Venture Debt — How do Companies Use it?

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Venture Debt is a form of debt given to companies dependent on Venture Capital ("VC") for growth. It's typically a loan that gets paid back equally over 2–3 years, has interest rates that are usually slightly higher than a bank's SME lending rates, and would often come with warrants. Much has been written about the terms of Venture Debt and the type of instrument it is. But I often get the question, "Why should a company raise Venture Debt?" To answer this, I've reflected on past observations of companies and entrepreneurs I've dealt with and decided to write this article to give my take on this subject.

The TLDR is that if the alternative to financing a company's growth is to raise equity from investors, then Venture Debt should be a lot cheaper as it doesn't require shareholders to dilute their shareholding too much. For a company that aims to grow its valuation rapidly, every percentage of shareholding saved is worth a lot. Yet, Venture Debt is a loan that must be repaid, and it is not the same as monies raised from selling equity. After observing many companies, I think Venture Debt is best used to solve timing differences when a company may need to spend money now but get back profits *or* value later. As I interacted more with the ecosystem, I found that effective founders think about using Venture Debt not only to earn profits but also to create value. "Value" can be anything, but mostly, it enables the company to grow faster so that it can command a higher valuation at the next round or turn profitable. In practice, the company will also have to evaluate the certainty of the value it gets back and how it can repay the debt. Debt repayment is certain, but returns are never 100% certain in business. Still, I think Venture Debt can be a good complement to venture capital. Below, I'll highlight some use-cases which I have encountered professionally.

Working Capital

More aptly named "working capital gap", this is the classic case that finance textbooks frequently mention. It's a cash flow deficit arising from a mismatch in credit terms to customers versus credit terms from suppliers. The working capital gap is best illustrated by an example like this.

Example

- XYZ Co. sold $10 worth of goods/services to customers on 60-day credit.
- XYZ Co. suppliers charge $5 for the goods/services but only gave 30-day credit
- XYZ Co. must pay its suppliers $5 after 30 days, but it only receives $10 from its customers 60 days later. Therefore, the company is $5 short for every $10 of sales for 30 days (i.e., the working capital gap).

The above is a very simplified example. You may find more details online in articles such as https://www.investopedia.com/terms/d/days-working-capital.asp. In practice, the high-growth VC-backed company is rapidly evolving, and so the question becomes, "How stable is the working capital cycle? Will you *always* get a 30-day credit term from suppliers and *always* give a 60-day credit term to customers?"

In my experience, companies are constantly negotiating with suppliers who want to give shorter credit terms and buyers who want more credit terms. Also, in a perfect world, where the working capital cycle is stable, XYZ Co. would always be able to borrow $5 for 30 days every time it makes a $10 sale (i.e., the loan repayments match the working capital cycle.) However, because the working capital cycle will probably not be stable, it is more likely that the venture debt provider gives XYZ Co. a $100 loan with a 30-month tenor. In this case, XYZ Co. can comfortably finance the working capital gap at the start of the loan's tenor, but as the loan gets repaid, XYZ Co. would have to find more financing.

The Rush for Revenue

Another classic case. Here, a company will typically explain the rationale for Venture Debt like this: "We're at a point where we are ready to scale, we just need $$$ to hire sales staff/spend on marketing (or do whatever gets more revenue) …".

Like the case of working capital, the issue here is the lack of certainty. How much revenue would you realize from these activities? Is it worth the cost? Most early-stage growth companies I've encountered are never 100% certain of how much revenue they would earn. However, companies must bear in mind that once taken, the debt will have to be repaid. Therefore, companies planning to use Venture Debt to grow their revenue must consider various scenarios relating to what revenues they aim to achieve, what would be a stretch, and what they can achieve more certainly. For example, XYZ Co. may say, "We're spending $5 on sales and marketing, and we'll definitely make $3, we're aiming for $8, and $10 would be a stretch." Therefore, it's better to take $3 of debt and finance the rest of the spending using equity. This, as supposed to the company saying, "we'll take S$5 in debt anyway!"

Hit the Metrics!

This is a range of activities that help a company hit metrics that matter. VC-backed companies are burning cash to grow at earlier stages, and profitability is not always the focus. Instead, the "success" of a company at this stage may be a whole host of metrics other than revenue and profitability. These are often business model specific, but examples include GMV, geographical presence, user base, website traffic, or even key product features, etc. While the first 2 use cases are all about trying to help a company achieve more revenues, "Hit the Metrics" may not be focused on revenue at all. In this case, the CFO may argue with the founder, "we took on a liability (loan), hit a metric, but made no extra money. How is this equitable?" This, in my opinion, is the main question to be answered if Venture Debt is to be used to "hit the metric". There must be some sort of tangible benefit from hitting the metrics. A common benefit that I see is once the company hits a certain metric, it opens up funding opportunities or gives a better valuation. For example, if XYZ Co. took debt to expand its user base, it could command a higher valuation during the next round of fundraising. Alternatively, if it took debt to expand to a second geographical market, it could then command a higher valuation and open the door to a new group of investors who are looking for a "regional play". Aiding future fund-raising is just one potential benefit. There are many others depending on the prevailing circumstances, but the important point is that if using Venture Debt to "hit the metrics", then the company needs to be clear of the benefit it will get from hitting its desired metrics.

Acquisition

When a company sees a suitable acquisition target, it may consider debt to finance all or part of the acquisition. The straightforward case for acquisitions financed by debt is when the target company is already profitable. Then, the profits can be used to pay off the acquisition loan, (i.e. the acquisition pays for itself). However, in reality, this scenario is rare. A profitable company usually carries a high price tag and as a result, requires a larger debt with a longer tenor which venture lenders may not be able to provide. But the straightforward case is not the only case. Sometimes, companies may be acquiring to “Hit the Metric” or “Rush for Revenue” and so all the parameters for “Hit the Metric” or “Rush for Revenue” should apply.

The Burning Question of Runway Extension

If you google “uses of Venture Debt”, invariably there will be articles that say Venture Debt can be used to extend a company’s cash runway. Some articles will say that it is one of Venture Debt’s major use cases. After about a year and a half of leading my first few Venture Debt transactions. I have got 3 different types of comments from 3 different companies.

1. Co. A says “Venture Debt really doesn’t extend my cash runway by much. This 30-month loan only gives me an additional month or two of cash runway, so what’s the point?”
2. Co. B says “Venture Debt only provides a moderate runway extension”
3. Co. C says “Thanks! Venture Debt provided my company a substantial runway extension!”

I reviewed all 3 cases and found that all 3 were similar companies with similar initial cash runway and took a similar amount of debt. So maybe someone got his numbers wrong? But I couldn’t find any major issues with their financial reporting. What is going on?

What Co. A said to me was bothersome. Co. A further elaborated and said something to the effect of, “I have $120 in cash and burn on average $10 a month (i.e., a runway of 12 months). I took $30 in Venture Debt that is repaid over 30 months (or $1 per month repayment, for simplicity’s sake). So now, I have $150 cash but burn $11 per month, my new runway is 150/11 = 13.6 months, an increase of 1.6 months only”. However, I realized that the other two companies also had the same average burn and took about the same debt amount. So let’s analyse the financials of the companies.

Cash runway without Venture Debt

Financial projections of Co. A, Co. B and Co. C

Month	0	1	2	3	4	5	6	7	8	9	10	11	12	13
Co A														
P&L		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	
Total Cash	120	110	100	90	80	70	60	50	40	30	20	10	0	Out of Cash
Co B														
P&L		-30	-25	-20	-5	-5	-5	-5	-5	-5	-5	-5	-5	
Cash	120	90	65	45	40	35	30	25	20	15	10	5	0	Out of Cash
Co C														
P&L		-60	-25	-10	-5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	
Cash	120	60	35	25	20	17.5	15	12.5	10	7.5	5	2.5	0	Out of Cash

All 3 companies have $120 at first and 12 months of cash runway. The difference is that Co. A projected to spend its cash evenly over 12 months, Co. B spent a larger amount upfront, and Co. C hoped to spend an even larger amount upfront. Here is what their financials look like with a $30, 30-month loan *(interest payments are ignored for simplicity’s sake, they represent only a small portion of the debt repayment here).*

Month	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Co A																			
P&L		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10					
Loan		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1					
Total Cash	150	139	128	117	106	95	84	73	62	51	40	29	18	7	Out of Cash				
Co B																			
P&L		-30	-25	-20	-5	-5	-5	-5	-5	-5	-5	-5	-5	-5	-5	-5			
Loan		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1			
Cash	150	119	93	72	66	60	54	48	42	36	30	24	18	12	6	0	Out of Cash		
Co C																			
P&L		-60	-25	-10	-5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	
Loan		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	
Cash	150	89	63	52	46	42.5	39	35.5	32	28.5	25	21.5	18	14.5	11	7.5	4	0.5	Out of Cash

Cash Runway with Venture Debt

In keeping with their comments, Co. A gets a small runway extension, Co. B gets a longer extension, and Co. C gets the longest extension. Revisiting what Co. A said, "…my burn is on average…." Therein lies the issue — Co A projected burn to be even and consistent, but *Venture Debt is best used for a case when you need to spend now and get value back later*. If the company is not projected to spend more upfront, then getting more cash upfront would not extend the runway. Very often, companies estimate runway by taking an "average P&L burn", but this ignores the actual timing of the expenditure. If calculated this way, companies won't see much runway extension from Venture Debt. In our earlier example, Co. A, Co. B, and Co. C have the same average burn rate but realized different runway extensions with Venture Debt because Co. B and Co. C's expenditures are more front-loaded. Perhaps the most interesting conclusion to this exercise is that, for many companies, management does indeed have some discretion to bring forward or delay expenditures. For example, if you are going to sell 1 chair a month for 12 months, you can choose to procure 1 chair a month or procure all 12 chairs on the first month. In short, Venture Debt will give a longer runway extension if the company can bring forward expenditures and spend the debt proceeds upfront.

The Curious Case of Venture Debt as "Insurance"

The proponents of this use case say that a company can take Venture Debt now to shore up its cash balance. If there are unforeseen circumstances in the future where the company needs to spend a larger amount, Venture Debt would help. Hence, taking some Venture Debt is prudent for most companies. This logic is sound and it could be a brilliant strategy. However, let us consider that case where a company took a $30 loan that's repaid $1 per month over 30 months, then in month 1, the company would have $30 to spend on "unforeseen circumstances", $29 in month 2, $28 in month 3, etc. The actual amount that the company can spend on unforeseen circumstances declines over time mainly because the loan is being repaid over time. So, Venture Debt can most definitely be used as an "insurance", but companies must be conscious of the fact that the amount of insurance or the "sum assured" provided will decline as the debt is repaid.

Bridge to Next Financing Round

This is referring to a scenario where a potential borrower is almost at the end of its cash runway and has not firmed up its next round of financing yet. Thus, it needs some debt for runway extension (as mentioned earlier) or as insurance (also mentioned earlier). While the use case is fairly straightforward for the company at this point, this scenario is interesting. This is usually not a scenario where a Venture Lender will readily lend since a Venture Lender usually requires the company to have a sufficient cash runway. Indeed, other quasi-equity instruments like convertible bonds have been used to provide this type of financing. However, there are times when Venture Debt can be used here to supplement an equity bridge round. Still, Venture Lenders would take extra care in due diligence for these types of deals mainly because, when a company is at the end of its cash runway, the risk of the company failing dramatically increases. Therefore, while “Bridge to Next Financing Round” may be an obvious use case, companies should bear in mind that it is also when Venture Lenders would least likely lend.

To end off, one last observation is that use cases for Venture Debt are not limited to just one of the above. Typically, Venture Debt is given as a loan that has no restrictions on its use case. If so, then the money is fungible, and companies can think of the same tranche of Venture Debt as having multiple use cases. For example, a company can take $10 in debt and spends $4 to hit metrics, $4 to meet working capital requirements and keep $2 for insurance. The possibilities are endless.

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