

Founder Focus: FAQs for Start-Up Success

A Start-Up's Guide to Debt Funding

Debt vs Equity

Securing adequate funding (debt or equity) is essential for any start-up.

A recap on the differences between debt and equity:

Debt	Equity
Money borrowed from a lender, with interest, for a set period, with an obligation to repay the monies to the lender on specified dates/ trigger events (specific situations that require early repayment)/at the end of the term	Issuance of shares in the company in exchange for money that the investor pays to the company as a contribution towards its share capital
Debt is senior to equity	No requirement to repay equity investments; instead the company may declare dividends for its shareholders (subject to having sufficient available profits) and the shareholders may sell their shares for a profit
Lenders do not get an ownership stake in the business (the exception being the grant of warrants which are a common feature of venture debt, for more on this, please click here)	No additional financial burden (in terms of liabilities incurred) on the company, and investors take an ownership interest in the company determined by the value of their investment and the company's valuation

Forms of Debt Funding

If debt forms part of the start-up's funding package, the business will need to consider the most suitable option. This will range from day-to-day banking facilities or short term options such as corporate credit cards and overdraft facilities, facilities to manage day-to-day cashflow, such as invoice discounting, through to corporate debt facilities to fund an event (such as an acquisition) or sizeable working capital needs.

Key Features of Debt Funding

Repayment Terms

Depending on the type of debt facility:

- on-demand: the debt is repayable at any time if the lender makes a demand for repayment (typical for short term and uncommitted debt);
- in instalments: the debt is paid down during the term of the debt on regular specified dates;
- bullet: all the debt is repayable in full on one date at the end of its term; and
- convertible: debt funding advanced by shareholders may have an option to convert the debt into equity, at a specific conversion price on specific conversion events, rather than repaying it in cash at the end of its term.

Interest

To be agreed on a transaction-by-transaction basis and either:

- fixed rate: a flat rate of interest agreed by the lender which does not change over the term of the debt; or
- floating rate: a rate that fluctuates over the term of the debt, for example by tracking Bank of England base rate.

Security

A lender may require security to be granted by the borrower over its assets to support its repayment obligations. If the borrower does not meet its repayment obligations, the lender (as beneficiary of the security) will have options to enforce including (depending on the nature of the security package), appointing an administrator to take control of the borrower and its assets or appointing an insolvency officer to sell individual assets to repay its debt.

Positive and Negative Undertakings

Debt funding, like equity investments, always includes a set of conditions and requirements to protect the lender's interests in its investment and to ensure the ongoing financial health of the borrower.

This can include positive and negative restrictions:

- positive undertakings: obligations requiring the borrower to take certain actions (for example, keeping assets in good repair or obtaining and maintaining appropriate authorisations from a regulator); and
- negative undertakings: restrictions on the borrower undertaking specific actions without lender consent (for example, prohibitions on taking on additional debt or selling key assets).

Financial Covenants

Financial covenants are metrics that the lender uses to monitor and test the financial health of the borrower's business.

Lenders may test the following:

- liquidity requirements: a minimum level of cash or assets to be maintained by the borrower;
- debt service: measuring a borrower's cashflow as compared to its debt repayment obligations;
- EBITDA: a minimum level of earnings before interest, tax, depreciation and amortisation (that, is profit); and/or
- leverage: a maximum threshold on the amount of debt incurred by the borrower as compared to its EBITDA (profit), to ensure the business does not become over leveraged.

Preparing for Debt Funding

When ready to reach out to potential lenders, here are some key tips from us to best prepare for agreement and negotiations:

- **organise your documentation:** make sure all relevant documents are up to date, accurate, and accessible – including financial statements, business plans, legal documents, and corporate governance documents. This will help ensure a smooth due diligence process;
- **assess financing needs/purpose:** consider the amount of funding required and the specific purpose for which the debt will be used (for example, whether it is for expansion, working capital, acquisitions, or refinancing existing funding);
- **prepare for due diligence:** it is important to anticipate the information and explanations that lenders will require. Prepare answers to any potential issues in advance;
- **consider existing equity and debt investments:** review your current capital structure, including existing equity investors and lenders. Understand the current debt and equity ranking and rights of the equity holders or lenders and how any incoming funding will impact their rights or if their consent is required;
- **develop a detailed term sheet:** draft/agree a clear and detailed term sheet outlining the key terms and conditions of the proposed deal; this will facilitate negotiations and reduce execution costs; and
- **undertake financial planning and projections:** prepare detailed financial forecasts to demonstrate the viability and growth potential of the business, and its plans.

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Any questions? Get in touch with the banking team



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