

Venture debt

Determining when it's the right path for your business

INTERVIEWED BY SUE OSTROWSKI

For startup companies lacking the cash flow or liquid assets to obtain a traditional bank loan, venture debt could be the answer to help elevate them to the next level.

"Startups often lack many of the characteristics that would give traditional lenders comfort that a regular commercial loan would be a good deal for them," says Michael Fink, attorney at Babst Calland. "Venture debt can be an alternative to help bridge the gap to a company's next valuation."

Smart Business spoke with Michael about how taking on venture debt can keep a business moving forward without decreasing its valuation.

WHAT IS VENTURE DEBT, AND HOW IS IT STRUCTURED?

At its core, venture debt looks similar to other commercial debt a company may incur; it may be structured as a term loan or line of credit, or an option to draw on either. The startup generally may choose the facility it feels best fits its needs.

However, because it's a riskier loan for lenders, venture debt terms are generally more favorable to the lender than those of traditional loans. Borrowers can expect an interest rate higher than the prime rate (5 to 15 percent being common), more lender control rights and expanded negative covenants, prohibiting, for example, making large purchases or divesting a line of business without the lender's consent.

Venture debt's availability is based primarily on a company's ability to raise future equity rounds, so venture debt lenders often require a small equity component in exchange for the higher risk the lender is taking on. For example,

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the lender may receive a warrant to purchase either common equity or the preferred equity to be issued in the next fundraising round, typically at a discount.

WHEN SHOULD A COMPANY CONSIDER PURSUING VENTURE DEBT?

Venture debt typically isn't available until a company has had a priced equity fundraising round that includes a valuation for the lender to work from. Once available, companies find venture debt useful for many capital expenditures or operational needs, or possibly even acquisitions, all without further dilution to the current stockholders.

It's common for startups to seek out venture debt after an equity round to bridge the gap to the next round. This could extend the cash runway to a new equity round and is generally cheaper to current stockholders than a whole new equity investment.

Finally, venture debt allows companies to avoid 'down rounds,' where a company sells shares at a lower price than in the previous round. A down round dilutes investors, can impact conversion and related capitalization calculations, may violate contracts, and signals to the public that the company may be troubled. Venture debt can help by providing a path to avoid this decreased valuation.

HOW CAN A BUSINESS DETERMINE IF VENTURE DEBT IS THE RIGHT PATH?

Just because you can go out and get money doesn't mean you should. There should be a solid reason for taking on venture debt or any other investment.

It's really dependent on the circumstances of the business. As with any financing deal, venture debt can get complicated very quickly, and an experienced attorney can help evaluate where a company stands. Additionally, venture debt can be obtained from a number of sources, and an expert adviser can help navigate those options.

Although the process could be completed quickly in some circumstances (generally resulting in less favorable terms to the company), having a clear vision of your cash needs three to six months ahead can allow you to secure the most favorable terms and position your company for success. If you have six months of funding left and you're not currently planning another equity round, it may make sense to start investigating your venture debt options now.

Venture debt can play a crucial role in helping companies grow. To determine whether taking it on makes sense for your business, speak with an expert adviser to help you work through the issues and come to the best decision. ●