

Morgan Lewis

DEBT FINANCING FOR EARLY STAGE VENTURES

Matthew E. Scherneck

May 6, 2019

© 2019 Morgan, Lewis & Bockius LLP

Morgan Lewis Technology May-rathon 2019

Morgan Lewis is proud to present Technology May-rathon, a series of tailored webinars and in-person programs focused on current technology-related issues, trends, and legal developments.

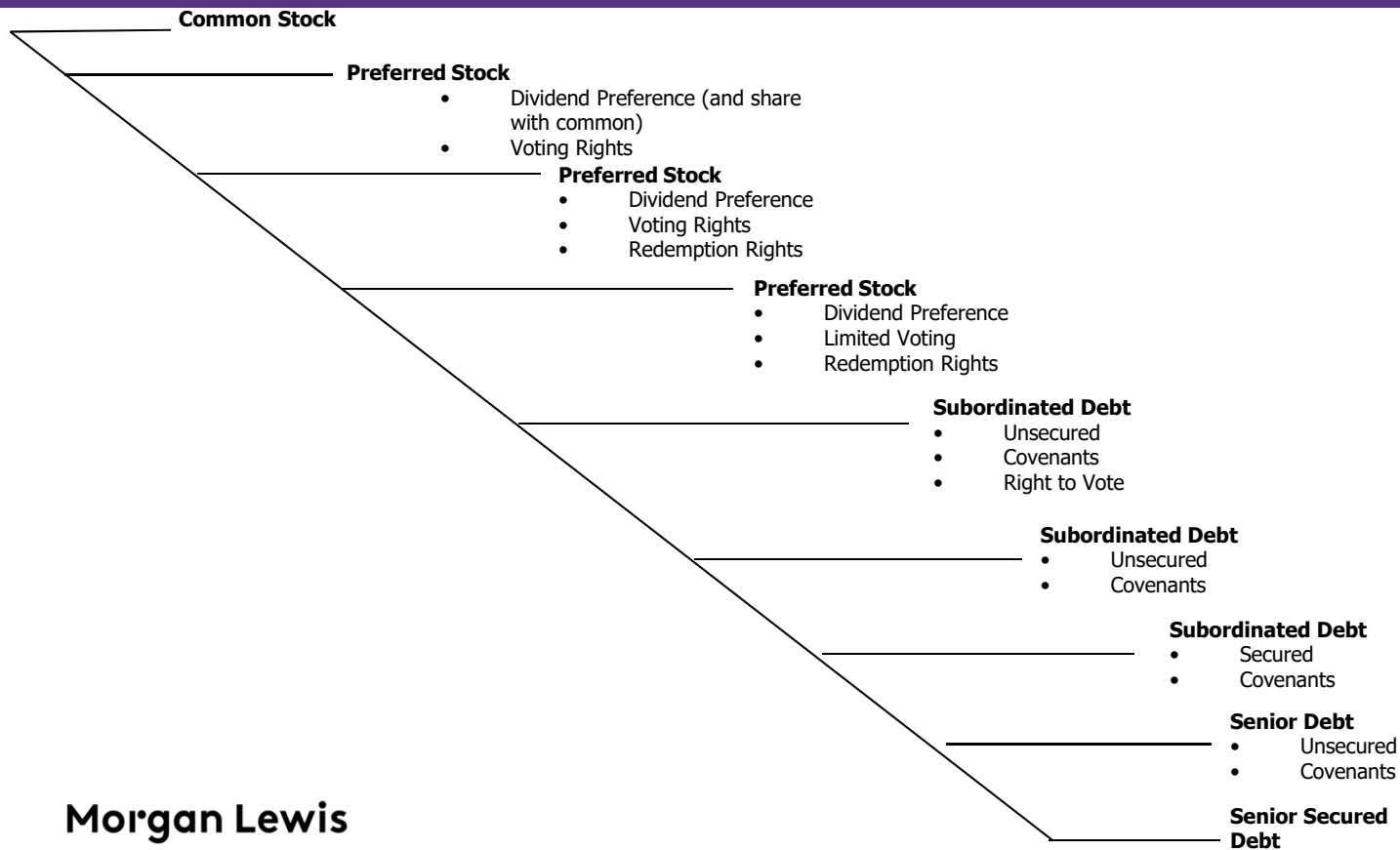
This year is our 9th Annual May-rathon and we are offering over 25 in-person and virtual events on topics of importance to our clients including issues of privacy and cybersecurity, new developments in immigration, employment and tax law, fintech, telecom, disruptive technologies, issues in global tech and more.

A full listing and of our tech May-rathon programs can be found at <https://www.morganlewis.com/topics/technology-may-rathon>

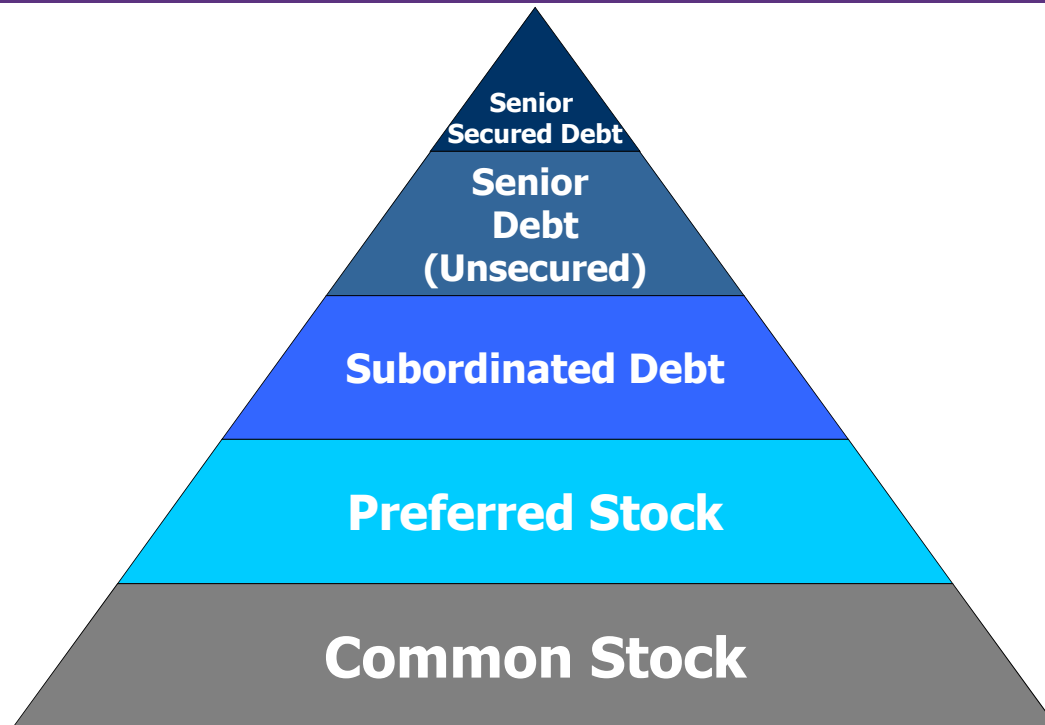
OVERVIEW

1. Capital Structure Characteristics
2. Early Stage Debt Financing – Debt vs. Equity
3. Early Stage Debt Financing – Fundamentals
4. Early Stage Debt Financing – Recent Market Trends
5. Early Stage Debt Financing – Term Sheet / Key Considerations
6. Early Stage Debt Financing – Collateral Issues
7. Early Stage Debt Financing – Pricing
8. Early Stage Debt Financing – IPO Implications

CAPITAL STRUCTURE - RANGE OF CHARACTERISTICS



Capital Structure – “Seniority”



Early Stage Debt Financing

Debt v. Equity

Debt Financing	Equity Financing
Debtor/Creditor Relationship	Equity Partner Relationship
Lower Cost of Capital	Higher Cost of Capital
Based on Cash Flow	Based on Expected Future Value
Periodic Interest Payments	"Interest" Accrued, but not Paid
Fixed Maturity Date	Defined Range of "Exit" Dates
Financial and other Covenants; Warrants	Less Restrictions
Retired through Operating Cash Flow	Redeemed through IPO, Recapitalization, or Sale
Board Observer Rights	Board-level Participation
Little to No Governance Involvement	Active Governance Involvement, as appropriate

Early Stage Debt Financing

Debt v. Equity (cont.)

Key Types of Debt

- Capital Expenditure/Equipment Financing
- Convertible Debt
- Bank Debt Financing/Accounts Receivable/Borrowing Base Credit
- Venture Debt

Early Stage Debt Financing

Key Considerations:

- Size (Dollar Amount)
- Duration
- Pricing of Loan (Fees and Interest)
- Timing of Amortization
- Covenants

Market Players

- Commercial banks with venture-lending arms
- Specialty Finance Firms
- Hedge Funds
- Venture Capital Funds

Morgan Lewis

Early Stage Debt Financing

Why Debt?

- Nominal to no dilution of capital
- Leverage equity raised to reduce the average cost of capital
- Extend cash runway
- Example:
 - Series A round: \$5 million at 20% ownership
 - \$25 million valuation
 - Monthly cash burn of \$500,000
 - Series A provides 10 month runway
 - Debt loan of \$1.5 million
 - Even with warrant at 50 bps, provides additional 3 month runway with 1/40th the dilution

Early Stage Debt Financing

Potential Obstacles

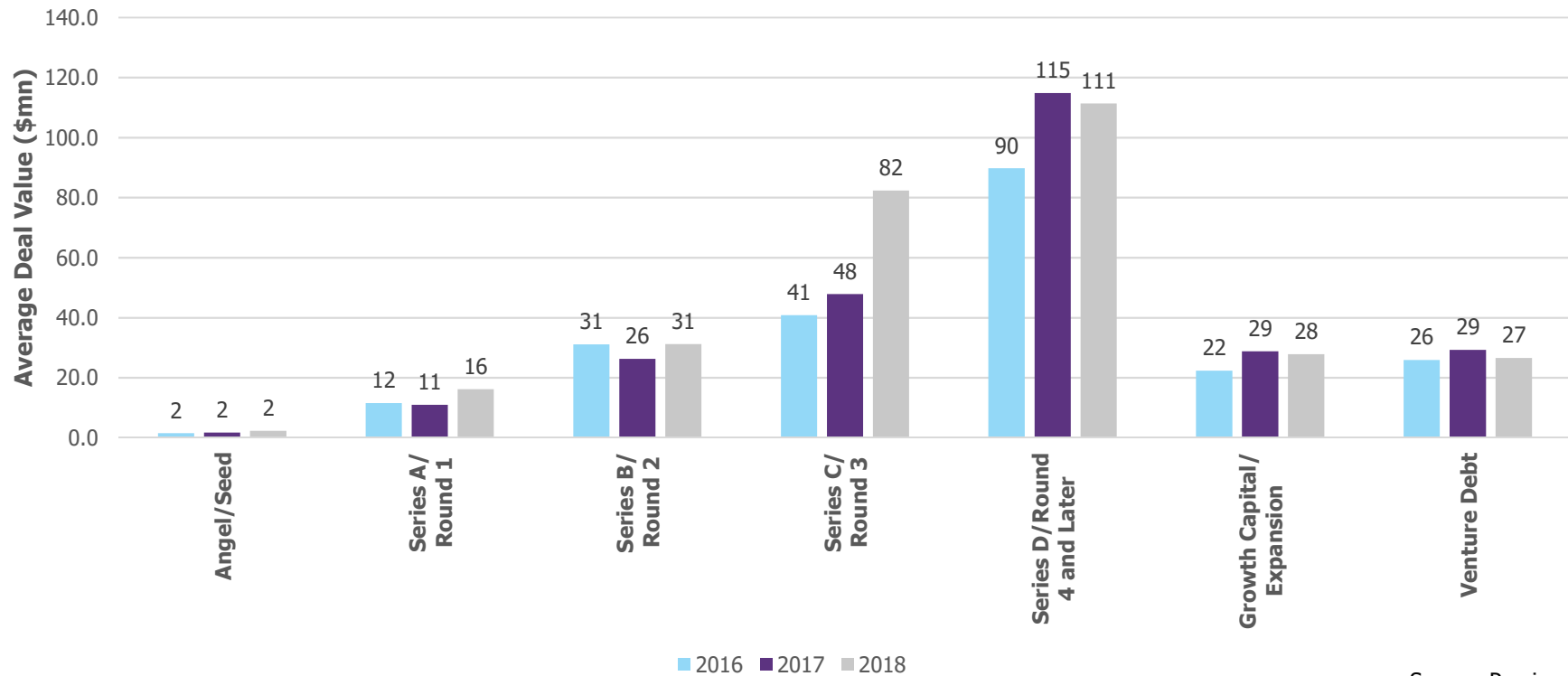
- Lack of track record
- Revenue
- Negative earnings
- Strong competition
- Cash on hand

Mitigants

- Founder's technical/market expertise
- Well-connected angel and venture investors
- Well-defined business plans

Early Stage Debt Financing Market Value

Fig. 5: Average Value of Venture Capital Deals, 2016 - 2018

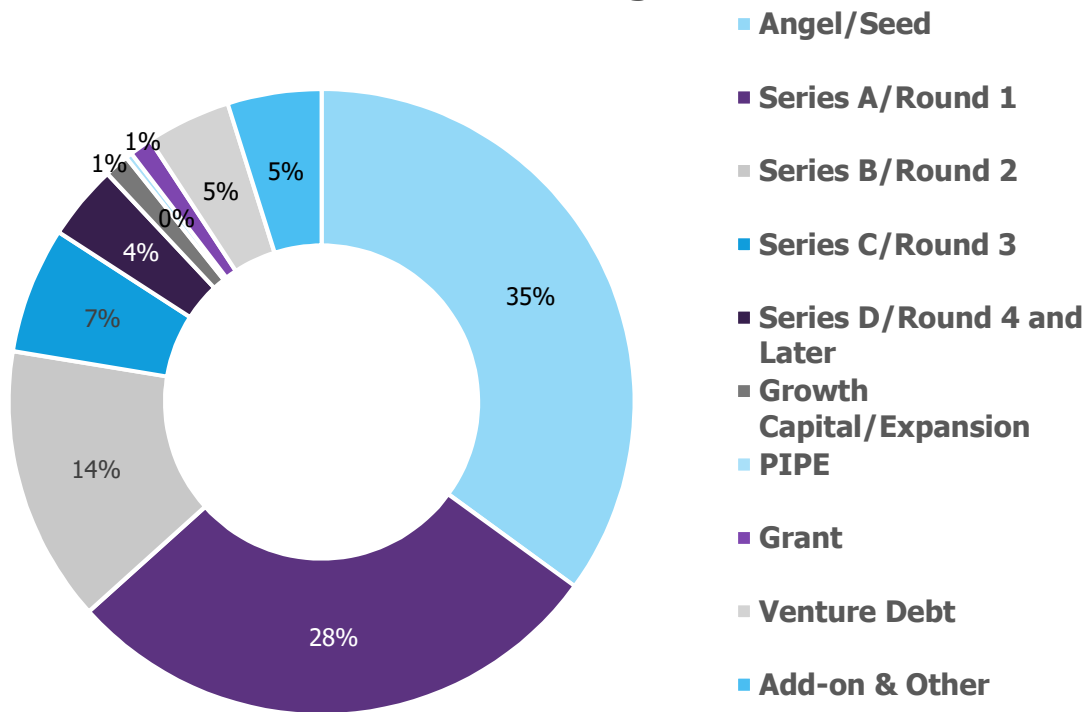


Source: Preqin

Early Stage Debt Financing

Recent Market Trends

Fig. 3: Number of Venture Capital Deals in 2018 by Investment Stage



Source: Preqin Venture Capital Report

Venture Debt = 14%
of deals in Q4 2018

Early Stage Debt Financing

The Term Sheet – Key Considerations

Closing Date

Due Diligence/documentation

Costs

Break Fee

Availability

- Entire Loan at Closing v. Tranched Loan v. Delayed Draw

Maturity Date/Repayment Schedule

- May be interest free for some period to reduce cash needed to service loan
- Bullet payments

Interest Rate

Morgan Lewis

Early Stage Debt Financing

The Term Sheet – Key Considerations (cont.)

Closing Fee

Maturity Fee

- Also known as an “End of Term” Fee; often in exchange for the reduction or absence of warrants

Prepayment Fee

- Make Whole v. Discounted Make Whole v. Percent of Drawn amount

Warrants

- Investor has the option to purchase stock in future at fixed price

Financial Covenants

Affirmative and Negative Covenants are common

Reporting

Board Observer Status

Board Seats

Morgan Lewis

Early Stage Debt Financing

The Term Sheet – Key Considerations (cont.)

Security and ranking

- Negative Pledges over IP

Legal Documentation

“Material Adverse Change” Clauses

Defaults and Events of Default

- Acceleration
- Waivers and Consents

Collateral Issues

Scope of collateral security is often negotiated

- Equity pledges only?
- Personal property only?
- Real estate collateral?
- Intellectual Property only?
- Bank accounts?

Collateral Issues

Exclusion for security interest in contracts that would be breached by grant of security interest

- Effect of UCC Section 9-406, 9-407, 9-408 or 9-409
- Overrides contractual prohibitions on granting of security interests in certain types of contracts, financial assets and licenses
- Allows lender to be a secured party in a bankruptcy
- Does not necessarily allow foreclosure, so if the contracts in question are critical collateral, loan structuring issues may arise

“Intent to use” trademark filings

Collateral Issues

Example exclusion

. . . notwithstanding anything in this Credit Agreement to the contrary, the term “Collateral” shall not include any (i) “intent-to-use” trademark applications for which a statement of use has not been filed and accepted with the United States Patent and Trademark Office or any intellectual property if the grant of a security interest therein would result in the cancellation or voiding of such intellectual property by the applicable Governmental Authority, or (ii) any agreement (including agreements relating to intellectual property) to which any Credit Party is a party, only to the extent and for so long as the terms of such agreement or any requirement of Applicable Law (x) validly prohibit the creation by such Credit Party of a security interest in such agreement in favor of the Administrative Agent (after giving effect to Sections 9-406(d), 9-407(a), 9-408(a) or 9-409 of the UCC (or any successor provision or provisions) or any other Applicable Law (including the Bankruptcy Code) or principles of equity) or (y) would result in a termination pursuant to the terms of any such agreement (other than to the extent that any such term would be rendered ineffective pursuant to Section 9-406, 9-407, 9-408 or 9-409 of the UCC (or any successor provision or provisions) of any relevant jurisdiction or any other Applicable Law (including the Bankruptcy Code) or principles of equity), in each case unless and until any required consents are obtained; provided further that Collateral shall include, and the security interest granted in the Collateral shall attach to, any proceeds, substitutions or replacements of any such excluded items referred to herein unless such proceeds, substitutions or replacements would constitute excluded items hereunder.

Early Stage Debt Financing Pricing

Market Terms - Traditional Venture Loan Types			
	Working Capital Facilities	Sr. or 2L Growth Capital Loans	Mezz./Sub. Debt
Typical Participants	Banks, non-bank growth lenders	Banks, non-bank growth lenders, select hedge funds	Non-bank specialty lenders, select hedge funds
Availability	Up to 85% of A/R Up to 50% of inventory Up to 100% of select PO's 3-6x MRR	Situation specific % of enterprise value Up to 50% of equity round 6-18x MRR % of specific asset or IP valuation	Situation specific Up to 5x forward EBITDA % of enterprise value
Interest Rate	4-7% floating	6-13% fixed or floating	9-15% fixed
Term	1-3 years	2-5 years	3-5 years
I/O Period	n/a	6-60 months	3+ years
Back-end Payment	Typically none	0-10%	0-15%
Warrant Coverage	Typically none	0-15%	0-20%
Collateral	1st lien on assets; negative pledge on IP	1st or 2nd lien on assets; negative/double-negative pledge on IP	2nd lien on assets or unsecured
Commitment Fee	Up to 1%	Up to 2%	Up to 2%
Prepayment Fee	0-2%	0-5%	3-5%
MAC Clause	Typically required by banks, typically not by other lenders	Typically required by banks, typically not by other lenders	Typically not
Liquidity/Financial Covenants	Liquidity / asset coverage Sometimes NONE	Equity raise Minimum liquidity Performance to plan Sometimes NONE	Debt service Minimum EBITDA Performance to plan Sometimes NONE
All-in Cost	5-9%	9-20%	15-25%

Morgan Lewis

Source: Spinta Capital

Early Stage Debt Financing IPO Implications

- IPO Activity is strong in 2019 and is anticipated to continue to be strong for the balance of this year. IPO's were roughly 54% of the value of all exits in Q1 2019
- Longer deals, including deals with debt capital in place, support a longer cash runway
- Debt deals postpone valuation negotiations (avoid down rounds and flat rounds)
- Bank debt working capital facilities evidence positive signals to the market
- Avoid or slow dilution

Source: PitchBook – NVCA Venture Monitor

CLE Alphanumeric Code

For those seeking CLE credit for this webcast, please keep the following alphanumeric code for your records: **LAI9932**

You will need this code to receive a Certificate of Attendance.

An attendance form and survey will pop-up after you exit the webinar.

Please fill out the form and you will be contacted within 30-60 days by our CLE administrative team.

We will process your credits for states where this program has been approved.

Questions? Please email **Jessica Feldman** at **jessica.feldman@morganlewis.com**

Q&A

Thank you for running in the 2019 Technology May-rathon with us.

We would be pleased to answer your questions.

The Q&A tab is located on the bottom right hand side of your screen. Please type your questions in the space provided and click Send. If we cannot address your question during the live program, someone will reach out to you directly via email with an answer.

Biography



Matthew E. Scherneck

New York

+1.212.309.6135

matthew.scherneck

@morganlewis.com

Matthew Edward Scherneck advises direct lenders, mezzanine investment funds, and venture capital investors on loans and other investment transactions with a wide range of borrowers across industry classes and of all sizes, types, and structures. Matthew also advises private equity clients and corporate borrowers on domestic and cross-border acquisition financings, out-of-court restructurings and workouts, bankruptcy matters, and real estate financings. Matthew leads transactions spanning diverse industries, including media and telecommunications, Internet and technology, food and beverage, real estate, retail, and healthcare. Matthew serves as the New York office local practice group leader for the finance group.

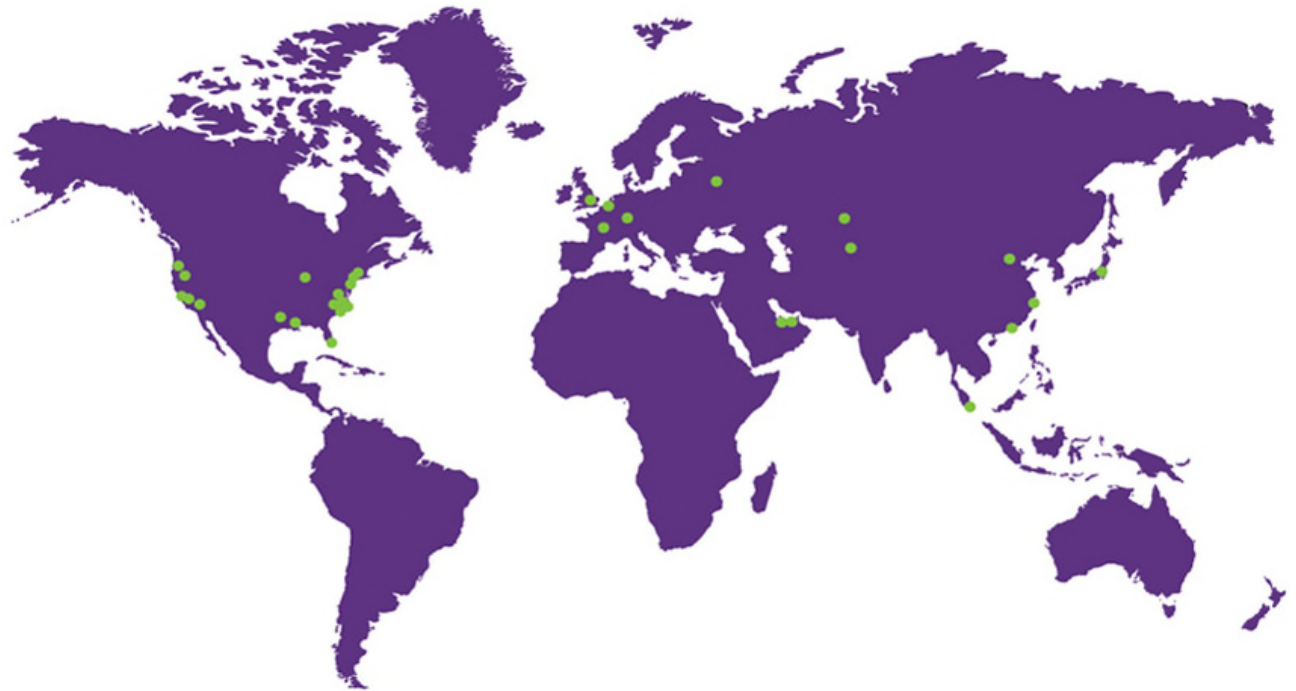
Morgan Lewis

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU

© 2019 Morgan, Lewis & Bockius LLP
© 2019 Morgan Lewis Stamford LLC
© 2019 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.

Morgan Lewis