convertible notes

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topics

- convertible notes vs equity investment
- when to use convertible notes
- how they work
- common points of negotiation with investors
- documentation and resources
- questions

convertible debt vs equity

- equity
  - investors receive shares (ordinary or preference) immediately on closing
  - the valuation and all preferential rights are agreed up front
  - a full set of investment documentation is usually required; subscription agreement, shareholders' agreement, new constitution
- convertible debt
  - debt instruments with investors receiving shares only on the completion of a new funding round or at maturity
  - valuation and preferential rights are determined by reference to the next funding round
  - simple documentation, convertible note only

when to use convertible debt

- smaller round, in ASEAN typically under S$1.5m
- where the company's growth plan calls for a more substantial round in the short term (12-24 months)
- when there are difficulties agreeing a valuation with new investors
- when there are difficulties agreeing preferential terms with new investors
- as a bridge financing while negotiating a larger round
- why? Because delaying negotiations around valuation and preferential rights until a larger funding round sometimes makes more commercial sense (and the company is typically more mature and can therefore negotiate better terms)

the basic conversion mechanics

- the convertible note is debt until converted to equity on a qualifying capital raise
- the debt converts into the highest class of new shares issued as part of that future capital raise (typically seed preference or series A shares)
- the conversion price is equal to the price per share of the future capital raise, less an agreed discount to reward investors for financing the company at such an early stage
- the conversion price is subject to a negotiated valuation cap

other mechanics

- exit or liquidity event
  - the debt converts or becomes repayable in cash, at the investor's option
  - the debt converts into the highest class of shares on issue at the time (most likely ordinary shares)
  - the conversion price is set by reference to an agreed valuation (often the valuation cap)
- maturity
  - maturity date is usually 12-24 months from investment
  - the debt converts or becomes repayable in cash, at the investor's option
  - the conversion price is set by reference to an agreed valuation (typically low to reflect a failure to raise additional funds in the agreed timeframe)

common negotiation points

- equity investment or a convertible note
- what constitutes a qualifying capital raise, ~$1m
- what is the discount to the qualifying capital raise, 15-25%
- what is the valuation cap
- interest rate
- when is the maturity date, 12-24 months
- what is the valuation for a conversion on the maturity date

documentation

- sometimes will have a term sheet
- convertible note agreement
- resolutions, waivers, consents
  - for taking on debt
  - for the issue of the convertible notes
  - for the issue of shares on any conversion of the notes

resources

- Simmonds Stewart has an ASEAN template KISS on its website, including an automated documentation process
- Simmonds Stewart about to release an ASEAN template SAFE on its website

Questions?

ESOPs

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topics

- what is it, when should I get one, and how big should it be?
- options vs shares
- the main variables
- documentation and resources
- questions

ESOP basics

- what is an ESOP?
  - a pool of options to subscribe for ordinary shares in the company at a pre-determined price (once vested)
  - used to hire, retain, and incentivise key employees
- when should I put an ESOP in place?
  - most institutional investors will require the adoption of an ESOP, if not already in place, i.e. at series A (or possibly series seed) round
  - earlier only if required for retention or attraction of key employees
- how big should my ESOP be?
  - almost always an ESOP pool of 10-15%
  - investors will participate on a *fully diluted basis*, so make sure the ESOP is not materially larger than required

why options?

- better for the employee
  - shares are taxed on the date they are received
  - options are taxed only on the date they are exercised
  - in practice employees will usually carry the options until an exit
- better for the company
  - avoids having a series of small shareholders on the cap table
  - more familiar to institutional investors
  - more familiar to experienced employees
- when do people get shares?

variables

- vesting, usually 4 years with a 1 year *cliff*
  - usually 4 years with a 1 year *cliff*
  - may be shorter for employees who joined prior to the ESOP
- exercise price
  - usually set at the value of the company at the date of grant
  - may be lower for employees who joined prior to the ESOP
- expiry date, usually 7 to 10 years
- leaving employees
  - lose all unvested shares
  - retain vested shares but may have a shortened time period in which to exercise
  - retain any shares acquired on any exercise of vested options

variables continued

- accelerated vesting on an exit
  - on a listing or trade sale
  - *single trigger* vs *double trigger* acceleration
  - sometimes a combination of single and double trigger acceleration

documentation

- a set of ESOP rules, including a template letter of grant and a template option certificate
- board and shareholder resolutions, waivers, and consents
  - adoption of the ESOP rules
  - grant of options to persons selected by the board from time to time (up to the amount of the ESOP pool)
  - issue of shares on any exercise of the options
- granting options under the ESOP rules
  - pass a board resolution authorising the grant of those options
  - send the employee the ESOP rules and a completed letter of grant
  - employee to counter-sign and return the letter of grant
  - send the employee the completed option certificate

resources

- Simmonds Stewart has an ASEAN template set of ESOP rules on its website, including an automated documentation process

Questions?

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