360 Leaders CFO Breakfast Forum

Hosted by Steven Dunne, Frog Partner and CFO

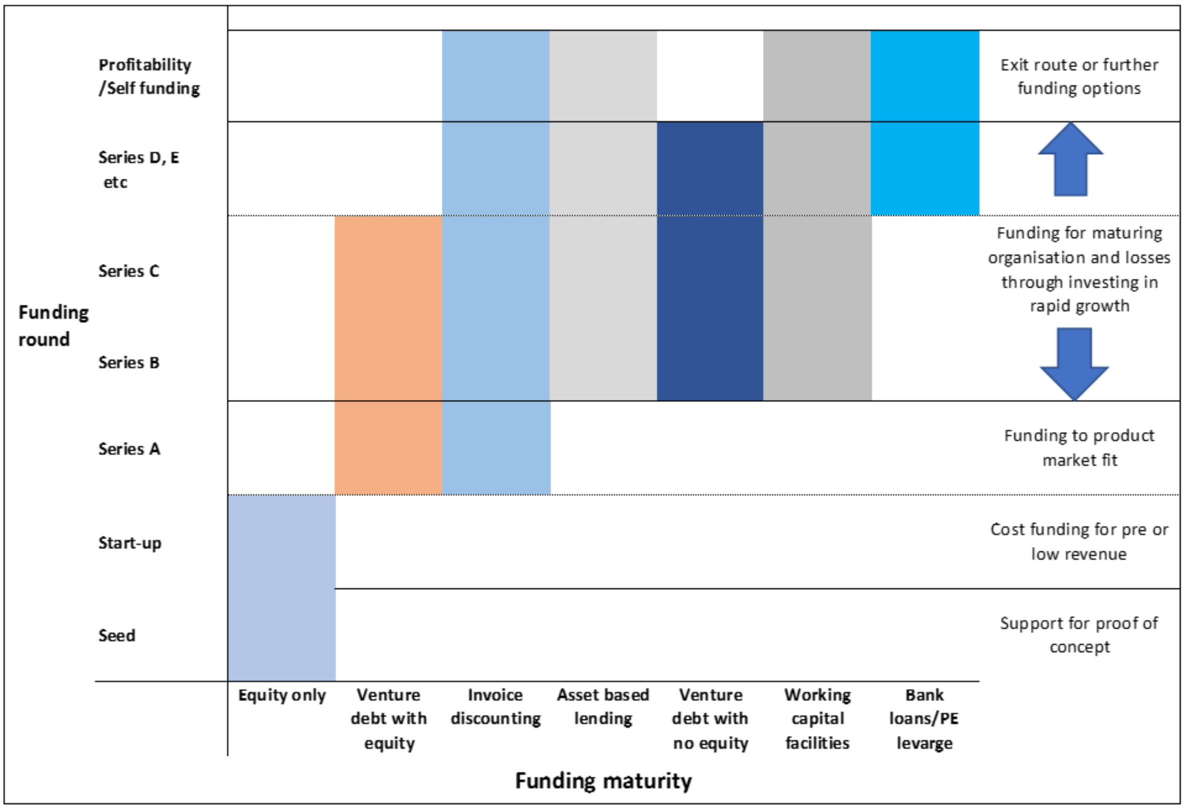
3 October 2017

Frog and 360 Leaders host event discussing funding options through the venture capital cycle.

Frog was delighted to host over 20 people at a breakfast in the Mews to discuss venture debt and other debt-like options. Harbert's Jerome Fonteneau shared his perspective on venture debt criteria and provision.

It was great to see so many of the Frog portfolio CFOs in attendance; a special mention must go to Raphael travelling in from our Berlin investment, McMakler. The portfolio CFOs took full advantage of the opportunity to get to know each other but it was also fantastic to meet new faces from the 360Leader invites. Participation was excellent from the start and demonstrated a wealth of diverse experience that the CFOs were very happy to share with each other.

The following visual was used to structure the discussion through the lifecycle.



Venture debt is a hot topic at present, not least because HMRC identified it as a weakness in the UK VC ecosystem that is a contributory factor to lower scale-up conversion to bigger companies than in the US.

Early stage venture debt

At the early stage of the lifecycle, Jerome explained that the minimum venture criteria are: a proven business model; ideally £1m revenue and a credible equity funding proposition although he explained that profitability is not a requirement. Venture debt is a good option to extend runway with less dilution than equity, but it must be carefully considered to ensure that the total cash impact is properly assessed (unlike equity it will be amortised(?)). The full cost should be taken into account including warrants or terminal bonus.

Providers will normally do their own due diligence and whilst a good equity syndicate is a positive, they will not want to rely on that. Covenants from venture vary depending on the provider and situation and can also be traded against cost. Feedback from those who had taken venture debt was that the covenants can sometimes hamper decision making. To avoid this, providers should remain open to discussions on covenants, a default not being good for either party. Whatever the specifics the earlier this issue gets addressed, the better.

No market formula exists for the venture debt amount that is appropriate but influential factors will include growth rate, balance sheet (equity invested and cash but not current assets) and the ability to retrench to a lower growth break even position. A common approach is to tranche the venture debt so that you only pay for what you need. This ensures the provider gets to see performance before increasing exposure.

Invoice discounting and other asset based lending (ABL)

Only a few people present had used the product, so it was explained that the lending against current invoices was invisible to clients, unlike factoring, where the debt is collected by a third party, posing a risk to client relationships. For some, invoice discounting was a good supplement for short term working capital peaks alongside venture debt. Others highlighted issues with bank lenders who have rejected an invoice discounting as it takes security from the business' facilities. Jerome was clear that as a non-bank provider, Harbert would be more concerned about long term value in the IP for example and would not care about current assets.

Invoice discounting can be an excellent support for growth but the consensus was that (i) it's a risk with a downturn or big seasonality (ii) customer concentration will make it unlikely (iii) good underlying credit risk of clients is vital (iv) they are not sophisticated lenders so you need to conform to a standard risk profile.

Given the tech nature of the businesses of most attendees, there was little experience of other ABLs but it was noted that there are interesting products out there like lending against future R&D tax credits or lease deposits and innovation loans.

Later stage venture debt

Businesses gaining scale and credibility can access venture debt without equity, but they almost certainly will be in a position where they could have raised more equity if they had wished. Venture debt providers are happy to see businesses outgrow them and then take on cheaper senior debt as part of a capital restricting exercise that might see both venture debt and venture capital being taken out, but equally, venture debt can sit behind bank debt.

Margin difference between venture debt and bank debt is very high at present due to low bank rates but historically is normally pitched at around 6% to get on overall return close to 10% for more mature businesses. At the early stage, the range might extend up to 20% depending on the risk factors.

Working capital facilities

CFOs who had worked within businesses further along in the scale-up journey talked about the requirement for increasing maturity in the business to take on working capital facilities. Some in the room explained that they had looked at working capital facilities but felt covenant-light venture debt was more flexible until they got closer to breakeven and better predictability. One suggestion was that revolving credit lines worked well with invoice discounting if provided by separate suppliers, though others noted that some banks insist on providing all or nothing to small businesses.

After a few comments about the final stage (usually the end of the scale-up journey with Frog) of reaching profitability, creating multiple options from mainstream debt and private equity to trade sale, the round table drew to a close, but it was great to see many participants stay on to continue the discussion.