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THE FUTURE FUND – A VENTURE INTO THE UNKNOWN FOR THE UK GOVERNMENT

To Our Clients and Friends:

On 20 April 2020, the UK Government announced the launch of an investment fund intended to deliver up to £500 million of investment and liquidity to high-growth companies impacted by the Covid-19 pandemic (the “**Future Fund**”). The Future Fund will provide UK-based companies with convertible loans ranging from £125,000 to £5 million, provided that the amount loaned by the UK Government is matched by third party investors. The UK Government’s total commitment to the Future Fund is £250 million. This new form of support is an important step in providing liquidity and investment to innovative high-growth companies as they are typically loss-making and thus ineligible to access financial support through the Coronavirus Business Interruption Loan Scheme (the “**CBILS**”) during the Covid-19 pandemic.

A *term sheet* issued by the UK Government sets out the primary terms on which convertible loans will be provided. The main points of the term sheet are considered in further detail below. In summary, the convertible loans are provided on market standard terms for high risk-assets. The UK Government’s funding must be matched by one or more investors (each a “**matched investor**”) for a company to be able to access the scheme. The loans will automatically convert into equity on the company’s next qualifying funding round (i.e. where the company raises equity capital for an amount at least equal to the total funding of the bridge finance), or at the end of the loan if the debt has not been repaid. The use of convertible loans rather than direct equity investments means that funds can be provided to a company without requiring a prior valuation, making them more cost and time efficient. They also provide a higher return for investors with the additional benefit of an equity ‘kicker’ through the conversion mechanism, which makes them suitable for high-growth but also less-certain business propositions.

Eligibility

In order to participate in the scheme, a business must be an unlisted UK registered private company that has raised at least £250,000 in equity investment from third party investors in the last five years. The company is also required to have a substantial economic presence in the UK, which is generally being interpreted as having the company’s headquarters and/or production or trading facilities located in the UK. Unlike the CBILS and some of the UK Government’s other support schemes, there is, however, no requirement to demonstrate that the company is struggling as a result of the COVID-19 pandemic. The Future Fund is set to open in mid-May and close to applications in September 2020. Funding will not be available through the Future Fund in respect of recently closed funding rounds.

Use of capital

The funding can solely be used for working capital purposes and cannot be used to repay any borrowings, declare or pay any dividends or bonus payments or, in respect of the UK Government's portion of the funding, pay any advisory or placement fees or bonuses to external advisers.

Terms of the convertible loans

Term

The convertible loans have a term of three years. This presents issues for venture capital trusts and certain venture capital investment funds as they are typically restricted from holding convertible loan securities that have a minimum term of less than five years. This may make finding matched investors difficult for some venture capital portfolio companies, meaning they would need to seek additional matched investors from outside of their current group of investors.

Interest rate

Although the initiative, which has been drawn up with the British Business Bank, may provide a much needed boost to certain start-ups, the terms of the convertible loans make this program equivalent to the UK Government investing tax payer money in high-risk, non-investment grade bonds. These investments are accordingly on the riskier end of the spectrum and this is reflected in the terms that the UK Government is prepared to provide for the funding. With the current market uncertainty, the high yield bond market is currently offering yields of between 8-10%, up from approximately 3.5% in early March. The term sheet issued by the UK Government provides that it shall receive a minimum of 8% per annum (non-compounding) interest to be paid on the maturity of the loan, although, the interest rate shall be higher if a higher rate is agreed by the company and a matched investor. While this interest rate is commensurate with interest rates for convertible loans issued to venture capital and angel investors, it is intended to reflect the high-risk nature of the investment and reward an investor accordingly.

Discount rate

To compensate for the higher risk categorisation, the convertible loans will automatically convert to equity at the next qualifying funding round, with an option to convert on a non-qualifying funding round. A "qualifying funding round" is a funding round where the company in raises at least the same amount in equity investment as that raised by the UK Government's bridge finance.

On conversion, a minimum discount of 20% applies which, as with the interest rate, shall be higher if a higher discount is agreed by the company and a matched investor. As an example, if the Future Fund provides a £1 million convertible loan to Company A, and in a future fundraising, Company A raises equity finance at £1 per share from a new investor, the loan will automatically convert into 1.25 million shares (equivalent to £0.80 per share). The conversion discount applies only to the principal amount outstanding under the loan and not to any accrued interest, which shall convert at the price of the funding round without the discount.

Repayment and redemption premium

To further offset the risk of the investment and encourage the companies to seek additional equity investment, the convertible loans carry a redemption premium of 100%. On maturity of the loan, if the majority of the matched investors prefer not to convert into equity at the discount rate to the price set by the most recent funding round of the company, they shall be entitled to receive a premium of 100% in addition to the outstanding amount of the loan, plus the accrued interest. Following the above example, the investors in Company A would be entitled to receive £2.24 million from Company A at the end of a three year term, which is equivalent to an internal rate of return of approximately 30%. Redemption premiums are normally only acceptable for high risk investments as, from the company's perspective, the loan can become a very expensive form of finance if the investors do not convert into equity prior to or at maturity of the loan.

The term sheet issued by the UK Government does not provide for the option of early repayment prior to the next funding round and specifically provides that the UK Government's portion of the loan shall automatically convert into equity unless it specifically requests repayment. This indicates that the UK Government does not intend for this to be merely bridge financing and wishes to participate in the potential equity upside.

While the interest rate, discount rate and redemption premium attached to the convertible loans may be considered market standard for some venture capital firms investing in high risk enterprises in a stable economy, these terms illustrate a high-level of risk that the UK Government is willing to take with tax payers' money in order to provide liquidity to businesses that may otherwise fail. As the scheme is reliant on the involvement and investment decisions of the matched investors, it is open to the risk of poor judgment by less successful investors and floundering companies that are willing to take on exceptionally expensive debt as a last resort.

Other terms

The UK Government is to receive limited corporate governance rights during the term of the loan and as a shareholder following conversion of the loan into equity. The term sheet contains a 'Most Favoured Nation' provision whereby, if the company issues further convertible loan instruments to new or existing investors on terms which are more favourable than those of the scheme, those terms will apply to the convertible loans provided by the Future Fund. There is also a negative pledge which prohibits the issuing company from creating any indebtedness that is senior to the convertible loan other than any bona fide senior indebtedness from a person that is not an existing shareholder or a matched investor.

International equivalents

The UK Government is not the only state government currently willing to invest in high risk assets. On 9 April, the U.S. Federal Reserve announced plans that, as part of its quantitative easing package, it was going to expand its ETF (exchange traded funds) buying program to include credit that has recently been downgraded to BB-/Ba3 (i.e. junk). However, the program is not open to all struggling companies and is aimed at those who have been recently impacted by the COVID-19 pandemic as the Federal

Reserve is only permitted to invest in corporates that were listed as investment grade as recently as 22 March 2020.

The French government is also providing a comprehensive support plan for start-ups with financing and liquidity measures representing €4 billion euros. Only €80 million of this is to be available as bridge financing to start-ups that were in the process of raising investment and is aimed to be step-in measure to assist those entities where an investor has pulled out since the start of the crisis. This is in stark contrast to the £250 million to be provided by the Future Fund to any high-growth company that meets the criteria set out above. The majority of the support from the French government is being provided through early payments of certain tax credits, worth €1.5 billion, and public guarantees over cash-flow costs, worth €2 billion. Germany has also implemented a special support program to provide up to €2 billion to start-ups who have a market value of more than €50 million and plans to work through venture capital firms who will distribute the support to businesses who are struggling as a result of the crisis. The minimum market capital requirement means that it is likely that these funds will be distributed to more established businesses, rather than fledgling entities who would struggle to survive in a normal socio-economic environment. It could be said therefore, that the Future Fund, when compared to positions taken by the governments of other leading economies, represents an investment in innovation and entrepreneurship in the UK.

Response of the VC community

The response to the concept of the Future Fund amongst venture capital firms and industry bodies has been overwhelmingly positive and it is seen as a big success for the Venture capital industry. Many feel that this level of investment in high-growth companies indicates that the UK Government recognises the immense value that the start-up industry provides to the economy as a whole. However, concerns have been raised about the detail of the plan. As the matched funding has to be provided through use of convertible loans, investors will not be eligible for EIS (enterprise investment scheme) relief, which applies only to new share issuances and provides income tax and capital gains tax relief to the holders of the shares. As referenced above, venture capital trusts (“VCT”) will generally be unable to participate in the scheme as a matched investor as (i) they are only able to hold convertible loans that have a minimum term of five years (whereas the convertible loans under the Future Fund have a maximum term of three years); and (ii) the loans held by a VCT can have an annual return of no more than 10% (which given the redemption premium is not the case with the convertible loans). Industry bodies such as the British Private Equity and Venture Capital Association have been engaging in ongoing discussions with the UK Government and hope to be able to iron out some of these issues in the coming weeks before the Future Fund launches.

Conclusion

The scheme is unprecedented and represents a bold move by the UK Government to provide support to the start-up industry. However, it also raises a number of questions, such as: (i) should the UK Government be providing tax payer support to high-risk fledgling entities backed by venture capital firms; and (ii) should state support to struggling companies be provided on such one-sided terms? While the intent of the governments of Germany and France is similar to that of the UK, the risk profile of their

support programs appears at first glance to be markedly different. Rather than protecting and facilitating the growth of the UK's tech industry, which may be better served through cash-flow relief measures, tax credits and loans on favourable terms, the terms of the convertible loans detailed above, particularly the lack of an early repayment option and the automatic conversion of the UK Government's loan to equity, provides for the possibility of large upsides in the long-run but entails taking on considerable risk. This could leave the program open to being misused by entities that either were already struggling or are not yet sufficiently established and who are willing to take on expensive debt that they will be unable to repay. Additionally, the scheme will only work to the extent that there is sufficient participation by venture capital firms who are prepared to provide the matched funding and are prepared to have the UK Government as a co-shareholder.



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Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact your usual contacts or any member of the Firm's Coronavirus (COVID-19) Response Team. In the UK, the contact details of the authors and other key practice group lawyers are as follows:

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