH RUSSELL

EQUITY OFTEN DOMINATES CONVERSATIONS around raising investment. Whether it be doing the rounds of VCs or putting together a crowdfunding campaign, entrepreneurs are often encouraged to trade away some of the control of their company every time they want a fresh injection of capital. However there is another option. By providing debt finance to venture-backed companies at a fraction of the equity cost of traditional investment, venture debt can prove invaluable for those looking to grow without excessively diluting the value of their shares.

One of the reasons venture debt is increasingly coming to the fore in the British investment landscape is down to the way it complements existing funding solutions. "We think about venture debt as a very flexible solution for venture-backed companies looking to supplement the equity they've raised," says Erin Platts, head of commercial banking at Silicon Valley Bank UK, the international tech-focused bank. Because venture debt is often used in conjunction with, rather than as replacement for, equity investment, the increasingly mature equity environment in the UK in recent years has inevitably created demand for increasing numbers of venture debt funds. "A really healthy and robust equity environment will always lead to a healthy and robust venture debt environment," she says.

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> Erin Platts, Silicon Valley Bank UK

Startups are increasingly taking advantage of venture debt for a variety of uses. "In this market it's used in many different ways," says Platts. The purpose venture debt is put to entirely depends on the model and sector a company operates in: for example a seasonal business Platts recently met with utilises the solution to fuel its marketing in advance of Q4. Alternatively, some startups may just use venture debt to give themselves more runway and meet their next milestone. "Some people have specific use cases they apply it to, whereas others think about it more as general growth capital," she says.

No matter the purpose it's put to however, venture debt is often structured the same way. As with any debt-based lending, one of the first things to consider is the collateral the loan is secured against. "The usual thing is that investors will have a first secured charge over the company," says Mark Taylor, head of growth finance at Beringea, the venture and growth investor. "It's like a mortgage but it will be leveraged against the business's assets." This is fairly straightforward in the case of startups working in hardware or manufacturing – which potentially have equipment, premises and stock to use as collateral – but things are a little more nuanced when it comes to SAAS startups or app developers. "In those cases, you're probably looking more at leveraging the repeat revenue of the business to service the debt," Taylor explains.

The next factor for an entrepreneur to consider is how the drawing and repayment of the debt will be structured. Off the bat, it's important to recognise that startups don't necessarily have to take all the funds in one lump sum. "The company doesn't need to draw down the full amount on day one because they're usually flush with cash," says Platts. As a result, there is usually a tranching period that lasts anywhere from three to 12 months on venture debt, which allows a startup ›

to draw down the funds in instalments and only make interest repayments on what it draws. "Once that 12-month period is up, then the facility would amortise typically over a three-year period with principal and interest payments being made on a monthly or quarterly basis," she explains.

But given startups are a high-risk business, this isn't the only thing that venture-debt lenders will expect in return for their investment. "Typically investors will take a warrant in the business that maybe equals 1% or 2% of the company," says Taylor. Effectively these warrants will grant venture-debt lenders an option to buy shares at a predetermined price, albeit at a much lower quantity than expected by an equity investor. Conversely, some venture-debt lenders like Beringea take a variable exit fee instead. "That means if we came into a company that was valued at £10m and it sold for £20m, we'd get an additional fee," he says. "But if it just sold for £10m we wouldn't get anything on top."

Even taking this into account, venture debt can cost a startup much less in the long term than raising larger equity rounds. "If you look at debt, it's obviously significantly cheaper than equity," Platts says. Whilst an entrepreneur raising a series B might be looking at giving up 15% to 20% of their company, the amount of equity they would be staking on venture debt is nearly an order of magnitude smaller. "For a debt round at a similar stage you might be looking at 2.5% of fully diluted ownership," she says. "It's a drop in the ocean."

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In light of this, venture debt is a very attractive facility for startups looking to raise series A and B rounds without significantly diluting their equity. "When they raise a £10m round, instead of taking all of it as equity, they can take some as equity and say £3m in debt," says Platts. And because the startup is having to draw less capital from their VCs, these combined rounds offer a win-win for entrepreneurs and investors alike. "Not only does that blended debt and equity save the management team on dilution but it also allows venture investors to keep some dry powder to help the business going forward," she explains.

However, it's important to note that this value for money doesn't necessarily scale with the business and larger startups might not get the same benefit when compared to other finance options. "Once a company is approaching series C, it usually tends to have revenue traction, repeat customers and clients and could be on a £5m, £10m, £15m or higher run rate," says Platts. At this stage, trading off even a little equity becomes far more costly than the other myriad debt solutions available to late-stage companies, whether that be recurring revenue lines, revolving lines of credit or covenants of debt. "Venture debt is actually a really expensive tool for companies of that stage," she says.

And this is the real art to utilising venture debt: finding the right balance when compared to other funding options. "There isn't a scientific answer to that," Taylor says. Overleveraging venture debt can spook investors that don't want their funds to be wiped out meeting repayments; leaning too heavily on equity can leave an entrepreneur with scarcely any stake in their own company. "You've broadly got to feel comfortable that you're going to have enough revenue to service the debt going forward," he says. "But don't take more equity than you need because once you've given it away, it's gone." ✖