Continue



You've probably heard about convertible notes before, but do you really know what they are? Convertible notes are a pretty common financing tool used by startups and investors, but the details can still be confusing. In this article, we'll break down exactly what a convertible note is, how they work, and the pros and cons of using them. We'll look at real-world examples of convertible note terms and structures. Whether you're an entrepreneur looking to raise money or an investor trying to understand startup financing, you'll learn the key things you need to know about convertible note is a type of shortterm debt financing that converts into equity. In simpler terms, it's a loan that turns into shares of stock. When a startup raises money from investors through convertible notes, the investors lend the startup money with the agreement that the principal and interest will be repaid at a later date, typically within 3 to 5 years. However, instead of repaying the money, the startup can convert the debt into shares of stock at a conversion discount. This means investors get equity at a lower price than new investors. For startups, convertible notes are appealing because they delay establishing a company valuation. For investors, convertible notes are attractive for several reasons: Upside potential: If the startup does well, the equity you receive could be worth substantially more than your original investment. Downside protection: If the startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the startup does well, the equity you receive could be worth substantially more than your original investment. The startup does well, the startup does well, the equity you receive could be worth substantial. The startup does well, the equity you receive could be worth substantial. The startup does well, the equity you receive could be Convertible notes typically have simpler legal documents and lower transaction costs versus a priced equity round. While convertible notes can be an efficient way to finance growth and share in future success. Convertible notes offer some useful advantages, but also come with potential downsides you should be aware of . On the plus side, convertible notes are flexible. They give startups a way to raise capital without determining a valuation upfront. The conversion terms can be negotiated when the company is in a better position. Convertible notes also typically have lower transaction costs than equity financings since they dont require a valuation. However, there are a few consider:Dilution: When the notes convert to equity, founders and existing shareholders will be diluted. The investors who put in the convertible notes also typically have lower transaction costs than equity financings since they dont require a valuation. in the company.Interest accrual: Convertible notes often accrue interest, so the amount of equity the investors receive will increase over time. This can further dilute founders and shareholders.Lack of transparency: With convertible notes, founders and investors dont know the exact amount of equity that will be allocated to the investors until the notes actually convert. This can create uncertainty. Default risk: If a startup struggles and cannot pay back the notes or negotiate a conversion, the investors. Overall, convertible notes can be useful for early-stage startups looking for flexible funding options. However, founders and investors should go in with their eyes open to the potential downsides like dilution, interest costs, and uncertainty. With the right terms and communications, convertible notes. Here are some of the most common FAQs:A convertible note is a loan that converts into equitytypically shares of preferred stockin a company. Investors loan money to a startup, and instead of the startup paying interest on the loan, the investors get the option to convert the loan into shares of stock in the company. Convertible notes are popular with startups because theyre faster and simpler than equity financing. Startups can raise money quickly without determining a valuation or dealing with the complexity of preferred stock. The conversion terms are negotiated later, often at the next equity round of funding. For investors, convertible notes provide the opportunity to invest in a startup at an early stage, with the possibility of gaining equity at a discount. If the startup is successful, the notes can convert into equity at a lower valuation, allowing investors to get more shares of preferred stock. Convertible notes also typically earn interest, providing the investor some return even if the notes dont convert into equity at a lower valuation, allowing investors to get more shares of preferred stock. notes dont convert into equity, in which case the investor is left with just the principal and any earned interest. For startups, a disadvantage is that convertible notes also add complexity to subsequent equity financing rounds. Does this help explain what convertible notes are and answer some of your most pressing questions? Let us know if you have any other questions? If you want further or more personalized assistance, contact us. Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many startups, you might decide to try and seek venture capitalespecially if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggest looming questions is likely: Whats my companys valuation? After all, your companys valuation will have a large effect on the kind of capital youll be able to raise and from whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups who raise angel or seed capital choose to use convertible notes when engaging investors. A type of financing for early-stage companies, many startups use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage startups from investors who are expecting to be paid back when their note comes due. But, instead of being paid back in principal with interestas would be the case with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note, acting as a short-term loan, ensures that you give the investor a stake in your startup later. From the investors point of view, the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well, youll repayment terms in the ballpark of a standard short-term loan, usually a year or two), along with repayment terms This is the note. The note will include a due date at which time its mature and the balance will be due, along with interest. Generally, however, the maturity date comes along and your startup has not yet convertible notes is that your company is on a strong growth trajectory and that is why the note is being issuedit amasses value for the investor and beelines to a priced round. Ultimately, the point of a convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convertible notes. because theyre simple and fast. Since convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round where you actually issue shares of stock. If you were to opt for a typical funding round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to, and whether or not you can even raise capital at all often hinges on whether you value your company correctlyin other words, whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible. In this scenario, therefore, convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing round. With a convertible note, then, you can secure financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business valuation. Since a convertible note is a loan from an investor, youll have certain terms just like you would with a traditional business loan. After all, investors interested in becoming noteholders are willing to accept the risks of financing a very early-stage startupmeaning that they expect the incentive that comes along with taking on that riskand this is reflected in your terms. Here are four terms of convertible notes that are important to understand: Valuation cap: Generally just referred to as the cap, the valuation cap is the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor on a maximum cap. The lower the terms for your investor into equity. since theyll reap bigger increases in your companys value the lower their buy-in begins. Discount rate: Convertible noteholders are generally see larger discounts (25% is standard for many very early investors). Maturity date: The maturity date, as we mentioned above, is the date on which the convertible note is due and you need to repay your investor for their loan. Interest rate: With convertible notes, an interest rate is not nearly as significant as it would be for a traditional loan. As a type of loan, however, the convertible note must carry interest. The interest rate is not nearly as significant as it would be for a traditional loan. usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in equity, however, youll do so for both the principal and the interest thats accrued. We mentioned this possibility briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your note. Your investor may decide to extend the maturity date on your convertible note and push you toward raising your Series A funding round. The investor might negotiate terms, increasing the discount or lowering the cap, but it may potentially be worth it if you can get your loan. Once again, a convertible note is a loan, and if the maturity date arrives, your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the investorial terms and the investorial terms and the investorial terms and term note to equity with a new cap. Finally, if you can find a common ground that works for you and your investor both, you can decide to convert the note are designed specifically for early-stage startups in high-growth phases. To actually make use of a convertible note, your company should be in talks with potential investors at angel and seed rounds of funding. Therefore, by the time you hit your convertibles. Plus, since these notes are debt before they convertible notes to create any value for noteholders, your company needs to be quickly growing on the path to a priced round. Otherwise, you might be stuck paying back your debts. Convertible notes are also ideal for early-stage startups who want to close funding fast. Because a convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. Additionally, you can close different terms with multiple investors with convertible notessomething you cant do once you price your round. If youre considering a convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible notes as a method of funding are their simplicity, speed, and avoidance of the need for valuation With a simple contract, your startup receives the funding it needs and the valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesnt have to worry about making regular payments along the way, so it doesnt impact your day-to-day cash flow. Cons: The major downside of a convertible note is that you will eventually be giving up some control over your business. When the convertible note comes due, the investor will be granted equity in your business. If youre not ready to split ownership of your business. If youre not ready to split ownership of your business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be issuing convertible notes to swaths of investors. In fact, not every startup should be raising venture capital at all. When youre considering whether or not to issue convertible notes, youll want to take a step back and make sure that youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups receive venture capital, the opposite is truestartup funding statistics show that only 0.05% of startups raise venture capital. With this in mind, lets take a look at some convertible note alternatives. There is substantial funding available out there that doesn't involve a convertible note alternatives. type of business, you should look at the myriad of small business grants available. There are hundreds of grants you can apply toand they dont require some of the same stringent credit requirements or extensive time-in-business history that other SBA loans do. Plus, our business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Plus, with an SBA microloan, you wont have to give up equity and youll receive access to the U.S. Administrations famous resource network. If you still feel that raising venture capital is the way to go for your startup, and youre comfortable with convertible notes because of the debt aspect they just dont like the idea of taking on a loan in very early stages of their company. The SAFE (Simple Agreement for Future Equity) is meant to circumvent this issue. Created by Silicon Valley startup incubator Y Combinator, the YC SAFE is meant to be a very flexible, founder-friendly alternative to convertible notes with zero debt involved. The SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE which means no repayment from your startup. SAFEs can also be done with or without a cap or discount. As you might expect, a SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS (Keep It Simple Security) works very similarly to everything weve already discussed. These are meant to be very short, customizable documents for both a debt agreement thats closer to a convertible note, plus an equity-only agreement thats closer to a SAFE. If you have a startup lawyer you trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Main Advantage of Convertible NotesIn essence, issuing convertible notes does not compel the issuer and investors to come up with a value of the company) at a time when they might not be able to properly perform valuation, i.e. when the company is just an idea that needs implementation. A valuation will be typically conducted during the Series A financing round, given a sufficient amount of data about the company. Terms of Convertible note to define its value, the following aspects should be taken into account: 1. Discount rate is the valuation rate used to discount future cash flows expected to be derived from an entity in discounted cash flow (DCF) analysis to determine the present value of the cash flows, or, in other words, what is the worth of the valued enterprise today.2. Valuation cap represents an additional reward for investors taking a risk by investing at the very beginning stage of a companys formation. It entitles convertible noteholders to convert to an equity stake in the company at the lower of the valuation price, or valuation price, or valuation cap, in the subsequent financing rounds.3. Interest rateTypically, convertible notes accrue an interest rateTypically, convertible notes accrue an interest rate. the date when a note becomes invalid because it is due. Thus, the maturity date refers to a date when a company, ABC Ltd., raised funds during the seed round of financing, issuing convertible notes with the valuation cap worth \$5,000,000 and no discount prior to the Series A round at a \$15 pre-money valuation cap on the note by the pre-money valuation cap adjusted share price. In this case, the adjusted share price of the Series A for convertible noteholders is \$3.33.Provided an individual intends to make a future investment of \$100,000 / \$3.33 would give the investor 30,030 shares.*Please note that a new investor investing the same \$100,000 / \$3.33 would give the investor 30,030 shares.*Please note that a new investor 30,030 shares.*Please note that a new investor investing the same \$100,000 / \$3.33 would give the investor 30,030 shares.*Please note that a new investor 30,030 shares.*Ple receive 6,666 shares (\$100,000 / \$15).More ResourcesCFI is the official provider of the Capital Markets & Securities Analyst. In order to help you become a world-class financial analyst and advance your career to your fullest potential, these additional resources will be very helpful: Like a SAFE note, a convertible note is a way for startups to raise money before theyve received a valuation. Investors who are issued convertible notes are, how they work, their advantages and disadvantages, and some legal and tax considerations. Learn.angelist.com explains that convertible notes, along with SAFE notes, are one of the most common ways for startups to secure early-stagee early-stage funding. According to the Angel Capital Association, 37% of angel deals in 2019 were accomplished with convertible notes. In a nutshell, heres how convertible notes work. First, an investor offers a convertible note to a founder, who in turn promises the investor equity in the company at a future date upon a conversion event. Until the conversion event occurs, the convertible note is just like traditional debt; it carries interest and has a maturity date. If the company does experience a conversion event, the total amount on the note and any interest accrued to date, learn.angelist.com explains. At that point, one of two things determines the price at which the convertible note specifies both, the lower of the two usually applies. A founder raises \$2 million by issuing convertible notes that have a valuation cap. If a convertible notes mature in three years and carry an interest rate of 5%. If the founder later raises \$4 million in a Series A round with a post-money valuation of \$20 million, this means the convertible notes and SAFE notes to secure early stage funding. In addition, both instruments offer future equity to investors for money upfront, and both convert into shares of preferred stock when a triggering event like a series A round occurs. However, there are significant differences between convertible notes and SAFE notes arent Convertible notes have maturity dates, and SAFE notes dont Convertible notes carry interest, and SAFE notes dont Convertible notes arent c additional criteria for which priced equity rounds trigger a conversion. Convertible notes have a number of advantages when it comes to raising equity. The primary reason is that the parties are leaving some of the most difficult aspects for the future is easier and thus faster and cheaper than raising equity. such as operating agreements, shareholder agreements, etc. Early-stage companies that dont have much of a track record can use convertible notes also come with risks and downsides that founders should carefully consider before using them to finance their startups. Although convertible notes are simpler than many equity financing arrangements, they require considerably more paperwork than SAFE notes. This makes them more time-consuming to issue and more difficult to negotiate. And unlike SAFE notes, convertible notes have deadlines and interest payments to deal with. For these reasons, many founders prefer SAFE notes when it comes to raising funds for their startups. If youre unable to raising funds for their startups and its investors. Because convertible notes give away future equity in your company, theres a risk that this equity will be worth a lot more than the value of the original loan, especially if you grow at a faster rate than expected. Before issuing convertible notes, we suggest hiring an attorney with appropriate experience so you dont run afoul of securities laws. They can advise you on matters such as how convertible notes are treated, how they are triggered, and what your legal rights and obligations are. Other key considerations for startups regarding convertible include whether: Youll be paying too much in interest, which could limit your cash flow Youre giving up too much in interest, which could limit your cash flow Youre giving up too much in interest. You have too many convertible notes with different terms, which might overcomplicate things and deter future investors. Whether you run a startup or an established business, we also suggest retaining an attorney to go over the tax implications of convertible notes. Convertible notes can be classified as either debt or equity for U.S. tax reporting purposes, depending on the facts and circumstances, according to AngelList. In practice, most convertible notes are treated as debt, but its always advisable for companies to consult a U.S. tax advisor when classifying these instruments for reporting purposes. Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many startups, you might decide to try and seek venture capitalespecially if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggest looming questions is likely: Whats my companys valuation? After all, your companys valuation will have a large effect on the kind of capital youll be able to raise and from whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage capital raises. In other words, convertible note is a type of short-term debt financing thats used in early-stage startups from investors who are expecting to be paid back when their note comes due. But, instead of being paid back in principal with interestas would be the case with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note like an IOU. An investor provides you with capital now and the convertible note like an IOU. startup later. From the investors point of view, the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well, youll repay them many times over. Typically, an investor will provide an early-stage startup in need of capital with a loan (with repayment terms in the ballpark of a standard short-term loan, usually a year or two), along with repayment terms. This is the note is not repaid like a normal short-term loan. Instead, you repay the investor for their loan with equity in your company, usually in conjunction with another funding round. If, however, the maturity date or call for the actual repayment of the note to equity, the investor can either extend the convertible notes is that your company is on a strong growth trajectory and that is why the note is being issuedit amasses value for the investor and beelines to a priced round. Ultimately, the point of a convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convert into a heavily discounted security in a successful, valuable company thats growing extremely quickly. Startups and investors choose to use convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round where you actually issue shares of stock. If you were to opt for a typical funding round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to, and whether or not you can even raise capital at all often hinges on whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating. an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible. In this scenario, therefore, convertible notes offer a large advantage. By using a convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business valuation. Since a convertible note is a loan from an investor, youll have certain terms just like you would with a traditional business loan. After all, investors interested in becoming noteholders are willing to accept the risks of financing a very early-stage startup meaning that they expect the incentive that comes along with taking on that risk of financing a very early-stage startup meaning that they expect the incentive that comes along with taking on that risk of financing a very early-stage startup meaning that they expect the incentive that comes along with taking on that risk of financing a very early-stage startup meaning that they expect the incentive that comes along with taking on the traditional business loan. terms of convertible notes that are important to understand: Valuation cap: Generally just referred to as the cap, the valuation cap is the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor on a maximum cap. The lower the cap, the better the terms for your investor, since theyll reap bigger increases in your companys value the lower their buy-in begins. Discount rate: Convertible noteholders are generally offered an additional discount on their share price to honor their share price to hon very early investors). Maturity date: The maturity date, as we mentioned above, is the date on which the convertible note is due and you need to repay your investor for their loan. As a type of loan, however, the convertible note must carry interest. The interest rates on convertible notes are usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in cash. When you do pay the convertible notes are usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the convertible notes are usually low. briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your note. on your convertible note and push you toward raising your Series A funding round. The investor might negotiate terms, increasing the discount or lowering the cap, but it may potentially be worth it if you can get your loan. Once again, a convertible note is a loan, and if the maturity date arrives, your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the investorial the investori return on their investment. You can try to convert the note to equity with a new cap . Finally, if you can find a common ground that works for you and your investor both, you can decide to convert the note into equity at a different valuation than the one originally intended. Ultimately, convertible notes are designed specifically for early-stage startups in high-growth phases. To actually make use of a convertible note, your company should be in talks with potential investors at angel and seed rounds of funding. Therefore, by the time you hit your Series A funding round, youll have a valuation, and you wont have to worry about your convertibles. Plus, since these notes are debt before they convert into equity, in order for convertible notes to create any value for noteholders, your company needs to be quickly growing on the path to a priced round. Otherwise, you might be stuck paying back your company if your note reaches maturity and your investor doesn't extend your note. Even worse, you could have to liquidate your company if you cant pay off your debts. Convertible notes are also ideal for early-stage startups who want to close funding fast. Because a convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. Additionally, you can close different terms with multiple investors with convertible notes something you cant do once you price your round. If youre considering a convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible note for your startup, first weigh these advantages and disadvantages. contract, your startup receives the funding it needs and the valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesnt have to worry about making regular payments along the way, so it doesnt impact your day-to-day cash flow. Cons: The major downside of a convertible note is that you will eventually be giving up some control over your business. When the convertible note comes due, the investor will be granted equity in your business. If youre not ready to split ownership of your business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be issuing convertible notes to swaths of investors. In fact, not every startup should be raising venture capital at all. When youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups receive venture capital, the opposite is truestartup funding statistics show that only 0.05% of startups raise venture capital. With this in mind, lets take a look at some convertible note alternatives. There is substantial funding available out there that doesn't involve a convertible note alternatives. founders of color. Along with those available for your specific type of business, you should look at the myriad of small business grants available. There are hundreds of grants you can apply toand they dont require equity or valuation. SBA microloans are ideal for startups because they dont require some of the same stringent credit requirements or extensive time-in-business history that other SBA loans do. Plus, these loans are also great if your business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Plus, with an SBA microloan, you wont have to give up equity and youll receive access to the U.S. Small Business Administrations famous resource network. If you still feel that raising venture capital is the way to go for your startup, and youre comfortable with convertible notes because of the debt aspect they just dont like the idea of taking on a loan in very early stages of their company. The SAFE (Simple Agreement for Future Equity) is meant to be a very flexible, founder-friendly alternative to convertible notes with zero debt involved. The SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE which means no repayment from your startup. SAFEs can also be done with or without a cap or discount. As you might expect, a SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high risk involved. Nevertheless, for extremely promising companies that are in high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS documents that allow founders and investors to work out terms terms that allow founders and investors terms term closer to a convertible note, plus an equity-only agreement thats closer to a SAFE. If you have a startup lawyer you trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Until 2023, access to capital was cheap, leading to increased funding for companies, soaring valuations, and heightened competition in funding rounds. However, as inflation rose due to multiple macroeconomic factors, the cost of capital continued to rise, making Venture Capitalists (VCs) more conservative and selective in their investments. As a result, in 2023, there was \$170.6 billion of VC money invested across 15,766 deals, which was well below the \$242.2 billion of VC money invested across 17,592 deals in 2022. In fact, 2023 deal values were about \$177 billion below the record levels achieved in 2021. Fortunately for founders, there are still opportunities to fundraise. However, the rules of the game have changedinstead of getting a set ownership stake in the company right away, investors are preferring to invest via convertibles across 63 deals in 2023. Thats up from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. Thats up from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US companies have issued more than \$40 billion of convertibles across 63 deals in 2023. That sup from \$29mu stake in the data from Dealogic, US company stake in the data from \$40 billion of convertibles across 63 deals in 2023. That sup from \$40 billion of \$40 billio billion and 54 transactions in all of 2022. Dealogic data for convertible notes issuedWhat are convertible notes? A convertible note is a type of short-term debt instrument used by startups to raise capital during early-stage funding rounds. subsequent funding round, rather than being repaid with interest. For founders, convertible notes take the pressure off of setting a company valuation immediately. With stock prices fluctuating in an uncertain market, a traditional funding round might mean selling shares for less than what they're worth. A convertible note gives the startup more time to prove itself and potentially command a higher valuation later, when the market (and investor confidence) recovers. For investors, convertible notes offer a safety net. They get a discount on their investment even if the startup doesn't take off. How do convertible notes work? Suppose you're starting a tech company called Acme, and you need \$50,000 to develop your first product. You find an investor, Sarah, who likes your idea but doesn't want to buy a share of your company right away. Instead, Sarah offers to lend you \$50,000 through a convertible note. Here's how the convertible note might work: 1. AgreementYou and Sarah agree that she will lend you \$50,000 with an interest rate of 5% and a maturity date of two years. You also agree that when Acme raises its next round of funding, Sarah's loan will convert into shares of the company at a 20% discount to the price per share in that round. 2. LendingSarah gives you the \$50,000, and you use it to develop your product.3. ConversionA year later, Acme raised \$1 million in a Series A funding round from venture capitalists. The price per share in this round is \$1. Now, because of the terms of the convertible note, Sarah's loan converts into shares at a 20% discount to this price. Without the discount, each share in the Series A round costs \$1.With the 20% discount, each share for Sarah's conversion costs \$0.80.So, Sarah's \$50,000 loan converts into 62,500 shares of Acme, which represents a certain percentage of the company, depending on the total number of solution (\$50,000 / \$0.80 per share).4. OwnershipAfter conversion, Sarah's \$50,000 loan converts into 62,500 shares of Acme, which represents a certain percentage of the company, depending on the total number of solution (\$50,000 / \$0.80 per share).4. OwnershipAfter conversion, Sarah's \$50,000 loan converts into 62,500 shares (\$50,000 / \$0.80 per share).4. OwnershipAfter conversion, Sarah's \$50,000 loan converts into 62,500 shares (\$50,000 / \$0.80 per share).4. OwnershipAfter conversion, Sarah's \$50,000 loan converts into 62,500 shares (\$50,000 loan converts into 62, shares outstanding.5. Repayment or conversionIf Acme hadn't raised more money within the two-year period, the convertible note would have matured. At that point, you would either repay Sarah the \$50,000 with interest, or if both parties agreed, the loan could convert into shares based on the terms outlined in the agreement. In this example, the convertible note allowed Acme to get the funding it needed without giving away equity right away, and it provided Sarah with the opportunity to investine the company early on, potentially leading to a higher return on her investment if Acme succeeds and its value increases over time. Terms of convertible notes typically include: 1. Principal amount This is the amount of money that the investor lends to the startup. 2. Interest rate determines how much interest rate, although it may be lower than typical loan rates due to the higher risk associated with startups. This reflects that investors are willing to accept lower returns in exchange for the potential upside of converting their investment into equity or be repaid by the startup. If the startup hasn't raised another round of funding iv the maturity date the investor may have the option to demand repayment of the loan.4. Conversion triggerConvertible notes typically convert into equity upon the occurrence of a specific event, such as the startup raising a subsequent round of financing above a certain threshold (e.g., Series A round of at least \$1 million). This event is known as the conversion trigger.5. Conversion price The conversion price determines how many shares the investor will receive when the note converts into equity. It's usually based on the valuation of the subsequent financing round, with a discount rate applied to benefit the investor. 6. Discount rate applied to benefit the investor will receive shares at a predetermined discount to the price per share in the subsequent financing round. For example, if the discount rate is 20% and the subsequent round's price per share.7. Valuation cap sets the maximum valuation at which the convertible note will convert into equity, regardless of the valuation of the subsequent financing round. This protects the investor from excessive dilution if the startup achieves a high valuation in the future. Benefits of convertible notes are used for several reasons: 1. FlexibilityConvertible notes are used for several reasons: 1. FlexibilityConvertible notes are used for several reasons: 1. FlexibilityConvertible notes are used for several reasons: 1. Flexibility for both startups and investors. Startups can raise money without immediately determining a valuation, which can be challenging in the early stages when the company's value is uncertain. Investors can provide funding without needing to negotiate the terms of equity ownership upfront.2. SpeedCompared to negotiate the terms of equity ownership upfront.2. access funding faster. This speed is valuable in fast-moving industries where timing is crucial.3. Deferred valuation of the company until it has more metrics, traction, or revenue, making it easier to attract investors who may be hesitant to invest based on early-stage valuations.4. Mitigated riskConvertible notes allow investors to participate in a startup's growth potential while mitigating some of the risks associated with early-stage investing. If the startup fails to raise further funding or does not perform well, the convertible note holder may have priority over other creditors in recovering their investment 5. Incentivizing early investment convertible notes often include features such as discount rates or valuation caps, which incentivize early investors who want to get in early but are wary of the risks associated with early-stage startups.6. SimplicityConvertible notes are often simpler and require less documentation compared to equity financing rounds, which can reduce legal costs and administrative burdens for both startups and investors:1. Uncertain valuationConvertible notes delay the valuation of the company until a future financing round. This uncertainty can make it challenging for startups to plan and for investors to assess the potential return on their investors. date of the convertible note. In such cases, the note may either remain outstanding with no clear path to conversion, or the startup may be required to repay the principal amount plus accrued interest, placing financial strain on the company. Can a convertible note be paid back by the startup under certain circumstances. Typically, convertible notes include provisions that allow for repayment in the event that the convertible note might be paid back: 1. Maturity date reachedIf the maturity date specified in the convertible note arrives and the startup has not raised a subsequent funding round triggering conversion, the note may require repayment. At this point, the startup may be obligated to repay the convertible note instead of converting it into equity. This could happen if the startup no longer needs the funds or if the terms of conversion are not favorable for either party.3. Change in circumstances for either party.3. Change in circumstances for either party and the convertible note instead of proceeding with conversion. It's important to note that the terms of repayment, including the timing and conditions, are typically outlined in the convertible note agreement. Both the startup and the investor should carefully review these terms to understand their rights and obligations regarding repayment. Additionally, repayment of a convertible note may have tax implications, so it's advisable to consult with legal and financial advisors before making any decisions. SAFEs vs convertible notes are both popular instruments used by startups to raise capital in the early stages of their development. While they serve similar purposes, there are some key differences between the two:1. Legal structureConvertible notes are debt instruments, meaning they represent a loan from the investor to the startup, with the expectation that the loan will convert into equity in the future. On the other hand, SAFEs are not debt instruments and do not accrue interest or have a maturity date like convertible notes. Instead, they are structured as a promise to issue equity to the investor at a later date, typically upon the occurrence of a specific triggering event, such as a subsequent equity financing round above a certain threshold (e.g., Series A round of at least \$1 million). In contrast, SAFEs often convert into equity at the next qualified financing round, but they may also have other triggering events, such as a change of control or dissolution of the company. An equity financing round of funding in which a company issues equity (ownership shares) in exchange for capital. On the other hand, a qualified financing round is a specific type of equity financing rounds, not all equity financing rounds are qualified financing rounds.3. Interest and maturity Convertible notes accrue interest over time and have a maturity date by which the loan must either convert into equity or be repaid by the startup. SAFEs do not accrue interest and do not have a maturity date, providing greater flexibility for both parties.4. Terms and complexityConvertible notes tend to have more complex terms, including interest rates, maturity dates, conversion discounts, and valuation caps. SAFEs are generally simpler and more standardized, with fewer terms and less negotiation required.5. or other adverse circumstances, as they have priority over equity holders in repayment. SAFEs do not offer the same level of protection, as they do not represent debt and do not have a repayment obligation. Overall, both convertible notes and SAFEs offer advantages and disadvantages for startups and investors, and the choice between the two depends on the specific circumstances of the fundraising round and the preferences of the parties involved. In the fast-paced world of startup funding, one method has risen into popularity for early stage companies looking to raise capital without the immediate burden of valuation negotiations convertible notes. remarkable rise in popularity due to its ability to strike a balance between the needs of both startups and investors. These short-term debt instruments offer startup founders a flexible means of securing funds without committing equity at the outset. understanding of how they work, their benefits, and how to use them. Let's get started!Convertible notes, explainedWhat is a convertible notes, explainedWhat is a convertible notes, explainedWhat is a convertible notes. that can be converted into equity at a later stage, usually during a subsequent financing round or an exit event. Investors lend money to startups with the expectation that it will be repaid or converted into ownership in the company. How convertible notes work When a startup issues a convertible note, the investor provides funding in exchange for a promissory note, which outlines the terms of the investment. The note typically includes details such as the principal amount, interest rate, maturity date, conversion feature, Instead of receiving immediate equity, the investor has the option to convert the loan into shares of the startup at a later date, usually when specific conditions are met, such as a subsequent funding round or an acquisition. Let's break that down: An investor lends money to a startup in exchange for a convertible note. comes due, the investor has the option to convert the debt into equity shares in the company, like stock. This typically happens when the startup raises a bigger round of funding or has an initial public offering (IPO). If the investor converts the debt, they essentially trade in the money owed to them for shares in the company. The conversion terms are outlined in the note and usually give the note holder equity with a discount rate. If the note is not converted, the startup has to repay the investor the full amount of the note so with this form of raising is that you dont really need to know what your company is worth to get the funds in your account you simply agree that when your company does eventually do a raise and your equity is valued, the lender (investor) will be provided (with any discount rate that might be agreed). This keeps everyone happy! The investor can be rewarded for taking the risk in investing early, by getting the opportunity for discounted shares, or at worst, getting their money back with interest; and the company gets money in the bank, can extend its runway, and be in a stronger position to raise more funds once everything is more certain. Let's break that down: For investors Flexible terms. Convertible notes offer flexible terms for both the investor and the startup founder. The terms of the note can be negotiated to meet the needs of both parties. Lower valuation risk. By using a convertible note, investors can avoid the risk of valuing the startup too early. The valuation of the company can be determined at a later date when more information is available. Delayed dilution. By using a convertible note, investors can delay the dilution of their equity until a later date when the company has a higher valuation. For startups Access to funds, fast. Convertible notes are often easier to obtain than equity financing. Lower legal fees. Because convertible notes are less complicated than equity funding rounds, the legal fees associated with them are typically lower. Delayed valuation. By using a convertible note, early stage startup founders can delay the valuation. By using a convertible note examples we have had first hand experience of the benefits of raising through convertible notes here at Cake so we can really vouch for the springboard they provide. A Convertible Note worked well for Cake as we were able to obtain early funding which allowed us to build and grow, while avoiding the delays and complications of a valuation. It still offered a financial return to investors via the 30% discount to the priced round. With the Convertible Note funding we progressed the company to achieve milestones that allowed a priced equity Here are a few more examples of well-known companies that used convertible notes in their early stages: AirbnbThe popular short-term rental startup Airbnb raised \$600,000 in 2009 through a convertible note from Y Combinator and Sequoia Capital. The note converted to equity with a 20% discount during Airbnbs \$7.2 million in 2007 through a convertible note from Sequoia Capital. When Dropbox raised its \$7.2 million Series A was just \$46 milliontoday the converted into equity at a 20% discount. Dropboxs valuation at the time of the Series A was just \$46 million through a convertible note in 2010. The note, and the time of the Series A was just \$46 million through a convertible note in 2010. The note, and the time of the Series A was just \$46 million through a convertible note in 2010. The note, and the time of the Series A was just \$46 million through a converted into equity at a 20% discount. led by First Round Capital and Lowercase Capital, convertible note agreementKey terms in a convertible note agreementBefore using convertible notes, you need to understand some of its key features: Conversion discount The conversion discount refers to the discount of the price of shares in the next funding round. The bigger the discount, the better for investors. Valuation cap puts an upper limit on the valuation used to determine the conversion price for the notes. Valuation cap protects note holders by ensuring they get equity shares at a price that values the company at no more than the cap amount. The lower the valuation cap, the more shares you can get. Interest rate is the percentage charged for borrowing money, like on a loan. With convertible notes, the interest rate is often low, around 5-8% per year. The startup issuing the note will pay note holders this interest on the principal amount. Maturity date is when the convertible note will pay note holders this interest on the principal plus any accrued interest. Conversion price is the price per share you pay to convertible notes into equity shares. Its equal to the lesser of the next funding rounds price per share minus the conversion discount OR the valuation cap divided by the number of shares outstanding. Next equity financing roundThe next equity financing round refers to the startups next sale of preferred stock to raise funds. The terms of this round determine the convertible note is critical. Dont hesitate to ask questions to make sure you have a firm grasp of how the notes provisions may affect you before providing funding. How to issue convertible notes involves several steps. Here's a general guide on how to issue convertible notes involves several steps. Here's a general guide on how to issue convertible notes involves several steps. cap, interest rate, maturity date, and any other relevant provisions. Consult legal and financial professionals to ensure compliance with applicable laws and regulations. 2. Prepare the convertible note agreement brough and financial professionals to ensure compliance with applicable laws and regulations. obligations of both the issuer (your company) and the investor. Cake has a convertible note template that's free to use with our equity management software. Approved by lawyers and used by many startup founders. Check it out.3. Execute the convertible note template that's free to use with our equity management software. This may involve verifying their accreditation status, conducting background checks, and reviewing their financial capabilities. Once the convertible note agreement is finalized, both parties (your company and the investor) should sign it. Ensure that all necessary parties sign the agreement, and keep copies of the executed document for recordkeeping purposes.4. Collect the fundsAfter executing the agreed-upon funds to your company. Ensure that you have a secure and traceable method for receiving the investment amount and documenting the investment amount and documentation.5. DocumentationAs you work towards your company goals, make sure

that you maintain accurate records of the convertible notes, including interest accrued and conversion terms. Use a reliable accounting system or software to track these details. Keep the investor informed about the progress of your business. This may include sharing financial statements, operational updates, and any significant events that may impact the conversion terms or the investor's investment.6. Conversion or repaymentAs the maturity date approaches, the convertible note agreement. It's or be repaid to the investor with the agreed-upon interest. Ensure you follow the terms outlined in the convertible note agreement. It's agreed to the investor with the agreed on the predetermined convertible note agreement. crucial to note that issuing convertible notes can be a complex process, and the specific steps may vary depending on the jurisdiction and the legal requirements applicable to your business. Seeking professional advice from legal and financial experts is highly recommended to ensure compliance and mitigate potential risks. While there are many vary depending on the jurisdiction and the legal requirements applicable to your business. benefits that come with convertible debt financing, there are important considerations to keep in mind too: Interest and conversion terms: Startups must carefully consider the interest rate and conversion terms: Startups must carefully consider the interest rate and conversion terms associated with excessive convertible debt is crucial. Additionally, negotiating favorable conversion terms, such as a discount or a valuation cap, can protect the interests of both the company and investors. Future financing rounds: Convertible notes typically convert into equity during subsequent funding rounds. with their long-term growth strategies. It's essential to evaluate the potential impact on ownership and control as new investors come on board. Investor relationships with early stage investors is vital for startups. Regular communication and transparency regarding the company's progress and future plans can help foster trust and support from investors, potentially leading to follow-on investments in subsequent funding rounds. Once you issue convertible notes, youre likely to have questions about convertible notes typically convert into equity when your startup raises its next round of funding, like a Series A. The notes convert at a discount to the Series A price per share. For example, if your Series A values the company at \$10 million and issues shares at \$1.0 million at \$1. convertible notes do accrue simple interest, often between 5 to 8% per year. The interest is usually paid at conversion. Some notes require interest payments before conversion. The interest rate and payment terms are negotiated between the startup and note holder. What happens if the notes dont convert? If your startup is unable to raise a round before the maturity date of the convertible notes, the notes typically become due and payable. Youll have to repay the principal plus any accrued interest to the noteholders. This scenario is known as a "maturity default." To avoid defaulting, startups often extend the maturity date to give them more time to raise. Can convertible notes be converted before the next funding round?Yes, convertible notes usually contain provisions allowing early conversion at the option of the note holders more flexibility and the startup more control over its capital structure. Do convertible notes have voting rights is one reason why convertible notes of voting rights is one reason why convertible notes (the former note holders) gain voting rights in the startup. The lack of voting rights is one reason why convertible notes have voting rights before the notes converted, the new equity shareholders (the former note holders) gain voting rights in the startup. are considered "bridge financing." The notes bridge the gap between seed funding and a Series A round that establishes equity ownership and more formal governance. Hope this helps clarify some of the most common questions about how convertible notes work! Let me know if you have any other questions. This article is designed and intended to provide general information in summary form on general topics. The material may not apply to all jurisdictions. The contents is not intended to be a substitute for such advice and should not be relied upon as such. If you would like to chat with a lawyer, please get in touch and we can introduce you to one of our very friendly legal partners. Startups often need funding before generating revenue, and one way they secure it is through convertible notes. These short-term loans from investors later convert into equity under specific conditions. They allow startups to postpone valuation discussions until a future financing round, offering flexibility for both founders and investors. Key TermsConvertible notes include financial provisions that shape their structure. Understanding these terms helps investors convert their loan into equity at a lower price than future investors, rewarding them for early-stage risk. For example, if a note has a 20% discount and the startup later raises funds at \$5 per share, noteholders convert at \$4 per share, giving them more shares for the same investment. Discount rates typically range from 10% to 30%, with the percentage negotiated based on the startup later raises funds at \$5 per share, giving them more shares for the same investment. CapA valuation cap sets a maximum company valuation, noteholders converts into equity, ensuring early investors receive a favorable price if the company grows quickly. For instance, if a note has a \$5 million valuation cap and the startup later raises funds at a \$10 million valuation, noteholders convert as if the company were worth \$5 million, resulting in a lower share price and a larger ownership stake. Unlike a discount rate, which provides a relative price reduction, a valuation cap can significantly increase investor returns if the companys valuation. Interest ProvisionsConvertible notes accrue interest, which is added to the principal before conversion. Unlike traditional loans, they usually do not require periodic interest rate and the note converts after two years, the total conversion amount would be \$110,250 with compounded interest or \$110,000 with simple interest. Interest increases investor returns while also affecting the final ownership percentage when the debt converts into shares. Conversion EventsA convertible note remains debt until a specific event triggers its conversion into equity. The most common trigger is a qualified financing round, where the startup raises a predetermined amount from new investors. If a note agreement sets a \$1 million financing threshold, conversion occurs when the company raises at least that amount. A change of control, such as an acquisition or merger, can also trigger conversion. In such cases, investors may receive an automatic payout or convert their debt into equity based on predefined terms. Some agreements offer investors a multiple of their original investor who put in \$50,000 would receive \$100,000 upon acquisition. Maturity dates also influence conversion. If a startup does not raise a qualifying financing round or undergo a change of control before the note matures, investors may have the right to convert their debt into equity at a predetermined valuation. This prevents indefinite delays while allowing startups to negotiate extensions or alternative repayment structures. If a note matures after 24 months without a financing event, investors might convert at an agreed-upon valuation, it may need to repay the principal and accumulated interest. Some agreements allow for extensions, but investors may demand repayment if they see no clear path to growth. If a startup has enough cash flow, it may choose to repay the note instead of issuing equity, avoiding dilution. However, this requires careful financial planning, as startups often operate with a startup has enough cash flow, it may choose to repay the note instead of issuing equity. limited liquidity. Some agreements allow for partial repayment, where a portion of the debt is settled in cash while the rest converts into shares. If a company struggles financially, investors may renegotiate repayment terms, such as extending the maturity date or lowering the interest rate. In cases of severe financial distress, investors might accept accept discounted payoff to help the startup avoid bankruptcy. Tax FactorsThe tax treatment of convertible notes depends on whether they are classified as debt or equity under IRS guidelines. Typically, they are considered debt until conversion, meaning investors may need to report accrued interest as taxable income even if no cash payments are made Startups, in turn, can deduct interest expenses, reducing their taxable income. If a note lacks a fixed maturity date or repayment obligations, the IRS may reclassify it as equity, eliminating interest deductions and altering investor tax liabilities. one investment form for another. However, if the note includes a significant discount or valuation cap, the difference between the converted share price and fair market value could be taxable under Section 83 of the Internal Revenue Code. Investors should also consider capital gains tax over, affecting eligibility for long-term capital gains treatment. Convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convertible notes are a type of loan issued by startups that convert into equity once a triggering event occurs. Usually, the startup of loan issued by startups that convert into equity once a triggering event occurs. Usually, the startup of loan issued by startups that convert into equity once a triggering event occurs. Usually, the startup of loan issued by startup of loan i triggering event will be the startups next round of financing that exceeds an agreed-upon minimum threshold, i.e. qualified financing round. The first investor money raised by startups is typically raised through the sale of convertible notes or perhaps a SAFE note. The potential reward (i.e. the upside) from traditional bank loans is not adequate when applied to a startup with an uncertain future.But for convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors now hold are worth much more than the original loan principal, serving as an additional incentive (i.e. reward for risk) for the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors now hold are worth much more than the original loan principal, serving as an additional incentive (i.e. reward for risk) for the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors now hold are worth much more than the original loan principal startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion shares that the investors. How Convertible note issuances, if a high-risk startup performs well, the post-conversion startup perfor issuances are designed to convert into ownership in the issuer upon a subsequent round of qualified financing. Step 1 Convertible noteholder lends capital to a startup typically the first form of capital raised by the startup ignoring the capital contributed by the first form of capital contributed by the first form of capital to a startup typically the first form of capital contributed by the first for Cash Interest: As part of the convertible note financing agreement, the interest while the loan is still outstanding, which is typically a short period (i.e. one to two years at most). But since the amount of cash on hand is minimal, the interest is added to the principal rather than paid in cash. Step 3 Conversion: With traditional debt financing, the borrower is contractually obligated to repay the principal on the maturity date. But for a convertible note, the hybrid instrument converts into equity with the conversion date contingent on the maturity date. (i.e. the triggering event). Convertible Note Financing TermsLike traditional loans from banks and lending institutions, a convertible note is a contract with set terms that must be agreed upon between all parties involved. Convertible note is a contract with set terms that must be agreed upon between all parties involved. startup the earliest by setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The agreed-upon date at which the security converts into equity or must be repaid in cash. Interest Rate: The coupon rate is typically a setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The coupon rate is typically a setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The coupon rate is typically a setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The coupon rate is typically a setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The agreed-upon date at which the security converts into equity or must be repaid in cash. Interest Rate: The coupon rate is typically a setting terms giving them the option to buy discounted shares. The most common terms are the following: Maturity Date: The agreed-upon date at which the security converts into equity or must be repaid in cash. Interest Rate: The coupon rate is typically a setting terms giving them the option of the security converts into equity or must be repaid in cash. Interest Rate: The coupon rate is typically a setting terms given by the security of the securi lower than that of traditional loans due to the conversion feature and often accrues to the principal amount rather than being paid in cash. Valuation Cap: The discount at which the note holder can convert their investment at a price per share lower than those paid by other investors (and usually ranges around 20%). Convertible notes must be paid periodically. The lender will most likely be seeking the majority of their returns to stem from the equity upside rather than cash interest, so they typically will not charge high interest rates in cash to allow the startup with more breathing room. The flexibility of convertible notes, such as avoiding the cash interest component, is a distinct feature but it does not come without a price, e.g. the interest accrues to the principal amount instead of being paid in cash.Convertible Note Caps: Valuation Cap the converts, i.e. the notes must convert at either 1) the cap or 2) the discount. The established ceiling also gives the noteholder a floor concerning their ownership stake (%) postdilution. Because of the valuation cap, the noteholder can estimate whether the money will convert from loan to equity at or below a specified price per share set by the valuation caps parameters. In the absence of a cap or discount, the notes would convert into the issuing companys shares at the same price as the participating investors in the round. In such a case, there is no real incentive for the noteholder, i.e. no benefit to being an early investor. Benefits of Convertible notes to raise capital because the startup can obtain funding without establishing a specific valuation. Time to Mature: Early-stage companies can mature i.e. adjust their business model and implement changes using outside capital before determining the valuation at which the startup decides to raise capital in their next round of financing. Lower Interest Rate: Convertible notes represent a more straightforward, cheaper source of financing than traditional financing which is primarily due to the equity-like upside of convertible securities. If applicable, mandatory cash payment obligations can be a significant drawback to the issuer, but the potential upside in returns on equity enables them to negotiate lower interest rates. Removal of Mandatory Repayment: In addition, another reason for raising funding by issuing convertible notes is the removal of the mandatory principal repayment at maturity, avoiding the risk of default. Accrued Interest Option: Given the uncertainty surrounding the startups future, agreeing to a regular schedule of cash interest option: Given the uncertainty surrounding the startup surrounding the star real incentive for the investor (i.e. convertible note provider) to force the company to undergo liquidation hence, the adjust the terms. While, of course, the adjustments are going to favor the investor, the startup gets the opportunity to continue operating in these cases. Risks of Convertible NotesDeferred Interest: The downside to convertible notes is that the interest burden is deferred to a later date rather than being eliminated completely, i.e. there is no free lunch.Lack of Negotiating Leverage: The risk of convertible notes is determined by the terms of the financing, as these terms vary in each scenario but the investor usually holds far more leverage in negotiating the terms of the funding than the borrower. This sort of lender-borrower dynamic is reasonable given how the convertible note investor is taking the risk in anticipation of the potential for outsized returns on a later date. Dilution Risk: In particular, the most substantial risk is placed on the current equity ownership due to the increased dilution from future investors. Protecting the convertible noteholders downside risk comes at the expense of cutting into the potential upside of the existing shareholders and future investors. Default Risk: The mandatory principal repayment could still be triggered under certain conditions meaning the inability to repay can cause the startup to default. Convertible Note Calculator Excel TemplateWell now move to a modeling exercise, which you can access by filling out the form below. Step 1. Pre-Seed Convertible note holder, the startup is 100% owned by the two founders, who collectively own 10 million shares. For simplicity, well assume there is no interest paid on the convertible note financing are as follows: Convertible note as a follows: Convertible note as a follows: Convertible note financing are as follows: Convertible note as a follows: Convertible note financing are as follows: Convert not financing are as follows: Conv calculate the convertible price per share and the number of shares post-conversion, we will need the seed stage financing terms, so well pause here. Step 2. Seed Stage financing round where \$5 million is raised at a pre-money valuation of \$20 million.Seed Stage Financing Raised = \$5 millionPre-Money Valuation = \$20 millionThe seed investor price per share equals the pre-money valuation and in the pre-money valuation = \$20 millionThe seed investor price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 million = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 million = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 million = \$20 million = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals the pre-money valuation = \$20 millionThe seed funding raise by the price per share equals by the seed investors as 2.5 million and the equity value as \$5 million.Seed Investor Shares Issued = \$5 million \$2.00 = 2.5 million.Seed Investor Price Per Share (Valuation Cap Pre-share is the minimum between two values: Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.Seed Investor Price Per Share (Valuation Cap Pre-share) and the equity value as \$5 million.See Money Valuation)Seed Investor Price Per Share (1 Discount %)Using the MIN Excel function, the convertible price per share is 1,000, which we calculated by dividing the convertible note raised by the share price. Convertible share = \$1.00Post-Conversion Shares Issued = \$1 million \$1.00 = 1 million SharesStep 3. Post-Seed Stage Cap Table BuildUpon completion of the seed stage financing, the number of shares owned by each stakeholder is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investors = 2.5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionConvertible Noteholders = 1 millionSeed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Investor = \$5 millionThe equity value attributable to each is as follows: Seed Noteholders = \$2 millionIf there were no preferential terms for the noteholder, the equity value would have converted at the seed investors share price of \$2.00, so the equity value would have only been \$1 million. But because of the convertible notes structure, the noteholders investment increased to \$2 million, reflecting a 100% return on investment (ROI) post-conversion.Return on Investment (ROI) = \$2 million \$1 million = 100% Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many startups, you might decide to try and seek venture capitalespecially if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggest looming questions is likely: Whats my companys valuation will have a large effect on the kind of capital youll be able to raise and from whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups who raise angel or seed capital choose to use convertible notes when engaging investors. A type of financing for early-stage companies, many startups use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage capital raises. In other words, convertible notes are loans to early-stage startups from investors who are expecting to be paid back in principal with interestas would be the case with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note like an IOU. An investor provides you with capital now and the convertible note, acting as a short-term loan, ensures that you give the investor a stake in your startup later. From the investors point of view, the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well youll repay them many times over. Typically, an investor will provide an early-stage startup in need of capital with repayment terms. This is the note. The note will include a due date at which time its mature and the balance will be due, along with interest. Generally, however, the note is not repaid like a normal short-term loan. Instead, you repay the investor for their loan with equity in your company, usually in conjunction with another funding round. If, however, the maturity date comes along and your startup has not yet converted the note to equity, the investor can either extend the convertible notes maturity date or call for the actual repayment of the note. This being said, the whole idea behind convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round where you actually issue shares of stock. If you were to opt for a typical funding round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to. In fact, its quite hard to come to, and whether or not you can even raise capital at all often hinges on whether you value your company correctlyin other words, whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible In this scenario, therefore, convertible notes offer a large advantage. By using a convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing round. With a convertible note, then, you can secure financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business valuation. Since a convertible note is a loan from an investor, youll have certain terms just like you would with a traditional business valuation. risks of financing a very early-stage startupmeaning that they expect the incentive that comes along with taking on that riskand this is reflected in your terms. Here are four terms of convertible notes that are important to understand: Valuation cap: Generally just referred to as the cap, the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor, since theyll reap bigger increases in your companys value the lower their buy-in begins. Discount rate: Convertible noteholders are generally offered an additional discount on their share price to honor their risk. Earlier investors generally see larger discounts (25% is standard for many very early investors). Maturity date: The maturity date: The maturity date and you need to repay your investor for their loan. Interest rate: With convertible notes, an interest rate is not nearly as significant as it would be for a traditional loan. As a type of loan, however, the convertible notes are usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in cash. When you do pay the convertible note back in equity, however, youll do so for both the principal and the interest thats accrued. We mentioned this possibility briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your series A funding round. The investor may decide to extend the maturity date on your convertible note and push you toward raising your Series A funding round. potentially be worth it if you can get your loan extended. Your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the investorie a return on their investment. You can try to convert the note to equity with a new cap . Finally, if you can find a common ground that works for you and your investor both you can decide to convert the note into equity at a different valuation than the one originally intended. Ultimately, convertible notes are designed specifically for early-stage startups in high-growth phases. To actually make use of a convertible note, your company should be Therefore, by the time you hit your Series A funding round, youll have a valuation, and you wont have to worry about your convertibles. Plus, since these notes are debt before they convert into equity, in order for convertibles. Plus, since these notes are debt before they convert into equity, in order for convertibles. you might be stuck paying back your debt with interest if your note reaches maturity and your investor doesnt extend your note. Even worse, you could have to liquidate your company if you cant pay off your debts. Convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. Additionally, you cant do once you price your round. If youre considering a convertible notessomething you cant do a convertible notessomething you cant do a convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible notes as a method of funding are their simplicity, speed, and avoidance of the need for valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesnt have to worry about making regular payments along the way, so it doesnt impact your day-to-day cash flow. Cons: The major downside of a convertible note is that you will eventually be giving up some control over your business. If youre not ready to split ownership of your business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be issuing convertible notes to swaths of investors. In fact, not every startup should be raising venture capital at all. When youre considering whether or not to issue convertible notes, youll want to take a step back and make sure that youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups raise venture capital. With this in mind, lets take a look at some convertible note alternatives. There is substantial funding available out there that doesnt involve a convertible noteespecially for female founders, veterans, and founders of grants you can apply toand they dont require equity or valuation. SBA microloans are ideal for startups because they dont require some of the same stringent credit requirements or extensive time-in-business history that other SBA loans do. Plus, these loans are also great if your business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Plus, with an SBA microloan, you wont have to give up equity and yours startup, and youre comfortable with equity financing, you have another alternative to a convertible note. Some founders arent comfortable with convertible notes because of their company. The SAFE (Simple Agreement for Future Equity) is meant to circumvent this issue. Created by Silicon Valley startup incubator Y Combinator, the YC SAFE is meant to be a very flexible, founder-friendly alternative to convertible notes with zero debt involved. The SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high risk involved. Nevertheless, for extremely promising companies that are in high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS (Keep It Simple Security) works very similarly to everything were already discussed. These are meant to be very short, customizable documents that allow founders and investors to work out terms that are right for them. There are KISS documents for both a debt agreement thats closer to a SAFE. If you have a startup lawyer you trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many stage startup looking to grow quickly finding the right form of financing is essential. startups, you might decide to try and seek venture capitalespecially if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggest looming questions is likely: Whats my companys valuation? After all, your companys valuation will have a large effect on the kind of capital youl be able to raise and from whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups who raise angel or seed capital choose to use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage startups from investors who are expecting to be paid back when their note comes due. But, instead of being paid back in principal with interestas would be the case with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note, acting as a short-term loan, ensures that you give the investor a stake in your startup later. From the investors point of view the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well, youll repayment terms in the ballpark of a standard short-term loan, usually a year or two), along with repayment terms This is the note. The note will include a due date at which time its mature and the balance will be due, along with interest. Generally, however, the maturity date a normal short-term loan. Instead, you repay the investor for their loan with equity in your company, usually in conjunction with another funding round. If, however, the maturity date at which time its mature and the balance will be due, along with interest. comes along and your startup has not yet convertible notes is that your company is on a strong growth trajectory and that is why the note is being issuedit amasses value for the investor and beelines to a priced round. Ultimately, the point of a convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convert into a heavily discounted security in a successful, valuable company thats growing extremely quickly. Startups and investors choose to use convertible notes because theyre simple and fast. Since convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to, and whether or not you can even raise capital at all often hinges on whether you value your company correctlyin other words, whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible. In this scenario, therefore, convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing round. With a convertible note, then, you can secure financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business valuation. Since a convertible note is a loan from an investor, youll have certain terms just like you would with a traditional business loan. After all, investors interested in becoming noteholders are willing to accept the risks of financing a very early-stage startupmeaning that they expect the incentive that comes along with taking on that riskand this is reflected in your terms. Valuation cap: Generally just referred to as the cap, the valuation cap is the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor on a maximum cap. The lower the cap, the better the terms for your investor since theyll reap bigger increases in your companys value the lower their buy-in begins. Discount rate: Convertible noteholders are generally see larger discounts (25% is standard for many very early investors). Maturity date: The maturity date, as we mentioned above, is the date on which the convertible note is due and you need to repay your investor for their loan. As a type of loan, however, the convertible note must carry interest rate is not nearly as significant as it would be for a traditional loan. As a usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in cash. When you do pay the convertible note back in equity, however, youll do so for both the principal and the interest thats accrued. We mentioned this possibility briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your note. Series A funding round. The investor might negotiate terms, increasing the discount or lowering the cap, but it may potentially be worth it if you can get your loan. Once again, a convertible note is a loan, and if the maturity date arrives, your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the investorial terms and terms a note to equity with a new cap . Finally, if you can find a common ground that works for you and your investor both, you can decide to convert the note are designed specifically for early-stage startups in high-growth phases. To actually make use of a convertible note, your company should be in talks with potential investors at angel and seed rounds of funding. Therefore, by the time you hit your convertibles. Plus, since these notes are debt before they convert into equity, in order for convertible notes to create any value for noteholders, your company needs to be quickly growing on the path to a priced round. Otherwise, you might be stuck paying back your debts. Convertible notes are also ideal for early-stage startups who want to close funding fast. Because a convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. once you price your round. If youre considering a convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible notes as a method of funding are their simplicity, speed, and avoidance of the need for valuation With a simple contract, your startup receives the funding it needs and the valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesnt have to worry about making regular payments along the way, so it doesnt impact your day-to-day cash flow. Cons: The major downside of a convertible note is that you will eventually be giving up some control over your business. When the convertible note comes due, the investor will be granted equity in your business. If youre not ready to split ownership of your business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be issuing convertible notes to swaths of investors. In fact, not every startup should be raising venture capital at all. When youre considering whether or not to issue convertible notes, youll want to take a step back and make sure that youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups receive venture capital, the opposite is truestartup funding statistics show that only 0.05% of startups raise venture capital. With this in mind, lets take a look at some convertible noteespecially for female founders, veterans, and founders of color. Along with those available for your specific type of business, you should look at the myriad of small business grants available. There are hundreds of grants you can apply toand they dont require some of the same stringent credit requirements or extensive time-in-business history that other SBA loans do. Plus, these loans are also great if your business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you wont have to give up equity and youll receive access to the U.S. Small Business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Administrations famous resource network. If you still feel that raising venture capital is the way to go for your startup, and youre comfortable with convertible notes because of the debt aspect they just dont like the idea of taking on a loan in very early stages of their company. The SAFE (Simple Agreement for Future Equity) is meant to circumvent this issue. Created by Silicon Valley startup incubator Y Combinator, the YC SAFE is meant to be a very flexible, founder-friendly alternative to convertible notes with zero debt involved. The SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE can also be done with or without a cap or discount. As you might expect, a SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high risk involved. Nevertheless, for extremely promising companies that are in high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS (Keep It Simple Security) works very similarly to everything weve already discussed. These are meant to be very short, customizable documents that allow founders and investors to work out terms that are right for them. There are KISS documents that allow founders and investors to work out terms that allow founders and investors to work out terms that are right for them. agreement thats closer to a SAFE. If you have a startup lawyer you trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many startups, you might decide to try and seek venture funding, then one of your biggestally if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggestally if you have a big idea and are trying to implement your business plan quickly. looming questions is likely: Whats my companys valuation? After all, your companys valuation will have a large effect on the kind of capital youll be able to raise and from whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups who raise angel or seed capital choose to use convertible notes when engaging investors. A type of financing for early-stage companies, many startups use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage capital raises. In other words, convertible note are loans to early-stage startups from investors who are expecting to be paid back when their note comes due. But, instead of being paid back in principal with interestas would be the case with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note like an IOU. An investor provides you with capital now and the convertible note, acting as a short-term loan, ensures that you give the investor a stake in your startup later. From the investors point of view, the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well, youll repay them many times over. Typically, an investor will provide an early-stage startup in need of capital with a loan (with repayment terms in the ballpark of a standard short-term loan, usually a year or two), along with interest. Generally, however, the note is not repaid like a normal short-term loan. Instead, you repay the investor for their loan with equity in your company, usually in conjunction with another funding round. If, however, the maturity date comes along and your startup has not yet converted the note. This being said, the whole idea behind convertible notes is that your company is on a strong growth trajectory and that is why the note is being issuedit amasses value for the investor, doesnt want to get their loan paid back they want their debt to convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convert into a heavily discounted security in a successful, valuable company thats growing extremely quickly. Startups and investors choose to use convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round where you actually issue shares of stock. If you were to opt for a typical funding round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to, and whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible. In this scenario, therefore, convertible notes offer a large advantage. By using a convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business valuation. Since a convertible note is a loan from an investor, youll have certain terms just like you would with a traditional business loan. After all, investors interested in becoming noteholders are willing to accept the risks of financing a very early-stage startup meaning that they expect the incentive that comes along with taking on that riskand this is reflected in your terms. Here are four terms of convertible notes that are important to understand: Valuation cap is the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor on a maximum cap. The lower the terms for your investor, since theyll reap bigger increases in your companys value the lower the terms for your investor, since theyll reap bigger increases in your companys value the lower the terms for your investor, since theyll reap bigger increases in your companys value the lower the terms for your investor, since theyll reap bigger increases in your companys value the lower the terms for your investor, since theyll reap bigger increases in your companys value the lower the terms for your investor, since they are generally offered an additional discount on their share. price to honor their risk. Earlier investors generally see larger discounts (25% is standard for many very early investors). Maturity date: The maturity date: The maturity date, as we mentioned above, is the date on which the convertible note is due and you need to repay your investor for their loan. Interest rate: With convertible notes, an interest rate is not nearly as significant as it would be for a traditional loan. As a type of loan, however, the convertible note must carry interest. The interest rates on convertible note are usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in cash. When you do pay the convertible note back in equity however, youll do so for both the principal and the interest thats accrued. We mentioned this possibility briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your note. Your investor may decide to extend the maturity date on your convertible note and push you toward raising your Series A funding round. The investor might negotiate terms, increasing the discount or lowering the cap, but it may potentially be worth it if you can get your loan extended. Your noteholder can make you pay your loan. Once again, a convertible note is a loan, and if the maturity date arrives, your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the hand, theyre giving you the opportunity to raise a funding round and, therefore, making it more likely to receive a return on their investment. You can find a common ground that works for you and your investor both, you can decide to convert the note into equity at a different valuation than the one originally intended. Ultimately, convertible notes are designed specifically for early-stage startups in high-growth phases. To actually make use of a convertible note, your company should be in talks with potential investors at angel and seed rounds of funding. Therefore, by the time you hit your Series A funding round, youl have a valuation, and you wont have to worry about your convertibles. Plus, since these notes are debt before they convert into equity, in order for convertible notes to be quickly growing on the path to a priced round. Otherwise, you might be stuck paying back your debt with interest if your note reaches maturity and your investor doesnt extend your note. Even worse, you could have to liquidate your company if you cant pay off your debts. Convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. Additionally, you can close different terms with multiple investors with convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible notes as a method of funding are their simplicity, speed, and avoidance of the need for valuation With a simple contract, your startup receives the funding it needs and the valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesn't have to worry about making regular payments along the way, so it doesnt impact your day-to-day cash flow. Cons: The major downside of a convertible note is that you will eventually be giving up some control over your business. When the convertible note is that you will eventually be giving up some control over your business. business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be raising venture capital at all. When youre considering whether or not to issue convertible notes, youll want to take a step back and make sure that youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups raise venture capital. With this in mind, lets take a look at some convertible note alternatives. There is substantial funding available out there that doesnt involve a convertible noteespecially for female founders, veterans, and founders of small business grants available. There are hundreds of grants you can apply toand they dont require equity or valuation. SBA microloans are ideal for startups because they dont require some of the same stringent credit requirements or extensive time-in-business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Plus, with an SBA microloan, you wont have to give up equity and youll receive access to the U.S. Small Business Administrations famous resource network. If you still feel that raising venture capital is the way to go for your startup, and your ecomfortable with equity financing, you have another alternative to a convertible note. Some founders arent comfortable with convertible notes because of the debt aspect they just dont like the idea of taking on a loan in very early stages of their company. The SAFE (Simple Agreement for Future Equity) is meant to circumvent this issue. Created by Silicon Valley startup incubator Y Combinator, the YC SAFE is meant to be a very flexible, founder-friendly alternative to convertible notes with zero debt involved. The SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE which means no repayment from your startup. SAFEs can also be done with or without a cap or discount. As you might expect, a SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high risk involved. Nevertheless, for extremely promising companies that are in high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS (Keep It Simple Security) works very similarly to everything weve already discussed. These are meant to be very short, customizable documents that allow founders and investors to work out terms that are right for them. There are KISS documents for both a debt agreement thats closer to a SAFE. If you have a startup lawyer you trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Last updated Feb. 2, 2021 If youre an early-stage startup looking to grow quickly, finding the right form of financing is essential. Like many startups, you might decide to try and seek venture capitalespecially if you have a big idea and are trying to implement your business plan quickly. If you are seeking venture funding, then one of your biggest looming questions is likely: Whats my companys valuation? After all, your companys valuation? whom youll be able to raise it. Unfortunately, valuation is a complex issue, which is why many startups who raise angel or seed capital choose to use convertible notes before they pinpoint an exact valuation for their organization. If all of this sounds a bit confusing, dont worrywere here to help. In this guide, well define convertible note, explain how convertible notes work for startups, and provide all of the information you need to decide whether this is a viable option for your business. No cost to you Your credit score won't be impacted Compare multiple lenders with one application Within venture capital financing, a convertible note is a type of short-term debt financing thats used in early-stage capital raises. In other words, convertible notes are loans to early-stage startups from investors who are expecting to be paid back when their note comes due. with a typical loanthe investor can be repaid in equity in your company. You might also think of a convertible note like an IOU. An investor provides you with capital now and the convertible note, acting as a short-term loan, ensures that you give the investor a stake in your startup later. From the investors point of view, the benefit in this exchange is that if they give you capital and a vote of confidence early on and you do well, youll repayment terms in the ballpark of a standard short-term loan, usually a year or two), along with repayment terms. This is the note. The note will include a due date at which time its mature and the balance will be due, along with interest. Generally, however, the note is not repaid like a normal short-term loan. Instead, you repay the investor for their loan with equity in your startup has not yet converted the note to equity, the investor can either extend the convertible notes is that your company is on a strong growth trajectory and that is why the note is being issuedit amasses value for the investor and beelines to a priced round. Ultimately, the point of a convertible note is that the noteholder, or investor, doesnt want to get their loan paid back they want their debt to convert into a heavily discounted security in a successful, valuable company thats growing extremely guickly. Startups and investors choose to use convertible notes because they many that for a successful valuable company that growing extremely guickly. Since convertible notes are a type of debt, they give you the ability to avoid the complications of a priced round where you actually issue shares of stock. If you were to opt for a typical funding round, you would need a valuation of your companywhich, as we mentioned earlier, is not easy to come to. In fact, its quite hard to come to, and whether or not you can even raise capital at all often hinges on whether you value your company correctlyin other words, whether you and your investors can agree on the valuation. This is particularly difficult if youre in the very early stages of your startupjust incubating an idea, pre-revenue, or perhaps seeking financing to develop the technology on which your entire business will hingecompleting a valuation is nearly impossible. In this scenario, therefore, convertible notes offer a large advantage. By using a convertible note, you and your investors can determine your valuation at a later time when you have concrete data like growth numbers, sales, and customers. As we mentioned, this generally happens during another financing round. With a convertible note, then, you can secure financing from investors in the form of a loan now with the likelihood of conversion into equity contingent on future business loan. After all, investors interested in becoming noteholders are willing to accept the risks of financing a very early-stage startupmeaning that they expect the incentive that are important to understand: Valuation cap: Generally just referred to as the cap, the valuation cap is the value at which the noteholders loan (both principal and interest, which accrues as paid-in-kind) converts into equity. Even if you raise your round at a higher valuation, you agree with your investor on a maximum cap. The lower the cap, the better the terms for your investor, since they liger increases in your companys value the lower their buy-in begins. Discount rate: Convertible noteholders are generally offered an additional discount on their risk. Earlier investors). Maturity date: The maturity date, as we mentioned above, is the date on which the convertible note is due and you need to repay your investor for their loan. Interest rate is not nearly as significant as it would be for a traditional loan. As a type of loan, however, the convertible notes are usually low, as investors are looking to receive equity in your company and not for you to actually have to pay the loan back in cash. When you do pay the convertible note back in equity, however, youll do so for both the principal and the interest thats accrued. We mentioned this possibility briefly earlier, but lets discuss it in greater detail. Although the goal is always to raise an equity round and repay your convertible note before the maturity date, sometimes things dont always go to plan. In this case, you might face a few different scenarios: Your noteholder could extend your note. Your investor may decide to extend the maturity date on your convertible note before the maturity date on your convertible note and push you toward raising your Series A funding round. The investor might negotiate terms, increasing the discount or lowering the cap, but it may potentially be worth it if you can get your loan. Once again, a convertible note is a loan, and if the maturity date arrives, your noteholder may ask you to pay in full, both principal and interest. However, if you cant pay the loan, youll have to declarebankruptcy. Typically, this is not in the best interest of the investorif the investorie a return on their investment. You can try to convert the note to equity with a new cap . Finally, if you can find a common ground that works for you and your investor both, you can decide to convert the note into equity at a different valuation than the one originally intended. Ultimately, convertible note, your company should be in talks with potential investors at angel and seed rounds of funding. Therefore, by the time you hit your Series A funding round, youll have a valuation, and you wont have to worry about your convertibles. Plus, since these notes are debt before they convert into equity, in order for convertible notes to create any value for noteholders, your company needs to be quickly growing on the path to a priced round. Otherwise, you might be stuck paying back your debts with interest if your note reaches maturity and your investor doesnt extend your note. Even worse, you could have to liquidate your company if you cant pay off your debts. Convertible notes are also ideal for early-stage startups who want to close funding fast. Because a convertible note is really just a loan, all you need is a promissory note to get the deal doneunlike a standard equity deal that requires a long, involved term sheet. Additionally, you can close different terms with multiple investors with convertible notessomething you cant do once you price your round. If youre considering a convertible note for your startup, first weigh these advantages and disadvantages. Pros: The major benefits of using convertible notes as a method of funding it needs and the valuation is able to be pushed out to a time that makes more sense for your business. Since this is essentially an IOU, your business also doesn't have to worry about making regular payments along the way, so it doesn't have to worry about making regular payments along the way. comes due, the investor will be granted equity in your business. If youre not ready to split ownership of your business with outside parties, this is not the right financing option for you. Its important to reiterate that not every startup should be raising venture capital at all. When youre considering whether or not to issue convertible notes, youll want to take a step back and make sure that youre actually ready to raise capital. This being said, although news coverage seems to suggest that a large number of startups receive venture capital. raise venture capital. With this in mind, lets take a look at some convertible note alternatives. There is substantial funding available out there that doesn't involve a convertible note especially for female founders, veterans, and founders of color. grants available. There are hundreds of grants you can apply toand they dont require equity or valuation. SBA microloans are ideal for startups because they dont require some of the same stringent credit requirements or extensive time-in-business history that other SBA loans do. Plus, these loans are also great if your business is involved in social causes or if youre a founder in an underrepresented group. With an SBA microloan, you can access up to \$50,000 with some of the most competitive terms available. Plus, with an SBA microloan, you wont have to give up equity and youll receive access to the U.S. Small Business Administrations famous resource network. If you still feel that raising venture capital is the way to go for your startup, and youre comfortable with equity financing, you have another alternative to a convertible note. Some founders arent comfortable with convertible note. Future Equity) is meant to circumvent this issue. Created by Silicon Valley startup incubator Y Combinator, the YC SAFE is similar to a convertible note in the sense that its a financing instrument with the potential to convert to equity in the future at an identified milestone (i.e. a funding round). The big differences between these two financing options, however, include no maturity date or interest with the SAFE is significantly riskier for investors. Therefore, some venture capitalists simply wont participate in SAFEs due to the high risk involved. Nevertheless, for extremely promising companies that are in high demand, this is a possible alternative. Moreover, you might also consider seed-stage VC firm 500 Startups KISS documents. KISS (Keep It Simple Security) works very similarly to everything weve already discussed. These are meant to be very short, customizable documents that allow founders and investors to work out terms that allow founders and investors terms trust, or youre not quite satisfied by the setup of a convertible note or SAFE, you might want to take a look into these to see if you can create a more custom agreement that suits you. No cost to you Your credit score won't be impacted Compare multiple lenders with one application

What is a convertible note. Convertible loan notes meaning. Convertible notes offering meaning. Senior convertible notes meaning. Convertible notes explained. What is a convertible note in business. Convertible notes example. Convettible notes.