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Startups Face Uncharted Waters As Funding Dries Up

By **Tom Zanki**

Law360 (March 27, 2020, 2:56 PM EDT) -- The coronavirus outbreak is crimping venture fundraising, forcing cash-hungry startups to consider hard choices that could require delaying capital raising, slashing expenses, or accepting more investor-friendly terms if they pursue a financing round.

Lawyers who advise private companies say the impact varies by industry — certain sectors are faring better amid the uncertainty — and existing deals are still getting completed as parties finalize negotiations remotely. But starting new deals, a process that requires site visits and in-person communication, is more daunting given travel restrictions.

Plus, venture firms are expected to become more selective in who they back amid this volatility.

"On the startup side, there definitely will be a slowdown in activity," Stradling Yocca Carlson & Rauth PC shareholder Ryan Azlein said. "We're seeing startup clients hunkering down, making sure that they are conserving cash and getting through this period of time. It's more survival mode."

Venture capital database CB Insights Corp. is projecting that global funding to private companies will total $77 billion for the first quarter, which would mark a 16% drop from the fourth-quarter 2019 total of $92 billion. Seed-stage funding, a startup's first official equity funding stage, is expected to drop 22%, according to CB Insights.

"The acute decline in seed-stage deals can be attributed to compounding economic factors — including uncertainty due to the spread of coronavirus," CB Insights said in a March 20 brief. "Seed investments from larger VCs are drying up as they redirect their attention from deal sourcing to managing existing portfolio companies."

CB Insights said investors of all stripes are protecting returns by shifting investments into safer assets, including bonds and gold. Using past outbreaks as indicators, the venture capital researcher said it expects private funding to continue its decline over the rest of the year.

Venture capital giant Sequoia Capital issued a letter earlier this month to startup founders and CEOs that likened the new coronavirus to a "black swan event" — a term for an unpredictable event with severe consequences. Sequoia cautioned companies to conserve their cash, scrutinize expenses and temper their fundraising expectations in order to navigate this period, according to a letter published to its Medium blog.

For companies able to complete funding rounds, lawyers note that startup founders may have to settle for terms more amenable to investors. Such shifts could result in lower valuations — meaning investors gain more ownership for the same dollars — and smaller deal sizes.

As venture financiers more selectively deploy capital and companies compete harder for cash, issuers may be forced to make concessions on deal structure. Investors may bargain for certain protections in this environment, including multiple liquidation preferences or redemption rights.

Lawyers say that venture capitalists seeking seats on a company's board of directors or the right to block certain transactions without their consent will have more leverage in this climate.

"There will still be [funding] opportunities, but it will be more competitive," said Covington & Burling LLP partner Brian Rosenzweig, who co-chairs the firm's securities and capital markets practice. "The terms of the rounds are likely to be less founder-friendly than they have been in recent history."

The bargaining position of companies also varies widely by industry. Startups tied to leisure, travel and event planning are hardest hit. Companies in these sectors are more likely to find themselves hunkering down in order to conserve cash.

Azlein noted that a client that provides technology for event producers recently reduced staff. Separately, corporate-travel startup TripActions Inc. reportedly laid off hundreds of employees as business activity plummeted since the coronavirus outbreak, according to the Wall Street Journal.

Prospects are brighter for sectors whose services are sought after in this period. With much of the country living under varying levels of quarantines and social-distancing requirements, lawyers note that companies providing remote health care services and work solutions are in demand. Shares of video conferencing startup Zoom Video Communications Inc., a venture-backed company that went public last year, have more than doubled since Jan. 1.

"Those companies are out raising money and are able to do that at attractive valuations," Goodwin Procter LLP partner Joe Theis said. "At a more general level, if you are not in one of those sectors, then the prospects of near-term financing are pretty remote."

Startups could also consider debt financing before pursuing a venture round. But Fenwick & West LLP partner Mark Leahy noted that lenders may be cautious, limiting loans to companies that have strong venture capital support or that possess enough cash to last several quarters.

"There always were hurdles to be able to get venture financing," Leahy said. "The hurdles moved up."

Stradling shareholder Christopher Ivey said he is advising clients to take this moment as an opportunity to reassess their weaknesses and business risks. A startup temporarily laying off workers might reconsider what their necessary employment base should be, he said. But Ivey also cautioned against overreaction.

"We still don't really know what the duration of this is going to be," Ivey said. "Given that uncertainty, you would hate to see companies take a dramatic reaction to the crisis that hurts them in the long term."

Plus, given the investor-friendly environment, lawyers note that cash-ready venture capitalists are still willing to pounce on opportunities.

"There are too many good companies and too many VCs who say this might be the time to invest in a good company," Cooley LLP partner Eric Jensen said.

--Editing by Kelly Duncan.

This story is the first in a two-part series about funding for public and private companies.