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The Rise of Venture Debt: Past, Present, and Future

Utilization of debt for venture capital backed firms has become an increasingly popular strategic component of young companies' capital structure. These emerging growth companies often view debt financing as a means to augment their cash position without having to give up as significant a portion of their ownership as required by additional equity financing. Ideally the debt will extend their cash runway allowing them time to reach certain milestones that increase their valuation. As noted in a past issue of the Young Venture Capital Society newsletter, "For a start-up company, venture debt is often a good first experience with VC's [that have recently joined the board of their portfolio company] 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"[1].

Today, due to increased competition from the growing number of funds and lenders, loan terms have become more competitive and advantageous for borrowers. The venture debt market, however, is constantly evolving causing it to be difficult for CFOs to keep pace with the ever changing lenders and loan structures.

Brief History

Venture debt emerged in the 1970's in the form of simple equipment financing transactions. A large number of equipment leasing firms were well prepared to maximize the value of certain types of equipment as collateral. The typical companies that required equipment financing were primarily semi-conductor firms that produced large quantities of computer and military hardware[2]. In its early form, venture debt was entirely collateral driven and never reached the 100% financing level. In the mid 80s however, Equitec Financial Group developed a leasing and loan product which offered 100% financing. Equitec devised the concept of using an "equity kicker" to increase yield in order to balance higher risk profiles and offset the resulting increased loss ratios when compared to bankable credit profiles. In these early transactions the "equity kickers" were typically success-based fees or warrants. Warrant coverage still remains the most common form in today's structures. The market grew and flourished in the late 80s and 90s. It reached its pinnacle during the infamous dot-com era. At that time, venture capital equity financing reached its height and venture debt mirrored this trend, as it reached a record high of nearly $5 billion in total financing during 2000 to go along with over $100 billion in VC

[1] Guliner, Matthew, and Paul J. Marino. "Venture Debt – Another tool of the VC." *Young Venture Capital Society*. 10 June. 2005.
[2] Sieling, Mark Scott. "Semiconductor productivity gains linked to multiple innovations." *HighBeam Encyclopedia*. 1 April 1988.

investment[3]. The bottom fell out of both these markets in 2001 as the Internet bubble burst. Many of the long term venture debt providers such as Comdisco, TransAmerica, and GATX abandoned this niche market. The remaining lenders then adopted a much more conservative approach. Some required full cash collateralization and others significantly reduced their risk appetite. The venture capital and debt markets began to rebound and regain their momentum in 2003. This trend was noted in a recent Dow Jones report, "Since the bubble, venture investors have been conservative about the use of debt, but as money floods the debt market lenders are being more aggressive"[4]. The venture capital equity market is again thriving as VC funding reached the highest quarterly level in six years with over $7 billion in investment during the first three months of 2007[5]. As seen in the past, the venture debt market followed the equity lead and has regained its pre-Internet bubble popularity.

Present Conditions

Current favorable market conditions provide an opportunity for emerging growth companies to incorporate venture debt into their business models. For the most part, VCs have embraced the venture debt product and strategically plan for a debt facility to supplement equity rounds. These investors are taking advantage of the current aggressive market conditions made available, in part, due to an abundance of lenders. According to a statement in *Dow Jones Venture Capital Analyst*, "Leading VC's are using the competition among lenders to get the best possible terms for their portfolio companies"[6]. Management and board members seem to appreciate the use of venture debt because it avoids further dilution and increases their valuation while the company continues to grow.

The lending market has greatly expanded in the past few years making it relatively easier for emerging growth companies to acquire debt financing. The increased competition leads to better terms and conditions for borrowers so financial flexibility is maximized while greater runway extension is secured. This notion is realized by one investor who notes, "There's so many of them [lenders], we generally do a bake-off and use one against the other to get terms. It's a very efficient and competitive market"[7]. Seeking proposals from multiple lenders may be the most effective tool to maximize capital structure by exploiting the variation in proposals to produce the most competitive terms. Lenders are willing to assume more risk because of relatively stable market conditions that have produced significantly lower default and delinquency rates.

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[3] Dow Jones VentureOne. <www.ventureone.com> 14 June 2007.
[4] Garland, Russ. "Venture Lending surges back but will start-ups pile on debt." *Dow Jones Venture Capital Analyst* July 2006, Volume X Issue 7: page 22.
[5] "Venture Capital Investment Surpasses $7 Billion in Q1 2007". Pricewaterhouse Coopers Money Tree Report. <www.pwcmoneytree.com>. 16 June 2007.
[6] Garland, Russ. "Venture Lending surges back but will start-ups pile on debt." *Dow Jones Venture Capital Analyst* July 2006, Volume X Issue 7: page 22.
[7] Garland, Russ. "Venture Lending surges back but will start-ups pile on debt." *Dow Jones Venture Capital Analyst* July 2006, Volume X Issue 7: page 22.

Strategically, the most ideal time for a VC-backed company to acquire debt financing is directly following an equity raise when they are at their peak liquidity position. This strategy enables the

company to achieve the most competitive terms and conditions. Adding debt to supplement an equity raise is also a cost effective way to improve cash position while maintaining valuable ownership in the company. As noted, “Perhaps the greatest benefit of venture lending is that it injects money into a business without heavily diluting the equity stake of the entrepreneur or venture capital investors”[8].

Over the years, strong VC funding activity has led to a very healthy venture backed debt market. In 2000, venture capital investment totaled approximately $105 billion with approximately $4.8 billion (5 % of the market) representing the amount of venture debt financing[9]. In contrast, $26 billion was invested by VCs last year with $2.5 billion representing venture debt, nearly 10% of the overall market[10]. Statistics indicate that venture funding activity continues to expand with over $7 billion of VC investment in the first quarter of 2007, representing an 11% increase from Q1 2006[11]. This growth is due to the maturing of the venture debt market with increased lenders and dollars available. These increasing values bode well for young companies that need outside financing to grow and survive.

The Future of Venture Funding

The near-term outlook for venture debt appears solid as the number of new entrants to the lending market has grown significantly over the past year. New investors mean more money available for borrowers and competitive structures. The market inevitably has moved, and terms and conditions are favorable for a company that wants relatively “cheap” money to extend its runway - but there will always be a risk/return trade-off. Borrowers must be aware that lenders often require a measure of compensation when taking on the risk of investing in a company that is cash-flow negative (other than the promise that the VC will step in during a downturn), and that compensation most often takes the form of warrants.

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[8] Hornik, David. “Venture Lending 101” *VentureBlog: A Random Walk down Sand Hill Road* 20 April 2004 < http://www.ventureblog.com/articles/indiv/2004/000520.html>
[9] Dow Jones VentureOne. <www.ventureone.com> 14 June 2007.
[10] Dow Jones VentureOne. <www.ventureone.com> 14 June 2007.
[11] “Venture Capital Investment Surpasses $7 Billion in Q1 2007”. Pricewaterhouse Coopers Money Tree Report. <www.pwcmoneytree.com>. 16 June 2007.

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