Understanding Convertible Notes: A Simple Math-Based Investor Overview

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1. What is a Convertible Note?

A convertible note is a form of short-term debt that converts into equity when a startup raises a future priced equity round. Instead of receiving repayment in cash, the noteholder receives shares, often at a discount or capped valuation compared to new investors.

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2. Key Terms in a Convertible Note

- Principal: The amount invested (e.g., $10,000)
- Interest Rate: Accrues until conversion (e.g., 8% annually)
- Discount Rate: The percentage discount on the share price (e.g., 20%)
- Valuation Cap: A maximum valuation used to calculate the conversion price (e.g., $2,000,000)
- Qualified Equity Financing (QEF): The priced round that triggers conversion (e.g., $300,000 minimum)

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3. How Conversion Works (Basic Example)

- Suppose you invest $10,000 with an 8% interest rate, 20% discount, and a $2M valuation cap.
- After 6 months, your note is worth:

$10,000 + ($10,000 x 8% x 0.5) = $10,400

- If the priced equity round is at a $2.5M post-money valuation, the price per share is:

$2,500,000 / 90,000 shares = $27.78/share

- Your discount price is: $27.78 x (1 - 0.20) = $22.22/share

- Cap price is: $2,000,000 / 90,000 = $22.22/share

- You get: $10,400 / $22.22 = ~468 shares

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4. How Negotiations with the Lead Investor Affect You

They DO affect you when:

- The lead investor sets the valuation for the priced round, which defines your conversion price.

- If the round is priced above the valuation cap, your cap activates.

- If it's priced below the cap, your discount applies instead.

They DO NOT affect you when:

- The lead investor negotiates board seats or protective provisions for themselves - this does not change your share count.

- The company issues new shares later (e.g., 500-share blocks) - you've already converted.

- The lead investor sets a price that triggers your better term (discount or cap) - you always get the most favorable outcome.

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5. Summary for Investors

- Convertible notes reward you for early risk by giving you more shares than new investors.
- You don't have to negotiate; your benefit is mathematically automatic.
- The lead investor determines when your note converts, but not how many shares you get - your terms decide that.

You win when the round closes. You win more if the valuation rises. And your early commitment is what makes it all possible.
