Convertible Debt: An Option to Structure Startup Financing

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One common way for new businesses to raise startup capital is to conduct rounds of financing among angel investors, venture capitalists and high net worth individuals. This is often preferable to trying to obtain a bank loan because banks are usually hesitant to lend money to startup firms that don't yet have a history of sales or financial success and profitability.

However, there are a few obstacles startups sometimes face when trying to raise funds from angels, venture capitalists and high net worth individuals. One is that it can take time for a business to complete a round of investor financing, but the startup needs money quickly to fund working capital expenses that go into starting a new venture. It might take two, three or more investors and several months or longer to complete a round of financing — the business can't afford to leave money raised during this time just sitting in an escrow account waiting to complete the round.

Another challenge is valuing the startup business. The valuation could change during the time that the round of financing is being completed, so early investors want to protect their ownership share in the business.

The Solution: Convertible Debt

One solution to this dilemma is to issue convertible debt instead of equity shares to your investors. Additionally, the debt can be secured by the assets of your business, such as intellectual property and hard assets, assuming any exist. This will solve both challenges:

- Your startup business can put money you've raised during a round of financing to work right away, instead of waiting until the round is complete. This will help you get your new business off the ground faster and make it easier to take advantage of opportunities that may arise.

- Your early investors have the potential to increase their share of ownership in the business if the valuation falls later during the financing round.

An example helps demonstrate how this could work:

Suppose ABC Startup Business wants to raise $5 million during a round of financing. It secures $3 million from an early investor at a $30 million valuation and an additional $2 million from another investor three months later at a $25 million valuation to complete the round.

The money is provided to the business in the form of convertible notes that will convert to preferred securities once the financing round is complete. In other words, the investors start out as note holders and become shareholders after their notes are converted to equity shares. They are also credited with accrued interest upon completion of the financing round — this is paid out in the form of additional shares in the business.

Both the startup business and the investors will benefit by using this financing structure:

- The business doesn't have to wait for three months to access the $3 million contributed by the first investor. Instead, it has instant access to these funds to help meet working capital expenses such as hiring employees, renting office space and developing new products.
- The business had to reduce the valuation to $25 million to get the second investor onboard, so the first investor benefitted from this $5 million reduction in value. The first investor will now own 12 percent of the business ($3,000,000/$25,000,000) instead of just 10 percent of the business ($3,000,000/$30,000,000). The second investor, meanwhile, will own eight percent (8%) of the business ($2,000,000/$25,000,000 = 8%).

Don't Get Tripped Up

Many entrepreneurs and owners get tripped up by these challenges when conducting rounds of financing to raise capital for their startup businesses. Either they don't have access to much-needed capital while the financing round is being completed, or investors balk because they are worried about the business valuation falling during this time.

Issuing convertible debt to investors instead of equity shares is a good solution to both potential challenges. An outsourced CFO services provider can help you structure your startup financing in a way that's most advantageous to both your business and your investors. An experienced outsourced CFO has worked with many other startup firms that are like yours, so this will go a long way toward helping ensure a successful round of financing.

Concluding Thoughts

There are a few obstacles that can arise when startups try to raise funds from angel investors and venture capitalists. One is that the startup usually can't wait until the financing round is complete to access the funds, and another is that early investors want to protect their ownership share in the business in case the valuation changes after they invest. A solution is to issue convertible debt instead of equity shares to your investors. An outsourced CFO services provider can help you structure your startup financing in the most efficient way for both your business and your investors.

About CFO Edge

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