Debt

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2016 Venture Debt Market Outlook

A Robust Market in Spite of Headwinds

Following a healthy run-up in total venture capital investing in the U.S. in 2014 and 2015, venture capital-backed companies now are sailing against economic and financial headwinds. In 2016, stock market volatility, a dramatic slowdown in new IPO listings, and the possible tapering of the growth of total venture investments have injected new uncertainty into their ability to raise additional capital.

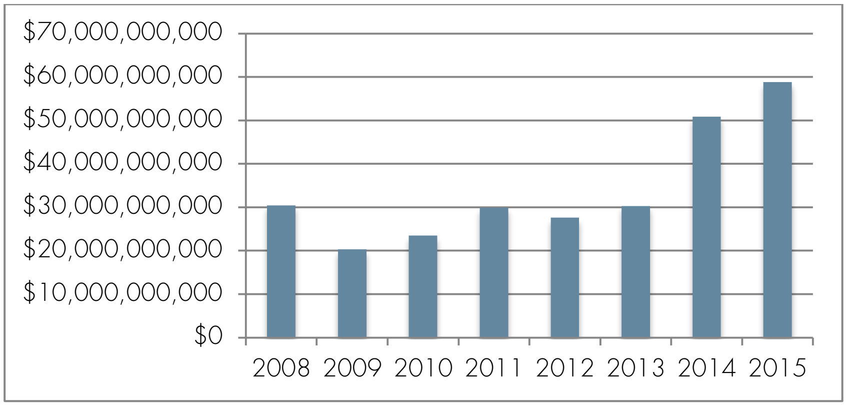
Therefore, early-stage technology, e-commerce, life science, healthcare and other companies seeking additional near- and intermediate-term financing are looking at all possible options. Venture debt, long a staple of emerging growth companies that need to extend product-development runways, is one that many will turn to. Three-to-four-year (or sometimes longer) term loans that include a small equity stake, executed through warrants, have become standard financing vehicles for venture-backed companies.

Like everyone else in an uncertain economy, both lenders and borrowers in the venture-debt marketplace currently find themselves on a shifting playing field. But in spite of the uncertainties, we expect to see a continuation of robust activity in debt financing for emerging companies in 2016. Borrowers should continue to have access to a competitive group of well-established lenders. And we expect those lenders will continue to innovate with an expanded array of debt vehicles designed to meet the unique requirements of early-stage companies.

Growth in Venture Investing Drives Demand for Debt

After the 2008 financial crisis, total venture capital investments in the U.S. nearly tripled from a low of $20.3 billion in 2009 to $58.8 billion in 2015 (Figure 1). Because venture debt deal flow tends to follow in the wake of venture equity investing, we have seen a robust and growing multibillion-dollar market in lending to venture-capital backed companies as well.

Figure 1: Total Venture Capital Investments (U.S.)



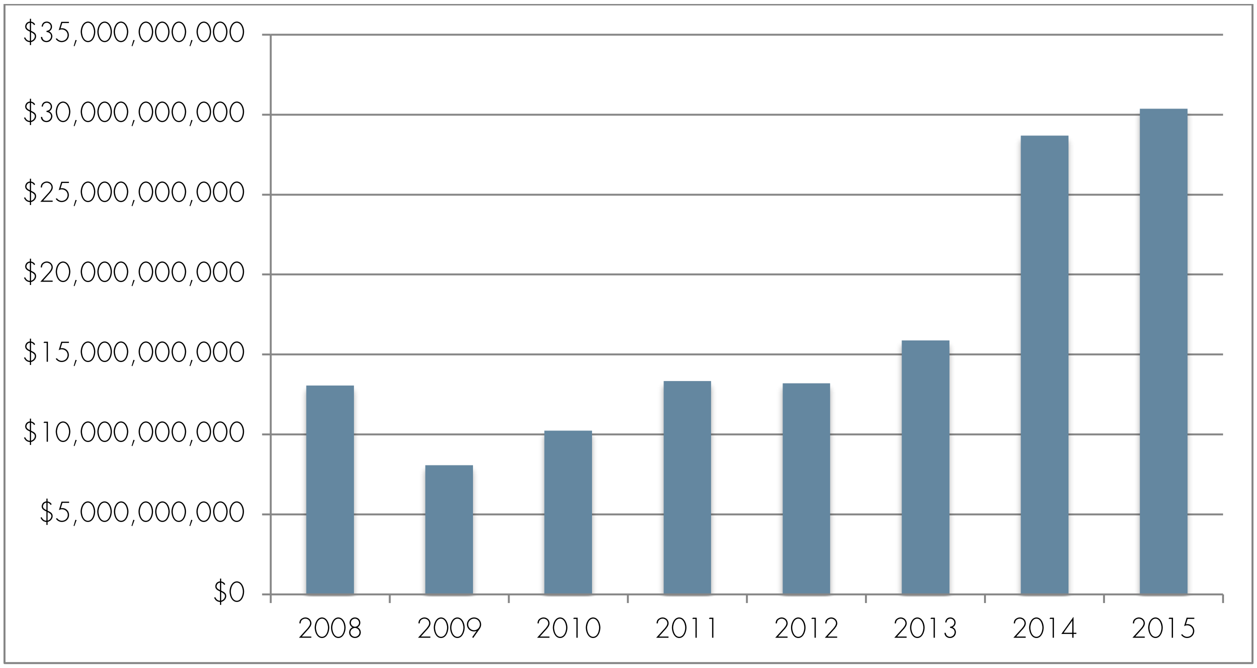
Source: PWC Money Tree Survey

Within this overall market, we see two distinct trends: tech startups are continuing to seek out traditional term debt deals, whereas life science and healthcare companies with typically longer and more expensive product development schedules are sometimes negotiating more complex debt financing arrangements. New lenders have entered the market to serve a broader range of needs, which has made sourcing and negotiating term debt and other forms of financing an increasingly complex process.

Tech Startups Compete for Cash: In the tech sector, traditional technology startups (computers and peripherals, electronics/instrumentation, IT services, networking equipment, semiconductors, software, and telecommunications) have long depended on venture debt to help manage their cash flow between equity rounds. These term debt deals often include warrants for future equity but in general are far less dilutive than B-, C- or growth equity rounds. Many tech companies that raised early rounds still have products in development prior to commercial launch and first revenue. In 2016, they can be expected to turn to venture debt to give themselves more time when they need to raise additional equity.

Figure 2 shows that the fast growth in venture capital invested in tech companies starting in 2009 started to taper off between 2014 and 2015. While overall venture investments in the U.S. increased by more than 15 percent between 2014 and 2015, venture investing in the high-technology sector increased by less than six percent.

Figure 2: High-Tech Venture Capital Investments (U.S.)



Source: PWC Money Tree Survey

That tapering in overall tech venture investing means companies in the sector recently have had to compete harder for new rounds of financing. When otherwise healthy startup companies face greater uncertainty in the timing of second and third rounds of financing, they often turn to venture debt to continue operations while they seek the additional equity. Therefore, even if the increase in venture equity funding continues at the slower rate in 2016, we can expect continued strong demand for venture debt from funded companies, with strong equity investor syndicates, that are moving into the final stages of product development and in need of cash to support their market entry.

Greater Leverage for Life Sciences Companies: Biotech and other healthcare companies have not seen the same tapering of venture investments between 2014 and 2015 that the tech sector experienced. But as the size of their deals increases and the time required to achieve commercial viability lengthens, their debt finance requirements may become increasingly complex. Discovery, development and FDA approval of new drugs and therapies can take years and hundreds of millions of dollars of investment before these companies see returns. But when the products are successful, the returns can be enormous. Lenders therefore have to balance the uncertainty created by long development cycles against the potential for very large payoff in the long run.

Many venture-funded life science companies that have made it through clinical trials still need substantial additional funding to get to market and achieve commercial viability. To meet the needs of these commercial-stage companies, new lenders have emerged with deal structures that often have no equity component at all. One such alternative is revenue interest financing, which can stake a claim on a portion of the future revenues of the borrower with little or no equity stake. Revenue interest financing agreements often range between $20 and $300 million and provide enough to support a successful market launch prior to a mezzanine round of private equity funding or an initial public offering (IPO).

Another alternative is structured financing, which may come with an equity stake, but with terms as long as 5 - 7 years. Because the longer term increases financial flexibility, life science companies in the market for large, late-series rounds of venture capital or who are positioning for IPOs often turn to structured debt. (For more background on emerging debt solutions for life science companies, see our January white paper, *Alternative Financing: Term Debt Options for Life Science and Medical Device Companies*.)

The complex debt requirements of life science companies have helped expand the market for debt financing, with commercial-stage lenders competing against more traditional venture debt lenders and banks to win deals with borrowers. This competition among lenders can be expected to continue and contributes to a healthy market for venture-debt borrowers in 2016.

When the Public Market Spigot Runs Dry

One concern of early-stage companies and the venture capitalists that back them is the recent near-shutdown of the market for initial public offerings (IPOs) and follow-on financings. After a post-financial-crisis high of 275 IPOs in the U.S. in 2014, the pace of IPOs fell by 38 percent to 170 in 2015. In January 2016 there were no IPOs in the U.S., and there were only eight in the entire first quarter of the year.

Even a temporary slowdown in IPOs may make it more difficult for later stage venture-backed life science companies to secure additional debt without lining up strong commitments for future equity investments from private investors. However, life sciences companies that have benefited from the rapid growth in overall U.S. venture investments over the past several years and progressed toward commercialization still are well positioned to secure those commitments. In 2016, those companies will have access to lenders providing extended term debt, revenue interest financing, structured financing and other options.

Tech companies that have not seen the same kind of growth in venture funding that fueled the life sciences sector are in a different position. However, because tech venture debt deals are more often shorter-term lending agreements with warrants providing equity stakes to lenders, they should continue to have access to adequate supplies of venture debt to meet their needs in 2016.

Navigating Debt Markets in 2016

A robust market with competition among lenders does not necessarily make lining up venture debt a sure thing for borrowers. In fact, the growing number of suppliers offering a broader array of more complex lending options makes the borrower's job as challenging as ever. Any company exploring such financing must answer some basic questions regarding its own profile to determine what type of financing may be available and most appropriate to fulfill its goals:

1. How will debt benefit the company?
2. How much debt will be necessary to achieve the company's goals/milestones?
3. Is the debt to be used for near-term operating expenses, capital expenditures or longer-term runway extension?
4. In what phase is the company?
5. Is the company burning cash? If so, how much? Are there at least 12 months left?
6. Who are the current investors? Will they need to participate in future equity rounds to keep the company moving forward?
7. How much equity has been invested in the company?
8. Is the company facing any regulatory risks or legal challenges?

Once a company has determined that early-stage term debt is the right option and examined which structure may be most appropriate, it then must identify appropriate lenders and solicit proposals. Because we expect the market to grow even more crowded with institutions looking to lend in 2016, we encourage companies to understand market trends and know who is active and eager to lend and who is more conservative and reserved. We often advise those seeking debt financing to not necessarily "go with who they know." When prospective borrowers target appropriate lenders based on deep knowledge of the current market, they can more effectively drive a competitive bidding process.

We believe early-stage debt financing can be a critical supporting component of the overall capital structure of companies that are in high-growth mode and pushing toward commercialization. The key for management seeking debt financing deals is to know the market and its players, to understand the available structures within each type of financing vehicle, and to drive a competitive process between lenders in order to negotiate the best possible terms. With abundant capital available and an ever-increasing competitive environment for lenders, 2016 should most certainly be a good time to be a borrower.

About Us

Capital Advisors Group's debt consulting division has provided early-stage corporate debt solutions to clients since 2003. We also manage customized separate cash accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. We provide FundIQ® money market fund research, and our CounterpartyIQ® service provides aggregation and credit analysis of counterparty exposures and risk assessment on short-term fixed income securities and portfolios.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

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