GUNDERSON DETTMER

WHAT TO KNOW ABOUT CROSSOVER ROUNDS AS A LATE-STAGE PRIVATE COMPANY

We represent *what's next.*

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Any Monty Python fans in here?

So What Are We Talking About Today?

- What is a Crossover Round
- History and Trends
- Benefits of a Crossover Round – Company Perspective
- Benefits of a Crossover Round – Investor Perspective
- Practical Considerations
- Deal Terms and Legal Considerations
- Outlook
- Q&A

What is a Crossover Round?

INVESTMENT

Private company investment by funds who also invest in public companies.

TIMEFRAME

Usually occurs within 12 months prior to an IPO, but the time period has been shortening.

FINAL ROUND

Typically is the final financing round before a company goes public.

VALUE OF A CROSSOVER

These rounds help establish a fulsome book for the IPO, where much if not all of the book is subscribed for by existing investors.

DUE DILIGENCE

Many crossover investors conduct extensive due diligence.

BIOTECH AND TECH

Crossovers are standard in biotech, but we also see crossovers in tech.

*If you are a late stage biotech and contemplating an IPO in the future, chances are you will either be transacting a crossover round or at least contemplating a crossover round.

History and Trends

Percentage of biopharma IPOs with crossover round increased through 2021

- In 2015, ~55% of biopharma companies that went public had a crossover round.
- 2020 and 2021, that percentage was above 80%.

AUM by top 10 crossover focused investors increased.

- Total AUM in 2016 for top 10 crossover funds was ~$18B. By the peak in early 2021 that had increased to $60B (public companies).
- AUM has now come back down to Earth with recent market pressures, and likely down more than 50%, with some funds down 70%.

Trends

- Crossover funds are still raising capital and making investments
- While participation peaked in the Q1 2021, we expect crossover rounds to continue to be the prevalent financing tool for pre-IPO life science companies.

Benefits of Crossover Round – Company Perspective

- Provides the company with more time to ***tell its story***:
  - Crossover investors have a better opportunity to evaluate a company prior to the TTW period and roadshow.
  - Important for pre-revenue biotechs where in-depth understanding of the science, product, regulatory pathway and market opportunities are important to an investment decision.
- Show ***prominent investor support*** prior to a public offering.
- Can help a company ***attract other high profile investors***.
- ***De-risks the IPO*** by getting participation commitments for a majority (or all) of the book.
- Long-term shareholders tend to have a ***stabilizing effect on share price*** post-IPO.
- Can ***raise a large amount of capital*** to support future operations if the IPO window closes quickly or the company has a bad regulatory result.

Benefits of Crossover Round – Investor Perspective

- Crossover investors are able to obtain shares at a ***significantly lower valuation*** than the IPO price (e.g., the IPO valuation is 1.4X-1.6X step-up to the crossover valuation).
- Crossover investors can ***position themselves to acquire a more significant allocation*** in the IPO.
- Crossover investors have ***more time to diligence the company***, science, technology and management at a level not possible in the TTW or road show process.
- Crossover investors can ***build a larger position in a company*** than otherwise possible through the IPO.

Practical Considerations

- The investors you choose for any crossover round likely can have a large impact on the success of your IPO. ***Choose investors carefully***.
- Investors have ***different deal provisions*** they either require or request.
- Expect ***more expanded diligence*** than a typical preferred financing.
- Understand how quickly your company can ***pivot to an IPO***.
- Need to ***carefully manage resources and staff up*** – as you will be balancing a crossover round at the same time as you prepare for an IPO and grow your business.
- Understand ***what valuation the business can support*** at both the crossover round and IPO stages.

Deal Terms and Legal Considerations

- Historically, invest in preferred stock – using the same preferred stock financing agreements as earlier rounds.
- Watch for Integration with IPO.
  - Take steps to make sure IPO and crossover round are separate.
  - Keep diligence efforts separate
- Consistency between information provided crossover investors and disclosed in S-1.
  - Cleanse any material non-public information that crossover investors learn in diligence.
- TTW Process:
  - If you want to use crossover investors names in TTW meetings, will need consent from such investors.
  - Maintain good records of TTW meetings for any questions on integration.
  - Materials provided to crossover investors and in TTW meetings should be materially consistent.

Deal Terms and Legal Considerations

- IPO Participation Rights
  - Crossover investors oftentimes will want a firm IPO participation right.
  - Be thoughtful about drafting
    - Commercially Reasonable Efforts vs. Shall
    - Caveat for securities laws and regulations, including FINRA
  - Beware of gun jumping.
  - Thoughtful of how deal terms may be disclosed publicly (investors rights agreements, side letters etc.)
- IPO Ratchet Rights
  - Provision that provides investors will receive additional shares to the extent IPO price does not meet a pre-terminated target.
  - Square, Inc's IPO in 2015 triggered a ratchet on the conversion price of the Series E Preferred Stock.
  - This can be drafted as a conversion price adjustment or as an obligation to issue additional shares.

Deal Terms and Legal Considerations (cont.)

- Increasing Liquidation Preferences
  - Valuations between crossover rounds and IPO pricing can be more narrow.
  - The liquidation preference per share increases over time.
  - Helps investors to protect against downside to the extent there is a liquidation event below or close to the internally targeted IPO price.
- Non-Voting Common Stock
  - Some investors have sensitivity to ownership levels above 5% or 10% due to SEC filings.
  - Will request a provision that investor has flexibility to convert preferred stock into standard common stock or a non-voting class of common stock (or preferred stock) at IPO
  - If structured correctly, than non-voting shares are not included in beneficial ownership calculations
- Note Financing Crossovers
  - Crossovers can be structured as Note Financing
  - Notes convert at a discount to the IPO price at the IPO, so the discount to the IPO is pre-negotiated.
  - Note Purchase Agreement may still include IPO Participation Rights and other rights.

Deal Terms and Legal Considerations (cont.)

- Board Rights
  - These are provisions where the investor has the right to board representation once the company closes the IPO (or board representation that continues).
  - The Company is obligated to nominate one or more persons at each stockholder meeting.
  - These rights are subject to fiduciary duties of the board, and can also be subject to majority of board agreeing that such nominee is qualified.
  - Should have sunset, based on time or ownership in the company.
- Special Registration Rights
  - Some investors will request a side letter/registration rights agreement specific to that investor.
  - While some of it will track the registration rights in the IRA, the side letter provides the investor more latitude on when to exercise the registration rights.
  - Once registration rights in side letter come into effect, the IRA registration rights should fall away with respect to the investor.

Outlook

For Companies looking to raise a Crossover Round

- Crossover round valuations based on discount to expected public offering price (e.g., 1.4X-1.6X step-up from crossover),
- Based on current public company valuations – flat and down rounds will be common,
- Look for more aggressive terms (anti-dilution ratchets),
- Diligence and negotiation will be more protracted,
- For life science companies – will likely be later in the regulatory process,

For Companies who raised Crossover Rounds in 2020 and 2021

- Too early to tell – as many companies are not running out of capital until later in 2023 or early 2024,
- Existing crossover funds may not have capital to invest their pro-rata in next round or may elect not to participate,
- Watch out for more aggressive terms (anti-dilution ratchets, pay-to-play, recapitalizations).

Conclusion

- Crossover Rounds are here to stay.
- Companies should be aware of how crossovers work as you prepare for next IPO window to open.
- **Q&A - insights@gunder.com**