MIND THE GAP: BRIDGE FINANCE

RONNIE DABBASI OF AFRIDI & ANGELL GUIDES US THROUGH IDENTIFYING THE PROSPECTS AND PITFALLS OF BRIDGE FINANCING.

Most entrepreneurs hope that their fundraising efforts will result in a venture capital equity financing. However, it is not uncommon for companies to meet their cash flow demands by raising convertible debt prior to or between equity rounds, and many angel investors will only participate in a new venture on this basis.

This type of debt is known as a "bridge loan," as it is a short-term loan that is designed to fund the business until it can raise equity capital.

Bridge loans provide the company with funding in the form of debt that will convert into equity upon the achievement of certain milestones or occurrence of certain triggers.

Bridge financing provides unique opportunities and challenges to both entrepreneurs and investors. We have set out the key features of convertible debt instruments below.

• Discount and conversion mechanics.
Bridge loans entitle the lender, upon conversion, to a discount on the purchase price of shares of the company in a qualified financing. For example, if the company is able to raise sufficient equity financing (for example, more than $500,000) within a prescribed period of time (for example, six months from the issuance of the security), the loan will automatically convert into shares of the company that are issued in such qualifying financing at a price equal to the purchase price for such shares, less a discount (which is generally between 10 percent and 30 percent depending on the other terms of the security and the demand for financing).

It is important for the entrepreneur to negotiate a reasonable timeline for securing future financing (which will end on the maturity date of the loan) and, if possible, a compulsory conversion if no such financing is obtained. The security may also provide that the loan will automatically convert in the event of a sale of the company and may be extended on the maturity date by the lender. Finally, it is worth noting that the discount may be achieved through the issuance of warrants, though this approach is very uncommon in the Middle East.

• Valuation and valuation cap.
Unlike in an equity round, the parties do not need to agree on a valuation since the conversion price will be determined on the basis of the next financing. Since start-ups are notoriously difficult to value, bridge loans are more commonly used in early-stage financing (though in some cases existing shareholders will offer

debt financing to growth and late-stage businesses).

Bridge loans may subject to a valuation cap, which limits the conversion price of the debt. The cap is generally used in early-stage deals where the investors are concerned that the next funding round could be at a much higher valuation than anticipated. Accordingly, a seed investor may set a valuation cap that often represents the valuation at which the investor would have purchased equity in the company. Entrepreneurs should be cautious when negotiating the valuation cap, as it may depress the start-up's future valuation (as determined by the next round's investors) to such amount. As a result, entrepreneurs may push for a valuation floor (rather than a ceiling) as part of the conversion mechanism.

- **Interest.**

Convertible debt instruments entitle the holder to interest. The rate should be low (generally between 6 percent and 12 percent) since the investor will be fairly compensated through the applicable discount. It is unlikely that the company will repay any interest or principal with cash, as the loan will generally be converted into equity (along with any interest due) in the next round or be in default if the company fails to raise additional funds.

- **Pre-emption rights and liquidation preferences.**

Some convertible debt securities give the holder two important rights that are generally available to preferred shareholders. First, the holder may be entitled to a pre-emption right that would permit the investor to purchase a pro rata portion of any new shares issued by the company. Second, the bridge loan may benefit from a liquidation preference, whereby in an exit transaction, the investor would be repaid its contribution (or a multiple thereof) before any proceeds are distributed to the shareholders.

- **Costs.**

Bridge loans are much easier and less costly to negotiate. While this is not necessarily the case in Western jurisdictions where certain documentation has become standardised, the difference between negotiating debt and equity funding is more pronounced in the Middle East.

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> "BRIDGE FINANCING PROVIDES UNIQUE OPPORTUNITIES TO ENTREPRENEURS AND INVESTORS"

About the author:
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CONVERTIBLE EQUITY FOCUS

While not nearly as popular as convertible debt, convertible equity is occasionally used as a vehicle for seed investments.

Convertible equity has many of the same features as convertible debt (for example, the discount, conversion mechanics, and valuation cap) without the protections afforded to lenders, such as entitlement to interest and repayment priority.

Understandably this type of security is infrequently used by venture capitalists.

However, it is worth noting that Shariah compliant VCs may consider purchasing convertible equity if the terms of the instrument comply with Islamic principles (which prohibit, among other things, the purchase of preferred shares) and compensate the investor for not benefitting from debt protections (for example, by increasing the discount or assessing fees on the company).