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Investor confidence: Lessons and risk mitigations

COVID-19 is affecting the future growth path of companies in several sectors. In addition, economic downturns often act as a catalyst for exposing systemic issues. This can have a significant impact on investor confidence not just in the valuation of a business but also in its governance and fundamentals going forward. For example, in the three years before the pandemic the FinTech sector was on a strong growth path. In many respects some FinTech companies are weathering the current downturn better and are anticipated by many to return to significant growth faster, than other less digitally enabled businesses. However, there are some mixed reports on investor confidence. This article explores some of the lessons from recent developments as well as risk mitigations for investors that can be deployed to help increase investor confidence whilst businesses navigate from crisis to rebuild mode.

Lessons

Hindsight may suggest that problems with the underlying health of some businesses had started emerging over 12 to 18 months ago when there may have been reports or questions that were addressed with an optimistic outlook to the future. Whilst a balance does need to be achieved in how much weight is put on reports and negative outlooks, what is now becoming clear is that such signs cannot and should not be ignored.

It is likely that there will be some investors who may have exited certain businesses when the first warning signs began to emerge. Equally there are sectors like FinTech where investors tend to have a higher risk appetite. However, a high stakes scenario is different to one where things are going wrong. In such cases it becomes even more important to have a risk mitigation strategy in place that helps to identify the problems.

Key considerations

- Use contractual tools and mechanisms to adjust risk allocation.
- Contractual tools and mechanisms can be agile, tailored and used at different trigger points.
- Develop and monitor a risk management strategy to help identify potential problems especially in higher risk scenarios.
- Act early on any signs of problems – ignoring them will likely be more costly in the medium to longer term.
- Undertake active damage limitation by timely and effective deployment of tools.
- Prepare an exit strategy to limit losses or to help deal with problems that cannot be overcome.

Risk mitigations

Set out below are some of the mechanisms and tools that investors can consider using to mitigate risks and help build confidence. These measures are not a one-size-fits-all. Some will be more suited to smaller investments where the investors have more influence, others would work well in larger deals. Investors need to achieve a careful balance of managing investment risk against being too heavy handed and stifling the agility, flexibility, innovation, ability to learn from mistakes and quickly adapt and quick decision making so key to success in some sectors.

Contractual mechanisms

Information and audit rights – Include MI reporting and audit rights in the lending/investment contract. The audit rights should not only give you access to premises, systems, records and other information, but also to employees, consultants and other staff. To protect the business, you should also address concerns around minimising business disruption and confidentiality.

Financial covenants – It is common in lending facilities to have financial covenants and it is arguable that they are only as good as the data available. However, financial covenants can be fortified by having the ability to change the frequency at which the financial covenants are measured, requiring the management of a company to provide certificates confirming compliance, designing covenants so they are measured not just by reference to financial statements but by other data points, for instance actual balance in bank accounts or the average payment cycle for suppliers.

Board supervision/monitor – Having a seat at the board table would provide an opportunity for oversight and influence, but this is not always possible depending on the size of the investment. An alternative can be to have a right to appoint an observer, or to require implementation of temporary enhanced monitoring and governance structures if certain trigger events arise, to help get a better understanding of the health of the business. That can be extended to board swamping rights, giving investors multiple votes in an event of default scenario, to allow day to day control to sit with the investors in such circumstances.

Earn-outs – Putting in place mechanisms to unlock different layers of the investment/lending by reference to not only financial performance but also other metrics like employee and customer satisfaction. This can help the company get the financial commitment it needs but also ensure the risk profile for the investment/lending is managed.

Structural considerations – When investing in a company that is on a growth path, you should consider how the injection of the investment/lending is undertaken. For example, the tranche of the investment/lending that is linked to expenses to be incurred for acquiring new customers can be designed to go into a SPV that will be acquiring the customer relationships and data. This can help mitigate against the risk of other group companies facing issues by, for example, having rights to have the customer data and relationships transferred to the investor when certain events of default arise or at least isolate the SPV from the wider group's financial issues.

Collaboration – Helping the company get support and collaboration from suppliers/providers in which you already have investments can be a useful checkpoint on the health of the business. If there are issues in any one of those businesses that are dependent on the other it could be an early indicator of a problem that is brewing. You can consider directing the company to which entities it engages with. This would need to be considered carefully, including from a competition law perspective.

Post-contractual mechanisms

Once the contracts are in place, it then becomes important to ensure information reporting, supervisory and governance rights are being exercised in a timely manner. It is not possible to anticipate all possible problems and provide for them in the contract. Below are some measures that could be useful to consider:

Culture – Reputation management is an active part of most businesses, particularly those that are customer facing and there is an important balance to be achieved. However, if reputation management is allowed to go unchecked, it can have catastrophic consequences for investors because negative reports are allowed to be dismissed and issues are not identified early in the cycle. Investors should consider putting in place measures to ensure the culture of the company matches its risk profile. This can include measures like ensuring visibility of key stakeholders to employees. No doubt, the full ramifications of such measures should be considered, including regulatory hurdles.

Events of default – It is important to ensure contractual triggers are not ignored and appropriate steps are taken either to exercise resulting rights or to reserve the rights to avoid there being a waiver.

Renegotiations/waivers – Any change in the contractual position should be recorded in accordance with terms of the contract. This includes any waivers and renegotiations that take place.

Interim remedies – If cooperation is not achieved or there is a real risk of losses, taking early action to preserve assets can be important. There is a wide range of interim remedies that are available from courts and arbitral tribunals that can assist, including freezing orders and orders allowing a party to obtain information in accordance with contractual terms.

Exit strategy

Despite best efforts it may not always be possible to anticipate and deal with problems. As such having a planned exit strategy can be a good way to limit losses or deal with diverging visions for the direction of travel for a business. This should include putting in place the relevant contractual clauses. In that regard, issues that we often see arising are:

Invalid termination – Termination rights must be exercised in strict compliance with the contractual terms. Failure to do so can result in claims for invalid termination with damages becoming payable.

Calculation of exit price – It is important to have clear contractual terms on how the exit price is to be calculated. Often references to "fair market value" are included without any rules on how that is to be determined in the absence of agreement. The contract should include a framework for the determination of the exit price in the event of a dispute.

Shareholder disputes – Inevitably an exit can result in issues arising between the investor and the founder. A common theme in these situations is for the aggrieved party to allege that the exit is resulting in significant damage and loss of business. These claims should be considered carefully, and steps taken, where possible, to mitigate.

Clawback period – In most jurisdictions the insolvency rules allow the liquidator to clawback certain payments made within a 12 to 24-month period prior to the liquidation. As such this should form part of the exit planning particularly where the exit is triggered as a result of problems in the business.

Conclusion

The recent developments will, no doubt, continue to be watched by the market carefully. However, the issues that are emerging from it are not insurmountable. Although in the short term they may further harm confidence, in the long term the lessons learnt will help increase resilience.
In the interim measures can be put in place to help increase investor confidence whilst balancing the flexibility and agility a business requires to rebound and rebuild.

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