Debt

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Debt Finance for Early-Stage Companies: Chronicling a Transformative Industry Shift

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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 24 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.

Note: For the purposes of this paper, we will define "healthcare" as life sciences/biotech, medical devices, diagnostics and health tech.

Executive Summary

There has been a noticeable shift over the past two to three years in how early-stage healthcare companies finance their operations. The traditional model, seed stage financing followed by venture capital and, perhaps, some mix of bank or venture debt, is becoming less and less the status quo. It appears more difficult now to get science and technologies off the ground through traditional methods. We are now seeing a mix of creative structures that sometimes include venture capital syndicates combining for large early rounds. Tech "unicorns" are raising incredible sums at massive valuations and we're now in what could be the tail end of an extended period when early-stage biotechs have had great success accessing funds via the public markets. We have also been seeing large pharmaceutical companies partner with young drug companies at earlier stages and significant licensing agreements or outright sales of programs in the clinic to finance other promising products in the pipeline. At the same time, as a result of these equity financing trends, or perhaps coincidentally, the debt financing landscape has been dramatically altered by new players in the market who have added to a growing source of funds for early-stage tech, health-tech and healthcare companies. In turn, there is now increased competition among lenders.

The goal of this paper is to attempt to chronicle the exponential growth of funding sources in the debt financing market, and provide an update on the continually shifting landscape of the markets.

A Brief History

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.

Due to the dearth of traditional sound credit qualities needed to secure significant debt facilities, leasing arrangements for equipment financing were developed by the many asset-driven lessors in the late 1980's. One of those equipment leasing companies, 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 equipment leasing deals, the precursor to what we know today as venture debt, the equity components came in the form of success-fees or warrants, usually assessed near or at maturity. However, as more lenders came into the space, physical asset-based collateral-driven lending practices loosened, giving way to general liens on all of the assets of the firm to collateralize the loan. These liens gave virtual or development-heavy businesses the ability to leverage equity with debt to fund growth capital without the dilutive or constraining properties of investor equity. However, venture lenders whose funds which were dominant in the market between the late 1980's and mid 2000's, were limited in their funding availability. Due to the fund sizes of these debt lenders, companies with significant equity and commercial launch viability tended to be a underserved participants in the growth capital market.

The market started to move following the credit crisis of 2008-2009. With the crunch pinching venture debt lenders into deal sizes that would typically top out at $30 million for exclusively strong venture backed companies, the timing was right for a new group of lenders to step in to provide larger and more flexible terms for later stage commercial or near-commercial stage companies. New lenders and structures began to emerge that may have had no equity component with deals sizes that ranged from $20 million to more than $100 million. These lenders were lending against the commercial viability of the products the borrowers were, or soon would be, offering. They were presenting longer term structures known as revenue interest financing or structured debt financing that would quickly begin to overlap into the realm once held exclusively by the venture debt players.

The current debt space for early-stage and more mature commercial companies has expanded to include not only the venture debt lenders and banks, but also the mezzanine and structured lenders. This has increased the competitive landscape for commercial stage lending over the past five years. These "mezzanine" debt and structured financiers often take equity in the company in the form of warrants, a common lender practice in the market going back to the venture lenders in the 1990's. Along with, or in lieu of, warrants, these structured lenders often implement a "revenue sharing" program, essentially taking a percentage cut of the company's future revenue. Revenue share or "royalties" may allow lenders to mitigate downside risk while staying off of a company's cap table. Many of these companies are the debt financing arms of venture capital and private equity firms which have a greater appetite for risk and therefore require a greater cost of capital. It is this landscape of varying structures and preferences into which a company walks when seeking debt financing.

Debt Coverage and a Diversity of Options

Bank Debt: At the earliest stage that it may make sense for companies to consider debt financing, there exists bank debt. Banks, specifically venture banks, historically have been well suited to provide smaller term loans to cash burning companies, because they have had relationships with these companies from day one when they need a checking account. In addition, they are positioned to quickly assess a client's debt financing needs. In return for the risk the banks take on these loans, the banks may require the borrower's other banking service business. In the best cases, it can be a win/win scenario as the early-stage company with simple needs has a one-stop-shop for loans and banking services while the bank can collect deposits and fees on all services. However, in today's shifting landscape, banks have been forced to take on more risk than they may have historically preferred in order to remain competitive. Though occasionally banks can service loans above $10 million, they mostly deal in loans between $1-$10 million.

Venture Debt: As opposed to bank debt, venture debt lenders typically can provide larger deal sizes for longer terms at a slightly higher cost of capital. It has become an accepted method of extending equity financing under the proper conditions populated by an established group of players that offer specific, somewhat formula-driven term debt options to young and promising companies. 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 will typically 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 such factors, these lenders have a long and successful track record of identifying companies that present solid credit profiles 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. Upside potential from the equity warrants of a successful company
4. A senior lien on all assets (commonly excluding intellectual property)
5. An interest rate that is meant to reflect the risk the lender is taking in such a transaction

The size and structure of these deals can vary, especially when taking into account the equity specifics and the repayment schedule, but on the whole these facilities can range from about $5 million to $30 million.

Structured and/or Royalty Based Finance

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 is still a viable option in some instances, there is a group of lenders that will begin to consider lending to such companies with an eye on future revenue streams. Historically, royalty finance was simply 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/IPO. These instruments can be implemented at a crucial stage when a company is moving from clinical to commercial phase or the funds can be deployed on an approved asset to further assets still in the pipeline.

In addition, some of these same lenders may also be able to offer a structured term debt facility to commercial stage companies that have demonstrated consistent revenue stream. Companies that may be looking to develop and expand new products, push into new markets, or pursue an acquisition may be good candidates for this type of structured debt financing. They may be 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, can be much more flexible in terms of repayment with longer terms (up to seven years) with extended interest only periods or even bullet structures. 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 of its financials.

Unlike the bank debt and venture debt, structured debt has the most leniency when it comes to the size of the facilities. Depending on the needs of the company and the leverage they can feasibly service, structured finance firms can put forward anywhere between $20 million and $150 million in debt and equity.

Market Size and Scope

Since the venture debt market's inception, there have been fluctuations in both the access to and the size of the debt facilities companies sought to acquire. The venture debt market originated with venture banks willing to leverage physical assets, it continued with venture funds taking all-asset liens as collateral against downside risk, and has expanded to include royalty and structured finance firms which secure future revenue streams and potential equity components to achieve risk off-setting returns. And, with each iteration, the leverage available increased to meet the needs of a progressively diverse set of companies; companies ranging from small cap nascent tech startups to large cap revenue-generating medical device and biotech businesses.

Interwoven with this growth in the industry were secular and cyclical market forces that expanded and contracted credit accessibility broadly across all markets. For instance, before the 2008 financial crisis, the approximate size of the life science venture debt market was $2 billion, inclusive of a few hybrid equity-debt providers. Following the crash, credit committees tightened their purse strings as uncertainty ruled Wall Street during 2008 and 2009. The eventual loosening of credit risk policy began in late 2009-early 2010, and as a zero interest rate policy begat gradually cheaper and easier money, venture debt funds started raising capital in earnest to take advantage of the favorable yield at relatively low risk. This "easy money" inflated the debt market. Taking into account publicized fund sizes as well as general credit flow through the market, we estimate the current debt (and partial equity) market to be over $20 billion, an order of magnitude greater than the pre-2008 high.

Though some of the expansion in the debt market can be attributed to the vacillating credit markets, much of the recent increase in the overall debt environment can be ascribed to the so called structured finance lenders entering the market and raising larger funds each year. Some of these funds have been able to attract investors and billion dollar funds, far outpacing what traditional venture debt lenders have traditionally put to work in the market. However, to be clear, some of these lenders are able to employ creative lending structures that combine debt and equity; a comparatively new form of financing that has pushed a lot of money into the life science debt market over the past several years as investors chase yield in a zero interest rate environment.

Conclusion

We have most certainly entered a new era of financing options for healthcare companies. The current state of the life sciences debt market, and the credit market as a whole, has changed dramatically in just the past five years. The main driver of that change is the ingenuity and diversity of investors willing to create efficiencies and help companies succeed in otherwise untested markets. From the staid asset-leveraging of the 1980's to the intrepid financial leverage of synthetic royalty, financiers have consistently innovated within the space to help diversify life science companies' options. Though market changes have expanded and contracted the debt market, it's most recent iteration has found the space to be as fertile and vibrant with financing choices as it has ever been, providing growth capital to a whole range of companies which would have otherwise had sole recourse to the equity markets. To be sure, debt financing is a market in constant flux but the new options available since the crisis of 2008 require corporate finance executives to do their research to determine the best course to help their companies grow.

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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