

Rise of venture debt financing in Irish corporate transactions

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As recently reported in the Irish Times, there has been a marked increase over the past number of years in non-traditional financing of corporate transactions in Ireland.

In the old days most investment transactions (venture capital, private equity and corporate investment) were "straight equity" deals, with the investor agreeing a valuation for the investee company and subscribing for the agreed % of newly issued shares in the company and/or buying issued shares from the current shareholders of the Company.

The headline pros and cons of straight equity transactions are well understood.

A significant advantage from the investors perspective is that they get to participate in the increase in the company's underlying value.

As against that, a principal downside for the investor is that equity investments are "locked in" and hard to extract - particularly in the context of private company transactions where there is probably a limited ability to sell the shares. Furthermore, particularly for tech sector companies, the investee company may not be generating sufficient distributable profits in the short term to fund dividends or a buy back of the shares.

A big drawback in a straight equity investment from the perspective of the existing shareholders in the investee company is that the new equity investment will usually result in a significant dilution of the existing shareholders share of the pie. Additionally, most equity investors go in on the basis of a comprehensive subscription and shareholders agreement- which will usually reserve preferential control/protection rights for the new equity investors.

The above realities on equity transactions have, as stated, lead to a marked rise in investment transactions being structured as debt transactions (perhaps with a slice of accompanying equity and/or the right to convert the debt into equity in the investee company in certain

circumstances).

In my experience, the traditional banks are not leading the charge on such debt funding transactions. Rather, high net worth individuals, (in view of the low interest rate environment we are currently living in, where there is no point in having your money on deposit in a bank) and specialist debt funds are increasingly active in the Irish market -actively looking to lend to Irish corporates' which need funding to grow their business.

Such non-bank lenders are developing a wide range of new funding products, most of which are now currently being described as "venture debt" products.

Typically such venture debt transactions are structured as "loan note" arrangements - with the corporate borrower issuing loan notes. These may or may not be convertible into equity in the investee company. The lender secures the debt lent with a mix of debenture/share charge arrangements.

The loan notes normally have an agreed interest rate coupon and are attractive for investors because they are a debt obligation of the borrowing company, meaning that their repayment is not dependent on the borrowing company having sufficient distributable profits. Rather, the test is that the borrowing company has sufficient repayment capacity.

The main attraction of such venture debt arrangements for existing shareholders of the borrowing company may be summarised as follows:

Speed. Private venture debt is usually faster to put in place than a traditional equity investment. It's certainly faster than traditional bank lending;

Reduced complexity. Venture debt transactions are normally "easier to paper" than the traditional equity document suite, and normally don't require complex company valuations; and

Non-dilution. The loan notes will not (absent conversion into equity) result in a dilution of their shareholding in the company.

Such venture debt arrangements may also have tax attractions for the parties concerned if structured correctly.

Notwithstanding the above attractions of venture debt, it goes without saying that such transactions should not be entered into lightly - and certainly only after a comprehensive analysis of the borrowing company's cash flow forecasts to be absolutely certain that the debt can be serviced.

In our experience, most venture debt funding is reasonably short term - with repayment horizons of 12 to 36 months being normal.

Venture debt carries higher interest rates than high street bank debt and all borrowing companies plan on refinancing venture debt with such cheaper high street debt - usually from their existing bankers.

A word of caution here - the traditional banking market is still slightly dysfunctional and in our experience you need a very long lead time getting such refinancing into place.

For more advice in corporate law, venture capital, private equity and investment, please contact Dominic at dominic.conlon@ogier.com

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