HOW-TO GUIDE

The fintech's guide to raising debt capital

Assembling the right people, process, and partners to secure an asset-backed credit facility

INTRODUCTION

Why we created this guide

The rise of financial technology, or fintech, has been one of the most exciting trends in technology over the past decade. Large fintech companies like Affirm, SoFi, and Opendoor have fundamentally changed the way consumers obtain educations, buy homes, and finance everyday purchases, and rising fintech companies are sure to power innovations in fast-growing areas like clean energy finance and creator royalties.

One key to the rapid growth of fintech has been startups' strategic use of debt capital in fueling company expansion, particularly for those fintechs that have a lending component.

There are two ways to raise capital: debt and equity. Equity fundraising is relatively simple and involves an investor buying a stake in a company. The funding from the investment can then be used to finance the company's growth.

Debt capital is less common for startups, and can come in several forms, including venture debt and asset-backed debt. This guide will cover asset-backed debt (often referred to, in the fintech world, as a warehouse line of credit), as that is the type of debt that fintech lenders rely on to fund the growth of their originations.

Despite the size of the global fintech market ($7 trillion), there remains very little information online about how fintechs can raise debt capital. Many promising fintechs realize too late that raising and managing debt capital is just as critical to their success as finding and retaining customers.

That's why we put together this guide to raising debt capital. It covers the people, processes, and partners fintech founders and finance leaders need to put in place to successfully execute a debt capital raise.

First, we cover the qualities to look for when hiring for a Head of Capital Markets and/or assembling a Capital Markets team. Then, we discuss the process of raising an asset-backed credit facility or warehouse line of credit. Finally, we cover the vendors and third-party partners you'll need to work with during and after your capital raise.

Our hope is that this guide helps fintech companies streamline their debt capital raise and management, which will enable them to spend less time worrying about capital availability and more time focusing on serving their customers.

PEOPLE

Finding the right people for the job

Overview

There are a few functional leadership roles that all startups need as they grow: a Head of Sales, a Head of Operations, and a Head of Engineering, for example. These roles often arise naturally (even if they are not initially titled as such). All startups must serve their customers, ensure smooth operations, and build out teams that can innovate and provide a high-quality product. But only startups that have a financing or lending component rely on asset-backed debt for growth will need to hire a Head of Capital markets.

For startups whose only funding source is equity from venture capital firms, it's enough for the CEO or another executive to run the fundraising process and, after funding has been wired, move on to other things. Yet when startups need debt capital or asset-backed finance to grow, hiring a Head of Capital Markets, or a CFO with the same skillset, turns out to be critical.

Debt capital and asset-backed credit facilities bring a whole new set of financial and operational questions not typically considered during an equity raise:

- Is the company ready to raise debt? Does it know how to run a tight diligence and negotiation process for doing so?
- How will the company report on its assets?
- Are the company's systems properly set up to generate the right files?
- What rules does the company have to follow to maintain access to its funding?
- At what point will the company run out of debt capital funding, which is essentially "inventory" for the company?
- Is there a plan for raising the next round of debt capital, and kicking off the capital raise process with adequate lead time?

Answering these questions and handling all debt capital-related issues is a full-time job, which is where your Head of Capital Markets comes in.

What does a Head of Capital Markets do?

Broadly speaking, a Head of Capital Markets is responsible for:

- Owning a startup's relationships with capital providers;

- Working with Legal, Operations, Product, and Finance to secure new sources of funding; and
- Building out scalable processes for reporting on and maintaining access to debt capital.

The typical Head of Capital Markets will have 5+ years of experience in Capital Markets (whether at a bank, a fintech, or both), and may have some experience with securitization (this is the capital markets "end goal" for many startups, as it ensures the lowest cost of funding).

In our experience, bank or private credit professionals with experience covering fintechs can anticipate possible financial and operational issues that may arise during a debt capital raise process and can operate at a high level from Day 1. This is the most common profile for Capital Markets leaders at VC-backed fintechs.

That said, we've seen some excellent Capital Markets leaders come from general investing or startup finance backgrounds as well. The only issue is that it may take longer for them to ramp up.

What skills do great Heads of Capital Markets bring?

In our experience, having the requisite knowledge of capital markets is necessary but not sufficient to be a great Head of Capital Markets, as there are several intangible requirements as well. Here are the top traits of great Heads of Capital Markets:

- Versatility. Great Heads of Capital Markets are as comfortable navigating the Byzantine lender landscape as they are debugging a borrowing base Excel spreadsheet.
- High execution standards. Great Heads of Capital Markets are willing to move fast and break things, but they also know that the lender-borrower relationship is based on trust and consistent execution, and that delays in funding are unacceptable.
- Data-driven. Great Heads of Capital Markets are opinionated on data schemas and concentration kickout methodologies. They've dealt with loan tapes and covenant monitoring (usually from the lender side), and they have strong opinions on the best way to format, measure, and track credit facility KPIs.
- Goal- and growth-oriented. One characteristic all great Heads of Capital Markets have in common? Ambition when it comes to company growth goals. The best capital markets leaders know that, with the tools available to today's fintechs, it's possible to raise $100M+ in debt capital only a year after launching a new

product. As a result, they negotiate today's term sheets with an eye towards keeping flexibility for tomorrow's funding options.

- Tech-forward. At a bank or mature fintech company, it may not matter if processes are manual or inefficient. But at a startup, every data analyst, financial analyst, or software engineer working on a capital markets-related task takes time away from the business' "front-end." That's why great Heads of Capital Markets leverage best-in-class technologies for financial data integration, workflow automation, and financial monitoring to serve their businesses as efficiently as possible.

PROCESS

How to raise a credit facility

Know your counterparty

As in any industry, it's imperative to start by knowing your audience. When raising debt, recognize that capital providers look for different attributes and have varying credit appetites. In this environment, you won't be the right fintech for all lenders and that's okay.

A fintech company is likely to have six to ten key critical features that are important to a credit facility (more on that below). Capital markets teams should put themselves in the lender's shoes and ask: what are the six to ten important items, and how does your company stack up against that list?

Be selfish with your time

The background work—the calls, the document requests, the analysis—add up. You want to spend time on transactions with the highest likelihood of execution, as opposed to spending time on convincing a lender to bend around its comfort zone.

Recognize and articulate the match between you and a given lender. The clearer the alignment between fintech and lender, the better the likelihood of a positive outcome. It's difficult and unproductive to force a lender's mandate if it's not realistic or differs from where a company is today. Raising any credit facility requires at least a two-way street: while lenders interview fintechs, fintechs should also interview the lenders.

Know the environment

Lenders will select the transactions that align with their mandate for the given times. Currently, we're operating in a lender's market. Lenders know the volume of deals they'll make in any climate, but especially in a lender's market, you must ask yourself, "What do I have to do to get on the deal list?"

Themes lenders look for

There are six themes that lenders will generally look for:

1. Company review. The group will conduct management meetings to discuss the company's history, ownership, business model, financial condition, funding strategy, management experience and strategic plan.
2. Review of originations and underwriting practices. The group will review the company's origination process, including origination channels, programs, and marketing procedures, and evaluate the company's underwriting guidelines.

3. Review of servicing practices. The group will review the processes and procedures used to service the company's portfolio.
4. Cash flow analysis. The group will estimate the cash flow generating capacity of the collateralizable assets and measure the ability of the proposed liability structure to survive the expected lifetime profile of asset cash flows. The group will develop base case asset performance assumptions (including projected loss curves and projected prepayment curves) by analyzing the originator's historical static pool vintage performance data as well as proxy performance data from similar originators. The group will next measure the ability of the proposed liability structure to withstand stress scenarios which entail deterioration in the base case asset performance assumptions.
5. Pricing analysis. The group will propose pricing and terms for the contemplated investment that align with pricing and terms for comparable market transactions.
6. Legal structure analysis. Unless the investment is intended to be recourse to the issuer, the group will structure the legal documents in a fashion that minimizes bankruptcy or insolvency related risks.

PROCESS

Monitoring the right metrics

Incentives shape behavior, especially on data-driven teams. For Finance and Capital Markets teams, aligning on the right key performance indicators (KPIs) with company leadership can streamline communication and clarify priorities before issues escalate. These capital markets KPIs can also serve as a “north star” during the debt capital raise, focusing teams on what will be important, post-raise.

What are capital markets KPIs?

Capital Markets KPIs, or key performance indicators, are quantifiable goals that help Finance and Capital Markets teams track and communicate their progress on their own team, and to stakeholders across the company.

We've typically seen Capital Markets KPIs fall into two major categories: capital access metrics, and team efficiency metrics. Both are important to measure and improve, but they serve different purposes:

- Capital access metrics relate to a company's ability to access debt capital. Examples include metrics such as a borrower's effective advance rate, for an asset-backed credit facility. These metrics tell you whether your company is accessing capital at a competitive rate.
- Efficiency metrics relate to a Capital Markets or Finance team's ability to streamline common debt capital operations, such as executing a draw request to access funds from a revolving credit facility. These metrics tell you how you might improve your internal processes around debt capital operations and management.

What are examples of effective Capital Markets KPIs?

Below, we list five examples of Capital Markets KPIs that are commonly adopted by startup Finance teams:

1. Effective advance rate. A borrower's effective advance rate is how much they're able to borrow (their max advance amount), as a percentage of the total value of their collateral. The stated advance rate (as defined in a credit agreement) and effective advance rate can differ when a borrower is borrowing against cash (this is usually inadvertent) or, as explained below, when a borrower pledges receivables that are ineligible or contain excess concentration. Tracking effective advance rate is a good way to ensure that a business isn't paying too much for its capital or pledging the wrong types of receivables.

2. Expected versus actual interest and fees, over time. Credit facility utilization is an underappreciated variable when it comes to calculating the "cost" of debt capital. Borrowers are not always aware that credit facilities can come with fees for using, or not using, a portion of a credit facility. For that reason, it's important to track the expected versus actual interest and fees, monthly. This insight can help Finance and Capital Markets leaders know what to negotiate for in future capital raises.
3. Ineligible receivables and excess concentration over time. As we covered in a previous post on borrowing bases, borrowers with asset-backed credit facilities don't get to borrow against all of their receivables. Rather, capital providers deduct ineligible receivables and excess concentration (the sum of receivables that exceed a concentration limit) from the portfolio total before applying an advance rate. Minimizing ineligible receivables and excess concentration is one way to ensure that a business maximizes capital access and minimizes borrowing costs.
4. Average number of turns, per funding request or recycling request. Many first-time corporate borrowers expect that executing funding transactions will be straightforward. More experienced borrowers, however, understand that draw requests and other transactions might require significant back-and-forth between the lender and borrower. This is particularly common in deals with complicated credit agreements, incomplete or inconsistent loan tape data, or unstable collateral values.
5. Financial covenant and portfolio triggers breached. The worst-case scenario for a Finance or Capital Markets leader is entering an event of default and losing access to capital. Of course, by the time a borrower trips a covenant, it's already too late! We recommend setting up automatic alerting when financial metrics approach covenant thresholds or portfolio triggers. That way, you can take measures to ensure compliance.

Why are Capital Markets KPIs hard to measure and improve?

Capital Markets KPIs tend to be difficult to nail down, regardless of how mature an organization is. The primary reason is that the responsibilities of a Head of Capital Markets can vary tremendously from week to week, or month to month.

Initially, a Head of Capital Markets might be brought on to a company to help raise debt capital. That process can take anywhere from a few months to a few quarters, depending on the company's negotiating power, financial track record, and capital provider. In that situation, should a Capital Markets leader be goaled on speed to deal execution, or on the quality of the deal they secure? Is it important for a Head of Capital

Markets to get multiple term sheets? You can see how the hypotheticals quickly add up, and how the counterfactual might be hard to imagine.

In equity or VC investments, the focus is on what could go right. In debt, effective capital management means focusing on and preventing what might go wrong! That carries a broad "surface area" of risk and responsibility. The second reason that Capital Markets KPIs are hard to measure is that most Capital Markets operations have traditionally been done via email and Excel, which are error-prone and hard to audit. Unlike venture capital, which enjoys a robust technology ecosystem, debt capital as an asset class has been underserved by technology and unable to prove their own effectiveness.

As we discuss below, having the right technology can provide much-needed visibility into the state of capital access and funding efficiency.

How can technology help improve Capital Markets KPI tracking and standardization?

You can't improve what you don't measure. At large public companies, Capital Markets teams can have several dozen employees, and sophisticated tooling for measuring Capital Markets KPIs. At smaller companies, however, we've found that the key role technology can play, when it comes to Capital Markets metrics, is enabling leaders to look at capital availability and operational efficiency even early on in a company's debt capital journey. These baselines can serve as reference points for future improvement.

Technology can help in this regard by serving as a system of record for tracking borrowing base size and advance rate over time, compliance with covenants and deliverables, and efficiency metrics like the average processing time for a funding request. We recommend starting with two to three KPIs that have been agreed upon between Finance and executive leadership, and expanding the scope of KPIs gradually.

PARTNERS

Picking the right vendors

Engaging with the right vendors before the debt capital raise can ensure that you're able to execute your transaction without any delays. Three types of vendors you're likely to encounter include data rooms, backup servicers, and verification agents.

Data rooms

A data room is a secure space that stores information–usually sensitive or confidential–and only allows certain individuals to access it. Traditionally, data rooms have been physical rooms under continuous surveillance that contain hard-copy documents. However, recently, most data rooms have become virtual and are hosted on online servers; they are called virtual data rooms (VDRs) and are part of the SaaS industry.

This virtual format has allowed data rooms to become more convenient to businesses, as they can be accessed from anywhere, allow for an unlimited number of approved users to access them at once, eliminate the cost of employing human security teams to guard and monitor physical data rooms, and prevent documents from being destroyed or lost.

Data rooms are notable for the extent of security they offer and their widespread practical applications. Data rooms significantly diminish the risk of confidential information being shared with unauthorized parties, a capability that other forms of file sharing (think Dropbox and Gmail) do not have. Furthermore, data rooms can be utilized in any situation that requires the secure sharing of documents.

Data rooms are often part of the debt capital raise process, as lenders and borrowers will want to share sensitive financial information in a dedicated portal, rather than over email.

Backup servicers

A backup servicer is a company that takes over the servicing duties (i.e., the collection and recording of loan and interest payments) for a portfolio of assets or receivables when a primary servicer can't perform its duties. Backup servicers usually step in for servicers when trigger events (usually defined in credit agreements for debt capital deals) happen. A key example of a trigger event is the insolvency of a servicer.

Servicing is a key part of the operations of most fintechs, which means many fintechs need to evaluate and select backup servicers to work with as they grow. It's not uncommon for fintechs in the lending industry to service their own loans, especially

when they first start out. Startups usually start with small portfolios, so their portfolio and servicing operations are (initially) easy to manage.

When negotiating an asset-backed credit facility with a lender, the selection of a backup servicer is generally a contractual requirement.

A portfolio of receivables isn't worth much if no one can collect it, or if the status of borrower payments can't be found. If a student loan startup faces bankruptcy, for example, how might that startup's creditors ensure that the outstanding portfolio of receivables can still be collected and tracked?

Enter the backup servicer, a vendor that is often required in fintech credit agreements, as a contingency plan. The backup servicer stands by ready to assume servicing duties if something happens to the primary servicer (which is often the fintech, or debt capital borrower).

Backup servicers typically offer three different levels of commitment: cold, warm, and hot. These terms refer to the frequency of the backup servicer's data and portfolio updates (i.e., how often the backup servicer refreshes its borrower and payment data to ensure accuracy) and the speed with which the backup servicer can assume servicing duties.

The more frequent the updates, the "warmer" a backup servicer is said to be, and the more a fintech can expect to pay for the engagement. Below, we provide high-level explanations of cold, warm, and hot backup servicer offerings that fintechs may come across (please keep in mind, however, that backup servicing details will vary by asset type, capital provider requirements, etc.):

- Cold backup servicer. In a cold backup servicer arrangement, loan and repayment data is updated infrequently and it may take several weeks for the backup servicer to take over servicing duties from the primary servicer.

- Warm backup servicer. In a warm backup servicer arrangement, loan and repayment data is updated moderately frequently and it may take 1-2 weeks for the backup servicer to take over servicing duties from the primary servicer.

- Hot backup servicer. In a hot backup servicer arrangement, loan and repayment data is updated frequently and a backup servicer can take over servicing duties from the primary servicer immediately, if necessary.

Verification agents

A verification agent is a company that checks the accuracy of a debt capital borrower's origination data and reporting.

Capital providers often require that borrowers appoint a verification agent prior to the execution of an asset-backed credit facility, as the verification agent's "stamp of approval" on borrower collateral reduces the riskiness of the credit facility and protects against excess advances in funding.

After a debt raise, when fintech borrowers request funds from an asset-based credit facility, capital providers often wait for a green light from the fintech's verification agent before moving forward.

Historically, the use of verification agents has been most common in securitizations, where the volume of credit events and the number of transaction participants makes it critical that all parties have a high degree of financial and legal certainty that the transaction's underlying assets are sound.

But verification agents are also increasingly common in private credit and fintech debt capital deals too, especially those transactions where capital providers want to know that the fintech's assets—think credit card receivables or single-family properties, for example—meet all the general and deal-specific validation requirements that the borrower and lender have agreed upon.

Finley's software simplifies debt capital raise and management for borrowers and asset managers. By automating due diligence, ensuring compliance, and streamlining ongoing reporting with capital providers, Finley helps ensure that companies always have access to funding when they need it. Finley's investors include CRV, Bain Capital Ventures, Y Combinator, Haystack, and Nine Four Ventures.

To learn more, visit finleycms.com.

Cross River is a technology-driven financial services organization that provides core infrastructure and embedded financial solutions with regulatory compliance.

Thank you to Len Losquadro from Cross River's Strategic Direct Lending group for contributing to this piece. The SDL group at Cross River pursues collateral-based investment opportunities, offering platform originators the ability to leverage assets across major ABS Sectors.

To learn more, visit crossriver.com.