The rising popularity of Convertible Loan Notes

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We have recently advised a number of clients, particularly in the Digital Media & Technology sector, on the issue of Convertible Loan Notes or "convertibles" (CLNs).

Imported a number of years ago from the US, CLNs are nothing new – but they becoming more popular as a means of raising finance in relatively short order, particularly by early-stage companies prior to closing a funding round.

CLNs are issued to one or more investors (called **Noteholders**) and provide evidence of a loan which can be converted into equity (shares) in certain circumstances. Each Noteholder is given a certificate by the company as evidence of the CLNs issued to them.

Unfortunately, CLNs are not currently eligible for Enterprise Incentive Scheme (**EIS**) or Seed Investment Enterprise Scheme (**SEIS**) relief. This is because HMRC takes the view that when CLNs are converted into shares, this is by way of repayment of a debt rather than a high-risk investment and therefore the issue of shares in these circumstances is not a "qualifying business activity". It seems unlikely that this will change in the near future.

From an investor's perspective, they will want to be compensated for losing the benefit of EIS or SEIS relief. This is achieved by balancing the amount of interest payable (we have seen rates of 5-15%) on the loan with a discount to the share price (we have seen rates of 10-40%) on the next funding round or on an exit being achieved.

For example, if a noteholder lends a company £100,000 and agrees a conversion price which represents a 10% discount to the share price on the next funding round which is £5 per share, the noteholder would receive 22,222 (rounded down) shares (100,000/(5*90%)).

The key variables to be agreed between a company and the noteholders are:

- **Security** – CLNs are typically unsecured, though they can be secured depending on the risk profile for the investor.

- **Interest** – the amount of interest payable on the loan until it has been repaid or converted into shares. Given that the purpose of CLNs is typically to provide bridging finance, it is usually agreed that the interest will "roll up" and only be paid by the company in certain circumstances.

- **Discount Rate** – the discount to be applied to the share price on the next funding round or exit. It may be agreed that a higher discount rate is applied if the company raises less than a target fundraising amount and a lower discount rate is applied if the company meets or exceeds a target fundraising amount.

- **Conversion Cap** – while more common in the US, "capping" is where the company and investor agree a minimum pre-money valuation for the company so that if the company raises less than a target fundraising amount, the investor knows what the worst scenario will be at the outset. It may be possible to agree this cap if a funding round is anticipated in the near future. However in our experience, CLNs are typically uncapped with the risk to the investor being reflected in the discount rate (as noted above).

- **Conversion Events** – these are the circumstances in which the debt should be converted into shares. Usually, CLNs will automatically convert into shares if the company meets a target fundraising amount by a target date.

However CLNs may also be converted into shares at the option of the Noteholders if the company raises less than its target fundraising amount, a certain date is reached without any funding round or exit being completed or there is an interim “change of control” of the company.

- **Redemption Events** – these are the circumstances in which the debt may be redeemed, or repaid, by the company. Usually, this would only happen where the company has raised less than a target fundraising amount, a certain date has been reached without any funding round or exit being completed or there is evidence that the company is in financial difficulties.

Whether you are an investor or a company seeking to use CLNs, we can help. Having advised a number of clients on CLNs, we are able to provide a quick and cost-effective service. Please get in touch with a member of our Corporate team to discuss further.

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