A.R.I.
APPLIED REAL INTELLIGENCE

VENTURE DEBT
10 THINGS TO KNOW

January 22, 2021

FIRM OVERVIEW

Applied Real Intelligence LLC ("A.R.I.") is a venture debt investment manager focused on providing financing solutions to innovative, high-growth, VC-backed companies operating in recession-resistant sectors and underserved regions throughout North America.

A.R.I.'s investment strategy aims to provide limited partners with superior risk-adjusted returns, security of capital, and strong portfolio diversification benefits.

ABOUT THE AUTHOR & FUND MANAGER

Zack Ellison, CFA, CAIA, is A.R.I.'s Managing General Partner and Chief Investment Officer. He leads A.R.I.'s investment activities, including sourcing, due diligence, structuring, execution, and portfolio management.

Previously, Mr. Ellison was Director, U.S. Fixed Income at Sun Life Financial, where he was responsible for corporate credit investing. Prior to Sun Life Financial, Mr. Ellison was a corporate bond and credit default swap trader at Deutsche Bank. During the Global Financial Crisis, he was a banker focused on leveraged loans within the media and telecom sectors at Scotiabank.

Mr. Ellison holds an MBA from The University of Chicago Booth School of Business and an MS in Risk Management from New York University's Stern School of Business. He has earned the Chartered Financial Analyst (CFA) and Chartered Alternative Investment Analyst (CAIA) designations and currently serves as a Board Member of CFA Society Los Angeles and the Southern California Chapter of the CAIA Association.

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EXECUTIVE SUMMARY

- Venture debt includes debt products for companies which have previously received institutional funding. Venture debt is usually provided in the form of short duration, senior secured term loans combined with equity warrants. This mix provides the lender with capital protection, current income, and unlimited potential return.

- Venture debt is provided to technology-enabled companies that use technology hardware, software, tools, platforms, libraries, and frameworks to make products or provide services that increase efficiency and effectiveness. Technology-enabled businesses are valued significantly higher than businesses that are not given the shift towards a digital, on-demand, economy.

- Over 75% of the venture debt market is controlled by fewer than 10 commercial banks and Business Development Companies (BDCs).

- The market is expanding rapidly and is expected to grow to $20-25bn by 2021YE.

- Returns have typically ranged from 15% to 25% annually through a combination of contractual interest and fees, and equity returns (via warrants) from 2005 through 2020.

- Venture debt has surprisingly low historical loss rates. From 2005 through 2020, a period that includes the worst years of the Global Financial Crisis during 2008-2010, losses in venture debt have averaged less than 0.50% annually,

- There are several factors that are unique to venture debt that significantly de-risk the loans and limit downside risk. The downside protection arises from a triumvirate of high performing operating companies, strong deal structures, and supportive VC-sponsors. Existing investors have a vested interest in the borrower's success.

- The three primary benefits of venture debt for investors are: 1) Superior risk-adjusted return; 2) Security of capital; 3) Strong portfolio diversification. Additional benefits that investors appreciate about venture debt: no "J-Curve" effect, relatively short duration, low volatility, no interest rate risk, and the opportunity to co-invest.

- The majority of institutional investors classify venture debt as an absolute return strategy that lies within their income generating or credit portfolios. For investors seeking direct exposure to venture debt, co-investment opportunities, and lower short-term volatility, private closed-end fund structures offer the only opportunity.

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1. VENTURE DEBT EXPLAINED

DEFINITION OF VENTURE DEBT

Venture debt includes debt products provided to companies that have already received funding from venture capital firms.

KEY ATTRIBUTES

- *Senior secured debt*
- *Contractual current income*
- *Unlimited equity upside*
- *Short duration*

Venture debt includes debt products provided to companies that have already received institutional funding, typically in excess of $15 million over multiple equity financing rounds, from venture capital firms.

Venture debt is generally provided in the form of short duration, senior secured (1st or 2nd lien) term loans, with an original maturity of less than four years, that are combined with equity warrants. This mix provides the lender with capital protection, current income, and unlimited potential return given the right to participate in the equity upside of the borrower.

Venture debt complements, and rarely substitutes for, funding provided by equity investors. Loans are customarily made three to nine months following a Series B, Series C, or later equity financing round. Benefits confer to both the underlying borrower and the borrower's existing equity investors – including the VC firms that have previously funded the borrower – principally by offering a minimally-dilutive and cheaper alternative to equity financing. The founding teams and their early investors are not meaningfully diluted out of their positions.

BENEFITS FOR BORROWERS

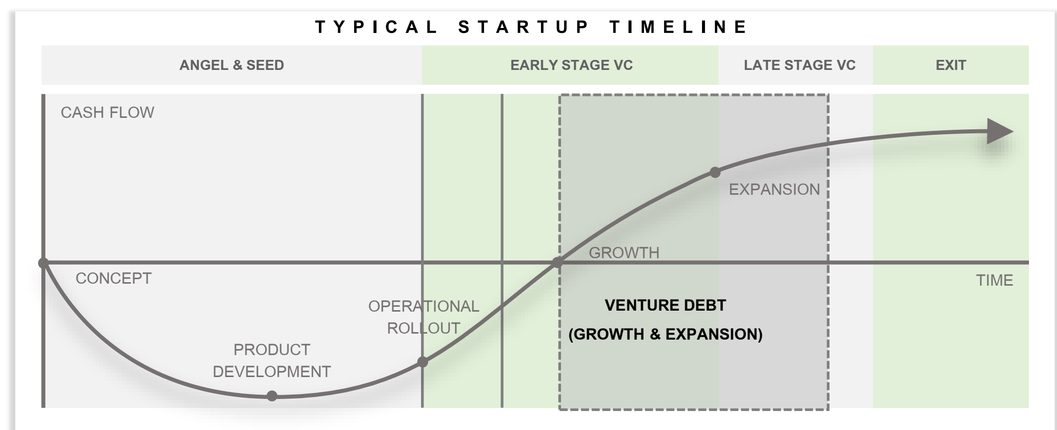
- *Complements equity*
- *Minimizes ownership dilution*
- *Lowers cost of capital*
- *Faster to obtain*
- *Extends runway*
- *Accelerates growth*

Venture Debt Benefits to Startups (Borrowers)	Venture Debt Benefits to Venture Capital Firms (Equity Investors)
Minimizes ownership dilution	Supportive and complementary to venture equity
Accelerates growth and expansion	Preserves ownership position
Extends runway	Conserves capital for other opportunities
Decreases cost of capital	Improves oversight and monitoring
Faster to obtain than equity financing	Reduces risk concentrations

TIMELINE

- *Generates revenue*
- *Cash flow to service debt*
- *Growth through expansion stage*
- *Following series B - D financing rounds*

Venture debt is typically utilized once a company has reached a growth or expansion stage and has the revenue and internally generated cash flow to support the fees, interest, and principal repayments associated with debt. By the time a company is eligible for a venture loan, it has already raised three to six rounds of equity funding in prior financing rounds (e.g., Pre-Seed, Seed, Series A, Series B, Series C, etc.). The borrower has been significantly de-risked at this stage given they have typically been operating for five to eight years and have undergone multiple due diligence reviews performed by experienced institutional investors.



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USES

- *Growth capital*
- *Runway extension*
- *Equipment leasing*
- *Working capital*

INDUSTRY ATTRIBUTES

- *Recession resistant*
- *High-growth*
- *Technology-enabled*

SECTORS

- *Software*
- *Internet & Business Services*
- *FinTech*
- *Healthcare Services & Supplies*
- *BioTech & Pharma*
- *CleanTech*
- *AgTech*
- *Supply Chain & Logistics*
- *Media & Telecom*

MARKET SIZE

- *$18bn in 2020*
- *~12% of total VC financing in 2020*

MARKET GROWTH

- *$20-25bn annually by 2021YE*

Venture debt is utilized for: 1) Growth associated with product development or new product offerings, and expansion into new geographies or market segments; 2) Optimizing the timing and valuation of the next equity financing round by extending the resources and timeframe of the borrower, enabling key valuation milestones to be met ("runway extension" or "bridging"); 3) Equipment leasing; and 4) Working capital. Venture debt is not used to facilitate mergers or acquisitions.

2. INDUSTRIES BEST SUITED TO VENTURE DEBT

Venture debt is provided predominantly to technology-enabled companies that use technology hardware, software, tools, platforms, libraries, and frameworks to make products or provide services that increase efficiencies and effectiveness. Technology-enabled businesses are valued significantly higher than those that are not given the shift towards a digital, on-demand, economy. Businesses that are technology-enabled present significantly less risk than those that are not.

Venture debt is best suited for high-growth companies operating in recession-resistant industries, such as: Financial Technology ("FinTech"), Software, Software as a Service ("SaaS"), Internet & Business Services, Business to Business Marketplace ("B2B"), Biotechnology ("BioTech") & Pharmaceuticals, Drug Discovery & Development, Healthcare Services & Supplies, Sustainable & Clean Energy Technology ("CleanTech"), Agricultural Technology ("AgTech"), Supply Chain & Logistics, E-Commerce Consumer Products, Media & Entertainment, and Telecommunications.

3. SIZE OF THE VENTURE DEBT MARKET

Venture debt lies at the intersection of two prominent asset classes: private middle market loans and venture capital. The private middle market loan market in the United States is approximately $400 billion in size.[1] The venture funding market has grown substantially, increasing nearly 5x in size from $32 billion in 2010 to $156 billion in 2020 in the United States.[2]

The size of the venture debt market is not precisely known because loans are made to private companies and are not required to be publicly reported in many cases. However, multiple specialized data providers estimate that venture debt represents 10-15% of the total venture financing each year in the United States. A.R.I. estimates that in 2020 venture debt accounted for approximately $18 billion, utilizing a bottom-up analysis of the publicly available loan data from banks, Business Development Companies ("BDCs"), and private funds.

The investment opportunity in venture debt expanded significantly following the Global Financial Crisis, when increased capital requirements and tightened regulations made holding corporate middle market loans more expensive and restrictive for bank lenders. This led to a greater opportunity for nonbank lenders, who stepped in to fill the demand for capital from borrowers. This structural shift, combined with the explosive growth of innovative early-stage companies seeking financing, has provided fertile ground for the growth of the market.

4. GROWTH DRIVERS OF THE VENTURE DEBT MARKET

A.R.I. expects the venture debt market to continue to grow quickly and substantially from its current size to reach $20-25 billion annually by year-end 2021 based on:

- More early-stage companies will be successfully launched and will require financing, thereby increasing the demand for capital from venture lenders. The proliferation of early-stage companies is underpinned by low (and falling) barriers to entry, including minimal costs to launch and run a business, and a continued inflow of human capital, including a growing number of talented graduates from the world's leading universities.

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FUNDAMENTAL GROWTH FACTORS

- *Rise in entrepreneurship*
- *More companies in the market*
- *Increased demand by borrowers*
- *Companies remaining private longer*

- Continued market maturation, including understanding and sophistication of borrowers and their equity investors, about how to utilize debt as an integral and larger piece of a firm's strategic financing plan and optimal capital structure. It is estimated that only 2% of the capital base of early-stage companies' is debt, compared with nearly 30% for companies in the S&P 500 Index.[3] A.R.I. projects that this 2% figure will grow to 3% or 4% in the next one to three years, implying near-term market expansion of 50-100%.
- Many early-stage companies are opting to stay private for longer, thereby increasing the need for funding sources, particularly debt that is minimally-dilutive and ably serviced by later-stage private companies.

A.R.I. believes that these factors will lead to continued growth of the total venture funding market, and a larger percentage of funding will be in the form of debt. This will facilitate opportunities to provide debt capital to attractive early-stage companies.

5. VENTURE DEBT MARKET CONSTITUENTS

TYPES OF LENDERS

- *Commercial banks*
- *Business development companies*
- *Private closed-end funds*

A.R.I.'s research indicates that over 75% of the venture debt market is controlled by fewer than 10 commercial banks and BDCs, such as Silicon Valley Bank (NASDAQ: SIVB), Pacific Western Bank (a unit of PacWest Bancorp, NASDAQ: PACW), Bridge Bank (a unit of Western Alliance Bancorp, NYSE: WAL), Comerica (NYSE: CMA), Hercules Capital (NYSE: HTGC), TriplePoint Venture Growth BDC (NYSE: TPVG), and Horizon Technology Finance Corp (NASDAQ: HRZN). The remainder of the market predominantly consists of closed-end private funds that hold less than $500 million in assets under management.

Other (non-venture debt) strategies that investors often compare to venture debt include direct middle market loans, mezzanine debt, high yield bonds, and syndicated bank loans. While all of these strategies have their merits, A.R.I. believes that venture debt is unique in its combination of attractive investment characteristics.

PRIVATE FUND CHARACTERISTICS

- *Superior risk-adjusted return*
- *Co-Investment opportunities*
- *Low volatility*
- *Direct & unlimited equity upside*

	Private Venture Debt	Venture Bank Stocks	Public BDC Stocks	Mezz Debt	Middle Market Loans	High Yield Bonds	Bank Loans
Superior Risk-Adjusted Returns	X		X	X	X		X
Co-Investment Opportunities	X						
Low Volatility	X			X	X		X
Direct & Unlimited Equity Upside	X		X				

6. HISTORICAL RETURNS OF VENTURE DEBT

HISTORICAL RETURNS

- *15-25% annually over 15 years*
- *Quarterly income from interest*
- *Upfront fees*
- *Backend fees*
- *Equity warrants*

Over the past 15 years, gross returns have typically ranged from 15% to 25% annually for private closed-end venture debt funds and publicly traded BDCs. These returns are achieved through a combination of interest, fees, and equity exposure (via warrants). Interest is typically a floating rate (e.g., Prime Rate + credit spread) that is paid in cash on a quarterly basis but may also include some form of payment-in-kind ("PIK") interest. Fees typically include those received by the lender at the time of initial loan underwriting ("upfront" fees) and at time of loan repayment ("backend" or "success" fees). Equity warrants are likely to be monetized at the end of the fund or when a portfolio company has a positive liquidity event, such as being acquired or going public via an initial public offering ("IPO").

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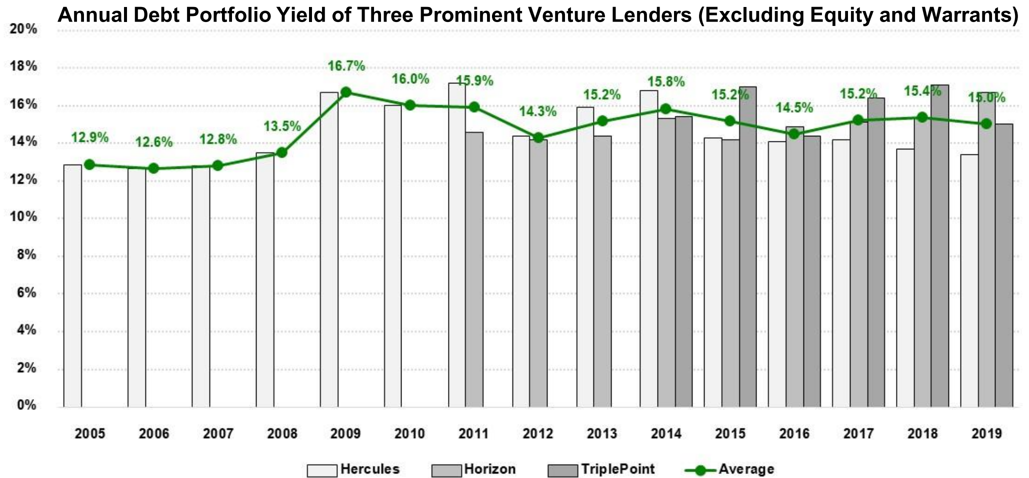
While the performance of many venture lenders is not generally available, a good proxy for performance is provided by publicly available data from three of the most prominent venture debt-focused BDCs: Hercules, Horizon, and TriplePoint. From 2015 through 2019, the average annual debt portfolio yield for the group was 15.1%, excluding equity and warrants.[4] While it is too early to know what the equity positions will be worth from these years, A.R.I. estimates that over time they will add another 3% to 6% to annualized return.

HISTORICAL RETURN

- *15%+ debt yield excluding warrants*
- *Warrants add another 3-6% annually*

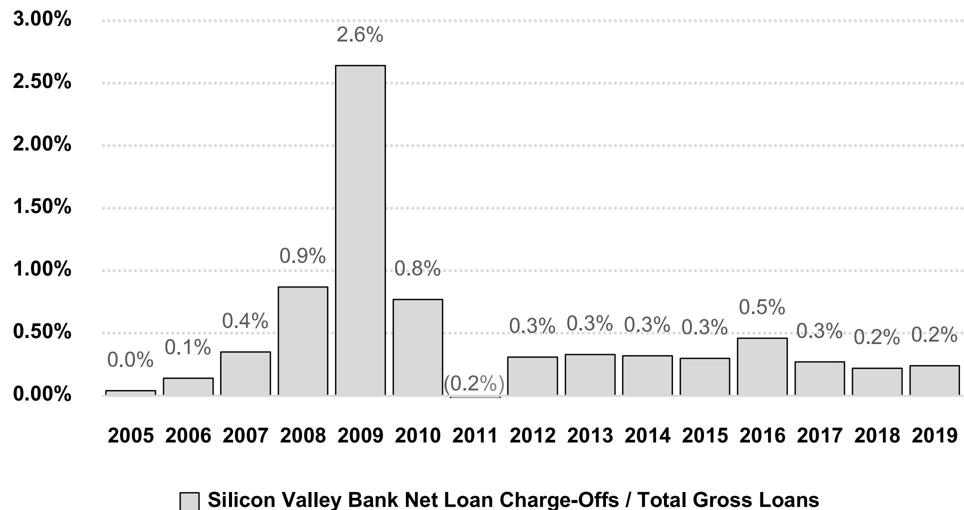


7. HISTORICAL LOSS RATES IN VENTURE DEBT

Venture debt has surprisingly low historical loss rates. From 2005 through Q1/2020 charge-offs in venture debt have averaged less than 0.50% annually, during a period that includes the worst years of the Global Financial Crisis of 2008-2010. Silicon Valley Bank, the largest publicly-traded bank focused on venture debt, had loan losses averaging 0.48% annually from 2005 to 2019.[5] Hercules Capital, the largest publicly-traded BDC focused on venture debt, had effective annualized losses of just 0.04% on $11.0 billion of capital committed from 2005 through Q3/2020.[6] The majority of venture lenders had comparably low loss rates to the two largest lenders, indicating that it is the strategy, more so than the specific manager, that protects against losses.

HISTORICAL LOSS RATES

- *Less than 0.50% annually for Silicon Valley Bank from 2005 through 2019YE*
- *0.04% on $11bn of capital committed by Hercules from 2005 through Q3/2020*
- *Most venture lenders have comparably low loss rates*
- *It is the strategy, more so than the specific manager, that protects against losses*



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8. WHY VENTURE DEBT LOSSES ARE SO LOW

LOW LOSS RATES

- *Short duration*
- *No interest rate risk*
- *Strong companies*
- *Strong deal structures*
- *Strong sponsor groups*

There are several factors that are unique to venture debt that significantly de-risk the loans and limit potential downside. The loans are typically outstanding for only two years before being paid down, requiring a short "look ahead" period by lenders, and are structured with floating rate coupons, negating any interest rate risk.

These attractive traits are bolstered by a triumvirate of downside protections arising from strong underlying operating companies, deal structures, and sponsor groups, elaborated on below:

1) Strong Underlying Company

STRONG UNDERLYING COMPANY

- *Revenue greater than $5mm*
- *Growth or expansion stage*
- *Talented management team*
- *Relevant competitive advantage*
- *Attractive margins of safety*

- Annual Recurring Revenue ("ARR") greater than $5mm (but often much larger) with a convincing business plan and clear path to sustainable free cash flow. On a standalone basis the company will be able to support timely payments related to debt, including interest, fees, and principal repayment.
- Technology-focused or technology-enabled, at the growth or expansion stage (typically having previously completed a Series B or Series C financing), with strong product-market fit and a supportive customer base.
- Talented management team with prior experience building and successfully monetizing early-stage companies.
- Relevant competitive advantage in a high-growth, recession-resistant sector that leverages innovation and technology.
- Attractive "Margins of Safety" via organic growth, viable capital structure, ample asset coverage, and strong VC-sponsorship.

2) Strong Deal Structure

STRONG DEAL STRUCTURE

- *Senior secured (1st lien) debt*
- *Low leverage*
- *Protective covenants*
- *Milestone-based*
- *Strict reporting requirements*

- To reduce the risk of default, the amount of debt must be appropriately sized for the borrower to have relatively low financial leverage (i.e., debt relative to revenue and/or cash flow). Typically, the venture loan is the only debt in the borrower's capital structure. To size the loan, there are three metrics that lenders often utilize: 1) Loan-to-Enterprise Value of less than 20%; 2) Loan-to-Latest Equity Raise of less than 33%; 3) Loan-to-ARR of less than 50%. The ratios, and threshold levels, can vary significantly depending on the lender's risk tolerance and the specific attributes of the borrower and industry sector.
- Underwriting secured debt with a 1st lien on the borrower's assets ensures that the lender will be paid first if the borrower defaults. In a bankruptcy proceeding, secured creditors hold a series of significant rights that unsecured creditors do not possess. As a result, secured creditors have significantly higher recovery rates in bankruptcy and other reorganizations than unsecured creditors.
- Protective covenants, promises undertaken by the borrower to take or not take certain actions, are utilized to protect the lender. In venture lending, these covenants typically involve minimum liquidity (e.g., cash on hand), maximum leverage (e.g., debt-to-ARR), as well as covenants that limit cash leakage and (potential) value destruction (e.g., limits on asset purchases and sales, dividend distributions, etc.). Furthermore, milestone-based financing can be utilized, and reporting requirements are strict.

3) Strong Sponsor Group

STRONG SPONSOR GROUP

- *Equity investors are subordinate*
- *Very low losses in the event of default*

- The sponsor group consists of the institutional equity investors who have funded the borrower. In practice, strong sponsor support has led to extremely low losses even in the event of default by the borrower. This is because the equity investors are subordinate to the secured lender which incentivizes the sponsor group to work constructively with the lender, oftentimes paying out the lender in full in times of stress.

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DIFFERENT FROM SBA LOANS

- *Higher return and lower risk*
- *Backed by VC-sponsors*
- *Tech-focused or technology-enabled*
- *Provided to high-growth companies*

Venture loans are not comparable to traditional small business loans, including Small Business Administration ("SBA") loans. Given the VC sponsorship, high-growth, and technology-focused nature of venture debt borrowers, they have a significantly lower risk-profile. It is noteworthy that: 1) venture debt borrowers have already received funding from venture capital firms while SBA, and other traditional small business borrowers have not; 2) prior to receiving venture debt financing, the borrower has already been materially de-risked by its equity investors, who have performed multiple rigorous due diligence rounds; and 3) venture debt is provided predominantly to technology or technology-enabled companies, while SBA loans are made to all types of borrowers, such as restaurants, dentists, freight truckers, fitness centers, landscaping services, beauty salons, and specialty contractors.

SBA losses on loans are magnitudes higher, with charge-offs averaging over 6.0% annually during the 2008-2019 period versus less than 0.50% for venture loans.[7] Given the substantially higher risk and lower return profile of SBA loans, the risk-adjusted return on venture loans is significantly higher than SBA loans.

9. WHY VENTURE DEBT IS ATTRACTIVE TO INVESTORS

PRIMARY BENEFITS FOR INVESTORS

- *Superior risk-adjusted return*
- *Security of capital*
- *Strong portfolio diversification*

The three primary benefits of venture debt for investors in BDCs and private closed-end funds are:

1. **Superior Risk-Adjusted Return**[8]
   a) 15 – 25% historical annual return
   b) 12 – 15% historical annual income
   c) Contractual income via debt coupon payments, upfront fees, and backend fees
   d) Unlimited upside via equity warrants
2. **Security of Capital**
   a) Senior secured (1st Lien)
   b) Collateralized by all assets
   c) Protective covenants
   d) Supported by VC-sponsors
3. **Strong Portfolio Diversification**
   a) Low market correlation
   b) Non-replicable investments
   c) Multi-layered diversification
   d) Exposure to income & growth

MORE BENEFITS FOR INVESTORS

- *No "J-Curve" effect*
- *Short duration*
- *Low interest rate risk*
- *Co-investment opportunities*

Additional benefits that investors appreciate:

1. No "J-Curve" effect
2. Short duration
3. Low interest rate risk
4. Co-investment opportunities

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10. HOW INVESTORS CAN GAIN EXPOSURE TO VENTURE DEBT

GAINING EXPOSURE

- *Bank stocks don't offer "pure" exposure*
- *BDC stocks have high MTM volatility and no co-investment opportunities*
- *Most private funds are at capacity due to high (re)subscription rates*
- *Allocators must work hard to identify talented emerging managers given track records in venture debt are limited*

The majority of institutional investors classify venture debt as an "absolute return" strategy that lies within their income generating or credit portfolios.

For investors that wish to access venture debt's high risk-adjusted returns, protection of capital, and portfolio diversification benefits, it can be a challenge to find the right investment vehicles that have capacity.

Banks that specialize in venture debt do not offer "pure" access to the asset class, do not allow for direct co-investment opportunities, and typically have more mark-to-market volatility than closed-end funds.

BDCs offer direct access to venture debt, but also suffer from potentially higher mark-to-market volatility and do not offer the benefit of direct co-investing that many private funds do.

For investors seeking direct exposure to venture debt, co-investment opportunities, and lower short-term volatility, private closed-end fund structures offer the only opportunity.

However, most private venture debt funds are already at full capacity given their relatively small size, closed-end structure (allowing for additional capital typically only when raising a new fund), and the high resubscription rates of their limited partners from one fund to the next.

Venture debt's moderate size as an investable asset class, its relatively short history, and the aforementioned factors do cause asset allocators to "work hard" to find the right manager who can also accept capital. As with all of finance, there is no "free lunch", but extremely high risk-adjusted returns await investors that can access the venture debt market.

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ENDNOTES

1. Nesbitt, Stephen. *Private Debt: Opportunities in Corporate Direct Lending*. John Wiley & Sons, 2019.

2. "PitchBook-NVCA Venture Monitor, Q4 2020". Pitchbook and National Venture Capital Association (NVCA), January 2021. https://pitchbook.com/news/reports/q4-2020-pitchbook-nvca-venture-monitor

3. Metinko, Chris. "It's Not All About Venture Capital: Tech Startups Eye Debt Raises." Crunchbase News, November 18, 2020. https://news.crunchbase.com/news/startups-debt-financing-vs-vc/.

4. All yield data is from the publicly available annual reports of Hercules Capital, Inc. (NASDAQ: HTGC), TriplePoint Venture Growth BDC Corp. (NASDAQ: TPVG), and Horizon Technology Finance Corporation (NASDAQ: HRZN). Data for HTGC and TVPG consists of each company's effective yield. Data for HRZN consists of dollar-weighted annualized yield on average debt investments (excluding any yield from warrants, equity, other investments and HSLFI).

5. All loss data is from the audited annual reports of Silicon Valley Bank (NASDAQ: SIVB) and is calculated as net loan charge-offs/total gross loans for the period of 2005-2019.

6. "Third Quarter 2020 Investor Presentation". Hercules Capital, October 29, 2020.

7. "Small Business Administration Loan Program Performance". U.S. Small Business Administration, March 31, 2020. SBA loss rates calculated as charge-offs/gross loan approvals for the period of 2008 through Q1/2020. https://www.sba.gov/document/report-small-business-administration-loan-program-performance

8. Estimated historical returns achieved by a range of publicly-traded BDCs and private closed-end funds from 2005 through 2020. Yields earned on loans made by banks are significantly lower.

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