Turnaround Strategies for Distressed Venture-backed Tech Start-ups, Living to Fight Another Day

Abdullah Mutawi - Partner, Head of Corporate Commercial - Corporate / Mergers and Acquisitions / Commercial / Private Equity / Digital & Data / Turnaround, Restructuring and Insolvency / Venture Capital and Emerging Companies

- Dubai International Financial Centre

MENA tech start-ups and the COVID Cash Crunch

While there is no doubt that the Covid-19 pandemic had a very negative impact on the global economy in 2020, a cursory review of global stock markets will show 2020 as a vintage year for the technology sector with a wall street bull-run that added billions of dollars of 'value' to the FAANG and 'tier 2' tech companies and saw the word's first trillion-dollar valuations, also in tech.

For the vast majority of tech companies however, 2020 created enormous uncertainty and a fair amount of distress. This was particularly the case in Q1 and Q2 when lock-downs and hyper-cautious cash preservation strategies meant that companies in all sectors were slashing costs to keep their heads above water and venture finance was in meagre supply. No more was this visible than in the early-stage tech company sector.

A fundamental principle of running a tech start-up is that entrepreneurs are expected to utilise as much of their seed or Series A cash as possible on the pursuit of building, testing, iterating, launching the tech/product and on driving customer acquisition, engagement and stickiness post-launch. They are not expected to draw higher than subsistence salaries or indeed to pay their employees generous salaries either. The founder's equity and ESOP pools are meant to take care of that. In most tech verticals, start-ups are also not expected to make a profit for many years while they throw everything at growth and, in some cases, growth is driven in the early years by spending money to acquire customers that don't even generate revenue. So, while bricks and mortar SMEs were able respond to Covid-19 by cutting costs, this was not a straightforward exercise for tech start-ups.

Another key factor when looking at tech start-ups is to understand the dynamics of funding and running an early-stage company. Delicate navigation is required to balance the objectives of spending to grow and not spending so much that you run out of money before your next fund raise. This is the foundation upon which venture capital is built. Founders wanting to protect their equity against over-dilution in the early stages of the company's life frequently limit the size of their fund raises to only the cash they think is necessary to hit the KPIs enabling them to achieve their targeted next valuation. This means precious little spare cash for contingencies.

When an unforeseen event like Covid-19 hits them, most tech start-ups have nowhere obvious to turn beyond cancelling salaries altogether and cutting back or further bootstrapping on the tech and product. And those strategies can only be sustained for a very short period of time which means that many companies face the prospect of running out of cash and having to fold. When this scenario arose with Covid-19, the path to survival for many companies meant looking to raise funds at short notice in an environment where funds themselves were uncertain about what was going to happen next and were not readily reaching for their cheque books.

Is death inevitable?

In the MENA region there were many examples of companies hitting a wall and having to fold. One example of a successful turnaround, which actually took place just before Covid-19, was that of logistics start-up Fetchr which was saved from bankruptcy at the 11th hour by an emergency injection of cash enabling it to restructure and turnaround the business.

In its early days, Fetchr was one of the darlings of the regional tech start-up scene, having raised over USD 50 million in venture funding including a USD 41 million Series B equity financing which was one of the largest rounds for a Middle Eastern start-up at the time. Unfortunately, various factors led to a catastrophic cash crisis at the company and its management ended up being days away from placing the company into a formal insolvency process when the rescue package was concluded.

However, turning around a company in that situation required enormous focus by the turnaround team and management. The mechanism by which the liquidity was raised was an equity down-round with a ‘pay-to-play’ mechanism that resulted in any existing shareholder declining to participate in the financing being diluted to almost zero.

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Down round equity financing

Venture capital financings typically follow a common pattern of equity funding rather than debt financing as tech start-ups do not have the commercial dynamics that would enable them to raise debt (with the exception of venture debt which is beyond the scope of this article). An initial ‘seed’ round (more often than not raised on convertible instruments rather than share issuances) will be followed by Series A, Series B, Series C rounds and sometimes beyond. Each such round will confer preferences with the shares issued including anti-dilution rights and liquidation preferences in increasing order of seniority. The expectation of founders and investors alike is that in each subsequent round, the price per share will increase (an ‘up round’) consequently reducing the dilutive impact of that subsequent financing on the shareholdings of those who have invested earlier and, crucially, the management and employees with stock options.

A down round financing is a priced-equity financing round where the price per share is lower than the price per share paid by investors in a previous financing round. Due to the equity-dilutive and negative psychological impact a down-round can have on investors and employees of the company itself, a down-round will generally be the last resort after alternative strategies such as cutting expenses or divesting non-critical assets (if there are any) have been considered and eliminated.

‘Pay-to-Play’

When a down round is being led by existing investors in the company, the existing investors may insist that other existing investors participate in the financing. The rationale being that if they are prepared to write a further cheque when the company is at the point of failure, they want other investors to either stump up the cash or accept some negative consequences which can range from punitive (e.g. a mandatory conversion to ordinary shares thereby stripping those shares of any preferences) to existential (e.g. wiping those shareholders out through the participating investors being able to invest their funds at a nominal pre-money valuation).

Navigating the down round

If the investors agree that a down round is the only viable option, there will typically be a race against time to get a deal done and funded before the company hits the wall. In scenarios such as this, there are a number of important considerations and issues the deal sponsors will have to keep in mind.

Rights Under Shareholder Agreements

Sponsors and their counsel should review the applicable governing documents of the company to assess all the applicable rights accruing to shareholders, sometimes multiple layers of rights depending on how many share classes are involved. They will also need to establish what consents are required to effectuate a new equity financing; again, this can be complex and layered as an insolvent tech start-up that has raised multiple equity rounds in the past will have multiple sets of consent from each share class. Counsel should also advise on whether other restrictions may exist that could block a new equity financing.

In addition to the governance dimensions of shareholder agreements, there are also likely to be significant issues around the economics of a down round and the triggering of anti-dilution mechanisms. Anti-dilution mechanisms are very common in venture backed SHAs and they have the ability to complicate things pretty quickly in a down round due to the effect of an anti-dilution clause being triggered on the conversion ratio of preferred shares to common shares. While a deep analysis of how anti-dilution mechanisms is beyond the scope of this article, the key point for the sponsors of a down round to consider is how anti-dilution is dealt with in their overall restructuring/turnaround strategy.

Typically, investors in a down round will be existing investors. But it is almost certain that any new investor(s) participating in the financing will insist on the waiver by the existing preferred shareholders of their anti-dilution rights. Moreover, the new investors will most likely insist on a preferential anti-dilution formula such as a full-ratchet formula rather than the more common broad-based weighted average formula to apply to the new round. These issues are not insurmountable but sponsors and their counsel should be aware that emotions and tensions will always run very high in a down round scenario and they should have a robust and watertight negotiation strategy so as not to waste precious time in negotiations in the limited time available before the money runs out.

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If the team is good, take care of the team

In cases like Fetchr, where an aggressive root and branch restructure of the business is the only hope of reversing the death spiral, it is inevitable that the senior management will be an immediate casualty needing to make way for an external team with the experience and expertise to execute the turnaround plan. Turnaround teams and down-round investors need to be decisive and swift in executing the plan.

But there are plenty of scenarios where the investors might still believe in the management team despite the company running out of cash or may feel, for whatever reason, that retaining the team is their only chance of seeing a return on their investment. In such situations the sponsors of a down round have to be conscious of the impact the round will have on the team and, in particular, understand the way in which any anti-dilution rights (see above) in the shareholders' agreement will impact the value of the management team and employees' shares. If the operation of the anti-dilution right has the effect of materially reducing (or wiping out) the upside for the team, this is going to kill the team's motivation to stay on.

Retaining the team in such situations might involve cash payments or equity incentives or a combination of those. In many down round situations, the sponsors and investors of the round will agree to an adjustment of the founder/employee stock options by creating a fresh ESOP pool that will be allocated after the round is closed and the effects of dilution have taken place. In situations where short term emergency cash is required to stave off insolvency proceedings, the sponsors of the round may agree to significant equity incentives that would vest upon the completion of certain turnaround milestones such as closing an initial 'breathing room' tranche to keep the company afloat while restructuring takes place followed by a further significant equity allocation upon closing a second investment tranche once the restructuring is completed within a specified timeframe. This type of arrangement certainly aligns incentives and provides the investors with some protection in the event that the turnaround team is not able to execute on its immediate mission.

No matter what structure is used to adjust employee incentives, the employees themselves have to believe in the turnaround plan and that the company has a viable and realistic strategy to save the company from the death spiral, re-establish value-creation and ultimately to achieve an exit. If the sponsors of the round have a strong belief that a strong exit is viable in the short to medium term, they might also consider a management carve out plan that carves out a small portion of the exit deal proceeds and allocates those contractually to the management team. The reason for doing this is to circumvent the liquidation preferences in the SHA so that management get incentivised with a 'top slice' of deal proceeds. If the management team believe in the possibility of the exit in the short to medium term, this is a highly motivating tool but requires expert knowledge to structure and negotiate. And it will be another element of the restructuring that will almost certainly require shareholder approval along with all the other approvals such as waiving pre-emptions, anti-dilution rights and so forth.

Fiduciary duties

Generally speaking, in all its major decisions, a board is required to exercise fiduciary duties to act in the best interests of the company. It might be easy to assume that a decision that will save the company from bankruptcy is preferable to allowing the company to collapse with the presumption that such a decision is consistent with fiduciary duties.

MENA tech start-ups are usually structured with a ‘holdco’ domiciled in a common law jurisdiction such as Delaware, Cayman, BVI, ADGM or DIFC. There are almost always one or more wholly-owned ‘opcos’ sitting in each of the countries where the company is operational. In MENA, we often observe that the same board members may sit on a holdco board at say Cayman or Delaware level in addition to sitting on an opco board in the UAE, KSA or Egypt. When considering a down-round, sponsors and their counsel will need to consider not only the law at the holdco level applicable to the proposed down round but also but also to the relevant laws where the directors reside and work.

For example, under Article 68 of the UAE Bankruptcy law, a Company must petition the court to commence bankruptcy proceedings after 30 consecutive business days from it either being unable to pay its debts when they fall due or being balance sheet insolvent. If the directors or senior management team fail to initiate the prescribed procedures under Article 68 of the Bankruptcy Law, this could be regarded by the UAE court as “mismanagement” of the company within the meaning of Article 162(1) of the Commercial Companies Law (‘CCL’) as recently amended wherein directors and executive management are potentially liable towards the company, shareholders and third parties for all acts of fraud, abuse of authority, breach of the provisions of the CCL or the company’s articles of association, and mismanagement.

At the Cayman and Delaware level (the level at which equity financings are raised) lawyers advising companies on down rounds have to consider the rise in equity holder litigation associated with down rounds and the decision-making that led to such financings taking place. Such cases have focused on the duty of care imposed on a board to follow a process of due consideration such as whether the board considered all reasonably available information, was appropriately engaged, and evaluated available alternatives. Litigation in those jurisdictions has also focused on conflicts of interest and challenging whether members of a board acted for the purpose of advancing the interests of the company and its shareholders or whether they have been motivated by a conflicting interest.

Legal frameworks will be very different across these legal systems but the sponsors of a down round and their counsel will need to be very clear on what duties are owed by the directors (and in some cases shareholders with management control) of a company and to whom those duties are owed. The applicability and meaning of applicable national law will also need to be tested and provided for.

Conclusion

The above considerations are headline items and barely scratch the surface of the myriad issues and challenges that the sponsor of a turnaround strategy and possibly a down round will need to navigate.

The most important thing to remember is that when cash is running out fast, the clock is ticking and the deal needs to be structured, papered and closed very rapidly indeed. Sometimes in a manner of days. There is no time to waste and the sponsors of the down round and their counsel are going to have to be prepared for multiple simultaneous discussions with relevant stakeholders and, more often than not, their legal counsel. It is not just a race for structuring, papering and procuring the relevant consents. The ‘buy-in’ is equally important and sponsors could do worse than having someone in charge of the comms strategy who is incentivised to do all the relevant communications to ensure that they get the deal done.

Finally, appointing the right legal counsel is also critical to the success of a turnaround because the strategy has failed the moment a technical insolvency comes into existence. Knowledge and assuredness at the holdco level is not sufficient. Local laws need to be heeded and boards need to ensure that there is no insolvent trading at the opco level or failure to adhere to local laws even where the financings and the down round itself is taking place in a different holdco jurisdiction.