Convertible Note Dilution: When Debt Turns Into a Shareholder Problem

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Learn how convertible debt turns into shares, when notes dilute shareholders, and which SEC filing terms matter.

When a company takes on debt, shareholders often breathe a sigh of relief - at least they're not diluting. But convertible notes don't stay as debt forever. They're designed to become equity. And when they do, existing shareholders absorb the dilution whether they knew it was coming or not.

Understanding how convertible note dilution works is essential for anyone investing in growth-stage, pre-revenue, or cash-burning companies - which describes a huge swath of the small and mid-cap universe.

What Is a Convertible Note?

A convertible note (also called a convertible debenture) is a type of debt instrument that can be - or must be - converted into shares of the issuing company's stock under specific conditions. The lender initially functions like a bondholder, receiving interest payments. But at a trigger event (maturity, a financing round, or the lender's election), the debt converts into shares.

At the moment of conversion, new shares are created and issued to the former debt holder. This increases the total share count - diluting everyone else.

The Key Terms That Determine Dilution Risk

Not all convertible notes dilute equally. The actual dilution impact depends on several terms buried in the agreement:

Conversion Price

The price per share at which the debt converts. A fixed conversion price (e.g., converts at $10/share regardless of market price) is less dangerous because the total dilution is knowable upfront. A variable conversion price (converts at a discount to wherever the stock is trading) is the hallmark of potentially predatory financing.

Conversion Discount

Many notes convert at a discount to market - commonly 15-30%. A $1M note converting at a 20% discount to a $10 stock would create shares at $8, meaning $1M / $8 = 125,000 new shares. If the same note converts after the stock has dropped to $5, the 20% discount makes the conversion price $4, and now you're getting 250,000 shares from the same $1M note.

Interest Rate and Accrued Interest

Many convertible notes carry 8-12% interest. When the note converts, the accrued interest often converts too - meaning the principal and the interest both become shares. A $1M note at 10% annual interest carried for 2 years becomes a $1.2M conversion - 20% more dilution than the original deal.

Warrants

Many convertible notes include warrant coverage - additional rights to purchase shares at a

specified price. These don't dilute immediately but represent "shadow dilution" hanging over the share count. A note with 50% warrant coverage on a $1M raise at $10/share gives the lender warrants on 50,000 additional shares.

Term

What It Means

Dilution Risk

Fixed conversion price

Converts at preset price (e.g., $5)

Moderate - calculable upfront

Variable conversion

Converts at % of market price

High to Extreme - unlimited

Conversion discount

Lender gets shares below market

Moderate - increases with discount %

Warrant coverage

Rights to buy more shares later

Moderate - hidden dilution overhang

Most Favored Nation clause

Lender gets best terms from any future deal

High - can worsen retroactively

How to Find Convertible Notes in SEC Filings

Companies are required to disclose convertible notes in 8-K filings when they're issued, and in every subsequent 10-Q and 10-K balance sheet. Here's where to look:

* 8-K (Item 1.01 or 3.02) - The initial disclosure when a note is signed. Attached as an exhibit, the actual agreement shows you all the conversion terms.
* Balance Sheet (10-Q/10-K) - Look under "Convertible Notes Payable" or "Notes Payable." The face value and carrying value will both be listed.
* Notes to Financial Statements - The footnotes in every 10-Q disclose conversion prices, maturity dates, and outstanding principal.
* Shares Outstanding (cover page of 10-Q) - Compare this number to the prior quarter. Unexplained jumps often indicate conversion events have occurred.

Watch for going concern language + convertible notes. If an auditor flags "substantial doubt about the company's ability to continue as a going concern" in the same period the company has variable-rate convertible notes outstanding, that's a high-risk combination. The company may be forced to issue ever more shares just to stay alive.

When Is Convertible Note Dilution Actually OK?

Not all convertible notes are red flags. Many legitimate, well-run companies use convertible debt as a bridge financing tool with reasonable terms. The key questions:

* Is the conversion price at a reasonable premium to current market price?
* Is the company generating revenue (or close to it) with a real plan to repay?
* Is the total note size small relative to the company's market cap?
* Does the company have access to other, less dilutive financing options?
* Are insiders participating or did they negotiate arms-length with the lender?

A well-funded SaaS company issuing $5M in convertible notes at a fixed $20 conversion price with a 5-year maturity is a very different risk profile from a pre-revenue biotech issuing the same dollar amount at "75% of the 10-day VWAP" with a 6-month maturity.

The Dilution Math: A Real-World Example

Let's say a company has 10 million shares outstanding and takes a $2M convertible note at 25% discount to market, with 100% warrant coverage. The stock is currently trading at $4.

* Conversion price: $4 × 0.75 = $3.00
* Shares from conversion: $2,000,000 / $3.00 = 666,667 new shares (6.7% dilution)
* Warrants: 100% coverage = $2,000,000 / $3.00 = 666,667 additional warrants
* If warrants exercise: total new shares = 1,333,334 (13.3% dilution)

And that's if the stock stays at $4. If the stock drops to $2 before conversion:

* Conversion price: $2 × 0.75 = $1.50
* Shares from conversion: $2,000,000 / $1.50 = 1,333,333 new shares (13.3% dilution)
* Plus warrants - the math gets worse with every dollar the stock falls

Tracking Convertible Note Risk With TraderTools

TraderTools monitors 8-K filings for new financing agreements and extracts conversion terms automatically. When a company you're watching issues a new convertible note, you get an alert with the key terms - conversion price, discount rate, warrant coverage, and our assessment of the dilution risk. No more digging through EDGAR exhibits.

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* Death Spiral Financing: When Convertible Notes Become Predatory
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