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A study on venture debt and its growth in India

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Abstract
The venture capital industry in India has grown tremendously and has helped in creating not just unicorns, but companies who have brought in major changes to the world. From In Mobi in 2011 to the 100th unicorn – One card in 2022, India not only had a boom of entrepreneurs but also a boom of investors, who rightfully believed that India's place under the sun is just round the corner. In this article, a brief scenario of venture capitalism has been discussed along side the new venture-designed yet traditional form of debt based funding and its growth in India.

Keywords: venture capital and debt, dilution, startup, NCDs, warrants

Introduction

In India, Venture capitalism began in 1986 with the start of liberalization of the economy. In 1988, the Indian Government issued certain guidelines and with that formalized venture capital industry. However such venture capital was limited to subsidiaries of ICICI, IDBI and focused on industrial concerns. The current capital financing of new-age companies or startups has drastically changed over the years, with more and more private investors from India and abroad entering the venture capital market. [1]

A startup or startup is a company that is undertaken by a entrepreneur to seek, develop and validate a scalable business model. In business terms, it can be defined as an entity that has its headquarter in India, opened less than 10 years ago and has annual turnover of less than 10 years. 'Startup India' [9] was government's initiative to attract, retain and develop entrepreneurs by providing microfinance to kickstart the business. Government introduced freedom from capital gains tax, inspections for the first three years and improved bankruptcy code to bring much needed confidence and participation into the startup world of India.

A startup can function smoothly as long its coffers are filled, to which problem most promoters or founders have found very few options in India. While personal investments are necessary, lack of personal funds or too little funds to start with brings in the concept of family fund or 'love money'. But rarely do family or friends have such spare capital or the ability to take risk. As such it is very difficult for founders to remain bootstrapped or build the startup with their own or family funds. Thus founders look for raising funds from either Angel investors, Venture capital firms, Venture Debt firms or Private Equity investors. [7, 8, 3]

A brief understanding of Venture Capital and its Providers

A Venture Capital Firm is a company that invest money into startups or emerging companies that seek funds. These VC firms raise money by offering limited partnership to investors. A VC firm may also serve as Venture Debt firm if they participate in debt deals instead of equity deals. [10] Prominent VC in India include Sequoia Capital, Accel Partners, Kalaari Capital among others [2].

Expectations of VC firms

Venture capitalists offer capital in exchange for equity in the startup. Equity which the founder(s) must give by diluting their ownership or reducing their ownership. Venture capitalists look for high growth, technologically-driven business in sunrise or new sectors. The VC's invest knowing that the startup will burn cash to grow and acquire customers, however they expect that the firm will scale, boost sales, increase ratio, get profitable and be more valuable with time.

During periods of economic boom, low interest rates to borrow money, VC firms (both domestic and international) pumped billions of dollars in Indian startup ecosystem. However, central banks around the world stopped the access to easy money and started raising interest rates. This resulted in a lot of problems for firms that need funds to survive in the market and as such news of layoffs have been more common than before.

Venture Debt and its difference from Venture Capital

Venture Debt is form of debt financing, typically a non-convertible, senior secured loan to companies backed by venture capital firms. While banks typically loans money to companies with strong fundamentals and sufficient collateral, these venture debt lenders provide debt-based financing to growth stage companies that may or may not be cash flow positive, they also may have little to no collateral to provide since technology-driven companies rarely have assets. The debt comes at many times, on the contingent that the startup already is VC funded and has strong growth potential. [4, 6]

While venture capital provides financing by taking up equity in a company, venture debt provides financing for generally short or long-term capital and expect to be repaid on their investment. The repayment is contractually required, every rupee that is so raised, must be paid back alongside interest. Venture debt providers at times also combine loans with warrants.

Uses cases of Venture Debt for startups

Venture debt work as a strategic tool which if used and incorporated effectively can yield great results for the borrowers:-

(a)Protecting equity dilution- By not raising funds through vc route, founders avoid dilution of their equity and control over the company. The previous shareholders also continue holding same percentage of stake without having to infuse fresh funds at fresh valuations. Understanding this with an example:
Company A has 4 shareholders including its founder. All have same equity stake, that is 25% each. The three external investors invested into the company when it was valued at 3,00,00,000 or Rs 5 Crore. Now the company has grown alongside its valuation which stands at 1.8 times of last time or 9 cr. It decides to raise 3 cr from a new VC firm at 9 cr valuation [13].
Dilution percentage = money to raise / post money valuation

* 100 = 3/9 * 100 = 25%

Percentage of ownership post dilution = % owned before raise - (% owned before * dilution percentage)

= 25 -(25*25%) = 25-6.25 = 18.75

(b)Extending runaway between rounds: Entrepreneurs can use venture debt as a runaway to the next series round. This allows them to remain financed and grow the company to a stage where they have higher capital raising ability.
(c)Financing working capital: The debt so raised can be used to finance the working capital of a rapidly growing business that require significant investment in working capital, capital expenditure (CAPEX) and even business acquisitions.
Venture debt is usually not available for seed-stage or idea-stage companies since the inherent risk of default is much greater. Companies without VC funding are generally avoided by Venture Debt providers [11, 15].

Indian Venture Debt Ecosystem
The growth of entrepreneurial focus in India has opened the gates for various funding options. Venture capital which had and still dominates majority of deals that take place, has slowed over the months in 2022, mostly due to macroeconomic conditions, tightening of monetary policy. As such alternative funding options like venture debt has grown rapidly and currently VD deals are at an all time high with average money raised also increasing.
According to public data available on Traxn, $538 million were disbursed in 2021, thats more than 50% of what was disbersed in 2020, i.e 271million dollars. Majority of these debt deals were provided to companies who were in series D and beyond stages, followed by Series A stage companies [20].
Fintech was the leading sector for number of deals and also led the sector with most amount of venture debt invested. With 111 deals and an average ticker or investment size of $5.85 million, 2021 saw great progress for venture debt deals.

Criteria That Attracts Venture Deal Providers
Venture debt follows into companies that have stable and predictable growth and revenue. Startups that are underleveraged, having 5-7% of debt to valuation ratio, have sufficient revenue to service the loan and a good amount of equity capitalization, usually brings both the lender and borrower to close the deal.

Structuring A Venture Debt Deal
After a through look into a company's balance sheet, income statements and its financial backers, does the Venture lender agree upon debt-based financing. A Non-Convertible debenture (NCDs) is issued by the borrower to the lender. NCDs is the underlying instrument in venture debt deals and is a coupon-bearing security. Along with issuance of NCDs, lenders subscribes to the equity warrants of the borrower. Warrants are securities which gives the holders the right(but no obligation) to subscribe to equity of the company a certain price within a specified period of time.
The interest rate component is a crucial part as the borrower need to pay it along side the initial principal. The rate of interest is different for different companies and venture debt funds. For example, Stride ventures charge 14% interest on the loaned amount. Many lenders offer interest only period before repayment of the principal can start.
Warrants as a security offers potential upside as a shareholder in the company. The amount of shares that the lender can subscribe to is usually set to a percentage of the loan commitment.
As such, lenders get returns on investment with a combination of fixed interest income and potential upside gain through warrants. The NCDs issued are senior secured debt. Event the companies who do not have fixed assets tend to use their patents, current assets as collateral to secure the debt. Furthermore the borrowers are institutionally backed with strong focus on corporate transparency and governance, thus limiting the chances of corporate fraud or embezzlement of funds.
The ticker size or investment size is usually 15% of total equity raised or between 25-50% of the previous round.
Startups that are growing month on month, have it more easy to finance the debt as the loan fixes the working capital mismatch. These startups also need to raise equity every 7-10 months to continue expansion and thus will find financing the deals much easier than the ones who are in their pre-revenue or concept-based stage [14].

Default on Venture Debt
Even with utmost and sincere scrutiny, a startup may default on its payments. Various reasons for the default may include- worsening cash flow situation, inability to conclude a deal/round. Under such circumstances the lender try to resolve amicably by talking with the founders, old investors, increasing the tenure to reduce monthly payments or refinancing the old debt with newer debt. Lenders have certain assets as collateral and can use them to recoup as much losses as possible. VD deals as such close upon very tight scrutiny to eliminate or reduce the chances of default.

Growth of Venture Debt in India
In 2021, India recorded ~2x growth in number of VC deals (1545 vs 809 in 2020) and average deal size also expanded from $12.4M to $24.9M. More than 90 mega deals of size $100M or more closed against 20 in 2020. With total deal value of $38.5B it minted 44 unicorns in a single year. The year was also monumental for exits as total exits reached above $14B across IPO and secondary transactions. [20]
In comparison, Indian startups raised $600 million of venture debt in 2021. Although it was two times the amount raised in 2020, it was just 1.5% of the money raised via VC deals [19].

However the macroeconomic situation soured and VC money slowed this year. For some numbers, VC funding in India in Q3 2022 fell to a ten quarter low of $2.8 billion across 387 deals, that is against the $6.6 billion across 404 deals in the previous quarter. As such, 2020 is regarded by founders as the year of funding winter.

Startups have now turned to venture lenders. In the six month period of 2022 alone have attracted $284 million in debt funding. With drying of equity market, startups can no longer raise money at the same kind of inflated valuations. Mobiwik one of the digital payments provider raised 35 crore in debt for leeway till it could go public, as markets worsened, its craped its plans for an IPO and decided to raise funds at lower valuation. Similarly to Mobiwik, Udaan, a B2B e-commerce platform raised 960 crore or 120 million dollars in form of convertible debt and notes as the late stage company finds it hard to raise equity capital.

Since the beginning of FY2022, Institutional investors are reducing exposure to high- growth companies and moving towards companies with sustainable business model. The startups need cash to survive and to reduce cash burn are resorting to layoffs. Byjus recently announced laying off 4000 employees along side other edtech startups like Unacademy and Vedantu.

In India prominent VD providers are Alteria Capital, Trifecta Ventures, Stride Ventures and Innoven. Alteria Capital closed its third fund at 1000 crore as venture debt asset class increase in popularity amid the funding winter [12]. The fund has backed the likes of Bharatpe and Dunzo, it plans to continue backing startups across early and growth stage with cheques sizes upto 150 crore. D2C startup MyClam raised 155 crore in debt from Trifecta and Stride. Edelwiess wealth management recently launched a $361 million debt fund to invest in startups looking to survive the funding crunch [17, 24, 22].

The change in outlook for founders to raise money through debt route also led to increase in scrutiny and more due-diligence. Conversation ratios are now smaller with filters sorting out mature, cash flow positive positive and good fundamental companies from the rest.

Despite a 11% growth in venture debt investments, i.e $312M vs $280M, it is still a small size against the overall venture market. It is less than 2% of VC deals in India while in US it is 15%. This means there is a lot of opportunity to grow and the current momentum will push VD sector ahead [16].

Conclusion

As fear of recession looms along side periods of high interest rates, it would be a difficult period for Startups and every stakeholders of it. From employees to share/debt holders, everyone involved will be effected in the long ‘funding winter’. Startups with high cash burn takes the equity route, so as to not put pressure on the already fragile cash flow situation. Venture debt as such is a double edged sword [20], where unless the borrower has sufficient revenues and cash flows, it cannot possibly pay up interest and principals periodically. Unless the startup has a sustainable business model it is going to be a messy situation for everyone involved in the startup ecosystem. Unprofitable startups that get listed on the stock exchanges are trading well below their listing price as investors rethink the intrinsic value of the company.

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