## 1.2 CONVERTIBLE NOTE

### Brief Description

A Convertible Note is a short-term unsecured debt instrument that converts into equity upon the occurrence of a triggering event. For example, when the convertible note is used as seed financing, the triggering event is usually the closing of a Series A equity round of financing. The underlying idea is that the investor receives shares 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).

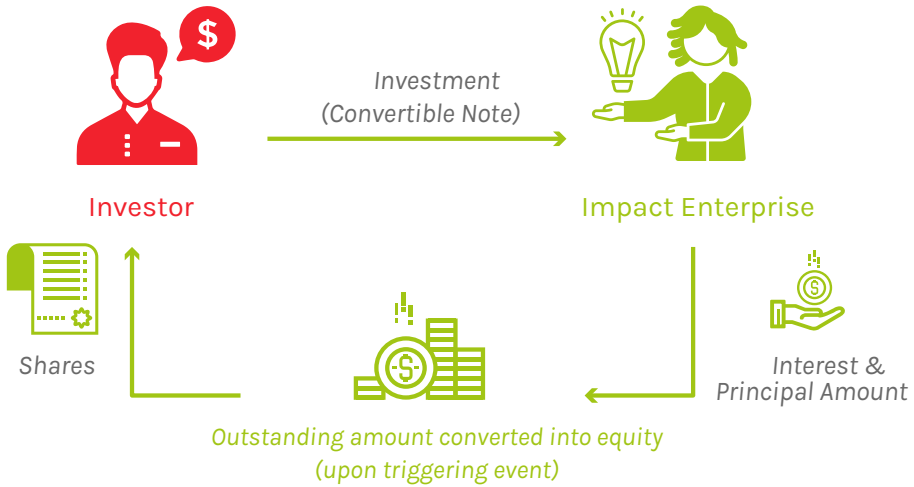



*Figure 1.3 – "Convertible Note", source: Roots of Impact.*

| | |
|---|---|
| **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 |

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

### Defining Criteria

1. **Triggering event:** Usually an equity funding round.

2. **Discount rate:** Allows the investor to convert to equity at a discounted price during a later round of financing. Discount rates typically range between 10% and 25%, and the discount factor is calculated as follows: [100 – discount rate]%.

3. **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, who are entitled to convert at the lower of the valuation cap or the price in the subsequent financing.

4. **Interest 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 the maturity date. In the majority of cases the interest converts into equity instead of being paid in cash.

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

### Variants and Optional features

- The triggering event can also be linked to a change of control, an M&A, or other predefined circumstances.

- Convertible Note with Revenue Share Agreement: the scheduled payment of the interest can be linked to a revenue share agreement, so a share of revenues is paid periodically instead of interest accruing to maturity, providing the investor with a return before the maturity date.

- 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[17]; Convertible Note with valuation cap but no discount[18]; Convertible Note with no valuation cap but with discount[19]; Convertible Note with both valuation cap and discount[20].

## PRACTICAL APPLICATION

### Benefits and Considerations, Capital Providers

| Benefits | Considerations |
|---|---|
| Debt claim until conversion ranks ahead of equity holders in a liquidation, offering limited downside protection | No control rights, board seat or veto rights before conversion (investors seeking these may prefer preferred stock). Although they will often have information rights |
| Interest accrues and typically converts, adding to the investor's stake at conversion | Repayment at maturity may not be practical where a seed-stage company does not hold sufficient cash, so extension or renegotiation is a common outcome |
| Discount rate and valuation cap offer some compensation for early-stage risk | Without a valuation cap, a high valuation penalises the investor and can misalign interests with the founders |
| Maturity date provides a negotiation lever if no priced round materialises | Return is only realised at or after conversion; until then the investor is not remunerated for early-stage risk (though it can be argued that the discount rate compensates for the additional risk borne) |

17 the outstanding amount, composed of the amount initially provided by the investor and the accrued interest, converts into shares at the lower of the valuation cap price or the price of the next qualified financing

18 the outstanding amount converts into shares at the lower of the valuation cap price or the price of the next qualified financing, with no discount applied to that price

19 the outstanding amount converts into shares at the price of the next qualified financing reduced by the agreed discount rate, with no ceiling on the valuation used for conversion

20 the outstanding amount converts into shares at the lower of the valuation cap price or the discounted price of the next qualified financing

### Benefits and Considerations, Enterprises

| Benefits | Considerations |
|---|---|
| Valuation questions limited at the very early stage of financing, avoiding problems of ownership percentage, taxes and option pricing | It is debt. The note sits on the balance sheet and creates a repayment obligation if no triggering event occurs before maturity |
| Simple, fast and cost-effective way to raise funds relative to a priced round | Accrued interest increases the amount converting, adding dilution that is easy to underestimate |
| Founder control is not diluted before conversion | Considerable dilution of founders and early investors at conversion is possible if terms are not modelled carefully |
| Interest typically converts into equity rather than draining cash during early growth | Stacking notes with different caps and discounts complicates the cap table |

### Selection Criteria Checklist

*Use to test whether a Convertible Note is a good fit for a given deal.*

- **Pre-valuation stage**: the company's value is genuinely hard to price and a priced round would be premature.

- **Credible conversion trigger:** a priced round or other trigger is realistically expected before the maturity date.

- **Debt tolerance:** the enterprise can carry a debt obligation and the residual risk of repayment at maturity.
- **Investor accepts deferred payment:** the capital provider is comfortable with interest accruing from the outset but paid only at conversion or repayment.
- **Priced early-stage risk:** cap or discount are agreed so the investor is compensated for entering early.
- **Local legal enforceability:** convertible debt is recognised locally, or an adapted template exists.

## Common Pitfalls

1. Setting the maturity date too early, so it arrives before a realistic Series A and forces renegotiation or default.
2. Ignoring accrued interest when modelling dilution, understating what converts at the triggering event.
3. Agreeing a note with no valuation cap, or with one drafted ambiguously, risking conversion-price disputes and a misalignment of interest in which investors are penalised by a high valuation and could be incentivised to refrain from helping the enterprise maximise its value.

## Examples of Relevant Terms

*As formulated in a contract; bracketed values are illustrative and negotiable.*

| | |
|---|---|
| **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 at 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 the 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%). Alternatively: The pre-defined valuation cap of (USD 4,000,000) increases by (USD 10,000) for every (1,000 units of social outcomes) achieved by the company up to a valuation cap of (USD 6,000,000). |

Other external case studies and additional resources about Convertible Notes can be found **here.**