CONVERTIBLE LOAN

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In the Brazilian Startup ecosystem, as they are instruments that guarantee equity participation to investors, Convertible Loan contracts are one of the main ways of financing, especially at the beginning of the company (early-stage).

A convertible loan is a loan with an option to convert into equity in the company. In the loan agreement, treated as a "lender", the investor lends money to the company, the borrower, receiving an option to convert its investment into equity or receive the money-back if certain contractual conditions are met. It is a contract very similar to debentures but not limited to corporations.

In addition, it is essential to clarify that the convertible loan, as it allows the redemption of the money lent to the company, differs from conversion options (known as SAFE) and subscription options (warrants).

After all, what are the benefits of convertible notes?

With the increase in the number of Startups and the increase in Venture Capital, convertible loans have been much more frequent among small companies.

The reasons are the most diverse for the popularization of the loan. Still, specifically, its simplicity due to low costs and greater agility in closing the round, compared to investments with the direct acquisition of shares and its pricing flexibility since there is no obligation to define a valuation for the company.

In Brazil, the practice has been different from what was planned for convertible loans compared to American Convertible Notes. Convertible loans are a specific instrument for rounds that act as a "bridge" to a more structured next round. Still, Brazil has consolidated itself as the main form of financing for seed-stage startups or even from the first substantial round (Series A).

One of the main reasons for the popularization is the limitation of the classification of corporations to the Simples Nacional, a shared tax collection, collection, and inspection regime applicable to Micro and Small Businesses, and its combination with the potentaial liabilities arising from equity investment in limited liability companies, such as labor, tax, and consumer debt risks.

After this stage, convertible loans appear as the widely used alternative to make these rounds viable, the transformation into a corporation (sociedade por ações) for the moment when the company is more mature and financially viable.

What are the main terms?

Nominal value:

The par value of the loan is the amount initially contributed by the lender (investor) that will be used to define the number of shares that will be converted for the lender's benefit at the time of their conversion. The contribution may depend on certain requirements conditioned to the achievement of certain goals by the company, either in installments or in cash.

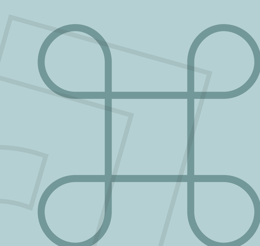
Interest and monetary restatement:

As it is an instrument initially intended for converting interest in the borrower, interest rates are usually low, aiming only to ensure that the credit does not depreciate over time, as there is no initial expectation that the lender would profit from the loan redemption, but with the conversion itself derived from the contract.
It is important to note that interest may or may not be convertible into shares, even if the standard in the Brazilian market is non-convertibility, since the conversion of interest ends up implying an additional discount on the valuation of the round due to the payment of the tax income by the investor.

Due date:

It is the moment when the borrower owes the payment, either in the conversion or even in the redemption, if that is the option. In the case of conversion, payment is made in shares, according to the valuation or mathematical formula originally negotiated between the parties.
Choosing the expiration date establishes expectations regarding when the company will be mature enough to carry out the transformation into a corporation and receive its first institutional capital. As a rule, a longer-term is more beneficial to the company as it guarantees a long period for improvement and guarantees that the transformation into a corporation will occur at the right time, with no loss to the company as a result, as companies often do not economically support the transformation and its resulting obligations.

Conversion:



This is the main topic of the list and the main object of convertible loan agreements. Conversion depends on the occurrence of some event, such as expiration or completion of a qualifying round. In these circumstances, the conversion may be automatic, regardless of the investor's approval, or optional, depending on the investor's consent. In both cases, the conversion does not depend on the company's will.
Maturity is usually a case of optional conversion in loan agreements. On the other hand, the qualified investment round is usually a hypothesis of automatic conversion of the mutual, as the main objective of the investment has been achieved.
Due to the conversion, a range of terms opens that are also worth mentioning:
Qualified Investment Round: A qualifying round is an investment made by one or more investors, generally greater than a pre-defined minimum amount, carried out with the direct acquisition of shares. The minimum amount varies greatly depending on the context of the company. It can be defined as guaranteeing investors that they will only lose their redemption right if the company demonstrates its operational viability and ability to finance itself adequately.
Valuation: The valuation represents the "fair" value of the company through an agreement between the parties on the investment date as the original idea of convertibles was to allow the postponement of the valuation definition until the moment of conversion when a qualified contribution occurs. Therefore, the concepts of valuation cap and discount were created. A valuation ceiling is an incentive to the investor that serves as a protection mechanism that the investor (lender) guarantees the limit up to which it accepts to be diluted in the next investment round.
Discount: Also an incentive to the investor, the discount is a percentage applied to the valuation of the qualifying round that guarantees the investor, holder of the convertible loan, better conditions for new investors because the investor should be rewarded for the additional risk he took by investing earlier in the business. The fee is usually 10% to 30%.

And, finally, among the advantages and disadvantages of convertible loans, we can list them as follows:

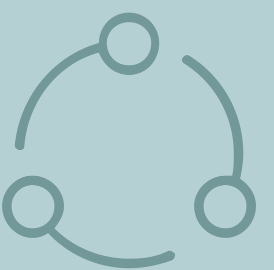
I.

Greater agility and lower costs compared to other routine contracts such as share subscription contracts, for example, and because they are cheaper and more agile rounds;

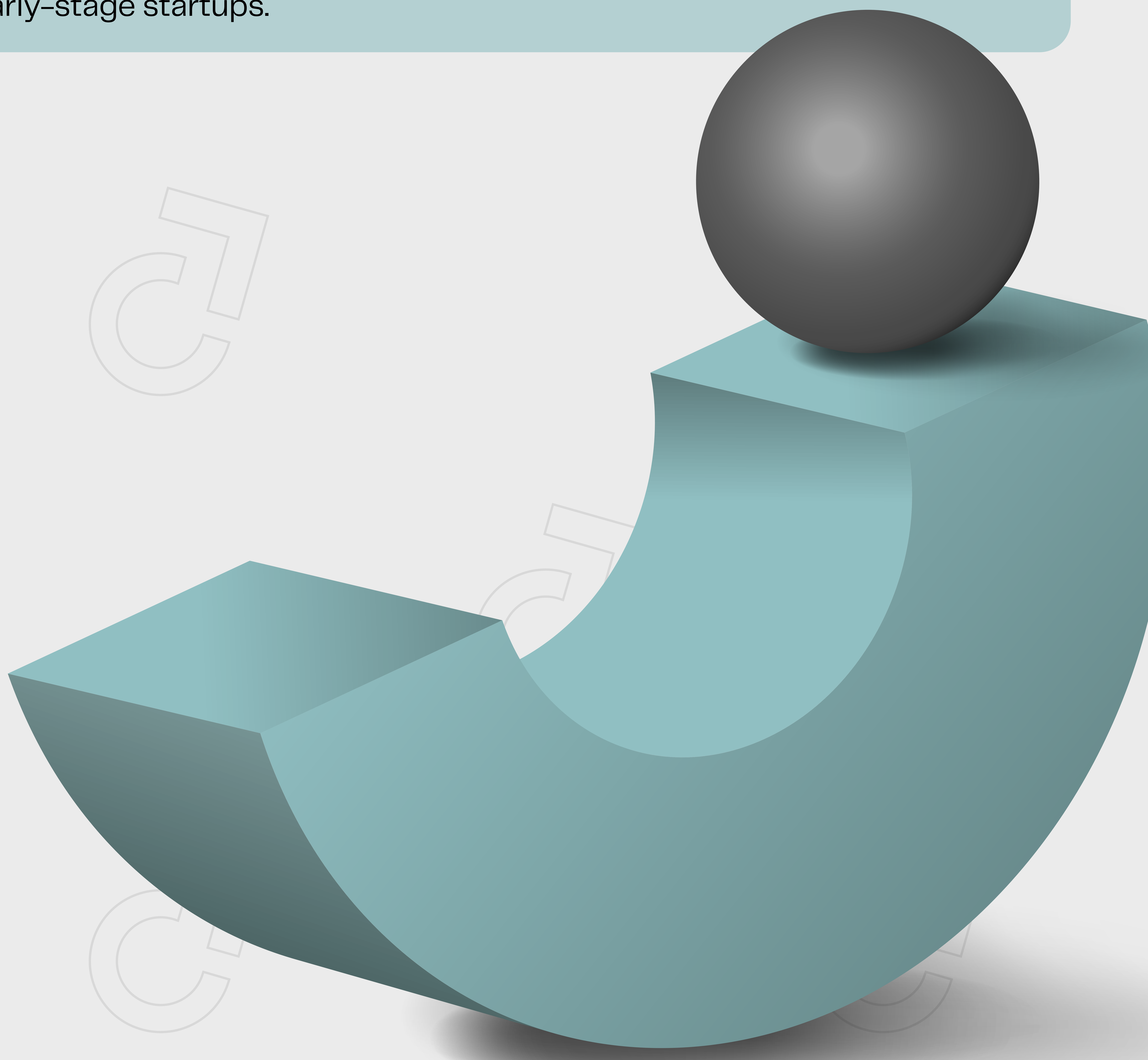
II.

Asset protection since, as are common judicial decisions that authorize the disregard of the legal personality of limited liability companies, the convertible loan allows the conversion to be postponed until after the transformation into a corporation, when the risks for the investor become much lower; and

III.



Flexibility in pricing due to the permission for the round to be negotiated without a fixed valuation marking, thus using the cap & discount, a practice that allows investors and entrepreneurs greater flexibility in efining terms, a factor of great quality for early-stage startups.



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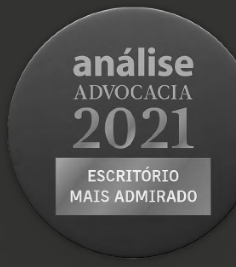

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