Our next chapter is on convertible debt. Now, convertible debt used to be very popular in the mid-to-late 90s. Then it went away for a while and now it's back with a vengeance. We're going to go into what convertible debt is and the pros and cons of using it?

Clint: What is convertible debt as an instrument, and in particular, how does it compare to all this preferred funding we've just been talking about?

Jason: Convertible debt is both debt that is convertible to preferred stock. What does that mean? At its core it's debt, it's a loan. It says, "I'm going to give you a million dollars, you promise to give a million back."

Now unlike a bank loan, we expect it to convert into preferred stock later. So the idea is that I give you money now, someone later down a road does a preferred financing with you and my debt converts into that round at a predetermined price or a discount to the price that the other person is paying.

Clint: Why would I want to do that as an entrepreneur?

Jason: Well, there are a couple of things that you might want to think about. In the old days, it used to cost about $30,000-$40,000 to do a financing. This was back in the mid 90s, when $45,000 or $50,000 was even more money than it is today. A convertible debt deal, it would cost you $5,000 and it would take you a couple of days to do it.

In the old days, there was this huge bias of "Do convertible debt. It's faster, cheaper, the lawyers don't get rich and you get your money faster." These days, the prices have gotten really compressed. Right now, you can do a series A deal for $20,000-$25,000. Convertible debt is around $15,000 or whatnot. From a cost standpoint, there is not much of a difference. It's a little faster and it's a little easier. But that was the original idea of why convertible debt became popular.

Later on, especially more recently, it became popular because entrepreneurs wanted to delay the value discussion. Unlike a financing where the venture capitalist or the entrepreneur has to agree with the entrepreneur on what the valuation is, in a convertible debt, we are not having those discussions. It is, "Here is a million dollars. You will give me a million dollars back or if you do a financing later that million will convert into new financing."

What you are negotiating is if there is a discount. Usually, there is a discount somewhere around 20% saying, "I get a 20% discount on the next guy's price just because I came in earlier and I took extra risk." The entrepreneurs like it because they are not having to have that valuation discussion, which is sometimes the hardest discussion to have.

Clint: Some of these convertible notes have a cap in them. Can you tell us about what a cap is and how that relates to the valuation discussion?

Jason: Let's say you start a company today. Normally, I am seeing companies in range be at a valuation of two-to-three-to four million dollars. You say, "Jason, I don't want to have a valuation discussion. I think this thing is already worth $10 million. You want to invest, I want you to invest. Let's just do a convertible debt. We'll put it in there and you can have a 20% discount to the next round."

I might be thinking, "Yeah, you know you're a pretty good salesman and it's a pretty interesting company. What if you can find some venture capitalist to fund you at the next round at $20 million? Man, that wasn't such a good deal for me. I put the money early, you worked a year, you then got this big valuation. I really didn't get the credit for being the early, early investor that I am."

So I am going to put what is called a cap on it. I am going to say, "I get a 20% discount unless up until the point the valuation equals 'X'. At that point, there's a cap. So I will get converted at no higher than that valuation no matter what the round is actually raised."

Now, the cap has a couple of implications. One, it protects the venture capitalist from having a larger valuation than we were expecting the conversion to happen. The other thing, there's a piece of paper that you have in your presence that says, "We agreed today that that highest valuation is equal to 'X'." Let's call it $8 million valuation. What do you think that does?

Well, let's pretend now that I didn't do the convertible note. Let's pretend I'm the venture capitalist. I come and I'm going to fund your company. The first thing I ask is, "Hey, have you taken on any money?" You say, "Yes, we took on a million dollars from Eugene Ventures."

"Oh yeah? What style was it?"

"It was convertible debt."

"Great. Was there a cap?"

You say, "Yeah."

I say, "What was the cap?"

The company says, "Well, it was kind of $5 million."

What number do you think I'm focusing on now as the venture capital for the valuation? It might be $5 million. So your cap actually starts to look like it's setting your next round more often than entrepreneurs think.

For this reason, the convertible debt isn't the magic goose that everyone says it is that, "Oh, you can delay the valuation discussion," because with the cap, we're pretty much having that discussion anyway. We're just not able to really have it in the open. It's kind of like you're having a passive argument with your girlfriend or your boyfriend that you really don't want to have but you're snipping at each other a lot. It's kind of like that.

Student: Is the 20% discount standard debt number I have to incur in one round? I've also heard things like maybe you shouldn't give away 20% upfront. Just say, "Do you know what? If we do a series A in the first six months, that's a 5% discount. Between six and ten, it's a 10% discount. etcetera." Actually step it up. What is the standard structure? What is the norm that you've seen around discounts?

Jason: So let me take a little bit of a tangent and get back to your answer, because you bring up a bigger issue. First of all, to venture capitalists like convertible debt? The answer is that I don't think venture capitalists should love convertible debts. I want to lock in a price. I want to know what I own, I want the certainty of what I'm buying today.

I am already not loving convertible debt and now you are going to put extra complexity on it. You're trying to get cute with it. You're going to try to negotiate it. To me, that would be a huge turnoff. I'd say, "Look, man. For whatever reason, someone came along a long time before you and I were doing this, when we were in diapers, and it was 20%. 20% seems reasonable."

And by the way, I do think what you're thinking about in terms of the timing is important. Usually, these convertible debt deals, the money doesn't last longer than six, nine, 12 months. I actually think that a 20% discount is fairly sane. I think a 5% discount, no. No one else would fund you, right? I was the first guy to step up and I feel like I should be getting a better deal.

Student: Which is a bigger sticking point in a negotiation, the discount or the cap?

Jason: The cap is always the biggest. We talked, the 20% is somewhere standard. I've seen 10% and I've seen 30%. I've never seen anything as low as 5%. With 20%, people are like, "Eh, fine."

Most lawyers will at least say, "Yes, that's fine." But the cap, again, we're now having a valuation discussion that we didn't want to have. For some reason, our relationship didn’t allow us to have the valuation discussion in the first place and now we are sort of having it implicitly. So those are where the sticky points really are.