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Convertible Debt or Outright Equity: Key Considerations for Investors in Early-Stage Companies

PRIVATE EQUITY INSIGHTS

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Introduction

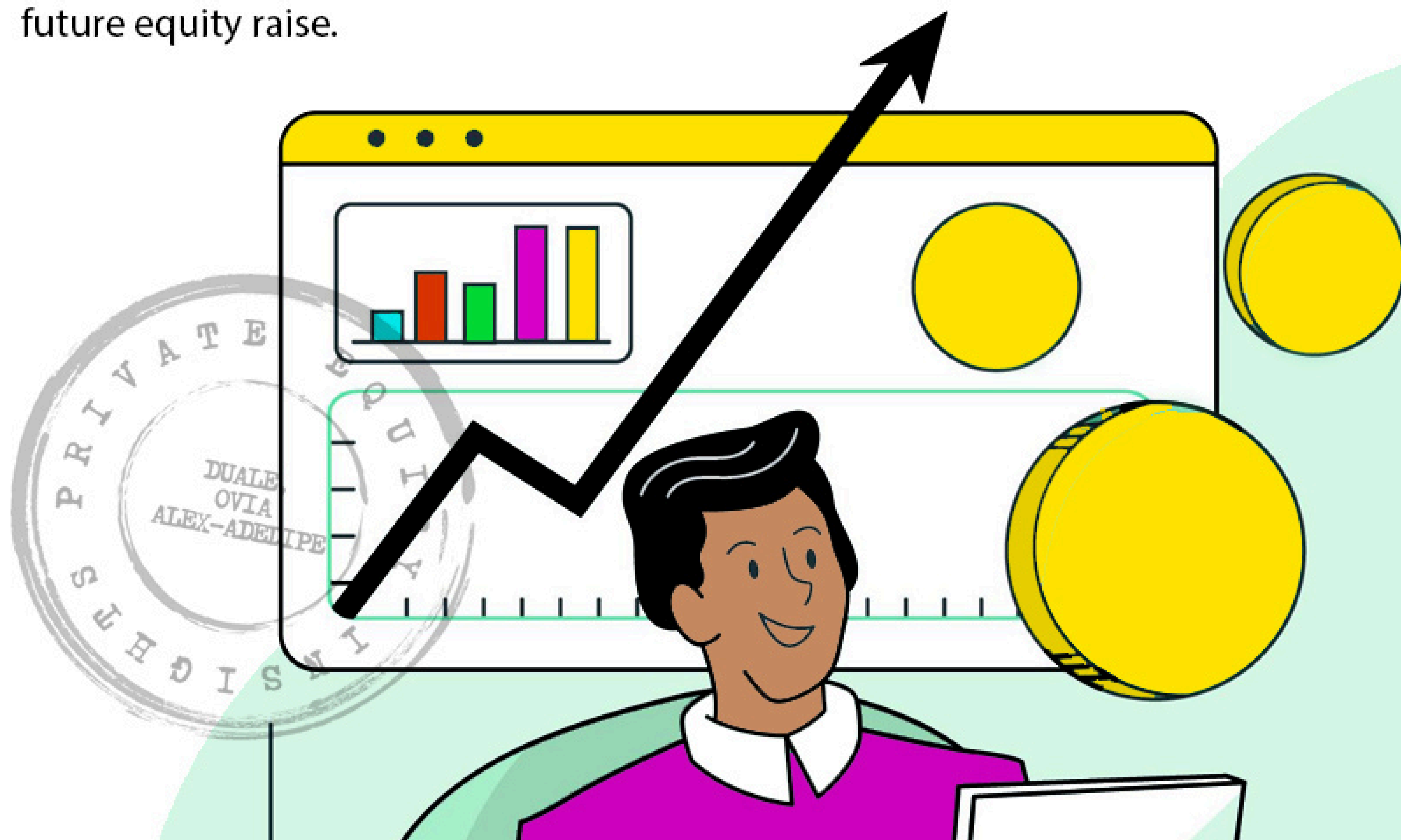
Investors often face a tough decision between convertible debt and outright equity when it comes to investing in startups or growth companies. Both options possess distinct characteristics, advantages, and risks, and understanding these details can help investors make more informed decisions that align with their investment goals.

In this edition of #PE-Insight, we take a closer look at the key considerations for each option as guide for investors looking to invest in early-stage companies.

Convertible Debt

What is Convertible Debt?

Convertible debt is a form of financing where the investor loans money to a company, evidenced by loan notes, with the option to convert the loan notes into equity at a later stage, typically during a future financing round. The debt comes with an interest rate and a maturity date, but the conversion feature allows the investor to potentially benefit from the upside of future equity raise.



Key Considerations for Investments by way of Convertible Debt:

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1. **Conversion Terms:** Investors often face a tough decision between convertible debt and outright equity when it comes to investing in startups or growth companies. Both options possess distinct characteristics, advantages, and risks, and understanding these details can help investors make more informed decisions that align with their investment goals.

2. **Interest and Maturity:** Convertible loan notes often accrue interest, which can increase the amount of equity an investor receives upon conversion. However, a convertible debt arrangement also comes with a maturity date, by which the company may either repay the debt or, at the investor's option convert the loan notes into equity.

3. **Risk Management:** Convertible debt is generally considered less risky than equity because it provides a repayment option if the company does not perform well. If the company fails to succeed or reach the conversion point, investors can potentially recover their principal and accrued interest.

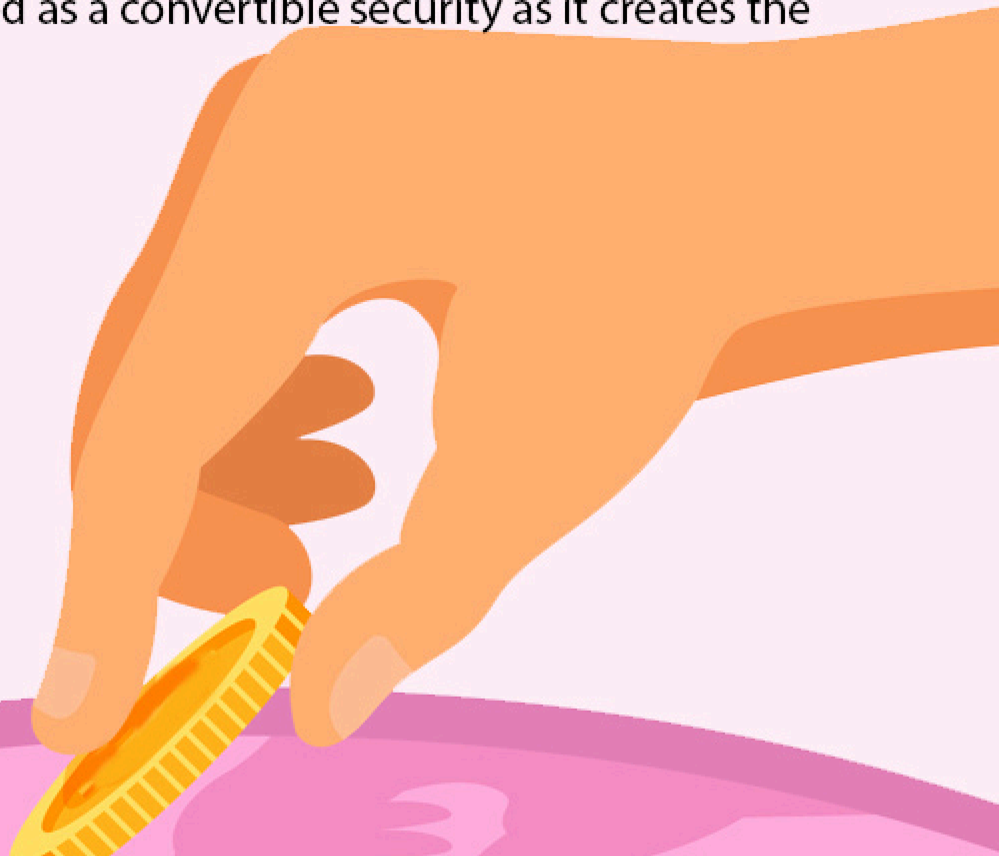
4. **Dilution:** Convertible debt may lead to dilution when it converts into equity. The impact on ownership percentages depends on the valuation at the time of conversion and the terms agreed upon. To safeguard against dilution, it is in the best interest of the investor to include pro-rata rights to future equity raise (where conversion has occurred) or to future issuance of convertible debt instrument.

5. **Control and Voting Rights:** Until conversion, convertible debt holders do not have equity ownership, so they would have relatively limited control over company decisions. This can be a concern for the debt holders as significant decisions could be made before conversion. To ensure better control in the affairs of the company, the investor may negotiate a board seat for the duration of the investment leading up to or sequel to conversion.

Outright Equity

What is Outright Equity?

Investors can decide to purchase or subscribe to the shares of a company directly, obtaining a stake in the company's ownership from the outset. As opposed to convertible debt, investors typically receive common or preferred shares, which come with ownership rights and potential dividends. Relatedly, preferred shares is regarded as a convertible security as it creates the option to convert to common shares.



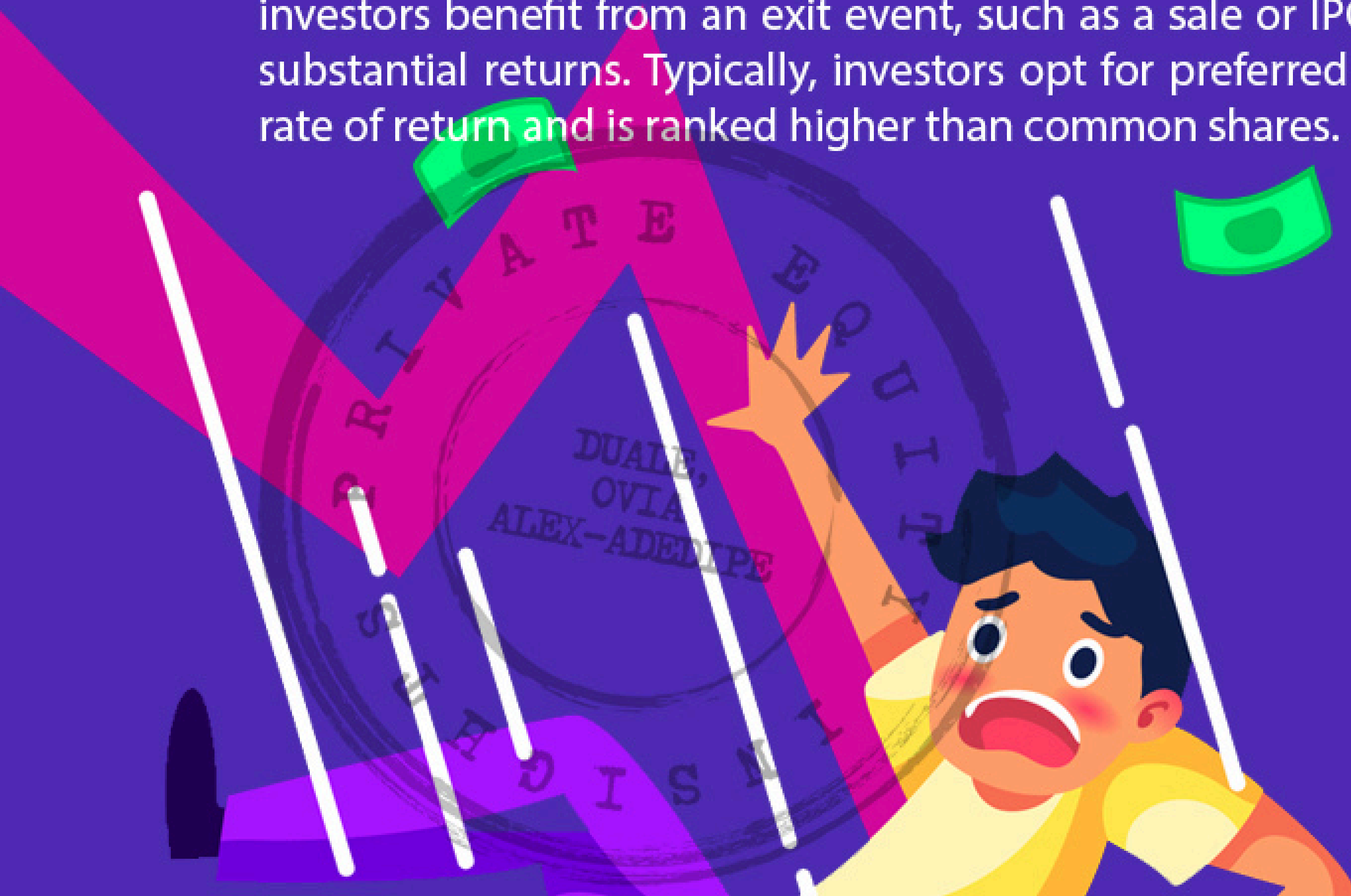
Key Considerations:

1. **Ownership and Control:** Equity investors receive ownership in the company, which often includes member voting rights and board representation. This can be advantageous if the company grows and requires strategic input.

2. **Potential Upside:** Equity holders benefit directly from any increase in the company's value. If the company performs well, the value of their shareholding can appreciate significantly, providing substantial returns.

3. **Risk of Dilution:** Equity investors face the risk of dilution if the company issues more shares in future financing rounds. However, this risk can be mitigated by the timing of the investment, for example at a later stage when the company is more stable. Anti-dilution provisions can also be included in the transaction documents to protect the voting power of the investor.

4. **Dividends and Exit Strategy:** Depending on the company's performance and the type of shares purchased, equity investors might receive dividends. Additionally, equity investors benefit from an exit event, such as a sale or IPO, which can offer liquidity and substantial returns. Typically, investors opt for preferred shares as it guarantees a fixed rate of return and is ranked higher than common shares.



5. **Long-Term Investment:** Equity investments often require a longer time horizon. Investors may need to wait years before seeing significant returns or liquidity events, which can be a drawback for those seeking quicker returns.

Making the Choice

Choosing between convertible debt and outright equity depends on several factors, including:

- **Investment Horizon:** Convertible debt may be preferable for investors seeking shorter-term involvement, as it often converts into equity in a defined timeframe. Outright equity suits those who are willing to wait for longer-term growth and potential exit opportunities.
- **Risk Tolerance:** If minimizing risk is a priority, convertible debt can offer a safer option with the potential for conversion upside. Outright equity involves higher risk but offers direct ownership and potential high rewards.
- **Control and Influence:** Investors who want a say in company decisions might prefer outright equity, whereas those focused on financial returns without in-depth participation might lean towards convertible debt.

Conclusion

In conclusion, both convertible debt and outright equity carry their peculiar merits and risks. It is important that investors carefully consider their investment goals, risk tolerance, and the specific terms of each instrument before making a decision. It is also worthy to note that both options can be utilized by investors can diversify their exposure to the company within the same investment round. Investors who bring both convertible debt and equity to the table may have greater negotiating leverage and control within the company. This dual approach can allow them to secure more favorable terms, whether in conversion rates, interest on debt, or the percentage of equity ownership.