Debt

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The Actors (and Directors) in the Debt Market

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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 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

CAG's debt finance consulting division (formerly Debt Advisors Group), was founded in 2003 with the goal of providing market clarity and client guidance in the rapidly changing debt financing landscape. The goal of this paper is to provide insight into the debt market from an insider's perspective. In doing so, we hope to demonstrate the need to possess a deep understanding of the debt market and its active lenders when seeking to leverage equity with debt financing.

A Brief History of Venture Debt

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 relative lack 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 a need to develop products, continue R&D or build out operations, primarily

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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 will implement a "revenue sharing" program, essentially taking a percentage cut of the company's future revenue. Revenue share or "royalties" often 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.

Securing a Superior Deal

Benefits of market specific knowledge and experience: Due to the ever-changing dynamics within the debt space, receiving and reviewing terms at a point in time does not necessarily ensure that they will remain constant year-to-year. There are many variables which can affect a debt facility that a company may negotiate at any given time. A deep understanding of the market and its players provides numerous benefits to navigating the debt process effectively.

- A Moving Target
  Lenders have great variability in size, scope, terms and appetite when compared with each other. These differences directly affect which deals each lender looks at, as well as how aggressive they may be in a given circumstance. For instance, if a lender has recently raised a new fund, they may be more

aggressive and eager to put the money to work. Therefore, in such circumstances, borrowers might benefit from uncommonly aggressive and competitive terms.

All lenders bring certain reputations to the relationship as well. Some are known as being very supportive when companies face difficult times, some are known to command higher than market equity stakes in companies, and some are known to provide more flexible structures than others. Such details may be difficult to ascertain unless a CFO embarks upon a deep study of the market prior to pursuing debt financing.

- Relationship Infrastructure and Negotiating Position
  Capital Advisors Group has worked with over 65 lenders in the debt space over the past 12 years, and has established relationships that facilitate the debt process and engender an open dialogue with lenders throughout the deal assessment stage. It is critical that CFOs foster such open discourse with lenders to better understand how lenders may be assessing the deal from their own credit perspective and how the terms look as they begin to form. Terms will improve or degrade based on the internal credit assessment each lender forms and borrowers should be prepared for (not surprised by) terms that are presented. Preparation sets the stage for negotiation.

Company- and industry-specific expertise: Having founded its debt consulting business more than a decade ago, and with advisors who've worked in the debt space for more than 30 years, Capital Advisors Group has consulted with companies from the healthcare (e.g. biotech, medical device, pharmaceutical, or general life sciences), tech, cleantech, media, bio-agriculture and oil and gas industries. This breadth of experience provides a sense of which lenders like to look at which sectors and can save the time it might normally take to wade through the field of lenders before finding enough to create a competitively sourced process.

- Deal Acceleration
  As with any financing, there can be fits and starts when pursuing growth capital. From lawyers creating lengthy non-disclosure agreements to a protracted negotiation of terms, a process that could take as little as 6-8 weeks might close 3-4 months after the initial talks have taken place. We've found that when companies are looking for debt, they are often looking for it in the near term and resistant to a prolonged financing process. As a result, a premium is placed on alleviating the items that can delay a debt financing such as deal structure, lender identification and understanding market terms for negotiation. Again, for these reasons, CFOs must do their advance work to understand the market in order to accelerate the close of the funds and secure the immediate use of the much needed capital.

- Understanding Your Place in the Market
  Having been in the debt financing business for over a decade, Capital Advisors Group has advised over 780 companies. Many of those businesses went on to accept the leverage they pursued and use it to expand their enterprises or finance an acquisition. But we've also advised countless companies who were looking for debt who could not plausibly obtain it, either due to an already oversized debt facility that needed to be restructured or a sinking market cap (which would jeopardize their cash reserves as well as their marketability to lenders) or even a lack of existing equity to support the debt they were seeking. It's important to understand the fiscal reality of a company's situation before addressing the debt market; otherwise you may waste time and money in the process.

A Brief Case Study

Each facility, like each company, is unique; it will conform to the particulars of a given situation. Some important parameters include when and how much the most recent equity raise was, what the cash burn and fiscal requirements are within the developing company, what kind of investor base has signed on to support the company, etc. All of these factors and more will determine the unique parameters of each deal. Yet, despite these variables, each deal has common themes which can inform analysis, foresight, pain points, and eventually lead to negotiable terms. These themes, as we have laid them out above, are present in the debt space and affect each debt facility within it.

Therefore, it can prove helpful to use a case study to illustrate a few aspects of the landscape which may be critical for any company to understand when looking to finance growth capital. Recently, Capital Advisors was engaged by a company to help place a facility for them after a recent round of equity financing. Having raised more than $150 million in their most recent equity round, we understood that their requirements would be outside the scope of typical venture debt. Timeliness in conjunction with market knowledge can be an effective tool to source competitive deals and, after reaching out to a few structured finance groups, we introduced a lender that had recently raised a new fund and was looking to place a large facility within a short timeframe. While this is not always the case, the structure the lender presented offered a very competitive rate, minimal dilution and allowed for a significant amount of financial flexibility. Here, timing was of the essence and the company achieved a superior deal.

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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