Growth Capital

Startup fundraising in lockdown: challenges and opportunities

The Covid-19 pandemic, and the global response to it, have massively disrupted almost every aspect and sector of the world economy, and venture capital fundraising is no exception. According to industry data, VC deal making in China for the first six weeks of 2020 was 60% lower than for the same period in 2019, and is only now beginning to recover.

The crisis presents a dilemma to both startups considering fundraising and their prospective investors.

- Startup founders, whilst they need to raise capital, are cautious of doing so at reduced valuations which could lead to excessive dilution. If they have raised VC money before, they must also be wary aware of the consequences of now conducting a down-round, on which investors in the previous round typically benefit from anti-dilution protection which further squeezes the founders' stakes.

- Investors, whilst they may have capital to spend and a mandate to do so, are primarily focused on shoring up their existing portfolio companies and will be wary of investing at the wrong valuation in non-Covid-resilient companies. Furthermore, investors' due diligence is significantly hampered by not being able to get into target businesses in person, look under the bonnet and kick the tires, making it difficult to commit substantial capital.

The result is a stalemate.

Typical VC deal structures work very well in benign economic conditions where growth matches expectations and all parties' interests are aligned. In such circumstances, liquidation preference structures are negated, down-round protections are not needed, "leaver" provisions have real teeth, founders are incentivised and investors reap the rewards.

However, deal terms do not adjust for unforeseen macroeconomic events and, when growth does not keep up with the business plan upon which a deal structure is based, key investor protections kick in and founders can very quickly find themselves diluted or even out-of-the-money, leaving them demotivated and potentially harming business performance and value still further.

Nevertheless, even in the midst of the current crisis, there are opportunities for both startups and investors.

Resilient sectors

A lot of VC deal activity in recent years has focused on B2C and B2B software companies, particularly app developers and SaaS providers focusing on helping consumers and businesses respectively to increase efficiency, visibility and activity. Since these companies are not dependent on face-to-face human interaction or shared workspaces, they should be relatively unaffected by remote working. Technology companies whose products are particularly in demand in a lockdown scenario (in the way of, say, Zoom, Spotify, Netflix or DocuSign) should not see any drop in their valuations and indeed should find themselves even more in demand as investors seek Covid resilience.

Bridging funding

Startup founders would be wise to consider bridging funding during this time. Bridging funding typically consists of convertible loans, advance subscription agreements (ASAs) or simple agreements for future equity (SAFEs).

The advantage of these structures for startups and founders is that, whilst they receive cash on day one, the moment of conversion into actual equity is deferred until some time in the future, by when their valuation should – hopefully – have recovered sufficiently to avoid the dilution which would result from issuing the equity on day one.

From an investor's perspective, providing bridging funding by way of a convertible loan is, structurally, a less risky investment than straight equity since, pre-conversion, they will rank as creditors in priority to the equity. In addition, they are likely to be able to obtain a discount to their future conversion price (10-20% is typical), plus interest which may further increase their equity stages. Since ASAs and SAFEs are not debt, they are less secure and therefore attractive for investors, so deeper discounts on conversion may be needed in order to encourage investment.

Since a convertible loan is primarily a debt instrument which increases the company's liabilities, startup founders and their fellow directors must be aware of their duties to all stakeholders when considering whether to take on this debt – please see our guidance on this complex topic here.

The UK Government's startup funding support plan, the Future Fund, is based on a convertible loan structure and is designed to help startups to top-up the amounts they raise in this way – please see our guidance note on the Future Fund here.

Phased investments

Very often, startups do not need all of the fundraising money on completion of a round. Similarly, investors may prefer not to commit all of the money on day one. A common solution is phased investments, under which investors provide a portion of the funds upfront and commit to further tranches in future subject to the achievement of agreed business growth milestones, sometimes at valuations which adjust upwards to take account of the achievement of those milestones. This type of structure could work very well in the present crisis – since it would allow:

- investors to withhold a significant part of their funds until the startup has demonstrated that it is on track to fulfil its business plan; and
- startup founders to delay issuing all of the equity until the valuation picks up.

Venture debt

Venture debt has become an increasingly important part of the startup fundraising landscape and is an interesting option for founders looking to raise funds at the present time whilst managing dilution, since the day one equity valuation is irrelevant. Innovative venture debt providers look to intangible assets specific to IP-rich technology companies, such as such as R&D tax credits, as collateral for their loans, and often require equity warrants to provide future upside. This type of structure could also work well in the current crisis.

Conservative valuations may not always be a bad thing

When assessing valuation on a fundraising round, it is vital that startup founders keep in mind future raises as well as the current raise. Achieving a sky-high valuation on one round is a great achievement, but it immediately ratchets up the pressure on the founders and the business, since it will likely be predicated upon a business plan featuring ambitious growth aspirations. If the business fails to keep up with that growth, then by the time the company raises again it may be forced to do so at either a “flat” or “down”-round valuation level, which may kick off the vicious circle of founder dilution, demotivation and reduced business performance.

By contrast, raising now at a conservative valuation based on achievable growth leaves some breathing space for future rounds and reduces the risk of a catastrophic down-round.

Employee share schemes

Startups frequently use equity to incentivise key team members, and just as frequently encounter the issue that the UK’s employment-related securities legislation imposes “dry” income tax charges on employees or directors who receive equity for less than its market value. This can make it difficult for startups to get meaningful equity into the hands of their key team members without a significant cash outlay or tax burden.

Companies whose equity valuations are depressed as a result of the current crisis could consider using the opportunity to set up employee share schemes on the basis of a – justifiably – lower market value, which could help to mitigate the cost outlay or tax implications.

Conclusion

Fladgate’s growth capital team has considerable experience of advising investors, businesses and founders on fundraisings in all kinds of economic conditions, and can advise on a variety of different structures. For a confidential, no-obligation chat about how to navigate these issues, please feel free to contact:

Jamie Hamilton
Partner
T: +44 (0)20 3036 7319
M: +44 (0)7852 040559
E: jhamilton@fladgate.com

Graham Spitz
Partner
T: +44 (0)20 3036 7878
M: +44 (0)7775 894974
E: gspitz@fladgate.com

Anthony Shatz
Partner
T: +44 (0)20 3036 7368
M: +44 (0)7855 516365
E: ashatz@fladgate.com

Yulia Leyko
Senior Associate
T: +44 (0)20 3036 7318
M: +44 (0)7789 276234
E: yleyko@fladgate.com