Financing for founders

A primer on SAFEs and their use in early-stage financing

INTERVIEWED BY JAYNE GEST

CHRISTIAN A. FARMAKIS
Shareholder and chairman of the board
Babst Calland

(412) 394-5642
cfarmakis@babstcalland.com

In 2013, San Francisco seed accelerator Y Combinator created a Simple Agreement for Future Equity (SAFE), which can be used in lieu of a convertible note. SAFEs spread throughout the California investment community. Now they're entering regions like Pittsburgh. Investors, however, haven't always embraced SAFEs as a reasonable vehicle for seed investment. They may be hesitant or uncomfortable with them.

Christian A. Farmakis, shareholder and chairman of the board at Babst Calland, first encountered SAFEs a few years ago when making a personal investment.

"I didn't know much about it at the time. I initially thought, 'How is this different than a convertible note?'" he says. "I read it and thought: 'If the investment goes well, I'm largely in the same position. If the investment doesn't go well, I will never be repaid, but I never expected to be.' So, I signed it."

Smart Business spoke with Farmakis about what entrepreneurs and investors need to understand about SAFEs.

What are the similarities and differences between SAFEs and convertible notes?

A SAFE is essentially a warrant (a contractual right to purchase equity upon the occurrence of a future triggering event, like a later priced investment round), but with the purchase price paid upfront.

SAFEs are like convertible notes in many ways. They can (a) include a discount on the per share price — a 20 percent discount would provide the investor 125 shares rather than 100; (b) include a valuation cap, capping the investor dilution when the triggering event occurs; and (c) give pricing protection for early investors. Because both are early-stage investment vehicles, the price per equity unit is not determined because the company has no company valuation.

A convertible note is a debt instrument. A SAFE is a contract. As such, a convertible note typically earns interest while it remains outstanding; a SAFE doesn't. Convertible notes usually result in more shares being issued upon conversion — the aggregate value is higher than the original amount due to accrued interest. From this perspective, SAFEs are advantageous to founders.

Notes frequently trigger on a priced round but are intended to be repaid with interest when they mature, say, five years later, if a priced round doesn't happen. SAFEs do not have this feature. They have no maturity date. At first blush, this convertible note characteristic favors investors. However, consider if this is materially favorable — in most instances, a failed startup usually doesn't have the funds to repay note holders after its creditors are paid.

How can founders and investors benefit?

Because the baseline forms are available from Y Combinator's website, SAFEs are fairly standardized, and the expenses associated with getting early-stage investors to sign a SAFE are lower. The startup doesn't carry SAFEs as debt on its financial statements. Also, if structured properly, founders aren't diluted as quickly as they might be with conventional debt.

If things go well, SAFEs give investors benefits like the percentage discount, valuation cap and most favored nation on the pricing. If they go badly, SAFEs benefit the founders, but the additional rights an early-stage investor loses aren't significant. Again, sophisticated investors who put money in early-stage companies generally don't expect to get paid back if they fail.

What should entrepreneurs be aware of?

Entrepreneurs should carefully consider the pro-rata investment rights usually contained in SAFEs to avoid unintended dilution. They should work with counsel to create a pro-forma cap table before issuing SAFEs to understand the impact upfront.

How have SAFEs changed?

Y Combinator has developed a new form of SAFE for early fundraising that involves larger amounts of money. It measures SAFE ownership after the round of SAFE money is accounted for but before the new money in a priced round (usually Series A) converts and dilutes the SAFE. This form separates the pro-rata investment rights and tailors them to apply to the next round of financing.

What's your advice for Pittsburgh investors?

There are similarities and differences between convertible notes and SAFEs. Ask questions to see which one makes sense for you as an investment vehicle. ●