Understanding Seed Stage Financing: SAFE Agreements vs. Convertible Notes

Securing early-stage funding is a pivotal challenge for startups looking to transform innovative ideas into thriving businesses. By understanding the nuances of SAFEs (Simple Agreements for Future Equity) and Convertible Notes, founders can make informed decisions that align with their venture's goals and investor expectations, ultimately propelling their startups towards success.

In the early stages, when startups lack revenue, profits, or a definitive valuation, traditional equity exchange becomes a complex endeavor. SAFEs and Convertible Notes offer innovative solutions that enable startups to raise capital without immediate valuation or equity dilution. SAFEs provide flexibility and simplicity, making them founder-friendly, while Convertible Notes blend elements of debt and equity, offering investor security

Here we will topically explore these two vital financial instruments. Each can simplify the funding process for founders navigating the turbulent waters of seed stage financing.

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Introduction

Navigating Early-Stage Financing

Launching a successful startup is an ambitious endeavor, and securing the necessary funding is often a critical step in turning visionary ideas into reality. However, for founders in the early stages of their startup journey, raising capital can be a complex and daunting task. Here we explore two financing instruments that simplify the process: SAFE agreements and Convertible Notes.

The Seed Round

The initial stage of fundraising in a startup's journey is often referred to as the seed round. During this phase, startups typically lack paying customers, market traction, profits, or even revenue. This lack of financial metrics makes it challenging, if not impossible, to determine a fair company valuation. In such situations, founders turn to financing tools like SAFEs and Convertible Notes to secure investment without immediately setting a valuation or giving away equity.

What is a SAFE?

Simple Agreement for Future Equity (SAFE)

A SAFE is a financial instrument designed to assist early-stage startups in raising funds without an immediate valuation or equity exchange. It addresses a significant challenge faced by startups: how to secure essential funding when they lack a concrete valuation or wish to defer equity issuance.

A SAFE is essentially a contractual agreement between an investor and a startup. In exchange for an investment, the investor receives a promise or "right" to obtain equity in the company at a predetermined, favorable rate when specific conditions, often referred to as "triggering events," are met. These triggering events are typically tied to a future financing or priced round, such as a Series A round investment.

Example of a SAFE Agreement:

Imagine a promising tech startup, Tech Startup Inc., is looking to raise $1 million to fund its initial product development. Tech Startup Inc. decides to enter into a SAFE agreement with an angel investor, Sarah. The terms of the SAFE agreement are as follows:

- Investment Amount: Sarah agrees to invest $1 million in Tech Startup Inc.
- Valuation Cap: They set a valuation cap at $10 million. This means that regardless of how much Tech Startup Inc. is valued at in the future, Sarah's SAFE will allow her to purchase equity at a maximum valuation of $10 million.
- Discount Rate: They also agree on a 20% discount rate, which means that if the valuation cap isn't reached in the future financing round, Sarah can purchase equity at a 20% discount compared to the price paid by other investors.

Now, let's fast-forward a couple of years. Tech Startup Inc. has made significant progress, and it's time for a Series A financing round. In this round, the company is valued at $20 million. Thanks to the SAFE agreement:

- Sarah can purchase equity at the previously agreed-upon valuation cap of $10 million, which is a better deal than the current valuation and will provide a significantly lower price per share than series A investors

The SAFE has served its purpose by allowing Tech Startup Inc. to secure early-stage funding without determining an immediate valuation, and it has rewarded Sarah for taking the risk of investing in the early stages.

In essence, SAFEs offer startups and investors a flexible and founder-friendly way to facilitate early-stage fundraising while deferring valuation discussions until a later, more mature stage in the company's development. This flexibility makes SAFEs a valuable tool for startups looking to attract investment in their early, uncertain stages.

Advantages of SAFEs

- Allows fundraising prior to a company valuation.
- Avoids an immediate equity dilution for founders.
- Does not accrue interest.
- There is no obligation for repayment if the company fails.
- A simplified setup and lower legal fees.
- Investors are rewarded through valuation caps and protected by discounts.

Disadvantages of SAFEs

- Typically used solely for early-stage companies, which can be riskier for investors.
- Lack of interest means investors may not recoup any investment if the startup fails.
- Less common than Convertible Notes.

SAFE agreements provide flexibility and simplicity, making them a founder-friendly financing tool, but their less widespread use can limit investor interest.

What is a Convertible Note?

Loan vs. Equity: Convertible Note

The Convertible Note represents a unique hybrid in the world of startup financing, blending elements of debt and equity. It serves as a strategic financial instrument employed by startups to raise capital during their early stages while offering investors the potential for future equity ownership.

Here's a closer look at how Convertible Notes work and why they are a popular choice for both startups and investors:

Convertible Note Mechanics:

- Initial Loan: A Convertible Note begins as a loan provided by an investor to the startup. This loan typically has a predetermined interest rate and a maturity date.
- Conversion into Equity: The key feature of a Convertible Note is its potential to convert into equity under specific circumstances, known as "triggering events." These events can include a subsequent financing round, an acquisition, or an initial public offering (IPO).
- Conversion Terms: Convertible Notes come with pre-negotiated conversion terms, such as a conversion discount and a valuation cap. These terms dictate how the loan converts into equity upon a triggering event.
- Maturity Date: Convertible Notes have a maturity date, which serves as a deadline for conversion. If a triggering event has not occurred by the maturity date, the investor can typically choose to either convert the note into equity or request repayment of the principal and any accrued interest.

Example of a Convertible Note:

Let's consider a hypothetical startup, InnovateTech, seeking $500,000 in early-stage funding. InnovateTech enters into a Convertible Note agreement with an angel investor, Alex.

Here are the terms of their agreement:

- Loan Amount: Alex provides a $500,000 loan to InnovateTech.
- Interest Rate: The Convertible Note accrues interest at an annual rate of 9%.
- Conversion Discount: They agree on a 20% conversion discount. This means that when the note converts into equity, Alex will receive shares at a 20%

discount compared to the price paid by other investors in the subsequent financing round.
- Valuation Cap: They set a valuation cap at $10 million, ensuring that even if InnovateTech achieves a higher valuation in the next funding round, the conversion will take place at a maximum valuation of $10 million.
- Maturity Date: The Convertible Note has a maturity date of 24 months from the date of issuance.

Several scenarios can unfold:

1. **Successful Financing Round:** InnovateTech successfully secures a Series A financing round within the 24-month window. The round values the company at $15 million. As per the Convertible Note terms:
    - Alex can convert the $500,000 loan into equity at a valuation cap of $10 million, receiving shares at a favorable price.
    - The 20% conversion discount further enhances the attractiveness of the investment.

2. **Maturity Date without Financing Round:** If, by the maturity date, InnovateTech has not conducted a financing round, Alex can choose to:
    - Convert the note into equity at the valuation cap and discount, as previously agreed.
    - Request repayment of the $500,000 principal plus accrued interest.

3. **Failure to Raise Funds:** If InnovateTech fails to raise a subsequent round and the company's valuation remains below the cap, the conversion may not occur, and Alex will have the option to either seek repayment or continue to hold the note.

The Convertible Note offers flexibility and a degree of security to investors, making it an attractive option for early-stage financing. Startups benefit from the ability to secure funding without setting an immediate valuation while incentivizing investors with conversion terms that can be highly favorable. This adaptability has made Convertible Notes a widely used instrument in startup financing.

Key Features of Convertible Notes

- ✓ Allow fundraising before company valuation.
- ✓ Avoid immediate equity dilution for founders.
- ✓ Considered safer for investors due to their debt-like nature.
- ✓ Flexible conversion terms.
- ✓ Commonly understood by investors.
- ✓ Potential for repayment through equity or cash.

Advantages of Convertible Notes:

- Provide a sense of security to investors.
- Flexibility in defining conversion terms.
- Greater acceptance among investors.
- Option for repayment in cash to avoid equity dilution.
- Potential for investor ROI through interest and equity.

Disadvantages of Convertible Notes:

- Complexity in determining ROI for investors.
- Typically used for early-stage companies, which can be riskier for investors.
- Potential loss of initial investment if the company dissolves.
- More complex structure and higher associated legal costs.

Convertible notes offer security to investors due to their debt structure and are often preferred by investors who are more familiar with this financing mechanism.

SAFE vs. Convertible Note: Choosing the Right Option

Factors to Consider

The choice between SAFEs and Convertible Notes hinges on several factors, including simplicity, legal requirements, familiarity, and risk tolerance.

Founder-Friendly vs. Investor-Friendly

- SAFEs tend to be more founder-friendly due to their flexibility and lack of interest.
- Convertible Notes are generally considered investor-friendly because the maturity date imposes restrictions on founders.

Flexibility vs. Maturity

- SAFEs offer flexibility by lacking a maturity date, allowing startups more time to achieve milestones before conversion.
- Convertible Notes are subject to a maturity date, which can range from 12 to 24 months, potentially hastening the conversion process.

Early-stage financing is a critical phase in a startup's journey, and choosing the right financing instrument can significantly impact its success. SAFE agreements and Convertible Notes provide valuable options for startups to secure funding without an immediate valuation or equity exchange. While SAFEs offer simplicity and

flexibility, Convertible Notes provide a sense of security to investors. Founders must carefully consider their unique circumstances and investor preferences when selecting the most suitable financing tool for their venture. Ultimately, the choice between SAFEs and Convertible Notes should align with the startup's goals and the expectations of its investors.

Founders should also be cautious about the potential dilution that may arise from the discussion and utilization of SAFEs and/or Convertible Debt when transitioning to the initial priced round. For an in-depth understanding of these financial instruments and their impact on post-pricing round dilution, we recommend referring to the provided resources below.

Please don't hesitate to reach out to us for assistance with any aspect of this process…

Videos:

Startup Financing 101: How SAFEs and Convertible Notes Work | Equity funding explained
https://www.youtube.com/watch?v=PtTDmeU-Kok

Startup financing 101: What's a valuation cap? SAFEs and Convertible Notes explained
https://www.youtube.com/watch?v=fcrsoartpFU

Startup financing 101: Pre-money SAFE vs. a post-money SAFE...what's the difference?
https://www.youtube.com/watch?v=Mj0LxtaLQIk

Understanding SAFEs and Priced Equity Rounds by Kirsty Nathoo (Y Combinator)
https://www.youtube.com/watch?v=Dk6JNTDec9I

Math:

SAFE vs. Convertible Debt Calculator
https://safes.carta.com/

Venture Math – SAFE and Convertible Debt
https://www.academyinvestor.com/post/venture-math