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Debt is good (sometimes)

How to tell when borrowing is a smart way to grow

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You've got a hot deal on the horizon and need to ramp up production. Or you need to add new staff, pronto, for your launch. But you don't have much cash and can't raise equity. Begging's not an option (you already did that when you started the company). Stealing is obviously out. That leaves one course: borrow the money. Debt financing can be a smart way to fund growth—if you do it right. This guide for growing technology companies outlines when debt financing is a good idea, what those loans typically look like, and choosing a lender.

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 tackle the ins and outs in two parts: here we look at when debt is good choice, types of available loans, and lending sources. In part two, "Debt demystified," we look at typical debt structures and terms, and how to evaluate them and close the deal.

When debt is your friend

First, let's dispense with a common myth: lenders will lend to you only when you don't need it. It may seem like lenders are very happy to call you the day after you close a large equity round, but the reality is, debt financing is available at many stages in your company's life cycle. You just need to match your situation and characteristics to the appropriate lenders and their guidelines.

So what's the right time to borrow? From the lender's point of view, it certainly doesn't hurt your prospects if you have a pile of fresh cash sitting in the bank. From your point of view, one of three needs typically will drive the decision to take on debt:

1. Revenue is growing and you want to finance your inventory or receivables.

Growing sales obviously makes you attractive to lenders, and financing accounts receivable to accelerate cash turnover is a common reason to take on debt. Companies often allow longer payment terms while they ramp up, and if you need inventory, your cash is going to be consumed by vendors while you wait for customers to pay up. You can borrow to cover the entire working capital cycle, though the bar for financing inventory as well as receivables will be higher than it is for financing receivables alone.

2. You need to buy time before another significant business milestone or round of equity financing.

If you're pre-revenue, using debt to extend your runway is an option (though typically only with venture debt lenders, which are described below). To land a loan, you'll need a defined path to your next milestone (ideally, a product launch and first revenue), and the extension period should be measured in months, not years.

3. You need capital equipment.

It's common to borrow for capital equipment purchases. Lease financing or capital equipment lines of credit are readily available, though for most technology companies the funds required are rarely a significant part of total expenses.

When you and debt just won't get along

Of course, there are times when lenders won't want to bother with you or it's not a good idea to take on debt.

Lenders need collateral—tangibles like receivables, equipment, inventory, and other hard assets. If you don't have that security and you haven't raised any venture capital, your borrowing options will be limited (and you'll only qualify for a small sum). If you also have no near-term revenue in sight, it's better to focus on raising equity.

Strong support from existing investors is essential to obtaining debt that isn't for working capital or equipment purchases. Most lenders will look to your investors for insight into your company, and will assess your investor strength, future funding capability, and investor views on your company's prospects. If you can't get consistent investor endorsements, try consolidating your existing equity support and supplementing it with new equity sources.

If your company faces significant product or execution risk, consider waiting until some of those risks are reduced before seeking debt. For example, if you have no traction on customer acquisition and your products are still in the R&D stage, wait until you have data that a lender can validate. The ebb and flow of the debt market—economic conditions and lender-specific conditions—can drive how much risk a given lender is willing to take. But regardless of overall debt market conditions, you will be more creditworthy if your company has reduced its product and customer risk.

The three faces of debt financing

There are three basic forms of debt financing for private technology companies: growth capital or term debt, lines of credit, and equipment financing.

Growth capital/term debt

Growth capital, or term debt, loans are the bread and butter of venture debt and bank lenders. These loans have a fixed term and maturity date, with the principal and interest repaid over the term of the loan. They can contain variety of features, such as deferred principal payments, interest-only periods, and balloon or final payments. The interest rate is usually fixed. Often they allow flexibility in how you draw on the funds, though the effective cost will be higher if you don't borrow the entire loan commitment.

This type of loan will be secured against all assets of your company, with the possible exception of intellectual property. It has the advantage of being for a fixed amount—it won't vary with asset or sales levels like a line of credit will. For a runway extension without sales growth, term debt may be your only option. Term debt will likely have the longest term and the highest cost of capital.

Lines of credit

A credit line is what it sounds like—the ability to borrow up to specified amount over a set time period. Credit lines require interest-only payments against the outstanding amount of the line and have a floating interest rate. Of course, at the end of the term you must repay any outstanding balance. Credit lines often are secured by a lien against the borrower's assets.

Credit lines are the most flexible and usually the least expensive: interest rates will be lower than term debt due to the shorter borrowing term, typically one to two years. An accounts receivable credit line can

work well to manage a growth ramp-up or seasonal sales and receivables patterns. Be sure you can use the money, though: paying all the fees and maintenance costs on a $1 million credit line isn't worth it if you use only $100,000.

Equipment financing

If you have to buy a lot of equipment, this one's for you. (Just remember, it's only good for leasing or purchasing equipment—you can't use it for anything else, like operations.)

Equipment financing often takes the form of a line of credit that allows multiple draws for specific pieces of equipment against a single line of credit. As with any line of credit, you'll need to evaluate interest rates and payment schedules; if the financing is structured as a lease, you'll also need to deal with buyout provisions. Equipment financing is secured only by the assets being financed. A variety of lenders provide equipment financing, including manufacturers, but an equipment line from an institutional lender gives you the ability consolidate purchases from multiple vendors under one umbrella.

Where the money lives

The two main classes of lenders (equipment financing aside) are banks that specialize in technology companies and venture debt lenders.

Banks

For a small private company, debt financing with a large retail bank will probably not be a good match unless the bank has experience in private technology companies, so look elsewhere even if you're already doing business with a big bank. If you need a lot of money, you may qualify with only a fairly small group of banks. For smaller amounts, it's worth investigating regional or specialty banks with experience with your investor group or industry. The Silicon Valley region is home to a number of banks that specialize in technology company lending.

Banks offer a variety of finance structures and are a good option for a line of credit to fund working capital growth. They may be the only source for a very early-stage company looking for a small amount of debt. Banks can likely provide the lowest aggregate cost of debt.

Banks can also structure a mix of loans that fit your needs, and if you require additional products, like letters of credit for purchases, it's often simple to wrap it all into a single loan agreement. Loans will usually be secured with a blanket lien against all your company's assets (with or without intellectual property). Generally, a bank will require fewer equity warrants (essentially, options to purchase equity) than a venture debt lender, and may require no warrants.

Venture debt lenders

Venture debt lenders typically offer growth capital loans with fixed repayment schedules and some flexibility about drawing the debt over time. Repayment schedules may be quite flexible. Some will offer line of credit–type arrangements, typically in conjunction with a term debt offering. Venture debt lenders require the highest level of equity warrants and generally have the highest aggregate cost of capital. In return, the

borrower usually gets the most lenient financial terms and covenants (if any). Loans are usually secured with a blanket lien against all the company's assets (again, with or without intellectual property).

The best way to find a venture debt lender is through your investors and board. Since venture debt lenders will rely on VC investors in evaluating lending prospects, it will be advantageous to engage with venture debt players who have backed other companies in your VC investors' portfolio. Some venture debt firms are publicly traded, and their SEC filings can provide interesting information about their loan terms and loan reserves.

Getting your act together and taking it on the road

If you think your company is well positioned for debt financing, and you know what kind of loan you need, the next step is selecting your lender. You'll need to manage the process—it pays to approach this like raising an equity round. Allow about a month to prepare, engage with potential lenders, and get their terms, then another month to negotiate terms and close the financing.

Your basic package should include recent interim financials, detailed projections and plans, and business plan and strategy slide decks. If you're seeking working capital financing, include background on customers and their terms and creditworthiness, and current accounts receivable aging. If you have inventory vendors, include purchase terms and transfer of title conditions.

It's more efficient to assemble one package for all lenders that tells both your financial and strategic business story. Having it all in one place allows you to respond quickly to lender diligence requests, and you know your data and story will be consistent. It's much easier to respond to follow-up questions from one set of data rather than trying to reconcile what you told lender A versus lender B.

Limit your initial inquiries to referrals from your investors or other trusted sources. Reactions from this first group of lenders will help you understand how lenders see your company and refine your pitch, if you want to look for other lending sources. Once you've got a few proposals, the next step is to assess the proposed debt terms.

What are the typical debt financing terms and structures, and how do you evaluate them? Stay tuned for part two of this guide.

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