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Convertible debt financing is a key fund-raising tool

INSIDER VIEW

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Today's down economy poses additional hurdles for startup companies that are trying to raise money from institutional investors. However, a valuable fundraising tool in a down economy, which many entrepreneurs are not familiar with, is a convertible debt, or bridge, financing.

By issuing promissory notes that convert into equity as part of a future preferred stock financing, companies can raise capital to "bridge" them to the future.

As part of a convertible debt financing, companies issue promissory notes. The principal and accrued interest under each note are not repaid by the company in installments over time, but instead become due and payable in full on the maturity date, typically one to two years after the date of issuance of the note, unless the company completes a "qualified financing" prior to the maturity date.

A "qualified financing" is a preferred stock financing that meets certain criteria, including a minimum amount of money raised. Upon completion of the financing, the debt converts into shares of the same series of preferred stock issued to other investors.

Structuring an early-stage investment as convertible debt has the following advantages:

• No valuation. Selling equity requires the company and investors to negotiate a value for the company, which can be difficult for early-stage companies, especially if investors are not experienced in performing valuations. With convertible debt, the company and investors do not need to agree upon valuation, which will be determined at the time of the next round of financing. Valuing the company at the time of the next round is helpful because the company will be further along in its development and therefore, can be easier to value. In addition, investors in the next round may be more experienced in conducting valuations.

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• Efficiency. A preferred stock financing involves the preparation and negotiation of more extensive documentation than a convertible debt financing. With fewer and less complicated documents, a convertible debt financing can be completed more quickly and at a lower cost.

• Attractiveness. In order to successfully raise capital, a company must present an attractive opportunity to potential investors. Convertible debt financings have features that are attractive to investors. Holders of promissory notes are creditors, and as such, would receive preferential treatment as compared with equity holders in the event of a bankruptcy or liquidation of the company. And holders of promissory notes often receive a "sweetener": Either the notes convert into preferred stock in the future round of financing at a "discount" to the price paid by other investors in that financing or the note holders receive a warrant to purchase capital stock of the company.

The discount is typically between 10 percent and 30 percent of the price paid in the financing. The warrant is a right to purchase shares of capital stock of the company at an exercise price based on the fair market value of the stock at the time of issuance of the warrant. The number of shares underlying the warrant is based on a percentage, generally 10 percent to 30 percent, of the principal amount of the debt divided by the price per share paid in the preferred stock financing.

• Familiarity. A convertible debt financing is generally not likely to present obstacles to completing a preferred stock financing in the future because venture capital firms and institutional investors, which could participate in the future, are familiar with the structure.

• No impact on common stock. Some entrepreneurs consider selling common stock to raise capital, to avoid having to complete a more complicated, less favorable preferred stock financing. However, selling common stock for fundraising purposes typically results in a high purchase price, and hence, high fair market value of common stock, making it difficult for a company to offer equity incentives to potential employees at a low price. Convertible debt financings do not present this issue because they do not affect common stock valuation.

A convertible debt financing is a cost-effective method of raising capital for a company that needs money in the short-term, but that plans to raise more money at some point in the future.

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