What solutions for Startups Affected by COVID-19 in Their Search for Financing?

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The impact of COVID-19 is particularly strong on start-ups in need of short-term financing and venture capitalists, whose contribution is essential to support the growth of these companies and who must make investment decisions in a context of widespread uncertainty.

Like others, we have noticed the slowdown in investment activity and that many start-ups are now finding it difficult to close rounds of financing or even get time or attention from potential investors.

In this context of uncertainty, we advise entrepreneurs who anticipate the need to soon close a round of financing to consider the following items:

Current investors

First and foremost, it is vital to consider the rights of your business's current investors, contained in corporate documents and agreements between the investors and the corporation, as they could impact your round of financing's feasibility. For example, if a valuation was obtained a few months ago and it is presently impossible to find a new investor to offer to purchase the corporation's shares at an equal or higher valuation, the consequences of proceeding "down round" will have to be considered. In some circumstances, the success of a new round of financing may even depend entirely on existing investors' support and consent.

It is also possible that, under certain conditions, existing investors may be willing to take a share of the risk faced by the corporation by participating in a new round of financing, thus eliminating the need of seeking funding from new investors.

Lastly, especially if one of the current investors is a venture capital fund or an active investor, it is likely that the corporation has agreed to specific milestones with that investor that could add to the difficulty of operating the business during a pandemic (for example, aggressive sales or production growth targets). But it is possible that your investor will be understanding and accept to review these milestones and associated timelines, which could lead to a positive impact on the corporation's burn rate and give it more leeway to weather the crisis.

In all cases, we recommend transparency between the corporation and its investors, adopting a "partnership approach" and, above all, not to try to hide the corporation's situation in its communications with its investors.

Potential investors

If there is no other option than seeking funding from new financial partners, it will be crucial to know the current situation of any targeted potential investor. As the current pandemic situation affects everyone, understanding the constraints faced by a potential investor is key in order to optimize the search for financing and the pitch process.

For example, if the potential investor has a specific investment thesis or policy, the investor may be even more thesis-driven and show less flexibility than before. Conversely, the investment thesis may be undergoing a re-evaluation.

In addition, many potential investors will be impacted by the type of clients they serve. For example, a fund manager whose clients are government institutions may still have as much capital to deploy in the current context as before Covid-19, unlike a fund manager whose clients are high-net-worth individuals who face uncertainty and liquidity problems themselves and put pressure on the fund manager to take a more conservative stance.

So, more than ever, you need to target your approach and make sure your potential investor is available to enter into a transaction in the near future.

Assistance programs

The various levels of government and some Crown corporations have released several assistance programs. In the context of a funding round, Export Development Canada ("**EDC**") and the Business Development Bank of Canada ("**BDC**") both announced co-investment assistance programs to provide access to additional financing for start-ups that already have a certain level of support from private investors.

These programs are a good opportunity for entrepreneurs who need to complete or initiate a round of financing, who are not eligible for certain other government assistance programs, and who are not generating enough cashflow to finance their activities through credit facilities on conditions that are viable for their business.

The program announced by EDC proposes a co-investment by EDC of an amount equivalent to that considered in an eligible round of financing, up to a maximum of $5,000,000.

As for the program announced by the BDC, the BDC Capital Bridge Financing Program also provides assistance in the form of co-investment in an amount equivalent to the amount the company receives from qualified investors:

1. BDC will offer financing as convertible notes whose default terms include a 20% discount rate on the price per share of the next round of financing and a term of three years.

   BDC may, however, decide to deviate from these terms and invest under the same conditions as the investors leading the round of financing.

2. The company receiving the investment must be Canadian and have raised $500,000 in external capital in the past. It must also have a proven business model and an existing customer base prior to the impact of COVID-19.
3. The business must have been "specifically impacted by COVID-19." Unlike some other government assistance programs, this one does not have a fixed scale relative to this criterion. Businesses can demonstrate how the current situation affects them through qualitative and quantitative indicators (e.g. disruptions in their supply or distribution chains, difficulties in getting paid). The important thing will be to show that the lack of cashflow and the difficulty of concluding a round of financing are related to the impact of COVID-19 and not to a situation inherent to the company.
4. The round of financing for which co-investment is being sought must have started after February 1, 2020.
5. The round of financing must be for a minimum amount of $250,000 (prior to investment by BDC) and the overall round of financing must ensure 18 months of runway before additional funding is required by the company.

   For example, a business with a monthly operational burn rate of $30,000 and $300,000 in financing would meet this criterion since (1) the round, prior to BDC investment, is over $250,000, and (2) the overall round of financing, including co-investment by BDC, would be $600,000 and would ensure 20 months of runway, based on its current burn rate.

6. There are no fixed criteria for determining who is an "eligible investor." We understand, however, that the investor must be a private firm that has demonstrated its capacity as a lead investor for the funding round in question its ability to conduct the due diligence process. The investor does not have to be Canadian but must be sufficiently known and credible in Canada.

We consider this convertible note financing offer to have three main advantages in the current environment:

1. It increases the total "post-financing" value of the business in the form of additional cash, and the size of the funding round without increasing the principal investor's risk, thus making the investment more attractive.
2. It avoids immediate valuation issues for the company, allowing the lead investor to maintain control over the valuation process through the funding round.
3. It is relatively simple, quick and inexpensive, and should not make the transaction process more complicated or burdensom for the lead investor.

In short, these co-investment-based assistance programs are appealing as they can be presented to an investor by a company with financing needs whose planned or ongoing funding round is currently at a standstill due to the situation created by COVID-19.

The programs may also be interesting elements to consider for an investor who wishes to have a co-investor or who would like the round of financing to reach a certain threshold to ensure that the company being invested in has sufficient runway after the investment, especially in the current context where it is difficult to predict subsequent rounds of financing.

However, the parties wishing to benefit from such programs will have to ensure that their situation meets each program's criteria and that they evaluate the financing terms offered as part of the assistance program in the context of the transaction.

Conclusion

Start-ups currently in need of financing should first discuss with their existing investors to try to find room for manoeuvre and assess the possibility of quickly obtaining financing, part of which could come from one of the assistance programs available.

In all cases, it will be necessary to measure the impact that additional funding from new investors could have on the rights and obligations that exist between the corporation and its current investors and to ensure that it does not trigger any particular rights or recourse or create ambiguities, contradictions or even events of default.

For more information in this regard or to find out about other measures that could help your business, do not hesitate to contact the Lavery team.

Our team is following current developments related to COVID-19 very closely in order to best support our clients and business partners. We invite you to visit the web page that centralizes all of the tools and information produced by our professionals.