COVID-19: PRESSURE POINTS: THE ECONOMIC IMPACT ON THE EUROPEAN VENTURE CAPITAL INDUSTRY (EUROPE) - UPDATED 22 APRIL 2020

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Legal Briefings – By **Aaron White and Victor Chiew**

The COVID-19 pandemic is creating significant economic challenges for industries world-wide. The European venture capital industry and the start-up ecosystem it supports is no exception.

RECENT TRENDS

Before the onset of the pandemic, European venture capital deal activity was very healthy. Whilst there was a downward trend in terms of deal count (attributable to late-stage VC investments attracting the majority of venture capital funding), aggregate deal value was at record highs. Furthermore, extensive corporate venture capital participation in European deals was continuing, venture capital-backed exits were at healthy levels (particularly in the software sector) and the number of venture capital funds and capital raised had picked up significantly.

IMPACT OF COVID-19

The COVID-19 pandemic will more than likely result in a decline in venture capital deal volume over the short to medium term, particularly for start-ups in the travel, leisure, events and retail sectors given the contraction in consumer activity and Government responses to the pandemic keeping people home. Venture capital investors and corporates who have raised venture funds will be examining start-up founder teams, products, markets and exit strategies more closely; corporates who invest off balance sheet are likely to refrain from investment activities to preserve cash reserves; and financial investors who prefer liquid assets such as hedge funds may put a hold on their venture capital investment activities.

MITIGATING THE DOWNTURN

Across Europe we are seeing some evidence of Government-backed and other stimulus efforts to help mitigate the downturn for start-ups. For example, the UK Government announced the creation of the co-investment "Future Fund" which will support UK companies that are unable to access the Coronavirus Business Interruption Loan Scheme due to their lack of profitability and their need for ongoing external investment to support liquidity and cash flow challenges. The Government will contribute an initial £250 million to the Future Fund. For any eligible UK-based company, the Government will invest between £125,000 and £5,000,000 in the form of convertible loan notes.[1] The Government will not be able to invest more than 50% in a financing but the amount that can be invested by investors in the financing will not be subject to a cap. The Government summary of the terms of the convertible loan notes can be found here. In addition, the UK Treasury announced that £750 million in funding will be targeted at small and medium-sized enterprises that are focused on R&D, to be made available through the innovation agency: Innovate UK.

The British Venture Capital Association is also engaged on a range of other COVID-19 issues affecting the venture capital industry, including faster approvals of EIS/VCT funding and faster payments of R&D tax credits; relaxation of state aid rules on EIS/VCT schemes; deferral of income tax and VAT payments; extending business rates relief to all businesses unable to operate because of government restrictions; extending the job retention scheme; and suspending wrongful trading rules.

France, through its dedicated agency BPI France, is setting aside €80 million to invest in start-ups which are seeking to raise finance, alongside matched investments from the private sector.

The German public venture capital umbrella-fund-investors, KfW Capital and the European Investment Fund, will be put in a position to step into the shoes of defaulting fund investors.

Both France and Germany have also extended their liquidity schemes so as to be available to start-ups.

The Dutch government is increasing its guarantee of start-up loans from 50% to 67.5% for loans of up to €266,667, while Sweden has extended its existing support for starting a business from 6 to 12 months.

IMPACT ON VALUATIONS, DUE DILIGENCE AND DEAL TERMS

For those start-ups who are able to attract venture capital investment during the downturn, there is likely to be a downward shift in valuation, in particular for later stage start-ups as they are more often valued relative to public markets. This could trigger down-round protection provisions, and founders and other ordinary shareholders should understand the impact on post-financing equity stakes - other options such as bridge financing or negotiating with investors to waive or partially reduce anti-dilution adjustments may need to be considered.

In terms of due diligence, in the short term we expect increased due diligence timelines due to the physical challenges in creating and populating data rooms and an inability to conduct in person due diligence sessions, site visits and management meetings, and also due to investors examining start-up founder teams, products, markets and exit strategies more closely. There will likely be an increased focus on business supply chain, operations and continuity due diligence, as well as the potential impact of COVID-19 on earnings projections, the execution of business plans, material contracts and general working capital and liquidity.

Finally, there may also be a shift towards more investor-friendly deal terms. Some examples include:

- **Participating preference shares**: investors may require participation rights which entitle them to receive their preference amount first in a liquidation event, with any remaining preference shares on an "as-converted" basis. Participation may be uncapped, or capped (typically at 3-5 times the amount originally invested including the amount of the liquidation preference).

- **Liquidation preferences**: investors may require the amount of the liquidation preference to be a multiple of the purchase price of the preference shares given that liquidation preference is typically a function of the perceived risk of the investment. 2-4 times preference would be typical.

- **Anti-dilution protection**: investors are likely to require that their economic ownership in the company is protected against possible dilution that may occur as a result of additional issuances of shares at a lower purchase price than paid by the investor, without the investor having to make a material new investment. We would expect weighted average formulas to remain the norm however.

- **Dividends**: we could see a shift to holders of preference shares having a cumulative dividend right entitling them to be paid, in addition to their liquidation preference, an amount equal to a certain percentage per year of the purchase price for the preference shares.

- **Pay-to-play provisions**: investors will strongly resist pay-to-play provisions which would require them to provide continued financial support in future financings (dilutive or otherwise). If included, a less severe restriction could be for investors to convert their preference shares into another series of preference shares (often referred to as 'shadow preference shares') that retain some or all of their liquidation preference but lose anti-dilution protection.

- **Special approval rights**: these protections will take on increased importance for investors in the current environment. For example, these would typically include amending articles to affect rights of preference shareholders; increase/decrease of authorised preference shares; authorise or issue equity securities senior to or on parity with preference shareholders; liquidation / dissolution / winding-up; merger / acquisition / sale of substantially all assets of the company; voluntary liquidation or dissolution; dividends, distributions and share repurchases (subject to customary exceptions).

- **Redemption rights**: minority investors in a later-stage profitable company may want to have some ability to exit the investment through redemption rights. We would not expect these rights to be unrestricted, rather available only in specified circumstances, subject to there being sufficient available profits e.g. if an exit has not taken place within a specified period.
- **Board representation**: the usual shareholding threshold for a venture investor to have a right to designate a representative to serve on the company's board of directors may be reduced (somewhere in the region of 10% is typical under ordinary circumstances). This will allow the investor to monitor the company's decision making (in addition to standard information rights) and to ensure that it is well run from an administrative and corporate governance point of view – something which will be particularly important in an economic downturn).
- **Warrants**: we may see more warrants being issued to investors as a bonus for cash investment in the current climate.

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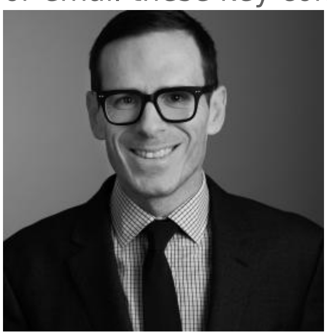
1. Convertible loan notes are not eligible for EIS or SEIS tax relief.

More on COVID-19

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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