
Ten Questions Every Founder Should Ask before Raising Venture Debt

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There's an adage that says your first job as a startup CEO is to make sure your company never runs out of cash. But when financing a growing company, venture debt can be a great supplement to venture capital and in some cases may be a necessity. Much has been written to help founders think through venture capital, but venture debt remains a bit of a black box. That's why we partnered with our friends at [Columbia Lake Partners](#), a leading European venture debt fund, to put together a white paper that helps startups approach venture debt in a thoughtful way.

For those of you short on time, below is a summary. And for the finance geeks among you, we've put together a [Venture Debt Model](#) for you to assess the true cost of venture debt.

SUMMARY

Why venture debt?

Venture debt refers to a variety of debt financing products for venture-backed companies. Typically, venture debt is provided by banks or dedicated venture debt funds as a complement to equity financing. It can act as an attractive way to finance a business with less dilution than equity and does not require a valuation to be set for the business. Additionally, venture lenders don't take board seats and have few governance requirements. But like any loan, venture debt needs to be repaid with interest over time.

When should I raise venture debt?

There is no "one size fits all" approach to venture debt, but there are five common use cases:

a) Extending the cash runway of a business to hit the company's next milestone (e.g. you've

raised \$10 million of equity but think you may need \$15 million to get to the next major milestone)

b) Preventing the need for a bridge round or a down round to get through a tough period without creating a negative signal

c) Funding large capital expenses, acquisitions, or acting as a bridge to profitability

d) Acting as insurance in case it takes longer than expected to hit the next milestone

Most companies raise venture debt immediately following an equity financing, when it is often easily accessible, your investors are optimistic, all of your diligence materials are fresh and readily available, and you have momentum.

When should I avoid venture debt?

It's a bad idea to use venture debt if any of the following apply:

- a) You don't think you can repay the debt
- b) The terms or covenants are too onerous
- c) Your venture investors are not supportive

To make the venture loan more economically sound, we recommend delaying the time when you draw down the loan. This will in turn delay the time when you have to start repaying the loan, which extends your runway and reduces the actual cost of the debt. We've created a handy [Venture Debt Model](#) to help you assess the effective cost of venture debt.

What terms should I be thinking about when raising venture debt?

Here are the key things to consider:

- a) The size of the loan
- b) The duration of the loan
(when does it need to be repaid?)
- c) The price of the loan
(what are the fees and interest rate?)
- d) The covenants
(what are the financial and non-financial covenants?)
- e) Timing of the amortization
(when do we start repaying the loan?)

Banks will have the lowest rates, so first talk to banks and then approach venture debt funds if you want additional capital.

What is considered "market" for these terms?

Term	Market Rate
Interest Rate	Banks: prime + 0-4%. Funds: prime + 5-9%
Duration	3-4 years
Amortization	Within 12 months of when a loan is drawn down
Closing Fees	0%-1%
Warrants	Banks: <1% dilution. Funds: ~1% dilution.

How should I react to covenants?

Non-financial covenants are common. Be cautious around financial covenants, which act as financial tests that must be met or else your company may be in default.

What happens if I can't repay the loan?

When the time comes to repay the venture loan, you have three options:

- a) Repaying:
You use cash on your balance sheet or equity from investors to pay it back.
- b) Refinancing:
You find another lender who will refinance the loan.
- c) Restructuring:
You try to negotiate a more favorable repayment plan with the lender.

If things are going well, repayment or refinancing is easy. But if your company is in trouble, you will need to work with your lender to restructure the debt and avoid foreclosure.

How do I decide which venture lenders to work with?

The most important thing to research when choosing a lender is how they've behaved in the past. In the event that things go south, you want a lender who will work with you to restructure the loan. You should conduct reference calls on the lender to see how they've behaved in tough times.

What is the venture lender's typical diligence process?

Venture loan diligence resembles the venture capital diligence process, although less intense. Be prepared to provide much of the same information you provided in your venture capital raise.

What's the best way to run a venture debt fundraising process?

Much like the venture capital world, you need to talk to a number of different banks and venture debt funds to get a better feel for how much capital is available. We strongly recommend engaging a venture lawyer who has worked on a large number of recent venture debt deals who will be able to advise you on getting the best possible terms. And just as you would with an equity round, make sure you have a few horses in the race so you can negotiate the best terms.

Venture debt won't be the right fit for all companies, but if structured properly, it can be a less dilutive way for you to finance your journey to the next milestone.

THE FULL PICTURE

Why venture debt?

Venture debt refers to a variety of debt financing products for venture-backed companies. Typically, venture debt is provided by banks or dedicated venture debt funds as a complement to equity financing. It can be a useful supplement to equity by allowing companies to extend their cash runway and get to their next milestone. Venture debt can result in less dilution for existing shareholders and does not require a valuation to be set for the business. Additionally, venture lenders don't take board seats and have few governance requirements.

There are also some downsides to venture debt (when compared to equity). A venture loan creates a cash expense for the company every quarter. Unlike equity, it needs to be repaid or refinanced at some point in the future. If the loan is not repaid, the venture lender can take over the company's assets. Furthermore, if venture debt is not negotiated properly, it can be very expensive or restrictive to a founder's ability to make decisions. That being said, if used correctly, venture debt can be a helpful financing tool to companies at any stage.

The main types of venture debt products are term loans, provided by both banks and funds, and revolving lines of credit, provided by banks. Venture term loans are most commonly

structured as three year loans, which amortize (get repaid) over time. The lender typically gets quarterly cash interest payments, some cash fees upfront, and warrants for company stock (options to buy stock in the future at the current price). Term loans are usually senior debt, meaning that they are repaid first in an exit or bankruptcy and are collateralized by a company's assets. Both banks and venture debt funds issue term loans.

Venture debt can also refer to another category of debt products called revolving lines of credit (or revolvers). Unlike a term loan, which is a lump sum of cash, the revolver functions like a credit card through which you can borrow ("draw down") up to a certain limit. For example, the most common type of a revolver is an accounts receivable revolver which allows you to borrow money based on the amount of account receivables on your balance sheet. In addition to accounts receivables-based revolvers, recurring revenue software businesses can take advantage of a new type of revolver that is tied to a company's recurring revenue ([more info here](#)). Revolvers are typically provided by banks, whereas venture debt funds tend to focus on term loans.

When should I raise venture debt?

Like in venture capital, there is no “one size fits all” in venture debt. Here are some situations when it may make sense to finance your company using venture debt:

- **To extend the cash runway of a business.**

If you have raised a \$10M equity round but believe you need \$15M to get to the next milestone in your business, venture debt can provide the remaining capital without increasing dilution.

- **As an insurance policy.**

You may want some extra cash as a cushion in the event that your company needs more time to get to its next milestone. For SaaS businesses, an MRR revolver can be a particularly cheap form of insurance.

- **To prevent the need for a bridge round.**

Raising a bridge round from your existing investors can be expensive and send a bad signal to prospective investors. Venture debt can act as a bridge to where you need to go without the pain of a VC-led bridge round.

- **To fund large capital expenses, an acquisition, or interim cash needs.**

Venture debt can be used as a cheaper alternative to equity to fund acquisitions or purchases of equipment. It can also fund new growth initiatives that require an amount of capital too small for an equity round.

- **To avoid setting a valuation (in the event of a down round).**

If your business has been underperforming or market conditions have changed and you are concerned that your next round of capital would result in a disruptive down round, venture debt can be a way to finance your business without having to set a valuation.

- **Funding to profitability.**

If your company is approaching profitability, venture debt can be a way of reaching the promised land without incurring additional dilution from equity.

Most companies raise venture debt immediately following an equity financing. You’ve got momentum, your investors are optimistic, and all of your diligence materials are fresh and readily available. This tends to be a time when venture debt is easily accessible.

However, the main downside to drawing debt immediately is that you will be paying down the debt for a long period before you can actually use the cash. This means that by the time you touch the cash from the venture debt, you’ve already repaid much of it. Instead of getting \$5M of extra cash runway, you’re actually getting \$4M of additional cash runway if you’ve already repaid 20% by the time you start using the venture debt. This means that the actual cost of the loan is higher than the headline interest rate since you’re paying interest that is calculated off

a \$5M loan on what is effectively only \$4M of extra cash. (For a detailed breakdown, see Sarah Tavel's posts on the topic [here](#) and [here](#).)

To make the venture loan economically sound, we recommend delaying the draw down period (the time when you actually get the funds) as much as possible. This means that you will delay the time when you begin paying interest and principal, which extends your runway and reduces the actual cost of the debt. Your ability to delay the draw will depend on the strength of your company and the competitiveness of the venture debt process. If you've got a good business with strong VCs, you can typically get 6-12 months. If you are unable to delay the draw down period, consider pushing for a 6-12 month interest-only period during which time you don't have to repay the loan. To put some rigor behind this analysis, we've assembled a [Venture Debt Model](#) for you to assess the true cost of venture debt (and compare against your equity options).

When deciding between debt products, our recommendation is that you start with the cheapest form of venture debt and then work your way over to more expensive forms. Banks have a lower cost of capital than venture debt funds but are typically constrained by the amount that they can lend. So you should start by talking to banks about their revolving line of credit and term loan options, and then approaching venture

debt funds for additional capital.

Much like the venture capital world, you need to talk to a number of different banks and venture debt funds to get a better feel for how much capital is available. We also strongly recommend engaging a venture lawyer who has worked on a large number of recent venture debt deals and will be able to advise you on getting the best possible terms.

When should I avoid venture debt?

Generally speaking, there are a few situations when it is a bad idea to use venture debt:

1. If you don't think you can repay it.

If your company is performing poorly and you don't think you'll be able to raise more equity in the future, you should avoid venture debt. Venture lenders have a right to take over your business if they are not repaid. You should only raise venture debt if you believe your existing investors or an outside investor will invest more equity in the future to repay the loan.

2. When the loan amortizes immediately.

As discussed, if you've raised lots of cash from equity, you want to delay when you draw down the debt because otherwise you'll end up repaying a significant portion of the loan before you can even use the money. This makes the effective cost of debt is much higher than meets the eye.

3. When the terms or covenants are too onerous.

It's critical that you have someone on your team who can model the cost of the debt and understand the impact of any covenants on your business to make sure you aren't signing up for anything you can't handle.

4. When your investors are not supportive.

Generally speaking, your VCs should be fine with venture debt if you make a compelling case for how the additional runway will benefit the business. But if you have investors who are allergic to venture debt, you should avoid it because it will be tough to attract venture lenders if they think your investors will be tough to work with.

Some of our founders have asked us if venture debt has any negative impact on future fundraising. Any VC who wants to invest in your company will do so, regardless of whether or not you have venture debt on your balance sheet. They may be slightly annoyed about the fact that part of their investment will go toward repaying debt, but we haven't encountered any situations where a VC has declined to invest because of venture debt.

What terms should I be thinking about when raising venture debt?

Venture debt speaks a different language than venture capital. Our most important recommendation is that you hire a lawyer who has experience negotiating venture debt deals. They can give you valuable context on what is "market" and help you zero in on the important terms.

Generally speaking, the five most important areas to consider include:

- **Size of the loan** (the actual dollar amount you will receive)
- **Duration of the loan** (how long until the loan must be paid back)
- **Price of the loan** (the fees and interest you must pay the lender)
- **Timing of amortization** (when do you have to start paying back the loan?)
- **Covenants** (what behavior could trigger a loan default?)

It's important to point out that the price of the loan is not just the interest payment. Lenders will use fees to increase the cost of the loan. To approximate the price of the loan, take the fees, divide them by the duration of the loan, and add it to the interest rate. So if you have a three year term loan with a 1.5% origination fee and 11% interest, the actual price of the loan is about 11.5%.

The table below outlines the typical fees you may see:

Fee Type	Explanation
Origination	Generally 1-2% of the full loan amount at origination.
Prepayment	Fee for paying a loan back early.
Waiver / Default	A penalty if a company underperforms or breaches a covenant and is in default.

Venture lenders make their near-term returns through fees and interest payments but their long-term upside from warrants. Warrants are the same as options. They provide the lender with a contractual right to buy stock in your company at a future point in time. Lenders typically describe warrants in terms of warrant coverage. If a \$1M venture loan comes with 10% warrant coverage, this means that the lender has the option to buy \$100K in equity at some point down the line, usually within the next 7-10 years, at an agreed upon exercise price (also known as a “strike price”.) This exercise price is usually set at the price per share of the most recent equity financing. Warrants are typically exercised at exit. If your company has a value at exit that is greater than the value of the exercise price, the lender will exercise the warrants at and capitalize on the difference between the exercise price and the price at exit.

What is considered “market” for these terms?

The table below provides a rough range for what we’ve seen in the market for these types of deals. Where you fall within these ranges will depend to a large extent on market conditions and the specifics of your business.

Term	Market Rate
Interest Rate	Banks: prime ¹ + 0-4%. Funds: prime + 5-9%
Duration	3-4 years
Amortization	Usually begins 0-12 months after the loan is drawn down (funds are received)
Closing Fees	0%-1%
Warrants	Banks: <1% dilution. Funds: ~1% dilution.

¹ The interest rate that commercial banks charge their most credit-worthy customers. The prime interest rate is largely determined by the federal funds rate, which is the overnight rate which banks lend to one another.

How should I react to covenants?

Most venture debt deals include a variety of covenants. Non-financial covenants describe situations where the lender needs to provide approval. This typically includes things like issuing dividends, selling the company, licensing IP, making acquisitions, etc. If you make one of these decisions without the lender's approval, this is called breaching a covenant. If you breach a covenant, you are in default. Sometimes you may encounter financial covenants. These are financial tests that must be met. For example, the lender may require that you hit a certain revenue target or maintain a certain cash balance. If you breach these financial covenants, then your company is in default.

Typically, venture debt deals do not have financial covenants because startups are unpredictable and need to be able to operate flexibly. Financial covenants are more common in later stage companies where there is more financial stability and predictability.

Default results in additional fees and penalties. It also means that the lender has the right to foreclose or take possession of your company and sell off its assets. In practice, lenders view foreclosure as a last resort. But the additional fees and threat of foreclosure prevent borrowers from willfully breaching covenants.

What happens if I can't repay the loan?

When it is time to repay the venture loan, you have a few options:

- **Repayment:**

You can use cash on your balance sheet or equity from investors to pay it back.

- **Refinancing:**

You can find another lender who will refinance the loan—essentially giving you a new loan to repay the existing loan.

- **Restructuring:**

You can try to negotiate a more favorable repayment plan with the lender.

When things are going well, you should not have any problems repaying a venture loan. You can either raise more equity to continue paying down the loan or you can refinance with a new lender.

But if you're unable to raise equity or refinance, you are at risk of default. While the lender has the right to foreclose and sell off your company's assets, venture lenders typically like to avoid this. They can usually do a better job recovering their loan if the company continues to operate. Instead, they will try to work with you and your investors to change the terms of the loan to provide some relief to the company—also known as a restructuring.

There are many different ways that restructurings play out. For example, the lender may ease up on amortization so you have more cash runway to develop the business. But they may charge additional fees and require that your investors invest more money into the company.

Usually restructuring becomes a three-way conversation between the VCs, lender and entrepreneur. It's during these times when having the right lender is critical. You want to choose a lender that has reputation for working with founders in a constructive way during tough times.

How do I decide which venture lenders to work with?

As discussed, venture lenders can behave very differently when things start going sideways and you need to restructure your loan. When choosing a lender, you need to research how they've behaved in the past in difficult situations. You should conduct reference calls on the lender with VCs and companies they've worked with—especially the ones that have gone through restructurings.

Generally speaking, you should start with the banks because they are cheaper. However, banks are typically limited in the loan size. In some cases, it may make sense to raise the debt from both a bank and a fund. This allows you to achieve a lower blended cost of

capital since part of the loan amount is funded using low-cost bank debt.

What is the venture lender's typical diligence process?

For venture lenders the most important question is—"will your company continue to be able to raise more venture capital?" This means that their loan will be repaid in the future. As a result, the venture lender diligence process resembles the venture capital diligence process as the lenders try to look at the business through a VC's eyes.

The specific pricing and terms of the loan will depend on both external and internal factors. Macroeconomic conditions at the time you raise the debt are critical. All things being equal, a faster growing company will get better terms. A company with better-known VCs will get better terms. A company that has more predictable revenue will get more favorable terms. But as in a venture capital financing, it all comes down to getting the lenders to believe in you and your business.

What's the best way to run a venture debt fundraising process?

- Ask your investors to provide you with introductions to lenders. Start with banks then move on to venture debt funds for more capital.
- During the initial calls, provide lenders with an overview of your business and a demo of your product.
- Provide interested lenders with diligence materials. Encourage these lenders to talk to your investors to get more conviction that you will be able to raise more venture capital in the future.
- Wait for the term sheets to come in—with any luck, you'll have a few options to look at.
- Weigh the pros and cons of each term sheet with your investors, provide counter proposals and enter in the process of negotiating on key terms. Be transparent with each lender about what it will take to win your business—they won't be offended.
- As you narrow the pool of options, conduct further diligence on the lenders. Ask the lender to connect you with companies where they had a default or restructuring to understand how they behave when times are tough.
- Make a final decision. Once a term sheet is signed, the venture lender will send over full loan documents. It is recommended that you work with a lawyer that has venture debt experience to review the documents.

We've covered the basics in this white paper. If you have any thoughts or questions, email the authors at brian@bvp.com and craig@clpgrowth.com.

And check out the [Columbia Lake Partners' blog](#) for a more detailed series of posts on all things venture debt.

APPENDIX A:

Active Venture Lenders in the US and Europe

Lender	Geographic Focus	Institution Type	Link
Silicon Valley Bank	United States	Bank	http://www.svb.com/
Comerica	United States	Bank	https://www.comerica.com/
City National Bank	United States	Bank	https://www.cnb.com/
Square One Bank	United States	Bank	https://www.square1financial.com/
Eastward	United States	Fund	http://www.eastwardcp.com/
Escalate	United States	Fund	http://www.escalatecapital.com/
Gold Hill	United States	Fund	http://www.goldhillcapital.com/
Hercules	United States	Fund	http://www.htgc.com/
Horizon	United States	Fund	http://www.horizontechfinance.com/
Lighthouse	United States	Fund	http://www.lcpartners.com/
MMVF	United States	Fund	http://mmvf.com/
NXT	United States	Fund	http://www.nxtcapital.com/
ORIX	United States	Fund	http://www.orix.com/
TriplePoint	United States	Fund	http://www.tpt.com/
Wellington	United States	Fund	http://www.wellingtonfund.com
WTI	United States	Fund	http://www.westerntech.com/
Silicon Valley Bank	Europe	Bank	http://www.svb.com/
Barclays Bank	Europe	Bank	http://www.barclays.com/
Columbia Lake Partners	Europe	Fund	http://www.clpgrowth.com/
Kreos	Europe	Fund	http://www.kreoscapital.com/
Harbert	Europe	Fund	http://www.harbert.net/

APPENDIX B:

Other Helpful Resources

Bessemer Venture Partners' venture debt model:

<https://bvp.box.com/BVPVentureDebtModel>

Columbia Lake Partners' venture debt blog:

<http://www.clpgrowth.com/our-blog/>

Sarah Tavel's two part series on venture debt:

<http://www.adventurista.com/2009/01/true-cost-of-venture-debt.html>

<http://www.adventurista.com/2009/01/true-cost-of-venture-debt-part-ii.html>

Leader Ventures' overview of venture debt:

<http://leaderventures.com/overview.pdf>

Latham & Watkins on venture debt:

www.lw.com/thoughtLeadership/key-terms-to-address-at-term-sheet-stage-in-venture-funding

Kauffman Fellows piece on venture debt:

http://www.kauffmanfellows.org/journal_posts/venture-debt-a-capital-idea-for-startups/

Fred Wilson's thoughts on venture debt:

<http://avc.com/2011/07/financings-options-venture-debt/>