

Understanding **Startup** Investment Instruments

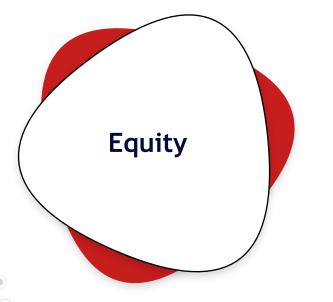


When it comes to funding a business, investor-based fundraising is just one option among many, including rewards-based fundraising, personal investments, friends and family, and good old-fashioned bootstrapping. Before you decide to seek funding from investors, it's important to be certain that investor support is the best or only way to move your business forward.

Once you've decided that pursuing investors is the right route for you, you have another choice in front of you: how are you going to do it?

There are three basic types of investor funding: equity, loans and convertible debt. Each method has its advantages and disadvantages, and each is a better fit for some situations than others. Like so much else about the fundraising process, the kind of investor-based fundraise that is right for you depends on a number of factors: the stage, size and industry of your business; your ideal time frame; the amount you are looking to raise and how you are planning to use it; and your goals for your company, both short-term and long.

Startup financing options are almost endless, and figuring out which option makes the most sense for you might seem complicated. So, let's try to dive deeper and have an in-depth understanding of financing options available to startups and how you, as a founder, can leverage this knowledge to fund your next venture.



An equity deal means that in exchange for the investment, the investor gets a part of the company's equity. The investor now owns some of the company in the form of shares – they are now a shareholder. The number of shares or in other words the amount of equity the investor gets depends on the size of the investment and the valuation of the company. The bigger the investment, the bigger share of the company you'll get. An investor should be familiar with the terms pre-money valuation and post-money valuation.

Pre-money valuation is the valuation of the startup before the investor's money is received or the last round's valuation. Post-money valuation counts in the financing received in the latest round. This plays a role for the investor because the amount of equity they will receive will depend on the valuation of the startup, which can depend on whether pre- or post-money valuation is used. Another thing to consider about an equity deal is the risk of dilution. If the startup wants to raise other equity rounds in the future, then new shares will be issued. The new shares will dilute existing investors' shares and the new investors' deals might have better conditions like preferential rights to dividends etc.



In essence, CCD is a debt that has to be converted to shares by a specified period. It is a hybrid security that is a mix of both debt (loan) and equity. CCD generally is a medium-term investment instrument, wherein there are convertible debentures that get mandatorily converted into equity after a predetermined time. Due to this mandatory conversion to equity, CCDs are often considered as deferred equity instruments. A CCD holder automatically becomes a shareholder in the company and acquires all the rights of a shareholder as prescribed under the Companies Act, 2013.

Compulsory Convertible Debentures (CCD)

According to the RBI guidelines, CCDs are treated as equity for all reporting purposes & financial statements, however, unless converted into equity, CCDs are not considered as part of the share capital of a company. Thus, the investor will not find a spot on the cap-table until the conversion takes place. For ventures, it means that they can pay their interests for a certain period & their principal amount during maturity without spending extra cash. Investors, on the other hand, consistently receive interest with the assurance of equity at a later stage. The disadvantage of accepting investment through a CCD is when anything goes wrong prior to conversion into equity. Since it is a debt on the books, it is a liability that needs to be repaid by the company or its founders to the investors.

Compulsorily Convertible Preference Shares (CCPS) When investors enter the cap table of a startup, they are given preference shares - shares that have rights to liquidate during the lifetime of the company. In India, these preference shares are generally issued as a class of CCPS. Startups keep the dividend rate of these instruments nominal, say 0.001% & thus, it becomes negligible. Though popular, this type of investment turns out to be quite disadvantageous for the startups as it inclines more towards the investors and restricts the ability of the founders to operate freely and pivot into better revenue streams.

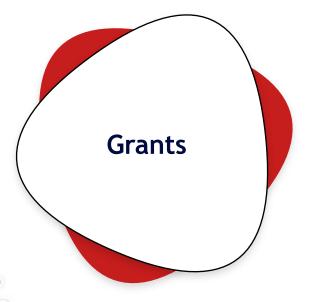
Investors, who are granted Compulsory Convertible Preference Shares or CCPS, have the privilege of linking the time of conversion to the company's performance. This essentially means that the investor might choose to convert CCPS to equity only after the company achieves the promised growth. If these milestones are not achieved, then investors may also have the option to increase their stake in the startup. At times, there might be a ratio linked to the conversion of CCPS to equity shares. The ratio is generally 1:1, meaning 1 CCPS upon conversion will become 1 equity share. But, there might be instances where the conversion ratio is 1:1.5, 1:2. 1:3 or in any other proportion. The conversion ratio is generally agreed upon in the Shareholder Agreement (SHA).



India Simple Agreement for Future Equity, popularly called iSAFE, is a founder-friendly convertible security note. Legally, as per company law, it takes the form of CCPS. iSAFE is a simple, easy-to-execute, 5-page document that founders can understand quickly. Such investment formats are becoming increasingly popular in India for early-stage startups as an investor makes cash investment in return for a convertible instrument. It is also easy in terms of compliance (for both founders & investors) with their template-driven agreement & they offer favorable terms to entrepreneurs.



An iSAFE note is not a debt instrument, but a founder-friendly convertible security note, that is beneficial for both startups & investors. iSAFE notes automatically convert into equity shares either on occurrence on specified liquidity events viz. next pricing/valuation round, dissolution, merger/acquisition etc. or at the end of 3 years from the date of its issue, whichever is earlier. They address the challenge of valuation for early-stage startups & minimize execution time, documentation, as well as transaction costs during fundraising. iSAFE are of different types. Some include a future fixed equity stake, while others come with valuation caps and discounts. iSAFEs are ideal for early-stage (including seed and pre-seed stage) investments into startups.

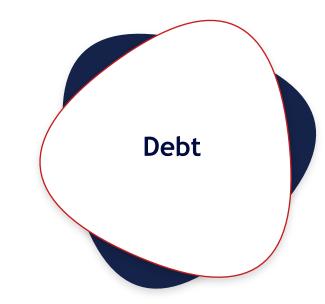


A grant is when a firm gets funds, normally to be used in particular functions, without the obligation to pay back or give shares of the company in exchange. For example, a company is awarded a INR 50,00,000 government grant as part of a program to support innovation and R&D. The startup's only obligation is to use the funds as agreed and report on its progress. A grant offers the best of both worlds in terms of the advantages of equity and debt. You don't have to pay back and you don't give away any control. Simply put, grant is free money!

If a grant targets startups, much like equity, it usually does not require the company to prove creditworthiness, to have revenues, or collateral. It should be accessible to most startups that fit the profile the grant is meant to support. Much like equity, receiving a grant also serves as seal of approval. Grants have highly competitive processes and winners are often praised publicly and receive good publicity. As mentioned, a grant attracts a lot of attention and normally gets thousands of applications, and hence gets very competitive. Also, the grant money is usually earmarked to certain types of investments or expenses. Therefore, you may not be able to spend the money as you wish.



Debt is when a firm takes a loan from a backer (e.g.: bank, person, government institution) with the obligation of repaying principal and interest in a defined schedule. With a loan you are not giving shares of your company to the creditors, you are simply borrowing money. This means that, differently from equity investors, creditors do not become your partners, do not dilute your ownership, and will not have a saying in how you run your business - you keep the control. Moreover, when you take a loan, you know all the terms of the relationship in advance.



The obligation to pay back debt tends to make entrepreneurs more careful with the way they manage their resources. When you know you need to honor monthly payments and return the amount borrowed at the end of the period, you become more careful with the way you handle your expenses, procure suppliers, manage your costs, and go after your goals more broadly. This often brings positive lasting results in terms of financial management and corporate strategy. On the other hand, banks & other lenders are notoriously risk averse. This means that they will only lend to companies that can prove they can pay back. This is often a challenge for startups, which may not have steady revenues yet, little or no collateral to guarantee the loan, and limited receivables.



A Foreign Direct Investment (FDI) is based on controlling ownership in a business in one country by an entity in another country. FDI provides a situation wherein both the host and the home nations derive some benefits. The home countries take advantage of the massive markets opened by industrial development whereas the host countries get to attain resources extending from financial, capital, entrepreneurship, technological knowhow and managerial skills, which assist it in supplementing its domestic savings and foreign exchange.

India's Foreign Investment is an endorsement of its status as a preferred investment destination amongst global investment. India's stable economic liberalization and its encirclement of the global economy have been key factors in fascinating FDI. To promote Foreign Direct Investment, the government has put in place an investor-friendly policy. Most sectors are open for 100% FDI under the Automatic Route, except for a few which are under the negative list. The investment can be made either in equities or in equity-linked instruments or debt instruments issued by the startups and if a startup is formed as a partnership firm or an LLP, the investment can be made in the form of capital or through any profit-sharing agreement which is decided mutually by the partners.



External Commercial Borrowing (ECB), as the expression hints, is the loan/ debt/ borrowings taken by an eligible entity in India for commercial purpose, externally i.e. from any recognized entity outside India in form of bank loans, suppliers' credit, buyers' credit or securitized instruments. The ECBs can be obtained through automatic route or approval route or by combination of both the routes. Monitored by RBI, ECB is a facility made available to Indian eligible entities to be able to seek huge investment from outside India and allow for foreign capital flow in India.

External Commercial Borrowing (ECB)

RBI in order to ensure inflow of clean funds, has divided the borrower as eligible entities & lenders as recognized nonresidents, & has further kept checks in form of forms of ECB, end-use restriction, minimum maturity period etc. ECB proceeds can also be used for working capital requirements, general corporate purposes or repayment of rupee loans. Only Central Government recognized startups shall be eligible for such provision. Minimum Average Maturity period for such ECB's shall be the same as the average of 3 years. Lenders/investors should necessarily be residents of FATF (Foreign Action Task Force) compliant countries. The borrowings can be either Foreign currency denominated ECB or Indian currency denominated ECB & should not exceed 3 million USD per Financial year (for automatic route).



Difference between Investment Instruments

| Basis | Equity | CCD | CCPS | iSafe | Debt |
|---------------------------|--|---|--|--|--|
| Instrument | Equity share has a face value of INR at the price of equity share. | Certain rights are agreed by the parties in the documents called debenture definitive documentation. | The rights of the parties are governed in the documentation called preference share and equity and preference share have face value collectively known as subscription share. | The rights of the parties are governed in the documentation called preference share and equity and preference share have face value collectively known as subscription share. | It is when a firm takes a loan from a backer with the obligation of repaying principal and interest in a defined schedule. |
| Interest | There is no interest. | The debenture shall bear interest on non- cumulative basis per annum. | The holders of the CCPS shall be entitled to the payment at certain % on non-cumulative coupon p.a. on each of preference share by way of dividend from the company. | An iSAFE is neither debt nor equity & there is no interest accruing, but for legal compliance purposes, it carries a non- cumulative dividend @ 0.0001%. | The loan shall bear interest on cumulative basis per annum. |
| Valuation | Aluation Pre-money valuation is required. No such valuation is required at the time of issuance. | | Pre-money valuation is required. | No such valuation is required. | No such valuation is required. |
| Pre- emptive rights | The investor shall have pro-rata right to participate in case of equity share to the third party & retain their shareholding. | There are no pre- emptive rights. | The investor shall have pro-rata right to participate in case of equity share to the third party & retain their shareholding. | The investor shall have pro-rata right to participate in case of equity share to the third party & retain their shareholding. | There are no pre- emptive rights. |

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| | Basis | Equity | CCD | CCPS | iSafe | Debt |
|---------------|--|---|--|--|---|--|
| | Exit Mechanism | There are various ways to provide the exit opportunity to the investor such as IPO, strategic sale of equity share & drag along option. | are various ways to provide the exit opportunity to the investor such as IPO, strategic sale of equity | opportunity to the investor such as IPO, | There are various ways to provide the exit opportunity to the investor such as IPO, strategic sale of equity share & drag along option. | In order to provide the exit opportunity, the loan shall be repaid. |
| - (e) X/Y | Governing law jurisdiction & arbitration | This shall be governed according to the law of India. And any disputes will be settled in the court. | India. And any disputes | the law applicable in India and any dispute | The term sheet shall be governed according to the law applicable in India and any dispute shall be settled by the arbitrator. | This shall be governed according to the law of India. And any disputes will be settled in the court. |
| ((0) / () () | Conversion | There is no conversion. | For infra companies - upto 30 years. For others - upto 10 years. Conversion ratio is decided by the issuer when the debenture is issued. | Can be issued for a maximum period of 20 years. Conversion ratio is decided at the time of issuance. | Automatically convert into equity shares either on occurrence on specified liquidity events or at the end of 3 years from the date of its issue, whichever is earlier. | There is no conversion. |

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Taxation of Investment Instruments

| Instrument | For the Investor | For the Startup |
|------------|--|---|
| Equity | The dividend income is taxable in the hands of assessee at the slab rates applicable. The difference between the Sale Price & purchase cost of the share is known as Capital Gain/(Loss). For taxation purpose, if STT is paid (i.e. the share is listed), then the tax is paid at 10% of the income in excess of INR 1 lac (if LTCG) & at 15% (if STCG). However, if the STT is not paid, then the tax is paid at 20% of the income with indexation (if LTCG) & at slab rate (if STCG). | • The company (being a closely held company) would be liable to pay tax if it has issued shares to the investor (other than a VC company or a VC fund or a specified fund or a company from a class or classes of persons as may be notified by the CG) at a consideration which exceeds the face value. The aggregate consideration as reduced by the FMV of the shares shall be 'Income from other sources' in the hands of the company. |
| CCD | The debenture shall bear interest which shall be taxable in the hands of the investor on the applicable slab rates. Transfer of CCD before conversion (i.e. when it is still a debenture), is liable to Capital Gains tax in India. Conversion of CCD into equity shares is not liable to tax. Where CCD's are converted into shares, & sold thereafter, the capital gains arising from such sale are taxed as gains on transfer of shares & the holding period is considered from the date of purchase of CCD. | Interest paid on CCDs is an allowable deduction under Section 36(1)(iii) of the IT Act. The dividend distributed to the investors, after conversion, is not taxable in the hands of the company. |



| Instrument | For the Investor | For the Startup |
|------------|--|---|
| CCPS | The preference/equity dividend shall be taxable in the hands of the investor on the applicable slab rates. Conversion of CCPS into equity shares is not liable to tax in India. Transfer of CCPS before conversion (i.e. when it is still a preference share), is liable to Capital Gains tax in India. Where CCPS's are converted into equity shares, and sold thereafter, the capital gains arising from such sale are taxed as gains on transfer of shares and the holding period is considered from the date of purchase of CCPS. | The preference/equity dividend distributed to the investors, after conversion, is not taxable in the hands of the company. |
| Grant | • NA | Subsidy shall be recognized as income of the company as per Section 2(24)(xviii) of the Act, unless the same falls in the exclusion part of Section 2(24)(xviii) of the Act. Where a portion of the cost of an asset acquired by a company has been met directly or indirectly, in the form of a subsidy or grant or reimbursement by the Central Government or a State Government or any authority established under any law or by any other person, then so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the company. |
| Debt | • Interest received is taxable under the relevant head at applicable slab rates. | • Interest paid is an allowable deduction under the IT Act. |





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+ 50 Valuation Assignments + 50

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