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Venture Debt for Fast-Growing Companies – Experiences, Challenges and Success Factors in Austria

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Abstract. This study investigates the utilization and impact of Venture Debt (VD) as a financing option for fast-growing companies in Austria, aiming to fill a significant knowledge gap in the field. Through an exploratory approach encompassing literature review and interviews with eight Austrian finance experts, the research delves into the experiences, challenges, and success factors associated with VD. The findings reveal a growing trend in the Austrian VD market, indicating its emergence as a crucial source of finance for firms post-early growth phases, particularly aiding in liquidity expansion and preventing share dilution. They also highlight VD's flexibility albeit with higher interest rates and shorter maturities. The findings underscore the growing importance of VD for Austrian fast-growing firms, emphasizing the need for enhanced education and awareness. Despite limitations regarding the scarcity of experts, the research contributes to bridging the knowledge gap surrounding VD in Austria, providing valuable insights from practitioners.

Keywords: Venture Debt, Finance, Fast-Growing Start-up Company, Austria

1. BACKGROUND

Fast-growing companies [1] – i.e., "firms that undergo a period of high growth in employment or turnover" [6], in many cases small- and medium-sized enterprises – are key players in the development of national economies. They drive technological progress, create new jobs and contribute significantly to economic growth. To fulfil this role, these firms need access to sufficient financial resources. Due to the difficulty to sustain high growth over time associated with these companies [2], access to external finance is often difficult. Much of the literature focusses on venture capital (VC) as a source of finance for start-ups and fast-growing companies [4]. In the shadow of VC, however, a relatively novel form of debt-based finance – Venture Debt (VD) – has also started to establish itself [8].

Venture Debt (VD) has been already successful in the U.S. and is seen and used there as a complementary source to VC fulfilling specific finance needs. It was first introduced in Europe (UK) at the end of the 1990s. In 2022 the European VD market reached 337 deals [10] which shows how popular VD already has become [8]. Reasons for the increasing supply of loans and the importance of VD are, for example, the tightening of monetary policy, which increased interest rates [7] and can make lending more attractive for debt capital providers [10]. Furthermore, the Venture Capital (VC) market has cooled down significantly since the end of 2021 due to investors acting more cautiously [3]. While there is at least some information and data available regarding VD in the U.S., not so much is known about VD in Europe and, even more specifically, the VD market in Austria. This is a significant knowledge gap for practitioners, start-up and scale-up firms, as well as policy makers in Austria.

2. RESEARCH QUESTION

Against this backdrop, the aim of the paper is to assess the experiences, challenges and success factors encountered when using VD for fast-growing companies in Austria. The following research questions are to be answered: How important is the use of VD for fast-growing Austrian companies? What are the possible uses and forms of VD? What are the pros and cons compared to VC and senior bank loans? What problems need to be overcome, and what factors enable the successful use of VD?

3. METHODOLOGY

In order to investigate this new instrument in the field of finance an exploratory study was carried out. Following a systematic literature and document review, interviews using semi-structured guidelines with five Austrian finance experts (stakeholders from the supply and demand side of VD finance) were conducted, transcribed and analysed using content analysis. In the interviews, topics like importance, fields of application, forms, and advantages and disadvantages compared to VC and senior bank loans were discussed.

4. RESULTS

Austria accounts in 2022 for 2,81% of the EU27's economic power but has only a share of total VD of 1.65% [10, 12]. This shows a significant usage gap in Austria. However, statistical data shows that the market for venture debt in Austria has expanded over the long term (capital raised in 2018: USD 28.5 million, 2023: USD 34.6 million). Setbacks caused by the coronavirus and other crises have only briefly interrupted this long-term development [9].

The results suggest that VD becomes an complementary option to VC for Austrian start-ups after early phases of growth. After the first phases of start-up companies, financed mainly by founders, family, business angels or state subsidies, i.e., when firms achieve the proof-of-concept phase, additional capital is needed to accelerate growth. The interview partners confirm that a number of innovative, fast-growing firms in Austria already use VD. The main motivations are to expand liquidity before further equity financing rounds and reducing share dilution. The experts see the use of VD finance especially in the following fields: product development, scaling of production capacities, development of new markets, and expansion of sales channels, as these can secure future liquidity.

The experts named international providers such as Silicon Valley Bank, Kreos Capital and Atempo Growth as well-known VD providers. The company Round2 Capital or various VD initiatives of traditional Austrian banks were named for Austria. AWS (Austria Wirtschaftsservice, the funding bank of the Austrian federal government) was repeatedly mentioned as an important support for VD financing, for example by collateralizing for certain loans.

The interviewed experts agree that VD can offer some opportunities for fast-growing companies compared to VC. In particular, the non-dilution of the capital shares of the founders and other existing shareholders was often mentioned. In addition, VD contracts are less complex, which leads to faster and more flexible financing options. However, the experts also emphasize the risks of VD, such as the repayment obligation and regular interest payments, which cannot only lead to liquidity problems but also means that cash inflows cannot be fully utilized for further investments. Serious problems arise in the event of liquidity bottlenecks. Another risk is limited entrepreneurial flexibility due to specific conditions and milestones VD providers impose [8].

According to the interviewed experts, VD offers Austrian companies more freedom and the possibility to take more risks compared to senior bank loans. This allows them to tailor their financing plans to their needs and growth objectives better. Examples for flexible agreements are different interest and repayment terms. Interest payments can be agreed as ongoing payments or at the end of the loan term. Regarding repayment options, companies can choose between bullet loans or loans with regularly scheduled repayments or an amortizing structure.

This flexibilization gave rise to a special form of combining the two, namely revenue-based loans, where interest and repayments are paid on an ongoing basis, but the amount is not fixed but adapts to business performance. So, high interest and redemption payments are made in the event of high sales, while the financial burdens are less in times of low sales.

In addition, the covenants for VD are less strict, which offers an advantage over bank loans and provides access to more capital than traditional banks offer. However, VD financing usually has higher interest rates and shorter maturities, which puts pressure on founders to become profitable faster.

The study showed that reducing the dilution of founders' shares prior to an exit is a popular application of VD in practice. Similarly, the possible delay of a company valuation is a motivation for using VD, especially if the start-up would be valued lower due to current high interest rates. Furthermore, the higher return on equity that can be achieved through VD (leverage effect) represents a capital-efficient solution when investing in new business areas, entering new markets or acquiring competitors.

Since knowledge about VD in Austria is constantly increasing, there are fewer and fewer Austria-specific challenges. Many of the challenges Austrian fast-growing companies face are comparable to the problems international companies (start-ups and scale-ups) face. The Austrian background therefore offers only minor advantages or disadvantages because they operate in a global environment. This can be seen, for example, in later financing rounds, where the investment volume is higher, and the proportion of international investors predominates [5].

5. HIGHLIGHTS AND HURDLE

The study underlines the growing importance of VD as a source of finance for Austrian fast-growing firms. VD has become and will even further be an important additional source of finance for start-ups and scale-ups. Still, Austria – as many other countries – has some catch-up to do, particularly in terms of education and awareness raising about this form of finance. An introduction to VD should become an integral part of entrepreneurial training programs and in general, business schools should teach the basics of VD to future generations of managers.

The Austrian market volume for VD is too small for current VD providers. New providers who can also work profitably with smaller volumes are needed. This can be done by a reduction in transaction costs (e.g. by diminishing legal limitations). Currently, as well accounting and disclosure regulations for companies as legal and bank-specific lending guidelines for banks often prevent VD financing.

Overall, the value of the study lies in providing an evidence base for thus under-researched area, particularly in the Austrian context.

There are also limitations: As VD is a relatively new but growing topic in Austria, the availability of experts, in terms of their number, is currently still limited. Therefore, despite the wide-ranging expertise of the experts in the field of innovative financing overall, it would have been desirable to conduct a larger number of expert interviews to gain an even more comprehensive picture of the topic. The same applies to scientific sources. Nonetheless, one of the strengths of this work lies in the choice of experts with different approaches to VD financing. By incorporating their perspectives, it was possible to gain a deeper understanding of the topic and the respective Austrian market. Further research is necessary to get an even better understanding of the uses and usage conditions of VD, covering more European countries and also specific issues such as on the role of (collaterals based on) Intellectual Property Rights (IPR) in VD finance (which is significant in VC).

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