SAFE Notes in Venture Capital: "Unsafe" for Startups?

Two Prominent Venture Capitalists Walk Into a Bar and Debate the Merits of SAFE Notes…

This Lesson: SAFE Notes Explained

For the files and resources, please go to:

https://breakingintowallstreet.com/kb/venture-capital/safe-notes/

(Excerpt from our VC & Growth Equity Course.)

This Lesson: SAFE Notes Explained

Two of the **most common** ways to fund an early-stage startup are **priced rounds** and **SAFE Notes** (“SAFE” = “Simple Agreement for Future Equity”).

With SAFE Notes, the investors do **not** get direct ownership right away (no shares!).

This Lesson: SAFE Notes Explained

Instead, **they get their preferred shares later**, when the company raises its first "priced round," such as a Series A.

In theory, SAFE Notes are faster and cheaper – but they may also create **long-term problems** for the startup!

This Lesson: SAFE Notes Explained

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Announcing the Safe, a Replacement for Convertible Notes

by Y Combinator 12/6/2013

Paul Graham

YC partner (and lawyer) Carolynn Levy has created a new alternative to convertible notes, called a safe, that has the advantages of convertible debt without some of the disadvantages. We're publishing a standard safe document for all startups to use, and we expect most future YC startups will use this when raising money.

"Safe" comes from "Simple agreement for future equity." Although the name is an acronym, we got tired of typing "SAFE" all the time when talking about it, and we've already switched to lowercase.

AVC ARC... ...ITTER

MAY 30, 2019

Unsafe Notes

I was reminded yesterday how much of a shit show raising seed capital via SAFE notes is. I can't and won't get into why I was reminded of that, but let's just say nobody wants to go there.

So I thought I'd repost the important parts of a post I wrote on this topic a couple years ago.

I have never been a fan of convertible notes. USV has done quite a few convertible and SAFE notes. We are not opposed to convertible and SAFE notes and will not let the form of security the founder wants to use get between us and investing in a company that we like.

But I continue to think that convertible and SAFE notes are not in the best interests of the founder(s).

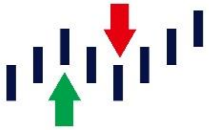
SAFE Notes: Lesson Overview

Part 1: SAFE Notes in a Seed Round

- **Cap Table:** Nothing changes! The co-founders and employees have their shares and options, and that's it

- **Seed Investors:** Do not get any shares in this round, even though they've invested $2M in the company

- **Valuation Cap:** Tells you the maximum valuation they can get shares at in the next priced round



- **Conversion Discount:** Tells you the discount to the share price they can get their shares at in the next priced round

Part 2: Conversions in the Series A Round

- **Scenario:** The startup raises $5M at a $10M pre-money valuation, so the VC firm *expects* to own ~33% ($5 / $15)

- **Step 1:** Calculate the "Price per Share" in this Series A, based on the Pre-Money Valuation / Pre-Money Shares

- **Step 2:** Determine the "Price per Share" that the SAFE Note investors get

- **Step 3:** Calculate each group's New Shares in this round and valuation of those shares

Part 2: Conversions in the Series A Round

- **Step 4:** Link everything into the post-Series A Cap Table and calculate the ownership percentages

- **Results:** The Series A investors do not own ~33%; they own only 29%!

- **Why:** Because the Seed Investors got their shares in this round, so the “real” Pre-Money Valuation was higher!

- **Solutions:** There are different ways to grant shares to the SAFE investors, such as methods based on weighted averages or “Dollars Invested” instead

Part 3: Options Pool Complexities

- **Very Common:** The Options Pool for employees is "upsized" in priced rounds like a Series A (e.g., 10% to 20%)

- **Meaning:** The employees get free (potential) shares in the company, which dilutes the Seed and Series A investors

- **How:** Take the Total NON-OPTION Shares, divide by (1 – New Option Pool Size %), and grant New Options based on the Total Shares * Option Pool Size %

- **Results:** The Series A investors now own only 25%, down significantly from 33% – because of these "free shares"

Part 4: Are SAFE Notes Worth It?

- **My Opinion:** No, not really – because many of their advantages no longer hold up quite as well

- **2013 (10+ Years ago):** Priced rounds were more expensive and difficult, and founders didn't want to negotiate valuations

- **Now:** Priced rounds have become cheaper and easier, and the benefits of SAFE Notes have lessened

- **SAFE Disadvantages:** Messy cap tables and unclear ownership; the **valuation cap** *does* set a price, and they're awkward if the company fails (neither debt nor equity)

Part 4: Are SAFE Notes Worth It?

- **Cynical View:** The real reason YC and other startup incubators pushed SAFE Notes is because **they know most startups will fail before their Series A rounds**

- **Logic:** Get everyone cheap/quick funding, let the survivors rise to the top, and deal with ownership problems later

- **"Successful Companies":** Will have bigger issues than SAFE Notes in future rounds, so it's not a big problem

Recap and Summary

- **Part 1:** SAFE Notes in a Seed Round

- **Part 2:** Conversions in the Series A (Caps and Discounts)

- **Part 3:** How an Options Pool Makes It Even Worse

- **Part 4:** Are SAFE Notes Worth It?