

Venture Debt and the Failure of Silicon Valley Bank: A Q&A with Yael Hochberg and Sabrina Howell

Yael Hochberg, **Sabrina Howell**, **Andrew Wong**, and **Lauren Hunt** — 4 MIN READ

The ripple effects of Silicon Valley Bank's (SVB's) rapid collapse in March 2023 were felt throughout the US economy. But the consequences were particularly acute in the world of venture capital (VC).

In this tightly knit world, SVB was perhaps the dominant institution for lending to startups and early-stage companies, an activity known as venture debt. What made its business model so risky that it led to SVB's demise, and what might that mean for the future of innovation financing?

Analysis Group discussed these questions with two of the firm's academic affiliates: Professor **Yael Hochberg**, of Rice University's Jesse H. Jones Graduate School of Business, and Professor **Sabrina Howell**, of the NYU Stern School of Business. Both experts on entrepreneurial finance, they spoke with Managing Principal **Andrew Wong** and Vice President **Lauren Hunt** about the capitalization of early-stage firms, SVB's unique role in the VC world, and what may be ahead for the funding of innovation.

Before we get to SVB itself, let's talk about how the funding of startups and early-stage companies generally works.

Professor Hochberg: Much of that financing happens through funding by VC firms, which provide capital for early-stage companies, usually in rounds that depend on their maturity and prospects for growth and profitability. In return, venture capitalists receive equity in the company, often in the form of preferred stock. Sometimes, however, the financing is provided in the form of what's known as venture debt.

Venture debt, which SVB was a major player in, is often used for companies that have already completed one or more rounds of VC funding. It's a way of providing needed capital to those firms without diluting the ownership stake or control of those who have already invested. These sorts of loans are ordinarily not available to young companies from institutions like traditional banks, because the investment is risky and many startups fail at an early stage. Since startups usually don't have the kind of assets that other companies use to secure these loans, lenders are sometimes compensated with options to purchase common stock at a later date.



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> YAEL HOCHBERG

What was SVB's significance in this environment, and how important was its use of venture debt?

Professor Howell: SVB was closely integrated into the VC ecosystem and had a deep knowledge of the industry. At one point, the startup accelerator Y Combinator estimated that 30% of its startups banked exclusively with SVB.

It was also a leading player in the venture debt market, extending loans to startups that would have had difficulty raising debt finance elsewhere. These loans were part of a larger strategy of banking not only the startups, but also the entrepreneurs, VC firms, and VC partners. And those VC funds and partners, in turn, were essentially guaranteeing the loans by providing next-round financing, and if a startup failed to pay, the VC firm would struggle to convince SVB to lend to its next startup.

It's a model that was only possible for a financial institution that was, as Yael mentioned, deeply embedded in the whole VC world.

It seems as though SVB's strategy worked well, at least for a time.

Professor Hochberg: SVB's deposits were closely tied to the VC funding cycle. There was a tremendous boom in VC funding to startups during the COVID-19 pandemic, and many of the startups that received cash during that period chose to park it at SVB and use the cash to fund future operations. As VC funding started to dry up in 2022, however, startups began to draw down on their balances in order to fund current operations.



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The bank's collapse was perhaps the fastest in history: Depositors withdrew some $42 billion over the course of a single day. What made the run so fast?

Professor Hochberg: Silicon Valley is an extremely tight-knit community. Venture capitalists and startup founders have dense, interconnected professional networks. So when something big is happening, information spreads fast.

Professor Howell: It's also interesting to note that SVB's deep connections with the VC industry were a double-edged sword. As we've seen, those close relationships were so important in establishing its success, but since, as Yael noted, information spreads so quickly through that community, they also led to SVB's very rapid demise. Another aspect of the speed of the run was technology – instead of lining up at the bank, founders could easily pull funds out on a smartphone app in seconds.

Zooming out a bit, what do you think the future holds for venture lending after SVB's demise?

Professor Howell: That's hard to tell. Liquidity will probably be less free flowing, at least for some time. The availability of venture debt may be much more restricted. Ultimately, this seems likely to increase the bargaining power of venture capitalists relative to entrepreneurs, and perhaps force startups to be more disciplined with capital. ■