Changing Environment for Venture Capital Transactions

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Valuation

Overall – Reduced Value.

A number of factors will likely combine to reduce valuations in coming months:

- Sharply adverse trends created by the pandemic will adversely affecting target's growth prospects, as well as buyers' balance sheets and available capital.
- Investors will expect to hold their investments for a longer time period before exit.
- The acquisition market is suffering adverse changes caused by: (a) many buyers adopting a "wait and see" approach, even for pending deals, (b) a pull-back in financing, and (c) strategic and PE buyers focusing on managing adverse impacts on their businesses, in some cases very severe.
- The initial public offering market will be closed to all but the very strongest companies.

Milestone Structure.

In a minority of situations, investors are able to hedge on valuation, retaining a right to receive more equity or improved conversion terms if the target fails to meet operating targets. These arrangements mitigate risks of a high valuation and help address uncertainty. Full ratchet anti-dilution protection is also a hedge against a too-high valuation.

Liquidation Preference

We will see a greater prevalence of senior liquidation preferences on new rounds and also more investor-friendly participating preferred stock. Participating preferred stock favors investors by providing for both a return of the initial investment (or a multiple of the investment), plus a share of the residual return after all liquidation preferences are paid.

The participation element is among the first terms to be required by investors, if a target lacks the leverage of alternative financing sources. Back in 2008 and 2009, the prevalence of participating preferred stock rose to 63% of surveyed financings, for example.

We might again see multiples of liquidation preference more often in deals, with the multiple ranging between 1.25 and 2 times, even for initial rounds. This structure for a later round by the same investor group enables investors to preserve a flat valuation (i.e., avoiding a write-down on their existing investment), but still improve their anticipated return on a new round.

Finally, we might see more recapitalizations involving a conversion of existing preferred stock into common stock, especially in down rounds, because of the strong negotiating leverage of new investors in these situations and the desire to simplify capital structures.

Dividends

Higher preferred stock dividends might become more common as an element of tougher deal terms. In the 2009 time frame, preferred stock dividends of 6% to 10% were routine, especially in Florida deals. Rather than being paid currently, these dividends typically accumulate and are payable on certain events, including liquidation, redemption, or conversion of the preferred common stock so that the funds remain invested in the business.

Tougher Conversion Terms

In recent years, we see company-friendly weighted average anti-dilution protection, rather than full ratchet protection. Even in deals that include full ratchet protection, the term is often later modified or waived in subsequent rounds to mitigate the heavily dilutive impact on management or to secure needed approvals.

However, given uncertainty about companies' prospects and valuation, we might see full ratchet anti-dilution in at least a minority of deals. (In the 2009 time frame, a survey reported that approximately 80% of deals featured anti-dilution protection, of which about 15% were full ratchet.) Full ratchet anti-dilution protection provisions should allow waiver of the provision by investors holding a majority of the shares of the benefiting class.

Redemptions (also called "Put Options")

Investor-driven redemptions are another investor-friendly term that becomes more common in challenging times. When included, redemptions typically provide for the investor to have the option to sell its equity to the company after about five years. Redemptions are typically staged in two to three payments after the five-year time period. In the 2009 timeframe, put options were included in 50% surveyed deals.

Redemption rights are much less important after the investor reaches a control position -- at that point, the investor group can force a sale of the company or other exits such as a dividend recapitalization or a share repurchase.

Pay to Play

Prospective Provisions. Pay to play provisions provide for various penalties such as a conversion of preferred to common shares or loss of other rights such as anti-dilution protection, board representation, preemptive rights or approval rights, if the investor does not participate in a later financing round. Play to pay provisions were included in significant minority of deals during the last recession, but recently have been relatively rare.

Investors might consider including a pay-to-play provision to force discipline among investors in subsequent rounds. Even before recent developments, we were seeing more situations in which a portion of the investor group fails to continue supporting struggling companies, leaving the remaining investors to lead round after round.

These rights often go away after an investor “plays” in later financing rounds for a certain minimum amount, such as the amount of the investor’s initial investment. This cap allows investors to reserve a limited fund amount for future investments in the company.

Pull-Through Provisions. Investors may structure an investment to provide a special benefit to each existing investor that agrees to participate in the follow-on round through a “pullthrough.” Under this arrangement, certain designated preferred equity that is already outstanding is “pulled through” into a more senior, favorable class. For example, a company could offer each investor who elects to participate in a financing round an opportunity to (a) purchase the security being offered and (b) have their investment in a prior round (e.g., the Series A) pulled through a senior round. This provides added incentive for participants (and punishes those that do not).

Ratably offering this opportunity to all investors is especially important in this context from a fiduciary standpoint.

Special Concerns in Follow-On “Down” Financing Rounds

Investors should be aware that controlling shareholders and directors might be subject to claims of alleged fiduciary duty breaches, especially in highly dilutive rounds priced at a discount to prior rounds. Plan ahead and if possible, follow these processes to help protect directors and controlling shareholders from shareholder claims:

- Canvass for alternative financing sources to set arms’ length terms. Watch for overreaching terms (such as multiple liquidation preferences) that might not be justifiable in hindsight.
- Importantly, offer all shareholders rights to participate in the transaction on a pro rata basis, through a rights offering. This rights offering can be extended for a defined period after an initial closing if timing does not allow the company to complete this process beforehand.
- Be sure to disclose investor and management conflicts in the rights offering.
- Secure approvals of disinterested shareholders and directors, after disclosure. In evaluating whether their approval satisfies statutes such as Section 144 of the Delaware General Corporation Law, closely consider whether approving directors or shareholders have conflicts of interests (e.g., compensation to management directors in or around the transaction).

Secure a fairness opinion – rarely used, but helpful to add support, especially in conflict situations.

Bridge Financing Terms

These financings will continue to be prevalent as funds provide more capital to keep portfolio companies alive. Here are a few common attributes:

- Typically short term, convertible into the next round at a discount or accompanied by warrants, so that the investor receives an equity premium for the risk of extending bridge financing while permanent financing is being arranged. Typically, this equity compensation increases over time if loan not repaid as promised.

- Often structured as debt secured by at least some accounts receivable, and in some cases by a blanket lien.

- Deals vary in terms of the investor’s due diligence and depth of covenants and representations. (Existing investors might require little diligence.)

- Watch for usury and original issue discount issues.

Investor Checklist

Here is a checklist of key deal terms for three different deals:

The investor friendly deal:

- Lower valuation; downward post-closing valuation adjustments for poor performance

- Staged investments, with funds tied to performance milestones, usually at the same valuation

- Senior liquidation preference for the new round over prior rounds; in some cases, recapitalizations converting existing preferred stock to common stock

- Multiple of investment participation on liquidation, without cap on the participation tied to overall return

- Dividends

- Full ratchet anti-dilution protection

- Extensive approval rights

- Redemption rights at investors’ option

- Penalty for missing dividends or redemption, such as penalty return or right to elect Board majority. Possible ability to force sale of company on missed redemption.

- Preemptive rights for investors only

- Right of first refusal and co-sale rights applicable to existing shareholders

- Drag-along rights tied to majority of all preferred stock and limited to founder and management stock

- New vesting schedule for previously vested founder and management stock
- Broad founder representations in the investment agreement, without knowledge qualifications
- Investor control of the Board of Directors

The company friendly deal:

- Higher valuation and multiple of earnings/revenues; value tied to expectations rather than historical performance; opportunity to increase valuation through postclosing performance
- Funds received at closing, or even more favorable, right to call more funds if needed
- Common stock securities or junior liquidation preference
- Straight liquidation preference, without participation
- No dividends
- Weighted average anti-dilution
- Minimal approval rights, limited to related party transactions
- No redemption rights
- No penalty for missing dividends or redemption
- Preemptive rights for investors and founders
- Right of first refusal and co-sale rights applicable to all shareholders
- No drag-along rights or the rights apply to all investors
- Founder and management stock vested
- No founder representations in the investment agreement
- Founder control of the Board of Directors

The mainstream deal:

- Fair valuation, without post-closing adjustments
- Funds received at closing without staged funding
- Senior liquidation preference over “angel” investors and early stage investors at lower

valuations; parity to other recent institutional investor rounds

- Straight liquidation preference, without participation
- Dividends payable on liquidation
- Weighted average anti-dilution
- Limited approval rights designed to protect the security, but not on core operational issues
- Redemption rights after five years, payable over three years
- Right of first refusal and co-sale rights applicable to existing shareholders
- Drag-along rights applicable to founders and existing shareholders, but only if approved by a majority of common stock holders. Might or might not apply to investors.
- Founder and management stock vested
- No founder representations in the investment agreement
- Balanced Board of Directors, with founder, independent, and investor representatives

National Law Review, Volume X, Number 97