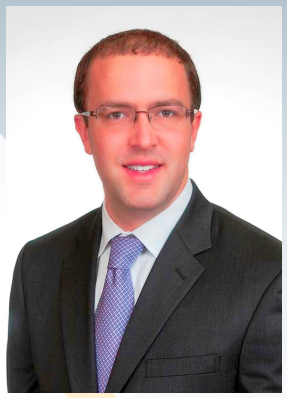
Raising Capital For Your Business?

The Advantages and Disadvantages of Convertible Debt



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Article 3 in a 3 part series

In the final article in our series detailing the advantages and disadvantages of various capital raising options entrepreneurs have, we will discuss a hybrid product often referred to as convertible debt. Convertible debt is a short term debt investment that converts to equity at a specific point in time (the "trigger event"). Both the investor and the entrepreneur intend for the debt investment to turn into equity from the onset of the investment. This article will discuss the details of convertible debt as well as some of the things both investors and entrepreneurs need to consider when using convertible debt to raise capital.

Convertible debt is typically held as debt for 18 – 24 months before it converts to equity and carries a coupon of 6 percent to 8 percent, with all interest accrued up to the date of conversion. As of the conversion date, both the principal and accrued interest are converted into equity. This means that the owner is able to use the capital provided for 18 – 24 months before any equity is issued. For the use of their capital, the investor will get a discount on the conversion of their debt to equity. Generally an investor is able to convert their note to equity at 80 – 85 percent of the fair market value of the stock as of the conversion date (illustrated later in this article), but in some cases the conversion rate could be as low as 70 percent.

The conversion from debt to equity occurs based on a predetermined trigger event. This trigger event can be any sort of milestone, such as the achievement of a revenue threshold, a predetermined time period has lapsed, or the next round of capital is raised. The most common trigger event is the company's next capital raise. The valuation used in the next capital raise is used to determine the amount of dilution the entrepreneur takes when the debt converts to equity.

The initial investment using convertible debt does not require the entrepreneur to value their company formally. Although convertible debt does not require the entrepreneur to value the company formally, typically the convertible debt is issued because the owners do not want to take dilution based on the current value of the company. Instead of valuing the company from the beginning, the entrepreneur receives the capital now, knowing that the investor will take a portion of the equity at a future trigger event. Whenever the trigger occurs, the investor will get its share of the equity based on the valuation at that time (not based on the initial investment valuation).

> Example: An investor may contribute $100,000 of convertible debt to ABC, LLC. The investor and ABC, LLC agree that the debt will convert to equity upon ABC's series A capital raise (the trigger event in this case). In 18 months, ABC, LLC has appreciated to a pre-money valuation of $1MM based on the Series A capital raise. At this time, the investor will convert their debt to equity and receive 10% of the equity in ABC, LLC. *This particular example is oversimplified for illustrative purposes.*

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The obvious question is, "Why would an investor agree to this when they could have acquired a larger share of the company when the initial investment was made?" To entice investors to make this type of investment, an entrepreneur will have to offer a discount on the conversion to equity. For example, an entrepreneur could offer a 20 percent discount on conversion (80 percent of FMV). In our example above, the investor would receive the equivalent of 125,000 dollars of equity for their initial loan – resulting in receiving 12.5 percent of the equity in ABC, LLC. The discount offered by the entrepreneur sometimes is expressed as a function of time between the initial investment and the time of the conversion. The discount is a method to reward convertible debt investors for the risk that they take by making the initial investment.

One feature that can be found in convertible debt that protects the investor is a valuation cap. The cap ensures that the investor receives at least a certain percentage of the equity in the company when the debt converts. This protects the investor in case the growth of the company is much greater than originally anticipated. A valuation cap sets a maximum valuation that can be used when determining the amount of dilution an entrepreneur takes upon conversion. This feature is investor friendly as it allows him/her to receive a larger portion of the company should the company experience appreciation greater than originally underwritten. Let's revisit our previous example where the convertible debt investment was 100,000 dollars. If there was a valuation cap of 750,000 dollars, the investor would have 16.67 percent of equity of the company instead of the 12.5 percent outlined in our original example, assuming the valuation of the company is $1MM as outlined in the example above. It is important that the entrepreneur gives considerable thought to the value of the cap before agreeing to this provision.

Convertible debt is a very attractive capital raising option when the anticipated appreciation in the business' value exceeds the discount conversion rate required by the investor. For example, if a company is able to appreciate in value 50 percent by using the funds from the convertible debt and only has to offer a 20 percent conversion discount rate, they are able to minimize equity dilution while still taking advantage of growth capital. As is the case with any capital raise, it is important that the entrepreneur determine the amount of capital that he/she needs and the anticipated growth in the business that is projected to happen given the capital raise. This will help determine what conversion discount the company can offer to the investor.

Convertible debt is a very attractive capital raising option for the right circumstances. As we outlined above, convertible debt is most attractive to a company that does not want to sell equity at their current valuation and believes they will see considerable growth in value with use of this new capital. If your business is experiencing a need for new capital, and you would like to be advised on your different options, please contact your Keiter Professional or Scott Zickefoose at SZickefoose@Keitercpa.com.

Previous articles in the series:
Article 1: The Advantages and Disadvantages of Equity Financing
Article 2: The Advantages and Disadvantages of Debt Financing

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