Guidelines

VENTURE DEBT AS A FINANCING INSTRUMENT FOR START-UPS

What Founders Need to Know in a Nutshell

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Venture debt is becoming an increasingly popular financing instrument for Swiss start-ups. Understanding how venture debt works, what it entails, and what is the right time to raise venture debt are important considerations. This GUIDELINE provides an overview in a nutshell of what founders need to know about venture debt.

1. What is Venture Debt?

In essence, venture debt is a catch-all term referring to loans that are tailored to the needs and the risks associated with start-ups. Venture debt is not only different from equity or mezzanine financing but also from other forms of credit. While the availability of "regular" loans depends mainly on the historical cash flow or the working capital assets of a borrower, venture debt providers focus on the start-up's ability to raise new equity capital to fund growth and repay debt. In most cases, start-ups do not yet generate sufficient revenue and therefore do not qualify for a "regular" loan. Taking out a "regular" loan would of course be more beneficial for the start-up, as the interest rates are lower and less collateral is required.

Venture debt transactions are typically structured as follows: A start-up company raises money from a private equity investor (venture capitalist, "VC") in an equity financing round and, either in parallel with, or shortly after the equity financing round, takes out a loan that is repaid over a certain time period (often between 24 and 36 months). The lender often gets a small "equity kicker" in form of a subscription right to participate in the equity financing round and/or a subsequent warrant coverage to subscribe for equity at the same terms as investors in the last financing round.

2. When Does Venture Debt Make Sense?

By taking on venture debt, a start-up can push back a new equity financing round to achieve a higher valuation, increase profitability and fuel growth, while at the same time minimizing dilution of existing shareholders' capital. Furthermore, venture debt allows a start-up to opt for the best equity/debt structure. Since debt is typically cheaper than equity, start-ups can leverage their equity raised by reducing the average cost of capital required to fund operations. From a strategic point of view, start-ups should consider raising venture debt when working on their equity or convertible loan term sheet. As mentioned above, often the taking out of a venture loan is synced with the closing of an equity financing round. But why does it make sense to take out a loan when the company is receiving cash from an equity round anyway? The answer is: A start-up's bargaining power is considerably higher when it has just received new equity. Bargaining power is key for start-ups to negotiate the terms of a venture debt loan.

Despite the benefits of venture debt, it might not be available or the right fit for every start-up. Since venture debt providers usually rely on a company's ability to find additional equity to fund its growth and repay the venture debt, venture loans are typically granted to start-ups which have previously raised money from professional VCs and demonstrated a clear fundraising strategy. Due to their investor base, this is usually not the case with seed-stage or pre-revenue start-ups (consisting largely of FF&F or business angels).

The ability to repay venture debt is crucial to a start-up given the adverse effects a default would have on its assets and future prospects (more on that below). This is when the importance of a sound and carefully negotiated venture debt agreement comes into play.

3. Legal Aspects of Venture Debt

The comprehensiveness and complexity of venture debt agreements are comparable to those of syndicated loan agreements by banks. When analysing and negotiating a venture debt agreement, two aspects are key: The start-up must ensure that the agreement does not impose excessive obligations/undertakings on it and that the events of default in the loan agreement – which in effect grant the lender grounds for extraordinary termination of the agreement – are limited and reasonable. To avoid pitfalls in venture debt agreements, start-ups (as borrowers) should pay special attention to the following key issues:

- **Conditions Precedent:** Venture debt agreements typically contain a list of conditions that must be fulfilled and/or documents that must be provided to the lender before the loan is paid out. Start-ups should ensure that the list of conditions precedent is not unnecessarily burdensome and does not unnecessarily delay the disbursement of the loan. The conditions should be specific and not subject to interpretation so that the start-up as borrower has a clear understanding as to what documents have to be delivered and in which form (e.g. articles of association, annual accounts, business plan, etc.).

- **Covenants:** For as long as the venture loan is outstanding, borrowers must adhere to certain covenants. Covenants are mainly divided into positive covenants, negative covenants, financial covenants and information covenants. While a positive covenant obliges the borrower to display a certain behaviour, a negative covenant obliges the borrower to refrain from a certain behaviour. Standard examples of negative covenants are negative pledge undertakings or covenants regarding indebtedness. In case of the former, the borrower undertakes not to create any securities for the benefit of third parties. In case of the latter, the borrower undertakes not to incur any additional indebtedness. A start-up needs to make sure that any securities and/or indebtedness necessary for the ordinary course of business (e.g. rental guarantees, trade credit) are carved-out. Unlike an equity investor, a lender has no statutory information rights towards the borrower. To assess the creditworthiness of the borrower and its ability to repay the loan, as well as to monitor covenants, the lender includes in the venture debt agreement undertakings by the borrower to provide specific information.

- **Representations and Warranties:** It is customary in venture debt agreements that the borrower makes certain factual statements to the lender. Representations and warranties in loan agreements focus on whether a borrower is legally capable of entering into the loan agreement and the nature of the borrower's business (including litigation, accounts, etc.). From the start-up's view, these factual statements should be limited to reduce the risk of misrepresentation. Misrepresentation constitutes an event of default. If a factual statement is not true or is likely to be untrue in the future, then the statement must be deleted or amended accordingly. Often, the lender insists that the borrower also provides factual statements regarding its group companies.

- **Events of Default:** In case of an event of default, the lender has the right to terminate the venture debt agreement early and request immediate repayment of the venture loan. The list of events of default in venture debt agreements is extensive and typically include a breach of representations and warranties, a breach of covenants, or other objective (e.g. default on amortisation payments or default under financial liabilities to third parties) or subjective (deterioration of the borrower's creditworthiness and/or collateral at the lender's discretion) events. For a start-up, it is key to include appropriate cure periods so that is has the ability to cure a breach before an event of default is triggered (which could lead to liquidity problems and, as a consequence, the loss of pledged assets).

- **Interest Rates and Other Fees:** Apart from interest rates, borrowers must pay special attention to other fees in loan agreements. Often, venture loan agreements contain additional fees such as "commission fees", "handling fees" or the like, which, in fact, constitute a hidden interest. Start-ups should also carefully assess potential breakage costs in venture debt agreements. Breakage costs are due in case of early repayment of the loan and should be avoided or at least kept to a minimum.

4. Collateral for Venture Debt

Due to the high risk inherent in venture debt loans, venture debt providers insist that a security package is provided by the borrower to secure the repayment of the loan. Under Swiss law, we typically see the following types of securities in the context of venture debt financings: Guarantees, sureties, assignment of receivables and pledges (pledge of bank accounts, pledge of shares, pledge of IP-rights, pledge of real estate).

Securities can be granted by the borrower itself, a group company of the borrower or even a third party. If securities are provided by a group company of the borrower for the benefit of the lender, the parties to such security agreements must be aware that Swiss corporate law imposes certain restrictions if securities are granted up-stream or cross-stream. The security may constitute a distribution of profits which makes it necessary that certain requirements are met in order to mitigate risks resulting from a breach of capital protection laws. The providing of up-stream and cross-stream securities must therefore be carefully assessed.

Under Swiss law, secured assets must be sufficiently specified and a pledge is only valid if possession of the pledged asset is transferred from the borrower to the lender. Therefore, so-called "floating charges" are not valid under Swiss law. Floating charges is a security interest over a group of assets which may change over time.

When entering into a venture debt agreement (incl. security agreements), start-ups should be aware that if they cannot repay or refinance the loan, the lender may enforce the securities to settle the outstanding loan amount. Depending on the type of security granted, a default event and the respective enforcement of securities can have a major impact on the start-up and its existence. In most cases, the only substantial value of a start-up is its intellectual property, which at the same time is the core of its business. If a start-up pledges its intellectual property as security for a venture debt, it must be able to raise additional equity or take up new debt in the future (or, in case of an event of default, within a couple of days) to repay the venture loan. Otherwise, the start-up will lose the pledged assets and – often related thereto – its business base. This is why it is particularly important to negotiate cure periods in venture debt agreements.

5. Subscription Rights or Warrants as Incentives for Investors

As an additional incentive for lenders to provide venture debt to start-ups, borrowers often grant lenders additional subscription rights to participate in the equity round and/or warrants. Warrants are essentially options to buy shares of a company. A separate warrant agreement lays down the terms and conditions of the warrants. Key terms involve the subscription price of the warrants, the types of warrant shares granted and potential additional rights of the warrant holder.

As start-ups typically have a shareholders' agreement in place, the warrant agreement must include an obligation for the warrant holder to become a party to the shareholders' agreement if the warrants are exercised. From a Swiss legal perspective, warrants must be backed/secured by sufficient (conditional) share capital.

6. Key Takeaways

Venture debt can be an efficient source of capital for start-ups. If a start-up considers venture debt as a possible means of financing, it needs to focus on two areas:
1) suitability for venture debt given its development stage, and
2) the legal key considerations for venture debt agreements.

Generally, institutional venture backing is a prerequisite for venture debt as the confidence in the company's growth path is critical to venture debt providers. Usually, venture debt is right for companies looking to extend their cash runway by a couple of months following a significant equity financing round because then they are able to obtain favourable terms. Also, stable revenue streams are best, however not mandatory to get a good venture debt deal. Naturally, venture debt is less common or recommended for pre-seed/seed stage start-ups.

Given the high level of collateralisation of venture debt loans and the risk of enforcement of securities by the lender, venture debt agreements and the respective security agreements have to be carefully drafted. A start-up must be sure to avoid getting into an event of default situation giving the lender the right to request immediate repayment of the loan and to realise securities.

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