THE STARTUP GUIDE TO VENTURE DEBT IN SOUTHEAST ASIA

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OVERVIEW

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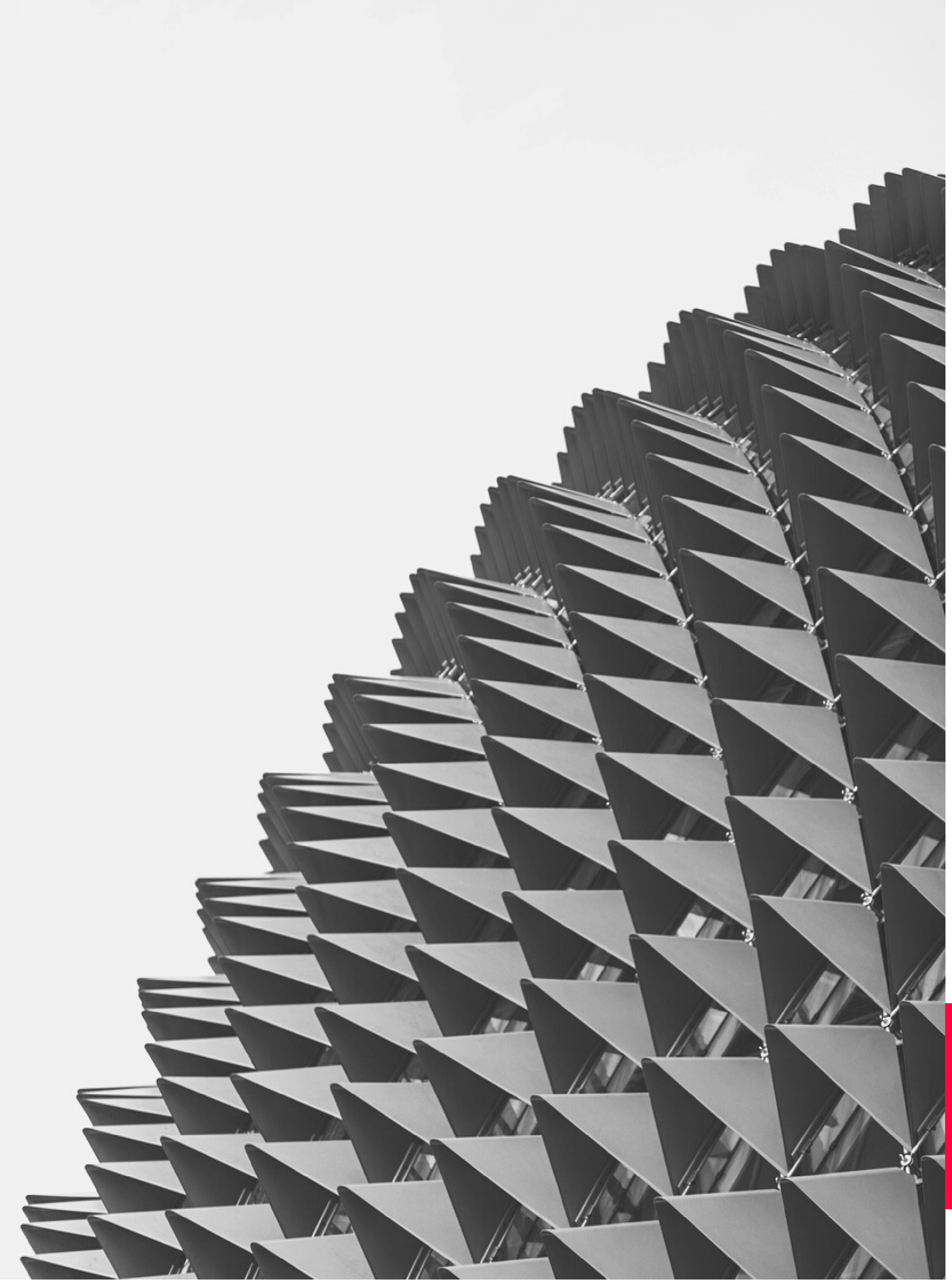

Traditionally, growth stage technology companies in Southeast Asia have raised venture capital via convertible debt or equity rounds. However, over the past 12-24 months we have seen a steady increase in the number of companies raising funds using a third method, venture debt.

We’ve created a guide to cover venture debt for startups and fast-growing tech companies in Southeast Asia – the what, why, when, who, and how.

WHAT IS VENTURE DEBT?

WHY IT'S HERE TO STAY

WHAT IS IT?

Venture debt is a form of debt financing, similar to bank loans but with a few key commercial differences. Venture debt is typically used by VC-backed, fast-growing companies that may not have positive cash flow or significant assets to use as collateral.

These companies are typically not eligible to receive traditional debt financing from banks or other institutional lenders (or would only be able to borrow at prohibitive interest rates).

Because the risk profile of a venture debt deal is higher than that of a traditional bank loan for the lender, venture debt providers use other ways to de-risk the deal, including:

- working with venture-backed companies (and therefore ‘piggy-backing’ off of a VC’s due diligence and taking comfort that the company has recently raised a reasonable amount of cash)
- a higher than market interest rate for a typical loan with an established company
- security over company assets (in the same manner as a typical debt facility)
- warrants that allow the lender to purchase shares at a later date and at a fixed price, providing additional upside.

TYPES OF VENTURE DEBT

TERM LOAN

With a term loan, a lump sum is provided by the lender (although it may be split into tranches), and the principal is paid back with interest over the term of the loan.

Venture debt providers generally offer interest rates of around 10-15% per annum (at the time of writing), which may be based on factors like the credit profile of the company, the term of the loan (2-4 years is typical), and the number of warrants being offered.

REVOLVING CREDIT FACILITY

With a revolving credit facility, a company can borrow and re-pay up to a specified amount over an agreed length of time – similar to an individual with a credit card.

Revolving credit facilities can be a useful tool for startups looking to manage their cashflow, since it can help cover outgoing expenses where income is bumpy or uneven.

WHY USE VENTURE DEBT?

COMPARED TO OTHER METHODS OF RAISING MONEY

VENTURE DEBT VS BANK DEBT

Many growth stage technology companies are not able to borrow from institutional lenders due to their risk profile. Venture debt is an alternative means for accessing debt funding.

VENTURE DEBT VS EQUITY FUNDING

There are a few reasons why a company may use venture debt as an alternative, or supplement, to equity financing:

LESS DILUTION

Avoiding dilution (where a shareholder's percentage ownership in a company is reduced) is one of the major reasons why founders seek venture debt. This also makes it an attractive option in later rounds when the cap table may be getting crowded and founders' stakes are reducing to a point where they may become too disincentivised.

BOARD CONTROL

Compared to other methods of raising capital, venture debt lenders do not typically require a director on the board.

TRANSACTION TIME

Compared to a traditional equity raise, the process of getting capital via venture debt is faster, as lenders take on less due diligence and the documentation (generally) requires less negotiation.

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VENTURE DEBT VS EQUITY FUNDING

THE DOWNSIDE

Unlike equity financing, venture debt (plus material interest) must be repaid in cash. Companies will need to repay using revenue or by raising a subsequent equity round and using part of the round proceeds.

Repaying out of cash flows may not be desirable to startups when compared to an equity financing. In some cases, future investors may also be reluctant to see a material portion of their investment money go towards repaying company debt.

ASSESSING IF YOUR COMPANY IS A GOOD CANDIDATE FOR VENTURE DEBT

The typical profile of a company taking on venture debt is a venture-backed, fast-growing startup at series A or later. By the time a company is ready to explore venture debt, it will already have cashflow and an established customer base.

Venture debt lenders prefer venture-backed companies (i.e. those who have received funding from VCs / institutional investors). Institutional investors will have 'vetted' the company, and can be a future funding source should the company need help in paying back the venture debt.

WHEN SHOULD I USE VENTURE DEBT?

AT THE SAME TIME AS AN EQUITY ROUND

Lenders typically prefer to finance companies that have recently completed an institutional equity funding round. The amount of venture debt available is often a proportion of the venture capital raised (often around 20%) – e.g. if your company has raised $5 million at Series A, you may be able to raise up to $1 million in venture debt.

BETWEEN EQUITY ROUNDS

Venture debt can allow startups to accelerate the growth of the business and therefore increase valuation before the next priced equity round. This approach can minimise the dilution that would occur with a more standard bridging round using convertible notes.

DURING LATER ROUNDS TO REPLACE EQUITY

Founders and other investors that have experienced a significant amount of dilution through several funding rounds may prefer venture debt to the further dilution associated with late-stage funding rounds.

KEY TERMS TO CONSIDER IN YOUR VENTURE DEBT TERM SHEET

INTEREST

As with a regular loan, companies will need to pay interest on their venture debt loan. A lender will determine the interest rate (which can be negotiated) based on a few factors, including:

- the company taking out the loan
- the term of the loan
- a floating or fixed rate
- the number of warrants provided by the company

When anticipating how much venture debt to take on, companies should understand the interest payments that will be paid in addition to the principal sum, and ensure that they can meet that sum going forward. Interest payments are often payable over the term of the loan, rather than a one off payment at the end of the term.

WARRANTS

Lending to a startup involves a higher risk of default than typical bank loans. To offset that risk venture debt lenders like to take a share in the upside provided by high growth companies. This is provided in the form of warrants in the company.

A warrant functions in a similar way to an option. It gives the lender the option to buy shares in the company in the future for a set price (the 'exercise price'). The exercise price is usually the share price at the latest company valuation.

SECURITY

As with an ordinary bank loan, venture debt lenders will take security over the assets of the company (and any other companies in the group). This means that if the company fails to repay the debt and/or interest on time, the debt provider can claim against the assets of the group, ahead of shareholders and any unsecured debtors.

LONG FORM DOCUMENTS

LOAN/FACILITY AGREEMENT

The loan agreement formalises the terms set out in the term sheet between the lender and the company. It will cover:

- the amount of the loan
- the structure/type of loan (term loan/revolving credit facility)
- the length/term of the loan
- the interest rate
- the repayment schedule
- representations and warranties by the company
- positive and negative undertakings from the company

SECURITY AGREEMENT

The security agreement will record the lender's security interest in the assets of the company/group, including:

- restrictions on how a company can deal with assets that are covered by the security agreement
- the rights of the lender to take control of the assets if the company defaults

WARRANT AGREEMENT

The warrant deed sets out the terms of the warrants granted by the company to the lender. It will cover:

- the number of warrants granted
- the exercise price
- the expiry date

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VENTURE DEBT PROVIDERS

We are seeing more venture debt funds setting up in Southeast Asia. Some examples of current venture debt firms lending to startups in Southeast Asia include:

- Innoven Capital
- Genesis Alternative Ventures
- Goldbell Financial Services
- Mars Growth Capital
- Partners for Growth
- DBS
- OCBC

GET IN TOUCH WITH US

WRAPPING UP

We hope that this guide provided you with a framework for understanding venture debt in Southeast Asia, and how it compares to equity financing as a way to get capital to help grow your company.

Browse our other venture capital resources on our website, or if you would like to discuss venture debt related matters with us, get in touch.

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Kindrik Partners is a corporate/commercial law firm that specialises in working with high growth technology companies. The firm advises on all aspects of venture capital fundraising, M&A transactions and commercial contracts.

Kindrik Partners has a leading Southeast Asian practice based out of Singapore. The firm works with over 180 high growth tech businesses across the region, including many well-known VC backed companies. Kindrik Partners also advises venture capital funds and other investors on investments into Southeast Asian companies.

See our full range of guides and templates at kindrik.sg/resources

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