Convertible Notes

Prepared for Team Parlay

Contents

Promissory Note Explanation

- The ***Promissory Note*** is often the executory piece paired with the *Purchase Agreement*
- It’s the actual debt instrument
- It’s existence does not constitute a proper equity round
    - There’s no constraints on the number of notes issued or the timing of the notes

Purchase Agreement Key Terms

- **Valuation Cap**: the converted equity valuation at the next round, provided the round's price is higher than the cap
  - A cap is very common but not actually required
  - The cap is **not** a valuation, but rather the settlement on fair market value between investor and entrepreneur

Purchase Agreement Key Terms

- **Interest Rate**: the compounding debt rate on the investment principal
  - Market rate is generally between 6 and 8%
  - The interest rate is a non-optional piece and must be specified, even if very low
  - It’s calculated in dollars but paid in converted equity not cash

Purchase Agreement Key Terms

- **Maturation Date**: the backstop date when interest stops and debt is considered matured
  - Typically 12-24 months and is planned to occur in sequence with an equity round
  - Causes conversion if round has not happened
  - Important to consider acceleration terms and default implications

Purchase Agreement Properness Padding

- The note should pay special attention to shareholder rights for the converted shares
- Investors for the next equity round will pay special attention to voting rights, board rights, and other majority shareholder rights like information rights

Equity Conversion Planning

- It’s best to backwards plan convertible notes from the next planned round of equity financing
- The main risk is having a note with cap that’s much lower than the round valuation and the (prospective) next round investors not getting enough equity
- You should model out several scenarios of next round valuations, allocations, and dilution