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Convertible Seed Financing: Let Common Sense Prevail, a Radical Proposal

Convertible financings, be they of the conventional convertible debt variety or the more recent SAFE form, have become a staple of the seed/startup financing scene. Unfortunately, these days Convertible financings are known as much for their abuse as for their utility. Too many startups (and their investors – it takes two to play this game) pile Convertibles on top of each other, for no reason other than keeping the lights on. Startups wind up with messy, problematic cap tables and disgruntled, confused, and disillusioned investors. It really does need to stop. I discuss this in further detail here: Stop the Madness! Reconsidering Convertible Debt.

I've given a lot of thought to the Convertible conundrum for several years now. I've concluded that the root of the problem is really quite simple. Entrepreneurs and investors have settled on a fixed conversion discount (typically 20 percent) that makes it tempting for entrepreneurs to stretch out time-to-conversion and increase deal size. Indeed, I've found myself advising startups to take as much money, for as long as possible, at a capped 20 percent discount rate.

Why?

Because while 20 percent for say three months might work out to something like 100 percent on an annualized basis, 20 percent for a year is, well, 20 percent on an annualized basis. And 20 percent/year, as a discount rate for a startup looking for venture or other risk capital, is extraordinarily cheap. And it only gets cheaper (faster, at that) if the startup can stretch the time-to-conversion beyond one year. The incentives of the current game for the startup are clear and convincing – take as much money as you can with a fixed 20 percent discount, and stretch the time-to-conversion out just as far as you can.

The crudest fix for this problem is a higher discount rate. But a higher discount rate – say 50 percent – can be very expensive if in fact the time to conversion is, say, three

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months. At the same time, 50 percent is still quite low if the startup can stretch the time of conversion out very far (I've seen convertibles outstanding for 3 years and more a lot of times).

What would a good fix look like? Simple: a variable discount rate based on time to conversion. Say, for argument's sake, five percent for each month the convertible is outstanding, with a cap at say 90 percent. This formula would deliver a more-or-less "market" rate of return to the investor over any period of time up to say two years, and so encourage the entrepreneur to drive conversion sooner rather than later. At the same time it would discourage entrepreneurs from engaging in larger convertible rounds tied to longer-term milestones better suited for priced rounds.

While this is a serious proposal, it will never happen. Not because it doesn't make sense: it does. Rather, it will be resisted by (i) too many entrepreneurs looking for cheap risk capital (understandable); and (ii) a low-end risk capital market that includes a plethora of less sophisticated investors who either don't understand the realities of the early stage risk capital market or are too anxious to buy their way into deals they are otherwise afraid they will be cut out of later on (unfortunate).

My advice? Well, entrepreneurs ought to balance the advantages of locking in as much cheap capital as possible for as long as possible against the disadvantages of fashioning increasingly problematic and complex cap tables. As for investors, a little common sense and a dose of gumption (self-respect?) wouldn't hurt.

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