Pre-money vs Post-money SAFEs, the Key Differences You Need to Know

Abdullah Mutawi - Partner, Head of Corporate Commercial - Corporate / Mergers & Acquisitions / Commercial / Private Equity / Digital & Data / Turnaround, Restructuring & Insolvency / Venture Capital & Emerging Companies

a.mutawi@tamimi.com - Dubai Maze Tower

Kareem Zureikat - Senior Associate - Corporate / Mergers & Acquisitions / Commercial / Venture Capital & Emerging Companies

k.zureikat@tamimi.com - Dubai Maze Tower

“When it comes to convertible instruments, there is no doubt that regional investors have a high degree of faith in the SAFE instrument. This is more so since the post-money SAFE was introduced and adopted as the standard form in the US.”

–*Hugo Cugnet*

While a handful of start-ups are lucky enough to find themselves generating significant revenue at an early stage, the vast majority will be burning capital to scale-up and generate traction in the market faster than their revenues can keep up. With banks unwilling to extend conventional debt financing to start-ups, founders typically have two options: when raising funds; undertaking a priced equity round; or obtaining financing through convertible notes.

Securing funding from a priced equity round is a time-consuming, expensive and difficult process, with a significant amount of time and cost being allocated to investor due diligence, legal fees and transaction negotiation. There is also the somewhat daunting task of agreeing to a valuation for an early stage company, which can be a more speculative process when compared to a standard discounted cash flow or multiples approach used for mature companies. The process can therefore be cumbersome to the investor and the founder alike, and should not be treated as the only available option for financing.

Venture capitalists and founders have demanded a simpler and faster way of deploying capital to early-stage start-ups, which resulted in the creation of the convertible note. With time, however, the convertible note grew in complexity, and without a standard form adopted in the market, several variations of the convertible promissory note were in circulation, which led to longer negotiations and caused ambiguities as to how the convertible note operates and what each investor would actually receive upon conversion of the convertible note into shares.

Y Combinator’s pre-money SAFE (Simple Agreement for Future Equity) was born in 2013, offering an even simpler and cheaper alternative to funding other than by way of a priced equity round, and in 2018, Y Combinator released its post-money SAFE.

The SAFE is not a debt instrument – it has no repayment date – and is not strictly an equity instrument. It is, in its simplest form, an agreement that the funds extended by the investor to the start-up will be either repaid or converted into shares based on certain defined conditions set out in the SAFE. The main trigger for conversion of the SAFE into equity is the successful closing by the start-up of a priced equity financing round.

One of the most important problems the SAFE has solved is the need to agree to a valuation prior to the investment, and instead the investors and the start-up would typically agree to a “valuation cap”, ignoring

for the purposes of this article the ability to agree to a discount, a valuation cap and a discount, or an MFN (Most Favoured Nations) clause.

A valuation cap represents the maximum valuation at which the investment will convert into shares. Therefore, if the valuation of the start-up on the upcoming priced equity round is less than the valuation cap, the investment will convert at that lower valuation, whereas if the valuation of start-up on the upcoming priced equity round is more than the valuation cap, the investment will convert at the valuation cap.

The pre-money SAFE assumes that the valuation cap is the value of the business prior to the investment made by all SAFE holders. The issue with this is that the start-up could continue to raise funds through pre-money SAFEs, including through high resolution fundraising (i.e. issuing SAFEs at different terms and valuations for different investors). This creates uncertainty for the investor and the start-up the investor's ownership percentage and the dilutive effect subsequent pre-money SAFEs will have on an investor's ownership. By way of example, assume a start-up enters into a pre-money SAFE with an investor for a total investment of USD 100,000 at a valuation cap of USD 900,000.

Subsequently, and given that a SAFE does not limit a start-up's ability to raise additional funds through other SAFEs, the start-up continues to raise funds for a period of 6 months raising a total amount of USD 200,000 from a number of other investors at a pre-money valuation of USD 900,000. These subsequent investments will dilute the ownership of our USD 100,000 investor. This situation gets even more uncertain for both the founder and the investor if the start-up raises additional funds at different valuations.

Now, compare this approach with the post-money SAFE, which describes the valuation cap as post-money value not only for our investor's USD 100,000, but for the total amount of money the start-up anticipates it will need to raise in the next 6 months using SAFEs. In this case, the investor and the start-up would agree that the business will likely need an additional USD 300,000 in the future, and can agree to a valuation cap of USD 1,200,000, which is the pre-money value of USD 900,000 plus the anticipated total investment of USD 300,000 over 6 months. This way, it will be much simpler for our investor and the founder to calculate the investor's ownership interest.

Therefore, the post-money SAFE treats investments using the post-money SAFE as its own "funding round", and each investor in this funding round will know its ownership percentages with certainty.

Pre-money SAFE notes can still be used for small investment tickets and where neither the founder nor the investor are certain that the business will be able to raise funds through a priced-equity round in the future, and therefore the pre-money SAFE gives the business the flexibility of not committing to a post-money value. Alternatively, if the investment ticket is larger or if the founder and investor are confident that the business will pursue a priced equity round next, the post-money SAFE may be the more suitable alternative offering certainty for the business, the founder and all SAFE investors.

While the SAFE note is a standard form document that helps founders and investors close investments quickly with minimal negotiations, it is important that neither founders nor investors take this for granted and that both parties seek legal advice to understand the legal and economic effects of the SAFE, including in the more somewhat complex scenarios where different SAFEs and different valuations are issued and what this means in the future when the SAFE is converted into equity or repaid.