PitchBook

PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis

Vincent Harrison
Analyst, Venture Capital
vincent.harrison@pitchbook.com

Kaidi Gao
Associate Analyst, Venture Capital
kaidi.gao@pitchbook.com

Data

Susan Hu
Senior Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Mara Potter**

Published on April 10, 2023

Contents

Key takeaways	1
Introduction	2
The current state of venture debt financing	2
How the collapse of SVB will impact venture debt moving forward	3
Outlook for 2023 and beyond	5

Takeaways From the Venture Debt Conference

Highlighting the various trends, opportunities, and challenges within the venture debt ecosystem

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- The use of venture debt has gained in popularity as many startups look to remain private longer and seek creative forms of financing that minimize dilution.
- The collapse of SVB highlighted the importance of liquidity and the need to always have cash on hand.
- A frozen exit environment observed since the start of 2022, along with cooling fundraising figures, has created a liquidity crunch in private markets. This liquidity crunch and the exit of SVB creates a unique opportunity for smaller private credit players to take up market share.
- Increasing levels of capital demand relative to supply will allow venture debt lenders to increase debt pricing.
- While credit underwriting has not changed much fundamentally, shifting valuation paradigms will renew the importance of taking a hard, realistic look at growth and profitability outlooks.

Introduction

Despite the growing popularity of venture debt products, venture debt remains a relatively unfamiliar and often misunderstood form of financing for many. The Venture Debt Conference, hosted in New York City on March 31, 2023, offered a unique opportunity for networking and discussion of nondilutive loan strategies for VC-backed and emerging-growth companies. This full-day forum addressed the growing interest in using venture debt to complement venture capital, providing opportunities for companies unfamiliar with alternative financing to discuss these investment strategies. Sponsors in attendance included Armentum Partners, Barnes & Thornburg, Horizon Technology Finance, RRBB Accountants and Advisors, DLA Piper, and Investor Brand Network.

The current state of venture debt financing

During the past few weeks, venture debt was put under the spotlight when several regional banks struggled and some failed. Those institutions are of a smaller scale compared with more mature banks such as J.P. Morgan but nonetheless play an essential role in financial ecosystems, including venture capital. The dust has not yet settled from these abrupt, seismic shifts in the realm of banks, and more questions than answers remain.

The perception of venture debt as an asset class has evolved and expanded over the past decade. For many years, venture debt funds were closely associated with the private equity asset class, despite the inability to achieve the same level of returns as PE. Over time, venture lending has become repositioned more accurately as private credit, showing that the asset class has become more institutionalized as it scaled. A panelist at the Venture Debt Conference shared that just three years ago, while attending an alternative investment conference on the West Coast, the investment community had a hard time grasping the appeal of venture debt because they could not understand why one would want to be in a business with the return of debt and the risk of equity. That sentiment has gradually changed as people started to get more comfortable with private credit amid the market downturn. Now that Silicon Valley Bank (SVB), a central player in the venture lending space for nearly four decades, is gone, some lenders see a great opportunity to fill in the lending gap SVB's demise left for early-stage startups.

Now that Silicon Valley Bank (SVB), a central player in the venture lending space for nearly four decades, is gone, some lenders see a great opportunity to fill in the lending gap SVB's demise left for early-stage startups.

The liquidity crunch and dwindling capital availability together added an additional layer of difficulty for venture-backed startups looking to raise equity rounds amid the ongoing macroeconomic headwinds. Many companies that raised two years ago, when the market was flush with capital, will likely run out of money by the second half of 2023. Now, companies are in a full-on race to reach profitability—this is especially true for mature startups sitting at the venture-growth stage—and those that are unable to become profitable will have to return to the market. Some panelists at the conference have been telling their portfolio companies to raise now instead of waiting until Q3 or Q4, when the landscape will likely be different.

Due to a surge in demand, the venture debt market has become much more lender friendly. Overall, rates have become higher and spreads have widened. Lenders are now able to get better covenants, and warrants have returned to debt term sheets

as well. Previously, when company valuations were inflated and investors competed against each other to access deals, some lenders held back from warrants, but the circumstances have changed. Lenders see opportunities in recapitalization rounds, where new equity is considered advantageous to have, and these penny warrants do matter because of the long timespan.

One piece of advice a CFO gave to the venture debt community is to not lower the bar when the tide is working in their favor.

Panelists unanimously agreed that credit underwriting has not changed, but the discipline has become more precise and stricter. The bar for debt issuance is higher, meaning that only high-quality companies can secure debt financing. One piece of advice a CFO gave to the venture debt community is to not lower the bar when the tide is working in their favor. A lesson from the VC market boom of 2020 and 2021 is that the overabundance of capital supply and competition put downward pressure on the bar. Lenders should be cautious and not give in to the pressure because lending to companies that should not get debt will potentially lead to bad outcomes two or three years down the line. In addition, in anticipation of entering a bear market for the next few years, there are concerns that highly leveraged lenders may run into challenges in a down market.

From the borrower side, it was stressed that timing is extremely important for raising debt. Startups should raise debt when they do not need it. In today's lending environment, it is nearly impossible for companies with less than 12 months of runway to obtain debt financing. This again ties to the trend that the selection bar has gone up, and only high-quality companies with ample liquidity are able to gain traction from lenders. When companies start exploring debt options, it is important to take into consideration the track record of potential lenders because the process is less about minute differences in basis points but more about having a long-term partner that will see them through thick and thin.

With regards to LP sentiment, it was mentioned that many investors look at venture debt similarly to how they view real-estate-type investments because of their shared features, such as high yield, low risk, and consistent cash flow. LPs have quite a few choices when it comes to where they will deploy their capital, and several LPs that made significant equity investments with elevated valuations during the past three years are worried about those portfolios, many of which are not currently marked to market. When lenders shared about their fundraising experience and the conversations they have had lately, the LP side is a mixed bag. There are some investors that compete with SVB Capital and are rightfully concerned. Of the family offices and institutional investors that pulled back during the past few years because they believed deals were overvalued, some are back, saying now is the time to invest. Some see a clear opportunity and are aggressive in their approach.

How the collapse of SVB will impact venture debt moving forward

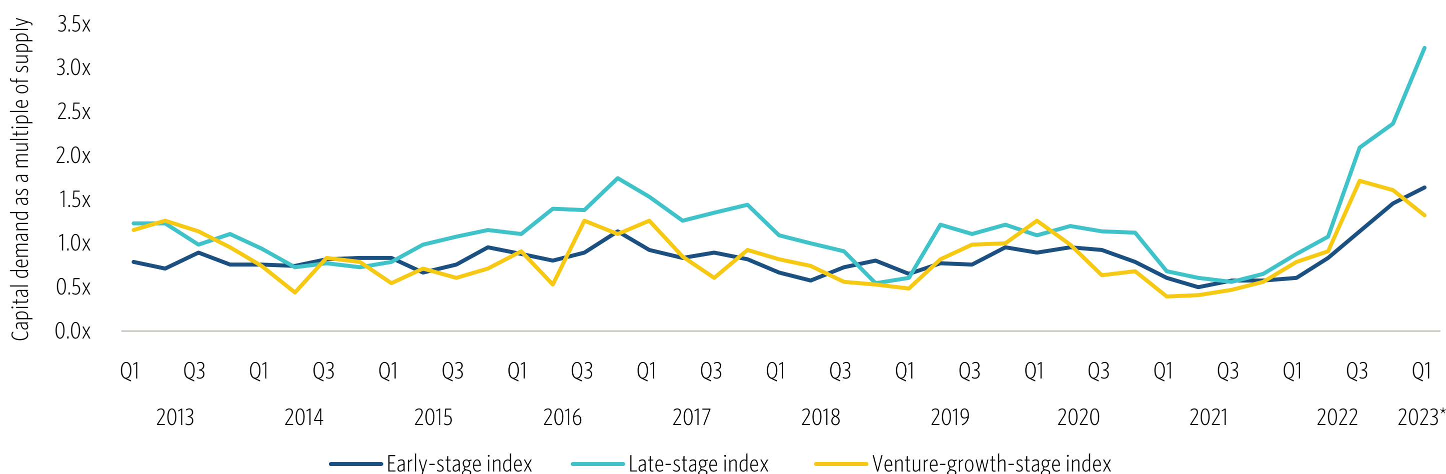
For the past four decades, SVB has implemented a number of tactics and strategies to establish itself as the preferred bank for numerous startups and investors. However, after the bank's recent collapse, there remains a great deal of uncertainty about the fate of the venture debt market and its stakeholders. One likely outcome is the surge in market dominance of the various private credit institutions that

competed with SVB, particularly nonbank lenders. SVB generated revenue from bank deposits by requiring startups with whom it did business to put their capital into its bank accounts. This allowed the bank to offer more flexible terms and rates relative to other private credit institutions that had a greater reliance on debt pricing. This insistence on deposits allowed SVB to secure a massive share of the market and made it hard for others to compete. Now, with SVB out of the picture, private credit players such as Hercules and TriplePoint can increase their market dominance.

This opportunity is especially important considering another likely outcome: a renewed focus on liquidity. For the past several years, many startups and their investors prioritized a growth-at-all-costs mindset over the constant need for liquidity. This made sense given the recent boom in capital availability—money was essentially falling out of the sky—meaning many startups could instead focus their efforts on optimizing growth. However, when SVB collapsed, leaving many startups unsure if they would be able to make payroll, it became clear that having access to liquidity is more important than it has ever been. Going forward, SVB's demise creates a real opportunity for lenders that are willing to lend to these businesses.

There are several reasons to believe that the willingness to lend will be high. First, SVB's collapse had little to do with the underlying health or quality of the startups it extended loans to or received deposits from. Many of the companies that SVB did business with were growing enterprises with demonstrated product-market fit, a defensive moat, and recurring cash flows. Such companies are highly attractive, and many of them make excellent lending candidates. Second, the dearth of capital observed in private markets gives private credit institutions more power over pricing. Indeed, capital availability has been at meteoric highs in recent years, with hundreds of billions of dollars entering the venture ecosystem and active IPO, SPAC, and M&A markets offering startups an abundance of liquidity options. However, with a frozen exit environment and fundraising numbers falling, capital

Capital demand-supply ratio in the VC marketplace



Source: PitchBook • Geography: Global
*As of March 31, 2023

is now becoming significantly scarce relative to demand. Fundamentally, the credit market's pricing is largely determined by the basic principle of supply and demand, just like any other market. Therefore, as the current demand for capital continues to exceed supply, it is highly probable that lenders will demand higher rates.

The advent of higher pricing is further compounded by an impending shift of valuation paradigms. Taking a hard look at growth and profitability expectations over periods of time, whether it is one year or a decade, will become increasingly important for both venture debt lenders and equity capital providers. The resurgence of inflation levels not seen in 40 years, coupled with the departure of near-zero interest rates, will fundamentally alter how much investors are willing to pay for future cash flows.

Outlook for 2023 and beyond

With a higher demand for venture debt across the board, rates are expected to tick up as capital availability becomes increasingly scarce. Beyond the supply-and-demand tension, cumulative loss will also play a role in determining rates. While many venture loan borrowers ultimately breach covenants at some point, over the last 20 years, loss rates have remained consistently low. However, should default rates ascend significantly, losses are expected to increase as well. As such, lenders are likely going to hyper-focus on metrics such as EBITDA and enterprise value as a remedy to mitigate risk and potential future losses.

The SVB crisis not only created a void in early-stage venture lending, which some believe will be filled by equity, but it also left a gap in the level of expertise and familiarity with the venture ecosystem. Fortunately, this has led to thoughtful conversations within the lending community about ways in which lenders can play a more central role in venture.

COPYRIGHT © 2023 by PitchBook Data, Inc. All rights reserved. No part of this publication may be reproduced in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, and information storage and retrieval systems—without the express written permission of PitchBook Data, Inc. Contents are based on information from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Nothing herein should be construed as investment advice, a past, current or future recommendation to buy or sell any security or an offer to sell, or a solicitation of an offer to buy any security. This material does not purport to contain all of the information that a prospective investor may wish to consider and is not to be relied upon as such or used in substitution for the exercise of independent judgment.