Choosing Debt Over Dilution

Promoters of VC-backed small startups who tap venture debt firms like **InnoVen** for more funds can have the capital and keep their equity too

BY DEEPTI CHAUDHARY

Bengaluru-based health care startup Practo has raised funding from investment firms like Sequoia Capital, Google Capital, Altimeter Capital and Matrix Partners. Similarly, home health care service provider Portea Medical has received funding from Accel Partners, International Finance Corporation (IFC), Qualcomm Ventures and Ventureast. Along the same lines, New Delhi-based eye care specialist Eye-Q has received funding from IFC, Helion Venture Partners and Nexus Venture Partners.

Apart from their general attractiveness to investors, the three health care startups also have this in common: A financial backer in InnoVen Capital India. The Mumbai-based firm has offered all of them venture debt, a relatively new fund raising option. Venture debts, or venture loans, are typically provided by specialised non-bank lenders to venture-capital backed companies to fund their working capital expenses. The difference is that unlike venture capital, venture debt rarely involves equity dilution by promoters.

Over the last 15 months, InnoVen Capital, which has offices in Mumbai and Singapore, has backed more than 30 firms, extending debt of over Rs 300 crore. Very few investors in the country can boast a portfolio like InnoVen's, which includes category leaders, including Snapdeal, Practo, yatra.com, Portea, Myntra, firstcry.com, ZoomCar, BlueStone, Eye-Q and Prizm Payments.

Started in India in 2008, the platform was rebranded InnoVen Capital India (from SVB India Finance) following a buyout of the business by Singapore's sovereign wealth fund Temasek Holdings and the UOB Group in 2015. InnoVen currently has investment commitments of $200 million (around Rs 1,382 crore). In India, InnoVen is the oldest and largest venture debt provider across various stages of growth and sectors. Since 2008, it has backed over 100 firms, extending venture debt of around $150 million.

Portea took venture loans of Rs 25 crore from InnoVen more than 18 months ago, while Practo availed a venture debt of Rs 18 crore in January last year. Eye-Q raised a venture debt of Rs 6 crore from the firm in 2014.

WHAT MAKES VENTURE DEBT ATTRACTIVE TO STARTUPS IS THAT IT GIVES ENTREPRENEURS MORE TIME AND LEEWAY TO GROW

What makes venture debt attractive is that it gives entrepreneurs more time and leeway to grow without diluting equity. "Promoters cannot keep on diluting equity as it can adversely impact them in the follow-on rounds [of funding]. Our capital increases a company's ability to achieve better outcomes and garner better return on investments. Venture debt extends runway and allows startups to do more in the same time," says Vinod Murali, managing director, InnoVen Capital India.

In the startup world, a majority of entrepreneurs end up giving away 20 to 35 percent of their equity at an early stage. In the subsequent rounds of funding, promoter holding is further diluted. The amount of equity that promoters give away in the early stages of a company's life cycle limits their dilution capability in later stages.

There are other factors too that make venture debt alluring. Unlike traditional bank loans, venture debt is available to startups that may not yet have positive cash flows and significant assets to pledge as collateral. Venture debt firms typically combine loans with warrants, or rights to purchase equity, to offset the risk of default.

Raising capital from later rounds of funding consumes time and energy

for young startups. Venture debt, on the other hand, is like a bank loan without collateral (though some venture lenders demand pledged assets like intellectual property or company laptops), wherein lenders expect the borrowing companies to pay an interest.

InnoVen Capital's interest rate is 15 percent for a loan duration of up to 36 months. The venture lender only backs startups that have raised funding from venture capitalists. It invests in companies along with the VC investor or after the initial funding round. "Discipline is stronger in VC-backed firms, there are no cash leakages," explains Murali.

Awareness about venture debt is low in the country and, typically, investors have to apprise their portfolio companies of its advantages. Helion Venture Partners, for instance, informed its portfolio firm Eye-Q about the option in 2014 when the company was looking to expand. After raising funds from Helion and other investors, the eye care specialist was not too keen on further equity dilution.

"Cost of capital in equity investment is over 25 percent. Therefore, a company needs to grow 30 to 35 percent to ensure adequate returns to its investors. We raised venture debt as it is cheaper. We needed money and the choice was between paying IRR [internal rate of return] of 25 percent or a 15 percent interest rate on debt, it made sense to choose the latter," says Rajat Goel, co-founder, chief executive and managing director, Eye-Q.

According to Goel, startups do not have many funding options besides equity dilution. "No one [banks] will give you loans at an early stage. Only after a company becomes stable do banks become interested and offer interest at the rate of 10 to 11 percent," says Goel.

From 28 hospitals in 2014, Eye-Q has now expanded to 43 hospitals and the focus is clearly on profitability.

Vinod Murali, MD, InnoVen Capital India Pvt Ltd

To maintain its lean structure, the company closed down three hospitals in the last two years as they proved financially unviable. "Our company is evolving on its path of profitability and is expanding as well," Goel explains.

Venture capital investors say it makes sense for startups and growth-stage firms to look at venture debt as a viable means of funding. A third of Helion Venture Partners' portfolio companies have raised venture debt. "We advise companies to consider venture debt for one reason—it's an extension of the runway [capital for growth, scale, reaching targets] without dilution," says Rahul Chandra, managing director, Helion Venture Partners, adding that with the help of venture debt, entrepreneurs can achieve more milestones and come to the market for raising further rounds in a stronger position. Helion Venture Partners did its first venture debt with SVB for a portfolio company in 2008.

Venture debt, however, has little relevance in large funding rounds as the venture lenders have smaller cheques. InnoVen, for example, extends loans of up to Rs 30 crore. Also, the product is structured such that it has only one fit. It doesn't have multiple formats to suit the various stages of growth of a company.

"Venture debt is structured in such a way that it's more like a personal loan. Repayments become a fixed cost. It's not suited to cash flows of a company," says Chandra, adding that a company may have periods of cash surplus as well as times of cash constraints but the current debt repayment structures do not take this into account.

To safeguard risks and garner better returns, venture debt firms often take a small equity exposure in the company they are lending to. The 'equity kicker', as it is called, can be even less than 1 percent. "Around 10 to 20 percent of the debt amount is the equity kicker because we want to capture long-term capital gains," says Rahul Khanna, managing partner at Trifecta Capital, another venture lender. Khanna had earlier worked with VC firms like Clearstone Venture Advisors and Canaan Partners, before he started Trifecta in 2014. "Given what I saw in the VC industry, one pattern that emerged was that there was no shortage of equity but there weren't alternative routes of funding either," he says.

Trifecta has extended venture debt to four firms so far, and primarily new-economy businesses. "They are asset-light, high-growth and services-led. Our belief is that health care and fintech will grow. Our money will follow high quality venture money.

VENTURE DEBT HAS LITTLE RELEVANCE IN LARGE FUNDING ROUNDS AS VENTURE LENDERS HAVE SMALL CHEQUES

We are very selective about who we partner with," says Khanna.

Trifecta's sweet spot is Rs 10-15 crore but it can write cheques between Rs 5 crore and Rs 25 crore. "Lessons learnt in the last 10 years have taught us to create diversification and not to get in too early. We will not get into businesses that have concept risk. We like companies that have revenues and positive-unit economics," says Khanna, adding that Trifecta is targeting a fund of Rs 500 crore and has already received commitments for half of this target.

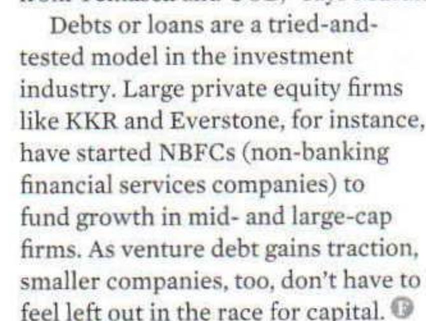
The equity kickers seem to have worked well for InnoVen. It had aggregated exits of $1 billion from companies like Prizm Payments, myntra.com, Freecharge and CarWale, among others.

As venture debt firms like InnoVen do not seek collaterals, the onus is on them to pick the right VCs and entrepreneurs to partner with. The firm has backed several startups multiple times over and has a success rate of over 99 percent. "The expectation is that entrepreneurs will pay. They want to create a legacy. For them, it's important to pay back. There is hardly ever a challenge on the intent of paying back. Next is capacity. We rate our companies on a monthly basis," says Murali.

But it's not always rosy. Like banks, venture debt providers, too, face defaults. InnoVen once had to write off a loan as the company became irrelevant after regulatory changes in its sector. In another instance, there were people issues, which impacted the company negatively.

A few bad apples aside, venture lenders are hopeful of a bright future for venture debt in India. In the US, venture debt is about 10 percent of total venture investing, according to experts. In India, while venture capital investors poured about $2 billion into early-stage firms last year, venture debt amounted to less than $100 million, show industry data. Besides InnoVen and Trifecta, other important companies in this space include Intellegrow and Sidbi.

InnoVen has set its sights on becoming an innovative Asia platform. By 2020, it intends to be present across Southeast Asia, India and China. "We will be about $500 million in size and have commitments from Temasek and UOB," says Murali.



Debts or loans are a tried-and-tested model in the investment industry. Large private equity firms like KKR and Everstone, for instance, have started NBFCs (non-banking financial services companies) to fund growth in mid- and large-cap firms. As venture debt gains traction, smaller companies, too, don't have to feel left out in the race for capital.