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Tips for Startups – Understanding Debt vs. Equity Investments

Bootstrapping your startup is a great way to preserve founder value by building your business through your own time and expertise. The theory is that in time, the value that you create using your own blood, sweat and tears will multiply. However, not all businesses have the same needs at the same time, and eventually most need cash. Even if you are able to bootstrap your way to profitability, there may still come a point at which you need an infusion of cash in order to expand your business.

Aside from crowdfunding campaigns or other sorts of pre-sales, this cash infusion will most commonly involve seeking investors. Whenever this happens, it is important to understand the different options available to you for investor financing, and the pros and cons associated with each. Investor financing may come as either debt (where the company has specific obligations to repay the funds to the investor) or equity (where the investor becomes a shareholder of the company). And then there is convertible debt, where the company has specific repayment obligations, but the investor is able to convert the debt into equity at some time in the future.

Confused yet? Don’t worry, it all makes more sense in practice.

True Debt

True debt is exactly what you think of as debt: one party lends money to the other, and the party borrowing has an obligation to repay the money to the lender. The debt will usually have some sort of interest, as well as terms around when and how it is to be repaid. Debt may be secured against assets, or in some cases guaranteed by a third party, such as a founder, when a startup without much in the way of assets is the borrower. Debt may also be unsecured, often in exchange for a higher interest rate due to the increased risk associated with default.

Generally, secured debt is considered to attract the least amount of risk for the lender, as it has an easily calculable return, and in the event the startup fails to perform, the debt is secured against assets. Lenders will also have priority on liquidation over shareholders, as debt precedes equity. However, if the startup is a homerun, a lender generally won't participate in the upside to the same degree as an equity investor may, as an equity investment will track increases in value of the company.

Convertible Debt

Convertible debt is a hybrid of debt and equity. Often issued as a "convertible note", convertible debt has the same attributes and options as true debt referenced above, but it also has a mechanism allowing the lender to convert the loan into an investment and participate in the potential upside. The conversion occurs at some future point, either at the investor's option, or upon a triggering event, such as an equity offering. At this point the debt is converted into equity shares.

Convertible debt has become a very popular vehicle at the seed stage for a number of reasons. In early stage startups, it is a great way to raise funds without having to decide on an exact valuation, or negotiate complicated share rights. This can be handy for founders wishing to avoid undervaluing the business based on the early stage of development. It also helps to avoid the need to engage in heavy negotiations when initial investors may be friends and family, which many founders are understandably reluctant to do. Angel investors often like this sort of investment as well, as they are often investing in an idea without proven revenues, which makes valuation difficult. Having a debt that is convertible upon an equity offering means the angel investor will get the benefit of a later investor's negotiation (such as an institutional or venture capital investor), after the founders have used the angel investment funds to grow the company. Even for later stage companies, a convertible note can work well as a “bridge loan” when a little bit of money is needed in advance of an equity offering intended to follow shortly.

The mechanics of conversion can vary as well. Some convertible notes will offer a discount on conversion. For example debt which is converting with a 20% discount means that a share offered for $1.00 will be converted for forgiveness of $0.80 of debt. This is intended to give the lender a bit of a bump in exchange for their early investment.

Another term beneficial to investors is a valuation cap, which provides a maximum pre-money value of the company at which the debt will be converted. What this means is that the company is agreeing to a *minimum* percentage of shares that the lender will be entitled to on conversion. For example, if there is $500k in convertible debt with a valuation cap of $5M, the lender will be entitled to a minimum of 10% of the shares. If the share offering in which the debt is set to convert provides a pre-money valuation of $10M, the lender would still be entitled to receive 10%, or $1M worth of shares, for conversion of their $500k in convertible debt.

Convertible notes will generally also have a maturity date, being the date on which the debt is due, and providing a drop-dead-date for conversion through an equity offering. If you are considering convertible debt, be careful to consider how each of the interest, discount, valuation cap and maturity date interact. Each is meant as a benefit to the investor, and can vary depending on the expected term of the debt, and the company’s need for funds.

Convertible debt allows a company to receive a cash injection quickly and easily, without taking an immediate dilution while the company or idea is still only partially formed.

Equity

Equity comes in different forms, but the common theme in equity is that it represents an ownership stake. Although equity provides less certainty over repayment, it does offer a greater potential to participate in the upside in a profitable company, or in a future exit.

Preferred Shares

Preferred shares are the favoured form of equity for most sophisticated investors, whether venture capital firms, other institutional investors, or just those savvy in the modern realm of investment. Preferred shares are the most common form of security sold in a private company financing, particularly anything labeled as a 'Series' round of investment.

Because they represent an equity stake, preferred shares are riskier than debt (shareholder's rights to participate in any upside generally come after other business obligations such as repayment of debt), but can contain a number of different rights and preferences beneficial to the preferred shareholder over other shareholders. These rights can include preferential treatment on dividends, or additional payments on an exit or liquidation event of the company, approval rights over certain key business decisions, a seat on the board, and other business terms that investors may request. Preferred shares often also have the ability to convert into common shares in certain events, such as if the company decides to list on a public exchange (the fabled IPO).

Preferred shares are generally reserved for significant investments, as their terms tend to be relatively complicated, often quite specific to the investor leading the investment round, and heavily negotiated. It takes a significant investment of both time and money, so is only justified if the incoming investment is large enough. This is one of the reasons why early stage investors may gravitate towards convertible debt: the size of the company may not yet warrant an investment that would justify the cost of a full equity financing.

Stock options or warrants

Stock options and warrants are both securities that provide the holder with the right to buy shares at a later fixed date, or upon the occurrence of certain events, at a price that is either pre-determined, or based on a pre-agreed formula. While a company generally won't raise money simply by selling options or warrants, each can be used as an “equity kicker” to sweeten other deals, or otherwise act as incentives.

In the case of an investment, a warrant can be used to provide upside potential to a lender. Or it can be granted to an investor that is willing to put in some funds now, but needs some potential for more upside to make the entire investment more attractive.

In the case of a founder or other key employee, options can also be used to provide an incentive to continue to contribute to the company with the promise of future upside. Because options can come with all sorts of terms around vesting (when and how they may be exercised and what may trigger expiration/cancellation) and other conditions, they’re less risky for the company than simply handing out shares.

Common shares

Common shares are the most basic unit of equity in a company, and generally the foundation upon which all other convertible securities are ultimately based. Common shares can also have various rights and privileges attached to them, such as voting and participation in profits, but they tend to rank behind other securities in terms of priority. For example, a common shareholder’s right to participate would come after debt-holders and preferred shareholders. Founders contributing a great deal of sweat equity generally hold common shares, which are sometimes made subject to reverse vesting agreements. These reverse vesting agreements allow the company to repurchase the shares at some set price or calculation, if the founder leaves the company early. This is done in order to protect the remaining founders from carrying the dead weight of a non-contributing founder.

Common shares are generally also held by employees that are granted shares (or options) as part of their compensation. Some companies split their common shares into voting and non-voting varieties in order to keep participation and control separate, while others leave these concepts lumped together and deal with control by carefully considering the number of shares issued. Friends, family and angel investors often come in at the common share level as well, in order to be treated the same as founders; however, later stage investors will generally look for something more than common shares.

While selling common shares is generally a less expensive proposition than preferred shares, as the common shares come pre-packaged, there may still be other costs associated with a shareholders' agreement or other business agreements that coincide with the purchase of shares.

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If you are looking to raise funds, there is no one-size-fits-all answer as to which structure is right for you, or for your investor. The key is to consider the various options and seek to balance the specific needs of the company with the risks and rewards available to the investor.

Whichever business relationship you and your investor ultimately decide upon, there will be important corporate structuring, tax and securities law issues to deal with, so make sure to seek legal advice early so that you understand the implications of any course of action.

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a cautionary note

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