Debt Financing for Healthcare Companies: The Current State of the Market

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

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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 22 years. Its debt finance consulting division helps venture-backed companies determine their optimum capital structure, identify appropriate lenders, source term sheets and negotiate deals.

Executive Summary
Capital Advisors Group's debt finance consulting division (formerly Debt Advisors Group), was founded in 2003 with the goal of tracking the debt financing markets and helping early stage companies secure the most competitive deal terms and conditions available. The goal of this paper is to provide an update on the shifting landscape of the debt financing markets, ranging from venture debt to structured debt and "synthetic royalty" based financing.

A Brief History

Corporate debt financing has been around in one form or another for about as long as there have been companies willing to take loans (i.e. a long time). However, the concept of venture debt, intended for companies that did not qualify for traditional bank financing, has only been around since the late 1960s. 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 short term operating leases (typically three years) to these early stage companies. In this emerging form of lending, venture debt was collateral driven and almost never reached the full 100% acquisition cost level for these cash-strapped firms.

In the late 1980s, Equitec Financial Group developed a leasing product that offered full equipment cost 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. As the years

BIO:
Rich Bowman has more than 30 years of experience in consulting, commercial lending and equipment leasing, most notably in the high technology and life science industries. He originally joined Capital Advisors Group more than seven years ago as President of Debt Advisors Group. Currently, Rich is overseeing business development for Capital Advisors Group's west coast region and marketing the firm's investment management and venture debt services to growing companies.

Prior to launching Debt Advisors Group in 2003, Rich held senior positions at GE, Comdisco, Inc., and Equitable Life Leasing Corporation where, for 15 years, he worked in financing products for early stage companies. Rich holds his FINRA Series 65 license.

passed and early stage firms became more virtual and required less equipment, other lenders entered the space and were willing to use this proven structure without specific equipment collateral utilizing a lien on all the assets of the firm. Currently most "venture debt" is referred to as a "growth capital line" which can be used for any corporate spending purpose. The cost basis of these loans is typically based on a percentage of current liquidity. The loans are structured on a 3 – 4 year term with a lien on all the assets of the firm except the "Intellectual Property", which is usually placed under a negative pledge.

When Debt Advisors Group was founded more than 11 years ago, the debt financing options for early stage companies in the healthcare space were somewhat limited but also fairly easily identifiable and formulaic. An early-stage, venture-backed company could seek venture-backed term debt financing, bank term debt financing, working capital and/or lines of credit, and equipment financing. As companies commercialized drugs or devices, they may have also been able to secure additional funds via royalty stream financing.

This lending environment remained relatively stable throughout the early and middle part of the last decade. However, these options left a financing gap for some companies; specifically, those later stage companies that had significant equity infusions through multiple clinical or development phases that were preparing for commercial launch. Venture debt may have been a feasible but inadequate option in terms of total deal size unless the lenders syndicated.

The Credit Crisis

Beginning in 2008-2009 the venture capital community was contracting and leaving many companies with limited access to additional equity financing for a commercial launch. M&A activity was still climbing out of a trough and venture debt deals ranging from the low single digit millions to a maximum of $25-$30 million were typically based on credit formulas that favored only those companies with significant equity on hand and blue chip venture backing. The timing was right for a new group of lenders to step in to fill this funding gap. New lenders and structures began to emerge that may have had no equity component with deals sizes that started at $20 million and ranged to more than $100 million – rocket fuel for a company primed for a commercial launch. Granted this new group of lenders was not focused on the earliest stage companies -those in pre-clinical, clinical or development phases. These lenders were going to be lending against the commercial viability of the products these companies were (or soon would be) offering. These new lenders on the landscape were offering 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.

Today: The Shifting Landscape

As this newer group of mezzanine stage or structured lenders has become better known within the healthcare industry, it has forced the entrenched venture lenders and banks to alter their game plan significantly in order to remain competitive in deals with companies that have FDA clearance or approval and that are close to or at the commercial stage. Revenue interest financing, which stakes a claim on a portion of the future revenues of the borrower, is typically offered without an equity stake in the company (i.e. warrants). Structured term debt may come with an equity stake but terms can be as long as 5-7 years thus increasing the financial flexibility for the borrower over the total term. These realities have forced the once formulaic venture debt model, which typically was a 3-4 year term that included a small equity stake in the company, to reassess the boundaries of its structures. To win deals, venture debt is now being forced to stretch its terms out as long as 5 years and drastically reduce warrant coverage to compete. For some of the strongest companies, venture debt is now eliminating the equity stake entirely, a move that was virtually unheard of just a couple of years ago.

Understand Your Options

While there is a great deal of activity in the market, not all debt financing structures are available (or appropriate) for all companies. Before seeking debt financing, it is important to understand where along the spectrum of available debt products your company falls. 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 answering the following questions:

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 development 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 then it must decide which structure may be most appropriate, identify the appropriate lenders and solicit proposals. Consider the following general stage/timing guidelines:

Company Stage					
	Pre-Clinical/ Proof of Concept	Clinical/ Developmental	Late Clinical/ Pivotal/ CE Mark	Regulatory Clearance/ Early Commercial	Commercial
Bank Debt					
Venture Debt					
Structured Finance					
Mezzanine/ Revenue Interest					

The Benefit to Borrowers

This increased competition has resulted in huge benefits to borrowers. Terms and conditions are continuing to improve as lenders compete for deals. There is far greater opportunity for negotiation than in recent years as more lenders are continuing to enter this lucrative market and competition increases more and more. However, the greater number of lenders, different deal structures and constantly shifting market has made the debt financing landscape that much more difficult to navigate. CFOs, and other financial professionals at companies interested in exploring their financing options, have to conduct that much more research into the debt market and all of its players in an effort to identify the deal structures that might provide the greatest advantage to the organization; certainly not an easy or enviable task in light of these recent changes within the market. And to be sure, the debt financing landscape is still very much in flux.

Conclusion

At Capital Advisors Group debt consulting, we have always recommended that those seeking debt financing not limit their lender search to their banker or referrals from peers and colleagues. With all of the new lenders and creative deal structures now available to those seeking debt financing in the healthcare space today, that message could not be truer. For those interested in seeking and securing debt financing, we recommend identifying no less than six lenders that might be suitable for your deal and understanding the typical structures of the deals that they may be

able to offer. Interview them, get to know them and research their reputation in the market. This is going to be a multi-year relationship, after all, and you want to enter into it with a good partner. Then, solicit term sheets and negotiate the deals on a comparative basis. Each lender may have slightly different evaluation criteria for deals they will pursue which is why the more you can bring to the table the better.

Alternatively, there are companies like Capital Advisors Group that make it their job to know all the players, know the structures and understand the state of the market at all times. Whether you do it yourself or engage a consultant to provide guidance and support throughout the process, from initial strategy to signing a term sheet, there has never been a better time to take advantage of increased competition in the market; especially for those companies that are nearing the commercial phase.

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