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Market Dislocations And Their Impact On Life Sciences Debt Financing

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While the financing markets have changed dramatically in the past 18 months, few industries have been as impacted as the life sciences industry. This is especially true for non-investment grade and earlier-stage life sciences companies.

Unlike investment-grade companies, which have generally not experienced significant difficulties in capital raising despite the impact of increased interest rates on their debt service costs, many other parts of the life sciences sector have encountered a host of recent financing challenges. These include access to financing markets, increasing interest rates, and tighter terms. As a result, companies seeking debt financing or encountering challenges in their existing debt financing now face a very different financing environment.

WHY THE MARKET IS DIFFERENT NOW

The recent dislocation in the financing markets has largely been driven by several macro-economic factors not specific to the life sciences sector, but affecting debt and equity markets more generally. These include the regional banking crisis, the hostilities in Ukraine, and the over-400-basis-point increase in SOFR (secured overnight financing rate) over this period. Prior to these events, cost-efficient debt and equity financing was readily available to life sciences companies. Capital access is essential to life sciences companies due to their need for significant amounts of ongoing capital to fund research and development and commercialization costs. It is particularly difficult for life sciences companies to stretch liquidity, as many of their costs are fixed, and life sciences companies cannot pause clinical studies or research and development without significant business consequences and jeopardizing patient safety and clinical data.

Further constraining capital access, many life science-specific lenders have increasingly been reserving significant amounts of capital to provide funding to existing portfolio investments. In many cases, this means holding back funds in anticipation of the need for additional liquidity injections or even "debtor-in-possession" financing for in-court restructurings. To put the liquidity pressures in perspective, the number of life sciences companies using an in-court process to restructure year-to-date has already surpassed all of 2022 and is projected to increase 300% year-over-year. All these factors have resulted in a constrained financing environment for non-investment grade and earlier-stage life sciences companies.

ENSURE ACCESS TO LIQUIDITY

For companies looking for new debt financing, ensuring access to liquidity is key. A few years ago, most companies

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had their pick of financing options. While this may be true for certain well-positioned companies today, for most of the non-investment grade or unrated life sciences sector that is no longer the case. Companies finding themselves in that position should first be focused on financing size, rate, fees, and partners. Many companies across sectors (not just life sciences) pushed off refinancing efforts at the end of 2021 as rates started to increase hoping for a better environment in 2022. They soon found themselves on the losing end of that bet both on rate and terms. This does not mean borrowers should not push hard for flexibility in their covenants, but they must have a clear view on which covenants are "must-haves," "need to haves," and "let's just stick it in there." This is very different from 2021 when almost all borrowers had negotiating leverage across the board on all these points.

In addition to constrained capital access generally, we also have seen recent trends toward tighter terms, including increased focus on limiting asset leakage and additional debt incurrence, regular reporting of KPIs and liquidity, and enhanced financial maintenance covenants, particularly in private debt transactions. For example, the restrictions and limits on out-licensing have increased as lenders want to make sure borrowers do not enter into below-market out-licensing deals as liquidity tightens, which could materially impact downside lender recovery. The back and forth over what is needed with the borrower's business plan and protecting the lender's rights often results in bespoke solutions.

This goes to what is likely the most important consideration for a life sciences borrower trying to navigate the new financing landscape — picking your partners carefully. Think about the relationship with the lenders and how you view them in supporting your business. Good counterparties will work with the company to provide amendments and waivers to effectuate the business plan. In the private credit space, once the lender is "pot committed," they generally work with the borrower to quickly provide amendments and other needed flexibility — as appropriate. In broadly syndicated deals, this may matter less to some degree, but even there it is important to understand who is in your syndicate and when you may need to go back for consent, which can be much more difficult than when dealing with nonsyndicated debt.

TREAT LENDERS AS PARTNERS

While having constructive and broad-minded lenders is crucial, it is also a two-way street, especially as a borrower begins operating in a stressed environment. For companies dealing with issues in their existing debt, it is important to get ahead of issues and treat the lenders as partners and prioritize communication instead of (over)managing the relationship. For instance, many life sciences companies are dealing with real liquidity concerns for the first time. Lenders will appreciate seeing that a borrower has been managing cash effectively as things have gotten tighter when the borrower comes to them for waivers or consents. Also, bringing in advisors with expertise in these situations, particularly on the operational side, can be key in managing communications and liquidity (although the cost of such advisors must be properly managed). All these measures will show lenders you are focused on trying to be partners in solving liquidity concerns.

For other issues, such as financial maintenance covenant or maturity issues, borrowers must give lenders a reason to extend the maturity of the debt or provide new money. This doesn't just go to the business case, but to also being a "good citizen." Many lenders may be dealing with numerous fires in their portfolios right now, so making it easy for the lenders is key. When you engage, be prepared with all the relevant information and the ask (and the proposed path forward).

While all or parts of the above may be relevant for only some but not all life sciences companies, one thing is clear across the spectrum — the financing markets are not the same as they were 24 months ago. Whether this is a short window of dislocation or a longer one remains to be seen. But now more than ever it is important to understand your situation and be proactive on your covenants, liquidity needs, and debt maturities.

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