# 1. 2 CONVERTIBLE NOTE

## Brief Description

A Convertible Note is a short-term unsecured debt instrument that will convert into equity upon the occurrence of a triggering event. For example, when the convertible note is used as a seed financing[13], the triggering event is usually the closing of a series A [14] equity round of financing. The underlying idea is that the investor receives shares [15] of the company and dividend payments in lieu of principal and interest payments. After the triggering event, the investor is entitled to convert at the lower of (i) the price of the financing round (after applying a discount rate, if any) and (ii) the valuation cap (if any).

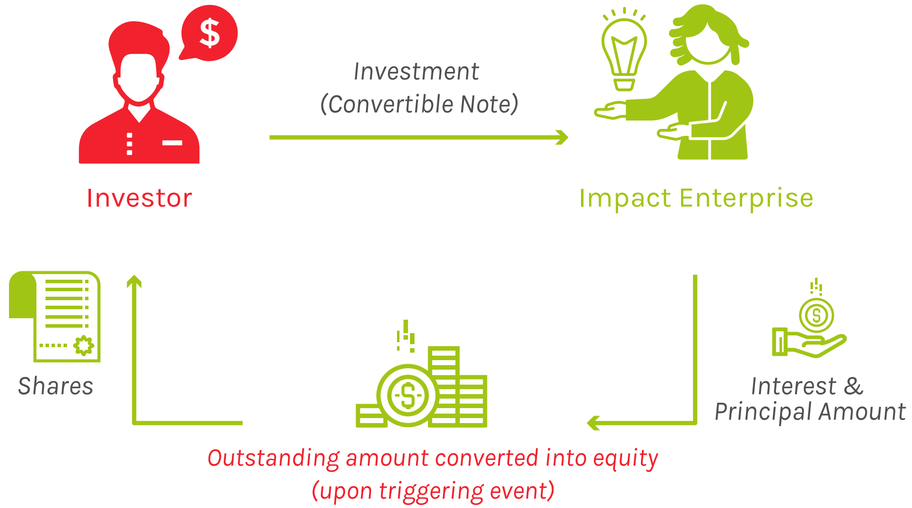


*Figure 1.3 - "Convertible Note", source: Roots of Impact.*

13 It usually refers to the first official round of funding of a startup, on top of the capital invested by the founders, close friends, family, and first supporters, which usually provide the pre-seed funding.

14 It is the round of funding subsequent to the seed financing. Startups usually raise capital via a Series A round when they have already developed a track record that shows the potential for further business expansion.

15 Usually preferred stocks.

| | |
|---|---|
| Purpose/Fit | Flexible, quick and simple source of funding in unpriced [16] seed rounds |
| Can replace | Equity, SAFE, debt – conventional loan |
| Risk/Return Profile | High Risk/High Return |
| Enterprise Lifecyle | Seed stage |
| Maturity | It depends on the maturity date defined ex ante |

**Emergency-Proof:** This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

## Defining Criteria

- **Triggering event:** It is usually an equity funding round.
- **Discount rate:** It allows the investor to convert to equity at a discount price during a later round of financing. Discount rates typically range between 10% to 25%, and the discount factor is calculated as follows: [100 – discount rate]%.
- **Valuation Cap:** Upon raising funds above a certain threshold, it allows the investor to convert at the cap share price. The valuation cap works as a ceiling on the valuation that will be used to calculate the conversion price for the convertible note investors, which are entitled to convert at the lower of the valuation cap or the price, in the subsequent financing.
- **Interes rate:** The convertible note is a hybrid debt instrument, and as such it has an interest rate. Unlike a traditional loan, however, the interest is typically not paid until maturity date. Furthermore, in the majority of the cases the interest coverts into equity instead of being paid in cash.

16 Unpriced in this context means that there is no company valuation that would allow to calculate the company share investors would get for a certain amount of investment

- **Maturity date:** Once the maturity date is reached, and no conversion has happened, then the company must pay back the principal and the interests accrued or convert into equity.

## Interesting Variants and Options

- The triggering event could be linked to a change of control, an M&A, or other predefined circumstances
- In the case of a Convertible Note with Revenue Share Agreement, the schedule payment of the interest could be linked to a revenue share agreement.
- Linking financial rewards to the achievement of impact, for example reducing the discount rate or increasing the valuation cap – see "Examples of relevant terms" below.

## Examples of Convertible Note structures

- **Traditional Convertible Note:** The outstanding amount composed by the amount initially provided by the investor and the interest payments accrued, are converted into common shares at the lower of the valuation cap or the price at the next qualified financing.
- **Convertible Note with Revenue Share Agreement instead of interest payments:** Unlike a traditional convertible note the interest payment are not accumulated throughout the period but a share of the revenues is periodically paid in order to provide the investor with a return before the maturity date.
- Convertible Note with valuation cap but no discount.
- Convertible Note with no valuation cap but with discount.
- Convertible Note with both valuation cap and discount.

| Examples of relevant terms (as formulated in a contract): | |
|---|---|
| Conversion | The outstanding balance of the Note's principal together with all accrued and unpaid interest under the Note shall be converted into shares of the company's capital stock pursuant to the Qualified Equity Financing to the lower of (i) a conversion price equal to (80%) (Discount Factor) of the price per share agreed to in the Qualified Equity Financing, and (ii) a conversion price equal to Valuation Cap divided by the fully diluted capitalisation as of immediately prior to the initial closing of the Qualified Equity Financing. |
| Discount factor | The Discount Factor is (80%). |
| Valuation Cap | The Valuation Cap is (USD 4,000,000). |
| Optional: Link to Impact Performance | - The pre-agreed discount rate of (20%) is reduced by (1%) for every (1,000 units of social outcomes) achieved by the company up to a discount rate of (0%).<br>- The pre-defined valuation cap of (USD 4,000,000) increases by (USD 10,000) for every (1,0000 units of social outcomes) achieved by the company up to a valuation cap of (USD 6,000,000). |

## Main Advantages

- Considerable dilution of early investors is prevented.
- No valuation questions at the very early stage of financing, and thus no problems of ownership percentage, taxes and option pricing.
- It is a rather simple, fast and cost-effective way to raise funds (while SAFE is even simpler).
- Founder control is not diluted.

## Main Challenges

- Investors could prioritise owning preferred stocks, which would enable them to receive control rights, board seat, veto rights, and/or other economic rights.
- Investors are not remunerated [17] for the early-stage risk they are taking. In fact, they get only paid once the company raises additional funding.
- If a Convertible Note is issued without a valuation cap, there is the risk of a misalignment of interest between the founders and the investors. In fact, the investors would be penalized by a high valuation and thus could be incentivized to refrain from helping the enterprise to maximize its value.

Case studies and additional resources about Convertible Note can be found here.

17 It could be argued that the discount rate compensates the investor for the additional risk borne.