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STAY SAFE:

WHAT EVERY STARTUP NEEDS TO KNOW ABOUT SAFEs

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INTRODUCTION

For many start-ups, raising capital is a huge area of concern. Several means exist which are used to raise money, ranging from Crowdfunding, Business Loans to Venture Capital funding. Keeping the above in consideration, there is a presence of certain financial instruments which facilitate raising capital for business enterprises. A prominent and modern example is the SAFE.

SAFE stands for (Simple Agreement for Future Equity). Introduced by YCombinator, an American start-up accelerator in 2013. It has since been used by a lot of start-ups as an instrument for early-stage capital raising.

What is a SAFE?

A SAFE is an investment agreement between a Start-up and an investor that creates potential future equity in the company in exchange for immediate cash. However, the investment only converts to equity on certain triggering events such as a future equity financing. (In most times led by an institutional venture capital fund)

Also known as SAFE Notes, a SAFE is a convertible security that allows the investor to buy shares in a future priced round. i.e., Series A Investment round.

SAFEs, in many cases, are used as an alternative to other convertible securities like the famed Convertible Note. (A convertible security is an investment that can be converted from one form to another i.e., funds to stocks, bonds to stocks)

Key Terminologies in a SAFE?

Valuation

A valuation is the process of determining how much a Company is worth. By setting the share price of a Company, the value of the Company can be deduced. In many cases, valuation is done by an Institutional Venture Capital fund.

Valuation Cap

A valuation cap is a mechanism that sets the maximum price when the investment will convert into equity. In other words, it sets a maximum amount that the investor will pay for preferred shares in a future equity round. It is an avenue used to reward early investors as it ensures the investor does not miss out in a situation where the company's projected value subsequently increases beyond the previously negotiated estimate.

A hypothetical example; The valuation cap in the SAFE between XYZ Company and Mr. May is $5 million.
If OPQ Capital value XYZ Company at $10 million during Series A and pay $1 per share; The SAFE note will convert into equity as if the price had been $5 million. That way, the division of $5 million by $10 million will result in the operative price per share for Mr. May. Which is $0.50.
(Share Price = Valuation Cap/Priced round valuation)

Discount

A priced round is an equity-based investment process where there is an offering and sale of newly created stock in a company at an agreed upon share per price. Priced Rounds are important in SAFEs because in most cases, conversion takes place after the next Priced round.

Priced Round:

A discount is a percentage off per share price of the stock sold in the next round. Discounts are benefits given to investors in a SAFE arrangement. A good example is a 20% discount agreed upon in a SAFE. In a case of an eventual Series A valuation of $10m, the discount will be activated and the investor will buy shares at a $8m valuation. That way, if the share price is $1 per share, an investor with a discount will pay 0.80 per share.

Most Favoured Nation Clause:

Popularly referred to as MFN Clause, it is a clause included in the SAFE that provides protection to investors by giving them rights and benefits received by later (subsequent) investors, if those benefits are more favourable than those originally agreed.

How do SAFEs work?

A brief outline

1

There is an agreement between the Startup and the Investor.

2

The terms of the agreement are negotiated with emphasis placed upon the Investment amount, discounts, trigger event and valuation cap. Also, other important considerations like the Most Favoured Nations Clause, Pro-rata rights, post money or pre money valuation status are considered amongst others.

3

Upon agreement and execution of the document, the funds are sent to the Start-up. With the funds applied according to the relevant terms in the agreement.

4

The investor does not obtain the equity (Preferred stock) until the event listed in the SAFE agreement triggers the

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When the trigger event occurs and the terms come in place. preferred stock of the Startup will be obtained by the Investor.

Benefits of a SAFE

Debt

Unlike Convertible Notes, SAFEs agreements are not debt instruments. They do not accrue interest or have maturity dates. This can prove beneficial to many startup founders, as the thought of paying capital plus interest within a certain time frame is not favourable and the inability to pay can lead to bankruptcy.

SAFEs are less complex:

The concise and straightforward nature of this agreement. Alongside the fact there are no end dates or interest payment to keep in mind, makes it an attractive financial instrument to Startup founders.

Paper work:

For many of the capital raising instruments there is a lot of paperwork involved. But with SAFEs there is less paperwork involved.

Legal Fees

Legal representation and advice is required to navigate the rules relevant to the industry of certain companies. Alongside negotiation and drafting of agreements. SAFE Agreements do not require as much legal fees in comparison to other financing arrangements.

Opportunity for more investment:

due to the fact SAFEs allow Startups to defer valuation. This creates an opportunity to exploit other capital raising instruments before the eventual valuation of the startup and issuance of preferred stock to investors.

Conclusion

In conclusion, SAFEs are preferred to other financing instruments due to their flexibility, ease and because of the time it affords Start-up founders to rack up investment. However, this financing option can be unfavorable to certain stakeholders if the terms are not negotiated properly and from a pragmatic standpoint.

It is advisable for Start-up founders to employ the services of a legal practitioner versed in Corporate Finance for advice, review, negotiation and documentation of SAFE agreements.

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