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Convertible loan notes

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A form of short-term debt that converts into equity, usually on a future financing round, the convertible loan note (CLN) has become increasingly popular in UK venture capital. It is worth noting at the outset that a CLN does not attract EIS relief in the same way that an advance subscription agreement can, although it does carry other benefits for investors.

What is a CLN?

A CLN is a type of debt instrument which can reward its holder for investing at the very early stages of a company's journey. In practical terms the investor loans money to the company and receives equity by way of return, at a lower price per share than the investors coming in at a future financing stage. Often if a future financing round does not occur by a given maturity date, the company is obliged to repay the principal amount loaned, along with any accrued interest. There can also be other triggers for conversion to equity (beyond a future financing round), such as a change of control.

Conversion

Discount rate and valuation cap

Not all CLNs contain both, but the discount rate is the percentage discount received by the CLN holder relative to investors in the future financing round and the valuation cap is a fixed valuation set at the date the loan is made, capping the price at which a CLN converts into equity.

It is common to see a conversion price based on the lesser of the (i) discount rate or (ii) valuation cap, but the exact mechanism for working out the conversion price will depend on the agreement reached between the company and the investor and recorded in the CLN.

We'd typically expect to see a discount of 10-30% apply.

Interest rate

A CLN will often accrue interest (as it is essentially a loan) which, rather than being paid in cash, usually accrues to the principal sum invested which increases the number of shares issued upon conversion following a future financing round. If no financing round occurs by a CLN's maturity date, the company will be liable to repay the principal sum along with any accrued interest.

A 10% interest rate is fairly typical, although we often do see investors offer up an interest free initial period.

Why use a CLN rather than issuing straight equity in the company (or an ASA)?

Valuation

Primarily because using a CLN defers the question of company valuation, which is helpful for early stage businesses who don't yet have many data points to guide their valuation. Theoretically, more data will be available for the purposes of valuation at the point of the future financing round.

More for your money

A CLN holder can receive significant discount on the share price during a future financing round (meaning their money goes further). If a valuation cap is utilised and a company takes off, the CLN holder can sometimes find itself in an enviable position of not only receiving shares for significantly less than incoming investors, but also at a price much less than a standard discounted rate.

A CLN might also often allow a company to pay back the investor prior to a future fundraising (unlike an ASA, which is not a loan, more an upfront payment for shares), something which could be attractive where a company is scaling quickly and successfully and doesn't want to give too much capital equity away. However, most investors would seek to limit the scenarios the CLN can be paid without their consent as ultimately they are investing with a view to holding equity.

Cost

Utilising CLNs as a way of generating cash, especially in the early stages of growth, is generally quicker (and cheaper) than administrating a full equity round. In addition, it allows the company to be flexible in its approach, as it can offer different investors different terms and conversion prices.

On an insolvency

In the event of insolvency, the CLN holder (as an unsecured creditor) will also rank above the shareholders and give investors the best chance of recovering any of their investment in such scenario.