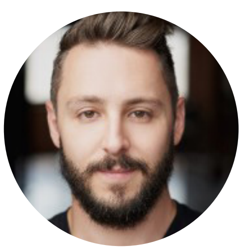
gould + ratner

Businesses Adapting to COVID-19 During and After the Crisis

Fred Tannenbaum
Partner

ftannenbaum@gouldratner.com
(312) 899-1613



Michael Lavin
Founder & CEO

Germin8 Ventures

Gould & Ratner presents the first installment of an interview series on adapting to the COVID-19 pandemic. We periodically sit down with some of the most accomplished and incisive venture capital entrepreneurs and executives and discuss their insights on relevant and pressing topics of interest to the community.

Fred Tannenbaum, a partner in the firm's Corporate Practice, recently discussed a variety of issues with Michael Lavin, Founder & CEO of Germin8 Ventures. Germin8 is one of the country's leading venture capital funds investing in seed and early stage companies in the agriculture and food tech industries. Germin8 has six portfolio companies at present with considerable resources to target more as opportunities present.

Fred: What would you say are the three key distinguishing features of your fund?

Michael: There are several distinguishing traits for our fund and it comes down to our recognition of meaningful market gaps, investing with principles and cultivating a proprietary ecosystem. Let's start with just the macro financing gap. Food and Agriculture contributes more than 1/3rd of global GDP, yet is substantially underfunded, attracting less than 5% of total venture funding. Moreover, the early-stages – Seed and Series A stages – are particularly underfunded, see limited investment by strategic domain experts, and this segment of the lifecycle is most likely to see softer activity amid the climate brought by COVID-19. Regarding investing with principles, we invest in this space because Food and Agriculture has a broken system.

The food system contributes more than 1/3rd of global GHG (greenhouse gas) emissions, production needs to increase 70% to feed the future 2050 population; meanwhile there's competing demands for natural resources, new disease pressures, constrained economics along the whole system and demands by consumers who are either undernourished, improperly nourished and/or desire expanded options. Food and agriculture is the single strongest lever to pull on to optimize environmental sustainability, human health and life on earth. We invest with great conviction in the deep science and technologies that have the greatest potential to drive profound, measurable impact. Having a very high impact threshold is a key cornerstone of our strategy.

Another cornerstone principle is our founder orientation. Founders are the DNA of the business. Our goal is to be dedicated, committed partners that enable them to reach their ambitious visions. To this end, we operate as extensions of the team and, likewise, only invest in a small number of companies led by exceptional founders. This segues nicely into the third distinguishing feature - cultivating a proprietary ecosystem.

We uniquely have strong strategic backing from industry veterans, executives, entrepreneurs, technologists and researchers all throughout the supply chain and throughout the globe. Not only are these people advisors for Germin8, but they're personally invested in our fund and we've take zero corporate capital. What this means is we have an arms-reach into a variety of corporate and academic resources, systems, networks, know-how and the like to create as many unfair advantages as possible for the founders we back. We have significant strategic firepower but zero encumbrances. We also believe all ships will rise together and so we make an effort to contribute into the broader ecosystem more than we take from it. In a short period of time, Germin8 has become an essential constituent in the ecosystem.

Fred: None of your portfolio companies is immune from the government orders regarding COVID-19 in addition to the natural personnel and business interruptions and displacements. Is there a common theme to how your companies have addressed these issues, in particular, internal issues like cash flow management and employee morale and retention and external issues like supply chain interruptions and shortages and vendor and customer relations?

Michael: I'll start by saying Germin8 is fortunate to have a focus on a relatively resilient sector, being food and agriculture. Plus, having a sound strategy to invest in the "must-have" technologies over the "nice-to-have" technologies lends itself to succeeding in virtually all cycles. In fact, the COVID-19 crisis and resulting shocks stress even greater needs for many of the offerings throughout our portfolio.
Additionally, our portfolio is largely constructed of SaaS companies, which have limited-to-no person-to-person requirements, and synthetic biology companies, which are somewhat insulated as they're focused heavily on R&D, though there's still essential wet-work to be done in the labs. Even with their strengths, however, they're also having to quickly adjust to new modes of work and life, creatively solve problems and capitalize on unique opportunities presented by all of this. Being nimble, creative and opportunistic is key, and a few important action steps are as follows:

1. Establish a tactical team internally to implement continuity and extra contingency plans. This team is responsible for segmenting essential work from non-essential, identifying critical control points for health and safety, developing smart transition strategies, building lots of redundancy to mitigate internal roadblocks and supply chain disruption, and swiftly communicating regular updates to the organization in manners that are effective, productive, signal confidence and incentivize culture and collaboration to continue and evolve in a positive direction.

2. Accept that this will have a profound impact and lasting ramifications on the "future of work". Remote work, collaboration and sharing is not easy. But with an open mind we may find ways of doing business and science that open our minds to new ideas and possibilities. Leadership skills and abilities to succeed with distributed teams are being tested. There are a host of digital tools to help, which we've compiled for our founders to review. But we've also informed them that the real challenge is cultural. Companies are now faced with extending company cultures to new channels, while remaining authentic. Vision, values, celebrations, recognition, compassion and conflict will be communicated very differently not just in the foreseeable future, but well into the future. Using the right tools and building thoughtful frameworks for the human elements is very important for constructively building culture in ways that can carry forward seamlessly in the future of work. It's worthwhile to enter this new mode and build with a long-term mindset. Build a thoughtful plan for this, welcome contributions to it and let it evolve.

3. Develop financial plans with a flexible framework built for stress and rebound. Venture investment is likely to wane significantly, and this influences a need to reevaluate cash runway and essential milestones. Startups should develop a plan for financial endurance (18 to 24 months if possible) and stress test it. Test all key assumptions. Our next recommendation is to also develop a good idea of the levers to pull in rebound scenarios. Practically speaking, rely on your instinct to slow the burn and focus on high value activities. Revisit the plans regularly with the executive team and board to align on the path we're tracking to.

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4. Explore all opportunities and actively seek to unlock hidden value in these times. Prepare for defense, but actively devise strategies to strike offensively at new opportunities afforded by a dynamic market environment. While others are scrambling, we can stay active, lean and capitalize on opportunities. Some such opportunities may include responding to new customer pain points that may prove to be scalable differentiators, addressing bottlenecks previously ignored but would now free-up cash or enhance customer experience; or capitalizing on the distress of others by making top hires, securing more affordable space or purchasing key equipment at auction.

We believe there are many silver lining opportunities. When others are passively riding-out or falsely optimistic, winning-advantages can be secured by those who embrace the new environment, steward with decisiveness and build to win in these circumstances. Cisco (Black Monday in 1987), Google and PayPal (dot-com bust in 2000), Airbnb, Square, and Stripe (all founded in the midst of the Global Financial Crisis).

Fred: If you suggest more cash runway than usual will be emphasized, and you couple that with probably lower valuations given the reduction of competitive funds, does this mean that VC funds will have a great ownership interest in these companies? If that is the case, then what does this mean for the ability to motivate founders and attract lateral executives? Or will the dilution come from friends and family which will result in lots of conflict? Or will founders strive to keep friends and family in the picture as long as possible to avoid this dilution notwithstanding the intangible benefits that a professional experienced VC like Germin8 brings?

Michael: It certainly depends on the company, their current cash balance and how they're reprioritizing certain elements of their plans. Some, particularly those who recently raised sufficient capital, may likely re-budget for prudence with no intention of rushing to raise in this climate. Most others aren't in that position and I suspect they will be needing more capital in order to navigate challenges and perform well in 2020 and into 2021. For these companies, which I suspect will comprise the majority of the bell curve, lower valuations than originally planned, and in many cases, down-rounds will in-fact mean more VC ownership and likewise less founder ownership.

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However, there's a balance to consider and it behooves investors to structure deals in a way that limits cap-table complexity, does not overly dilute founder ownership, reserves a sufficient ESOP pool for hiring and retaining talent, all while keeping valuation reasonable such that capacity is preserved for VC's to find the next round attractive at a market step-up and still see an opportunity for a venture-worthy return outcome. Touching more on your specific questions, maintaining founder equity is essential and Germin8 has passed on numerous deals simply because the founder had too little and thus wasn't properly aligned.

If founders can preserve this by raising through convertible instruments, smaller rounds and adequately-sized ESOPs that can provide top-off later, then those are good strategies to help strike the balance I've mentioned. Regarding the hiring of executives, one of the greatest signals to investors is a founder's or founding team's ability to attract top-tier talent without having deep pockets. It's a true test and early indicator for the quality of the vision, capability of the leadership and overall inspiration. And lastly, if the company hasn't yet raised a venture-backed round, it could be advantageous to hold-off, go stealth and raise a small, swift round from some additional angels that aren't family and friends. A lot could be said for quietly setting the stage to launch big and dominate the market, all while preserving your founder equity.

Fred: The past several years have been very good for venture capital funds. Interest rates have been historically low. The economy has been expanding and world growth relatively synchronized. The supply of capital has been abundant. Markets have been very liquid. In light of the dramatic reversal in economic fortunes and abrupt drying up of liquidity, do you think that investors are going to be more wary of committing funds locked up for so long, requiring so much patience and uncertainty, in such an uncertain world? If so, does that present opportunities for the intrepid like your fund?

Michael: Absolutely. All of the above. Until markets normalize to a level where recent losses are perhaps earned back and investors see signs of expansion, investors will generally be illiquid and have diminished confidence. I tend to think this is compounded by anxious expectations for some time now that a recession is on the menu for 2020 as well.

Newcomer venture funds seeking to raise funds and establish themselves at this time will certainly have greater difficulty than in the recent past. Some bent on raising now may struggle to raise committed funds and revise their structure to pledge funds. Others may revise their strategies altogether or hit pause. I would expect fund formation in opportunistic funds could have more success.

These may be venture funds that invest in secondary shares, which it acquires from primary investors seeking liquidity. It's very likely we'll see more secondary transacting this year. For Germin8, our fund is on the right side of this cycle as we just closed our fund raise, are well capitalized and have always had a solid strategy to keep ample reserves for supporting our companies with follow-on investing. You can be certain that Germin8 will be supporting its current portfolio, making new investments and capitalizing on the opportunities presented by a market with less competition for deals and attractive valuations. We'll have to be extra thoughtful, though, regarding syndicates and making sure we're all committed to carrying these companies through. That's always been our style anyhow.

Fred: Will early stage companies be at a disadvantage to competitors backed by larger better capitalized companies in the new environment?

Michael: Actually, I think quite the contrary. Undercapitalized businesses can be at a major disadvantage, but I believe it depends on the stage of the life cycle. Companies that have established a series of valuation step-ups and now find themselves undercapitalized could indeed be most vulnerable. Early stage companies can also be vulnerable as there's fewer dollars investing in these opportunities. However, many early-stage companies are very lean, nimble and built for capital efficiency.

Investment dollars put to work in the right early stage companies can go a lot farther and yield a lot more upside once milestones are made and investment appetite improves. And with regards to the well-capitalized companies, the capital resources and momentum is enticing, but some of these companies are substantially "marketing fluff" with superficial valuations, versus credible breakthroughs, traction and fundamentals. Some are now re-opening their latest rounds of financing to bring in even more cash. I think those that have disillusioned investors in the past will not be able to in the future. They need to adapt in a lot of respects where frankly the leaner early stage companies have meaningful advantages.

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Fred: Once this pandemic ends, do you see major permanent structural shifts in the venture capital industry? For example-- How long money is tied up? More transparency? More leverage to investors? Less patient capital or actually more patient capital? Lower valuations? More structured deals with milestones? Less patience with management teams? Or will we forget about all this in a couple of years?

Michael: I hate to sound negative, but a first consideration is I think we can expect that pandemics like this will become more commonplace in our future. Just like seasonal hurricanes, earthquakes, droughts and other unpredictable "acts of god," I think pandemics will be among these. It's hard to say if that's in five years or ten, but we should be ready for it.

A second consideration is that philanthropic-oriented Impact Investing has come into vogue and often tends to be backed by patient long-term capital. I think it's likely that first time funds will have difficulty in their fundraisings if they have a longer than market fund life. However, established funds may have more success raising with longer lives. In fact, the established firms managing several funds might cleverly position long-term funds as an attractive asset class on its own. I think for all funds, we can count on flexible structures with options to extend the investing period and or fund life given certain events.

Fred: If pandemics are likely to become more commonplace, will you pivot to companies analyzing microbes for medicinal purposes instead of food production purposes? Will you also consider fund structures which are either longer term, but at the same time let people out after x years, like 10 years and give those who want to exit the right to do so and those who want to stay the right to do so? Almost akin to a 10 year open end fund?

Michael: I love this question because while it's easy to see that we're FoodTech and AgTech oriented, our motivation for this sector focus isn't solely to address food security (i.e. feeding 10 billion people by 2050), but we're also driven to solve human health problems via changes in the food system, all while being more sustainable and supporting the economics of the people who put food on our table. One major human health concern is antibiotic resistance, in which animal agriculture has been a significant driving factor. Historically, 80% of antibiotics (also known as antimicrobials) sold in the United States have been used for livestock.

Every year, 23,000 Americans die and two million get sick because of antibiotic resistant bacteria, and our antibiotics are losing their effectiveness in part because of overuse and misuse in livestock farming. Combine this critical need with advancements in genetic engineering plus health-promoting microbials, and you have potential replacements to antibiotics in animal agriculture. This would not only directly resolve a key source of resistance, but proven effectiveness and safety in the animal models could potentially translate into human models. We like platforms with such potential as this and we're moving ahead on a particular investment as we speak.

This particular company isn't only showing evidence that it's a suitable replacement to antibiotics, but it also positively impacts the producer's bottom line and it's to be confirmed but it may also significantly reduce methane emissions (a dangerous greenhouse gas that is up to 30x more potent than carbon dioxide). In addition to this, we also keenly evaluate microbe platforms within Ag-biologicals for carbon capture, soil health and crop nutrition. We may be making an investment in this space very soon as well.

Regarding the 10-year fund life question and whether we'd consider building-in flexibility for LP's to exit or stay beyond the ten years, I'm certain we would consider this for the next fund. While we invest with a strict focus on opportunities that could yield an outsized venture worthy return within five years, that's of course hard to predict and our LP's are a top priority. Any way we can distinguish our fund as LP friendly, aligned and principled is something we want to explore doing. To this end, allowing such flexibility can be a benefit to the LP's, but there would need to be some consideration to the practicality of it, ensuring that interests are marketed with first priority to continuing LP's, and exiting LP's should likely incur a discount for the liquidity.

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Fred: Once this pandemic ends, what changes do you see your portfolio companies undergoing? For example-- More technology and work remotely? Less office space? More stockpiles of inventories to avoid supply disruptions? More focus on microbials defensively to fight infectious diseases instead of offensively to enhance the efficiency of organisms? Less travel and more video? Less staff? More direct channels and not indirect to keep customer contact? More opportunities for consolidation due to cash strapped companies? More pricing terms on prompt payment? Any particular portfolio company in mind for significant structural change?

Michael: I'm certain that there will be lasting ramifications on the workplace and companies, young, old, small or big, will have more remote work. The stigmas associated will largely be abandoned and those that move fastest will be those that succeed in such a transition and figure out the balance that works best for them. With regards to our portfolio companies, we can expect to see innovation in the external interfacing with customers during the sell-cycle, implementation, troubleshooting and updates to be more autonomous, DIY and consistent, while maintaining the right element of touch. I'm also sure that internal practices have the potential to move even faster and scaling strategies will evolve considerably.

On the latter, lots of companies choose their headquarters location based on available talent and sometimes there's a challenge to match talent with important physical assets or distribution networks. As remote work enhances and becomes more commonplace, companies will have more options for practical distributed operations. I'll also comment on your question about defensive microbials. As mentioned earlier, novel microbes certainly represent a promising opportunity health and efficiency. They're not without challenges, such as they need sufficient lifespan, colonize in the right locations of the gut, have proper dosage with economics, and they're often highly-targeted to certain bacterium and mechanisms of action. But they hold great promise, are enabled by novel gene-editing approaches, computational methods can drive efficient discoveries and the regulatory pathway is clear.