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Q&A with Haim Zaltzman & Jim Morrone

The Healthcare & Technology Industries' Burgeoning Emerging Growth Debt Market

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The emerging growth debt market has grown significantly in recent years, with the majority of deals in the healthcare and technology spaces. Latham & Watkins partners Jim Morrone and Haim Zaltzman, who focus their practices on emerging growth companies, gave an overview of the market's current state and offered their predictions for 2015 in their recent webcast, Emerging Growth Debt, Part I.

In this Q&A interview Morrone and Zaltzman share highlights from the discussion. For more information, listen to the recorded version of Emerging Growth Debt, Part I, available through February 26, 2016.

What is emerging growth debt?

Zaltzman: Emerging growth debt is debt that is usually accompanied by a warrant or another equity kicker that is provided to a pre-profit company in the emerging growth space, which, in our experience, is mainly in the healthcare or the technology space.

How has the emerging growth debt market changed in recent years?

Zaltzman: We have seen the market grow significantly over the last few years, with deal sizes that vary from around US$1 million dollars for earlier stage companies, particularly on the technology side, to up to US$180 million dollars. Our estimate, based on both private and public data, is that the market is now between US$13 and US$15 billion per year. The market covers both public and private companies with revenues up to US$200 million. All industries are covered in the market, with the market largely divided into two basic product groups – healthcare and technology. Some lenders do work with both, some do only one or the other.

We've seen debt grow significantly as part of the capital structure of companies in these spaces. You used to see debt be a very small percentage of a company's balance sheet — 10 to 20 percent was usually the max you would see. Now we see 30 to 50 percent with many companies, so it has definitely become a large part of the strategy that goes along with the equity financing these companies raise as they move up their lifecycles.

The sophistication of the market has also grown significantly. We now see syndicated deals, which are deals where you have multiple lenders, including first and second lien deals in this space, which we never saw before. We see a lot of activity where companies are refinancing year after year in strategic ways so that they can get better debt positioning or extend their runway.

What are some of the pros of having debt versus equity in this space?

Morrone: As a borrower, if you can access debt financing it can be advantageous. Given the robust market and the availability, this is one of the things that every company should be at least considering in their capital structure. If debt financing is available, it is relatively cheap.

Debt financing can also be non-dilutive or minimally dilutive. There are oftentimes warrants associated with these deals and pricing on those has been favorable to borrowers of late, therefore debt financing is much less dilutive for the cap table. Debt financing can also be used to extend the runway from an equity financing. What we often see is debt financing put in place either at or near the time of an equity financing. From the lenders perspective, it is a good sign that people are putting equity in and making bets on the company.

Zaltzman: Diligence does seem to be less intensive than the diligence for equity rounds. Debt providers often piggyback or rely on some of the diligence that the equity players have done in recent rounds. Debt providers are not concerned about some of the equity elements of the diligence, so diligence can be more limited and the debt facilities are typically put in place a bit faster than the equity facilities for companies in this space. It is always hard, depending on the product, to give a good indication of how fast a debt provider will be able to move, but once a term sheet is signed we say, depending on the product, it can be anywhere from two weeks if it is very simple, smaller debt facility to three months if it is more of a structured debt, very heavy IP-type facility. But, relative to an equity round where people are often lining it up for three, six or even nine months, it is significantly faster.

What are some of the potential downsides to debt financing?

Zaltzman: Unlike equity, there are restrictive covenants on operations. This is probably the biggest downside. Once you put in a debt facility, you have a lender who is not an equity player and is very concerned about its collateral and being paid off. The lenders are not going to get the returns of equity. The lenders are much closer to what you expect from debt, and therefore their interest is protecting their principal. One of the ways they do that is with restrictive covenants and operations. The typical ones that always come up are limitations on indebtedness, limitations on investments, limitations on liens — the typical things you would see in debt products that can be fairly restrictive for an emerging growth company. Some of the restrictive debt covenants are very focused on cash and use of cash. Cash for a pre-profit, pre-cash flow company is very important. The lenders are very sensitive to a company's cash position and where it is going to be down the runway, so they care about either hitting milestones, or generating revenue to make sure that they don't run out of cash.

And, of course, it is debt and you do have to pay it back. Interest is monthly and although the principal is often delayed, it does need to be paid back. It can put pressure on growth and additional capital raising if you need to make these payments back. All of these facilities are secured one way or another. We almost never see unsecured facilities in this space. Obviously when you are providing security, it does put those assets at risk.

What are the key takeaways about the emerging growth debt market for management/boards?

Zaltzman: If you are considering debt, just think broadly about the market. There are more than 40 players. We see private equity firms that are entering the market via certain debt funds. There is a lot of interest in this space and if a company is keeping its mind open and is thinking broadly about the market, they tend to see better results.

Morrone: When I started in 1999-2000 this was not nearly as common. Today, it is at least considered with almost all, if not all, of our clients and put in place with the vast majority of them. Think about it early and often. It is always a good idea to start building contacts with some of these institutions and lenders. Plan ahead, think about it longer term, in the same way that you already think about equity raises. People are always thinking about when the runway is out, when they are going to be needing to raise equity, etc. This should just be part of that strategic discussion along with what milestones you are achieving and when and how those play in with the timeline. You are never too early or too small to consider it – there are options out there and it could be very helpful.

What are some trends that may emerge in this area in 2015?

Zaltzman: I absolutely think deal sizes will continue to increase. There are a lot of new debt funds in the market, so there is more money on the debt side. There has also been a lot more focus on later stage companies where larger deal sizes make more sense, both on the healthcare side, where it is pre-IPO or close to exit, and on the technology side, where there has been more of a desire for some companies to stay private longer. The longer they stay private, the more likely it is they will need or want some sort of debt product, and the sizes of that debt product are likely to be larger. So I do believe we are going to have pretty large deal sizes.

Find out More About Emerging Growth Debt

For more information on emerging growth debt, listen to the recorded version of Emerging Growth Debt, Part I, available through February 26, 2016.

CONTACTS

Haim Zaltman
San Francisco, Silicon Valley
T +1.415.395.8870
haim.zaltman@lw.com

Jim Morrone
Silicon Valley
T +1.650.463.3058
jim.morrone@lw.com

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