

# Founder Focus: FAQs for Start-Up Success

## Navigating Venture Debt Financing: The Pros and Cons

In the rapidly evolving landscape of scale-ups, access to capital is vital for growth and innovation. Traditional methods of financing, such as equity investment, are often the first choice for founders, but they may not always be the best fit. KPMG's recent Venture Pulse Survey from Q4 showed that venture capital investment in Scottish start-ups increased 14% in the final quarter of 2024. However, the economic landscape in the UK remains challenging and founders are looking at alternative avenues for funding, including venture debt financing. Looking locally in Scotland, the possibility of funding startups with debt rather than equity financing is something which has been specifically provided for in the British Business Bank's Investment Fund for Scotland, where small loans (between £25k - £100k) and debt financing (between £100k - £2million) form part of the funding available.



### What is Venture Debt Financing?

Venture debt financing is a form of debt capital that is tailored for high-growth companies. Venture debt is typically offered by specialised lenders (including, clearing banks with growth capital style products) who understand the unique needs and challenges of emerging businesses, making it a suitable option for scale-up founders.



### Pros of Venture Debt Financing:

- 1. Preservation of Equity:** One of the primary advantages of venture debt financing is that it allows scale-ups to raise capital without equity dilution, which can impact decision-making and future profitability. Venture debt lets founders maintain more control over their business.
- 2. Flexible Terms:** Venture debt lenders often offer more flexible terms, often with limited or no financial covenants. Venture debt lenders tend to monitor a company's "burn rate" (the amount of cash the company is spending each month) and cash

runway (the amount of time a company has before it runs out of cash), rather than more traditional financial covenants, such as leverage and debt service. This flexibility can be especially beneficial for growing companies with unpredictable cash flows or seasonality in their revenue. Customised repayment schedules and structures can often be negotiated to align with the company's growth trajectory and business plan.

- 3. Complementary to Equity Funding:** Scale-ups in Scotland can use venture debt financing in tandem with equity funding. This combination can provide a balanced approach to funding, allowing for accelerated growth and minimising equity dilution. Venture debt can bridge the gap between equity rounds (which makes debt financing particularly attractive with the funding sector currently experiencing a squeeze), providing capital for specific growth initiatives.
- 4. Interest-Only Periods:** Many venture debt agreements include an interest-only period, during which time the company is only required to pay interest on the loan. This can provide relief in the preliminary stages of a company's development when cash flow may be tight, allowing resources to be directed towards growth and innovation.
- 5. Conversion to Equity:** One intriguing feature of venture debt financing is the possibility of converting the debt into equity under certain circumstances. This can be a win-win for both the company and the lender. It can also be viewed as a show of goodwill from both the founders and the lender, with each displaying that they are on the growth journey of the company together. Typically, if the company achieves specific milestones or undergoes a subsequent equity funding round, the lender may have the option to convert a portion of the outstanding debt into equity at a predetermined fixed price. This aligns the interests of both parties, as the lender now shares in the company's potential upside. However, founders should carefully consider the terms of such conversions, as they can affect ownership and control. Nevertheless, this conversion feature can provide additional flexibility in the company's capital structure, potentially reducing the long-term debt burden and enhancing the alignment of interests between founders and investors.



### Cons of Venture Debt Financing:

- 1. Debt Obligation:** Founders need to be aware that venture debt financing comes with the obligation to repay the loan, including interest. Failure to do so can lead to default, which may result in the loss of assets or legal action by the lender.
- 2. Interest Costs:** While venture debt can be more cost-effective than equity financing, it still incurs interest costs. Often, these rates of interest are higher than charged under traditional debt financing. These costs can add up over time, especially if the company is unable to grow as expected, leading to financial strain.
- 3. Risk of Overleveraging:** Taking on too much debt can lead to overleveraging, where a company's financial obligations become unsustainable. Careful consideration of the debt-to-equity ratio is crucial to avoid this risk.
- 4. Complexity:** Venture debt agreements can be complex, with terms that require careful negotiation and understanding, often in a short space of time. Legal and financial expertise is usually required, which can add to the overall cost, or the company can accept the documentation on a "take it or leave it" basis, which carries its own risks.
- 5. Limited Use of Funds:** Venture debt is typically used for specific purposes, such as financing growth initiatives. It may not be suitable for covering general operating expenses, and misuse of funds can lead to a company breaching the agreed debt documentation.
- 6. Path to Profitability:** Venture debt lenders usually insist on their borrowers implementing an ambitious business plan, with the terms of the loan on offer tied to key milestones such as revenue and accounts receivable, or key events such as further equity investment. The business plan and key milestones agreed with the lender should be carefully considered by the borrower as these will be important for the business moving forward.

Venture debt financing offers founders an alternative means of raising capital without relinquishing equity. It can be a valuable tool for accelerating growth, funding strategic initiatives, and maintaining control over the business. However, founders should approach venture debt with caution, understanding the potential risks and complexities associated with it.

Ultimately, the decision to pursue venture debt financing should be based on a thorough evaluation of the company's financial situation, growth prospects, and funding needs. When used strategically and responsibly, venture debt can be a valuable addition to the company's financing toolkit, helping Scotland's burgeoning scale-up sector thrive and innovate.

#### Any questions? Get in touch with our banking team



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