MARKET INSIGHTS:

The Ownership Advantage: Delaying a Series A with Venture Debt

Q3 - 2017

You're out of early-stage start-up territory (i.e. with revenues exceeding $2m). You are close to breaking even but you need to continue spending to scale up.

How do you finance that growth plan? It's very likely that your bank is either unwilling or just unable to provide meaningful financing amounts, and you face a similar situation for government grants or programs. So you must raise equity from venture capital (VC) funds. Or do you?

Venture debt can help defer the need for equity from VCs until your valuation is more attractive, or if equity is absolutely necessary, reduce the impact of its dilution on your current ownership. This edition of *Market Insights* explains what venture debt is, its availability in Canada, and its benefits and pitfalls.

What is Venture Debt?

Venture debt is a type of debt financing provided to businesses by non-bank lenders to fund growth, i.e. working capital or capital expenses. Venture debt typically *complements* a VC investment, but can also be deployed without a VC sponsor. From the perspective of those companies' existing shareholders, the main purpose of venture debt is to minimize the dilution impact to their ownership, while providing the growth capital necessary to reach the next valuation milestone.

Unlike traditional bank lending, venture debt is available to early-stage growth companies that do not yet have positive cash flows or significant assets to use as collateral, but that do have good recurring revenues and visibility into future cash flows as they approach breakeven, typically within 12-18 months.

Venture debt lenders structure their loans with warrants, royalties, or some other form of upside, to compensate for the higher risk inherent in earlier-stage growth companies. Such upside also creates strategic alignment between lender and borrower.

Venture Debt in Canada

Data is scarce with respect to venture debt in Canada. FirePower estimates that about $0.8-1.0bn worth of venture debt investment opportunities arise annually in Canada, based on the amount of VC funds flowing into Canadian companies ($3.5bn for 2017, based on *CVCA Infobase* data) and the limited number of institutional players deploying such capital, such as our own $140m Gap Debt™ fund.

Venture Debt – The Ownership Advantage

Suppose a company is worth $10m today, and it seeks to raise $2.5m. Further suppose it can either raise equity or venture debt.

After five years, assume the company sells for $40m. The calculations below compare the cost of raising equity vs. venture debt. The difference is staggering: **nearly $5m.**

Choice of Financing	Today	In Five Years
Venture Capital (Equity)	Stake Sold to VC for $2.5m: 20%, with a 1x liquidation preference[1]	Value of Liquidation Preference: $2.5m Value of VC's Stake: .$7.5m[2] **Cash return to VC: $7.5m**[3]
Venture Debt	Loan Terms (for illustrative purposes only): » Interest: 13% » Warrants: 3%[4] » Principal Amortization: 80% Bullet at Year 3[5]	Net Value of Warrants: $1.05m[6] Interest Paid: $0.91m[7] **Cash Return to Gap Debt™ : $1.96m**[8]

As can be seen, venture debt is extremely valuable to fast-growing companies; because of their immense enterprise value growth, the cost of selling off equity is particularly high. **Why then, do many companies take on equity over venture debt in these situations?**

It is true that some entrepreneurs don't have a favourable view of debt of any kind. They view it as restrictive to their cash flows (debt servicing), their ability to operate freely (covenants) and exit horizon (fixed term). There is no denying that venture debt imposes **operational** constraints, but it is unreasonable to claim that VCs have no checks and balances. The VC investor will have extensive **strategic** control (through voting rights and board members) and thus significant influence over operations.

The nature of a financing is not an easy nor a light decision to make. Our view is that companies should consider all choices available to them, and generate proposals from both equity and venture debt funds, making a final decision with the benefit of knowing their options. And sometimes, the best choice may be a combination of both.

FIREPOWER CAPITAL
Toronto | Montreal
647.260.2069 | info@firepowercapital.com | www.firepowercapital.com

MARKET INSIGHTS:

The Ownership Advantage: Delaying a Series A with Venture Debt

Q3 - 2017

RECENT PRIVATE DEBT TRANSACTIONS

SEPTEMBER 2017

Equity Injection

For

The undersigned is a co-investor to the company

AUGUST 2017

Acquired

The undersigned acted as the exclusive advisor to the seller

JUNE 2017

Gap Debt

For

The undersigned is a lender to the company

ABOUT FIREPOWER CAPITAL

FirePower Capital is the investment banking and private capital firm built for Canada's entrepreneurs. We help their mid-market businesses complete mission-critical transactions.

For more information and resources please visit www.firepowercapital.com.

1 At a pre-money valuation of $10m, $2.5m purchases $2.5m / ($10m + $2.5m) = 20%; Liquidation preference means VC recoups investment first
2 Assuming no further rounds of financing, the 20% stake, after the liquidation preference is paid, of a $40m company (share value) is equal to 20% * ($40m - $2.5m) = $7.5m
3 The cash return to the VC is equal to the sum of the liquidation preference plus the value of its stake less the initial investment
4 Assuming half the warrants have a nominal strike price and the other half have a strike price equal to the pre-money valuation ($10m)
5 Amortized over 24 months; first 12 months interest only period
6 Assuming no further rounds of financing, net value of warrants is equal to 3% of $40m less the outstanding debt ($1.2m) less the cost of exercise ($0.15m) = $1.05m
7 Interest is paid over 3 years at a 14% rate, on outstanding principal
8 Cash return to venture debt is equal to the sum of the net value of warrants, and the interest paid.