Understanding common types of seed investments: 4 useful charts

For an early-stage startup, the prospect of securing financing through seed investment for up-front capital expenses can be daunting. This is a simple guide that outlines the advantages and disadvantages of common types of seed investments.

The two most common categories of seed investments available to startups can largely be categorized as convertible debt financing or convertible equity financing. Understanding the differences between the options is essential for a founder to choose the form of financing that is right for her or his startup.

Convertible debt financing

In a traditional seed financing of convertible debt, a startup borrows money from an investor. The borrowed debt automatically converts to equity at a later time. Typically, the conversion date is the closing of a Series A preferred stock financing. At this time, instead of receiving its invested money back, with interest, the investor receives shares of preferred stock.

Convertible note

While there are certain advantages to issuing convertible notes to raise capital, too often startups incur too much debt in doing so. This practice can often prove to be detrimental to their financial viability. This chart summarizes some of the main advantages and disadvantages of the convertible note financing option.

Advantages	**Disadvantages**
Delays valuation and leaves it flexible to meet the needs of subsequent investors	Requires repayment of the loan, with interest, if the startup does not raise a Series A round before the maturity date (usually within 12-18 months)
Interest payments do not typically need to be paid in cash each month	Complicates calculations of interest payments and schedules, because there are numerous investors with notes of different start times
Provides a quicker and cheaper financing option than issuing equity, because it can close in weeks instead of months	The noteholders may force the company into bankruptcy if the startup cannot repay the loan and is in default under the note (unless the startup renegotiates with investors to extend the loan)
Allows for note proceeds to be used to increase the value of the startup, because ownership dilution is deferred	The interest that accrues until an equity conversion means slightly more dilution for all shareholders
	Undermines the startup's business standing for

Ease and speed in drafting agreements	considerations of lines of credit and big partnerships because of large amounts of debt on its books
LLC's can use it.	

One question that is increasingly relevant: what happens if a startup subsequently raises digital tokens rather than equity? Will the note convert?

Convertible equity financing

In a convertible equity financing, a startup issues a convertible security in return for investment. Similar to convertible debt financing, convertible equity investment converts to equity at a later time – *i.e.,* atthe closing of a preferred round of equity financing. Since it is equity and not debt, it does not have convertible debt financing's characteristics of repayment at maturity and interest. Thus, there is a possibility that the equity never converts to preferred stock, and there is nothing in the terms that requires the investment to be repaid to the investor.

This chart summarizes some of the main advantages and disadvantages of the convertible equity financing option.

Advantages	**Disadvantages**
Potentially provides a lower capital gains tax benefit for investors, since, as equity, it is likely classified as qualified small business stock	Is complex to structure (high legal bills and long time to close)
Does not have to be repaid	Usually involves giving some level of board control to investors
Does not accumulate interest	
Gives certainty of valuation to a startup	If valuation is too low, there is a risk for diluting founders' stake. If it is too high, it can impact interest from next round investors who do not like to price down rounds from the round before, to avoid legal risks from diluted shareholders
Delays valuation discussion	

Two types of convertible equity financing instruments are commonly used for seed investments: Y Combinator's Simple Agreement for Future Equity (SAFE) and 500 Startups' Keep It Simple Security (KISS). Below are charts summarizing the advantages and disadvantages of these two specific convertible equity options.

SAFE

Advantages	Disadvantages
Does not have a maturity date (which provides flexibility) nor does it accrue interest (which saves a little equity dilution in the future when it converts). There is also no need to spend resources extending such things as maturity dates or interest rates	Creates more dilution for issuers than intended, by delaying valuation, often several times, thus negatively impacting future valuation and the startup's financial viability
The documents are very short - 5 pages, with little to negotiate aside from the valuation cap	Can create undue negotiating tension between CEOs/founders and new investors at conversion, when the founders and other common stockholders see the actual dilution
Removes the deadline, so a startup can take cash on an as-needed basis from each investor without creating a new looming deadline	May force a down round as the only option for a Series B lead investor due to dilution
Converts at the next capital raise with a fixed valuation, regardless of the round's size, thus reducing the possibility that the investor's investment will have an overinflated increase in value between the issuance and conversion due to the discount or valuation cap	May not be advisable for use with LLC's; SAFEs are generally treated as non-compensatory partnership options (NCPO's) in LLC's and tax treatment of NCPO's can be uncertain. The holder is subject to pass-through tax treatment in LLC upon the conversion of the SAFE.
Takes away the "liquidation preference" premium that note holders receive when they convert into a new priced equity round under a valuation cap, by creating a new class of shares, "Safe Preferred Stock," with the same rights and preferences as the investors receive in the new round, but the liquidation preference, conversion price and dividend rate are adjusted to reflect the actual money invested	

KISS

Advantages	Disadvantages

If there is no equity round before conversion, it is converted at the valuation cap.	Has debt-like features such as maturity dates (default is 18 months) and interest rates
Offers appealing protections to investors, such as rights to information and ability to participate in future financings	*See also above two (2) charts*

Created in 2013, SAFEs are now seeing more frequent use as early stage companies seek to obtain financing quickly through the use of recognized documents. However, before entrepreneurs accept outside financing using this form of convertible equity, they should take care to understand all the implications of taking the "SAFE" approach.