The challenge of financing pre-EBITDA companies

Guest comment by **Aymen Mahmoud** and **Anh Lee** of McDermott Will & Emery

Obtaining debt finance is generally not difficult for companies with strong revenues. But, for companies at a nascent stage of development, things are not so straightforward. There is, nonetheless, growing interest in the space

In a world where credit has never been more abundant, borrowers with strong EBITDA track records are broadly able to avail themselves of relatively cheap credit in a low interest rate environment. However, for pre-EBITDA companies, it has not always been so straightforward. Even before March 2020 and the advent of covid-19, many businesses had yet to run a true cash EBITDA profit, instead showing promise by way of gross profit or even recurring revenue.

For them, the historic financing landscape did not include traditional money-centre banks, which have been driven by tighter regulations since 2008. Rather, it consisted more of venture capital and angel investor types, meaning their financing sources were often dilutive, intrusive or both. Even in a market where a significant proportion of private credit managers are actively trying to lend to companies with an EBITDA lower than £20 million ($28 million; €23 million) – and even into the pre-EBITDA positions – financing these growth companies can involve varying levels of complexity.

Pre-EBITDA companies are faced with a dual perception. On the one hand, they are viewed as inherently risky due to their net profitability, their significant outflows and cash burn and their expensive product development costs without promise of return. They also rely heavily on the integrity of their intellectual property, meaning that challenges to it can be extremely detrimental to their long-term viability.

On the other hand, these businesses are considered extremely attractive, primarily because of their growth trajectory, additive mergers and acquisitions opportunities and significant ability to generate new equity through an active scale-up market filled with liquid retail and institutional investors.

Fierce competition

The past few years have seen a considerable increase in the number of these businesses being financed in the leveraged loan market, particularly through private credit funds. For the right business, competition to lend can be fierce.

Revenue-based or pre-EBITDA financing can (and often does) take the form of hybrid equity and debt financing. However, with growing competition, more transactions are being completed without any equity kicker or other upside element. It is a well-heeled area of lending in the US leveraged loan market, where a huge number of growth businesses have used these financings, but the European market has been more hesitant until recently.

As a result, while some features are common on both sides of the Atlantic, the absence of more standard terms in Europe and the comparative competition among European lenders to become involved in this more nascent type of lending can allow borrowers to ameliorate terms and optimise documentation on a range of issues. It is worth examining some of the features of these businesses, in particular compared with those that have taken out more traditional leveraged loans.

The minimum equity expected from lenders for this type of business is typically higher than that demanded of private equity-owned EBITDA-generating credits, and normally ranges from 50-80 percent rather than 30-50 percent. For private credit unitranche lenders (which provide the majority of these financings, especially in Europe) this provides comfort that their debt sits ahead of a significant cushion of equity.

Lenders will also expect significant security or collateral from the borrower when compared with the leveraged mid-market, where European collateral has been reduced to a small subset of assets in recent years. Of particular importance to borrowers is protection around IP, since many of these pre-EBITDA companies are technology companies with very valuable IP.

The other key collateral item is bank account security. Ownership may also be somewhat dispersed, and some internal restructuring may be needed to enable the business to provide proper collateral. In these instances, shareholder agreements should be looked at carefully to avoid immediate or future issues under a debt financing.

Path to profits

From a borrower's perspective, these types of businesses are not often familiar with leveraged credit, particularly where it is not backed by private equity owners whose scale of borrowing offers a negotiating advantage. It is important to be familiar with the key business restrictions, particularly against key business strategies. For example, lenders will want to protect their return from these types of businesses. This should be contrasted with the extremely viable option of an IPO for the right technology business. Borrowers and lenders may debate the practice – common in Europe, though less so in the US – of making a prepayment from the proceeds of any listing.

One key consideration should be whether the business is expected to reach EBITDA-based profitability (versus gross profit) during the life of the financing. For some, it will be a mandatory requirement after a fixed period but, for others, it will be driven by the type of underlying revenues. One example of this would be a truly

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recurring software-as-a-service revenue, which relies on an initial sale to drive starting revenue, retention revenue of customers that stay with the business and revenue expansion.

For those revenues that are retained and recur, the underlying business is viewed as having significantly more resilience than those with sales where customers might cancel their subscriptions after a short period. Compare this with a gross profit or gross margin business, which does not have truly recurring revenue, and it may be seen as a weaker credit. However, it is important not to overestimate the terminology because the private credit market is extremely sophisticated and undertakes vigorous and detailed credit analysis.

If, as noted, the business has significant underlying cash costs, this will drive certain key metrics. For example, any ability to pay in kind some or all of its interest may allow for accelerated research and development, which could offer a competitive advantage. This might be tempered by a more stringent (when compared with post-EBITDA financings) regime for the incurrence of debt, the argument being that if the first indebtedness cannot be serviced in cash, no further indebtedness should be incurred. Many of these pre-EBITDA financings impose greater restrictions around the payment of dividends. A dispersed, non-listed shareholder base will often not expect dividends while the company is in growth mode prior to a listing or a sale.

Once the business reaches an agreed EBITDA-based profitability, it will be said to have converted into EBITDA-based metrics or what is commonly known as 'the flip'. At this point, many of the operational restrictions will fall away, and many documentary optimisations (such as grower baskets) and new flexibilities may become available.

There may also be certain economic advantages to achieving the flip, such as a step down in interest rates as the risk falls. Of course, at this point, lenders may expect all their interest to be serviced in cash, unlike the PIK position.

Companies wishing to avail themselves of these financing packages will need to organise the information that lenders expect to see.

They will also need to work with advisers that are experienced, not only in dealing with the issues faced by pre-EBITDA businesses, but in helping strong businesses to use leverage without giving away too much in terms of economics and optimising flexibility to ensure maximum business opportunity, growth and profitability. ■

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