

# Debt Funding in India Series

November 10, 2020

## ONSHORE FUNDING ROUTES: VENTURE DEBT

Venture debt can be best described as a bridge between equity financing and traditional debt. Venture debt as a product has been designed to cater to the debt requirements of the startup ecosystem. Venture debt investors typically serve the debt requirements of early and growth stage companies which are looking for additional capital to facilitate their growth and partner with the investee companies with the intent to benefit in the longer run.

The growing Indian start-up ecosystem is dominated by service companies which are generally asset lite. This makes it difficult for them to raise debt from traditional sources such as banks and NBFCs because of insufficient collateral / security. This is the vacuum in the market which venture debt seeks to fill.

We have listed down a few FAQs which will help understand the venture debt product better:

### 1. *What is venture debt?*

Venture debt is a medium-term debt product that has been designed to serve the needs of the startups which are looking for growth capital and have already raised equity financing from seed investors or venture capitalists.

### 2. *How is venture debt different from other traditional forms of debt financing?*

Venture debt products are underwritten on the basis of the venture capital raised by the investee and the growth potential of the investee, rather than on the basis of the assets and the cash flow position of the investee (as is the case with other lenders like banks and other financial players). This makes this option preferable to start-ups and companies in the service sector which are asset lite. Further, venture debt is a medium-term debt product, i.e., the tenor of the venture debt is typically up to 3 years, unlike other typical business loans which have a longer tenor of around 6-7 years.

### 3. *When should one prefer venture debt?*

Venture debt is, as mentioned above, a bridge between debt and equity. Where investee companies are looking for additional cash to top-up the equity financing and the promoters and the early stage investors are reluctant to dilute themselves substantially, venture debt offers a good solution. Venture debt ensures that the promoters and early stage investors are diluted nominally and provides them necessary cash to grow the business to increase valuations for subsequent rounds.

### 4. *What are the sectors in which venture debt investors operate?*

While venture debt investors are typically sector agnostic, however, they have been quite active in fintech, e-commerce, food-tech, ed-tech, healthcare, consumer brands, logistics, ridesharing etc.

### 5. *At what stage do venture debt investors invest in?*

Venture debt investors generally invest in early stage companies that have raised one or two rounds of equity financing from reputed venture capital firms. However, in recent times venture debt investors have also started backing some mid-stage companies.

### 6. *What are the diligence requirements for a venture debt investor?*

The diligence process by the venture debt investors is less detailed than that of a diligence undertaken by the equity investors prior to their investment. Venture debt investors generally derive comfort from the extensive diligence and the investment undertaken by the equity investors of the investee company.

### 7. *What are the different models of venture debt in India?*

There are various venture debt models which are prevalent in India. They are as follows:

- Term loan: The venture debt is structured by way of a term loan. This model is generally followed by the NBFC players in the venture debt industry.
- NCD subscription: The venture debt investment is structured by way of subscription of non-convertible debentures that are issued by the company. This model is generally adopted by the alternative investment funds.

An equity kicker (such as right to subscribe to shares at a future time) as a consideration for the venture debt investment may also be agreed between the parties.

### 8. *What is the standard tenure and other terms of a venture debt?*

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Venture debt is a medium-term debt product, with the tenor of the debt ranging between 18 months and 36 months. The venture debt has a fixed interest or coupon which is payable on monthly/quarterly basis, post a mutually agreed interest-moratorium period. The interest or coupon rate for a venture debt is slightly higher than a traditional bank or NBFC loan, however, the risk involved in a venture debt is also considerably higher.

#### 9. ***Are venture debt investments secured? If yes, what is the typical security package?***

As the borrowers are generally asset-lite companies, the venture debt is typically secured by way of hypothecation on the current and future assets including the intellectual property/brand of the investee companies. If the borrowing entity has a holding company or a material subsidiary, the lenders may also seek a corporate guarantee from such entities. Promoters are required to provide a personal guarantee in rare instances as well.

Accordingly, the security package for a venture debt is much lighter than that of a bank / financial institution loan, where fixed charge on certain assets, floating charge on all other assets, corporate and personal guarantees are the norm.

#### 10. ***What are the documents entered into for a venture debt investment generally?***

The parties generally enter into a term loan agreement or a securities subscription agreement which is the master document which governs the rights and obligations of the parties. Additionally, a hypothecation deed is entered into between the parties to cover the provisions relating to the security package. In an NCD subscription, the investee company is required to appoint a debenture trustee to hold the security and the debentures for the benefit of the subscribers/debenture holders. Hence, certain additional documents in relation to the appointment and the rights and obligation of the debenture trustee and the investee company are entered into between the investee company and the debenture trustee.

#### 11. ***What are the general governance norms sought by venture debt investors in India?***

The venture debt investors have standard lender rights which includes covenants (both positive such as information rights, and negative such as amendment of terms of instruments, creation of encumbrances and availing new loans), information and inspection rights etc. They don't have representation on the board of the investee company other than in case of an event of default.

#### 12. ***Why are most of the venture debt investors in India domestic entities?***

Most of the venture debt investors in India are resident entities, even if they have been set up by non-resident investors. This is primarily due to the regulatory environment in India making venture debt unviable for non-resident investors.

- If the investment is structured as an ECB, there are restrictions on the end-use of funds by the borrowing entity such as meeting working capital requirements and general corporate purposes. In addition, all-in-cost ceiling (i.e. the maximum return that can be provided to the lender) and the minimum maturity of the loan makes the route commercially unviable for venture debt investments.<sup>1</sup>
- If any partly paid instruments are subscribed to by non-resident investors, such instruments need to be fully paid up within 12 months of issuance under the exchange control norms in India. This condition restricts them from getting the benefits of the equity kicker structured by way of subscription of partly paid instruments. The same conditions do not apply for resident investors.
- Considering that venture debt also has some elements permitting issuance of equity shares, any issuance of equity instruments to non-residents need to be issued at a price which assigns the investee Indian company a valuation of at least the fair market value of the investee company's shares. Accordingly, the right to subscribe at a future date at a pre-agreed price (which is generally pegged to the valuation of the investee at the time of providing the venture debt) becomes challenging. The pricing norms are not applicable in case of resident investors, and hence are easier to structure.

To overcome these challenges, foreign investors have opted to incorporate captive vehicles in India for on-lending.

As can be seen, venture debt or 'venture lending' is a relatively new model and is turning out to be a preferred avenue of raising financing by companies in India.

#### **Debt Funding Team**

<sup>1</sup> Please refer to our earlier piece on ECBs [here](#).

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