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CONVERTIBLE PROMISSORY NOTES: A FINANCING MODEL FOR TECH STARTUPS IN NIGERIA

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INTRODUCTION

According to Bloomberg, about 80 percent of startup businesses fail within the first 18 months. A major reason for this is limited access to finance and Nigeria is not left out of these statistics. In fact, recent study suggests this numbers have risen to a whopping 90 per cent. The prohibitive interest rate and inability of business owners to satisfy conditions precedent to drawdown of loan facility granted by financial institutions, result in stillbirths of many small businesses. Can banks really be blamed for the high interest rates given the cost and time it takes to conclude loan recovery exercise and the delays associated with the dispensation of justice in this clime? In our last issue, we discussed various financing models used by tech startups in Nigeria and proposed an alternative funding model. This paper examines the practicalities and relative benefits of deploying Convertible Promissory Note (CPN) as an alternative or additional funding model for tech startups desirous of breaking new grounds that are unable to access conventional financing. Put simply, CPN is a tool for an investor to gain the advantages of two worlds in that an investor is able to seamlessly transit from a lender to an equity investor and vice-versa. For the issuer of CPN, immediate access to cash to fund necessary growth plan is guaranteed.

THE MODUS OPERANDI OF CPN

A CPN is a bridge between equity financing and debt financing usually deployed by start-up companies to generate capital in anticipation of Series A fund raising exercise. With CPN, the investor lends money to the company and rather than collecting the principal sum and interest at maturity, as would be the case with a typical loan, he converts the loan to equity in the company. The conversion happens at a heavily discounted price in a company that is fast growing and developing. He takes the risk of investing in the company with the hope that the investment would yield a good return when the note matures.

Due to the relative ease of securing capital through CPN, many startup companies may be tempted to raise capital using this model. Although CPN may not result in immediate dilution of equity, founders must be careful not to dilute their equity in exchange for fund that is not required for the short time plan of the company because future CPN can be issued at a higher valuation. Founders must also be careful not to issue too many CPN and lose the management, control and administration of their companies to people who are not familiar with the vision of the company.

An investor (the noteholder) who intends to invest in CPN would typically enter into an agreement with the company (the note issuer) to lend money to the company at an interest. Parties draft, negotiate and execute a Convertible Note Purchase Agreement to document their understanding. The agreement contains the amount an investor agrees to lend to the company and the commitment of the company to issue notes to the investor as acknowledgement of debt. The noteholder would usually insist on including a valuation cap , interest on the principal sum and discount on the price per share, he does this to obviate a situation where his note will convert to shares at a very high price. The company should however ensure that the interest and discount rate are not too high and the valuation cap is not too low so as to prevent the purchaser's note from converting at a discounted price thereby diluting the company's share capital.

The agreement would also contain terms of conversion of the Note to Equity and the maturity date amongst others. The maturity date is the pre agreed date the company must repay the principal sum and the accrued interest if the notes have not been converted to equity or the principal sum and interest previously repaid. The maturity date is however an assurance to the investor that the notes would not be held indefinitely, and even if conversion does not happen, the holder is certain of getting the principal sum and the accrued interest.

Conversion of notes to equity would usually take place upon the occurrence of a qualified financing or a non-qualified financing depending on the circumstances. Also, the note holder would be entitled to the principal sum and accrued interest upon maturity or the occurrence of an event(s) of default. The noteholder is usually anxious as to the price the notes would eventually convert into equity and the determination of the conversion price is usually based on an agreed matrix. The note may also contain some standard covenants. The company should ensure that the terms are not too restrictive or too strict so as not to affect seamless administration.

Parties may also agree to subordinate the interests of some categories of debtors to the interest of the noteholder in the event of liquidation. It should be noted that the order in which assets of the company are applied in liquidation is regulated by the Companies and Allied Matters Act and the Companies Winding Up Rules. We are of the view that parties' agreement must comply with the provisions of insolvency statutes otherwise the agreements would be void. Please note that a noteholder is not a secured creditor and consequently, his interest is not registrable. Nigerian law places the interests of secured creditors above the interests of unsecured creditors in liquidation. Sometimes, the company might intend to repay the principal sum and interest instead of converting the note to equity. Parties can agree that the note may be transferable to another person.

CONCLUSION

Parties to a CPN are advised to seek legal advice in the process of negotiating their agreements to avoid unintended outcomes as some of the terms of the agreement are technical and may be difficult to understand. Also, parties should always include a valuation cap in the agreement to avoid undue negotiation tension in the likely event of conversion. We also recommend that CPN be employed by tech companies with sound corporate governance structures to raise needed capital without diluting the share capital of the company.

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