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How Cash-Needy Private Companies Are Avoiding Dreaded Down Rounds

Few rules govern private markets, but some companies' confidential maneuvers to bypass a valuation hit could raise eyebrows.

By
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January 25, 2023 at 6:00 AM EST

For startups that rode the tech boom to soaring valuations, few things are harder to swallow than the dreaded down round. It happens when backers throw fresh money at a fast-growing business and demand more equity than previous investors got for a similar amount of cash. The result is a decline in value—sometimes by an embarrassing amount.

It's such a badge of dishonor in Silicon Valley (not to mention alarming to employees with stock options) that private companies and investors are coming up with inventive workarounds. Private markets have few disclosure requirements, so most of the maneuvers aren't made public. "What they try to do is sort of defeat reality," Tom Slater, a Baillie Gifford fund manager whose firm buys stakes in private companies, said at a conference earlier this month. "Do you want to accept reality that your valuation has fallen by 50%? Because that's potentially quite disruptive internally."

Structuring deals with confidential perks, such as promising investors discounted shares in a potential public offering, is one way to avoid a down round, says Next Round Capital Partners founder Ken Smythe, who helps startups obtain financing. "Everyone is trying to avoid marking their company down," he says. "There are many flavors to these structured deals, but what's constant is that it's unpriced, so you're basically kicking the can down the road on the valuation."

Last year was especially tough on cash-starved startups. The amount of money invested in private companies in the first nine months of 2022 dropped 33% from the same period in 2021, according to GlobalData Plc. By the end of November, investors were getting shares of closely held companies in the secondary market at a record 50.5%

median discount off the price set in the most recent funding round, says Forge Global Holdings Inc.

Prominent tech unicorns and fintech darlings have seen some of the largest down rounds. Sweden's Klarna AB, a "buy now, pay later" pioneer, had one for the ages: In July it accepted funding at a $6.7 billion valuation, an 85% drop from only a year earlier. In December cybersecurity startup Snyk took a down round, raising capital at a $7.4 billion valuation—a 14% discount to its previous round, in September 2021. The haircut could've been worse for the Boston-based business, which had dismissed about a fifth of its workforce and shelved plans for an initial public offering. Funds at T. Rowe Price Group Inc. and BlackRock Inc. both marked down Snyk's value by about 20%.

Companies with enough cash to fund only 12 months of operations or less are particularly vulnerable, with rising interest rates making borrowing more expensive and the IPO market in a deep freeze. Even healthy privately owned businesses risk being devalued when shares of similar publicly traded companies slump. "The painful part is, in this environment, you're going to have to give up a lot more of the company's equity to raise the same amount of cash," Smythe says. "This year many will have to swallow the pill, and you'll start seeing more down rounds."

Not everyone considers these moves to be worrisome. "I don't think companies are at fault for being creative to avoid a down round," says Jon Caplis, founder of hedge fund research firm PivotalPath. "They have to do what they can to survive." For hedge funds and venture capital firms, which have plowed billions of dollars into now-struggling enterprises, dodging a down round gives them an opportunity to acquire additional equity on better terms. It can also allow them to avoid divulging lower valuations to their own investors. Caplis says it could be a problem if hedge funds are "guiding their underlying companies to avoid lower valuations when raising money," which would enable them to increase their holdings without having to mark down their portfolios or reduce fee revenue.

Arctic Wolf Networks, a Minnesota-based provider of cybersecurity software and services, in September raised $401 million by selling a convertible note to new and existing investors including Ontario Teachers' Pension Plan, Owl Rock Capital and hedge fund Viking Global Investors. Such notes typically convert into shares if the company does well. If it doesn't, investors get their money back, plus interest.

Although an Oct. 6 statement announcing the transaction didn't disclose the perks those investors received, a document seen by Bloomberg News provides some details: Investors will get as much as 25% more equity if the company goes public. If it stays private, the interest due on the note converts into shares. Either way, investors get a fatter payoff.

They will also receive a guaranteed rate of return and can cap the amount of debt Arctic Wolf assumes. At least one investor says the cybersecurity outfit's value has declined: In September a Liberty Street Funds vehicle valued Arctic Wolf 8.6% less than it did nine months earlier. In an emailed statement, Arctic Wolf said it's "well-equipped to continue our strong execution track record" while declining to discuss funding details.

Indigo Ag Inc. in Boston, which helps farmers adopt more sustainable technologies, was valued at $3.8 billion after a 2021 funding round. It raised more in July at the same

valuation, but this time the company, which has been burning through more than $10 million a month, promised investors cheaper shares in the next funding round, according to people familiar with the matter who asked not to be named discussing private terms. A representative for Indigo declined to comment.

Then there are so-called internal rounds, which occur when a company taps existing backers for additional cash, sometimes with structured perks. “Internal rounds have always been an issue on the audit side, because the new cash might imply a value that’s not reflective of the company’s true value,” says Taylor Rosanova, a principal at accounting company Marcum LLP. “Investors may be very willing to throw an additional $5 million into a company that they’ve already invested $100 million in, without caring about the valuation, in order to help the company turn a corner and save their initial investment.”

There’s another way to acquire funding without accepting a valuation change: debt financing, which startups usually prefer to avoid. Struggling grocery delivery service Gopuff—which has cut staff, scrapped an IPO and hiked customer fees—turned to borrowing after relying on equity in eight funding rounds since 2016. Last year the Philadelphia-based company opted to raise money via a $275 million revolving credit line and also sold a $600 million note that can convert to equity.

Capchase Inc., which provides financing to startups, has seen loan applications surge 350% over the past year. “There are a lot of companies that are just not going to make it,” says co-founder Miguel Fernandez. “They’re applying at the eleventh hour. They’re scraping for cash.” *—With Loukia Gyftopoulou and Linly Lin*