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2022 MID-YEAR TECHNOLOGY AND LIFE SCIENCES Non IPO REPORT

Market Update and Playbook for Late-Stage Private Companies

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Introduction

Following a record-breaking year for initial public offerings (IPOs) in 2021, the U.S. capital markets screeched to a halt in 2022 with the lowest IPO activity levels seen in decades. Rather than presenting an analysis of the handful of IPOs that were completed this year (as we have typically provided in this semi-annual report), this report presents an analysis of the state of the IPO market (or lack thereof), discusses practical advice for companies that are currently in registration or are planning to pursue an IPO once market conditions become more favorable, and provides an overview of alternative financing trends, including private financings, alternatives to equity financings, special purpose acquisition companies (SPACs), reverse mergers, and M&A exits.

We would like to thank the team that conducted the research and provided editorial input for the *2022 Mid-Year Technology and Life Sciences "Non" IPO Report*. The partners on the team included Shannon Delahaye, Andrew Gillman, Lauren Lichtblau, and Michael Nordtvedt, with additional contributions from Heath DeJean and Austin March (Corporate/Capital Markets); Amy Simmerman (Corporate Governance); Craig Sherman (Emerging Companies); Scott McCall and Kristen Stidham (Employee Benefits and Compensation); Erik Franks, Andrew Hirsch, and John Mao (Finance); Jason Breen, Robert Ishii, and Ethan Lutske (M&A); and Miranda Biven and Norman Hovijitra (Strategic Partnering Transactions).

The third-party data included in the report was obtained from research provided by PitchBook, SPAC Track, and S&P Global Market Intelligence.

Please feel free to share your comments or questions by contacting Michael Nordtvedt (mnordtvedt@wsgr.com) or any Wilson Sonsini capital markets partner.

The IPO Market in 2022

Technology IPOs

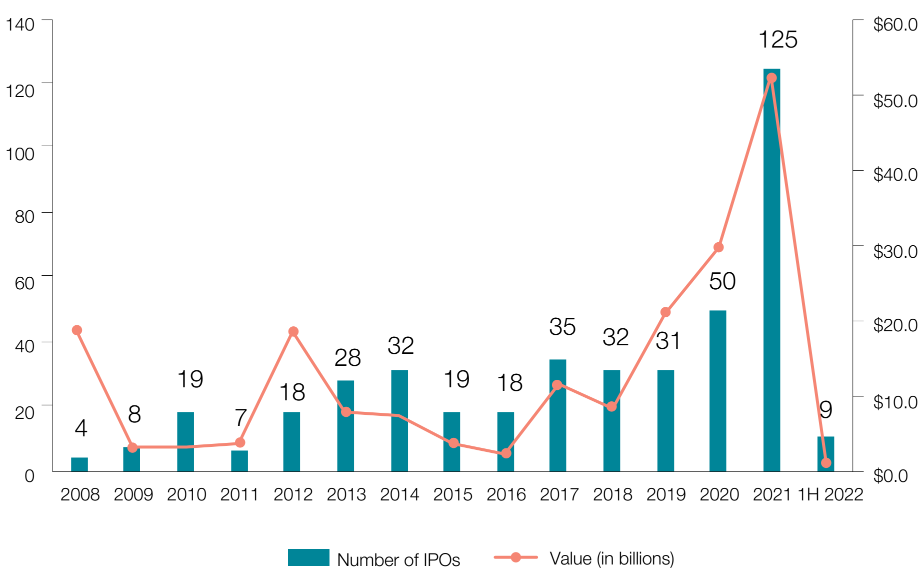
Nine technology companies completed IPOs during the first six months of 2022, compared to 64 in the first half of 2021. Of the nine technology IPOs in the first half of 2022, four companies are engaged in development and/or manufacture of electronic equipment, instruments, components, and semiconductors.

After seeing record levels of activity in 2021, market volatility caused by inflation, rising interest rates, and the ongoing conflict in Ukraine clearly took its toll. This trend was observed across all sectors as increasingly risk-adverse investors are deterred from growth stories and projections; instead, many opt for a "wait-and-see" approach, resulting in IPO levels similar to those seen during and in the aftermath of the 2009 financial crisis.

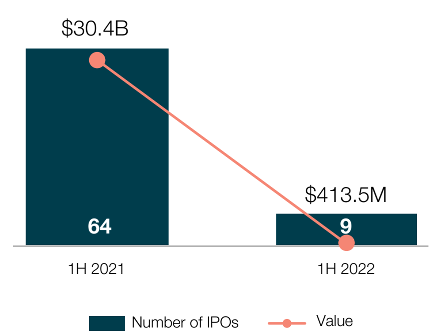
In addition to fewer IPOs, valuations for companies able to go public were also significantly impacted, with only one technology IPO valued at over $100 million and one valued at between $50 million and $100 million. Compared to the first half of 2021, which saw 18 technology IPOs with a total deal value exceeding $500 million, and another 21 with a total deal value between $250 million and $500 million, none of the technology IPOs we surveyed from the first half of 2022 exceeded $250 million. The average value for technology IPOs in the first half of 2022 was $45.9 million, compared to $474.3 million in the first half of 2021.

"After seeing record levels of activity in 2021, market volatility caused by inflation, rising interest rates, and the ongoing conflict in Ukraine clearly took its toll."

Number of IPOs and Value



IPO 1H 21 vs. 1H 22



Life Sciences IPOs

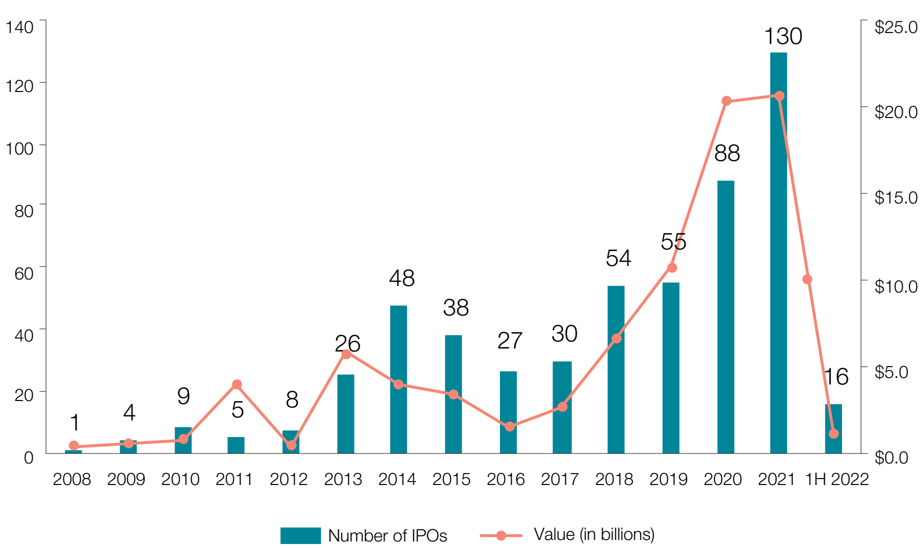
Sixteen life sciences companies completed IPOs during the first six months of 2022, compared to 68 in the first half of 2021. Of the 16 life sciences IPOs, seven were completed by biotech companies.

While the COVID-19 pandemic influenced the high number of health- and science-related IPOs in 2020 and 2021, with biotech valuations hitting a record high in early 2021, investors began to aim to capitalize on a post-pandemic economic recovery and shift their focus away from capital-intensive growth sectors like biotech. This shift, combined with rapid rises in interest rates and inflation and ongoing uncertainty in the post-pandemic landscape, has resulted in significantly lower valuations for life sciences companies than those seen in 2021, and reduced companies' access to capital.

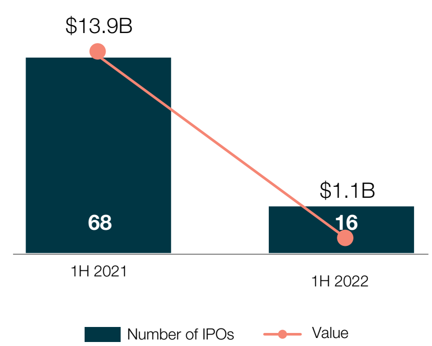
Consistent with the pattern from recent years, there were more IPOs in life sciences than technology during the first six months of 2022. Of the 16 life sciences IPOs, five had a total deal value exceeding $100 million, while one technology IPO had a deal value above $100 million in the same period. Two life sciences IPOs had a total deal value between $50 million and $100 million. Compared to the first half of 2021, which saw six life sciences IPOs with a total deal value exceeding $500 million, and another nine with a total deal value between $250 million and $500 million, none of the life sciences IPOs we surveyed from the first half of 2022 exceeded $250 million. The average value for life sciences IPOs in the first half of 2022 was $70.8 million, compared to $204.9 million in the first half of 2021.

"While the COVID-19 pandemic influenced the high number of health- and science-related IPOs in 2020 and 2021, with biotech valuations hitting a record high in early 2021, investors began to aim to capitalize on a post-pandemic economic recovery and shift their focus away from capital-intensive growth sectors like biotech."

Number of IPOs and Value



IPO 1H 21 vs. 1H 22



Stock Price Performance of 2021 IPOs for U.S.-Headquartered Companies on Major U.S. Exchanges (Excluding SPACs)

As reflected by the above graph, companies that completed their IPOs in 2021 have significantly underperformed relative to the broader market. As a result, portfolio managers at institutional funds and investors more broadly have begun to steer clear of investments in growth-oriented stories.

This trading dynamic has been driven by several interrelated factors. Prolonged loose monetary and fiscal policy in the United States has inflated the prices of many asset classes, including, and maybe especially, stocks. As the U.S. Federal Reserve increased interest rates to control inflation in the economy generally, the cost of capital for companies increased and the risk premium associated with growth companies decreased, driving lower stock prices. The macroeconomic impact of higher interest rates, global supply chain disruptions, and the impact of geopolitical tensions has dampened consumer demand and increased the chances of recession, further driving stock prices lower. Finally, the volatility introduced into the market as a result of all of these factors has diminished investor confidence in company valuations, which is particularly troublesome for the IPO market.

Practical Advice for Companies in Registration

"Should I Stay in Registration?"

Companies that have already confidentially submitted a draft registration statement or publicly filed a registration statement in anticipation of a near-term IPO will want to consider whether to "withdraw" their registration statement.

This decision will largely depend on the viability of an eventual IPO, the anticipated timeline, and the need for additional capital.

If the company believes its IPO has been pushed out 18 to 24 months, regardless of whether there is a rapid recovery of the capital markets, then a "withdrawal" from registration might be prudent.

Considerations in Favor of Withdrawal

- Clear path toward a private financing raise without lingering integration concerns with the IPO
- Return to life as a private company outside of the U.S. Securities and Exchange Commission's (SEC's) microscope
- Regain flexibility over investor communications and public relations without triggering "gun-jumping" concerns
- Companies that have not publicly filed their registration statement can avoid exposing earlier submissions when they resume the IPO process

Considerations Against Withdrawal

- Could extend IPO timeline if the company eventually resumes the IPO process (due to both the SEC review implications outlined below and the time required to re-engage the working group)
- The SEC is likely to treat any restart as a first submission with a full 30-day review cycle for comments*
- Can be a challenging message to stakeholders, including investors, employees, and potentially the broader public (although message has been made easier by companies that have already withdrawn, and by general awareness of the turbulent markets)

*If sufficient time has passed since prior filing or submission, the SEC may still treat the registration statement like a first submission, even if a company does not withdraw its registration statement.

Mechanics of Withdrawing a Registration Statement

Publicly Filed Registration Statement

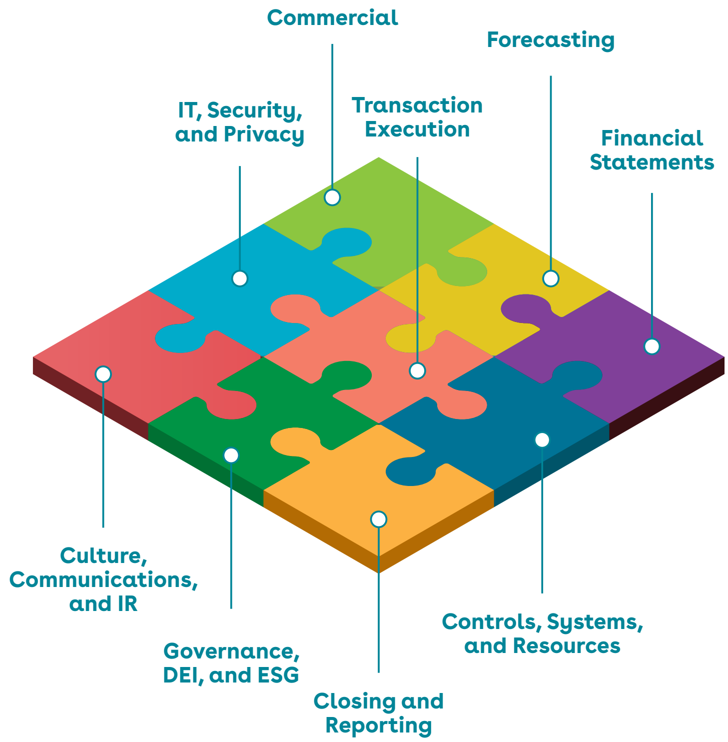
- Follow procedures set forth in Rule 477 of the Securities Act, which requires the submission of an application to the SEC requesting that the SEC consent to the withdrawal

Confidential Draft Registration Statement

- The SEC does not provide for a formal withdrawal process for draft registration statements that have been confidentially submitted
- Consider taking formal board action and then communicating the company's intentions to terminate the IPO process to the SEC staff and underwriters

Key Elements of Public Company Readiness

Companies that remain in registration or desire to kick off an IPO process once market conditions become more favorable should continue to focus on preparing themselves for life as a public company. Being ready to be public involves transformation across many functional and operational areas, and it requires a major contribution from many participants.



Commercial

The company's commercial engine must be consistently firing on all cylinders to avoid a post-IPO revenue stumble.

- Have a solid revenue pipeline when the company is post-commercialization
- Maintain reliable and trustworthy suppliers and a resilient supply chain
- In the case of life sciences companies, establish and maintain relationships with dependable contract research organizations

Forecasting

The key is to meet or slightly exceed expectations. Missing forecasts can lead to disproportionate stock price impacts.

- Commercial, revenue-generating companies should establish procedures for robust revenue, expense, and operating results forecasting
  - Validate processes by assessing prior period forecasting accuracy
  - Begin formal forecasting processes several quarters prior to an anticipated IPO
  - Develop post-IPO quarterly and full-year forecasts
- Pre-commercial life sciences companies must have dependable third-party service providers to avoid unexpected changes in clinical development timelines

Key Elements of Public Company Readiness (cont.)

Financial Statements

Select independent auditors early, develop a thorough understanding of requirements, and plan to deliver.

- Emerging Growth Companies (EGCs) will need two years of audited financial statements plus reviewed subsequent interim period statements
- If the company made any "significant" acquisitions in prior periods, may also need audited financial statements of target companies
- Public Company Accounting Oversight Board (PCAOB) audits and interim reviews are substantially more involved than the private company American Institute of Certified Public Accountants (AICPA) audits and interim reviews

Controls, Systems, and Resources

Assessing needs and gaps early, implementing appropriate controls and systems, and hiring the right people are lengthy processes.

- Companies should ensure that they are implementing appropriate processes, platforms, and controls early, including as they relate to internal controls over financial reporting and financial planning, disclosure controls, enterprise resource planning, human resources information systems, and equity administration
- Consider engaging consultants to assess gaps and recommend remediation as IPO planning commences

Closing and Reporting

Close the books and draft mock press releases and quarterly reports on public company timing for several quarters pre-IPO.

- Public companies are held to tight reporting cycles
- Accurate and efficient financial closes are critically important
- Public company financial reporting includes earnings press releases generally accompanied by earnings calls with analysts and formal SEC filings
- Anticipate—and allow time for—auditor reviews/audits and audit committee review and input

Key Elements of Public Company Readiness (cont.)

Governance, Diversity, Equity and Inclusion (DEI), and Environmental, Social, and Governance (ESG)

Laws, listing requirements, and investors are increasingly focusing on DEI and ESG matters.

- Board and committee matters:
  - Director independence
  - Board composition (relevant skills and experience, with appropriate consideration also given to diversity)
  - Assess gaps and begin recruiting qualified directors early
- Act as if you are a public company (establish board committees with written charters, etc.)
- Draft key policies, including insider trading policy, corporate governance guidelines, code of conduct, and communications/Regulation FD policy

Culture, Communications, and Investor Relations (IR)

Engage internal and/or external communications and IR resources early to help shape communications content and strategy.

- Actively manage change and cultural impacts
- Coordinate messaging by considering all stakeholder audiences, including employees, customers and suppliers, pre-public stockholders, public investors, governmental entities, and others, to establish a consistent company narrative and effectively articulate the long-term vision and brand
- Engage IR and learn to "talk to the street"; it is vital both for compliance and relationship-building. To align with corporate governance around financial disclosure, identify key performance metrics and prepare reporting for public release
- Conduct mock earnings calls with sell-side analysts

Key Elements of Public Company Readiness (cont.)

Information Technology (IT), Security, and Privacy

Public companies are more attractive targets for bad actors and for regulators. Ensure your company's internal processes and policies are in order before the spotlight is turned in your direction.

- IT and security should be a priority
- Assume and prepare for the worst; focus on resiliency and business continuity
- Security is a journey without an end point
- Data privacy requirements are rapidly evolving in the U.S. and internationally, and there are substantial penalties for noncompliance

Transaction Execution

The process of going public is time consuming and exciting. Keep your eyes on the prize—business execution remains paramount. Address the culture changes head on.

- Engage key resources early, including counsel, independent auditors, investment banks, and readiness/execution consultants
- Hire to fill skills gaps
- Prepare in advance where possible
- Consider designating a project manager

Focus on Prudent Financial Stewardship

With an increased focus on profitability and cash burn by investors and greater challenges in raising capital, companies may need to re-evaluate their cost profiles and take steps to manage their cash flow.

Current Environment

- Many late-stage private companies will find themselves with fewer options while they wait for the stock market to calm—and will be burning through cash while they wait

Investor Sentiment

- General expectation that the first technology companies to hit the IPO market will be larger, better known, and profitable
  - Profitability is becoming more important even for young companies with fast growth
  - Deeper diligence on non-growth metrics like margins and free cash flow
- General expectation that the first life sciences companies to hit the IPO market will be those with relatively de-risked clinical assets

Common Cost-Cutting Measures

- Workforce reductions and/or hiring freezes
- Prioritizing investments with near-term ROI
- Reducing expenses on events, conferences, travel, and employee perquisites
- Identifying other operational efficiencies

How Do Companies Incentivize Employees When an IPO Has Been Delayed or Withdrawn from Registration?

Maintain the Status Quo

Take a wait-and-see approach and view the potential employee departures as an acceptable business risk. This may be a good alternative when an IPO is delayed rather than withdrawn. Consider how to manage options and restricted stock units (RSUs) that may expire in the near-term.

Advantages

- No approvals required
- No cash outlay or dilution

Disadvantages

- Risk of employee departure
- Options and RSUs could expire, further disincentivizing employees

Award Additional Cash

No change to options and RSUs, but pay employees additional cash (e.g., salary increase, cash-based incentive compensation award, retention award, etc.) to offset decreased value (real or perceived) of equity awards. This alternative can be executed across the entire employee base or selectively.

Advantages

- No equity dilution and maintain equity plan share reserve
- Can begin climb to public company compensation levels
- Generally does not require stockholder consent

Disadvantages

- Requires cash outlay at a time when minimizing cash burn may be key
- Cash payments typically taxed as ordinary income

Make Additional Equity Grants

Grant additional equity awards as a supplement to existing awards that are underwater or have lost value.

Advantages

- Typically no stockholder approval required (assuming no expansion of the equity plan share reserve)
- Employees benefit from future stock appreciation while retaining the value of underwater options to come back into-the-money
- Can be implemented quickly
- Generally, no cash outlay or expenditure
- Can be done selectively to target key contributors
- Can add to equity position for future anticipated IPO

Disadvantages

- Increases equity overhang
- Depletes available equity plan share reserve
- Results in additional stock-based compensation expense on financial statements

How Do Companies Incentivize Employees When an IPO Has Been Delayed or Withdrawn from Registration? (cont.)

Provide Secondary Liquidity for Employees

If the IPO has been delayed, consider providing an opportunity for liquidity in the secondary market for employees or a third-party investor. This arrangement can be done in connection with a financing.

Advantages

- Employees receive a cash payment for equity, providing liquidity for long-term employees, which can lead to increased retention
- Overhang is reduced

Disadvantages

- Cost, complication, and timing delay may result from tender offer or other rules
- May be difficult to find a buyer

Make a Cash Payout for Outstanding Stock Options

Employees may be willing to accept an immediate or cash payment subject to vesting in exchange for cancellation of the underwater options.

Advantages

- Employees receive a cash payment for options with little perceived value
- Overhang is reduced and equity plan share reserves are typically replenished
- If cash payments are subject to vesting, could provide retention incentive over time

Disadvantages

- Requires a cash outlay at a time when minimizing cash burn may be key
- Could result in additional financial accounting compensation expense if other than a "value for value" exchange
- Employees no longer benefit from stock appreciation; potentially provides wrong incentive
- Cost, complication, and timing delay may result from tender offer or other rules

Reprice Outstanding Stock Options

Companies can lower the exercise price of outstanding options based on lower value of common stock.

Advantages

- Generally, no cash outlay or expenditure for the company
- Easy to implement and fast, and can have immediate retention impact if unilateral and no consideration is required in return

Disadvantages

- Can result in incremental stock-based compensation expense for financial accounting purposes
- Could result in potential claims of corporate waste if no consideration is provided in exchange for repricing
- May affect qualification as incentive stock option (ISO) and/or related holding periods

How Do Companies Incentivize Employees When an IPO Has Been Delayed or Withdrawn from Registration? (cont.)

Exchange Outstanding Stock Options

Companies can exchange for new options with lower exercise price or other equity awards.

Advantages

- Generally, no cash outlay or expenditure for the company
- If the ratio of the exchange is less than 1:1, could decrease overhang and result in replenishment of available equity pools

Disadvantages

- Could result in incremental stock-based compensation expense for financial accounting purposes
- Employees might perceive the exchange to be less valuable if the company requires additional vesting or gives less than a 1:1 ratio
- In the U.S., could result in potential claims of corporate waste if no consideration given in exchange for new option or award
- Cost, complication, and timing delay may result from tender offer or other rules
- If new options are granted, qualification as ISOs may be impacted and/or the related ISO holding period may restart

Adopt a Management Carve-Out Plan

Places management at the “top of the funnel” in an exit. This approach may be a good alternative for companies that are considering an exit.

Advantages

- Helps to provide incentives to management where existing liquidation stack may result in no value being paid to holders of common stock
- Allows for more focused retention efforts on key personnel
- No immediate cash outlay
- Does not contribute to equity overhang

Disadvantages

- May require stockholder support/approval
- Can be subject to stockholder scrutiny and potential litigation in an exit
- Limited scope does not result in an incentive for lower-level employees and at the time of an exit event could result in negative employee sentiment
- Typically does not fully offset the negative impacts to management of large liquidation preferences
- Often requires continued service through an exit, which may diminish perceived value
- Taxable at ordinary income rates

The Private Placement Fundraising Environment in 2022

Private Venture Fundraising Trends

As set forth in more detail in Wilson Sonsini's *1H 2022 Entrepreneurs Report*—and consistent with the trends that we are seeing in the IPO market—in the face of economic and geopolitical uncertainties, the first half of 2022 has seen a cool down for the venture market following a record-breaking 2021:

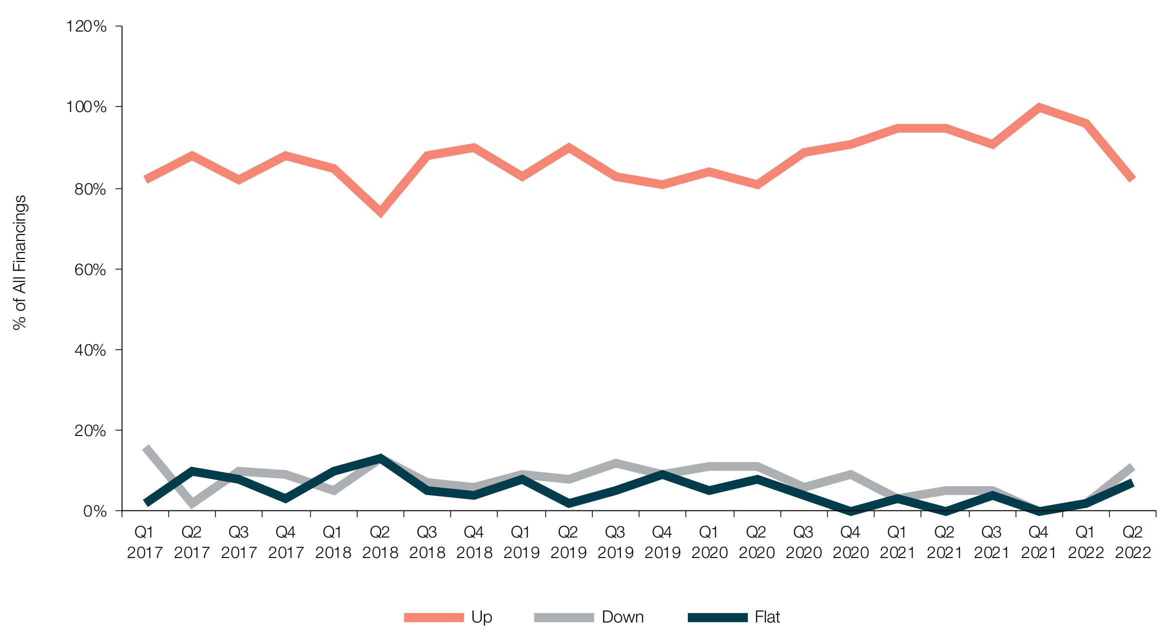
- Median valuations have declined from 2021 highs
- Round sizes have begun to decline

Severe declines in the valuations of publicly traded companies are likely to continue spilling over into the venture market, with the decline in Series B and later pre-money valuations producing an increase in down-round financings and ending a record streak of six consecutive quarters with over 90% up rounds per quarter. However, deal terms continued to be company-favorable in the first half of 2022. Given the increase in down-round financings, companies are continuing to use SAFEs and convertible promissory notes as a way to raise money without setting a price.

Notwithstanding the fundraising difficulties faced by later-stage companies, Series Seed and Series A rounds saw impressive gains in both median pre-money valuations and amounts raised, nearly reaching, or surpassing, the quarterly highs achieved in 2021.

"Severe declines in the valuations of publicly traded tech companies are likely to continue spilling over into the venture market . . . producing an increase in down-round financings."

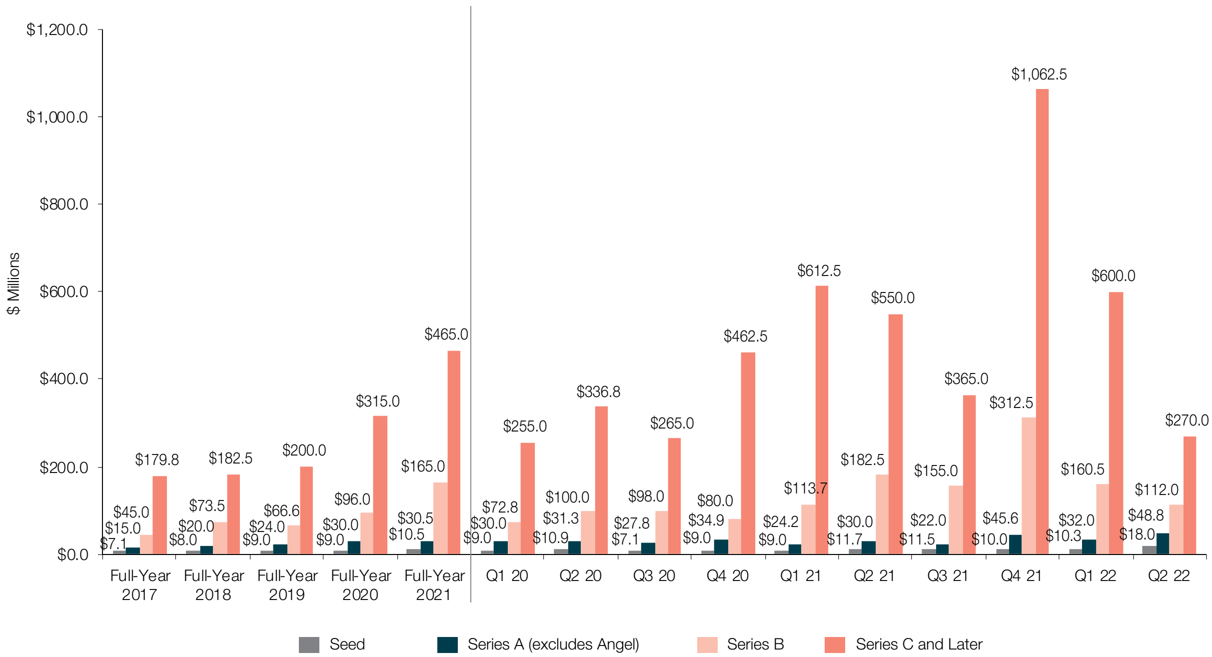
Up and Down Rounds by Quarter



Source: Wilson Sonsini's *1H 2022 Entrepreneurs Report*

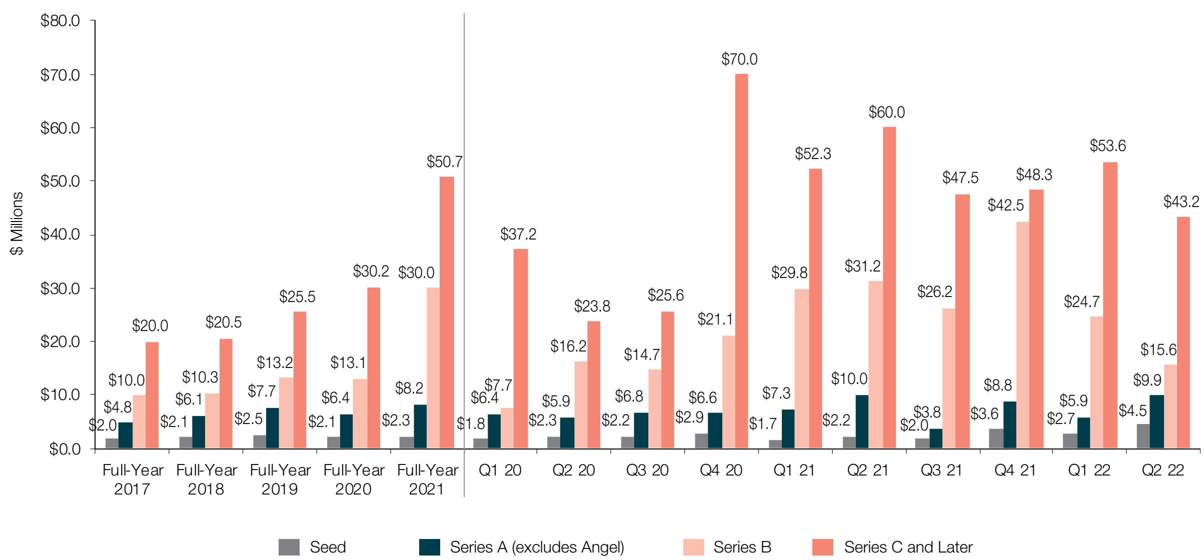
Private Venture Fundraising Trends (cont.)

Median Pre-Money Valuation



Source: Wilson Sonsini's *1H 2022 Entrepreneurs Report*

Median Amount Raised - Equity Financings



Source: Wilson Sonsini's *1H 2022 Entrepreneurs Report*

Down-Round Financings

As declining public company valuations continue to spill over into the venture market, companies should be prepared for possible down-round financings where companies sell capital stock at a price lower than that achieved in a prior financing. Down-round financings can involve different terms, structures, and governance considerations than what companies have become accustomed to in recent years.

What Typically Drives Down-Round Financings?

Global Factors

- Macroeconomic climate
- Market/industry no longer trendy or in the limelight

Company-Specific Factors

- Underperformance
- Restart/model pivot
- Investor exhaustion

Down Rounds Can Be Problematic...

Bad Optics

- Perception that a decreased valuation means the company is on the wrong track
- Negative effects on employee morale and retention, including as a result of "underwater" stock options
- Reduced liquidity opportunities through "secondary" transactions

Anti-Dilution Protections

- Most venture-backed companies have anti-dilution protections built into their organizational documents
- Anti-dilution protections will benefit existing investors in an exit, but usually at the expense of management and employees

Adverse Impacts on Investors

- Down rounds may require investors to write-down the value of the company's securities that they hold
- For institutional investors, this may negatively impact fund economics and the ability of their fund to raise additional capital

...but Often It Can Make Sense to Embrace the Down Round

Avoiding a valuation hit with a "flat" round often comes at the price of accepting a highly structured deal, which can cause more pain over the long term:

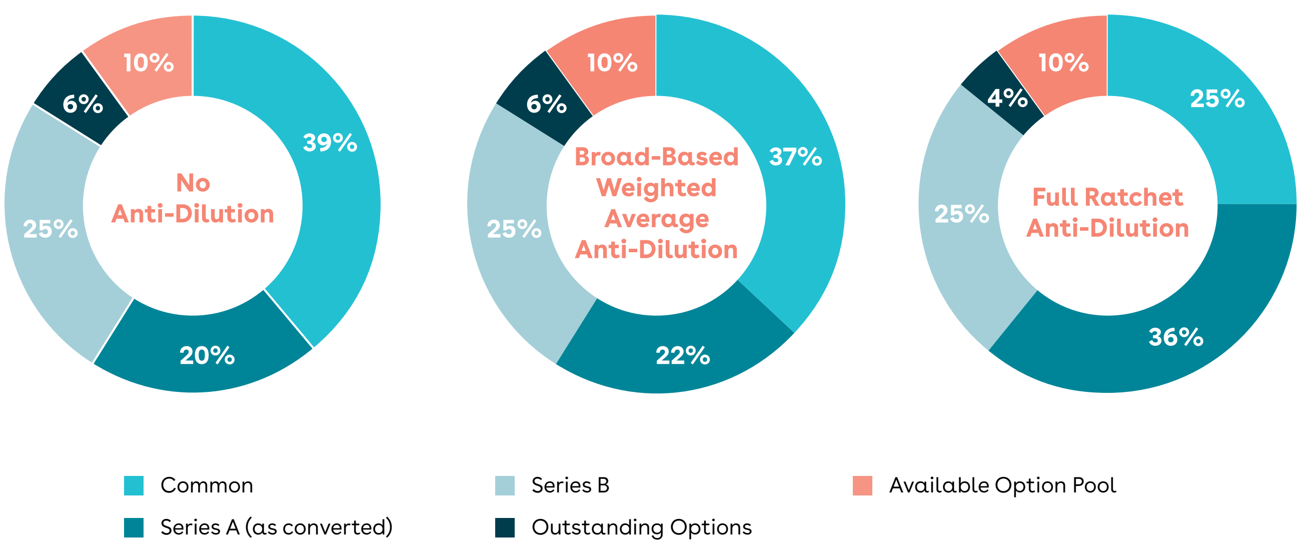
- Highly preferential terms for new-money investors (e.g., liquidation preference multiples, participating preferred, warrants, etc.) can create misalignments and disagreements among the stockholder base
- Can set an undesirable precedent for future investments in the company, even if the financing environment later becomes more favorable
- Accepting a cleaner deal with a lower valuation can be a faster, easier way to obtain needed capital

Structuring a Down-Round Financing

Impact of Anti-Dilution Protections

Anti-dilution provisions adjust the conversion ratio of preferred stock by giving preferred holders a larger share of proceeds in an exit where preferred converts to common in lieu of taking the liquidation preference:

- Full ratchet anti-dilution provisions adjust the conversion ratio based solely on the price at which new securities are sold, as if prior rounds had been issued at the same price per share as the new round
- Broad-based weighted average anti-dilution provisions adjust the conversion ratio based on price *and* the amount of the new securities—so a smaller down round results in a smaller adjustment



In the above-noted example, a $50 million Series A post-money valuation with approximately $14.3 million is invested at $6.06 per share. The Series B raise is at $30 million pre-money, with $10 million invested and 5% of available options included in the post-money valuation.

Potential Terms in a Down-Round Financing

Senior Preferred Stock

- Gives holders a liquidation preference, which puts holders at the front of the line for receiving proceeds upon liquidation of the company

Participating Preferred Stock

- Participating preferred gets both the liquidation preference and a pro rata share of any remaining proceeds
- Contrasts with non-participating preferred, which is guaranteed only the liquidation preference in priority

Cumulative / Accruing Dividends on Preferred Stock

- Guarantees a minimum annual rate of return in front of junior equity

Redemption Provisions

- Provides a fixed opportunity to exit after a specified period (usually more than five years)
- Can allow investors to force a sale of the company

IPO Conversion Ratchets

- If the IPO price does not reach a target, the preferred conversion ratio is adjusted so the target is met
- Gives the investor down-side protection or a guaranteed return

Warrants

- Offers additional upside to new investors as a sweetener

Which Investors Will Participate in the Financing, and How?

Existing stockholder agreements likely give existing investors pro rata participation rights.

Pro rata rights can be waived, subject to the terms of the applicable stockholder agreements.

Several potential reasons for a company to allow all existing stockholders to participate:

- Provides an opportunity to communicate with all investors and minimize perceptions of unfairness.
- If structured properly, offering broad participation can help avoid or mitigate future litigation.
- Funds with "skin in the game" may be more likely to step up and provide support during a difficult period.

Note that, except in very rare circumstances, only stockholders that are accredited should be invited to participate.

"Pay-to-play" provisions are one way to incentivize existing investors to participate in a financing.

Provisions come in many forms, depending on the situation:

- Convert all preferred stock into common by way of a preferred stock vote, then permit participants in the financing to exchange some or all of their common stock back into new preferred stock.
- File a charter amendment on the eve of a financing providing that non-participants' preferred stock will instantly be converted to common or into some other shadow series with lesser rights.

Often implemented in connection with a financing, but in some cases may be pre-existing.

Sometimes existing preferred is converted into common stock or a new series of preferred stock at a 1:1 ratio, and sometimes at a much more punitive ratio.

Pay-to-plays may also be used in combination with, or to effect, a complete recapitalization of a company.

Building a Good Financing Process

Down-round financings can invite legal scrutiny and stockholder litigation against the company, management, and even participating investors.

Successfully defending against these suits in Delaware courts often depends on ensuring that the courts apply a deferential standard of review ("business judgment") instead of a more exacting approach ("entire fairness").

Certain deal procedures can help achieve deferential court review and stave off litigation.

- **Negotiation/approval of the transaction by an independent committee of directors**
- **Approval of the transaction by a majority of disinterested stockholders**
- **Offer the financing on equal terms to all stockholders that are accredited**
- **Conduct appropriate pre-financing diligence on the market and alternative transactions**
- **Make careful and complete disclosures to stakeholders of the financing's terms**
- **Ensure directors understand their fiduciary duties and any conflicts of interest**
- **Make appropriate use of financial and legal advisors**
- **Build a good record of the board's deliberations and process**

What Happens to Employee Equity Awards in a Down Round?

The worst-case scenario is that a recapitalization of the company wipes out the value of employee equity by diluting all existing equity awards and potentially increasing the aggregate liquidation preference.

More typically, the impact of a down round is that the post-financing common stock valuation is less than the exercise price of at least some of the outstanding options, making those options "underwater."

It is important to keep in mind that even older awards that are not underwater will have potentially lost significant value and this loss of unrealized value may be demotivating.

Given the impact of a down round on employee equity awards, companies may wish to consider different ways to incentivize their employee base, prevent departures, and maintain employee morale. For additional information on incentivizing employees during a down round, refer to page 11 of this Report.

Alternatives to Traditional Equity Financings

Given the state of the public and private equity markets, many issuers that were preparing to go public have been forced to evaluate alternative paths for adding cash to their balance sheets, either to aid the eventual IPO marketing effort or to bridge the enterprise's ability to fund operations until it is able to raise funds as a public company.

However, given the proximity to anticipated IPOs, many late-stage private companies have been hesitant to undertake traditional fundraising rounds through the sale of preferred stock. This is usually because macroeconomic conditions have created significantly reduced enterprise valuations, and raising a new round of equity financing would create a benchmark that is dramatically lower than the valuation that the company would seek in an IPO. A lower valuation would obviously also entail significant dilution to existing stockholders.

Below we explore several alternatives for late-stage private companies such as structured financial products, debt financing, and certain types of strategic partnering transactions available to life sciences companies.

Structured Financial Products

We have seen an increase in the number of issuers that are contemplating non-traditional, structured financial products to raise additional capital. Usually, the capital sources for these financings are outside investors, and are often private equity funds that can supply a large portion of the potential capital. Anecdotally, we have heard that many of these funds still have meaningful pools of capital that they are looking to deploy, and they have turned their attention to the late-stage private company sector, looking to participate on the eve of a liquidity transaction. While these investments are typically bespoke and vary in many ways, there have been some common traits that we have noticed with respect to the various structures being offered.

"[M]any of these funds still have meaningful pools of capital that they are looking to deploy"

Convertible Securities

Convertible debt or preferred stock typically converts immediately upon the occurrence of an IPO, although some issuers delay conversion and price determination until a later date when the shares issuable upon conversion are freely tradable.

Occasionally, the conversion is at the option of the holder and survives the IPO event, extending the conversion option and creating additional value for the investor. These securities typically include a dividend/interest coupon that is payable in-kind and increases the notional amount that converts into the underlying common stock.

A common maturity (for convertible debt) or investor put (for preferred stock) is at least five years from issuance, though shorter terms have been funded. It is rare for the issuer to be able to optionally redeem these securities, as that would erode the value of the embedded conversion option.

In general, investors prefer the senior position in the capitalization stack that convertible debt offers, although some investors are willing to receive preferred stock if there are contractual limitations on incurring additional debt.

Two Types of Convertible Securities:

Discounted

- Converts into common stock at a discount that increases over time
- For example, a discount of 15% to the price of common stock during the first year from issuance, increasing by 2.5% or 5% for each subsequent year in which conversion occurs

Market Value

- Converts at the market price
- Essentially a sale of future, unpriced equity

Non-Convertible Securities Accompanied by Warrants

In contrast to a convertible security, which requires the holder to choose to either convert into the underlying equity or be repaid the invested amount, the issuance of non-convertible securities accompanied by warrants allows the investor to receive both the initial amount invested and any equity upside from the warrants.

This type of structure typically features a dividend/coupon that is aimed at a minimum return for the investor, and like the convertible variety, is commonly payable in-kind, although some instruments require cash payments as a punitive measure if there is no liquidity event after a specified time period.

It is most common for these types of securities (other than the warrants) to be redeemable at the option of the issuer, subject to a minimum return on investment. The warrants commonly have a fair market value or penny exercise price, and the value of the warrants should be considered when valuing the total economic return of the non-convertible security.

Similar to the maturity/investor put date in convertible instruments, we typically see a five-year term, with the warrants exercisable for 10 years.

Non-Convertible Securities Accompanied by Warrants: Other Considerations

Covenants

- Given the bespoke nature of these financings, investors typically request covenants that are more extensive than the protective provisions found in the issuer's existing charter, and sometimes insist on bespoke operational or financial covenants not typically required in traditional preferred stock financings (e.g. covenants on indebtedness, limitations on asset dispositions, continuity of business, minimum cash).
- Particular care should be taken with respect to agreeing to covenants associated with securities that survive the issuer's IPO.

Governance Matters

- Investors in these late-stage financings often expect some sort of board representation or board observer status commensurate with the size of investment relative to the issuer's existing capitalization.

Transfer Restrictions/Lock-Up

- Two of the more highly negotiated, and somewhat related, ancillary terms relate to the ability of the investor to transfer the securities (or underlying shares) for a period post-issuance and whether the investor will be subject to the lock-up provisions of the existing investors' rights agreement.
- Issuers should consult with their lead investment bank to evaluate the potential impact on the marketing process if the investor is able to sell shares into the market concurrent with or shortly after a contemplated IPO.

Registration Rights

- Once any transfer restrictions and/or lock-up cease to apply, to the extent an investor qualifies as an affiliate, the investor may require registration rights to be able to freely transfer the underlying shares of common stock.
- Usually, registration rights for the convertible/non-convertible security and warrants themselves are not required, as there is no liquid market for those securities, even post-IPO.

To date, most issuers that have received and evaluated these structured equity financing proposals have ultimately decided to wait. However, while many issuers opportunistically raised significant amounts of cash in financings in the period preceding the slowdown in the IPO market, those cash balances will dwindle the longer the market window remains closed. If issuers are not able to access the public capital markets in the next three to six months, we anticipate an increase in the number of issuers who decide to pursue these types of structured equity and debt financings.

Debt Financing

In addition to evaluating non-traditional, structured financial products, some late-stage private companies are inquiring about the availability of traditional debt financing. Our general sense is that venture debt facilities and revolving credit facilities remain available to companies that have significant equity valuations and a solid path to cash flow break-even or sustained recurring revenue growth rates, but that the terms of such financings will generally be more creditor-favorable and the relative size of such transactions may be smaller than we would have expected from similarly situated companies in recent years.

Venture Debt Secured Term Loans

- Available from banks, non-bank venture lenders, and sometimes direct lenders in amounts up to $50 million to $100 million.
- Intended for companies with significant equity valuations and a solid path to cash flow break-even or sustained recurring revenue growth rates.
- Often structured as subordinated debt in combination with a senior credit facility, or they can be stand-alone term loans.
- Typical maturity of 36 to 48 months, with an interest-only period of 12 to 24 months (sometimes longer), which will give additional runway prior to an IPO or other exit.
- Generally accompanied by warrants, or in lieu of a warrant, a "success fee" payable upon an exit transaction.

Revolving Credit Agreements

- Generally secured by all assets of the company (sometimes excluding intellectual property) and provided by banks and some non-bank direct lenders.
- Recently, these lenders have been more cautious in their underwriting and their due diligence can be more extensive than previously, but traditional revolving credit agreements remain available.
- Typically regulated by a borrowing base made up of accounts receivable (and occasionally inventory), or recurring revenue in the case of SAAS companies.
- Generally, accounts receivable/inventory financings will not have warrants, while recurring revenue financings often do have warrants.
- Historically, very large revolving credit agreements have been provided by banks hoping to underwrite the company's IPO, in the range of $250 million - $500 million. For the most part, these facilities have been provided to companies that already had substantial cash resources and the facilities have largely remained undrawn. It is not clear to what extent similar credit facilities are available in the current environment.

Strategic Partnering Transactions

For life sciences companies, strategic partnering transactions provide another path for securing available capital. Strategic partnering transactions span a wide variety of deal structures, and include the following:

- Co-development and/or co-commercialization arrangements, potentially with cost and/or profit sharing
- Platform-based collaborations involving multiple named or unnamed products and/or targets
- Spin-outs that transfer rights to an asset to a new corporate entity that can be separately funded
- Regional transactions that transfer rights to an asset for a specific country or group of countries (e.g., for Europe, China, Japan, or all territories other than the U.S.)
- Joint venture arrangements between multiple parties for regional or worldwide development and commercialization of an asset
- Option/right of first negotiation arrangements that give the option holder a right to acquire or license an asset, often coupled with funded research and development of the asset
- Funded clinical trial arrangements
- Consortium arrangements that provide technology and/or intellectual property access to multiple entities
- Technology or intellectual property licensing-only arrangements (i.e., without significant collaborative work between the parties)

The market for strategic partnering transactions in the life sciences industry is not typically strongly correlated to the IPO market. We expect this is due to a variety of factors, including the relatively stable demand for healthcare, large biopharma's consistent interest in finding next-generation products to fill their pipeline, and the ability to tailor strategic transactions to the particular business needs of each party. Instead, the potential for a strategic partnering transaction should be considered based on the company's internal expectations and needs, including the developmental and commercial stage of its assets, and the expected demand from large biopharma for its particular assets in their technology space.

Although challenges in the IPO and other financial markets may put additional pressure on raising capital through strategic partnering transactions, we have seen that the general structure and types of strategic partnering transactions, as well as strategies to increase leverage in partnering transactions, remain the same despite these external financial pressures.

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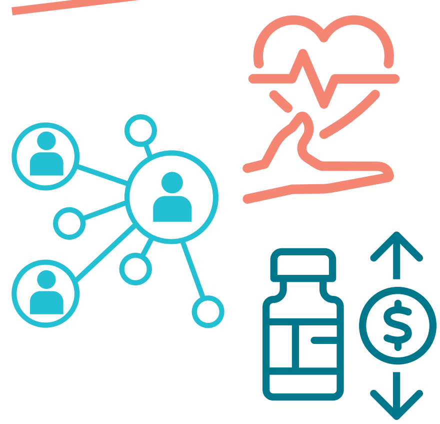


Alternatives to a Traditional IPO

Special Purpose Acquisition Companies (SPACs)

The emergence of a strong private investment in public equity (PIPE) market in 2020, paired with the ability to use long-term financial projections to market the PIPE, made going public through a business combination with a SPAC (a de-SPAC) an attractive pathway for growing companies, especially companies that were pre-revenue.

SPAC IPOs and de-SPAC transactions continued to have a strong first half of 2021. However, de-SPACs faced significant headwinds in the second half of 2021 and the first half of 2022, with (1) increased regulatory risk following statements and proposed rulemaking released by the SEC, (2) a softening of the PIPE market following a wave of underperforming de-SPAC'd companies, (3) a broader market shift away from higher-risk, early-stage companies, and (4) very high redemption rates by public SPAC shareholders, which resulted in less post-closing cash than expected for the public company.

The number of SPACs searching for de-SPAC targets remains high, with SPACs generally having a two-year window to close an initial business combination. As such, target companies continue to receive interest from SPACs.

However, in light of (1) the significant uncertainty as to the amount of cash the company will have following the de-SPAC, (2) the transaction costs for de-SPACs often being significantly higher than the costs for an IPO, (3) the dilutive effect of SPAC sponsor equity and SPAC warrants, and (4) lower valuations across the board, many target companies have chosen to delay or altogether cease discussions with potential SPACs.

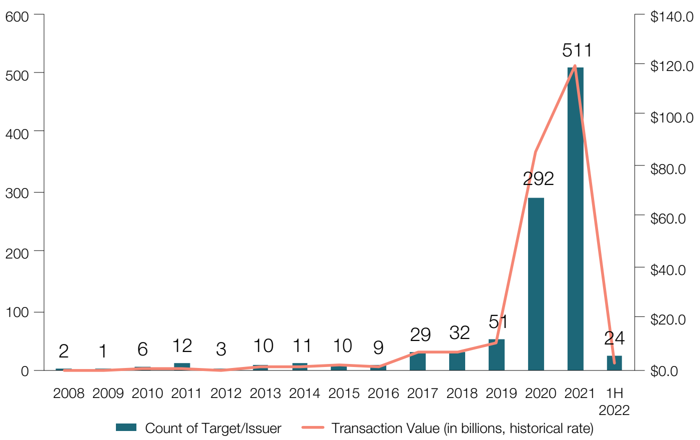
We expect SPACs to continue to provide a path for target companies to go public, but we also expect that SPAC IPO and de-SPAC activity will return to historical norms.

"SPAC IPOs and de-SPAC transactions continued to have a strong first half of 2021. However, de-SPACs faced significant headwinds in the second half of 2021 and the first half of 2022 . . ."

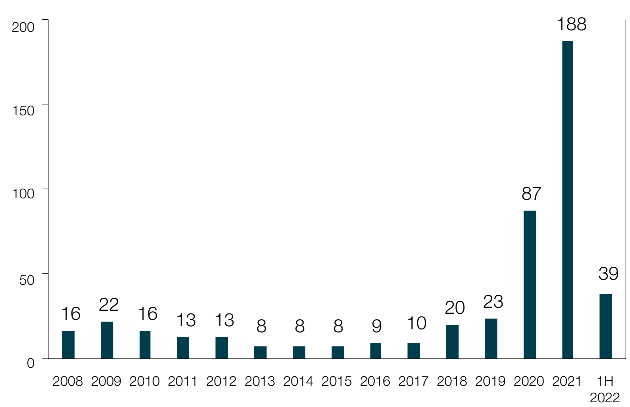
591
SPACs on the hunt as of 6/30/22

509
SPACs expiring within the next 12 months

U.S. SPAC IPO Counts and Transaction Value 2008 to 1H 2022



de-SPAC Transactions by Year (U.S. Buyers) 2008 to 1H 2022



Reverse Mergers

A "reverse merger" is a transaction where a private company goes public via a business combination with a public company. The private company is usually significantly larger than the public company and the stockholders of the private company end up controlling the combined public entity.

The pre-closing public company is usually an entity whose main or only asset is its exchange listing and (sometimes) its cash; many of these "zombie" public companies operate in the biotech space, where outcomes can be more "binary" if programs fail in clinical development or fail to obtain registration. For investors in such companies, a reverse merger is a last-ditch effort to retain some value.

> "…[M]any of these 'zombie' public companies operate in the biotech space, where outcomes can be more 'binary' if programs fail in clinical development or fail to obtain registration."

For the private company, a reverse merger functions as both a merger transaction and an IPO, combining the mechanics and structure of a merger with the SEC disclosure requirements of an IPO.

Reverse mergers are similar to de-SPAC transactions; both are vehicles for private companies to go public by accessing a pre-existing pool of cash in a non-operating public company. However, there are a number of important differences that a company should consider:

Key Differences Between Reverse Mergers and De-SPACs

Availability of Public Company Acquirors

- Unlike SPACs, reverse merger public companies were not created for the purpose of facilitating a reverse merger transaction, but are artifacts of operating companies going public and failing. At any given time, there is a limited number of suitable vehicles.

Existing Assets and Liabilities

- The public company in a reverse merger might have historical liabilities or legacy assets that SPACs do not. The private company will need to diligence potential liabilities and ensure it is sufficiently protected against them. Where there are legacy assets, public companies will often try to arrange structures whereby the value of those assets accrue to their existing stockholders.

Shell Company Status

- The public company in a reverse merger is often not a shell company as defined under the technical SEC rules. This affords the post-closing public company more flexibility than a de-SPAC, as the go-forward company may be immediately S-3 eligible and not suffer other shell company penalties.

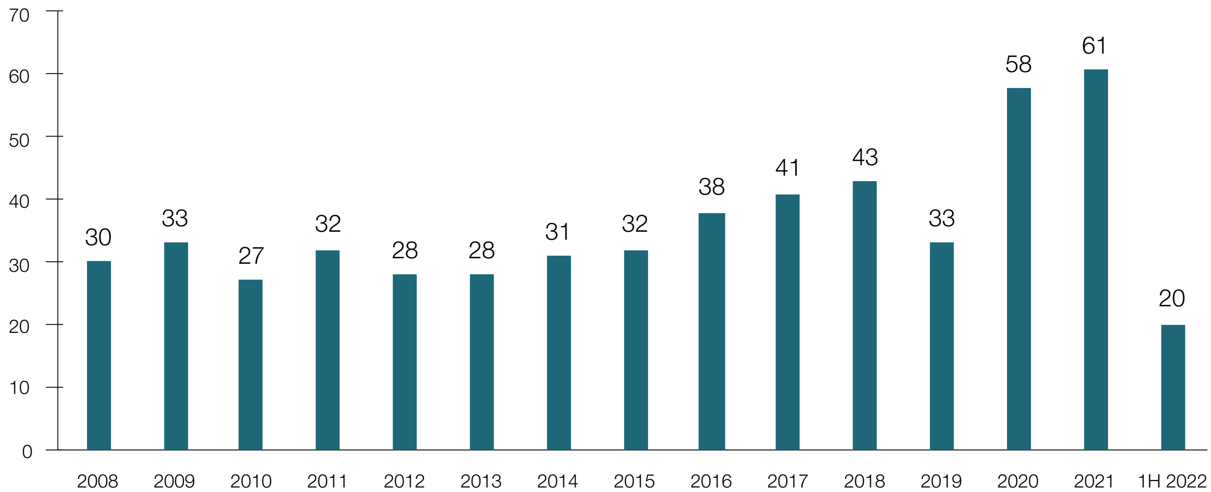
Dilution to Private Company Stockholders

- The reverse merger public company will generally not have warrant coverage in the same manner as a SPAC, resulting in a transaction that may be less dilutive to the private company's stockholders.

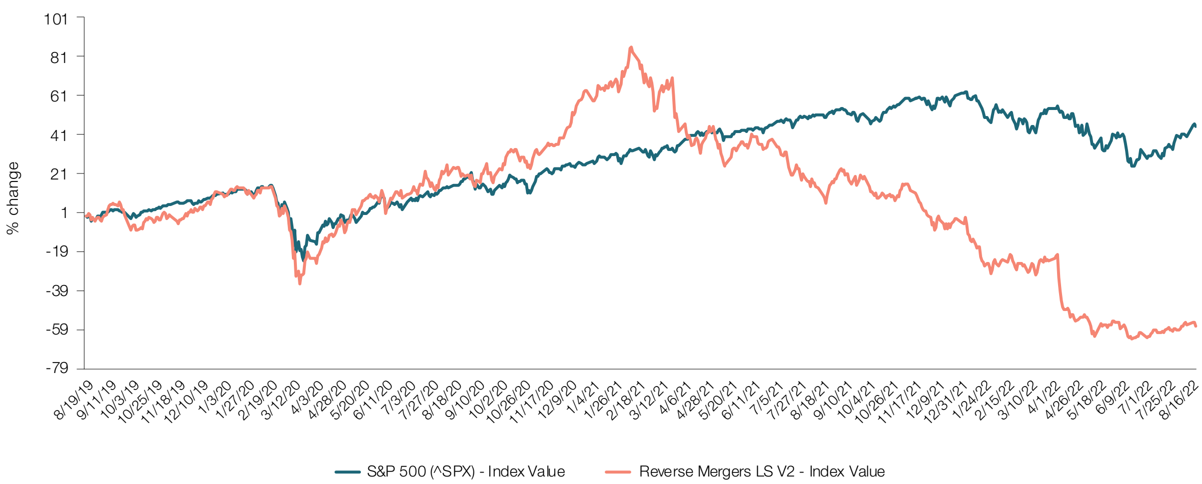
Deal Certainty

- Public company stockholders in a reverse merger do not have the redemption rights that are available to SPAC stockholders, and so there is higher certainty that the public company's cash will be there at the end of the process.

Number of Reverse Mergers by U.S.-Headquartered Healthcare Buyers, 2008 to 1H 2022



Three-Year Stock Price Performance for U.S.-Headquartered Healthcare Companies Resulting from Reverse Mergers since 2008



Since 2021, and corresponding to the price performance trends we are seeing in the IPO markets as reflected by the graph above, healthcare companies that have completed a reverse merger in lieu of an IPO have begun to underperform relative to the broader market.

M&A Exits

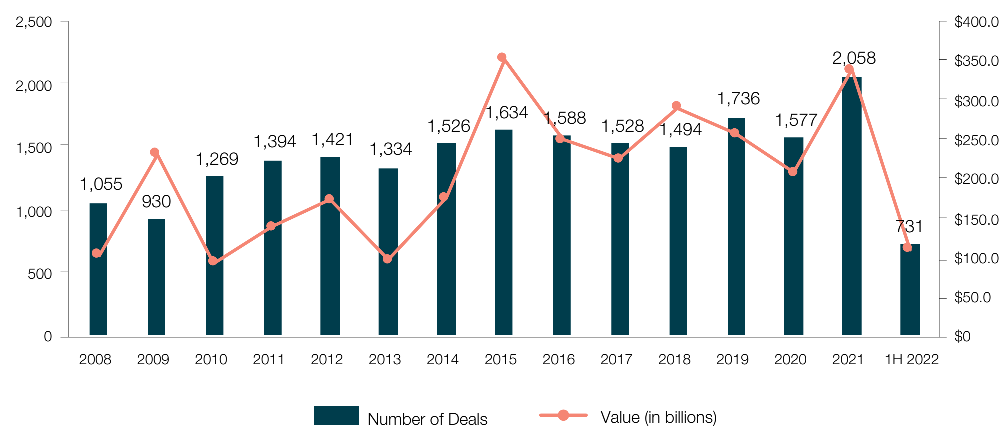
A down market can have several implications for mergers and acquisitions involving private company targets. It may limit the number of companies in the market for acquisition targets as the ability to finance acquisitions becomes more constrained and expensive, cash conservation policies are implemented, and stock consideration becomes devalued. Following a robust market, buyers may also focus on the integration of targets they purchased before the downturn. On the flip side, a down market could result in potential buyers entering the market looking for bargains on more favorable terms following a period of stiff competition and rising valuations for targets.

In a down market, certain sellers may be forced into sales processes if financing is unavailable or other market conditions make remaining independent more challenging. Others may be hesitant to start a process, given the perception that exit valuations may be too low based on the expectations set prior to the downturn, or the perception that the terms will be too buyer-favorable.

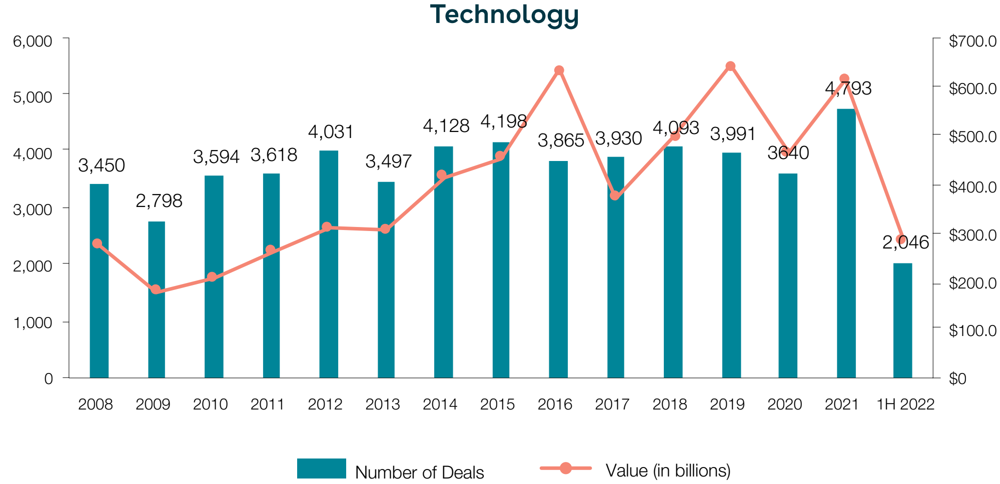
M&A activity in the technology space during the first half of 2022 is not far off pace compared to 2021, and has not seen as dramatic of a drop-off as we have experienced in the IPO markets. However, life sciences M&A activity, particularly in the biotech space, has decreased more than for technology companies. This is likely due in part to the same factors that are driving reduced IPO activity, namely, a shift to less speculative investments by buyers coupled with lower valuations. Companies will only sell if they need to, or if buyers are willing to pay an outsized premium to market.

Number of Deals and Value

Life Sciences



Technology



Important M&A Considerations in a Down Market

The impacts that a down market may have on a particular deal can be very fact and industry specific, but there are several considerations to be particularly mindful of during challenging economic times:

Bridge Financing

- Assess the cash requirements of the seller to determine whether any additional financing will be required to close the sale or bridge the seller to its next financing event if the sales process is unsuccessful.
- There should be particular focus on potential fiduciary duty issues when considering the terms on an insider-led financing, as significant proceeds going to the bridge financing sources at the expense of the common stock may be looked at negatively in hindsight.
- In granting exclusivity to a potential buyer, a seller should also consider whether it needs the flexibility to explore and/or consummate financing during the exclusivity period.

Alternative Transaction Structures

- Assess whether an alternative transaction is available to the seller (e.g., asset carve-outs or strategic partnerships can help a seller weather the down market until a more lucrative opportunity becomes available).

Representation and Warranty Insurance

- Assess whether a representation-and-warranty insurance policy is available for the transaction to limit the holdback of proceeds and maximize the consideration payable at closing.
- The pricing and demand for this product has decreased in 2022, which may facilitate representation-and-warranty insurance being available for a larger range of transactions.

Composition of Seller's Board

- Assess whether members of the seller's board could be considered conflicted, especially given the breadth of what can constitute a conflict under Delaware law. If half or more of the directors are conflicted, the board is likely to be held to a higher standard of judicial review in a stockholder suit, which can lead to more protracted, costly, and contentious litigation.
- Examples of conflicts include directors (or affiliated funds) with rights to payments not made (or not made equally) to holders of common stock, post-acquisition employment, relationships with fund investors that are receiving differential benefits, and relationships with the buyer.
- Fund investors will want to be cognizant of the possibility of being named as a controlling stockholder in a lawsuit or for aiding and abetting fiduciary duty breaches. Buyers will also want to be aware of being named for aiding and abetting.

Board Process

- The seller's board and its advisors should be careful to document in board minutes the board's process, its reasons for acting, and its understanding of its fiduciary duties and any conflicts of interest.
- Board minutes and related board documents are critical evidence in stockholder lawsuits, and boards should appropriately use board minutes to tell their story.
- Assess whether certain safeguards can be implemented to limit the likelihood of a successful stockholder lawsuit and help show fair process, such as use of a special committee, approval of disinterested stockholders, exploration of alternatives/market checks, independent valuations/fairness opinions, allocation of proceeds to holders of common stock out of preferences, limited benefits to management, and appropriate disclosures to stockholders.
- Equally important, board members and other parties involved in a transaction should be mindful of how texts, emails, and other similar communications can undermine the work that a board does.

About Wilson Sonsini

Wilson Sonsini is the premier firm advising technology, life sciences, and other high-growth companies seeking to raise capital through the issuance of equity, equity-linked, and debt financial instruments. During the past 20 years, the firm has represented some of the world's most iconic companies in connection with high-value IPOs. The firm is consistently ranked by *Bloomberg*, *Thomson Reuters*, and *CapitalIQ* as a leading advisor to companies and underwriters based on the number of completed IPOs and equity and equity-linked offerings. Since January 1, 2010, Wilson Sonsini has also been the leading legal advisor to issuers in IPOs valued at $50 million or higher that involve U.S. technology companies trading on major U.S. stock exchanges, according to *CapitalIQ*.

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