In debt to technology

When should a growth business use venture debt? **Anna Devine** looks at the recent financing for SafeGuard, a UK payroll company, in search for clues.

For Bjorn Reynolds, chief executive and founder of UK-based payroll tech company SafeGuard World International, it was good old-fashioned business values that convinced the entrepreneur and his partners to take a $15 million credit facility from the Birmingham, Alabama-headquartered fund manager Harbert Management Corporation.

Reynolds rates Harbert's reputation highly when listing off his reasons.

"Every CEO we talked to that had done business with them said they were very pleased," Reynolds tells *Private Debt Investor*. "Speed and certainty are key. We were very convinced by their sincerity, their due diligence … and how long they said it would take to do it … and the way they complement our business. We got the approval and money moving quickly."

The senior secured amortising term loan is split into two tranches, David Bateman, senior managing director of London-based Harbert European Growth Capital Fund and lead on the deal, explains.

SafeGuard has drawn $10 million and can draw the other $5 million tranche subject to hitting certain revenue milestones. The four-year loan paying a 10 percent cash yield topped up with payment-in-kind interest and fees leaves the pricing on the transaction at 12 percent all-in over the life of the loan. There is also a ten-year warrant included, which enables Harbert to buy an undisclosed percentage of shares in the company upon an exit.

Harbert's 'penny warrant' – as the option is known in VC circles – is a kicker with the potential to massively increase its return on the deal. It's a share purchase option, but rather than buying those shares at the exit price, Harbert would pay a nominal consideration, meaning future valuation increases accrue substantial returns.

Typically, warrants are said to range anywhere between 1 and 20 percent.

The warrant is key to growth capital returns and is in place to compensate the high default/low recovery risk of tech firms like SafeGuard. The company provides global payroll and employment outsourcing options and counts blue-chip firms like Skype and Amazon amongst its clients. It will be valued at around $100 million or a multiple of three times at the end of its current business plan, according to three private equity firms which were interested in the business, Reynolds says. Growth projections are around 30 to 40 percent, meaning even a single digit percentage of the exit valuation of the business could reap big rewards for Harbert.

This was the case with Facebook or Google, both of which used venture debt during their start-up days. Growth capital providers in these mega-growth tech companies would have made colossal profits from their warrants, *PDI* understands.

Facebook for instance received $100 million in debt financing from US fund manager Triplepoint Capital in 2008, an amount dwarfed by its $104 billion market value as at the time of its IPO in May 2012. It's likely the warrant was worth substantially more than the 2008 loan when the company listed.

From the borrower perspective, SafeGuard avoids having to give away upfront a big slice of its hard-earned equity in return for investment.

Johan Kampe, senior managing director at Harbert, explains: "Companies who chose to raise growth debt often do so to delay the pricing of their business at a particular moment in time, with the expectation of raising equity on more favourable terms in the future and lowering the overall cost of capital. Many successful companies have used growth debt - some of today's most successful companies in technology - to lower their cost of capital. The cost of equity can fall dramatically [providing] you achieve certain things before a private equity firm then prices the business."

YOUR BANKER WON'T GO THERE

Traditional bank lenders don't consider early-stage businesses like SafeGuard viable lending opportunities. One reason is that during the investment period they are still loss-making. In addition, banks

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often require collateral in the form of personal assets.

Although SafeGuard's high street bank had been supportive in the past, "we just knew they wouldn't [provide us with the capital] so we didn't approach them. They are just risk averse. Typically they wouldn't look at our business. The EBITDA is at a loss on the business plan. It's not a model for the bank even though in 2012 we were recognised as one of the fastest growing businesses in the UK," Reynolds says.

The capital provided by Harbert envisions the business running at a loss for the first two years of the investment. The business plan sees Safeguard make $36 million in revenues and lose about $4 million EBITDA in 2014. By 2015, it plans to make $54 million in revenues but lose about $0.5 million in EBITDA. By the fourth quarter of 2016, the business is expected to be back in positive territory.

The investment plan focuses on sales and development teams as well as technology and infrastructure. SafeGuard has taken on 14 new sales people, upping numbers to 30 and hopes to take on another 20 by 2016, by when it's thought their labour will start to pay off. A small part of the proceeds of the venture loan was used to buy a perpetual software licence.

BULL MARKET

At first, Reynolds thought the only viable source of investment was private equity. After initiating a process either side of the Atlantic, in which SafeGuard almost signed a deal with a private equity sponsor, the company decided to pause and explore the market.

The tech company duly appointed Monroe Credit to run a process but it was MMC Ventures, a UK venture capital firm with an equity share in SafeGuard north of 20 percent, that introduced Harbert to the deal.

"Private equity firms would have different expectations and the incentives are different. They want to generate a multiple. They focus on the upside. For our companies, going with a private equity firm would involve probably giving up 15 to 20 percent of the company, which is one big downside. With equity, the company also usually has to change its governance, which comes with a board seat and a vote on strategy," Bateman says, adding that Harbert leaves things the way they are.

Reynolds adds: "We have a strong board, a strong vision. We have a long term plan not a short term one. When we understood the debt market and that we could go down that route, we felt debt would be a way better cultural fit for us."

"Growth debt is becoming well understood in the market and as such more widely used. It fills a real funding gap for SMEs, one that is not a focus for traditional lending institutions like banks. [It's a space] left for a few specialist lenders," Kampe remarks.

But what Reynolds discovered in fact was that there were more options than he imagined. "Intrinsically we discovered that the debt market had opened up massively with quite a few firms like Harbert to choose from," Reynolds says.

TERMSHEET

SAFEGUARD

"WE WANT TO SEE 15 PERCENT GROWTH AT LEAST. SOME OF OUR COMPANIES ARE GROWING AT OVER 80 PERCENT YEAR ON YEAR."
Bateman

Other firms now lending growth capital in the UK include Silicon Valley Bank, Kreos Capital, Bank of London and The Middle East and Metric Capital. Clydesdale Bank has also set up a venture debt unit, *PDI* understands.

Reynolds says he was surprised by how bullish the market is. "We had four offers from debt funds. All structured differently… I was surprised by the appetite in the UK to do this deal and it was even stronger in the US, particularly on the PE side. Managers there are a lot more bullish than in Europe."

NICHE PLAYERS

SafeGuard is an easy fit for Harbert as it's just the kind of company it specialises in.

"We are one of the few lenders who will lend to companies that are not reporting positive EBITDA. We generally take an enterprise value approach. How we distinguish ourselves is that we understand [technology-based] businesses and use that domain knowledge to lend safely," Bateman says.

Two-hundred signed customer contracts worth an estimated $80.3 million over the next three were reassuring, offering Harbert visibility and diversification.

SafeGuard's investment in technology and the management team also helped cement Harbert's credit decision. "The company has been able to grow quickly in recent years without raising a lot of external capital. We see this as a hallmark of a good business model and an indicator of a strong management team," Bateman says.

Lending to start-ups comes with risks of course. Bateman outlines potential errors and problems like losing contracts or being out-gunned or overwhelmed by competition.

But he has done his homework. There is a lot of room to grow, SafeGuard holds a 0.6 percent share of an estimated $5 billion market. As is the case with this loan, "we generally keep our loan exposure below 30 percent of trailing revenues", he says. "We regard ourselves as well collateralised by the business, in the sense that there is a business here worth a good deal more than our loan."

For potential deals: "We want to see 15 percent growth at least. Some of our companies are growing at over 80 percent year on year," Bateman adds.

To emphasise what he feels is a conservative leverage approach to high risk deals: "There are a lot of LBOs happening at much higher [debt to revenue or leverage] ratios than we would do" with many leaving no wriggle room as they are "priced for perfection", he observes.

It is the exit that really matters though. Despite the company facing a loss-making period Reynolds feels comfortable with the arrangement.

Harbert has tapped into an attractive opportunity. Tech in the UK, particularly London's 'Silicon Roundabout' hub is actively promoted as where the tech start-up poster children play and where a European tech giant, equal to Amazon or Alibaba, could emerge.

"Technology cloud businesses have shown high growth and strong margins. The multiples for these businesses have continued to remain strong through the downturn. Now we are a business which is attractive in the debt market. Two to three years ago that wouldn't have happened," Reynolds says.

Private debt is getting SafeGuard onto a fast track to a higher valuation with minimum equity dilution. It seems a wise move by the borrower to take advantage of benign credit conditions. And if things go to plan, Harbert will be well rewarded for its support. ■

SAFEGUARD TIMELINE

2007 SafeGuard World International (SGWI) spins out of the original SafeGuard World, first established in 1969.

2008 Signs on FedEx as a client. MMC Venture Capital invests for 20 percent stake.

2009 Skype becomes a customer.

May 2010 Forms strategic partnership with Workday, a cloud-based application for human capital management, to implement global payroll solutions for shared clients. Amazon and eBay are added to client base.

August 2013 Starts seeking private equity investment. External equity financing is obtained from US investors.

January 2014 Receives private equity term sheet but pauses. Launches private debt mandate with Monroe Credit. Gives the company 8 to 12 weeks to find a provider.

April 2014 Looks at a number of term sheets.

August 2014 Secures senior secured growth financing from Harbert European Growth Capital Fund.