PRESSURE POINTS: VENTURE CAPITAL IN SOUTHEAST ASIA POST-COVID-19 (ASIA)

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Legal Briefings – By **Mark Robinson, Jamie McLaren and Matthew Wentz**

The Covid-19 pandemic has created significant economic challenges for industries world-wide. The Southeast Asia venture capital industry and the start-up ecosystem that it supports are no exception.

Start-ups in particularly hard-hit industries have found themselves at risk in these uncertain times as sales have softened and private fundraisings have proved more challenging or taken longer to complete. Founders have needed to look hard at their businesses, including their cash runway, forecasts, capex and assumptions, in order to weather the storm.

PRE-COVID-19 TRENDS

Before the onset of the pandemic, Southeast Asia venture capital deal activity was relatively healthy. Whilst there was a downward trend in terms of deal count (attributable to late-stage VC tech, fintech and e-commerce investments attracting the majority of venture capital funding), aggregate deal value was at record highs.

In addition, the amount of “dry-powder” in the Southeast Asian ecosystem has never been higher and valuations and cheque sizes for early-stage investment rounds had increased significantly from previous years.

Furthermore, Southeast Asia’s start-up ecosystem and, in particular, the internet economy has been rapidly growing at an unprecedented rate.

The internet economy value hit US$100 billion in early 2019[1] for the first time, powered by the rapid increase in financial and consumer engagement in fintech, e-commerce, online media/travel and “super-app” companies capitalising on mobile and mobile-internet first economies.

The companies that were able to tap into these consumer trends proved popular with venture capital investors throughout 2019 with US$16 billion, or two-thirds, of the capital invested going to just nine established unicorn companies: Bukalapak, Go-Jek, Grab, Lazada, Razer, SEA Group, Traveloka, Tokopedia, and VNG.

IMPACT OF COVID-19

The Covid-19 pandemic, which some have called the 'black swan of 2020'[2], will directly or indirectly continue to materially affect business activity levels and operations for start-ups for many months to come.

This 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, ride sharing, workspace sharing, leisure and events sectors given the contraction in consumer activity and government responses to the pandemic.

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 are likely to refrain from investment activities to preserve cash reserves; and financial investors who prefer liquid assets may be much more cautious about their venture capital investment activities.

Covid-19 will undoubtedly deliver winners and losers, and start-ups in the region that remain financially prudent and provide relevant opportunities and solutions could find themselves capitalising on the current situation and the gradual relaxation of control measures in the medium term.

In many cases, Covid-19 has resulted in a pronounced uptick in activity in areas such as e-commerce, online entertainment and social media, online medical and health services, home working and education tools, and non-contact services such as robotics and artificial intelligence, particularly for supply chains and logistics.

For more mature companies in the ecosystem, founders may be under pressure by existing financial investors to accelerate exit plans and go to market, either through sale of non-core assets or through initial public offerings (in order to gain access to liquidity and key capital markets).

However, this may prove challenging in the current environment due to the increased scrutiny on growth companies from the market generally and the perceived valuation gaps between existing investors, who may have over-paid in previous investment rounds, and the market, which may view this as the “new normal”.

GOVERNMENT-LED FUNDING SCHEMES

Across Southeast Asia, we have seen some evidence of government-backed and other stimulus efforts to help mitigate the downturn for start-ups.

For example, Singapore unveiled several measures to help businesses amid the Covid-19 outbreak. These measures include wage subsidies to help businesses keep their workers, deferment in income tax payments for companies, as well as cash payouts. To ease cash flow for businesses, the Singapore government also announced the enhancement of the property tax rebate (for qualifying commercial properties), as well as various existing financing schemes including the Enterprise Financing Scheme's SME Working Capital Loan, the Loan Insurance Scheme and the Temporary Bridging Loan Programme.

The Singapore government has also recently made an additional S$285 million available to finance "promising" start-ups as part of the Singapore government's fortitude budget, which aims to allow those start-ups to sustain their innovation and commercialisation activities in various sectors.

The Malaysian government announced an economic stimulus package on 27 March worth RM250 billion (approximately US$57 billion) which included a microcredit scheme for SMEs. As part of the package, RM100 billion (approximately US$23 billion) will be used to support businesses, including a government guarantee scheme initiative.

In addition, a further RM4.5 billion (approximately US$1 billion) has been ear-marked by the government to support SMEs' short-term financial liabilities. Bank Negara Malaysia has also issued a directive to all banks to grant an automatic six-month moratorium of all loan/financing repayments with effect from 1 April.

In Indonesia, the government signed regulations in lieu of law (*Perppu*) in order to authorise an additional IDR405.1 trillion (US$24.6 billion) of spending from the 2020 state budget, a large proportion of which will be allocated as a social safety net and relief fund for SMEs. The *Perppu* also gave Bank Indonesia authority to disburse sharia short-term liquidity loans or financing for certain systemic or non-systemic banks.

The Vietnamese government issued decrees in March/April which sought to provide a variety of incentives to dampen the economic impact of the Covid-19 outbreak. The incentives included tax breaks, delaying tax payments, and deferring land-use fees for businesses.

The Prime Minister also instructed the State Bank of Vietnam to launch a credit support package amounting to VND250 trillion (approximately US$10.5 billion) for businesses, and instructed the Ministry of Finance to offer a support package of VND30 trillion (approximately US$1.2 billion) for ensuring social security for employees.

IMPACT ON VALUATIONS, DUE DILIGENCE AND DEAL TERMS

For those start-ups that 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 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 any anti-dilution adjustments may need to be considered.

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 the potential impact of Covid-19 on earnings projections, the execution of business plans, material contracts and general working capital/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.

- **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; increases/decreases of authorised preference shares; authorising or issuing 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, typically 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, eg 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 reduce (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] The e-Company SEA 2019 report released by Google, Temasek and Bain&Company, June 2019.

[2] https://medium.com/sequoia-capital/coronavirus-the-black-swan-of-2020-7c....

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