FUNDRAISING – INSTRUMENTS & MECHANISMS

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CAN AN INVESTOR INVEST WITHOUT VALUATION?

VALUATION

- Startup valuation is the process of quantifying the worth of a company.

- Valuation discount: Early investors would get a pre-determined discount on the share price finalized after valuation.
- Valuation Cap: This is a mechanism which guarantees a minimum stake to the early investor

Parameters	Valued	Unvalued
Stage of Investment	Series A and Later	Pre-seed and Seed
Amount of Investment	Upwards of USD 500K	USD 100K-1Mn
Type of Investor	Marquee VC Firms	Angel Investors, Incubators, Accelerators, Micro VC Firms
Use of Funds	Scale product and generate revenue	Build MVP and get initial users
Instruments Used	CCPS, Equity	SAFE,CN,CCD
Time to conclude	3-6 Months	1-2 Months

When is Valuation necessary?

Under the Companies Act, while raising funds a Startup has to obtain Valuation Report by a Registered Valuer (RV) before issuing following instruments under Private Placement or on Preferential basis [Sec 62(1)(c)]

- Prior to issuing Equity shares, Partly or Optionally or Compulsory Convertible Preference Share or Partly Optional or Compulsory Convertible Debentures.
- Prior to issuing shares other than cash.
- Prior to issuing Sweat Equity shares either for cash or for consideration other than cash.

NON REQUIREMENT OF VALUATION

- Rights Issue
- Compulsorily Redeemable securities

CONVERTIBLE NOTE

- ➢ Convertible notes have sufficiently emerged as one of the **attractive forms** of raising capital **by start-ups in today's current market**.

- ➢ These **debt instruments allow investors to lend money to the company with the option to convert their debt into equity at a later date**.

✓These are types of debt security, **repayable at the discretion of the holder or which can be converted into equity stock at some future date not exceeding 10 years from date of issue of such convertible note under conditions stated in the instrument**.

✓The **start-up company acknowledging receipt of money (minimum Rs 25 lakhs from an investor) initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding ten years from the date of issue of the convertible note, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.**

DEFINITION UNDER COMPANIES ACT, 2013

- “Convertible note” is defined as an instrument evidencing receipt of money initially as a debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of the start-up company upon occurrence of specified events and as per the other terms and conditions agreed to and indicated in the instrument.
- The Act does not explicitly provide for issuance of convertible notes. However, Section 62(3) of the Act enables a company to raise loan with an option to convert it into equity.

Valuation requirement for Convertible Securities

- As per Sub-clause (h) of Clause (xii) of Rule 13 of the Companies (Share Capital and Debenture) Rules, 2014, where convertible securities are offered on a preferential basis with an option to apply for and get equity shares of the issuing Company, the price of the resultant shares pursuant to such conversion shall be determined either upfront at the time when the convertible securities is being offered or at the time, when the holder of convertible securities becomes entitled to apply for shares.
- Provided that the company shall take such decision at the time of offer of convertible security itself and make such disclosures in the convertible note agreement.

Exemption under deposit rules

Pursuant to Clause (xvii) of Rule 2 of Companies (Acceptance of Deposits) Rules, 2014, an amount of INR 25 lakhs or more received by a start-up company, by way of a convertible note (convertible into equity shares or repayable within a period not exceeding ten years from the date of issue) in a single tranche, from a person, will not be considered as a deposit.

Who can issue convertible notes?

Only Startups which are recognized by the Department for Promotion of Industry and Internal Trade (DPIIT), can issue Convertible Notes

Whom can Convertible notes be issued to?

- Foreign Investors
- NRI and resident Investors
- Indian Investors and Indian Companies

Issuance of Convertible Notes to person resident outside India under automatic route:
The Foreign Exchange Management (Non-debt Instruments) Rules, 2019 defines 'convertible note' as an instrument issued by a startup company acknowledging receipt of money initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding 5 years from the date of issue of the convertible note, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.

Individuals' resident outside India (excluding the citizens of Pakistan and Bangladesh or entities registered or incorporated in Pakistan or Bangladesh) may purchase convertible notes issued by an Indian startup company for an amount of Rs. 25,00,000/- or more in a single tranche.

ISSUANCE OF CONVERTIBLE NOTES TO PERSON RESIDENT OUTSIDE INDIA UNDER APPROVAL ROUTE:

- A person resident outside India may acquire or transfer, by way of sale, convertible notes, from or to, a person resident in or outside India, provided that the transfer takes place in accordance with the pricing guidelines as prescribed by RBI. Prior approval from the government shall be obtained for such transfer in case the startup company is engaged in a sector which requires government approval.

IT MAY BE NOTED THAT A START-UP ENGAGED IN THE FOLLOWING SECTORS AND EXCEEDS THE FDI LIMIT SPECIFIED IN THE SCHEDULE I OF THE FEMA ACT, 1999, REQUIRES PRIOR APPROVAL FROM THE CENTRAL GOVERNMENT BEFORE ITS CONVERTIBLE NOTES CAN BE CONVERTED INTO EQUITY SHARES.

1. **Banking;**
2. **NBFC's activities in Financial Services Sector;**
3. **Civil Aviation;**
4. **Petroleum including exploration/ refinery/marketing;**
5. **Housing & Real Estate Development sector for investment from persons other than NRIs/OCBs;**
6. **Venture Capital Fund & Venture Capital Company;**
7. **Investing companies in Infrastructure & Service Sector;**
8. **Atomic Energy & related projects;**
9. **Defence and strategic industries;**
10. **Agriculture (including plantation);**
11. **Print Media;**
12. **Broadcasting;**
13. **Postal services.**

WESTERN IDEAS IN INDIA

ISAFE (INDIA SIMPLE AGREEMENT FOR FUTURE EQUITY)

- SAFE stands for "Simple Agreement for Future Equity", and SAFE notes are a form of convertible security issued by very early start-ups to raise funds in their initial seed stage from individual angel investors. At this stage, it may not be possible to assign a value to the idea or minimum viable product. Thus, with no pre-money or post-money valuation, SAFE notes are an option to raise funds.

- It is a contract between the start-up company and the angel investors to issue them equity in the company at a future date at a valuation determined in the future subject to fulfillment of certain conditions with respect to valuation thresholds achieved by the company or capital infusion in a later round by qualified institutional Venture Capital (VC) funds.

WHAT ARE THESE SAFE NOTES?

- **NO INTEREST:** These are non-debt convertible securities. They are simpler than the terms of a convertible note which may attract payment of interest till conversion at a particular rate, and other clauses which may deter future equity investors. Thus, SAFE notes don't require payment of any interest.

  CONVERTIBLE TO EQUITY: They can be converted to equity shares in the future at a discount, which means initial investors may get equity from the start-up in the future at a price much lower at which investors put money in the subsequent rounds.

- **VALUATION REQUIREMENT :** These instruments are issued without carrying out valuation at the time of issuance, as valuation is deferred to future rounds.
- **MATURITY:** As it is not debt, there is no specified term of maturity other than conditions for conversion in the future.
- **ACCOUNTING AND REPORTING REQUIREMENTS:** There is no specific guidance issued by the accounting standards or the Institute of Chartered Accountants of India for accounting iSAFE notes in India. However, since the iSAFE notes in India take the legal form of CCPS, they have to be shown under the Preference Share Capital head. These will be ultimately classified under the “Shareholder Funds” head of the balance sheet.

IS ISAFE SAFE?

KEEP IT SIMPLE SECURITY ????

- Converted automatically on Maturity Date if there is no equity raised within the term
- In case of No equity investors receives the same returns that an equity investor would receive

REVENUE BASED FINANCING

- Investors get a percentage of future revenues in return for the money invested.
- No equity is issued.
- Founders can use this instrument to enable more sales, make profit and use the profits to reinvest in the business, improve the product and even generate more sales.
- Repayment is from the revenue generated
- Investors end up in making 15-30% over the money invested in the company.
- Klub, Getvantage, Credavenue are some of the investment firms that finance start ups on revenue basis.

DIRECTOR`S LOAN

- Angel Investors may not allow
- Usually happens at Series A when VC Firms invest.

VENTURE DEBT

- Debt financing by NBFC without any Collateral. Such firms as termed as Venture Debt firms.
- Interest 15%-24% annually
- Generally not preferred at early stage of start up
- Preferred after Series A

CCPS (COMPULSORY CONVERTIBLE PREFERENCE SHARES)

- CCPSs are increasingly becoming preferred investment instrument for high net worth and Private equity investors to bridge the gap in mismatch in valuation expectation between investors and promoters. The CCPS are anti dilution instrument or hybrid instrument.
- CCPS instruments that mandatorily changed into equity shares of the issuing organization on the predetermined condition at the time of releasing of the instruments.
- CCPS typically posses lower interest rate as compare to NCDs. It is also deemed as capital instruments.
- As per RBI norms, the CCPS ought to be treated at par with equity shares.

ANTI DILUTION

- CCPS are benefited to the promoters of the company to keep their equity stake intake when Company issue equity shares to new investor. The Promoters may convert their CCPS which was taken at the time of Lower valuation of shares when new investor bring the money at higher valuation thereby promoters can increase its stake without bringing money at higher valuation.

BENEFITS TO PRIVATE EQUITY INVESTORS:

CCPS offers several benefits for private equity investors. During the conversion time, the investor can link the performance of the company. This essentially indicates that the share shall get converted only in the situation when the NBFC accomplish the target growth. In case the target is not laid out, the company has every right to crank up its stake.

According to norms of the capital market regulator, any acquisition of fifteen percent or more (in case listed organization) opens up the possibility of offers. Likewise, a PE firm can drive direct equity of @14.9% and remain in the form of securities, which might transform into equity within eighteen months. In this ways, the companies have a chance to exist the one year lock-in period for private equity investment.

Stamp Duty Aspect Of CCPS

The payment related to the stamp duty is governed by the stamp duty act of the respective states. It should be noted that no stamp duty applies to the Equity Share Certificate.

CCPS UNDER COMPANIES ACT, 2013

- Section 42, Companies Act, 2013
- Section 62, Companies Act, 2013
- Section 55, Companies Act, 2013
- Companies (Prospectus and Allotment of Securities) Rules, 2014
- Companies (Share Capital and Debentures) Rules, 2014.

PARTICIPATING & NON-PARTICIPATING LIQUIDITY PREFERENCE

- 10%CCPS at 1X Participating
- Valued at 10 Crs
- Investor A- Invests 1 Cr (10%)
- Dividend: 10%
- End of 2 Yrs: 1 Cr + 20 Lakhs = 1.2 Cr

- Acquisition offer- 12 Crs
- 1.2 out of 12 Crs the investor makes first
- Balance = 10.8 Crs
- Participating-Investors can participate in residual profits by converting to equity shares and participate in surplus profit.
- 10% of 10.8 = 1.08
- 1.2+1.08 = 2.28 Crs

0.01% CCPS AT 1X NON-PARTICIPATING

- Dividend amount is negligible, therefore investor would choose to convert.
- Option not to convert when valued lower.
- 1.08 Crs if valued at 12Crs. Hence preferred to convert.

SHARE WARRANTS

- Share warrants or stock warrants are documents issued by a company that give you the right to buy or sell the company's shares at a specific price at a particular date or within a set period. By owning share warrants you get the right to buy or sell shares of a company at a particular price, but you are not obliged to do so.

- Why Share Warrant?
  - To Raise Capital
  - To Finance Acquisitions
  - To Encourage the Purchase of Bonds or preferred stocks
  - To Attract or retain Employees

ISSUE OF SHARE WARRANTS

- The Articles of Association must authorize the issuing of share warrants.
- The shares must be completely paid-up.
- A share warrant is a negotiable instrument, and the ownership of shares can be transferred only by delivery.
- Each warrant has attached coupons that bear the dates when the company will pay the dividend. This is because it is naturally impossible for the company to identify every shareholder.
- As such, a dividend will be paid to the one who produces the appropriate coupon.

How are Stock Warrants Taxed?

- **When a Warrant is Subscribed:** When a person subscribes to a warrant by paying a subscription premium, neither the company nor the subscriber has to pay a tax.

- **When Subscription Premium is Forfeited:** If the warrant subscriber doesn't convert the warrant to shares before the date mentioned on the warrant, the company will forfeit the premium. In these cases, the subscriber must claim the premium amount as a capital loss. The upfront premium is the capital receipt, and there are no tax implications.

- **When Warrants are Converted to Shares:** In the case of conversion of warrants into shares, the subscriber must pay taxes despite not having to sell the shares.

- **When the Sales are Sold:** Once the underlying shares in the warrant are sold after conversion, the gain/loss attracts taxes as capital gain/loss. The share cost is the share's fair value on the conversion date.

COMMUNITY STOCK OPTIONS IN INDIA

AN UNEXPLORED AREA

SIMILAR TO ESOP & ISSUED TO CUSTOMERS

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