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CNPLAW BUSINESS GUIDE SERIES: DEBT AND EQUITY FINANCING

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Introduction

While there are various Singapore government grants available to Singapore-incorporated companies, not every company will qualify for such grants or find them sufficient for its growth or working capital. In such case, funding from investors becomes a necessity, whether it is from the infamous 3Fs (friends, family and fools) or venture capitalists. This article examines the common forms of debt and equity financing adopted by private companies incorporated in Singapore to raise funds.

Prospectus requirements

It is important to note from the outset that the Securities and Futures Act (Cap. 289) of Singapore ("**SFA**") requires a prospectus to be issued for all offers of securities (including shares and debentures) or securities-based derivatives contracts unless they are excluded or exempted from such requirement. Exempted offers include:

- small personal offers where the total amount raised from such offers within any 12-month period does not exceed S$5 million or such other amount as may be prescribed by the Monetary Authority of Singapore (section 272A of the SFA);
- offers made to no more than 50 persons within any 12-month period (section 272B of the SFA);
- offers made to institutional investors (section 274 of the SFA); and
- offers made to accredited investors (section 275 of the SFA),

In each case, subject to any further conditions such as the offer not having been accompanied by an advertisement (other than an information memorandum prepared as a basis for the investment decision) and no promotional expenses having been incurred in connection with the offer. Companies looking to raise funds without a prospectus should therefore ensure that their offers fall within the relevant exemption or are otherwise not regulated under the SFA.

In the crowdfunding space, debt-based crowdfunding (commonly known as peer-to-peer (P2P) lending) and equity-based crowdfunding are subject to the above prospectus requirements as they are considered to be offers of securities, including crowdfunding involving the use of digital tokens or cryptocurrencies which fall within the definition of securities under the SFA. In addition, operators of crowdfunding platforms that facilitate such offers or provide advice relating to such offers may be seen to be "dealing in securities" or "advising on corporate finance", respectively, which are regulated activities requiring a capital markets services licence under the SFA. Other types of crowdfunding which are not securities-based (such as rewards-based or donation-based crowdfunding) do not fall within

the above purview of the SFA, though crowdfunding for charitable purposes will be subject to the Code of Practice for Online Charitable Fund-raising Appeals, which is based on ensuring the legitimacy, accountability and transparency of charitable appeals hosted on crowdfunding platforms in Singapore.

Debt vs equity

The two main types of financing available to companies are debt and equity. Debt financing involves the borrowing of monies while equity financing involves selling part of the equity in the company. Deciding between debt and equity financing will depend largely on the stage of the company's life cycle and its financial status and business needs, amongst other things.

In determining the type of financing to adopt, a key consideration is whether the company is willing to relinquish any equity as this would result in a dilution of ownership and, potentially, management control and a sharing of any profits of the company, which may ultimately cost more than a loan. The upside to this is that, unlike a loan, no repayment of monies is required, which can be advantageous to companies without significant cash-flows or profits yet and which need a longer trajectory to break even. Companies may also potentially raise more funds through equity financing, where the capacity of the business to support debt is constrained, particularly where the growth potential of the business supports a high valuation of the potential earnings.

In terms of speed, debt financing in the form of a simple loan from investors is generally faster to secure. This is mainly attributed to added time required for investors to conduct due diligence and negotiate investor rights before acquiring equity in a company as this is usually seen as a long-term investment. However, there are instances where debt financing may also involve such due diligence or negotiations, particularly if the loan is sought from banks or other financial institutions (which is outside the scope of this article), or in hybrid cases combining both debt and equity financing such as venture debt and convertible debt as further discussed below. As part of such due diligence or negotiations, the investor may require the company to rectify any issues and provide certain warranties (to be qualified by any disclosures) and indemnities to mitigate any risks discovered during the due diligence exercise.

Debt financing

Loans are typically obtained as a short-to-medium-term solution to provide immediate or recurring cash flow for working capital needs, although longer-term finance may be required to finance capital expenditure. They may be subject to interest with a fixed repayment plan and secured by collateral provided by the company and/or its founders in favour of the lender, such as personal and corporate guarantees and charges over assets. In addition, the lender may require the company to give negative covenants to restrict or

prohibit the company from carrying out certain acts which may adversely affect the loan, such as incurring further indebtedness and creating further encumbrances over assets. The lender will be able to assert limited control over the management of the business in this manner, despite not have any voting rights in the company

Some companies may find debt financing unsustainable due to the strain of repayment, high interest rates or lack of significant assets to offer as collateral over time. The severe implications of becoming insolvent and possibly even being wound up as a result of defaulting on loans is another reason for businesses not to overextend their debts. Any guarantors of the loans would also be affected, running the risk of bankruptcy in the case of personal guarantors, which are usually the founders. Many start-ups therefore prefer to treat debt financing as an interim arrangement (such as a bridge loan or subordinated debt that converts into the next equity round) until they can secure more permanent financing.

Hybrid financing

An alternative form of debt financing is venture debt which has recently emerged in Singapore and aims to support high growth enterprises between equity financing rounds. Under a venture debt, the loan quantum is usually a percentage (e.g. 30%) of the amount raised in the company's last equity financing round, coupled with an option for the lender to acquire equity in the company at a percentage (e.g. 20%) of the loan quantum in the future. The Singapore government has introduced venture debt programmes in support of this, such as the Enterprise Financing Scheme (EFS) Venture Debt Programme which provides a loan quantum of up to S$8 million to eligible companies.

Venture debt is to be distinguished from convertible debt where the lender usually has the right to convert the loan quantum to equity upon the occurrence of certain trigger events (such as a qualified equity financing round), subject to any anti-dilution rights as further discussed below. This would result in a higher dilution of ownership of the company compared to a venture debt where equity to be acquired is limited to a percentage of the loan quantum. This distinction is intended given that venture debt is meant to complement and not replace equity financing, providing start-ups with a quick boost without drawing significantly on equity reserves.

Equity financing

Equity financing is generally carried out via a subscription of new shares in a company which can have one or more classes (and sub-classes) of shares. While it is also possible for investors to acquire existing shares in the company via a share transfer (e.g. from a founder or a leaving shareholder) and limit the effect of dilution only to the transferor, the funds for such share transfer would be payable to the transferor and not the company requiring such funds. Such share transfer would also be subject to stamp duty of 0.2% of the purchase price

or the net asset value of the shares, whichever is higher.

Typically, the founders of a company would hold ordinary shares with voting rights and, depending on the parties' negotiations, incoming investors may then subscribe for preference shares with preferential rights. Any subsequent equity financing round would then involve a subscription of a new class of preference shares, usually with preferential rights ranking higher than those offered in the last equity financing round.

Preference shares are characterised by the preferential rights attached to them with respect to priority of repayment of capital in a liquidation event (such as a trade sale), participation in surplus assets and profits, cumulative or non-cumulative dividends, voting and/or priority of payment of capital and dividend in relation to other shares in the company. Parties may further negotiate for preference shares to be redeemable by the company and/or convertible to ordinary shares in the future, including in a qualifying IPO.

Conversion rights attached to preference shares may be accompanied by anti-dilution rights where the company subsequently issues new securities at a price lower than the price of the existing preference shares (i.e. a down-round). Anti-dilution rights are usually based on a full ratchet or a weighted average formula. A full ratchet adjusts the conversion price of the existing preference shares to the lower price in the down-round, while a weighted average adjusts such conversion price by taking into account: (a) the number of ordinary shares outstanding prior to the down-round calculated on a fully diluted, as-converted basis (i.e. broad-based); or (b) the number of the ordinary shares outstanding prior to the down-round calculated by considering only ordinary shares issuable upon conversion of the preference shares in question (i.e. narrow-based). As anti-dilution rights in favour of the investor will inevitably further dilute the founders' shareholdings in the company, the founders should consider whether they are willing to offer such anti-dilution rights and if so, which formula should be applied in the circumstances.

Pursuant to section 75 of the Companies Act (Cap. 50) of Singapore, the rights attached to preference shares must be set out in the company's constitution prior to issuing such shares. It would also be prudent to amend the company's constitution for consistency with any investment agreement between the parties to avoid any conflicting provisions in the company's constitution, given that the company's constitution is a public contract separate from such investment agreement and binds the company and the registered shareholders and not just the parties to the shareholders' agreement.

In addition to the rights attached to preference shares, investors may also request other investor rights such as board representation, inclusion in quorum for board or shareholder meetings, pre-emption rights or rights of first refusal, tag or drag along rights, information rights and/or reserved matters (depending on whether the investor will be a minority or

majority shareholder or is a lead investor in the equity financing round). Parties will usually spend some time negotiating such investor rights as they will allow the investor to exert influence over the management of the company, though this may be beneficial to the company to a certain extent if the investor is a business collaborator or has relevant expertise to contribute to the company.

Venture capital investment model agreements

To facilitate seed rounds and early stage financing, the Singapore Academy of Law and the Singapore Venture Capital & Private Equity Association have launched a set of model agreements known as Venture Capital Investment Model Agreements ("**VIMA**") which comprise the following documents:

- venture capital lexicon;
- non-disclosure agreement;
- convertible agreement regarding equity (CARE);
- series A term sheet (short and long form template);
- subscription agreement; and
- shareholders' agreement.

However, VIMA should only be used for general reference and not as legal advice. The relevant documents provided in VIMA may need to be customised and supplemented to meet the parties' requirements, especially to incorporate any negotiated points in compliance with applicable laws and best practices. Legal advice in respect of each financing round should be sought for this purpose.