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Raising Money Using Convertible Debt

By: Entrepreneur |
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There's debt financing, there's equity financing, and then there's convertible debt. Find out why this third option can work well for startups.

By Asheesh Advani

Last month, in my article about debt and equity financing, I mentioned another solution that some entrepreneurs have found to be a happy middle ground between debt financing and equity financing. That solution is convertible debt, which is simply a loan (a debt obligation) that can be turned into equity (stock ownership), generally upon the occurrence of future financing.

So what's to like about convertible debt? At first glance, it seems like a rough deal for the entrepreneur looking for startup financing: It involves loan repayment, interest accumulation and, if things go well, loss of control associated with the sale of stock.

The simple truth is that entrepreneurs should like convertible debt because savvy startup investors love convertible debt. It's an excellent way to secure investment funds without setting a valuation on a company--an uncertain and disruptive process for the early-stage or pre-revenue company--that can protect early investors from dilution in the next round of financing.

Consider this example. You run a startup company--let's call it Rapid Growth Inc., or RGI--and you're convinced that the best way to make your business succeed is to attract a large amount of equity capital from an "institutional" venture investor. You know that attracting this investment won't happen quickly, but you need to raise money immediately to get RGI off the ground and get some clients to prove the business proposition. So you turn to your friends, relatives and "angel investors" referred by your network. What terms should you suggest to these early investors? Debt, equity or convertible debt?

For most businesses that don't need venture capital to reach profitability, simple loans are often the best and cheapest strategy. In my last column, I discussed some of the reasons entrepreneurs are attracted to equity even when they realize that debt is more likely to result in a decent return for their investors.

However, if you're certain that RGI will require venture capital, then convertible debt is likely to be a better option than outright debt or equity. This is primarily because it avoids the need for you to set a valuation on your company before an institutional investor comes in. Determining how to value a startup is notoriously arbitrary, and entrepreneurs raising money from relatives and friends tend to over-value their new businesses. Convertible debt eliminates the risk of a "down round" (an investment round with a share price lower than the previous round).

In the case of RGI, if you elected to use equity financing, you might set a company valuation of \$2.5 million before financing (this happens to be the round number selected by many first-time entrepreneurs). If you raise \$500,000 from relatives, friends and business angels, you'll have a "post money" valuation of \$3

million. If you receive an offer from an institutional investor to invest \$2 million in RGI and the investor elects to value the company at \$2 million, you'll likely have to convince your relatives and friends to approve this new investment and they'll be disappointed that the institutional investor will get a lower share price (it would be 33 percent lower in this example).

But if you had used convertible debt rather than equity financing for raising the initial \$500,000 for RGI, your relatives and friends would've received a better deal. Their risk would have been lower because if you'd taken a long time to raise the next round, their debt would have accumulated interest. And when the new investor closed, they wouldn't have suffered as much dilution from the new investment.

In addition, convertible debt often includes terms to provide a discount or bonus upon conversion into equity. In other words, your friends and relatives could have received a discount off the share price negotiated by the institutional investor. The amount of the discount is negotiable, but a good rule of thumb is 20 to 25 percent per annum. So if it takes six months to close the next round, and the discount is 24 percent for each year the loan remains outstanding, your relatives and friends would have received shares at a price that was 12 percent lower than the next round's investors--regardless of the valuation. Although everything is deemed to be negotiable by the traditional venture capitalist, these terms provide some leverage.

So if convertible debt is such a smart way to go, why isn't it more popular? One reason is that it requires a lawyer to draft the terms and this can be expensive for an entrepreneur during the startup stage. Perhaps a more important reason is that entrepreneurs are scared of debt: The mere idea of accumulating \$500,000 worth of debt can be daunting for any business owner, let alone a startup entrepreneur. Ironically, that fear of debt can get in the way of financial success.

There are three critical decisions to make when using convertible debt:

- 1. What will be the event that triggers the conversion?** You can elect to specify an event (or set of events) such as a revenue threshold, a financing threshold or another business milestone. Typically, entrepreneurs and investors agree to set the conversion to occur at a financing event.
- 2. Will there be a discount upon conversion?** It's a tricky decision to provide a discount to early investors. But if you don't provide a discount or set it too low, you might not get investors to commit before the next round is close to fruition. And if you set the discount too high (or if it takes a long time for you to raise the next round and you don't place a limit on the discount), the next round's investor will factor in the discount when pricing the stock. Effectively, this may mean that you--the entrepreneur--will pay for your generosity out of your own shares! Be wary of this.
- 3. What will happen to the investment if the conversion event doesn't occur?** If the debt is set to convert to equity when you raise \$10 million, and if this never happens, what should happen to the initial investment? It could remain as debt. Or you could elect to add a clause that allows the debt to convert to equity at the discretion of the investor or the discretion of the company.

To boil it down, using the convertible debt method of financing with family, friends and angels essentially boils down to you saying, "I need money, and you have it. But I don't know how much my company is worth, so let's see if professional investors or the passage of time will set the value for us while giving you an upside that's more in keeping with the risk."

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