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Coronavirus - help for early stage companies

THE FUTURE FUND

5 June 2020

The Future Fund - the latest financial support for businesses during COVID-19

Last month the Government launched the Future Fund, a new programme of financial support for "innovative UK companies with good potential". We look at how the scheme works and who might be eligible to participate.

The Future Fund became available on Wednesday 20 May and offers to match sums invested by third-party investors in eligible companies which may be struggling during the current economic disruption. The scheme is currently open for applications until the end of September 2020.

The Government is keen to ensure the UK retains its world leading position in science, innovation and technology and recognises that smaller companies in these industries may typically rely on equity investment and, being either pre-revenue or pre-profit, are ineligible for other COVID-19 financial support programmes offered by the Government to date.

It has therefore established the Future Fund scheme to make funding rapidly available to such enterprises to enable them to continue their growth trajectory and reach their full economic potential. Click here to access the British Business Bank's website for full details concerning the Future Fund.

Key features

An investor or group of investors ready to invest in an innovative company can apply to have their sums matched by the Future Fund. On a successful application, the Future Fund, third-party investors and company receiving the investment will enter into a convertible loan agreement under which the agreed sums will be paid in cash to the company. Third-party investors invest on the same terms as the Future Fund and are not required to take an equity stake in the company.

Provided the company is eligible, the Future Fund will match up to 100% of the amount being lent by third-party investors. There is a cap of £5m per investee company, with a minimum requirement of £125,000. Investors may choose to lend above the cap, however these amounts will not be matched.

Applications are considered on a "first come, first served" basis, and the application process does not make any distinction on the size of investment.

At the present time, the Government has limited the aggregate amount available to the scheme to £250 million, and is keeping this amount under review. However, demand so far has been strong and it is anticipated that the Government will increase its commitment.

Participants in the scheme enter into a convertible loan agreement on standardised and non-negotiable terms provided by the Future Fund. Key features of the agreement include:

- The term of the loan is 36 months and cannot be repaid earlier other than with the agreement of all the investors;
- Interest accrues at a minimum of 8% per annum, but no interest is payable until the loan converts into equity;
- The loan converts into equity in certain circumstances, including an exit or a new funding round; and
- The proceeds of the funding must not be used to:
  a) repay any borrowings from a shareholder;
  b) pay any dividends;
  c) pay any bonuses to employees, consultants or directors for a period of 12 months;
  d) pay any advisory fees to corporate finance entities or investment banks.

Who is eligible for the Future Fund?

Eligibility criteria apply both to the investors and the company in which the investment is to be made.

Investors

Investors must fall within one of a number of categories to be eligible to participate in the scheme. These include, among others:

- Professional investors (both individual and institutional);
- High net worth companies, unincorporated associations and trusts;
- Certified sophisticated investors;
- Certified high net worth individuals; and
- The equivalent of the above according to the law in the investor's home jurisdiction.

Definitions of the above investors are made by reference to certain laws, regulations and guidance relating to the provision of financial services in the UK. These should be consulted to determine whether an investor falls into the relevant category.

The Government also states that the total number of investors (including the Future Fund) should not exceed 149, to avoid the requirement to produce a prospectus for the financing.

Investee companies

The company receiving the investment must meet following criteria to be eligible for the scheme:

- The company must have raised at least £250,000 in equity from third-party investors in previous funding rounds in the last 5 years (from 1 April 2015 to 19 April 2020, inclusive);
- If the company is a member of a corporate group, it must be the ultimate parent company;
- The company must not have any of its shares or securities listed on a regulated market, multilateral trading facility, recognised investment exchange or similar;
- The company must be a UK incorporated limited company;
- The company must have been incorporated on or before 31 December 2019; and
- <u>Either</u> 50% or more of the company's employees are based in the UK, <u>or</u> 50% or more of the company's revenues are from UK sales.

Although the Government describes the scheme as aimed at "innovative" UK companies, the scheme is open to companies operating in all sectors.

If a company has benefited from other forms of Government financial assistance relating to COVID-19, this does not exclude them from applying for the Future Fund.

How does the convertible loan work?

On a successful application, the company, investors and Future Fund will enter into a convertible loan agreement, under which the investor(s) and Future Fund will make unsecured loans in the agreed sums to the company on the same terms.

The loans will rank at the same rate with other unsecured debts of the company and will be subordinated to any secured debt.

The term of the loan is 36 months, during which time neither principal nor interest is payable by the company. Interest will accrue on the loan, the rate of which is to be agreed between the third-party investors but which cannot be below 8% per annum, but accrued interest is only payable under certain circumstances.

On maturity, the loans will automatically convert to shares in the company, unless the majority of the investors by value, or the Future Fund, choose to have the loan repaid instead. If the latter, the company must pay back the principal of the loan plus a premium equal to 100% of the principal amount (no interest is payable in this case).

This means that, at maturity, the company could be required to pay back double the amount originally invested. This would be equivalent to paying an annual compound interest rate of 26% over three years. The risk for the company, therefore, is if the third-party investors and/or the Future Fund decide they want their money back, imposing a very large liability on the company that would have to be refinanced and could adversely affect its value to other investors. It is to be supposed that the expectation is that the value of the investment at conversion will be sufficient to make this option unattractive to investors, or the Tax payer, but there is no guarantee that this would be the case. This is likely to mean that only investee companies that cannot raise traditional equity from its backers will chose this option, and any investee should ensure that as little as possible is subject to the risks of the scheme.

If, on the other hand, the company experiences strong growth over the term of the loan and feels it is in a position to prepay some or all of the loans, it can do so with the consent of all of the lenders.

Any loans not repaid on maturity will convert into shares in the capital of the company. The company may choose to repay any accrued interest to investors in cash or convert the interest into shares. The Future Fund will then remain a shareholder of the company unless and until it chooses to dispose of its shareholding, which it may transfer to any institutional investor for any price and without being subject to any pre-emption rights.

The loans may also convert automatically into shares before the maturity date in any of the following circumstances:

a) The company undertakes further rounds of equity financing;
b) The business is sold, either by way of a share sale or asset sale; or
c) The company's shares are listed for trading on a recognised investment exchange.

However, if, on an exit (that is, a sale of the business or listing of its shares), the lenders stand to receive less in cash than the principal loan sum plus the 100% redemption premium, they have the automatic right to repayment of these amounts in lieu of conversion.

The investors (and Future Fund) are also entitled to demand immediate repayment of the principal, unpaid interest and the 100% redemption premium on an event of default. The agreement contains the usual events of default that one would see in this type of loan, such as the company failing to pay debts as they fall due and other insolvency related events.

The agreement also contains an unusual provision that grants the Future Fund the option to require the company to repay the loan or buyback any shares the Future Fund holds in the company if it decides (in its absolute discretion) that it would be prejudicial to the reputation of the Future Fund or the UK Government to continue holding its loan/equity in the company.

We presume this might apply if the company carries on a line of business with which, for political reasons, the Government does not wish to be involved. However, it also raises the question as to whether this clause could also be invoked if the whole concept of the Future Fund becomes politically unacceptable and the Government decides to extract itself from all investments. The latter eventuality may be unlikely, but the discretion available to the Government under the wording in the agreement is wide.

Advantages of the scheme

- **Quick access to funds** – the application process appears to be relatively uncomplicated and efficient. The Future Fund requires certain information to be provided when the application is made and may request further evidence thereafter, however it will not be carrying out the extensive due diligence such an investment might elicit under normal commercial circumstances. This said, applications are expected to take a minimum of 21 days to process.
- **Incentivise investors** – the availability of the Future Fund may make the prospect of investing in a growing business more attractive for equity investors by reducing the amount of capital they need to put at risk.
- **Favourable terms** – provided that the investee company does not get into financial trouble or breach the terms of the convertible loan agreement, it may not have to repay any sums to the investors on maturity of the loan, instead converting all loans to equity.

Potential risks of the scheme

- **Commercial terms** – the Future Fund operates on a commercial basis and has the same rights to a return on its investment as the third-party investors. It should be noted in particular that interest is charged at a minimum of 8% and added to the amount of the loan on conversion, a minimum discount of 20% on the issue price of the shares is applicable on conversion, and, if the Loan is repaid, either at the election of the investors or on an event of default, all investors and the Future Fund are entitled to a Redemption Premium equal to 100% of the principal amount of the Loan.
  Although the scheme may enable quicker access to funding than an eligible company might otherwise achieve via commercial investors, the costs of funding may not necessarily turn out to be cheaper.
- **Possible repayment on maturity** – on maturity, the Future Fund or third-party investors may demand repayment of the loan plus the Redemption Premium instead of retaining equity in the company. If such an election were made, this could adversely affect the company's financial resources and put the company at risk of insolvency. Although causing an investee company to enter an insolvency process is rarely a desirable outcome for investors, if the company does not demonstrate a positive financial outlook or growth potential at the end of the 3-year term, the Future Fund and/or investors may decide to pull out of their investment despite the impact on the company.
- **Narrow eligibility criteria** – although funding is available to companies operating in all sectors, the narrow eligibility criteria set by the Government may, in reality, substantially restrict the number of companies that might benefit. For example, the investee company must have already undertaken substantial equity funding in recent years, and, of course, one or more third party investors must already be lined up and ready to invest. This means that the fund is not an option for start-ups or first round investment companies
- **Legal costs** – the Future Fund requires a company solicitor to be appointed to facilitate the payment mechanics on completion of the convertible loan agreement.

How we can help

The Future Fund programme is one of the more complex financial support schemes offered by the Government to companies contending with the current economic disruption.

Although the terms under which the convertible loans are made are non-negotiable, it may be worth obtaining legal advice to determine the rights and obligations on the parties involved, particularly concerning eligibility for the scheme and the effect of redemption and conversion of the loan.

It should also be noted that a director of the investee company, when making the application, must confirm that the company has the appropriate authorisations, waivers and approvals in place to fulfil its obligations in respect of the convertible loan agreements, including its ability to issue equity on conversion. We are able to advise on whether the relevant authorisations were in place, and if not, assist in making the necessary arrangements.

Finally, as already mentioned, the company receiving the investment is required to appoint solicitors to handle the distribution of funds on execution of the convertible loan agreement.

If you have any further queries on the Future Fund, please contact Kath Shimmin or Paul Duggan.

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