IPs and insolvency lawyers well placed to help avoid disaster

The sooner management teams start planning for the worst, the greater their chance of steering successfully through the crisis, say **Stuart Alford** and **Howard Morris**

The willingness of venture capital to invest large amounts based on an assessment of what might be rather than what is (to take a chance in other words, albeit one that is carefully calculated), is what has powered the tech industry to become an engine of wealth production and progress.

Venture capital investment in tech peaked in 2021 at $347 billion. But over the last 18 months valuations have fallen, the cost of money is no longer cheap, and other sectors can offer a shorter path to revenue and exit. At the same time inflation is driving up costs. So far this year, VC investment in tech has dropped significantly to $80 billion. AI is still, unsurprisingly, continuing to be a bright spot for investors. Many tech start-ups through to later stage growth companies are facing their first financing crunch as they consume the remains of their 2021 equity raises and must compete in a challenging market for further investment.

So, shall we see a wave of restructurings in the tech industry? Is restructuring even possible for companies that have little or no debt and revenue? What are the views of the VC investors?

Intense competition

Of course, plenty of tech companies, both start-ups and more mature companies, have failed over the last decade during the boom in tech investment. Their technology has not worked, could not be developed as envisaged, was overtaken by the ideas and technology of competitors, or did not resonate in the markets they expected. And, notwithstanding the eye-watering amounts of capital deployed, there has still been intense competition for every dollar or pound of VC cash. In those cases, there has not been much to do for the restructuring and insolvency profession. The good staff often leave to go to competitors and the technology itself may have very little value as an isolated asset.

But now we are in a different place. This is going to make for challenging times for portfolio companies, placing an emphasis on prudent financial management and revenue generation. Having said that, opportunities still remain. Talent does not disappear overnight, compensation levels may settle, and capital is still out there; corporate venture capital might be best primed to step in and look for opportunities to build for the long term at more favourable valuations.

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But let us return to the question of whether a restructuring of a tech company is even possible. The usual company restructuring turns on reducing debt or the burden of debt, converting it to equity or payment in kind, thus allowing more of the debtor's revenue to be freed from debt service. The obvious problem is that tech start-ups and even later stage growth companies have not taken on debt (or not much) and are not yet generating significant revenue. This is in fact less the case than often thought. There has been a growing market for debt in the tech sector, so often there is debt to restructure. And remember that many conventional restructurings require new money; a debt for equity conversion or postponing repayment will not necessarily be enough to achieve a rescue.

New equity

An equity-driven restructuring (as opposed to a debt-driven one) is possible because the economic outcome for the debtor and its investors may not be very different from the conversion of debt to equity plus a new money injection. The valuation of assets may have fallen and so a new equity raise may be at a significant discount, or "down round". The existing equity investors who may have contributed to successive subscriptions will likely baulk at the idea of the company borrowing from a new source and granting security and thus relegating the equity investors to an inferior position, so they may be willing to put in new equity or take on the role of debt providers.

This will hinge on whether investors have the appetite to pivot and structure debt/bridging solutions that give them favourable terms while meeting the immediate financing needs of their portfolio companies.

We must not underestimate the adaptability of the VC and tech eco system. Concentrated in this industry are some of the very best creative, and intensely commercial, minds. Market participants have a history of adapting, with savvy investors coming out of the woodwork to seek opportunities. Those with a specialism or appetite for special situations are always on the look-out, and well capitalised corporates always have an eye to add-ons or cherry-picking intellectual property. While we have seen some examples of this over the last 12 months, the floodgates are yet to open. Nevertheless – and it's hard to predict – H2 2023 may well see a significant uptick in this kind of activity.

We have seen a lot of tech financial crises over the last 18 months. IPs and, of course, specialist lawyers are uniquely placed to help companies avoid disaster. Boards and management need to focus on costs and cash management and to look at how plans for development and growth might be adjusted. They need to bring in people with skills in these areas that have not been nearly so important in the past. The passion and belief of founders and inventors need to be supported by rigorous financial analyses and, as we well know, the sooner management teams turn to plan for the worst the more choices they will have and the greater their chance of steering successfully through the crisis.

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