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DRBM Bulletin

RBI allows Convertible Notes for Indian Startups

Executive Summary

May it be any part of the world, raising money for early stage Startup Companies has always been a difficult task. The main reason being difficulties in valuing early stage companies where no financial track record is evident. There came a concept of SAFE which is a short form for 'Simple Agreement for Future Equity'. It was introduced by **Y Combinator** which is a US based Incubator. **SAFE** allows startups to raise funds from investors which do not take form of either debt or equity. However, in the Indian context, issuing convertible notes to foreign investors was always forbidden since the Reserve Bank of India and the Ministry of Commerce and Industry allowed foreign direct investment only in equity instruments or such other instruments that were considered at par with equity like compulsorily convertible preference shares or compulsorily convertible debentures.

With effect from January 10, 2017, **RBI** has amended the Foreign Exchange (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, to allow Startup Companies to issue **Convertible Notes** to foreign investors. This will open a plethora of funding opportunities for Startup Companies; also allowing the investor to grab early bird benefits. This write-up aims to throw some light on the main characteristics of the Convertible Notes.

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Preface

When Startup Companies start seeking capital, they are in early stage of operations. Some of these companies would have not even started making sales. However, they deploy a great deal of technology and are expected to capitalise on it to make a great company. At this moment, valuation of the company becomes a difficult task. Investor and Entrepreneur get on the same page but they cannot form a consensus on valuation and eventually the shareholding. Entrepreneurs want a high valuation for the sake of getting more money or for lower dilution of equity. At the same moment, Investors demand lesser valuation as a fringe benefit of tapping the early bird opportunity or to acquire more interest in the equity of the startup company.

How do these instruments work

To get over the difficulties, these instruments offer specific discount to the Investor. The money is parked with the startup company in the form of Debt. Whenever the startup goes for next round of Institutional Funding, the valuation determined by the Institutional Investor is accepted as a base to calculate the number of shares the individual investor would receive thereby granting genuine benefits to the early investors without hampering the entrepreneurs.

Let us understand this by way of an example:

1. ABC, a Startup Company is seeking investment of INR 2.00 Crore against valuation of INR 20.00 Crores. Promoters are ready to dilute 10% of the equity for this investment. However, the investors don't agree upon this valuation as they cannot digest the methodologies used. As such, direct investment into equity doesn't stay easy. Here comes the Convertible Notes ('CNs') into the picture.
2. ABC Co. gives offer to the CN Investor which is often combined with conditions like Discount Rate or Valuation Cap or Both Discount and Valuation Cap combined. Let us assume that the offer in the given scenario is for investment of INR 1.00 Crore against Discount of 20% and Valuation Cap of INR 40.00 Crores.
3. The precondition is that the company will obtain Institutional Investment within 3 years; else, the money will be repaid to the CN Investor at an interest rate of 12% per annum. Depending upon the valuation determined by the Institutional Investor, actual shares will be allotted to CN investor against conversion of Convertible Notes into Equity.

Following case studies will help us understand the concept in a better way:

Sr. No.	Particulars	Case – 1	Case – 2	Case – 3	Case – 4
A	Valuation Cap (INR in Crores)	40.00	40.00	40.00	40.00
B	Rate of Discount	20%	20%	20%	20%
C	Valuation by Institutional Investor [Jan-2020] (INR in Crores)	30.00	40.00	50.00	No Inst. Investment
D	Total Number of shares of the Company	1,00,000	1,00,000	1,00,000	1,00,000
E	Value per share [C / D]	3,000	4,000	5,000	-
F	Value per share as per Valuation Cap [A / D]	4,000	4,000	4,000	-
G	Discounted Value per share for CN Investors [Discount on lower of E and F]	2,400	3,200	3,200	-
H	Total Investment in CN by CN Investors (INR in Crores)	1.00	1.00	1.00	1.00
I	Shares to be received by CN Investors [H / G]	4,167	3,125	3,125	-
J	Total Value of shares of CN Investors (INR Crores) [I x E]	1.25	1.25	1.5625	-

In the first case, the company obtains Institutional Investment at a total pre-money valuation of INR 30.00 Crores which is less than the Valuation Cap determined by the company for CN Investors. Here, the CN Investors will get 20% discount and they will receive 4,167 number of equity shares in lieu of conversion of Convertible Notes worth INR 1.00 Crore into equity of the Company. At the pre-money valuation as determined by the Institutional Investor, 4,167 shares would yield value of INR 1.25 Crores, thereby saving the Investors from downside risk.

In the second case, the company obtains Institutional Investment at a total pre-money valuation of INR 40.00 Crores which equals the Valuation Cap determined by the company for CN Investors. Similar to Case – 1, the CN Investors will get 3,125 number of equity shares on conversion which will amount to total valuation of INR 1.25 Crores.

In the third case, the company obtains Institutional Investment at a total pre-money valuation of INR 50.00 Crores which is more than the Valuation Cap determined by the company for CN Investors. The discount will be calculated on the basis of valuation cap and thus granting the CN Investors 3,125 equity shares on conversion, value of which will amount to INR 1,56,25,000.

In the fourth case it is assumed that the company fails to obtain Institutional Investment within the predetermined period of 3 years. Here, the company will be responsible to repay the CN Investment of INR 1.00 Crore along with interest @ 12% per annum as agreed to between the company and the CN Investor.

Going ahead with RBI's new notification

Earlier, investment in Debt Instruments of Indian Companies by way of FDI was not permitted. Further, the ECB Guidelines were so stringent that attracting investments through Debts was a herculean task. With effect from January 10, 2017, the RBI has amended the Foreign Exchange (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 by virtue of Notification No. FEMA 377 dated January 10, 2017. Now, 'Startup Companies' are allowed issue Convertible Notes (Debt Instrument) to Foreign Investors.

A Convertible Note is an instrument issued by a startup company evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such startup company, within a period not exceeding five years from the date of issue upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the agreement.

Technical Glitches:

1. Convertible Notes can be issued only by Startup Companies. Startup Companies are those which are registered under the Companies Act, 1956 / Companies Act 2013 and are recognised as such by the Department of Industrial Policy and Promotion of the Ministry of Commerce & Industry of the Government of India. The definition of Startups as given by the Ministry of Commerce & Industry says that a Startup Company should not be more than 5 years old and should not be having a turnover of INR 25 Crores. Further, the company should be working for 'innovation, development, deployment or commercialisation of new products or processes or services which are driven by technology or intellectual property'. Also, certification for the same has to be procured from one of the agencies mentioned in the notification dated February 17, 2016.

   ✓ That means, only those startups who have passed the acid test of recognition by MOCI and who have satisfied all the conditions of the aforementioned notification can only avail benefits of Convertible Notes.

2. The Notification says that the money accepted will be treated initially as a Debt. However, such Debt shall eventually be converted into Equity. As such, the nature of the instrument needs some clarification.

   ✓ The current FDI Policy does not specify anything with respect to the Convertible Notes. Accordingly, amendment to the current FDI Policy is required.

3. Speaking about quantum of investment, the notification specifies that person resident outside India may purchase Convertible Notes issued by an Indian startup company for an amount of twenty five lakh rupees or more in a single tranche. Further, if an NRI wants to invest in the Convertible Notes of Indian Startup Companies, he / she shall do so only on non-repatriation basis.

   ✓ Startup Companies launching funding campaign on foreign platforms keep the minimum investment size of USD 5,000 which amounts to INR 3,25,000 approximately. The limit specified in the notification of INR 25,00,000 would require investment in USD of almost 38,000. Even for foreign investors looking for Startup Investment Opportunities, this amount is a little bit on higher side.

4. Other conditions refer to:
   a) Inward remittance through banking channels or by debit to the NRE / FCNR (B) / Escrow account,
   b) Prior approval from the Government to be obtained for such transfers in case the startup company is engaged in a sector where foreign investment requires Government approval and
   c) Valuation Methodologies and Reporting as per RBI guidelines

   ✓ These other conditions are perfectly fine as long as they do not culminate into practical problems. The procedure should be smoothened from bank's end so that Startup Companies won't face any kind of hardship.

Closing Remarks

The notification can be a Game Changer and may bring in major reforms into the Indian Startup Ecosystem. Foreign Crowd-funding Platforms can assist Indian Startup Companies to raise funds with minimal efforts and in turn give financial benefits to the investors. However, as discussed above, clarification is required on many points. We can expect Press Note / Corrigendum / Explanatory Statement in this regard.

Nonetheless, it's a great move by the Government towards modernisation and would result into more sophistication of Indian Startup Economy in the long run.

Credits:
[RBI FEMA Notification No. 377 Dated January 10, 2017]

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