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Accelerating growth with Venture Debt

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Introduction

In what was a very challenging 2020 for the Irish economy, the market for venture debt remained open and active. This was supported by robust venture capital ("VC") activity and the acceleration in adoption of technology, which acted as a boon to a cohort of highly innovative Irish businesses. In 2020, VC funding to Irish SMEs was up 13% to €925m versus the previous year. Although a proportion of this VC funding was targeted towards supporting existing portfolio companies, there were a number of large new investment rounds that took place, such as the €65m raise by Let's Get Checked and the €73m raise by Fenergo, both of which closed in Q2 2020. Buoyant equity markets supported venture debt activity in 2020 as companies sought to avail of non-dilutive growth capital to accompany their VC raises. We also saw venture debt providers support non-VC backed businesses as demonstrated by Silicon Valley Bank's reported financing with Teamwork, a software development company based in Cork.

Across continental Europe and the US, economic uncertainty in 2020 heightened the focus and importance of venture debt to high growth businesses. Where the pandemic's swift impact left many VC-backed companies struggling with capital runway, and uncertainty over equity valuations, venture debt lenders were quick to provide non-dilutive bridge financings to extend runway until trading normalised and valuations improved. The market for venture debt globally has been further supported by low interest rates and high levels of dry powder amongst venture debt funds who are eager to deploy.

Looking forward to 2021, we see venture debt continuing to play an important role in financing growth for VC and non-VC backed businesses in Ireland. As we further discuss in this report, VC-backed businesses can consider raising venture debt as a supplementary source of non-dilutive capital as part of a new funding round. Given the uncertain economic outlook, venture debt can be also be considered as an insurance policy against running out of cash runway to the next milestone. In such instances, venture debt can be structured as an undrawn line, to be called upon as and when required. We also expect to see high growth, non-VC-backed businesses who do not necessarily meet the lending criteria of traditional senior lenders, to continue to avail of venture debt in 2021. For such businesses, venture debt proceeds can be used for working capital requirements or growth capex, including acquisitions.

What is venture debt?

Venture debt is a financing solution for companies (usually VC-backed) that lack the assets and cash flow to raise traditional senior debt financing. Facilities are provided by dedicated venture debt funds or specialist banks and are often raised immediately following an equity round, when marketing and diligence reports are readily available. The amount of venture debt raised in a single transaction is usually 25-45% of the most recent VC fund raise.

Venture debt proceeds can be used to finance early stage businesses that are proving their business model or later stage VC-backed businesses that are entering new markets and approaching positive free cash flow. Facilities can be structured as short term bridging facilities or longer term growth loans, depending on the company's strategic objectives. Venture debt providers can also offer lines of credit to fund working capital, which can be tied to a company's monthly recurring revenue, receivables or inventory.

Venture debt providers look for the following characteristics when assessing the credit worthiness of a venture debt candidate:

- Recurring or subscription-based revenue models, with good visibility of cash flows. To assess a company's revenue profile, lenders will analyse its contracted monthly recurring revenue, average revenue per customer, revenue churn and the run-off profile of customer cohorts.
- Diverse customer base with low levels of churn. Lenders will focus on customer churn, retention and renewal rates.
- Availability of collateral, including intellectual property.
- The company is approaching or has recently achieved profitability or positive cash flow generation. Lenders will focus on a company's customer lifetime value, total contract value, burn rates, customer acquisition costs, customer retention costs and cash runway.
- The company benefits from the backing of a reputable VC or private equity fund.
- Lenders may look for warrants from borrowers to provide some protection in the event of a default.

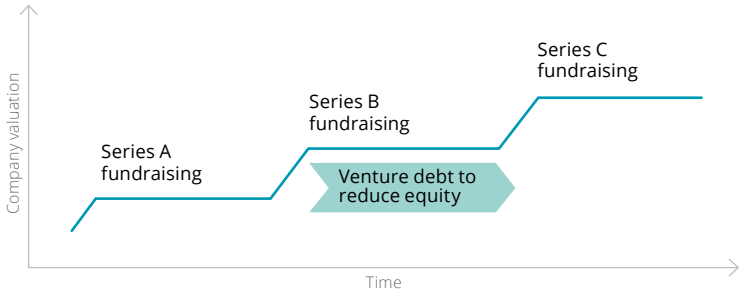
Venture debt lenders can also provide revenue-based growth loans to businesses with established levels of recurring sales. Such lenders are able to provide businesses with facilities of up to 2.0x annualised run-rate recurring revenue. Borrowers of recurring revenue facilities typically have an established track record and operate subscription-based business models (eg SaaS) with low customer churn and an ability to upsell services to existing customers. Recurring revenue facilities can provide borrowers with additional flexibility and are highly supportive of growing businesses with a stable and predictable revenue base.

When to use venture debt?

Venture debt facilities are usually, though not exclusively, raised alongside or shortly after an equity raise in order to extend a company's cash runway with a view to minimising dilution and maximising shareholder value. The following scenarios are common use cases of venture debt:

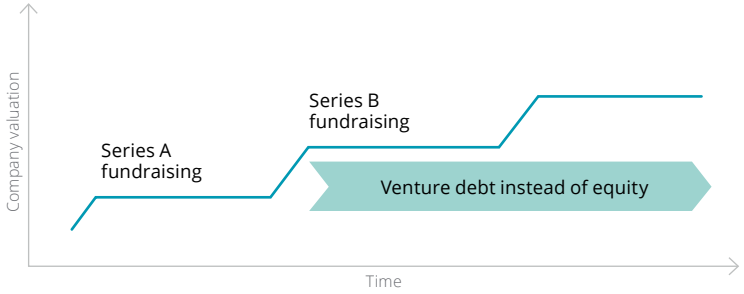
Increase cash runway to next valuation milestone

Raising venture debt can extend a company's cash runway to its next valuation driver, which is typically achieved by reaching a predetermined milestone (eg product launch). Once this milestone is reached, a company will be able to raise funds at a higher valuation at the next equity round, thereby substantially reducing dilution.



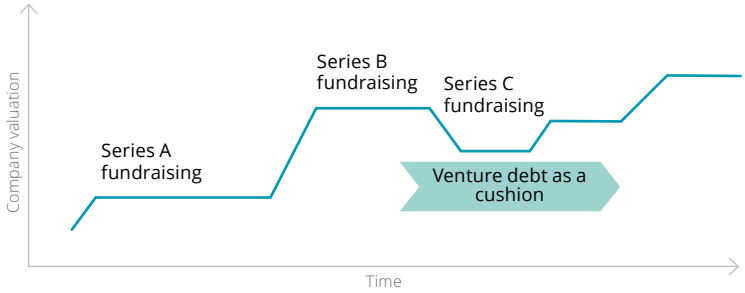
Extend runway to cash flow positive

Venture debt proceeds can be used to extend the cash runway of a company to becoming cash flow positive, which may reduce or eliminate the need to raise additional equity financing. In such a scenario a company could raise a small amount of equity and leverage venture debt to fund the company until it generates revenues from its first customers. In this scenario venture debt would substantially reduce shareholder dilution by enabling the company to fundraise at a significantly higher valuation or by eliminating the need to raise such funds.

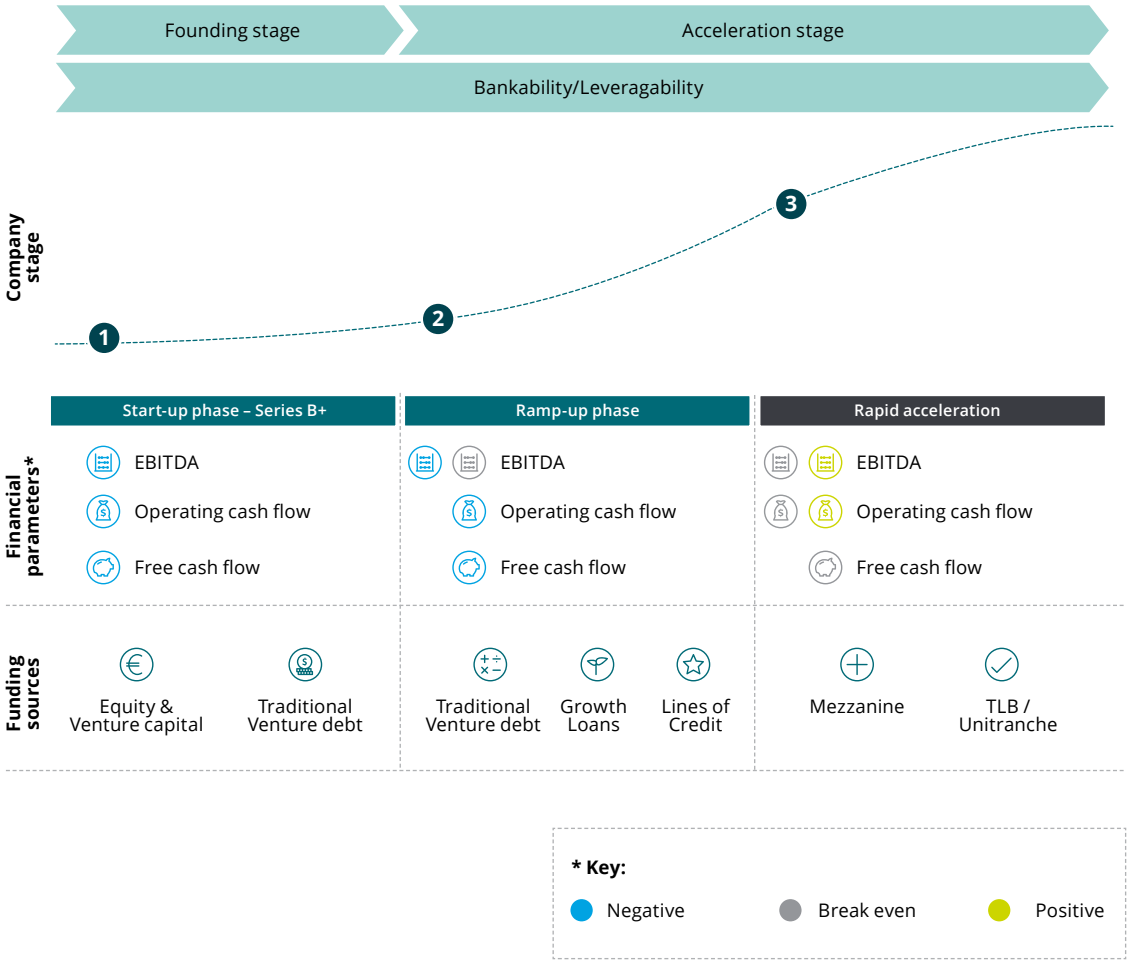


Provide Insurance for delays

It is not uncommon for companies to experience delays to achieving particular milestones, which can result in cash shortages. In such scenarios, venture debt can be considered to help bridge the funding gap until the company is back on track to achieving the valuation milestone in question. As such, venture debt can serve as a cash buffer in the event of such milestone delays, which may result in more favourable valuations and lower levels of dilution.



Venture debt for each stage of growth



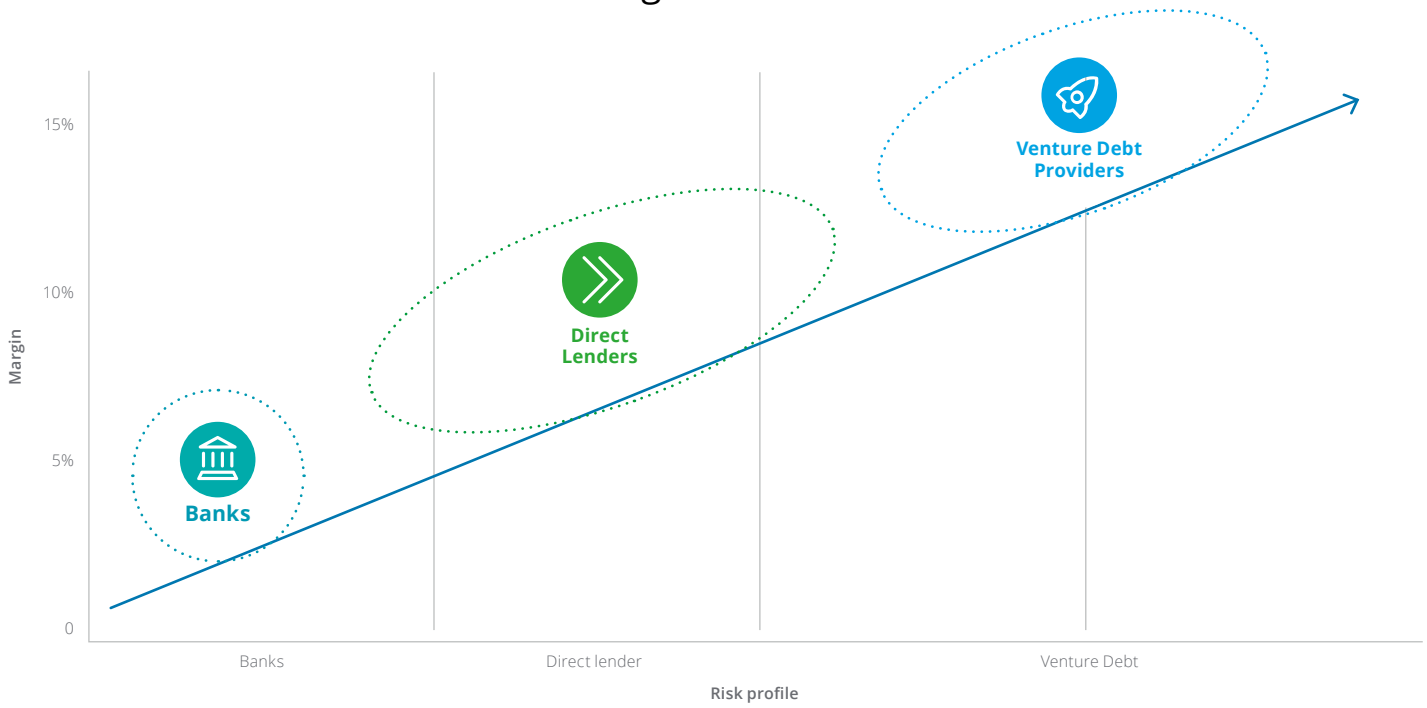
Advantages of venture debt

- Provides additional capital between VC rounds, which can be used to fund growth or working capital requirements.
- Facilities can be structured depending on a company's needs.
- Generally no covenants and the availability of interest only periods.
- Cheaper source of capital than equity, with minimal dilution.
- Adding leverage through venture debt will increase returns to equity investors.
- Interest on venture debt is tax deductible.
- Unfavourable valuations can be avoided by extending the cash runway to the next valuation milestone.
- Liquidity shortfalls arising from delays to the business plan can be mitigated.

Other considerations for venture debt

- Venture debt is priced higher than traditional sources of senior debt, reflecting the early-stage maturity profile of borrowers.
- Repayments during the early stages of a company's life cycle could be financially burdensome for the company.
- Potential dilution in the event of a default, if lenders exercise their warrants.
- Inability to repay principal and interest can lead to default.
- Security is taken by a venture debt provider on a company's intellectual property.

Indicative overview of lender financing costs



Conclusion

There is strong appetite amongst funds and specialist banks operating in Ireland and internationally to provide venture debt facilities to early stage businesses that are looking to scale and grow. This provides borrowers with significant choice and flexibility when it comes to determining the optimum capital structure that best fits the strategic objectives of management teams and shareholders. As the leading debt advisory team in Ireland, Deloitte Debt & Capital Advisory is well placed to provide unique insight and guidance in structuring and raising venture debt facilities to ensure maximum flexibility, whilst minimising default risk and enhancing shareholder value.

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175 MAKING AN IMPACT THAT MATTERS since 1845