

The Great Convertible Note Debate...What New Angels Need to Know

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Moderator: John Huston

Types of Notes

Bank Loans

Asset Based Loans

Mezzanine Debt

High Yield Notes

Venture Debt

Revenue Participation Notes

Convertible Notes (*This session's focus*)

Convertible Notes Defined

Capital raised by early stage ventures via selling notes that convert into the next equity round:

- Originally just bridge notes
- Often bought by those who were buying the equity later
- No cash interest is paid (accrued)
- Buyers expected notes to convert, not be paid at maturity
- Economics may include a conversion discount, a valuation cap, and/or warrant coverage

5 Convertible Note Issues to Consider

- 1) Convertible Notes are not “BAD” or “GOOD”just “BETTER” in some instances than others
- 2) Key components affect economics vs. control
- 3) 3 viewpoints: entrepreneur, Board member, angel purchaser
- 4) Honoring the terms & conditions: “Inside” or “Outside” round?**
- 5) What are the venture’s likely outcomes (“Outcomes Map”)?**

“Inside” versus “Outside” Rounds

One important factor that affects the appropriate terms and conditions is whether the next equity round into which the notes will convert will be an “inside round” (comprised of current noteholders and shareholders) or an “outside round” (requiring a significant number of new investors to fill out the financing). **With inside rounds the odds that the conversion discount will be honored are probably higher than with an outside round.**

Outcomes Map.....the company might.....

- 1) Go out of business
- 2) **Bootstrap, never raising any more capital prior to the exit**
- 3) Sell more debt
- 4) Sell more equity
- 5) Sell more debt & equity (in which order?)
- 6) Be bought prior to ever raising more capital
- 7) Be eventually bought/IPO-ed after subsequent rounds of capital
- 8) **Become a zombie (surviving, but incapable of luring an acquirer)**

4 Handouts (14 pages)

- Checklist of the 18 basic terms for debt term sheets (2 pages)
- Glossary of 26 Convertible Note Terms (4 pages):
 - Economics issues = 13
 - Control issues = 13
 - 26
- 40 Advantages + 38 Disadvantages of convertible notes (7 pages):
 - The Entrepreneur's viewpoint = 32
 - The Angel Purchasers' viewpoint = 32
 - The Director's viewpoint = 14
 - 78
- *"Is it wiser to buy convertible notes or preferred stock?"* (1 page)

Annarie Lyles

An angel investor since 2011, Annarie has invested in several dozen companies that fit the theme of "healthy living systems" -- she gets excited by innovations that prevent pollution and disease, or promote environmental sustainability. She is a member of Jumpstart New Jersey and serves as president of the Philadelphia chapter of Investors' Circle. Annarie has been a mentor or partner to entrepreneurs, both informally and via accelerator programs, and she sits on several non-profit and for-profit boards. Raised in a California business family, Annarie earned degrees in biology from Yale and Princeton. During prior careers, she negotiated biotechnology deals to develop new immunotherapies and managed more than two dozen transactions worth over \$2 billion, helped run zoos, advised endangered species breeding programs, and enjoyed ecology adventures in the tropics. She lives in Princeton, NJ with an ecology professor and their two young adults. Annarie relishes woodland rambles with friends and hounds, and has recently rediscovered the joy of SCUBA.

David J. Sorin

- Dave Sorin is a partner at McCarter & English, Chairing the Venture Capital & Emerging Growth Companies practice. He focuses primarily on privately- and publicly-owned startup, early stage, emerging growth, and middle market technology, tech-enabled and life science enterprises, as well as the investors, executives, and boards of directors who support and lead them. Dave has a long track record of successful representation of growth companies, having been repeatedly recognized by well-known periodicals for a unique combination of legal acumen and sound business judgment. He also brings to bear his broad range of knowledge and experience in counseling enterprises and investors in diverse emerging growth markets, technology industries (including software, information technology, e-commerce, cybersecurity and communications), and life sciences. Many of the companies he represents are well-known names throughout the Mid-Atlantic region.
- One industry-leading publication has recognized Dave as one of New Jersey's top 100 business people, categorizing him within an "elite group" of executives who "are the voices of their industries." He was later identified by another industry publication as one of the region's "top deal makers." *Chambers USA*, an international guide to lawyers and law firms, called Dave the State's top corporate lawyer. Most recently, *SmartCEO Magazine* named McCarter the New York region's large law firm of the year in the tech and tech-enabled industry sector and named Dave the leading lawyer in that category. He has been named a Super Lawyer in each of New York, New Jersey and Pennsylvania.

Today's Agenda

- Advantages & disadvantages of convertible notes
- Experiences with convertible notes
- Q & A

QUESTIONS & REBUTTALS

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