Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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As was again clear at last week's Senate Banking hearing, credit availability is much on the mind when it comes to LMI communities and small business. This makes a good deal of sense given the capital proposal's unintended consequences, but it's only part of the story. When start-up ventures are unable to get bank loans, they turn to the capital market. This is often necessary due to the start-up's risk, but in recent years it's also been driven by hundreds of billions of investor dollars desperately chasing higher yields as the Fed year-in, year-out kept real rates below zero. Now that rates are finally, really positive, yield-chasing funds have evaporated. As the *New York Times* made clear, unicorns have turned into zombies. Some of the walking dead deserved to die long ago, but the flood of capital-markets funds exiting this sector also strands ventures that could and should have been vital innovators. Had these entities been buoyed by bank loans as soon as they were viable, many would still be walking.

Not every zombie is an innovator we'll sorely miss. Many bet big on not-so-critical products such as still more scooters. However, one sector left high and dry – early-stage biomedical research – is literally a matter of life and death.

In February of 2021 when the economy was growing but real yields were negative, the total enterprise value of approximately 700 publicly-traded biotechs was $598 billion. As of the latest data, this is down to $213 billion – about 64 percent. Why?

Biomedical innovation has long been the province of venture-capital companies because of the high cost of the intellectual capital needed to assess a treatment's potential success and the price it might then extract from the health-care system based on probable patient populations. The fewer the patients, the higher the price has to be or private capital stays on the sidelines no matter the grievous harm done by a rare disease.

However, many early-stage drug and device companies are creditworthy when judged not by return on investment likely with scientific success, but instead on the strength of their resources or, for very early-stage entities, universities or private foundations willing to guarantee a loan. The fact that the only bank willing to bet big on early-stage biomed was Silicon Valley Bank is not exactly a ringing endorsement of bankability, but the fact remains that SVB's loans to early-stage biomed are among the assets that were sold to another bank at about par because they're likely to be good credit.

The key to widespread bank lending for super-vital biomedical innovation is getting banks to make the long-term, lower-cost loans that insulate early-stage companies from fickle markets and predatory investors. The Foundation Fighting Blindness has pioneered the analytics necessary to create a bank-loan market for early-stage biomed, priming the pump with the federal guarantees

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long deployed to whet the interest of private lenders. We are hopeful that bipartisan, bicameral legislation to authorize this guarantee will be introduced early next month, creating a class of what we call BioBonds. Think green bonds for life-saving treatments instead of renewable energy and you've got the point.

Passing this bill in a Congress this fractious won't be easy even though our best guess on its deficit impact is that BioBond guarantees are a negligible cost to taxpayers, especially compared to the benefits of speeding medical treatment and cures.

But what if we succeed and Congress creates this critical new asset class even as the nation's biggest banks likely to enter this arena also groan beneath a load of new capital rules? Some may still choose to do the analytics necessary to offer a vital form of long-term credit with deep, deep market potential now that the analytics are made a lot easier thanks to the federal guarantee and the capital cost to banks is sharply reduced by ready sale into a secondary market that does not now exist. Many others may stay away not because they don't want to do this business, but because they are reckoning with steep capital shortfalls and can't do anything more about anything else.

Worse still is that, if Congress does not enact the BioBond bill and capital costs rise still higher, then banks will continue to totally avoid early-stage biomed credit because its analytical cost at a time of scarce capital for existing customers will be even higher. If banks are unable to meet this critical market's needs, early-stage biomedical companies will have two high-risk choices.

The first is to throw their lot in with that of private creditors, getting what are sure to be higher-cost loans for shorter tenors at risk also to venture integrity if the lender is also a private-equity company. And VCs will surely come back in the biomed game when rates drop and yield-chasing resumes. That will revive the prospects for struggling treatments and fund new ventures, but at the cost of exactly the same volatility evident over the past two years that's left all too many zombies that could have become thriving ventures finishing clinical trials ahead of regulatory approval for urgently-needed therapies.

It shouldn't need a federal guarantee to get banks to lend to creditworthy early-stage biomed companies. Over time, banks could come to understand this sector and stable long-term loans originated in relationship-banking entities could wean urgently-needed innovators from easy-to-find venture capital investments when times are flush and high-cost creditors outside the regulatory perimeter when they're not. But banks curtailing lending aren't banks willing to enter a sector even though it urgently needs them – they'll be hard-pressed to do the business they can with the customers they have. A more robust, reasoned capital construct isn't the only answer to creating a regulated window for early-stage biomed lending. But it's an answer and one we ignore at considerable peril.