Key terms of convertible notes and SAFEs

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Other than the accumulation of interest over time and the date of maturity (typically convertible notes only) convertible notes and SAFEs are effectively the same form of instrument. In this article, I explain the terms most common in each of these fundraising tools.

What are the key terms of convertible notes and SAFEs?

Circumstances of conversion:

Both convertible notes and SAFEs typically become due for repayment (convertible notes only) or convert into shares of the company at a specific time or the occurrence of a particular event.

The specific time when the money given by the investor (plus interest for convertible notes) must either be paid back (convertible notes only) or converted into company shares is referred to as the "maturity date." The maturity date is heavily negotiated, similar to the term of a standard loan, but often is pegged at a date two to three years after the date when the money is invested. SAFEs usually don't have a maturity date.

The typical event that triggers repayment or conversion into company shares is the company's undertaking of a traditional equity financing. Commonly, at the time of the next traditional equity financing following the sale of the convertible note or SAFE, the convertible note or SAFE will become due for repayment or convert into shares of the company automatically. This mechanism is heavily negotiated and can include additional particulars, such as conversion only at the discretion of the investor or upon a traditional equity financing that rewards the investor with a satisfactorily significant benefit for taking on the early-stage risk of failure.

Discount rate

The discount rate is the amount by which the share price in the traditional equity financing is discounted for the convertible notes or SAFEs. The discount rate is sometimes referred to as the "bonus rate" since it can be viewed as a bonus to the investor in the convertible note or SAFE for taking a risk on the company earlier than other investors in a traditional equity financing.

An example of the discount rate is as follows: suppose that the convertible note or SAFE investor gives the company $1 million and the convertible note or SAFE specifies that it is subject to a 50 percent discount rate. This would mean that at the time of a traditional equity financing the convertible note or SAFE would convert into shares of the company at a 50 percent "discount" from the price being paid by other investors in the traditional equity financing. If the shares in the traditional equity financing are being sold to others at $1 per share, the convertible note or SAFE investor's $1 million would convert at a price

of $0.50 per share (a 50 percent discount). At that rate, while the investors in the traditional equity financing would get 1 million shares with a $1 million investment, the holder of a convertible note or SAFE would get 2 million shares for their earlier $1 million contribution.

Like circumstances of conversion, the discount rate is typically heavily negotiated, with the discount rate being greater (*eg,* 50 percent) if the company is desperate to get cash in exchange for a convertible note or SAFE quickly, or if it has a short or shaky operating history. The discount rate is typically lower (*eg,* 10 percent) if the company rests on more solid ground. Although discount rates can vary widely, a 20 percent discount tends to be the typical discount rate in the market.

Valuation cap

The valuation cap is a mechanism used to cap the risk early-stage investors will take in case they give cash at the riskiest time for a startup and then the company finds gold in the backyard. Often the valuation cap works in tandem with the discount rate so that if each results in a different share price the investor gets the best deal of the two.

The valuation cap is a cap on the ultimate valuation of the company as it pertains to the convertible notes or SAFEs. The lower the valuation cap, the greater the discount in the convertible note or SAFE. The higher the valuation cap, the lesser the discount.

To fully understand the impact of the valuation cap, hypothetical scenarios must be considered.

Take again, for example, the $1 million given to the company by the investor via a convertible note or SAFE described above. Let's say that the convertible note or SAFE includes a valuation cap of $2 million. Then let's say that at the time of the traditional equity financing the company receives a valuation of $4 million and is to sell shares in the traditional equity financing at the same price used above, $1 per share.

The discount for the convertible note or SAFE is calculated by dividing the valuation cap by the traditional equity financing valuation and then subtracting that value from 1 (representing no discount). In this example such would be portrayed mathematically as $2 million / $4 million = 0.5 and 1 – 0.5 = 0.5. The price per share for the conversion of the convertible note or SAFE is then calculated by multiplying the discount by the traditional equity financing share price, here 0.5 x $1 = $0.50 per share.

Discount rate and valuation cap working together

Finally, to illustrate how the discount rate and the valuation cap can be used together, consider a scenario where all of the above details are the same except that both the discount rate above of 50 percent and a valuation cap of $8 million are built into the convertible note or SAFE. Calculating the discount from the valuation cap in this scenario would work as follows: $2 million / $ 8 million = 0.25 and 1 – 0.25 = 0.75. The price per share for the convertible note or SAFE would then be calculated as 0.75 x $1 = $0.75.

Note that in this scenario price per share for the convertible note or SAFE using the valuation cap would end up being greater than that which would result by applying the discount rate (remember that the discount rate would be the traditional equity financing price per share discounted by 50 percent, here, $0.50 per share). In most convertible notes and SAFEs, the

investor would in this circumstance be allowed to take advantage of the better of the two deals, or $0.50 per share rather than $0.75 per share.

As you adjust the inputs, you will gain a further understanding of the importance of how discount rates and valuation caps in convertible notes and SAFEs work together. With this understanding, you can see why these two key terms are often highly negotiated: they are the foundation of a key source of funding for early-stage companies.
