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SETTING UP YOUR STARTUP FOR DEBT FINANCING

TAPPING DEBT IN AN UNCERTAIN TIME

A quick guide for tech startups.

By Chris Kondo
RoseRyan Consultant

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INTRODUCTION

Early on, the COVID-19 pandemic and economic uncertainty led to a rush for capital. Many public companies could act quickly by drawing on existing credit facilities or hitting the capital markets for new debt offerings. Listed companies ranging from General Motors and consumer product giants to technology companies **drew over $124 billion in debt in just the first three weeks of March 2020,** and more followed later.

Accessing capital for private technology companies, however, takes time, as anyone who has gone through a traditional venture capital equity round knows well.
They, too, were advised to consider drawing on credit lines—even if they did not need the extra cash—to prepare themselves for the unknown times ahead.

Companies that had existing debt borrowing capacity in place were able to tap some "just in case" or emergency cash. But what about the others?
When uncertainty persists, the need to proceed carefully—yet with haste—is a must.

For those that are thinking about incorporating debt financing into their capital strategy going forward, let's recap the basics of debt financing.

WHY DEBT FUNDING?

The well-known path of venture capital equity as the primary source of capital source doesn’t have to be the only option your company explores.
It can be augmented with debt.
But debt comes with a number of unique conditions that need to be viewed as a part of a **complete capital strategy.**
The pros and cons should be weighed.

Pros of Debt Financing

- Non-diluting (except for warrants discussed later); equity ownership impact is minimal
- Lower cost of capital than equity
- No impact on governance; debt holders don't want board seats
- Quick access; tap as needed, assuming borrowing capacity is already in place
- Serves as a cushion or runway extender.

Cons of Debt Financing

- Needs repayment
- May have financial or operating covenants
- Holds a primary security interest in company assets
- Debt holder behaviors may not align with equity holders
- Debt holder adds little strategic value beyond the money.

FORMS OF DEBT FINANCING

Generally debt financing falls under two forms: **revolving credit lines** and **term loans.** A third form are **equipment leases** or **equipment loans** that would be used to finance individual or groups of large equipment purchases.


REVOLVING CREDIT LINES
FORMS OF DEBT FINANCING
TERM LOANS

REVOLVING CREDIT LINES

A revolving credit line involves the borrower paying interest on any outstanding amounts. In theory, the borrower must repay the outstanding amounts; however, if the credit line continues to exist, the amount on the line "revolves," or refreshes itself with each new borrowing— effectively, the borrower never repays the principal. Of course, there is a term/end date on the credit line itself, at which point, borrowing either needs to be refinanced or paid off. Credit lines used to be only for financing the borrowing base, which was made up of accounts receivable and inventory. But today there are numerous "formulas" for the borrowing base such as MRR (monthly recurring revenue) or subscriber value.

Pros of Revolving Credit Lines

+ Cash flow impact is isolated to interest on outstanding borrowings
+ No repayment of principal until the end of the credit facility or the borrowing base formula is less than the outstanding debt
+ Flexibility
+ Low cost.

Cons of Revolving Credit Lines

- Requires careful management
- Can be volatile; a decline in sales impacts the borrowing base quickly and can trigger repayment.

TERM LOANS

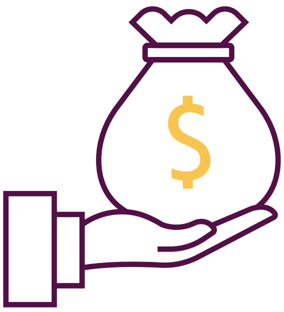
A term loan is simply a loan with a fixed term and pre-specified payment terms. Generally these loans contain an interest-only period when no principal payments are made. Then, normal principal amortization begins. With these loans, you're likely to find three-year terms with the interest-only period lasting six months or more. There will be an extended draw period; however, lenders are usually not interested in providing a term loan that will not be drawn upon.

Pros of Term Loans

+ Predictable, fixed structure and terms
+ Not tied to a formula or borrowing base fluctuation
+ Funds usable for any purpose
+ Large, positive cash flow impact until amortization.

Cons of Term Loans

- Higher effective cost
- Higher warrant coverage
- Exists for long period of time
- May have covenants in existence over a long time frame.



DEBT SOURCES

> Lending sources tend to be banks or specialty venture debt firms. Where should you turn? Consider the pros and cons, and know that some venture debt firms are **publicly traded,** which can provide some **transparency that may tip the scales.**

Pros of Turning to Banks

+ Generally lower cost
+ Lower warrant requirements
+ Easy to access from existing relationships.

Cons of Turning to Banks

– Risk averse in general, lower amounts offered

– Often requires financial covenants

– Collateralization against cash balances may reduce the effective borrowing amount.

Pros of Turning to Venture Debt Firms

+ Willing to take more risk
+ Larger debt sizes
+ Usually covenant free or limited covenants
+ More flexibility in deal terms.

Cons of Turning to Venture Debt Firms

– Much higher effective cost (there are many components of the cost, including fees, end-of-term repayment balloon payments)

– Higher equity/warrant requirement.

UNDERSTAND THE DEBT RAISE PROCESS

The best time to raise debt is simultaneously or shortly after an equity round. Debt should not be used as the last-resort funding option, and lenders will generally not want to be the last money in. They also aren't interested in lending into a situation where the company has only three months of cash on had. Instead, you'll want at least a year of cash runway when you go out to raise debt.

The debt raise process is similar to an equity raise, and the same materials you would use in an equity raise will be used in the debt raise. In this case, lenders will be looking at the quality of the equity investors and the valuation direction.

There are many more venture debt lenders than just the big names, so you may want to consider using an advisor that places debt deals and can give you access to a much larger pool of lenders.

As in any capital raise, it is a process that takes up management's attention—a large portion of the process can fall to the Head of Finance or the CEO to manage at least up to the term sheet stage. Careful cash flow modeling of different debt deals and their true impact on usable cash and their respective costs is a critical effort when evaluating different options.

FINAL CONSIDERATIONS

Debt on its surface is pretty simple, you borrow money then you have to pay it back.

The strategic evaluation of why and how to use it is the next level that a company needs to assess. Various stakeholders may have positive or negative experiences with debt lenders that will color their interest for debt. But there is no doubt, that in times of disruption, companies with debt facilities can marshal that cash quickly and shore up their resources to face the uncertainty.

CHRIS KONDO

Chris Kondo is a senior consultant helping emerging growth companies to make strategic decisions to manage their growth and lead the finance and accounting functions. His consulting experience at RoseRyan has put him in key finance positions at Roku, NatureBox, Emerald Bioscience and Pensando Systems. He previously was vice president of finance at Azanda Networks, corporate controller at Chips & Technologies and director of business development at Intel.

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510.456.3056

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