QONVERSATIONS WITH QAPITA

QONVERSATIONS ON FUNDING INSTRUMENT CHOICES FOR EARLY STAGE FOUNDERS

SPICE ROUTE
FINANCE

MODES OF FUNDING

Instrument	Convertible Notes and Convertible Debentures	Equity	Grant	Debt	Revenue Based Financing
Use Case	Ideation, Testing, Market Study, Initial traction, MVP	For strategic scaling, early working capital and team buildup, PMF	For new product development, Pilot, Proof of concept, Prototype	For working capital, Bridge funding	Increase your runway during the scale up phase.

WHEN SHOULD A FOUNDER CONSIDER THESE INSTRUMENTS?

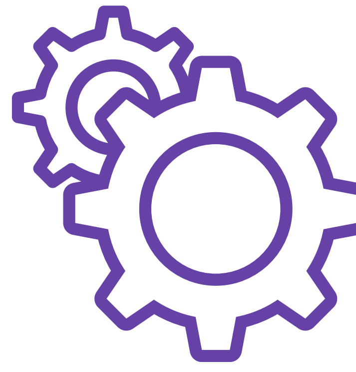
Security Type	When to use the instrument?
Equity shares	For strategic scaling, early working capital and team buildup, and achieving product market fit, and the founders are willing to dilute
Compulsory Convertible Preference Shares (CCPS)	In the early stages, when determining a valuation is difficult, because of a lack of cash flows. These give investors some special rights and allows investors to convert their investment into preference shares.
Compulsory Convertible Debentures (CCD)	Same as CCPS but provides investors are entitled to earn some interest income. These are compulsorily converted to equity after a set term. . Best for early stage companies with unstable cash flows
Convertible Notes	The underlying principle is the same as CCDs but there is no compulsory conversion needed. The conversion generally occurs after a subsequent round of funding. Best for early stage companies with unstable cash flows.

FUNDING CHOICES FOR FOUNDERS

At various levels within the early stage, founders have exposures to different fundraising opportunities:

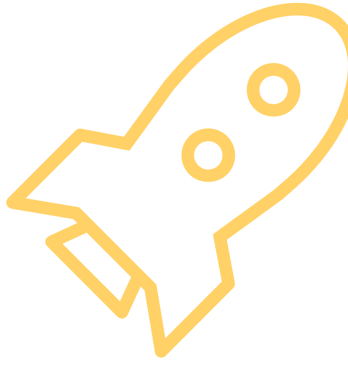
IDEA

Types of Investor
Friends/Families, angel networks



MVP

Types of Investor
Incubators/Accelerators, micro VCs



PILOT

Types of Investor
Micro VCs

PMF

Types of Investor
VCs

EQUITY SHARES

Founders generally dilute equity when they require infusions for wide strategic scaling.

We usually advice founders to achieve the product market fit status where there is proof of value of the product and there is a demonstrable proof of scaling.

Diluting equity at such a stage is not only beneficial for the company but also the investors, who are likely to benefit from the improved scalability.

COMPULSORY CONVERTIBLE PREFERENCE SHARES (CCPS)

1

CCPS are preferred by investors when the company is in the early stages.

2

Usually, investors like these instruments because:

- Extra protection in a liquidation event: They have prior claim over the company's assets as per the waterfall mechanism

3

The main privilege comes in the form of their conversion being linked to company performance.

4

Investors can chip in resources at a lower valuation and eventually convert shares to equity- which means you can get a higher dividend without committing more capital

5

It's also not a burden on the startup as there are no debt repayments.

6

There are a hefty amount of compliance requirements:

- A valuation report and certificate is needed
- FEMA rules and FDI rules will also apply as they allow foreign investment

COMPULSORY CONVERTIBLE DEBENTURES (CCD)

CCDs are a hybrid instrument that mandatorily get converted into equity after their maturity period lapses.

The RBI's guidelines state that they are to be treated as equity but not the company's share capital. Thus they can provide security to investors in the form of debt repayments but are ultimately converted to shares.

CCDs are also easier to invest in for foreign investors as opposed to other convertible securities

There are many regulatory hurdles of using this instrument:

- A valuation report and certificate is to be obtained from a certifying officer at the time of investment
- Alignment with FEMA guidelines, SEBI rules and FDI regulations and procedures is a must.

CONVERTIBLE NOTES

These are debt instruments that give the investor the right to convert to equity. There is no compulsion

Conversion generally happens at the time of subsequent funding that the venture receives

The compliance requirements are fewer:
- No valuation report and certificate needed

However, only "recognized" startups can issue convertible notes as per RBI regulations and The Companies (Acceptance of Deposits) Rules of 2014.

SAFE (SIMPLE AGREEMENT FOR FUTURE EQUITY)

SAFE is termed as an "equity derivative contract" which will convert initial capital invested into company stock based on contractual terms & conditions.

SAFEs are popular worldwide because there is no interest repayment, no maturity date, no compulsory conversion.

The conversion is dependent on contingent events, making them more flexible.

SAFEs were not successful in India because they cannot be classified as debt or equity, and are not recognized as a legitimate instrument.

iSAFE (India Simple Agreement for Future Equity)

iSAFE is a standardized, template driven agreement that is gaining traction in India. It is a hybrid of all the securities mentioned above and is neither debt or equity.

However it can be regulated by Company Act, 2013 as a CCPS, which makes it secure.

In case of failure, all the assets that remain after the liabilities are returned belong to the investors.

It is free from all the tedious documentation procedures that need to be adopted in case of CCDs.

CONVERSION PROCESS

The conversion process entails converting a hybrid security into equity.

Conversion tends to be subject to various terms and conditions that have to be agreed upon by the investors and founders.

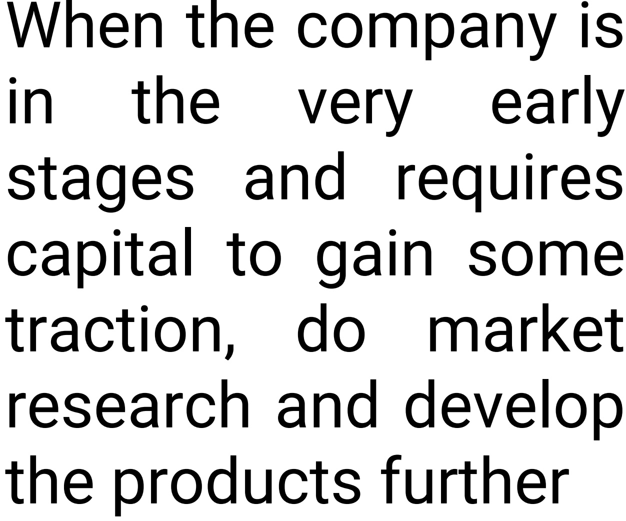
Some key terms that founders should understand:

- Valuation floors and caps: These protect the investors holdings
- Discounts: Allow investors to benefit off lower valuations in the subsequent rounds

In our experience, discounts can be subject to company performance and even the time taken to raise subsequent rounds.

WHEN SHOULD YOU USE CONVERTIBLES?

When the company is in the very early stages and requires capital to gain some traction, do market research and develop the products further



When raising bridge rounds in between funding rounds to extend the runway and keeping valuation stable or growing

When the valuation is undetermined.