Convertible Debt

An alternative investment structure
Convertible Debt

Introduction

This article looks at the use of convertible debt by business angels and other early-stage investors as a means of making an investment.

“Convertible debt” (also known convertible loan note which may be shortened just to ‘loan note’) is not a term of art but instead refers to any type of investment made initially by loan that can, or perhaps must, later convert, in whole or in part, to an equity investment. This is an extremely flexible investment vehicle and it could be used in many ways. In order to be more specific, some of the key terms that can be used in convertible debt are set out below.

Key terms in convertible debt

<table>
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<tr>
<th>Term</th>
<th>Comment</th>
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<tbody>
<tr>
<td>1. Parties</td>
<td>The borrower will always be the company into which the debt may convert to equity, but the lender could be any tax-efficient vehicle or the investor personally.</td>
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<tr>
<td>2. Conversion</td>
<td>The document needs to set out when the loan will convert and how it will convert.</td>
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There are almost unlimited conversion mechanisms. Some of the most popular include:

a. Conversion based on a fixed pre-money valuation at the time of investment;
b. Conversion based on a pre-money valuation (less a discount) at the time of a later investment, typically by a VC;c. Conversion based on a formula looking at sales, turnover, profit, milestones or some other measurable; and
d. Conversion based on another relevant valuation e.g. of a patent.

The loan can convert on some or all of the following:

a. On demand;
b. On a later financing event (i.e. VC investment);
c. On meeting sales, turnover, profit milestones or some other specific event;
d. On exit/sale; and
e. On a maturity or long stop date.

The loan can convert in a number of ways:

a. In full;
b. In part;
c. To ordinary shares; and
3. Security
The loan can be secured or guaranteed as with any other loan. With early-stage companies with few assets, candidates for security include:

- A personal guarantee from the founders;
- Any IP (e.g. patents);
- Any revenue stream;
- Trading assets/stock/work in progress; and
- Current account

4. Redemption
The loan is, until converted, a loan and can be called by the investor. There are many potential triggers that could mean the loan is called:

- On default (typically the threat of insolvency or failing to hit certain benchmarks/targets);
- On breach of any key terms of the convertible loan;
- On demand (rare); and
- On a redemption date or long stop date.

5. Interest
The convertible loan will almost certainly attract interest and a rate must be set. The rate will reflect the risk the investor is taking, but it should be remembered that the real reward mechanism is via conversion, so rates of 5% to 12% per annum are common. Interest will typically be rolled up and be payable when the loan converts or is repaid. Where the company is planning to issue several tranches of convertible debt, and potentially some warrants as well, it might be a good idea to have the interest be payable in cash, as otherwise it can be very problematic to compute the capitalisation tables when engaging in discussion with a second-round investor. Where this is not the case, the interest is added to the principal and converted to equity. It is possible to leave this choice to the investor on conversion.

6. Consent rights and minority protection
While rare, there is nothing to prevent the convertible loans from being treated as a class and having similar consent rights and protections as the equity holders commonly have. If so, then conversion and redemption might also be expressed as a class right (i.e. a majority have to vote in favour of it) rather than as an absolute right.

7. Transferability
If required, the convertible loan notes can be made transferable, but it is worth noting that, even if not transferable, they still are classed as a ‘security’ and the provisions of the Financial Services and Markets Act will still apply.

How do you make money by investing in convertible loan notes?

Convertible loan notes are an asset class just like any other. Investors make money by being able to sell them for more than they paid for them. While interest will apply, it is rarely significant in calculating returns. In some circumstances, the investor will subscribe for convertible loan notes shortly before a financing event and may be able to sell his notes before they convert. However, this is rare and investors would normally convert the loan to equity and sell the equity.
Where the investment is not proceeding well, the investor would call the convertible loan with interest (hopefully) before the company becomes unable to repay the loan.

What is the most common structure of a convertible loan?

While it is true that there is an extremely wide choice as to how convertible loans can be structured, there are some typical structures. These can be divided into three categories:

1. A simple pre-money valuation conversion;
2. A more complex pre-money formula-based conversion; and
3. A discounted conversion.

Further details - simple pre-money valuation conversion

Just as with equity, the investor values the business and works out a price he is willing to pay for the share that the founders are willing to accept. The investor then advances the convertible loan so that it will convert into shares based on that 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, irrespective of any movement in the share price.

Further details - more complex pre-money formula-based conversion

As with the simple valuation mechanism just described, this is a way of valuing the business at a given time (which is most commonly the time of conversion). However, in this case, rather than attempting to agree on a numeric valuation, the investors agree on a mechanism to value the business at conversion e.g. using a multiple of turnover; a series of certain stepped valuations to be determined by the facts at the relevant time; or any other mechanism that will allow the investor and the company to compute (without challenge) the valuation at conversion and determine how many shares will be issued to the investor.

Further details - discounted conversion

This is a somewhat different solution to the valuation problem. In short, the parties agree that they can’t or won’t agree on a valuation and resolve to leave valuing the company to the next round of investors, who are not only better qualified to value the business, but also are in a better position to do so because the business will be easier to value accurately by this time. 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. The discount ranges from 10% to compensate for a small risk assumed for a short period, to any agreeable figure. The range normally quoted is 10% to 40%, but these figures are usually used when referring to short-term “bridging” investments where the next round of financing is expected within 12 months. There is nothing to stop discount percentages going into the 90s where the risk justifies it, but it should be borne in mind that this may have an adverse effect on any later round of financing, or else have to be renegotiated with the new investor at such time.
To illustrate how the discounted conversion mechanism works, some examples are included below.

You agree to invest £100,000 by way of a convertible loan and you agree that the risk and the investment window would 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 £100,000 investment would yield 125,000 shares, giving a 25% return on investment. The formula therefore is:

\[
\text{ROI} = \frac{1}{(1 - X)} - 1; \text{ where } X \text{ is the discount rate expressed as a decimal. Of course, the interest return has to be added to this as well.}
\]

Where the holding period for the investment is longer, it is possible to compound the discount each year or to have stepped and increasing interest/conversion rates to compensate for the extra risk and encourage an exit. For example, if you agree that the discount would be 30% compounded every year and it takes three years to secure the next round of financing at an eventual valuation of £1 per share, then your discount would entitle you to pay just £0.343 per £1 share, giving an ROI of 243%.

To look at this from another angle: Where an investor is looking to get a 10 times return after four years, this would equate to requiring a compounded annual 55% discount.

**How are gains taxed?**

Interest will be subject to income tax. Unless the terms of the convertible debt are comparable to the terms of convertibles listed on the Stock Exchange, the interest will be treated as a dividend. This means that the effective rate of tax paid on the dividend (allowing for the associated tax credit) is 25% for a 40% taxpayer and 36.1% for a 50% taxpayer. If the terms are comparable to those of listed convertibles, the interest will be taxed as interest i.e. income tax will be payable at the recipient’s marginal rate, with credit for the 20% tax being deducted by the company at source.

Capital gains (whether arising by a sale of the convertible loan or the equity) are subject to capital gains tax. This assumes that the income tax rules relating to shares and securities held by employees and directors do not apply. If you were a director of the company when the investment was made, the rules relating to convertible employment-related securities could result in an income tax charge (rather than the more favourable capital gains tax regime) on conversion of the debt, whether or not the shares resulting from the conversion are then sold. These rules can apply because the legislation deems that someone who is a director is to be regarded as acquiring their securities by reason of employment, even though the factual reality is very different (the legislation disregards the fact that, in reality, the acquisition has nothing to do with an employment relationship and there is no bonus, in any normal sense of the word, involved).

If the income tax rules can be avoided (by, for example, taking up a board position only after the investment is made, or not at all), you would wish to establish whether any relief from CGT might be available. Unfortunately, the CGT exemption under the Enterprise Investment Scheme will not apply and this might be an issue for UK taxpayers, who might have secured an exemption from CGT if they had subscribed for ordinary shares. However, Entrepreneurs’ Relief could apply if you hold a minimum of 5% of the voting shares and have been an officer or an employee (part-time is allowed) for a period of 12 months before the disposal. These conditions mean that if you only hold convertible debt, you would need to hold the shares resulting from the conversion for 12 months before exiting in order to be able to secure the relief. Because one of the conditions for Entrepreneurs’ Relief is that you are a director or employee, care would be required to avoid the application of income tax rules relating to employee shareholdings.
If Entrepreneurs’ Relief is secured, the gain would be reduced from the prevailing rate (likely to be 28%) to just 10%. Capital gains eligible for this relief are subject to a lifetime limit of £5m (after which the standard CGT rates apply). It is also of note that none of the other restrictions that apply to EIS relief apply to Entrepreneurs’ Relief (e.g. concerning preferred rights; the nature of the trade undertaken by the company; holding periods longer than the one-year period for Entrepreneurs’ Relief; the need for investment to be made by way of subscription for a new issue of shares; avoiding the “receipt of value” from the company rules; the size of company restraints etc.).

An alternative to a convertible debt investment could be an investment where much of the money invested is made available by way of a non-convertible loan and the balance by way of equity. Consideration could be given to the founders’ shares ratcheting down (to become a smaller percentage of the issued share capital) when the debt is repaid, waived, or in other prescribed circumstances. Thus, on an exit, the convertible loan would be repaid and any profit would accrue to the equity; with careful structuring, and depending on the particular circumstances, the gain on the shares could benefit either from the EIS CGT exemption or from Entrepreneurs’ Relief.

Needless to say, the particular facts of any particular case would need to be reviewed to identify the optimal structure from a tax perspective.

**Why invest through convertible debt?**

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

**Advantages of investing via convertible debt**

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<th>Advantage</th>
<th>Explanation</th>
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| 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 by a VC on the upcoming (or at least hoped for) financing round, with the loan conversion based on such VC’s later valuation, but less a discount to reflect the conversion 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. Accordingly, the investor effectively prices the investment based on how much compensation for the risk of investing before the next round he thinks is required. Not only does this protect the investor from getting the value wrong, it also saves arguing with the founders about the valuation and protects the investor from a down-round (i.e. earlier investors cannot pay more per share than later investors). This can be especially useful in a friends and family round, where such investors will normally not negotiate on the valuation but accept what the (normally optimistic) founder suggests. |
| 2. Security and credit risk| As the investment is (until converted) a loan, 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 take security for their investment in any applicable form, including a charge over a patent/the IP/a personal guarantee/a charge over book debts or a general floating charge over the company.

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.

Connected with the fact that it is often used where another investment round is contemplated in the foreseeable future, it means that less due diligence is required (i.e. the due diligence undertaken by the next-round investor will effectively be used for the benefit of the convertible loan holder).

Accordingly, using a convertible loan for short-term bridging finance, or a hot deal that will do very well very quickly, is ideal.

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 (and even anti-dilution provisions if required) that minority equity shareholders have.

By its nature, any convertible loan note provides the flexibility to protect an investor from risk in the early stages of growth and then to allow the investor to participate as an equity shareholder for the later, less uncertain, stages of growth.

5. Presentation

Save where registered security is taken, the identity of convertible loan investors 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.

If no exit is forthcoming but the company is relatively successful, the convertible loan investors will be repaid their capital and interest. If the investment is made by way of equity, it is often not possible for the company to buy the investors’ shares back as it will often have insufficient distributable profits available for the purpose.
# Disadvantages of investing via convertible debt

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<tr>
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<tbody>
<tr>
<td>1. Potentially poorer returns</td>
<td>This is the key flaw in using a convertible loan. Investors are usually looking for that “home run” of a ten (or more) times return on investment. If an investor was to hold equity and was able to exit after a period of good growth on a further financing event, then his return would be much higher than that achieved using a simple convertible loan investment in the same situation. Of course, it is possible to structure in a stepped return, a high discount or a capped conversion price (capping conversion rates is especially helpful as it essentially increases the levels of discount only in very high growth investments), but this might have an adverse impact on the second-round investor, or the investment may be conditional on a renegotiation of the terms of the convertible loan. However, it should not be forgotten that a high return on investment is a rare (but desirable) scenario. The reality is that first-round investments are subject to significant risks and often fail. A convertible loan is a hybrid instrument. Prior to conversion it protects the investor from significant risk and at conversion it allows the investor to participate in the greater equity returns at a time when risks are lower and the company is no longer inviting equity investment from new angels.</td>
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<tr>
<td>2. No EIS</td>
<td>EIS relief probably does not apply.</td>
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<tr>
<td>3. It's complicated</td>
<td>Flexibility is a double-edged sword. Just as the convertible loan can be tailored to suit an investor’s needs, a poor understanding of those needs and how the convertible loan works can mean the investment structure does not operate as the investor anticipated. This is especially prevalent in respect of a discounted conversion loan, because setting an appropriate discount is both vital and not a core skill for equity investors. The convertible loan document will also need to address default, collateral, interest rates and security (security will need separate documentation).</td>
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<tr>
<td>4. Misalignment of interests</td>
<td>When using a discounted conversion mechanism, a curious conflict of interest is created. Because the debt converts into equity at the then current agreed value (less a discount), an investor receives more shares with a lower valuation, whereas the founders retain a smaller interest with a lower valuation.</td>
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<tr>
<td>5. Entrepreneurs don’t like debt</td>
<td>Sometimes it’s as simple as that and they won’t accept a convertible loan investment.</td>
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<td>6. Is short-circuiting valuation discussions right?</td>
<td>There is an argument that if you can’t agree a valuation with the founders or don’t feel qualified to compute a valuation, then investing in such a company would not necessarily be appropriate.</td>
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Conclusions and top tips

To conclude, here are some top tips for using convertible debt:

- Convertible debt is very well suited for short-term investments;
- Convertible debt is especially useful in situations where there is a desire to participate in long-term growth, but a reluctance to be exposed to high levels of risk;
- Convertible debt is suitable for uncertain markets e.g. where the expected growth is initially low, but where growth may rapidly accelerate due to certain foreseeable factors;
- It is vital to set the conversion mechanisms correctly, using capped values where appropriate, and to look at a number of potential investment outcomes;
- It is equally vital to make sure there is a long stop conversion date or an on-demand conversion right to avoid holding a ‘non-convertible’ convertible loan;
- As with any loan, further borrowing or security should be prevented with a negative pledge and any director or founder shareholder loans should be subordinated;
- Be wary of granting the company a right of pre-payment, if pre-payment is to be allowed. It should be possible only if a satisfactory return has been received. Using a pre-payment penalty can assist in this respect; and
- Do not forget to consider how your gains will be taxed and how tax can lawfully be mitigated.

In summary, convertible debt does have a role to play and can be an extremely useful tool in the armoury of an investor. It has found much favour in the States, with good reason, as it suits investors who want to mitigate some risk while still taking advantage of the relatively high returns associated with unquoted stocks. However, there is no question (especially without the tax benefit of EIS relief) that equity will continue to be the preferred investment structure.

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