Raising Money With Short-Term Notes (*Entrepreneur Magazine* – June 1, 2003)

The question of using short-term notes comes up often regarding various ways to put together an equity funding deal for individual investors in your firm, while providing them with a measure of hedge protection as they try to make up their minds on the strength of your firm's prospects for sales and profits.

At issue is the arrangement under question, where a small pool of potential investors (perhaps two to three, or as many as four to six) would like to provide funding for your business, but they're also cautious and wish to hedge a bit on the timing for when they finally step out and commit to putting money into your firm. In many situations, they're waiting for some better news about the firm's dealings in the market or with a potential revenue contract prior to writing the check and taking their equity stake.

One way to structure the deal would be to allow them to first loan the money to the business with a built-in equity conversion feature as part of the loan contract. This provision includes specific terms and pricing for them to turn the long-term liability directly into an equity position in the business at a predetermined future date, if and when they think the time is then right to do so. If that time does not come, they can always remain a creditor to the company and receive traditional repayment of principal and interest over time, until the debt is paid back.

This type funding deal requires you to evaluate whether this is a good idea for the company and determine what types of risk exposure are related to these kinds of terms. There are four basic issues to contend with in this arrangement:

1. Will the outside funding parties request some form of collateral on the loan, which can either tie up company assets or put a lien on the owner's personal assets (house, car, boat, investment accounts and so on)?
2. At what price will the loan convert to shares of stock in the company? For example, will it be based upon a predetermined formula tied to some type of economic performance (a ratio based upon sales revenues, profits or assets), or will it be set today at a fixed conversion rate, regardless of future operating performance?
3. This issue deals with the timing on the conversion. Some deals are structured so that the debt converts to equity on a specific date that both the lender and the entrepreneur agree on. Others provide a window of time within which the lender has the option to convert the outstanding loan to a common stock equity position in the firm.
4. Which party holds the option to initiate the conversion process? For example, in some deals, the owners hold an option that allows them to turn the outstanding liability into an equity position for the former creditor. These are not as common as the opposite arrangement, where the lender holds the option and makes the decision to convert the debt to equity or not.

Perhaps the most typical configuration of these four issues is that the deal is a fully amortized, collateralized convertible loan with an initial term of four to five years, set at an interest rate that is pegged to the prime rate plus a margin (to cover the additional risk), with the principal and interest payments set up quarterly. The price at which the loan converts to the shares is preset, so the conversion is calculated by taking the outstanding principal loan balance and dividing it by the preset conversion price to determine how many shares will be issued. And the conversion is preset to happen at the lender's option within a window of time, normally anytime during the life of the loan.

It's also popular for the timing to be anytime during the first three years of a five-year loan, after which the option expires. This provision gives the borrower some protection of equity such that if the company can make regular payments on the loan for three years (out of five), the owners are probably more interested in paying off the loan in full and not having to give shares of stock to the lender through a conversion. Once the loan is paid in full, the liability is removed from the balance sheet and no equity is transferred, allowing the owners to keep their original stake.