January 2024

Houlihan Lokey

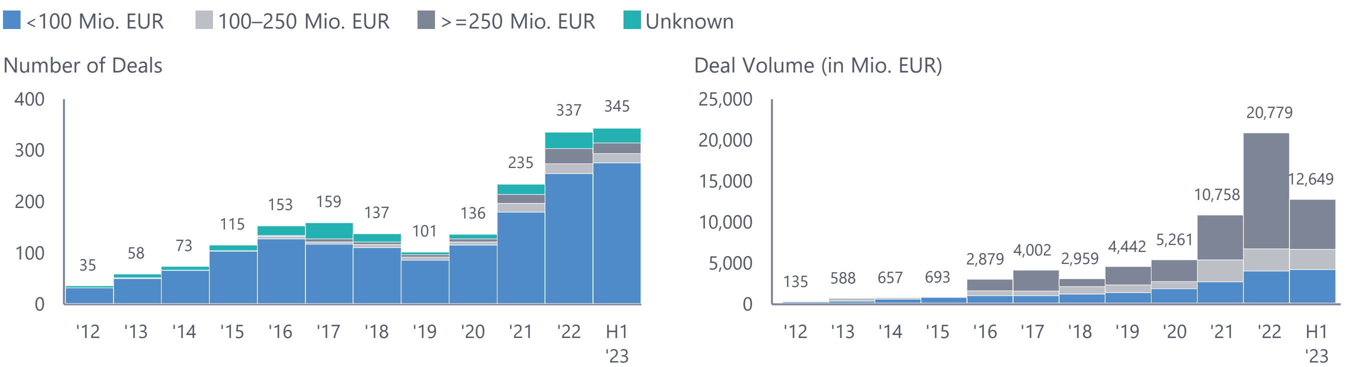
Venture Debt Market in Europe

Venture Debt Market Is on the Rise in Europe

The venture debt market in Europe has experienced substantial growth over the past decade. In 2022, it reached its peak with a total allocation of EUR 21 billion distributed across 337 venture debt financing deals. This figure surpassed the levels recorded in 2021, when the number of deals exceeded 200 for the first time, and represented a significant growth from 2014, when this number remained well below 100.

For 2023, the data suggests that, in terms of number of deals, the 2022 levels will again be notably exceeded. In fact, as of the first half of 2023, 345 deals had already been completed, corresponding to a deal volume of around EUR 12.6 billion (Figure 1). This shows that the bankruptcy of the Silicon Valley Bank in the first quarter of 2023 seems to have been promptly absorbed by European market participants.

Figure 1: Venture Debt Transactions in Europe



Trends of the Venture Debt Market in Europe

Over the past decade, the importance of venture debt as a financing component has steadily increased in comparison to equity-based financing. Since late 2021, significant changes in the startup financing landscape have occurred, due to geopolitical conflicts, the energy crisis, and rising interest rates, which created more challenging fundraising conditions, leading investors to adopt a more cautious approach throughout 2022.

Despite this, the market for venture debt financing in Europe continued to expand. Consequently, the ratio of market volume on the venture debt market to the venture capital market in Europe rose from 10%–15%, observed between 2016 and 2021, to 24% in 2022 (Figure 2).

This growth can be attributed, on the demand side, to the maturation of the European startup ecosystem, which is witnessing an increasing number of companies in later-growth phases. Given their higher financial stability, these are more suitable for venture debt, stimulating demand for this financing instrument. Indeed, while in 2012–2014 late-stage venture deals accounted for 73% of all European venture debt transactions, in 2020–2022, this balance grew to 86% (Figure 3).

On the supply side, the venture debt offering is in continuous development. Most recently, the market entry of BlackRock Inc., through the takeover of the venture debt provider Kreos Capital, represents the development of this market.

Figure 2: European Venture Debt Deal Volume Relative to the Venture Capital Market

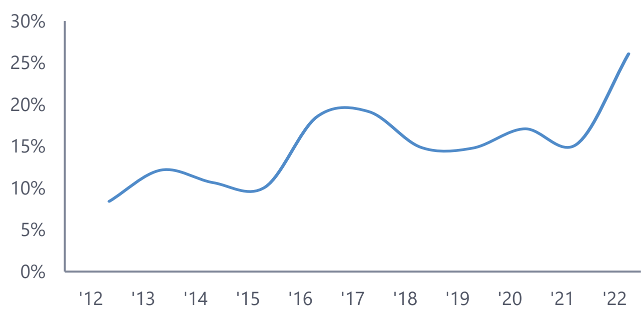
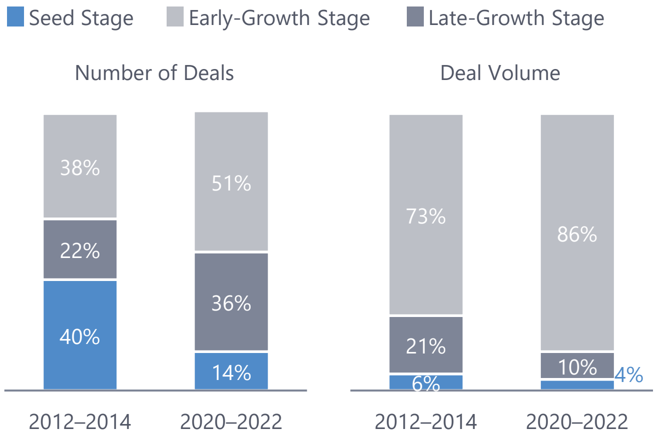


Figure 3: Share of Venture Debt Deals by Growth Phase



Sources: "Venture Debt in Deutschland und Europa: eine Bestandsaufnahme," KfW Research; Dealroom.

Venture Debt Considerations

In Q1 2023, with the IPO market effectively closed and valuations down materially from their 2021 peak levels, venture debt has become an important source of minimally dilutive capital for early- and late-stage venture companies. Venture debt represents a lower cost of capital than equity and allows a borrower to extend its cash runway and bridge to the next round of financing. In addition, venture debt financing typically does not require a valuation reset, which may be particularly advantageous in the current market environment. For investors, venture debt typically offers high risk-adjusted returns with historically low loss rates.

Pros	Cons
Minimal ownership dilution for investors and management.	High base rate implies higher cost of capital relative to historical levels (i.e., before the recent Fed interest rate hikes).
Debt issuance does not require a valuation reset.	Debt typically has a shorter duration and is expected to be paid down by rounds of equity financing.
Extends cash runway.	Potential for restrictive covenants and/or mandatory drawdown period terms.
Faster to obtain than equity financing.	Greater degree of selectiveness exhibited by capital providers in the current macroeconomic environment.

Growth Equity Company Considerations

- Growth equity companies, especially those in the technology space, are often unprofitable as they continually invest in revenue growth. In such situations, metrics such as customer retention, customer acquisition cost, and recurring revenue are considered in order to understand the business fundamentals that drive longer-term valuation prospects.
- For debt covenants, annual recurring revenue-based leverage metrics are often used in place of EBITDA-based leverage ratios for rapidly growing technology companies.
- The "Rule of 40" is another metric that is frequently applied to such companies. It is the principle that a company's combined growth rate and profit margin should exceed 40%. This metric evaluates the combined profitability and growth metrics of a business in aggregate. In the current environment, companies that are curtailing cash burn to extend cash runway will have lower growth expectations. The Rule of 40 enables horizontal performance comparisons across both public and private companies that are looking to balance growth and profitability.
- Companies that secure venture debt typically have strong sponsor support and have completed multiple rounds of financing. The implied multiple and discount rates from these financings can then be adjusted for differences in the subject company and the market performance of the sector between the last round of financing and subsequent measurement dates. Calibration of financial performance to financing rounds provides insight into market-based indications of value, required rates of return, and valuation multiples relative to public market equivalents for these high-growth venture companies.

Venture Debt Valuation Considerations

- In a typical venture debt financing structure, a debt security is issued with a floating base rate (e.g., SOFR) plus a cash margin and attached equity warrants. Interest payments are often structured as payment-in-kind (PIK) or a hybrid of PIK and cash. Fees charged by the lenders can come in the form of underwriting original issue discount (OID) or back-end exit fees.
- Per section 4.11 of the AICPA's "Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies" (the Valuation Guide), the unit of account is determined based on the "economic best interest" at which market participants would transact the securities:

  > "When estimating the fair value of the fund's position in a given portfolio company, the concept of 'economic best interest' is relevant to the determination of the nature of the assumed transaction and what grouping of assets may be appropriate. Therefore, the task force believes that it is appropriate to consider the unit of account for investments reported under FASB ASC 946 to be the individual instruments to the extent that is how market participants would transact, or the entire position in each type of instrument in a given portfolio company held by the fund (e.g., the entire senior debt position, the entire mezzanine debt position, the entire senior equity position, the entire warrant position, and so on) to the extent that is how market participants would transact."

- Section 4.15 of the Valuation Guide discusses typical valuation methodology for hybrid securities as follows:

  "When the assumed transaction is based on value being maximized through a transaction in the investment company's entire interest in the portfolio company, then the investment company's Schedule of Investments will generally present the aggregate fair value of the investment in each portfolio company along with each class of debt and equity owned in that portfolio company at its allocated value. One reasonable basis for allocating value amongst the instruments could be to estimate the fair value of each instrument independently, considering the assumptions that market participants would use in pricing each instrument, and then to allocate the aggregate fair value considering either the relative fair value of all the instruments (e.g., the fair value of equity or warrants vs. fair value of debt) or the residual fair value for one of the instruments after subtracting the fair value of the other instruments (e.g., the residual fair value of debt after subtracting the fair value of equity or warrants, or vice versa)."
- As such, when evaluating a venture debt instrument at the investment date, it is customary to consider both the explicit OID as part of the underwriting process, "bifurcate" the value attributable to the equity features of the instrument (such as warrants), and treat it as an incremental synthetic OID when conducting a calibration analysis of the implied IRR of the venture debt issuance. This treatment is based on the premise that an investor would likely require a higher rate of return for a debt security without the equity upside.
- Take, for example, a $100.0 million venture debt investment issued at fair value with an explicit OID of 2.0% and a warrant kicker with a fair value of $3.0 million. In this instance, the synthetic OID would be 3.0% based on the $3.0 million warrant kicker as a percentage of the $100.0 million of debt par value. The effective all-in OID in this case is 5.0% (2.0% explicit OID + 3.0% synthetic OID), and thus, the implied yield (or IRR) on the straight debt security at the origination date should be calibrated to a 95.0% price at issuance (i.e., $95.0 million).
- Therefore, at the investment date, the debt instrument and warrants are valued separately; the sum of these two components should equal the original purchase price. At subsequent valuation dates, the debt security and equity features would continue to be valued separately and then aggregated for comparison to the original purchase price.
- The value of the equity features and/or upside attached to the venture debt issuance can be derived based on either a current value method waterfall constructed on a common stock equivalent basis or via an option pricing method.
- Enterprise value coverage for a venture debt issuance at a particular measurement date is determined via calibration to the last known round of financing adjusted for changes in financial performance and market performance between the measurement date and last round of financing. In the absence of a recent round of financing, enterprise value may be determined based on an income approach, specifically via the discounted cash flow method or based on a market approach, such as the guideline company and/or guideline transaction methods.

Houlihan Lokey's Unique Expertise

- In recent years, private security valuation at the fund level has become increasingly important to private fund investors seeking transparency around the estimation of net asset value and fees. On this topic, the SEC issued Rule 2a-5 of the Investment Company Act of 1940. This rule had detailed requirements for a general partner to determine fair value in "good faith." Fair value in good faith is dependent upon the selection and application of methodologies in a consistent manner, including specific key inputs and assumptions. Rule 2a-5 allows the board to designate the fund manager as the valuation designee, who in turn may engage third-party valuation advisors to perform fair value determinations, subject to ongoing board oversight and compliance with certain conditions.
- Houlihan Lokey has a successful track record and robust experience in assisting its clients—including private equity, venture capital, hedge funds, sovereign wealth funds, and family offices—with ongoing portfolio valuation work and fund-related transactions.
- Houlihan Lokey values large portfolios of highly structured, venture-backed unicorn investments for various investors across the globe. In addition, our Capital Markets team has substantive private placement experience in structuring and raising capital with leading industry participants in growth and structured equity. Our valuation practice has deep technical expertise and market presence across various industries and asset classes. This is further enhanced with access to the firm's dedicated industry groups in the investment banking practice, which provides an unmatched level of expertise and transaction experience to inform the valuation process.

CONTACTS

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Source: Refinitiv. Excludes accounting firms and brokers.

2022 M&A Advisory Rankings Global Transactions Under $1 Billion

	Advisor	Deals
1	**Houlihan Lokey**	**381**
2	Rothschild	369
3	JP Morgan	217

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Source: Refinitiv.

2022 Global Distressed Debt and Bankruptcy Restructuring Rankings

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1	**Houlihan Lokey**	**58**
2	PJT Partners	30
3	Lazard	29

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Source: Refinitiv. Announced or completed transactions.

1998 to 2022 Global M&A Fairness Advisory Rankings

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1	**Houlihan Lokey**	**1,232**
2	JP Morgan	1,030
3	Duff & Phelps, A Kroll Business	938

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Source: PitchBook.

2022 Most Active Global Investment Banks to Private Equity Firms

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1	**Houlihan Lokey**	**242**
2	Lincoln International	192
3	Deloitte	190

ABOUT PORTFOLIO VALUATION AND FUND ADVISORY SERVICES

Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our (i) strong reputation with regulators, auditors, and investors; (ii) private company, structured product, and derivative valuation experience; and (iii) independent voice. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries, along with our real-world transaction experience and market knowledge, from our dedicated global Financial and Valuation Advisory business.

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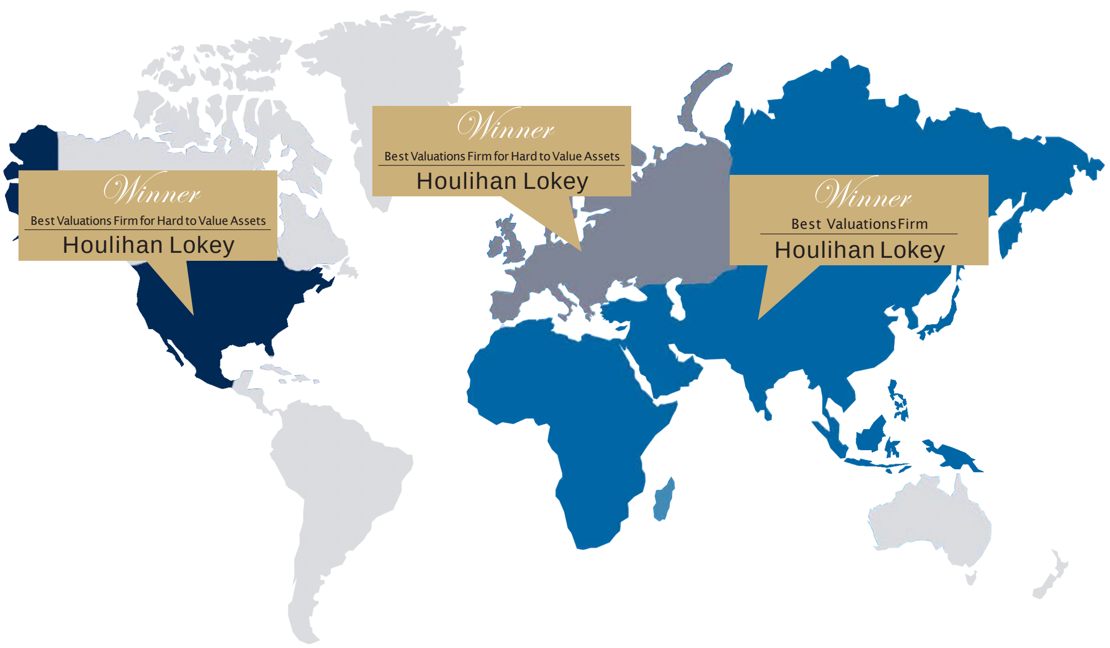
The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2023 and in Europe in 2020–2023, and it was named "Best Valuations Firm" in Asia in 2020–2023. Houlihan Lokey has now won these awards in all three geographic regions for four consecutive years!



HFM AWARDS

The HFM Services Awards recognize hedge fund service providers that have demonstrated exceptional client service, innovative product development, and strong and sustainable business growth over the prior 12 months.

Houlihan Lokey

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