2220 - Entrepreneurial Finance and Venture Capital

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Lecture #11

Convertible notes and SAFE

- Non-priced investment; conversion price depends on future valuation
  - Convertible notes: debt
  - SAFE: equity
- Fast and cheap
  - Minimal due diligence
  - No negotiation on valuation, control terms
- Reduce cost of experimentation: maximize option value
  - Due diligence costs incurred only if venture raises subsequent round
  - Popular choice for seed investments
- On the other hand, lower investor incentives to add value
  - Without cap, all upside goes to founders
  - Cap realigns incentives but amounts to a max valuation, which requires due diligence/negotiation

Seed investor stake upon conversion at Series A

- Define
  - FV = face value of convertible note/SAFE
  - Post-money = post-money valuation of Series A
  - Series A = stake required by series A investor
  - X = series A price

- No discount, no cap
  - FV/Post-money

- With discount
  - $\frac{\text{Seed shares}}{\text{Total shares}} = \frac{\text{FV}/[(\text{1-Discount})X]}{\text{Post-money}/X} = \frac{\text{FV/Post-money}}{\text{1-Discount}} = \frac{\text{Stake w/o discount}}{\text{1-Discount}}$

- With cap (minimum stake)
  - Calculate stake as if seed round had been priced using cap
  - $\frac{\text{FV}}{\text{Cap+FV}}(1 - \text{Series A})$

Factors when choosing early stage investors

- Alignment between founders and investors
  - Angels: own capital, low/informal monitoring $\rightarrow$ small investments $\rightarrow$ comfortable with small exits (10-20M)
  - VCs: large funds + intensive monitoring + concentrated returns $\rightarrow$ target large exits (1B+)

- Signaling risk
  - If VC does not follow-on $\rightarrow$ strong negative signal for other investors
  - Angels lack capacity to follow-on $\rightarrow$ lower signaling risk

- Funding risk
  - If things go well, easier/cheaper to raise funding from previous round VC than to bring in new investors (better information)
  - Angels lack capacity to follow-on $\rightarrow$ higher funding risk