

ACCION

Raising Wholesale Debt and On-lending Capital



You thought the hard part was over.

You've built an innovative and exciting product to loan funds to consumers and small businesses. You've found equity investors and have the cash you need to expand operations. You're ready to throw open the doors to new customers.

But how can you extend loans to customers without money in the bank? It may be months or years before you see net profits on extended capital. How can you grow in that time? Without a track history or physical assets, you are nowhere near the minimum requirements for traditional small business loans. How can you raise the on-lending capital you need to grow your loan portfolio?



**Prepared by Accion Venture Lab, April 2017
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The Consultative Group to Assist the Poor (CGAP)'s 2006 technical guide, "Commercial Loan Agreements," also served as reference in writing this text.

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If a balance sheet lender has already received equity financing, why should they also seek out wholesale debt?

Early stage balance sheet lenders commonly use equity as capital for on-lending to customers: it's money that they already have, and they may not be aware of other options. However, better options exist for a growing lending business.

Equity is an extremely expensive source of capital: it represents ownership of your company. Obtaining equity is also typically a long, involved and competitive process. By contrast, loans and wholesale debt can be much less expensive since they are paid through interest, and though the application is still an involved process, it is typically shorter and less complex than the equity process.

For these reasons, equity should be prioritized for operating expenses, and loans should be obtained for on-lending purposes.

How is debt financing different from traditional bank financing?

Startups are not good candidates for the traditional loans that fund most small business growth. Traditional loans are typically less than \$500,000, secured with collateral and intended to be used as working capital or for capital expenditures. These loans frequently require a business to have been in operation or to have been profitable for two or more years. Given the substantial requirements for traditional loans, they are seen as being low risk and thus provided at attractive rates.

An example of traditional bank financing would be a factory that takes out a loan to purchase new manufacturing equipment, posting the mortgage of its building and the new equipment itself as collateral against the loan.

Compared to these traditional small businesses, startups are perceived as extremely risky because they lack all or most of the standard indicators of security: operating history, demonstrated profitability and physical assets. Furthermore, lending startups may be seen as even more risky than other startups because repayment depends not only the startup's business outcomes, but also the risk of the end borrower. Debt providers see this level of risk as disproportionate to traditional loans.

How does a startup estimate how much funding they will need?

The debt process can be extensive and as a result, a startup should seek at least two years of funding in a debt raise. The estimated debt requirement should be based on confident estimates of the terms of underlying loans, including duration, interest rates and default rates, and may rely on inputs including:

- Macroeconomic factors
- Competition
- Lending model
- Changes in portfolio quality over time
- Strength of local currency
- Loan officer efficiency

Expect a debt provider to ask questions to understand how the amount of the request was determined, and management should be able to speak confidently and in detail about this process. Be consistent in the ask and explanation, since dramatically shifting the ask either up or down signals to a debt provider that the estimate is not thoughtful or not well understood.

Given the challenge of raising wholesale debt, young startups may need to seek funding from multiple smaller debt providers comfortable with startup risk to gain sufficient funds. As a startup develops positive repayment history and becomes lower risk, larger amounts will become available from single lenders.

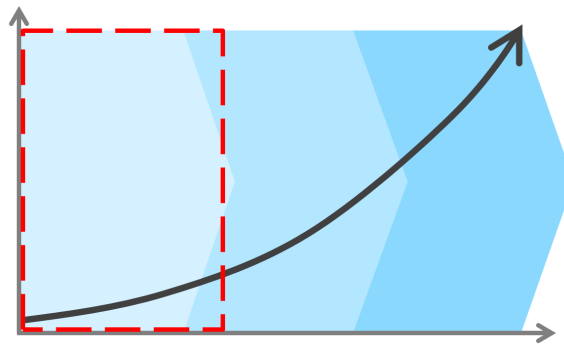
Who provides on-lending capital to lending startups?

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Different debt providers are more appropriate based on the stage of growth.

These generalizations are intended only to guide an initial approach, and are not intended to be exhaustive or comprehensive of all options.

Early Stage



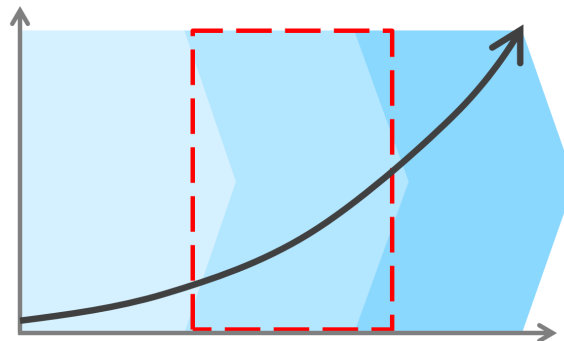
At this stage, a lending business may have only extended a few loans. Without a proven track record, debt providers must gamble on the business model rather than performance. This is the most challenging stage for raising debt.

- **Private debt providers** include small funds, debt funds within private banks, and family offices. These organizations lend from personal capital, have a great deal of discretion in terms and restrictions, and often can be more flexible on structure, minimums and interest rates. However, as this is a heterogeneous group, there is a great deal of variety and idiosyncrasy in offerings and practices. Introductions to smaller players may be challenging to arrange, but often equity investors can be a good source of contact information. Examples include ResponsAbility and Deutsche Bank’s social finance funds.
- **Non-profits and foundations** are mission-driven organizations that accept below-market returns through instruments such as low-interest loans or recoverable grants. “Venture philanthropy,” an emerging class of non-profits, make funds available where a for-profit company can show quantifiable impact against social impact goals. Non-profits and foundations often extend funds for longer tenors and lower interest rates than other debt providers. Examples of relevant non-profits include Kiva.

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Growth Stage



At this stage, your business has developed a limited track record for lending and has achieved breakeven with expenses. While there are more options for obtaining debt, lenders will also have a higher bar for diligence than in earlier stages, including an expectation of audited financial statements.

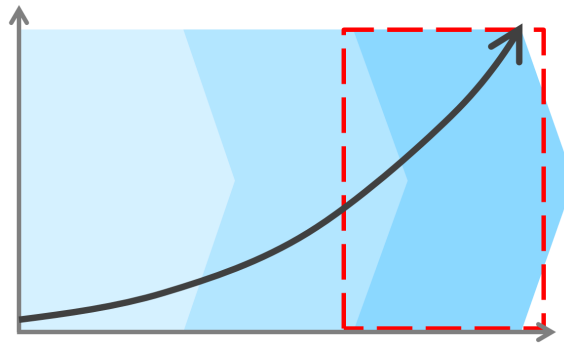
- **Non-bank financial institutions or companies** (referred to as NBFIs or NBFCs) offer debt with more flexible structures and fewer restrictions than commercial banks; however, their pricing is often not negotiable. NBFIs often have a specific industry focus, and their terms vary by market.
- **Development Finance Institutions** (DFIs) provide large, scalable amounts of debt capital to established lending companies after a lengthy diligence process. They typically have non-negotiable minimum requirements for the size of loan portfolios to fund. These minimums are often publicly available on their websites. Networking and personal relationships are often necessary to reach decision-makers and understand the process and requirements. For these reasons, DFIs are rarely the right choice for a lending startup’s first debt provider. Examples of DFI debt programs include OPIC’s Portfolio for Impact and DEG’s Up-Scaling Program.

Your startup can still raise debt at this stage from private investors and non-profits, but their funding may be too small to support a larger business.

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Maturity



At this stage, your company has a track record for lending and an established business. Raising debt becomes significantly easier and you can consider traditional sources of financing, such as:

- **Commercial banks and credit unions** are the most traditional sources of debt for small businesses. They can be attractive partners because of their expertise in local markets and use of local currency. Typically, these regulated entities have strict capital requirements and limit their lending to businesses with at least three years of history or substantial collateral (e.g., land, equipment). Furthermore, government support programs for SMEs are usually channeled through the formal banking sector, so entrepreneurs should also investigate any government assistance or subsidy tied to bank financing. For example, Citibank and Commercial Bank of Africa have experience providing on-lending capital to mature startups in sub-Saharan Africa.
- **Institutional investors** are large institutions that require yield to meet expense and payout requirements, such as pension funds or insurance companies. High minimum investment sizes require a lengthy diligence process; however, the large size makes them a good long-term partner to scale their investment over time. These debt providers are often interested in buying a full portfolio of loans through loan securitizations, and thus require a high level of disclosure about key financial metrics related to your loan portfolio. Blackrock is an example of an institutional investor that purchases portfolios of loans.

The debt providers described in Early Stage and Growth Stage remain relevant but are unlikely to provide sufficient capital to fully cover the needs of a mature business.

How should a startup initiate contact with a debt provider?

From first contact, a borrower should seek to convey credibility and experience. A warm introduction is helpful in providing this impression. Your equity investors, personal contacts or local community of entrepreneurs are all great sources for such introductions. Conferences may provide opportunities to meet debt providers; however, an introduction will still be very helpful in such a circumstance. Conferences targeted by specific geography or industry (for example, East African FinTech) will be a better source of contacts than conferences with a more general focus. Unsolicited, cold pitches to debt providers have a lower probability of success.

Before requesting an introduction to a debt provider, ask your equity investors, personal contacts and local entrepreneurs about that debt provider's preferences, objectives and limitations. By doing your research beforehand, you can evaluate whether this provider would be a good partner and how best to tailor your pitch.

Once you have been introduced, your first email to a debt provider should be brief and professional. In addition to the names of your equity investors, you should include a version of your pitch deck that has been modified to explain your loan book size, the amount of debt you seek and specific detail on how you will deploy that capital. Equity investors are great sources of feedback on these materials. Do not share confidential numbers for your business (revenue, number of customers, etc.) until requested by the debt provider.

Because warm relationships are essential for most debt providers and because the debt raising process can take a significant period of time, it behooves a startup to begin soliciting advice and building a network of warm contacts months or even a year in advance of requesting funds. Startups can also minimize the risk associated with this relationship-building process by selecting a debt provider with an ability to scale, starting with small amounts and then growing the lending amounts as the business grows.

Warm introductions are less necessary for development finance institutions (DFIs) that often conduct formal processes for applicants. For instance, the Overseas Private Investment Corporation (OPIC) has open "calls for proposals" during certain time periods with a formal, criteria-driven application process.

How can an entrepreneur impress a debt provider?

- **Include thoughtful, thorough delinquency, collections and write-off policies and procedures.** Young businesses may not yet have significant experience with delinquency. Clear procedures give a debt provider confidence that you will capably handle these events as they arise, and show that your team is thinking about how your business will grow.
- **Address the greatest risks to your business.** Think of the questions and concerns your debt provider will have, and proactively address them in your materials. Ensure that you have specific, thoughtful answers for how your business will address those challenges.
- **Describe a vision for growth.** A debt provider wants confidence that you are thoughtful about how your operations and business will change as it grows and what challenges will have to be overcome.
- **Be upfront about past defaults or adverse events.** A good debt provider will find evidence of such events in your underlying portfolio data and will wonder why such an event was not proactively mentioned. Tell your debt provider what happened, why it happened and what your business has done to prevent a reoccurrence.
- **Know key ratios and figures off the top of your head.** Be able to fluently discuss the most important metrics describing your business: recent history, short-term and near-term goals, projections and factors influencing these figures. Note that historical actuals and projections should be consistent across all documentation and throughout all conversations.
- **Provide clean, clear and well-formatted materials.** Just as you would wear a suit to an important interview, your data should put its best foot forward. If you know that a debt provider has specific requirements (minimums, ratios, etc.) highlight those figures and make them easy to find. Equity investors can provide feedback on your materials. Ask a friend who is unfamiliar with your business to review your documents and share what they find unclear.
- **Own the process.** Debt providers have many other priorities. Furthermore, they are actively evaluating your commitment to the business and ability to lead. Consider yourself the “owner” of the investing process: suggest next steps, reply quickly to emails, and proactively provide information you think will benefit the debt provider’s decision-making.

What are traditional banks looking for?

Traditional lenders prioritize the question “Will I be repaid in the worst-case scenario?” over the question “Will I be repaid if business proceeds as planned?”

Worst-case scenarios that concern lenders may be:

- Poor business practices
- Fraud
- Injury, sickness or other compromise to key employees
- Adverse market events
- Seasonality
- Weather

While traditional lenders are also interested in understanding and confirming your business’ financial information and operating processes, their evaluation will often focus on identifying and valuing collateral.



What are other, non-traditional lenders looking for?

Non-traditional lenders seek to predict the most-likely scenario. To do so, they balance a quantitative and financial analysis with a qualitative and non-financial analysis.

Financial Analysis	Non-Financial Analysis
<p><i>Can your business' liquidity support loan repayment?</i></p>	<p><i>Can you scale your business sustainably and maintain control of risk?</i></p>
<ul style="list-style-type: none"> • Recent quality of your loan portfolio <ul style="list-style-type: none"> • Repayment history • Current cash on hand • Current and projected revenue / cash flow <ul style="list-style-type: none"> • Portfolio aging / PAR (30, 60, 90 and 120 days) • Cost of capital • Operating expenses / budget • Fundraising history and future requirements • Scheduled existing debt and repayment • Key ratios: <ul style="list-style-type: none"> • Assets to liabilities • Debt to equity • Interest coverage ratio (cash flow to interest expense) • Debt service coverage ratio (includes principal repayments) • Expense coverage ratios 	<ul style="list-style-type: none"> • A compelling story: <ul style="list-style-type: none"> • “This business should exist, and we are the ones to lead it.” • “We will realize better gains than market or incumbents” • <u>Team</u>: <ul style="list-style-type: none"> • Quality of team • Key employee / overconcentration of responsibilities with one person • Experience in lending business roles • <u>Operations</u>: <ul style="list-style-type: none"> • Credit evaluation policies • Underwriting policies • Fraud control measures • Risk policies and controls • Write-off and delinquency policies • Collections processes <ul style="list-style-type: none"> – <i>If this is outsourced, how you selected your outsourcer and how you enforce ethical norms</i> • Legal compliance and enforceability of contracts (especially for off-balance sheet lenders) • Potential alternative, monetizable forms of collateral besides land or equipment

Debt providers are typically NOT looking to see a set minimum amount of cash in the bank. They are also not necessarily looking to see a 100% repayment history of underlying loans if write-offs are accounted for.

What disclosure and transparency should you provide to lenders?

Since startups tend to have less financial information than regular businesses, it is especially important for your information to be reliable and accurate, and you will have to represent that all information shared is truthful in final loan agreements.

- **Bring your finance manager to meetings with lenders:** Lenders will trust your financial statements more if they are able to speak with your finance manager and determine whether he or she is knowledgeable about financial reporting. Be sure your financial manager can fluently discuss the most important metrics describing your business: recent performance, short-term and near-term goals, projections and factors influencing these figures.
- **Share any financial audits completed:** An external audit can be a great source of credibility. Let lenders know if your financial reports have been audited by a reliable firm or if your finance team received help from any other trusted accounting professional.
- **Explain your accounting standards:** There are many different methods and standards of accounting, so be sure to let lenders know how you have prepared your financial reports. Lenders will prefer local or international standards (e.g., GAAP) over internal or ad-hoc standards.
- **Disclose as much as possible:** Studies have shown that better disclosure and transparency leads to better access to credit for companies. When you send information to debt providers, highlight notable trends and other important conclusions. Being proactive in showing financial information and trends to lenders is almost always better than trying to hide your troubles and having lenders find out themselves.

Important key metrics and documents to disclose include:

- All financial statements available (balance sheet, income statement, cash flow)
- Pricing terms that you offer to underlying borrowers
- Loan-level data, including terms of underlying loans such as tenor, interest rates and covenants
- Loan origination data (i.e. new and repeat loans) and ongoing portfolio performance (i.e. NPLs)
- Cohort analyses comparing different risk algorithms (if applicable or available)
- Descriptions of loan pricing methodology standards

How does a loan book's collateralization affect its debt eligibility?

Pledging a company's assets as collateral will improve access to debt funding. This is called 'secured borrowing' and is common for businesses that on-lend capital for asset purchases, e.g. mortgages. Assets can only be pledged as collateral once, and in the case of a default, the lender would have the right to seize the pledged assets to offset their loan exposure to a company.

In theory, any asset owned by your company can be used as collateral. In practice, cash or investment securities are most commonly used. Liens on loans provided by on-lenders are also a form of collateral, as it gives the initial lender recourse to the payments from the on-lenders loan. So, if a lender provides a loan of \$100 to an on-lender, in theory that on-lender should now have \$100 of collateral assets that it can pledge back to the borrower as liens, cash or a combination of both.

A portfolio of secured loans are more attractive as collateral to debt providers than portfolios of unsecured loans since an end borrower's collateral offers an additional layer of protection to lenders.

When calculating the value of your loan book as collateral, debt funders typically "haircut" its stated value to protect against the risk of the collateral asset value dropping. The riskier the asset, the higher the haircut applied. Since cash is a no-risk asset, no haircut is applied to cash collateral. Your company can agree to a higher haircut to improve your standing with a debt funder. Providing more collateral than the value of the loan is referred to as "overcollateralization."

Collateral is commonly pledged to a collateral agent, who holds the collateral over the life of the transaction. This is commonly a local bank.

Local regulations affect types of collateral and the collateral process. You can receive guidance from your local counsel, as well as from the World Bank's DoingBusiness.org subsection "Getting Credit."



Applying for Debt

What questions should an entrepreneur ask to evaluate a debt offer and a debt provider?

Because obtaining debt can be challenging, entrepreneurs may jump to accept offers before fully questioning whether an offer is the right deal for them.

Do I trust this debt provider?

You should have full confidence that your debt provider will be a trustworthy partner as you grow your business. Reference checks with other borrowers in the lender's portfolio will help determine the lender's reputation and relationship with its clients.

A debt provider who understands your business also understands its challenges, and will be more likely to help you restructure your loan should an adverse event occur. A good debt provider will check your calculations, push to understand your policies, and question your requested limit. Be wary of debt providers who seem uninterested in details.

Does this debt provider understand our business?

How quickly do I need funds?

Different types of debt providers move at different speeds. If your business has an especially urgent need, some partners will be more suitable than others.

Be realistic about what your business can afford, and do not threaten your future success with unworkable commitments. Be thoughtful about how overhead will grow, and do not assume that as your business grows, you will be able to locate windfall bargains or avoid bad luck. Ensure the timeline by which you expect to receive payment from your customers matches the repayment timeline that your debt providers expect. For example, if you offer five-year loans to your customers, debt that requires repayment in three years is unlikely to support your lending model. Similarly, ensure that customers are charged sufficient interest to cover the interest required to service debt.

Does a realistic projection of our cash flows allow for this repayment structure?

What are typical terms for the usage of debt funds?

Wholesale debt can only be used to fund underlying loans or working capital. Debt cannot be used to introduce a new product or to enter a new territory. Debt providers' analysis and diligence is not intended to be adequate to gauge the risk of such activities.

Some debt providers may restrict their funding to only part of your portfolio, either due to their risk tolerance ("Our funds can only be extended to collateralized loans") or impact targets ("Our funds can only be extended to women"). Show debt providers you will be a good partner by discussing the specific operational measures you will take to protect their interests.

Debt providers may also apply further restrictions. To determine whether requested restrictions are appropriate, compare offers from multiple debt providers. Equity investors and the local entrepreneurial community are great sources for counsel as to whether fees and restrictions are reasonable for the market. Note that a good debt provider will be upfront, transparent, and happy to explain and discuss expectations. Evasiveness, hesitancy or resistance in discussing expectations indicates that a debt provider may not be a good partner over the long term.

If requested restrictions are reasonable, establish the exact requirements in writing as soon as possible. Once you understand their expectations, include operational and administrative plans for how you intend to meet those expectations as part of your application.

If you decide that the requested restrictions are unreasonable, broach your concerns in conversation and try to negotiate a solution. Do not be afraid to walk away if fees are unreasonable or unmanageable, since such structures can prevent your business from becoming profitable. Debt providers may also make unreasonable requests for oversight, such as requesting to observe board meetings. Equity investors can act as partners in pushing back on such requests, but note that you may have less flexibility if only one or two debt providers are willing to lend.

What loan structures can a startup choose for receiving wholesale debt?

Debt providers generally offer a choice of structures, and business details will dictate the right choice.

- **Revolving Credit Facilities**: Revolving Credit Facilities work similarly to personal credit cards: there is a maximum amount available to borrow, with flexibility up to that limit. Interest is maximum on the amount outstanding at any one time. This can be beneficial to both borrowers and lenders. For lenders, this means you can reduce your exposure to a company to the bare minimum that is needed at any one time. For borrowers, this means you can avoid paying interest on money that is not earning revenue with underlying borrowers.
- **Tranched Exposure**: A startup can elect to receive wholesale debt funds either in one payment or in multiple installments disbursed according to a schedule written into the debt contract. Tranched exposure can become complicated and should be used only if it makes sense for the business or is requested by the borrower.

How can a lending startup use guarantees as credit protection?

Guarantees are a common form of credit protection and are particularly useful for startups, since more of these businesses do not have an established, independent credit history to rely on.

- **Personal Guarantee**: Where a manager's creditworthiness is better than his company's, debt providers may require that individual to guarantee provided loans. In such a case, if the company defaults, that individual would have to pay the debts on the company's behalf.
- **Guarantees from Other Sources**: Other entities can provide guarantees to lending, including development finance institutions and local governments. These sources, especially those with public credit ratings, make the borrowing process much easier, since the debt provider can offer terms based on the guarantor's creditworthiness, rather than the startup's creditworthiness.

A letter of credit functions similarly to a guarantee. Typically issued by a bank, a letter of credit pledges that in the case of default or other specified event, the issuing organization will pay a certain amount to the lender or beneficiary. Collateral is usually required to receive a letter of credit.

What tradeoffs exist between local and foreign currency?

To determine the merits of taking foreign currency or local debt, a company must consider a number of factors. First, in an ideal world, the cost of debt with should be matched with the revenue earned by a company. If you are lending in Kenyan Shillings, getting debt in Kenyan Shillings is ideal. If you are receiving payments in dollars, dollar denominated debt will work. If local currency debt is not available, which it frequently isn't, hedging the currency risk associated with a hard currency (USD, Euro, GBP) loan from a foreign investor may be necessary. Hedging costs vary widely by country, but can reach to 10% in countries with high inflation or volatile exchange rates and where there is limited trading in the currency on international exchanges. Frequently, companies must evaluate the risk of taking foreign currency debt that results in exposure to currency fluctuations. This is not ideal, but in this situation, the cost of the hard currency debt should be sufficiently low that the debt could still be repaid even with a significant movement in the underlying currency.

Providers of local currency debt are few and far between and will often be limited only to those institutions with exposure to local currency through a deposit base, like a commercial bank. Because these traditional lenders often fall into the traps mentioned previously with regards to startup lending, this may not be an option.

In assessing the need for a foreign lender, one should also consider the complexity of taking on foreign debt investors from a regulatory and tax perspective. For instance, in India, taking on foreign investors requires the structuring and registration of a specific type of security called a non-convertible debenture that is highly regulated by the Reserve Bank of India. Costs associated with this type of security make it prohibitive for most startups in the early stages of their evolution. In Kenya, foreign investors must pay a 15% withholding tax on all interest that is sent back to a foreign country. Knowing some of these basic regulatory requirements and challenges can help determine the most appropriate jurisdiction from which to fundraise.

When projecting costs of foreign currency capital, build depreciation into your model through sensitivities: one scenario based on historical fluctuation data, and a second scenario as reasonable "worst" case. A useful guiding question for building the worst case scenario is, "How badly would this currency need to depreciate before I would be unable to repay my debt?"

What legal terms can increase a debt provider's confidence in investing?

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Legal terms clarify and protect the rights of both borrowers and lenders. When lending to startups, debt providers will often require extra legal provisions to protect against the risk of default.

- **Asset Disposal**: The borrower promises not to sell, lease, or otherwise dispose of any of its revenues or assets through any type of direct or indirect transaction.
- **Key Employee Risk**: Debt providers may want to ensure that key members of the team do not leave the company. Adding a Key Employee provision allows a debt provider to cancel a loan if specified management personnel leave the firm (usually just one person, the CEO).
- **Material Adverse Change (MAC)**: A MAC clause establishes a metric that is important to a business' operations and allows the debt provider to cancel a debt if that metric is not met. For example, some debt providers may require companies to maintain sufficient capital or equity/asset ratio to be maintained throughout the life of a loan.
- **No Prior Liens (aka "Negative Pledge")**: This term requires the company to confirm that none of the assets it is pledging as collateral in this contract have already been pledged to any other companies as collateral or as a lien.
- **Notices of Default**: The borrower promises to inform the debt provider of any event of default on another agreement or other condition that will materially affect its ability to perform its loan obligations.
- **Restrictions on Incurrence of Indebtedness**: Borrower agrees not to incur additional indebtedness in excess of an agreed-upon amount or without the lender's consent.

What legal terms can increase a debt provider's confidence in investing?

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- **Super Seniority:** If a company defaults, debt holders are paid before equity holders. But within debt holders, there is a hierarchy of seniority, so some debt holders may receive more payment than others in a default scenario. "Super Seniority" ensures that a debt provider will be paid first.
 - **Pari Passu:** The note ranks at least pari passu or equally with all other outstanding unsecured and unsubordinated obligations of the issuer, existing and future.
- **"Use" Covenants:** Debt providers can specify that the funding they provide can only be used for certain applications. This is particularly true for providers of on-lending capital, as lenders will often require that their funds are used for on-lending and not for other operational expenses. (See Page 17 for more information.)

Equity-like Terms: Some terms force debt to behave more like equity. Entrepreneurs should consider these terms a last resort, as they capture profits that would otherwise go to shareholders (including company founders and employees who hold equity).

- **Performance-based Interest Rates:** Sometimes debt providers need to be incentivized with upside potential for their interest income, depending on the borrower's performance. In cases like this, debt providers could ask for the interest rate they receive on debt to be set as a % of a performance metric, for example, EBITDA or Profit After Tax.
- **Corporate Governance Rights:** Like with equity investments, a company could offer limited veto rights and/or board seats to debt providers. This concession would be unusual and often problematic to equity investors. Nonetheless, as a last resort this agreement helps debt providers ensure the company uses funds in the right way and is heading in the direction initially promised.

What financial costs are associated with wholesale debt?

- **Ongoing interest and repayment**: These direct costs should be incorporated into all future profitability models and measures. (See Page 23 for more information)
- **Legal fees and closing costs**: These fees can be significant (up to tens of thousands of dollars), and typically a startup is responsible for covering these costs for both the company and the lenders.
- **Other fees**: Fees for arrangement, commitment, prepayment and facility fees may be required to compensate the lender for their time and expense in arranging the loan. They are usually payable upfront and may be paid from first drawdown under the loan. These fees should be incorporated in the cost analysis of the loan to ensure affordability to the startup.
- **Guarantee costs**: Guarantee costs can vary widely, but they are usually less than the difference between the interest rate a company can receive by itself and the interest rate the guarantor could receive. For example, if you could raise at 10% and your guarantor could raise for 7%, you would pay the guarantor some amount equal to or less than 3%.

What non-financial costs are associated with wholesale debt?

Beyond financial costs, obtaining wholesale debt incurs significant opportunity and indirect costs:

- **Use of collateral**: Collateral can only be pledged once.
- **Certain legal terms**: Super seniority and other arrangements may impact your leverage in future debt negotiations.
- **Debt-to-equity ratio**: Accepting debt to leverage your company will affect this key ratio, making you less attractive to subsequent debt providers until the amount has been repaid. (Note that off balance sheet financing should preserve this ratio)
- **Equity subordination**: Wholesale debt will take preference over founders' equity in a liquidation event.
- **Your time**: Time spent developing debt provider relationships, completing applications and negotiating terms is time spent away from growing your business.

What repayment structures exist?

Borrowers usually have a choice of repayment type. A startup's projected cash flows are the most important factor in determining which structure is best for the business. Note that loans typically have a fee associated with prepayment that can be a point of negotiation.

- **Bullet repayments:** Principal is repaid in full at the maturity date. Usually interest payments are made throughout the life of the debt. This is the default structure for most lending agreements.
- **Tranched repayments:** The principal payment on the debt is paid over several years, reducing the outstanding amount of the debt over time. This decreases the risk associated with the need for large sums of cash needed to meet a single bullet repayment.
- **Lockbox account:** A lockbox account is way for a lender to make sure that debt proceeds are used towards their stated purpose and that repayments of debt to the on-lender are automatically allocated to paying the on-lenders debt. The initial lender would have rights over the lockbox account, which ensures that the lender receives cash flow first, before the cash is used by the lender for other purposes. For example, if \$100 are lent to the company, the \$100 are on-lent plus interest. When the company receives repayment from its underlying borrower, the repayment is received into the lock box account. A lender will often collect its interest directly from this lockbox account before the company is allowed to take money out to pay for other operational expenses. This can also allow a lender to monitor the use of the funds, only allowing cash from the lockbox account to be used for lending.
- **Sinking fund:** A sinking fund is an account where a borrower deposits money that will be used to repay debts in the future. Sinking funds can have specifications that require the company to make incremental payments in the fund over time. For example, if a borrower has to make a \$100 principal payment on a five year debt, the lender may require that the borrower put \$20 per year into their sinking fund, so that the money needed to repay the debt will accumulate until the debt is due.

What should a startup do to ensure a healthy ongoing relationship with a debt provider?

It is important to maintain a good relationship with debt providers to maintain their confidence in case you wish to receive further debt or require flexibility in your repayment. In addition, existing lenders will serve as key references for future lenders. However, different types of debt providers will have different styles and different definitions of a “good relationship.” Very large, more formal debt providers will mostly be interested in repayment and would only want updates on significant financial milestones, whereas smaller debt providers prefer a personal relationship and the opportunity to advise your business. During the application and negotiation processes, ask debt providers about their preferences and their relationships with other funded companies. In addition, establish reporting requirements upfront to ensure you can meet each lender’s expectations over time.

Smaller debt providers and social impact investors typically appreciate or even expect proactive reporting on how you have deployed their capital. Should you anticipate repayment risks, share these with your debt providers along with your research and plans to address. Remember that your debt providers have experience with similar types of businesses and may be able to offer you advice and introductions to help grow your business.

Your debt providers may need to prepare reporting on their impact and how their funds have been used. Share data and make it easy for debt providers to show their internal and external stakeholders how your business is furthering their goals: amount lent, population affected, etc. Debt providers with a social mission may also appreciate anecdotes and other documentation of their investment’s impact.



What should a startup do if an adverse event affects repayment?

First, as quickly as possible, understand what happened, what you need to recover, and how you will prevent a similar event in the future. Encourage your employees to be honest and to provide their own insights on what happened and potential solutions.

Notify your debt providers as soon as the problem is identified and understood. Though your first impulse may be to postpone this unpleasant conversation, you will ultimately benefit from moving quickly: the sooner your debt providers understand your circumstances, the sooner you can receive the additional time or funds you will need to recover. In your communications, you should:

- **Acknowledge your ultimate personal responsibility** as this business's leader. You need to regain your debt provider's trust, and shifting blame to an employee or to events beyond your control will not help a debt provider feel that you will manage a future event differently.
- **Provide a full accounting of events**. If your debt provider later discovers key events you failed to share with them, they will wonder what else you have failed to share, and you will have further damaged their trust in you.
- **Clearly articulate what your business will need to recover** from this circumstance (additional time or funds) and how you developed this estimate. Consider offering two or three suggestions for how you can work with your debt provider, along with the implications of each plan.
- **Provide a robust, thoughtful plan** for incorporating what you have learned to improve your operations to prevent a future reoccurrence of such an event.

Understand that no matter whether this event was unavoidable or beyond your control, your debt provider will likely view your relationship with greater apprehension and less confidence. Do not take their concerns personally, and instead focus on re-earning their trust and good will.

Restructuring typically affects the payment schedule and a penalty may be applied. It is uncommon for a debt provider to renegotiate the interest rate as a method of recovery, as such could incentivize poor repayment.

If you are fortunate enough to have a debt provider who will work with you to reschedule your payments, you should expect the new schedule to require significant financial discipline and additional ongoing communication, so you should incorporate this burden into your forecasts and budgets.

What if a startup totally defaults on its wholesale debt?

Complete default is fairly rare, given that policies, controls and provisioning are usually structured to ensure lenders are repaid under adverse circumstances.

In a default situation, the government or equity investors seize control of your business and determine how to liquidate assets to repay lenders. While regulations vary by country, current company leadership will almost certainly be replaced, and collateral and the company's assets will be sold to pay off lenders in order of seniority. Equity will have zero value and cannot be used as collateral.

Founders are typically indemnified from forfeiture of their personal assets by their company's limited liability structure. However, if they have provided a personal guarantee to the debt provider, their home, automobile and other property may be seized. Note that even if a personal guarantee has been provided, most debt providers would consider collecting personal property to be an extreme step, if only because doing so could hurt their reputation and make other startups hesitant to work with them.

How does the renewal process differ from the first approval process?

Once your startup has repaid its first loan, renewal with the same provider will almost certainly be the easiest route to further credit (assuming your provider is of sufficient size to continue to offer you debt).

However, though renewal is likely the easiest option, it is not necessarily the best. With an established a track record of successful repayment, it will be easier to attract potential partners and to negotiate better terms. Even if you believe your existing lender is offering you acceptable terms for renewal, it is worthwhile to solicit other offers, since you may be able to use those offers to seek even more favorable terms from your preferred provider.