BREAKDOWN OF SAFES AS AN INVESTMENT VEHICLE

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This Breakdown of SAFEs as an Investment Vehicle article was created by Elizabeth Resteghini from Morse for Scroobious founders.

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There are a number of ways that a company can raise funds from investors, such as doing an equity financing, a convertible note financing or a SAFE financing. In this article I break down what a SAFE is, some of the risks and benefits to investing with a SAFE for both companies and investors, and how a SAFE differs from a convertible note.

What is a SAFE?

SAFE stands for Simple Agreement for Future Equity. The current industry agreed upon standard form of SAFEs are available at the YCombinator website (https://www.ycombinator.com/documents). A SAFE allows an investor to invest in a company with the invested funds typically converting into shares of stock upon a triggering event. Generally, the goal is to invest with a SAFE and have it converted 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. For a dissolution event or liquidation event the priority of payment would be outlined in the SAFE.

The standard form of SAFE was updated in 2018 by YCombinator; as updated, the shares issuable upon conversion of the SAFE are calculated on a "post-money" basis which provides 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 after the issuance of a SAFE, the expected dilution and ownership percentages would change.

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. There is also a Most Favored Nations clause form of SAFE, which 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 the SAFE (for example, a valuation cap or discount) prior to the termination of the SAFE that 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 than the investor and the company can amend the terms of the SAFE to match such more favorable terms.

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 equity 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.

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.

How does a SAFE differ from a Convertible Note?

Convertible Notes are another way for companies to raise capital. Convertible Notes will represent debt on the books of a company and can typically either be repaid or convert into shares of stock. Convertible Notes have maturity dates and interest rates, which SAFEs do not have. SAFEs allow for the similar general goal of Convertible Notes; however, SAFEs are not debt instruments so can be a little riskier for investors in that if a triggering event outlined in a SAFE does not occur (like a future preferred stock financing or liquidation event like an acquisition) then the SAFE could be outstanding indefinitely.

What are some of the benefits and risks with SAFEs?

Some key benefits of a SAFE is that the form document from YCombinator is the current generally accepted standard document in the industry, which means investors and companies will likely spend a less amount of time on drafting and negotiating (and subsequently less on fees associated therewith). Companies enjoy SAFEs because they do not represent debt, they have no maturity dates, and they have no interest that accrues. In addition, investing through a SAFE can happen on a typically much quicker timeline than with an equity financing or even a convertible note financing because there are less terms and documents to negotiate. SAFEs can allow for capital to be quickly raised by a company in between an equity financing round or prior to a seed financing round. 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 are that SAFEs are not debt instruments, and they do not represent a current equity stake in a company. Therefore, because you are not receiving equity at the time of your SAFE investment, you will not have any stockholder voting rights in the company until such time as the SAFE were to convert in preferred 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). As noted above, there is a chance that 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.

Final takeaways

In summary, SAFEs can be a great investment vehicle for both companies and investors by quickly providing companies with the funds they need to operate and grow their business, and allowing the opportunity for investors to potentially convert their SAFE in a future preferred stock equity financing round for an increased number of shares than other new investors at the time of the financing would receive by way of the SAFE discount or valuation cap. However, investors and companies should keep in mind the potential risks involved with SAFEs including a SAFE never converting into shares if a triggering event does not occur or a founder getting very diluted in their ownership.

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