Beyond equity: How startups can leverage venture debt to fuel growth

Equity financing continues to be scarcer and more expensive than in prior years, so naturally founders are looking for alternatives to traditional venture capital.

Europe enjoyed a major increase in equity investment in a very short period of time across 2021-2022 – since then there has been a huge retrenchment of both the availability of that capital, and the perceived valuations of technology businesses, fuelling a strong market for venture debt.

Compared to more traditional equity finance, venture debt allows entrepreneurs and their shareholders to grow their companies whilst minimising dilution.

When is venture debt applicable for a business?

At a high level (although this is not a hard and fast rule) businesses which might suit the instrument are revenue generating, can demonstrate sustained growth in those revenues, and have a clear product market fit. These companies should have good business models with nice margins and pricing power, and can also ideally present decent levels of forecastability in their P/L.

The majority – but not all – of these companies are VC or equity backed.

There is typically a time in every growth tech or life science business where it should have access to alternative forms of capital aside from equity, to support its growth before turning profitable or exiting. Most companies will have multiple events along the way where they need to raise capital – and at certain points they should be able to unlock alternative, less dilutive financing options to equity – either reducing their dependence on equity, or substituting an equity round entirely.

There are multiple use cases in which venture debt suits the situation of a business. For example, to support organic growth, i.e. funding the organic burn of a business so that it grows its revenues as quickly as possible and therefore scales the enterprise valuation of the company, or to fund M&A, where the leading tech players in a market look to consolidate others and finance the acquisition of such targets without raising equity. To date, at *Claret*, we've backed around 180 companies, supporting each one in various situations like this.

What is the benefit for the company?

Venture debt is an attractive financing option for management teams seeking to extend their runway, lower their cost of capital and keep growth momentum. When used correctly, it fuels sustainable growth and helps to maximise value creation.

Ultimately, venture debt provides access to financing that is used to get a business from one value point in its journey to the next, with less dilution along the way than if it used equity. These companies can then either raise an equity round 12-24 months later at a much higher valuation (i.e. saving tons of dilution for the shareholders than if they had used equity instead of the debt), or they may be bridged all the way to profitability, or even to an exit, thus avoiding raising more expensive capital at all.

Alongside lower dilution and a lower cost of capital from day one, it therefore also helps the shareholders to optimise the timing of their future capital raises, and allows those same early shareholders to retain control and governance of the business.

There is also a huge amount of value-add to be gained. Larger venture debt funds tend to have considerable networks that can be leveraged and accessed by entrepreneurs. Whether that's introductions to investors, senior level staff, potential customers (on the B2B SME side), or just connecting good entrepreneurs where there is some crossover in product, markets, geographies, strategies or challenges.

When should it not be used?

Shrinking businesses, with weak or falling margins are typically unsuitable. Very high burn, inefficient businesses are not ideal candidates – and even less so should they appear to be structurally loss making.

It’s worth noting that any substitution (in place of equity) should only be executed in successful, growing companies that could raise equity, but choose not to (rather than those who cannot raise venture capital, and instead are seeking debt as a last resort).

Ultimately, successful, high growth technology and life science businesses tend to reach a point in their journey where they can access alternative forms of finance to equity, such as venture debt, to support further growth. This type of financing minimises dilution and helps to reduce the cost of capital needed to fund a business’ operations. At the same time, it allows shareholders to optimise the timing of future capital raises, whilst retaining control, and opens up opportunities for founders to tap into a hugely expanded network via the lender.

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