Are We Entering Another “Nuclear Winter” for Venture Capital Financing?

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The U.S. and many other countries are stuck in, or just emerging, from stay-at-home orders that, among countless other consequences, have largely shut down the pipeline for new investment in early stage ventures. According to PitchBook, after a robust investment market in the 4th quarter of 2019 and 1st quarter of 2020, the amount of new financings since the pandemic began has fallen off a cliff, with steep declines in both numbers of completed deals and total dollars invested compared to April 2019. To those of us who lived through previous downturns, this change feels a lot like the dot com bust circa 2000 or the “Great Recession” that followed the global financial crisis of 2008 all over again.

So what lessons can today’s emerging companies learn from past market downturns, and what changes can we expect to see in the market for these investments? Will we return to the days of down rounds and significantly increased negotiating leverage on the part of investors? Or will promising young companies remain attractive as investments for the substantial dry powder in the market, giving founders continued leverage to pit investors against one another to secure the most favorable deal? In large part, it will likely depend on several key factors, such as how long we are forced, or choose, to live in a world of social distancing, when we can safely return to frequent business travel and in-person meetings and how much long-term damage the pandemic inflicts on various elements of any given business’ operations, such as supply chains, labor, other costs and customer demand for a company’s products or services.

Venture capital and early-stage finance is a highly personal business – investors like to get to know the team they are investing in, and they also like to do significant diligence on the product and its potential market. The latter may still be possible, although less predictable in a volatile market. The former becomes significantly more difficult when you cannot meet in-person. Zoom and other virtual conferences simply are not the same as spending a few days or weeks in person with the founding team. Further, the volatile public markets and impossibility of rationally valuing companies makes the potential runway needed from investment to sale more unpredictable, and most likely longer in nearly all cases.

While far from exhaustive, some key items that entrepreneurs should be thinking about in this type of environment are (i) how to work with existing investors to increase their company’s runway with respect to any cash in the bank, (ii) what can be done to negotiate with vendors and licensors to ensure continuity of business and limited disruptions to necessary components of goods and services sold by the company, (iii) addressing stock options and employee equity incentives that may now be under water due to decreased valuations and (iv) how to address and safely rebound from any work interruptions or furloughs.

For example, companies that raised significant funding in the months leading up to the current pandemic should be best positioned to survive. They may even be positioned to thrive and extend their expected runway if that funding anticipated increased hiring, which may now be available at lower cost. But for those that were nearing the end of their current runway and planning to raise in the 2nd or 3rd quarters of 2020, they will need to revise spending plans to conserve cash, and likely should raise as little as necessary in the near term to ride out the disruption.

Of course, the uncertainty of how long the current disruption will last could make accurate runway projections nearly impossible. When searching for equity investment dollars in a scarce market, most emerging companies will need to be patient and willing to accept terms that may not have been "market" just a few months ago. In past downturns, we frequently saw investors look to reduce risk and boost returns with participating preferred stock, high accruing and compounding dividends, multiples on liquidation preferences, redemption rights, tranched investments with milestones, strong investor controls over operations (including tying use of funds to strict budgets) and stronger downside protection, even including full ratchet anti-dilution in some cases.

These types of terms may sound crazy to founders who have become accustomed to more recent market norms and intense competition among investors for deals, all of which resulted in a hard fought balance between founders and investors where certain terms had become widely accepted standards, such as 1x liquidation preferences without participation rights, broad-based weighted average anti-dilution, more limited preferred stock protective voting rights and no fixed or accruing dividends. Given the likely continuation of limited travel and social distancing, we expect longer diligence cycles to become common and investors will likely want to conduct more in-depth diligence in certain areas, meaning that founders will need to allow more time (both in terms of process length and their personal involvement) to complete a raise. While not wanting to give away the store, realistic negotiations that balance the interests of both sides will be the key in many cases to saving the strong early stage ecosystem that has developed in the U.S.

Although we expect that, overall, investors will become more conservative and therefore new investment will be scarcer, attractive companies may have no trouble finding capital. Even in this case, the terms offered are likely to follow the market in many ways, which suggests that even these "hot" companies should consider the broader market, and likely take only an amount of funding they will need to execute in the near term. Remember that Airbnb was formed in 2008 and successfully navigated the Great Recession. So it is a safe bet that new companies will continue to emerge, especially in sectors that have seen increased interest as a result of the pandemic, such as remote work, telehealth and the privacy and cybersecurity issues resulting from such trends, and those investors who recognize them early will look like the next group of prescient investors.

If you have questions or would like additional information, please contact Lori Smith (smithl@whiteandwilliams.com; 212.714.3075), Josh Galante (galantej@whiteandwilliams.com; 212.868.4836) or another member of the Corporate and Securities Group.

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