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Financing by Convertible Notes for Start Ups

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Introduction

Convertible Note allows start-ups to raise funds via debt, which is convertible to equity or repayable at the holder's option. As explained in the earlier part "Start-up funding through Debt", Private Limited companies are prohibited from accepting the Debt from individual unless it is a start-up, and the individual is a member or director of the company.

Insights into Convertible Notes

- Government has allowed Start-up Companies* to accept the funding through the convertible notes from individuals or corporates, either resident or non-resident, in the tranches which are not less than of INR 25 lakhs.
- Convertible notes are repayable at the option of the holder or convertible into the equity based on the conditions and events specified in the agreement.
- Maximum period for which convertible notes can be issued, has been increased from 5 years to 10 years. Within such period it either has to be repaid or converted into the equity.
- Agreement terms contain conditions as well as the cap and floor for the future valuation at which Notes will be converted.

Insights into Convertible Notes

- Valuation is not required to be carried out during such issue.

* Start-up company means private company incorporated under the Companies Act 2013 or Companies Act 1956 and recognized as a start-up in accordance with the notification issued by the Department of Industrial Policy and Promotion (DIPP).

Differences: iSAFE and Convertible Notes

iSAFE

- In legal term, these are the compulsorily convertible preference shares (CCPS).
- They are compulsorily convertible in the equity. It can be repaid if both the company and investor agree.
- Compliance costs are higher since authorized capital needs to be increased along with the ROC filings for the compliances.

Convertible Note

- Legally, this is a Debt taken by the company.
- It is also convertible to equity based on the conditions stipulated in the agreement. However, it is repayable at the option of the holder. (Repayment can be restricted for some defined period such as closing of current funding round).
- Less compliance cost compared to iSAFE.

Benefits

- Valuation is not required during the issue of Convertible Notes.
- Equity is not diluted at the time of issue.
- Private Limited company is not allowed to take debt, but CN gives a way out.

Limitations

- Holder has right to call for repayment at any time, such option can push start-up to bankruptcy.
- Minimum investment amount is INR 25 Lakhs which may discourage low-ticket size funding from the angel investors.
- Floor and Cap for the valuation needs to be agreed in the Convertible Note Agreement.

THANK YOU

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