CORPORATE MATTERS: CONVERTIBLE NOTE FINANCING

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We have seen an increased number of term sheets for convertible note financings lately and thought it might be helpful to discuss some of the terms and conditions of these notes. In an earlier issue of *Insights*, we discussed angel investing and the risks (and rewards) of that strategy. Convertible note financings are used for seed financing and are a very economical and efficient way for start-up companies to obtain seed capital without losing control of the early-stage company.

CONVERTIBLE NOTE

A convertible note financing is short-term debt that automatically converts into shares of preferred stock upon the closing of a Series A financing round. This method of financing is favored by company founders because it can be completed very quickly, is somewhat simple, and is relatively inexpensive in terms of legal costs. A convertible note purchase agreement and note can be a few pages long and prepared and closed in a few days.

While start-up companies can issue common stock to early investors, there are a variety of reasons why the founders may be reluctant to do so. These include the difficultly in putting a value on an early stage company and potential tax issues for founders issued stock at nominal values. Because convertible notes are debt not equity, their issuance puts off the valuation matter until the later round of financing – by which time the company may have developed to an extent where more and better information is available on which to base a valuation.

INTEREST

Typically the convertible note provides for simple interest (not compounded) on the amount of the loan in the 5% to 8% range. Most notes we have reviewed recently have included 6% interest, and that seems to be the current market rate. The interest rate on these notes is less important, as it is unusual for the notes to actually be repaid. Rather, they are converted into preferred stock upon the Series A round, and the benefit to the investor is the conversion discount negotiated when the loan was negotiated. It is unusual for these convertible notes to allow for prepayment by the company because the last thing an investor wants is, after taking considerable risk, to be repaid one year later at a 6% interest rate.

CONVERSION DISCOUNT

The conversion discount is essentially the reward to note-holders for their investment risk by allowing them to convert the amount of the loan plus interest at a discount from the purchase price paid by the Series A investors.

The current market discount rate appears to be 20%, and this rate can be negotiated with the company. It should be noted that a rate that is too high can turn off potential investors at a later time. A note can also include a conversion discount that increases over time. The logic being that the longer the note is outstanding the higher the risk that the Series A round will not take place.

WARRANTS

Investors will sometimes request the issuance of warrants in lieu of the conversion discount. Company founders involved in a seed round will resist this, as it involves increased legal fees, and it appears that the conversion discount is by far the most common way to reward investors for their risk.

VALUATION CAP

A conversion valuation cap allows investors to benefit from any significant increase in the value of the start-up company subsequent to their investment. A "cap" is not a valuation but a negotiated term of the note, and different investors in the same company may have different cap amounts.

A cap is a ceiling on the value of the start-up where the company sets a maximum dollar amount for purposes of determining the conversion price, which permits investors to convert their loan, plus interest, at a lower price than the purchase price paid by the Series A investors.

If the note includes both a discount and a cap, the agreement will usually provide for the conversion price to be the lower of (i) the price per share determined by applying the discount to the Series A price per share and (ii) the price per share determined by dividing the cap by the Series A pre-money value. The reason for this approach being the lower the conversion price, the more shares the note-holders are issued upon conversion.