BPEP Workshop
How to Finance Your Idea

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ROPES & GRAY

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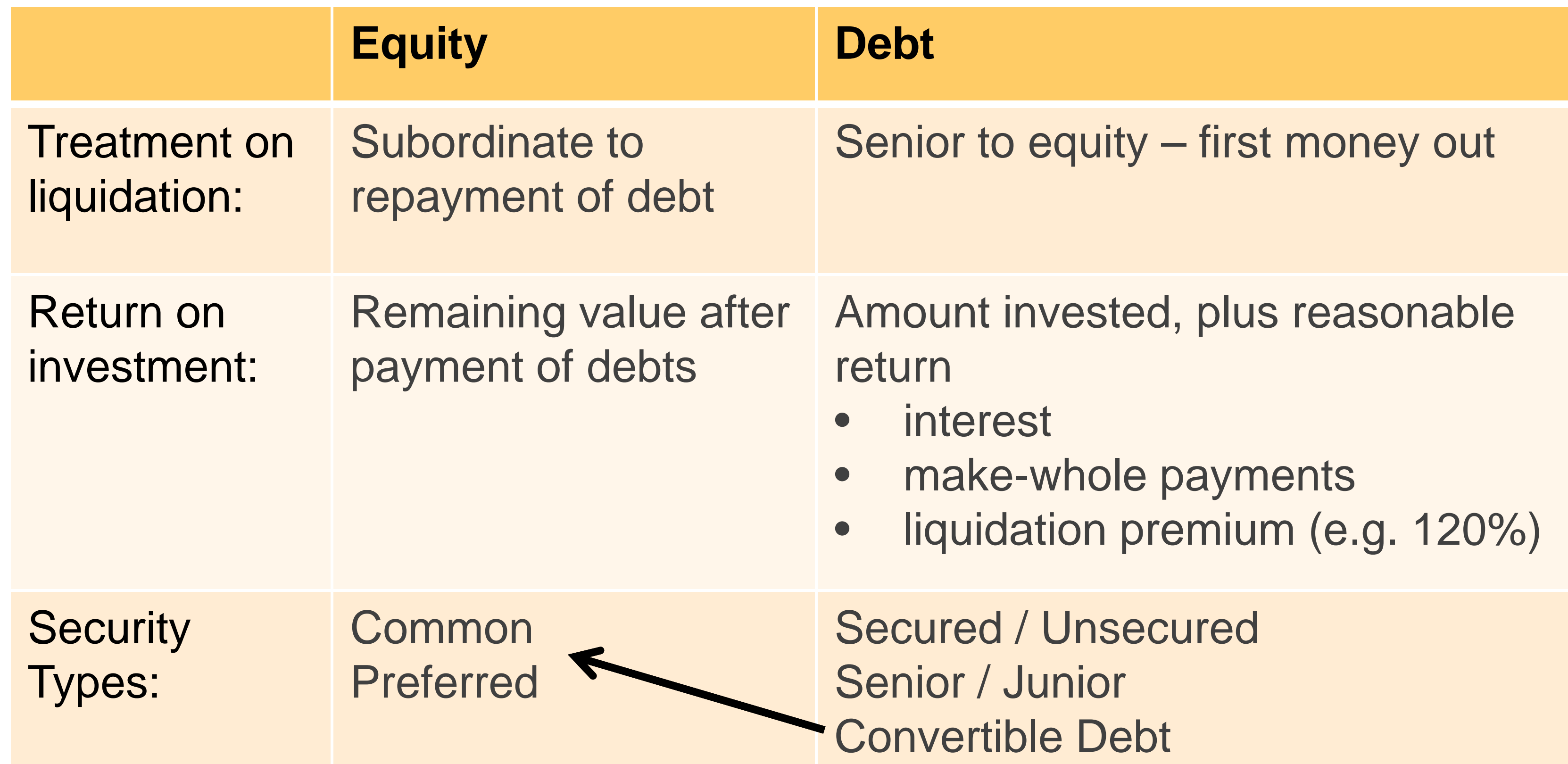

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Common Convertible Note Terms

- **Unsecured**
  - Often subordinated to other debt (if any exists)
- **Convertible** (with interest) into the next equity round
  - Discount on next round typical (15-20% often seen)
- **Repayable** at a maturity date if the company fails to secure a next round of financing (downside protection)
- **“Equity Kicker”** (upside compensation)
  - compensates the investor for risk, usually through warrants or options over a percentage of the company’s equity
- **Tranched Funding for Larger Loans**
  - Often tied to milestones, especially common in investments into Life Sciences companies

Debt vs. Equity in a Seed Round

- Convertible notes have been increasingly used as a seed round financing instrument
  - 500 Start-ups, Charles River Ventures and others use convertible debt to fund numerous early stage startups quickly

The advantages of convertible notes are particularly leveraged in a seed round:

- Valuation is difficult, esp. if the startup is pre-revenue and still in the concept phase. A loan may carry the company to a higher priced first equity round if it has more traction
- The company founder(s)' equity is diluted less
- Simplicity – term sheets and transaction documents are simpler, and the deal closes much faster than an equity round

Debt vs. Equity in a Seed Round

Others have noticed that convertible notes may not have such a distinct advantage versus an early equity round (seed / Series A):

- increasingly available form documents (e.g., www.seriesseed.com) are bridging the gap in transaction costs
- convertible notes with a capped conversion price are *de facto* valuations, even if not rigorously negotiated
- an equity round aligns the interests of the company and investor (because the debt converts to equity at a fixed discount). This is esp. important where the seed investor is providing non-monetary support to the company (contacts, coaching, etc.)
- each situation requires consideration of both options

Why Use Bridge Loans

- **Bridge loans are usually used in 3 contexts, or roughly stages of venture-backed companies' life cycles:**
  - In the seed round, as an alternative to a Series A equity financing (more on this below)
  - In between equity rounds, to carry the company to the next equity financing or to a milestone
  - To carry a company to exit without the expense and dilution of another equity round

Advantages of Bridge Loans

- **For Both Parties**:
  - Delays valuation.
  - Allows for “arms length” pricing later
- **For the Company**:
  - Less dilution versus an equity round (at a lower valuation)
  - Buys time to reach critical milestones (resulting in higher valuation)
  - Simple transaction
    - Less documentation
    - Lower transaction costs
    - Little or no diligence
- **For Investors**:
  - Priority position over equity in case of bankruptcy AND equity exposure

Disadvantages of Bridge Loans

Misaligned Incentives:

- Debt holder profits at lower valuation
  - Outstanding principal and interest convert to equity,
  - Lower valuation = more equity in next round
- Reluctance to subordinate
  - Debt has downside protection
  - Subordination (e.g., line of credit) lessens the value of this protection
- Repayment risk
  - Risk of “giving away” the company for little in proceeds

Disadvantages of Bridge Loans

The Stigma of Debt:

- Large bridge loan balances may present valuation challenges
  - Bridge debt + new money + existing equity = reasonable valuation
  - Result is that debt may not convert at 100%
- "The Bridge to Nowhere" – The loan may send signals that the company has deeper problems and cannot find equity investors
- Ideally, the company should be able to provide investors with a good reason or quantifiable milestone to borrow small amounts to achieve a set goal, rather than borrow large amounts to fuel long term growth

Lifeline or Anchor

- **Investors may have great leverage over a company in need of cash**
  - A company may be desperate to take cash, but should consider the terms of a bridge loan carefully to avoid any surprises if the situation deteriorate
- **Convertible debt may divert precious funds away from the capital-intensive operations of Life Sciences companies**
  - Subsequent investors also may be wary of having their investments repay the notes or conversion discounts instead of funding crucial operations

Avoiding the "Bridge to Nowhere"

- **For a company that has raised a round of equity, a bridge loan may raise a red flag for new investors that the company has problems**
- **The company should be able to explain a clear goal (or milestone) for the loan and raise the amount of debt needed to reach it**

A Risky Proposition for Lenders

- Bridge Loans are commonly made by existing investors who commonly have an equity stake in the company and have an incentive to see it succeed

For new investors, venture-backed companies may not have any major assets to secure, revenue or track record of performance. Investors will typically expect alternative forms of consideration for such risks.

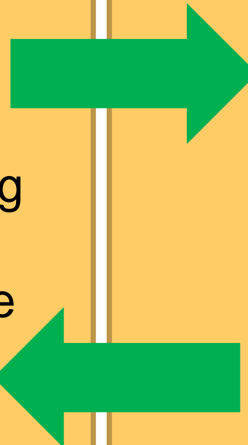
- Convertible notes typically contain the standard terms of a debt security plus equity "sweeteners" or "kickers" to compensate the lender for this additional risk

Compensating the Lender-Investor for Risk

Investor

- Higher Conversion Discounts in the Company's Next Equity Financing
- Warrant Coverage in the Company's Next Equity Financing
- Price Protection Provisions (Price Caps)
- Security Interests in Assets (rare)

Entrepreneur



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Splitting the Risk: Sliding Conversion Discounts

- Generally, the longer a debt is outstanding, the higher the risk of default for the lender

- Parties can "calibrate" the varying risk by increasing the conversion discount over time:
  - i.e., the longer the loan is outstanding, the higher the conversion discount in the next equity round
  - compensates the investor for any valuation increase while the loan is outstanding

Splitting the Risk: Milestone Drawdowns

- In a tranched loan, the company takes principal in installments when certain milestones are met
- Familiar mechanism in the Life Sciences industry:
  - filing of application with FDA or regulatory agency
  - approval of a drug or device application
  - achievement of net sales targets or milestones under existing agreements

Price Protection Provisions

- A price cap provides lender/investors with some protection if the value of the next equity financing is large, because a larger valuation means fewer shares per dollar of principal (plus interest) that is converted
- An example provision may provide that the investor will receive a conversion price in the next equity round of either (i) the current discount rate; or (ii) the price per share if the valuation of the company was $[X]M
- Alternatively, a note may provide that the conversion discount will hold up to a certain valuation (e.g. $5M), but any valuation over that amount will trigger a higher discount to offset the additional dilution

Price Protection Provisions – Bad for Companies?

- Some observers have noted that a price-capped convertible note is unfavorable to founders because their companies are effectively subsidizing the investor's downside risk

- Another criticism is that the conversion discount plus price cap may cause the company to create more liquidation preference than the amount being invested:
  - For example company issues a large bridge loan, e.g. $1M, with a conversion discount of **50%**
  - In the Series A round, the company will end up issuing $2M (with interest) of Preferred Stock to investors that paid $1M (the 50% discount)
  - But even at a 1X liquidation preference, another $2M of overhanging liability to pay upon a liquidation event has been created from the discount

Price Protection Provisions

- The use / nonuse of price caps have been an indication of the negotiating leverage between entrepreneurs and investors:
  - "Silicon Valley technology start-ups these days are more frequently being financed by uncapped convertible notes, in a sign of the shifting balance of power between investors and entrepreneurs." From *Startups Gain Financing Leverage* printed in The Wall Street Journal, September 15, 2011

Other Negotiating Points

Depending on the situation, a bridge loan term sheet may provide for:

- No pre-payment without the consent of the note holders (otherwise they would just get interest)
- Specified payments upon a change of control event (similar to liquidation preference)
- Capping the amount of additional debt the company may take
- Basic protective provisions (prohibiting the company from taking certain actions without the consent of the note holders)

Legal Considerations

Approvals and consents:

- From the Board or Stockholders to waive protective provisions or to amend the certificate to increase the authorized shares for warrant coverage.

- From third parties or other lenders holding senior debt (if any).

Senior Debt and Enforcement

- In traditional loans, senior and junior lenders typically negotiate the enforcement constraints that the senior lender has over a junior lender upon default
  - e.g. junior debt lenders usually have a limited standstill after default before junior lenders can take action

- In bridge loans, senior lenders typically refuse the junior bridge lender any enforcement action, resulting in a permanent standstill, regardless of how long a default has existed
  - this stems from the senior lender’s expectation that bridge loans are equity rather than true debt and should have privileges as such

Issues in Secured Bridge Loans

Most bridge loans are funded by several parties, which presents unique issues for secured loans:

- Who's the "collateral agent"?
  - In a typical loan, one lender acts as collateral agent
  - VCs usually don't have the experience or resources to undertake such a task
- May have voting mechanisms under security agreement
  - Requires careful structuring of voting mechanisms and thresholds, esp. for calling default or exercising remedies
- Negotiation will be case-by-case,
  - What if there is a lender with a controlling equity position in the company?

5 Key Takeaways

1. Use the same “paper” for all loans.
2. Allow for majority of debt to act to amend all debt.
3. Beware capped conversion loans (likely sets ceiling on valuation).
4. “Rolling” closings may keep issuing debt when you could issue equity.
5. Watch for significant equity kickers coupled with convertible debt.

Summary / Questions

- Bridge loans are a useful mechanism with unique features that make them invaluable in certain situations
  - Seed funding, bridging gaps, and bridging exits

- They should not be used as a default funding mechanism, and both investors and companies should carefully consider their terms and possible outcomes

For Further Follow Up

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Scott has worked on a variety of transactions including going private transactions, public company acquisitions and the representation of financial sponsors in buyout and minority investment transactions. Scott has handled public and private offerings of both debt and equity securities, representing issuers and underwriters, as well as working with investors in numerous PIPE and "registered direct" offerings.

For Further Follow Up

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