A cautionary tale

The good and the ugly of convertible debt financing

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EVENT: Don't miss ASPIRE 2019 on March 21, where Chris Farmakis will moderate the afternoon panel on financing your business. Register at www.aspiredealmakers.com/pittsburgh/register.

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Convertible debt is a common investment vehicle by which early-stage companies raise capital, where an investor grants to a company a short-term, often interest-bearing loan that converts into equity of the company at a future date. The convertible debt investors agree to push the question of what the company is worth — the valuation — down the road until the company's next priced funding round. In return, the investors receive certain advantageous terms at the time that the debt converts to equity.

Smart Business spoke with Christian A. Farmakis, shareholder and chairman of the board, and Justine M. Kasznica, shareholder, at Babst Calland, about this investment vehicle.

What are the benefits for these investors?

As with any loan, the convertible debt note accrues interest until a defined maturity date. Unlike a standard promissory note, the convertible note often includes a conversion discount, valuation cap and other terms designed to mitigate the investor's risk.

With the conversion discount, these investors receive a discount on the price per share at which their note converts to equity at a future priced round. Although discounts vary, it's commonly set around 20 percent. Thus, if the price per share is set at $1, an investor's convertible debt note would convert at a price of 80 cents per share.

With a valuation cap, (a) a maximum value of the company is established, solely for the purpose of calculating conversion of debt to equity; and (b) the investor's price per share will be capped at the agreed upon number.

How can convertible debt negatively impact the startup?

Convertible notes are intended to be short-term investments. But when a company doesn't get to its priced round quickly — or may require more notes to generate sufficient capital to keep the company in business — the founders can run into trouble. By the time the company gets to a priced round, the accrual of interest, conversion discounts and valuation caps can result in a disproportionate percentage of the company being owned by the convertible debt investors, leaving the founders and employees as well as future investors with little future upside. Such a scenario can scare away new investors and render a company uninvestable.

How can founders get out of this scenario?

In many cases, this situation can be remedied through a renegotiation of the notes. For example, the valuation cap can be renegotiated or waived by the existing noteholders. Also, noteholders may agree to waive interest payments to reduce the impact of the conversion and the dilution effect on the founders. Still other times, noteholders may be interested in a buyout to get some or all of their money back.

A company's negotiation and bargaining power is greatly enhanced if it can point to new investors who have conditioned their investment on a cap table adjustment. Noteholders can often be persuaded to give up or alter their contractual rights, if such a decision will help the company get the critical investment it needs to succeed.

What can be done to avoid this problem?

Although startups are often forced to accept bad financing deals just to get enough operating capital to survive, a few best practices can help mitigate some of these issues.

- Fully understand the impact convertible debt financing rounds will have on shareholder equity positions by working through a variety of conversion and post-financing scenarios with advisers.
- Where possible, try to treat multiple investments as if they were a single round, with a super-majority vote of the holders needed to amend the notes, making it easier to effectuate future note amendments.
- When possible, ask for protective provisions such as prepayment rights, voluntary conversion prior to the maturity date and time-based conversion discounts (where the discount is smaller if the company can get to a priced round sooner).
- Take time to know and cultivate a personal relationship with investors and to communicate regularly the company's successes and challenges, which can go a long way in gaining goodwill in the event terms need to be renegotiated. ●

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