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An overview of bridge financing

By: Shehzad Huda, Nicolas Bolduc and Eryn L. Pollard

Introduction

Many companies are faced with the challenge of how to "bridge" the gap between the time when they will run out of funds and when they hope/expect to receive a cash infusion. Bridge financing rounds, which can be in the form of either an equity or debt investment, have been around for ages but, in today's venture capital climate, have become a crucial fundraising mechanism in the world of high growth companies.

What is the purpose of a bridge financing?

Generally, a company is motivated to conduct a bridge round in order to achieve milestones and inflection points necessary before its next major fundraise. The cash raised from a bridge financing round allows a company to (1) keep its lights on and employees paid long enough to hit those milestones or (2) invest in growth opportunities to accelerate the speed at which it can reach key inflection points.

Because of the typical funding gap between financing rounds, startups oftentimes struggle to keep operations afloat. For example, the average startup only has between 12-18 months of financial runway and, in 2022, 44% of startups failed due to a lack of cash.[1] Bridge financings give a company "extended runway" by providing a rapid cash infusion, which allows a company to continue to cover its operating expenses, as they become due.

Moreover, once a company is confident that the business will remain above water, it can re-invest bridge funds back into the business via R&D, market expansion, key employee hirings, or sales and marketing efforts. Seizing these growth opportunities may allow a company to reach significant performance metrics and milestones that are prerequisites for the company to scale and be successful at its next major fundraise.

What are the types of bridge financing?

Typically, bridge rounds are structured as equity investments (such as preferred stock financings), convertible instruments (such as SAFEs and convertible notes), or debt financings (such as bank lending).

1. **Equity Investments**: In an equity financing, investors acquire preferred stock of a company with specific preferential rights such as liquidation preference on an exit event, dividends, pre-emptive rights, and special governance rights. These equity investments require a valuation at which the preferred stock is being purchased, and thus, are usually led by an institutional investor who is in the business of valuing high growth startups. Startups should be aware that, given that major milestones and inflection points are not usually achieved by the time of a bridge financing, company-favorable valuations can be a challenge. As such, leading investors may value the company lower than the

prior funding round (a "down-round"), keep a static valuation, or increase the valuation by a less-than-desirable amount. To learn more about down-rounds and the associated consequences, please refer to the following *Accelerate* article: Down Rounds 101.

2. **Convertible Instruments**: Convertible instruments, such as convertible notes and SAFEs, are a common form of bridge financing in which an investor provides capital that will convert into equity upon the occurrence of a future event such as the company's next funding round or an exit event. To learn more about convertible notes and SAFEs and common provisions and terms, please refer to the following *Accelerate* article: Overview of convertible notes and SAFEs.
3. **Venture Debt**: Venture debt, in the form of term loans or revolving lines of credit, is a common source of supplemental capital. To learn more about the venture debt, please refer to the following *Accelerate* article: Is your company ready for venture debt?.

What are the pros and cons of bridge financing?

While bridge financings are a great option for many companies, it is important to consider the pros and cons from the company's perspective.

1. **Pros:**

- Bridge financings, especially via convertible instruments, offer a more streamlined (and cheaper) process compared to traditional long-term financing option.
- Bridge funds provide a rapid cash injection allowing companies to extend runway, cover operational costs and/or invest in growth to achieve milestones. This, hopefully, leads to higher valuations at the next major fundraise.

1. **Cons:**

- Bridge financings may have a negative connotation to venture investors, especially if the financing includes secured and/or senior debt terms. In those cases, bridge financings may signify that a company is in a distressed financial state or that it is not meeting various performance benchmarks. Ultimately, making it more challenging to fundraise at a later stage.
- If the bridge financing is in the form of a venture debt facility, the interest rates can be high and/or the repayment terms can be unfavorable. Oftentimes, loan documentation also contains various covenants and negative covenants (such as minimum balance sheet targets, restrictions on equity issuance, etc.) that can present a burden to a company's operations.
- If the bridge financing is in the form of equity, the bridge investor may receive more favorable terms than in a standard fundraise, such as lower valuation, participating preferred stock, higher dividends, pro rata rights and/or redemption rights. Moreover, terms such as these may send a message that the company is distressed to future investors.
- If the bridge financing is in the form of convertible instruments, it is possible that the company does not meet the conversion threshold (i.e. the next equity financing or exit transaction) before the maturity date. If the company needs to repay the principal amount of the instrument, it will likely become an additional stressor on the cash reserves and runway.

Conclusion

Although there are certain undesirable consequences associated with bridge financings, financing rounds such as these offer companies a lifeline to bridge funding gaps and seize growth opportunities. Companies should think carefully and consult with counsel to strategize how best to structure these bridge financings in the best possible way.

[1] Does Your Startup Have Enough Runway? (jpmorgan.com); The 3 top reasons why startups failed in 2022: study (cnbc.com)
