Preparing Your Startup For Debt Financing

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Introduction

Welcome to GrantTree's Guide to Preparing Your Startup for Debt Financing.

Until recently, UK startups found it extremely difficult to acquire corporate debt. This is because traditional institutions - the only game in town at the time - were unable to judge the probability that a fledgling company would default and therefore automatically deemed most of them too risky for loans and other lines of credit.

The few startups that weren't turned away were offered loans attached to highly unfavourable terms. This made borrowing unappealing and, in many cases, completely unfeasible.

A lot has changed since then. The market for startup debt has matured significantly, incorporating new lenders and instruments that cater to a far wider array of companies and stages of development.

The market's diversity has dovetailed perfectly with founders' perennial quest to protect their equity, as well as the more recent decline in the appetite of private investors to engage with early-stage businesses.

Debt financing is now a crucial branch of the startup funding ecosystem that helps countless companies to hire, innovate, and grow.

However, while founders' awareness of debt financing has evolved with the market, many lack clarity on which of their growing list of options is best for their business and what they can do to maximise their chances of securing funding.

This guide is designed to tackle these and other uncertainties.

Written by GrantTree's funding experts, these pages explore a range of relevant debt funding topics, including:

- The advantages and disadvantages of debt
- The debt financing options available for high-growth startups
- A typical debt financing process
- Getting your startup ready to apply for debt financing

If you have any questions about debt financing or the other funding options available to your startup, GrantTree's specialists would be happy to help.

Just drop us a line, and one of our team will be right with you.

Contents

Is Debt Financing Right For You?

Maintain Equity

One of the biggest advantages of debt financing is that it is non-dilutive, meaning it doesn't require founders to relinquish equity in their businesses.

Holding on to equity gives you a larger share of your company's profits and the financial rewards at exit. Maintaining equity also lets you retain more control over your startup's decision-making; what products to prioritise, when to sell the business, and so on.

Speaking of selling your business, surrendering equity to investors can affect your chances of exiting at a time of your choosing. Angels, VCs and other investors generally expect a particular return on their capital - 10X to 20X if you're a successful startup - so they may push your business to reach their target valuation before sanctioning a sale.

This situation - one of many restrictions investors can impose on your startup - may conflict with your plans to capitalise on your company's success. Investors may even decide to remove you from the company if they don't feel you are capable of delivering their desired ROI.

Relative Cost

For high-growth startups and scaleups, debt is usually a much cheaper source of capital than equity investment. We can see how the cost of debt and equity funding differ with an example.

Let's say your startup is worth £10 million, and you're deciding whether to take out a four-year loan worth £1 million with an 8% interest rate or sell 10% of your shares for £1 million.

After four years, the loan will cost you £1,320,000. That's a net cost of £320,000, assuming you do not pay down the loan until it matures.

Meanwhile, if your share value increased by 20% year on year over the same period - an achievable target for a startup - the net cost would be over £2 million, more than six times higher than the loan.

Of course, these calculations are contingent on your company growing relatively quickly. If your company grows slowly or decreases in size, debt can be the more expensive option.

Speed

You can usually secure a loan in a matter of weeks - far less time than the months it takes to complete a fundraise. In fact, GrantTree has secured seven-figure loans for our clients in less than seven days.

Debt financing's speed makes it more suitable for financial problem solving, like bridging a cash shortfall or making time-sensitive investments. It also makes acquiring debt less distracting than raising equity, which is far more involved.

Valuation

Debt financing allows you to extend your cash runway, giving your business more time to hit key milestones before your next fundraise. This is especially useful if you're heading into product/market fit.

Hitting milestones - higher revenues, big-ticket hires, steeper growth - can make your business far more attractive to prospective investors, allowing you to secure funding on more favourable terms.

Reasons to Be Cautious

Borrowing Limits

Providers will only lend you so much money. If you need to raise a lot of capital, you may want to look at equity funding or bolstering your loan options with government funding such as R&D Tax Credits and innovation grants.

Regular Payments

The obligation to make regular payments can take your business into a cash crunch or put it at risk of default. Your risk of defaulting will be especially high if you have a lumpy cash flow. For example, if you have low-volume, big-ticket contracts and one of your clients is late paying a large invoice.

Personal Risk

Some early-stage creditors may ask you to provide a personal guarantee, meaning you will be forced to liquidate your private assets if your company defaults on its loan.

Investor Concerns

If you're making large, regular loan repayments, prospective investors may take issue with the idea that their capital is going straight to your lender.

That said, since 2010, we have seen investors grow more comfortable with existing debt in their portfolios and now see it as a way for businesses to maximise their non-dilutive funding.

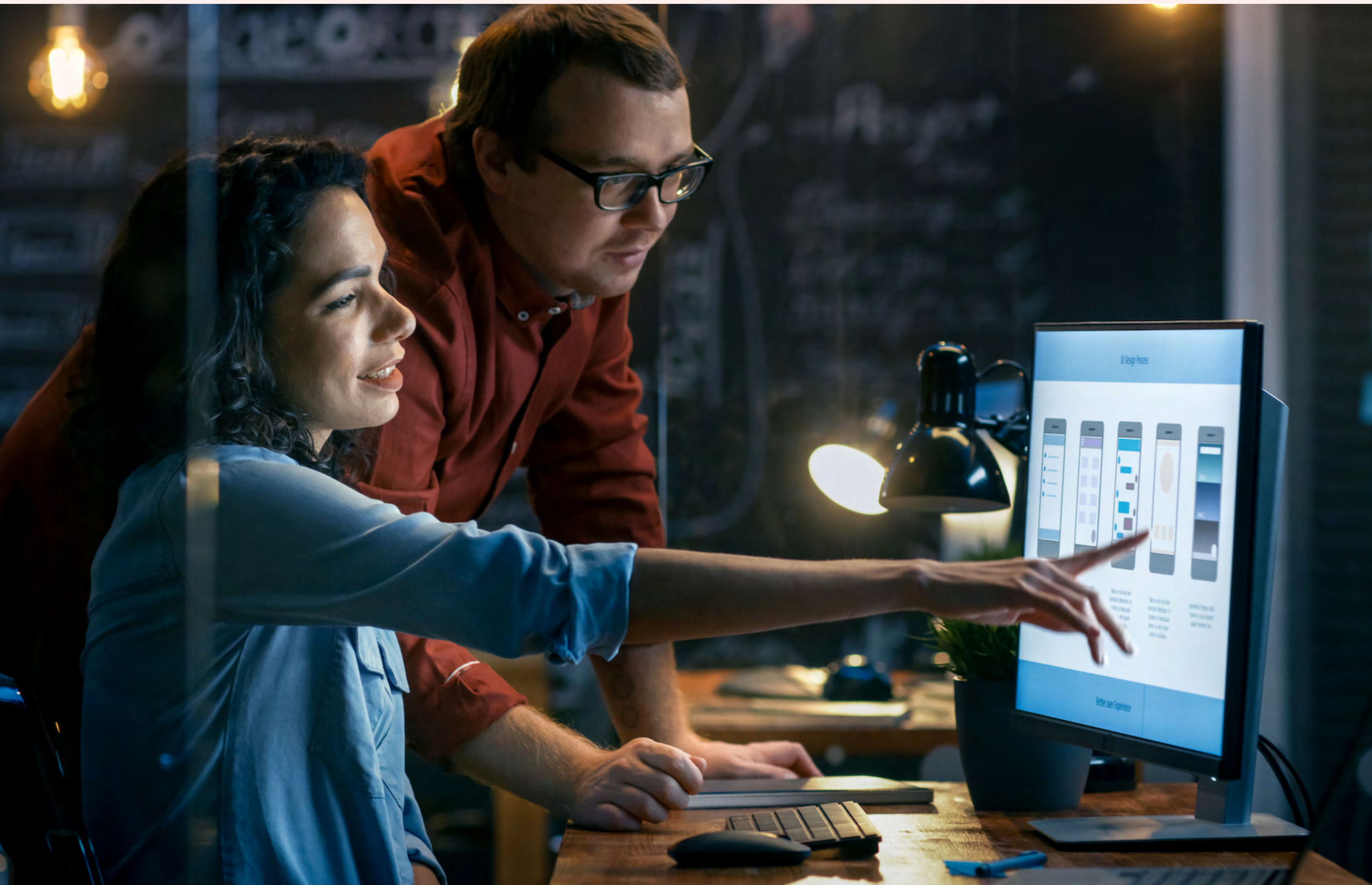
Key Metrics for Lenders

Now that you have a better sense of whether debt financing makes sense for your business let's look at the different metrics providers care about when determining whether to lend your startup money.

Whether and how much these metrics matter depends on your lender and the kind of debt you're looking to acquire. For example, if you're seeking revenue-based financing, your provider will look at your company's earnings and growth potential.

If you're looking to advance your R&D Tax Credits windfall, the size and quality of your R&D claim will be more relevant.

Lenders generally investigate these variables during due diligence. However, some providers will perform a light vetting at the very beginning of the borrowing process, so it's essential to have a good grasp of your metrics before reaching out.



Revenue Growth

Historical and potential revenues are important metrics for prospective lenders as they indicate whether your startup will be able to repay its loan.

Revenue data is essential if you want to leverage your sales and growth figures to secure debt, as in the case of Revenue Based Financing.

Asset Values

A common way to acquire debt is to leverage assets as security. If you're looking for asset-backed debt, your lender will need to know how much security you can offer by evaluating the property and machinery you are hoping to leverage.

You may be interested in asset finance, whereby you take on debt to buy a specific asset, like a piece of equipment. In that case, the asset you want will serve as security, and your lender will look at its value and depreciation.

IP-rich businesses don't have many tangible assets to lend against. That's where grants and R&D tax credits come in. With GrantTree's Advance Funding service, you can use these government schemes as future assets that you can borrow against.

Learn more about Advance Funding here.

Cash Forecasts

While revenue projections tell a provider how quickly your business is expected to grow, cash flow forecasts reveal the balance between your company's income and expenditure. This gives lenders a much more holistic view of your company's financial health.

Credit Histories

Almost all lenders will check your company's credit history. However, as a younger company, your startup may not have developed a decent credit profile. In which case, your lender may look at your and your co-founders' credit histories as part of their risk assessment.

Future Funding

As a startup, there's every chance that, at some point, you will forecast zero cash. Lenders that are used to dealing with startups are aware of this possibility and will take a more qualitative approach when examining where your future funding is coming from.

These lenders will look at potential equity rounds you have on the horizon and may ask for letters of intent from existing shareholders stating that they won't let your company fail and would be willing to reinvest going forward.

What Terms Will Lenders Ask For?

Loan to Value

If you are offering security or are looking to finance the purchase of a particular asset, the lender will also consider the loan-to-value ratio; the relationship between the amount of money you are borrowing and the value of the assets you are using as security.

You'll know this calculation well if you've ever taken out a mortgage. Here's an example.

Say you wanted to take out a loan against existing machinery worth £100,000. The lender decides to implement a 20% buffer, as disposing of the machinery will likely incur a discount, giving you a loan value of £80,000.

The LTV is the amount borrowed divided by the asset's market value. In this example, the LTV is 80%: £80,000 divided by £100,000.

A lower LTV means less risk for the lender, as they have more of a buffer against their share of the asset's value decreasing, should they need to liquidate it.

A lower LTV also means that you have more equity in the asset, which lenders view as a sign you are less likely to default.

Security

Lenders will look at whether your loan is secured (if you are providing business assets as security) or unsecured (you are not providing assets as security).

From the lender's perspective, secured loans are far safer. That's because if your company defaults on your loan, the lender will have the legal right to possess and sell your company's assets to recoup their capital, reducing their risk of loss. Secured loans also have higher seniority than unsecured loans.

Because they are riskier, unsecured loans command far higher interest rates than secured loans. Unsecured loans all tend to be much smaller–as a startup, you'll be lucky to get a loan of more than £200,000.

Of course, if you want to take out a secured loan, you'll need something to leverage. Either a physical asset like a piece of machinery or future income from a reliable source, such as an R&D Tax Credits payment from HMRC.

Fixed vs Floating

The lender will determine whether your loan should have a fixed or floating charge.

A fixed charge is 'attached' to a particular asset. If your company doesn't keep up its repayments, your lender has the right to possess and sell the asset to recoup its capital. A floating charge is not attached to a specific asset. Instead, it 'lands' on however many assets reflect the value of your loan.

Fixed charges are less flexible - you have to seek permission from your lender before disposing of the affiliated asset - and take priority over floating charges.

To demonstrate the difference in priority, let's say you had three assets worth £1 million and take out three £1 million loans with fixed charges against these assets. If your business went into administration and the assets were sold for £1 million each, those three loans would be satisfied (ignoring interest for the sake of argument).

However, if you took out a fourth £1 million loan on a floating charge basis, it would not get repaid unless there were other sources of cash or assets in the business.

Debt Seniority

Seniority refers to where a debt obligation sits in your capital stack. The more senior the debt, the higher its repayment priority should your company encounter financial difficulties and the lower risk to the lender.

Senior debt commands a lower interest rate than subordinated debt, so offering seniority is a good way to reduce the overall cost of your loan if you have multiple debentures on the business.

However, you may already have other obligations in your capital stack which command seniority, in which case you would be limited in terms of what you could offer a new provider.

Personal Guarantees

A personal guarantee is where an individual - usually a business owner or director - promises to repay their company's debts using their private assets and savings.

There are two kinds of personal guarantees: limited, where lenders can only collect a certain percentage of the outstanding balance from your assets; and unlimited, where you will be liable for the full outstanding balance.

Offering your savings and property as collateral can create great personal risk. Most founders already shoulder a lot of risk when starting their own company, so the extra pressure of a personal guarantee may be more than you are willing to tolerate.

For these reasons, we recommend that you only leverage personal assets as a last resort and that you use business assets, receivables and other metrics wherever possible.

What Will Lenders Lend Against?

Grants and R&D Tax Credits

GrantTree's Advance Funding service lets your borrow money against the expectation of government-sponsored funding like an R&D Tax Credit or an Innovate UK or EU grants. With Advance Funding, you can borrow up to 80% of your expected funding amount up to 12 months ahead of schedule.

Personal Assets

Property, possessions like cars and jewellery and cash savings that would back up a personal guarantee.

Business Assets

Lenders are happy to accept a wide range of tangible assets as security, including land, property, inventory, equipment and vehicles.

Cash Reserves

Certain providers will accept sizeable cash reserves as security. Though if you do have large cash reserves, you might want to reconsider taking out a loan.

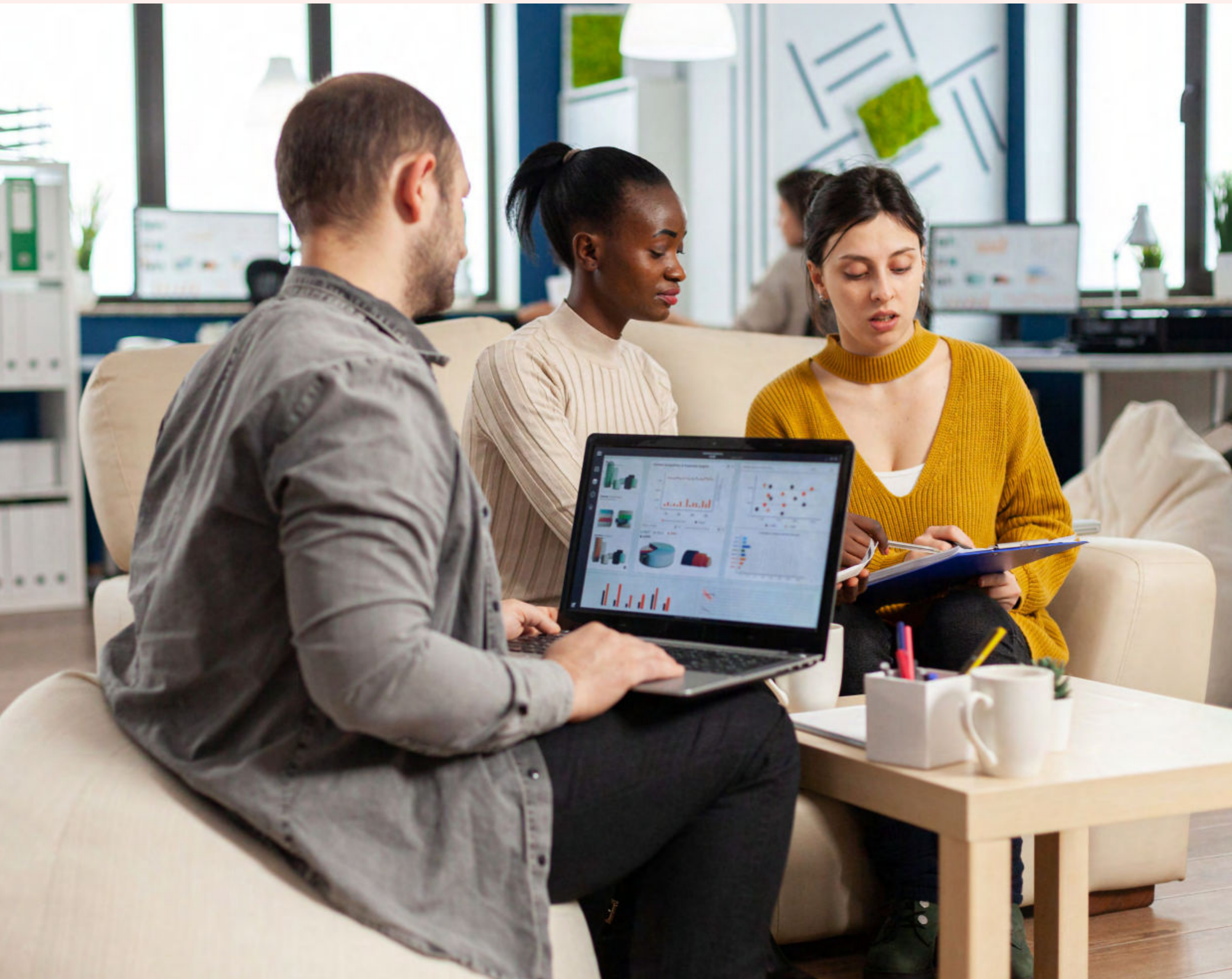
Revenue

Some providers lend against strong and growing revenues, like those generated by a SaaS business. This usually comes with extra strings attached, such as giving your lender control of your invoices or payment gateways.

Forms of Debt Financing

So far in this guide, we've covered the benefits of debt financing, what metrics lenders look for, the different terms they'll look to secure, and the various forms of security and assurance you can offer providers to access loans.

Armed with this understanding, let's now look at the various types of debt financing that may be suitable for your startup and when in your company's lifecycle each instrument is most beneficial.



Starting Out

Personal Guarantee-Backed Loans

At the beginning of your company's journey, you likely won't have corporate assets or sources of capital such as revenues and government funding to use as security. In which case, you may need to sign a personal guarantee to access a business loan. We have already explained the risks of personal guarantees. However, you may be able to acquire some protection for your private assets by taking out insurance.

Startup Loans

Startup Loans are a state-backed scheme offering favourable rates to businesses less than two years old. Founders can borrow between £500 and £25,000 at a fixed interest rate of 6% for up to five years.

Depending on your startup capital, a Startup Loan can be a valuable source of relatively inexpensive debt financing. The rates are much more generous than those offered by high street banks and other private lenders. And unlike most traditional financial institutions, Startup Loans are available to very early-stage companies.

Seed

R&D Tax Credits Advance Funding

If you're planning to claim R&D Tax Credits, GrantTree can advance you up to 80% of your claim amount as soon as you've completed your first financial quarter—a whole year ahead of schedule.

Our Advance Funding service combines all the benefits of government funding - generosity, accessibility, equity protection - with the speed of debt financing. And thanks to the extra reassurance provided by our tax credits delivery team, our partners can offer you market-leading interest rates and other generous terms on your advance.

Once you receive your money early, you can reinvest it straight away in further development, which means a larger R&D Tax Credit claim a few months down the line.

Find out more about Advance Funding.

Grants Advance Funding

GrantTree also offers Advance Funding on innovation loans. If you have won a grant from a recognised body like Innovate UK, GrantTree can advance you up to 80% of your grant value as soon as you are notified that your application was a success.

That means you can get to work immediately rather than waiting months for each of your grant instalments.

Seed to Series A

Venture Debt

Venture debt is tailored to startups and other high-growth, VC-backed companies.

Unlike other forms of financing, venture debt does not hinge on collateral or your company's cash flow. Instead, lenders prioritise your ability to continue growing and raise additional investment capital, enabling you to repay your loan.

Venture debt is most commonly structured as a convertible loan, a form of short-term debt that turns into equity at an agreed time or moment called a 'trigger'. Typically, triggers are equity fundraises over a specific size.

The convertible loan structure solves two problems: One, it incentivises lenders to finance high-risk companies by offering them the prospect of a potentially lucrative shareholding. Two, it allows investors to establish financial relationships with companies that are too young to accurately evaluate through traditional means.

Venture debt can help you raise additional investment capital quickly and without significant dilution to your company's equity. If you want to learn more about this form of financing, take a look at the range of detailed articles on Silicon Valley Bank's website.

Revenue-Based Financing

Revenue-Based Financing (RBF) is a form of debt companies use to scale their sales operations.

Rather than receiving monthly repayments, RBF providers take a share of their client's earnings - usually between 3% and 8%. The total cost of the loan is determined by a repayment cap, which typically ranges from 1.35x to 3x the original value of the loan.

Revenue-Based Financing is most suitable for high-margin, cash-generative businesses with steady monthly recurring revenues. To apply, you will need to provide prospective lenders with up to one year's worth of bank statements to demonstrate the health of your income stream and a documented plan to increase sales with your new capital.

R&D Tax Credits Advance Funding

R&D Tax Credits Advance Funding is also suitable as you work towards your Series A. As your investment in development work grows - financed by your seed funding - the size of your R&D Tax Credits claim - and your advance - will increase considerably.

Learn more about Advance Funding.

Series A to Series B

Venture Debt

Venture Debt becomes much more suitable as you work towards your Series B.

According to Silicon Valley Bank, lenders will "typically aim to provide 25-30% of an equity round as debt". As your funding rounds increase in size, so will the amount of venture debt available to you.

Bridge Loans

Bridge loans help you pay the bills while you seek your next round of funding. They are particularly useful if you're in the middle of a raise or are hoping to secure a higher valuation by growing your business a little more before approaching investors.

Bridge Loans, also known as interim financing, typically have a repayment term of one year. They are generally secured against an asset and have higher interest rates.

Beyond Series B

Mezzanine Finance

Mezzanine finance is a blend of corporate debt and equity funding. It is subordinate to pure debt, meaning traditional debt lenders are paid out first in the event of bankruptcy. This makes mezzanine loans riskier for the lender and more expensive for the borrower, with interest rates typically ranging from 12% to 20%. In most cases, mezzanine finance lets lenders convert their outstanding debt into an equity holding if the borrower defaults.

Mezzanine loans are primarily used to finance a specific acquisition or project. Businesses pursue mezzanine loans when they cannot raise enough funding from traditional corporate loans because their perceived risk of default is too high but they do not want to surrender additional equity to investors.

Mezzanine loans - which are often described as a blend of expensive debt and cheap equity - typically mature in five or more years. Usually, borrowers will only need to service the loan's interest, leaving them with more cash to invest in growth.

Preparing for Debt Financing

In the final section of this guide, we'll look at what your company can do to prepare to secure debt as quickly and efficiently as possible. We'll start by looking at a typical debt financing process.

Step 1: Decide Your Finance Strategy

Identify how much capital you want and what form of funding makes the most sense for your business.

Step 2: Identify the Right Instrument

Next, you need to decide which of the various funding instruments suits your company's needs.

Consider things like whether you have leverageable assets, whether you can lean on government funding, and what are your expected revenues.

Step 3: Approaching Lenders

Once you've chosen your instrument, you need to pick a suitable lender.

A good way to do this is to identify a few institutions or platforms with strong reputations offering favourable terms. Loan comparison websites like money.co.uk can help you narrow down your choices.

Once you've picked a handful of lenders you'd be happy to work with, reach out to them to kickstart the next stage of the process.

Step 4: Due Diligence

Due diligence is where your prospective creditor conducts checks to determine whether your company matches its risk profile and on what terms they'll be able to lend you money.

Creditors will ask for a range of evidence to confirm your company's financial situation, including detailed bank records, a business strategy including strategic goals, and information on your current and prospective investors.

Step 5: Reviewing the Loan Agreement

Once the lender or lenders have completed their due diligence checks, they will send you a formal loan agreement stating how much money you will be borrowing and on what terms.

It's a good idea to get this agreement checked by a lawyer. If you're happy with the agreement, all that's left to do is sign it and wait for your loan to arrive in your bank account.

Getting Ready for Debt Financing

That, in a nutshell, is what the process of securing debt financing looks like. Though things can look a lot different depending on who you are borrowing from and what kind of financing you are looking to acquire.

There are also things you can do to influence how much your company is able to borrow, on what terms you're able to borrow it, and how quickly you can access the funds.

Building Up Your Security

The first and most important thing you need to do to get your startup ready for debt financing is to build up whatever it is - cash, revenue, assets, avenues to government funding - you're planning to leverage.

The more you can build up before applying for your loan, the better terms your business will be able to command from potential lenders.

Securing Letters of Intent

Letters of intent are written agreements between two parties to take some action at a later stage. They are usually not legally binding but are a helpful way of showing that you have traction with a partner, supplier, distributor or investor.

Letters of intent can help your pursuit of debt financing by proving to prospective lenders that you have new financial opportunities on the horizon and are, therefore, less likely to default on your loan.

For example, if you had a letter from a large distributor agreeing in principle to sell your product, a creditor would likely interpret it as a sign that your revenues will rise in the near future.

A letter of intent from prospective investors can also reassure venture debt lenders that your company has achieved a certain valuation. This will give them the confidence to lend you more money on better terms.

Like the other documentation mentioned above, you should look to include letters of intent before you approach potential creditors. The letters should be as detailed as possible, including information like pricing, valuation, and dates for delivery and execution.

Collecting the Correct Documentation

Before you start seeking prospective creditors, you should also look to assemble and organise all the paperwork your prospective creditors will look at during the due diligence process. Again, the more you prepare in advance, the more time you'll save once you've identified the provider you want to work with.

The kind of documentation you need to provide varies by instrument and provider. If you're looking for Venture Debt, your investor will be more interested in reviewing your business strategy. If you're looking for equipment financing, your creditor will want to know about the machinery or vehicle you're purchasing.

The list of documentation a prospective creditor will be interested in includes but is not limited to:

- Financial statements for current and previous years
- Business plans and strategy documents
- R&D Tax Credits applications
- Successful grants applications
- Analyses of your market/industry
- Organisational charts
- Lists of current board members and senior leadership team, including bios
- Terms sheets from previous investment rounds
- Purchase agreements
- Detailed lists of valuable assets
- Technical information about your research and development work

Secure Your Advance Funding

GrantTree's Advance Funding enables high-growth companies to bring forward key investments in people, equipment, and innovation.

Through our service, you could access up to 80% of your R&D Tax Credits or innovation grant windfall up to twelve months ahead of schedule.

How Advance Funding Works

1. We get to know your company and run a quick initial eligibility test on a short call
2. We perform due diligence and eligibility checks together with our partner
3. We advance you up to 80% of your R&D Tax Credit claim or innovation grant

Why Use Advance Funding

Advance Funding is not for everyone. However, many CFOs currently use the ability to access a substantial cash sum on short notice in the following ways:

- To increase their cash runway between investment rounds
- As a backstop in case their investment round drags on
- To hit key business targets to negotiate investment terms
- As a buffer against challenging economic conditions

Learn More About Advance Funding

Ready to explore Advance Funding? Book a call with one of our Advance Funding specialists below!

Explore Advance Funding

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