

Venture Debt: A legal guide for startup founders

Startups have a myriad of aspects to consider regarding their business, one of which is financing. Scaling your business requires a level of financing that founders are usually unable to front themselves.

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That's why startups usually consider external financing options. Whilst equity financing is the most common, venture debt [*Gaining Traction In Australia*](#) and if you are unaware of what venture debt is, here is a quick legal guide to help you.

What is Venture Debt?

Venture debt, as the name implies, is a type of debt provided to fast-growing startups, early-stage companies and those looking to scale-up operations. The debt can be offered by different kinds of lenders from individual angel investors to venture capital funds. There are 3 main types of venture debt offered:

1. Term loan Term loans are similar to traditional bank loans which are to be paid in full by the end of the term including the principal and the accrued interest. For payment of interest, some loans may have an interest-free period, after which the loans will have to be paid at regular intervals throughout the loan term. For principal repayment, borrowers may have to pay at regular intervals or make a 'balloon' payment. A balloon payment refers to the entire principal amount being paid in one go at term end. The percentage of the interest on

the loan depends on several factors including warrants offered by the borrower, credit history and profile of the borrowing founders, and the loan terms. Warrants are rights to buy the startup's shares at a specified price within a certain time period.

2. Revolving credit facility A Revolving Credit Facility largely resembles a credit card facility where a maximum withdrawal limit is set by the lender. You can borrow and repay your dues at intervals, as long as you stay within your maximum spending limit. However, interest payments do accrue and there may be a yearly fee, regardless of how much you withdraw. With the revolving credit, startup founders benefit as there are no regular fixed payments. It also serves as a way to meet operating expenses in months with tight cash flow. They do not require extensive modelling and estimating cash flows to see if you can repay the loan amount as you only withdraw as much as you can pay.
3. Revenue loan A revenue loan is a mix of both debt and equity instruments. It is a loan that requires interest payments at regular intervals, but the amount varies according to the startup's turnover. If the revenue is declining, your interest payments will be lower for that time. Revenue loan lenders require warrants as these loans are usually given to high-growth companies who are likely to pay back the loan quicker. Founders who take startup loans have to bear higher effective interest rates generally and these interest payments do not result in tax savings as they are paid in the form of royalty and not interest.

Advantages of Venture Debt financing

An important aspect to consider regarding venture debt is that it is not a replacement for equity but is rather used to complement it. Venture debt is a good choice when choosing to finance large purposes, such as fixed assets.

Venture debt also is advantageous for businesses in between investment rounds. The debt finances operational costs without having to manage significant fundraising costs of equity. Furthermore, the biggest advantage by far is that it does not dilute ownership of existing shareholders. Adding equity means relinquishing control over the business which may not be in the best interests of the founders.

Disadvantages of Venture Debt financing

Venture debt options are only available to startups that have undergone fundraising rounds and have equity capital. This is one of the biggest drawbacks as it cannot be used by bootstrapping startups or pre-seed ventures.

Venture debt lenders often lend to startup companies with high growth rates, to mitigate risks. Hence, companies that cannot grow or haven't exhibited aggressive growth are at a disadvantage when looking to venture debt to raise finance. These companies are likely to obtain loans at higher interest rates which proves unfavourable with slow growth prospects.

Should I choose Venture Debt?

Venture debt can be the perfect source of easy and favourable financing if you are confident about the startup's growth prospects and achievement of milestones. Unlike raising equity, it will help you retain control and ownership and steer your startup according to your vision. To identify whether venture debt may be the right option for your company, consider the following carefully:

1. Extent of Dilution for Existing Shareholders – Raising more equity means more shareholders on board, and a reduced share for existing

shareholders, i.e. dilution of ownership. Taking on debt reduces the level of dilution existing shareholders will have to face.

2. Retaining Control – Unlike shareholders, debt lenders do not take direct control of the business. They will however, require frequent updates regarding business performance and finances.
3. Bad Time for Company Valuation – Raising equity requires companies to be evaluated and prices are set accordingly. However, financing through debt does not require valuation. If you fear a down round of equity, post high growth, it would be better to opt for debt.
4. Quicker Access to Cash – If you need faster access to cash and are in urgent need, venture debt is a better option. The process requires lesser due diligence and is often a faster process enabling you to get finance quicker than if you had chosen the equity route.

When is Venture Debt an appropriate option?

The timing of securing for debt is also important alongside your business' reason to opt for it. Companies are in an advantageous position for debt at or during rounds of equity. During an equity round, the startup looks to be a favourable and promising investment. Investor confidence indicates good times ahead for the company and can offer an edge to the startup when negotiating for debt. You can negotiate and discuss better terms including lower interest levels.

Debt is also opted for during rounds of equity as it allows the business to meet operational expenses and support working capital. Raising another

round isn't a feasible option at this stage and debt can be easier to manage as it can be paid back after another equity round.

- Venture debt is a financing option available for startups, particularly beneficial for this with aggressive growth trajectories.
- Venture debt offers flexibility in terms of payments, depending on the type of debt chosen.
- Debt Financing is better than equity in cases of urgent liquidity requirements, retaining greater control of business, and avoiding dilution of ownership.

Need expert legal help?

Like all financing options, venture debt comes with its own set of complexities and technicalities. The decision to opt for debt depends not only on the timing, but also your business structure and future outlook. Before you opt for debt finance, or any financing options, it is advisable to connect with an expert who can help you comprehend and choose the options best suited for your business.

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Mark Lazarus is a Director at Lazarus Legal. At Lazarus Legal, the [Startup Lawyers](#) are qualified to help startup founders identify and choose financing options and negotiate the best deals for our clients. If you're looking for expert legal help, [Connect](#) with their specialists today to explore the best capital raising option for your startup.

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