Venture Debt (Private Credit)

Interview preparation summary · PC track

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INT.CY.1.a · The product

Explain what venture debt is, how it differs from a bank loan and from venture equity, and weigh the cost of the debt against the dilution it avoids.

Venture debt is lending to companies backed by venture capital investors, usually before they are profitable or cash generative. A bank lends against historic earnings, assets and financial tests; a venture lender has no earnings to lend against, so it lends against the strength of the equity behind the company, its cash and runway, and the milestones that will unlock the next round. Repayment comes from cash on the balance sheet, the next equity raise, growing revenue or an exit, in roughly that order of likelihood. For the company the loan extends runway between rounds, funds equipment or working capital, or buys time to reach a milestone that justifies a higher valuation, and it dilutes founders and early investors much less than the same amount of equity. The price is a coupon, fees and often a small grant of warrants. For the lender the return is capped, with a little upside through warrants, while a failure costs principal, so the lender wants investors with a record of backing their companies with follow-on money. Venture debt is not a substitute for equity: repayments are fixed whether or not the plan is met, so too much debt shortens the effective runway and raises the risk of a failed round. The usual mistake is to call it cheap equity. It is cheaper only if the milestone is reached and the later round is priced higher; if the round is flat or down, the debt has cost money and the dilution is the same. A strong answer compares the interest and fees with the dilution avoided, and says who carries the risk if the plan slips.

WORKED EXAMPLE: DEBT NOW OR EQUITY NOW

Pennard Sensors needs 6m to reach a certification milestone in nine months. Route A is to raise 6m of equity now at a pre-money valuation of 40m. Route B is to borrow 6m for a year at 12% interest only with a 1% fee, then raise 6m of equity after certification at a pre-money valuation of 60m. Which route is better for existing holders, and when does it stop being better? Figures are in millions.

Answer: Route B is better by about 1.83m if certification is reached and the round is priced at 60m pre-money; if the round is no higher than 40m pre-money, Route B is worse by the 0.78m of cost and leaves a debt to repay.

> **Interview tip:** Say that venture debt buys time at a known cost, give the dilution saved and the cost in your first two sentences, and then say what happens if the milestone is missed.

INT.CY.1.b · The product

Describe the main venture debt instruments and terms (term loans, growth capital, equipment lines, recurring-revenue loans, revolving lines), and work out payments under interest-only periods, amortisation, fees and prepayment protection.

A term loan is drawn in one amount, or in tranches tied to milestones, and repaid on a schedule. A growth capital loan is a larger term loan to a company with real revenue. An equipment line is drawn against specific purchases and repaid over the life of the equipment, which gives the lender a clear asset. A recurring-revenue loan is sized on annual recurring revenue from subscription customers rather than on earnings. A revolving line flexes with working capital, often against receivables. Most term loans start with an interest-only period, commonly several months to a year or more, which keeps cash in the business while it grows, and then amortise in equal instalments or on a declining schedule. Pricing has several parts: a cash coupon, an up-front or facility fee, an end-of-term or final payment set as a percentage of the original loan and due at maturity or on prepayment, a commitment fee on undrawn amounts, and warrants. Call protection or a prepayment fee, often stepping down year by year, discourages early repayment; the end-of-term payment usually remains due. When you work a schedule, compute interest on the opening balance each month, check which months are interest only, and remember that early

repayment leaves the lender with the fixed fees but less interest. The usual mistakes are to forget interest in the amortisation phase, to apply the prepayment fee to the original amount instead of the balance, and to treat the end-of-term payment as avoidable by repaying early.

WORKED EXAMPLE: SCHEDULE AND PAYOFF ON A 12M TERM LOAN

A lender provides a 12m term loan at 11% a year with a 1% fee, a 5% end-of-term payment on the original amount, 12 months interest only and then 24 equal monthly principal instalments. Interest is paid monthly on the opening balance. What does the borrower pay in month 13, what is the total interest, and what does it pay to settle in full just after its month 18 instalment if a 2% prepayment fee applies to the balance? Figures are in millions.

Answer: Month 13 is 0.61m, total interest is about 2.70m (total income about 3.42m), and settlement after month 18 is 9.78m.

> **Interview tip:** Describe the schedule in the order of the cash: interest only first, then principal plus interest, then the fees, and say that the end-of-term payment is due on prepayment as well.

INT.CY.2.a · Underwriting and pricing

Underwrite a loss-making company by computing runway and burn including the loan's own debt service, and by judging the equity investors, the equity cushion, the next round, concentration and asset coverage.

With no positive cash flow, the first question is whether the company can reach its next financing, so the analysis starts with cash, net burn and runway, and it must include the loan's own debt service: interest from the first month and principal once amortisation begins. Next come the equity investors. Their record of funding follow-on rounds, their remaining reserves and their reputation with other investors matter more than the headline valuation, because the next round or a bridge from existing holders is how most loans are repaid. The equity cushion is the amount of equity raised relative to the loan, and a larger cushion means more value stands behind the debt. Then test the plan: what growth or milestone is needed to raise at a good price, how that compares with recent history, how far the next round must close before cash runs out, and what happens if it is six months late or priced flat. Check concentration in customers, dependence on a single product or a regulatory event, and the key people. Intellectual property and equipment are secondary support: a buyer for a failed company pays little, so the lender underwrites to the next round and treats assets as a backstop. The usual mistakes are to quote runway without the debt service, to count loan proceeds as cash that is not available, and to be persuaded by the size of the market instead of the evidence of the numbers.

WORKED EXAMPLE: RUNWAY WITH AND WITHOUT THE LOAN'S REPAYMENTS

Halden Logistics Software has cash of 9m and net burn of 0.9m a month. It asks for a 6m loan at 12% with 12 months interest only and then principal of 0.25m a month, with no fee. Equity raised to date is 36m. How long does the cash last before and after the loan, and what does that mean for the next round? Figures are in millions; interest is monthly on the opening balance.

Answer: Runway rises from 10 months to 14 full months, not the 15.6 of the shortcut; with a six-times equity cushion the credit depends on closing the next round before month 12.

> **Interview tip:** Always add the debt service to the burn before you quote runway, and say how many months of margin remain between the date the next round is needed and the date cash runs out.

INT.CY.2.b · Underwriting and pricing

Price a venture loan by combining coupon, fees, end-of-term payment and warrants into a blended yield and IRR, and net off expected loss.

A venture lender's return has four parts. The coupon is the cash interest. Fees include an up-front or facility fee and sometimes a commitment fee on undrawn amounts. The end-of-term payment is a percentage of the original loan paid at maturity or on prepayment. Warrants give the right to buy shares at a fixed exercise price, usually the price of the latest equity round; the number of shares is the coverage percentage times the loan, divided by the exercise price. For a quick estimate, add the coupon to the fees spread over the loan's weighted average life, which is the average time each pound of principal is outstanding. A precise answer builds the monthly cash flows and solves for the IRR. Fixed fees raise the annualised return when the loan is repaid early, because they are earned over a shorter life, which is why borrowers resist heavy prepayment terms. Warrants are upside, valued as the gain between the exercise price and the later share price, and they are not relied on to justify a loan; many are worth little and a few are worth a lot. To compare loans on a loss-adjusted basis, multiply the probability of default by the loss given default to get expected loss over the life, spread it over the average life, and subtract it

from the annual yield. The usual mistakes are to add fees in full to an annual yield, to leave out the end-of-term payment, to value warrants at the share price without deducting the exercise price, and to deduct the default probability without the loss given default.

WORKED EXAMPLE: BLENDED YIELD ON A 10M LOAN

A fund lends 10m at a 12% coupon with a 1% fee, a 5% end-of-term payment, 12 months interest only and then 24 equal monthly principal instalments, with warrants of 5% coverage at an exercise price of 2.00 a share. The probability of default over the life is 8% and the loss given default is 45%. Estimate the yield, the IRR, the warrant value if the shares are worth 6.00 at exit, and the yield after expected loss.

Answer: Quick yield about 14.9%, exact IRR about 15.4% effective, warrants worth 1.0m if the shares reach 6.00, and about 13.1% after expected loss on the quick basis.

> **Interview tip:** Give the coupon, then the fees spread over the average life, then say the warrants are upside you do not underwrite to, and finish with the yield after expected loss.

INT.CY.3.a · Protection, trouble and portfolio

Set out the covenants and protections a venture lender uses and why financial maintenance covenants are light, and analyse what happens in trouble: a down round, missed milestones, waivers, restructuring or a wind-down, and recovery from assets and intellectual property.

Leverage and interest cover tests are rarely useful when earnings are negative, so venture loans lean on other protections. A minimum cash covenant, often a number of months of forward burn and sometimes required to be held with the lender, gives early warning well before cash runs out. Information rights give monthly accounts, budgets and board materials. Security is usually a first-ranking charge over the assets, with intellectual property either charged or protected by a negative pledge, which stops the company giving security over it to others but gives the lender nothing it can enforce itself. A material adverse change clause lets the lender stop funding or call a default if the business or its prospects change significantly, but it is vague and used with care. Drawdown conditions, milestone-linked tranches and sometimes investor-support provisions complete the package; counsel handles the legal detail. When things go wrong, typical triggers are a missed milestone, a down round, a covenant breach or a failed raise. The lender chooses between enforcing, waiving or amending for a price, and restructuring or a managed sale. A waiver should be paid for with a fee, a higher margin, tighter reporting, more warrants or new equity first. Recovery in a wind-down comes from cash, receivables at a discount, equipment at a heavy discount and a sale of intellectual property and customer contracts, less costs of realisation. The usual mistakes are to count assets at book value, to omit costs, to leave out the end-of-term payment and accrued interest from the claim, and to enforce in a way that destroys more value than a funded plan would preserve.

WORKED EXAMPLE: RECOVERY IN A WIND-DOWN

A lender with first-ranking security over all assets is owed 8.0m of principal, 0.4m of end-of-term payment and 0.1m of accrued interest by a failed company. Realisable assets: cash 1.0, receivables of 1.2 at 75%, equipment with book value of 2.0 at 40%, and an intellectual property and customer contract sale for 3.0. Wind-down costs are 0.8. What is the recovery, and what if the intellectual property sale fails? Figures are in millions.

Answer: Recovery is 57.6% (loss given default 42.4%), falling to 22.4% if the intellectual property cannot be sold.

> **Interview tip:** Say that you discount each asset class, deduct costs, include everything owed in the claim, and then show how much of the recovery depends on the single largest asset.

INT.CY.3.b · Protection, trouble and portfolio

Build a venture debt portfolio and show judgement: granularity, stage, sector and vintage mix, reserves, relationships with venture investors, and the case for lending to one company and not another.

Venture borrowers fail for reasons that are individual and hard to predict, so a venture debt portfolio is built from many small positions across stage, sector and vintage. Position limits are set so that one default is a small fraction of the fund; a useful check is how many defaults it takes to wipe out a year of income. Stage mix matters because earlier companies carry more risk of failing to raise, while later growth companies carry lower loss rates but larger loans and tighter pricing. Sector spread avoids a single regulatory or funding cycle hurting the book, and vintage spread avoids lending everything at the top of a valuation cycle when down rounds follow. A fund also keeps reserves for follow-on draws and for waivers or amendments, and tracks warrants as a separate and lumpy source of return. Relationships with venture investors supply deal flow, information and support when a borrower is in trouble, but a relationship is not a guarantee and every loan is underwritten on

its own. In an interview, show judgement with a comparison: prefer the company with funded runway, an investor with reserves and evidence of growth over the one with a charismatic founder and a binary event after cash runs out. When asked why venture debt, give a genuine reason: the mix of structured downside protection and exposure to innovation, the need for company-by-company analysis, and the close contact with founders and investors. The usual mistakes are to treat warrants as certain, to ignore concentration, and to answer judgement questions with a list of features and no choice.

WORKED EXAMPLE: GRANULAR AGAINST CONCENTRATED

Two funds each hold 100m and earn 14m of income a year. Fund G holds 25 loans of 4m. Fund C holds 10 loans of 10m. In both, a default loses 50% of the loan. How much does each default cost, and how many defaults wipe out a year's income? What is the net return after two defaults? Figures are in millions.

Answer: A default costs 2.0% in Fund G and 5.0% in Fund C; it takes 7 defaults to wipe out a year's income in G and 2.8 in C; after two defaults G earns 10% and C earns 4%.

> **Interview tip:** Quote the loss per default and the number of defaults that wipe out a year's income, and say that the point of granularity is the spread of outcomes, not a higher average return.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.