Venture financing in uncertain times

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The current COVID-19 pandemic has significantly impacted global markets, and many venture capital investors (VCs) are engaging in full portfolio reviews. For some portfolio companies, the review will reveal an immediate or near-term need for an injection of capital. Given venture finance has a relatively long heritage, we can look to previous economic shocks to identify investment terms and tools that are suddenly once again relevant. This insight provides a general summary of some techniques VCs and venture-backed companies can use to recalibrate risk during these uncertain times. Also, although government response to COVID-19 is evolving in real time, government backed loan programs should also be looked to as another tool to use in addressing working capital and liquidity requirements.

Bridge financings

SAFEs have become a common tool for providing bridge financings, and are particularly appropriate when companies and investors are confident an equity financing will materialize, converting the SAFE into equity. Distressed company bridge financings are different, in that they provide some protection if the company fails, and the "bridge" turns into a "pier":

- Distressed bridge financings are generally structured as straight debt (i.e., non-convertible), a combination of debt and warrants, or convertible debt. Using debt provides downside protection in case the company fails or there is a "fire sale," because the bridging investor will be repaid before the equity holders participate in the proceeds of the liquidation or sale. This type of financing can allow companies additional runway, while governments sort out their direct and indirect economic support programs being put in place in response to the COVID-19 pandemic.
- Straight debt can be the best tool to finance a company that has an immediate need for capital to meet its obligations (e.g., making payroll). It also may be the only tool that is available if the company requires shareholder consent to complete a financing with an equity component, and the company anticipates delays or will be unable to obtain the necessary consent.
- Having the bridge debt secured provides additional protection for the investor, even though putting security in place is likely to take additional time, and may require consent of the company's existing lenders. In a situation where existing lenders have security in place, the bridging investor may be required to subordinate its security interest, particularly if the existing lenders are banks or other financial institutions. Depending on the circumstances, however, existing lenders that are not institutions may be asked to subordinate their own interests to the bridge lender. If the company has not granted security to existing lenders, there may be an opportunity to establish priority over certain valuable assets of the company. A few examples of desirable assets investors may wish to take security over are: tax refunds, refundable credits or other government financial assistance that will be payable to the company in the near future.
- A new debt facility, including bridge debt, will also allow lenders the opportunity to add additional approval rights or

controls that relate to any particular business and liquidity concerns as a result of the pandemic's impact on operations or financial position of the borrower.

- In addition to interest, bridge lenders may also consider including warrant coverage as part of the bridge financing terms. The issuance of warrants allows lenders to acquire equity on exercise, augmenting the rate of return over and above the interest rate accruing on the debt.

Equity financings

For a convertible preferred financing, an array of terms exist to provide downside protection to investors, which can be introduced either on an a-la-carte basis or as a full menu for very high-risk situations:

- **Tranched / Milestone-based rounds:** Financing can be provided in tranches conditional on the company achieving pre-determined milestones. If milestones are not achieved, the funding is not advanced, unless otherwise agreed by the investors, and/or and a valuation adjustment might apply to funds already invested.
- **Liquidation preferences:** In recent years, sequential rounds of preferred shares often rank *pari passu* on liquidation (i.e., all investors holding that class of preferred shares, regardless of which series they participated in, will receive the same liquidation proceeds). In lean times, a "last in, first out" ethos usually prevails, such that the last money takes priority in the waterfall before existing series of preferred holders receive their proceeds.
- **Liquidation multiples:** During the financial crisis and early 2000s, it was common to see liquidation preferences of 1.5X, 2X and even greater (mainly for later rounds), as well as being "participating preferred", i.e., preferred holders receive their liquidation preference **and** participate with common shareholders in distributing the remaining proceeds.
- **Accruing dividends:** An accruing dividend of six to eight percent can be in addition to or as an alternative to a liquidation multiple. In recent years, where accrued dividends are negotiated, they often disappear on conversion of preferred to common. In difficult times, accruing dividends may also convert to common, or may be required to be paid out in cash on conversion.
- **Redemption:** Preferred shares may be redeemable after a fixed amount of time, with five to seven years historically being the most common period. The redemption price may also be set as the greater of the liquidation amount (including any accrued dividends), or fair market value. Use of redemption rights can have adverse tax and accounting consequences, and if investors want to avoid those consequences, pressure to obtain liquidity can be achieved by investor rights to mandate the sale of the company after a certain period.
- **Full ratchet price protection:** Full ratchet price protection automatically adjusts the conversion price of the preferred stock to the lowest price at which the company raises financing, and can be a powerful protection if the company pursues a future down round, where shares are issued below the prior round per share price.
- **Tougher / enhanced veto rights:** Investor veto rights should be tightened up to ensure that downside protections that are established are not easily unwound in future financing rounds.
- **Pay-to-play penalties:** If investors want co-investors to be committed to continuing to support the company through future rounds of financing, they might consider imposing penalties over and above the dilutive impact of not participating, if co-investors fail to take up their pro rata share in the next round. Penalties may include automatic conversion of their preferred stock into common stock (either on a one-for-one basis or at a punitive ratio), or the loss of board seats or other investor rights.
- **Voting drags:** Investors may wish to incorporate voting drags that go beyond the usual requirement that all

shareholders must support the sale of a company (or other exit) if approved by the holders of a minimum specified percentage of the issued and outstanding shares. With a broader voting drag, all shareholders can also be required to vote in favour of other fundamental changes if supported by the investors (or some other specified shareholder group). This can be a powerful downstream tool where, for example, a company is required to embark on a down round to attract fresh capital.

Of course, there is no substitute for setting an appropriate valuation for new financing rounds, to reflect the adjusted risk profile for the company.

Stock option top-ups and founder carve-outs

Down rounds can discourage founders who are already under operational and economic pressures, as their equity can get stranded at the bottom of the liquidation waterfall. If the company has a view to a potential liquidity event, it may be desirable to either top-up the stock option pool or negotiate a special carve out for the benefit of founders to ensure they remain motivated. Founders can put themselves in a better negotiating position to ask for equity top-ups if they also agree to a salary reduction to reduce cash burn.

Government-backed programs

In Canada, Business Development Bank of Canada (BDC), Export Development Canada (EDC), and other federal, provincial and local government institutions are actively taking steps to address COVID-19 by introducing financial assistance programs designed to provide relief to individuals and businesses. For example, BDC has announced the availability of working capital loans of up to $2 million with flexible repayment terms, such as postponements of principal for qualifying businesses. In addition, both BDC and EDC have been tasked with deploying the federal government’s $10 billion Business Credit Availability Program, which has been launched to inject capital into the Canadian business community.

A few additional thoughts

If a VC has a director on the board of any portfolio companies, now is an appropriate time to audit the company’s director and officer insurance to ensure necessary protections are in place in the event of the company’s insolvency. It is also desirable to ensure that the companies are on top of employee withholdings and other payments that can result in personal director liability.

The VC investors we know strongly prefer investing in a vibrant economic environment without driving terms that, until recently, would be seen as harsh. However, VCs are under their own pressures from limited partners. We can take comfort that these financing techniques have in the past been reliable approaches to successfully realign interests among limited partners, VCs, companies and their founders.

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