Debt

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Life Sciences Venture Debt – Three Tips to Navigate a New Age of Caution

After enjoying years of favorable borrowing conditions, emerging biotechnology growth companies are facing headwinds generated by the current disruption of global financial markets. Inflation is high, interest rates are on the rise and equity markets are sinking. Lenders have shifted to conservatism, setting the bar higher for borrowers who now must adjust to new realities.

Most people know that the Standard &Poor's 500 index has declined more than 20 percent into bear market territory in 2022. But for those who thought the S&P was in rough shape, they need look no further than the NASDAQ Biotechnology Index, or NBI, to see that things could be much worse: over the 12 months ending June 30, 2022, the NBI plummeted 26 percent.

This trend has greatly curtailed equity-financing opportunities for development-stage biotechs seeking to raise capital from public or private sources. According to the Pitchbook/NVCA Venture Monitor, private venture capital financing in biotech was just about even year-over-year through Q1 2022, but the number of deals dropped by more than 18%. More capital is flowing to fewer companies, with a higher percentage shifting to later stage companies.

Headwinds for Venture-Debt Financing

These equity financing trends are now also filtering down to affect venture debt financing, the popular tertiary source of funding for development stage biotechs. Venture debt markets tend to be very closely aligned with equity markets. Over the past five years, when equity financing was strong, venture debt in biotech boomed, culminating in record years in 2020 and 2021. The Pitchbook/NVCA Venture Monitor shows that healthcare venture lending set annual records in deal volume from 2017 to 2021. But deal sizes began to drop in 2021 and got off to a paltry start in 2022.

At Capital Advisors Group, we have closely followed the debt financing market for nearly 20 years. In 2022, we see unique, emerging challenges to healthcare lenders as they seek to remain active in the market while protecting themselves against further downside scenarios. Challenges include:

- Lower leverage: In prior years, companies with strong credit profiles (i.e., long cash life, a deep pipeline of assets, lofty market caps, and/or backing from top-tier VCs) could command higher leverage ratios from lenders. While the target leverage is dependent on how a company plans to use the proceeds of a loan, in some cases companies may have been able to borrow up to 50% of their cash on hand, within certain loan limits. That ratio is almost certainly lower now, as lenders protect against a continuation of soft equity markets.

- Greater scrutiny of assets: It has long been the case that lenders prefer that biotech companies have a deep pipeline of assets in case a lead asset fails. A company with a strong cash position can likely reset and focus on developing other assets. This preference is often becoming a de-facto requirement in the current environment. Single-asset biotechs and development-stage medical device companies have historically faced an uphill battle when seeking debt financing, and we expect this trend to continue. Platform-technology biotechs, which can sometimes be viewed as single-asset technologies as well, can also expect greater scrutiny.

- Covenants and tranches: Lenders will take additional protective measures such as increasing covenants and adding multiple tranches to reach the total desired financing amount. Typical covenants may require that companies maintain a fixed minimum cash balance, or a multiple of the monthly cash burn, in a controlled account at all times. Terms may also be presented in multiple tranches that require evidence of positive clinical data or additional equity raises before future tranches are funded.

Three Ways Borrowers Can Cope

In this market, more development stage healthcare companies are seeking debt financing to extend runway to reach critical milestones and, in some cases, to delay the requirement for dilutive equity rounds. And while the process may be more difficult than it has been in the recent past, there are steps you can take to improve the prospects of securing the debt financing you need. Here are three:

1. Be conservative: It's now more critical than ever to right-size your loan and have a clear story about your use of proceeds. Lenders have no interest in funding a path to nowhere. Therefore, a company must be prepared to lay out a clear timeline of clinical milestones, reasonably conservative cash projections, and plans for raising additional capital. As stated above, companies with strong cash positions, top-tier investors, and a deep pipeline of assets in clinical trials will generally fare better than those who don't satisfy those criteria. All but the companies with the strongest credit profiles should expect lower loan limits, less negotiating power, and fewer borrowing options.

2. Expect greater lender protections: By nature, lenders (both funds and banks) are a conservative group because they must always consider how to protect their investments against downside risk. In this environment, there is even greater scrutiny of all aspects of the loan process. A lender can protect its investment by requiring that a company keep a minimum amount of cash in a bank or investment account at all times. The account may be subject to an account control agreement between the bank, borrower and lender that grants the lender security interest in the account. The lender may be allowed to freeze assets or otherwise control the funds in the account, should the need arise. In addition, the loan may be split into multiple tranches, with critical development or clinical milestones to unlock access to additional funds. Again, these structural components assure the lender that the company is making positive clinical, financial, and/or commercial strides.

3. Run a comprehensive process: Venture debt financing is, by no means, an efficient market. Lenders approach the market with an investment strategy set by internal parameters. Perhaps a lender's existing portfolio is suffering, and they choose to step back from the market for a time. Others may have raised a fresh fund and are seeking to be more active and complete larger financings. Still others, based on experience, may avoid certain technologies or platforms. It is more important than ever to research the field of lenders, solicit competitive proposals, and to find the one that's the best fit for you.

Capital Advisors Group closely monitors the health of the venture debt industry via proprietary research into public filings of loan providers, including banks and business development companies (BDCs). The first quarter numbers show a healthy industry with defaults averaging around 0.45% and impaired loans or loans classified as "troubled" standing at 1.4%. While it seems a risky business to be providing loans to companies with no revenue, the lenders in the space have impeccable credit selection skills. But we expect credit to tighten in reaction to the diminished equity environment, and we'll continue to closely monitor the health of the market.

Set Realistic Expectations

Biotech borrowers have enjoyed a multi-year run of an incredibly strong borrowing environment. Now, the shift to conservatism is underway, and expectations must shift with the times. We encourage prospective borrowers to conduct a thorough investigation of the borrowing options available to them. We also recommend paying close attention to the rising cost of borrowing, as most rate structures are tied to benchmarks that move with the Fed Funds rate. Lastly, approach the market with realistic expectations. We regularly have conversations with CEOs and CFOs who expect debt financing to bail them out of a tight spot. Debt should never be used as a bail-out or a bridge to nowhere, and that reality is truer today than ever.

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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