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Convertible Financing 101 for the Entrepreneur

In this month's installment of Ophthalmic Product Development Insights, we'll explore convertible notes for seed financing for the early-stage entrepreneur. (As a general rule, neither this article nor any article constitutes legal advice and you should always consult your attorney when getting down to the specifics.)

Before discussing how to approach and use a convertible note, it helps to define some terms. A convertible note is essentially an I.O.U. issued by the entrepreneur's company to the investor in exchange for the investor making a loan to that company. The note can usually be paid back in cash or equity and it is usually set up to automatically convert into equity upon a subsequent financing event (usually referred to as qualified financing). While there are certainly a few more details to keep in mind, the beauty of a note is that it allows the entrepreneur to access much needed financing with simple documentation and without the need to negotiate the terms of a larger equity financing. The note also allows the entrepreneur to avoid the complications and costs that can arise from negotiating a company's valuation without key data points, the impact of that valuation on incentive equity/stock option grants, and the related potential tax implications of equity and/or stock options, giving him the ability to focus more of his time and energy on advancing his vision. On the investor side, the variables, or toggles, referred to as the conversion discount and/or capped price per share (or valuation cap) can allow investors to have the amount of their loan, plus accrued interest, converted into equity at a reduced price relative to the other investors in the subsequent, qualified-financing round. The investors receive these terms to offset some of the early-stage risk they are taking on, as compared to later investors.

Now, on to connecting the dots.

Say you have an idea—maybe even a patent filed—and some early, "reason-to-believe" evidence. The evidence could be preclinical or clinical data and all you need to do is move the project forward to some value inflection point in order to attract investment. Therein lies the proverbial "chicken-or-the-egg" scenario: How do you finance the activities necessary to get to the larger value inflection point when pharma companies, biotech companies, venture capitalists and other institutional investors are often not willing to invest prior to seeing proof of concept? The targeted disease, the *in-vivo* target, the signaling pathways, the clinical development path and the regulatory path are just a few of the considerations at the forefront of the potential investor's mind, any one of which could be a gating item to their investment (a gating item is something that the investor needs to see before proceeding to the next step). Objective manifestations of value such as: a crucial animal model showing efficacy against the standard of care; an *in-vivo* pharmacokinetics study demonstrating sustained release of the delivery plat-

form; or a pre-investigational new drug FDA meeting to firmly establish the development plan and approvable endpoints will help the potential investor get comfortable enough to make that leap. Yet, the achievement of these milestones can't happen without some basic funding. In these types of situations, a convertible note may allow you to access this much needed early-stage capital to fund the efforts necessary to reach these initial proof points and help facilitate a subsequent, much larger pharma, biotech or VC deal. The reader should note that this paradigm is not only applicable to attainment of the first round of substantial external investment, but may also be applied to increase asset value between rounds of investment. Here is an example of how a note might work:

Imagine an investor agrees to loan an entrepreneur $1 million in exchange for a note in the amount of $1 million plus interest that accrues at a rate of 4 percent per year. The note stipulates that the investor can require the entrepreneur to pay the loan back in cash or equity on or after the maturity date of the note. The note further stipulates that when the entrepreneur is able to raise $4 million in financing from other investors (the qualified financing step) the note will automatically convert into equity. Without taking into account the conversion discount and/or capped price per share (valuation cap), the amount of equity (in number of shares) received by the investor will be equal to the principal amount plus interest accrued divided by the share price offered to other investors at the qualified financing. In order to account for the fact that the initial investor (noteholder) put her money in at an earlier stage than the other investors (involving more risk due to less proof of concept/efficacy), the note will generally grant the noteholder a conversion discount and/or capped price per share (or valuation cap). The conversion discount is a multiplier that allows the noteholder to essentially get more equity (shares) for the same dollar amount.

By way of example, if the share price is $1 and the conversion discount is 20 percent, then the $1 million note (interest omitted for simplicity) would autoconvert into 1.2 million shares at the qualified financing. The conversion discount is a useful tool when entrepreneur and investor are far apart with regard to their respective views on the value of the asset/company at the time the note is issued.

Additionally, if the investor and entrepreneur are less far apart regarding the asset/company valuation when the note is issued, the toggles referred to as capped price per share (or valuation cap) can be used to account for the same concept of the initial investor putting money in at a more risky stage. The capped price per share and valuation cap toggles create the same net effect because they both put a maximum on the share price that the investor (noteholder) will pay at the qualified financing stage, regardless of what other investors are paying.

Finally, it should be noted that the share price paid by other investors at the qualified financing round may be solely derived from a formal valuation of the asset/company at or around the time of the qualified financing or it may simply be negotiated by the other investors and the entrepreneur (taking into account valuation on some level). The take-home lesson is that the basic structure of the note (simplified here) is adaptive and thus opens the door to attractive scenarios for both entrepreneur and early investor.

Bearing in mind the adaptive nature of convertible notes and further expanding upon their potential application, the entrepreneur should note that the loan/investment can also be made in the form of discounted or "free" services-in-kind. For example, you may be looking for a loan because: you may require key proof-of-concept preclinical work; external consultants may be needed to hone clinical development plans; or maybe a pre-IND meeting is critical to convincing VC investors to support the budget for further clinical trials, and medical writing and regulatory support is needed. In such scenarios, an entity that provides those services may be willing to provide them at no charge or at a discount in exchange for the issuance of a convertible note. This bartering services for equity is an especially powerful catalyst because it makes it easier for the investor to make the investment (and invest more) since his investment isn't in the form of cash.

The convertible note is a critical financing arrow in the entrepreneur's quiver. As you're likely to also be managing a busy clinical practice, these arrangements can allow quick, easy access to funding so that you can focus on creating value with R&D. The key to ensuring a successful transaction is maintaining an open dialogue so that both entrepreneur and investor understand each other's objectives and sensitivities. Topics such as dilution, granting increased upside in exchange for early investment, protection of downside risk, timing of potential licensing/exit transactions and considerations of whether such an event is expected prior to or after a qualified financing and the mechanics of how such an event is dealt with, etc., will most likely arise. We will be delving into them in subsequent columns. With a spirit of collaboration and the goal of a win-win scenario front and center, the convertible note can be an efficient tool for funding early-stage assets, supporting established program acceleration and/or setting the stage for a mutually fruitful endeavor.

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