Debt
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# Alternative Financing: Term Debt Options for Life Science and Medical Device Companies

*Capital Advisors Group is a Boston area-based institutional investment advisor that has been helping venture-backed companies invest their cash assets for more than 25 years. Its debt finance consulting division helps early stage companies, both public and private, determine their optimum capital structure, identify appropriate lenders, source term sheets and negotiate debt financing deals.*

## Executive Summary

As uncertainty begins to creep steadily into the minds of investors and IPO markets noticeably cool coming into the end of the year, revisiting the debt markets and the options they hold might prove fruitful for companies seeking financing in the medium-term. This paper will review the types of debt financing available to earlier stage companies and when and how such financing might be appropriate.

## A Brief History of Debt Financing

Financing projects and growth through debt has long been a staple of modern corporate economics. However, debt for companies which have very little credit history, a relative lack of fungible assets, negative cash flow and little to no revenue (often for 2+ years) in the past presented an untenable risk for many traditional bank lenders. Therefore, early stage companies with a need to develop products, continue R&D or build out operations, primarily sought equity investment, which resulted in a potentially significant dilution to fund their goals.

Debt financing has been around in one form or another for decades. Venture debt was first introduced in the late 1960s for new technology firms that did not qualify for traditional bank financing. These start-up companies not only lacked a proven track record, but also were burning through cash. Historically, the only way such companies could raise capital was through equity financing. Then, a number of equipment leasing companies that were well-prepared to maximize the value of certain types of equipment as collateral, began underwriting equipment leases to these early stage companies. In this emerging form of lending, venture debt was collateral driven and almost never reached the 100% financing level for these cash-strapped firms.

In the late 1980s, Equitec Financial Group developed a leasing product that offered 100% financing. Equitec devised the concept of using an "equity kicker" on each deal to increase yield on a portfolio basis to balance the higher risk profile of the borrowers and to offset the inevitable increased loss ratio when compared to bankable credit portfolios. In these early transactions, the "equity kickers" came in the form of success-based fees or warrants. This 100% financing model, which utilizes warrants on a

short-term basis (typically three years), remains the primary structure used by venture lenders today.

### Venture Debt

Venture debt financing has come a long way from the days of equipment lease financing, its predecessor. It has become an accepted method of extending equity financing under the proper conditions. The venture debt space currently is populated by a growing group of players that offer specific, somewhat formula-driven term debt options to young and promising companies. Both banks and non-bank funds, as well as specialty finance companies, are active in this space. As with many venture debt deals in the life sciences sector, lenders typically will assume the risk of financing a company with negative cash flows, an unproven product and insufficient collateral. Why might they engage in such a deal? Despite these risks, such lenders have long and successful track records of identifying the factors that bolster the profiles of early-stage companies, such as:

1. The presence of venture capitalists and their implicit guarantee of support for their portfolio companies.
2. The quality of the intellectual property.
3. The significant upside potential from the equity warrants of a successful company.
4. A senior lien on all assets (commonly excluding intellectual property).
5. The possibility of winning the deposit business of the borrowing company (typical of bank covenants).
6. An interest rate that is meant to reflect the risk the lender is taking in such a transaction.

Having advised hundreds of companies over the past 13 years on venture debt deals, Capital Advisors Group consistently has strived to help companies understand both the pros and cons of this type of financing? We believe that under the right circumstances, venture debt financing can make sense for many reasons, including:

1. Debt is almost always less dilutive than equity.
2. Early-stage term debt can extend a company's cash runway and allow it to reach significant milestones. This, in turn, increases the valuation of the company in subsequent rounds of equity funding. It is common to see early-stage debt financing being used as a bridge between equity rounds that can be used to achieve those valuable milestones.
3. Leverage is an indirect benefit of venture debt that can help boost the internal rate of return (IRR) of the VC. The VC's IRR is calculated based on actual deployed capital, as opposed to the total amount funded by its investors. Consequently, the use of debt can help boost the IRR of the VC.

Characteristics of Venture Debt:

- This is the traditional form of early-stage lending. Deals range from $1MM up to $30MM and may be financed for a typical term of three to five years.
- Interest-only periods and staggered draw-downs are common features.
- Borrowers can expect to pay a facility fee, back-end balloons and principal and interest payments.
- Lenders might expect to receive warrants in the 2% to 6%+ range.
- Companies may expect a runway extension of one to eight months.
- Venture debt may be made available along with an Accounts Receivable line of credit for those companies that have existing revenues.

## Revenue Interest Financing

As companies move toward late-stage Phase III trials, near term FDA approval, CE Mark/European commercial-stage or post-FDA approval, new opportunities for debt financing begin to emerge. While venture debt may remain a viable option, in some instances there is a group of lenders that will consider lending to such companies with an eye on future revenue streams. Historically, royalty finance simply was a method of taking a sum of cash up front and paying down the loan with revenue streams generated from the commercial assets. More recently, however, a group of lenders has emerged that are willing to make a similar upfront payment based on future revenue streams. Known as Revenue Interest Financing or "Synthetic Royalty" financing, such lenders have filled a financing gap that used to be open only to additional equity or acquisition/IPOs. These instruments may be implemented at a crucial stage, such as when a company is moving from clinical to commercial or the funds may be deployed on an approved asset to further assets still in the pipeline.

Characteristics of Revenue Interest Financing:

- This is an option for companies to monetize their existing intellectual property. Companies effectively sell a portion of their existing or future revenues in order to access near-term capital requirements.
- The deal size for this type of structure ranges from $20MM to $100MM and the terms are typically five to six years.
- A common structure may have interest-only payments for half of the term, augmented by quarterly royalty payments of a certain percentage of net revenues once said revenues exceed a fixed threshold. The loan is fully amortized over the second half of the term.
- Lenders target a relatively high IRR of 15% to 22% but the deals can add as much as 18 months in cash runway, are non-dilutive and have a broad scope for negotiating features such as buy-out options if the royalty streams become too high.
- From a diversification point of view, by selling a portion of revenues upfront, the company is sharing some of the market risk of a certain product line with the lender.

## Structured Financing

Early-stage companies that have demonstrated consistent and growing revenue may have the option of working closely with a specialized set of lenders that offer tailor-made debt financing terms (traditionally called mezzanine debt and also known as structured debt). Good candidates for this type of structured debt financing include companies looking to develop and expand new products, push into new markets, ramp up marketing efforts or pursue an acquisition. These types of companies are in a position to leverage their existing commercial products and acquire the capital they need to meet their goals on terms that are designed specifically with their financial profiles in mind. The lenders in this space, where companies have demonstrated greater commercial viability, are much more flexible in terms of repayment. Longer terms with extended interest-only periods or even bullet structures are common. Because structured-debt financing terms are so varied, it is difficult to pin down the terms that may be available to a specific company without a thorough due diligence review of its financials.

Characteristics of Structured Financing:

- Structured financing is typically available to early stage commercial companies with an EBITDA in the range of $10MM to$50MM.
- This is the least formulaic and most flexible kind of structure. $10MM to $100MM+ may be made available for terms as long as eight years.
- A common feature of structured deals is an interest-only period that covers more than half of the term. The coupon rates are in the 10 to-12% range. This coupon is readjusted upwards when amortizing

payments begin to allow the lenders to recover their targeted IRRs in the 15% to 19% range. Structured debt provides flexibility up front in exchange for large payments later in the term.

## What Structure is Right for Your Organization?

Having reviewed the primary options for early-stage term debt financing, we believe that 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. The answers to these and other such questions will dictate the lenders and the types of deals that might be available to the borrowing company.

We recommend considering the following factors:

1. How will debt financing benefit the company?
2. How much financing 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? Is 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 which structure may be most appropriate, the company then must identify appropriate lenders and solicit proposals. Since the onus of securing the best possible deal usually falls on the finance team, it is helpful to think of this process from these key executives' perspectives. Debt financing can be most effective only after the team has worked to model various cash utilization and debt scenarios to determine the best strategic use of early-stage term debt. Next, we often advise those seeking debt financing to not necessarily "go with who they know." This is a space that is growing evermore crowded with institutions looking to lend and we encourage companies to understand market trends, know who is active and eager to lend and who is more conservative and reserved. Prospective borrowers should target appropriate lenders based on this knowledge of the market and drive a competitive bidding process. Finally, the crucial stage comes in negotiating terms sheets; how to negotiate, where to push back and how to achieve the best possible deal for your company.

## Conclusion

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