THE CASE FOR VENTURE DEBT

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Technology companies can create tremendous value, but to do so they require capital to fund their early development.

Unfortunately, they often struggle to obtain that capital from traditional lenders, and instead find themselves relying exclusively on equity funding that can be expensive and impose unwelcome restrictions. To avoid these challenges, many tech businesses are turning to venture debt. Not only is venture debt an attractive alternative for entrepreneurs, as we'll see, it also offers compelling, differentiated returns for investors.

Venture debt demystified

Software and other technology companies often need capital to fund their sales, marketing, and product development activities.

Since GAAP frequently treats these as expenses, young companies typically report negative operating margins as they grow, which can impede access to traditional debt financing.

The fact is that banks are ill-equipped to gauge the future profitability of rapidly growing enterprises with negative incomes, and their lack of tangible assets makes asset-based financing virtually impossible.

It's because they can't access traditional financing that so many high-growth tech businesses look to equity providers for funding. But what founders and CEOs usually discover is that equity capital comes with caveats. Selling equity can dilute founders' upside economics, while liquidity preferences and other mechanisms increase downside risk. Equity backers typically also demand managerial input, reducing founders' control and strategic flexibility.

To be clear, equity is the right starting point for almost every business plan. Nevertheless, relying on it exclusively often leads to suboptimal results.

Another option that allows businesses to augment their capital base, while enjoying a more efficient capital structure and greater flexibility, is venture debt.

In fact, debt can be a very effective way to fund the runway necessary to reach profitability, allow more flexibility around the timing of valuation events, and help founders reduce the amount of equity required thereby decreasing dilution.

Underscoring the point, the use of venture debt has increased in recent years as those benefits have become more widely understood. Today, it accounts for between 10 and 15 percent of total venture capital invested in a given year (approximately $8 billion to $12 billion annually).

Investors benefit from high yields and diversification

Venture debt typically generates high yields, but the coupon is only one of the benefits these assets can afford investors. While the interest rate on venture debt is particularly eye-catching in a zero interest rate environment, the drivers of that rate are even more important from a portfolio management perspective.

High yields, in this case, don't just reflect higher underlying risk. The return profile is also driven by the underwriting process for venture debt, which differs from the way that loans to mature companies are priced in some important respects.

Large, mature companies have credit metrics that are easily compared against their peers, and the price of their credit — expressed as a spread over the risk-free rate — is transparent.

The market for that lending is therefore reasonably efficient, and prices for given borrowing categories will often respond in lockstep to changes in the macro environment.

By contrast, venture debt is more idiosyncratic. Young tech companies lack long financial histories, and their growth rates make extrapolating from the records that they do have impossible. Investing in them is about gauging the people running the business as much as it's about mechanically analyzing financial statements, rendering read-across comparisons difficult.

Beside the fact that growth companies' credits are hard to compare to one another, lenders aren't competing on price alone. A host of other factors are important to growth companies, including:

- The reputation of a firm's principals
- Their records with other entrepreneurs
- The personal chemistry between teams

All of these inform a borrower's choice of financial partner. This gives lenders more leeway around pricing than they'd have with mature borrowers. The result is that the underlying credit isn't the only thing driving yield.

In short, the market for mature companies' debt is more efficient and transparent than the venture equivalent. The variables that drive pricing are comparatively well understood and predictable, which implies a somewhat homogeneous market for similar instruments — they will tend to move together as the environment changes. Since venture loans are constructed on a different basis, they provide a degree of structural diversification for investors.

SaaS growth rates underpin lending

The structural differences between the underwriting processes outlined above are likely to endure, suggesting that the yield gap between conventional and venture loans will persist. However, venture debt is also attractive for other reasons, including the borrower universe. While some tech companies — chip manufacturers, for example — look a lot like traditional industrial concerns, a software company's business model is different in many important respects.

Business software was historically sold via a one-time perpetual license fee, sometimes with a smaller recurring maintenance fee.

Today, by contrast, cloud-based software is sold on a monthly, quarterly, or annual subscription basis. The installed base represents a very reliable annuity stream, with extremely consistent revenues and high contribution margins. And, the reliability of those revenues is complemented by a very steep growth profile.

Virtually every business in the world is shifting its software from on-premises to the cloud. In fact, 73 percent of companies plan to make their business systems completely software as a service (SaaS) based by the end of 2020.

This is a multi-decade, secular shift that is driving enormous growth for SaaS companies. Just consider that while on-premises solutions are only growing at 8 to 9 percent, SaaS revenues are growing by an average of 25 to 30 percent.

Any investment in acquiring SaaS customers can therefore generate tremendous returns, even if near-term cash flows look challenging. In our experience, SaaS companies typically have to spend $1 on sales and marketing to acquire $1 of annual recurring revenue. The negative cash flow that is reported in that first year looks very different in subsequent periods, as the development and sales expenses have already been funded, and run-rate margins can approach 80 percent over 8 to 10 years.

Given those metrics, software companies can create $3 to $5 in enterprise value from every $1 invested in sales.

Software business models also afford downside protection

The potential for such efficient value creation (and the rapid natural deleveraging that follows) allows loans to be structured at comparatively low LTV ratios. Not only that, the downside protection that this gives investors is augmented by other factors.

The underlying businesses tend to be quite recession resilient. Accounting systems and marketing automation platforms, for example, are typically mission-critical. Even in economic downturns, companies don't get rid of their core software subscriptions.

In addition, the sales function in a SaaS company is a growth driver, which affords its managers a degree of cost control that doesn't exist in other business models. If a traditional business generates the same sales in consecutive years, it will report 0 percent growth.

Conversely, a SaaS company that reports equivalent unit sales in years one and two has doubled in size. If it doesn't generate any sales at all, it will report flat year-over-year revenues. This is a very powerful revenue model, and that power is amplified by the ease with which customers can adopt and implement SaaS software solutions compared to on-premises products.

Although software companies have never been subject to the same capacity constraints that manufacturing businesses operate under, SaaS models affords them even greater potential for growth.

While the upside benefits of this model are obvious, it also offers an underwriter substantial downside protection. Specifically, sales spending can be cut significantly without really affecting the current revenue base. If business conditions merit it, there is flexibility to cut costs within the business and to harvest the existing cash flow stream, implying much greater coverage for debt than the reported P&L might suggest.

Stakeholder alignment is also important. Loans should be underwritten against realistic risk appraisals, and an understanding of the support that the company's equity sponsors can provide. Managing shareholder relationships so that support is given when needed can be a critical element in a lender's risk management process.

Properly structured and managed, venture debt therefore combines a number of attractive characteristics for lenders. The structural characteristics of the origination and underwriting processes form a constructive basis for pricing and other terms.

Moreover, many of the potential borrowers have business models that, while not conforming to traditional underwriting characteristics, are tremendously well suited to support debt.

Higher yields reflect structural differences between venture debt and other corporate lending

Venture lending can generate higher yields than other classes of corporate debt. But it is a mistake to think of the yield purely in terms of the risk of the underlying credit.

The link between risk and yield is much less mechanical in venture debt than in other credit markets, and many other factors influence pricing and returns.

The result is that a properly constructed venture debt portfolio can provide investors attractive returns relative to underlying risk and offer an important source of diversification within an income mandate.