PRIVATE EQUITY NEWS

Convertible loans and private equity: the growth opportunities in Germany

Nikolaus von Jacobs and Matthias Weingut

The classic convertible loan, a financing instrument popular in the venture capital sector, could also be an investment option for private equity investors in times where attractive equity investments in Germany are very competitive. In particular, in the context of growth investments, which are often similar to venture capital conditions, a convertible loan can be a better alternative when further capitalisation is sought in addition to a (private equity) lead investor.

From a venture capital perspective, the convertible loan is a very flexible financing instrument that is often available at short notice and can usually be concluded without much effort. Convertible loans can be characterised by a loan component and a conversion component and are usually found in the early stages of a company's existence, when it is still difficult for the parties to evaluate the start-up.

However, convertible loans are increasingly used for private equity investors to develop growth investment opportunities. The terms and conditions of a convertible loan should then be adjusted. This provides different scenarios for investors to consider, such as a private equity lead investor looking for additional investors. In this case, the lead investor will have concrete ideas about their investment that allow them to let another, more cautious private equity investor make an investment that is senior to them, allowing for a predictable, attractive profit based on a fixed interest rate, coupled with the option of a later equity investment. This is more so if such a private equity investor replaces debt financing of the company, which often is the alternative route to obtain further funding.

Another example might be a situation in which a private equity investor wants to postpone the decision of an equity investment while also being willing to invest into a more senior instrument with the subsequent option to convert into equity at an attractive conversion rate (by means of a pre-determined internal rate of return).

German banking supervisory regulations, for the permission of credit transactions, must be observed for each convertible loan, irrespective of whether the loans are granted by a venture capital or private equity investor. Although a convertible bond would not require any such permission, the parties often consider this alternative as too costly and inflexible.

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>
> Nikolaus von Jacobs (left), Matthias Weingut
> McDermott Will & Emery

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Those regulatory permission requirements can be avoided if the investor has control over the company from a corporate perspective. Such control can be based, for example, on a voting agreement or on a security transfer of shares. In the course of the latter, the shares in the borrower would form collateral for the lender and would suffice to comply with the regulatory control requirement, as opposed to a sole share pledge, which would only provide for collateral but no control.

Security transfer

Certainly, such control is not often desired by the parties, but there might be situations where the shareholders believe in their growth business and therefore are willing to accept such security transfer to enable the next growth step of the company.

With respect to the adaptations of the convertible loan, a private equity investor will want to retain as much freedom as possible. In addition, the investor will expect to be able to convert at any time, to exclude termination by the company and, even in the event of an exit by a lead investor, to be paid out or still be allowed to convert. Unlike in the venture capital case, a conversion or company valuation is not based on a later financing round (including a potential discount or valuation cap) but on a previously agreed internal rate of return of the lead investor's equity investment or, alternatively, a pre-agreed internal rate of return of the convertible instrument in the event of conversion.

Moreover, the private equity investor will request certain veto rights that can be backed by a small equity participation, which enables corresponding minority protection rights in the shareholder meeting for the investor. Finally, especially in the case of foreign private equity investors, a "tax gross-up" common in financing may be included in the documentation.

The interest in the growth sector in Germany is ever-increasing and will continue rise. Private equity investors are increasingly investing in the growth sector partly because of high competition for mature companies and appealing business models. Convertible instruments are a good means to invest in this area characterised by higher risk in structurally reducing exposure.

Foot in the door

Throughout 2021, we expect private equity investors to use such convertible loan situations as an additional option to get a foot in the door of an attractive target company even if the current situation/valuation does not (yet) allow a direct equity investment.

From a company perspective, we feel this set-up could also be a good option to avoid a debt financing by a bank at an early stage, which usually provides for a stricter regime in terms of covenants.

Dr. Nikolaus von Jacobs is a partner and Matthias Weingut is an associate focusing on private equity and mergers and acquisitions at law firm McDermott Will & Emery in Munich.