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# DEBT FINANCING FOR EARLY STAGE VENTURES

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# Morgan Lewis Technology May-rathon 2018

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.

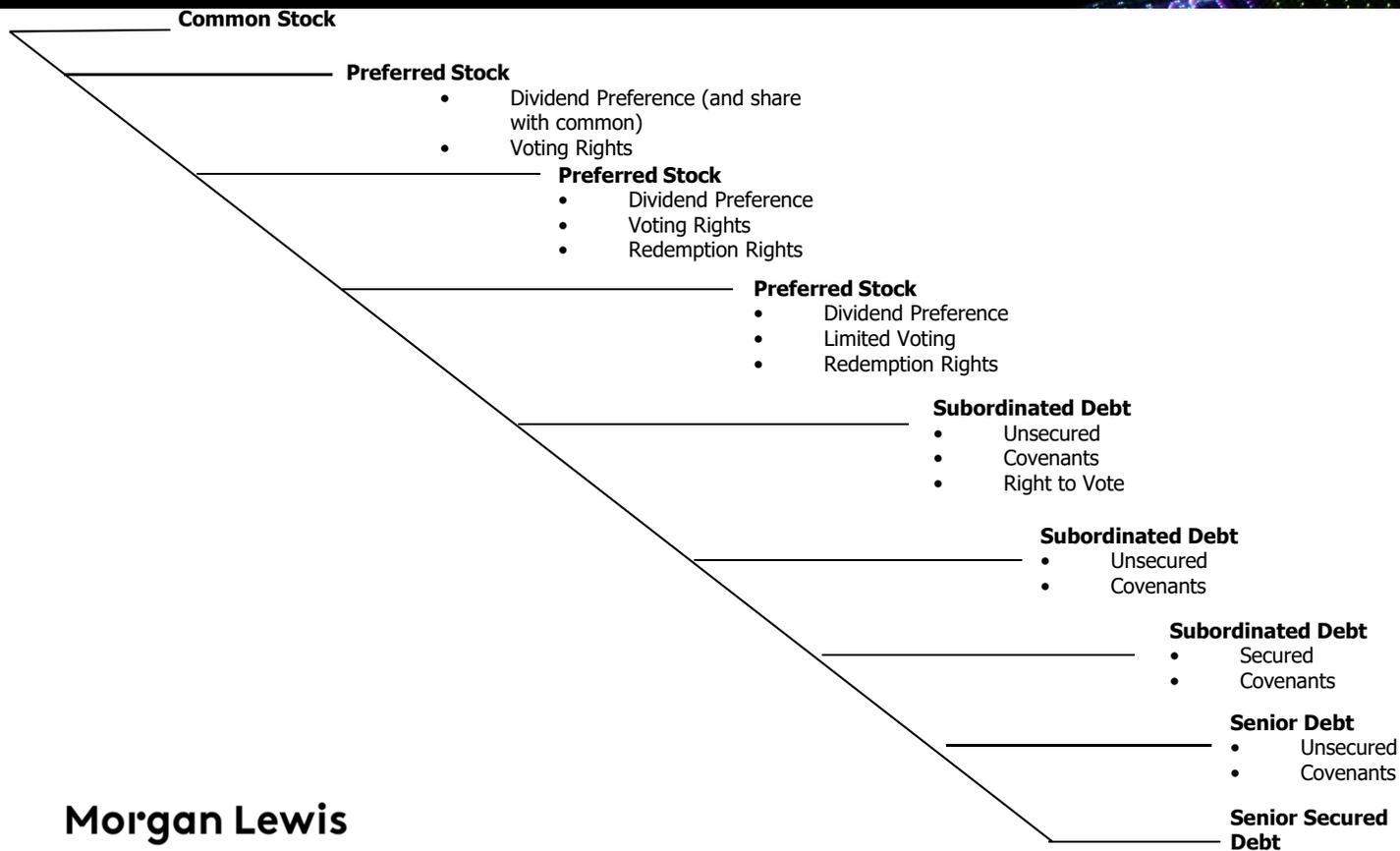
This year is our 8th Annual May-rathon and we are offering over 25 in-person and virtual events on topics of importance to our clients including issues of privacy and cybersecurity, new developments in immigration, employment and tax law, fintech, telecom, disruptive technologies, issues in global tech 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

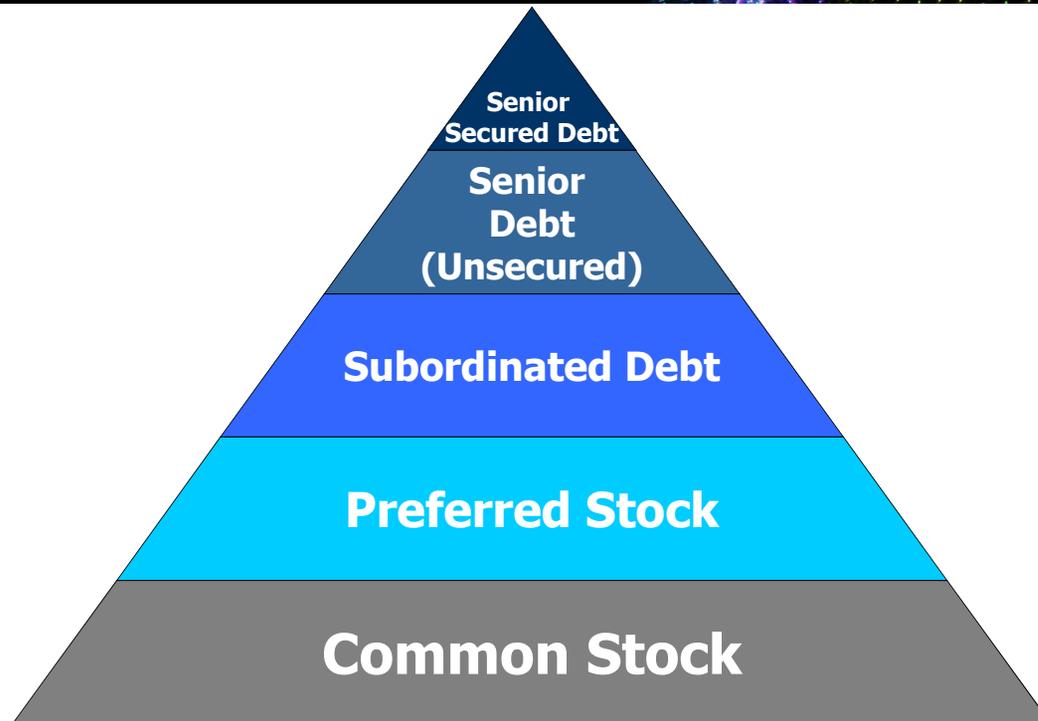
1. Capital Structure Characteristics
2. Early Stage Debt Financing – Debt vs. Equity
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# CAPITAL STRUCTURE - RANGE OF CHARACTERISTICS



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# Capital Structure – “Seniority”

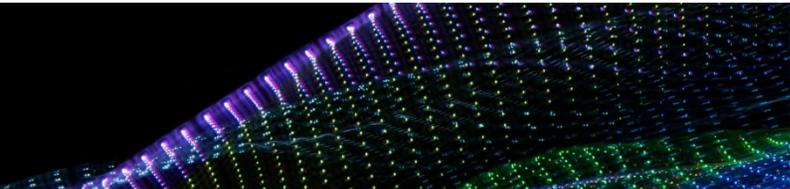


# Early Stage Debt Financing

## 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

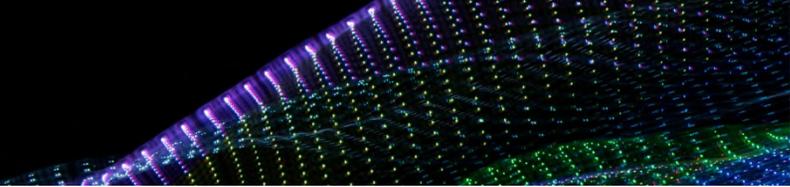
# Early Stage Debt Financing Debt v. Equity (cont.)



## 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:

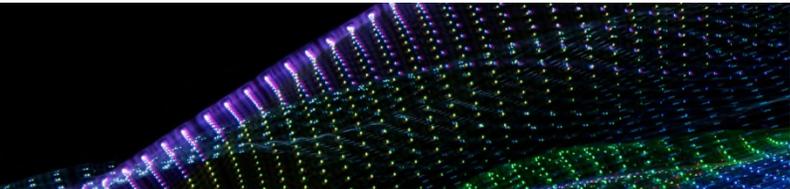
- Size (Dollar Amount)
- Duration
- Pricing of Loan (Fees and Interest)
- Timing of Amortization
- Covenants

## Market Players

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

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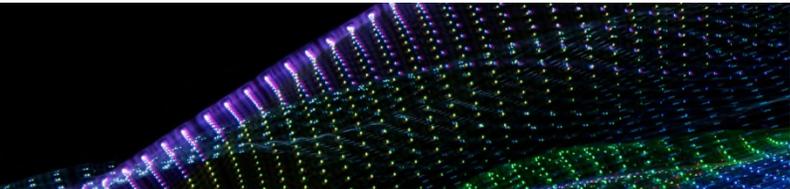
# Early Stage Debt Financing



## 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

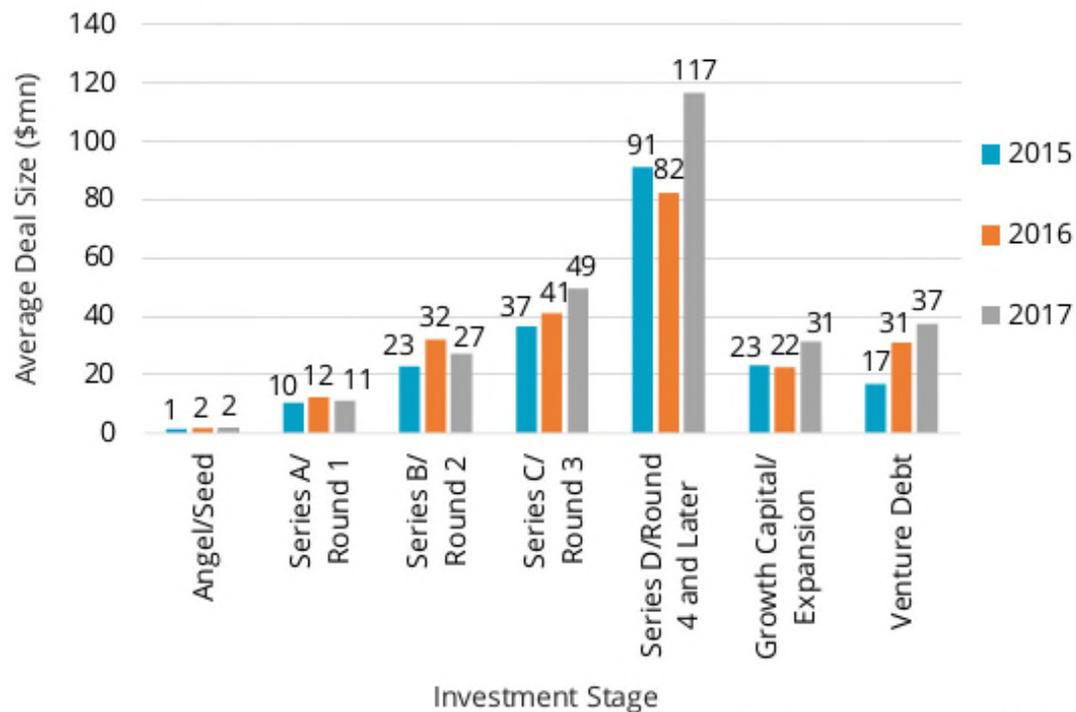
- Lack of track record
- Revenue
- Negative earnings
- Strong competition
- Cash on hand

## 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 by Investment Stage, 2015 - 2017



# Early Stage Debt Financing

## Recent Market Trends

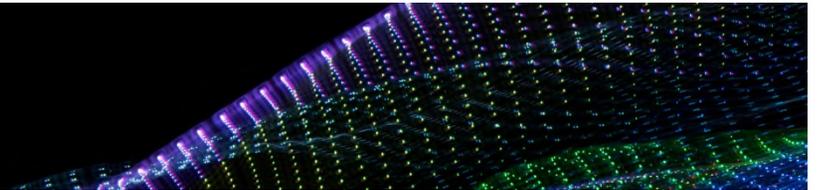
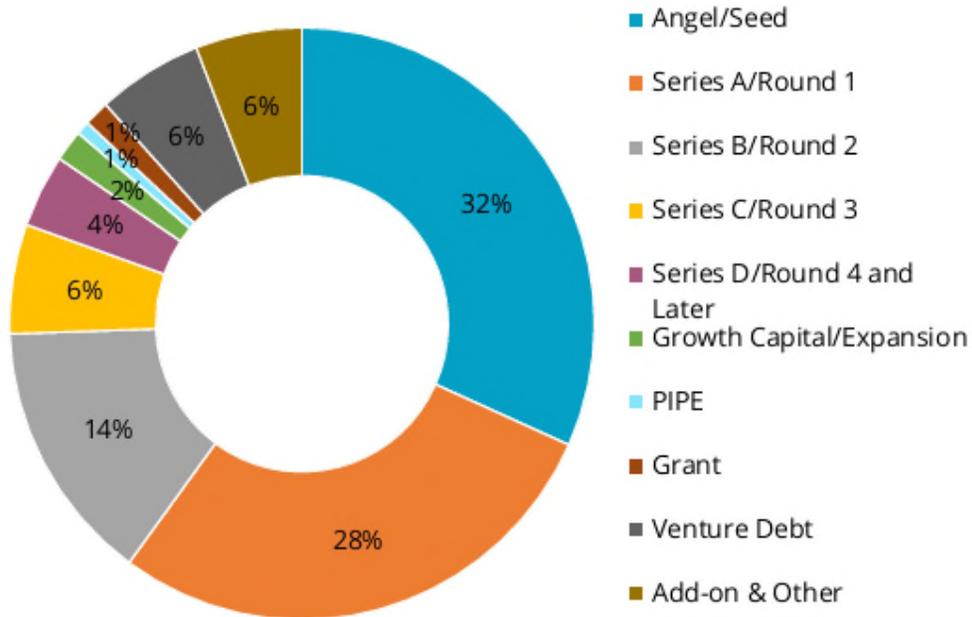


Fig. 3: Number of Venture Capital Deals in 2017 by Investment Stage

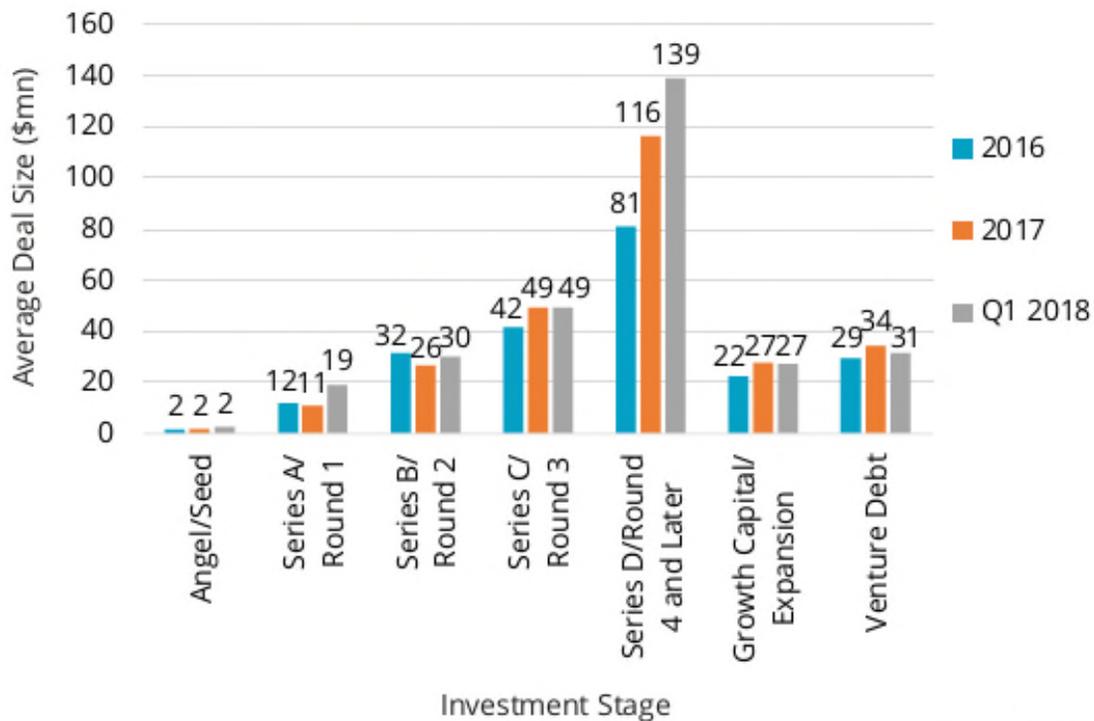


Venture Debt = 14%  
of deals in Q1 2018

Source: Preqin Venture Capital Online

# Early Stage Debt Financing Recent Market Trends (cont.)

Fig. 5: Average Value of Venture Capital Deals by Investment Stage, 2016 - Q1 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**

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# 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**

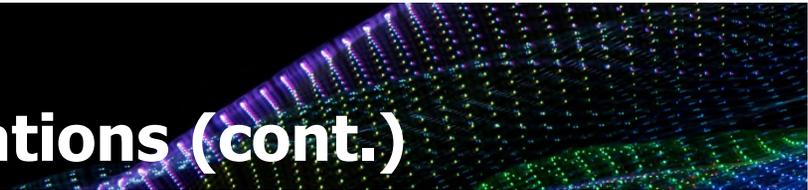
### **Affirmative and Negative Covenants are common**

### **Reporting**

### **Board Observer Status**

### **Board Seats**

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# **Early Stage Debt Financing The Term Sheet – Key Considerations (cont.)**

## **Security and ranking**

- Negative Pledges over IP

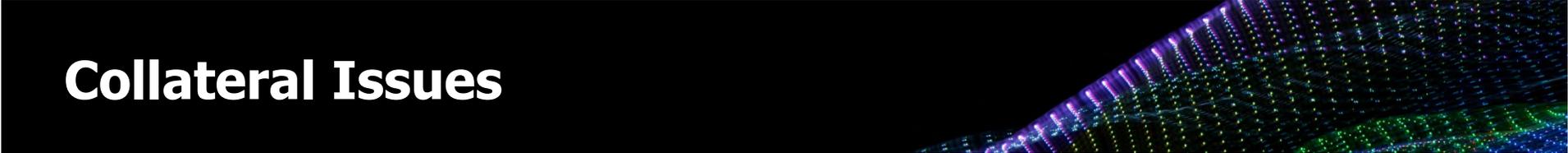
## **Legal Documentation**

## **“Material Adverse Change” Clauses**

## **Defaults and Events of Default**

- Acceleration
- Waivers and Consents

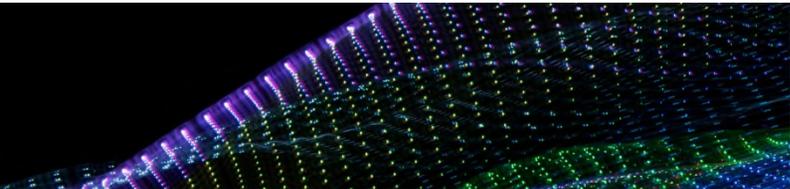
# Collateral Issues



## **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

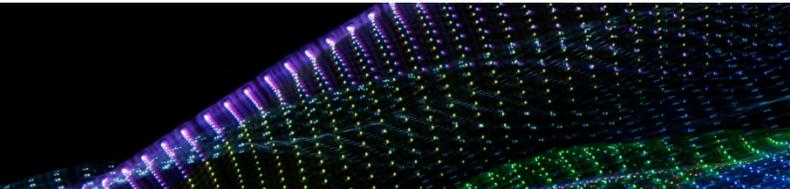
Market Terms - Traditional Venture Loan Types

	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%

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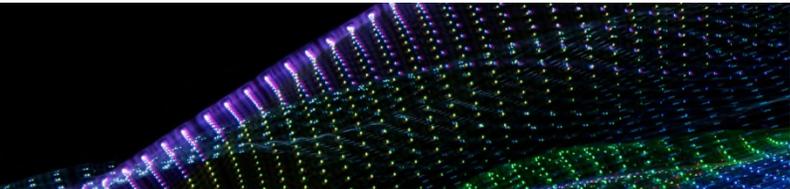
Source: Spinta Capital

# Early Stage Debt Financing IPO Implications



- IPO market was 19% weaker in Q1 2018 than the prior year period
- 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

## Q&A



Thank you for running in the 2018 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.

## Biography



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Matthew Edward Scherneck advises second lien and mezzanine investment funds 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 on leveraged buyouts and corporate borrowers on domestic and international acquisition-related financings, real estate financing, out-of-court restructurings, bankruptcy matters, and workouts. Matthew's borrower-side client base encompasses diverse industries, including real estate funds, media, Internet, food and beverage, and traditional and Internet retailers.

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