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Debt demystified

Choosing a loan that fuels growth—and leaves room to maneuver

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By Chris Kondo

RoseRyan Consultant

You've decided debt financing is right for you. The loan proposals are rolling in. How do you determine which loan (if any) will fuel your company's growth and which will leave you sweating and hemmed in? This guide for growing technology companies covers typical debt structures and terms, what to watch out for, how to evaluate loan proposals, and how to build a strong lender relationship that will carry you through the rough patches.

Smart debt financing: the right time, the right lender, the right loan

Venture capital, however difficult to obtain, continues to be the first source of financing for young technology companies. But debt financing—aka borrowing—is a viable alternative. It even has advantages: it can reduce your overall cost of capital or minimize ownership dilution. We're tackling the ins and outs in two parts: in part one we looked at when debt is a good choice, types of available loans, and lending sources. Here we dig into typical debt structures and terms, how to evaluate them, and how to close the deal.

Driving the devil out of the details

The first step in evaluating loan proposals is understanding the key elements of loan agreements, the pitfalls that could be lurking in them, and how to assess them in light of your company's situation.

Term length

Your term length will depend on the type of loan you get, the type of lender, and how risky the lender thinks your company is. Growth capital, or term debt, typically has a term of three to five years; venture lenders generally will offer the longest terms (at a commensurately higher cost). For lines of credit, a term of one to two years is common; longer terms will be more difficult and costly to obtain. Equipment financing terms can vary, but you should target their length to be less than the economic life of the equipment you will be financing. Finding the right term length for your company involves balancing the higher cost of longer terms, the net cash flow provided by debt, and the effective cost of debt (see "Making a decision," below).

Interest rates

The interest rate will be a fixed or variable rate based on some margin over prime or LIBOR (London Interbank Offered Rate). The interest rate is an important factor in evaluating a loan, but you need to consider the total effective cost of debt, not just the interest rate in isolation.

Payment schedules

You may receive a variety of proposed principal repayment structures. Typical features include interest-only payment periods and large final principal payments at the end of the loan term. Try to structure payment timing to balance your company's cash flow needs against the effective total cost of the debt. A couple of things to consider: with certain debt structures, paying off the debt may mean more than just paying the outstanding principal balance, and you may also face prepayment penalties should you choose to pay off the debt early. Consider the implications of such penalties—it may seem unlikely that you will want to retire the debt early, but prepayment terms can be a hindrance to refinancing or retiring the debt in the future.

Credit line borrowing bases and advance rates

For lines of credit, the borrowing base and advance rate comprise elements of a formula determining how much you can borrow. The borrowing base may be defined as an asset group such as receivables. The advance rate is the percentage of the borrowing base that you are allowed to borrow. In the most basic situation, what you can borrow against the credit line is equal to the borrowing base multiplied by the advance rate percentage.

It's common for lenders to place eligibility restrictions on borrowing base assets that limit either the borrowing base or the advance rate. For example, typical restrictions on an accounts receivable–based credit line include limits on customer concentration and on international customers. Eligibility factors are negotiable and should be tailored to your company's business.

Be sure to model different scenarios and their impact on your effective borrowing capacity; the downside, or lower growth, scenarios will help you determine your realistic capacity. Naturally, you want the largest borrowing base and the highest advance rate possible, but your lender may be more flexible on one parameter than the other.

Fees

Loan and facility fees will be stated as specific dollar amounts or as a percentage of your loan commitment. Fees will affect your total cost of debt measurement and your net cash flow available from the debt—and as with interest rates, it's wise to focus on those big-picture calculations, not on the fees alone.

Covenants

Growth capital loans should have no financial covenants, but a credit line will probably require them. Financial covenants, which require you to adhere to specific limits or standards in your firm's operations, are risk mitigation mechanisms for the lender. They may include balance sheet ratios, minimum net worth, minimum revenue levels, and percent achievement to plan—and they can seem designed to put you into an uncomfortably tight box.

No borrower likes covenants, but they can be structured to give you some room to move. This requires understanding your lender's concerns and your business's degree of volatility. If your lender wants financial covenants, develop business scenarios to determine a reasonable range. If you're not comfortable that you can manage your business without breaking a financial covenant, don't accept it.

Note that accounting rules can affect covenants, so consider building in some flexibility for rule changes—especially if you have ratio covenants based on assets, liabilities, or net worth. Deferred revenue treatment resulting from changes to revenue recognition rules, for example, can have a significant impact on traditional balance sheet ratios. Consider excluding deferred revenues and deferred costs from your covenant metric computations, and incorporate flexibility in your loan agreement for items that may get classified as liabilities—for instance, equity instruments such as warrants. Your lender shouldn't mind refining the calculation of any covenants to exclude items that are non-cash in nature or that distort your true financial condition.

Conditions of default

The typical loan agreement contains numerous conditions of default, many of which are technical and compliance related. As long as you are diligent and aware of these conditions throughout the term of the loan, you should not be at undue risk of tripping up—consult experienced legal counsel for help in evaluating them. And maintain good communication with your lender after closing the loan: that makes it easier to work out any minor technical compliance issues that may arise.

Warrants

Stock warrants are usually part of the debt structure for private technology companies. Venture debt lenders typically require more warrants than bank lenders. To compare warrants across lender proposals, evaluate them in terms of their coverage ratio (the value of the warrants as a percentage of the debt being provided). Lenders will usually want warrants of your most recent preferred stock equity round at the price of that equity round, though in some cases they may accept common stock warrants at the current fair market value. Warrants will usually be immediately exercisable and not conditional on future usage of your debt commitment. Companies and investors have different sensitivity to the value of warrants and potential equity dilution, so be sure to get your stakeholders' views on appropriate warrant levels.

Material adverse change (MAC) clauses

A material adverse change (MAC) provision is a catchall that lets your lender call foul and slap a default condition on you during the loan term. Although getting a loan without a MAC is preferable, if you have no other choice, be sure to contact legal counsel for help in containing its scope.

The real-world effects of a MAC clause will depend on your relationship with your lender and how it responds when things get tough. Due diligence on potential lenders is key here: finding out how your lender typically deals with troubled loans and difficult situations will give you insight into its behavior under stress. Remember—your relationship with your lender does not end with signing of the loan agreement.

Collateral

Your lender generally will secure a term loan or line of credit with a blanket lien on your company's assets. With an equipment financing line, the lien will be only against the specific assets under consideration. Your lender will have a secured priority position under the Uniform Commercial Code (UCC), meaning it will be first in line to get paid should your assets be liquidated. The lien may include intellectual property (IP) or simply a negative pledge on IP, which means you agree not to pledge or encumber your IP to another party. Your legal counsel can advise you on the practical implications of using IP as collateral security. This issue is important to equity holders, so take your investors' position on it into account when evaluating the form of the lien.

Making a decision: how much do you get and what will it cost?

Many debt structures and terms are common across lenders, but that doesn't mean you'll be able to compare loan proposals at a glance. To evaluate competing loan proposals, you'll need to calculate the effective cash flow and effective cost of debt.

Effective cash flow

Since the need for a cash infusion is the reason you're taking on debt, the effective cash flow from the debt is an essential factor in loan evaluation. The effective cash flow is the net cash flow generated by the debt over each period of time. Effective cash flow can vary over the life of the loan, and the cash flow profile in year one may be critical, so you'll want to break it down by quarter or by month. Once principal amortization begins on a term or growth capital loan, the effective cash flow looks very different. If your debt proposal includes a credit line, model different borrowing scenarios with it to arrive at a range of effective cash flows.

Effective cost of debt

The effective cost of debt includes the interest you pay, the bank's fees, and the value of your warrants. It is essentially your APR computation, which can be expressed as an IRR (internal rate of return) of the cash flows over the loan term against the amount borrowed. To get a realistic number, value your warrants at their strike price, not their Black-Scholes fair value. If you have a credit line, compute your effective cost of debt based on the amount of credit you expect to use, not on the maximum borrowing limit.

Impact on your business

While there are a few rules of thumb in debt deals, the best approach to selecting and structuring a debt agreement is to make sure it fits your business situation and is in line with market norms.

Make use of outside expertise such as legal counsel, finance professionals, and your investors to assess the reasonability and risks in the proposed terms. When you seek legal counsel, look for debt specialists who have handled multiple financings with different lenders and companies. Finance professionals who have worked with the lenders you're considering can provide market insight as well as practical experience with how those lenders operate. Your investors and their portfolio companies can provide a broader range of market data.

Assess all the structural terms and covenants in your loan proposals based on how they'll affect your company's operation. A loan agreement with covenants, limits, and conditions of default that will cause constant concern is not likely to be a good fit regardless of the effective cash flow or cost of debt. You don't want your loan terms influencing how you manage your business.

Once you've selected a lender and agreed to a summary loan proposal/term sheet, you'll probably be required to make a good-faith cash deposit in order to proceed to full loan documents. Make sure your term sheet covers all the key elements in the loan that you feel are important. The process of entering into the loan agreement and signing the associated documents usually moves fairly quickly—your deal may close in a matter of a few weeks. Experienced legal counsel with specialization in debt financing will be a big help.

Staying on your lender's friend list

Although your lender won't serve on your board or influence your company strategy, it will have the strongest legal collateral security position in your company. It's in your interest to maintain a strong working relationship with your lender both before and after signing the loan agreement. Make sure you understand who will be managing your debt relationship when the deal is done and who has the authority to deal with defaults. A company rarely progresses exactly as planned, and things could get tough from both your company's and your lender's perspective. Your lender's reputation, track record, and history of behavior when things don't go well should be part of your evaluation process, but you also need to keep tabs on the relationship over time.

It's better to be active than reactive in this relationship. Lenders don't like surprises, and may react unpredictably to them. Your loan agreement will require standard reporting of financial statements and usually the submission of compliance certificates. An active approach to your lender relationship would include

providing quarterly updates just for the lender that highlight progress, explain setbacks, and provide more color than your raw financial statements. Your lender has to report on its portfolio of deals, and regularly discussing market conditions, competitors, and products with the lender helps you build context for your future operating results.

Did you miss part one of this series? It covers determining when debt financing is a good idea, understanding what your loan options typically look like, and choosing a lender. Get it here.

About Chris Kondo: A seasoned RoseRyan consultant, Chris Kondo has over 15 years of experience working with private technology companies.