HAYNES BOONE

PRIVATE CREDIT CONNECTIONS

From The Insider's View

Doug Prescott, Director at TD Cowen, shares his thoughts on the most impactful changes to the private credit markets in 2023 and new frontiers for the next few years.

Doug Prescott

Company & Title: *TD Cowen, Director - Private Capital Solutions*
Education: *Tulane University*
Current City: *New York, NY*
Fun Fact: *I was in a Best Buy commercial that aired during the 2004 NFL playoffs*
Favorite sports team: *Los Angeles Dodgers*

The past year has been filled with a number of macroeconomic and geopolitical events that have impacted the economy as a whole and, in turn, private credit deal flow. In your view, which of these events was the most impactful on 2023 and which will have the longest-lasting implications for the private credit market?

The collapse of Silicon Valley Bank stands out, but it would be wrong to look at it in isolation. It was already a very precarious, risk-off environment. The market was pricing in >60% recession odds, there was high uncertainty around both the peak and duration of the rate cycle, leveraged loan issuance down ~50%, no demand for IPOs or follow-ons...and so on. Adding to all of that, in response to the regional bank turmoil at the end of Q1, fed funds futures sharply reversed to show 50 basis points of cuts through YE23, which fueled the fire of pricing extremes into idiosyncratic catalysts and drove continued volatility across asset classes. The resulting uncertainty highlighted the importance of accessibility and execution, two phrases repeatedly used to describe the value proposition of private debt. Traditional lenders stepped back, and direct lenders were there to provide liquidity on a bilateral or club basis. This trend of displacing syndicated markets has been happening in a geologic sense for 10-plus years, as private debt has grown into a trillion-dollar asset class (comparable with BSL + HY) and finances ever-higher-profile LBOs, but this volatility refreshed and validated the thesis.

In our corner of the life sciences market, many of the firm's clients and their VC backers were borrowers of, or held deposits at, SVB – in many cases, both. Unlike most sectors, where profitability is a prerequisite for borrowing and the decision tree is between syndicated debt, bank loans or private debt, the companies we advise are typically evaluating between raising capital through private debt, equity, or royalty financings (which can be structured as replacements for equity or credit). The combination of dislocation in the equity market, plus uncertainty around their deposit bank, drove urgency to shore up balance sheets and manage expenses. This prompted a wave of interest in exploring private financing alternatives and an increased supply of deal flow. Even for potential borrowers who were not yet mature enough to tap these markets, we conducted many information sessions and teach-ins to prepare management teams that will consider non-dilutive financings in the future, which is usually a strong precursor for near-to-medium term transaction volume.

As we look toward 2024, how do you view the outlook for private credit compared to other asset classes?

Broadly, private credit will continue to be utilized as a first-line financing tool. More institutions will move to establish larger and more specialized efforts to cater to this market. The investor demand will be there, and we believe larger companies will continue to look to this market for capital. There has been a tremendous amount of money raised for private credit strategies over the last five years, and now comes the time for deployment. So as bank lending and syndicated debt markets continue their comeback, I think you'll see more pricing pressure as direct lenders compete with themselves and alternatives for quality opportunities.

In biotech, companies have raised over $11 billion in committed capital through private debt and royalty financings over the last 12 months, and those facilities were provided by the highest number of unique investors since we started tracking them. This evidences the demand growth and increased competition we're seeing for these transactions on the buy side, which we do not believe will slow down.

What are the key considerations or terms that you will be looking for in private credit deals as we move into 2024?

Many of our clients are growth-stage issuers amid, or heading into, an initial product launch – so flexibility is a core focus given the impending

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change in the business profile. We tend to advise our clients that cost of capital is an important point of analysis, but not the most important if the documentation is prohibitively tight.

In the last few years, the small-to-mid cap life sciences space has seen a trend of transactions that utilize multiple non-dilutive securities across the same capital structure, simultaneously and with plans for future financings of this type. This drives a major focus on collateral packages and future flexibility around what issuers can do with maturing collateral that wasn't core to the initial underwrite, but becomes financeable within the life of the loan or royalty financing (e.g., pipeline programs that advance post-funding). This is especially important when demand for equity is not there, as our clients are typically R&D-heavy organizations that will need to finance again in the medium term, so they are highly focused on optimizing their future ability to raise capital through another debt or royalty financing, licensing transaction or strategic partnership.

Should we be on the lookout for any new frontiers for private credit in the next year or two? What can investors do to differentiate themselves from increasing competition?

Private credit will continue to expand, and life sciences will be a large part of that in the same way that ARR lending has grown within the software space. Over the last six or so years, the negative stigma around using debt to finance a commercial stage, but cash burning biotech company has receded.

Investors and borrowers have found comfort with a responsible amount of leverage in these situations based on the highly recurring revenue, minimal COGS, and long-duration IP protection that therapeutics can offer. If you build a standalone P&L for the commercial part of the organization (excl. R&D unrelated to lifecycle management), the result is typically a highly free cash-flow positive enterprise that can be competitively underwritten. These advantages have also contributed to the significant rise in popularity of synthetic royalties, or revenue interest financings, where the marketer of a drug creates a royalty on a product that did not previously exist. In their purest form, synthetic royalties create a transaction where the investor's return is tied solely to the success of the product. The issuer benefits from the flexibility of not having mandatory repayments and the investor benefits from a consistent revenue stream that is largely uncorrelated to broader macroeconomic trends. We would not be surprised if synthetic royalties started to expand to other sectors

with products that offer long-term, predictable revenue bases.

Legacy healthcare-focused equity strategies will further expand into structured investments, and more generalist direct lenders will establish dedicated teams with the domain expertise to underwrite the clinical, regulatory and commercial diligence needed for these investments. The product of this will be investors continuing to gravitate towards the interest we see from issuers in partnering with a long-term financing provider that can invest across the capital structure throughout its lifecycle, even if it comes at a facility-level premium.

We have seen investors effectively differentiate based on an understanding that these agreements are truly bilateral and domain expertise is a key success factor for origination. Borrowers view this as a real partnership, and they want to work with investors that demonstrate a deep understanding of their business and the industry in which they operate.

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Doug Prescott & TD Cowen
Doug is a member of TD Cowen's capital markets team and works in the Private Capital Solutions group. TD Cowen formally established the PCS group in 2018 to capitalize on the growth in the private capital markets and advise public and private companies across sectors and products, from senior debt to growth equity. Within the group, Doug covers life sciences – biotech, pharma, tools, diagnostics and medtech – and advises issuers on raising capital via senior debt, synthetic royalty, royalty monetization and development financing transactions. The TD Cowen PCS team has represented life sciences clients on over $7 billion of committed proceeds since 2020. Prior to TD Cowen, Doug worked at Capital One in the commercial banking group.

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