An Overview of SAFEs and Convertible Notes as Investment Instruments

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Companies seeking to raise capital and investors desiring to invest funds into promising companies have a number of investment vehicles available to them, such as conducting an equity financing, a convertible note financing, or a SAFE financing. This article provides an overview of two popular investment instruments, SAFEs and convertible notes, together with a comparison of the two and an analysis of certain risks and benefits for companies and investors.

Understanding SAFEs

SAFE stands for Simple Agreement for Future Equity. A SAFE allows an investor to infuse capital into a company at the time the SAFE is entered into and the funds will typically convert into shares of stock upon a triggering event. Generally, the goal is to invest with a SAFE and for it convert into preferred stock upon the next preferred stock financing round (if one occurs). However, if a liquidation event such as an acquisition occurs prior to the conversion of a SAFE, it would typically result in conversion of the SAFE into common stock which would then be sold as part of the acquisition or allow the investor to cash-out by receiving back the original amount they paid for the SAFE. If a dissolution event occurs before the conversion of the SAFE, the investor would be entitled to receive a portion of the proceeds equal to the amount originally paid for the SAFE, to the extent there were any remaining assets available. The priority of payment upon a dissolution event or liquidation event would be outlined in the SAFE.

The current industry agreed upon standard form of SAFE is available at the YCombinator website. In 2018, the standard form of SAFE was updated to be on a post-money basis. This allows for some additional certainty to founders regarding expected dilution, and investors of their expected ownership upon conversion of the SAFE. However, if additional rounds of SAFEs or any convertible notes are issued afterwards, the expected dilution and ownership percentages would change.

Valuation Cap, Discount, or MFN:

The terms of a SAFE typically include either a valuation cap or a discount rate. In certain scenarios, the greater of a valuation cap or a discount rate may be agreed upon, in which case the investor gets to choose to elect whichever conversion method would result in them receiving more shares upon conversion. Less frequently, a Most Favored Nations (MFN) clause will be used in the SAFE.

- *Most Favored Nations.* A Most Favored Nations form of SAFE typically has no valuation cap or discount rate, and instead has a term that if the company issues any subsequent convertible securities with terms more favorable than those of such investor's SAFE (for example, a valuation cap or discount) prior to the termination of such SAFE, then the company will provide notice to the investor; and if the investor determines such terms are more favorable than the terms received in their SAFE, the investor and the company can amend the terms of the investor's SAFE to match such more favorable terms. In certain scenarios, an MFN provision could be negotiated into a SAFE that has a discount rate or valuation cap if the investor was concerned that there could be future rounds of convertible securities issued with more favorable terms.

- *Valuation Cap*. A valuation cap is the maximum valuation price a SAFE will convert into shares of stock. The lower the cap, the better it is for the investor because it means that their SAFE could convert into more shares. However, if a future preferred stock financing occurs and the SAFE has only a valuation cap and the valuation of the company at the time of the financing is below or the same as such SAFE valuation cap amount, the SAFE investor would receive no extra shares upon conversion of the SAFE. Conversely, if the valuation of the company skyrockets upon the next equity financing, the SAFE investor could have the opportunity to receive a large amount of additional shares upon conversion versus any new investors just coming in. An example of a SAFE valuation cap is that if the valuation cap on the SAFE is $5,000,000 and the company at the next preferred stock equity financing is raising money at a $10,000,000 valuation, the investor is able to convert their SAFE at a price per share equivalent to $5,000,000. For this reason, investors typically try to negotiate lower valuation caps while companies will try to negotiate higher valuation caps.

- *Discount Rate*. A discount rate means that when the SAFE converts it will do so at whatever the agreed upon discount is upon the next preferred stock equity financing, resulting in the investor receiving more shares for their investment. For example, if a SAFE has a 15% discount and the next priced preferred equity round is at $1.00 per share, the investor will pay only $0.85 per share, and thus receive more shares per dollar from their SAFE investment compared to the new investors who are investing at the full price per share. As a result, investors usually try to negotiate for higher discounts, and companies will try to negotiate for lower discounts.

Benefits and Risks of SAFEs:

Some key benefits of a SAFE are that the form document from YCombinator is the current, generally accepted standard document in the industry, which means investors and companies will likely spend less time drafting and negotiating (and therefore less on fees associated therewith and closing can also typically occur on a more accelerated timeline). Companies tend to prefer SAFEs because they do not represent debt, they have no maturity dates, and they have no interest that accrues. Investors like SAFEs because if the SAFE converts into preferred stock, they have the opportunity to get more shares for their dollar (by way of discount or valuation cap) as a reward for the risk they took.

Some risks for investors with SAFEs are that they are not debt instruments, and they do not represent a current equity stake in a company. Therefore, because the investor is not receiving equity at the time of your SAFE investment, it will not have any stockholder voting rights in the company until such time as the SAFE were to convert into stock. In addition, unlike a convertible note, the investor will not earn any interest on the SAFE and there is no maturity date that would put pressure on the company to timely do a financing. The SAFE will only convert if certain triggering events occur (typically a future preferred stock financing round or upon a liquidation event). If such triggering events do not occur, the SAFE could be outstanding indefinitely. SAFEs also pose a potential risk to founders because upon conversion of a SAFE into a future preferred stock equity financing, depending on the terms of the SAFE, the founders could get quite diluted in their ownership.

Understanding Convertible Notes

Convertible notes are debt instruments, pursuant to which an investor essentially loans funds to a company in exchange for a convertible note with terms providing for conversion of the note into stock or repayment of the principal amount plus interest. The convertible note is structured such that the capital borrowed either converts into shares of stock in connection with a future financing round at a lower price than that paid by future investors as a result of a pre-negotiated valuation cap or discount rate, or is repaid upon maturity of the convertible note. Convertible notes provide investors with the downside protection of holding a debt instrument (versus equity, which is junior to debt in terms of priority of repayment) while also providing the potential upside benefit of the ability to convert the investment into shares of stock of the company upon a future equity financing or upon a liquidity event.

- *Accruing Interest.* Convertible notes accrue interest over time; interest rates vary but a range of 4-8% annually is typical. As a result, the amount owed to investors under the convertible notes will increase over time. Conversely, SAFEs do not accrue interest.

- *Discount Rates and Valuation Caps.* Convertible notes typically convert into stock of the company in connection with a future equity financing round. Due to the risk that an investor undertakes, the terms of convertible notes typically include language that provide for a valuation cap or a discount rate upon conversion of the note into equity, such that the investor would pay a reduced price per share than the new money investors in such future financing round.
  - *Discount*. A convertible note may include a prescribed conversion discount rate, effectively causing the noteholder to purchase equity at a lower price per share than that paid by future investors. For example, if a company raises capital by issuing convertible notes with a 20% conversion discount rate and then subsequently raises capital in an equity financing round in which investors pay $1.00 for a share of stock, the capital invested in the convertible notes would convert into equity at an effective purchase price of $0.80/share. In such a scenario, whereas a new investor investing $100,000 in the equity round would receive 100,000 shares in return for its investment ($100,000/$1.00 = 100,000 shares), a convertible note investor that previously invested the same amount of capital would receive 125,000 shares of stock upon conversion of the note ($100,000/$0.80 = 125,000 shares). While conversion discount rates are negotiable and can vary, a range of 15-20% is typical.

  - *Valuation Cap*. A convertible note may also include a “valuation cap” which is effectively a maximum valuation at which the convertible note will convert into equity of the company, irrespective of the valuation that is actually negotiated with investors in a future equity financing round. The purpose of a valuation cap is to protect against companies raising capital in an equity financing round at a higher than anticipated valuation, which would result in the convertible note converting into fewer shares of stock. A convertible note with a valuation cap protects investors by putting in place a ceiling for the valuation amount that their note will convert upon, resulting in more shares being issued to the convertible note investor.

- *Maturity Date.* Once a convertible note’s maturity date is reached, the convertible note becomes due and payable, together with all accrued interest, if an equity financing has not yet occurred and the convertible note has not been converted into stock. Occasionally, convertible notes will have terms that provide that the investor, at their election, can convert the note into equity instead of needing to be repaid. While the maturity date can be negotiated, 2 years is quite typical. Conversely, SAFEs do not have a maturity date.

Benefits and Risks of Convertible Notes:

Some key benefits of convertible notes for companies are that they can be a quicker way to raise capital for a company versus doing an equity financing. However, since there is no industry standard form of convertible notes, SAFEs are typically the quickest alternative. Investors like convertible notes because they have maturity dates, accrue interest, and represent debt on a company’s books.

Some risks with convertible notes are that the accruing interest coupled with the principal adds up over time and can be difficult for a company to repay, or upon conversion, the principal plus interest coupled with a discount or cap on conversion can have the potential of heavily diluting founders. Convertible notes do not represent a current equity stake in a company. Therefore, because an investor is not receiving equity at the time of the convertible note investment, it will not have any stockholder voting rights in the company until such time as the convertible note were to convert into stock.

Comparing SAFEs to Convertible Notes:

- Convertible notes represent debt on the books of a company and can typically either be repaid or convert into shares of stock. Whereas SAFEs do not represent debt, and typically convert into equity or remain outstanding.
- Convertible notes have maturity dates, and SAFEs do not.
- Convertible notes have interest rates, and SAFEs do not.
- There is an industry agreed upon standard form of SAFE, unlike convertible notes, so SAFEs can be quicker to negotiate, allowing for capital to be quickly invested into a company.
- Investors can negotiate to have a discount rate and/or valuation cap on conversion with both SAFEs and convertible notes.
- SAFEs and convertible notes do not represent equity unless and until they convert into shares of stock, so in both cases the investor will not have stockholder voting rights until conversion.

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