Be an Angel, Fund a UK Company

CONVERTIBLE NOTES

INTRODUCTION

'Convertible notes' also known as a convertible loan note or convertible debt refers to any type of investment made initially by loan that can, or must convert, in whole or in part, to shares. This is an extremely flexible investment vehicle and it could be used in many ways.

KEY TERMS

1. Parties

The borrower will always be the recipient company, into which the loan may convert to equity. The lender could be any tax-efficient vehicle or the investor personally.

2. Conversion

There are almost unlimited conversion options. Some of the most popular include:

a. Conversion based on a fixed price at the time of investment
b. Conversion based on a discounted price at the time of a later conversion
c. Conversion based on a measurable formula
d. Conversion based on another relevant valuation

Conversion of the loan can be executed:

a. On demand or on specific conversion points;
b. On a later financing event (i.e. VC investment);
c. On exit/sale; and
d. On maturity.

The loan can convert in whole or part into ordinary shares or some other class of shares.

3. Security

The loan can be secured or guaranteed as with any other loan.

4. Redemption

The loan is, until converted, a loan and can be called by the investor under the terms of Loan Agreement. These could include:

a. On default;
b. On breach of any contractual terms of the Agreement;
c. On maturity; and
d. On an early redemption by paying a premiumif provided by the Agreement.

5. Interest

The convertible loan will earn interest. The rate will reflect the risk the investor is taking. Interest will be paid on due dates or rolled up and payable on conversion or repayment. Most convertible loans will offer interest of over 6% per Annum.

HOW DO YOU MAKE MONEY BY INVESTING IN CONVERTIBLE NOTES?

Convertible loan notes are an asset class just like any other, investors make money:

- By selling the notes for more than they paid for them
- By converting the loan to equity and selling the equity
- By holding the note to maturity for the interest

WHAT IS THE MOST COMMON STRUCTURE FOR A CONVERTIBLE NOTES?

The most common structures are:

1. A fixed price price or a simple pre-money valuation conversion
2. A discounted conversion

These are explained in more detail below:

FIXED PRICE OR PRE-MONEY VALUATION CONVERSION?

The investor advances the funds so that it will convert into shares based on the agreed pre-money valuation. For example, if the company has 100 shares and is valued at £100,000, then the pre-money valuation is £1,000 per share and, on conversion, the investor will receive 10 shares, on at £10,000 investment, irrespective of any movement in the share price.

DISCOUNTED CONVERSION

In this solution the parties agree to postpone a valuation and resolve to leave valuing the company to the next round of investors. Later investors are generally better qualified to value businesses and can often do so with greater accurately as the business has matured. Of course, the convertible loan investor does not want to invest at the same price as a later investor, who will almost certainly be taking less risk. To reflect this, the convertible loan investor and the company agree that a discount will be applied to the valuation to reflect the additional risk. The discount ranges from 10% to compensate for a small risk assumed for a short period, to any agreeable figure. Please refer to the following example.

You agree to invest £10,000 by way of a convertible loan and you agree that the risk and investment justify a 20% discount. On the next round of financing, the company is valued at £1 per share by the second-round investor. Then, instead of swapping £1 of debt for £1 of equity, it would convert at the discounted valuation of £0.80, which means that a £10,000 investmentwould yield 12,500 shares, giving a 25% return on investment. The formula therefore is: ROI = [1 / (1 - X)] – 1; where X is the discount rate expressed as a decimal.

EXAMPLE *of a convertible in a Listed comapny*

Harry invests £1,000 at 9% for a term of 360 days. The note converts at a 10% discount to the market price.

Harry can treat the loan as a straight loan and receive £1,090 after 360 days

OR

Harry can convert part or all of the loan. Harry decides to convert the entire loan on the 360th day. The total amount to convert is £1,090 (Loan + Interest).

The market price for the PLC share is 0.20p, Harry will be issued with 6055 shares at the discounted price of 0.18p with the balance of 0.10p refunded.

If Harry then sells all of the shares at 0.21p he will receive £1,271.55 before costs
A profit of 271.55 before costs.

WHY INVEST THROUGH CONVERTIBLE NOTES?

An investment through a convertible notes has a number of advantages when compared to an equity investment. The major advantages and disadvantages are summarised below:

ADVANTAGES OF INVESTING VIA CONVERTIBLE NOTES

1. Valuation

This is the most cited reason to invest through a convertible loan. It only applies where the conversion criteria are based on the later valuation of the business, for example by a VC, on the upcoming financing round. The loan conversion would be calculated using the VC's later valuation and the predetermined discount rate.

This is an advantage because friends, family and (to a lesser extent) angel investors are not especially qualified to value the business and, indeed, any valuation of an early-stage business is extremely difficult without comparable assets or cash flow to look at.

ADVANTAGES OF INVESTING VIA CONVERTIBLE NOTES

2. Security and credit risk

As the investment remains a loan until conversion, the investor has a greatly reduced credit risk. Convertible loan monies are repayable before any equity holder receives any payment on insolvency and the investor has (subject to the terms of the document) the freedom to call the convertible loan at any time in order to mitigate any loss of the invested principal.The convertible loan investors can often take security for their investment.

3. Speed

The scope of a convertible loan is wide, but it is often possible to keep the drafting simple. This means that it costs less in terms of both time and money to instigate it.

4. Flexibility

While the convertible loan documentation can be kept simple, it can also be drafted to the same level of sophistication as a shareholders' agreement, with the convertible loan investment being treated as a separate class and enjoying almost the same minority protections (andeven anti-dilution provisions if required) that minority equity shareholders have.

5. Presentation

The identity of convertible loan is not public information. This also has a secondary benefit in that the founders also do not feel that their equity has been diluted from the moment they receive the convertible loan investment. In their eyes, the dilution comes later, but this is often eased by taking on substantial funds or achieving a partial exit.

6. Incentivisation

Convertible loan investors can use stepped interest rates and the threat of calling the debt to encourage the founders to move more quickly towards an exit/a further financing event.

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