BACKGROUND

Early in 2010 NZVIF engaged PriceWaterhouseCoopers to prepare a guide on this subject.

The guide was finalised in June 2010 and a copy can be found at http://www.nzvif.co.nz/documents/deal_information/I/I2/Guide_PWC_ConvertNotes.pdf.

PWC's guide is really focused though on the tax implications of using convertible notes for seed and early stage investment rather than the key commercial considerations for investors.

Some additional commentary on those key commercial considerations has been kindly prepared by Bill Payne as a further source of information on this important subject. This was originally posted on Bill's blog at www.theicehouse.co.nz in December 2009 and Bill then updated his commentary in July 2010 for the purposes of this note. Readers are encouraged to have a look at Bill's many other angel investment related posts on that blog as well.

Bill's comments below are obviously based on his experiences in the US market and so need to be read in that context. Bill also notes that his comments relate to the second of the three common uses of convertible loans observed in the New Zealand market that are outlined below. US angel investors are also using convertible debt for "proof of concept" funding and true bridge notes (when the subsequent investor had already been identified).

As a starting point for this note we have set out below some of the NZVIF's key observations regarding the common commercial drivers for the use of convertible notes in the New Zealand early stage investment market.

NZVIF OBSERVATIONS OF THE USE OF CONVERTIBLE NOTES IN THE NEW ZEALAND MARKET

From NZVIF's recent experience we see three main types of use of convertible notes for seed and early stage investment:

1. Pre seed "proof of concept" deals. This is where angel investors use a convertible note to put small amounts of money (up to $150k) into to a company prior to a full angel round. As a rule, we haven't seen discounting to the next round in these deals. However typically there is quite a lot of structure to the milestones/tranching in these deals and so if companies miss targets the funders don't go on to do a full angel round at all. The essence of these deals is that investors employ a relatively simple instrument for relatively small sums and use the initial investment phase to reach the next level of comfort in terms of the company's prospects.

2. Full angel round deals. Convertible notes are being used in some instances for full investment rounds, and we have seen discounting to the next equity investment round used. What we will often see here is that the angel investor in effect agrees the conversion process and price up front and the equity round term sheet also. If targets are not met at the time of conversion then there is likely to be a revaluation as a result.
3. Bridging finance. Essentially this is capital which is put into companies prior to a full equity round - in essence a shareholder loan with a conversion option. The ability to convert at a discount to the price of the full equity round is common in these instances. It is becoming more common for angels to require the right to convert at a significantly lower fall-back valuation though if the company fails to secure further funding (as Bill discusses below in the US context of full angel round deals).

CONVERTIBLE DEBT IS SELDOM THE RIGHT SECURITY FOR STARTUP INVESTMENTS

Bill Payne, July 2010

Just after the Internet bubble burst in 2001, many of us angels were "crammed down" unmercifully by subsequent investors in our portfolio companies. These new investors were funding our companies at valuations far below the pricing we had agreed to earlier, resulting in substantial dilution to our ownership.

To avoid these "cram downs", some angels began investing in startups using debt instruments that convert to equity at the same time and under the same terms as subsequent investors, with a small discount in pricing, based on the greater risk in our earlier investment. While there are some advantages to using convertible debt for early stage investments by angels, I dislike these instruments and seldom use them.

The advantages of convertible debt investments by angels in startup ventures are:

- Protection from down rounds, at least by the next subsequent investor. (It would be my contention that the only protection from subsequent down rounds is negotiating the appropriate valuation at the time of the initial angel round. Only "over priced" deals are eventually crammed down.)
- No need for contentious negotiations with entrepreneurs over pre-money valuation. We can leave these negotiations to the subsequent investors (VCs).
- As debt holders, investors "stand ahead" of all shareholders, in the case of an early unplanned liquidation.
- Legal costs for investing via a debt instrument are generally much lower than for an equity investment, particularly compared to a preferred equity round.

The disadvantages of using convertible debt in angel deals though are simple: At exit we angels end up leaving too much money on the table:

- According to Wiltbank (see my blog dated December 14, 2009), angels lose money on 50% of deals and make 75% of their ROI on only 7% of our deals. Clearly, this means that we angels can only bet on home runs (or "smash hits" in a theatrical analogy).
- Down side protection at the expense of ROI is unacceptable. As an example, convertible debt holders are lucky to enjoy a 30% discount off the valuation of the subsequent round. But, in "smash hits," the valuation of the target company may have tripled in value with the angels' money, before the subsequent investor is engaged.
- Protection from down rounds implies one of two perspectives:
    - The angels are unwilling or unable to negotiate the appropriate valuation at the time of their investment.
    - The angels are focused on downside protection at the expense of enjoying huge returns on that tiny fraction of deals that, in fact, provide all our ROI.
- Convertible debt investments can create misalignment between entrepreneurs and angels. It is clearly in the angel's best interest to eventually convert at a low valuation, while entrepreneurs wish to see conversion at a higher valuation. This can result in contentious Board meetings!

My perspective is that angels should (a) look only for "smash hits," (b) negotiate an appropriate valuation at the time of investment, (c) don't chase losers by continuing to invest when they don't meet milestones and (d) enjoy the fruits of your labors on those very few "smash hits" that, in fact, provide wonderful exits.

CAN WE MAKE CONVERTIBLE DEBT MORE PALATABLE FOR ANGELS?

Convertible debt instruments often convert from debt to equity upon the closing of a subsequent round of investment under the same terms and conditions as the new round.

If a convertible note is used in an angel deal, I prefer a clause with a fall-back position that allows investors' to convert at their option at a favorable valuation, should subsequent investment round not be closed within a fixed timeframe (such as 12-24 months). If capital cannot be raised in that time period, the note holders would have the option to convert to equity at a very favorable valuation to the investors. Let's say, for example, that, for a $500K round from angels, the entrepreneur would like to value the company at $5 million and the investors feel the price should be $1 million (both pre-money valuations). The entrepreneur is confident s/he can raise an additional $2 million within a year, and offers a note with a 30% discount off the pricing of the subsequent round.

It is my position that the angels should also insist that, if the entrepreneur is not successful in raising the additional funding within a stipulated period of time, the angels have the right to convert from debt to equity at their price ($1 million pre-money valuation) at the end of that period of time. In other words, there is a defined fall-back position for the angel investors, if they choose to take it.

Bill Payne is a prominent angel investor - possibly one of the most well known in the USA - he's previously been referred to as the closest thing America has to an Entrepreneur Laureate. Over a 25-year period, Bill has invested in more than 50 companies, mentored hundreds, and founded four angel networks. In recognition of his contributions, Bill was awarded the 2009 Hans Serveriens Award, the US Angel Capital Association's highest honour.

He has also written a book, The Definitive Guide to Raising Money from Angels, as well as having written or been interviewed for articles in The New York Times, USA Today, Business Week and many other investor/education articles and websites.

Bill spent five months in New Zealand in early 2010, hosted by BNZ, FoRST, NZVIF, The ICEHOUSE and the University of Auckland Business School, assisting a range of organisations with the development of NZ's angel investment market.