Venture and growth

INTERNATIONAL DEBT FINANCE INTELLIGENCE REPORT 2024 SUPPLEMENT

DLA PIPER

Venture and growth

A maturing market, an agile product

With a dedicated Venture and Growth practice spanning the US, the UK, Ireland, Europe and Asia, DLA Piper has played a key role in the development of this global lending product. The product was initially geographically focused in California and New York, then growing in Europe and Asia, with particular focus on the technology, healthcare and life sciences hubs. Initially concentrating on early to mid-stage venture debt, the product suite has grown to include mid- to late-stage growth financings involving larger debt levels, co-lending arrangements, syndicated financings and more tailored documentation.

Venture and Growth Debt Finance remains popular. It has an important use in lengthening the growth runway between equity rounds, pertinent in times of unsettled equity markets. At the later stages, it allows for scaling up pre-exit, its use is non-dilutive (save for warrant issuance) and does not create an equity pricing event. The latter feature is particularly welcome when valuations would otherwise imply a flat or down-round for an equity raise.

Venture and Growth Debt Finance products serve a very specific section of the market – they're specially designed for early stage and high growth companies. Given they cannot be built around an EBITDA model, other testing measures have been developed around KPI measures, for example recurring revenues (monthly or annually, MRR or ARR), numbers of customer contracts, progress of drug licensing and testing, minimum liquidity and burn rate coverage. Availability is often tranched, stepping up on milestone achievement.

In some cases, no measures are realistically possible, and the debt case is a derivative of the equity case. Lenders in the market have a specialist focus, typically staying very close to the equity funders and the management teams. Monthly monitoring of cash and KPIs is normal. This high level of focus and adaptability has helped the evolution of Venture and Growth Debt products to support this section of the market, and the product suite has continued to adapt.

This market has changed dynamically and positively year on year (even in a turbulent year as we have just seen), with the debt quantum available and number of deals increasing, and new entrants to the market providing new products and approaches.

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Venture and growth debt in 2023

Early in the year, against a backdrop of an unsettled equity market, and pressures caused by the marked and swift increase in base rates, we experienced a drop in venture finance activity. Nervousness around the equity case and valuations, uncertainty around the timing of future funding rounds, and the impact of increased interest costs on burn rates all contributed to an increased focus on fixed cost control in managing the cash runway. This led to tighter credit terms, more use of warrants and some more forms of financial covenant/metrics. We also saw greater use of tranched loan availability depending on performance and increased use of minimum liquidity maintenance covenants.

The waves caused by the circumstances that hit Silicon Valley Bank and others created further changes in a market which was already evolving at a fast pace. New players have entered the market, which is now very much on the radar of all the major international banks. BlackRock's acquisition of Kreos Capital underlines the increasing attention paid to this market.

The product has shown resilience, and indeed the number of deals has increased year on year. The latest data available at the time of writing shows a total of 345 deals having been completed in Europe at the first half year 2023 compared to 337 for the whole of 2022.[1]

Our experience of H2 2023 would indicate this momentum has been maintained, or at least picked back up in Q4 after a slower Q3.

Market participants report that given the pickup in the equity markets, valuations at least appear to be stabilising, while still down from the all-time highs of previous years. The slow-down in IPOs exits and the unattractiveness of a down-round or even a flat round may partly explain the resilience of – or at least the continued appetite for – debt in this market.

A maturing product: has Venture and Growth Debt come of age in Europe?

From some 35 recorded deals in 2012 to in excess of 350 last year, European initiated Venture and Growth deals have shown consistent growth. Against the backdrop of a challenging equity market and increased interest costs, providers have shown adaptability and made changes to key features in response. For example, the use of extended interest only periods, the ability to PIK, the charging of fees at the "back end" and, the inclusion of adapted covenants crafted to allow stepped drawdown based on performance to manage risk.

The number and variety of providers has ensured that there's a range of product variations and approaches, from small facilities on very standardised terms at the below EUR2.5 million mark to bespoke LMA derived facilities at the EUR15 million plus mark, with variations in between and, at the larger end of the market, syndicated facilities being provided. Venture and Growth Debt has now taken its place alongside ARR- and EBITDA-based leveraged facilities in the established spectrum of funding, and it's no surprise the larger financial institutions are attracted to this space to be able to offer the full range of support to startups as they move through the lifecycle to growth, pre-IPO and beyond.

> *We see providers having confidence in lending into multinational structures across Europe as the startup ecosystem – particularly across the Nordics and Germany – is very well established.*

The startup and growth economy is viewed favourably by many governments as a key area of innovation and growth. The German government, for example, has recently passed the Financing for the Future Act (*Zukunftsfinanzierungsgesetz*), which contains various legal frameworks to improve the financing of forward-looking investments and to facilitate capital market access for businesses, particularly startups, high-growth companies and SMEs. The importance of the startup and growth economy to the tech sector was also underlined in the UK when the collapse and rescue of Silicon Valley Bank was closely attended to by the Bank of England. The need for life sciences innovation and funding was all too keenly shown during the pandemic.

[1] Houlihan Lokey Venture Debt Market in Europe, January 2024

Themes to look out for in 2024: Are we witnessing the start of a new cycle?

PORTFOLIO MANAGEMENT

Given current activity levels, the outlook at the beginning of 2024 looks positive, however there a good many Venture and Growth borrowers spending longer time "on the books" and hence the portfolio has grown. We're seeing more term extensions and readjustment of covenants, whereas historically we would see more frequent redemptions, refinances and exits. In some cases, we're seeing work-outs and restructurings as companies re-shape facilities due to underperformance.

DOWN (AND FLAT) ROUNDS

Valuations may be stabilising, but where they remain lower than the valuations underpinning earlier fundraisings, for companies with insufficient burn coverage we'll see flat- or down-rounds, unless further debt can be raised to extend the runway. Lenders holding warrants – and those taking new warrants – will be focussing on down-round protections.

CONSOLIDATION

We're starting to see some portfolio companies grow through consolidation by acquiring underperforming or less well funded rivals. This is not normally part of the growth business plan but we anticipate opportunities will arise. They're normally equity funded, but lenders will need to be brought on board to give consent.

SECONDARY MARKET

We expect an uptick in exits via IPO or sales, but while markets remain slow, we anticipate investors will be looking for other ways to provide returns to portfolio investors, for example by tapping the secondary market in venture investments. Lenders will be looking at the change of control provisions in their debt facilities, and may also be considering ways in which they can diversify their exposure by way of sub-participation or transfer.

CASH IS STILL KING

We expect to see a continued focus by lenders on burn-rate, minimum liquidity and effective monitoring. We also expect to see a continued focus on cash management and security – particularly on cross-jurisdictional deals. For their part, we anticipate borrowers will be all too aware of the dangers of putting all their cash in one basket, however unlikely a repeat of the situation that affected Silicon Valley Bank and others in March last year may seem.

SUMMARY

Venture and Growth Debt has become an established and better understood product area internationally – it has proved agile and adaptable in a changing market, and 2024 looks to be another year of growth and opportunity.

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