



Working Paper

Raising of Convertible Debt from Abroad by Startup Companies

1. **Background:** During our discussions over the last one year the representatives of Startups and Venture Capital (VC) firms have highlighted that current foreign exchange regulations governing borrowing from abroad, do not meet the requirements of Fintech and Startup companies. As per these stakeholders, foreign investors, at times, intend to invest in their companies in the form of convertible debt (i.e. loan convertible in to equity) instead of directly investing as equity.
2. **Issues:** It has been observed that foreign investors including Venture Capital/Private Equity funds and angel investors usually take interest to invest in startups; however, keeping in view the financial risks associated with startup companies, at times they prefer to provide funds initially as loan and subsequently decide about participation in the equity of the company. Startup firms also face funding issues due to unavailability of collateral/security, which is a prerequisite by most of the lenders. However, VC firms and angle investors then try to cover the risk through alternate means. Thus, sometime foreign investors charge premium for taking such risk, in the form of high return on loan amount or discount at the time of issuance of shares.
3. **Existing Regulations:** As per existing FE Regulations, companies can borrow funds from abroad under different categories (as defined in Chapter 19 of Foreign Exchange Manual) within the parameters defined for each category of loan. However, startup companies may face following issues while raising financing from abroad:
 - a. **Convertible debt:** Convertible debt is more like quasi equity, however, until it is not converted it is accounted for as debt in the financial statements. There is no specific category for raising funds through these convertible debt instruments, which may be converted into equity shares of the start-up at any time by the lender/investor. Currently, only Project Loans can be converted into equity either after completion of the project or after 3 years, whichever is later, only after obtaining prior approval of Exchange Policy Department.
 - b. **Credit rating:** The long-term credit rating of the borrower/its sponsors must not be less than BB- issued by recognized credit rating agency, except in case of exporters raising FCY loan up to 80% of its annual exports or intercompany loans.
 - c. **Eligible lenders:** As per existing regulations, loan cannot be raised from individuals abroad like angel investors.

4. **Proposed Changes in Chapter 19 of Foreign Exchange Manual:** A new type of loan may be introduced to meet the specific needs of startup companies keeping in view the issues they are facing in raising capital, in the form of convertible debt, from abroad under current regulations. Accordingly, following new paras may be introduced in chapter 19 to facilitate the startup companies:

“Para 7(vii) PSBA mobilized as Convertible Debt:

A company may raise funds from abroad in the form of convertible debt i.e. the lender shall have the option to convert the loan into equity of the borrowing company, subject to following terms and conditions:

- a) The borrowing company is incorporated as a private limited/public unlisted company under the Companies Act, 2017 (erstwhile Companies Ordinance 1984) for not more than 7 years, provided that such entity is not formed by splitting up, or reconstruction of a business already in existence.
- b) The borrowing company has annual revenue below PKR 2 billion since its incorporation.
- c) The borrowing company has equity (including retained earnings) below PKR 300 million as per latest audited financials.
- d) The requirement of long-term credit rating (as defined at para 7(i)(a) above) shall not applicable.
- e) In addition to the eligible lenders (as defined at para 7(i)(b) above), funds can be raised from all those investors which are eligible for issuance of shares in terms of Para 6 of Chapter 20 of Foreign Exchange Manual.
- f) The maturity of such loans shall range from one (1) year to five (5) years. The loans may be rolled-over subject to the condition that its total tenor will not exceed 5 years, in any case.
- g) The all-in-cost ceiling is given as under:

Maturity Period	Borrowing Cost Ceiling excluding relevant benchmark rate
One (01) Year to three (03) Years	250 bps
Above three (03) Years up to five (05) Years	350 bps

The borrowing cost ceiling includes spread over relevant benchmark rate, loan related insurance premium, and other loan related fees payable in foreign currency; except the commitment fee, cost & expenses and fees payable in local currency.

- h) The funds borrowed under this category can be credited in a foreign currency account opened and maintained in terms of Para 9(ii), Chapter 6 of the Foreign Exchange Manual.
- i) The principal can be repaid in bullet payment on maturity and no prepayments would be allowed.
- j) The outstanding loan amount, including accrued profit/mark-up, can be converted in to equity of the borrowing company on or before the maturity of the loan. The borrowing company may issue shares in favor of lender, in accordance with para 6 and 7 of Chapter 20 of Foreign Exchange Manual. However, the shares cannot be issued below the latest break-up value as determined by the external auditors included in the category A of the State Bank’s approved list of Auditors.

- k) The rupee liability of the loan (including accrued profit/mark-up) shall be determined by converting the FCY loan amount, outstanding as per last month-end or quarter-end (in case where last month-end figures are not available) financial statement, in to PKR by using the prevalent mark-to-market exchange rate (mid-rate) announced by State Bank of Pakistan.
- l) The facility of forward cover shall not be available.

Para 18(xiv) PSBA mobilized as Convertible Debt:

- **Documentation Requirement:**

- a) The loan/credit agreement.
- b) A list of the company's Directors along with their National identity numbers/ passport number and certified true copies of the same.
- c) Beneficial ownership of the borrower.
- d) An authenticated copy of the final repayment schedule (as per Appendix V-92).

- **Other conditions:**

- e) On complete disbursement of foreign currency loan, as per the underlying loan agreement, the Authorized Dealer will maintain the Proceeds Realization Certificates (PRC).
- f) The Authorized Dealer can affect the remittance of principal, interest and other fees, once the loan is registered. A copy of the Proceeds Realization Certificate (PRC), a certificate confirming the applicable benchmark rate and a certificate confirming payment of applicable taxes will be attached with the Form 'M' indicating LRN as remittance authority shall be maintained with Authorized Dealer at all times."
