

What is a conversion cap?

What is a conversion cap? How can it affect stock ownership?

Conversion caps in convertible notes can set the price at which notes convert, and thus can greatly affect future financing rounds and the ownership of a company. This article explains the implications of a conversion cap for stock ownership and, in turn, later financings.

What is a conversion cap?

A cap dictates the highest price per share (PPS) that a note holder will pay for shares when the note converts at the time of a subsequent financing.

Therefore, if a bridge lender negotiates a low cap and the company ends up with a very high valuation in its subsequent financing round, then that bridge lender's shares will convert at a significantly lower PPS than was paid for by the subsequent financing round investors, which will result in the bridge lender having a significant ownership stake in the company.

Why does this matter? The following example highlights what can happen with a low conversion cap:

GrowCo is a tech startup founded by Justin B. The only shareholder initially, Justin B holds 5 million shares of GrowCo's common stock. GrowCo's capitalization table is below.

After one year of operating, Justin B needs more money to continue his work, so he enters into a convertible bridge loan with his friend, Amy E. Amy E's note is worth \$500,000, and she negotiates a cap of \$3 million. GrowCo's capitalization table after the note issuance is below.

Stockholder	Common Shares
Justin D	5 million

Convertible Note Holder	Cap	Note Amount
Amy E	\$3 million	\$500,000

Two years after the bridge loan, GrowCo has expanded rapidly and is preparing for its Series A financing round. GrowCo is now valued at \$9 million, and the Series A investors (Fast Growing Fund, L.P., Strong Performance, L.P. and Next Level Investments, L.P.) each invest \$1 million, for a total of \$3 million). The Series A investor share calculations are below.

Series A Investor PPS	\$1.80	GrowCo valuation (\$9 million) divided by the number of shares outstanding prior to the Series A financing (5 million shares)
Series A Investor		

Shares	555,555	Amount invested by an investor (\$1 million) divided by the Series A PPS (\$1.80)
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At the time of the Series A financing, Amy E's note automatically converts into Series A shares. Because Amy E's conversion cap was \$3 million, she receives 833,333 Series A shares.

Amy E's conversion cap resulted in Amy P receiving a 66 percent discount on the Series A PPS. Her share calculations are below, along with a side-by-side comparison against a regular Series A investor and GrowCo's post-Series A capitalization table.

Note Holder Series A PPS	\$0.60	Noteholder's conversion cap (\$3 million divided by the number of shares outstanding prior to the Series A financing (5 million shares))
Note Holder Series A Shares	833,333	Note amount (\$500,000) divided by the Note Holder Series A PPS (\$0.60)

	Series A Investor	Amy E
Price Per Series A Share	\$1.80	\$0.60
Series A Shares	555,555	833,333

GrowCo's Post Series A Financing

Stockholder	Common Shares	Series A Shares
Justin D	5 million	
Fast Growing Fund, L.P.		555,555
Strong Performance, L.P.		555,555
Next Level Investments, L.P.		555,555
Amy E		833,333

The takeaway

Caps can create big discounts and can greatly, yet unintentionally, affect stockholder ownership of a company.

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