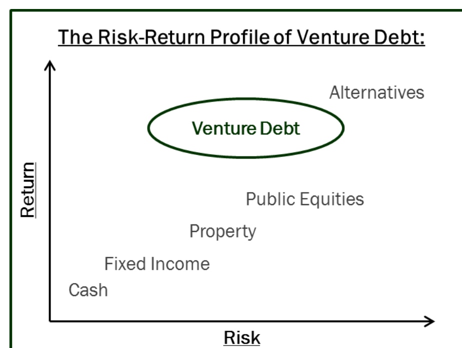
FAIRVIEW CAPITAL

VENTURE DEBT: AN APPEALING HYBRID STRATEGY

Venture debt has always been a part of the venture capital landscape, though its purpose and use have evolved over time. In today's low interest rate environment, investors are taking a harder look at opportunities to back venture debt funds as a way to enhance returns in credit and fixed income portfolios without taking on undue risk or increased volatility.

What is Venture Debt?

Venture debt is financing that is provided to high growth companies that cannot attract conventional debt financing because their cash flow or asset values will not support typical underwriting standards. As a consequence, venture debt will carry terms that seek to match these risks with commensurate reward. In most cases the debt is senior to other claims and will be collateralized by specific assets, equipment or intellectual property, depending on where a deal is perceived to fall on the risk-reward spectrum.

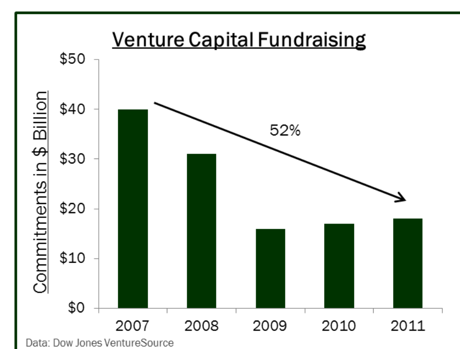


Generally venture debt will be structured as high-yielding, amortizing term loans – ensuring that principal repayment begins immediately. Besides a base interest rate, additional fees are usually charged by the lender to originate, modify, restructure or prepay a loan, all of which serve to boost the loan's ultimate yield. In addition, warrants are typically issued to the lender, which can provide the ultimate lottery ticket: considerable upside through nominal ownership of shares in a company that is sold or completes an IPO at a handsome profit. This can occur several years after the loan has been repaid; instances abound where warrant positions realized significant value to the lender even when the debt facility was never drawn down.

Historically, venture debt was almost exclusively an adjunct to venture equity. In the venture industry's early days, large – and expensive – equipment purchases were financed through "venture leasing" transactions, which freed up equity capital for operational use and company development. The higher risk profiles of developing companies (little or no revenues and negative cashflow) demanded greater risk mitigation mechanisms for lenders, often in the form of investor guarantees. Over time, favorable repayment and loss experiences for lenders minimized straight-up guarantees in favor of other collateral and potential for profit sharing through warrant ownership. Importantly, venture lenders continue to eschew burdensome financial covenants, providing greater flexibility to early growth companies.

The Demand for Venture Debt

The venture debt market is estimated to average between $2 billion and $3 billion in new loans annually, and growing. Demand for venture debt has continued to increase in the face of tightened lending standards at traditional financial institutions and a decline in venture equity fund-raising. Over the 13-year period ending in 2011, the FDIC reports that the total number of banks declined by over 25%, while it estimates that allocations to commercial loans dropped almost 20%. More recently, venture capital fund-raising has been challenged, with 2011 commitments having dropped 52% from 2007 levels, and fund sizes declining an average of 28% over the same period. These metrics confirm the need for alternative financing sources. Furthermore, the entrepreneurial community has embraced capital efficient business models that can demonstrate success without traditional institutional backing, providing an even greater opportunity to venture lenders.



Its Use in Practice

Flexibility is a prime attraction of venture debt's use in financing various aspects of a company's growth. While every situation contains variables that confound a "one size fits all" characterization, venture debt is principally used in four situations. The first use is to finance the purchase of specific assets, such as equipment and inventory. These loans, which are secured by the assets purchased, are an outgrowth of historical "venture leasing" activities.

Second, early in a company's development there may be a need to finance operations through to an identifiable milestone, which would likely result in a new equity financing at a step-up in value. Third, companies that are on a positive growth trajectory may seek short-term capital to accelerate that growth (revenues) to achieve profitability. And lastly, more mature companies may look to add capital to their balance sheets in anticipation of a public offering or other M&A activity.

The question arises as to why a company wouldn't simply raise more equity capital from new or existing investors to satisfy its financing needs. Certain situational patterns suggest the use of venture debt creates a win-win-win scenario for lender, venture capitalist and entrepreneur. Structured appropriately, venture debt can enhance a company's value (and by extension, existing investors' value) while obviating the dilution to investors and entrepreneurs that normally occurs with a new third-party equity financing. Taken to a successful conclusion, that means more money in the pockets of entrepreneurs and venture capitalists and better returns for their investors.

In theory, a similar result can be achieved if existing equity investors simply provide capital on a pro-rata basis. They may well desire to do so, though resistance from entrepreneurs who still are likely to suffer ownership dilution in a company with a promising or proven business model can be problematic. Moreover, most venture capitalists operate in a portfolio context – they manage a venture fund containing many portfolio company investments. Do they have enough reserves? Would the incremental dollars create unwanted concentration?

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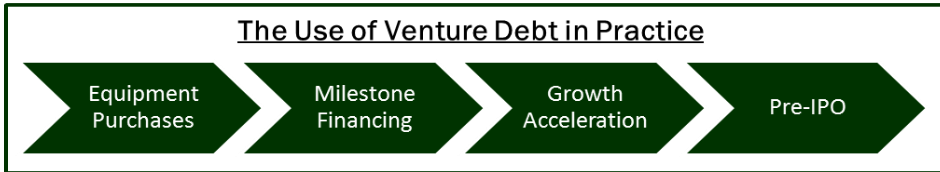
Are their partners convinced providing follow-on capital is the best use of their resources? While this dynamic is difficult to measure, it is an important part of the decision matrix.



The Venture Debt Fund Structure

Lenders to the market include a variety of financial institutions, publicly-traded specialty finance companies, hedge funds, and private investment pools capitalized by third-parties – i.e. venture debt funds. Venture debt funds are typically structured much like venture equity funds, with some significant differences. They generally employ traditional governance provisions and limited-life terms, though management fees and carried interest structures can vary substantially. They also tend to recycle proceeds from loan repayments for a defined period of time (three to five years) up to a targeted multiple of their initial capitalization. By doing so, they in effect leverage the private capital to generate a consistent stream of current income while multiplying their opportunities to participate in upside from warrants.

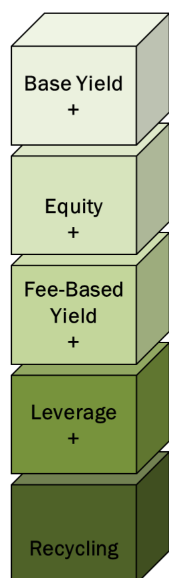
Given today's low interest rate environment, more venture debt funds also have begun employing third-party leverage. One of the most attractive ways to do so is through the use of the Small Business Administration's loan program to Small Business Investment Companies (SBICs), which can provide up to twice the amount of private capital at very attractive interest rates. The resulting rate arbitrage can further enhance investor returns.

Its Attraction for Investors

Venture debt can be an attractive investment option for institutional investors seeking alternative-type returns within specialized credit portfolios at risk levels generally found in fixed income or property investments.

Investor returns are comprised of three fundamental components: a base return, fee-based yield, and returns from warrants. Stated interest rates on venture loans usually range from high single digits to mid-teens. As noted earlier, fees for loan origination, restructuring, prepayment, etc. provide additional yield. These components are further enhanced by recycling loan repayment proceeds, as described above. Finally, warrants for 1-2% of a company are not uncommon, and can provide significant additional upside to investors.

Venture Debt Generates Multiple Sources Of Return



Base Yield
- Core debt component with a 10-15% interest rate; 1.2x–1.4x cash-on-cash return

Equity Component
- Warrant coverage for company stock generally around 1% of the company priced to yield a further cash-on-cash return
- Often includes equity participation rights in future rounds of financing

Fee-Based Yield
- Restructure fees, prepayment fees, success fees

Leverage
- Many venture debt funds utilize leverage to further bolster returns

Recycling
- Invest each LP dollar 2.0x–3.0x over 3-5 years

Taken together, these elements can provide very attractive returns to investors. Beyond that, venture debt benefits investors in several ways:

- **Risk mitigation to the downside** – The seniority and amortizing nature of venture debt are features that increase the likelihood and rate of repayment, thereby mitigating risk of loss. A survey of 8 venture debt funds reveals historical "loss ratios" of between 0.5% and 6% of invested capital. (Compare that to early-stage venture equity funds that may lose 30% or more of their capital.) Furthermore, these same funds on average recouped between 30% and 80% on deals in which they recovered less than 1x principal.

- **Exposure to venture industry deals** – Venture debt provides unique access to venture deals and the equity players who invest in them. While participation in certain venture equity funds remains a challenge for investors, exposure to those firms' deals can be had through debt and warrant positions.

- **Short and/or shallow J-Curve** – Because venture debt funds structure loans with a current pay component, they generate income immediately. Doing so allows a debt fund to offset costs and expenses associated with the deep J-Curve experienced early in a typical venture equity fund's life.

- **Early distributions** – While not universal, many venture debt funds -- even those with recycling provisions -- will distribute current income to investors early in their life. Doing so provides investors with a stream of returns not unlike fixed income investments.

By creating a portfolio of venture debt fund commitments, investors are likely to enjoy the benefits of the subsector while avoiding manager concentration risks. In doing so, they can achieve attractive returns that can be superior to other credit-oriented investments while maintaining a risk profile appropriate to the asset class.

Fairview Capital Partners has almost 18 years' experience designing portfolios to meet the needs of our investors. We would be pleased to discuss with you our ability to develop a customized venture debt fund portfolio to capture the attractive benefits of the sector, while mitigating risk through diversification.

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