Haas Impact Fund

Dealmaking: Convertible Notes

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Contract forms for early stage

1. **Common Stock** (friends and family)
   - No control provisions
2. Convertible **Preferred Stock**
   - Equity with preferred rights on control and cash flow
   - "Convertible" refers to conversion to common in the cases of success (mainly IPO) that takes away control rights form investor
3. **Convertible Notes**
4. **Convertible Notes without the debt provision**
   - **SAFE**s: Simple Agreement for Future Equity

Convertible Note (and SAFEs) rather than Preferred Stock offering

- Due diligence takes time
  - When small dollars in question, not worth it
  - No real advantage in pinning down valuation when you can build it into the terms
- Term Sheets cost legal fees
  - Even when financier prepares term sheet, the cost is usually put on the entrepreneur
  - Eg: raising $150,000 and spending $25,000 on legal fees makes no sense
  - Thus the growth in pre-packaged legal forms
  - Convertibles are another way around this

Convertible Notes

- Some examples / descriptions
  - https://bottomlinelawgroup.com/2011/10/31/convertible-note-financing/
  - https://www.cooleygo.com/convertible-debt/

- Safe
  - https://www.ycombinator.com/documents/

Basic Idea of a Convertible Note

- Give the entrepreneur startup funds (< $2 million usually)
- Provide a loan with a 1 – 2 year horizon
  - The point of the convertible debt is the "convertible" word
  - Loan payback is not often relevant, but the loan duration is a forcing mechanism
    - 1-2 years are extendable, but with approval
- Convert to equity at next round (within the term of the loan)

- Main features (next slides) are about the conversion and the next equity round (Second Seed or Series A)

Main Feature #1

Price **discount** on conversion

Basic idea:

- An early seed investor invests very early in the company when there is a lot of risk because the idea/ market has not been proven
- The "series A" investor invests 1-2 years later, with some milestones met

- Shouldn't the seed investor be able to buy shares cheaper because of taking on added risk?
- This "discount" is exactly that – the price discount for the added risk.

Discount on Conversion

Discount on Conversion: Usually 0-20%.

Example: Say the Note was $500,000. If the firm successfully makes it to raising a Series A round, the $500,000 will need to convert to shares.

- Let's imagine the Series A new investor pays $5 /share.
- Without a discount, the note investor will get 100,000 shares.
- But shouldn't the riskier investment (the seed investment) have a better deal for taking more risk?
- If the price per share is $4 (a 20% discount off $5), the note investor will get 125,000 shares, which is better.
- This is essentially the same concept as later rounds paying a higher price for a similar equity stake because uncertainties are removed over time.

Main Feature #2

Valuation Cap

Basic idea:

- Imagine a convertible note investor invests $250,000 in a startup, expecting that the startup's idea might be worth $6 million if the entrepreneur can prove the market in the next 18 months.
- The entrepreneur has tremendous success and the valuation of the company at the next round is instead $25 million.
    - Because the seed investor has only a note with a promise to convert to shares in the next round (the Series A) at a price per share relative to the valuation at the Series A, the investor gets a smaller equity stake than if the investor had originally bought shares in the seed round.
    - Intuition (not exactly right, but close): a $250,000 investment in a company that is worth $25 million does not get you as much equity % as a $250,000 investment in a company that is worth $6 million.

Valuation Cap

- The Valuation Cap is a key feature that makes investors interested in doing deals using convertible notes
  - Not as true for large fund investors, whose interest is in access to future rounds
- Caps ensure that the investor will get a big enough equity stake for the initial money, conditional on the firm surviving to the next round. It also keeps incentives aligned .
  - Incentive alignment := Both the entrepreneur and investor want the company to do well before the note gets "priced"
    - The term "pricing a round" means allocating equity stake (or, equivalently shares relative to the total pool of shares) to the investor for the investment dollars.
- A valuation cap used to be applied as a "pre-money cap" on the next round, but have moved toward a "post-money cap" because ventures started taking more seed-stage convertible notes before the 1st priced round.

Main Feature #3: Access to future rounds

- This is often the feature that makes larger investors (VCs) interested or those whose play is the next round.
- Notes include a term that gives the Note Investor the right to participate a certain percent in the equity round (Series A).
  - E.g.: Right to invest 25% of the funding in the Series A. Sometimes framed in dollars.
- The right varies by size of note investor, ranging roughly 20-50% of new money

- Big picture here… Imagine a $250,000 convertible note investment. A $200 million VC fund who funds this note does not care how $250k performs and would not waste time with this small investment EXCEPT that it cares about access to Series A opportunity