Flow
Capital

THE FOUNDER'S GUIDE TO VENTURE DEBT

2020

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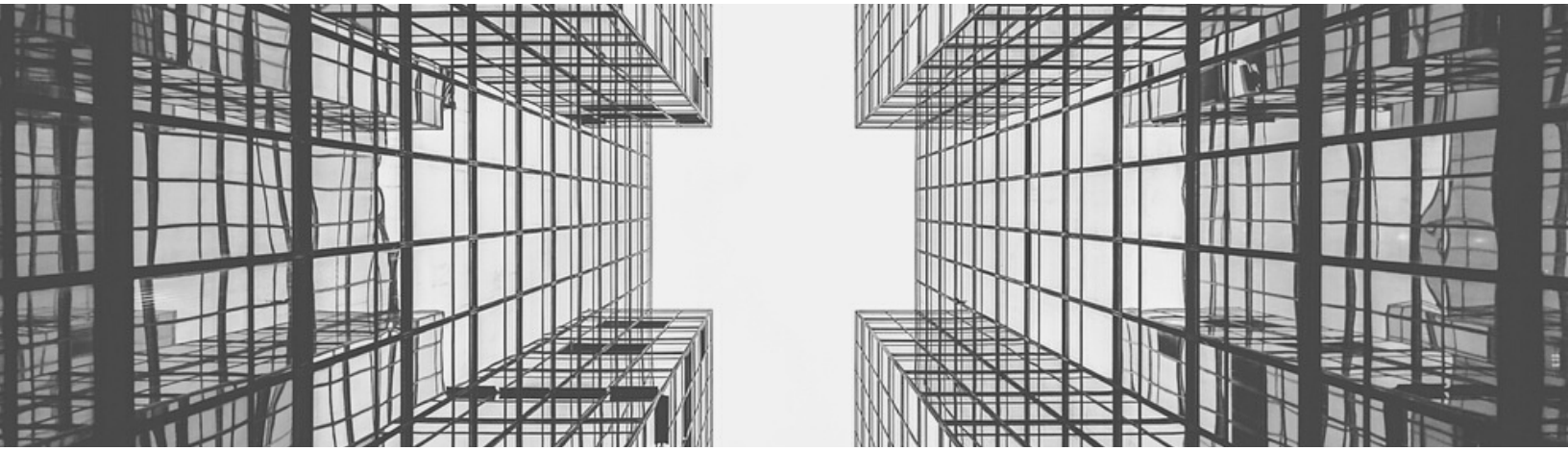


INTRODUCTION

As a founder or CEO of a company, you will find that raising capital is a significant part of your efforts and, for better or for worse, a major challenge. Understanding the basics of raising capital is crucial for success because capital is essential for fuelling growth. Unfortunately, the fundraising headlines you see as you scroll down your LinkedIn feed generally showcase venture-backed companies reaching astronomical valuations. Some founders and CEOs are under the false impression that the size of your VC funding round goes hand-in-hand with your level of success. Unfortunately, this isn't always in your best interest.

While equity can and does play a critical role in helping founders and CEOs meet their business goals, all capital comes at a cost. While being featured on the front page of TechCrunch highlighting your multi-million dollar equity round may be very appealing, using equity alone to grow a company has very important implications.

Increases dilution.
Not only does increased dilution lead to smaller payouts for founders, CEOs, and other investors when the company is acquired or goes public, but too much dilution too early leads to a loss of control over the direction of the business.

Gives up control.
Another component of the business you give up when you raise equity capital are board seats. This means you need to obtain consent from your equity investors when making important decisions, such as strategy, product roadmaps, and staffing decisions.

Forces a business valuation.
There are cases when the company is growing very quickly or is about to achieve a key milestone, where it would be better to defer a valuation until a later date when the business will likely be worth more.

Takes attention away from growing the business.
Raising equity can be a long and complicated process. This effort diverts management's attention away from what should be their key area of focus: growing the business.

The key to real success in raising capital is to optimize the company's cost of capital by finding the right combination of capital sources that enables you to maintain more control of the business for longer.

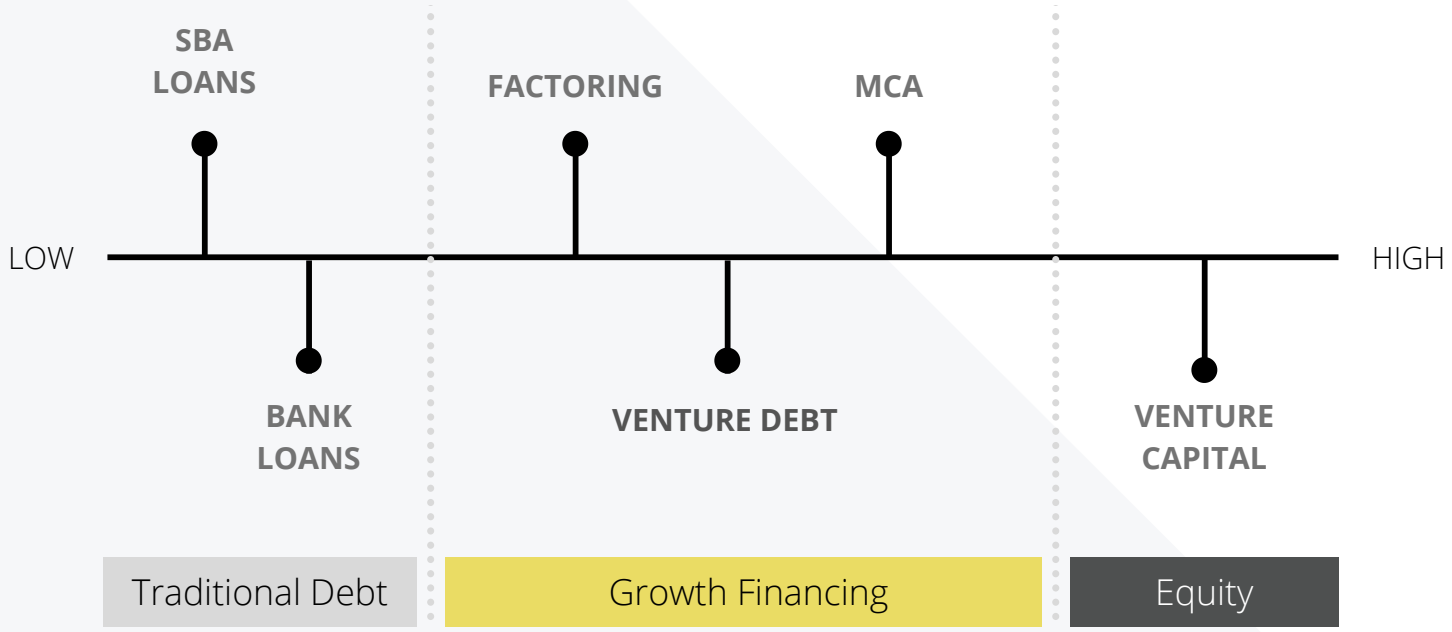
In this e-book, we will be introducing you to venture debt, how companies use it, when to use it, and tips for finding the right lender.

WHAT IS VENTURE DEBT?

Also known as venture lending, venture debt is an attractive financing option for early and growth-stage companies. This form of alternative debt generally consists of a term loan lasting up to five years with warrants on company stocks.

Venture debt is available to both non-VC and VC-backed companies as it can be used as a complement or alternative to equity financing. While it does require companies to be post-revenue, venture debt is a founder-friendly form of growth capital that enables businesses to reach their growth objectives while maintaining control and minimizing equity dilution.

Blended Cost of Capital



USES OF VENTURE DEBT

Extending Cash Runway

Venture debt plays a supporting role in extending cash runway, especially when the company is raising equity rounds. Typically, companies receive funding in stages (Seed, Series A, Series B, etc.) This format is beneficial for both the investors and the entrepreneurs. The equity investor reduces their risk by introducing multiple yes/no and valuation checkpoints, while the entrepreneur reduces dilution by raising successive rounds at higher valuations. Each funding round is designed to fund 12 to 24 months of operations. To help extend the cash runway of a business, venture debt can provide companies an extra cushion of cash in case of delays without significantly increasing dilution. This may also help to increase the company's valuation and result in a higher equity raise.

Preventing a Bridge Round

Bridge rounds are a small round of funding to hold a startup over until its next larger round of funding. These are structured as loans that convert into shares when the company raises its next round. Although this can be done quickly, it can be expensive and could be a signal to new investors that the company did not hit its target in the time planned. Instead, venture debt provides no signalling risk, frees up the full amount of equity to be raised fresh at the round, and it does not require a valuation.

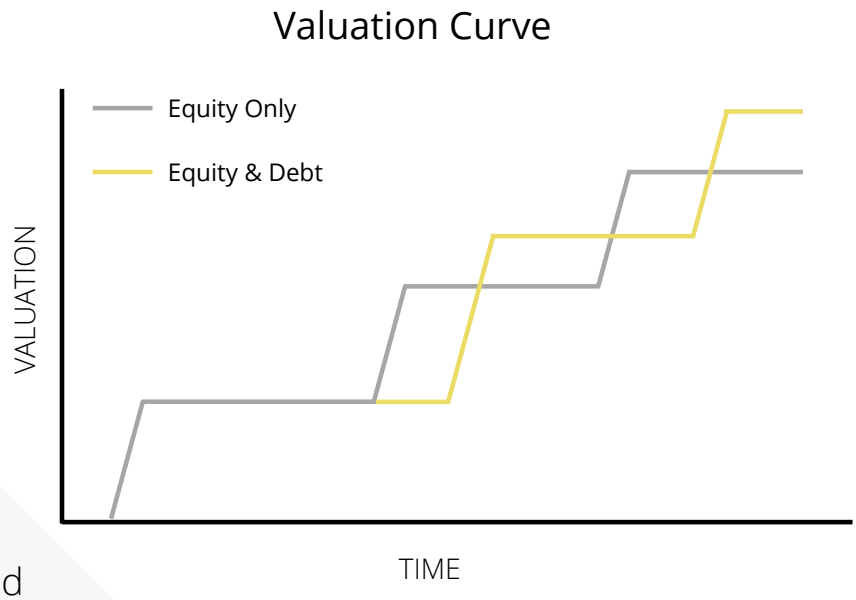
The Insurance Policy

As mentioned before, each funding round is designed to get the company to its next funding round. Before closing a round, VCs look at how much cash the company is forecasted to use (burn) to reach the next milestone. This amount is spread over the cash runway and the rate at which the money is spent is called the burn rate. Using venture debt can act as an insurance policy in the event the company needs more time to get to its next milestone.

USES OF VENTURE DEBT

Avoid Setting a Valuation

A valuation determines the present value of a company using a variety of factors such as financial projections, market value of the company's assets, its capital structure composition, and the management of the business. There are times when a business may be underperforming or market conditions change. This may cause concern that the next round of capital will result in a down round. Venture debt is a way of financing your business without having to set a valuation. Instead, it allows you to fund growth initiatives and achieve milestones so that the your company is in a better position for valuation at the next equity round.



Funding Large Capital Expenditures

Some growth initiatives require an amount of capital too small for an entire equity round, such as funding equipment purchases or even acquisitions. Venture debt can be used to fund these large purchases without depleting the company's cash balance or going through a round of equity.

Bridge to Profitability

For companies on the cusp of reaching breakeven, venture debt can propel your company forward during a critical period of growth. This form of financing is minimally dilutive and can completely eliminate the need for a final round of equity.

For the full Founder's Guide to Venture Debt, download the full version here:

www.FlowCap.com/Founders-Guide-to-Venture-Debt-e-Book