Debt

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A New Era of Debt Financing: Flexibility Continues to Grow as Hidden Costs Arise

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Executive Summary

This paper provides an update, in broad terms, on the state of the debt financing markets. Capital Advisors Group works with companies across industries that are early stage or, for other reasons, may not qualify for large commercial bank debt financing facilities. In this semi-annual review of the market, we will discuss how fierce competition has led to increased flexibility in structure and length of terms as well as the emergence of low-to-no warrant deals. However, while rates on deals remain little changed since the last decade, there is a new wrinkle in pricing that will likely lead to higher cost of capital over time.

Historical Context

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 for the foreseeable future have historically presented an untenable risk for many traditional banks. Therefore, early-stage companies with a need to develop products, continue R&D or build out operations, sought equity investment primarily through venture capital or strategic investors, which resulted in potentially significant dilution to fund their goals.

During the 1980s, typical options for early-stage companies were limited to leasing arrangements for equipment. One of those equipment leasing companies, Equitec, devised the concept of using an “equity kicker” on each deal. Equity kickers increased yield on a portfolio basis to balance the higher risk profile of the borrowers and 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 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 more dilutive properties of investor equity. However, these “venture lenders,” whose funds were dominant in the market between the late 1980s and mid-2000s, 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 underserved participants in the growth capital market.

The market began a dramatic shift following the credit crisis of 2008-2009. The crunch pinched venture debt lenders into deal sizes that would typically top out at $30 million for only the strongest venture backed companies. So 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 often had no equity component, with deal sizes ranging from $20 million to more than $100 million. These new entrants were lending against the commercial viability of the products the borrowers were, or soon would be, offering. And 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 occupied exclusively by the venture debt players.

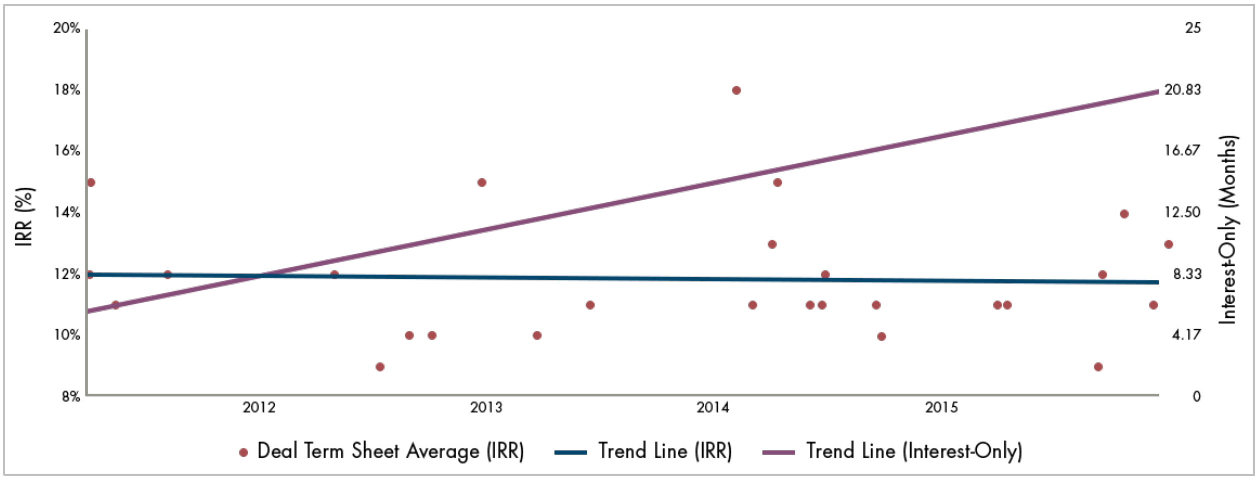
The current debt space for early-stage and more mature commercial companies has expanded beyond the traditional venture debt lenders and venture banks. Mezzanine and structured lenders, public funds, private specialty funds and arms of large Business Development Companies (BDCs) have dramatically increased the competitive landscape for early stage lending over the past five years. It is this landscape of varying structures, preferences and choices into which a company walks when seeking debt financing. Competition to win good deals is fierce and has forced many traditional lenders to stretch the boundaries of their appetite for risk and compete by expanding the parameters of their structures. Generally, this trend has made borrowing for earlier stage companies far more attractive than it once may have been.

The Good: Increased Competition

As with any market, the increase in competition has delivered clear benefits to companies looking to leverage their capital structures with debt. Prior to this shift, the emerging private debt market in the early 2000s provided few options for lender and/or borrower maneuverability. Term sheets would generally focus on maturity, interest only period, interest rate and warrants. These were the primary driving forces behind every lender's return on investment.

But as the diversity of debt funds expanded, so too did the flexibility and variety of repayment options. Now we may see terms such as "payable-in-kind" (PIK) interest, "variable maturity," "full bullet," "revenue share," etc. appear alongside the usual rate and equity kicker language. Each of these new terms can affect the ultimate value of a financing in many ways. Very often they can push out the repayment of the loan, giving the borrower longer availability and greater flexibility of the financing. Indeed, if a debt financing term sheet can be seen as a "machine," adding more "levers" to pull gives the lender more opportunity to tailor the term sheet to the specific needs of the client. This can be especially helpful in the healthcare sector, where certain milestones such as FDA approval and data readouts can prove great markers for inflection points. These points of value allow lenders to hedge their risk as well as provide necessary funding leading up to and through such an event.

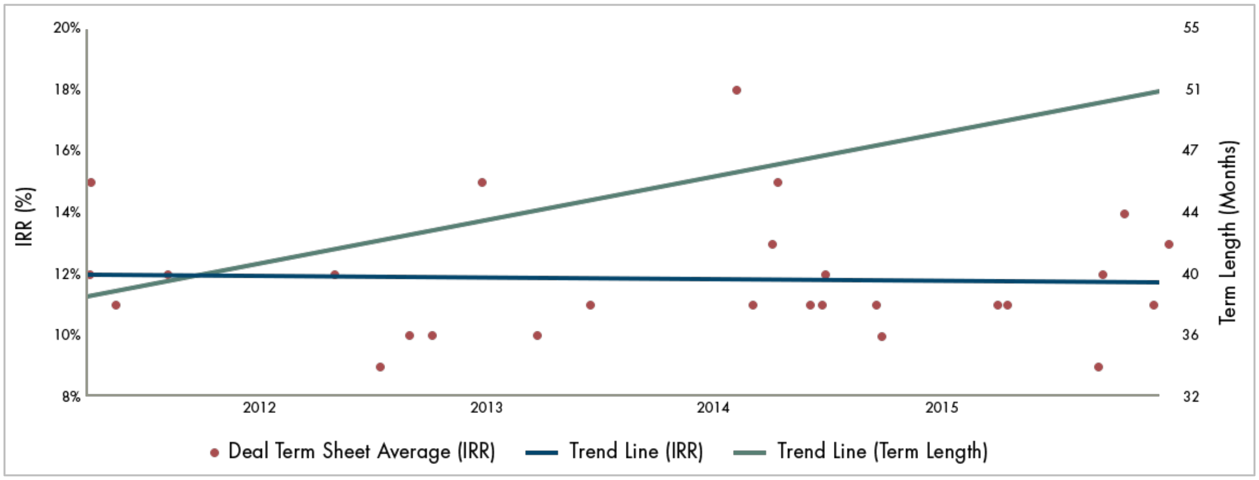
Figure 1



Source: Capital Advisors Group

Such new terms alone don't constitute the only changes, either. Figure 1 (above) from data based on deals we have completed since 2012 shows that interest-only periods have increased over the last half-decade.

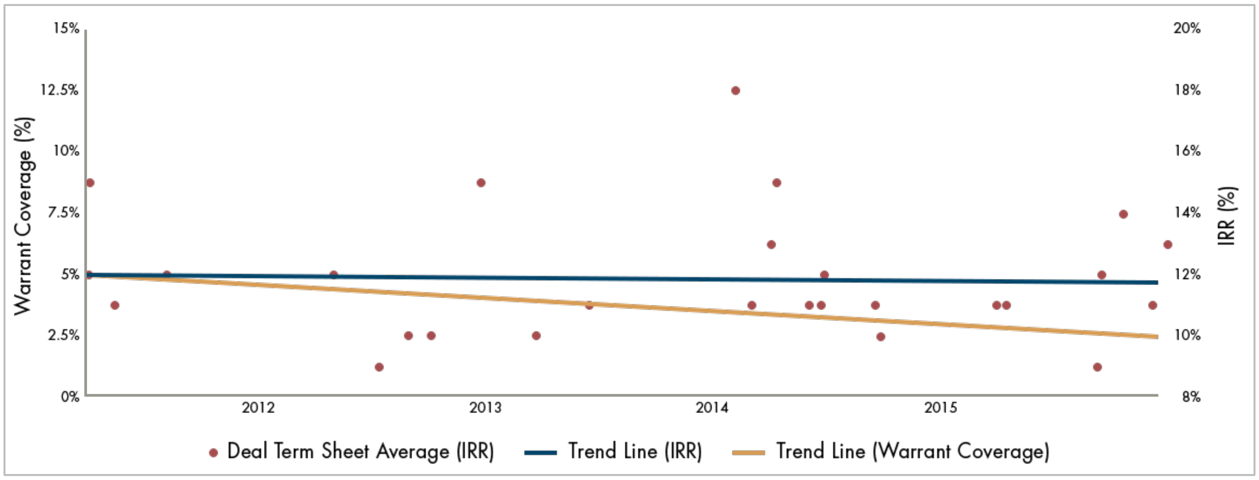
Figure 2



Source: Capital Advisors Group

Figure 2 (above) as well illustrates growth in the length of terms offered during the same period. Another benefit of competition can be seen in the downward trend in warrants (Figure 3), as these equity components are increasingly being replaced with predictable, one-time cash-outs in the form of success fees. In that way, the borrower has more clarity on the exact "cost" of the loan throughout the term than with a warrant, the value of which can at times be obfuscated by private company status and public market volatility.

Figure 3



Source: Capital Advisors Group

Indeed, a lengthening in I/O period coupled with drop in interest rates and warrants would lower the overall internal rates of return (IRRs) over that period, all else being equal. However, as can be seen in Figures 1, 2, and 3, IRRs have remained relatively static between 2011-2016. The cause of this can be related back to how companies pay for this increase in flexibility.

The Not So Good: Hidden Costs and Covenants

While increased competition has certainly resulted in a net benefit to the borrower, lenders still have internal return targets to meet as well as a growing need to somehow hedge against their longer and more flexible terms.

One method they're using to meet return targets is a general abandonment of fixed interest rate financings. Just a few years ago, float-to-fixed interest rates were fairly standard across the industry. However, fixed rate loans are now more difficult to come by, and the reasons are fundamentally evident. In every term sheet, there is a section detailing the rate at which the loan will accrue interest, and that rate is now typically tied to short-term benchmark rates such as LIBOR or the WSJ Prime rate which is published daily in the Wall Street Journal. These benchmarks are directly affected by the Fed funds rate (the rate which the Fed advises banks charge each other in the Federal Reserve System). The Fed effectively creates a floor, slightly above which exist the WSJ Prime rate and LIBOR (i.e., Fed funds rate + marginal spread = LIBOR, etc). Therefore, with borrowing rates now commonly indexed to either LIBOR or WSJ Prime, they are inherently dictated by the Fed funds rate. At the moment, as of mid-2017, that rate appears poised to continue rising over the coming years. Therefore, all-in cost calculations on loans presented to borrowers today are based on static interest rates. A gradual increase in the Fed funds rate will now float those formerly fixed or stable IRRs. Figure 4 illustrates the interest payment implications using an example of a $10M loan with a 48 month maturity and an 18 month interest-only period.

Figure 4

$10M Loan; 48 month maturity; 18 month I/O	
8% IR Full Term	$2,266,497
Change to 9% IR at 9 months	$2,479,448
Interest Payment Increase = ~9% over term	+$212,951

A final caveat is the growing burden of covenants. Covenants can come in many forms and have not changed in any significant fashion over decades of financings in the debt market. However, in order to hedge against the longer, more flexible structures, covenants are growing in popularity among venture and structured lenders. The flexibility and generous repayment terms discussed above are fantastic incentives to sign on with a lender. However, those benefits can disappear if hard and sometimes abstruse covenant language is attached to the deal. A significant hindrance to flexibility can be minimum liquidity covenants, which require the company to hold a certain amount of their average cash burn in their operating accounts, therefore limiting the total use of funds. Such covenants can be especially hampering for cash-burn-heavy companies in the healthcare sector looking to extend their runways. Another covenant which is often levied on companies is a performance-to-plan stipulation, usually between 70% and 90% of the company's stated revenue projections. If the company fails to reach that threshold, the senior lender can accelerate repayment or place the debt into default. These and other covenants can be easily tripped and negate flexible term, such as a lengthened I/O period or maturity.

Conclusion

Can it be said that burgeoning competition has ultimately benefitted borrowers and the private debt industry as a whole? Considering the new options and broader availability, we believe so. However, it is not completely without its drawbacks. Potentially higher repayment terms and cumbersome covenants are just some of the potential issues which rode in with the diversity of structure on the backs of the large (and small) debt players crowding into the market. Now, more than ever, it is crucial for borrowers to know their options and the potential implications of their decisions as they look for the best deals.

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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