MicroVentures

The Rise in Popularity of Convertible Notes

MicroVentures is an online Venture Capital Firm. We conduct thorough due diligence on startups from all over the United States, are a FINRA registered Broker/Dealer, and bring securities offerings to market. Unlike a traditional Venture Capital Firm, MicroVentures' capital comes from individuals who are either accredited or non-accredited investors. These individuals have the opportunity to invest "a la carte" in our offerings, many times along side prominent Angel Investors and Venture Funds. We frequently get questions from investors regarding convertible notes. Here's what you need to know about the convertible note funding structure and when, how & why we use them.

What is a Convertible Note?

Entrepreneurs have two options when it comes to raising money to fund their company, debt or equity. Debt is a loan which they must pay back within an agreed upon amount of time, with interest. Equity means they are instead providing a portion of ownership of their company in exchange for the investment.

A convertible note (referred to as a "note" in the Venture Capital world) is a hybrid funding solution. Notes are loans which convert to equity at an agreed upon milestone or maturity date—usually a Series A round led by a VC Firm.

One important concept to understand about Convertible Notes is that they do not set a valuation on what the company is worth. This is one of the key distinctions between Convertible Notes and Equity Ownership. An equity owner will say "your company is worth $10M and I own 20% of that company—i.e. $2M worth." A convertible note will instead be a $100K loan, which converts to equity when a VC comes in and sets this valuation in the next funding round or another agreed upon milestone is meet.

Lets review the features of a Convertible Note and then walk through an Example.

Features of Convertible Notes

There are 5 key features: Maturity Date, Conversion Milestone, Discount Rate, Valuation Cap and Interest Rate.

Maturity Date: Notes are typically structured as 18-24 month loans given by angel investors to small businesses in order to help them achieve proof of concept, close large customers, or acquire talent which will lead them to a follow-on investment from a Venture Capital Firm. The Maturity Date is the date on which the convertible note converts from debt (a loan) to equity ownership in the company.

Conversion Milestone: An event that triggers the conversion of the note from debt to preferred equity. This typically, occurs with a subsequent investment from a large VC/institutional investor. This institutional investor will set the terms of the next round of financing.

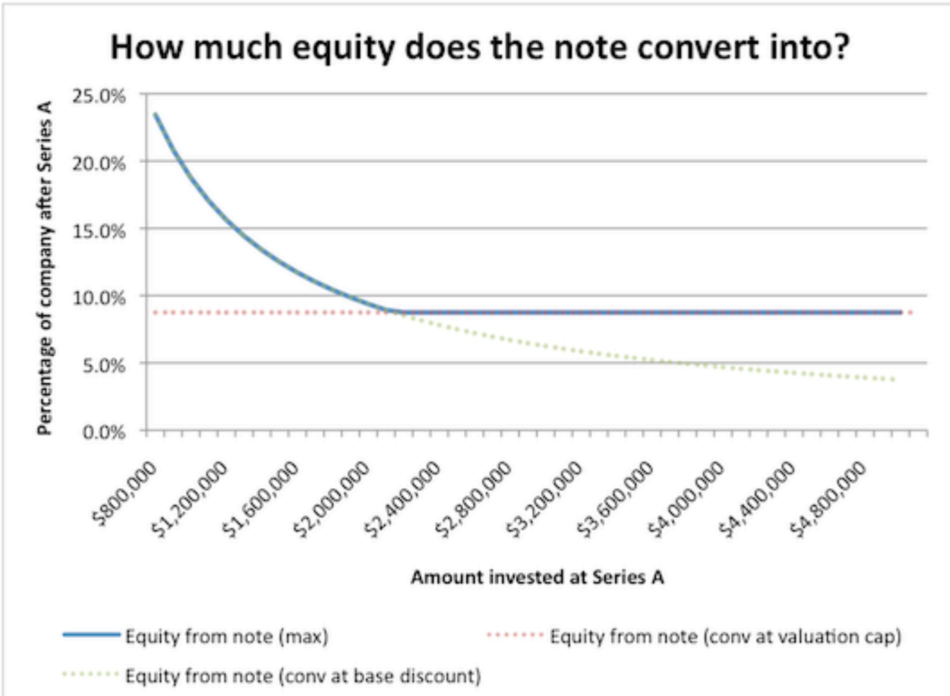
Discount Rate: The discount rate is the discount that is given to the investor when the "conversion" from debt to equity occurs. The investor (lender) shares will typically convert at a 15-20% discount to what the new investors are paying. This discount is given to early investors for taking on extra risk by investing early.

The graphic below shows the concepts described above: milestone and discount. Here you see if an investor were to invest $1,000 in a company at a 20% discount to the next milestone (in this case a subsequent round of financing) the investor receives more shares and therefore more ownership at the same price as a later investor.

Valuation Cap: A Valuation Cap ("cap") is a pre-determined maximum valuation on the company where the investor agrees to convert his/her shares. Caps are used to protect early investors in case the value of the company skyrockets in the next financing round, the investor will get to convert his/her investment at the cap. Caps can get a little confusing. An easy way to remember the key mechanics is as follows: Investors want to buy in as cheaply as they can. The lower the cap the better the deal an investor gets. The higher the cap, the worse the deal.

For example, if the investor and the company agree on a $5M cap, and the institutional investors who come in on the deal much later decide to value the company at $10M, then the investor converts his/her shares at the pre-agreed upon $5M valuation rate and see's an immediate increase in their return.

Caps are also important because to a certain extent they protect investors and provide them with a certain share of the company. Otherwise, early investors could be easily diluted when follow-on investments occur.



This illustration shows how much seed investors own after converting their note into shares. Without the valuation cap, seed investors end up with an ever-diminishing share of the company as the valuation increases.

Convertible notes can be either Capped or Uncapped. *Scott Edward Walker is the founder and CEO of Walker Corporate Law Group explains in* TechCrunch, why caps are important as follows:

> "The interests of the founders and the investors are 'misaligned' if the investors are issued convertible notes that are not capped. This is because it's in the founders' interest to maximize the company's valuation in the Series A round, and it's in the noteholders' interest to minimize it. Investors are thus "penalized" for helping a startup get a higher valuation as a result of their introductions, domain expertise, etc."
> http://techcrunch.com/2012/04/07/convertible-note-seed-financings/

Interest Rate: Interest on a convertible note is calculated as simple interest, which means it ignores the effects of compounding. Additionally interest accrues and is paid out on the maturity milestone and is not paid out during the life of the loan. Typical interest rates on convertible notes are in the 5-7% range. When a note converts to equity the full principal loan amount plus any accrued interest converts with the loan.

A good way to wrap your heard around Convertible Notes is to walk through some examples.

Walk Through a Convertible Note Scenario:

Convertible debt is most commonly used as a bridge loan between two rounds of financing. For example, if you previously raised $1,000,000 in series A funding and you were going to raise $5,000,000 in a series B round, you might use a bridge loan if you needed $250,000 until the funding was completed.

Recently though, convertible debt has become a popular seed round financing instrument.

Here is a basic overview of how convertible notes work:

- An angel investor invests $200,000 in a startup as a convertible note.
- The terms of the note are a 20% discount and automatic conversion after a qualified financing of $1,000,000.
- When the next round of funding occurs, say at a $2,000,000 valuation, the investor's note will automatically convert to equity.

In this scenario, let’s assume the shares were priced at $1.00. Since there is a 20% discount, the investor can use that $200,000 investment to purchase shares at the discount rate of $.80 each, instead of the $1.00 price that other participants in the current funding round will have to pay. That gives the initial investor 250,000 shares for the price of 200,000, which is a 25% return — not bad.

Caps can also be added to convertible debt, as described above. It is important to note however that Caps and Discounts are not applied simultaneously. It is the lesser of the Cap or Discount that will be used on the conversion date; whichever is most advantageous to the investor.

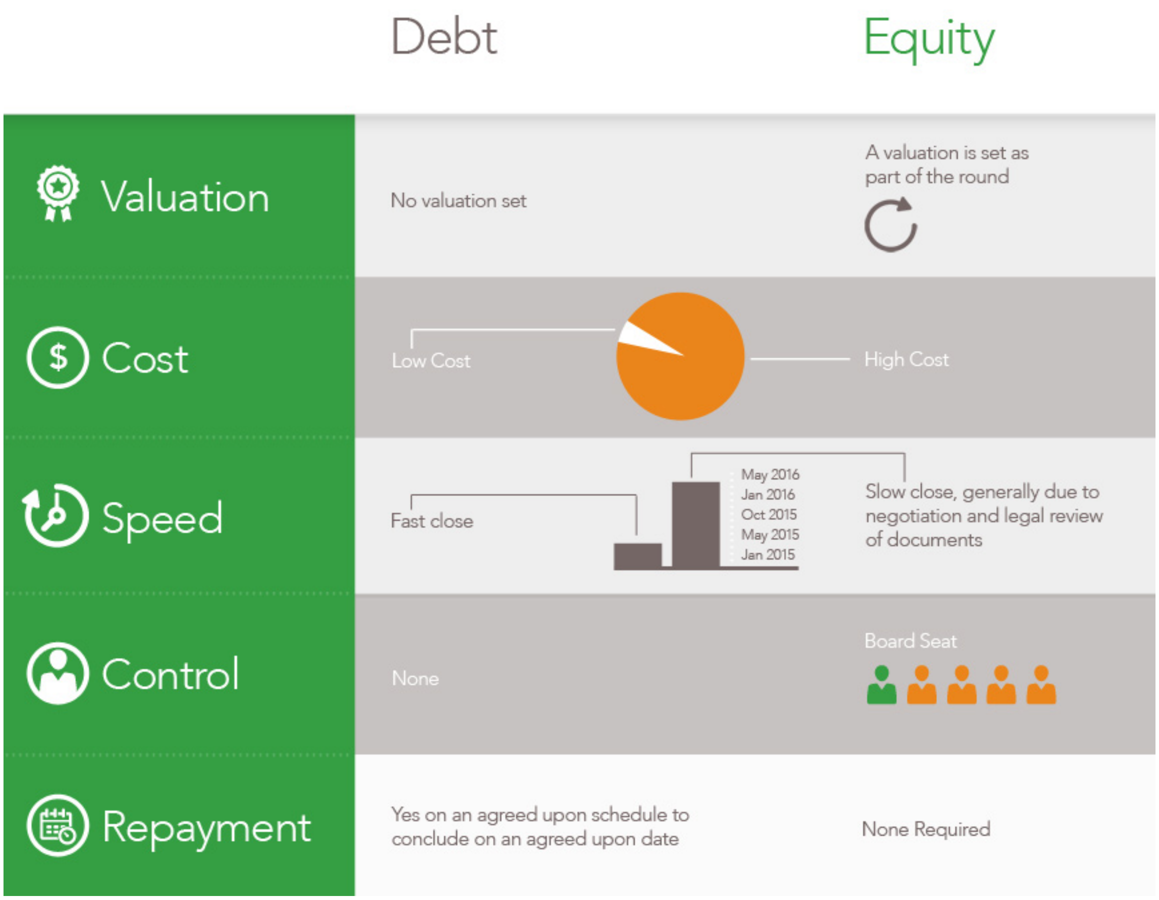
A cap sets an upper limit on the valuation at which investors shares will convert to equity. So in the example above, if the pre-money cap was $1,500,000, and the subsequent round of funding occurs at $2,000,000, the per shares price equals $0.75 ($1.5M/$2M times your share price $1). In this example the discount resulted in a $0.80 share price and the cap in a $0.75 share price. The investor would be given the $0.75 per share price.

Now let’s compare this to Equity:

While a convertible note might be a little confusing to calculate, equity is a breeze. The startup is assigned a pre-money valuation and a share price is determined. When you invest, you know exactly what the terms are and how many shares you will own in that round.

Here's how it works:

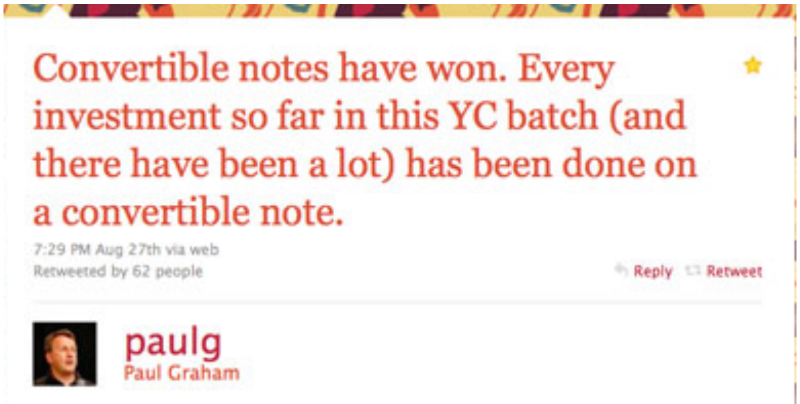
- The startup has a pre-money valuation of $1,000,000 with 1,000,000 shares outstanding. This puts the share price at $1 per share.
- An angel investor makes an investment of $200,000 and receives 200,000 shares.
- The post-money valuation is $1,200,000 and the new investor owns 16.6% of the company.



Scenario's Where Notes are Popular

Convertible Notes are generally used in early stage investing during what is called a Seed Round. Seed Rounds are typically the first funding put into a company after the founders have put in their time, money, and hard work. Notes are also typical as "bridge loans," as they fill the gap between venture capital/institutional money rounds, which are called Series A, B & C rounds. The reason Notes are popular in these situations is that they do not require that the round be "priced," i.e. there is no valuation set for the company. Series A, B, C rounds are always priced and generally led by a VC who is thought to have the ability to set "fair" terms given industry dynamics and current financing trends. This ability of a note to NOT be "priced," is advantageous because it cuts down on both negotiation time and allows for the valuation to be set by the VC in the next round who has more leverage on setting terms. Ultimately when the VC invests, the convertible note investors benefit from a discount to their terms for having gotten into the deal ahead of time. (See discount rate).

Paul Graham, the co-founder of Y-Combinator, arguably the best if not second best seed accelerator program in the world, came out in 2010 on Twitter and said:



Why People Use Convertible Notes

Unlike a decade ago, when there were only a few places an entrepreneur could go to seek capital to bring his/her idea to life; today, there are lots of places to look for money.

Some common sources include:

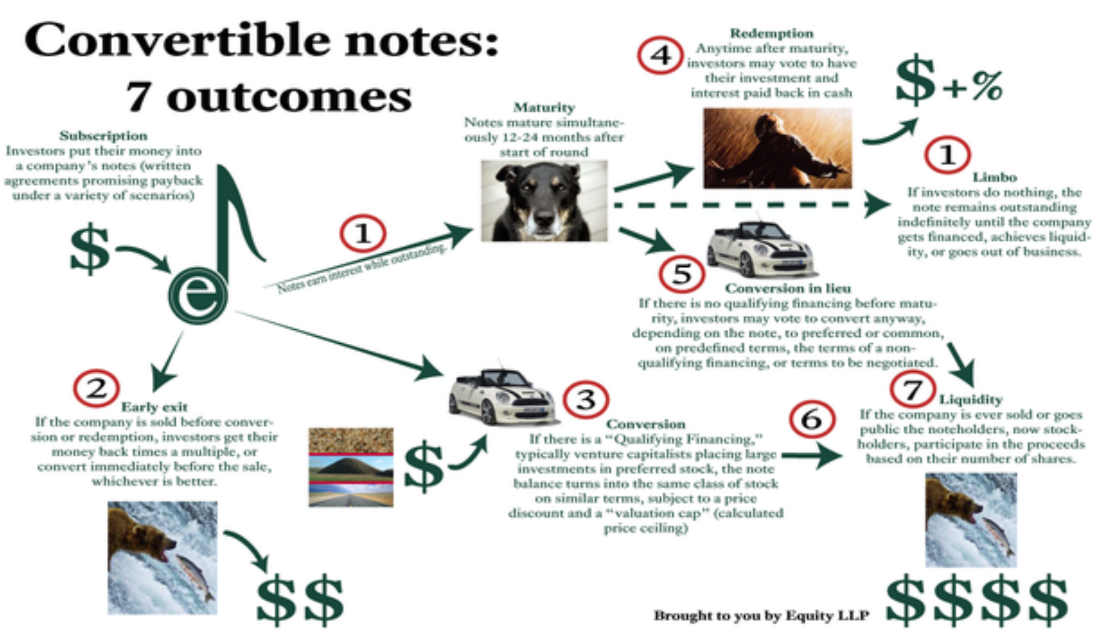
- Friends & Family
- Donation Crowd Funding Sites
- Traditional Banks and Loans
- Incubators
- Angel Investors
- Angel Groups
- Equity Crowd Funding Sites
- Venture Capital

This variety of funding sources puts founders in a more favorable position allowing them to delay valuation and therefore retain ownership of their company.

It is also generally seen as more favorable when larger institutional investments are made as they tend to like to value the company first; if other investors have already set a valuation, there is a possibility for a "down round" which devalues those early investors' shares.

While there are hefty legal fee's involved in an equity round upwards of $30,000, in many cases, convertible note legal fee's are easily below $10,000 and can be expedited by using a SAFE (Simple Agreement for Future Equity) Note—the internet available and investor ready document created by Y-Combinator helps companies expedite their funding rounds.

Below is an info-graphic which depicts some of the scenarios/outcomes of convertible notes. http://equityllp.quora.com/Convertible-notes-7-outcomes



How MicroVentures Works

As previously mentioned, convertible notes are becoming increasingly popular in the early stage venture funding landscape. Today MicroVentures sees about 70% use of convertible notes in the early stage companies we fund.

MicroVentures offerings are free to browse for registered investors and investments can be made with as little as $3,000. We offer both primary investments in early stage startups and fund investments in late stage high growth opportunities like (Twitter, Yelp and Facebook, prior to their respective IPOs). Our deals are structured as investments into a LLC, which collectively aggregate investor funds, and in turn the LLC invests in either a convertible note or shares of equity ownership. If you are interested in investing or browsing our offerings please registered with MicroVentures. If you are interested in funding your startup via our platform please submit your company for review.

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