Venture Debt Set to Increase Role During Crisis

As COVID-19 hits valuations, companies could look to debt to extend runway

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Key takeaways

- Venture debt has grown its slice of the venture industry in the past few years, shedding much of its negative image. With valuations falling across the industry amid the COVID-19 crisis and economic downturn of unknown length, the VC industry could see a rush of companies raising debt to lengthen runway at a cheaper cost than a down round.
- The lending landscape is set for shakeup. Lenders that have moved further from traditional strategies to enter the venture lending space could retract, leaving fewer VC-focused lenders. This will push deal terms in favor of the lenders after years of competition made covenant free and covenant-lite loans common.
- Debt raises do not come without risk. Even for startups showing strong revenues, debt repayments can cut into cash streams for growth. As many companies have seen revenues slashed, debt repayments will likely put even more stress on some companies. The relationship between lender and investor will help drive the decision making on whether debt is right for a company in need of cash.

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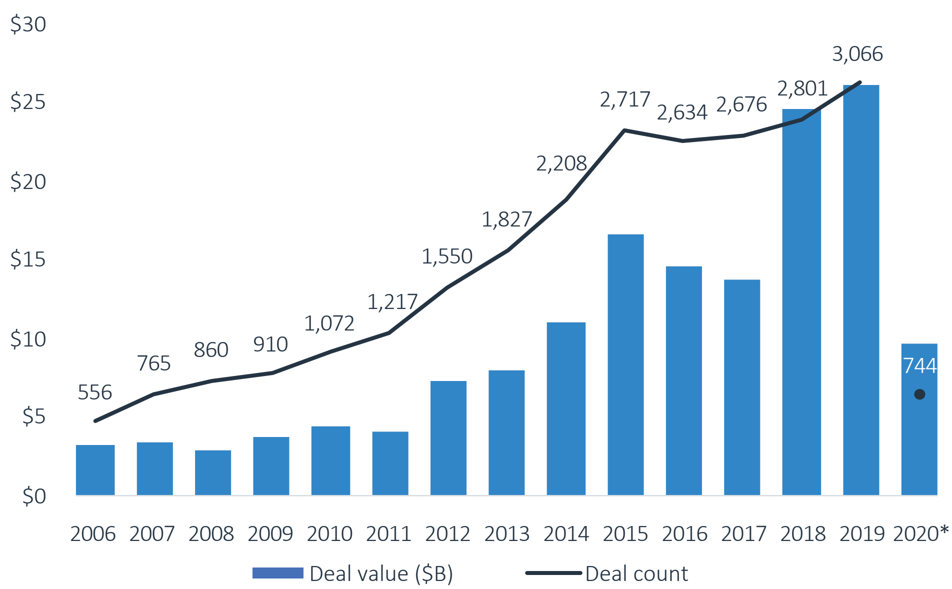
Introduction

Venture debt doesn't receive the same coverage that equity financings do but serves as a major piece in the capitalization of VC-backed companies. With the current crisis throwing the VC industry into tumult, venture debt is set to act in a more pronounced capacity than it has in the past. Though certain companies will benefit from shifts in the economy, a large portion of startups will feel the painful effects of the slowdown.

Investors have nearly unanimously stated that the first thing a company should do is lengthen its runway, cap frivolous spending and set itself up as best as it possibly can to weather the storm. Sequoia sent its Black Swan note to its portfolio companies in early March, and a month later it seems many companies have taken heed of the guidance.[1] Companies that have raised capital in the past six months or so will have an easier time lengthening runway to survive the economic downturn than companies that haven't. Those scrambling to find capital at terms to which they have become accustomed over the past several years (and aren't likely to find it) are loath to raise a down round. As a result, venture lenders are already seeing an increase in new borrowing requests while their existing clients call down credit lines and extend current debt facilities.

As venture debt has grown alongside venture equity fundraisings over the past decade, more lenders have entered the space—both dedicated venture lenders as well as traditional banks and debt providers that have expanded their reach into startup lending. While estimations of the overall size of the US venture debt market vary widely, loans from major business development companies and public banks such as SVB have swollen in size. Debt is even tranched into large rounds for many capital-intensive startups burgeoning at the early stage. In

Venture debt deal activity



Source: PitchBook | **Geography:** US
*As of April 21, 2020

1. See the note Sequoia released on Medium.

September 2019, for example, startup financing provider Mission Lane raised $500 million in its first institutional financing, including $300 million in debt. Brex, which provides credit products to startups, raised around $300 million in debt in 2019.

Global private debt has expanded substantially over the past decade as post-GFC regulations limited bank lending and traditional fixed-income investment returns suffered an extended timespan of low interest rates. In 2019, more than $125 billion was raised in private debt rounds globally. VC-backed companies, lenders and the venture firms playing their own part in the venture debt market will all be affected by reactions to the COVID-19 crisis, shifting venture lending terms and adjusting the risks involved.

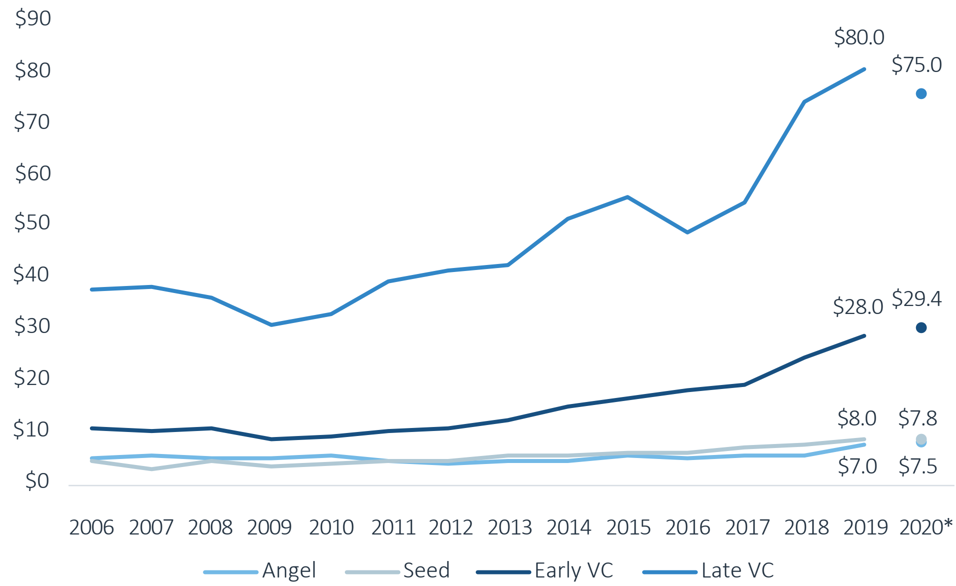
How the debt market will affect VC-backed companies

Venture debt may be a valuable alternative to equity financings for some companies. For one, it is cheaper than raising equity, especially when investors may be looking for steep discounts. Interest rates are historically low, and though many startups may not qualify for the lowest rates on loans, those used by venture lenders can fluctuate alongside reference rates such as LIBOR, which has fallen below 1% for shorter maturities. Venture debt will also provide runway to startups looking to reduce burn rate without diluting founders or other early investors. The inflated valuations of the past few years have made down rounds a likely outcome for companies that have taken hits to growth but need to raise capital in the near future.

Many companies early in the VC lifecycle rely entirely on venture dollars for operation because they bring in little to no revenue. For these startups, raising a round in the near term will be necessary to survive if they do not have enough cash on hand to sustain through the downturn. Even companies with strong revenues raise funding with a gross burn rate in mind, theoretically raising enough outside funding to couple with revenues and carry the company through to its next benchmark of growth. These burn rates, too, will need to be reassessed and readjusted. In both situations, several factors will determine the source of new capital to be raised, with some likely taking the form of debt.

One of those factors will be the ability and willingness of existing investors to provide a company with new equity. Investors are not immune from the effects of a downturn. Even those flush with cash will not be able to support the whole of their struggling portfolio companies. VC firms have deployed substantial influxes of capital over the past few years compared to a decade ago, raising new funds at a much faster clip. As investors look to reserve enough capital for their top portfolio companies, the rapid investment pace has left firms with lower percentages of follow-on capital in their portfolios' desperate time of need. SoftBank, the largest tech-focused fund, has even reportedly sought to raise an additional $10 billion to help support its struggling portfolio.

Median VC pre-money valuations ($M) by stage



Source: PitchBook | **Geography:** US
*As of March 31, 2020

The lofty valuations realized over the past few years largely influenced companies' ability to raise capital and the structure of those deals. The quick economic shock that unfolded over Q1 has left many companies exposed with high valuations and without the revenues or growth expectations to justify. A fresh equity raise will need to be priced, and the current market won't be as favorable as the past couple years. If existing investors are able and willing to provide capital to an existing portfolio company that hasn't yet hit the benchmarks for a new round, the private valuation may not change. In this situation, and depending on the amount of capital needed, both sides could opt to use debt instead, or convertible debt. This would protect both founder dilution and the investment of the GP by providing the relief needed.

If outside investors are required to capitalize a new financing, a repricing of equity shares could end in a down round valuation. We have seen down rounds decline over the past decade, with roughly 9% of rounds concluding with a valuation lower than the company's previous raise, a relatively low figure. Down rounds can be devastating to founder and existing investor equity, as the new firm entering the deal will be able to take a large stake, diminishing the value of past shares. A company in need of financing that is able to raise debt can worry less about valuation, enabling the c-suite to position the business back on track and shore up business programs that have felt economic impact from the COVID-19 fallout.

The benefits of the flexibility that debt provides have already been on display. Airbnb has recently raised a total of $2 billion across two debt rounds, the largest venture loans that can be almost directly tied to COVID-19's effect on the economy. These deals, announced over the past couple of weeks, provide Airbnb a much-needed lifeline of capital as it audits the damage the massive drawdown in travel has done to its business. The company could have raised equity, but existing investors reportedly balked at a new funding round given the current environment. Even though Airbnb lowered its internal valuation, enlisting new investors to raise a massive round could have dropped the valuation further, especially given the length and extent of Airbnb's revenue slowdown can't yet be determined. We think this scenario is playing out on a smaller scale across a range of VC-backed businesses.

Debt, of course, doesn't come without risk for companies

Debt rarely comes without risks. It is easy to talk about low interest rates and the cheapness of debt to equity, but realistically many companies won't qualify for the lowest rates. Even those loans will need to be repaid on a scheduled basis, taking a bit out of revenues that could have been reused for growth. The impact of the economic crisis goes beyond valuations, and revenue disruptions are a problem when looking to pay back debt. Airbnb was reportedly a profitable company at one point, but with revenues almost completely depleted, even this large company seemingly poised to go public in the next year had to raise a debt round at an interest rate of 10%+ LIBOR. The company's first loan, which was provided by PE firms Silver Lake Partners and Sixth Street Partners, will have Airbnb paying over $100 million annually until its maturity date. The loan also includes warrants for the lenders that reportedly will convert into roughly 1% of the company. With Airbnb's valuation reportedly falling to $18 billion in the deal, a $1 billion equity raise would have taken more than 5.5% of the company. It would have also diluted existing investors and put Series E and Series F investors underwater.

Early-stage companies looking to secure new debt financing will be scrutinized heavily for how their businesses have fared through the early months of the slowdown. The ability to cover loan payments will be a major factor even for young companies with a long track record of revenues. Even during strong economies, debt burdens can put unneeded strain on repayments. In cases where revenues have dropped too far, lenders will likely perceive the business as too risky. The growth of SaaS and subscription-based business models with recurring revenues are good candidates for venture debt. Banking institutions that partake in venture lending often require clients to consolidate their banking activities under the umbrella of the bank, ensuring close monitoring of the company performance.

Few lenders are willing to engage with young companies, perceiving them as too risky, so investors go out of their way to establish trust with this small pool of lenders and protect those relationships. They do this by striking an implicit contract not to abandon the borrowing company and leave the lender on the hook for losses. This helps to create good will and secure loans should companies need them down the line, which is especially pertinent for early-stage startups with low revenues. The case could be made that investors would advise weak portfolio companies not to draw down revolving credit lines in circumstances such as the industry finds itself now. Investors are not immune from feeling the impact of the crisis, and while no investor wants to abandon their portfolios, an unprecedented economic shock such as this has likely left many funds without the reserve capital to save all of their portfolio companies. This will create additional risk for lenders and could block certain companies from raising debt rounds to sustain operations and lengthen runway.

How venture debt lenders are affected

The growth of venture lending has come from not only dedicated venture debt funds, but also from interest in direct lending and extended loan programs from lenders not focused on startups, such as banks and other institutions. Research has shown that capital losses from venture lending are low, at under 2% annually. The strong economic climate of the past 10 years has widened the institutions willing to provide debt to young companies, even as regulations have restricted some bank lending to startups. Much like the broader venture industry, these nontraditional lenders will be put to the test to see whether or not they will remain an entrenched participant in VC or if they will retreat to their classic strategies.

A retreat of nontraditional lenders will put a strain on the supply of venture debt in the near term. As many companies seek a debt round, a smaller pool of possible lenders means fewer loan options available. And much like VC firms, lenders will need to assess their own portfolios to make sure their capital reserves are in position to protect existing investments.

The high number of lenders in recent years has moved debt terms in favor of startups. "Founder friendly" has encompassed debt as much as equity financings. This has manifested in competition on interest rates, and more importantly the lessening of covenants. Across private lending, covenant-free and covenant-lite loans have become more commonplace. A retraction of lenders in the market could resurface covenants in loans. While these protect lenders and can be disastrous for companies if a default occurs, they can also be used to monitor progress of the company, allowing lenders to step in before it's too late to provide support.

Options such as revenue-based financings will fare much the same. These products have become an option for companies that allow each to pay a set percentage of their revenues per month over the lifetime of the debt, in theory lessening the burden of repayment during months that see sales lag. Lenders focused on recurring revenue businesses will likely find increased desire for products such as this as companies look to shore up capital shortages until the market calms.

It's important to note that lenders focused on startups and VC-backed companies will likely not shift away from their strategies simply because more startups may be looking for debt to supplement capital raises or extend runway. Much like VC firms, these lenders know their market and understand how it will react to the current economic climate. If the crisis extends and debt paybacks struggle, we expect loan refinancings to help extend payback periods and decrease interest rates when possible. If banks and tourist lenders retreat further, the fear of having a loan recalled will likely push borrowers to refinance with lenders focused on startups and the venture market.

In addition to private lending, the emergency Paycheck Protection Program launched as part of the US Government's $2.2 trillion economic stimulus package will help many small businesses cover paycheck's to employees, but it is only designed to cover up to eight weeks—legislation has been passed to add an additional $320 billion onto the program after it ran out of money in a week. This provides businesses with time to assess damage but does not provide runway extension for companies in need of VC financing. Lingering questions remain over the legality and optics of companies accepting government cash while being backed by VC firms that hold roughly $120 billion in dry powder. For example, an early piece of the legislation would have lumped together a startup's employees with the those of its largest investors' other portfolio companies, similarly to how PE portfolio companies have largely been exempted from the program. While many VCs, lenders and startups may have unresolved questions about the program, it could be a vital lifeline for some; according to a startup layoff-tracking website, 284 startups are confirmed to have laid off more than 27,000 workers since March 11.[2]

Conclusion

Venture debt, from both a lending and borrowing perspective, has many hurdles ahead. Lending has been through many recessions, but the growth of the venture debt market, including the surge in number of lenders, has provided novel characteristics for the market to iron out. The venture industry has benefited greatly from ample available capital over the past few years, which has pushed up deal sizes and valuations and given way to the "growth at all costs" mentality that has pervaded.

While debt will help companies prevent dilution and lengthen runway, it won't be an easy raise for any company that needs cash. In many ways, the venture debt market will mirror the broader venture industry.

2: Coronavirus Tracker, Layoffs.fyi, accessed March 11