All About Startup Funding In India

Coinmen Consultants LLP
www.coinmen.com

Preface

The purpose of this document is to assist Indian startup founders to understand the nuances of fundraising in India, including various fundraising instruments and their underlying features, benefits, and tax & regulatory implications.

Contents

Abbreviations 04

Funding Imperatives For Startups 05

Funding Sources For Startups 07

Funding Instruments For Startups 08

Convertible Notes 09

CCDs/CCPS 11

External Commercial Borrowings 14

Takeaways 16

Abbreviations

CCD – Compulsorily Convertible Debentures

CCPS – Compulsorily Convertible Preference Shares

CN – Convertible Notes

DCF – Discounted Cash Flow

ECB – External Commercial Borrowings

FDI – Foreign Direct Investments

FEMA – Foreign Exchange Management Act, 1999

MB – Merchant Banker

NCD – Non-Convertible Debentures

NROI – Non-Resident of India

OCD – Optionally Convertible Debentures

PCD – Partially Convertible Debentures

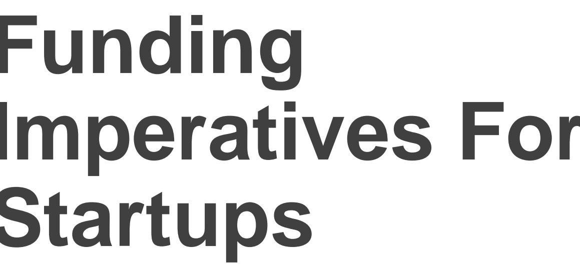
NCPS – Non-Convertible Preference Shares

OCPS – Optionally Convertible Preference Shares

PCPS – Partially Convertible Preference Shares

ROI – Resident of India

SEBI – Securities Exchange Board of India



Funding Imperatives For Startups

Raising capital is typically one of the first issues that any startup has to deal with. The question whether one should run a bootstrapped startup or raise funds through external sources is the first dilemma which bothers budding or early-stage entrepreneurs. While the choice hinges on numerous factors, it is important to appreciate what each source has to offer in terms of features, advantages/disadvantages, and tax & regulatory implications.

BOOTSTRAPPING

Initially, the startups rely on their own savings to fund the venture until they reach a certain stage when they are confident that the idea is worthy of a marketable product/service which can also be monetized. The moot question is that for how long should they remain bootstrapped. And while there is no straight answer, one should be aware to maintain the balance between lower valuation and excess dilution of control vis-à-vis need for funds. Of late, it has been seen that startups which are cash-positive on unit level tend to sustain better.

Common Sources

Relatives, friends, etc. This involves relatively small amounts of funds.

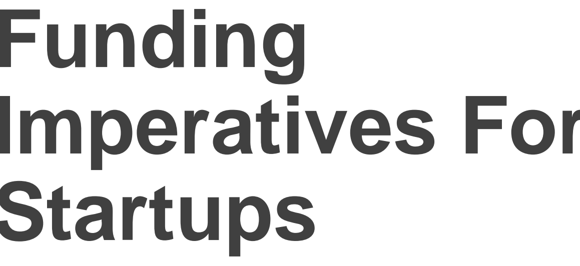
OTHER FUNDING SOURCES

Other funding sources could simply involve borrowings from financial institutions like any other working capital loan, but that requires adequate collateral security to be deposited/pledged with the financial institutions which the startup could not initially afford, as it is still a baby which is learning to walk.

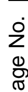
Another source of funding is raising capital through venture capitalists (such as incubators, accelerators, angel investors, or venture capital firms) which invest their funds in exchange for equity. Of course, the equity dilution is not feasible from day one, and therefore, hybrid instruments are preferable.

Moreover, it could prove beneficial to get good mentors on board who have more knowledge and network, other than the funds they infuse.

The most common sources of external funding have been discussed in detail in the ensuing sections.



Funding Imperatives For Startups



Pros and cons of bootstrapping and other funding sources

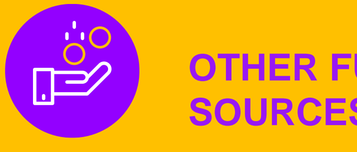
BOOTSTRAPPING

Pros

- Sole decision-making power of the founder(s)
- No uncertainty in terms of raising funds
- More autonomy in running the business operations
- No dilution of ownership

Cons

- Slow growth due to limited funds
- Lack of market credibility
- Limited scope of expansion



OTHER FUNDING SOURCES

Pros

- Synergy
- Better market credibility/visibility due to presence of established investors
- Strategic guidance from experienced entrepreneurs/investors
- Assistance in scaling up

Cons

- Dilution of control in case of equity funding
- Fixed interest outflow in case of debt funding
- Slow decision-making due to numerous stakeholders
- Less autonomy in running the business operations

Funding Sources For Startups

- **Angel Investors**

Individual investors, family and friends looking to support and fund a promising venture at an early stage for a potentially high return.

- **Venture Capital/Private Equity Funds**

Individuals/firms who/which manage funds aimed towards specific startup sectors and stages.

- **Family Offices**

These investors include super rich business houses which usually invest for long-term.

- **Traditional banking channels**

Some startups may prefer raising funds through banking channels rather than diluting their ownership stake. However, for early-stage startups with no revenue streams, it is difficult to obtain loans without adequate collateral in exchange.

- **Capital Markets**

Indian markets

One may explore the initial public offer (IPO) route, but this generally triggers in once the startup has reasonably matured in the market. There is a dedicated platform for small and medium-sized enterprises (SMEs). However, this may not be a feasible option for early-stage startups.

Overseas listing

Currently, India does not allow Indian entities to list overseas. However, discussions are in process to make that a reality.

- For Indian startups, raising money from overseas investors is also an option. However, many-a-times, investors require business to have a holding company in the overseas jurisdiction. This is technically known as flipping the structure or externalization. This is not easy to achieve, given the existing foreign exchange regulations in India.

Funding Instruments For Startups

CONVERTIBLE INSTRUMENTS

As the name suggests, these instruments are hybrid in nature, with dual characteristics. Initially, they act as debt instruments (earning a fixed interest rate or fixed dividend rate) and at a later stage, they get converted into equity – either compulsorily or at the option of the investor – subject to fulfillment of mutually decided conditions.

Since startups, at least in the initial stages operate in cash-preserving mode, the interest/dividend is usually cumulative and converted into equity rather than regular payout in cash.

Investment by non-residents in convertible instruments are governed by FDI regulations under FEMA, irrespective of the legal status of the receiving entity.

Examples – **CNs, CCDs, CCPS.**

NON-CONVERTIBLE INSTRUMENTS

These instruments are not convertible into equity at all and are purely in the nature of debt. Since these instruments do not provide an option to convert into equity, they are the least preferred source of investment for the investors as no equity stake is promised.

Investment by non-residents in non-convertible instruments are governed by ECB regulations under FEMA.

Examples – **NCDs/NCPS, OCDs/OCPS, PCDs/PCPS, pure loans.**

Each of the above instruments namely CNs, CCDs/CCPS and ECB have been discussed in detail in the ensuing section.

Convertible Notes

CONVERTIBLE NOTES

Definition

- As per the Companies Act, 2013:

  An instrument evidencing receipt of money initially as a debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of the start-up company within a period not exceeding 10 years from the date of issue and upon occurrence of specified events and as per the other terms and conditions agreed to and indicated in the instrument.

- As per FEMA:

  Same as in Companies Act, 2013 except that the maximum period in FEMA is still 5 years.

  We believe that this should have also been amended to 10 years but, for some reason, it seems to have been missed out.

Prerequisites for issuing CNs

- Can only be issued by DPIIT-recognized startups;
- Can only be issued by a private limited company;
- Minimum investment amount per investor – INR 25 Lakh in a single tranche.

Features

- CN can only be issued by a startup recognized by the DPIIT.
- Can be issued to ROI as well as NROI unless an individual, who is a citizen of Pakistan or Bangladesh, or other than individual, which is registered/incorporated in Pakistan or Bangladesh*.
- Investment by non-resident investors shall be subject to sectorial restrictions and other restrictions prescribed under FDI Guidelines under FEMA.
- Subsequent conversion in equity is subject to prescribed pricing and other guidelines under FDI Guidelines under FEMA.

  ** Vide notification dated 22 April 2020, the Central Government extended the approval route for making FDI in equity instruments to all countries sharing land border with India. However, in our opinion, since CN does not fall under the definition of equity instruments (which includes CCDs and CCPS); restriction on CN issuance with government approval only applies to Pakistan and Bangladesh citizens/entities.*

Convertible Notes

Advantages

- No share valuation is required while issuing CNs. This makes it convenient for startups to raise funds without worrying about the valuation.
- Investors do not have any control or voting power until CNs are converted into equity.
- From investors' perspective, CNs are preferable over CCDs as, under CNs, the investor has an 'option' but 'not an obligation' to convert debt into equity.

Disadvantages

- Since CNs are akin to call options, the investors may opt not to convert them into equity and the CNs will remain as debt and thus require redemption. This could potentially put financial stress on the startup companies. Hence, it is important that the CN agreement is drafted carefully.
- The threshold of minimum investment of INR 25 Lakh in a single tranche also becomes a hurdle for start ups raising funds.
- CNs can only be issued by DPIIT-recognized startups and that too by startups which opt for incorporating a company as the form of the legal entity.

Taxation aspects

- Subsequent conversion into equity is exempt from capital gains tax. However, the conversion price shall have to be at FMV. In case the conversion price is anything other than the FMV, it shall be taxable as under:

  → **Conversion price greater than FMV** – Difference between the conversion price and the FMV is taxable in the hands of the startup company.

  However, this is exempted in case the company is a DPIIT-recognized startup and has obtained tax exemption approval from the income tax authorities at the time of conversion.

  → **Conversion price less than FMV** – Difference between the conversion price and the FMV is taxable in the in the hands of investor.

- Interest paid on CNs, if any, shall be a tax-deductible expense for the startup entity.
- Interest received by the investor shall be taxable in the hands of the investor based on the applicable rates under the ITA or tax treaty (in case of NR investors), whichever is more beneficial to the investor. Startup entity will be obliged to comply with the withholding tax provisions.

CCDs/CCPS

COMPULSORILY CONVERTIBLE DEBENTURES/PREFERENCE SHARES

Definition

- CCDs/CCPS are considered as good as equity and fall under the definition of capital instruments under the Indian foreign exchange regulations.

  Non-convertible/optionally/partially convertible debentures and preference shares are governed by the ECB guidelines which have been discussed later in this document.

Minimum investment

- Unlike CNs, no minimum investment limit is prescribed for CCDs.

Features

- CCDs can be issued to ROI as well as NROI unless an individual, who is a citizen of any country sharing land border with India, or, in case of other than individual, any entity, which is registered/incorporated in any country sharing land border with India.
- Valuation report to be obtained from a registered valuer irrespective the issuance is made to ROI or NROI.

In case of foreign investors, following conditions are applicable:

- Issuance cannot be at less than the price determined by internationally accepted valuation methodology. Acceptable methods include the DCF method.
- Valuation to be certified by a CA, practicing Cost Accountant, SEBI-registered MB.
- Price/conversion formula required to be determined upfront at the time of issuance of CCDs.
- Issue price at the time of conversion into equity cannot be less than FMV worked out at the time of issuance of CCDs. In other words, the FMV worked out during the issuance of CCDs will act as a floor price.
- Pricing guidelines do not apply if the investment is made on non-repatriable basis. The same shall be treated at par with domestic investments made by residents.
- Coupon rate on CCDs/dividend rate on CCPS cannot exceed SBI PLR (prevailing on the date of board meeting in which such issue is recommended) + 300bps.

CCDs/CCPS

Advantages

- From investors' perspective, it is certain to get equity stake at the time of conversion into equity.
- It provides for transparency, as the terms and conditions of CCDs are decided upfront. Such terms and conditions include price/conversion formula.
- From startups' point of view, unlike the CNs, there is no uncertainty as to redemption on demand since the conversion into equity is compulsory,. Furthermore, since the conversion into equity is certain, CCDs have comparatively low coupon rate.
- Unlike CNs, there is no minimum investment threshold nor there is any pre-condition of being recognized as a startup by DPIIT.

Disadvantages

- Valuation at the initial stage of startups is always a challenge. Hence, fixing the price/conversion formula is a tedious task.

Taxation aspects

- Subsequent conversion into equity is exempt from capital gains tax. However, the conversion price shall have to be at FMV. In case the conversion price is anything other than the FMV, it shall be taxable as under:

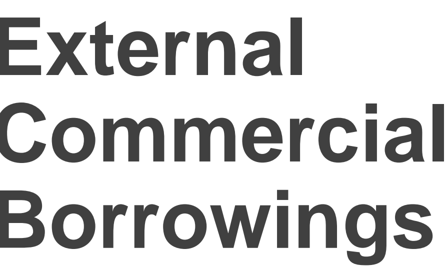
  → **Conversion price greater than FMV** – Difference between the conversion price and the FMV is taxable in the hands of the startup company.

  However, this is exempted in case the company is a DPIIT-recognized start-up and has obtained tax exemption approval from the income tax authorities at the time of conversion.

  → **Conversion price less than FMV** – Difference between the conversion price and the FMV is taxable in the in the hands of investor.

CCDs/CCPS

- Interest paid on CCDs, if any, shall be a tax-deductible expense for the startup entity.
- Interest received by the investor shall be taxable in the hands of the investor based on the applicable rates under the ITA or tax treaty (in case of NR investors), whichever is more beneficial to the investor. Startup entity will be obliged to comply with the withholding tax provisions.
- Dividend paid shall be table in the hands of the investors at applicable rates under the ITA or tax treaty (in case of NR investors), whichever is more beneficial to the investor. Startup entity will be obliged to comply with the withholding tax provisions.



External Commercial Borrowings

EXTERNAL COMMERCIAL BORROWINGS

Definition

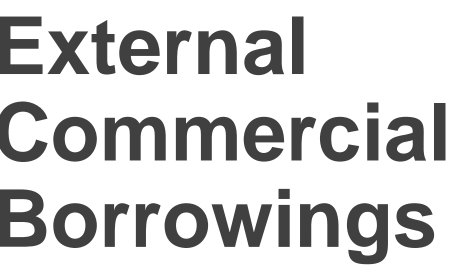
- ECB guidelines specifically provides for ECB facility for startups. Startups are allowed to raise ECB under automatic route subject to the applicable norms.
- Anything except compulsorily convertible instruments (CCDs and CCPs) and CNs fall under the definition of ECB. Example – Optionally, partially or non-convertible instruments, regular loans, etc.

Prerequisites for availing ECBs

- Startup should be a DPIIT-recognized startup on the date of raising ECB.
- Borrowing per startup will be limited to USD 3 million or equivalent per financial year either in INR or any convertible foreign currency or combination of both.
- Minimum average maturity period will be 3 years.

Features

- Unlike CCPS and CCDs, there is no cap on the all-in-cost ceiling for startups. It is based on mutual agreement between the parties.
- Lender/Investor shall be a resident of a FATF-compliant country.
- Foreign branches/subsidiaries of Indian banks and overseas entities in which Indian entity has made ODI as per the extant ODI policy will not be considered as recognized lenders under this framework.
- No restriction on end-use for startups as long as it is in connection with the business of the startup.
- Conversion into equity is freely permitted subject to Regulations applicable for foreign investment in Startups.



External Commercial Borrowings

Advantages

- No dilution of equity at any stage since ECBs are in the form of pure debt.
- Usually, a cheaper source of funding than equity but extremely hard to avail at a good rate without collateral security.
- Startups have been given numerous relaxations for raising funds through ECBs vis-à-vis any other entity. This includes no end-use restrictions as long as it is utilized for the business.

Disadvantages

- From startup entity's point of view, there is always a fixed interest cost attached to it, unlike hybrid instruments, once converted into equity.
- Too many regulatory compliances to comply with due to application of foreign exchange regulations.
- Maximum cap of USD 3 million or equivalent per financial year

Taxation aspects

- Interest paid on ECBs is a tax-deductible expense for the startup entity.
- Interest received by the lender shall be taxable in its hands based on the applicable rates under the ITA or tax treaty, whichever is more beneficial to the investor. Startup entity will be obliged to comply with the withholding tax provisions.

Takeaways

- Based on the discussions made in this document, it is quite clear that there is no straight-jacketed formula to decide whether one should remain bootstrapped or should reach out to investors for funding. However, the following factors are important to consider before coming to a decision:

  → **Business model of the startup**: Each business model has its peculiarities. Some business models may require huge initial investments even at the product development stage vis-à-vis other business models which may not require huge investments initially and the requirement to raise funds arises only once the product/service viability has been tested and one has now decided to scale up the operations.

  → **Maturity stage:** Fundraising will also depend on the stage at which the startup is in its lifecycle. In the initial stage, it is always better to dilute minimum control since the valuations are relatively low at the initial stage. If at all, one decides to reach out to external investors for funding, it is advisable to explore raising funds through CNs or CCDs.

- Amongst the various funding instruments discussed, convertible notes are the most preferable instrument amongst the startups and even the investors for numerous reasons as under:

  → They provide flexibility to the investors to redeem their investment without converting into equity.

  → Lesser compliance requirements before the funds can be raised.

Coinmen Consultants LLP

At Coinmen, our aim is to provide financial expertise to help set up your business and provide profound advisory for its growth.
This presentation is put together by our team to ensure that you're prepared well in advance to address the financial challenges that can potentially arise for your business in India.

NITIN GARG
Partner – Tax & Regulatory Services
+91 98991 46777
nitin@coinmen.com

KARNIK GULATI
Manager – Tax & Regulatory Services
+91 99710 11899
karnik.gulati@coinmen.com

Disclaimer: This publication does not constitute as professional advice. The information in this publication has been obtained or derived from sources believed by Coinmen Consultants LLP (Coinmen) to be reliable but Coinmen does not represent that this information is accurate or complete. Any opinions or estimates contained in this publication represent the judgment of Coinmen at this time and are subject to change without notice. Readers of this publication are advised to seek their own professional advice before taking any course of action or decision, for which they are entirely responsible, based on the contents of this publication. Coinmen neither accepts or assumes any responsibility or liability to any reader of this publication in respect of the information contained within it or for any decisions readers may take or decide not to or fail to take.

Coinmen Consultants LLP
www.coinmen.com