Vantage point **It's time for growth debt to help firms scale up**

Expert analysis by David Waxman

There has been much discussion about the direct lending market's growth and evolution over the years, but the growth debt market's development has not received as much attention, particularly in Europe.

The growth (venture) debt market started 30 years ago in the US and 20-plus years ago in Europe. In its early phases, a few debt providers – led by Silicon Valley Bank in the US and Kreos Capital in Europe – provided early-stage tech companies with small, high-yielding, amortising senior debt with a significant equity component for runway extension. These managers provided a niche product with consistent double-digit returns that, although attractive for LPs, they could not put much capital into it in a way that would interest larger firms.

Fast forward to 2020, the growth debt market has grown to $10 billion per annum at a rate of 20-30 percent annually. It has evolved into a much broader market in terms of companies, industries, stages and use cases.

Flexible structures

Growth debt continues to serve early-stage companies but also mid- and late-stage growth, as well as 'scaling stage'. There are growth companies in every industry with multiple use cases, which enables the deployment of significantly more capital. For example, as high-growth companies are held privately for longer, a scaling software as a service company with a revenue run rate in excess of $100 million might continue prioritising growth over profitability for several years. Rather than raise additional dilutive private equity, it might raise private debt of $50 million-$100 million.

Banks and direct lending funds may not be equipped to serve these companies, as they are not yet consistently profitable and the direct lenders have different relationships, experience, knowledge base and underwriting methodology.

The same set of leading growth debt managers that founded this niche three decades ago, and have grown and evolved with the market, are well positioned to serve this scaling-debt market. It has the same ecosystem and sponsors – only larger – that these firms have been serving over many years.

As one would expect, these scaling-stage companies require a slightly different debt structure than those at early- or mid-stage growth. The leading growth debt managers can provide large, creative, flexible debt structures for these companies.

Increasing component

The evolving debt structures may have slightly lower cost, fewer equity features and less upfront amortisation. As low loan-to-value ratios continue (10-20 percent), they provide an attractive risk-return profile for LPs. This enables LPs to put more capital to work as the established firms executing these transactions can comfortably support fund sizes in excess of $1 billion-$1.5 billion.

This phenomenon is especially compelling in Europe, as it is a less competitive market and typically yields are higher than in the US.

The growth debt space is now positioned to become a larger component of LPs' private debt portfolios as they continue to search for an increase in yield, maintain a low risk profile and put larger allocations to work. ■

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