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## ■ **Venture debt, a value-creation tool for today's fast-evolving private equity market**

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The global credit crisis and resulting recession across many major economies will have long-term consequences for the private equity industry and the companies into which it invests. A premium will be attached to private equity firms that can add real value to companies, whether at an early stage in their development or at a time when businesses mature and internationalise their activities. Private equity firms will need to rethink their strategies and provide solutions that combine innovative financing products with operating skills relevant to the businesses into which they want to invest. As a result, we will see a renewed focus on forms of private equity investing that offer attractive long-term returns to investors, but with lower and better managed risk.

One such private equity strategy can be found in venture debt investing. For many of us, at first sight, the idea of lending money into the high risk, uncertain world of venture capital may sound quite risky. However, upon closer inspection, it becomes apparent that venture debt investing combines many of the skills and attributes of venture equity investing and mezzanine financing, resulting in a lower risk investment opportunity. However, unlike traditional asset-based lending practiced by banks and other mainstream financial institutions, venture lending requires the highly developed skills of a venture capitalist to understand and manage the risks associated with start-up companies and their new technologies. Venture debt, if employed in the proper amounts and at the appropriate times, creates significant value for all constituents – the portfolio companies, venture equity investors and venture debt providers alike.

### **Example of the value provided by venture debt**

Imagine that you are the CEO of a start-up technology company. Your company has been fundraising for the past two quarters and is about to close on its Series A venture equity round. The equity being raised is expected to enable you to finish developing your product and achieve early traction with customers prior to having to raise your next round of equity capital. You believe that you can achieve the milestones determined by you and the investors with this capital, but you know it will be tight and that extra cushion would be beneficial. Specifically, you think the potential for slippage in your development timeline and the unpredictable nature of the current economic environment and its potential impact on customers could put your company in a situation where you would have to raise money before achieving your Series A milestones. This would put the company at risk of not raising its next round or at least put it in a position to garner a low and heavily dilutive valuation.

After a discussion at your first board meeting, your board suggests that getting a growth capital loan from a venture debt provider as an 'insurance policy' is the most prudent option. You ask why not just apply for a loan from a bank, wondering about the trade-offs in terms of pricing and capital restrictions. They explain that unlike traditional banks, venture debt funds are not constrained by regulatory policies and can therefore provide covenant-free loans with more flexibility and better access to larger amounts of capital. You contact a handful of venture debt providers and set up meetings to walk through your business and its value proposition. Venture

debt funds conduct similar due diligence as an equity investor would, albeit in a more expeditious fashion. They evaluate deals based on the market opportunity, technology, team, competitive landscape, stage, financial metrics and many other attributes. You are fortunate to receive three growth capital term sheet proposals from venture debt funds. The pricing of the proposals varies with respect to the key terms: (i) yield to maturity; (ii) warrant coverage; (iii) right to invest in the next equity round; (iv) loan term; and (v) draw period. While the pricing is probably the most critical piece of your decision making process, your board makes certain that you also focus on the firm you choose. They note that a team that acts and operates like a true partner and a fund with real access to capital that can continue to provide additional capital over the long term are also very important attributes to consider. You ultimately choose the most attractive pricing-plus-firm package.

Unfortunately, your development timeline does slip and the economy enters a modest recessionary state. However, instead of raising your Series B equity round at the worst possible time, you are able to draw down on the growth capital facility, which provides you with about nine months of additional runway at your current monthly cash burn. During the following six months, your company is able to get through its initial development activities and begin quality discussions with potential customers. As well, the economy begins to recover. You are now in a position to spend the remaining three months prior to cash fume raising your Series B. Ultimately you raise a successful Series B at a 50 percent step-up in valuation.

### Structure of venture debt

This example depicts one of the many scenarios in which venture debt can provide the entrepreneurs and equity investors with tremendous value. As for the venture debt fund, it benefits in this example clearly from the yield it charges on the loan, but also from its ability to share in the company's upside potential through its ownership in the company from the warrants and the direct equity investment option.

Venture debt is available to start-ups to help fund their development and growth beginning in the early stages of their lifecycle and extending through to their later stages of development. The ultimate goal for a company with venture debt is to receive cash runway extension, generally six to nine months, in exchange for meaningfully less dilution than would be the case if a company raised additional equity. Importantly, venture debt is virtually always invested in conjunction with venture equity. Venture debt comes in a variety of forms, including but not limited to growth capital, equipment loans, subordinated debt and convertible loans. Growth capital and equipment loans are the most common forms of venture debt. Growth capital loans are typically used to fund general corporate and operational needs and can be employed by start-ups at virtually any stage of development. These loans are covenant-free, non-restrictive loans that provide true runway and maximum flexibility. They are generally secured by all of the assets of a company. Equipment loans enable a company to finance specific assets in a cost effective manner without using valuable and expensive equity dollars. These loans are secured by the equipment itself and have no covenants. Equipment loans are also appropriate for companies at any stage of development.

When deployed properly, venture debt is an efficient source of capital that can enable a company to extend its cash runway and achieve important milestones, which ultimately enhances the company's valuation while minimising the investors' and team's dilution. In exchange for the meaningful value created for the team and equity investors, the venture debt firm is rewarded with a fixed yield on its loan and ownership in the company and thereby the opportunity to share in its upside potential. Venture debt is a form of private equity investing which meets the challenges of today's fast-evolving market, offering attractive long-term returns to investors but with lower and better managed risk.

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David Chamberlain has over 25 years of experience in private equity and financial management. David spent 16 years with Unigestion, a leading European alternative asset management firm. As Managing Director, he built one of Europe's foremost private equity fund management businesses, exploiting all facets of the primary and secondary markets. He also served as Finance Director of Unigestion and previously worked in investment and financial management with the Continental Grain Group and Deloitte Haskins & Sells in London and Paris.

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