MARKET INSIGHTS:
Tapping into Private Debt: Unlocking Opportunity
Q1 - 2019

It's tough to find capital to execute on ambitious plans to grow, acquire or turn things around in Canada, particularly if you're looking for $1 to $20 million in financing. Canadian entrepreneurs have experienced this predicament for years, and while the situation has improved recently as capital availability reaches new records, financing sources remain largely few and lacking flexibility.

Bridging the Financing Gap

In our conversations and deal-making experience, entrepreneurs often direct their capital-related frustrations at the unwillingness of venture capital ("VC") firms and traditional banks to fill the financing gap. There is, however, a lesser known category of capital, **private debt** (aka alternative debt), that has grown to address these shortcomings.

Private debt lenders are different from VCs and traditional banks in that they typically do not require the asset coverage demanded by traditional bank debt, or the potential for a 10x return that attracts venture capital. These specialized lenders seek a return in between bank debt and venture capital, investing significant time understanding a company's business model in order to provide a more meaningful amount of financing and more flexible structures relative to banks. There is no requirement for "homerun" potential to access private debt; companies that have promising prospects – but are not necessarily the next Google or AirBnB – make strong candidates.

Recently, a specific form of private debt, venture debt for tech companies, has stolen the spotlight. That is a positive development, but it can make non-tech borrowers believe this kind of financing isn't available to them. In reality, private debt can be useful in addressing a range of different issues across industries.

1. Accelerating Growth

There is a segment of growing companies that are not achieving the 100% year-over-year growth that attracts strong VC interest. Further, they typically don't have the EBITDA to access bank financing beyond small lines of credit.

Private debt may provide a solution. Often this type of debt facility will grow with the borrower; as the company realizes various milestones, more capital becomes available. Typically, this positions the company to better execute on its growth strategy (relative to not raising capital), ultimately reaching a positive cashflow position where it can access lower-cost bank financing.

2. Financing an Acquisition

Growing through acquisitions also poses a financing challenge for entrepreneurs, as bank financing may be unavailable on a timeline that works for the acquisition process, or falls short of the dollar size that's needed or expected (especially if the deal is not 'vanilla').

Private debt can be used as a bridge to complete an acquisition when timing is tight, and after closing, to provide the runway needed for the combined entities to become financeable by banks. Also, much like banks do for more established companies, some private lenders will provide acquisition lines to companies executing on an acquisition strategy. The lender underwrites the acquirer and its strategy and provides indicative terms for future acquisitions. This arrangement allows an acquirer to move quickly once they've found an acquisition target – an advantage in the current competitive M&A environment.

3. Reducing the High Cost of Equity

While it's true that an early-stage, hypergrowth company is likely to find an equity investor to provide capital, that potential investment raises the issue of valuation. VCs make bets that aim to yield a 10x return on their investment, knowing that many bets will fail.

Private debt lenders typically move faster than VCs, and can delay the need for an equity raise, while allowing the company to keep its “foot on the gas” and build enterprise value. Alternatively, private debt can also pair with an equity investment to reduce overall dilution for business owners.

There is an additional advantage in using private debt to delay an equity raise: continuing to build, then doing a larger round at a higher enterprise value. At that juncture, the company will attract an expanded group of VC, private equity, and strategic investors with an appetite for larger deals and the resources to add meaningful value to the business.

The example below illustrates the significant cost of an early stage equity investment to a high growth company relative to the cost of private debt.

What’s the Cost? Private Debt vs. Equity

Suppose a company is worth $10m today, and it seeks to raise $2.5m. Further suppose it can either raise equity or private debt. After five years, assume the company sells for $40m. The calculations below compare the cost of raising equity vs. private debt. The difference is staggering: **$5.5m.**

Choice of Financing	Today	In Five Years
Venture Capital (Equity)	Stake sold to VC for $2.5m: 20%, with a 1x liquidation preference[1]	Value of liquidation preference: $2.5m Value of VC’s stake: $7.5m[2] **Cash return to VC: $7.5m**[3]
Private Debt	Loan Terms (for illustrative purposes only): - Interest: 13% - Warrants: 3%[4] - No principal amortization	Net value of warrants: $1.05m[5] Interest paid: $0.975m[6] **Cash return to lender: $2.0m**[7]

As can be seen, private debt is extremely valuable to shareholders of fast-growing companies. Because of their immense enterprise value growth, the cost of selling off equity is particularly high.

The Private Debt Takeaways

While private debt is more costly than traditional bank debt, it’s typically available on a much shorter timeline, in a more meaningful size, and with far more flexibility on terms and structure. It can provide a bridge to lower cost financing by supporting the growth necessary to get there, and can significantly lower the cost of more expensive, dilutive equity financing.

Bottom line? Put private debt into your arsenal of financing options, and when you’re looking for growth (or other) capital, consider whether private debt is an option that makes sense for your business.

1. At a pre-money valuation of $10m, $2.5m purchases $2.5 / ($10m + $2.5m) = 20%; Liquidation preference means VC recoups investment first
2. Assuming no further rounds, 20% stake, after the liquidation preference is paid, of a $40m company (share value) is equal to: 20% * ($40m - $2.5m) = $7.5m
3. The cash return to the VC is equal to the sum of the liquidation preference plus the value of its stake less the initial investment
4. Assuming half the warrants have a nominal strike price and the other half have a strike price equal to the pre-money valuation ($10m)
5. Assuming no further rounds of financing, net value of warrants is equal to 3% of $40m ($1.2m) less the cost of exercise ($0.15m) = $1.05m
6. Interest is paid over 3 years at a 13% rate, compounded daily and payable monthly, on outstanding principal
7. Cash return to Gap Debt is equal to the sum of the net value of warrants, and the interest paid

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