VERVE VENTURES

AN INTRO TO CONVERTIBLE LOANS

What investors need to know about the most common financing form besides equity

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TOPICS

When startups want to raise money, they can choose between different options. The most commonly used instrument is equity, but other sources of financing such as debt, grants, SAFEs and convertible loans are frequent, too. This eBook explains what investors need to know about convertible loans, the most common financing form besides equity.

- What is a convertible loan?
- What is the difference between investing in equity and investing in a convertible loan?
- A convertible loan doesn't give you a valuation of the company
- The discount
- Other important terms

AUTHOR

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Eugen Stamm
Startup Journalist

WHAT IS A CONVERTIBLE LOAN?

Consider the perspective of a startup that needs to raise capital. Going to a bank and asking for a loan is in most cases a non-starter: Banks don’t lend to risky unproven businesses without collateral.

Convertible loans are loans that will be converted into shares of the company later. Setting up a financing round with a convertible loan is simpler and faster than doing an equity financing round. The negotiations with investors and formalities for an equity round usually take several months, drafting the paperwork associated with it will keep lawyers busy, and the resulting capital increase necessitates an entry in the commercial registry after a notary meeting. Compared to this, a convertible note is less work.

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Often, convertible loans are used to bridge the funding gap that might arise between two major equity financing rounds because the company hasn’t achieved the milestones needed for the next financing round yet. Another reason is when existing investors want to extend the startup's cash runway (the number of months until the cash runs out) without defining a valuation. Finally, macroeconomic crises (think Covid, for example) can create the need to strengthen a startup's financial position quickly (also usually by the existing shareholders).

WHAT IS THE DIFFERENCE BETWEEN INVESTING IN EQUITY AND INVESTING IN A CONVERTIBLE LOAN?

Convertible loans are a form of debt financing. They will appear on the balance sheet as liabilities, and the investors become creditors of the company (unlike equity investors who become shareholders). Should the startup go into liquidation, the proceeds will first be used to repay the creditors (loan holders). Convertible loans are subordinated to normal loans (get paid after other creditors have been paid in full). Shareholders are the last to receive liquidation proceeds.

Bank loans need to be paid back. Convertible loans aren't designed to be paid back (Cash reimbursement is usually only foreseen in case of dissolution or insolvency of the company even though sometimes, a payback clause can be found in the contracts). They can or will, at a defined point in the future, be converted into shares of the company. Investing in a convertible loan hence means to wait for a certain time until you become a shareholder. The terms of the convertible loan define the compensation for that patience (interest rate) and for the additional risk that was taken by investing before the conversion event (discount).

The terms of the convertible loan define the compensation for the additional risk that was taken by investing before the conversion event.

Many venture capital firms don't want to invest in convertible loans as their first investment in a startup because unlike with equity financing, convertible loans don't grant a say in company decisions.

A CONVERTIBLE LOAN DOESN'T GIVE YOU A VALUATION OF THE COMPANY

When you invest in equity, you know at what price you buy shares of the company. An equity financing round puts a price tag (the valuation) on the whole company.

When a startup issues a convertible loan, there is no valuation of the company at that moment. As an investor in a convertible loan, you don't know at what valuation you invest, and you don't know yet at what price per share your capital will be converted into shares in the future. You do, however, know how high the reward for this uncertainty is (mainly in the form of a discount, more on this later).

The lack of a valuation is why convertible loans are used mainly for bridge financing rounds, which as their name implies, bridge the gap between two equity financing rounds. These bridge rounds are usually smaller in size compared to the equity round. They just provide enough liquidity for the startup to reach the next milestone, putting it in a position to raise another equity round. The risk for the investor is, of course, that the milestone will not be achieved.

A startup can be in a position of weakness or strength when issuing a convertible loan. Maybe the company failed to reach key performance indicators or struggled to grow at the same speed as in the past. The money it has raised in the past has proven not to be sufficient to reach the targets that would permit a new equity financing with a markedly higher valuation. In this case, a convertible loan gives the company fresh capital to execute its plans. It can be a way to avoid a down round, which means issuing shares at a lower valuation than in the past. Founders (and existing investors) want to avoid down rounds because they send a negative signal and may damage employee morale. Shareholders also face bigger dilution in down rounds.

However, a convertible loan can also be issued from a position of strength. If things are going well and there is a clear positive momentum, which means also a lot of interest from investors, a convertible can be used to raise additional capital without losing too much time talking to many different investors and haggling over valuation.

Since there is no need to discuss the valuation and find a consensus on it with investors, convertible loans are simpler than an equity round. There is also no need for a capital increase and a notary meeting, which makes the process faster and cheaper.

Convertible loans are simpler than an equity round.

Sometimes, however, startups issue convertible loans as an addition to heavily oversubscribed financing rounds. Since they cannot (or do not want to) accommodate every investor interested in joining the equity round, they give them at least the possibility of already securing the position of future shareholders.

THE DISCOUNT

The discount is the main reward for investors. It is expressed in a percentage, say, 10% to 20% (which are figures we see frequently). The next qualified equity financing round will establish a valuation of the shares. Investors get a 20% reduction on that price. If the share price of the next round is EUR 10, convertible loan investors will be able to convert their capital at a price of EUR 8 into shares, giving them more shares of the same share class as new investors. If you invested EUR 10'000 in the convertible, you'll receive 1250 shares in the equity financing round, while other investors that only invest in the equity round would receive 1000 shares for EUR 10'000.

OTHER IMPORTANT TERMS

Interest

Usually, the convertible loan also carries interest, say, 2% (or a similar figure corresponding to current interest rates), that will accrue from the date of the investment until the conversion date. Sometimes, the rate is 0% but it can also be as high as 10% if the startup is in a weak position. In any case, the rates usually seen in convertible loans are considerably lower than what a bank loan for such a company might be if it would be available.

Qualified Financing

The size of the financing round that will trigger the conversion is set with a minimum amount, for example, "gross proceeds to the company of at least EUR 5 million". If the company doesn't manage to raise this amount in the next financing round, the conversion will usually not take place automatically, but the investors get to choose if they want to convert the loan into shares or not. (Choosing not to convert generally makes little sense for the investor.)

Maturity date

This date determines the deadline when the loan can/has to be converted even if no "qualified financing" took place beforehand. Again, in this case, it's usually up to the investors to decide whether they want the conversion or not.

Change of control

This clause considers the possibility of the startup being bought before a qualified financing round takes place or the maturity date is reached. A change of control usually also results in mandatory conversion of the loan into shares often at the same discount as it would be for an equity round.

OTHER IMPORTANT TERMS

Accession to shareholders' agreement

Investors, prior to receiving converted shares, have to accede to the shareholders' agreement that is in force at the time of the conversion.

Valuation Cap

It is in the interest of the convertible loan holders that the company valuation at the time of conversion is not excessive and that it reflects the risk they took by investing at an earlier stage. Therefore, a maximum valuation at which the conversion takes place can be put in place. This does not mean that the valuation in the next financing round cannot be higher or lower, it only defines an upper ceiling of what convertible loan holders will actually pay for their shares. Often, a cap is used as starting point to discuss the valuation of the next round. However, not all convertible loan contracts include a cap.

Valuation Floor

Opposite principle of the Cap that serves as protection for the founders by stipulating a minimum valuation. Investors generally wouldn't want such a clause. However, if the company is in a position of strength, investors might have to accept it if they really want to invest.

CONCLUSION

As has been explained in this short eBook, a convertible loan is a relatively quick and uncomplicated way for a startup to secure additional financing. Sometimes it's a lifebuoy, in other cases, it's a good tool for successful entrepreneurs to raise capital without spending too much time on discussion.

From the point of view of an investor, it is the entry ticket to becoming a shareholder in the next equity financing round.

ABOUT US

Verve Ventures is the leading European startup investment firm for qualified and institutional investors. A team of investment professionals screens thousands of companies and selects the best investment opportunities after a rigorous due diligence process. We focus on European technology and science driven startups. Our investors are qualified private investors, family offices and pension funds. Since inception in 2010, Verve Ventures has invested over EUR 220 million in over 140 startups with a team of 45 employees based in Switzerland, France and Germany.

Steffen Wagner & Lukas Weber
Founders

140
Portfolio **Startups**

220m
Total invested

45
Employees

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