Structured Debt Finance for Healthcare Companies: How Has it Changed the Lending Landscape?

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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Rich Bowman
Senior Vice President & Head of Debt Consulting
rbowman@capitaladvisors.com

Stefan Spazek
Senior Vice President
sspazek@capitaladvisors.com

Main: 617.630.8100

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 eleven 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.

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 23 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 deals.

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 of seed stage financing followed by venture capital and, perhaps, some mix of bank or venture debt is becoming less and less the norm. It appears more difficult now to get ideas 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. We are seeing large pharmaceutical companies partner with companies at earlier stages and licensing agreements or outright sales of programs in the clinic to finance other products in the pipeline. In addition, the debt financing landscape has been altered by new players in the market who have added to a growing source of funds for early stage healthcare companies and created increased competition among lenders.

The goal of this paper is to provide an update on the shifting landscape of the debt financing markets, ranging from bank debt to structured debt with a specific focus on how this structured financing has helped fuel an extremely competitive debt market.

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 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 three to four year term with a lien on all of the firm's assets except "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 and venture debt loan structures had certain limitations.

Today: The Shifting Landscape

Today, as we will discuss later, we are seeing a newer group of structured lenders that has become better known within the healthcare industry. These lenders have forced the entrenched venture lenders and banks to alter their game plan significantly in order to remain competitive in deals with companies that are commercial stage or those that have FDA clearance or approval and are nearing 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 three to four-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 five 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.

Below we will cover the different lending sources and how increased competition has forced these lenders to alter their structures from then (four to five years ago) to now.

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. See the example below:

	Then	**Now**
Deal Size	$1 - $5 million	$1 - $10+ million
Deal Structure	Debt would make up a small percentage of existing equity (up to 50%) and the company would need at least a year of cash. Shorter interest-only period and longer amortization.	The company may be permitted to take on more leverage and sometimes have less than 12 months of cash. Sometimes banks may stretch interest-only periods beyond typical terms of 6 months.
Cost of Capital	Rates in the high single digits	Rates in the low- to mid-single digits
Warrants	2-5+% of the deal size	Sometimes none in competitive bids
Length of Term	36 months	36 – 48 months

Covenants	May be performance to plan or other covenants.	Often no covenants for stronger companies.

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

Characteristics of Venture Debt:

	Then	**Now**
Deal Size	$5 - $20+ million	$5 - $30+ million
Deal Structure	Debt would make up a small percentage of existing equity (up to 50%) and the company would need at least a year of cash. Shorter interest-only period and longer amortization.	The company may be permitted to take on more leverage and sometimes have less than 12 months of cash. Interest-only periods may be significantly extended.
Cost of Capital	Rates in the low double digits.	Rates sometimes in the high single digits
Warrants	3-6+%	Sometime none in competitive bids
Length of Term	36 months	42 – 60 months

Covenants	May be performance to plan or other covenants.	No covenants for stronger companies.

Structured and/or Royalty Based Finance

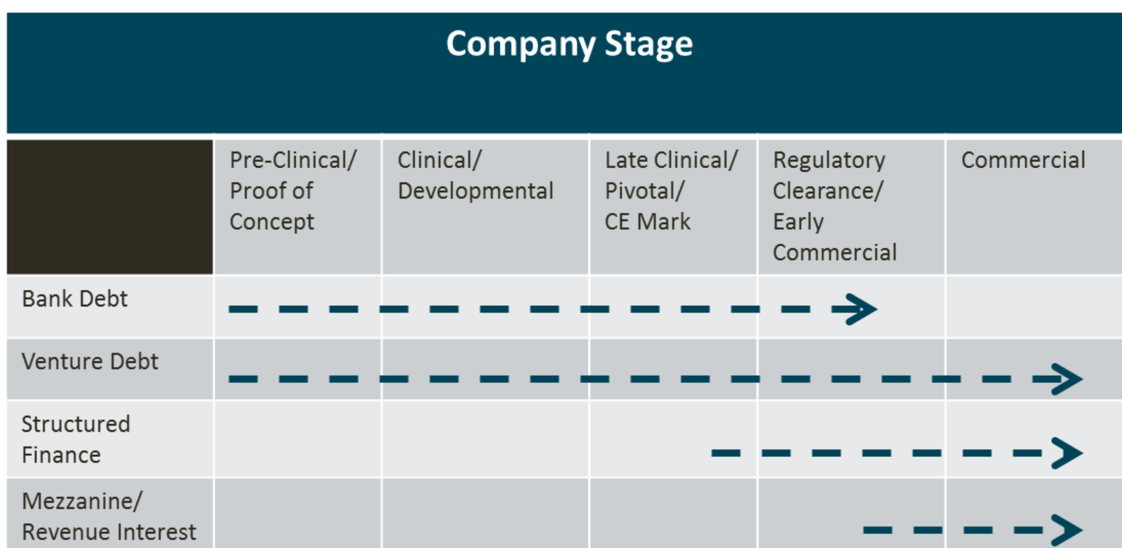
As companies move toward late stage Phase III trials, near term FDA approval, CE Mark/European commercial stage or post-FDA approval, new opportunities for debt financing begin to emerge. While venture debt is still a viable option in some instances, there is a group of lenders that will begin to consider 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.

	Then	**Now**
Deal Size	Not a popular or well-known option for earlier stage	$10 - $100+ million
Deal Structure		The company may be permitted to take on significant leverage with potential non-amortizing loan terms of 5-7 years.

Cost of Capital	healthcare companies.	Rates often in the mid to high double-digits
Warrants		Typically no warrants but there may be a term of revenue participation or royalty payments.
Length of Term		60 – 84+ months
Covenants		Often performance to plan or minimum revenue or EBITDA requirements.

Illustration: Typical Deal Structure by Stage of Development



Conclusion

We believe the structured finance lenders' increased focus on earlier stage healthcare companies has built up top-down competitive pressure in the market. This increased competition has resulted in huge benefits to borrowers. Companies that may have previously solely turned to venture debt financing now may have more options. Thus, the competition for good deals has heated up. In turn venture lenders seeking additional deal flow may be competing harder for deals that previously would have been well suited to the banks. This trickle-down effect means that terms and conditions are continuing to improve as lenders compete harder for deals. There is far greater opportunity for negotiation than in recent years

as more lenders are continuing to enter this lucrative market as the competition increases. 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.

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