

What every CFO should know about equipment financing

J Alden Philbrick

For biotech startups, securing loans for equipment early on can ease financial worries down the road.

As the life science industry continues to evolve and mature, CFOs are increasingly challenged to secure capital to foster their companies' growth. Although equity is the main source of sustenance for life science companies, equipment financing is a layer of capital that is becoming increasingly important. Simply put, equipment financing is the practice of using a firm's equipment as collateral to receive cash—but, in fact, it is much more than that. In the life science industry, in particular, equipment financing is a way of leveraging equity to extend a company's cash runway, which buys time and enhances value.

Structuring the deal

Although there are many different types of loans available to biotech companies (see Table 1), securing an equipment loan is typically the first priority for a startup. In general, equipment can be financed through a variety of leasing agreements, such as operating, tax-oriented and finance leases, or by securing a loan. Leases are traditionally used, and beneficial, when the equipment in question has a high obsolescence factor—that is, when it needs to be replaced within two to three years. In the life science industry, for the most part, equipment has a very long, useful life, so a loan structure rather than a lease usually makes the best dollars and sense.

An equipment loan, unlike a lease, can be used to finance diverse categories of equipment as well as soft costs. In the life science

sector, these loans are used primarily to support the purchase of laboratory, manufacturing and computer equipment, as well as furniture. Soft costs that are often included in the funding mix are tenant improvements, shipping and software. **Box 1** includes a list of selected firms that provide equipment loans to life science companies.

One of the most important things to keep in mind when negotiating the terms of a loan agreement is that the equipment should be the sole source of collateral. Avoid contracts that have restrictions on other parts of the business or balance sheet. A basic equipment loan should not include financial covenants or blanket liens on other company assets, such as intellectual property or receivables.

Other negotiable terms in an equipment loan are total loan amount, interest rate level,

duration of the take-down period (the time frame in which the borrower can draw funds), minimum funding amounts, length of the payback period, and timing and level of any warrant participation. Additionally, a request by the lender for an option to invest in future private equity rounds is a negotiable item. In the current market, typical terms would include single-digit interest rates, a 36–48-month payback period and minor warrant provisions.

The ease of securing an equipment loan and the flexibility of the terms are based on a variety of factors. The amount of a potential borrower's cash on hand, in conjunction with its cash burn rate, historic and projected, are of paramount importance to a lender, as it is indicative of the borrower's ability to repay the loan. Therefore, it is best to secure a loan

Table 1 Types of financing that can extend a company's equity

Type of financing	When applicable	Use
Equipment loan	Startup company (and beyond) that has secured its first equity investment and needs equipment	To finance purchased equipment and related soft costs
Venture loan	Usually later-stage company with strong backing from a venture capital syndicate	To be used for any purpose
Working capital/ accounts receivables loans	Revenue-generating companies	To finance receivables and contract payments
Bridge loans	Companies approaching cash-out and negotiating a new equity round	Forms a 'bridge' between venture rounds, when a company needs some money to operate
Real estate loans	For mature, typically public companies with cash flow	To build and own laboratory and office space
Convertible debt	Public companies	Cash for operating purposes; loan is converted to shares at a later date
Royalty investments	For companies that have products on or near the market	To obtain cash up front in return for sharing future product revenues

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Box 1 Selected firms that provide equipment loans to life science startups

- Oxford Finance Corporation (Alexandria, VA, USA) <http://www.oxfordfinance.com/>
- GE Capital (Stamford, CT, USA) <http://www.gecapital.com/>
- Comerica (Detroit, MI, USA) <http://www.comerica.com/>
- Silicon Valley Bank (Santa Clara, CA, USA) <http://www.svb.com/>

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when funds are plentiful. Lenders also take into account committed cash from investors, grants and sales; previous equity rounds and the quality of the investors; and the company's stage of development, industry sector and management team. All of these components need to show strong momentum, which is essential for a biotech firm to obtain follow-on venture capital, and gives the lender comfort that the company will be well-positioned to pay back the loan.

As shown in Figure 1, a life science company that augments its equity with debt can extend its cash runway by as much as six months, a significant period of time for a company working to reach scientific milestones and hustling to secure new equity rounds. Equally important is that debt can increase the total cash on hand by 30–50% at the most critical juncture—when a company is negotiating follow-on equity several months before it runs out of cash.

Lease or buy?

Leasing has two primary benefits: (i) it protects against equipment obsolescence (as long as the term is short) and (ii) it preserves cash on a monthly basis. Leasing rather than buying is practical for companies that will

realize a competitive advantage by always having state-of-the-art equipment for purposes such as computing and screening. It should be noted, however, that if a company chooses to extend a lease beyond the initial term or to purchase the equipment at the end of the term, it is likely that the total cost of leasing will surpass the expense that would have been incurred from an outright purchase.

Because laboratory equipment used by life science companies is diverse and useful for many years, leasing is generally not a practical or cost-effective solution for such companies. Negotiating leases on many individual pieces of equipment is time-consuming and daunting and, furthermore, in the biotech industry there is little justification for having the flexibility to return leased equipment. Therefore, it is almost always in the best interest of a life science company to enter into a loan agreement instead of a lease.

Pitfalls of borrowing

Putting a debt facility in place has many advantages, but, as with any business transaction, there are a few common pitfalls that all companies should be aware of when planning to borrow:

- **Agreeing to overreaching collateral terms.** Be wary of lenders who require financial covenants or blanket liens on company assets, such as intellectual property and accounts receivable. Using only the financed equipment as collateral should be sufficient.
- **Waiting too long to borrow against equipment.** Because the equipment should be the sole collateral, you will get the maximum financial leverage from it when it is new and has a higher value. Entering into a loan agreement several months or years after the purchase date is, therefore, not optimal.
- **Waiting until you are low on cash to request financing.** It is much easier to put a loan facility in place while you have money in the bank. You will have more negotiating power on terms and conditions if you seek debt shortly after an equity raise, and borrowing at that time will still provide adequate runway extension.
- **Financing terms longer than the useful life of the equipment.** Quite simply, if it is likely you will need to swap out a piece of equipment in a few years because of obsolescence, it is not prudent to enter into a loan agreement that extends beyond that timeframe.
- **Borrowing from a financing firm that may not react well to cash swings.** It is highly beneficial to work with a firm that knows your industry. Because it is commonplace for a life science company to receive new cash just when the till is running out, business agreements with lending firms that understand this cyclical nature of equity rounds will eliminate tensions and surprises.
- **Seeking financing on specialty equipment.** It may be difficult to secure a loan for customized equipment such as molds or assembly line machinery used to produce highly specialized or unique products. This equipment may have little resale value in the event of a loan default, and will not be as attractive to lenders as collateral that has a broader use.

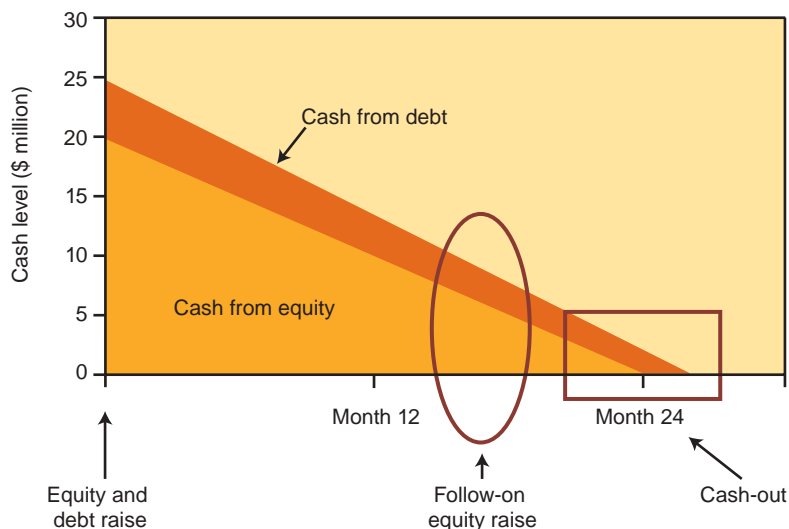


Figure 1 The role of equity and debt in a two-year cash burn business model. An equipment loan can extend a biotech startup's time to reach 'cash-out' (when it will run out of money) by up to six months. Such a loan can also put the startup on sounder financial footing to negotiate its next round of equity financing.

Summary

Life science companies can benefit greatly by using their equipment to secure debt financing. It gives them an extended cash runway and more time to negotiate their next equity round. Cash is king at every stage of growth for a life science company, and it is the fuel that drives the development of products that solve worldwide health and environmental problems.

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