Convertible loans or SAFE Notes: Is it the same? What is the best choice for me?

Simple Agreements for Future Equity (SAFEs) and Convertible Loans are very interesting instruments to raise capital in early-stage start-ups. Even though they are similar financing instruments, it is important for entrepreneurs to understand the difference. Doing the right choice can be a key component of the success and growth of the start-up.

Convertible Loans:

Convertible loans are a very popular way of investing for angel investors and accelerators. A convertible bond is a debt, a loan which converts into equity in the next financing round. What makes different convertible loans from traditional equity financing is that the process is much simpler. With convertible debt, legal fees are considerably lower than for a loan agreement and it avoids the discussion on valuation, making the process much faster.
The idea behind convertible loans is that when the company will decide to raise a future round, the loan will have the ability to convert into the stock that the company sells. The investor gets an interest rate that generally ranges from 5% to 12% and the loan will convert at a discount in the next round.

Main terms when negotiating a convertible bond:

The Discount:
The discount on the share price at which the loan converts into equity is a key component of Convertible Debt. There are recent cases of convertible bond deals that were not issued at a discount, but those are rather exceptional cases caused by the market conditions at the seed stage and early stage. Investors do not work like banks, their idea is to own equity in the company in the early future. Discounts generally range between 10% and 20%. The convertible loan agreement can define that the discount can increase over time depending on the time that the next round takes to close.

Valuation caps:
The valuation cap is the maximum valuation at which the conversion can take place. By adding a valuation cap to the contract you are ensuring that the loan will convert at maximum to the valuation cap.
The valuation cap protects the initial investor and is a very important incentive to take early-stage investors on board.
The idea behind the valuation cap is that if a company does really well and gets the equity round at a very high price, the investor will be able to get the shares at a lower valuation, at the amount settled in the valuation cap. Having a discount is attractive for the investor but the price of the shares might be higher than what they would have paid if they had bought equity in the first place. It would not be fair for the investor who took all the risk when the company was less valued to get only a discount on a high amount.

For example, let's say the entrepreneur and investor agree on a 10 million valuation cap and at the time of conversion the company has performed well and is valued at 16 million. Even if the investor has a discount of 20%, he will not get a discount at 16 million but at the valuation cap, in this case, 10 million. A valuation floor can also be argued, which is a minimum valuation at which conversion can take place, which is the exact opposite of a valuation cap.

Interest rates:
Convertible debt is a loan and therefore works with interest rates that accrue until the conversion date. Interest rates in convertibles are often low compared to traditional bank loans. The interest rate and discount are linked, a higher interest rate implies a lower discount and vice versa. Interest rates are often negotiated between 5% and 12% associated with a discount between 10% and 30%.

Maturity date:
The maturity date is the deadline by which the loan needs to be converted if no financing round took place. This conversion will happen at the share price at the last equity financing before the convertible loan. What often happens is that the convertible debt holder will ask to postpone it while approaching the maturity date.

The main drawback we encounter in convertible notes is debt. Raising capital through convertible debt means that until conversion, the balance sheet of the start-up will have debt. Depending on the legislation of the country where the start-up is incorporated it can become a personal liability problem for the founders who might have to reimburse the loan. It is therefore a very important thing to keep in mind for founders when raising convertible debt.

To sum up, convertible notes are a very interesting debt instrument for raising capital in early-stage start-ups.

Simple Agreement For Future Equity

SAFE agreements were created in 2013 by Y Combinator, an American accelerator. In the United States, they are becoming a very popular instrument, although in the European continent they are still very uncommon and most founders don't know about their existence.

The idea behind SAFEs is that there is a direct exchange of cash today in exchange for future equity. Basically SAFE notes are not debt, they are convertible equity, and the investor buys an unpriced warrant in the start-up.

In a SAFE agreement, investors and entrepreneurs can agree on a valuation cap. However, differing from convertible loans, SAFEs are not a loan and therefore there are no interest rates in some countries like the United States, they don't have a maturity date. However, in most cases in Europe, we have been seeing maturities set for 2 to 4 years.

SAFEs can be interesting for entrepreneurs due to their simplicity compared to convertible loans. The lack of legal costs, paperwork and standardisation that a loan requires makes it a very interesting option for start-ups seeking funding in a bridge financing. It is possible to download SAFE notes, for US-based companies, from the YCombinator website in a 5-page straightforward and very simple format. Another advantage of SAFEs in comparison to convertibles is interest rates. As mentioned before, convertibles often work with interest rates that range from 5% to 12% which is an additional expense.

On the other hand, from an investor's perspective, SAFEs are riskier investments than convertibles. Not having a maturity date (this only applies to SAFEs in the US, as mentioned previously, in Europe SAFE notes do have maturities) can be an advantage for the entrepreneur, eliminating the requirement to communicate with the investors. However, when companies are struggling, the lack of communication and information can be definitely a drawback for investors. Another important point to mention for investors is if the company does not perform well and does not grow enough, what can happen is that its stock will not convert into equity.

The problem we find in the European continent is that there is no common legal framework for startups. European startups need to work within the context of the specific law of the country in which they are based, often need to use notaries and procedures can be quite bureaucratic. This certainly remains a handicap compared to the US market where it is quite standard to incorporate startups in Delaware and where investors and attorneys are very familiar with Delaware law. Nevertheless, different countries now have legal instruments that took inspiration from the US SAFE notes. For example, BSA AIR in France, SeedFast in the UK etc.

To sum up, SAFE notes are a very interesting instrument for founders to raise capital, they have very simple legal complexities, and unlike convertible bonds, they are not debt and therefore don't have interest rates.

	SAFE	Convertible Debt
Contractual Obligation	Warrant	Debt
Interest Rate	N/A	Set at issuance, usually 5%
Maturity Date	N/A	Set at issuance, at maturity date: a) Pay principal + interest b) Convert debt to equity
Valuation Cap and Discount Rate	Yes	Yes
Conversion Event	Future financing round	Future financing round, qualifying transaction, or agreed upon conversion
Bottom Line	The simple and straightforward (<5 pages) nature combined with the lack of a future repayment deadline (maturity date) typically promotes better terms for entrepreneurs.	Greater control of a conversion event, but the complex nature (legal fees) and principal repayment obligation (bankruptcy risk) can make convertible notes less appealing for entrepreneurs.

Conclusion

To conclude, SAFE notes have become a popular financing instrument for startups in the US due to its simplicity, its lack of debt and it is seen as founder friendly.

In Europe, SAFE notes (under different names) are slowly becoming more popular but are not very common yet. Convertible notes are still the standard instrument; they are slightly more complex but still much faster, easier and cheaper than issuing equity and it does not require going to a notary.

The most important thing when deciding which instrument to use is that the founders must be fully informed and aware of how both convertible instruments work and their future impact on the equity of the start-up