Venture Credit: Finding Opportunity in Disruption

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AUGUST 23, 2022

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As disruptive as volatile financial markets can be to investors, there are often outstanding opportunities born out of the market turbulence.

One part of the market that is being particularly challenged this year is initial public offerings (IPO). According to Renaissance Capital, the number of IPOs being priced in 2022 year to date is down 87% compared to 2021, while the proceeds raised in public offerings is down to just $4.4B YTD compared to $142.4B in 2021 (as of 8/23/2022)[1]. Recently IPO'd companies have also seen their valuations get compressed, with the stock performance for recent IPOs -43% YTD versus the S&P 500's -13% loss (as of 8/23/2022)[2].

The drying up of IPO activity is having ripple effects throughout both public and private markets. Late-stage companies that were looking to raise money in the near future through an IPO are shelving those plans and delaying the "exit" that early investors had expected.

Earlier stage companies are also impacted, as their venture capital (VC) investors become more risk-averse and plan for a tougher fundraising environment. As a result, VCs are telling portfolio companies to preserve cash, plan for a longer time between fundraising rounds, and even prepare for down rounds or raising money at a lower valuation than the prior round.

This delay and challenge in fundraising create a predicament for early-stage companies. Many companies still have promising growth prospects, despite the economic uncertainty, yet remain in a phase of their life cycle where they need significant cash to achieve their growth potential. However, even with these cash needs, founders may be hesitant to raise equity capital at this time of weaker valuations, given the risk of significant dilution (meaning the founder has to give up a greater amount of equity in order to achieve the same amount of funding).

It is out of these disruptions in venture equity funding that today's opportunity for venture credit emerges. It is important to note that beyond the near-term dynamics, venture credit is an attractive long-term opportunity for suitable investors, even in a healthier and more normalized fundraising environment, given the risk and return characteristics detailed below.

What is Venture Credit?

Venture credit, or venture debt, is a loan specifically designed for fast growing, early-stage companies. It is often used between equity financing rounds to provide companies with the cash they need to meet their growth targets.

For companies, using venture debt is an attractive option in order to avoid significant equity dilution, mostly in an environment like today, when equity valuations have come under considerable pressure.

Venture credit is not intended to replace equity fundraising, but to complement it. For example, using debt can bring down a company's total cost of capital (equity fundraising can be expensive to founders and existing investors who have to give up ownership to the new equity holders) and provide the company with additional time to raise equity at more attractive valuations.

For investors, venture debt is attractive because it often generates a much higher yield than traditional fixed income, has some downside protection built in through strong covenants (the lending terms to which companies agree), and has the potential for greater upside given the addition of equity-like kickers, such as warrants.

How is Venture Credit Structured?

Venture loans are structured to meet the unique needs and risks of individual companies, but they tend to have the following similar characteristics:

Higher Yields: In order to compensate investors for the greater risk associated with early-stage companies, venture loans tend to carry much higher yields than traditional credit, often low-double-digits to mid-teens yields.

Shorter Time Horizons: Most venture loans are structured to mature in three years or under, often being repaid during the next financing round. These loans often include prepayment penalties that compensate the lender if the company chooses to repay the loan early. The immediate yield generation and shorter loan life mean that venture credit investors begin getting capital returned to them much sooner than equity investments.

Floating Rate: Many venture loans have floating rates, so as prime lending rates increase in the economy, the interest rate the venture loan generates will increase. Loans often have floors on the interest rates as well, resulting in debt investments with much less interest rate sensitivity than fixed interest rate loans.

Made to Companies With Low Debt Currently: In order to control risk, venture lenders will ensure that loans are made at low loan-to-value ratios, meaning the company does not already have significant debt compared to its valuation. Typically, the loan size will be 20-35% of the last equity round, or 6-8% of the total company valuation (as of 8/23/2022)[3]. In addition, venture lenders will ensure that loan covenants are put in place to ensure companies do not take on additional debt. As a result, venture companies will typically have much more equity and much less debt than more mature, middle-market companies. Because of these covenants and low debt levels, venture debt has often had lower default rates and higher recovery rates compared to loans made to other risky, yet more mature and indebted borrowers.

Senior in the Capital Stack: Venture loans are senior secured loans, meaning they are at the "top" of the capital stack, or the first to be repaid in the event of a restructuring or bankruptcy (before preferred and common equity holders).

Outside of the Traditional Lending Environment: The opportunity for venture credit exists because many traditional lenders, meaning banks, cannot take on the risk of lending to such early-stage companies. These companies are oftentimes rapidly using cash and do not have meaningful assets against which they can borrow.

Include Equity Upside in the Event of Success: Most venture loans come with an equity "kicker," often in the form of warrants, to allow investors to participate in equity upside if the company is successful. Warrants are the right to buy equity at a set price in the future. Warrants are valuable to investors if the value of the equity has increased above the warrant strike price. If a company is successful and its equity valuation increases meaningfully, these warrants can enhance the returns in the venture credit fund, or offset credit losses in other investments in the venture credit portfolio.

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What is the Expected Risk and Return Profile for Venture Credit?

Risks

The risks with venture debt come from the significant business risks associated with early-stage companies, which could result in credit losses. Venture companies face significant challenges and uncertainties in scaling their businesses and achieving profitability, with many early-stage companies failing at various stages of their life cycle. If a company falters, it may have trouble repaying its loans, causing losses for credit investors.

Unlike other debt investments, interest rate risk is mitigated through floating rate loans. Still, if companies experience significant duress due to a rise in interest rates, lenders may need to consider restructuring to preserve the stability of the company and the capability to repay the loan principal.

Returns

The returns for venture credit investors come from the yield, repayment of principal, and the equity component.

The yield on venture debt is high compared to other debt, often ranging from low-double-digits to mid-teens yields.

This high yield compensates investors for the risk they take by lending to early-stage companies, while companies are willing to pay these rates because it is still a better alternative compared to significant equity dilution. Further, companies are often willing to pay higher yields than other lenders are offering in order to partner with strong venture credit providers who can be very valuable through their network and guidance during the next capital raise. There are also inefficiencies in the venture lending market, with gaps in market coverage that allow niche players to provide much-needed capital at rates that are attractive to investors.

Repayment of loan principal is, of course, an essential part of achieving total returns. As a result, prepayment penalties are built into the loan to cushion returns if companies choose to repay the loan early.

The potential equity component of the returns usually comes from warrants that are issued with the loan. These warrants give the lender the right, but not the obligation, to buy equity in the future at a set price. Suppose the borrowing company is successful and experiences significant equity value appreciation. In that case, these warrants become valuable to the lender, who can buy the equity below market value, and thus significantly enhance overall returns. Note, these warrants can have longer terms than the loans themselves, meaning the equity upside can take longer to materialize than the debt component. Some funds will also do direct equity investments or convertible notes to enhance the equity portion of the returns (here is an important distinction that the venture debt itself is typically not a convertible loan, meaning it is intended to be paid back and not converted into equity).

All in, venture credit funds typically target 15-20% gross IRRs (internal rate of return), with the majority of returns coming from the high base yields, with the potential for upside from the equity warrants and strong loan performance, and downside from credit losses.

Venture credit returns are expected to have a lower correlation to public markets and the economy than other alternative asset classes. First, the yield generated from the loans is stable through market turbulence, outside of major credit events. Second, because venture credit acts as an attractive alternative

to equity fundraising in between rounds, venture credit does not need an open and liquid IPO market to thrive (unlike other parts of venture investing, like late-stage venture). Broader market disruptions can even be attractive for venture credit because they reduce financing competition and allow lenders to demand better terms, including a larger equity warrant allotment. Of course, if the economy were to experience a protracted and severe downturn, businesses could have trouble repaying loans, resulting in credit losses. Strong underwriting and proper sizing of loans help to mitigate this risk.

Comparing Risk and Returns for Venture Credit and Venture Equity

Though the risk of credit loss in venture debt is meaningful, hence the high yields, venture credit is less risky than venture equity, given the debt is senior in the capital structure (gets repaid first, where equity is last) and often has significant downside protections built into the loan terms. For example, in the event of a failure in the business that results in a restructuring, equity holders could see their equity stakes become worthless or, at best, significantly diluted. In contrast, senior debt holders have a greater chance of some repayment.

Of course, lower returns for venture debt come with lower risk than venture equity. Venture equity has the potential for much greater upside, while venture credit will generate comparatively lower, but more consistent returns, mainly through its yield component.

The returns from venture credit are often experienced in a much shorter time frame than venture equity. Venture credit begins generating income for investors as soon as loans are deployed, while returns from venture equity can take years to materialize, waiting for an eventual exit via an IPO, acquisition, or other transaction. As a result, venture credit will return capital to shareholders much faster than venture equity and often has much shorter fund lifespans.

Because of its different risk/return profile, venture credit should not be seen as a substitute for venture equity, but instead, as a compliment to venture equity exposure and an attractive way to boost yield and return in a broader portfolio, while still controlling risk. In a low return world for public equities and fixed income, venture credit can be a compelling investment option for appropriate investors.

How Can Investors Get Exposure to Venture Credit and What Makes Venture Credit Managers Successful?

In order to get exposure to venture credit, we look to venture credit limited partnership funds that are managed by experts in the field. We look for the following characteristics in fund managers for venture credit investments:

Reasonable Size: Smaller funds are easier to manage and can be more selective with their loans. A smaller number of deals in each fund allows fund managers to be closer to their borrowing companies, while also enabling successes in a smaller number of deals to have a more significant impact on fund returns. Smaller funds can also exploit niche opportunities that larger players cannot address.

End Market Expertise: Having expertise in the end markets where the fund is lending is critical. This allows the fund to find opportunities that other lenders, like venture-focused banks, may have missed, and allows for a more accurate assessment of each portfolio company's risks.

Conservatism in Underwriting, and Robust, Ongoing Due Diligence: Mitigating credit risk is the most important step in achieving the targeted return profile for venture credit. We look for funds that target

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low loan-to-value ratios, are not making aggressive assumptions about exit valuations just to pay back the loans, and have built-in proper covenants for downside protection. Further, we look for managers that avoid binary-outcome, or one-product companies, where credit risk is far greater in the event of the one-product failure. Fund managers should be deeply engaged with portfolio companies and their management teams, and have done significant due diligence on the businesses in order to achieve comfort with risks. Lastly, fund managers should also have close relationships with the company's other capital partners to get confidence in these partners' willingness to provide further financing support in the future.

Strong Industry Relationships: Venture capital is a relationship-first industry. We prefer to invest with long-standing industry participants who can use strong relationships for access to attractive deals and for pricing power given their strong networks and what they can bring to potential borrowers. In addition, we want to avoid new entrants, or "tourists", in venture, given the higher barriers to entry due to relationships and the risk of poor execution.

Footnotes

[1] https://www.renaissancecapital.com/IPO-Center, 8/23/22

[2] Renaissance IPO index and S&P 500 returns via Bloomberg, 8/23/22

[3] Silicon Valley Bank, How Startups Use Venture Debt, 8/23/22

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