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
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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.

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 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 recessions,” Allner says. 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.”