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Asia Venture Capital The Road Ahead in 2023

- Market Overview
- 10 Key Asia Venture Capital Emerging Themes in 2023
- Key Deal Terms Unpacked

Market Overview

Caution expected to persist in 2023

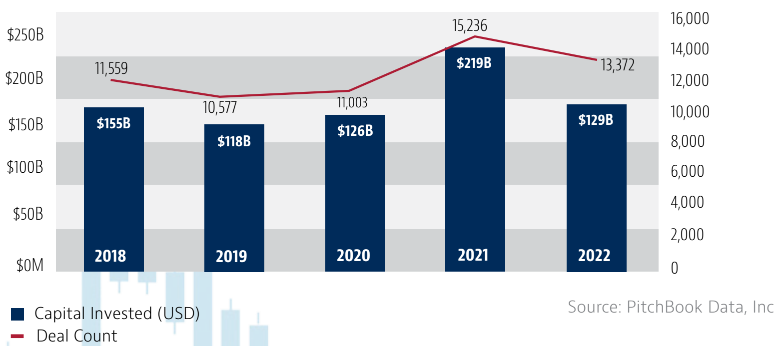
After a period of record global deal activity in 2021, the venture capital market took a step back in 2022 with a number of financial sponsors pressing pause on investments. Asia was no exception to the challenging venture capital market last year. The prevailing impact of COVID-19, the Ukraine conflict, increased regulatory scrutiny (particularly in the technology sector) and other political tensions contributed to a greater level of caution.

Whilst retractions in valuations have been felt most across late stage companies, early stage companies are expected to be put under relatively more pressure in the coming months as cash runways are stretched. Various macro headwinds, in addition to the recent Silicon Valley Bank (SVB), Silvergate and Signature headlines, are creating further challenges for fundraising.

Despite significant dry powder to deploy, financial sponsors are expected to continue to be highly selective, in search of deals with a greater focus on (or a path to) profitability.

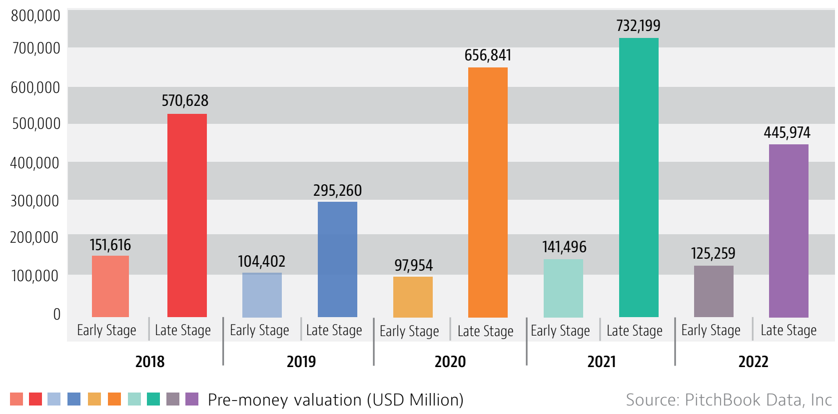
In this regional market overview, we look at a number of the key emerging themes in 2023 across the venture capital market in Asia.

Asia venture capital - deal activity



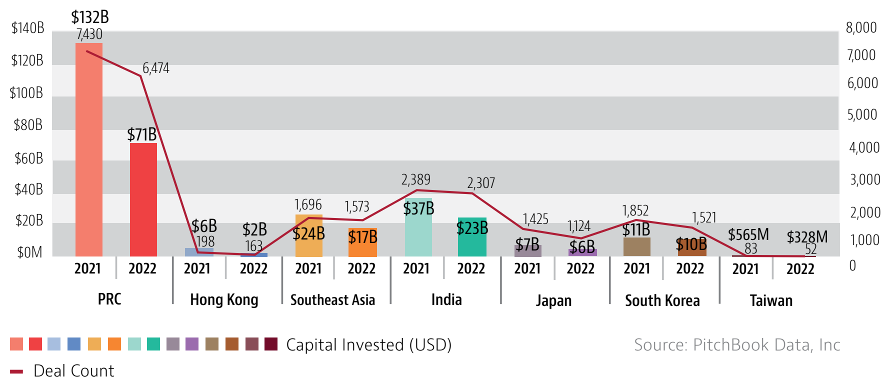
Deal activity by value and volume retreated in 2022, closely aligned with 2018-2020 historical averages.[1]

Asia venture capital - valuations



A decline in valuations in 2022 had a greater impact across the late stage market (relative to the early stage market).[1]

Asia venture capital - geographical comparison



Across various Asian markets, venture capital investment declined consistently against record deal activity in 2021.[1]

1 Figures have been rounded up or down to the nearest whole number.

10 Key Asia Venture Capital Emerging Themes in 2023

1 Extending cash runways

With valuations under pressure, many investee companies have advised investors they are tightening their belts, looking to extend cash runways and push out funding rounds where feasible. Head count, remuneration packages, advertising budgets and other expenses are in focus. Founders walk a fine line to strike the balance between decelerating cash burn, maintaining growth rates and ensuring high performers remain incentivised - all while keeping investors onside ahead of the next funding round.

2 Due diligence in focus

While the dust is still settling on the fallout from the FTX collapse and more recently, SVB, increased regulatory scrutiny has also given rise to further caution from investors. Investors are seeking greater levels of comfort, ensuring the investee company's house is in order to support cashflow projections and valuations. With travel restrictions relaxing across Asia, we expect to see more opportunities for face-to-face interaction in connection with due diligence processes. Additional time should be factored into the funding timetable for investor due diligence to increasingly test founders across a range of financial, legal and compliance areas.

3 An increasingly investor-friendly environment

Relatively investor-friendly terms are expected to continue in 2023 with a greater emphasis on more favorable preferred equity rights and governance terms.[2] A break down of some of the emerging preferred equity trends is set out in Schedule 1 - *Key Deal Terms Unpacked*.

4 Convertible instruments feature in selective markets

Convertible notes and SAFE (*Simple Agreement for Future Equity*) instruments are increasingly being deployed by investee companies seeking to defer challenging valuation negotiations and/or as a bridge between equity financing rounds.[3] A break down of some of the emerging trends in respect of convertible notes and SAFE instruments is set out in Schedule 1 - *Key Deal Terms Unpacked*.

5 Challenging credit and venture debt markets ahead

With reduced valuations and tightening of credit markets, investee companies seeking to raise capital on a down round will potentially trigger existing anti-dilution protections and complicated readjustments of equity structures. Venture debt can provide investee companies with preferred funding terms, particularly when faced with valuation pressures. However, investee companies considering venture debt facilities face some additional challenges following the recent SVB collapse and a general tightening in funding requirements within the venture debt market.[4] We expect that many companies will move to diversify their banking relationships and engage in conversations with other potential lenders for refinancing options or additional working capital / liquidity lines of credit. However, venture debt lenders are expected to proceed cautiously. This potentially opens the way for non-bank lenders to fill the gap albeit on more conservative, lender friendly terms.[5]

6 Employee incentives

With a focus on reduced cash burn, start-ups and growth companies will increasingly look to employee equity models to retain, reward and motivate star employees, and companies may need to dip into the options pool to attract and incentivise senior talent. The dilutive effects of such incentive plans are expected to continue to feature in investors' valuation and investment discussions.

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2 PitchBook, PitchBook VC Dealmaking Indicator, 3 March 2023.
3 This excludes jurisdictions where investee companies typically do not issue convertible debt (whether due to regulatory reasons or otherwise) such as Malaysia, South Korea, Taiwan and Japan.
4 See the Baker McKenzie Debt Finance Update (SVB Week in Review and Practical Takeaways, 20 March 2023).
5 PitchBook, Nonbank lenders pounce on venture debt market after SVB collapse, 14 March 2023.

7 Sustainability remains a key focus for sponsors

We anticipate an increased emphasis on sustainability and social impact in venture capital deals and expect to see more companies including sustainability and social impact metrics in their performance criteria. Model ESG letter agreements increasingly look to incorporate standardised ESG-related provisions in financing agreements.[6]

8 Extending pre-IPO funding timetables

As a number of companies explore pre-IPO financing ahead of deferred IPO timetables, it remains important to carefully assess and structure convertible instruments or preferred equity issued to pre-IPO investors, screening out any potential regulatory hurdles to facilitate a smooth process for a future listing.

9 Secondaries

Secondary investment opportunities are likely to feature in the second half of 2023, creating additional liquidity options for investors.[7] While reaching consensus on valuations remains challenging, liquidity requirements are likely to weigh heavily on funds affected by the denominator effect with limited IPO exit options.

10 Hot sectors and markets to watch in Asia

Technology and innovation remain in the spotlight as key drivers for growth for financial sponsors and corporate venture capital investors alike, featuring, in particular, Fintech, Healthcare / Healthtech, Artificial Intelligence, Big Data, E-commerce, Alternative / Renewable Energy and Logistics / Warehousing.[8]

Key growth markets in the region are expected to remain a focus for investors. In particular, Southeast Asian markets and India remain buoyant despite global headwinds; Japan deal activity continues to feature, particularly across relatively mature technology based opportunities; and the long-awaited China reopening is also expected to create a positive ripple effect across the broader regional market.

Navigating the Headwinds

Upcoming investment conditions are expected to present some challenges for early-stage and growth companies in particular. In 2023, we anticipate that deal terms for venture capital transactions across the region will continue to evolve with investors expected to be increasingly selective. Companies are responding - working hard to streamline and reduce cost burn, and extending the runway before the next raise if required. Founders that can successfully navigate their way through the year ahead will need to be prepared to adapt to the changing market conditions.

Minority investments continue to present opportunities in the broader Asian private equity market, with a higher percentage of disclosed deals relative to PE buy out transactions in recent years.[9] Notwithstanding the growth in minority stake transactions, liquidity concerns remain a key issue for investors, and we expect investments to increasingly be structured with more flexibility for investor driven exit requirements.

Looking forward, as inflationary pressures eventually ease and markets stabilise in due course, we expect to see a gradual increase in venture capital and growth capital deal flow return to the region. With an uptick in global venture capital firms entering the Asian market (particularly North American and European based funds), coupled with a general increase in cross-border deal flow, increased competition for venture growth deals is expected to resume in the region.

6 For example, see the VIMA model documents released by the SVCA.
7 PitchBook, PE secondaries market set to boom in 2023, 7 December 2022.
8 Based on a recent survey of deal data from Baker McKenzie offices from across the Asian region.
9 PitchBook Research (APAC PE deals 2000 - 2023).

Schedule 1 - Key Deal Terms Unpacked

Recent market conditions have led to a shift in deal terms sought by investors for venture and growth deals. While there are notable variances in certain jurisdictions, we set out a selection of general trends emerging in 2023 across:

- preferred equity;
- convertible notes; and
- SAFE instruments.

Preferred equity

Preferred equity terms

- *Liquidation preference multiples and participation*. Investors are increasingly seeking liquidation preference multiples of up to 1.5x to 2x and, in some cases, potentially 3x, with an option to participate in the remaining proceeds following receipt of a liquidation preference.
- *Dividend rights.* Subject to applicable law, investors are likely to seek enhanced dividend preferences (to align any expected return on investment) and cumulative dividends.
- *Redemption and other exit rights.* More favorable redemption rights are increasingly prevalent (e.g. elections for repayment or conversion on maturity, or rights for extensions to the maturity date) in addition to drag-along rights, rights of first refusal and other exit rights (including pre-IPO lock-up periods).
- *Information flow and board rights.* Investors are increasingly seeking greater oversight and control at the board level coupled with veto rights via progressively stringent reserved matters.
- *Pre-emptive rights.* Investors may request enhanced pre-emptive rights which rank ahead of other shareholders by up to 1.5x to 2x the investor's ownership interest in some cases, subject to local regulatory requirements.
- *Deferred vesting of founder interests.* Increasing requests from investors to defer or restrict founders' equity interests with vesting schedules linked to performance are expected.
- *Founders' covenants.* Investors may increasingly call for founders to stand behind company warranties and other covenants.

Convertible notes

Convertible note terms[10]

- *Higher liquidation preference*. Liquidation preference multiples of up to two times in the event of an exit or liquidation are increasingly being sought.
- *Conversion discounts.* Investors may seek greater conversion discounts of up to 30% of the issue price at the relevant equity financing round, up from 15% - 20% (conversion discounts may vary, depending on the perceived risk / return profile).
- *Cash requirements and financial covenants.* Some investors may require tighter minimum cash requirements, leading to potentially slowing down a company's growth / investment plans. Investee companies may also be required to maintain certain financial ratios during the term of the instrument.
- *Operational covenants.* Investors are increasingly requiring additional undertakings from investee companies to restrict certain business activities and certain corporate actions without the investors' consent.
- *Compounding interest.* It is increasingly common to see either "in cash" or "payment-in-kind" (PIK) compounding interest, at higher interest rates than the 1 - 2% historical 2021 / 22 range.
- *Warrants or options.* An uptick in warrants or options exercisable at a future date, tracing back to the relevant current valuation is also expected.

SAFE instruments

The use of SAFE instruments in Asia has been another interesting feature that is expected to continue in 2023. SAFE instruments attract a simple investment structure generally requiring limited negotiation. Unlike a convertible note, a SAFE is not a debt instrument (i.e. no interest component, repayment terms or maturity date (although in some regional markets certain structures have started to emerge whereby a long-stop date for conversion is included)). SAFE instruments typically include conversion discounts (e.g., 20% - 30%) and/or valuation caps. Investors in Asian markets are increasingly seeking the optionality to apply a more investor favourable outcome when considering conversion discounts vis-à-vis valuation caps.

10 This excludes jurisdictions where investee companies typically do not issue convertible debt (whether due to regulatory reasons or otherwise) including Malaysia, South Korea, Taiwan and Japan.

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