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Overview of convertible notes and SAFEs

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One logistical challenge that all companies face – whether they are pondering keeping the lights on or expanding into an exciting new area of development – is how to raise cash.

Ways to put money into the coffers come in many shapes and sizes, but each generally falls into one or a combination of the following four categories: (i) the sale of goods or services; (ii) non-dilutive government or nonprofit grants; (iii) the sale of equity; or (iv) taking on debt. Convertible notes and SAFEs (an acronym for "simple agreements for future equity") are hybrids of the last two categories.

What are convertible notes and SAFEs?

Simply, convertible notes and SAFEs are agreements between a company and an investor to exchange shares tomorrow for cash today. Each functions as follows: the investor agrees to give the company a particular amount of money now and in exchange receives the right, at a point in time or upon a specified event in the future, to convert that money into shares of the company, usually at a significantly better rate than what the investor would have gotten had they simply waited to purchase shares from the company directly through a standard equity sale.

What are the differences between convertible notes and SAFEs?

Like the exercise of raising cash, convertible notes and SAFEs can come in many forms. The primary differences between convertible notes and SAFEs are interest and maturity.

A convertible note functions much like a traditional loan. The initial amount of cash given by the investor to the company acts as the principal and that amount accumulates interest at an agreed upon rate over time. Once the proscribed amount of time has passed ("maturity") or the particular event has taken place, the principal and interest accrued on the convertible note become due and the investor can either get the principal and interest back in cash or convert the corresponding value of the principal and interest into the company's shares.

A SAFE is basically a convertible note that, in an attempt to simplify, has eliminated the interest and maturity components. With a SAFE, the sole value to the investor is the company's shares which the investor receives when the invested cash converts upon a particular event.

Why use convertible notes or SAFEs rather than traditional debt or traditional equity financings?

The rationale for using convertible notes or SAFEs to accumulate cash rather than taking on traditional debt or undertaking a traditional equity financing is simple.

Traditional debt has the drawback of being satisfied only by the company giving the lender cash when the debt becomes due. This is problematic for early-stage companies that don't have consistent cash flow. Traditional debt becoming due for such companies often creates circumstances whereby the company is forced to raise more money via convertible notes, SAFEs, a traditional equity financing, or taking on yet more debt simply to pay off prior lenders, which diverts time and energy from the company's main business and can itself accrue an additional hefty expense. Convertible notes and SAFEs avoid this problem by allowing for the debt to be repaid via the conversion of the invested sum into shares, preserving precious cash on hand.

A traditional equity financing has the drawback of requiring a company to set a valuation. How much is each share in the company worth? This is also particularly problematic for early-stage pre-revenue companies that have little basis upon which to ascribe a positive valuation. Convertible notes and SAFEs avoid this problem by facilitating the exchange of cash for shares in the future, effectively kicking the valuation discussion down the line to the time of a traditional equity financing, when the company is likely to have a stronger basis upon which to establish a positive valuation. Convertible notes and SAFEs also have the benefit over a traditional equity financing of not surrendering any company control to the investor at the time that the money is given, effectively buying the company a few more years to develop without having the investor in the boardroom.

As with any important business decision, whether you are in the position of the company or the investor, legal counsel should always be consulted to verify that the terms of any convertible note or SAFE are fully understood by and agreeable to all parties involved.
