ALLEN & OVERY

Covid – 19 update

Impact of Covid-19 coronavirus on private fundraisings – key legal considerations for investors and issuers

While the full impact on private fundraisings and the growth capital sector will not be seen for some time, it is clear that the days of free flowing cash for some growth companies are coming to an end. Investors have heightened sensitivity to the potential risks and liabilities associated with new investments, with some shifting focus to their existing portfolios and ensuring those businesses are sufficiently capitalised to ride out the inevitable global downturn. There will undoubtedly be regional differences but the sector is likely to slow in terms of overall activity in the short to medium term. However, high cash-burn companies will still need to come to market and there remains record amounts of cash available for deployment. As with any significant disruption, new opportunities will arise, particularly in sectors such as technology and life sciences.

We are seeing both Investors and Issuers having to adjust their expectations as to the timing and contractual terms required to successfully close fundraising processes, and Issuers are looking increasingly at alternative financing options to running a full equity round. We have summarised below certain of the key legal and market issues which both Investors and Issuers should consider in light of Covid-19.

– **Due Diligence** – Investors should consider running an enhanced due diligence exercise to better assess the short and medium term impacts of Covid-19 on an Issuer's business and be cautious of simply relying on a diligence exercise conducted by any 'lead investor'. The Issuer's Covid-19 mitigation and contingency plans, as well as updated business plans and cash requirements, will form a key part of an Investor's diligence requests. Issuers should be prepared for increased scrutiny on their forecasts and expect to provide additional detail on a wide range of business and legal areas, including: (i) force majeure and termination provisions in customer/supplier contracts; (ii) insurance coverage; (iii) cybersecurity and remote working arrangements; and (iv) employment matters, including the impact of local labour laws on the Issuer's ability to react to workforce requirements.

– **Conditionality** – While deal certainty is a critical element in any fundraising process, in these testing times, it is likely to become an area of increased stress for an Issuer. Investors may consider including conditions precedent to address both specific Covid-19 related issues identified during due diligence, as well as more general pandemic related events such as the formal lifting of Government-imposed restrictions. Material adverse change (MAC) conditions will become a battle ground in those markets where such terms are common, but Investors should carefully consider the formulation of any such clause so as to give it the best chance of being enforceable. In any new transaction, a general market MAC clause may be hard for an Investor to rely on given it will likely be treated as having "bought into" the current market volatility from the coronavirus crisis. Investors may be more successful with targeted and specific conditions precedent or MAC provisions that focus on determinable financial metrics (which could be both target specific and macroeconomic in nature). In a similar vein, while the current lockdown situations may restrict or hinder parties from satisfying certain of their obligations under a subscription agreement, broadly speaking, there may be limited scope Investors to exercise force majeure clauses in committed funding arrangements. To enforce a force majeure provision it is generally necessary to show that performance has become physically or legally impossible, and not just more difficult or unprofitable; this is a high threshold and a change in the market conditions that renders performance more expensive is not generally accepted as being a force majeure event.

– **Pre-completion access and information rights** – If there is the possibility of an extended period of time between Investors committing to fund and closing of the round, Investors should consider what access and information rights they need from the Issuer in the interim. Typically, incoming minority investors would receive reasonably minimal rights and few operational commitments regarding the Issuer's business prior to funding. However, in light of the evolving landscape and the fast-changing jurisdictional approaches to lockdowns and restrictions, Investors may be able to command greater access and consent rights prior to getting on the cap table, particularly if the business changes are as a result of evolving Covid-19 policies and regulations. While previously relatively unusual in growth capital transactions, pre-completion covenants with regard to the operation of the business may also be appropriate.

– **Regulatory Engagement –** Investors and Issuers will need to consider how they can manage regulators where consents may be required, for example, with respect to foreign investment approvals. A number of jurisdictions have already amended their FDI regulations in light of Covid-19 (for example, India's restrictions regarding Chinese investors, EU seeking to preserve critical assets such as medical / health businesses and the expansion of Italy's "*Golden Power*" rules). Where regulators are not functioning at maximum capacity, parties may need to be realistic about their respective performance obligations vis-à-vis regulators and the timing implications of obtaining such approvals. Parties should enter into a dialogue to the extent that they can find reasonable solutions to these issues.

– **Tranched investment commitments –** Investors are seeking various ways to reduce their risk, with an increasingly popular option being to adopt deferred money structures. These often take the form of an initial small investment to keep the business operating, and future tranches being released only achieving certain metrics, such as the financial performance of the business improving or a minimum amount of capital being raised as part of the round. Issuers should give enhanced scrutiny to such structures given the difficulty in forecasting how the Covid-19 crisis will affect performance in the next 12 months or so. We are seeing Issuers (and existing investors) considering whether it may be better off raising a fuller amount at a slightly lower valuation now, rather than risk the uncertainty of a prolonged funding process with the hope of negotiating better terms.

– **Investor-friendly terms –** Coupled with a widely reported general downward shift in valuations, there is a general expectation for transaction terms (even those which are in not 'downround' territory) to swing back in favour of Investors following what has been a prolonged movement toward Issuer and founder-friendly terms over the last couple of years. Companies needing to raise capital will increasingly encounter Investor-friendly positions on terms such as liquidation preferences (with multiples of entry value, and possibly also participating liquidation preferences, back on the table), dividend rights, and, subject to local law requirements, specific enhanced redemption or buy-back rights. General transaction risk is likely to be pushed on to the Issuer (and founders), rather than institutional investors, and this will be reflected across terms including wider warranty coverage, specific indemnities and higher financial protections. While Issuers may have to be pragmatic about such terms, any provisions which raise a material prospect of the company not receiving the promised funds (e.g. an investor walk-away right) must be considered in the context of the ongoing solvency of the business. If a proposed term raises material doubts as to whether the Issuer can expect to receive the cash it needs to stay solvent, there may be stronger grounds to push back.

– **Impact of 'downrounds' –** The economic impact on some businesses will result in an inevitable recalibration of value and the likelihood of downrounds (a financing in which a company sells shares at a price per share that is less than the price per share it sold shares for in an earlier financing) is very real. For distressed companies in a downround situation, Issuers can expect Investors to demand better terms for following their money, including a repricing or conversion of existing round securities, additional board seats, enhanced consent rights on future rounds and vetos over exit transactions. If these terms are not acceptable, coupled with the dilutive effect on the founders of a downround, Issuers may need to consider other forms of financing to buy them time until they can command more favourable equity terms. Alternatively, Issuers may be able to maintain valuations (at least pricing at the same price as the previous round) in exchange for some of these enhanced terms as some Investors will seek ways to reduce the likelihood of a downround given the impact this has on its carrying value and reporting obligations in its financial statements.

– **Alternatives to equity –** Alternative funding sources, such as venture debt providers, are getting increasing numbers of requests from firms that aren't in a position to run a full equity round but are in need of a lifeline. Venture debt packages often come with an equity-kicker in the form of warrants or partly paid shares, and almost all lenders will require security over the company's assets, which typically would require consents from certain shareholders. Issuers will therefore need to consider the terms of these products and determine which approvals may be required from its existing investors and start those discussions early. Convertible instruments may also provide liquidity options to Issuers and such instruments bring with them a range of pros and cons – they can often be put in place quicker than an equity round, with the additional upside of allowing the company to defer placing a value on itself and therefore potentially avoiding a downround scenario. However, whilst a convertible instrument technically delays putting a price on the company, it will often contain terms such as a valuation cap and a fixed conversion price, and these may act to anchor price negotiations for the next round.

– **Government support –** the governmental response to the Covid-19 crisis has varied around the globe but an increased investment in the private sector by the state is a common theme. Initial relief packages were not universally helpful for the high-growth sector as they often required the relevant business to have strong revenues and/or a good credit rating. This was a challenge for start-ups that were either pre-revenue or whose business models did not immediately prioritise profitability. Whilst the focus of most governmental support has been broadly focussed on small and medium sized businesses, recently, however, we have started to see governments develop packages specifically targeting the growth and venture capital sector, such as the UK's Future Fund, and similar schemes in France and Germany. Many of the details for such schemes are yet to be finalised but most appear to require matching funds by private investors and many expect to rely on convertible instruments as the means for making the investment. While potentially an attractive source of funds, Issuers and their stakeholders must carefully consider the implications of taking state funding, and the conditions that come with such investment. Enhanced reporting or new covenants on business activities may be undesirable, particularly when there are other funding options available.

– **Exit considerations –** While lower valuations may provide for some opportunistic M&A activity, and some specific sectors with links to Covid-19 (such as healthcare and logistics) may see increasing M&A activity, in the short to medium term M&A retrenchment is likely to occur in tandem with a reduction in IPOs as an exit mechanism. The IPO window has closed fairly quickly as extreme volatility returned to public equities. Issuers that are seeking a 'pre-IPO' fundraising round with the aim of adding investors to its cap table for the purposes of a credible IPO story may have to change their IPO timeline horizons. Similarly, companies may need to open discussions with existing investors regarding the exit commitments in their shareholders' agreements if the relevant dates or time periods to undertake an IPO or trade sale would be hit in the next 12-18 months. As well as trouble launching a deal in the public markets, a slowdown of trade sale exits is probable given that potential buyers may be heavily focusing on liquidity and maintaining operations rather than investing externally. That being said, there will still be a number of opportunistic buyers in the market (particularly those in well-capitalised sectors such as technology) and boards would be well-advised to ensure they are prepared for any eventuality. Practical steps such as checking that the company data room is up to date and that corporate housekeeping is in good order may yield dividends in due course.

– **Execution logistics –** The lockdown restrictions in place across many jurisdictions are making deal execution more challenging – it is harder to carry out some aspects of due diligence, conduct meetings, hold presentations and negotiations, and ultimately arrange and proceed with execution. In those jurisdictions requiring a physical presence of a third party for closing (for example, signing of documents before a notary), advanced coordination on the logistical aspects will be key to ensuring that closing can happen. For remote executions, parties should ensure that they are clear on which formalities need to be followed in the relevant jurisdictions, particularly when dealing with documents such as deeds which include a witnessing requirmenet.

CONCLUSION

The commentary above is primarily designed for issue spotting and provoking discussion and thinking given that many of the issues highlighted above will be transaction, sector and circumstance specific. Investors are openly reporting that the Covid-19 health crisis will indeed have an impact on investment activity and companies will need to react accordingly. However, transactions are still being done in these difficult times and, despite a potentially deep global recession on the horizon, companies that are realistic and flexible about the fundraising process have good reason to expect to be successful with their capital raise.

Contact

Brendan Hannigan
Partner
Tel +65 6671 6068
brendan.hannigan@allenovery.com

James Mythen
Partner
Tel +65 6671 6077
james.mythen@allenovery.com

William Samengo-Turner
Partner
Tel +44 20 3088 4415
william.samengo-turner@allenovery.com

Sugianto Osman
Partner
Tel +62 21 2995 1728
sugianto.osman@allenovery.com

Alun Evans
Partner
Tel +65 6671 6072
alun.evans@allenovery.com

Dion Alfadya
Counsel
Tel +62 21 29951762
dion.alfadya@allenovery.com

Tom Jokelson
Senior Associate
Tel +65 6671 6162
tom.jokelson@allenovery.com

Heather Ong
Senior Associate
Tel +65 6671 6073
heather.ong@allenovery.com

Zi Yang Lim
Senior Associate
Tel +65 6671 6161
ziyang.lim@allenovery.com