Dealmaking in the Downturn

CVCA Presentation

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FASKEN

CVCA
CANADIAN VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION

Introduction and Overview

Are economic headwinds and geopolitical unrest propelling us into a rocky start to 2023? Join our panel of experts as we explore ways to get the deal done in this difficult environment.

A. **Trends in Fundraising** [Jonathan Halwagi]
B. **Venture Capital T&Cs** [Jonathan Conlin]
C. **Private Equity M&A** [Caitlin Rose]
D. **Financing with Tighter Credit Conditions** [Angela Onesi]
E. **Workforce Considerations** [Karen Sargeant]
F. **Restructuring Considerations** [Stuart Brotman]
G. **Governance Considerations** [Shahrooz Nabavi]

Trends in Fundraising

1. Uncertain Times Trigger Caution
   a. With the public market downturn, institutional investors especially pension plans are slower to commit to new investments as they
      i. assess their relative exposure to private and public strategies,
      ii. take another look at the valuations of private investments, and
      iii. try to predict future volatility.
   b. Fundraising targets which were on the rise in 2021 and early 2022 were slowly falling in late 2022. We expect this trend to continue in 2023.
   c. Caution ≠ Standstill: we are still seeing appetite, but for lesser amounts and for familiar products.
   d. ESG-focused products are still attracting interest.
   e. The uncertain economic environment benefits established managers with strong track records or managing ESG-focused strategies.

> Nugget: Asset managers will need to adjust their expectations and be more patient as we expect fundraising to take more time.

Trends in Fundraising (con't)

2. Impact on Fund Terms
   a. The fund terms pendulum continued to swing favorably to the benefit of managers in 2021-2022.
   b. We have already stated seeing a move to the benefit of investors in late 2022 and early 2023 as manager faced with uncertainty on fundraising accept more concessions in order to close transactions.

> Nugget: Asset managers can expect pressure on management fees and other fund terms (ex. governance and transparency requirements) as investments by institutions become scarcer and slower.

Trends in Fundraising (con’t)

3. Alternative Strategies
   a. Other than a notable increase in private debt funds (from mez to senior secured), we have not yet seen a notable shift in proposed strategies.
   b. If the downturn becomes more pronounced (and extended), we would normally see the emergence of “downturn strategies” (opportunistic funds).

> Nugget: As fund strategy trends go, we have seen a reaction to rising interest rates but have yet to see a move towards opportunistic strategies.

Venture Capital T&Cs

1. Valuation – Bridging the Gap

a. Many founders still have valuation expectations that are derived from peers raising during the frothy 2020 – early 2022 period.

b. Further, many companies are now trying to raise a Series A or Series B at a valuation that represents a premium to their previous round, which itself may have been completed at an arguably unsustainable valuation.

c. Investors, meanwhile, are dealing with write downs in their portfolios and supporting existing investments. Growth stage financings and the capital markets are revealing that many early stage investments may have been overvalued.

> Nugget: Investors need to educate company builders about the current state of the market, with data, to arrive at a mutually agreeable valuation. Good companies will continue to get financed. Companies with poor unit economics, or in unproven sectors, likely will be asked to ‘go back to the drawing board’ before raising institutional money. Further, expect warrants to be used more frequently as a bridge to get investors a requisite piece of the company’s cap table for their cheque size.

Venture Capital T&Cs (con't)

2. Protecting the Downside

    a. In the last three years, a relatively standard set of legal terms have dominated venture financings. Certain of these terms – anti-dilution rights, liquidation preferences and dividends – have settled into somewhat company-friendly 'norms'.

    b. Investors are revisiting these terms to see what tools are available to protect their capital and try to have better visibility to a baseline return.

    c. Company builders may be more willing to negotiate on these terms if they achieve their top line valuation.

    d. This higher 'hurdle' for companies to jump over in the future may create a problem down the line if headwinds maintain or increase.

> Nugget: We predict a return to more investor-friendly legal terms in venture financings. Specifically, the use of liquidation preferences greater than one times non-participating and the use of cumulative dividends. We believe companies and investors will find mutual agreement on these terms especially in instances where investors may feel they are investing at a premium as mentioned above.

Venture Capital T&Cs (con't)

3. 'Preventing the next FTX' vs. 'Time Kills All Deals'

   a. With a renewed focus on fundamentals in the investment decision making process, the expectation is that investors will require more tangible evidence of company performance to underpin a valuation.

   b. Therefore, we expect many investors may understandably wish to play the 'wait and see' approach, both before and after signing an LOI and entering exclusivity.

   c. Further, the recent FTX saga will generate a renewed emphasis on a robust due diligence process. This will increase time, cost and management's bandwidth.

   d. We further expect companies will be alive to this and will therefore try to drive a fast process to reduce deal execution risk. Companies will need to ensure the due diligence process does not become 'let's wait and see if the company can hit its next business milestone before we invest'.

> Nugget: Deals undertaken on a fast, focused timeline will get done in 2023. Deals where investors use the post-LOI period to wait until the company hits its next business milestone (rather than just complete DD) will often die on the vine. Expect companies to drive pace as a result.

Venture Capital T&Cs (con't)

4. The True Value-Add Investor
    a. Increased accountability is coming for companies, particularly at the early stage when they don't have a track record.
    b. Company builders will therefore expect that investors contribute their expertise, primarily in the board room but also with introductions assistance with customers and talent acquisition.

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Private Equity M&A

1. Shifting of the balance of power
   a. Buyers were moving fast, accepting terms (e.g. true “clean walk”, limited conditionality). Expect a swing back towards center. As a buyer, should be able to ask for those specific indemnities
   b. Keep in mind a good asset is a good asset, and there are arguably less targets (since as a seller, if you have the choice not to sell, you might opt for status quo) so still can’t be too aggressive
   c. Canadian positioning for a buyer is an interesting one: while cost of capital is high, and interest rates are soaring, the Canadian banking system is not “closed for business” in the same way Europeans and Americans are approaching it so there may be some opportunities for Canadians to be more competitive
2. Bridging the valuation gap
   a. Still a gap between seller expectations and buyer valuation. Use of earnouts to be expected, balance of sale and other mechanisms to get to alignment.
3. Value creation initiatives = acquisition opportunities
   a. Carve out deals, privatizations, minority investments

> Nugget: Deals will get done. The amount of dry powder out there combined with poor capital markets performance, a focus on “value creation” initiatives, and certain companies in distress due to inflation, supply chain challenges, a tightening of the credit market and geopolitical unrest will make for some matches made in heaven. Be patient and seek out the diamond in the rough.

Financing with Tighter Credit Conditions

1. Transitioning to Tighter Credit Conditions
   a. Financial institutions are being more selective in whom they lend to and for what deals. Leveraged deals are undergoing greater scrutiny so lenders need to be approached with this in mind.
2. Tips to Gain Credit Approval
   a. Use earnouts, other appealing structures to minimize financing risk upfront
   b. Manage financial covenant breach risks and operational risks – build in hedges, equity cures and liquidity reserves for revenue crunch periods
   c. Use the carrot of ESG and sustainability initiatives
3. Alternative Sources of Financing
   a. Consider private credit, ABLs, bridge financing

> Nugget: Despite tighter credit conditions, financing will be available from lenders if deals are structured to mitigate perceived risks to them but more time needs to be built in for credit approvals.

Workforce Considerations

1. Size of workforce may depend on size of Fund
2. Increasing the Workforce
   a. Hiring talent
   b. Retaining talent
      i. Importance of equity compensation
      ii. Work-life balance
3. Downsizing
   a. Voluntary Measures
   b. Involuntary Measures

> Nugget: Being in tune to employee aspirations will help attract and retain talent. Where a workforce reduction is in order, there are many options available.

Restructuring Considerations

1. Distress in the portfolio:
   a. Mandates more regular and detailed monitoring of future obligations and available liquidity
   b. Assumptions based on historical access to capital are less reliable
   c. Active consideration of restructuring alternatives while there is ample liquidity to execute is advised
2. Opportunities in distress:
   a. Distress in the market drives opportunities as troubled companies seek acquisition and investment partners
   b. Timelines are compressed and expect increased competition
   c. New players and competitors (restructuring advisory firms, special situations bankers, bridge and other high return lenders)
   d. Insolvency specific deal structures: asset sales via traditional vesting orders, share sales by reverse vesting transactions (a uniquely Canadian tool), plan funding approaches, stalking horse transactions and loan-to-own opportunities

> Nugget: Founders in distress often over-estimate the likelihood of securing further funding. Sponsors should bring a healthy level of skepticism to management's expectations, keep a close eye on future liquidity and be open to considering strategic (including restructuring) alternatives. Distress advantages those with capital and can open the toolbox to unique and potentially value supportive structures.

Governance Considerations

1. Directors' Fiduciary Duties

a. As the market moves towards more down-round or distressed financings or structured transactions, typically there are broader and more challenging considerations for Board of Directors to consider as they exercise their judgement in discharging their duties as directors.

b. Generally, directors' duties are two-fold:

   i. the duty to act honestly and in good faith with a view to the best interest of the company - commonly referred to as the "duty of loyalty"; and

   ii. the duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances – commonly referred to as the "duly of care".

c. Duty of loyalty and duty of care are often referred to as "fiduciary duties" and these duties are owed to the corporation (the entire enterprise) and not to self or a subset of the shareholders.

d. Various statutes (such as corporate, employment, environmental and tax statutes) impose statutory duties (and hence liability) on directors.

> Nugget: Directors' fiduciary duties apply all the time but in more challenging transactions there is often a heightened focus on these duties as there are more difficult decisions to make - decisions may have broader and far-reaching implications on different groups of stakeholders or impact may be disproportionate between different groups.

Governance Considerations (con't)

2. Application of Duties and Considerations

a. In insider-led transactions or in transactions where all directors have a conflict of interest, directors' decisions are more likely to be scrutinized, particularity if terms are overly investor-favorable or terms punitive to existing shareholders.

b. If a corporation is close to insolvency, and following, the relative importance of stakeholders other than shareholders, such as creditors and employees, is increased, since the economic value of the shareholders' interests is (arguably) nominal once the corporation is insolvent.

c. Business Judgement Rule - Deference is given to Board's decisions if a decision is reached in an informed basis within a range of reasonable alternatives after the Board has taken into consideration the interests of all and made all reasonable inquiries to be well informed.

d. There is no "bright line" test to determine if directors applied appropriate "business judgement". Circumstances and facts matter and are key. Process is important and evidences the Board's discharge of duties!

> Nugget: Directors nominated by investors wear different hats and in discharging their fiduciary duties, directors must be mindful of which hat they are wearing and to be careful to not act in a manner or use language that suggests they are acting in a self-interested manner or not giving meaningful consideration to the impact of a transaction on all.

Governance Considerations (con't)

3. **Board Process Matters**

   a. Consider process early - It is more difficult to discuss proper process when discussions have been active for a period of time or where company is near insolvency.

   b. Hold regular meetings, start early and fully discuss all alternative paths to a proposed transaction

   c. Engage input and perspectives from experts and professionals – lawyers, accountants, investment bankers.

   d. Assess comparable market transactions.

   e. Provide shareholders and creditors with a right to participate and provide a reasonable period for them to decide.

   f. Provide fulsome disclosures to shareholders and other stakeholders as to exactly what is changing and the implications of a transaction on the go-forward cap table / rights.

   g. Take good minutes. Document the process and deliberations. More fulsome to show that the board considered and deliberated and exercised care in arriving at decisions.

   h. Directors should declare any conflict of interest and abstain from Board deliberations and voting.

> Nugget: Good process is often a Board's best defense against a claim that appropriate diligence was not carried out by the Board in discharging its fiduciary duties.

Contact the Fasken team

Jonathan Halwagi
Partner | Fund Formation & Alternative Investments
+1 514 397 5226
jhalwagi@fasken.com

Shahrooz Nabavi
Partner | Co-Leader, TMT
+1 604 631 4910
snabavi@fasken.com

Jonathan Conlin
Partner | TMT, M&A and Private Equity
+1 604 631 3237
jconlin@fasken.com

Caitlin Rose
Partner | Co-Lead, Private Equity
+1 514 397 5277
crose@fasken.com

Karen Sargeant
Partner | Co-Leader, Labour, Employment & Human Rights
+1 416 868 3475
ksargeant@fasken.com

Angela Onesi
Partner | Co-Leader, Banking and Finance
+1 514 397 7681
aonesi@fasken.com

Stuart Brotman
Partner | Leader, Insolvency and Restructuring Group
+1 416 865 5419
sbrotman@fasken.com

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