EXTENDING THE RUNWAY

With business revenues on a downward spiral, portfolio companies are in need of capital to weather the Covid-19 crisis. But with valuations down and sponsors targeting a greater amount of equity, many stakeholders are looking to venture debt to extend their runways, *Simon Thompson writes.*

Developed in the US, venture debt is a specialist finance product that is lent out as a supplementary boost, alongside equity funding. The vehicle allows loss making, growth companies without sufficient assets or Ebitda for conventional bank or commercial funding, to access capital, leverage investments and minimise the dilution of equity shares.

Venture debt facilities are structured with warrants and monthly repayments that are delayed for the first 6-12 months. Providers of venture debt are characterised by their lenience on payment dates and their flexible, sometimes non-existent, covenants. Lenders like Shawbrook Bank and Silicon Valley Bank, generally deliver venture debt matching facilities of up to 30 per cent of the equity that's raised alongside of it. Others like Columbia Lake Partners, aren't so bound by specific ratios and will deliver funding a year or more after companies' last raise was completed.

A number of portfolio companies have few capital and liquidity raising options that don't require giving away equity shares. And it is not the ideal time to be doing so, with PitchBook data indicating that valuations have fallen by 20-50% from a few months ago.

Chris Allner, chairman of IC at Downing says that equity is likely to sell for more after the market returns to health. "Valuations are likely to be lower from equity providers, after a period of heady pricing, prior to Covid-19. This may encourage companies to look at debt options, which are less dilutive, thereby giving some real impetus to the venture debt market."

Craig Netterfield, managing partner at Columbia Lake Partners says venture debt usually allows a company the additional runway they need to maximise its uplift of value in the lead up to its next capital raise. "The extra time and capital just gives the company the insurance and the comfort to be able to hit whatever metrics they need to hit to get to the next round."

Venture debt is a useful financial tool for founders and management teams, but it may be just as relevant for VC and PE sponsors. Isaac de la Peña, general partner at GED Capital says that he has used venture debt a number of times to edge out other firms on investments. "It has been

30%

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6–12

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the deal breaker." He explains that they have been able to offer hybrid solutions, between equity and venture debt, that competing firms can't. "We invest equity in their company and also bring venture debt. That allows them the capital they need for their business, with less dilution."

De la Peña warns that using equity to get liquidity in the short term opens up the risks of over diluting management and founders equity shares in the long term. "The entrepreneurs and the founders still have to do the biggest effort in pushing the company forward. If they have a very small share of the equity then there clearly isn't alignment. They are not going to be incentivised to be focused on the business. That is a situation ready for trouble." So, de la Peña asserts: "If you have the debt, you have less dilution and are able to avoid this situation."

TACKLING TURBULENT TIMES

One of the factors that makes venture debt so powerful at the moment, is the uncertainty over how long the crisis will last. No one knows just how long the lockdown period is going to prohibit portfolio companies from making revenues. Allner acknowledges that venture debt providers are a lot more flexible and understanding of these challenges, especially when it comes to missed payments. "So far the venture debt companies have been very helpful, we have seen interest deferred and them being very supportive of companies."

In the same vein, venture debt lenders allow companies to be more agile with how they use debt facilities. For instance, take funding market pivots in response to the crisis.

Sonya Iovieno, head of venture & growth banking at Silicon Valley Bank says they don't have to worry so much about tripping the operating and financial covenants that can all of sudden make its loan due, as they would with a more conventional bank loan. "It can be used by the company for whatever they want to use it for - for growth milestones or whether it's just an insurance policy or for launching new products or into new markets."

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Still, it is no silver bullet funding solution. Joaquin Duran, managing partner at ArcanoBlueBull, a tech focused corporate finance advisor, says that while he is seeing an increasing number of venture debt deals being done, most companies still find it really hard to get. "At this point venture debt lenders can select who they go with, and they can be really picky."

Venture debt lenders in the market are more inclined towards growth companies and/or companies that have recurring contracts, billings and/or predictable, ongoing revenues of another form. That often means SaaS tech companies and B2B companies.

Though, Netterfield notes that 25 per cent of Columbia Lake Partners' loan book is made up of B2C companies.

ADDITIONAL SUPPORT

William Chappel, head of growth & venture at Shawbrook Bank, expects boosted demand will see market stakeholders become a lot more acquainted with the nuances of this niche product in the years to come. He explained that venture debt is more about supporting strong venture backed companies that can't find lending in the normal corporate and commercial markets, than it is about helping companies in crisis. "Venture debt is about helping fund companies' growth. If a company with sticky revenue can get equity, then they may be eligible for taking on venture debt."

While venture debt is making for softer landings for many companies short of revenues, it is also working as jet fuel for portfolio companies boosted by the crisis, such as those in e-commerce or digital technology. "There are companies that are benefiting from the crisis, who've got huge growth projections and need funding to expand rapidly, but also don't want to sell their equity just yet," says Iovieno. She anticipates that a lot of new customers for venture debt providers will be crisis-born innovation companies. "Turmoil and disruption always breed innovation, there will be new companies and ideas coming out of this period pretty rapidly and ideally we will be funding many of them with venture debt."

LIMITATIONS

Richard Anton, general partner at Oxx, has half a dozen portfolio companies with venture debt facilities and would have more, if venture debt didn't have some key limitations. "Amortisation is the killer with venture debt... having to start paying it back after the interest only period, is very problematic [for a lot of companies]."

He says that there are a few structural tweaks that could make venture debt much more accessible. Offering the facilities with rolled up interest to be paid at the end of the loan term, is one example. Anton speculates that there will be more innovation and flexibility as the facility becomes more commonplace in Europe.

But Allner claims that venture debt offerings are already a welcome and distinct improvement on what was available in the previous crisis. Back then, traditional banks were far less flexible and accommodating to small businesses. "The landing for some of these growth companies finding life challenging will be softer, because of the understanding of the venture debt providers, compared to what we have had in previous recessions," Allner says.

The Covid-19 crisis could be venture debts' moment, De la Peña adds. "It's a product that should shine in this environment, because the shocking speed of the pandemic has left many profitable businesses struggling with short-term liquidity." He and sponsors like Allner will be watching to see whether it can fully deliver on its promises. "This environment is going to show how venture debt reacts in challenging times." I