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FILLING THE FUNDING GAP: CONVERTIBLE LOANS AS AN ALTERNATIVE FINANCING SOLUTION DURING TIMES OF MARKET VOLATILITY

2020 has been a turbulent time for the global economy. A pandemic, geopolitical tension, trade wars and an impending 'Brexit' have created a fragile investment environment beset by ongoing volatility in both public and private debt and capital markets. This environment poses problems for many investors, debt or equity, as economic forecasts swinging between questionable optimism and extreme pessimism make it difficult for investors to price those assets that do come to market. But that is not to say that businesses are not in need of capital, nor that there is any absence of investors willing to provide it. Instead, rather than refusing to invest entirely, investors' approach in some situations has been to shift away from traditional debt and equity financing structures into more bespoke financing solutions better suited for such uncertain times.

Convertible loans are one such financing solution that appears to be finding favour with investors who are looking to deploy equity capital but are facing difficulties in doing so given the current market conditions. This article looks at some important considerations for parties in documenting a convertible loan, in particular, the extent to which the loan terms reflect a debt or an equity instrument and how those terms are impacted by the key commercial features of the investment.

With their hybrid nature, convertible loans can be a helpful tool for investors by generating a fixed return on capital deployed as debt now, with the flexibility to capitalise that debt and achieve an equity upside at a later date (presumably once the investor has a clearer picture of the value of the underlying business). Given the lack of clarity surrounding COVID-19 and its ongoing impact on business and the wider economy, this feature of convertible loans makes them an intriguing option for investors when considering alternative financing solutions.

Overview of convertible loan agreements in the current market

A convertible loan is traditionally a short-term loan that may be converted into equity at a later date – usually a fixed date or upon the occurrence of a particular event (such as an IPO, change of control, or at the election of one or both of the parties). Conversion is typically available to the investor at a discounted share price to a future valuation of the underlying business. Prior to conversion, interest will generally accrue on the unpaid balance of the loan. Interest is often capitalised and added to the loan balance up until the point of conversion (i.e., PIK rather than cash-pay). This reflects, first, the desire to preserve the short-term liquidity benefit for the company that debt service would otherwise erode and, second, the fact that the investor's return is intended to come from an equity upside and the coupon is primarily a risk-mitigation feature.

One of the key advantages of a convertible loan is that an investor can generate a fixed return from the interest accruing on the loan, while retaining the option (and sometimes an obligation) to convert that debt to equity at some point in the future. Structuring the investment as debt prior to conversion is also attractive to investors because the unconverted debt will rank higher than the existing equity in an insolvency of the borrower, thereby increasing the investor's chances of recovering its investment. A convertible loan therefore can be viewed as a less risky investment than a simple subscription for equity.

A long-time staple of start-up funding, the current investment environment suggests that convertible loans may come into sharper focus as a financing solution for a broader range of businesses. The impact of the COVID-19 pandemic has forced even companies that are already successful to analyse their business model and implement new strategies. In this respect, mature businesses are operating more like start-ups in requiring injections of cash to develop growth segments and bridge the gap to a future liquidity event. Convertible loans allow a business to source this liquidity now at a fixed coupon, while compensating the investor for what is likely to be a riskier investment by giving them a right to share in the business's upside.

When it comes to documenting a convertible loan, however, its nature as a hybrid debt/equity instrument begs the question whether the terms of the loan should align more with those of a debt instrument or an equity instrument. The answer to this question lies in the key commercial features of the investment, namely, factors such as the size of the investment, the investment timeline and the valuation mechanism and triggers for conversion. These factors will determine the extent to which an investor will want to include more restrictive 'debt-like' provisions (such as negative covenants and information undertakings) or take a more M&A-style approach to the documentation (for example, by conducting a more extensive due diligence exercise and adopting M&A-style warranties). Some of the more pertinent debt and equity terms to consider are highlighted below. These are not the only considerations parties should bear in mind when considering whether to enter into a convertible loan, however, and parties should work closely with their legal and tax advisors to ensure that a convertible loan is suitable for their particular situation.

Equity considerations

In determining equity conversion mechanisms, parties tend to focus on the upside opportunities that are being created. However, it is important that the investor understands exactly how a conversion will be achieved (from both a legal and practical perspective), and what investor and ongoing shareholder protections they want to secure. Some of the key questions an investor should ask themselves are:

- **Timing** – In considering whether a convertible loan agreement is appropriate, investors should first think through when the conversion will take place. What is the investment timeline/term of the loan, and how realistic is the intended exit/conversion event (for example, an IPO) in the context of that timeframe? The intended tenor of the loan may determine the value placed by the investor on including 'debt-like' loan terms as a means of protecting their interests during the pre-conversion period.
- **Control** – Another overriding theme to consider is control, both during the period prior to conversion and with effect from

the moment the investor becomes a shareholder. Does the investor want to have a board seat (or even special decision-making powers) to have a say in strategic decisions that may impact the investor's conversion rights? What investor protections will be included in the shareholders' agreement (for example, provisions such as drag, tag and transfer restrictions) and will any special rights attach to the shares that the investor will receive? Parties should be careful not to trip over regulatory disclosure or notification requirements in this context.

- **Types of conversion rights** – The investor will want to consider the different types of conversion rights available to them. Will the conversion be mandatory or at the discretion of the investor or the business? If the trigger is mandatory, what events or circumstances will result in a conversion? Do existing shareholders have any veto rights that could prevent or inhibit conversion? In this regard, it is necessary to consider any ROFO or pre-emption rights that may need to be worked through. An investor will always prefer to have control over whether the loan is redeemed or converted, and the business's existing shareholders will typically seek to ensure that the loan will convert in a wide-range of circumstances, and that the existence of the convertible loan will not prevent the business from future rounds of equity funding or an exit.
- **Conversion mechanics** – Another point for consideration is how the conversion will be effected. When the conversion right is triggered, will the conversion be by way of a new share issuance or a transfer of existing shares to the investor? Will the conversion mechanics vary depending on the nature of the conversion event? The mechanism will ultimately be driven by where the debt sits vis-à-vis where conversion is intended, and the role of minority interests in the capital structure of the business.
- **Conversion price** – Perhaps the most obvious point to consider from an equity perspective is the conversion price and the mechanism for valuing the shares for the purposes of conversion. A valuation cap may be placed on the business, thereby setting a maximum price per share for the conversion. If the actual valuation of the shares at the time of conversion is higher than the agreed cap then, for the purposes of calculating the number of shares to be issued or transferred to the investor, the valuation will be deemed to equal the cap. A valuation cap protects the investor in circumstances where the business's valuation increases rapidly. Parties may also agree to fix the valuation of the business at a particular price for the purposes of conversion. Where this occurs, investors will want to ensure that the terms of the loan restrict the business and its existing shareholders from undertaking activities that could reduce the business's value without the investor's consent.

The answers to these questions will also feed into the role of due diligence and the investor's approach to the transaction generally. Where conversion is intended to occur on a hardwired date or upon the occurrence of an event outside the investor's control, the investor will likely place greater weight on its due diligence of the underlying business. This may be particularly important where the constitutional documents of the conversion entity (such as its articles of association (or equivalent) and any shareholders' agreements) contain restrictions on transferring or issuing shares (such as drag or tag rights, or any rights of pre-emption). In negotiating the share class and other rights associated with the conversion shares (for example, voting, dividend and distribution rights), the investor should always consider the role of the existing shareholders and whether their shareholding will be diluted.

Debt considerations

As we highlight above, the extent to which a convertible loan arrangement incorporates traditional 'debt-like' terms will be driven by the key commercial features of the investment. In circumstances where the term of the loan is lengthy, or where a specific valuation of the conversion shares is hardwired into the loan documentation, an investor may want to ensure that the loan terms adequately protect it from value leakage and dilution. Some of the terms that investors are likely to focus on in this respect are:

- **Negative covenants** – One of the main ways an investor can regulate the activities of its borrower and the underlying business prior to a conversion event is to include a suite of negative covenants in the loan documentation. The particular areas of focus for the investor are likely to be, among other things, those covenants that regulate the business's ability to dispose of assets, to incur further indebtedness, to make distributions to its shareholders, and to restructure its share capital. Restrictions such as these may provide the incoming investor with comfort that the existing shareholders will not impair the value of the business prior to the investor becoming part of the equity.
- **Representations and warranties** – In the same vein as negative covenants, the representations and warranties required by an incoming investor are likely to reflect the level of risk associated with the investment and the extent of the due diligence it has undertaken. In this regard, parties should consider the role that due diligence should play in the overall transaction, and where the representations should fall on the spectrum between traditional 'debt-like' representations and more all-encompassing M&A-style warranties. Such an exercise may not be necessary if the trigger for future conversion is tied to a liquidity event that will involve a wider due diligence exercise (for example, an IPO or capital markets issuance).

- **Information undertakings** – Having visibility of the financial condition of the business in which it is investing is likely to be an important consideration for an incoming investor. This is particularly pertinent where the investor does not have board participation or observer rights, as there are likely to be information asymmetries between the investor and the business's existing shareholders. Common information undertakings include the provision of regular financial statements, obligations to disclose correspondence between the business and its shareholders and/or creditors, and obligations to disclose the occurrence of material events in the course of the business's day-to-day operations (for example, the commencement of material litigation against the business).
- **Financial covenants** – Linked to the provision of financial information is the question of financial performance and whether a deterioration of the business's financial condition should trigger consequences under the loan documentation. While by no means a regular feature of convertible loans (particularly in a start-up context), a financial covenant may be appropriate in loan arrangements of a longer tenor and/or where a fixed valuation of the conversion shares is hardwired into the documentation. In this context, an investor may require additional rights, changes to valuation methodologies, or even the repayment of the loan, if the financial condition of the conversion entity deteriorates beyond a particular point.

The extent to which the business's existing shareholders are willing to cede control/influence over the business's activities to the new investor will ultimately be driven by where the leverage lies in the course of the parties' negotiations. The existing shareholders may feel that the incoming investor is sufficiently compensated by the interest rate applicable to the loan, or by the potential upside that the investor stands to derive upon conversion, such that significant protections under the loan terms are unwarranted. Conversely, where the incoming investment is critical to the ongoing health of the business, or represents a substantial portion of the business's future capital, the new investor may be in a position to insist upon a greater number of more 'debt-like' protections in the documentation. Exit considerations may also have an impact on negotiation dynamics, as negative control and access to non-public information may have implications for a future IPO or sales process.

Conclusion

We live in an uncertain investment environment for debt and equity investors alike. While this has made it more difficult for some businesses to attract investment through more conventional means, it has created an opportunity for alternative financing solutions to fill the resultant funding gap. Given its inherent flexibility as a hybrid debt/equity instrument, a convertible loan represents one such solution. Although by no means a 'one size fits all' for investors, the variety of structuring options for a convertible loan financing mean it is a worthy alternative for counterparties to consider where the transaction features and wider tax considerations permit.

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