VISTARA GROWTH

OWN YOUR GROWTH SERIES

How to Steer Clear of the “Amortization Cliff”

Introduction

Most venture debt loans from bank and private lenders are amortizing, requiring payments of both principal and interest. These loans are almost always the wrong fit for technology companies that are prioritizing growth over cash flow. While this financing option offer an attractive “teaser” interest-only period, companies often get tripped up once monthly principal repayments are added into the mix, resulting in unforeseen costs or stressful refinancing circumstances.

At Vistara, we advise tech entrepreneurs -- especially those focused on growth – to steer clear of amortizing payment structures. Instead, we suggest non-amortizing (interest-only payment) loans designed to support growth and help companies avoid the dreaded “amortizion cliff,” when principal payments have the potential to jeopardize their operations or even over the cliff to their demise.

The Mismatch for Growing Tech Companies:

Amortizing Venture Debt Can Shrink Rather Than Extend Runway

There are very practical reasons for growing tech companies to avoid amortizing and other shorter-term debt instruments – it simply doesn't fit the business model.

When prioritizing product development and acquiring customers, few growth-oriented tech companies generate positive cash flow. Most are investing more capital than they are generating from customers, often measured as a monthly "burn rate". For companies with loans, this also includes monthly interest payments.

While the growth stage can last for many years, most venture debt is offered either as an annually revolving credit facility that matures and must be renegotiated every 12 months, or as term debt that offers 6, 12, or maybe 18 months of interest-only payments.

During long bull markets, tech companies can become accustomed to easily renewing and increasing their credit facilities or refinancing before the teaser interest-only period ends and they reach the amortization cliff.

But what if they can't? Unfortunately, a surprise shock that makes it difficult or unappealing to refinance debt or raise new equity with only a few months of runway is not unusual. Most recently, this shock took the form of the COVID-19 pandemic, but quite often it is something more commonplace, such as slower growth because of a delayed product launch or higher than expected customer churn.

For Your Own Safety, Stay Well Back of the Amortization Cliff

Case Study: How six months of runway suddenly becomes three and leads to a lower valuation:

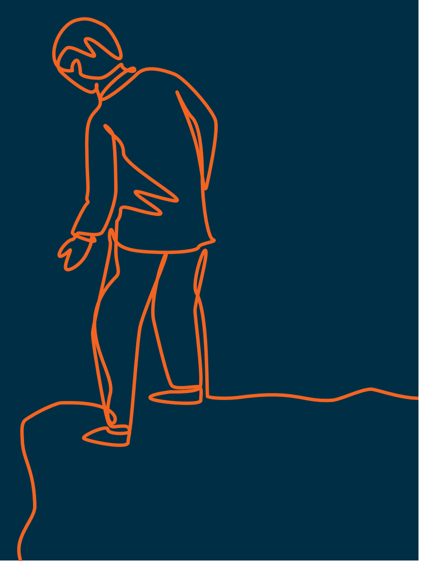
COMPANY & SCALE:
Software company with $1 million monthly recurring revenue ($12 million ARR)

EQUITY FINANCING:
Last raised a round 12 months ago, seeking lead for the next round

VENTURE LOAN DEBT:
Raised $12 million (~1x ARR) along with equity, 12 months interest-only payments, followed by amortizing payments of $500,000 per month

RUNWAY & BURN RATE:
$3M in the bank and $500,000 per month operating burn > six-month runway to negotiate its next financing round – a bit tight, but not uncommon

RUNWAY WITH AMORTIZING PAYMENTS:
Burn doubles to $1.0 million, its runway is halved to only three months and **they are looking over the amortization cliff!**



OUTCOME: Company is in a bad negotiating position, accepts a lower valuation leading to unnecessary dilution

The Real Cost of "Cheap" Debt

As we have outlined before, a cheap-looking loan can be like cheap software: not scalable, a distraction, and ultimately, more expensive. Consider these additional costs of an amortizing loan:

1

The need to keep too much uninvested capital in reserve.

Responsible CFOs "reserve" cash against the loan balance from day one to ensure that they can meet amortization payments. Often, 6-12 months of amortization payments is reserved, which could represent 50% of the entire loan (See example on page 2).

If a company reserves cash and only invests at most 50% of a loan, a 6% interest rate costs at least 12% on the capital actually deployed!

2

The fees and time associated with constant refinancing.

Planning for the inevitable amortization cliff often leads to loan amendments with an existing lender or refinancing with a new lender. Both involve legal expenses and a variety of amendment, prepayment and refinancing fees, and if changing from one bank lender to another, also moving all bank accounts.

This is not only a **costly distraction** for the finance team, but often many members of management.

3

The opportunity cost.

Though amortizing term loans have 36–60-month maturities, they tend to get refinanced not at maturity but ahead of any amortization, or every 12-18 months to avoid principal payments shortening the runway as mentioned above.

Savvy tech CFOs often consider the interest-only period the functional maturity, so a 5-year maturity with a 1-year interest only period is practically a 1 year loan. They understand that any amortization **giving up opportunities for growth** without the support of stable financing.

In Summary

Once you put an appropriate price on internal time and opportunity cost, and after including all the fees and expenses, **a 6% loan might actually be costing 15-20% and probably more, while containing restrictive covenants associated with "cheap" loans.** At Vistara, we offer fully non-amortizing loans that are more growth-oriented and transparently priced, giving companies and their investors much-needed peace of mind. They also prove to be much more cost effective (see sidebar).

The Highlight Reel

How a Savvy CFO Evaluated Options, Chose a Non-Amortizing Loan and Looked Like a Hero

During 2019 a CFO had difficulty convincing his board of directors of the value of a loan from Vistara versus the company's existing bank and other traditional venture debt proposals. The CFO had experienced the highs and lows of growth-stage companies and lived through several financing crises, and did not want a loan that could potentially knock the company off course. He negotiated with a variety of lenders before settling on Vistara's form of non-amortizing "growth debt." At first his board thought our loan looked expensive but fortunately they eventually trusted his experience and instincts.

When COVID-19 struck, many CFOs lived through failed refinancing process and rigid lenders that broke promises of additional credit and refused to extend interest only periods forcing repayment of the loan at the worst possible time. Having secured growth capital with minimal dilution and no principal for a full 36 months from a long-term growth-oriented partner in Vistara, the CFO looked like a hero to his board and his CFO network, proving that what initially looked expensive to some was actually great value. Board members have subsequently introduced Vistara to a number of their portfolio companies.

So, when does an amortizing loan make sense?

At Vistara Capital Partners, we are focused on providing flexible financing solutions for tech companies in growth mode. Amortizing payments removes rather than adds capital for a growing company, which is in direct conflict with its main objective. Rather, lenders should allow companies to access more capital as they reach certain growth milestones, not less by clawing back principal via amortization payments.

Still, there are some scenarios where amortizing loans are a good fit, including:

- Cash flow-positive companies that can comfortably pay down debt with regular cash flow.
- Companies with high confidence that they are on the cusp of significant and sustainable positive cash flow.
- Companies that are committed to raising large rounds of new equity every 12-18 months. But relying on new equity to avoid the amortization cliff is a dangerous game!

Partner with Vistara

We work as partners to help growth-oriented technology companies, founders and early investors own more of their growth and keep more of their companies. To learn how Vistara Growth's flexible financing helps companies reach their full growth potential while minimizing dilution, follow our "Own Your Growth" series, or feel free to reach out and **contact us** directly.